

Financial Sector and Economic Development: How Institutions, Financial Markets, and Prudential Oversight can be Enhanced to Accelerate Economic Growth and Sustainable Development in Sub-Saharan Africa

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ABSTRACT

The author began the paper with a brief historical perspective of financial development and economic growth in general and in Sub-Saharan Africa in particular. He then presented the methodology employed during the research. This was followed by the review of the literature. Next the researcher outlined his findings preceded by analysis and policy implications for decision-makers in Sub-Saharan Africa. The writer ended the paper with some policy recommendations to accelerate the development of the financial sector and spur economic growth and sustainable development in Sub-Saharan Africa.

Keywords: *Financial development, Sub-Saharan Africa, Economic growth*

1. INTRODUCTION

Historical Perspective on Financial Development and Economic Growth: A growing volume of theoretical and empirical work shows that the development of institutions and financial markets are vital to economic growth (Levine, 2003). The relationship between financial development and economic growth is a long-debated issue among economists. Building on the works by Bagehot (1873), Schumpeter (1934), Gurley and Shaw (1955), Goldsmith (1969), and McKinnon (1973), recent research (Demetriades and Andrianova, 2004; Levine, 2003; and Beck, 2006) has employed cross-country, panel, industry-level, firm-level, and case study analyses to demonstrate that financial development promotes long-term economic growth. Some studies go as far as to suggest that developed financial markets are essential for long-term growth (Acemoglu et al., 2004). Hence, a developed and sound financial sector results not only in the availability of financial services, but also contributes to growth. Gelbard and Pereira Leite (1999) empirically demonstrated that there is a strong positive relationship between financial depth and growth in SSA.

Financial sector and economic development are of particular importance for SSA economies. Collier (2006) argues that SSA currently faces its best opportunity for growth since mid-1970s. He also claims that SSA is the most natural resource abundant region after the Middle East. But at the same time, there are only two SSA countries (Seychelles—54 and Mal—74) in the first 100 rank according to the Human Development Index of 2008 (HDI 2008). Moreover, 24 countries out of 25 that have “low human development” are from SSA with high level of poverty influencing human development measures (life expectancy, literacy, educational attainment, and GDP per capita). Hence, efficient utilization of natural wealth is critical, and financial sector development can contribute to an efficient allocation of resources.

SUB-Saharan Financial Sectors: Financial sectors in SSA countries are among the least developed in the world. To some extent this can be blamed on misguided policies of the past that encouraged substantial political interference in the operation of financial institutions. Historically, SSA countries placed significant emphasis on building and protecting the real sector, and most countries believed they could reach their development objectives through selective credit allocation.

As economic and financial conditions were deteriorating in the late 1980s and early 1990s, SSA countries embarked on a policy of dismantling controls. These reforms usually included (1) granting central banks more autonomy to conduct monetary policy; (2) liberalizing interest rates and eliminating administrative allocation of credit; (3) transitioning from direct to indirect monetary policy implementation; (4) restructuring banks to restore their solvency; and (5) improving infrastructure, especially bank supervision. Steps were also taken to liberalize the external current and capital accounts.

While the pace of reform has varied and some restrictions remain in place in some countries, progress in liberalizing financial markets has been substantial through SSA. However, financial intermediation is still low, and by some measures has even declined. For instance, between the early 1980s and the end of 2004, the simple SSA average of private sector bank credit to GDP fell from 15.6 percent to 15.1 percent. Excluding 15 countries whose financial sectors showed signs of sustained development during this period, the average private sector credit to GDP ratio declined from 17.2 percent in the early 1980s to 8.7 percent by the end of 2004. This is all the more striking considering that during this period efforts to liberalize the financial sector were combined with greater discipline in implementing monetary policy, which in most SSA countries pushed down inflation outcomes and lowered fiscal deficits (McDonald and Schumacher, 2007).

2. METHODOLOGY

This paper relied on the literature review of current relevant articles focusing on financial development and economic growth in SSA. Except where a source was needed specifically for its perspective on broad issues relating to financial development and SSA, the author screened papers by “financial development”, “Sub-Saharan Africa” “financial system in Sub-Saharan Africa” and by numerous variants of keywords, focusing specifically on Sub-Saharan Africa. Source papers included refereed research studies, empirical reports, and articles from professional journals. Since the literature relating to financial development and Sub-Saharan Africa is voluminous, the author used several decision rules in choosing articles. First, because financial sector is changing fast in today’s environment, the author used mostly sources published from 2000-2011, except where articles were needed specifically for their historical perspectives. Second, given the author’s aim to provide a practical understanding of the main issues in financial development, he included, in order of priority: refereed empirical research papers, reports, and other relevant literatures on current trends in financial systems development. To get some

perspective on the current state of financial development and economic growth, the author began with a review of the current literature.

3. LITERATURE REVIEW

Institutions and Financial Development: Theoretical and empirical studies emphasize the need to pay more attention to institutional development as institutions play a vital role in financial sector development. North (1990) offers the following definition for institutions: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." Institutions determine the costs of acting in different ways in political and economic contexts.

North (1990) examines the nature of institutions and the consequences of institutions for economic performance and applies his theories to a range of historical examples, including the development of financial markets. Some cross-country studies (Beck, Demirguc-Kunt, and Levine, 2004; Honohan, 2003) have shown that countries with better-developed financial intermediaries experience faster declines in measures of both poverty and income inequality, underscoring that the development of financial markets and institutions is helpful in reducing poverty.

Many researchers have shown that the institutional environment has an important impact on the functioning of the financial sector (Tressel and Detriagiache, 2008; Demetriades and Fielding, 2009). La Porta et al (1998) argues that legal origin determines the level of financial development. He suggests that common law-based systems, originating from English law, are better suited for development of financial markets than civil law systems, arguing that common law has been instrumental in protecting private property than civil law, which aims at addressing corruption in the judiciary and improving the power of the state.

Roe and Siegel (2009) stress the role of political stability in financial sector development. Contrary to works of La Porta, they find that current political instability explains the level of financial development more than historical legal origin. They link political stability to economic growth and financial development, which is close to the idea of Rajan and Zingales (2003) in exploring political economy as determinants of financial development. In their work Rajan and Zingales (2003) argue that simultaneous opening of both trade and capital account hold is the key to successful financial development. Opening trade and capital account not only fosters competition and reduces inefficiencies, but might also give incumbents new opportunities that will bring them even higher profits to cover any negative effect from higher competition.

Djankow, MacLiesh, and Shleifer (2007) explore credit institutions in 129 countries over 25 years and show that contract rights and enforcement institutions play a big role in the development of financial markets. Their findings show statistical significance of creditors' rights and information sharing institutions for private credit. Acemoglu and Johnson (2005) highlight the importance of property right institutions. They argue that property right institutions have a crucial power in determining long-run growth, investment and financial development, whereas contractual institutions shape financial intermediation and slightly influence growth and financial development.

Studies show that institutional factors are also crucial for financial development in SSA. Demetriades and Fielding (2009) address the lack of information on borrowers, corruption and political instability as

main challenges for financial development in eight countries of West Africa. McDonald and Schumacher (2007) point to financial liberalization, stronger legal institutions, legal origin, lower inflation, and increased sharing of information as key contributing factors for financial sector development in SSA. Some studies on Asian countries consider political institution and political party structures (Zhang, 2006), rule of law, political stability, government effectiveness, and regulatory quality (Gani and Ngassam, 2008) as main drivers of financial development. Other studies have a broader coverage. For example, Huang (2005) explores the effect of political liberalization on financial development in 90 developed and developing countries based on political liberalization and freedom indexes. Ito (2006) examines the relationship of institutions and financial development considering financial openness, corruption, and law and order as main challenges. He finds that financial openness stimulates equity market development only if some threshold level of legal development has been attained.

Debt Markets in Sub-Saharan Africa: The debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative has help to improve SSA external debt situation. Thirty-three SSA countries were considered HIPC and a large number of them have benefited from the Multilateral Debt Relief Initiative (MDRI) and the bilateral debt cancellation measures, which were launched in 1996. As a result, SSA external debt has fallen considerably from an average of 103 percent of GDP in 1995-2000 to about 34 percent of GDP in 2001-08. By the end of 2008, external debt to GDP had dropped to its lowest level since 1980, constituting 20.4 percent of GDP. In contrast, the domestic debt market is growing rapidly. SSA's domestic debt as a share of GDP has doubled to about 22.4 percent between 2001-2008 from an average of about 11 percent between 1980 and 1989 (Adelegan and Radzewicz-Bak, 2009).

Nonbank financial institutions are widely regarded as being critical for bond market development given their long-term investment strategies. If bond markets are underdeveloped, both pension funds and insurance companies are forced to hold short-term securities, which do not correspond to the liability side of their balance sheet and therefore expose them to maturity mismatches. In order to meet the growing demand for longer dated securities from nonbank institutional investors, several countries (e.g., Kenyan, Nigeria, Tanzania, and Zambia) have pursued strategies to lengthen the maturities of their government bonds up to 10 and 15 years. Longer-term instruments help pension funds manage some risks, as well as provide useful benchmark for pricing long-term assets (Adelegan and Radzewicz-Bak, 2009).

Creditor Rights, Financial Development and Growth: A fast-growing literature has found a clear link between financial development and growth. Countries with better-functioning institutions and markets grow faster. King and Levine (1993) reported that financial development, proxied by several measures of financial deepness (such as bank liabilities and bank credit), predicted long-run economic growth, capital accumulation, and productivity increases for a sample of 77 countries for 1960-89. The results tended to hold for smaller samples of countries. Omitting SSA countries did not significantly alter the results. Levine and Zevros (1998) used indices of stock market development to measure the finance-growth link and found that whether a financial system is bank-based or equity-based does not seem to matter much. To rule out simultaneity bias, Levine, Loayaza, and Beck (2000) dealt directly with the issue of causality by using instrumental variables in cross-country studies of growth. They concluded that there is a very strong connection between growth and the exogenous component of financial development.

Although the relationship between growth and financial development has been found to be strong, the channels by which financial development causes growth are still under discussion. Levine (2005)

identifies some functions that financial intermediaries have traditionally performed that improve welfare: production of ex ante information about possible investments; monitoring of investments and implementation of corporate governance; diversification and management of risks, including liquidity risk; mobilization and pooling of savings; and facilitation of exchange of goods and services. He concludes that, to the extent that each of these functions may influence savings and investment decision, they can also influence economic growth. However, exactly how services provided by financial intermediaries influence growth is not well understood.

If financial development is good for growth and probably reduces inequality, a crucial question for countries that need to grow fast, such as those in SSA, is how to ensure that all obstacles to financial intermediation have been eliminated. Recent studies have focused on the links between financial development and the legal institutions that can facilitate credit contract, exploring the nature of those contracts based on the power theory of credit, information theories of credit, and the legal origin of institutions (e.g., French or English). These theories are complementary rather than alternative; they explain how legal institutions could boost financial intermediation and facilitate access to credit for a large number of customers, some with new and small projects (McDonald and Schumacher, 2007). The power theory of credit emphasizes that financial institutions would be more willing to extend credit if, in case of default, they could easily enforce contracts by forcing repayment or seizing collateral. The amount of credit in a country would then depend to some extent on the existence of legislation that protects creditor rights and on the quality of procedures that lead to repayment.

For the information theories of credit, the amount of credit to firms and individuals would be larger if financial institutions could better predict the probability of repayment by their potential customers. Consequently, the more banks know about the credit history of prospective borrowers, the deeper credit background check they can carry out.

Efficient exchange of information can reduce the cost of screening borrowers. In advanced countries, databases centralizing information on borrowers are often established by the private sector or maintained by central banks. These registries collect information on the standing of borrowers in the financial system and make it available to lenders. The system improves transparency, rewarding good borrowers and increasing the cost of default, and could reduce the reliance of the poor on informal finance. McDonald and Schumacher (2007), and Singh et al. (2009) show that information-sharing is associated with greater financial development.

Legal origin also has implications for financial developments. Beck, Demirguc-Kunt, and Levine (2002) identified a political and an adaptability channel through which legal origin affects credit markets. The political channels depends on the balance between state power and private property rights. For example, civil law that promotes institutions that favor state power over private property rights would tend to have adverse implications for the growth of credit markets. The adaptability channel recognizes that legal tradition differ in their ability to evolve with changing conditions. It has been argued, for instance, that common law traditions evolve efficiently because judges respond case by case to changing conditions. Both channels imply that countries whose law is French in origin should have on average substantially slower financial development than British common law countries.

Empirical evidence supports this institutional approach. Djankov, McLiesh, and Sheleifer (2005) found from data for 149 countries that, after controlling for macroeconomic factors like GDP growth, inflation, and fiscal imbalances, legal institutions have made a clear contribution to the development of financial

markets. Similar findings were reported by Galindo and Micco (2001) in cross-sectional regression of Latin American countries. This author concurs with the evidence on the importance of institutions for financial development in SSA countries.

Supervision in SSA: Many sources—among them the Joint World Bank-IMF Sector Assessment Programs (FSAP)—concur that supervisory capacity remains limited in most of SSA. Many supervisory agencies or departments are understaffed and lack essential skills. Compliance with the Basel Core Principles for Effective Banking Supervision (BCP) is low and supervisory enforcement is also often very low. Supervision of nonbank sector is even weaker—or nonexistent. However, recent years, several countries have embarked on major reform programs (often following FSAPs) to upgrade their regulatory frameworks and banking supervisory skills.

Summary of the Supervisory Structure: Some Key Observations

Central banks are the dominant supervisors for banks in SSA. The legacy of the colonial powers is visible: countries with the British tradition typically house bank supervision in the central bank, while most French colonies established bank supervision in a separate agency.

Central banks are also often called upon to organize supervision for deposit-taking NBFIs as a natural extension of their bank supervisory responsibility. In more countries, the central bank has some responsibility in supervising this group of institutions. As a logical consequence, the same is happening with respect to microfinance. Some countries are well advanced in supervising these institutions, while in others, central banks have been recently assigned the regulatory and supervisory responsibility over microfinance institutions, and are trying to develop capacity in this area.

In several cases, the supervisory responsibility of the central banks goes further than banks and other deposit-taking institutions, making the central bank the dominant supervisor. For instance, Nigeria and Uganda, the central bank is also the pension fund supervisor; in Mozambique, the stock exchange supervisor; and in Swaziland the insurance supervisor. More generally, in a number of cases the central banks seem to be the supervisor-by-default, given the lack of capacity outside the central bank (Quintyn and Taylor, 2007).

Stock Markets and Financial Development: Fifteen SSA countries have stock markets, most of them established over the past decade. The value and role of stock markets in financing industry has been debated in advanced as well as developing countries. While advocates point to the need for long-term finance, others fear that generally weak regulation will hinder market efficiency and the value of price signals in allocating investment resources.

Stock markets in SSA remain immature. Except in South Africa and Zimbabwe, average market capitalization is about 27 percent of GDP; it is as low as 1.4 percent in Uganda. This contrasts with emerging markets like Malaysia, which has a capitalization ratio of about 161 percent. Market liquidity is also very low: turnover ratios are as little as 0.02 percent in Swaziland compared with about 29 percent in Mexico. Low liquidity implies greater difficulty in supporting a local market with its own trading system, market analysis, and brokers, because of the low business volume. In most SSA stock markets, informational and disclosure deficiencies prevent trading in most listed stocks. Further, supervision by regulatory authorities is often inadequate (Regional Economic Outlook, 2006).

Stock markets in SSA have contributed to financing for listed companies but there is no evidence yet of broader economic benefits. Corporate financing pattern in certain SSA countries suggests that stock markets are an important source of finance. In Ghana, the stock market financed about 28 percent of total asset growth of listed companies between 1995-2002, 16 percent in South Africa between 1996-2000, and 8 percent in Zimbabwe between 1995-1999. In all three countries, the stock markets were for those companies the single most important sources of long-term finance. However, it remains unclear whether these economies have benefited through, for example, greater savings and investment or increased investment productivity. Finally, to date all SSA stock markets remain dependent on regional government subsidies for their operations (Regional Economic Outlook, 2006).

4. FINDINGS

The main findings of the research are as follows: Financial deepening could narrow income inequalities and reduce poverty, and that stronger property rights reinforce these effects. However, liberalizing interest rates and lending alone could be detrimental to the poor if not accompanied by institutional reforms, in particular stronger property rights and wider access to creditor information.

Savings constraint is a key impediment to financial market deepening and development of the domestic bond market. Low savings result in a low level of financial intermediation by banks.

A confluence of many variables drives the level of development of the domestic bond market in SSA, and that no single class of variables is wholly responsible for the underdevelopment of the domestic bond markets in SSA. Structure, investment profile, law and order, size of the banking sector, and level of economic development all matter for domestic bond market development in SSA. Similarly, macroeconomic factors such as interest rates, exchange rates, the presence or absence of capital controls, and fiscal balances also matter.

Insufficient legal protection of creditor rights and information asymmetries about borrowers' ability and willingness to repay debts could explain why most financial markets remain shallow in SSA.

There is a strong correlation between legal and oversight institutions and financial development. While financial liberalization and macroeconomic stability promote deeper financial markets, when financial liberalization efforts are similar, those countries with stronger creditor rights and information sharing have deeper financial systems in SSA.

5. DISCUSSION AND ANALYSIS

Institutions and Financial Development: The literature review presented above underscores the importance of institutional reforms for SSA countries. Verriest (2009) points out that changes in the institutional environment are even more sensitive to weak institutional settings such as in SSA countries. Others (Demetriades et al 2009) argue that financial depth (credit to private sector/GDP) is shallow in SSA economies not because of the lack in the creditworthiness of the borrowers, but because of the lack of developed infrastructure that would enable banks to screen and monitor borrowers. Another consideration in SSA is the heavy dependence on foreign aid, both financial and technical assistance, from various international and/or foreign organizations/donors. Nkusu and Sayek (2004) demonstrate that development of the local financial market positively enhances the impact of aid, which is significantly larger when local financial markets are more developed.

Debt Markets Development: Promoting domestic bond market development is becoming also important due to benefits stemming from improved efficiency in its functioning. Domestic bond markets enhance capital allocation by directing savings towards assets with a higher return, provide alternative sources of financing, and facilitating risk management through distributing risk among different groups of investors. The development of the domestic bond market as sub-segment of financial market contributes to the growth of a country's financial system.

Developing SSA bond markets has also become an important policy focus of multilateral financial institutions. A joint initiative of the IMF and World Bank has been launched to assist, inter alia SSA countries, in building up bond markets by developing effective medium-term debt management strategies that are consistent with the goal of maintaining debt sustainability. The question is whether this initiative will have the desired effect in terms of bond market development. While there are conflicting views on the determinants of bond market development, most argue that fundamentals such as stable macroeconomic policies, improved regulation, enhance transparency, and stronger investor protection are particularly important.

A number of SSA countries have recently decided to upgrade the investment guideline for nonbank financial institutions, recognizing the significance of soundness rules for promoting bond market development. It is important that rules governing portfolio investments for nonbank financial institutions aim at: (i) limiting risks and mismatches, which may occur on the balance sheets of these institutions; and (ii) setting sound principles for investments. On the one hand, it is also essential that institutional investors should not be compelled to hold the majority of their portfolios in government bonds because it may lead to creation of "captive" markets. Principles governing investments in credit quality papers and foreign currency denominated securities, as well as accounting rules requiring mark to market valuations, are yet to be established by SSA countries.

There is still potential for further growth of investments by institutional investor in domestic bond markets. Further reforms in the pension fund system, in particular the shift toward funded schemes, are likely to have a positive impact on the assets of the pension sector and insurance companies (Adelegan and Radzewicz-Bak, 2009).

Savings constraint is a key impediment to financial market deepening and development of domestic bond markets. Low savings will result in low level of financial intermediation by the banks. On average, gross savings as a share of GDP for SSA countries was 18.1 percent in 2008, while gross investment as a share of GDP was 27.3 percent. On average, private savings as a share of GDP was 9.8 percent in 2008, and 11 percent between 1991 and 2008. The regional aggregates disguise considerable variation in private savings as a share of GDP across countries. Only five SSA countries (i.e., about 40 percent) had private savings that were less than 10 percent of GDP in 2008. Private dissavings (negative savings) as a share of GDP are as low as about negative 21 percent for the Republic of Congo. On the other hand, private savings was as high as about 40 percent for Botswana in 2008. The median savings ratio as a share of GDP in 2008 was 9.9 percent (Adelegan, 2008).

Typically the savings shortfall pertains to both private and public sectors, but the savings-investment gap is wider for the public sector. The public sector shortfall tends to crowd out investment in the private sector by limiting the flow of private savings available for domestic intermediation. Fundamentally, very low domestic savings is a major constraint on domestic bond market development in SSA economies.

Policy Measures for Dealing with the Challenges of Low Domestic Savings: Fiscal policy measure: Fiscal policy measures can be used to correct the public sector's negative current account balances, as well as the imbalance between savings and investment in the private sector. A useful policy handle is savings incentives in terms of an interest rate policy that will encourage savings. Private savings can be mobilized through increases in interest rates.

Broader access to financial services: Generally, poor domestic savings is a major constraint confronting SSA countries. There is a need to access capital from elsewhere to finance growth and innovation and deepen the market. Bond market development is expected to make an important contribution to economic growth through improving access for firms (Adelegan, 2008). Modern development economists have emphasized that broader access to financial services should be a central development agenda of financial sector reforms (Demirguc-Kunt et al., 2008).

Promotion of Growth: For a number of low-income countries, consumption and growth are low. Any increase in income is diverted towards greater consumption. Policies that are geared towards promoting growth will also promote savings and facilitate market deepening.

External Financing: The role that the external sector can play in financial market deepening is also crucial. The reason that external financing increased was because of low savings and the unavailability of local finance. External finance potentially has a role to play in deepening the financial market and facilitating the development of the bond market (Adelegan and Radzewick-Bak, 2009).

Supervision: Chandler's statement that "Strategy follows strategy" is particularly applicable to the design of financial sector supervisor in SSA in which the first step needs to be the development of a "regulatory strategy" to prioritize sectors that need a supervisory framework and to determine the intensity with which these sectors should be supervised. Regulatory structures, in turn, need to follow this strategy in a way that will allow a flexible response to future developments in the financial systems. Such a strategy also needs to take into account the ubiquitous issue of capacity constraints, which, in many ways, is the crux of the regulatory problem in the SSA. Any strategy should also take into account the need to keep the central banks involved in the supervisory process.

Capacity Constraint: Capacity constraints are major hurdles for any reform in SSA. Supervisory agencies in most SSA countries lack skilled and trained staff, as well as the equipment and infrastructure to conduct on-site inspections and off-site supervision. Salary scales are typically low, making staff retention a major challenge because, once trained and proficient, staff is easily lured away by higher paying commercial banks or other financial institutions.

In addition, supervisory skill must continuously evolve in response to industry trends. In recent years, the widespread adoption of risk-based supervision, combined with ever more complex banking regulations and supervision has placed a premium on the constant upgrading of supervisory skills. Thus, countries that are unable to provide the right incentives to attract and retain suitably qualified supervisory staff run the risk of falling ever further behind supervisory practice in the rest of the world.

The design of supervisory structure will have to take into account these capacity constraints for the foreseeable future. Capacity constraints clearly argue against setting up separate agencies for each segment of the system, as this would result in a spreading of resources too thinly across several different regulatory bodies. It also calls in question plans that would merely upgrade or strengthen existing separate agencies. Faced with capacity constraints it is crucial to pursue economies of scale.

The issue on institution design has also implication for the ability of the regulatory agency or agencies to attract and retain suitably qualified staff and the incentive structures faced by regulatory personnel. Finally, capacity constraints also argue for retaining a role for the central bank in the supervisory process as of the better-resourced institutions in most countries (Quintyn and Taylor, 2007).

The Role of the Central Bank: In the specific case of SSA, there are some strong arguments for central banks to remain involved in financial sector supervision. These arguments tend to outweigh the standard arguments in favor of the separation of monetary policy and supervision, at least at the current stage of development in SSA. In line with Goodhart (2002), the author see three major arguments for keeping the central bank involved in the regulatory process.

First, it can reasonably be expected that the banking sectors will remain the dominant segment in the financial systems in the foreseeable future. Moreover, the central banks are currently responsible for banking supervision in a large number of countries. This role is partly the result of historical factors, but also reflects the synergies between banking supervision and monetary policy, which are particularly important in bank-dominated financial systems. There are also important information advantages in keeping banking supervision and monetary policy in the same institution, as the information collected for the two functions overlaps to a great extent. Hence, the combination of the synergies between monetary policy and banking supervision, and the expectation that banks will remain dominant justifies a continued supervisory role for the central banks.

Second, developing economies are more prone than advanced economies to periods of financial instability or even financial crises. This places a particularly high premium on the strength and effectiveness of crisis management arrangements. The central bank is an indispensable part of these arrangements, both because of its traditional lender-of-last-resort function and also because it often possesses the greatest expertise in the financial sector. Most ministries of finance lack the skilled and experienced staff needed to take on a lead role in crisis management. By contrast, there is a greater likelihood that, if these resources are to be found anywhere, they are to be found in the central bank. Thus, keeping a meaningful role for the central bank facilitates coordination at times of crises.

The third, and arguably the strongest, reason is that in many developing countries, central banks are often one of the few reputable institutions with a reasonable degree of independence from the political process and also from commercial interest (Regional Economic Outlook, 2006).

In developing a regulatory strategy, two issues need to be considered, which are (i) at which point in time during its development should a segment of the financial system be regulated and, thus be brought into the supervisory net. This is the issue of scope; and (ii) once a segment has been identified as needing supervision, what type of regulatory and supervisory regime should be imposed. This is the issue of intensity. Such a regulatory strategy will need to be regularly updated to stay abreast of market developments and contain, monitor, or control emerging risks, particularly in an environment where public confidence in financial systems is fragile and could be undermined easily by a crisis. The primary purpose of developing a regulatory strategy is to allow strategy and structure to be considered together. The agreed-upon structure should be such that it serves the strategy by allowing for scale economies and building capacity (Quintyn and Taylor, 2007).

The two most important factors to be taken into account in supervisory and regulatory framework are the countries' capacity constraints and the need to keep a role of the central bank in the supervisory process.

Stock Markets: The literature suggests that the following preconditions are necessary if countries are to benefit from stock market development, some of which are lacking in some SSA countries: (1) Sound macroeconomic environments and sufficiently high income levels. Income levels, domestic savings, and investment are important determinants of stock market development in emerging markets; (2) Appropriate sequencing. Stock markets should follow depth. Research shows that a percentage point increase in financial sector development increases stock market development in SSA by .06 percentage point, controlling for macroeconomic stability, economic development, and the quality of legal and political institutions; and (3) Transparent and accountable institutions. Good quality institutions, law and order, democratic accountability, and limited corruption are also important determinants of stock market development. These factors reduce political risk and enhance the viability of external finance. Stock markets now face the challenge of regionalization and need better technical and institutional development. While analysts have argued for regionalization in SSA as a way to overcome small market size, there are important preconditions for successful regional approaches, such as legal harmonization (bankruptcy and accounting laws) and a liberalized trade regime. Robust electronic trading systems and central depository systems will also be important. Other financial sector reforms—steps to improve the legal and accounting framework, private sector credit evaluation capabilities, and public sector regulatory oversight—would also be beneficial (Regional Economic Outlook, 2006).

6. IMPLICATIONS FOR PUBLIC POLICY IN SSA

Institutions and Financial Development: It is intuitive that institutional factors do influence financial systems through various direct and indirect channels. However, simply because of having very limited resources and a number of constraints (e.g., limited knowledge base, limited financial resources, and cultural factors) institutions can only be improved slowly. Hence, it is extremely important for policymakers to know which institutional factors are critical for financial sector development. While strategic goals vary from country to country and certain factors can be less, or more important for policymakers, this paper provides some evidence that institutional factors matter, which could help guide the sequencing of institutional reforms to promote financial sector development (Nkusu and Sayek, 2004).

Debt Markets: The above analysis shows that savings constraint is a key impediment to financial market deepening and development of the domestic bond market. Low savings result in a low level of financial intermediation by bank. On average across countries, an expansion in domestic debt has a crowding-out effect on private debt. Overall, the analysis shows that a confluence of many variables drives the level of development of the domestic bond market in SSA, and that no single class of variables is wholly responsible for the underdevelopment of the domestic bond market. Structure, investment profile, law and order, size of the banking sector, and level of economic development measured by per capita income all matter for domestic bond market development in SSA. Similarly, macroeconomic factors such as interest rates, exchange rates, the presence or absence of capital controls, and fiscal balances also matter (Adelegan, 2008).

The factors that explain the level of development of the domestic debt market in SSA are the developmental stage of the economy measured by the safety of the investment environment, such as: contract viability, profit repatriation, and payment delays; bureaucratic quality; level of interest rates and volatility of changes in exchange rates, capital controls, and fiscal balances (Demirgüç-Kunt et al., 2008).

Creditor Rights: The main policy implication is that protection of creditor rights in SSA deserves more attention. This is one area where reform, though much needed, has been lacking. Creditor rights in SSA are inadequate in terms of both regulation and its enforcement.

Strengthening creditor rights is, however, complex. First, it requires changes to legislation governing debt collection and collateral. In some cases reforms may have both regional and national dimensions that should be addressed. For example, the uniform commercial acts enacted by the Organization for the Harmonization of African Business Laws (OHADA), apply to matters like debt collection, collateral, and bankruptcy in most francophone African countries, but the necessary procedures are specified by domestic legislation. For countries that are part of monetary unions, regulations related to some forms of financial crimes and corruption, such as money-laundering, and issued by regional bodies. Reform efforts should look at flaws and gaps in both national and regional legislation (Levine, 2005).

The institutional infrastructure should also be revised to make collateralized loans more generally available. For example, the ability to register property efficiently would help to build financial markets, because banks prefer land and buildings as collateral and the availability of collateral is crucial for bank willingness to grant credit. In turn, to register a property, its boundaries have to be determined and for this, cadastres and land surveys should be promoted. Good legislation on debt recovery depends on efficient property registration and land surveying in both cities and countryside (McDonald and Schumacher, 2007).

A Need for a Forward-Looking Reform Strategy: Financial sector needs to be a reform priority for SSA. At present, they neither support economic development nor improve the quality of services available to the poor. Against this background of increasing empirical and survey evidence linking finance with growth, and the identification in many SSA countries of access limit as important obstacle to the expansion of firms, financial sector reform is one of the keys to progress on growth in SSA.

While research on how best to address financial sector challenges is still under review, reforms should be directed to key obstacles. By now, there is considerable evidence on common bottlenecks as well as lessons learned from earlier reform efforts. Renewed reforms should at first focus on obstacles identified in numerous studies and seek to improve implementation of reforms based on lesson from the past. While important issues will apply to all countries, financial sector reforms should acknowledge country-specific factors, such as their level of development.

The following key priorities are proposed: Eliminate distortions: While banks on average are profitable, more dynamic development of the banking sector is hampered by manifold restrictions and supervisory forbearance. Remaining important restrictions are interest rate controls and the excessive use of costly regulatory monetary instruments, such as high reserve requirements. Eliminating or reducing such restrictions could spur development of the banking sector. Similarly, an end to supervisory forbearance would allow better pricing of risk and facilitate interbank relations.

Increase market size: Empirical evidence finds high costs for financial market development from small market size. At least 14 SSA countries belong to monetary unions and should be working to promote financial integration so that members will benefit more fully from a large market. Other countries will benefit more fully from a larger market. Other countries would benefit from a harmonized approach to regulate in the context to low restrictions to market entry, to all financial firms to benefit from economic of scale and scope.

Promote a prudential framework in line with economic situation: Prudential frameworks have been developed for more diversified economies. In SSA, some prudential rules, such as the ones on risk diversification, are routinely violated, and others, such as minimum capital levels, and zero risk weights for government debt, may not be appropriate for the different levels of risk. In the context of efforts to review the appropriateness of the prudential framework, and with many SSA countries considering Basel II, this may be an opportune time to revise the prudential framework for SSA. SSA countries should be active in international forums discussing such issues.

Apply the legal and regulatory framework even-handedly. Improved governance of the economy must be supported by evenhanded application of the legal framework, which is more likely if there are commercial courts and perhaps specialized judges. Differences in commercial law and practice among those countries that already have harmonized their laws should be reviewed regularly and if necessary amended (Regional Economic Outlook, 2006).

7. POLICY RECOMMENDATIONS FOR SSA ECONOMIES

Debt Markets: A regional approach to bond market development should be considered: Structural factors, such as the size of the economy, its openness, and the origin of its legal system may be difficult to change. However, other factors such as the small size may be overcome through a regional approach to domestic bond market development.

The investment environment should be improved: Greater efforts and increased funding would strengthen the safety of the investment environment to ensure contract viability, ease of profit repatriation and minimization of payment delays, and reliability of enforcement of law and order. These improvements will raise the level of economic development and ultimately bond market development.

Competition should be encouraged: SSA countries can also accelerate the development of their bond market by encouraging competition in financial intermediation and a reduction in their bureaucratic practices.

Governments should implement appropriate macroeconomic policies: The level and volatility of interest rates, the volatility of changes in the exchange rates, and capital controls are important in domestic markets. While these recommendations are designed to promote development of bond markets in SSA, care must be taken. For example, capital account liberalization prior to domestic market development offers risks as well as rewards. In addition, governments seeking bond market development need to adhere to international standards by securities issuing firms and encourage growth and competition in banking so as to minimize the substitutability of banks and bond market intermediation, and promote complementarity between the banking system and bond market development. The authorities will also need to follow stable macroeconomic policies to make it attractive to hold domestic currency denominated debt instruments and thereby develop a deep and liquid domestic debt market (Adelegan and Radzewicz-Bak, 2009).

Creditors Rights: Loan and other formal banking sector services are jeopardized by the existence of informal finance mechanisms. Informal finance should be discouraged because it functions outside the supervisory framework that ensures that only those who comply with the requirements to become bankers could deal with the savings of the population. One way to prevent further disintermediation is to apply anti-money-laundering regulations, which in many countries apply only to the formal banking sector, to the informal financial sector.

SSA countries should also increase the sharing of information in credit markets. One major constraint here is that many countries setting up private credit bureaus is not considered commercially viable. Some countries, however, have found that having the government or central bank set up public registries can be extremely productive. Once they are established and coverage is increased, it may be possible to turn them over to the private sector. Bilateral and multilateral partners can step up their assistance for such registries. Credit bureaus should cover as much information as possible on the repayment profile of customers, including information on payments of utilities services, rent, and loans made by micro lending institutions (McDonald and Schumacher, 2007).

Supervision: The author recommendation is that countries develop a regulatory strategy. This should be built around two types of decisions to develop regulatory capacity: (i)) at which point in time during its development should a segment of the financial system be regulated and, thus be brought into the supervisory net. This is the issue of scope; and (ii) once a segment has been identified as needing supervision, what type of regulatory and supervisory regime should be imposed. This is the issue of intensity. Following Chandler's remarks on strategy and structure, the author recommend that the institutional structure of regulation should be design in light of a country's regulatory strategy (Quintyn and Taylor, 2007). The presence of strong corporate governance mechanisms will also help boost investor confidence in regulatory issues (Yartey and Adjasi, 2007).

Reforms in a range of areas could support development of the SSA's stock markets and in turn contribute to economic growth. Steps to improve the legal and accounting framework, private sector evaluation capabilities, and public sector regulatory oversight would also be beneficial. Appropriate sequencing of reforms is important: stock markets tend to develop only after financial sectors have reached a certain depth (Regional Economic Outlook, 2010).

Procedures for handling a systemic crisis or failures within all the financial services markets should be drawn up promptly in preparation for contingencies (IMF African Department, 2009).

8. CONCLUDING REMARKS

SSA central banks must give adequate weight to financial sector stability against a tradition in the region that has long focused on financial sector development. The banking system is the main conduit through which foreign inflows are intermediated, and so bank capital and risk management practices must be monitored carefully. However, the challenges for central banks go well beyond assessing the capacity of the capital base of a commercial bank to absorb the kinds of shocks that lead to more nonperforming loans. Links between various parts of the financial markets, such as bank and the stock markets, must be assessed, as must the foreign exchange market implications of macroeconomic-driven shifts in bank balance sheet (Quintyn and Taylor, 2007).

The rise of some SSA countries to emerging market status gives them a tremendous economic opportunity. Access to capital markets is a key ingredient to high and sustainable private sector-led growth, and this access had long seemed out of reach for SSA; it is now a reality. Evidence is already mounting that financial flows are being translated into growth in financial intermediation in these countries. To help ensure sustained growth, the countries must ensure that macroeconomic policy and capital account prudential policies are tailored to avoid the traps of volatile short-term flows, and that supervision promotes financial sector stability and effective intermediation (Nellor, 2008).

Finally, deepening domestic financial market is key to enhancing their capacity to handle external financial volatility over the long term. As mentioned earlier, interbank, capital, and foreign exchange markets are still shallow in most SSA economies. Strong regulatory and supervisory frameworks could help reduce inefficiencies and enhance competition. There is also scope for reforms to encourage the development of more stock markets by putting in place frameworks that will allow better risk assessment, reduce market uncertainty, and improve transparency. Broader bond markets will allow diversification into longer-term investment instruments—important for long-term investors. Developing forward hedging instruments would also generate some stability in the foreign exchange market by reducing forward settlement risks (Ltaifa et al., 2009).

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