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Making Finance Work for Africa

● Patrick Honohan and Thorsten Beck

African finance operates in an extreme environment in terms of scale, informality, governance, and shocks

Entrepreneurs in Africa mention access to and cost of finance as barriers to their firms' growth more often than do those in any other part of the world. If only for that reason, improving the situation of the financial sector should be a priority for African policymakers.

Indeed, as a new study by Honohan and Beck finds, conventional measures of financial depth and efficiency show African countries falling considerably behind those in other regions. For example, the mean net interest margin in African banks, at 800 basis points, is about 320 basis points higher than the world average. Interestingly, the authors find that the gap is even larger if they compare a matched sample of affiliates of the same foreign-owned banks in Africa and elsewhere.

To explain the wider margins in Africa, the authors take a close look at bank-level correlates of the margins, such as operating costs, profitability, and loan loss provisions. They find that all these elements contribute to the wider margins. The higher profitability may be associated with high perceived risks. But it is also likely to be explained in part by less competition, as documented by the much higher concentration in the typical African banking system. A deeper interpretation traces the wider margins to scale and to deficiencies in the information and legal infrastructure.

The authors show that their analysis leaves only 60 of the 320 basis points of difference unexplained.

The authors' analysis shows that financial depth is lower in Africa than elsewhere not only in raw terms but also when controlling for other factors, such as inflation, per capita income, and other plausible explanatory variables. (For some African countries, such as Mauritius and the Seychelles, which score well on depth measures, conditional underperformance is only marginally significant.) One associated factor here is the higher recorded African deposits in international banks abroad.

Credit-based depth is further below international comparators than are deposit-based measures of depth. Consistent with this, the authors find that liquidity in African banking systems is high and growing. Interestingly, the shallowest banking systems in the region are the *most* liquid.

The authors suggest that this pattern is consistent with a correlation between the degree of confidence of depositors in the banks (or in macroeconomic stability) and that of the banks in their borrowers. They discuss policy measures that can aid economic agents in building confidence, including improvements in credit information and in the legal infrastructure for assuring contract enforcement.

Trends in recent financial sector data for Africa reveal a distinct turnaround since the mid-1990s. Private credit and other depth indicators have been increasing steadily as a

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share of GDP—and the increase is broad. Indeed, four of every five countries for which data are available have had an increase in financial depth since 2000.

Similarly, organized securities markets have shown a sharp increase in capitalization and listings in the past few years. In the Lagos stock exchange alone about \$3 billion in new capital was raised in 2006 to meet the new banking capital requirements. And listed bonds have increased in number and maturity.

The region's stock exchanges are still very small (except for Johannesburg's). But a comparison of their performance with that of other developing country exchanges using the World Bank's financial sector development indicators (<http://www.fsdi.org>) shows that African markets are close to the average in size (relative to the economy), access, and stability. Only in efficiency are African markets well behind the rest—a deficiency that again can be associated with gaps in the information infrastructure.

The shortcomings of African finance can be attributed largely to the

fact that it operates in an environment that is extreme in four key dimensions: scale, informality, governance, and shocks. The authors examine alternative policy solutions that have been suggested to deal with these and distinguish between two approaches: *modernist* and *activist*.

Each approach has its advocates and its strengths, though each also can overreach. Modernist solutions sometimes overreach by unthinkingly attempting to transplant models from advanced economies into unprepared environments (an example is the advanced version of the Basel 2 capital accord for banks). Activism is surely necessary to help ensure direct access for all to the needed financial services, but weak governance is its Achilles' heel. The authors review how these tensions can be resolved in instances ranging from microfinance regulation to regional cooperation on currency unions.

Patrick Honohan and Thorsten Beck. 2007. Making Finance Work for Africa. Washington, D.C.: World Bank.

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