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***Regional Financial Integration: Its Potential Contribution to
Financial Sector Growth and Development in Sub-Saharan Africa***

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I. Introduction

The growth-critical, poverty-reducing role of well-developed domestic financial markets can hardly be overstated.² Unfortunately, except for a few middle-income countries, the financial sectors in most African countries lag on most indicators of development, even when compared to low-income countries in other parts of the world (Gulde et al, 2006).

Regional financial integration could potentially address several of the issues associated with the small, fragmented financial markets in Africa. Consolidated financial markets can yield many benefits: bring together scarce savings, viable investment projects and financial infrastructure; boost the numbers and types of financial institutions and instruments; increase competition and innovation; reduce inefficiencies in lending; expand opportunities for risk diversification; help improve regulatory and supervisory bodies; insulate central banks from domestic fiscal excesses; harmonize regional laws and institutions; and create additional opportunities for learning by doing.

However, the long, uneven history of attempts to integrate markets in sub-Saharan Africa (SSA) casts doubt on the potential gains from regional integration, while the current configuration of multiple and overlapping regional arrangements in Africa may well be a significant hindrance to the realization of these gains.³ Despite a proliferation of regional policy initiatives and institutions, actual market integration has been constrained by several factors: limited intra-regional trade, lack of political will in some quarters, underdeveloped economic and financial infrastructure, and limited regulatory and supervisory capacities. Moreover, regional integration may not solve all the problems that plague African financial markets. For example, it does not directly address low savings and productivity, market inefficiencies, barriers to access, or scarcity of assets that can serve as collateral.

¹ The authors thank, without implicating, Robert J. Corker and colleagues in the IMF's Money and Capital Markets Department for their comments.

² For a detailed exposition on the growth-critical role of financial markets in the mobilization of savings, channeling investible resources, information dissemination, diversification and risk management, lowering transaction costs, etc. please refer to Levine (1997, 2004). Financial development also aids in poverty-reduction by alleviating credit constraints on low-income households and insuring against shocks (Galor and Zeira, 1993)

³ For a list of the regional groupings and their membership please see Appendix Chart 1.

This paper examines how regional financial integration can help address some of the obstacles that have caused financial sector development in Africa to trail behind that in most developing countries. The purpose is to assess the potential role for regional financial integration in Africa, in light of theory and past experience, both in SSA and elsewhere. To do so, we analyze in detail how regional financial integration could in theory address these problems (Section II); what role regional integration has actually played thus far in African financial sector development (Section III); and what lessons can be learned from instances of regional financial integration in other parts of the world (Section IV).

Our analysis indicates that financial integration can contribute significantly to strengthening and developing SSA's financial markets, provided (1) policymakers are firmly committed to integration, including to allowing regulators to be independent of national government interference, and (2) there is an equally firm commitment to broader economic integration and building on existing networks, reinforced by a financial commitment to building the necessary infrastructure. However, even if these factors are present, financial integration will not solve one major problem — access to financial services for economically and geographically excluded people — and may even make it worse. So, at the same time as pursuing regional financial integration, policy makers should be addressing domestic financial development aggressively through separate channels.

II. How Could Regional Financial Integration Address Africa's Financial Sector Challenges?

Regional financial integration in theory

Regional financial integration refers to a process, market driven and/or institutionalized, that broadens and deepens financial links within a region. At the very least, this process involves eliminating barriers to cross-border investments and differential treatment of foreign investors. Further deepening of financial links can take the form of harmonizing national policies, laws, and institutions. Over time, cohesion of regulatory frameworks, operational structures, and information systems, and convergence of prices and risk assessments mean that national financial markets within the region effectively function as one. Taking this concept further, a group of countries may set up a regional bond or stock market, distinct from and potentially coexisting with national markets, with the specific intent of pooling resources, risks, and returns. Whatever form they take, functioning regional financial markets have a certain minimum set of prerequisites (Addo, 2007): currency convertibility and payment systems to reduce settlement delays; information and communication infrastructure; and the removal of legal and regulatory barriers.

Regional financial integration can help small financial markets take advantage of the “systemic scale economies” that accrue to larger systems.⁴ Regionalism can offer significant opportunities for allocating capital to its most productive use, propel financial development within the region, and bring additional benefits on the institutional side (Garcia-Herrero and Wooldridge, 2007).

- Regional markets expand the scale of and opportunities for financial intermediation. Pooling national savings can facilitate the financing of large, lumpy investment projects, where funding for such projects might be scarce or unavailable at the national level.
- Larger markets can make it more cost effective to improve aspects of the financial infrastructure, such as payments systems, regulation and supervisory regimes, all of which have high initial fixed costs.
- Regionalization can introduce efficiencies in financial markets. By raising the number and diversifying the types of financial institutions that operate in a particular local market, integration fosters competition and lowers the prices of financial products and services.
- Small financial systems are more likely to be incomplete. Smaller markets are typically skewed in terms of the available institutions (banks rather than non-bank institutions) and instruments (debt rather than equity). Information markets are also likely to be incomplete as high-cost credit rating services are usually absent.
- Regional markets are better able to cope with risk. They allow for greater diversification of assets and markets for individual investors. And they allow individual financial systems to tap into a collective pool of reserves in the event of an idiosyncratic shock or speculative attack.
- Regional reporting requirements can compel greater accountability and transparency on the part of national monetary authorities. Regional institutions can also inure central banks against pressures from national fiscal authorities.
- Finally, regional financial integration can lead to a harmonization of business practices, laws and institutions, closer to those prevailing in the most developed member state.

⁴ The following discussion on “systemic scale economies” draws on Bossone, Honohan and Long (2001), and Bossone and Lee (2004).

The process of regional integration does not necessarily preclude integrating globally, via an overall capital account liberalization. But the two are quite different. Low-income countries lacking in sound policies and strong institutions might be especially vulnerable to macroeconomic volatility from exposure to global financial markets (Demirguc-Kunt and Detragiache, 1999; Alfaro et al, 2005). Regional rather than global, liberalization of trade in financial services may be a more advisable first step for these countries and put less of a strain on the regulatory authorities.

But regional financial integration also raises the likelihood of cross-border spillovers of financial distress and contagion risks.⁵ Where financial systems are small and underdeveloped, a few large financial institutions with complex balance sheet linkages and exposures across markets, beyond the monitoring ability of the local monetary authorities, may make it difficult for the supervisory and regulatory authorities to do their job effectively, with concomitant risks.

Moreover, there are limits to the benefits that can accrue from regional financial integration, depending on the commonalities and dissimilarities of member profiles. When the members of a regional sub-grouping have very similar structures and challenges, regionalization may pool rather than solve national problems. For instance, where all member financial systems are characterized by excess liquidity and high interest rate spreads, that might indicate a region-wide paucity of viable investment projects and long-standing structural problems. Regionalization, without national efforts to address the core problems, will not be effective here. The gains from harmonizing of practices and laws might also be limited in a regional grouping with similar low initial conditions. And even after some form of regional integration, several small country groupings may still not reach the threshold needed to benefit from scale economies (Honohan and Beck, 2007). Thus, some combination of regional and multilateral liberalization may be what works best for low-income countries (Jansen and Vennes, 2006).

In addition, while advanced members can serve as effective benchmarks for other members, a regional grouping with asymmetric partners raises the risk that financial resources will flow primarily towards the member country with the most viable investment options, stunting the development of credit markets in smaller countries — though the smaller markets may still benefit from improved payments and regulatory regimes, and possibly from improved financial services for savers. On the other hand, banks that might have sought increased market share by expanding to unserved customers and areas may instead seek to compete for the business of already-served customers in the regional markets now open to them.

⁵ For details on fundamental cross-border effects and contagion see Faruquee (2007).

The status of financial markets in Africa

There is a great deal of disparity in the development of financial markets among the countries in sub-Saharan Africa. At one extreme, some countries are in the process of setting up rudimentary payments systems and other support infrastructure in the aftermath of a period of political and economic disruption. And at the other extreme are those grappling with policies to promote offshore banking and effective integration into global capital markets.

In general, however, the region has shallow, underdeveloped financial markets (Figure 1). Their development has been hampered by a multitude of factors. Common problems include poverty, political and economic uncertainty, fiscal dominance, lack of effective collateral and information systems, weak judicial institutions, limited investment opportunities in the private sector, exposure to significant external shocks, technological constraints, and the shortage of skilled personnel with expertise in banking and finance. Theory would tell us that many, but not all, of these problems could be eased through regional financial integration.

Most financial sectors in SSA can be characterized as small, regardless of how “small” is defined: in terms of the number of financial institutions and their market capitalization; the range of financial institutions, products and services; the availability of investment opportunities; the proportion of the population with access to formal financial services; the size of the support infrastructure; or the resources of the regulatory authorities. Small market size means that most African financial systems cannot take advantage of many of the “systemic scale economies” already discussed. For instance, Table 1 indicates how small stock markets in sub-Saharan Africa are, even relative to low-income countries as a group.

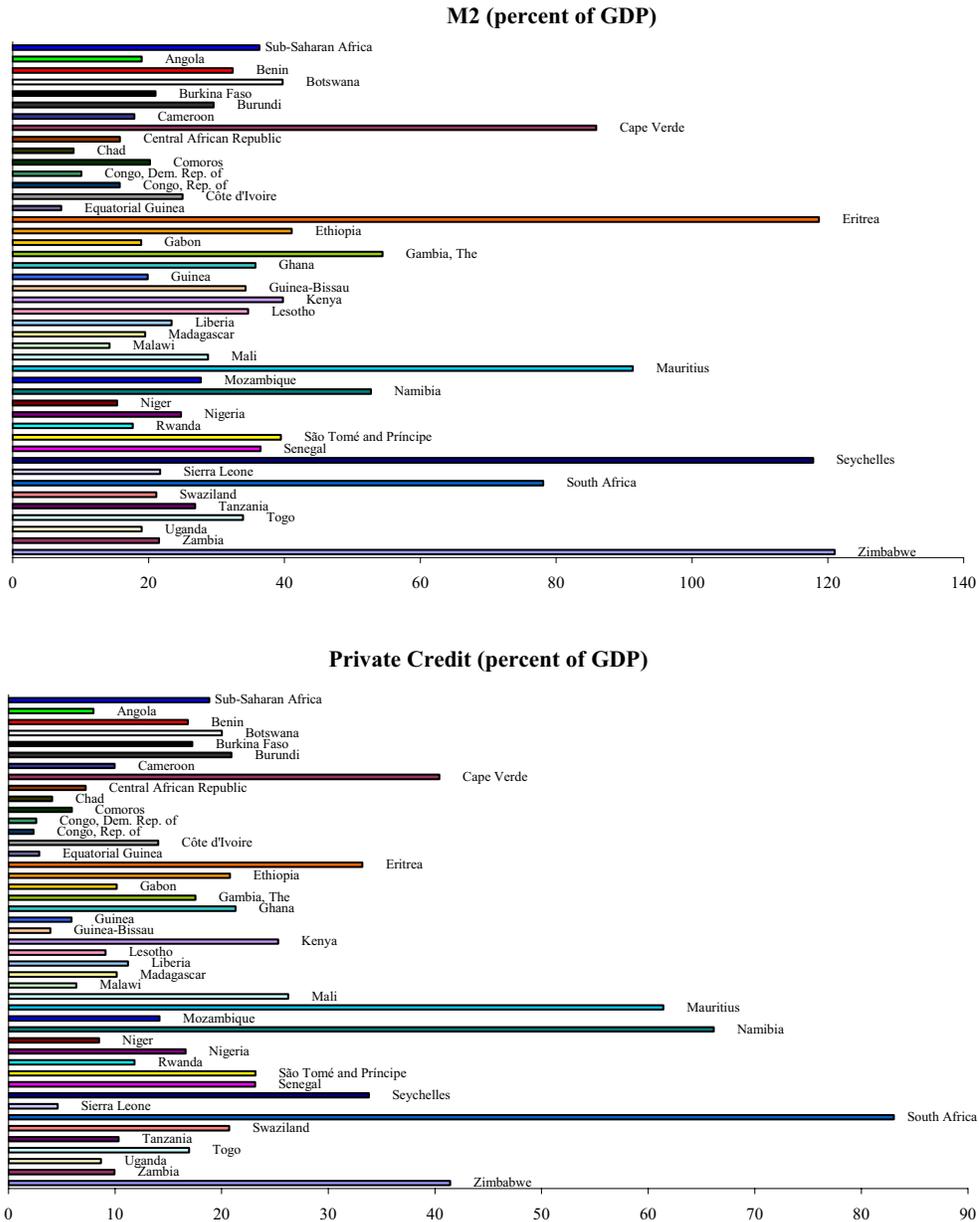
Table 1. Sub-Saharan Africa: Stock Market Development Indicators

	Number of Listed Companies (total)	Market Capitalization (percent of GDP)	Stocks traded, turnover ratio (percent)
Botswana	18	38.2	2.4
Cote d'Ivoire	40	23.8	3.7
Ghana	32	13.4	3.4
Kenya	51	53.7	15.8
Mauritius	41	55.8	6.0
Namibia	9	8.5	4.6
Nigeria	202	28.6	13.8
South Africa	401	280.4	49.5
Swaziland	6	7.5	0.0
Tanzania	6	4.7	2.3
Uganda	5	1.2	3.1
Zambia	12	13.6	2.0
Zimbabwe	80	..	7.9
Low-income countries	6122	74.5	97.6

Source: World Development Indicators, 2007.

Note: Data are for the most recently available year, 2005 or 2006. Low-income countries are as defined by the World Bank.

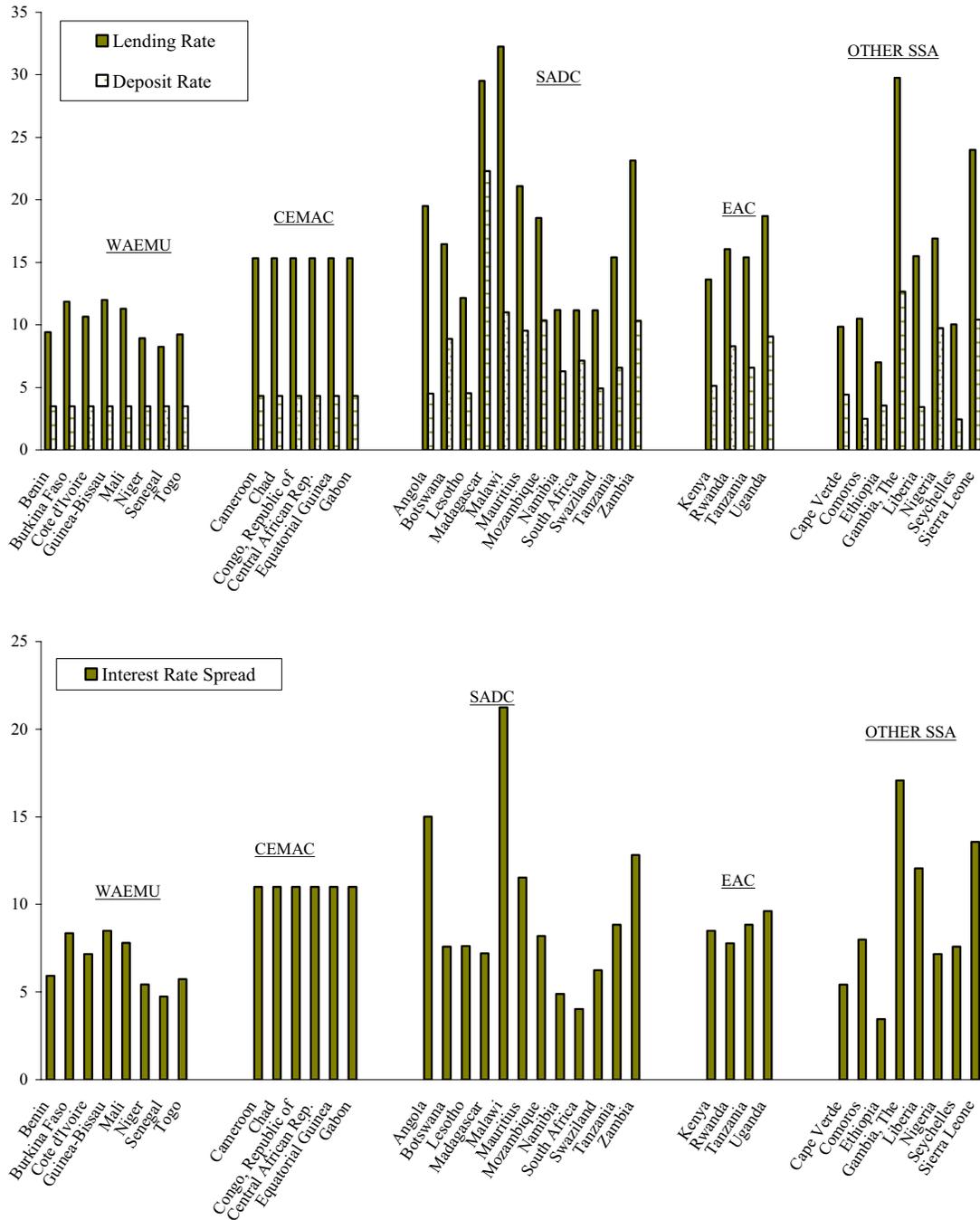
Figure 1. Sub-Saharan Africa: Financial Indicators, 2006



Source: IMF, African Department Database, 2007.

The banking sector dominates the financial systems in most African countries. Most banks are fairly sound but not particularly efficient, with high overhead costs. Most banking systems are characterized by excess liquidity and high real lending rates and interest rate spreads (Figure 2). Nonbank financial institutions and capital markets have a limited presence in only a few countries. Financial institutions in general are held back by poor governance and a non-transparent operating environment.

Figure 2. Interest Rates, 2006



Source: International Financial Statistics Database, 2007; BCEAO

Note: Interest spreads are calculated as the difference between the lending and deposit rates for 2006, where data are available. For CEMAC countries the data are the interest rates set by the central bank, the effective rates may vary by country depending on charges, fees, and type of clients. For WAEMU the lending rates are the prime lending rates in July 2007.

The public sector has long had a strong presence in African financial markets, both as owner and borrower. Although this role has been declining in recent years, the scarcity of private sector investment opportunities and the limited autonomy of monetary authorities mean that government securities still feature prominently in the portfolios of most financial institutions.

The theory applied to Sub-Saharan Africa

Given the small, fragmented structure of African financial markets, the most obvious advantage of regional integration is that it increases market size. Small financial systems that come together stand to exploit economies of scale in such areas as banking supervision, information sharing systems and other market infrastructure with high fixed costs. Pooling resources to finance large investment projects at the regional level can also be useful where financial markets are shallow. In fact, as the proliferation of cross-border banks in Africa indicates, given the advantages of wider markets, financial institutions find ways to operate with multiple sets of rules even without formal attempts at standardization (World Bank, 2007). But they would be more efficient and effective if national regulatory and other differences were removed.

Regionalization would promote this institutional cohesion — the upgrading and harmonization of local practices. Financial laws and frameworks in the relatively advanced financial markets in Africa could serve as benchmarks for other members in their regional groupings.⁶ And the adjustment and regulatory burden of this harmonization process might be lower than that of integrating into advanced global financial centers.

Regional institutions can also serve both to attract international capital flows and act as the first line of defense against sudden reversals of such flows. African countries are only now beginning to feel the impact of the steady expansion of cross-border private capital flows that has taken place over the last decade or so. While the number of SSA countries rated by international credit rating agencies has grown in recent years, the median rating, excluding South Africa, is B — well below investment grade (IMF, 2007, Box 2.3). The pooling of reserves increases the likelihood that national financial systems will be able to withstand shocks. Thus, a group of countries could inspire more confidence in international capital markets than an individual country.

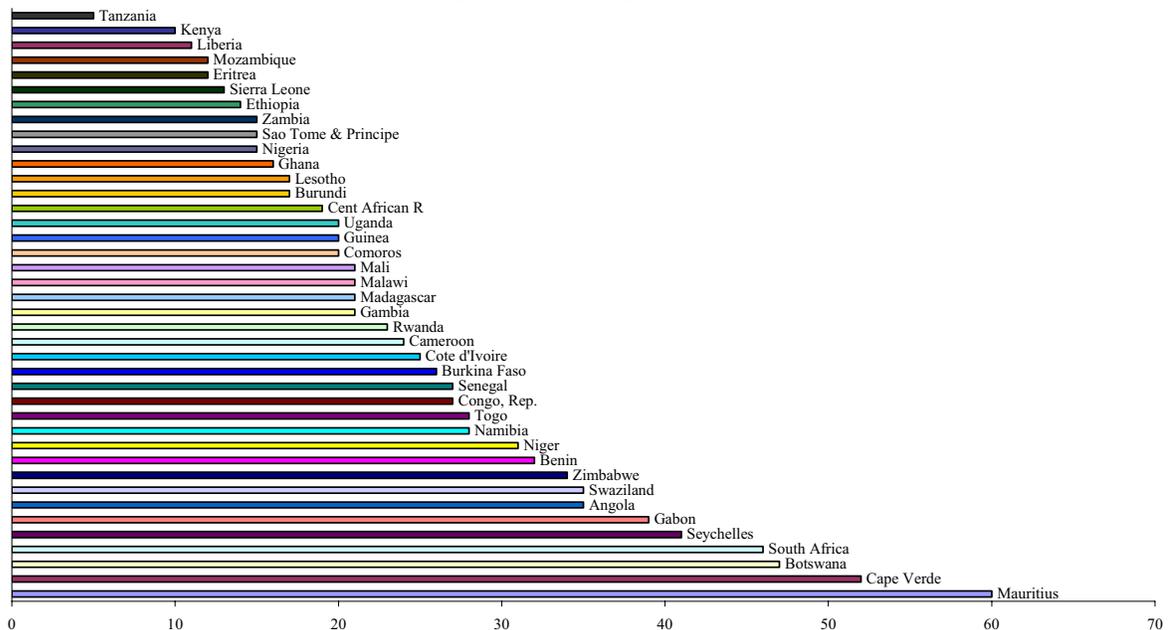
Regional integration can function as an external agency of restraint and enhance the credibility of the monetary authorities where the government has a long history of bank financing of the fiscal deficit. Supranational monetary authorities are more likely to be immune to pressures from national authorities to finance fiscal deficits. In addition,

⁶ In the absence of viable domestic investment opportunities, less developed members in asymmetric regional groupings do run the risk of losing their scarce savings to the more advanced members. But this risk is lower at the regional rather than the global level.

supranational supervisory authorities can more easily resist national political interference in supervisory matters. This is one way to ensure that the recent downsizing of the role of the government in the region is not reversed.

However, regional integration may have limited success in addressing one of the main financial sector issues in SSA— access to formal financial services and products (Figure 3). Fewer than 20 percent of African adults have an account with a formal or semiformal financial institution (Honohan and Beck, 2007). Even though microfinance institutions do serve some of the financial needs of low-income households and small and medium enterprises, what might be more effective are domestic financial sector strategies with innovative savings and credit products and effective methods of reaching all segments of the population (for instance, via mobile phone banking). Regional integration, by replicating existing lending patterns on a larger scale, may in fact worsen the problem of financial exclusion,

**Figure 3. Access to Financial Services
(percent of adult population)**



Source: Honohan (2006).

Note: For details on the underlying methodology please consult Honohan (2006).

III. Actual African Experience with Regional Financial Integration

Africa has a long, albeit uneven, history of attempts at regional cooperation. Established in 1910, and subsequently updated and relaunched in 1969, the Southern African Customs Union (SACU) between South Africa, Botswana, Lesotho, Namibia, and Swaziland, is the

oldest customs union in the world. Monetary cooperation along historical colonial lines is more common among African countries than in other parts of the developing world. The CFA zone countries constitute one such long-standing monetary union.

Recent years have seen a renewed interest in new forms of regional cooperation and the revitalization of those already in existence. Part of the inspiration has come from the recent successes of the larger markets in the developing world, China and India. Political will, advances in information and communication technology, and a desire to consolidate markets, are all driving the discussion on how regional integration can address some of the problems that hinder financial sector development in Africa.

In what follows we look at a select sample of regional arrangements, those where the trend is toward financial market integration. We seek, in light of the previous theoretical discussion, to assess both what they have done to enhance regional financial integration, and the impact of those measures.

CFA Franc Zone

The CFA franc zone has survived decolonization, a significant devaluation, and a transformation of its peg currency. The two regions that comprise the CFA franc zone, the West African Economic and Monetary Union (WAEMU), and the Central African Economic and Monetary Community (CEMAC,) each have its own regional central bank and distinct versions of the CFA franc. While these regions represent two of the more advanced examples of institutionalized financial cooperation (WAEMU more so than CEMAC) they do not have well-integrated financial markets (Masson and Pattillo, 2005). For instance, while it is true that banks need to obtain only a single permit (*agrément unique*) to operate within WAEMU or CEMAC, they are additionally required to get permission from national finance ministries before they can operate in individual member countries. Hence, banks typically stay within national borders and the region does not have an effective interbank market.

Both regions have shown some progress in harmonizing of structural policies via a common business law. But the most important area of cooperation thus far has been regional surveillance. Recognizing that the 1994 devaluation was precipitated in some part by the fiscal excesses of some member states, the two regions have since adopted fairly conservative macroeconomic convergence criteria.

WAEMU

Fostered by regional institutional arrangements and the abolition of all capital controls, integration of financial markets in WAEMU is further along than in other parts of Africa,

especially when it comes to harmonization of rules.⁷ A single banking commission was created in 1990 to reinforce regional banking supervision (*Commission Bancaire de l'UMOA*). However, despite the presence of the commission and the BCEAO (*Banque Centrale des Etats de l'Afrique de l'Ouest*), the regional central bank, some national banking systems are still fragile and the interbank market is underdeveloped. Given the gaps in risk assessment and the lack of collateral, activity in the regional interbank market is largely restricted to in-group subsidiaries. Excess liquidity in some banking systems continues to coexist with liquidity shortages in others. Differential reserve requirements by country, ranging from 3 percent in Guinea-Bissau and Togo to 15 percent in Benin, further distort cross-border competition.

Since 1998, the *Bourse Régionale des Valeurs Mobilières* (BRVM) has served as a regional exchange for trades in stocks and bonds. The growth of this exchange has been curtailed by the political disruptions in Côte d'Ivoire and is concentrated in the bond markets. In 2006, total market capitalization was just under 24 percent of regional GDP, and the bourse lists 40 companies, compared to a market capitalization of 280 percent of GDP and 401 listed companies at the Johannesburg Stock Exchange.⁸ Prospects for further growth of the market are constrained by both supply-side factors (a dearth of large listable companies in the WAEMU region), and demand-side factors (a dearth of institutional investors).

Progress on other fronts of market integration has been achieved largely through supranational regulatory laws and bodies. Since 1995, the regulatory framework for cooperative financial institutions has been based on the PARMEC law (*Projet d'Appui à la Réglementation sur le Mutuelles d'Epargne et de Crédit*). In the rapidly proliferating area of microfinance, a regional institution—*Banque Régionale de Solidarité* (BRS), with regional institutional shareholders—has been created. The BRS tends to concentrate largely on refinancing microfinance institutions rather than provide direct loans (Bred Gestion, 2006).

One encouraging development is the rapid growth of the regional market in local currency debt, especially public debt. Spurred by the cessation of central bank financing of fiscal deficits, the market in treasury bills and government bonds has been expanding since 2000. In the absence of restrictions regional investors within WAEMU, mostly banks, have in recent years taken up roughly half the treasury bills issued. In fact, the rapid growth of the treasury bill market in WAEMU, the excess liquidity in most banking systems, and the continuing lag in private sector investment opportunities has meant that governments in these countries have been able to raise funds at low costs largely unrelated to their credit ratings (Sy, 2007).

⁷ However, WAEMU countries have retained a number of capital controls vis-à-vis investors from outside the region and residents wanting to invest abroad.

⁸ Based on data from the World Development Indicators.

Despite these institutional measures, further regional integration in the WAEMU is made difficult by continuing challenges. Intraregional trade, at just over 10 percent of total trade, is a poor motivator for further integration. And while substantial progress has been made on the harmonization front there are still differences across borders. For example, bankruptcy proceedings and rules on the realization of collateral vary across countries. Despite the *agrément unique*, national authorities continue to use discretion in licensing and de-licensing of banks.

The deeper structural problems that have plagued member countries also make it harder to build regional financial markets. The lack of diversification in economic activity across the region means that investor portfolios are limited to a few assets and there is very little cross-border competition in lending. One clear sign of the lack of effective integration of financial markets in WAEMU member countries is the simultaneous co-existence of liquidity shortages in some countries with substantial excess liquidity in other countries and region-wide.

CEMAC

Financial integration in the CEMAC remains limited and significant impediments continue to exist, despite a common currency area and a comprehensive regional institutional setup. In fact, financial integration lags behind that achieved by WAEMU despite a similar institutional setup. Some of the structural problems that hinder WAEMU financial integration are exaggerated in the CEMAC region. Because CEMAC countries are predominantly oil-producers, diversification of economic activity and investment opportunities is a bigger problem here. Institutional initiatives have also lagged behind WAEMU. Reform of the regional payments system that was launched in 2003 has been slow. This contrasts with WAEMU, where a modernized payments system (STAR-UEMOA) is in the final stages of implementation. Moreover, political will for regional integration is low among CEMAC members.

Not unlike the rest of Africa, financial markets in CEMAC countries are dominated by banks. The regional banking commission, the Commission Bancaire de L'Afrique Centrale (COBAC) is charged with overseeing bank compliance with prudential norms and granting or withdrawing licenses. Despite the harmonization of banking laws on paper, differences in operational efficiencies, reserve requirements and taxation regimes for banks mean that banking sector integration is still incomplete (Saab and Vacher, 2007). So CEMAC financial systems have not been able to realize the efficiency gains that accrue from greater competition. The interbank market is highly underdeveloped and there is no mechanism or incentives for the flow of funds from banking systems with excess liquidity to those with demand for liquidity.

A regional stock exchange (BVMAC) was established in 2003, independently of the Douala Stock Exchange (DSX) established by Cameroon; trading has not commenced in either market. Given the small base of large companies and investors it seems unlikely that both exchanges will be viable. Moreover, the simultaneous development of two securities exchange creates the potential for conflict between national and regional rules and unnecessary duplication of costs.

Southern Africa

In the southern part of the continent, integration is driven predominantly by the presence of the region's economic giant, South Africa. This does not mean that formalized institutional arrangements are absent. Regional integration has taken place formally between the overlapping memberships of the Southern African Customs Union (SACU) and Southern African Development Community (SADC).

The regional dominance of South African financial institutions is especially strong in the subgroup that makes up the Common Monetary Area (South Africa, Lesotho, Namibia and Swaziland). However, the incomplete convergence of interest rates within this subgroup implies that institutional differences and the limited investment opportunities outside South Africa hamper market integration (Aziakpono, 2005). Nevertheless, in 2003 South African banks accounted for more than 70 percent of banking assets in Namibia, Lesotho, and Swaziland, and they have been making significant inroads in other SADC markets (Jansen and Vennes, 2006).⁹ The market-driven character of this process poses its own set of challenges for the host regulatory authorities, who may not have the resources or the experience to monitor the sophisticated cross-border financial institutions. Moreover, despite this regional integration, the disparity in the levels of financial development among CMA members still persists (Aziakpono, 2004).

Since 1997 the Committee of SADC Stock Exchanges (COSSE) has been promoting the harmonization of listing standards for SADC members that have stock exchanges to the listing standards of the Johannesburg Stock Exchange (JSE). The medium-term goal is to set up a system of automated trading of nationally-listed securities at the regional level.

East African Community

Kenya, Tanzania and Uganda—the three original members of the EAC have a long—sometimes contentious history of regional cooperation based on a common legal tradition and

⁹ The current membership of SADC includes Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

long-standing trade ties.¹⁰ In 2001 the EAC was relaunched, with the goal of creating a common market, common currency and ultimately a political union. Thus far, the most concrete development has been the implementation of the customs union in 2005, presumably in an effort to increase the very modest levels of intra-regional trade (Table 2).

Table 2. EAC Countries: Bilateral Trade Flows
(Averages for 1995-99 and 2000-06)

Exports from Country 1 to Country 2 (percent of Country 1's total exports)										
Country 1	1995-99					2000-06				
	Country 2					Country 2				
	Burundi	Kenya	Rwanda	Tanzania	Uganda	Burundi	Kenya	Rwanda	Tanzania	Uganda
Burundi	0.00	1.86	2.81	2.97	0.23	0.00	5.46	5.75	0.11	1.47
Kenya	0.29	0.00	2.24	10.44	14.96	1.19	0.00	2.70	8.16	17.42
Rwanda	1.02	0.53	0.00	0.15	0.00	0.52	0.07	0.00	0.05	0.45
Tanzania	0.47	3.71	2.62	0.00	1.32	1.50	3.05	0.50	0.00	1.28
Uganda	0.00	0.46	0.29	0.68	0.00	1.70	9.01	3.41	1.34	0.00

Imports from Country 2 to Country 1 (percent of Country 1's total imports)										
Country 1	1995-99					2000-06				
	Country 2					Country 2				
	Burundi	Kenya	Rwanda	Tanzania	Uganda	Burundi	Kenya	Rwanda	Tanzania	Uganda
Burundi	0.00	4.59	0.75	2.93	0.00	0.00	13.24	0.48	9.99	3.26
Kenya	0.04	0.00	0.02	0.62	0.09	0.00	0.00	0.00	0.40	0.25
Rwanda	0.53	16.26	0.00	6.75	0.52	0.81	20.03	0.00	1.53	5.01
Tanzania	0.10	9.24	0.01	0.00	0.22	0.00	7.02	0.00	0.00	0.32
Uganda	0.03	38.15	0.00	1.14	0.00	0.00	31.09	0.06	0.85	0.00

Source: Direction of Trade, 2007

While the EAC is generally not considered ready for a monetary union and common currency, it has made some progress in integrating its financial markets. The banking sector exhibits a high degree of integration, as subsidiaries of multinational banks operate in all three countries. Lack of a single currency is not seen as a barrier to further progress. The region does not have a single central bank, but regulators have shown a strong commitment to staying on top of regional developments, although there is much scope for harmonizing the rules.

In 1997 the original members of the EAC set up the East African Member States Securities Regulatory Authorities (EASRA) to harmonize and regulate capital market policies, encourage cross-border listings and develop a regional rating system for listed companies. National exchanges have also undertaken several initiatives to promote regional integration and market growth. A number of steps have been taken to ensure that EAC investors face minimal barriers to entry in member stock exchanges. The issuance of medium-to-long-term government bonds has helped market development by setting a benchmark. EAC members have harmonized trading rules around the standards set by Kenya's Capital Market Authority.

Before financial integration in the EAC can go much further, there is an urgent need to upgrade, standardize, and institutionalize at the regional level several aspects of the financial

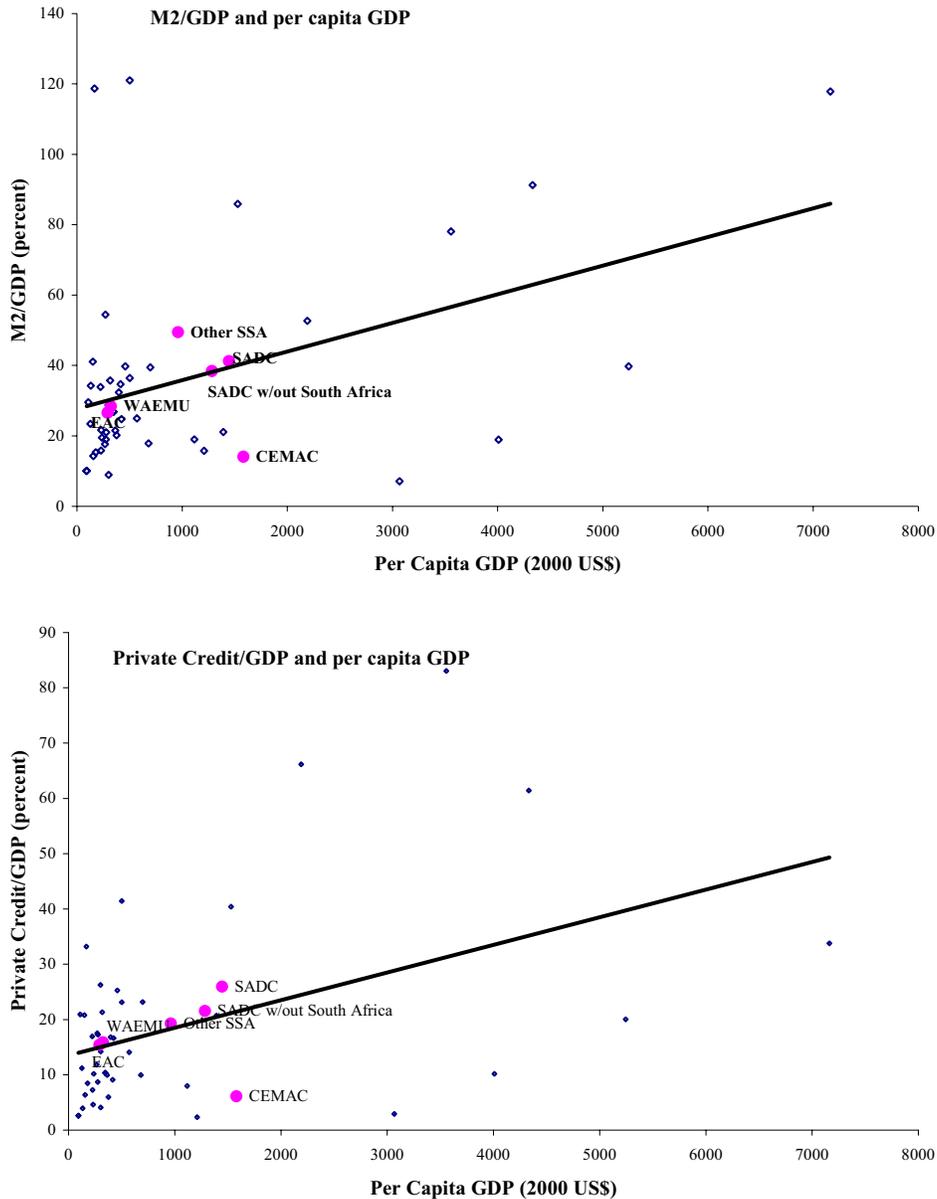
¹⁰ Burundi and Rwanda joined the organization in June 2007.

infrastructure, including regulation, payments systems, legal frameworks, accounting practices, and credit information. This process has been further complicated with the entry of Burundi and Rwanda, whose financial sector development and structures are quite different from those of the original membership.

Why has Africa not seen the benefits from financial integration that theory promises?

Many of the hypothesized gains from regional integration have not been manifested in the actual experience of regional organizations in Africa. Money/GDP ratios in all these regions remaining below the very low average of other SSA countries (Figure 4). The disappointing progress is attributable to a number of factors:

Figure 4. Broad Money, Private Credit and per capita GDP



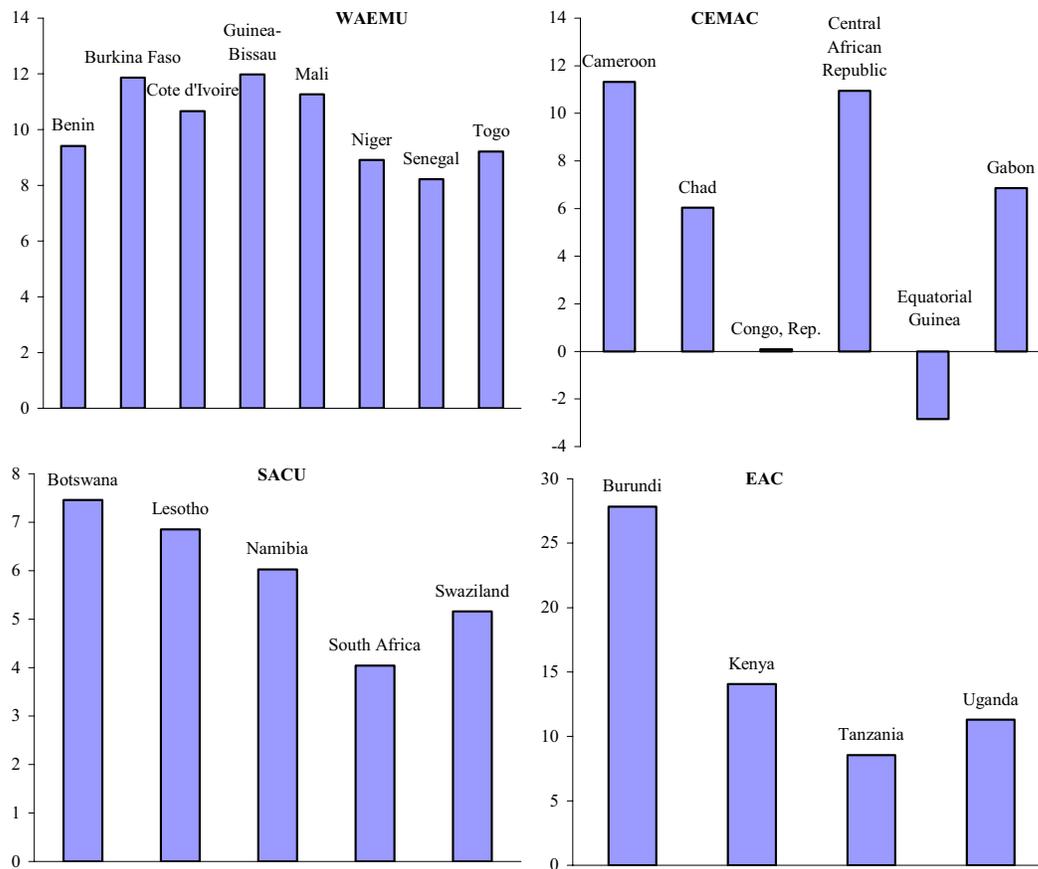
Source: IMF, African Department Database, 2007.

Note: The plots are based on data for 2006. Regional aggregates are calculated as simple averages of their memberships. Other SSA includes countries that are not members of the regional groupings indicated here.

A large part of the problem is the current “spaghetti bowl” configuration of regional arrangements in Africa right. The pattern of multiple, overlapping, and often contradictory regional memberships and commitments endangers political cooperation and increases the likelihood of conflicts of interest and confusion regarding the priorities of individual members.

Even within the more advanced examples of financial cooperation, there have been problems with the sequencing and prioritization of the steps towards integration. The general tendency has been to concentrate on the creation of regional financial institutions while paying less attention to pre-existing financial links between multinational financial institutions that operate in more than one market. Encouraging and regulating the looser links between cross-country financial institutions might in some cases be more effective than creating a centralized regional body. *De facto* integration among banks in the SACU region has been more effective in harmonizing real borrowing costs than the *de jure* integration in the CEMAC or EAC regions (Figure 5).

Figure 5. Real Cost of Borrowing



Source: World Development Indicators, 2007; BCEAO; IMF, Information Notice System, 2007.

Note: Real cost of borrowing is the lending rate adjusted for inflation for 2006. For WAEMU countries the real cost is calculated as the prime lending rate in July 2007 adjusted for inflation in that month.

Underdeveloped domestic financial markets have also been a stumbling block for regional integration. The functioning and growth of regional markets is easier when domestic markets provide the basic underpinnings. In a classic chicken and egg dilemma, regional pooling of

resources cannot develop domestic financial markets unless the domestic markets have already reached a minimal degree of development.

While it seems clear that “systemic scale economies” await regional markets in Africa, it is not as clear what the most suitable scale actually is, or how to achieve it. Regional groupings comprised of similar members generally lack benchmarks and seem to pool their problems as well as well their resources (e.g., CEMAC). Less developed members in asymmetric groupings seem unable to bridge the development gap with the more advanced members (SACU).

But perhaps the most important reason SSA countries have not seen the benefits from regional financial integration that theory promises is that, even in the most integrated region (WAEMU), true financial sector integration does not exist. Effective regional financial integration requires the subordination of short-term national interests to the goal of regional financial market development. The continuation of national government intervention in regulatory and supervisory decisions, and in many cases of different national regulations, as well as efforts to protect national interests, undermines efforts to create true regional financial markets.

IV. Lessons from other parts of the world

Perhaps experiences with regional financial integration in other parts of the world can offer African policymakers with some insights regarding how to pursue more effective financial integration.

The European Union

As the most advanced example of regional financial integration, the European Union (EU) seems like the most obvious place to begin this exercise. However, given the stark differences between European and African economies, great care must be taken in trying to apply lessons from the EU to Africa. The “European model” of financial market integration has evolved and adapted over decades, and functions in an institutional and economic environment that is in many respects quite different from that found in most African countries.

The European Commission’s 1985 White Paper lays down two, seemingly irreconcilable, principles for integration — mutual recognition and harmonization (Steil, 1999). Mutual recognition or “competition among rules,” as the concept is also known, ensures the continued existence of separate and distinct national legal and regulatory systems. Harmonization of minimum standards calls for member states conform to certain EU specified requirements, and thus limits the scope for “competition among rules”. This tension

is inevitable in any process of merging national markets. What did help the reconciliation process in the EU is that the volumes of cross-border trade and investments on the ground were quite large—quite unlike the situation in SSA. So the institutional process was actually reflecting, and may even have been lagging behind, the market. In Africa by contrast, some of the more advanced examples of regional integration are based on a pre-existing currency arrangement, based on the region's colonial history. Intra-African trade and investment, outside of certain concentrated pockets, is relatively limited. Moreover, given the similar structure of most African economies, it is not clear that there is a vast untapped potential to increase the scale of such trade (Honohan and Lane, 2000). While regional integration could address some of the barriers to regional transactions, a process driven more by theory than existing economic ties is likely to be quite challenging.

Even with the requisite political will and a long history of cross-border economic transactions, the resource requirements for creating and sustaining integrated financial markets within the EU have been considerable. Since the beginning, grants by the Structural Funds, loans by the European Investment Bank, and more recently guarantees by the European Investment Fund have played a role in making the overall process of integration effective and equitable (Griffith-Jones, Steinherr, and Fuzzo De Lima, 2006). These mechanisms have allocated substantial funds to building the necessary infrastructure, including communication and transport networks, to facilitate regional transactions. At the same time, resources have also been allocated to mitigating the income differentials between member states, including those created by the emerging pattern of regional trade and investment.

The initial institutional environment faced by the EIB was not dissimilar to that found in several Africa countries today — capital controls, small, segmented capital markets, discrepancies in banking sector development, incomplete information markets. This market-developing role of financially sound, effective regional institutions, especially the European Investment Bank (EIB), should be of particular interest to African countries. It highlights the need for an overarching regional body to play a promotional role in setting up the financial infrastructure needed to support the development and operation of regional markets. It also highlights the vast resource requirements necessary for such a body to play its role effectively. One reason for the EIB's continued financial soundness has been prudent lending policies, as it will not lend to weaker members without credible third party guarantees. This approach is likely to be severely limiting for a regional organization with several poorly rated members, and illustrates the difficulties in setting up a similar well-funded organization in the African region.

Developing countries

The experience of other developing countries might be more relevant to African policy-makers — except that the path of regional financial integration in other parts of the developing world has been similarly problematic.

Chronic capital shortages at the regional level has meant that countries in **Latin America and the Caribbean** have been more interested in getting access to global financial markets — regional and global financial integration have served as complements rather than substitutes. For instance, among small country groupings, such as the **Caribbean Community (CARICOM)**, common regional standards can be just as effective as a means to attract foreign capital from global markets as they are to foster regional markets. In fact, most of the *de facto* regional integration here is the result of the subsidiaries of foreign banks that operate in more than one local market (IDB, 2002).

The experience of the **Central American Common Market (CACM)** illustrates that even one of the more successful trading blocs in the developing world will not necessarily evolve into common financial markets (Cooper, 2007).¹¹ In principle, policy-makers recognized the relationship between trade in goods and that in financial services. Preliminary attempts at integrating financial markets were made via the establishment of the Central American Central Bank System with the Monetary Council at its apex. But the institutional initiative never really got off the ground. A marked reluctance on the part of national interest groups and authorities, including the central banks, to align their interests has meant that financial cooperation in the region remains limited. Even with thriving intra-regional trade, political will plays a significant role in integrating financial markets.

In recent years, banking integration in Central America has taken place via subsidiaries of global financial institutions.¹² But the equity and private debt markets remain underdeveloped due to problems that are quite similar to those found in SSA — small, family owned business structures, economic and political factors, weak regulation and limited institutional investor base. And while the creation of a regional capital market seems more feasible than the development of many small national markets, the task is challenging. Regional initiatives to integrate capital markets, such as the Memorandum of Understanding on building a common trading platform signed by Costa Rica, El Salvador, and Panama in September 2006, have stalled due to technical difficulties (Shah et al, 2007). African countries wanting to embark

¹¹ Since its inception intra-regional trade in the CACM, comprising Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, has increased from 6.5 percent in 1960 to between 15-20 percent in recent years (Cooper, 2007).

¹² Several regional financial conglomerates (and their subsidiaries), that dominated the banking system in Central America, have recently been acquired by global financial institutions (Shah et al, 2007).

on a similar path would do well to weigh the benefits of pooling against the considerable initial set-up costs of a regional capital market.

On the institutional front, regional development banks created in the 1960s have since evolved to provide support to new national, sub regional and regional financial instruments, and improving the terms and cost at which members access global financial markets (Titelman, 2006).¹³ Having done better than national financial institutions through the crises of the 1980s and with reserves in excess of the Basel Core reserve requirements these development banks have a better credit rating than their members and hence they are able to access global markets on better terms than their members — a role that could be especially important to some smaller African economies with poor ratings.

The vulnerability of national financial systems remains a major source of macroeconomic instability in the region. Raising and harmonizing regulatory standards among members remains on the agenda, an issue that must be addressed with some urgency and separately from that of regional integration (Machinea and Rozenwurcel, 2006).

In the aftermath of the Asian Crisis of 1997-98 policy-makers in **East Asia**, not surprisingly, launched a number of regional policy dialogues to institutionalize the close linkages among their financial systems that the crisis had revealed. While the crisis had been precipitated by lack of investor confidence, it also indicated that, among the economies of East Asia, geographical proximity and structural similarities warranted the creation of some sort of a regional body charged with liquidity assistance, surveillance, and exchange rate coordination (Park, 2006). After attempts to create an Asian monetary fund were unsuccessful, the **Chiang Mai Initiative** (2000) has been the main forum to strengthen existing cooperation among the members of the Association of Southeast Asian Nations (ASEAN), plus China, Japan, and the Republic of Korea.

As East Asian economies acknowledge the need for regional coordination even when the only links between financial systems may be in the way that investors form expectations, they are also moving forward with the development of local bond markets to complement their bank-dominated national financial systems (Park et al, 2006). To this end, regional governments have created two **Asian Bond Funds (ABF)**, pooling a portion reserves from central banks.¹⁴ ABF1 channels investment to dollar-denominated bonds issued by sovereign and quasi-sovereign Asian borrowers, ABF2 does the same for local-currency bonds. ABF2

¹³ The Andean Development Corporation (1968), the Central American Bank for Economic Integration (1961), and the Caribbean Development Bank (1969) were all created as subregional development banks to mobilize medium to long term resources for productive investments.

¹⁴The central banks of China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand contribute to ABF.

might be of particular interest to African sovereigns trying to develop local currency debt markets, even though central bank reserves are significantly lower than those in Asia.¹⁵ The collaborative effort has yielded many benefits from “learning by doing” for Asian central banks. More significantly, they have also learned from each other’s experiences with market impediments (Ma and Remolona, 2005).

The “Asian model” of financial integration is based on cooperation rather than institutional integration. It might be especially relevant to African governments concerned about the impact of regional integration on national sovereignty.

V. Conclusion

Regional financial integration can play a significant role in developing domestic financial markets in Africa. But at the very least it requires that policymakers devise a coherent strategy based on the recognition that national interests can best be served by achieving regional goals.

Any strategy intending to realize the benefits of regional financial integration would be well-served by incorporating the lessons from Africa’s own experiences with regional arrangement thus far, as well as those from other parts of the world.

- Regional financial integration works best when it builds on pre-existing economic relationships between member states. The progress made by the EU can be attributed in large parts to existing trade ties between member states. Given the low levels of intra-regional trade in Africa, this calls for greatly strengthened efforts to enhance regional economic integration.
- Economic ties are necessary but not sufficient for successful regional financial integration. Merging financial markets is at least as much a political process as it is an economic one. Creating and sustaining regional institutions that can oversee and regulate the process requires a considerable amount of political will, particularly the will to let regional interests overrule temporary national interests, and the willingness to back it up with ongoing resource commitments.
- Well-functioning, autonomous regional institutions can play a significant role in market development. They can catalyze the harmonization of national policies and laws and present the common face of the regional grouping to the rest of the world.

¹⁵ For details on the recent activity in local-currency debt markets in sub-Saharan Africa please refer to IMF (2007, Chapter V).

But policy makers need to see the advantages of harmonized policies, and commit to supporting them.

- Most importantly, regional markets do not instantaneously fix everything that is wrong with domestic financial markets. In fact, underdeveloped domestic markets can be additional encumbrance to regional integration. Specific national problems warrant national financial sector development strategies.

Thus, for SSA countries to achieve successful regional financial integration, with all the resulting benefits in terms of larger, more efficient, more dynamic, and more stable financial systems, national governments must be firmly committed to both financial and economic integration, even to the extent of allowing short-term national concerns to be outweighed by the benefits of long-term regional cooperation. The alternative may well be the continuation of small, inefficient financial sectors, which are unable to contribute effectively to economic growth and poverty reduction.

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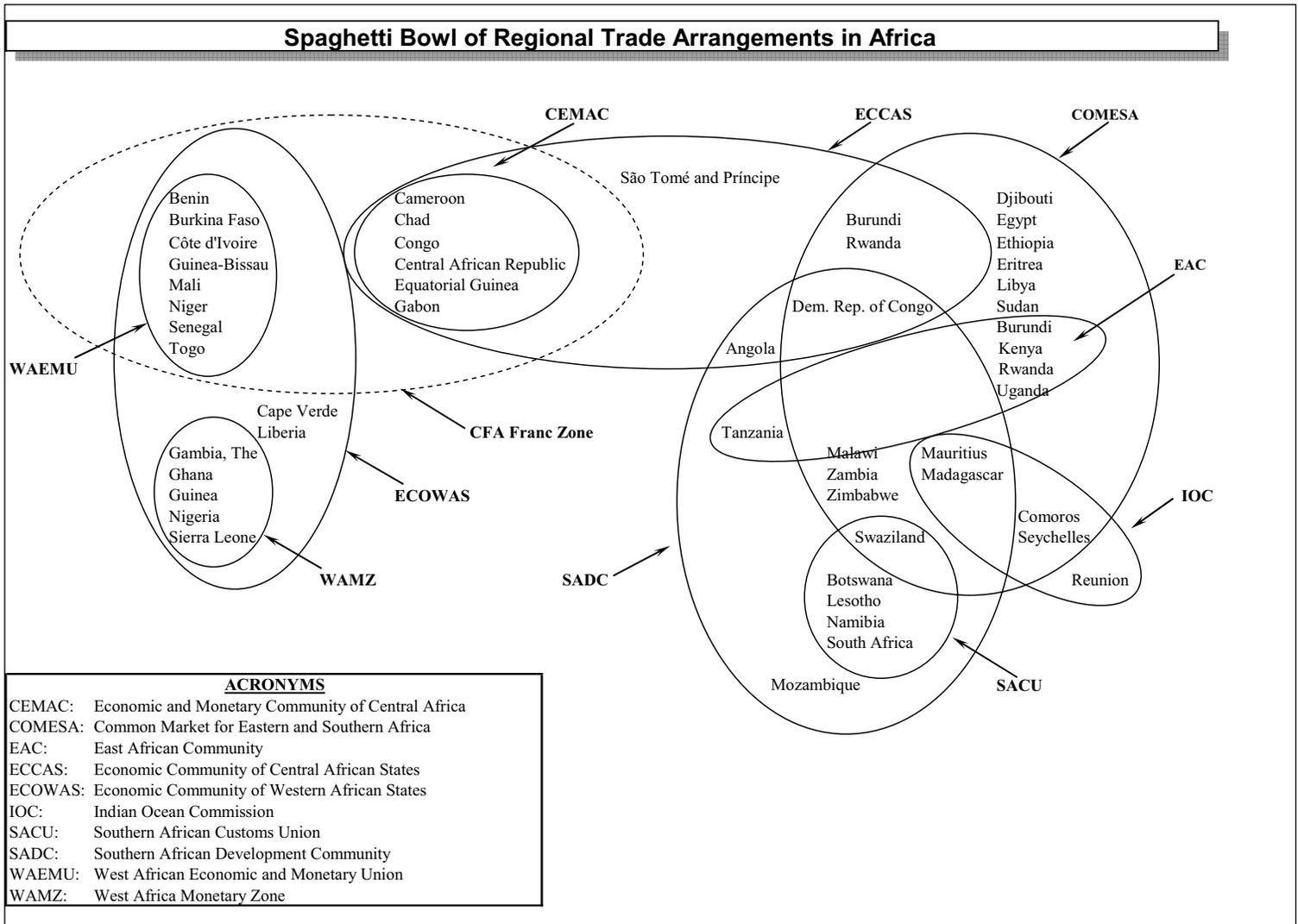
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Appendix Chart 1



Source: Tsangarides, Ewencyk and Hulej, 2006 (chart updated)