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The Urgent Need for Financial Reform to Mobilise Savings in Sub-Saharan Africa

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In IPC Policy Research Brief #6, Pollin, Epstein and Heintz provide alternative proposals for monetary policy and financial-sector reform in sub-Saharan Africa, focusing on such issues as targeting short-term interest rates, instituting moderate exchange controls, proposing large-scale loan guarantee programmes and reviving state development banks (see also the directly related IPC Policy Research Brief #4).

This One Pager emphasises the importance of financial-sector reform for domestic resource mobilisation. The reason: savings mobilisation by liberalised financial systems in sub-Saharan Africa has been deeply unsatisfactory, severely constraining investment and making faster, sustainable growth unlikely.

Domestic savings collapsed in the 1980s, fell further in the 1990s and, despite partial recovery after 2000, have remained low and fluctuating. The Figure shows that savings performance in the region has been worse than in Latin America, and in complete contrast to that in East Asia.

External sources can partially plug this gap, but both FDI and workers' remittances are low compared to those in other regions. Substantial increases in ODA are required, but aid is volatile and often converted into flight capital, in large part due to liberalisation of the capital account. A longer-term solution requires stronger domestic resource mobilisation based on reform of the formal financial sector.

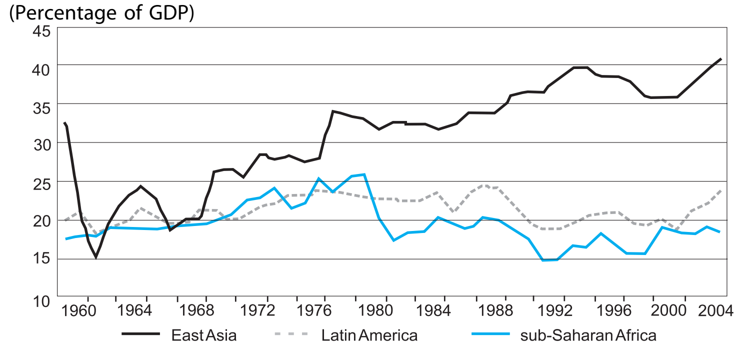
There is not, in fact, an absolute scarcity of savings in sub-Saharan Africa. Households hold substantial precautionary savings because of low and uncertain incomes. But their savings pattern is very irregular, and can involve as much dissaving as saving. Savings rates might rise as a result of higher economic growth, but the region's growth volatility adversely affects household capacity to save.

In this environment households require secure saving assets that allow for many small transactions—a service unlikely to be provided by the liberalised financial sector. Thus, a large part of savings goes into non-financial assets (livestock, real estate and jewellery) and into the informal financial sector, instead of financing productive investment.

African households save in non-financial assets partly in order to demonstrate status and wealth, but also because they typically face a risky financial environment. Informal financial assets are also favoured because they tend to involve small and frequently repeated deposits with institutions that operate in geographically and socially confined community settings.

The weakness of the formal system in mobilising savings has been exacerbated by financial liberalisation. The closure of state-owned banks with wide outreach was a significant factor. In addition, commercial banks limited their branch network, focusing on more profitable urban-based activities and reducing exposure in rural areas. Small depositors have also been discouraged by high minimum deposit and balance requirements as well as by the time and administrative effort required to complete transactions.

Gross domestic savings by developing regions, 1960-2004
(Percentage of GDP)



Source: World Development Indicators, 2007.

Savings with the formal financial system could increase provided that there were improvements in access, adequacy and reliability of financial assets. First, the semi-formal financial sector should be encouraged to provide further outlets for household savings.

Second, technological innovation should be promoted to ameliorate the problems of remoteness and costs of access to finance, including starting ATMs, mobile banks and, more significantly, mobile phone banking, particularly in rural areas.

Third, microfinance institutions could play a significant role in mobilising savings and pooling other financial resources in conjunction with the formal system. Sub-Saharan African banks should be encouraged to cooperate more with such institutions.

A more effective and radical measure, however, would be to use public mechanisms to mobilise savings, such as revitalised postal savings institutions and strengthened public pensions systems. Development finance institutions, more than 60 of which remain across the region, could also be rebuilt.

Public banking institutions in sub-Saharan Africa in the past have been associated with inefficiency and misuse of funds, and have often been subject to political pressure. Nonetheless, given the poor performance of liberalised formal finance, there seem to be few other viable alternatives if formal domestic savings mobilisation is to recover and sustain increased public and private investment.

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