DEVELOPMENT OF DOMESTIC FINANCIAL INSTITUTIONS FOR INCLUSIVE GROWTH IN AFRICA

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Introduction

Domestic financial markets can play a critical role in promoting inclusive growth. The savings-investment-growth link remains central to the question of financial sector development and the ability of financial institutions to fully play their intermediary role. Putting in place well-functioning domestic financial infrastructure is, therefore, crucial for catalyzing domestic and foreign resources for growth and investment.

Development of domestic financial institutions to ensure inclusive growth has, however, remained a global challenge with as much as 54% of adults worldwide being financially excluded. Sub-Saharan Africa is the region with the lowest share of banked households[1]. This worrisome level of access to finance in Africa poses a serious challenge to inclusive growth. This necessitates pragmatic efforts by policymakers to remove barriers for the development of domestic financial markets in order to enhance inclusive growth.

Given this context, the objective of this paper is to examine the efforts so far in Africa in developing domestic financial markets for the purpose of achieving inclusive growth, the challenges therein; the need for Regional Financial Integration (RFI) and the way forward.

Theoretical and empirical evidence on the causal relationship between domestic financial development and inclusive growth

Economic theory suggests that finance shapes the distribution of economic opportunities. The financial system affects the degree to which a person's economic opportunities are defined. It influences who can launch a new business venture and who cannot, who can acquire education and who cannot, who can live in a neighborhood that fosters the cognitive and non-cognitive development of their children and who cannot, who can pursue one's economic dreams and who cannot.

A more competitive, better functioning financial system exerts a disproportionately positive impact on relatively low-income families. According to the extent that the financial system performs these functions well, economies tend to grow correspondingly faster. For example, when banks screen borrowers effectively and identify firms with the most promising prospects, this is a first step in boosting productivity growth. When financial markets and institutions mobilize savings from disparate households to invest in these promising projects, this represents a second crucial step in fostering economic growth.

When financial institutions monitor the use of investments after financing firms and scrutinize their managerial performance, this is an additional, essential ingredient in boosting the operational efficiency of corporations, reducing waste and fraud, and spurring economic inclusivity. There is a robust positive relationship between financial development and both poverty alleviation and reduction in income inequality. It is not just that finance accelerates economic growth, which trickles down to the poor; rather, finance exerts a disproportionately positive influence on lower-income households. Building on the finance and poverty connection, there is a direct link between finance and human welfare. When policy reforms foster the development of the financial system, financial services improve, accelerating economic growth, which ultimately leads to ending extreme poverty and boosting shared prosperity.

Research has established the robust positive impact of financial sector deepening on economic development in many countries. There is a well-established body of empirical evidence which shows that countries with higher levels of credit to the private sector relative to GDP experienced higher average annual real GDP per capita growth. Recent research has also pointed to a significant indirect impact of financial deepening on poverty alleviation. By changing the structure of the economy and allowing more entry into the labour market by previously unemployed or underemployed segments of the population, finance helps reduce income inequality and poverty, as evidence

1. U. Kama, M. Adigan: "Financial Inclusion in Nigeria: Issues and Challenges". Central Bank if Nigeria. August, 2013.

from Thailand and the US[2]. A study[3] employed the trivariate causality test to examine the dynamic relationship between financial development, growth, and poverty in South Africa. The study reported that financial development and economic growth granger cause poverty reduction. The paper also found economic growth to granger cause financial development and, in the process, lead to poverty reduction in South Africa and a similar result was found on Ghana[4].

Determinants of Performance of the Financial System to ensure that they contribute to inclusive growth

The Level of Financial Intermediation: This has to do with the depth of the financial system or its size as measured by several indices such as the ratio of the financial system's assets to gross domestic product; ratio of financial system's liabilities to gross domestic product, claims of the financial intermediaries on the private sector, relative to the gross domestic product; and the ratio of bank credit to the private sector relative to total credit in the system.

The Efficiency of Financial Intermediation: The efficiency of financial intermediation has to do with the quality of financial services. Such quality varies depending on several variables. Where workers in the financial system (e.g. bank-staff) lack requisite skills-set, which may lead to poor analysis of projects; inappropriate oversight of borrowers, and sub-optimal levels of financing and inefficient capital allocation.

The Composition of the Financial Intermediaries: In the financial structure, there are financial intermediaries known as Non-Bank Financial Intermediaries. This category includes, Pension Funds, Insurance Companies, Mortgage Finance Institutions, Mutual funds, Unit Trusts, Stock Exchange etc. when the banks are unable to give long-term finance, (if they have only mobilized short-term funds) the Pension Funds and Insurance Companies can make such long-term funds available in a well-diversified financial system.

The Features of the Financial Sector in Sub-Saharan African Countries

As a result of the reform program in the last two decades, the financial system in most Sub-Saharan African countries has transformed despite being highly dominated by the banking system. Even though there are many other institutions, including finance and leasing companies, they are often linked to banks through ownership. The financial system was also becoming more stable, mostly due to addressing loan losses in state-owned banks, increasing provisioning and increase in minimum capital. The NPL ratio in many Sub-Saharan African Countries reduced in recent years while the risk-weighted capital/asset ratio rose.

The resilience of the banking system in most countries to the recent global financial crisis reflects the improved personnel and institutional capacity, including risk management and loan procedures, as well as the stronger regulation and supervision of the Central Banks as well as limited connections with the international financial system. There has also been progressed in many countries in the financial infrastructure, most notably through the establishment of the Credit Reference Bureau and improvements in the payments system. In payments, the RTGS payments system became operational in many countries. This reduces the problems of default in payments that have proved very costly in some countries. However, there is evidence of low intermediation efficiency, despite high savings mobilization capacity of the banking system in most countries. The explanations are numerous.

Government's financing needs crowd out credit to the private sector, reflecting the (perceived) lower risk of government securities. Credit is concentrated among a few borrowers, with most of the enterprise population being left out. There is also little competition from outside the banking system, consistent with the bank-based nature of the financial system in most countries. There is very limited physical outreach of the banking sector. Microfinance in most countries has remained limited in size, with only a small portion of the potential market being served. Additionally, Microfinance institutions are restricted by the lack of a proper regulatory framework and the prohibition to take deposits in some countries. As well, non-bank financial intermediaries and securities markets are less developed.

Given the importance of SMEs in creating employment, the lack of credit supporting their activity in Sub-Saharan African Countries financial systems is a major drawback for development. International financial indicators show that in Sub-Saharan African countries' businesses, in general, are

2. Giné, Xavier, and Robert M. Townsend. 2004. "Evaluation of Financial Liberalization: A General Equilibrium Model with Constrained Occupation Choice." Journal of Development Economics 74, 269–307
3. Odhiambo M. N (2009): "Finance, Growth and Poverty Nexus in South Africa". A Dynamic Causality Linkage. The Journal of Socio-economics, 38 pp.380-325.
4. Quartey P. (2005): Financial Sector Development Savings, Mobilization and Poverty Reduction in Ghana" UNU-WIDER Research paper No. 71, United Nations University, Helsinki.

disadvantaged through less access to finance than competitors in other regions.

In an effort to increase the level of participation of financial institutions to finance small and medium enterprises, the African Development Bank (AfDB), is implementing a number of initiatives designed to encourage the participation of financial institutions. One notable initiative is the African Guarantee Fund (AGF). The AGF is owned by AfDB, AECID and DANIDA with contributions of US$10 million, US$20 million and US$20 million, respectively[5]. Over the next 3 to 5 years, this share capital is expected to increase to US$ 500 million, giving the institution capacity to guarantee up to US$2 billion worth of SME loans. The additional capital will be coming from bilateral donors, private investors as well as from DFIs.

Innovations in financial system development to ensure inclusive growth in African countries.

Africa is innovating in new and exciting ways. The best example of this is Africa's mobile revolution. Kenya is the global example of how cellular technology can be leveraged to offer financial services at great scale and low cost. The M-PESA (M for "mobile" and PESA, Swahili word for "cash money") otherwise "mobile cash money" mobile money service in Kenya stands out as a model (for other African nations) of how consumer access to financial services can be revolutionised through technology. The service provides the average Kenyan without a bank account the opportunity among others to transfer cash; purchase airtime credit; pay bills, and purchase goods and services without the use of cash by simply transferring value from one individual to another through float balance on the phone. With a significant portion of the Kenyan population depending on money transfer from the employed, the introduction of M-PESA provided a cheaper, safer, more efficient means of transferring money to their dependents in the remote villages[6]. Even the business population with traditional banking accounts adopted the channel to pay wages, bills, salaries and pay for services provided in the remote part of the country. The populace was able to overcome the challenges of illiteracy, documentation bureaucracy, minimum balance requirement, and limited traditional banking distribution channels all of which limited the ability of the majority to open the conventional banking accounts.

The factors which are peculiar for the success of mobile in Kenya include wide usage of mobile phones which provided a ready potential market for mobile money service, the creation of the right government regulatory environment; the liberalization of the telecom sector, and prompt granting of mobile money transfer service license among others. The government of Kenya ensured the creation of the right environment for innovation while at the same time ensuring the stability of the financial system. Many African countries have also in recent times stepped-up the campaign for banks to invest heavily in other low-cost branchless channels such as ATMs, point-of-sale (POS) and mobile banking, etc.

Existing challenges for technology-based financial services in many African countries including among others, stringent regulations that govern the activities of technology-based financial services, limited interoperability; and low level of financial literacy and income among others.

Fostering and improving the microfinance institutions (MFIs) in Africa is also a top priority across the continent. Ministers of Finance and Economic Development of member countries made recommendations to the African Union Commission (AUC) in 2009 to consider minimum standards and policies concerning microfinance. Currently, microfinance specific legislation and regulations exist in almost all African countries.

Existing challenges for Microfinance development in many African countries including among other high costs of outreach, high transaction costs, Know Your Customer (KYC) and security challenges and insufficient resources, which limit MFIs their capacity to purchase world-class banking solutions that can help them fulfill their requirements and support their growth targets.

How Regional Financial Integration can support growth, development and poverty reduction in Africa.

African countries have been strengthening and modernizing their financial systems as part of their domestic reform programmes, recognizing that strong financial systems will deliver dividends in terms of growth and poverty reduction. However, despite these efforts, African financial systems lack depth and deliver only a limited range of products, at a relatively high cost, with the result that the expected benefits have not materialized to the full. Many studies have concluded that the disappointing outcome in Africa reflects, inter-alia, the small scale of the operations of most African financial

5. African Development Bank (2012) "African Guarantee Fund for Small and Medium Sized Enterprises Information Memorandum, Tunis.
6. Ngugi Benjamin and Pelowski Matthew (2010): "M-PESA: Case Study of the Critical Early Adopter's Role in the Rapid Adoption of Mobile Money Banking in Kenya".

system, and that this deficiency could be corrected through promoting regional financial integration (RFI).

RFI's contribution to growth comes through four different channels; (i) it provides further powerful stimulus for domestic financial reforms; (ii) it increases the scale of operations and cooperation, thereby increasing the system's efficiency and productivity; (iii) it induces foreign direct investment (FDI) inflows and (iv) it enables the African systems to grow into regional and ultimately global players in financial markets. A major new circumstance favouring RFI is the renewed, and credible, efforts towards fostering African Continental Free Trade Area (ACFTA). Increased Intra-Africa trade requires a higher level of financing and increased access to financial services and products, which may be more efficiently provided by regional institutions, services, and products. The expected progress in the implementation of ACFTA will no doubt increase the demand for financial services and may, thus, induce a demand-led regional Financial integration within Africa

Proposed Solutions to Establish Well Functioning and Inclusive Financial Markets

a) Address regulatory bottlenecks and allow mobile phone services to thrive;

b) Taking a strategic approach by developing a national financial inclusion strategy which brings together diverse stakeholders, including financial regulators, telecommunication, education ministry, etc.

c) Paying attention to consumer protection and financial capacity to promote responsible and sustainable financial services;

d) Provision by governments, development banks, and financial institutions partial loan guarantees to commercial banks that lend to SMEs. This approach would be particularly useful in sectors such as agriculture, for which credit is difficult to access due to lack of collateral and important climate risk.

e) Put in place credit reference bureaus and rating agencies responsible for providing banks with information on their clients, this would help reduce risk thereby lowering interest rates and facilitating businesses' access to credit;

f) Provision of financial (and managerial) literacy training, particularly for micro-enterprises that would otherwise not have the ability to present a viable business plan to secure a loan;

g) It is necessary for MFIs to be integrated in the formal financial system in order to scale-up their activities while retaining their comparative advantage in their relatively lower interest rates. Several MFIs have successfully made the transition to formal financial institutions in a few African countries.

h) Provide microfinance institutions with hedging instruments as well as risk management and mitigation tools. The goal is to offset currency risks faced by MFIs (which might borrow in dollars or euros and lend in local currencies).

i) Given the importance of financial services to the economy and the reality that SMEs are not only less likely to access credit and to pay more for it, but it is also necessary for policymakers to design innovative financial products geared towards SMEs.

Conclusion

Innovation and a wide spread of public and private activities and partnerships can contribute significantly to the development of African financial markets. However, access to finance is still a challenge for most Africans. Overcoming this bottleneck is critical if Africa is to increase its investment rate and its growth potential, as financial intermediation is the key to channeling resources into productive activities. Making African financial markets work for investment and development will require significant efforts aimed at among other things, creating and maintaining a stable macro-financial environment; establishing an incentive framework and a business climate supportive of entrepreneurship and private sector development; strengthening legal and regulatory environment; diversifying the supply of financial products and resources; regionalizing financial markets through legal harmonization and cross-listing at regional level and fostering an all-out national training effort in managerial and technical skills related to financial operations and use of proper accounting procedures and adequate auditing and financial information dissemination.

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