



Shockwatch Bulletin

Sub-Saharan Africa's economic downturn and its impact on financial development

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Key messages

- Sub-Saharan Africa is experiencing a deterioration in financial markets including a 'credit crunch' in the banking sector, reduced availability and increased expense of international finance – which has been made worse by the 'Brexit' shock – and increased financial fragility. On-going governance problems are making these issues worse.
- Importantly for the region's long-term growth prospects, scarce banking finance is being used in sectors with little or no transformational effect such as extractives or middle class consumer finance.
- This is starving sectors which would transform the economy – such as manufacturing, trade and agri-processing – of the financing they need to grow, reducing the prospects for structural changes that would diversify the economy and create employment.
- Policy suggestions include tailored macro prudential policy for sub-Saharan, more robustly directing credit into priority sectors and international cooperation to tackle corruption.

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Acronyms

AFDB	African Development Bank	IFC	International Financial Corporation
BIS	Bank for International Settlements	IFI	International Financial Institutions
CBN	Central Bank of Nigeria	IFRS	International Financial Reporting Standards
CBK	Central Bank of Kenya	IMF	International Monetary Fund
CDC	CDC Group	Ksh	Kenyan Shilling
DFI	Development finance institution	LIC	Low income countries
DFID	Department for International Development	MDRI	Multilateral Debt Relief Initiative
EIB	European Development Bank	MIC	Middle Income Countries
ESRC	Economic and Social Research Council	PIDG	Private Infrastructure Development Group
FDI	Foreign direct investment	NDIC	National Deposit Insurance Company
FX	Foreign exchange	NPL	Non-performing loans
GDP	Gross Domestic Product	SSA	Sub-Saharan Africa
GNP	Gross National Product	UK	United Kingdom
IBRD	International Banks for Reconstruction and Development	UNCTAD	United Nations Conference on Trade and Development
IDA	International Development Association		

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Executive Summary

Global GDP growth rate was 3.1% in 2015 and – before the Brexit shock – was forecast at 3.4% in 2016 and 3.6% in 2017 (IMF, 2016f). This is being driven by a weak and uneven growth in advanced economies and the continued rebalancing of the Chinese economy. Lower commodity prices and strained global financial markets are expected to continue (IMF, 2016f).

This has affected sub-Saharan Africa where GDP growth fell to a 15-year low of 3.5% with expectations of further falls to 3% in 2016 (IMF, 2016b). These economic problems are now causing a deterioration in the financial markets in the region including:

- A ‘credit crunch’ in the banking sector resulting from the economic slowdown reducing the pace of growth in lending;
- Reduced availability and increased expense of international finance including bonds and equity. This is likely to be made worse by the ‘Brexit’ shock hitting global financial markets at the time of writing; and
- Increased financial fragility with declines in banks’ asset quality, capital ratios and profitability and increasing the likelihood of a banking crisis if conditions worsen further.

These trends are strongest in oil-exporting countries. This includes Nigeria where the economic recession is being deepened by rising bad debts in the oil sector causing banks to contract their lending and the devaluation of the Naira which has swollen the value of US dollar-denominated private and sovereign bonds. Responding to this, the Central Bank of Nigeria has acted robustly to maintain financial stability but at the expense of deepening the contraction in credit.

Oil importers have fared better with more limited credit contraction and financial fragility on domestic financial conditions. However, they remain vulnerable to the weakening investor appetite in international capital markets.

Countries have also been impacted by governance problems. These undermine confidence amongst international investors and domestic savers and are worsening financial conditions. These include:

- Kenya where three institutions have failed due to insider loans and fraudulent financial statements;
- Nigeria where (in 2016) there have been corruption allegations at four major banks linked to former ministers and investigations relating to corruption amongst central bank officials;
- Mozambique where the scandals relating to the ‘tuna bonds’ and undisclosed borrowing from Credit Suisse and VTB have caused a collapse in international FDI and other private financing; and
- Ghana where the public finance concerns has led to currency devaluations, ballooning costs and reduced liquidity in sovereign bonds that has necessitated an IMF bail-out.

In addition – and most importantly for the region’s long-term growth prospects – much of the scarce finance that is available is being used in sectors with little or no transformational effect such as extractives or middle class consumer finance.

This is starving sectors which would transform the economy – such as manufacturing, trade and agri-processing – of the financing they need to grow, reducing the prospects for structural changes that would diversify the economy and create employment.

Policy needs to address these new and less favourable conditions for private financing of development. Whilst conventional policy approaches, particularly ‘getting the basics right’ (such as continuing to build regulatory and legal capacity) and anti-cyclical development financing, remain relevant, new thinking is also needed. This includes:

- Developing macro prudential policy that is tailored to the risks in sub-Saharan African financial systems;
- Policy that more robustly ensures that finance is provided to priority sectors;
- International cooperation to tackle corruption

Sub-Saharan Africa has made remarkable and unprecedented progress in economic growth and poverty alleviation in the last decade. Tackling these issues in the financial system is needed if this progress is to be maintained.

1. Introduction

Global GDP growth rate was 3.1% in 2015 and – before the Brexit shock – was forecast at 3.4% in 2016 and 3.6% in 2017 (IMF, 2016f). This is being driven by a weak and uneven growth in advanced economies and the continued rebalancing of the Chinese economy. Lower commodity prices and strained global financial markets are expected to continue (Tyson, et al. 2014; IMF, 2016f; Papadavid, 2016).

These global shocks have affected sub-Saharan Africa where GDP growth fell in 2015 to a 15-year low of 3.5%. It is expected to fall further, to 3%, in 2016.

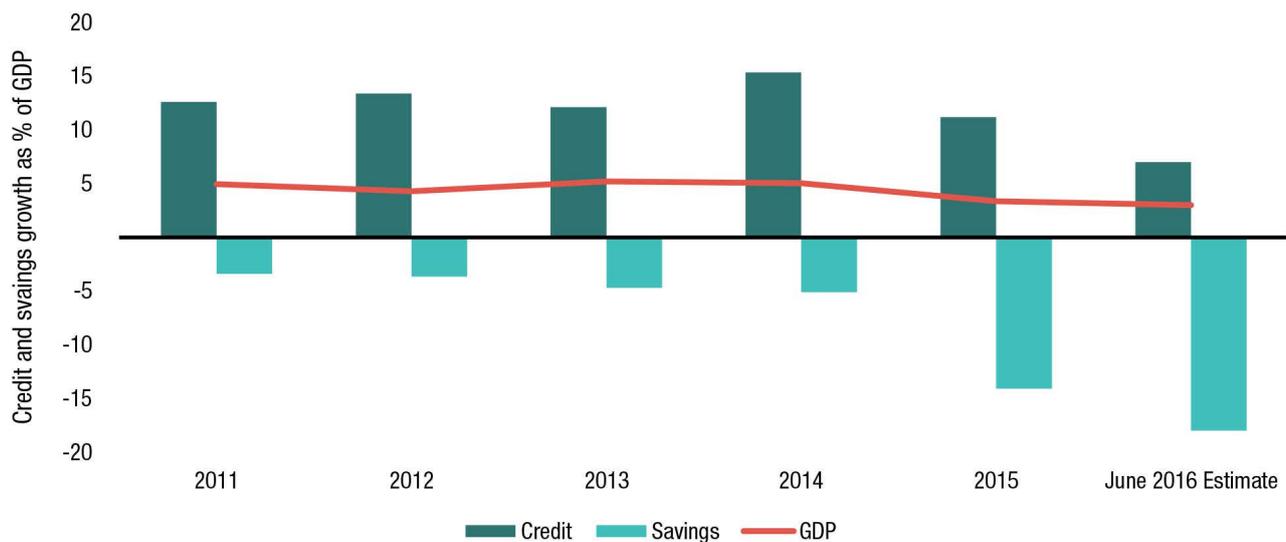
This sharp decline in growth was due to the shocks from collapsed commodity prices, tighter financial conditions

and severe drought in parts of southern and eastern Africa (IMF, 2016).

By early 2016, these economic problems were beginning to manifest in slowing financial development as well as rising financial fragility. Indicators of this include the following (Figure 1):

- A ‘credit crunch’ in the banking sector resulting from the economic slowdown reducing the pace of growth in lending in some countries and stalling it in others;
- Reduced availability and increased expense of non-bank sources of finance including cross-border capital;
- Increased financial fragility with declines in banks asset quality, capital ratios and profitability.

Figure 1: Sub-Saharan Africa’s growth rates for GDP, private credit and savings (2011 to June 2016)



Source: World Economic Outlook database, IMF, April 2016; ODI for 2016 estimates.

Notes: (i) 2016 estimates are for the six months to June 2016. (ii) See footnote for more detail of methodology.¹ (iii) Credit and savings growth are shown on left hand axis and GDP growth on right hand axis.

1 2016 estimates throughout the paper are based on central bank or other regulator figures that were available for March-June 2016. These include published financial stability reports and periodic (such as weekly, fortnightly or monthly) interim statements and one-off press statements from the central bank. Some central banks provided internal data from supervisory reports to the ODI. The data was available eight countries including major economies. In addition, for other major economies where such official sources of data was not available, interim financial statements of major banks were examined. The trends from these data points were then extrapolated as an average to the region. This was done separately for oil importers and oil exporters as the trends between them were materially different (See Section 2 for discussion of this). Mozambique was excluded from the average as not being representative of trends in other economies. The reasons for this are discussed in section 4. Rates of change for 2011 to 2015 are annualised rates. 2016 rates are for the six month period to June 2016 only.

These trends were strongest in oil-exporting countries and more moderate in oil-importing countries, highlighting the vulnerability of sub-Saharan Africa's economies and financial systems to commodity price cycles.

In the short-term, as well as increasing the risks of financial instability, these trends are reinforcing the current recessionary forces in the region by reducing the availability of private finance for development – colloquially termed a 'credit crunch'.

However, more important is the question of whether the current conditions will cause a deterioration in long-term private finance. This includes in relation to both its scale and cost and in relation to whether it is flowing into the 'right' sectors for structural economic transformation.

As will be discussed, to date, although there has been strong growth in private finance prior to 2015, much of that finance has flowed into the 'wrong' sectors – that is those with relatively low impact on structural economic transformation. This includes sectors such as extractive industries, consumer finance and short-term working capital.

Other sectors such as manufacturing and agriculture, with much greater potential impact on structural economic transformation, have received little or no financing.

Policy needs to address these new and less favourable conditions for private financing for development. Whilst conventional policy approaches, particularly '**getting the basics right**' and **anti-cyclical development financing**, remain relevant, new thinking is also needed. This includes:

- Developing **macro prudential policy** that is tailored to the sub-Saharan African context;
- Policy that more robustly **directs credit into priority sectors**; and

- **International cooperation to tackle corruption** more effectively

Sub-Saharan Africa has made remarkable and unprecedented progress in terms of economic growth and poverty alleviation in the last decade. Tackling these issues in the financial system is needed if this progress is to be kept on track.

The structure of the paper

In Section 2, the paper examines the impact of the economic slowdown on key aspects of financial deepening at the regional level.

Sections 3 and 4 analyse specific challenges for sub-Saharan Africa that have become more apparent since the downturn in economic growth. These include:

- **Financial fragility linked to the downturn in commodity exporting countries.** This involved a detailed examination of the region's largest economy, Nigeria; and
- **Continued weak governance and institutional capacity** in public and private financial institutions. This is discussed in the context of Ghana, Kenya, Mozambique and Nigeria.

Section 5 examines the long-term implications of these issues for structural economic transformation. This is discussed in relation to three contrasting case study countries – Nigeria, Kenya and Ethiopia – each having adopted different approaches to channelling finance into priority sectors with different levels of success.

Section 6 discusses the policy implications of the findings.

2. The impact of the economic slowdown on financial development

In the last decade, financial development in sub-Saharan Africa has made significant progress including growth in private credit, inflows from international investors and increasing levels of financial inclusion.

Nevertheless, the level of financial development remains below that of other regions and further progress is needed to support development.

If this is achieved it is forecast that further financial deepening would boost growth and reduce its volatility, although only if this can be achieved in combination with financial stability (IMF, 2016b).

In this section we examine the effects of the recent economic slowdown on achieving these goals.

Sharply contracting private credit growth

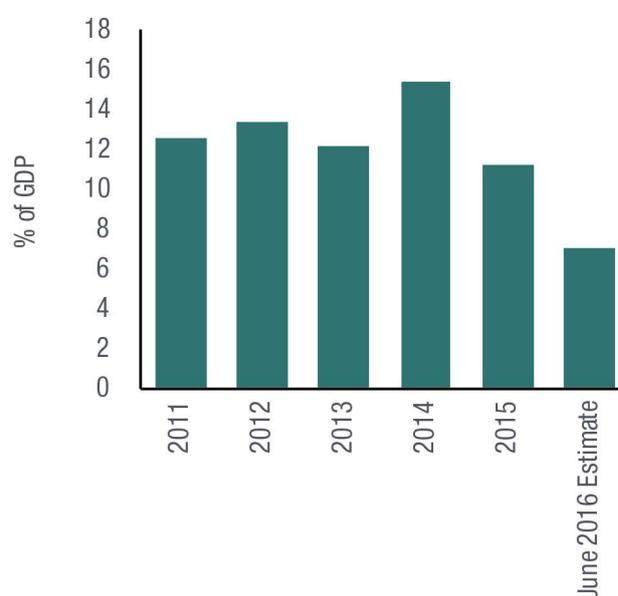
Growth in private credit is an important component of finance for development because it can both alleviate credit constraints on private sector development and is an important aspect of the expansion of financial access.

Most sub-Saharan African countries have experienced a decade-long increase in private credit with credit growing at an average rate of 10% per annum leading to a doubling of the credit-to-GDP ratio for the region as a whole. Growth has been particularly strong in oil-exporting economies and fragile states (although the latter grew from a low base)(IMF, 2016b).

This growth has included rapid growth in regional banks in sub-Saharan Africa including the emergence of large, regional banks domiciled in South Africa, Kenya, Nigeria and Togo (IMF, 2016b).

However, in 2015 and 2016,² the region's private credit growth contracted with it dropping to 11.2% of GDP in 2015 and an estimated 7% for the half year to June 2016, almost half of the average for 2011 to 2014 of 13.4% (Figure 2).

Figure 2: Sub-Saharan Africa private credit growth (2011 to June 2016)



Source: World Economic Outlook database, IMF, April 2016; ODI for 2016 estimates.

This pattern of slowing credit growth is differentiated by country. Low-income countries have seen a steady and high level of credit growth since 2011 which was sustained in 2015 when it remained at 18.9% before moderately falling to 15% by June 2016.

The decline was more marked in middle-income countries where credit growth fell to 8.9% 2015 and 3% by June 2016 (Figure 3).

² See footnote 1 for discussion of the estimate methodology.

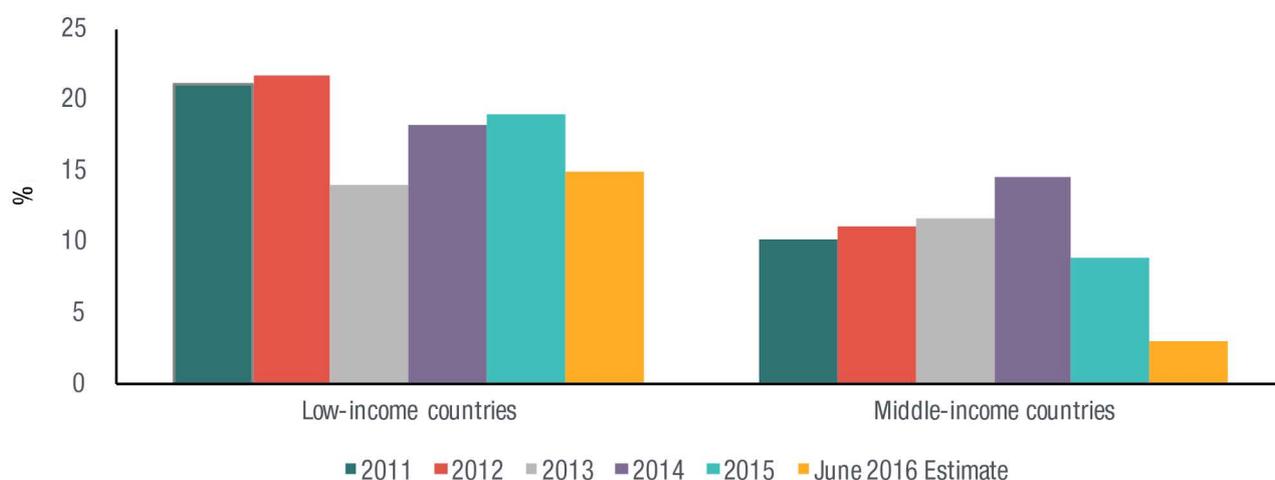
This reflects that many middle-income countries are also oil exporters. Oil exporters saw a significantly sharper contraction in private credit growth compared to oil importers. For oil exporters, private credit growth fell from 16% in 2014 to 5.3% in 2015 and effectively stagnated in 2016 when credit growth has been estimated at 0.5% to June 2016.

As will be discussed in the next section, this is due to the dominance of lending to the oil sector in these countries. As non-performing loans have increased due to deteriorating conditions in the oil sector, provisioning

for non-performing loans have increased, reducing bank profitability and threatening financial instability. This has been accompanied by robust central bank action to maintain capital bases in order to ensure financial stability

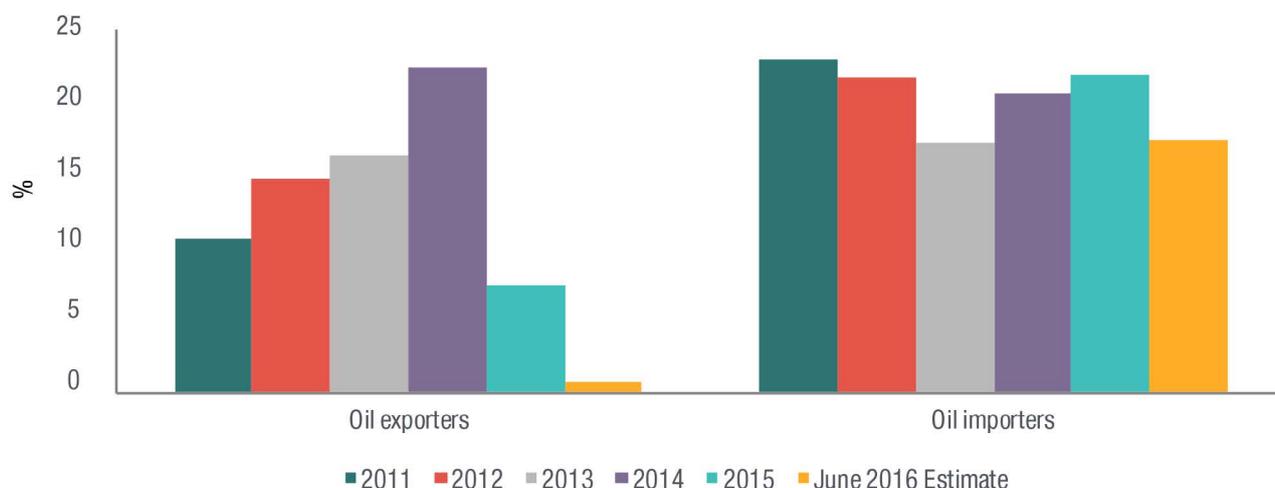
However, banks have responded to this by reducing lending. This effect of falling commodity price leading to a contraction of private lending is one of the most important negative impacts of the current economic slowdown (Figure 4).

Figure 3: Low and middle income countries' private credit growth (2011 to June 2016)



Source: World Economic Outlook database, IMF, April 2016. Note: (i) 2016 estimates are not available for individual countries; (ii) Excludes South Sudan where figures have been affected by conflict.

Figure 4: Oil importing and exporting countries' private credit growth (2011 to June 2016)



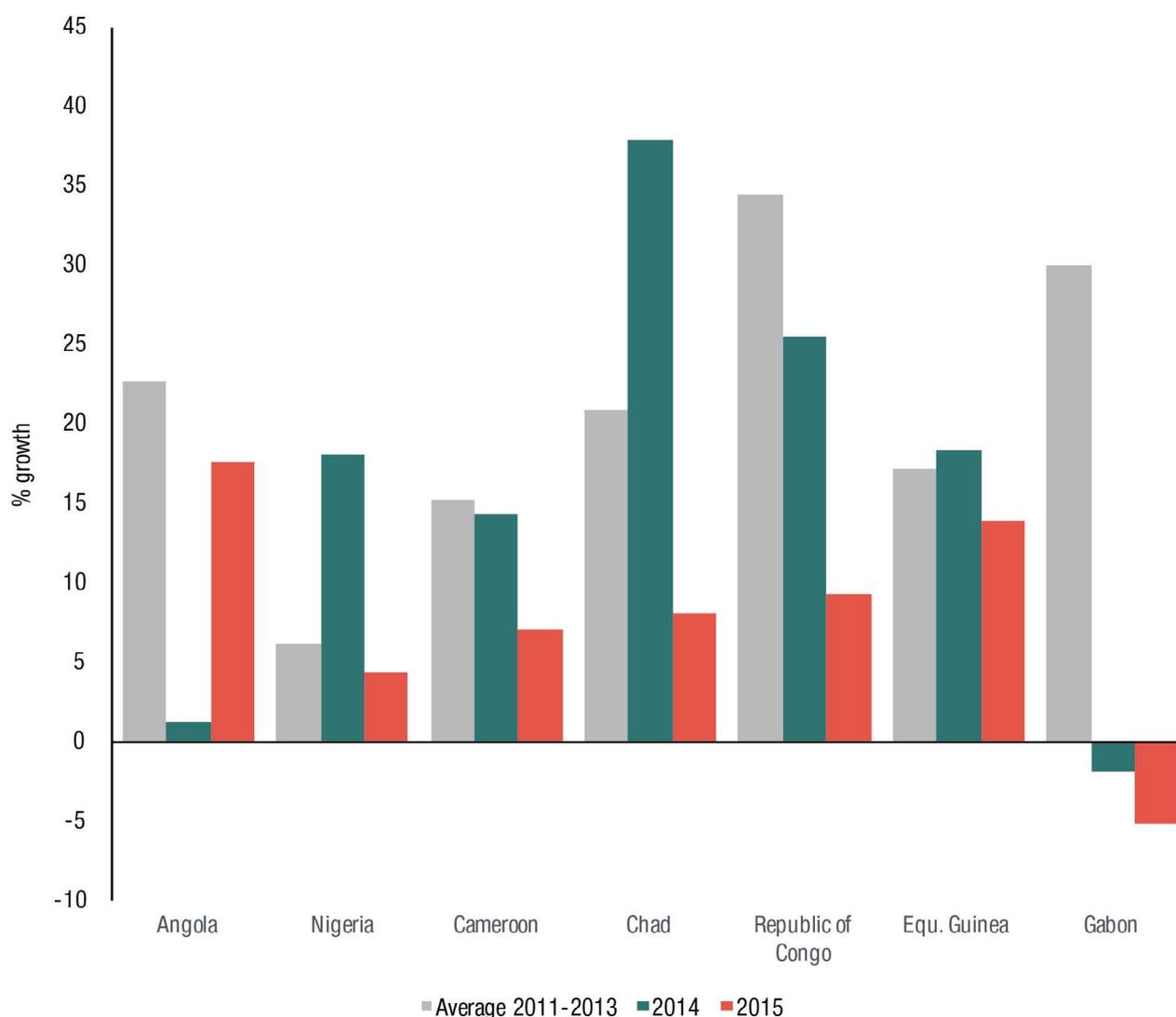
Source: World Economic Outlook database, IMF, April 2016; ODI for 2016 estimates.

This pattern took place in almost all oil exporters. Nigeria, the region's largest economy, experienced high levels of credit growth in the five years preceding 2015, followed by a collapse in lending in 2015 to 4.4%, slowing in 2016 to effectively zero. Angola showed a similar pattern but with a drop in credit growth in 2014 to only 1.1% and recovery in 2015 to 17.6%. Cameroon, Chad, the Republic of the Congo and Equatorial Guinea also saw sharp contractions in credit growth. Gabon saw a contraction in, not just the rate of growth, but in total private credit (Figure 5).

By contrast, oil importers³, have maintained more stable private credit growth throughout the period with 15.7% in 2015 and 12.5% in the first half of 2016. This is because their economies have been much more robust in relation to the economic slowdown with many maintaining strong GDP growth (IMF, 2016b). This is reflected in the continued buoyancy of private credit growth including in Ethiopia, Kenya, Mozambique, Rwanda and Tanzania.

The exception to this was Ghana which has experienced a 'boom and bust' cycle in the banking sector. This is discussed further in Section 4 (Figure 6).

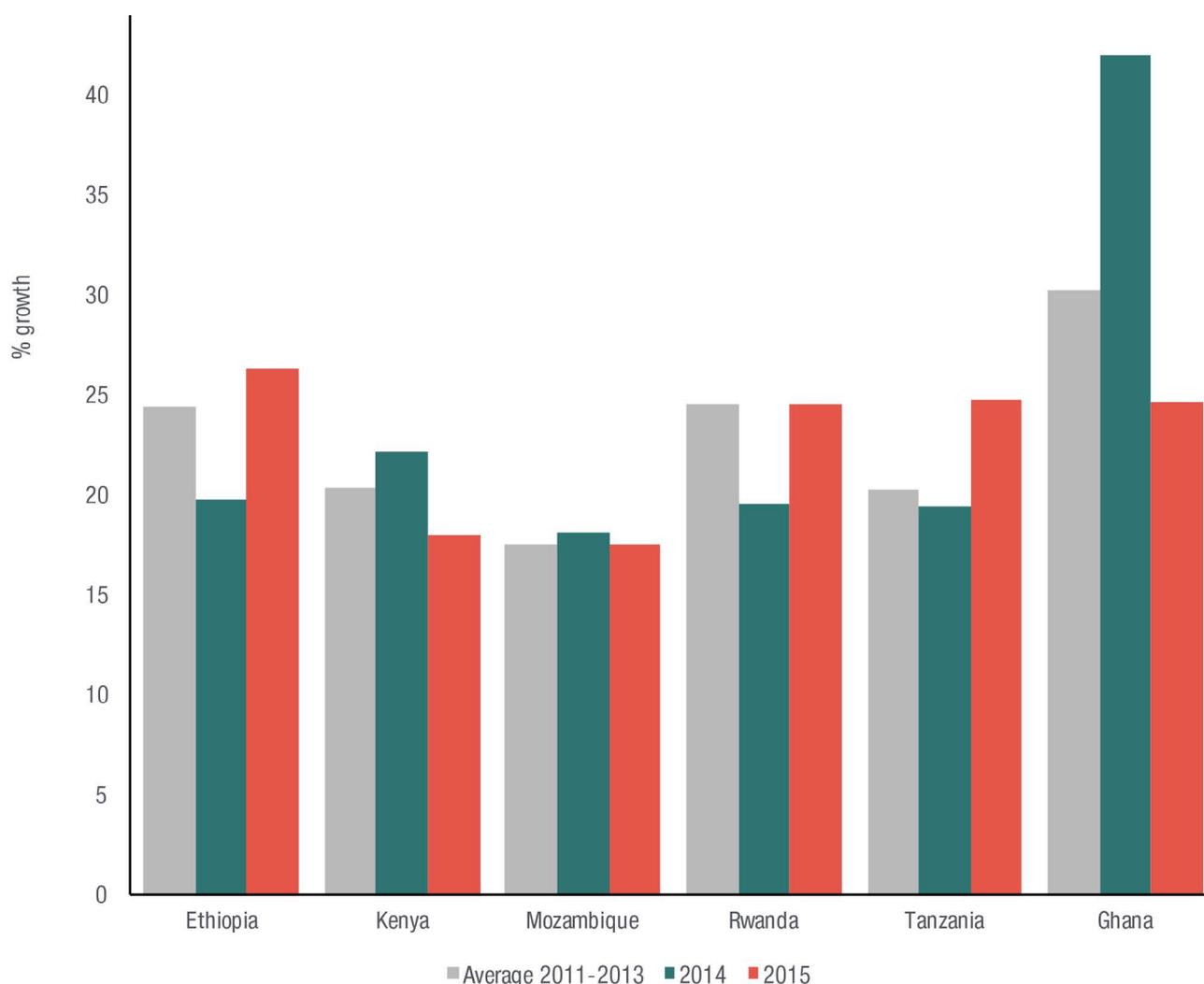
Figure 5: Selected oil-exporting countries' private credit growth (2011 to 2015)



Source: World Economic Outlook database, IMF, April 2016. Note: (i) 2016 estimates are not available for individual countries; (ii) Excludes South Sudan where figures have been affected by conflict.

3 Defined by the IMF as countries where net oil exports make up 30% or more of total exports.

Figure 6: Selected oil-importing countries private credit growth (2011 to 2015)



Source: World Economic Outlook database, IMF, April 2016. Note: 2016 estimates are not available for individual countries.

Declining saving levels

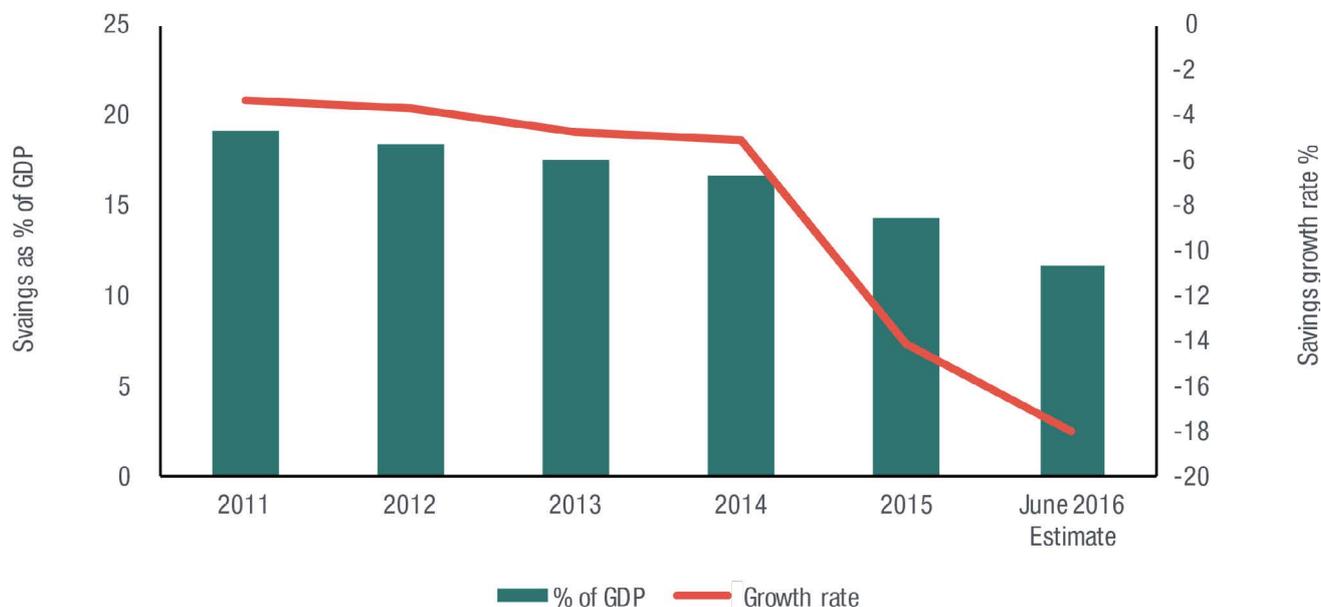
Domestic savings in the form of deposits from households and businesses provide a stable, low cost and low risk source of financing for the banking sector. However, despite progress in financial access for households (Demirgüç-Kunt et al., 2015; IMF, 2016b), sub-Saharan Africa has struggled to improve mobilisation of domestic savings. In fact, savings rates relative to GDP for the region have moderately declined since 2010 (IMF, 2016b).

The impact of the 2015 economic slowdown has been to accelerate this trend. Prior to 2015, although savings

as a percentage of GDP were declining, the rate of decline was relatively muted with the average for region only decreasing from 17.8% in 2010 to 16.9% by 2014.

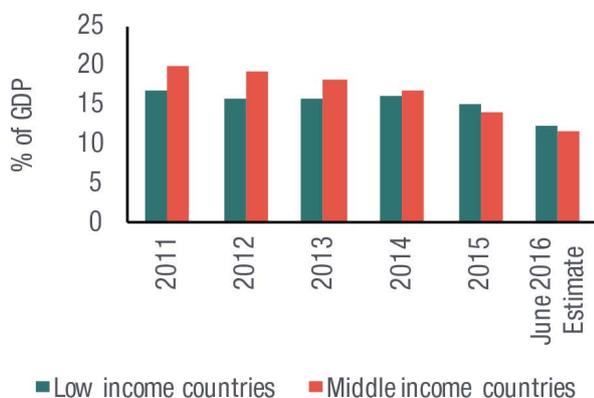
However, there was then a lurch downwards in savings rates which fell to 14.3% in 2015 and to 11.7% in 2016. This represented a rapidly negative growth rate in savings which changed from between -3.4% and -5.1% between 2011 and 2014 to -14.1% in 2015 and -18.0% in 2016, representing a sharp drawdown on the stock of savings in the region (Figure 7).

Figure 7: Sub-Saharan Africa savings and savings growth rate (2011 to June 2016)



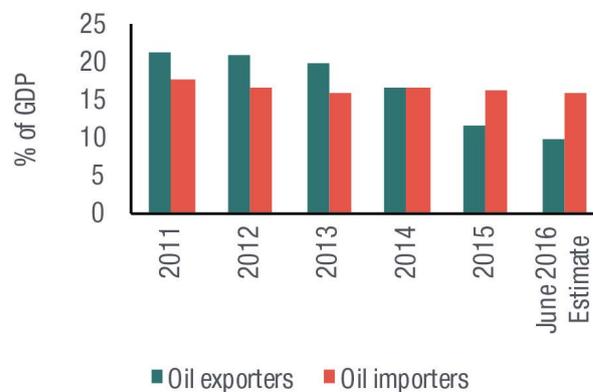
Source: World Economic Outlook database, IMF, April 2016; ODI for 2016 estimates.

Figure 8: Low and middle income countries savings (2011 to June 2016)



Source: World Economic Outlook database, IMF, April 2016; ODI for 2016 estimates.

Figure 9: Oil importing and exporting countries' savings (2011 to June 2016)



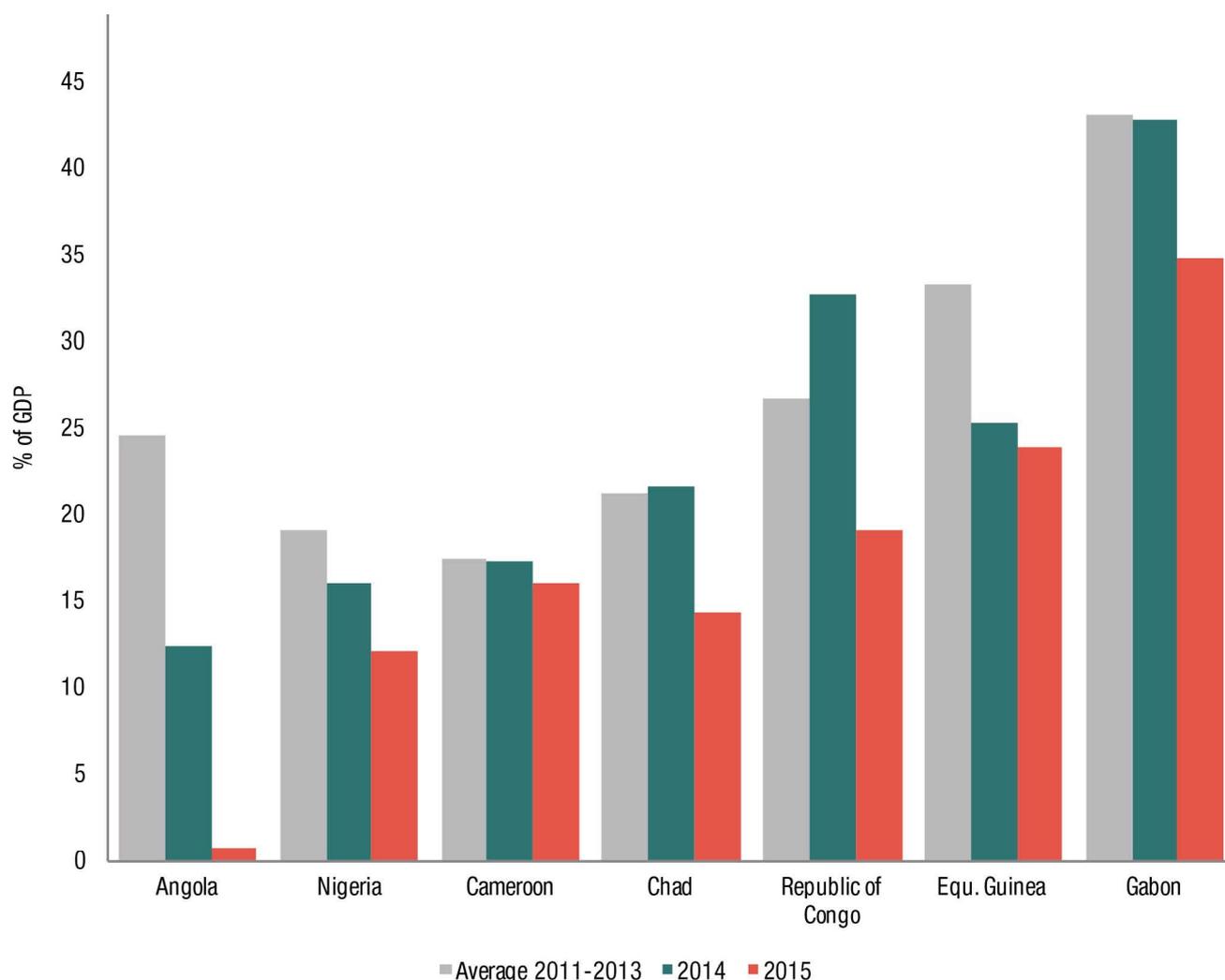
Source: World Economic Outlook database, IMF, April 2016; ODI for 2016 estimates.

These trends were broadly based with declining savings rates in both low and middle income countries. (Figure 8). However, the trend was again stronger amongst oil importers with oil importers' savings rates remaining more stable (Figure 9).

When examining individual countries, the decline in

savings rates were again notably based in the region's oil exporters. This included Nigeria and Angola where deposits are dependent upon oil companies. It was also seen in other smaller, oil-exporting LICs including Cameroon, Chad, the Republic of the Congo, Equatorial Guinea and the Gabon (Figure 10).

Figure 10: Selected oil-exporting countries' savings (2011 to 2015)



Source: World Economic Outlook database, IMF, April 2016 (Note: (i) 2016 estimates are not available for individual countries; (ii) Excludes South Sudan where figures have been affected by conflict).

However, amongst oil importers, the trends for savings are more varied.

Ethiopia, in particular has maintained savings rates of between 26% and 33% for all of the past five years, including 2015, through government policy that targeted high savings through the expansion of bank branches and insurance (Central Bank of Ethiopia, 2015).

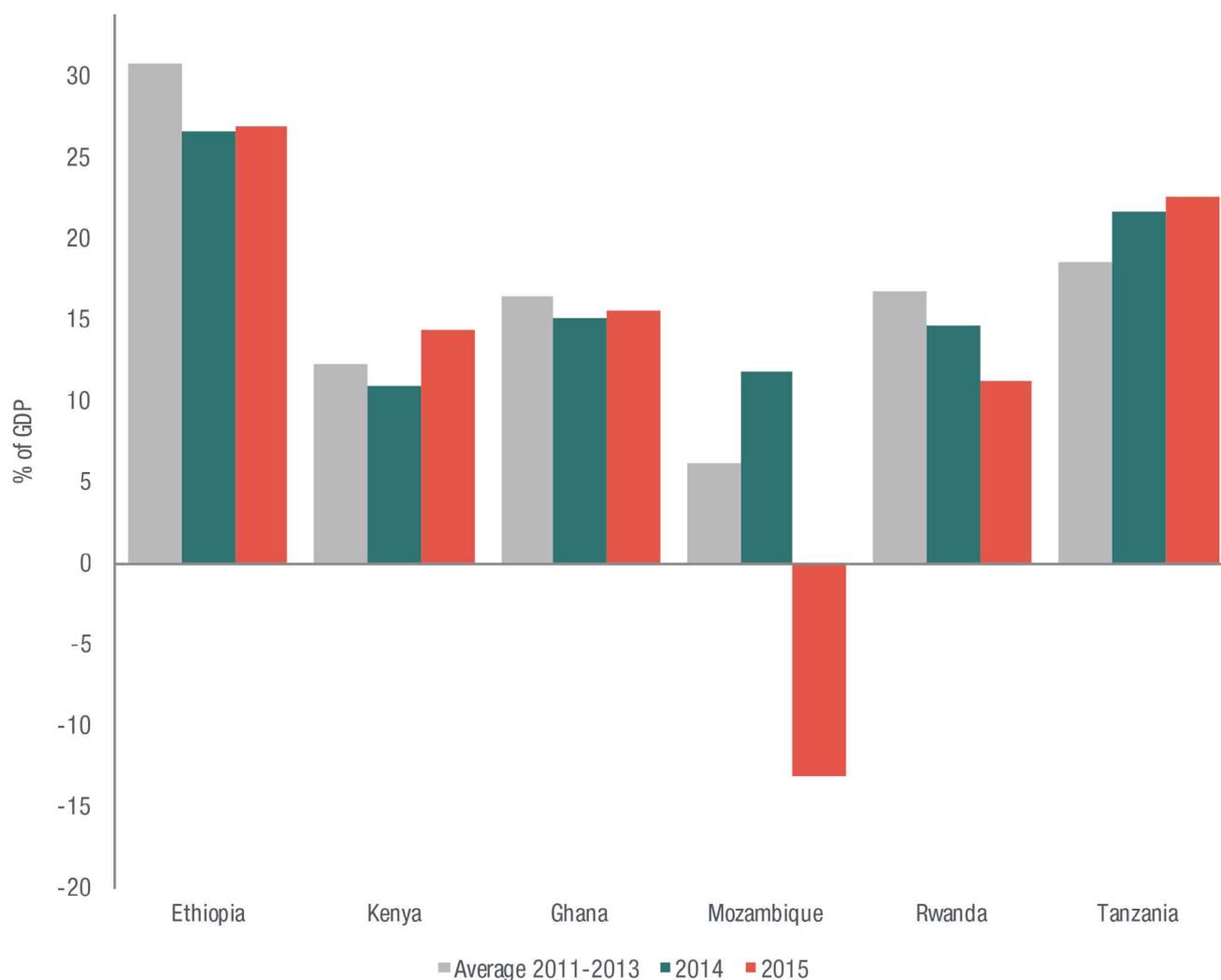
Kenya, Ghana and Tanzania, who have some of the highest financial inclusion figures in the region, have maintained savings levels – although all remain well below Ethiopia.

Rwanda suffered a decline in 2015 despite increases in financial access and the government actively promoting a 'savings culture'.⁴ This has been ascribed to still limited financial access in rural areas and low per capita incomes (Malunda, 2012).

Mozambique suffered negative savings rates in 2015. This has been due to a failure to expand financial access and a reliance on foreign capital as well as the collapse in confidence following corruption and misgovernance in 2015 and 2016. This is discussed further in Section 4 (IMF, 2016c) (Figure 11).

4 http://www.newtimes.co.rw/PDF_ads/World%20Saving%20Day.pdf

Figure 11: Selected oil-importing countries' savings (2011 to 2015)



Source: World Economic Outlook database, IMF, April 2016 (Note: 2016 estimates are not available for individual countries).

It is worth noting, however, that these figures are for formal savings only. Use of informal financial services, including for savings, remains more common than formal services in the region with 40% of adults using informal cash savings and non-cash savings such as livestock, land and property.

Key reasons for informal savings include a lack of trust in formal financial institutions because of the risk of fraud or collapse. The issue of institutional trust is key to the transition from informal to formal savings but, in sub-Saharan Africa, has been undermined by institutional failures. (Bachmann and Hanappi-Egger, 2014). It is also one of the factors contributing to the apparent paradox of

rising financial access without a concomitant rise in savings in some countries (Demirgüç-Kunt et al., 2015). This is discussed in more detail in Section 4.

Reduced and more costly cross-border capital flows

Sub-Saharan Africa has been the recipient of large cross-border inflows of international capital since the financial crisis of 2007. Portfolio flows have been particularly strong including sovereign bonds, private equity⁵ and mutual funds (Tyson, 2015a; 2015b).

Such flows can be an important source of capital

5 Defined as FDI by some agencies.

for development but are also associated with financial instability if they are volatile or short-term (Tyson et al., 2014a; Tyson, 2015a; 2015b).

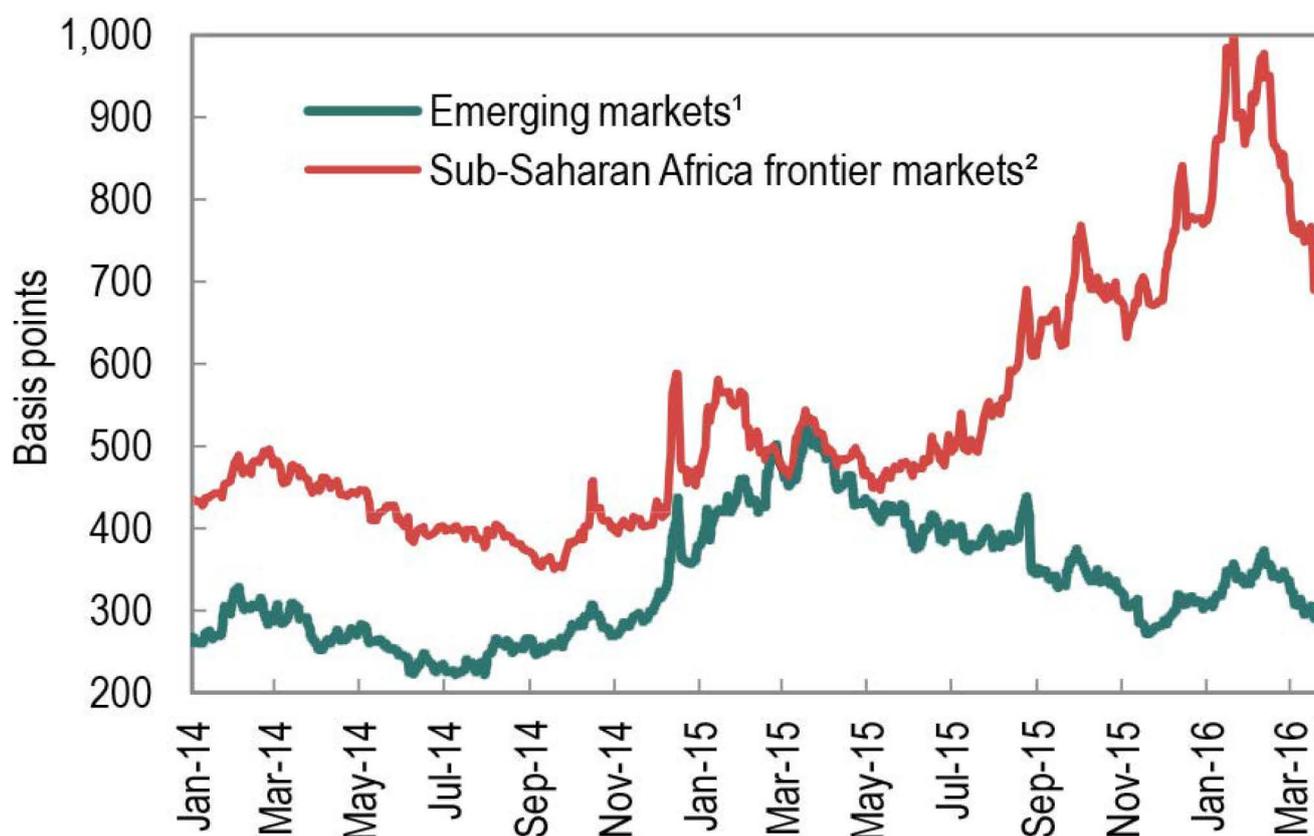
Since the economic slowdown in sub-Saharan Africa began, there has been a reduction in the volume and an increase in the cost of these flows.⁶

This reflects both the gradual tightening of US monetary policy and bouts of volatility in global emerging markets which has dampened investor appetite for ‘frontier markets’ (IMF, 2015b).

In sub-Saharan Africa, this reduction in investor appetite has also been increased by country-specific issues. These issues include:

- Concerns about debt sustainability particularly where the accumulation of dollar-denominated debt has been combined with sharp currency devaluations such as in Nigeria, Ghana and Zambia;
- Countries needing finance from the IMF including Ghana and Angola (with Zambia in discussions with the IMF). Nigeria has also sought emergency funds from the World Bank; and
- Concerns about governance, including continuing fraud and corruption in the banking sector in a number of countries and, in Mozambique and Ghana, mismanagement of public funds.⁷ These issues are discussed further in Section 4.

Figure 12: Sovereign bond yields (2014 to March 2016)



Source: IMF, 2016 (Note: The sub-Saharan Africa frontier markets spread includes Côte d’Ivoire, Gabon, Ghana, Kenya, Nigeria, Senegal, Tanzania, and Zambia).

⁵ Defined as FDI by some agencies.

⁶ The database by country for 2014 and 2015 has not yet been published by the IMF and World Bank. Comments are based on IMF, 2016b.

⁷ Financial Times (2016) ‘EM borrowing costs rise as credit fears grow’ January 20; (2016) ‘Re-run of 1980s-style default wave “unlikely”’ April 26; (2016) ‘Bad times send African borrowers back to the IMF’ May 11.

Because of these issues, sub-Saharan Africa sovereign bond spreads have widened significantly, including relative to global emerging markets (IMF, 2016b).

For example, Zambia issued a bond in 2016 at 10.75% compared to 8.625% in 2014 and Mozambique and Ghana yields jumped to 15.1% and 10.5% compared to 2014 issuance yields of 8.0% and 8.125% respectively (IMF, 2016b; Tyson, 2015a)⁸ (Figure 12).

As a result of these changes in cross-border capital flows, some countries in sub-Saharan Africa have seen net portfolio outflows in 2014 and 2015.⁹ This includes Kenya, Nigeria, Zambia and Ghana. In the region, only Mauritius continued to experience material net inflows¹⁰ (UNCTAD, 2016).

In addition, cross-border bank loans, an especially important source of funding for countries without access to international capital markets, also declined significantly in 2015 from their 2014 levels (IMF, 2015b).

More positively, the collapse of the commodity prices has led to greater diversity in the sectors receiving cross-border capital flows away from the previous concentration in the extractive sector. For example, there has been

greater flows into financial services, consumer goods and telecommunications (Tyson, 2015b).

However – and as will be examined in Section 5 – growth in lending to these sectors is less likely to alleviate credit constraints on structural economic transformation.

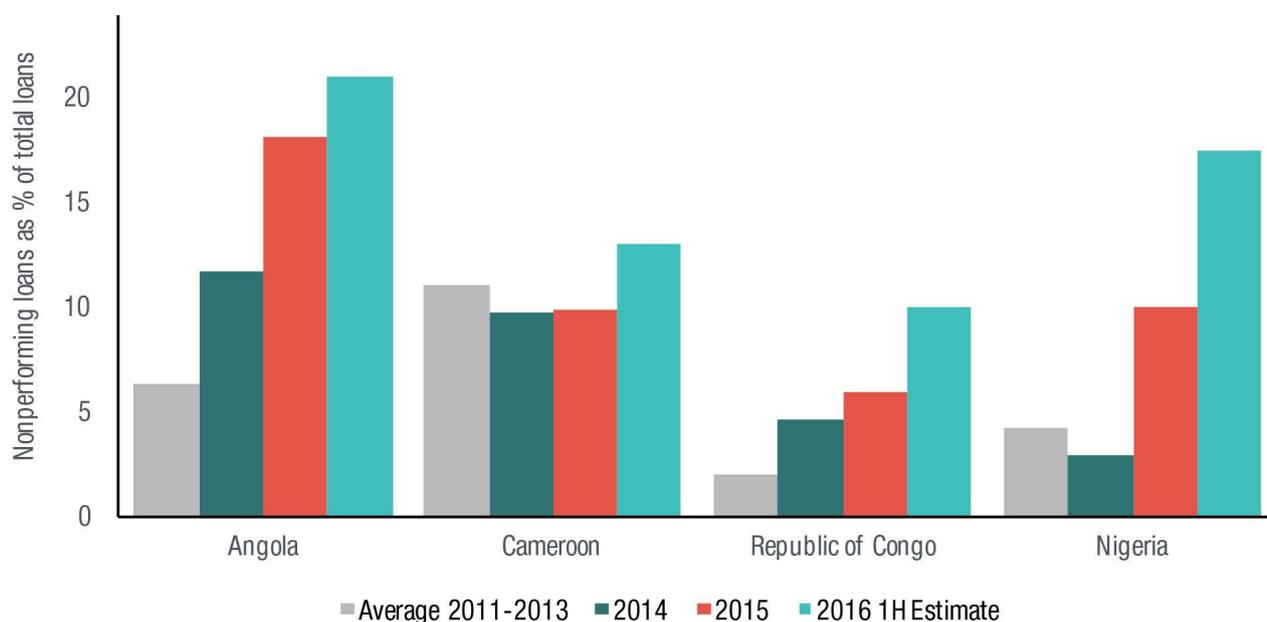
Weakening financial stability

Critical to development is financial stability. In the last decade in sub-Saharan Africa, financial crises have become less common and the region was relatively unaffected by the global financial crisis (Beck et al., 2008).

However, institutional failures remain relatively common. For example, between 1990 and 2009, 57% of sub-Saharan African countries experienced institutional failures. Causes include inadequate regulation and supervision, poor governance, illiquidity and insolvency (Reinhart and Rogoff, 2009; Tyson, 2014). As will be discussed in Section 4, there has again been a recurrence of such problems in 2014 and 2015.

Increasing financial fragility is also highlighted by rising non-performing loans¹¹ and worsening capital adequacy

Figure 13: Selected oil-exporting countries' non-performing loans (2011 to June 2016)



Sources: World Economic Outlook database, IMF, April 2016; IMF country reports; Central banks' financial stability reports and press releases; Fitch country ratings reports; selected major bank financial reports and press releases; Notes: (i) Excludes countries where data are unavailable from these sources; (iii) Excludes South Sudan where figures have been affected by conflict).

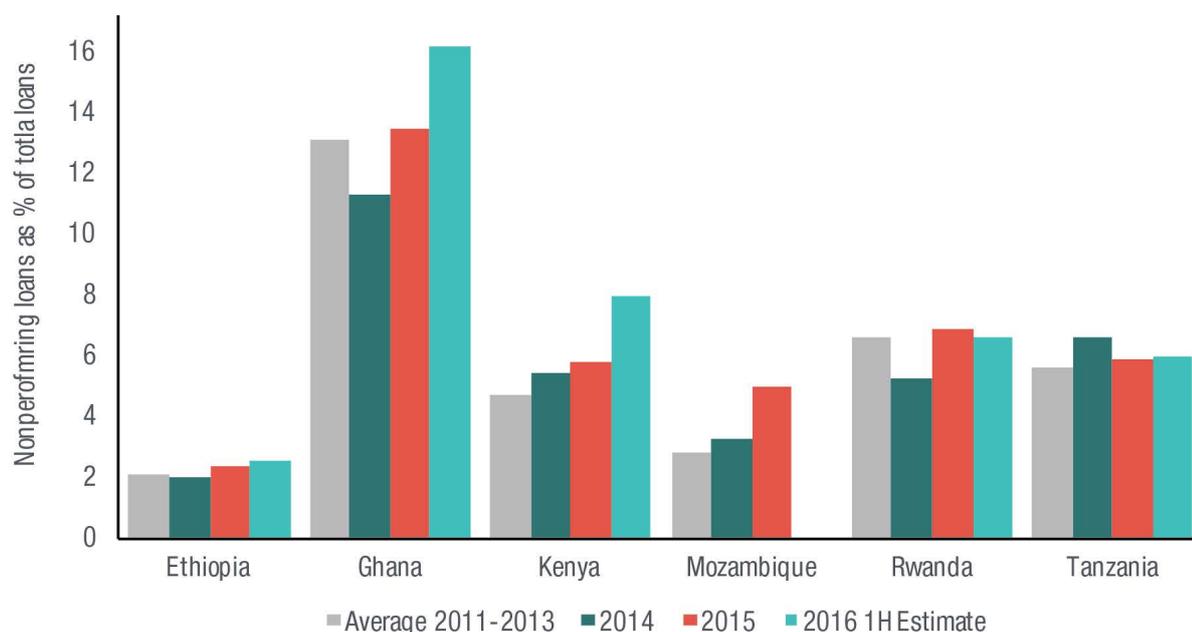
⁸ Financial Times (2016) 'EM borrowing costs rise as credit fears grow' January 20; (2016) 'A Mozambique bond offer so good, it's bad' March 17.

⁹ Financial Times (2016) 'Lending to emerging markets comes to halt' February 5; (2016) 'EM markets face significant capital outflows' April 8.

¹⁰ IMF World Development Indicators. Country level data for 2015 is not yet available.

¹¹ Although reported figures can be affected by underreporting. (EIB, 2015a)

Figure 14: Selected oil-importing countries' non-performing loans (2011 to June 2016)



Sources: World Economic Outlook database, IMF, April 2016; IMF country reports; Central banks' financial stability reports and press releases; Fitch country ratings reports; selected major bank financial reports and press releases; 2016 figures for Mozambique are not available.

ratios in some countries. Banking sector profitability has also declined. The outlook is for further deterioration given the economic environment (IMF, 2016b).

This is again most notable in oil exporters where the average non-performing loan ratio rose from 7.3% in 2014 to 9.8% in 2015. Rising nonperforming debts were worse in Angola, Nigeria and the Republic of Congo (Figure 13).

For oil importers the trend in non-performing loans was more mixed with moderate or no increases in the latter. Only Ghana has seen high levels of non-performing loans. However, these comparative figures are affected by underreporting of bad debts in some countries. This is discussed further in Section 4 (Figure 14.)

Conclusion

Overall, the effect of the recent economic slowdown has been to retard financial development. The most important effects are:

- A curtailment of the previously rapid credit growth in the region;
- A sharp slowdown in savings rates;
- Decreasing liquidity and increasing costs of cross-border flows; and

- Deteriorating asset quality, capital adequacy ratios and profitability in banking institutions.

However, these trends are differentiated by country. Oil exporters have been badly effected with a notable 'boom and bust' cycle in their financial systems. This is discussed further in Section 3.

The slowdown in private credit growth and the decreased liquidity and increased cost of cross-border capital flows is likely to make credit constraints on economic growth stronger.

The lack of traction in mobilising savings and its declining rates in 2015 – despite increased financial access – is also a concern in terms of economic growth. The failure to mobilise savings in many countries is a missed opportunity to raise stable and low-cost financing for development as well as failing to realise the stabilisation of household welfare that savings offer (e.g., Dercon, 2008; Collins et al., 2010).

Weakening financial soundness¹² in the region's banks are also of concern. As will be discussed, there has been a renewed bout of institutional failures in the region.

Nevertheless, the majority of institutions, and particularly systemically important institutions, have met or exceeded required regulatory ratios for capital and liquidity and are likely to remain sound. However, they are

¹² See IMF financial soundness indicators for definition (for example, IMF, 2016b).

likely to contract credit and have greater risk aversion in lending portfolios. Such financial conditions are negative for economic growth.

In conclusion, the economic slowdown is being transmitted to the financial sector and has caused a

reduction in private finance for development particularly in oil producers. This is likely to increase the constraints on development from finance including its potential to be a 'binding constraint' (Rodrik, 2013) on structural economic growth.

3. Oil exporters and financial fragility

As discussed in Section 2, the slowdown in financial development as a result of the economic slowdown in sub-Saharan Africa is most apparent in oil-exporting countries. This has included sharp contraction in credit growth, declines in savings rates, reductions in cross-border capital flows and rising indicators of financial fragility in the banking system. In this section we will examine the link between oil-exporting dependency and financial fragility in more detail.

The link between commodity price shocks – such as that experienced in 2014 and 2015 when oil prices fell from over \$100 a barrel in 2013 to near \$20 in late 2015 – and the financial sector has a number of direct and indirect transmission channels.

The most important direct effect is asset impairment in banking and other institutions with credit exposure to commodity exporting entities leading to higher non-performing loans, reduced bank profitability and weakened liquidity.

However, there are also important indirect and feedback effects including general economic contraction, domestic fiscal rebalancing and currency devaluations. As a result, commodity price downturns tend to increase the likelihood of institutional failures and systemic financial crises (IMF, 2015a).

Further, while these relationships are common to all regions, sub-Saharan African countries are more vulnerable with higher non-performing loans and a higher likelihood of banking crises following price declines. (IMF, 2015a).

Also of importance is that the effect is moderated by institutional quality with adverse effects being greater in less resilient countries with poor governance, weak fiscal space and those without macro-prudential regulation (IMF, 2015a).

In this section we will review these issues in relation to the region's largest economy and major oil exporter – Nigeria.

Nigeria

Nigeria is highly dependent on the oil sector as it accounts for about 70% of Government revenues and 85% of exports. The collapse in oil prices in 2014 and 2015 has led

to a sharp slowdown in GDP growth in Nigeria (Ajakaiye and Tella, 2016).

Because of these issues, 2016 fiscal income from oil is a quarter of the 2014-2015 levels. This has not been alleviated as oil prices recovered in the first half of 2016 to more moderate levels of about \$50 a barrel. This is due to conflict in the Niger Delta involving attacks on oil pipelines which has reduced production volumes (Interview material; Central Bank of Nigeria, 2016).

Since early 2015, the Nigerian currency, the Naira, has been under significant devaluation pressure in informal foreign exchange markets. The Government and Central Bank sought to manage the currency to a peg of N198 to the dollar but this resulted in a significant depletion of official reserves. This depletion has been increased due to the government oil company having been found to have more than \$12.5 billion of missing funds, allegedly due to corruption and illicit outflows.¹³

In early 2016, the Government continued to try to hold the peg, including though restricting access to official foreign exchange for buying selected goods. However, by June 2016, the pressures for a currency devaluation were unrelieved, official foreign exchange reserves had been depleted from \$42 billion in January 2014 to \$26 billion and, in June 2016, the Naira was floated with the Central Bank of Nigeria announcing a managed transition to a market-based rate (Central Bank of Nigeria, 2016).

Because of these events, the Nigeria financial system is suffering from deteriorating conditions. These problems have originated in the sharp declines in oil price and the high concentration of lending to oil and gas companies which accounts for 28% of assets with some banks having greater concentration of up to 47% of their loans in the sector.

Approximately half of this credit goes to international oil companies (and is well-collateralised) and to companies with access to global liquidity. However, it also includes national oilfield operators, especially for inventory financing during refinement cycles and asset acquisition during the oil price boom. These companies do not have access to alternative liquidity nor good quality collateral and have had large

13 Financial Times (2015) 'Unanswered questions on Nigeria's missing oil revenue billions' 13 May. <https://next.ft.com/content/e337c7a4-f4a2-11e4-8a42-00144feab7de>

provisions made against the loans for expected credit losses (EIB, 2015a; Interview material).

By the first quarter of 2016, five Nigerian banks – First Bank, Diamond, First City Monument Bank, Eco Bank and Skye – had issued profit warnings to the stock exchange. First Bank Holdings, which is Nigeria’s largest bank by assets, recorded the highest drop in profits (82%), closely followed by First City Monument Bank and Diamond Bank with declines of 79% and 78% respectively.¹⁴ This was due to non-performing loans reaching an estimated 15% to 20% of total loans.¹⁵

Losses have been incurred at the country’s 22 commercial banks because they have been involved in oil-related loan syndication, although exact figures are not yet known.^{16 17}

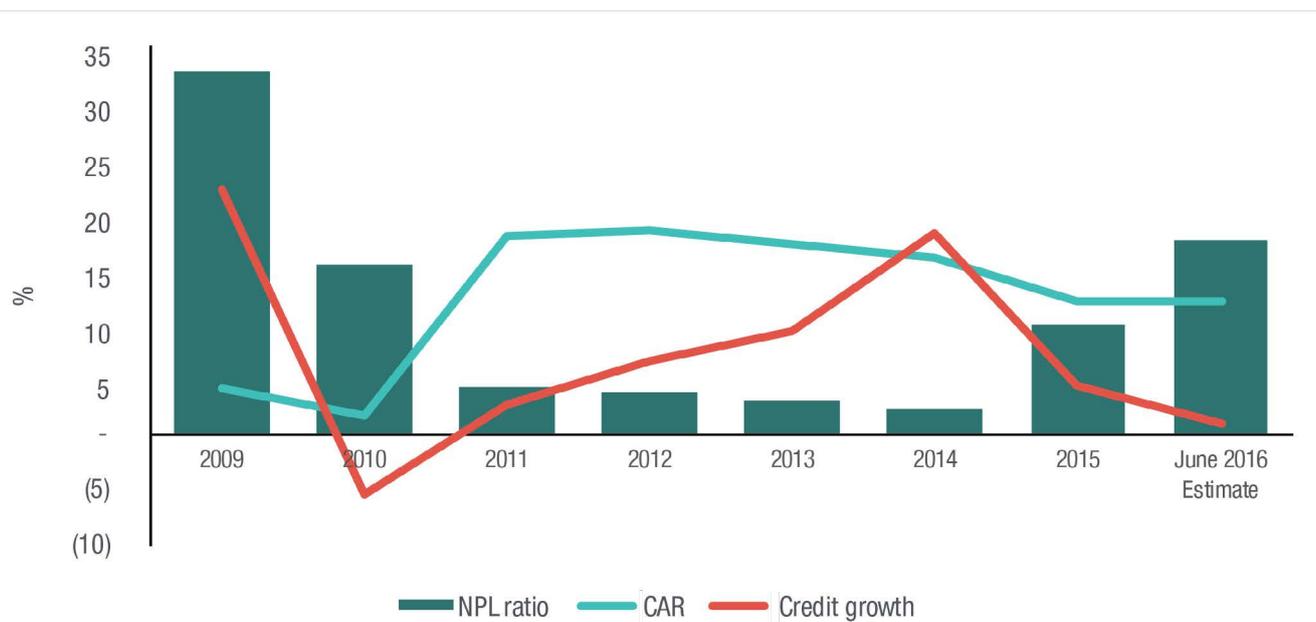
Reflecting this, there has been a sharp rise in non-performing loans and a decline in capital adequacy ratios. In order to rebuild capital ratios, this has resulted in a rapid contraction in credit growth by early 2016. By

March 2016, credit growth was effectively zero (Figure 15).

However, stress testing published by the Central Bank of Nigeria in December 2015 and supervisory reports in the quarter to June 2016 indicated that although asset deterioration has been significant and widespread, vulnerability to falling below capital requirements is limited to medium and small banks with larger and systemically important banks remaining sound, except to more severe economic conditions. Furthermore, all banks met the regulatory capital adequacy ratios as at June 2016 (Central Bank of Nigeria, 2015a; Interview material).

This is partially because the Central Bank of Nigeria has taken a robust approach to loan provisioning and capital adequacy ratios. This has included increasing the requirement for general provisioning on performing facilities from 1% to 2%, requiring banks to maintain capital buffers above their minimum prudential

Figure 15: Private credit growth, capital adequacy ratio and non-performing loan ratios (2009 to June 2016)



Sources: Central Bank of Nigeria, World Bank Financial Indicators Database April 2016; 2016 estimates – Financial Times and interview material.

15 Financial Times (2016) ‘Nigerian banks suffer from exposure to oil groups’ 21 April.

16 Ibid.

17 This includes the government seeking to prevent cost restructuring which is needed to restore profitability and rebuild capital bases. For example, over, 5,000 employees have lost their jobs in the banking industry in 2016 amid a high general unemployment rate of 10.4%. The Ministry of Labour and Employment issued an order for banks to stop layoffs and the Central Bank Governor met with banks to discuss excessive layoffs. However, the effectiveness of these interventions is not yet apparent as some banks have continued to reduce staff (<http://sundiatapost.com/2016/06/03/economics-behind-current-downsizing-nigerian-banks/>).

18 Source: Central Bank of Nigeria.

requirements and the introduction of IFRS 9 which requires forward-looking and anti-cyclical provisioning.¹⁹ The latter is of particular relevance to Nigeria because of the very pro-cyclical nature of both its broader economy and its financial sector.

However, the liquidity and foreign exchange exposures in the financial sector are less positive.

In relation to liquidity, the oil and gas sector are the biggest source of deposits in many institutions but these have slumped as companies have a drawdown on cash reserves to counterbalance poor cash flows from core businesses.

In addition, some regulatory actions have negatively affected liquidity. For example, the Treasury Single Account – which mandates all ministries, departments and agencies to remit government revenues into a single account at the Central Bank of Nigeria – was implemented and drained approximately Naira 1 trillion from banks' deposits.²⁰ This has, however, been partially offset by adjustments to the Central Bank of Nigeria Cash Reserve Ratio – the amount banks are required to hold in cash at zero interest rates at the Central Bank of Nigeria – from 31% to 20%, although this remains amongst the highest in sub-Saharan Africa (Interview material).

Stress tests by the Central Bank of Nigeria in December 2015 indicated that banks are susceptible to liquidity issues. This included a number of banks which would become illiquid in the event of a prolonged run on deposits (defined as 30 days). This included systemically important banks with unsecured credit. The Central Bank of Nigeria concluded that there is 'high contagion risk through unsecured interbank exposure' (Central Bank of Nigeria, 2015a). However, as at March 2016, all banks had met liquidity ratio requirements and deposits had stabilised (Interview material).

Overall, the liquidity position of banks remains vulnerable but is only likely to become unmanageable if the situation was to deteriorate further and the Central Bank of Nigeria had insufficient reserves to act as lender of last resort.

In relation to foreign exchange, there is a high level of foreign exchange exposures in Nigeria banks' balance sheets. This is because many Nigerian banks financed themselves between 2013 and 2015 through

USD-denominated Eurobonds, creating foreign exchange losses and refinancing risk for these banks (EIB, 2015b).

The devaluation of the Naira in June 2016 and the refusal of London-based financiers to launch a new sovereign bond in mid-2016 will make this problem worse.²¹

However, some banks are more susceptible than others. For example, Nigeria's largest Bank, First Bank, has foreign exposure positions which would result in a net gain – not a loss – in the event of a devaluation as at December 2015.²²

The Central Bank of Nigeria has sought to reduce these risks though implementing strengthened regulation and supervision of systemically important banks. This has included adopting the recommended Basel Committee on Banking Supervision to regulate systemically important banks. Eight banks have been designated as systemically important which, at the end of 2015, collectively accounted for 68.9% of the industry total assets and 71.3% of total industry deposits. The strengthened supervision of them has included recovery and resolution planning (Central Bank of Nigeria, 2015a; Interview material).

These Central Bank of Nigeria measures are welcome and show that a robust approach to the impact of the economic slowdown is being taken by the Nigerian authorities to ensure financial stability is maintained.

However, they are also likely to add to the 'credit crunch' in the economy because banks are required to maintain more aggressive provisioning and capital ratios which, without improved profitability or recapitalisation, can only be achieved by reduction in the size and risk of lending portfolios (Interview material).

Indeed, March 2016 figures indicated that credit growth has stagnated. Furthermore, capital inflows into Nigeria has been significantly curtailed in first half of 2016 (Interview material).

Overall, the banking system appears reasonably sound and it is unlikely that there will be any systemic crisis unless there is a further deterioration in the economy. However, there is an urgent need for the financial sector to be less pro-cyclical and dependent on the oil sector respectively.

Tackling this structural problem is important to the structural transformation of the Nigerian economy and is discussed further in Sections 5 and 6.

19 The mandatory effective date was 1 January 2018.

20 <http://www.cenbank.org/Out/2016/BPSD/Guidelines%20for%20the%20Operations%20of%20TSA%20by%20State%20Governments%20in%20Nigeria.pdf>

21 The Financial Times (2016) 'Nigeria's rigidity over forex dents global bond ambitions' June 8, 2016.

22 First Bank of Nigeria, Annual Report, December 2015.

Conclusion

This section has discussed the close linkages between commodity dependence in an economy and financial fragility in its banking sector.

The primary transmission mechanism is via lending being concentrated in the commodity sector and the credit quality of that lending deteriorating when commodity prices decline.

In addition, there are secondary affects including more general deterioration in asset quality because of the impact of economic downturns in other sectors in the economy and due to rising unemployment.

The section discussed this in detail in relation to Nigeria. However, similar cycles can be observed in other sub-Saharan African countries who have high levels of dependency on commodity exports.

For these countries, government and central banks have typically acted quickly and robustly to maintain

financial stability in the face of these pressures. Measures have included increasing capital adequacy and liquidity ratios, ensuring standards of loan provisioning are high and forward looking, and seeking to enable liquidity for individual institutions and for the financial system at a systemic level.

However, these actions raise a central dilemma for policy makers in oil-export dependent economies – that, faced with the downward side of commodity price cycles, actions that enhance financial stability also deepen credit contraction, thus adding to the recessionary forces within an economy.

To escape this ‘vicious cycle’ what is needed is economic diversification. For the financial sector, this means diversification away from commodity sectors to sectors that can build such a transformation of a developing economy. How the financial sector can and must contribute to this challenge is discussed in Sections 5 and 6.

4. Weak governance of financial institutions

The need to build institutional capacity to support financial development is central to policy. This includes formal legislative and regulatory frameworks as well as capacity within regulators and private institutions.

In the last decade there has been significant progress, although indicators of good governance still show sub-Saharan Africa lagging behind the rest of the world. Deficiencies include weak supervisory capacity, poor corporate governance, deficient legislative arrangements and poor accounting and auditing standards (EIB, 2015a).

The economic environment in 2015 and 2016 has tested this environment. This has led to the re-emergence of significant governance and regulatory problems which had added to the slowing of financial development.

The case studies in this section highlight these issues in more detail. They include Ghana and Mozambique where governance and policy problems in the public sector have had negative spill-over effects in the financial sector.

They also include Kenya and Nigeria where alleged failures of governance in private and public institutions – including corruption and fraud – have led to institutional failures.

These case studies also highlight that mismanagement of public finances, corruption and fraud have been facilitated by international private financial institutions.

The conclusion is that these issues continue to undermine effective financial regulation and supervision and so increase financial fragility (IMF, 2016b).

Ghana

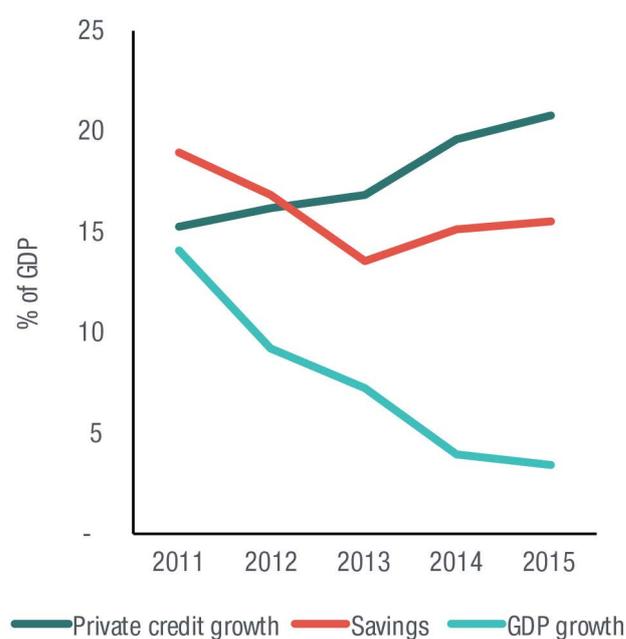
Between 2011 and 2015, Ghana has experienced sharply slowing GDP growth originating in falling commodity prices. By 2015, GDP growth had declined from 14.0% in 2011 to 3.5% with a forecast of 4.5% for 2016. This has been accompanied by currency depreciation, high inflation and tightening of interest rates (IMF, 2016b).

Although this macroeconomic instability originated in commodity prices, it was compounded by poor governance in the public sector. This included the rapid expansion of public debt to finance current account spending which

became increasingly difficult to maintain because it was seen as unsustainable and led to the curtailing of access to international capital markets, which had been used extensively by Ghana to finance its current account (Tyson, 2015a; EIB 2015)²³.

In 2015, Ghana sought IMF support for its fiscal deficit which was granted in conjunction with a fiscal adjustment and debt management program (IMF, 2016e) (Figure 16).

Figure 16: Ghana's GDP growth, private credit growth and savings (2011 to 2015)



Source: World Economic Outlook database, IMF, April 2016. Note: GDP and private credit are given as growth rates. Savings are given as a percentage of GDP. This is to provide consistency with the IMF database.

23 In late 2016, Ghana was able to issue a 15-year \$1 billion Eurobond to help finance its fiscal deficit, but only with a 10.75% interest rate and a World Bank guarantee. This compared with an interest rate of 8% for a 10 year Eurobond in 2013 (Tyson, 2015a).

These macroeconomic problems have affected the banking sector. These materialised in 2015 when the IMF imposed the fiscal adjustment program and concerns about debt sustainability started to be reflected more strongly in international financial markets. The latter included sovereign credit rating downgrades, ballooning sovereign bond spreads and sharply contracted capital inflows (IMF, 2016e).

Private credit growth continued to expand until early 2015 but, by mid-2015, credit growth had sharply slowed accompanied by rapid rises in non-performing loans (Bank of Ghana, 2015; IMF, 2016e).

Non-performing loans have been particularly high in the manufacturing sector, which has been affected by the volatility in the exchange rate and below-demand electricity production, and at state-owned electricity companies which are experiencing weak financial performance due to excessive debts and the failure to collect payments adequately (Bank of Ghana, 2015; IMF, 2016e).

Bank stability has also been undermined by increasing dollarization of deposits in response to the sharp depreciation of the Cedi, and increasing foreign exchange mismatches in bank balance sheets (Bank of Ghana, 2015).

Furthermore, banks are having problems in financing their operations in private markets because of continued

impaired access to international capital. As a consequence, their borrowings recorded a slowdown in growth from 69.2% in December 2014 to 15.7% in December 2015 (Bank of Ghana, 2015).

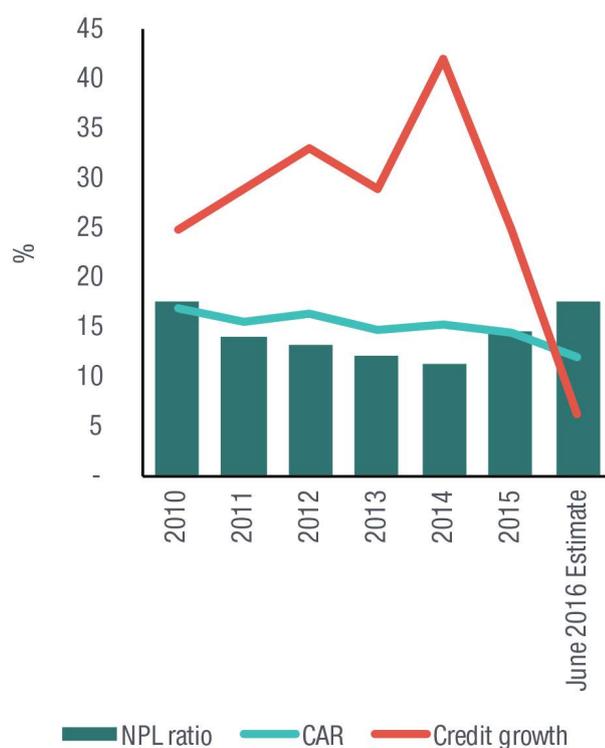
More positively in terms of financial stability, capital adequacy ratios have declined but not fallen below minimum thresholds despite increased loan provisioning reducing bank profitability (Bank of Ghana, 2015; IMF, 2016e) (Figure 17).

The government and the Bank of Ghana, as part of the IMF adjustment programme, have responded to maintain financial stability as well as financial flows to the real economy. New legislation is being enacted to strengthen the central banks independence, including limiting its lending to the government, and to strengthen supervision and regulation of the financial sector. The latter includes stricter provisioning for impaired assets and implementation of Basel III (IMF, 2016e).

However, downside risks for the Ghanaian banking system remain high. The banks have been significantly weakened by the economic conditions including greater fragility in their balance sheet and reduced – although still adequate – capital ratios.

Importantly, events have reversed progress in deepening of domestic capital markets and access to international capital markets, reducing banks' ability to finance new lending.

Figure 17: Private credit growth, capital adequacy ratio and non-performing loan ratios (2009 to June 2016)



Source: Bank of Ghana financial stability reports; IMF, 2016b; IMF, 2016e.

Kenya

The economic slowdown in the region affected Kenya less than other countries with GDP growth for 2015 at 5.6% and a 2016 forecast of 6.0% (IMF, 2015e).

This is reflected in the Kenyan banking sector, which has experienced strong growth in private credit and savings as well as the rapid expansion of financial access through innovations in mobile banking. Kenyan banks have also expanded regionally, especially in the East African Community (IMF, 2015e; CBK, 2015).

In 2015, Kenyan banks were well-capitalised with a core capital to total risk-weighted assets of 15.6% in December 2015 and continued robust growth in the financial sector with loans and deposit growth of 16.6% and 12.2% respectively. There was some deterioration in asset quality with non-performing loans increasing from 5.4% in December 2014 to 6.1% in December 2015 but this was modest compared to other sub-Saharan African countries (CBK, 2015).

However, in 2015 and 2016 three Kenyan banking institutions failed. This was not, however, due to insolvency or liquidity problems, but due to failures in corporate governance including fraud and corruption. The institutional failures included:

- Dubai Bank which was put into receivership in August 2015 because of 'serious liquidity and

capital deficiencies' including cash reserves falling below statutory liquidity levels and failure to meet financial obligations in the interbank market. The Central Bank of Kenya commented that the causes of failure had been 'violations of banking laws and regulations, including failure to maintain adequate capital and liquidity ratios as well as provisions for non-performing loans and weak corporate governance structures'. The Kenya Deposit Insurance Co-operation, the public deposit guarantor and official receiver, oversaw its liquidation, including only partial payment to larger depositors in late 2015.²⁴

- Imperial Bank was placed under statutory management of Kenya Deposit Insurance Co-operation in October 2015 after the bank suffered losses of Ksh35 billion. Deposits required restructuring with losses for larger depositors and the Ugandan subsidiary was sold. The issues resulted from what the Central Bank of Kenya described as 'fraudulent activities ... and unsound business practices'. These included alleged insider loans by senior management. This has resulted in an on-going forensic audit of more than 700 accounts and more than 22,000 transactions dating back over 13 years and the instigation of both civil and criminal charges against the former management of Imperial Bank.²⁵
- Chase Bank was closed in April 2016 following a depositor-run after unsecured insider loans by directors became known. It was subsequently re-opened under the management of Kenya Deposit Insurance Company and with liquidity guarantees from the Central Bank. Further details of the issues has not been provided by the Central Bank of Kenya at the time of writing.²⁶

In April 2016, the Central Bank of Kenya was sufficiently concerned about contagion risks from the collapse of these banks to provide formal liquidity support to all regulated banking and microfinance institutions in order to contain the risk of a 'bank run' on deposits.^{27, 28}

Such actions, whilst protective of the banking system, are considered to be effectively crisis responses by a central

bank in its role as lender of last resort. To date, they are proving effective in managing systemic problems arising from these individual institutional failures.

However, the failures raise concerns about ongoing poor corporate governance and regulatory compliance within the banking sector in Kenya. These concerns have been expressed by a number of academics, industry participants (including by the Kenya Bankers' Association) and senior bankers.²⁹

They indicate that, although the formal legislative and regulatory framework in Kenya is strong – such as including International Financial Reporting Standards for asset classification and provisioning, the use of Basel II and III standards for capital adequacy frameworks and the presence of state-backed deposit insurance (IMF, 2016b) – there is a failure to comply with or enforce this framework.

They also indicate that there are ongoing problems with alleged criminal fraud by senior management, insider lending, and failure to comply with International Financial Reporting Standards for asset classification and provisioning.

Moreover, such failures in banking institutions in Kenya have been a repeated occurrence. This includes the 1990 'Goldenberg Scandal' when 10% of GDP was lost though insider loans facilitated at high levels of government (Wrong, 2010) and a series of banking scandals and failures where, between 1985 and 1989, 15% of the financial system liabilities were insolvent and nine insolvent institutions were restructured. These led, in 1992, to Kenya suffering a formal banking crisis. (Ndung'u and Ngugi, 1999; Ngugi, 2000; Rogoff and Reinhart, 2009).

It also means that it is difficult to assess the risks within the financial sector, including as part of the supervision by the central bank, because fraudulent and insider lending and non-compliance with International Financial Reporting Standards mean that financial statements showing apparently sound capital and asset quality ratios and other financial information may not be reliable.³⁰

As at the time of writing, it would appear that the banking system remains sound and that the Central Bank of Kenya has been effective in acting to contain institutional problems from becoming systemic through

24 CBK press release. 14 August 2015; 24 August 2015; 3 September, 2015.

25 CBK press release. 31 March 2016.

26 CBK press release. 20 April 2016.

27 CBK press release. 10 April 2016.

28 The Central Bank of Kenya have also declared a moratorium on new banking licenses. CBK press release. 17 November 2015.

29 For example, by the Financial Times (2016) 'KCB chief urges Kenya banking sector consolidation' April 25; Interview material.

30 For example, by the Financial Times (2016) 'KCB chief urges Kenya banking sector consolidation' April 25; Interview material.

rapid and robust responses. This includes quickly putting the failed institutions into receivership and liquidation and through market support including public deposit insurance and acting as lender of last resort.

However, the recent events highlight the continued weaknesses in governance and regulation of the Kenyan banking system including high levels of fraud and corruption.

This has an important negative affect on financial development as it undermines public trust in financial institutions, which is one of the most important factors that causes low levels of formal deposit mobilisation from households despite high levels of financial access. (Collins et al., 2010; Tyson, 2014; Bachmann et al., 2014).

Mozambique

Mozambique's economy has experienced significant growth in GDP over the past two decades, supported in part by large investments in the mining sector and strong inflows of foreign direct investments and overseas development aid (Balchin et al., 2016).

However, Mozambique has also sharply increased its sovereign debt through international capital markets and lending that has been mismanaged by the government.

This includes, in 2014, a \$850 million loan for a tuna fishing fleet that was spent on military gun boats. (Tyson, 2015a). In 2016, this loan had to be restructured because it is denominated in US dollars and, following a 28% devaluation of the metical, it became unpayable. It was then restructured and the government assumed the obligation in 2016 (World Bank, 2016; IMF, 2016g).

Mozambique also incurred \$1.5 billion of debt, or 10% of GDP, through loans from Credit Suisse and VTB Bank. These debts were not publically disclosed until the IMF was asked for a facility in early 2016.

Both of these loans broke Mozambique's own budgetary ceilings and agreements with donors. None of Mozambique's institutions were consulted. They have contributed more than \$2.3 billion or 17% to the foreign debt burden (IMF, 2016g).

Following the disclose of these loans, Mozambique's debt to GDP ratio was revised upwards to 86% and the IMF reported a 'high risk of distress'. (IMF, 2016g). The sovereign's credit rating was downgraded by Moody's, Fitch, and Standard and Poor's. Fourteen donors and funding agencies suspended their direct budget support in April 2016 (World Bank, 2016; IMF, 2016g).

These events have led to a deterioration in the economy that had already been hit by falling commodity prices, currency devaluation, high inflation and fiscal and monetary tightening. This has included collapsing FDI in 2016 (World Bank, 2016).

This economic environment is having spillover effects in the banking sector. (World Bank, 2016). Credit growth in the quarter to March 2016 stagnated at 0.3%. There has been significant dollarization in banking assets with sharp rises in foreign currency denominated loans and deposits. (Banco di Mocambique, 2016). Non-performing loans have doubled from 3.2% in December 2014 to 8.9% by December 2015,³¹ and is reported to have increased further in 2016 (World Bank, 2016).³²

Overall, the spillover effects of the problems in the public sector to the private sector have been material and are causing a significant contraction in finance within the real economy from both the banking sector and from FDI.

Nigeria

Corruption in Nigeria has been an 'open secret' for many years. This includes in recent statements by President Buhari addressing this issue.³³

It has had significant negative effects on banking sector development including through insider trading, insider loans and fraudulent accounting practices (Okereke and Kurotamunobaraomi, 2015) and increased costs and credit misallocation (Ndikumana, 2013).

In the 2009 crisis, corruption and fraud were the key causes of a banking crisis. This included insider fraud and corruption by senior managers at banks which was not adequately controlled because the Central Bank of Nigeria's supervision was compromised by lack of adequate inspections and enforcement. (Sanusi, 2010). Post-2009, the Central Bank of Nigeria has attempted to improve regulation but it remains inconsistent (Ajakaiye and Tella, 2015).

Throughout 2015 and 2016, there were continued allegations of corruption and fraud. This included, in March 2016, an investigation by the Economic and Financial Crimes Commission into 'questionable financial transactions' in four major banks which were linked to corruption allegations against the former Minister of Petroleum Resources. It also included an investigation into a number of senior central bank officials in April 2016 which are under investigation, although their findings are not yet known at the time of writing.

31 <http://allafrica.com/stories/201510280152.html>

32 This is believed to be underreported due to not using international accounting standards for recognition of non-performing debts (World Bank, 2016).

33 For example, as reported in the Financial Times, (2016) 'Nigeria struggles to recover looted billions' June 6.

34 Financial Times (2016) 'Three Nigerian bank CEOs questioned in anti-corruption drive' May 10.

Addressing corruption requires building effective institutions including an independent and effective regulator. As for Kenya, there is been a wide ranging formal framework of legislation in Nigeria but with weak enforcement (Okereke and Kurotamunobaraomi, 2015)³⁵. This is despite the Central Bank of Nigeria reiterating their lack of tolerance for ‘allow[ing] the banking system to be used as a conduit for any illicit transaction’. Nevertheless, governance and especially corruption remain issues for Nigeria.³⁶

Conclusion

The economic slowdown in the region has not been the cause of the failures in governance in public and private institutions highlighted in this section.

However, these long-standing problems combined with the increased financial fragility and slowdown in financial development resulting from the current economic environment increase the possibility of financial instability.

For example, the cases of Mozambique and Ghana show how mismanagement of public finance has had secondary effects on bank asset quality and profitability and reduced cross-border capital inflows.

Similarly, the instances of fraud and corruption in Kenya and Nigeria increase the possibility of a ‘bank run’ occurring at an individual institution which, in the current fragile environment, is more likely to become contagious.

They also highlight an important issue in the current stage of financial development in sub-Saharan Africa – that many countries have established an appropriate formal

framework for regulation and supervision of their financial systems but that such formal frameworks have little value unless they are robustly and consistently adhered to and enforced.

In practice, in some countries in the region, this is not the case. This undermines effective financial regulation and supervision and thereby increases financial fragility (IMF, 2016b).

They also highlight that weak governance – and especially fraud and corruption – is eroding public trust in financial institutions. Without such trust, successful, long-term financial development is not possible.

For example, without public trust deposit mobilisation is impaired and household savings will remain in the informal sector. This undermines the ability of economies to mobilise savings, a critical source of cheap, stable and local currency investment.

Finally, there have been a number of instances where, as sub-Saharan African financial systems have become increasingly integrated into the global financial system, fraudulent and corrupt practices have been facilitated by financial entities from advanced economies (such as in the case of Mozambique). A more robust approach from, and partnership with, these advanced economies is needed to tackle these practices.

Overall, the continued presence of weak governance of public and private institutions has reinforced the negative impact of the current economic slowdown including increasing financial fragility and curtailing financial development. The policy implications of these observations are discussed further in Section 6.

35 This includes: (i) Corrupt Practices Decree, 1975; (ii) Bank and Other Financial Institutions Acts (BOFIA), 1990; (iii) Failed Banks (Recovery of debts) and Financial Malpractices Act No. 18 of 1994; (iv) Failed Banks Act No. 16 of 1996; (v) The Foreign Exchange (Miscellaneous Provisions) Act No. 17 of 1995; and (vi) Money Laundering Act No. 3 of 1995.

36 Nigerian Times. <http://nigeriantimes.ng/news/Central-Bank-of-Nigeria-efcc-collaborate-to-investigate-fraudulent-transactions-in-banks/>

5. Implications for structural economic transformation

As noted in the introduction, although the short-term effects of the current economic conditions on financing for development are important, more critical is whether there will be a long-term impact.

In this section, we will examine the longer-term effects. In particular, the section will focus on the role of bank lending in financing sectors of importance for ‘structural economic transformation’ and defined as increasing productivity in the economy (Rodrik, 2013).

It starts with a brief literature review relating to finance and structural economic transformation.

It will then go on to present some preliminary findings that indicate that growth in bank lending in the region in the last five years has flowed into sectors with relatively little importance for structural economic transformation.

This is illustrated in relation to three case studies. These are an example of an oil-exporting country, Nigeria, and an oil-importing country, Kenya. Both have followed conventional policy in relation to financial development, focusing on bank lending through private financial institutions, encouraging cross-border capital flows and ‘getting the basics right’ for regulation, supervision and the business environment.

However, although both have experienced strong growth in the financial sector, these policy approaches have also had limited success in directing private capital into priority sectors for structural economic transformation.

The paper then examines a very different case study – Ethiopia. Ethiopia’s financial sector is heavily dominated by its Government who direct credit into key sectors for structural economic transformation in line with its active industrial policy. This has been very successful in increasing finance for priority sectors.

The chapter will conclude by discussing some preliminary implications of the discussion.

A brief literature review

The traditional argument that links financial system growth to economic growth is that financial systems provide information that coordinates the efficient allocation of investment to productive areas. Whilst they also provide important additional functions such as pooling savings, transforming maturity and facilitating capital accumulation, it is ‘ultimately through improvements in resource allocation and productivity growth that finance helps economies grow more quickly’ (Beck et al., 2011: 11).³⁷

However, recent empirical work has presented a more complex relationship between the financial system and growth.

Firstly, studies have shown that different forms of financial growth have different effects on economic growth. For example, enterprise credit has a much stronger positive relationship on growth than household credit (Beck et al., 2009).

Secondly, it has been found that there is not a linear, but a bell-shaped, relationship between the scale of financial systems and economic growth (Arcand et al., 2012). This is because, beyond a certain level of financial size relative to GDP, the positive effect on economic growth begins to decline while costs of financial volatility increase (Satay et al., 2015).

Thirdly, for emerging markets, these costs of instability also increase with increasing speed of financial development and are present even at relatively low levels of financial development. This has been attributed to a lack of strengthening in governance, supervision and regulation in parallel with financial sector growth (Satay et al., 2015).

Overall, these results imply that there can be too much finance as well as too little and that financial development can proceed too fast as well as too slowly.

³⁷ An additional problem is that this framework then uses the size of the financial system relative to GDP as the key empirical definition of ‘financial development’. For example, this might include the ratio of financial assets to GDP (Beck et al., 2011). There has been some recent work on developing more sophisticated definitions of ‘financial development’ with multi-dimensional measures (Satay et al., 2015; Svirydzenka, 2016). and financial soundness indicators (IMF, 2016). For example Satay et al. (2015) has defined financial development as a combination of depth (size and liquidity of markets), access (ability of individuals to access financial services), and efficiency (ability of institutions to provide financial services at low cost). (Satay et al., 2015). These are promising but still do not directly include productivity increases.

They also imply that financial flows to different sectors may have differential effects on growth. However, to date, the research has produced only a crude analysis of this – such as only two ‘sectors’ being defined (such as used by Beck et al., 2009).

A more nuanced and detailed empirical analysis and theoretical framework is needed to link finance and productivity increases in the real economy.

Currently, this is largely absent but some possibilities can be suggested. For example, one approach – which is adopted by this paper – is a theoretical framework based on an extension of the structuralist approach.

The original structuralist approach has not focused on financial systems but on the real economy with a three-sector model comprised of agriculture, industry and services. Finance is only introduced as a ‘first order principle’ in the form of ‘sound money’ (Summers, 2003; Rodrik, 2007) which is defined as ‘not generate (in) liquidity beyond the increase in nominal money demand at reasonable inflation’ (Rodrik, 2007: 33) and as institutions such as central banking, fiscal policy and regulation (Rodrik, 2007).

Finance can also be a binding constraint – that is the key constraint that prevents structural transformation taking place. For example, this might include impediments such as a high cost of financing of investment, low investment returns or low savings returns (Rodrik, 2007).

More recent work has developed a more sophisticated framework and proposes an ‘optimal financial structure’ for development. It is argued that the optimal financial structure is exogenously determined by the factor endowments of the real economy because they determine efficient mobilisation and allocation of capital. The optimal structure is also dynamic, changing as the endowment structure of an economy changes during development (Lin and Xu, 2012). The exogenous determinants of an optimal financial structure include firm size, risk and financing needs. If the financial structure does not complement the factor endowments of the real economy, then the financial system is inefficient and hinders economic growth (Lin, Xifang and Ye, 2011).

However, these frameworks lack a deeper theory of financial markets. For example, they lack specified transmission channels and do not provide for endogenous

instability or structural change. This is problematic because – and despite stating that one of the central aims of the approach is to explain historical development patterns (Rodrik, 2007) – the framework relating to financial systems excludes one of its most notable features, namely financial instability and crisis.

The empirical support for these theoretical innovations is also weak. For example, empirical studies define financial structure as the balance between banks and stock markets but with an undeveloped rationale as to why this parameter is the crucial factor that relates finance to factor endowments and productivity (Lin, Xifang and Ye, 2011; Cull and Xu, 2011; Lin and Xu, 2012). In addition, financial development continues to be defined only by the growth of credit (Cull and Xu, 2011).

The paper suggests that an alternative is to allow the core concern of the structuralist approach – increases in productivity – to take ‘centre stage’ in relation to ‘financial development’. However, significant research is needed to develop a theoretical framework, definition and empirical basis to link financial development to productivity increases.

This includes addressing that because finance may only be the binding constraint in some instances and because its effects interacts with other factors such as institutional environments, its effects may be variable in different instances.

Some empirical work has been done in relation to sector growth and productivity. For example, it has been argued that manufacturing investments have more ‘transformative growth impact ... per dollar of investment’ than commodity sector investments (Balchin et al., 2016).

Evidence-based policy approaches have also reflected this focus. For example, DFID define structural transformation and transformative growth using productivity (Interview material).

In the case studies that follow the paper adopts an approach to link finance to different sectors to structural economic transformation based on this work, whilst recognising their gaps and weaknesses. In the section that follows, sectors have been defined based on their ‘transformative growth impact ... per dollar of investment’ as shown in Table 1 below.

38 <http://www.cdcgroup.com/What-we-do/Our-Mission/>

Table 1: Sectors and their transformative growth impact

Transformative growth impact	Sector	References
High	Agriculture Manufacturing Services (including tourism, financial services, business services, utilities, communication & others) Infrastructure	Balchin et al. (2016); Khanna et al. (2016)
Medium	Trade Real estate & construction	
Low	Extractives Consumer finance	

Source: Author

This is part of the ESRC-DFID sponsored grants made in 2013³⁹ and 2016 for which one of the goals is to fill this important gap in the existing research.⁴⁰

Country case studies

Nigeria

As discussed in Section 3, the Nigerian economy and its financial sector are dominated by the oil sector and experience ‘boom and bust’ cycles in relation to oil prices. Because of this, there is a need for economic diversification.

This goal has been highlighted by the Government of Nigeria in its 2016 budget⁴¹ (te Velde et al., 2016).

The economic concentration in the oil sector is reflected in the composition and growth patterns of private credit.

In 2014,⁴² 22.0% of private credit and 33.6% of the growth in bank lending between 2011 and 2014 was to the oil sector (Figures 18 and 19).

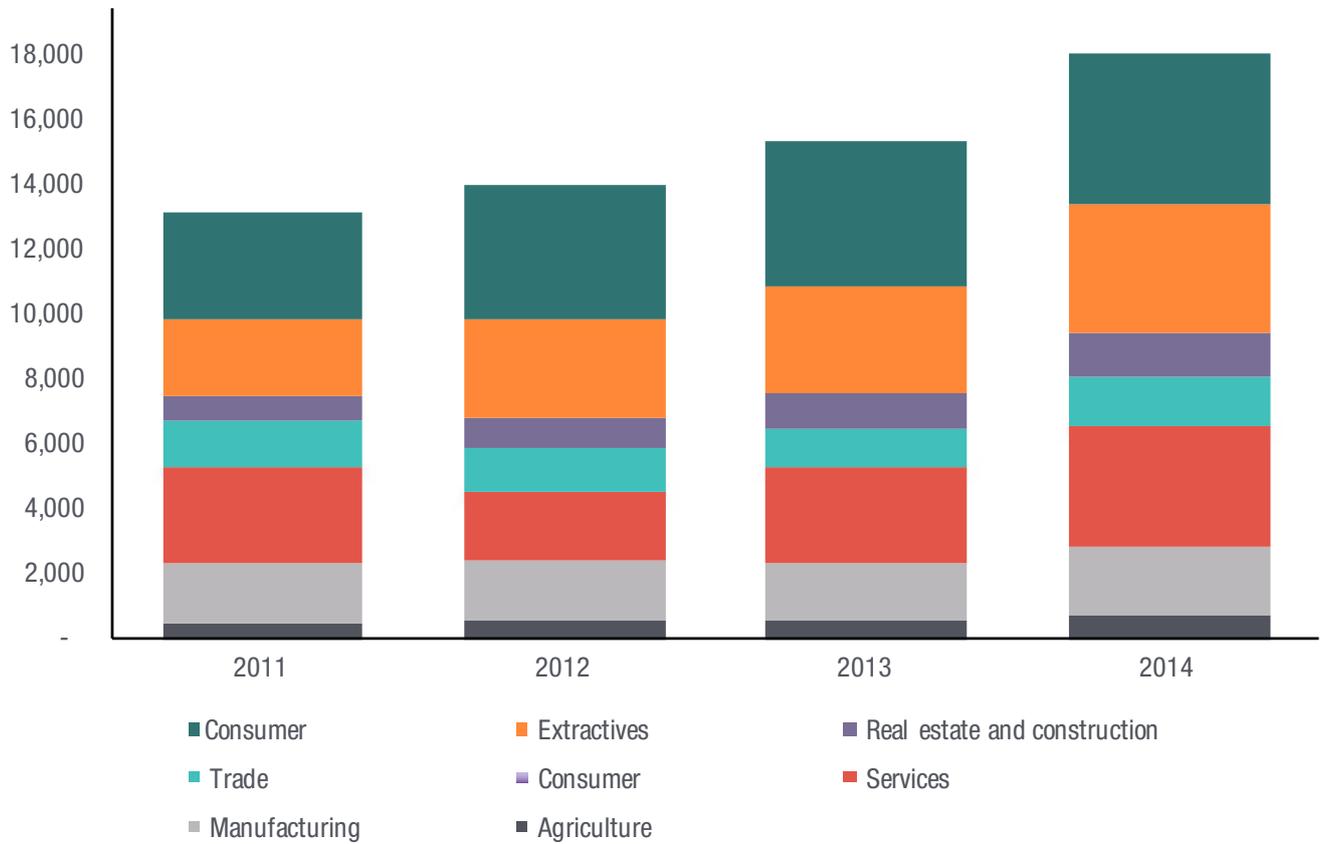
39 Further details are available at <http://degrp.squarespace.com/degrppublications/2013/12/2/sustaining-growth-and-structural-transformation-in-africa-how-can-a-stable-and-efficient-financial-sector-help>

40 Further details are available at <http://www.birmingham.ac.uk/news/latest/2016/03/International-collaboration-on-financial-research-could-change-lives-in-Africa.aspx>

41 <http://www.budgetoffice.gov.ng/pdfs/2016/2016BudgetSpeech.pdf>

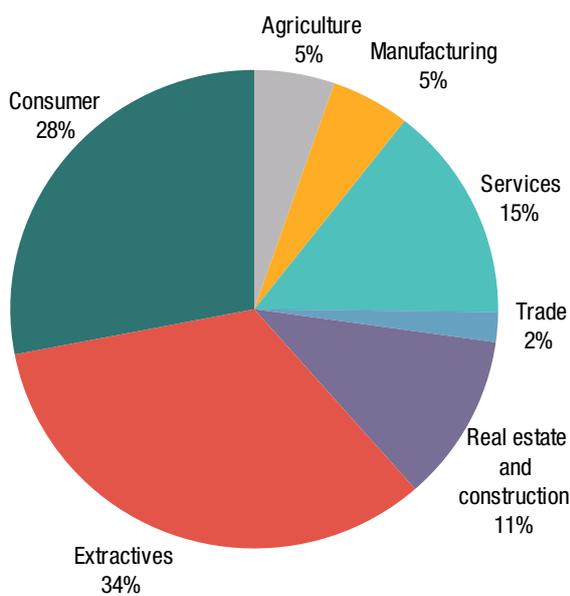
42 Figures for 2015 have not been published by the CBN at the time of writing.

Figure 18: Sector composition of outstanding private credit (2011 to 2014)



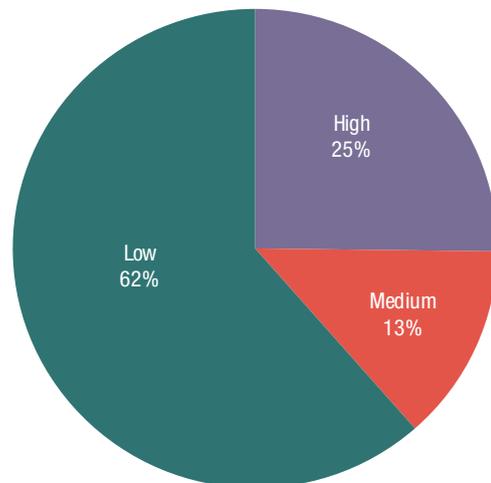
Source: Author elaborated from Central Bank of Nigeria data.

Figure 19: Sector composition of private credit growth (2011 to 2014)



Source: Author elaborated from Central Bank of Nigeria data.

Figure 20: Allocation of private credit growth to sectors ranked by impact on structural economic transformation (2011 to 2014)



Source: Central Bank of Nigeria elaborated by author based on the mapping in Table 1.

However, this is not as concentrated as might be expected with other sectors also receiving a significant portion of private credit. For example, there has been significant credit to the consumer lending and real estate sectors. These accounted for 25.9% and 7.6% lending of total 2014 private credit and 28.0% and 11.3% of its growth between 2011 and 2014 respectively.

However, these sectors probably have little transformation effect on productivity or diversification. Furthermore, they are both pro-cyclical because they are subject to secondary effects of oil price shocks through their effect on households.

By contrast those sectors of importance to structural economic transformation – such as manufacturing, services and trade – experienced more muted absolute increases and relative declines in private credit. Illustrating this, agriculture received only 4.0% of 2014 private credit, and growth in the share of private credit in the previous five years was negligible. Manufacturing received only 11.9% of 2014 private credit, a relative decline from its 14.4% share in 2011 and a small absolute increase from Naira 1.9 trillion in 2011 to Naira 2.1 trillion in 2014. Trade received 8.4% of total 2014 lending and five year lending was also effectively stagnant from Naira 1.4 trillion in 2011 to Naira 1.5 trillion in 2014, representing only 2.4% of the growth in private credit.

Overall, only 25.2% of bank lending growth between 2011 and 2014 went to sectors with high transformational effects, 13.3% with medium effects and 61.5% to sectors with low or no effects (Figure 20).

This pattern of credit has been a long-standing structural feature of the Nigerian banking system which has persisted despite various policy initiatives to try to alleviate these problems. For example, these have included a number of Government-financed funds in partnership with commercial banks for the agricultural sector and for SMEs. However, in practice the level of disbursement through these facilities remains relatively low (Ajakaiye and Tella, 2016; Central Bank of Nigeria, 2015).

However, despite this negative outlook in relation to bank lending supporting structural economic transformation, there are some positive trends in financing for development where finance has been sourced outside of the banking system.

In particular, FDI inflows to Nigeria have been strong. Although, as for private credit, much of this has gone into the extractive sector and there were net outflows in 2015 (Tyson, 2015b; UNCTAD, 2016), manufacturing has received inward FDI averaging \$1.7 billion in the 2011

to 2014 period. This included FDI from China and South Africa (Chen et al., 2014). This has supported growth in the Nigerian manufacturing sector including in exports (Balchin et al., 2016).

In addition, as noted, the need to diversify the economy has been identified as a strategic goal in the Nigeria 2016 budget. This has included the announcement of subsidised funding for agriculture and a focus on job-creating sectors such as manufacturing and SMEs.⁴³

The Central Bank has sought to support these budgetary goals in a number of ways. They include risk mitigation and guarantee schemes for and direct funding of private credit facilities in the agricultural and SME sectors and for electricity generation. However, as for previous policy initiatives, disbursements under these facilities remain relatively small (Central Bank of Nigeria, 2015a).

The Central Bank of Nigeria also announced a *de facto* credit policy in January 2016 by requiring their approval for new loans to ‘qualifying sectors’, which were composed of agricultural value-chains, manufacturing, mining and solid minerals, infrastructure and other real sector projects. Trading activities and refinancing of projects are ‘not encouraged’.⁴⁴ The outcome of this new measure is not yet known.

Overall, despite these policy measures, more needs to be done to direct credit into sectors with positive transformational impact and to counterbalance the current entrenched patterns of bank lending and FDI as part of efforts to reduce the commodity dependency of the Nigerian economy.

Kenya

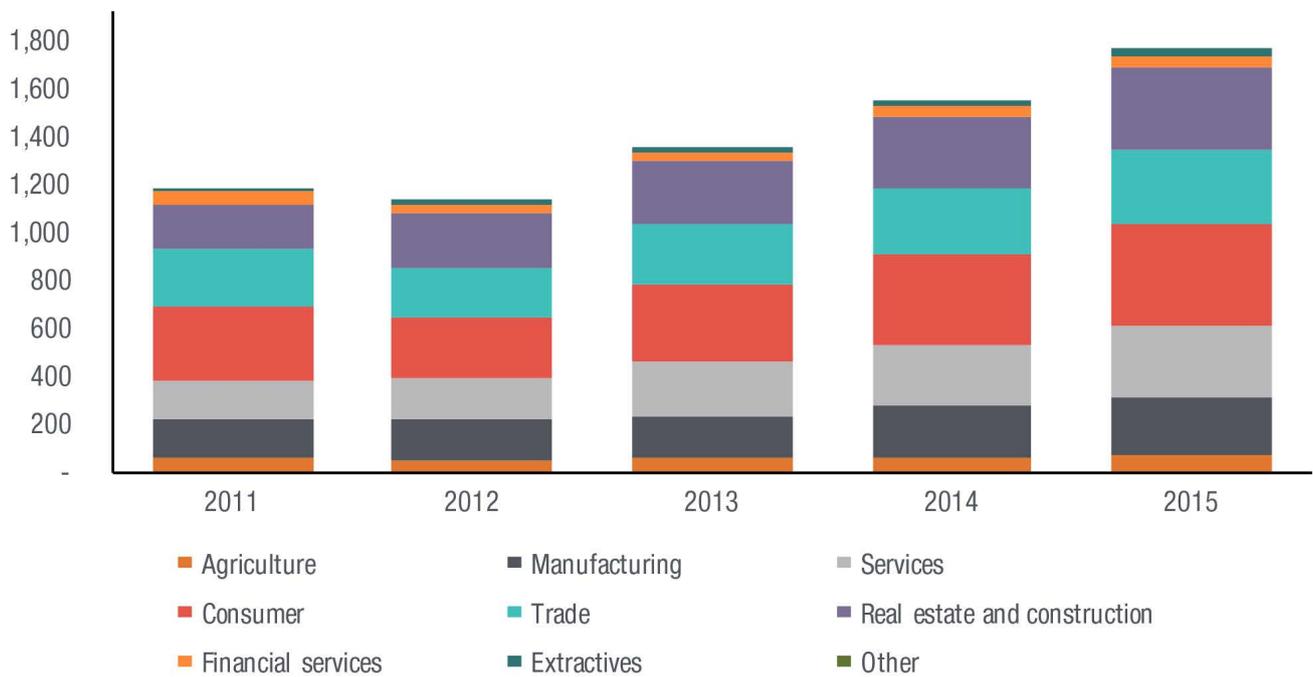
In 2007, the Government of Kenya published ‘Kenya Vision 2030’ which sought to set out a long-term national planning strategy aiming to transform Kenya into a middle-income country by the year 2030 (Government of the Republic of Kenya, 2007). It sought to develop sectors where Kenya has competitive advantages, including high-value agriculture, manufactured goods, financial services and tourism. It also seeks to develop Kenya as the key financial hub for the region (Kenya National Bureau of Statistics data; Khanna et al., 2016).

This development strategy has been reflected in the sector composition of private credit. Total private credit has grown at an annual average rate of 19.6% between 2011 and 2015 with private credit reaching 36.8% of GDP in 2015. Positively, this growth has been broadly distributed across sectors including those with high transformation growth impact (Figures 21, 22 and 23).

43 Budget speech 2016, “The Budget of Change” delivered by His Excellency, Muhammadu Buhari President, Federal Republic of Nigeria to a joint session of the National Assembly’. Available at <http://www.budgetoffice.gov.ng/pdfs/2016/2016BudgetSpeech.pdf>

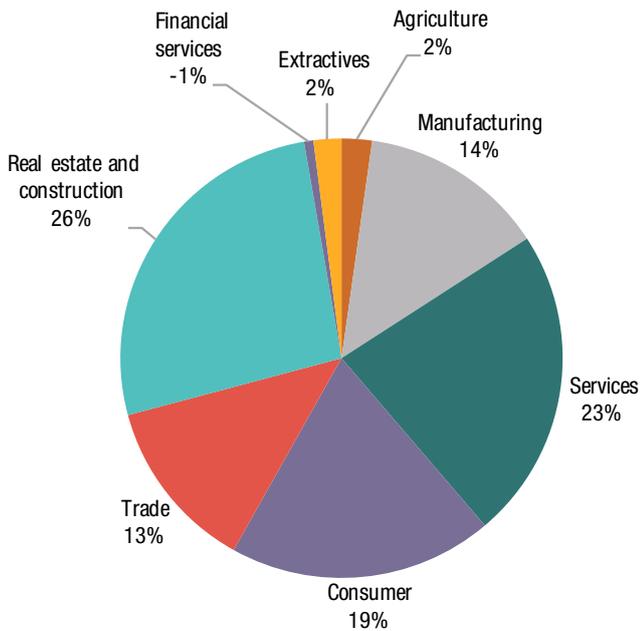
44 <http://www.cenbank.org/Out/2016/FPRD/CRR%20Reduction%20Circular%20Jan%202016.pdf>

Figure 21: Sector composition of outstanding private credit (2011 to 2015)



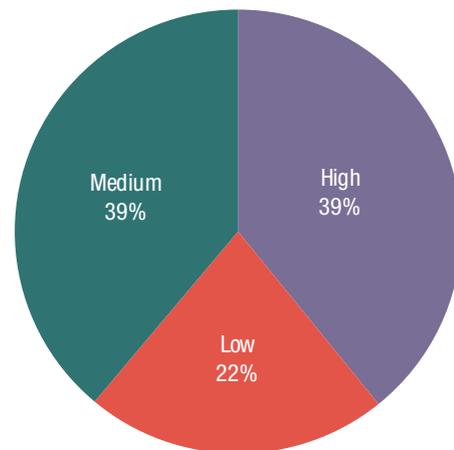
Source: Central Bank of Kenya

Figure 22: Sector composition of private credit growth – 2011 to 2015 (%)



Source: Central Bank of Kenya

Figure 23: Allocation of private credit growth to sectors ranked by impact on structural economic transformation – 2011 to 2015 (%)



Source: Central Bank of Kenya elaborated by author based on the mapping in Table 1.

This includes manufacturing and services which, in 2015, received 12.6 and 15.9% of total private credit and 13.8% and 23.2% of the growth in private credit between 2011 and 2015 respectively. It also includes increases in sectors with medium impact, including trade and real estate and construction. FDI has also flowed into these sectors with FDI flows to Kenya reaching a record \$1.4 billion in 2015, including strong flows into manufacturing, exports and consumer services (UNCTAD, 2016).

However, there are also important exceptions to this positive picture.

Firstly, agriculture has received only marginal absolute increases in private credit in the last five years with credit to the sector increasing from Ksh 61.9 million in 2011 to Ksh 75.0 million in 2015. Furthermore, its relative share of private credit has fallen from 5.2% of total private credit in 2011 to 4.0% in 2015. This is because credit has been expanded primarily through commercial financial institutions including banks and microfinance organisations and they see the agricultural sector as commercially unattractive because of low returns and high levels of non-performing loans. Given that subsistence agriculture remains the predominant livelihood in Kenya this lack of capital to increase productivity remains a barrier to structural economic transformation (Tyson, 2014).

Secondly, Kenya has seen strong growth in consumer finance. Between 2011 and 2015, credit to the sector grew from Ksh 318 million to 432 million, representing 15.9% of total credit in 2015 and 23.2% of private credit growth between 2011 and 2015. Again, this is due to the commercial attractiveness of the sector for private institutions who have built large consumer lending businesses focusing on wealthier, urban customers. Although the relationship of consumer credit and structural economic transformation has not been adequately empirically researched, in a country such as Kenya where financing is one of the 'binding constraints' on growth there is an 'opportunity cost' of using credit for middle class consumption lending (Tyson, 2014).

As noted, Kenya has developed a liberalised private financial market to both finance development and allow development of a financial hub. However, this has implications for structural economic transformation because it allows credit to be allocated to sectors according to private incentives. As we have seen, this produces mixed results with some sectors important for structural economic transformation receiving finance but others not.

In addition, the development as a financial hub for a relatively small economy also introduces the risk of financial instability. This includes greater difficulty in maintaining macroeconomic stability because of the need

for liberalised cross-border capital flows and exchange rates to enable a hub. It also creates a need to regulate and supervise financial institutions that are within the domicile of the economy but with regional and internal business which can be challenging for central banks (IMF, 2012; Khanna et al., 2016).

Ethiopia

The Government of Ethiopia has executed a public-led industrial policy that has aimed for diversification of the economy with poverty reduction through development of export-led manufacturing. The strategy has been successful with persistently strong economic growth averaging 10.1% annually from 2004 to 2015 and an emergence of a strong manufacturing sector in textiles, garments and leather products, as well as agro-processing, (although from a low base). In addition, industrial parks have been developed (IMF, 2015; UNDP, 2015). Growth for 2016, however, is forecast to decline to 4.5% because of a severe drought which has reduced agricultural output and required a supplementary budget to provide humanitarian relief. (IMF, 2016b) Nevertheless, this growth is amongst the strongest and most consistent in the last decade in sub-Saharan Africa.

This strategy has predominantly been financed under state direction. This includes state-owned development banks which have executed credit policy to direct funds into trade, infrastructure (such as electrical production and for trade-orientated transport systems) and state-owned enterprises. These banks include the Commercial Bank of Ethiopia, which accounts for two-thirds of system-wide assets (IMF, 2015f; Alemu, 2016).

Regulation of private banks is strict with private banks only permitted since 1996. Only domestic private banks are permitted. These private banks are required to invest the equivalent of 27% of their new lending in bonds at the Development Bank of Ethiopia who then lends to priority sectors and the former adhere to state directives on policy lending. As well as directing credit to these sectors, this has also avoided the 'hoarding' of liquidity by private banks that is a common feature of many developing countries' private banks. In relation to institutional stability, it is required that loans are fully collateralised with high ratios of assets to loans (IMF, 2015f; Alemu, 2016).

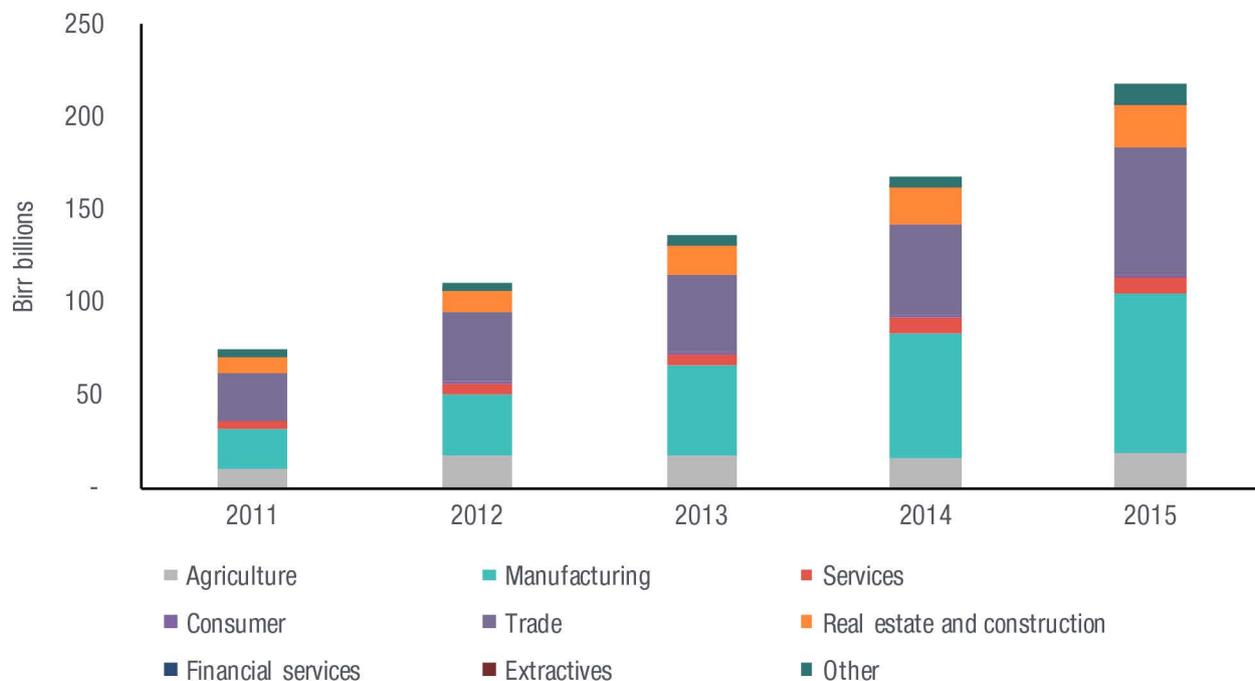
By 2015, private credit was only 9.4% of GDP and less than 25% of banking assets are in private banks. Ethiopia also has limited adherence to international standards of banking supervision and regulation with no use of IFRS, Basel II or III Standards⁴⁵ and no deposit insurance. Financial access is also limited (IMF, 2016b). The figures below show the combined sector composition of credit for both the private banks and for the state-

45 There has been implementation of Basel I but the National Bank of Ethiopia has stated that they see Basel II and III as inappropriate for the Ethiopian banking system (Alemu, 2016).

owned Development Bank of Ethiopia. As can be seen, the strategy of state-led credit policy has led to an exceptionally high percentage of credit flowing into sectors of high importance for structural economic transformation (Figures 24 and 25).

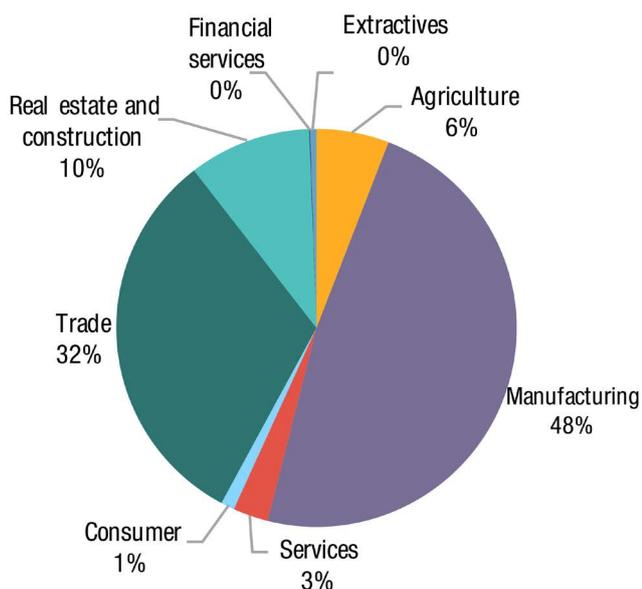
In particular, manufacturing saw a tripling of absolute levels of credit between 2011 and 2015, representing 75.9% of outstanding credit in 2015 and receiving more than 45.7% of credit growth between 2011 and 2015.

Figure 24: Sector composition of outstanding public development bank and private credit (2011 to 2015)



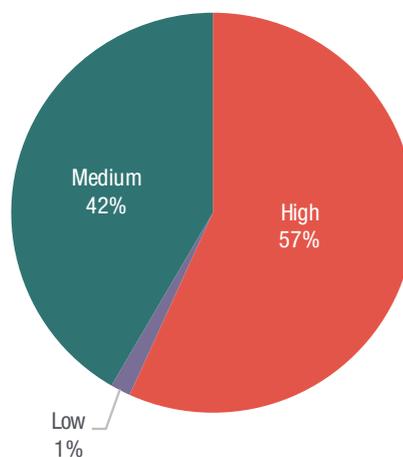
Source: National Bank of Ethiopia.

Figure 25: Sector composition of public development bank and private credit growth – 2011 to 2015 (%)



Source: National Bank of Ethiopia.

Figure 26: Allocation of public development bank and private credit growth to sectors ranked by impact on structural economic transformation – 2011 to 2015 (%)



Source: National Bank of Ethiopia, elaborated by the author based on the mapping in Table 1.

Overall, more than 57.0% of credit growth was directed to high priority sectors for transformation. A further 42.5% flowed into medium priority sectors. This included trade which saw a near doubling of absolute levels of credit between 2011 and 2015, held 31.5% of outstanding credit in 2015 and which received more than 30.1% of credit growth between 2011 and 2015. Only 1.5% of credit growth was directed into low priority sectors (Figure 26).

Overall, this policy appears to have been highly successful both in channelling funds to priority sector and in creating inclusive and transformational growth.

However, there are some caveats. For example, there are concerns about the ability of the state to continue to provide the scale of finance needed as economic development deepens. The state has sought further funding. For example, it issued a sovereign Eurobond in 2014 to finance industrial parks, the sugar industry, and power transmission infrastructure. Notwithstanding this, it is also seeking to transition towards a greater role for the private sector in order to increase the scale of financing for private enterprises. This includes examining public-private partnerships that would use private finance but retain state control (IMF, 2015f).

There are also concerns about SMEs' low levels of financial access and finance (Alemu, 2016). However, given that growth has also been accompanied by falling poverty levels (including because of employment creation in the labour intensive flower and textiles sectors) (Alemu, 2016), growth has been inclusive despite these concerns.

It also includes policy to increase savings. Currently, savings are well above average for the region with savings rates of between 26% and 33% for all of the past five years. However, government policy would like to target even higher savings through the expansion of bank branches and insurance and through banks being encouraged to expand their branch network and developing tailored savings instruments for homebuyers and Ethiopia's diaspora (Central Bank of Ethiopia, 2015; IMF, 2015f).

In addition, there are moves to encourage FDI. Historically, FDI has been low. For example, in 2015, it was only 3.6% of GDP. However, the state is encouraging it to grow and in 2015 there was \$2.2 billion of inward FDI into the textile and garment industries (UNCTAD, 2016).

In addition to these issues, there have also been specific negative effects on private banks of the policy choices in Ethiopia. This includes the effects of the bond noted earlier that directs 27% of private bank assets to the Development Bank of Ethiopia which, because of its negative fixed yield has caused private banks to suffer declines in profitability with banks' annual profit growth slowing from 10% to

2% since 2011 when the policy was introduced. Private banks has also responded by increasing holdings of 'safer' assets (Limodio and Strobbe 2016).

Overall, the positive effects of increasing lending in priority sectors through government policy needs to be assessed in conjunction with negative impact on other forms of financing for development including the effects of 'financial repression' on private credit growth especially to riskier sectors (Limodio and Strobbe 2016).

Conclusion

As has been shown in this section, the pattern of credit growth by sector is closely correlated with sector growth in the real economy in the case studies we examined.

In Nigeria, where credit is allocated by private institutions, credit is concentrated in the extractive industries and consumer finance with little allocated to agriculture, manufacturing and trade. This correlates to the dominance of oil and the lack of diversification and structural transformation in its economy.

In Kenya, where credit is also allocated by private institutions, credit is more diverse across sectors including being allocated to tourism, manufacturing and trade. This is correlated with the greater economic diversification in the Kenyan compared to the Nigerian economy. However, it has also seen credit being allocated to consumer lending, arguably diverting scarce capital from more transformational uses. In addition, the growth in consumer finance may lead to increases in household debt, excessive imports and exchange rate appreciation.

By contrast, in Ethiopia, where the state has significant control of credit allocations, credit is concentrated in manufacturing and trade which have been key in its economic growth and poverty alleviation.

However, despite these correlations, the existing research base does not allow us to conclude as to whether the relationship between credit and structural transformation is causative and, if so, in what direction. For example, increasing credit may relieve financing constraints in a given sector, thus causing it to grow differentially in terms of other sectors. Alternatively, the differential growth in a sector may attract greater financing. This relationship needs further empirical research.⁴⁶

However, one conclusion that can be drawn currently is that, based on our limited sample of three case studies, there appears to be a close relationship between credit being directed into priority sectors for structural economic transformation and the extent of control of credit allocations by the state compared to private actors.

The experiences of Nigeria and Kenya contrast with that of Ethiopia so much as to imply that allowing private financial institutions to freely allocate credit may lead to a

46 This is the topic for the ERSC grant noted earlier.

misallocation of credit in relation to the needs of structural economic transformation – that is externalities relating to structural economic transformation exist but are not being counteracted by policy.

The Ethiopian experience also suggests that an effective developmental state can better influence the direction of credit to sectors likely to speed up economic diversification as well as promote mutually beneficial partnership and interface with the private sector to further deepen financial

development that is compatible with enhanced economic diversification.

It also implies that ‘financial development’ that comprises of the growth of private credit – rather than how that credit is being allocated within the real economy – is unlikely to contribute optimally to structural economic transformation.

The policy implications of this is discussed further in the next section.

6. Conclusion and policy options

As discussed in the paper, the current economic slowdown is causing a slowdown in financial development in sub-Saharan Africa. Credit is contracting, savings have declined, cross-border capital is less available and more costly, while indicators of financial soundness have deteriorated.

There have also been failures in governance of private and public institutions, including corruption and fraud that have deepened these problems.

These have also undermined the public trust that is essential for long-term formal financial development.

While it seems unlikely that these conditions will develop into a financial crisis unless there are further significant economic shocks, they are negative for economic growth – and especially given the on-going ‘credit crunch’ – in an economic environment that is already difficult.

In this context, policy needs to counterbalance the short-term negative effects. However, it also needs to address the long term needs to maintain and balance financial sector development and stability.

Adapting current policy approaches

In relation to policy responses to achieve this, a continued focus on the conventional approach of ‘getting the basics right’ is required.

In particular, as highlighted in Section 4, good formal legal and regulatory frameworks have been established in many countries. However, **enforcement and compliance** remain weak. Where failures have occurred, central banks – such as those in Kenya and Nigeria – have been robust in responding. However, enforcing more comprehensive compliance, rather than responding to failures, needs to be a continued focus.

This involves on-going work to build institutional capacity including human capital and management information systems. This needs to be led by national central banks. However, international development agencies (such as DFID) could also encourage regulatory collegiate exchanges to assist in technical assistance.

There is also a need for DFIs and governments to provide **anti-cyclical financing** to mitigate recessionary forces and maintain macroeconomic stability.

The IMF has reformed concessional facilities for lower income countries to create more flexibility and less conditionality (Tyson et al., 2014).⁴⁷ It has also been active in providing country assistance, as discussed earlier. These funds have been useful in stabilising countries’ fiscal situations, including in Ghana and Angola (IMF, 2016b).

The World Bank Group has also provided increased assistance in 2015 and 2016 with outstanding IBRD loans increasing from \$2.9 billion at March 2015 to \$3.3 billion at March 2016, and IDA development credits increasing from \$41.7 billion at March 2015 to \$47.3 billion at March 2016. However, these funds were not being used primarily for economic development but for health (including the Ebola crisis) and other social services (World Bank Group, 2015; 2016).

Overall, although these are helpful in relation to fiscal financing and welfare, they do not address the need for more anti-cyclical financing for priority sectors for structural economic transformation. This is discussed further below.

New policy options

In this section, we highlight some new thinking in policy approaches.

The first two are essentially extensions of ‘getting the basics right’ into two new areas which need greater development by both national governments and international bodies given the current economic environment. These are:

- Giving **macro prudential regulation** more emphasis including tailoring it to the sub-Saharan African context; and
- **International cooperation to tackle illicit capital flows** relating to strengthening governance and reducing fraud and corruption.

47 For example <https://www.imf.org/external/np/pp/eng/2016/041416.pdf>

In addition, we also discuss a policy question that has not been adequately addressed by current conventional policy approaches. This is how to **more effectively direct credit into priority areas for structural economic transformation.**

Macro prudential policy development

Despite the recent set-backs discussed in this paper, sub-Saharan African financial systems are likely to continue to deepen and become more integrated with the global financial system. Policy is needed to protect them from instability in relation to both the pro-cyclical nature of domestic economies and to the risks from volatile private cross-border capital.

Globally, improved macro prudential frameworks have been developed by the G20 and the Financial Stability Board following the global financial crisis of 2007. These include new regulatory standards from the Basel Committee on Market Supervision, known as Basel III. These standards augmented the preceding Basel II by introducing more stringent requirements for capital, liquidity and leverage, including counter-cyclical requirements and system supervision (Basel Committee, 2010).

Sub-Saharan African countries are in the process of implementing Basel II and III (IMF, 2016b). However, the standards are, arguably not relevant, too complex and costly for the regional context.

In particular, they lack relevance because Basel II and III standards are designed to manage complex market risk, complex interbank transmission mechanisms and very large and international institutions that dominate in advanced economies. However, such risks and institutions are rare in most sub-Saharan African countries.

Developing macro prudential regulation of more relevance to the risks in sub-Saharan financial system – which are primarily credit risks, including pro-cyclical credit cycles, and operational and governance risks – would be more effective in achieving strong regulation. They would also be cheaper and easier to apply. More tailored regulation needs to be agreed between sub-Saharan Africa regulators and the Basel Committee.

However, the low relevance of Basel II and III for sub-Saharan Africa's financial systems has resulted partially because of the lack of an effective voice for developing countries in the various international bodies which discuss and set global financial regulation and supervisory standards (Tyson et al., 2014).

For example, of the 27 nations whose central banks are represented on the Basel Committee, and the 24 nations represented on the Financial Stability Board, there are only seven middle income countries and no lower income countries (Tyson et al., 2014).

Sub-Saharan African representatives could be added as members of the Basel Committee, committee observers and Expert Sub-Committees in order to provide a formal channel for this dialogue (Tyson et al., 2014).

This could facilitate the development of different standards that would be more appropriate for middle level and infant markets, addressing specifically the different types of risks that such markets face compared to their advanced counterparts.

This could also be combined with an explicit acceptance of a 'two speed' approach to attaining full compliance with international standards which paces expected regulatory standards to different levels of financial development and complexity rather than the current 'one size fits all' approach.

Furthermore, implementation of macro prudential regulation in the region needs to be more rapid to ensure that the current issues do not become more critical. Agreeing tailored standards, as well as the needs discussed earlier to continue to build institutional capacity, would facilitate this.

International cooperation on tackling corruption and money-laundering

Responsibility for tackling corruption and fraud lies primarily with the host governments in which it occurs.

However, it 'takes two to tango' because illicit outflows from sub-Saharan Africa also involve illicit inflows to other countries.

In addition, as has been highlighted by the recent 'Panama Papers' and the collaboration in Mozambique by western financial institutions, illicit flows to and from sub-Saharan Africa are being facilitated by financial institutions who are regulated and supervised in advanced economies including the offshore financial centres which they have domicile over.⁴⁸

Greater cooperation from advanced economies is needed to identify such illicit inflows where they enter their economies either through their financial systems or through other asset markets such as real estate and to take firm action against the financial institutions that are facilitating them.

This includes supporting the suggested policy in the UK of creating transparency of beneficial ownership of assets channelled through offshore financial centres.

Such cooperation is already in progress in relation to tax. This includes proposals to establish multilateral information exchanges and improved territorial-based taxation. This shows that such initiatives are useful and possible (Tyson et al., 2014).

Overall, greater international cooperation is needed to help sub-Saharan Africa and other regions tackle corruption and fraud in a comprehensive manner.

48 <http://www.theguardian.com/news/2016/apr/26/forget-the-camerons-the-african-giveaway-is-the-real-panama-papers-story>

Directing credit to priority sectors for structural transformation

As discussed in Section 5, the last five years have seen rapid credit growth in sub-Saharan Africa but much of that credit has not been directed to priority sectors for structural economic transformation.

This problem is likely to be made worse by the on-going ‘credit crunch’ in 2016 and policy needs to address this issue to keep long-term structural economic transformation on track

However, these policy choices are made more complex for two reasons.

Firstly, policy that aims to ensure financial stability often has a trade-off with credit expansion. For example, central banks are acting to ensure institutional stability by increasing capital ratios and NPL reserves. However, such actions force further credit contraction. Overall, it is difficult to find an appropriate balance between the arguably mutually exclusive goals of financial stability and the expansion of credit during cyclical downturns.

Secondly, directing credit can be difficult in financial systems which have been liberalised and are dominated by private commercial institutions.

In Section 5, this problem was implicit in Nigeria and Kenya. In the case of Ethiopia, scarce credit is being effectively directed into priority sectors but this has only been achieved through a state-led credit policy which is unlikely to be feasible in terms of replicating the larger, more complex and liberalised private financial markets of other countries.

Alternative policy approaches are already being enacted.

For example, policy can seek to attract private investors directly. Over the past decade, sub-Saharan African countries such as Ethiopia, Ghana, Tanzania and Uganda have created or reformed institutions intended to attract FDI. However, results have been mixed. This has been explained as being due to failures to lead and coordinate programs well (Ansu et al., 2016).

Policy also includes ‘ring-fenced’ funds that are provided by state development banks or other DFIs as wholesale lending to commercial banks for lending to specified priority sectors. This includes SMEs and microfinance.

Similarly, risk sharing or risk mitigation instruments for priority sectors (such as infrastructure) have been established by IFIs, although, as they are relatively new, their success is not yet able to be assessed.

However, as discussed in Section 5, there is a weak empirical base to link finance to various sectors to

different transformation effects. So these policies may not be targeting the right sectors. In particular, it is unclear if targeting SMEs or households versus large-scale enterprises is the most effective approach.

Similarly, private sector financing is also provided by DFIs such as the IFC and the UK’s CDC Group and majority-owned PIDG. However, such financing by DFIs is limited to individual firm-level investments. Again it is not clear if a sector or value-chain approach would be preferable.

Because of these limitations, the evidence for the impact of these policies on broader macroeconomic development remains weak.⁴⁹

Overall, there is an opportunity for more innovation in policy approaches in financing for structural economic transformation including anti-cyclical financing and sector-based or value-chain approaches respectively (Tyson, 2015c).

Conclusion

In conclusion, current policy approaches are useful to counteract the slowdown in financial sector development in sub-Saharan Africa in 2015 and 2016.

They including a continued emphasis on ‘getting the basics right’, and financing by the IMF and World Bank or by private sector DFIs respectively.

They also include the robust action by many central banks to respond to deteriorating financial soundness in their financial systems and to tackle governance issues.

However, more is needed. There is a need for all countries to establish appropriate formal frameworks for micro and macro prudential regulation and for them to be consistently enforced. There is a need for advanced economies to partner with them on this in relation to tailoring regulatory standards and tackling illicit outflows from their economies relating to corruption and fraud.

However, most importantly for the long-term outlook is the need for greater financing, including counter-cyclical financing, for priority sectors for structural economic transformation.

The policy options in relation to this are varied but as well as the current risk sharing and risk mitigation instruments, they could support active national credit policy – including state-led credit policy – and greater focus from DFIs on developing a stronger empirical base to better target their approaches to developing sectors of importance.

49 Evidence for employment creation is positive (Tyson, 2015c).

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