47175

Distr.: General

E/ECA/TRADE/95/4
December, 1995

Original English

UNITED NATIONS
ECONOMIC AND SOCIAL COUNCIL

UNITED NATIONS
ECONOMIC COMMISSION FOR AFRICA

FINANCIAL SECTOR LIBERALIZATION IN AFRICA IN THE FRAMEWORK OF ECONOMIC REFORM PROGRAMMES

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Financial sector reforms have become an integral part of economic reforms in Africa. Many of the structural adjustment programmes supported by the World Bank, the International Monetary Fund and other donors in Africa bear a component which requires the restructuring of the financial sector. It is generally acknowledged that the performance of the financial sector in many African countries has been less than satisfactory, as has been the outcome of many of the financial sector reforms implemented. Accordingly, an evaluation of the performance of financial sector reforms in Africa is indeed warranted and timely.

Banking and finance structures in many African countries remain underdeveloped, financial instruments are narrow, and dispersion of the few financial institutions that exist is often highly skewed and concentrated mainly in urban centers. Furthermore, the state of underdevelopment of the formal financial sector is reflected in the important role played by the informal financial institutions in the mobilization and allocation of financial resources. A large proportion of credit needs of some important sectors that should be the engine of growth remain unfulfilled or only partially fulfilled through the informal financial sector.

The most salient features of the financial system in Africa are: the low level of financial intermediation which takes place in the formal financial sector; the apparent alienation of officials of the formal financial sector from a large proportion of the African population; the neglect of the needs of the small-scale entrepreneur and the rural peasants; and an apparent lack of commitment by the formal financial system to the socio-economic transformation of African countries. Accordingly, the focus of most formal financial institutions in Africa(especially the banking sub-

sector) has been on support of trade-related activities, at the expense of investment in productive sectors.

An efficiently functioning financial system can contribute to the development of a country. The experiences of the Newly Industrializing Countries of Asia bears witness to this observation. The financial sector's contribution to growth lies in its ability to enhance efficiency and to move excess savings from surplus units to deficit units. Furthermore, efficiently functioning financial systems often lower the cost of transferring resources from savers to borrowers. A properly functioning banking and finance system is an essential infrastructure for a country to achieve higher levels of development. It is in this context, that structural adjustment programmes often carry an element of ***"financial sector reform."***

While it is appreciated that African countries need to continue with a strategy of reducing financial repression, restoring bank solvency, and improving financial infrastructure, it is now acknowledged that in some cases African countries have moved too fast to improve balance sheets and recapitalize banks in an environment where the main borrowers (the government and public enterprises) are financially distressed and the institutional capacity is weak.[1] *In devising financial reforms in some African countries, there appears to have been perhaps too much emphasis on quick fixes, an overestimation of the benefits of restructuring bank balance sheets and recapitalization, and an underestimation of the time it takes to improve the financial infrastructure in an environment where the major borrowers are from the public sector and the institutional capacity is weak.*

---

[1] *World Bank:* ***Adjustment in Africa: Reform, Results, and the Road Ahead****, World Bank Policy Report, October, 1993.*

Appropriate sequencing of financial reforms is therefore essential for their success. In implementing such reforms, it is wiser to move gradually and to improve economic fundamentals first before complete deregulation. The relationship between the ***"financial sector"*** *and the* ***"real sector"*** *makes it imperative that due consideration should be made of the impact of such reforms on the real sector. Financial reforms should be designed and implemented in such a way as to ensure the stability of the financial system; while gradually removing financial repression, dismantling directed credit programs, introducing better accounting, legal, and supervisory frameworks, and continuing with institution building and deepening of financial intermediation.*

I. INTRODUCTION

1. Financial sector reforms often are designed to : increase competition in the financial sector by opening up entry and exit from the sector; increase the range of financial instruments available to both savers and investors through an expanded financial infrastructure and instruments; improve the determination of interest rates in order for them to reflect the opportunity cost of financial resources; improve the allocation of foreign exchange and the determination of the exchange rate in order for it to reflect the opportunity cost of a unit of foreign exchange; and improve the overall process of financial intermediation, and mobilization and allocation of financial resources.

2. In Section II of this paper, we examine ***developments in banking and finance in Africa.*** *The main observation is that notwithstanding the efforts that have been made in many African countries to develop this sector, it is still narrow and underdeveloped. Furthermore, although efforts have been made to establish capital markets in a number of African countries, these are still relatively underdevelopment, except for the South African capital market. Nevertheless, a number of African countries are making concerted efforts to improve the functioning of their financial sectors, including capital markets.*

3. Section III looks at Africa's ***recent experience with financial sector reforms.*** *Most African countries have in recent years embarked on such reforms, often in the context of structural adjustment programmes. While the importance of financial sector reforms is generally acknowledged, the experience of African countries with such reforms has been rather mixed and in some cases disappointing. Fundamental issues often emerge from an assessment of the impact changes in exchange rate policy, interest rate*

policy, and liberalization of the financial sector have had on African economies. These are some of the issues we will briefly touch on in this paper. It should be made explicit that no one doubts the need and importance of financial sector reforms in African countries, but what is at the center of the debate is the substance and form such reforms should take as well as their sequencing.

4. Section IV examines ***issues in financial sector reforms.*** *Certain conditions are necessary for the success of financial sector reforms, accordingly, understanding the role of financial sector reforms within the framework of overall economic reforms is essential for their success. The success of such reforms depends not only on the conditions prevailing in the economy but also on the sequencing of such reforms.*

II. Banking and Finance

5. The financial system in many African countries remains a serious handicap to Africa's socio-economic development as it continues to be characterized by a narrow range of financial institutions and instruments; heavy ownership of such institutions by the public sector; a large proportion of non-performing loans in the portfolios of banks and non-banks; lack of relevant management skills; and general repression of the financial system. Accordingly, notwithstanding the efforts made by some African countries to reform the sector, it has been unable to cope with rapid developments both at home and abroad, particularly technological advances; and more importantly it has failed to adequately mobilize resources to support development in Africa.

6. The problems of the effectiveness of formal financial markets to mobilize and allocate financial savings in Africa is partly mirrored in the important role played by informal financial markets in providing credit and avenues for savings. The informal financial sector is believed to be larger than the formal sector in a number of African countries and is made up of various types of individuals and intermediaries including: money lenders, mutual aid societies, cooperative savings and credit associations, and staff and welfare schemes.[2]

7. Further studies have shown that in certain African countries, the growth in the volume of savings and lending activities outside the formal banking system has been faster, and probably even larger

---

[2] *Bential B. et al: Rural Finance in Ghana, A Research Study prepared for the Bank of Ghana on behalf of the Ministry of Economic Co-operation of the Federal Republic of Germany, Bonn, 1988.*

than within the system. In rural Ghana, it was estimated that as much as 60 percent of financial savings are done with informal bodies. Studies on Malawi, Nigeria, Tanzania and Zambia also revealed that the informal financial markets play a significant role in the mobilization and allocation of financial savings.[3]

8. The main reasons that have been cited for the spread of the informal financial markets in Africa have included: the close association between the financial services provided by these institutions and the promotion of ties of solidarity and friendship among the members of the groups; the provision of credit services tailored to the needs of the borrower; flexibility in the terms and repayment periods of loans; and the low or virtually no costs of administration and transactions costs borne by participants. Thus notwithstanding the higher risk of default on loans extended as well as default by those who collect the money to be saved, the informal financial markets continue to persist in many African countries because of the gap they fulfill.[4]

---

[3] *For further readings on informal financial markets in Africa see: C. Chipeta and M.L.C. Mkandawire: The Informal Financial Sector in Malawi: Scope, Size and Role, African Economic Research Consortium (AERC), 1988; M.P. Miracle, D.S. Miracle and Laure Cohen: Informal Savings in Africa, Economic Development and Cultural Change, Vol,. 28, 19 ; Adedoyin Soyibo: Financial System Regulation, Deregulation and Savings Mobilization in Nigeria, African Economic Research Consortium Workshop paper, Dec. 1989.*

[4] *C. Chipeta and M.L.C. Mkandawire: Links Between the Informal and Formal/Semi-Formal Financial Sectors in Malawi, African Economic Research Consortium, Research paper no.14, November 1992; M. Hyuha, M.O. Ndanshau, and J.P. Kipokola: Scope, Structure and Policy Implications of Informal Financial Markets in Tanzania, African Economic Research Consortium, research paper no. 18, April 1993; Ernest Aryeetey: The Relationship Between the Formal and the Informal Sectors of the Financial Market in Ghana, African Economic Research Consortium, research paper no. 10, October, 1992; and Degene Aredo: The Informal and Semi-Formal Financial Sectors in Ethiopia: A Study of the Iqqub, Iddir, and Savings and Credit Cooperatives, African Economic Research Consortium, research paper no. 21, October 1993.*

9. Economic entities that operate in the informal financial markets owe their very existence partially because of the duality of the African economies, repression of the formal financial markets, the inefficiencies inherent in operations of some formal financial institutions, the flexibility provided by the informal financial markets, and macroeconomic conditions prevailing in some African countries as a result of certain government policies. The formal financial sector in many African countries has been heavily biased in favour of urban centers, and against rural areas; plagued by bureaucratic red-tape in the provision of credit, a factor which has militated against rural borrowers most of whom are illiterate or semi-illiterate.

10. The banking and finance system existing in many African countries partly owes its origins to the institutional framework established during the colonial period. Many of the monetary and financial arrangements existing in African derive from the pre-independence period when African countries were largely dependencies of cosmopolitan powers. Many of the Currency Boards created in the pre-independence period became the nucleus of central banks established in the post-independence era. Among the most notable Currency Boards created during this period were: the West African Currency Board (established in 1913); the East African Currency Board (1919); the Southern Rhodesia Currency Board (1939), and later replaced with the Central Africa Currency Board (1954) after the two Rhodesia and Nyasaland were joined into the Federation of Rhodesia and Nyasaland.

11. Most of the Pound Sterling Currency Boards were established on the general understanding that they were to: act as automatic changers of money, providing 100 percent Sterling cover for any currencies they issued; and were not to pursue independent monetary

policy, such as providing of credit.[5] *In French West Africa, Banque de l'Afrique Occidentale (1901-1955) began to issue new notes in 1945 for the newly created Franc Monetary Zone of West Africa. Banque d'Etat du Maroc, an international private bank, was granted rights of issue by the French according to the Treaty of Algeciras in 1906. The Central Bank of Egypt also grew from the National Bank of Egypt, founded in 1898 as a private note-issuing bank. Banco Nacional Utramarino of Portugal was founded in 1864 and authorized to issue colonial notes. It established a branch in Luanda, Angola. A new bank, Banco de Angola, was established in 1926 and was endowed with powers to issue new "escudo notes" for the territory and to redeem the Angolan escudo notes issued by the Banco Nacional Utramarino. Similar developments in the field of money and finance took place in Mozambique, Portuguese Guinea, and Sao Tome and Principe.* [6]

12. A number of commercial banks operating in the cosmopolitan cities of Europe, often established agencies and/or branches in the colonies and territories. The banking and finance systems that emerged in the post-independence period reflected therefore to a certain extent the institutional infrastructure established in the pre-independence period. However, two notable developments took place in the post-independence period which had a significant bearing on the development of African financial systems. These were: the nationalization of financial institutions in the post-independence period; and establishment of government owned and/or

---

[5] *For further readings on African Currency Boards see: J.B. Jones: The West African Currency Board, 1912-1962; J.W. Kratz: The East African Currency Board, IMF Staff Papers, 1 July 1966, pp. 240-241; S.K. Basu: Central Banking in Emerging Countries: Study of African Experiments, Asia Publishing House, Bombay, 1967, pp. 52-66.*

[6] *J.K. Onoh: Money and Banking in Africa, Longman, London, 1982, pp. 25-49.*

controlled development institutions or agencies. Firstly, as part of a general desire to free African countries from control of colonial masters, nationalization and/or increased government control of enterprises, including banks, took place in many African countries in the advent of independence. Secondly, in the belief that the African private sector was too weak to mobilize resources needed for development, most African governments, established development banks/institutions/agencies. These were intended to play a catalytic role not only in mobilizing resources but also spearheading development.

13. Notwithstanding the good intentions of many African governments in nationalizing financial institutions and creating new development banks and agencies, the outcome in many of these countries was less than desired. These developments gave rise to: increased involvement of government in the ownership and /or control of banks and other financial intermediaries; conflict of interest of major shareholders of these institutions, government and public enterprises, and in the management of banks; increased share of non-performing loans as major borrowers, who are also shareholders failed to meet their obligations; and reckless borrowing from abroad, often guaranteed by government.

14. Furthermore, financial repression became common place, as African governments tried to keep interest rates low in order to minimize the cost of credit to themselves and to public enterprises, and in the belief that low interest rates will stimulate investment. Credit rationing also became common place. These events, therefore, general gave rise to an inefficient and poorly functioning financial system in many African countries. The financial reforms currently underway in most African countries are intended to address this situation.

15. In recent years, a number of important developments have occurred which have had a significant bearing on the efficacy of

monetary and financial policies in Africa as well as on developments in major monetary aggregates. These developments have included, internal strife and civil wars which have rendered monetary and financial policy management irrelevant in some countries and given rise to inflationary financing to support military expenditures; deteriorating terms of trade and its impact on export earning capacities of African countries and their external reserve positions; fiscal budget imbalances in some countries; and decreasing real net resource flows. These developments have made the conduct and management of monetary and financial policy in Africa more difficult.

16. The decline in the terms of trade of many African countries, prior to the recent recovery in prices of some primary products, gave rise to a sharp decline in the "net worth" of many borrowers from African financial institutions and in turn an increase in "non-performing loans" in the portfolios of such institutions. The weakening of the financial sector in a number of African countries should, therefore, not only be perceived in the context of poor management and of heavy ownership of such institutions by government, but also in the framework of such adverse external developments. This is not to deny that some mismanagement of financial institutions has taken place in some African countries.

17. African countries appear committed to financial reforms in the framework of overall economic reforms, but such reforms need to be position in the context of their impact on the "real sector" i.e. the production and export base.

III. Financial Sector Reforms in Africa: Experience and Outcome

18. Many African countries have in recent years embarked on financial sector reforms, in the context of overall reforms of their economies. These reforms have focused on reducing financial repression, restoring bank solvency, and improving financial infrastructure. To restore bank solvency, many of the countries have embarked on programmes designed to downsize publicly-owned banks; privatizing them where possible and encouraging new entrants.

19. It is now acknowledged that a number of African countries in implementing financial sector reform programmes, moved too fast to improve balance sheets and recapitalize banks in an environment where the main borrowers (the government and public enterprises) were financially distressed and institutional capacity was weak.[7] *Successful implementation of financial reforms requires striking a balance between the need to increase competition and the need to ensure the solvency of financial institutions.*

20. Financial sector reform calls for more nuances than simply "letting the market work". The arguments are in favour of a gradualistic approach to such reforms, mainly because the development of "borrower net worth" will determine the health of the real and, ultimately, the financial sector; and the initial conditions of the banking sector, such as its stock of human capital, the initial portfolio mix, and the internal incentive

---

[7] World Bank: **Adjustment in Africa: Reform, Results, and the Road Ahead, A world** Bank Policy Research Report, October, 1993.

systems, will determine the success of the reformsa.[a] *Authorities can do much to increase the market orientation of their financial system, such as eliminating grossest interest subsidies; moving towards market financing of government debt; raising deposit rates at least to only slightly negative or modestly positive levels, while paying attention to budgetary implications. However, complete deregulation of the financial sector has to consider links of this sector with the real sector and its institutional developments. Poorly conceived financial reforms can prove destabilizing to an economy.*

21. Financial reforms that take account of the initial condition of portfolios of banks, their information capital, and their stage of institutional developments are more likely to succeed than those that do not. Restructuring of the financial sector often becomes the mirror image of that in the real sector. Restoration of bank financial health unavoidably requires decisions about what to do with non-performing loans. Furthermore, efficient cleaning of banks balance sheets often entails substantial reorganization of claims over the corporate sector and can prove costly to government and the public. Accordingly, while financial reforms are necessary in many African countries, their design and implementation has to take due cognisance of the links with the real sector, of their implications on borrower net worth, and ultimately their effects on the portfolios of banks and the general institutional health of the financial system.

22. In trying to evaluate Africa's experience with financial sector liberalization, it is important to assess the extent to which the reforms had an impact on major macroeconomic variables such as rates of inflation; exchange rate policy and management;

---

[a] *Gerald Caprio,Jr., Izak Atiyas and James Hanson:* ***Financial Reform Lessons and Strategies****, World Bank Working Papers, WPS 1107, February, 1993.*

inflationary financing of budget deficits; and the general level of financial intermediation in various African countries. However, it should be born in mind that the final goals of macroeconomic policy are to achieve high levels of output growth and employment, in environment of relative price stability.

Box 1: Financial Sector Reforms: The Experience of Ghana

Ghana adopted in 1983 the Economic recovery Program (ERP) which has been credited with moving the economy from a state of near collapse to achieve positive rates of growth consistently over a period of a decade. The Program initially focused on stabilization of the economy, particularly reducing fiscal budget deficits, lifting price controls, liberalizing interest rates and exchange rate systems, and rehabilitation of the infrastructure.

Financial sector reforms in Ghana began in earnest in 1988. Accordingly, at the start of the Economic Recovery Program, the Ghanaian financial system was highly controlled; interest rates were set by the central bank; banks were subjected to sectoral lending guidelines and were required to hold government instruments which offered little or no interest; and real interest rates were negative. The financial system was also characterized by: dominance of state-owned institutions; a large proportion of savings mobilized in the formal financial system satisfying public sector borrowing requirements; low level of participation of the general population in the formal financial sector; an insignificant contribution of the non-bank financial institutions to financial intermediation; and a large informal financial sector, estimated at 45 percent of all private sector savings mobilized initially through informal channels.

In order to address this situation, the Ghanaian Government embarked on a series of successive financial sector reform programs. The Government started the process with a program of wide-ranging financial reforms which included: abolishing interest rate controls and sectoral credits; and introduction of a weekly auction of Treasury Bills as an initial step towards a system of indirect monetary control.

These reforms were expanded under the first Financial Sector Adjustment Credit (FINSAC I) as prudential regulations were strengthened and actions taken to improve bank supervision; seven banks were restructured, with some non-performing assets transferred to a newly created government agency, the Non-Performing Assets Recovery Trust (NPART); and banks were allowed to set lending and deposit rates freely.

Box 1: (Continued): Financial Sector Reforms: The Experience of Ghana, 1983-1994

The focus of the Government during the second Financial Sector Adjustment Credit (FINSAC II) has been on; reducing distortions in the financial system by encouraging positive real interest rates; increasing competition in the banking system through a divesture of public shareholdings in banks; and improving the legal and regulatory framework applicable to non-bank financial institutions.

Notwithstanding these efforts, the financial sector in Ghana remains one of the weak points in the economic reform programs that the country has adhered to during the last twelve years. There is need to improve the process of financial intermediation of formal financial institutions and to deepen the system. Furthermore, actions are needed to strengthen confidence in the system and wherever possible to improve the linkages between the formal and informal financial sectors.

The World Bank proposes a three-pronged approach to enhance financial intermediation in Ghana: restoring macroeconomic stability; increasing competition; and investing in the financial infrastructure. Increased competition could be achieved through the privatization of state-owned banks and the liberalization of licensing policies for private financial institutions (both bank and non-bank). Furthermore, improving management and viability of rural financial institutions as well as strengthening linkages between formal and informal financial intermediaries could help mobilize savings and provide savers with opportunities to earn positive real interest rates on their deposits. Investing in the development of information flows and human capital and strengthening the legal infrastructure is one way the Government can help develop an effective financial system in Ghana.

Source: *World Bank: **Ghana Financial Sector Review: Bringing Savers and Investors Together**, Report No. 13423-GH, December 29, 1994*

A. Monetary and Credit Policies

23. It is generally acknowledged that rates of ***monetary and credit expansion*** *have a significant bearing on rates of inflation prevailing in an economy. Accordingly, high rates of monetary and credit expansion are often associated with high rates of inflation. Monetary policy generally attempts to support low rates of inflation, adequate real interest rates, a stable financial sector that is able to efficiently mobilize and allocate financial resources. To keep inflation low, total monetary growth needs to be consistent with this objective.*

24. An examination of rates of monetary and credit expansion among the various sub-regions of Africa shows that most of the countries have progressively moved towards lower rates of monetary and credit expansion in an effort to achieve price stability. A few exceptions, however, remain with very high rates of monetary expansion and rates of inflation.

25. Among the countries of the Preferential Trade Area of Eastern and Southern African States (PTA), most countries had average rates of monetary expansion (narrow money) of below 20 percent during the period 1988-1993; with the exception of Sudan, Somalia, Kenya and Malawi. A similar pattern is evident if one examines the rates of growth of broad money. Sudan and zambia had annual rates of inflation in 1993 that were in excess of 100 percent, while Kenya and Mozambique recorded rates above 40 percent.

26. Notwithstanding these developments, convergence of monetary and credit policy within the PTA sub-region is feasible. Many of the countries have already moved towards "single digit inflation rates" and accordingly it will only require those countries with high rates of inflation to adopt more stringent "anti-inflationary policies."

27. As for the countries of the Economic Community of West African States (ECOWAS), many of the countries belong to the CFA Franc zone, and accordingly pursue common monetary and credit policies. The countries belonging to the CFA Franc zone have generally recorded low rates of monetary and credit expansion and in turn have enjoyed relative "price stability". On the other hand, countries of the sub-region that do not belong to the zone have often recorded higher rates of monetary expansion and in turn high inflation rates. During the period 1988-1993, average rates of monetary expansion in Ghana, Nigeria and Sierra Leone were in excess of 30 percent and for Guinea Bissau 53.3 percent. Most of the countries of the CFA Franc zone had average rates of monetary expansion below 10 percent and in a few cases negative rates. However, following the recent devaluation of the CFA Franc, rates of inflation accelerated significantly in many of these countries as wage demands intensified and the initial impact of the devaluation on the cost of imported goods filtered through the economies.

28. Similarly, achieving convergence of monetary and credit policies among countries of the Economic Community of Central African States will require that non-CFA Franc zone countries like Zaire and others intensify their efforts to reduce inflation rates. These countries have higher rates of inflation relative to those within the Zone. Zaire's annual rate of inflation is in the thousands. Burundi and Rwanda, which also do not belong to the Zone, have recorded moderate rates of monetary and credit expansion and in turn their rates of inflation had tended to be low.

29. Most of the countries of the Maghreb Arab Union (UMA) have had moderate rates of monetary and credit expansion and accordingly low rates of inflation. Achieving convergence of monetary and credit policies among these countries should prove much easier than in

other sub-regions. Furthermore, the financial infrastructure is relatively developed in most of these countries which should facilitate the process of monetary and financial integration.

30. Many African countries have in the past followed a policy of directed credit in one form or another. Directed credit has frequently been justified by the need to assist agriculture or infant industry. However, such programs have often proved a failure partly from misuse of the privilege and low repayment rates, which has often undermined bank profitability and increased government deficits. Similarly, providing subsidized loans to agriculture through agricultural marketing boards has also proved ineffective and often costly. The economic distortions arising from directed credit may outweigh the benefits from such programs. Accordingly, in the course of financial reforms most African countries have embarked on dismantling targeted credit programs or at least reducing their scope.

31. Notwithstanding these recent developments regarding directed credit programs in Africa, the experience of some of the Newly Industrializing Countries shows that well-planned and executed directed credit programs can play a catalytic role in engendering economic growth. Targeted credit programs often appeal to African countries for the simple reason that they have a low political visibility since they do not require parliamentary approval. Nonetheless, the resource misallocation arising from such programs can be substantial. It is often the case that targeted credit ends up going to the better off rather than those who need it most. It also tends to weaken the financial sector to the extent that the subsidy for directed credit comes from the financial sector through forced lending at below-market rates; and weakens incentives to assess credits, monitor them, and even collect debts.

32. Accordingly, should African governments wish to pursue a policy of targeted credit, it is advisable that such schemes should

be kept small; leaving them broad based so that the responsibility for credit allocation remains with banks; and limiting as much as possible the subsidy element of the programs. Most African countries have in recent years moved away from targeted credit, in favour of market allocation of credit. Nonetheless, the merits of directed credit in promoting growth in rural areas , and particularly the agricultural sector, should not be completely ruled out. Well conceived and executed programs can play an important role in energizing the rural sector and agriculture.

The Success of a number of Asian countries in allocation of credit to priority areas suggests that a role for government exists in this area. Furthermore, the South Korean case illustrates that government credit allocation schemes need not lead to a decline in the quality of investment and can be important in promoting capital accumulation and growth in the early stages of development. [9]

---

[9] *Heather D. Gibson and Euclid Tsakalotos: The Scope and Limits of Financial Liberalization in Developing Countries: A Critical Survey, The Journal of Development Studies, Vol. 30, No. 3, April 1994, PP. 578-628.*

Box 2: Financial Sector Adjustment Programs: The Kenya Experience

Kenya, unlike many other African countries, had many of the elements necessary for the development of a vibrant and dynamic financial system, including a diverse institutional base, competent Central Bank staff and management, and a relatively unfettered regulatory framework.

Nonetheless, the financial system in Kenya portrayed many of the weaknesses characteristics of many African financial systems including: a relatively controlled and fragmented financial system; relatively low spreads between minimum savings and deposit rates and minimum lending rates, although real interest rates were positive; the differentiated interest rate structure between banks and non-bank financial institutions which produced fragmented credit markets; poor performance of development finance institutions as reflected in large loan arrears; differences in the regulations governing banking and non-bank financial institutions which resulted in fragmentation and fragility of the financial system; weak supervisory capacities of the central bank to carry out its surveillance role and enforce banking regulations; and inappropriate Government actions and policies which contributed to the slow development of the capital market in Kenya.

It is against this background that the Kenya Government embarked in the mid-1980s on financial sector reform whose main objectives were to: develop a more efficient and market-oriented financial system in order to improve resource mobilization and allocation; increase the efficiency of financial intermediation; and develop more flexible instruments of monetary policy. The aim of the Government was to move towards more market-driven financial system and accordingly a number of measured were introduced including: the widening of bank spreads; the introduction of a cash ration; the establishment of a discount window facility at the Central Bank; increases in the maturity and variety of government debt instruments; adoption of an auction system for government debt instruments; strengthened regulation and supervision of non-bank financial institutions; and greater alignment between the operations of banks and non-bank financial intermediaries.

The limited autonomy of the Central Bank of Kenya meant that the Bank was forced most of the time to accommodate central government borrowing.

Box 2:(Continued): Financial Sector Adjustment Programs: The Kenya Experience

Monetary policy in Kenya was essentially driven by fiscal policy considerations. With limited autonomy to set an independent monetary policy, the Central Bank of Kenya usually accommodated the domestic borrowing requirements of the Central Government. Accordingly, monetary policy was essentially driven by fiscal policy. Nonetheless, the Central bank of Kenya had at its disposal a number of monetary instruments with which to regulate expansion of domestic credit, including the "daily cash reserve requirements" and "liquid assets ratio." The Central Bank, nonetheless rarely enforced these mandatory requirements but often relied on quantitative ceilings on domestic credit.

As part of the Government's financial sector reforms, attempts were made to abandon inefficient monetary policy instruments and strengthen monetary control. The Central of Kenya removed controls on lending-related fees and charges early 1990, and thereby effectively freeing interest rates; and in late 1990, the Bank improved the Treasury Bill auction system; and in July 1991, interest rates were fully deregulated. The Bank also converted its claims (overdrafts) on the Central Government into trading portfolio of Treasury Bills, and thereby creating an instrument with which it could stabilize both monetary expansion and interest rates.

Kenya has essentially followed a flexible exchange rate policy since 19982, although certain restrictions on foreign exchange transactions applied. Over the period 1982-1990, the real effective exchange rate of the Kenya shilling depreciated by 38.2 percent and in nominal terms the value of the currency fell by 47.3 percent against the US dollar during the same period. In recent years, Kenya has undertaken even further liberalization of the foreign exchange market.

A three-fold growth in the number of banks has taken place in Kenya since independence in 1963. While in 1972 Kenya had only eight banks, the number almost doubled to 15 by 1982 and by 193 30 banks were operating in the country. This rapid growth, however,had its side effects as two banks closed their doors in 1986 due to liquidity problems and the Government was forced to institute stringent laws to safeguard public deposits and in 1989 the "Consolidated Bank" was established to regulate the operations of a number of banks and financial institutions that were in trouble.

B. *Exchange Rate Policies*

33. African countries have since the failure of the generalized fixed exchange rate system in 1973 and the adoption of generalized floating by the industrialized countries experimented with various types of exchange rate arrangements along the continuum of fixed exchange rate, adjustable peg, managed float and freely floating exchange rates. Immediately following the collapse of the fixed exchange rate system, many African countries either devalued their currencies and maintained their peg, moved to a new type of exchange rate peg (mostly to the SDR or a basket of currencies) or to a free float. The largest number, however, opted for some form of a peg either to the SDR, US$ or a basket of currencies.

34. The economic crisis of the 1980s which beset many African countries and produced serious external and internal economic imbalances in many of these countries forced many to re-evaluate their exchange rate arrangements. Most African countries found themselves in a situation where the external balance had become a binding constraint, especially in the face of deteriorating terms of trade, escalating external service burden, and falling real net resource flows. Many of the countries had no further access to borrowing from international financial institutions. Against this background and within the framework of structural adjustment programs supported by the World Bank and the IMF, many African countries began to re-examine their exchange rate arrangements. The serious balance of payments positions prevailing in many of these countries forced many of them to abandon "internal balance" as an immediate economic goal in favour of achieving some form of stability in the "external balance". Accordingly, the exchange rate policy became an important instrument for promoting external balance.

35. It is in this respect, that many African countries have

progressively moved within this continuum of exchange rate arrangements towards more flexible exchange rate regimes. Many at the moment are either on a freely floating system, or managed floating, or adjustable peg. The only largest group of African countries that still maintain a fixed peg are the fourteen countries of the CFA Franc Zone in Central and West Africa which have traditionally been linked to France. These countries were also recently forced to devalue their currency vis-a-vis the French Franc as a result of adverse developments in their external positions.

36. The problems associated with defining exchange rates ranges from distinguishing between "nominal exchange rates" and "real exchange rates", "nominal effective exchange rates" and "real effective exchange rates", "spot rates" and "average rates", and finally "buying rates" and "selling rates". This diversity of terms complicates the analysis of exchange rates. The difficulties of defining exchange rates are also complicated by the fact that even during a given day "spot buying rates" differ from "spot selling rates", the differential being the arbitrage fee charged by banks. For statistical purposes, the problem becomes more complicated as a decision has to be made whether to use "weekly averages", "monthly averages" or "end-of-the -period figures" as the true indicator of developments in a country's exchange rate.

37. The "nominal Exchange rate" of a currency is often defined as the "number of units of a domestic currency" needed to buy "a unit of foreign currency" or conversely "the number of units of a domestic currency" that "a unit of foreign currency" can buy. Another important distinction is between "nominal effective exchange rates" and "real effective exchange rates". The real effective exchange rate index is usually used as an indicator of competitiveness and is formulated as the "nominal effective exchange rate index adjusted for movements in prices or costs at home relative to those abroad".

38. Another important terminology is the "equilibrium exchange rate" defined as the rate at which "foreign exchange markets" clear without any form of distortions, either administrative or institutional in nature. In the long run, what is of significance if whether "a country's real exchange rate" approximates the "real equilibrium exchange rate". The two approaches for determining the equilibrium real exchange rate are the "Purchasing Power Parity (PPP)" approach and the related "relative price of tradable to non-tradable goods" approach. According to the Purchasing Power Parity approach, the equilibrium real exchange rate is proportional to the relative price levels of home country and its trading partners, that is to the relative purchasing power of the national currencies. In this respect, the relative inflation rates determine the rate of change of nominal exchange rate over time. Thus the equilibrium real exchange rate according to this approach is defined by the relative price of the home country's consumption basket in terms of the foreign country's consumption basket.

39. An alternative related approach to the determination of the equilibrium real exchange rate is the "relative price of tradable to non-tradable goods" approach, which provides a summary measure of the incentives guiding resource allocation between the two key sectors of the economy. According to this approach, in the long run a country's real effective exchange rate will approximate the relative price of imported (or tradable) goods in terms of domestic (or non-tradable) goods. In accordance with this approach, if the domestic price of tradables rises relative to the price of non-tradables, resources will be reallocated towards tradable sectors and trade balance will improve and vice-versa if the domestic price of tradables falls. The equilibrium real exchange rate, therefore corresponds to the relative price of tradable to non-tradable goods

that yields simultaneously internal and external equilibrium.[10]

40. A further important distinction that needs to be made is between "official exchange rates" and "parallel rates". Official exchange rates are those rates which prevail on official foreign exchange markets while "parallel rates" are those which prevail in "secondary markets" or "black markets". The differential between the official exchange rates and parallel markets is often defined as the "black market premium" and often reflects the imbalances existing in a country's foreign exchange markets and more importantly overall macroeconomic imbalances.

41. The real effective exchange rate index has often been used to determine the appropriateness of an exchange rate policy. It has often been perceived that an increase in this index over its level in the base period when the external position of the country was considered adequate is an indication of a deterioration in the external competitiveness of the economy. Accordingly, competitiveness of the economy can be restored to its base period level through a change in the nominal exchange rate, a change in the level of domestic prices (or costs) relative to those abroad, or through a combination of the two.[11] *The assumption is that in the long run the real exchange rate will approximate the equilibrium real exchange rate.*

42. The issue of "optimal and sustainable exchange rate regimes" combines two important issues that have been the center of intellectual and academic discussion for sometime, i.e. the issue of what is an "optimal exchange rate regime" and that of what is a

---

[10] *Bijan B. Aghevli, Mohsin S. Khan, and Peter J. Montiel: Exchange Rate Policy in Developing Countries: Some Analytical Issues, IMF Occasional Paper No. 78, March 1991, Washington D.C.*

[11] *G.G. Johnson and IMF Staff:* ***Formulation of Exchange Rate Policies in Adjustment Programs****, IMF Occasional Staff Papers, No. 36 August 1985, Washington, D.C.*

"sustainable exchange rate regime". The issue of an optimal exchange rate regime hinges on the choice of the type of exchange rate system a country wishes to adopt, while that of sustainable exchange rate regime hinges on the policy mix needed to sustain an exchange rate regime.

43. The issue of an optimal exchange rate regime centers around choice of policies, the type of shocks the country is likely to encounter and the structure of the economy. Accordingly, the optimal management of the exchange rate depends on the "policymakers economic objectives", "the source of shocks to the economy", and "the structural characteristics of the economy in question". The first issue in determining whether an exchange rate regime is optimal or sub-optimal relates to the "objective function" of a given society as defined by policymakers. This entails defining a "welfare function" in the context of available policy options. In practice, defining such a welfare function has proved illusive and accordingly policymakers have tended to narrow it to a criterion of macroeconomic stability, defined in terms of minimizing the variance of real output, the price level or real consumption in the face of transitory shocks. However, policy conflicts abound in trying to achieve these objectives simultaneously.

44. The extent of the disharmony of exchange rate policies in Africa is reflected not only in the divergence of exchange rate arrangements between countries within individual sub-regions but also among sub-regions. Furthermore, within the continent there also exist currency zones, such as the CFA Franc zone and the Rand Monetary Area. Notwithstanding these differences there has been significant progress since the mid 1980s in reducing the exchange rate premia between official exchange rates and parallel rates. The three-and-four digit premia that had existed in the early 1980s have virtually disappeared in many African countries through devaluations and/or adoption of flexible exchange rate regimes.

45. In terms of convergence of exchange rate arrangements, the countries of the Southern African Development Community (SADC) appear to have broadly moved towards similar exchange rate regimes in recent years. Many of the countries have progressively moved towards adoption of "independently floating exchange rate regime". As of September 30, 1994, five out of the nine countries of the Community were on an independently floating exchange rate regime. Three others were pegged to the South African Rand by virtue of belonging to the "Rand Monetary Area."

46. Similarly, countries of the Preferential Trade Area for Eastern and Southern African States (PTA), now transformed into the Community of Eastern and Southern African States (COMESA), have also progressively shifted towards similar exchange rate arrangements in recent years. At the end of 1992, eight of the countries of the PTA were pegged to a "basket of currencies", and only five were on an independently floating exchange rate regime. However, by the end of September, 1994 nine countries had adopted independently floating exchange rate regime and another three were on a "managed float." A number of countries of the sub-region remain on a "single currency peg" or are pegged to a "basket of currencies".

47. Among the countries of the Economic Community of West African States (ECOWAS), a majority (7) belong to the CFA Franc Zone and are accordingly pegged to the French Franc. Nonetheless, three countries of the sub-region have adopted "independently floating exchange rate regime." Convergence of exchange rate arrangements among ECOWAS countries will depend to a certain extent on the consistency of exchange rate policies of the CFA Franc zone countries with the "monetary harmonization programme" of ECOWAS. The most difficult decision the ECOWAS countries will have to make collectively will be whether to move towards a "single currency peg" (i.e for example all of them joining the CFA Franc zone), or

whether to move towards "independently floating exchange rate arrangements." That decision will indeed be a difficult one.

48. Similarly, the majority of the countries of the Economic Community of Central African States (ECCAS) as of September 30, 1994 were pegged to the French Franc by virtue of belonging to the CFA Franc zone. Only one country had adopted an independently floating exchange rate regime and another was on a managed float. For the countries of the Maghreb Arab Union, three of the countries of the Sub-region are pegged to a "currency basket" and two others, including Egypt which is not a member of the Arab Maghreb Union, are on a "managed float."

49. Harmonization of exchange rate policies of various sub-regional groupings in Africa is feasible but will require concerted efforts to achieve convergence of policy. Furthermore, the economic and social costs of adjusting exchange rate policies will vary among countries as well as among sub-regional groupings. Nonetheless, achieving convergence of exchange rate policies is an essential element in accelerating the process of monetary and financial integration in the various sub-regions.

50. The shift towards flexible exchange rate regimes by African countries, although necessary, has not been without economic and social costs as attested by the recent devaluation of the CFA Franc. Minimizing the social cost of adjustment, including adjustment of the exchange rate, has proved one of the most difficult tasks facing African policy makers. Furthermore, the argument that devaluation and/or adoption of flexible exchange rate arrangements will improve external competitiveness of African economies has proved illusive for many African countries, especially in the context of deteriorating terms of trade.

51. The challenges facing policymakers in African countries in devising optimal and sustainable exchange rate regimes are indeed

formidable as they have to deal with not only defining the "welfare function" for the country in question on the basis of which "economic policy objectives" can be prioritized, but also determine the institutional and structural framework needed to support an exchange rate regime. The choice of an exchange rate regime for a given country depends partly on the policymaker's economic objectives; the source of shocks to the economy; and the structural characteristics of that economy. The first issue that needs addressing is what "criterion of optimality" should be used in deciding on a country's exchange rate arrangements. The most satisfactory criterion is the "welfare function" of a society which gives an indication of the priorities of a given society in terms of various economic objectives and the trade-offs between them. However, such a comprehensive welfare function does not exist to be of help to policymakers. Accordingly, the focus has been on a relatively narrow criterion of macroeconomic stability, defined in terms of minimizing the variance of real output (employment), the price level, or real consumption. However, even with this narrow definition, policy conflicts are bound to arise as stabilization of any single macroeconomic variable runs the risk of destabilizing some other variable that may also be of relevance to general welfare of a society.

52. The criterion of optimality that has been commonly adopted, especially by industrial countries, has been the "stability of real output". The policy focus has therefore been on managing the exchange rate so as to minimize the variance of real output around its full capacity level in the face of random shocks arising from diverse external and domestic sources. However, for most African countries that face severe problems of unemployment and/or underemployment, stabilization of real output may not be their primary economic goal. For most of them, the balance of payments has become a binding constraint in the face of deteriorating terms of trade, high external debt service payments, and declining net external resource flows. Accordingly, while the primary goal of

most African countries remains that of achieving sustainable economic growth with high levels of employment, severe balance of payments imbalances have forced many to direct their attention to this problem in the hope that once the external balance has been stabilized, they can once again redirect their attention to the primary goal. Many have, therefore tried to design their exchange rate policies with the aim of maintaining external competitiveness at a level consistent with a sustainable balance of payments position.

53. An important choice facing countries in instituting a floating exchange rate regime is whether it should take the form of an auction or an interbank market. The experience so far has been that markets operated by the commercial banking sector have been less subject, than officially operated markets, to destabilizing intervention in the form of inappropriate official purchases and sales or ad hoc controls on access to the market. Another major consideration in setting up the floating markets has been the need to incorporate safeguards against destabilizing speculation and the establishment of monopoly positions by some operators in the market.

54. Where a sufficient number of capable commercial banks exist or there is a pre-existing network of operators dealing in the parallel market , the interbank arrangement is likely to be more efficient, and will require less resources at an official level to ensure its success. In many countries adopting floating arrangements, the effects of existing payments arrears have created difficulties and solutions to the problem have included removing the backlog of arrears from the market and subjecting them to a phased repayment. Another important aspect of the handling of payment arrears (overhang) is early contact with creditors to ensure the best possible environment for the start-up of the market.

55. An associated concern of many policy makers in adopting a floating exchange rate regime has been adequacy of reserves and techniques of foreign exchange "cash-flow arrangement". To assist in providing as stable an environment as possible for the introduction of a floating exchange rate system, and with the aim of minimizing the initial depreciation of the exchange rate after floating, it is imperative that arrangements be made in advance for ***"bridging finance"*** *from official or commerical banks sources ahead of drawings under Fund Stand-By or other Arrangements and rescheduling of existing debt.*

56. It is also of critical importance for the functioning of the floating market that exchange rate regime be supported by implementation of appropriate policies of demand restraint and structural change and by increased resource inflows, especially of the type that can be readily fed into the exchange market. Furthermore, successful operation of an exchange rate float will be helped by strengthened confidence in the economy and more particularly in its external payments position.

57. A floating exchange rate system, nonetheless, presents certain difficulties for many African countries. Firstly, there is the risk of high exchange rate volatility as confidence in the success of the stabilization plan fluctuates. Secondly, with the loss of exchange rate as a nominal anchor for domestic prices, the need to find another nominal anchor (for instance money supply) increases. However, the considerable uncertainty as to the functioning of money markets, especially in African countries, makes it less desirable to have to rely heavily on money as an intermediate target. Furthermore, the incomplete development of financial markets makes the relationship between indirect control instruments (such as discount facilities and reserve requirements) and monetary targets a very uncertain one. Accordingly, given the severe institutional deficiencies, a system of credit ceilings is likely to be the only effective readily available instrument of monetary

control. Finally, the operation of an efficient foreign exchange market may not be technically feasible in a situation where financial markets are underdeveloped. In view of the linkages between different financial operations, some degree of development in other financial markets is necessary to support the operation of a smoothly functioning foreign exchange market with a floating rate.

58. In summary, while many African countries have in recent years opted to adopt market-determined exchange rate regimes, nonetheless the efficient functioning of these markets is premised on a number of factors; some of which may not exist in some countries. Accordingly, analysis of "optimality and sustainability" of exchange rate regime would have to be done on a country-by-country basis or sub-regional basis. It may be worth noting that, widespread use of unified floating exchange rate systems by developing countries began with the introduction by Uganda in mid-1982 of a secondary auction market for foreign exchange.[12] *Other countries in Africa that have now gained some experience with floating exchange rate arrangements include Zambia, Tanzania Mauritius and more recently Malawi. The experiences of these countries may prove extremely useful in assisting other African countries to avoid some of the pitfalls experienced by their predecessors in trying to move to more flexible exchange rate arrangements .*

[12] *Peter J Quirk, Benedicte Vibe Christensen, Kyung-Mo Huh, and Toshihiko Sasaki, Opcit.*

C. Interest Rate Policy

59. Financial reforms implemented in many African countries have often contained a shift from administratively set interest rates to market determined rates. Nonetheless, notwithstanding the merits that have been advocated for market determined interest rates and disadvantages of administratively set rates, few monetary authorities (even in industrialized countries) are prepared to accept as reasonable any interest rate level that is freely market determined. Accordingly, interest rate liberalization is not synonymous with laissez-faire policies regarding the determination of interest rates, but requires the replacement of administratively set interest rates by indirect monetary management that operate through the markets. [13]

60. It is generally acknowledged that "interest rates" are an important policy variable which influences not only the demand and supply of investable resources and the decisions of economic agents to invest or consume, but they also affect the exchange rate, capital movements between countries, as well as inflation. Accordingly, the management of interest rate policy as well as monitoring the long term structure of such rates often occupies monetary authorities both in developed and developing countries.

61. Many African countries in the past have followed a policy not only of administratively set interest rates, but in some cases even a policy of low and unchanging interest rates. This policy partly emanated from the belief that maintaining low interest rates will promote investment; improve the allocation of investment among sectors (through directed and subsidized credit to perceived

[13] *Sergio Pereira Leite and V. Sundararajan: Issues in Interest Rate Management and liberalization, IMF Staff Papers, Vol. 37, No. 4, December 1990.*

priority sectors such as agriculture); and help to keep financial costs down so as to avoid inflationary effects of interest rate liberalization.

62. The belief that low interest rates stimulate investment and growth has been challenged by many people who have argued that if real interest rates are reduced below market equilibrium levels, demand for investment will no doubt increase, but actual investment will decrease, since at low interest rates insufficient savings will be generated to finance these investments and may therefore give rise to rationing of existing resources. Such a situation often generates inefficiencies in the allocation and utilization of financial savings. [14] *A policy of low interest rates may therefore not only inhibit investment, but also reduce the average rate of return on ivestment below the maximum attainable under more open competition for financial resources.*

63. Numerous challenges face monetary authorities in African countries as they embark on the process of financial sector liberalization. Among the issues the authorities need to examine and address are the following: adequacy of interest rate levels consistent with economic goals of a country; the need to maintain positive real rates of interest (or reduced their negativeness) in order to attract financial savings; determining an appropriate level of interest rate differentials between domestic and world interest rates in order to avoid or reduce the destabilizing effects of capital movements; determining an appropriate level of relationship between interest rates and the rates of return on investment; monitoring the relation between interest rates in

---

[14] *For further reading on the effects of a policy of low interest rates on savings, investment and growth see Ronald I. McKinnon: Money and Capital In Development, The Brookings Institution, Washington, 1973; and Edward S. Shaw: Financial Deepening in Economic Development, Oxford University Press, London, 1973.*

formal and informal financial markets; and determining an appropriate structure of interest rates.

64. The issue of liberalization of interest rate policy in African countries is compounded by a number of other factors, including: the underdeveloped nature of money and capital markets which renders a policy of indirect intervention in the conduct of monetary policy more difficult; the oligopolistic nature of the financial sector, with heavy ownership of financial institutions by the public sector; and the inconclusive evidence as to the impact changes in interest rates have on financial savings, investment and growth.

65. Despite these uncertainties as to the impact changes in interest rates have on major economic variables, nonetheless, it is also acknowledged that financial intermediation in a highly repressed financial sector is less efficient. It is in this context, that many African countries are implementing financial sector reforms in the belief that this will result in a more efficient financial system. The challenge facing monetary authorities in African countries is therefore how to design and implement appropriate strategies for financial sector liberalization. Pereira Leite and Sundararajan argue that if a country's interest rate system is inappropriate, and until conditions for free interest rate obtain, some kind of interest rate management policy may be necessary. [15] *Furthermore, they state that:*

> *"Any move toward a more liberal interest rate regime should be associated with the development of appropriate monetary policy instruments that are capable of influencing the rates indirectly to reflect monetary policy objectives, such as containing credit expansion or*

---

[15] *Sergio Pereira and V. Sundararajan: Opcit.*

ensuring that divergences from world rates are not excessive (resulting in large capital flows). In this regard, the appropriate choice of operating techniques of monetary policy becomes important to ensure that monetary control does not exert an undue impact on growth, and to promote further development of financial markets."

66. The two authors further advise that interest rate liberalization has a better chance of success if the following key issues are addressed at the outset of the liberalization process:

(i) Will there be adequate competition?

(ii) Are the money market and monetary policy instruments adequate to influence the marginal cost of funds to banks?

(ii) Will the market-determined lending and deposit rates respond rapidly to shifts in monetary policy and to developments in international interest rates and exchange rates?

(iv) Is the banking system sufficiently sound to face interest rate competition?

(v) Is the bank supervision mechanism sufficiently strong to anticipate the effects of liberalization and react to it in a timely and efficient manner?

67. An interest rate reform policy has to be implemented in the context of a general reform of the financial sector and within a framework of an overall package of economic reforms designed to improve the performance of an economy. Such reforms need to be carried out in tandem with policies designed to increase competition in the financial sector; policies designed to reduce selective credit policies based on below-market rates and improve allocation and utilization of financial savings; measures designed to strengthen the money and interbank markets and to improve the

effectiveness of monetary policy instruments; the development of market-based instruments of monetary control and fostering of money markets; reforms of laws governing issuance and transfer of short term securities, the development of well-capitalized and supervised dealers, and introduction of new financial instruments.

68. Interest rate liberalization also requires that authorities take due cognisance of the relative importance of domestic and international factors in determination of domestic interest rates. For a relatively open economy, ignoring developments in world interest rates in determining domestic rates can prove disastrous. Significant monetary reforms to develop money markets and strengthen monetary policy instruments need to accompany interest rate liberalization in order to enable the authorities to acquire technical ability to influence money market rates or, more generally the marginal cost of funds to banks. Developing adequate bank supervision machinery is also important in interest rate liberalization. In an environment in which many financial institutions are weak and have a large share of non-performing loans and high operating costs, without adequate bank supervision, unexpected failures of individual financial institutions can be expected to lead to **"systemic crises"** *following liberalization. Accordingly, a close review of the soundness of the banking system and adequacy of bank supervision are some of the critical elements for the effectiveness of interest rate liberalization.*

69. Another important issue to be considered is the sequencing of interest rate liberalization. Many countries liberalize segments of the financial system in steps. The sequence in which liberalization of nonbank institutions, private banks, state-owned banks and government securities has proceeded varies from country to country. The appropriate sequence would depend on the initial regulatory and institutional features.

70. The more fundamental issue regarding interest rate

liberalization in African economies is whether changes in such a policy are likely to generate desired results such increased savings and investment, growth in output and employment, and internal and external balance. The literature on factors affecting savings behavior of household units and firms is abundant, as are the explanatory variables determining savings. A substantial literature relating to the level of saving and the impact, or lack of impact, of various government policies on this level (including interest rate policy) have developed over the years. Among the factors that have been identified as affecting savings are the following: the rate of interest; real income levels; openness of an economy and the working of international capital markets; the real rate of return on investment; income distribution; pension fund schemes; taxation incentives, such as tax exemptions on interest income; the inflation rate; terms of trade shocks; as well as dependency rates. [16]

71. It is acknowledged that in a closed economy, the stock of capital will decline if consumption equals production, since the existing capital will gradually be consumed if funds are not set aside for its replacement. Historical evidence indicates that an increase in per capita capital stock makes an important contribution to increased productivity and rising standards of living. Accordingly, saving is needed to maintain the capital stock. More may be needed to make sure that the capital stock grows in proportion to a growing population; and even more may be needed for an increase in the capital/labour ratio in order to increase per capita output. [17]

---

[16] *For more details on factors affecting savings see: Jonathan D. Ostry and Carmen M. Reinhart: Private Saving and Terms of Trade Shocks, IMF Staff Papers, Vol. 3, No. 3, September 1992; and Nicola Rossi: Dependency Rates and Private Savings Behavior in Developing Countries, IMF Staff Papers, Vol. , No. , 19 .*

[17] *Roger S. Smith: Factors Affecting Saving, Policy Tools, and Tax Reforms, IMF Staff Papers, Vol. 37, No. 1, March 1990.*

72. While the complexity of linking changes in the savings to changes in interest rate policy in industrialized countries is acknowledged, the issue is even more complex for African countries. Determining the transmission mechanism between changes in interest rates and changes in savings and investment behavior has proved extremely difficult. The analysis is made even more difficult by the need to disaggregate the various factors that may affect savings. Some of these factors have been enumerated above.

73. Notwithstanding these observations, the need to improve the mechanisms for the determination of interest rates and enhance their role in the mobilization, allocation and utilization of financial resources in African countries is generally acknowledged. Furthermore, the distorting effects of administratively set interest rates on the allocation and utilization of financial savings is also recognized. However, although the need for reform of interest rates policies in many African countries is required, nonetheless it should be also acknowledged that the transition from administratively set interest rates to market determined rates is full of uncertainties and possible dangers of introducing "systemic risks" if the process is not managed properly.

74. The argument is not that interest rate reforms should not be undertaken in Africa, but rather that the process of transition from administered interest rates to market determined rates should be managed properly in order to avoid destabilizing the financial system. Interest rate liberalization has to be accompanied by complimentary measures designed to improve the infrastructural and institutional arrangements of the financial sector. Without these complimentary measures, interest rate liberalization is less likely to succeed. Recent theoretical developments indicate that interest rates in free markets may fall short of market-clearing levels, or may rise to risky levels, with adverse consequences for financial institutions and the economy at large. To prevent such outcomes,

economic stabilization and improved bank supervision should generally precede complete removal of control on interest rates [18]

---

[18] *Delano Villanueva and Abbas Mirakhor:* ***Strategies for Financial Reforms in Developing Countries****, IMF Staff Papers, Vol. 37, No.3, September, 1990.*

IV. Isues in Financial Sector reforms

75. Financial sector reform is a complex process which often extends over a number of years and its successful implementation often depends on a number of key institutional and economic conditions being in place including: basic legal structures; acceptable accounting regulations and practices; effective banking supervision; and a macroeconomic climate featuring low inflation and exchange rate stability.[19] *Furthermore, proper sequencing of the reform process is essential for its success.*

76. Many African countries have in recent years been implementing financial sector reforms with a view to reducing financial repression, eliminating credit controls, and achieving positive real interest rates or at least reducing their negativeness. The general objective of such policies has been to improve mobilization of domestic savings, attract foreign capital, and improve financial intermediation.

77. Experience with countries that have implemented financial sector reforms reveals that success was partially premised on: establishment of a stable macroeconomic environment; prudential supervision of the banking system; and appropriate sequencing of stabilization reforms, banking regulations, and interest rate policies. [20]

78. The decision as to whether a country should adopt a ***"gradualistic approach"*** *or a more* ***"dramatic approach"*** *to financial sector liberalization will depend to a certain extent on the*

---

[19] *Eduardo Borensztein: Structural Policies in Developing Countries, IMF Paper on Policy Analysis and Assessment Series, No. 94/19, 1994.*

[20] *Delano Villanueva and Abbas Mirakhor: Opcit.*

macroeconomic conditions prevailing in the country as well as the current state of health of the financial sector. Empirical evidence from some countries that have implemented such reforms shows that some adopted a gradualistic approach and others the dramatic approach. In some of these countries, there was outright liberalization or deregulation of interest rates in a short period of time, whereas in others it involved gradual liberalization over a longer period in which frequent adjustments were made to regulated interest rates. Some of the countries that adopted a gradualistic approach included Singapore, South Korea and Taiwan which engaged in flexible management of interest rates that progressively resulted in positive real interest rates. On the other hand, Argentina, Chile, Turkey and Uruguay adopted a more dramatic approach and liberalized interest rates within a relatively short period of time. However, in many of these countries because of prevailing adverse macroeconomic conditions and weak financial sectors, financial liberalization resulted in a decline in output, deterioration in the rate of inflation, and widening external imbalances. The only country were a drastic approach to interest rate liberalization appears to have worked is Malaysia. It is believed that favourable macroeconomic conditions and a relatively healthier financial sector contributed tremendously to the success of the programme.

79. The above analysis would appear to indicate that unless macroeconomic conditions are favourable and the health of the financial sector relatively strong, a more gradualistic approach to financial sector liberalization is more preferable than a dramatic one. Such an approach allows the financial system to gradually adjust to the new environment and minimizes output losses arising from firms becoming bankrupt as they try to swim in the new and more competitive environment. Inappropriate sequencing of such reforms can result in a collapse of the financial sector which in turn will produce a ***"systemic crisis."***

80. A suggestion for a gradualistic approach to financial sector liberalization should not be equated with "non-action" in the implementation of such reforms, but rather provides words of caution as regards to the design of such programmes and their sequencing in the implementation process.

81. Financial sector liberalization in developing countries of Asia and Latin America during the 1970s and 1980s took place under the following conditions: as part of a general trend towards less government intervention in economic activity; a common belief that moves towards domestic liberalization were a necessary response to growing liberalization at the international level; and a growing dissatisfaction with the way in which regulation of financial markets was working.[21] *The policy choices therefore were for quick fixes that could yield results within the shortest period as possible.*

82. The experiences of these countries with financial sector liberalization have provided useful lessons on a number of key issues, especially with regards to linkages between the "financial sector" and the "real sector"; imperfections that may exist in financial markets and thereby render the principle of perfect competition unattainable; the importance of strengthening the institutional and regulatory framework in the process of financial liberalization; and the impact of prevailing macroeconomic conditions on the success of such programmes.

83. It is now acknowledged that the existence of market failures may hamper the liberalization process and accordingly a simplistic approach to financial sector liberalization can produce a serious "systemic crisis" in the system. *In this respect, appropriate care*

[21] *Heather D. Gibson and Euclid Tsakalotos: The Scope and Limits of Financial Liberalization in Developing Countries: A Critical Survey, The Journal of Development Studies, Vol. 30, No. 3, April, 1994, PP. 578-628.*

Box 3: *Financial Sector Liberalization: The Indonesian Experience*

Developments in the Indonesian financial sector have to a large extent been influenced by developments in the petrochemical industry. The economy as a whole benefitted during the 1970s as net exporter of oil. The effect of the oil revenues was felt strongly on the fiscal system as the government began to increasingly rely on oil revenues as its chief source of revenue.

The conversion of oil revenues and large foreign borrowing into local currency, at fixed dollar exchange rate, to finance government domestic spending increased the money supply and added inflationary pressure. Furthermore, during the 1970s the Bank of Indonesia used as a main instrument of monetary control, the extension of liquidity credits to the banking system, state enterprises and corporate companies. The liquidity credits extended at subsidized rates and fixed maturities were an important element in government pursuit of policy objectives. The Bank also set up complicated rediscount financing system for loans to state banks, in an effort to influence the direction and quantity of credit.

As time passed, the gap in interest rates between state banks and private banks grew as controlled interest rates became misaligned. In order to stem inflationary pressures the Bank used credit ceilings on individual banks, including private and foreign banks, which were used in conjunction with the use of subsidized liquidity credits.

The position of the state banks as recipients of preferential funding, and lack of competition for deposits due to interest rate ceilings, allowed the state banks to become the dominant intermediaries. Furthermore, by granting state banks guaranteed access to the discount mechanisms, loans were increasingly financed through liquidity credit facilities. The state banks, with most of their loans secured through Bank of Indonesia accommodation, had little incentive to mobilize savings and could use excess reserves for more speculative purposes. Favoured firms acquired large debt burdens and the risks present in the financial system concentrated among a specific group of corporate firms. The financial structure which resulted after a prolonged period of repression began showing characteristic weaknesses: overly dependent financial system, and a banking system overly-exposed to the dominant state-owned industries.

Box 3: (Continued): Financial Sector Liberalization: The Indonesian Experience

The impetus to monetary and financial reform came with the series of negative shocks of 1982 which included, the deepening recession in the world economy and weakening oil markets. These factors caused a reduction in Indonesia's oil revenues, which was felt as a real reduction in government non-debt budgetary expenditure. This in turn impacted adversely on economic growth and forced the government to undertake broad structural adjustment reforms, including the reform of the financial system.

The broad objectives of the financial reform programme were: to increase domestic resource mobilization to help offset the loss of oil revenues; to increase the efficiency of financial intermediation; to provide attractive local-currency-denominated assets to prevent capital outflow; and to improve methods of monetary control. The financial reform programme, which began in earnest in June 1983, contained a wide and sweeping package of measures which included: measures to reduce the use of credit ceilings as a tool of allocative policy and monetary control; phased removal of particular loan categories from access to Bank of Indonesia liquidity credits; removal of a wide range of loan type from eligibility to such credits; measures to increase the competitiveness of the monolithic state banks, including deregulation of interest rates on most categories of deposits and loans (excepting priority loans); introduction of new methods and tools of indirect monetary control, through the Bank of Indonesia issuing its own debt certificate and introducing two new discount facilities; and introduction of a new money market instrument to allow the Bank of Indonesia more leverage to inject or remove liquidity from the economy.

The reform was followed by a sharp rise in interest rates which had adverse impact on the financial positions of many of the large, indebted, Indonesian bodies. As payments on existing loans began to surpass revenue flows, many firms found their ability to service existing debt sharply eroded. The large increase in credit requirements of priority firms, combined with the reduction in the credit creating capability of state banks, led rapidly to financial problems. The loan portfolios collected under policy structure providing inadequate incentives for project selection, and implicit government credit guarantees, began showing frailty. Indonesian banks began showing heavy arrearage in all sectors.

Box 3: (Continued): Financial Sector Liberalization: The Indonesian Experience

The impact of the reforms on the profitability of banks was predictably adverse, declining for all categories of banks. State banks developed loan exposure so large that their solvency was at stake and the risk of the whole Indonesian financial system collapsing a possibility. Furthermore, long term lending by banks as a proportion of total bank credit started to fall. The Bank of Indonesia was forced to intervene in order to secure the solvency of banks. The Bank partially re-opened access to the discount window. It can be stated that the first financial reform package in Indonesia had little success in achieving its goals and had actually resulted in the weakening of the financial system by aggravating the problems of non-performing loans. A second "big bang" of financial sector liberalization in Indonesia started in 1988 and was announced in three stages: the ***Pakto*** *(banking regulation) of October, 1988; the* ***Pakdes*** *of December 1988; and the* ***Pakjan*** *(credit deregulation) of January 1990. The key elements of the reform were: removal of the monopoly of state-owned banks over deposits of state-owned enterprises; the permission for existing financial institutions to engage in broader areas of activities; allowing foreign banks and non-bank financial institutions to increase branch networks beyond the capital Jakarta and for new foreign banks to enter the market through joint ventures; and dismantling of the tiers of subsidized loans that the Bank of Indonesia used to direct credit.*

Following these reforms, the banking sector doubled in size as more than 135 new commercial banks set up business. Furthermore, the Jakarta stock exchange boomed, as higher interest rates made bank finance an expensive source of capital and banks started to use the stock exchange to raise equity capital. Interbank rates increased an banks began to compete for funds. The reforms were indeed producing a more dynamic financial sector in Indonesia, but basic weaknesses of the system remained. Too much money was being diverted into speculation, and gains being made in the property and stock markets were producing a speculative bubble. The state banks were feeling the squeeze, as they no longer had access to subsidized liquidity credits from the central bank.

Box 3: (Continued): Financial Sector Liberalization: The Experience of Indonesia

Furthermore, the need for corporate firms to refinance their operations at record interest rates produced severe financial problems for many of them,, and in particular those in the agricultural and industrial sectors that had become dependent on subsidized loans.

*The situation reached a crisis in late 1992 with the collapse of Bank Summa, but the symptoms of the crisis had started to become evident in mid-1991 and the Indonesian government reacted by putting in place a new **Pakto** (banking regulation) whose measures included: separation of banking from underwriting and brokerage in order to prevent conflict of interest; better scrutiny of bank directors; higher bad debt reserve levels for banks; and new rules aimed at reducing foreign exchange speculation and share trading by banks.*

*Source: **Limits to Financial Liberalization: The Experiences of Indonesia and the Philippines**, Savings and Development, Quarterly Review, No. 4, Vol. XVIII, 1994.*

should be exercised in the design and implementation of financial reform programmes. A strategy which integrates some aspects of liberalization with the development of appropriate financial institutions designed to serve the **needs of the real economy** may be more desirable to developing countries, and African countries as well, most of which have a relatively underdeveloped financial infrastructure. In such countries, the aim should be to develop and promote financial liberalization strategies which combine measures of liberalization of the sector with the development of old and/or the creation of new financial institutions. [22]

---

[22] *Heather D. Gibson and Euclid Tsakalotos: **The Scope and Limits of Financial Liberalization in Developing Countries: A Critical Survey**, The Journal of Development Studies, Vol. 30, No. 3, April, 1994, PP. 578-628.*

84. The need for financial sector reforms in Africa, in order to improve the efficiency of existing financial markets and develop new ones, is now generally recognized. Nonetheless, the transitional problems associated with such reforms and the worth of knowledge gathered from the Asian and Latin American experiences dictate that pragmatic and realistic programmes should be devised if they are to succeed.

85. Financial sector reforms generally entail a move towards a more market-oriented financial sector and a typical programme often involves an attempt to allow interest rates to be market determined, and a removal of quantitative controls on the allocation and distribution of credit. A shift to market-determined interest rates basically means the monetary authorities relinquish the administrative setting of deposit and lending rates. Financial sector liberalization also often involves reducing quantitative controls exercised by the authorities in credit allocation and its distribution in order to allow the financial institutions greater say on the use of their liabilities.

86. The broader objective of financial sector reforms is generally to eliminate and/or reduce financial repression. Financial repression is usually characterized by the authorities maintaining controls on nominal interest rates, in the belief that low rates will promote investment and minimize the cost of borrowing to government; and maintaining compulsory credit allocation, in the belief that that will result in credit being granted to key priority sectors of the economy. The generally acknowledged negative effects of this policy are that there is no evidence that negative real rates of interest stimulate investment; and more importantly in a financially repressed economy, the government taxes financial intermediation directly or indirectly through forcing banks to hold a certain percentage of their deposits in government bonds or non-interest bearing reserves held at the central bank. Furthermore, the authorities also maintain a variety

of credit allocation programmes such as lending requirements imposed on banks, compulsory loans at preferential interest rates, refinancing schemes, development institutions, and credit grantees. In such an environment, the efficiency of the financial sector is usually impaired.

87. Financial sector reforms are therefore designed to remove some of these market imperfections and introduce efficiency in the financial intermediation process. The danger with some of the financial reform programmes implemented in African countries is that "failures of financial markets" has been equated to "government involvement and intervention" in such markets. This often leadss to the denial of the role of government in the financial sector; except in providing supervisory services and use of indirect monetary instruments. However, as it has been stated the experience of the Asian countries reveals that in the early stages of development, government intervention if appropriately applied can play a catalytic in the development process. The financial reform programmes in Africa often deny this empirical reality. The World Bank Operations Evaluation Department (OED) also advises for careful planning, sequencing and implementation of financial sector reforms within a broader overall economic reform programme:

> "While certain components of the reform program- institutional and competition reforms, for instance- could begin early in the adjustment process, widespread financial liberalization should wait for macroeconomic stabilization and liberalization in the real economy." [23]

88. The need for financial sector reforms in Africa is generally acknowledged. It is also agreed that both the infrastructure and

---

[23] *World Bank: Adjustment Lending: Lessons of Experience, Operations Evaluation Department (OED), Lessons and Practices, No. 2, September, 1993.*

the institutional framework of the sector need to be strengthened for it to effectively play the role of mobilizing resources for development and financial intermediation. Nonetheless, experiences from countries in other regions that have implemented such reforms call for careful design, sequencing and implementation of such programs if at all they are to succeed. This suggests that financial reforms need to be deliberately sequenced with regard to other reforms and realistic timeframes adopted.

REFERENCES

1. J.K. Onoh: **Money and Banking in Africa**, Longman, London, 1982.

2. J.B. Jones: **Then West Africa Currency Board,1912-1962.**

3. S.K. Basu: **Central Banking in Emerging Countries: Study of African Experiments,** Asia Publishing Hose, Bombay, India, 1967.

4. C. Chipeta and M.L.C. Mkandawire: **Links Between the Informal and Formal/Semi-Formal Financial Sectors in Malawi**, African Economic research Consortium (AERC), research paper No. 14, November, 1992.

5. M. Hyuha, M.O. Ndanshau and J.P. Kipokola: **Scope, Structure and Policy Implications of Informal Financial Markets in Tanzania**, African Economic Research consortium, research paper no. 18, April, 1993.

6. Ernest Aryeetey: **The Relationship Between the Formal and the Informal Sectors of the Financial market in Ghana,** African Economic Research Consortium, research paper no. 10, October 1992.

7. Gerald Caprio,Jr., Izak Itayas and James Hanson: **Financial Reform Lessons and Strategies**, World Bank Policy Research Papers, Wps 1107, February 1993.

8. Delano Villanueva and Abbas Mirakhor: **Strategies for Financial Reforms**, IMF Staff Papers, Vol. 37 No. 3, September 1990.

9. Gerald Caprio, Jr. and Lawrence H. Summers: **Finance and Its Reform: Beyond Laissez-Faire**, World Bank Policy Research

Papers, WPS 1171, August 1993.

10. lfred Thorne: Issues in Reforming Financial Systems in Eastern Europe: The Case of Bulgaria, World Bank Policy Research Papers, WPS 882, April 1992.

11. Millard Long and Silvia Sagari: Financial Reform in Socialist Economies in Transition, World Bank Policy Research Papers, WPS 711 June 1991.

12. Eugene L. Versluysen: Financial Deregulation and the Globalization of capital Markets, World Bank Policy Research Papers, WPS 40, August 1988.

13. Mark Gertler and Andrew Rose: Finance, Growth, and Public Policy, World Bank Policy Research Papers, WPS 814, December 1991.

14. W. Max Corden: Exchange Rate Policy in Developing Countries, World Bank Policy Research Papers, WPS, April 1990.

15. Masahiro Kawai: Optimal and Sustainable Exchange Rate Regimes, IMF Staff Papers, Vol. 40, No. 2, June 1993.

16. Lant Pritchett: Measuring Real Exchange Rate Instability in Developing Countries: Empirical Evidence and Implications, World Bank Policy Research Papers, WPS 791, October 1991.

17. Mohsin S.Khan and Peter J. Montiel: Real Exchange Rate Dynamics in a Small, Primary-Exporting Country, IMF Staff Papers, Vol. , No.

18. Ronald Mcdonald and Mark P. Taylor: **The Monetary Approach to the Exchange Rate**, IMF Staff Papers, Vol. 40, No. 1, March 1993.

19. Karim Nashashibi and Stefano Bazzon: **Exchange Rate Strategies and Fiscal Performance in Sub-Saharan Africa**, IMF Staff Papers, Vol. 41, No. 1, March 1994.

20. Miguel A. Kiguel: **Exchange Rate Policy, the Real Exchange Rate, and Inflation: Lessons from Latin America**, World Bank Policy Research Papers, April 1992.

21. Shantayanan Devarajan and Dani Rodrik: **Do the benefits of Fixed Exchange rates Outweigh Their Costs? The Franc Zone in Africa**, World Bank Policy Research Papers, WPS 777, October 1991.

22. Patrick Honohan: **Monetary Cooperation in the CFA Zone**, World Bank Policy Research Papers, WPS 389, March 1990.

23. Dong He and Robert Pardy: **Stock Market Development and Financial Deepening in Developing Countries: Some Correlation Patterns**, World Bank Policy Research Papers, WPS 1084, February 1993.

24. Bela Balassa: **The Effects of Interest Rates on Savings in Developing Countries**, World Bank Policy Research Papers, WPS 56, September 1989.

25. Sergio Pereira Leite and V. Sundararajan: **Issues in Interest Rate Management and Liberalization**, IMF Staff Papers, Vol. 37, No. 4, December 1990.

26. Guillermo A. Calvo and Carlos A. Vegh: **Interest Rate Policy in a Small Open Economy**, IMF Staff Papers, Vol. 37, No. 4, December 1990.

27. Nicola Rossi: **Dependency Rates and Private Savings Behavior in Developing Countries**, IMF Staff Papers. Vol. , No.

28. Jonathan D. Ostry and Carmen M. Reinhart: **Private Saving and Terms of Trade Shocks**, IMF Staff Papers, Vol. 39, No. 3, September 1992.

29. Roger S. Smith: **Factors Affecting Saving, Policy Tools and Tax reform**, IMF Staff Papers, Vol. 37, No. 1, March 1990.

30. Carlo Cottarelli and Angeliki Kourelis: **Financial Structure, Bank lending Rates, and the Transmission Mechanism of Monetary Policy**, IMF Staff Papers, Vol. 41, No. 4, December 1994.