Financial Market Liberalization and Its Impact in Sub Saharan Africa

Hamid Rashid, *Ph.D.*
Senior Adviser for Macroeconomic Policy
UN Department of Economic and Social Affairs, New York

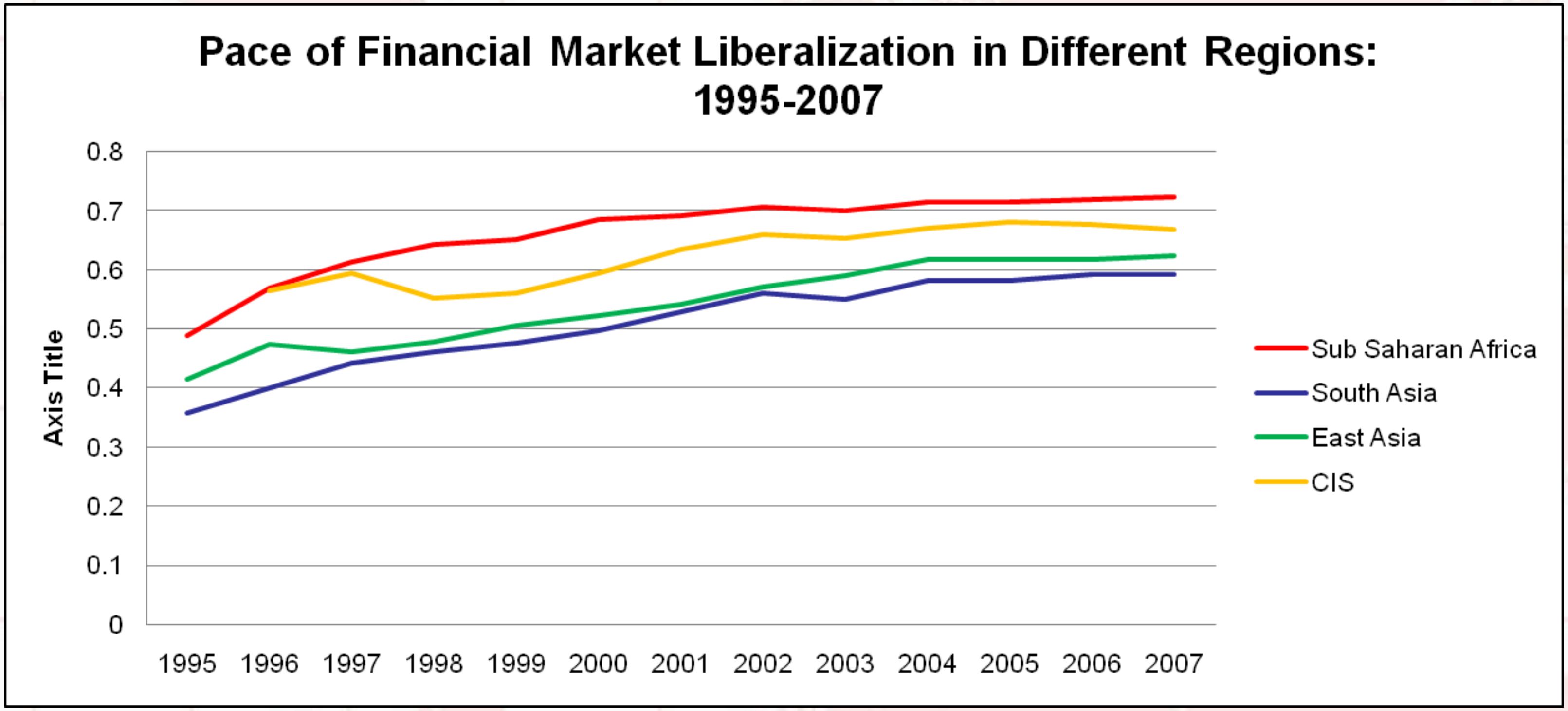
Why Financial Market Liberalization?

- Financial market liberalization (FML) was one of the main thrust of Washington Consensus Policies
- Proponents had argued FML will:
  - Enhance financial deepening, mobilize savings and new deposits and increase availability of credit
  - Make the banking sector more competitive and efficient and lower transaction costs, which in turn, will lower interest rate spreads
  - Strengthen bank supervision and regulation
  - Remove barriers to entry, improve country's access to foreign capital with foreign bank presence and improve financial stability
- Sub Saharan African countries, barring a few exceptions, embraced FML too quickly and too strongly

Measuring Financial Market Liberalization

- An IMF staff paper (Tressel *et al*, 2008) provides a very comprehensive cross country measure of financial market liberalization covering 91 countries for 1973-2005 (updated until 2007)
- The FML index, prepared by Tressel *et al*, takes a higher value (between 0 and 1) if:
  - Less stringent reserve requirements for banks
  - No directed credit
  - No subsidized credit
  - No credit ceiling
  - No interest rate controls
  - No or limited entry barriers for domestic and foreign banks
  - Privatization of the banking sector
  - No restrictions on capital account transactions
  - No restrictions on banks to engage in security/equity market operations
- Average FML index for our sample of 29 Sub-Saharan Countries increased from 0.48 in 1995 to 0.72 in 2007 – Only Eastern European countries liberalized faster than SSA countries

Financial Market Liberalization in Sub Saharan Africa Outpaced that in Other Regions



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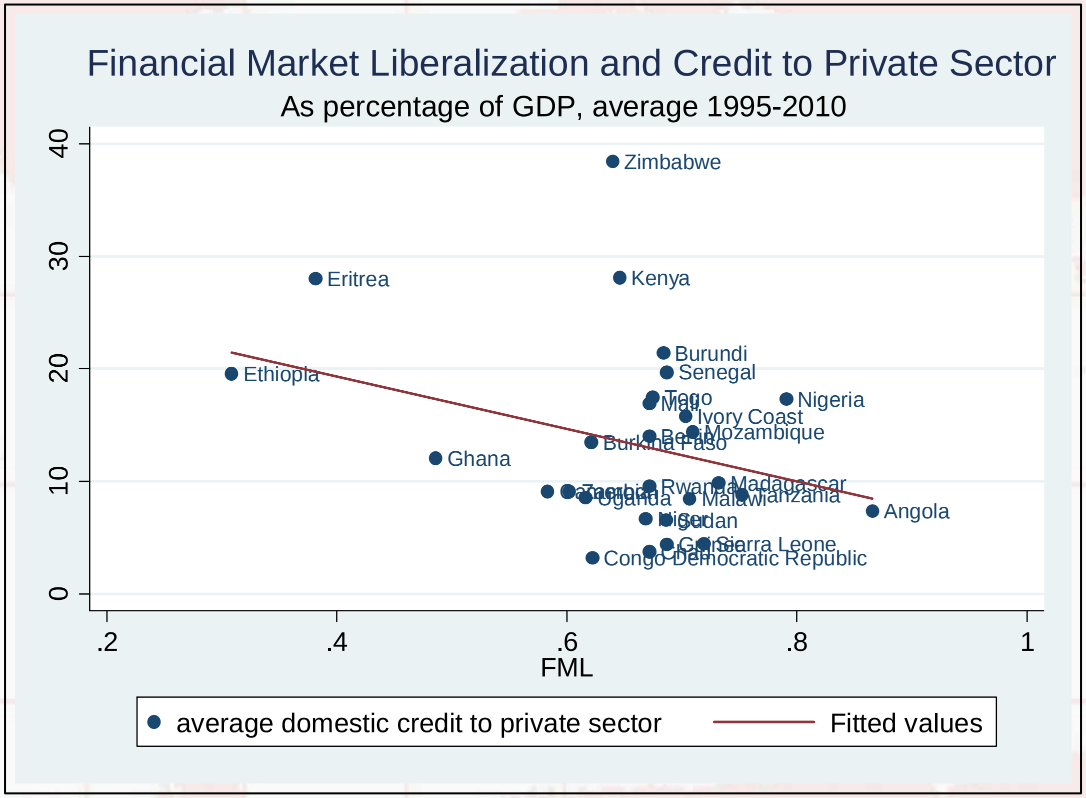
Financial Market Liberalization Also Meant…

- In absence of credit ceilings and targets, banks are free to create booms and bust lending cycles and have excessive concentration of lending in certain sectors
  - Housing loans, leading to house price bubbles
  - Consumer loans, promoting consumerism
  - Predominance of short-term loans
- In absence of directed credit, central banks can no longer promote priority sector lending to promote SME or industrial development
- In absence of geographic diversification requirements, government can no longer channel credit to under-served regions or communities
  - Financial exclusion instead of financial deepening
- Universal access to deposit insurance schemes meant foreign banks are allowed to compete against domestic banks for retail deposits
- Universal banking models meant that banks can engage in speculative investments

Has FML Increased Flow of Credit in SSA?



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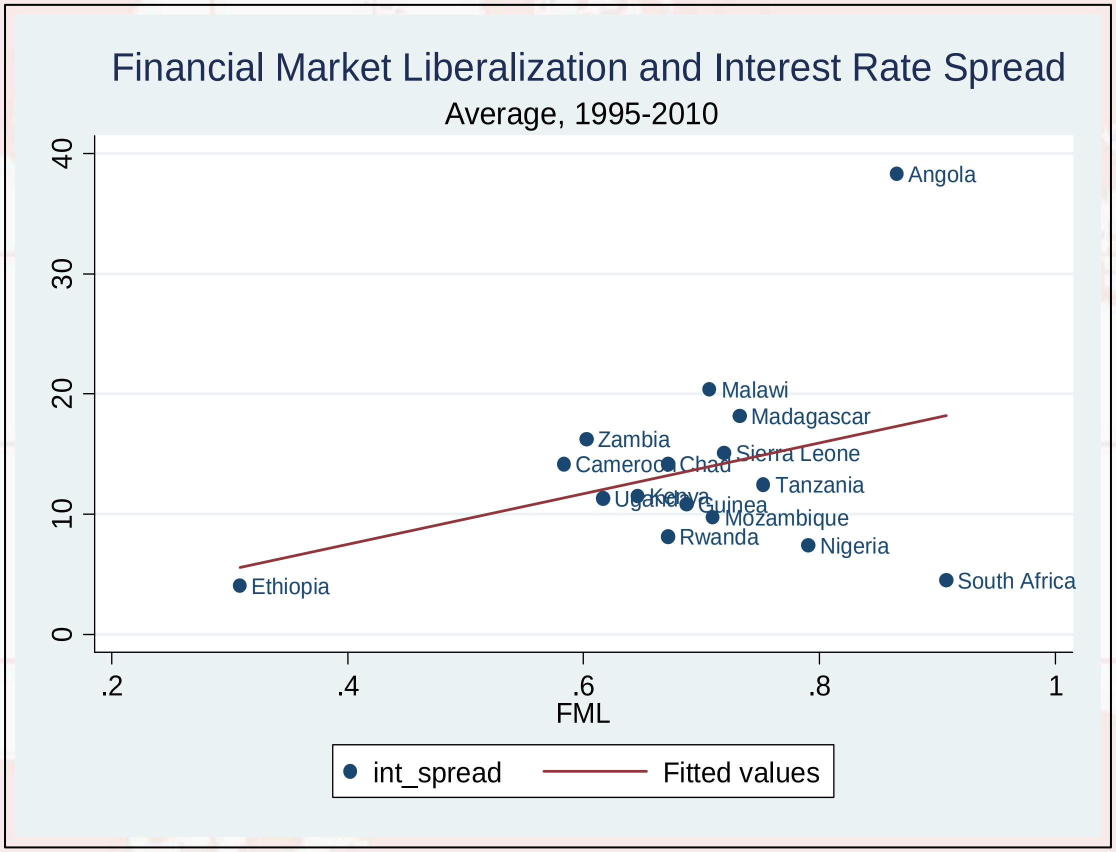
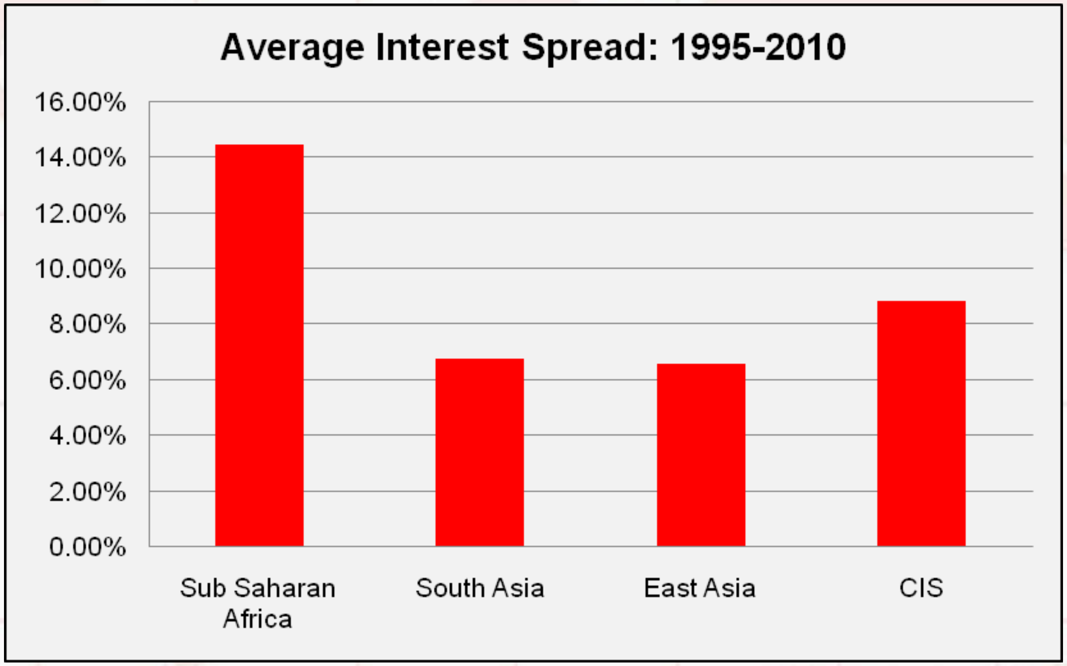
Has FML Reduced Interest Rate Spreads?

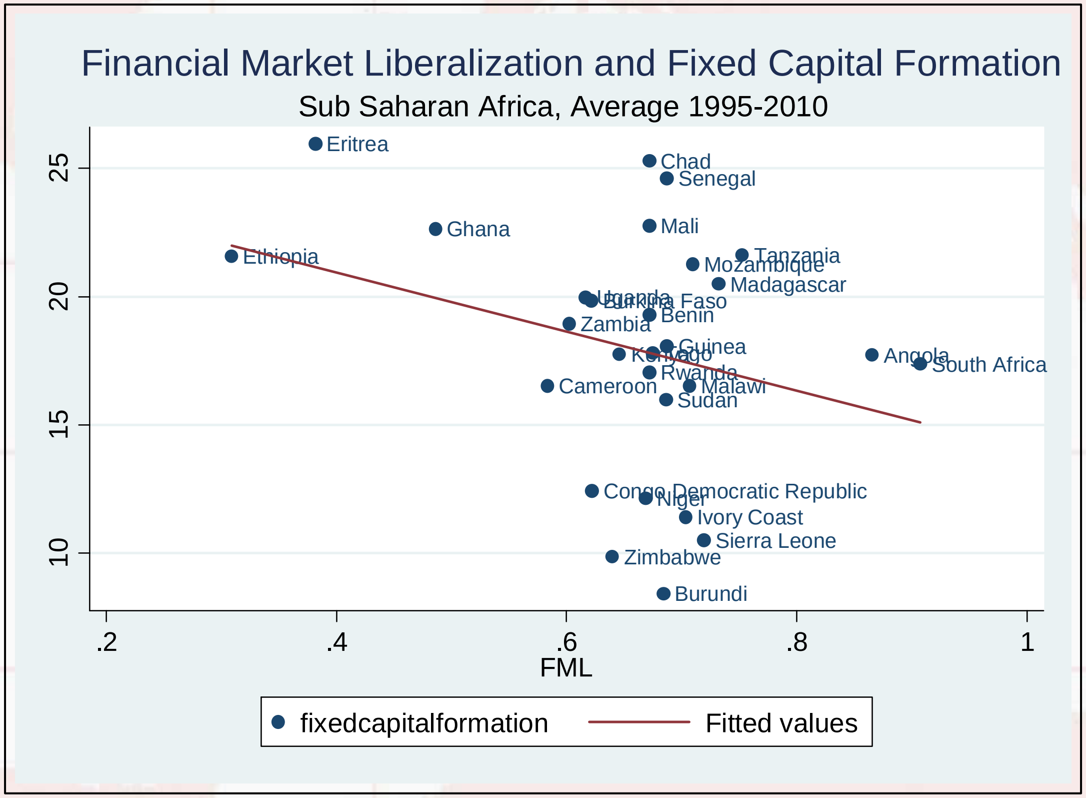


Interest Rate Spread in SSA and Other Regions



Source: Author's calculation from WDI database, excludes Zimbabwe and Congo D.R.

What about Fixed Capital Formation?



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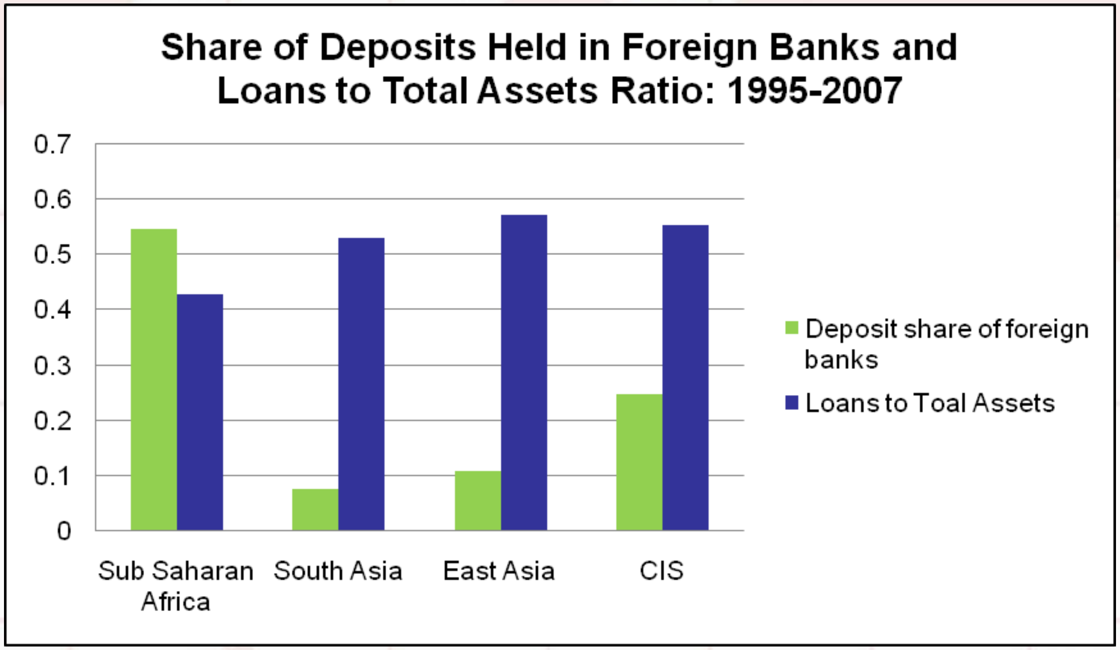
In Majority of SSA Countries, FML …

- Only led to reduced lending to productive sectors of the economy
  - Household and consumer loans in many SSA countries account for as much as 40-60% of total loans
  - During the boom years in the East Asian economies, household loans typically accounted for less than 20% of total bank loans
  - Consumer loans are crowding out business loans, especially loans to SMEs
- Allowed banks to reduce lending relative to their total assets and engage in non-lending activities (trading in equity and short-term securities)
- Increased presence of foreign banks contributed to further decrease in core banking activities – move towards more short-term lending

Dominant Presence of Foreign Banks in SSA



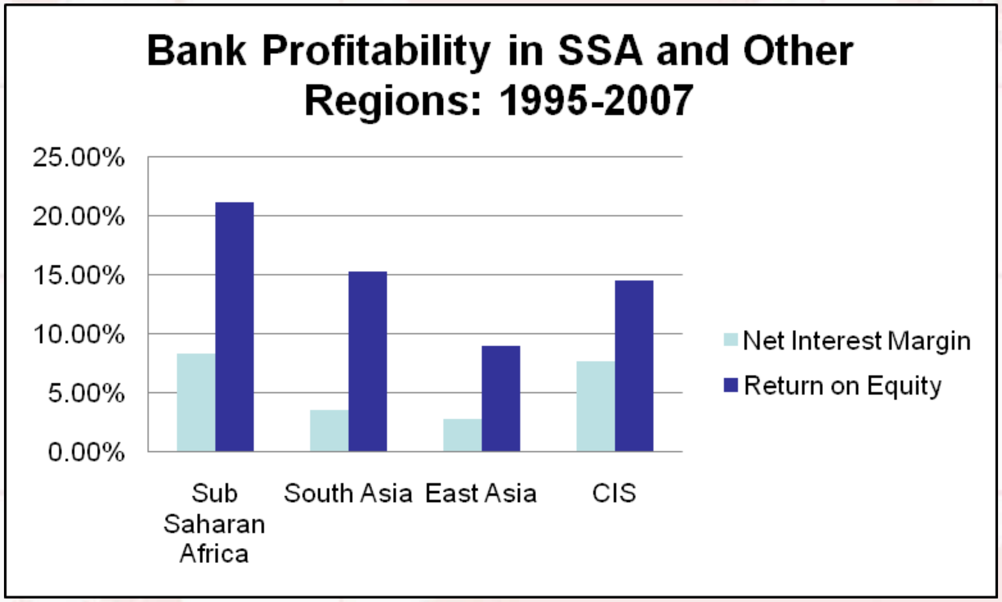
Source: Author's calculation from Bankscope database

FML Increased Dominance of Short-term deposits

- Foreign banks, contrary to the expectation that they will bring new capital to the host country, largely rely on domestic deposits to fund their banking and non-banking activities in SSA
- Foreign banks are efficient in collecting deposits - they control over 55% of retail deposits in SSA
- FML increased competition among banks and made deposits more fleeting – short-term deposits account for more than 50% of retail deposits in many SSA countries. In East Asian economies, banks were typically endowed with long-term deposits, which allowed them to lend long-term
- As foreign banks know less about domestic borrowers, they are typically unable to fully utilize their deposits and channel their excess deposit to inter-bank market
- Wholesale deposits in inter-bank market are typically more costly and volatile than retail deposits – increasing the cost of funds for domestic banks

FML Increased Bank Profitability…

- FML was supposed to increase competition among banks
- In SSA, opposite has happened – bank profitability increased substantially
- SSA banks are most profitable among all regions of the world

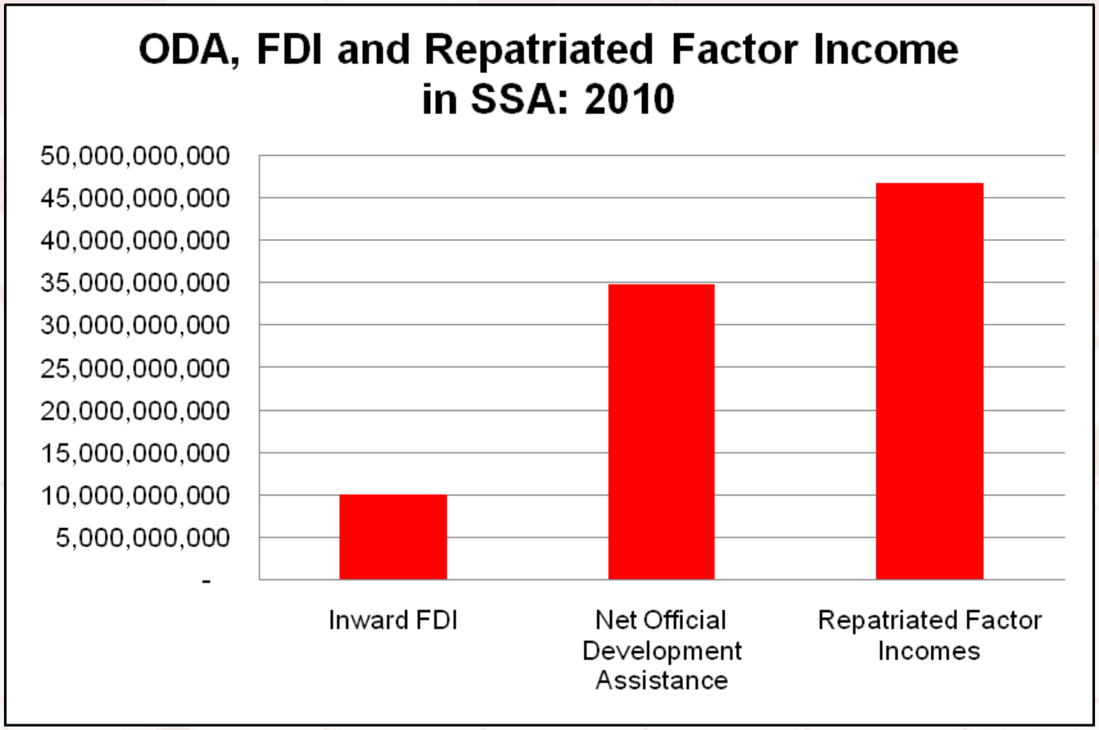


Source: Bankscope

FML Facilitates Repatriation of Profits..

- Financial and capital market liberalization facilitates repatriation of profits through banking and non-banking channels
- Total factor payments from our sample of 29 SSA countries increased from USD 10.9 billion in 1995 to USD 46.6 billion in 2010 – it reached as high as 6% of the combined GDP of these countries in 2008
- A significant portion of these payments are profits earned by foreign banks and MNCs operating in SSA
- Total factor payments out of these 29 SSA countries was larger than the combined ODA (USD 34.8 billion) and FDI (USD 10.1 billion) these countries received in 2010
- When the SSA region is yet to boost savings and domestic investments, these profits, if not repatriated, could help boost productive investments and industrialization of the region

Repatriated Factor Incomes from SSA



Source: The World Bank

Rethinking Financial Market Liberalization

- Contrary to expectations, financial market liberalization did not benefit the Sub Saharan economies
- FML did not bring down the cost of borrowing or increase access to credit – interest rate spreads remain very high and credit is still scarce in the region
- Increased presence of foreign banks, as a result of FML, reduced deposit share of domestic banks – foreign banks are now holding majority of deposits in SSA, contributing to increase in the volatility and cost of funds for domestic banks
- Even when the quantity of credit improved, its quality deteriorated. Rapid increase in household, consumer and short-term credit continue to crowd out credit to real sectors of the economy, especially to SMEs and manufacturing sector
- Repatriation of profits, mostly earned by foreign banks and large MNCs exacerbate the shortage of investable capital in SSA - East Asia could not develop, nor could the US or Europe, if it had to repatriate such large sums of profits year after year
- While we discuss the structural challenges to industrialization in SSA, we cannot possibly ignore the adverse impact of FML on industrial development
- In designing industrial policy, we must rethink financial market liberalization and how it impacts industrial development

Rethinking Financial Market Liberalization: Points to Ponder

- Is financial market liberalization reversible?
- Can SSA pursue industrial policies and achieve industrial development without reversing financial market liberalization and re-asserting control over its banking system?
- Are development banks sufficient to mitigate the adverse impacts of financial market liberalization?
- What are the minimum levels of financial market controls and regulations SSA must re-introduce to ease financing constraints, channel credit to productive sectors and promote industrial development?