Growth Research Programme

A stable and inclusive financial sector for low-income countries

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This brief summarises and sets in context the results of the DEGRP-funded research project '[Financial regulation in low-income countries: balancing inclusive growth with financial stability](#).' With a focus on African low-income countries (LICs), the project examined how countries can structure and regulate their financial systems to achieve both inclusive growth and financial stability.

The project was led by Professor Stephany Griffith-Jones from the Overseas Development Institute (ODI) and Columbia University in collaboration with researchers from the Institute of Development Studies (IDS), the Overseas Development Institute (ODI), United Nations Conference on Trade and Development (UNCTAD), University of Nairobi, University of Ghana's Institute of Statistical, Social and Economic Research (ISSER), and the Ethiopian Development Research Institute (EDRI).

Key messages:

1. Compared with countries at higher levels of income, finance is scarcer in LICs and more expensive, mainly due to excessively high interest rate spreads.

2. The global financial crisis demonstrated that more finance is not always better. It is particularly important to avoid rapid increases in credit, and real estate booms.

3. Financial diversification contributes to both inclusive growth and stability; it reduces systemic risks, serves the needs of customers better and introduces healthy competition.

4. Public development banks can help to support the process of structural transformation through, for example, financing infrastructure and SMEs.

The issue: sustained and inclusive growth in low-income countries

Financial exclusion remains the norm for most people. Worldwide, approximately 2.5 billion people do not have a formal bank account and financial access remains a challenge (Demirgüç-Kunt et al., 2012). In addition, policy-makers, central bankers and financial regulators have always faced major conceptual and institutional challenges in trying to find the right balance between financial stability, financial access, growth and equity.

Where there has been economic growth, there are concerns about whether this growth is inclusive. There are also concerns about whether such growth can be sustained in the long term (McMillan et al., 2017). The wider global economy continues to grow at a slower pace than before the 2008-2009 financial crisis and commodity prices also remain lower. Financial crises small and large continue to emerge (for example, most recently in Turkey and Argentina), and there is risk of contagion. In recent years, financial conditions for African LIC governments to borrow internationally have significantly tightened.

Sub-Saharan Africa has seen strong growth in many economies, but this growth has not been inclusive (McMillan et al., 2017; ACET, 2014; UNECA, 2011). A strong and functioning financial sector is critical to remedy this issue: a robust financial system can help to support transformation of economies, to make them more inclusive for all, and more resilient to economic and financial crises.

The DEGRP research

Aims

The DEGRP project investigated the relationship between financial sector regulation and financial sector structure with the aim of understanding how this relationship shapes financial stability and inclusive growth in African low-income countries (LICs). The project predominantly focused on four key countries (and also included middle-income countries with lessons for LICs): Kenya, Nigeria, Ethiopia, and Ghana.

More specifically, the research explored:

What scale, and what pace of growth are desirable in a country's financial sector. This included asking what the most appropriate level and composition of capital inflows is to maximise inclusive growth, while ensuring stability and promoting equal income, and exploring how capital account management influences the pattern of capital inflows.

How domestic financial regulation varies in countries with different economic and financial structures, and how it influences financial structures and behaviour, and more broadly wider financial and macro-stability and inclusive growth. This involved analysis of what forms of domestic and international regulation in LICs, such as Basel III, are most likely to achieve the optimal balance between stability and growth. It also included analysis of what types of financial regulation and capital account management are most likely to realise these aims, especially in countries that face informational, administrative, and capacity constraints, such as many LICs.

Methods

The team carried out a series of systematic and in-depth reviews to provide background for the research and to benchmark their findings. These examined the relationships between domestic financial structures and financial regulation, domestic and international financial regulations, and their implications for inclusive growth and stability.

The reviews were complemented by in-depth country case studies led by senior African researchers, who also had important policy experience. As well as analysing data from central banks on the lending and performance of commercial banks, the team carried out a series of interviews with key stakeholders in various LICs. They also consulted with a range of stakeholders at each stage of the research to increase engagement with their research. These included LIC policy-makers, world class academics such as Nobel laureate Joseph Stiglitz, and donor agencies such as the UN, Japan International Cooperation Agency and DFID.

Findings and recommendations

1. **Credit is often unavailable and expensive**

   Compared with countries with higher levels of income, credit is less available in LICs, but it is also more expensive and has shorter maturities. The research found that while LIC banks are generally well capitalised and very profitable, they are charging their clients' excessive interest rate spreads. Though the number of banks has increased significantly in recent years, in countries like Ghana spreads have hardly fallen. Credit is therefore very expensive for borrowers, which is problematic for economic growth and transformation into high productivity activities.

A further challenge noted in the research is that bank credit is available mainly to those seeking short-term loans (consumer credit and working capital) or to the government. It is not as available to small- and medium-sized enterprises (SME), or long-term finance which can fund infrastructure needed for economic transformation and development more broadly.

On the positive side, capital adequacy (the minimum equity which banks must have available) in case study countries was far above the required Basel III level. This helps financial stability.

2. Better finance is needed

Given these barriers to accessing credit, there is a need for better access to credit and increased provision of long-term finance for investment in sectors such as infrastructure, agriculture and manufacturing. This is particularly important when the economy is doing poorly; during these times it becomes very hard to obtain credit and yet this is exactly the time increased credit is needed.

The research argues for counter-cyclical mechanisms that could be used to dampen credit growth when this becomes excessive, whilst raising credit growth in bad times. It also suggests that there is a role for "good" development banks: national development banks, which can co-finance with commercial banks to fund priority sectors and projects. These banks play a critical role in finance by guiding the market. They can help steer investment in underserved segments of the economy that are important for transformation and job creation. The literature on national development banks shows many such banks have faced a range of challenges in the past. Equally, the research also suggests that there are many good examples of successful development banks, such as KfW in Germany. As well as playing a counter-cyclical role, they can help provide the long-term finance that is key to the development process, but which the private sector rarely provides at the scale needed.

3. Building a strong financial ecosystem

In addition to better access to credit, countries also need more diversified financial systems with a mix of different types of financial institutions. This would support both financial inclusion and stability, as institutions would be exposed to different sectors and risks.

Increasing the supply of finance to diverse sectors is likely to be easier with a diverse set of financial institutions: large and small banks; diversified and sector-specific; commercial and development-oriented. Microfinance Institutions (MFIs), credit unions, cooperative banks and mobile banking are also critical.

Capital account management of private flows, as well as prudent public foreign borrowing, is needed to avoid build-up of vulnerabilities through volatility of short-term capital.

4. The role of national and international regulation

Effective national regulation (e.g. supervision of assets and liabilities of commercial banks, assessing risks of their balance sheets and use of financial instruments) is central to all financial systems. There has been significant progress in the development of strong national regulatory frameworks, including for the banking system, in many of the countries studied. However, there is a growing reliance on foreign capital flows, which is risky, as it creates financial sector vulnerability (for example, linked to currency mismatches) with uncertain benefits for growth. This has already been shown to be true by the increased cost of borrowing by African LICs.

When it comes to international regulation, the research found that tailoring it to the national context is vital. If LICs are to use financial regulation to help strike the right balance between growth and stability, it will need to be designed explicitly for the circumstances of those countries, rather than simply transplanted from developed countries, as Basel II and Basel III have been in certain places (Griffith-Jones and Gottschalk, 2016).

In addition, regulation should be designed to support growth rather than stifle it, as well as naturally safeguard financial stability. Regulation should also be adjusted to allow for the establishment of institutions that include in their mission social and developmental goals.

The financial sector in Ghana, Kenya, Nigeria and Ethiopia

Ghana and Kenya have systems with open capital accounts, which are dominated by private banks. Nigeria is a large, oil-based economy, with a more sophisticated financial system and domestic banks penetrating other African markets. Ethiopia has a heavily regulated bank-based financial sector in early stage of development, with a large (though decreasing) role for government owned banks – including a large public development bank – and restricted capital account opening.

These differences are partly due to previous policy choices, and partly because initial conditions, such as economic structure, are varied too. All three countries have failed to service SMEs and provide finance for long-term infrastructure. They are also characterised by high lending rates with high base rates (owing to weak macro-economic policies and government lending) coupled with high interest rate spreads (owing to lack of innovation and high perceived risks).

Wider relevance

The research has contributed successfully to several key policy and academic debates around financial sector development. It was also one of the first to comprehensively discuss lessons for low-income countries from the 2008-2009 global economic and financial crisis.

It has highlighted **the ongoing importance of being prepared to respond to financial crises**. While crises have occurred mainly in high- and middle-income countries in recent years, LICs are at risk nonetheless. Countries such as Nigeria have already suffered a financial crisis following the global financial crisis of 2009 (Ajakaiye and Tella, 2014). It is important to manage domestic credit booms and rapid increase in short term capital inflows. This is reflected by the fact that counter-cyclical and macro-prudential regulation have become more mainstream.

The project has also enhanced the debate on how rapid increases in finance or high levels of credit can be harmful for the economy. Before the global financial crisis, many believed that more finance is always good, but the research showed this is not always the case. The Bank of England (BoE), International Monetary Fund (IMF), the Bank for International Settlements (BIS) and a range of academics have since revised their thinking on this. At this time, Griffith-Jones and her team were publicly discussing these issues in international fora (see e.g. Haldane and Madouros, 2012; Turner, 2009).

In addition, the research has highlighted the importance of the **cost *and* availability of finance**. Interest rate spreads are high in African countries, particularly in countries such as Ghana. The Kenya case study suggested that more competition and management of overhead costs can help banks to reduce spreads. Whilst the research involved initial discussions with the Governor of the Central Bank of Ghana, (te Velde et al., 2015), the debate is gaining further traction years later.

The President of Ghana recently argued at a transformation meeting held by the African Center for Economic Transformation (ACET), also a DEGRP grantholder, "in our own country, the banks for the past 30 years have been very content with making lots of money, but not being particularly involved in the risk-taking that contributes to economic development or significant transformation".

Since the project's completion, two other DEGRP-funded projects have taken forward the ideas discussed, building them into their research examining Basel III regulation and inclusive finance. The DEGRP principal investigator is also focusing on the role of better finance and good development banks, not least in her recent book (Griffith-Jones and Ocampo, 2018) on the future of national development banks.

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