
Analyzing Financial and Private Sector Linkages in Africa

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Abstract

This paper contributes to improving financial sector analysis in Africa by developing a framework for analyzing financial and private sector linkages in the Region. Analyzing such linkages has become more important given the central role assigned to the private sector in most Poverty Reduction Strategy Papers (PRSPs) in Africa and the need to foster financial sectors supportive of private sector activities and real sector development.

In developing this analytical framework, the paper uses a case study of a fictional African country named **Sahara Republic** to provide a *practical illustration* of the most important aspects of the relationships between the financial and private sectors. This analysis is done primarily from the perspective of the financial sector, with the ultimate aim of identifying relevant interventions to increase the contribution of the financial sector to private sector development and economic

growth. It is however recognized explicitly that some private sector interventions will also be necessary in order to make the private sector more attractive to financial intermediaries and markets.

It is expected that this proposed analytical framework will serve as a useful **diagnostic tool** for World Bank-IMF staff and consultants involved in the evaluation of financial and private sector linkages in Africa, either as part of the Bank-Fund Financial Sector Assessment Program (FSAP) or as Task Team Leaders involved in designing and implementing financial sector development projects in the Region. Private sector specialists working on private sector development assignments in Africa could also find this useful. Most importantly, we expect this exercise to stimulate other efforts to develop appropriate frameworks and tools to support sound financial sector analysis in Africa.

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1. INTRODUCTION

Following the 1997 East Asian financial crisis, there was a surge of interest in the systematic assessment of financial systems in developing countries, with a view to identifying vulnerabilities and evaluating financial sector contribution to growth, development and poverty alleviation.

This sharpened focus on financial sector analysis is most exemplified by the World Bank-IMF Financial Sector Assessment Program (FSAP), introduced in May 1999. FSAPs aim at conducting in-depth assessments of countries' financial systems, including the sensitivity of the financial system to macroeconomic shocks, the stability and efficiency of financial institutions and markets, adequacy of legal and financial infrastructure, as well as compliance with specific international standards and codes². Outside the FSAP framework, authorities in various developing countries are also taking steps to improve financial sector analysis in a bid to reinforce financial systems and identify ways to maximize their contribution to economic development.

The findings of a recent review of World Bank assistance in the financial sector clearly underscore the importance of financial sector analysis³. It was revealed that World Bank financial sector projects which were preceded by Economic and Sector Work (ESW) had a higher probability of success than projects implemented without previous analytical work.

This paper contributes to the enhanced focus on financial sector analysis by developing a framework for analyzing the linkages between the financial sector and the private sector in African countries. Analyzing these linkages is important in several respects. First, the financial sector is crucial to the implementation of private sector-led growth strategies in Africa. In the process of developing comprehensive Poverty Reduction Strategy Papers (PRSPs), most countries in Africa have come to realize that faster economic growth is a necessary condition for poverty alleviation and that the private sector is the most reliable locomotive for faster growth.

There is thus a renewed emphasis on private sector-led growth strategies, with a concentration on removing the key bottlenecks to private sector operations and further reducing the direct participation of government in business activity. However, a private sector-led growth strategy has little chance of success unless effective and sustainable support is forthcoming from the financial sector. The degree to which the private sector contributes to growth and poverty alleviation will depend *inter alia* on the extent to which the sector can gain access to critical financial services, such as credit, payments and risk management services. Assessing the strength and reliability of financial and

² Some of the codes typically (but not always) assessed in an FSAP include: i) the Basel Core Principles for Effective Banking Supervision; ii) CPSS Core Principles for Systemically Important Payments Systems; iii) the IMF Code of Good Practices on Transparency in Monetary and Financial Policies; iv) the IOSCO Objectives and Principles for Securities Regulations; v) IAIS Core Principles for Insurance Supervision; and vi) Anti-Money Laundering and Combating Financing of Terrorism.

³ *Financial Sector Reform: A Review of World Bank Assistance (2 vols.)*, World Bank OED, March, 1998

private sector linkages is therefore an important step in the preparation of effective poverty-reduction strategies anchored on faster, private sector-led economic growth.

Second, the health and performance of the private sector is a key determinant of the health and performance of financial institutions and markets. Thus, evaluating the robustness of the financial sector and identifying vulnerabilities will require an assessment of the health and performance of the principal segments of the private sector serviced by financial institutions and markets.

This paper adopts a case study approach to provide a *practical illustration* of a framework for analyzing financial and private sector linkages in Africa. It presents an analysis of such linkages in a fictional African country called **Sahara Republic** (henceforth Sahara)⁴. Where applicable, the analysis also makes use of a fictional time frame, with the time period under consideration specified as **01 AD to 10 AD**.⁵ The local currency used in Sahara is the *donge*.

It is expected that this proposed framework will be useful as a **diagnostic tool** for Bank-Fund staff and private consultants (individuals or firms) involved in the evaluation of financial and private sector linkages in Africa, either as part of the Bank-Fund FSAPs, or as Task Team Leaders involved in designing and implementing financial sector development projects in the Region. Private sector specialists working on private sector development assignments in Africa could also find this useful. Most importantly, we expect this exercise to stimulate other efforts to develop appropriate frameworks and tools to support sound financial sector analysis in Africa.

The rest of the paper is organized as follows: Section 2 presents an overview of the financial and private sectors in Sahara Republic while Section 3 provides a description of the macroeconomic and policy context within which both sectors operate. Section 4 is an evaluation of the contribution of the financial sector to private sector development, evaluating the access of the private sector to saving, credit, payment and risk management services. Section 5 assesses the linkages between the performance of the private sector and financial stability while Section 6 offers a list of recommendations for improving the linkages between the financial and private sectors in Sahara. Annex 1 provides a *checklist of issues* to be covered in analyzing financial and private sector linkages in Africa while Annex 2 proposes a tentative action plan for strengthening such linkages.

2. SAHARA FINANCIAL AND PRIVATE SECTORS: BACKGROUND INFORMATION

Overview of the Financial System

The Sahara financial system consists of a fairly diverse collection of banking and non-bank financial intermediaries, including 21 commercial banks, 2 development finance institutions (DFIs), 2 leasing companies, 4 micro-finance institutions, 7 primary

⁴ Sahara is an imaginary country and is constructed to reflect generic characteristics observed in many African economies in general and financial systems in particular. Any direct resemblance to an actual African country is purely coincidental.

⁵ We assume that the present year is 11 AD.

mortgage institutions (PMIs), 10 insurance companies, 3 discount houses, a Social Insurance Fund, and 25 *bureaux de change*. There is also a fairly active money market and a young stock exchange.

The financial system is relatively underdeveloped with financial assets representing about 22% of GDP as at end-10 AD. Over the past four years, financial assets have grown at an average rate of 3% per annum (in real terms), largely due to the impact of financial liberalization and the entry of new financial intermediaries. The *banking sector* dominates the financial system accounting for 90% of total *non-central bank* financial sector assets (Table 1). The banking sector is highly concentrated, with the three largest banks accounting for over 60% of banking assets, 70% of total deposits and 80% of branches. There is limited competition from non-bank financial intermediaries (NBFIs) as most NBFIs are small and many are actually owned by commercial banks. Although the sector used to be largely government-owned and controlled, it is now predominantly private and the three remaining state-owned banks currently account for a mere 2% of banking sector assets. There are 3 foreign banks presently operating in Sahara.

The *insurance industry* is underdeveloped with gross premiums collected in 10 AD amounting to less than 1% of GDP. The industry is dominated by non-life companies (property-liability insurers), with life insurance relatively unimportant. The insurance sector also exhibits a high degree of concentration with the largest insurance company, the state-owned **Asante Insurance Corporation** accounting for over 90% of gross premiums written in 10 AD⁶. The other 9 private firms are relatively inactive.

The *Sahara Bank for Industrial Development (SBID)* and the *Sahara Agricultural Development Bank (SADB)* are government-owned development finance institutions. The SBID was established to provide credit and other financial services to medium and large scale enterprises while the SADB focuses on credit to farmers, especially those involved in the cultivation of tobacco, the main cash and export crop. Both DFIs lend at subsidized interest rates and are currently in poor shape with high levels of non-performing loans. The authorities are considering plans for the restructuring and possible privatization of these institutions.

⁶ Asante Insurance has a monopoly over the insurance of all government property.

**Table 1: Structure of the Sahara Financial System (assets)
(end-10 AD)**

Type of Institution	No. of institutions	Market share (%)*
Commercial banks	21	90
Insurance companies	10	1.1
DFIs	2	1.8
Mortgage firms	7	1.6
Leasing companies and MFIs	6	0.1
Discount Houses	3	1.4
Pension fund	1	4.0
Total	50	100.0

Source: Sahara Central Bank

* Percentage of total financial assets

The *mortgage finance industry* is composed of the dominant and state-owned Sahara Federal Mortgage Corporation (SFMC) plus 6 other PMIs while the *pension system* consists of the monopoly and state-owned Sahara Social Insurance Fund (SSIF), which covers both private sector employees and government workers. The SSIF does not provide coverage to the self-employed.

The leasing industry consists of 2 private, stand-alone leasing outfits with the bigger firm, **Riwaya Leasing**, accounting for over 90% of the market. Commercial banks are not involved in the leasing business. Leasing is underdeveloped and currently accounts for less than 1% of total domestic capital stock.

Micro-finance is in its infancy in Sahara. There are four micro-finance institutions (MFIs), established by non-governmental organizations (NGOs) to facilitate the access of low-income Saharans to credit and other financial services. These MFIs are small and they currently have limited outreach and suspect sustainability. MFIs currently report a combined membership of 3,000 and the largest, **Chapati Foundation**, accounts for over 95% of total loans by value and number.

Three *discount houses* are currently operating in the financial system, involved in buying and selling government securities, especially treasury bills. They also offer short-term saving facilities to households and firms, mainly in the form of 3-month certificates of deposit. *Bureaux de change* are authorized dealers in the spot market for foreign exchange and facilitate the access of small users to foreign exchange. They emerged following the deregulation of the Sahara foreign exchange market in 05 AD.

The Sahara *money market* is comprised of the inter-bank funds market as well as the market for treasury bills, certificates of deposit, and commercial papers. The market has become fairly active recently following the liberalization of the financial system and the increase in the number of financial institutions. The *Sahara Stock Exchange* (SSE) was established in 05 AD, primarily as a vehicle to implement the government's privatization program. The market is still relatively young and as at end-10 AD, there were only 5 equities and 3 bonds listed, with market capitalization standing at 4% of GDP.

Regulatory and supervisory oversight for the financial system is provided by a number of agencies including the Sahara Central Bank (SCB), the Ministry of Finance (MoF), the Sahara Deposit Insurance Corporation (SDIC), the Securities Markets Authority (SMA), and the Sahara Insurance Commission (SIC). These regulatory agencies share information and coordinate their activities through the Financial Sector Oversight Council (FSOC), a regulatory coordinating body chaired by the Minister of Finance.

In addition to the formal financial intermediaries and markets enumerated above, Sahara has a wide variety of *informal financial institutions and financial arrangements*, including local moneylenders, rotating savings and credit associations (ROSCAs), as well as savings and credit cooperatives (SACCOs). These informal financial institutions provide financial services to segments of the population not reached by the formal financial system and are found in both the urban and rural areas although they are more prominent in rural Sahara.

Overview of the Private Sector

The Sahara private sector can be divided into 3 broad categories:

- **The formal private sector** consists of large, incorporated enterprises, which tend to be either state- or foreign-owned (multinationals) and are dominant in food processing, pharmaceuticals and other heavy industry. Virtually all these firms are found in the capital, **Hakuna**.
- **The informal, urban private sector** covers numerous unregistered micro, small and medium-scale enterprises, mostly owned by indigenous Saharans. These enterprises tend to be individually or family-owned and are particularly prominent in metal and wood works, paper and printing, as well as in construction, transport and trading (wholesale and retail). They are geographically concentrated in the capital **Hakuna**, as well as in the second-largest city, **Matata**.
- **The informal, rural sector**, consisting almost entirely of small-holder agriculture, engaged in the production of food crops as well as in tobacco and cotton production.

Overall, the private sector dominates economic activity in Sahara, accounting for over 85% of GDP and roughly 90% of the employed labor force as at end-09 AD. The sector also accounts for 57% of domestic fixed investment and over 90% of total exports. Over 90% of private sector output and employment comes from the informal sector (both rural and urban), particularly from agriculture, trade, construction and road transport. It is estimated that over 40% of the inhabitants of the capital, **Hakuna** are employed in the informal urban sector⁷.

Primary sector activities (agriculture, livestock, fishing and forestry) dominate domestic production in Sahara. Available data indicate that agriculture is the largest segment of the primary sector and the centerpiece of overall economic activity,

⁷ The large size of the informal sector is probably a reflection of the pervasive presence of the state in economic activity and attempts by the private sector to circumvent restrictive government regulations.

representing roughly 60% of overall GDP, 80% of total employment and 97% of total exports⁸. Agriculture (including tobacco production) is dominated by private, small-holder farmers and the public sector has historically been relatively inactive in agriculture, except for a few tobacco estates owned and operated by the state-owned cigarette manufacturer.

The secondary sector (including industry, mining, energy, etc) has been historically small and at end-10 AD represented only 20% of GDP, 8% of employment and 3% of exports. The industrial sub-sector is dominated by state-owned import-substituting firms, especially in food processing, beer and beverages, tobacco, pharmaceuticals, textiles and leather. Food, tobacco, and textiles are the most active segments of this sector, jointly accounting for over 70% of secondary output in 10 AD. Two state-owned industrial conglomerates, **Amara Holdings and Jambo Enterprises**, account for a sizable proportion of industrial output and are involved in the production of a wide variety of consumer products, ranging from toilet soap to television sets.

At independence, the manufacturing sector was dominated by foreign companies, mostly subsidiaries of European multinationals. This situation was however sharply reversed in 01 AD when the Sahara Enterprises Promotion Act (SEPA) was passed by Parliament. Under the SEPA, certain activities, including tobacco production, financial services and manufacturing of consumer goods were reserved solely for ownership by Saharans and many foreign firms were nationalized by the government. Despite recent privatizations by the Sahara government, the largest manufacturing firms are still state-owned as the privatized firms have tended to be the smaller and less economically important ones. Total private sector participation in industry has however increased sharply in recent years with the emergence of numerous medium-scale outfits in metal works, as well as in paper and printing.

The tertiary sector (trade, construction, transport, telecommunications, banking and other services) represents 20% of GDP and 12% of employment. This sector grew rapidly over the past five years, following the liberalization of the banking, insurance and telecommunication industries. The tertiary sector has proven to be the most vibrant area of private sector activity in Sahara, especially in wholesale and retail trade, transport and financial services. Public sector contribution to tertiary activities is mainly concentrated in utilities, public administration and public services.

Exports in Sahara are dominated by traditional primary commodities, especially tobacco. There are also sizeable exports of cotton. Non-traditional exports (such as arts and crafts) are however beginning to increase, due mainly to recent efforts by the authorities to diversify the economy.

⁸ Tobacco accounts for over 90% of total agricultural exports.

3. MACROECONOMIC AND POLICY ENVIRONMENT

Macroeconomic Performance

Macroeconomic performance in Sahara has been mixed over the past five years (see Table 2).

Table 2: Sahara Republic: Selected Macroeconomic Indicators

	06 AD	07 AD	08 AD	09 AD	10 AD
Real GDP growth (%)	3.3	4	4.7	4.9	5.6
Inflation rate (CPI; end of period)	11.2	13.6	18.3	22	30
Overall fiscal balance (% of GDP)	6.5	5.8	7	7.7	7
Gross Domestic Savings (% of GDP)	10.5	9.8	10.8	7.9	n.a.
Gross Domestic Investment (% of GDP)	18.5	17.4	16.2	15.6	n.a.
Resource balance (% of GDP)	-8	-7.6	-5.4	-7.7	n.a.
Nominal Treasury bill rates (%)	22.87	22.83	28.4	30.2	45.5
Lending rates	30.25	29.49	32.4	38.7	55.4
Deposit rates	16.72	18.4	23.4	25.2	30.1
Spread	13.53	11.09	9	13.5	25.3
Domestic debt (% of GDP)	29.2	30.2	24.5	22.4	25.8
Exports (f.o.b.; % change in value)	-1.1	-2.3	-12.8	1.1	-0.7
Imports (f.o.b.; % change in value)	13.3	2.9	-11.5	10.7	-3.9
Current account balance (% of GDP)	-4.4	-4.9	-5.5	-6.2	-8.5
International Reserves (months of imports)	4	2.8	2.6	1.7	1.3
Average Market Exchange Rate (Donges/\$)	58.8	60.4	120.1	120	120.2

Source: Sahara Central Bank

Real GDP growth has been satisfactory, averaging 4% over 07-10 AD, due largely to the end of two consecutive years of drought in 06 AD and a subsequent jump in the production and export of both tobacco and cotton. In comparison to GDP growth, Sahara population has been growing at 3.5% per annum and per capita income remains low, currently standing at US\$270.

As measured by the Consumer Price Index (CPI)⁹, *inflation* in Sahara is high and currently stands at 30% per annum. The high inflation could be traced to high *fiscal deficits*, which peaked at 7.7% of GDP in 09 AD, most of it financed by the banking system. As at December 10 AD, domestic government debt stood at 25.8% of GDP, with the central bank and commercial banks holding a combined 95% of the total. The private sector has therefore suffered substantial crowding-out as the government has become the largest user of domestic savings. Bank credit to the private sector stands at only 4% of GDP and has grown only 2% in real terms over the past three years.

The financial markets are characterized by an inverted yield curve with *nominal 3-month treasury bill rates* standing at 45.5% (15% in real terms) as of December last year¹⁰. Not surprisingly, this has diverted a significant amount of domestic financial savings into treasury bills at the expense of the private sector. Indeed, loan-deposit ratios of the banking system dropped from 43% three years ago to 32% as of December 10 AD.

Interest rate spreads are also large, standing at 25.3% as at end-10 AD, discouraging both domestic savings and private investment. These large spreads are

⁹ 01 AD=100

¹⁰ In comparison, 2-year treasury bonds carried yields of 12% in nominal terms.

mainly traceable to: i) high reserve requirements imposed on banks by the SCB; ii) high overhead expenses in banking; and iii) high levels of non-performing loans. At the end of 09 AD, domestic savings amounted to only 8% of GDP, grossly insufficient to meet domestic investment needs, estimated at 15.6% of GDP.

The external accounts picture is worrying. The *current account* is in deficit amounting to over 8% of GDP and *international reserves* are at all-time low levels, averaging 2.1 months of imports over 07-10 AD. These trends illustrate Sahara's vulnerability to adverse movements in international terms of trade due to the excessive dependence on tobacco exports (97% of total exports) and its substantial imports of oil. Due to the sharp fall in tobacco prices in late 08 AD, Sahara's foreign exchange losses due to lower tobacco prices are estimated at between US\$2-3 billion relative to 02 AD earnings, assuming the same volume of exports¹¹.

As at end-June 10 AD, Sahara's *external public debt* stood at \$10.4 billion in nominal terms, including \$5.2 billion in arrears. With a substantial proportion of Sahara's total debt on concessional terms, the present value of the total debt stock amounted to \$8.6 billion, representing 300% of exports of goods and services¹². The reduced ability to generate foreign exchange has adversely affected Sahara's ability to service its external debt, thus increasing the accumulation of arrears and worsening the debt overhang¹³.

Not surprisingly, the local currency, the *donge*, has fallen in value to around D120 to a dollar, compared to D58.8 to a dollar in 06 AD. This has substantially increased the cost of imported inputs for the manufacturing sector and sharply curtailed cash flow, adversely affecting the ability of companies to service bank loans. Due to the incomplete deregulation of the foreign exchange market, there exists a large gap between the official and the parallel market rates with the dollar trading at a 10% premium on the parallel market in 10 AD¹⁴. Sahara is heavily dependent on *official development finance* (ODF) which represented over 80% of net resource inflows in 10 AD. Private capital flows have been relatively low and consists principally of foreign direct investment (FDI) which increased sharply from 06 AD in response to the launch of the privatization program.

Financial Sector Policies

Before 05 AD, the Sahara financial system was repressed and characterized by interest rate controls, ceilings on credit expansion, selective credit policies, high reserve requirements and fixed exchange rates. There were also restrictions on entry into the banking industry as well as official constraints on the range of assets and liabilities banks could hold. In contrast, non-bank financial intermediaries were relatively free of government regulations.

The largest commercial banks were state-owned and mainly serviced state-owned enterprises who were the major depositors and borrowers from the banking system. Government-controlled banks held a 70% share of total banking assets. In addition, the

¹¹ As at December 10 AD, tobacco prices were 40% below their levels three years ago.

¹² Three-year average of exports, ending 10 AD.

¹³ Sahara is one of the Highly Indebted Poor Countries (HIPCs).

¹⁴ Frequent SCB interventions in the foreign exchange market has created a wedge between the official rate and the parallel market rate.

SBID and the SADB were established as specialized state-owned DFIs to direct credit to the so-called preferred sectors of the economy (industry and agriculture).

This atmosphere of “financial repression” led to serious distortions in the financial sector, discouraging financial savings, encouraging regulatory arbitrage by banks, and lowering the efficiency of investments. The commencement of financial liberalization in 05 AD following the adoption of a Stabilization and Structural Adjustment Program (SSAP), marked a clean break with the era of financial repression. Key reforms implemented include the liberalization of interest and exchange rates, promotion of market based allocation of credit, softening of entry conditions into the financial system, and the privatization of state-owned banks, excluding DFIs. Reserve requirements however remain high with required cash and liquidity ratios of 35% for banks, mainly to compensate for the high levels of government spending¹⁵. Since reserves are mainly maintained in the form of unremunerated reserves at the SCB, they constitute an implicit tax on the banking system and in 10 AD, it was estimated that the implicit tax on the banking system was equivalent to roughly 5% of government revenue.

While financial liberalization has increased the number of financial institutions, thus increasing competition in the system, it has also increased the fragility of financial intermediaries. The banking system expanded rapidly with 15 banks licensed over a five-year period, in addition to the establishment of 25 bureaux de change, 5 insurance companies, 4 primary mortgage institutions and 3 discount houses. A recent report from the SCB indicated that several banks, many of them recently licensed, are shaky, with low capital adequacy ratios, high volumes of insider lending and high incidences of fraud. Two banks were recently taken over by the Deposit Insurance Corporation and the SCB has subsequently suspended the licensing of new banks until a thorough assessment of the health of the banking industry could be conducted.

Private Sector Policies

Until 05 AD, the Sahara economy was highly centralized and inward looking, with a strong focus on import substitution and government ownership of the key areas of economic activity. There was a battery of domestic market and price controls (especially on agricultural output), restricted access to foreign exchange, high import tariffs and strict quota restrictions, rigid labor market laws, and a bias against exports as evidenced by the imposition of high taxes on exports. In general, the business environment was not conducive to private sector development due to excessive controls and the pervasive role of government in economic activity.

In 05 AD, following a sharp fall in international tobacco prices, the government began the implementation of a Stabilization and Structural Adjustment Program (SSAP), supported by an IMF Stand-by Arrangement and a World Bank Structural Adjustment Credit. The SSAP was a program of reforms covering the liberalization of financial, trade, export and exchange regimes, liberalization of domestic markets and prices, especially for agricultural commodities¹⁶, reform and privatization of state-owned

¹⁵ The SCB recently introduced market-based tools of monetary control but still relies heavily on direct controls to control liquidity.

¹⁶ A major change was the abolition of the commodity board system.

enterprises, as well as reforms in various business regulations. It also included provisions for labor market reforms, promising more flexibility in wage determination as well as in the hiring and firing of employees.

After a vigorous start, the implementation of the SSAP has slowed in the past two years as opposition grew among various interest groups. In 09 AD, the Sahara Parliament voted to discontinue implementation of the SSAP. By then, reforms implemented were limited to the areas of tariff reforms, liberalization of domestic commodity markets and prices, the creation of an export promotion agency, financial deregulation and the partial liberalization of the foreign exchange market. Outstanding measures awaiting implementation include the reform of the tax framework, labor market reform and the privatization of state-owned industrial enterprises.

4. THE FINANCIAL SECTOR: CONTRIBUTION TO PRIVATE SECTOR DEVELOPMENT

Real Sector Performance

As described earlier, economic performance in Sahara has been mixed over the past five years, with satisfactory GDP growth combining with high inflation, large fiscal deficits and growing pressures on the external accounts. In tandem, private sector performance has also been mixed and uneven.

Although the production of tobacco and cotton has recovered from the recent drought, production of staples such as maize, yams, cassava, millet, soybeans, and sorghum is still sluggish, posting a combined 15% decline in output. Poor post-harvest handling of staples has also been a major problem. Both the livestock and fishery sub-sectors experienced satisfactory growth of 5% each over 08-10 AD. Overall, the aggregate agricultural production index stood at 230.5 in 10 AD (02 AD=100), representing a 10% fall in agricultural output, relative to two years earlier.

The manufacturing sector (mainly food and textiles) has fared much worse, recording negative growth rates from 07 AD through 10 AD, with the biggest slump (-7.2%) recorded in 08 AD. The decline in production averaged 6.8% over the last three years. The substantial fall in the value of the *donge* following exchange rate liberalization in 05 AD increased the costs of imported raw materials and spare parts for industrial production. Profits and sales went down significantly and there has been a spate of shutdowns in the manufacturing sector leading to a sharp fall in the number of workers employed in this sector. By end-09 AD, capacity utilization in manufacturing had fallen to only 21% and manufacturing exports are down 15% relative to 10 AD exports.

Problems facing the manufacturing sector include: i) erratic power supply which has forced many manufacturers to resort to high-cost private generation of power; ii) the virtual collapse of physical infrastructure in Sahara; and iii) substantial reduction in the purchasing power of Saharans leading to unplanned accumulation of inventories by many firms. The continued dominance of this sector by public enterprises has also contributed to the poor output performance as these enterprises are bogged down by high costs, competitive inefficiency, and low productivity.

In sharp contrast, the tertiary sector has been vibrant, recording an average growth rate of 5% over the past three years. The main engines of growth in this sector were wholesale and retail trade as well as banking and other financial services. These activities have grown at an average rate of 4% in real terms over the past three years. Transport and telecommunications have also witnessed robust growth, averaging 3% in real terms.

Financial Sector Performance

Here, we explore the **relevance** of the financial sector to the Sahara economy in general and the private sector in particular. **Relevance** of the financial system is defined for our purposes as the performance of financial institutions and markets in four critical areas: i) savings mobilization and outreach; ii) resource allocation; iii) provision of payment services; and iv) provision of risk management services. In exploring the performance of the system, particular emphasis is placed on the degree to which households and firms have access to these financial services.

Savings mobilization and outreach. The Sahara financial system currently does a poor job of providing saving facilities and mobilizing financial resources from households and firms. The system is relatively shallow as indicated by an M2/GDP ratio of 11% but this number overstates the extent of financial savings given that currency constitutes a high 32% of broad money and non-financial forms of saving are substantial¹⁷. Although banks account for 90% of total financial sector assets (excluding central bank assets), bank deposits amount to less than 10% of GDP. Only five million Saharans have bank accounts in a total population of 86 million. This lack of depth becomes more glaring if we compare Sahara with four neighboring countries (**Makapo, Bunika, Bilisi and Banduru**) which are similar in size and stage of development (Table 3).

Table 3: Comparative Indicators of Financial Depth (end-10 AD)

	Sahara	Makapo	Bunika	Bilisi	Banduru
M2/GDP (%)	11.0	25.0	18.9	16.0	23.0
Private Credit/GDP (%)	4.0	15.0	12.0	9.0	15.4
Bank deposits/M2	68.0	86.9	82.0	84.5	85.6

Source: Respective Central Banks

Saving through non-banking forms of financial intermediation is also minimal as non-bank financial intermediaries are underdeveloped. The insurance industry is underdeveloped, even by developing country standards, the monopoly pension fund has limited coverage and collective investment schemes are absent. The capital market is young and market capitalization on the SSE represents 4% of GDP. The range of financial saving vehicles available in Sahara is therefore narrow and the level of financial sophistication is low as bank deposits represent the major forms of financial savings.

¹⁷ Land, jewellery, and cattle are major forms of non-financial savings in Sahara.

The financial system also has very poor outreach, with 430 bank branches in the entire country together providing approximately one branch per 200,000 people. In comparison, **Makapo** has one bank branch per 50,000 people and **Bilisi** has one branch per 70,000. Even though over 70% of Saharans live in the rural areas, 95% of commercial bank branches are urban-based with most branches located in **Hakuna** (215 branches) and the second-largest city, **Matata** (98 branches). Hence, rural deposits are small, constituting only 5% of total bank deposits. The four existing micro-finance institutions are all based in the capital, **Hakuna** and currently have no outlets in the rural areas. Rural dwellers therefore have limited access to saving facilities and find it difficult to smooth income and expenditure profiles. Rural saving is thus largely in cash form or through ROSCAs and SACCOs.

The shallowness, narrowness and limited outreach of the Sahara financial system could be traced to the long period of financial repression during which interest rates were administered, credit ceilings and directed credit were the norm, and entry into the financial system was rigidly controlled. Since the financial system was liberalized in 05 AD, it has been struggling to shake off the legacy of years of close control. Other factors discouraging Saharans from holding financial savings include: i) the limited dispersion of financial outlets; ii) limited menu of financial assets; iii) poor payment system and high transaction costs of holding and accessing bank deposits; iv) low income levels; v) the widespread perception of fragility in the banking sector; and vi) the lack of confidence in the domestic currency due to high inflation.

Resource allocation. Overall, the financial sector does not provide adequate resources to support private sector growth and development. The Sahara private sector has limited access to finance, with bank credit to the private sector standing at only 4% of GDP and loans representing a relatively low 32% of deposits as at end-10 AD. Private sector credit accounted for only 35% of total domestic bank credit, much lower than in neighboring countries (Table 3). It is estimated that personal savings, loans from friends and relatives, supplier credit and retained earnings constitute over 80% of financing for most firms in Sahara. Further, high levels of non-performing loans in the banking system (about 25% of gross loans and advances) suggests that most bank loans are not allocated efficiently.

High-yielding government securities (especially treasury bills) now account for a substantial portion of bank portfolios, with the share of government securities in total bank assets climbing from 10% in 06 AD to 40% by 10 AD. Bank assets outside Sahara have also been growing rapidly, representing over 22% of total assets as at end-10 AD.

Most bank loans and advances are made in the urban areas with rural dwellers (especially women) relegated to informal sources of finance, including family and friends, village moneylenders, ROSCAs and SACCOs. Farmers therefore have difficulties in obtaining credit to purchase inputs (seeds, pesticides, fertilizer), hire farm hands and bridge the long lag between planting, harvesting and selling their crops. As mentioned earlier, existing MFIs are yet to establish a presence in rural Sahara.

Formal banks are not inclined to service low-income Saharans, who mainly engage in small financial transactions which these banks find too costly to provide. The

underdevelopment of the MFI sector therefore means these underserved groups are denied access to valuable financial services and are unable to undertake income-generating, poverty reducing activities.

Table 4 below displays the *sectoral distribution* of bank private sector loans in Sahara. It reveals that the distribution of bank credit is not aligned with the sectoral distribution of domestic output. Although economic activity in Sahara is dominated by agriculture, (with a 51% share of GDP), lending to agriculture has been historically small and stood at 10.3% of total credit in 10 AD. Bank credit to the private sector is instead concentrated in trading activities (including tobacco marketing), which has a 12% share of GDP. By end-10 AD, wholesale and retail trade accounted for 45.6% of total loans and advances outstanding¹⁸. Available data on value-added in various sectors show a similar pattern, with trade receiving more bank loans as a percentage of value-added than other sectors.

Table 4: Sectoral Distribution of Private Sector Credit (10 AD; % shares)

	<i>Share of GDP</i>	<i>Share of Credit</i>	<i>Credit/value-added (%)</i>
Agriculture	51.0	10.3	1.2
Manufacturing	8.9	32.4	7.8
Trade	12.1	45.6	12.6
Building and Construction	7.2	3.1	0.4
Mining	0.6	2.0	0.2
Transport, electricity and water	5.8	6.5	1.0

Source: Sahara Central Bank

There is also a chronic shortage of *long-term finance* (debt and equity) in Sahara. Available data on the maturity profile of bank lending indicates that 86% of bank credit consisted of loans of 12 months maturity or less, compared to 79.4% in 08 AD (Table 5).¹⁹ Loans between 1 year and 3 years maturity accounted for a mere 7.7% of total credit (6.5% average over the period) and only 6% of loans outstanding had maturity greater than 3 years. Overdrafts constituted a high 60% of total loans and advances. One reason for the absence of long-term finance is the structure of bank deposits as demand deposits constituted over 80% of total deposits in 10 AD.

Table 5: Maturity Structure of Loans and Advances (% shares)

	08 AD	09 AD	10 AD
1 year and less	79.4	83.1	86.4
1-3 years	15.2	11.7	7.7
Over 3 years	5.5	5.2	5.9

Source: Sahara Central Bank

The lack of long-term finance in sufficient amounts is a major obstacle to the development of the private sector in Sahara. Term finance is important to the private sector in several ways: i) access to term finance encourages innovation and risk-taking by

¹⁸ A significant proportion of this is export finance, especially for tobacco and cotton exporters.

¹⁹ Most of these advances consisted of *loans on call*.

entrepreneurs thus increasing the probability of engaging in high-return projects; ii) most investment projects with high returns have long gestation periods which require long-term finance; iii) financing long-term investments with short-term debt sharply increases project risk and failure rates are likely to increase substantially; iv) access to long-term finance enables firms to engage in strategic, long-term planning since they have to worry less about the liquidity risks associated with failing to renew short-term credit; iv) without long-term finance, firms cannot easily undertake modernization of plant/equipment, adopt more productive technologies and expand productive capacity.

Long-term *debt capital* is in principle available from the Sahara Bank for Industrial Development (SBID) and the Sahara Agricultural Development Bank (SADB), the state-owned DFIs. Unfortunately, the SBID has not made a loan in the past three years and is for all intents and purposes irrelevant to the private sector. Seventy percent of its loan portfolio is non-performing and the bank is plagued by weak management, the lack of quality internal direction, extensive politicization of lending (due to government ownership), low commercialization and a general lack of the necessary banking skills to appraise and monitor loans²⁰. The SADB is experiencing similar problems.

Other potential sources of long-term financial resources are grossly underdeveloped or currently malfunctioning. *Contractual savings institutions* (life insurance and pensions) are natural sources of long-term finance by virtue of their relatively stable and long-term liabilities. However, gross insurance premiums amounted to only 0.5% of GDP in 10 AD. The industry consists mainly of non-life companies, whose liabilities/reserves are predominantly short-term. The two life insurance companies currently in operation are small and are engaged in reverse term transformation, deploying most of their long-term reserves into short-term government securities²¹. The largest insurance company, the state-owned **Asante Insurance Corp.**, has substantial holdings of short-term bank deposits, especially in the three remaining state-owned banks²². It has also begun to increase its real estate holdings.

The *pensions industry* is dominated by the Sahara Social Insurance Fund (SSIF), which covers only a small proportion of the total labor force in Sahara and is hampered by high administrative costs (amounting to over 40% of contributions in 10 AD). Each year, about D40 billion of new contribution is made into the SSIF compared to about D10 billion in outflows. This gives the SSIF considerable resources at its disposal for deployment into long-term investments. Unfortunately, the SSIF also exhibits substantial reverse term transformation and its long-term investments are concentrated in overvalued real estate, amounting to 70% of its assets²³.

One important form of long-term finance required by households is *housing finance*, but the availability of housing finance in Sahara is severely limited. Mortgage lending is concentrated in the Sahara Federal Mortgage Corporation (SFMC), which approved only 30 mortgages between 08-10 AD, most of them in Hakuna. It is virtually

²⁰ Saharans also have a poor record of loan repayments to government-owned financial institutions.

²¹ The *Institutional Investors Act of 01 AD* stipulates that at least 30% of insurance reserves should be held in the form of government securities.

²² Asante is a composite insurance company, offering both life and non-life products.

²³ A substantial part of the real estate investment is for SSIF's own use.

impossible to obtain mortgages outside the main urban centers and even the number of urban mortgages fall far short of housing requirements. Rapid urbanization in Sahara has generated a robust demand for urban housing which the SFMC is ill-equipped to satisfy. Other PMIs are relatively inactive, granting a combined 20 mortgages in the past two years. In general, mortgage lending has been limited by: i) weaknesses in property rights; ii) inadequate land registry system which has resulted in numerous land ownership disputes; iii) difficulties in using land as collateral; and iv) rising costs of imported construction materials.

At this juncture, there are severe shortages of affordable housing units especially in Hakuna and Matata, the two main urban centers. Many urban dwellers consequently end up living in slums or on the streets. Many others save small sums over a long period of time in order to build their own houses. The housing sector has therefore not been able to contribute effectively to economic growth, losing its potential catalytic effects on construction and employment.

The *capital market* is young and is not yet in a position to provide reliable long-term finance to the private sector. With only 5 equities and 3 government bonds listed and market capitalization standing at 4% of GDP, the market lacks the critical mass needed to offer a reliable source of capital for firms. There have been no equity issues in the past two years and the development of the corporate bond market has been hampered by macro-imbalances and the lack of credit rating firms. The lack of new equity issues could be traced to: i) the reluctance of family-owned businesses to dilute ownership; ii) the tedious and costly process of making public offers; iii) general lack of awareness about the operations of the capital market; and iv) the desire of many businesses to remain unregistered and stay under the radar screen of the Sahara tax authorities.

One segment of the financial sector which holds some promise for alleviating the shortage of medium to long-term finance is *leasing*. Leasing is especially suitable for financing small and medium scale enterprises (SMEs) which encounter the biggest obstacles in raising finance through conventional bank loans (see below). Since leasing is based on an underlying asset, it offers an alternative form of financing investment for SMEs whose lack of collateral and/or short credit history customarily make it difficult to obtain loans from banks. However, leasing in Sahara is still relatively underdeveloped, with limited leasing products and market penetration. It is estimated that total assets on lease in Sahara account for less than 1% of total domestic capital stock. There are only 2 leasing outfits, with the bigger firm, **Riwaya Leasing**, accounting for over 90% of the market and there is a concentration of activity in finance leases, with “low ticket” items (mainly motor vehicles) dominating leased assets²⁴.

The absence of a Leasing Law has been a major impediment to the development of the industry. Without a legal foundation, it is difficult to enforce leasing contracts especially when a lessee defaults. There are also some tax issues affecting leasing, especially the introduction of International Accounting Standard No. 17 (IAS 17), which removed the right of the lessor to claim capital allowances under finance leases, which are the most common form of leasing in Sahara.

²⁴ As mentioned earlier, commercial banks in Sahara are not involved in leasing.

The allocation of financial resources is also biased in favor of large, blue-chip enterprises, particularly multinationals, even though small and medium-scale enterprises (SMEs) dominate the Sahara private sector. These SMEs have only minimal and unreliable access to both short-term and long-term finance. Most of the financing available to SMEs is very short term, consisting mainly of collateralized overdraft facilities, and even then, only the larger and relatively more sophisticated SMEs have reliable and regular access to overdraft facilities. Other forms of working capital including short-term loans, letters of credit and trade credit remain seriously limited. Banks have therefore not developed the necessary skills to downscale and lend to SMEs and continue to perceive the sector as inherently risky. While some banks are beginning to offer more financial products, including trade finance, insurance credit and guarantees, these are also reserved for the larger companies and the top scale of the SME sector.

One unfortunate feature of the system is the fact that existing non-bank intermediaries do not target the underserved segments of the Sahara population but compete directly with banks in servicing fairly large corporate clients. Many NBFIs are actually owned by banks who established them as a way of circumventing official restrictions during the era of financial repression.

The access of SMEs to equity capital is also limited although the second-tier securities market (SSM) of the Sahara Stock Exchange now offers relatively relaxed listing requirements tailored to the characteristics of SMEs. For instance, second-tier firms are required to provide a 3-year trading record, compared to the 7-year record required of first-tier companies. Also, a minimum of 50 shareholders are required for second-tier firms, compared to 400 for first-tier companies. There are currently 9 firms listed on the SSM, but these are invariably the larger and more sophisticated medium-sized enterprises.

The limited size and lopsided pattern of resource allocation in Sahara outlined above is a product of several factors: i) difficulties in contract enforcement, including a cumbersome court system plagued by clogged dockets, poorly trained judges, and low credibility; ii) poorly prepared project proposals by potential borrowers and the general lack of commercial and entrepreneurial skills in the private sector; iii) poor credit culture, as many people got used to defaulting (without penalties) on loans from state-owned banks and credit schemes; iv) narrow range of assets acceptable as collateral and difficulties in perfecting and realizing collateral; v) high risks and high transaction costs of lending in rural areas; vii) poor accounting, auditing and financial reporting environment which makes it difficult for banks to assess the creditworthiness of potential clients; and viii) high reserve requirements imposed by the SCB.

Payment services. The Sahara payment and settlement system is poorly developed and does not offer a fast and secure means of transferring funds. Currency (notes and coins) constitutes over 40% of narrow money and 32% of broad money. This is much higher in neighboring countries such as **Bunika** and **Bilisi** where the share of currency in broad money is 18% and 15% respectively. A recent SCB survey of household expenditures, business payments and other financial transactions revealed that over 95% of transactions (both volume and value) are conducted on a cash basis. This heavy reliance on cash generates high transaction costs, hampers domestic trade and

significantly slows down economic activity. Trade is considerably restricted since most transactions have to be conducted face-to-face. Long distance purchases of goods are virtually unheard of and businesses making payments to suppliers also have to pay in cash²⁵. One factor which has encouraged the use of cash for most business transactions is the large size of the informal sector in Sahara.

Next to cash, checks are the only other payment instruments available. Even though checking deposits dominate bank deposits, personal checks are rarely used for individual transactions due to long delays in clearing checks, the high incidence of fraud, and a pervasive lack of trust²⁶. In 10 AD, the average number of checks cleared per day was 500, with an average value of only D20 million. Inefficiencies in the postal system also mean that the few check transactions that take place have to be face-to-face.

Dud checks are quite common in Sahara and it is estimated that over 40% of all checks written by individuals and businesses in 09 AD were against accounts with insufficient funds. Check forgeries are also common. There are no specific criminal penalties for bouncing checks and offenders usually go unpunished. The Sahara Bankers Association (SBA) recently proposed that banks withdraw checkbooks from anyone who bounces more than four checks in a year. A proposal to impose a fine equivalent to 20 times the value of the checks bounced is also under consideration. The Association recently proposed the establishment of a “rogue database” to keep track of perennial offenders. Although the Criminal Code covers check forgeries, offenders are rarely prosecuted.

The check clearing system consists of the Inter-Bank Clearing and Settlement System (IBCSS), which handles bilateral payments among banks²⁷. Only commercial banks are admitted to the IBCSS and other financial institutions access the IBCSS through correspondent commercial banks. Settlement is done on a net basis and is executed at the end of each day through transfers from banks’ settlement accounts at the SCB to a special account, also at the SCB. The SCB allows banks to overdraw their settlement accounts in case of insufficient funds and theoretically, such overdrafts are overnight lending only. But many banks have overdrawn their accounts at the SCB for as long as three months and the SCB continues to bear a huge exposure to this settlement risk. Plans are however under way to require banks to post collateral as a condition for admission and participation in the IBCSS²⁸.

Overall, there is very little technology involved in the operation of the payments system. One major factor that has limited the efficiency of the payment system is the limited computerization of banks, although this situation is changing rapidly.

Due to the paucity of the commercial banking branch network outside the main cities of **Hakuna** and **Matata**, it takes 12 days to clear a check within the same city and about a month to clear checks from upcountry. There is only one clearing center located

²⁵ The reliance on cash effectively imposes a geographical segmentation on the market for goods and services in Sahara.

²⁶ Government and corporate checks are used primarily to meet payroll payments.

²⁷ The IBCSS is owned and run by the SCB.

²⁸ It is not yet clear what kind of assets will be eligible as collateral.

in **Hakuna** and all checks have to be physically carried there, which accounts for the long delay in clearing checks from upcountry. Families in rural Sahara face substantial delays in receiving remittances from relatives living and working in the urban centers. Since remittances finance a substantial portion of household consumption in rural areas, such long delays impose serious hardships on rural dwellers.

Saharans who hold bank deposits invariably have to convert this into cash in order to complete most transactions²⁹. Debit and credit payment instruments are not yet available in Sahara and wire transfers are few and unreliable. In general, cashless payment instruments have not been developed.

For households and businesses, most bills also have to be paid in cash and usually involve face-to-face transactions. Saharans can only pay power, telephone, water and other bills by physically visiting the nearest branch offices of the relevant utility and handing over cash. In the current inflationary environment, larger volumes of notes are needed to consummate transactions and an inordinate amount of time is wasted counting out notes to make payments. The largest denomination is the D20 bill, which makes counting more onerous³⁰. Due to the high costs of printing currency, the SCB now prints new notes once every six years and most of the notes currently in circulation are therefore worn and tattered.

The heavy reliance on cash-based payments imposes high transaction costs on both the banking system and the economy as a whole. Most banks have a large number of staff dedicated solely to counting and sorting currency and also incur costs related to securing and moving large amounts of cash from place to place. Banks have to pay the cost of hiring armored vehicles and armed security guards to accompany cash as well as buying the necessary insurance coverage. Not surprisingly, banks' "bullion vans" have become prime targets for armed robbers, which has resulted in prohibitively high costs of obtaining the necessary insurance coverage for such cash movements. The increased risks have also forced banks to hire more armed guards to accompany bullion vans, substantially increasing overhead costs.

The payment and settlement system for transactions in securities is equally rudimentary. Securities are paper-based and all trades on the Sahara Stock Exchange are executed manually. At present, trades are settled 15 days after the trade (T+15 basis), which is grossly inefficient and raises settlement risks. The Stock Exchange is in the process of establishing an automated clearing, settlement and depository (CSD) system alongside an automated trading system, with the ultimate objective of "dematerializing" securities and increasing the efficiency of trading.

Cross-border, international payments work reasonably well in Sahara as many domestic banks have reliable correspondents abroad. The reform of the foreign exchange market and the removal of exchange controls have also significantly increased access to

²⁹ Post office money orders are becoming popular although the inefficiency of the post office in redeeming postal orders is an obstacle.

³⁰ A few banks are beginning to offer direct debits for making some regular payments, such as insurance premiums

foreign exchange. Other factors that have improved the transfer of money internationally include: i) the licensing of bureaux de change which has facilitated access to foreign exchange for small users; ii) allowing exporters to retain all their export proceeds; and iii) allowing the holding of dollar deposits in domestic banks.

Risk management services. The Sahara financial system does not provide adequate mechanisms for risk protection and the contribution of the financial sector to the social safety net is negligible. As described earlier, the insurance industry is underdeveloped with gross premiums in 10 AD amounting to less than 1% of GDP.

Non-life insurance accounts for over 95% of premiums and 8 of the 10 insurance companies in existence are property-liability companies, concentrating principally on automobile insurance which is mandatory in Sahara. The state-owned **Asante Insurance Corp.** is a composite firm, writing both life and non-life policies while the other life company writes only life policies³¹. There are no reinsurance companies and firms have to buy re-insurance from overseas.

Most insurance firms are poorly capitalized and weak. The only company of respectable size is the state-owned insurance firm which has a monopoly on the insurance of government property. Six insurance companies are organized as mutual associations, which makes expansion and mergers more difficult. The insurance industry as a whole is plagued by high administrative costs, in the range of 50-55% of premiums collected. Marketing costs account for the lion-share of administrative costs given the high commissions paid to independent agents.

The range of policies offered by property-liability companies is basic and narrow. Motor vehicle, marine and fire insurance overwhelmingly dominate and other forms of insurance such as homeowners', workers' compensation, mortgage, and fidelity insurance are absent. The *type* of coverage is therefore heavily skewed towards property, while liability and casualty coverage is limited. Most non-life policies outstanding are for third-party liability automobile insurance.

Only two companies provide life insurance coverage of any sort and life insurance products consist mainly of pure life insurance, disability and annuities. Medical and health insurance are unavailable. As at end-10 AD, it was estimated that there were only about 100, 000 holders of life insurance policies in a population of 86 million.

A combination of low income levels, high premiums and poor awareness and knowledge of insurance has discouraged most Saharans from buying insurance policies. Premiums are generally high due to the high levels of administrative expenses and in addition, insurance companies have a poor track record of meeting legitimate claims. In 10 AD, the loss ratio for the entire insurance industry (claims as a proportion of premiums) was 10%. As a result of these factors, less than 2% of Saharans are covered by any sort of insurance policy and those that are covered are dismally underinsured.

³¹ An amendment to the Insurance Act in 02 AD ended the regulatory separation of life and non-life lines of business.

Other constraints facing the insurance industry include: i) limited availability of actuarial information and statistics on mortality and morbidity (especially relevant for life companies in pricing premiums); and ii) the high rates of HIV infection among Saharans has made life insurance unattractive.

Another important component of a risk management framework is *pensions*. Pension plans provide retirement income and help ensure that workers do not fall into poverty upon retirement. The pensions industry is dominated by the monopoly Sahara Social Insurance Fund (SSIF), a state-owned, Provident Fund which covers salaried workers in the formal private and public sectors. It receives mandatory contributions from the basic salary of workers (age 16-55) equivalent to 8% per annum, with employees contributing 3% and employers, 5%. There is a maximum salary cap of D50,000 (approximately US\$400) per annum. The SSIF provides a lump sum payment based on total contributions paid plus interests earned at retirement (minimum 55 years of age), invalidity, death, emigration and/or withdrawal after a long period of unemployment.

By focusing only on salaried workers, the SSIF has a limited coverage with only about 300, 000 Saharans participating (about 2% of urban workers). The self-employed currently do not have access to the SSIF. This is a serious gap given the size of the informal sector and the preponderance of self-employed Saharans. The effective coverage is even smaller given the fact that many employers successfully evade participation. The limited coverage of the SSIF means that most workers (and their families) are not protected from falling into poverty upon the death or retirement of the primary income-earner.

The Fund also experiences a high rate of evasion as many employers do not remit contributions and the SSIF's collection and inspection systems are abysmal. It has a largely manual and disorganized record keeping system and there are no clear penalties for non-remittance of contributions to the SSIF. Available evidence indicates that retired workers often encounter problems receiving their benefits. The SSIF itself estimates that it is about 6 months behind in the payment of benefits and many retirees report being forced into taking up part-time jobs while waiting to collect their benefits from the SSIF.

The SSIF is also bedeviled by high administrative costs (amounting to over 40% of contributions in 10 AD) and a concentration of investments in overvalued, low-yielding real estate. The Ministry of Labor is the designated regulatory and supervisory agency to oversee SSIF activities but this oversight has not been effective.

There are plans to liberalize the pension industry and give Saharans more flexibility in choosing retirement plans. Two years ago, Asante Insurance began to offer pension plans in the form of annuities but this is yet to catch on with Saharans. Some large companies, especially the multinationals, have recently started their own pension schemes to supplement the SSIF.

In sum, the framework for risk management in Sahara is grossly inadequate³². It is therefore not surprising that many potentially profitable investments are not made because they are deemed too risky. Individual Saharans are not adequately protected against unforeseen contingencies and it is common for workers to fall into poverty upon retirement due to the inefficiencies of the SSIF. A significant proportion of the population has no pension protection of any sort and have to rely on family and friends for old-age income support.

5. THE PRIVATE SECTOR: THREATS TO FINANCIAL STABILITY

There are serious concerns about the stability of the Sahara banking system as evidenced by the following statistics as at end-10 AD: i) 5 banks (holding 3% of system assets) were officially classified as distressed by the SCB, with capital of under 4% of risk-adjusted assets; ii) 18 out of 21 banks (75% market share) did not meet the statutory paid-up capital of D1 billion; iii) aggregate banking system capital stood at a low 5% of risk-adjusted assets and 10 banks with a 6% market share have capital lower than the required 8% of risk-adjusted assets; iv) non-performing loans of the banking system amounted to roughly 25% of gross loans and advances; v) substantial under-provisioning, with provisions standing at 50% of regulatory requirements; vi) insider lending amounting to 60% of banking system capital, compared to 10% two years earlier; vii) poor internal controls and high incidence of fraud, as 15 banks reported fraud incidents in 10 AD with losses totaling over D200 million; viii) 10 banks, representing 60% of system assets, holding net foreign exchange positions in excess of 50% of net worth; and ix) 12 banks have overdrawn their settlement accounts at the SCB for the past three months. Two banks (**Sitima Commercial Bank and Bariki International Bank**) were recently taken over by the Deposit Insurance Corporation.

The current fragility in the banking sector could be traced to a number of factors including: i) rapid growth in the number of financial institutions and increased risk taking, following financial liberalization; ii) inadequacies in banking supervision as supervisors struggle to cope with the expanded number of financial institutions; iii) shortage of critical banking skills; iv) poor governance and management oversight; and v) concentration of loan risks. The poor performance in some segments of the economy has also contributed.

As the authorities begin to focus on restoring the soundness of the banking system, a look at the current exposure profile of the financial system raises further concerns about the portfolio quality of banks. The banking system is substantially exposed to a small number of manufacturing borrowers as 10 firms account for 80% of total credit to the manufacturing sector. The system also shows substantial concentration of exposure to tobacco exporters, with 10% of tobacco exporters accounting for 70% of total credit outstanding to this line of activity. A large tobacco exporter recently absconded from the country, effectively defaulting on billions of *donges* in bank debt. The vulnerability of the banking system is magnified by the high levels of loan and risk concentration, due to the absence of reliable, non-bank sources of finance for the private sector.

³² Given the underdevelopment of financial markets, market-based facilities for risk management such as *forward markets* are non-existent in Sahara.

Table 6 below provides a breakdown of outstanding loan amounts by industry for the largest borrowers from the banking system. A “large borrower” is defined as one with at least D1 billion in loans outstanding. Overall, obligations of the top-20 borrowers currently represent 20% of total banking system capital and 30% of system core capital and it is estimated that close to 25% of these loans are impaired.

Large borrowers in manufacturing have a total of D120 billion of loans outstanding, accounting for 58.5% of all loans over D1 billion. The continued softness in the manufacturing sector therefore poses significant risks to the health of the banking system. High lending rates have further compounded the problem. Nominal bank lending rates hit 55% in 10 AD and not surprisingly, many borrowers are struggling to service bank debt.

Table 6: Largest Borrowers from the Banking system
(outstanding amounts by sector; billion donges, 10 AD)

Sector	Total bank debt (D billion)	% of total
Agriculture	2.4	1.2
Manufacturing	120.0	58.5
Trade	30.2	14.7
Building and Construction	22.5	11.0
Mining	8.3	4.1
Transport, electricity and water	21.6	10.5
TOTAL	205.0	100

Further, Sahara firms are highly leveraged, which is alarming given the current low levels of profitability. A survey conducted by the Sahara Central Statistical Office (SCSO) in 08 AD indicates that debt-equity ratios for manufacturing firms was over 150%, much higher than ratios in other African countries of similar size and economic structure. Debt-equity ratios in the service sector also exceeded 100% and it is estimated that overall, equities account for a negligible 4% of total corporate financing.

Table 4 showed that a substantial portion of the borrowing from the banking system is short term, principally in the form of overdrafts. Anecdotal evidence indicates that many firms use short term funds to finance long-term investments. This is particularly ill-advised in the current environment of poor profitability and shrinking cash flows in the private sector. The SCB estimates an average interest coverage ratio of 1.1 for the largest borrowers from the manufacturing sector, indicating a low capacity to meet interest payments on outstanding bank debt out of operating cash flows³³. Sahara firms however do not have any foreign currency debts as the banking system does not lend in foreign exchange (even though they hold dollar deposits) and the corporate sector is still not allowed to borrow from abroad, despite the recent liberalization of capital controls.

³³ The interest coverage ratio is an indicator of debt sustainability, defined as the ratio of operating cash flows (operating income before interest, taxes and depreciation) to interest payable on loans (see Pomerleano, M. *Corporate Finance Lessons from the East Asian Crisis*, World Bank Private Sector Note No. 155, Oct. 1998.

Another source of vulnerability is the significant levels of government arrears and unpaid bills to suppliers and contractors, most of them small and medium-sized firms³⁴. Many of these firms have subsequently run up large overdraft balances with various banks. This problem is widespread, affecting businesses who deal with the central government as well as the state and local governments. Not surprisingly, this has translated into difficulties in servicing debt obligations. Especially affected is the construction industry, where the central government owes over D60 billion to local construction firms for several projects. It is estimated that over 10, 000 construction workers have been laid off in the past two years and another 2, 000 placed on half-shift as a direct result of the government's unpaid bills. There are no reliable estimates on arrears outstanding with other tiers of government although this is suspected to be quite substantial.

Other segments of the financial sector have also been affected by adverse developments. Most notably, the insurance industry has suffered a wave of policy surrenders in the past two years, especially in the commercial property business line. This has forced many insurance companies to sell assets at fire-sale prices. The Insurance Commission suspects that some companies may already be distressed and has initiated a full-scale audit of insurance companies to determine their safety and soundness.

6. IMPROVING FINANCIAL AND PRIVATE SECTOR LINKAGES: RECOMMENDATIONS

As mentioned earlier, successful implementation of a private sector-led growth strategy in Sahara requires a financial system that is ready and able to provide effective support to the private sector. It is also important that the financial sector is responsive to the changing needs of the economy at large. In particular, the sector should be in a position to support the desire to diversify Sahara's economy beyond tobacco into tradable items with a much higher value-added. Attaining these goals will require a battery of policy and institutional actions to address the observed constraints impeding the operations of the financial sector and obstructing stronger linkages with the private sector.

It is important to point out at this juncture that making the financial sector more relevant to the private sector will also require *actions aimed at making private sector borrowers more attractive to the financial sector*. It should be recognized that the existence of serious non-financial constraints to output expansion means that fixing the financial sector alone will not necessarily generate faster output growth from the private sector. We therefore provide a few recommendations that could help strengthen the private sector.

The following paragraphs propose a sequence of actions to strengthen financial and private sector linkages in Sahara, identifying actions to be taken immediately and those to be taken in the medium to long-term. Given the capacity limitations in Sahara, implementing these actions will definitely require substantial amounts of donor assistance, both financial and technical. We therefore suggest that the Sahara authorities use the ongoing dialog with both bilateral and multilateral donor agencies to develop a

³⁴ These include suppliers of office supplies, military supplies (food, uniforms, beds, mattresses, etc) as well as supply of foodstuff to boarding students in 19 Sahara Federal Government Secondary Schools.

concrete financial sector development program that could attract donor support. Aside from the World Bank, the IMF and bilateral donors such as the UK DFID and USAID, a useful source of assistance worth exploring is the Financial Sector Reform and Strengthening Initiative (FIRST) which provides technical assistance grants for short- and medium-term projects in the area of financial sector development³⁵.

As a first step in this direction, Annex 2 provides a tentative action plan that the Sahara authorities could modify as appropriate and implement with donor assistance.

Financial Sector Interventions

Immediate Priorities

Macroeconomic and financial policies. The financial system is very sensitive to macroeconomic policies and conditions and cannot mobilize and allocate resources in an unstable macro-financial environment. One key source of macro-instability in Sahara is the high level of fiscal deficits, which has resulted in high inflation and current account deficits. It is therefore urgent to take steps to rationalize government expenditures and bring fiscal deficits under control. The inflationary impact of deficits could also be minimized by reducing the extent to which the financial system finance government spending. One option that might be considered is to impose limits on government borrowings from the banking system either as a percentage of total revenue or as absolute cash limits.

Banks also bear a substantial burden in the form of high levels of unremunerated reserve requirements. This imposes an implicit tax on the banking system and reduces their flexibility in determining portfolio composition. It is therefore desirable to reduce the current level of reserve requirement or consider paying some interest on these balances.

Lastly, the authorities should continue the liberalization of the foreign exchange market so as to reduce the current premium on the parallel market and eventually eliminate the existing multiple exchange rates.

Financial supervision. It is crucial for the authorities to restore confidence in the financial system by taking steps to promptly resolve insolvent financial institutions, including those taken over by the SDIC, either through liquidation or mergers. There should also be a careful audit of remaining financial institutions to determine their soundness and viability and institute corrective actions if necessary. While these steps are underway, it is advisable to exercise caution in the granting of new bank licenses until the financial condition of the banking system improves considerably. These steps should go some way in assuring the public that financial intermediaries are robust enough to be safe repositories for their savings.

One factor behind the deteriorating condition of banks is the rampant violation of critical prudential limits and controls, especially limits on insider lending, provisioning and capital adequacy requirements. It is therefore important for the SCB to substantially

³⁵ Detailed information on the FIRST Initiative is available at www.firstinitiative.org

lower its tolerance levels with respect to such violations and be more aggressive in its use of sanctions against erring banking institutions. Non-enforcement of prudential regulations erodes the credibility of the SCB and makes the task of prudential oversight more difficult.

Payment systems. The poor state of the payments system requires urgent attention. As such, it is recommended that the authorities establish a Sahara Payments Committee to oversee the modernization of the payment system. In the short run, this committee could commission a more detailed study of the payments system and map out an action plan to upgrade it.

Medium to Long-Term Priorities

Financial supervision. Since the quality of financial supervision is a key determinant of the financial condition of banks, it is imperative that the central bank reinforce key elements of the supervisory process. In particular, the SCB should strengthen off-site surveillance and on-site examinations, including *inter alia*: i) introducing a standardized rating system for banks; ii) focusing inspections on risks assumed by financial institutions, rather than on compliance and controls; iii) improving the integrity of prudential returns; and iv) standardizing the Bank Surveillance and the Bank Examination Reports.

Bank failures however can still occur even under the best of circumstances. It is therefore advisable to take appropriate steps to strengthen the capacity of SCB and SDIC for contingency planning, crisis management and failure resolution. To carry out their tasks effectively, both SCB and SDIC need well-qualified staff with the appropriate skills. More systematic attention thus needs to be paid to staff development in supervisory agencies by introducing comprehensive learning curricula and training programs for supervisors, including prescribing a minimum number of training hours per year for each supervisor, against training needs.

Financial institutions. Measures are also required to strengthen financial intermediaries directly, particularly in the areas of management and governance. Management is the first line of defense against bank failures and should receive appropriate attention. The development of adequate risk-management systems in banks and other financial institutions is critical if they are to understand, measure and control the various risks inherent in their operations.

Other steps that might be considered for strengthening institutional capacity in the financial system include: i) licensing more foreign banks to increase competition and facilitate transfer of banking skills; and ii) designing a coherent strategy to expand the quantum of skilled professionals in financial intermediaries and markets, including banking, insurance, leasing, and capital markets. Such a strategy is best designed in conjunction with the respective professional associations and they should be involved in its development as early as possible.

Savings mobilization. The low level of savings mobilization is a concern that should attract attention from the highest policy levels. Although the absolute level of savings is hampered by low income levels, there is room to encourage saving in financial

forms. The high levels of inflation has substantially reduced the willingness of Saharans to hold financial assets. It is therefore imperative that macro-economic stability be established and interest rates remain positive in real terms to encourage the holding of savings in financial form. The low level of savings is also due to the poor distribution of financial outlets around the country, especially in the rural areas. One way to increase the number of financial outlets in Sahara is to consider establishing a Postal Savings Bank to capitalize on the wide spread of post offices around the country and help in mobilizing small savings especially from rural dwellers.

Other measures that could encourage the holding of financial savings include: i) improving the efficiency of making payments through the financial system; and ii) considering the introduction of new savings vehicles, such as a National Savings Certificate, to complement traditional bank deposits.

Resource allocation. Banks in Sahara are reluctant to lend given the weaknesses in the legal framework underlying financial transactions. There is no coherent bankruptcy and insolvency law, which means that the rights and obligations of debtors and creditors are often unclear. There are additional complications with attaching, perfecting and realizing collateral. One area that should therefore receive serious attention is instituting a program of legal and judicial reform to improve the speed, transparency and integrity of the mechanisms for contract enforcement. Such a reform program could include: i) the introduction of a coherent bankruptcy and insolvency law, clearly spelling out the rights and obligations of debtors and creditors; ii) expansion of commercial courts beyond Hakuna, preferably establishing one court per district to facilitate access to its services; and iii) establishment of an efficient land registry system to facilitate the use of land as collateral³⁶.

There is also a need to improve the ability of banks to evaluate the creditworthiness of potential clients by taking steps to improve the financial information infrastructure in Sahara. Measures are required to: i) introduce internationally acceptable accounting, auditing and financial reporting standards; ii) establish credit information bureaux; and iii) encourage the development of financial information vendors such as the financial press (electronic and print), credit rating agencies, registries and depositories and market research agencies.

Since the high levels of lending rates serve to discourage borrowing, measures are also required to address the underlying causes of high interest rates and spreads. This will however require further study of the key factors behind the observed trends in spreads. A few possible factors that may require attention include the high levels of government borrowing, high levels of unremunerated reserve requirements and the increasing levels of non-performing loans in the banking system.

Lastly, given the importance of SMEs to the Sahara economy, it is important to address the problems they face in raising finance from the financial system. One approach is to encourage the establishment of venture capital outfits in Sahara to provide start-up capital for SMEs or take equity stakes in existing enterprises. There will however

³⁶ Efforts could also be made to develop the use of movable property as collateral for loans.

be a need to also conduct training for SMEs in the preparation of business and financial proposals for bank and venture capital funding. Other business development services for SMEs, including marketing assistance, information, technology development and business linkage promotion will also be useful in making them more attractive to financial institutions.

Micro and rural finance. The development of the micro-finance industry in Sahara offers an avenue to improve the provision of financial services to the poor, especially in rural areas. It is particularly interesting that some micro-finance methodologies, including group lending and character-based lending offer some promise in overcoming the credit risks that banks face in lending to the poor. However, the orderly development of the industry will be helped if the authorities develop a coherent national micro-finance policy which spells out an enabling legal and regulatory environment as well as appropriate policies conducive to the development of micro-finance institutions (e.g. ending directed credit schemes which harm micro-finance institutions). The national policy could also clearly indicate the respective roles and commitment of different stakeholders such as the SCB, donors, micro-finance practitioners as well as the government in the development of the micro-finance industry.

It is equally important to strengthen the capacity of existing micro-finance institutions in the design and delivery of appropriate financial products as well as in best practice managerial techniques. MFIs particularly need help in strengthening management information systems as well as in training of loan officers to appraise and monitor loans. Finally, the long term development of MFIs would benefit from strengthening linkages between them and the commercial banking sector to provide a sustainable source of funding with which MFIs can make small loans to their beneficiaries. In the same vein, the authorities should explore ways in which to strengthen the linkages between informal financial institutions (ROSCAs, money lenders, etc) and formal financial institutions. This would increase the deposit base of banks and would enable informal financial institutions to provide a broader range of financial services (such as money transfers) to their numerous members and clients.

Long-term finance. Given the importance of term finance to the development of the Sahara private sector and the economy at large, developing viable sources of long term finance should be high on the agenda of the authorities. It should however be pointed out that pre-conditions to the development of term finance include maintaining macroeconomic and policy stability as well as improving the efficiency of contract enforcement and realization of collateral. Without these preconditions, it is unlikely that one can build a solid foundation for the sustainable provision of term finance to the private sector in Sahara.

On the institutional front, the two development finance institutions (SABD and SBID) offer some promise in channeling long term funds to both the agricultural and the industrial sector. However, given the current weaknesses in these institutions, there is a need to: i) restructure and introduce partial private ownership of SABD and SBID; ii) introduce commercially-oriented governance in both institutions and end their provision of subsidized credit; iii) introduce regular supervision of both institutions; and iv) design

and implement strategies for raising debt capital from non-governmental sources, perhaps by issuing bonds on the capital market.

The contribution of the capital market to raising long term finance could also be improved by: i) increasing the supply of securities through the privatization of state-owned enterprises; ii) generating demand for securities through pension reform and introduction of collective saving schemes; iii) conducting an educational program for companies and investors on the benefits of the capital market; iv) promoting the development of the government bond market, as a stimulus for the corporate bond market; and v) strengthening SMA oversight of the market to instill confidence and trust in capital market activities. However, given the small size of the capital market in Sahara and the small size of the economy as a whole, it might be more useful for the authorities to explore regional options for capital market development. There is already some informal discussion of regional integration among the respective capital market regulators in Sahara, Makapo and Bunika. We strongly recommend here that the regional approach be taken more seriously as it offers an avenue to create the requisite critical mass for capital market development than could be generated within Sahara alone. Nonetheless, it should be recognized that some of the measures proposed earlier to promote the Sahara capital market will still be relevant in a regional context because the successful integration of capital markets depends on the efficiency of the individual markets. Integrating poorly functioning markets will definitely not produce a vibrant and efficient regional capital market.

Developing term finance will also require measures to develop housing finance and leasing. Improving the provision of *housing finance* in the country will require: i) restructuring SFMC and allowing it to explore private sources of funding; ii) allowing the use of land as collateral and creating a land registry to facilitate the verification and transfer of land rights. Developing *leasing* will require: i) introducing a comprehensive leasing law as soon as possible; and ii) removing current fiscal disincentives and allowing lessors to claim capital allowances under finance leases.

Finally, reforming and developing the contractual savings industry (insurance, pensions) will go a long way in increasing the volume of long-term funds available given the long term nature of their liabilities (details below).

Risk management and contractual savings. The authorities could improve the framework for risk management by taking steps to develop both insurance and pensions in Sahara. Development of the insurance industry could be pursued by: i) ending the monopoly of **Asante Insurance** over the insurance of government property in order to promote competition in the industry; and ii) conducting an education program (jointly with the insurance industry) for the populace on the benefits of insurance

On the pensions side, establishing a National Pension Policy to include provisions for the registration and supervision of pension schemes, investment guidelines, etc should help provide a more stable environment for the development of pension funds. It is important to complement this with institutional reforms in the pension industry, including ending the monopoly of the SSIF and allowing the emergence of privately-managed pension funds.

On the policy front, it is recommended that the authorities remove current restrictions imposed by the Institutional Investors Act of 01 AD on the portfolios of both insurance and pensions and encourage them to undertake more long-term investments, such as long-term policy loans, long-term deposits in commercial banks and investments in long term securities.

Payment and settlement systems. One of the key services provided by the financial system is the facilitation of payment for goods and services. It is therefore critical to modernize the Sahara payment system to enable the financial sector contribute maximally in this regard. First, there is the need to establish a firm legal foundation for the payment system, specifying the rights and responsibilities of various parties (payer, payee, etc) as well as strict and enforceable penalties for abuse of the system. There should also be an effort to reduce the heavy dependence on cash transactions through an educational campaign designed to promote the use of checks and other non-cash payment instruments (including debit and credit cards).

Since rural areas suffer disproportionately from the inefficiencies of the payment system, special attention should be paid to improving the access of rural dwellers to payment services. Available options in this regard include the introduction of mobile banking and check cashing services in rural areas, and the possible use of a Postal Savings Bank as the foundation for developing a functioning rural payments system, linked directly to the commercial banking system.

Other reforms and improvements required in the payment infrastructure include: i) encouraging the electronic linkage of bank branches to accelerate check processing and clearing; ii) reducing SCB's exposure to settlement risk by restricting clearing house membership to banks that meet strict criteria relating to capital and net worth; and iii) considering the introduction of a Real Time Gross Settlement System (RTGS) to handle large-value transfers while the IBCSC concentrates on small value transfers.

Some Private Sector Interventions

Immediate Priorities

It is imperative to resume the suspended private sector reform agenda, especially the planned privatization of state-owned enterprises. The divestment of government holdings in the two conglomerates, **Amara Holdings and Jambo Enterprises** is particularly urgent. This will go a long way in injecting the much needed efficiency and competitiveness into the private sector and improve its contribution to economic growth. Aside from long-overdue changes in ownership, other reforms are required to ensure that the business environment is conducive to the orderly development of private enterprises. Examples of such needed reforms include: i) streamlining the procedure for business registration; ii) reform of the tax framework to improve tax administration and reduce the excessive dependence on export tax; iii) labor market reform, especially the introduction of more flexibility into wage determination; iv) introducing low, uniform tariffs on imports and rationalizing non-tariff barriers; and v) considering the privatization of the power utility to reduce costs of enterprises in private generation of power.

Medium to Long-Term Priorities

The over-dependence on tobacco is a major source of vulnerability and shocks to the Sahara economy. Therefore, in the medium to long-term, the authorities should accelerate efforts to diversify the economy into non-tobacco, but tradable activities. This will facilitate the provision of financial services to a private sector that is more robust and less vulnerable to cyclical shocks.

It is also important to significantly reduce the costs of doing business in Sahara by reforming public utilities and improving physical infrastructure (roads, post and telecommunications, power). Given the fact that over 70% of Saharans live in rural areas, the private sector should be encouraged to become involved in improving physical infrastructure in rural areas. This will not only raise the well being of rural dwellers, but also go some way in reducing the costs of financial intermediation and encouraging the spread of financial outlets into the rural areas.

Finally, there is an urgent need to address other issues critical to sustainable private sector development in Sahara including promoting foreign investment and developing entrepreneurial skills among indigenous businessmen. The authorities could also consider the establishment of a Small Business Agency to oversee the development of small and medium-scale enterprises.

Annex 1: Suggested Outline for Analyzing Financial and Private sector Linkages

A. Background Information

Financial sector

- Structure of financial system: types, number and size of financial intermediaries and markets; ownership of financial intermediaries
- Overall size of financial system and relative shares of intermediaries and markets (financial assets/GDP); concentration and competition in specific sub-sectors (concentration ratios, entry policy, ownership).
- Regulatory agencies and institutions covered; note any gaps in coverage of regulatory framework (e.g. NBFIs not supervised)
- Briefly describe informal financial arrangements, if any (ROSCAs, SACCOs, moneylenders, etc)

Private sector

- Structure of private sector (sectoral, geographical and size distribution of enterprises, formal and informal)
- Structure of output (distribution of economic activity across primary, secondary and tertiary sectors; contribution of sectors to GDP, employment and exports)
- Ownership structure: foreign vs. indigenous ownership of enterprises
- Relative sizes of formal vs. informal components of the private sector

B. Macroeconomic and Policy Environment

- Review of current levels and trends in key macroeconomic variables: real GDP growth, inflation, fiscal balance, monetary conditions, interest rates and spreads, domestic savings and investment, current account, terms of trade, international reserves, exchange rate trends, external public debt.
- Implications of trends in these variables for the stability and performance of financial intermediaries and markets
- Review of key financial sector policies: interest rate, credit allocation, taxation of financial intermediation, exchange rates and exchange controls.
- Review of key private sector policies: degree of government participation in business activity, industrial policy (export promotion vs. import substitution), domestic market and price controls, (if any), access to foreign exchange, trade regime (tariffs and quotas), labor market laws, taxation of enterprises; other business policies.

C. Financial Sector: Contribution to Private Sector Development

- Some background on real sector performance: GDP growth, performance in different sectors (output, sales, profits, capacity utilization, etc)

Resource mobilization and outreach

- Savings mobilization: M2/GDP ratios, currency/M2, bank deposits/GDP, number of people with bank accounts, size of insurance and pension reserves, mutual funds.
- Diversity of saving instruments: bank deposits, insurance, pension, securities, mutual funds etc
- Outreach of financial sector: number of bank branches and other financial outlets, geographical distribution of branches and outlets (rural and urban) relative to geographical distribution of population, population per branch/outlet.
- Explain observed trends in saving mobilization and outreach

Resource allocation

- Real sector performance and effective demand for credit
- Allocation of credit (by banks, non-banks and markets) between private sector and government (private sector share of total credit, private sector credit/GDP, growth of private sector credit, bank loan/deposit ratios); share of foreign and government assets in bank portfolios; importance of informal financing.
- Allocation of credit by location (rural vs. urban): rural loans/total loans, banks vs. micro-finance institutions (if any)
- Sectoral distribution of credit: credit received vs. share of sectors in GDP; credit as share of sectoral value-added.
- Allocation of credit by tenor (short vs. long-term finance, both debt and equity); sources of long-term finance: banks, capital markets, pensions, insurance, development banks, leasing.
- Allocation of credit by size of enterprise: micro, small, medium and large
- Allocation of credit by income levels and gender
- Explain observed patterns in size and distribution of credit

Payment services

- Use of payment instruments and implications: cash, checks, debit cards, credit cards, wire transfers, etc; cash/narrow money, cash/broad money; number of checks cleared daily; percentage of total transactions conducted in cash.
- Describe formal payment systems: small value vs. large value systems
- Efficiency and oversight of payment systems: cost and speed of transfers, abuse of system and sanctions; risks and risk management in payment system.
- Clearing and settlement system for securities markets
- Cross-border international payments

Risk management services

- Overview of risk management facilities: insurance, pensions, forward markets
- Size and efficiency of insurance industry: premiums/GDP, insurance assets/total financial assets, solvency margin, diversity of life and non-life products
- Pensions: coverage (number of participants, percentage of total population), pensions vs. traditional safety net arrangements, viability of pension plans; traditional safety net arrangements.
- Forward markets

D. Private Sector: Threats to Financial Sector Stability

- Financial condition of banks and other intermediaries (capital, assets, management, earnings, liquidity, sensitivity to market risks); explain observed financial condition.
- Performance of private sector and implications for bank loan portfolios
- Exposure profile of banking system (sectoral distribution of loans, performance of largest borrowers from the system, corporate leverage, etc)
- Exposure to government agencies and state-owned enterprises (if any)
- Government arrears and unpaid bills to suppliers and contractors
- Implications for other financial intermediaries

E. Recommendations

- Financial sector interventions (immediate actions; medium to long-term actions)
- Private sector interventions (immediate actions; medium to long-term actions)

Annex 2: Promoting Financial and Private Sector Linkages in Sahara

Action Plan (as at Q2: 11 AD)

Timing	Measures	Responsibility
Ongoing	Streamline government expenditure and control fiscal deficits	Sahara Central Bank (SCB)/Ministry of Finance (MoF)
	Continue liberalization of forex market	SCB/MoF
	Implement measures to attract foreign investment	Investment Promotion Council
Q4: 11 AD	Introduce limits on government borrowing from the banking system	SCB/MoF
	Commence resolution of insolvent financial institutions	SCB with donor assistance
	Determine soundness of remaining financial institutions	SCB
	Establish Sahara Payments System Committee	SCB and Bankers' Association
	Resume privatization agenda	MoF and Presidency
Q1: 12 AD	Begin upgrade of prudential regulations to international standards	SCB with donor assistance
	Commence capacity building for off-site surveillance division of banking supervision department	SCB with donor assistance
	Commence capacity building for on-site examination division of banking supervision department	SCB with donor assistance
	Begin strengthening framework for contingency planning and failure resolution	SCB/SDIC with donor assistance
Q2: 12 AD	Begin design of legal framework for payment system	SCB
	Begin drafting of leasing law	SCB and Ministry of Justice
	Commence work on a land registry system	Ministry of Justice with donor assistance
Q2: 12 AD	Begin design of legal framework for payment system	SCB
	Begin preparatory work on Real Time Gross Settlement System (RTGS)	SCB with donor assistance
	Begin work on National Microfinance Policy	SCB with donor assistance
	Design capacity building program for MFIs, including linkages with commercial banks	SCB with donor assistance
	Begin work on National Pension Policy	Retirement Benefits Commission
	Commence trade and tax reforms	MoF and Ministry of Trade

Timing	Measures	Responsibility
Q3: 12 AD	<p>Initiate educational campaign to promote use of non-cash payment instruments</p> <p>Begin work on strengthening corporate governance and risk management in banking institutions</p> <p>Initiate measures to establish a Postal Savings Bank</p> <p>Introduce National Savings Certificate</p>	<p>SCB and Bankers' Association</p> <p>SCB and Bankers' Association</p> <p>SCB, Sahara Postal Service and Ministry of Telecommunications</p> <p>SCB/MoF</p>
Q4: 12 AD	<p>Establish Small Business Administration (SBA)</p> <p>Design and conduct training for SMEs in preparation of business and financial proposals</p>	<p>MoF and Ministry of Industries</p> <p>SBA with donor assistance</p>
Q4: 12 AD	<p>Commence feasibility study on establishing a credit bureau</p> <p>Initiate measures to introduce internationally acceptable accounting and financial reporting standards</p> <p>Begin work on comprehensive bankruptcy and insolvency law</p> <p>Initiate measures to improve efficiency of judiciary and reliability of contract enforcement</p>	<p>SCB/SBA with donor assistance</p> <p>Sahara Accounting Standards Board with donor assistance</p> <p>Ministry of Justice with donor assistance</p> <p>Ministry of Justice and Presidency with donor assistance</p>
Q1: 13 AD	<p>Begin reform of insurance industry, including ending monopoly of Asante Insurance</p> <p>Encourage entry by private insurance firms</p>	<p>Sahara Insurance Commission and MoF</p> <p>Sahara Insurance Commission</p>

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