Report of the Proceedings of the International Conference on Finance and Development: Evidence and Policy Issues

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The Kenya Institute for Public Policy Research and Analysis (KIPPRA) and Finance and Development Research Programme (Europe), University of Manchester

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KIPPRA in Brief

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List of Abbreviations

ACSM	Augmented Capital Structure Model
BCCI	Bank of Credit and Commerce International
BSE	Mumbai Stock Exchange
CAR	Capital Adequacy Ratio
CBK	Central Bank of Kenya
CSW	Commercial Sex Workers
DCs	Developed Countries
DfID	Department for International Development
DFIs	Development Finance Institutions
EMH	Efficient Market Hypothesis
FDI	Foreign Direct Investment
FDRP	Finance and Development Research Programme
FINSAP	Financial Sector Adjustment Programme
FOREX	Foreign Exchange
GARCH	Generalised Auto-Regressive Conditional Heteroscedasticity
GATT	General Agreement on Trade and Tariffs
HIPC	Highly Indebted Poor Countries
IDPM	Institute for Development Policy and Management
IDS	Institute for Development Studies
IPAR	Institute of Policy Analysis and Research
ISS	Institute for Social Studies
KIPPRA	Kenya Institute for Public Policy Research & Analysis
KTMM	KIPPRA/Treasury Macroeconomic Model
LDCs	Less Developed Countries
MFIs	Micro-Finance Institutions
MSEs	Micro and Small Enterprises
NBFIs	Non-Bank Financial Institutions
NBSSI	National Board for Small Scale Industries
NGOs	Non-Governmental Organizations
OECD	Organization for Economic Cooperation & Development
PCA	Prompt Corrective Action
SACCOs	Savings and Credit Co-operative Societies
SEBI	Securities and the Exchange Board of India
WTO	World Trade Organisation

CONTENTS

Executive Summary

A lot of research has been done in finance and development with the aim of establishing the direction of causality. This effort has been necessitated by the fact that important links exist between finance and development. Although there is no unanimous agreement among economists as to what leads to the other, there is substantial evidence that financial development is an important prerequisite for economic development. However, the movement from finance to development is a complex process that requires a careful analysis, given the unique characteristics of the financial market and the intricate links between private and public finance. Gaining an insight into the many aspects of finance and how they translate into development formed the core objective of the conference.

More importantly, the conference came at an appropriate time to shed some light on the implications of current financial reforms and chart the way forward. Indeed, there are many issues emanating from these reforms that require an objective analysis. These include the kind of public policies needed to promote competitive financial markets, the effects of macroeconomic management on financial development, and regulatory issues. There is also need to understand the implications of globalisation on finance, the role of rural finance and micro-finance institutions and the role played by non-bank finance institutions.

The conference was organised by the Kenya Institute for Public Policy Research and Analysis (KIPPRA) and Finance and Development Research Programme (FDRP) in Europe, and funded by the British Department for International Development (DfID). It sought to provide a forum for sharing of ideas among finance and development researchers and practitioners in Africa and the rest of the world. Participants were drawn from government ministries, the Central Bank of Kenya, universities, research institutions, financial institutions, non-governmental organisations and the private sector. The Vice President and Minister for Home Affairs, Prof. George Saitoti, officially opened the conference and participated in some of the discussions.

The two-day conference was organised in two parallel groups (A and B) with eight (8) sessions. Group A dealt with international financial flows, financial sector reforms, savings, and finance and development. Group B focused on corporate capital structure, micro-finance and rural credit markets. The first (plenary) session was devoted to introductory and welcoming remarks by the Director of KIPPRA and the official opening speech by His Excellency the Vice President. This was followed by presentation of four (4) papers. Other sessions focused on international financial flows, financial sector reforms, savings and development; bank performance and regulation; flow of funds and finance in conflict and reconstruction; banking regulation; corporate capital structure, micro-finance and rural credit markets; emerging stock market (reforms and performance) and financing development; and corporate financing and financing issues. A plenary discussion and the way forward concluded the conference.

SESSION 1: INTRODUCTION, OFFICIAL OPENING AND PLENARY PAPERS

The Executive Director of KIPPRA formally welcomed participants to the workshop, gave brief introductory remarks and highlighted the workshop objectives. He then invited the FDRP (Europe) representative, to make the first opening statement before inviting His Excellency the Vice President to officially open the workshop.

1.1: Statement from KIPPRA

The Executive Director of KIPPRA, Prof. Mwangi Kimenyi, thanked all participants for attending the workshop. He also thanked the FDRP in Europe for collaborating with KIPPRA in organising the workshop. The director described KIPPRA's mission as that of carrying out public policy analysis and capacity building. He thanked His Excellency the Vice President and the Minister for Home Affairs for having availed himself at the conference despite his tight schedule. With these few remarks, the Director invited the Vice President to give the opening address.

1.2: Official opening speech by His Excellency the Vice President and Minister for Home Affairs, Prof. George Saitoti

His Excellency the Vice President and Minister for Home Affairs, Professor George Saitoti started by thanking the participants and organisers of the conference. He noted that the conference came at a time when there was great need to take stock of the successes and failures of the financial reforms in Africa and find suitable options for the future development of the sector. In his remarks, Hon. Professor George Saitoti expressed concern over the role of donor funding and its implications on external debt. He argued that policy reversals/failures were partly due to stringent donor conditionalities and noted that there is need for both the recipient country and the donor to negotiate before implementation of policies. He expressed concern over the enormity of the domestic debt and advised that externalising it would ease pressure on interest rates (see appendix for full speech).

After the formal opening of the workshop, Hon. Saitoti sat through the first two presentations and responded to a number of questions raised by the participants.

PAPER PRESENTATIONS

1.3: Financial sector liberalisation in Kenya: the critical issues

Njuguna Ndung'u (KIPPRA)

The paper studies financial regulation in Kenya and raises some critical issues. The paper notes that financial liberalisation involves removal of controls on interest rates; establishment of freedom of entry and orderly exit; reduction of cash and reserve ratio requirements; minimising credit allocation guidelines; liberalisation of the foreign exchange transactions and the capital account; and use of indirect instruments of monetary policy.

Financial liberalisation in Kenya has been associated with banking crisis; high interest rate spread; widening of the resource gap; depression of savings and investment; slackening of financial deepening; increased poverty; open market operation limited to the primary market; and tight money paradox. This may be explained by the inappropriate effects of indirect instruments of monetary policy; macroeconomic instability; poor sequencing; power of interest groups; a segmented financial market; and heavy government presence in two major banks. Other factors that explain the above outcomes are interest rates movements that do not reflect the level of economic activity and banking sector dominance with an oligopolistic structure. Financial liberalisation in Kenya commenced when there were controls on foreign exchange, imports and capital account transactions.

1.4: International financial flows and the challenges of financing development in Africa: an overview of challenges, prospects and implications

Alemayehu Geda (ISS/KIPPRA)

The paper examines the role of international capital flows in financing development in Africa. It reviews the recent growth performance of the continent, the challenges of reducing poverty and how this growth might be financed. It also examines the prospects of Overseas Development Assistance (ODA), foreign direct investments (FDI) and other capital flows, and also touches on the problems of capital flight and external debt. The paper indicates that the prospect of ODA flows is no longer bright. Encouraging FDI and other capital flows is therefore vital in bringing about sustainable capital flows to Africa. It points out that reversing capital flight and debt cancellation could bring about meaningful change in alleviating the financing problem. Because the new financial architecture does not seem to address possible problems that African countries face, the implication is that the role of international capital flows in financing development in Africa remains a formidable challenge to policy makers and development partners in the years to come.

1.5: The participation of foreign-owned banks in the domestic banking sector of African economies

Victor Murinde and Moses Tefula (University of Birmingham)

The paper examines the degree of foreign bank penetration in the domestic banking market and the impact of foreign bank participation on the lending behaviour of domestic banks. The paper first critically reviews and disintegrates the competing views on the role of foreign-owned banks in African economies. It then analyses whether ownership can explain differences in the banks' lending patterns by examining lending patterns of domestically owned local banks in comparison with those of foreign-owned banks. The paper devices a plausible and consistent methodology using Bank-Scope databases for sub-Saharan Africa. The results of the study suggest that:

(i) Foreign penetration has a significant impact in the activities of the commercial banking sector in sub-Saharan Africa.

(ii) Foreign banks increase competitiveness and efficiency.

(iii) There are no significant differences between asset penetration and loan penetration. This implies that foreign bank participation in the loan market is proportionate to overall investments.

(iv) Bank loan supplies and growth patterns are similar for both domestic and foreign banks, but increased foreign participation reduces the viability of loan supply.

(v) There is no significant difference between non-performing loans of foreign and domestic banks.

(vi) Foreign banks are more profitable but not necessarily better capitalised although increased foreign participation enhances liquidity management and overall capitalisation of banks for both domestic and foreign banks.

1.6: The implications of the evolving micro-finance agenda for regulatory and supervisory policy

Kirkpatrick, C. (Institute for Development Policy and Management (IDPM) and Maimbo, S. (University of Manchester)

The paper discusses the implications of the evolving micro-finance regulation and supervision. It considers the implications of recent trends in providing the poor with financial intermediation services for regulatory and supervisory policy, and discusses the alternative regulatory models that have been proposed to match the pace of innovation, diversity and development in the micro-finance industry. The paper concludes that in the interim, it is important that research be directed at establishing a consolidated set of core principles for effective micro-finance activities that national regulators can translate into specific performance benchmarks, guidelines, rules and regulations.

Questions and Discussions

- Moses Makayoto asked why civil wars were endemic in Africa. In response, Hon. Prof. Saitoti cited unequal distribution of resources and marginalisation of some groups as one of the root causes of wars in Africa. He underscored the need for Africa to solve existing conflicts and come up with policies to prevent further conflicts.
- A local businessman, Chris Kirubi, asked how Africa could empower the blacks by empowering businesses run by indigenous people. The Vice President noted that there was need for rural-urban balance in banking services and strategies to alleviate poverty in rural areas. In reply to a question by a participant on why donor-funded projects in Kenya are not sustainable, Prof. Saitoti cited cases where donors insist on their own suppliers of materials, equipment and personnel, therefore giving recipient countries a raw deal.
- A participant asked whether selling 49 percent of shares in Telkom (Kenya) ownership would bring down interest rates. Honourable Saitoti responded that it was true that the sale could relieve domestic debt to some extent, and noted that the whole issue revolves around effective privatisation process in general.
- On why most African governments were uncomfortable with massive donor inflows through the Non-Governmental Organisations (NGOs), Honourable Saitoti pointed out that NGOs ought to be subjected to the stringent transparency requirements similar to those governments often face when dealing with donors/creditors for financial support. The Vice President noted that it is true that NGO's receive massive inflows, but cautioned that one-man NGOs cannot guarantee transparency.
- Penina Kariuki of the Central Bank of Kenya (CBK) asked whether the nature of bank ownership matters. In response, Victor Murinde acknowledged that bank ownership matters.

However, he explained that data were not available to enable them carry out a detailed analysis.

- ❖ Alemayehu Geda of KIPPRA asked the presenter (Victor Murinde) to comment on the quality of data in general and particularly in reference to Ethiopia. The presenter observed that bank-score data has its own limitations, exclusion of small banks being one of them. He further said that the paper had excluded Ethiopia when grouping the banks according to categories.
- ❖ Peter Kimuyu of the Institute of Policy Analysis and Research (IPAR) asked Victor Murinde whether his data were representative enough to allow him conclude that there is no pattern of lending between the foreign-owned and domestic banks. In response, Victor said that data used in the paper covers up to (five) 5 years and that the data are aggregated. He however noted that an analysis of a cross-section of banks over the years could shed light on the degree of penetration of the banks.
- ❖ A participant asked Victor Murinde to explain what local banks could borrow from foreign banks in order to become competitive. Victor responded that lessons learnt were included in the paper. He however stated that the presence of foreign-owned banks may introduce some element of competition in the market and therefore efficiency. He referred the participant to a study carried out by WTO/GATT on financial institutions.
- ❖ Hezron Nyangito of KIPPRA asked whether the issue of profit repatriation arises from capitalisation. Victor responded that profit repatriation is an issue of further research and that investment patterns need to be identified.
- ❖ Penina Kariuki of the CBK asked whether the conversion of Micro-Finance Institutions (MFIs) to commercial banks was in the agenda. One of the presenters (Colin Kirkpatrick) said that the issue of conversion of MFIs to commercial banks is not a problem as long as MFIs meet the criteria for conversion.

- Maureen Were of KIPPRA asked the presenters (Kirkpatrick and Maimbo) whether they had taken into consideration the diversity of the MFIs and the different purposes they serve. In addition, she wanted to know who would be the best-suited regulator given that the Central Bank was not the best regulator and at the same time MFIs cannot be entirely left to market forces.

SESSION 2: INTERNATIONAL FINANCIAL FLOWS, FINANCIAL SECTOR REFORMS, SAVINGS AND FINANCIAL DEVELOPMENT

Chair: Victor Murinde (University of Birmingham)

2.1: The East Asian crisis and financing corporate investment: is there a cause for concern?

Nigel Driffied (University of Birmingham) and Sarmistha Pal (Cardiff Business School)

In view of limited empirical evidence concerning the microeconomic aspects of corporate financial problems in the East Asian countries, the paper analyses the financing pattern of corporate investment in Indonesia, Korea, Malaysia and Thailand. It examines the role of various internal and external financing variables on corporate investment in the sample countries. The results indicate that a large number of sample firms especially in Indonesia depend on free cash flow. There was also a steady increase in debt-equity ratio in all the countries. There were signs of agency costs in the use of cash flow in Korea and Malaysia and also in the use of debt financing in Malaysia and Thailand.

2.2: International capital mobility: evidence from developing countries

David Ndii (Kenya Leadership Institute)

This paper uses data from 71 countries—49 developing and 22 OECD—to investigate the determinants of long-term international capital flows by use of multivariate GLS, with income growth replaced by an instrument. The results challenge the widespread belief that developing countries, and in particular African countries, are capital-constrained. The massive capital flight from Africa and other developing countries to developed countries should not be a surprise at all. A major shortcoming of models that suggest that capital should flow from rich to poor countries is that they are based on a one sector Cobb-Douglas technology growth model that assumes similar labour productivity across all countries. Once adjustments are made for human capital (differences in labour quality), the productivity differentials between developing and developed countries tend to converge. Indeed, factoring in the quality of labour (human capital), its productivity and external effects reveals insignificant productivity differential between developed and developing countries. This happens even without taking into account the effect of political risk which not only accelerates capital flight from poor countries to rich countries but also blocks new capital flows from DCs to LDCs.

The main findings of the paper are as follows:

- The major determinants of international capital flows are population dynamics and return on capital.
- There exists a close to perfect co-movement of savings and investment in developed countries even though cross-border financial activity in these countries suggests highly integrated capital markets. This high correlation between savings and investments could be a result of the two being driven by common but exogenous factors such as technological progress, population dynamics and relative price distortions.
- In industrialised countries, savings and investments move in the same direction due to the effects of demographic change, government policy and domestic financial market conditions.
- Capital flows from developed countries to developing countries are limited because of capital market imperfections and the fact that the returns to capital across countries are almost the same.

- The low levels of investment observed in developing countries reflect low rates of return on investment rather than a shortage of capital.
- The paper has far-reaching implications for public policy as well as the *aid business*, which, according to the findings, is premised on the wrong assumption that developing countries in general and African countries in particular are capital deficient. Public polices should not merely aim at attracting international capital but should rather aim at making capital more productive by investing more in education, reducing political risk and generally creating an environment that increases the productivity of capital.

2.3: Financial liberalisation in Kenya: where are we now?

Ndung'u, S.N and Kiringai, J. (KIPPRA)

The paper traces Kenya's experience with financial sector liberalisation and reviews the achievements since the liberalisation process was initiated in 1991. It outlines the perceived benefits of financial liberalisation from a theoretical standpoint. Selected indicators are brought out to show the outcomes. The question asked is what factors have led to the dismal outcome in the early years of financial liberalisation? In light of this, the paper assesses the emerging literature on policy mix, sequencing and the necessity of macro-stability for a successful financial liberalisation process. The paper concludes that sound public finance and public debt management is clearly lacking and has had a negative impact in all other aspects of financial reforms. Contrary to expectations, there have been no gains from liberalisation.

2.4: Impact of financial sector liberalisation on competition, innovation and efficiency in the Ghanaian banking industry

Kweku Baa Korsah (KPMG Ghana), Francis Sasraku Mensah (Ghana Commercial Bank), Ernest Kwadwo Nyarko (KPMG), Noel Ayitey Tagoe (KPMG Ghana)

The research aims at empirically clarifying aspects of the debate relating to competition, innovation and efficiency in the commercial banking sector. The primary objective is to establish whether, with the implementation of the financial sector adjustment programme (FINSAP), the banking industry has witnessed increased competition, innovation and efficiency. The investigation is based on Data Envelopment Analysis (DEA), Herfindahl Indexes and Lorenz Curves. It produces a detailed account of how well the banks are prepared to deal with the competitive pressures placed on them by deregulation. The study concludes that the nature, incidence and competition in Ghana have an important impact on market performance and therefore high relevance to devising and applying a competition policy. The cost- efficiency of the industry is only 61 percent implying that the industry loses a substantial portion of its cost to inefficiency.

2.5: Savings and financial sector development: Panel Cointegration Evidence from Africa

George Mavrotas and Roger Kelly

The paper uses integration and cointegration tests for a dynamic heterogeneous panel of 17 African countries to examine the impact of financial sector development on private savings. It uses three different measures of financial sector development to capture the variety of channels through which financial structure can affect the domestic economy. The empirical results obtained vary considerably among countries in the panel, therefore highlighting the importance of using different measures of financial sector development rather than a single indicator. Although the evidence is rather inconclusive, there is a positive relationship between financial sector development and private savings in most of the sample countries. Liquidity constraints do not play a vital role in most of the African countries in the group, since the relevant coefficient is negative and significant in only a small group of countries.

2.6: Child wealth, financial development and savings in Africa: comparative evidence on the old age security fertility motive

David Ndii (Kenya Leadership Institute)

The paper investigates the effects of financial development on saving and fertility behaviour in the context of an old age security fertility motive in sub-Saharan Africa. In particular, the paper investigates the interaction between the family and capital market provision of old age security; that is, the effect of capital market development on fertility. The analysis compares private saving and financial wealth ratios averaged over 1970 to 1992 for 49 developing countries, ranking them by the rate of fertility decline and per capita income growth alternately. Financial wealth is approximated by time and saving deposits of banks as a ratio of GDP. It argues that bearing and investing in children is an asset accumulation decision with potentially significant implications for fertility behaviour, savings, financial development and therefore growth. The paper explores the old age security fertility motive in sub-Saharan Africa and finds an old age security fertility motive that explains the high child wealth preference in Africa. The main findings are:

- The availability of secure financial assets reduces the consumption risk associated with childlessness in old age and therefore induces a fertility decline.
- There exists a positive correlation between savings and growth particularly in developed countries. However, this need not be true in sub-Saharan Africa because the life-cycle hypothesis may not be applicable since savings rates (in many LDCs) vary more systematically with demographic transitions from high to low fertility, than with income growth.

- The high birth rates in sub-Saharan Africa reflect a desire for large families and old age security as an important fertility motive.
- In Africa, financial development is inversely correlated with the birth rate and positively correlated with the savings rate.
- Higher child mortality (low survival rate) is associated with higher savings rate.
- Whereas higher returns on capital are associated with falling birth rates elsewhere, in Africa, this is associated with higher birth rates. This implies that child wealth is more valuable in Africa than in other developing countries.
- Agrarian households differ from non-agrarian ones in regard to the joint determination of fertility and saving. A large proportion of agricultural employment is associated with high birth rates and low savings rates.
- In Africa, financial development is found to induce lower birth rates and higher savings rates consistent with portfolio choice behaviour.
- Implications: Since child mortality risk enters importantly into households' wealth preferences, health care interventions aimed at reducing health care costs might be more effective in influencing fertility behaviour than birth control subsidies.

Questions and Discussions

- A participant asked Noel Ayitey Tagoe to explain the effect of proliferation of forex bureaux and Western Union money transfers on the Ghanaian banks. Tagoe replied that it encouraged repatriation of funds into Ghana. The mechanisms for money transfer (especially Thomas Cook and Western Union money transfer) have resulted in increased bank profitability even when the local currency is weakening. They have also resulted in currency substitution (dollarisation) whereby even salaries are negotiated in dollars.

- Ndung'u of KIPPRA wondered whether the model presented by Tagoe encompasses the fact that Ghanaian treasury bills are advertised in the streets. Tagoe concurred that he did not include this aspect in his model, but commented that the treasury bills had resulted in the contraction of funds in the stock market in Ghana. A participant asked whether there was a situation of rural banks in Ghana making profits from the rural folks before moving out. Tagoe answered that there are some rural banks in Ghana that are very profitable and that fiscal incentives are given to those who invest in rural banks.
- Penina Kariuki of Central Bank of Kenya (CBK) asked Jane Kiringai and Njuguna Ndung'u why they did not consider the new measure of money as used by the Central Bank of Kenya. The presenters argued that the new measure would result in double counting.
- Another participant noted that Kenya had already implemented liberalisation though not in the sequence suggested by theory and asked the presenter to give the way forward. Ndung'u responded that donor conditionalities compound the sequencing problem.
- A participant from CBK made a clarification that the government uses treasury bills to finance fiscal deficit and Open Market Operations for monetary policy controls in contrast to what was presented. Ndung'u pointed out that that was not the case. Instead, CBK uses the same instrument to control both fiscal and monetary issues.
- Benjamin pointed out that the method of 'before' and 'after' analysis as used by Ndung'u and Kiringai of KIPPRA in analysing liberalisation lacks the ability to detect counterfactual issues. He therefore advised that effects of financial sector be simulated using a macro model and the results compared to counterfactual. He further wondered whether there was adequate allowance for full impact of financial sector liberalisation to be realised. Jane Kiringai

responded that the 'before' and 'after' analysis is usually problematic and will therefore consider the alternative proposed.

- Eric Ronge of KIPPRA asked why Ndii's paper did not address the impact of infrastructure given that the poor state of infrastructure in some developing countries could be the major obstacle to international capital flows. In response, Ndii agreed that having an infrastructure variable is useful but wondered how this could be modeled. He explained that modeling differences in infrastructure across countries would render the model intractable and would also introduce some computational problems since developing a country's infrastructure is an investment decision. Similarly, some international capital flows go into investments, some of which are directed to some areas of a country's infrastructure. In many instances, bilateral and multilateral flows to developing countries go to infrastructure.
- Jane Kiringai of KIPPRA asked whether there was a minimum requirement for number of years in education to enable a country to take off. David Ndii explained that countries with an average of 4, 5, and 6 years of schooling have managed to take off. He gave an example of East Asian countries. He however noted that sub-Saharan Africa has a higher threshold.
- Ndung'u of KIPPRA wondered why David Ndii concluded that the community has not accepted birth control mechanism, whereas health care is accepted. David responded that birth control methods were rarely used because many households preferred to have more children for old-age security.
- A participant from Nigeria asked whether the paper by David Ndii had taken into consideration the effects of HIV/AIDS on investment in education. The presenter responded that the rate of return and labour drives investments and that HIV/AIDS affects the labour force directly though this issue was out of the scope of his investigation.

- Njuguna Ndung'u of KIPPRA commented that savings would not respond to interest rate unless income is at a particular target. This is contrary to what was presented in the paper. He wondered whether intermediate targets could do and gave an example of education.

SESSION 3: BANKING PERFORMANCE AND REGULATION

Chair: Joy Suppakitjarak

3.1: Resolving bank failures in Uganda: policy lessons from the recent bank failures

Brownbridge, M. (Ministry of Finance, Uganda)

The paper examines the policy actions taken to deal with distressed banks once regulators realise that a bank is distressed. Intervention in distressed banks is often the most difficult aspect of regulatory policy for the bank regulator to implement, as it has potentially serious economic, budgetary and political implications. The paper points out that although the danger of bank closures affecting other efficient banks cannot be ignored, the systematic risks of closing small banks should not be ignored. Also, the regulators should be sceptical about the prospects for successfully rehabilitating distressed banks and open resolution should only be attempted when a distressed bank has some value left and not when a bank is already insolvent. The paper concludes that open resolution should be strictly time limited to a few months at most. The regulators should avoid attempting open resolution under statutory management except in circumstances where *de facto* government guarantee of deposits already exists. Also, open resolution of an insolvent bank should be avoided unless there is a strong probability that the bank can be both recapitalised and restructured into a viable bank within a very short time.

3.2: Banking sector regulation and performance: the post-reform Ethiopian experience

Alemayehu Geda and Seif Dendur (Addis-Ababa)

The period 1974-1991 in Ethiopia was characterised by state-led development strategy. It was also a period of intense conflict. The overthrowing of the military regime in 1991 and the adoption of the structural adjustment package in 1992 brought about major policy changes in the banking sector. The paper evaluates the banking sector regulation and performance in post-reform Ethiopia. The study shows that the government strategy of gradual institutional building before intensive reform has been the right approach for liberalisation and this is attested by the performance of post-reform banks although the performance is not uniform across the banks. However, institutional building could have the undesirable effect of rent seeking. Therefore, a challenge for a successful financial reform in Africa is to find the right mix of institutional building (such as regulatory framework) and to minimise the potential for rent seeking at the same time.

3.3: Explaining bank regulatory failure in Zambia

Maimbo, S. M. (University of Manchester)

The paper discusses regulatory failure within the context of the 1995 and 1997/98 bank failures in Zambia. Using 'excessive regulatory forbearance' as an indicator of 'regulatory failure', the paper examines why regulatory forbearance occurred and why the Bank of Zambia failed to enforce the required corrective action in a timely and consistent manner, even at the risk of encouraging and permitting fraudulent and wrongful trading. The paper concludes that delays in regulatory decision-making were not always the result of direct political interference, but rather the result of bureaucratically institutionalised regulatory forbearance.

3.4: Regulatory frameworks for effective financial systems in Africa

Kimenyi, M. S. (KIPPRA)

The paper highlights the importance and complexity of financial sector regulation and discusses the theories of regulation, principles of regulatory design and the rationale for regulating the market for financial services. Issues on regulatory frameworks and lessons learnt from financial crisis in different economies and the regulatory challenges in developing countries, and in particular the experience in Kenya are also presented. The paper notes that debate on regulation theories is polarized on the relative role of the state and the market. Some of the arguments identified are those premised on social welfare, market failure, consumer protection, interest-group theory of government and regulatory capture. The paper elaborates on the rationale for regulating the market for financial services. Some of the issues identified are that financial market failure is caused by a number of factors such as information asymmetry, market power and wasteful competition. Also, financial institutions are highly geared in that most of the funds they put at risk belong to depositors. These institutional linkages in the payment system are prone to domino effects where failure in one institution can affect the entire financial system. Given their importance as conduits for implementation of monetary policy, there is need for governments to devise regulatory frameworks to be enforced for effective and efficient financial systems. The paper pinpoints that lack of political and operational autonomy by regulating authorities is a major weakness in regulatory frameworks. Devising appropriate financial sector regulatory frameworks remains a challenge in Africa and all over the world. Governments have to contend with the complex task of finding the right mix of regulatory frameworks capable of providing effective regulation.

3.5: Bank capital adequacy, endemic bad debts and the determination of interest rates

Green, C. J. (University of Loughborough)

The paper sets out a simple general equilibrium model of interest rate determination and considers the implications on interest rates of bank capital adequacy regulations such as those in the Basel Agreement. The paper analyses the impact on interest rates of increased bank competition, and increased loan write-off by banks. It also analyses a dynamic rational version of the model. The findings show that capital adequacy regulations give rise to two distinct capital regimes: one in which banks are unconstrained because they have an adequate cushion of 'excess' capital and the other in which banks are 'capital–constrained' and their lending is directly restricted by minimum capital requirement given the size of their equity capital. The paper finds that the effect on interest rates depends critically on which capital regime prevails: bank lending rates and the cost of capital in the economy may rise in one regime and fall in another. The possibility of regime switches has an important impact on the dynamics of interest rate movements. Temporary stock market bubbles or crashes may occur during the adjustment process. The model has interesting implications for bank management and regulatory policy.

3.6: Risk and governance in African commercial banking: in the shadow of the market

Abt, W. and Mian, Atif (WPA)

The paper takes a close look at bank privatisation in Africa. It evaluates the impact of such privatisation from both a theoretical and an empirical perspective. It then looks into the process of privatisation and presents a theoretical discussion, complemented by empirical evidence, on what kind of restructuring programmes, sale methodologies, and such auction processes are likely to be successful in real life. The conclusion is that the potential downsize of privatisation can come from two contrasting sources. First, under strong regulation, a private bank can become too risk-averse. Secondly, under regulation, private ownership could lead to looting, or excessive risk-taking. These potentials of downsizing of privatisation point to the importance of well functioning regulatory regimes and specifics of how privatisations are accomplished. Evidence suggests that privatisations in Africa have generally been at least modestly successful. An empirical investigation into the relative risk exposure of local private and international banks suggests that incomes of local banks are riskier than those of international banks, despite being less profitable. For optimal process of privatisation, a minimalist strategy works best. The government should only take a few basic restructuring steps such as quickly recognising bad debts, and perhaps getting rid of excess employment. However, reorganisation appears to be frequently necessary in order to maintain the banking process.

Questions and Discussions

- The problem of prompt closure of insolvent banks was brought forward by one of the participants. He wanted to know whether the bank regulator would close down an insolvent bank if it lacked the funds to repay insured depositors. Green replied that lack of funds is not a reason for delaying closure, because delay will probably increase the eventual cost. Instead the regulator should present the full facts to the government and request for the funds to repay insured deposits if the deposit protection fund has sufficient funds to cover liabilities.

  A participant questioned whether there are alternatives to liquidating failed banks. He pointed out that depositors preferred that the failed banks be kept open under statutory management since the assets recovered through liquidation were typically very low. Brownbridge of the Ministry of Finance, Uganda, replied that depositors would indeed prefer a failed bank to be kept open because this would enable them to avoid any loss of their deposits. But then, the cost of allowing depositors to escape without loss will be borne by the taxpayer and will worsen moral hazard in the banking industry.

❖ Ndung'u asked Seife of Addis-Ababa to explain how Ethiopia can invite foreign banks participation in the sector. Seife responded that the Ethiopian government feared that entry of foreign banks would compete out domestic banks.

❖ A participant questioned whether something could be done to make auditors of banks more accountable to regulators. Maimbo of University of Manchester replied that there has been a move towards addressing the problem. He said that this was as a result of the high profile failure of BCCI (Bank of Credit and Commerce International), where the role of auditors has come under increased scrutiny from the regulators. He added that increasingly, regulators are incorporating specific provisions in legislation that require auditors to:

  (i) Immediately report to the regulators and security agents any illegal activities detected.
  (ii) Prepare a report on key elements of banks' activities, for example non-performing loan portfolio and the level of insider loans.
  (iii) Participate in tripartite meetings of regulators, auditors and management on an annual or quarterly basis.

❖ Another participant raised a question on the level of social inhibitions in restricting the effectiveness of regulatory implementation of supervisory directives. The respective presenter referred the participant to a study conducted in Zambia where it was found that the personal style and characteristics of key players in the regulatory system (Minister of Finance, Governor, Director Financial System Supervision) had an important impact on regulatory effectiveness. He observed that it was easier to implement regulations when key players had a cordial personal relationship. It was also noted that some key players engage in 'self-censorship' of their recommendations because of anticipated responses from higher authorities. The social structure in the regulatory authority has a key role to play in regulatory and supervisory effectiveness.

- A participant raised a question on the experience of harmonising different regulatory bodies responsible for the financial sector in one institution, as is the case in the UK. The respective presenters equally expressed their concern that with too many different bodies responsible for regulating different financial institutions, scarce supervisory skills would be spread too thinly. There is, therefore, a case for considering the centralisation of different financial sector supervisory agencies in one institution.
- A participant asked whether, given the prevalence of insider lending in failed banks, there should be a restriction on ownership concentration in banks, with all the banks having to be listed on the stock exchange with publicly held equities. Mwangi Kimenyi responded that limiting ownership concentration in banks is necessary and that both Uganda and Zambia are introducing limits on the share of a bank's equity that can be held by one person or related parties. He however noted that given the very limited development of stock markets in Africa, listing the shares of all banks on the stock markets is unlikely to be feasible.
- Another participant wanted to know what the bank regulators could do to make commercial banks more innovative and provide longer-term loans. In response, Professor Kimenyi said that in a market system, the regulators cannot force banks to give long-term loans. He added that banks, like any other profit-maximising institution, would avoid taking risks in a highly risky environment. Encouraging banks to make longer-term loans requires macro-economic stability and institutional reform. He gave an example of the legal sector, which can help reduce the risk of long-term lending.

- The issue of prudential regulation was raised by one of the participants who wondered whether prudential regulation could actually encourage imprudent risk-taking by banks. Professor Kimenyi responded that this was actually supposed to be the case, especially where regulators extend regulatory forbearance to an imprudently managed bank. He illustrated that where the bank regulators intervene in a distressed bank but fail to discipline or remove the managers responsible for mismanagement, the mismanagement and reckless risk-taking is likely to continue.
- Wendy Abt was asked to elaborate on positive privatisation effects. He responded that privatisation effects include better management of costs and lending risks as a consequence of less interference and focus on profitability.
- Another participant asked why local and government banks are generally less profitable than international banks. Wendy observed that the reasons are different for each category. In the case of local banks, they are smaller and have comparatively high cost of funds whereas government banks have high loan-loss provision and operating expenses.
- On the same issue, another participant asked why the performance of private sector banks was better than that of government-owned banks and that in the case of other industries, a change of ownership alone does not lead to better financial performance. The presenter replied that banking is different from other industries and that banking is particularly ill-suited for government ownership. This is because the incentives for the government to ensure that loans are only given according to commercial criteria and that loans are recovered are very weak, and therefore the plague of bad debts in government banks.

SESSION 4: FLOW OF FUNDS AND FINANCE IN CONFLICT AND RECONSTRUCTION

Chair: John Mbaku (Weber State University)

4.1: Flow of funds and policy modeling for Kenya

Victor Murinde, Christopher J. Green, and Njuguna Ndung'u

The paper aims to contribute to the on-going effort to identify feasible strategies for financial sector reform and macroeconomic policy design for Kenya. Analysis of flow of funds is used to underpin a macroeconomic model that captures the financial sector and other special features of the Kenyan economy. The model is estimated using annual aggregate data for the 1963-1999 period. On the basis of estimation results, the model is subjected to a dynamic counterfactual simulation test in order to isolate the potency of specific instruments that typically constitute the policy packages applied during financial sector reforms and macroeconomic stabilisation.

4.2: Modeling the flow of funds in India

Tomoe Moore, Christopher J. Green and Victor Murinde

The paper is part of a broader project with objectives of analysing the financial system in India, developing and estimating a complete flow of funds model within a system framework, as well as conducting policy analysis by simulation.

4.3: Financial reconstruction in conflict and post-conflict countries

Tony Addison, Alemayehu Geda (ISS/KIPPRA), Philippe Le Billon and S. Mansoob Murshed (WIDER/UNU)

The paper discusses some of the principal issues relating to the reconstruction of the financial sector in conflict–affected countries and focuses on currency reform, rebuilding (or creation) of Central Banks, and revitalisation of the banking system and its prudential supervision and regulation. The findings show that in reconstruction, Central Banks often remain weak and under-resourced. The consequence is haphazard and lenient supervision of the financial system, which is compounded by the frequently lax accounting and reporting standards of commercial banks. Regulatory forbearance is also common, reflecting not only the technical weakness of Central Banks, but also the pressure of powerful interests—including war criminals—that straddle both state institutions and the financial sector. The outcomes are leniency in the licensing of banks, insider-lending, excessive risk exposure, and general failure to curb emergent bank crisis. This in turn destabilises the economies recovering from war, and the fiscal burden of bank crises limits development and poverty spending, therefore threatening 'post-conflict' reconstruction.

Questions and Discussions

- A participant wanted to know the role of the insurance industry, given its rapid growth in Kenya. Ndung'u remarked that insurance companies facilitate continuity. Geda of KIPPRA also observed that there was no emphasis on the insurance industry, other than merely mentioning it.
- A participant sought to know why when addressing the issue of conflicts, priority was given to banking and not the political issues. Geda responded that it is important to have a simultaneous approach, though there are cases where banking has to be given priority, depending on the nature of the country. He gave an example that where a country does not have currency, priority is given to other sectors.
- Geda was asked whether it was possible to reconstruct an economy without revisiting the issues that led to political conflicts. He responded that his paper focused on countries in conflict and therefore issues that resulted in conflict are bound to be addressed.
- A participant noted that banks hold high liquidity in comparison to loans and wondered whether Treasury bills and cash reserve ratios could be the cause. Brownbridge concurred with the participant and noted that banks have tended to invest in treasury bills despite the fact that Treasury bill rates are lower

than lending rates. He attributed this behaviour of banks to non-response of demand for financial services.

SESSION 5: BANKING REGULATION

Chair: Dr Hezron O. Nyangito (KIPPRA)

5.1: Can prompt corrective action rules work in the developing world?

Brownbridge, M. (Ministry of Finance, Uganda) Maimbo, S. M. (University of Manchester)

"Prompt Corrective Action" (PCA) provisions were enacted in the United States (US) in 1991 and are under consideration in a number of developing countries. This is partly as a result of bank failures in the 1990s, which have proved costly for governments and tax-payers. The paper provides empirical evidence on the incidence and cost of regulatory forbearance in Uganda and Zambia, through an examination of regulatory intervention in distressed banks in these countries. The paper examines whether introducing PCA rules in developing countries can provide an effective constraint on regulatory forbearance and in doing so improve bank regulation and supervision. The paper concludes that if PCA rules are to contribute to improving bank regulation in developing countries, they should be introduced as part of a more comprehensive set of prudential reforms that strengthen both operational independence of the bank regulators and their accountability to the public, improves on-site examination capacities of the regulators, strengthens accounting standards in the banking industry, and raises public and political understanding of the need for strong and partial bank regulation.

5.2: The design, development and implementation of bank licensing policies and procedures in Zambia

Maimbo, S. M. (University of Manchester)

The paper reviews the design, development and implementation of bank licensing policies and procedures in Zambia between 1980 and

1994. It argues that the weakness in licensing procedures for new commercial banks may have contributed to the bank failures of 1995 and 1997/98. There was insufficient regard given to the quality of perspective owners, directors and managers of new commercial banks; minimum amount of capital required; the development of reasonable business plans and the financial strength of the proposed owners. The paper concludes that in strengthening its licensing policies and procedures, it is important that the Bank of Zambia does not adopt an overly cautious approach to licensing of banks, and especially local banks. Local banks can provide services that foreign and government banks are either unwilling or unable to offer, and can also inject the much-needed financial competition in the financial sector.

5.3: Financial sector reform and regulation in Kenya

Kirkpatrick, C. (University of Manchester) and Kagira, B.

Despite the wide-ranging economic reforms on liberalisation, Kenya's economy has recorded the worst growth rates in the country's economic history over the 90s. As the country prioritises poverty reduction through sustainable economic growth, the financial sector is expected to play a catalytic role in facilitating economic growth through financial intermediation. Kenya's persistence of financial crises in 80s and 90s calls for a review of prudential reforms. The aim of the review is to assess the soundness of the regulatory regime in terms of correcting the causes for the past bank crises. The review also aims to determine adequacy of the regulatory framework in creating a market structure that is responsive to the development needs of the economy. The study found the following weaknesses: lack of regulatory independence; lack of clarity on circumstances under which the bank can intervene through formal or informal actions; lack of legal provision for development of credit rating and reference bureau; and inadequate capacity of bank surveillance. It recommends regulatory independence, credit data bank and enhancement of CBK's supervisory capacity, among others.

Questions and Discussions

- Since Prompt Corrective Action is going to be triggered by Capital Adequacy Ratio (CAR) going below the threshold, won't external shocks result in low CAR in developing countries?, asked Eric Ronge of KIPPRA. In response, Maimbo gave an example of macro-economic shocks and noted that bank problems seldom occur due to shocks but mismanagement.
- A participant wondered whether it was profitable to compare and contrast the licensing requirements currently in existence in developing countries with the aim of encouraging arbitrage. Maimbo of University of Manchester responded that international comparison on relaxation of licensing requirements is currently on board. He mentioned that the Basel Committee was undertaking a review.
- Another participant remarked that nowadays, Non-Bank Financial Institutions (NBFIs) are subjected to the same conditions as commercial banks except for the capital requirements. He commented that there was need to evaluate what NBFIs are doing today and what they used to do.
- More autonomy has been given to CBK and yet no significant reforms have been witnessed. Can we have another body to monitor CBK?
- Infighting in the boardroom of institutions that have failed is common in Kenya. A participant wanted to know whether Kenya needs regulation or inspection or both.
- In regard to bank failure, a participant commented that there was need to differentiate between indigenous banks, foreign banks and domestic banks and find out why indigenous banks are failing.
- A participant who acknowledged that international banks were doing well wondered whether the same set of rules governing international banks need apply to domestic banks. In response, Bernard Kagira said that it was dangerous to have

different regulatory rules. Such differences would result in unfairness and relaxation of rules.

SESSION 6: CORPORATE CAPITAL STRUCTURE, MICRO-FINANCE AND RURAL CREDIT MARKETS

Chair: Prof. Francis Mwega

6.1: Agricultural credit and performance of selected financial institutions in Kenya

Nyangito, H. O. and Ndirangu, L. (KIPPRA)

Availability of credit in the rural areas is a key accelerator for agricultural development. Credit is required for production and marketing activities, short- and long-term investment and for development of rural micro-enterprises. However, in most developing countries, rural financial services are inadequate. This paper analyses the status of credit availability to the agricultural sector in Kenya and also assesses the financial performance of two financial institutions as case studies. The analysis indicates a general declining trend of credit availability to the rural areas from both the commercial banks and government institutions. The analysis of financial institutions indicates that they have a reasonable outreach. Their self-sustainability, however, is low as indicated by positive subsidy dependency indices. This implies that on-lending interest rates do not adequately cover the cost of financial intermediation. The policy challenge is how to provide appropriate incentives to attract credit from financial institutions to the rural areas and to provide an improved legal and regulatory framework that reduces the risks of lending to the agricultural sector.

6.2: From fragmentation to embeddedness: towards a framework for the institutional analysis of financial markets

Susan Johnson (University of Bath)

The paper sought to develop a framework for understanding the financial intermediaries in Karatina, Kenya, using the institutional analysis framework. The paper analysed institutional features that seek to solve the financial intermediation problem of collective action institutions by examining their rules, monitoring and enforcement mechanisms. The approach allows for a systematic analysis of the embeddedness of financial institutions. The nature of the financial institutions generates financial services that encompass a wide range of key features, including collateral requirements and the ability to exercise choice. The differences in transaction cost that these institutions incur arise out of the differences in their institutional form and this in turn explains the fragmentation. The approach used suggests that the sources of fragmentation can be theorised as arising out of underlying social structures. It is, therefore, through an analysis of the influence of social structures on the rules, monitoring and enforcement mechanisms of financial institutions and the financial services to which they give rise to, that a more fruitful analysis on the way financial institutions operate and the ability of particular socio-economic groups to use them can be developed.

6.3: Impact of micro-finance enterprises on the efficiency of micro-enterprises in Cape Coast

Vijay K. Bhasin and Wisdom Akpalu (University of Cape Coast)

The paper sought to assess the level of technical efficiency of micro-enterprises in Cape Coast, Ghana and the role of credit in influencing the level of efficiency. The paper also evaluated the performance of micro financial enterprises with regard to the provision of credit services, and performance of the National Board for Small Scale Industries (NBSSI) with regard to the provision of training services to micro-enterprises. The results of the analysis indicate that credit is positively related to technical efficiency. While the delivery of training services by NBSSI was found to be sufficient, that of credit was poor. Micro-enterprises obtain credit mainly from the informal sector. The paper recommends more funds to be made available to NBSSI and other informal suppliers of credit for on-lending to micro-enterprises. It also recommends group-lending to be encouraged so as to reduce loan defaults.

6.4: Micro-finance and behaviour change among Nairobi's commercial sex workers

Dorothy McCormick and Kaendi Munguti (Institute for Development Studies, University of Nairobi)

Micro-finance gives poor people resources that expand the range of their economic choices. Since poor women often have fewer options than poor men, micro-finance is often seen as especially beneficial to them. The paper seeks to contribute to the sustainability debate of subsidised credit programmes using results from an assessment of a project offering micro credit to commercial sex workers in Nairobi. Most of the literature on micro-finance has stressed the need to design financially sustainable programmes. Proponents of this view argue that the subsidised credit programmes of the 1960s and 1970s failed almost everywhere and that the only way to ensure that poor people have access to credit over the long run is to build financially sound micro-finance institutions. However, this focus on sustainability has recently been put into question mainly on the grounds that full sustainability may be incompatible with outreach to the poorest borrowers. The results of the analysis show that, judged by the usual indicators of repayment rates and financial sustainability, the programme was not successful. However, the programme was highly successful in its social objectives. The paper argued that it is unattainable for programmes targeting very poor borrowers to find full financial sustainability. Such programmes may require continuous subsidies to enable them provide appropriate services to the poorest of their clientele.

6.5: The determinants of capital structure of micro and small-scale enterprises in Kenya: evidence and sensitivity analysis results

Peter Kimuyu, VictorMurinde and Christopher J. Green

Using a data set of 2000 businesses drawn from the 1999 national baseline survey of Micro and Smallscale Enterprises (MSEs) in Kenya, the paper analyses financing behaviour of MSEs. Although the results are very preliminary, they emphasise four findings with important policy implications:

(i) When MSEs wish to increase leverage, the main sources of financing are co-operatives, NGOs and to a less extent banks.

(ii) Size on its own does not matter for the MSEs to resource additional financing. However, what matters is what the MSEs do in regard to their size. When, for instance, MSEs expand, they gain easier access to co-operative funds and they also quite easily overcome credit constraints.

(iii) The main activity of the MSE is important for higher leverage, with firms in non-primary activities having higher leverage.

(iv) Failure to keep business records is detrimental when an MSE wants to obtain finance and increase leverage.

The study recommends further research on these issues.

6.6: Corporate financial structures in India

Christopher J. Green, Victor Murinde, and Joy Suppakitjarak

The paper documents the financial structure of a large sample of Indian companies using a data set of published accounts of more than 1000 companies reported every year during the period 1989-1999. The data set consists of quoted and non-quoted non-financial companies. The data set was used to document and characterise development in company financing in India over the last decade. The authors compare the sources-uses approach to analysing company financial structure with the asset and liability approach. Comparison is made with results of other industrialised countries in recent studies and financial structures of companies over time and across sectors. The study found that Indian-quoted non-financial companies exhibit financial structures that are not markedly different from their OECD counterparts. During the 1990s, both quoted and unquoted companies have experienced changes in their financial structures. These changes may be associated with liberalisation of the capital markets in the early 1990s. However, the changes in the unquoted companies took place more gradually over time than did those of quoted companies. In aggregate, business groups appeared not to have particularly close financial relationships among one another.

Questions and Discussions

- In reference to Nyangito and Ndirangu's paper, it was noted that there was need for clarity on how the figures quoted in regard to demand and supply for agricultural credit were arrived at. They seem to contradict the observation that people in rural areas fear taking loans. In response, the presenters noted that the figures were based on a financial sector survey and are used to show the potential demand and supply of credit.
- A participant remarked that some of the proposed policy recommendations such as raising interest rates and tax rebates conflict with macroeconomic objectives. However, Nyangito responded that raising interest rates was important for sustainability while tax rebate is consistent with the policy of poverty reduction.
- Bhasin was asked to use statistical tests to test the significance of the findings indicated by the data. Given that most small-scale traders rely on relatives as source of financing, on what grounds do we expect NBSSI to be a potential source of financing?
- Questions for McCormick: Since commercial sex workers (CSW) also reduce with age and marriage, does poverty really

matter? Given the fact that some CSW are involved in commercial sex activities full-time, should this be seen as a poverty- or business-related issue? In terms of policy implications, is there a possibility of separating the social and financial functions when dealing with CSW? Won't more women have returned to the commercial sex business if the loan repayment requirements were stringent? In response to the above questions, McCormick argued that the information on age and marital status was just given as a general profile and only showed up in the ability to repay the loan where the response from those with regular 'partners' was high. The separation of social and financial functions is analytically possible. The problem is that some micro-finance institutions that could handle the credit side usually shy away due to the social stigma that characterises commercial sex work.

- The following questions were directed to Murinde *et al*: What is the direction of causality between a higher leverage and access to credit? Do the conclusions made hold for the entire spectrum of MSEs given that they are divided into formal and informal? There is a mix-up between discrete and continuous variables. How was the data coded? What are the implications of some of the hypothesised signs being either positive or negative? Social networking could also influence the ability to negotiate and get accessibility to credit. To what extent is this variable captured in the available data? In response to the above, the authors stated that the paper was still incomplete and more analysis was still going on. Nonetheless, the richness of the data allows one to carry out separate analysis in terms of informal and formal MSEs. The authors promised to look into other issues raised regarding data.
- In regard to the paper by Suppakitjarak *et al*, a participant remarked that changes in the debt ratios might have been influenced by what was happening to the monetary policy. Another participant wanted to know why equity for quoted

companies increased over time? Is it because of the liberalisation? Conclusions should have some policy implications. What reasons account for the rising debt ratios for the quoted companies over time?

SESSION 7: EMERGING STOCK MARKETS: REFORMS AND PERFORMANCE

7.1: The response of market microstructure to revitalisation: evidence from the Nairobi Stock Exchange

Rose W. Ngugi, Christopher J. Green and Victor Murinde

The paper analyses the key microstructure aspects of efficiency, volatility and liquidity by comparing the period before and after the implementation of institutional changes, namely the establishment of a market regulator, change in trading system, and entry of foreign investors.

The main econometric results are fourfold:

(i) A significant efficiency gain in price discovery process with the shift to open out-cry trading system. However, efficiency gains were augmented especially with the entry of foreign investors and expansion of stock brokerage firms. The EMH weak efficiency hypothesis was rejected despite a decline in the level of inefficiency in the 'after' reform period with evidence of both short-run and long-run predictability of stock returns.

(ii) Revitalisation period was characterised by high volatility, which shows a declining tendency following the entry of foreign investors. Leverage effect was significant and there was evidence that volatility imparted on stock prices. Conditional volatility was stable and clustering.

(iii) A negative relationship was indicated between efficiency gain and volatility. However, weak form efficiency was rejected partly because marginal declines accompanied efficiency gains.

(iv) Temporary gains in liquidity are indicated with the entry of foreign investors, which are accompanied by efficiency gain and low volatility.

Perhaps of importance to policy makers is the finding that though the entry of foreign investors was associated with a positive impact on market performance including a temporary rise in liquidity, low volatility, and efficiency gain in the price discovery process, these gains may be unsustainable if factors that attract foreign investors are weak and increased local investors participation is not sustained.

7.2: Market microstructure of the Mumbai Stock Exchange

Christopher J. Green, Victor Murinde and Joy Suppakitjarak

The paper seeks to trace the main regulatory changes and related market microstructure improvements that have been undertaken in order to revitalise the Mumbai Stock Exchange (BSE) since the establishment of the exchange in 1875. The aim is to document the evolution of the market, emphasising how securities have been traded over time and the influence of the various changes in the trading systems on the market behaviour and success. The paper then investigates whether investments in improving the market microstructure have positive value, taking a sample of selected stocks on the BSE. Although the BSE was established more than a century ago, it was not until the 1980s, the era of globalisation, when investors began to invest away from their home. The results show no improvement of liquidity and the cumulative abnormal returns due to the recommendations of the screen trade system (BOLT) in May 1995. However, when the Securities and the Exchange Board of India (SEBI) cleared the BSE expansion in 1997 there was an increase in CARs especially for B1 Scripps.

7.3: Investment and uncertainty: evidence from Kenyan firms and the Nairobi Stock Exchange

Rose W. Ngugi, Victor Murinde and Christopher J. Green

This study examines the relationship between investment and uncertainty for a panel of listed firms in the NSE. This is an attempt to contribute to empirical search for the nature of the relationship between investment and uncertainty. Theoretical literature on this relationship is inconclusive while the empirical literature so far shows a negative relationship. The study also draws implications on the competitiveness of the capital market as a source of funds for long-term investment following a revitalisation process aimed at strengthening the institution set-up. The conditional variance of stock returns derived using GARCH (1.1) model is used as a measure of uncertainty. Tobins's q model was adopted. Other variables indicated in the traditional investment models to influence investment were included in the analysis. The results show a positive and significant relationship between average q and investment but negative and insignificant relationship between average q and uncertainty. Controlling for financial constraint with the cash flow variable, the results show evidence of imperfection in capital market. A negative relationship is indicated between investment and uncertainty and a positive and significant relationship between uncertainty and cash flow variable. However, a positive relationship is indicated between the uncertainty and cash flow variable. A negative relationship is expected if cash flow proxies the future profitability given the negative relationship between investment and uncertainty. The positive relationship, therefore, implies increased uncertainty with an imperfect capital market. With a more significant uncertainty variable when cash flow variable is introduced in the model, the authors conclude that imperfections in capital market augment the negative relationship between uncertainty and investment. The results show support for irreversibility theory and that the degree of irreversibility varies across firms.

7.4: The role of international capital flows, aid and export earnings in financing development in Kenya: analysing the options using the KIPPRA-Treasury Macro Model for Kenya

Stephen N. Karingi and Maureen Were (KIPPRA)

The paper uses the KIPPRA-Treasury Macro Model (KTMM) to analyse the economic implications of utilising different options of financing development activities in Kenya. The paper considers three options open to a country, namely:

(i) Capital flows from the global pool of savings in the form of foreign direct investment.

(ii) Access to resources from multilateral agencies in form of grants and loans.

(iii) Adoption of an export-led growth strategy where higher export earnings are the main source of financing development.

The paper attempts to answer the question on whether there is an economic rationale why Kenya should pursue a particular strategy or adopt a combination of options. The paper further pursues the question of the extent to which the government can influence any of these options and whether it would be possible to structure a policy package to achieve a positive optimum impact. The simulation results show that an increase in government investment financed through concessional foreign financing has a higher positive impact in the economy in terms of GDP. This is followed by an export-led growth strategy where there are also significant positive effects on the economy. However, the long-term impact of these financing options could not be explored due to the medium term nature of the KTMM. While the government can continue pursuing higher investments through concessional loans in the medium term, the long-term impacts of an export-led strategy might outweigh an aid-led recovery. As for the FDI, the analysis suggests that it is likely to have a positive impact on the economy. But if positive impacts on the economy are to be derived from higher FDI flows, a policy environment must be created for a crowding in of domestic investment to take place and for productivity to rise. The paper concludes that a combination of different strategies can be utilised to maximise the benefits and ensure sustainability of the development path. In conclusion, the paper suggests that the country should pursue policies that improve competitiveness of exports and the composition of government expenditure with a bias towards government investments as a preferable shift in fiscal policy.

Questions and Discussions

- The value of R^2 in the paper by Suppakitjarak *et al* is too low for the regression results presented in tables 8, 9, and 10 of the paper. It might be advisable to use a non-linear estimation technique or add more explanatory variables.
- In reference to Karingi and Were's paper, a participant wondered how the authors could keep on proposing policies based on increases, for example increased government investment, or exports, when the country is in a recession. It is also important to explain why the economy is in a recession. Another participant asked whether we should be talking of complementarity to existing investment in terms of improving quality and maintenance, for example maintenance of existing roads, or entirely new investments? Are simulations stochastic or deterministic? In response the presenters argued that the idea is to evaluate the impact of different options of financing development using the macro model for Kenya. It is also possible to separate the aid flows into development and operations and maintenance, but this will yield different results.

SESSION 8: CORPORATE FINANCING AND FINANCING ISSUES

Chair: Prof. Peter Kimuyu (IPAR)

8.1: The determinants of capital structure choice in Zimbabwe: preliminary results

Enard Mutenheri and Christopher J. Green

The paper examines the determinants of capital structure decisions of listed non-financial firms in Zimbabwe. Using nine alternative measures of leverage, the results suggest that firm-specific factors are important determinants of the choice of capital structure in Zimbabwe. The results also show that ownership concentration and institutional ownership have a positive impact on borrowing decisions. There is also strong statistical evidence that corporate tax, insider ownership and dividend policy adversely affect firm borrowing decisions. However, the paper finds weak evidence to support the hypothesis that business risk and profitability adversely influence the choice of capital structure. The paper found that macroeconomic factors are not important determinants of capital structure decisions in Zimbabwe. The paper concludes by noting that, for better understanding of corporate borrowing decisions in the real world, there is need to define the variables according to the perspective of key decision-makers. In particular, knowledge of how managers and investors measure capital structure variables is important.

8.2: Business groups and dividend policy: evidence from Indian firms

Ronny Manos, Victor Murinde and Christopher J. Green

The paper synthesises the transaction cost theory of dividend policy with the market failure and political economy theories of business groups in emerging markets. While the former suggests that dividend policy is inversely related to dependency on external finance, the latter theories imply that dividend policies of group-affiliated firms are mainly determined by group considerations. A sample of 1412 firms (comprising 858 independent firms and 554 group-affiliated firms) is used. The sample is refined from the universe of all quoted and unquoted Indian private sector firms available on PROWESS, totalling 6548 firms (4506 independent and 2042 group-affiliated). After some preliminary tests to determine whether the dividend policies of group-affiliated firms are substantially different from that of independent firms, qualitative and limited dependent variable econometric techniques were applied to the data in order to disentangle the determinants of dividend policy of group-affiliated versus independent firms. The results suggest that while the decision to pay dividends is sensitive to considerations of transaction-cost regardless of group-affiliation, the payoff level of group-affiliated firms is less sensitive to transaction cost considerations compared with the case of independent firms. The study however does not give the reasons why payoff ratios of firms affiliated with diversified groups appear sensitive to considerations of transaction cost and how dividend decisions of group-affiliated firms should be modeled.

8.3: Improving rural women's access to credit: a case study of women groups in Kakamega District, Kenya

Nelson H. W. Wawire (Kenyatta University)

The paper sought to identify factors that constrain access to and availability of affordable credit to women's groups in rural Kenya. It also highlighted ways and means of improving access to and availability of affordable credit to the groups. The study observed that most groups lacked adequate mechanisms and information to ensure access to affordable credit. The groups were reluctant to get credit due to lack of appropriate collateral, perceived high interest rates and bank charges, lack of insurance covers for their businesses, general fear of prosecution in case of default, poor network and ineffective outreach programmes conducted by institutions offering credit, lack of drive, inadequate information, inexperience in taking loans, and reluctance of formal financial institutions to lend to groups. Taxation of the businesses was found to erode the already inadequate working capital. In the absence of formal credit, alternative sources include member's contributions, which form 93 percent of funds used by the groups, although the default rates are high. The study recommends consideration of other forms of collateral other than land. It also proposes counselling for the groups and an introduction of a legal and regulatory framework that will remove barriers to credit provision to micro-enterprises by commercial banks and other micro-finance institutions.

8.4: Corporate financial structures in developing economies: evidence from a comparative analysis of Thai and Malay corporations

Sanjiva Prasad, Christopher Green and Victor Murinde

The paper analysed the financial structures of Malay and Thai non-financial companies using an unbalanced panel consisting of published accounts of 174 listed Thai companies over an average period of about five and half years and 165 listed Malay companies over an average of just under eight years. The paper innovatively specified and estimated an Augmented Capital Structure Model (ACSM) that encompasses debt, equity and retained earnings and therefore provides a composite representation of the patterns of company financing in developing economies. The paper then estimated a model using three data sets: historic cost accounts; Last-In First-Out (LIFO) inflation adjusted account; and First–In-First-Out (FIFO) inflation adjusted accounts. The main findings with important implications for firms in financing decisions were fourfold:

(i) Although evidence generally supports the Pecking Order hypothesis, there is also evidence to suggest 'reversed pecking-order' of finance.

(ii) Further evidence exists to suggest that the 'brake' of equity valuation preventing over-gearing by unprofitable firms may not be working for both Malaysia and Thailand.

(iii) Information asymmetries still persist.

(iv) Risk is found to have a non-linear influence on leverage; the risks of bankruptcy are therefore non-linear as postulated by the traditional capital structure school of thought.

8.5: Capital structure and business groups: evidence from Indian firms

Ronny Manos, Victor Murinde and Christopher J. Green

The paper synthesises two strands of corporate finance literature. The first strand relates to a firm's capital structure decisions, with emphasis on the pecking order theory and the trade-off theory. The second strand relates to business groups and theories regarding their role, particularly in the context of emerging markets. The synthesis is then used to generate some plausible models that explain the capital structure decisions of group-affiliated and independent firms. The models are estimated and tested on a sample of 1472 Indian firms, of which 912 are not affiliated and 560 are group-affiliated. In general, the results show that group-affiliated firms are significantly different from their independent counterparts in terms of their capital structure decisions. In terms of the main determinants of capital structure decisions, the results show that group affiliation has a strong effect on capital structure decisions such that group profitability has a strong negative effect on the leverage decisions of group-affiliated firms. This may be because profitable groups create internal capital markets to avoid having to resort to expensive external finance. The study also finds that size and growth do not matter for the capital structure decisions of independent firms. In addition, only liquidity has a positive (albeit small) impact on the capital structure decisions of group-affiliated firms while intangibility and profitability, group debt and group sizes have a negative effect. However, there were no significant differences between group and non-group firms in terms of the impact of age and stock liquidity on capital structure decisions.

Questions and Discussions

- Mutenheri was asked whether it is possible to narrow down the variety of measures for the dependent variable? What econometric methods would one require to do so? What is the distinction between the market value and book value debt? On his part, the presenter reiterated that the dependent variable is defined in nine ways because of the controversy in the literature. The distinction between the book and market value also matters.

- ❖ Referring to the paper by Manos *et al.*, a participant wanted to know why group-affiliated businesses had a high rate of failure. Another participant pointed out that the history of payments could have been one of the issues that explain firm reputation.
- ❖ The following issues were raised in reference to Wawire's paper: It is important to take into consideration the social status of women—decision-making by women is influenced by men's decisions; Why were women groups created?; Why not men groups?; Women groups might have been created because women are vulnerable and easy to influence by different self-interest groups such as government and political parties. Since it appears to be quite obvious that women groups' inability to access credit is due to uncreditworthiness, it would be interesting to undertake some deeper analysis of the reasons why women groups are not able to fulfil the lending conditions. Is it because of poverty issues, non-viable businesses, or lack of entrepreneurial skills?
- ❖ Wawire reiterated that all the selected women groups were involved in economic activities and were not merely formed for political reasons. While it may appear obvious that women groups lack access to credit due to their inability to fulfil lending conditions, the major contribution of the study are the recommendations proposed to solve the problem.
- ❖ From the paper by Prasad *et al* a participant wanted to know the relationship between debt-equity ratio and the interest rate in a liberalised economy? Inflation adjustments are undertaken only for the independent variables but inflation also has an impact on the dependent variables. It is not clear how the pecking model would be affected by the fact that

some of the firms are not likely to source funds from the market. What are the positive and negative effects of using short-term versus long-term sources of financing? Why Malaysia and Thailand? Would the differences between the countries yield different results? Is the same analysis applicable to countries like Kenya? Was there any attempt to capture structural change in financing investment, for example a switch from one source to another for the period covered?

- In response, the presenter (Victor Murinde) noted that stock exchange markets in East African Community (for example Uganda) are fairly recent compared to those in Malaysia and Thailand. Nonetheless, a similar analysis can be done for other countries. He stated that already there was work being carried out on the Nairobi Stock Exchange. Referring to another question, he noted that dummies can be used to capture the period before and after liberalisation.
- In regard to the paper by Manos *et al.*, a participant wanted to know why the authors had used a sample of 1472 firms and not any other. In response, the presenter noted that ideally, it is better to start with the universe comprising many firms since some firms end up being dropped due to incomplete information.

SESSION 9: SUMMARY: PLENARY DISCUSSION AND WAY FORWARD

Chair: Prof. Mwangi Kimenyi (Director, KIPPRA)

The final session of the workshop consisted of both groups. Participants were asked to make general observations about the conference. Conclusions were made upon a wide range of issues as summarised below:

- The conference should not be like other conferences where issues and recommendations raised are hardly implemented. Efforts should be made to implement policy recommendations from the conference.

- In future, authors of papers to be presented at the conference should prepare executive summaries of about five pages which should be circulated in advance so as provide comprehensive comments.
- *MFIs*: Policy and regulatory issues on micro-finance institutions (MFIs) should take into consideration the social and poverty dimensions of MFIs. When governments, for example, regulate micro-finance institutions (MFIs), this has implications on poverty reduction and therefore regulations must be linked to poverty reduction efforts. In this regard, participants were informed that a meeting of all stakeholders in MFIs is being organised by the Central Bank of Kenya (CBK), and Prof. Kimenyi noted that KIPPRA was willing to provide support where possible.
- *Central Banks*: Central Banks should be brought under scrutiny given their central role in regulating and supervising the banking/financial sector. The public must know *who watches the watchman* (CBK). In other words, there must be a system that checks the Central Bank to ensure that it performs its functions well. The public must be made aware of how CBK came to lend money to people in the past and how to address past mistakes. This may necessitate some sort of parliamentary involvement in these issues.
- The highly complicated models developed add no value if they cannot be widely used. How widely will these models be used?
- *Monetary integration*: Since several presentations revealed that Central Banks in Africa are facing a wide range of difficulties in formulation and implementation of monetary policy, we should consider a possibility of having monetary integration, for example through joint ventures in the East African Community and a possibility of a common currency.
- *Cross-border banking*: The issue of cross-border banking was raised. A case where domestic laws are not applicable to a bank due to diplomatic immunity was deliberated. In future, the issue of cross-border banking and regulations should be

addressed together with the implications on finance and development. In responding to this matter, a participant from CBK stated that a memorandum of understanding is usually signed between the Central Bank and cross-border banks and the banks are not subject to any legal requirements. It was noted that the diplomatic immunity on cross-border banks ought to be given on a case-by-case basis after considering the uniqueness of each bank. Having a blanket waiver could adversely affect the manner in which some banks operate if they are not subjected to some form of regulation.

- *Involvement of civil society and NGOs*: In future, a similar conference should be organised for civil society and NGOs to educate them on their role in finance and development. These institutions play a key role in advocacy, and are good in pressurising the government to implement policies that promote development.
- The need to design a code of ethics that sets standards for banks to regulate their behaviour was emphasised. This will in a way contribute to self-regulation of banks as they adhere to the code.
- Given the similarities among the financial sectors across countries, it would be necessary to come up with an African theoretical perspective to banking/financial issues that incorporate the similarities and distinctiveness of African countries. This could be a very important tool when formulating policies and dealing with other multinational banks as a continent.
- *Development Finance Institutions (DFIs)*: DFIs have become weaker today than they were in the last two decades. Why? Does the present (weak) state of DFIs augur well for overall development in Africa? Are we going to develop the country on the basis of bank overdrafts? Are we going to witness any development in the housing sector if developers rely on bank overdrafts? Why can't we explore the possibility of converting short-term loans into long-term loans through the stock

market? In general, how do we finance development in Africa? In reference to this issue, Prof. Kimenyi observed that the Central Bank was well placed to give answers to these questions. He recalled that His Excellency the Vice President had in his speech talked about the possibility of externalising debts and converting them into long-term maturity as one of the ways of addressing the debt problem in Kenya.

Omissions and shortcomings of the conference

- The development aspect and the link between finance and development were not adequately addressed by the conference. In addition, the concept of financial decentralisation in relation to development was not picked up.
- Another shortcoming of the conference was that it gave an overwhelming attention to private finance and hardly touched on public finance. In future, this bias should be rectified to incorporate public finance and also address the institutional challenges to mobilisation of finance.
- While the regulatory aspect of banks was well addressed, the conference failed to tackle the issue of the deposit protection schemes and the important role they play in assisting the regulator (Central Bank) to bail out troubled banks. The rate of recovery for institutions that have been under liquidation, for example, is only about 30 percent and therefore depositors end up losing 70 percent of their money. In some cases, fixed assets of financial institutions are sold during a recession thereby attracting prices that are far below their market value. In such a situation, the deposit protection fund should be used to purchase the assets of ailing institutions and therefore minimise loss to depositors. The chair of the session, Prof. Kimenyi, commented on the importance of the issue and thanked CBK for their active participation. He encouraged closer

ties between KIPPRA and CBK in discussing other matters related to finance.

- ❖ Research in other areas of the financial sector other than banking should be encouraged; that is, other non-banking financial institutions such as co-operatives, SACCOs and the general informal financial sector which has grown tremendously. Participants observed that the role of savings and credit co-operative societies (SACCOs) should not be ignored given the large sums of savings they handle and their important role in financial intermediation both in rural and urban areas. Governments should come up with modalities to assist SACCOs to make them stronger in the financial system.
- ❖ The conference concentrated more on formal banking while little attention was given to informal banking, micro-finance institutions and savings and credit co-operative societies. Future research should focus on SACCOs and the impact of unregulated deposit taking. In addition, research is required on vibrant financial systems, where they have taken root and the reasons for these developments. To the contrary, it was noted that a lot of work has been done in the informal financial markets and, as a starting point, this work should be compiled into a compendium before addressing what needs to be done. In reference to many of the issues raised by the participants, Prof. Kimenyi informed the conference that KIPPRA had already launched a survey document on the legal and other constraints on access to financial services in Kenya, which, though not specifically directed at MFIs, raises pertinent issues in relation to informal finance.
- ❖ The African banking market lacks product innovation because mismanagement has been allowed to thrive. Therefore, there is need for research work to explore the issue of risk management, product management and the alternatives to use of heavy collateral in securing loans.

- ❖ There should have been some reference to a country with a successful financial sector in terms of management issues as a basis from which we can learn. No paper was based on the success stories. Research should be done on those countries that largely owe their economic development to finance.
- ❖ The issue of national/domestic debt did not feature, yet it has implications on the banking sector.
- ❖ Bad debts, their magnitude, effects and what ought to be done to resolve the problem should be addressed in future conferences.
- ❖ Following the liberalisation of the financial sector, some work on FOREX bureaus should be picked up.

Remarks by Colin Kirkpatrick, (University of Manchester)

Colin had three major observations:

- ❖ We need to be clear on what the objectives of the financial sector are. What is it that finance should do to assist or promote development?
  - (i) Financial sector development is a means to an end and not an end in itself. It drives the economy and should be seen in broader development ends of generating growth with poverty reduction gains.
  - (ii) Financial development activities affect growth in investment. This link between the financial system and how it contributes to investment activity was highlighted by some of the papers during the conference. It should be clear to all that the financial system leads to greater investment activity by facilitating efficient mobilisation of resources.
  - (iii) The conference also highlighted ways in which the financial sector needs to contribute to development, savings mobilisation, deposit rate policy and macro performance.
- ❖ How do we manage the market? What is the role of regulation in managing the market process?

(i) The World Bank Development Report recognises the importance of regulation. Better regulation does not necessary imply less regulation. There have been a lot of discussions regarding regulation policies. However, the danger is a tendency to focus on the role of regulation in correcting market imperfections instead of achieving proper outcomes and sustainable development—that is making markets to work efficiently.

(ii) What is required is a regulatory approach that will support a competitive environment while taking consumer interests into consideration.

(iii) The issue of regulating regulators is a broader issue that touches on matters of political economy.

❖ We should recognise the increasing diversity of the financial sector. The tendency to traditionally focus on commercial banks is not satisfactory. There were a number of papers that reflected the diversity of the financial sector—MFIs, stock and equity markets. Some papers also touched on Non-Bank Financial Institutions (NBFIs) and the informal financial markets. How do we manage this diversity and the linkages between the sub-sectors?The three issues have far-reaching policy implications to the decision makers as identified below:

❖ There needs to be a clarity of objectives—what are you trying to achieve by your policy? Having clear objectives gives some direction as to what policy makers are trying to achieve in terms of broad development goals. Identifying objectives determines how you measure the impact.

❖ It is important to have in place a system for systematic assessment of the impact. This should not be limited to cost-benefit analysis. Regulation policy has positive and negative effects and, therefore, it is important to assess what the net policy proposals would be.

❖ Networking within the region is important in sharing and learning from common experiences.

Way forward: Victor Murinde (University of Birmingham)

- Victor Murinde started by thanking those who presented papers and other participants. He noted that the project will ensure that the papers get wider dissemination. In this regard, a team of editors composed of Green, Kimenyi, Ndung'u and Murinde has already been constituted to work on the papers as the papers use different approaches to address different issues.
- Authors will be given an opportunity to think further about their papers particularly in view of comments raised during the conference. Revised copies should be submitted by end of September 2001.
- Avenues for publication: high quality papers will be published in the African Journal of Finance and Development. However, bulky papers with extensive case studies could lose their content if reduced to the standard size of journal papers and will therefore be published in the form of a book.
- It is important to meet the deadline since processing of many papers is difficult and time consuming.

Vote of thanks: Njuguna Ndung'u (KIPPRA)

Dr Ndung'u started by thanking everybody. In particular, he thanked the Vice President and Minister for Home Affairs, Professor George Saitoti; Victor Murinde of University of Birmingham; and Christopher J. Green of Loughborough University for giving a push to the completion of conference papers under their jurisdiction. He thanked the Central Bank of Kenya for their support and active participation; Prof. John Mbaku of Weber State University who though being on visit to KIPPRA got highly involved in the conference; all participants; KIPPRA staff, and in particular Ruth Gathee who gave a lot of support in the final preparation of the papers; participating universities; and DfID for supporting the conference financially.

10. APPENDIX

10.1 Speech by His Excellency the Vice President and Minister for Home Affairs

Mr. Chairman,
Distinguished Researchers,
Ladies and Gentlemen.

It is with great pleasure that I join you in this important conference on "Evidence and Policy Issues on Finance and Development in Africa." This conference comes at a time when there is great need to take stock of the successes and failures of the financial reforms in Africa and find suitable options for the future development of the sector.

Ladies and Gentlemen, the major challenge facing many African countries today is the high level of poverty. To reverse this trend we require high and sustained economic growth. It must be understood however, that although economic growth is necessary it is not a sufficient condition to poverty reduction. Evidence available shows that deliberate efforts must be made to ensure that there is growth and equity in order to realise sustainable development. The question that this conference should address itself to is - how can financial institutions in the continent help in the fight against poverty?In this connection I would like to make two observations relevant to this conference:

First, financial institutions should be configured to assist governments in creating growth and reduce poverty. This can only be achieved if financial institutions enhance access to credit by smallholder farmers and small and medium size enterprises through the banking system and the micro-finance institutions. By reaching out to the small-scale farmers and medium size enterprises, the financial sector can play the dual role of contributing to growth and poverty reduction.

Second, research on the links between financial development and growth should provide practical solutions as well as the relevant secondary reforms required to guide policy makers. Issues like the provision of financial services to meet the needs of the poor, especially access to credit, are very important to many countries in Africa.

Experience in Africa shows that by and large, these cardinal objectives have not been fully realised and it is therefore necessary to reflect briefly on the historical trend of the African economies.

Ladies and Gentlemen, prior to the mid-eighties governments in the region set themselves to provide and direct overall directions in economic activities through adoption of various policies such as fixing exchange rates, setting interest rates and price controls. Governments also set sectoral ceilings for credit allocations. Similarly foreign trade was restricted through tariff and non-tariff barriers on imports. While government intervention in

economic activities was justified, in some respects, at the time of independence, the extensive government participation impacted negatively on key macro-economic variables. For example, intervention quite often resulted in high deficits, discouraged savings, produced hyperinflation, economic stagnation or decline, and over valued exchange rates.
These maladies were not felt severely due to the fact that they were implicitly covered by huge external inflows in the form of debts and grants. However, following continuous and sustained decline in capital inflows the situation changed for the worse as most countries faced the danger of economic stagnation.

In order to address these weaknesses Structural Adjustment Programmes were adopted in the mid 1980s by African countries with the support of the Bretton Woods Institutions.

The Structural Adjustment Policies were aimed at restoring economic stability through reduction of government deficits, curtailing inflation. Letting the market determine prices in the financial, foreign exchange and the goods markets, as well as providing a free and conductive environment for the emergence of the private sector as the leader in generating growth would facilitate these. In Kenya, for example, the financial sector was liberalised under this umbrella and in the process financial institutions were restructured in order to compete and manage funds more efficiently.

Many years after having implemented the Structural Adjustment reforms, there is no doubt that many countries in sub-Sahara Africa have recorded positive growth rates in their economies.

Unfortunately there are still a number of countries that have lately experienced macro-economic instability, unmanageable public debt, hyperinflation, volatile exchange rates, sluggish or negative GDP growth rates and volatile interest rate. In these circumstances there is temptation to blame liberalisation as the cause of these failures. For example, Kenya has experienced very high interest rates to the extent that farmers, investors, and entrepreneurs have and still find it very difficult to borrow. In addition, those who borrowed during the period of controls and low interest rates have been caught up with higher interest rates, making it extremely difficult for them to repay their loans. This matter has lately generated a heated debate on the management of interest rates.

There are several factors, which may have led to the high interest rate regime, and the emerging interest rate spread between lending and deposit rates in African countries and which need addressing. First, lack of fiscal discipline has produced an environment of unsustainable fiscal policy supported by short-term domestic debt. This has tended to produce a conflict in the co-ordination of monetary and fiscal policy. The outcome has been to put an upward pressure on domestic interest rates.

Second, there has been persistent macroeconomic disequilibrium in most African economies resulting in high domestic borrowing by the governments. This has led to both high interest rates and also crowding out private sector investment, and worse of all, a build up of domestic debt.

Third, is the inefficiency in the banking sector as the banks and financial institutions also funded non-viable projects. This is further exacerbated by the oligopolistic structures in the banking sub-sector.

I believe that these reasons are not exhaustive and I would like to request this conference to explore other causes of the poor performance of our financial institutions.

Ladies and Gentlemen, another area that deserves examination by this conference is the role of donor funding, its effect on development and external debt. It is evident that when donor funds are efficiently spent in the development of infrastructure and capacity building, significant improvements have been realised. On the other hand, where external funded projects or programmes were not well conceived the benefits were delayed and in certain instances were not realised at all. The other dimension is when donors insisted that procurement must be made from the source country. More often than not this was done at inflated prices or obsolete equipment were supplied to developing countries.

Since a number of such projects were financed through concessionary loans, developing countries had little scope to reject the procurements. Furthermore, even when such projects became operational, resources for maintenance were not forthcoming, hence expected benefits were never realised. In addition, lack of resources for maintenance fed into government expenditures and made fiscal management difficult.

Donor conditionalities most of which were arrived at unilaterally led to frequent policy reversals which in turn have been detrimental to the reform process in the financial and other sectors. It is my sincere belief that what we need is genuine partnership and selectivity of development projects. As partners, conditionalities should be fully negotiated between the recipient and donor countries to give credibility and ownership to the set of conditionalities to be implemented.

Another important factor that has adversely affected African countries is the declining and uncertainty surrounding official development assistance. Given this scenario, African countries need to put in place programmes aimed at gradually reducing over-dependence on donor funding. This will require that countries deepen their reforms to implement policies that ensure competitiveness in production, financial deepening and create conducive macroeconomic environment for increased foreign direct investments.

In Kenya for example, the PRSP has put in place policies to revive and sustain growth while at the same time addressing poverty and inequality. These policies encompass the following broad areas:

- domestic resource mobilisation;
- infusion of net resource inflows from the rest of the world;

- domestic fiscal policies and flexible financing options;
- changing the composition of government spending towards public investment with strong complementarity to private investment and poverty reduction effects; and
- an enabling environment for the private sector to thrive and to generate wealth.

These policies require a vibrant financial system that facilitates the financing of private investment, screening of viable projects and borrowers, absorbing of public debt and above all creating conditions favourable for a market niche to develop the micro-finance and other small players to participate in the financial system.

Ladies and Gentlemen, the domestic and foreign debt that many African countries face today has adverse effects on economic development. Despite these adverse effects, the level of debt has continued to increase over time in Africa. In the case of foreign debts many countries are no longer able to effectively manage them—many cannot even service these foreign debts. Besides renegotiations of foreign debts, countries in the region need to seek ways of relaxing some of the stringent conditions which bar several poor countries benefiting from the HIPC Debt Reduction Initiative. Besides the external debt, domestic debt, too, has to be serviced and this also reduces available domestic resources. The servicing crowds out credit to the private sector and reduces the level of economic activity. There is therefore need to explore possible ways and means of solving the problem. Some of the solutions include externalising the domestic debt; creating a domestic debt fund from privatisation proceeds and other sources; and converting a proportion of the domestic debt into long-term government stocks in the Central Banks.

Success in reducing domestic debt would substantially reduce the pressure on domestic interest rates and help in co-ordinating monetary and fiscal policies. This is an experience countries in other regions have faced and found solutions. The conference would add value in showing the way forward here.
Ladies and Gentlemen, on behalf of the government and on my own behalf, let me thank DfID for providing research funds for this project. I would also like to thank all of you who have participated and made this conference a reality.

With these remarks I wish you fruitful deliberations and productive outcomes.

Thank you for listening.

10.2 Conference programme

TUESDAY, 10 JULY

08:00 am	**Registration**: Ball Room, Grand Regency Hotel. *Chair: Prof. Mwangi Kimenyi, Executive Director, KIPPRA*
09:15 am	**Introduction and welcome** *Professor Mwangi Kimenyi, KIPPRA; Victor Murinde, University of Birmingham*
09:30 am	**Official opening** *His Excellency the Vice President and Minister for Home Affairs Prof. George Saitoti*
10:00 am	**Financial sector liberalisation in Kenya: the critical issues** *Njuguna Ndung'u, KIPPRA*
10:15 am	**International financial flows and the challenge of financing development in Africa: an overview of challenges, prospects and implications** *Alemayehu Geda, ISS (The Hague)/KIPPRA*
10:30 am	**Discussion**
11:00 am	**Tea/coffee break**
11:30 am	**The participation of foreign-owned banks in the domestic banking sector of African economies** *Victor Murinde and Moses Tefula, University of Birmingham*
12:00 noon	**The implications of the evolving micro-finance agenda for regulatory and supervisory policy** *Colin Kirkpatrick (IDPM) and Samuel Maimbo, University of Manchester*
01:00 pm	**Lunch**

TUESDAY, 10 JULY
GROUP A

INTERNATIONAL FINANCIAL FLOWS, FINANCIAL SECTOR REFORMS, SAVINGS AND FINANCIAL DEVELOPMENT

INTERNATIONAL FINANCIAL FLOWS AND DEVELOPMENT
Chair: Victor Murinde

02:00 pm	**The East Asian crisis and financing corporate investment: is there a cause for concern?** *Nigel Driffield, University of Birmingham and Sarmistha Pal, Cardiff Business School*

02:40 pm **International capital mobility: evidence from developing countries**
David Ndii (Kenya Leadership Institute)

03:00 pm **Tea/coffee break**

FINANCIAL SECTOR REFORMS, SAVINGS AND DEVELOPMENT

03:20 pm **Financial liberalisation in Kenya: where are we now?**
Njuguna S. Ndung'u and Jane Kiringai, KIPPRA

03:40 pm **Impact of financial sector liberalisation on competition, innovation and efficiency in the Ghanaian banking industry**
Kweku Baa Korsah, KPMG Ghana; Francis Sasraku Mensah, Ghana Commercial Bank; Ernest Kwadwo Nyarko, KPMG Ghana; and Noel Ayitey Tagoe, KPMG Ghana

04:00 pm **Savings and financial sector development: Panel Cointegration Evidence from Africa**
George Mavrotas and Roger Kelly

04:20 pm **Child wealth, financial development and savings in Africa: comparative evidence on the old age security fertility motive**
David Ndii (Kenya Leadership Institute)

WEDNESDAY, 11 JULY
BANK PERFORMANCE AND REGULATION

Chair: Joy Suppakitjarak

08:00 am **Resolving bank failures in Uganda: policy lessons from the recent bank failures**
Martin Brownbridge, Ministry of Finance, Uganda

08:20 am **Banking sector regulation and performance: the post-reform Ethiopian experience**
Alemayehu Geda, KIPPRA, and Seife Dendir, Addis-Ababa

08:40 am **Explaining bank regulatory failure in Zambia**
Samuel Munzele Maimbo, University of Manchester

09:00 am **Regulatory frameworks for effective financial systems in Africa**
Mwangi S. Kimenyi, KIPPRA

09:20 am **Bank capital adequacy, endemic bad debts and the determination of interest rates**
Christopher J. Green, Loughborough University

09:40 am **Risk and governance in African commercial banking: in the shadow of the market**
Wendy Abt and Atif Mian, WPA

10:00 am **Tea/coffee break**

FLOW OF FUNDS AND FINANCE IN CONFLICT AND RECONSTRUCTION

Chair: John Mbaku, Weber State University

10:20 am **Flow of funds and policy modeling for Kenya**
Victor Murinde, Christopher J. Green, and Njuguna Ndung'u

10:40 am **Modeling the flow of funds in India**
Tomoe Moore, Christopher J. Green and Victor Murinde

11:00 am **Financial reconstruction in conflict and post-conflict countries**
Tony Addison, Alemayehu Geda, Philippe Le Billon and S. Mansoob Murshed, WIDER/UNU

BANKING REGULATION

Chair: Hezron O. Nyangito

11:20 am **Can prompt corrective action rules work in the developing world?**
Martin Brownbridge, Ministry of Finance, Uganda and Samuel Munzele Maimbo, University of Manchester

11:40 am **The design, development and implementation of bank licensing policies and procedures in Zambia**
Samuel Munzele Maimbo, University of Manchester

12:00 noon **Financial sector reform and regulation in Kenya**
Colin Kirkpatrick, University of Manchester and Bernard Kagira

01:00 pm **Lunch**

02:30 pm **Plenary Discussion and Way Forward**

GROUP B

TUESDAY, 10 JULY
CORPORATE CAPITAL STRUCTURE, MICRO-FINANCE AND RURAL CREDIT MARKETS

MICRO FINANCE AND RURAL CREDIT MARKETS

Chair: Francis Mwega

02:00 pm **Agricultural credit and performance of selected financial institutions in Kenya**
Hezron O. Nyangito and Lydia Ndirangu, KIPPRA

02:20 pm	**From fragmentation to embeddedness: towards a framework for the institutional analysis of financial markets** *Susan Johnson, University of Bath*
02:40 pm	**Impact of micro-finance enterprises on the efficiency of micro-enterprises in Cape Coast** *Dr Vijay K Bhasin and Wisdom Akpalu, University of Cape Coast*
03:00 pm	**Micro-finance and behaviour change among Nairobi's commercial sex workers** *Dorothy McCormick and Kaendi Munguti, IDS, University of Nairobi*
03:20 pm	**Tea/coffee break**

CORPORATE CAPITAL STRUCTURE

03:40 pm	**The determinants of the capital structure of micro and small-scale enterprises in Kenya: evidence and sensitivity analysis results** *Peter Kimuyu, Victor Murinde and Christopher J. Green*
04:00 pm	**Corporate financial structures in India** *Christopher J. Green, Victor Murinde, and Joy Suppakitjarak*

WEDNESDAY, 11 JULY

EMERGING STOCK MARKETS: REFORMS AND PERFORMANCE

Chair: Susan Johnson

08:00 am	**The response of market microstructure to revitalisation: evidence from the Nairobi Stock Exchange** *Rose Ngugi, Victor Murinde and Christopher J. Green*
08:30 am	**Market microstructure of the Mumbai Stock Exchange** *Christopher J. Green, Victor Murinde and Joy Suppakitjarak*

FINANCING DEVELOPMENT

09:00 am	**Investment and uncertainty: evidence on Kenyan firms and the Nairobi Stock Exchange** *Rose Ngugi, Victor Murinde and Christopher J. Green*
09:30 am	**The role of international capital flows, aid and export earnings in financing development in Kenya: analysing the options using the KIPPRA-Treasury Macro Model for Kenya** *Stephen Njuguna Karingi and Maureen Were, KIPPRA*
10:00 am	**Tea/coffee break**

CORPORATE FINANCING

Chair: Peter Kimuyu

10:30 am	**The determinants of capital structure choice in Zimbabwe: preliminary results** *Enard Mutenheri and Christopher Green*
11:00 am	**Business groups and dividend policy: evidence from Indian firms** *Ronny Manos, Victor Murinde and Christopher J. Green*
11:30 am	**Improving rural women's access to credit: a case study of women's groups in Kakamega District, Kenya** *Nelson H.W. Wawire, Kenyatta University*

FINANCING ISSUES

12:00 noon	**Corporate financial structures in developing economies: evidence from a comparative analysis of Thai and Malay corporations** *Sanjiva Prasad, Christopher Green and Victor Murinde*
12:30 pm	**Capital structure and business groups: evidence from Indian firms** *Ronny Manos, Victor Murinde and Christopher J. Green*
01:30	**Lunch**
02:30 pm	**Plenary discussion and Way Forward**

CLOSING ADDRESS

(Guest Speaker)

10.3 List of Conference Participants

1.	Aleke Dondo	Managing Director, K-Rep Holdings
2.	Alice Njambi Kinyungu	Senior Researcher, PERINET - Africa
3.	Augustine Cheruiyot	Research and Development Manager, K-Rep Holdings Limited
4.	Bernadette Wanjala	MA student, University of Nairobi
5.	Bernard Kagira	MA student, University of Nairobi
6.	Biswajit Dasgupta	Country Treasurer, ABN-Amro Bank NV
7.	Caesar Cheelo	MA student, University of Nairobi
8.	Christopher J. Green	Loughborough University
9.	Clive Davis	KIPPRA
10.	Colin Kirkpatrick	IDPM, University of Manchester
11.	David Ferrand	DfID
12.	David Muthaka	MA student, University of Nairobi
13.	David Ndii	Kenya Leadership Institute
14.	Donald Atieno Ouma	Research & Development Manager, Nairobi Stock Exchange
15.	Alemayehu Geda	KIPPRA
16.	Andrew Mulei	Executive Director, ICEG
17.	Catherine Masinde	DFID, Enterprise Development Co-ordinator, Kenya,
18.	Claude Sumata	Centre for African Studies, London
19.	Dorothy McCormick	IDS, University of Nairobi
20.	George Mavrotas	University of Manchester
21.	Hezron Nyangito	KIPPRA
22.	Jennifer Riria	Managing, Director, Kenya Women Finance Trust
23.	Moses Ikiara	KIPPRA
24.	Njuguna Ndung'u	KIPPRA
25.	O. Sule	Chairman, Department of Economics, University of Nairobi
26.	Stephen Karingi	KIPPRA
27.	Vijay Kbhasin	University of Cape Coast
28.	Wilson Wasike	KIPPRA
29.	E. K. Ysiror	Deputy Director, Deposit Protection Fund
30.	Enard Mutenheri	
31.	Eric Ronge	KIPPRA
32.	Ernest Kwadwo Nyarko	KPMG, Ghana
33.	Geoff West	Economic Adviser, Ministry of Finance and Planning
34.	George Kararach	UNICEF
35.	George Omino	Manager, Micro Finance Division, Central Bank of Kenya
36.	Hilda Basa	KIPPRA
37.	Hon Prof. G. Saitoti	Vice-President, Office of the Vice-President & Ministry of Home Affairs
38.	Isabella W. Mwangi	MA student, University of Nairobi
39.	James H. Rmurigo	Managing Director, Suntra Stocks Ltd
40.	Jane Kiringai	KIPPRA

41. John Kashangaki	Managing Director, K-Rep Advisory Services
42. John Mbaku	Weber State University
43. John Mutua	KIPPRA
44. John Obere	Acting Chairman, Economics Department, Kenyatta University
45. John W. Karani	MA student, University of Nairobi
46. Joseph Wambua	KIPPRA
47. Josephat Mboya	Senior Consultant, K-Rep Advisory Services
48. Joy Suppakitjarak	
49. Julius Njuguna Mungai	MA student,University of Nairobi
50. Kaendi Munguti	IDS, University of Nairobi
51. Ken Mayore	MA student, University of Nairobi
52. Lydia Ndirangu	KIPPRA
53. Martin Brownbridge	Ministry of Finance
54. Mary Ndunge Nguli	MA student, University of Nairobi
55. Maureen Were	KIPPRA
56. Mohammad Z. Hoque	Sultan Qaboos University
57. Moses Sichei	Kenya Commercial Bank
58. NancyNafula	KIPPRA
59. Nelson Wawire	Kenyatta University
60. Ngure Mwaniki	Mwaniki Associates
61. Nigel Driffield	University of Birmingham
62. Noel Ayitey Tagoe	KPMG, Ghana
63. Paul Kimalu	KIPPRA
64. Pauline N Mwangi	MA student, University of Nairobi
65. Mwangi Kimenyi	KIPPRA
66. Francis Mwega	University of Nairobi
67. G. Mwabu	KIPPRA
68. Kabiru Kinyanjui	Senior Program Specialist, IDRC
69. Peter Kimuyu	IPAR
70. Terry C. I. Ryan	Economics Department, University of Nairobi
71. Victor Murinde	University of Birmingham.
72. Riungu Murithi	MA student, University of Nairobi
73. Robert Nyaga Kivuti	MA student, University of Nairobi
74. Roline Njiru	MA student, University of Nairobi
75. Ronny Manos	
76. Rose Ngugi	University of Nairobi
77. Ruth Gathee	KIPPRA
78. Samuel Maimbo	IDPM, University of Manchester
79. SanjivaPrasad	
80. Seife Dendir	Addis Ababa
81. Shobhna Shah	Senior Economist, Ministry of Finance and Planning
82. Steve N. Anjichi	Kenya Institute of Bankers (KIB)
83. Susan Johnson	University of Bath
84. Titus Muya	Chairman, Family Finance
85. Tomoe Moore	
86. Wambui Wagacha	KIPPRA
87. Wendy Abt	WPA, Inc.

10.4 KIPPRA PUBLICATIONS

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