THE CHANGING PARADIGMS OF FINANCIAL SECTOR POLICIES AND REGULATIONS IN AFRICA: LESSONS FROM THE PAST

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BIOGRAPHY

Meshach Jesse Aziakpono was born in Nigeria on 21st January 1969. He obtained the degree of Bachelor of Science (Hons) in Economics and Statistics with a Second Class Hons Upper Division in 1994 at the University of Benin, Benin City, Nigeria; the degree of Master of Science in Economics in 1998 at the University of Ibadan, Nigeria, and a PhD in Economics in 2008 at the University of the Free State. His PhD thesis, titled "The Depth of Financial Integration and its Effects on Financial Development and Economic Performance of the Southern African Customs Union Countries", won the Founders' Medal for the best PhD dissertation in Economics in South Africa.

He started his career as a Research Assistant at the Nigerian Institute of Social and Economic Research (NISER) in Ibadan, Nigeria in 1994. He has subsequently lectured in universities in Nigeria and Lesotho. In 2004 he joined Rhodes University in South Africa where he rose to the position of Associate Professor and the Coordinator of the Master's Programme in Financial Markets in the Department of Economics and Economic History.

He joined Stellenbosch University Business School in February 2010 as a Professor of Development Finance and until April 2013 was the Head of Development Finance Programmes in the School. Prof. Aziakpono has worked as a consultant among others for the Organisation for Economic Co-operation and Development (OECD) Centre and African Economic Research Consortium (AERC) where he is also a network member and a resource person. In 2009 he was a visiting scholar to the International Monetary Fund in Washington DC, USA, and in 2012 a visiting scholar to the INSEAD in Singapore.

He has served as a member of the Academic Board of Economic Research Southern Africa and as a Peer Review Member of Research Processes at University of Johannesburg, Faculty of Economics and Financial Sciences. He has successfully supervised three doctoral and over 100 Master's students. He has published 32 papers in international peer reviewed journals and chapters of books as well as 10 peer reviewed working papers series.

Over the years he has also presented over 80 papers in local and international conferences and workshops. His research has focused on the broad areas of financial integration and financial sector development, as well as monetary policy issues in Africa with strong emphasis in applied econometrics. He is married to Philomina.

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ABSTRACT

Since independence in the 1960s and 1970s African countries have explored alternative development policy paradigms to address the monumental development challenges they have been confronted with. At the early stage, influenced by the prevailing Keynesian world view, many governments adopted financial policies and regulations that centred on the dominant role of the state. With a global shift in development paradigm in the late 1970s inspired by the "neo-liberal" orthodox economic theory, labelled as the "Washington Consensus", African countries adopted Structural Adjustment Programmes (SAP) with financial liberalisation policies prescribed by the Bretton Wood institutions – the International Monetary Fund (IMF) and World Bank – which followed generic free-market oriented policies with minimal role for the state. These policies were implemented in most African countries from the early 1980s through to the 1990s. However, towards the end of the 1990s mounting criticisms of the Washington Consensus policies in Africa and around the world led to a rethink of the approach. A new consensus appears to have evolved with more nuanced and eclectic policy prescriptions that adopt a balanced view of the role of the state and the private market. In this lecture I evaluate the financial sector policies and regulations in Africa influenced by the shifting global economic development paradigms from the 1960s to the present. Based on the lessons learned I make some proposals for African countries.

INTRODUCTION

Mr. Vice Chancellor, with gratitude to Jehovah, the Almighty God, I present this inaugural lecture on behalf of the Faculty of Economics and Management Sciences of this great university. I do so with all humility.

A review of the history of financial policies in Africa and indeed around the world reveals a key political economy problem at the core of the policy debates. That is, what the role of the state ought to be and what it should leave, with as little interference as possible, to private sector and individuals (Kanbur, 2015). Two extreme views seem often to have dominated the discussions of the role of the state in economic development. The first view, inspired by the classical and neoclassical economic school of thought initiated by Adam Smith, stressed a minimal state interference in the economic affairs of society (Smith, 1773). According to this view, markets function best with minimal state interference. The second view, inspired by the Keynesian school of thought which gained ascendency during the Great Depression of 1929-39, contends that to achieve economic development in the presence of market failure the role of an effective government is not only necessary, but may even be sufficient (Todaro and Smith, 2003).

At the time of independence of most African countries, during the 1960s and 1970s, the Keynesian view was in vogue and as such the new independent states' governments simply followed suit. Governments were seen as agents of economic development dominating all aspects of economic activities. However, globally from the late 1970s there was a resurgence of the 'neo-liberal' or 'market fundamentalist' agenda often labelled the 'Washington Consensus'. The Washington Consensus policy prescriptions advocated structural adjustment programmes (SAP) which followed generic free-market oriented policies. These policies were adopted in most African countries from the early 1980s through to the 1990s. However, towards the end of the 1990s mounting criticisms of the Washington Consensus policies in Africa and around the world led to a rethink of the approach. The emerging post-Washington Consensus policies represent what appears to be a new consensus, which is not a complete abandonment but a repackaging of the Washington Consensus in a form that takes into account the heterogeneity of countries and with a focus on inclusive growth and poverty and a more balanced view of the roles of the state and the private sector. Most of these policies have been externally prescribed and influenced.

In this lecture I will provide a review and an evaluation of the financial sector policies and regulations from the

1960s to the present. Of course, a lecture such as this would hardly be able to do justice to a detailed review of such policies; instead, it sets out an overview of these policies to indicate the general directions of policy. I broadly divide the financial sector policy developments in Africa since 1960 into three phases. The first phase spans the period from the 1960s to the end of the 1970s and represents an era in which economic activities were dominated by the active role of government. The second phase spans the 1980s and 1990s, during which the continent followed a set of policy prescriptions of the Washington Consensus. The post-Washington Consensus era is the third phase, from the 2000s to the present. Corresponding to each era, I will evaluate the financial sector policies in terms of their merits for African countries, highlight some lessons and propose some recommendations.

The rest of the presentation is organised as follows. First, I address the question of why the financial system matters. Next I review developments in Africa to provide some context for the policy review that follows. Following the policy review I evaluate the financial sector policies in terms of their performance in African countries. Finally, the lecture is concluded with some lessons and policy recommendations.

WHY THE FINANCIAL SYSTEM MATTERS

It worth reprising the answer to this question no matter how seemingly familiar this subject may appear. Renowned economists such as Bagehot (1873), Schumpeter (1912) and Gurley and Shaw (1955) have long recognised that an efficient financial system is important for economic growth and development. In more recent years, several theoretical models including the new growth models have been used to demonstrate the relevance of financial development for economic growth (Amable and Chatelain, 1996; Berthelemy and Varoudakis, 1996; Boyd and Smith, 1992; Bencivenga and Smith, 1991).

The vast literature analysing the role of the financial system suggests several functions performed by the financial system that are vital for economic growth and development. These functions include, among others, the provision and facilitation of payments systems, mobilisation of savings, allocation of capital, and monitoring and exerting of corporate governance (Levine, 2004; Montiel, 2003; and Levine, 1997). For instance, an efficient payment system helps to reduce transaction and information costs and financial risks, as well as increasing reliability and speed of exchanges. This, in turn, saves individuals time and energy that would have been wasted under a barter system with all its coordination problems (Berthelemy and Varoudakis, 1996). Consequently, it promotes specialisation and innovation, which lead to productivity improvement and, in turn, economic growth.

Similarly, by helping to reduce financial intermediation costs an efficient financial system ensures that more of the savings mobilised can be channelled to investment (Pagano, 1993). Again, because of the ability of the financial system to evaluate, screen and monitor projects and to diversify and manage risk, it helps to improve the quality of the allocation of savings which then ensures that the marginal productivity of each rand invested is increased (Montiel, 2003). Hence, from a theoretical standpoint, the financial system is pivotal for economic growth and development.

Since the pioneering statistical work of Goldsmith (1969), McKinnon (1973) and Shaw (1973), many empirical studies using different analytical techniques have explored the relationship between financial development and economic growth in a variety of countries – developed countries, emerging markets and developing countries. While a significant amount of the studies have demonstrated a strong and positive relationship between some measures of financial development and economic growth, there are also many studies that have found a strong negative or weak relationship (see Levine, 2004 and Aziakpono, 2011).

Traditionally, empirical researchers on the subject have often cast the research question in terms of whether or not finance (or financial system) matters for growth, as if to say that if a weak relationship is found, then it does not matter, in which case policy makers may turn attention to somewhere other than finance in order to stimulate growth. Casting the problem in that way is somewhat ludicrous. The key concern should be not whether or not an efficient financial system matters, but rather how to manage the financial systems so as to produce the desired results of stimulating economic growth and development while ensuring the stability of the system. This is particularly imperative in Africa where economic development seems to have eluded many countries.

SOME FACTS ABOUT DEVELOPMENTS IN AFRICA

The 1960s went down in history as the decade of political independence of most African countries. In 1960 alone some 17 African countries attained political independence, with a total of 32 countries within the

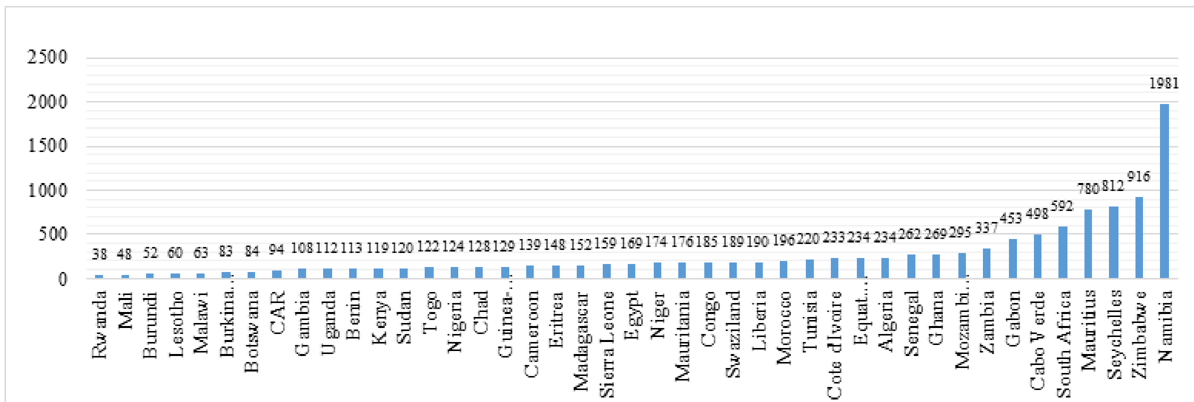

Figure 1: GDP per capita (current US$) at independence

Note: For many of the countries data was not available for the year of their independence. For such countries, the data used was the available data closest to the date of their independence. Source: World Bank (2016a).

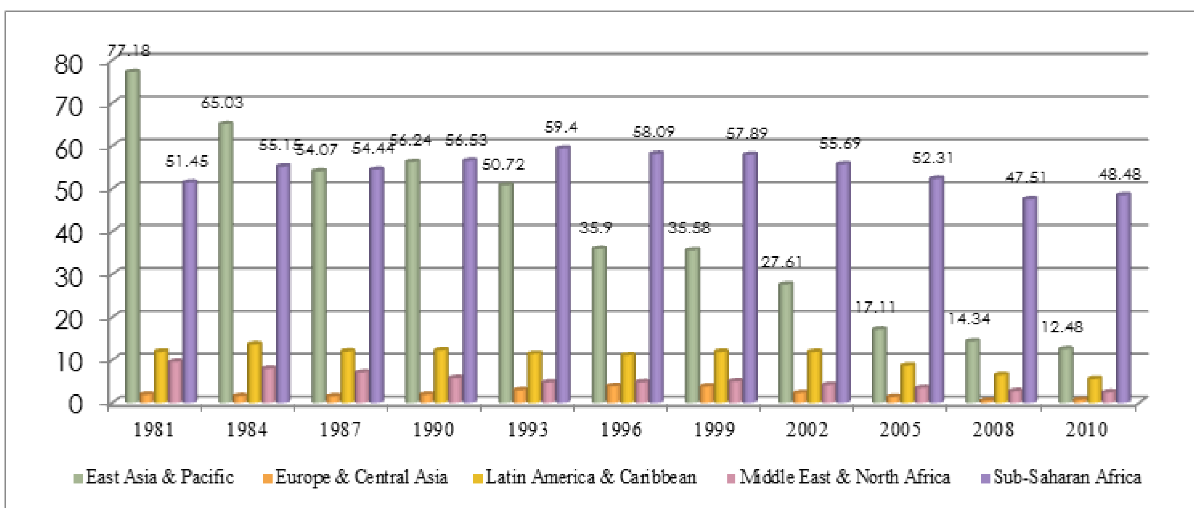

Figure 2: Poverty headcount ratio at US$1.25 a day (% of population)

Source:World Bank (2016a).

decade of the 1960s. By the end of the 1970s the majority of African countries had attained political independence.

At independence the countries were very poor. As shown in Figure 1, very few of the countries had GDP per capita above US$200 in nominal terms. While some African countries managed to record significant growth during the 1960s and 1970s, the level of per capita GDP remained abysmally low throughout those decades, and indeed up to the current time, and remains the lowest in all the regions of the world (see Table 2).

A look at other indicators of economic development reveals a similar pattern. The number of people living below US$1.25 a day is a good indicator of the level of poverty in a country. Data for the period before 1980 is difficult to find. However, one can infer the level of poverty at the time of independence by considering the level one or two decades later. As Figure 2 shows, as a ratio of the total population, the number of people living below US$1.25[1] a day in 1981 was 51% and has remained very high throughout the decades, dropping marginally to 48% in 2010 in sub-Saharan Africa (SSA). Evidently, the situation was far worse at the time of independence of most countries than it was in 1981. Thus, not only was the poverty level very high at independence, but SSA is the only region where poverty has remained very resilient.

The human factor is one of the most important elements in any consideration of economic development. Focusing on education and training, which is central to human capital development, records show that not

[1] *Purchasing power parity*

Table 1: SSA Educational attainment for total population (1960-2010)

Year	No Schooling	Highest level attained						Average years of total schooling	Pop (1000s)
		Primary		Secondary		Tertiary			
		Total	Completed	Total	Completed	Total	Completed		
		(% of population aged 15 and over)							
1960	74.1	21.9	6.1	3.6	1.4	0.4	0.2	1.4	2 371.3
1970	67.9	26.1	7.8	5.6	2.1	0.5	0.3	1.8	2 705.4
1980	57.5	30.2	10.7	11.3	4.2	1.0	0.5	2.7	4 051.5
1990	48.7	31.4	13.6	18.3	7.7	1.6	0.8	3.7	5 440.6
2000	42.1	33.3	16.5	22.3	8.6	2.2	1.1	4.4	6 938.3
2010	34.9	33.8	18.4	28.8	12.4	2.6	1.3	5.3	9 209.8

Source: Barro & Lee (2016).

only was the level of development very rudimentary at independence, but even several decades later, the state of human capital development remains deplorable with the majority of the population still illiterate. From Table 1, one can see that in 1960 only 6.1%, 1.4% and 0.2% of the population (15 years and above) had completed primary school, secondary and tertiary education respectively. As highlighted in Table 1 the pace of progress in human capital development has remained very slow. As of 2010 still only a meagre 18.4% of the population (15 years and above) completed primary school, with those who completed secondary and tertiary education being 1.4% and 1.3% respectively.

Moreover, many of the countries at independence lacked most of the basic institutions and infrastructure necessary for the state to function well. The majority of the population lived in rural areas with very limited access roads. For instance, according to the World Bank Economic Development Indicators, only 18.8% of the roads in SSA were paved in 2009. We can imagine what the situation was at the time of independence in the 1960s/1970s.

One can go on and on with other aspects of developments in Africa. The long and short of this story is that at independence African countries were very poor and underdeveloped and the situation has largely remained the same. To say the least, the tasks of managing the newly independent states were monumentally challenging and daunting given the very limited resources and the prevailing needs of the time. Attempts to grapple with the many development challenges have elicited several policy responses. The financial sector policies as part of the milieu of policy responses are considered next.

FINANCIAL SECTOR POLICIES AND REGULATIONS IN AFRICA

The Pre-Washington Consensus Phase

As noted above, during the 1960s and 1970s the state dominated all aspects of economic activities including the financial sector. Studies show that the government invested in large state-run basic industries and regulations were enacted to control prices, restrict trade and allocate credit and foreign exchange (Heidhues and Obare, 2011). With specific reference to financial sector policies and regulations, the era was characterised by what the neo-liberal (orthodox) economists labelled 'financial repression'. This refers to a system in which the government determines who gets and gives credit and at what price and regulates which financial institutions are permitted to do business and how they are permitted to operate; and the government owns banks and other financial intermediaries and controls international capital flows (Williamson and Mahar, 1998). Governments controlled interest rates and direct credit allocation as well as regulating entry of both domestic and foreign private financial services firms and capital, and exchange controls. And in some instances, governments nationalised privately-owned financial firms. A key objective of these policies was to help the governments to mobilise and direct savings for industrialisation and to marshal domestic and international financial resources for domestic investment to achieve economic growth and development (Epstein and Grabel, 2007). As noted by Epstein and Grabel (2007), a variety of state-owned, state-regulated and state-directed financial institutions were created to mobilise and channel credit to agricultural and industrial sectors of the economy,

as well as to important social sectors such as housing, education and health.

While several reasons could be adduced to justify such policies[2], they were basically to keep with the general tenor of the time which was dominated by the Keynesian world view as noted above and to achieve the developmental aspirations of the newly independent states. The private sector was seen as too backward and market institutions were mostly non-existent, and as such the state was necessarily seen as the general agent of economic development.

The financial policies and the general economic policies which place strong emphasis on the role of the state have been criticised on several fronts. McKinnon (1973) and Shaw (1973) present a very compelling case against the pre-Washington Consensus financial sector policies and regulations in what is now known as the McKinnon-Shaw hypothesis. The central argument of the hypothesis is that because of state control, low interest rates discourage financial savings in domestic institutions. Instead, domestic savers prefer to hold funds abroad, a phenomenon called 'currency substitution'[3], and current consumption becomes more appealing. Low saving rates result in low investment which, in turn, affects employment and economic growth. Moreover, state involvement meant that financial and capital markets in developing countries were fragmented and repressed which prevented an efficient allocation of resources, leading to low quality of investment, often serving only a small segment of politically-connected borrowers who can gain access to the scarce low-cost credit. Whilst the majority of the borrowers are left with no option than to either patronise the unregulated 'informal' lenders who often charge exorbitant interest rates or manage with unmet need for capital (Epstein and Grabel, 2007). As a natural solution, orthodox economists proposed a set of financial liberalisation policies which form part of the policy prescription of the Washington Consensus.

The Washington Consensus Phase

The term 'Washington Consensus' was coined by the renowned economist John Williamson to describe a set of market-oriented reforms originally designed for the Latin America[4]. The 10-point policy package quickly became seen as a model for the wider developing world. Unlike the state-dominated policies of the Keynesian era of the 1960s and 1970s, the neo-liberal policy agenda advocated market economy, fiscal discipline, trade and exchange rate liberalisation and financial liberalisation among others (Todaro and Smith, 2003). The Washington Consensus policy held sway in much of the 1980s and 1990s and was promoted by the World Bank, International Monetary Fund (IMF) and western donors.

In response to the African crisis in the late 1970s the World Bank and IMF promoted SAPs under their structural and sectoral adjustment loans where compliance with market reforms and fiscal discipline became preconditions for such loans. A major emphasis of the SAPs was the need to adopt financial liberalisation measures characterised by the following six dimensions (Williamson and Mahar, 1998: 2):

- "The elimination of credit controls.
- The deregulation of interest rates.
- Free entry into the banking sector or, more generally, the financial-services industry.
- Bank autonomy.
- Private ownership of banks.
- Liberalisation of international capital flows".

The set of liberalisation policies were implemented with high hopes and promises[5]. First, based on the McKinnon-Shaw hypothesis it was touted that financial liberalisation would promote a high level of financial savings, investment, employment and growth which should translate to poverty reduction. Second, orthodox economists contended that financial liberalisation would improve the quality of investment by ensuring that savings were efficiently allocated since market mechanisms would ensure that rate-of-return criteria and objective practices would be followed. Also it was believed that liberalisation would encourage financial innovation through the creation of new financial instruments, institutions and markets. This, in turn, would provide opportunities to diversify and share risk and eliminate the need for informal finance with its exploitative tendencies. In addition, proponents argued that liberalisation would improve the overall efficiency of the financial system by eliminating wasteful and corrupt practices that flourished under financial repression.

Despite the persuasive arguments by its influential proponents, and the promises and hopes raised, the years of implementation of the SAP policies seems to have recorded the worst economic performance in the history of Africa, whilst most of the promises

[2] *See Epstein and Grabel (2007).*
[3] *See Aziakpono (1999, 2005) and Aziakpono and Babatope-Obasa (2004).*
[4] *See Williamson (1990).*
[5] *See Epstein and Grabel (2007).*

were never met. Moreover, there is abundant research evidence[6] to confirm that the liberalisation policies were associated with banking, currency and financial crises around the world as well as in Africa. Because of the devastating effect of the SAP policies on the economies of the developing nations and the poor, William Easterly describes the 1980s and 1990s as lost decades (Easterly, 2001). Similarly, other prominent economists (such Joseph Stiglitz, a Nobel Prize winner in economics) have been very vocal in criticising the Washington Consensus policies[7].

The Post-Washington Consensus Phase

The devastating effects of the Washington Consensus policies, coupled with the mounting criticism of the policies, led to a rethink of the approach. The results were changes to the Washington Consensus approach and an evolution of what is now labelled a 'New Consensus'. However, unlike the inward-looking state-centred development paradigm of the 1960s and 1970s, and the neo-liberal market-oriented generic policies of the Washington Consensus, the policies of the New Consensus are more nuanced and eclectic with a focus on human-centred development. Whilst the New Consensus has evolved over time, the Summit of the Americas in Santiago, Chile, in April 1998 and the Commission on Growth and Development, which produced its report in 2008, are the main representatives of the New Consensus' view on development.

The New Consensus retained some of the key aspects of the Washington Consensus. For instance, it stressed the importance of market-based development, but recognised that there are large market failures that cannot be ignored (Todaro and Smith, 2003). While acknowledging that the government has a meaningful and crucial role to play, it clearly asserts that "governments should not try to do too much, replacing markets or closing the economy off from the rest of the world" (Commission on Growth and Development, 2008: 4). One of the distinguishing features of the New Consensus is the ostensible control it gives to individual countries to adapt the policies to their specific country context rather than following some generic policy prescription. The following sentences from the Commission's report capture the core of the New Consensus's financial sector policies:

- "If the financial system fails to reach large portions of the population, household savings will be stunted… The absence of savings channels is inequitable as well as inefficient" (p.56). Hence, it advocates inclusive banking and financial services.
- "One way to speed up financial sector development is to invite foreign financial firms to invest in the sector" (p.56). That is, it encourages openness of the financial system.
- "Careful regulation and supervision are required to prevent banks from expanding credit too far" (p.57). Thus, appropriate regulation and supervision are necessary ingredients for financial system development.

As its name indicates, the New Consensus is still new and the implementation of its policies is still evolving. Hence, empirical evaluation of the outcomes of its policies is still nascent. Nonetheless, it has been criticised for "lack of clarity on specific policy advice" because of the eclectic nature of its policies, unlike the generic policy prescription of the Washington Consensus and as "a recipe for confusion, an 'anything goes' scenario" (Kanbur, 2008: 53).

OUTCOMES UNDER DIFFERENT POLICY REGIMES

The pre-Washington Consensus policies initially led to some success. For instance, as observed by Heidhues and Obare (2011), major investments were made in infrastructure (roads, ports, telecommunications and power generation), and health and education improved significantly. Though per capita GDP remained very low, as shown in Table 2, SSA recorded a significant growth, averaging 3.3% and 4.4% in the 1960s and 1970s respectively. This was in sharp contrast to the dismal growth recorded during the 1980s and 1990s when the SAP policies were implemented. In the 1960s, the SSA had the lowest growth compared to other regions, either rich or poor. However, by the 1970s SSA had overtaken all the groups of rich nations such as OECD, the Euro area and European Union and the world's average, but lagged behind the growth record of the league of developing nations. By the 1980s and 1990s, when the SAP was implemented, SSA had the lowest growth rate compared to other regions of the world and was far below the world's average.

The adverse effect of the SAP policies become even more evident when one compares the real per capita GDP of the different decades from the 1960s. By the 1970s the level of real GDP per capita had risen to

[6] *See Heidhues and Obare (2011), Epstein and Grabel (2007), Williamson and Mahar (1998) and Aziakpono (1999).*
[7] *See Stiglitz (2002) and Kanbur (2008).*

Table 2: GDP growth (annual %) and GDP per capita in US$

GDP growth (annual %): 1966-2015						
	1960s	1970s	1980s	1990s	2000s	2010-15
East Asia & Pacific	5.2	7.3	7.7	8.1	8.8	7.7
Euro area	5.8	3.8	2.3	2.2	1.4	0.8
European Union	4.9	3.6	2.3	2.2	1.6	1.1
Latin America & Caribbean	6.0	6.7	2.3	2.5	3.2	2.6
MENA	9.8	5.4	1.4	4.4	4.5	2.0
OECD	5.6	3.7	3.0	2.6	1.7	1.8
SSA	3.3	4.4	1.4	2.0	5.5	4.3
World	5.6	4.1	3.1	2.7	2.9	2.9
GDP per capita in current US$: 1966-2015						
East Asia & Pacific	100	178	333	673	1 816	5 446
Euro area	1 783	4 837	10 412	21 425	30 609	38 021
European Union	1 560	4 048	8 867	18 122	27 469	34 610
Latin America & Caribbean	434	1 038	1 894	3 274	4 976	8 958
MENA	254	892	1 946	2 440	4 469	8 155
OECD	2 220	4 876	11 059	20 876	29 612	37 240
SSA	164	356	593	568	854	1 686
World	678	1 411	2 920	4 965	7 083	10 297
GDP per capita (Constant 2005 US$): 1960-2014						
East Asia & Pacific	168	255	431	837	1 645	2 872
Euro area	11 765	17 605	21 634	26 764	31 971	32 790
Europe & Central Asia			2 953	2 612	3 471	4 524
Latin America & Caribbean	2 199	3 269	3 925	4 127	4 757	5 565
MENA	1 272	1 896	1 726	1 774	2 235	2 545
South Asia	252	284	345	466	690	1 026
SSA	776	949	897	794	872	1 003
World	3 607	4 697	5 359	6 099	7 166	7 839

Source: World Bank (2016a)

US$949, but as the SAP policies kicked in, it started to drop in the 1980s to US$897, and reached the lowest level of US$794 in the 1990s. Despite the growth records in the 2000s, the level of per capita GDP only managed to overtake the 1970s' level after 2010. While it is difficult to tell what would have happened if the continent had continued with the post-independence policies, one can observe that all the regions where the SAP policies were implemented experienced a significant drop in their growth trajectories as evident in Table 2. Interestingly, the East Asia & Pacific (EAP), the only region that comprises many countries that did not adopt the SAP policies, continued to experience accelerated growth throughout the decades including the 1980s and the 1990s. The EAP region not only experienced rapid growth but was able to reduce poverty levels drastically, so that from a record high of 77% of the population living below US$1.25 a day in 1981 the level dropped to a mere 12.5% in 2010. In contrast, as shown in Figure 2, the ratio of people living below US$1.25 a day increased throughout the 1980s and 1990s in SSA. What is clear from this brief analysis is that had African countries continued with the post-independence policies, their growth trajectory would have been different and in all likelihood better than was experienced with the SAP policies. This view is further supported when one considers the trend since the 2000s when the SAP policies were no longer in fashion: African economies returned to a strong positive growth trajectory and have outperformed all other regions with the exception of the EAP.

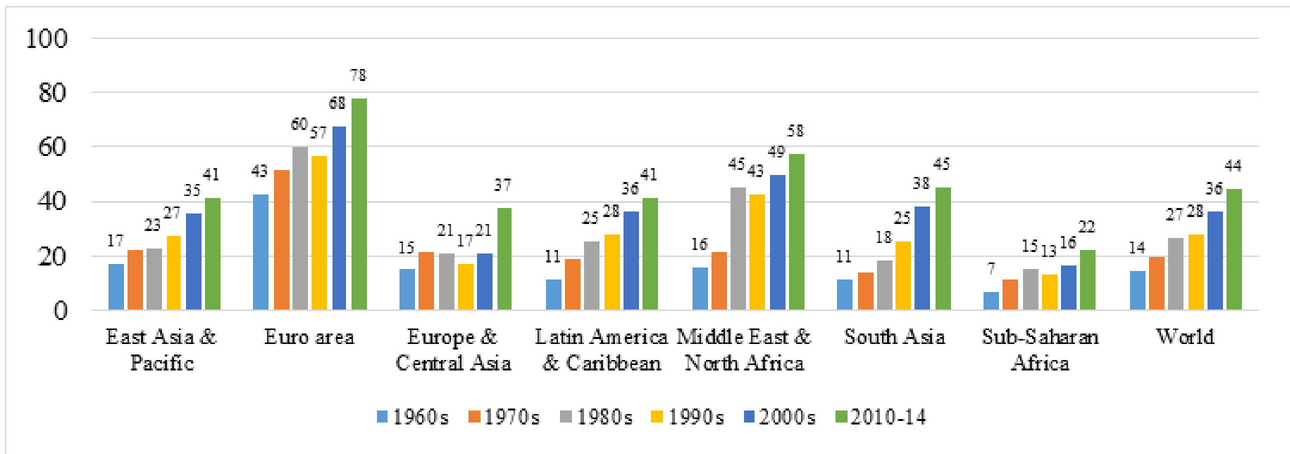

Figure 3: Bank deposits to GDP (%) (1960-2014)
Source: World Bank (2016b)

With specific reference to the performance of the financial system, if the orthodox arguments for financial liberalisation of the Washington Consensus era were to hold, we would expect the financial system to improve in at least two areas: the level of financial savings and credit to the private sector should increase. We use these two indicators along with others to assess the performance of the financial system since the 1960s. Given that the financial system in Africa has been dominated by banks since independence, we focus mainly on the banking sector.

The first indicator measures the ability of banks to mobilise savings and is computed as a ratio of bank deposits to GDP. Figure 3 presents the picture for SSA and other regions for the different decades since 1960s. As shown in Figure 3, for each of the decades, SSA records the lowest ratio. Furthermore, for the entire period the level of deposit mobilisation by banks relative to GDP remains meagre. The highest recorded so far in SSA is 22% in the current decade (2010-14), just half of the world's average. The evidence shows no discernible positive effect of the liberalisation policies on deposit mobilisation by banks in SSA. If anything, it rather suggests a negative effect during the 1990s as the ratio dropped from 15% in the 1980s to 13% in the 1990s. This may be connected to the numerous banking crises experienced on the continent during the 1990s as a result of the liberalisation policies. Thus, it would appear that the increasing trend in deposit mobilisation by banks experienced in the 1960s, 1970s and 1980s was interrupted in the 1990s because of the adverse effect of the liberalisation policies. Recovery during the 2000s has been slow, especially in view of the global financial crisis. Again, using this indicator, it is hard to attribute any increase in deposit mobilisation by banks in SSA to the liberalisation policies of the 1980s and 1990s.

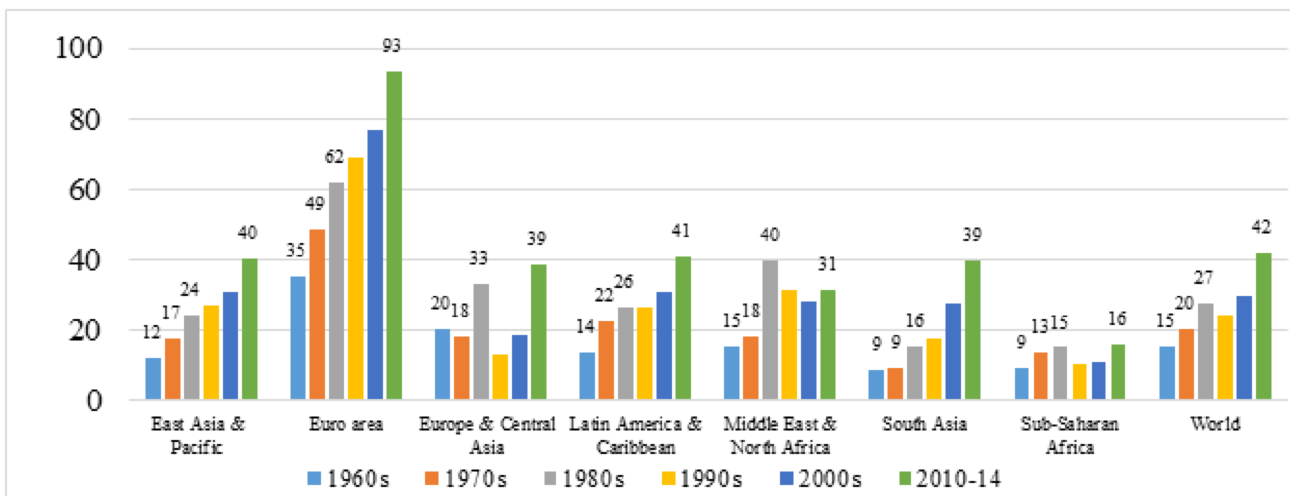

Figure 4: Private credit by deposit money banks and other financial institutions to GDP (%)
Source: World Bank (2016b)

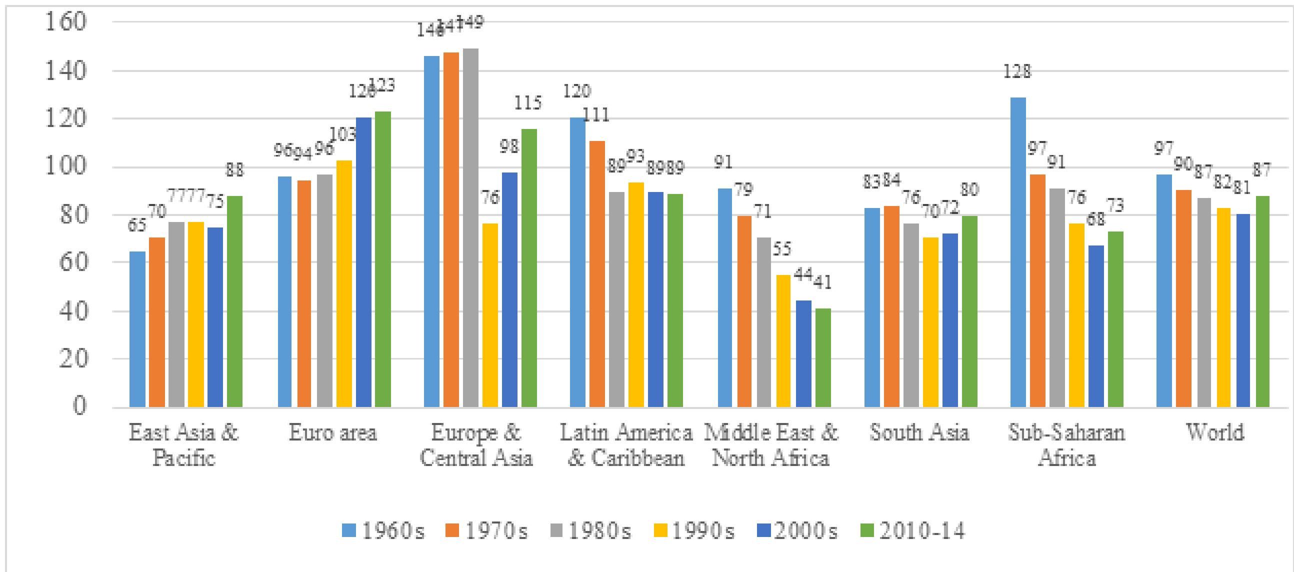

Figure 5: Bank credit to bank deposits (%): 1960-2014

Source: World Bank (2016b)

The second indicator is the ratio of private credit by deposit money banks and other financial institutions to GDP. This ratio is presented in Figure 4. This indicator also shows that the SSA region recorded the least credit to the private sector for all the decades except the 1970s when South Asia recorded a slightly lower ratio, with the highest ratio ever recorded by SSA being 16% in 2010-14. For the entire period one can also observe an interruption in the 1990s and 2000s in a trend of a modest increase in the ratio recorded from the 1960s to the 1980s. One can attribute the drop in the ratio of private sector credit during the 1990s and 2000s to the adverse effects of the financial liberalisation policies.

Figure 5 reports the ratio of bank credit to bank deposits to show the extent to which the banking system uses the deposit mobilised to advance loans, that is, the effectiveness of the intermediation function. It also highlights the extent of credit creation by banks. In the 1960s, SSA banks made more loans than the deposits they mobilised (approximately 128% of deposits) and the ratio at the time was higher than that of other regions with the exception of the Europe & Central Asia (ECA) region. During the 1970s and 1980s, in SSA the ratios were 97% and 91% respectively, which is high when compared with the ratios for the rest of the regions. From the 1990s to the current decade, the ratio has dropped significantly. What is evident from this is that from the 1960s to the 1980s banks made better use of their deposits to advance loans than from the 1990s to the present. Unfortunately, because of lack of data it is difficult to judge whether the quality of loans advanced during the earlier periods was better or worse than in recent periods. Nevertheless, it does show that there is some scope for policy intervention to ensure that the excess liquidity in the banking system in recent years is used to finance the economy.

Another way of evaluating the effectiveness of a financial policy regime is the number and extent of crises that occurred during the regimes. We use the banking crisis dummy for the analysis. Figure 6 presents the banking crisis dummy for Africa for the period from 1960 to 2011. The indicator takes a value of one when a systemic crisis[8] occurs and a zero when none occurs. As Figure 6 shows, for the period from 1960 to 2011 a total of 131 banking crises occurred in Africa of which 92 occurred in the 1990s and 35 occurred during the 1980s. During these two decades when financial liberalisation policies were implemented, a total of 38

[8] *The World Bank Global Development Finance Database note on the banking crisis dummy, defines a banking crisis as systemic if two conditions are met: a. Significant signs of financial distress in the banking system (as indicated by significant bank runs, losses in the banking system, and/or bank liquidations), b. Significant banking policy intervention measures in response to significant losses in the banking system. The first year that both criteria are met is considered as the year in which the crisis starts becoming systemic. The end of a crisis is defined as the year before both real GDP growth and real credit growth are positive for at least two consecutive years.*

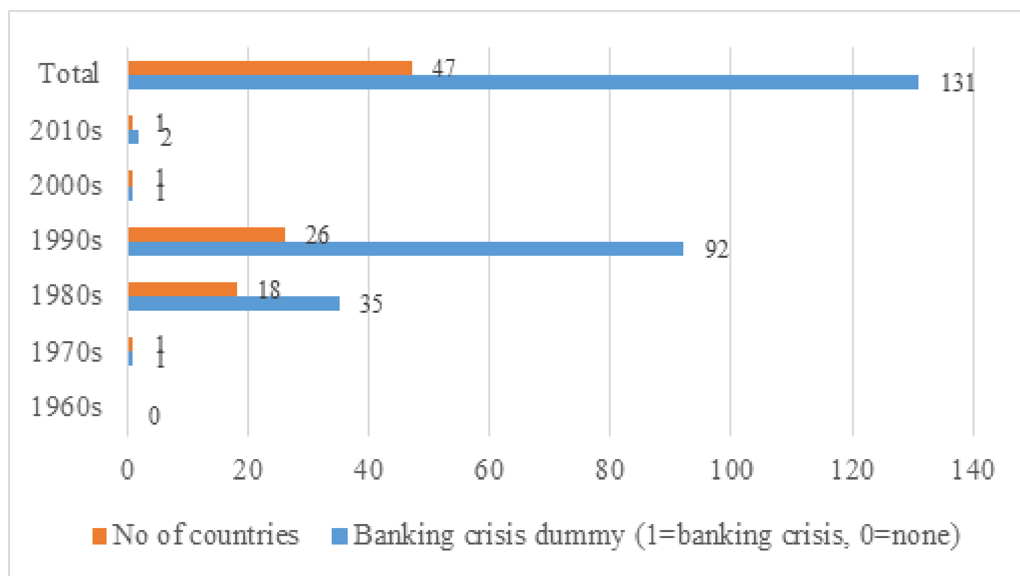

Figure 6: Africa: Banking crisis dummy and number of countries affected (1960-2011)

Source: World Bank (2016b)

individual countries experienced banking crises. The fact that the financial systems of these countries were not integrated among themselves shows that the crises were not as a result of contagion; rather, they were individual cases. Thus, as has generally been found in the literature[9], this evidently shows that rather than stimulating the development of the financial system, the liberalisation policies destabilised the system.

Overall, comparing the three policy phases, it is clear that the African economies and the financial system performed better during the decades of the pre-Washington Consensus policies than when the Washington Consensus policies where applied. This conclusion is supported by all the indicators analysed. The evidence seems to suggest that during the era of the New Consensus, the continent has returned to a positive growth trajectory. Similarly, the financial system has started to witness improvement as evident in the drastic reduction in the number of financial crises since the 2000s (only three in one country so far), and the increase in banks' deposit and private credit ratios.

MY TAKE ON THE ISSUE

Now I return to the question of an appropriate role for the state and the private sector. From the African story presented so far it is evident that in the past, especially the decades from the 1960s to 1990s, the state had tended to either do too much or too little with adverse consequences as we have seen above. Where does the appropriate balance lie? The New Consensus advocates a middle ground between the two extreme views adopted earlier, which takes into account the specific context of a country. However, the eclectic nature of its policies mean that there is no clarity on specific advice. My take on this issue is similar to the view advocated by the New Consensus, but I go a step further to provide some specific policy proposals for African countries, albeit with some generalisation.

To put my proposal in proper context I use a simple framework to illustrate the financing landscape and needs and articulate the appropriate role for the state and the private sector. Figure 7 presents the framework graphically. It assumes that all economic activities and units can be arranged in a continuum ranging from point A to B using two metrics to assess them for financing. The first metric is risk, either perceived or real, and the second is cost recovery. The risk curve represents how individual economic units or activities are assessed. Given information asymmetry problems and transaction costs, an activity or unit can be judged as very risky or less risky. At point A, an economic unit or activity is viewed as very risky and at point B, it is seen as less risky, while as one moves from point A to B the risk level tapers. The flip side of the risk curve is the cost recovery curve, which denotes the ability to recover the cost of investment. At point A the ability to recover cost is seen as very low, close to zero, but this increases until point B, where 100% of the costs may be recovered. Naturally, in terms of financing, private financiers such as banks, stock and bond markets, insurance companies,

[9] *See Williamson and Mahar (1998) and Epstein and Grabel (2007).*

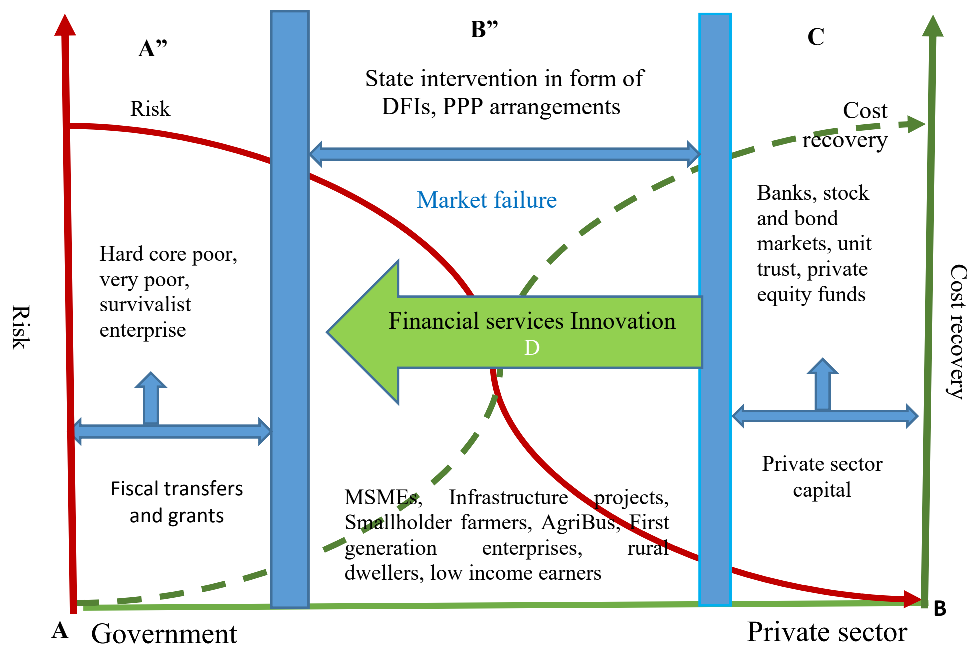

Figure 7: Financing landscape and needs[10]

unit trusts and private equity funds will provide finance to the economic unit or activity whether it is an individual, business or project that lies close to point B. The range within which private sector capital would readily provide finance is designated as C. At the other extreme, within the range designated as A”, no financial institution owned by either government or the private sector would be willing to provide finance to any economic unit or activity because of the high level of risk and low cost recovery. These would include the hard core poor and very poor individuals and survivalist enterprises. Normally, support for such individuals and enterprises would come in the form of fiscal transfers, grants or aids provided by governments or charity organisations. The middle space denoted as B” is often called the ‘missing middle’. Economic activities or units are typically not so poor as to deserve a grant nor so viable as to qualify for private sector finance. Economic units and activities in this segment would include MSMEs, smallholder farmers, Agribusinesses, first generation enterprises, low and middle income earners, rural dwellers, infrastructure projects and the like. Without any form of intervention, businesses, individuals and projects within this zone will be neglected.

In a country where property rights are poorly defined, legal and judicial systems are weak, contract enforcement is difficult and the information gap is high (due to absence of or weak information bureaus, a poor national identification system and poor accounting standards), businesses and individuals will be opportunistic in their behaviour which, in turn, will raise their risk level and the potential for cost recovery will be reduced. Moreover, in situations where individuals or businesses lack viable collateral because of where they are located, such as rural areas with limited access roads and shantytowns or slums in cities, they would be unlikely to qualify for private sector finance. Hence, the segment marked C will be very narrow while B” will be very large. This is the case of market failure which is typical of African countries.

As noted above, just as at independence, most African countries are still very underdeveloped, lacking most of the institutions necessary for a free market system. As underdeveloped countries, the developmental challenges are still monumental. For African countries to catch up with developed countries, they still need to invest massively in both social and economic infrastructures such as transportation systems (roads, railway lines, airports and seaports), electricity generation and distribution, education and training institutions (especially technical education to training the masses of the youthful population), hospitals and so on. In addition, there is a need to provide market-

[10] *DFIs refers to development finance institutions and PPP refers to public-private partnership*

friendly institutions such as information bureaus, well-functioning courts at different levels and types, and a national identification system for all citizens. Moreover, businesses need to be financed, especially smallholder farmers, Agribusinesses, MSMEs, and first generation enterprises that are currently neglected because of risks and transaction costs. It would be naïve to expect that governments would be able to shoulder such responsibilities alone or to pass the bulk to the private sector. All available resources (the state, private financial markets and institutions, international investors and donor resources, etc.) need to be harnessed to confront these developmental challenges.

Where do the defects of the financial policies during the pre-Washington Consensus era lie? The presence of widespread and significant market failures as highlighted above justifies the need for the governments of African countries to play a very active role in the financial sector and indeed the whole economy. As noted above, during the pre-Washington Consensus era such active roles included ownership of financial firms, control of interest rates and direct credit allocation and barriers to entry of both domestic and foreign private financial services firms and capital and exchange controls, and in some instances, nationalisation of privately-owned financial firms. In addition to controlling financial firms the state also owned and controlled industrial firms. While the objectives may be laudable and the actions taken commendable, a number of pitfalls can be identified. First, the governments at the time did not have the capacity to undertake the tasks that they needed to carry out in view of the state of human capital development; hence a more modest view of their roles would have been more manageable. Encouraging an active and growing role for the private financial firms would have helped to complement the state's efforts. Second, with specific reference to providing finance, encouraging active private sector participation instead of nationalising privately-owned firms would have helped to increase the size of the pot of available finance to the economy.

I now turn to the financial liberalisation policies implemented during the Washington Consensus era. As highlighted earlier, the government privatised most of the firms owned and controlled by the state, and let the free market forces to determine credit allocation and interest rates. In contrast to the pre-Washington Consensus policy era, the delegated roles to the private sector were overstretched in view of the prevailing weak private sector capacity at the time. In the absence of effective free market institutions and environment and competing demands for scarce funds, private financial firms could only intensify credit rationing and in most cases concentrate their services in the urban areas, thus neglecting the previously targeted priority sectors such as agriculture, industries, education, housing and health. Thus, shifting most of the financing roles to the private sector further fuels market failure, thereby expanding the 'missing middle' to the detriment of the economy.

Now I return to the question of an appropriate balance between the role of the state and the private sector to offer my take on the matter. First, I share the view that both the state and the private sector have a role to play to achieve the desired economic growth and development and that both of them must and should be allowed to play their roles effectively. I will begin with the role of the state before turning attention to the role of private financial services firms. For the purpose of the discussion that follows I will focus on two segments of Figure 7, zones B" and C, to identify the role of the state in each segment.

The role of the state in Segment C

As highlighted above, in Segment C the private financial firms are willing to provide finance to economic units and activities since the market mechanisms for cost recovery and risk management are readily applicable. It would therefore be a waste of effort for the state to be involved in the direct provision of finance within this space[11]. Instead, the role of the government would include regulation and supervision of the banks and other financial markets and institutions to ensure the stability of the financial system, and creating appropriate market incentives and environment for private financial firms to function effectively and efficiently and to innovate. Private sector here refers to both domestic and foreign private financial firms.

Regulation refers to the set of laws and rules applicable to the financial firms such as banks, insurance companies etc., while government supervision relates to the monitoring of activities of financial firms and ensuring compliance with rules and laws (Nyantakyi and Sy, 2015). The literature on regulation of financial

[11] This is one area where the pre-Washington Consensus policies erred. Though the private sector was backward at the time, the same was true of the state. Hence, the policies of nationalisation and creating barriers to entry of domestic and foreign financial firms were inappropriate as they limited the opportunities for the private sector to learn and to grow. Encouraging the private sector would have also increased the available pool of funds and engender competition.

firms identifies a number of reasons why this may be necessary[12]. Among others, these include: to promote competition, to protect consumers, to ensure financial system stability and avoid systemic financial crises, and to ensure monetary stability. Information asymmetries can lead to moral hazards and other opportunistic behaviour including excessive risk taking on the part of financial institutions which may cause systemic financial crises. The experience of the 2007/8 subprime financial crisis is a stark reminder of the adverse effects that a financial crisis could wreak on the economy. Hence, regulation and supervision is necessary.

The literature on financial regulations suggests an evolving gamut of regulatory instruments that can be used by regulatory and supervisory authorities. The latest of these sets of instruments are encapsulated in the Basel III Accord, which came as an aftermath of the global financial crisis to prevent the occurrence of such crises in the future. Basel I and II had been introduced earlier: Basel III tries to strengthen the micro-prudential regulation that existed in Basel II, in addition it introduced macro prudential regulations to prevent systemic crisis. Among the new sets of innovative instruments introduced in Basel III are leverage ratio, a countercyclical capital buffer, a global minimum liquidity standard for internationally active banks, and arrangements to strengthen cross-border supervision and resolution. The adoption of Basel III is still at an early stage in developed countries such as the USA and European countries, and some people may argue, justifiably so, that Basel III is too advanced for African countries at the moment[13]. Nevertheless, given the spread of pan-African banks within Africa, it is worth suggesting that the regulatory and supervisory authorities in African countries begin to work concertedly to see how to adapt some of the instruments of the latest Accord for their banking regulation. Especially, it would be necessary to promote actively and to strengthen cross-border supervision within Africa, and to adopt common standards for regulating internationally active banks within Africa.

Lastly, given the emerging role of mobile money[14] within the financial system in Africa, regulators need to devote resources to understanding the workings of the system and regulate it accordingly. So far a conservative approach has been adopted in its regulation in countries where it has flourished such as Kenya, Uganda and Tanzania. While such a conservative approach has been helpful for the emergence of this innovative mechanism of addressing the perennial problem of financial exclusion in Africa, it is however very pertinent for regulatory authorities not to ignore the potential that it may have to cause financial crises in the future. And given its wide spread in Africa and the growing integration of financial systems, a crisis in one country may spread quickly to others.

I now turn attention to appropriate incentives for the efficient functioning of private financial institutions and markets. The government can help the private financial system to flourish with innovations and to operate efficiently by creating appropriate market-friendly incentives and environment. At the core of this is to ensure a stable macro economy through appropriately coordinated fiscal, monetary and exchange rate policies. In addition to the broad macroeconomic policies, governments need to create market-friendly institutions that guarantee property rights, encourage ease of doing business, and reduce information and transaction costs. Such basic market-friendly institutions will include credit reference bureaus that are linked to an efficient national identification system. This would help to reduce the information asymmetry problems inherent in credit markets and as such reduce the resultant credit rationing[15] phenomenon prevalent in African countries. Further, the establishment of well-resourced and empowered commercial courts would help to improve the debilitating problems of weak legal systems and contract enforcement that hinder access to credit in formal financial institutions.

Appropriate and well-implemented regulations coupled with the right market-friendly institutions and good macroeconomic policy environment would help private financial institutions and markets to flourish and this, in turn, will promote competition and innovation. Ultimately, this would shift the boundary of zone B" to the left and reduce the size of the 'missing middle' (zone C) with positive outcomes for the economy as a whole.

The role of the State in Zone B"

The size of the 'missing middle' in most African countries is such that government cannot relegate the role of active provision of finance to the private sector alone. Whilst efforts to create the right environment for

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[12] See Barth, Caprio and Levine (2002).

[13] E.g. Nyantakyi and Sy (2015).

[14] Adjasi (2015) provides a useful insight on the spread of mobile money in Africa.

[15] See Akerlof (1970) and Stiglitz and Weiss (1981) for a masterful elucidation of this problem.

the private financial markets to thrive will help, there is still abundant scope for the government to directly intervene given the existing state of underdevelopment and financing gap[16]. I now turn attention to some of the options for governments to intervene in the provision of finance to economic units and activities.

The available options typically follow either one of the following two principles. First, interventions that encourage private financial institutions to provide financial services to underserved sectors by reducing and sharing risks and transaction costs due to market imperfections. One example of such interventions is credit guarantee schemes that target specific sectors such as Agribusinesses, smallholder farmers, MSMEs and the like. There are examples of guarantees provided for individuals, especially low to middle income earners, to finance the purchase of their first house, as well as students' loan guarantee schemes. A guarantee scheme often involves government partnering private financial institutions such as banks whereby the banks provide the credit while the government agency guarantees the repayment in case of defaults by borrowers. Guarantee schemes are usually employed where the targeted borrowers lack the standard collateral required by the lending institutions. One beauty of guarantee schemes is that it can expand supply of capital to small firms and high-risk sectors by private intermediaries without the government agency having to warehouse excessive credit risks. It also provides opportunities for private financial firms to learn about the requirements of new client groups and the perceived high-risk sectors. The existence of excess liquidity in the banking system in SSA, as highlighted above, makes the credit guarantee option a viable one.

Another example of risk and cost reduction and sharing intervention is a public private partnership (PPP) arrangement. Like guarantee schemes, PPP arrangements help to harness private sector capital and know-how to leverage the limited state capital in project development and finance. Both guarantee schemes and PPP arrangements are common in some African countries, and these should be aggressively promoted and encouraged. Ultimately they help to expand the currently underutilised private sector capital to the middle space (zone B").

The second principle of intervention involves the setting up of alternative institutions and programmes that supply capital directly to markets, projects, firms and individuals that private financial institutions and markets cannot reach or are unwilling to serve, at least for now. Many African governments have established development banks or finance institutions to play this role. While the records of success of such institutions are limited, nevertheless, they are very relevant and absolutely needed. The literature highlights a number of challenges faced by such institutions[17]. These include inadequate capitalisation; poorly defined goals, mandates, objectives, strategies and targets; weak governance structure; and weak regulatory and supervisory structure that often muddles ownership with control. For development banks and institutions to play their rightful roles, attention would need to be given to addressing these challenges.

The role of the private sector

With or without the right environment as highlighted above, private financial markets and institutions have a role to play in the financing of economic activities in the economy. A major distinguishing feature of private financial firms is the profit or financial motive, unlike development finance institutions that pursue both development goals and financial objectives. With a clear profit mandate, private financial firms have compelling incentives to explore avenues beyond the traditional low risk ventures represented in zone C of Figure 7. With growing competition among financial firms operating in zone C, the profit margin has increasingly plummeted and financing opportunities are declining. In contrast, as one moves to the left from zone C towards the middle, the financing opportunities are many and the returns are much more promising. Of course, moving into the middle space would require more innovative instruments, products and methods than conventionally used in zone C. Experiences have shown that banks and institutions that innovatively leapt into the middle space are reaping the dividends. A notable example is Capitec Bank in South Africa which by using innovative technology has managed to penetrate the often neglected segment of the markets with the result that it has overtaken Nedbank as the fifth largest bank in South Africa in terms of deposits. The experience of mobile money, especially in East African countries, is an excellent example of how technology can be innovatively harnessed to overcome the traditional constraints that prevent formal financial institutions from reaching low income earners, and rural and slum dwellers. Other innovative technology-driven methods for reaching the underserved market segments include ATMs, card (POS) devices and internet kiosks.

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[16] *See Shimeles, Rebei and Ndikumana (2009) for an estimation of the financing gap in Africa.*
[17] *See Calice (2013).*

Of course each of these has its peculiar challenges that banks must understand and manage.

CONCLUSION

As the saying goes, the only thing that is constant is change. African countries will continue to be affected by the winds of change around the world. Policy makers and political economists will be swayed according to the wind of change of the time and their personal leanings. Nevertheless, the key question of what role the state and the private market should play in the financial system will remain and will be answered differently at different times. No one answer will be absolutely right or wrong at any time. No set of generic policies and regulations will fit all situations and countries. Every policy or regulation, no matter how appropriate it may be, will have its own limitations which only time will reveal. The pains of bad policies will be felt by the citizens and not so often by the proponents. Therefore, policy makers must be wise enough to evaluate each policy proposal carefully against their environmental, country and project specific realities, no matter where it comes from or who the advocates are.

The challenge going forward is, as it has always been, that African countries lack the capacity to scrutinise every policy proposal that comes their way against realities. To avoid the disastrous path of the past governments in Africa must be committed to investing in capacity building and development in policy and scenario analyses and evaluation. As the world become technologically smarter and more intricately linked, the complexities of future challenges and policy proposals will soar. Lagging behind in developing the right skills and capacities to deal with and manage these issues will only spell disaster for the lagging countries. I hope efforts will not be too little, too late.

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