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Financial regulation in Ghana: Balancing inclusive growth with financial stability

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Abstract

Following the financial crisis, many countries are beginning to prioritize financial stability through regulation, and seeking to balance such policy priorities with the promotion of inclusive growth, especially in poor countries. Sustained financial sector restructuring and transformation in Ghana has succeeded in creating one of the most vibrant financial services centers in the sub region. Ghana has therefore seen a significant increase in the number of banks, including pan-African groups, with a rapidly expanding deposit base. Currently, Ghana is home to 27 banks, of which 15 are foreign owned and six are African banks. However, a number of cross-cutting challenges remain, including access to credit by the private sector and the high cost of credit, which tends to militate against small-scale businesses. While the authorities have continued to work on these challenges, current macroeconomic challenges continue to hamper efforts to lower the cost of credit and to expand access to credit for most small-scale businesses.

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1 Introduction

There is an extensive literature on the link between financial development and economic growth (see for example Bencivenga and Smith, 1991; Pagano, 1993; King and Levine, 1993; Levine, 1997). Well-functioning financial systems serve a vital purpose by offering savings, payment, credit, and risk management services to individuals and firms. Financial inclusion is important for development and poverty reduction. Financial inclusion is defined by the IMF *Global Financial Development Report 2014* as the proportion of individuals and firms that use financial services. There is a large literature on the linkages between access to finance and economic development (see Levine 1997). Development theory illustrates the impact of financial inclusion on economic development. Several models elucidate how financial exclusion and, especially, lack of access to finance can lead to persistent income inequality or poverty traps, as well as lower growth (Aghion and Bolton 1997; Banerjee and Newman 1993; Galor and Zeira 1993).

Considerable evidence abound that indicate that the poor benefit enormously from access to basic financial services such as payments, savings, and insurance services. However, while financial inclusion has important benefits, boosting financial inclusion is not trivial. If care is not taken, efforts to promote financial inclusion can lead to defaults and other negative effects. Griffith-Jones and Karwowski (2013) demonstrate that fast credit growth could exacerbate vulnerabilities and enhance the risk of financial crises. More recently, the global financial crisis of 2008-2009 has heightened public awareness of the need for supervision and regulation of individual banks.

Following the financial crisis, many countries are beginning to prioritize financial stability through regulation, and seeking to balance such policy priorities with the promotion of inclusive growth, especially in poor countries. Since the inception of the recent financial crisis, safeguarding financial stability has become increasingly dominant in economic policy discussions. In many cases, reforms have been put in place aimed at building stronger supervisory and regulatory frameworks whilst financial sector policy in general is focused on pursuing growth and development in the context of financial stability, as well as creating inclusive growth to support social stability and equity.

This paper is a case study of Ghana, a small open economy that has sustained decades of first and second-generation reforms since the early 1980s. This study, like the others in this volume, investigates the potential trade-off between financial sector regulation and financial stability in Ghana. The study adopts an analytical approach to identify and analyze the key obstacles or gaps in the financial sector for funding inclusive growth. The paper also explicates why financial stability matters in an increasingly globalized world and the challenges in securing and safeguarding financial stability while pursuing financial inclusion. The paper is organized around these issues. Section 2 analyzes the structure and role of the financial sector in the Ghanaian economy; Section 3 examines issues in financial inclusion in the country; Section 4 discusses access and cost of credit; Section 5 discusses the issues in capital flows and financial stability; Section 6 explains prudential regulations; while Section 7 provides a summary of the issues and conclusions.

2 Structure and role of the financial sector in the Ghanaian economy

2.1 The Financial Sector in Ghana's Economic Development Strategy[1]

The medium-term national development policy framework–*Ghana Shared Growth and Development Agenda 2010–2013* **-** is the over-arching policy framework that provides the broad policy parameters for economic growth and development in Ghana[2]. The policy thrust of Ghana's second medium-term Private Sector Development Strategy (PSDS II) is about developing a thriving private sector that creates jobs and enhances livelihoods for all. The development of a well-functioning financial system to serve the vital purpose by offering savings, payment, credit, and risk management services to individuals and firms is a key policy objective in the development agendas of the State.

Both policy documents have underscored the crucial role of finance for furthering growth, innovation and prosperity in Ghana. Government's financial sector strategies for economic development and poverty reduction revolve around two policy prongs. They are: 1) financial sector policies for long term shared economic growth; and 2) enhanced access (inclusiveness) in the Ghanaian financial sector (MOFEP, 2012).

Finance for Shared Growth

The Government of Ghana recognizes shared economic growth is the surest way to sustained reduction in poverty in the country and that in order to attain shared economic growth there is the need to ensure the availability of medium to long-term financing, deepen the resource mobilization of the banking system, ensure that banks want to and can safely lend these resources, and enable productive formal sector firms to find the mix of equity and debt finance they need to grow, as well as tools for risk management. *"If the provision of mainstream financial services in Ghana is to improve as to quantity and quality, more competition and a greater presence of strong profitable and efficient financial institutions are needed"* (MOFEP 2012:7).

Financial Inclusion

The second policy prong is concerned with improving the access of low-income households and microenterprises to financial services as the focus of financial

[1] This section draws on the Financial Sector Strategic Plan II (FINSSP II) (MOFEP, 2012).

[2] The GSGDA was to be implemented within a four-year term covering the period 2010–2013 (recently completed). A new policy framework has been drafted to cover the period 2014-2017 and it is currently undergoing stakeholder consultations.

sector policy. Thus, Ghana's economic development framework identifies the most pressing needs in Ghana's financial sector are to:

- increase the availability of credit;
- lower the cost of credit to productive enterprises; and
- extend the reach of basic savings, payments, credit, and insurance services for low-income people, the smallholder farmers and microenterprise.

2.2 The Financial Sector in Ghana: Structure, Conduct and Performance

The financial sector of Ghana is dominated by the banking industry. Banks play a critical role in every economy. The banking system, through its intermediation process, reallocates scarce resources from those members of society in surplus (depositors) to those in deficit (borrowers). Typically, banks perform this intermediation role by transforming small liquid deposits into larger illiquid loans. It is said that the intermediation process is efficient when the demands of both depositors and borrowers can be satisfied at low cost, while mobilizing funds for investment that offers the potential to deliver enhanced economic growth (Schinasi, 2006).

Griffith-Jones and Karwowski (2013) have taken the view that financial sectors in Africa can support growth on the continent by mobilising sufficient savings, intermediating savings at low cost and long maturity to investors and consumers and helping companies and individuals manage risks. The efficiency and effectiveness with which the financial sector in Ghana has played these roles in the country has been limited but improving. Effective banking systems expand financing opportunities for both large and micro-enterprises, while also supporting financial sector development.

2.2.1 Structural reforms in the financial sector

The Ghanaian financial sector is largely dominated by banks[3]. The banking industry is fairly saturated, comprising 27 commercial banks (up from 16 in the year 2000), 137 rural and community banks, and 58 non-banking financial institutions including finance houses, savings and loans, leasing and mortgage firms. The Banking (Amendment) Act 2007 provides three categories of banking licenses in Ghana:

- Class I Universal banking license, which allows the holder to transact domestic banking business, previously classified as universal banking license.
- Class II Banking license, which allows the holder to conduct banking business or investment banking business with non-residents and other class II banking license holders in currencies other than the Ghanaian currency except to the extent permitted by the Bank of Ghana for trading on the foreign exchange market of Ghana and investment in money market instruments.
- General banking license, which allows both the Class I and Class II banking business in and from within Ghana.

[3] The insurance market is relatively well developed, with more than 30 companies competing on the market, with a high level of foreign participation. Capital markets have also been developing at a rapid pace.

All the banks in Ghana are Class I Universal banks doing business across all areas of banking.

Ghana's financial system has gone through a process of liberalization, restructuring and transformation over the last two decades. The transformation started as part of the Financial Sector Adjustment Programs (FINSAP I and II), which was implemented from the late 1980s through the mid-1990s. Prior to the banking sector reforms in the 1990s, the banking sector in in Ghana was dominated by state-owned banks with official allocation and pricing of credit and as a consequence, the banking system was uncompetitive and the intermediation process was inefficient. The banking sector was characterized by limited innovation and suitable governance structures. In many cases, credit decisions lacked commercial considerations, resulting in several bank failures. The key focus of the financial reforms was therefore the restructuring of the financially distressed banks, the improvement of the regulatory and supervisory framework, and the promotion of non-bank financial institutions (MOFEP, 2012). There is no gainsaying that the financial sector reforms have yielded many positive dividends. Since the reforms, the financial sector has seen rapid development in terms of growth in number and variety of financial institutions and services. Today, Ghana boasts of a more diversified financial system resulting from the privatization state-owned banks and the increased competition occasioned by the licensing of several new banks, including many foreign ones. In recent years, the Ghanaian banking industry has transformed to accommodate changes in the global and domestic macroeconomic environments, structural and conduct deregulation and prudential regulation, along with technological and financial innovation.

2.2.2 Financial sector stability issues

Financial development requires an enabling environment for it to thrive. The probability that a country will suffer a banking crisis is depends on global factors, contagion factors, and domestic factors (Forbes and Warnock, 2012 and IMF, 2013). The global financial crisis of 2008-2009 and the subsequent U.S. Federal Reserve's "tapering announcement" in May 2013, which contributed to capital outflows from some sub- Saharan African frontier markets and exchange rate depreciations are clear testaments of how imbalances and instabilities in the macroeconomy create instabilities in financial markets and real sector growth slippages. It is, therefore, of utmost importance to keep a watchful eye on risks or threats to stability in the macroeconomic and financial environments before these can metamorphose into a real crisis situation.

Overall, macroeconomic developments in Ghana in 2014 have not been impressive. The Ghanaian economy faces significant macroeconomic challenges in 2014 due, in part, to high and extraordinary fiscal and current account deficits during 2012-2013. This negative outcome reflects weak fundamentals and poor macroeconomic management. In the few years preceding the 2012 general elections, aggregate fiscal discipline became loose, in part, due to the national elections, as government spending had been growing at unsustainable levels. Government undertook excessive fiscal expansions partly financed by foreign borrowing, thereby increasing Ghana's vulnerability to sudden capital flow reversals. Not surprisingly, the year 2013 recorded high deficits in both the fiscal and current accounts in the context of weak foreign reserves. The year 2014 has been extraordinarily difficult for Ghanaians as the Government had to contend with both domestic imbalances, especially in the fiscal area, and severe terms of trade and exchange rate shocks. The growing economic imbalances resulted in heightened financial fragility and uncertain expectations, which led to rapid outflow of capital and increased the probability of a severe crisis as a result of a falling exchange rate and rising interest rate. Partly as a result of rising fiscal deficits, the debt to GDP ratio remained elevated in 2014, as government borrowing has risen rapidly. Government debt has risen past 60 percent of GDP, raising concerns about fiscal sustainability and the risk of debt distress and macroeconomic stability going forward and highlighting the need for fiscal consolidation.

Ghana's current account deficit increased to 13.2% of GDP in 2013, from 12.2% of GDP in 2012. By the end of February 2014, Ghana's net international reserves have also declined significantly, covering less than one month of imports of goods and services. This is in spite of positive capital flows (private debt and FDI in particular). Private capital flows (including FDI) fell as a percent of GDP from 7.4% in 2012 to 6.6%. Foreign direct investment (net) declined by 0.8% of GDP while medium and long term loans declined by 0.4% of GDP in 2013. Net international reserves fell from US$3.2 billion in December 2012 to $2.1 billion by end 2013 and $1.7 billion by January 2014 covering only less than one month of imports of goods, services and factor payments. Headline inflation exceeded the monetary policy target of 9% ±2 for 2013. The consumer price inflation increased from 10.1% in January 2013 to reach 13.5% in December 2013 and 14.0% in February 2014. Inflation has been on the rise since January 2013 and the rising trend is expected to continue due to recent adjustments in prices of petroleum products and utilities, rising prices of imported products due to the depreciation of the Ghanaian Cedi.

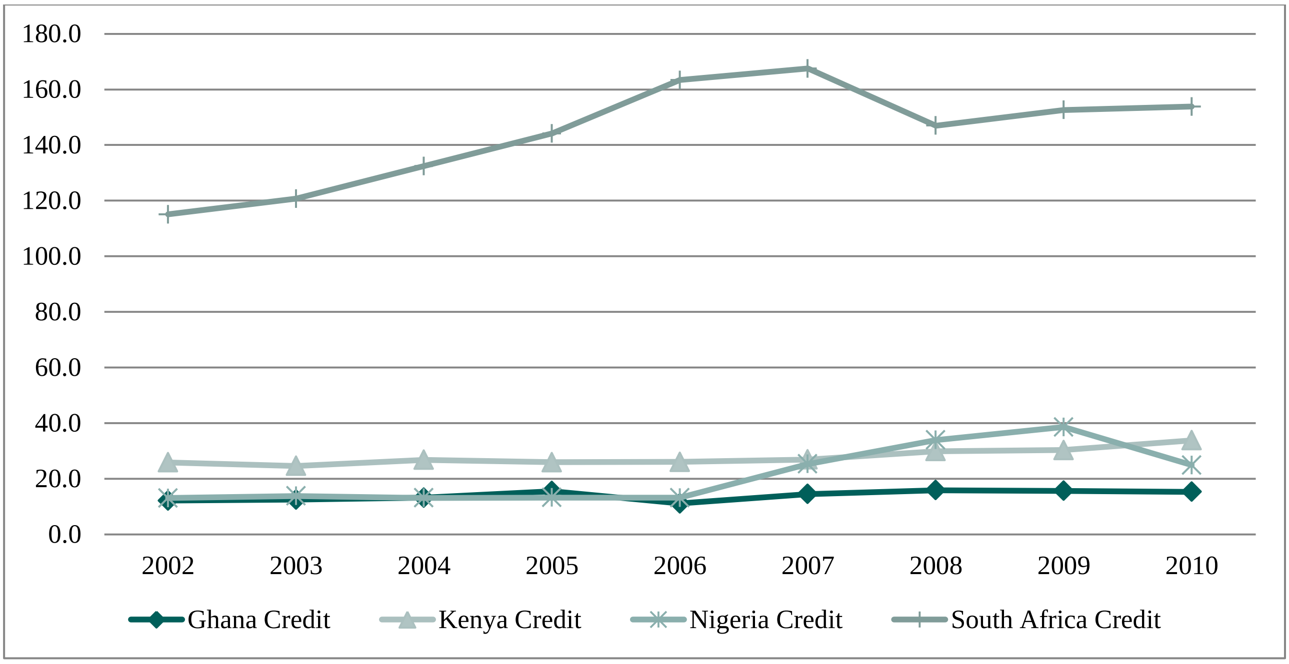
The Central Bank reacted on February 4, 2014 announcing new measures intended to restore stability in the foreign exchange markets. Under the new rules, commercial banks and other financial houses were banned from issuing cheques and cheque books on foreign exchange accounts and foreign currency accounts. The Central Bank also directed that no bank should grant a foreign currency-denominated loan or foreign currency-linked facility to a customer who was not a foreign exchange earner. The central bank also prohibited offshore foreign deals by resident and non-resident companies, including exporters in the country. It also prohibited over-the-counter cash withdrawals from foreign exchange and foreign currency accounts not exceeding US$10,000 or its equivalent in convertible currency per person per travel, and that this should only be permitted for travel purposes outside Ghana. The new measures also provided that all undrawn foreign currency-denominated facilities should be converted into local currency-denominated facilities. These measures were introduced following pressure on the local currency, which depreciated sharply within the first few months of 2014. However, in spite of these measures, the local currency continued to depreciate against all the major foreign currencies. Many policy analysts and the business community found the reaction of the Central Bank somewhat perplexing given that the underlying drivers of the instability were quite not unfamiliar in Ghana's recent economic history. As it became apparent that the measures were not working optimally and the business community continued to express their frustrations about the foreign exchange restrictions, the Central Bank decided to relax some of the restrictions and later had to withdraw them entirely.

Although the Ghanaian Cedi continued to fall after the Central Bank had introduced the exchange rate restrictions – between January and September 2014, the Cedi had fallen by about 40% against the US dollar - the currency has stabilised after the infusion of $2.7 billion into the economy through a US$1 billion Eurobond floatation and $1.7 billion cocoa syndicated loan facility. The government is currently negotiating with the IMF for an economic reform and bailout package. The negotiations have already inspired some confidence in the economy as investors expect that an agreement could help stabilise the economy, which had been growing for the past few years on the back of its export of cocoa, gold and oil.

2.2.3 Financial sector development issues

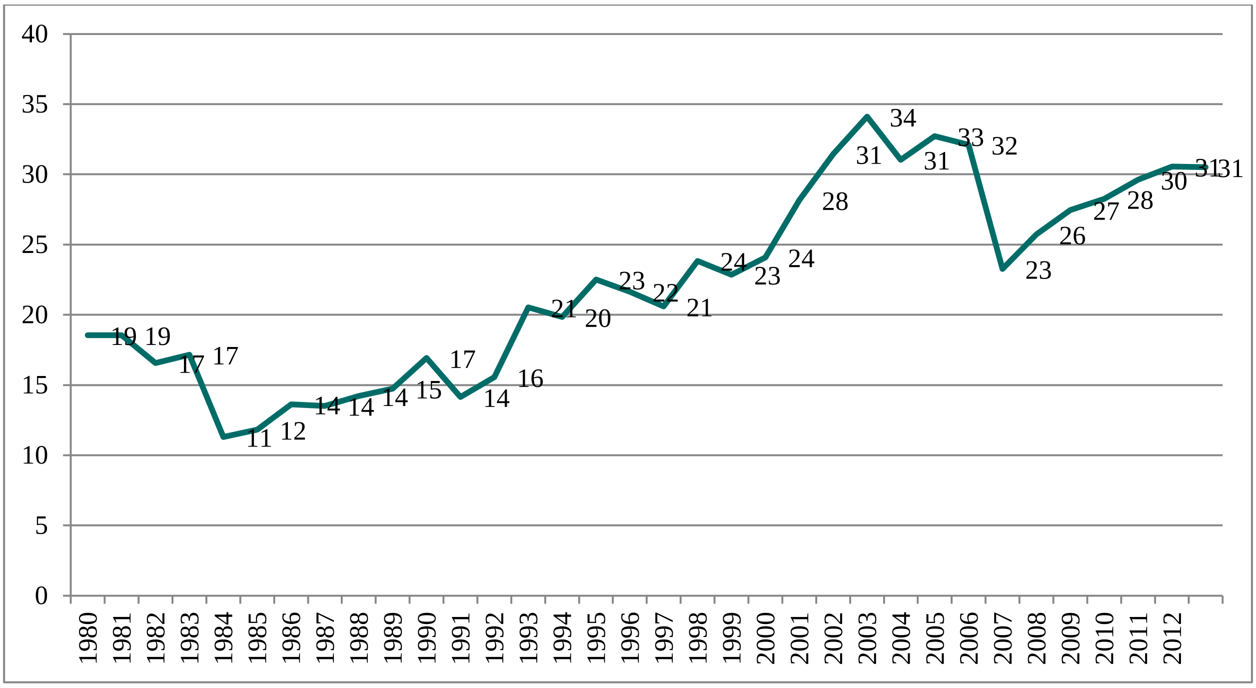
The developments in Ghana's financial sector can be gleaned from the level of financial intermediation and financial deepening. The ratio of private sector credit to GDP and the ratio of broad money (M2) to GDP depict financial depth (Figures 1 and 2). As can be seen, credit provided to the private sector, in relation to the GDP, has significantly increased over time but it is unimpressive when compared with other comparator countries. The rapid expansion of banking activities has resulted in more than 100 percent growth in the banking sector's assets over past two decades. The broad money (M2/GDP) ratio has also shown significant increase over time and reached 32% in 2012 compared to 15% in 1992. One common characteristic of the banking system in Africa is that a large number of banks invest in government securities, primarily treasury bills. This is symptomatic of a highly dysfunctional banking intermediation and it is responsible for the low level of private credit provision that we observe in many African countries (Allen, Otchere and Senbet, 2011).

Figure 1: Trends in Domestic Credit to Private Sector (% GDP)



Source: African Development Indicators 2013

Figure 2: Money Supply (M2 % of GDP)



Source: World Bank, World Development Indicators

Ghana's banking sector in 2013 suggests that the banking industry remained strong in terms of financial soundness indicators such as asset growth, solvency, liquidity and profitability. In contrast to low investment yields of 2 percent in global financial markets, banks in Ghana on average had ROE of over 20 percent and ROAs of over 5 percent (Table 1). This is apparently consistent with the high interest spreads in the industry in Ghana. The Capital Adequacy Ratio (CAR) for the industry as in July 2014 was about 16 percent, beyond the prudential limit of 10 percent (Table 1). Asset penetration, measured as the ratio of total assets to GDP, was 40.5 percent indicating continued deepening of the financial sector in the economy.

Table 1: Profitability Indictors (%)

Item	Jul.-07	Jul.-08	Jul.-09	Jul.-10	Jul.-11	Jul.-12	Jul.-13	Jul.-14
Gross Yield	15.1	15.9	20.0	21.3	9.6	8.7	10.4	12.7
Int. Payable	7.3	6.9	11.0	10.7	3.7	2.8	3.9	4.1
Spread	7.9	9.0	9.0	10.6	5.9	5.8	6.5	8.5
Asset Utilisation	14.5	16.1	20.1	19.5	9.0	8.9	10.1	10.5
Interest Margin to Total Assets	7.0	7.1	7.7	9.3	4.2	4.2	5.2	5.3
Interest Margin to Gross Income	48.3	44.2	38.4	47.7	46.9	46.9	51.3	50.2
Profitability Ratio	15.7	14.5	13.8	12.6	14.8	22.0	22.5	23.7
Return on Assets (%) Before Tax	3.7	3.2	3.3	3.2	3.5	4.6	5.5	6.3
Return on Equity (%) After Tax	24.4	23.0	23.7	19.3	18.1	26.7	27.7	31.4

Source: Bank of Ghana

Table 2: Capital Adequacy Ratio-Industry (%)

Item	Jul.-07	Jul.-08	Jul.-09	Jul.-10	Jul.-11	Jul.-12	Jul.-13	Jul.-14
RWA/Total Assets (RHS)	66.1	77.3	78.3	68.5	65.3	74.4	67.4	70.5
CAR	14.5	14.4	14.7	19.3	17.0	15.5	18.6	16.2
TIER 1 CAR	13.3	13.0	13.0	18.5	15.4	13.6	16.8	14.6

Source: Bank of Ghana

Ghana's impressive record on financial sector development may entail new risks in an environment of high credit growth. They Central Bank has noted that NPLs have increased since 2007, after recording a consistent year-on-year decline from 22.7% in 2002 to as low as 6.4% in 2007 (Table 3). There is a relatively high ratio of non-performing loans (NPL) in Ghana compared to peer countries. The ratio for the industry in Ghana was 12.8 percent in 2013. The Central bank is reportedly taking steps to encourage banks to write-off long outstanding "loss" accounts with 100% provisioning, that otherwise tend to overstate the true NPL ratios. For example, when the loss category was accounted for, the NPL ratio as at June 2013, declined to 4.7 percent, which compares favorably with NPL ratios in other peer countries such as South Africa. The Central bank is therefore focusing on applying provisioning rules on overdraft facilities as well as tackling issues related to the build-up of unclaimed deposit balances or dormant accounts.

Table 3: Bank Non-performing Loans to Total Gross Loans (%)

Year	Ghana	Kenya	Nigeria	South Africa
2002	22.7	18.1	21.4	2.8
2003	18.3	34.9	20.5	2.4
2004	16.3	29.3	21.6	1.8
2005	13.0	25.6	18.1	1.5
2006	7.9	N/A	9.3	1.1
2007	6.4	10.6	9.5	1.4
2008	7.7	9.0	7.2	3.9
2009	16.2	7.9	36.1	5.9
2010	17.6	6.3	20.1	5.8

Source: World Bank, 2013 and MOFEP, 2012

Generally, the year 2013 saw a pickup in threats to Ghana's financial system stemming from both external and domestic sources. Threats to stability from external sources related mainly to increased global financial market volatility on the back of the US Fed's perceived indication to end its accommodative monetary policy by tapering bond purchases. Exchange rates adjusted sharply towards the end of 2013 as the rate of depreciation recorded 14.7 percent for the year 2013. In early 2014, there was additional pressure on the exchange rate following the announcement of new reform measures in the foreign exchange markets. Hence, the Ghana Cedi depreciated by more than 17.6 percent during the first quarter of 2014 compared to a mere 1.1 percent during the corresponding period in 2013. The other main threats to the outlook include a global economic downturn or a further deceleration of growth in major emerging markets, which could weaken exports through lower commodity prices or reduce inflows of aid and FDI with dire consequences for planned or ongoing resource development projects in Ghana. Continued lower global commodity prices will also weaken current account balances and put pressure on the domestic currency with its attendant destabilizing consequences for financial stability.

The latest stress tests conducted by the Bank of Ghana showed that banks in Ghana could remain solvent should the risks from the global financial markets, especially the Euro area, crystallize. However, a simultaneous failure of banks in UK and the rest of the world, including Pan-African banks, could pose significant risks to the financial system.

The upside risks to financial stability in 2014 is expected to emanate mainly from:

- Continued depreciation of the Cedi,
- Slowdown in the pace of economic activity
- Upward trend in inflation
- Fiscal challenges, and
- The high, but declining, non-performing loans which continues to pose significant challenges to the banking industry

According to the Central bank, measures taken to contain threats to the system included maintaining a tight monetary policy stance by increasing the monetary policy rate by 100bps in the first half of 2013 and enforcement of earlier measures introduced to deal with the sharp depreciation of the Cedi in 2012. These measures were mainly macro-prudential and included reduction in the Net Open Positions (NOPs) of banks, a requirement for banks to keep statutory reserves in Cedis only and a 100 per cent reserve cover for VOSTRO balances to be maintained at the central bank.

Further measures to consolidate financial stability included adoption of risk-based supervision and regulatory participation in regional financial stability bodies aimed at sharing experiences with a view to reducing cross-border contagion. Also, efforts have been intensified to formalize the operations of microfinance institutions in the country in order to induce some discipline in the activities of such institutions to reduce the threat the proliferation of such institutions pose to the system.

2.2.4 The Role of Domestic and Foreign Banks

The banking system in Ghana consists of the Central Bank and deposit taking institutions. The Central Bank is technically independent of government control, but in practice it works closely with the Ministry of Finance and help formulate and implement macroeconomic policies of the government. The deposit taking institutions are made up of local banks and branches or subsidiaries of foreign banks. Foreign banks have played an important role in banking development in Ghana; their share of total banking assets has increased significantly.

The Ghanaian banking sector has a high foreign dominance, with 15 out of the 27 commercial banks (over 50%) in the sector having foreign majority equity, most of them originating from Nigeria (Table 4). Six out of the fifteen foreign banks are African banks, accounting for about a third of total banking assets in Ghana. The recent expansion of pan-African banks in West Africa is contributing to stronger competition and financial deepening. But it has also increased risks. Financial distress in one country can spill over more easily to other countries when markets are integrated; and more complex financial linkages and exposures across markets can strain the monitoring ability of supervision agencies. In this context, effective supervision becomes both, more important and more difficult.

There are ongoing efforts at promoting financial integration in West Africa, and this effort includes strengthening of financial sector regulation and supervision.

There is, however, the need to further strengthen effective mechanisms for cross-border cooperation in particular, information sharing, and crisis management. One major lesson that the global financial crisis has provided is the importance of regional cooperation, regional policy dialogue and harmonization of financial sector supervision.

Table 4: Domestic and Foreign Banks

GH¢ Mil	Domestic (11)		Foreign (15)			
			Others		*Of which: Pan-African (6)*	
	Bank	Total Assets	Bank	Total Assets	Bank	Total Assets
1	GCB	3,135.60	BBG	2,792.91	ABL	849.75
2	ADB	1,458.95	BOB	134.42	BOA	600.77
3	NIB	910.33	BSIC	189.08	ECO	3,953.02
4	MBG	832.92	EB	186.47	FAB	373.34
5	CAL	1,435.37	ICB	304.93	GTB	748.31
6	TRB	189.92	SG	1,056.66	SBG	2,842.73
7	UTB	1,189.13	SCB	3,491.60	UBA	1,401.73
8	PBL	782.28			ZBG	1,654.24
9	UBG	1,146.43				
10	HFC	764.51				
11	FBL	1,491.68				
Sub-total		*13,337.12*		*8,156.07*		*12,423.89*
Grand Total						33,917.07

Source: Bank of Ghana

In Ghana, sustained financial sector restructuring and transformation has succeeded in creating one of the most vibrant financial services centres in the sub region. The liberalization of the sector coupled with the introduction of “universal banking” in 2003 led to an influx of foreign banks and investors, mostly leading brands from Nigeria, South Africa and beyond. Certainly, these investments were apparently driven by good economic policies and profit opportunities as well as prudential banking supervision, rather than market size.

Looking back, the entry of foreign banks and investors into the financial services industry has increased competition in the banking industry as well as the introduction of strong business practices, technology, products and risk management systems, and has given impetus to dynamic efficiency in the industry. Traditional domestic private banks have also held their own, and grown particularly fast, as they accounted for 22 percent of assets as at the end of 2012 compared with only 12 percent in 2005.

Table 5: Performance of Domestic and Foreign Banks in Ghana

Year	Foreign Banks	Local Banks	Local Private Banks	All Banks
		Income Cost Ratio (efficiency ratio)		
2012	0.49	0.62	0.63	0.5
2011	0.53	0.70	0.65	0.6
2010	0.62	0.76	0.65	0.6
2009	0.79	0.76	0.84	0.6
		Return on Assets (%)		
2012	4.38	2.18	2.20	3.5
2011	2.98	1.24	1.59	2.4
2010	2.70	1.24	1.73	2.3
2009	2.18	0.49	0.70	1.4

Source: PWC, 2013

The Bank of Ghana has currently embarked on an upgrading of financial sector legislation and supervisory practices to deal with the growing complexities of an evolving financial landscape with increased foreign participation and a growing role of microfinance institutions. The resolve is to continue to pursue financial sector development, focusing on enhancing depth, access, efficiency and stability.

In sum, while the opening up of the banking industry to national, pan-regional and foreign banks could be a key contributor to the development of the country, nonetheless, efforts must be intensified to create the appropriate regional regulatory framework to encourage more financial integration while stemming the inherent risks. This calls for the coordination of financial regulation, through information sharing about systemically important institutions, applying common rules across jurisdictions, and creating a common level field. There should also be common enforcement through shared cross-border regulatory and supervisory agencies.

3 Issues in financial inclusion

There is a growing recognition of the importance of financial inclusion for economic and social development. This stems from a common understanding that access to financial services has a critical role in reducing poverty, boosting shared prosperity, and supporting inclusive and sustainable development (IMF 2014, GFDR). Considerable evidence abound that indicate that the poor benefit enormously from access to basic financial services such as payments, savings, and insurance services. However, while financial inclusion has important benefits, boosting financial inclusion is not trivial. If care is not taken, efforts to promote financial inclusion can lead to defaults and other negative effects. The global financial crisis, precipitated by the subprime mortgage crisis in the United States in the 2000s, indicates that things can get out of hand, especially if credit starts growing rapidly[4].The lessons from the global financial crisis is that extending access to finance without proper safeguards can have severely negative implications both for consumers and for financial stability. Thus, the promotion of credit without sufficient regard for financial stability is likely to result in a crisis.

A competitive and efficient financial sector is a prerequisite for economic development and growth especially in developing countries. According to Claessens et al. (2004), competition in the financial sector is important since it affects the efficiency of production of financial services, the quality of financial products and the degree of innovation in the sector. They argue that the degree of competition in the financial sector can affect the access of firms and households to financial services which in turn influences overall economic growth. Thus greater competition in financial sector lowers cost of intermediation. Further, Besanko and Thakor (1992) also find that more competitive banking system leads to higher growth rates.

According to the Alliance of Financial Inclusion (AFI), financial inclusion refers to all initiatives that make formal financial services available, accessible and affordable to all segments of the population. Particular attention should be directed to the segment of population that have been historically excluded from the formal financial sector due their peculiar characteristics, regarding their income level and volatility, gender, location, type of activity and level of financial literacy. In general, the concept of financial inclusion goes beyond improved access to credit to include improved access to savings and risk mitigation products, a well-functioning financial infrastructure that allows individuals and companies to engage more actively in the economy, while protecting consumer’s rights.

[4] The key contributing factors responsible for the crisis included the overextension of credit to non-creditworthy borrowers and relaxation in mortgage-underwriting standards (IMF 2014).

The AFI suggests a three dimensional framework for accessing financial inclusive which borders on access, usage and quality of financial services available to users. It is in these areas that the work done under the FinScope Ghana 2010 survey comes in handy. The survey aimed at establishing credible benchmarks and indicators of access, provide insights into regulatory and market obstacles to growth and innovation and highlight opportunities for policy reform and innovation in product development and delivery.

According to the survey, access to financial services in Ghana is higher in urban areas than in rural areas since urban areas are generally equipped with infrastructure that support services including financial services. Besides, the level of literacy beyond secondary education is quite appreciable, constituting more than half of the population with less than 25 percent with no formal education at all. Prominent among the factors cited for influencing how people interact with financial services are, access to amenities, infrastructure and wealth profiles. People whose livelihoods are constrained by access to basic amenities rarely prioritize usage of financial services, since their primary focus is on survival issues. The survey revealed that a significant proportion of Ghanaians aged 15 years or more do not have access to basic amenities. The divergence in terms of the lack of access to social amenities is more pronounced in the rural areas. It also came out the only 12 percent of Ghanaian adults earn most of their income in the form of wages and salaries. The formal financial institutions tend to target these groups due to the regularity and less volatile nature of their sources of income. The bulk of adults from both the rural and urban sectors earn their income on an irregular and inconsistent basis. In the rural area, most incomes are generated through farming and from running own business, whereas in urban areas self-employment and remittance from a household member.

In terms of usage of financial services, the survey revealed that about 44 percent of Ghanaian adults do not use any form of financial product or mechanism (be it formal or informal) to manage their financial lives. Some 40 percent use formal financial services and about 29.4 percent use informal financial services. The proportion of the population that makes use of informal products and services demonstrate the significance of the informal sector in Ghana. Within the formal sector, the banks play a more dominant role than the non-bank formal financial institutions. Some 34 percent of Ghanaian adults have a bank account, and about 20 percent use products from non-bank financial institutions according to the survey results. In addition, about 73.1 percent of Ghanaian adults claim that none of the income they receive passes through a bank account. The proportion of adults who received all their income as cash was 60.6 percent in urban areas and 82.0 percent in rural areas. In fact most Ghanaians, both in the rural and urban areas prefer to receive their income in cash, and the evidence suggests low financial literacy especially in rural areas even though anecdotal evidence suggests that access to financial services will enhance their welfare. The FinScope survey 2010 findings illustrate the interwoven nature of the link between people’s livelihoods and the extent to which they engage with the financial system.

4 Access and cost of credit

That the cost of credit is generally high in Ghana is a well-known cliché. In fact, the cost of credit is placed high in the World Competitive Index Reports and Surveys by the Ghana Association of Industries among the obstacles to doing business in Ghana and it is considered to be a major impediment to investment and economic growth. If high prices exclude large parts of the population, this may be a symptom of underdeveloped physical or institutional infrastructure, regulatory barriers, or lack of competition (IMF, 2014; GFDR).

High interest rate spreads and low credit availability to the private sector have been persistent problems in Ghanaian banking in spite of recent financial sector reforms. Ghanaian businesses have moaned incessantly over the past few years about how high interest rates are squeezing the life out of the enterprises. The financial reform process in Ghana resulted in changes in the structure of the banking sector and triggered the elimination of the regime characterized by official controls to a market-based regime. In spite of the positive results of these reforms, the interest rate spread remains excessively and persistently high. As a consequence, credit availability to the private sector remains limited.

Several studies of bank spreads have examined the determinants of spreads in the banking systems of developing countries.[5] They found several variables to be correlated with higher spreads, including: a lack of adequate competition in the banking industry; high inflation; high fixed and operating costs; perceived market risk; and the existence of regulatory constraints. In any case, the persistence of wide interest rate spreads should be cause for concern for *policymakers because such spreads could be symptomatic of a number of systemic problems.*

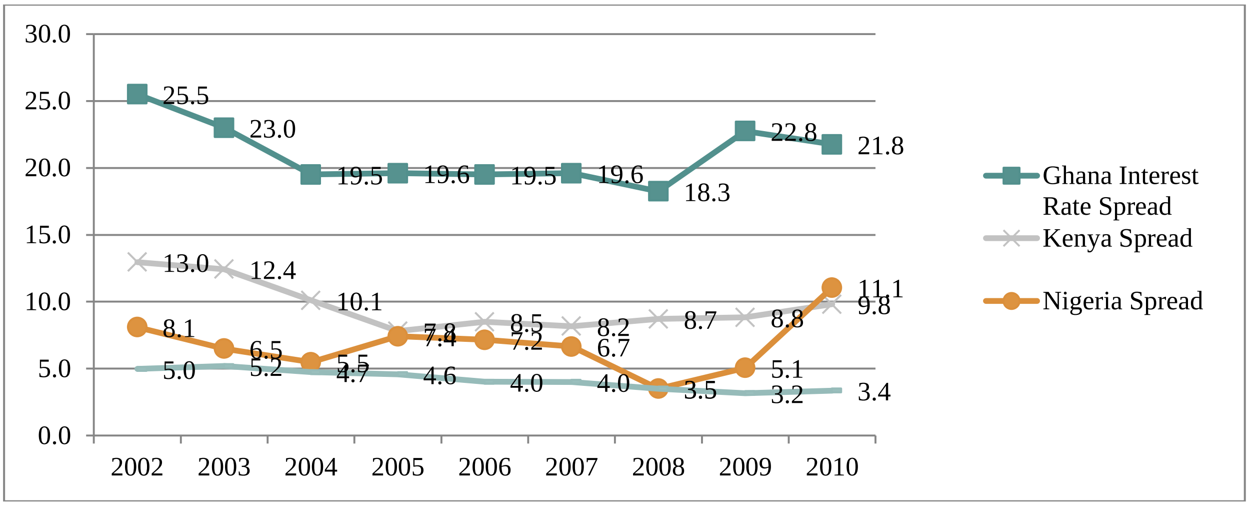
Interest rate spread, difference between the rate of interest banks pay savers and the one they charge borrowers, is often taken as a measure of banking efficiency or inefficiency. The literature shows that wide spreads can be inimical to economic growth as they are associated with credit rationing and thus contribute to financial disintermediation (see Williamson, 1987). Wide spreads are generally thought to reflect inefficient financial service provision. When the spread is too high, it does not only discourage potential savers with low returns but also impedes credit expansion because of high lending rates.

Figure 3 reviews the trends in interest rate spreads for Ghana and three comparator African nations - Nigeria, South Africa, Kenya. The data indicates that in all the years under review, Ghana’s interest rate spread far exceeded that of the three African countries; South Africa reported the lowest spread. Indeed, it is reported that Ghana has the highest lending rates in Africa and one of the highest in the world. In spite of growth in the number of banks in the industry, banks continue to charge high interest rates far above the policy rate. Also, the spread between the

[5] See Demirgu, Kunt, and Huizinga (1999).

lending and deposit rates continues to be overly high. Competition in the banking sector appears to be weak. Ghanaian banks incur high overhead costs and their pre-tax returns on assets and equity are among the highest in sub-Saharan Africa due to their wide interest margins. A competitive market is designed to be more efficient; firms are required to operate at the minimum cost of production, which will then lead to a manageable interest rate spread. However, this has not been the case of Ghana's banking sector over the past two decades. The rigidity of the country's interest rate spread over time signals the weakness of monetary policy, which is expected to influence both deposit and lending rates.

Figure 3: Trends in Interest rate Spread (%)



Source: African Development Indicators 2013

5 Issues in capital flows and financial stability

On the whole, capital flows provide many benefits to recipient economies. Foreign resources complement domestic savings in financing investment and also contribute to the development of domestic financial markets. Developing countries are characterized by persistent current account balance of payments deficits (see Table 6 for an example – Ghana).

Table 6: Current Account Balance

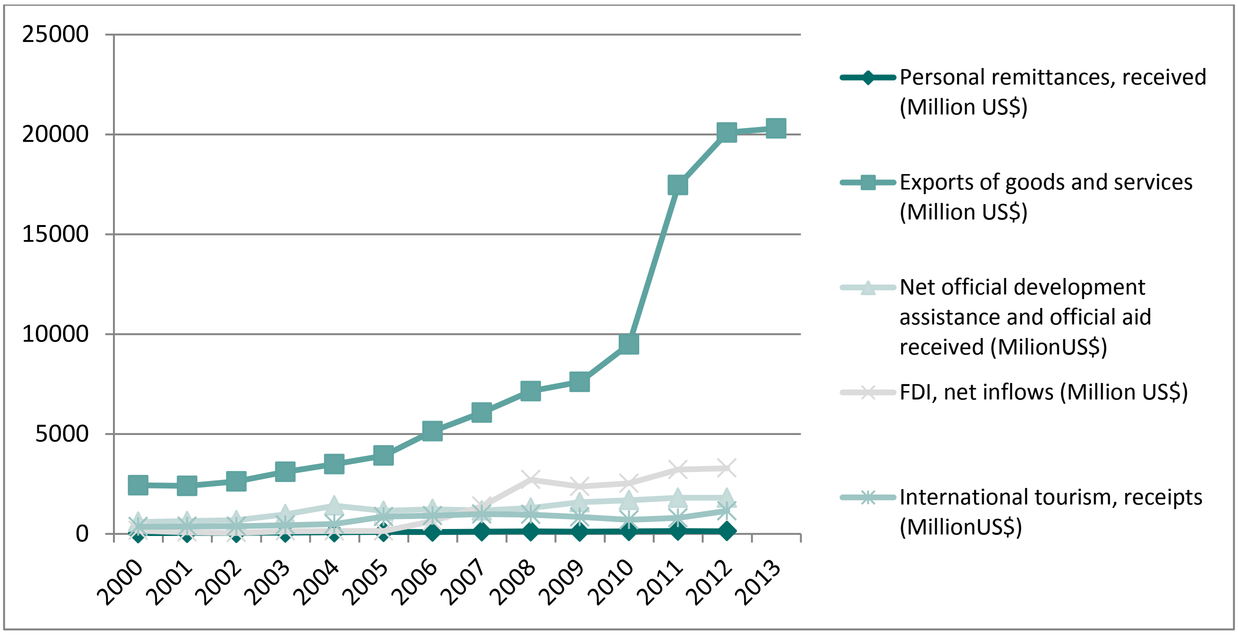
Year	Current account balance (BoP, Million US$)	Current account balance (% of GDP)
2005	-1104.6	-10.3
2006	-1056.1	-5.2
2007	-2378.8	-9.6
2008	-3327.4	-11.7
2009	-1897.2	-7.3
2010	-2747.3	-8.5
2011	-3503.9	-8.9
2012	-4777.5	-11.4

Source: World Bank

There are a number of alternatives policy options for dealing with current account balance of payments deficits. One way of dealing with these imbalances is the decumulation of international reserves as a means of financing such deficits. However, given that in most instances reserves are already meager, it makes such an option unsustainable in the medium to long term. Inflows of capital, in the form of either foreign aid or private capital, have become an alternative to many emerging economies. Despite the apparent benefits of capital inflows, however, the magnitude and speed of such flows to emerging economies could pose significant risks. In particular, there have been concerns about emerging economies' vulnerability to a sudden reversal in capital flows and the resulting implications for financial stability and economic activity.

The increased access to external financing led to substantial capital flows to Ghana from the second half of 2007 onwards. Foreign aid constitutes an important source of development finance in Ghana. As with many other aid recipient countries, Ghana gets aid in the form of budgetary and project support. In Ghana, both the level and proportion of aid (% of GNI) has increased from the levels in the early 1990s. Net ODA increased from under US$300 million in 1990 to peak at about US$928 million in 2004. It decreased over the 2005-06 period (when Ghana was undergoing the HIPC initiative) but has since increased, and reached about US$820 million in 2009 (Figure 4). The Aid to GNI ratio has followed a similar trend although it is less pronounced. The Aid/GNI ratio increased from about 4.6 per cent in 1990 to a peak of about 10.7 per cent in 2004 but fell to about 5.4 per cent in 2009. The ratio has fallen consistently since 2009 to 4.9 percent in 2012, even though in nominal terms, net ODA flows have continued to increase.

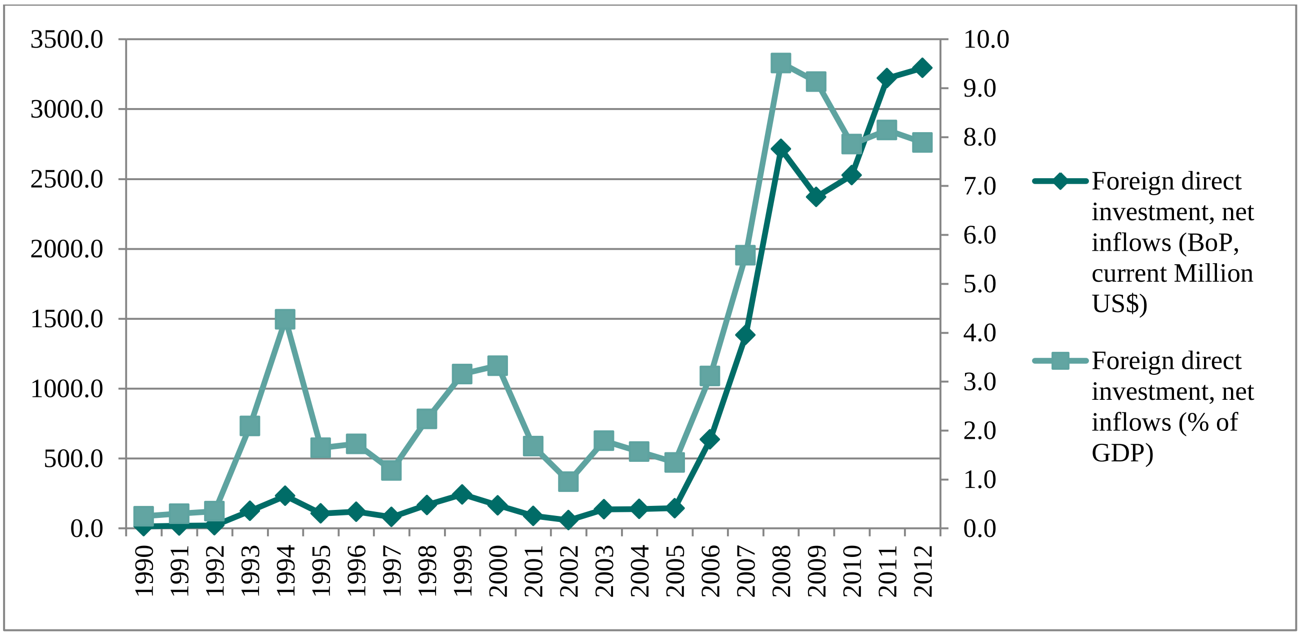
Figure 4: Sources of Capital Flows to Ghana (million US$)



Source: World Bank, World Development Indicator

Capital flows in the form of foreign direct investment (FDI) and portfolio investment have also assumed some prominence over the years. Indeed, total private capital flows, consisting of FDI and other private capital, has increased since 2000 (Figure 5). From the 2000 level of about US$630 million total private capital peaked at about US$2.25 billion in 2007 before reducing marginally to reach the 2009 level of about US$2.08 billion. Undoubtedly (FDI) is increasingly becoming an important component of total private capital flows, particularly since 2006. Before then private inward remittances accounted for the biggest share of private capital flows to Ghana. For the non-FDI component of private capital flows, the improvements in the political climate plus the growth of the world economy may help explain this increase. FDI to Ghana is dominated by the resource-seeking type and so the increases observed from about 2006 would have been accounted for largely by the mining sector. Of course the favourable political and economic climate has helped in maintaining the momentum of the FDI inflows into the country.

Figure 5: Contribution of FDI to Ghana's GDP



Source: Word Development Indicators and Bank of Ghana

6 Issues in prudential regulation

Bank failures create serious negative externalities that ultimately lead to a loss of confidence in the financial system. This creates the need for the supervision and regulation of individual banks. Regulation could take the form of structural, conduct and prudential. Structural regulation tends to make entry into banking markets difficult, allowing incumbent banks the opportunity to exercise market power. Structural regulation measures might include the functional separation of banks into different activities (for example, the separation of commercial banking from investment banking), or the creation of entry barriers through minimum capital requirements or restrictions on the types of business banks are allowed to transact. Conduct regulation seeks to regulate the strategic or operational policies or decision of banks. Feasible conduct regulation measures might include imposing controls on the level of interest rates, the volume of loans granted, or the expansion of branch networks. Prudential regulation, on the other hand, seeks to safeguard the stability of banks and protect consumer interests. Possible prudential regulation measures might include provisions for the central bank to act as lender-of-last-resort.

Regulation can help The Bank of Ghana is directly in charge of regulating and monitoring the banking sector. The Bank of Ghana serves as a lender of last resort to all banks irrespective of ownership. Thankfully, Ghana does not yet have too much to worry about systemically important globally active too big to fail banks and financial institutions. Nevertheless, the central bank is quite active in building up supervisory capabilities of early identification and addressing of any incipient systemic risks. Routine stress test exercises are mandatory for banks to identify vulnerabilities.

The regulatory and legal regime in Ghana has evolved over the years to meet the changing structure of the Ghanaian banking industry as well as the risk levels associated with the pace of expansion. These prudential regulations relating to banking and non-banking financial business aim at achieving a sound and efficient banking system in the interest of depositors and other customers of these institutions and the economy as a whole. In line with the Bank's objective of ensuring the safety, soundness and stability of the entire financial system, the Bank in January 2011, set up a microfinance office within the Banking Supervision department to regulate and supervise microfinance institutions in the country. In July 2011, the Bank issued operating rules and guidelines on microfinance for the information of the general public and for compliance by operators in the microfinance sub-sector with the view to sanitizing their operations and safeguard the interest of their patrons. The rules and guidelines dealt with categorization of microfinance institutions into tiers, defined permissible activities, stipulated minimum paid-up capital and other licensing requirements.

In recent times, the Bank of Ghana has reviewed upwards the minimum capital required for commercial banks to operate in the country to GH¢120 million from the 60 million Cedis it set previously. The bank has also reviewed upwards new capital requirements for other financial institutions. Savings and Loans companies will now be required to have GH¢15 million Cedis as their new minimum capital from the GH¢7 million required earlier. The Rural and Community banks are now required to have a minimum capital of GH¢300, 000 up from GH¢150, 000 previously.

These prudential and legal regulatory reforms over the years coupled with upgrading the skills and competences of the supervisory staff have ensured that the Ghanaian banking system continue to be sound, well-liquid and adequately capitalized. This notwithstanding, there remain significant counterparty risks as well as cross-border risks resulting from integration of the financial markets in the sub region as a result of the expansion of regional banks with Nigerian origin. Ghana has already adopted risk based Basel II capital adequacy regime and preparatory work for adoption of the revised Basel III version including its liquidity coverage standards are in progress.

7 Summary and conclusion

Ghana's economy is experiencing some severe short term pressures in the form of fiscal and current account deficits that have exacerbated pressures on the local currency and inflation. Conditions were broadly challenging in 2013 and worsened in 2014, with continued volatility in the prices of Ghana's major export commodities – cocoa and gold. Interestingly, the situation was not directly caused by US tapering and capital flow reversals, as one would expect. The impact of the tapering was indirectly felt through increased commodity price volatility, even though the medium term outlook remains strong with expectations of the start of the gas infrastructure project and the solution of the energy crisis that had plagued the country. The international prices of cocoa and gold are also recovering, and hence the downside risks to economic growth in the medium terms are rather limited.

The pace of financial sector development has been strong and the sector continues to attract a lot of foreign direct investment, especially from other regional banks. The Central bank has therefore continued to fine-tune its regulatory regime to stem cross-border risks to the financial sector, while providing room for the financial sector to thrive and play its expected role in enhancing economic growth and development. So, far there is little evidence of a trade-off between regulation on the one hand and economic growth and development on the other.

In Ghana, sustained financial sector restructuring and transformation has succeeded in creating one of the most vibrant financial services centers in the sub region. The liberalization of the sector coupled with the introduction of "universal banking" in 2003 led to an influx of foreign banks and investors, mostly leading brands from Nigeria, South Africa and beyond. Certainly, these investments were apparently driven by good economic policies and profit opportunities as well as prudential banking supervision, rather than market size.

Ghana has therefore seen a significant increase in the number of banks, including pan-African groups, with a rapidly expanding deposit base. As a dynamic economy with regional importance and large infrastructural needs, Ghana can greatly benefit from, and contribute to, regional financial integration. Currently, Ghana is home to 27 banks, of which 15 are foreign owned and six are African banks. The assets of the latter represent more than a third of total assets in Ghana, testimony of growing regional integration, on the back of a rapidly expanding industry.

The dynamic expansion of pan-African banks in West Africa has contributed to stronger competition and financial deepening. But it has also increased risks. Financial distress in one country can spill over more easily to other countries when markets are integrated; and more complex financial linkages and exposures across markets can strain the monitoring ability of supervision agencies. In this context, effective supervision becomes both, more important and more difficult.

Looking back, the entry of foreign banks and investors into the financial services industry in Ghana has increased competition in the banking industry as well as the introduction of strong business practices, technology, products and risk management systems, and has given impetus to dynamic efficiency in the industry. However, the fact that foreign banks account for nearly 60 percent of total assets of the banking industry (about 25 percent by Nigerian banks) is worrisome, as it poses cross-border risks to the banking system. This notwithstanding, domestic banks have also held their own, and grown particularly fast, as they accounted for 39.3 percent of assets as at the end of 2013 compared with only 12 percent in 2005.

However, a number of cross-cutting challenges remain, including access to credit by the private sector and the high cost of credit, which tends to militate against small-scale businesses. While the authorities have continued to work on these challenges, current macroeconomic challenges continue to hamper efforts to lower the cost of credit and to expand access to credit for most small-scale businesses.

On prudential regulation, the Central Bank has been proactive in reforming the banking system, and has reviewed upwards again the minimum capital required for commercial banks to operate in the country to GH¢120 million from the 60 million Cedis it set previously. The bank has also reviewed upwards new capital requirements for other financial institutions such as Savings and Loans companies which will now be required to have GH¢15 million Cedis as their new minimum capital from the GH¢7 million required earlier. The Rural and Community banks are also now required to have a minimum capital of GH¢300, 000 up from GH¢150, 000 previously. The Central Bank has also set itself to enhance the institutional infrastructure for prudential regulation, such as the establishment of a Deposit Insurance scheme and also an orderly framework for dealing with problem banks in the future, among others. These prudential and legal regulatory reforms over the years coupled with upgrading the skills and competences of the supervisory staff have ensured that the Ghanaian banking system continues to be sound, well-liquid and adequately capitalized. This notwithstanding, there remain significant counterparty risks as well as cross-border risks resulting from increasing integration of the financial markets in the sub region as a result of the expansion of regional banks, particularly those with Nigerian origin

On access and cost of credit, it is true that spreads in Ghana are rather pronounced even though there is no published data on the variable. Lending rates are in the region of 30 percent and above while savings deposit rates hardly get to 8 percent per annum. Ghanaian banks are notoriously the most profitable in the sub region. This suggests there is a role for government or regulatory intervention to promote competition and prevent abuse of market power. There may be a good case for considering the introduction of competition (antitrust) and consumer protection laws to protect consumer welfare. Whereas banks often attribute the high lending interest rates to rigidities in their funding costs, particularly related to banks' term deposit liabilities, there are also instances where particular subsidized funds that are to be administered by these banks for the benefit of small and medium scale enterprises are also priced as regular loans. These effectively frustrates government efforts to enhance access to finance for the benefit of the vulnerable and the excluded, who have no options other than to go to money lenders who also quote extremely high rates. Fortunately, the Exports Development and Agricultural Investment Fund (EDAIF) has been restructured and will now take equity participation in particular projects as well as administer some of the government schemes intended to reach the financially excluded. It is hoped that EDAIF will succeed in this regard and thereby introduce another modality in the delivery and enhancement of access to credit for the benefit of the vulnerable.

Finally, on the management of capital flows, Ghana continues to attract significant amounts of flows including ODA, foreign direct investment, and portfolio flows among others. While such openness could have clear benefits in helping to fill the resource gap, there are potential risks particularly from sudden stops and capital flow reversals that one must be mindful about. The phenomenon of increasing financial integration in the sub region and the high interest shown in investing in Ghana's banking sector could raise cross-border risks that could crystallize in the absence of effective regulation. It is however positive to note that the Central bank is engaging with other supervisory authorities in regional countries for information sharing and collaboration to stem such potential risks. Also, the Central bank has confirmed that the US tapering has not resulted in significant outflows yet. The Central bank argues that investors are probably considering the strong medium term prospects of the country and hence remain comfortable with holding their investments. This notwithstanding, the continued depreciation of the local currency should be of concern because investors would be compelled to act when the local currency depreciation cross a particular threshold that could jeopardize their investments.

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