Philipp M Hildebrand: The role of central banks in fostering economic development

Speech by Mr Philipp M Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank, at the Inaugural Meeting of the Africa Emerging Markets Forum, Gerzensee, 1 October 2007.

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1. Introduction

On behalf of my Governing Board colleagues, let me warmly welcome you to the SNB Study Center Gerzensee! It is an honour and a privilege for the Swiss National Bank to host the Inaugural Meeting of the Emerging Markets Forum for Africa.

I trust you are well rested this morning. By now, you will have noted that the Study Center Gerzensee is not a five star hotel. Compared to other conference centres, the service provided here is modest. We like to think that we emphasise substance rather than style. We try to create an atmosphere conducive to learning. The Center serves multiple purposes. It is here, for example, that we organise advanced courses for selected central bank professionals from all over the world. According to the traditional policy of the Center, only one participant per country is allowed in each Central Bankers Course. In the 25 years since the creation of the Center, more than 300 participants from African central banks have attended these courses. We therefore like to think that the Study Center Gerzensee make a humble contribution to integrating African central banks into the global central banking network.

The EMF has chosen to come to Gerzensee to address the challenges that emerging Africa is facing. Undoubtedly, these challenges are enormous. In recognition of the importance of this gathering, the SNB is proud to host your deliberations. The EMF and the Swiss National Bank share the view that private investment is ultimately the driver of sustained economic growth and poverty reduction. However – and I think that we would again agree – public policy matters a great deal. It does so primarily by providing a sound macroeconomic environment, by improving financial markets, and by strengthening property rights and institutions.

Institutional weakness has, of course, received much attention in the recent past. Every year, the World Bank’s *Doing Business Report* points out the same three main obstacles to private investment activity in Africa: a massive bureaucratic burden, widespread corruption, and the resulting high cost of doing private business.

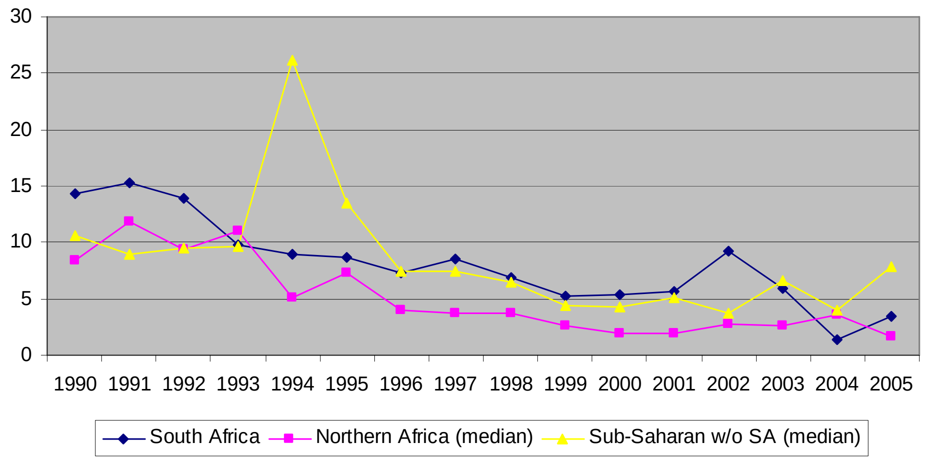
Other areas of public policy that aim to promote economic activity generally receive less attention. The fight against red tape and corruption is unquestionably important. But progress in macroeconomic and structural policy should not be overlooked. As a central banker, I would like to take this opportunity to review progress in those areas which are related to the activity of monetary authorities. I believe that the three following core activities of central banks can have a substantial impact on the environment for doing business: maintaining price stability, maintaining a safe and efficient payment system, and supporting the development of the financial sector.

2. Price stability

Let us first consider price stability. Low and stable inflation rates allow the private sector to plan for the future, lead to a lower need for costly price adjustments, prevent tax distortions and thus create a stable business environment. On the other side, high and unstable inflation creates random wealth transfers between creditors and debtors. Since their fiscal base is weak, governments in Africa have often relied on seignorage to improve their income stream, creating high inflation rates as a by product. How has inflation developed throughout the continent in recent years?

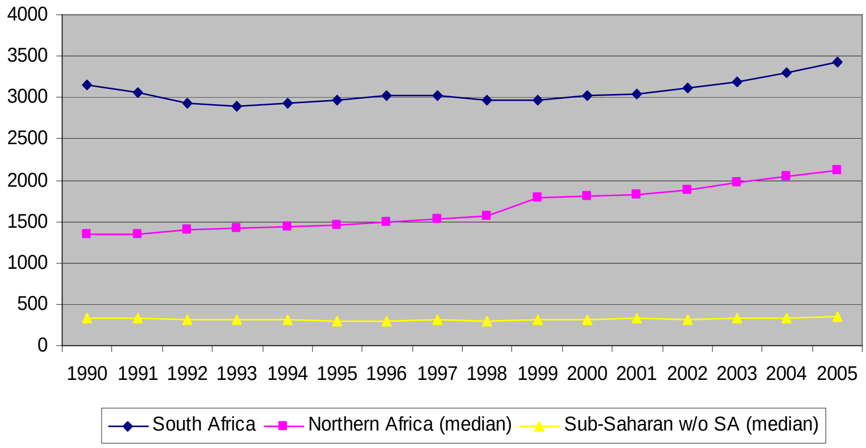
Figure 1 depicts inflation in Africa from 1990 to 2005. It displays inflation in South Africa, as well as the median inflation rates in 39 other sub-Saharan economies and in 5 North African economies. I focus on the median inflation rate because this measure is not sensitive to large outliers such as Zimbabwe. As you can see, inflation in Africa has trended downward over the past 15 years, with the exception being the aftermath of the Tequila crisis in 94/95. In South Africa and northern Africa inflation is now well below 5%, while sub-Saharan Africa also displays single digit inflation rate.

Figure 1: Inflation in Africa (in %)



The figures displayed suggest that businesses and households in most African countries now enjoy an environment of increasingly stable prices. Undoubtedly, the recent inflation record has contributed to the increasingly robust growth environment. Figure 2 shows that per capita growth has picked up in recent years in parts of Africa. This is particularly true where disinflation was strongest.

Figure 2: GDP per capita in Africa (in constant 2000 USD)



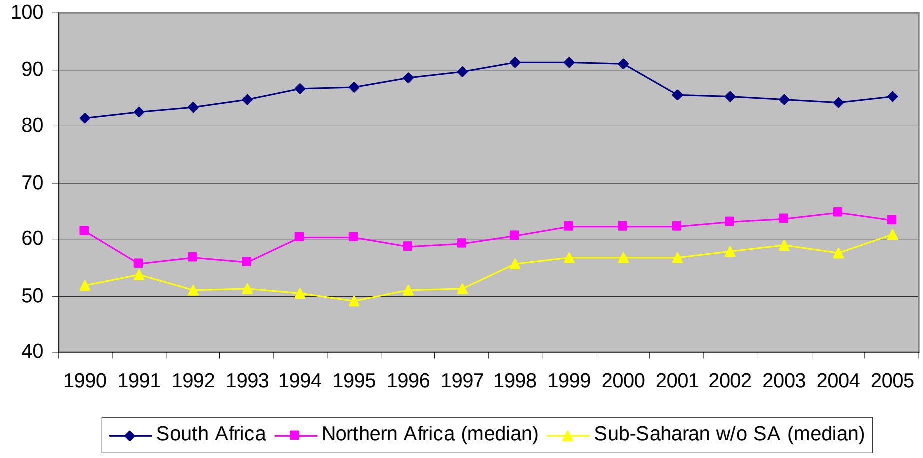
Governments no longer seem to rely on money printing as a revenue source. This is a sound policy development which encourages private sector activity. Going forward, the challenge for African central banks will be to maintain this recently acquired track record.

3. Payment systems

Next let's look at the payment system. The development of the payment system determines how easy it is for firms and consumers to access and transfer money. Can businesses pay their suppliers by writing a cheque or making an electronic transfer? Or do they have to undergo the cumbersome and insecure process of sending cash physically? Can households pay for consumer goods with debit cards, cheques or credit cards, or do they have to carry significant amounts of cash with them? Can workers in urban areas transfer money to their rural families by simply sending an SMS, or do they have to carry it with them on a dangerous bus ride?

Particularly in Africa, where distances are vast and security is often a concern, the availability of non-cash payment instruments can increase the returns to economic activity for businesses and households. Figure 3 shows that today, most economies in Africa are still strongly cash based. Both in sub-Saharan and northern Africa, more than one-third of funds available for immediate payments are in cash form. The notable exception is South Africa where the level of non-cash money is above 80%, and thus similar to that of Switzerland. Developments over the past 15 years show a promising picture for other countries on the continent as well. Since 1995, the share of non-cash money has increased from 50 to 60 percent in sub-Saharan Africa, and 55 to 65 percent in North Africa. This mirrors the increased availability of electronic payment instruments available to businesses, but also to households.

Figure 3: Share of Non-Cash Money in Africa (in%)



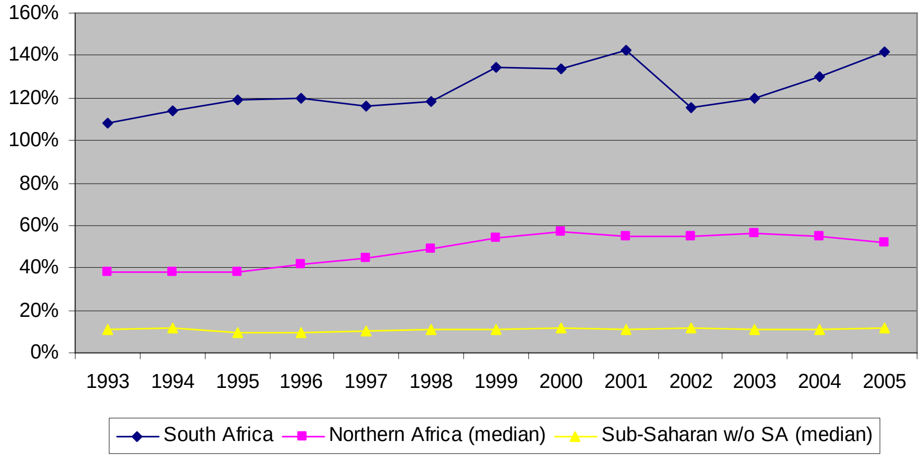
How can central banks foster the further development of safe and efficient payment instruments in Africa? First and foremost, central banks must take a leading role in the development, operation and oversight of necessary infrastructure, such as interbank and retail payment systems. In doing so, it would seem natural to take advantage of international knowledge and expertise. As financial sector regulators, central banks can further create a market environment which encourages the entry of new service providers, as well as the development of innovative payment instruments, such as SMS-banking and mobile-banking. As an oversight authority, it is then the task of the central bank to ensure that new payment services adhere to the security requirement desired by businesses, households and financial institutions.

4. Financial sector development

Third, let's take a brief look at financial sector development. An efficient and deep financial sector provides enterprises with debt and equity to finance their growth, thus spurring economic activity. At the same time a deep financial sector can provide households with savings and credit products to smooth their consumption patterns, again increasing their return from economic activity, and reducing poverty.

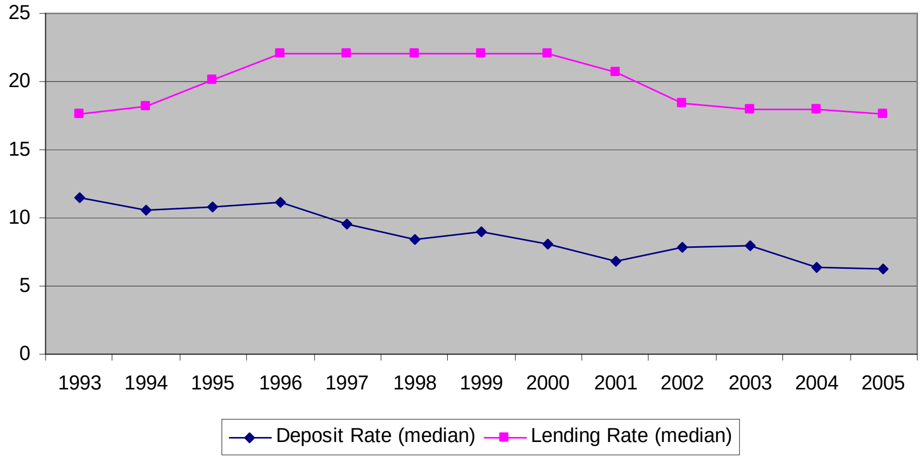
To what extent have financial sectors grown and become more efficient in Africa in recent years? Figure 4 displays the volume of private credit, as a percentage of GDP, for South Africa, other sub-Saharan countries and for Northern Africa. With credit exceeding GDP, the financial sector in South Africa boasts a similar size to that of many North American and European countries. By contrast, the financial sector is very shallow in the rest of sub-Saharan Africa, with credit volumes at less than 20% of GDP. Even more worrying is that the financial sector has hardly deepened over the past 15 years.

Figure 4: Private Credit / GDP in Africa (in%)



Continuing this undoubtedly bleak picture, we see that the financial sector in sub-Saharan Africa has become neither more efficient, nor more competitive in recent years. Figure 5 displays the nominal rates at which banks lend money, as well as the rate they pay for deposits. Lending rates have stayed more or less constant from 1993 to 2005. Since inflation has decreased substantially over this time, the real interest rate that banks charge has actually increased. By contrast, the nominal deposit rate has decreased, so that the real deposit rate has been constant. Together this implies that the interest rate spread charged and earned by banks has increased substantially in the last 15 years.

Figure 5: Lending and Deposit Rates in Sub-Saharan Africa (w/o SA)



What can African central banks do to foster deeper and more efficient financial sectors? In most African countries, central banks are responsible for regulating and supervising banks. Here central banks should ensure that regulatory requirements are not prohibitive for new market entrants, particularly foreign financial institutions who may bring cheaper capital and new technology to the sector. Moreover, central banks can foster the development of sustainable microfinance and rural financial institutions to cater to the vast agricultural and microenterprise sector. They can do so by adopting regulatory requirements which suit the limited sphere of activity of these institutions.

5. Conclusion

Ladies and gentlemen, let me conclude these brief introductory remarks. How can we assess the contribution of central banks to improving the business environment in Africa? Most African central banks have been successful in reducing inflation. This enables the private sector to plan ahead and engage in contracts without worrying excessively that their proceeds may be eroded by rapidly rising inflation.

Central banks have also fostered improvements in the payment system, which have reduced the costs of accessing and transferring money for businesses and households. The cash intensity of most African economies suggests, however, that there is still room for improvement in this area. A greater challenge for central banks lies in fostering growth and efficiency in the financial sector. The banking sector in many countries of the continent remains small and sadly displays a low level of efficiency and competition.

I sincerely hope that this Forum will contribute to finding solutions to these and other challenges to emerging Africa. Let me close by wishing you a successful EMF here at the Study Center Gerzensee.