# TABLE OF CONTENTS

Acknowledgements................................................................................................................ iv

Executive summary ................................................................................................................. v

**Chapter 1: Introduction** ....................................................................................................... 1

1.1 Financial system and inclusive growth .............................................................................. 1
1.2 Challenges for regulation of the financial system and its institutions.............................. 2
1.3 Rationale and objectives of the report................................................................................ 4
1.4 Structure of the report......................................................................................................... 5

**Chapter 2: African financial systems and performance**...................................................... 6

2.1 Introduction.......................................................................................................................... 6
2.2 Financial markets and institutions........................................................................................ 7
2.3 Financial systems in three case-study countries.................................................................. 14
2.4 Conclusion............................................................................................................................ 17

**Chapter 3: Financial deepening and inclusive growth**......................................................... 18

3.1 Introduction.......................................................................................................................... 18
3.2 Overview of the roles of the financial sector in promoting inclusive growth...................... 18
3.3 Financial deepening, economic growth and inclusion.......................................................... 19
3.4 What kinds of financial deepening are (most) beneficial for inclusive growth?................. 26
3.5 Conclusion............................................................................................................................ 33

**Chapter 4: Regulation of the financial sector and development**........................................ 35

4.1 Regulation and liberalization in case study and other countries ......................................... 36
4.2 Direct evidence on financial regulation and growth............................................................. 38
4.3 Conclusion............................................................................................................................ 50

**Chapter 5: Conclusions and policy recommendations**...................................................... 52

5.1 Main policy conclusions...................................................................................................... 52
5.2 Policy recommendations on how financial regulation can best contribute to inclusive development.................................................................................................................. 53

**References** ......................................................................................................................... 55
ACKNOWLEDGEMENTS

This study was prepared under the guidance and supervision of Adam Elhiraika, Director of the Macroeconomics and Governance Division. The Economic Commission for Africa (ECA) core drafting team comprised Gamal Ibrahim, Habiba Ben Barka, William Davis, Deniz Kellecioglu and Selamawit Getachew.

The report benefitted from valuable contributions from Malcolm Sawyer, Emeritus Professor of Economics, University of Leeds, United Kingdom of Great Britain and Northern Ireland, and Yonas Bekele, ECA. The study also received valuable contributions from participants in the Expert Group Meeting that reviewed the study, held in Addis Ababa on 14 November 2018.

The editing, layout and printing of the report was undertaken by the ECA Publications and Conference Management Section.
EXECUTIVE SUMMARY

The financial services sector has often been seen as playing a crucial role in funding development. Historical experience and academic literature, however, are far from clear on how growth in different parts of the financial services sector affects economic and social development. The importance of getting the governance of the financial sector right in order to achieve sustainable development is emphasized in both the Addis Ababa Action Agenda and the 2030 Agenda for Sustainable Development.

In Africa, although the financial sectors of most African countries are still at an early stage of development, many are growing rapidly. This signals the growing importance to the continent of having an effective approach to financial sector governance. Such an approach should balance the objectives of efficiency, contribution to growth and development and stability of the financial sector, among others.

In this context, the present report examines what type of development of the financial sector would best serve inclusive development in Africa, and what approach regulators should pursue in order to achieve this. The study is informed by the case studies of three African countries (Kenya, Morocco and South Africa) in addition to a review of current literature and original policy analysis. The study begins with an introductory chapter that provides an overview of the topic, recent developments in Africa’s financial sector and the ongoing debates in the academic literature.

This is followed by a review of African financial systems, which looks at how they function and how well they are performing in supporting inclusive development on the continent. In particular, there is great diversity in the size and scope of the financial systems in Africa, ranging from some of the least financialized economies in the world through to one which some measures as the most financialized (South Africa). In general, financial systems in Africa remain smaller than those of the rest of the world; however, financial deepening – understood as an increase in the ratio of financial assets or liabilities to gross domestic product – is occurring in Africa, and African countries are attempting to enhance the depth and efficiency of financial institutions, while innovative financial services are expanding. Further measures are needed to expand the number of countries that have access to finance in a well-regulated context, and promote the financing of “green” investments.

The report sets out the relationship between financial deepening and inclusive growth and, in particular what kind of financial sector development can best support inclusive growth in Africa. There are a number of channels through which the financial sector can support inclusive growth, namely: the provision of credit to the private sector; providing access to finance and the financial system, including the payment system; through supporting the Government’s financing needs and financing public development projects; and mobilizing additional funds for investment. Overall, financial deepening appears to positively contribute to growth up to a certain level of financial depth; beyond that level, it reduces growth; and it appears to reduce poverty. Most African countries (with the exception of South Africa and to some degree North African countries) can benefit from further financial deepening; however, the impact it has on inequality is less clear.

The type of financial deepening matters, in particular credit to the private sector and financial intermediation, which appear to have a positive
impact on growth; but household credit and speculation have negative effects. The stock markets in low-income countries, and the development of financial services that facilitate illicit financial flows and financial crime, can both undermine growth and financial stability. In addition, bank size, and which sectors and projects are financed, are important.

Promoting greater financial inclusion (that is, extending the number of individuals that have access to financial services, especially those who were previously excluded) can also contribute to poverty reduction, but the type of financial inclusion matters. In particular, individuals having access to payment systems for receipt of remittances, and programmes designed to support their having access to important goods and services (such as affordable housing), combined with consumer protection and efforts to promote financial literacy, can be strongly beneficial. The impact of micro-credit is more mixed and in some cases appears to have led to a shift towards informal employment. As such, micro-finance should not be a substitute for efforts to promote the development of transformative sectors providing decent jobs.

Finally, the report looks at what kinds of financial sector regulation Africa should pursue to best support inclusive development on the continent. The financial sector cannot be assumed to be self-regulating or self-correcting, as historically, such an approach has led to many financial crises. In examining the details of what approach to financial regulation should be pursued, the results from the study highlight the importance of: improving credit information; promoting competition (including via entry from foreign banks, as long as there is an adequate regulatory framework in place); preventing financial crime and illicit financial flows; adopting sound macroprudential regulations (including those dealing with the financial stability risks of an open capital account); providing regulations that support the creation of financial innovations (for example, Islamic finance); and ensuring the private monitoring of banks, strong corporate governance and regulations that are linked to national development goals. Furthermore, it is important to balance the need to allow banks to diversify their portfolios with the need for the primary focus of lending to be on transformative activities. Capital requirements are crucial to ensuring growth and financial stability, at least up to a certain point.

Regulations should support the creation of financial innovations (for example, Islamic finance). In addition, the results of this study highlight the importance of competition, counter-cyclical regulation, the prevention of illicit financial flows and financial crime, transparency and accountability, in terms of how it effects African countries.

The report concludes that robust financial sector regulation is vital for the financial sector to support inclusive growth in Africa, and that further growth in the financial sector should be encouraged for most African countries. At the same time, while the financial sector is still relatively small (and has relatively limited political influence), African countries should seize the opportunity to introduce regulations to ensure that the sector's activities support the rest of the economy in the most effective way possible. This includes ensuring that the sector's primary focus is on lending to the private sector, in particular those economic sectors that are most important for economic transformation, such as manufacturing and infrastructure services. Regulations should also provide for and encourage diversification and financial inclusion (in a context of strong consumer protection, ensuring that funds are not diverted away from more transformative investment).

Competition and counter-cyclical regulation should be part of an overarching developmental macroeconomic policy framework.
CHAPTER 1: INTRODUCTION

1.1 Financial system and inclusive growth

Economic development and industrialization require financing and funding, and the growth of the financial system, including banks, other financial institutions and financial markets, has often been seen as a crucial element. There have been long debates on the nature of the relationships between what has been termed “financial deepening and development” on the one hand, and “economic and social development” on the other. The ways in which financial institutions operate — to whom they provide credit and on what terms, the financial assets and returns offered to savers — play a large role in who benefits from financial development, and specifically in whether and how financial development fosters inclusive growth.

Financial deepening and development relate to the growth and activities of financial institutions and financial markets, and to the ways in which growth takes place: involving the development of financial intermediation, the growth of financial assets and liabilities, the involvement of more people with the financial system, the innovations of new types of financial assets (such as derivatives and securitization in the recent decades) and the general growth of financial markets and trading in financial assets.

The 2030 Agenda for Sustainable Development and Agenda 2063 set out inclusive and sustainable development objectives for Africa. The financial system will have key roles to play in whether those objectives can be achieved. The financial sector has the potential for facilitating savings through providing financial assets for savers, channelling savings and funds into investment, and monitoring the use of funds for investment and for enabling inclusive growth, among other things.

The policy agenda has to ensure that financial institutions and markets play a positive role in inclusive growth, and the ways in which they are regulated play a crucial role here. The form and effectiveness of the regulation can have significant effects on the stability of the financial system, on limiting financial crises and on output and employment. Regulation has implications for the diversity of financial institutions and can affect how and to whom financial institutions provide credit.

To support the sustainable and inclusive development agenda, the financial sector must meet a range of functions, such as helping to mobilize sufficient savings; intermediating savings at low cost and short-term and long-term maturities to investors and consumers; ensuring that savings are channelled to investment opportunities that best support inclusive, sustainable development; helping companies and individuals to manage risk; and ensuring that financial institutions and the financial system as a whole balance risk and return. The 2030 Agenda and the Addis Ababa Action Agenda have both emphasized the critical need to tackle these gaps at the national and global levels that hinder the realization of inclusive and sustainable development. Sustainable Development Goal 10.5 of the 2030 Agenda underscores the need to strengthen regulatory frameworks to increase transparency and accountability of financial institutions.

The Addis Ababa Action Agenda has a number of commitments that encourage member States to enhance their transparency and accountability.
of financial institutions in order to foster stability, safety and sustainability, while also promoting access to finance and sustainable development (United Nations, 2015). The following paragraphs highlight these commitments:

**Paragraph 109.** Strengthening regulatory frameworks to increase transparency and accountability of financial institutions; hastening completion of the reform agenda on financial market regulation; addressing the risk created by “too-big-to-fail” financial institutions and addressing cross-border elements in effective resolution of troubled systemically important financial institutions; assessing, and if necessary, reducing the systemic risks associated with shadow banking and sustaining or strengthening frameworks for macroprudential regulation and countercyclical buffers.

**Paragraph 110.** Reducing mechanistic reliance on credit rating agency assessments, including in regulations, promoting increased competition and avoiding conflict of interest in the provision of credit ratings, support building greater transparency requirements for evaluation standards of credit rating agencies, and committing to continue ongoing work on these issues, including in the United Nations.

### 1.2 Challenges for regulation of the financial system and its institutions

Governance has been at the heart of the finance development policy debate during the past three decades. Much of the literature on economic regulation (including that of the financial sector) attempts to make policy recommendations to enforce property rights, reduce transaction costs and ensure competition, in line with what Khan (2012) referred to as “market-enhancing governance”. This stands in sharp contrast to the “growth-enhancing governance” framework, which is intended to build productive capacities and further economic growth and structural transformation. This focus seems to link the study of economic organizations to the institutions surrounding them, such as government agencies, financial institutions and universities supporting research and development in industry. In this context, “financial regulation policies constitute the foundation basis for the mechanisms through which financial development exerts a positive impact on economic growth and poverty reduction” (Murinde, 2012, p. 1).

The first and major challenge for regulation of the financial system is to facilitate development of the financial sector in ways that aid and support inclusive and sustainable growth. The financial sector has had a long history of crises. Laeven and Valencia (2012) detailed more than 400 exchange-rate crises and sovereign-debt crises, including banking crises. Banking crises in particular can have devastating effects on the real economy in terms of employment and output. The global financial crisis of 2007/2009 is a recent illustration of the contagion effects of financial crisis, and many would point to the weakening of effective financial regulation in the United States and elsewhere as a major contributory factor in that set of crises.

Adequate and effective regulation of the financial system is then required to promote and safeguard financial stability. At the same time, regulation has to underpin the growth of the financial system in terms of volume of credit provision which enhances investment and savings. Financial liberalization (and more generally, relaxation of regulation and its implementation) and the elimination of “financial repression” (following McKinnon, 1973, Shaw, 1973) were promoted as raising savings, investment and thereby economic growth. Financial liberalization and deregulation have been advocated on the grounds of enhancing economic growth through stimulating savings and raising the quality and quantity of investment. But it may often be associated with credit booms and subsequent banking crises.

Although the financial sectors of most African countries are still at an early stage of development,
the recent fast credit growth in many economies of the region calls for caution, signalling the need for effective regulation of African financial systems, since rapid credit growth can give rise to systemic financial and macroeconomic risks (Griffith-Jones, Karwowski and Dafe, 2014). This is not just a question of the quantity of finance, though this is extremely important, but also what we might call its quality.

Different types of economic activities (and actors) require different types of finance in terms of cost, maturity and risk characteristics. The more financial systems are able to meet these needs, the more likely they are to be supportive of inclusive growth. The key lesson from the recent global financial crisis is the need for financial regulation to avoid the build-up of systemic risk (Beck, Carletti and Goldstein, 2016; Griffith-Jones, Karwowski and Dafe, 2014; Levine 2011). The recent global financial crisis also challenged the view that developed countries’ financial systems and their regulation should be emulated by developing countries, given that the financial systems of developed countries have been so problematic and so poorly regulated.

Financial regulation needs to balance growth and stability, while ensuring that the financial sector is able to achieve the right amount of growth. It is not clear from a theoretical perspective (or from existing literature) what approach to regulating the financial sector would best achieve this, despite the number of reforms to the financial regulatory framework that have been agreed upon internationally, following the recent global financial crisis.

Although there is growing pressure to further strengthen regulation and supervision of financial institutions, the debate over how regulation and supervision affects bank efficiency, for example, remains unsolved. Proponents of financial regulation argue that tighter regulation and supervision helps to prevent market failures, promotes sound banking practices and enhances bank efficiency. For example, based on a global dataset of 132 countries to examine the effects of various types of regulatory measures and financial innovation on the recent financial crisis, Kim, Koo and Park (2013) found that regulatory measures such as stronger restrictions on bank activities and strengthened entry requirements have decreased the probability of banking crises. While capital regulation and Government ownership of banks have positive effects on the likelihood of currency crises, official supervisory power has a negative effect.

Others, however, have argued that tighter regulation and supervision causes banks to make sub-optimal capital allocation and lending decisions that mainly serve the interests of regulators and their entourage (Triki, and others, 2017). There is also a risk that heavy regulation could result in unnecessary costs in the form of additional administrative costs, excessive barriers to economies of scale, scope or innovation, creation of rents, or encouraging financial institutions to maintain excessive levels of liquidity in their portfolios and (or) to be excessively risk-averse in their lending practices (Jomini, 2011). Christensen (2011), however, found that tighter financial regulation has a positive long-term economic impact and that the transitional costs for the banks’ adjustment to the tighter requirements are limited.

The financial reform challenges facing policymakers are serious and consequential. Without effective financial regulation, financial systems can become unstable, triggering crises that can devastate the real economy as evidenced by the recent global financial crisis (Spratt, 2013). It is therefore important to ensure that regulation is adequate to promote financial stability. The second challenge for regulators is to ensure that the regulatory framework is fully consistent with developmental requirements. Regulators must pay attention to the ways in which funds are distributed by financial institutions and to the operations of various types of financial institution. The third challenge comes from the evolution of the financial system (often in response to regulation) and the need to ensure that the rules of regulation and their implementation keep pace.
In recent decades, there has been a clear trend towards more complex financial institutions, which is challenging for regulators. According to Beck, Carletti and Goldstein (2016): “Higher financial sector complexity calls for greater sophistication of financial regulators, and also creates regulatory complexity due to the lengthening of the intermediation chain and closer international financial integration.”

The fourth challenge comes from microprudential regulation and consumer protection. A monetary system relies on trust and confidence – money is only accepted by an individual when there is trust that the money is genuine (and not forged) and confidence that the money will be accepted by others in future. The provision of credit is based on assessment of the risk of non-payment, and backed by legal remedies in the case of default. Placing savings in a financial institution is encouraged by a degree of confidence in the financial security and honesty of the institution. Consumers need to be protected from the complexities of financial products, comprehensible information on the financial products being offered, and policies need to be put in place to limit the mis-selling of financial products. Particular concern arises over personal debt extended at high interest rates and to those with little prospect of being able to repay.

1.3 Rationale and objectives of the report

The objective of the present report is to set out how the financial sector can foster inclusive growth, taking into consideration the experiences of financial deepening and growth, and poverty and inequality; and looking at the regulatory frameworks for the financial sector, and the ways in which regulation can aid or hamper inclusive growth and development. It contains two main sources of evidence:

- How different approaches to financial regulation have performed historically, including in three case study countries.

The three countries (Kenya, Morocco and South Africa) have all been involved in processes of financialization in the sense that their financial institutions and markets have grown substantially and in a number of ways many more people are involved in the financial system – often in the name of financial inclusion and a rapid expansion of bank accounts, especially through mobile banking. In general, the degree of financialization and financial deepening are much higher than most African countries, and South Africa stands out among the most financialized in the world.

- How well different modes of financial development have supported inclusive growth historically

The conclusions draw on a large number of empirical investigations (often econometric) of the relationships between dimensions of financial development and economic growth and between financial development and inequality and poverty. Those studies also explore how different financial structures may influence the quantity and quality of funds and thereby the degree of inclusive growth. Some of the studies are to be interpreted in terms of whether and how the financial sector can become “too big”, especially in the sense of a larger financial sector seeming to contribute to slower rather than faster growth.

The purpose and modes of regulation for the financial sector is considered. Building on the evidence on financial deepening and inclusive growth, recommendations will be made for how African countries can attempt to steer financial sector development along paths that have shown to contribute to inclusive development, while at the same learning lessons from various past and present approaches to financial regulation and how well they have fared.
1.4 Structure of the report

The report begins with a review of the state of financial systems in Africa. Chapter 2 provides a comparison of the size of the financial sector throughout African countries, as the size and structure of the financial sector is often postulated to have an impact on the rate of growth. In addition, it contains a review of the performances of African financial systems in recent years to see how well these systems have been serving the continent’s development, and to what extent a different approach may be needed.

Chapter 3 presents a review of evidence on the different ways that the financial sector can develop and how these are related to inclusive development. The relationships between the scale and nature of financial institutions and markets and inclusive growth are significant for the encouragement of financial development and the regulation of the financial sector.

Chapter 4, contains an examination of the functions of financial regulation and supervision and their role in economic management in Africa. It also contains an analysis of how the various approaches to financial regulation have performed historically and what this may mean for Africa.

Chapter 5 presents the main conclusions and recommendations of the report.
CHAPTER 2: AFRICAN FINANCIAL SYSTEMS AND PERFORMANCE

2.1 Introduction

During the past four decades or so, there has been a near global growth in financial institutions and financial markets. The term “financialization” has often been used to encompass this growth. Financialization means “the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies” (Epstein, 2005a, p. 3).¹ Some features of financialization are specifically relevant for this report, because they have the most impact on growth and its inclusivity. These features are: the growth, depth and efficiency of the financial markets (banking sector, stock and bond markets); the role and performance of financial institutions (here referred to as central and commercial banks, insurance companies and pension funds, and other development and financial institutions); and the general trends towards financial liberalization and financial inclusion.

A sound and efficient financial system plays a key role in mobilizing and transforming both domestic and foreign resources and savings into assets that can meet the needs of investors, hence maximizing return on investment and allowing a higher level of investment in the most productive investment opportunities (Ndikumana, 2001). In most African countries, the financial system is generally recognized to be relatively small compared with developed, emerging and other developing economies. When looking at the progression of Africa’s financial systems during the past two decades, Beck, and others (2011, p.1) have argued that “the promise of the efforts at liberalization, privatization, and stabilization in the 1980s has only been partly fulfilled, though African finance has been stable for quite a while now. Since the peak of the banking crises in the 1980s, there have been few systemic banking crises, though pockets of fragility persist, often related to political crises or deficiencies in governance.”

More recently, the 2008–2009 global financial crisis (a series of financial crises centred in the United States, the United Kingdom of Great Britain and Ireland and some European countries)² affected African countries through a global recession and sharp falls in international trade, output and employment through a range of contagion effects. Cömert and Uğurlu (2016) focused on the 15 countries most affected by the global crisis and “great recession” and Botswana was the only African country included. Its inclusion was viewed in terms of its heavy dependence on exports of commodities. Gottschalk, (2016, p. 61) noted that: “Financial systems in African low-income countries have relatively low levels of integration with the global financial system, when compared with those systems of most other countries around the world”. Their less-integrated systems meant that the financial transmission channels were less important and enabled African financial systems to escape almost unscathed from the global financial crisis.

It has been a general feature of the processes of financialization that countries have become increasingly engaged with international financial systems. Financial liberalization, involving the removal of exchange and capital controls, has been

---

¹ There is a large amount of literature on financialization (e.g., Epstein, 2005a and b; Van der Zwan, 2014; Sawyer, 2014; and Vercelli, 2014).
Financial regulation for inclusive growth in Africa

a major contributory factor to financial globalization. In this section, some key aspects of the experiences in African countries during the past decades in relation to financial development, deepening and inclusion, are set out, with a particular focus on the case studies of three countries (Kenya, Morocco and South Africa).

2.2 Financial markets and institutions

African financial markets have traditionally been dominated by the banking sector. But more recently, the landscape has changed with the development and growth of capital markets (stock and bond markets, and private equity markets). This emergence of capital markets can be partly explained by efforts to liberalize, deepen and broaden the financial sector and the increased participation of the private sector in both finance and economic development. Another factor that has contributed to the recent growth of the capital markets in Africa is the 2008–2009 global financial and economic crisis, which had an impact on developed markets and on the interest of foreign investors looking for higher yields in emerging and developing markets.

2.2.1 Banking sector

The banking sector in Africa has made significant progress in terms of its development and openness. Many African countries have made some progress in reforming the institutional framework and creating an enabling environment for people to have increased access to the banking sector services and infrastructure. Close to 32 per cent of the African adult population have a formal banking account, compared with 21 per cent in 2011; and there are about 10 bank branches per 100,000 adults, compared with 7 in 2011; and 17 ATMs per 100,000 adults compared with 10 ATMs in 2011 (Global Financial Development Database (2017/2018)).

This improved access to banking sector services on the continent is comparable to developing economies with an average of 32.5 per cent of their adult population having an account at a formal financial institution, and a median of 10.5 bank branches per 100,000 adults. Although the proportion of the adult population holding a bank account has grown rapidly in recent years, there are significant disparities between African countries and there is a need for African countries to catch up with the rest of the world. For example, Mauritius has the highest share of adult population with an account at a formal institution in Africa (89.5 per cent in 2017), followed by Namibia (77 per cent) and South Africa (67 per cent), while in countries such as Madagascar, the Niger and South Sudan less than 10 per cent of the adult population have a formal bank account.

This progress (in terms of having better access to banking services) can be partly attributed to the increased penetration of foreign-owned banks in African countries. Foreign banks represent more than half of the total number of banks and the share of foreign bank assets accounts for more than half of total bank assets. A growing number of those foreign banks are African-owned banks that have expanded their operations across borders by establishing subsidiaries in many African countries (between 10 and 30 countries), increasingly filling the gap left by the retrenchment of traditional European and American banks as a result of the 2008–2009 global financial and economic crisis and the impact it had on advanced economies.

Some of the big pan-African banks include Ecobank, a Togolese-founded bank that operates in 36 Central and West African countries; Bank of Africa, initially created in Mali and now operating in 17 countries across Central, Eastern and Western Africa; and Attijariwafa Bank, the largest bank in Morocco with subsidiaries in 9 African countries. The expansion of pan-African banks is perceived as contributing to the growth and depth of the banking sector, enabling greater competition among financial institutions and providing increased access to loans and deposits, especially for small and medium-sized enterprises (SMEs) and individuals (International Monetary Fund, [IMF] 2016a).
The depth of the banking sector, as part of financial deepening, has improved in Africa but still lags behind other developing regions. Various factors and indicators can help to measure the depth of financial institutions such as banks; these include the ratio of private credit by deposit money banks to gross domestic product (GDP), deposit money banks’ assets as a percentage of GDP, and the ratio of nonbank financial institutions’ assets to GDP.

Figure 2.1 sets out a widely used measure of financial deepening, that is the ratio of private credit to GDP. Such a measure relates to the formal sector and hence may understate the extent of credit through omission of the informal sector. It does, however, reveal a very wide variation in this credit ratio, with Mauritius standing out as the country with the highest ratio by far (97.66 per cent), followed by Tunisia (73.45 per cent) South Africa (66.06 per cent) and Morocco (63.17 per cent). This reveals that the four countries are highly financialized economies, reflecting higher levels of income, compared with the rest of the continent. Low-income countries, such as South Sudan (1.66 per cent), Sierra Leone (5.07 per cent), the Democratic Republic of the Congo (5.71 per cent) and Guinea-Bissau (7.83 per cent) have the lowest ratio of private sector credit to GDP, which is a result of the lack of productivity-enhancing financial services.

Other indicators used to assess or measure the depth of the banking sector in Africa include the ratio of liquid liabilities to GDP, and banks deposits. These two indicators revealed an improvement of financial deepening in Africa between 2000 and 2016, with median ratios of both liquid liabilities and banks deposits to GDP increasing by between 10 and 15 percentage points, to 47.2 per cent and 38.9 per cent, respectively, (see figure 2.II). African countries, however, have lower liquid liabilities and bank deposits (all scaled against GDP) than countries in other developing regions, and substantially lower ratios than in member countries of the Organization for Economic Cooperation and Development (OECD).

There are significant disparities among African countries, with several middle-income countries (Algeria, Cabo Verde, Mauritius, Morocco, Seychelles and Tunisia) recording relatively high ratios of liquid liabilities and bank deposits to GDP. The countries with low financial deepening in terms of monetary resources are in Central, East and West Africa, with the lowest levels of liquid liabilities and bank deposits as percentage of GDP recorded in countries such as Burundi, the Democratic Republic of the Congo and the Niger.

Many analysts have argued that the African banking sector is highly liquid but with limited lending opportunities. For example, Nyantakyi and Sy (2015, p.2) found that “Africa’s banking industry is as competitive as those in Latin America and the Caribbean and not very different from the competitive environment existing in high-income OECD countries. However, the banking sector in Africa is much shallower and less penetrated than those in other major regions of the world.”

The banking system in some African countries is characterized by inefficiency, through high interest rate spreads and margins, which can be explained by the small size of the markets, the lack of scale economies, and high risks due to political instability, economic vulnerability and underdeveloped contractual frameworks (e.g., trading, clearing and settlement systems). In such countries, spreads between deposit and lending interest rates are relatively high, meaning that returns for savers are very low while lending interest rates are very high, thus rendering the banking sector very expensive and providing disincentives for both savings and lending.

For example, the bank net interest margin has averaged 6.5 per cent since 2000, and bank overhead costs represent close to 6 per cent of total assets (average during the period 2000–2016). Other factors that contribute to the inefficiency of banks in some African countries are the cumbersome requirements for deposit customers, such as the high fees and documentation requirements to open
Financial regulation for inclusive growth in Africa

The requirement to present several documents of identification (e.g., passport, national identification card, birth certificate, pay slip, utility bill) can represent a major barrier to banking for the large share of the African population that lives and works in the informal sector.

Notwithstanding the high cost and high risk of the banking system, banks in Africa remain relatively profitable. This is mostly evidenced by the high profits (in terms of higher returns on assets and equity) of foreign banks' subsidiaries in Africa, compared with their subsidiaries in other regions of the world. The high penetration of foreign banks in many African countries presents significant opportunities for the growth and deepening of the financial system. By bringing technology and experience, foreign banks can help to increase competition and availability of credit/assets.
improve efficiency and overall governance, and create scale economies.

For African countries to reap the benefits of foreign bank penetration or any other factor that could bring about the development of the banking sector, the legal, regulatory and institutional frameworks need to be in place. In many African countries, the legal environment for the banking sector has not been conducive to the development of the sector, mainly because of the difficulty in designing, implementing or enforcing sound contractual and informational frameworks, or because of the limited capacity (in terms of resources and independence) of the regulators to demand corrective actions. The nature and role of the legal and regulatory frameworks, and how it can affect the financial sector, will be discussed in greater detail in chapter 4 of the present report.

**2.2.2 Capital markets**

The importance of developing domestic capital markets on the continent has gained significant momentum during the past years, especially as alternative sources for financing development on the continent. At the continental level, Agenda 2063 calls upon Member States to promote the development of capital markets in order to strengthen domestic resource mobilization and scale up investment and financing into the continent’s development programmes. At the national level, countries are increasingly supporting the development of their domestic capital markets under their national development visions (e.g., Kenya Vision 2030, Nigeria FSS2020, Rwanda Vision 2020, Uganda Vision 2040, and Zambia Vision 2030) to mobilize long-term financing, especially for developing the real and social sectors. For example, the continent’s funding gap for the development of infrastructure, housing, agri-business and SMEs is estimated at more than $300 billion a year. The New Partnership for Africa’s Development Programme for Infrastructure Development in Africa (NEPAD-PIDA) estimates that Africa will need to invest up to $93 billion annually for both capital investment and maintenance for its infrastructure development programme: however, only $60 billion can be met from the countries’ domestic resources and assistance from development financial institutions and other partners.

The relative paucity of financial markets in African countries has often been noted. Many African countries with shallow and immature financial systems find it difficult to gain access to global capital markets. African capital markets are small, fragmented and illiquid; and the costs for small transactions are very high. Although African capital markets have developed over the years with 31 stock exchanges (from only 7 in 1988),
Financial regulation for inclusive growth in Africa

Their growth, depth and efficiency have been affected by: low income levels; ineffective collateral registration systems; weak judicial institutions; exposure to external shocks; weak human capital and financial infrastructure; limited portfolio choice options; inadequate monetary policy and capital account regimes; inadequate financial literacy; and inadequate pension fund reform.

Table 2.1 indicates the general small scale of stock markets in African countries, though South Africa stands out with the highest stock market capitalization relative to GDP on the continent. Figure 2.11 shows the volumes of the market capitalization in the five biggest stock markets (Egypt, Morocco, Nigeria, South Africa, and Tunisia). South Africa dominates with a total market capitalization estimated at $1.2 trillion.

The Johannesburg stock exchange displays a surprising upward trend both in terms of market capitalization and value traded. Its ratio of stock market total value traded to GDP increased from about 50 per cent in 2000 to 123 per cent in 2017, compared with an African average of 5 per cent in 2000 and 28 per cent in 2017. With regard to listing, South African and Egypt account for more than half of the companies listed on all African stock exchanges.

The African stock markets are characterized by low liquidity, weak or underdeveloped infrastructure, high concentration of large firms and shares in a few stocks, and limited exposure to external/foreign participation. The low liquidity or low volume can be explained in part by the weak contractual and informational frameworks (e.g., trading, clearing and settlement systems) or the absence of central depository systems. If these systems are present but operating at a slow or inefficient pace (a single transaction may take months to execute), it can hamper the issuing and trading of shares, reduce the scope for high turnover and prevent financial integration or attractiveness to international investors.

The exception is South Africa, which has a stock market comparable to those in more advanced economies – something that is attributable to its strong financial market infrastructure and robust legal frameworks. It is the highest performer on the ABSA African Financial Markets Index, with an overall

Table 2.1: Stock market capitalization as percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>6.92</td>
<td>16.87</td>
<td>24.09</td>
<td>31.56</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>5.40</td>
<td>0.39</td>
<td>7.41</td>
<td>13.04</td>
<td>25.94</td>
<td>35.10</td>
<td></td>
</tr>
<tr>
<td>Egypt</td>
<td>3.74</td>
<td>10.30</td>
<td>30.84</td>
<td>66.10</td>
<td>40.48</td>
<td>18.72</td>
<td>13.79</td>
</tr>
<tr>
<td>Eswatini</td>
<td>20.05</td>
<td>4.86</td>
<td>6.86</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>26.78</td>
<td>9.81</td>
<td>5.26</td>
<td>8.48</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>5.30</td>
<td>30.10</td>
<td>9.49</td>
<td>28.03</td>
<td>31.15</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malawi</td>
<td></td>
<td>5.06</td>
<td>19.03</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mauritius</td>
<td>33.69</td>
<td>29.46</td>
<td>34.29</td>
<td>72.48</td>
<td>64.94</td>
<td>66.59</td>
<td></td>
</tr>
<tr>
<td>Morocco</td>
<td>2.77</td>
<td>14.64</td>
<td>31.87</td>
<td>43.88</td>
<td>74.06</td>
<td>45.45</td>
<td>57.05</td>
</tr>
<tr>
<td>Namibia</td>
<td>4.84</td>
<td>11.39</td>
<td>1.48</td>
<td>0.17</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>3.95</td>
<td>17.04</td>
<td>7.47</td>
<td>17.76</td>
<td>11.14</td>
<td>10.56</td>
<td>8.28</td>
</tr>
<tr>
<td>South Africa</td>
<td>111.69</td>
<td>172.56</td>
<td>160.55</td>
<td>194.61</td>
<td>247.77</td>
<td>245.42</td>
<td>328.08</td>
</tr>
<tr>
<td>Tunisia</td>
<td>4.98</td>
<td>21.82</td>
<td>12.03</td>
<td>8.35</td>
<td>23.76</td>
<td>20.32</td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td></td>
<td>1.16</td>
<td>13.14</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Rep. of Tanzania</td>
<td>1.94</td>
<td>4.33</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zambia</td>
<td>9.38</td>
<td>6.44</td>
<td>25.83</td>
<td>14.36</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>26.83</td>
<td></td>
<td>136.54</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Financial regulation for inclusive growth in Africa

The African bond market is dominated by short-term government securities with activity focused on domestic primary markets. In 2016, the Treasury Bonds and Bills issued in Africa in local currency amounted to close to $220 billion, representing about 9 per cent of GDP. Many African countries are increasingly interested in developing domestic bond markets and addressing some of the market constraints, such as lack of government benchmarks, ineffective domestic market infrastructure (clearing and settlement systems), and very low foreign holdings of domestic debts. There is also great traction from investors to invest into low volatile government, municipal, corporate and diaspora bonds in Africa, leading increasingly to oversubscription to bonds issued on the continent.

For example, the recent Nigerian Government bond auction in June 2018 was oversubscribed with investors’ bid reaching 66.7 billion Naira ($183.4 million), while the initial offer was set at 60 billion ($165 million). In Kenya, bonds trading have been 21 per cent higher from 2017, with a turnover of 232 billion Kenya shillings in the five months to May 2018. Even in post-conflict situations, African Governments have been working towards issuing bonds to raise capital and to help finance their development programmes. Mali, for example, is planning to issue 35 billion CFA ($64.2 million) worth of bonds with a coupon of 6.25 per cent.

More recently, improvement on sound macroeconomic fundamentals (i.e., macroeconomic and fiscal stability, economic growth) in many African countries, reduced access to multilateral and bilateral concessional funding (given the middle-income status of an increasing number of African countries) and the tightening of global liquidity conditions have resulted in the emergence of local currency-denominated bond issuance. According to the International Monetary Fund (2017), the ratio of local currency debt to GDP rose from an average of 14 per cent between 2011 and 2013, to 21 per cent in 2017. Local currency bonds have been issued mostly to help recapitalize banks, assisting Governments to finance their deficits, and setting the benchmarks for pricing financial assets and risks management tools (IMF, 2009). However, given that the local currency bond markets are mainly short-term (maturities of less than one year are very common) and are not very attractive to foreign investors, this creates concerns about diversification of investors, rollover risks, macroeconomic vulnerability and debt sustainability. Furthermore, some of the market microstructure constraints,

\textbf{Figure 2.III: Selected African stock exchanges}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{stock_exchanges.png}
\caption{Selected African stock exchanges}
\end{figure}

\textit{Source:} Taken from the African Markets (www.african-markets.com); PwC (www.pwc.co.za).
such as small size, low liquidity, lack of long-term maturities, and limited investor base, are challenges to the growth and sustainability of the local currency bond markets and overall bond markets resilience.

To tackle and mitigate some of the risks to bond markets development in Africa, it is critical that Governments and policymakers ensure sound macroeconomic policy and a stable political environment, build up robust market infrastructure (trading, information dissemination, clearing and settlement systems), promote incentives that reinforce good market participation, harmonize legal and regulatory frameworks, and facilitate the cross-listing of bonds on several national exchanges. In addition, widening the investor base, attracting institutional investors (e.g., pension funds and insurance companies) and developing yield curves will contribute to promoting the development of capital markets.

2.2.3 Non-financial institutions

The development and deepening of financial systems are supported by both financial and non-financial institutions. Non-financial or non-bank financial institutions are public and privately owned institutions that do not have a full banking licence and cannot accept deposits from the public. They can, however, provide alternative financial services, such as investment (both collective and individual), risk pooling, financial consulting, brokering, money transmission, and check cashing (World Bank, 2018a). These institutions include institutional investors (pension funds and insurance companies), venture capitalists, currency exchanges, and market makers (broker dealer institutions). For example, institutional investors enable individuals or firms to invest in collective investment vehicles in a fiduciary rather than a principal role. The collective investment vehicles invest the pooled resources of the individuals and firms into numerous equity, debt and derivatives promises (World Bank, 2018a).

Institutional investors have been one of the main driving forces of capital markets development in Africa. Given their growing assets, pension fund companies are increasingly investing in both capital markets (as fiduciaries) and in local and international development projects (as investors). A recent study by ECA (2018a, p.23) found that “African pension funds have been expanding in recent years, albeit from a low base, thanks to the rise of the middle class and the regulatory reforms that have brought more people into the social security net in several countries”. Pension coverage in Africa, however, remains very small, compared with other regions, and the pension funds asset as a percentage of GDP are relatively low (between 5 and 10 per cent), except in South Africa (more than 100 per cent in 2016) and Namibia (87 per cent in 2016) (OECD, 2017).

It is estimated that pension funds in the six largest African markets could grow to $7.3 trillion by 2050 (from $800 billion in 2014) should the conducive demographic, economic and regulatory factors be in place (ECA, 2018a; Maurer, 2017). The growth in assets, which must be carefully managed, also brings supervisory and regulatory challenges. One of the key challenges is how to encourage the portfolio diversification necessary for these systems to manage risk, while ensuring that diversification does not become a source of risk as pension funds venture into hitherto unknown asset classes and markets (ECA, 2018a).

Although Governments are not categorized as financial or non-financial institutions, it is important to understand the role they played in shaping the development of the financial systems. During the post-independence era (1960s–1970s), African Governments played a decisive role in the financial system. With the initial goal of using financial system development as a tool to speed up economic growth, African Governments became directly involved in creating financial systems and providing financial services. They were in full control of regulatory measures (e.g., putting restrictions on interest rates ceilings and floors) and had sole, if not quasi, ownership of banks and development financial institutions. However, this “activist approach” to financial development
resulted in high and volatile inflation and negative real interest rates, as well as mismanagement and inefficient allocation of resources.

During the 1980s and 1990s, many African Governments started liberalizing and privatizing their financial systems, based on advice and recommendations from the international financial institutions. Some of the policies pursued by Governments included monetary stability, market-based price finding and market-based provision of financial services. This “modernist” approach created more stable financial systems, but could not deal with some of the constraints of the system, such as the persistent shallowness, high costs and limited access to banking systems. The mixed outcomes of the policy approach led African Governments to rethink their role/involvement in financial development, pushing many to pursue a “market-developing” approach starting in the 2000s with an emphasis on Governments playing the role of creating and enabling markets, and strengthening institutions to build an efficient and stable financial system (Beck, Fuchs and Uy, 2009). This approach enabled the development and standardization of contractual frameworks (e.g., accounting and disclosure standards) and the strengthening of banking laws, regulation and supervision (e.g., through the Basel Accords).

2.3 Financial systems in three case-study countries

The three countries covered in the case studies (Kenya, Morocco, South Africa) have all been involved in processes of financialization in the sense that their financial institutions and markets have grown substantially, and in a number of ways many more people are involved in the financial system – often in the name of financial inclusion and a rapid expansion of bank accounts, especially through mobile banking. In general, the degree of financialization and financial deepening are much higher than in most African countries, and South Africa stands out among the most financialized in the world.

2.3.1 Kenya

Kenya has a well-developed financial system for a country of its income level (Beck and Fuchs, cited from Mwega, 2014). Its level of financial development is not too far off from the predicted level in a global cross-country model (Allen, and others, cited from Mwega, 2014). Christensen, (cited from Mwega, 2014) classifies Kenya as a frontier market economy whose financial market is advanced, but not to the same extent as emerging markets such as South Africa, given that its liquid liabilities (M3)/GDP ratio was 42 per cent by the end of 2017, compared with an average of 63 per cent for emerging market economies in the 2008–2010 period, although these indicators have improved over time. It is therefore unlikely that the size of the financial sector in Kenya is beyond the threshold to have a negative impact on economic growth (authors’ calculations based on Kenya, National Bureau of Statistics, 2018; Mwega, 2014). Furthermore, all econometric analyses identified in the literature review for the present report that investigated the relationship between financial development and GDP growth in Kenya, indicated a positive relationship (Kelly, 2016; Onuonga, 2014; Uddin, Sjö and Shahbaz, 2013) or no effect (Nyasha and Odahimbo, 2015).

Domestic new credit to the private sector as a share of GDP has been falling in recent years, with interview respondents indicating that this was due to crowding out by Government borrowing (authors’ analysis of Kenya, National Bureau of Statistics, 2018). It also appears that the interest rate cap that Kenya had introduced in 2016 may have dramatically accelerated this trend; however, firms in Kenya, including in the manufacturing sector, had reported having better access to credit than the average for the rest of Africa (excluding North Africa) (World Bank, 2013).

Financial inclusion in Kenya has been monitored through financial access surveys of which three have been conducted, in 2006, 2009 and 2013. The proportion of the adult population using various types of formal financial services increased from
27.4 per cent in 2006 to 41.3 per cent in 2009 and stood at 66.7 per cent in 2013, among the highest in Africa. In addition, the proportion of those accessing informal financial services and those excluded from formal financial services has declined substantially. Up to 2013, deposit accounts increased from approximately 2 million to 18 million while loan accounts have increased from 1 million to 3 million since 2007. The most dramatic increase is usage of mobile money services (Mwega, 2014).

2.3.2 Morocco

The Moroccan financial system (including banking, insurance, pension funds and asset management) is well diversified and has considerably modernized in recent years. The country’s system assets are comparable to those of high-income countries, and Morocco is ranked among the top five financial markets in Africa, along with Angola, Egypt, Nigeria and South Africa. According to the Global Competitiveness Report (World Economic Forum, 2018), Morocco ranked 72nd out of 144 countries for the indicator of development of the financial market. The country has made notable progress in improving access to financial services (e.g. banking density measures by number of branches per 10,000 residents increased by 50 per cent since 2008) and in meeting the needs of the private sector (including access to credit).

The country’s financial system is dominated by the banking sector, which accounts for 89 per cent of total assets. In 2017, the Moroccan banking sector consisted of 83 institutions, which included 19 banks, 6 offshore banks, 33 finance companies, 13 microcredit associations and 10 intermediary fund transfer companies. The total assets of the banking sector are estimated at 1.2 billion dirhams, representing about 120 per cent of GDP (Bank Al-Maghrib, 2017a). In addition, the banking sector is highly concentrated with the top three banks accounting for 67 per cent of total assets. These banks have established broad financial groups comprising insurance, asset management and other financial services. It is estimated that now close to 70 per cent of Moroccan adults have a bank account, compared with 43 per cent in 2008. According to Bank Al-Maghrib (2017b), the sectoral distribution of bank credits is well diversified, with households and companies operating in the sector of “financial activities” accounting for 33 per cent and 13 per cent, respectively, of loans granted.

Overall, Moroccan banks have been, relatively well capitalized and increasingly profitable. However, rising nonperforming loans in recent years, above 7 per cent due to weak activities in the construction and real estate sectors, have led the central bank to reinforce a close monitoring of the bank asset quality, especially risky loans.

The insurance sector has also expanded considerably in recent years, representing 8 per cent of GDP, and premiums totalling 38.7 billion dirhams in 2017, an increase of 10.9 per cent from 2016. The sector comprises 18 companies (17 of which are privately owned), with the top five insurance companies accounting for three quarters of total premiums. Life insurance and capitalization reached 16.9 billion dirhams of written premiums, an increase of 18.8 per cent, while non-life insurance generated 21.8 billion dirhams of written premiums, an increase of 5.5 per cent (Bank Al-Maghrib, 2017a).

In 2017, the penetration rate, which corresponds to the ratio of premiums issued to GDP, stood at 3.7 per cent. Although relatively high, compared with African and Middle East countries, this insurance penetration rate remains very low, compared with those of advanced economies.

In terms of investment, assets under management in the insurance sector reached 166.1 billion dirhams in 2017, compared with 151.9 billion dirhams in 2016, an increase of 9.4 per cent. The share of interest-rate assets in total investment in the insurance sector increased to 48.2 per cent in 2017 from 46.9 per cent in 2016, while the share of equity assets and real estate assets recorded a slight decrease to 44.4 per cent and 4.3 per cent respectively in 2017 from 45.6 per cent and 4.5 per cent in 2016. In terms of stability and resilience, a stress test was conducted to assess the risk of
exposure of insurance companies to market risk and real estate risk. The test was based on stock market shock, calibrated on the basis of a drop of 10 per cent to 25 per cent in quoted stock prices. The tests found that the prudential requirements for solvency are well respected by Moroccan insurance companies. Another stress test (macro), which was conducted on a group of insurance companies representing more than 78 per cent of the industry, with a horizon of simulations of two years covering the years 2018–2019, shows that the insurance sector in Morocco will maintain its resilience to risks and shocks by 2019. A deterioration of macroeconomic conditions, however, may result in a slight decrease of the rate of coverage of the solvency margin, from 435 per cent to 403 per cent between 2018 and 2019.

Pension fund contributions were estimated at 45.7 billion dirhams in 2017, about 4.3 per cent of GDP. The number of contributing members reached 4.5 million, representing 41.8 per cent of the employed labour force. In terms of the benefits provided by the different pension schemes, they reached 53.3 billion dirhams, or 5.0 per cent of GDP. Total reserves increased by 4.5 per cent to reach 293.7 billion dirhams in 2017. The assets under management of the pension funds in 2017 amounted to 292.0 billion dirhams, representing a growth rate of 4.3 per cent compared with 2016. The investment were characterized by the preponderance of bond investment, which accounted for 70.8 per cent of all total investment in 2017, compared with 28.0 per cent for equities.

The Government of Morocco has recently reformed and upgraded the legal, regulatory and oversight frameworks for the capital markets in order to diversify the sources of financing the economy, and more particularly revive the Casablanca Stock Exchange (CSE), whose market capitalization had fallen from 100 per cent of GDP in 2007 to 70 per cent in 2016. In 2016, the capital market experienced structural reforms, including the transformation of the Moroccan Capital Market Authority (AMMC) and the demutualization of the stock market. There are 75 company listings on the CSE, 10 of which are in finance, telecommunication and construction. Those 10 listings alone account for 70 per cent of total capitalization, of which 30 per cent is for the three largest banks. The volume of the issues was estimated at 1.4 billion dirhams in 2017, down from 2 billion in 2016 and 7.8 billion in 2011.

One major problem of the stock market remains the very low liquidity ratio, which recorded a slight upward trend during the past three years. In 2017, it reached 10.4 per cent, up from 9.5 per cent in 2016. The number of securities traded increased significantly in recent years, and by 31 per cent from 217 million in 2016 to 284 million in 2017.

2.3.3 South Africa

South Africa is widely regarded as among the most financialized economies in the world. The ‘finance and insurance, real estate and business services’ accounts for over 18 per cent of measured GDP (figures given for 2018Q1). In recent years, it has been the only sector that has grown in relation to GDP. Credit provided to the private sector had increased from 67 per cent of GDP in 1980, to 105 per cent in 1993 and to 177 per cent in 2017; and stock market capitalization from 67 per cent in 1980 to fluctuating around 250 per cent in the late 2000s and early 2010s, and reaching 352 per cent in 2017. International financial linkages have also expanded. Derivatives dominate over other types of investment, especially long-terms ones, such as foreign direct investment and portfolio investment. Derivatives with their more speculative nature continue to flow in and had a value equivalent to 39 per cent of GDP in the first quarter of 2018.

2.4 Conclusion

This brief overview of Africa’s financial systems would suggest that there is large diversity in the size and scope of these systems ranging from some of the least financialized economies in the world through to what some measure as the most financialized (South Africa). There has, however, been a general trend towards an increase in financial deepening –
in terms of scale of banks deposits and stock market capital valuation – but the financial systems in Africa mostly remain much smaller than in other regions of the world and in many other emerging markets. The 1980s and 1990s saw substantial changes in the regulation of the financial system, especially in terms of financial liberalization and privatization.

Over all, demand for financial services in Africa has picked up considerably in recent years, spurred largely by growth and an emerging middle class, which is estimated at more than 34 per cent of the continent’s population. African countries are re-focusing their efforts to enhance the depth and efficiency of financial services to meet the growing needs of the accelerating economic pulse on the continent. While the focus of recent financial sector growth has largely benefitted from the established large and medium private sector or the growing middle class, emphasis is now shifting towards depth and efficiency of the financial institutions and financial markets, and the expansion of innovative financial services. The deepening of financial development is taking new initiatives in the form of mobile technology to capture lower income segments and the “unbanked”, as a more efficient and effective means to reduce high transaction costs and distance to financial institutions, or attract the informal sector towards formal financial institutions.

Developing and strengthening financial sector infrastructure, ensuring a strong business environment, and facilitating financial services access must be among the priority actions of African countries in order to deepen the financial sector. With this in mind, the following policy recommendations are given:

Increase access to finance by developing consumer finance, corporate credit information database and credit guarantee system; strengthening regulatory frameworks for micro-finance (e.g., consumer protection, bankruptcy laws); and promoting finance for green growth (i.e., investment in green projects);

Make finance resilient to crisis by encouraging the adoption of micro-prudential and macroprudential policies, and the implementation of Basel principles (II and III);

Encourage openness and competitiveness by facilitating foreign investment and participation, as well as skills and capacity transfer;

Innovate and develop new and lower-cost financial services and business models that are better adapted to the African context. Go beyond the existing use of mobile phone-based services or other innovative tools (e.g., M-Pesa, Msanzi, Wizzit) and develop more tailored services for domestic savings.
CHAPTER 3: FINANCIAL DEEPENING AND INCLUSIVE GROWTH

3.1 Introduction

It is relevant to consider whether and how growth in the financial sector (also referred to as financial deepening and development) can contribute to the generation of inclusive growth. This can help to guide African Governments as to whether to encourage further development of their financial sectors, and what kind of financial development to encourage to best further inclusive growth.

The present chapter provides an analysis of how far financial development supports inclusive growth, and what kind of financial development do so in particular. To approach this systematically, the chapter provides an overview of the roles that the financial sector can play in supporting inclusive growth; a review of the empirical evidence of the impact that financial development has on growth, and on inequality and poverty; and an examination of what kinds of financial deepening are beneficial for growth.

3.2 Overview of the roles of the financial sector in promoting inclusive growth

The financial sector (banks, financial institutions, financial markets) can potentially make its contributions to growth through facilitating savings, providing linkages between savings (domestic and foreign) and investment through financial assets, and the monitoring of the use of investment funds. How far the financial sector contributes to inclusive growth also depends heavily on how many are included in the financial sector (e.g., how many hold savings accounts) and how the financial sector allocates its funds (e.g., are some groups favoured and others discriminated against, or how well does it finance investment in economic activities that tend to promote inclusive growth, such as labour-intensive activities). In particular, through their credit/investment, deposit and insurance decisions, financial institutions determine who can have access to specific financial services and who is excluded, and, more broadly, who benefits from the investment that the financial sector decides to finance (e.g., employee, customer or business partner of firms that are financed). The nature of the relationship between banking institutions and their customers is also important as to who receives financing and on what terms. In addition to intermediating finance, financial institutions assess the risk of their investment and monitor the use of finance they have extended.

Spratt (2016) provides a suitable framework for analysing in more detail how the development of the financial sector affects inclusive growth. He identified four highly significant channels through which the financial sector can do so. Based on this, in order to maximize its contribution to inclusive growth, financial regulation should try to steer financial sector development towards supporting inclusive growth through each of these channels to the greatest extent possible, while managing any trade-offs between the various channels.

The first channel relates to the provision of credit to the private sector by the banking institutions. The regulation of this channel requires balancing the encouragement of competition, low regulatory barriers to entry and efficiency in mobilizing domestic savings and foreign capital
and channelling them to productive investment, with the need to limit the instabilities that may result from competition and credit expansion. It is also important for financial regulation to aim at steering the financial sector towards financing the investment that are most important for economic growth and other major economic outcomes.

The second channel relates to people having access to finance and the financial system, including to the payments system and to credit. Regulation of financial institutions has to deal with issues such as ensuring that people have low-cost access to the payments system and the provision of credit in ways that are affordable and yet do not generate credit booms and debt traps. “Rapidly growing credit to households – even though desirable and potentially welfare enhancing when strengthening reasonable levels of domestic demand and financial inclusion in a sustainable way – might, however, cause financial instability if not regulated prudently” (Griffith-Jones and Karwowski, 2015, p. 203). At the same time, it is important not to divert scarce finance towards poor borrowers if the poor could in fact benefit more if this finance was used to fund transformative activities, such as the growth of the manufacturing sector.

The third channel refers to government interactions with the financial system. This specifically includes the ways in which a Government draws on private financing for its fiscal position and for public development projects. It also includes the more direct involvement of the State through ownership of banks and the operation of State development banks.

Lastly, the fourth channel, which is closely related to the second channel, concerns capital markets, their role in mobilizing finance and how regulation relates to this.

While there may be trade-offs between getting the financial sector to support inclusive growth through these channels, all of them are important and to the extent possible, financial regulation should aim for them to all play a positive role, while making judicious choices in case of any trade-offs. The remainder of the present chapter looks at evidence related to what kind of financial sector development might best be able to achieve this.

3.3 Financial deepening, economic growth and inclusion

This section looks at empirical studies on financial development and deepening, providing evidence that links them with growth and then with inequality and poverty. Consideration is given to how far and in what ways the growth and evolution of the financial sector can aid inclusive growth; and which developments in the financial sector that may harm growth or inclusivity.

3.3.1. Financial development and its effect on growth

It has often been argued that the role of the financial sector in facilitating savings, linking together supply of funds (from savings) with demand for funds (for investment purposes) and the monitoring of investment, enables faster economic growth.

Financial deepening and development have a range of dimensions, and studies differ in how financial deepening is measured. The key issues are whether financial deepening have a positive, negative or zero effect on the pace of economic growth; and whether the sign and size of the effects

3 In addition to considering the volume of credit that the financial system channels to the private sector, its quality (i.e., ability to finance investment that are a priority for development) should also be taken into account.

4 In this regard, financial systems need to achieve the right balance of financial risk and return, at both the systemic and individual levels. At the systemic level, pursuing an improved contribution of the financial sector to growth through investment in higher risk, higher return investment needs to be balanced with avoiding the damaging financial crises. For example, though rapid credit expansions tend to boost growth in the short term, they also tend to be associated with financial crises which cause greater reduction in output and the growth associated with the credit boom that generated them.
of deepening on growth vary depending on size of the financial sector.

In his extensive review of empirical literature, Levine (2005, p. 921) concluded that “the preponderance of evidence suggests that both financial intermediaries and markets matter [positively] for [long-run growth] even when controlling for potential simultaneity bias”. Arestis, Chortareas, and Magkonis (2014) conducted a meta-analysis of the empirical evidence on the effects of financial development on growth, and agreed that “the results suggest the existence of a statistically significant and economically meaningful positive genuine effect from financial development to economic growth” (Arestis, Chortareas, and Magkonis, 2014, pp. 557–559). Barajas, and others (2013), and Rousseau and Wachtel (2011, p.276), supported this conclusion.

Beck, Degryse and Kneer (2013) supported the idea that greater financial intermediation contributes positively to growth in the long run, but the size of the financial sector (once intermediation is controlled for) does not affect long-run growth. Beck, and others (2012) supported the positive role of enterprise credit but not household credit using a dataset from 45 developed and developing countries, including 3 African countries. Griffith-Jones (2016) found that there can be a positive role for financial deepening in supporting growth with regard to low-income countries because their finance is more scarce, their financial intermediaries less efficient but also more profitable, and competitive pressures are less than in countries with higher levels of income. According to Griffith-Jones (2016, p. 142):

The scope for well-managed financial sector development is thus very large in LICs [low-income countries]. The potential for this to contribute to inclusive growth is similarly large. The potential risks are also significant, however. This is evidenced by the numerous and costly crises that have occurred in recent decades, both in emerging and high-income economies. [African LICs, excluding North Africa] have suffered very few banking crises in the last decade, but this does not imply that there is room for complacency, especially if financial sectors grow significantly and fast.

Valičková, Havranek and Horvath (2014, p. 506), based on an examination of 67 studies on financial development and economic growth, concluded that “the studies imply a positive and statistically significant effect [of financial development on growth]”. Pietrucha and Acedański (2017), in a cross-sectional regression across 144 countries, found a positive effect from some calculations of financial depth on growth following the global financial crisis. Beck, and others (2011), in comparing the financial development and growth performance in Africa with those in low- and middle-income countries in East Asia, found that their estimates “suggest that 0.4 of a percentage point of [the] difference in average annual growth [between the two regions] – a quarter of the difference – was caused by the lower level of financial development [in Africa]” (Becks, and others, 2011 p.10).

Kutan, Samargandi and Sohag (2017) studied economic growth and financial deepening in [countries in North Africa and Western Asia] during the period 1980–2012. Their results showed that “credit to the private sector significantly promotes economic growth in the long term, in the presence or absence of institutional quality in the model. Money supply (M2) [which is closely related to bank deposits], however hinders (promotes) long-term economic growth in the absence (presence) of institutional quality” (Kutan, Samargandi and Sohag, 2017, p.244).

Many of the studies carried out during the past decade or so have cast doubts on the robustness of these results of positive relationships between financial deepening/development and economic growth, and more generally many have found that the relationships between the size of financial sector and economic growth have weakened and often turned negative. For example, Kar, Nazhoğlu and Ağır (2011) studied 15 countries from North Africa and
Western Asia during the period 1980–2007 using six alternative financial development indicators. They found that: “The empirical results show that the direction of causality between financial development and economic growth is sensitive to the measurement of financial development in the MENA [Middles East and Northen Africa] countries. … [T]he direction of causality seems to be country and financial development indicator specific.”

Nyasha and Odhiambo (2015, Abstract, p.54) investigated “the dynamic causal relationship between bank-based financial development, stock market development, and economic growth in Kenya – during the period from 1980 to 2012 and found an unidirectional Granger-causal flow from economic growth to bank-based financial development in Kenya”. They had failed to find “any causal relationship between market-based financial development and economic growth, and between bank-based financial development and market-based financial development in Kenya. The study, therefore, concludes that the development of the Kenyan banking sector is largely driven by the country’s real sector.”

At the same time, one can argue that, while finance may not lead the rest of the economy, to the extent that businesses need credit to operate, the rest of the economy would not have been able to expand as fast if financial services inputs had not been available. This suggests that, while taking actions to boost the supply of financial services, independent of demand may not boost growth, allowing the sector to expand with rising demand may be important.

Nyasha and Odhiambo (2017, pp. 322–340) examined bank-based financial development on economic growth in Ghana during the period 1970–2014, with four proxies to measure bank-based financial development and a composite index. Their empirical study showed the following results:

This may suggest that certain types of financial activities (bank lending to the private sector) had a positive impact on growth in Ghana, while others did not. Nyasha and Odhiambo (2018) conclude that the relationship between financial development and economic growth is “highly complex, and is dependent on a number of factors. Hence, the argument that financial development always leads to economic growth should be taken with extreme caution”. It can, however, also be argued that financial sectors in many African, and more generally, lower income countries being relatively smaller and simpler, “provide an advantage in that governments have more policy space to influence the future nature and scale of their financial system. Furthermore, the fact that the financial sector is smaller may imply it is less powerful politically; thus this potentially gives more autonomy to regulators – and more broadly to governments – to shape the financial sector” (Griffith-Jones with Karwowski, 2015, p. 217). That being said, if this effect was large enough to mean that growth was greater with a small financial sector, we would expect this to show up in the regression results – but it mostly does not (except to the extent that an excessively large financial sector can undermine growth).  

Arcand, Berkes and Panizza (2015, p. 105) “use different empirical approaches to show that finance
depth having a negative effect on output growth when credit to the private sector reaches 100 per cent of GDP”. Cecchetti and Kharrouchi (2012) and Sahay and others (2015), using a broad measure of financial development, support the idea that financial development is positive for productivity growth up to a certain level of financial development and that additional financial development after this is bad for growth. Cournède, Denk, and Hoeller (2015), based on 50 years of data for OECD countries, found that most of those countries were already at the point where further growth in the financial sector was likely to slow down GDP growth.

The case studies of Kenya and South Africa carried out for the present report suggest that for Kenya, further dynamic financial development will be positive, but that South Africa has already reached a level of financial development in which the size of its financial sector is a drag on growth. For Kenya, all of the country specific econometric literature on the impact of financial deepening on the country’s growth indicates that the effect has been positive (Kelly, 2016; Onuonga, 2014; Uddin, Sjö and Shahbaz, 2013) or neutral (Nyasha and Odahimbo, 2015), which may underplay the way that allowing the financial sector to expand in response to rising demand could contribute to growth. The study of South Africa indicates that the large scale of the financial sector has not improved economic growth or ensured financial stability. According to Isaacs and Kaltenbrunner (2018), South Africa is significantly exposed to a new financial crisis, mainly due to a recent surge in short-term capital flows, in the form of derivatives. The negative repercussions of financialization in South Africa are also visible through the reduced amounts of financial resources to productive investment; the increasing household, government and private sector debt, as well as stubborn unemployment levels; and the poverty levels, while inequality increases.

Measures of financial deepening have often included ratio of bank credit to GDP (or similar). Bank credit to the private sector includes credit to firms that finance production and investment and credit to households that finance consumption. Household debt enables additional spending and in that way provide short-term demand stimulus, but it does not directly contribute to investment or to longer-term growth. Bezemer, Grydaki, and Zhang (2016), in their study analysing data from 46 countries for the period 1990–2011, found that a large credit-to-GDP ratio can be a drag on growth, with rising credit-to-GDP ratios coinciding with shifts in the composition of credit toward real estate and other asset markets and hence away from investment in productive assets. They also found insignificant or negative correlations of credit stocks with output growth using a range of econometric techniques.

The International Monetary Fund maps household debt-to-GDP ratio against an index of financial development, finding a positive relationship. Their findings reveal that “at very low levels of household debt to GDP, below 10 percent, the association between increases in debt and future real GDP growth is positive; it turns negative when household indebtedness exceeds 30 percent of GDP. Beyond that point, the correlation declines slightly, but it maintains its negative sign. The presence of this nonlinearity is consistent with recent findings of a bell-shaped relationship between financial deepening and long-term growth … and studies relating this to increased financial risks” (IMF, 2017, pp.63 and 65). The sample covers 35 advanced economies and 45 emerging markets (of which 9 are African countries – Botswana, Egypt, Ghana, Kenya, Mauritius, Morocco, Namibia, Nigeria and (OECD) economies, using six measures relating to financial development. Overall, their study concludes that a large size of the financial sector has a negative impact on GDP growth. However, for the stock market capitalization and the turnover ratio, a positive and nonlinear relationship with growth is found though there is a threshold level past which further capital market development does not stimulate growth. For other variables negative relationship are found for relatively high levels of financial deepening. Regarding the negative effects of financial deepening on growth, given that most European Union countries and OECD countries will tend to have a high level of financial deepening relative to the rest of the world (given their high income levels), these results may be driven by further financial deepening reducing growth once a high level of financial depth has already been achieved – this is the general finding from more recent literature during the past decade.
South Africa) over different periods, some going back to 1950.

Overall, the majority of this empirical work suggests that greater financial deepening contributes positively to growth, especially up to a certain point (with many papers pointing to the relationship turning negative after that point). Though this section also provides a review of papers that point in the other direction, these results could be explained as being due to their focus on countries in which the level of financial development is already high (as in Prochniak and Wasiak, 2017) or due to the research question being whether the financial sector brings about growth across the economy, which ignores the positive effect that allowing the financial sector to expand in response to demand could have on growth (as in Nyasha and Odhiambo, 2015, Abstract).

African countries, with the exception of South Africa and to some degree North African countries, have not yet reached the level of financial development at which further financial development would have a negative effect on growth (by contrast, South Africa and to some degree North African countries appear to have exceeded this point, as discussed earlier in the present section). Accordingly, given their current stage of financial development, it would appear that African countries (except South Africa and to some degree North African countries) should not fear further financial development per se and this should positively contribute to growth.

The empirical work surveyed in this section illustrates the complexity and diversity of the relationship between financial deepening and economic growth. Some broad conclusions can nevertheless be drawn. First, a positive relationship between financial deepening and economic growth has often been found at low to medium levels of financial deepening, though there is evidence for the relationship being weaker or becoming negative at high levels of financial deepening. Second, when financial deepening has involved higher household debt, then it is likely to be negatively linked with growth.

3.3.2 Financial system and financial crisis

The financial system has often exhibited periods of financial crisis, often associated with periods of rapid and unsustainable credit expansion, rising asset prices (e.g., of stock market, of property) and price bubbles. Historically, the financial sector has been prone to episodes of crises, with 424 financial crises recorded by Laeven and Valencia (2013) for the period 1970 –2011, of which 147 were banking crises, 211 currency crises and 66 were sovereign debt crises. Authors, such as Beck, and others (2011), Bertin, Ohana and Strauss-Kahn (2016), have recorded financial crises in African countries and note the general lack of crisis since 2000. Rapid credit expansion and asset price rises have generally been at play in the generation of financial crisis. Rapid credit expansion is commonly linked with booming demand and increased economic activity, and employment and an expanding economy; however, the boom in demand proves unsustainable, and more significantly the effects of the financial crisis and resulting recession are to depress output and employment, and often to do so on a long-term basis. After a financial crisis, output and employment do recover, but the losses from the financial crisis are often found to be much greater than the gains from the preceding boom.

Spratt (2016) has argued that without effective regulation, there are instabilities of the financial system, which can readily lead to financial crises, which in turn can have devastating effects on output, employment and growth. He found that: “Achieving the right balance between…objectives is a delicate, but crucial task. Too great a focus on stability stifles growth, while a headlong dash for growth is very likely to sow the seeds of future crises” (Spratt, 2016, p. 21). Historically, financial liberalization has often been associated with credit

---

6 See Malcom Sawyer for a full discussion of papers which find no or negative (at high levels) between financial development and economic growth (2013 and 2017).
booms and subsequent banking crises. As such, the risks of credit booms should be weighed against any other expected benefits when Governments are deciding whether or not to pursue financial liberalization.

3.3.3 Inequality and poverty
There are many ways in which financial deepening can influence the evolution of poverty and inequality. Demirguc-Kunt and Levine (2009) outlined the various routes through which financial deepening can have an impact on inequality. They argue that the theory on this matter is not unambiguous, and that while the theoretical analysis provides indications of a range of possible mechanisms linking inequality with the operation of the financial system, many of the core questions about the nature of the relationship between inequality and finance are empirical. Although they found that the accumulating body of empirical evidence is far from conclusive, they argue that the findings of cross-country, firm-level, and industry-level studies, policy experiments, and general equilibrium model estimations all suggest that financial development has a strong beneficial effect on the poor and that poor households and smaller firms benefit more from this development, compared with rich individuals and larger firms.

Beck, and others (2011) have asked what the mechanisms are through which financial deepening has the effect of reducing poverty and based on this, they suggested that economic theory implies a number of channels. On the one hand, providing the poor with access to credit might help them to overcome financing constraints and allow them to invest in microenterprises and human capital accumulation. On the other, there might be indirect effects through enterprise credit. By expanding credit to new and existing enterprises and allocating society’s savings more efficiently, financial systems can expand the formal economy and pull larger segments of the population into the formal labour markets.

Beck, Levine and Demirguc-Kunt (2007) presented results showing that “financial development disproportionately helps the poor”, implying not only poverty reduction, but an improvement in the position of the poor relative to the impact that financial development has on the average person. This may also imply a reduction in inequality, depending on which measurement is used. By contrast, Beck, and others (2011) found a slight negative relationship between poverty reduction and private credit to GDP for 68 countries (of which 25 are African countries) between 1980 and 2004, including taking into account several control variables.

In Kenya, the proportion of the adult population having access to formal financial services had increased from 27.4 per cent in 2006 to 66.7 per cent in 2013 (Mwega, 2014), but the extent of inclusion may have been limited to accessing payment services only, rather than savings, credit or insurance (Institute for Economic Affairs, interview, 16 August 2018). Yet having better access to payment services has proven very important for reducing or alleviating poverty, as many Kenyans depend on internal remittances, which were very expensive prior to the introduction of mobile money-based transfers. Kenyans that have access to mobile money can now also have access to credit and deposit-taking services through the mobile money medium.

Several papers provide evidence of the impact that financial development has on inequality. Unlike Beck, Levine and Demirguc-Kunt (2007) who found that financial development reduces inequality, Nikoloski (2012) used multivariate panel data analysis on 161 developed and developing countries for the period 1962 – 2006 and found an inverted U-shaped relationship between financial sector development and income inequality; hence financial development is associated with higher inequality at lower levels of financial development, and with lower inequality at higher levels.
Jauch and Watzka (2016) investigated the link between financial development (measured by the ratio of credit to GDP) and inequality (measured by the Gini coefficient) using an unbalanced dataset of up to 148 developed and developing countries for the period 1960–2008. They found that financial development increases income inequality in those countries and that more developed financial markets lead to higher income inequality; and that there is a positive relationship between inequality and financial development, highly significant but relatively small. With the Gini coefficient measured on a scale of 0 to 100, they found that an increase in the provision of credit by 10 per cent would lead to an average increase in the Gini coefficient of 0.22.

According to Adams and Klobodu (2016), who examined the effect of financial development and control of corruption on income inequality in 21 sub-Saharan African countries for the period 1985–2011, their empirical results showed that financial development tends to increase income inequality and that control of corruption appears to reduce income inequality. Furthermore, the interaction of financial development and the control of corruption was found to be negatively and significantly related to income inequality.

The South African case study may reveal one of the mechanisms by which financial development tends to increase inequality: the better-off tend to have greater access to credit than the poor, which may enable them to further increase their wealth through investment. Figure 3.1 specifically shows that individuals with incomes in the top tier, (i.e., more than 15,000 South Africa rand as gross monthly income) are the group that increasingly absorbs the vast majority of credits. Ten years earlier, their share of all granted credits was approximately 60 per cent, but by the first quarter of 2018 it was 75 per cent. This group was the only one that experienced increasing absolute amounts of credit, compared with all the other income groups who experienced declining amounts.

In summary, most of the studies reviewed in this section suggest that greater financial development tends to increase inequality, though the effect may be modest. There is, however, the possibility that for countries who have been successful in controlling corruption, financial development may help to decrease inequality.

The empirical literature is not able to capture some of the complexities of the various types of financial sector development and the impact they have on inequality. In particular, the financial sector inevitably makes decisions on how credit and funds are allocated – which groups receive funds and which do not, and on what terms. Financial institutions make decisions on who they regard as creditworthy and who they do not. These decisions often have significant impacts on income inequality.
not and as such, assessments favour some groups and discriminate against others. The promotion of inclusive growth would require that the poor and disadvantaged groups receive funds.

3.4 What kinds of financial deepening are (most) beneficial for inclusive growth?

There are three key ways to analyse this question. The first is to examine what types of financial services are likely to support inclusive growth; the second is which sectors or borrowers should be financed to achieve inclusive growth; and the third is to look at the impact that financial inclusion has on inclusive growth. The subsections below address these three ways in more detail.

3.4.1. Types of financial services and financial institutions

In terms of what types of financial services are positive for inclusive growth, some of the literature reviewed earlier in the present chapter considers this question. In particular, Beck, Degryse and Kneer (2014) and Levine (2005), who found that greater financial intermediation contributes to long-run growth, with the latter finding that financial markets also have a positive impact. Valíčková, Havranek and Horvath (2014), based on a survey of 67 papers, found that stock markets contributes to faster growth than other institutions. Spratt (2016, p. 36), however, made the following argument:

Stock markets can only allocate capital efficiently if prices reflect underlying fundamentals, providing accurate signals to investors. There is evidence that this is generally not the case in LICs [low-income countries], where share prices often move up and down together depending on market sentiment… Rather than boost growth by increasing the efficiency with which capital is allocated, therefore, LIC stock markets may be more likely to undermine stability by amplifying boom and bust cycles…the growth benefits of stockmarket cycles are less likely to be felt in LICs than the risks to financial stability. While stock markets are an important part of financial systems in more developed economies, there is a good case for LIC policymakers to focus their efforts elsewhere.

The International Monetary Fund (2012) also attempts to answer this question of how financial sector development can best contribute to growth. On the negative side, a domestic financial system that is dominated by some types of non-traditional bank intermediation or that has a high proportion of foreign banks has, in some cases, been associated with adverse economic outcomes, especially during the financial crisis. Furthermore, “there may be levels beyond which the beneficial effects on growth and stability of some financial structures diminish” (2012, p. 142). The Fund noted that: “Cross-border connections through foreign banks are beneficial most of the time, but during a crisis may be associated with instability or limit the active participation of these banks in the local economy” (IMF, 2017, p. xii). In addition, it found that “on average, an increase in household debt boosts growth in the short term but may give rise to macroeconomic and financial stability risks in the medium term” (IMF, 2017, p.xii).

Some researchers have also highlighted the importance of bank size for outcomes. For example, “at country level, our findings indicate that most countries in the WAMZ [West African Monetary Zone] could foster long run economic growth through changes in the size of financial institutions” (Diallo and Mendy, 2017, Abstract). According to Griffiths-Jones and Karwowski (2015, p. 225):

Smaller, more decentralized banks may be more appropriate in low-income countries, especially to lend to small and medium enterprises, partly because they can know their customers better, reducing asymmetries of information. Overall, a more
Financial regulation for inclusive growth in Africa

diversified banking system, with large and small banks, as well as private and public development banks, seems to offer benefits of diversification (and thus less systemic risks), complementarities in serving different sectors and functions, as well as providing competition for providing cheap and appropriate financial services to the real economy.

3.4.2 Financing for priority sectors and projects

The present section looks at which sectors (and which individuals) should be provided with finance for financial development to best contribute to inclusive growth. Financial deepening that sees finance extended to investment that are most important for development is most likely to drive positive economic outcomes. Financial development that includes positive financial inclusion is also likely to do this.7

Returning to the financing of priority investment for development in Africa, evidence tends to point to the positive role of credit to the private sector (as argued by Beck and others (2012), Kutan, Samargandi and Sohag (2017) and Nyasha and Odahimbo (2017)). Among the various parts of the private sector, given the historical experience of manufacturing in facilitating sustained, inclusive growth, this means greater credit to the manufacturing sector (ECA, 2016).8 It may also mean investment in expanding or making more efficient sectors that are essential for the success of the manufacturing sector. These include services inputs used by the manufacturing sector. For example, Pesce and others (2018) have noted that growth in the services and manufacturing sectors is highly correlated, and that the efficiency of infrastructure services has a strong impact on manufacturing competitiveness. Balchin and others (2016) reviewed a number of studies showing that investment and higher productivity in services improves productivity in other sectors, total factor productivity and other indicators of economic performance.

In line with this approach, Diallo and Meny (2017), based on a study on the West African Monetary Zone from 1990 through to 2015, have argued that “our findings suggest that structural reforms are needed in order to channel private credit to long run productive and growth-driving sectors”. Beck and others (2012), Kutan, Samargandi and Sohag (2017) and Nyasha and Odahimbo (2017) have all found that increased credit to the private sector is good for growth. Beck, Degryse and Kneer (2014) support the idea that greater financial intermediation contributes positively to growth in the long run. Karwowski (2018) contrasted a “more is more” view of credit held by financial deepening proponents with “the financialization-based assessment of credit that “what you finance matters”. She did this using data for twelve African countries: Angola, Benin, Eswatini (formerly Swaziland), Mali, Malawi, Niger, Nigeria, Sao Tome and Principe, Sierra Leone, Sudan, Uganda and United Republic of Tanzania. From her results, she found that financial deepening in the region has been “misplaced since much of the expanding credit has very limited transformative potential” (2018, p.3). In the light of this, Karwowski (2018, p.3) made the following observations:

Careful disaggregation of credit data, by economic sector and credit purpose, shows that lending in the twelve [African] countries with fast credit expansion favour borrowing by the service industry at the expense of manufacturing investment. Given the importance of manufacturing for development and economic transformation … this trend is alarming and suggests that private sector lending insufficiently supports economic transformation, a central feature of development. In fact, in some SSA

---
7 Though there are other important aspects of a well-performing financial sector, as outlined at the beginning of the chapter, such as balancing risk and return, ensuring consumer protection and preventing illicit financial flows, it would seem that these would best be controlled through appropriate regulations rather than steering what kinds of assets the financial sector invest in.
8 Another priority for growth would be the financing of key national development projects, such as in infrastructure, disease eradication, environmental protection or science and technology.
Financial regulation for inclusive growth in Africa

Economies (the Niger and Uganda) credit and mortgage extension is on the rise, which might contribute to the unproductive use of financial funds thereby creating financial fragility and weakening future growth and development.

Karwowrski (2018) has argued that this contradicts advice to liberalize financial sectors and pursue financial deepening. However, by contrasting investment in services and manufacturing, Karwowrski has ignored the positive effect that input services (especially infrastructure services) can have. Furthermore, even if Africa’s financial deepening is not contributing to structural transformation, it may still be having positive effects, including through growth, by financing investment that boost within-sector productivity in the services sector.

In addition to boosting the development of the manufacturing sector, the financial system may be able to best contribute to growth by financing national development projects. As outlined in ECA (2018a), a number of innovative financing techniques can be used to mobilize additional funds for national development projects. In order to achieve this, Governments will need to put in place appropriate regulatory frameworks, for example, when using social impact bonds or public-private partnerships. In addition, a financial system that suppresses tax evasion and avoidance can help to increase tax revenue that can be used to finance national development projects. As such, financial regulation’s role in preventing illicit financial flows and requiring professional and financial services providers to report suspicious transactions, can help to increase the financial system’s ability to finance investment in priority national development projects.

One of the ways in which countries can encourage additional finance to flow to priority projects and sectors is through the use of development banks. Such banks (whether regional or national) are specialized banks publicly established to cater or provide long term funds for specific sectors of the economy like agriculture, industry (small, medium and large-scale industries) over the long term. Commercial and merchant banks provide little long-term finance, so development banks fill this gap. Development banks can also be a means to finance projects, such as those with positive spill-over effects or social benefits that are beneficial for national development but would not receive sufficient financing from the private sector alone.

Development banks have had mixed success in Africa. In South Africa, the Development Bank of South Africa has been quite successful in mobilizing funds for national development projects, especially in the area of infrastructure, and the Development Bank of Ethiopia is also noted for its successes (ECA, 2018a). By contrast, in Kenya, national development finance institutions have been less successful. Up to 2013, the country’s development finance institutions were not considered to be fulfilling their potential to serve the Kenyan economy by providing long-term finance (Central Bank of Kenya, cited from Mwega, 2014). This was at least in part because they did not benefit from a combination of sufficient ground rules and an adequate allocation of finance. This is mirrored in the historical poor performance of state-owned banks in Kenya, attributed to poor governance and interference by the State in running these banks (Mwega, 2014). ECA (2018a) found that the major challenge facing development banks is that they are often run inefficiently. This suggests that appropriate governance and sufficient finance are important to the success of development banks.

Development banks are using a number of different techniques to help to mobilize additional finance for strategic projects, with varying success. One such approach is co-financing, through which development banks can help to mobilize additional finance from the private sector and share risk with these lenders. With co-financing, investors can gain a greater level of comfort through partnering with a development bank due to its connection with Governments, its financial strength, its willingness to remain through difficult economic conditions,
Financial regulation for inclusive growth in Africa

and its financial imprimatur, all of which help to attract other financiers. One example of successful development bank co-financing in Africa was the case of Eleme Petrochemicals in Nigeria, which became a world-class chemical manufacturer – from a poorly performing industrial giant – when the International Finance Corporation provided advice, financing and deal structuring to allow privatization of the State-owned firm. Development banks can also play a positive role in producing innovations to boost financial inclusion. The Economic Commission for Latin America and the Caribbean (2016) highlighted that national development in Latin America and the Caribbean have been successful in developing new products and services that have expanded access.

ECA (2018a) has argued that development banks can help to mobilize additional finance by serving as guarantor for private concerns seeking funding from international capital markets and institutions. They can also help to prepare feasibility reports for small and medium-sized enterprises and use these to look for long-term credit from international financial institutions such as the International Finance Corporation and Africa Finance Corporation, improving credit access for these enterprises. As aforementioned, increased credit to the private sector for productive activities tends to support growth; furthermore, African firms often face difficulties in attracting sufficient finance, as is the case in Kenya (and more broadly in Africa – see Karingi and Davis, 2016).

3.4.3 Financial inclusion and inclusive growth

Financial inclusion refers to the process of increasing numbers of people using financial services. This section provides discussions on various types of financial inclusion and the apparent impacts they have on inclusive development, focusing on two main points: how to promote financial inclusion and the effects of financial inclusion on inclusive growth.

How to promote financial inclusion

One of the key types of financial inclusion is promoting greater physical access to financial institutions (see e.g., Zewdu, 2016). This can be done through expansion of networks of financial institution branches, or through allowing financial institutions online. These methods can be used to allow more people to have access to the whole range of financial services provided by institutions. Expanding physical access will support inclusive growth, but only to the extent that greater use of the financial services that individuals decide to use (once they gain physical access), support inclusive growth. In Africa, having physical access to financial services is often a key issue, for example, in Ethiopia9 (as outlined in Zewdu, 2016) and in Kenya prior to the introduction and widespread uptake of mobile financial services (as highlighted in the country case study produced for the present report). Kenyans now have access to a range of financial services through their mobile phones, including the payment system, credit and savings. The transformative nature of M-PESA, in particular has had a noticeable impact on financial inclusion, and the availability of a ubiquitous payment system for low-income people has further enhanced innovation throughout a variety of development sectors, including agriculture, health, education and clean energy (European Investment Bank and United Nations Capital Development Fund, 2014). The proportion of the adult population in Kenya having access to formal financial services increased from 27.4 per cent in 2006 to 66.7 per cent in 2013 (Mwega, 2014).10

9 Recently, restrictions to physical access have been indirectly exacerbated by the financial regulations issued by the National Bank of Ethiopia (NBE). According to Zewdu (2016), the NBE has discouraged more financial institutions to join the financial sector by raising the paid up capital for both commercial banks and microfinance institutions (MFIs). In addition, having access to banks has worsened by the recent financial regulation that led banks to operate through an extremely conservative lending policy (know your customer), though this policy may reduce future non-performing loans (NPLs) for banks and reduce the risk of illicit financial flows, which is positive. All these measures led banks to shy away from serving small and medium-sized enterprises, new and young firms.

10 Some respondents interviewed as part of this report, however, noted that many of those included in statistics on financial inclusion might be accessing payment services only, rather than savings, credit or insurance (Institute for Economic Affairs, interview,
Credit unions have filled the gap in missing bank agencies in some municipalities in Brazil (ECA, 2018a). Rodrigues and de Oliveira Gonçalves (cited from ECA, 2018a) using a sample of 3,580 Brazilian municipalities estimates the effect of credit unions on the income of municipalities and found an average impact of R$ 1,825 in GDP per capita.

Morocco has had success in promoting financial inclusion through a range of initiatives different to those used to boost the number of people that have physical access to financial services. Some of the innovative initiatives in Morocco regarding financial inclusion include the transformation of the Morocco Post office into a commercial bank, the launch of the private credit bureau, and adoption of policies on consumer protection and financial literacy, among others. For example, the new banking law that was promulgated in 2015, provides for a legal mandate for consumer protection and introduces licensing and supervision of new actors that will help to promote inclusion, such as participative banks (e.g., Islamic banks) and non-bank providers of payment and transaction account services. Bank Al-Maghrib is a member of the Alliance for Financial Inclusion and has demonstrated strong commitment under the Maya Declaration. Morocco has also recently provided the legal basis for Islamic finance, which has given access to savings products to those who may previously have self-excluded because they did not consider available savings products to be compatible with their religious beliefs (see the section on Islamic finance in chapter 4 of the present report.

With regard to gains and achievements, notable progress has been made, especially in facilitating access to credit. For example, private credit to GDP (73 per cent) and household credit to GDP (31 per cent) are both above income group averages. The number of small and medium-sized enterprises (SMEs) that have easy access to a loan or line of credit has doubled since 2007. In addition, microcredit outstanding grew by 7.7 per cent in 2016 with a volume managed by a workforce of 7,100 people (+ 8 per cent), and with a network of approximately 1,681 points of sale and about one million customers.

South Africa has had success in promoting financial inclusion. In 2004, the country introduced the Financial Sector Charter, which has been instrumental in increasing the focus on financial inclusion and the engagement with lower-income households. As a result, overall financial inclusion was increased from 55 per cent in 2005 to 85 per cent in 2016. This means that most adults in South Africa now have some form of financial product from a regulated financial institution (South Africa, National Treasury, 2017).11

In South Africa, it appears that the cost of bank accounts had been an important factor in restricting access to them. This is illustrated by the fact that, following the launch of an inclusive banking strategy by one of the country’s largest banks, 900,000 low-cost bank accounts were opened between 2007 and 2012; most of the account holders for these accounts had never used banking services before (B4D Pathfinder, cited from ECA, 2018a).

Other approaches to promoting financial inclusion that have increased the number of people having access to finance include crowd-funding (which in 2017 was estimated to have reached $16 billion worldwide (Polzin, Toxopeus and Stam, cited from ECA, 2018a), but it might require a strong contract enforceability to encourage anonymous funders to contribute to financing); international factoring guarantees; and payroll loans through which repayments are deducted from the borrower’s wages (Economic Commission for Latin America and the Caribbean, cited from ECA, 2018a).

---

11 This improvement has not adequately translated into a better quality of life for low-income households, nor into viable economic prospects for many small firms. Challenges for financial inclusion to contribute to inclusive growth are discussed in the subsection on “Impacts of financial inclusion on inclusive growth” of the present chapter.
**Effects of financial inclusion on inclusive growth**

Beyond looking at how to expand specific types of financial inclusion, it is important to consider whether increased usage of the various types of financial products by those who previously used them, supports inclusive growth. In order to investigate whether this is the case, consideration is given to microfinance, which describes the effort to provide financial services (in this case credit, savings or insurance) at small scale, often targeting poor customers who were previously excluded. Financial inclusion would follow from microfinance through financial services being provided to those who had previously been effectively excluded from credit, whether as a result of discrimination and exclusion based on gender, ethnicity, among others, and through poverty and high credit risk. In theory, economic activity would follow from those who had previously been unable to purchase, for example, materials and capital equipment to enable production and sales now being able to do so. Furthermore, financial inclusion that increases resource mobilization (through extension of savings services or insurance, which is a form of saving) would in theory to be beneficial for growth as it would tend to encourage greater savings, greater investment and greater productivity.

Morduch (1999) reviewed several studies on the impact that microfinance has on poverty and found that the evidence is mixed, especially with regard to microcredit (but is more positive regarding savings programmes). Banerjee and Duflo (2011) found that microfinance has only a modest impact on reducing poverty, and is unlikely to be transformative. Some authors (Bateman, Blankenburg and Kozul-Wright, 2018, among others) have doubted the contribution of microfinance to development and transformation. Microcredit, by definition, provides small loans to individuals or micro-enterprises. Such loans can provide sufficient funds to acquire (or lease) goods for sale, materials, agricultural inputs. Based on her study of microfinance, Barrowclough (2018, p.12) made the following observation:

It should be obvious that lending very small amounts of money (usually less than $100) to individual entrepreneurs-to-be is unlikely to be able to generate jobs and create a dynamic market on the scale needed to fundamentally change the economic environment, even at a very local level. Indeed, the fact the level is local is part of the problem—many microfinance loans were financing small-scale trading and could even be displacing other traders or provoking a shift towards informal employment. Lending to the poor can only ever be one aspect of a broader and deeper approach, whereby governments tackle directly the issue of job-creation, skills development, trade and development rather than imagining that anyone or everyone can be an entrepreneur.

In particular, Bateman (2018, p. 45) points to two specific demand-related outcomes [which] worked to counter any meaningfully positive impact from microcredit:

The first of these is displacement. This is the situation where a new microenterprise helped into operation by microcredit is able to survive and create some new jobs, but it only manages to do so by eating into the local demand that had been supporting an incumbent microenterprise, which is forced to contract its own level of employment and low revenue to a roughly similar degree. … The second negative factor here is exit (or enterprise closure). This is the situation where a new or incumbent microenterprise is forced to close outright because of the increased local competition caused by additional new entry.

A global survey by Gomez (2008) has shown that in general 75 per cent of new micro-enterprises do not survive beyond two years. The degree to which small loans to individuals are, or can operate in effect as household debt and which places individuals into a cycle of debt have also
been highlighted. As aforementioned, expansion of household credit appears to have ambiguous or negative effects on growth (see IMF, 2012, 2017; Bezemer, Grydaki, and Zhang, 2016; and Beck and others, 2012, who all found that household credit does not have a positive effect on growth using a dataset from 45 developed and developing countries, including 3 African countries). This suggests that there is a need to manage expectations about microfinance programmes and especially microcredit. It also underlines the importance of being careful not to divert scarce finance towards microfinance programmes from other investment that may have a greater impact on poverty reduction and inclusive development by propelling economic transformation, such as priority national development projects (e.g., investment in infrastructure, health improvements, education, science and technology) or investment in transformative sectors, such as the manufacturing sector and services sectors that provide key inputs to it (see e.g., Balchin and others, 2016; ECA, 2016; and Pesce and others, 2018).

In addition, there is consumer protection risks associated with the extension of financial services to the previously excluded. The country case study on South Africa prepared for the present report underlined the risk of exploitation by financial services providers. Furthermore, bank charges are still unreasonably high, and the insurance sector employs abusive charging practices. This suggests that strong consumer protection policies, as well as competition (which is explored in more detail in chapter 4) may be important complements or even prerequisites for efforts to expand financial services, in order to ensure that they are provided on terms that are advantageous for customers.

There are some successful examples of financial inclusion programmes, especially from the country case studies, through expanding access to credit using programmes similar to those being used in Morocco. For example, the financial inclusion programmes being implemented by the Ministry of Economy and Finance in Morocco, which is aimed at promoting and raising the number of people that have access to affordable housing and increasing the amount of SMEs that have access to credit, have resulted in major and positive development impacts. This draws a distinction with other types of microfinance as these inclusion programmes are targeted to enabling poor borrowers to purchase goods that are likely to have a significant, positive impact on their lives (in the case of efforts focused on affordable housing) and targeted towards enterprises that can boost productivity and provide decent work (small and medium-sized enterprises), in contrast to micro-enterprises, which may actually be less productive and provide worse-remunerated work than the rest of the economy.

In Kenya, increasing the amount of people that have access to the payment system has achieved a significant reduction in poverty by reducing the cost of remittances, which are an important source of income for many who are poor and others. At the same time, with having easier access to the payment system, African countries will need to take measures to prevent this from facilitating illicit financial flows (this topic is discussed further in chapter 4 of the present report).

To conclude, the type of financial inclusion that is pursued and the value for money provided by the financial sector both matter in terms of whether greater financial inclusion will support inclusive development. Expansion of microcredit appears to have an impact on inclusive development that is often ambiguous; however, certain types of programmes that help people to have access to credit extension programmes (e.g., those focused on affordable housing and credit for SMEs in Morocco) can have positive effects. Expansion of access to savings is positive in terms of enabling more individuals to save and in mobilizing resources for investment, but the South African example shows that strong consumer protection is needed to prevent savers from being exploited by financial institutions. Finally, having easier access to the payment system for the purposes of remittances
appears to have strong, positive impacts on poverty reduction.

Capital market and financial inclusion

Africa’s debt markets are dominated by government securities mostly of short duration, with activity focused on the domestic primary market and limited activity in the secondary market. These markets are serving the top crust of formal business landscape — the larger corporates. According to the Inter-agency Task Force, they suggest that one of the biggest challenges policymakers and stakeholders face in raising resources for sustainable development is how to tackle excessive short-term oriented decision-making and develop financial markets that are inclusive, long-term oriented, and that support sustainable development (United Nation, 2017). To this end, inclusive finance is crucial to sustain economic and social development. In the emerging and developing economies, efforts to develop financial services for SMEs have been growing and have evolved considerably during the past few decades. In response to a growing understanding of the financial needs of SMEs, there has been a shift toward commercializing these efforts through formal financial services such as microfinance market, equity capital markets and debt capital markets.

In Morocco, The Second Capital Market Development and SME Finance Development Policy Loan (DPL) was approved by the World Bank in May 2017. It is a $350 million budget support operation. In April 2014, $300 million was approved for the first DPL. The programme objectives are to: improve access to finance for small and young enterprises; strengthen capital markets by improving the institutional framework and broadening the range of instruments; improve the financial sustainability of the Mandatory Pension Fund for Civil and Military Services; and strengthen the oversight of the banking sector (World Bank, 2018b).

Africa’s economy is dominated by SMEs and it is important to stress that a deep, transparent and accessible capital market forms a critical element of the entire financial sector. Accordingly, there is an urgent need for African capital market stakeholders to spread the opportunity to embrace other segments of the African business landscape, especially SMEs. African Governments and policymakers must identify and tackle the bottlenecks that prevent capital markets from becoming more inclusive, such as: enacting regulatory and legal reforms on inclusive capital market; providing accessible and affordable funds for SMEs business growth and expansion; leveraging platforms and risk-sharing private investors and the public; increasing publicity and scrutiny of SMEs’ operations; and ensuring improved and accurate information collection and sharing on financing SMEs.

3.5 Conclusion

In the light of the relatively low levels of financial deepening in African countries (with the exception of South Africa and to some degree North African countries), most African economies appear to be operating where higher levels of financial deepening would stimulate rather than depress growth. It may also be suggested that in order for financial deepening to aid growth, there have to be regulatory measures to ensure that further financial deepening does not foster credit booms and instabilities.

In addition, the evidence reviewed mostly suggests that financial deepening helps to reduce poverty, but tends to worsen inequality. This suggests that African countries that prioritize growth and poverty reduction can benefit from pursuing greater financial development, but they may need complementary policies (such as progressive fiscal policies) to help to offset the worsening of inequality, and consider that efforts to reduce corruption become increasingly important with greater financial development.

The arguments outlined in this chapter and the literature reviewed suggests that specific types of financial development contribute to growth and its inclusivity, more than others. In particular,
the development of financial intermediation and markets, credit to the private sector (at least up to 100 per cent of GDP), financing for transformative sectors (such as manufacturing and the inputs to that sector), priority national development projects, stable banks and a diversified financial system with large and small banks, would all appear to be positive (to the extent that there is adequate governance of the process of public mobilization of funds.

By contrast, based on the evidence provided in chapters 3 and 4, greater investment in real estate and non-productive investment, domination of the financial sector by non-traditional forms of financial intermediation or foreign banks and rapid credit expansions and asset price rises, appear to have negative effects. This suggests that Governments should try to steer financial sector development towards the financing of private sector investment to bring about the outcomes that will be positive for growth. Literature seems to be divided on household credit (though united that it has a negative effect on more than 30 per cent of GDP) and stock market development. New approaches are needed to encourage financial inclusion, but this should be closely monitored to ensure that there are not negative effects on financial stability or diversion of credit from sectors that focus on economic transformation.

To ensure that financial development does not worsen inequality and reduce poverty, it is important to promote financial access and inclusion and prevent exploitative financial practices, including through regulatory measures. Regarding efforts to promote financial inclusion, insights from Ethiopia and Kenya are also instructive. In both examples, not having physical access to financial institutions had restricted financial inclusion. In the Kenyan case, however, the broad uptake of mobile money made it much easier for individuals who did not have physical access to a bank to benefit from internal remittances, which as a result, made such remittances much more affordable.

The experience of Kenya suggests that countries with significant numbers of migrant workers (internal or external) that support families living elsewhere can significantly reduce or alleviate poverty by enabling migrant workers to have cheap and secure access to mobile money. Furthermore, expanding financial literacy could aid with expanding financial inclusion. The experience of Morocco suggests that expanding the access that SMEs have to credit, promoting affordable housing and laying the legal groundwork for Islamic finance (to financially include those who were previously self-excluded for religious reasons) can have positive impacts on poverty reduction.
CHAPTER 4: REGULATION OF THE FINANCIAL SECTOR AND DEVELOPMENT

There is little to no literature that directly addresses how different approaches to financial regulation development affect inclusive growth. As a result, the present report looks separately at the impact that financial regulation has on growth, and then the impacts on inequality and poverty. Combining these analyses will help to piece together which approach to financial regulation can be good for both growth and making sure that it is inclusive.

Much literature on economic regulation (including that of the financial sector) attempts to make policy recommendations to enforce property rights, reduce transaction costs and ensure competition, in line with what Khan (2012) refers to as “market-enhancing governance”. This stands in sharp contrast to the “growth-enhancing governance” framework that is intended to build productive capacities and further economic growth and structural transformation.

This chapter follows the growth-enhancing governance framework and provides an analysis of the different approaches to financial regulation based on either direct evidence of their impact on development outcomes of interest; or a less direct approach that looks at its contribution to resource mobilization and allocation for investment that support inclusive development. In line with this, the chapter contains a review of the evidence on financial regulation and the impact it has on inclusive development, using literature that tries to measure financial regulations and directly investigate its impact on economic growth, complemented with insights from the country case studies conducted for the present report, and other selected African countries. In addition, it provides an analysis of the literature and case study findings to develop policy recommendations.

While there is substantial evidence in this area, it does not provide a comprehensive picture of the impacts that all the different approaches to financial regulation have on economic growth, including possible new approaches but have not yet been tested. The review carried out in chapter 3 was to complement the evidence of financial regulation growth with evidence working on different parts of financial sector development and what impact these appear to have on growth. Such evidence can also help to complement the direct evidence of financial regulation and growth in guiding financial regulation in Africa, by showing what kind of financial sector development will be best for growth.

In addition, though (as outlined in chapter 2) most African countries (with the exception of South Africa) have not experienced the de-linking of finance from production, this has become commonplace in advanced economies and therefore African countries need to put in place regulations ahead of time to prevent this before it occurs. In this spirit, the present chapter contains an examination of the best approaches to financial regulation and supervision that best supports growth in the real economy, as well as reductions in poverty and inequality.

During the past four decades, financial liberalization has led to a substantial growth in the financial sector and the possibility for finance to become disentangled from the productive sector. This has meant that a large portion of the sector’s activities has been focused on “speculative” investment that is intended to profit from the dynamics of financial
markets, rather than through financing investment that will yield profits as a result of boosting the quantity or quality of production. Such activities can create profits for financial institutions (though they often provide inferior returns – see, for example, Makridakis, Hogarth and Gaba, 2009) but will not result in increases in the quantity or quality of aggregate production, that is, inclusive growth (even if measures of financial services value added are increasing).

In addition to leading to wasteful diversion productive resources, financial liberalization since the 1980s has led to instability in the financial sector. This can be explained by Minsky, (1992) and his financial instability hypothesis, that the financial sector will follow cycles of stability and instability. Periods of stability create complacency and willingness on the part of stability to engage in greater financial risks. There is the tendency to shift from hedging strategies (income is expected to cover interest and principal repayments) to speculative strategies (income covers interest payments needed to finance investment only in the short term) to Ponzi finance (receipts are insufficient to cover even interest payments). Furthermore, periods of stability, as often perceived to be the case in the 1990s and 2000s (the great moderation) in the words of Bernanke (2004), may lead to greater risk-taking and to political and other pressures for de-regulation and for slacker enforcement of regulation. This combined with the disengagement of the financial sector from production, means that periods of stability lead to increasing risk-taking which can also be in assets that are fundamentally unproductive from a social perspective.

In line with the predictions of Minsky (1992), economies have experienced a repeated history of financial crises, from the Dutch flower bubble to the dotcom boom to the 2008 financial crisis (see, for example, Rheinhardt and Rogoff, 2009). Though crises are often followed by periods of enhanced financial regulation and repression, after some time they are again followed by deregulation, as Minsky (1992) predicted. This underlines the cyclical nature of financial crisis and regulation and the failure of the financial sector (or regulators) to learn on a sustained basis about the tendency for financial markets to pursue, en masse, unproductive investment, leading to financial crises. Furthermore, it underlines that regulators cannot afford to assume that financial institutions are rational or self-regulating, or that a laissez-faire approach to the sector will lead to increased investment and effective demand. Instead, regulators in Africa and beyond need to supervise and regulate the financial sector to prevent excessive risk-taking and steer the sector’s activities towards financing real production.

4.1 Regulation and liberalization in case study and other countries

In Kenya, there was a major shift to a system of financial regulation, under which the aims of financial regulation were ensuring financial stability and consumer protection, and away from the direction of credit and control over interest rates. Kenya drew heavily on regulations from other countries (including, notably, Canada), but over time regulators have adjusted certain aspects of these regulations to be more appropriate for the Kenyan context. Regulators are also applying a “regulatory sandbox” approach, in which certain regulations can be relaxed to allow financial services innovations to be tested. Once the regulator is able to observe their operation, the regulations that were relaxed can either be reintroduced, modified or removed (Capital Markets Authority, interview, 13 August 2018).

South Africa produced a 2011 policy document entitled, *A safer financial sector to serve South Africa better*, which sets out a policy framework...
structured around the following four pillars: financial stability; consumer protection and market conduct; expanding access through financial inclusion; and combating financial crime. These pillars are to be implemented and enforced by specific public institutions, while being co-ordinated by a Council of Financial Regulators. In general, the 2011 policy document emphasises “a system-wide approach to financial stability and regulation, bolster the supervision of individual institutions, and ensure better coordination and information sharing” (South Africa, National Treasury, 2011). It also advocates for broadening the scope of regulation so as to cover unregulated financial activities that have the potential to create systemic risks to financial stability. From April 2018, South Africa has been implementing the “twin peaks” regulatory model with separate regulators for prudential regulation and market conduct (South Africa, National Treasury, 2018). Under the Financial Sector Regulation Act of 2017, various councils and committees will facilitate collaboration between these regulators (EY, 2018).

In Morocco, the new banking law, adopted in 2014 and promulgated in 2015, provides a new supervision framework that complies with the Basel standards. Under the new law, Bank Al-Maghrib has the exceptional powers to resolve banks and extend

Table 4.1. Comparison of Basel Committee on Banking Supervision guidelines with Bank Al-Maghrib requirements

<table>
<thead>
<tr>
<th></th>
<th>BCBS 2014 1/</th>
<th>Morocco 2013</th>
<th>Morocco 2016–2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Perimeter of large exposures</strong></td>
<td>Single counterparties or groups of connected counterparties</td>
<td>Single counterparties or groups of connected counterparties</td>
<td>No change</td>
</tr>
<tr>
<td><strong>Denominator</strong></td>
<td>Total capital until 2019, then tier 1 capital 2/</td>
<td>Total capital</td>
<td>Tier 1</td>
</tr>
<tr>
<td><strong>Numerator</strong></td>
<td>“Accounting method.” In the case of loans, exposures net of specific provisions</td>
<td>Same as BCBS</td>
<td>No change</td>
</tr>
<tr>
<td><strong>Risk mitigation</strong></td>
<td>List of eligible credit risk mitigations</td>
<td>Same (e.g., gross exposures reduced by explicit security interests)</td>
<td>No change</td>
</tr>
<tr>
<td><strong>OBS conversion</strong></td>
<td>Same as standardized approach to RWA</td>
<td>Same as BCBS</td>
<td>No change</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Limits</th>
<th></th>
<th>Above 5 per cent</th>
<th>No change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reporting</strong></td>
<td>Above 10 per cent</td>
<td>Above 5 per cent</td>
<td>No change</td>
</tr>
<tr>
<td><strong>Prudential</strong></td>
<td>25 per cent of numerator, 15 per cent for G-SIB exposures to other G-SIBs</td>
<td>20 per cent of numerator</td>
<td>15 per cent for counterparties relating to the bank or any group of connected obligors that fail to provide consolidated accounts</td>
</tr>
</tbody>
</table>

| **Exemptions**          | Sovereigns and public entities treated as sovereigns | Only the Government of Morocco; foreign sovereigns not exempt |
|                        | Any portion of an exposure secured by financial instruments issued by sovereigns, or explicitly guaranteed by sovereigns | Banks only exempt for 1-day interbank exposures |
|                        | Banks | |

| **Penalties**           | “Breaches of the limit, which must remain the exception, must be communicated immediately to the supervisor and rapidly rectified.” | Exposures over limit deducted from total capital |
|                        | | Reduce regulatory total solvency ratio |

| **Implementation**      | Transition period to January 2019 | - | Transition period for denominator and new 15 per cent threshold |

Source: International Monetary Fund and the World Bank (2016).
Notes: BCBS, Basel Committee on Banking Supervision; OBS, On Balance Sheet; RWA, Risk Weighted Assets; G-SIBS, Global Systematically Important Banks.
its regulatory and supervisory responsibilities to financial conglomerates that control credit institutions. Another innovation under the new law is the introduction of cross-border supervision mechanisms and rules for risk management on a consolidated basis. The three top banking groups that operate across borders and more increasingly in Africa have been identified by Bank Al-Maghrib as systemically important banks. As such, supervisory colleges were set up with supervisors from various host countries in order to ensure close supervision of bank asset quality, proper monitoring of internal control and governance, and to limit or reduce all types of risks. An assessment undertaken by the International Monetary Fund and the World Bank (2016) found that the supervision of the banking sector in Morocco has improved and is effective (see table 4.1).

According to Ackah and Asiamah (2016), in Ghana, “sustained financial sector restructuring and transformation has succeeded in creating one of the most vibrant financial services centres in West Africa.” With the influx of foreign banks and investors that followed financial liberalization, they found that “the entry of foreign banks and investors into the financial services industry in Ghana has increased competition in the banking industry as well as the introduction of strong business practices, technology, products, and risk management systems, and has given impetus to dynamic efficiency in the industry” (2016).

A major challenge is the limited access the private sector has to credit and the high cost of credit that puts small businesses at a disadvantage. The high profits of Ghanaian banks suggest “a role for government, in the form of regulatory (and even more forceful) intervention to promote competition and prevent abuse of market power. There may be a good case for considering the introduction of competition (antitrust) and consumer protection laws to protect consumer welfare” (Ackah and Asiamah, 2016). Ackah and Asiamah also pointed to difficulties faced by the Government in increasing “access to finance for the benefit of the vulnerable and the excluded, who have no options other than to go to money lenders who also quote extremely high rates” (2016). They viewed the Central Bank as being proactive in reforming the banking system through upward revision of the minimum capital required for commercial banks to operate in the country. Prudential regulation has also been improved with the establishment of a Deposit Insurance scheme and an orderly framework for dealing with problem banks in the future.

In the Sudan, the Government has pursued a policy of financial repression, ostensibly to make public borrowing more affordable than would otherwise be the case. Analysis undertaken by Abdul-Jalil (2017), however, suggests that this has not been the case and that public borrowing from the domestic market under financial repression is in fact more expensive than borrowing from international markets. This implies that financial repression has led to a fiscal transfer from the State to financial institutions in the Sudan.

4.2 Direct evidence on financial regulation and growth

The following section presents a summary of the authors’ findings, the policy implications on growth and conclusions of the literature reviewed, as well as insights from country case studies conducted to support the present report. In some cases, these do not measure the direct impact that financial regulations have on growth, but rather its impact on other variables that is expected to be positively related to growth, for example, the efficiency of financial institutions, competition in the financial sector and addressing corruption in financial institutions. The material is organized by key policy areas, with subsections on each of the various policy areas that cover the insights from the literature regarding that policy area.

When financial sectors are riddled with market imperfections and market gaps, it is important to investigate how to meet these missing markets (whether this is best done through regulatory
changes to encourage the private sector to meet these market needs, or through government provision of such services. In this regard, public development banks have worked well in supplying credit to sectors that are very important for development, which are undersupplied by private credit providers (ECA, 2016).

### 4.2.1 Role of credit information

Better access to credit information (i.e., information about the credit history of borrowers) appears to improve economic growth. The establishment of public credit registries to provide effective regulations of private credit bureaux (including mandatory reporting requirements) could help to boost growth and access to growth. Papers that support this include: Caggiano and Calice (2016), based on Gulf Cooperation Council countries for the period 2002–2010; Houston and others (2012), who found a positive effect on economic growth for a sample of 69 countries; and Giannettia and Jentzsch (2012) who found that the introduction of a mandatory reporting system borrowers has a positive impact on financial intermediation and financial access, especially in countries that have a credit reporting mechanism, based on a sample of 172 countries for the period 2000–2008.

By contrast, Martinez-Peria and Singh (2014) found that publicly regulated credit registries did not increase firm access to finance (and therefore growth, see the second subsection of the present chapter), based on a sample of 63 countries for the period 2002–2013. In addition, Behr and Sonnekalb (2012) found that information sharing between lenders does not affect access to credit, but their study is based on only one country (Albania). Nevertheless, the balance of the empirical evidence seems to be in favour of public credit registries and private credit bureaux.

In Kenya, credit reference bureaux were introduced after the Banking (Credit Reference Bureau) Regulations 2008, were introduced by the Government. Revised regulations allowing for sharing of positive and negative credit information by banks and deposit-taking microfinance institutions were gazetted in January 2014. By 2014, the two licensed Credit Reference Bureaux had received a total of 3.5 million credit requests from banks, more than 53,000 requests from individual customers (Mwega, 2014). These policies appear to have produced good results in terms of access to credit. In 2013, only 17.2 per cent of firms surveyed in Kenya identified access to finance as a major constraint, compared with a 26.5 per cent average among all countries included in the World Bank Enterprise Survey during the period 2010–2017 (only the most recent survey for each country is used in the calculation). Among manufacturing firms, 23.5 per cent of firms identified it as a major constraint. This is significantly better than the average across all countries in the World Bank Enterprise Survey (28.5 per cent) (World Bank, 2013).

As noted in chapter 3, evidence suggests that increasing credit to the private sector is the best type of financial deepening for growth.

Other policies appear to have undermined these measures to increase credit to the private sector; this underlines that credit bureaux or registries may only be able to boost credit to the private sector (and growth) in the context that banks are encouraged to lend to the private sector (see box 1).

In this context, it would be in the interest of African countries to put regulations in place for the establishment (and regulation) of private credit bureaux. There does not appear to be a reason why the evidence for a cross-section of countries presented above would not apply to African countries, especially since the studies are based on data for a broad range of different countries.

---

13 Interview respondents for the country case study noted that micro- and small-sized enterprises, which make up the bulk of enterprises in Kenya, might be excluded from these surveys as their experience was that many firms had difficulties accessing credit (Kenya Institute for Public Policy Research and Analysis, interview, 15 August 2018).
4.2.2 Role of domestic and foreign competition

Several of the studies reviewed for this report, underline the importance of competition in the financial sector for improving its contribution to growth. Caggiano and Calice (2016) reviewed several studies in this regard. They found that, as in other areas of financial regulatory policy, theory is unclear as to whether competition in financial services will have a positive impact on growth. On the empirical side, however, the weight of evidence seems to suggest that greater competition in financial services is good for growth. This includes empirical work of Caggiano and Calice (2016) in looking at Gulf Cooperation Council economies, in addition to Claessens and Laeven who found a similar relationship with a sample of 16 economies, Liu, and others for a sample of 48 countries, Love and Martinez-Peria for 53 countries, Leon for a sample of developing countries, and Ryan, and others for a sample of 20 European countries (all cited from Caggiano and Calice, 2016).

Jayakumar, and others (2018) also found that the competition in the banking sector significantly contributes to long run economic growth based on a sample of 32 European countries during the period 1996 – 2014. Barth, Caprio, and Levine (2008) also found that “an approach that... encourages competition, including competition by foreign banks, and requires or encourages greater diversification appears to work best to foster more stable, more efficient, and less corrupt financial-sector development”. In addition, as noted earlier in the present chapter, Ackah and Asiamah (2016) argued greater competition, enforced through regulatory policy, would benefit the banking sector in Ghana. Though there are studies that present contrary evidence (Fernandez de Guevara and Maudos for a sample of 21 countries, and Hoxha, both cited from Caggiano and Calice, 2016),
the balance of evidence seems to suggest that greater competition in financial services is good for growth. In Kenya, key informants interviewed for the country case study argued that banks had charged excessive interest rates for borrowers, which, according to economic theory, would seem to indicate insufficient competition (and could be remedied through improving competition or regulating interest rates as the Kenyan Government has done).

In the African context, there again seems to be no reason why greater competition in the banking sector should not also be good for growth in Africa given these general results (especially given that several of them involve a broad range of countries). Furthermore, several African countries appear to be facing challenges to competition in the financial sector, these include Ghana (see, for example, Ackah and Asiamah, 2016), Mozambique and South Africa (ECA, 2018b).

In addition, a number of the studies reviewed here suggest that openness to competition from foreign banks will be good for growth. For example, Barth, Caprio and Levine (2004) looked at a database on bank regulation and supervision covering 107 countries. They found that restricting entry by foreign banks increases bank fragility which tend to be associated with the risk of bank default losses resulting therefrom. Pesce and others (2018) also emphasized the importance of efficient services, especially financial and infrastructure services, to drive economic growth and structural transformation in African countries, while Borchert and others (cited from World Bank, not dated) underline that “credit as a share of gross domestic product can be expected to have a positive impacts for all African countries except South Africa).

Balchin, and others (2016) reviewed several studies and found that allowing imports of financial services is associated with positive effects on economic growth, so long as appropriate regulatory frameworks are already in place. Barth, Caprio and Levine (2008) found that “an approach that… encourages competition, including competition by foreign banks… appears to work best to foster more stable, more efficient, and less corrupt financial-sector development.” Ackah and Asiamah (2016), as aforementioned, found that the entry of foreign banks and investors into the financial services industry in Ghana has increased competition in the banking industry.

There have been some cases that a financial regulator has decided to introduce a new product to the market that has been shown to be beneficial, allowing investment from foreign banks that have expertise in providing this financial service can facilitate delivery. This occurred with the introduction of Islamic financing to Morocco, in which the Government allowed investment from banks from the Gulf countries with expertise in delivering this type of finance (Arab Maghreb Union, interview, 19 May 2017). See the subsection on Islamic finance in the present chapter for further details.

As such, it appears that African countries could benefit from allowing foreign competition in the banking sector. In addition to the importance for African countries to have an appropriate regulatory framework in place before allowing foreign entry, it is worth noting that the presence of foreign banks presents specific challenges for regulators. According to the International Monetary Fund (2012), “cross-border connections through foreign banks are beneficial most of the time, but during

---

14 Rather than looking at the direct impact on growth, these five papers look at the impact of competition in financial services firms access to finance. However, except at high levels of financial isolation rate of access to finance seems to be good for growth. Therefore, since competition in financial services seems to be good for access to finance, it is most likely to be good for growth.
a crisis may be associated with instability or limit the active participation of these banks in the local economy.”

In particular, the banks that are part of multinational corporations that operate in different countries with various levels of financial regulation and supervision, a subsidiary of a multinational in one country can be exposed to financial risk from other branches and subsidiaries of the same group, especially if they are operating in countries that have inadequate financial supervision and regulation. This is because, depending on the applicable laws, bankruptcy in one jurisdiction may trigger bankruptcy of the group (if not directly, indirectly as liquidity is sucked from various parts of the group to try to support failing parts). This suggests that when allowing foreign banks to enter markets, African countries should try to pursue cooperation with other regulators to ensure minimum standards, or restrict entry from foreign banks that will be exposed to excessive financial risk because of high-risk operations at the same group.

One approach that member States of the Economic Community of West African States (ECOWAS) and Morocco are applying, is the use of supervisory colleges that bring together the banking supervisors for each multinational bank from each of the various countries in which the bank operates, to share information and views relevant to its supervision and regulation. This approach is also applied in the Association of Southeast Asian Nations (ASEAN) and the European Union. Relevant experts recommend frequent, substantive communication between supervisors that are members of supervisory colleges. They also highlight the risk of entry by banks that are “too big to regulate”; this suggests that boosting capacity in financial regulations should occur if entry of such banks is allowed, or, failing this, limitations on bank size should be used to restrict entry by banks that are too big for the host country to effectively regulate. Furthermore, experts have raised concerns about the political influence of large banks on financial regulation – these concerns should also be taken into account when considering allowing greater foreign bank entry (ECA, 2018b).

Managing cross-border financial stability risks also have implications for the recently agreed African Continental Free Trade Area (AfCFTA). As AfCFTA includes commitments to progressive liberalization of services, African countries may face a discussion as to how (and how far) to make commitments to open their markets to banks from other African countries. In doing so, they will need to balance the benefits of foreign competition (and the quid pro quo involved in trade negotiations) with the need to manage cross-border financial stability risks, inter alia. One approach to this could be for African countries to pursue agreements on supervisory colleges, information sharing and regulatory coordination in parallel to making market access commitments; this would allow African countries to reap the economic benefits of foreign competition while managing cross-border financial stability risks. If this is not possible, then African countries could still allow entry by banks from other African countries, but place limitations on “national treatment” commitments under AfCFTA allowing them to require enhanced disclosure by foreign banks and to require foreign banks to hold additional capital to account for financial stability risks that may come from other countries.

### 4.2.3 Regulations to prevent financial crime and illicit financial flows

As outlined in ECA (2018c) financial crime and illicit financial flows are a major development challenge in Africa. In particular, a range of estimates agree that Africa has been losing at least $30 billion annually through such flows (Cobham and Janský, cited from ECA, 2018c; Boyce and Ndikumana, 2012; 15 ASEAN has been successful in promoting strong information-sharing among supervisors about multinational banks operating in more than one-member country in the bloc. As a result, the approach ECOWAS takes to sharing information among regulators has been inspired by the ASEAN approach.
Financial regulation for inclusive growth in Africa

Spanjers and Salomon, cited from ECA, 2018c). Some estimates are much higher; for example, ECA estimates indicate that the continent has been losing at least $73 billion net annually through trade mis-invoicing alone (when combined with the estimate of Africa’s losses through “balance of payments leakages” (Spanjers and Salomon, cited from ECA, 2018c), this would give a total of $100 billion annually). ECA (2018c) outlines several other negative impacts that illicit finance flows have on development, beyond the financial losses, and its effect on public spending and investment.

Many illicit financial flows (defined by the High-Level Panel on Illicit Financial Flows from Africa as the cross-border movement of money that is illegally earned, transferred or used, or effects aggressive tax avoidance) are transferred through the formal financial system or facilitated through payments made through this system (African Union and ECA, 2015). In order to prevent this, countries can use financial regulations to oblige formal-sector financial institutions to restrict access to the payment system for payments that appear to have a high probability of being illicit, to “know their customers” for the purposes of identifying and preventing possible illicit transactions, and to report payments suspected of being illicit to the relevant government agency. As outlined in ECA (2018c), it is beneficial to supplement these rules with enhanced due diligence for “politically exposed persons”, that is, persons holding influential positions in public office. In Morocco, for example, the country’s financial intelligence unit received reports of suspicious transactions from the country’s banks. Furthermore, the country’s banks passed details of all international transactions to relevant authorities, which use software to analyse financial data and identify suspicious transactions (United Nations Office on Drugs and Crime, interview, 17 May 2017). The country’s financial intelligence unit has the legal right to block suspicious transactions up to 10 days from receiving transaction report (Unité traiteur du renseignement financier, 2016).

In addition, the country uses “know-your-customer” rules that must be applied by accountants, banks (both domestic and offshore), finance and insurance companies, gaming operators, lawyers and real estate intermediaries. These include enhanced due-diligence rules for politically exposed persons (United States Department of State, 2017).

Professional services providers, including accountants, finance and insurance companies, gaming operators, lawyers and real estate intermediaries, can be privy to transactions that could be illicit financial flows. Governments can legally require these persons to report suspicious transactions, as is done in Morocco, for example (United States Department of State, 2017). This may help to identify and prosecute cases of illicit financial flows and make it more difficult for those behind illicit financial flows to affect them, if they do not wish to use the services of such service providers.

In Kenya, concerns have been raised about the use of mobile money to effect illicit financial flows (see ECA, 2018c; anonymous, interview, August 2018). In particular, there had been reports of individuals...

---

16 In addition, Zúñman (cited from Moore, Prichard and Fjeldstad, 2018) estimates that Africa loses at least $15 billion annually due to tax evasion in private offshore holdings alone. There have been a number of criticisms of the methodology used to measure trade mis-invoicing as part of the Boyce and Ndikumana, ECA and Spanjers and Salomon and estimates. However, the fact that all methodologies agree on losses in the tens of billions of dollars annually, notwithstanding different assumptions and different data, suggests that it is highly likely that Africa is losing financial flows around these levels.

17 One example of how payment through the formal financial system financial flows is illicit financial flows through trade mis-invoicing. In particular, this invoice trade can be an excuse for front companies organized crime syndicates (or simply businesses wishing to evade foreign exchange regulations and taxes) to transfer funds out of the country through the formal financial system to pay for the mis-invoiced goods or services (The Economist, 2014). In Morocco, for example, trade mis-invoicing occurs and the country has regulations in place to prevent use of the formal financial system to access foreign exchange or transfer funds out of the country in the case of supposedly trade with fake counterparties, or where no goods are shipped in return (Office des Changes, interview, 18 May 2017).

18 The Financial Action Task Force (2013) defines a politically exposed person as an individual who is or has been entrusted with a prominent public function.
using mobile money as a way to effect anonymous illicit transactions, especially since there was previously an initial period of 30 days after opening a mobile money account that an individual would be able to use a mobile money account without using his or her identity. Furthermore, there were reports of individuals registering mobile money accounts using the identity cards of deceased persons (ECA, 2018c; anonymous, interview, August 2018). Following this, mobile money providers in Kenya have begun to require new registrations for mobile money accounts to provide a photograph of themselves at the time of registration and verifying identity cards with the national identity card database, in order to register the accounts (Kenya, National Treasury, interview, 17 August 2018). Such measures would prevent the use of mobile money for anonymous transactions. However, in order to prevent mobile money’s use for illicit financial flows, it would appear necessary for mobile money providers to also be subject to reporting requirements for suspicious transactions. To this end, in Kenya, mobile money providers are regulated by both financial regulators and telecoms regulators. In addition, safeguards would need to be put in place regarding the use of data on mobile money transactions, in order to safeguard individuals’ privacy and to prevent such information from being misused, for example, in unauthorized surveillance or blackmail of individuals involved.

Beyond this, all five of Africa’s subregions have Financial Action Task Force-style regional bodies; their member countries are monitored in implementing the recommendations on preventing money laundering and the financing of terrorism that were developed by the Financial Action Task Force. These are internationally active standards on preventing money laundering and terrorist financing and could be an important part of African countries’ efforts to prevent illicit financial flows and financial crime. ECA (2018c) underlines that money laundering is still a concern for African countries and greater implementation of relevant anti-money-laundering regulations is needed to prevent illicit financial flows. Terrorist financing is also a concern for some African countries, such as Morocco (United Nations Office on Drugs and Crime, interview, 17 May 2017).

In addition to implementing the Financial Action Task Force recommendations, there may be other steps that countries can take regarding their financial regulations to prevent illicit financial flows and financial crime. One of these could be to require greater scrutiny of transactions with jurisdictions. Jurisdictions provide account holders with a greater degree of financial secrecy, which could present a higher risk of illicit financial flow. Once finance is transferred into such jurisdictions, it may be difficult for African countries to get information about it to check whether there is unpaid tax on the funds or whether they had an illicit origin. Similarly, if a jurisdiction has a poor record with asset repatriation, they may wish to conduct greater scrutiny to such transactions.

One way to assess the level of secrecy of a specific jurisdiction is to use the financial secrecy index developed by the Tax Justice Network. This index, however, provides a single score for each jurisdiction in terms of the level of financial secrecy, but because of the network of information-sharing agreements that exists between pairs or groups of countries, some countries may find it easier to get information from those jurisdictions than others. Individual African countries may therefore wish to compile their own lists of jurisdictions from which they cannot access information about assets held by their nationals. African countries may also wish to regulate international financial transfers above and beyond the Financial Action Task Force recommendations to prevent funds becoming opaque or unrecoverable in offshore jurisdictions.

In order to do this, the first step could be to require a higher level of due diligence for such transfers. For example, when a transfer is for payment for a good

---

19 Even when finances transferred to a jurisdiction with which the relevant authorities in the African country in question are able to access information about their nationals’ accounts easily, there is still the risk that funds could be transferred to a third jurisdiction.
or service, African Governments could require the person requesting a transfer to produce proof such as an invoice, details of the company providing the good or service. In the case of remittances to friends or relatives, proof that the person to whom the funds are being remitted resides in the country to which the funds are being transferred. For other types of transfers, African Governments could consider requiring financial institutions to send a record of these transfers to the tax authority so that they can be taken into account as necessary in audits of an individual’s tax return. If this implies a too high administrative cost, another alternative could be to levy withholding taxes on international financial transfers that cannot be proven to be either payments for goods or services or remittances. The United States already levies withholding taxes on international financial transfers to jurisdictions with which the country has no effective information exchange; and there would therefore seem to be little reason why African countries cannot follow a similar approach. In addition, African countries could also restrict the levying of such withholding taxes to jurisdictions with which they have no effective information exchange, if they are able to process information sent from the other’s jurisdiction and use it in the assessment taxes due.

In order to prevent proceeds of corruption or other crimes being transferred to jurisdictions from which it would be difficult to recover, African countries could consider preventing individuals who may be involved in corruption or crime from making international financial transfers, with possible extensions for the international purchase of goods and services or remittances, from which the individual can provide suitable proof that this is the purpose of the transfer. In deciding on measures for regulating international financial transfers, African countries will need to balance the need to tackle illicit financial flows with the need to not unnecessarily restrict the freedom (including to benefit from investment opportunities abroad) or privacy of their nationals as well as the need not to generate excessive administrative costs and opportunities for corruption among officials and financial sector employees involved in implementing such a regulatory system. Any policy decisions in this direction will need to be taken based on national priorities, circumstances and capacities.

On the repatriation of offshore assets, the country’s efforts to encourage voluntary repatriation of assets by declaring an amnesty for those holding assets abroad and a lower tax rate for those repatriating their assets, alongside a higher tax rate for those discovered holding undeclared overseas assets, was followed by some repatriation of assets held abroad (Bank al-Maghrib, 19 May 2017, interview). Other commentators, however, have noted that the amount of resources repatriated to Morocco has been limited and less than expected.

Some African countries, including Kenya, have recently taken steps to establish “international financial centres”, which is intended to encourage investment in the country’s financial services sector and increase trade in financial services. Doing so will increase the imperative for these countries to effectively apply regulations against illicit financial flows, as lax standards could result in illicit financial flows being routed through these jurisdictions which help to hide the illicit origin or destination of such flows. To the extent that these jurisdictions

---

This may complicate the process of assessing tax due on these funds and of recovering funds if the third jurisdiction does not share information or has a poor record with repatriation of illicit funds. To the extent that these funds are only subject to income tax, transfer to a third jurisdiction might not affect income tax liability, but when capital gains and wealth taxes are due, it would indeed complicate this process.

As such, unless the risk of onward transfer to a jurisdiction with which there is little effective information exchange and/or repatriation of funds can be addressed, it may be necessary to not make the distinction between these two different types of jurisdiction. If African countries can agree with other jurisdictions to regulate their own banks to prevent such onward transfer, then they may be able to take a different approach for transfers to jurisdictions with information exchange/repatriation of illicit funds, then they may be able to be more liberal in allowing transfers to such jurisdictions.

---

The Moroccan authorities use such an approach in regulating access to foreign exchange for international purchases (Office des Changes, interview, 18 May 2017).
attract greater deposits and investment from abroad as a result of their push to establish international financial centres, it will also be important for them to share information with other jurisdictions, so that unscrupulous individuals do not use the new African international financial centres to hide the proceeds of crime or corruption, or to hide wealth in order to evade tax. This is of particular concern because some African jurisdictions, including Kenya, provide a high level of financial secrecy (see Tax Justice Network, cited from Moore, Prichard and Fjeldstad, 2018). To the extent that foreign nationals hold financial accounts in their territories, African and other countries should in any case improve information sharing regarding those accounts with relevant authorities of the concerned countries, to prevent the abuse of financial secrecy to hide illicitly acquired wealth or tax evasion, or both.

4.2.4 Macroprudential and capital account regulation

A number of the studies reviewed for the present report underlines the importance of Africa establishing macroprudential regulations. These are regulations that examine indicators relating to the stability of the entire financial system, rather than just individual financial institutions. In particular, Griffith-Jones, Karwowski and Dafe (2016, p. 15) drew “a key lesson from recent crises … [which is] the need for regulation to be both countercyclical and comprehensive to avoid the build-up of systemic risk”. Gottschalk (2016) found that that “macroprudential regulation to address systemic risks [in] … Africa may not yet be up to scratch, if assessment is undertaken using Basel metrics, such as stress tests. Nevertheless, the region seems to be doing rather well – though further assessment is warranted – if one takes into account the sort of rules and tools that African countries have in place to address their specific needs” (p.75). Kasekende, Bagyenda and Brownbridge (2012) also emphasized that effective macroprudential regulations should be a priority for bank regulators in Africa.

In addition, based on the literature review for this study, it is important for African countries to regulate their capital account, but more research is needed as to exactly how this should be done. Massa (2016) notes the rising trends of private capital flows to low-income countries within which there are surges and declines, reversals and sudden stops in times of crisis. As she remarks “private capital flows (i.e., FDI, portfolio investment, cross-border bank lending), in some cases and under certain conditions, may carry important opportunities, but they are also a significant source of risks. Accordingly, “it is important to develop adequate and effective capital account management policy tools” (Massa, 2016, p. 55). In particular, the international supplier of banking services can lead to contagion the financial crisis from one country to another, to the extent that firms in one country depend on business with or lending from financial institutions in another country, and the stability of the financial sector in the second country is threatened. Gottschalk (2016, p. 61) found that a key challenge facing African countries regarding financial regulation is “how best to manage risks from a more integrated financial system with the rest of the world coming as a result of capital account liberalization, with particular focus on ‘currency mismatches’, which may constitute an important threat to the stability of African financial systems.”

With regard to the specifics of how to regulate the capital account, Massa (2016) remarked that “the evidence on the types of capital account management tools that have been used in LICs over time is extremely limited and in many cases out of date’, making evidence-based policymaking problematic. There are, though, a range of policies to be evaluated to help manage surges in capital flows. These include capital controls and official exchange intervention. In addition:

- Financial sector reforms, which include among others prudential regulation and supervision, are a capital account management tool that aims to influence indirectly capital inflows or outflows with the objective of reducing the vulnerability of an economy to systemic financial crises. Particularly relevant in
this context are regulations on currency mismatches in the balance sheets of financial and non-financial agents. In this context, it is important to examine whether regulatory measures should be done via domestic prudential policies (e.g. regulating currency mismatches in the balance sheets of banks) or through capital controls, by analysing their respective advantages and disadvantages. More precisely, domestic financial regulation may work for loans channelled through the banking system, whereas loans lent to nonfinancial companies directly may require capital controls, if they become too large (Griffith-Jones, Gottschalk and Spratt, 2016, p.166).

ECA (2018b) notes that both inbound and outbound capital flows could be regulated. Regarding inbound capital flows, Palma (cited from ECA, 2018b), highlights the role of capital inflows in triggering financial crises in Brazil, Mexico and the Republic of Korea. The Republic of Korea recovered from its financial crisis more quickly because a higher capital inflows were channelled towards investment, suggesting that regulations to steer capital inflows towards investment may be advisable.

Lastly, given that the main risks associated with international capital flows appear to be linked to financial stability, it may be advisable for African countries to regulate their capital accounts based on the principles of macroprudential regulation, with regulations being designed to manage financial stability risks associated with international capital flows. In addition to this, there should also be capital account regulations to prevent illicit financial flows, as detailed in the section on illicit financial flows. Such an approach (regulating capital flows by concentrating on the twin objectives of safeguarding financial stability and prevent illicit financial flows) may allow African countries to strike the right balance of harnessing international capital flows as a form of development finance while managing reducing the associated risks of financial instability and illicit financial flows.

4.2.5 Regulation of bank activities, diversification and capital requirements

Based on the literature reviewed, restricting bank activities appears to have negative outcomes. In particular, Barth, Caprio and Levine (2008, p. 539) found that “an approach that…removes activity restrictions on banks…appears to work best to foster more stable, more efficient, and less corrupt financial-sector development”. Caggiano and Calice (cited from World Bank, not dated) also found that restrictions on activities of banks undermine growth based on data from the Gulf Cooperation Council countries for the period 2002–2010. This may be because allowing banks to engage in various types of activities helps them to diversify their portfolios and allows them to achieve a better mix of risk and return. Barth, Caprio and Levine (2008) emphasized that their results suggest that encouraging or even requiring greater diversification produces better economic outcomes. That being said, reviews evidence that certain types of activities tend to be beneficial for economic outcomes, while others are not.

Kasekende, Bagyenda and Brownbridge (2012) have argued that bank regulators in Africa should focus on three areas: "setting regulations on the assets and business activities of banks which complement capital adequacy requirements as a microprudential tool". This suggests that the best approach may be not to ban banks from undertaking certain types of financial services, but to regulate their provision and encourage or incentivize a focus on the financial services that are most beneficial for inclusive growth. This could be done through the risk weights selected for different asset classes used to assess whether banks institutions meet capital requirements; it could also be done through moderately taxing holdings of less-desirable financial assets (with taxes set at a level low enough to allow banks to hold them for diversification purposes, but high enough to
discourage a shift in their operations towards these asset classes).

Strong capital requirements are good for growth, at least up to a certain level. Four of the studies reviewed for this report looks at the impact of capital requirements on economic outcomes. Three of them suggest that capital have a positive impact on economic outcomes; in particular, they recommend the implementation of the first two pillars of Basel II and implementation of Basel III (Barth, Caprio and Levine, 2008; Basel Committee on Banking Supervision, 2010; Kasekende, Bagyenda and Brownbridge, 2012). In addition, the International Monetary Fund (2012) underlines that protective financial buffers have a positive effect on growth up to a high level (above which increases in the size of these buffers can have a negative effect).

According to Barth, Caprio and Levine (2008), developing countries should first focus on “developing the legal, information, and incentive systems in which financial systems flourish to the benefit of everyone.” 21 Gottschalk (2016, p. 72) has argued that “African regulators make the important point that, like Basel I and II, reforms under Basel III maintain a focus on capital adequacy requirements, which may not be as relevant for Africa as it may be for developed countries”. He noted that the African banking systems holds capital in excess of the minimum regulatory requirements, and hence the proposed higher relative and absolute capital ratios would have little effect in Africa. Kasekende, Bagyenda and Brownbridge (2012, p. 27) agree that the “Basel III reforms have been formulated to deal with the deficiencies of financial regulation as they are perceived in developed countries. They are less relevant for African economies, whose banking systems have different characteristics and face different challenges.”

4.2.6 Role of regulation in financial innovation

In Kenya, regulators are applying a “regulatory sandbox” approach, in which certain regulations can be relaxed to allow financial services innovations to be tested. Once the regulator is able to observe their operation, the regulations that were relaxed can either be reintroduced, modified or removed. This approach is credited with allowing the country’s flourishing mobile money sector to develop, which has had a substantial impact in reducing poverty in the country and boosting financial inclusion.

In general, it seems that the regulatory sandbox approach would support innovation and possible improvement in the ability of financial services to respond to clients’ needs. It will be important, however, for regulators to maintain close supervision of financial products or providers benefiting from the regulatory sandbox to ensure that financial stability, consumer protection or illicit finance risks do not emerge and to re impose regulations quickly when it becomes apparent that particular financial innovations are in fact undesirable.

An important form of financial innovation that African countries could benefit from is Islamic finance. Islamic finance provides the promise of mobilizing additional resources into the financial system from individuals who would not otherwise save in the formal financial system for religious reasons. In addition to mobilizing additional resources, Islamic finance also has the advantage that finance mobilized in this way tends to be directed to production by the private sector; as outlined in chapter 3 of the present report, additional finance provided to the private sector for productive activities that has the most positive impacts on growth of any type of financial deepening.

21 Barth and others (2004) found that the stringency of capital requirements is not positively associated with bank development; however, this does not mean the capital requirements are not good for growth in the economic cycle (since while they may not encourage bank development, they may protect economic output by preventing financial crises). Though it could be argued that if capital requirements did indeed boost economic output over the business cycle by reducing the risk financial crises, then they would be positively associated with development in regressions, because financial crises would tend to reduce the size of a number of banks. This may not be the case to the extent that banks are protected in financial crises by Government intervention. Accordingly, the lack of a link between capital requirements and bank development does not necessarily undermine the argument that capital requirements help to boost economic output over the cycle.
Several African countries have recently introduced Islamic finance. One example is Morocco, which until recently, some Moroccan savers had preferred not to invest saved funds, since they considered it un-Islamic to save in banks that charge interest on loans. However, other countries have managed to introduce Islamic finance through a specific legal approach in which interest is not charged by investors, though they are still able to get a return. This is done through a different treatment of the ownership rights, so that payments to the investor are not considered to be interest payments. In addition to creating the appropriate legal framework, Morocco has introduced Islamic finance by allowing investment in the banking sector by banks that have experience in providing Islamic finance in other countries, such as Saudi Arabia or the United Arab Emirates. The country was also in the process of preparing to launch a Sukuk, which is a Government bond that is compatible with Islamic law, in 2017. The legal framework for the Sukuk has been created, but the Government has not yet issued Sukuk bonds (Arab Maghreb Union, interview, 19 May 2017).

One of the challenges facing Islamic finance in some cases is ensuring that Islamic financial institutions adhere to capital requirements. In particular, the risk-management criteria developed for capital requirements (in which banks must balance the need to repay creditors and/or depositors with the risk of default on loans that they have extended) may not be appropriate for Islamic financial institutions (in that depositors accept to share in profits and losses of those to whom they have extended finance). One such example is in the Sudan, which had challenges in applying the Basel capital requirement accords (Hassan, cited from Abdul-Jalil, 2018). At present, the Central Bank of Sudan imposes a modified version of the Basel capital requirements and is transiting towards the implementation of Basel III (Abdul-Jalil, 2018). This suggests that countries using Islamic finance may wish to adapt capital requirements to ensure prudent financial management that recognises the differences of Islamic finance to other sorts of banking.

### 4.2.7 Other insights on financial regulation and development

The literature review for this study has underlined the importance of proper implementation of financial regulations and institutional effectiveness for outcomes. This includes Caggiano and Calice (2016), International Monetary Fund (2012) and Kasekende, Bagyenda and Brownbridge (2012). Kasekende, Bagyenda and Brownbridge (2012) in particular emphasize that strengthening the supervision of banks to ensure that regulations are enforced should be a priority for bank regulators in Africa.

Two of the studies reviewed looked at the use of private monitoring by banks. Barth and others (2004, p. 245) found that “Regulations that encourage and facilitate private monitoring of banks are associated with better banking-sector outcomes, i.e., greater bank development, lower net interest margins, and small nonperforming loans”. While Barth, Caprio and Levine (2008, p. 539) found that “an approach that favours private monitoring…appears to work best to foster more stable, more efficient and less corrupt financial-sector development.”

In addition, there were a number of other insights from the literature reviewed in this study. In particular:

- Beck and others (2011) found that: “A lesson to be learned in Africa from the crisis [is that] it seems … that the growth benefits of a well-developed financial system can only be reaped in a stable macroeconomic environment protected by an appropriate regulatory and supervisory framework and strong internal bank governance. This means there should be more transparency and accountability in bank management, less direct government intervention in the regulatory and supervisory process, and a focus on building up mechanisms of
market discipline. However, the situation also highlights the demand-side constraints in terms of financial literacy and consumer protection…” (p. 12).

- In a study focused on African countries, Triki and others (2017) used a dataset on regulation and supervision in 42 countries to investigate the relationship between the regulatory framework and bank efficiency. They found that: “The effects of some bank regulation in Africa is highly dependent on the size and risk level of the bank…Overall, our findings support the argument that regulators should be adapted to the risk and size level of the institutions that are being regulated” (p. 183).

- In the Sudan, financial repression appears to have been counter-productive and to have led to a fiscal transfer from the State to financial institutions in the Sudan. This suggests that in order to effectively apply a policy of financial repression, there has to be effective governance in the institutions that will decide on how to apply this policy (and those responsible for government borrowing).

- ECA (2018b) highlights the importance of strong corporate governance, self-regulation for the financial sector (in addition to regulations designed and enforced by Governments) and internal controls.

Relevant experts have also argued that financial regulations should be designed to support national development plans (ECA, 2018b). Kenya has recently adopted the approach of developing policy-based financial regulation, in which new financial regulations proposed by regulators must be based on established Government policies (Capital Markets Authority, Interview, 13 August 2018). The challenge is in understanding what specific financial regulations would be most likely to achieve the desired development outcomes and would best support growth, greater income equality and poverty reduction. The recommendations contained in the present report may help Governments to achieve these goals; but in general, Governments can pursue the principle of using available evidence, and dialogue with the private sector (see ECA, 2014), to design or customize financial regulations that will help to achieve national development priorities.

4.3 Conclusion

The evidence reviewed in this chapter suggests a number of key takeaways for Africa on how financial regulation can best contribute to inclusive development. First, African countries need to ensure strong supervision and enforcement of regulations at the level of individual financial institutions and at the systemic (macroprudential) level. These regulations should be adapted to different types of institutions. The regulations should not be overly restrictive, that is, it should not ban certain bank activities, but should try to encourage or incentivize a focus on financing productive activities. They should, however, require the financial system to help identify and prevent illicit financial flows. African countries should also be complemented by effective competition policy and should allow competition from foreign banks as long as appropriate regulations are in place and enforced, including by using supervisory colleges for multinational banks. More transparency and better information in the financial sector (private monitoring and credit information) should also be encouraged, and new developmental instruments, such as Islamic finance to enhance domestic resource mobilization.
CHAPTER 5: CONCLUSIONS AND POLICY RECOMMENDATIONS

During the past four decades, financial liberalization has led to a substantial growth in the financial sector and the possibility for finance to become disentangled from the productive sector. This has meant that a large portion of the sector’s activities are focused on “speculative” investment that is intended to profit from the dynamics of financial markets rather than through financing investment that will yield profits as a result of increased investment and effective demand, that is, inclusive growth.

Economies have experienced a repeated history of financial crises, from the Dutch flower bubble to the Wall Street crash to the dotcom boom to the 2008 financial crisis. Though crises are often followed by periods of enhanced financial regulation and repression after some time they are again followed by deregulation. This underlines the failure of the policymakers to learn on a sustained basis about the tendency for unregulated financial markets to pursue, en masse, unproductive investment, leading to financial crises.

All of this underlines that regulators cannot afford to assume that financial institutions are rational or self-regulating, or that a laissez-faire approach to the sector will lead to increased investment and effective demand. Instead, regulators in Africa and beyond need to supervise and regulate the financial sector to prevent excessive risk-taking and steer the sector’s activities towards financing real productive activities that will reduce poverty and inequality. In this spirit, and based on the evidence gathered in the present report, the following conclusions and policy recommendations are suggested.

5.1 Main policy conclusions

Most African countries’ financial systems are still relatively small in relation to the size of their economies, which allows more space for African policymakers to try to shape their financial systems to serve well the needs of development, by helping support inclusive and sustainable growth and desirable structural change. Furthermore, the size of the financial sector being smaller in these countries, as a proportion of GDP, may imply that it is less powerful politically; thus, potentially this gives more autonomy to regulators (and more broadly Governments) to shape the financial sector to serve the real economy. Besides the size, the structure of the financial sector is also important. When financial sectors are riddled with market imperfections and market gaps, it is important to investigate how to meet these missing markets (whether this is best done through regulatory changes to encourage the private sector to meet these market needs, or through government provision of such services). In this regard, public development banks have worked well in supplying credit to sectors that are especially important for development which are under-supplied by private credit providers.

The main policy conclusions are as follows:

- Various types of financial development (measured by different financial indicators) have different impacts on inclusive growth. As a result, African countries should try to steer financial development towards emphasis on credit to the private sector, including a possible focus on small and medium-sized enterprises and sectors critical to economic transformation, including manufacturing and services
sectors that are critical for manufacturing competitiveness such as infrastructure services.

- Financing for transformative sectors as well as priority national development projects, development of stable banks and a diversified financial system with large and small banks would appear to be positive, to the extent that there is adequate governance of the process of public mobilization of funds.

- Expansion of household credit, speculative trading and equity markets (with the exception of expansion of financial inclusion) appears to be less beneficial. This should be done with care as there are benefits to allowing banks, for example, to diversify their portfolios among various types of investment.

- Smaller, more decentralized banks, may have an important role to play in African countries, especially to lend to small and medium-sized enterprises, partly because they can know their customers better, reducing asymmetries of information. Overall, a more diversified banking system, with large and small banks, and private and public development banks seems to offer benefits of diversification (and thus less systemic risk) complementarities in serving different sectors and functions, as well as providing competition for offering cheaper and appropriate financial services to the real economy.

- New approaches are needed to encourage financial inclusion, but this should be closely monitored to ensure that there are no negative effects in terms of financial stability or diversion of credit from sectors that focus on economic transformation.

- Boosting financial inclusion can have strong, positive effects on reducing poverty. Though African countries have made considerable progress in boosting financial inclusion in recent years, there is still some way to go to catch up with the rest of the world. As such, new approaches may be needed in many countries. Institutions involved in efforts to promote financial inclusion should still be carefully regulated to avoid risks to financial stability.

5.2 Policy recommendations on how financial regulation can best contribute to inclusive development

In the light of the above conclusions, the following recommendations are proposed for Africa on how financial regulation can best contribute to inclusive development:

- African countries should encourage the development of their financial sectors, while putting in place appropriate regulatory frameworks and attempting to encourage or incentivize these sectors to focus on economically beneficial activities (such as credit to the private sector, especially transformative sectors, and financing of national development projects).

- Banks should be allowed to pursue diversification of their portfolios through various financial activities, even as their principal focus is on such economically beneficial finance. In terms of the regulatory framework for the financial sector, African countries should focus on: strengthening the supervision of banks to ensure that regulations are enforced, and creating an effective macroprudential toolkit to address the multifaceted risks to the systemic stability of the financial system.
• Within the above approach, regulation should be countercyclical and comprehensive to avoid the build-up of systemic risk; domestic and global regulation and supervision are important; and regulation can be adapted to the size and risk level of the institution being regulated.

• Allowing greater bank competition, including allowing the entry of foreign banks appears to support growth, as long as appropriate regulatory frameworks are in place. Regulatory sandbox approaches can have benefits in encouraging financial innovation, but should be approached with caution and close monitoring. Strong capital requirements are good for growth, but implementing the Basel principles may not be a priority for African countries at this time.

• Capital account – it is important to develop adequate and effective capital account management policy tools (Massa, 2016), though it remains unclear as to how exactly this should be done. Islamic finance – the experience of Morocco has shown the benefits of providing for Islamic finance to boost resource mobilization and financial inclusion.

• To prevent illicit financial flows and financial crime, African countries should implement current standards on preventing corruption and money-laundering, or consider new approaches to prevent illicit financial flows being hidden or sheltered offshore.

• Regulations providing for the private monitoring of banks appear to have positive impacts, as do those to improve access to credit information. Countries should strive for more transparency and accountability in bank management, less direct Government intervention in the regulatory and supervisory process, and more focus on building up mechanisms of market discipline; and work towards improving financial literacy and consumer protection. If Governments decide to apply policies of financial repression to reduce the cost of government borrowing, they should make sure that there is adequate governance of these policies and of the process of government borrowing.

• Financing inclusive growth should be part of an overarching developmental macroeconomic policy framework. To prioritize growth and poverty eradication that can benefit from greater financial development, African countries should also pursue complementary policies (such as progressive fiscal policies) to help offset the worsening of inequality.
REFERENCES


Basel Committee on Banking Supervision (2010). An assessment of the long-term economic impact of
Financial regulation for inclusive growth in Africa

stronger capital and liquidity requirements. Available at https://www.bis.org/publ/bcbs173.pdf


Financial regulation for inclusive growth in Africa


Financial regulation for inclusive growth in Africa


