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Deepening Financial Markets in Francophone West Africa*

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Abstract

The financial sector is becoming more important because of the natural resource booms. The taxation of natural resource exports will generate large increases in revenues and this will transform the ability of governments to borrow in the markets for sovereign debt. These constitute temporary influxes of money: resources will deplete and debt must be serviced. Hence, to be sustainable, they must be channelled into productive assets. The public financial sector – central banks, sovereign asset funds, and development banks – has the critical role of administering this process. ... / ...

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.../... The implication of the resource discoveries for private investment is that since the economy will be growing rapidly, investment offers higher returns and lower risks. Investment demand will increase across a wide range of real assets. The financial sector needs to meet this demand for loans: raising the finance and allocating it to projects. The resource booms also have implications for the respective roles of the public and private financial sectors. To date the private financial sector has helped to finance public investment. The resource booms change this: governments will have far more revenue, and bankable investment opportunities will strongly increase. Hence, instead of funds flowing from the private financial sector to the government, they will need to flow in the other direction: surplus public revenues need to be allocated to private investments through the financial sector.

1. Introduction: The New Opportunity

The Franc Zone provides its members with a public good that has two important benefits – a low-inflation environment, and a common currency that spans many small economies. This public good has the potential to enhance the functioning of the financial sector, both public and private. That potential is about to become much more important because across West Africa the major new economic phenomenon is the natural resource booms. Senegal is an example: what until recently was an agricultural economy is being transformed by an array of resource discoveries. Burkina Faso is now a major exporter of gold. I discuss these developments more fully in two recent books (Collier, 2010, Collier and Venables, 2011). Here I want to focus on their important implications both for public finances and for investment and hence for the financial sector.

The implications of the resource booms for public finances are both direct and indirect. Directly, as new discoveries come on-stream, the taxation of natural resource exports will generate very large increases in revenues. Indirectly, this will transform the ability of governments to borrow in the markets for sovereign debt. When Senegal issued a sovereign bond two years ago the interest rate it had to pay was 9 percent. In contrast, when Zambia issued its first sovereign bond in September 2012, it was over-subscribed by \$12bn and the interest rate was only 5.6 percent. Zambia is a fairly typical African country, with fairly abundant natural resources and reasonable democratic governance. There is a major difference between borrowing at 9 percent and at 5.6 percent. Borrowing at 9 percent is extremely risky: unless the entire proceeds of the loan are well-invested in public assets the return is unlikely to cover the costs. In Senegal, as I will show, neither of these conditions looked to be credible. However, the potential to borrow commercially at acceptable rates enables resource revenues to be substantially scaled up.

The resource booms have important implications for both public and private investment. As to public investment, both resource revenues themselves, and the sovereign borrowing they permit, are temporary influxes of money: resources will deplete and debt must be serviced. Hence, to be sustainable, this new public money must be channelled into productive assets. The public financial sector – central banks, sovereign asset funds, and development banks – has the critical role of administering this process.

The implication of the resource discoveries for private investment is that since the economy will be growing quite rapidly, investment offers higher returns and lower risks. It is therefore likely that investment demand will increase across a wide range of real assets. An important role for the financial sector is in meeting this demand for investment: raising the finance and allocating it to projects. In raising the finance to meet the demand for investment, savings can potentially be attracted directly from the public sector, from domestic households and firms, and from foreigners. In allocating lending, the financial sector needs to develop much stronger capacities to assess risks and returns both at the level of the individual project and the sector. As to which sectors are most important, although governments often instinctively want to encourage investment in the resource sector itself, and also export diversification, the most important private investments are in those goods and services which are not readily tradable internationally, such as retail distribution. Within the non-tradable sector, expansion of the construction sector is particularly important. Investment goods are

partly in the form of equipment and partly in the form of structures. Whereas equipment can be imported, structures have to be constructed domestically and the capacity to produce them can become a bottleneck.

Finally, the resource booms have important implications for the respective roles of the public and private financial sectors in scaling up public and private investment. To date, in much of Africa, the private financial sector has helped to finance public investment. There was a double rationale for this: the public sector wanted to invest but lacked tax revenues, whereas the private sector was not generating many bankable investment projects. The vehicle for this flow of finance has been domestic sovereign debt which has been held by the banking sector. In effect, the government borrowed money from the banks to finance public investment. The resource booms radically change this: governments will have far more revenue, and bankable investment opportunities will strongly increase. Hence, instead of funds flowing from the private financial sector to the government, they will need to flow in the other direction: surplus public revenues need to be allocated to private investments through the financial sector. The architecture of how public revenues can safely be used to finance private investment is one of the three new challenges of facing the financial sector. The other two challenges are how the public financial sector can manage the flow of new revenues into public investment, and how the private financial sector can manage the flow of private savings, domestic and foreign, into private investment. The use of public finance for private investment is the most contentious of the three challenges and it is probably the least important, so I will leave it till last. First, I turn to the most important challenge – how the public financial sector can channel public revenues into public investment.

2. The Role of the Public Financial Sector in Scaling Up Public Investment

West Africa is chronically short of public investment. Both contributing to and reflecting this shortage, governments currently lack the capacity to convert public revenues into good projects. The vital role of the public financial sector is to build and then utilize this capacity. Conceptually, it has two stages. First, a sufficiently high proportion of the new money must be ring-fenced for investment, protected from political pressures to use it for consumption. Second, the actual design, selection and implementation of public investment projects must be subject to much higher standards than has been customary.

Ring-Fencing Public Money from Consumption

Consider the first stage, which is about the political ring-fencing of revenues and borrowed money for public investment. It is evident that there will be periodic political pressures, notably around election times, to use such money for consumption. The challenge for the public financial sector is to be able to resist this pressure. The defences that can be built are a combination of rules, institutions, and support from citizens and their representatives. Ghana provides a good current example both of the political pressures and of how rules can be used to contain them. Upon discovering oil in 2007, the then government of Ghana instructed the central bank to issue sovereign debt. Once this money was borrowed, the government spent heavily in the run-up to the election. Inevitably, this spending included much consumption and ill-considered investment. However, Ghanaians swiftly learnt from

these mistakes. In 2011 the legislature passed a constitutional amendment requiring that 30 percent of oil revenues should be saved. Laws on borrowing were also enacted. These are pertinent examples of how new rules can be used to guide the distinctive decisions faced by resource-rich countries. So what should the rules be?

Budgets in resource-rich countries are essentially decision processes for allocating revenues to a variety of expenditures. Over recent decades two principles of good budgeting have been widely accepted; one macro the other micro. The macro principle is that aggregate expenditures should be kept broadly in line with aggregate revenues (which for present purposes we will treat as exogenous). Commonly, this principle has been encapsulated in the *balanced budget rule* which sets ceilings both for the fiscal deficit and for the ratio of debt to GDP. The micro principle is that the marginal benefit of expenditures should be equated across categories. Since it is reasonably assumed that priorities will change over time, this principle has been encapsulated in the *integrated budget rule* which discourages pre-commitments of revenues, and earmarking of particular revenue streams, to particular items of expenditure.

Resource-rich developing countries face distinctive fiscal problems, the solutions to which involve distinctive principles. They therefore need distinctive rules which encapsulate these principles. At the core of the distinctive problem is that, unlike other countries, the key revenue source for government spending is *unsustainable*. Manifestly, this is not a marginal problem: unless it is properly faced the consequences for welfare are liable to be disastrous. Hence, we should not expect it to be adequately dealt with by minor tweaks to the budget process. It is particularly problematic because inter-temporal resource allocation is an issue that standard budget procedures barely address: budgets are essentially devices for annual commitment. At the most, governments announce Medium Term Fiscal Frameworks, but these are essentially informal statements of intentions over a three year horizon; not only do these statements of intent have only limited credibility, there is no intention that they will bind a successor government beyond an election.

The distinctive principle for a resource-rich country is that a certain proportion of revenues should be saved, whether in financial assets or domestic investment. Conventional budgeting processes are inadequate to deal with this problem in two important respects. First, they lack any mechanism for inter-temporal commitment, most especially over the horizon of around a generation which is likely to be required for resource depletion. Commitment technologies are valuable to governments to reduce the risk of temporary lapses resulting from random short term political pressures: that is indeed why they adopt the balanced budget rule and the integrated budget rule. But in the case of savings out of resource revenues a commitment technology is even more important. It is not just that without it there is a risk of a random lapse; rather, without it the incentive to save is reduced even for a good government. Without a commitment mechanism, the savings of one government may merely transfer spending power to a bad successor. Indeed, the rationale for saving depends upon the current government believing that *all* future governments will behave prudently. In the absence of a rule, a good government may reasonably decide that it is better to spend all the revenue now on items that it regards as desirable, rather than risk its savings being spent by a successor government on items that the current government regards as less valuable. Worse, without a commitment technology, as

wealth accumulates the incentive to be a rogue government that favours only expenditure on consumption actually increases. Hence, a long-term savings rule is not a mere nice-to-have addition to the standard budget rules, it is paramount.

Second, because the balanced budget rule is defined in terms of expenditure relative to revenues, it misses the key required distinction between expenditure on consumption and the acquisition of assets. Domestic investment, which is aggregated under the balanced budget rule with consumption as expenditure, is the activity which for a resource-rich country it is most important to distinguish. Hence, the recent practice of modifying the balanced budget rule so as to exclude resource revenues – through concepts such as ‘the non-oil fiscal balance’ – has only limited analytic basis. Indeed, the government of a resource-rich developing country which actually constrained total expenditure to be equal to non-resource revenue would be massively misallocating its resource revenues, both under-consuming and under-investing. Conventional budget rules cannot be restored to relevance simply by setting resource revenues to one side. Rather, the principles underlying the optimal management of resource revenues must be woven into the foundation of a distinctive set of budget rules.¹

Rules for Offsetting Depletion

Savings from resource revenues need to be substantial, and in most circumstances the actual rate of saving out of revenues should rise over the course of depletion: all revenue from the last barrel of oil should be saved, otherwise it is unsustainable. How best might this principle of a rising savings rate be incorporated into rules? Formulating a rule involves a trade-off between accuracy and simplicity. The less accurate is the rule the more sub-optimal the allocation it will generate and the more subject is it to challenge and change. However, it is more difficult to build a critical mass of citizen support for a complex rule than for a simple rule. A sensible compromise between accuracy and simplicity may be to have a rule in which the savings rate starts at some modest rate, rising annually through the lifetime of extraction. For example, the revenues from an oil discovery with an economic life of 20 years might start with a savings rate of 30 percent, as in Ghana, and rise annually by three percentage points so as to end at 90 percent. Would such a savings rule be practical politics? Arguably, it might be more practical than a rule for a constant savings rate that cumulated to the same asset value. Evidently, it is easier for politicians to commit to the formula ‘God make me good, but not yet’. This is, indeed, the explanation for the infamous ‘weeping willow’ pattern of medium-term budget projections: the government acknowledges that this year spending will rise, but reassures markets that this will be reconciled by future fiscal tightening. Yet in respect of savings from natural resource revenues, such a behaviour profile is actually optimal: the politically easy is the appropriate decision.

Rules for Managing Volatility

One simple principle for smoothing expenditures in the face of revenue volatility is a *hedging rule*: governments should lock into budget assumptions by hedging resource revenues for the forthcoming year. This, for example, is already being done by the government of Ghana. A more complex, but fundamental principle is that governments should make an assessment of optimal expenditure: that

¹ I elaborate on this in Collier (2012).

level above which revenues should be parked, and below which expenditures should be sustained by drawing on liquid assets. It is important to ground this estimate in realism. One approach is a Chilean-style panel of independent experts. Another is to adopt a mechanical rule such as a long-term moving average of commodity prices. The mechanical rule has the advantage that it cannot be as readily manipulated by political pressure and is more transparent. Further, it is manifestly not a forecast and so it is easier for citizens to understand that it is liable to be wrong and so needs an override rule as a second line of defence. That second line of defence is a further rule, namely that if liquid assets become dangerously depleted due to a run of misfortune, expenditure needs to be reduced preemptively below its optimal level rather than risk an abrupt collapse in expenditure upon the exhaustion of liquid assets. A simple and effective formulation for the rule is that in no year may more than a certain proportion (such as a quarter) of the remaining liquid assets be withdrawn. In the event of persistent over-optimism in revenue projections this imposes a gradual adjustment to reality. The final rule specifies the target level of liquid assets. This is analogous to the conventional target for foreign exchange reserves, commonly specified as so many months of imports. In the case of resource revenues, the numeraire should evidently be the revenues themselves rather than imports: hence the rule would be that *liquid assets for purposes of smoothing revenue volatility should be built up to a certain multiple of resource revenues*. The actual multiple can only be determined by studying the expected volatility of revenues and the damage that expenditure volatility would inflict.

In equilibrium the government will thus be holding foreign financial assets for two different purposes, expenditure smoothing and offsetting depletion. There is a good case for holding these assets in separate funds, with distinct rules. The key difference is that the depletion offset fund needs to be protected from being plundered to finance consumption. As discussed above, the distinctive challenge facing resource-rich societies is the need for commitment to long term asset accumulation. Hence, this needs to be embodied in the rules of the depletion offset fund. The rules cannot, however, be as simple as saying that financial assets cannot be liquidated, since it will be optimal gradually to shift the composition of the fund from foreign financial assets to domestic investment. Hence, the rule should be that *assets cannot be liquidated to finance consumption*. To distinguish this accumulation of both foreign and domestic assets from a conventional Sovereign Wealth Fund, I refer to it as a *Sovereign Development Fund*. In contrast, this is part of the legitimate purpose of the smoothing fund. It is not the only purpose, since the fund is meant to smooth all expenditure, both on consumption and investment. Hence, for this fund, the rule should be that the assets cannot be liquidated to finance expenditures in excess of the planned expenditure. Further, it might be useful to place the implementation of the hedging rule within the smoothing fund: analytically, it is a means of achieving expenditure smoothing, and politically it enables the Finance Minister to be distanced from the decision to spend money on any particular hedge which may or may not turn out to have been vindicated by events. The purpose of the fund is thus to make expenditure resilient to revenue shocks, whether by hedging or by the accumulation of liquidity, and so I term it a *Sovereign Resilience Fund*.

Building Capacity for Public Investment

The second stage in converting public money into productive public investment is to build the capacity to invest. I term this investing-in-investing. The IMF and World Bank have recently

benchmarked public investment processes for 71 developing countries with a Public Investment Management Index. This has four components: project appraisal, project selection, project implementation and project evaluation, and each is scored on a scale of 0-4. Fortunately, six of the eight BCEAO member countries have been benchmarked and I present the results in the Table below.

Table 1: Public Investment Management Index for BCEAO Countries

Country	Overall PIMI	Appraisal	Selection	Implementation	Evaluation
Mali	2.16	3.17	2.40	1.73	1.33
Burkina Faso	2.09	1.17	3.20	2.00	2.00
Cote d'Ivoire	1.87	3.50	1.20	1.47	1.33
Benin	1.56	1.17	2.40	2.67	0.00
Senegal	0.94	0.83	1.60	1.33	0.00
Togo	0.92	1.00	0.80	1.20	0.67

Source: Dabla-Norris et al (2011)

To get a sense of what is possible South Africa has an overall PIMI score of 3.53 and Brazil of 3.12, so scores below 2.0 which characterizes four of the six countries are very troubling. Note, for example, that while Senegal was borrowing money at 9 percent, its capacity to undertake public investment as measured by the PIMI was extremely low, at only 0.94. Borrowing at such high rates in these circumstances was evidently irresponsible yet the public financial system in Senegal was not in a political position to restrain the government: it lacked rules, institutions and a critical mass of informed citizens, so these things need to be built.

However, what is striking about the PIMI scores for the BCEAO countries is not that they are low, but that drilling down in detail, they are very variable. For example, Cote d'Ivoire is exceptionally good at project appraisal, although very bad at everything else. Rather than the difficult task of learning from South Africa or Brazil, suppose that the member countries of the BCEAO learnt from each other. Specifically, suppose that all countries raised each component of the index to the best level already attained by any member. So, appraisal would be modelled on practice in Cote d'Ivoire, Selection and Evaluation on Burkina Faso, and Implementation on Benin. This would raise the PIMI to 2.84, placing the BCEAO countries collectively as the fifth best among the 71 developing countries rated, on a par with Thailand. I see no overwhelming obstacle to the BCEAO facilitating such learning, for example, encouraging Burkina Faso to learn from Cote d'Ivoire and Cote d'Ivoire to learn from Burkina Faso.

Where institutionally should the capacity to appraise, select, implement and evaluate public investment projects be lodged? It is a set of public financial skills that are probably best not subsumed within Ministries of Finance. The core job of a Ministry of Finance is to run the annual budget, and so its institutional DNA is not well-suited to long term financial thinking. Sound instincts for long term financial management are more naturally found in central banks. Hence, my suggestion is that such capacity should be lodged in Sovereign Development Funds operated under the joint auspices of the BCEAO and the national Ministries of Finance. Indeed, by building some common capacity across member states, it would be possible to economize on scarce but necessary skills. To be clear, the purpose of such a Sovereign Development Fund would not be to take public investment out of the national budget process, but rather to reinforce decision taking with semi-independent expertise that had the authority to vet proposed projects.

3. The Role of the Private Financial Sector in Scaling Up Private Investment

The past role of the private financial sector in financing public investment through holding government debt gave the banking system an easy life: it took in deposits from households and firms and passed money on to government. It did not need to develop the skills necessary for profitable finance of private investment. The prospective boom in private investment makes it imperative that these skills now be developed, but it is not clear that the traditional banks are well-suited to this role. The core private business of most African banks is not the finance of long-term investment, but the finance of working capital and trade credit. This is necessary, but not sufficient.

In a modern economy private investment has two dominant components: households invest in housing, and firms invest in equipment and structures. Housing is the single most important component of investment, typically around half of all tangible assets. In West Africa this simply has not happened. The financial sector relates only to high-income housing, leaving the potential mass market of housing for ordinary urban households completely unmet. Conversely, firms find it extremely difficult to raise the long-term risk-bearing finance needed for fixed investment in equipment and structures. I will therefore focus on these two unmet needs: mortgage finance for simple urban housing, and long-term risk capital for firms.

Housing finance²

Commercial banks have administrative cost structures which preclude their entry into the finance of mass housing. In the 19th century Britain urbanized, at a pace and at income levels broadly comparable to Africa now. That urbanization triggered innovation in the mortgage market: the invention of building societies. They were able to out-compete banks because they had much lower administrative costs and much lower risks and so could work on narrower spreads. Their lower costs reflected their specialization in long-term, low-risk lending: the setup costs of a loan could be spread over many years and default was limited by good collateral. Not only were spreads low, but in 19th century Britain inflation was low, so that nominal interest rates could be low. As a result, the repayment of a loan was not artificially accelerated by the erosion in real terms of the principle. With low administrative costs

² The discussion of housing finance draws on Collier and Venables, 2012.

and a substantial branch network, building societies were able to lend at repayment rates of around 5 percent per year. They were also able to build a large deposit base from ordinary savers. While lending very long and borrowing short was potentially a recipe for a run on deposits, the conservative business model protected them from insolvency and the central bank protected them from illiquidity. In the 19th century it was the banks rather than the building societies that faced runs on their deposits.

Although some African cities have building societies, they cater to either high-end housing, or to civil servants. The task is to reinvent them for ordinary housing. To get an order of magnitude for housing finance that would be enable the purchase of a decent home by a non-elite household, we need some assumptions as to the debt service that is viable, and the cost of a house. Based on typical rental rates in Dakar, payments of interest and principle would be affordable to the occupants of informal housing at around \$500-\$800 per year. Suppose that the unit cost of decent housing could be reduced to around \$15,000. Then, a mortgage of around two-thirds of the cost of the house would be viable at an interest rate of around 5 percent. Further, with the advent of e-banking, the scope for mass savings has been demonstrated: the M-KOSHA scheme in Kenya attracted over a million savings accounts in its first year of operation. There is evidently potential for building societies to use e-technology to harness this depositor base.

However, for housing to function as low-risk collateral, building societies need other conditions to be met. Legal title has to be clear, and court processes reliable. Further, systems whereby a lender can cheaply observe the credit history of the borrower, whether there are other liens on the property, and the actual occupancy of property (to establish whether it is tenanted) are needed. Housing must be affordable, of standard design, and built to enforced standards, so that it can readily be accurately valued. African housing investment has been affected, directly and indirectly, by public policies that have prevented the formal sector from providing housing that meets these requirements: for example, building standards have been set too high. These standards have not been enforced beyond the remit of the formal sector, and so if informality were efficient urban Africans would be well-housed. Informal builders would build decent homes cheaply; informal finance would finance them cheaply; informal dispute settlement procedures would restrain opportunism; community processes would coordinate to provide the public goods of settlement; and the market itself would internalize the value of rising density. Yet ordinary urban households are not well-housed: the typical living quality provided by informal housing is pitiful, and it also fails to provide the resident labour force with sufficient proximate opportunities for decent incomes. For investment in housing to happen on a large scale through formal channels requires a series of supporting conditions. Unit costs of construction in the formal sector must be low enough to be affordable by ordinary urban households. Legal title must be secure, marketable and support collateral and rental. Finance must be available and affordable both for small construction firms and for mortgages. Infrastructure must be planned and provided in advance of settlement, and residential services must swiftly be forthcoming subsequent to settlement, while both must be financed by capturing a share of the value added to productivity by density. The location of settlement, transport infrastructure, and public regulation must be supportive of income opportunities. Each of these is not merely vulnerable to inept policies; it is in need of appropriate policies.

The persistence of multiple impediments is because the payoff to policy reform in any one of these areas in isolation is very limited, given that the others remain and will in aggregate be binding. Since each is the responsibility of a different group of policymakers, the rational strategy for each policy team is inaction. The potential for urban housing can be unleashed only by a coordinated push across a wide range of policy teams. This in turn requires that housing policy be elevated politically. Within African governments, Ministries of Housing largely restricted their focus to the provision of housing to senior civil servants, and the maintenance of inherited formal regulatory standards which conformed to international practice. Meanwhile, among international thinking on African housing policy, the prevailing view has become that the priority is to help informal housing to work better rather than to make formal housing investment work for ordinary households. Such an approach accepts rather than confronts the lack of coordination.

Long-term risk capital for investment by firms

Private finance for investment has had two fashions: local stock markets and micro-finance. However, neither of these is important for the growth process. Stock markets have proved to be insufficiently liquid to be other than decorative, and micro-finance focuses on micro-enterprises whereas what matters is finance to scale up established firms. The pertinent financial mechanism is neither social enterprise nor stock markets, but venture capital.

Venture capitalists typically provide not only long-term equity but management expertise. This hands-on role both builds the human and organizational capital of the firms in which they invest, and provides a flow of information whereby investors can continuously update their judgments, learning where to put in extra capital and where to write off losses. In turn, venture capitalists either risk their own money or raise it in international capital markets. Market conditions have never been better for raising finance for venture capital in Africa. International portfolio managers have been forced to recognize that prospects for OECD economies are far worse than they had expected, implying both lower returns and higher risks, whereas Africa has become the fastest growing region in the world. Since current portfolios hold virtually no African assets, over the next few years there will be considerable movement of capital. The remarkable investor appetite revealed for Zambian sovereign bonds is indicative of this rapid shift in investor perceptions.

The typical venture capital firm that can operate successfully in West Africa will have a mixed team of international and local expertise. It may usefully be twinned with business schools that can deepen business skills. BCEAO may need to review regulatory arrangements to ensure that they are conducive to the sector.

4. The Role of the Public Financial Sector is Scaling Up Private Investment

Finally, I turn to the contentious issue of whether public finance should be channelled to private investment.

The record of national and sub-regional African development banks is discouraging. Intrinsic to banking is the exercise of judgment, and this implies considerable room for discretion: lending decisions cannot be mechanized. But discretion exposes decisions both to corruption and to

accusations of corruption. Given the heightened suspicion of government current in West Africa it is doubtful that the pre-conditions yet exist for successful general purpose development banks that lend on a discretionary basis on business propositions.

Consider each of the proposed three components of the private financial sector: banks, building societies, and venture capital firms. The banks will automatically have more finance available for private firms as the government ceases to need to borrow domestically. In the limit, the government can start buying back its domestic debt – quantitative easing - thereby transferring public money to the banks in a way that avoids any moral hazard. This would force the banks to develop the skills with which to deploy the money in the private sector. Channelling public money to venture capital firms would be extremely risky: the essence of successful venture capital is that firms should have their own money at risk. Performance of venture capital firms is difficult to observe and so the scope for corruption would be considerable.

In contrast, to the banks and venture capital firms, channelling public money into building societies has several advantages. To avoid the perception of corruption, public financial institutions should not themselves take on the functions of building societies. Rather, the Sovereign Development Fund should lend money to them, while the BCEAO supervises them to ensure that they are properly managed. In Britain, the failure adequately to supervise Northern Rock produced the first bank run in 150 years.

The case for providing public money for ordinary housing is a strong one. Even Chile, which has a very tightly-managed public sector, subsidizes private low-income housing investment. The first advantage is that it is low-risk: the underlying assets that function as collateral have value that does not depend upon many unobservable and uncontrollable aspects of the investment, unlike finance to enterprises. The second advantage follows from the political economy of the housing sector: many of the determinants as to whether housing is good collateral, such as the functioning of the legal environment and the provision of supporting infrastructure, are under the control of the government itself. By making a significant investment in the housing sector through finance for building societies, the government increases its incentive to reform housing policies. Third, housing has important employment externalities. Its construction employs low-skilled young men who might otherwise be a source of social trouble. Fourth, it has important political externalities: its ownership by ordinary households builds a class of people with an economic stake in the polity: houses are the classic foundations of a 'property-owning democracy'. Fifth, decent housing has health externalities such as improved sanitation, and education externalities such as the enhanced ability of children to do homework. Finally, urban housing has growth externalities: decent urban housing will usually be multi-storey in contrast to single-storey informal housing. This enables economic density to be increased without overcrowding. Increased economic density is itself an externality since it enhances the demand for local businesses.

Recall that in a well-functioning economy investment in housing is not marginal: it is typically around half of all tangible investment. Hence, if the public financial institutions focus on transferring public money to this type of investment they are not merely wagging the tail of the dog: they are wagging the dog!

5. Conclusion

West Africa is at a promising moment of economic opportunity provided by its resource discoveries. The lesson of Nigeria tells the region that this opportunity is not automatic: harnessing public revenues to sustained development is challenging both politically and technically. The financial sector is critical for this process: its institutions are the systems of governance and decision which determine whether revenues are invested productively or spent unsustainably.

There are some tempting sirens of fashion. Under current market conditions it is tempting to issue sovereign bonds. But until the crucial task of investing-in-investing has been undertaken the money raised could not be well used. Modernity appears to beckon through the establishment of conventional Sovereign Wealth Funds. But such funds would lock money away in very low return foreign investments and so would be irresponsible. Politicians will surely wish to revive general purpose development banks, offering their appointees discretion in handing out money to firms. It is clear where this would be likely to lead: back to the past.

Instead, I have suggested some practical initiatives. In the public financial sector two new institutions are needed: Sovereign Development Funds and Sovereign Resilience Funds. The former ring-fence for investment a legislated share of resource revenues, together with all money borrowed abroad. They also build the capacity for public investment, thereby servicing the investment component of the national budget. Sovereign Resilience Funds hedge revenues to protect the budget in the short term, and save surplus revenues to smooth expenditure over the medium term. In the private sector I have suggested encouraging building societies to provide finance for low-cost formal housing, built by the private sector. At the other end of the asset spectrum, I have advocated the encouragement of venture capital firms providing long-term equity finance for established enterprises. Finally, while being cautious regarding the channelling of public revenues to private investment, I have suggested that there is a strong case for public finance to be channelled into building societies. If depleting natural assets are converted into decent affordable housing through an efficient financial sector the next generation will thank you.

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