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## Article

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## Financial sector development in Africa—an overview

It is now generally accepted that financial sector development is central to economic development (Levine, 1997), and that inclusive financial systems are important for inclusive development (Levine, 2004, Park and Mercado, 2015). The positive impact of financial sector development on economic performance is also supported by evidence from Africa, although the results are not strong mainly due to poor quality of available data (Senbet and Otchere, 2010).

Financial systems perform multiple functions, including liquidity provision, information production, price discovery, risk management, and governance, etc. (Levine, 1997). For financial development to have the desired impact, there has to be clear channels or linkages to economic development. In the banking sector, for instance, mere savings mobilization is insufficient unless these savings are intermediated for efficient resource allocation through private credit provision. By the same token, the mere existence of stock exchanges is immaterial unless they are active in the production of information and liquidity through well-functioning trading systems (see Senbet and Otchere, 2010, for details). Therefore, in designing financial sector reforms, policies should be guided by a functional perspective of financial systems, and not just savings and capital mobilizations.

To enhance the developmental potential of finance, most African countries liberalized their financial sectors between the late 1980s and the late 1990s, mostly as part and parcel of the structural adjustment programmes promoted by the IMF and the World Bank. The reforms included removal of credit ceilings, liberalization of interest rates, restructuring and privatization of state-owned banks, the introduction of a variety of measures to promote the development of private banking systems and financial markets. Accompanying these measures were bank supervisory and regulatory schemes, including the introduction of deposit insurance in certain countries (Cull et al., 2005).

At a broader level, a more liberalized financial environment has emerged in Africa because of financial sector reforms. These

reforms have also been stimulated by rapid improvements in global conditions and technology connecting Africa with the outside world. Therefore, it is not accidental that Africa began to experience good performance both in the real and financial sectors. Until recently, Africa had experienced uninterrupted growth for about two decades, and was for many years one of the highest growth regions of the world (IMF, 2013). It is also interesting that even stock markets began performing impressively. During the pre-crisis period, African stock markets performed surprisingly well in terms of both absolute returns and risk-adjusted returns (Senbet and Otchere, 2010, Allen et al., 2011), despite the challenges they had faced in terms of low capitalization and liquidity.

Moreover, there are currently encouraging forces at play that enhance the prospects of Africa to integrate into the global financial economy. For example, there is growing integration of world capital markets, including those in emerging economies, with increasing capital mobility. Barriers to international capital flows have been reduced. In addition, there are rapid advances in information technology connecting Africa with the outside world, allowing outside investors seeking the benefits of international diversification to access African financial systems in an efficient manner.

Despite this impressive performance both in terms of financial sector reforms and economic growth, financial markets in Africa are considerably less well-developed than markets elsewhere in the world on virtually all indicators of financial development (Green, 2013). In fact, the financial sectors of most African countries remain quite underdeveloped even by the standards that obtain in low income countries. The development gap and financial inclusion gap are wide in Africa (Allen et al., 2016). The development gap pertains to both banking and non-bank systems. In the non-bank finance area, for instance, based on the standard measures of trading activity and capitalization, most African stock markets are quite thin with low levels of liquidity provision. This issue is being increasingly recognized as an impediment to economic growth, and there are now ongoing initiatives to build regionally integrated stock markets.

Notwithstanding its less developed status, the financial sector in Africa weathered the recent crisis remarkably well, especially when compared to other developing regions. There are several reasons for this outcome: first, the generally weak integration with the rest of the global financial sectors meant the potential for direct contagion was minimal. Second, even in countries such

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as South Africa where the financial sector is well integrated with the rest of the world, contagion effects were minimal, especially in the banking sector, largely due to robust regulation of the banking sectors in Africa (Kose and Prasad, 2010). Third, weak financial deepening may also have worked to enhance resilience of the African financial sector through reduced exposure (low share of private sector credit relative to GDP).

The global financial crisis was a rude awakening to governments around the world. It revealed severe regulatory gaps and distorted incentives in the banking sector and the overall financial system, which lead to a build-up of risk exposures not only by banks but “shadow” banks as well. The crisis has spurred renewed efforts to enhance the resilience of the financial sector by reducing the frequency and severity of future crises through among other things, the introduction of the Basel III accord. Moreover, apart from capital standards, there are now standards for supervision and monitoring of bank liquidity, which typically arises from a mismatch between short term bank liability and long term assets. A major feature of the 2008 global crisis was a sudden dry up of liquidity in the system, which led to the shutdown of the credit markets in the US and beyond.

Financial sector regulators in Africa have also embraced some elements of Basel III to strengthen their financial sectors through beefing-up regulatory capital, improving risk management and governance, etc. However, the other challenges faced by African policy makers include the need to enhance financial broadening through financial inclusion, as well as financial deepening (Beck and Maimbo, 2013).

Despite these developments however, a lot remains to be uncovered regarding the African financial sectors. This special issue is informed by several considerations. *First*, much of what is known about development finance in breadth and in detail tends to be based on, to a large extent, the experiences of the more intensively researched Asian and Latin American economies, and less on the African experience. *Second*, the sub-Saharan African experience itself is diverse, with South Africa and to some extent Nigeria and Kenya increasing in maturity in financial market development, while the rest of countries lead small, relatively underdeveloped and fragmented financial markets (Green, 2013). This raises the question of how one could rationalise these varied experiences and whether the “successful” experiences with financial sector development are replicable in the hitherto less successful economies.

Even among the relatively more successful countries, the paths followed appear very different. In Kenya, for example, financial broadening appears to be at the centre of financial sector development, while the South African case is rooted in financial deepening. There is thus a need for more country focused studies to unmask the peculiarities of the different African economies (see for instance, Allen et al., 2016). *Finally*, the global financial crisis, and earlier crises have introduced new uncertainties for all emerging markets and pre-emerging countries, such as sub Saharan Africa (SSA). This calls for more research to inform how SSA can and ought to adapt its financial sectors to this new environment, and thus enhance its resilience to shocks, whether they emanate from the domestic or international environments.

To shed light on these many issues pertaining to developments in the sub-Saharan African financial sector, and its linkages to economic performance, the African Economic Research Consortium (AERC) commissioned collaborative research on the theme: *Financial Sector Reform and Development in Africa*. The project is broad in scope, covering issues such as financial regionalisation and globalisation; financial liberalisation and how it impacts growth; financial inclusion and finance for SMEs; financial sector innovations, including mobile money; banking sector and stock markets developments in sub-Saharan Africa, and financial sector regulation and competition.

This special issue is based on selected papers from the collaborative research. For this review, we categorize the contributions into four parts, namely access to finance and SME financing, financial services and inclusion, banking systems and stability, and markets and developments. In the following section, we provide an overview of the papers.

## 1. Part 1: Access to Finance and SME Financing

Financing constraint severely affects developing countries, particularly African countries and this problem can inhibit firm growth and exacerbate poverty. Using enterprise-level dataset from the World Bank’s Enterprise Survey, **Babajide Fowowe** investigates the effects of financing constraints on growth of firms in Africa using both objective and subjective measures of access to finance. Preliminary analysis shows that African financial systems are characterized by small banking systems. Banks in Africa are poor in channeling deposits to the most efficient uses, signaling low intermediation efficiency. This constraint leads to situations where banks prefer to invest in government securities rather than lend to the private sector. In addition, African banks have low outreach, with banks enjoying high interest rate spreads and targeting short-term finance, to the detriment of long-term finance for investments.

A key feature of the dataset used in this study is that it provides a set of subjective measures of access to finance which reflect firms’ perception of the business environment, as well as objective measures of the business environment (such as whether firms have an overdraft facility), which help overcome the potential shortcomings of subjective measures. The subjective measures suggest that financial constraint exerts a significant negative effect on firm growth. Also, Fowowe finds significant positive relationships between the objective measures of finance and firm growth; specifically, the objective measures show that firms that are not credit constrained experience faster growth than those that are credit constrained, thus prompting the author to conclude that participation in financial markets promotes firm growth.

The constraints have led to several outcomes. First, African firms have limited access to external finance; only about 23 percent of African firms use loans, while about 46 percent of non-African firms have loans or lines of credit. The author attributes this state of affair to high interest rates, complex application procedures, and high collateral requirements, among others. Second, African firms rely extensively on banks for external finance, with the sample firms obtaining over 75 percent of

external finance from banks. Third, African firms face high account fees, high minimum balance, and restrictive documentation requirements. All these factors inhibit firms' ability to obtain credit. A policy implication emanating from the results is that firms that wish to grow must overcome credit constraints and obtain more external finance. In addition, the development of credit rating agencies and better risk assessment departments in banks to ensure effective risk assessment of borrowers can reduce loan default rate and consequently, bank margins.

One group that is significantly affected by access to finance or lack of it in Africa is small and medium sized enterprises (SMEs). In most African countries, SMEs are perceived as the engine of growth and transformation. However, access to finance continues to plague this sector. In the second paper, **Peter Quartey, Ebo Turkson, Joshua Abor and Abdul Iddrisu** examine SME access to finance in the West African sub-region where the problem of access is very acute and has contributed to the slow growth of SMEs. The authors examine, among others, whether there are similarities and/or differences in the determinants of SMEs' access to finance across countries in the sub-region. They observe that long-term financing in terms of equity capital is virtually non-existent for the SME sector. In most countries within the ECOWAS sub-region, the SME sector faces serious constraints in accessing formal finance. Factors such as lack of collateral, difficulties in providing creditworthiness, small cash flows, inadequate credit history, high risk premiums, underdeveloped bank-borrower relationship and high transaction costs account for this state of affair. Various SME finance programmes adopted by governments, such as interest rate subsidies, directed lending, and guaranteed funds have not succeeded in alleviating the financing problems facing the SME sector partly because of lack of efficiency and transparency in the operation of such programs.

Using subjective measures derived from the survey responses of the firms in the WBES database and objective measures of a firms' access to finance which they derived from the share of internal and external financial resources of working capital, the authors conduct the analyses first at the sub-regional level by examining the determinants of access to finance. The sub-regional level analysis has the tendency to obscure some important differences in terms of the influence of the various explanatory variables on access to finance. Consequently, to unmask important differences across countries, the authors also conduct country level analysis that delineates the differential effects.

At the sub-regional level, the authors find that firm size, ownership, strength of legal rights, depth of credit information, a firm's export orientation and the experience of the top manager strongly influence access to finance. At the country level, they find that the determinants of access to finance varies across countries. One striking result is that in Mali, where government support for SMEs is directed more towards women-owned businesses to meet the Government's Millennium Development Goals (MDGs), the gender of top manager significantly determines a firm's access to finance. Also, women in Mali mostly engage in small businesses that do not require huge investments, and this provide little incentive for them to seek financing from

banks and other financial institution. The Malian case is unique and does seem to contradict the conventional notion that women disproportionately face barriers to finance compared to their male counterparts. It nonetheless shows how government policy can be used to address access issues if the political will to do so is strong.

## 2. Part II: Financial Services and Inclusion

There is widespread recognition in the developing world that financial inclusion can reduce poverty, enhance growth, and promote sustainable development. Development agencies such as the World Bank realize that inclusive financial systems not only enable poor people to save and borrow, and thus allow them to invest in entrepreneurial ventures, but they also help insure beneficiaries of inclusive programs against socio-economic vulnerabilities. Technological advances, especially the use of mobile phones, have facilitated the provision of financial services to the poor in a relatively cheap and reliable manner. African countries have experienced a boom in the use of mobile phones, which have helped solve both problems of distance or access and transaction costs that have hindered traditional financial services providers in the past from extending services to the hitherto unbanked. In the third paper, **Alfred Shem, Maureen Odongo and Maureen Were** examine whether the pervasive use of mobile telephony to provide financial services has enhanced savings mobilization in Africa. In the sub-Saharan African region, the East African countries have recorded significant improvement in the use of mobile money, and this motivates the authors to focus on Kenya, Uganda, Malawi and Zambia. However, Kenya has been the leader in the use of mobile telephone financial services. Therefore, the authors conduct a more in-depth empirical analysis on Kenya.

Using both descriptive statistics and regression analyses, the authors test the hypothesis that mobile phone money usage encourages savings. They find that mobile financial services positively impact savings and that those who utilize or have access to mobile financial services are far more likely to save than those who do not. Higher levels of education or financial literacy and income have positive effect on savings, but family size has negative effects on savings, as high dependency ratio constrains the ability to save. While women are more likely to save than men, the latter save more money than women. A policy implication that emanates from the results is that expanding and deepening the scope of mobile financial services is an important avenue for promoting and mobilizing savings particularly for the poor and low income earners who have limited access to the formal financial system.

The paper by **Andreas Freytag and Susanne Fricke** assesses the overall economic effects stemming from the sectoral linkages of the financial services sector in Nigeria and Kenya, - countries that have relatively developed financial sector in sub-Saharan Africa.<sup>1</sup> Inter-sectoral linkages, comprising backward

<sup>1</sup> South Africa is excluded from the study as there are similar studies on this country already.

and forward linkages, reflect the interconnectedness between the sectors of an economy, with mutual interdependencies between sectors influencing the extent to which growth in one sector contributes to growth of other sectors as well as the overall growth. The financial sector is crucial for a country's economy and business environment, as it provides opportunities for employment and income generation, savings and investment, wealth accumulation and loan provision; hence its development can have positive spillovers effects on other sectors. The effect of inter-sectoral connectedness of financial services in emerging countries, especially in Africa has not been analyzed in detail.

Using input-output analysis comprising assessments of backward and forward linkages of the financial sector to the other sectors of the economy and the assessment of overall economic (multiplier) effects emanating from the financial sector, the authors find evidence of sectoral interconnectedness of the financial services sector in the Nigerian and Kenyan economies. The Nigerian economy shows relatively low direct backward and forward linkages for the financial services sector, and the values for total backward and total forward linkages rank highest during the study period (2007, 2009 and 2011). The high total backward linkages indicate that the financial services sector creates additional demand for the output of upstream sectors, leading to increased upstream investment, capacity utilization and upstream technological upgrading. For Kenya, direct and total backward linkages as well as direct and total forward linkages rank relatively low. As the authors argue, the relatively low values do not allow for a distinct assignment of growth-inducing or growth-enabling functions of the financial services sector in the country. The results show that the financial sector plays a more significant role in the Nigerian economy than the Kenyan economy. However, controlling for the role of technology or the communication sector within both economies results in low linkages of the financial sector in both countries.

### 3. Part III: Banking Systems and Stability

**Jacob Oduor, Kethi Ngoka, and Maureen Odongo** investigate the impact of regulatory capital beef-up on banking sector stability and competition. Their study is motivated by the flurry of actions by financial sector regulatory authorities, particularly central banks, in the aftermath of the global financial crises. Many African countries have increased, or are in the process of increasing regulatory capital in line with Basel III pronouncements with the view to strengthening the resilience of local banks to shocks. The questions the authors address are: (1) whether increasing regulatory capital increases stability of the banking system, and (2) how increasing regulatory capital affects banking sector competition given that raising the capital adequacy requirements tends to increase concentration of the banking sector.

The authors employ panel study approach to investigate the impacts of capital requirements on financial sector stability and on competition in the financial sector. Using data on 162 commercial banks in 37 African countries over the period 2000–2011, and measuring financial sector stability by nonperforming loans and competition by the Lerner Index, the authors find no

significant impact of regulatory capital on competition in the banking sector. However, they find evidence of positive impact of regulatory capital on competition among foreign banks. The authors surmise that this could be due to the fact that foreign banks may obtain additional capital at concessional rates from their parent companies and thus do not bear the full brunt of the costs arising from higher regulatory capital requirements, unlike domestic banks that have to source the additional capital on the open market. The higher costs faced by domestic banks are passed on to consumers, resulting in reduced competitiveness of domestic banks.

Regarding the impact of increasing regulatory capital on financial sector stability, the authors find that raising the regulatory capital requirement increases instability in the African banking sector. However, the big banks do not experience instability. The authors assert that increasing regulatory capital ratios could be encouraging banks to hold more risky assets by understating their risks. They do so through the use of complex in-house risk assessment models. Consequently, banks in effect hold less regulatory capital than they are supposed to have given their risk profiles and this outcome explains the instability. The authors conclude that raising regulatory capital may not be sufficient to mitigate financial sector instability in the African banking sector and that additional measures may be needed. They also conclude that the nature of ownership of banks and bank size matter for the impact of regulatory capital on competition in the banking sector.

Relatedly, **Eftychia Nikolaidou and Sofoklis Vogiazas** also explore the issue of financial sector stability, but from a slightly different vantage point. The authors examine the credit risk determinants in five sub-Saharan African (SSA) countries and attempt to relate the situation in the five African countries to the experiences of the Central East and South East European countries. The paper is motivated by the dearth of studies on credit risk determinants in sub-Saharan African countries. The authors argue that there aren't many studies that address this issue, and given the importance of banking sector stability for sound economic performance, and the impact of credit risk on stability of the banking sector, it is imperative that more light is shed on the drivers of credit risk in SSA. The five study countries are South Africa, Namibia, Kenya, Zambia and Uganda. Data considerations and the need to sample across countries at different stages of development inform the choice of countries.

The authors use the Autoregressive Distributed Lag (ARDL) methodology, and a 'case study' approach for each country. They find that in the long run, non-performing loans (NPLs) are primarily driven by macroeconomic factors, especially money supply. This is explained by the fact that the banking sector in the five SSA countries are generally stable and well capitalized, with low loan-to-deposit ratios. Thus, the risks tend to emanate from outside the banking sector. The results suggest that easing (expansionary) monetary policy is associated with lower NPLs. They also find that, apart from monetary policy variables, NPLs are driven by different factors in different countries. In other words, country-specific factors are important drivers of NPLs in the five sub-Saharan African countries. Parallels and lessons are drawn from CESEE countries' experiences.



#### 4. Part IV: Markets and Development

Extant literature shows that African stock markets are small and are characterized by poor liquidity, high concentration and insufficiently developed market infrastructure. The integration of national stock exchanges has been proposed as a solution to some of these impediments. Establishing regional stock exchanges also offers other benefits including harnessing much needed capital to the African countries. Despite these benefits, progress towards stock market integration for African stock exchanges has been slow. **Sunil Bundoo** analyses the extent of stock market integration in the Southern African Development Community (SADC) region. The SADC members have established national stock exchanges in Botswana, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe. The author assesses the degree of beta and sigma convergence and identifies the existence of long-run equilibrium relationships in the stock market returns.

A Committee of SADC Stock Exchanges has been set up to promote a transparent regulatory environment that aims at protecting market participants, attracting investors, improving the exchanges' operational capacity and technical underpinnings, promoting cooperation, harmonization of trading, clearance, and settlement procedures among the exchanges, and providing a forum for information exchange and discussion of development of the region's stock markets. Using price-based approach to measure stock market integration, the author does not find any evidence of cointegration relationship of the SADC markets when using the US market as benchmark, except during the financial crisis when the markets were cointegrated. The SADC stock markets, however, offer good diversification benefits to foreign investors. The stock exchanges in the region are therefore urged to work towards greater integration so that they can attract more sustained portfolio flows.

In the last paper, **Ousmanuo Njikam** investigates the role of policy complementarities in the financial liberalization-growth nexus. The study is motivated by the fact that while nearly all African countries have liberalized their financial sectors, the growth impact of financial liberalization in the region remains weak, at best. This state of affairs seems to contradict the evidence in the literature (e.g., [Stiglitz, 1998](#)) which touts financial liberalization as a key driver of economic growth. The question then is: why is the evidence in Africa not consistent with what has been documented elsewhere? The author hypothesizes that complementary reforms, or their absence, could be the reason for the insignificance of financial liberalization in impacting growth.

Based in this conjecture, the author examines the relationship between economic growth and financial liberalization across sub-Saharan African countries, with the view to ascertaining

how policy complementarities affect this relationship. Using a sample of 45 sub-Saharan African countries, the author finds that in the absence of policy complementarities, per capita GDP growth in the post-liberalization era is not statistically different from that of the pre-liberalization period. However, financial liberalization positively affects growth if accompanied by improvements in schooling, governance, macroeconomic stability, etc. Inflation is found to reduce the impact of financial liberalization on economic growth. An implication of the study is that sub-Saharan African countries could potentially realize substantial GDP per capita growth if greater attention is paid to policy reform complementarities (involving human capital, macroeconomic stability, governance, etc.). In essence, these areas can be considered as the binding constraints to growth in sub-Saharan Africa.

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