Chapter 6

All Financial Sector Policy Is Local

Introduction

The financial sector challenges described in this book are not new. Africa’s informal economy, lack of scale, volatility, and governance problems have been discussed extensively. Not new either is a long list of solutions that have been tried in one form or another. Many solutions have been discredited in one decade only to become the preferred flavor of financial reform in the next. Yet, the challenge of limited and costly finance in Africa persists. The importation and application of solutions being implemented on other continents today is not taking place in Africa at a rate sufficient to make a substantial and sustainable impact on the availability of affordable finance.

We argue in this chapter that the problem has not been in the choice of the solutions, but, rather, the direction and quality of the application of these solutions to Africa’s local circumstances and the failure to build or scale up homegrown solutions. Or, as one of the leading political economists of our time has put it, “the problem of underdevelopment cannot be solved by economists coming up with better policies for poor countries to adopt. . . . The problem is that they are not adopted” (Robinson 2009, 8). We therefore caution in this chapter that, unless there are changes in the politics of financial reform in Africa, even the recent opportunities of globalization, technology, and regional integration will suffer the same fate as others that once offered promise to resolve Africa’s financial constraints.

Modernist Reform Policies: Africa’s Achilles Heel

For far too long, the modernist policy agenda discussed by Honohan and Beck (2007) has held sway in far too many African financial systems. Governments, regulators, and development partners, encouraged by international financial institu-
tions, have all focused on policies aimed at modernizing the macroeconomic, contractual, and information framework, with the objective of reducing information asymmetries, improving legal certainty, and lengthening the planning horizon of investors. This agenda has included updating the laws governing financial contracts and ensuring their proper and reliable enforcement through judicial reforms to make certain that property rights are clearly defined and enforceable, both in general terms and as they apply to specific modern financial instruments.

The choice of policy instruments has been appropriate. Modernization represents the bedrock of any credible vision for national financial sectors, whether in Africa or elsewhere. The problem has been the application of the modernist agenda according, primarily, to the premise that modernization is equivalent to the best practice of the advanced market economies. Although all stakeholders acknowledge that transplanting best practice that is benchmarked against developed economies is likely to take time, this agenda has been pursued, and the shift in this direction has been accepted as progress. A second problem has centered on the fact that these reforms are necessary, but far from sufficient. They constitute the needed framework in which private providers of financial services can flourish, thus deepening and broadening financial systems. However, they are not sufficient for supplying the required incentives to realize this framework; moreover, they ignore other constraints, including demand-side constraints. As has become clear through our three main messages, financial sector policy has to move beyond the modernist policy agenda, in addition to adjusting it to the African context.

Unless policy makers and the development partners who work with them deliberately redefine progress in financial sector development to suit local African conditions, the modernist agenda will continue to overreach in Africa. We neglect Africa’s real local constraints at our own peril. It is not enough that we continue to tweak overambitious structures imported from advanced economies. The evidence of this overreach is clear in the design of African stock markets, in capital regulatory standards for banks, in collateral requirements and the requirements for opening accounts, and in the exclusive nature of payment systems, which are influenced by what is held to be best practice in advanced economies.

Unfortunately, there are numerous examples of real political economy considerations—all well intentioned—that feed the modernist agenda. These include, but are not limited to the following:

- **The global financial architecture:** The well-intentioned work of international standard-setting bodies and international financial sector assessments such as the joint Financial Sector Assessment Program of the International Monetary Fund and World Bank naturally lend themselves to the modernist view. Instead of international standards being judged as benchmarks for certain types of economies and financial institutions, they soon evolve into minimum requirements for all economies.

- **International efforts in anti-money laundering and combating terrorist financing:** The work of the Financial Action Task Force in combating money laun-
dering and terrorist financing, which includes the listing of noncompliant countries, has reinforced the desire of all countries, especially developing countries, to comply with a minimum set of standards even if it has been explained that these standards ought to be tailored to national circumstances.

• **National regulatory incentive and cost structures:** National regulators, often the central banks, do not have the incentives or the resources to design and develop regulations that suit national requirements. Regulatory and supervisory skills are in short supply and are often remunerated at less than the rates available in private financial institutions. The cost of adapting regulations to national circumstances can be high; plus there is the additional risk that one may have to explain to ministers of finance and parliaments why the standards fall short of international best practice.

• **The globalization of financial institutions, products, and personnel:** The number of global financial institutions, products, and finance experts has increased tremendously. With the full range of destinations demanding their resources and skills, these experts will first gravitate to countries where standard international best practice is already embedded. National regulators who want to continue attracting international finance and talent are obliged to hesitate before considering any tempering of international standards.

As significant as these pressures are, Africa must overcome them if it is to make meaningful progress in increasing the availability of affordable finance for markets and for growth. **All financial sector policy in Africa is local.** The failure to pay attention to the real national context undermines efforts to build the foundations of an effective financial system for the long run. In the rest of this chapter, we discuss some options for stakeholders involved in financial sector development in Africa. We also discuss the politics of financial sector reform and the various challenges that countries with diverse profiles face in Africa.

**The Activist Reform Agenda Revisited: Larger, More Efficient, and Stable Financial Markets**

According to Honohan and Beck (2007), the *activist* perspective on finance is concerned with achieving results in areas where the anonymous private financial sector is not conspicuously successful: finance for agriculture and the rural economy, for microenterprises and small enterprises, and for low-income households, as well as long-term finance in general. Inherent difficulties, risks, and costs impede the effectiveness of private financial markets in each of these areas. The activist agenda sees the need for special interventions to help correct market failures. These well-intentioned interventions include enacting protective legislation and efforts at establishing competent and politically independent prudential regulators to guard against the weak, reckless, or corrupt management of financial intermediaries that could cause the collapse of these intermediaries. The activist agenda also sometimes advocates the establishment of a variety of special public, charitable, or
otherwise privileged intermediaries who—it is hoped—can help push the financial system toward the frontier in these areas.

Because of the disappointing performance of many publicly owned financial institutions (all too often subverted through politicized management or through corruption), the risk of overreaching in this regard is well known and has caused the activist agenda to be viewed with admirable suspicion (that is, noble in its intentions, disastrous in its unintended consequences). This view is not unwarranted, but it is incomplete. African finance needs a new and positive activist reform agenda, one that expands the reach of financial markets and lengthens financial contracts, yet honors the progress that has been made in making financial systems more stable, one that enables markets rather than replacing them. African finance calls for an activist reform program that is true to the realities of Africa’s political economy. While this does not exclude learning from the experience of other regions, such as East Asia (box 6.1), it emphasizes the need to adjust these lessons to the African reality.

The short-term election cycle of African politics is at natural odds with the long-term nature of financial sector development and reform. So is the plethora of policies to encourage savings in East Asia, accompanied by efficient financial intermediation, were a critical part of the success. Beyond these two important and mostly uncontroversial dimensions, however, East Asian governments intervened heavily in markets. The success of these interventions relied on complementing market-based competitiveness with government-induced contests that combined cooperation with competition (World Bank 1993). Rewarding industries and firms that used subsidies successfully, often judged by their ability to export, while withdrawing subsidies from failing enterprises was a critical part of the approach. So, unorthodox instruments were applied, but they were continued only while there was evidence of success, and exports were considered a good indicator and easy to monitor. More importantly, these measures were removed when they did not or no longer worked.

Many of the unorthodox policies successfully implemented in East Asia have not worked in Africa. Financial repression and industrial policies have had little, if no positive impact on financial and economic development in Africa. On the contrary, financial repression has depressed savings and resulted in the misallocation of credit. As discussed above, directed credit and government-owned banking have not only resulted in large losses, but have dis-

Box 6.1 Learning from the East Asian Miracle

The East Asian miracle has often been heralded as proof that unorthodox government interventions can have a positive impact on growth. Specifically, on top of sound macroeconomic policies, many East Asian countries adopted policies that ran counter to the modernist approach, including targeted and subsidized credit, interest rate floors and ceilings, and government-owned banks (World Bank 1993). Most East Asian economies relied on development finance institutions (DFIs) as a catalyst for funding investment projects. What, if any, lessons does the East Asian success story hold for Africa?

There are several important lessons from East Asia for Africa (World Bank 1993). First, macroeconomic stability was key to the success of the East Asian economies. Second, policies to encourage savings in East Asia, accompanied by efficient financial intermediation, were a critical part of the success. Beyond these two important and mostly uncontroversial dimensions, however, East Asian governments intervened heavily in markets. The success of these interventions relied on complementing market-based competitiveness with government-induced contests that combined cooperation with competition (World Bank 1993). Rewarding industries and firms that used subsidies successfully, often judged by their ability to export, while withdrawing subsidies from failing enterprises was a critical part of the approach. So, unorthodox instruments were applied, but they were continued only while there was evidence of success, and exports were considered a good indicator and easy to monitor. More importantly, these measures were removed when they did not or no longer worked.

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Politically convenient financial sector policies and programs that are incompatible with market-based financial sector development. Ill-designed agricultural subsidies, expensive technological platforms, and poorly governed state-owned financial institutions, to name but a few, continue to act to the detriment of sustainable financial sector policies.

Even if policies have been designed to leverage technical insights, there has been weak implementation. While this weak implementation is partly caused by the shortage of qualified personnel in certain key areas, it is largely caused by inade-
quate incentives and sanctions and by the pervasive failure to apply appropriate laws and regulations and adhere to established systems and procedures (Ablo, Vantzos, and Sharif 2004).

Regulators routinely acknowledge complete awareness of the technically appropriate policy decisions that are needed to impact the access to and the cost of finance, but are unable to implement them for a host of political economy reasons, the most common of which include the centralized nature of policy making, political patronage, the lack of freedom of expression, and the dominant political elites. These political realities manifest themselves differently across the continent, but, in all cases, they prevent the implementation of optimal solutions.

Instead, the political realities call for the design and development of second-best solutions that go beyond the preoccupation with, for many countries, unachievable optimal policies and that take these governance realities into account more systematically. A study on governance, political economy, and economic development in Zambia (World Bank 2008c) has identified three complementary approaches that can help identify a way forward for financial sector reform in Africa generally, as follows:

- **First, seek out incremental reform options that are feasible given political economy realities.** To contend with political economy realities, a reform agenda must take the interests of stakeholders into account. For instance, stakeholders are generally not interested in achieving some abstract and notionally efficient systemic optimum. Their interests are in achieving better results in relation to concrete goals that matter for them. From this perspective, the challenge is to identify specific reforms that can meet both the economic imperatives of improving service provision, reducing poverty, and helping move economic development forward and the political imperatives of enjoying the support of influential stakeholders and not generating widespread opposition. Generally, such reforms tend to be incremental. In the financial sector, efforts to establish collateral registries, especially land registries, provide a useful example. This has long been a focus of donor efforts to support reform in the hope that these might unlock credit from the banking sector, with limited success. From a political economy perspective, this failure can be explained in large part by the great number of political and bureaucratic stakeholders that benefit from the existing arrangements for land and by the potentially destabilizing consequences of disrupting a long-standing compromise between customary and statutory arrangements. However, while comprehensive reform may be infeasible, the prospects may be better for an approach that focuses more narrowly on enhancing the transparency of the rules of the game by which individuals gain access to land titles. This would formalize the current system of informal tribute into a set of rules that explicitly support national interests, without challenging directly all the elite interests associated with the current status quo on land.
• Second, draw on the knowledge of economically optimal policies in the design of reform. While a necessary step in uncovering politically feasible approaches to reform involves loosening the grip of optimal models as a guide for the design of reform, the point is not to set these models aside entirely. Their normative logic is a useful point of reference, a North Star to help navigate change. Yet, as with ocean-going navigation, the journey is long, and the best route is not necessarily the most direct one. In the financial sector, for example, it is expedient to draw on existing model legislation or policies in the interest of cost-effectiveness and aligning the country to international best practice. Unfortunately, politically, this approach can sabotage internal domestic buy-in into the spirit of the proposed legislation or policies. Expensive as it may be, first strengthening the analytic capacity behind a national policy within and outside government may be more sustainable. Given the dynamics of national decision making, having technically strong policy-making voices inside and outside government that enjoy the respect of national elites could offer a real opportunity to influence public decisions for the better and could help alleviate the ideologically polarized (and not always well-informed) edge that currently characterizes the discourse between development partners and governments.

• Third, consider the options for strengthening institutions. The tension between efficient, pro-poor policy on the one hand and governance realities on the other is universal; the quality of a country’s governance institutions helps shape the extent to which the result supports or undermines development. Economic development is easier to achieve in countries where political and bureaucratic institutions are strong. So, to support better policy making and implementation, a focus on feasible policies should be complemented by an effort to seek out feasible options for institutional strengthening. In financial sectors where institutions are weak, the key is dependent upon credible mutual commitment among subgroups of the elite to take reciprocal actions. To illustrate, consider the high costs of financial services in many African countries. Part of the problem is consumer acceptance of these high costs of financial services as a given. Yet, currently, the costs are so high that they prohibit greater access to finance. Moreover, despite the high costs of financial services, consumers are unwilling to change banks; not without reason, they view the costs of closing current bank accounts and opening new bank accounts also as too high. A credible commitment to financial literacy and consumer protection is therefore necessary to overcome long-standing public skepticism and the associated resistance to resisting high banking prices. This would require systematic engagement in the reform of the consumer-demand side of the market.

This policy reform agenda requires the deliberate involvement and partnership of key stakeholders on the continent in establishing and executing the reform agenda: politicians, regional bodies, national regulators, international develop-
ment partners, and beneficiaries of any broadening and deepening of financial services, such as civil society and consumer associations. Before discussing the role of the various stakeholders, however, we turn our attention to the politics of financial sector reform.

**The Politics of Financial Sector Reform**

Throughout the book, we discuss the policy reforms necessary to expand finance and lengthen contracts, while safeguarding financial systems. However, it is not obvious that policy makers will make the appropriate reform decisions. The view focusing on the public interest has argued that politicians should act to maximize public welfare, but the evidence accumulated by economists, historians, and political scientists has shown a contrary reality. Politicians primarily maximize private interests, whether the interests of their voters or special interest groups. Short-term election cycles undermine the focus on long-term financial development objectives; objectives that maintain the dominant position of elites undermine the incentives of these elites to undertake reforms that can open up financial systems and, thus, dilute the dominant position of the elites.

Path dependence in political structures and the underlying socioeconomic distribution of resources and power make the adoption of growth-enhancing policies, such as financial sector policies, difficult or impossible if the policies threaten to reduce the relative dominance of the incumbent elites. The financial sector is critical for an open, competitive, and contestable economy because it provides the necessary resources for new entrants. Numerous examples in the history of finance have supported the idea that open and thriving financial markets are unhealthy for closed political and economic systems. An incumbent elite that is not willing to be subjected to checks and balances will not be able to agree not to expropriate holders of financial claims against it and will not allow private financial markets to flourish that might provide financing to competing groups.

The three overarching messages of this book are closely related to the discussion on the politics of financial sector reform. An important effect of financial sector deepening and broadening is the increase in competition and contestability throughout the economy (Rajan and Zingales 2003). New players, new markets, and new products undermine the rents of the incumbents not only in the financial sector, but throughout the economy. Having access to transaction and savings services allows larger segments of the population to participate in the modern market economy. Broader access to credit is conducive to a more competitive real economy by fostering new entrants and contestability. The financial infrastructure propagated by the modernist agenda, such as collateral and credit registries, reduces the rents that incumbents gain from their privileges of wealth, a track record, and connections. Thus, creating competition in the financial system fosters competition throughout the economy and ultimately fosters private sector development, which is so crucial for economic growth and poverty reduction; the
critical role of competition, however, makes competition more difficult to achieve because incumbent elites are not interested in competition if it will potentially undermine their position.

Pushing a financial system beyond banks toward new providers and products creates the same resistance from incumbent financial institutions, most prominently from banks. Banks typically oppose the introduction of positive information in credit registries because the registries harness the competitive effect of information sharing. Attempts to extend credit registries and payment systems beyond banks will also meet with resistance from banks because these registries and systems will undermine the dominant market position of banks within African financial systems. Similarly, banks might undermine the emergence of powerful capital markets because these markets constitute a threat to the privileged position of banks in bank-based financial systems.

An essential role—we link now to our third message—will be played by the constituency of financial sector reform. The traditional beneficiaries of African finance—blue chip businesses, multinational enterprises, and wealthy individuals—will not push for any financial sector reform that expands financial services, because they also obtain their services from outside the country. Small enterprises and previously unbanked segments of the population constitute the main potential beneficiaries of reform. In the long term, it is crucial to identify and seek the support of the constituency for financial sector reform, which consists of the beneficiaries of a broadening of financial services. Financial literacy can be important in this context, and financial journalists can be major actors in this effort (box 6.2).

**The role of technology and globalization**

Political economists such as Acemoglu, Johnson, and Robinson (2004) have stressed the importance of path dependence, whereby dominant elites formulate policies that help entrench their socioeconomic and political power. However, they also point to exogenous influences that can shift the equilibrium of influence. Most prominently and related to the themes of our book, globalization and technology can be game changers not only because of the possibilities they represent for deepening and broadening financial systems, but also because they move the playing field. They help create growth coalitions that benefit from financial deepening and broadening. Globalization and regional integration can lead to new opportunities and, thus, new potential winners who will depend on thriving financial institutions and markets to exploit the opportunities. Regional integration and globalization can also help distance the financial sector from the political sphere at the level of financial institutions and at the level of regulators. They are certainly not a panacea, as has been demonstrated by the initial, failed privatization of Uganda Commercial Bank in favor of a foreign investor that was tainted by connected lending and looting. Nonetheless, they offer policy space for financial sector reform. Similarly, technology can create new opportunities and winners rather swiftly, which may give the process of financial broadening critical momentum.
Over the short term, activist policies have to take into account the trade-offs we discuss above. In the long term, the objective must be the creation of a constituency for financial sector reform through growth coalitions. While the short-term approach would therefore consist in focusing on homegrown reform agendas that are already supported by political and economic actors, the medium- to long-term approach would include institution building supported by broader growth coalitions.

What is the role of regional integration?
Throughout the book, we point to the benefits of regional integration. Regional integration can help reduce the scale diseconomies stemming from the fixed costs in financial service provision and the fact that most African economies are small. The scale economies of regional integration can be reaped at the level of financial institutions, such as multinational banks, and at the level of financial markets through regional and cross-listing arrangements. However, they can also be reaped at the level of financial infrastructure, including payment systems, credit registries, and even the regulatory and supervisory framework (World Bank 2007a; Irving 2005). Delegating certain politically charged tasks to a supranational platform can

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**Box 6.2 Financial Journalism**

Financial sector issues are rarely treated in the popular media across most of Africa despite the fact that they affect most people’s daily lives. At the same time, there is a large knowledge gap on financial sector issues among the population at large. For this reason, the Making Finance Work for Africa Partnership, with support from the Federal Ministry for Economic Cooperation and Development of Germany and in cooperation with DW-Akademie of Deutsche Welle, an international news broadcaster, is now offering training courses on financial reporting for radio and television journalists from across the African continent. The program seeks to support financial literacy and a better understanding of financial sector topics among the African audience. Thus far, 40 television and radio journalists from 24 stations in 11 African countries have been trained in financial reporting for television, radio, and online. During training courses, the journalists have produced over two dozen television and radio reports, as well as online multimedia dossiers on topics ranging from financial capability to microinsurance, the informal financial sector, and access to finance.

The challenge is not so much teaching journalists the technical skills to understand and then report on financial sector issues, but sharing information about everyday problems involving financial sector issues. The ability to describe and communicate real stories is critical so that people can relate financial sector issues such as inflation, high bank fees, or microcredit to their routine experiences. Explaining financial sector issues in simple, easily understandable language helps reach the audience. Journalists can thus play a major role in expanding awareness about relevant financial sector issues beyond specialists and the interested (and often incumbent) elites.

also mitigate the political tensions and conflicts of interests that naturally occur in a sensitive sector such as finance. This becomes most obvious in the area of DFIs, in which subregional entities, such as the East African Development Bank, have fared much better than national DFIs. The benefits of regional integration arise across the three aspects of finance on which we focus in this book. Regional financial integration helps expand financial systems by enabling the spread of new products and delivery channels and by enabling larger segments of the population to transfer money across borders, fostering economic integration. Regional financial integration can help lengthen contracts by providing a larger scale. Regional integration is necessary in regulation and supervision in light of the growing role of regional banks.

What are the practical steps to regional integration? One size does not fit all. Some parts of Africa, most prominently the currency unions of Central Africa and West Africa, already have structures in place that can be used to advance integration. In other parts of Africa, most prominently East Africa and southern Africa, there is political impetus for more regional integration. Building on a World Bank study (2007a), we argue that much can still be achieved without waiting for political integration by focusing on the following:

- **Private sector–led efforts:** In many countries, foreign financial institutions have been purchasing local intermediaries. Some now have subsidiaries in several countries within individual regions, and a few have networks that spread across much of Sub-Saharan Africa. These institutions are establishing themselves as regional leaders in integration by the private sector. By addressing intercountry barriers, policy makers should support the efforts of these entities to reduce costs. To reduce costs, institutions need to establish back offices to manage customer relationships, lending, balance sheets, and other business activities on a regional basis.

- **The technical harmonization of regulations:** Policy-level integration is moving slowly on the continent, and more can be achieved. In southern Africa, regulators have started discussing harmonized regulations and a financial reporting framework for banks and insurance companies. Information-sharing agreements are in place; there is crossborder participation in supervision; and there are instances, at least in principle, of single license regimes for financial service firms among groups of countries. This process can be accelerated by encouraging more frequent formal and informal meetings among regulators. Even in the absence of bilateral political agreements, regulators can develop common policies and approaches to supervision on a wider range of issues. Reaching formal and informal standards on ownership, corporate governance, the treatment of nonperforming loans, and other technical issues will make it easier for private sector institutions to cross borders and integrate markets.

- **The physical standardization of financial infrastructure:** While accepting that a regionally integrated payments system may be more efficient and more stable
than a purely national one, we recognize that, in many regions, such a system remains an aspiration. The legal framework as a regional solution alone would need to include (1) laws and regulations of broad applicability that address issues such as insolvency and the enforcement of contractual relationships; (2) laws and regulations that have specific applicability to payments systems (such as legislation on electronic signatures, the validation of netting, and settlement finality); and (3) the rules, standards, and procedures to which the participants in a payments or securities system agree. While working toward such a framework, regulators can agree on the standardized physical specifications of the physical payment systems infrastructure. (In southern Africa, many have already done so.) This principle can be applied to other financial sector infrastructure, including credit bureaus. At the regional level, the availability of crossborder credit information would enhance the ability of financial institutions to compete as they do at the national level, but in a larger market; this would encourage competition in both price and innovation and would also benefit borrowers and increase access.

- **Upgrade of information and communication technology (ICT):** To harvest the benefits of technology in the financial sector, it is imperative that efforts be undertaken to upgrade and collaborate in the regional development of ICT networks. ICT is the backbone and future of affordable financial services. A World Bank study of mobile banking services (or m-banking) in southern Africa found countries at different levels of ICT development (see Stone et al. 2009). ICT sectors among the middle-income countries such as South Africa and Namibia were comparatively better developed. In other countries, the telecommunications sector is still mainly characterized by the monopoly of state-owned operators or service providers. Only a few countries in the region have an extensive telecommunications backbone that employs a combination of microwave radio relays and fiber-optic cables; other countries are at an advanced stage in deploying such a backbone. Numerous countries in the region are landlocked (for example, Malawi and Zambia) and do not have the possibility of direct connections to submarine fiber. Such countries will have to rely on expensive satellite links for international traffic and may be unable to afford or access high-bandwidth links. Few countries have an extensive, high-speed backbone and access network to reach out to many users, which creates an artificially low demand for bandwidth. Even where an extensive broadband-capable backbone and access network exist, such as in Namibia and South Africa, the price of high-speed connectivity is substantial and well beyond the means of the majority of the population. Thus, most telecommunications providers in the region aim for low volume and high margins rather than high volume and low margins in the provision of services.

It is a positive that many of these steps are already under way and that there is renewed energy in addressing some of the long-standing barriers to financial inte-
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migration within four regional economic communities, namely, the Economic and Monetary Community of Central Africa (CEMAC), the Southern Africa Customs Union, the Southern African Development Community, and the West African Economic and Monetary Union (UEMOA) (Wakeman-Linn and Wagh 2008). Between 2000 and 2008, the share of Sub-Saharan African intraregional exports (non-mining) in the total exports of the region increased from 23.3 to 27.7 percent, continuing the trend toward greater intraregional trade since the beginning of the 1990s (Gurcanlar 2010). At the same time, as we discuss in chapter 2, a growing number of private banks headquartered in Sub-Saharan Africa are expanding their networks across the region. For example, Ecobank (Togo) has 600 branches in 29 countries in the region; Bank of Africa (Mali) has 105 branches in 10 countries; and Kenya Commercial Bank has 194 branches in five countries (though most are in Kenya). South-South investment by Nigerian and South African banks is playing a large and expanding role. There is also a growing trend toward the regionalization of stock exchanges, especially an increase in the cross-listing of major companies on several Africa stock exchanges, particularly in Angola, Mauritius, Namibia, Nigeria, South Africa, Tanzania, and Uganda. The issuance of regional bonds by sovereign-linked entities and by large corporations in CEMAC and UEMOA is increasing.

These developments are largely market driven and are occurring in an environment marked by a complex web of overlapping regional trade arrangements. Many countries in Africa belong to several regional trade arrangements with wide variation in country coverage and scope. These range from existing economic and monetary unions such as CEMAC, UEMOA, and the South African Common Monetary Area within the Southern Africa Customs Union to the rapidly emerging common market of the East African Community and the complex trade arrangements of the Economic Community of Western African States, which includes states that are members of UEMOA and states that are not.

The expansion of intraregional trade and the emergence of crossborder banking institutions and capital market operations in this complex environment is remarkable and is testimony to the power of competition among private nonfinancial and financial corporations in increasing private and financial integration across the region, albeit from a low base. However, the small share of intraregional trade in total trade, the limited number of private banks with significant crossborder branch networks, the weak commitment of member states in the case of some regional economic communities as shown by the continued presence of barriers to intraregional payments even within the two CFA franc currency zones in Central Africa and West Africa, the small number of corporations with cross-listings across stock exchanges in the region, and the limited number of countries benefiting from the emergence of regional bond markets are signs of the gaps in private banking and financial integration resulting from the multiplicity of overlapping regional trade arrangements and the wide variation across the legal, regulatory, supervisory, and institutional frameworks facing nonfinancial and financial companies. While the overlapping nature of regional trade arrangements in Africa is an inescapable po-
Political reality, the progressive harmonization of the legal, regulatory, supervisory, and institutional framework in existing trade arrangements with best international standards would reduce the variation in business conditions faced by nonfinancial and financial institutions operating across borders in the region and allow these institutions to reap the benefits of scale resulting from deeper integration within and across trade groups (World Bank 2011b).

The Stakeholders

What is the role of the stakeholders in the financial reform process?

**Domestic policy makers**

As gatekeepers to Africa’s financial systems, national regulators have a tremendous responsibility for the sustainable development of financial sectors in the region. They hold the balance between effective modernist and activist financial sector development strategies. However, they operate in a broader political setting of domestic policy makers, including ministries of finance.

The findings of this book suggest that national regulators in many countries deserve credit for their role in strengthening financial systems across the continent. Today, most African banking systems are stable, well capitalized, and liquid. Africa has left behind the traumatic experiences with bank fragility of the 1980s and 1990s, and its resilience during the recent financial crisis is testimony to the effectiveness of the lessons it has learned.

Nonetheless, Africa’s challenges are significant. The challenge for regulators is to achieve stability, while pursuing financial deepening and inclusion. This book’s findings suggest that regulators should pursue a holistic approach to financial sector reform that begins with a change in perceptions about financial institutions, products, and services in Africa and, subsequently, a change in policies, legislation, regulations, and supervisory practices. In table 6.1, we recap our three main messages and their implications for domestic policy makers across the three themes of the book: expanding access, lengthening contracts, and safeguarding finance.

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<th>Policy</th>
<th>Expanding access</th>
<th>Lengthening contracts</th>
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<td>Fostering competition</td>
<td>1. Innovation can come from an unexpected quarter</td>
<td>4. The need for new providers and products</td>
<td>7. Mitigate the risks of competition</td>
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<td>Looking beyond institutions</td>
<td>2. Services matter, but not who provides them</td>
<td>5. Look beyond traditional providers</td>
<td>8. Supervise according to risk, not name</td>
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*Source: Author compilation.*
Innovation can come from unexpected quarters: Licensing legislation ought to recognize that financial innovations are no longer the exclusive preserve of banks and financial institutions. Telecommunications companies, grocery stores, bus companies, and other actors that play a significant role in the economic life of Africa have the potential and ought to be encouraged to provide formal and semi-formal financial services without having to convert to a formal bank or financial institution as long as the resources put at risk do not represent public savings. The definitions of financial services in current bank-centric legislation need to be revised to accommodate the transformational impact that technology has had on the ability of nonbank actors to provide financial services. Definitions are important and have significant cost implications for service providers. For example, in a number of African countries, licensing requirements still carry physical inspection requirements that are accompanied by costly compliance costs for potential service providers.

Services matter, not who provides them: Connected to the point above, national regulators should focus on the specific financial services offered or proposed, not the nature of the institution providing or aiming to provide the services. This view encourages the unbundling of financial services across banks and nonbank actors. As long as the risk of consumer abuse is adequately catered for, different actors should be encouraged or at least not discouraged from providing narrowly defined services such as the deposit collection services offered by sole proprietors for informal retailers, the payment services and foreign exchange services of domestic and international bus companies, the mobile financial services of telecommunications companies, the credit and crop insurance services of agricultural input supply traders, and the narrow regional or community-based banking services of cooperative associations.

Financial literacy: Broadbased financial literacy programs for children at a young age should be endorsed by national regulators in Africa. Ideally, such programs should be provided by the private sector and agencies other than regulators. The reality of the resource limitations in Africa suggests that national regulators will need to take the first step in developing these programs. Specific roles for regulators include (1) facilitating regular diagnostic reviews of national financial literacy standards to establish regular benchmarks for financial literacy and consumer behavior and (2) working with industry to develop financial consumer awareness campaigns. Specific activities might include the design of graphic tables with comparative information on the full pricing of financial products, community and village road shows to explain major financial concepts, training on the delivery of financial education by retail officers, financial literacy messages in m-banking systems, campaigns on new pension systems, basic brochures on financial services, the inclusion of financial literacy in school curricula, campaigns on the management of debt and the avoidance of overindebtedness, and campaigns on the economics and the benefits of the insurance market. Only with a much higher level of financial awareness
and improved financial behavior will consumers be able to make informed financial decisions in the context of their specific economic and social circumstances.

The need for new providers and products: Encouraging new products and services is an art, not a science. It involves regulators’ signaling to market participants that the market is open to product innovations without opening the gates to fraudulent products and Ponzi schemes that, after their collapse, leave the public with less confidence in financial services. On the other hand, the government development of specific new institutions and products should (1) be limited to wholesale facilities, (2) enjoy strong private sector buy-in and participation, and (3) be subject to clear sunset clauses and, in the interim, be managed using sound corporate governance structures. State financial institutions, credit guarantee schemes, and mortgage refinancing facilities have a place in the financial system if they meet these three basic criteria.

Look beyond traditional providers: As long as Africa is dominated by banks, finance will remain short term, expensive, and limited in reach. Africa needs to become a laboratory for innovation that provides solutions to the unique problems of the continent in financial sector development, especially with regard to long-term finance. There are many options, including adopting innovative products and solutions in m-banking, enhancing the availability of long-term savings products for recipients of remittances (for example, encouraging investment in housing or insurance products), facilitating the development of housing finance (for instance, providing liquidity facilities such as the one currently being established in Tanzania), significantly deepening the exchange of credit information to encompass supplier credit and thereby enhance the access to formal finance markets, or creating partnerships in such areas as the finance of public-private partnerships (PPPs) and local capital market development. Regulators need to signal to the market their appetite for experimentation and then act upon it.

Business development, including the development of entrepreneurial skills: Firms need to be enabled to identify investment opportunities, assess their own financing needs, and present attractive business proposals to potential financiers. Improving financial capability and the bankability of firms will strengthen the knowledge, understanding, skills, attitudes, and, especially, the behavior requisite to making sound financial decisions and being more attractive as potential borrowers.

Mitigate the risks of competition: Competition is vital to efficiency in the provision of financial services and to expansion in the depth of financial markets. The development and outreach of financial service provision depend on important issues in public policy that regulators must address not only by licensing more banks, but also by more effectively monitoring the behavior of current market participants and making unwarranted anticompetitive behavior public. Allowing more competition also involves risks, however, because national regulators have to adjust constantly to changing market structures, new products, and new providers. The idea is to allow more competition by adopting a more flexible regulatory framework, which allows risk-based supervision, but also more immediate intervention
where necessary. This pressure on supervisors can be increased if the competition of international players is allowed.

Supervise according to risk, not name: In pursuit of the modernist agenda, there are many regulatory structures in Africa that are far more unwieldy than the risk they are established to mitigate. Today, for example, nonbank supervision departments supervise microfinance sectors that are miniscule components of the financial sector, and bank inspectors still inspect the physical premises of rural branches to assess the risk of physical theft although commercial insurance can cover most of these physical risks, many of the risks have migrated to technological risks, or the risks should be the primary responsibility of service providers. The increasing complexity of financial institutions and instruments requires greater emphasis on risk-based supervision methods that allocate only limited supervisory resources to assessing the magnitude of risks. National regulators should be encouraged periodically to review their staffing requirements, update their procedures for assessing industry risks, and determine appropriate legislative, regulatory, and supervisory responses.

Consumer protection: As African markets become more sophisticated, national regulators need to strengthen the consumer protection framework in their countries. For many, this should start with a diagnostic review of consumer protection and financial literacy in each country and be followed by the drafting of appropriate regulations and standards to address weaknesses in the current framework that are collectively agreed by the government, regulators, and the financial sector. At a minimum, the regulations are likely to include (1) prohibiting unfair credit and credit-marketing practices and (2) promoting responsible credit granting and use and, for this purpose, prohibiting reckless credit granting. Operationally, two specific elements of an effective consumer protection regime are (1) the identification of an agency or department to implement education campaigns, conduct research, develop policies, investigate complaints, and ensure compliance with the law and (2) the establishment of an effective mechanism for receiving and resolving consumer complaints. An effective system for handling, analyzing, monitoring, and resolving consumer complaints and disputes will have a strong impact on financial institution behavior. Potential areas of work would include delineating the rules for financial service providers in handling consumer complaints; developing a centralized system to register, track, and analyze data on complaints and complaint resolution; and advising on the creation of an out-of-court mechanism to resolve consumer disputes. In most African countries, there are currently no established procedures for handling consumer complaints within financial institutions and no out-of-court dispute resolution mechanisms.

**International development partners**

If policy makers are to implement the reforms approach discussed above properly, then development partners must adopt an equally different approach in the way they provide technical assistance for financial sector reforms in Africa.
**The selectivity of the focus on policy reform:** First, there must be greater selectivity and more careful application of best practice models across heterogeneous African countries. While African financial sector policies share a common thread and common pillars, the interpretation and application may differ according to whether a country is fragile, landlocked, resource rich, governance constrained, or middle income (Addison et al. 2005; Maimbo 2007). Every financial sector strategy should be designed and developed so as to identify the specific limitations within the particular context and seek ways of addressing them that are tuned to local circumstances. At the same time, financial sector policy tools do not need to be reinvented for each country, but need to be adapted and sequenced correctly. The specific needs of African financial sectors require experimentation and innovation to generate African solutions. International best practice has often failed to have an impact in Africa. To this end, development partners need to leverage the diversity of country characteristics to harvest diverse solutions tested in different markets and then scale up in countries with similar characteristics.

**Policy-based assistance:** Development partners should pursue more policy-based assistance. This change in direction is necessary to achieve the goal of integrated financial sector reform. The need for deeper, comprehensive financial sector policy reform has increased as countries have completed first-generation reform. Many of the challenges African financial systems face today are structural in nature, and this has implications for broad policy reform. In deepening the financial sector reform agenda, many countries have been confronted with a range of issues relating to governance (for example, the cross-ownership of banks and pension funds and the exposure to loss-making state-owned enterprises). They have also been confronted by unfunded (implicit) contingent liabilities, particularly in pensions, as well as unaddressed policy issues relating to transparency in reporting and disclosure and the accountability standards of regulators. Policy-based lending operations are central to embedding financial sector reform within broader structural reform in the economy and ensuring that the reforms are aligned with national development strategy. It is important to highlight that many types of budget-support loans to governments may not be the best vehicle for supporting financial sector reform. Although the focus of this instrument has shifted in recent years toward a growth agenda (as opposed to social sector and public sector reforms), the financial sector remains a modest component of the effort: often only limited attention is paid to the financial sector in these multisectoral operations. Given the long-term and politically contentious nature of financial sector reform and in the absence of complementary support through other vehicles, financial sector reform may not receive the focus, the sustained commitment, and the close supervision needed for success. Policy-based operations are also well aligned with the Paris Declaration principles of (1) reinforcing the ownership of the policy agenda, (2) strength-
ening harmonization across development partners, (3) customizing programs to suit the circumstances of countries, and (4) selecting only critical actions for government intervention, while encouraging private sector solutions.  

- **Investing in capacity development and financial sector deepening**: Policy-based assistance must not supersede traditional technical assistance activities, however. Development partners should continue to invest in the capacity development of country authorities and regulators to enable them to implement policy, safeguard financial sector growth, and create an enabling environment that motivates innovation and ensures stability. Yet, to achieve the ambitions espoused in this book, the technical assistance needs to be broadened to support the entry of new players and expand outreach by requiring the increased use of outreach facilitation instruments, such as partial credit facilities to encourage banks to engage with small and medium enterprises (SMEs) or liquidity facilities to provide banks with longer-term funding to deepen the market for mortgage finance. Promoting innovation will require greater use of instruments that work directly with the private sector to incentivize and support innovation (participation in challenge funds, the funding of product development, and so forth). The targeted scale-up of transaction services will require additional investments in market infrastructure such as regional payment systems, collateral registries, and credit reference infrastructure.

An example of an area in which development partners have the resources and scale to make a significant impact is regional integration. However, given the wide variations in regional economic communities, development partners need to adopt a differentiated approach to regionalization. In existing economic and monetary zones, development partners can focus on strengthening regional institutions, developing crossborder banking, and integrating market infrastructure. In economic communities with a strong political commitment, development partners can support a greater spectrum of activities, including legal and regulatory harmonization, mutual supervisory recognition, infrastructure integration, regional securities markets, regional financing facilities for priority sectors, and regional institutional capacity strengthening for policy formulation and coordination. In communities with weaker political commitment, development partners can initially focus on a narrower range of activities, such as regional payment systems, cross-listing, and cooperation on capital markets, and progressively expand toward a broader financial integration agenda in line with the deepening of political commitment to integration.

**Redefine the Role of Government with the Necessary Safeguards**

Guided by the generally agreed principle that government intervention should support rather than distort the incentives for the private sector provision of finan-
cial services, a formal redefinition of the role of government in the financial sector in each country is proposed. This approach, labeled market-friendly activism, restricts financial service provision by government-owned institutions to a few, selected, and time-bound interventions in areas in which gaps and market failures remain, while policy actions are taken to fill the gaps and remove the market failures, thus opening the market to private initiatives. This approach recognizes that, in some countries, there might be room for well-designed, restricted interventions, in collaboration with the private sector, to foster financial development and broaden access to financial services.

It is important to stress that the space for market-friendly activism varies across countries (Dafe 2011). In general, such policies can be more successful in countries with conditions favorable to minimizing the governance trap. This is typically the case in countries with checks and balances, including beyond the political sphere. A strong private sector can be such a check, as can a thriving media sector that critically analyzes government decisions and programs. More diverse countries have the potential to provide more checks and balances, although they are often also the backdrop for ethnic politics that can easily lead to the abuse of activist policies.

One option often discussed is to move the responsibility for activist policies and market interventions away from the political sphere to (1) donors, (2) supranational regional institutions, or (3) nonprofit organizations. All three options offer advantages in terms of reducing the risk of corruption and graft; all three options, however, also raise concerns among national taxpayers about transparency and accountability.

In summary, in the short to medium term, the conditions in many African countries, especially countries with severe governance challenges, may be such that the responsibility for adopting activist policies and programs will be rather outside the political sphere or, at a minimum, in the political sphere but with strong monitoring and oversight by a third party that does not report to the political sphere. In the long term, however, it is preferable that the necessary country-level checks and balances be developed.

Many governments are turning to the private sector to design, build, finance, and operate infrastructure facilities hitherto provided by the public sector. PPPs offer policy makers an opportunity to improve the delivery of services and the management of facilities. There is no reason why the same principles cannot be applied more intensively to state-owned financial institutions. Indeed, in many countries, this is already taking place, albeit often narrowly centered on the privatization option discussed above.

A holistic review and restructuring of current government institutions and programs could yield substantial economies of scale and reduce the current contamination of private sector–led efforts to increase the access to financial services. Rather than establish a new program each time the government prioritizes a particular sector, region, or activity, the government should focus on using a single agency or
institution to prepare and draft the eligibility criteria for the program and then
tender the retail implementation of the program to interested institutions. All
bank and nonbank financial institutions would be eligible to bid for the tender. By
leveling the retail financial sector landscape in this manner, the government would
increase pricing and product transparency in the microfinance sector and increase
the involvement of the private sector in the delivery of commercially sustainable
programs.

There are several well-defined types of PPP and, increasingly, many permuta-
tions and combinations. One of the strengths of PPPs is their flexibility in ad-
addressing specific situations. Types of PPPs that are relevant for the financial sector
include PPPs for service contracts, management contracts, leasing, and joint ven-
tures and partnerships. We discuss several options in box 6.3.

One Size Does Not Fit All

As we emphasize throughout the book, one size does not fit all. While there are
commonalities across Africa, as we document in chapter 2, and similar challenges
in expanding access, lengthening contracts, and safeguarding finance, there are also
significant differences. We cannot design a financial sector strategy for each of the
53 countries of the continent, but we can point to commonalities across groups of
countries. The groups are not geographical; rather, we have composed the groups
based on the prominence of characteristics of African finance we have identified as
challenges. These are size, informality, volatility, and governance, plus any special
circumstances. Table 6.2 summarizes the challenges and priorities facing some of
these countries.

Low-income countries versus middle-income countries

On average, the financial systems of low-income countries are smaller and less well
developed than those of middle-income countries, and the financial reform priori-
ties of the two sets of countries therefore vary. The priorities of countries at low
levels of financial development will naturally tend to be included in the Finance for
Markets agenda rather than the Finance for Growth agenda, that is, the priorities
will be focused on basic short-term financial services. In addition, low-income
countries often also face severe capacity gaps, which may prevent the buildup of
regulatory institutions and other elements of financial infrastructure. Middle-
income countries, meanwhile, can focus more attention on the Finance for Growth
agenda, that is, on long-term financial transactions. Given the higher-income level
of middle-income countries, scale diseconomies can be more easily overcome.
Many middle-income countries can therefore expand their financial systems more
easily beyond the banking sector toward capital markets and contractual savings
institutions. Middle-income countries also have more room to address demand-
side constraints, including larger financial literacy campaigns and the necessary in-
stitutional structures for consumer protection. Low-income countries should focus
Box 6.3 What to Do with State Financial Institutions?

While many African countries have privatized commercial banks, others have recapitalized them. In addition, many countries still maintain DFIs, though, for every active one, there seems to be one that is moribund.

In line with a new role of government, that is, away from a market-replacing activity to a market-enhancing activity, what are the options for state financial institutions? The following are some of the possibilities and the related opportunities and challenges.

Rationalization
First of all, governments need to identify and separate subsidies aimed at solving market failures from the actual financing flowing through financial institutions. Often, subsidies aimed at increasing the use of credit do not address any of the underlying causes of the problems in access. In most countries, governments have provided loans to small producers either through public banks or by using directed credit programs at subsidized rates, while failing to address other business constraints.

Management contracts
Under a management contract, a private firm assumes the overall responsibility for the operation and maintenance of a service delivery system and retains the freedom to make day-to-day management decisions. In many cases, this involves managing the employees of the state financial institution who are employed in the service delivery system. Management contracts generally do not require the implementation of significant institutional changes. Rather, the existing public enterprise generally remains in place, and the personnel of the management contractor assume the line management responsibilities. Whereas the goal of service contracts is to reduce the operating costs of an organization, the goal of management contracts is typically to improve the internal management and operations of an organization. Because this change requires time to implement and take effect, the typical duration of a management contract is three to five years.

In Africa, management contracts have typically been used as precursors to privatization. Yet, there is no reason why they cannot be used as an ongoing renewable arrangement until the institution is able to hire and retain its own qualified management staff. In some countries, preprivatization management contracts have worked so well that the privatization option has been delayed.

In Tanzania, after the performance of the National Microfinance Bank (NMB) began to exceed expectations under management contractors, the privatization of the NMB lost momentum and became more difficult. As the profits of the NMB rose, so did the voices expressing opposition to the privatization. The government was unable to maintain support for the original plan of privatization that called for the sale of 70 percent of NMB shares to a strategic investor. At the height of the heated political debate, the board of directors of the NMB, who had been appointed by the president of Tanzania, publicly expressed their opposition to the privatization. The president responded by replacing the entire board. The result of these political challenges, apart from the delays in the privatization by one and a half years, was an amended privatization strategy, calling for the sale of only 49 percent of NMB shares to a strategic investor. Another 21 percent was to be sold to Tanzanian citizens at a later date.
All Financial Sector Policy Is Local

As a consequence of the delays in the privatization, the contract for the NMB management contractors was extended several times. The original contract was due to end in April 2001. It was extended to April 2002, April 2003, April 2004, April 2005, and, finally, to December 2005, or until privatization had taken place, whichever came first. Privatization finally took place in September 2005, and the contract was closed.

Privatization
There are various ways to privatize a state financial institution, as follows: (1) sale to a single strategic investor; (2) sale, in part or in whole, to an employee stock ownership plan; and (3) sale of shares to the public through an initial public offering. Each option carries advantages and risks. Strategic investors can inject capital and skills but may be obliged to deal with a public perception that the government has “sold out,” especially if the strategic investor is a foreign-owned entity. Employee schemes typically work best as part of an overall privatization scheme, lest the new entity be left with insufficient capital. Public offerings have the additional advantage of supporting the development of local capital markets, but empirical evidence suggests that governments typically underprice the shares in an effort to entice public participation in the market (Caprio et al. 2004).

The lessons of successful privatization efforts suggest the importance of (1) conducting a comprehensive market survey of viable sale options through due diligence of the investor’s market reputation (not merely the investor’s capital strength), as well as understanding the investor’s future intentions in regard to strengthening the capital and management of the bank; (2) involving international bank managers and professional specialists in advising the government on the transaction; (3) dealing swiftly and decisively with nonperforming loans and reversing the weak repayment ethic among borrowers at state banks; and (4) undertaking the privatization process within a strong legal and regulatory framework and supported by an independent central bank.

On the road to privatizing banks, it is necessary to enforce the regulations on all banks, to reveal the weaknesses of the state bank, publish audits, and avoid rapid privatization and excessive delays (Caprio et al. 2004). In the case of Uganda Commercial Bank, the privatization process took too long, and the bank was sold to a buyer without capital, banking reputation, or expertise. The buyer secretly assigned shares to another bank, thereby weakening the sector. This delay impeded competition and efficiency in the credit market and led to a loss of 2 percent of gross domestic product (GDP) during restructuring in 1998. On the political front, the privatization problem of Uganda Commercial Bank was aggravated by the reluctance of politicians to undertake reform because of the fear that they would lose their political influence, as well as their benefits that were associated with directed credit.

Corporatization
Corporatization refers to the transformation of state assets or agencies into state-owned corporations so as to introduce corporate management techniques into the administration of these assets or agencies. The corporatization process involves the sale or attribution of shares to corporate entities by listing the shares of the state-owned corporation as publicly

(To be continued on next page)
Box 6.3 What to Do with State Financial Institutions? (continued)

traded stocks on stock exchanges. A common model involves corporatizing a state institution so that it is operated as an autonomous joint-stock company, while the state remains majority stockholder and the institution is run by state entities that are separate from the central government administration (Stoyan and Zhang 2002).

A revealing experience is the case of the NMB in Tanzania, which was initially offered for sale to the private sector in 1997 (see above). The government, with the support of the World Bank, sought external managers to lead a restructuring that was intended to make the NMB more attractive to investors. Some NMB products were revamped, which generated an improvement in performance standards, product profitability, and public confidence. There was a concern that the weak credit culture could damage NMB’s loan performance, but new loan products were researched, designed, tested, and rolled out. The NMB progressed from a loss-making institution to a profit-making one.

Ownership policy
As the rationalization of existing institutions and programs is taking place, the authorities may wish to examine proposals for state-owned banks in the future within the framework of a formal ownership policy. A case in point is Malawi. The recently proposed Malawi Development Fund, the Financial Inclusion in Malawi Project, and the National Guarantee Scheme, as well as other, future institutions and programs need to be evaluated against an ownership policy that maintains the spirit of divesting government of retail activities. Such a policy should define the government’s overall ownership objectives and the government’s role in governance and clarify how the objectives and the role should be realized. The ownership policy should be published and should not be subject to frequent change. Specifically, it is important that the government undertake a holistic review of the sector and, for each institution and program, ask the following questions:

- Mandates: Are the policy mandates and objectives clear? These must derive from an adequate assessment of needs. Are perceived market gaps, missing markets, and so on well understood?
- Options: Once the gaps have become well understood, alternative means of meeting the needs should be considered. Is a government institution or program the most cost-efficient means? Can the private sector be leveraged as an alternative means of distribution instead? An assessment of the efficiency of a government institution or program in this regard must explicitly assess the costs inherent in building and maintaining an adequate governance framework in terms of human resources, investment in systems, and maintenance costs.
- Financing: How are the policy objectives (subsidies) to be funded? Subsidies must be made explicit. Allowing funding through cross-subsidies (from the profits on nonpolicy activities) invites mission creep and private financial sector displacement.

Corporate governance
The corporate governance structure for the institution or program must foster complementary private sector support for the institution or program and minimize the risk of political
All Financial Sector Policy Is Local

Box 6.3 What to Do with State Financial Institutions? (continued)

interference. A key aspect of this process is ensuring that the management and board of directors are not only competent, but also able to exercise autonomy in the management of the institution or program. This will require key matters to be addressed, as follows:

- What is the composition of the board, and how is the board nominated and selected? Patronage or professionals?
- How is the chief executive officer appointed and compensated? Appointment by shareholders—common among DFIs—affects the quality of the board. The board must be empowered to hire and fire the chief executive officer.
- How well are commercial practices embedded in the governance structure in terms, for example, of internal control, risk management, internal and external audit, and so on? The board must be held accountable for these issues under the legal framework and in practice.
- Do risk management systems simulate the impact of alternative policy programs and the pricing of the same—the level of the subsidies—on the value of the capital so as to enable the provision of quantitative backing to management and the board in making the trade-offs between policy objectives and commercial principles and objectives?
- Is an independent, professional external audit planned? The state auditing agency is no substitute.
- Is there a performance measurement procedure? Financial and commercial performance measures and policy performance measures should be defined in concrete terms. Objective methods for the measurement and evaluation of performance should be established and embedded in the compensation system.

Source: Maimbo and Saranga (2009).

on achieving economies of scale so as to expand payment services and basic credit among the population and capacity building among supervisory authorities.

While the Finance for All agenda is important for low- and middle-income countries, the priorities are different in the two sets of countries. In low-income countries, the priority will be on basic transaction services, while it will be on more advanced savings and credit services in middle-income countries. Middle-income countries are also able to pay more attention to specialized areas of finance, such as housing finance and infrastructure finance.

The policy priorities therefore also vary between low- and middle-income countries. Low-income countries focus on basic infrastructure elements, such as payment systems, credit registries, and the regulatory and supervisory framework, while middle-income countries can more easily expand the regulatory realm toward other segments of the financial system and toward consumer protection institutions. Donors also have a different role in low- and middle-income countries: they take a much more prominent role in the former and adopt more of an
### Table 6.2  Country Characteristics and the Primary Areas for Financial Sector Policies

<table>
<thead>
<tr>
<th>Country type</th>
<th>Primary challenge</th>
<th>Focus areas for financial sector policies</th>
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|                       | low income: provide basic short-term financial services | • payment systems  
|                       |                                                       | • regulatory framework  
|                       |                                                       | • supervisory capacity building  
|                       |                                                       | • financial sector strategies  
|                       | middle income: deepen and broaden financial systems   | • housing finance  
|                       |                                                       | • PPPs for infrastructure finance  
|                       |                                                       | • green finance  
|                       |                                                       | • innovative solutions  
|                       |                                                       | • institutional capacity building to support integration with global financial markets  
|                       |                                                       | • private health insurance, pension reform  
|                       |                                                       | • capital market development  
| Size                   | small: regional integration                          | • foreign bank entry regimes: licensing  
|                       |                                                       | • crossborder supervision: home regulatory memorandums of understanding  
|                       |                                                       | • macroeconomic safeguards to deal with volatility  
|                       | large: expand the diversity and penetration of the financial sector | • institutional and product diversification  
|                       |                                                       | • affirmative regulatory regimes for nonbank financial institutions  
|                       |                                                       | • capacity building to support coordination among regulators in different sectors  
| Sparsely populated     | expand the reach of the financial sector             | • mobile branches, agency arrangements, and technology solutions  
| Resource rich          | turn natural wealth into other forms of wealth        | • strengthen the provision of longer-term finance, for example, by using sovereign wealth funds  
|                       |                                                       | • PPPs for infrastructure finance  
|                       |                                                       | • build capital markets  
|                       |                                                       | • promote deepening the provision of finance by banks for SMEs, for example, to support economic diversification  
|                       |                                                       | • strengthen supervision and financial sector governance  
|                       |                                                       | • promote innovation and diversity in financial products  
| Affected by conflict   | rebuild basic financial infrastructure                | • extend the reach and coverage of microfinance institutions  
|                       |                                                       | • build payment systems and enable cheaper remittance processes  
|                       |                                                       | • financial capability  
|                       |                                                       | • build basic oversight capacity to ensure good governance of the financial sector (including anti–money laundering)  
|                       |                                                       | • rebuild the banking sector and promote the entry of experienced regional banks  
|                       |                                                       | • the early decisions on market structure must be accurate  

Source: Author compilation.

advisory and analyst role in the latter. Low-income countries often need donor support to implement financial sector strategies and to strengthen retail financial institutions, such as decentralized microfinance institutions, that show potential in the effort to increase outreach and push out the access frontier. Donor support is often provided to middle-income countries in more specialized technical areas.
Basic capacity building is critical for low-income countries, while upgrading skills and ongoing training is more the challenge in middle-income countries.

**Small versus large countries**

Policy makers in small economies (for example, Seychelles) face different opportunities and challenges relative to policy makers in large economies. In small, low-income countries, the challenges discussed above are exacerbated. The solutions are more costly, and the necessary scale is less likely to be reached. Small financial systems are more concentrated and therefore less competitive. Smaller countries therefore stand to gain more from regional integration in terms of higher-quality and lower-cost financial services. Participating in a regional exchange and a joint regional regulatory framework can help lower costs and extend the access to financial services. These countries may lose some independence in the integration process, but they will gain greater access to a broader range of financial services. Similarly, landlocked countries stand to benefit more from regional integration, including integration beyond financial integration, than countries with direct access to the ports and thus better transportation options.

Smaller countries also stand to gain more from globalization because of the entry of foreign banks. Multinational banks can rely on shared technology and back-office facilities with parent banks and subsidiaries in neighboring countries. Costs thus become lower. However, such gains have often not been exploited fully because of regulatory constraints and differences across countries. Because the market is too small for domestic financial service providers, small countries have to rely more heavily on outside financial service providers, such as foreign insurance companies and international equity funds. Capital account liberalization is more important for small countries needing to attract funding, which puts a higher premium on the macroeconomic safeguards necessary to deal with the ensuing volatility.

On the other hand, larger countries with a critical mass can be more ambitious in creating diverse financial systems beyond banking, especially through contractual savings institutions and capital markets. Larger countries are more likely to have sufficient scale for the private funding of infrastructure and to be able to supply the tools necessary for banks and markets.

Larger countries can offer policy makers more room for activist policies because there are likely to be better checks and balances in these countries. There is also more room for affirmative regulatory actions to push banks toward the frontier without running the risk that the banks will exit the market. Policy makers in large markets can thus be more ambitious, and they have a larger permissible margin of error. As Honohan and Beck (2007) point out, there is likewise more room for an active financial sector dialogue with a larger number of stakeholders and participants and, often, in a more vibrant media landscape.

**Sparsely populated countries**

Population density is an important predictor of financial development, as we discuss in chapter 2. If a large share of a country’s population lives in rural areas or if
the population is widely dispersed, this exacerbates the challenges of scale. As Honohan and Beck (2007) indicate, it is important to look beyond population density to the population distribution within a country: is it concentrated in a small area, leaving large parts of the country uninhabited, such as in Algeria or Chad, or is it distributed in smaller population centers across the country, as in Tanzania? One must also look at the income distribution in population centers because less-populated areas may have more resources and, accordingly, the necessary scale to justify financial service provision.

A widely distributed population is especially challenging for the Finance for All agenda because outreach becomes more costly in this case. Innovative solutions are especially important, some of which we discuss in chapter 3. Mobile bank branches, agency agreements, and technological solutions can help overcome the challenges of scale. Viewing beyond the banking system to microfinance institutions and semi-formal institutions such as savings and credit cooperatives may be important.

For donors, this is challenging, too. An emphasis on microfinance in rural areas, rather than full-fledged banks, may be useful. Though this may be tempting in such countries, one must not concentrate solely on the capital city area.

**The resource rich**

The economic structure of many African countries is dominated by commodities, such as aluminum (Mozambique), copper (Zambia), or oil (Algeria and Equatorial Guinea). This dependence on commodity exports might make these countries achieve significantly higher GDP per capita than other countries in the region, but also subjects them to a much larger fluctuation in income levels. Consistent with the Dutch Disease hypothesis, many of these countries also suffer from high real and volatile exchange rates that crowd out non-commodity sectors and industries. Recent cross-country comparisons have shown that economies relying on natural resources benefit as much from financial development in terms of pro-poor growth as other economies and that manufacturing industries more reliant on external funding benefit from financial deepening in resource-based economies more than do corresponding industries in other economies (Beck 2011). This implies that financial sector policies are as important for commodity-exporting countries as they are for other countries. Yet, cross-country comparisons have also shown that commodity exporters have smaller financial systems than predicted by the level of GDP per capita and macroeconomic stability and that banks are more liquid, more well capitalized, and more profitable, but give fewer loans to firms. There is thus a premium on financial sector reform in economies dependent on natural resources; the challenge will be to transform natural wealth into other forms of wealth; the domestic financial system will have a critical role.

Because of the long-term nature of natural resource extraction, a focus on long-term intermediation capacity is important. Sovereign wealth funds can play a major part, though appropriate governance structures are crucial, including the establishment of limits on the contribution of these funds to public deficits so as to ensure
long-term sustainability and intergenerational equity. Similarly, other long-term instruments, such as pension funds and insurance companies, can provide key inputs. However, there is a premium on fostering access to credit by SMEs. While some of the commodity exporters have high GDP per capita, income distribution is often highly skewed, and access to financial services is often restricted to a small segment of the population.

Among policy priorities, governance tops the agenda because of the Dutch Disease effect on the governance agenda that has been observed in commodity-exporting countries throughout the world. Large amounts of money invite graft and corruption; the proper handling of these resources for the benefit of the population at large is therefore decisive. Another important priority is macromanagement, that is, carefully managing the capital inflows related to commodity exports and avoiding an overvaluation of the exchange rate. Donors can have a pivotal role in financial sector policy by advising on macropolicy and helping in the design of governance structures, but also by pushing intensely for financial sector reform. Ultimately, commodity-exporting countries could be the drivers of regional financial integration.

**Countries affected by conflict**

Financial transactions are being undertaken even in the presence of violent conflict and the absence of state authority, which is the case in Somalia. Finance for Markets exists even under the most adverse circumstances; however, it is costly, inefficient, and often excludes large parts of the population. Wherever formal financial systems break down, informal networks expand and take over. Where national currency loses its value completely, foreign exchange takes over. Formal financial service provision is often reduced to urban areas or even limited to the capital city as banks abandon rural areas. Commercial banks often collapse because borrowers are unable to repay and their branches are being looted. A similar fate often hits central banks. The postconflict authorities are presented with destroyed physical and financial infrastructure.

What are the first priorities in the financial sector after a conflict? The priorities of Finance for Markets loom large; among them is the challenge of reestablishing a stable national currency that can be used as a medium of exchange throughout the country, beyond establishing mechanisms of monetary policy that might include the even more basic challenge of reintroducing coins and bills. High on the list is the challenge of building the necessary infrastructure for Finance for Markets, such as the payment system and a basic regulatory and supervisory framework. Simplicity is key in this context given the limited human and financial resources. Often, these challenges consist as much in building physical infrastructure as in building human and organizational infrastructure. However, a chaotic postconflict environment also offers openings for shady businesspeople and shady deals, so that strict rules on anti-money laundering and combating the financing of terrorism might be even more important in the context of postconflict countries than elsewhere.
Rebuilding the formal banking sector is another daunting task. Old bankers might have left for good or are associated with the old regime. The licensing of new banks with appropriate fit and proper standards will be vital. Promoting the entry of reputable and experienced multinational banks from the region or beyond can be useful in rebuilding the financial system; at the same time, it is important to keep the system contestable and open for future domestic or international entrants.

Finance for All challenges also loom large in fragile and postconflict countries. Informal financial arrangements will dominate the financial landscape for many years to come, and the challenge will be to create links between formal and informal financial service providers. Given the destroyed infrastructure, the formal banking system will face a difficult task in seeking to expand beyond urban areas. Promoting the outreach and coverage of microfinance seems a more promising route in this context than focusing on bank outreach. Technology seems a particularly useful instrument in this context of destruction.8

Rebuilding the basics of the financial sector is often not on the immediate agenda for postconflict governments and donors, but can play a consequential role in jump-starting the private sector and rebuilding an inclusive market-based economy. Government-to-person payments are often important in the context of rebuilding economies, as are rebuilding contracts given to local contractors, which might require short-term financing. Donors have a decisive role in postconflict economies, but careful hand-holding and supervision are certainly necessary. It is important to focus on basic structures, while developing a comprehensive financial sector strategy with a long-term outlook.9 Capacity building should top the agenda so as to avoid long-term donor dependence.

Conclusions

Financial sector policies have again moved to the center stage of the development agenda in many African countries. The challenges are similar: expanding access and lengthening contracts, while safeguarding the financial system. However, the circumstances and contexts vary from country to country. The main messages developed in this book are general and have to be translated into specific policy formulations for each country.

Africa’s financial systems are on the move. There is a lot to be gained. There is ample evidence that deeper and broader financial systems can help African progress out of poverty. Accepting the opportunities that globalization, regional integration, and technology offer can result in steeper growth trajectories. As we argue in this concluding chapter, these opportunities require a redefinition of the roles of the private sector, the public sector, and donors. They require a look beyond the dichotomy of modernist and activist approaches toward an approach that recognizes that all financial sector policy is local. Reaping the benefits of these opportunities requires a recognition of the politics of financial deepening and the creation of constituencies for financial sector reform. Financing Africa demands that we
look beyond the crisis toward the structural challenges and opportunities the continent presents.

Notes

1. For a discussion of these two views in the context of financial sector policy, see Barth, Caprio, and Levine (2006). For a more general survey on the role of politics in financial development, see Haber and Perotti (2007).

2. The general point about path dependence in political and institutional structures is most eloquently and convincingly made by Acemoglu, Johnson, and Robinson (2004).

3. One of the most prominent examples is the greater ease with which the United Kingdom was able to gain access to war finance after the Glorious Revolution of 1688, given that the taxation power was not held by the king, and the checks and balances made a default on government debt less likely.


5. The term market-friendly activism was first used in the Latin America region; see de la Torre, Gozzi, and Schmukler (2007).

6. This does not imply that these countries do not need long-term resources, but rather that the priorities are in the Finance for Markets area.

7. There are large low-income countries, such as Ethiopia and Kenya, but also small middle-income countries, such as Botswana and Mauritius.

8. Donors in Haiti have recently focused on technological solutions for the payouts for government assistance after the recent earthquake.

9. The Iraqi reconstruction offers an interesting example: the objective of introducing the technically most advanced infrastructure for stock exchange trading was repudiated by traders in favor of a simple blackboard solution.