

Financial Sector Reform Policies and Poverty Reduction

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1. Introduction

Africa is a richly endowed continent and yet is engulfed in poverty of immense proportions. Sub-Saharan Africa, as a region, ranks lowest in terms of human development, with its 612 million inhabitants sharing gross domestic product of only \$326 billion in 1997, less than that of Holland, a country with only about 15 million inhabitants. Life expectancy at birth in Sub-Saharan is the lowest in the world and fewer people in Africa have access to safe drinking water. With population growing at about the same rate as output, per capita income in Africa has remained stagnantly low over the years. The majority of Africans live on less than \$1 a day. In addition to severe geographical constraints, natural disasters, civil wars, poor governance and economic mismanagement have contributed to the general impoverishment of the continent. More people are now under the poverty line than was the case twenty years ago. With all its agricultural potential, Africa is now a net importer of food. Threat of famine and starvation has made some parts of the continent dependent on international aid for survival.

Finance is the oil for growth. It is indeed the life-blood of the economic system. The financial system is the vessel that carries this life-blood through the economic system. It is the system of institutions and operations that canalises the financial resources into productive use. In most developing countries, the economies are characterized by dual systems running parallel – monetized and non-monetized; formal and informal systems. On the one hand is the money economy where transactions predominantly take place with money as a medium of exchange and on the other is the non-monetized rudimentary economy where the subsistence economy and barter dominate. The other kind of dualism refers to the formal financial system with the banks and other formal financial intermediaries as distinct from the informal system made up mostly of various shades of rotating credit systems and moneylenders. The poor usually operate in the non-monetized system and/or the informal financial system.

In the 1980s, when most African countries adopted an IMF/World Bank supported Structural Adjustment Programme (SAP), financial sector reforms formed a major part. The

financial sector reform involved institutional restructuring, enhancement of the legal and regulatory framework for banking operations, and liberalizing interest rates. Clearly, The financial sector reform has more to do with the formal system than with the informal sector activity. In particular, policy reform by way of interest rate liberalization affected the formal sector directly and any impact on the informal financial activity was only secondary. Arguably, a credible transmission channel for the reforms to reach the poor will be through institutional and regulatory reforms via quasi-informal market.

This essay investigates the impact of financial sector reforms on poverty reduction. The main aim here is to assemble and crystallise thoughts and research in this area with the aim of informing policy-making. It will also attempt to point out policy-relevant issues that may require further research.

The rest of the paper is organised as follows: the next section looks at what the financial sector reforms entail. We will pick on example of the reform in Ghana to illustrate the elements involved. Section 3 looks at the poor and their need for financial services. Section 4 investigates whether the financial reforms have had any impact on poverty reduction. We conclude in Section 5 with some recommendations.

2. The Financial Sector Reform

For most African countries, the financial system was virtually underdeveloped in the period up till independence. After the introduction of money in the colonies principally for the reason of taxation, not much was done to develop the financial system of the colonies. There only a few expatriate banks, which catered for the needs of the expatriate merchants. These banks failed to advance loans to local peasants and entrepreneurs primarily because they lacked collateral securities. Credit thus circulated only among the big expatriate commercial houses, which could afford to provide 'good' collateral. The collateral demanded included life assurance policies, stocks, shares, bills and other financial instruments, which could not be found in the portfolio holding of the natives. Thus, after independence, most African governments initiated plans to indigenise their banking sectors so as to make credit easily accessible to the indigenes.

After independence, the pressure to develop economically led to fiscal pressures, which put severe strain on the financial sector. With interest rates fixed at ridiculously low

levels most governments borrowed cheap from the financial system and there by crowded out the private sector. As the economies of African countries run into more macroeconomic problems, the financial sector became more and more distressed. For instance, the high inflation rates experienced in some countries together with the devaluations that were introduced to correct the imbalances left most banks with negative net worth.

In the rest of this section we will describe the financial reform in Ghana, which is the epitome of financial reforms elsewhere in Africa.

The period 1983-1988 was an era of crisis in the financial system in Ghana. High default rates had rendered most bank assets non-performing, the high rates of inflation had wiped out the capital base of most banks, and the weakened confidence in the financial system had adversely affected bank deposits. These affected the ability of the banks to perform their intermediation function properly. This also affected the recovery effort initiated under the ERP. Thus, in 1988, a comprehensive Financial Sector Adjustment Programme (FINSAP) was launched. The FINSAP was financed with an adjustment credit from the World Bank, with co-financing from Japan and Switzerland. The Government of Ghana also contributed by converting its loans to the banks into equity and by paying government guaranteed loans to the state-owned-enterprises.

The financial reform involve institutional restructuring, enhancement of the legal and regulatory framework for banking operations, and liberalizing interest rates. These were carried out in phases. FINSAP-1 covered the period 1988-1991; FINSAP-2 is from 1992-1995; and FINSAP-3 started in 1995.

The major objectives of FINSAP-1 were: (1) to review the legal and regulatory environment and amend the existing Banking Acts and Laws; (2) restructuring the banking sector to make the banks viable and efficient; and (3) revitalize the financial sector by creating new institutions. FINSAP-2 and 3 were to continue with the restructuring of the financial sector.

(i) Regulatory and Legal Reforms

The Banking Law (PNDCL 225) was revised in 1989. The innovations in the new law included (i) the tightening of risk exposure limits, (ii) establishment of tighter capital adequacy ratios, (iii) strengthening of accounting standards and making them

uniform for all banks, (iv) broadening the scope for audits of the banks, (v) imposition of stringent reporting requirements, and (vi) improvement of on-site and off-site supervision of banks by the Bank of Ghana. A revised Bank of Ghana Law (PNDCL 291) was also enacted in 1992 to give more supervisory powers to the central bank. These two laws together provide the legal and regulatory framework for the banking business in Ghana.

In order to bring more financial institutions under the purview of the Bank of Ghana a Financial Institutions (Non-Banking) Law (PNDCL 328) was also enacted in 1993. This law covered the activities of discount houses, finance houses, acceptance houses, building societies, leasing and hire-purchase companies, venture capital funding companies, mortgage financing companies, savings and loans companies, and credit unions.

(ii) Financial Restructuring

The reforms also involved management and financial restructuring of the banks. New boards were created for most of the banks and there were shake-ups in the top management positions as well. Financial restructuring involved in the main the recapitalization of the banks with equity injection where liquidity was low, and the cleaning up of their balance sheet of non-performing assets.

(iii) Institutional Restructuring

There was also institutional restructuring of the financial system involving the establishment of new institutions, mergers and liquidation of banks and divestiture of public sector shareholding in some of the banks. Under the FINSAP, five new banks and twenty non-bank institutions were established. This was to encourage competition in the financial sector. In 1995, the Social Security Bank merged with the National Savings and Credit Bank. Under the institutional restructuring, the money market was formalized in the creation in 1991 of a second discount house, the Security Discount Company (SDC) to compete with the Consolidated Discount House (CDH), which was created in 1987. Both were wholly owned by the banks in Ghana and charged with carrying out interbank operations. These institutions help optimise the allocation of resources within the

banking sector and facilitate proper mobilization of resources to the needy sector; thus, reducing structural imbalances in the system.

Although the first rural bank in Ghana was established in 1976, the period of the financial sector reform saw a lot more of them coming up. This was to make up for the inability of the commercial banks to reach the rural areas and also to support agriculture. The rural banks were established as small unit-banking operations, which are owned and managed by the rural communities. The central bank also owns shares in the rural banks and also acts as their supervisor. The prime aim was to mobilize savings from the rural folk and also to help cottage industries.

(iv) The Capital Market

Under the FINSAP, Ghana's capital market was established in 1989. The Ghana Stock Exchange (GSE) began full operations in November 1990 with 12 listed companies and one Government bond. Market capitalization within the first two years of operation increased from 30 billion cedis in 1991 to 43 billion cedis in 1992 while the listed companies increased to 15. In 1993, the total market capitalization went up by about 120 percent to 95 billion cedis. Thus, the GSE established itself as a profitable investment venture for the Ghanaian economy with total capital gains amounting to 123 percent at the end of 1993.

There is no doubt that the Ghana Stock Exchange has the potential to attract long-term financing of investment in Ghana. During the seven years of its existence, the market has raised about 140 billion cedis and US\$ 4.8 million through equities and bonds and the number of listed companies has risen to 21.

(v) Interest Rate Liberalization

Under the financial reform interest rates have been deregulated. This move was in part to encourage competition among the banks. But, the deregulation of the interest rate was also to conform to the new form of financial programming Ghana was following under the Structural Adjustment Programme (SAP). Under the SAP, Ghana was using the money supply as the nominal anchor. This implied that the price of money (the rate of interest) should be determined by market forces.

The move towards interest rate liberalization was a gradual process. The first distinctive move was the abolition, in September 1987, of the maximum and minimum deposits, except the minimum saving deposit rate, which was temporarily maintained at 12%. In February, 1988 minimum lending rates for commercial banks were also abolished and by March of 1989 commercial banks were given the right to determine their own rates and display them in their banking halls. In November 1990, there was further liberalization of the financial sector by the abolition of 20% mandatory lending to agriculture. Thus by the beginning of 1991 the financial sector was almost liberalized. Since the liberalization, both real lending and real Treasury bill rates have been positive. Saving rates have been struggling to stay positive. This is reflective of the weak mobilization efforts by the banks since most savers would rather hold their idle balances in the form of the relatively risk-free but high yielding government bills.

3. Financial Habits of the Poor

Poverty is sometimes difficult to define. Some times using an absolute standard of welfare (e.g. amount of income, consumption, life expectancy, housing conditions), one can be described as poor. As against this absolute measure of poverty, there is also the *Relative* measure which identifies the poor by relating their position to another individual or an international average. Sometimes we identify the poor by certain characteristics. Usually, the extreme poor (also sometimes referred to as the "hard-core poor") are more likely to be underweight, susceptible to illness, and have higher mortality rates; they are the least likely to own assets (e.g. land) and have severe fluctuations in their employment status. Their immediate challenge is to obtain adequate food/nutrition in order to survive. If their income increased, they would spend proportionately more on food than anything else.

Although qualitative indices are very relevant for understanding the poor, they can also give rise to speculative conjectures. Thus in most cases poverty analysis is based on quantitative expressions using income expenditures. Apart from the more conventional approach based on income expenditures, the amount of calorie in-take and even social indicators such as security, freedom from harassment and dignity can all indicate poverty levels [Chambers, 1988]. Salmen (1992) defines as absolute poor those

with income-per-person too low to afford 2,250 calories per day and thus at risk of poverty-induced under-nutrition.

If we use the generally accepted income definition and characterized the poor as those with little or no money, one then wonders what kind of financial services the poor will demand. Can those with little or no money save or invest? The poor in the villages of Africa have since time immemorial been engaging in non-monetary saving. Thus most from rural households in Northern Ghana would save the cattle and use it as dowry when their sons get married. But do the poor do financial saving?

Zellar and Sharma (1998) pointed out that “the myth that poor households in developing countries, who often earn less than a dollar a day, are not credit worthy or able to save has been firmly put to rest in recent years”. This view is supported by other writers like Rutherford (1999). In their opinion, poor households, place special value on reliable and continued access to different types of financial services, which are available at reasonable cost and cater for their specific needs. The authors noted that the availability of credit and savings facilities could help poor rural households manage and often augment their meager resources and acquire adequate food and other basic necessities for their families. In addition, short- term borrowing or savings are often used to maintain consumption of basic necessities when household incomes decline temporarily — after a bad harvest or between agricultural seasons, for ex ample.

Rutherford (1999) gave three reasons why the poor need to save to accumulate large sums:

- Life-cycle needs – dowry, funeral expenses, childbirth, education, home building, widowhood, bequest.
- Emergencies – *personal emergencies* such as sickness or injury, loss of employment, or the death of a bread winner; *impersonal emergencies* such as war, floods, fires, drought, or the displacement of slum dwellers by the authorities.
- Opportunities – investing in existing or new business, buy land or other productive assets.

Rutherford (1999) argues that there are three ways in which the poor raise the large sums they need:

1. by selling assets they already hold (or expect to hold).

2. by taking loan by mortgaging those assets
3. by finding ways of turning their small savings into large sums.

The first method does not usually require 'financial service' but the second and third usually require the use of a financial institution. But the formal banks usually shun the poor.

Research by Musinguzi and Smith (2000) examining savings and borrowing behaviour in rural households in Uganda concluded that

- Lack of savings was due to low income and lack of access to financial institutions due to poor confidence in them. Households savings were not directed at productive ventures but rather future consumption on needs such as school fees and medical expenses
- Borrowing was less prominent in the rural areas as compared to those at the urban areas or trading centers. Reasons for not borrowing ranged from lack of collateral, lack of access, risk of non-repayment or refusal by the lender. Those who borrowed obtained accessed them mainly from informal sources such as friends, relatives and sometimes in the form of assets rather than finance. The use of loans was however not directed at productive ventures such as farming inputs but for medical expenses, rent and food.

Another survey by Zellar and Sharma (1998) in nine countries including 5 from Africa, found that

- A large number of poor households in developing countries experience real constraints in the financial market due to unfavourable prevailing transaction terms
- Because the cost of failure can be high at extremely low incomes, poor households are likely to be risk averse and sensitive about the projects they choose to finance. Access to credit may enhance their capacity to bear risks and therefore indirectly foster technology adopted and asset accumulation.
- Poor households in Africa and Asia face complex, multiple constraints on earning opportunities. They lack education, markets, and other essential services. Thus the impact of financial services on welfare is likely to vary with accessibility to complementary inputs such as irrigation, education, and market services.

Because of the rejection by the formal sector, the poor seek their financial services from the informal sector.

Institutions in the informal financial sector include deposit collectors, money lenders, Rotating Savings and Credit Associations (ROSCAs). These informal mechanisms vary from country to country but their basic operation is to provide a means for accumulating large sums by the poor. Deposit collectors will accept people's savings and return a lump sum to them, moneylenders will provide the lump sum up front and then collect 'savings' in repayment, and ROSCAs allow people to get together and make savings from which each in turn takes a lump sum.

But do these mechanisms cater for the financial needs of the poor? Rutherford (1999) argues that these mechanisms are time-bound, while the needs of the poor for basic financial services are never ending. In addition the poor lose interest by saving through these mechanisms. Further more these mechanisms do not have the flexibility of the formal system in terms of savings and withdrawals. Besides, these mechanisms for satisfying basic financial needs is built on trust and carries too much risk.

Wright and Mutesasira (2001), compared risks associated with savings of poor people in Uganda and found that those who were lucky to have access to the formal sector were less likely to lose any savings and in terms of relative loss they were better off than those who saved in the informal sector. Those with no option but to save in the informal sector were almost bound to lose probably about one quarter of what they save there.

4.4 Bank Response to Liberalized Policies

The relationship between financial structure and economic activities has long been established [McKinnon (1973), Shaw (1973)]. This relationship hinges, on the one hand, on the importance of saving and investment in the determination of a nation's output; and on the other, in the role of financial intermediaries in the saving-investment process. A collapse in the confidence of either borrowers or lenders can break the link between saving and investment and may lead to decline in economic activity.

The link between financial structure and real activity cannot be overemphasized in any economy in particular in relation to the role of financial intermediaries in the credit supply process. Ghana has one of the lowest domestic savings rates in Sub-Saharan Africa. For example, total savings as a percentage of GNP fell from about 17 percent in 1960 to about 1 percent in 1982. The corollary to this was that investment in the country also fell. From a level of 14.2 percent of GDP in 1970, investment also dropped to about 1.3 percent of GDP by 1982. After years of structural adjustment, the ratio of domestic saving to GDP in 1995 stood at just about 12 per cent.

Whereas governmental policies have not done much to encourage savings by Ghanaians, the banks themselves have not done much by way of mobilizing funds. After years of controlled interest rates which culminated in a regime of financial repression, interest rates were deregulated and allowed to be influenced by market forces.

Unfortunately, interest rate movements since the liberalization have not produced the advantages envisaged. For example, the essential argument in favour of abandoning direct controls is that, where the controls are enforced and are effective, they force banks and other financial institutions to adopt portfolio positions (patterns of lending and borrowing) which are different from those which the banks would choose if they were left entirely to their own devices. In particular, the risk-return configuration of bank lending was distorted by the administrative direct controls of interest rates. Thus through interest rate liberalization, the banks were expected to optimise their portfolio management.

However, since the liberalization, as if by collusion, the banks display similar rates with an ever widening gap between lending rates and deposit rates. The lending rates closely follow the hikes in the discount rates while the saving rates remain either the same or even fall. Since 1990, saving rates have hovered between 9 percent and 24 percent while lending rates have been in the range 17.5-39 percent. This gives a spread of over 10 percent between the lending and the saving rates. Such wide spreads coupled

with safe investments provided to the banks through the sale of securities lead to a weakening in the intermediation function of the banks.

Appendix A: Annotated Bibliography