Financial Sector Development in the IGAD Region

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Ali I. Abdi (PhD) and Emerta A. Aragie (MSc)

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I. Introduction

Financial development and domestic capital formation are principal driving forces behind any country's sustainable growth, and effective financial institutions are important facilitators. Financial institutions are the key channel between savings and investment, and their efficiency is a key determinant of a country's economic growth. This strong positive relation between financial sector development and economic growth has been supported by theoretical and empirical studies. The countries with advanced economies exhibit well developed and mature financial systems and dual causality is postulated in economic literature.

Both theory and evidence support the proposition that enhancing financial sector performance results in higher economic growth. The theoretical argument for linking financial sector development to growth is that a well-developed financial system performs several critical functions to enhance the efficiency of intermediation by reducing information, transaction and monitoring costs. A modern financial system promotes investment by identifying and funding good business opportunities; enables the trading, hedging, and diversification of risk; and facilitates the exchange of goods and services. These functions result in more efficient allocation of resources, a more rapid accumulation of physical and human capital, and faster technological progress, which in turn feed economic growth. Thus, getting the financial system of developing countries to function more effectively in providing the full range of financial services promotes high sustainable economic growth.

Research also supports the hypothesis that financial sector development boosts economic growth. In a wide range of studies, the initial level of financial development is shown to be a good predictor of subsequent rates of economic growth, physical accumulation, and productivity growth. Some studies have shown that countries with higher levels of financial development grow faster by about 0.7 percentage point a year[1]. The financial sector facilitates the mobilization of resources; allocation of credit; pooling, pricing and trading of risk, and monitoring and supervising borrower's behavior. To facilitate and promote private sector investment, better domestic financial systems need to mobilize domestic resources.

The financial system of a country comprises different types of financial institutions, including banks, and non-banks deposit taking institutions, insurance companies, mutual funds, finance companies, investment banks and specialized financial institutions, microfinance institutions and the equity and securities markets. The financial markets enable the transfer of funds from people who save to people who have productive investment opportunities[2] and that need financing. The financial system in developing countries is often dominated by the banking systems, which in most such countries holds at least 80 percent of the assets of all financial intermediaries. In many of these countries, the financial markets are controlled by a few, large banks. Their size is based, not on economies of scale, but on restrictions on new bank licenses, and controls that discourage competition[3].

[1] Creane S., Goyal R., Mobarak A, and Sab R. "Financial Development in the Middle East and North Africa", IMG, 2003
[2] Mishkin, S., "The Economy of Money, Banking and Financial Markets", Seventh Edition, 1998
[3] World Bank Policy Report (April 2001) "Finance for Growth: Policy Choice in a Volatile World", A World Bank Policy Research Report, A co-publication of the World Bank and Oxford University Press, April 2001.

II. Financial Development and Growth: A Literature Review

Classical economic theorists, such as Ricardo, focused on shortages of real factors, land and capital, as constraints on economic growth and did not consider the role of financial markets. The impact of financial sector development on the real economy has more recently become the subject of wide literature and a vast number of theoretical studies have been carried out[4]. These studies assert a positive and significant relationship between financial sector development and economic growth. One of the first pioneers of modern development theory, Joseph Schumpeter, argued that efficient financial institutions were essential for economic growth and development. Other economists have stressed that the efficiency or inefficiency of the financial sector is a crucial determinant of a country's economic growth, and that development of financial markets is usually led by sound macroeconomic policy[5].

The emergence of new theories of endogenous economic growth has given additional evidence to the relationship between growth and financial development as these models postulate that savings behavior directly influences not only equilibrium income levels but also growth rates. Thus, financial markets can have a strong impact on real economic activity. The existence of a vibrant and efficient financial sector helps in pooling the savings of households and firms and making it available to entrepreneurs[6].

The studies of McKinnon (1973) and Shaw (1973) provide valuable theoretical insights into the role of financial sector in developing economies. They outlined the constraints placed on economic development by an ineffective financial sector and the benefits that accrue from financial liberalization in developing or low income economies, even if the deep-seated problems of these economies are related to all the economy, not only to the financial sector. Kelly and Marvotas (2003) also asserted that developing countries lack an appropriate financial sector. They note that in pursuit of such a financial system, many developing countries have implemented far-reaching financial reforms, including lifting restrictions on bank lending, the provision of market-based systems of credit allocation, lowering of reserve requirements, easing of entry restrictions to the banking sector, and privatization of state owned banks.

Hallwood and McDonald (2000) postulate that a country's international financial difficulties often cannot be separated from problems in its domestic financial system. A balance of payment crisis can easily be sparked in the capital account even by a suspected domestic banking crisis which induces investors to take their money out of a given country. Hence, there is a need for a sound financial system to support a country's position in the international financial system and its external sector viability.

All the theoretical arguments for linking financial development to growth emanate from the fact that a well developed financial system performs several critical functions. An effective modern

[4] Outerville (1999)
[5] Barger (1998)
[6] ADB (1997)

financial system mobilizes savings, promotes investment by identifying and funding good business opportunities, monitors the performance of business managers, enables risk diversification and reduction. These functions result in a more rapid accumulation of physical and human capital and faster technological progress which in turn promotes economic growth.

A vast number of empirical studies have been carried out to investigate the effects of financial intermediation as a driving force behind a country's savings, investment, and growth rates. Results of the studies support the thesis that financial sector development boosts economic growth. In a wide range of studies, the initial level of financial development is shown to be a good predictor of subsequent rates of economic growth, physical accumulation, and productivity growth, even after controlling for income, education, political stability, and measures of monetary, trade and physical policy.

Empirical research on the link between financial development and economic growth can be traced back to the pioneering work of Goldsmith (1969), which stressed the connection between a country's financial superstructure and its real economic infrastructure[7]. Al-Mashat conducted an empirical study to assess the impact of financial sector development on non-government saving's and economic growth in Egypt using data from 1960-99. The statistical analysis carried out shows that the non-government savings respond positively to most of the indicators of financial sector development. Egypt's experience indicated that as market-based financial systems are established, higher real return on savings, greater efficiency of the financial system, and a large share of resources intermediated through financial institutions all contributed to higher savings. Kelly and Mavortas used improved savings data in Sri Lanka over the period 1970-97 and created an index of financial sector development indicators. Their empirical findings clearly suggested a strong and positive effect of financial sector development on private savings in Sri Lanka during the period examined.

Other research shows that measures of the size of the banking sector and the size and the liquidity of the stock market are highly correlated with subsequent GDP per capita growth[8]. Moreover, emerging evidence suggests that the level of the banking sector development exerts a causal impact on economic growth.

Cross-country studies have also uncovered a contemporaneous correlation between the level of financial development and growth. This correlation exists across a variety of measures that capture both the efficiency and the financial system. Some studies have shown that countries with higher levels of financial development grow faster by about 0.7 percentage points a year. On the other hand, an underdeveloped financial system leads to financial repression and hence can constrain or inhibit economic prospects[9]. World Bank research shows that a 10 percent increase in financial depth is associated with an increase in per capita GDP growth of 2.8 percent, a remarkable increase.

[7] Hossein Jalilian and Colin Kirkpatrick (2001)

[8] Asli Demirguc-Kunt and Ross Levien (2002)

[9] Financial repression means the imposition of liquidity constraints through allocation of loans by administrative means rather than use of the market.

Regardless of how financial development is measured there is clear evidence of a cross-country association between financial sector development and the level of income per capita. Diverse econometric evidence shows that the contribution of finance to long-term growth is chiefly by improving total factor productivity. Goldsmith clearly documented a positive correlation between financial development and the level of economic activity in thirty five countries, using data prior to 1964. An important reason why many developing or transition countries experience very low rates of growth is that their financial systems are underdeveloped; a situation referred as financial repression[10]. Financial development also contributes to poverty reduction, and can provide a firm basis on which to undertake more focused, micro empirical investigation of how specific financial sector policies and programmes can be deployed as effective instruments for achieving poverty reduction in low-income countries.

[10] Mishkin (1998)

III. Comparative State of Financial Sector Development in IGAD

In this section, available financial development indicators in IGAD countries are assessed and compared with each other. Indicators of financial sector development and deepening that are reviewed are: broad money (M2), bank deposit liabilities (BL), and domestic credit (DC), as a percent of GDP, quasi money to broad money and interest rate spread.

Table 3-1: Financial sector indicators as a percent of GDP

	Period Average			
	1980-89	**1990-99**	**2000-04**	**2005-08**
Broad Money (M2)				
Djibouti	---	---	---	---
Eritrea	---	---	---	---
Ethiopia	40.6	48.7	47.7	43.8
Kenya	28.6	40.5	40.2	33.3
Somalia	---	---	---	---
Sudan	33.0	18.8	14.2	22.6
Uganda	---	10.0	14.0	15.0
SSA[11]	20.9	18.5	21.1	25.3
Banks Deposit Liabilities				
Djibouti	---	---	---	---
Eritrea	---	---	---	---
Ethiopia	19.1	26.2	36.9	38.7
Kenya	22.0	32.8	33.9	34.0
Somalia	---	---	---	---
Sudan	18.6	11.1	8.9	15.4
Uganda	---	---	14.1	14.7
SSA	13.2	11.7	13.8	16.9
Private Sector Credit				
Djibouti	---	---	---	---
Eritrea	---	---	---	---
Ethiopia	43.3	49.3	53.5	55.3
Kenya	33.7	38.9	39.9	36.7
Somalia	---	---	---	---
Sudan	35.9	177.0	10.4	16.7
Uganda	---	---	10.0	7.0
SSA	25.3	16.2	13.7	12.6

Source: Computed from IFS of IMF

[11] Countries including Benin, Burkina Faso, Cameroon, Central African Rep., Chad, Niger, Rep. of Congo, Cote d'Ivoire, Gabon, Gambia, Mali, Senegal, Mauritania, and Rwanda. The choice of the countries is guided by availability of data and similarity in data reporting format.

Comparison among IGAD countries shown in Table 3.1 shows that the broad money to GDP ratio is higher for Ethiopia and Kenya as compared to other countries in the sub-region. However, this may not signify a higher level of financial sector development and does not correspond to reality. This may simply signify the monetization level of the economies as they are mostly urbanized economies. A lower ratio is observed in the case of Uganda and Sudan.

Again, bank deposit liability to GDP ratio is larger in the economies of Ethiopia and Kenya and a lower level of the sector's development is associated, in this case, with Sudan and Uganda in relative terms.

The credit aggregates suggest that the member states of IGAD show increasing private sector credit to GDP ratio. Research studies have shown that higher ratios of private sector credit to GDP are indicators of financial sector development and deepening. In IGAD domestic credit to GDP ratio ranges from 7-55 percent of GDP.

Higher quasi-money as percentage of broad money implies the development of the financial markets and the availability of financial products for long term investment. This is associated with the important role of savings and time deposits, and other less liquid long term financial assets as sources of long term investment relative to transaction balances. Available data shows that quasi-money as percentage of broad money in all IGAD member states has improved. Kenya has the highest ratio among the IGAD sub-region; on the other hand, Uganda and Sudan have the lowest implying that in these two countries long term financial products like savings and time deposits plays less important role relative to transaction balances.

Table 3.2: Narrow and quasi-money as percentage of broad money

	(1980-89)	(1990-99)	(2000-10)
Quasi-money			
Djibouti	51.8	44.8	45.8
Eritrea	---	62.2	54
Ethiopia	28.9	29.7	43.5
Kenya	49.8	58.5	52.8
Sudan	22.5	27	36.2
Uganda	17.8	27.7	34.2
Narrow Money			
Djibouti	48.2	55.2	54.2
Eritrea	---	37.8	46
Ethiopia	71.1	70.3	56.5
Kenya	50.2	41.5	47.2
Sudan	77.5	71	63.8
Uganda	82.2	72.3	65.8

Source: World Development Indicators

The interest rate spread shows the level of competition and the extent to which transaction costs prevail. Cross-country data shows that transaction cost as shown by the interest rate spread is higher for Uganda and Djibouti. Kenya has had the highest margin in the 1990's and early 2000's. The spread is lower for Ethiopia (3.5 percent in 2005-08). The low interest rate spread in Ethiopia for the earlier years was partly due to administrative controls on interest rates. Overall, there is a declining trend in interest rate spreads signifying the increasing ease of transactions and improving competition in the markets for credit.

Comprehensive Index of Financial Sector Deepening in IGAD Countries

The index computed shows us that countries have varying ranks. To arrive at an all-inclusive average index, the indices are developed as a composite based on assigned set of weights to each of the indicators based on their relative strength in showing financial sector development[12].

The countries covered are only few and we do not find it relevant and representative to classify these countries into categories as having high, medium, and low financial development in absolute terms before calculating the comprehensive index. The index indicates only the relative ranking of the countries in the IGAD region in totality, based on the indicators analyzed. Given the list of indicators used, the comprehensive index revealed that Kenya and Ethiopia have relatively deeper financial sector development, while Sudan has the lowest index.

Table 3.3: Interest Rate Spread for IGAD member countries

	(1980-89)	(1990-99)	(2000-10)
Djibouti	---	---	9.6
Eritrea	---	---	---
Ethiopia	---	3.9	3.8
Kenya	3.5	12.3	10.0
Somalia	---	---	---
Sudan	---	---	---
Uganda	7.6	9.2	11.3

Sources: IMF, International Financial Statistics

Caveats of the Methodology

While we employed a frequently used method of comparing level of financial sector development, we feel that the methodology is not without limitations. The results obtained might be confusing as countries with observable transformations and dynamism in the financial sector could be ranked lower as compared with nations with rudimentary and traditional financial products. Thus, this part of the work has to be used in conjunction with the preceding sections as beyond the usual financial ratios, those sections give us information on the level of penetration and development of "high level" financial products such as derivatives and financial markets including securities and stock markets.

[12] The given weights are M2/GDP 2, BL/GDP 2, DC/GDP 1, and M2/NM 3.

IV. Monetary Policy in IGAD Member Countries

All countries have some form of central monetary authority or bank that is responsible for financial matters. Despite simple variations in the responsibilities and mandates of central banks, the primary duties of the majority of the central banks include: implementation of a monetary policy, promotion of the stability of the country's financial system, and the management of the national currency and foreign exchange system.

The central banks implement the country's monetary policy using the main available instruments. Monetary instruments often include: open market operations, bank reserve requirement, interest rate policy, re-lending and re-discount facilities and credit policy. The effectiveness of monetary policy instruments largely depends on the size and maturity of the financial sector. Countries with complex financial markets have larger freedom to effectively implement monetary policies to affect prices, output, unemployment and other macroeconomic variables.

Theoretically the central bank should be an "independent" and "autonomous" institution. Most developed industrial countries maintain autonomous central banks while in most developing countries governments often co-manage monetary policy. In the IGAD region the design and implementation of monetary-policy is managed by the central banks. Variations in human and material resources of central banks in the region determine the efficiency of monetary policy in affecting the real sector of each Member State. Also variations in the level of maturity of the financial system (such as commercial banks and financial markets) are important determinants.

The member countries of IGAD have operating central banks, except Somalia where political instability for the past two decades had incapacitated the Central Bank. There are efforts underway by concerned stakeholders to rebuild that central Bank so that it can play its part in maintaining macroeconomic stability and contribute to the nation's economic growth. The monetary policy in the IGAD region is dominated by the objective of maintaining macroeconomic stability, while ensuring economic growth. Low levels of inflation (usually single digit inflation) and exchange rate stability have been the major policy targets of the central banks of the region. It is accepted that macroeconomic stability is essential to providing economic activities and agents a favorable condition for effective decision-making.

During periods of domestic social, political and economic crisis and instants of external shocks, countries face problems of high inflation with significant economic, social and income distribution consequences. The recent oil price shock fueled inflation both directly from the domestic price of oil and indirectly from the high cost in the production and transportation of goods and services. The inflation rate reached 17 and 44 percent in Ethiopia in 2007 and 2008, respectively. Similarly, in 2008 the rate reached 14.3, 18 and 26 percent in Sudan, Eritrea and Kenya, respectively[13].

[13] IMF, International Financial Statistics

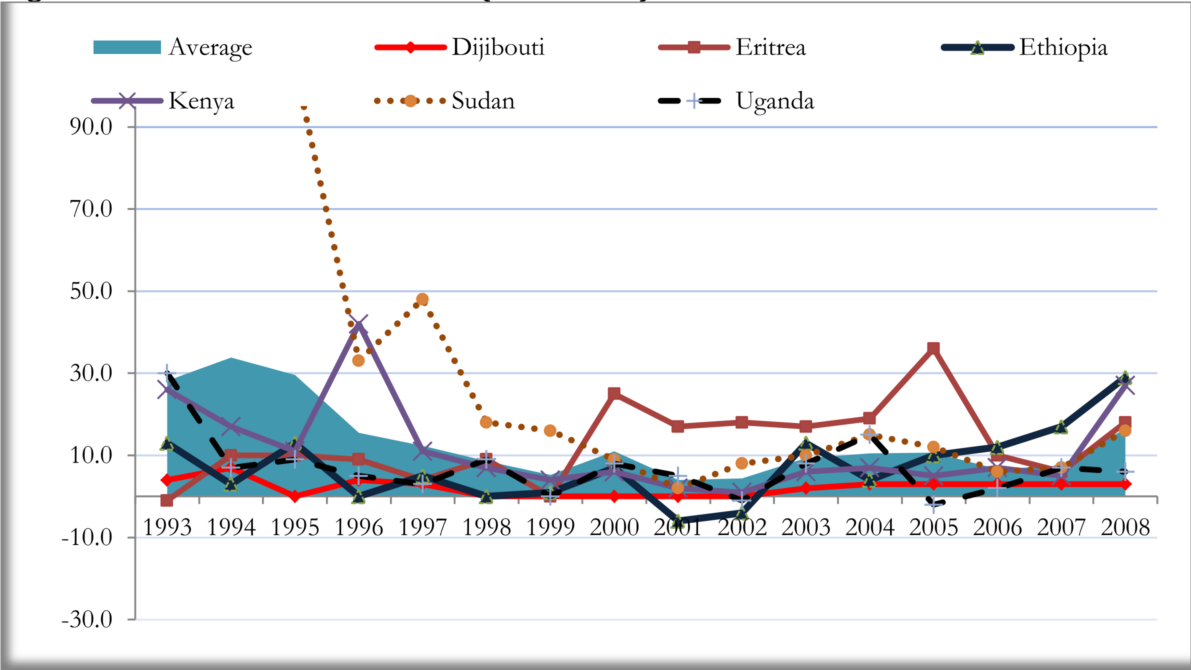
The central banks in the region have varying capacities to execute monetary policy objectives. The Central Bank of Kenya (CBK) is regarded as an active central. It has succeeded in modernizing the financial and monetary sector of Kenya. The financial sector (including financial and securities markets) are dynamic and this facilitates effective implementation of monetary policies. The Ugandan financial sector is improving as the country extends its commitment to introduce and transform various financial products and markets.

Unlike the common practice in the rest of the IGAD member countries, the Bank of Sudan added to its main functions the role of continuing social support program for national mobilization for social security and for the improvement of productivity. Unlike other central banks, it also emphasizes measures on the policies supply side.

As shown in the table, the variability of inflation among IGAD countries has generally decreased over time. The IGAD region saw a rapid and very volatile rise in inflation in the 1990s. Thereafter, a consistent decline in the dispersion in inflation was observed stabilizing in the mid of 2000's. The oil price shock increased the inflation in the IGAD region by 9 percentage points in 2008 alone, reaching 17.5.

The country-by-country analysis shows that most of the member countries of IGAD are converging to the regions average. An exception was Sudan in the early 1990's; and now Ethiopia and Kenya are having one of the highest inflation levels in the region. On average, inflation in the IGAD sub-region remains very high, exceeding 4 percent for each year under review. While it declined from 33.8 percent in 1994 to 4 percent in 2001, the average rate was 16.5 percent in 2008, owing to the negative impact of high oil prices on inflation. Djibouti and Uganda were generally able to keep inflation in single digits.

Figure 4.1: Inflation trends in IGAD (1993-2008)



Sources: IMF, International Financial Statistics

Apart from the level of inflation the variability of the rate is another factor which inhibits macroeconomic integration. We can also use the variability level as a robustness-checking instrument for the possibility of monetary coordination in the region. As shown by the table below the squared deviation of inflation observations from mean declined as we move on average from the 1990's to the 2000's implying that the region is becoming relatively stable.

Table 4-1: Squared deviation of inflation rate in the IGAD region (1993-2000 and 2001-08)

Country	1993-2000	2001-08
Djibouti	9.0	0.8
Eritrea	381.7	533.9
Ethiopia	201.5	9.7.9
Kenya	1150.0	468.0
Somalia	---	---
Sudan	20,365.9	156.0
Uganda	578.9	208.0
Average	3,781.2	379.1

Source: Own calculation

In order for the IGAD member countries to attain monetary policy harmonization, they would first have to implement coordination with their central banks. To reach the level of establishment of common monetary policy for the IGAD members, the following various conditions, among others, would have to be met.

- The successful integration of all IGAD economies;
- Abolition of capital controls between countries;
- A framework for common foreign exchange operations and maintenance of an "IGAD" foreign exchange reserve;
- Coordination of the role in conducting monetary policy, financial supervision and lender of last resort functions; and
- Progress towards currency convergence and a common currency.

Summing up, while the declining rate of inflation since the 1990's suggests an increasing possibility of macroeconomic harmonization in the IGAD region, the recently observed international food and oil prices surges pose an inflation threat.

V. Commercial Banking in IGAD Region

The financial system constitutes various institutions among which commercial banks are dominant in developing economies including the IGAD sub-region. Modern commercial banking in some parts of the region started in the early 1990s, but banking activity has remained passive and rudimentary since then. Some possible factors in the low development of the financial sector are: the weak economies of member countries and limitations on the forward and backward linkages between the real and financial sectors and lack of basic infrastructures. Frequent conflicts (which seem to be a peculiar feature of the eastern part of Africa) and resource limitations explain the underdevelopment of commercial banking business.

Financial products are not well differentiated; they are mostly traditional and banks are not innovative and dynamic in providing financial services. Among the traditional services of commercial banks are credit creation (short, medium and long-term), fund transmission services, deposit creation and payment services. In advanced economies, the banking sector provides ample and innovative state-of-art financial services thereby playing an important economic advancement.

While most member states allowed the entry and functioning of foreign banks, some of the countries such as Ethiopia do not permit the operation of such banks in the economy. It is largely accepted that the entry of foreign banks benefits an economy through the diffusion of banking technology, the flow of investment capital, and the attraction of foreign direct investment from investors that have affiliation to the expatriate bank. A possible adverse impact of entry of foreign banks is that unless the domestic banks become mature enough to compete, local existing banks will lose market share. Also an open financial sector exposes a country to external shocks as financial crisis are contagious across borders.

On the number of commercial banks operating in the region, Kenya has the largest number of banks (about 46), Sudan has 30, Uganda 22, Ethiopia 14, Eritrea 2 and Djibouti has 3 banks. A few banks dominate the banking sector in terms of branch networks, clients served, deposits mobilized and outstanding credit disbursed to economic agents. For example, in Djibouti, two banks dominate the market and are responsible for 95 per cent of deposits and 80 per cent of total domestic lending. In Ethiopia, the Commercial Bank of Ethiopia (a public bank) is by far the biggest in some respects larger than all the private banks put together. It accounts for about 33.9 percent of the total bank branches and 66.7 per cent of total outstanding credit. In Eritrea, the Commercial Bank of Eritrea is the dominant bank controlling nearly 80 percent of all banking sector assets in the country. In Kenya the top three banks account about 61 percent of net assets of the top ten commercial banks.[14]

The structure of the commercial banking sector has implications for resource distribution and for the behavior of economic agents. In situations where the sector is dominated by the government, resources such as credit tend to disproportionately move to public enterprises. Such situations have implications for the effectiveness of monetary policy as some big commercial banks are

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[14] See Nelson M Waweru and Vector M. Kalani (2009)

stronger than weak regulatory bodies (e.g.., Central Bank). The structure of commercial banks ownership is diverse in the IGAD region. The main Banks in Eritrea and Ethiopia are mainly government owned. While banks in Uganda are mainly foreign, that of Sudan is mainly domestic private. Commercial banks in Kenya are largely public and are foreign owned[15].

Even though the banking sector is the main component of the financial system in the IGAD region, it is by far less developed and its outreach is quite shallow. The number of people, on average, served by a bank branch is very big. The number of bank branches in Ethiopia is 596, Kenya 904, in Sudan 522, in Uganda 359, and in Eritrea and Djibouti very small[16]. The bank branch to population ratio in these countries is as high as 127,000 in Ethiopia, 31,000 in Kenya, 70, 000 in Uganda, and 79, 210 in Sudan. These figures are large as compared to an average of 7,000 per bank branch in the Common Market for East and Southern Africa (COMESA) countries[17]. Moreover, bank branches are concentrated in the urban centers and the rural areas in which the economies of these countries depend (agriculture) are largely marginalized from banking services. In Sudan, about 36 percent of total bank branches are located in the capital, Khartoum. In Ethiopia, 38.4 per cent of bank branches are concentrated in Addis Ababa. Studies indicate that only 10 percent of Ugandan rural population and 5 percent of the rural poor have access to financial services.

Table 5-1: Distribution of commercial banks branches in IGAD

Particulars	**Capital City**	**Regions**
Djibouti	100%	0.0%
Eritrea	-	-
Ethiopia	38.4%	61.6%
Kenya	39.8%	60.2%
Somalia	-	-
Sudan	36.0%	64.0%
Uganda	-	-

Source: Central banks of respective countries

Unlike the rest of the IGAD member states, in the Sudan Islamic banking is the dominant business in the North of the country. Conventional commercial banks operate in the Southern part of Sudan. The financial sector in Somalia has a distinct feature; money transfer agents (*Hawalas*) have recently dominated it. These operators also provide travelers checks and non-interest bearing deposits, make small loans, and perform other bank-related services.

Banking development is measured by the amount of deposit resources mobilized and credit extended as percentage of GDP. In this regard, IGAD member states lagged behind in the level of deposits mobilized, which averaged 24 percent. The ratio of deposit liabilities to GDP was 32 percent in sub-Saharan Africa, and 59 percent in East Asia[18]. The ratio of private credit to GDP

[15] Russo and Ugolini (2008)
[16] According to the Central Bank of Sudan, commercial banks spread data, 36 percent of the bank branches is in Khartoum
[17] Kasekende and Opondo (2003)
[18] Russo and Ugolini (2008)

averages 21.4 percent in the IGAD region, 24 percent for SSA, and 30 percent in East Asia[19]. Also see Table 5.2 for comparison on basic financial ratios among IGAD member countries and regional average with that of SSA average.

Table 5-2: Banking depth indicators in the IGAD region (a percent of GDP) in 2008

Countries	Bank Credit to private sector	Bank credit to central government	Demand and saving deposit	M2
Djibouti	27.8	2.1	---	---
Eritrea	25.5	96.3	---	---
Ethiopia	25.5	26.7	38.7	80.7
Kenya	25.9	7.6	34.6	39.8
Sudan	13.7	4.9	16.1	23.7
Somalia	---	---	---	---
Uganda	9.9	-4.1*	14.7	19.5
IGAD Average	21.4	27.5	26.02	40.93
SSA Average**	13.3	-2.9	16.6	24

*As claims on the central government are less than liabilities to central government.
** Average of fifteen countries in the region and for 2007
Sources: IMF-IFS and own computation

Among the activities of commercial banks are extension of credit services and mobilization of deposits. Developments in these areas explain the development of the industry as well as the industry's contribution to economic growth through channeling financial resources from where it is relatively abundant to where it is scarce. With regard to allocation of credit, developments in sectoral and clients distribution of loans are areas to consider[20]. In relation to beneficiary sectors of bank loans, disbursement of more loans to the private sector is assumed to be an indicator of financial development. Of the total domestic credit extended by the banking sector of the IGAD sub-region, the private sector took an average share of 64.3 percent from 2000 to 2008 (Table 5.3). This implies that the banking sector is contributing to the expansion of the private sector although the sector is generally constrained by lack of long-term finance. See section VII. The share varies across countries. In Eritrea (74 percent) and Ethiopia (53 percent), credit to the central government took over half of domestic credit by the banking sector crowding out availability of investible finance to the most efficient private sector. Commercial banks in Djibouti, Kenya and Uganda allocate a larger share of domestic credit to the private sector amounting to 84, 70 and 114 percent respectively. This shows that the banking sector in these countries is relatively less repressed.

[19] Russo and Ugolini (2008)
[20] By sectors, we mean economic sectors such as agriculture, industry, trade, etc; while by clients of the banking sector, we mean the government, the private sector, and public enterprises.

Table 5-3: Loans and advances by clients in IGAD region (2000-08)

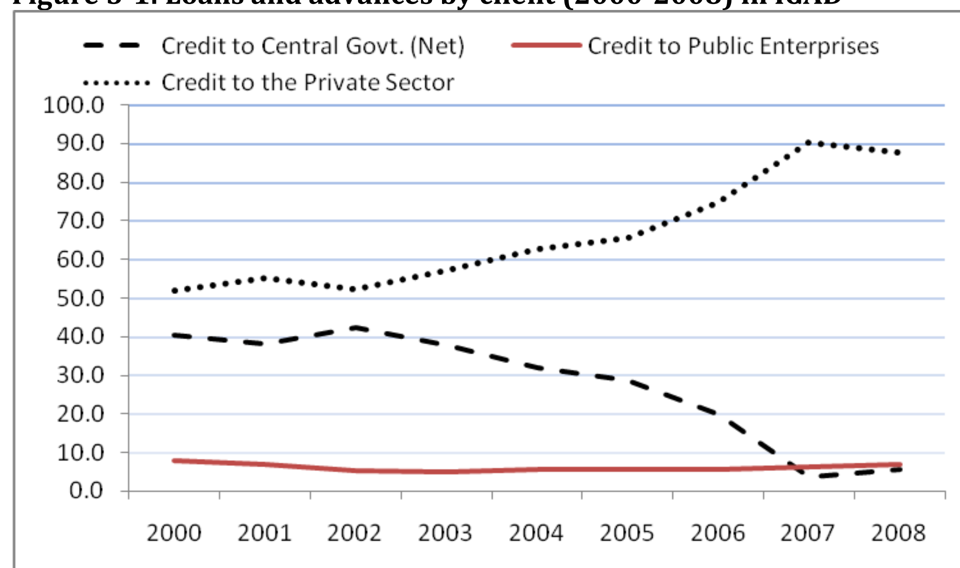
(As percent of commercial banks domestic credit)

Particulars	Credit to Central Govt. (Net)	Credit to Public Enterprises	Credit to the Private Sector
Djibouti	12.3	4.0	83.7
Eritrea	74.1	4.2	21.7
Ethiopia	52.7	6.3	41.0
Kenya	22.7	7.3	70.0
Somalia	-	-	-
Sudan	36.4	8.6	54.9
Uganda	-19.3	5.2	114.1
IGAD Average	29.8	5.9	64.3

Source: Computed from IFS-IMF

In relation to the trends over the past ten years in the share of domestic credit extended to various clients of the banks, there has been a general trend that credit to the private sector is gradually improving from about 52 percent in 2000 to 90 percent in 2007 although it slightly declined to 88 percent in 2008 (Figure 5.1). This trend shows that the private sector is increasingly benefiting from the gradually transforming banking sector in the sub-region. On the other hand, credit to central government has been moving in a direction opposite to the developments in credit to the private sector. Domestic credit to public enterprises remained more or less constant over the period since 2000 to 2008 within the range of 5 to 8 percent.

Figure 5-1: Loans and advances by client (2000-2008) in IGAD



Source: IMF

Banks credit in the region is short-term in nature with most of it channeled to trade and related services. Long-term credit, which is solely needed by other sectors for new investment and expansion, are very scarce. The economic foundation of most of the countries in IGAD, which is agriculture, gets by far the lowest share of finance disbursed by the banking sector. For example, it is as low as 7.9 percent in Uganda and 8.6 percent in Ethiopia while trade and related services enjoy shares of as large as 63 percent and 32.7 percent, respectively. Industry which has to be transforming if these countries have to build their economies in a sustainable manner also enjoys only a scant drop of financial resources from the banking sector as compared to trade credits which are known for their short-term nature. Other sectors such as building and construction, mines, power and water sectors receive a good portion of bank credit exceptionally in Kenya and Ethiopia. This is a desirable trend as most of these sub-sectors are production sectors. The regional average also reflects a similar trend with those major observations. While trade and other services benefit the larger share of 39 percent of total banking sector credit over 2005-2008, it was followed by other sectors (36.5 percent), industry (16.1 percent) and agriculture (8.4 percent). Note that trade and allied sectors enjoy bank credit amounting to more than two fold of that of industry and quadruple of that of agriculture. Table 5.4 shows the secotral distribution of bank credit in the IGAD region.

Table 5-4: Sectoral distribution of bank credit in the IGAD region
(2005-2008 average in percent)

Particulars	Agriculture	Industry	Trade and other services	Others
Djibouti	-	-	-	-
Eritrea*	12.0	21.0	51.0	16.0
Ethiopia	8.6	16.6	32.7	42.1
Kenya	5.2	11.1	9.4	74.3
Somalia	-	-	-	-
Sudan	-	-	-	-
Uganda	7.9	15.6	63	13.5
IGAD Average	8.4	16.1	39.0	36.5

Source: Various reports of central banks of respective countries
*Figures for Eritrea are based on 2002

Banking Sector Soundness

Effective provisioning of financial services largely depends on the sustainability of commercial banks.

Are banks in the IGAD sub-region vibrant and sound? This can be seen by observing trends in their financial soundness position. This includes elements such as capital adequacy, asset quality, liquidity and earnings. As a general observation, there is not much concern regarding the financial soundness of banks in IGAD region. The following observations are in order:

- Net foreign and domestic assets in the balance sheet of commercial banks have gradually increased over recent years. For example, net foreign assets of commercial banks in Uganda surged by 20 percent and 37 percent during 2006/07 and 2007/08. Net domestic assets also increased by double digits yearly. In Ethiopia, net external assets have increased for longer periods despite the declining trend in 2008 owing to significant import financing because of high oil prices.

- Owing to increasing deposits in commercial banks by economic agents that generally outweigh the loans made, liquid assets of commercial banks is increasing. As a result excess liquidity as a percent of deposit liquidity is stable or increasing. For example, in Kenya, the ratio is around 20 percent. On the other hand, loans and advances as a ratio of deposits and cash amount to about 80 percent. Excess liquidity has also been a feature of Ethiopian banks. Excess liquidity has reached 78 percent of actual reserves in 2007 implying that there is no liquidity crunch in Ethiopia. This excess liquidity is expected to persist in the near future as commercial banks have credit limits they can extend in an effort to contract the economy. In Uganda, the ratio of liquid assets to total deposit decreased from 59 percent in 2003 to 47 percent in 2007, which is not a desirable progress.

- The capital of banks is also increasingly profitable[21]. Except for the highly competitive banking sector of Kenya, entry is not easy in other areas of the IGAD sub-region. Hence, operating banks are highly profitable. For example, the profitability rate is more than 25 percent in Ethiopia. As a result, the banks' capital increased by about 31 in 2007. Owing to the increasing capital of banks, capital adequacy ratio will remain manageable.

- With reared to capital adequacy ratio[22], in Kenya it reached 19.8 percent which is above the statutory minimum level. In Ethiopia, the capital adequacy ratio is as low as 10 percent compared to a marginally above 17.7 percent in Uganda.[23]

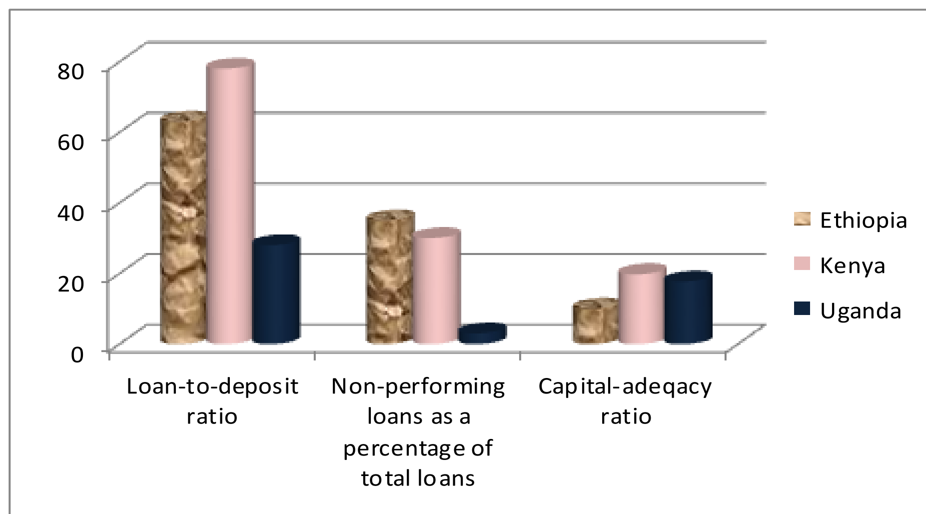
- Non-performing loans are higher in Ethiopia with a share of above 35 percent of total loans. In Kenya, it reached about 27 percent. It is low in Uganda with about 2.5 percent of loan and advances. Hence, those banks in countries with big non-performing loans need to exert efforts to reduce such bad loans.

[21] In addition to the paid-up capital, the total capital of banks also increases as some part of the profit will be retained as the bank's capital.

[22] Capital adequacy ratio (CAR) is defined as the ratio of capital over asset.

[23] See IKED (2006): Ethiopia: Innovation and Growth in International Comparison

Figure 5-2: Financial soundness of bank



Source: IKED (2006): Ethiopia: Innovation and Growth in International Comparison

Prospects and Challenges for the Commercial Banking Sector in the IGAD Region

Prospects

Though it has a long history in the IGAD sub-region, commercial banking in the region is shallow and underdeveloped. But in recent periods, the sector has transformed; and private commercial banks are looming. Foreign banks have also become increasingly integrated into the commercial banking industry. There has also emerged a specialized type of commercial banking activity, the Islamic banking in Sudan. Such type of banking provides financial products which fit for the Islamic ideology. Although banking has developed gradually, the sector needs to transform significantly so that it can effectively catalyze economies.

The banking industry in the IGAD region has registered some successes in spite of some structural and policy problems such as weak and poor economies, low gross national saving, underdeveloped infrastructure, acute political instability, macroeconomic volatility and policy disadvantages. However, if the recent trend is sustained, the future is bright for the sector. New positive developments which should shape the prospects of the sector include (i) encouraging growth history of most of the member States; (ii) revival of peace and stability; (iii) increasing regional integration efforts; and (iv) encouraging policy packages.

Unlike the periods prior to mid-1990's, like the rest of sub-Saharan Africa, the IGAD member countries have registered a renewed growth performance. These countries have grown by an average rate of 5.5 percent during the 2000's vis-à-vis the 1980's and early 1990's (2.9 and 3.5 percent average rate, respectively). This renewed growth, if sustained, can support the growth of the banking industry through the forward and backward linkage between the financial sector and the real sector. The growth of the real sector of the economies creates a potential demand for banking services as it also helps generate surplus savings which has been a constraint for a long-term financial credit.

Lack of peace and stability have been the distinguishing feature of the IGAD member States. They suffered frequent intra and inter-state. This has disrupted normal economic activities. The financial sector is the most affected sector. While the real sector somehow operates the formal financial sector remains passive in countries in conflict. If the ongoing peace efforts by multilateral organizations such as IGAD succeeded, it will create favorable conditions for the growth and maturity of the banking sector.

Regional integration is an important objective of the IGAD region. As IGAD works for strong economic relationships and harmonized macroeconomic policies among member States, the fact that most of the member states are also members of Common Market for Eastern and Southern Africa (COMESA) allow for wide markets and the possibility of learning in the protected markets of the regional blocs. The emergence of development banks in the regional blocs will also encourage for the flow of additional finance sources to the commercial banks. Such initiatives can create alliances among banks and other financial institutions in the regional economic communities where the institutions could share business, resources and expertise.

Apart from non-policy factors, improving the macroeconomic environment and policy setting including policies that allow the growth of the private sector, can also improve the chances for future commercial banking sector development in IGAD region.
In addition to gradually improving the working environment, there is a need for developing vibrant commercial banks with innovative financial products and instruments. Such a financial sector is crucial for the development of any economy. The institutional set-up of the financial market is important in the transmission of monetary and credit policy effects on investment.

Challenges

The existence of dynamic financial system, specifically commercial banking in the IGAD sub-region, is essential to build the economies of member States. The economies are backward in many respects including infrastructure development, industrialization, commercialization and private sector development. The financial requirements in these areas are huge. Securing the required finance demands an effective banking sector to mobilize both domestic and foreign resources. A mature financial system also helps in the process of allocating scarce resources to their most effective uses and under the principle of rationality. Nevertheless, the banking sector in IGAD member countries is not mature enough to mobilize and then satisfy the huge demand for investible financial resource. Long-term finance is scarce and resources are rationed on non-economic criteria in most cases. Hence, the future role of commercial banks of IGAD member countries shall be stimulating the economies by playing their role of bridging savers and investors and allocating financial resources to their best uses effectively. More important is adequate financial resources from both local and external sources so that development projects can sustainably be financed. However, commercial banks will face structural as well as regulatory and policy challenges that need to be taken into consideration if the banking sector is to emerge as an important tool for development.

The national economies of the IGAD member States are characterized by large informal economies. These informal economies concentrate primarily in rural areas although the urban areas are characterized by dualism (modern formal and traditional informal economies co-exist). Moreover, the resource mobilization capacity of the banks is constrained by poor domestic saving. Such initial conditions can work as detrimental factors for the transformation of the banking sector in the region. Hence, unless there is a kind of big push to transform the sector, banks may not be able to play their role of promoting productive investments and providing efficient services to investors and corporate activities.

The dualism in the economies of the sub-region is also characteristic of the financial system. Formal financial institutions such as banks co-exist with informal financial activities by moneylenders. Informal (traditional) financial sources and services dominant formal financial products in both rural and urban areas although it is more dominant in rural areas. Informal lenders and other traditional credit institutions are necessary in the early stages of development when credit and collateral is scarce. The trend is, however, gradually to modern sources of finance. Although the informal indigenous financial institutions allow the satisfaction of short-term financial needs, the dualism can inhibit the natural development of modern financial systems. The causes of such dualism in the financial sector are the dualistic nature of the economies; underdeveloped infrastructure; and constrained access to financial services from formal sources.

The bureaucracy and policy environment have been cited as constraints of doing business in most of Africa. Weak regulatory institutions and rule of law remain constraints of development and expansion of business including banking activities in the IGAD sub-region. For example, the weak regulatory capacity of National Bank of Ethiopia has been cited as an excuse for the prevention of introduction of foreign commercial bank branches in Ethiopia. Such structural, regulatory and policy challenges shall be corrected gradually so that the banking sector can transform to modern service provision.

VI. Specialized Financial Institutions and Non-Banks

1. Development Banks

Apart from the concern with the growth and maturity of commercial banks, a further concern should be the emergence and development of specialized financial institutions. Specialized financial institutions include those that generally raise funds through long-term or specialized types of deposits. These specialized intermediaries often lend to particular types of borrowers such as investment, industrial, construction and development banks. Their importance in overall economic growth emanates from the specific function they play building on their objectives. Specialized financial institutions usually perform the following functions:

- Advance long-term loans and credits for the development of specific sectors;
- Act as a guarantor of liabilities and projects for viable entities;
- Supervise and control the activities of projects financed by the bank;
- Participate in some cases in the equities of business entities and projects;
- Accept current and time deposits so as to mobilize funds for investment; and
- Monitor and follow-up end use of loans advanced.

As a mechanism for encouraging investment in strategic sectors of the national economies, IGAD members have in most cases established or allow the possible creation of such specialized banks. Such specialized banks include: the Construction and Business Bank and the Development Bank of Ethiopia, the Eritrean Development and Investment Bank (EDIB), Nile Industrial Development Bank, the Agricultural Bank of Sudan, Industrial Bank of Sudan, the Uganda Development Bank, Centenary Rural Development Bank, and Housing Finance Bank, the Development Bank of Kenya, Industrial Development Bank of Kenya and the Agriculture Finance Corporation. Djibouti has one development bank (the Banque de Développement de Djibouti) specializing in extending financial services to strategic sectors. Owing to instability since 1991, specialized financial institutions are no longer operational in Somalia.

2. Non-bank Institutions

Non-bank financial institutions include insurance companies, and pension funds. The availability or unavailability of such institutions is one other indicator of financial development. Non-bank financial institutions have remained undeveloped in the Eastern part of Africa.

Kenya has a well-functioning and active insurance market backed by insurance brokers, and pension funds. The state owned pension fund in Kenya covers 13 percent of the labor force, while Private Occupational Retirement Benefits Schemes serve about 1.5 percent (250,000) of the labor force in Kenya, and Voluntary Individual Retirement Benefits Schemes serve a few members.

Overall only 15 percent of the workforce in the country participates in any form of formal pensions and retirement benefits arrangements. The Nairobi Stock Exchange was established in 1954 (one of the oldest in Africa) and has now over 61 listed firms.

Insurance companies and a pension fund dominate non-bank financial institutions in Ethiopia. There are currently ten insurance companies operating in Ethiopia. While one of them is a public insurance institution, the rest are private share companies that started since 1991. There is only one pension fund operating in the country, which provides retirement funding to public employees. The pension fund is not active in the equity and financial markets and no stock market exists. The corporate bond market is shallow and only government parastatals such as the Ethiopian Telecommunications Corporation and Ethiopian Electric and Power Corporation are active in this area.

In Djibouti, there are three insurance companies (GXA Assurances, AMERGA and Ethiopian Insurance Corporation) and bureau de change operating in Djibouti. There is one insurance company, the National Insurance Corporation of Eritrea (NICE) established in 1992 and no other non-bank financial institutions actively functioning in Eritrea. In Somalia, currently, remittance companies are the only functioning non-bank financial institutions. No equity and bond markets exist in any of the above listed countries.

There are several insurance companies, seven credit institutions and a stock exchange. The Ugandan Stock Exchange started in 1998 with the listing of the East African Development Bank 4-year bond. There is also the repurchase agreement market introduced in 2002. In Uganda, Bank of Uganda introduced a 2-year, 3-year, 5-year and 10-year government bonds. In Sudan, the insurance market of the country includes fifteen insurance companies, and this industry dates back to the 1940's. The Khartoum Stock Exchange (JSE), established in 1994 has about 40 listed companies; and 42 kinds of government Musharaka certificates. The market is dominated by Government Musharaka Certificates and Central Bank Mushraka Certificates.

VII. Access to Long-term Bank Credit

1. Commercial Banks

The financial sector plays a central role in the process of economic development and growth in a country by providing financial resources and lubricating the economy. The fundamental activities of commercial banks in the IGAD region include mobilization of deposits, extension of credits, and management of money transfer activities. However, most of Bank credit is short-term trade and consumers' credit. Most of banking operations are restricted to foreign exchange, trade and treasury operations and other more profitable short-term activities than providing medium and long-term access to credit. There are various factors behind the short-term nature of credits in this and other developing regions of the world. Among these factors are (i) the short-term nature of deposits; (ii) lack of adequate information; (iii) lack of dynamic banking staff; (iv) government regulation; (v) lack of marketable liquid assets to be used as collateral.

The source of bank credit is the deposits mobilized by households, private and public enterprises, and the government. The nature of deposits partly governs the type of credit banks can extend to economic agents. The vast majority of deposits in the financial sector tend to be short-term time deposits and demand deposits. The ratio of demand to time deposits is more than 100 percent in some countries signifying the nature of these economies where clients need to have easy access to their financial assets. Such short-term deposits are not suitable for financing long-term investments on a large scale because of maturity mismatches.

High transaction costs due to lack of information is another factor for the lack of long-term investment finance in IGAD region and other low income countries. Business firms usually do not prepare the required data such as cash flows and business profiles making it difficult for the banks to extend medium- and long-term credit. Banks charge borrowers high interest rates on longer maturity loans, to cover risks. In the sub-region, interest rate spreads were high during the 1990's and early 2000's. thus, finance is not only scarce but is also costly.

The lack of trained and skillful credit assessors is another factor behind the credit constraint in the economies of the IGAD region to cirmvent this problem, banks have generally required firms to pledge more collateral than the value of the credit they receive.

Above all, the scarce access to longer maturity credit is largely explained by weak creditor rights and virtual inability to ennforce contracts which make lending a risky business. In most of these countries, the rule of law is weak and business activity is mostly exposed to bribes and corruption. The poor business practices and limits on information on credit worthiness of potential clients is a major constraint on credit.

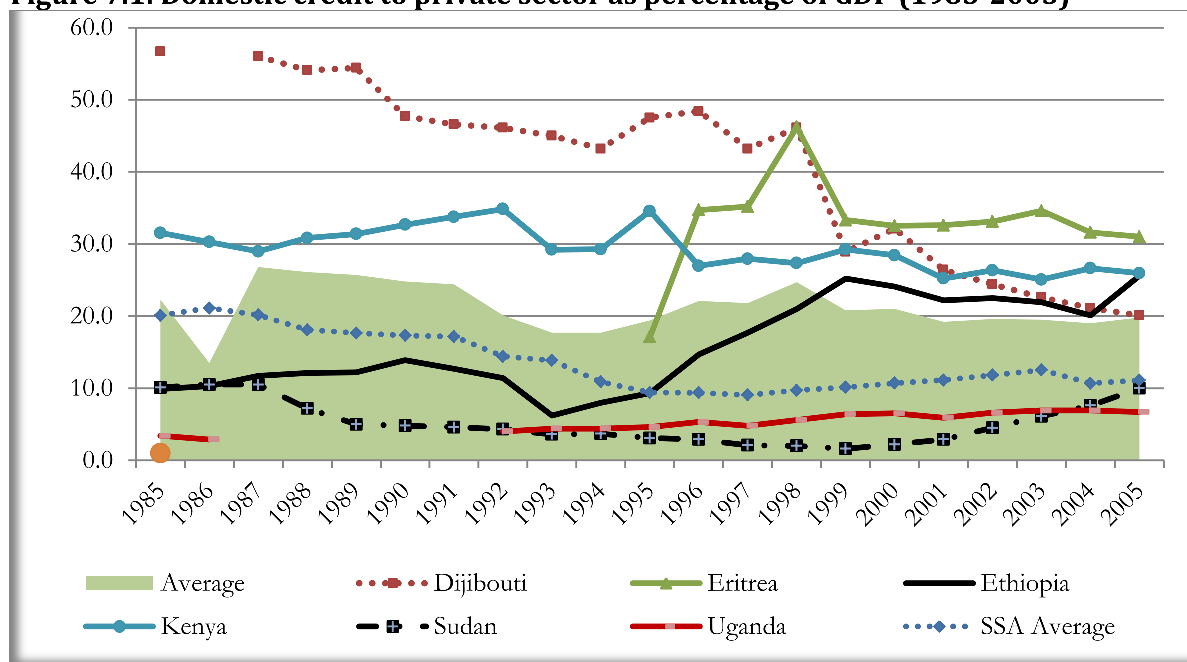
Historically, IGAD member states financial system has been characterized by heavy government interventions and regulations, centralized lending by the central bank to public enterprises, and the absence of indirect monetary policy instruments. This has affected the development of the financial sector for long-term lending and partly resulted in a non-price allocation of credit to less productive public enterprises.

The lack of collateral also acted as a constraint for access to credit for business firms in the sub-region. small firms are usually less capital intensive, and thus have limited collateral and very restricted access to finance. Profitable and bankable business ideas cannot guarantee investment finance unless tenders are assured of valuable assets to be used a collateral.

The domestic banking system in most of the IGAD member States play a sub-optimal role in facilitating development finance to promote economic activity. Most of the available financial resources in the banks is allocated to finance trade related businesses. In spite of the dominance of the agricultural sector in the respective national economies, the sector received limited credit access from the banking system. The industry and infrastructure sectors are also deprived of the required level of finance.

Credit access in the IGAD sub-region is indicated below by the trend in the ratio of domestic private sector credit as a percentage of GDP. While there is disparity across countries, the regional average remained below 20 percent. The ratio was well above 20 percent during the late 1990's and the early 2000's. Considering cross country disparity, while Eritrea, Kenya and Ethiopia enjoyed higher domestic credit to the private sector (as percent of GDP), Uganda and Sudan had the lowest in the group. Djibouti had the highest rate during the early year examined.

Figure 7.1: Domestic credit to private sector as percentage of GDP (1985-2005)



Sources: World Development Indicators

Limitations on access to credit in the sub-region prevail. In Kenya finance is reported as the major barrier for start-ups and as the second (after marketing) major constraint during normal operations of small firms. It is estimated that 43 percent have financial constraints at the start-up and 20 percent face such constraints during normal operations. The same trend prevails in the rest of the region.

The emergence and expansion of capital markets has contributed to relaxing long-term credit constraints, specifically for investment purposes. While progress has been made in some countries of the region, including Kenya and Uganda, other members of IGAD have no significant equity markets. In Ethiopia there have been recent attempts to generate equity finance by some firms through the sale of shares in the market. Nevertheless, the lack of secondary markets to trade shares is a major constraint on access for finance from this source. The regulatory and supervisory environment of such transactions is not developed.

2. Development Banks

The development of national and regional development banks is another way out to break the credit challenge for long-term productive investment. Despite the existence of functioning national development banks in the region, there is still a credit limit as the sources of funds for lending in the banks are the local economic units and small and poor national government. The East African Development Bank was re-established in 1980 and has Kenya and Uganda among its members[24]. Other shareholders include the African Development Bank, bilateral donors and some foreign commercial banks. The specific objectives of the Bank are the provision of financial and technical assistance for the promotion and development in member states of industries, agriculture, forestry, tourism, transport and infrastructure, with preference for projects which promote regional cooperation.

The bank provides a range of products and services which are tailor-made for the region's development requirements. As of 2009, the capitalization of EADB is valued at approximately US$275 million.

The Bank gives due attention to sectors that ensure regional integration. Of the total support extended by the Bank, the development of infrastructure such as energy, transport and telecommunications accounted for 48 percent, was followed by tourism and other services at 28 percent, industry at 20 percent, and agriculture and forestry 4 percent.

National Development Banks in IGAD Countries

Though there has not been any development bank for the IGAD sub-region, there are national development banks in member states functioning at different stages of maturity. Since the fund raising capacity for long-term development projects and infrastructural investment is very limited, replicating the case of the East African Development Bank in the IGAD region is required. In the member countries of IGAD specialized banks were established mainly by all the governments to assist the strategic sectors of the national economies. These specialized institutions include investment banks, industrial banks and construction banks. The national development banks extend financial services including medium and long-term credit to industrial activities so that the economies can attain industrialization. As most of the IGAD member countries rely heavily on

[24] The Bank was established in 1967 for Kenya, Tanzania and Uganda, and has Burundi and Rwanda as members since 1980

agriculture and have under developed economic infrastructure, the development banks normally extend financial services and resources to these and other productive sectors at preferential interest rates.

While all member states have one or more development banks, Kenya, Sudan and Uganda have more specialized development banks. The institutional existence of such banks is encouraging, but member states could benefit more if the banks were innovative and effective.

Table 7-1: The stance of national development banks in IGAD region

Country	No. of Development Banks	Type of Banks
Djibouti	1	Banque de Développement de Djibouti
Eritrea	1	Eritrean Investment and Development Bank
Ethiopia	1	Development Bank of Ethiopia
Kenya	2	Development Bank of Kenya and Industrial Development Bank of Kenya
Somalia	1	Somali Development Bank (ceased operations)
Sudan	3	Nilein Industrial Development Bank, Industrial Development Bank, and Islamic Cooperative Development Bank of Sudan
Uganda	2	Uganda Development Bank and Centenary Rural Development Bank

VIII. Microfinance in the IGAD Region

Microfinance is defined as the supply of financial services to low-income people who normally do not have access to these services through the formal financial system. It covers a broad range of financial services including loans, savings, money transfers, insurance, and other financial services. Providing the poor with access to financial services is a means of exposing them to economic opportunities. Banks in developing countries typically serve no more than 20 percent of the population leaving the rest to semi-formal and informal financial alternatives.

The informal financial alternatives include loans from family and friends, moneylenders and traders. Such informal credits are often limited in amount are rigidly administered, and involve very high interest costs. The provision of sustainable economic opportunities at the grass root level, especially provision of the required financial services at competitive rates, is offered through microfinance institutions.

Microfinance has evolved and led to the creation of a growing number of institutions around the developing world. In IGAD microfinance has been in place in the last three decades. Many of the member states have issued the relevant policy directives and have allowed and supported the establishment of Micro-Finance Institutions (MFIs). Before it emerged in a well-structured and institutionalized form, the microfinance industry started operations in the sub-region as early as the 1960's as some organizations introduced the idea of saving and credit among the poor. Although still lacking depth and quality of financial services, the industry evolved through different stages of development, and reached its current state with Kenya and Ethiopia leading the region.

In Kenya there are over 100 microfinance organizations operating, half of which are non-governmental organizations practicing micro lending across the country. In Ethiopia, since the formal inception of the micro-financing system, 28 MFIs were licensed while currently 26 of them are operational. In Djibouti, the largest microfinance institution was the Social Development Fund which distributed loans mainly to women. There are two microfinance programs that are active in Eritrea: the Southern Zone Saving and Credit Scheme and the Saving and Micro Credit Program. The lending interest rate varies from 14 percent to 16 percent across the two institutions. In Uganda microfinance service is composed of three deposit taking institutions extending services such as loans, savings, deposits and insurance coverage to clients who do not have access to financial services from formal banks.

Another measure of the success of micro-financing business is the number of clients served. In Kenya, only 1.7 percent adults are benefiting from the sector while 38.4 percent of the population is excluded from any financial services[25]. The 26 microfinance institutions in Ethiopia serve close to 2.4 million poor, almost 3 percent of more than 25 million potential clients[26]. In Sudan, it is estimated that the supply of microfinance covers about 1-3 percent of potential demand. The

[25] ibid

[26] The potential clients are estimated based on the 32 percent headcount of absolute poverty indicator, according to Ministry of Finance and Economic Development of Ethiopia.

microfinance sector in Sudan is largely credit-oriented, and some specialized and commercial banks provide microfinance services.

The outreach of the microfinance industry is very limited in the sub-region as compared to millions of potential clients. Moreover, there is no dynamism in terms of financial products provided by MFIs. The MFIs in IGAD members are limited to traditional services of credit extension and sometimes mobilizing clients' savings. Only recently some institutions have started money transfers and tax collection activities. In some parts of the region there are attempts by modern banks to extend microfinance services to low income clients. As a result while microfinance can be used as a "silver bullet" for poverty and conflict mitigation, it has not been used effectively in the sub-region where poverty and conflict have been emerged as development challenges.

The evolution and success of the microfinance industry vary across IGAD members as follows:

Djibouti: The microfinance program is a relatively new initiative in Djibouti. The Social Fund for Development was created to improve the social and economic life of the poor by granting micro credits for income generating projects in order to contain unemployment. It currently administers a credit line of Djibouti Francs 156 million (equivalent to almost US$1 million) for microfinance operations, and works with 13 microfinance specializing agencies which provide loans and savings products. The Social Fund targets women and is trying to diversify its clientele by providing credit services to small enterprises which have no access to the financial system[27].

The government of Djibouti concluded an agreement with the International Fund for Agricultural Development for a Microfinance and Microenterprise Development Project which set up the first savings and credit association in Djibouti in February 2008. The savings and credit association is urban-based and as of December 2008, had a membership of 2,432 people.

Eritrea: The saving and Micro Credit Program and the Southern Zone Saving and Credit Scheme are the two largest microfinance institutions in the country. Together they cover about 90 percent of all microfinance customers. They are both working with a similar village-bank approach which aims to build up sustainable long-term financial institutions in the villages. The Southern Zone Saving and Credit Scheme was established late in 1993 as the first micro-finance programme in Eritrea[28]. The savings and micro credit program started in 1996 as part of the Eritrean Community Development Fund. It started to operate independently since 2002 to provide financial services to vulnerable groups in both rural and urban areas with an outreach of all administrative zones of the country and over 13,900 customers, out of more than 3 million potential customers. The proportion of women in the total customer base is in the range of 40-43 percent, and repayment rates range from 92 -99 percent.

Ethiopia: The development of the microfinance industry in Ethiopia can be traced back to the early 1970s, when non-governmental organizations were directly funding micro credit services as part of their relief programs. Microfinance in a well-structured and institutionalized form evolved after the

[27] See IMF (2009)
[28] Graeub and Kraehenbueh (2004)

National Bank of Ethiopia issued the legal proclamation in 1996. Currently the 26 microfinance institutions operating in the country serve 2.4 million customers. Their assets were birr 6.1 billion and outstanding credit and customers savings were birr 4.8, and 1.6 billion respectively as of June 2009.

Over 90 percent of the industry's customer base is rural of whom 40 percent are women. Microfinance institutions in Ethiopia consider household heads as a major recipient of the loan. The level of outreach is 3 percent of the total population and 10 percent of the estimated target population implying that a lot needs to be done to benefit the eligible poor.

Kenya: Although micro credit has been extended to the poor since the 1960s informally, as an industry, microfinance institutions are relatively new in Kenya[29]. Microfinance in Kenya has transformed significantly and currently about 130 non-governmental organizations agencies' provide microfinance alongside social welfare activities. Apart from individual clients, these organizations have credit facilities that have reached 2.8 percent of medium and small enterprises.

Somalia: The financial sector in Somalia is currently dominated by *Hawalas* with the main purpose of channeling remittances. There are small donor funded microfinance programs but there is no conducive environment and regulatory framework for microfinance institutions. However, as peace and stability returns to the country, the economic, developmental and stability role of microfinance institutions is indispensible and all stakeholders should take committed responsibility in a move to introduce the industry in the financial sector.

South Sudan: Microfinance has a special importance and role in the South Sudan, in view of the prolonged conflict. Accordingly, it has 6 major microfinance institutions with and outreach of 5 percent of the potential customer base[30]. The composition of beneficiary sectors is dominated by the trade sector (68 percent) followed by agriculture and manufacturing. The lack of skill on alternative economic activities plays a significant role in limiting microfinance services to the trade sector. Microfinance customers are mainly women (67 percent)[31], who form most of the poor and marginalized segments of society.

Uganda: Among the challenge facing Uganda currently, as is the case in the rest of the IGAD region, is poverty. Microfinance has been considered as an effective instrument for development in Uganda and the government allowed the development of the industry. As a result, over the last few decades, microfinance has increasingly provided services to the Ugandan poor. Currently there are three microfinance institutions operating in the country and over 60 percent of the beneficiaries of their services are women[32].

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[29] Hospes et al (2202)
[30] Morgan (2009)
[31] SUMI and BRAC Nov 08 figures cited in April (2009)
[32] ADB (2001)

Role of Microfinance for Poverty Alleviation and Conflict Prevention

IGAD member countries are poor: "Poverty Mapping in Djibouti City" shows that about 400,000 people live below the poverty line[33]. In Eritrea, more than 66 percent of the population is estimated to live in poverty[34]. In Somalia, it was estimated that, as of 2003, over 43 percent of the population lives in extreme poverty (defined as individuals living on less than 1 US dollar a day) whilst over 73 percent of the population live in general poverty (defined as individuals living on less than 2 US dollars a day)[35][36]. In the Sudan, a recent joint World Bank-UNDP mission estimated that about 60-75 percent of the population in the North and 90 percent in the South live below $1 a day in income[37]. A comparable level of poverty exists in Uganda and Ethiopia. A regional comparison shows that Sub-Saharan Africa (SSA) average per capita income of US$ 951 is much higher than the IGAD region's average income US$640. IGAD's member States are some of the world poorest countries, and social services have been below the average for SSA. The average access to sanitation and primary school completion rates are only 38 and 47 percent respectively, compared to 42 and 60 percent in Sub-Saharan Africa.

Frequent inter-state and intra-state conflicts have been prevalent in the IGAD member countries. There have been deadly intra-state conflicts between Ethiopia and Somalia, and Ethiopia and Eritrea. The majority of the IGAD countries also experienced at least one episode of inter-state war over the last few decades. Civil conflicts in these countries: (Ethiopia, Somalia, Sudan, and Uganda) lasted for 2 to 3 decades. Such frequent and extended conflicts degraded the socio-economic base of these countries and led to a huge income gap with the rest of the world.

Coupled with poverty and conflict, lack of start-up finance has been one of the factors constraining production and income. The role of microfinance institutions in asset building and alleviation of poverty and restoring stability is of particular importance in the IGAD region as the poor in the region have limited access to credit services from the formal sector. Moneylenders charge more than 100 percent interest rate as compared to a rate of much less than 20 percent charged by microfinance institutions.

Micro financing can be viewed as a strategic tool to alleviate poverty. It does not require collateral, but willingness to work and a desire to carry out some business activities, which provides employment and income. By offering a range of tailored financial and non-financial service to the poor, it can reduce poverty through raising household income thereby enabling household

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[33] ADB, ADF, Djibouti: Result Based Country Strategy Paper 2007 -2010, October 2007.
[34] Rena, Ravinder and Ghirmai Tesfy (2—7) "Poverty and Microfinance in Eritrea – A Discourse", New Orleans (USA): The Global Journal of Finance and Economics, Vol. 4. No. 2 (September), pp. 147-161.
[35] Feasibility Study on Financial Services in Somalia, UNDP Somalia and European Commission Somalia Unit, 2004.
[36] Despite this huge demand, owing to the existing instability, there are no formal microfinance institutions serving ordinary people in Somalia.
[37] Microfinance in Sudan, An assessment of the current status of the industry for the First National Consultative Forum on Microfinance Khartoum, 12-14 November 2007

members to have better access to education and health raise the awareness of one's individual rights, and hence participation in community affairs, and acquisition of entrepreneurial skills.

Besides providing start-up capital for the poor, microfinance institutions can also impart basic skill development training. At the early stages of post-conflict situations, such funds and skill development activities have been given by relief organizations as a way of linking aid to sustainable development. Conflicts erode the already shallow financial infrastructure and microfinance institutions could operate at lower scales than any other formal financial operators[38]. To alleviate poverty microfinance presents a better, longer-term, and more sustainable option for assisting the eligible poor than does humanitarian assistance. It offers the chance to support economic activity and employment creation after years of stagnation, endemic poverty and marginalization of the poor. Microfinance providers could influence future policies governing microenterprise and small business development projects.

Micro-enterprises development is an essential extension of microfinance schemes. If microfinance is to have a sustainable impact on poverty eradication, it must eventually scale-up into creating a private sector of effective entrepreneurs who function in the formal economy. Hence, microfinance can be considered as a tool for transforming the economy of IGAD countries through development of small enterprises. This requires skill development and education policies to create an appropriately trained labor force. It also benefits the government through formalizing the informal sector and increasing the tax base.

Challenges of Microfinance Institutions in the IGAD Region

There is a very extensive demand for the existing as well as new financial and non-financial services of microfinance institutions in the IGAD region. However, the actual outreach, coverage, product ranges and service quality is unsatisfactory. A number of factors have limited the present MFI's ability to expand and meet demand, and discouraged the entry of new actors. The most pressing challenges include:

i. *Weak legal framework:* In the IGAD region the general legal framework that regulates the microfinance sector is not yet developed. The regulatory environment sometimes creates unfavorable situations for microfinance institution to enter, expand and/or exit easily. The capital requirement, extensive control and regulations, lack of effective laws and property rights codes are among the problems facing the microfinance industry.

ii. *Lack of trained manpower:* Effective provisioning of innovative financial and non-financial services require trained and appropriate employees with the skill required by the financial sector. In most of the IGAD countries, the financial sector is not advanced and there is a lack of specialized training institutions for staff. Moreover,

[38] The role of microfinance under a post-conflict situation in the case of Bosnia, Mozambique, Rwanda, and Cambodia is documented in Doyle (1998).

the microfinance industry operates at the grass root level on small per capita loans, and the institutions cannot compete for the few existing skilled staff.

iii. *Constrained access to funds*: Especially during the early stages of operations, microfinance institutions face great difficulty in raising the required funds to satisfy eligible customers' needs. This forces microfinance institutions to limit their coverage and the maximum amount of loan per person. Microfinance institutions usually require longer periods before they become financially self sustainable. In most cases, microfinance institutions remain liquidity-constrained while the formal banks are faced with the problem of excess liquidity.

iv. *Lack of best practice information*: The MFIs currently operating in IGAD region are not well integrated and suffer from a low access to best practices (such as on developing new products, training their staff, and monitoring their operations adequately). Access to best practice operations is important for maintaining a low cost structure, despite the dispersed settlement of their customers and small loan per capita. Country associations of microfinance institutions, development agents, and supporting agencies need to address such problems by creating coordination between micro-finance providers in term of data, information, and exposure to best practices.

v. *Lack of diversity in beneficiary sectors*: Micro credits in the region are concentrated to trade activities and are not diversified across sectors owing to limited entrepreneurial skills across all economic sectors. Further support to small enterprises to expand and diversify their businesses into other productive activities would help MFIs to be able to serve a greater customer base and diversify the risk of their portfolios.

vi. *Political uncertainty:* Although micro-financing is understood as a tool for maintaining stability, political instability and conflicts (both intra and inter-state) acts as an impediment for micro-finance programs. Conflict gives MFIs operational challenges and delays their ability to attain scale and financial sustainability. MFIs that establish operations or continue to operate in conflict environment are compelled to adjust their strategies and operational procedures to manage the adverse effects on their programs.

vii. *Weak economic condition*: The IGAD region faces difficult economic circumstances and low per capita income. Working under such environment provides challenges and many difficulties that can undermine the success of MFIs efforts. To operate a small enterprise in a region with weak real demand for goods and services affects the sustainability of small enterprises and their supporting microfinance institutions.

IX. Conclusions and Recommendations

A comparative analysis of financial development in the IGAD region clearly shows that on average the region lags behind in financial development in line with the low-income status of the member countries. The financial sector has been developing over time in the region. Like the rest of the developing world, commercial banking is by far the dominant financial institutions operating in the IGAD region. However, the banking industry itself is not developed as indicated by various financial ratios. Banking products are passive and are largely related to the traditional activities of extending money transfers, and deposit and lending services. While in most member States foreign banks are allowed to operate, Ethiopia is an exception in this regard.

The financial sector plays a central role in the process of economic development and growth by providing resources and lubricating the economy. This important role is not yet fully played by the financial system in the IGAD region. The financial sector focuses on traditional activities of money transfers, deposit mobilization and short-term lending. There are various factors behind the short-term nature of credits in this part of the world. Among these factors are: i) the short-term nature of deposits; ii) lack of adequate information; iii) lack of dynamic banking staff; iv) heavy government regulation; and v) lack of liquid assets to be used as collateral

Monetary policy in the IGAD region lays emphasis on ensuring macroeconomic stability and high sustainable economic growth. Each member state pursues its own monetary policy, dictated by domestic economic developments, without taking the rest of the region and the need for harmonized macroeconomic environment into consideration. Even though there has been no active move to harmonize the monetary policy environment in the region, the volatility and level of inflation in the IGAD member States has generally declined since the 1990's. The inflation rate declined from about 30 percent on average during the early 1990's to single digit levels in 2001-07.

A few banks control the market in terms of branch network, clients served, deposits mobilized and outstanding credits. In Djibouti, two banks dominate the market and are responsible for 95 percent of deposits and 80 percent of total domestic lending. In Ethiopia, just one bank - Commercial Bank of Ethiopia (a public bank) is by far the biggest, with a market share exceeding all the private banks put together. In Eritrea, the Commercial Bank of Eritrea is the dominant bank controlling nearly 80 percent of all banking sector assets in the country. In Sudan, the Bank of Khartoum has about 36 percent of total bank branches in the country.

Specialized financial institutions including development banks are key components of the financial system of the region. As a mechanism for encouraging investment in the strategic sectors of their economies, IGAD countries have established specialized banks. Such institutions are, at different stages of maturity in the region. While some countries have only few a specialized institutions, others allow for the establishment of multiple specialized institutions to assist different economic sectors.

The economic relevance of microfinance institutions is high in the IGAD region, as micro-financing is an important instrument for asset building of the marginalized and the poor thereby contributing to poverty alleviation and to restoring stability. Recognizing the potential role of microfinance,

IGAD member States have started to issue the relevant policy directives and supported the establishment of such institutions. The outreach and coverage of microfinance services in the region is limited, as only 1.7 percent of Kenyan adults, and 1-3 percent of potential demand in Sudan is covered. Institutional and capacity constraints must be removed if the industry is to contribute for poverty alleviation and stability.

Non-bank financial institutions including stock markets, corporate bond markets, insurance companies, and pension funds exist at different stages of development in the region. Insurance companies and credit institutions dominate this sub-element of the financial system. However, more advanced types of financial markets such as capital and security markets also exist in some parts of the region. Stock exchange markets are operating in Uganda (since 1998), Sudan (since 1994) and Kenya (since 1954).

Another important component of specialized financial institution is development banks. Such institutions are established to extend financial services to national economies e.g. agriculture and industry. While the existence of development banks is encouraging by itself, the member States can benefit if they innovate in the utilization of development finance.

The financial sector in the IGAD region is greatly dominated by banking activities. Financial markets and secondary markets are not advanced. In some parts of the region bank services are limited to traditional banking activities and innovative services are limited. The underdevelopment of financial and secondary markets further contributes to the lack of access to long-term credit, particularly for investment purposes.

Lack of collateral, information asymmetry and the short-term nature of deposits have been recognized as causes of limited access to bank credit. Governments and banks need to install an appropriate policy and regulatory environment.

- As a mechanism of relaxing credit constraints to business firms, governments should acknowledge the potential role of financial and capital markets. In the rest of the world these have been important venues to raise long-term investible financial assets.

- Governments should provide credit guarantee to banks when they lend to small enterprises with no valuable asset to be used as collateral. As Islamic banking shows intangible assets such as experience, education, and skills can be used as collateral with such credit guarantee from the government thereby offering equal opportunity to all potential producers.

- As the domestic capacity may be very narrow, member states shall set up a centralized development bank for the region to raise international finance to fund long-term development programs and projects[39].

[39] Even though identifying barriers is not the mandate of this paper, it shall be the purpose of future research.

- As a mechanism of supporting medium and small-scale projects in this region micro credit through microfinance institutions should be expanded. Most of the developing world has recognized the developmental role of such institutions. However, the region has not as yet, realized the potential economic, social and political benefits of successful microfinance industry. Administrative and regulatory institutional barriers for the entry of effective operations and outreach of microfinance should be eliminated.

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