

Financial-sector development and inclusive and sustainable economic growth in sub-Saharan Africa

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Abstract

This working paper examines the evidence relating to the relationship between finance and economic growth in sub-Saharan Africa. It reviews the financial landscape, progress and gaps in its development since 2000. Although the region as a whole has made significant progress – including expansion of the banking system’s scale and of financial access – there remain notable weaknesses, such as low domestic savings mobilisation, underdevelopment of capital markets and insufficient credit to key sectors for inclusive growth. It explores differences attainments in financial development and discusses how capital could be better aligned to the needs of economic transformation in the region.

Key words: Financial market development, Financial development, Africa, inclusive growth, economic transformation

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Acronyms

AfDB	African Development Bank
AIM	alternative asset market
DFI	development finance institution
FCAS	fragile and conflicted-affected states
FCDO	Foreign, Commonwealth and Development Office
FDI	foreign direct investment
FSDA	Financial Sector Deepening Africa
GDP	gross national product
IFI	international financial institution
LIC	low-income country
LMIC	lower middle-income country
MIC	middle-income country
OECD	Organisation for Economic Co-operation and Development
SEZ	special economic zone
SME	small- and medium-sized enterprise
SOAS	School of Oriental and African Studies University of London
SSA	sub-Saharan Africa
SDG	Sustainable Development Goal
UK	United Kingdom
UMIC	upper middle-income country
US	United States of America
USD	United States dollar

1 Introduction

Inclusive and sustainable economic development¹ requires finance for the investment that underpins its fundamental processes – capital formation and productivity improvement.

The aspiration to mobilise sufficient finance for development, given an outlook marked by reduced flows from donors and international investors,² needs domestic financial systems to be developed (World Bank, 2015; United Nations Economic Commission for Africa, 2015; Attridge and Engen, 2018; Tyson and Beck, 2019).

There has been increasing focus on how this can be done. Critical to this is a nuanced understanding of the role of finance in development. Evidence shows that the relationship is non-linear, highly variable between countries and regions, intermediated by institutional factors and subject to demand as well as supply. Furthermore, not all finance is equal, and the quality of finance – defined through stability, cost, liquidity and maturity and by finance being directed into sectors which are positive for inclusive economic growth – is crucial.

This working paper examines the increasingly nuanced evidence relating to the relationship between finance and economic growth in the context of countries across sub-Saharan Africa (SSA).

This chapter reviews the broad evidence to set the scene for the rest of the regionally focused discussion, drawing in particular on Lin (2012) and Tyson and Beck (2018).

Chapter 2 reviews sub-Saharan Africa’s financial landscape and progress and gaps in its development since 2000. It will show that although region as a whole has made significant progress – including in expansion of the banking system’s scale and of financial access – there remain notable weaknesses, such as weak domestic savings mobilisation, underdevelopment of capital markets and lack of credit to key sectors for inclusive growth.

Chapter 3 explores a further important theme – that while some countries in the region have seen strong financial deepening, only a few are seeing a strong relationship between this and inclusive economic growth, and some have made little or no progress in financial development. The section will discuss the reasons for these differences in attainments in financial development and in the strength of the relationship between that development and inclusive economic growth.

¹ Referred to as economic development or economic growth in this paper.

² For a detailed discussion of international capital flows, see Tyson and Beck (2018), and for blended and donor finance, Attridge et al. (2019).

Chapter 4 discusses the policy implications, and calls for greater innovation in sourcing new capital that is better aligned to the needs of economic transformation in the region. Chapter 5 concludes.

Financial development – but not financial access – drives economic growth and poverty reduction

Inclusive economic growth – defined by growth in gross domestic product (GDP) in combination with poverty alleviation (Rodrik, 2007; McMillan et al., 2017) – depends on the financial system to mobilise investment resources for private-sector development, infrastructure and the development of human capital (such as education and health care) (Griffith-Jones et al., 2014; Tyson and Beck, 2019).

Reflecting this, there is broad academic evidence that financial-sector development³ is a causal factor in such economic growth (for example, Stiglitz and Weiss, 1981; Gelb, 1989; World Bank, 1989; Roubini and Sala-i-Martin, 1991; King and Levine, 1993; Levine et al., 2000; Levine, 2005).

The key aspect of this causal role is the mobilisation of savings into investment in the real economy, in combination with low cost of capital, long-dated financing and effective risk management and financial stability (Griffith-Jones et al., 2014; Tyson and Beck, 2019).

Because of its fundamental importance for investment, financial development can be positively associated with reduced poverty and income inequality in low- and middle-income countries (L&MICs) (although not in advanced economies) (Beck et al., 2007), but this is not always the case. Rather, there is significant heterogeneity in the relationship between financial development, poverty and income inequality between regions and countries (Rewilak, 2013; Andrianova et al., 2015)

Finance also interacts directly with poverty at the household level. Poor households suffer from risk and uncertainty because their incomes are both low and volatile due to their reliance on informal employment and subsistence agriculture. Better financial access supports positive coping mechanisms and household resilience (Collins et al., 2009; Demirgüç-Kunt et al., 2017).

The effects of financial access, however, vary by product. Savings products have the strongest link to poverty alleviation, as they can be used to smooth consumption and manage shocks, such as a breadwinner’s death or loss of employment, thus increasing household resilience. Payment services also have a positive relationship to poverty alleviation as they lower costs and increase the speed and security of payments (Collins et al., 2009; Armendáriz and Morduch, 2010; Demirgüç-Kunt et al., 2017).

The effects of credit on low-income households and poverty are, at best, mixed however. The majority of studies have found that credit has little or no significant

³ Financial development is defined as a combination of depth (measured by the size and liquidity of markets), access (the ability of individuals and companies to access financial services) and efficiency (the ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets). It can be observed in the increasing number, scale and diversity of financial institutions, including banks, insurance companies, mutual funds and pension funds, and in financial markets, such as FX, stock and bond markets, increasing liquidity and turnover, and number of ‘market makers’ (Sahay et al., 2015; Svirydenka, 2016).

impact on income or on other positive outcomes, such as improvements in education, health or women’s empowerment. Moreover, credit can be associated with unsustainable indebtedness in poor households (Collins et al., 2009; Demirgüç-Kunt et al., 2017).

Credit for micro and small enterprises is not associated with improvement in livelihoods and transformational change. Rather, such enterprises – even with access to credit – have very low graduation rates to larger more efficient and productive businesses. Similarly, access to finance in the agricultural sector has no significant effect on yields or on household income. Further, microfinance in rural areas fails to provide credit to the smallest farmers and poorest households, tending to be channelled to wealthier and politically connected households (Cramer et al., 2020).

There is some evidence that broader financial development reduces poverty by enabling low-income households to participate in new opportunities as structural transformation is taking place. For example, evidence from Thailand shows that financial deepening from around 1975 onwards helped reduce poverty by facilitating the migration from subsistence agriculture into salaried jobs in urban manufacturing (Gine and Townsend, 2004). Ayyagari et al. (2013) show that in the case of India, financial deepening in the 1990s and 2000s helped reduce rural poverty both by increasing incomes of small-scale entrepreneurs and facilitating rural–urban migration. Tyson et al. (2020) found that in Kenya, spatial inequality was reduced by increased financial access, enabling communities on the margins of ‘growth hubs’ to engage in emerging value chains and employment opportunities.

Finally, the strong negative effect of instability of the financial sector on poverty and income inequality is of great importance. Rewilak (2018) focuses on the impact of different types of crises on the income of the poorest income quintile. He finds the strongest negative effect on the incomes of the poor is associated with currency crises, followed by banking crises, and that the main channel through which crises negatively affect the income of the poor is macroeconomic instability.

1.1 The strength of these relationships varies over time and between countries

The finance–growth nexus varies across the spectrum of GDP per capita. It is particularly strong for middle-income countries (MICs)⁴ with increased financial development not only driving economic growth but also accelerating poverty alleviation and reductions in income inequality. The effects are lower for low-income countries (LICs) and lower, or even negative, for advanced economies (Rioja and Valev, 2004a; Rioja and Valev, 2004b; Barajas et al., 2012; Barajas et al., 2013; Arcand et al., 2012; Arcand et al., 2015).

Thus, the strongest effects of finance in accelerating economic development and reducing poverty is as countries graduate to lower middle-income status (LMIC). However, after upper middle-income (UMIC) status is reached, these effects start to

⁴ Recent evidence suggests that there is an optimal level of finance for an economy at a given stage of its development – in other words, there can be too much finance as well as too little – and that the positive effects of financial development on growth start to decline and turn negative at higher levels of financial development. However, as most financial development in L&MICs remains well below the relevant turning point, this is not particularly pertinent to this discussion (Arcand et al., 2015).

fade. For example, Arcand et al. (2015) show that the relationship between financial development and economic growth across a broad cross-section of countries becomes insignificant at higher levels of financial development, turning negative and significant at very high levels of financial development.

Further, the ‘vanishing effect’ of financial development is not associated with output volatility, banking crises, low institutional quality, or by differences in bank regulation and supervision or other possible explanatory variables (Arcand et al., 2015; De Gregorio and Guidotti, 1995; Rousseau and Wachtel, 2011; Swamy and Dharani, 2020).

It is argued that this pattern is due to investment increasing productivity in L&MICs until they approach the productivity frontier – a process that is consistent with the underlying process of structural transformation being to increasing productivity within an economy through capital accumulation. Beyond this frontier, however, further capital has diminishing effects on productivity (Aghion et al., 2005; McMillan et al., 2017).

In addition to this variation in the strength of the relationship between finance and growth over time, there is also significant variation in this relationship between individual countries, as shown both by the econometric evidence and by the comparative experiences of different countries and regions.

There is some debate about the causes of these variations. There is significant evidence that they are explained by the presence or absence of well-functioning institutions. Such institutions include financial intermediaries, markets and regulators and their role is linked to financial and macroeconomic stability, transparency in markets, prices and information and in the quality of the investment environment (for example, Stiglitz and Weiss, 1981; Arestis and Demetriades, 1997; Acemoglu et al., 2005; Rodrik, 2007; Demetriades and Law, 2006; Honohan and Beck, 2007; Lin and Xu, 2012; Andrianova et al., 2015; UNCTAD, 2019).

A more recent and more nuanced explanation for these variations relates to the structure of the financial system and how it serves the needs of structural transformation, including on a dynamic basis.

One aspect of this has been empirical work that links the role of finance to the sectoral composition of credit. For example, empirical work has shown the importance of finance being directed into enterprise development rather than household credit (Collins et al., 2009; Beck et al., 2012; Toporowski et al., 2013) and into sectors of importance for employment creation and productivity growth such as agriculture and manufacturing (Batiano et al., unpublished). Conversely, where finance goes into the extractive sector or into consumer lending or real-estate booms, the effects on inclusive economic growth are diminished (Toporowski et al., 2013; Jordan et al., 2016; Chakraborty et al., 2017; Mian et al., 2017; Mueller, 2018).

Another aspect of financial structure that is discussed in the literature is the balance between the banking sector and capital markets. It is proposed that banks serve lower-income countries better because they are more effective in providing credit to smaller enterprises and in monitoring risk and investment in data-poor environments. It is then proposed that as financial systems develop, capital markets grow and become more important in economic growth because they are able to finance more

innovative, long-term and high-risk projects as well as provide public information that encourages the development of more complex and diverse financial structures (for example, Boyd and Smith, 1998; Alan and Gale, 2000; Stulz, 2001).

However, the evidence to support this view is somewhat mixed. Some comparative countries’ experiences in Asia and in certain advanced economies, such as Germany and Japan, support this view. Others, such as early-stage development in the United Kingdom (UK) and United States (US) – as well as more recently developed countries such as Malaysia, South Korea, South Africa and Thailand – emphasise a role for capital markets in this phase. In addition, some empirical evidence indicates that the relative mix of banks and stock markets matters little compared to the overall level of financial development as defined by credit within the economy (Beck et al., 2001). These views and the related evidence are discussed in more depth in an accompanying paper (Soumaré and Kanga, 2020).

Finally, the supply side of finance is also important. Investment mobilised through domestic deposits is associated with greater efficiency and lower cost of finance as well as being less pro-cyclical. By contrast, cross-border capital flows, and particularly portfolio flows, are linked with procyclical economic development and financial instability (for example, Ocampo et al., 2014; Tyson, 2016).

1.2 Financial stability is vital for pro-poor growth and resilience

The contribution of finance to economic growth is also dependent on financial stability. Low- and middle-income countries have repeatedly been subject to damaging bouts of financial instability which, as noted above, are associated not only with damage to GDP growth but also with differentially negative effects on low-income households.

In LICs, financial instability is typically associated with the failure of individual banking institutions rather than systemic crises. These are most typically due to governance problems such as mismanagement and corruption, often associated with political capture of the financial system. However, they can also be driven by cross-border capital inflows that drive credit booms, although only 10% of global credit booms occur in LICs (Tyson and McKinley, 2014; Arena et al., 2015).

By contrast, MICs more typically suffer from systemic crises. This is associated with their financial systems becoming increasingly interconnected domestically and internationally, leading to rising cross-border capital inflows during period of high liquidity in international capital and subsequent credit booms. Indeed, historically, 75% of global credit booms occur in MICs. Credit booms interact with weak regulation, credit in excess of country-specific structural factors and fundamentals, high levels of foreign currency debt and ‘wasteful’ use of credit (such as in real estate or consumption) to undermine growth (Barajas et al., 2013; Arena et al., 2015; Ocampo et al., 2014; Akakaiye and Tella, 2014; Griffith-Jones and Gottschalk, 2017). Also typical, although less common, is financial instability caused by contagion through domestic channels (such as interbank markets, capital markets and wholesale lending) which, during the middle stages of financial developments increase but remain thin (Tyson and Raga, 2020a).

Financial instability is associated with increased poverty. This is partly because of its negative impact on economic growth and partly because most countries, when returning to growth after financial instability, do so at a permanently lower level of

GDP per capita (Laeven and Valencia, 2012; Beck and Tyson, 2018). It is also partly due to financial instability having distributional effects. Economic instability affects the incomes of poor households more than wealthier households, because of the greater uncertainty surrounding their net income and their lower levels of resilience (Guillaumont Jeanneney and Kpodar, 2011; Demetriades et al., 2017).

Overall, the interaction between financial stability and financial development needs to be carefully balanced. Developing economies should be mindful of the cyclical behaviour of macroeconomic variables (and especially fixed exchange-rate regimes), credit expansion and cross-border capital inflows. It is difficult, however, to distinguish between beneficial financial deepening and destabilising credit booms (Arena et al., 2015).

Regulation needs to carefully balance the growth, regulation and liberalisation of financial systems to manage these issues. The literature shows that in countries across SSA, from 1950 to 2016 financial liberalisation was linked to growth *de-acceleration* (also the experience of Latin America and Asia) because it can lead to more frequent financial crises (Cramer et al., 2020). Reasonably strong institutions should be a minimum prerequisite to such liberalisation (Kose et al., 2009). Other supportive policies to reduce risks include hedging against potential currency, maturity and balance-sheet mismatches, and limits on net foreign open positions, ensuring that financial institutions do not rely solely on short-term funding and adjustment of capital risk weights (Arena et al., 2015; Tyson and Beck, 2018). Recent implementation of Basel II and III in SSA is also helpful (although these need to be tailored to L&MICs). (See, Jones et al., 2019 for a detailed discussion of Basel II and III in relation to SSA; Jones and Zeitz, 2019; Jones and Knaack, 2019.) Such measures are likely, however, to have limited effectiveness in the face of major global shocks for economies whose linkages to global financial systems are deepening. A better approach is deepening of domestic financial systems.

1.3 A dynamic ‘optimal financial structure’ for an economy

As discussed above, while there is strong evidence that financial development drives economic growth, this relationship is mediated through key variables, including institutional strength and financial stability. Moreover, this relationship varies significantly between countries and temporally through their development process.

This has led to the argument that an optimal financial structure is one that is specific to different stages of development and that supports and evolves with the dynamic structural transformation of the real economy and the demand it generates for investment.

Lin, Sun and Jiang (2011) argue that the optimal structure is one that reflects the demands of the real economy, including factor endowments (labour, capital and natural resources). These factor endowments change as structural transformation progresses, meaning that the financial structure must also evolve if it is to fully support growth (Lin, Sun and Jiang, 2011; Lin, 2012).

Arcand et al. (2012) use a similar concept of a ‘financial possibility frontier’ and propose that there is a ‘Goldilocks level’ for the level of credit in any given period. When countries’ level of credit is ‘too cold’ this is due to deficiencies in structural variables including financial inclusion and informality in an economy (as well as the

variables discussed relating to macroeconomics and institutions); but the level of credit relative to GDP can also be ‘too hot’, with elevated risks of financial instability.

These models are of interest because they provide a more nuanced view of how financial development can support economic growth and how it needs to evolve dynamically as economic development progresses.

So, for example, Lin (2012) proposes that in relatively underdeveloped economies there is typically an abundance of unskilled labour and a scarcity of capital. This means that finance needs to be directed to labour-intensive industries and relatively small informal firms – needs which are best met by banking institutions. As economic development progresses, increasingly capital-intensive, higher-skill and larger firms and enterprises emerge in conjunction with improvements in public infrastructure. Such development requires greater intensity and scale of financing, which needs to be provided by non-banking institutions including capital markets and public finance (such as development banks). In an optimal financial structure, this process of changing financial structure is dynamic and closely matched to the changing needs of governments, firms and households (Allen and Gale, 2000; Lin, 2012).

Finally, it is worth mentioning the Growth Diagnostic Framework developed by Hausmann, Rodrik and Velasco (2005; 2008). This deconstructs growth into factors of production including labour, physical capital and human capital, and examines gaps in multiple variances that constrain growth in the productivity of these factors. Finance can be one of the identified variances that constrain growth through low returns on investment, inadequate domestic savings, private appropriation of returns or inadequate access and so forth. The advantage of this approach is it places deficiencies in finance in the context of the broader macroeconomic and political context and highlights the multi-dimensional nature of constraints on growth.

This discussion raises the question of what causes a financial structuring gap relative to the optimal structure of an economy. Lin (2012) identifies the nature of state control of the financial system as key. Some countries have adopted a policy of ‘financial repression’ – including controlling entry to the banking sector, controlling interest rates and intervening in the allocation of bank loans – that aims to direct scarce finance into priority sectors. Such policy has led to finance accelerating economic development, most notably in Asia. Success stories include China, Japan, South Korea and Taiwan. In SSA such approaches in Ethiopia and Rwanda are also proving successful (and are discussed further in following sections). However, such financial repression can also be poorly executed and lead to distortion and wasted financial resources (Lin, 2012).

Alternatively, some countries have adopted policies of financial liberalisation to allow free-market development of financial systems. These policies have been effective in many advanced economies. But, as noted earlier, in SSA, where such liberalisation was central to structural adjustment programmes promoted by the International Monetary Fund (IMF) in the 1980s and 1990s, they are associated with growth *de-acceleration*. This indicates that they are not optimal for LICs whose structural transformation is nascent and, instead, can lead to non-productive allocations of credit relative to transformational needs (Lin, 2012).

A further aspect is the broader political economy. The financial sector is particularly susceptible to state capture, leading to distortions including corruption and serving

the needs only of elite household, firms and state actors. While such problems can arise in advanced economies and MICs too, they are particularly prevalent in LICs and fragile situations (Nkurunzia, 2010; Lin, 2012).

These concepts need further empirical investigation. Some evidence has already been gathered. Demirguc-Kunt, Feyan and Levine (2011) constructed a measure⁵ of the mismatch and found that deviations from the actual financial structure and the estimated optimal one is closely associated with reduced economic output, and found a robust and negative relationship⁶ between a sub-optimal financial structure and economic activity. However, this qualitative research was largely based on wealthy countries belonging to the Organisation for Economic Co-operation and Development (OECD), and has not been replicated for lower-income countries. Some empirical work has been done to close this gap. Cull and Xu (2011) used firm-level data across 89 countries to look at how labour growth rates of firms vary with the financial structure and found that employment labour is faster in LICs with a higher ratio of private credit to GDP. Again, this result is consistent with these models.

1.4 Conclusion

Recent academic work has developed the concept of an optimal financial structure and how it might change over time. To date, however, this literature provides limited quantification of the financing gap or specifics that might guide policy-making. More empirical work needs to be done to develop quantitative evidence, and quantification is needed to develop the concept of the optimal financial structure and its role in the strength of the relationship of financial development of economic growth.

Nevertheless, the concept is a powerful one and subsequent sections of this paper will draw on the idea that there is an optimal financial structure at a given time for a given country, that identifying gaps against it is a useful exercise, and that we can draw on the broader literature to provide some guidance as to what the critical gaps might be.

The literature also supports the critical importance of a close match to the needs of structural transformation of an economy, including demand in the real economy. This is dependent upon non-financial factors such as the broad business environment, institutional strength, macroeconomic stability, the political economy and public policy as well as the dynamic process of transformation (Aghion et al., 2005; McMillan et al., 2017).

⁵ This was done by regressing a measure of financial structures share GDP per capita while controlling the key institutional, geographical and structural traits of those countries. They then use the coefficient to compute the estimated optimal financial structure for each country and each year as well as a financial structure gap which it was equal to the natural logarithm of the absolute value of the difference to the actual estimated optimal financial structure.

⁶ After controlling for the level of bank development, securities markets development, a standard set of controls and countries variables.

2 The financial landscape in sub-Saharan Africa (2000–2020)

The last two decades have been an eventful time in financial markets. Global financial liberalisation since the late 1980s has led to a continual increase in finance relative to GDP, huge growth in cross-border capital flows and increasing financialisation of economic growth. Much of this has been positive and delivered the capital needed for economies to transform. The period has also, however, been characterised by repeated financial crises at the national, regional and global levels. The effects of these financial shocks have been greatest for L&MICs, where their impact has disrupted GDP growth with an average recovery period of six years (Tyson and McKinley, 2014).

During this period there has also been significant financial deepening in SSA. The Financial Development Index developed by the IMF (Box 1) shows steady progress in the financial development of the region with the index increasing from 0.12% to 0.16% between 2000 and 2018 (Figure 1).

Financial deepening has, however, been concentrated in the banking sector (as shown by the Financial Institutions Index, which includes banks, insurance companies, mutual funds and pension funds). Further, much of the progress has been in financial access with only moderate progress in relation to scale and relatively little in relation to efficiency (and related costs of credit) and capital market development (as shown by the Financial Markets Index) (Figure 1).

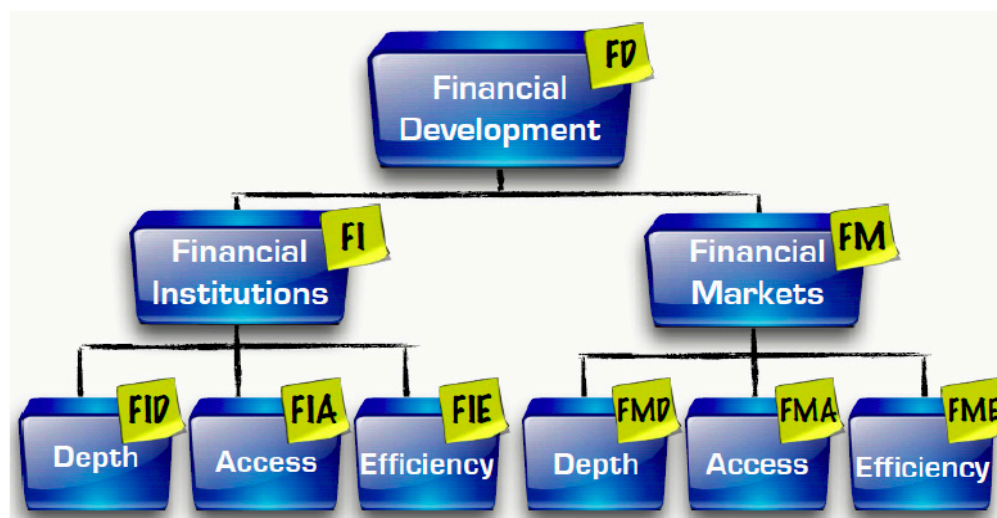
Box 1 Measuring financial development

Since the 1970s, the literature on finance and growth has focused on the ratio of private credit or stock market capitalisation to GDP as proxy variable for financial development. However, this only measures a single dimension of importance – scale – in the contribution of finance to economic development. In order to better capture a more comprehensive array of key variables, multi-dimensional indexes have recently been developed.

The most recent and comprehensive of these is the IMF’s Financial Development Index. In this index, financial institutions include banks, insurance companies, mutual funds, and pension funds. Financial markets include stock and bond markets. Financial development is defined as a combination of depth (size and liquidity of markets), access (ability of individuals and companies to access financial services), and efficiency (ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets). It covers the period from 1980 to 2018 for 183 countries and draws on multiple data sources to assess these variables (see Table 1).

These factors are then summarised into an overall index of financial development, with a second level for financial institutions and financial markets and a lower tier for depth, access, and efficiency (see Figure 1).

Figure 1. Financial Development Index Pyramid



A complementary source is user-based micro-data such as enterprise and household data capturing access to and use of financial services as well as barriers to financial inclusion. A number of such sources are also used, including FinScope 2018.

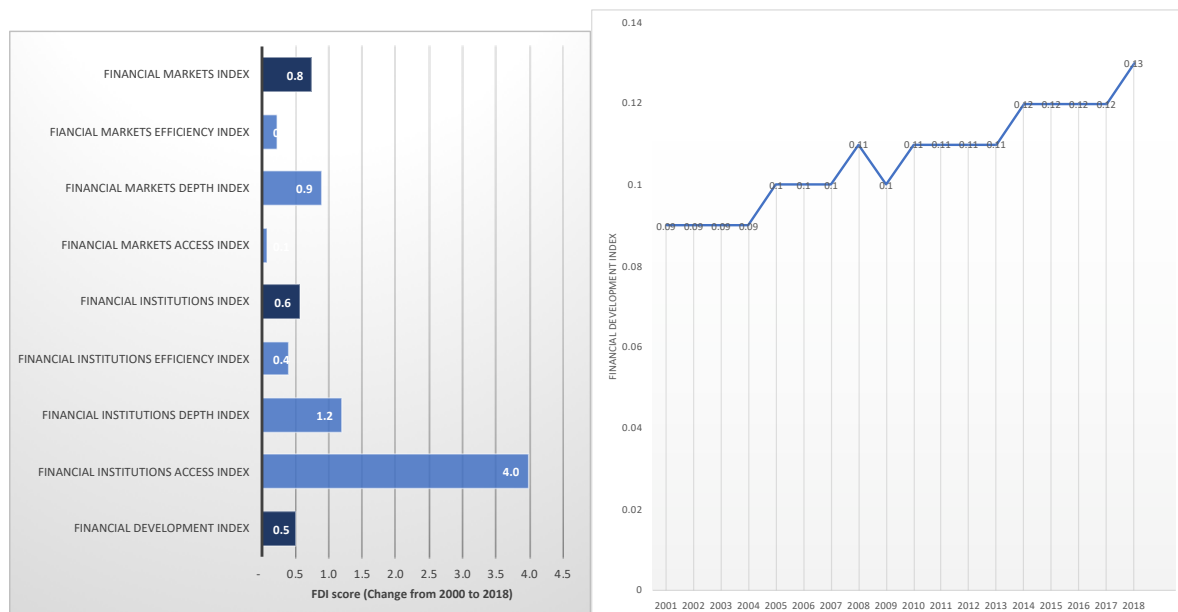
Sources: (text) Tyson and Beck (2018); Svirydzhenka (2016; Figure 1 reproduced from Svirydzhenka (2016)

Table 1 Data sources for the IMF's Financial Development Index

Category	Data source	Indicator
Financial institutions		
Depth	FinStats 2015	Private-sector credit to GDP
		Pension fund assets to GDP
		Mutual fund assets to GDP
		Insurance premiums, life and non-life to GDP
Access	FinStats 2015	Bank branches per 100,000 adults
	IMF Financial Access Survey	ATMs per 100,000 adults
Efficiency		Net interest margin
		Lending-deposits spread
		Non-interest income to total income
		Overhead costs to total assets
		Return on assets
		Return on equity
Financial markets		
Depth	FinStats 2015	Stock market capitalisation to GDP
		Stocks traded to GDP
	BIS debt securities database	International debt securities of government to GDP
	Dealogic corporate debt database	Total debt securities of financial corporations to GDP
		Total debt securities of non-financial corporations to GDP
Access	FinStats 2015	Percentage of market capitalisation outside top-ten largest companies
		Total number of issuers of debt (domestic and external, nonfinancial and financial corporations)
Efficiency	FinStats 2015	Stock market turnover ratio (stocks traded to capitalisation)

Source: Svirydzenka (2016)

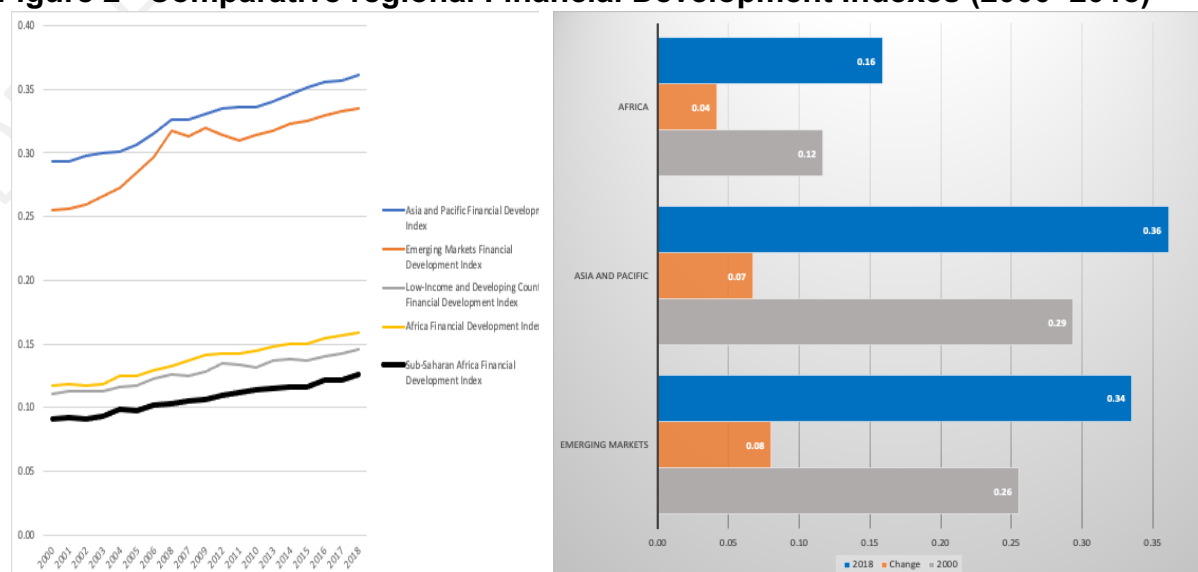
Figure 1 IMF Financial Development Index (2018) and sub-component change (2000–2018)



Source: IMF Financial Development Database; downloaded November 2020; elaborated by author

Furthermore, the level of financial development remains well below what is needed to support the investment required for regional graduation to middle-income status. This can most clearly be observed by comparing Africa with other regions, which shows that the continent lags at both an absolute and relative basis in terms of progress made since 2000. As illustrated in Figure 2, the average Financial Development Index score for Africa in 2018 is 0.16, with progress since 2000 being shown by an increase in the index of 0.04. By contrast, in the Asia-Pacific region, the 2018 Financial Development Index score reached 0.36 with progress over the 20 years being nearly double that of Africa at 0.07. The comparisons are similar for emerging markets more generally (Figure 2).

Figure 2 Comparative regional Financial Development Indexes (2000–2018)



Source: IMF Financial Development Database; downloaded September 2020

At the core of this relatively muted progress outside financial access is continuing weakness in the basic functioning of the banking system. The banking system is essential for intermediating savings into lending, providing risk-management channels and payments systems and its efficiency and scale is critical to providing the finance needed for development.

The banking sector in SSA has long been characterised by significant constraints. Banking systems suffer from risk aversion driven by the poor investment environments, which leads to demand-side weaknesses due to a lack of bankable opportunities, political risk and legal risks (such as weak contract and collateral enforcement). This leads to excessive levels of liquidity and capital at banking institutions. The banking sector is also often inefficient and lacks an adequate level of competition, leading to a high cost of credit. In some countries – and especially fragile states – it can also suffer from state capture (Nkurunzia et al., 2012). These problems mean that the banking sector remains too small on a relative and absolute basis (as measured by bank lending to GDP) with lending concentrated in government and elite corporations (Griffith-Jones and Gottschalk, 2016; Tyson, 2017a; 2017b; Calabrese et al., 2017).

There are also notable gaps in the ‘financial architecture’ that impede the basic functions of financial system. For example, intermediation is impeded by thin interbank markets and gaps in credit bureaus (Beck et al., 2007; Brown et al., 2009; Tyson and Raga, 2020a). Risk management is impeded by illiquid or absent markets for products such as foreign exchange and interest-rate derivatives (Tyson, 2019). There is an absence of specialist exchanges such as commodity exchanges (Nyarko, 2019).

These gaps in the financial architecture create inefficiency in the basic function of the banking systems, impede their specialist functions and can act to make the banking sector more fragile and susceptible to shocks.

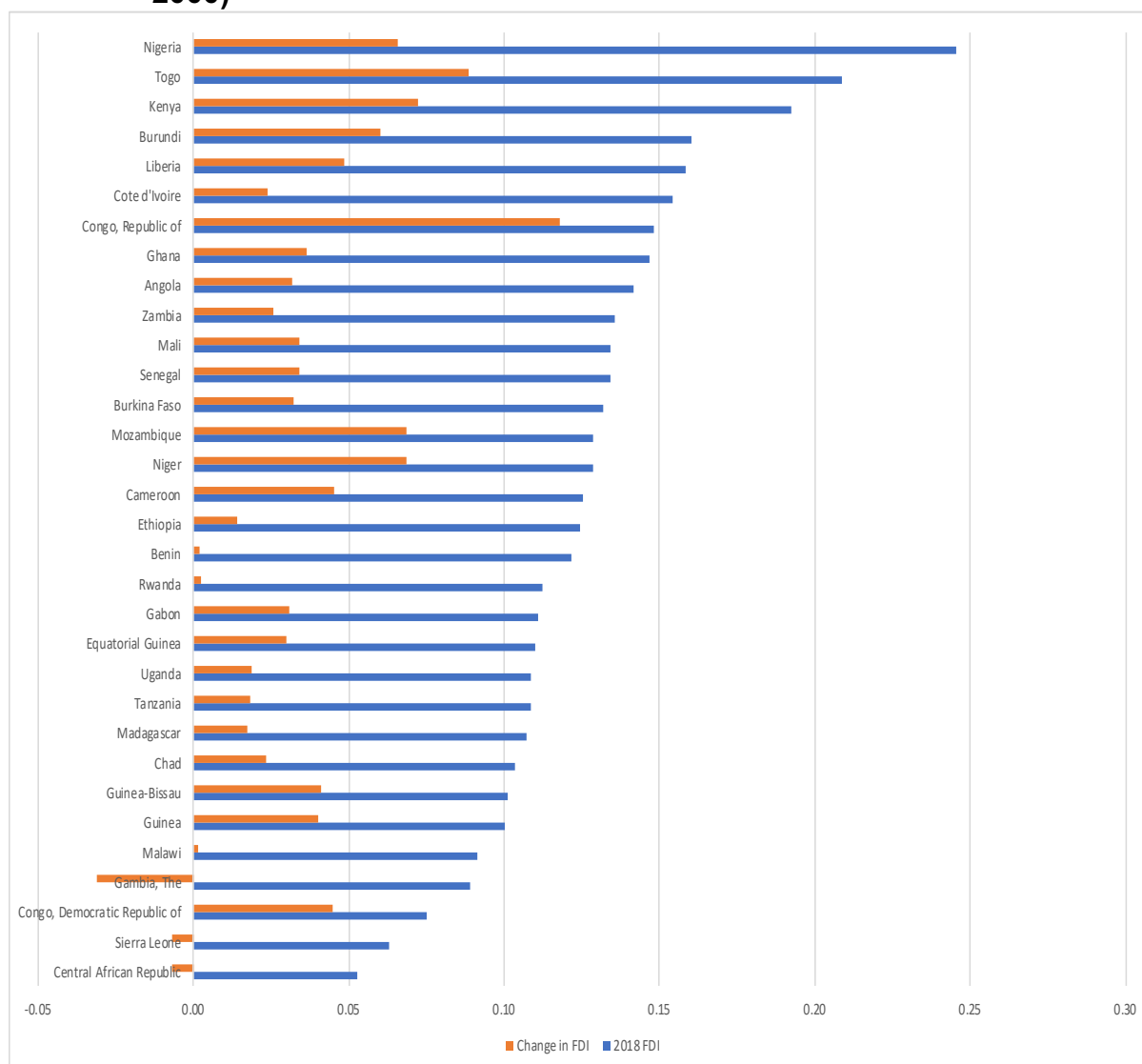
It might be hoped that these fundamental problems would be fading in Africa, which has achieved greater levels of macroeconomic development and political stability since 2000. However, the evidence suggests that, while there has been progress, it remains well below the levels needed to accelerate economic development (Griffith-Jones and Gottschalk, 2016).

Clearly, much more needs to be achieved – and more rapidly – in order that the levels of financial development in the region can support SSA's continued economic progress (see Box 1 for detailed aspects of this landscape.) were considered in Box 1.

2.1 Mixed progress in financial development across the region

Progress in financial development is mixed across the region. There is a modest relationship with per capita income and progress has been concentrated in banking rather than capital markets. Progress has been uneven by country both in relation to progress made over the last two decades and in relation to the level of financial development achieved (Figure 3).

Figure 3 Financial Development Index by country (2018 and change since 2000)



Notes: In this working paper, SSA is defined as excluding SACU (Botswana, Lesotho, Namibia, South Africa, and Swaziland (Eswatini)), small states (Cabo Verde, Comoros, Eswatini, Lesotho, São Tomé and Príncipe), international financial centres (Seychelles and Mauritius) and countries where data quality was inadequate (Eritrea, South Sudan and Zimbabwe, which does not provide data to the IMF).

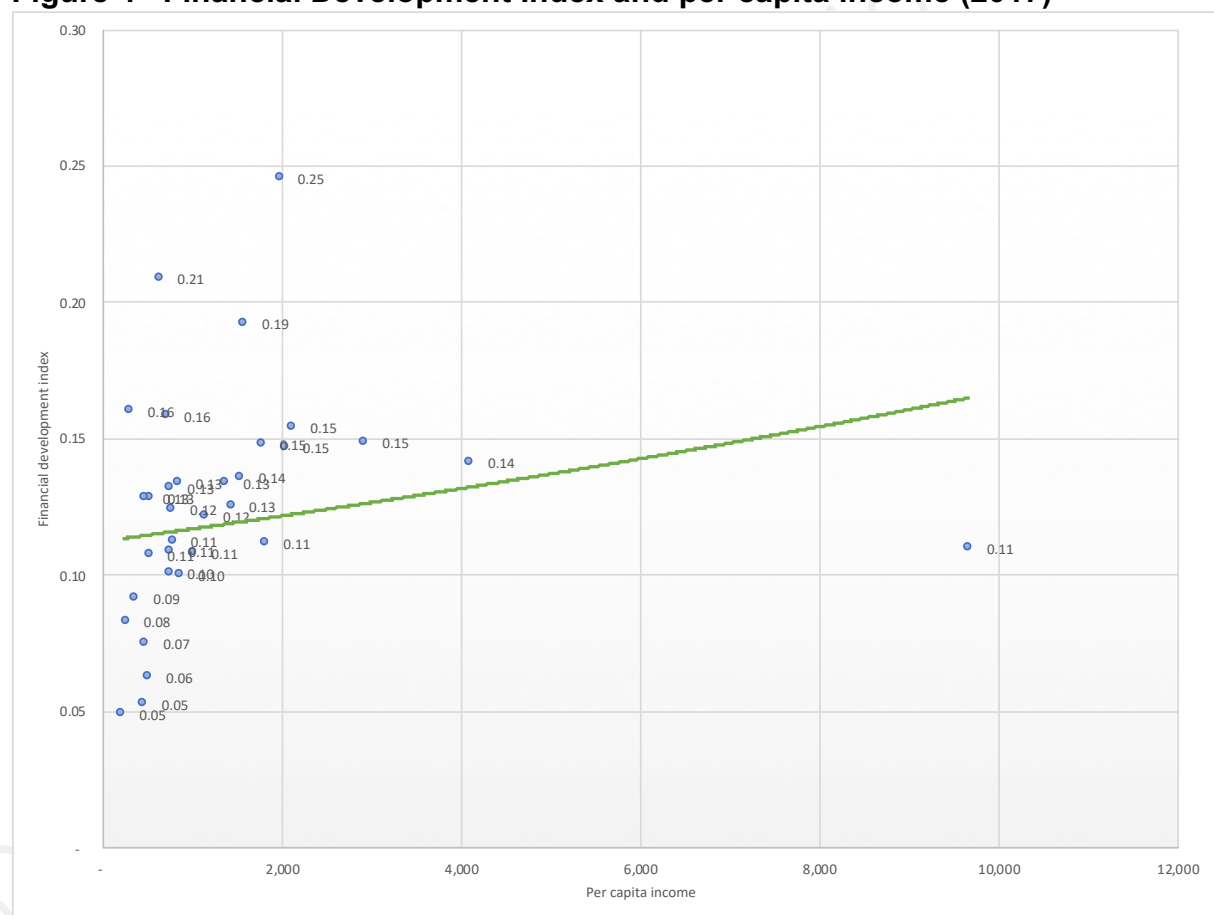
Source: IMF Financial Development Database; downloaded November 2020; elaborated by Author

As expected, these differences between countries are partly explained by economic development with the expected positive board relationship between per capita income and financial development. For example, two countries are leading financial development in the region – Kenya and Nigeria – and both have higher than average per capita GDP. Twenty-three out of 33 countries (70%) have both low levels of financial development and low levels of GDP per capita (and often are also fragile and conflicted-affected states (FCAS)). For example, FCAS include the Central African Republic, the Democratic Republic of the Congo, Eritrea, Guinea, Guinea-Bissau, Malawi, Sierra Leone and South Sudan.

There are, however, notable exceptions. Togo has the second highest financial development in the region but a lower per capita GDP. This is because of its role in regional banking through Togo-headquartered Ecobank (Tyson and Raga, 2020b). Burundi and Liberia both have high levels of financial development but some of the lowest per capita GDP in the region. This is because the political economy in these FCAS has facilitated ‘state capture’ of the financial system (Nkurunzia, 2010; Nkurunzia et al., 2012; Tyson, 2017a; 2017b; Calabrese et al., 2017).

A notable number of resource-dependent economies – such as Angola, Equatorial Guinea, Zambia and Zimbabwe – have lower levels of financial development than would be expected for their per capita GDP. This relates to the financial sector serving the extractives industry rather than households and SMEs, sometimes in combination with its ‘state capture’ (Figure 4; Table 2).

Figure 4 Financial Development Index and per capita income (2017)



Note: trend line is linear relationship between the Financial Development Index and per capita income; see Table 2 for countries by name.

Source: IMF and World Bank data elaborated by the author

Table 2 Financial Development Index and per capita income (2017)

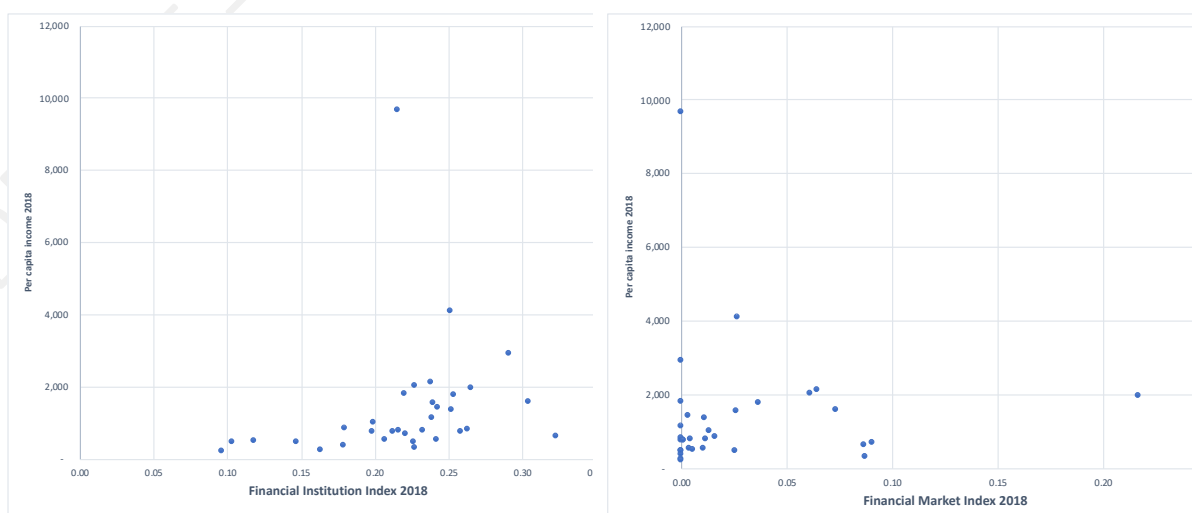
	LIC (per capita income \$<1,035)	LMIC (per capita income \$1,035-\$4,045)	UMIC (per capita income >\$4,045)
Below average FDI (<0.10)	Central African Republic; ^{i,ii} Congo DR; ⁱ Guinea; ^{i,ii} Guinea-Bissau; ⁱ Malawi; ⁱ Sierra Leone; ^{i,ii} South Sudan ^{i,ii}	None	None
Mid-range FDI (0.11-0.14)	Burkina Faso; ^{i,ii} Ethiopia; ⁱⁱⁱ Madagascar; ⁱ Mali; ^{i,ii} Mozambique; Niger; ^{i,ii} Rwanda ⁱⁱⁱ ; Tanzania ⁱⁱ ; Uganda	Cameroon; ⁱⁱ Senegal; Zambia; ⁱⁱ Zimbabwe ^{i,ii}	Angola; ⁱⁱ Equatorial Guinea ⁱⁱ
Above average FDI (>0.14)	Burundi; ⁱ Liberia; ⁱ Togo ⁱ	Congo Rep; ^{i,ii} Côte d'Ivoire; ⁱ Ghana; ⁱⁱ Kenya; Nigeria ⁱⁱ	None

Notes: ⁱCAS; ⁱⁱresource-intensive or commodity exporters; ⁱⁱⁱstate-led finance; some small island states (SIDS) and countries with poor data excluded; Zimbabwe does not report data to the IMF so its Financial Development Index has been estimated based on the World Bank development indicators.

Sources: IMF and World Bank data elaborated by the author

There are also notable differences in development between the banking system sector and the capital markets. The majority of countries have achieved improvements in the financial institution index, most having a score above 0.20 and a modest positive relationship between per capita income and financial institutional development with some notable outliers. By contrast, very few countries have achieved significant capital market development, with only Côte d'Ivoire and Kenya making progress (Figure 5).

Figure 5 The Financial Institution Index and Financial Market Index compared with per capita income in sub-Saharan Africa (2017)



Sources: IMF and World Bank data elaborated by the author

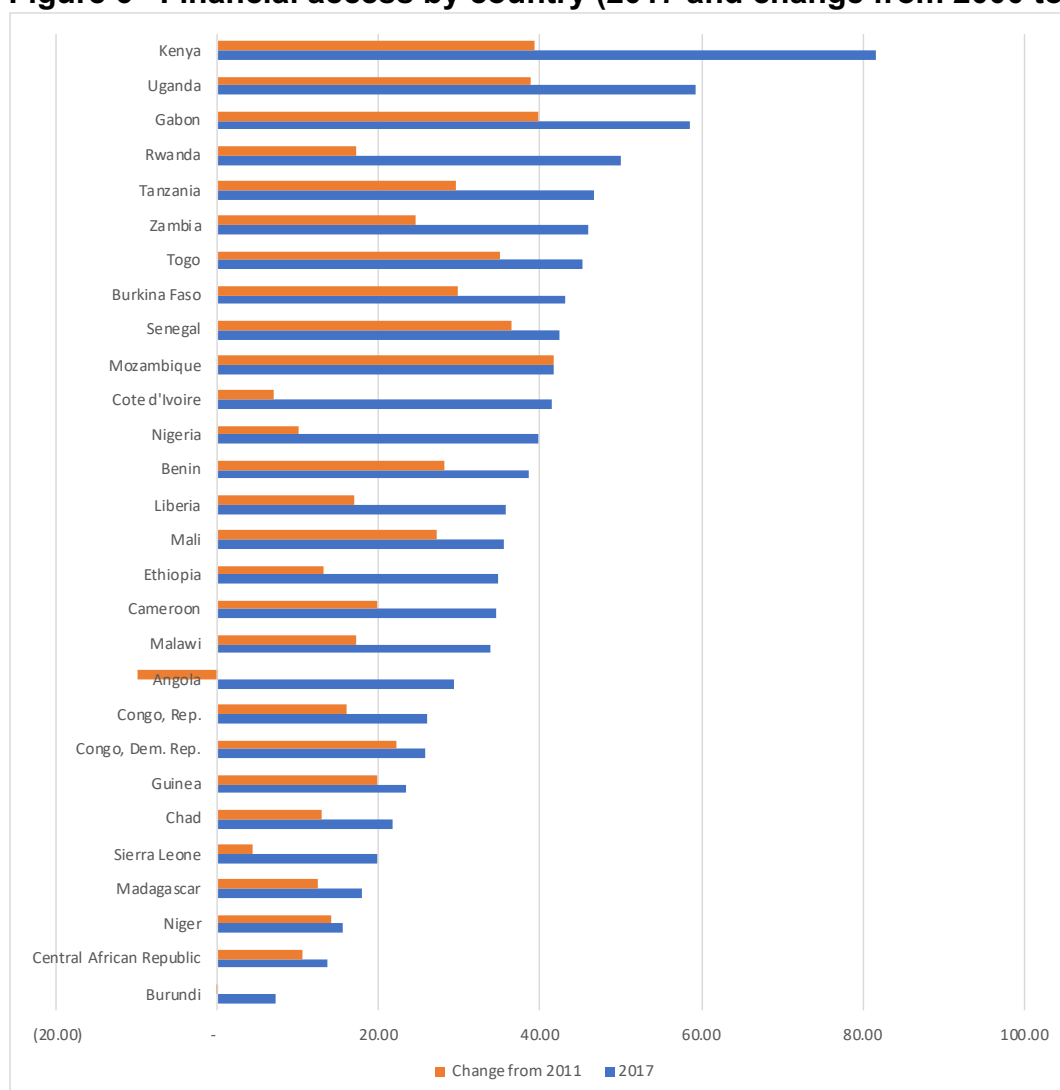
In Section 3 we explore these differences between countries in more detail. In this section, we discuss achievements and gaps in financial development.

2.2 Strong but uneven progress in financial access

The major achievement in relation to financial development in the region has been the expansion of financial access in banking services with the average for adults across SSA with financial access (as measured by those over the age of 15 years with a bank account) increasing by 19% since 2000 to 36% – a near doubling of access levels. This progress has been driven by the widespread uptake of mobile banking. The emergence of large regional banks has also been important as they have placed the use of mobile banking to increase their customer base at the heart of their strategy. In addition, the growth in the telecoms sector has been a key enabler of this trend.

As for financial development more generally, however, progress in expanding financial access has been uneven. For example, Kenya has achieved exceptional financial access of over 80%, building on innovative and Kenyan-originated e-banking platforms. This success has been replicated in other countries including in Ghana, Uganda and Tanzania. Elsewhere access remain relatively low. For countries where access remains below 40%, there are two broad categories. First, there is a cluster of LICs and FCAS. Second, there are resource-dependent MICs. For example, Angola, Cameroon and Nigeria have relatively low levels of financial access especially given their relatively high per capita GDP. In both instances, financial access not been a policy priority (Figure 6).

Figure 6 Financial access by country (2017 and change from 2000 to 2017)



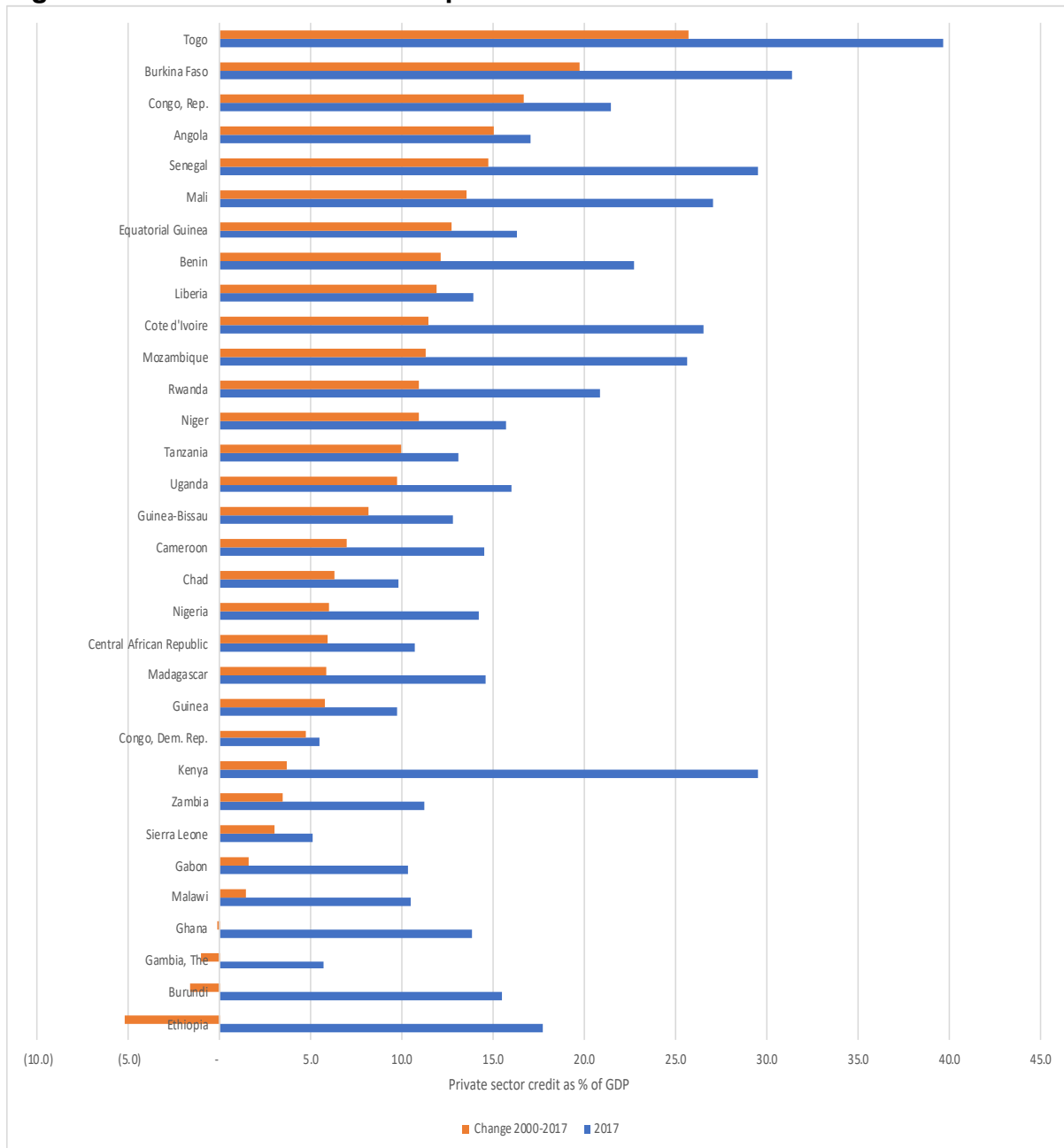
Notes: Measure is a percentage of the adults defined as 15 years and older with a bank account.

Sources: Global Findex, World Bank

2.3 Private-sector lending is too small, too expensive and misaligned with transformation

In relation to domestic credit to the private sector, there has been progress. Between 2000 and 2017, the average domestic credit to the private sector as a percentage of GDP increased from 9.2% to 17.7% – again a near doubling. However, as for other dimensions, progress has been uneven with some countries making strong progress but the majority having, by 2017, domestic credit to private sector remaining below 20% of GDP (Figure 7).

Figure 7 Domestic credit to the private sector in sub-Saharan Africa

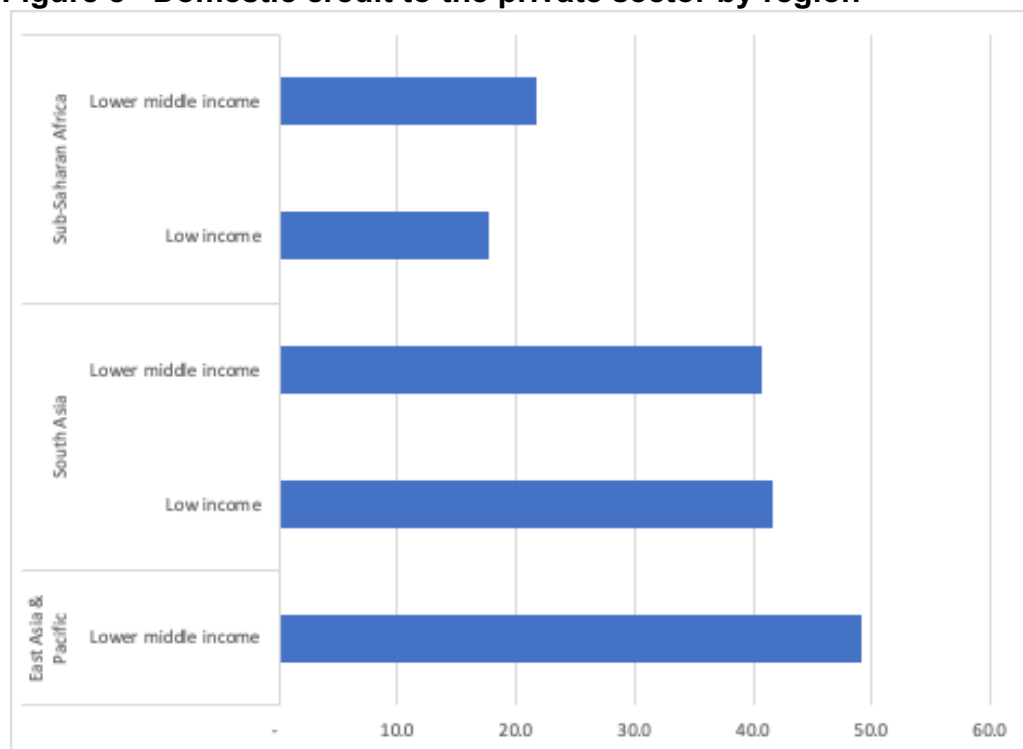


Notes: Ethiopia data is for 2016, taken from the African Development Bank, as the latest available data from World Bank Financial Development database is 2008.

Source: World Bank Financial Development database

These levels are insufficient, as can be seen by looking at regional comparisons. In LICs in sub-Saharan Africa, the average is 17.8% of GDP and for LMICs of 21.8%. This compares unfavourably with Asia where even LICs achieve levels above 40% (Figure 8).

Figure 8 Domestic credit to the private sector by region



Note: simple average of countries.

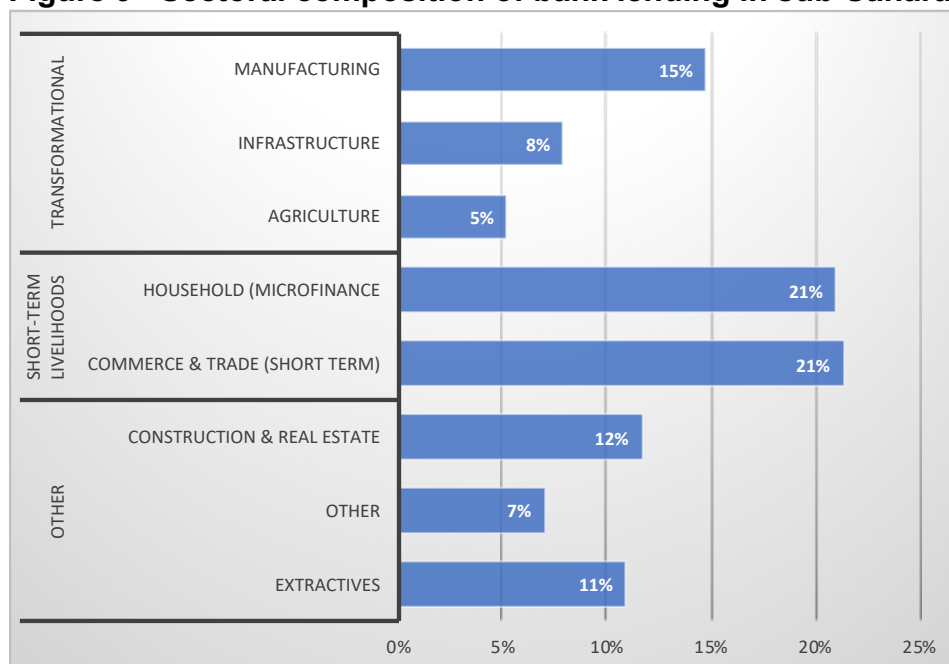
Source: World Bank Financial Development database

A further critical problem relating to lending to the private sector is the sectoral composition which is poorly aligned to the needs of economic transformation; 72% of bank lending goes either to sectors with little or no contribution to transformation (such as extractives and construction and real estate) or to economic activities which support short-term household livelihoods and consumption (such as microfinance and short-term commerce and trade) but not transformational change.

By contrast, financing of sectors where capital investments are critical to transformation account for only 28% of total lending in the region. Manufacturing, a key sector for employment creation, receives 15% of lending (although this proportion has increased since 2010). Financing for infrastructure, a critical enabler of broad economic growth, and for agriculture,⁷ where poverty is concentrated, make up only 8% and 5% of total lending respectively. All of the financing in these key sectors is well below that needed to increase productivity and employment creation (compared to financing levels during Asia’s industrialisation and estimates of financing needs for the region) (Figure 9).

⁷ Low levels of lending to the agricultural sector is of concern because of the concentration of not only the poor, but the extreme poor, in the sector. Lending is inhibited by perceived high risks in the sector. These can be mitigated by well-structured agricultural value chain financing (AVCF). But the success of AVCF depends on further interventions on a holistic basis for value-chain development (EIB, 2020).

Figure 9 Sectoral composition of bank lending in sub-Saharan Africa (2015)



Source: ERSC research programme database

A further basic problem in bank lending is the high cost of credit. It remains stubbornly high and has shown little or no trend to compression since 2000. Margins between the lending and deposit rate are 10.6% – the highest globally – and the region has the highest bank returns on assets (1.9%) and equity (16.8%). Such high cost of credit suppresses investment in the economy (Honohan and Beck, 2007; Griffith-Jones et al., 2014; Tyson and Raga, 2020a) (Table 3).

Table 3 Financial sector efficiency and competitiveness

	Sub-Saharan Africa	LICs	MICs
Bank cost to income ratio (%), 2017 ⁱ	61.4	58.9	54.0
Bank overhead costs to total assets (%), 2017 ⁱ	5.9	6.2	3.6
Bank return on assets (%), after tax, 2017 ⁱ	1.9	1.9	1.5
Bank return on equity (%), after tax, 2017 ⁱ	16.8	17.3	12.6
Bank concentration (%), 2017 ⁱⁱ	66.4	70.5	61.0
Interest rate spread (lending rate minus deposit rate, %) 2018 ⁱ	10.6	16.6	6.6
H-statistic (closer to 1 implies greater competition), 2014 ^{i,iii}	0.47	0.35	0.60

Notes: ⁱ Simple average of countries with available Global Financial Development (GFD) data; ⁱⁱ simple average of countries with available WDI data; refers to assets of three largest commercial banks as a share of total commercial banking assets; ⁱⁱⁱ H-statistic measures the elasticity of banks' revenues relative to input prices. Under perfect competition, an increase in input prices raises both marginal costs and total revenues by the same amount, and hence the H-statistic equals 1.

Sources: GFD metadata; Tyson and Raga (2020b)

There is some debate about the causes of these high costs. Griffith-Jones et al. (2014) argue that the high spreads that result in high profitability are not justified,

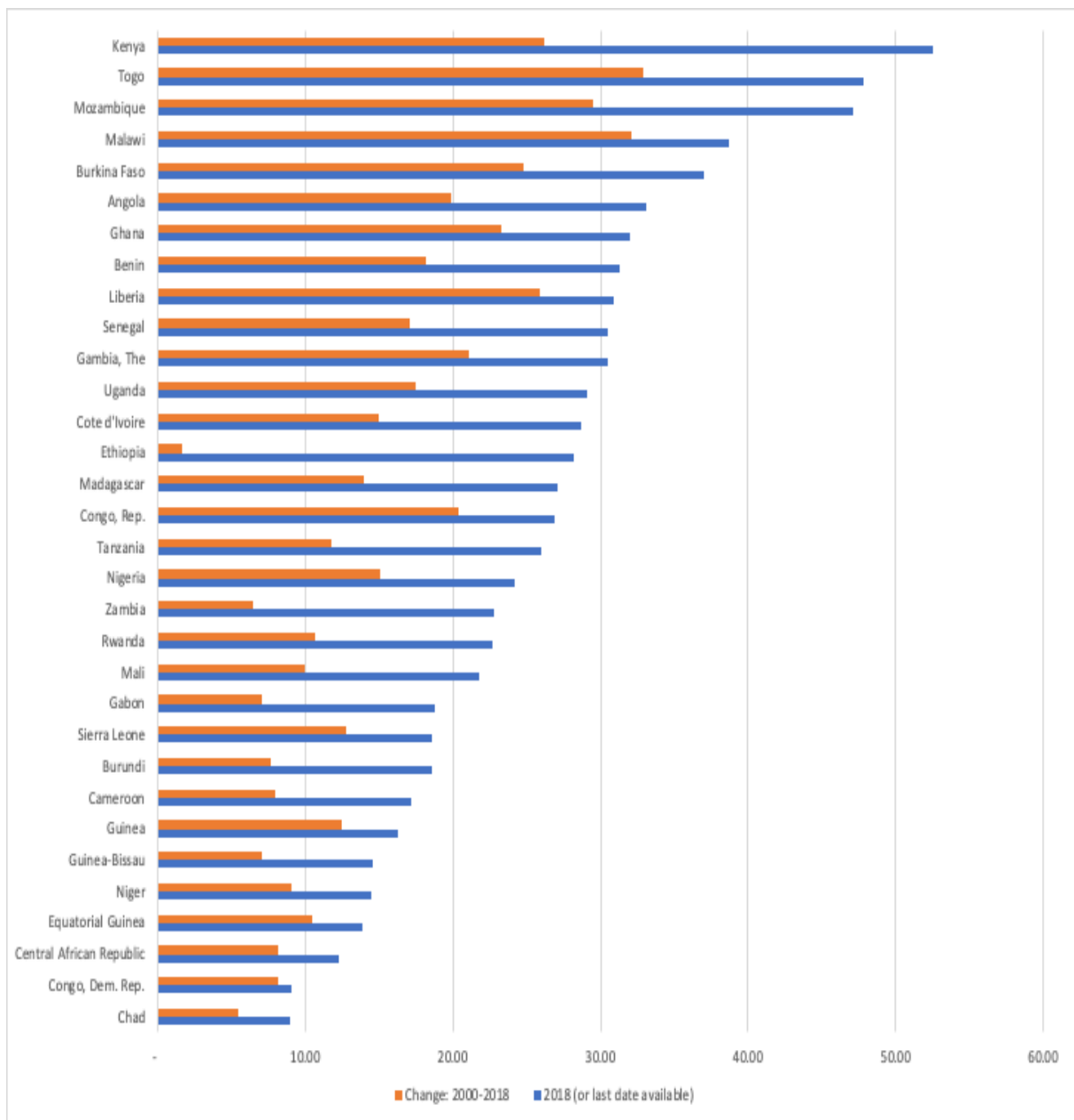
since banks in Africa lend to creditworthy borrowers with low defaults. Instead, it is argued that the high costs related to the lack of competition. This has not, however, been supported by the observation that, despite increasing competition between sub-Saharan African banks in the last decade, margins have not compressed. For instance, Griffith-Jones et al. (2014) find that high spreads in Ghana hardly fell despite the significant increase in number of banks in recent years.

2.4 Domestic savings mobilisation provides traction – but more is needed

One of the key functions of the financial system is to mobilise savings for intermediation into investment. They offer an ideal form of financing for development as they are stable, low cost and, potentially, long term. It should be noted, however, that domestic savings mobilisation has a structural relationship with the per capita GDP and, hence, tends to accelerate only as countries graduate to middle-income status (Tyson, 2015). Domestic savings can be mobilised through a number of channels. For LICs, the most important of these is bank deposits. As economic deepening progresses, however, other forms of domestic saving vehicles become complementary, including insurance assets, mutual funds and pension funds. Such vehicles are important because they facilitate long-term contractual savings (Tyson, 2015).

Across the region, domestic savings mobilisation has deepened since 2000, with bank deposits relative to GDP increasing from an average of 15.4% of GDP in 2000 to 22.2% in 2017. Almost all countries have made progress and some have made strong progress. For example, Kenya, Mozambique and Togo have achieved levels of domestic savings that, by 2017, exceeded 40% of GDP. However, as for other measures of financial deepening, there is a notable number of countries where savings mobilisation remains below 20% and a number of countries which have made only modest progress and remain in the range of 20% to 40% of GDP (Figure 10).

Figure 10 Domestic savings mobilisation by country

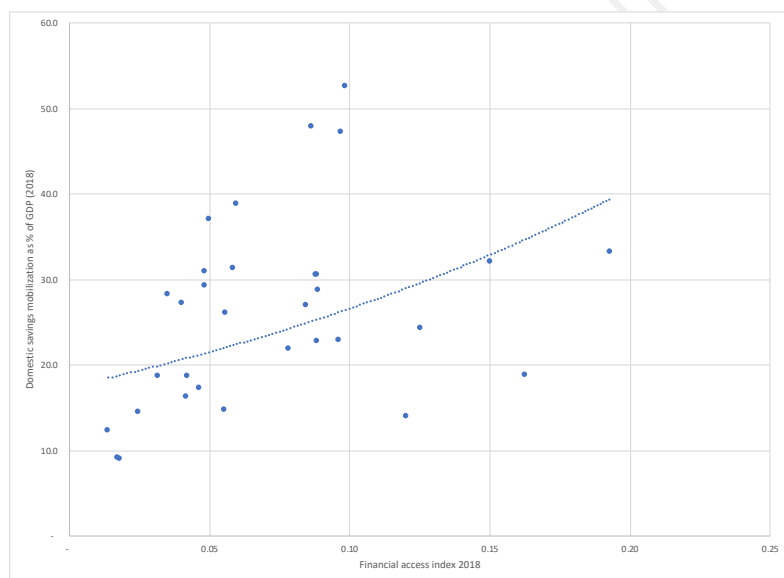
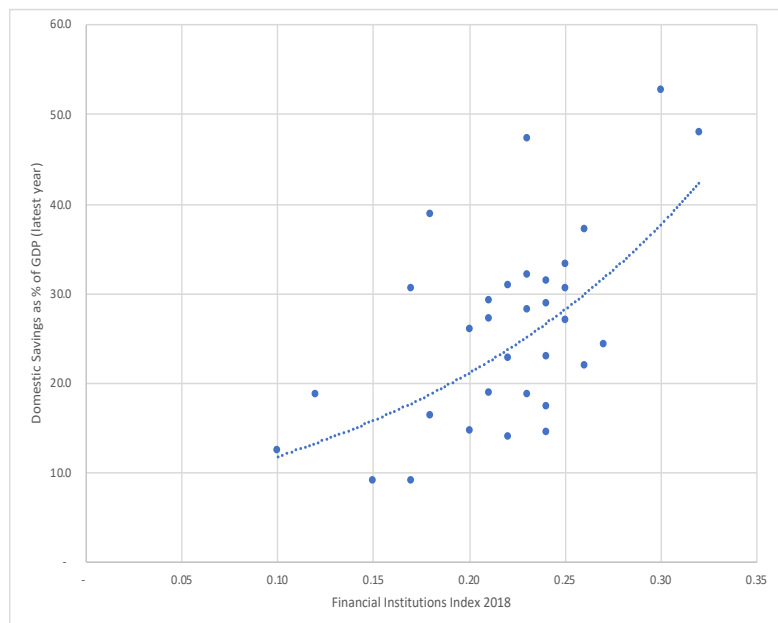


Notes: combined assets for bank deposits, insurance assets, mutual fund assets and pension fund assets; adjusted for countries with hyperinflation; excluding countries where datasets are incomplete or absent.

Source: World Bank Financial Development database

In addition to per capita GDP, a significant component of these differences is explained by financial institutional development with a strong correlation between this and deposit mobilisation relative to GDP (which averages 89% for the region) (Figure 11).

Figure 11 Domestic savings mobilisation, financial institutional development and financial access



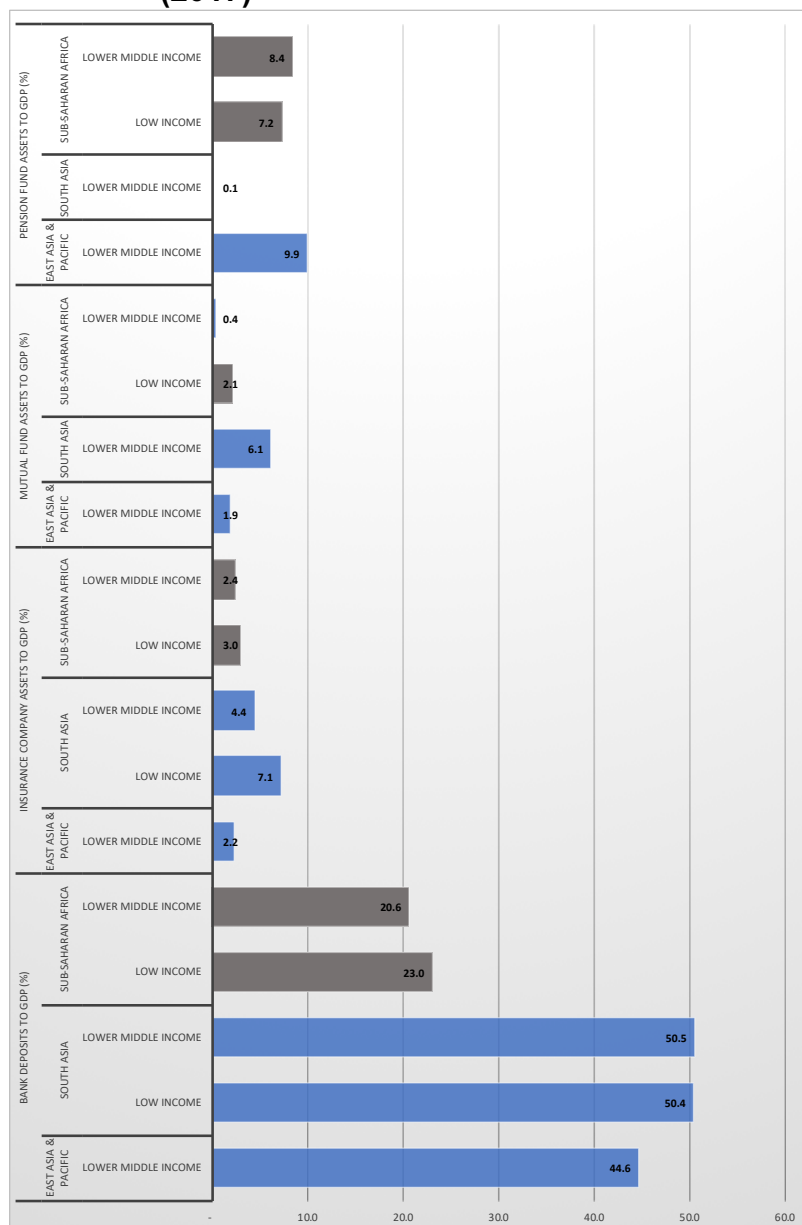
Notes: adjusted for countries with hyperinflation; excluding countries where datasets are incomplete, not comparable or absent; correlation is by country and over the period 2000–2017 (latest data available).

Sources: IMF Financial Institutions Index and World Bank Financial Development database

This relationship is unsurprising as broad academic evidence shows that the mobilisation of savings into formal financial institutions is related to the presence of and access to the relevant financial institutions as well as to the level of trust placed in them. Where financial development has progressed, it would be expected that all of these dimensions would be strengthened, leading to greater savings mobilisation. By contrast, where these factors are weak, households are more likely to save through informal financial institutions or through non-financial assets (such as land, livestock or jewellery) because these are more useful in terms of income generation and seen as more secure than formal financial assets (Collins et al., 2009; Tyson, 2015). Nevertheless, savings mobilisation in SSA remains significantly below other regions. For example, LICs and LMICs in Asia mobilise approximately double the level of deposits relative to GDP (Figure 10).

There has also been weak progress in non-deposit mobilisation of savings. For all countries in the region, bank deposits continue to dominate as the main vehicle for domestic savings mobilisation. By contrast, there has been relatively little traction in mobilising savings through insurance, mutual funds and pension funds. However, comparable countries show this may be unrealistic as levels of non-deposit mobilisation are generally low in all LICs and LMICs (Figure 12).

Figure 12 Domestic savings mobilisation by vehicle with regional comparatives (2017)



Notes: adjusted for countries with hyperinflation; excluding countries where datasets are incomplete or absent; simple average of countries.

Source: World Bank Financial Development database

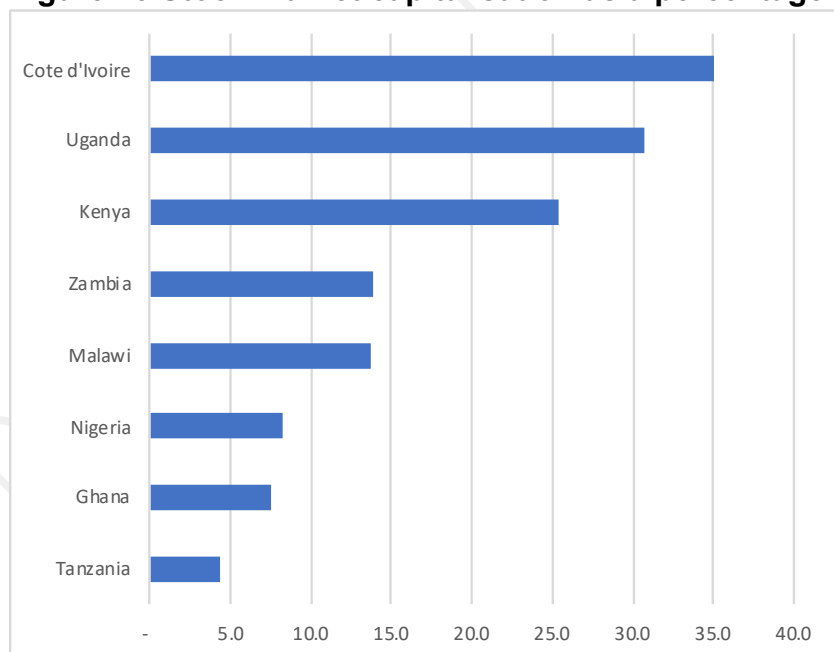
In addition, there are some notable exceptions. In Kenya, Uganda and Tanzania, for example, in 2017 pension assets reached 13.2%, 8.5% and 8.2% of GDP, respectively. This much stronger performance has been driven by the development of private institutions, such as insurance companies and mutual funds which provide products that are specifically designed for low-income households (in Kenya) or by active government policy such as government-mandated pension contributions for public employees (in Tanzania and Uganda) (Tyson, 2015).

2.5 Capital markets remain underdeveloped across the region

Capital markets⁸ play an important complementary role for bank financing in economic development. They offer an opportunity to both mobilise and diversify the financial sector and intermediate the long-term and large-scale finance needed for enterprise investment, infrastructure and, thus ultimately, structural transformation (for example, Boyd and Smith, 1997; Caprio and Demirguc-Kunt, 1998; Levine and Zervos, 1998; Beck et al., 2011; Green, Maggioni and Murinde, 2000; Murinde, 2006). In many developing countries – most notably in Asia and Latin America – capital markets have been key in mobilising finance for development. They offer a particularly attractive option where banking lending is constrained because they provide an important alternative source of finance for development with both the appropriate scale and the cost. Because of this, the Addis Ababa Action Agenda underscores the role of capital markets and encourages policy support for their development (UNCTAD, 2016; 2019).

Over the last two decades, the African continent has in an increasing number of new stock exchanges with growth in shares listed and traded volumes. Twenty-eight countries across SSA now have national stock exchanges and the total capitalisation exceeds more than USD1.1 billion. Despite these improvements, capital markets in SSA⁹ remained underdeveloped. Average capitalisation remains small relative to GDP and the number of listings is low. For example, the highest stock-market capitalisation in SSA is 35.1% of GDP in the Côte d’Ivoire, way below the comparative regions (such as the East Asia and the Pacific region whose capitalisation relative to GDP is 112%) (Figure 13).

Figure 13 Stock market capitalisation as a percentage of GDP



Notes: Latest year available – 2012 for countries except Nigeria, which was 2017; excluding countries where datasets are incomplete or absent.

Source: World Bank Financial Development database

⁸ See the companion paper, Soumaré and Kanga (2010), for a more detailed discussion of capital-market development in the region.

⁹ Excluding South Africa

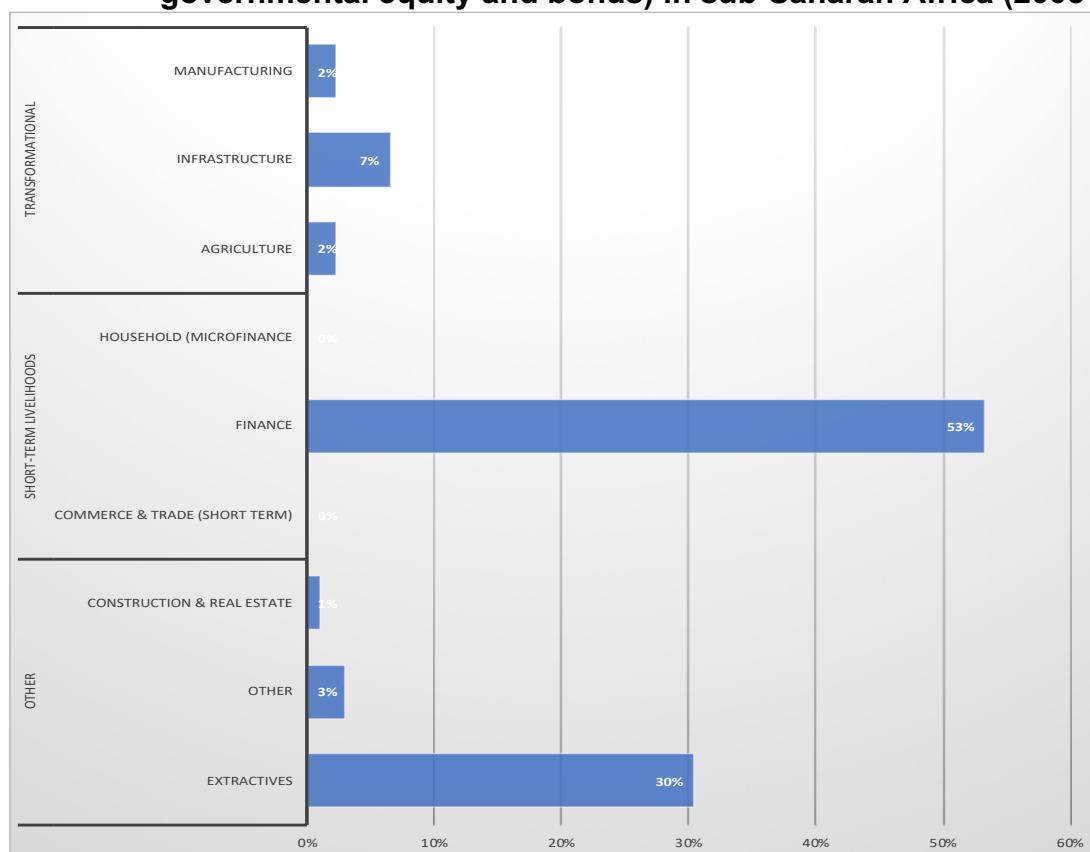
Furthermore, markets are dominated by public debt (and especially short-term government debt), the range and tenure of securities is limited and liquidity is weak. There is limited interest from domestic and international investors. These effects have contributed to high costs of issuance and secondary market volatility – adding a further layer of disincentives to issuers and investors (Murinde, 2006; Beck et al., 2011; Soumaré and Kanga, 2010).

The underdevelopment of capital markets is explained by a number of structural factors including the small size of the domestic economies, macroeconomic and business environment and the quality of institutions (Soumaré and Kanga, 2020). The listing and issuance requirements in most African stock exchanges are also too high relative to the capacity of the domestic companies. For example, the lengthy administrative procedures for listing, the high transaction costs, the lack of training and knowledge about capital markets, as well as the lack of transparency in some of these marketplaces are all constrain listings (Soumaré and Kanga, 2020).

A more encouraging recent trend has been the emergence of regional stock markets. These are of importance because many low-income economies lack the critical mass to sustain a well-developed capital market in isolation. Nevertheless, this development remains nascent (Soumaré and Kanga, 2020). Policy efforts to tackle these problems have included improving regulation and incentives such as tax breaks. International donors have offered technical capacity building to support these efforts. To date, however, these have not been particularly effective (Murinde, 2006; Beck et al., 2011; Soumaré and Kanga, 2020).

A further problem – and similar to that relating to bank credit – is that most of finance being mobilised remains concentrated in a few sectors. In particular, 30% of capital raised in the last decade has gone to the extractive sector, making little contribution to economic transformation. The second most dominant sector is financial services which received 53% of finance mainly by regional banks to expand their expansion. This is more encouraging as regional banks on-lend to small and medium enterprises (SMEs) and low-income households as part of the expansion of financial access (Tyson and Raga, 2020a) (Figure 14).

Figure 14 Sectoral composition of primary capital market issuances (non-governmental equity and bonds) in sub-Saharan Africa (2005–2015)



Source: Author (based on ERSC research programme database)

2.6 Financial stability and regulation have strengthened but challenges are growing

As discussed earlier, financial stability is essential in order to realise the benefits of financial development. In sub-Saharan Africa, there has been steady progress in improving the regulatory and governance frameworks, and banks have high levels of capital and liquidity (and, indeed, perceived excessive ‘hoarding’). Non-performing loans have been reduced in some countries (EIB, 2020).

There have been specific regulatory improvements. These include the broad enactment of Basel I across the region. Selected aspects of Basel II and III banking regulations are being considered, although the majority of jurisdictions and banking institutions have not fully enacted these new international regulations. This is in part because of a debate about their appropriateness to the financial stability risks in the region as well as due to more basic capacity issues at regulators and bank institutions. The International Financial Reporting Standard 9 (IFRS 9), which has a more robust approach to the recognition of non-performing debt and stronger banking-resolution mechanisms, has also been widely implemented (Jones, 2019; EIB, 2020).

Nevertheless, failures of individual banking institutions remain common. For example, in SSA, between 1990 and 2009, 57% of countries experienced domestic institutional failures. Typical problems that lead to such banking failures include failures of

governance, insider lending and corruption. Such failures have undermined public trust in banking institutions which, as noted, also undermines key goals for the financial development such as deposit mobilisation (Lunogelo et al., 2009; Mezui et al., 2012; Central Bank of Kenya, 2013; Tyson, 2015; Beck and Tyson, 2018).

Such failures have also resulted in some countries experiencing systemic banking crises. Ghana saw a wave of institutional failures in 2015 which resulted in the Bank of Ghana leading a managed consolidation of failed institutions and a programme of reform of the banking sector. Reforms included a robust asset quality review which uncovered substantial previous unrecognised impaired loans, many of which were loaned to state-owned enterprises in the energy sector. The government subsequently restructured much of this debt during 2017. There was also a 230% increase in the minimum capital requirements in 2018. A number of institutions had difficulty in meeting these higher capital requirements and the Bank of Ghana had to manage a prolonged resolution process. Actions included managed mergers of weak institutions into stronger ones, the revoking of licences, and voluntary dissolution and capital injections under government guarantees. These events led to a consolidation of the banking sector with the number of banks failing dropping from 34 in 2017 to 23 by early 2019. The Bank of Ghana also had to provide government deposit guarantees in order to prevent ‘bank runs’ at formal banks and microfinance institutions. Nevertheless, several creditors saw forced ‘haircuts’ on amounts due, which undermined investor confidence. These reforms and strengthening of the banking sector are expected to continue but their impact has been a suppression of economic growth and a significant fiscal cost (EIB, 2020).

The Nigerian banking sector has also seen repeated financial crises including in 2009 and 2015. Weak corporate governance, malpractice and corruption have also been major problems in the Nigerian banking sector, along with poor regulatory compliance and enforcement. In 2009, there were widespread failures of banking institutions and the Central Bank of Nigeria had to inject significant liquidity and restructure eight banks. By 2016, some of these problems had been addressed but a high percentage of lending to the oil industry in combination with a decline in oil prices led to a number of companies being unable to service their loans, causing another cycle of bad debt and institutional failures. The policy response placed restrictions on the use of foreign currency. However, the national reserves needed for this were rapidly depleted and the government had to allow currency to float freely. It then suffered further depreciation. Nigeria's history in relation to capital-flow management illustrates the dilemma that L&MICs face in balancing the trade-off between allowing sufficient capital inflows to stimulate growth while managing the associated financial instability risks. On this occasion, however, the non-performing assets problems were well managed by the Central Bank of Nigeria, including setting up a resolution corporation and enforcing compliance with rebuilding of capital base and recognition of bad debts. Since 2018, the banking sector has been more stable, but credit growth has been essentially static (Sanusi, 2010; Ajakaiye and Tella, 2016; Tyson, 2016).

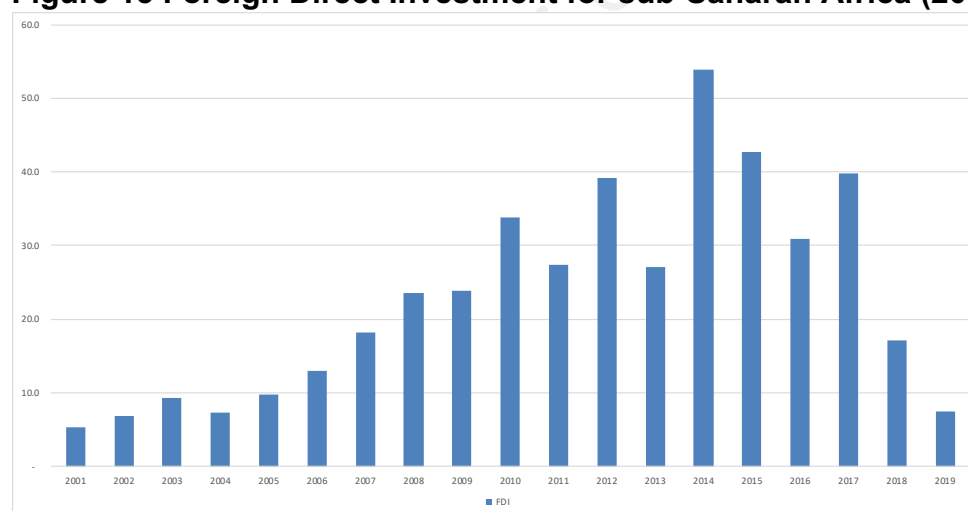
In Kenya, there have also been repeated problems. The political violence in 2007 created a surge in non-performing loans. There was a further collapse of three banks in 2015 and 2016 because of failures in governance and insider lending. The Central Bank of Kenya responded with managed consolidation of failed institutions into stronger banks which contained systemic risks, although lending has yet to

experience a substantive return to growth. The Kenyan banking sector was also affected by control of lending rates although, following a contraction in lending, they were rescinded in 2018 (EIB, 2020).

Finally, the Basel III framework has had some unintended negative consequences in the region. There has been a weakening of international correspondence banking relationships as global banks withdrew from the market, which was seen as excessively risky in relation to strengthened regulation on anti-money-laundering and financing of terrorist organisations. Angola, for example, lost all of its US dollar correspondent relationships. Mauritius and the Seychelles saw a decline of a third in correspondence banking activity. Countries with the highest terrorist risk profile – most notably in the Sahel and the Horn of Africa – also had all relationships terminated (EIB, 2020).

Sub-Saharan Africa has seen increasing levels of cross-border flows since the global financial crisis of 2007 when the region became an ‘alternative investment’ destination with more than USD550 billion flowing into the region between 2008 and 2019. Such international finance can supplement domestic financial resources and are channels for increasing integration into the global financial system. The majority of these flows have been foreign direct investments (FDIs) which accounted for USD395 billion or 72% of the total and is positive because of FDIs’ stability and potential spill-over effects¹⁰ (Figure 15).

Figure 15 Foreign Direct Investment for sub-Saharan Africa (2001–2019)



Notes: latest year available was 2019 but this was incomplete for a number of reporting countries and so is understated; excluding countries where datasets are incomplete or absent.

Source: World Bank Development Indicators database

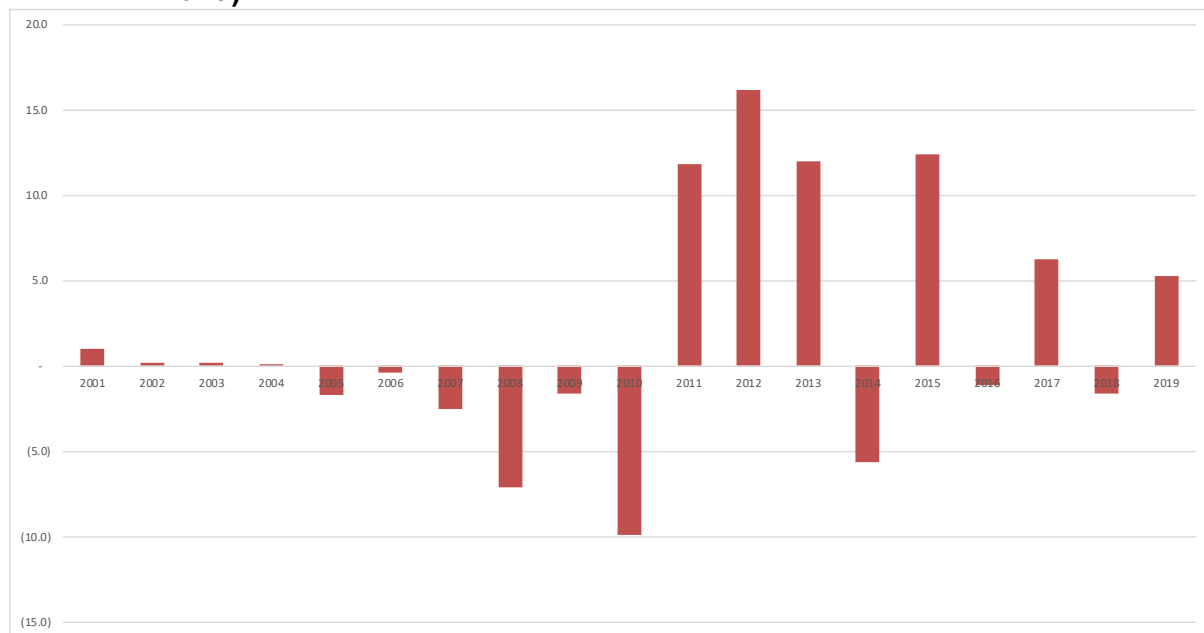
However, the benefits of this FDI have not been fully realised in the region. While, telecommunications and financial services – both critical enablers of transformative growth – received a significant share and there was some greater diversification by sector and country (for example, Ethiopia received a total of USD 19 billion in the same period, mainly for its manufacturing sector), much of this FDI went to the extractive sector (including in the Congo DR, Mozambique, Nigeria, Sudan and

¹⁰ See Velde (2019) for more detailed discussion of the advantages and disadvantages of FDI and the factors determining its contribution.

Zambia) and peaked in 2014 as the commodity price ‘super cycle’ went into decline from 2015 on. Many countries in the region, and especially LICs, received little or no FDI beyond the extractive sector throughout the period. Given this, it is unsurprising that FDI in this period has not been associated with significant productivity growth in host economies in the region (Bastiano et al., 2020).

Since 2011, there has also been significant growth in portfolio flows with USD36.7 billion flowing into the region between 2008 and 2019. This mainly consisted of USD-denominated sovereign Eurobonds (IMF, 2020) (Figure 16).

Figure 16 International bond and equity flows for sub-Saharan Africa (2001–2019)



Notes: Latest year available was 2019 but this was incomplete for a number of reporting countries and so is understated; excluding countries where datasets are incomplete or absent.

Source: World Bank Development Indicators database

Such ‘hard currency’ debt can finance economic development and, indeed, some of this finance was applied to, for example, infrastructure development (for instance, in Nigeria). Where such infrastructure projects are well executed, they can boost economic growth. Elsewhere, however, the ‘hard currency’ debt was mismanaged or mis-spent. For example, in Mozambique proceeds from sovereign bond issues were misappropriated through fraud and, in Ghana, proceeds were used for pay rises for civil servants prior to an election. Contributing to these problems were weak debt-management capabilities as well as corruption and ‘pork barrel’ politics (Tyson, 2015).

Such portfolio flows also create financial instability risks. They have repeatedly been the cause of financial crisis in L&MICs because they can be pro-cyclical, causing macroeconomic disruption (Kinderberger, 2005; Rogoff and Reinhart, 2009; Ocampo et al., 2010; Boissay et al., 2013; McKinley and Tyson, 2014; Tyson et al., 2014a; 2014b; Ocampo and Griffith-Jones, 2018). Consistent with this, since the downturns in commodity prices in 2015 and the Covid-19 pandemic in 2020–2021, some

countries’ debts have become unsustainable with, at the time of writing (March 2021), Zambia in default and others at high risk of default (IMF, 2020).

Managing risks from such international capital flows can be difficult for developing economies. Recent financial liberalisation has diminished capital-management tools, there is often a lack of access to foreign-currency swap arrangements and the use of countercyclical monetary policy can be counterproductive (Tyson and Beck, 2018).

Management of African cross-border capital flows is made more complex because of the increasing intermediation via offshore financial centres. The most important offshore financial centre for Africa is Mauritius with over USD80 billion or 22% of the region’s total FDI flowing through the country between 2008 and 2019. Other offshore banking centres are also important, including those in the Caribbean and Namibia. These offshore financial centres offer key advantages of tax neutrality and US or UK legal jurisdictions which help mitigate some of the risks (most notably political and legal risk) that deter investment in some African countries. Because of this, they are widely used by International Financial Institutions (IFIs) and private investors. Offshore financial centres can, however, also be conduits for illicit outflows, especially from commodity exporters (Nkurunzia et al., 2012). Key to balancing these pros and cons is strong regulation and transparency including those implemented under the Global Forum and by national regulators in offshore financial centres (Tyson, 2018).

A further regulatory challenge has been the growth in regional banking. Since the mid-2000s, there has been a rapid growth in foreign banks’ subsidiaries with headquarters in Africa (i.e. Pan-African banks or PABs). Factors driving this include a search for better business returns and increased diversification of assets and risks outside the location of parent banks. Increasing market size and macroeconomic stability of investment destination and country-pair (à la ‘gravity’ model) factors such as geographical and cultural proximity have also been important (Mathieu et al., 2019; Tyson and Raga, 2020b).

At present, there are ten major PABs¹¹ based in Kenya, Nigeria, South Africa and Togo. These have become systemically important institutions in the countries where they have a presence. For instance, PABs account for account for 20% or more of their respective host-country banking system assets and the majority of deposits in many smaller countries (for example, in 2013, PABs accounted for 70% of total deposits in Benin, Chad, Central African Republic and Mali) (Enoch et al., 2015; Mathieu et al., 2019; Tyson and Raga, 2020b).

PABs’ impact on financial deepening has been broadly positive. They have contributed to the expansion of financial access and credit growth including for households and SMEs. For instance, Kenyan PABs leveraged their expertise in agent and mobile banking to reach the unbanked population in East Africa. Moroccan PABs in West Africa have increased lending to SMEs (Beck et al., 2014; Born and Mathieu, 2015). Nigerian banks are responsible for the 20%, 26% and 35% growth of bank branches in Ghana, Sierra Leone and The Gambia, respectively, and have been reported to be increasingly present outside capital cities (IMF, 2015). They have also intensified competition in a number of countries, which, along with their basic operating model, has made them more efficient and less profitable than other

¹¹ Not counting PABs with headquarters in North Africa (Mathieu et al., 2019).

institutions (IMF, 2015; EIB, 2016). However, this also relates to their greater exposure to the less creditworthy SME sector and commensurately higher non-performing loans (Pelletier, 2014; Tyson and Raga, 2020b).

This trend also poses risks. Based on ownership linkages, Kenya, Morocco, Nigeria, and South Africa are the main centres of connection among the banking sectors in SSA (Mathieu, 2019). PABs in Morocco and South Africa have large cross-border investment linkages outside Africa. This means that there are heightened contagion risks in the event of crises to and from African and non-African financial systems. The region has seen some progress in developing cross-border supervisory colleges and regional regulatory harmonisation to manage these risks but these need further development (IMF, 2015).

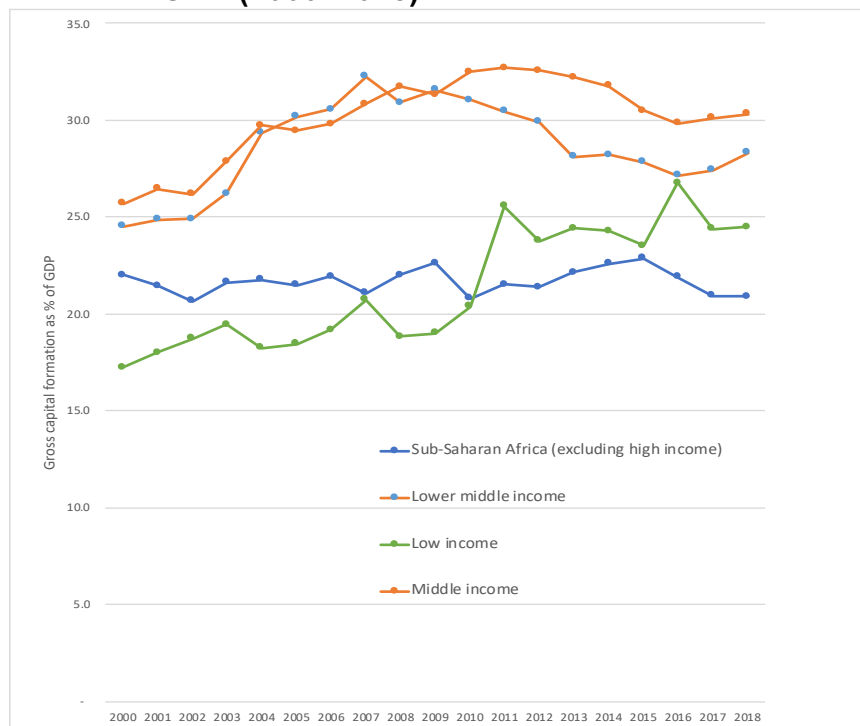
2.7 Conclusion

In this section we have reviewed the progress made in financial development since 2000. On the positive front, the scale of the financial sector has grown. Regulation has been broadly strengthened and systemic financial stability risks contained. Most impressively, there has been a sharp rise in financial access in the region including in remote and rural areas where poverty is often concentrated.

However, deficiencies and gaps remain. While credit has grown, it remains too small, too expensive and too short term. Domestic savings mobilisation remains insufficient and non-bank savings institutions underdeveloped. Progress has been largely limited to the banking system, with little development of capital markets except in a few countries and gaps in the financial architecture. Critically, the finance that is being provided is poorly aligned with the needs of transformational growth. Far too much continues to go to sectors with little or no contribution to such growth, for instance to extractive or short-term uses such as local trading and households. By contrast, far too little is going to agriculture and manufacturing.

The effects of these deficiencies in financial development can be seen in the most fundamental driver of economic development – investment (for example, Cramer et al., 2020). Investment (as represented by gross capital formation) in the region remains stubbornly low. Over the last two decades, it has been essentially been static. By contrast, in the same period, other developing countries (including LICs) have seen consistently higher levels of investment with steady increases since 2000 (Figure 17).

Figure 17 Regional comparatives in gross capital formation as a percentage of GDP (2000–2018)

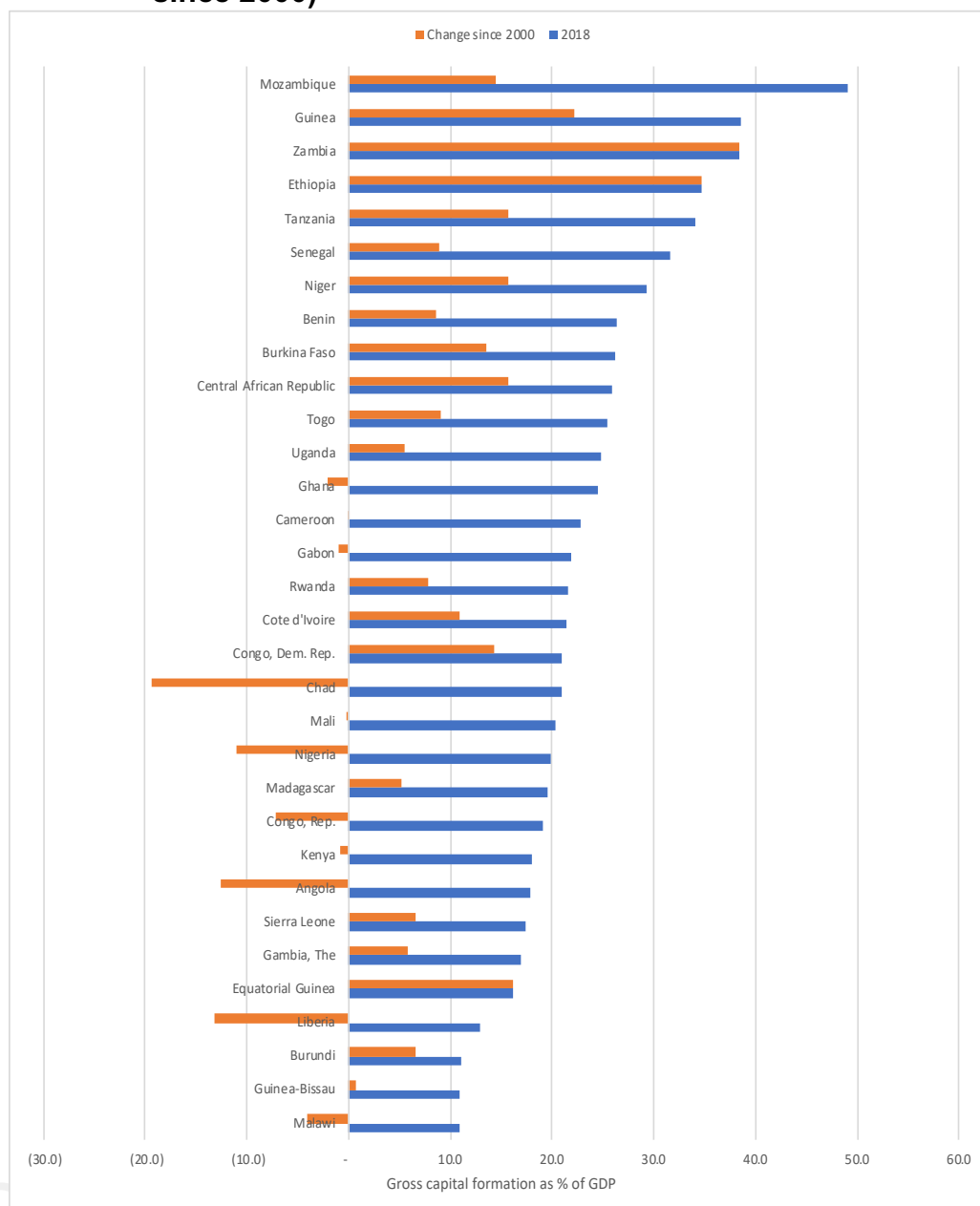


Note: Latest year available was 2018.

Source: World Bank Development Indicators database

This pattern of insufficient investment is also true of individual countries. Almost all countries in SSA – 25 out of 32 (78%) – have investment levels below the 28.3% of GDP being achieved by LMICs elsewhere (Figure 18).

Figure 18 Gross capital formation as a percentage of GDP (2018 and change since 2000)



Notes: Latest year available was 2019 but this was incomplete for a number of reporting countries and so is understated; excluding countries where datasets are incomplete or absent.

Source: World Bank Development Indicators database

A few have achieved higher levels of investment, but these include those that have done so only in extractives. For example, Mozambique had a 49% gross capital formation of GDP in 2018 but this reflected booming investment in its natural gas reserves. Similarly, Guinea and Zambia have achieved high levels of investment of 38.6% and 38.4%, respectively, but this relates to investment in their extractive industries.

There are some exceptions to this gloomy picture. Ethiopia has achieved the highest level of investment in the region outside the resource-dependent economies with a gross capital formation level of 34.7% of GDP in 2018. Tanzania also achieved a high level of 34.0% of GDP in 2018, a near doubling of investment level since 2000. But neither achieved this through domestic private financial development. Rather, Ethiopia achieved it through state-directed investment and by attracting Chinese FDI into the manufacturing and services sector (accounting for 60% of all FDI into Ethiopia in 2019). Tanzania achieved it by attracting investment from China and the Middle East (such as into the USD11 billion port in Dar es Salaam and into coastal special economic zones (SEZs) (UNCTAD, 2020).

These deficiencies in the formal financial-sector development also have another important implication: finance for the private sector and households in the region continues to be dominated by informal financial services. As discussed, evidence shows that this is useful for supporting informal occupations and bolstering household resilience (although it can also be associated with trapping low-income households in ‘survivalist’ informal occupations and over-indebtedness). What it does not do is provide the finance needed for structural transformation, including the capital investments needed for increasing productivity and enabling larger-scale enterprises – both of which lie at the heart of economic transformation and which brings with them higher wage and secure formal waged employment that enable permanent escapes from poverty.

Overall, a significant ‘financial structuring gap’ remains in SSA between the existing financial structure and the ‘optimal financial structure’ needed for inclusive and sustainable economic transformation.

In Section 3, we examine the implications of this in more detail and at the country level by considering what causes this gap and how it affects the relationship between financial development and economic growth.

3 Exploring country variances in the role of finance in economic development

3.1 Introduction

A key theme of this working paper is that finance is not a goal in itself. Rather, its importance is in supporting and enabling inclusive and sustainable economic growth (‘economic growth’) through investment.

The evidence that this holds true for African countries is much more mixed (Murinde, 2012). Recent studies have examined this issue at the regional level and linked it to the quality of credit within the financial system. For example, Murinde (2012) and Menyah et al. (2014) found that the finance–growth nexus in Africa has been weak. Demetriades and Janes (2011) found that while bank balance sheets grow with GDP, bank credit does not follow or lead growth in Africa – further indicating a broken link – although Demetriades and Rewilak (2020) clarified this in that where the quality of credit is high (as defined by the Z-score, and measure of liquidity and a levels of impaired loans) the finance–growth nexus held in SSA (as well as in other regions). This research suggests that, at a regional level, healthy banks and more broadly strong institutions, are essential for finance to have a positive effect on economic growth in sub-Saharan Africa (Murinde, 2012).

Beyond this regional view, there are also significant differences between countries in the strength of this relationship. As discussed, these differences relate to non-financial factors such as the political and macroeconomic environment. But they also relate to the ‘quality’ of finance – such as the scale, cost, tenure and sector – a country’s financial structure provides. This section addresses these issues.

The discussion draws on the academic evidence and, in particular, econometric studies examining the strength of this relationships between financial development and economic growth. This literature includes, for some countries and at a regional or income category (such as for LICs, the majority of which are in SSA), a reasonable number of well-founded econometric studies (see Appendix A1).

There are, however, significant research gaps and some of the evidence is mixed and contradictory. Some studies relate only to certain periods, which can be structurally different from the post-2000 period being discussed in this working paper. In addition, nearly all studies examine only the reasons behind the differences in the

relationship on a discursive basis (Ajakaiye and Finn, 2012).¹² As such, while this current academic literature provides a useful quantitative evidence, because of its shortcomings and gaps, the discussion here remains tentative. Financial development has a strong relationship with economic growth under certain conditions

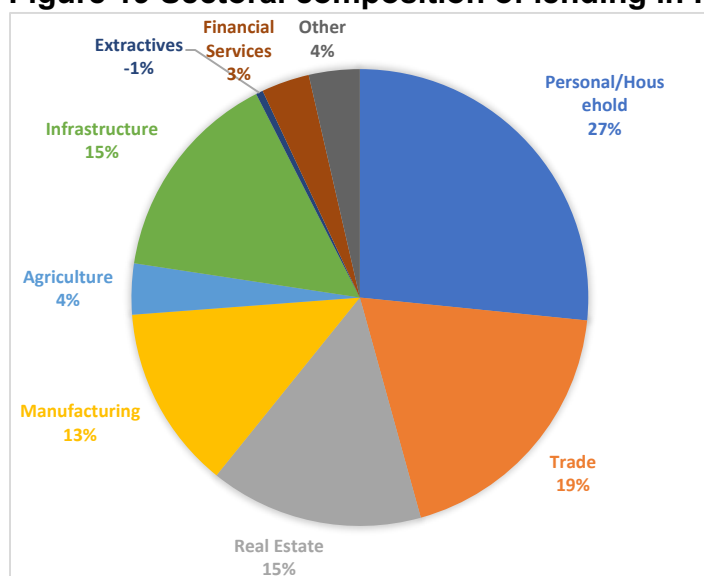
As discussed, some countries in SSA have made significant progress in financial development relative to their peers. However, of these only a select group have a strong positive relationship between financial development and economic growth when it is good ‘quality’ and combined with macroeconomic stability and institutional strengthening.

These countries’ financial development appears to be characterised by the qualities that support the scaling-up of transformational investment. Their banking sectors have grown in scale significantly. But, more importantly, this has been accompanied by increasing diversification of lending by sector, increasing financial access and reasonable financial stability – all supported by a broad context of stability in macroeconomic fundamentals and in political and regulatory institutions.

The best example in the region is Kenya, which has one of the highest financial development index scores in the region at 0.20 in 2018 and that progress has been broadly achieved across almost all key indicators. There is consistent econometric evidence showing that this has been a positive causative factor in long-term economic growth (section 3.2). Its financial sector has grown in scale. Credit to the private sector has grown significantly, reaching 27.8% in 2018, well above the regional average of 17.8% of GDP and above the average for LMICs of 21.8%. Equally importantly, this growth in credit has been directed to reasonably well-diversified sectors. This has included lending to households, trade and SMEs – all of which support short-term livelihoods and resilience and made growth more inclusive. In addition, credit has grown in sectors that support longer-term transformation, including infrastructure and manufacturing (Figure 19). The only sector where growth in lending has been sub-optimal is agriculture, which received only 4% of total lending in 2019. Reflecting this (among other factors), although output in the agricultural sector has increased over the last decade, productivity has not and, in fact, has fallen in some counties (Tyson and Diwakar, 2020) (Figure 19).

¹² Ajakaiye and Finn (2012) comment on these issues in more detail. They note that the empirical evidence relating to finance–growth linkages in African countries is mixed. Studies find opposing results regarding the direction of causality, even when they use the same econometric methodologies. Some studies find a significant relationship between banks, stock markets and economic growth. Others focusing on the role of external-sector finance (foreign aid, inflows of FDI) also find mixed results although these may be due to variance of model specifications and data sets. There are shortcomings in the studies: empirical results regarding finance–growth linkages are not robust to the time period of data. Multi-country data sets fail to grasp country-specific effects. The empirical studies provide no clear-cut solutions on regulation design.

Figure 19 Sectoral composition of lending in Kenya (2019)



Source: Central Bank of Kenya (2019b)

Much of this growth has been funded by deposit mobilisation, with savings mobilisation nearly doubling since 2000 to reach 54% of GDP in 2018 – the highest in the region. Financial access has seen exceptionally strong expansion, with formal inclusion reaching 82.8%. Complete exclusion fell to 11.0% in 2019 with access reaching marginalised groups including low-income households, women and rural households. This has been driven by the growth of mobile banking accompanied by government support and strong development of information and communication technology (ICT) (Central Bank of Kenya et al., 2019a). The growth in the banking sector has been accompanied by strengthening regulation and institutional soundness. As discussed in Section 2, there have been a number of financial instability problems in Kenya but they have been fairly well managed by the Central Bank of Kenya in recent years, and the political and macroeconomic environment has been reasonably stable following the establishment of the new constitution in 2010 (Upadhyaya, 2017; Central Bank of Kenya, 2020).

Kenya’s capital markets have also deepened. However, bond markets are concentrated in government securities and equity markets in a few large banks, real estate and telecoms companies. As such, while positive, Kenya’s capital market development needs to deepen further in order to support medium-term economic development (Soumaré and Kanga, 2020).

The Kenyan financial sector has some shortcomings. Increased competition has not driven increased efficiency in the banking sector, with little improvement in the cost of lending. This issue also remains politically sensitive. Caps on interest rates were introduced in 2016, but repealed in 2019 because they were seen to have caused contraction in lending. But the high cost of credit remains a constraint on investment (Central Bank of Kenya, 2020; Tyson, 2015).

Nevertheless, Kenya’s financial development is an example of how broad improvements across multiple dimensions of ‘quality’ in financial development can provide strong positive effects on economic growth.

3.2 The role of financial development is weakened by deficiencies in the same factors

In countries where these dimensions of ‘quality’ are weaker, there is a commensurate weakening in the financial developments in driving economic growth. Examples are Ghana and Côte d’Ivoire. Both have strong financial development with index scores of 0.15 in 2018, and supportive econometric evidence that financial development has positively driven growth. However, this evidence also indicates that the relationship is more volatile and weaker than for Kenya (section 3.2). These differences in the strength and consistency of the relationship appear to be related to a number of factors including endogenous factors within the financial system and exogenous ones relating to the macroeconomy and political economy (Kedir et al., 2018).

In Côte d’Ivoire, GDP growth has been strong over the last decade supported by infrastructure and private-sector investments and a steady improvement in the business environment. There has also been increasing digitalisation and diversification of the economy into manufacturing and agricultural processing. Nevertheless, the economy remains concentrated in the agricultural sector¹³ with macroeconomic cycles related to their prices (IMF, 2019a). Against this background, the banking sector has grown and strengthened and Côte d’Ivoire has the largest stock market in the region relative to GDP. The financial sector, however, has weaknesses in its ability to support economic growth. Credit to the private sector remains low at 7.4% of GDP at 7.4% in 2020 – barely a third of the average of 21.8% for LMICs.¹⁴ New issuances on the stock markets are limited for the private sector. There has been a steady increase in financial access from 21% in 2014 to 41% in 2017 driven by increasing use of mobile banking (according to the Consultative Group on to Assist the Poor, CGAP). But this remains modest for a LMIC and financial access is less inclusive, with continued marginalisation of the poor and women and a limited range of online financial products.¹⁵ Further, approximately 20% of private banks remain undercapitalised and public banks do not comply with prudential regulations. The government has been criticised for being slow to reform these weak institutions, which has undermined confidence in the banking sector (IMF, 2019a).

In the case of Ghana, the financial sector also shows weaknesses. In the early 2000s, the state owned the majority of financial institutions and they were moribund and dysfunctional with accumulation of high non-performing debts. An extended programme of financial reform was instigated including privatisation of banks, legislative and policy reforms and strengthening of regulation. These problems re-emerged in 2016 with nine banks identified as undercapitalised. Banks were required to rebuild their capital, but a number of institutions had to be restructured by the Bank of Ghana, including the assumption of non-performing loans into a state-owned ‘bad asset’ bank. The cost of this restructuring totalled 3.8% of GDP in 2018 and 2019. Bank of Ghana was criticised for not having been sufficiently robust in its regulation

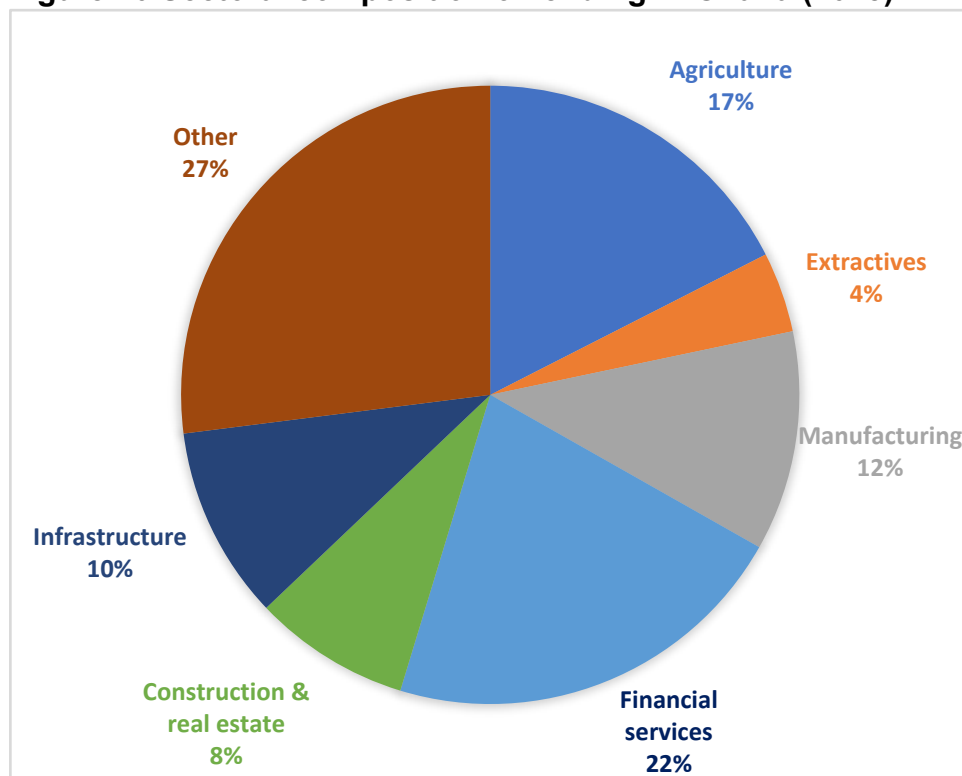
¹³ Notably agricultural commodities such as cocoa beans and cashew nuts.

¹⁴ Sectoral breakdown of lending by member country is not available from the Central Bank of West African States (BCEAO).

¹⁵ (<https://www.cgap.org/blog/cote-divoire-financial-inclusion-crossroads>).

of these institutions and a programme of regulatory and supervisory strengthening has been implemented. Because of these issues, financial development stalled, credit growth effectively came to a halt and private credit relative to GDP remains low at 13.9% in 2019. Positively, lending is reasonably well diversified for the region. However, as for Côte d’Ivoire, the key factor is that the economy is concentrated in agricultural commodities and, in addition to the effects of price cycles on the macroeconomy, lending to the agricultural sector is well below that needed for improved productivity and development of the sector (IMF, 2019a) (Figure 20).

Figure 20 Sectoral composition of lending in Ghana (2018)



Source: Price Waterhouse Coopers, Ghana

The banking sector in Ghana is also concentrated, with the three largest banks accounting for 41% of banking assets, which has impeded competition with little or no improvement in efficiency and the cost of credit. Financial access in Ghana rose from 29% of the population in 2011 to 58% in 2019, partly supported by the adoption of mobile banking, but this remains modest for the region and access remains limited among the poorest households and in rural regions (IMF, 2019b).

3.3 The relationship between finance and growth is weak in resource-dependent economies

A number of countries in the region are considered to be resource-dependent, which appears to be a causal factor in a weak relationship between financial development because of the relationship between commodity prices and financial and macroeconomic instability. Such economies are prone to ‘boom and bust’ cycles in commodity prices. This has been particularly notable between 2000 and 2016 when

there was a ‘super-cycle’ of rising commodity prices followed by a collapse from 2015. Such cycles affect private-sector growth, fiscal revenues and are often also associated with macroeconomic instability including currency devaluation and debt unsustainability (Tyson and McKinley, 2014; Tyson, 2015).

In such resource-dependent economies, credit to the private sector is often also concentrated in the resource sector, making credit quality dependent upon commodity prices. If commodity prices rise, then as risk appears to wane, credit grows, including to more marginal lenders. But when prices fall, so does creditworthiness, leading to rising non-performing debts and banks needing to write-off debts and rebuild their capital base. In a worse case, institutions fail. But more commonly, this results in a retraction in lending – colloquially known as a ‘credit crunch’ – as banks seek to manage rising non-performing loans and rebuild their capital base by sharply reducing new lending. Such a response then has a procyclical and reinforcing recessive effect on the macroeconomy of decline in commodity prices (Tyson, 2015).

What is interesting is that these ‘boom and bust’ cycles only have a moderate effect on financial development in isolation. As shown in Table 4, the average across all categories of oil-exporting countries and resource-dependent countries is moderately below that of countries that are not resource-dependent. For MICs, the difference is not significant across the categories. For LICs, the difference is larger but still small and also affected by the concentration of FACS among LIC oil exporters (Chad only) and resource-dependent countries (Democratic Republic of the Congo and South Sudan) (see Table 4).

Table 4 Financial Development Index for oil exporters, resource-dependent and non-exporters in sub-Saharan Africa (2018)

IMF definition	LICs	MICs	Average (all)
Oil exporting	0.10	0.15	0.14
Resource dependent (non-oil)	0.10	0.14	0.11
Non-resource dependent	0.12	0.16	0.13
Source: IMF financial development index (2018) data elaborated by author			

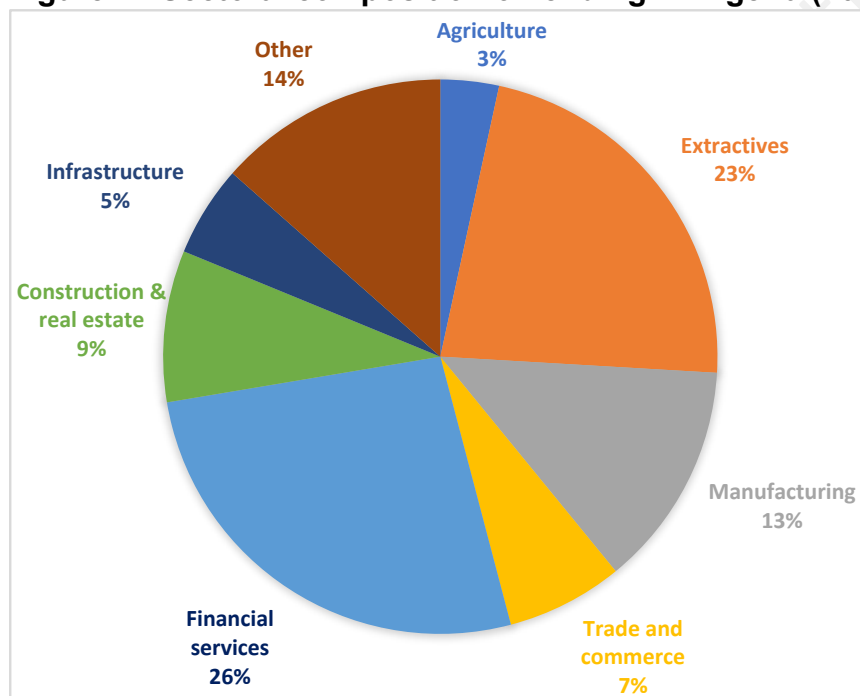
These cycles also appear to weaken the relationship between financial development and economic growth with the major oil and commodity exporters in the region – including Angola, Nigeria and Zambia – having weak or mixed evidence of financial development supporting economic growth (section 3.2).

This is consistent with the broad academic evidence showing that macroeconomic and financial instability reduce the effects on financial development on growth (as discussed earlier). The specific effects of resource-dependence have also been examined in a number of academic studies. Nili and Rastad (2017) conducted an econometric study based on a sample of economies and found that financial-sector development has less influence in oil-exporting economies. They attributed this to the presence of oil revenues undermining the development of a competitive financial sector, and that the resulting greater inefficiency and the weakness of the private sector other than extractors undermined economic growth. Barajas et al. (2013) used a data set including more than 130 countries from 1975 to 2005 to examine the finance–growth nexus by income level, across regions and between oil-exporting and non-oil-exporting countries, and found that in the former, the impact of increased financial intermediation was weak. Barajas et al. (2013) suggest that the influence of

banking-sector development on economic growth in oil-exporting countries becomes weaker as the degree of oil dependence increases.

An interesting example is Nigeria. A significant number of econometric studies show that the impact of financial development on economic growth in Nigeria is mixed (section 3.2). Nevertheless, Nigeria has a large banking sector and relatively well developed and sophisticated capital markets, as shown by having one of the highest levels of financial development SSA, with a financial development index score of 0.21% in 2018. This discrepancy is explained by the structure of its financial sector failing to drive inclusive economic growth. In 2015, more than 30% of credit goes to the extractive sector, although by 2018 this had fallen to 23%. A further 26% of lending in 2018 went to the financial services whose clients are dominated by the government and large national and international oil companies (as reflected in the low level of financial access in Nigeria) (Figure 21).

Figure 21 Sectoral composition of lending in Nigeria (2018)



Source: Nigerian National Bureau of Statistics

As discussed earlier, Nigeria has also experienced financial instability in which a significant factor was the dependence of asset quality on oil prices, especially in 2015 when these collapsed, resulting in sharp creases in non-performing loans. This led to a sharp contraction in credit relative to GDP and this ‘credit crunch’ added to recessionary pressures (Akakaiye and Tella, 2014; Tyson, 2015).

Outside extractives, financial development is unbalanced in Nigeria. Financial access is low at 39% nationally with significant areas of lower financial access in rural areas and especially in the fragile northern provinces. Credit to the private sector remains low relative to GDP at 14.5% in 2017. Bank deposits relative to GDP are also low at 16.3% in 2017 (and actually show a decline from 2013 when they reached 18% of GDP because households and firms drew down on savings during the 2016 economic recession). Other forms of savings mobilisation are also underdeveloped

for a LMIC, including insurance, mutual funds and pensions. Nigeria’s capital markets are also relatively small for LICs with a stock-market capitalisation of only 8.3% of GDP in 2017 and, as for bank lending, a concentration of debt and equity in government securities and oil companies.

These factors mean that there is a lack of finance for SMEs and households – making the pattern of growth in Nigeria less inclusive, including suppression of mass employment creation. Furthermore, finance is a significant constraint on non-extractive private-sector firms (for example, 32% of firms in 2015 identified finance as a major constraint on growth, according to the World Bank database). This has contributed to a low level of public and private investment in Nigeria relative to GDP (ODI, unpublished, 2020).

3.4 LICs suffer from a demand, not a supply, constraint on finance

The reasons for economic underdevelopment in LICs are complex and multidimensional, a full discussion of which is beyond the scope of this working paper.¹⁶ However, their economic and financial structure is fundamentally different from more advanced economies. Their economies are dominated by subsistence agriculture and informal, small-scale, non-farm enterprises with a lack of private-sector formal employment. There is limited diversification of the economy making it susceptible to shocks (such as those from commodity prices, health emergencies or weather-related events, as well as chronic stress from climate change¹⁷) and reversals in economic growth. Productivity is low, reflecting fundamental deficiencies in the economy including inadequate basic infrastructure (such as power and roads), deficiencies in human capital (such as health and education) and weak institutions including in government and regulation (and which is often accompanied by high levels of corruption especially in commodity-dependent economies, and weak public financing¹⁸) (Steinbach, 2019).

The financial sector is also significantly different. It is small, inefficient and concentrated in banking. Lending from banking institutions is concentrated in governments and a few elite corporations and households, with high levels of capital and equity hoarding reflecting a lack of domestic savings mobilisation. There are typically low levels of financial access for non-elite households and SMEs. Indeed, the formal financial system could be described as fundamentally deficient in relation to its ability to support economic growth.

These inadequacies also mean that the majority of enterprises and households in LICs are reliant on informal finance. As discussed, such informal finance does help sustain informal livelihoods and household consumption but effectively makes little or no contribution to the savings mobilisation and the large-scale, long-term investment capital needed for transformation.

¹⁶ See Steinbach (2019) for a more detailed discussion of LICs’ constraints on growth.

¹⁷ Extreme weather events such as droughts, floods, and heatwaves occur more frequently and with greater intensity than in the 1980s and 1990s (IPCC, 2014; Chaney et al., 2014; Hoeppe, 2014). Recoveries from droughts appear to be taking longer, resulting in less time for livelihoods to be restored between them, and thereby rendering countries even more vulnerable to the adverse impacts of climate change (Schwalm, 2018). Climate-related destruction of crops and livelihoods could push many populations in LICs further into poverty, which is aggravated by LICs’ limited capacity and resources to counter the adverse effects of climate change (Hallegatte et al., 2016).

¹⁸ Government revenues in these countries are often lower than in other LICs, leaving them heavily dependent on foreign aid to finance critical government spending. While government debt ratios in most of today’s LICs are significantly lower than in 2001 – helped largely by debt-relief initiatives – their general rise since 2013 has contributed to increased vulnerabilities (World Bank, 2019a). The interest burden brought about by greater indebtedness could constrain poverty-reducing expenditures, particularly on health and education.

Given this complex web of interrelated and multidimensional deficits, LICs often suffer from a ‘vicious circle’ of underdevelopment, low growth and poverty. Despite this, since 2000, the number of LICs worldwide has more than halved from 64 in 2001 to 31 in 2020. The residual LICs are concentrated in SSA and, of those seeing improvements, one-off events accounted for a significant factor. For example, major commodity discoveries,¹⁹ the end of conflicts and greater regional trade integration (at both a global and regional level) all bolstered economic growth (Steinbach, 2019).

Against this background, LICs in SSA have some of the lowest levels of financial development globally. They have low absolute levels of financial development and consistently score lower than their middle-income peers (Table 5).

Table 5 Financial Development Index for FCAS and non-FCAS sub-categories in sub-Saharan Africa (2018)

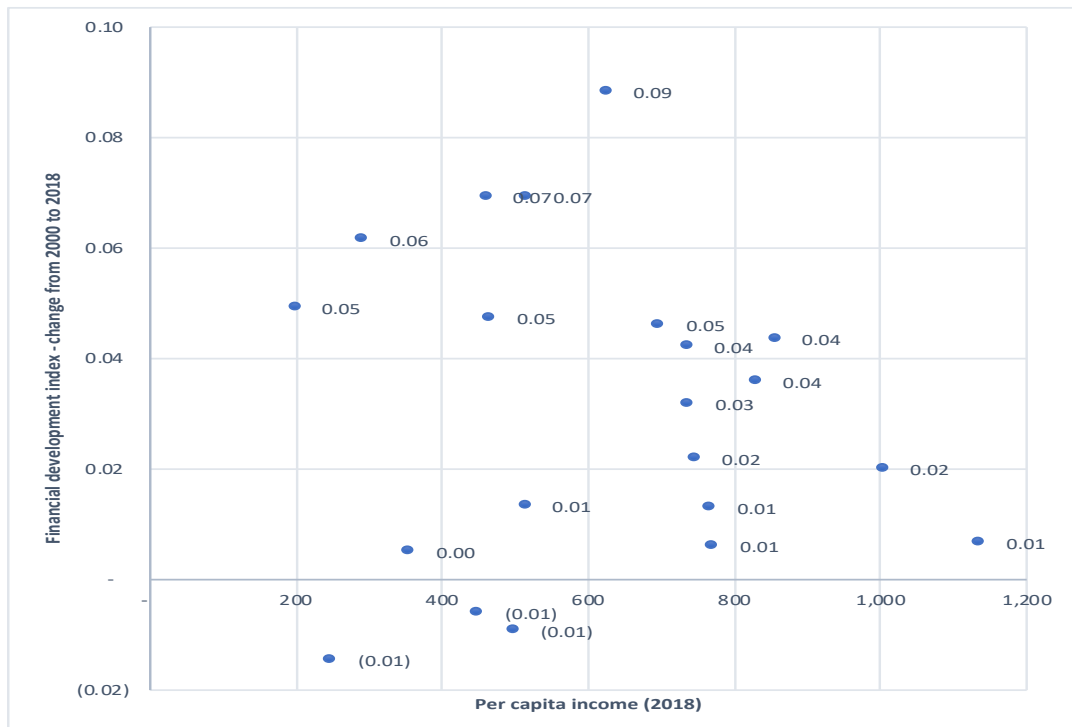
IMF definition	LICs	MICs
FCAS	0.11	0.15
Non-FCAS	0.12	0.15
All	0.11	0.15

Source: IMF data elaborated by author

Relative progress in developing their financial systems has been made in LICs. Indeed, the majority of LICs have made modest but positive progress in financial development since 2000 – although others have made little or no progress or even fallen back into lower levels of financial development (Figure 22).

¹⁹ Including in Cameroon, the Democratic Republic of Congo, Guinea, Indonesia, Mauritania and Mozambique.

Figure 22 Financial Development Index (2000–2018) against per capita income in low-income countries (2018)



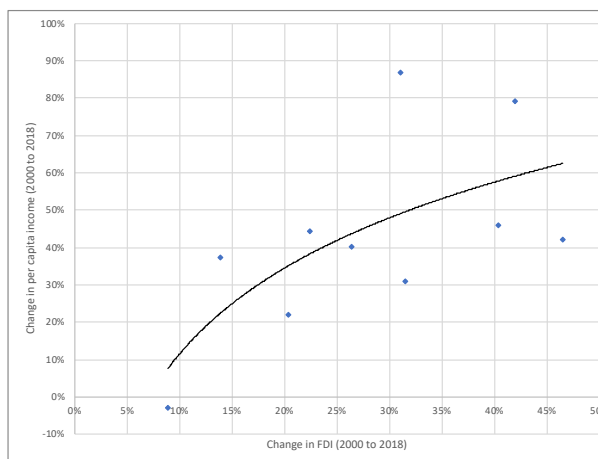
Sources: IMF and World Bank data elaborated by author

This modest progress is not, however, supporting economic development. Instead, LICs have a mixed relationship between financial development and economic development with some studies finding a positive relationship (Jung, 1986; Ghirmay, 2004; Bist, 2019), some no relationship and some a negative relationship between the two (Menyah et al., 2014; Esso, 2010) (section 3.2).

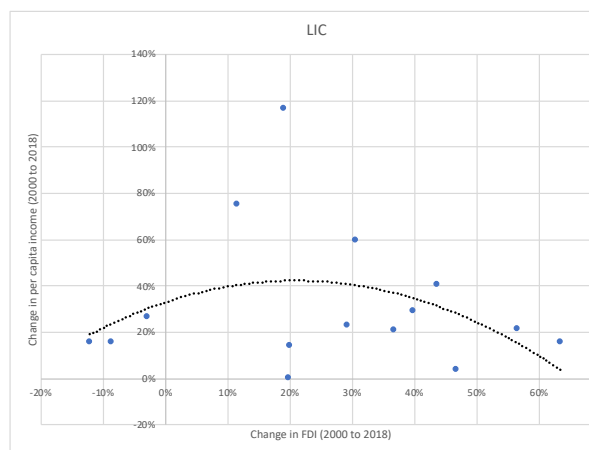
This inconsistent relationship can also be observed by looking at the relationship between improvements in financial development and changes in per capita income over the last two decades. MICs, as expected, have a strong correlation (+60%) between improvements in financial development and growth in per capita income between 2000 and 2018. By contrast, LICs have a low and negative correlation (–10%) between changes in these two factors. Lastly, in low-income FCAS, changes in financial development and per capita income have a negative correlation (–48%, although this relationship may be distorted by the low number of observations (6) in the sample). This suggests that LICs find it difficult to get onto to the ‘lowest rungs’ of the bell-shaped curve whereby financial development is a causative factor in economic development as proposed by Arcand et al., (2015) and others (see discussion in Section 1) (Figure 23).

Figure 23 Relationship between financial sector development and increases in per capita income for sub-Saharan Africa (2000–2018)

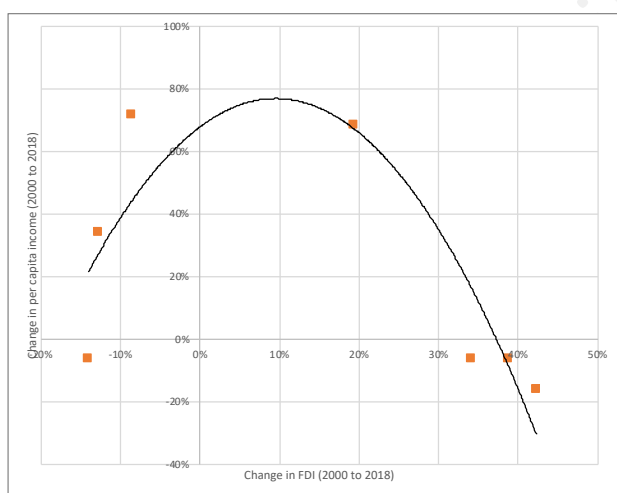
MICs: correlation 60%



LICs (excluding FCAS): correlation – 10%



FCAS: correlation –48%



Sources: IMF and World Bank data elaborated by author

The academic evidence provides guidance on what drives this lack of traction in financial development driving economic growth in LICs. Two important themes of evidence stand out. First, while finance is certainly a constraint on growth, it is by far from being the only one. So, where financial constraints are moderated, this is insufficient in itself to accelerate economic growth. This is reflected in studies that have found a long-run, co-integrating relationship with factors in the real economy. For example, these include macroeconomic growth, trade openness, capital formation, consumer price index and features of the labour force. A number of country-level studies also provide evidence on this (Bist, 2019; Brixiova, 2010) (section 3.2). Second, academic evidence further suggests that the lack of traction is driven by constrained demand, as well as constrained supply, of finance. This evidence was best supported for SMEs, which dominate the economies of LICs,

making it of particular relevance to them. Such demand constraints relate to the weak business environments and lack of bankable projects in LICs (apart from the extractive sector).

However, data on demand-side constraints in LICs has weaknesses and needs further development (Triki and Faye, 2013; Dinh et al, 2010). Furthermore, there is a general research gap relating to financial development and its role in growth ‘take-offs’ in LICs, so these remarks remain tentative.

3.5 FCAS suffer from ‘state capture’ of the formal financial system

Fragile and conflict affected states (FCAS) in sub-Saharan Africa all suffer fundamental problems that extend beyond those in LICs described above. However, FCAS also encompass a broad and idiosyncratic group of countries and include both LICs and MICs. As such, it is difficult to generalise across them. Nevertheless, it is possible to draw some generalities.

Critical, of course, is the political economy. As well as characteristics in common with LICs (such as a poor-quality business environment and infrastructure), FCAS are plagued by unstable and conflict-affected politics, insecurity and the presence or aftermath of armed conflict. The economy is characterised by macroeconomic instability and a high concentration in subsistence agriculture and informal livelihoods. This leads to high and persistent levels of poverty, including high levels of extreme poverty (McKechnie et al., 2018).

Against this background, it is notable that the level of financial development achieved in FCAS is mixed. Some FCAS have some of the lowest levels of financial development and per capita income in the region (such as the Central African Republic, Sierra Leone and South Sudan). Others have high levels of financial development. For example, Burundi and Liberia, countries with among the lowest per capita GDP in the region, have a financial development index score of 0.16. Similarly, a number of FCAS that are also MICs have high levels of financial development. For example, Angola has a financial element index score of 0.14 (Tables 2 and 4).

This reflects the fact that the banking sector in FCAS can be of significant scale relative to GDP. However, it masks significant deficiencies in the structure of the financial system and its relationship to economic growth. Key among these is that the political economy of FCAS often facilitates ‘state capture’ of the financial sector. Banks serve ‘insiders’ affiliated with the political and business elites, at the expense of ‘outsiders’ in the presence of weak and politically influenced supervision and regulation. This is also often associated with corruption and illicit outflows, especially in countries that also have significant commodity endowments. Other overt problems can arise from this state capture of the financial system. For example, in Zimbabwe, the government appropriated cash from private banks and used banking institutions to channel illicit finance offshore. In Liberia, the Governor was alleged to have appropriated USD106 million of cash reserves held at the Central Bank. In Mozambique, the proceeds of international bonds were appropriated by the ruling party. Other problems can be more mundane. For example, insider lending is rife, especially where banks are implicitly or explicitly state-controlled (Nkurunzia, et al, 2012); Tyson, 2016; Tyson, 2017a; Tyson, 2017b; Tyson, 2018; McKechnie et al., 2018).

Another key problem is that financial access in FCAS is often limited. This is true of not only LICs but also MICs. This relates to a lack of inclusiveness as a core value of financial development as well as a distrust of formal financial institutions. So, informal finance and remittances fill the gap (Tyson, unpublished, 2016; McKechnie et al., 2018).

FCAS are also plagued by dollarisation, often accompanied by hyperinflation. For example, this has been the experience of countries such as Angola, the Democratic Republic of the Congo, Liberia, and Zimbabwe. Such dollarisation is notoriously difficult to reverse. Further, dollarisation is persistent – that is, it has a high level of hysteresis – so that even after the hyperinflation and exchange-rate depreciation that it typically causes has abated, dollarisation continues for up to a decade. Any progress towards de-dollarisation can also rapidly reverse. De-dollarisation through ‘forced’ measures rarely lasts and can lead to rapid capital flight. Overall, once dollarisation is established, only long-term macroeconomic and political stability can rebuild the trust in the financial system that is required to reverse it (Tyson, unpublished, 2016).

Unsurprisingly, given these fundamental weaknesses in banking systems in FCAS, while there are some countries with evidence of a positive relationship (for example, Côte d’Ivoire), the majority have a neutral or negative relationship between the two (for example, the Central African Republic, Madagascar and Mozambique). However, as for LICs, it should be noted that the academic evidence on the financial sector in FCAS is limited, beyond research into informal finance. There is a need for more research on how formal financial development can be reformed to support economic development in such environments.

3.6 Some LICs have positive experiences of state-directed credit

Against this generally neutral or negative background for the positive role of financial development in the economic development of LICs, an alternative strategy stands out: state-directed credit. Outside the region, state-directed credit has been a central part of the development process, most notably in Asia (including in China, Japan, South Korea, Taiwan and Vietnam). The historical experience of Asia is beyond the scope of this paper,²⁰ but it could be characterised as a ‘developmental state’ which co-ordinates industrial policy across investment (most notably to adopt new technologies and for diversification of economic sectors), finance and state policy (most notably in trade) (Lin, 2012; Stiglitz et al., 2013).

There has been persistent scepticism about the ability to replicate such industrial policy in Africa. Various factors – most notably the political economy – are seen as too weak and corrupt to allow success. These deficiencies in Africa’s capabilities are also most commonly pointed out in LICs, which are seen as lacking the bureaucratic capacity to execute complex policy co-ordination and because market failures in such economies are more pervasive (Stiglitz et al., 2013). These concerns are not to be discounted, but two countries in SSA stand out as having made significant progress through state-directed development: Ethiopia and Rwanda.

Following the end of the civil war in Ethiopia in 1991, the new government led by the Ethiopian People’s Revolutionary Democratic Front adopted an ‘Agricultural

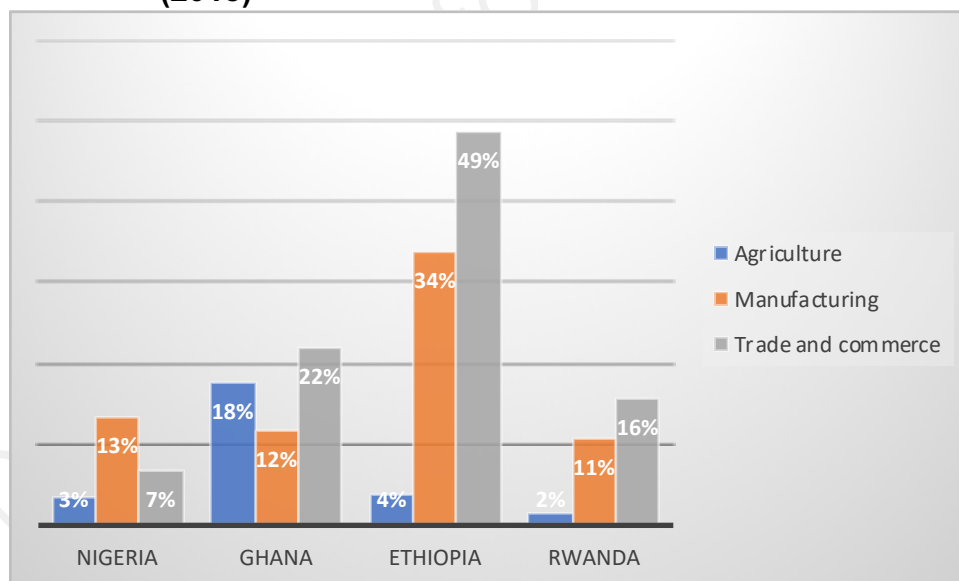
²⁰ See Lin (2012) for a discussion of the theory of structural economics.

Development-Led Industrialisation’ (ADLI) policy. This included co-ordinating investments in agriculture and infrastructure, which rapidly reduced poverty and food insecurity. These were then enhanced by the government co-ordinating investments in manufacturing including SEZs and FDI and investment in infrastructure. This has made Ethiopia one of the fastest-growing economies in Africa with double-digit growth over the last decade with improved diversification and stability²¹ (Shumuye, 2015; Ministry of Finance, the Federal Republic of Ethiopia, 2019).

A key component of the ADLI was state-controlled finance. The financial sector is dominated by the state-owned Commercial Bank of Ethiopia and by the Development Bank of Ethiopia. These institutions led significant increases in the mobilisation of domestic savings (which grew as a percentage of GDP from 7% in 2005 to 24% in 2019), which was then directed into lending to priority sectors and public investment (with such investment growing from 13% in 2004 to over 30% of GDP by 2019) (Ministry of Finance, the Federal Republic of Ethiopia, 2019).

The priority sectors identified by the Ethiopian government have been manufacturing and domestic and international trade. Finance has been directed through policy into these sectors including development of SEZs. As can be seen in Figure 24, this has resulted in Ethiopia having significantly higher levels of finance for these sectors relative to peers and this has been a key factor in growth in the absolute and relative size of the manufacturing sector and growth in trade over the last decade. Finance still lags needs in the agricultural sector, however (Balchin et al., 2018).

Figure 24 Comparative shares of bank lending to GDP by selected sectors (2018)



Source: Central Banks and NSO elaborated by author

Private financial markets in Ethiopia were also constrained as part of ADLI. FDI was prohibited and domestic private investment was not allowed in the country until 2019. Since then, 16 private banks have emerged, but they remain relatively small (Ministry of Finance, the Federal Republic of Ethiopia, 2019). These restrictions on private

²¹ Although at the time of writing (March 2021) conflict has recurred in Tigray and Oromia provinces in Ethiopia.

financial development have had some significant advantages – most notably overcoming the problem experienced by other countries in the region of insufficient investment in agriculture, manufacturing (which has grown at an average of over 10% annually of the last decade) and infrastructure. However, it is also had some disadvantages as Ethiopia’s economic development has progressed. Financial access is low and SME growth has becoming increasingly constrained by finance. The National Bank of Ethiopia has sought to encourage remittances from the diaspora and there has been a deliberate policy of nominal exchange-rate depreciation. These policies were, however, only partly successful and this was a factor in the moderate privatisation of the banking sector in 2019. In addition, there is evidence that the state-owned banks have higher levels of default rate than comparative private banks (Zwedu, 2014; Bezabeh and Desta, 2014; Tehulu and Olana, 2014; Ministry of Finance, the Federal Republic of Ethiopia, 2019).

Rwanda is another country in sub-Saharan Africa where state-directed industrial policy, including finance, has been key to the development process. Since genocide in 1994, the Rwandan Patriotic Front (RPF) (under the leadership of President Paul Kagame since 2000) has led a series of seven-year National Strategies for Transformation programmes.²² These have been focused on development of the agricultural sector and diversification of the economy (including tourism), and donor-funded state-led reconstruction of infrastructure. The Rwanda Development Board was mandated improve the investment environment and it played a crucial role in co-ordinating ministries and agencies to facilitate private-sector investments and privatise state-owned enterprises. International aid and FDI have been important sources of financing.²³ The strategy has led to significant acceleration of economic growth, which averaged 7.5% over the decade to 2018, and reductions in poverty with per capita GDP growing at 5% annually over the same period²⁴ (Calabrese et al., 2016).

As for Ethiopia, Rwanda has a relatively undeveloped and small private banking sector. Nevertheless, access to finance is reasonably strong with 68% of adults in Rwanda having formal financial access through nearly 500 licensed microfinance institutions and savings and credit co-operative organisations. These high levels of access have facilitated relatively high savings and deposit rates in the country and financial stability has been good. Since 2018, the government has sought to further develop the private sector to encourage deepening investment in the private sector in the country (Calabrese et al., 2016).

Against this background, as a LIC, Rwanda has achieved reasonable success in relation to mobilising finance for manufacturing, with 11% of total finance being directed into the sector. However, progress in mobilising funds for agriculture remains poor despite the dominance of the sector in its economy (Figure 24). This is partly because the financial sector has grown, but 35% of total lending has gone to the real-estate sector, largely to finance shopping malls, offices and upper-tier housing in the capital (Calabrese et al., 2016; National Bank of Rwanda, Financial Stability Report, 2018–2019).

²² (<https://www.sida.se/globalassets/global/countries-and-regions/africa/rwanda/d402331a.pdf>).

²³ (<https://fas.org/sgp/crs/row/R44402.pdf>).

²⁴ (<https://www.worldbank.org/en/country/rwanda/overview>).

Rwanda is interesting because, as noted above, one of the reservations in relation to industrial policy in Africa has been government capacity. In this regard, Rwanda stands out. Booth et al. (2017) conducted an in-depth study in Rwanda and found that, by regional standards, Rwandan policy is well co-ordinated. Ministries and agencies are run under a well-functioning cabinet, co-ordinated by an Economic Cluster and several inter-agency, co-ordinating bodies, including the Industrial Development and Export Council. However, Booth et al. (2017) also noted weaknesses including inadequate engagement with the private sector, lack of in-depth sectoral knowledge or weaknesses in investment co-ordination.

As discussed, Ethiopia and Rwanda are examples of successful economic development through state-led finance – including, most notably, national development banks – and challenging the notion that African governments are inadequate to consider industrial policy and the financial policies related to them.

Nevertheless, a cautionary note. Ethiopia and Rwanda are the exceptions. Elsewhere in the region, failed and underperforming development banks are numerous. In particular, there was large-scale failure of development banks in the 1970s and 1980s, when incompetence and corruption undermined them and led to a focus in policy on private finance. The pervasive market failures in transformational finance (particularly in manufacturing and agriculture highlighted in Section 2), the successes of development banks in other regions (such as in Latin America and Asia) and the achievements in Ethiopia and Rwanda mean that there is a case to revisit the potential of state-led finance in economic development in Africa. Griffith-Jones and Ocampo (2018) provides a detailed examination of this issue.

3.7 Conclusion

This section has highlighted that the growth–finance nexus is dependent upon the quality as well as the absolute scale of financial development. As noted in the introduction, at a regional level there is evidence that this relates to the strength of institutions including of the asset portfolios. However, in this discussion we suggest that this may relate to a much broader range of issues including the extent of financial stability and how the growth of the financial sector is directed into the real economy.

The most important of the latter is the central composition of credit growth and where the finance is directed into sectors that are important for economic transformation. As we have shown, the extent to which this has been achieved in SSA is mixed, with some economies making good progress but others either seeing financial development in ways that is not optimal in relation to the financial structure needed for economic transformation. In addition, a number of countries are being left behind, particularly those with political and macroeconomic instability.

In the Section 4 and section 5, we discuss the policy implications of this and the earlier discussions in Section 2, with a focus on how finance can be better aligned with the needs of economic transformation.

4 Policy priorities for sub-Saharan Africa: tapping new sources of aligned capital

4.1 Introduction

The previous sections have discussed progress in financial-sector development in sub-Saharan Africa since 2000, and highlighted significant progress with financial systems, with increasing scale and sophistication. A particularly notable achievement has been the sharp increases in financial access with commensurate support for livelihoods among low-income households. Financial stability has also consolidated because of improvement in capacity in regulatory and other key institutions and the emergence of large regional banks with greater capabilities and capital and liquidity strength.

However, significant gaps remain. First, financial development has been concentrated in the banking sector with little progress in capital-market development. Second, there has also been little progress in relation to efficiency with a knock-on effect on the cost of lending. Third, domestic savings mobilisation remains muted with the widespread underdevelopment of savings institutions beyond bank deposits. Finally, there are significant gaps in the financial architecture including, for example, underdevelopment of interbank markets, markets for hedging products and a lack of well-developed commodity exchanges.

For economic growth, this underdevelopment of the scale and diversification of lending means that support inclusive and sustainable economic growth is weak in many countries in the region. This leads to the principal problem for the region – insufficient investment in both public goods (such as infrastructure) and in risk capital for private-sector development.

Furthermore, there has also been uneven progress between countries, driven by two main factors. The first is the macroeconomic and political environment. Stability and soundness in these factors are an essential foundation for financial development and for its causative role in growth. Where these foundations are absent, such as in FCAS, or weak, such as in some LICs, it is difficult for financial development to gain traction or for it to support economic development.

The second factor is the existing financial structure fails to serve the needs of inclusive and sustainable economic growth. In resource-dependent economies, the issue is often that lending is heavily concentrated in the extractive sector (frequently accompanied by a macroeconomic and financial instability related to commodity prices). In other economies, lending is too short term, too expensive and concentrated in the wrong sectors. Moreover, progress in financial access has been

uneven with some countries still seeing low levels, particularly for marginalised groups.

In this section, we discuss the implications that follow on from this analysis. Importantly, but beyond the scope of this paper, is that the foundations of political and macroeconomics stability are essential for economic development. In situations where these prerequisites are absent, the policy priority may well be to focus on establishing universal financial access. This is because the likelihood of building a pro-growth financial system is limited and needs to wait until these non-financial sector fundamentals are present. Furthermore, these situations are often accompanied by high levels of poverty, including extreme poverty. It is imperative to adopt policies to address these issues in the short term. Approaches that have been successful include providing ringfenced funds on a wholesale basis to commercial banks to provide credit to specific groups such as low-income households or micro and small businesses. However, while such interventions can support informal livelihoods and help increase resilience among low-income households, it is important to recognise that they are unlikely to contribute materially to economic transformation.

Beyond fragile situations and where macroeconomic and political fundamentals have been established – as is increasingly the case in the sub-Saharan Africa – there is a clear argument that building a financial sector is important to support growth. The financial sector also needs to have a financial structure which is closely aligned to economic transformation – in other words, its ‘quality’ is as important as ‘quantity’. In assessing how this can be done, it is also important to recognise that the inherent characteristics of private-banking development and the incentives within it are not necessarily aligned to the needs of economic transformation. For example, there is an urgent need to reduce the cost of capital. However, the cost of lending in the region has been intractably high and increased competition and challenges to the perceived risk of lending have failed to drive down the cost of lending, and the banking sector continues to exhibit capital and liquidity hoarding and constrained sectoral composition of lending portfolios. This appears to relate to financial institutions continuing to respond to the perceived high risks of lending (including those caused by difficulties in credit assessment and enforcement, meaning that non-performing loans are exceptionally high). Some policy approaches have achieved improvements in this situation. For example, blended finance or other forms of public risk-sharing have been effective in increasing private finance into targeted sectors but the scale of such mobilisation remains too small.

Initiatives to close gaps in the financial architecture – for example, establishing credit bureaus, encouraging the deepening of interbank markets or establishing exchanges or providers of hedging instruments – have probably improved the efficiency of financial markets, but this has not been reflected in lending margins. Given this, it is possible – indeed, arguably, likely – that the responsiveness of lending rates will remain modest and banks will continue to hoard liquidity and capital with limited sector diversification in lending portfolios. This means that further development of the private banking sector – which is also progressing rapidly without policy interventions – may not be the solution to moving the financial structure towards its ideal (although it may contribute to improvements in the overall development of the financial system including liquidity, efficiency and risk management); and the weak finance–growth nexus in SSA in relation to private banking-sector development is likely to persist.

Instead, it is necessary to identify new sources of capital that can be crowded into the right sectors, for the right periods of time and at the right cost. We explore three ways to do this – building capital markets, tapping new pools of capital with aligned interests and reconsideration of development banking. We discuss each of these in turn.

4.2 Greater focus on regional and international capital markets

As discussed in Section 2, capital markets can play an important role in financing economic development. In particular, they are important in mobilising risk capital for private-sector development and long-term, large-scale finance for infrastructure. But capital markets across SSA remain underdeveloped and, where they have achieved some growth, are typically dominated by government debt.

New approaches to interventions have included supporting the issuance of local currency bonds in markets in the region. For example, this has been an approach taken by the International Finance Corporation (IFC), Financial Sector Deepening Africa (FSDA) (via Africa Local Currency Bond Fund, ACLB), the African Development Bank (AfDB) and KfW. The intended outcome of these interventions is, first, to mobilise finance for the stated purposes of the bonds. For example, bonds have been issued with proceeds committed to investment in low-income households, SMEs or social welfare goals (such as housing, health care and education). Other issuers have ring-fenced proceeds for green infrastructure (most commonly energy). There is reasonably strong evidence to support the direct impact of such interventions in mobilising funds for their stated purposes, including through acting as anchor investment and providing technical assistance to bring issuances to market.

Less clear, however, is whether this type of intervention has secondary or market-building effects. The intended theories of change provide for such effects including spill-over effects that create market deepening, including encouraging further bond issuances, deepening the investor base for local currency bonds and stimulating the development of secondary markets with improved liquidity and price transparency. However, the evidence of these spill-over effects is limited. This is partially because of the difficulty of measuring such secondary effects, including the need to establish general equilibrium effects in the targeted capital markets. Further work into this issue, sponsored by FSDA, is in progress at the time of writing.

Within the context of these interventions, however, it is also necessary to consider what should be the optimal strategic direction of capital-market engagement for the region – in particular, that capital markets require critical mass, including in an investor base and in secondary market trading. The problem of achieving critical mass is particularly pronounced for smaller countries in SSA, whose GDP is small in both relative and absolute terms and, even if there were significant economic growth, it is likely to remain so.

A number of possible approaches could be taken to address this problem. One is to encourage the development of regional credit markets. This approach might be particularly relevant to building on successes in the region in countries such as Kenya, Nigeria or South Africa. It is, however, politically sensitive because hitherto there has been some ‘national pride in having a stock exchange. Despite this, there is now increasing co-operation among countries in SSA including through the African Union and continual strengthening of trading and currency blocs including in East,

West and southern Africa. The imperative to develop deep capital markets through regional hubs may, therefore, become more politically palatable. Encouraging discussion of such options within policy-making circles would assist in further thinking on this issue.

A second approach would be to seek to tap international capital markets. Since the beginning of financial deregulation of global financial markets in the 1990s, there have been increasing capital flows from advanced to emerging economies. These have not been entirely unproblematic, including being a factor in financial crises in Asia and Latin America. Nevertheless, for over 30 years they have been a key source of capital for economic development and offer a potentially huge pool of international capital that could be tapped by the region in the immediate term.

Since 2008, there have been increasing flows of international capital to SSA through FDI (including private equity) and through portfolio flows (predominantly Eurobonds), but much more limited capital flows as equity and as non-sovereign debt.

Conversely, there has been limited engagement in international capital markets. There are issuers who have successfully raised funds in capital markets based in London and New York, but they have historically been concentrated in extractives.

Nevertheless, in the last decade, there has been some modest diversification of companies coming to market. For example, the London Alternative Investment Market (AIM), a specialised capital market for relatively small companies and funds, have seen issuances by African names in logistics, agricultural processing, financial services and airlines.

Recent work by the London Stock Exchange identified 4,000 companies suitable for capital raising on AIM, but also noted significant barriers to bringing them to market and only 400 of them were suitable for immediate consideration. Key barriers identified included that some companies, although large and well established, were often family businesses that did not necessarily want to have external capital. Other companies would like to raise capital but had problems meeting the transparency and governance requirements for a listing on AIM (such as, for example, auditing, accounting standards and management organisation).

Further policy support to address these barriers to accessing international capital markets would be welcome. In particular, firms that have established sound businesses, particularly in sectors of interest to economic development, could be supported to further enhance their business models and practices to meet the requirements of an international listing. Such interventions have already been led by some Development Finance Institutions (DFIs). For example, CDC Group commonly works with companies in the region to scale their businesses and improve their internal control and management practices both through mentoring and through capital injections. Such mentoring programmes accompanied by development capital could be accompanied by more strongly defined exit plans on international exchanges.

Also important in this regard is to develop investor appetite for such equity and bond issuances. Critical in this respect are domestic and international institutional investors who hold vast pools of long-term capital, which, if it was tapped, could be an ideal source of capital for the region. In examining how companies could be brought to

market, their requirements need to be addressed. This is potentially possible through the creation of funds which pool assets, and hence meet the risk appetite of institution investors through diversification, and which are publicly traded, allowing liquidity and fiduciary requirements to be met. The FCDO in the UK is currently supporting the development of such funds and further progress in this important area may well prove effective in crowding in private finance for development into the region.

A similar creation of suitable vehicles for institutional investors, including pension funds and life insurers, in the region’s domestic markets would also be a way to both mobilise finance for development and build critical mass in its capital markets. This is of particular interest because, as highlighted earlier, domestic savings mobilisation across the region is relatively muted. Further, there is evidence that where domestic savings are being mobilised through such institutional funds, they are being invested outside host economies, often in assets in advanced markets. This means that the region is in danger of suffering from a drain of capital even if domestic savings mobilisation increases. Development of domestic funds tailored to the requirements of such investors would thus be a double win for the mobilisation of finance in SSA.

4.3 Tapping new pools of capital with aligned interests

Since around 2010, an important new trend for the region in relation to mobilising finance for development has been the global growth in alternative types of investors. These include socially responsible investors who seek a ‘double bottom line’ of financial returns in combination with development or social returns of various types, and green bonds.²⁵ These market trends are creating a unique opportunity for L&MICs to access finance for the greening of their economies, meet the Sustainable Development Goals (SDGs) and mobilise finance for sectors – such as agriculture – with high social returns but that have limited commercial attractiveness.

To date, however, there has been a low level of participation by African countries. There have been 13 green bonds issues in SSA since 2008 – which is trivial relative to the global market (Box 2) (Tyson, 2020).

²⁵ Defined as bonds whose proceeds are to be used for financing climate change and adaptation or socially responsible goals²⁵ – or more formal bonds that comply with the Green Bond Principles (GBP) and standardised certification of a bond as ‘green’. This asset class has grown exponentially to more than USD6 tn since 2010. Common uses of the proceeds include the financing of green infrastructure particularly in energy, transport, construction and agriculture as well as wider variety of uses of green bonds including, for example, financing of projects directed towards preserving the environment or biodiversity (Tyson, 2020).

Box 2 African Green Bonds (2012–2019)

African Green Bonds have been issued largely to domestic investors in local currency either through private placements or through public offerings on national stock exchanges. They include issuances for sovereign bonds with sovereign guarantees and municipal authorities seeking to raise money for urban infrastructure.

Nigeria

- Sovereign Bond by the Federal Government of Nigeria – 18 December 2017; tenor five years. Currency: Nigerian Naira (N10,690,000,000)
- Access Bank PLC – 1 March 2019; tenor – five years. Currency: Nigerian Naira (N15 billion)
- Sovereign Bond by the Federal Government of Nigeria – 3 June 2019; tenor seven years. Currency: Nigerian Naira (N15 billion)
- North South Power – 18 February 2019; tenor 15 years. Currency: Nigerian Naira (N8,500,000,000)

Kenya

- Acorn Holdings – 16 October 2019. Currency: Ksh 4.3 billion

South Africa

- City of Cape Town, South Africa – July 2017 (maturity: July 2027). Currency: USD84 million
- City of Johannesburg, South Africa – June 2017 (maturity: June 2024). Currency: US dollar (USD136.9 million)
- Nedbank – August 2012 (maturity: August 2017). Currency: US dollar (USD297.2 million)

Morocco

- BMCE Bank – November 2016 (maturity: November 2021). Currency: US dollar (USD50.1 million)
- Moroccan Agency for Solar Energy – November 2016 (maturity: November 2034). Currency: US dollar (USDD115.2 million)

Namibia

- Bank Windhoek – 17 December 2018. Currency: US dollar (USD4.8 million)

Republic of Seychelles

- Sovereign Blue Bond by the government – 10 October 2018; tenor 10 years. Currency: US dollar (USD15 million)

Ghana

- Government of Ghana – 2 September 2020. Currency: US dollar (USD42 million)

A key constraint on African countries’ involvement is that investors have a wide choice of countries and regions and, unfortunately, African countries are a relatively unattractive option because of higher risks in relation to foreign exchange, political risk and the macroeconomy, and which are difficult to hedge. In addition, there are insufficient ‘bankable’ green and social assets or projects suitable for bonds financing (Tyson, 2018a; 2020).

These issues are also particularly acute for socially responsible and international institutional investors – critical investor classes for green and social bonds. This is because such investors have either high governance standards for green and social goals or fiduciary and regulatory responsibilities which limit the risk of assets in which they can invest – effectively excluding them from investing in many African countries (Tyson, 2020).

Bridging these risks is essential to crowding more investment into African green and social bond markets. There have been important recent initiatives to address this, such as strengthening the framework through national green-bond programmes led by Kenya, Morocco, Nigeria and South Africa. These countries have focused on introducing clear green bond guidelines, definition and governance, including independent certification and monitoring of proceeds. For example, the Johannesburg Stock Exchange became the first African exchange to launch a Green Bond Segment and Green Listing Rules, helping to promote further green bond issuance. Nigeria has launched a green bond programme to co-ordinate partnerships with the Nigerian Stock Exchange. The Moroccan Capital Markets Association has introduced guidelines on complying with principles of green bond issuance, produced with the support of the International Finance Corporation. In Kenya, the Central Bank is leading the development of a regulatory and governance framework in conjunction with the Nairobi Stock Exchange and private financial institutions, including training a pool of Kenyan-based licence verifiers and seeking to issue a benchmark sovereign green bond. It has also developed a financing facility which pools green assets for securitisation – an interesting innovation for domestic markets. These efforts are paying off with issues completed in Morocco, Nigeria and South Africa and Kenya (Tyson, 2020).

Beyond these national initiatives, however, policy support has been relatively muted. In particular, IFIs, such as the IFC, have mobilised significant finance for green infrastructure and the SDGs through innovative financing. For example, they have created specialist funds with high Environmental, Social and Governance (ESG) standards dedicated to environmental or social purposes. These have been successful in raising billions of dollars – but only for MICs and mainly in Asia and Latin America. Conversely, LICs have largely not participated and, in particular, there has been minimal allocation of finance from such initiatives to countries in sub-Saharan Africa (Tyson, 2020).

Such specialist funds need to be expanded into LICs and into specific sectors of interest for transformation and poverty alleviation. For example, funds could be mobilised that are dedicated to agriculture, which offers an opportunity to create high social returns because it has the potential to alleviate poverty through improving productivity in subsistence agriculture, transitioning to new agricultural practices and facilitating trade and processing of agricultural goods. In combination with moderate financial returns, such funds could be attractive to socially responsible investors.

Overall, more needs to be done to raise Africa’s participation in these specialist investor markets, with greater focus on policy interventions that benefit LICs. In particular, there is a need to engage in funds and similar pooled-asset programmes, which should be a policy focus among development agencies, including IFIs and DFIs.

4.4 Reconsideration of development banking in sub-Saharan Africa

As mentioned in Section 3, development banks have had a mixed history in sub-Saharan Africa. Their effectiveness has frequently been undermined by poor management and corruption. There have, however, been some excellent examples at a country level where state-directed credit has been instrumental in accelerating growth.

In addition, there are also recent examples of successful regional development banks. Most notable among these is the African Development Bank (AfDB), which is a large regional institution managing a lending portfolio of USD380 billion (including through trust funds). It has been instrumental in leading investment across the continent including, most notably, in infrastructure development in energy and transport. Since the 2008 global financial crisis, the AfDB has broadened its goals to focus on industrialisation and development of the agricultural sector. The AfDB is also leading climate adaptation and resilience in the region and has been important in supporting trade integration (ICAI, 2020).

All of these goals are highly compatible with the needs of economic transformation – which is no coincidence since the fundamental function of a development bank such as the AfDB is to support economic development, especially in areas where private finance is absent or inadequate (Griffith-Jones and Ocampo, 2018).

It also represents an excellent example of a successful regional development bank that challenges earlier conclusions based on the poor historical experiences of development banking in the region. In this regard, it is also worth noting that since 2000 there has been broad strengthening in the region in relation to public governance, which is reflected in the greater effectiveness of institutions such as development banks.

Overall, we would suggest revisiting the importance of developing banks in the region and a reassessment of under what conditions they can succeed in complementing private financial development. In particular, there may be a strong argument to consider greater capital financing from donors and from national governments in the region for institutions that are well governed and can demonstrate a track record of successful investment economic transformation (Griffith-Jones and Ocampo, 2018).

5 Concluding remarks

This working paper has highlighted the significant achievements in financial development in sub-Saharan Africa since 2000. Many of the fundamentals within the banking sector have been established and there has been significant success in access to finance.

At the same time, the financial sector remains poorly aligned with the needs of economic transformation and this, at least partially, explains the weak relationship between financial development and economic growth in many SSA countries compared to other regions. There is a need for further research to develop a more nuanced understanding of the relationship.

Looking ahead, finance needs to be aligned much more closely with the needs of inclusive and sustainable economic growth. The paper has suggested some ways in which this might be achieved. In particular, the global trend towards green finance and socially responsible finance is significant for the region and there is clearly an opportunity to seize a share of these markets to accelerate growth and poverty alleviation in African countries.

Against this background, there are reasons for pessimism. At the time of writing, immediate concerns relate to the COVID-19 pandemic, while the global challenges of climate change remain unresolved. In addition, there is global political uncertainty regarding future opportunities in relation to trade and global value chains. Finally, Africa faces challenges (as well as opportunities) from its slow demographic transition and swelling youth unemployment.

Nevertheless, there are also reasons for optimism. Young Africans have never been better educated, better connected and healthier with the wealth of talent and energy that brings. The continent is at the centre of the ‘fourth industrial revolution’ in economic digitalisation. Regional political co-operation and integration have strengthened, promising economic gains for all. All of these factors also speak to the opportunity for significant progress in economic transformation of countries across sub-Saharan Africa in the next decade.

Appendix

This section is an overview of the country-level academic literature relating to financial and economic development in sub-Saharan Africa.

African LICs

A limited number of studies examine the relationship between finance and growth for LICs in SSA and have found *mixed results* relating to the causal relationship between financial development and growth. Bist (2009) examined 16 LICs over the period from 1995 to 2014 and found strong evidence of a long-run positive relationship between financial development and economic growth for a majority of the countries (9 out of 16) but a *negative relationship* for other countries (3 out of 16, namely the Central African Republic, Madagascar and Mozambique). Jung (1986) found that this relationship was led by supply but Bist (2009) found it was led by demand. Ghirmay (2004) found a causal link between financial development and economic growth in 13 SSA countries. However, Menyah et al. (2014), using a dataset of 21 African countries, did not find evidence of finance-led-growth in LICs in the region. Eso (2010) also examined the finance–growth connection with focus on Burkina Faso, Cape Verde, Côte d’Ivoire, Ghana, Liberia and Sierra Leone and established that financial development precedes economic growth in Ghana and Mali, growth leads finance in Burkina Faso, Côte d’Ivoire and Sierra Leone, and finance and growth cause each other in Cape Verde and Liberia. In the context of LICs, using both simple and unidirectional concepts of causality, Jung (1986) found that supply leading causality is more frequent but that findings are sensitive to the individual country.

Angola

There is a little or *no significant relationship* between financial development and economic growth, with growth strongly related to oil prices and exports (Quixina and Almeida, 2014; World Bank, 2019; Yusaf et al., 2020).

Burundi

There is a *weak relationship* between financial development and economic growth in Burundi although the financial system is also at a low level and affected by general underdevelopment and state capture by political elites (Nkurunziza, 2010; Nkurunziza et al., 2012).

Cameroon

Studies have found a positive short-run and long-run relationship between financial development and economic growth in Cameroon. This includes between 1980 and 2014, with the relationship being attributed to financial liberalisation and mediated through a boost to investment in both the formal and informal sector (Puatwoa and Piabuo, 2017) and for the 1970–2005 period (Johannes et al., 2011).

Central African Republic

Financial development is found to have a significant and *negative impact* on growth. One-third of loans extended by banks are non-performing and the business climate, marked by socioeconomic problems and weaknesses of the judicial system, prevents the enforcement of guarantees, thus contributing to private-sector defaults and is considered a cause of this relationship (Bist, 2019).

Côte d’Ivoire

Financial development and economic growth are *positively related* but subject to shocks including political and those relating to cocoa prices (Foade, 2011).

The Economic Community of West African States (ECOWAS)

There is a limited number of studies on ECOWAS but Atindehou et al. (2006) find a *weak and two-way causal* between finance and economic development in the region.

Ethiopia

Studies find that bank-based financial development and economic growth from 1980 to 2014 are causally and *positively* linked in the long-run relationship from banking development to economic growth (Eshatuu, 2016; Nyasha et al., 2016; Shiferaw, 2019). There is also microeconomic evidence of a positive effect of finance on growth of firms in the manufacturing sector in Ethiopia, but that this is stronger for self-financed forms than externally financed ones (Edjigu, 2016; Regesa et al., 2017). Evidence also supports that firms can be constrained by demand, rather than supply, of finance (Ashenafi, 2015).

Ghana

Evidence is of a *mixed relationship* between economic growth and financial development. Takyi and Obeng (2013), examining the period from 1988 to 2010, found a positive relationship between financial development and trade openness and a negative relationship with inflation, and interest rates. Ibrahim and Alagidede (2019) examine the relationship over the 1980–2016 period and finds a long-run relationship between positive and negative shocks to financial development and growth. Adusei (2013b) reports that financial development undermines economic growth in Ghana.

Kenya

A significant number of econometric studies for Kenya consistently show a *positive causal relationship* from financial development to economic growth. Wolde-Rufael and Yemane (2009) examine the causal relationship between financial development and economic growth in Kenya for the 1966–2005 period, with exports and imports as additional variables to the finance-economic growth nexus. It finds a two-way and causal relationship between domestic credit from the banking sector and economic growth and between liquid liabilities and economic growth. Uddin et al. (2013) examined the same relationship over the period of 1971–2011 and found that financial-sector growth has a long-term positive impact on economic growth. Kagochi (2013) finds that growth in the banking sector enhances growth in both the long term and the short run in the period from 1970 to 2008. However, this study provides more varied reasons for this relationship. Odhiambo (2009) found the relationship was determined by demand for, rather than the supply of, financial services, hence linking it to the broader investment environment. Mahmoud and Fakhri (2013) found that, over the period 1960–2013, the relationship was dependent on the interaction between FDI and financial development. Chen et al (2020) link the relationship to inflation and changes in fiscal expenditure.

Madagascar

Financial development is found to have a significant and *negative impact* on growth (Bist, 2019).

Mozambique

Financial development is found to have a significant and *negative impact* on growth (Bist, 2019).

Nigeria

A significant number of econometric studies examine the role of the financial development on economic growth and findings are *mixed*. Iheanacho (2016) examines the relationship between financial intermediary development and economic growth in Nigeria over the period 1981–2011 and finds it to be weakly negative in the long run and significantly negative in the short run, and highlighted the role of the oil sector in driving this relationship. This is consistent with other econometric studies of

the nexus between financial-sector development and economic growth in oil-exporting countries which consistently show a weak or even negative relationship between the two (Adeniyi et al., 2015; Cevik and Rahmati, 2013; Nili and Rastad, 2007; Nwani and Basse Orie, 2016; Quixina and Almeida, 2014; Samargandi et al., 2014). Chukwu and Agu (2009) investigate the causality between financial depth and economic growth from 1971 to 2008 and find a stable long-run relationship that is predominantly demand-led. Focusing on stock-market development, Enisan and Olufisayo (2009) also examine the finance–growth nexus in Nigeria and report weak evidence of a relationship to growth. However, a study by Ndako (2010) in Nigeria reports that there is a unidirectional causality from financial development to economic growth.

Sudan

Mohammed and Sidiropoulos (2006) study the effect of financial development on economic performance from 1970 to 2004 and report a *weak relationship* between financial development and economic growth in Sudan, attributing this to banks’ inefficient allocation of resources coupled with the absence of an appropriate investment climate required to promote significant private investment and foster growth in the long run, as well as the poor quality of credit disbursement of the country’s banking sector. This study was conducted before the prolonged conflict and separation of the country into Sudan and South Sudan.

Tanzania

Evidence on the effect of financial deepening in Tanzania is *mixed*. Some studies have found that financial deepening is a causal factor in economic growth (for example, Odhiambo, 2005) but other studies have not (Akinboade, 2000; Odhiambo, 2017). However, a number of micro-economic studies of the effect on finance in the agricultural and SME sector have found positive effects of finance on growth of firms and enterprises (Kinda and Loening, 2008; Nkwabi, 2019; Swai, 2017; Wangwe and Lwakatare, 2004). It is not clear why there is a discrepancy between this macro and micro economic evidence.

Zambia

The relationship between financial development and economic growth is relatively *weak* in Zambia, according to the limited number of studies. For example, Pal (2014) examine the 25-year period between 1986 and 2002, which included extensive financial-sector reforms. It finds that the relationship to growth was weak and linked this to poor credit allocation and low mobilisation of domestic savings. UNCTAD (2017) finds that the high cost of finance in Zambia impeded growth. Miambo and Mavrotas (2008) also link the weak savings mobilisation to weaknesses in poverty-reducing growth.

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