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Role of the State in Financial Sector Development in Sub-Saharan Africa

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A major lesson in development knowledge and practice during the 20th century is the realisation that neither the free market nor pervasive state intervention and control, working alone, can lead to sustainable development (Ajakaiye, 1990, Adelman, 1999). The challenge, therefore, is to secure a social order where welfare of the people is maximised in an environment where the ingenuity, enterprise and initiatives of private individuals and organisations are combined with a purposive state intervention, regulation and guidance. Clearly, this social order requires full participation of all stakeholders in the development process, ranging from problem identification, selection of priority actions, implementation, monitoring implementation and assessing impact or outcomes. In such an environment, enduring cooperative relationship should exist amongst the social partners, viz., business community, government officials, politicians and political office holders, labour unions and the civil society organisations. Such cooperative relationship should rest squarely on intensive formal and informal discussions and consultations in an environment of mutual respect, trust and sincerity of purpose. In such an environment, development in all sectors of the economy and society are well coordinated in a mutually reinforcing manner.

Economic development requires growth with structural and technological change (Ajakaiye, 2003). Therefore, growth is a necessary but insufficient conditions for economic development. In sub-Saharan Africa (SSA), growth increased from an annual average of 1.7 percent between 1980 and 1990 to 2.8 percent between 1990 and 2003 (World Development Indicators, 2005). On the other hand, the structure of output of

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the region remained largely unchanged between 1990. Again, as shown in the World Development Indicators, 2005, there was no perceptible structural transformation of the African economy. Output remained dominated by crude materials production (in the form of agriculture and mining) and services while the contribution of transformation activities (manufacturing) was small and generally falling. In contrast, the share of agriculture in total output for East Asia fell from 29 percent in 1980 to 14 percent by 2003; the contribution of manufacturing, which was already high by 1980, increased further by 2003.

With respect to technological change, electric power consumption per capita as at 2002 was only 457 kWh compared to 849 kWh for East Asia; telephone lines per 1000 persons was only 11 as at 2003 (the lowest in the world) compared to 161 in East Asia; mobile phone lines per 1000 persons as at 2003 was only 52 compared to 195 for East Asia; and Internet users per 1000 persons was only 20 compared to 68 for East Asia. With respect to the number of researchers in R&D per million persons and number of technicians in R&D per million persons between 1996 and 2002, only Burkina Faso, Central African Republic, Republic of Congo, Guinea, Madagascar, South Africa, Uganda and Zambia had non-zero entries. All other SSA countries had either zero entries or the data was not available. Clearly, while there was considerable improvement in growth, there was no structural change in output, largely as a result of technological backwardness. Evidently, whereas the over 7 percent growth of output in East Asia was accompanied by structural and technological change, the very miniscule growth in output of SSA was characterised by structural retrogression and technological backwardness. Thus, while there are indications of economic development in East Asia, there was none in the case of SSA.

The primary role of the financial sector, especially in a developing, is that of mobilising financial resources from the savers and directing these resources into channels of desired development activities. Thus, the pioneering works of Gurley and Shaw (1967), Shaw (1973) and McKinnon (1973) drew attention to the relationship between real and financial developments in terms of the role of financial intermediation, monetisation and capital formation in determining the path and pace of economic development. The financial sector is made up of the banking sub-sector and the stock or capital market. Again, financial sector development requires growth in the volume of activities as well as changes in the structure of the market. Probably more important is the changing character of the linkages between the financial sector and

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the rest of the economy. Generally, as the economy develops, the expectation is that the volume of transactions in the financial sector will increase and there will be less reliance on the banking sector, at least, for long-term credit.

Available data suggests that the financial sector in SSA is lagging behind that of the rest of the world. For instance, the M2/GDP ratio, which was 32 percent in 1990, increased marginally to 37 percent by 2003. In the case of East Asia, the corresponding figures are 63.1 and 158.8 percent respectively. The SSA figures are less than 50 percent of the world average. In terms of efficiency, despite the series of unilateral and structural adjustment programmes induced liberalisation of the banking sector in SSA, the interest rates spread increased from 8.2 percent in 1990 to 12.4 percent by 2003. In the two periods, the interest rates spread for SSA was the highest in the world implying that the SSA banking sector remains the least efficient in the world.

Turning to SSA stock market, market capitalisation, which is one of the measures of size, was about $143 billion in 1990. By 2004, it has doubled to reach $294 billion. Impressive as this seems, it is extremely inferior to the growth of East Asian stock market size, which increased from about $87 billion in 1990 to over $1 trillion by 2004. Another measure of size is the number of listed domestic companies. For SSA, there was a decline in the number of listed companies from over 1000 in 1990 to about 900 by 2004 while in the case of East Asia, the number increased from 774 in 1990 to 3,582 by 2004.

In view of the relatively poor performance of the SSA economy and its financial sector, it is clear that the role of the state in the financial sector development has to go beyond the usual provision of regulatory frameworks as this presupposes that the market exists in the first place. To provide a basis for the articulation of the roles of the state in financial sector development of the SSA countries, I will briefly discuss the dominant channels of linkages between the financial sector and the economy in the next section. The concluding section contains suggestions on the roles of the state in creating and expanding the size of the financial sector in SSA.

Channels of Linkages Between the Financial Sector and the Economy

In characterising the role of the state in the financial sector of SSA, it should be instrumental to briefly describe the channels of linkages between the financial sector and the economy. In this connection, it is

pertinent to take account of the fact that the functioning of an economy involves the production of goods and services (production); generation of income as factors are compensated for their contributions to production (income-generation); and usage of a part of income generated to purchase final goods and services while saving the other part (expenditure and savings). As economic agents, (household, businesses and government) carry on their consumption and production activities, they need the facilities of credit (short and long-term credit) and equity (financial services) provided by the financial sector. These financial resources can be injected through supply (production) channel or through demand (final consumption) channel. In reality, financial resources are injected into the system through a combination of both channels. However, at any point in time, one of these two channels may be dominant and the role of the state in the financial sector development should be influenced by the imperatives of the predominant channel and the level of development of the economy. It is, therefore, important to briefly sketch the workings of the two channels bearing in mind the above stylised facts about an economy.

Workings of the Demand Channel

When the bulk of the financial resources is used to boost the consumption of final goods, then demand channel is dominant. In that case, empirical specification of the aggregate consumption function may look like the followings:

$$C = f(Y,M);\ f'y,\ f'm > 0 \qquad (1)$$

Where,

C = private and government final consumption expenditure

Y = income

M = financial resources (mainly in the form of credit).

Equation (1) says that increase in income and or financial resources will lead to an increase in private and government final consumption expenditure. Accordingly, when the banking sector makes more financial resources available to consumers, the immediate effect is for the increased effective demand to put upward pressure on prices. Through higher prices, the increased financial resources will be funnelled to the producers. Meanwhile, ceteris paribus, rising prices will lead to increased output as existing producers step up action and/or new producers, attracted by high profits come into the economy to set up. Ultimately, the level of economic activities (consumption and production) will be

higher. Needless to say, the possibility and speed of realising these outcomes depend, among other things, on the existence of excess capacity and the degree to which the economy is self reliant in production and consumption. The desirability of the outcomes will also depend critically on the extent to which the structure of production, determined by the expenditure pattern, conforms to the long-term development aspirations of the people.

Nevertheless, whenever the demand channel is predominant, a rise in bank lending rate will make credit more expensive and, hence, reduce effective demand. Reduced demand will force producers to lower prices to clear the market. Under this circumstance, increases in interest rates should be efficacious in fighting inflation as it should help choke off excess demand for goods and services on account of higher cost of funds needed to finance final consumption expenditure.

In such an economy, the capital market will be very deep and active and corporate bodies will normally patronise this market for investment fund while relying more on retained earning and other internal sources such as accounts payables for finance most of their working capital. Also in such an economy, monetary policy takes into account the level of capacity utilisation. In general, when the capacity utilisation is reaching around 75 or 80 percent, the monetary authorities will invariably pursue high interest rates policy to manage demand and this signals to the real sector producers that it is time to seek investment fund from the capital market to expand capacity. As soon as new capacity comes on stream, the level of capacity utilisation will drop to between 60 and 70 percent, at which time the monetary authorities will commence downward review of interest rates. In general, monetary policy is not permanently restrictive, as it tends to oscillate between restrictive and expansionary policy depending on the level of capacity utilisation.

Observers of the US and EU monetary policy postures will find empirical support for this pattern of monetary policy formulation implying that the demand channel is, indeed, the dominant one. In these developed economies, the financial sector is fully developed in the sense that the banking and capital markets are fully established. In essence, an economy where the linkage between the financial sector and the economy is dominated by the demand channel is one where the banking sector meets the financial services required by consumption activities and the capital (bond) market meet the financial services required by production activities. In such economies, the role of the state can be limited to regulation and surveillance.

Workings of the Supply Channel

Supply is predominant when the bulk of financial resources is used to boost the production of goods and services. The relationship can be specified thus:

$$Q = f(K,L,M);\ Q'k\ Q'l\ Q'm > 0 \qquad (2)$$

where,

Q = Output

K = Physical capital

L = Labour

M = Financial Resources (credit).

Equation (2) says that output will increase if there is an increase in the supply of capital, labour and financial resources which is mainly in the form of short and long-term credit. The transmission mechanism goes thus. When there is an increase in supply of financial resources to producers, part of it will be used to finance variable inputs (working capital) while the remaining part will be used to finance increase in physical capital (investment) thereby increasing production capacity. The increase in credit via the process of transfer of real assets and payments for inputs is transmitted into income which invariably leads to increases in final consumption expenditure and savings. Consequently, increase in demand may lead to increases in prices of certain commodities. This event, however, depends on the length of the production cycle and existing stock of inventory of finished goods. The increase in saving as a result of increase in income, on the other hand, will lead to an increase in the financial resources which can be mobilised by the financial sector. This invariably makes more funds available for investments.

Under this channel, an increase in the cost of credit will lead to a reduction in output as producers reduce their demand for credit. Besides, cost of production will increase as a result of the increased cost of funds. Where feasible, the cost increase will be passed on to prices especially where a large proportion of working capital is financed from borrowed funds. Otherwise, the profit margin and hence, the possibility of relying on internal source of funds to meet financial resource requirement will be reduced thereby further discouraging any expansion in output.

In the supply channel, interest rate and prices are positively related, contrary to the expectations of the proponents of financial repression framework. As succinctly put by Thomas Tooke (1844) and as cited by Humphrey (1986):

"A general reduction in the rate of interest is equivalent to or rather

constitute a diminution in the cost of production... in all cases where an outlay of capital is required... The diminished cost of production hence arising would, by the competition of producers, invariably cause a fall of prices of all the articles into the cost of which the interest of money entered as an ingredient." (p. 144)

In the same vein, Patman (1952) asserted that, "The more interest that business must pay for the capital it uses the more it adds to cost of doing business. To that extent, increases in interest rates are inflationary". (p. 735)

It should be noted that when Tooke and Patman were making their assertions, the Western European economies were at the initial stages of modernisation. Their capital markets were quite rudimentary and the producers relied heavily on the banking sector for working capital and investment funds. In other words, the supply channel was dominant and this realisation informed the conduct of financial sector policies during the early 19th century. By the middle of the 20th century, the demand had become dominant. Accordingly, the financial sector policies changed to what it is today. However, largely under the influence of the international financial institutions, many developing countries embarked on financial sector policies similar to those of the present day developed countries ignoring the fact that the supply channel of linkage between the financial sector and the economy is still dominant. Consequently, there is widespread disappointment in outcomes.

Role of the State in SSA Financial Sector Development

Clearly, in an economy where the supply channel of linkage between the financial sector and the economy is dominant, the financial sector itself is dominated by the banking sub-sector with the capital market either non-existent or quite rudimentary. Evidently, this is a better approximation of the situation in virtually all of the SSA countries. The role of the state in financial sector development in SSA should, therefore, go beyond regulation and surveillance of the banking sector to the establishment and deepening of the capital market.

For this purpose, the state should intervene to get things started in the capital market. Therefore, the reform of public sector enterprises should be instrumental in establishing and deepening the capital market. To begin with, the lucrative public sector enterprises should be commercialised and given necessary institutional framework (including incorporation as companies) that will enable them to form the foundation stocks

of the capital market. The investment programmes of such enterprises should cease to be funded by government treasury once they are listed in the capital market. Instead, they should issue bonds in the nascent capital market as a way of gradually diluting the ownership. Over time, the share of government in the total equity of the companies should be falling and this process can be speeded up by government offering its own stock for sale to the nascent investing public. The next step is for the government to pursue aggressive reform measures to make hitherto unprofitable public sector enterprises quite profitable and hence eligible for commercialisation and subsequent listing on the national stock exchange. This way, the number of enterprises listed on the national stock market will increase and the market capitalisation will also grow.

It is imperative to recognise that in order to sustain the growth of capital market in SSA, the prevailing syndrome of minimalist state should change. Instead, government should be seen as an agent that plays three inter-related roles in the development process in general and the capital market development in particular. The first role is that of an enabler where government creates enabling environment for all economic agents to maximise their socially acceptable welfare.

The second is that of a frontier shifter where government continues to invest in sectors and activities which are either too risky or too large for private entrepreneurs. A contemporary example is the role of the US government in the space programme between 1960 and now. It should be recalled that it is only recently that private sector involvement in the sector as investors becomes perceptible. This is because the government has shifted the frontier considerably and it is now possible for the private sector to exploit the new field. Outer space programmes are still entirely in the responsibility of governments of the developed countries. It is, therefore, inappropriate for anyone to restrict the roles of governments of SSA countries and, indeed, developing countries to that of an enabler. Instead, what is required is to continuously build capacity and retooling the public sector to be able to play the roles of an enabler and a frontier shifter. In order for government to be able to play the role of frontier shifter without regular recourse to the budget, public sector enterprises should be sold at appropriate prices and the proceeds should be kept in development fund accounts that can only be used for frontier shifting investment programmes.

The third role of the state is that of initiating development activities. In other words, state intervention is required to get things started in an otherwise green field. This is essentially similar to the second role of the

state except that the fund for these activities will have to come from the development budget. It is reasonable to presume that with the exception of countries emerging from wars and severe state breakdowns, most SSA countries have passed this stage. However, states emerging from war situations and or those that really have nothing to privatise should not be precluded by the current development paradigm from creating public enterprises. The challenge for development practitioners and policymakers is to design appropriate monitorable framework for progressing towards commercialisation and privatisation at the earliest possible time. The current strategy of preventing the state from initiating development activities in areas where the private sector is either unwilling or unable to venture is tantamount to compromising development prospect of the present day developing countries. The point here is that the role of the state in financial sector development in SSA should be viewed from the prism of a developmental state. Development partners, practitioners and policymakers should be preoccupied with the articulating strategies for ensuring that the state does not deviate from the path of a responsible developmental state. This is imperative if SSA countries are to catch up with East Asian countries, keep pace with them and possibly surpass them.

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