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Regulatory Challenges Strategically Enhance Banking Efficiency and stability: The study of East African countries

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ABSTACT

The purpose of this paper is to assess and promote safe and sound banking systems, including the policy, legal and regulatory framework which affects developing countries' banking systems, especially in terms of the range of institutions and products available, their financial performance and their outreach, particularly to the rural and lower- income population. This review of the experience is intended to help guide other countries that are in the process of adopting legislation and regulations. The study also examines how the operation of banking systems and their clients may be affected by the impact of business and commercial laws and institutions, such as the impact on contract enforcement and the operation of banking systems.

Keywords: Sub-Saharan Africa, Banking Reform, Market for Credit

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I INTRODUCTION

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If Africa's growth recovery is to be sustained and widespread, effective financial systems are a clear prerequisite. They can ensure that viable business opportunities receive the credit they need, no matter who the entrepreneur may be. The financial sector is made up of the banking sub-sector and the stock or capital market. Again, financial sector development requires growth in the volume of activities as well as the rest of the economy. Generally, as the economy develops, the expectation is that the volume of transactions in the financial sector will increase and there will be less reliance on the banking sector, at least, for long-term credit. With an open, competitive and strong financial sector, opportunities are widened and governance improvements underpinned. A rapidly growing number of poor Africans are beginning to feel the benefits of direct access to formal and semi-formal finance – savings facilities as well as credit and other services at the micro level. Effective finance has a role to play and can speed and improve the provision of physical infrastructure, and the overall governance and business environment.

The primary role of the financial sector, especially in developing countries, is that of mobilizing financial resources from the savers and directing these resources into channels of desired development activities. Against that general background, a useful point of departure is briefly reviewing the nature of the three core functions of national banking systems. The first core function is the mobilization of domestic savings in a safe and efficient manner. This, of course, is the deposit gathering function, which must be rooted in the conviction on the part of the public that deposit balances - especially current account balances - will be paid at par and on demand. The second core function is the channeling of those savings, through the credit decision-making process, to their most efficient uses. To this end, the credit decision-making process must be thorough, objective and balanced; only then will national savings be channeled into the most productive investments. This will, in turn, promote growth and permit borrowers to service their debts in a timely fashion, thereby ensuring the safety of depositors' funds. The final core function is the provision of an efficient, low cost, safe and widely available means of making and receiving payments. Public trust in the banking system will only flourish in a setting in which bank clients - small and large - have virtually complete confidence that they can make and receive payments on a safe and timely basis.

Available data suggests that the financial sector in (SSA) Sub Saharan Africa is lagging behind that of the rest of the world. For instance, the M2/GDP ratio, which was 32 percent in 1990, increased marginally to 37 percent by 2003. In the case of East Asia, the corresponding figures are 63.1 and 158.8 percent respectively. Turning to the SSA stock market, market capitalization, which is one of the measures of size, was about \$143 billion in 1990. By 2004, it had doubled to reach \$294 billion. Impressive as this seems, it is inferior to the growth of the East Asian stock market size, which increased from about \$87 billion in 1990 to over \$1 trillion by 2004. Another measure of size is the number of listed domestic companies. For SSA, there was a decline in the number of listed companies from over 1000 in 1990 to about 900 by 2004, while in the case of East Asia, the number increased from 774 in 1990 to 3,582 by 2004. As economic agents, (household, businesses and government) carry

on their consumption and production activities, they need the facilities of credit (short and long-term credit) and equity (financial services) provided by the financial sector (Olu 2005)

These financial resources can be injected through the supply (production) channel or through the demand (final consumption) channel. In reality, financial resources are injected into the system through a combination of both channels. However, at any point in time, one of these two channels may be dominant and the imperatives of the predominant channel and the level of development of the economy should influence the role of the state in the financial sector development. An increase in income and or financial resources will lead to an increase in private and government final consumption expenditures. Accordingly, when the banking sector makes more financial resources available to consumers, the immediate effect is for the increased effective demand to put upward pressure on prices. Through higher prices, the increased financial resources will be funneled to the producers. Meanwhile, rising prices will lead to increased output as existing producers step up action and/or new producers, attracted by high profits, come into the economy to set up. Ultimately, the level of economic activities (consumption and production) will be higher (Amadou 2006).

Resuming normal economic activity will be severely impeded without a revival of commercial banks and insurance companies. The provision of bank finance for working capital, fixed investment, and residential reconstruction must also restart. Banks may take considerable time to restore their capital base, restructure their bad debts, and re-equip and re-staff themselves. In Rwanda, US7 millions was transferred from the network of rural bank co-operatives and into the hands of those responsible for the genocide: the number of bank clients fell to 42,000 compared with 400,000 before the atrocities. Two years after the end of Liberia's civil war, 78 per cent of commercial bank loans were classified as nonperforming. Financial liberalization only works when financial regulation and supervision improves as well (as financial crises over the last two decades demonstrate). Legal reform must also create clear property rights (for collateral-based lending) and punish fraud. For example, (Rodrik 1998) argues that there is no evidence in the data that countries without capital controls have grown faster, invested more, or experienced lower inflation. The weaknesses prevalent in the financial systems of developing countries are seen in acute form in conflict-affected countries. These include banking legislations that either omits important prudential regulations or is imprecise; shortages of supervisory skills in financial authorities; and supervisors unwilling to enforce prudential regulations. Considerable technical assistance is required. This requires significant public funds. The key challenge is therefore to rebuild economies so that the benefits of recovery are spread as widely as possible across society, and especially down to the poor.

Banks form the core of financial systems. Thus, whether a country' is in financial system is unharmed or not depends in large part on the soundness of its banking system. Since the late 1970s, virtually every country on the African continent has

experienced banking sector problems. These problems can be quite costly to the country concerned—in both financial and economic terms. Transparency is a cardinal virtue in this domain. Transparency implies openness, communication and accountability. Transparency is introduced as a means of holding public officials accountable and fighting political corruption. When government meetings are open to the press and the public, when budgets and financial statements may be reviewed by anyone, when laws, rules and decisions are open to discussion, they are seen as transparent. There is less opportunity for the authorities to abuse the system in their own interest. This is even more reason why we must do our best to understand the causes of banking sector problems and find effective ways to address them, preferably before crises occur. Usually banks are an instrument of policy in any economy. If the economic system is a capitalist in nature, usually they are owned privately and publicly. If the system is one such as used to be in the Soviet Union (central planning), then banks and other financial institutions are owned by the State, and the State cannot venture to leave huge financial resources outside the purview of the planning agency since it might jeopardize the smooth execution of the plans. From this follows the fact that financial institutions are created as instruments of the major philosophy that guides the economy. They live and die in accordance with the existence of the main philosophy and policy.

Sub-Saharan African countries are facing major challenges: to improve banking sectors, to mobilize revenue and reduce poverty, and to integrate themselves into the financial liberalization. Banking growth rates are still not high enough to make a real dent in the wide-ranging poverty and enable these countries to catch up with other developing nations. It is required to have a sustained and substantial increase in real per capita GDP growth rates in these countries, together with significant improvements in social conditions.

Keeping the above facts and drawbacks in mind, this study has been conducted. The objectives are, *to assess and promote safe and sound banking systems, including the policy, legal and regulatory framework, which affects developing countries' banking systems, especially in terms of the range of institutions and products available, their financial performance and their outreach; particularly to the rural and lower-income population. This review of the experience is intended to help guide other countries that are in the process of adopting legislation and regulations. The study also examines how the operation of banking systems and their clients may be affected by the impact of business and commercial laws and institutions, such as the impact on contract enforcement and the operation of banking systems.*

Organization of the remaining paper is as follows: section (2) is review of literature, which discusses the causes of banking sector, problems, financial growth and its indicators, strengthening of Africans' financial sector and challenges for reform sector. Section (3) is about banking system in east African nations. Moreover, finally section (4) concludes the papers.

2. REVIEW OF LITERATURE

2.1. Causes Of Banking Sector Problems:

The first order of business is to consider the factors that lead to unsound banking systems. In most cases, banking sector problems begin with lax management within individual banks. Nevertheless, lapses in sound banking practices appear to be pervasive in developing countries in large part because bank owners and managers often lack strong enough incentives to act prudently. Often there is also a lack of legal and judicial infrastructure, which banks cannot perform properly without and that leads to a breakdown in the credit discipline. One of the principal reasons why incentives are weak is lack of transparency about banks' operations and financial condition, which makes it difficult for market participants or even bank supervisors, to distinguish the weak institutions from the strong. In many developing countries, as in many industrialized countries, loan valuation and provisioning standards are not rigorous enough to prevent banks from concealing the full extent of non-performing loans. The lack of reliable data and uniform disclosure rules make it difficult for the market, including deposit holders, to compare relative performance. In these circumstances, the market is not in the position to perform the essential role it plays in countries where bank operations are more transparent, that is, rewarding good performers and sanctioning the poor ones.

The problem is compounded when domestic banking supervision is also weak, either because laws and regulations are not comprehensive enough, or because bank supervisors are not free from political interference, or indeed, because the supervisory authority does not have the necessary human and financial resources to carry out its responsibilities effectively. An aggravating factor is the fact that banks in developing countries typically operate in a more volatile economic and financial climate than institutions in industrial countries. Unfortunately, for the most part, banks in developing countries have not responded with appropriate caution, and supervisory authorities have not required sufficiently high capital cushions against the higher risks. Weakness of banking sector can be traced to a variety of sources. It makes sense, therefore, that a successful attack on the problem of unsound banking systems should be launched on several fronts. In fact, a number of constructive steps are already under way.

At the national level, many countries, including Ethiopia, Uganda, Sudan, and Eritrea, have taken or are taking steps to strengthen their banking systems. Banking laws have been updated throughout the region and many countries have made efforts to upgrade their supervision of banks. In particular, Uganda considerably strengthened its banking supervision following its banking crisis in the early 1990s, a terrible one, indeed and is often used as a model for reforms in the region, and beyond. The region also has begun to see a wave of bank consolidations, as is typical in the rest of the world, or example there have been extensive bank restructurings, mergers, and privatizations in Ethiopia (Geda 1999) and, to some extent, in Sudan. The Central Bank of Sudan also abandoned treasury bills and government bonds, instruments on which interest was paid. In their place, the Central Bank has issued financial

certificates that conform to the Islamic system. One of the main objectives of financial institutions is mobilizing resources (in particular domestic savings) and channeling these to would-be investors. This intermediation role of financial institutions takes different forms in different economic systems. Ethiopia's history of the last three decades clearly shows the validity of this statement.

Uganda has developed regional standards on loan classification and provisioning and on the role of external auditors, and the major milestone that enabled Uganda to move towards full compliance with the Basel Core Principles. The enactment of the new Financial Institutions Act (David 2006) while the Bank of Uganda welcomes the increased use of technology and the growth in financial innovations, there is a challenge in terms of preparing the sector for the implications of increasing globalization. The Bank of Uganda shall endeavor to develop the requisite supervisory and regulatory skills. We expect to have well-capitalized and well-managed financial institutions to face up to the challenges presented by increasing globalization.

The important point is to strengthen the financial system so that it is less prone to crisis, and so that whenever a crisis does occur, the resultant damage to the financial system and to the real sector of the economy is minimized. When banks are not prudently run, not only they allocate resources inefficiently, they also expose themselves to losses at the slightest hint of market turbulence. The Bank of Uganda is therefore determined to insulate the economy from external shocks by adopting prudent monetary policies, a credible exchange rate regime and a well-capitalized, efficient and transparent financial system. To this end, the Bank of Uganda has continued with the structural reforms in the banking sector. The access to finance is an important factor in consumption smoothing and hence poverty reduction. The evidence for a poverty trap is due to liquidity constraint that limits the ability of the rural households on the amount to borrow (Gulde and Pattillo 2006)

Nevertheless, it is clear from the extent of banking sector problems in some of African countries and elsewhere in the world that major gaps remain in national and international efforts to strengthen banking systems. At the national level, many of the fundamental causes of unsound banking systems persist, including poor internal governance and a lack of transparency about banks' operations and financial condition, inadequate supervision, and excessive official complacency about problem banks. Moreover, all too often efforts to strengthen domestic banking systems, though welcome, are undertaken only after crisis has struck. It is very important to recognize that this may be the only time when there is sufficient momentum for real reform, as this is very high price to pay. We must be able to do better and avoid such exorbitant costs before the crises exceed 10 percent of GDP.

2. 2. Financing Growth

Banks are the biggest source of formal finance in developing countries. The banking sector indicators have been developed to extend and complement the financial

development that relies heavily on indicators associated to the size, efficiency and stability of the banking sector. The traditional indicators used to assess the size of a country's banking sector are the ratio of M2 (a measure of money supply) to Gross Domestic Product (GDP), and the ratio of private credit to GDP. Both have limitations.

The ratio of private credit to GDP includes non-performing loans and hence disregards the quality of credit allocation. The two traditional indicators of return on assets and the ratio of operating costs to assets are complemented by indicators of competitiveness and by indicators of the efficiency of the banking system structure. Lower profitability and higher bank asset (or deposit) concentration typically related to lower efficiency in the banking sector. The stability indicators are measured by capital adequacy, liquidity, sensitivity to market risk, and asset quality of both lenders and borrowers. One of the foundations of the theoretical literature on banking regulation is that branch banking leads to more stable banking systems by enabling banks to better diversify their assets and widen their depositor base (Carlson and Mitchener 2005).

Finance Growth Indicators

Table – 1. Banking size indicators

1. Central bank assets to GDP	2. Deposit money banks assets to GDP
3. Financial system deposits to GD	4. M2 to GDP
5. Private credit to GDP	6. Private credit to total domestic credit
7. Private credit to total funding	

Table – 2. Banking Sector efficiency indicators

1. Returns on assets (adjusted)	2. Operating costs to total assets
3. Operating costs to total assets	4. Lending-deposit rates spread
5. Three-bank concentration ratio (assets)	6. Three-bank concentration ratio (deposits)

Table – 3. Banking stability indicators

1.	2. Non-performing loans ratio
3. Real credit growth adjusted	4. Market-to-book-value of equity (borrowers)
5. Debit-to-book-value of equity (Borrowers)	6. Interest coverage ratio (Borrowers)
7. Liquid Capital adequacy ratio assets to total assets	8. Liquid assets to deposits and short-term borrowing
9. Total return index volatility	10. Market to book value of equity (banks)

(World Bank 2005)

2.3 Money and its Categories

The **supply of money** is measured and placed into categories based upon its accessibility. Accessibility refers to how easily you can access and use the money. The first category called **M1** - contains the total dollar amount of currency and coins in circulation, also includes transaction (checking) account balances, traveler's checks that are not issued by banks. The next category of money is called **M2** - contains all balances under M1, and M2 contains savings accounts and time deposits (certificates of deposit) of less than \$100,000. M2 also includes money market mutual funds. M2 does not contain stock or bond market mutual funds. **M3** contains everything under M2 and M1, and time deposits over \$100,000 and includes bank repurchase agreements. Bank repurchase agreements are short-term loans to banks. It contains the overnight Eurodollars deposits of U.S. currency held at foreign banks, or U.S. currency deposits held by U.S. banks overseas. Overnight refers to the short time period the funds are held on deposit.

2.4 Strengthening Africa's Financial Sector

Access to financial services—savings and loans—is lower in SSA than in other developing regions. On the savings side, household deposits in commercial banks have increased slowly relative to GDP since the 1990s. Whereas 90 percent of households in industrial countries have savings accounts, one-fourth of households in other low and middle-income countries have them and only a tenth of households in a large set of SSA countries do. Banks serve mainly governments, the formal sector, and affluent households. Widespread poverty limits both the demand for and the supply of savings facilities. The share of the population having a formal savings account is strongly correlated with poverty rates and per capita income (Gulde and Pattillo 2006; and Gulde 2007). Poor people have only small sums to save, which limits banks' economic opportunities, given the high costs of maintaining small accounts. Banks often respond by charging for opening and maintaining a deposit account, making access to bank services more difficult for small-scale savers. Some countries are reinventing state and development banks to promote more financing. Gabon, for example, is using development banks to channel credit to priority sectors (Kablan 2007). Other countries, such as members of the West African Economic and Monetary Union (WAEMU), are forming state-owned specialized banks to give certain sectors access to desired types of finance.

Many African countries have set up stock markets to help companies raise long-term finance. Whereas there were just five stock markets in SSA in 1989, there are now 15, including the most recently established in Malawi, Swaziland, and Uganda. Corporate financing patterns in certain SSA countries, such as Ghana, South Africa, and Zimbabwe, suggest that stock markets can be a source of finance, but only for a limited number of listed firms. In addition, in all SSA countries except South Africa, stock markets suffer from little turnover and market capitalization partly because of inadequate informational and disclosure rules and supervisory frameworks. Finally, stock markets tend to be more efficient and deliver greater economic benefits when

basic financial sector infrastructure and a well-functioning banking system are in place. Most African capital markets are still tiny and fledgling especially in comparison with their counterparts in other regions. In sub-Saharan Africa, the Johannesburg Stock Exchange accounts for nearly 90 percent of the total value of the region's market capitalization (listed shares). Even the Nigerian exchange, ranked second among sub-Saharan exchanges in 1999, had a market capitalization of just \$2.94 bn (equivalent to 6.9 per cent of gross domestic product). In the case of West Africa's other exchanges, the eight-country regional exchange in Côte d'Ivoire and the Ghana Stock Exchange, the amounts were just \$1.5 bn (5.5 per cent) and \$916 mn (12.1 per cent), respectively. Except for the Johannesburg exchange, most African exchanges share other impediments to their growth and development: too few indigenous companies, small average company size, and low liquidity levels (the value of shares traded in relation to total market capitalization). The number of companies listing shares generally is low, and trading in one or just a few stocks often dominates total trading activity (Irving, 2000)

Remittances to SSA countries, another type of capital inflow, have increased rapidly in recent years. In 2005, they totaled \$188 billion—twice the amount of official assistance developing countries received. Moreover, there is evidence that such flows are underreported. Indeed, remittances through informal channels could add at least 50 percent to global recorded flows. Most of the reported flows go to regions other than SSA, but SSA has still been part of the overall rising global trend. Between 2000 and 2005, remittances to the region increased by more than 55 percent, to nearly \$7 billion, whereas they increased for developing countries as a group by 81 percent (Gupta, Patillo and Wagh 2007). As strong demand for money transfer services continues, spurring needed improvements in the financial sector infrastructure for remittances, more people including the rural poor could gain access to financial services. Africa receives just 4 percent of total remittances –by far the smallest share - to developing countries and just 33 percent of those to India, the top recipient. In contrast, countries in Latin America and the Caribbean receive about 25 percent of all remittances, as do countries in the East Asia and Pacific region. However, countries need to reform payment systems to increase the efficiency of remittance services. Predictable legal and regulatory frameworks must be in place that does not discriminate against smaller money transfer operators, and there is a need for competitive market conditions and skills upgrading in the industry. Bringing recipient households into the formal financial sector is only the first step in using remittances more effectively. Country surveys indicate that, although households typically spend a large proportion of their remittances, their propensity to save can be as high as 40 percent. For policymakers, the challenge is to channel these savings into productive uses.

Beyond developing international guidelines, we also need to find ways to deal with other difficult and even more pressing issues. Such as: how to help countries to take corrective action against problem banks, preferably early while distortions are small; how to close down insolvent banks; how to design payments systems so as to limit contagion; and how to ensure that lender of last resort facilities do not prolong the

lives of unsound banks or lead to moral hazard. To do this, the region must improve productivity, increase investment, and dramatically raise levels of domestic savings.

The level of domestic savings in sub-Saharan Africa remains below that of all other developing regions, representing only about 12% of aggregate GDP. Savings rates in Asia, meanwhile, are as high as 30%, and even in South Asia the savings rate is 17%. In addition, it can be done much to increase revenues, without raising marginal tax rates, by eliminating exemptions and broadening the tax base. To encourage private savings, governments must reform property ownership laws and more broadly promote private sector development, improve the investment climate, build infrastructure, and increase access to credit. Strengthening financial sectors is critical to supporting such reforms. In addition, reforming weak banking sectors can have a direct impact on savings, as weak banks tend to have higher loan-to-deposit spreads and thereby discourage savings and investment. A stronger financial sector is also critical to improving income levels. Low-income families, small-to-medium size enterprises, and rural entrepreneurs in developing countries have difficulty obtaining financial services. Banking sector penetration in a typical sub-Saharan African country is around 1% of GDP, far below a more advanced economy like Brazil, where penetration is approaching 25%, or industrialized countries where it is near 85%. Women's World Banking estimates that fewer than 2 percent of low-income entrepreneurs worldwide have access to financial services. Fragile banking systems not only misallocate resources, but also leave themselves vulnerable to terrorists, money-launderers, capital flight, and others who would abuse the financial system. Financial institutions that simply forward financial resources to the public sector will not be able to play an intermediating role (King, and Levine 1993). The financial services to low income households and entrepreneurs in the remote urban and rural areas may be the most effective way to increase monetization, savings, reduce poverty and achieve broad-based economic growth. Yet in Africa, fewer than 2 per cent of low-income producers have access to financial services from the moneylenders. Therefore, financial intermediaries need to adopt new paradigms and take on new and aggressive roles in building financial infrastructure that serves the majority of people and enable the poor to share economic growth.

Table -4. M2 to GDP ratios of various countries, 1993-1998

Country	1993	1994	1995	1996	1997	1998
USA	0.60	0.57	0.57	0.58	0.58	0.60
Italy	0.54	0.51	0.47	0.45	0.47	0.47
Chile	0.40	0.37	0.39	0.39	0.40	0.42
Brazil	0.73	0.38	0.28	0.24	0.28	0.28
Ethiopia	0.28	0.32	0.28	0.25	0.25	0.21
Kenya	0.17	0.16	0.15	0.15	0.14	0.13
Sudan	0.12	0.24	0.14	0.11	0.10	N/A
Eritrea	0.02	0.01	0.01	0.01	0.01	0.01

Source: IMF (2000)

Table-5. Ratio of loans to the private sector to total domestic loans of various countries, 1993-1998

Country	1993	1994	1995	1996	1997	1998
USA	0.81	0.82	0.8.	0.83	0.83	0.85
Argentina	0.70	0.76	0.71	0.71	0.72	0.73
Nigeria	0.31	0.32	0.42	0.68	0.64	0.71
Kenya	0.63	0.54	0.59	0.62	0.67	0.58
Ethiopia	0.12	0.16	0.26	0.38	0.44	0.44
Sudan	0.21	0.28	0.28	0.32	0.34	0.31
Eritrea	0.39	0.41	0.14	0.14	0.29	0.27

Source: IMF (2000)

Table-6. Ratio of loans to the private sector to total domestic loans of various countries, 1993-1998

Country	1993	1994	1995	1996	1997	1998
USA	0.81	0.82	0.8.	0.83	0.83	0.85
Argentina	0.70	0.76	0.71	0.71	0.72	0.73
Nigeria	0.31	0.32	0.42	0.68	0.64	0.71
Kenya	0.63	0.54	0.59	0.62	0.67	0.58
Ethiopia	0.12	0.16	0.26	0.38	0.44	0.44
Sudan	0.21	0.28	0.28	0.32	0.34	0.31
Eritrea	0.39	0.41	0.14	0.14	0.29	0.27

Source: IMF (2000)

2.5 Challenges for Reform

While several Sub-Saharan African countries have already made substantial progress in reforming and modernizing their financial sectors, there is still much work to do:

- a) Banking systems often function with a substantial degree of government ownership or control. Many African countries faced external shocks; the primary cause of financial distress of banks is political, in the form of pressure not to recover debts, or to lend to weak borrowers including politically connected private sector borrowers, and the government itself.
- b) Bank supervision remains weak, enforcement tools inadequate, and management standards low. Most African financial sectors need reform in the areas of prudential regulations, banking supervision, bankruptcy laws and contract enforcement law. Compliance with international codes and standards is also an area in need of reform.
- c) The depth and size of Sub-Saharan Africa's financial markets are inadequate. The banking industry is highly concentrated (in a study of 5 Sub-Saharan African countries, 60% of banking sector assets were concentrated in, at most, 4 banks); loan

portfolios are not diversified, reflecting national economies; capital markets are shallow; and insurance and pension systems are not well developed:

d) Mobilizing the Diaspora was the latest step that aims to promote greater investment on the African continent. The African Diaspora is already playing an important role in African development. Each year it remits an estimated \$45 billion. Mobilizing the Diaspora sought to explore how these funds could be better structured to promote sustainable development on the continent. It is also considered that the African Diaspora is stimulating the transfer of intellectual resources and creative business practices (Hampshire 2004). However, just 6% of remittances are actually channeled into investments. There is an appetite within the Diaspora to invest in Africa: 91% of those questioned said they would be interested in doing so if certain obstacles were tackled, such as a lack of reliable information of the business environment in Africa is discouraging investment (Banjoko 2004). Amongst the investment vehicles available to the Diaspora, bank accounts and property are the most readily available. A private equity fund is the investment vehicle with the greatest potential to create employment and create a multiplier effect in the economy, particularly if it is private equity investment into small and medium-sized enterprises (SMEs). Governments must promote private equity investments in Africa by creating tax incentives for the Diaspora. Without reforms in these areas, financial systems will continue to experience high levels of non-performing loans, interest rates that do not adequately reflect the level of risk, and the crowding out of the private sector. In Africa, as in most other developing regions, the predominant source of banking stress is nonperforming loans. A loan is seldom classified as nonperforming until payments due under the contract have fallen six or more months in arrears.

The financial sector has an economy-wide effect. All other sectors rely on financial intermediation for growth. Second, perhaps more than in any other economic sector, a stronger, deeper financial sector can protect an economy from external as well domestic shocks. Therefore, financial sector openness can promote stability. As financial institutions aggregate capital, they must move it into the business and industry sectors where they can earn the best risk-adjusted returns for their savers. That means investing in the businesses that can make the best use of their capital. In other words, those offer the highest productivity. Moreover, rising productivity—output per worker—is at the root of raising living standards. Ghana took a very systematic approach to reforming its financial sector in the early 90s. In the first phase of those reforms, the government placed ceilings on net bank credit to the government to avoid crowding out the private sector. While administrative controls on interest rates remained in place, they were gradually relaxed. The second phase of reform focused on liberalizing controls on interest rates and bank credit. The third phase was a gradual shift from a direct system of monetary controls to an indirect system that utilized market-based policy instruments.

Individual banks experience stress when the cash flows generated by their earning assets prove insufficient to service their deposits and other debt. As long as a bank is

perceived either to be intrinsically solvent or to be supported at least implicitly by credible government guarantees, its managers can manage the stress by selling liquid assets and by borrowing funds from new depositors and from other institutions. This paper seeks to show that, during the last two decades, the banking systems of most African countries have been under more or less permanent stress and to explain why. The explanation combines two factors: First, depositors' vulnerability to loss: the constant difficulties individual depositors encounter both in obtaining timely and reliable information and, regulatory strategies that did not efficiently counteract the weaknesses because of the limited fiscal capacity and the regulatory policymakers operate. Financial instability occurs when the reliability of information about savings and investment opportunities deteriorates sharply enough to disrupt the flow of savings and investment.

3. THE BANKING SYSTEM IN EAST AFRICAN NATIONS

3.1. Eritrea

According to the International Monetary Fund, commercial banks in Eritrea—all government owned and operated—appear to comply with prudent regulations. Although the commercial banking sector is largely profitable, mostly owing to income from foreign exchange transactions, a high proportion of non-performing loans burdens the sector. The Commercial Bank of Eritrea (CBE) deploys only 29% of the funds collected from its depositors. At the same time, a lack of finance for small firms in Eritrea is an important obstacle for the development of the country. Core lending activities do not generate sufficient income to cover operating costs at most commercial banks (Eije Von 1998). Helping Eritrea move out of the current crisis requires close attention and thoughtful adaptation of Bank instruments; it will not be enough to take standard instruments from the shelf and expect them to yield success. At the same time small firms, which are considered major actors in the economy, are constrained in their growth by a restricted access to credit. According to the National Survey (1995), the small firms in the country have financial, marketing, transportation, personal and other constraints. Finance is reported as the major barrier for start-ups and as the second after marketing during normal operations of small firms: 43 percent have financial constraints at the start-up and 20 percent face such constraints during normal operation. The bank's corporate policies are reflected in the Country Program's emphasis on promoting growth, human development, private sector development, environmental sustainability and financial management. Despite some early difficulties, bank assistance has ultimately been in line with the processes of the Comprehensive Development Framework.

3.2 Kenya

Kenya acquired its first separate currency on 14 September 1966, when the IMF announced the initial par value for the Kenya shilling. The powers of the Central Bank of Kenya (CBK) were reduced in the early 1990s with the liberalization of the financial sector. The commercial banks are free to set their own interest and exchange

rates. The banks rapidly rising loan-able resources from the banking system to the private sector, increased access to social services, growing confidence of the business sector, and better prospects for the economy. The central bank of Kenya adopted a monetary policy in 2003 that sought to support economic recovery while ensuring macroeconomic stability with particular focus on inflation, stable interest rates and the exchange rate. As a result, the measures they took created conditions for increased competition among commercial banks for a limited supply of Government securities. In the financial year 2004/2005, the bank of Kenya focused on an exit strategy from high inflation environment and by June 2005, overall inflation had eased significantly. Further easing continued through October 2005 when overall inflation fell to 3.7%. Throughout the period since 2003, economic activity continued to expand with real GDP growth rising from 2.8% in 2003 to 4.6% in June 2005 and at 5% or more by June 2006.

The bank of Kenya is responsible for two other important assignments besides monetary policy. The first is to ensure that those who are placing their resources in banks and financial institutions are protected. The Central Bank is required to ensure that banks and financial institutions are competently managed and completely transparent. The second responsibility of the Central Bank is to ensure that banks act as efficient financial intermediaries utilizing the nation's savings effectively to create jobs and improve national welfare. The central bank has also revised prudential regulations based on global experience. During the past two years, the Bank's supervision process identified infringements to the banking laws and regulations. These include the problems of an inadequate legal framework for enforcing remedial action and gaps in supervisory capacity to perform critical transaction testing and to form an independent opinion on the value of securities that collateralize non-performing loans. They set out to tackle these challenges by complementing professional skills available within the Central Bank with highly specialized skills that were sourced externally. The central bank's new in-depth approach to the supervision of banks and financial institutions activities has become the norm for the routine supervision missions. An important challenge faced by the banks has been the disposal of collateral used to secure non-performing loans. These changes to the methods for disposal of collateral have the benefit of improving credit allocation in favor of credit worthy borrowers, maintaining financial discipline among borrowers and early recognition of bad debts (Mullei 2005). Going forward, the Central Bank of Kenya sees three main pillars, which constitute their vision for their banking sector. First is the achievement of a sound legal framework for the banking sector. Second is the achievement of an efficient and stable financial sector. Third is increased access to financial services. The Government has given a firm commitment to limiting its domestic borrowing to manageable levels and it will be creating a favorable environment for expansion of credit to the private sector and increasing economic growth with enhanced access to financial services.

3.3 Ethiopia

The establishment of the Abyssinian Bank in 1905 marked the start of modern banking in Ethiopia. With the fall of the Derg in 1991, the new government faced the difficult tasks of organizing the demobilization as well as starting the transition to a market economy (Hansson 2004). War and the Derg's policies had left a crippled economy and an impoverished people. Economic reform began soon after the new government took power. Despite five years of rapid economic growth based on sound economic policies and high levels of aid, Ethiopia remains one of the world's poorest countries. The economy is estimated to have grown at a rate of 6.8 per cent in real terms in 2004/05 and is approaching the 7 per cent growth rate needed to reach the Millennium Development Goals (MDG).

Due to the nature of the Ethiopian financial sector, in which there are no foreign banks, a non-competitive market structure the state-owned banks have the dominant role and strong capital controls. The Ethiopian economy would benefit from financial sector liberalization, especially from the entry of foreign banks and the associated privatization of state-owned banks (Kiyota, Peitsch and Stern 2007). Ethiopia appears unique compared to its East African neighbors (namely Kenya, Tanzania, and Uganda) and many other developing countries in that it has not yet opened its banking sector to foreign participation. The Ethiopian banking sector remains isolated from the impact of globalization. Although Ethiopian policy makers understand the potential importance of financial liberalization, it is widely believed that liberalization may result in loss of control over the economy and may not be economically beneficial. Ethiopia's financial sectors remain closed and they are less developed than its neighbors are. Ethiopia has no capital market and very limited informal investing in shares of private companies. A series of financial sector reforms has been introduced since 1994, when private banks were allowed to be re-established. Nevertheless, the three large state-owned banks continue to dominate the market in terms of capital, deposits and assets.

3.4. Sudan

Before Sudanese independence, there had been no restrictions on the movement of funds between Egypt and Sudan, and the value of the currency used in Sudan was tied to that of Egypt. In 1959, the Bank of Sudan was established, and in February 1960, the Bank of Sudan began acting as the central bank of Sudan, issuing currency, assisting the development of banks, providing loans, maintaining financial equilibrium, and advising the government. Work started in implementing the Banks Restructuring Program announced in 2000, with the objective of establishing large and sound banking units to meet the international competition in the banking industry. One of the main functions of Bank of Sudan is to perform the role of "Lender of last resort", by assisting banks in overcoming problems of temporary liquidity shortages and reducing the finance gap for the important economic sectors (Hassan 2004a). Meanwhile, Dubai Islamic Bank (DIB) has acquired 60% of Sudan's Al Khartoum Bank. The Government of Sudan had owned 99% of the bank's total shares and Sudanese investors, the remaining 1%. DIB will own the majority of shares in Al Khartoum Bank, Sudan's first bank, established in 1913. Khalil General Manager -

points out that until recently, Sudanese banks were used to paying a rate of return on deposits and investment certificates much higher than those paid by banks and financial institutions outside of Sudan. "The purpose was to attract the liquidity both in local and foreign currencies circulating outside the banking system, to encourage savings and turning it into real investments. The banks have been freed from government control over their sectoral lending, but in the second stage of reform, all Sudan's banks have until 2003 to meet the Basel criteria. If they fail, they will be forced to sell out or close (Hassan 2004b). "Al Khartoum Bank has recorded high growth rates during the past few years. The bank was able to increase profits to US\$7 billion in 2004 as compared to US\$3.5 billion in 2003. These results reflect its ability to grow and we are confident that performance will further improve" (Kooheji 2005). Economic reforms have been successfully applied, and the activation of all economic sectors and other activities has caused an increase in the average growth of the industrial section to 4.6%, according to the last report issued by the International Monetary Fund. The Central Bank of Sudan continued to play its role as the bank for the central and regional governments, and for government and semi-government institutions, contributing to their capital formation and keeping their accounts in both local and foreign currencies.

3. 6 Uganda

The Bank of Uganda was established on 16 May 1966 as the bank of issue, undertaking the function previously served by the East African Currency Board in Nairobi. The government-owned Uganda Commercial Bank (UCB) provided a full commercial banking service, complementary to and in competition with other commercial banks in the country. The financial sector in Uganda is strong and resilient. Public confidence in the banking sector has increased as indicated in the rising level of total deposits. The government supported the establishment of a stock exchange in Kampala, and it inaugurated the Capital Markets Authority in 1995/96. The initial stage of capital market development concentrated on the inner-bank market and the sale of Treasury bills, which the Bank of Uganda started selling in 1992 at weekly auctions. The exchange was officially opened in 1997, but in 1999, had not been active since inception. The IMF finds a strong link between Uganda's improved record of accomplishment in that regard and a series of steps the country took in 2002 to strengthen the sector. The IMF study finds a marked improvement in the health of Uganda's banking system after distressed banks were closed, a risk-based approach to supervision was introduced, and the country's dominant state-owned Uganda Commercial Bank was sold to an international bank (IFC 2006). There is also a need to widen the outreach banking services into the rural areas. Therefore, Bank of Uganda shall continue to encourage the growth of Microfinance institutions (MFIs) to improve access to financial markets.

4. CONCLUSIONS AND POLICY IMPLICATIONS

An effective domestic banking system is one of the most basic prerequisites for robust economic performance over time all financial sector development is critical to

stronger economic growth, improved productivity, increased investment rates and better savings rates. A competitive and open financial sector can play a critical role in this process. Over the past twenty years, all the above-mentioned East African countries have experienced major problems within individual banking institutions or entire banking systems. While there are so many reasons for the banking failure, and those reasons may vary from country to country, the following common denominators have been presented in virtually all such episodes. Among those are a) a rapid changes in the macroeconomic and macro-financial environment, b) inadequate internal controls and procedures, together with lapses in official supervision, and c) concentrated patterns of credit or market risk exposure.

Even though countries have used a variety of devices to spread costs over a long period, it has been common a direct fiscal costs ranging from 5% to 10% of GDP. Literally tens, if not hundreds, of billions of dollars of precious domestic savings have been poured into a bad credits in a setting in which such savings are in very short supply. The paralyzing effects of banking crises on both lenders and borrowers have also severely restrained the GDP growth. The erosion of public confidence in the banking system should be considered and reforms are needed to remedy the prevailing problems that are so vital to the long run success of those countries in question. The road ahead will be set with problems and challenges that will not be easily overcome. Given the dynamic nature of the banking industry, it can only be expected that routine, technical, and operational issues will emerge from time to time and move forward. Since the level of saving in Africa is low for any meaningful and transformational investment, the alternative weapon they may have among others is through increased monetization or credit creation. To achieve these results, an efficient banking system, prudential controls and a friendly, non-distorted macroeconomic framework are required.

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