THE IMPACT OF THE FINANCIAL CRISIS ON AFRICAN FINANCIAL SYSTEMS[1]

Introduction

With the financial sectors still bleeding in developed countries, policymakers in Africa are rightly debating the impact of the crisis on their financial sectors and countries. Conventional wisdom thus far has suggested that they have little to worry about. It is argued that the transmission mechanisms between the financial systems in Africa and the rest of the world are weak and will minimize the impact on the crisis. African financial institutions are not exposed to risks emanating from complex instruments in international financial markets because most banks in Sub-Saharan Africa rely on deposits to fund their loan portfolios (which they keep on their books to maturity); the interbank market is small; the market for securitized or derivative instruments is either small or nonexistent, and few rely on foreign borrowing to fund their lending operations. Exceptions to this position are then made for countries like Nigeria and South Africa which are seen as having meaningful transmission mechanisms with the larger financial systems in crisis.

This conventional position is now being challenged. As the immediate crisis faced in the last couple of months subsides, and policymakers begin to consider the longer term impact of the crisis in Africa, an emerging view is that the impact on the financial sector in Africa may actually be more significant and longer lasting than first assumed, and the impact on the non-financial sector in Africa will be more notably than has been the case in developed countries. More recently, however, this conventional position is being questioned. Four concerns include the following:

1. Weakened local investor confidence in equities and bonds on African Stock Exchanges

Up until the recent crisis, African stock markets were displaying resurgence and an energy that had not been seen for years. Prior to 1989, there were just five stock markets in sub-Saharan Africa and three in North Africa. Today there are 19 stock exchanges ranging from starts ups like Uganda and Mozambique stock exchanges to the Nigeria and Johannesburg stock exchanges.2 With the exception of South Africa, most African stock markets doubled their market capitalization between 1992 and 2002. Total market capitalization for African markets increased from US$113,423 million to US$ 244,672 million between 1992 and 2002 (Yartey & Adjesi, 2007:6). Ghana had five new equity listings in 2004; the Kenya Electricity Generating company IPO if 2006 – the country's first in five years attracted strong demand and enormous public interest. Since then, the 2008 cellphone company IPO's of Safaricom and Celtel in Kenya and Zambia respectively have both been oversubscribed. This emerging confidence in the African stock markets is going to be negatively affected. Expectations that investors weary of the markets in developed countries will seek opportunities in African and other developed economies are misplaced. The small size and illiquidity of Africa's stock markets (partly a reflection of the low levels of economic activity) is likely going to be amplified rather than overlooked as both international and local investors adopt more cautious investment strategies. Thus, while the price-earnings ratios for many African stock markets were above their sectoral equivalents in mature markets in 2007, the ongoing fallout from the subprime mortgage crisis in the US will act as a reminder that what goes up eventually comes down and dampen investment plans. Already, examples are emerging. The market turnover on Uganda's bourse dropped 60 percent during the third quarter (Busuulwa, 2008).

[1] Policy Discussion Paper drafted by Samuel Munzele Maimbo for the AFPD (East & Southern Africa) field staff retreat held on October 24-25, 2008.

2. Return to ultraconservative lending practices

Banks in Africa have not been known for their innovative and liberal banking practices. Most have been extremely conservative and traditionally invested in government securities and fixed assets. In recent times, this had started to change. Real private sector credit, in particular, has been growing at an accelerating rate, and its median value has doubled in the past decade. Even as a share of GDP, it has turned the corner, with the median share approaching 18 percent in 2007, a bout a third higher than at its anemic trough in 1996. Much of this increase was on the back of innovative non-collateralized lending practices. Salary and other cash flow based lending have been on the emergence with positive outcomes for customers in the form of consumer loans. In October 2008, Pan-African micro-lender Blue Financial services its loan book grew 236 percent and posted earnings growth of 167 percent in the six months to August 2008. Unfortunately, it is not unimaginable that in the near term banks will have seen the results of the sub-prime market and decided to ease their hitherto aggressive loan book expansion. The possibility of overreaching their adoption of conservative credit appraisals processes and procedures does not bode well for the growth of private sector lending on the continent.

3. Losses arising from central bank reserve management practices

In recent times, the reserves of small African central banks are growing because of debt relief, foreign aid, and other external inflows. And while these reserves may be small in absolute terms, the foreign currency reserves may be huge relative to the economy. How they are managed in these times is of crucial importance. It has not been uncommon, for some central banks to place as much as 50% of their total reserves with external fund managers on account of their own lack of skills in reserve management. At this point it is hard if not impossible to determine with certainty the impact of the financial crisis on the reserves of the central banks. However, at least one central bank has indicated that it has suffered not negligible financial losses on account of investing in hitherto top rated financial institutions in developed economies. If this type of loss is more widespread, it is likely to occur in central banks with no overall policy for managing the Central Bank's reserves in place; limited capacity to oversee their relationship with their fund managers nor to monitor the market risks or capable information technology system for managing and monitoring the reserves portfolio.

4. Renewed debate on the role of governments in the financial system

The government bailout of financial institutions in developed countries will be abused by those keen to entrench government involvement in the financial sector – even when such entrenchment is detrimental to the financial system. While the many government led programs in the financial sector have been well intentioned, the unintended consequences have often been severe on the level of interest of the private sector in investing in the financial sector as well as the credit culture of beneficiaries. Global experience suggests that despite the seeming advantages of government intervention in broadening access to credit, especially through government-owed banks, public banking services in developing countries have generally not been successful. There is a close association between such participation and lower levels of financial development, less credit to the private sector, wider intermediation spreads, greater credit concentration, slower economic growth and recurrent fiscal drains. Despite these arguments, the recent massive government purchase of shares in financial institutions will not be seen as a short term remedial measure, but rather a long term repudiation of government exclusion from the sector – the unintended consequences of this position experiences in the 1970's and 1980s may yet again revisit the continent if this view finds traction with policy makers for existing and planned government owned financial institutions (Scott, 2007).

5. Weakened balance sheets resulting from a downturn in the real economy

Declining demand for commodities will impact African countries significantly. In Zambia for example, the economy is likely to take a hit from a share decline in copper prices (-24%ytd). As the financial crisis surges into all parts of the real economy in developed economies, African countries will experience a substantial decline in exports as the rapid pace of trade expansion in this decade decelerates sharply. The IMF now projects that growth in world trade volumes in 2009 will be 4.1 percent compared to 9.3 percent in 2006. A notable part of this fall will be African. In this environment, large projects in African that require external financing to complement shorter term bank financing will face difficulties in sources these finances, and where they do, will face higher interest rates, because of flight to safety and greater risk aversion of lenders. As investments falls, some projects will not be completed making them unproductive and saddling bank's balance sheets with non-performing loans. Lower commodity prices, combined with a credit crunch and increased risk aversion will make it more difficult to finance and develop capital investments. In countries where the fall in investments is simultaneous coupled with drops in export earnings, a slowdown in GDP growth, and a sharp drop in domestic assets e.g. a local housing market correction[2], weakened bank balance sheets could result, including in some cases, bank failures.

Conclusion

The present financial crisis will affect financial systems in African countries differently depending on the present quality of the financial sector. To each there is a litany of technical options for them to consider. These include: Management takeovers[3]; blanket guarantees on all deposits[4] reduce reserve requirements[5]; offering to buy bad loans from commercial banks[6] and revise deposit insurance guidelines[7] to name but a few that were exercised by various governments during the month of October 2008 alone.

At the policy level, however, three issues are prominent which policy makes need to consider:

Financial Literacy

The first is the need to advance the financial literacy cause more than ever. Financial literacy needs to be significantly scaled up in African countries aiming to weather this, and future crisis: First, it allows people to increase and better manage their earnings – this crisis was triggered by

[2] In most African countries mortgage markets are thin with people largely building from savings. However, construction of commercial properties is largely finances with loans from local and regional banks. With an economic slowdown, demand for office space may stagnate and real estate investments may suffer losses which affect bank portfolios.

[3] Oct. 21: Argentina's government announced it might take over the management of $28.7 billion in private pension funds that sharply declined in value this year

[4] Oct. 13: Blanket guarantee on all bank deposits in Australia. New Zealand took similar measures. Australia also guarantees wholesale bank funding

[5] Oct. 21: Central Bank of Brazil continues acting to tackle the liquidity in the local money market. It announced a program to reduce reserve requirement able to free up to BRL100b to the market

[6] Oct. 5: In Chile viable banks were offered the possibility of selling bad loans to the Central Bank, with a repurchase agreement based on future profits

[7] Oct. 7: Leaders of France, Germany, Britain, Italy, the European Central Bank and the European Commission agree on bank bail-out guidelines and deposit insurance of E50,000 but stopping short of a Europe-wide solution to recapitalize banks

the consequence of unsound consumer borrowing in the housing market in the US. Financial literacy programs in African will help people better manage life events like housing education, illness, job loss or retirement in the face of ever innovative financial products and services. Second, higher financial literacy significantly contributes to economic inclusion. It accounts for more low-income households using insurance and deposit services, for instance, or keeping their savings in banks rather than under the mattress. It helps people understanding how deposit insurance with or without explicit government guarantees protect their savings – in turn minimizing the risk of bank runs when they hear of financial crisis. Third, it helps poor people opt into the formal financial systems as they overcome misconceptions about the extent of the credit crisis and the price of credit. Many who are financially illiterate are unaware of how best to use credit facilities and become over-indebted, including to micro-credit facilities where markets have become more competitive in recent years.

Commercial banking capital regulations (Basel II)

The recent crisis will reenergize the debate on the ddefinition and measurement of capital. What level of capital is adequate for banks to remain safe and sound? What criteria should be used to assess that the adequacy of capital? The 1988 BCBS Capital Accord set a minimum standard definition of capital which has largely been well adopted across the continent after decades of banking supervision reforms. Today, most countries have been assessing assess the impact of the implementation of Basel II on the financial sector; drafting transition strategies for implementation of Basel II, taking into account country specific financial circumstances; drafting procedure manuals for the transition process; design and implement a training programs for the process, and drafting the relevant circulars/regulations outlining the procedures for the calculation of relevant prudential regulations within the Basel II framework. It has also been widely accepted that implementation of Basel II would be gradual. Post crisis, African countries will join the rest of the world in debating the role Basel I may have played in causing the crisis and about whether Basel II, had it been implemented earlier, could have lessened the turmoil. Many will now question the key features of Basel II notably the use of credit rating agencies and internal bank models to determine capital. During the crisis, the credibility of ratings has been damaged by frequent and large downgrades and internal models employed by even the largest and most-sophisticated banks failed to track risk accurately. African countries will need to significantly re-work their strategies for adopting Basel II. Some question whether this effort should even be made. Rather, they argue that there needs to be an acknowledgement that risk-management standards have changed so much that it is necessary to move directly to a new agreement: Basel III (Caprio et al, 2008

Government ownership

Secondly, the government needs to make it explicitly clear that they will only intervene in the financial sector in methods that result in government ownership in a crisis only when: (i) it is necessary to strengthen the capital base of banks to remove fears of insolvency; (ii) the managers have proved unable to raise equity capital from private sources; (iii) the bank is essential for the payments and credit systems, and (iv) the bank can reasonably be expected to be made viable in the long term. But more importantly, government need to ensure that there is agreement on the time-framework for the management and exist from that investment. The amount, structure, other terms and conditions of the government intervention, and subsequent handling of the investment, including the exit strategy, should be in accordance with *commercial principles*. The use of commercial principles will help to minimize market distortions and long-run taxpayer's costs. A dialogue on these issues is best held before, rather than in the heat of a crisis.

In order to be in a position to address both the technical and policy issues listed above, it is essential that domestic financial regulators enhance their analytical capacity to monitor and respond to national and global financial crises. The must be in a position to analyse and advise governments on the: sources of vulnerability in their economy to the international financial crisis; options for policy makers for attracting market-based long-term financing without inordinately exposing the country to unfavorable terms and conditions; methods for strengthening cross border supervision to minimize the risk of banking sector contagion – especially in countries with widespread foreign ownership; Impact of the deceleration in the real economy on the financial sector; impact on the national economic program, and the; significance of the slowdown in private capital flows (FDI and portfolio) to the country.

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