BANKERS' CONFERENCE

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1. PREFACE AND OVERVIEW

1.1 Preface

The Third Annual Bankers Conference took place on August 9, 2001 in Windhoek, and deliberated on the theme Optimal Financial Structure in Namibia . The main objectives of the conference were (a) to understand the inter-relationship between finance and growth particularly against the backdrop of global experience (b) to review the Namibia s financial structure as it evolved over the years with emphasis on major parameters of performance like efficiency, and contribution towards the process of economic growth (c) to identify the financing gaps in the economy against the backdrop of growth imperatives and finally (d) to come up with suggestions towards putting in place an optimal financial structure. It was for this reason that the central bank invited eminent speakers to address the conference and share their experiences on the optimality of the financial structure in Namibia that could enhance growth.

1.2 Overview and Reflections

Mr. Tom K. Alweendo, the Governor of the Bank of Namibia in his opening speech shed light on the need for putting in place a more robust, efficient and effective financial superstructure that could effectively contain systemic risks and conducive to growth.

The paper on the Role of Financial Development in Economic Growth , presented by Dr. Norman Loayza of the World Bank reflects the role of the exogenous component of financial development on economic growth. It also presents evidence concerning the legal, regulatory, and policy determinants of financial development. The results of the regression analyses in his analytical framework produced very consistent findings that confirm that exogenous component of financial intermediary development is positively and robustly linked with economic growth. The regression results are also consistent with the theoretical models that predict that better functioning financial intermediaries accelerate economic growth. However, the results do not favour models that emphasise the potentially growth-retarding impact of financial development.

The paper from the Research Department of the Bank of Namibia essentially reviews the Namibian financial structure. It shows that the financial structure in Namibia is dominated by the banking industry. It further pointed out that the financial services are urban-biased. The paper suggests that if the economy has to succeed in mobilising domestic resources for investment optimally, financial services should be extended to the rural areas.

In the paper titled Imperatives of growth and development: The emerging financial gaps presented by Dr. Tekaligne Godana, an analogy of irrigation system is used to illustrate a credit system in any economy. A good financial system is likened to a complete irrigation system with a dam at a site suitable to harness all the water resources in the catchment area, an effective channel system with minimal water leakage and effective distribution, in particular to the most productive site. The irrigation system illustrates two core issues in this paper. First, efficient operation of the existing irrigation system and second, construction of a new complementary irrigation system.

Dr. Jaafar bin Ahmad, presented a paper that attempt to evaluate the role of banking institutions in the development of Namibia since independence. The paper find it disturbing that the direction of bank credit has not shifted much over the last decade in favour of the productive sectors. The paper also

indicates that the issue of access to credit facilities by the small and medium scale enterprises, including agriculture, while of concern, contain two facets. On the one hand the financial institutions need to address the inherently higher risks which they have to absorb by comparison to their normal credit risks. A better mechanism to minimise or lower these risks is however absent. In conclusion, he argued that a change of paradigm may not be required, but more in terms of the tinkering of the current system.

2. OPTIMAL FINANCIAL STRUCTURE FOR NAMIBIA

Opening Address

Mr. Tom K. Alweendo,

Governor, Bank of Namibia

Board Members of the Bank of Namibia, Deputy Governor, Distinguished Guests, Ladies and Gentlemen, it is with great pleasure that I welcome you all to the third in the series of the Bank of Namibia Annual Bankers Conference. Let me, on this occasion, extend my very warm greetings to all our guest speakers and in particular Dr Norman Loayza of the World Bank who I am told is visiting Namibia for the first time. I hope you will be able to avail yourself of the traditional Namibian hospitality and relish some of the beauty of the countryside during your short stay. To our other speakers and other invited guests, let me thank you for honouring our invitation.

You may have noted that the theme of this years conference, namely, Optimal Financial structure in Namibia , though a challenging one, is not quite new particularly to us as a central bank. Those of you who participated in our first conference which focused on Banking and Economic Development as we enter the new millennium may actually be wondering why we are revisiting this issue so soon again. The answer is simple. Like I emphasized in my Annual Speech in November last year, the imperative for growth is by far one of the greatest challenges facing Namibia at the present moment. Growth in output and employment by ensuring an improvement in the standard of living of those who still live below the poverty line will also make redistribution of wealth which remained highly skewed even to this day easier to achieve. It is only through a process of rapid economic growth that some of our people can be made richer without making anyone poorer. As a central bank we have always appreciated our role in this process. Hence the cardinal focus of the Bank s monetary policy has been to ensure price stability as a necessary pre-condition for economic growth through our commitment to the pegged exchange rate arrangement. For achieving the set goals, monetary and financial stability becomes imperative. This demands putting in place a more robust, efficient and effective financial super structure that could effectively contain systemic risks and conducive to growth. It is in this context that the choice of the present theme gains relevance.

The role of the financial sector in the growth process is fairly well documented. Our first in the series of papers today will be devoted to providing very robust country-wide experiences in this area. The financial sector plays a prominent role in channelling resources from the surplus (savers) to the deficit (investors) sectors of the economy. By meeting the investment requirements of the economy, financial intermediaries aid the process of capital formation and hence economic growth. The development of financial markets may offer households the possibility of diversifying their portfolios and increase their borrowing options.

Financial intermediaries play an informational role by collecting, processing, and evaluating the relevant information on alternative investment projects. Moreover, they induce entrepreneurs through their risk sharing function, to invest in riskier but more productive technology. Through this means, financial intermediaries ensure the efficient allocation of resources to investment projects that provide the highest marginal return to capital. In the process, they increase the average productivity of capital. In other words, financial intermediaries are now known to play a more proactive role in the growth

process as against the passive role of deposit mobilisation with which they were identified in the past. In the words of King and Levine, financial intermediaries determine which economic organisations will survive and which will perish, which entrepreneurs will control organisation and which will not, which types of investment can be made and which cannot, and which new economic products can be introduced by firms and which cannot .

However, our focus today is not merely on the relationship between the financial intermediaries and economic growth but also on a review of the structure of the financial system and its implications for economic growth in Namibia. Simply put, our interests centre on how the number, size, distribution and performance of the financial institutions in the economy affect the pace and content of economic development particularly by identifying and directing our efforts towards filling the financing gaps in the economy through appropriate policy initiatives. Moreover, the direction and magnitude of credit available to domestic entrepreneurs is also a matter of major policy concern. The number and geographical distribution of financial institutions and the implications this may have for competition and growth also receive our utmost attention. In short, the development of the financial system is our strategic priority.

Be that as it may, we are also very conscious of our role as a regulator. The achievement of the objective of financial stability dictates that we must ensure the safety and soundness of the nations financial system. Any form of intervention that puts at risk the solvency, liquidity and profitability of financial institutions and hence their survival will also negatively impact on economic growth. As the apex financial institution, it is, therefore, our duty to ensure an optimal financial structure that is conducive to the overall economic development and at the same time could effectively contain systemic risks.

Ladies and gentlemen, you will agree with me that our task is not an easy one. It is our firm belief that through our interaction today, very useful policy deductions will emerge. It is with this end in view that the format of this years conference has been slightly modified. You will observe that the last session of today consists of a discussion by the panel of presenters ably chaired by the Deputy Governor of the Bank. I am sure that during the course of these deliberations to which we invite all of you to actively participate, pertinent issues that will guide policy implementation by the Bank in the coming years will be highlighted.

I wish you very fruitful deliberations.

Thank you.

3. THE ROLE OF FINANCIAL DEVELOPMENT IN ECONOMIC GROWTH*

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3.1 Introduction

This paper attempts to answer the question of whether better functioning financial intermediaries exert a causal influence on economic growth. Economic theory does not provide a single answer on the link between finance and growth. Some models show that economic agents create debt contracts and financial intermediaries to ameliorate the economic consequences of informational asymmetries, with beneficial implications for resource allocation and economic activity.[i] However, other models note that higher returns from better resource allocation may depress saving rates enough such that overall growth rates actually slow with enhanced financial development [Bencivenga and Smith 1991; King and Levine 1993b]. Furthermore, Robinson (1952) argues that financial development primarily follows economic growth and the engines of growth must be sought elsewhere.[ii] In terms of policy, if financial intermediaries exert an economically large impact on growth, then this raises the degree of urgency attached to legal, regulatory, and policy reforms designed to promote financial development.

This paper examines whether the exogenous component of financial intermediary development influences economic growth. We also present evidence concerning the legal, regulatory, and policy determinants of financial development. While past work shows that the level of financial development is a good predictor of economic growth [King and Levine 1993a,b; Levine and Zervos 1998; Neusser and Kugler 1998; and Rousseau and Wachtel 1998], these results do not settle the issue of causality. Although this paper does not fully resolve all concerns about causality, it uses new data and new econometric procedures that directly confront the potential biases induced by simultaneity, omitted variables, and unobserved country-specific effects that have plagued previous empirical work on the finance-growth link.

Methodologically, the paper uses a cross-sectional instrumental-variable estimator, which follows directly from traditional growth studies. Data for 71 countries are averaged over the period 1960-1995, so that there is one observation per country. Unlike much of the cross-country growth literature, we use instrumental variables to extract the exogenous component of financial intermediary development. For this purpose we use the insight provided by LaPorta, Lopez-de-Silanes, Shleifer, and Vishny (1997,

* This paper is based on financial Intermediation and Growth: Causality and Causes by R. Levine, N. Loayza, and T. Beck, *Journal of Monetary Economics* 46 (2000) 31-77.

i Also, see Townsend (1979); Gale and Hellwig (1985); Diamond (1984); Boyd and Prescott (1986); Diamond and Dybvig (1983); and Greenwood and Jonanovic (1990). For reviews of this literature see Gertler (1988) and Levine (1977).

ii For more on how economic activity influences the financial sector, see Patric (1966) and Greenwod and Jonanovic (1990).

1998; henceforth LLSV). They note that most countries can be divided into countries with predominantly English, French, German, or Scandinavian legal origins and that countries typically obtained their legal systems through occupation or colonization. Moreover, LLSV (1998) show that national legal origin strongly influences the legal and regulatory environment governing financial sector transactions. Since legal origin explains cross-country differences in financial intermediary development and since legal origin is (reasonably) exogenous, we use legal origin as an instrumental variable to control for simultaneity bias.

In conducting this research, we construct a new dataset and focus on three measures of financial intermediation. One measures the overall size of the financial intermediation sector. The second measures whether commercial banking institutions, or the central bank, is conducting the intermediation. The third measures the extent to which financial institutions funnel credit to private sector activities. Our financial development indicators improve on past measures by (i) more accurately deflating nominal measures of intermediary liabilities and assets, (ii) more comprehensively measuring the banking sector, and (iii) more carefully distinguishing who is conducting the intermediation and to where the funds are flowing. While the financial intermediary indicators are still imperfect measures of how well financial intermediaries research firms, monitor managers, mobilize savings, pool risk, and ease transactions, these three measures provide more information about financial intermediary development than past measures and together they provide a more accurate picture than if we used only a single measure. Moreover, they produce similar conclusions.

Our regressions produce a very consistent finding: the exogenous component of financial intermediary development is positively and robustly linked with economic growth. In interpreting the results, note that the findings do not reject the view that economic activity influences financial development. Rather, the results show that the positive link between finance and growth is *not only* due to growth influencing financial development; the strong positive relationship between financial intermediary development and long-run growth is at least partly explained by the effect of the exogenous component of financial development on economic growth. Economically, the impact is large. For example, the estimated coefficients suggest that if Argentina had enjoyed the level of financial intermediary development of the average developing country during the 1960-95 period it would have experienced about one percentage point faster real per capita GDP growth per annum over this period.

The results favour the growth-enhancing view of financial intermediation espoused by Hamilton (1781), Bagehot (1873), and Schumpeter (1912). In turn, the results are less consistent with those that minimize the positive role of financial intermediaries in the growth process [Adams 1819; Robinson 1952; and Lucas 1988]. Similarly, this paper s findings are consistent with theoretical models that predict that better functioning financial intermediaries accelerate economic growth. Our results do not favour models that emphasize the potentially growth-retarding impact of financial development. Finally, this paper s findings highlight financial reform. If economists can identify legal, regulatory, and policy reforms that promote financial development, this may positively influence economic growth.

Consequently, we also examine whether cross-country differences in particular legal and regulatory system characteristics help explain cross-country differences in the level of financial intermediary development. The degree to which financial intermediaries can acquire information about firms, write contracts, and have those contracts enforced will fundamentally influence the ability of those intermediaries to identify worthy firms, exert corporate control, manage risk, mobilize savings, and ease exchanges. Thus, as argued by LLSV (1997, 1998), the legal and regulatory system will fundamentally

influence the ability of the financial system to provide high-quality financial services. LLSV (1997) examine securities markets. In contrast, we combine their data on the legal and regulatory environment with our data on financial intermediation to study the links between financial intermediary development and cross-country differences in legal and accounting systems.

The results provide useful information to policymakers. The data suggest that countries with legal and regulatory systems that give a high priority to creditors receiving the full present value of their claims on corporations have better functioning financial intermediaries than countries where the legal system provides weaker support to creditors. Moreover, contract enforcement seems to matter even more than the formal legal and regulatory codes. Countries that efficiently impose compliance with laws tend to have better developed financial intermediaries than countries where enforcement is more lax. The paper also shows that information disclosure matters for financial development. Countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable. Finally, we confirm these findings when using the legal origin dummy variables (English, French, German, Scandinavian) as instrumental variables to extract the exogenous component of the legal, enforcement, and accounting environment: the legal/regulatory system exerts a powerful influence on financial sector development. While considerable research remains, taken together, this paper s findings provide support for the view that legal and regulatory changes that strengthen creditor rights, contract enforcement, and accounting practices boost financial intermediary development with positive repercussions on economic growth.

The rest of the paper is organized as follows. Section II presents the results using cross-sectional data. Section III provides information on how the legal and accounting environment explain cross-country differences in financial development. Section IV concludes.

3.2. Finance and Growth: Cross-Sectional Analyses

This section examines the relationship between financial intermediation and growth using a pure cross-sectional estimator. We begin with the pure cross-sectional estimator because it more directly follows from the large cross-country growth literature.

(a) Financial intermediary development

As discussed above, numerous theoretical models show that economic agents may form financial intermediaries to mitigate the economic consequences of information and transaction costs. More specifically, financial intermediaries emerge to lower the costs of researching potential investments, exerting corporate control, managing risk, mobilizing savings, and conducting exchanges. Theory further suggests that, by providing these services to the economy, financial intermediaries influence savings and allocation decisions in ways that may alter long-run growth rates.[iii] Thus, modern economic theory provides an intellectual framework for understanding how financial intermediaries influence long-run rates of economic growth.

To evaluate the empirical predictions advanced by a variety of theoretical models regarding the relationship between finance and growth, therefore, we would ideally like to construct measures of the ability of different financial systems to research and identify profitable ventures, monitor and control managers, ease risk management and facilitate resource mobilization. It is impossible, however, to construct accurate, comparable measures of these financial services for a broad cross-section of

iii For example, see Greenwood and Jovanovic (1990), Bencivenga and Smith (1991), and King and Levine (1933b).

countries over the past 35 years. Consequently, to measure the provision of financial services, this paper constructs three indicators of financial intermediary development. (We also consider two additional measures in the sensitivity section). While each has particular strengths and weaknesses, we improve upon past measures of financial intermediary development. [iv]

LIQUID LIABILITIES equals liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP. This is a typical measure of financial depth and thus of the overall size of the financial intermediary sector [King and Levine 1993a]. This commonly used measure of financial sector development has shortcomings. It may not accurately gauge the effectiveness of the financial sector in ameliorating informational asymmetries and easing transactions costs. Also, LIQUID LIABILITIES includes deposits by one financial intermediary in another, which may involve double counting. Under the assumption that the size of the financial intermediary sector is positively correlated with the provision and quality of financial services, many researchers use this measure of financial depth [Goldsmith 1969; King and Levine 1993a; and McKinnon 1973]. Thus, we include it as one measure of financial intermediary development.

COMMERCIAL-CENTRAL BANK equals the ratio of commercial bank assets divided by commercial bank plus central bank assets. COMMERCIAL-CENTRAL BANK measures the degree to which commercial banks versus the central bank allocate society s savings. Again, this measure of financial intermediary development does not directly measure the effectiveness of banks in researching firms, exerting corporate control, mobilizing savings, easing transactions, and providing risk management facilities to clients. Thus, COMMERCIAL-CENTRAL BANK is not a direct measure of the quality and quantity of financial services provided by financial intermediaries. The intuition underlying this measure is that banks are more likely to identify profitable investments, monitor managers, facilitate risk management, and mobilize savings than central banks. Thus, King and Levine (1993a,b) recommend including COMMERCIAL-CENTRAL BANK as an additional measure of financial intermediary development.

PRIVATE CREDIT equals the value of credits by financial intermediaries to the private sector divided by GDP. This measure of financial development is more than a simple measure of financial sector size. PRIVATE CREDIT isolates credit issued to the private sector, as opposed to credit issued to governments, government agencies, and public enterprises. Furthermore, it excludes credits issued by the central bank and development banks. PRIVATE CREDIT is our preferred indicator because it improves on other measures of financial development used in the literature. For example, King and Levine (1993a,b) use a measure of gross claims on the private sector divided by GDP. But, this measure includes credits issued by the monetary authority and government agencies, whereas PRIVATE CREDIT includes only credits issued by banks and other financial intermediaries. Also, Levine and Zervos (1998) and Levine (1998) use a measure of deposit money bank credits to the private sector divided by GDP over the period 1976-1993. That measure, however, does not include credits to the private sector by non-deposit money banks and it only covers the period 1976-1993. PRIVATE CREDIT is a broader measure of credit issuing financial intermediation and its time dimension

iv One way this paper improves upon past measures of financial intermediary development is by accurately deflating nominal measures of financial intermediary liabilities and assets. Specifically, while financial intermediary balance sheet items are measured at the end of the year, GDP is measured over the year. Some authors try to correct for this problem by using an average of financial intermediary balance sheet items in year t and t-1 and dividing by GDP measured in year t [King and Levine 1993a]. This however does not fully resolve the distortion, especially in highly inflationary environments. this paper deflates end-of-year financial balance sheet items by end of year consumer price indices (CPI) and deflates the GDP series by the annual CPI. Then, we compute the average of the real financial balance sheet item in year t and t-1 and divide this average by real GDP measured in year t. This is described more fully in the data appendix. Although we have attempted to be ascareful as possible in constructing the data, measurement errors undoubtedly remain. We could not identify any reasons to believe, however, that this would systematically influence this paper s findings since we control for a variety of factors including the level of economic development - and use intrumental variable procedures.)

is twice as long, 1960-1995. We should also emphasize here that these financial intermediary measures are not simply picking up the relative importance of state-owned enterprises and the overall level of nationalization. In the analysis below, we control for the role of state-owned enterprises and this does not affect the conclusions. While PRIVATE CREDIT does not directly measure the amelioration of information and transaction costs, we interpret higher levels of PRIVATE CREDIT as indicating higher levels of financial services and therefore greater financial intermediary development.

Table 3.1 provides summary statistics on the financial intermediary development indicators. **The data are listed country-by-country in the Appendix, Table A1. (Summary statistics and correlations with other variables used in this paper are provided in Tables A2).** There is considerable variation across countries. For example, PRIVATE CREDIT is less than 10 percent of GDP in Zaire, Sierra Leone, Ghana, Haiti, and Syria. PRIVATE CREDIT, however, is greater than 85 percent of GDP in Switzerland, Japan, the United States, Sweden, and the Netherlands. Real per capita GDP growth also exhibits considerable cross-country variation. For instance, Korea, Malta, Taiwan, and Cyprus all enjoyed growth rates over greater than 5 percent per annum over the 35 year period, while Zaire, Niger, Ghana, Venezuela, Haiti, and El Salvador all suffered growth rates of less than negative 0.5 percent per year from 1960-95. Thus, the dataset offers rich cross-country variation for exploring the link between growth and financial intermediary development.

Table 3.1 Summary Statistics: 1960-1995

	Financial intermediary Development		
	Liquid Liabilites	Commercial Central Bank	Private Credit
Mean	43.44	78.16	38.29
Median	37.48	83.89	27.01
Maximum	143.43	98.99	141.30
Minimum	9.73	23.72	4.08
Standard deviaion	25.61	18.26	28.71
Observations	71	71	71

LIQUID LIABILITIES = liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonblank financial intermediaries) divided by GDP, times 100.

COMMERCIAL-CENTRAL BANK = assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.

PRIVATE CREDIT =credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

The positive relationship between income per capita and financial development is illustrated in Chart 3.1. Chart 3.1 shows that all three financial intermediary development indicators tend to increase as we move from low- to high-income countries. Since conditional convergence is a feature of cross-country data sets over the post 1960 period [Barro and Sala-i-Martin 1995], the positive correlation between income per capita and financial development may then suggest a negative relationship between financial development and economic growth. Indeed, four out of the five countries with the highest level of PRIVATE CREDIT have slower than average growth rates (Japan is the lone exception). In any case, these summary statistics highlight the importance of controlling for the level of real per capita GDP —

as well as a host of other economic and political factors in assessing the independent relationship between financial intermediary development and economic growth.

Chart 3.1 Financial Development Accross Income Groups, 1960-95

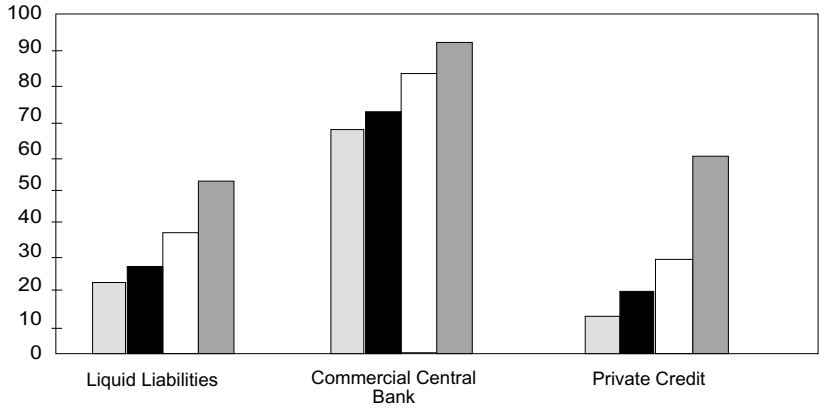
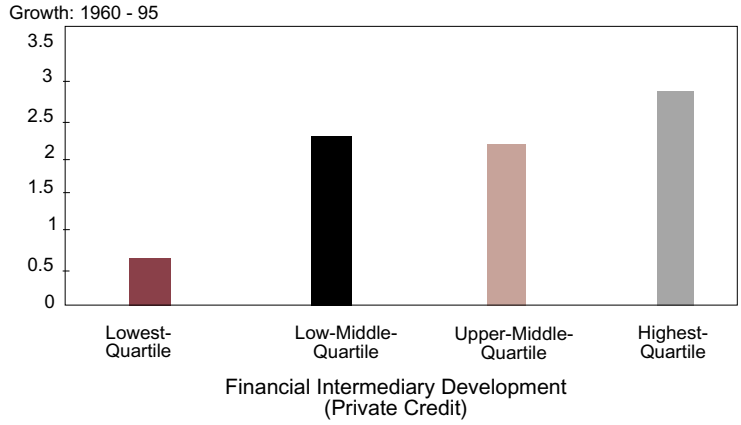


Chart 3.2 illustrates that countries with higher levels of PRIVATE CREDIT tend to enjoy faster growth rates over the 1960-95 period than countries with lower levels of financial intermediary development. Indeed, of the ten fastest growing countries over this 35-year period, all of them had larger-than-average values of PRIVATE CREDIT. Many well-known Asian Miracles, such as Malaysia, Thailand, Japan, Taiwan, and Korea, were in the top quartile of countries as ranked by financial intermediary development. It is worth noting that four European countries (Greece, Ireland, Portugal, and Cyprus) were also among the ten fastest growing countries during this sample period. Each of these countries also had comparatively well-developed financial systems. Certainly, many factors may account for these economic success stories. At the other end of the spectrum, seven of the ten countries with negative growth rates over the 35-year period were in the lowest quartile of countries as defined by financial intermediary development (Zaire, Niger, Ghana, Haiti, Liberia, Sierra Leone, and Guyana). The banking systems of these countries have been in disarray for much of the last 35 years (See, for example, Gelbard and Leite 1999, Mehran 1998, Sheng 1996, and Caprio, Atiyas and Hanson 1994 for discussions of the individual countries). Government ownership of banks, massive official intervention in credit allocation, high levels of nonperforming loans, controls on interest rates, and numerous restrictions impede the ability of the financial systems in these countries from mobilizing and allocating capital efficiently.[v] But, these countries suffer many other economic policy and political maladies. Thus, we now turn to regression analyses where we control for an array of factors associated with economic growth (including country specific-factors) and also confront potential biases induced by simultaneity.

v Some countries have effectively improved their financial systems through a range of financial reforms, e.g., Ghana, as documented in Gelbard and Leite (1999). Thus, it is important to exploit the time-series dimension of the data. We do this below.

Chart 3.2 Summary Statistics: 1960-1995



(b) Legal origin

To confront the issue of simultaneity, we identify instrumental variables for financial intermediary development. Here, we follow LLSV (1998) in looking to legal origin. Comparative legal scholars place countries into four major legal families, English, French, German, or Scandinavian, that descended from Roman law [Reynolds and Flores 1996]. As described by Glendon, Gordon, and Osakwe (1982), Roman law was compiled under the direction of Byzantine Emperor Justinian in the sixth century. Over subsequent centuries, the *Glossators* and *Commentators* interpreted, adapted, and amended the Law [Berman 1997]. In the 17th and 18th centuries the Scandinavian countries formalized their own legal codes. The Scandinavian legal systems have remained relatively unaffected from the far reaching influences of the German and especially the French Civil Codes.

Napoleon directed the writing of the French Civil Code in 1804. He made it a priority to secure the adoption of the Code in France and all conquered territories, including Italy, Poland, the Low Countries, and the Habsburg Empire. Also, France extended her legal influence to parts of the Near East, Northern and Sub-Saharan Africa, Indochina, Oceania, French Guyana, and the French Caribbean islands during the colonial era. Furthermore, the French Civil Code was a major influence on the Portuguese and Spanish legal systems, which helped spread the French legal tradition to Central and South America.

The German Civil Code *(B rgerliches Gesetzbuch)* was completed almost a century later in 1896. The German Code exerted a big influence on Austria and Switzerland, as well as China (and hence Taiwan), Czechoslovakia, Greece, Hungary, Italy, and Yugoslavia. Also, the German Civil Code heavily influenced the Japanese Civil Code, which helped spread the German legal tradition to Korea. Unlike these Civil Law countries, the English legal system is common law, where the laws were primarily formed by judges trying to resolve particular cases.

This paper takes national legal origin as an exogenous endowment since the English, French, and German systems were spread primarily through conquest and imperialism. It is critical to recognize, however, that exogeneity is not a sufficient condition for economically meaningful instrumental variables. It must also be the case that there are good reasons for believing that legal origin is closely connected to factors that directly affect the behavior of financial intermediaries. LLSV (1998) trace differences in legal origin through to differences in the legal rules covering secured creditors, the efficiency of contract enforcement, and the quality of accounting standards. Thus, legal origin is connected to legal and regulatory characteristics defining financial intermediary activities.

Table 3.2 presents regressions of the financial intermediary development indicators on the dummy variables for English, French and German legal origin, relative to Scandinavian origin (which is captured in the constant). We extend the LLSV (1998) data set from 44 countries (with financial intermediary data) to 71 using Reynolds and Flores (1996). The data are listed in the Appendix, Table A1. Some of the regressions also control for the level of real per capita GDP. The major message is that countries with a German legal origin have better developed financial intermediaries. While countries with a French legal tradition tend to have less well-developed institutions than other countries on average, this result does not hold when controlling for the overall level of economic development. Also, as indicated by the P-values of the F-test, the legal origin variables explain a significant fraction of the cross-country variation of the financial intermediary development indicators.

Table 3.2 Legal Origin and Financial Intermediary Development, 1960-95

	Liquid Liabilities		**Commercial-Central Bank**		**Private Credit**	
C	3.829	0.958	4.506	3.063	4.027	- 0.674
	(0.000)	(0.081)	(0.000)	(0.000)	(0.000)	(0.386)
ENGLISH	-0.134	0.249	-0.170	0.022	-0.717	-0.090
	(0.325)	(0.038)	(0.002)	(0.716)	(0.002)	(0.646)
FRENCH	0.434	-0.052	-0.270	-0.078	-0.894	-0.268
	(0.001)	(0.703)	(0.000)	(0.152)	(0.000)	(0.190)
GERMAN	0.477	0.683	0.048	0.152	0.401	0.738
	(0.016)	(0.000)	(0.100)	(0.010)	(0.076)	(0.002)
INCOME		0.330		0.166		0.541
		(0.000)		(0.000)		(0.000)
OBS.	71	71	71	71	71	71
Prob(F-test)	0.001	0.000	0.040	0.000	0.000	0.000
R-square	0.23	0.44	0.12	0.30	0.26	0.55

LIQUID LIABILITIES = liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonblank financial intermediaries) divided by GDP, times 100.

COMMERCIAL-CENTRAL BANK = assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.

PRIVATE CREDIT =credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

Values for the financial intermediary development indicators are averages over the period 1960-95 period.

ENGLISH = English legal origin

FRENCH = Napoleonic legal origin

GERMAN = German legal origin

Scandinavian legal origin is the omitted category

INCOME = Logarithm of real per capita GDP in 1960

(c) Legal origin and growth in a pure cross-section of countries

1. Cross-sectional estimator

The pure cross-sectional analysis uses data averaged over 1960-95, such that there is one observation per country. The basic regression takes the form:

$$GROWTH_i = \alpha + \beta FINANCE_i + \gamma\ [CONDITIONING\ SET]_i + \varepsilon_i,$$

where the dependent variable, GROWTH, equals real per capita GDP growth, FINANCE equals either LIQUID LIABILITIES, COMMERCIAL-CENTRAL BANK, or PRIVATE CREDIT, and CONDITIONING SET represents a vector of conditioning information that controls for other factors associated with economic growth.[vi]

To examine whether cross-country variations in the exogenous component of financial intermediary development explain cross-country variations in the rate of economic growth, the legal origin indicators are used as instrumental variables for FINANCE. Our method of estimation is the generalized method of moments (GMM)[vii] In estimation we have only used *linear* moment conditions, which amount to the requirement that the instrumental variables (Z) be uncorrelated with the error term (ε). The economic meaning of these conditions is that the instrumental variables can only affect the dependent variable through the explanatory variables, that is, they cannot have an independent effect on the dependent variable. In the context of the cross-sectional growth regressions, the moment conditions mean that legal origin may affect per capita GDP growth only through the financial development indicators and the variables in the conditioning information set (that is, the other determinants of growth). We test this condition.

Testing the validity of the moment conditions is crucial to ascertaining the consistency of GMM estimates. The specification test we use is the test of overidentifying restrictions introduced in the context of GMM by Hansen (1982) and further explained in Newey and West (1987).[viii] If the regression specification passes the test, then we can safely draw conclusions taking the moment conditions as given. That is, we cannot reject the statistical and economic significance of the estimated coefficient on financial intermediary development as indicating an effect running from financial development to per capita GDP growth. We can safely discard the possibility that the relationship between financial intermediary development and growth is due to simultaneity bias or to omitted variables linked to *legal origin*.

2. Conditioning information set

To examine the sensitivity of the results, we experiment with different conditioning information sets. We seek to reduce the chances that the cross-country growth regression either omits an important variable or includes a select group of regressors that yields a favoured result. We report the results with three conditioning information sets. The simple conditioning information set includes the constant, the logarithm of initial per capita GDP and initial level of educational attainment. The initial income variable

vi Due to the potential nonlinear relationship between economic growth and the assortment of economic indicator, we use natural logarithms of the regressors.

vii Two-stage instrumental variable procedures produce the same conclusions.

viii Intuitively, the fact that we have more moment conditions (instruments) than parameters to be estimated means that estimation could be done with fewer conditions. We can use this fact to estimate the error term under a set of moment conditions that excludes one instrumental variable at a time; we can then analyze if each estimated error term is uncorrelated with the instrumental variable excluded in the corresponding instrument set. The null hypothesis of Hansen s test is that the overidentifying restrictions are valid, that is, the instrumental variables are not correlated with the error term. The test statistic is simply the sample size times the value attained for the objective function at the GMM estimate (called the J-statistic). Hansen s test statistic is distributed as c2 with degrees of freedom equal to the number of moment conditions minus the number of parameters to be estimated. We report this statistic in the Tables.

is used to capture the convergence effect and school attainment is used to control for the level of human capital. The policy conditioning information set includes the simple conditioning information set plus measures of government size, inflation, the black market exchange rate premium, and openness to international trade.[ix] The full conditioning information set includes the policy conditioning information set plus measures of political stability (the number of revolutions and coups and the number of assassinations per thousand inhabitants (Banks 1994)) and ethnic diversity (Easterly and Levine 1997). Thus, for each of the three financial intermediary development indicators, we present regression results for the (i) simple, (ii) policy, and (iii) full conditioning information sets.

3. Regression results

The results indicate a very strong connection between the exogenous component of financial intermediary development and long-run economic growth. Table 3.3 summarizes the purely cross-sectional instrumental variable results for nine regressions, where the instrumental variables are the legal origin variables. For brevity, we report only the coefficients on the financial development indicators. Each of the three financial intermediary development indicators (PRIVATE CREDIT, COMMERCIAL-CENTRAL BANK, LIQUID LIABILITIES) is significantly correlated with economic growth at the five percent significance level in the simple, policy, and full conditioning information set regressions. The exogenous component of financial intermediary development is closely tied to long-run rates of per capita GDP growth. Furthermore, the data do not reject the orthogonality conditions at the ten percent level in any of the nine regressions. The inability to reject the orthogonality conditions plus the result that the instruments are highly correlated with financial intermediary development (Table 2) suggest that the instruments are appropriate. These results indicate that the strong link between financial development and growth is not due to simultaneity bias. The estimated coefficient can be interpreted as the effect of the exogenous component of financial intermediary development on growth.

The regression results also indicate an economically large impact of financial development on growth. For example, India s value of PRIVATE CREDIT over the 1960-95 period was 19.5 percent of GDP, while the mean value for developing countries was 25 percent of GDP. The results suggest that an exogenous improvement in PRIVATE CREDIT in India that had pushed it to the sample mean for developing countries would have accelerated real per capita GDP growth by an additional 0.6 of a percentage point per year.[x] Similarly, if Argentina had moved from its value of PRIVATE CREDIT (16) to the developing country sample mean, it would have grown more than one percentage point faster per year. This is large considering that growth only averaged about 1.8 percent per year over this period. These types of conceptual experiments, however, must be treated as illustrative only; they do not account for how to increase financial intermediary development.

ix The black market exchange rate premium is frequently used as an overall index of trade, exchange rate, and price distortions [Easterly 1994; Levine and Zervos 1998]. The inflation rate and size of the government serve as indicators of macroeconomic stability [Easterly and Rebelo 1993; Fischer 1993].

x To get this, recall that the regressors are in logs and note that the ln(25) - ln(19.5) = 0.25. Then, use the smallest parameter on PRIVATE CREDIT from Table 3, which equals 2.5, so that 2.5*(0.25) = 0.63.

Table 3.3 Financial Intermediation and Growth: Cross-Section Regressions, 1960-95

Dependent variable: Real per Capita GDP Growth, 1960-95

Instrumental variables: Legal Origin Dummy variables

Regression Set #1: simple conditioning information set

Explanatory variable	*Coefficient*	*Standard error*	*T-statistic*	*P-value*	*Obs*	*J-Statistics*	*Hansen-test*
Private Credit	2.515	0.814	3.090	0.003	71	0.00189	.013
Commercial-Central Bank	10.861	3.086	3.520	0.001	71	0.01626	1.15
Liquid Liabilities	1.723	0.844	2.041	0.045	71	0.03491	2.48

Regression Set #2: simple conditioning information set

Explanatory variable	*Coefficient*	*Standard error*	*T-statistic*	*P-value*	*Obs*	*J-Statistics*	*Hansen-test*
Private Credit	3.222	1.245	2.589	0.012	63	0.00799	0.50
Commercial-Central Bank	9.641	4.039	2.387	0.021	63	0.0373	2.35
Liquid Liabilities	2.173	0.908	2.394	0.020	63	0.03799	2.39

Regression Set #3: simple conditioning information set

Explanatory variable	*Coefficient*	*Standard error*	*T-statistic*	*P-value*	*Obs*	*J-Statistics*	*Hansen-test*
Private Credit	3.356	1.150	2.918	0.005	63	0.02239	1.41
Commercial-Central Bank	11.289	3.258	3.465	0.001	63	0.00325	0.20
Liquid Liabilities	2.788	0.903	3.089	0.003	63	0.0901	2.46

Critical values for Hansen-Test Over Identifying Restrictions (2d.f.): 10% 4.61; 5%=5.99

Simple conditioning information set: logarithm of initial per capita and schooling

Policy conditioning information set: simple set, plus government size, inflation, black market premium and openness to trade.

Full conditioning information set: plus indicators of revolutions and coups, political assassinations, and ethnic diversity.

Liquid Liabilities = Liquid Liabilities of the financial system (currency plus demand and interest bearing liabilities of banks and non-bank financial intermediaries divided by GDP, times 100.

Commercial-Central Bank = assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.

Private Credit = credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

3.3 Searching for Determinants of Financial Intermediary Development

This section undertakes a limited search of potential legal and accounting determinants of financial intermediary development. We use LLSV s (1998) data. Instead of examining the links between the legal/regulatory environment and measures of bond market and equity market development as in LLSV (1997, 1998), we study the ties between the legal environment and measures of financial intermediary development. Moreover, unlike earlier studies, we use instrumental variables to assess whether the positive association between legal/regulatory indicators and financial development is due to simultaneity bias.

(a) The legal and accounting environment

We use three LLSV (1998) indicators of national legal and regulatory systems: the legal rights of creditors, the soundness of contract enforcement, and the level of corporate accounting standards.

1. Creditor rights

The degree to which the legal system supports the rights of creditors will fundamentally influence financial contracting and the functioning of financial intermediaries. Specifically, legal systems differ in terms of the rights of creditors to (i) repossess collateral or liquidate firms in the case of default, (ii) remove managers in corporate reorganizations, and (iii) have a high priority relative to other claimants in corporate bankruptcy.

AUTOSTAY equals one if a country s laws impose an automatic stay on the assets of firms upon filing a reorganization petition. AUTOSTAY equals 0 if this restriction does not appear in the nation s legal codes. The restriction would prevent creditors from gaining possession of collateral or liquidating a firm to meet a loan obligation. Thus, all else equal, AUTOSTAY should be negatively correlated with the activities of credit issuing intermediaries.

MANAGES equals one if firm managers continue to administer the firm s affairs pending the resolution of reorganization processes, and zero otherwise. In some countries, management stays in place until a final decision is made about the resolution of claims. In other countries, a team selected by the creditors replaces management. If management stays pending resolution, this reduces pressure on management to pay creditors. Thus, MANAGES should be negatively correlated with the activities of credit issuing intermediaries.[xi]

The third measure of the legal rights of credits is SECURED1, which equals one if secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. SECURED1 equals zero if non-secured creditors, such as the government or workers get paid before secured creditors. In cases where SECURED1 equals zero, this certainly reduces the attractiveness of lending secured credit. SECURED1 should be positively correlated with activities of intermediaries engaged in secured transactions, holding everything else constant.

CREDITOR is a cumulative index of these creditor rights indicators and equals CREDITOR =

xi Here it is important to highlight a substantive weakness with AUTOSTAY and MANAGES. They do not measure the efficiency of the legal and regulatory system in coping with bankruptcy. For instance, two countries could have very similar legal codes, such that management stays in place pending the resolution of a bankruptcy hearing and there is an automatic stay on the assets of a firm until the bankruptcy courts process the reorganization petition. However, the two countries legal and regulatory systems may process bankruptcy and reorganization very differently. One country s system may take a long-time and be subject to great uncertainty. The other may be very rapid, efficient, and transparent. Thus, a major difference across countries may be the quality of the bankruptcy system, not the laws themselves. Currently, there do not exist cross-country measures of the speed, transparency, and fairness of bankruptcy systems.

SECURED1 - AUTOSTAY - MANAGES. CREDITOR takes on values between 1 (best) and -2 (worst).[xii] One would expect countries with higher values of CREDITOR to have stronger creditor rights and better-developed financial intermediaries, all else equal.

Table 3.4 gives summary statistics on CREDITOR, and the data are listed in **Appendix Table A1**. As shown there is substantial cross-country variation in CREDITOR, where the maximum value is 1, the minimum value is -2, and the standard deviation is about 1. Brazil, Colombia, France, Mexico, Peru, and the Philippines (all countries with a French legal origin) are countries where CREDITOR=-2, indicating that their legal systems do not stress the rights of creditors. In contrast, the legal codes of Egypt, Hong Kong, India, Indonesia, Israel, Korea, Malaysia, Nigeria, Pakistan, Singapore, Thailand, United Kingdom, and Zimbabwe stress the rights of creditors, such that CREDITOR=1. CREDITOR is an indicator of legal codes, however, it does not incorporate information regarding enforcement.

Table 3.4 Summary Statistics on the Legal and Accounting Environment

	Legal and Accounting Environment		
	CREDITOR	ENFORCE	ACCOUNT
Mean	-0.3	7.5	61.2
Median	0	8.2	64.0
Maximum	1	10.0	83.0
Minimum	-2	3.6	24.0
Std. Dev.	1.1	2.0	13.5
Observations	44	44	40

CREDITOR = index of secured creditor rights.

ENFORCE = index of law and contract enforcement.

ACCOUNT = index of the comprehensiveness and quality of company reports

Values for the legal environment indicators are averages over the 1982-95 period.

Values of accounting quality are assessments of company reports in 1990.

2. Enforcement

The effectiveness of the legal system in enforcing contracts will materially influence financial sector activities. RULELAW, from LLSV (1998), is an assessment of the law and order tradition of the country that ranges from 10, strong law and order tradition, to 1, weak law and order tradition. This measure was constructed by International Country Risk Guide (ICRG) and is an average over the period 1982-1995. Given the contractual nature of banking, higher values of RULELAW are likely to positively influence banking development. CONRISK, also from LLSV (1998), is an assessment of the risk that a government will — and therefore can — modify a contract after it has been signed. CONRISK ranges from 10, low risk of contract modification, to 1, high risk of contract modification. Specifically, modification means repudiation, postponement, or reducing the government s financial obligation.

xii We could have redefined AUTOSTAY and MANAGES such that values of one indicated stronger (instead of weaker) creditor rights. This would have produced values of CREDITOR between 0 and 3 and would not have altered the results. We did not do this for consistency: the variables in this paper are defined the same as the variables in LLSV (1997,1998).

This measure was constructed by ICRG and is an average over the period 1982-1995. Legal systems that effectively enforce contracts will tend to support banking activities.

ENFORCE equals the average of RULELAW and CONRISK. The empirical analyses focus on this aggregate index of the efficiency of the legal system in enforcing contracts Summary statistics on ENFORCE are given in Table 3.4, and the data are listed in **Appendix Table A1**. As shown, there is substantial cross-country variation in ENFORCE, where the maximum value is 9.99, the minimum value is 3.55, and the standard deviation is 2.2. The countries with very high values of enforcement, values of ENFORCE greater that 9, are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Japan, Netherlands, New Zealand, Norway, Sweden, and Switzerland. In contrast, countries where contract enforcement is poor, values of ENFORCE less than 5 include Colombia, Nigeria, Pakistan, Philippines, Peru, and Zimbabwe.

3. Accounting standards

Information about corporations is critical for exerting corporate governance and identifying the best investments. Accounting standards that simplify the interpretability and comparability of information across corporations will simplify financial contracting. Furthermore, financial contracts that use accounting measures to trigger particular actions can only be enforced if accounting measures are sufficiently clear. ACCOUNT, from LLSV (1998), is an index of the comprehensiveness of company reports. The maximum possible value is 90 and the minimum is 0. The Centre for International Financial Analysis and Research assessed general accounting information, income statements, balance sheets, funds flow statement, accounting standards, and stock data in company reports in 1990. We expect ACCOUNT to be positively correlated with financial intermediary development.[xiii] As shown in Table 4, ACCOUNT exhibits substantial cross-country variation. The data are listed in Appendix Table A1. The maximum value is 83, Sweden, while the minimum value in our sample is Egypt (24). The United States has a value of 71, which is well above the mean value of 61.

(b) Determinants of Financial Intermediary Development

Table 3.5 shows that cross-country differences in creditor rights, enforcement quality, and accounting standards help explain cross-country differences in financial intermediary development, even after controlling for the level of income per capita. Jointly, the variables CREDITOR, ENFORCE, and ACCOUNT explain a significant amount of the cross-country variation in the three financial intermediary indicators (PRIVATE CREDIT, LIQUID LIABILITIES, and COMMERCIAL-CENTRAL BANK). Each of the legal/accounting indicators, however, is not significantly correlated with all of the intermediary measures. For instance LIQUID LIABILITIES is most closely associated with ENFORCE and CREDITOR. In turn, PRIVATE CREDIT is very strongly linked with ENFORCE and ACCOUNT.[xiv]

xiii This is not necessarily true and raises the need for a general conceptual qualification. An economy with perfect information, perfect contract enforcement and perfect legal codes (i.e., an economy with essentially zero transaction and information costs) would have little reason for financial intermediaries. Put differently, market frictions motivate the emergence of financial intermediaries, e.g., Boyd and Prescott (1986). Conceptually, this implies that at very high levels of legal system development and information dissemination, a marginal increase in legal efficiency or information quality may cause a reduction in the role and importance of financial intermediaries. However, quadratic expressions for ACCOUNT and CONRISK never entered significantly.

xiv Since CREDITOR, ENFORCE, and ACCOUNT are measured over the 1980s and 1990s, we use financial intermediary measures over the same period. However, we get very similar results when the analysis uses financial intermediary measures over the period 1960-1995. These results are available on request.

Table 3.5 Legal Environment and Financial Intermediary Development (1980-95)

	Liquid Liabilities				Commercial Central Bank				Private Credit			
	OLS	OLS	OLS	IV	OLS	OLS	OLS	IV	OLS	OLS	OLS	IV
C	2.830	3.880	4.830	4.402	3.950	3.640	4.200	4.403	1.480	2.557	4.368	4.322
	(0.000)	(0.002)	(0.000)	(0.000)	(0.000)	(0.000)	(0.001)	(0.000)	(0.000)	(0.020)	(0.001)	(0.003)
CREDITOR	0.216	0.179			0.009	0.020			0.125	0.088		
	(0.001)	(0.027)			(0.641)	(0.504)			(0.033)	(0.173)		
ENFORCE	0.178	0.229			0.008	0.014			0.200	0.253		
	(0.000)	(0.003)			(0.022)	(0.454)			(0.000)	(0.000)		
ACCOUNT	-0.002	-0.001			0.005	0.004			0.017	0.018		
	(0.745)	(0.866)			(0.024)	(0.042)			(0.005)	(0.002)		
INCOME		-0.174	-0.099	-0.05		0.052	0.031	0.007		-0.179	-0.044	-0.039
		(0.395)	(0.387)	(0.672)		(0.236)	(0.325)	(0.844)		(0.262)	(0.711)	(0.804)
LEGAL			0.412	0.361			0.091	0.115			0.606	0.600
			(0.003)	(0.009)			(0.014)	(0.002)			(0.001)	(0.001)
Obs	36	36	36	36	36	36	36	36	36	36	36	36
Prob(F-test)	(0.000)	(0.000)	(0.0000	(0.003)	(0.000)	(0.001)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
R-square	0.57	0.59	0.39	0.39	0.51	0.52	0.52	0.50	0.68	0.69	0.66	0.66

LIQUID LIABILITIES = liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP, times 100.

COMMERCIAL-CENTRAL BANK = assets of deposit money banks divided by assets of deposit money banks plus central bank assets, times 100.

PRIVATE CREDIT = credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

CREDITOR = index of secured creditor rights.

ENFORCE = index of law and contract enforcement.

ACCOUNT = index of the comprehensiveness and quality of company reports

LEGAL = index of legal environment. Specifically, LEGAL is the first standardized principal component of CREDITOR, ENFORCE, and ACCOUNT

Simultaneity bias does not seem to be driving these results. As instrumental variables, we use the legal origin dummy variables for countries with French, English, and German legal origins.[xv] Since we only have three instruments, we construct a general index of the legal and regulatory environment. We

xv First, note that the legal origin variables help explain cross-country differences in creditor rights, enforcement quality, and accounting standards. As shown by LLSV (1998), English legal tradition countries have laws that emphasize the rights of creditors to a greater degree than the French, German, and Scandinavian countries. French civil law countries protect creditors the least, with German and Scandinavian civil law countries falling in the middle. In terms of enforcement quality, countries with a French legal heritage have the lowest quality of law enforcement, while countries with German and Scandinavian legal traditions tend to be the best at enforcing contracts. Finally, LLSV (1998) show that countries with an English legal tradition tend to have much better accounting standards than French or German civil law countries.

compute the first standardized principal component of CREDITOR, ENFORCE, and ACCOUNT and use this as the index of the legal/regulatory environment governing financial transactions. We call this index LEGAL. In the simple OLS regression, LEGAL explains a substantial amount of the cross-country variation in all of the financial intermediary development indicators, even after controlling for the level of real per capita GDP. When we use an instrumental variables estimator to control for simultaneity bias, the results are unchanged.[xvi] The basic message that emerges from Table 5 is that countries with (i) laws that give a high priority to secured creditors, (ii) legal systems that rigorously enforce contracts, and (iii) accounting standards that produce comprehensive and comparable corporate financial statements tend to have better developed financial intermediaries.[xvii]

(c) Discussion of Causes

These findings in conjunction with those in LLSV (1998) are *consistent* with the view that countries with particular legal origins tend to create particular types of laws, regulations, and enforcement mechanisms. These laws, regulations, and enforcement mechanisms directly influence the functioning of financial intermediaries. Financial intermediaries that are better at ameliorating information and transactions costs induce a more efficient allocation of resources and faster growth.[xviii] While it is difficult to change legal origin, the results offer a strategy for boosting financial development and accelerating long-run growth. Countries can target reforms that ensure that lenders have confidence that the legal system will quickly, transparently, and effectively enforce their claims against borrowers and that outside investors have easy access to high-quality, comprehensive, and comparable information about firms.

3.4 Conclusions

This paper first examined the nature of the effect of financial intermediary development on economic growth. We used an instrumental-variable procedure applied to cross-country data. Our basic result was that the exogenous component of financial intermediary development is positively associated with economic growth; specifically, the large, positive link between financial intermediary development and economic growth is not due to potential biases induced by omitted variables, simultaneity or reverse causation.

Next, we investigated whether cross-country differences in the legal rights of creditors, the efficiency of contract enforcement, and accounting system standards help explain cross-country differences in the level of financial intermediary development. The results are clear: countries with (1) laws that give a high priority to secured creditors getting the full present value of their claims against firms, (2) legal systems that rigorously enforce contracts, including government contracts, and (3) accounting standards that produce high-quality, comprehensive and comparable corporate financial statements tend to have better developed financial intermediaries. The paper s findings are consistent with the view that legal and accounting reforms that strengthen creditor rights, contract enforcement, and

xvi None of these findings changes when the instrumental variable set is expanded to include the LLSV (1999) exogenous variables, i.e., religious composition of the population, ethnic diversity, and distance from the equator. These results are available on request.

xvii The evidence we provide suggests that the strong link between financial sector development on the one hand and the legal/regulatory environment on the other is not due to simultaneity bias. These results do not suggest that the legal/regulatory environment only impacts growth through financial intermediary development. Rather, these results imply that the legal/regulatory environment has an important impact on financial intermediary development.

xviii Put differently, when countries are endowed with a certain legal heritage, this produces a probability distribution regarding the laws, regulations, and enforcement mechanisms that they are likely to adopt. Thus, for example, the data suggest that countries with a French Civil Code have a lower probability of selecting laws that give a higher priority to secured credits, selecting accounting standards that produce high-quality corporate financial statements, and enforcing contracts than countries with English, German, and Scandinavian legal systems. The resultant laws, regulations, and enforcement mechanisms then affect the ability of the financial system to research firms, exert corporate control, mobilize savings, and provide risk management and transactions services.

accounting practices can boost financial intermediary development and thereby accelerate economic growth. Due to data limitations, however, we do not conduct a comprehensive evaluation of the regulatory determinants of financial intermediary development [e.g., see Calomiris 1989; Kane 1985,1989; Barth, Nolle, and Rice 1997; BIS 1997; Calomiris and Gorton 1991; Kroszner and Rajan 1994; Kroszner and Strahan 1996; Barth, Caprio, and Levine 1999]. Future work would substantially broaden and deepen our understanding of the determinants of financial intermediary development by obtaining additional measures of the legal, supervisory, and regulatory factors that determine the level of financial intermediary development.

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APPENDIX A: COUNTRIES IN THE SAMPLE

Argentina
Australia
Bangladesh
Barbads
Belgium
Bolivia
Brazil
Canada
Chile
Columbia
Costa Rica
Cyprus
Denmark
Dominican Republic
Ecuador
El Salvador
Fiji
Finland
France
Germany
Ghana
Great Britian
Greece
Guatemala
Haiti
Honduras
Iceland
India
Ireland
Isreal
Italy
Jamaica
Japan
Kenya
Korea
Liberia
Malaysia
Malta
Mauritius
Mexico
Nepal
Netherlands
New Zealand
Niger
Norway
Pakistan
Papua New Guinea
Paraguay
Peru
Phillipines
Portugal
Senegal
Sierra Leone
South Africa
Spain
Sri Lanka
Sweden
Switzerland
Syria
Taiwan
Thailand
Togo
Trinidad and Tobago
United States of America
Uruguay
Venezuela
Zaire
Zimbabwe

APPENDIX B: VARIABLES AND SOURCES

Variable	Definition	Original Source	Secondary Source
Level and growth rate of GDP	Real per capita GDP Real per capita GDP (for initial GDP in cross-section regressions)	World Development Indicators Penn World Tables	Loayza et al. (1998)
Government size	Government expenditure as share of GDP	World Development Indicators	Loayza et al. (1998)
Opennes to trade	Sum of real exports and imports share of real GDP	World Development Indicators	Loayza et al. (1998)
Growth rate of terms of trade	Log difference of the terms of trade, divided by five	World Development Indicators	Loayza et al. (1998)
Population growth rate	Log difference of the total population divived by five	World Bank, International Economics Department	Loayza et al. (1998)
Inflation rate	Log difference of Consumer Price Index	International Financial Statistics (IFS), line 64	
Average years of schooling	Average years of schooling in the population over 25	Barro and Lee (1996)	
Average years of secondary schooling	Average years of secondary schoolin in the population over 15	Barro and Lee (1996)	
Black market premium	Ratio of black market exchange rate and official exchange rate minus one	Pick s Currency Yearbook through 1989 and World Currency Yearbook	
Liquid Liabilities	{(0,5)*[F(t)/P_e(t) +F(t-1)/P_e(t-1)]}/GDP(t)_a(t)], where F is liquid liabilities (line 55l), GDP is line 99b, P_e is end-of period CPI (line 64) and P_a is the average annual CPI	IFS	
Commercial-Central Bank	DBA(t)/(DBA(t)+CBA(t)), where DBA is assets of deposit money banks (lines 22a-d) and CBA is central bank assets (lines 12a-d).	IFS	
Private Credit	{(0.5)*[F(t)/P_e(t) +F(t-1)/P_e(t-1)]}/[GDP(t)/P_a(t)], where F is credit by depost money banks and other financial institutions to the private sector (lines 22d + 42d), GDP is line 99b, P_e is end of period CPI (line 64) and P_a is the average CPI for the year.	IFS	

VARIABLES AND SOURCES (CONT)

Bank Assets	{(0.5)*[F(t)/P_e(t)+F(t-1)]}/GDP(t)/P_a(t)], where F is domestic assets of depost money banks (lines 22a-d), GDP is line 99b, P_e is end of period CPI (line 64) and P_a is the average CPI for the year.	IFS	
Bank Credit	{(0.5)*[F(t)/P_e(t)+F(t-1)/P_e(t-1)]}/GDP(t)/P_a(t)] where F is credit by deposit money banks to the private sector (lines 22d), GDP is line 99b, P_e is end of perod CPI (line 64) and P_a is the average CPI for the year.	IFS	
Legal origin	Dummy variables for British, French, German and Scandinavian legal origin	Reynolds and Flores (1996)	LLSV(1998) and own coding
Accounting	Index created by examining and rating companies 1990 annual reports on their inclusion or omission of 90 items in balance sheets and income statements. The maximum is 90, the minimum 0.	Center of International Financial Analysis & Research Inc.	LLSV (1998)
Rulelaw	Measure of the law and other tradition of a country. It is an average over 1982-1995. It ranges from 10, strong law and order tradition, to 1, weak law and other tradition.	International Country Risk Guide (ICRG)	LLSV (1998)
Conrisk	Measure of the risk that a government will modify a contract after it has been signed. It ranges from 10, low risk to 1, high risk and is averaged over 1982-1995.	ICRG	Knack and Keefer (1995)
Autostay, Manages,	AUTOSTAY equals one if a country d laws impose an automatic stay on the assets of firms upon filing a reorganization petition, and zero otherwise. MANAGESequals one if firm managers continue to administer the firm s affairs pending the resolution of reorganizatiion processes, and zero otherwise. SECURED1 equals one if secured creditors are ranked first in the distribution of the proceeds that result from the dispositon of the assets of a bankrupt firm, and zero otherwise.	National Bankcruptcy and reorganization laws	
Assassinations	Number of assassinations per thousand inhabitants. Data are averaged over 1960-90	Banks (1994)	

VARIABLES AND SOURCES (CONT)

Revolutions and Coups	A revolutio is defined as any illegal or forced change in the top governmental elite, any attempt at such a change, or any successful or unsuccessful armed rebellion whose aim is independence central government. Coup d Etat is defined as an extraconstitutional or forced change in the top government elite and/or its effective control of the nation s power structure in a given year. Unsuccessful coups are not counted. Data are averaged over 1960-9-	Banks (1994)	
Ethnic fractionalization	Average value of five indices of ethnolinguistic fractionalization, with values ranging from 0 to 1, where higher values denote higher levels of fractionalization.	Atlas Narodov Mira, 1964; Muller, 1964; Roberts, 1962 Gunnemark, 1991	Easterly and Levine (1997)
Bureaucratic efficiency	Average of three indices published by Business International Corporation (1984): efficiency of the judiciary system, red tape and corruption. The data are averaged over 1980-83	Business International Corporation (1984)	Mauro (1995)
Corruption	Measure of corruption, with the scale readjusted to 0 (high level of corruption) to 10 (low level). Data are averaged over 1982-1995.	ICRG	Knack and Keefer (1995)
Index of state-owned enterpirses	Measures the role of SOEs in the economy, ranging from 0 to 10, with data averaged over 1975-95. Higher scores denote countries with less government owned enterprises, which are estimated to produce less of the country s output.	Gwarney, Lawson and Block (1996)	LLSV (1999)
Property Rights	Rating of property rights on a scale from 1 5o 5. The more protection private property receives, the higher the score.	Holmes, Johnson Kirkpatrick (1997)	LLSV(1999)
Cost of business regulation	Rating of regultion policies related to opening and keeping open a business. The scale is from 0 to 5, with higher scores meaning that regulations are straightforward and applied uniformly to all businesses and that regulations are less of a burden to business.	Holmes, Johnson and Kirkpatric (1997)	LLSV (1999)

VARIABLES AND SOURCES (CONT)

Risk of expropriation	Assessment of risk of outright confiscation or forced nationalization . It ranges from 0 to 10, with lower scores indicating a higher risk and data are averaged over 1982-1995.	ICRG	Kanck and Keefer (1995)
Religious Composition	Percentage of the population that were (1) Roman Catholic, (2) Protestant, and (3) Muslim in 1980.	Barrett (1982), Worldmark Enyclopedia of Nations 1995, Statistical Abstract of the World 1995, United Nations Demographic Yearbook 1995, CIA World Factbook 1996.	LLSV (1999)
Distance from equator	The distance of the country from the equator, scaled between 0 and 1.	CIA Factbook 1996	LLSV(1999)

APPENDIX

TABLE A1: Economic Growth, Financial Development and Policies across countries

Country Code	Country Name	Average annual growth rate 1960-95	Financial Development Indicators LIQUID	COMMERCIAL	PRIVATE	Legal Origin	Policy Variables CREDITOR	ENFORCE	ACCOUNT
ARG	Argentina	0.62	18.34	74.16	15.69	F	-1	5.13	45
AUS	Australia	1.98	51.73	92.67	54.82	E	-1	9.36	75
AUT	Austria	2.89	67.50	98.44	65.30	G	0	9.80	54
BGD	Bangladesh*	0.71	24.69	86.38	13.55	E			
BRB	Barbados*	2.65	51.59	91.85	40.79	E			
BEL	Belgium	2.65	49.02	92.01	25.65	F	0	9.74	61
BOL	Bolivia*	0.36	16.39	31.60	13.14	F			
BRA	Brazil	2.93	19.16	61.68	22.10	F	-2	6.31	54
CAN	Canada	2.39	56.50	89.00	60.86	E	-1	9.48	74
CHL	Chile	1.45	22.96	52.81	27.81	F	-1	6.91	52
COL	Columbia	2.23	22.41	80.16	22.08	F	-2	4.55	50
CRI	Costa Rica*	1.61	29.38	72.82	21.77	F			
CYP	Cyprus*	5.38	74.49	92.72	62.39	E			
DNK	Denmark	2.18	49.48	88.10	42.45	S	0	9.66	62
DOM	Cominican Republic*	2.50	20.58	73.34	19.11	F			
ECU	Ecuador	2.39	20.05	62.16	17.99	F	1	5.93	
SLV	El Salvador	-0.61	26.94	72.04	22.85	F			
FJI	Fiji*	1.85	37.48	96.95	23.65	E			
FIN	Finland	2.80	45.35	97.22	51.78	S	-1	9.58	77
FRA	France	2.43	63.37	96.54	75.47	F	-2	9.09	69
DEU	Germany	2.45	57.46	97.57	76.46	G	0	9.50	62
GHA	Ghana*	-0.96	17.58	39.78	5.07	E			
GRC	Greece	3.22	53.34	74.36	36.72	F	-1	6.40	55
GTM	Guatemala*	0.93	20.22	75.16	13.32	F			
GUY	Guyan	-0.28	52.96	58.02	20.52	E			
HTI	Haiti*	-0.66	22.60	23.72	7.71	F			
HND	Honduras*	0.60	23.04	76.54	23.86	F			
ISL	Iceland*	3.01	31.76	88.94	34.79	S			
IND	India	1.92	32.95	63.68	19.53	E	1	5.14	57

APPENDIX

TABLE A1: Economic Growth, Financial Development and Policies across countries (Cont)

Country Code	Country Name	Average annual growth rate 1960-95	Financial Development Indicators			Legal	Policy Variables		
			LIQUID	COMMERCIAL	PRIVATE	Origin	CREDITOR	ENFORCE	ACCOUNT
IRL	Ireland	3.25	54.74	94.73	49.14	E	-1	8.38	
ISR	Isreall	2.81	51.95	84.28	37.43	E	1	6.18	64
ITA	Italy	2.93	77.48	87.77	59.03	F	-1	8.75	62
JAM	Jamaica*	0.42	36.85	78.09	24.55	E			
JPN	Japan	4.30	125.94	96.72	128.38	G	0	9.34	65
KEN	Kenya	1.96	35.74	81.27	23.93	E	1	5.54	
KOR	Korea, Republic of	7.16	41.02	83.95	66.52	G	1	6.97	62
LBR	Liberia*	-0.47	9.73	37.90	10.16	E			
MYS	Malaysia	4.11	63.74	96.45	47.20	E	1	7.11	76
MLT	Malta*	6.65	143.43	92.57	43.97	E			
MUS	Mauritius*	3.02	46.87	82.21	24.36	F			
MEX	Mexico	1.97	25.57	69.38	22.89	F	-2	5.95	60
NPL	Nepal*	0.77	20.27	57.86	7.72	E			
NLD	Netherlands	2.20	71.41	98.10	86.69	F	-1	9.68	64
NZL	New Zealand	1.12	49.63	82.43	37.59	E	0	9.65	70
NER	Niger*	-2.75	14.43	83.89	13.05	F			
NOR	Norway	3.18	54.04	90.02	81.62	S	-1	9.86	74
PAK	Pakistan	2.70	38.68	67.89	20.77	E	1	3.95	
PAN	Panama*	2.03	33.37	71.97	40.22	F			
PNG	Papua New Guinea*	1.12	31.05	89.12	20.84	E			
PRY	Paraguay*	2.38	17.62	65.29	14.52	F			
PER	Peru	0.06	18.52	86.04	13.32	F	-2	3.59	38
PHL	Phillipines	1.16	27.50	81.40	27.01	F	-2	3.77	65
PRT	Portugal	3.65	78.02	90.35	55.01	F	-1	8.63	36
SEN	Senegal*	-0.44	22.80	84.54	27.51	F			
SLE	Sierra Leone	-0.34	16.83	49.55	5.07	E			
ZAF	South Africa	0.39	51.44	94.77	71.94	E	0	5.85	70
ESP	Spain	2.88	70.31	92.74	65.05	F	0	8.10	64

APPENDIX

TABLE A1: Economic Growth, Financial Development and Policies across countries (Cont)

Country Code	Country Name	Average annual growth rate 1960-95	Financial Development Indicators LIQUID	COMMERCIAL	PRIVATE	Legal Origin	Policy Variables CREDITOR	ENFORCE	ACCOUNT
TWN	Taiwan, China	6.62	66.97	95.72	57.32	G	0	8.84	65
THA	Thailand	4.88	47.79	84.66	48.52	E	1	6.91	64
LKA	Sri Lanka	2.70	30.34	57.80	17.11	E	0	3.58	
SWE	Sweden	1.89	53.49	88.94	89.11	S	-1	9.79	83
CHE	Switzerland	1.42	123.41	98.99	141.30	G	-1	9.99	68
SYR	Syrian Arab Rep*	2.51	43.32	46.93	8.83	F			
TGO	Togo*	0.46	32.90	82.05	21.88	F			
TTO	Trinidad and Tobago*	1.12	37.46	91.72	31.20	E			
GBR	United Kingdom	1.96	48.63	83.55	46.31	E	1	9.10	78
USA	United States	1.71	62.12	93.11	113.07	E	-1	9.50	71
URY	Uruguay	1.03	29.47	59.24	21.21	F	0	6.15	31
VEN	Venezuela	-0.88	36.84	90.90	33.12	F		6.35	40
ZAR	Zaire*	-2.81	16.03	28.58	4.08	F			
ZWE	Zimbabwe	0.84	46.92	75.80	23.01	E	1	4.36	

*Countries added to the LLSV (1998) sample

LIQUID LIBILITIES = liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and nonbank financial intermediaries) divided by GDP, times 100.

COMMERCIAL-CENTRAL BANK = assets of deposit money banks divided by assets of deposit money banks plus central bank asses, times 100.

PRIVATE CREDIT= credit by deposit money banks and other financial institutions to the private sector divided by GDP, times 100.

Values for the financial intermediary development indicators are averages over the 1960-95 period.

Legal origin: E=English, F= French, G=German, S= Scandinavian

CREDITOR= index of secured creditor rights

ENFORCE=index of law and contract enforcement

ACCOUNT = index of the comprehensiveness and quality of company reports.

APPENDIX:

TABLE A2: Descriptive Statistics, Cross-Section 1960-95

	GDP growth	Initital income per capita	Average years of schooling	Private Credit	Commercial-Central Bank	Liquid Liabilities	Government size	Openness to trade	Inflation rate	Black market premium	Revolution and Coups	Assas-sinations	Ethnic fractio - lization
Mean	1.95	3120	4.06	40.86	79.26	45.21	14.75	59.46	15.56	23.34	0.16	0.29	0.29
Median	1.98	2019	3.65	27.91	83.89	41.02	13.16	54.33	9.08	5.36	0.07	0.10	0.19
Maximum	7.16	9895	10.07	141.30	98.99	143.43	31.37	231.69	90.78	277.42	0.97	2.47	0.87
Minimum	-2.81	367	0.20	4.08	23.72	14.43	6.68	14.05	3.63	0.00	0.00	0.00	0.00
Standard deviation	1.92	2519	2.50	29.16	17.37	26.26	5.23	36.43	18.25	49.31	0.22	0.50	0.27
Observations	63	63	63	63	63	63	63	63	63	63	63	63	63

CORRELATIONS

	GDP growth	Initital income per capita	Average years of schooling	Private Credit	Commercial-Central Bank	Liquid Liabilities	Government size	Openness to trade	Inflation rate	Black market premium	Revolution and Coups	Assas-sinations	Ethnic fractio-naliza tion
GDP growth	1												
Initial income per capita	0.04	1.00											
Average years of schooling	0.30	0.82	1.00										
Private Credit	0.43	0.63	0.57	1.00									
Commercial-Central Bank	0.46	0.48	0.43	0.64	1.00								
Liquid Liabilities	0.56	0.39	0.45	0.77	0.59	1.00							
Government Size	0.21	-0.36	0.46	0.30	0.38	0.30	1.00						
Openness to trade	0.19	-0.18	-0.04	-0.09	0.08	0.30	0.31	1.00					
Inflation rate	-0.28	-0.15	-0.10	-0.38	-0.48	-0.42	-0.24	-0.28	1.00				
Black market premium	-0.38	-0.28	-0.30	-0.37	-0.54	-0.26	-0.11	0.36	0.27	1.00			
Revolution and Coups	-0.24	-0.35	-0.30	-0.40	-0.46	-0.44	-0.42	-0.23	0.41	0.20	1.00		
Assassinations	-0.15	-0.09	-0.14	-0.14	-0.07	-0.17	-0.31	-0.27	0.24	0.02	0.51	1.00	
Ethnic fractionalization	-0.35	-0.43	-0.47	-0.34	-0.20	-0.29	-0.06	0.07	0.03	0.20	0.16	0.01	1

4. A REVIEW OF THE NAMIBIAN FINANCIAL STRUCTURE

Research Department

Bank of Namibia

4.1 Introduction

Namibia on the eve of independence in 1990 could be described as having had a siege economy, which was isolated from the rest of the world and which was characterised by extreme disparities in the distribution of income and access to public services. The country remained an exporter of primary commodities bereft of any expertise in developing finished products for exports or in meeting domestic consumption requirements. Thus, the process of industrialization in Namibia suffered considerably as a result of the cumulative impact of the policies pursued in the earlier regime. The overall economic activity accordingly turned sluggish in the initial years of independence (1990-93) in the wake of a severe drought that erupted during 1991-92 and the recessionary trends witnessed in the global economy.

If we exclude the period 1990-93 as an outlier, the Namibian economy grew on an average at 4.4 per cent between 1994 and 1999. During this period, the rate of saving on an average stood at 22.6 per cent of GDP, while the rate of investment stood at 19.0 per cent. Thus, the period witnessed a surplus of savings of 3.6 per cent during the period under review. The country also witnessed considerable inflow of foreign direct investment during this period. Direct foreign investment rose from N$348.9 million in 1994 to N$526.6 million in 1998. These figures as a ratio to GDP were 3.2 per cent and 2.8 per cent, respectively.

It is paradoxical that with such a high rate of saving and inflow of sizeable direct foreign investment in to the country, Namibia experienced not only lower than the warranted rate of growth but also a high level of unemployment. The growth in per capita income is estimated at 1.9 per cent between 1990 and 1999. The inequities in income distribution remained a cause for concern. Unemployment was growing at the rate of 3 per cent per annum.

The macroeconomic scenario presented above clearly reveals that the economy is beset with chronic problems of unemployment, inequities in income distribution and low growth despite the fact that saving is no longer a constraint on the process of economic growth in Namibia. This presents an interesting spectacle when we realise that some of the fast developing countries (as for example the South Asian countries) witnessed considerably higher rates of growth in their initial stages of development. The growth rates in those countries were mainly triggered by high saving rates complemented by inflow of direct foreign investment. The obvious question that arises then is: what hampers the growth process in Namibia from achieving its potential level?

There is no gainsaying the fact that stepping up the rate of investment in the economy is the key towards raising the growth level. This is important for two reasons. Firstly, investment contributes to the productive capacity of the economy and thereby facilitates the acceleration of the growth process. Secondly, it contributes to employment generation. Further, in the case of a technology deficient economy like Namibia, supplementing the domestic investment program by allowing the inflow of direct

foreign investment facilitates the absorption of technology and enhances the capacity build up in the various sectors of the economy, particularly, in the manufacturing and export sectors. Thus, the process of mobilising savings and ensuring their flow to the productive sectors of the economy assumes paramount significance from the point of view of raising the investment level and in stepping up the growth rate in the economy.

The process of mobilization and channeling of savings to the productive sectors of the economy mainly rests with the financial system. The financial system evolves as the economy develops and fine-tunes itself to the domestic economic requirements. The genuine financing needs of the various sectors of the domestic economy are to be met adequately and at appropriate rates of interest in order to meet the targeted rates of growth. Herein lies the efficiency and effectiveness of the financial system as an instrument of growth. Efficiency refers to the extent the financial system provides financing at the lowest cost. Effectiveness refers to the extent the financial system caters to the genuine productive requirements of the economy. On the empirical front, many researchers (for instance Levine and Renelt 1992, Levine 1997, Demirguc-Kunt and Levine 1999) have tried to explore the relationship between the financial sector and economic growth. The conclusion, which emanates from these studies, is that financial development has a positive first-order relationship with economic growth (Levine, 1997). The faster the financial super structure adapts to the dynamic and variegated requirements of the growth process, the greater it would facilitate the acceleration of the growth process. Similarly, as the growth process accelerates, there will be greater demand on the financial system in terms of not only quantum of finance to be made available but also in terms of innovations in financial instruments and products. An efficient payment and settlement system serves to grease the wheels of finance and growth.

It is against the above backdrop that a review of the financial system in Namibia has been attempted here. The objective of this paper is to provide an over view of the financial structure as it evolved through the 90 s so that such a survey would serve as a bench mark for facilitating discussions on how we should move forward towards an optimal financial structure.

The financial system in Namibia is relatively young and is regarded as well developed compared to financial systems in Sub-Saharan Africa. It is also pertinent to note that Namibia s financial system has not experienced financial repression of the type witnessed in most developing countries. However, the country, like most developing countries, has a dual financial system made up of formal and informal sectors. The formal sector includes a central bank, commercial banks, savings bank, a building society, insurance companies, pension funds, unit trust and others. The informal sector comprises of cash loan operators, pawnbrokers, moneylenders and others. In addition to these formal and informal financial institutions, there are a number of development finance institutions in Namibia that forms an integral part of the Namibian financial system. A brief account of these institutions is set out below.

4.2 THE BANKING SECTOR

The banking sector covers the central bank, commercial banks, the building society, the savings bank and development finance institutions. These institutions are briefly reviewed in what follows.

(a) Central Bank

At the apex level of the financial system is the Bank of Namibia, which is the central bank of the country. The Bank was established by section 2 of the Bank of Namibia Act, 1990 (Act No. 8 of 1990). The major objectives of the central bank are to promote and maintain a sound monetary, credit and financial system in Namibia and sustain the liquidity, solvency and functioning of the system; to promote and

maintain internal and external monetary stability and an efficient payments mechanism, to foster monetary, credit and financial conditions conducive to the orderly, balanced and sustained economic development of Namibia; to serve as the Government s banker, financial adviser and fiscal agent and finally to assist in the attainment of national economic goals.

The Bank functions within the ambit of the multilateral agreement entered into between the Governments of the Kingdom of Lesotho, the Republic of South Africa and the Kingdom of Swaziland dated 5 December 1974, as subsequently amended to include the Government of the Republic of Namibia, which was added thereto on 6 February 1992. A major provision that needs mention in this regard is Article 3 of the agreement relating to transfer of funds within the common monetary area which prescribes that the contracting party shall not apply any restrictions on the transfer of funds, whether for current or for capital transactions, to or from the area of any other contracting party, save that a contracting party may apply restrictions resulting from investment or liquidity requirements which may from time to time be prescribed by it for its financial institutions.

Further, Namibia being a member of the common monetary area (CMA), the exchange rates between the participating countries are fixed. The CMA has many characteristics of a monetary union, as the exchange rates vis a vis other member states are fixed and capital flows are free. As a consequence, the individual countries (besides South Africa) cannot directly influence interest rates and money supply. Monetary policy in such a system is subordinated to the exchange rate policy, as domestic credit creation must be kept within limits in order to ensure a sufficient volume of net foreign assets of the banking system. In case of Namibia, the Namibian dollar is pegged to the Rand one to one. It has been the experience that this arrangement has been working quite well over the years as has been reflected in the achievement of relatively price stability.

The major instrument of monetary policy used by the Bank of Namibia is the Bank Rate. The Bank adjusts the Bank Rate in line with the monetary policy stance of the South African Reserve Bank. As at present the Bank Rate is kept 25 basis points below the South African Repo Rate. The banks as at present maintain a minimum of 1 per cent of the net demand and time liabilities as deposits with the Bank of Namibia. The Bank also allows the commercial banks to keep their excess balances with the Bank of Namibia through the call deposit facility of the Bank. The central bank also accommodates the commercial banks with an overdraft facility. This facility is open to commercial banks after exhausting other sources of short-term funds in the market.

(b) Commercial Banks

The banking industry plays the dominant role in the financial sector. The industry is well developed, and offers a wide range of services. The sub-sector uses high level of information technology.

Currently there are five commercial banks in the country with total assets valued at N$12,063 million as at December 2000. These are Standard Bank, First National Bank, Commercial Bank of Namibia, Bank Windhoek and City Saving and Investment Bank. Commercial banks account for close to 35 per cent of total financial assets. Around 90 per cent of total credit to the private sector is provided by the commercial banks. The two commercial banks, namely Standard Bank and First National Bank account for close to 60 per cent of total commercial banks assets.

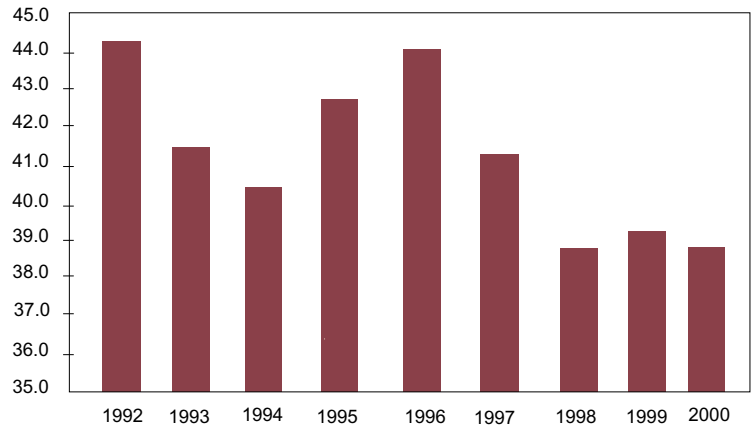
The commercial banking system in Namibia has strong links to the South African system that allows them to benefit from technology advancements at relatively lower costs. South African shareholding in

the Namibian commercial banks is very strong. There are no formal barriers to entry to the banking sector but high initial capital lay-out required and competition with existing commercial banks might serve as barriers to entry.

Relative Size of Commercial Banks

The assets of the commercial banks as a share of total financial assets have been fairly stable during the 1990s (see chart 4.1). In 1994 the assets of the commercial banks as a proportion of total financial assets decreased to 40.4 per cent from 44.2 per cent in 1992. This ratio decreased to 38.6 per cent by the end of 2000. This implies the growth of the other financial institutions, which in turn is a reflection of the widening of the financial system.

Chart 4.1 Commercial Banking Assets as Ratio to Total Financial Assets[1]



Source: Bank of Namibia

Ownership Structure

A notable feature of the Namibian banking system has been the dominance of South African shareholding (see table 4.1). To illustrate the point the two biggest banks, Standard Bank and First National Bank are 100 per cent and 78 per cent South African owned, respectively. On the other hand, there are only two commercial banks with majority Namibian shareholding.

1 Refer to table 3 for a definition of total financial assets.

Table 4.1 Ownership Structure of Banking Institutions

Bank	Shareholding Company	Country of Origin
Bank Windhoek	Bank Windhoek Holding Ltd.	Namibian (56.4%) South Africa (43.6%)
City Savings and Investment Bank		
	Namibia Harvest	Namibian (64.7%)
	Government Institutions	
	Pension Fund(GIPF)	Namibian (34.6%)
	Individuals	Namibian (0.7%)
Commercial Bank of Namibia	Namibian Banking Corporation	
	- DEG	Germany (5.7%)
	- NEDCOR	South Africa (47.3%)
	- SFOM	France (47.3%)
First National Bank	First National Bank Holdings Ltd.	South Africa (78.0%)
	General Public	Namibian (22.0%)
Standard Bank Namibia Ltd.	Standard Bank Investment Group	South Africa (100%)
SWABOU	GIPF	Namibia (33.1%)
	TransNamib	Namibia (13.0%)
	Minorities	Namibia (48.9%)

Source: Bank of Namibia.

Geographical Distribution of Bank Branches

At present there are 85 commercial bank branches in the country. However, it is pertinent to note that there are quite a number of unbanked areas. Furthermore, most rural areas remain without any financial intermediary. The spread of the bank branches is concentrated in urban centres.

Table 4.2 Regional Distribution of Commercial Bank Branches

Region	Pop.Density (persons per sq.km	No of Branches excl agencies	% Share of total . Population	Average Household Income	Average per Capita Income	Population per bank branch
Caprivi	4.6	2	6.6	6690	1235	45211
Erongo	0.9	14	5.4	18176	4058	3962.1
Hardap	0.6	6	3.9	19076	4406	11082.5
Karas	0.4	10	3.9	24782	5287	6116.2
Khomas	4.5	22	11.6	41858	8825	7594.1
Kunene	0.4	4	4.2	10385	1829	16004.3
Ohangwena	17.0	1	13.7	6691	897	179634
Okavango	2.7	2	9.0	9185	1498	58415
Omaheke	0.6	3	3.4	16014	3113	17578.3
Omusati	13.9	0	11.0	8491	1211	189919
Oshana	25.6	6	11.6	10326	1547	22480.7
Oshikoto	4.8	3	8.4	8550	1384	42915
Otjozondjupa	1.0	11	7.3	12844	2919	9321.5
Namibia	0.6	85	100	15804	2786	16587.3
Rural		11	71.1	9157	1502	91003
Urban		74	28.9	28746	5946	5467

Source: Bank of Namibia and Central Bureau of Statistics

From Table 4.2 it can be seen that commercial bank branches are mainly concentrated in the Khomas region followed by the Erongo and the Otjozondjupa regions. The bank branches covered in various regions are: Khomas (22), Erongo (14), Otjozondjupa (11) and Karas (10). These four regions together account for close to 80 per cent of total bank branches but cover only 32.1 per cent of the population. The Standard Bank and First National Bank account for more than 50 per cent of the number of branches. The commercial Bank of Namibia and the City Savings and Investment Bank on the other hand, have little rural presence.

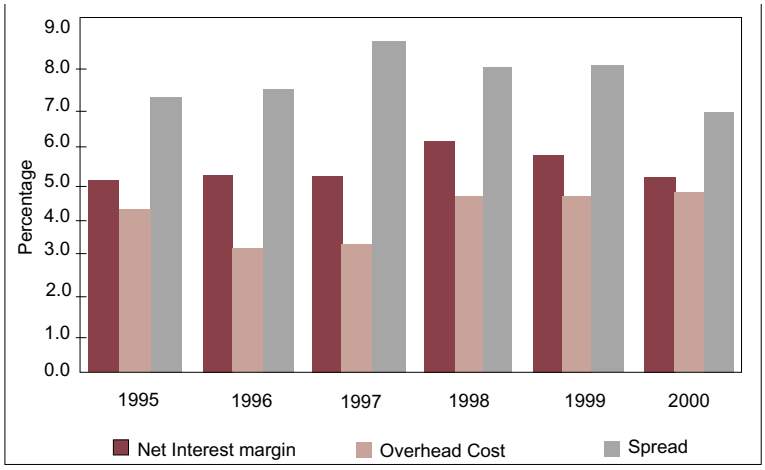
It is pertinent to note that there appears to be a close correlation between the number of bank branches and per capita income. This is corroborated by the fact that the regions with many bank branches have the highest per capita income. Accordingly these regions are also characterised by high industrial activity.

Efficiency

One of the main functions of financial intermediaries is to channel funds from savers to investors. In this paper, we use three measures of efficiency with which commercial banks perform this function. These are the **net interest margin** (which equals the accounting value of a bank s net interest revenue

as a share of total assets), the **overhead cost** (which equals the accounting value of a bank s overhead costs as a share of its total assets) and the **spread on short term banking operations** (which represents the gap between the lending and borrowing rate). Efficiency improves when these indicators are exhibiting a declining trend.

Chart 4.2 Banking Efficiency



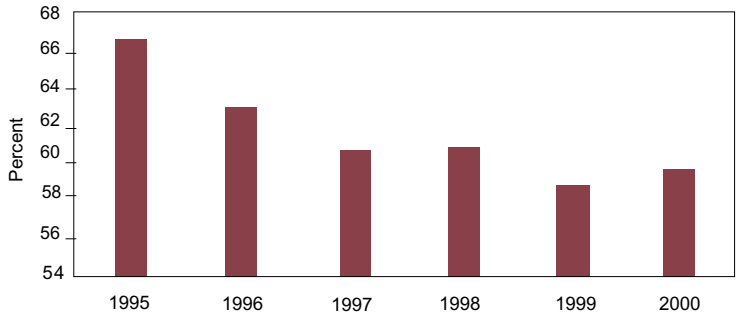
Source: Bank of Namibia

It may be easily seen from chart 4.2 that all three indicators remained by and large constant over the period 1995 to 2000 with minor variation. This shows that over the period there have not been any perceptible efficiency gains.

Concentration

For purposes of measuring the concentration ratio, in this paper, we take the ratio of the two largest banks assets to total banking sector assets. A highly concentrated commercial banking sector might result in lack of competitive pressure to attract savings and channel them efficiently to investors. A fragmented market on the other hand might evidence undercapitalised banks.

Chart 4.3 Banking Concentration



Source: Bank of Namibia

It may be easily seen from chart 4.3 that the concentration ratio for the banking system in Namibia is very high. It has been as high as 66 per cent in 1995 but it has declined to 60 per cent as at the end of 2000. While the declining trend is encouraging, the ratio still remains high as compared to the situation in some of the developing countries. This could have adverse consequences for efficiency and competition.

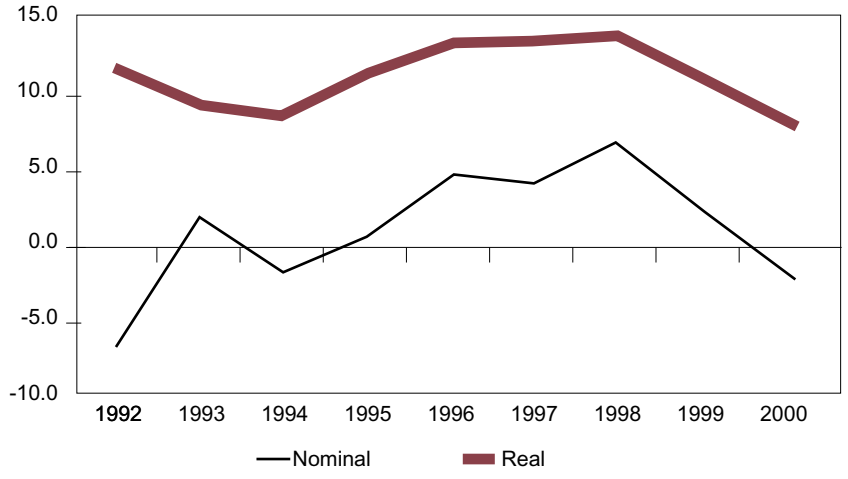
Purveyors of Credit

The commercial banks credit to the private sector as a percentage of GDP constituted 37.5 per cent in 1993 and 57.2 per cent in 1999. Lending to the private sector increased over the periods, although the direction of credit was geared mainly towards individuals and less to the business sector.

The Process of Deposit Mobilisation

The deposits of commercial banks grew at an average rate of 18.6 per cent during the period 1993 to 2000. While the deposits grew at an average rate of 20.5 per cent during the period 1993-1998, the average rate of growth slipped to a low of 12.9 per cent during the period 1998-2000. This slide in the growth is attributable to the steep fall in the real rate of interest offered on the deposits (please see chart 4.4). It is noteworthy that the real rate recorded a steep decline from 4.6 per cent in 1996 to a low of 2.2 per cent in 1999 and thereafter further declined and became negative in 2000. This trend also resulted in a significant decline in the fixed and savings deposits over time. In order that banks sustain their deposit mobilisation efforts at levels achieved earlier, it becomes imperative that they should ensure a fair rate of return to the depositors. It has been the experience in many developing countries that banks offer a minimum of 2/3 per cent real rates of interest to depositors. While this rate is considered to be minimum in terms of offering incentive for saver, banks elsewhere offer still higher rates of interest depending up on the rates of return offered on alternative avenues of investment in the economy with a view to achieving higher levels of deposit mobilisation. This aspect assumes significance from the point of view of the fact that the domestic savings is expected to grow at a rate of 4.5 per cent on an average during the NDP2 period and if banks are to attract a sizeable chunk of these savings.

Chart 4.4 Nominal and Real Deposit Rate



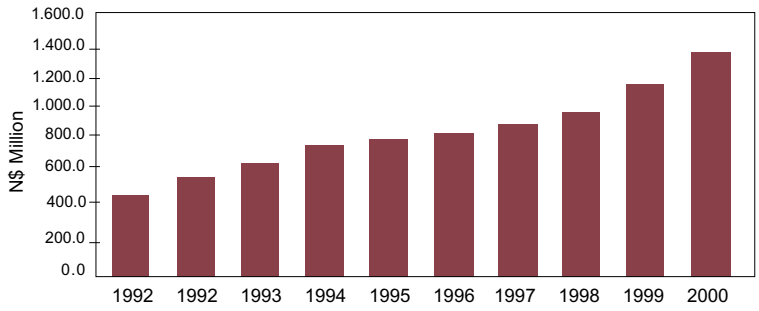
Source: Bank of Namibia

(c) Building Societies

SWABOU is the only building society in the country and it is 100 per cent domestically owned. The largest shareholders are the Government Institutions Pension Fund (GIPF) and Transnamib. SWABOU has three business units: (i) Life Insurance, (ii) Building Society and (iii) Short-term Insurance. It provides home loans and loans on commercial buildings and manages its loan portfolio through share and deposit investments, the life unit offers multi-protect and mortgage protect which relate to the real

estate industry. The building society has 14 branches and 1 agency. In terms of asset development SWABOU has increased in size over the years from N$611.8 million in 1992 to N$950.0 million in 1996 and further to N$1.5 billion as at the end of 2000. In terms of contribution to the total financial system the assets of the SWABOU accounted for a sizable 13.7 per cent as at the end of 2000.

Chart 4.5 Asset Development of SWABOU

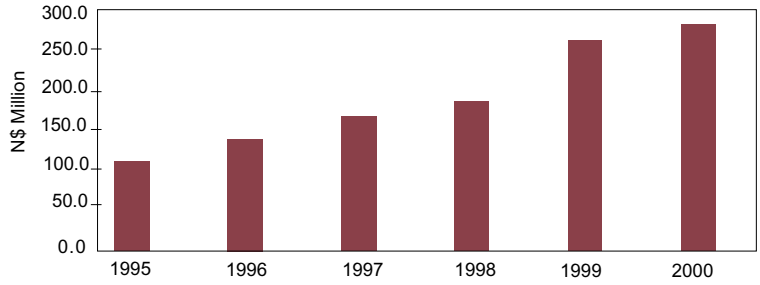


Source: SWABOU

(d) Savings Bank

The Namibia Post Office Savings Bank is the only savings bank in Namibia. The savings bank has two main features. Firstly, the interests on deposits are tax-free. Secondly, there are no charges levied on the financial services offered. The savings bank also does not give loans to its customers. The Ministry of Finance is the lender of last resort. The services provided by the savings bank are carried out through more than 95 post offices and mobile agents countrywide. The products offered include savings accounts, savings certificates, save as you earn accounts and fixed term deposits. The savings bank also offers money transfers, i.e. postal and money orders. Total assets of Nampost increased substantially from N$105.1 million in 1995 to N$275.8 million in 2000.

Chart 4.6 Asset Development of Nampost

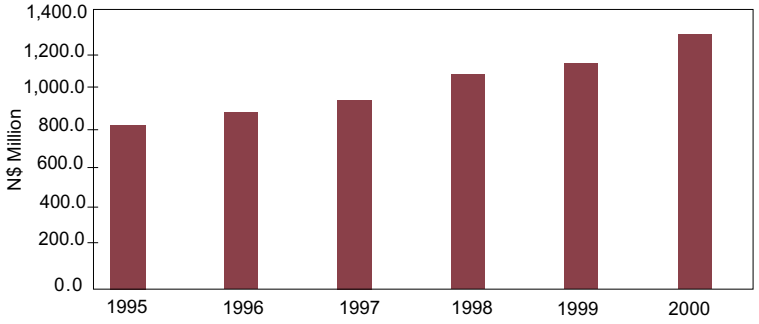


Source: Nampost

(e) Development Finance Institutions

There are a number of development finance institutions operational in Namibia. Among the prominent institutions are the Agricultural Bank of Namibia (Agribank), the Namibia Development Corporation (NDC), the National Housing Enterprise (NHE) and the Development Fund of Namibia (DFN). The combined assets of these institutions amounted to N$1.2 billion as at the end of 2000. This represents about 3.9 per cent of the total assets of the Namibian financial system.

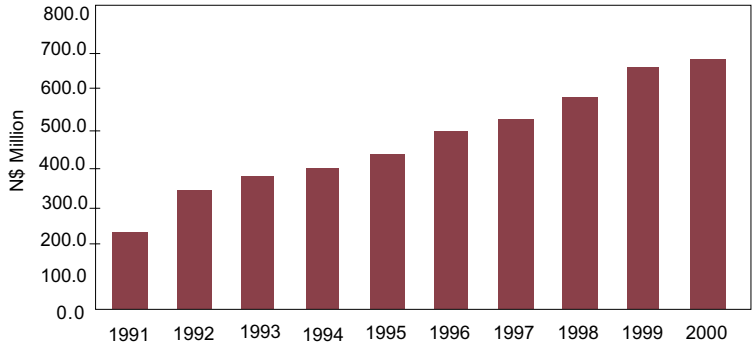
Chart 4.7 Assets of Development Finance Institutions



Source: Agribank, NHE, NDC, DFN

The genesis of the Agribank goes back to 1922, when it was established as the Land and Agricultural Bank of South West Africa. This Land Bank functioned autonomously until 1969 when it was incorporated into the Land Bank of South Africa. The following ten years that ensued, the Bank operated as a branch of the Land Bank of South Africa. The Agribank in its present form was finally constituted in terms of the Agricultural Bank Amendment Act No. 27 of 1991 on 23 December 1991. The activities of the Agribank are controlled by a Board of Directors, which also formulates the loan policy of the Bank. The Agribank provides for loans to individual farmers, co-operatives, control boards and statutory agricultural institutions. In March 1992 the Cabinet approved certain schemes to provide for the advancement of Namibians contemplated in Article 23(2) of the Namibian Constitution. There are basically three schemes, i.e. affirmative action scheme, housing loan scheme for employees and the national agricultural credit programme. Total assets of the Agribank increased from N$318.3 million in 1993 to N$447.3 million in 1996 and further to N$666.7 million in 2000. On average assets of the Agribank accounted for about 5 per cent of total assets of the Namibian financial system.

Chart 4.8 Assets Development of the Agribank



Source: Agribank

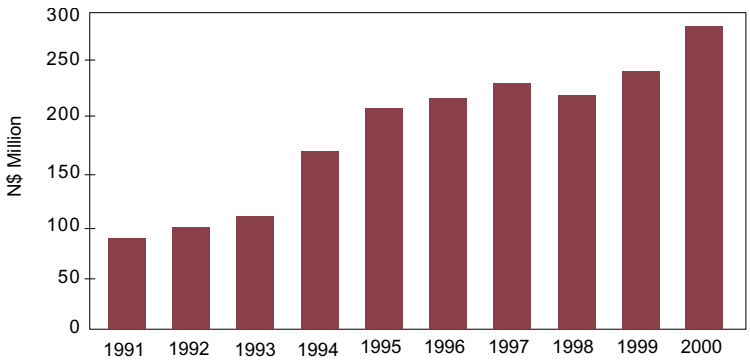
The NDC was established under the Namibia Development Corporation Act, Act 18 of 1993. The NDC is a parastatal and is wholly owned by the Government of Namibia. The Ministry of Trade and Industry (MTI) is the custodian ministry. The main business objective of the NDC is the provision of financial and related services. The mission of the NDC is to promote economic growth and development, through entrepreneurial support on a sustainable basis.

The NDC offers a variety of financing products such as agro-industries assistance scheme, business assistance scheme, credit guarantee scheme, franchise financing, lease financing, rural women

enterprise development scheme, small builders bridging fund, SME start-up assistance programme, traders aid fund, wholesale financing fund and a young entrepreneur assistance scheme. In addition to the different financing products, the NDC also acts as an implementing agency for various ministries. Total investments and loans of the NDC grew from N$115.8 million in 1995 to N$124 million in 2000. In terms of contribution to the total financial assets it constituted 0.9 per cent as at the end of 2000.

The NHE is a parastatal under the jurisdiction of the Ministry of Regional and Local Government and Housing. The NHE was formalised by the NHE Act of 1993, thereby replacing the National Building Corporation, which was established in 1982. The activities of the NHE are directed by the National Housing Policy, which mandates the NHE to act as a lending institution as well as a housing developer. According to the mission statement of the NHE its primary purpose is to enable communities to house themselves by giving people country wide access to loans, investment opportunities, serviced land, advice and support that they may need to acquire or erect shelters of a standard and cost acceptable to them. Total assets of the NHE grew from N$87.4 million in 1992 to N$212.6 million in 1996 and to N$283.0 million in 2000. Composition wise the assets of the NHE accounted for about 2 per cent of the total assets of the Namibian financial system as at the end of 2000.

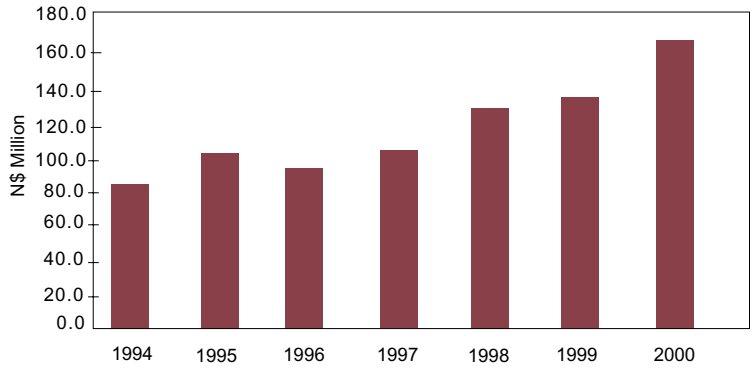
Chart 4.9 Asset Development of the NHE



Source: NHE

The DFN was established in 1987 as the Development Fund of South West Africa/Namibia by the transitional government with an initial fund of N$40 million. This amount was complemented by another N$30 million from the Job Creation Fund after independence. The mission of the DFN is to promote economic and social development in Namibia by extending finance to economically viable projects and programmes. Emphasis is placed on historically disadvantaged entrepreneurs and communities in the less developed and neglected areas, and on the manufacturing, tourism and service sectors. As a ratio to total financial assets the assets of the DFN remained constant at 0.8 per cent since 1994.

Chart 4.10 Asset Development of the DFN



Source: DFN

4.3 Non-Bank Financial Institutions

Commercial banks and the non-bank financial institutions have certain fundamental characteristics in common, i.e. both perform the basic role and function of financial intermediation. The type of financial assets that commercial banks and non-bank financial institutions create for the ultimate lender have qualities in common, but they differ by degree of liquidity, convenience, risk, yield etc. However, it must be stated that the liabilities created by commercial banks do have the special quality of being used as money — the means of payment and exchange — whereas other financial assets created by other financial intermediaries do not. This is the core difference between bank s and non-bank financial intermediaries.

This section discusses the role of the non-bank financial institutions in Namibia s financial system. The non-bank financial institutions under consideration are the pension fund corporations, insurance companies and unit trusts. Compared to the five deposit money banks, there are many non-bank financial institutions in Namibia. For example, in the year 2000 there were almost 500 pension funds, 9 short-term insurers, 8 long-term insurers and 8 unit trusts registered with the Directorate of Financial Services in the Ministry of Finance. These non-bank financial institutions came under the ambit of the Namibia Financial Institutions Supervisory Authority (NAMFISA) in 2001. In terms of size, non-bank financial institutions accounted for about 60 per cent of the total assets of the Namibian financial system as at the end of 2000.

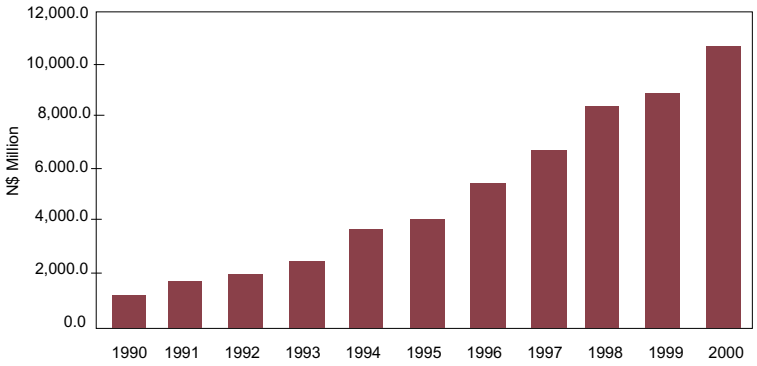
(a) Pension Funds

Pension and provident funds are non-profit seeking institutions[2], which administer employees and employer s provisions against the day they are physically or mentally unable to work[3]. The sources of finance for a pension fund are: (a) contributions by employees and employers; (b) investment income and (c) cash generated through the sales of assets.

The total number of registered pension funds has been growing fast ever since independence. Whereas the total number of pension funds was only 179 as at the end of 1992 there were 455 registered pension funds as at the end of 1996. This figure increased to over 500 as at the end of 2000.

2 It should be made clear that non-profit refers to the fund itself, however the administrators of the fund in general are profit seeking.
3 Falkena, Fourie, Kok: The Mechanics of he South African Financial System; 1989, pg. 132.

Chart 4.11 Asset Development of Pension Funds



Source: Directorate of Financial Services

The total assets of pension funds in Namibia are estimated to be around N$10.5 billion as at the end of 2000. This represents about 60.8 per cent of all the assets of non-bank financial institutions, or 33.5 per cent of all the assets of the financial system. The GIPF accounts for about 80 per cent of the total assets of pension funds. Other big pension funds in Namibia include Rossing Retirement Fund, Napotel, Transnamib Retrenchment Fund, NDC-Amcom, Local Authorities Retrenchment Fund, Standard Bank Namibia and University of Namibia.

(b) Insurance Corporations

Insurance companies provide financial benefits to policy holders and their beneficiaries in the event of accident, illness, death, disaster or the incidence of business or personal cost. Benefits are funded by premiums collected from individuals, employers or societies representing the individuals and by proceeds from investments of the premiums. Many insurance companies provide both life (long-term) and non-life (short-term) insurance. Non-life insurance provides financial benefits in the event of death, accident, fire, flood, property loss or damage, liability claims or the incurrence of health related expenses. This type of insurance is used primarily for spreading risk for a particular period rather than for building investment portfolios.

There are eight long-term insurance companies operating in Namibia, covering the following areas: *disability, fund insurance, funeral, health, life and sinking fund*. The majority of these insurance companies are wholly owned by parent companies in South Africa and are in addition to local prudential requirements also subjected to stringent prudential requirements by the parent companies in South Africa.

After pension funds, the long-term insurers are the largest non-bank financial type measured by the size of total assets. The total assets of long-term insurers is estimated at around N$3.3 billion as at the end of 2000, representing about 9.4 per cent of total assets of the financial system or 17.0 per cent of the assets of non-bank financial intermediaries. This industry is dominated by one player, Old Mutual, which accounts for almost 80 per cent of the total assets of long-term insurers. A distant second is Sanlam, which accounts for 10.9 per cent of total assets.

There are 9 short-term insurance companies registered with the Registrar of Financial Institutions. The larger short-term insurance companies in the country are Mutual and Federal, Sanlam, FGI Namibia Insurance, Santam Namibia and Southern Life[4]. Other institutions include the Insurance Company of Namibia, the Namibia National Insurance Company, First Bowring, Allianz Insurance, Corporate

4 Southern Life ceased doing new business in Namibia in 1998 after introduction of new legislation in Namibia.

Guarantees, National Strike Riot Insurance Association (NASRIA), SWABOU and others. These short-term insurers cover a wide spectrum of areas, such as fire, motor guarantee, accident, marine, aviation, and personal and co-insurance.

The total assets of short-term insurance companies doubled between 1993 and 1996 from nearly N$100 million to over N$200 million. As at the end of the financial year 1997 the total assets of short term insurance companies stood at N$255 million. The total assets of short-term insurers are estimated at about N$340 million as at the end of 2000. This represents about 1.3 per cent of total assets of the financial system and 1.4 per cent of the non-bank financial sector. In terms of concentration, this sector is dominated by three big companies (Mutual and Federal, Sanlam and FGI Insurance Namibia) that collectively account for about 80 per cent of the total assets of short-term insurers.

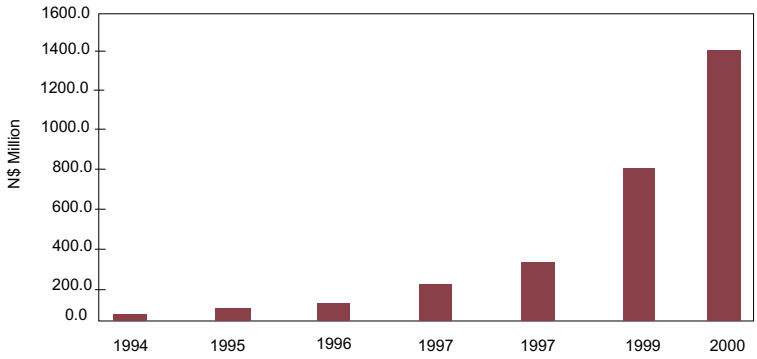
(c) Unit Trusts

A unit trust is an investment mechanism that provides a large number of investors with means to participate in a diversified portfolio of investment. The main advantage of membership of a unit trust lies in the mutual pooling of resources for investment under professional management. The unit holders, thereby, acquire an undivided portion of a widely spread portfolio, consequently minimizing risk. Even the small saver thus acquires all the advantages of equity/fixed interest investment, while liquidity is retained through the guarantee to repurchase units at prevailing market values. Professional management to the portfolio provides the dual advantages of continuous supervision of the investments in the unit trust and the elimination of the administrative routine of payment for scrip, registration, dividend/interest collection, attendance to rights issues, safe-keeping, etc.

The unit trust industry in Namibia does not have a long history. The first unit trust in Namibia was launched by Sanlam in August 1994. As at the end of 2000 there were eight registered Unit Trust Management Companies in Namibia. They are Sanlam Unit Trust Management Company, Old Mutual Unit Trust Management Company, and Commercial Bank of Namibia Unit Trust Management Company, Standard Bank Unit Trust Management Company, Investec, Namibia Unit Trust Managers, Metlife Unit Trust Management Company and the Bank Windhoek Unit Trust Management Company.

Although unit trusts have not been in existence that long in Namibia, they have been doing relatively well and the industry as a whole has continuously increased its assets over the years. For example, in 1994 (the year when the first unit trust was established), the total assets of unit trusts were only N$24 million. However, in 1995 this figure more than doubled to N$52 million. The total assets of unit trusts in Namibia were N$85 million and N$213 million in 1996 and 1997, respectively. By the end of 2000, these assets reached a level of N$1.4 billion representing 8.1 per cent of the total assets of the non-bank financial institutions and 4.5 per cent of the total financial assets.

Chart 4.12 Assets Development of Unit Trusts



Source: BoN and Old Mutual

4.4 Money and Capital Market

Money and capital markets are traditionally distinguished as separate segments of the financial market, according to the maturity profile of financial instruments. Money market instruments are characterised by maturities of up to one year, while instruments with longer maturities are classified as capital market instruments. This section focuses on the structure of the Namibian money and capital market, with particular reference to the Namibian Stock Exchange (NSX).

(a) The Money Market

This section presents the structure and extent of development of the money market in Namibia. In Namibia, money market debt instruments and claims, include the following: call deposits with the Bank of Namibia, call deposits with commercial banks, interbank loans, bankers acceptances, negotiable certificates of deposits, treasury bills, overdrafts with commercial banks, overdraft with the Bank of Namibia and Agricultural Bank Bills. Some of these instruments are briefly discussed below, in terms of the purpose, participants and problems or constraints facing such participation or trading.

Call Deposits with the Bank of Namibia

The purpose of the call deposit facility for commercial banks is to influence the level of liquidity in Namibia and to prevent the drain of official reserves. This facility was introduced because the Bank of Namibia realised that during times of excess liquidity in the Namibian economy, commercial banks in Namibia transfer these excess funds to parent or associated institutions in South Africa, resulting in the building up of foreign assets by these institutions. To counter or to slow the pace of such movements, the Bank of Namibia created the call deposit facility for commercial banks as an investment outlet for these excess funds.

Interbank Loans

The interest rates applicable to Namibian interbank loans are freely negotiable, but they are usually fixed on a weekly basis. The domestic interbank rates have always been a few basis points above the corresponding rate in South Africa. It has been observed that quite frequently, some commercial banks are forced to borrow from the overnight loan facility at Bank of Namibia (at a higher interest rate) even though there are surplus funds in the market. This indicates that the Namibian interbank market is not efficient or that participation is restricted.

Bankers Acceptances (BA)

In Namibia, BA bills are issued for a period of three months (90 days) and the relevant rates are based on corresponding South African instruments. The fact that commercial banks sometimes obtain BA s from the South African money market suggests that there is a short supply of these instruments in Namibia. On the other hand, it may also be argued that commercial banks in Namibia are hesitant to lend through BA s due to lower profit margins in these bills as opposed to their overdraft facility, which yield higher returns.

Negotiable Certificates of Deposits (NCD s)

In Namibia, banks issue NCD s to raise funds for three, six and twelve months. It has been observed that apart from commercial banks who invest in NCD s, other agents such as corporate or institutional investors, limit such investments. Another factor hampering development of this market is the outflow of funds to South Africa for better rates. These aspects of the NCD market in Namibia hinder its full development potential.

Treasury Bills (TB s)

Treasury bills in Namibia are issued at discount rate for three month (91 days), six months (182 days) and 12 months (365 days). The fact that they are issued by the government accord them high status. These instruments normally attract a wide range of investors such as commercial banks, individuals, investment trusts, insurance companies, stockbrokers and other public enterprises. Most of the allotments at primary issue in the early 1990 s were made to commercial banks, which tender on their account for their liquid asset requirement and on behalf of bank customers. However, with the increased interest of stockbrokers and individuals in tendering for these bills in the primary market the share of commercial banks allotments has been declining. While there are an increasing number of secondary market transactions taking place in these instruments, the secondary market still remains rudimentary.

Table 4.3 Outstanding Treasury Bills as Ratio to GDP

	Treasury Bills (N$ Million)	Nominal GDP (N$ Million)	TB s as Ratio to GDP
1991	20.0	6,882.0	0.3
1992	145.1	8,093.0	1.8
1993	265.0	9,302.0	2.8
1994	262.7	11,549.0	2.3
1995	420.0	12,707.0	3.3
1996	992.1	15,012.0	6.6
1997	1,678.2	16,797.0	10.0
1998	1,888.3	18,858.0	10.0
1999	2,446.0	21,230.0	11.5
2000	2,640.0	24,145.0	10.9

Source: Bank of Namibia

Overdrafts with Bank of Namibia

The central bank accommodates the commercial banks with an overdraft facility. This facility is open to commercial banks after exhausting other sources of short-term funds in the market. To ensure that commercial banks do not use the facility without first exhausting the money market, the Bank of Namibia charges a penalty rate, which is higher than any other rate at which short-term funds are lent in the economy. This facility ensures that liquidity problems in the economy are smoothed out and the financial system remains stable. Bank of Namibia s overdraft facility is, however, not used to a maximum, because some of the commercial banks have access to funds from their parent or associate institutions in South Africa.

Agricultural Bills

Agricultural Bank bills are short-term bills issued by the Agricultural Bank of Namibia on a 9- day basis. The bills are revolved every 91 days. Commercial banks mostly buy these bills through private placements. This most attractive feature of this instrument offers it status as a liquid asset, because government guarantees such bills. This means that commercial banks may buy and hold them to meet liquid asset requirement. As a result, the secondary market in these papers is virtually non-existent.

(b) The Capital Market

The capital market is regarded as that segment of the financial market where securities with maturities of longer than one year are issued and traded. A wider definition of capital market also includes the equity market and the market for derivatives. Issuers of capital market instruments are traditionally the corporate sector and government, which require long-term financing to fund their operations. The largest investor base consist of institutional investors like pension funds and insurance companies, which need to invest in securities that match their long-term liabilities and that have the potential of achieving the return expected by their clients. A capital market is not quite complete without the presence of a stock market, which provide a platform where financial instruments could be traded in an organized manner. Therefore, the remainder of this section will discuss the role of the Namibian Stock Exchange (NSX) in the Namibian financial system.

(c) The Namibian Stock Exchange

The Namibian Stock Exchange (NSX) was established in 1992[5]. Equity, interest bearing securities and derivatives can be listed and traded on the exchange. Thus far, emphasis is placed on equities, but a number of bonds issued by government and state-owned enterprises have also been listed. The NSX is a dual listed stock exchange, meaning that companies can list on the NSX and other exchanges at the same time. Companies, which have dual listed shares must decide which of the two exchanges is for primary listing. Listing on the NSX is classified into five sectors, namely financial, retail, mining, fishing and industrial.

Corporate bonds or debt instruments in the form of debentures are also listed on the stock exchange. The primary issuers of such debentures, thus far, have been public corporations such as the Agricultural Bank of Namibia (Agribank), the National Housing Enterprise (NHE) and Air Namibia[6]. The most recent listing is that of Air Namibia, which were listed at a coupon rate of 15 per cent and matures in 2004. Coupons on these bonds are paid out twice a year.

5 Prior to 1992 there was a stock exchange in the early 1900 s in Luderitz, following the discovery of diamonds in that part of the country. The existence of this bourse was, however, short-lived.
6 The NHE bonds expired at the end of 1998.

Government bonds have also been listed on the NSX. Initially, more than 11 government stocks were listed, but as from May 1998, they were consolidated into three bonds. While the bonds before consolidation were issued at a coupon rate of 12 per cent and one at a coupon rate of 13 per cent, the consolidated bonds were issued at 12 per cent coupon rate.

Performance of the Namibian Stock Exchange

The performance of the Namibian Stock Exchange can be gauged from the following major parameters viz., the size, liquidity and efficiency. To measure the ***size*** of stock market we have used the stock market capitalization (initially overall and secondly local market capitalisation) as a ratio of GDP, for the ***liquidity*** we have used the stock market total value of shares traded to GDP, and lastly for ***efficiency*** we have used the stock market turnover ratio, which is the ratio of the value of total shares traded and market capitalization. This rate indicates how often, on average, a share changes hands during the year. It is an indicator of the stability of shareholdings in listed companies. These indicators are displayed in the table 4.4.

Table 4.4 Size of the Stock Exchange

	1995	1996	1997	1998	1999	2000
Size (overall)	548	506	921.4	845	1572.8	1398
Size (local)	5.4	14.8	20.0	13.3	20.1	9.8
Liquidity	18.8	43.9	54.5	54.5	93.1	102.7
Efficiency	0.3	0.8	0.5	0.6	1.2	1.4

Source: Bank of Namibia and Namibian Stock Exchange

As may be seen from the table 4, stock market capitalization has been as big as 548 per cent of GDP in 1995 and this has increased to 1398 per cent of GDP in 2000, though recording relative declines in 1996 and 1998. However, local capitalization portrays a different picture. The stock market capitalization as a ratio to GDP stood at only 5.4 in 1995. This ratio increased to 20 in 1997 and 20.1 1999, before declining to 9.8 in 2000. On the other hand the total value of shares traded to GDP was 18.8 as a ratio of GDP in 1995 and this ratio grew to above 100 in 2000. From table 4 is also clear that liquidity on the Namibian Stock Exchange although increasing is still very low.

Listings

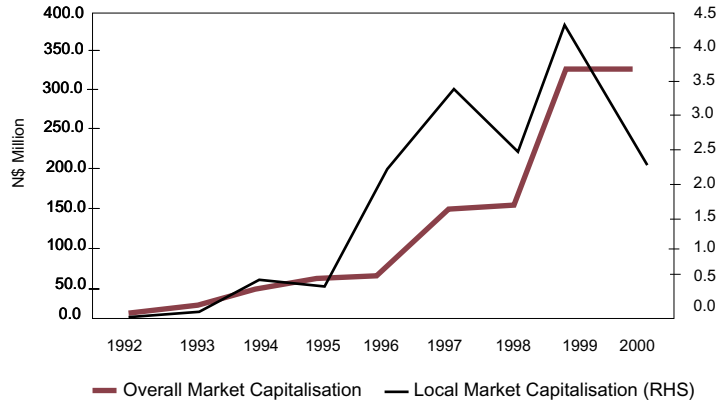
One of the major objectives of stock exchanges is to increase the number of listed companies and, thus, the number of traded securities. The rationale behind this is to enable companies to raise capital, on the one hand, and to provide an investment outlet for prospective investors on the other. The growth in the number of companies on the NSX has been rapid. Whereas there were only 4 listed companies in 1992, by 2001 this figure grew to 41. During the same period the number of local companies listed on the NSX increased from 3 to 15. However, this growth has stagnated in the past three years.

Market Capitalisation

Market capitalisation, which is merely a product of the total number of shares and their respective prices, is one of the most often referred to measures of performance in case of the stock market. As is evident in chart 6 below the overall market capitalisation of the NSX, which reflects the total shares of

both locally listed companies and dual listed companies have been growing rapidly since the establishment of the NSX in 1992. Since the inception of the NSX, the largest share of market capitalisation was taken up by the financial sector (72 per cent), followed by the mining (13 per cent) and industrial (12 per cent) sectors. Local market capitalisation, which reflects the total value of shares of local listings only, has been on the increase during the first seven years of the establishment of the NSX. However, the past two years saw a continuous decline in the local market capitalisation. It is notable that local market capitalisation is significantly lower than the overall market capitalisation. The sectors dominating local market capitalisation are mining (31 per cent), followed by the industrial sector (29 per cent) and the financial sector (21 per cent).

Chart 4.13 NSX Market Capitalisation

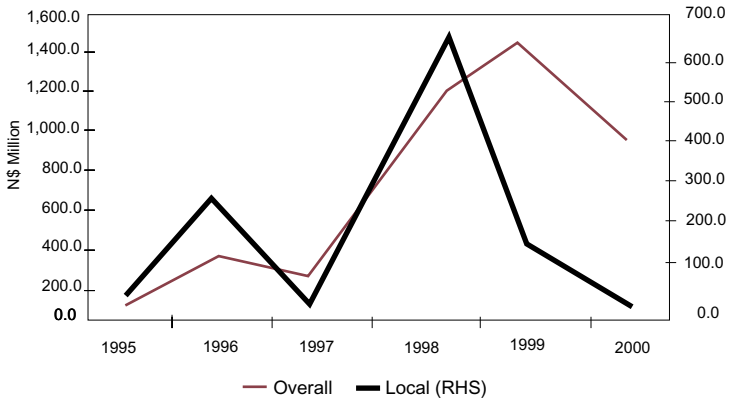


Source: Namibian Stock Exchange

Trading Activity

The number of deals on the NSX has also recorded an increase during the past 8 years. Whereas the total number of deals recorded in 1993 were only 75, by 2000 it rose substantially to 4,582. The annual trading of volumes has however been fluctuating, but generally displaying an upward trend. Most of the trading, however, takes place in dual-listed shares, mainly because those shares are listed and exposed to a bigger exchange, the JSE. Volumes of local shares traded have been very small and have been declining from 1996 to 2000.

Chart 4.14 Volumes Traded



Source: Namibian Stock Exchange

Market Concentration

The market concentration measure gives the extent of domination by a company or group of companies on the stock exchange. This measure is given by the percentage share of given companies in the whole market capitalisation. A substantial share of the overall market capitalisation is in the hands of the top ten companies. In the case of local shares, the largest chunk is still held by the top five companies.

Specific issues affecting the performance of the NSX

Dual Listings

The role of the stock exchange in mobilizing funds for use in Namibia is still being questioned. The argument in favour of this is that dual-listed companies take capital from the NSX to expand their operations or for capital investments in South Africa. This is further supported by the fact that there is no reliable mechanism for monitoring what dual listed companies do. It can therefore, not be said with confidence that capital raised by these companies are indeed used in Namibia. In contrast, if it is true that funds are raised on the NSX and used in South Africa, then the NSX is simply a channel through which funds flow to South Africa or elsewhere. Such a situation is of course not desirable. Another issue related to this one is that of liquidity of shares on the NSX. Most trading activities in shares listed on the NSX and other exchanges normally take place on other exchanges. This deprives the local exchange of liquidity.

Limited Supply of Shares

One of the reasons for the low liquidity in shares on the NSX seems to be a direct result of excess demand for shares. The high demand for shares in Namibia, in turn, may be attributable to the regulation 28 which compels institutional investors to invest at least 35 per cent of their assets domestically. The short supply of shares could be alleviated by aggressively promoting the stock exchange through, for example, educating possible issuers on the possible advantages of raising funds from the stock exchange. In addition, educating the public in general could also in the long run increase participation on the stock exchange.

Interaction with Other Institutions

The growth in activities on the NSX is largely attributable to the demand for shares by non-bank financial institutions, which in turn is attributable to the implementation of the domestic assets requirement. This entails a buy-and-hold practice by non-bank financial institutions. The stock exchange has, thus far, depended largely on contractual savings from insurance corporations and pension funds. A limited supply of shares seems to suggest that the mutually beneficial relationship between the non-bank financial sector and the NSX cannot be improved further. The relationship between the NSX and commercial banks cannot be accurately established, because the amount of funds they raise on the NSX is not known. However, a mutually beneficial role is not ruled out. This is so, because banks, in particular investment banks, have a major role to play in terms of presenting companies for listing, providing funding advise, brokering services, promoting and marketing companies, etc. This is an area that presents some opportunities for the commercial banks in Namibia, since little in this regard has been forthcoming. Another interesting possible future development that may result in the increase in the supply of shares and liquidity of the NSX is the possible privatization of parastatals. Thus far, there are no parastatals listed on the NSX, because they are wholly state owned. However, a situation may emerge whereby these entities may be privatized,

meaning that they could then be listed on the NSX. Such a situation would of course be beneficial for the NSX in the sense that it would result in an increased supply of shares and hopefully liquidity. For this reason, there is need for government, private sector and labour to make a concerted effort to initiate and drive the process of privatization.

Conclusion

The aim of this paper was to provide an overview of the financial structure in Namibia. This serves to facilitate further discussion of analytical perspectives on the effectiveness and efficiency of the financial system as would be reflected in the subsequent papers.

Generally, Namibia s financial system is relatively developed as compared to many countries in Sub-Saharan Africa. The regulatory and policy framework is liberal and largely subject to market discipline, such that financial repression has not been a serious issue in Namibia. The monetary policy framework has been reasonably conservative and has kept inflation relatively low and stable. In addition, prudential supervision and regulation of the financial system continue to be shaped according to international standards and best practices.

The financial structure is dominated by a financially sound banking industry. The assets of commercial banks as a proportion of total financial assets, although still high, have been declining since the early 1990s. This clearly shows that the financial system has been widening, particularly in terms of the variety of institutions. However, the sector seems to suffer from a number of shortcomings.

The first relates to the high concentration of the formal banking system. This is not conducive to the promotion of competition and efficient financial intermediation. Secondly, while it is sound and profitable, the commercial banking system does not seem to be enthusiastically entrepreneurial. This is more pronounced in the case of credit extension to the more productive, small businesses and micro lending in rural areas. This issue is quite complex, but it does raise the question as to the optimality of the financial intermediaries in fulfilling their function as channels of resources between savers and investors.

As has been pointed out earlier a matter of major concern in recent years has been the slide in real interest rates offered on deposits and the significant fall in fixed and savings deposits. This presents a cause for concern, particularly in the context of the envisaged growth rate of 4.5 per cent (on average) during the NDP2 period. The need to offer a fair rate of return to prospective investors (depositors) gains relevance in this context if banks are to gather a sizeable part of this savings.

This review also suggests the existence of an urban-bias in the provision of financial services. If the economy has to succeed in mobilizing domestic resources for investment, the financial system should extend itself to rural areas. Clearly, there appears to be a close correlation between the presence of a bank branch and the per capita income of that area. Nevertheless, whether the present bank density in the country is optimal remains a subject for debate. Studies on banking in the early stages of industrialization suggested that proximity enabled banks to better identify the potentialities of local communities and more efficient lending.

Evidently, non-bank financial intermediaries in Namibia have also grown remarkably during the 1990s. For example, registered pension funds grew from only 179 in 1992 to over 500 by the end of 2000, with an estimated total assets of N$10.5 billion. Even here, the level of concentration is very high, with the GIPF alone accounting for about 80 per cent of the total assets of pension funds. Even in the case of

the long-term insurance whose total assets are estimated at around N $3.3 billion, Old Mutual and Sanlam largely dominate the industry. Unit trusts are a very new phenomenon in Namibia, whose total assets was only N$24 million in 1994 and by the end of 2000 reached N$1.4 billion. All these suggest that the financial structure in Namibia has grown substantially over the last decade. The question beyond this presentation is the extent to which this fulfils the critical function of filling the financial gaps for growth and development.

Finally, the review has outlined the emergence of a money and capital market in Namibia, which is still in its infancy. It is clear that the interbank market is still undeveloped, presenting a critical policy challenge.

In the case of a stock market, a remarkable step towards its development has been made, with the establishment of the NSX in 1992. Judging from the NSX overall market capitalization and the growth of listed companies; its performance has not been disappointing. However, this is more attributed to the dual listing arrangement. Local market capitalization is still too low and volumes of local shares being traded have been low and declining. We argue that privatization of parastatals, and their listing on the NSX, is likely to make a positive contribution to the development of the stock market in Namibia.

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5. IMPERATIVES OF GROWTH AND DEVELOPMENT: THE EMERGING FINANCIAL GAPS

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5.1 Introduction

The financial system in any economy is central for a proper functioning of the economy. It is even more important in countries where capital is scarce, which characterises many developing countries. Domestic financial mobilisation and its effective allocation is perhaps one of the great challenges facing many African countries. Namibia is no exception. This paper will address two issues. The first issue is whether or not the current financial system performs its functions efficiently and the policy options thereof. The second issue is whether or not the existing financial system can ever be able to cater for all sectors of the economy and whether there is need for a complementary financing arrangement for some sectors.

A credit system is like an irrigation system. The network of distribution channels must be dense enough to reach the whole of the economy and all parts of the country. (Maria Nowak, ESF)

I will use this analogy of an irrigation system to illustrate the two issues I want to address. The first aspect is the efficient operation of the existing irrigation system while the second aspect is a question of constructing a new complementary irrigation system to develop new areas. A good financial system is like a complete irrigation system with a dam at a site suitable to harness all the water resources in the catchments area, an effective channel system with minimal water leakage and an effective system of water distribution to where the water is used in the most productive way, in the right quantity and at the right time. This analogy with an irrigation system is meant to illustrate the different but highly interdependent roles a financial system must play in the process of economic development. Of course no single irrigation system, however good, can adequately irrigate the whole country and therefore, there is always need for new irrigation systems to irrigate new land.

The financial system should be able to mobilise available savings in the economy by providing the necessary infrastructure and suitable financial instruments to the community. This mobilisation entails both new savings as well as transforming those savings, which take less productive forms into financial savings, which can then be channelled into productive investment. This effective mobilisation of savings can be likened to the construction and maintenance of an irrigation dam together with its network of water feeding system.

The financial system should be able to channel the mobilised financial savings into the most productive areas in the economy. As an intermediary between savers and investors, a financial institution must perform the allocation function in the most effective way possible. This allocation of available funds to the most productive areas can be likened to the efficient distribution of the dam water to where it will make the greatest impact on production.

In performing its savings mobilisation and savings allocation functions, the financial system should

minimise the cost of performing these functions. A financial system that absorbs a significant portion of the savings in the form of high costs and high profits, would have failed in its role of efficient intermediation between those who save and those with productive investment opportunities. It should be emphasised that low cost intermediation would translate into high returns to savers and low borrowing cost to investors. This low cost intermediation can be likened to building and sustaining irrigation channels with least water leakages.

If a financial system fails in its role as an effective vehicle for mobilising and allocating of savings, it will negatively impact on the productivity and growth of the economy. A financial system can thus be judged by how effectively it performs its functions and at what cost. In the next section we will briefly discuss the performance of the financial system in Namibia with respect to savings mobilisation, efficient allocation of savings as well as the cost of intermediation. Section 3 will discuss the need for complementing the existing financial system with new forms of financial institutions to cater for some specific sectors and groups of borrowers. Section IV summarises the discussions and draws some policy implications.

5.2 The Performance of the Financial System in Namibia

The financial system in Namibia is comprised of the Bank of Namibia, 5 major commercial banks, a large number of pension funds, building societies, insurance companies, investment institutions as well as a small but a growing stock exchange. Undoubtedly, a financial system is not just a list of financial institutions but also encompasses the different financial instruments used in financial transactions, the rules of the game as set by controlling and regulating agencies as well as the interrelationships among the actors in the domestic, regional and international markets. In this paper we will focus only on the commercial banking sector for two reasons. One, the commercial banking sector is the most dominant sector in the financial system in Namibia and plays a clear intermediary role than any other type of financial institution. Two, in many developing countries including Namibia, the capital market in the form of a stock exchange is a very recent phenomena and plays a very limited role in the financing of real investment.

The banking sector will continue to be the major source of business finance in many developing countries. In any case the American and British model of business finance, which relies mainly on the capital market is hardly suitable for a developing country like Namibia. Development and growth objectives require a stable and predictable source of finance, which a capital market with its extreme volatility cannot provide. In the introduction, we have identified key functions performed by the financial sector in general and the banking sector in particular. These functions are: mobilisation of savings and allocation of savings. These functions need also to be performed at the least possible cost. In the following sub-sections I will briefly discuss the question of whether the Namibian banking sector mobilises and allocates national savings efficiently and at least cost.

(a) Has the Banking Sector been effective in Savings Mobilisation?

People make savings for different motives including maintaining a stable consumption path over time in the face of fluctuating income, for contingency in unforeseen circumstances, for the purchase of durable goods like household appliances, to build a house or to invest in capital goods in their businesses. Whether there exists a banking system or not people will make these necessary savings but the savings may take different forms like precious metals, cattle and real property. Although the savings by households can be quite significant, they will not be sufficiently productive unless they take the form of financial savings which can then be channelled into productive investment. The banking

system can greatly facilitate the transformation of unproductive forms of savings by providing financial savings instruments (various types of deposits) at attractive terms and at convenient locations with a client oriented service.

Table 5.1 Savings Mobilisation by the Commercial Banking Sector in Namibia

	1996	1997	1998	1999	2000
Total deposits as % of GDP	38.8	38.0	37.1	39.3	38.9
Time & savings deposits as % of total deposits	55.5	56.4	50.3	48.7	41.1
Total assets as % of GDP	45.4	48.9	46.7	47.4	50.0

The overall size of the commercial banking sector as measured by the total assets of the sector in relation to GDP (about 47%) is very high compared to many African countries. The share of bank assets in GDP is 6% in Ghana,, 29% in Kenya, 66% in South Africa and 21% in Zimbabwe. The average for high-income countries is about 55%, not significantly higher than that of Namibia.

The extent of financial savings mobilisation and its trend over the last few years is shown in Table 5.1. Looking at total deposits as a percentage of GDP, the figure has changed very little from 1996 to 1999. The relatively high total deposits to GDP ratio may not indicate high savings mobilisation effort by the banking sector. It may be just a reflection of the payment system in the economy. Direct salary payments into employee bank accounts could be one explanation for the high deposit- GDP ratio. A better measure of savings mobilisation is the share of time and savings deposits in total deposits. As can be seen from Table 5.1 this share has declined from 55.5% in 1996 to only 41.1% in year 2000.

Another measure of savings mobilisation effort of the banking sector is population per bank branch and the geographical distribution of bank branches. With respect to population per bank branch, Namibia has done quite well in comparison with other Southern African countries. It is second after South Africa in banking density at close to 20000 people per bank branch compared to South Africa s 11000. However, the geographical distribution is highly skewed, the southern and central parts of the country are much better served than the northern parts. But, if one takes the population density into account, the distribution of bank branches is less skewed. In general, it appears that there is a reasonable access to banking across the country. Whether this means that bank services are accessible to the vast majority of the population is quite a different matter to which we will return later.

(b) Has the Financial Sector been effective in allocating funds efficiently?

The question of efficient allocation of financial resources by the banking sector has to be looked at from two different perspectives. The first perspective is that of the owners of the bank and the other is that of society s economy-wide perspective. The guiding principle from the owners perspective is maximum return on their capital. From this owners perspective there is no doubt that Namibian banks have been doing quite well.

Table 5.2 Rate of return on Capital in the Commercial Banking Sector (N$ million)

	1996	1997	1998	1999	2000
Total income	700.16	742.34	905.68	977.15	1119.7
Net interest income	476.33	518.37	540.15	577.3	611.49
Other income (mostly fee income)	223.83	223.97	365.53	399.85	508.2
Total operating expenses	325.1	323.1	403.72	464.93	537.93
Provisions	101.49	89.44	172.99	139.9	105.5
Income before tax	275.77	329.85	328.97	372.42	476.26
Income after tax	181.46	218.74	191.17	268.89	317.8
Capital account	644	782.7	919	1080.7	1291
Gross rate of return	42.82	42.14	35.8	34.46	36.89
After tax rate of return	28.18	27.95	20.8	24.88	24.62

With an average gross rate of return of over 38% and an average after tax rate of return of over 25% the commercial banking sector has been a very profitable sector.

The pre-tax rate of return on equity capital for the 4 major commercial banks ranged from 40% to as high as 68% in the period from 1996 to 1998 (Ikhide, 2000). This translates to an after tax rate of return of 25 to 46%.

Looking at international comparison, in a sample of 44 developed and developing countries only Zambia had a higher before tax profits to total assets ratio. The average before tax profits to total assets ratio for the 44 countries was 0.013 compared to Namibia s 0.039. Regarding interest margin, there are only 6 countries in the 44 countries sample with higher interest margin than Namibia (5 Latin American countries and Zambia (Demirguc-Kunt & Huizinga, 2000). It is quite clear that profitability and interest margins are very high in Namibia by any regional or international standard.

It is also quite clear that the high returns on equity are not just the result of low capital debt ratio but also high interest and non-interest margins (gross margin) ranging from 96% to as high as 235%! for the 4 commercial banks in the period 1996 to 1998 (Ikhide, 2000). Fee income constituted 26.5% of total income during the period under consideration.

From the economy wide perspective, the efficiency of the banking sector in allocating financial resources can be judged by looking at whether funds are channelled to the most productive sectors. This requires that attention be given to the distribution of loans across different sectors as well as its distribution among different types of clients within each sector.

Table 5.3 Claims of the Commercial Banking Sector

	1996	1997	1998	1999	2000
Claims on the private sector (N$ mill)	5663.2	6553.5	7129.3	7434.2	8699.8
% of total assets	83.18	79.77	80.82	74.3	72.12
Mortgage loans (millions N$)	1559.5	1757.5	2040.6	2453.3	2990.1
% of claims on the private sector	27.54	26.82	28.62	33	34.37
Claims on business (millions N$)	2252	2699.4	3049.3	2725.1	3134.8
% of claims on the private sector	39.77	41.19	42.77	36.66	36.03
Claims on Central Government &					
non-financial Public Enterprises (N$ mill.)	533.1	808.7	844.4	1156.6	1183.1
% of total assets	7.83	9.84	9.57	11.56	9.81
Foreign assets (millions N$)	349.7	536.7	548.4	877.8	1753.3
% of total assets	5.14	6.53	6.22	8.77	14.53

Looking at Table 5.3, we can make the following observations.

1. Claims on the domestic private sector have been declining as a percentage of total bank assets and the share of foreign assets has been increasing correspondingly. The share of the domestic private sector has declined from 83.18% in 1996 to 72.12% in 2000. During the same period the share of foreign assets almost tripled, rising from 5.14% to 14.53%. Such an allocation of domestic savings away from domestic investment and towards foreign placement cannot promote domestic investment and growth.

2. Looking at the claims on the domestic private sector, a lion share of it consists of mortgage loans (over 30%). The share of mortgage loans both in total private credit and in total bank assets has increased during the period. Combined with other private loans like instalment credit, the non-business private sector accounts for up to 60% of private sector credit. The business sector receives the balance of close to 40%. In fact, during the period under consideration the business sector has been loosing out in credit allocation as its share of total private sector credit has declined from 39.77% in 1996 to about 36% in 2000. The allocation of credit within the private sector is highly skewed to the less productive sectors.

3. Claims on the public sector, most of it in treasury bills and government securities has also been increasing during the period. Lending to Central Government and non-financial Public enterprises has increased from 7.83% of total assets in 1996 to 9.81% in 2000. If the perceived relatively low productivity in the public sector is true (there is no empirical evidence on relative productivity in the public and private sectors in Namibia), an increasing share of credit to the sector can hardly be growth enhancing.

Data on size distribution of loans is not readily available and therefore, it is very difficult to quantify the degree to which small entrepreneurs have access to bank-finance. However, high risk-aversion by banks and collateral requirements in all loan consideration has undoubtedly made access to bank finance by small entrepreneurs difficult. Judging by wide spread complaints about access to finance for

SMEs, it is evident that the vast majority of small businesses in Namibia do not have access to banking services despite a reasonable access to bank branches. According to studies undertaken in a large number of Developing countries, fewer than 2% low income entrepreneurs and producers have access to financial services other than money lenders (WWB Forum, 1995). This lack of access to credit by small businesses is mainly because most such businesses lack collateral. In addition because of the small size of loans the unit administrative cost is too high that makes providing loans to small businesses unattractive to commercial banks.

(c) Has the Banking Sector been effective in its Intermediation Role?

An effective financial intermediation exists when the pool of savings from savers is channelled through to investors with the least possible leakage. If the intermediation cost is high, much of the savings will not find its way into investment reducing the potential growth rate of the economy. Table 4 below presents some measures of the cost of intermediation in the commercial banking sector.

Table 5.4 Cost of Intermediation in the Commercial Banking Sector

	1996	1997	1998	1999	2000
Operating expenses as % of total assets	4.78	3.93	4.58	4.65	4.46
Operating expenses as % of total income	46.43	43.52	44.58	47.58	48.04
Overhead costs as % of total assets	1.91	1.52	1.69	1.81	1.3
Overhead costs as %of operating exp	40.08	38.63	36.98	38.87	29.05
Net interest margin	7	6.31	6.12	5.77	5.07
Interest rate spread	7.01	7.6	8.55	8.94	7.48

During the five years period operating expenses amounted to 46% of total income and about 4.5% of total assets. Overhead costs accounted for 36% of total operating costs. In international comparisons of banking sector efficiency overhead costs as percentage of total assets is used. With 1.6% of total assets, the Namibian banking sector compares well regionally and internationally. Overhead costs as a share of total assets is 6% in Ghana, 2% in Egypt, 3% in India, 4% in Kenya and 4% in South Africa (Demirguc-Kunt & Levine, 1999). However, low overhead costs may not indicate cost efficiency but a low level of capital investment in equipment and banking infrastructure. The summary statistics on the whole commercial banking sector may also hide wide divergence among different banking institutions. For example operating costs as a percentage of equity capital vary from 41% to as high as 106% (Ikhide 2000).

Another measure of efficiency as well as level of competition in the banking sector is the net interest margin defined as net interest income as a ratio of total assets. An average of 6% interest margin over the five years period is quite high by regional as well as international standards. Internationally the net interest margin is between 2 to 4%. The net interest margin is 1% in Egypt, 8% in Ghana, 3% in Mauritius, 4% in South Africa and 5% in Zimbabwe (Demirguc-Kunt & Levine, 1999). A 50% difference in net interest margins between South Africa and Namibia is hard to explain given the highly integrated nature of the banking sectors in the two countries.

The spread between deposit and lending rates ranged between 8 and 9 percentage points during the last 10 years. Over the last five years the interest rate spread averaged eight percentage points (BON data). This is indeed a very high spread and there seems to be no tendency for the interest rate spread to narrow even in high liquidity periods. The high interest rate spread and the high operating costs are indications of limited competition in the sector. The high cost of intermediation is a serious resource leakage. By reducing this leakage more resources can be channelled into productive investment.

Our brief discussion above indicates that there is room for improvement in the area of further savings mobilisation as well as increased access to sectors that hitherto have not received enough attention. It is also possible to cut the intermediation cost (the resource leakage) so more of the mobilised savings can be channelled into investment. It is also imperative for the banking sector to be pro-active and be less risk-averse in its lending policies to small businesses in urban areas and small farms in the rural areas. Net foreign assets have been building up very rapidly during the last three years and reached a high of N$ 772.2 million by the end of year 2000. The liquidity ratio of the commercial banking sector has risen from 18.8% in 1996 to a high of 27.4% at the end of 2000. The high liquidity ratio and high level of net foreign assets indicate that the banking sector can and should encourage borrowing and investment by the business sector. The high interest margin currently experienced by the banking sector could be used to encourage savings and investment by raising the deposit rate and lowering the lending rate, perhaps by some half a percentage points and thereby narrowing the interest rate spread.

Creation of special lending windows for small and medium enterprises, encouraging retail banking using the unofficial credit market, etc. can be used to address the imbalances in current lending activity. Government policies encouraging competition and monitoring oligopoly behaviour can also address some of the problems, especially that of high gross margins. However, in a small country like Namibia it is hardly possible to have real competition in the financial sector. A stable financial system with a solid capital base and adequate profitability is indispensable to sustain confidence and attract inflows of foreign capital. Too many small banks with inadequate capital base engaged in throat-cutting competition cannot provide a stable and confidence instilling financial sector.

5.3 The need for Complimentary Finance Institutions

It should be recognised that existing financial institutions, even with all the good will and improved efficiency, can only channel a limited amount of finance to small businesses and farms. The commercial banks operate in a liberalised market environment where the primary objective is the financial profitability of their operations. The free capital flows within the Common Currency Area (CMA) and by extension in the global financial market severely limits the extent to which banks in Namibia can shoulder developmental roles at the expense of financial viability. Given the firm commitment of the Namibian government towards a market economy, government can only encourage the commercial banking sector to pay more attention to the financial needs of small borrowers.

This encouragement can take the form of tax incentives, credit guarantee, rediscounting schemes and other market based policy instruments. The days are gone when government could channel resources to priority sectors using direct administrative allocation of credit. In this connection it is highly doubtful that the policy of 35% domestic investment requirement on pension funds and insurance companies has had the desired effect, that of increased domestic real investment. The free capital mobility mentioned above as well as the limited coverage of the domestic investment requirement (banks are not subject to such a requirement) means that funds will find their way out of the country if returns are higher on the South African market.

The challenge is how to mobilise more savings and channel more resources to small urban entrepreneurs and rural communities in order to foster accelerated economic growth, create employment and address the severe imbalances in income and wealth. A Global Policy Forum convened to discuss the problem of access to finance for small businesses concluded that financial services to low income entrepreneurs and producers may well be the single most effective means to tackle poverty and create broad based economic growth (WWB Forum, 1995).

The need for creating and developing financial institutions and credit instruments to reach the vast majority of small savers and borrowers should not be looked at as an attempt to go back to the policy of regulated and government administered financial market. In fact, the new forms will be highly complementary to the existing financial system and institutions. Moreover, the existing financial institutions should actively participate in the creation of new financial arrangements for small businesses through different channels and specialised credit institutions.

Although the experience with directed credit has been disastrous in many developing countries, the liberalised financial system currently in operation in most of those countries for the past 10 to 15 years has failed to channel savings into productive areas. Though quiet few, there are countries that have utilised direct credit policy to priority sectors to achieve high and desirable pattern of growth. Japan (1930-60), South Korea (1960-80) and Malaysia in the 1970 s and 1980s are among those few shining examples. We can draw the following important lessons both from the many failures and from the few success stories in directed credit policy.

- The importance of macroeconomic stability for the success of credit policy
- The need for careful targeting of sectors as well as beneficiaries
- The need to create appropriate credit institutions and credit instruments
- Adequate monitoring, performance evaluation of the system and its beneficiaries with a transparent system of incentives and disincentives.

In the following sub-sections we will briefly look at these preconditions for successful credit policy to foster economic development in the context of the Namibian economic and policy environment.

(a) Macroeconomic Stability

Macroeconomic stability has taken centre stage since the early 1980s as a result of serious imbalances in the economies of many developing countries in the form of high inflation, high budget deficit, balance of payment problems and unsustainable levels of domestic and external debts. Since then many countries have attempted to redress these imbalances through structural adjustment programmes which included financial liberalisation policies. The results have been mixed across the African continent. Some countries are still struggling with the same imbalances 15 years down the road and others are continuously challenged by new imbalances.

Namibia as a recent entrant into the community of independent Nations has been fortunate to learn from the catastrophic experiences of many countries on the continent. It has been able to maintain low budget deficits, low government debt as well as a stable (albeit high) inflation rate. Namibia has also maintained and encouraged a basically market oriented development with little government interference. Although the country faces serious structural imbalances with inadequate income growth rate, extremely high unemployment and extreme income disparity, the basic elements of

macroeconomic stability are in place. Therefore, one of the pre-conditions for a successful credit policy exists. Not only that, the severe structural imbalances in the form of low growth rate, high unemployment and income disparity makes government credit policy absolutely essential.

(b) Targeting Sectors and Beneficiaries

In a country as labour surplus as Namibia and endowed with natural resources, it appears relatively easy to identify sectors for special attention to achieve the goals of income generation, employment creation and desirable income distribution. Labour-intensive and natural resource based industries come to the fore for promotion and special assistance. However, without denying the importance of utilising existing comparative advantage of the country, the credit policy must be formulated with a view of not only short and medium-term considerations but also with a view of creating a long-term competitive advantage.

Therefore, the credit support policy should be based on a careful analysis of current needs and constraints as well as future opportunities and challenges. As the information required for such kind of analysis is enormous and quiet varied, the identification of sectors for special credit support needs to be done in consultation involving government, business, unions, academia, NGOs, community based organisations as well as donors.

With regard to the beneficiaries in the selected sectors, it is quiet evident that small and medium sized firms and farms need the most support. The commercial banking sector cannot adequately cater for these types of clients because of the high administration costs and high default rate. The credit policy needs to be flexible to accommodate even larger firms that might want to venture into promising new areas with technological spin-offs.

(c) Creating and Developing Specialised Credit Institutions

As we have noted earlier, the commercial banking sector must operate on a sound market criteria and cannot be burdened with social and developmental functions. Yes, private businesses do have social obligations to the community and cannot be indifferent to developmental needs. They need to be encouraged to play their part in the developmental efforts of the nation. But government must recognise and appreciate that commercial banking institutions primary responsibility and accountability is to their shareholders.

Thus, to advance developmental goals, government needs to consider seriously the creation and promotion of appropriate institutions and forms of credit provision to selected sectors and groups. This might take different forms:

Development finance institutions: Such institutions can directly provide finance to certain sectors on a long-term sustainable terms and conditions or indirectly through support schemes to other financial institutions. The creation of Namibia Development Bank and the Credit Guarantee Scheme are good beginnings in the right direction. Although details are still sketchy on how the Development Bank will operate and on its areas of special focus, we feel that facilitating credit provision to small businesses and small firms should figure prominently in its operations. Players in the financial sector should welcome these government initiatives as highly complementary and supportive to their activities.

With the creation of such developmental financial institutions, the pressure on commercial banks to take on direct developmental roles would be much less. In many of the successful economies of South-East Asia and Japan, various types of development finance institutions have played a major role. Given

appropriate organisation, management, transparent policy and a market environment, such development finance institutions can play a major role in the development of Namibia.

Retail banking institutions: Many studies on financing small and medium enterprises find that the major problem is not the cost of finance but the very limited access to finance. It is found that small businesses borrow at extremely high interest rate from money-lender for their working capital needs which indicates their ability to service their debts. In order to mobilise more savings and provide the necessary credit to small businesses and firms, a network of retail banking has shown to be effective in many countries. In Japan there were more than 950 mutual loan, credit associations and co-operatives with over 12000 offices specialised in financing small businesses (Urruita, 1988).

Co-operatives and credit associations are not new in Africa but their financial resource is extremely limited. In a framework of a competitive financial market, these associations and co-operatives can effectively mobilise and channel financial savings. The failure of many co-operatives and associations in the 1960s and 1970s was mainly due to the policy environment under which they were operating rather than their inherent inability to mobilise and allocate financial resources. In the Namibian context, the unofficial credit markets like pant banks mushrooming everywhere can be assisted to take on financing of working capital for small businesses. With the right type of organisation, management and incentives, the unofficial credit market can serve as an effective channel to reach a large number of small businesses. Commercial banks and development finance institutions can make use of these credit institutions as their retail outlets. This requires however, an extensive reorganisation, training and re-capitalisation of the emerging curb-market.

An agency relationship between commercial banks and retailers will enable the commercial banking sector to concentrate on its traditional clientele — large and established business sector. Currently, it seems that the banking sector is not positively disposed to the pant-banking sector. The pant-banking sector needs to orient its lending more towards business finance with as little collateral requirement as possible.

The average loan size in the unofficial credit market is very small and therefore average administrative costs are very high. Coupled with a high default rate, the interest charged can be extremely high. In the literature and policy debates on finance to SMEs, there is now a consensus that subsidised interest rates is not the right approach. Instead, it is suggested that overhead costs of retail banking institutions and loan associations should be subsidised until they reach sufficient lending volumes. Such institutions should also be supported in the form of training and expert advice (WWB Forum, 1995).

The assistance towards overhead costs should also be extended to commercial banks lending activities to small borrowers. In pursuing the objective of catering for small business finance, credit policy should not be discriminatory against established financial institutions. In fact, the policy should create a competitive environment between established financial institutions and new players in the provision of financial services to targeted sectors and groups. Such a competitive environment should ensure the objective of finance to small businesses and farms is achieved at the least cost possible.

(d) Monitoring and Performance Evaluation

An appropriate institution to monitor the functioning of specialised credit institutions and to evaluate their performance against set standards is necessary. Indicators like loan recovery rate, cost-effectiveness, coverage both in lending and mobilising savings need to be monitored closely. If the new credit institutions function in an otherwise relatively competitive financial market environment, bench-mark standards are provided by the performance level in the general financial market. The comparison

against market standards will make it possible to quantify the additional costs incurred by society to provide access to finance for small businesses.

For a monitoring and performance evaluation exercise to have the desired effect of improving the functioning of the system, it should be accompanied by a system of incentives. The incentives could take the form of continued cost subsidies, rediscounting, refinancing and re-capitalisation facilities, further training and business development support. In the event a credit institution falls far short of a reasonable performance standard it may loose not only special support from government but, in the worst case, may also loose its licence to operate in the sector. The institutional arrangement for monitoring and performance evaluation should allow for participation by all concerned parties — government, financial sector representatives, loan and credit associations as well as donors contributing to the funding of the programme.

Conclusion

If Namibia is to achieve its goals of accelerated growth, employment creation and a desirable pattern of income distribution, the financial system should play a major role in harnessing the nations savings and channelling it into productive areas. Especially, the financing needs of small businesses and small farms needs to be addressed. As we have argued in this paper, a two-pronged approach (improving the operations of existing financial institutions and the creation of specialised credit institutions) is necessary.

The existing financial system needs to be made more effective and more responsive in performing its resource mobilising and allocation functions. This should be achieved as far as possible through self-regulation by the sector itself than by direct government regulation. Of course government is responsible for providing clear guidelines, operational rules and procedures. The Bank of Namibia and the Ministry of Finance through the newly created financial sector supervision institute can adequately perform the monitoring and supervision of the financial sector as a whole in a co-ordinated manner. Improvement in efficiency in the banking sector can release some resources which can then be channelled into sectors which hitherto have been disadvantaged in accessing bank finance. The banking sector should be encouraged with appropriate policy instruments and incentives to cater for the financing needs of small businesses.

However, even with improved efficiency and all the good will by the banking sector towards small businesses, the nature of the commercial banking business limits the extent to which the banking sector can address the huge financial gap in the small enterprise sector.

Therefore, it is imperative to create, develop and sustain other complementary specialised financial institutions and credit arrangements for small borrowers. We have indicated the different forms such specialised institutions can take ranging from development financial institutions, co-operatives, loan associations and private bank retailing. A good credit policy is one that encourages and supports all types of credit institutions and foster competition among them. The policy of support to small business finance should avoid interest rate subsidy but instead should be directed at subsidising overhead costs and institutional support.

It is also important for the success of the credit policy that all stakeholders are consulted and they actively participate in the design of support systems, in mobilising funding for the programme and also in monitoring and evaluation of the performance of the programme and its beneficiaries. The programme should be a partnership between government, the financial sector, the corporate sector, credit and loan association as well as the small enterprise sector.

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6. TOWARDS AN OPTIMAL FINANCIAL STRUCTURE: IS THERE A NEED FOR A PARADIGM SHIFT

Jaafar bin Ahmad

6.1 Introduction

This essay is an attempt to evaluate the role of banking institutions in the development of Namibia since independence in 1990. Debates over the desired role of financial institutions in promoting economic growth and development are not new. Among the issues raised at the operational level is the efficiency of these institutions in mobilising resources or savings and their utilisation. Where the savings originated and how they are applied became an issue in terms of the lending channels and directions.

Historically, nearly all governments seemed to find such distribution in lending unsatisfactory. They found it necessary to intervene in order to channel funds to target sectors in the interest of promoting rapid economic development.

In many developing countries the formal financial system is usually consisted of a very few institutions, and they are mostly foreign owned. Two observations can be made in respect of these institutions. Firstly, local business had difficulty in having access and secondly the foreign banking institutions seemed to prefer extending financing to only trading companies, mines and other established institutions, which are often also foreign owned.

With reference to those who were either without or with little access to the banks, the alternative sources are to make use of the informal sector. These were made up of moneylenders, traders and pawnbrokers and related others. The available funds are often small and expensive.

Resort to other alternative sources such as to the equity and capital markets are limited on account of their early stages of economic development.

There are also attempts by the governments at bridging the gap in the supply of credits with various degree of success. The establishment of Development Banks is one of them to meet long term financing needs. These banks were very popular in the 1950 s and 1960 s and being actively promoted by the World Bank during the period, but have almost disappeared now on account of poor track records.

6.2 The Namibian Financial System[7]

It is with this background that the Namibian Financial System (NFS) is evaluated.

The NFS is relatively small with total assets equivalent to only 151 per cent of GDP or approximately N$36.5 billion, as compared with 310 per cent for South Africa. At the apex of the NFS is Bank of Namibia, five commercial banks, one building society, about 500 pension funds, several insurance corporations (17), the Post Office Savings Bank (Nampost), Unit Trust Companies (8) a number of financial auxiliaries such as asset management companies (19) and stock broking firms (6) and others.

7 For the purpose of this paper the Financial System is defined, as being composed of the Monetary Authority, Deposit Money Corporations, Other Banking Institutions and Non-Bank Financial Institutiions. Though the Bond-Market and the Equity market are important elements of the Financial System of any Economy, they are not included the definition of Financial System.

Table 6.1: Assets of Namibian Financial System (2000)

Type of Financial Institution	Total Assets (N$ Million)	N$% to assets	total % to GDP
Monetary Authority (Bank of Namibia)	1,986.3	5.4	8.2
Deposit Money Corporations	12,063.0	33.0	50.0
Other Banking Institutions	2,479.0[8]	6.8	10.3
Sub Total Banking System	16,528.3	45.2	68.5
Non-Bank Financial Institutions[9]	20,000.0[10]	54.8	82.8
Overall Total	36,528.3	100.0	151.3

Source: Bank of Namibia and J. Steytler
(Unpublished paper on non-bank financial institutions in Namibia)

Private sector financial institutions dominate, with the five commercial banks making up 33 per cent of total assets. The non-bank financial sector is large and accounts for about 54.2 per cent of the total assets of the financial system. Among the non-bank financial institutions the biggest type is the pension funds as a group, followed by the insurance corporations. The pension funds category alone account for an estimated 32 per cent of total assets of the financial system.

The two largest banks (First National Bank and Standard Bank) account for over 60 per cent of the risk assets of the commercial banks. These are well-established South African institutions, in operation in Namibia since before 1990.

Domestic privately owned banks (Bank Windhoek and CSIB) together account for a distant third with 24 per cent of the risk assets.

Table 6.2 Ownership of Banks

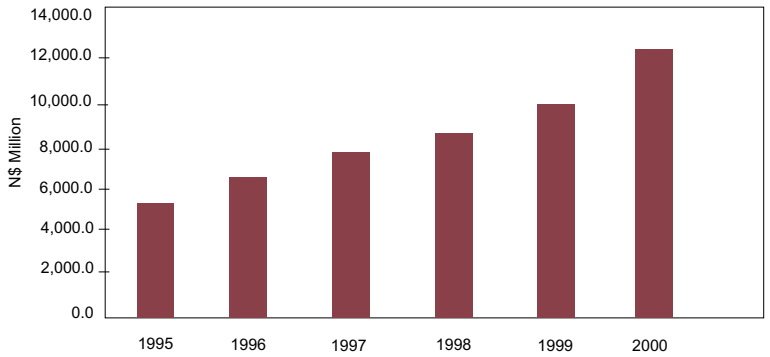
Bank	Percentage	Country of Ownership
Bank Windhoek	100	Namibian
City Savings and Investment Bank	100	Namibian
Commercial Bank of Namibia	94.4	South African & France
First National Bank of Namibia	78	South African
Standard Bank Namibia	100	South African

Source: Bank of Namibia

SWABOU, the only building society accounts for about 38 per cent of the total mortgage market.

8 Refer to the combined assets of the SWABOU building society, the Nampost Savings Bank, the National Housing Enterprise and the Agricultural Bank of Namibia.
9 The assets of pension funds, insurance corporations and unit trust.
10 Estimate based on the total funds under management by Namibian asset managers.

Chart 6.1 Total Assets of Commercial Bank (N$ Million)



Source: Bank of Namibia

It is difficult to infer in any degree of detail from the published sources over their collective strength. But from the prospective of the available prudential ratios the banking system appears to be financially sound, with NPL ratio of only 4.7 per cent at the end of 2000 and return to assets averaging 4 per cent per year over the period 1997 to 2000.

Table 6.3 Key Profitability Ratio s of Commercial Banks

	1997	1998	1999	2000
Return on Assets	3.6	3.8	3.9	4.4
Return on Equity	48.1	44.3	40.3	44.0
Net Interest Margin	6.6	6.8	6.5	5.9
Net Interest Spread	6.8	6.4	5.8	5.4
Cost-to-income ratio	46.2	44.6	47.6	47.9

Source: Bank of Namibia

From a systemic perspective, development of the NFS will continue to follow closely that of South Africa, where the NFS in terms of total risk assets is only 2 per cent of the two combined. This is reinforced by Namibia s fixed exchange rate to the Rand regime as well as its membership in the Common Monetary Area.

At a micro-level, where some data is available, some observations could be made in respect of the direction of savings and their utilisation[11].

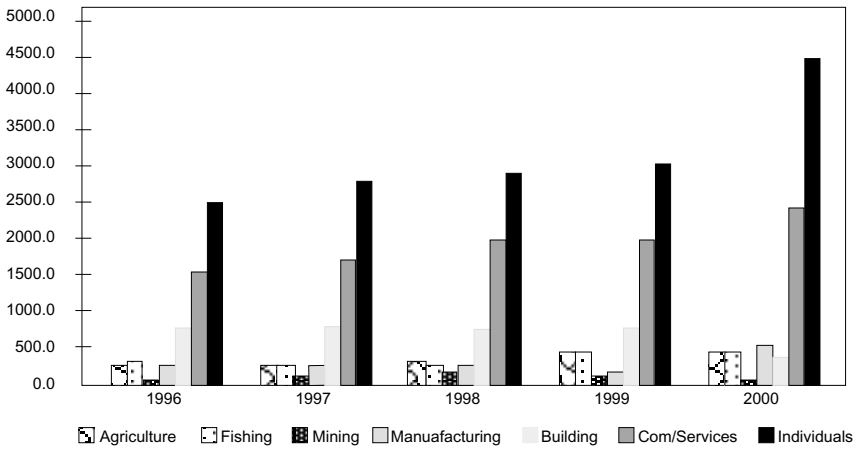
Direction of Credit

The predominant pattern over the observed time series 1996 — 2000 had been the apparent bias of lending for consumption. It almost consistently dominated the combined total of lending to all the productive sectors of the economy. In 1996 total borrowing by individuals was close to N$2.4 billion and grew on at an annual average of 18.8 per cent to N$ 4.5 billion in the year 2000. The corresponding combined total for the categories: agriculture, fishing, mining, manufacturing and building and

11 because of its importance in NFS, the focus is hereby made on the banking institutiions.

construction was only N$1.7 billion in 1996 (29.4 per cent of total) and N$1.8 billion in 2000 (21.3 per cent of total).

Chart 6.2 Direction of Lending



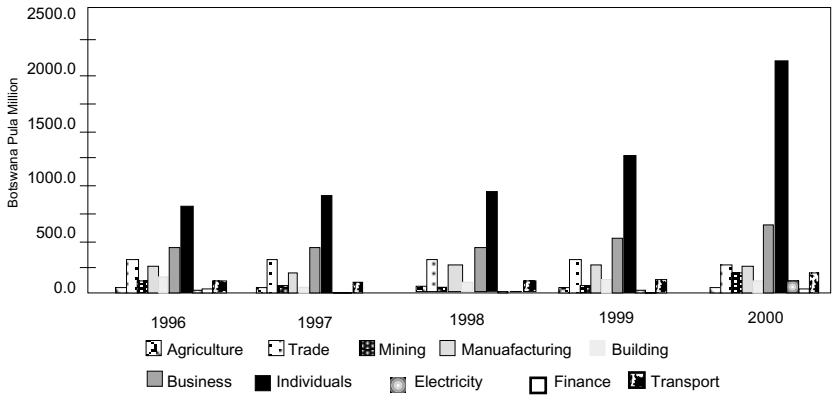
Source: Bank of Namibia

Borrowings under the category Commercial Services took up a share of 27.6 per cent on average annually for the period 1996 to 2000, and accounted for the second largest category. The pattern where individuals predominate is not at all surprising as the major source of income of the population is from the public sector. Government expenditure is on average close to 36.7 per cent of GDP and its wage bill accounted for nearly 15.8 per cent of GDP of about N$24.1 billion in nominal terms in 2000.

What is disturbing, however, has been that direction of bank credit has not shifted much over the last decade in favour of the more productive sectors.

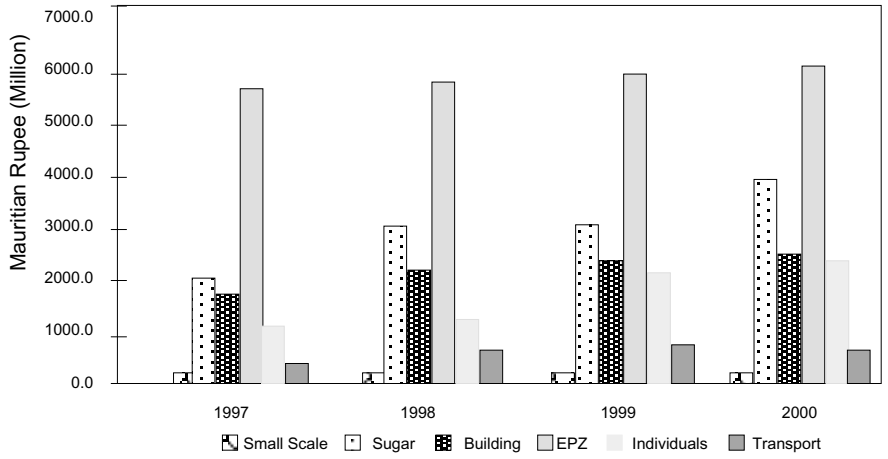
The low level of commercial bank credit extension to the mining, fishing, manufacturing and agricultural sector is surprising and needed to be explored in further detail as they constituted among the major sectors of the economy in their contribution to growth and development. In terms of size they accounted for a sizeable 30.3 per cent of the GDP, with primary industries (Agriculture, Fishing and Mining) 20.1 per cent. This resulted in contrary to expectations by comparison to the other rapidly developing economies, except Botswana.

Chart 6.3 Direction of Lending (Botswana)



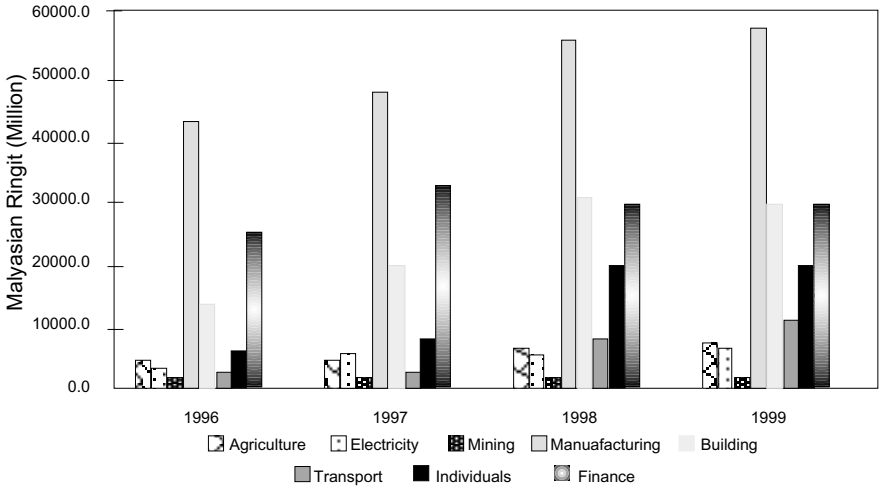
Source: Bank of Botswana

Chart 6.4 Direction of Lending (Mauritius)



Source: Bank of Mauritius

Chart 6.5 Direction of Lending (Malaysia)



Source: Bank of Malaysia

It could perhaps be inferred that some of those sectors, in particular fishing and mining, financed their investment and expansion from either or both internally generated funds and/or from outside the NFS. This is supported by the fact that since independence most of the inflows in terms of foreign direct investment were channelled into the fishing and mining sector, respectively.

The Agribank has a good track record in channelling credit to the agricultural sector as evidenced from the N$695.2 million of loan assets on its balance sheet as at the end of May 2001. As a ratio to agricultural GDP Agribank loans accounts for 57.4 per cent. This figure is small when compared to the size of total risk assets of the NFS, which is over one and half times of GDP. It does not say much as well, since it is generally accepted that the GDP of the agricultural sector is grossly underestimated, in particular that of subsistence farming. Contrary to the experience of the more successful developing economies a large proportion of subsistence farmers in Namibia does not seem to have access to credit.

The results above do not portray a positive picture in relation to productive investments. The banking institutions of Namibia do not seem to have played fully its role as a partner in promoting economic growth.

The pattern where consumer credits predominate, witnessed a growth of 18.8 per cent on average per

year for the period 1996 to 2000. This rate accelerated to 40.8 per cent in the year 2000. The rapid increase was fuelled by instalment purchases for cars, other consumer durables and housing mortgages.

Deposit rates over the same 5-year period grew by only 15.8 per cent, while the loan to deposit ratio averaged around 94 per cent per annum for the period 1992 to 1995 and 96 per cent in the last 5 years (1996 to 2000).

Deposits in excess of six-month maturity have however lost some grounds from 10.9 per cent in 1995 to only 2.9 per cent in 2000.

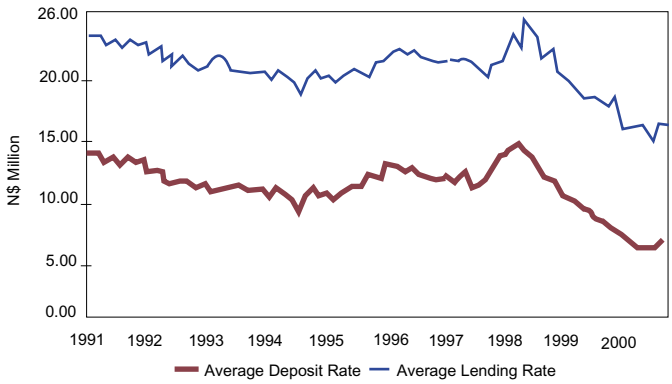
Negative real interest rates could have played a role, but if trends persist, banks are in danger of having to take a significant erosion of the maturity mismatch in their portfolio, especially when more of the banks deposit base is short term and lending dominated by non-productive consumer durables.

Cost of Funds

Cost of funds is to a certain extent a good barometer of competition among the financial institutions. The spread between either prime or average lending rates against the average deposit rates is normally two percentage points or less in industrialised economies. In some rapidly developing countries this figure is no more than four percentage points.

The questions raised usually evolve around the right the measure of costs of fund. Perhaps this is the right question to raise at the micro-level, but at the level of the industry the question may not be relevant. For the banking sector over 90 per cent of bank funding has been from deposits, particularly among the LDCs.

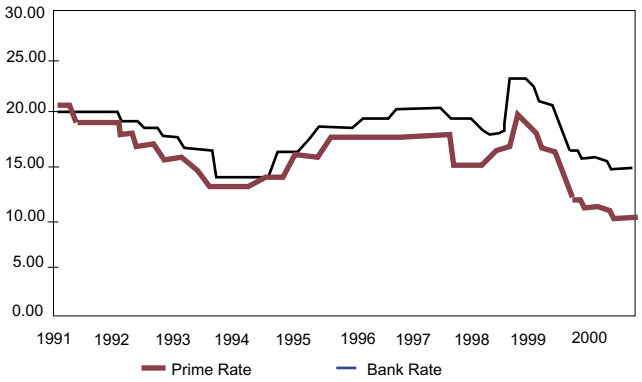
Chart 6.6 Average Lending and Deposit Rate



Source: Bank of Namibia

Such spread has been wide consistently at an average of close to 10 percentage points in Namibia. This gap has been consistent with the spread observed between the prime rates and the Bank of Namibia s Bank Rate. This gap rose from 100 basis points in January 1995 to 465 basis points in December 2000.

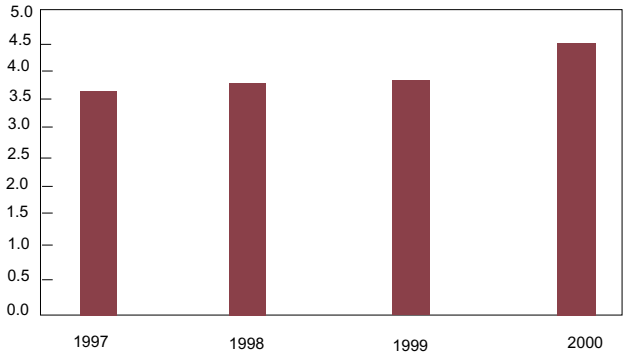
Chart 6.7 Spread between Prime and Bank Rates



Source: Bank of Namibia

These spreads are reflected directly on banks profitability. The Banks return on total assets in the aggregate, averaged consistently above four percentage points. When compared to an average rate of return of less than 2 percentage points in developed economies banking in Namibia is indeed a better industry to invest in than most.

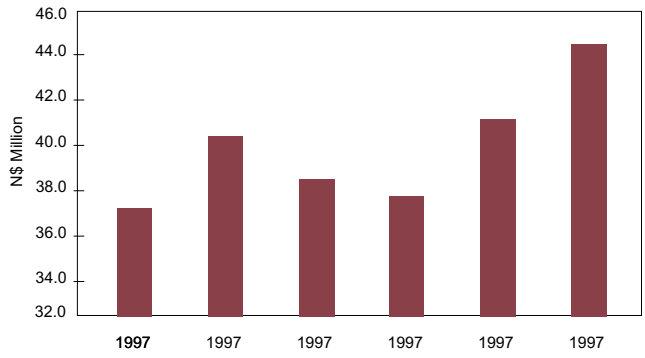
Chart 6.8 Bank Return on Total Assets



Source: Bank of Namibia

This development raised two related points. The high cost of funds or translated into cost investment reflected the low level of loan raised by the productive sector throughout the post independence decade. At an inflation rate of 9.8 per cent per annum, average return to investment will have to exceed cost of funds by a significant margin. It would not be surprising therefore to observe firms financing their expansion from internally generated funds and from outside sources. The high concentration of bank lending to individuals, while by itself not a healthy trend is of concern because of the risks associated with an average high interest rate level and the large share taken up by individuals especially during any economic downswing.

Chart 6.9 Financial Deepening



Source: Bank of Namibia

The second point to this development is the surprising inelasticity of the spread, which persisted over a decade. Despite the significant progress observed in the total size of the NFS in relation to the economy since 1995, as measured by broad money supply as a ratio to GDP, which is supposed to reflect the ability of the system to raise capital for growth and its capacity to diversify risk. This ratio increased from 37.4 per cent in 1995 to 44.3 per cent in 2000. Such financial deepening was not deep enough apparently in Namibia, as the progress has not led to a more competitive arrangement to drive down costs of investment in the economy. The phenomenon is surprising from another perspective. The complete integration of the NFS with that of South Africa, which is expected to widen competition, has failed to make an impact on funding costs locally. On the contrary, the spread between the lending and funding rates have been observed to be as large in South Africa as those in Namibia.

Questions of Access to Bank Credits

When individuals dominate bank credit as a category, the normal question of access raised in developing countries takes a different flavour in Namibia.

It is however expected as consumer credits especially for housing, cars and other consumer durables are easily secured and mostly tied-in to guarantees of the employers. With Government as the primary source of income (20.2 per cent of GDP) as opposed to primary industries (22.8 per cent of GDP) and manufacturing (9.8 per cent of GDP), lending to individuals could be expected to continue to crowd out the rest of the economy.

These loans are essentially collateral based where the risks of default are contained through the residual asset value and other added securities. The same could be expected to occur from borrowings by other economic categories.

For the larger categories of borrowers in the economy, the question of access may not also arise. The lower share of credits (50 per cent as a group) observed was for other reasons than access. It is with the smaller of categories that concerns were raised. This has been due to either the lack of or narrower access to bank credits among the small and medium scale enterprises. Banks could have been reluctant to lend when risks of defaults are higher; when collaterals are inadequate or lacking; when track records are absent or for a combination of these factors.

Ironically, the small and medium scale enterprises including agriculture (such as stock farming) are the most prevalent and constituted the bulk of the Namibian economy. Together they accounted for over 75 per cent of the GDP and supported either directly or indirectly the same share of employment. Any

increase in the share of the bank credits to this sector is therefore a significant contribution to economic growth and development.

A more effective solution is needed to bridge the gap between the SMA sector and the NFS. The reluctance of banks to extend credits is presumably and understandably an issue of risk versus security, which could be a difficult obstacle, if left alone market forces. Some of the barriers could be institutional in nature.

The first is collateral security over credit extended. A solution has to be found in the rural agricultural sector to convert communal land into an acceptable marketable form of security.

It has been a major challenge in meeting rural credit demand, especially among the communal area farmers. Financial institutions that have successfully penetrated the rural credit market have been disappointing and not expected to increase over the immediate term. Except for the presence of the Agribank, the other five commercial banks were absent. It is not left to the banks alone, however, to address the reluctance of banks to participate, policy makers too have a role to play. They need to come to grip with the fundamental underlying problems of lack of proper security. In a wider context the formation of a Credit Guarantee Scheme to small scale enterprises could be the solution and worth considering. Successful models of such scheme could be studied from a number of successful, rapidly developing economies.

The second is over the wide reluctance of the banking community to be closely associated with any particular ventures beyond the usual traditional credit evaluation process. This reluctance stems again from a number of factors, but all could be related to Transaction Costs. By comparison to some of the larger loan portfolio, credits to medium and small-scale enterprises are relatively tiny, and typically transaction costs are high. A closer scrutiny on project viability and their recovery, if non-performing, could prove exorbitant to the banks. Historically, a popular solution is to overcome high transaction costs and risk, many countries have restricted to subsidised credit. Unfortunately, the track records of subsidised credit programmes have not been successful in reaching the intended targets.

A successful solution, which has been implemented, is group lending. The best-known example is the Grameen Bank approach in Bangladesh, which attracted following among other countries in East Asia. In Indonesia, a certain Badan Kredit Kecamatan (roughly translated Small Credit Scheme) has been successful in supplying no collateral based credits to individual borrowers. Other solutions targeted at the very small-scale enterprise, packaged with training and other skill transfers should be looked into and tailor-made for Namibian circumstances. Yet another example is the successful Raiffeisen or Volksbanken (people s bank) in Germany, which operate as savings and credit co-operatives. The big advantage of these type of financial institutions is their ability to considerably reduce transactions costs.

The third is over the need for the NFS to recognise that it is also a partner in the development process. A detached view taken by the local banks over their presence in the economy, as often relevant to a more developed one could be contrary to this economic development objective. In a number of emergency countries foreign banks dominated their financial sector, where credit and finance were mostly extended to big enterprises and often also foreign owned. More innovative approaches are required for the NFS in order to rise to the challenges of development.

Alternative Sources of Financing

In Namibia it is difficult to observe any other significant source of financing except the equity and capital

market. However, because of size for entry and access this segment of the market is confined mostly to the well-established enterprises.

6.4 Summary and Conclusion

The major focus of the essay has been confined mostly to the banking sector in the NFS. It is both due to its position in the economy as financial intermediaries as well as the better availability of data.

What emerged since post independence has been that nothing significant has changed in terms of the role the banking institutions have played in the economy. There has been hardly a shift in the share of lending to the rest of the productive sector. Lending to individuals dominated credit facilities exclusively throughout the last decade, which was in contrast to experience of some dynamic LDCs.

Why such a phenomenon is observed in Namibia and not in many other countries, needed to be looked into in more detail.

The other observation is the large spread between the average lending rates and average costs of deposits. Financing deepening and asset expansion in Namibia and its complete integration into the Financial System of South Africa have apparently not made an impact. The consolation is that the spread is equally large as in South Africa. Strong presence in Namibia of South African banks could be the explanation.

The low level of borrowings by the more dynamic and productive sectors, which have access, is a puzzle. More studies and surveys are required to seek out the sources of funding of these enterprises. The best guess now is that their investments are both internally generated and sourced from their head offices outside. Conversely, these sectors had been stagnating and therefore had not much need for such funding.

The issue of access to credit facilities by the small and medium scale enterprises, including agriculture, while of concern, contains two facets. On the one hand the financial institutions need to address the inherently higher risks, which they have to absorb by comparison to their normal credit risks. A better mechanism to minimise or lower these risks is however absent.

Some examples are observed in other LDCs. But these models needed to be carefully evaluated for their relevancy and effectiveness in the Namibian context.

The other facet is the collateral security of requirements in support of credit facilities extended. This requirement precluded immediately a major segment of the economy from access. Many small and medium scale enterprises and the rural sector would not have the track record and the required expertise to prepare project proposals and for many neither the right assets to use as collaterals. In the communal areas land would not be acceptable as property rights are often not clearly defined. Therein lies a dilemma. The NFS may have the desire to expand and lend to the productive sectors, which comprise the bulk of the economy, but the risks and return are not well balanced for them to do so.

Leaving market forces to resolve these problems will not do, because of the absence of a proper institutional arrangements to bridge the gap between risks and return on the one hand and safety and security on the other. The market may take more time to resolve these issues. What are needed are policy initiatives.

On balance a change of paradigm may not be required, but more in terms of the tinkering of the current system. The NFS is as an institution modern and efficient but observed to be wanting in pro development strategies initiatives. Policy innovations are required above all to coax these institutions in favour of attaining the Naional Economic Development Objectives.

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7. CONCLUSION AND ISSUES EMANATING FROM CONFERENCE

Research Department

Bank of Namibia

Generally, Namibia s financial system is relatively well developed as compared to many countries in Sub-Saharan Africa. The regulatory and policy framework is liberal and largely subject to market discipline, such that financial repression has not been a serious problem in Namibia. It also emerges that the financial system in Namibia is dominated by the banking industry that are sound financially, but urban — biased. The cost of capital proxied by the spreads of lending and borrowing rates is quite high, both in nominal and real terms. Though the credit problem is largely attributed to high cost of capital, it is also acknowledged to have been exacerbated by accessibility. The absence of commercial banks branches in the rural areas where the majority of population live makes credit to them a remote possibility. Also high cost of capital raises questions with respect to real competition in the domestic financial system.

All the papers presented agreed on one theme that financial development is important for economic growth. The international experience shows that legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices can boost financial intermediary development and thereby accelerate growth. However intervention by the monetary authority in the existing system is not advisable, rather an effort must be geared towards creating a complementary system. Introduction of subsidies will not improve the effectiveness and efficiency of the system, but rather create more inefficiency.

Issues Emanating from Conference

The discussions and deliberations at the conference brought forth important issues of major policy relevance. These issues are highlighted below:

There is high savings - low investments growth dilemma

The general experience with developing countries is one of high investment, low saving resulting in saving-investment gap. This implies that in order to ensure appropriate flow of funds to the productive sectors of the economy, countries resort to external financing so as to ensure an uninterrupted and accelerated growth process. However, in the case of Namibia, the situation is somewhat reversed with savings exceeding investment. Divergent views emerged from the discussions on this issue. Most are of the view that investment opportunities exist in Namibia but the risk averse behaviour of commercial banks prevent credit flow. On the other hand, there are others who although admit the high saving argument, disagree on the point that there are investment opportunities in the Namibian economy.

A large chunk of private sector credit is directed towards financing consumption expenditure, instead of productive investment expenditure

Due to the risk—averse behaviour of the commercial banks, the flow of credit gravitated towards financing the most secure sector viz., for financing consumption expenditure (e.g. hire purchase, mortgage etc.) rather than for the productive sectors of the economy. Empirical evidence suggests that for faster growth, it is imperative to ensure greater flow of credit to the business sector rather than to

individuals. As such, the revealed trends in credit flows of banks over the years seem to be shying away from point of view of creating a financial environment that triggers the growth process. Although, it has been admitted that the creation of other medium and long term financial institutions like the development bank could help to ease the situation, it was felt that commercial banks need to play a greater role in the development process by encouraging credit towards productive sectors as opposed to the current pattern that is biased towards short term loans.

The cost of capital is very high in Namibia as evidenced by high bank spreads

The presence of high cost of capital of banks as revealed by the studies has been discussed particularly with reference to the real competition in the domestic financial system. Existence of real competition must affect prices (interest rates). In other words, competition should normally drive down cost of capital. It was, therefore, felt that the non-existence of a competitive environment in the banking sector may have been responsible for the continued existence of high level of cost of capital over the years. It was accordingly felt that this issue needs the attention of policy makers.

High level of monetary integration between Namibia and South Africa, is it a hindrance to growth?

The question of whether monetary integration between Namibia and South Africa promotes or hinders growth has been discussed. The preliminary findings suggest that integration is good for growth as it ensures lower inflation and macroeconomic stability. One speaker suggested that a currency board arrangement would work better in terms of promoting growth in Namibia. As there has not been much debate surrounding the operations of a currency board arrangement and the extent to which it differs with the current arrangement, the issue therefore remained unclear as to how a currency board arrangement is superior to the current arrangement. It was felt that there is a need for further research in this area.

The lack of property rights in rural areas impede potential credit extension to this sector

It was argued that the flow of credit to the rural areas is severely constrained owing to problem of property rights. In other words, the rural people do not have necessary collaterals that are required by the financial institutions before a loan is secured. This entails carving out a land tenure policy in rural areas that would empower communal farmers to have property rights over their land. It was felt that this initiative could overcome the problem of borrowing against a collateral.

There are too many development finance institutions in the economy this may cause someinefficiencies in the system.

The role of development finance institutions in filling the gap of the capital requirements for investment purposes in the Namibian economy cannot be overemphasised. It was pointed out that there are many development finance institutions in the country performing almost similar (if not the same) functions. These are the NHE, Agribank, NDC and DFN. These institutions have different structures and boards. It was therefore argued that there is a need for streamlining the institutions by putting them under one umbrella body say, the Development Bank of Namibia, in order to reduce operational cost and improve efficiency and for achieving better co-ordination of policies.

Paradigm Shift

On the issue relating to the paradigm shift, the paper by Jaafar bin Ahmad opines that there is no need for a paradigm shift. The paper however pointed out the need for changes in the institutional structure. A query was raised as to whether such changes do not constitute paradigm shift. It was also agreed that in order to meet the financing gaps in the system, there is a need for putting in place new institutions such as community banks, rural banks and other development finance agencies. After discussing the issue at length, it emerged that there is a need for a paradigm shift.

In **conclusion**, the consensus seems to have converged around the view that finance and growth are closely associated and it is imperative to put in place a robust financial system that is growth oriented. Cross-country evidence indicates that better functioning financial intermediaries characterised by financial widening and financial deepening accelerates the economic growth process. Further, the differences in the legal rights of creditors, the efficiency of contract enforcement, and accounting standards help explain cross-country differences in the level of financial intermediary development.

The overall discussions seem to have converged on the view that there is need to have a re-look at the financial structure from the point of view of meeting the emerging financing gaps, size, geographical distribution and types of instruments. A highly concentrated commercial banking sector might result in lack of competitive pressure to attract savings and channel them to investors. It was therefore felt that the financial system needs to be reviewed from the point of view of evolving a competitive environment that would help reduce the high levels of spreads, net interest margins and overhead costs.

In order to ease the extension of credit, particularly to the farm and business sectors, it was argued that clearly defined Property rights and contract enforcement and accounting standards are imperative. It was felt that the existing credit guarantee scheme could be improved further with a view to encouraging credit to small and medium enterprises. New financial institutions should be introduced in order to take care of the neglected areas. It is also felt that the promotion of a competitive environment should form the core of enabling legal framework.

The discussions at the meeting also focussed on the role of Government in promoting investment projects.

Regarding the provision of incentives and subsidies, there were divergent views. It was pointed out that country experiences revealed that where ever interest rate subsidy schemes were pursued, they resulted in promoting inefficiencies. On the other hand some speakers felt that keeping in view the developmental needs of the economy and the level of risk involved in extending credit to specific sectors particularly in rural areas, the introduction of subsidies could be thought of. However, the discussion did not result in any broad convergence of views on this issue.

Finally, on the issue concerning the high saving-low investment syndrome facing the country, participants felt that there is a need for in-depth theoretical and empirical research that would enable us to understand the contributing factors to this ethos for the purpose of putting in place appropriate corrective policy measures.