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# Finance in Africa

## Achievements and Challenges

*Thorsten Beck*

*Michael Fuchs*

*Marilou Uy*

The World Bank  
Africa Region  
Finance and Private Sector Development Department  
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## Abstract

In spite of shallow financial markets, Sub-Saharan Africa will not escape the repercussions of the global financial crisis. The global turmoil threatens the progress Sub-Saharan Africa has made in financial sector deepening and broadening over the recent years and underlines the importance of continuing and deepening the necessary institutional reforms. In this context it is important to define the role of government in expanding financial sectors in a sustainable and market-friendly manner. Foreign banks have brought more benefits than risks

for their host economies in Sub-Saharan Africa, but are certainly not a panacea and not a substitute for institutional and policy reform. The profile of foreign banks, however, has changed, with more and more regional banks emerging. This trend toward regional integration is promising as it might allow the small African financial system to reap benefits from scale economies, but it also requires regulatory and supervisory improvements and coordination across the region.

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# **Finance in Africa – Achievements and Challenges**

**Thorsten Beck, Michael Fuchs, and Marilou Uy**

\* Thorsten Beck is Professor of Economics, CentER, and Chair, European Banking Center, Tilburg University and Research Fellow, CEPR, London; Michael Fuchs and Marilou Uy are Lead Economist and Sector Director in the Finance and Private Sector Development Department Sub-Saharan Africa of the World Bank. This paper has been prepared for the African Competitiveness Report 2009. We would like to thank Ed Al-Hussainy for excellent research assistance. This paper's findings, interpretations, and conclusions are entirely those of the author and do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

## **1. INTRODUCTION**

Hope has been in the air for finance in Africa. Financial systems across the continent have become deeper, more efficient, and more stable over the past several years. While the global crisis will affect Sub-Saharan Africa as much as other developing countries in the world—though mostly through real rather than financial channels—today its financial sectors are in a better position to weather the global turmoil than they have been in the past and can help their host economies smooth the impact of the crisis. Nevertheless, the increasing integration of Africa into the global economy through capital flows and foreign direct investment in the financial sector poses new challenges for policymakers and underlines the importance of well-informed financial-sector policy.

This paper will discuss recent trends in African financial systems and focus on two major but controversial policy issues: the role of government and the role of foreign banks. Debates on both issues have changed dramatically over the past decades. The approach of governments replacing markets was seen as necessary in the 1960s and 1970s; this changed into an almost laissez-faire approach focusing on liberalization and privatization in the 1980s and 1990s, before the pendulum swung back somewhat toward a more active, albeit different, role for government during the past 10 years. Similarly, the attitude toward integration into global financial markets has changed dramatically over the past decades and will surely be further influenced by the ongoing financial crisis. Some countries went full circle, from nationalizing foreign banks in the 1960s and 1970s to privatizing failed government-owned banks to international banks in the 1990s. The profile of foreign banks in Africa, however, has changed, as we will discuss below.

Financial-sector policies have become a centerpiece in the debate on how to foster growth in low-income countries and reduce stark poverty levels. Over the past 15 years, ample

evidence using different aggregation levels and methodologies has been accumulated on the growth-enhancing effect of financial-sector development.<sup>1</sup> It is primarily through improvements in resource allocation and productivity growth that finance helps economies grow faster.<sup>2</sup> Financial deepening helps especially those industries more dependent on external finance,<sup>3</sup> and also helps to reduce financing constraints, particularly for smaller firms.<sup>4</sup> Financial deepening has thus a transformative effect on economies, shaping the industrial structure, the firm size distribution, and even organizational structures.<sup>5</sup> Cross-country comparisons also show a pro-poor effect of financial deepening:<sup>6</sup> it is the poorest quintile that sees their income share grow fastest with financial deepening, and countries with deeper financial systems experience faster reductions in poverty levels.

After a decade of macroeconomic and financial reforms, the shallowness of finance in Africa is worrying, especially given the potential that finance has to foster economic growth and meet the Millennium Development Goal of halving poverty levels by 2015. However, there have been promising trends and developments. The next section of this paper presents the current status of finance in Africa and some promising trends. The third and fourth sections focus on two critical areas: the role of governments in deepening and broadening financial systems in Africa and the role of foreign banks. The final section concludes and looks forward.

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<sup>1</sup> This is not to downplay the reverse causation from economic development to deeper and more sophisticated financial systems.

<sup>2</sup> Beck et al. 2000; Love, 2003; Wurgler, 2000.

<sup>3</sup> Rajan and Zingales 1998.

<sup>4</sup> Beck et al. 2005.

<sup>5</sup> Demirguc-Kunt et al. 2006.

<sup>6</sup> Beck et al. 2007.

## 2. FINANCE IN AFRICA: GROWING FROM A LOW LEVEL

Given the central importance of finance for economic development and poverty alleviation, the superficiality of African finance is alarming. African financial systems are small, both in absolute terms as in relative terms. Figures 1 and 2 show the ratio of liquid liabilities to GDP and the log of liquid liabilities in US dollars, respectively, with data for 2007. With a few exceptions—such as Mauritius, South Africa, and a handful of offshore financial centers—African financial systems are among the smallest across the globe, both in absolute terms and relative to economic activity. Many African financial systems are smaller than a mid-sized bank in continental Europe, with total assets often less than US\$1 billion. Small size is connected to low productivity and skill shortages, and prevents banks from exploiting scale economies; in addition, it might deter them from undertaking large investments in technology. In addition, Africa's financial systems are characterized by very limited outreach, with less than one in five households having access to any formal banking service—savings, payments, or credit (Figure 3). Again, this is in stark contrast not only to continental Europe, where access to a checking account is taken for granted, but also to other regions of the developing world, where penetration rates are typically between 30 and 50 percent. Behind these low numbers, however, is some intra-regional variation, with banking penetration surpassing 40 percent in South Africa but remaining below 20 percent in most of East Africa.

Banking is also very expensive in Africa, as reflected by high interest spreads and margins (Figure 4).<sup>7</sup> This spread between deposit and lending interest rates provides disincentives for both savings and lending, as it depresses the returns for savers and pushes

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<sup>7</sup> We denote *spreads* as the difference between ex-ante contracted loan and deposit interest rates and *margins* as the actually received interest (and non-interest) revenue on loans minus the interest costs on deposits (minus non-interest charges on deposits).

lending interest rates up. Compared to other regions of the world, financial systems in Africa also have higher levels of overhead costs (Figure 5). High spreads, margins, and overhead costs can be explained by the same factors as the low levels of financial depth, shown above in Figures 1 and 2. The absence of scale economies and the very high risks due to weak and underdeveloped contractual frameworks and economic and political volatility drive up banking costs and reduce time horizons for both investors and borrowers. These costs make outreach to savers and borrowers who need small transactions commercially unviable. Decomposition of interest spreads and cross-country comparisons of interest margins typically point to the small size of African banking systems, deficient contractual frameworks, and limited protection of property rights as an explanation of the excess spreads and margins in Africa compared to other regions.<sup>8</sup> Most striking is the difference from South Asian countries, such as Bangladesh, India, or Pakistan, which—in spite of similar challenges in governance and volatility—are all in better positions to exploit scale economies. In spite of high costs and high risks, banks are, however, very profitable (Figure 6). Indeed, subsidiaries of foreign banks in Sub-Saharan Africa have higher returns on assets and equity than subsidiaries of the same banks in other regions of the world.<sup>9</sup> This trend will most likely be even stronger in the months and years to come, as global investors' risk appetite is fading. This might reflect partly the very high risks of banking in Africa and partly the lack of competition. This lack of competition in turn, is again related to the lack of scale in most African financial systems, which limits the number of financial institutions that an economy can sustain. However, it is also related to the widespread incidence of informality, which reduces the base of potential clients of the formal financial system.

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<sup>8</sup> Honohan and Beck 2007; Beck and Hesse 2009.

<sup>9</sup> Honohan and Beck 2007.

Banking is also very expensive for deposit customers, as reflected by very high minimum balance requirements and annual fees not only for checking customers but even for savings account holders in many African countries (see Figure 7).<sup>10</sup> Moreover, these high costs alone can explain why less than 20 percent of the population in many African countries has a bank account. Using simple back-of-the-envelope calculations, Beck et al. show that 54 percent of the population in Cameroon, 81 percent in Kenya, 40 percent in Madagascar, 94 percent in Malawi, 89 percent in Sierra Leone, and 93 percent in Uganda cannot afford the fees for checking accounts, given their annual income and the assumption that they cannot spend more than 2 percent of household income on financial transaction account charges.<sup>11</sup>

High fees, however, are only one factor behind the limited outreach of Africa's financial systems. High documentation requirements to open an account—that is, the need to present several documents of identification, such as passport, pay slip, utility bill, and so on, also represent significant barriers given that large parts of the population live and work in the informal sector. Africa again stands out along this dimension, as becomes obvious from Figure 8. Similarly, physical access is limited, as the low bank branch and ATM penetration numbers for Africa illustrate.

The gap between Africa and other regions of the world is even starker in other parts of the financial systems. Only a third of countries in the region have stock markets, which are mostly small and illiquid (Figure 9). The actual float of the listed companies is low. The low transaction volume in both primary and secondary markets is self-enforcing, as it deters new

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<sup>10</sup> Beck et al. 2008; World Bank, 2008.

<sup>11</sup> Beck et al. 2008. The 2 percent assumption is based on Genesis 2005. Fees on savings accounts are typically lower and many of these countries also have (postal) savings banks that offer basic accounts, but these accounts typically do not have the same functionality and many savings banks offer services of limited quality—that is, long queues and limited access to funds.



issuers. Only 13 African countries have seen corporate bond issues; in all these cases, the issues have been highly concentrated in the telecommunications and banking sectors.<sup>12</sup> While there have been some signs of improvement, such as large initial public offerings (IPOs) on the Ghanaian, Kenyan, and Nigerian stock exchanges, it is unlikely that these advances will make capital markets sustainable. Attempts at establishing regional markets have been less successful than expected, as the example of the regional exchange in Abidjan shows, as do the continuous political struggles related to creating a similar regional exchange for the Central African Monetary Union.

However, many countries in Sub-Saharan Africa have not only seen economic growth pick up in recent years, but financial deepening and broadening have occurred in them as well. While this might be partly driven by demand and partly by international capital inflows, improvements in the institutional framework of finance—such as the establishment of commercial courts and alternative dispute resolution systems, the establishment or improvement of collateral registries and credit reference bureaus, and macroeconomic stability—have certainly contributed to this improvement. Stronger confidence in Africa’s financial systems is also reflected in the quintupling of private capital inflows over the period 2000 to 2007;<sup>13</sup> these surpassed donor inflows for the first time in 2006, thus reversing a long-term trend. This surge of private capital into Africa was part of increased capital flows to emerging markets resulting from the worldwide liquidity glut. However, as cross-country comparisons show,<sup>14</sup> these flows partly also reflect improved macroeconomic fundamentals in many African countries, such as macroeconomic stability and fiscal discipline. When looking behind this aggregate, however, one

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<sup>12</sup> IMF 2008.

<sup>13</sup> IMF 2008.

<sup>14</sup> IMF 2008.

notes that capital flows are concentrated in specific countries and sectors, such as natural resource extraction, thus benefiting only narrow parts of the economy and society.

Standard indicators of financial intermediary development, such as liquid liabilities to GDP, bank deposits to GDP, and private credit to GDP have demonstrated financial deepening in most African countries over the past years (Figure 10). As credit has been growing faster than deposits in most countries, financial intermediation—that is, the extent to which banks intermediate society’s savings into private credit—has also increased, although from very low levels. Efficiency and profitability indicators, on the other hand, have shown no clear trend over the past years, with the median fluctuating, pointing to continuous problems of scale and competitiveness.

The improvement in banking system indicators and continued weakness in financial markets is consistent with the status of African financial sectors as bank- rather than market-based systems. The focus of financial policymakers on improving the infrastructure necessary for sound and efficient banking—such as establishing credit registries, upgrading collateral registries, and improving creditor rights—is thus consistent with level of economic and financial-sector development in Africa. An overemphasis on capital market development, on the other hand, would be premature, given that the necessary legal and regulatory conditions are not in place and—most importantly—the necessary demand from corporations is lacking. Furthermore, international experience suggests that small economies have an increasingly difficult time supporting liquid stock exchanges in a global economy, independent of their income level, as stock exchanges are subject to scale and network economies.<sup>15</sup> The more successful large enterprises across the developing world increasingly list abroad at a few exchanges, be it through

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<sup>15</sup> Domowitz et al. 2001.

cross-listing or through issue of American Depository Receipts and General Depository Receipts. Within Africa, the Johannesburg Stock Exchange will most likely be the only stock market able to sustain sufficient scale in the years to come, and even that only in cooperation with stock exchanges in Europe and North America. On the other hand, there is a need to mobilize long-term resources locally—for example, for infrastructure projects—which will require a comprehensive policy package, including pension reform.

Although not documented in a statistical sense, there seems to have been progress in expanding outreach as well. Technological advances have allowed Sub-Saharan Africa to leapfrog, as, for instance, in utilizing mobile telephone technology for expanding the share of population having access to payment services, as the example of M-Pesa in Kenya has shown. Banks across the region are offering innovative financial and low-cost products and utilize new technologies to reach out to larger shares of the population (Box 1). As we will discuss below, changes in market structure seem to have resulted in more innovative marketplaces in several countries, with a number of banks attempting new ways and products to expand outreach.

**Box 1: The impact of the financial crisis on Africa**

Although the direct impact of the current crisis in the United States and Europe on African financial systems is relatively contained—given that African banks are not as closely integrated in the global financial system as other regions of the developing world and hold most of their assets and commitments on rather than off the balance sheet—indirect effects through the real economy and through reduced private capital inflows caused by reduced risk appetite might very well have negative repercussions for real and financial sectors in Africa.

African banks are, on average, not exposed to risks arising from complex derivative instruments or products. They have typically low loan-deposit ratios and high liquidity reserves. Unlike in several European countries—and with the notable exception of South Africa—there is also very limited

household lending, at the core of the financial crisis in the United States and other developed economies. And, unlike other emerging economies, African banks typically do not rely on foreign borrowing to finance their domestic lending. To the contrary, subsidiaries of European parent banks typically have net foreign asset positions.

There will be important second-round effects, however, through international trade channels. Reduced worldwide demand for African exports, both commodities and other exports, will dampen economic growth and might thus expose financial system to increased credit risk. The economic crisis in the United States and Europe will most likely also lead to a reduction in remittance flows. Reduced capital flows and increased lending risk can lead to a tightening of credit conditions and reduced access to credit. Collapsing equity prices can weaken financial sectors where banks have made loans to clients to purchase shares, as in Nigeria.

A second significant risk can arise through the channel of international capital flows. Like the rest of the developing world, Africa has recently benefited from the global liquidity glut, attracting significant capital inflows, especially in countries with large natural resources. With such flows predicted to decrease substantially in 2009, this will affect African economies significantly. The decrease in commodity prices will therefore hit commodity exporters twice—through reduced earnings and reduced capital inflows. Given the small size of African financial systems, even a small absolute drop in capital inflows can have a relatively large effect on these markets. The resilience of remittance flows—although these are also showing signs of weakness—to the economic downturn might mitigate its negative impact somewhat.

The large share of foreign-owned banks across Africa has brought stability over the past years, as we discuss, but also exposes the region to additional contagion risk. The crisis could possibly be transmitted to Sub-Saharan Africa if financial distress among parent foreign banks in Western Europe leads either to a withdrawal of capital or to a calling in of loans made to their African subsidiaries. The first scenario seems unlikely, given the low levels of equity that European banks have in Sub-Saharan Africa and the high returns on this equity, but because of the seriousness of the current predicament it

cannot be excluded that cash-strapped foreign banks could withdraw capital as the crisis continues to unfold. In addition, the appetite for further investment might be significantly reduced. While the second scenario seems more likely, the overall dependence on foreign subsidiaries in Africa on parent bank funding is relatively low. The recent rise of pan-African banks might reduce the contagion risk from European banks, but to the extent that the home economies of these banks—mostly from Nigeria and South Africa—are also affected by the crisis, this might actually introduce additional contagion risk.

There will also be more lasting and perhaps serious impacts of the financial crisis in the more medium term, due to mounting pressures to lessen the impact of the crisis through fiscal stimulus, when the shallow depth of local sovereign and corporate debt markets result in rapid crowding out of private-sector lending by the banks, thus undoing recent years' deepening of private access to credit. Pressures may also arise—particularly in those countries exposed to the commodity price collapse—to bail out problem institutions suffering from rapid growth in non-performing loans. Finally, pressure will surely mount to intervene directly to support particularly vulnerable sectors through subsidized or directed credit.

A final—and somewhat collateral—impact can come through both changes in the overall international regulatory architecture, following the current crisis and currently under discussion in the G20 forum, as well as through repercussions from emergency measures taken in the United States and Europe on financial-sector policy debate in Africa. Take first the reform of the international regulatory architecture. There might be an impact through risk ratings for emerging market debt, which in turn makes lending to developing countries more expensive and less attractive. Similarly, higher capital requirements for large international banks might make them more reluctant to invest in developing country subsidiaries. Finally, the way weak banks in Europe are being resolved—nationalization or mergers—might have an impact on their subsidiaries in Africa.

In addition, the recent emergency measures in the United States and Europe—including widespread nationalization and bailouts—might have negative repercussions for financial-sector policy dialogue throughout the developing world, as they seem to suggest that government ownership and

heavy-handed government intervention into the financial sector are again in vogue. While the final verdict on these different measures is still out, in as much as they are temporary they do not invalidate the general financial policy paradigm that has arisen in recent years. Governance failures and aggressive risk taking has taken place both in privately owned and government-owned financial institutions. The current crisis is the result not of too little but rather of misguided regulation that left out large parts of the financial system (investment banks and the “shadow financial markets”) and relied on industries such as the credit rating agencies that had perverse incentives to overstate quality of securities. Finally, moral hazard on a macro-level (“Greenspan-Bernanke-put”)<sup>i</sup> and on a micro-level (such as “too-big-to-fail” policies, the push for aggressive lending through Fannie Mae and Freddie Mac, etc.) have significantly contributed to the boom and subsequent bust. An emphasis on heavy-handed regulation and restrictions on financial institutions and markets is therefore not called for. Further, the harmful experience of decades of bank government ownership is in no way negated.

However, while financial underdevelopment seems, prima-facie, to help countries isolate themselves against immediate contagion risks, it also reduces the ability of the real economy to cushion the impact of the current crisis. Cross-country experience has shown that a critical function of financial system is to diversify risk not only across firms but also over time, and a robust system can help smooth the impact of shocks.<sup>ii</sup>

Source: This box is based on background work by Antonio David, Smita Wagh, Giulia Pellegrini, and Uzma Khalil from the World Bank.

i) This refers to the expectations of financial institutions and other financial market participants to be bailed out in times of widespread fragility, expectation that have been mostly fulfilled.

ii) Bacchetta and Caminal 2000

The next two sections will discuss the role of government and the integration of financial systems into the international financial markets, respectively. We will draw on the existing literature, experiences across Africa, and experiences from other developing regions of the world to discuss the proper role of government and an adequate reaction to the trends toward globalization.

### **3. THE ROLE OF GOVERNMENT IN THE FINANCIAL SECTOR**

One of the most controversial issues in financial-sector policies has been the proper role of government. This debate in Africa is largely parallel to discussions in other regions of the world. It started with a prominent role for governments after independence in the 1960s and 1970s, followed by a withdrawal of government in many countries in the 1980s and 1990s. By now, a consensus is emerging that again sees a prominent role for governments, beyond providing macroeconomic stability and the institutional framework, by taking a more active but market-friendly approach.

Supported by international financial institutions, in the 1960s and 1970s governments had traditionally a decisive role in African financial systems, ranging from regulatory restrictions (interest rate ceilings and floors, etc.) to directed credit programs and government ownership of banks and development finance institutions (DFIs). This *activist approach* aimed at replacing markets that did not exist at the time of independence, with governments being directly involved in providing financial services. The goal was to support sectors and industries that were traditionally shut out of the market-based financial system, such as agriculture, small-scale industries, and industries depending on long-term finance.

The outcome of these market-replacing efforts has been disappointing, both on the financial- and the real-sector sides. This can be explained by flaws in the two main assumptions of the market-replacing approach. The first is that governments know better than markets, and the second is that governments act in the best interest of society. Both assumptions have been proven wrong across the developed and developing world. Bureaucrats have turned out to have limited knowledge and expertise for running financial institutions and systems and they do not maximize society's welfare, but are rather subject to political and regulatory capture—that is, influence from the political sphere and the regulated entities, as hypothesized by the private-interest view.<sup>16</sup>

Again following the advice of international financial institutions, many countries in Sub-Saharan Africa started liberalizing and privatizing their financial systems in the 1980s and 1990s. While the Washington Consensus cannot be exactly seen as a laissez-faire approach, it puts a heavy emphasis on markets over government. There is a focus on monetary stability, market-based price finding, and market-based provision of financial services. At the same time, disenchantment with the DFIs resulted in drying up of donor funding for these institutions.

Sub-Saharan Africa has made significant progress in monetary stability. With the exception of a few outliers, most notably Zimbabwe, the majority of African countries has achieved inflation below 20 percent over the past few years. Sub-Saharan Africa has also made substantial progress in private ownership of banks. With a few exceptions—such as Eritrea, Ethiopia, and Togo—most countries' banking systems are today dominated by privately owned financial institutions, be they domestic or foreign.

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<sup>16</sup> Barth et al. 2006.



These reforms and their achievements in monetary stability and private ownership, however, have only partly fulfilled their promise. African financial systems are significantly more stable than before. The write-down of bad loans has led to a shrinking of the financial systems in some countries, but overall financial intermediation has improved in many countries. As discussed above, many countries have started to reap the benefits of reforms of the 1990s that were politically often difficult. Despite this progress, however, Africa's financial systems are still characterized by their shallowness; by their high costs, exemplified by high interest rate spreads; and by limited access to finance, as maintained in the previous section.

Disappointment with some of the outcomes of the modernist approach adopted through the past two decades of African financial-sector reforms has fostered yet another swing back toward more government involvement. This time around, however, African governments have leaned more toward a market-friendly role that creates and enables markets instead of trying to replace them.

Over the past 10 years, there has been increasing emphasis on going beyond macro-stability toward strengthening the underlying institutions to build an efficient and stable financial system, including robust contractual and informational frameworks and incentive-compatible regulation and supervision. This policy approach can be referred to as a *market-developing* approach—creating markets rather than replacing them (see Box 2). Unlike both the activist and modernist agendas of previous decades, the agenda of this new market-developing approach is daunting, as it involves long-term institution building. It ranges from developing the contractual framework to informational requirements (such as accounting and disclosure standards) and strengthened bank regulation and supervision. It goes beyond transplanting laws and rules from the developed world to building up local capacity and norms. The role of governments in this

context is a difficult one—it entails going beyond setting the rules, but without suppressing private initiative.

### **Box 2: Deepening and broadening financial system: A taxonomy of policies**

To understand the role and impact of different government policies on deepening and broadening financial systems, Beck and de la Torre suggest a taxonomy that builds on the concept of the Access Possibilities Frontier—the maximum commercially viable outreach of a country’s financial system given certain “state variables” that do not change in the short term, such as market size; macroeconomic fundamentals; available technology; the quality of the transport and communication infrastructure; the effectiveness of the contractual and informational frameworks; and the degree of general insecurity associated with crime, violence, terrorism, and so on.<sup>i</sup> One can then identify the problem of the financial system as being either below or unsustainably beyond the frontier or facing a frontier too low relative to countries of comparable levels of economic development. The types of access problem can be mapped into different policy options that focus on (1) developing, (2) enabling, or (3) harnessing markets. These different policies all contrast with market-replacing policies, which have mostly led to financial-sector deepening that is unsustainable, if any deepening at all.

If the main problem is that of too low an access possibilities frontier, the policies to highlight would be *market-developing policies*, that is, those that aim at improving the state variables and moving the frontier and thus involve fundamental reforms such as improving macroeconomic stability, building a privately owned financial system, and improving the contractual framework. In some countries, non-financial-sector policies, such as improving security or upgrading the transport and communication infrastructure, might be the critical areas to push out the frontier.

Changes in the state variables involve changes in fundamental institutions and, thus, take a long time to materialize. To the extent that a financial system is operating below the possibilities frontier, there is room for *market-enabling policies* that might help deepen and broaden the financial system even in the absence of perceptible changes in state variables. Where the main reason for being below the

possibilities frontier is the demand problem of self-exclusion, the appropriate policies would emphasize raising financial literacy, both for households as for enterprises. If—as is more likely—the main problems reside with sub-optimization in credit supply, a wider range of policy options can be considered, starting with competition policy, allowing entry from reputable market players and securing access to the payment system for all financial institutions. This also includes reviewing barriers stemming from bank regulation and AML/CFT regulation that might reduce banks' appetite for expanding lending and their customer bases.

A third category of government policies, defined as *market-harnessing*, tries to prevent the financial system from moving to an unsustainable equilibrium beyond the frontier because of imprudent lending. Market-harnessing policies therefore aim at keeping banks' incentives to take aggressive risks in check through a mix of measures aimed at strengthening market and supervisory discipline. Market-harnessing policies are also important on the demand side to avoid predatory lending, which results in unsustainable overborrowing by individual borrowers.

i) Beck and de la Torre, 2007.

The institution-building agenda in the contractual system is substantial and reflects the deficiencies in the respective laws and their enforcing institutions. It ranges from modernizing bankruptcy legislation to improving the court system or building alternative dispute resolution mechanisms and establishing or improving asset and collateral registries. Few countries in Africa currently have credit registries or credit reference bureaus, an indispensable part of an effective and competitive system of financial intermediation. Many central banks and regulatory authorities still do not have political and operational independence; they have limited supervisory skills and lack the required enforcement powers.

Recent cross-country research has helped identify some priorities within the institution-building agenda. Specifically, improvements in the contractual framework, such as creditor

rights, have a relatively larger effect on financial intermediation in high-income countries, while improving credit registries has a relatively larger impact on financial deepening in low-income countries.<sup>17</sup> A second piece of evidence on reform prioritization comes from the transition economies of Eastern Europe and Central Asia. Focusing on enforcement mechanisms for simple contractual arrangements such as collateral recovery can result in more benefits than reforming more complicated multi-stakeholder conflicts such as bankruptcy.<sup>18</sup>

In addition, legal system reforms have to be context-specific, particularly with respect to the legal tradition. In spite of their shortcomings and deficiencies, court systems in the former British colonies still have a reasonable reputation. They can rely on a large body of case law and precedents, from London and other parts of the former British Empire. What courts in many common-law countries in Africa are lacking are capacity and financial sector-specific skills. The introduction of commercial courts might be helpful in this context. The situation in most Civil Code countries in Africa is different, as courts in these countries have deficiencies along many dimensions and suffer from very low reputations. In these countries, establishing alternative dispute resolution systems might be more helpful.

Cross-country comparisons using Doing Business indicators show that Africa has made progress in reforming the contractual and information framework. The average cost of contract enforcement across Sub-Saharan Africa has dropped from 56 percent of a typical debt contract in 2003 to 49 percent in 2008, while it has increased from 28 percent to 29 percent in the rest of the world. Such diverse countries as Ghana, Mozambique, and Rwanda have implemented reforms to reduce the number of procedures and the time it takes to enforce a contract. While there has been only little progress in establishing new credit registries over the past years, the existing

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<sup>17</sup> Djankov et al. 2007.

<sup>18</sup> Haselmann and Wachtel 2007.

ones, both private and public, have expanded their penetration (Figure 11). Although these numbers are often driven by a few reform-minded governments, such reforms can have important demonstration and contagion effects across the region.

Beyond institution building, there are other shortcuts that have been identified through experience and that can be summarized under the heading *market-enabling policies* (Box 2). Creating the necessary legal and regulatory frameworks for leasing and factoring is among them, as both financing techniques are especially conducive for small- and medium-sized enterprise (SME) lending. The regulatory and supervisory framework can also be an important lever for financial deepening and broadening, beyond its important stability role. Specifically, the regulatory framework can critically influence the degree of competition and innovation in a financial system. Allowing entry from new reputable market players, be they domestic or foreign, can be important to maintain contestability and competition, especially in small financial markets. Adjusting loan classification and capital requirements so as not to bias against agricultural or SME loans can be important, as the following two examples illustrate. Adapting the loan classification system to allow bullet loans rather than forcing quarterly repayments can help agricultural lending synchronize with farming cycles. The lower tail risk of SME loans—that is, the lower probability of very high loan losses—would imply lower capital charges for SME lending in spite of their higher overall riskiness.<sup>19</sup> Another important area of competition where government action might be necessary is that of ensuring access to payment systems and other network services on an equal basis for all financial institutions—incumbent and new—that qualify under fit and proper criteria. Finally, the current push for and implementation of tougher anti-money laundering and combating the financing of terrorism (AML/CFT) regulations has

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<sup>19</sup> Adasme et al. 2006.

critical repercussions not just for financial integrity and stability, but also has potentially negative consequences for the deepening and broadening of the financial system.

Sometimes the role of government in fostering access might have to go beyond competition policies and take the form of affirmative regulatory policy. Examples include the moral suasion exercised by authorities to make South African banks introduce the Mzansi (basic transaction) Account. Inducing banks to share or ensure interoperability of payments infrastructures (including ATM networks) can help avoid undesirable competition on access to infrastructure while enhancing desirable competition on price and quality of service, thereby facilitating the achievement of cost-reducing scale economies and lowering entry barriers to new financial service providers.

Moral suasion can be an important policy lever, but has its limitations. Larger countries with larger potential markets might have an easier time coaxing their banks into taking certain actions (such as establishing basic transaction accounts or opening up network services) than smaller markets. Further, there is a fine line between moral suasion and political interference, as the recent example of Uganda has shown. Frustrated by the disappointing results of earlier attempts to increase access to financial services, in early 2006 the Ugandan government announced its intention that each district should be serviced by at least one financial institution. In those districts where no financial service provider was in operation, the government mandated the establishment of savings and credit cooperatives (SACCOs) to be supported with payments, services, and so on supplied by the poorly managed government-owned Postal Savings Bank.

Market-enabling policies can also try addressing hindrances such as coordination failures, first mover disincentives, and obstacles to risk distribution and sharing. Although not easy to define in general terms, given their variety, these government interventions tend to share a

common feature in supporting incentives for private lenders and investors to engage without unduly shifting risks and costs to the government.<sup>20</sup> These market-promoting interventions also provide a new role for existing DFIs beyond retail lending, although their success will require adjustments in their business models and governance structures.

One of the major challenges with any government-based solution is establishing a governance structure that avoids political capture of the program and expropriation of the benefits by the few connected. This is where donors as well as regional institutions can play an important role, as they are more removed from direct political pressure on the national level.<sup>21</sup>

In the context of the on-going global crisis, *market-harnessing* policies are again on the top of policymakers' agenda. There seems to be a need to strengthen crisis-preparedness including cooperation between authorities—such as central banks, ministries of finance, deposit insurers, court judges, tax authorities, and so on—in designing and implementing financial institution resolution practices. Lender-of-last-resort, liquidity management, and payment systems routines and infrastructure are often ill-prepared in Sub-Saharan Africa, cumbersome in operation, and highly discretionary. Bank resolution practices are often open to endless, arbitrary court challenges, and deposit insurance schemes are slow to pay out depositors and unable to liquidate efficiently, if at all. Thus, by improving their crisis-preparedness, African countries will

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<sup>20</sup> An analysis of this type of “market-friendly roles for the visible hand” in Latin America is found in De la Torre et al.(2007), which presents case studies of such intriguing examples as: (1) the creation of an Internet-based market for the discounting of post-delivery receivables by SMEs in Mexico; (2) a Chilean program to promote lending to SMEs via the auctioning of partial government guarantees; and (3) a variety of structured finance packages orchestrated by a Mexican development fund to finance agricultural production (e.g., shrimp, corn). Examples in Africa might include the partial credit guarantee, with 50-50 risk sharing, established by the Bank of Tanzania, and the World Bank-supported Africa Trade Insurance Facility. Another important area where DFIs can help is in infrastructure financing, where private market players are often reluctant to enter given political and economic uncertainty and the current global crisis has reduced the necessary risk appetite for foreign investors even further. The role of the Development Bank of South Africa in catalyzing private participation in projects at the municipal level is also an interesting example to study.

<sup>21</sup> Learning from positive examples within the region is also important in this context. The governance structure of the Development Bank of South Africa (DBSA) has been studied extensively in this context (Scott 2007). The African Association of DFIs has also established a set of governance guidelines.

not only be able to improve their ability to respond to possible immediate difficulties, but can also address long-standing development needs supporting the preservation of asset values in situations where financial institutions must undergo restructuring or be resolved.

#### **4. THE CHALLENGE OF GLOBALIZATION**

Integration into international financial markets has been a second important and controversial aspect of financial-sector policy over the past decades. Although capital account restrictions are still in place in many countries, these are often more de-jure than de-facto. And while capital account liberalization has many benefits, it has to be managed carefully on the macroeconomic level and accompanied with appropriate regulatory policies. The benefits of increased capital inflows will be reaped only in the presence of well-developed local financial institutions and markets, but capital inflows can in turn accelerate financial and institutional deepening.<sup>22</sup> As in the case of government interventions, a context-specific and pragmatic approach is therefore called for.<sup>23</sup>

While there has been a focus on opening capital accounts toward developed countries, the potential of regional financial integration has been much less exploited, although there are large economies of scale to be reaped by cooperation in technical areas such as harmonizing approaches to bank regulation or payment systems.<sup>24</sup> Reducing if not eliminating intra-regional capital account restrictions can help deepen and broaden financial systems within the region. It allows more efficient risk diversification for financial and non-financial corporations alike. It can help overcome the scale problem for financing large projects, such as those in infrastructure.

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<sup>22</sup> See Kose et al. 2009 for a more detailed discussion on the threshold values for benefits from capital account liberalization and its “collateral” benefits.

<sup>23</sup> For a more in depth discussion, see Beck et al. 2009.

<sup>24</sup> World Bank 2007b.



While reducing dependence on international capital markets to a certain degree, such intra-regional capital account liberalization seems less risky than complete capital account liberalization vis-à-vis international investors.

Unlike capital account liberalization, foreign bank entry has been less controversial in the academic literature, though more so in the political arena. At the time of independence, most Sub-Saharan African countries started with foreign bank-dominated banking systems but subsequently nationalized them. After the disappointment with government-owned banks, many countries started privatizing again. In many countries, privatization was to foreign banks, since there were no domestic resources and skills. While in the mid-1990s less than a quarter of banking systems were dominated by foreign-owned banks and many countries still had predominantly government-owned banking systems, by 2005, more than half of the region's countries had a banking market with either a dominant or a significant share of foreign-owned financial institutions (Figure 12).

Foreign bank entry has several advantages that are specific to Africa: international banks can help foster governance, they can bring in much-needed technology and experience from other parts of the region (in case of South African or Nigerian banks), and they can help exploit scale economies in their small host economies (Box 3). Where increasing the role of foreign banks is part of a broader reform strategy to build and deepen the necessary institutional infrastructure for financial deepening and broadening, as discussed above, foreign bank entry can be a catalyst for improvement.

**Box 3: International experience with foreign bank entry**

The market share of foreign-owned banks has increased across the developing world over the past 20 years, especially in Latin America and Central and Eastern Europe. This entry has been partly fostered by financial liberalization in the host countries and partly by the need for the recapitalization of failed

government-owned banks. The variation across countries and over time has allowed an assessment of the impact of foreign bank entry on depth, efficiency, stability, and access in the host countries.

Foreign bank entry and participation has, more often than not, had a positive effect on efficiency and stability of host countries' financial systems, with varying effects on outreach.<sup>1</sup> Cross-country evidence has confirmed that foreign-owned banks are more efficient than domestic banks in developing countries, and that foreign bank entry can indeed exert competitive pressure on domestic banks to become more efficient except in economies where small size, high concentration, or regulatory restrictions on bank entry reduce contestability and competition. Critically, foreign banks can help reduce connected and politicized lending, as they typically operate at arm's length from the ruling political and economic elites of their host countries. This can help improve competition in the real sector and overall governance in the economy. Foreign banks can also have a stabilizing effect on host countries' credit markets. Foreign banks typically show less volatile lending behavior and help smooth business cycles in the host economies, relying on deep pockets of their parent banks. While contagion risk from foreign banks' home countries to the host economies has appeared to be of little risk so far, the ongoing global crisis might change that.

In terms of outreach, the experience is mixed, with the effect depending on the mode of entry (green field versus merger), retail orientation of the foreign bank, and, most importantly, the contractual and information frameworks and competitive environment in the host country. On the one hand, foreign banks have been known to bring in new lending techniques that can overcome information problems and high costs of lending small amounts, thus expanding access to these borrower groups. On the other hand, in economies with weak contractual and informational frameworks, foreign banks might focus on large enterprises with tangible assets to use as collateral or international connections, thus shunning the small enterprise segment because they do not have access to the necessary soft information and relationship lending technique. But even if foreign banks are less inclined to serve small and medium-sized enterprises and poorer households, they do exert competitive pressures on domestic banks to go down market.

The empirical evidence of the impact of foreign banks on financial deepening and broadening has been mixed. Bank-level evidence often points to the reluctance of foreign banks to cater to smaller enterprises, while firm-level evidence does not report any adverse effect of foreign bank entry for these firms. The evidence also varies across regions, with the effect being overwhelmingly positive among transition economies of Central and Eastern Europe, where foreign bank entry was part of a critical policy package to sever connections between financial sector and state-owned enterprises and overcome the banking fragility of the 1990s. The evidence of Latin America, on the other hand, is rather mixed, and very much a function of the competitive environment of the host country.

i) See Cull and Martinez Peria 2007 for an overview.

Foreign bank entry can help, but is not sufficient to improve the efficiency of intermediation and the availability of credit. There are many factors that can prevent countries from reaping the potential benefits of foreign bank ownership. The presence of dominant government-owned banks can reduce competitive pressures and allow other banks—domestic or foreign-owned—to earn rents from the inefficiency of government-owned banks, as the example of Kenya shows. The absence of a sound contractual and informational framework reduces the feasibility of small business lending, as seen in Zambia where lending to the private sector as a percentage of GDP remains low despite two decades of financial liberalization. The small size of many financial markets in Sub-Saharan African markets might make foreign banks reluctant to incur the fixed costs of introducing new products and technologies. The small size of many markets also does not allow for the necessary competitive pressure. The result in many Sub-Saharan African countries has been a concentration of both domestic and foreign banks' portfolios on government papers and international assets and a shying away from private-sector lending.

Nevertheless, the recent new generation of foreign banks in Africa has been more beneficial for outreach. The new wave of foreign bank entry after liberalization in the 1980s and 1990s has seen not only the return of old colonial banks but also some new important players, such as several South African banks; banks from non-African regions other than Europe; and several regional banks, such as the Bank of Africa and Ecobank. Several banks have established a franchise in supporting the development of financial access, such as the Dutch Rabobank with (controlling minority) stakes in banks in Tanzania, Zambia, and Mozambique; and more recently the Nigerian Access Bank, with a focus on improving access to finance by SMEs with subsidiaries in West Africa as well as in Kenya and Zambia. Many of these new entrants have put a much higher weight on sustainable outreach, introducing new products and technologies.

The example of Uganda shows the positive impact that foreign bank entry can have on access to financial services in Africa. The South Africa Standard Bank purchased the largest government-owned bank after a first failed privatization and subsequent renationalization. Over the past years, Standard Bank did not only fulfill its commitment to not close any branches, it even opened new ones, and it increased lending to the agricultural sector.<sup>25</sup> However, this rather successful privatization also shows that foreign bank entry is not a panacea. Standard Bank still dominates the national banking market as well as many of the small up-country local markets. This lack of competition might have reduced the benefits arising from the shift from a government-dominated financial system to a privately owned financial system.

In a nutshell, Africa has gained a great deal from foreign bank entry in the past decade, including from the entry of pan-African banks. Finance is now more sound and efficient, but foreign bank entry is not a universal remedy. Only in competitive environments with effective

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<sup>25</sup> Clarke et al. 2009.

contractual and especially informational frameworks can host economies and societies reap maximum benefits. The experience of the past decade has also shown that countries should choose their foreign banks carefully. Countries such as Mozambique, Tanzania, and Uganda had to renationalize their just-privatized banks as the foreign purchasers turned out to have insufficient resources or management skills. It was not until the second round that privatization was successful.<sup>26</sup> In spite of the overall stabilizing role of foreign bank participation, one should not downplay the risk of a foreign subsidiary dominating the financial system if the parent company is in trouble—a scenario that has become again more likely in the current global financial turmoil.

Although beneficial for efficiency and outreach, the rising South-South financial integration also poses challenges for supervisory authorities. There is an increasingly pressing need to improve reporting, accounting, and disclosure practices, and also to develop and respect memoranda of understanding among supervisory bodies regarding exchange of information on the soundness of financial institutions. Although there are no signs of the withdrawal of foreign banks, the risk remains and supervisory authorities in Africa need to be aware of any such risks to be able to prevent or, if not prevent, to prepare for orderly exits, should they occur.

Finally, the lack of regional integration has reduced the benefit that Sub-Saharan African countries can gain from foreign bank entry. By harmonizing bank regulatory frameworks, authorities could reduce regulatory costs for banks active across several countries of the respective region. Allowing banks to establish branches in other countries rather than having to establish subsidiaries could reduce the costs of market entry—by reducing costs of, among other aspects, multiple corporate structures—and foster competition. It is important to note, however,

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<sup>26</sup> World Bank 2001.

that introducing such a “regional passport for financial services” approach requires at least supervisory convergence, if not integration, as the current crisis experience in Europe shows.

## **5. LOOKING FORWARD**

Africa’s financial systems have seen deepening and broadening over the past years, the result not only of improvements in the macroeconomic and institutional framework, but also of the worldwide liquidity glut, which directed more capital flows into Africa. The current global crisis threatens to reverse this trend and undermine this recent progress. In these adverse circumstances, it is even more important to upgrade the necessary frameworks for sound, efficient, and inclusive financial systems. As we have discussed in this paper, this work calls for further institution building—such as judicial reform and the establishment and reform of collateral and credit registries—as well as cautious and context-specific government intervention to help financial market participants expand financial services to the frontier of commercially sustainable possibilities. Efforts to deepen financial sovereign and corporate bond markets need to be intensified, to improve the capacity for local debt financing, to provide instruments of suitable maturity and security for longer-term savings, and to facilitate the financing of African infrastructure.

These market-enabling policies require strong authorities that take an active role in redefining regulatory frameworks to include competition, inclusion, and efficiency as goals, while crowding in rather than crowding out private initiative. In those situations where governments are called upon to intervene in financial markets, they have the opportunity to provide market-conforming interventions, such as partially guaranteeing credit to groups of borrowers, such as SMEs, that are vulnerable to crowding out, while encouraging private banks

to go further down-market and develop expertise in credit risk assessment. This policy approach implies a new role for development finance institutions on the wholesale and coordination level rather than retail lending. These policies also call for the embracing of technology to leapfrog in the attempt to broaden the outreach of the financial system. The fall-off in remittance flows intensifies pressure on governments to facilitate reduction in the pricing of remittance transfers by opening competition among money transfer operators, lessening the costs of the domestic leg of transfers through interoperability between payments service providers, and leveling the playing field between providers of mobile-banking services and similar services provided by banks.

The current crisis also calls for a cautious approach to opening capital accounts. A premium should be put on regional integration to reap benefits from scale economies. While the time may not be right for opening capital accounts, the current crisis should not be used as a pretext for re-imposing capital controls, given the negative repercussions such controls have for macroeconomic discipline and governance. The region stands to gain a great deal from the presence of both global and regional financial institutions in terms of efficiency, competition, stability, and outreach. Foreign bank entry, however, is not a panacea and cannot substitute for the necessary domestic reforms.

For better or worse, the future of Africa's financial systems is closely linked to the development of global finance, as are its real economies. However, it is up to Africa's financial sector stakeholders—bankers, donors, and policymakers—to guide financial sector reforms in a way that maximizes Africa's opportunities.

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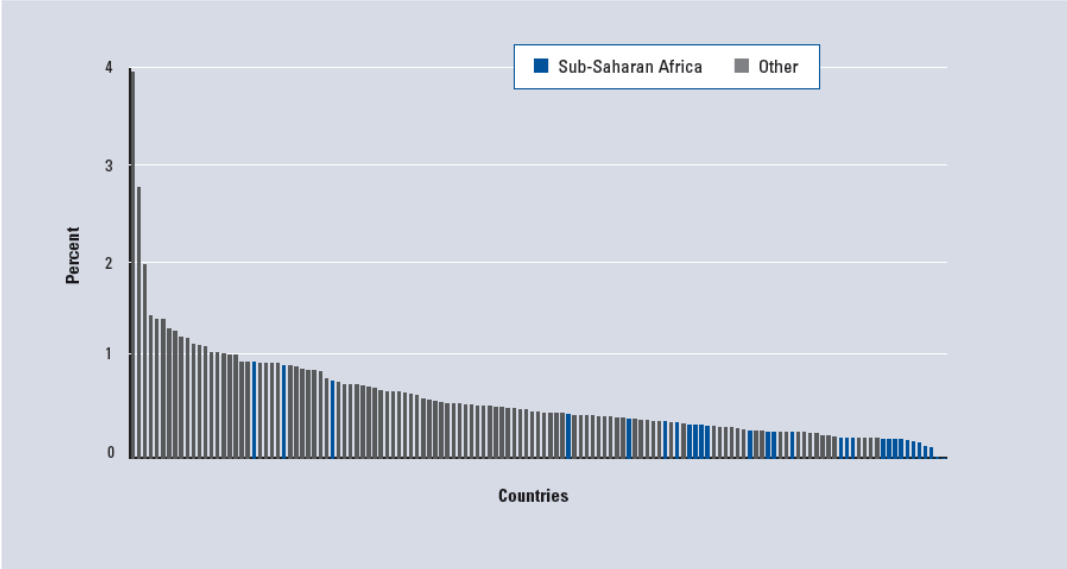
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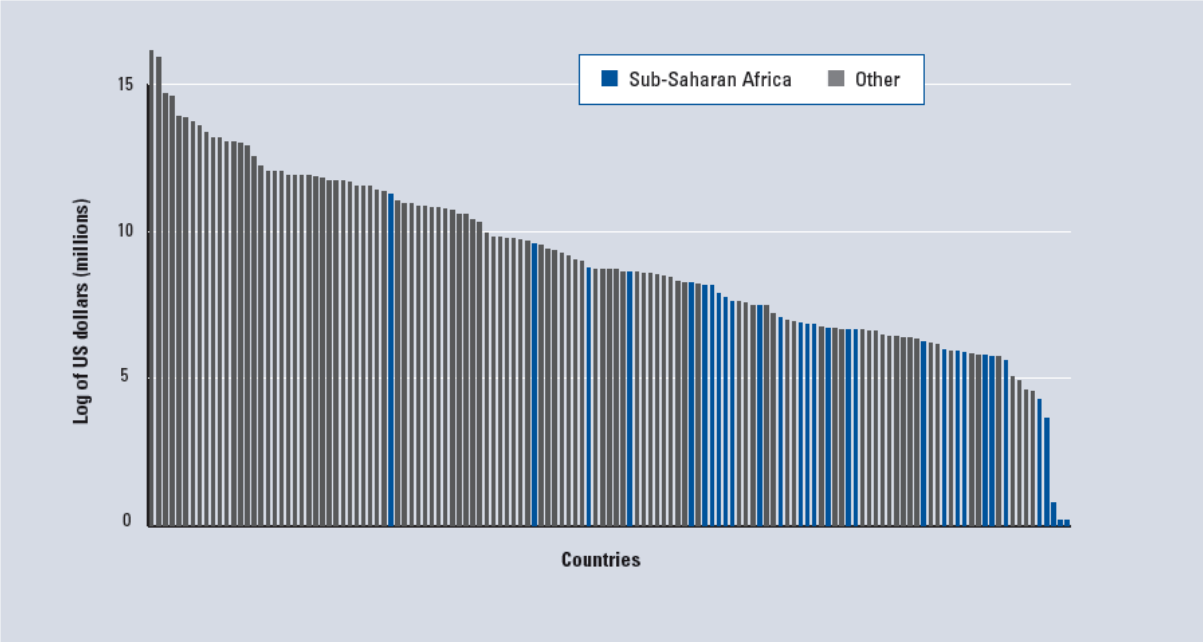
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**Figure 1: Liquid Liabilities to GDP across countries**



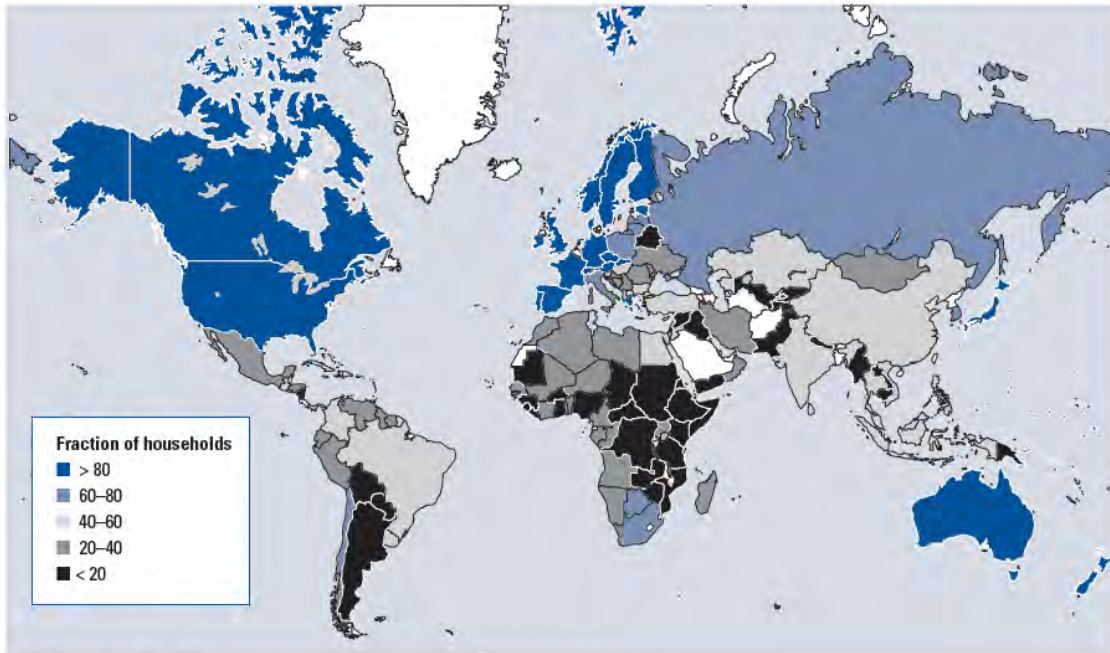
Source: Beck and Demirgüç-Kunt, 2009.  
 Note: Sample size is 161 countries; data are for 2007. One bar denotes one country; countries in sub-Saharan Africa are marked with blue.

**Figure 2: The absolute size of financial systems across countries**



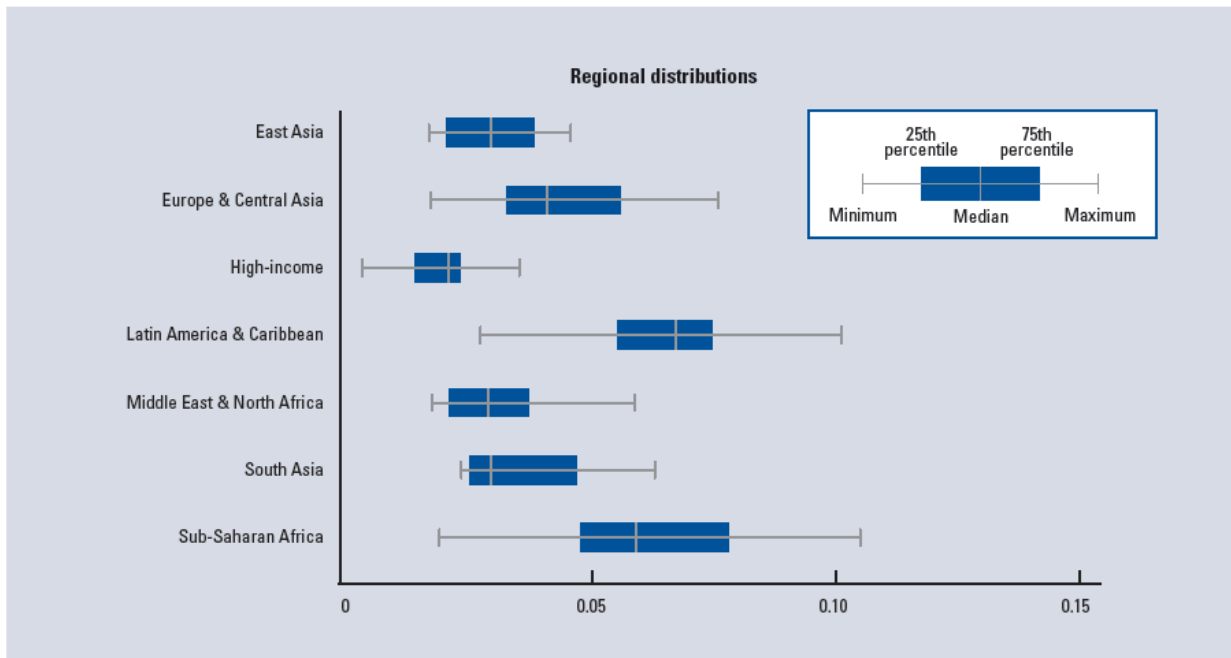
Source: Beck and Demirgüç-Kunt, 2009.  
 Note: Sample size is 133 countries; data are for 2007. Liquid liabilities are computed in log of US\$ millions. One bar denotes one country; countries in sub-Saharan Africa are marked with blue.

**Figure 3: Access to Financial Services by Households across the Globe**



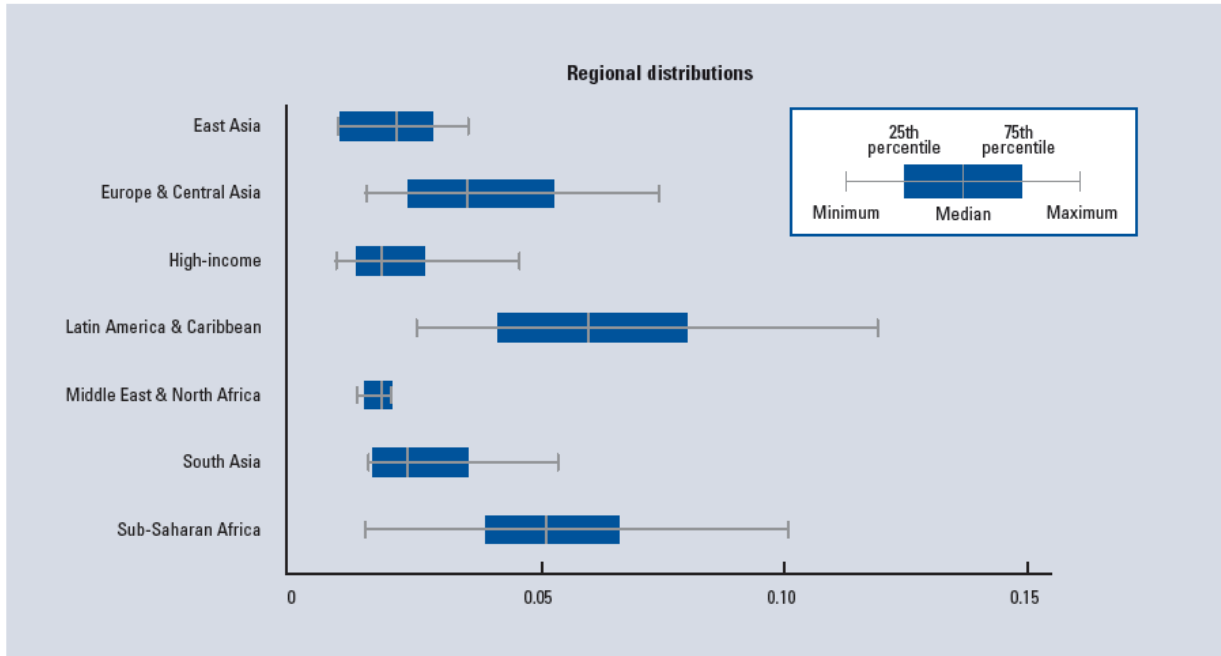
Source: World Bank, 2007a.  
 Note: Data are for 2003–04 and indicate the share of households with access to a financial account.

**Figure 4: Net interest margins across regions**



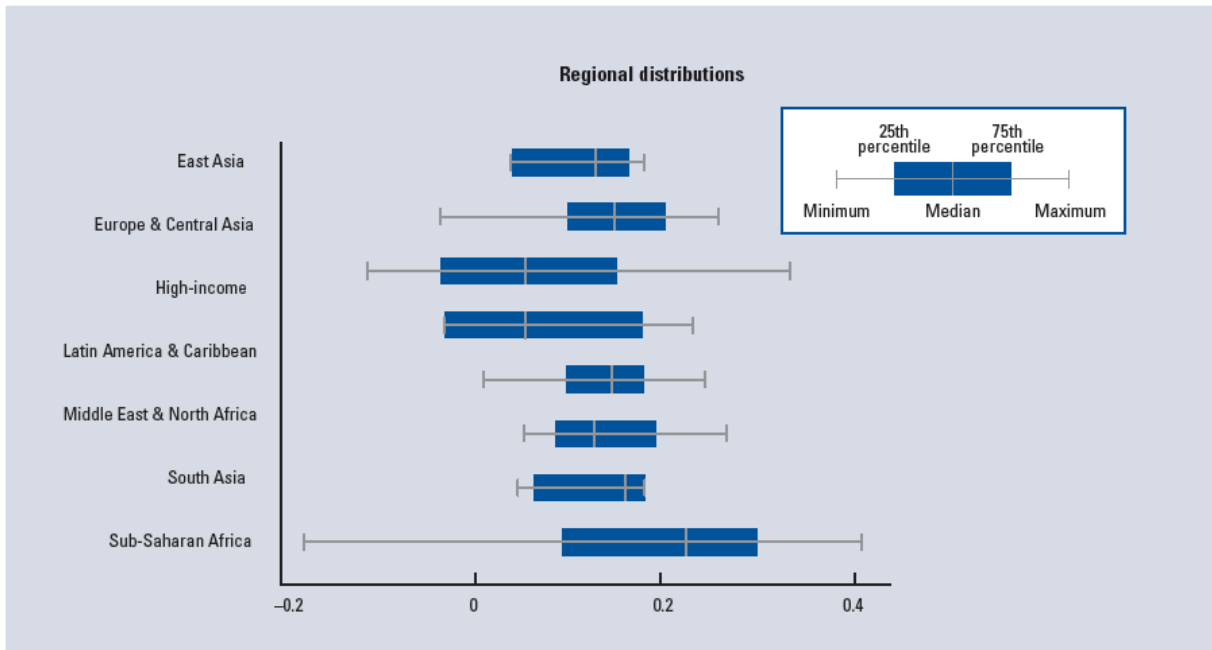
Source: Beck and Demirgüç-Kunt, 2009.  
 Note: Sample size is 133 countries; data are for 2007. Net interest margins are calculated as net interest revenue divided by total earning assets.

**Figure 5: Overhead costs across regions**



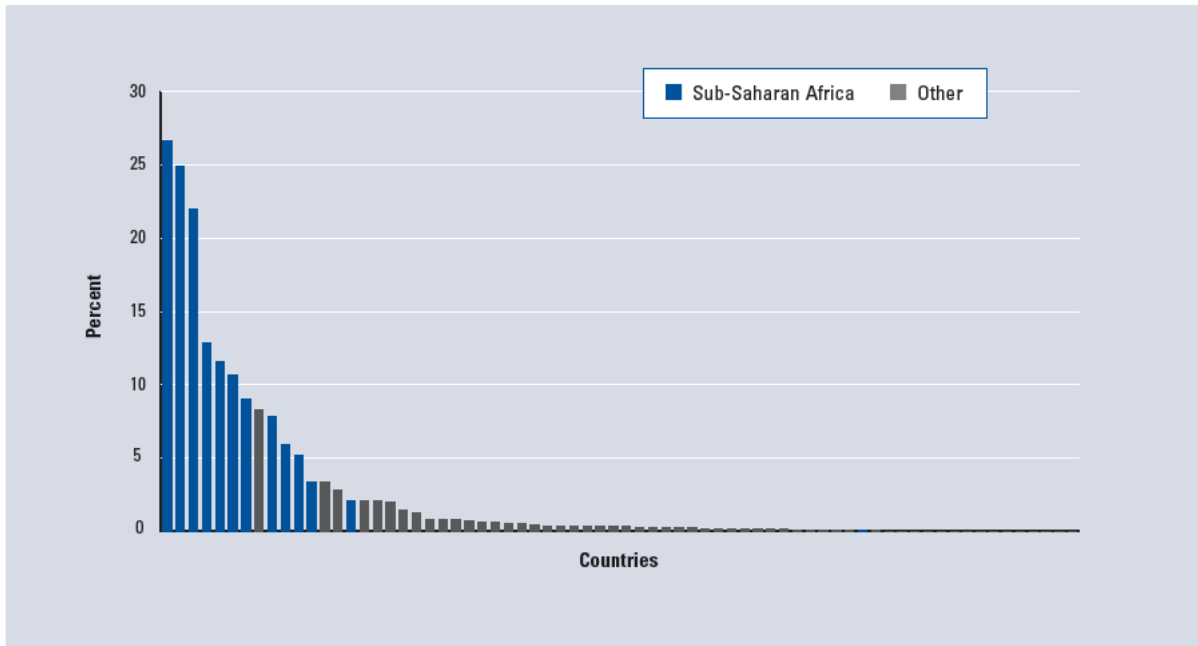
Source: Beck and Demirgüç-Kunt, 2009.  
 Note: Sample size is 135 countries; data are for 2007. Overhead costs are relative to total assets.

**Figure 6: Banks' returns on equity across regions**



Source: Beck and Demirgüç-Kunt, 2009.  
 Note: Sample size is 136 countries; data are for 2007.

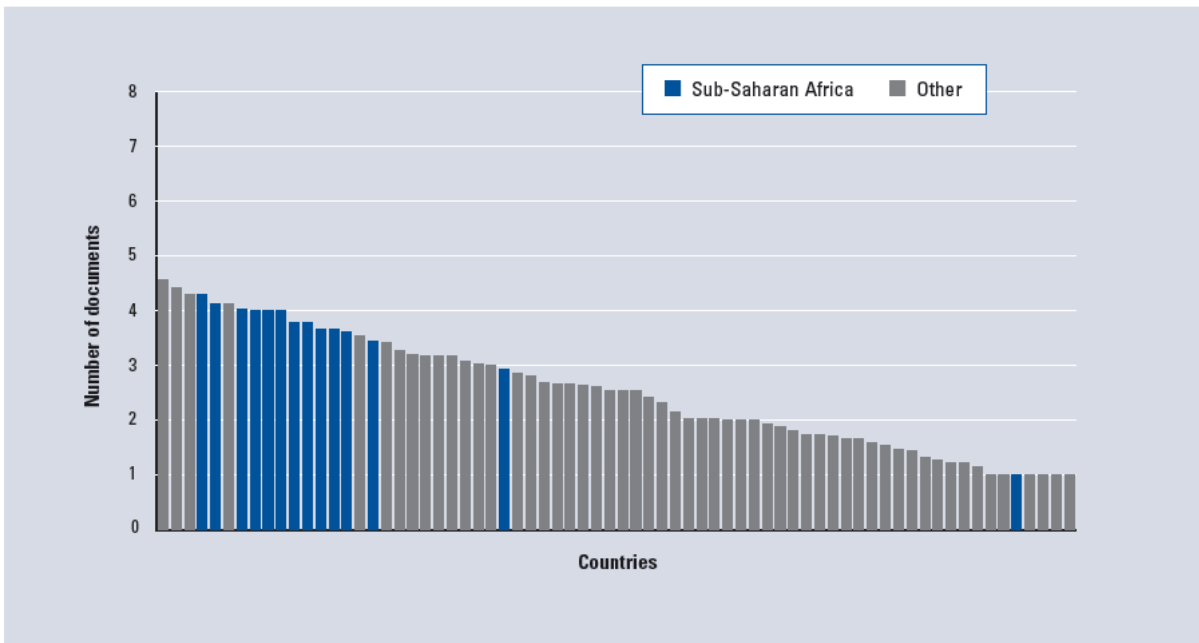
**Figure 7: Checking account fees relative to GDP per capita**



Source: Beck et al., 2008.

Note: Sample size is 88 countries; data are for 2004 and indicate the fees to maintain a checking account relative to GDP per capita. Countries in sub-Saharan Africa are marked with blue.

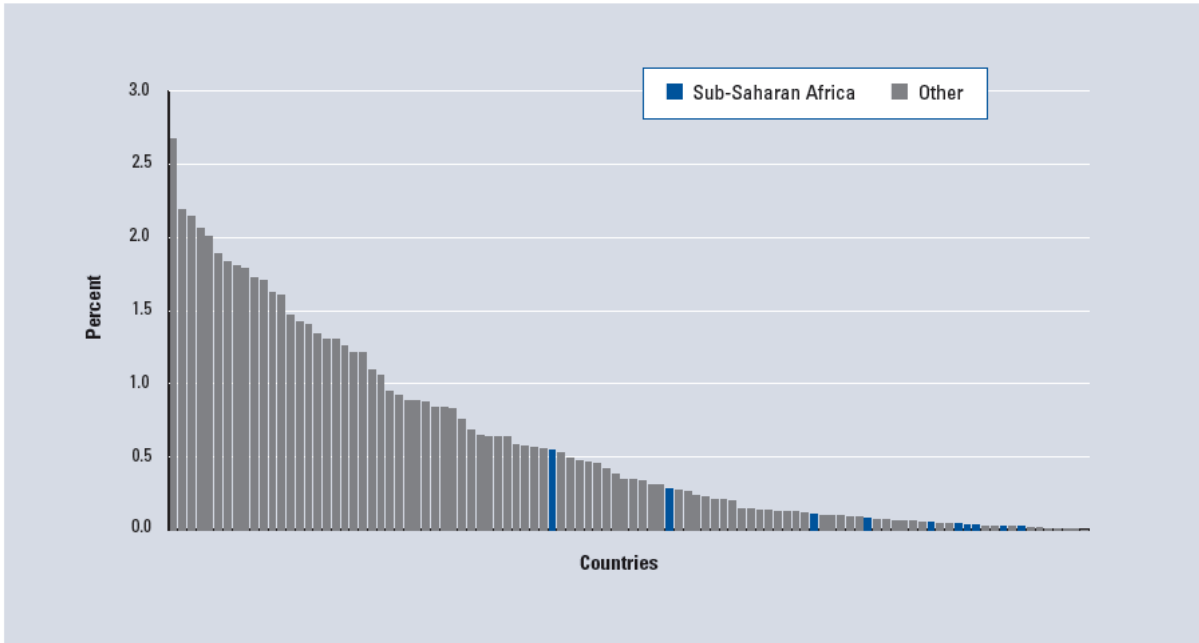
**Figure 8: Documentation requirements across countries**



Source: Beck et al., 2008.

Note: Sample size is 88 countries; data are for 2004 and indicate the number of documents needed to open an account. Countries in sub-Saharan Africa are marked with blue.

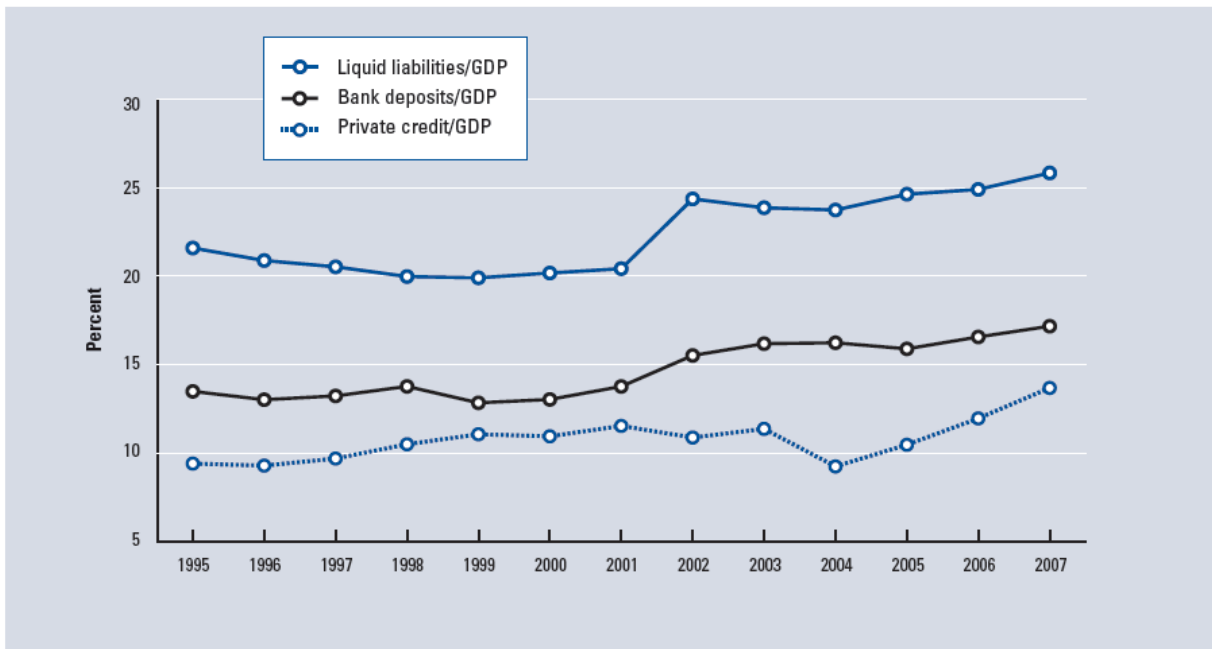
**Figure 9: Stock market turnover across countries**



Source: Beck and Demirgüç-Kunt, 2009.

Note: Sample size is 101 countries; data are for 2007 and indicate value traded relative to market capitalization. Countries in sub-Saharan Africa are marked with blue.

**Figure 10: Financial deepening in Africa, 1995 to 2007**

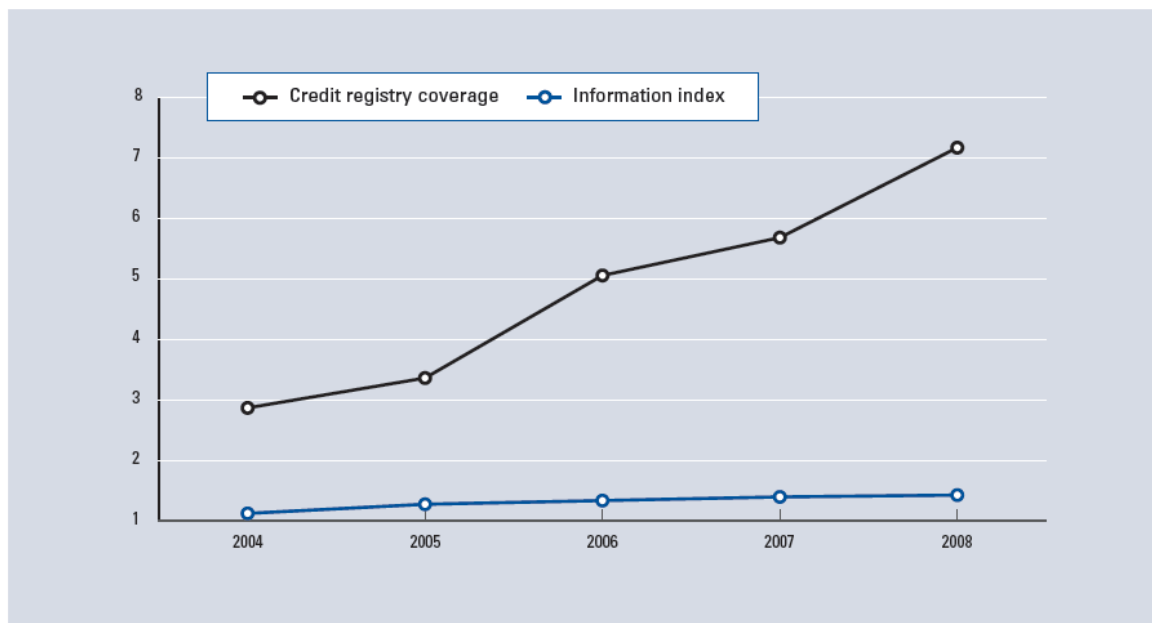


Source: Beck and Demirgüç-Kunt, 2009.

Note: This graph shows the median of liquid liabilities to GDP, bank deposits to GDP, and private credit to GDP across sub-Saharan Africa for each year.



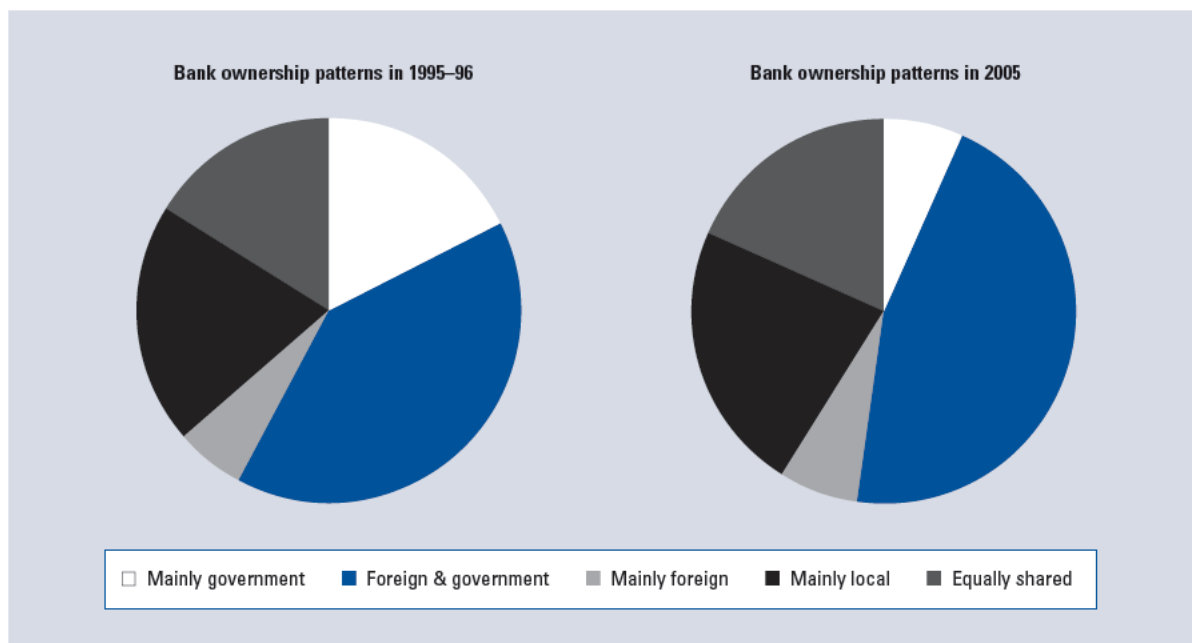
**Figure 11: The development of credit registries in Africa**



Source: IFC, 2009.

Note: The series are the average for the credit information index (from 0 to 6) and the proportion of adult population covered in a credit registry, respectively. In case there are both public and private registries, the larger number is used.

**Figure 12: Bank ownership in Africa over time**



Source: Honohan and Beck, 2007; authors' calculations.

Note: *Mainly government* (foreign, private) means more than 60 percent of total assets of the banking system are of this ownership form; *Foreign & government* means these two together hold more than 70 percent; *Equally shared* is a residual category.