E E Ngalande: The importance of financial system modernisation in Africa

Keynote address by Dr E E Ngalande, Governor of the Reserve Bank of Malawi, at the Perago User Group Conference, Johannesburg, 24-25 April 2003.

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Introduction

Ladies and Gentlemen:

Thank you for the invitation to speak, and thank you all for being here. I have been asked to share some thoughts on the importance of financial system modernisation, with specific reference to Africa and in particular the SADC region.

Being a central banker, I am confronted with reaching macroeconomic objectives such as price stability, economic growth, balance of payments equilibrium and financial stability. A mammoth task indeed, and living in Africa, one that proves to be extremely challenging at the best of times. Most countries in Africa are confronted with pressing socio-economic problems such as poverty, unemployment, lack of education, lack of housing, and famine, to name but a few. One is constantly tempted to try and address these symptoms, but is faced with the reality that, in the long run, these problems can only be solved by addressing the causes thereof.

It is widely acknowledged that sound financial infrastructure is a prerequisite for a sound financial system, which is in turn a key factor in increasing the economic growth potential of a country, and of a region. Given the rapid rate of globalisation and the dynamic nature thereof, there is tremendous pressure on a country to modernise its financial system in compliance with global trends, standards and best practices, and to avoid being left behind in the dynamic drive to faster, better and safer financial transactions.

Today I hope to affirm the causal link between a sound and modern financial system and macroeconomic objectives, not only in my country, but also in the whole SADC region. I am going to focus on the role of the central bank in this regard, both as payment service provider and overseer of the financial system as a whole. Finally, I would like to use this opportunity to take stock of where the countries in SADC stand in the whole modernisation process and to share my views on a possible way forward from here.

From the outset, however, I wish to clarify what I understand under the term ‘financial system’. It is often interpreted as physical infrastructure such as clearing and settlement systems, but is in fact a much wider concept which encompasses the different financial markets, the legal and regulatory framework, role players, business processes, systems and technology required to provide, support and manage the financial system in a country.

Why is it important to build financial infrastructure?

A sound and robust financial system is a key contributing factor to financial stability in a country. Although a definite causal link exists between real economic stability and financial stability, sound and robust financial systems play an important role in reducing the risk that distortions in the real economy will develop into a financial crisis and could even minimise the adverse effects of such a crisis in the event of it occurring.

A sound and robust financial system is essential for mobilising capital that is necessary for sustainable economic growth. The major objectives of macroeconomic policy in a country are the level of employment, price stability, GDP-growth as a measure of economic growth and equilibrium on the balance of payments, especially in open economies such as those in the SADC region. Domestic financial system weaknesses have potential repercussions on exchange rate stability and the balance of payments. An unsound domestic banking system will be less capable of providing an efficient foreign exchange market and will complicate monetary policy decision making by distorting the link between interest rates, economic activity and inflation. This will by implication make monetary targeting more vulnerable to policy errors. Underdeveloped or developing economies are dependant on investment and uncertainty about the soundness of the national payment system in a country may trigger capital flight or deter foreign investors, thereby putting pressure on the balance of payments and deepening economic recessions. This is likely to, in turn, have an adverse knock-on effect on the level of employment and the general inflation level.

Furthermore, a country that does not conform to international standards and best practices with regard to its financial system, risks isolation from the international economic community. Globalisation is a global trend toward the freer flow of trade and investment across borders, resulting in the integration of the international economy. In a globalised world, no country can afford being isolated, as there is no room in a globalised world for an economy isolated from world trade and foreign investment. Globalisation also brings many benefits such as access to foreign capital, global export markets and advanced technology much needed in underdeveloped and developing countries. These benefits have positive social and economic consequences such as faster economic growth, which, in turn, alleviates poverty, leads to higher labour and environmental standards and facilitate democratisation. Countries that resist globalisation, risk being marginalized. In order to become a role player in regional and international trade, countries have to ensure that their financial system is stable, as measured by international standards.

From a regional perspective, problems in a domestic financial system often spill over to neighbouring countries, especially if the countries in the region are involved in close economic co-operation, which is one of the primary objectives of the Southern African Development Community. It is therefore important that the region as a whole should ensure that their financial systems comply with international best standards, as this would play a large role in facilitating regional integration. Regional integration, as we know, holds a number of advantages for participating countries. Firstly, the region benefits from the resultant expansion of trade between member states which will be supported by a simultaneous integration of the financial sector. Closer trading links between countries in a region also strengthens their capacity to participate in world trade, allowing countries to become more competitive outside the trading block. Cross-border payments and settlements will be facilitated by the removal of unnecessary financial obstructions and constraints. Secondly, the elimination of geographic constraints will facilitate the extension of services and the movement of people across borders and finally, optimum use will be made of scarce resources. The co-ordination and sharing of limited resources such as skills, technological infrastructure and financial systems will contribute to a higher rate of economic development for the region as a whole. It is also important from an international perspective, where increasing emphasis is being placed on the financial sector in the global economy, that SADC economies meet international expectations as far as possible in such areas as payment, clearing and settlement systems, banking supervision and monetary policy.

The role of the central bank

The central bank's core responsibilities in an economy are the maintenance of monetary stability, ensuring financial system stability and the promotion of the efficiency and effectiveness of the financial system.

The maintenance of monetary stability;

This role of the central bank involves the formulation and implementation of monetary policy objectives with the overall objective of achieving low inflation and protecting the value of a country's currency. A strong relationship exists between monetary and broader financial stability in that financial stability is a prerequisite for the effectiveness of monetary policy, and therefore the monetary stability in a country.

The maintenance of financial system stability.

The central bank performs a pivotal role in ensuring the smooth and efficient functioning of markets and infrastructure such as the payment system in a country. This role of the Bank is multidimensional and includes the following:

- The provision of physical infrastructure, for example real-time gross settlement (RTGS) systems;
- The operation of such infrastructure;
- Mitigating systemic risk by providing the liquidity needed to oil the wheels of the financial system;

- Oversight of infrastructures such as the national payment system as well as financial markets in order to ensure the smooth and efficient functioning thereof; and
- Supervising the financial system on an ongoing basis. The central bank acts as the guardian of financial stability, which is necessary to efficiently allocate resources and absorb liquidity shocks. The Bank has to continuously and comprehensively monitor potential threats to financial stability. This is necessary for prevention of crises, but in the event that they do occur, also for swift crisis resolution. The central bank should consider regulatory and/or operational intervention in cases where financial stability is threatened.

The promotion of the efficiency and effectiveness of the financial system.

The central bank is concerned with the robustness of the financial system both on a national and global level as disruptions in settlement in securities markets have the potential to spread to payment systems and to the financial sector in general. The central bank has to ensure compliance with international best practices and standards as laid down by institutions such as the Bank for International Settlements and the International Monetary Fund. Standards such as the BIS Core principles for Systemically Important Payment Systems and the Group of Thirty Recommendations Regarding Securities Clearance and Settlement are the result of collaboration and shared experiences between the major financial institutions in the world and provide a blueprint that a country should consider to become a global player and be internationally competitive.

The role of the central bank in this regard can thus be summarised as:

- Ensuring that policies relating to the efficiency and safety of payment systems are designed to comply with the aforementioned international standards, bearing in mind that the implementation of such standards should be done with the appropriate degree of flexibility to adequately cater for the individual circumstances of each country;
- Monitoring, but also participating actively in the development of standards relating to payment systems and cooperating with stakeholders in improving such standards; and
- Fostering and developing public policy that supports the financial system in a country. This would include addressing legal and regulatory impediments to the effective and efficient functioning of the financial system.

Key features of a sound and robust financial system[1]

A sound financial system is one that remains stable and efficient in the wake of shocks such as interest rate hikes, severe exchange rate fluctuations, financial crises in other systems, but also non-economic events such as terrorist attacks. Robust financial systems are characterised by three basic characteristics: flexibility, resilience and internal stability.

A financial system is flexible in that it continues to function efficiently under a full range of economic circumstances. This implies that the system is adaptable to market developments and the dynamic forces of demand and supply and is able to adequately perform its role in mobilising savings, diversifying risks and allocating resources. The system is also not rigid and can adapt to support the functioning of financial markets.

The system is resilient in that it remains capable of allocating resources efficiently, timeously and with certainty, even in times of financial crises or external shocks. Technological and infrastructure vulnerabilities in the financial system have also been adequately addressed. The system therefore possesses the necessary redundancy, recovery and resumption capabilities required to prevent, mitigate and manage disasters.

The financial system is also internally stable in the sense that the system itself is not a source of economic shocks. The system has a high degree of predictability and integrity, and has sufficient internal controls in place to mitigate operational risk.

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1 From a report of the Working Party on Financial Stability in Emerging Market Economies, "Financial Stability in Emerging Market Economies. A strategy for the for the formulation, adoption and implementation of sound principles and practices to strengthen financial systems." Bank for International Settlements. Basle, April 1997.

From a macroeconomic point of view, central banks should focus on policies that promote financial stability, that is those that are aimed at containing fluctuations in aggregate economic activity as far as possible, promote sustainable growth and avoid economic uncertainty.

From a structural point of view, policies should ensure that relative prices are in line with economic fundamentals and that structural conditions promote the efficient and sustainable allocation of real and financial resources. Such policies include tax policies and policies pertaining to the allocation of productive factors.

The key elements of a sound and robust financial system can be divided into three categories, namely the infrastructure building blocks that support effective market functioning, institutional governance and regulation and supervision.

Infrastructure building blocks that support effective market functioning include the following:

- A legal and judicial framework which provides legal certainty in financial matters;
- Accounting systems capable of providing accurate, relevant, transparent and comprehensive information timeously;
- Other mechanisms and institutions for the application of codes of conduct, conventions and best practices to limit price manipulation, fraudulent behaviour and other detrimental practices;
- Sound payment and settlement systems, as these provide mechanisms through which payments can be made in risk-free money and as such are essential to the smooth operation of market economies; and
- Market diversity and depth. Financial systems need to have a broad array of instruments and markets and to provide a sufficient range of services if they are to be efficient and flexible and resilient enough to continue to function effectively in the face of major economic changes.

On the topic of institutional governance, deficiencies in management and control have been common elements in banking and other financial crises. The quality of the institutional governance of financial businesses is crucial to reducing the likelihood that crises will emerge, as well as to limiting the severity of the crises when they do occur.

Finally, financial regulation and supervision play an essential role in fostering financial robustness. Official oversight of the financial system encompasses financial regulation, including the formulation and enforcement of rules and standards governing financial behaviour as well as the ongoing supervision of individual institutions. Regulators should seek to support and enhance market functioning, rather than to displace it, by establishing basic rules of the game and seeing that they are observed. Regulatory/supervisory authorities should promote the reliability, effectiveness and integrity of the market infrastructure, in particular payments and transactions systems.

The Malawian experience in payment system reform

At this juncture let me briefly share with you our own experiences in Malawi our efforts in modernising the payment system.

The transformation of the payment system in Malawi has been influenced to a great extent by the structural reforms that have been implemented in the financial sector since the early 1980s. These reforms were initiated by the Malawi Government as part of the overall Structural Adjustment Programmes (SAPs) that the country has implemented since 1981 with the assistance of the International Monetary Fund and the World Bank. The reforms were specifically aimed at making the whole financial system more responsive and efficient so that it can adequately support the development requirements of the country by providing the required financial resources.

There are also other factors that influenced payment systems reforms in Malawi. These include: the need to attract foreign investors into the country, the effects of liberalised economic policies adopted in the 1990s and the introduction of the Southern African Development Cooperation (SADC) Regional Payment Systems Modernisation Project by the Committee of SADC Central Bank Governors. The introduction of the SADC Payment Systems Regional Modernisation Project added impetus to the reform process that was initiated under SAPs.

The financial system in Malawi, like in many developing countries, is relatively small, underdeveloped and dominated by a few financial players who offer a limited range of services. The economy is predominantly rural-based and cash is the dominant mode of payment. Against this backgroung our efforts have been geared towards promoting the use of cash-less payment instruments in line with our vision and strategy.

In order to effectively coordinate the reform process we formed a mother body - the National Payments Council (NPC) which is chaired by the Reserve Bank of Malawi. Membership of the Council includes all financial institutions and service providers like telecommunications company and power supply company. Thus all major stakeholders have been actively involved in payment systems reform initiatives in Malawi. We have found this to be of critical importance because in our view we consider that the task of forging the country's payment system vision and strategy is a shared responsibility.

Through this collaborative effort we have today made tremendous progress in modernising our payment system. The Reserve Bank of Malawi spearheaded and fully financed the establishment of a proprietary Wide Area Network (WAN) infrastructure and a transaction switch - called the Malawi Switch Centre (Malswitch). The switch centre, which was a dream three years ago, is now a reality and this has been our major achievement. Under the Malswitch Model, Malawi has managed to link up all the commercial banks and other major players in the financial system in a single network infrastructure providing a number of products including the following:

Smart Card

The smart card is intended to reduce cash usage. Some of the commercial banks operating in Malawi have entered into an agreement with Malswitch to become issuers of the smart card. In addition, some private companies and Government Departments have started paying salaries to their employees through the smart card scheme. Retailers and merchants are also actively using the smart card.

Virtual Private Network (VPN)

This is part of the Malswitch system that offers a national online system linking all small commercial banks (a corporate Wide Area Network) to transact with each other while maintaining complete security and confidentiality of their data. This facility could also be used by government departments and large retailers who have branch networks across the country.

The Electronic Bidding System

This enables the Financial Market Operations Department of the Reserve Bank of Malawi to accept bids for Treasury Bills and Reserve Bank of Malawi Bills electronically. Capturing, cancellation and notification of bid results is also done electronically.

Real Time Gross Settlement (RTGS) System

As you are all aware Malawi was the first country to implement an RTGS system using Perago's Central Real Time Inter-bank Settlement Processor (CRISP) software. The CRISP System in Malawi became live on 19th March 2002. We initially started with nine participants including the Reserve Bank of Malawi, but within the one year period the number of participants has increased to eleven. The system is working well and meeting our requirements.

Government Credit Ceiling Authority System (CCAS) Project

The project to automate Government funding arrangement is aimed at replacing the current manual process which involves physical movement of Government officers and paper between Treasury on one hand and the Reserve Bank of Malawi and the commercial banks on the other. All funding processes and reimbursements to commercial banks will be done electronically.

Electronic Cheque Clearing House (ECCH) Project

The ECCH is expected to be operational by the end of this year and will be running on Malswitch infrastructure. The project is spearheaded by commercial banks.

Since this is an RTGS gathering I thought I should also briefly share with you the benefits we have derived from the CRISP System during the one year period it has been operational. The CRISP System provides the Reserve Bank of Malawi with up to the minute liquidity position of the financial market which is essential for proper decision making in as far as risk management is concerned. In addition commercial banks are able to determine their treasury positions and make informed investment decisions. The fast transmission of funds through the CRISP System has also enabled economic agents outside the banking system to make cost effective investment plans since funds are no longer unnecessarily tied up in the payment system as was the case before.

The CRISP System has also enabled us to retrieve in a timely manner statistics on liquidity of money market players. The statistics are invaluable for the formulation and conduct of monetary policy. You will agree with me that in the absence of an RTGS system which does not have a comprehensive statistics module, data on liquidity might be difficult as well as time consuming to acquire. This obviously leads to misdiagnosis and its resultant wrong monetary policy prescription.

Before I conclude the Malawian experience I would like to request participants to discuss and share experiences on the following RTGS related issues.

- Provision of intra-day liquidity is one of the most important aspects of an efficient RTGS system. In Malawi the Reserve Bank provides intra-day liquidity at a cost. Some participants, especially discount houses, suggest that intra-day liquidity should be free. These players do not hold liquidity reserve requirement (LRR) balances with the central bank. The question is, should these participants be given preferential treatment?
- After establishing an RTGS system, what is an appropriate cost recovery policy the central bank should adopt to sustain the operations of the system while at the same time ensuring that the system is affordable. Malawi, in particular would like to learn how others have approached this issue within their own countries.
- Through the use of the RTGS the float the banks used to enjoy is totally reduced. This used to be one of the sources of profits for banks. After the introduction of the RTGS what are the alternative sources of revenue which our banks should now rely on?

Ladies and gentlemen, I also wish to urge you to seriously debate on the issues relating to the role of this CRISP User Group and how often should its members meet. The issues to be tackled by the user group should also be discussed and agreed. This is particularly important at this stage to avoid this group simply being a social club. We need to derive some benefit from it and assist each other to ensure that our systems are efficiently managed.

What is the status of financial system modernisation in SADC and what are the next steps?

Various steps can be taken to help strengthen financial systems. On a macro-economic level, sound, market-orientated banking and financial systems should be promoted by undertaking structural reforms necessary to remove distortions in the economy that weaken the financial system and undermine effective supervision. Stronger supervisory regimes and the institutional strengthening of the supervisory agency in a country should be undertaken. Countries should acquire high-quality payment and settlement systems and other market infrastructures such as effective clearing and book-entry systems, and ensure that such reforms are supported by the necessary legal reforms. More generally, countries should ensure that the general financial business practices and processes are in line with international best practices. In taking these steps to modernise or strengthen the financial system in a country, the help of international institutions such as the International Monetary Fund, the World Bank and the Bank for International Settlements, or companies that specialise in financial sector reform can also be employed.

Most countries in the SADC region have already taken an important first step in developing a sound and robust domestic payment system, which is to define a payment system strategy and development plan. Many countries already have the legal framework required to support such a payment system in place, while five countries in SADC have gone further and have already acquired a real-time gross settlement system. Seven others are set to move in this direction within the foreseeable future.

Regular consultation with other countries and market participants is important, especially on a regional level, to ensure coordination of policies and strategies, but also to share views and possibly learn from one another. In order to share these views with and get input from a wider audience, and to communicate their achievements to the rest of the world, countries may consider publishing their experiences in payment system reform by, for example, publishing a so-called 'Red Book' in consultation with the Bank for International Settlements with the objective of providing a clear and reasonably comprehensive description of that country's payment systems. I would like to challenge the SADC countries that have already undertaken comprehensive payment system reform programs since the completion of the 'Green Book' on SADC payment systems, to update these by now outdated descriptions by publishing a 'Red Book' that reflects the current status of the payment system in that country. And of course, conferences such as this Perago User Group Conference also provide a platform for sharing experiences, keeping abreast of new financial system developments and international best standards and practices.

1998 Annual figures	Total exports to other SADC countries (USD million)	Exports to other SADC countries as % of total exports	Total imports from other SADC countries (USD million)	Imports from other SADC countries as % of total imports
Angola	3.26	0.09	222.35	9.96
DRC	5.33	0.51	230.43	25.91
Malawi	101.16	21.14	375.60	66.38
Mauritius	25.44	1.49	248.19	11.36
Mozambique	106.50	43.52	354.00	43.31
Seychelles	1.33	1.47	57.62	15.04
South Africa	2,607.51	9.70	407.49	1.39
Tanzania	32.86	5.58	181.79	11.57
Zambia	201.94	19.78	564.13	51.88
Zimbabwe	494.34	28.58	1,058.84	40.40

Source: Direction of Trade Statistics Yearbook. 2002. International Monetary Fund, Washington. Comparable figures were not available for Namibia, Botswana, Lesotho and Swaziland.

This slide shows import and export statistics of selected countries in the SADC region and is based on the 1998 Direction of Trade Statistics published by the International Monetary Fund. These statistics show that a significant portion of the foreign trade of many SADC countries is with other countries in the SADC region. It therefore makes sense to start thinking of closer co-operation among countries within the Community with the aim of eventually having a shared regional infrastructure in line with international trends in regional groupings such as the European Community. A prerequisite for participating in such a regional infrastructure will be for countries to ensure that their domestic payment systems are sound and robust, which has been the main focus of the SADC Payment System Project. Perhaps we need to start thinking of linking our RTGS-systems in some way as to take the first steps towards regional settlement and interbank clearing systems.

Conclusion

In conclusion, I wish to once again stress the importance of the financial sector in a regional economic strategy. There is a need throughout SADC to improve existing financial systems in order to encourage both domestic and foreign savings, which can then be channelled into productive investments. SADC payment system initiatives can play a role in this process by promoting co-operation between role players in the financial sector. Financial co-operation is expected to result in greater economies of scale, a pooling of expertise, and the enhanced credibility of the reform process. It can also lay the groundwork for financial integration initiatives further down the line. These initiatives should be undertaken as part of a more holistic integration process, which also takes into account both the political and economic realities faced by the countries of Southern Africa. Central banks should work together to establish a sound basis for full economic integration in the region. Attention should be focussed on the building of a compatible financial infrastructure in the region. The challenge is a mighty one, but it is time for SADC, as well as every other country and region, to meet it.

Lastly, I would like to commend Perago for taking this initiative of forming a User Group for the CRISP System. I believe this group will prove to be valuable to all of us as members since we will be able to share views and experiences to ensure efficient utilisation of the CRISP system. I only hope that this forum will continue for the benefit of all its members.

Once again I thank you very much.