Prospects for Financial Sector Reform in the Context of Regional Integration in SADC

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF ABBREVIATIONS

ADRs	American Depository Receipts
ATM	automatic teller machines
BCM	Banco Comercial de Moçambique
BNA	Banco Nacional de Angola
BPD	Banco Popular de Desenvolvimento (Mozambique)
BSE	Botswana Stock Exchange
CAP	Caixa de Crédito Agro-Pecuaria a Pescas (Angola)
CMA	Common Monetary Area (Namibia, Swaziland, Lesotho)
COMESA	Common Market for Eastern and Southern Africa
DRC	Democratic Republic of the Congo
EAC	East African Community
ECSAFA	Eastern, Central and Southern African Federation of Accountants
ESAAG	East and Southern African Association of Accountants-General
EU	European Union
FISCU	Finance and Investment Coordinating Unit (SADC)
FPI	foreign portfolio investment
GDP	gross domestic product
GEAR	Growth, Employment and Redistribution project (South Africa)
IFSC	International Financial Services Centre (Botswana)
IMF	International Monetary Fund
IOC	Indian Ocean Commission
IPFA	Institute of Public Finance and Auditing (South Africa)
JET	South African electronic trading system
LuSE	Lusaka Stock Exchange (Zambia)
NBC	National Bank of Commerce (Tanzania)
NSX	Namibian Stock Exchange
SACU	Southern African Customs Union
SADC	South African Development Community
SADCC	Southern African Development Coordinating Conference
SADCOSAI	SADC Organisation of Supreme Audit Institutions
SEM	Stock Exchange of Mauritius
SMMEs	small, medium and micro-enterprises
STRATE	South African electronic settlement system
ZSE	Zimbabwe Stock Exchange

INTRODUCTION

The reform of the financial sector has been an important component of the structural adjustment programmes pursued by developing countries, whereby reform entails reducing government involvement, freeing up financial markets, and strengthening financial institutions. In Southern Africa, however, the financial systems of most countries remain relatively underdeveloped, in spite of these reforms. The Southern African Development Community (SADC) is currently in the process of drafting a protocol on finance and investment, which should address the issue of financial sector development. The questions that arise from this are, firstly, what kind of role can SADC play in promoting financial sector development, and secondly, what are the possibilities for financial integration within SADC?

One of the stated aims of SADC is monetary integration; however, no timetable for monetary integration has been drawn up, nor has there been any in-depth discussion of the issue at SADC level. It seems that, while monetary integration may be a long-term goal of the organisation, it is not considered achievable at present. To complement monetary integration, the establishment of a wider internal market for financial services would be required, as well as the convergence of a number of financial variables. *Financial integration* encompasses all of these goals, including a common currency. Some SADC leaders have spoken of the need for financial integration within the region, but the use of the term has not been clearly defined. Indeed, Linah Mohohlo, the governor of the Bank of Botswana, recently said that, "financial integration should not require any surrender of sovereignty" (*Business Week*, 18/9/2000), which raises the question of what exactly is meant by the term "financial integration." The question of whether SADC should aim to follow an EU-style approach to financial integration, or whether it should continue with its current *ad hoc* approach, has therefore not been addressed.

A related issue is the questionable political will with regard to economic integration, as demonstrated by SADC's leaders. The 14 countries of SADC are at differing levels of economic development, with South Africa accounting for about 78% of the region's total GDP. Some countries, such as Angola, the DRC, and (increasingly) Zimbabwe, are facing economic crises, due to internal instability. Other countries, like Botswana and Mauritius, are stable and have reasonable growth rates, but face the problem of diversifying their economies. The countries of the Common Monetary Area[1] are still heavily dependent on South Africa. Others, such as Tanzania, Mozambique and Zambia, are dealing with the transition from a heavily state-dominated economy to one that relies on market forces. Each nation has its own development strategy that has been tailored to the specific needs of their own economy. However, economic integration by its very nature requires some sacrifice of national sovereignty, in order to reap the benefits of a single market. While the rationale for economic integration in Southern Africa is well-understood, there appears to be an unwillingness on the part of member states (perhaps understandably) to substitute regional priorities for national ones, making the decision-making process slow and difficult. The result is that little progress has been made towards economic integration thus far.

[1] Namibia, Swaziland and Lesotho.

Given this rather discouraging background, this paper looks at the role that SADC *can realistically* play in developing the financial systems of the countries of Southern Africa. Section I reviews some of the literature and theory around financial sector reform, particularly in the context of Southern Africa. Section II offers an overview of the financial systems of the various SADC countries. Section III considers regional integration, looking at SADC as an organisation, as well as highlighting some of the possible barriers to integration. Section IV explores the issue of SADC's role in financial sector reform, and makes some suggestions that could perhaps be considered in the drafting of the Finance and Investment Protocol. Finally, Section V contains some concluding comments as well as suggestions for further research.

SECTION I: REFORMING THE FINANCIAL SECTOR

1.1. Paradigms: Financial sector liberalisation and reform

There is still some debate as to the role of the financial sector in promoting economic growth, and the appropriate measures to use in developing a sound and efficient national financial system. This section will look at some of the arguments that have been made in the literature.

1.1.1. The financial sector and economic growth

Growth requires the mobilisation of long-term savings, which can then be channelled into productive investment. Financial institutions act as intermediaries for this process. It follows then that a more efficient and diversified financial system will assist in increasing the level of domestic savings as well as promoting foreign capital inflows. A well-developed financial system also assists business and government in better managing risk. Intuitively, then, the financial system is important in that it creates an environment for growth to occur.

There is some debate as to whether the financial sector is essentially passive, following developments in the real economy, or whether the financial sector can actually induce growth. Studies have shown that the domestic savings rate is an important determinant of growth in developing countries (Ikhide, 1996). Looking at 77 countries between 1960 and 1989, King and Levine (1993) found that initial financial depth helps to explain subsequent growth performance. They found, too, that financial indicators were closely correlated with GDP growth. King and Levine also looked at the success of adjustment lending by the World Bank and its relationship with financial depth, concluding that adjusting countries with greater financial depth tended to grow faster. However, their studies have been challenged by others on the grounds that causation between financial development and growth was not proven in their studies (Kenny & Moss, 1998).

On the other hand, Montiel (1996) notes that the depth of a country's financial sector is dependent on its level of growth and development. Since financial markets are characterised by problems of information asymmetry, high monitoring costs will lead to higher interest premiums on loans and to the rationing of credit. Monitoring costs will tend to be higher in less developed countries, due to the generally lower net worth of borrowers (to serve as collateral) and to less efficient systems of property rights and accounting standards. Thus, the costs of financing investment are higher and may be prohibitive in some instances, leading to a greater reliance on self-finance and informal institutions.

There is a tendency to assert that investment levels in SADC are lower than desired because of a high cost of capital. However, improving access to capital will not necessarily raise investment levels. Sherbourne (1999) offers several reasons, besides a lack of capital, why investment in Namibia in particular has been lower than desired.

1. The savings generated in Namibia are not easily suited to the types of investment available. For example, a large part of Namibia's savings are held in pension funds and life assurance schemes, which tend to seek out low-risk, liquid assets such as certain shares and bonds. On the other hand, the kind of investments likely to promote growth in Namibia will be small-scale and high-risk. There is therefore a mismatch between savings and investment opportunities in the country.

2. Namibian financial institutions are failing to seek out and finance profitable investments. It may be that there is a lack of competition in the banking sector that reduces the incentives of banks to explore new profit opportunities.

3. The investment environment is such that the number of profitable investments is limited and higher returns are available in other countries. The investment climate of a country is influenced by, among other things, tax rates, labour market conditions and trade barriers.

4. Namibia lacks indigenous entrepreneurial talent to exploit opportunities.

This analysis can be extended to other countries in SADC, which also suffer from problems such as the lack of an investor culture, little competition in the banking sector, a dearth of entrepreneurs, and an environment often not conducive to doing business. Indeed, many development finance institutions in the region have complained that there are insufficient projects for them to finance (Harvey, 1991). Financial sector reform can address some, but not all, of these problems.

1.1.2. How can developing economies promote financial deepening?

As mentioned earlier, financial reform is seen as an important component of structural adjustment measures. In this regard, the World Bank and IMF structural adjustment measures have been based on the following principles:

- State-owned banks are likely to be driven by political rather than economic objectives, leading to a misallocation of credit, and a concomitant high proportion of non-performing loans. The use of commercial criteria should therefore improve the efficiency of bank lending;

- Interest rate ceilings have traditionally had the effect of producing negative real interest rates. Allowing interest rates to be determined by the market should raise nominal interest rates above inflation, which should encourage domestic saving;

- The opening of the financial sector to new local and foreign banks should help to foster competition; and

- A shift from direct (e.g. quantitative credit ceilings) to indirect monetary control (e.g. the use of open market operations to influence liquidity) will increase the efficiency of monetary policy.

The relationship between interest rates and savings levels in developing countries is, however, rather controversial. The Keynesian view that the relationship between the interest rate and savings is insignificant, may be more applicable in developing than in developed countries. For example, savings may often be held in real rather than financial assets, which would tend to distort the link between savings and the interest rate (Ikhide, 1996). Savings in developing countries are also likely to be affected by many other factors, such as income, political stability, investor confidence, and so on (Johnson, 1994). The Keynesian view in fact encourages low rather than high interest rates, in order to stimulate investment. Most of the financial sector reform programmes undertaken by developing countries have however assumed that higher interest rates will lead to higher savings, and therefore higher levels of investment. In the long run, interest rates are predicted to fall as output increases. However, it has been argued that high interest rates, especially coupled with devaluation, will have a stagflationary effect by increasing the cost of capital and import prices (Nissanke, 1994).

Financial reform programmes have also been criticised on the basis that they have neglected the institutional aspects of reform, and have relied too heavily on interest rate liberalisation. Nissanke (1994) argues that financial markets have a greater tendency to suffer from market failure, due to information asymmetries. She notes that a history of government mismanagement of financial institutions does not necessarily justify exclusive reliance on the market to develop the financial sector.

1.1.3. Banks

Banks form the core of the financial sector in most developing countries. Banks are best at monitoring projects and enforcing contracts when public information is limited and the legal and financial infrastructure is immature. Efficient banking systems promote the development and efficiency of other parts of the financial system. Schmidt (1999) states that bank lending to the private sector is strongly correlated with macroeconomic investment, productivity and growth in developing countries. The lack of financial information and the agency problems that may arise, however, pose challenges for banking in Africa. Informational problems may lead to credit rationing or high interest rates, which restrict access to credit for deserving individuals and businesses, particularly small business. Financial reform should therefore address such issues.

1.1.4. Stock markets

A key component of many developing countries' reform programmes has been stock market development. Foreign investors have shown an increasing interest in emerging, or developing country, markets, primarily due to low interest rates in developed countries and to improved policy environments in developing countries. The lion's share of this portfolio investment has gone to Asia and Latin America, but Africa's share of the total is increasing (Kenny & Moss, 1998). Stock markets allow companies to raise capital and thus diversify ownership and improve their debt-equity ratios. Stock markets may also have an influence on the mobilisation of savings and can improve the efficiency with which these savings are allocated, because allocation is determined by the market rather than administratively. In addition, a well-functioning stock market should encourage a shift from non-financial assets to financial assets, improving the country's savings rate.

Given the difficulty of encouraging domestic savers and developing an investor culture, it is also important to attract foreign investors to the market. Foreign investment reduces the cost of capital and adds liquidity to the market. Furthermore, as opposed to loan capital, equity capital does not have to be repaid, and there is more flexibility with regard to dividend payments that loan payments. This makes equity capital a more appropriate mechanism for financing higher-risk projects.

Stock markets are also useful vehicles for privatisation, offering ordinary citizens the opportunity to become shareholders in formerly state-owned companies. This is important in view of the empowerment objectives of many African countries.

However, the empirical evidence as to whether stock markets have contributed to growth in developing countries is mixed. There is also a view that stock markets have become something of a symbol of national pride and may therefore be established for the wrong reasons (Kenny & Moss, 1998).

1.1.5. Sequencing of reforms

The sequencing of financial reforms is crucial. Macroeconomic stability is generally regarded as a prerequisite for successful financial liberalisation. Liberalising interest rates in an environment of high inflation, for example, can make the goal of positive real interest rates difficult to achieve. Furthermore, high levels of government debt may crowd out private sector access to credit, and hence private sector investment. The institutional structure of the financial system should be strengthened before embarking on liberalisation, as liberalisation may otherwise result in destabilisation. The need for effective regulation and supervision is higher in liberalised financial regimes, than in environment of heavy state control.

1.1.6. Globalisation of financial services

Finally, the global context cannot be ignored when considering issues of financial sector reform and liberalisation in developing countries. As mentioned above, private capital mobility has increased tremendously in recent years. Trade in services, including financial services, has grown faster than trade in goods over the past decade (Wahba & Mohieldin, 1998). The increasing globalisation of financial services has implications for developing countries; for example, local institutions will face greater competition from much larger foreign institutions. This should be seen as a factor to take into account when developing a programme for financial sector reform.

1.2. The context and experience of financial sector reform in Southern Africa

1.2.1. Reforms after independence

The legacy of colonialism has determined to a large extent the current state of most of the SADC countries' financial infrastructure. In most of the SADC countries, foreign-owned financial institutions were originally set up to provide finance to local white- or Asian-owned businesses, foreign businesses, and foreign trade, neglecting African interests and development objectives (Harvey, 1991).[2] After independence, governments therefore implemented reforms to address these problems, using credit to try to improve the distribution of income and wealth. In many instances, banks were nationalised, or new, state-owned, banks were set up.

In some SADC countries, such as Tanzania, Mozambique and Angola, the financial system was entirely state-owned. In other countries, ownership was mixed or mainly concentrated in private hands (this latter group includes the Southern Africa Customs Union (SACU) countries and Zimbabwe). The financial sector was strongly dominated by banking institutions, which supplied only a limited range of products. The exception was South Africa, which had a large and developed stock market, and, to a certain extent, Zimbabwe. Furthermore, competition between banks tended to be limited, which meant that service was generally poor and innovation was stifled. The state was often heavily involved in directing credit to government projects and parastatals, and to areas considered priority sectors (Soyibo, 1997).

Nominal interest rates were kept at low levels, to encourage investment and subsidise favoured borrowers (Brownbridge & Harvey, 1998). As a result, real interest rates were often negative. Furthermore, governments used the financial system as a source of implicit taxation, since the repression of interest rates allowed the financing of deficits at low cost (Aryeetey, Senbet & Urdy, 1997). Reserve requirements were often set at high levels, forcing banks to hold Treasury Bills or government stocks with low returns.

A number of studies have estimated the tax revenue as a proportion of GDP extracted from the financial sector in this manner. Giovanni and De Melo (1993, in Montiel, 1996) calculate the interest savings by the government in Zimbabwe on its debt at 19% of GDP, during the years 1981-86. Ikhide (1992, in Montiel, 1996) examined the impact of implicit taxation with regard to unremunerated reserve requirements in eight Sub-Saharan countries. For five of these countries, the implicit tax amounted to over a quarter of government revenue.

Exchange controls were employed by governments to ensure that local savings were held in the form of domestic assets. Furthermore, they were used to limit bank lending to foreigners in order to ensure greater access to credit for indigenous borrowers (Brownbridge & Harvey, 1998). In Zambia and Zimbabwe, for example, exchange

[2] South Africa's sophisticated and diversified financial system was also geared mainly towards the needs of the white minority. A number of institutions have been set up to focus on the needs of small entrepreneurs, and banks have introduced products aimed at the poorer section of the population. Nevertheless, recent allegations of racism made against the major banks demonstrate that a significant proportion of the black population still struggle to gain access to credit (for discriminatory and/or other reasons).

controls were indirectly used as an instrument for the allocation of credit – companies with foreign exchange allocation were likely to be profitable and therefore less risky.

In addition, regulation and supervision of the financial sector, inherited from colonial days, was almost non-existent (Brownbridge & Harvey, 1998). As a result of these policies, some banks (especially those owned by the government) accumulated a large amount of bad debt, resulting in eventual insolvency.

Also, the financial sector was (and still is) characterised by the parallel existence of informal financial institutions, often based on pre-existing social and economic relationships (Montiel, 1996). The existence of such institutions reflects the high costs of monitoring and high associated risks of lending faced by the formal banking sector. Informal financial institutions are likely to continue to play an important role in loan finance in the future.

1.2.2. Liberalisation

Most SADC countries underwent some liberalisation of their financial sectors in the late 1980s and early 1990s, as part of structural adjustment programmes. These reforms have generally entailed increasing real interest rates to positive levels, using commercial criteria to allocate credit, strengthening prudential regulation and supervision, and restructuring of state-owned banks.

Table 1 shows that the financial sector in most SADC countries is fairly liberalised. Nevertheless, liberalisation in general has not contributed to a deepening of the financial system, nor has it resulted in an increase in the level of domestic savings. Some adverse consequences have also been observed, such as the widening spreads between lending and deposit rates. Also, greater competition has resulted in a narrowing of focus for many banks. The restructuring of banks has been expensive, and banks have often had to be recapitalised more than once after restructuring (Montiel, 1996).

Table 1: Extent of financial liberalisation

	State ownership of commercial banks*	Foreign ownership of banks prohibited	Regulation of interest rates	Fixed exchange rate	Government intervention in the allocation of credit	Exchange controls on the current account	Exchange controls on the capital account
Angola	✓	✗	n.a.	✓	✓	✓	✓
Botswana	✗	✗	✗	✗	✗	✗	✗
Lesotho	✓	✗	✗	✗	✗	✗	✓
Malawi	✓	✗	✗	✗	✗	✗	✓
Mauritius	✗	✗	✗	✗	✗	✗	✗
Mozambique	✗	✗	✗	✗	✓	✓	✓
Namibia	✗	✗	✗	✗	✗	✗	✓
South Africa	✗	✗	✗	✗	✗	✗	✓
Swaziland	✓	✗	✗	✗	✗	✗	✓
Tanzania	✓	✗	✗	✗	✗	✗	✓
Zambia	✗	✗	✗	✗	✗	✗	✗
Zimbabwe	✓	✗	✗	✓	✗	✗	✓

* including partial ownership / minority share
Information on the Democratic Republic of Congo and the Seychelles was not available.
Sources: Economist Intelligence Unit; SADC Central Bank Governors

It may be that the benefits have yet to accrue. It may also be that further structural reforms are needed before the benefits of financial liberalisation can be realised. Brownbridge & Harvey (1998) point out that in many instances banks were badly-managed and/or corrupt, and that attracting deposits into such institutions did not increase the efficiency of financial intermediation. The macroeconomic context in which these reforms were undertaken has also not always been suitable, especially in where the macro environment was characterised by high levels of inflation or large budget deficits. In the latter case, raising nominal interest rates had the effect of escalating government debt.

Another problem has been the lack of professional and administrative capacity in the financial sector in some SADC countries, due to extensive state involvement. A liberalised financial environment requires a different set of skills, notably in the area of regulation. Brownbridge & Harvey (1998) give several reasons why regulation in a liberalised environment is more difficult:

- New entry increases the number of banks requiring supervision, and new banks need to be supervised more closely than well-established ones;
- Greater competition may increase the risk of bank failure due to reduced profit margins; and
- Liberalised financial markets increase volatility, and banks may be more susceptible to exchange rate risk as a result.

1.2.3. Entry of new banks

While state-owned involvement in the banking sector has decreased, liberalisation has encouraged new banks to enter the market in many SADC countries, including Malawi, Mozambique, Zambia and Zimbabwe. Some of these banks are foreign-owned. However, Standard Chartered, a long-established foreign bank in the region, has begun to reduce its branch networks in order to concentrate more on corporate banking. It has also sold some of its assets in the region (Brownbridge & Harvey, 1998). Barclays Bank appears to be doing the same. Indigenous private banks have entered the market – some have failed, while others have survived in less than optimal conditions. Local banks have played an important role in promoting competition in the banking sector, and have lent to certain borrowers that may not have been able to obtain credit elsewhere, such as small businesses.

Several South African banks have taken advantage of the opening up of opportunities in the region, establishing new branches or taking over existing banks, sometimes in privatisation deals. However, the focus of South African banks has tended to be on lending to the corporate, as opposed to the retail, sector. Stanbic Bank, which has he biggest presence in the region out of all South African banks, mainly concentrates on the financing of trade and investment rather than retail banking. Part of the reason for this is that it can lend amounts of money that local banks cannot. Most foreign and regional banks have followed a similar strategy with regard to their operations in Africa, tending to leave the retail market to the local banks. The retail market requires larger investments (in branch networks), and as Flint (2000) notes, "in many countries the investment required to enter the retail market is not justified on economic grounds." However, there is a possibility that Stanbic may extend its E-Plan product to other African countries. This fully electronic banking network aimed at the low-income market has proved successful in South Africa, substantially lowering the costs of catering to this market.

Table 2: Presence of South African Banks in the SADC Region

Bank	*Country*
Stanbic	Botswana, DRC, Lesotho, Mozambique, Tanzania, Swaziland, Namibia, Zambia, Zimbabwe.
ABSA	Namibia, Tanzania, Zimbabwe.
Nedcor	Malawi, Mauritius, Mozambique, Lesotho, Namibia
Investec	Botswana, Mauritius, Namibia
First National Bank	Namibia, Botswana, Swaziland

* includes shareholdings in local banks.
Sources: Economist Intelligence Unit; Standard Bank; Business Day

The more market-friendly policies which have been adopted by countries in SADC have opened up many opportunities for new investments in the region, and such new investments require finance. Project financing is an area which requires a good banking infrastructure. Privatisation has also created opportunities for banks. Foreign banks in particular have recently played a major role in putting together and financing privatisation deals.

1.2.4. Tightening of regulations

Banking regulations have been tightened recently, especially in the wake of the Asian crisis. In Zambia, stricter rules were prompted by an increase in money laundering, forcing the closure of three banks. There appears to be much room for improvement, however. The capital adequacy of banks in the region is, in general, low by international standards, with many banks regarding the benchmark stipulated by the Bank for International Settlements as a target to meet rather than a minimum to maintain (World Economic Forum, 1998). Deposit insurance does not exist in all countries, although there appears to be a policy of "too-big-to-fail" operating in many countries. Government, or the central bank, may feel compelled to take over an ailing bank, in order to save jobs and depositors' assets, and this policy has resulted in moral hazard problems with banks undertaking excessively risky investments (Aryeetey, Senbet & Urdy, 1997). Furthermore, banking supervision is often lax or outmoded, and banking licences have not always been granted on merit. The absence of skilled supervisors and regulators compounds this problem. As a consequence, some banks in the region still have problems with non-performing loans. The technological development of SADC banks lags behind in many instances, and communications infrastructure is often inadequate.

There is also a need for a greater range of banking services. Rural areas tend to be underbanked. While informal mechanisms such as credit rotation schemes have provided a means of overcoming these problems, there is room for the expansion of formal banking services into these areas. Semi-formal institutions can help to bridge the gap between the formal and informal sectors of the market, by acting as intermediaries (Aryeetey, Senbet & Urdy, *op. cit*.).

1.2.5. Stock market development

As mentioned earlier, financial systems in the Southern African region have tended to be bank-dominated. However, a number of stock exchanges were established during or after the period of reform, in Mauritius, Botswana, Namibia, Swaziland, Malawi and Zambia. More recently, exchanges have opened in Mozambique and Tanzania. The market capitalisation of some of these exchanges has grown rapidly over the past few years.

Nevertheless, stock exchanges in the region are small and illiquid, with the obvious exception of the JSE Securities Exchange in South Africa. They are also extremely volatile. These smaller exchanges are effectively competing with each other for investment from abroad. Some countries even have restrictions on foreign ownership of shares. Tanzania, for example, does not allow foreigners to invest in its newly-created stock market, although this regulation is expected to be repealed in the next few years. Zimbabwe also has restrictions on foreign participation in its stock market, limiting acquisition to 35% of shares traded on the exchange.

The following table shows the results of a survey by Forbes Global and the US-based Milken Institute in mid-1999, on access to capital in Africa. African countries were ranked according to three measures of access to capital: the breadth and depth of capital access; corruption and transparency; and risk. Table 3 shows the top ten countries, with the SADC countries highlighted.

Table 3: Ranking of selected African countries according to measures of access to capital

Country	*Rank*
South Africa	**1**
Egypt	2
Mauritius	**3**
Botswana	**4**
Morocco	5
Côte d'Ivoire	6
Ghana	7
Nigeria	8
Kenya	9
Zimbabwe	**10**
Zambia	**11**

Source: Economist Intelligence Unit

Stock markets can play an important role in that they allow companies to access long-term finance, which banks have not generally been willing to provide. In some of the SADC countries, major factors in the decision to establish an exchange were the opportunities offered by the privatisation process and the role that stock exchanges could play in this process. Recently-privatised firms that have listed on SADC bourses include Press Corporation in Malawi, ZCCM in Zambia, and Tanzania Oxygen in Tanzania. Listing these large companies has given a boost to the exchanges' market capitalisation and has allowed a significant number of local people to become shareholders in the privatised companies, which would not have been likely had the companies been sold directly to buyers (Jeffris, 1995).

Low liquidity is a problem faced by many of the SADC stock exchanges. This tends to decrease the attractiveness of investing on the exchange, since portfolio investors often take a short-term view on the market and prefer to be able to shift between different stocks and different markets as easily as possible. The low level of liquidity on SADC markets arises for several reasons. The first is the high proportion of institutional investors on SADC exchanges, who tend to follow a "buy and hold strategy" (Kenny & Moss, 1998). Secondly, while the larger exchanges in the region are open throughout the week, some of the smaller exchanges are open only on certain days, and then only for a few hours at a time. Thirdly, the dominance of the market by a few large companies also results in less liquidity.

In conclusion, it should be mentioned that, while this analysis has treated SADC as a group, the financial systems in the SADC region are characterised by great heterogeneity, partly owing to the dissimilar histories of these countries. Section II highlights some of the characteristics of the financial systems in the individual countries.

SECTION II: AN OVERVIEW OF FINANCIAL SYSTEMS IN THE SADC COUNTRIES[3]

2.1. Angola

Angola is, by African standards, a relatively wealthy country, largely due to its oil and diamond reserves. However, the economy has been characterised by macroeconomic imbalances since independence in 1975, owing for the most part to the ongoing civil war.

The banking system in Angola has been heavily controlled by the government since independence, although some reforms have taken place in the 1990s. Until 1991 there were only two banks in Angola, the Banco Nacional de Angola (BNA), which served both as a central bank and a commercial bank, and Banco Popular de Angola, a commercial bank owned by the state.

The BNA no longer operates as a commercial bank, and three Portuguese banks have opened. Citibank, Paribas and Equator Bank all have representative offices in Luanda. The Angolan government created a parastatal, Caixa de Crédito Agro-Pecuaria a Pescas (CAP) in 1991, which took over the commercial banking activities of the BNA in 1996.

Nevertheless, the banking system remains problematic. Banking services outside of Luanda are extremely limited, due to the security risks posed by the ongoing civil war. Long-term credit is difficult to obtain, which means that long-term investments have to be financed from external sources. Stringent exchange controls are still in place, and the exchange rate is fixed by the government, creating a large parallel exchange market. This means that domestic savings tend to be converted in US dollars and deposited with one of the Portuguese banks, or overseas. Notably, in some years, Angola's domestic savings have comprised over 25% of GDP, although there are huge fluctuations in this level. This is probably due to the boom and bust nature of Angola's economy, and its heavy dependence on oil revenues. A significant proportion of savings is therefore likely to be accounted for by large parastatals and government.

Foreign exchange shortages prevail. CAP is also used extensively as a means of propping up parastatals, through the provision of concessionary or interest-free loans. Furthermore, there is no capital market and the insurance industry is state-run.

Angola's financial sector is unlikely to develop further until after the civil war has ended, and the government is able to correct the deep-rooted economic imbalances that exist in the country.

2.2. Botswana

[3] The Democratic Republic of Congo and the Seychelles were not included in the analysis, due to lack of information.

The mainstay of Botswana's economy is diamonds. Botswana has managed its economy relatively well since independence, which as a result has remained stable. It has not had not undertake any major economic reforms, including financial sector reforms.

There are four main banks operating in Botswana: Stanbic, Standard Chartered, First National Bank, and Barclays Bank. Stanbic is wholly owned by its South African parent company, while the other three have a minority local ownership. There is also a building society and a savings bank, and a number of development finance institutions. The Botswana Development Corporation, in particular, is a major investor through equity and loans.

Botswana has made significant progress in developing its financial services industry over the past few years. Since 1994, Botswana has seen the launch of its first credit card, its first point-of-sale debit card, the introduction of foreign exchange bureaux and foreign currency accounts, and the abolition of exchange controls. Advances have also been made with regards to automating and interlinking banking processes and branches, and cheque-clearing time has been reduced. On the legislative side, a new Banking Act was passed in 1995, which widened the scope of the original Act.

Interest rates have remained more or less stable over the past two decades, and positive real interest rates have been maintained since 1993. M2 money supply as a percentage of GDP, an indicator of financial depth, appears to have stagnated since 1980, and is still much lower than that of South Africa. Another indicator of financial depth – domestic credit to the private sector as a percentage of GDP – has also shown little growth over the past two decades. Furthermore, value added in banking as a percentage of GDP has not shown much increase since 1980, and remains around the 10% level.

Whether this picture will change over the next few years depends partially on the success of Botswana's recently-established International Financial Services Centre (IFSC). The diversification of Botswana's economy away from mining is a priority of the government, and financial services are seen as an industry in which Botswana can develop a competitive advantage. The objective of the IFSC is to act as a conduit for funds from South Africa and the rest of the world, into Africa, with its main services being the administration of offshore collective investments and international business companies. It is hoped that the concessional tax rate of 15% will attract international companies to Botswana, with priority being given to companies from the SADC region. Two companies, African Banking Corporation and African Alliance, have been awarded certificates for regional and international banks, and six others, including HSBC and Absa, are expected to follow soon.

The central bank issues Bank of Botswana Certificates, which range in maturity from one to nine months and which are traded on the secondary market. The majority of these certificates are held by commercial banks. Indirect monetary policy tools are used, namely the bank rate and open market operations through the purchase and sale of Bank of Botswana Certificates.

The Botswana Stock Exchange (BSE), which has been operating since 1995[4], is small, although a number of dual-listed companies give a significant boost to its market capitalisation. Like most of its African counterparts, the BSE is characterised by low liquidity. Nevertheless it has been increasing used by local companies to raise finance, which is an encouraging sign. Five unit trusts have recently been established by African Alliance, with two of these being regional funds, focused on the SADC market.

Data on foreign portfolio investment into Botswana is scant, but international investment position data reveals that, as of end-1998, the stock of foreign portfolio investment in equities amounted to US$148.7 million, while foreign investment in debt securities stood at US$3.7 million. Botswana's bond market is rather underdeveloped, with only a few bonds available.

A great amount of effort appears to have been put into developing Botswana's financial sector. Nevertheless, the country still has some way to go before its financial services industry can claim to be world-class, in terms of the cost of services, the range of products offered, and the quality of services. Furthermore, significant portions of Botswana's vast territory remain underbanked, due to the geographical distribution of financial services. Nevertheless, some banks in Botswana appear to be taking steps to extend their branch networks.

2.3. Lesotho

Lesotho's population is small and mainly rural, with per capita income at only US$396 (1998 figures). The country's membership of the CMA has a strong influence on the financial sector, with movements in interest rates, money supply and so on being closely linked to developments in South Africa.

Two SA banks dominate the banking sector: Stanbic and Nedbank. Stanbic acquired Barclays Bank of Lesotho in 1995, and also recently bought a 70% share in the ailing Lesotho Bank from the government, with R600 million being loaned to the government by Stanbic to salvage customer savings. The state-owned Lesotho Agricultural Development Bank was closed down in 1998, since no buyer could be found. The bank was originally set up to provide banking services to rural people and to provide credit for agriculture, in which a large proportion of Lesotho's population is engaged. This is a market in which the commercial banks have been reluctant to engage.

Probably due to its low level of income and the lack of adequate banking services, the level of savings in Lesotho is extremely low. According to the World Bank's African Development Indicators, gross domestic saving has been consistently negative over the period 1980 to 1998, although dissaving has been reduced considerably in recent years. Government dissaving accounts for some, but not all, of this amount. A possible reason for the highly negative savings level is that migrant labourers (from which Lesotho receives a considerable portion of its gross domestic income) tend to invest their savings in South African banks. There is evidence that a considerable amount of assets belonging

[4] The informal market began operations in 1989, however.

to Basotho nationals is held in the South African banking system (Mowatt & Zulu, forthcoming).

The main source of growth in credit over recent years has been credit extended to the Lesotho Highlands Water Project, which may have resulted in some crowding out of lending to the private sector. Indeed, domestic credit to the private sector as a percentage of GDP increased steadily until 1995, after which it began to decline rapidly.

2.4. Malawi

Malawi is classified as a least developed country, with a GDP per capita of just $238 (1998 figure). It has followed the IMF Structural Adjustment Programme route, which has included an overhaul of its financial sector.

Before the reform programme began, there were only two banks in operation, namely the National Bank of Malawi and the Commercial Bank of Malawi, both state-owned. Preferential lending rates were granted for agriculture, and banks were required to direct 50% of their credit to the sector. Other loans tended to be concentrated in a few conglomerates, which also accounted for most of the deposits. There was no secondary money market, and no capital market. The Reserve Bank of Malawi used credit ceilings, administered interest rates, changes in reserve requirements and moral suasion as its tools of monetary policy.

Malawi's reform programme was launched in 1988. It was based on increasing the flexibility of interest rates, stimulating competition in the banking sector, developing a money market and a secondary market for bonds and equities, and a gradual move towards indirect money control (Soyibo, 1997). Controls on interest rates were fully removed by 1990 and quantitative credit controls relaxed in 1991.

Additionally, state-owned banks were recapitalised, a task which was made easier by the restructuring of the banks' major customers, Malawi's large parastatals. Claims on non-financial state enterprises have fallen rapidly in line with this. Furthermore, exchange controls on the current account were relaxed in 1994. Foreign exchange bureaux have recently been introduced, but there is sometimes a scarcity of foreign exchange, which is generally obtained from tobacco sales.

The reform process has resulted in the entry of several new banks into the market - there are now five commercial banks, a discount house, as well as a number of financing houses, development finance institutions, leasing companies, a savings bank, and a mortgage finance institution. As a consequence, new products have been introduced, interest is now paid on demand deposits, and banks' opening hours have been extended. ATMs are in operation for some banks. There is a move towards greater automation of payment and clearing systems in banks. Nevertheless, the services offered by the financial sector remain fairly rudimentary, and the informal sector remains an important source of credit. Furthermore, the reform process does not appear to have stimulated domestic saving, as might have been expected. While there have been large fluctuations in the ratio of savings to GDP since the reforms began, the ratio stood at a mere 0.7% of GDP in 1998, down from 10.8% in 1980. Government dissaving has decreased during this period, which suggests that the drop in total saving must be due entirely to the private sector.

With regard to banking supervision, the legal framework was revised in 1989, with the introduction of a new Banking Act. The Reserve Bank of Malawi has tightened up its regulations and enforcement. Directives on credit concentration, capital adequacy, provisions for bad and doubtful debt, limits on foreign currency lending, foreign currency exposure limits and a policy statement on liquidity management, have recently been issued. Banks have also adopted international accounting standards. The KPMG Africa Banking Survey reveals that capital adequacy ratios are generally greater than 15% for the major banks operating in Malawi. The returns on capital and assets also appear to be healthy, using South African banks as a benchmark for comparison.

Monetary policy is now conducted on a more market-based approach. The central bank has been issuing Treasury Bills of varying maturities since 1994. And where most of the 1980s were characterised by negative real discount rates in Malawi, there has been a sharp shift to positive real interest rates.

The Malawi Stock Exchange was established in December 1994, but only went into operation in November 1996, when it received its first listing. The dual listing of Old Mutual on the MSE recently has significantly boosted its market capitalisation, resulting in a jump from US$147 million at the end of 1998 to US$7910 million at end-1999.

Malawi's financial sector reform programme progressed gradually and more smoothly than in many other African countries. Growth in the real sector of the economy is required, however, before further development can realistically occur. Finally, it is interesting to note that Malawi remains one of the few SADC countries where South African banks do not operate.

2.5. Mauritius

Mauritius has been one of the SADC region's star performers economically, achieving growth rates above 5% throughout most of the 1980s and 1990s. As a small island economy, it has grown through a strategy of export promotion. It undertook its own structural adjustment programme, which began in the early 1980s.

The financial liberalisation programme involved interest rate liberalisation, the abolition of direct control on bank credit, and a move towards using indirect monetary policy tools such as open market operations. Full currency convertibility was attained in 1994. The bank rate is now a market-related one, linked to yields on treasury bills that are auctioned on a weekly basis.

The banking system is dominated by two banks, the Mauritius Commercial Bank and the State Bank of Mauritius. There are a number of other smaller banks in operation, however. There is an extensive ATM network across the island, and ATM-sharing mechanisms are now in place. Progress has also been made with regard to developing a better, electronically-based, national payment system. To stimulate the development of the financial sector, the government provides tax incentives for financial institutions under the Pioneer Financial Services Scheme.

Mauritius also has an offshore banking sector, which was set up as part of the Mauritian government's strategy to make the financial sector the fourth pillar of the economy, alongside sugar, tourism and clothing. Offshore banks, of which there are eleven, offer merchant banking, insurance, fund management and securities services. Non-residents are the main customers of this sector, often US companies with investments in India. A tax treaty between Mauritius and India creates tax advantages to companies with investments in India that channel their funds through Mauritius. Tax incentives are available for offshore banks and offshore trusts.

M2 money supply as a percentage of GDP has increased steadily since 1980, indicating a deepening of the financial sector. Over the same period, interest rates have remained fairly stable, and real rates mainly positive. Mauritius also has one of the highest savings rates in the region – climbing from 10.5% of GDP in 1980 to 24.2% in 1998. Value added in banking has increased to around 5% of GDP, although the latest figures available are from 1995. This is one of the highest in the SADC region.

Banking supervision is in line with international standards, as prudential regulations were strengthened as part of the financial sector reform process. New capital adequacy guidelines were issues in 1994, in line with those prescribed by the Bank for International Settlements. Banks have also been required to observe international accounting standards since 1994.

The Stock Exchange of Mauritius (SEM) has been in operation since 1989. Its market capitalisation is currently around US$1643 million, with 48 listed companies. Liquidity has also increased substantially, although it is still low by international standards. The increase in liquidity has been aided in part by the introduction of an electronic clearing and settlement system and central depository at the SEM.

Data on foreign portfolio investment (FPI) is only available from 1994-98. FPI inflows totalled US$176 million in 1995, but fell to –US$15 million in 1998, probably as a result of the Asian crisis.

2.6. Mozambique

When the civil war ended in 1986, Mozambique began the process of rebuilding its economy. Since the start of its structural adjustment programme in 1987, Mozambique has moved away from its formerly socialist economic policies towards a market-friendly approach which has attracted many foreign investors.

With respect to the financial sector, Mozambique was served mainly by two state-owned banks, Banco Comercial de Moçambique (BCM) and Banco Popular de Desenvolvimento (BPD). These banks were used in the main to provide off-budget finance to loss-making parastatals. Claims on non-financial state enterprises tailed off dramatically after the inception of the reform programme in 1987.

New banks began to enter the market, but the services they provided were limited: mainly short-term, trade-related finance and fee-for-service business. This situation has begun to change, however, with lengthening loan terms and declining lending rates, although trade finance still remains the most important area of business for banks.

A key component of the reform programme has been the privatisation of the two state-owned banks. BCM and BPD were privatised in 1996 and 1997 respectively. The latter has subsequently changed its name to Banco Austral. Another important reform was the development of new legislation and regulations to govern the banking sector. These have included, among other things, legislation to allow the establishment of leasing companies and regulations regarding capital adequacy ratios.

There has been a trend towards developing new products and services, partly as a result of the competition introduced by the entry of a number of new banks. The branch network of banks has also been extended dramatically.

Gross domestic saving was positive for the first time in many years in 1997. In 1998, saving as a percentage of GDP stood at 1.7%. Value added in banking was at 3% of GDP in 1998.

On the monetary policy side, open market operations are now an important tool. Treasury bills were introduced in 1997, and efforts are underway to develop the money market further. The exchange rate has been floating since the mid-1990s.

A small stock exchange was established in 1999, as was Mozambique's first venture capital fund.

Mozambique's financial sector appears to be set to expand along with the real sector. The current stability of the Mozambican *metical*, the low levels of inflation and the high economic growth trend suggest that the financial sector will develop new products and services, and should grow in importance as a contributor to GDP.

2.7. Namibia

The Namibian economy is small and dependent mainly on mining and agriculture. It has close historical ties to South Africa, receiving its independence from that country in 1989. Unlike many SADC countries, no serious reform of the financial sector was needed, since the sector historically has been market-driven.

There are five commercial banks in Namibia: Bank Windhoek, First National Bank of Namibia, Commercial Bank of Namibia, Standard Bank and Nedbank. The banking sector is modern and efficient, and provides comprehensive domestic and international banking services.

The Banking Institutions Act of 1998 replaced the old regulatory regime inherited from South Africa. The Act is based on international supervisory practices and banking standards, and empowers the Bank of Namibia with more effective regulatory powers.

To curb the outflow of savings to South Africa, the government introduced legislation that requires at least 35% of Namibian-generated funds to be invested in specified local assets. As a result, gross domestic savings increased from 13% of GDP in 1995 to 19% in 1998. A number of merchant banking and asset management firms have been established in Namibia to take advantage of the minimum assets legislation.

As a member of the Common Monetary Area, there are no exchange controls between other CMA countries (South Africa, Lesotho and Swaziland) and Namibia. The exchange control regime closely mirrors that of South Africa, as does its monetary policy.

M2 money supply as a percentage of GDP is high by SADC standards, and has been increasing steadily since independence. Domestic credit to the private sector has also risen, from 22% of GDP in 1990 to 39% in 1998. Looking at the four largest banks, in most instances bank profits have risen consistently since 1992, as have both the return on capital and the return on assets.

The Namibian Stock Exchange (NSX) was established in 1992. A large portion of its market capitalisation is comprised of dual-listed South African companies. Namibia's market capitalisation is one of the largest in Africa, and amounted to a staggering 875% of GDP at the end of 1998 (to put this in perspective, the JSE's market capitalisation was 128% of South Africa's GDP in the same year). If only the local market is considered, however, this figure is reduced to only 14% of GDP. More local firms are using the NSX to raise capital, however, and local stocks tend to be more liquid than the dual-listed stocks. At the end of 1999, there were 41 companies listed on the exchange, with 14 of these being local companies.

Foreign portfolio inflows peaked in 1995 at US$82 million (when they accounted for 19% of gross domestic saving) but fell to –US$4 million in 1998. Flows appear to be evenly balanced between equity and debt securities.

2.8. South Africa

The South African economy is much larger than any of its counterparts in SADC, and is more diversified. Agriculture, mining, manufacturing and the services sector all play an important role in the economy. The Growth, Employment and Redistribution (GEAR) document has informed economic policy since 1996, as has South Africa's re-entry into international organisations such as the World Trade Organisation, the IMF and the World Bank.

South Africa has a sophisticated financial sector. South Africa's value added in banking, both in absolute terms and as a proportion of GDP, is the highest in the SADC region. Although there are around 41 banks operating in South Africa (10 foreign-controlled), the banking sector is dominated by First National Bank, Nedcor, Standard Bank and Absa. Standard Bank was recently the subject of a hostile takeover bid by the smaller Nedcor, but the merger was blocked by the Minister of Finance. The smaller banks tend to concentrate on specialised markets and services, while the four large banks mentioned above have a strong retail and corporate focus. Top international banks have entered the investment banking sub-sector in particular.

The financial services industry also appears to be growing in importance for South Africa, as value added in banking rose from 10% in 1980 to 17% in 1998. M2 money supply as a percentage of GDP has remained relatively constant since 1980, and stood at 54% of GDP in 1998. This is the third highest in the SADC region, after the Seychelles and Mauritius, which have both experienced high growth rates of M2 money over the past decade. Real interest rates have been climbing since 1992, due to the contractionary monetary policy followed by the South African Reserve Bank. On the other hand, the domestic savings rate has been on the decline, falling from 31% in 1980 to 17% in 1998. With regard to private savings, this is partly due to a greater flow of funds out of the country, as well as the increased uncertainty around the value of the rand. Government dissaving has been significantly reduced since hitting a peak in 1993 at 9% of GDP – it is now around 3%.

In spite of the sophistication of South Africa's financial services industry, access to credit is often cited as a constraint on entrepreneurship. The bigger banks have tended to steer away from risky markets, or markets which they do not understand. However, there are a number of state-owned institutions that facilitate the supply of finance to small, medium and micro-enterprises (SMMEs), such as Khula. On the retail side, the demand for loans has been partly filled by microlending institutions, which the government is now attempting to regulate better after allegations of unethical practices. Informal lending institutions such as *stokvels* continue to play an important role in the financial system. Such institutions are now subject to special regulations. The government has also tried to crack down on pyramid schemes, which have been gaining in popularity recently.

The JSE Securities Exchange has a large market capitalisation, given the size of South Africa's economy. As of end-1999, market capitalisation was US$262,606 million and there were 668 listed companies on the exchange. It is the largest stock exchange in Africa. The volumes and value of shares traded have increased immensely during the 1990s, as has the liquidity. To some extent this can be attributed to increased interest by foreigners in the South African market, but also to more efficient systems in place at the stock exchange. For example, an automated trading system was introduced in 1995, replacing the old trading floor.

FPI into South Africa has risen dramatically since 1994. Foreigners invested US$13,557 million in debt and equity securities in 1999, as opposed to US$2,917 million in 1994. FPI inflows accounted for approximately 7% of GDP in 1999. Interestingly, while inflows into equities have risen more gradually, flows into the bond market have been extremely volatile. Portfolio outflows have also increased significantly since 1995, due to the partial relaxation of exchange controls, with a record US$5,082 million leaving the country in 1998. Most of this was invested in foreign equities.

The South African financial services industry is therefore well-developed and is of an international standard. It is a possible area of competitive advantage for South Africa, especially since the country also has many well-trained financial professionals. However, access to credit and banking facilities by the poor is an issue that still needs to be properly addressed.

2.9. Swaziland

Swaziland is a small kingdom bordering South Africa and Mozambique. It has a strong manufacturing sector, which accounts for around 40% of GDP.

The banking sector has seen a consolidation over the past few years, with the takeover of Meridien Bank by First National Bank in 1995, and Barclays Bank by Standard Bank in 1998. The state-owned Swaziland Development and Savings Bank has also recently been closed down. Standard Bank, Nedbank and First National Bank also operate. Other sources of finance include the Swaziland Building Society, which provides mortgage lending facilities, and the royal investment trust, Tibiyo TakeNgwane, which lends to small businesses. There are several other venture capital schemes; the central bank guarantees 75% of any loan obtained from these schemes. The Swaziland Industrial Development Company finances industrial projects. Informal savings and credit co-operatives are also an important component of the financial sector.

Foreign exchange controls are almost identical to those of South Africa, since Swaziland is part of the CMA. The Swazi currency, the *lilangeni*, is at parity with the South African rand. Monetary policy is conducted through the discount rate, open market operations, and reserve and liquidity requirements. Most treasury bills are held by the commercial banking sector.

M2 money supply as a percentage of GDP was at 27% of GDP in 1998. This indicator has tracked the movements of South Africa's M2 money supply closely. As a percentage of GDP, domestic credit to the private sector has been declining since 1994, probably due to rising interest rates.

A stock market opened in Swaziland in 1990, but there was no physical location for the exchange and trading took place over the telephone. The official Swaziland Stock Exchange came into operation in 2000, and there is now a trading floor. As noted in *Business Day*, however, there was no trade at all on the exchange's opening day. New legislation is necessary to allow government to regulate the market properly. The market capitalisation of the exchange has fallen significantly since 1996 when it was US$471 million to 1998, when it amounted to only US$85 million.

FPI is low, and inflows have not exceeded US$1 million in any year since 1989. In fact, the stock of FPI at the end of 1999 was a mere US$310,000. All of this was held in equity securities. However, gross domestic savings have increased significantly since the early 1980s, comprising 19% of GDP in 1998 as opposed to 6.5% in 1980.

2.10. Tanzania

The Tanzanian government followed strongly socialist policies until the 1980s, with the aim of making Tanzania a wholly self-reliant state. Agriculture accounts for about half of its GDP, although other sectors in the economy, such as tourism and mining, have yet to realise their full potential. GDP per capita is low at US$257 (1998 figure).

The financial system was structured with the aim of making Tanzania a self-reliant state. There were three banks in operation – the National Bank of Commerce, the Cooperative and Rural Development Bank, and the People's Bank of Zanzibar, the latter which operated mainly on the island of Zanzibar. The banking sector was heavily controlled by the government, who made most of the loan decisions. Tanzania's financial institutions therefore became mechanisms to finance the budget deficit and subsidise loss-making parastatals.

Furthermore, bank workers were generally poorly-paid and accounting systems and internal controls weak (Soyibo, 1997). Moreover, there was a lack of traditional banking skills, since the state took responsibility in deciding who would get credit and who would not, and hence loan decisions were made mostly on the basis of political expediency.

The first reforms took place between 1986 and 1989, when interest rates were allowed to rise gradually. Following this, the state banks were restructured and recapitalised. The system of fixed interest rates and fixed differentials was replaced in 1991 by a single maximum lending rate. There was a gradual switch toward a greater use of indirect monetary policy instruments. The real discount rate was persistently negative until 1994, when it shot up to 29%. At the same time, gross domestic savings as a percentage of GDP has increased since 1994, although off a very low base. Savings as a proportion of GDP stood at 6% in 1998. M2 money supply as a percentage of GDP has been declining over the past few years, and currently stands at about 19%. Domestic credit to the private sector as a proportion of GDP has also been declining recently, from 10% in 1994 to 4% in 1998.

The exchange rate regime is now floating, and the parallel rate has almost disappeared. Tanzania has also relaxed exchange controls on the current account. Controls on the capital account require that foreign investment must be subject to an approval process.

The National Bank of Commerce (NBC) was split into two separate entities, one dealing with corporate clients and the other with smaller customers. A 70% stake was sold to

Absa in 1999. When Absa bought NBC, it was technically insolvent and loan decisions were being made on political rather than economic grounds. Absa has since turned NBC around, doubling its performing loan portfolio as a proportion of assets (*Business Day*).

Other banks in operation include: Stanbic, which took over Meridien Bank in 1998; Standard Chartered; Barclays; and Eurafrica Bank Tanzania, in which Belgium's Banque Belgolaise is the main shareholder. The government has a majority shareholding in the Cooperative & Rural Development Bank, the Tanzania Investment Bank, and the Tanzania Postal Bank. As a result of new entrants and better management, value added in banking has increased, from 1.4% in 1990 to 2.4% in 1998.

An additional component of Tanzania's financial sector reform programme was the strengthening of the Bank of Tanzania's role in monitoring and enforcing banking regulations. There are regulations on large credit exposure, capital adequacy, liquidity ratios, open foreign exchange positions, provision for bad debt, restricted lending, and deposit insurance. There is a money market in operation, consisting of short-term deposits, interbank borrowings by commercial banks through the clearing-house, and treasury bills.

The Dar es Salaam Stock Exchange was launched in 1998, with two listings, Tanzania Breweries and Tanzania Oxygen. The stock exchange was used as a privatisation vehicle for these two companies, to ensure a portion of local ownership. Foreign purchases of shares on the exchange are currently not allowed, but it is expected that this restriction will be removed in time.

2.11. Zambia

Zambia's economy is dependent largely on copper mining. It has undergone a strict structural adjustment programme since the 1980s, part of which involving the liberalisation of financial sector.

There are around 20 banks in operation in Zambia today, as opposed to only five in 1980. The banking system consists of private banks, both international and domestic, and parastatal banks. Banks were encouraged to enter the market by Zambia's liberalisation policies and the relatively low minimum capital requirements. There were also expectations of large profits. Under the radical economic reform programme of 1985-87, interest rates were liberalised and, as a result, the spread between lending and deposit rates quickly widened, increasing bank profits.

Soyibo (1997) notes that Zambia did not take sufficient account of sequencing in its reform programme, which meant that there were periods of dramatic reform, followed by reversals of some of the reforms.

M2 money supply as a percentage of GDP has declined considerably from levels set in the 1980s, due to the tight monetary policy followed as part of Zambia's structural adjustment programme. At the end of 1998, M2 was at 14.2% of GDP, as opposed to

29.2% in 1980. Claims by the monetary sector on the private sector have also fallen, both in total and as a percentage of GDP. In 1998, domestic credit to the private sector amounted to US$184 million, or 5% of GDP.

Real interest rates have been consistently negative until recently, with the real discount rate reaching –45% in 1992. Domestic savings levels have experienced large fluctuations since 1980, but in general have followed a downward trend. In the 1980s, savings levels tended to be above the 10% of GDP level (in spite of negative real interest rates), but they have remained below this benchmark over the past decade. This is in spite of the fact that government dissaving was, for the most part, higher in the 1980s than the 1990s.

Banking regulations have recently been tightened. A new Banking and Financial Services Act of 1994 replaced the Banking Act of 1972. This Act transferred the functions of the Registrar of Banks from the Ministry of Finance to the Bank of Zambia. A revision of the Banking and Financial Services Act was undertaken in 1997, to make the Act applicable to non-bank financial institutions and deposit protection schemes. Pyramid schemes are now prohibited. Further, demanding regulations regarding start-up capital and statutory reserve requirements on foreign exchange deposits caused six of the 13 registered banks to close during 1997. Stricter rules on disclosure have been prompted by an increase in money laundering activities.

Domestic financing for business operations is difficult to obtain, except for export-oriented production. Rather than lending, banks tend to absorb excess liquidity by purchasing treasury bills. Most businesses therefore self-finance, or turn to international sources of finance in hard currency. Medium and long-term borrowing is made impossible by high interest rates.

Exchange controls have been abolished and residents are allowed to hold foreign exchange accounts. The deposit levels in such accounts tend to be quite high, because of concerns about the depreciation of the Zambian *kwacha*.

The Lusaka Stock Exchange (LuSE) was established in 1994, and in 1997 it was the best-performing market in sub-Saharan Africa. Its market capitalisation increased from US$229 million at end-1996 to US$706 million at end-1997. However, it dropped to US$301 million at end-1998, partly due to disappointment surrounding the lack of progress on the privatisation of Zambia Consolidated Copper Mines. The LuSE is regulated by the Securities and Exchange Commission. The clearing and settlement process is automated and achieved three days after trade (T+3 basis).

While financial sector reform has increased the number of banks operating in Zambia, lending activities by banks and savings activities by the private sector seem to have been reduced since the early 1980s. This may be partly due to high interest rate spreads, raising questions as to whether an increase in the number of banks has actually promoted competition. Once there is greater confidence in the domestic currency and inflation has been brought under control, however, saving and lending activities may be increased.

2.12. Zimbabwe

Zimbabwe has a fairly well-diversified economy, with the main sectors being agriculture, mining and manufacturing. Its economy is slightly smaller than Angola, making it the third largest economy in the SADC group. Zimbabwe has also followed an IMF-prescribed structural adjustment programme, which has resulted in the removal of price controls, the deregulation of foreign investment, trade liberalisation, exchange rate liberalisation, and financial sector reform.

Zimbabwe's financial sector is relatively well-developed, although it has been experiencing some problems recently. There are a number of commercial banks, merchant banks, finance houses, building societies, and discount houses. There is a wide branch network. The main commercial banks are Barclays Bank of Zimbabwe, Standard Chartered Bank, Stanbic, the Commercial Bank of Zimbabwe, and Zimbank, in which the government is the major shareholder.

The Zimbabwean government encouraged the entry of local banks, as part of its indigenisation policies. Sound regulation of the banking sector has often given way to political concerns, particularly since the Ministry of Finance is responsible for issuing banking licences, and so the Reserve Bank of Zimbabwe has been unable to fulfil its banking supervision mandate effectively. Nevertheless, a directive on capital adequacy was issued in 1998, which requires compliance with the 8% level set by the Basle Accord.

In 1998, United Merchant Bank issued fraudulent bills. The bank subsequently collapsed, bringing down the Zimbabwe Building Society with it. The ongoing land crisis has also affected the banking sector. Currently, banks are not lending to farmers, particularly those whose farms have been earmarked for redistribution. This is because farmers generally use their land as collateral, but cannot do so without security of tenure. However, without credit, farmers may not be able to purchase sufficient seed, fertiliser, animal feed, etc., which could result in a decline in agricultural output in near future.

The discount rate remained at the 9% level from 1981 through to 1989, with the real rate being for the most part negative or marginally positive. Both deposit and lending rates jumped dramatically when the interest rate regime was liberalised in the early 1990s, and the real discount rate climbed to positive levels. The exchange rate was market-determined from 1994 to 1999, when the government again fixed the currency to the US dollar. The differential between the parallel rate and the official rate has increased significantly as a result, especially during 2000, when the increased political uncertainty and the lower tobacco sales sent the parallel rate plummeting. There has also been a slight reversal in the liberalisation of exchange controls, with the current account still being subject to some control.

Gross domestic savings have fallen in recent years, although the savings rate (as a percentage of GDP) has increased steadily since the 1980s. The savings rate has been higher than that in South Africa since 1994, and stood at 20% in 1998. Domestic credit to the private sector as a percentage of GDP has increased from levels in the 1980s, and was at 17% of GDP at the end of 1998.

The Zimbabwe Stock Exchange (ZSE) is fairly small but well-established. There were 70 companies listed on the exchange at the end of 1998. Its capitalisation is dominated by a few mining companies. Although the ZSE survived the Asian crisis fairly well, it has been hard hit by the current economic problems which are plaguing Zimbabwe. Foreign investment on the ZSE was permitted in 1993, although there is a limit on foreign participation, which stands at 35% of the total equity of a company. Foreign portfolio inflows were positive for the first time in many years in 1994, amounting to US$50 million (or 0.7% of GDP) due primarily to investment in equities. Unfortunately no data on portfolio inflows is available for the years following 1994.

2.13. Summary

This chapter has highlighted some of the main characteristics of the financial systems in the individual SADC countries. It is clear that the disparate histories and experiences of the Southern African countries have shaped their individual financial sectors differently. There are, for obvious reasons, strong similarities between the CMA countries. Angola, Mozambique and Tanzania are all formerly socialist economies, with a history of state involvement in the banking sector. Malawi, Zambia and Zimbabwe had a mixture of state and private sector participation in the financial sector. Botswana and Mauritius are currently trying to diversify their economies and have identified the financial sector as a potential driver of growth.

With the exception of Angola, all of these countries have, or are on the path to having, a liberalised financial sector with strong prudential regulation. Many have undertaken structural adjustment programmes. With a few exceptions (notably Mauritius) it seems as though structural adjustment has not facilitated easier access to credit for business, both domestic and foreign. Furthermore, access to saving and loan facilities for the rural population is inadequate in many of the countries, including South Africa. Measures to promote such access, through the establishment of development finance institutions and the direction of credit to preferred sectors, have generally not been successful, although informal institutions are playing an important role in this regard.

Finally, it seems clear that financial sector development cannot take place independently from growth in the real sector of the economy, and that an environment of macroeconomic stability, especially monetary stability, needs to be fostered before the financial services industry can flourish.

SECTION III: REGIONAL INTEGRATION

SADC was set up in 1980 (as the Southern African Development Co-ordinating Conference, or SADCC) to reduce the dependence of countries in Southern Africa on their large neighbour, then apartheid South Africa. With the democratic elections in South Africa in 1994, the context changed. South Africa joined SADC in 1995, and a rearrangement of SADC’s objectives was required.

SADCC had a sectoral focus, with the responsibilities for co-ordinating activities lying largely within various countries, rather than with the small Secretariat. The objective was not so much integration as co-ordination, with activities taking place on a project basis. When South Africa joined, it was assigned the responsibility of co-ordinating the Finance and Investment Sector. The Finance and Investment Sector Co-ordinating Unit (FISCU) was established in South Africa's Department of Finance (now the National Treasury). Proposals for the restructuring of SADC, in line with its new objective of economic integration, have been approved but have yet to be adopted. These proposals involve a higher level of centralisation of activities at the SADC Secretariat in Gaborone, Botswana, a measure which is expected to give greater impetus to the integration process.

The possibilities for macroeconomic convergence have been discussed by SADC Ministers of Finance, and a Macroeconomic Subcommittee was recently established to work on the issue. The major task of FISCU at this stage is to draft a Finance and Investment Protocol, combining inputs from a wide range of participants. On the finance side, inputs will be sourced in particular from the Committee of Central Bank Governors, the Committee of SADC Stock Exchanges, the Committee on Insurance, Securities, and Non-Banking Financial Authorities, and the SADC Banking Association. So far, a clear, co-ordinated policy on the financial sector has not yet been articulated, although all four committees have their own stated aims and objectives. It is anticipated that the Finance and Investment Protocol will draw together these objectives, and link them with other aspects of integration, such as macroeconomic convergence.

3.1. Challenges

SADC faces several challenges as an organisation promoting regional integration:

Firstly, the large size of South Africa relative to the other economies could result in a polarisation of economic activity in South Africa if integration is not handled carefully. This is true of the market for financial services as well. South Africa's dominance of the region also leads to accusations of hegemony, which means that South Africa is sometimes constrained in the role it can play. SADC countries may be fearful of becoming mere "colonies" of their larger neighbour. The suspicions of South Africa's neighbours play themselves out both in the political and the business arena. Problems experienced by Absa in Tanzania (*Business Day*, July 27, 2000) point to the latter, for example. South Africa therefore needs to manage its role in the region carefully, not just politically but in economic and business matters as well. On a related note, South Africa will also need to redefine its relationship with other members of the CMA and SACU, in such as way as to foster interdependence rather than dependency.

Secondly, regional integration involves sacrifices in terms of national sovereignty. A harmonisation of financial regulation, for example, could mean that countries have to set aside certain national policy objectives in the interests of the region as a whole. Furthermore, the benefits of regional integration may take a long time to accrue – longer than the length of a particular leader's term of office, perhaps. Mustering the political will to take regional initiatives seriously is therefore an important requirement for financial integration, and integration in general. Ownership of the process of regional integration is also important, and may be difficult to achieve given the current differing development needs of the SADC countries.

Thirdly, most countries within SADC belong to one or more other regional grouping – SACU, the Common Market for Eastern and Southern Africa (COMESA), the Indian Ocean Commission (IOC), the East African Community (EAC), to name a few – all with mostly economic aims. This significantly constrains the resources (financial and human) that governments can devote to SADC. Indeed, some countries give preference to one group over another, which results in non-attendance of meetings, etc. It is not clear how this thorny issue should be resolved, however. A rationalisation of such initiatives seems, politically, to be out of the question. A more hopeful possibility might be co-operation between the various organisations, to eliminate areas of overlap.

Finally, the objectives of financial integration will clearly be thwarted in an environment of political and economic instability. The two countries in SADC currently involved in civil wars are Angola and the DRC, with troops from Namibia and Zimbabwe also being involved in the conflict. The recent turmoil in Zimbabwe over land invasions has also done little to promote investor confidence. SADC as an organisation has not been able to quell these conflicts. In terms of economic integration, however, a phased approach could be used, whereby countries in conflict or facing severe macroeconomic instabilities are excluded from regional economic arrangements and initiatives until their "houses are in order."

3.2. Which approach to follow?

As mentioned in the introduction, there is no clear policy as to whether SADC is aiming for EU-style financial integration or something else, nor on the time-frames for these goals to be achieved. Currently, the initiatives of the Committee of Central Bank Governors have taken place on a project basis, an approach that seems to have worked well. The initiatives falling under the SADC Ministers of Finance have tended to target more ambitious areas, such as development finance, investment promotion, and macroeconomic convergence. Consequently, achieving "buy-in" from member state governments has been rather more difficult, because of the perceived political trade-offs involved in some of these areas.

3.2.1. Financial integration, EU-style

Financial integration in the EU has included the adoption of a common currency, a common central bank, the establishment of a liberalised internal market for financial services, and some convergence of financial variables, such as interest rates and the inflation rate.[5]

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[5] There is a worldwide trend towards *global* financial integration, and much discussion around the integration of developing countries into global financial markets. While capital does flow more freely

For regional financial integration to occur, there needs to be an abolition of restrictions on the free movement of capital within the region, i.e. a removal of exchange controls. Banks, insurance companies, and other financial institutions should be free to establish themselves anywhere in the region. There also needs to be, at the very least, some compatibility in financial regulation. If this is not the case, national regulatory bodies will raise concerns about funds from their own countries being channelled into what they may perceive to be unsound institutions or investments. A banking crisis in one country would have ripple effects throughout the entire region. Certain minimum standards therefore need to be met, if not complete standardisation of rules and regulations. Financial integration is therefore more complicated than trade integration since, unlike tangible goods, financial services suffer from problems of asymmetry of information and therefore require more intensive regulation.

The benefits of financial integration include the creation of a region-wide market in financial services, which will increase the efficiency of the financial sector by allowing resources to flow to their most efficient uses. Furthermore, if achieved successfully, financial integration will make the region concerned a more attractive investment proposition for foreign investors, given the current small size of most of the SADC economies. An integrated capital market might increase liquidity, for example, which will increase the attractiveness of the market for investors.

In the EU model, the integration of the market for financial services was driven partly by market forces and partly by national governments (Underhill, 1997). Three key elements were identified as being crucial for financial integration to occur. These were:

- The free flow of capital between EU member states;
- The freedom of establishment of financial institutions within the region; and
- The freedom of provision of financial services across national borders.

Financial integration was aided by the changed global financial context. Reforms in countries such as France and Germany have resulted in a more "marketised" financial sector throughout Europe, bringing the markets of continental Europe and London, the centre of EU market, closer together.

Financial integration has proved difficult in many areas, as the EU experience has borne out. Cross-border capital flows are still subject to a number of constraints, including the relatively high cost of cross-border payments. Institutional investors face restrictions on cross-border investments, and great differences in national regulatory regimes still exist (Pelkman, 1997). Differences in tax treatment also create barriers. For example, the development of a regional market for insurance services has been hampered by the non-tax deductibility of insurance payments if the services are purchased outside national borders. Proposals to implement a minimum withholding tax throughout Europe, in order

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between countries than previously, there is a long way to go before a truly integrated global market is established.

to minimise tax competition were resisted, in particular by Luxembourg, which has no taxes on capital at all.

3.2.2. Co-operation

A looser form of integration, which takes places through co-operation, would perhaps be more appropriate approach for SADC at this stage. Forums could be set up for various role-players in the financial sector to meet and discuss possible areas of overlapping interest. This could involve agreements to share infrastructure or facilities, exchange of information, and/or the initiation of regional projects aimed at improving the financial sector. Co-operation between SADC countries in the financial sector can help realise economies of scale in this manner. Furthermore, SADC countries can utilise the expertise of South African financial professionals, as well as those in Zimbabwe, Botswana and Mauritius. Regional capacity-building exercises could also be undertaken. Such initiatives are generally politically neutral and are thus much easier to implement than measures such as the liberalisation of exchange controls and tax harmonisation.

The problem with this kind of approach is that it is *ad hoc*, rather than taking place within the context of greater economic integration. It is also much less ambitious.

Obligations to a regional organisation such as SADC can also help countries to maintain the momentum and establish the credibility of the reform process (Calamitsis, 1999). This will depend on how seriously countries regard these obligations, however. Harvey (2000) argues for an external agency of restraint, negotiated and accepted by SADC member governments, which would lock countries into agreed reforms. According to Harvey, foreign investment is critical to the success of regional integration and such an agency will enhance investors' confidence in the sustainability of reforms. It is, however, unlikely that such an agency of restraint would be politically acceptable at this early stage in the integration process in SADC.

Given the diversity of the financial systems within the SADC region, the dominance of South Africa in terms of its much larger and more developed financial sector, and the perceived need to maintain some degree of flexibility in implementing national policies at this stage, a regional approach to financial sector reform based on co-operation, rather than integration, seems to be a more appropriate route to follow. The case for harmonising rules and standards in SADC at the moment is not clear, given the differing development needs. For example, banking legislation appropriate for Mauritius may not be appropriate for a country such as Tanzania, and vice versa. Aryeetey, Senbet & Urdy (1997) point out that cognisance need to be taken of each country's particular needs and problems for regional agreements to be successful. The groundwork for financial integration in the future could possibly be laid through more informal co-operation mechanisms.

A background document to the still-to-be-developed SADC Finance and Investment Protocol emphasises the following as being key to the process of regional economic integration (USAID/FISCU, 1998):

- The need for a broad-based, participatory and incremental approach, with a requisite level of ownership at both the political level and at the level of civil society and the private sector;
- The need for a flexible approach, with implementation at different speeds for different countries, given the variation in the countries' levels of development;
- The need for practical means to create incentives to comply with SADC benchmarks; and
- The use of Memorandums of Understanding, which are not legally-binding, to arrive at agreement on particular policies and courses of action.

If SADC is to achieve monetary integration in the longer term, some degree of convergence on the financial side will also be required. This should be borne in mind when considering a regional approach to financial sector development. Nevertheless, a less ambitious and more politically-acceptable programme should be developed for implementation over the next few years, concentrating on areas in which regional co-operation can be achieved without too much difficulty. One priority for now could be the role of the financial sector in promoting *trade* integration. Banks, for example, are important in providing trade finance. Barriers to free trade may be created by exchange control regulations. And efficient cross-border payment and settlement for trade transactions requires well-functioning payment systems.

SECTION IV: CO-OPERATION AND INTEGRATION IN THE FINANCIAL SECTOR

Since most SADC countries are still in the process of developing their financial sectors, a regional – as opposed to a national – approach could be taken in this regard. This is a possible advantage that SADC has over groupings such as the EU. In many cases, national structures are not yet in place, or need to be reviewed. If this process can be undertaken in a regional context, financial integration will be easier to achieve in the future.

4.1. Banking

What more can policy makers in SADC do to further develop and strengthen national banking systems?

1. *Banking and other financial legislation should be appropriately formulated according to international principles and standards*. Banking crises generally carry large fiscal costs and can seriously damage a country's credibility. A banking crisis in one SADC country could also have a spillover effect on other countries in the region, especially as regional integration progresses. To avoid the possibility of such crises occurring in the region, policy-makers need to ensure that good banking supervision legislation and institutions are in place in all SADC countries. In the short-term, an assessment could be made of the existing banking legislation and banking supervision practices in the region. Where this legislation and implementation is considered to be

inadequate, expertise from other SADC countries could be brought in to suggest improvements, bearing in mind the possible goal of harmonisation later on. A common approach to combating money laundering, corruption, and pyramid schemes, for example, could also be developed. In the longer-term, steps could be taken to harmonise, for example, regulations on asset and risk classification, capital adequacy ratios, and deposit insurance (Mistry, 1996a). As the World Bank points out, banking supervision is administratively demanding and institution-intensive, requiring a sufficient number of skilled supervisors. SADC countries could work towards a fully-harmonised set of regulations, which would allow for expertise to be imported from countries with a surplus of skills to those with deficit of skills in this area. Alternatively, a bank from one SADC country setting up a subsidiary or branch in another SADC country could be regulated from its home market, as is the case in the EU. This would lessen the pressure on regulators in countries where there is less expertise, as these countries would most likely be the ones importing banking services from other countries.

2. *Improving linkages and communication between banks in the region.* Payment systems could be inter-linked, in order to speed up the processing of transactions. These measures would, among other things, assist in promoting regional trade (Mistry, 1996). A project under the auspices of the SADC Central Bank Governors is currently tackling some of these issues [*see section 4.8*]. Measures to speed up cross-border clearing of cheques could be implemented. More generally, priority should be given to upgrading the communications infrastructure in SADC countries where such infrastructure is inadequate.

3. *A greater diversity of financial instruments could be developed in order to assist individuals, business and government in managing their risk better*. While banks cannot be forced to adopt new instruments, it may be that a lack of competition in the banking sector, or a lack of financial expertise, has impeded innovation. The array of financial instruments available in most SADC countries is limited. Fora such as the SADC Banking Association can promote the sharing of information between banking organisations in terms of different products which banks can offer their customers. New innovations developed in one country could be extended to the rest of the SADC region, especially in terms of banking services for the poor. Innovative ways of encouraging lending to higher-risk, longer-term projects should be developed. New regulations could be introduced across the region to permit the operation of credit-unions (as in South Africa) or small village-owned banks (such as those operating in the Philippines and Indonesia) (Nelson, 1999). The possibilities offered by Internet banking and e-commerce could be explored, especially in terms of their potential to reduce transaction costs in banking. However, there needs to be realism about what the Internet and e-commerce can and cannot do. Limited Internet access in most of the SADC countries, and limited levels of computer and other literacy could pose significant constraints.

4. *Create an enabling environment for the entry of new banks, both foreign and local*. Foreign banks can provide expertise and training for the local population, although

traditionally these banks have concentrated mainly on serving corporate customers. Local banks on the other hand tend to understand the market better, and therefore are better placed to lend to smaller businesses and individuals. The entry of new banks into the SADC market will hopefully fuel competition and growth, which in turn will result in a greater diversity of products and services being provided by the financial market in SADC countries. The entry of foreign banks could also promote technology and skills transfer.

4.2. Money Markets

Money markets refer to a market in short-term debt (maturities of one year or less). Unsecured overnight loans, commercial bills, treasury bills, and repurchase agreements are some of the instruments used in the money market. A well-developed money market allows banks and other financial institutions to manage their liquidity position effectively (Brummerhoff, 1999). Money markets also constitute an important tool for the monetary authorities in implementing monetary policy, through open market operations. Better-developed money markets can therefore encourage the move from direct to indirect monetary policy instruments. Successful open market operations require a sufficient number of participants and instruments, however, in order to be successful – otherwise, large fluctuations in interest rates may occur (Aryeetey, Senbet & Urdy, 1997).

All SADC countries have money markets, although these are at varying degrees of development. For example, many SADC countries do not have interbank money markets (where banks borrow from and lend to each other), or secondary markets in government debt. The main instruments used in the SADC region are marketable treasury bills and short-term government bonds.

Brummerhoff (1999) suggests several ways of developing money markets in the SADC region. These include fostering interbank markets in SADC countries to improve the effective use of available funds, and developing secondary markets in government debt. In countries with more advanced money markets, the range of instruments used should be widened to include bankers' acceptances, negotiable certificates of deposit, and commercial paper.

4.3. Capital Markets

The two components of capital markets which will be considered here are stock markets and bond markets.

As discussed in Section I, capital markets in most of the SADC countries are not likely to have a large impact on economic growth over the next few years. Nonetheless, capital markets still have a role to play. For example, Jeffris (1995) finds that the main impact of the Botswana Stock Exchange has been to allow institutional investors to diversify their portfolios, rather than the raising of new capital.

In order to broaden the role of capital markets in economic development, SADC countries will need to encourage individual share ownership as well as attracting foreign investors.

With regard to the former, this may require an extensive marketing and education programme, in order to promote a culture of investing. Domestic ownership of shares is important because it provides a buffer to the volatility of international capital flows (Kenny & Moss, 1998). To attract small investors, however, the stock exchange will need to be able to offer higher returns than other assets, while also not being too risky (Jeffris, 1995). The potential for smaller, higher-risk companies raising finance through the stock market is therefore limited, and such companies may need to find other avenues for raising capital, such as development finance institutions (Jeffris, 1995).

In order to attract more *foreign* investment, there needs to be provision of adequate financial information on companies listed on the SADC exchanges. This is one area in which regional co-ordination could be beneficial. The other SADC exchanges could perhaps "piggy-back" on the JSE's marketing systems in order to spark investor interest. For example, the JSE sells its market information to Reuters, Bloomberg and others; foreign investors can then tap into this information through services provided by such companies. Statistics from the other SADC exchanges could perhaps also be included in such information packages. Furthermore, the JSE produces a newsletter, which could be expanded to include market statistics from SADC exchanges.

Haphazard accounting regulations throughout the region mean that financial disclosure is not always in line with international standards, although this varies across countries. Financial regulators in the region could set some minimum standards for disclosure rules. As a first step, the SADC exchanges have harmonised their listing requirements along the line of the JSE. The establishment of guarantee funds and the prevention of insider trading are other issues that could be discussed by SADC exchanges and their regulators.

The SADC Committee of Stock Exchanges has as its aim a linked network of exchanges, as opposed to the creation of one regional exchange. The ultimate aim is to link trading systems and clearing and settlements systems, which would enable a market participant to trade on any one of the SADC markets. Although some have argued for the creation of a single regional stock exchange, developments in technology are such that the physical location of the exchange is no longer particularly important.

Movements towards electronic trading and settlement systems have also been made. South Africa has recently implemented the STRATE settlement system, in order to reduce settlement time and the concomitant systemic risk. It also has an electronic trading system (JET) in place. Mauritius, Zambia and Tanzania also have electronic settlement systems. The SADC Committee of Stock Exchanges plans to implement the Mauritian system in exchanges currently without central depositories.

The JSE has offered to link the other SADC exchanges to JET and STRATE, but the response has been mixed. The Namibian Stock Exchange is currently linked to the JET system, which has helped to increase their liquidity. However, a problem with the system is that it is dependent on operations in South Africa. For example, the Namibian market cannot open on South African public holidays, since the JET system is not in operation on these days. Other SADC exchanges have therefore been rather reluctant to take up the JSE's offer, especially with regard to STRATE, which has only recently been introduced in South Africa and is therefore more or less untested.

Dual listings and the listing of American Depository Receipts (ADRs) are other possible mechanisms to develop capital markets in SADC countries. The former would involve South African companies with their primary listing on the JSE Securities Exchange, taking a secondary listing on one of the regional bourses. Many of the companies listed on the Namibian and Botswana Stock Exchanges are dual-listed South African companies, which has had the effect of dramatically boosting their market capitalisation. Another example is the Zambian company Trans Zambezi International, which is also listed on the Zimbabwe Stock Exchange. Dual listings increase liquidity, and allow foreign companies to raise capital locally for their local operations. A disadvantage arises from the contagion effect: if, for example, the JSE suffers a crash, and a significant proportion of an exchange's shares are dual-listings with South Africa, then the effect of the crash will be quickly felt on the local market as well.

An ADR represents a fixed number of shares or bonds that are held in trust. In the US case, Mexican shares were issued as ADRs in the US market. They proved popular with investors because they were denominated in dollars, cleared easily and allowed investors to easily get involved in a foreign market (Wellons, 1997). South African Depository Receipts could possibly be used to issue the shares of companies located in, say, Zimbabwe or Zambia, on the JSE. A disadvantage of ADRs might be that trading shifts away from exchanges in the region to the JSE.

Some relaxation of exchange controls may need to take place for dual listings and ADRs to be feasible. There might be other regulatory barriers that prevent the dual listings or the issuance of ADRs. For example, South African institutional investors were, up till 1999, prevented by the Financial Services Board from investing in any of the SADC markets. It would be interesting to look at whether there has been a significant change in the pattern of South African portfolio investment into the region since this regulation was removed.

Bond markets provide another mechanism for raising capital. There is a trend towards using long-term debt to finance, *inter alia*, parastatals, local authorities and municipalities through the bond market, as opposed to central government funding. Bond markets are not developed in the region. Botswana, Zambia and Namibia have bond markets, and government bonds have been issued by Swaziland and Zimbabwe. South Africa, which has a large bond market attracting significant foreign investment, has only a small market for corporate debt. The remaining countries in SADC have little or no activity to date in long-term debt markets. According to a study done by the Lusaka Stock Exchange, bond market development in Zambia has been constrained by the limited number of dealers and investment advisors, as well as by macroeconomic factors. The study advises an extensive education campaign, the strengthening of incentives to institutions such as commercial banks to trade on the secondary market, and less stringent licensing fees for dealers (*The Times of Zambia*).

4.4. Data

A major handicap in devising effective policy is the lack of reliable data sources for many of the countries. Data on capital flows, for example, are generally not very detailed or reliable, with many transactions being recorded on the current account under the item "private transfers" (Kasekende, Kitabire & Martin, 1996). Good statistics are also crucial for effective regulation of the financial sector. Some co-operation between SADC countries to enhance the capacity of statistical units in central banks, for example, could help to alleviate this problem. A bilateral reconciliation initiative between SACU countries in the area of balance of payments statistics has recently begun, which could eventually be extended to other SADC countries. The SADC Committee of Central Bank Governors has also set up a database of monetary and financial statistics, which is updated biannually by the individual central banks. The database has statistics on national accounts, prices, balance of payments, exchange rates, government finance, interest rates, and money and banking. The database is available on the Committee's website (www.sadcbankers.org).

4.5. Technology and innovation

The telecommunications sector is crucial for the effective functioning of the financial system. Unfortunately, telecommunications infrastructure is inadequate in most of the SADC countries, necessitating the use of satellite technology in some instances. Flint (2000) notes that, in the case of Stanbic, their use of satellite technology has been resisted by national telecommunications companies. If SADC countries are committed to developing their financial sectors, they will therefore also need to place a high priority on the upgrading of their national telecommunications infrastructure.

Such advances in information technology have made the location of markets less important, as large amounts of money can be transferred around the world at the touch of a button. New technology therefore makes cross-border services viable, allowing for better exploitation of economies of scale. Banks may use their online operations to expand into foreign markets, without having to undertake the costly process of physically setting up operations there. New innovations suitable for the SADC market can also be developed. An example is the Smart Card system currently in use in South Africa, which enables pensioners to draw their pensions without the use of expensive terminals or telecommunications equipment, or without even the requirement of literacy (Nelson, 1999). However, there is a downside: new technology challenges existing regulation and supervision of the financial sector, meaning that regulators and regulation need to keep up to speed with these new developments.

The Committee of Central Bank Governors currently has an Information Technology Forum that addresses technology-related issues in central banks.

4.6. Accounting standards

According to the World Bank (1999), the development of legal and accounting systems significantly explains the development of financial intermediaries. Good accounting standards improve the ability of investors to determine which firms are worthy of investing in. The task of banking regulators can be made much easier if banks employ sound accounting standards. An initiative to bring the accounting systems of all SADC countries in line with international standards is currently beginning. The aims of the project are moving to an accrual-based accounting system in all countries, training of members of public accounts committees, and establishing greater independence for the offices of the auditors-general. The project is being driven by several accounting bodies, including the SADC Organisation of Supreme Audit Institutions (SADCOSAI), the East and Southern African Association of Accountants-General (ESAAG), the Eastern, Central and Southern African Federation of Accountants (ECSAFA), and the Institute of Public Finance and Auditing in South Africa (IPFA).

4.7. Exchange controls

If financial integration is the ultimate goal, exchange controls will need to be liberalised, at least within the region, if not generally. The implementation of a free trade area in SADC will be inhibited by exchange controls on the current account side; however, only Mozambique and Angola presently have current account controls. Controls on the capital account are still maintained, however, with the exception of Mauritius, Botswana and Zambia. South Africa is currently giving preferential access to investment flows to SADC countries as part of its exchange control liberalisation. For example, South Africans are allowed to invest up to R250 million per new investment in SADC, as opposed to R50 million for other countries.

The liberalisation of the capital account should take place in conjunction with other measures. The free mobility of capital within the region will require harmonisation of regulations throughout the financial sector, in order to decrease the possibility of arbitrage between the different countries, which could create instability. For example, capital might tend to flow to those countries that have sounder regulatory environments, while companies may prefer to list on exchanges that have listing requirements that are more lax than others. Interest rate and exchange rate arbitrage may also occur, highlighting the need for financial integration to proceed along with the convergence of certain key variables. Mutual recognition of each other's institutions as sound will also be required.

There is a free flow of capital between countries of the Common Monetary Area, namely South Africa, Namibia, Lesotho and Swaziland. A common complaint of the smaller countries is that there is a natural tendency for savings to flow to South Africa, rather than being invested locally. Consequently, Namibia has adopted a system of domestic asset requirements, whereby at least 35% of investments must be held domestically. If capital controls are liberalised within the SADC region, a similar problem may arise, which could result in a weakening of the financial sectors in some of the countries. Some form of compensatory mechanism will therefore have to be devised, as it is unlikely that even asymmetric liberalisation will solve the problem.

4.8. Role of the central banks

The functions performed by central banks in terms of, among other things, money markets and banking supervision, make them crucial to the process of financial sector reform. The efforts of the SADC Committee of Central Bank Governors are therefore encouraging. Substantial progress has been made since the inception of the Committee in 1995.

The Governors Committee, which meets on a biannual basis, provides a forum for discussion on issues such as exchange controls and monetary policy. Regular meetings of technical and specialised sub-committees also take place. Training facilities and programmes offered at the South African Reserve Bank and the Bank of Tanzania have been extended to the rest of the region.

An investigation into the legal and operational frameworks existing in SADC banks is currently being undertaken, with the eventual aim being to harmonise these. Issues to be tackled include the independence of the central bank.

In terms of banking supervision, the aim is to standardise regulations in accordance with international principles, as established by the Basle Committee. Banking supervisors have been discussing issues such as capital adequacy requirements, training of banking regulators, money laundering, and illegal banking activities.

SADC central bankers also have a project dealing with payment systems. Payment systems refer to the instruments, organisations, operating procedures, and information and communication systems used to effect the transfer of money. Payment system reform has been an integral part of most countries' financial sector reform programmes. The design of payments systems affects the efficiency with which monetary policy is conducted, the soundness of financial institutions, and the functioning of the economy as a whole (Balino, Johnson and Sundararajan, 1996). SADC countries need to design national payments that reduce transaction costs, since the manual systems that are currently in operation tend to result in long delays and increase the risk of fraud. Electronic systems reduce time lags in settlement, which in turn decreases the risk that a debtor might fail, for example. Currently the South African Reserve Bank is leading a project designed to establish efficient national payments systems in each SADC country. Once this has been achieved, moves will be taken to facilitate cross-linkages between the payments systems in various SADC countries, to enable cross-border transactions to take place with ease.

4.9. Role of the SADC Finance and Investment Co-ordinating Unit (FISCU)

FISCU has an important role to play as the co-ordinator of activities related to financial co-operation and integration. The key functions of FISCU are to ensure the involvement of all stakeholders in the process, to steer the direction of the economic integration process, as well as to procure financing from donor organisations for integration projects.

FISCU has been charged with the development of a Finance and Investment Protocol for the region. The Protocol will set out the manner in which financial integration should be achieved, including time-frames and institutional arrangements. The project will be financed by the EU, and consultants have been chosen to work on the project along with FISCU staff members.

The restructuring of SADC that has recently been approved by the SADC Summit is likely to result in the shifting of FISCU to the SADC Secretariat in Botswana. This raises questions as to the continuity of the work begun by FISCU in South Africa. Nevertheless, this move should ensure better co-ordination with and support from the SADC Secretariat. It should also help to soothe fears of South African dominance, since the staff of FISCU will be comprised of nationals from various SADC countries, not only South Africa.

4.10. Sequencing

How should a regional approach to financial sector development be sequenced? The approach outlined above suggests that, initially, more informal mechanisms of co-operation in the financial sector will be the most appropriate. Firstly, institutional arrangements to facilitate discussion within stakeholder groups need to be set up. This has to a large extent already been done, with the establishment of the Committee of Central Bank Governors, the SADC Ministers of Finance, and several private sector bodies. Commitment from SADC member governments is essential to ensure that meetings take place and that resolutions are carried out - even in the case of private sector organisations, which in any case will need to work closely with government institutions. Secondly, a comprehensive assessment of the various financial systems in the region will need to be undertaken. This will highlight the differences between these systems, as well as where the major areas of weakness lie. While targeting these areas of weakness will be the responsibility of the various national governments, experts in other SADC countries could possibly have inputs into the process. Some harmonisation of rules and regulations could take place, where appropriate. SADC meetings may also encourage bilateral co-operation between countries where areas of interest overlap. Furthermore, common SADC positions could be developed on issues to be negotiated at fora such as the IMF/World Bank annual meetings and meetings of the World Trade Organisation.

Further down the line, and depending on progress made in other areas of economic integration, some steps towards promoting financial integration could be taken. A first step would be to look at harmonising financial sector rules and standards. This would enable free trade in services to take place. It could also enable the free establishment of financial institutions throughout the region, which would promote competition and efficiency. Finally, SADC countries could undertake a commitment to liberalise exchange controls within the region within a certain time period. As mentioned above, complementary measures will need to be adopted if such a liberalisation is to be successful.

Whether these measures should be undertaken or not will have to be considered carefully. For some countries, the benefits of financial integration may be outweighed by the costs of large capital outflows, by the increased volatility of their financial markets, or by a banking sector dominated by foreign banks, which have no interest in catering for local development needs, to name but a few of the problems which may arise.

Measures to develop the financial sector cannot be implemented in ignorance of the broader economic environment. For example, the land crisis in Zimbabwe and the government's response to it has created a great deal of uncertainty, pushing up the cost of capital. Even with efficient systems and the best regulation, the financial sector will not help to promote economic growth if there is no business being done in the real sector of the economy. A virtuous circle needs to be created, where policies to promote economic growth are adopted by all countries in the region, a strong stand is taken against corruption, and there is a commitment to property rights and the rule of law. For SADC to work on an economic level, there needs to be consensus regarding what is good economic policy.

SECTION V: CONCLUDING COMMENTS AND QUESTIONS FOR FURTHER RESEARCH

Financial integration in SADC is likely to be a long-term process. There are some objectives that can be achieved immediately and without the necessity of an accompanying political process. Other objectives, such as liberalising capital flows in the region, will require more time and negotiation. The large size of the South African financial sector in comparison to those of other SADC countries could result in, for example, a polarisation of capital flows; these kind of issues need to be addressed before agreements can be reached. As with the free trade area, some asymmetry of reform or liberalisation might be necessary, depending on the individual circumstances of each member country.

The goal of financial integration needs to be considered in conjunction with the other objectives of SADC. A broad range of stakeholders will need to be involved in the process, including ministries of finance, central banks, and the financial community.

The restructuring and reform of the financial sector in SADC countries is in most instances incomplete. This represents an opportunity for regional co-operation and integration: rules and regulations governing the financial sector can be harmonised, the further development of stock markets can take on a regional dimension, etc.

Greater financial integration and better financial systems will assist in attracting private capital flows. It should be mentioned that private capital inflows are something of a double-edged sword. Given the low level of domestic savings and investment, however, it seems that SADC countries will need to attract more of these inflows to promote economic growth. Institutions and policies should be in place to ensure the efficient use of these flows, as well as to control their potentially destabilising effects. The banking system is the core institutional structure on which all other financial institutions depend. Priority should therefore be given to developing sound banking infrastructures in the SADC countries, including the development of efficient payment systems.

In terms of further research topics, the paper provides no discussion of development finance. It also does not consider insurance markets, which are mostly undeveloped in the SADC region and which form an important component of the financial sector. Other possible topics include looking at the connections between financial and monetary integration. For example, what kind of financial arrangements need to be in place for monetary integration to take place? SADC's objective of macroeconomic convergence cannot be achieved without some complementary financial sector policies. Would free flows of capital in the region require some form of tax harmonisation? It would also be interesting to look at the measures that have been put in place to promote financial integration in other regional groupings, particularly developing country arrangements such as Mercosur. Finally, the possibility of creating a financial hub for the region in Johannesburg could be explored, as well as the complementary policies which would be required to make this a politically acceptable and economically viable strategy for all the SADC countries.

Financial integration and financial sector reform are complex subjects, and this paper has only touched on some of the issues involved. Technical committees are already working on many of the topics discussed in the paper. Nevertheless, the paper aimed to present a framework in which to consider some of these topics, and could perhaps assist in preparing an agenda for future action.

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APPENDIX

Figure 1: Value added in banking (%GDP)

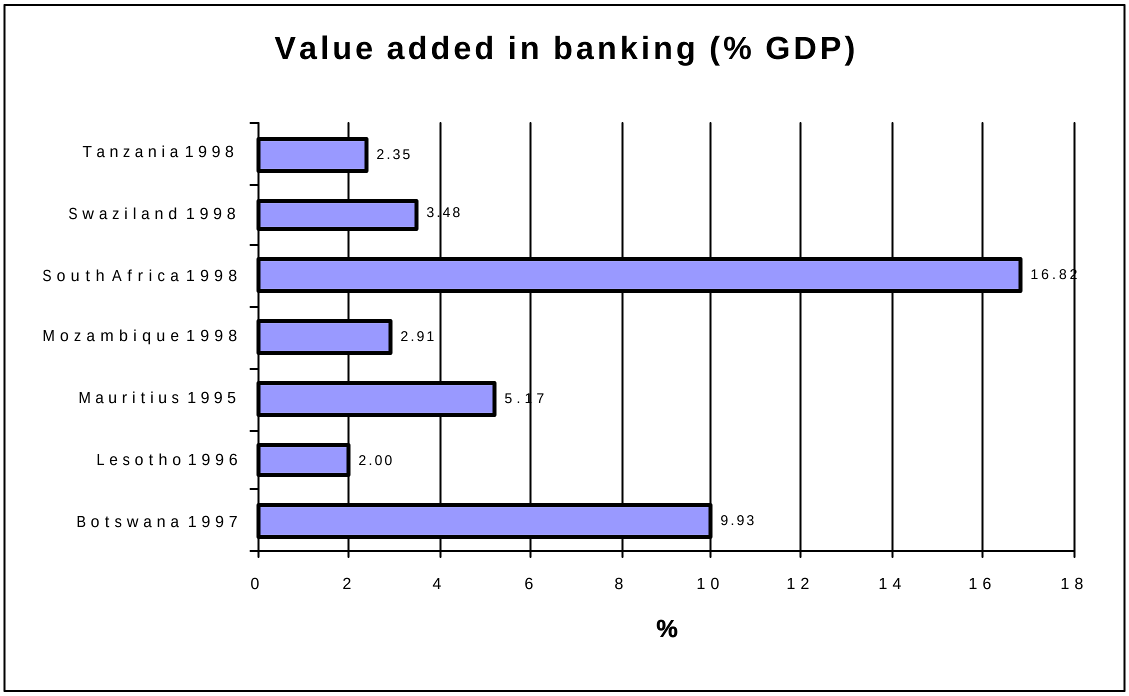
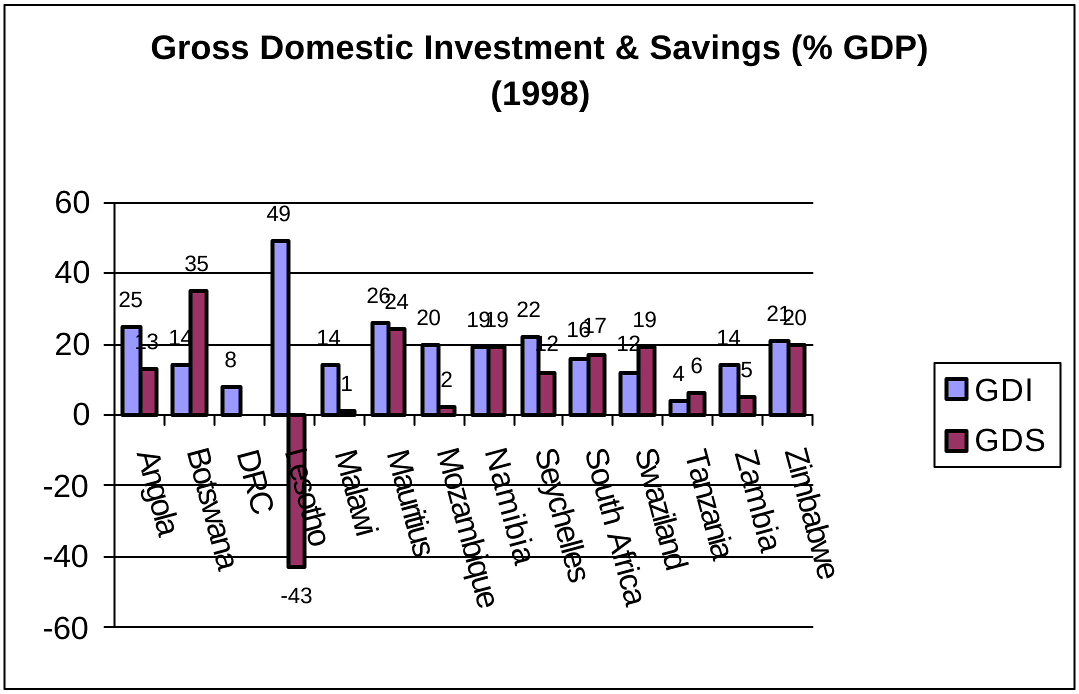
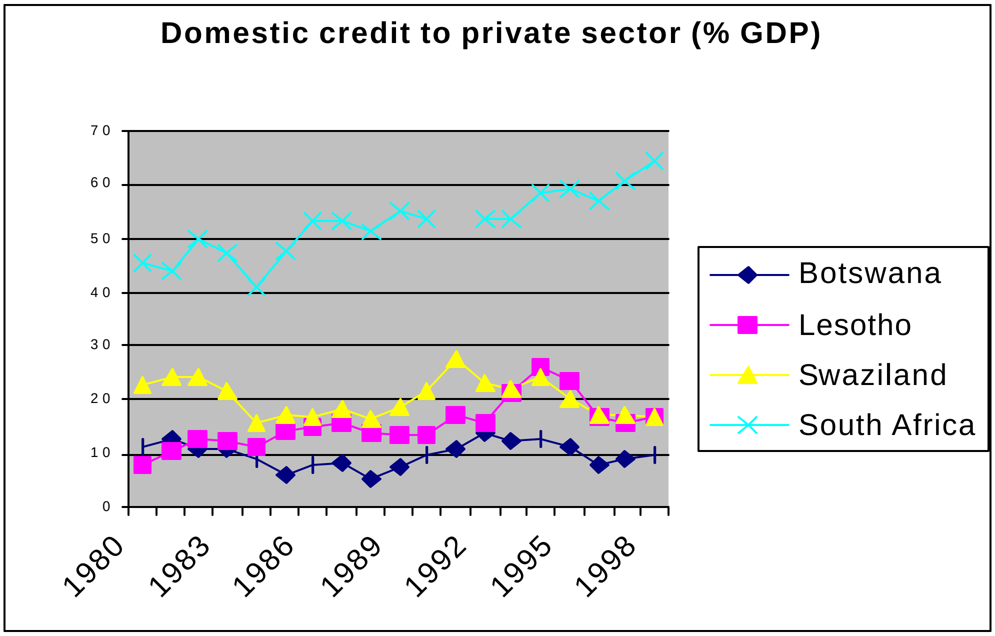


Figure 2: Gross Domestic Investment & Savings (%GDP)



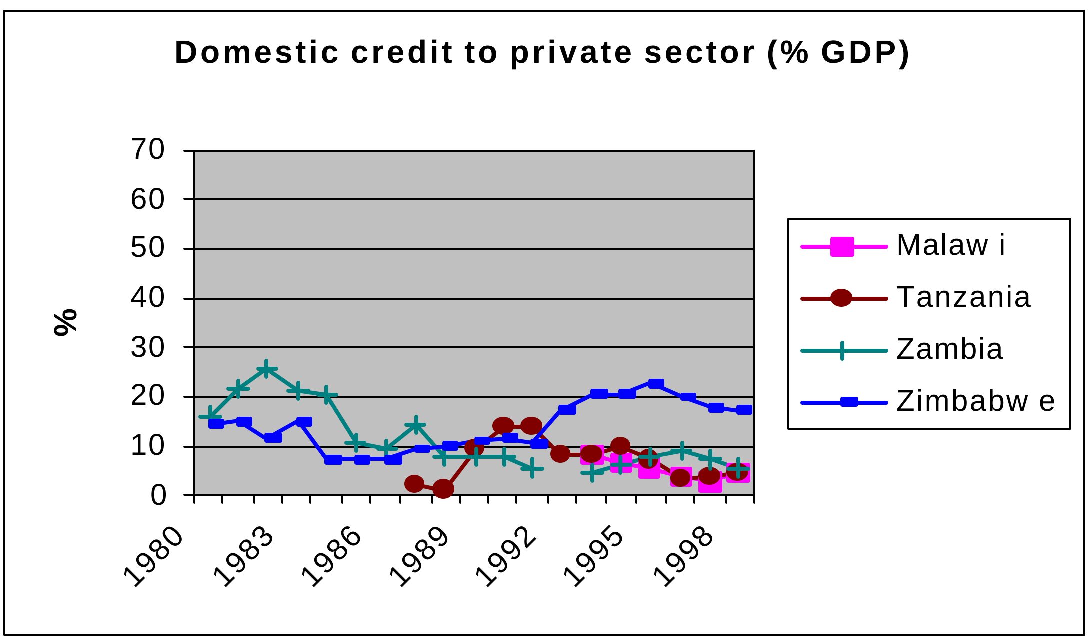
Source: World Development Indicators, 1999

Figure 3: Domestic credit to the private sector (%GDP)



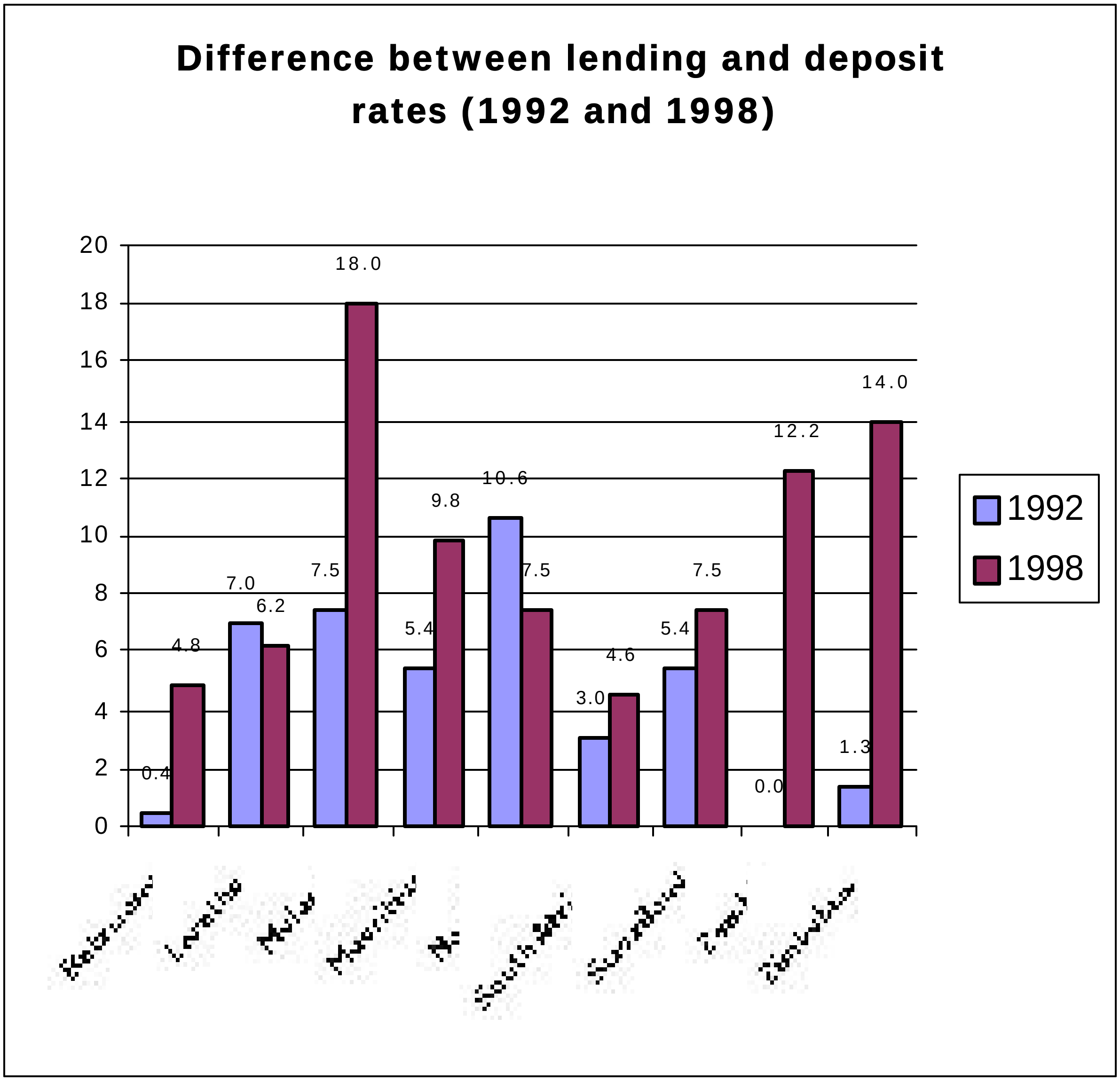
Source: IMF International Financial Statistics, 2000

Figure 4: Domestic credit to the private sector



Source: IMF International Financial Statistics, 2000

Figure 5: Interest rate spreads

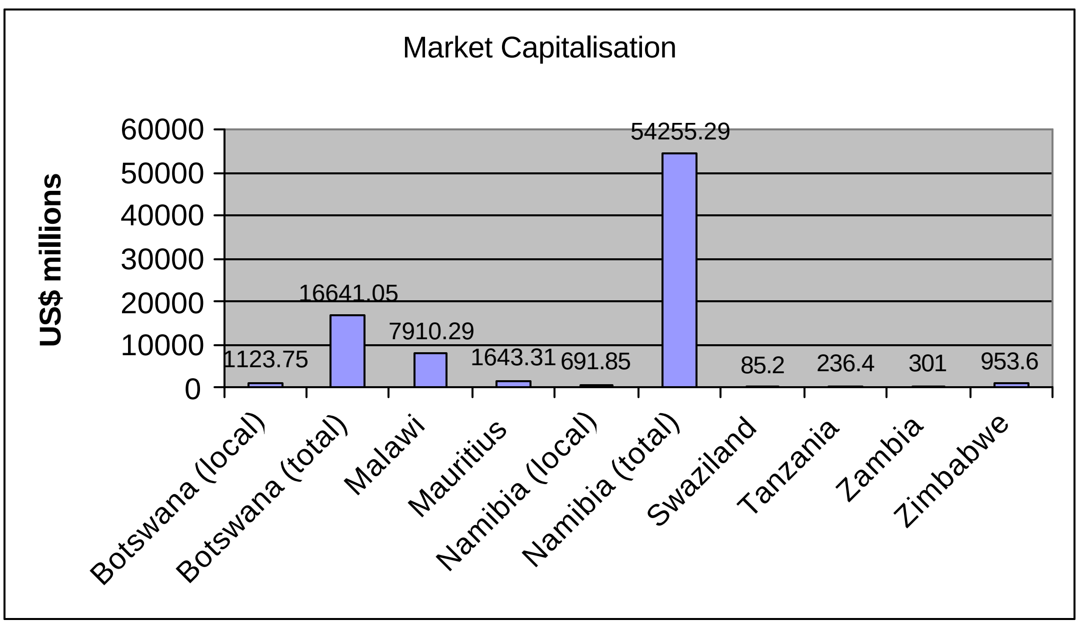


Source: IMF International Financial Statistics, 2000

Figure 6: Number of listed companies

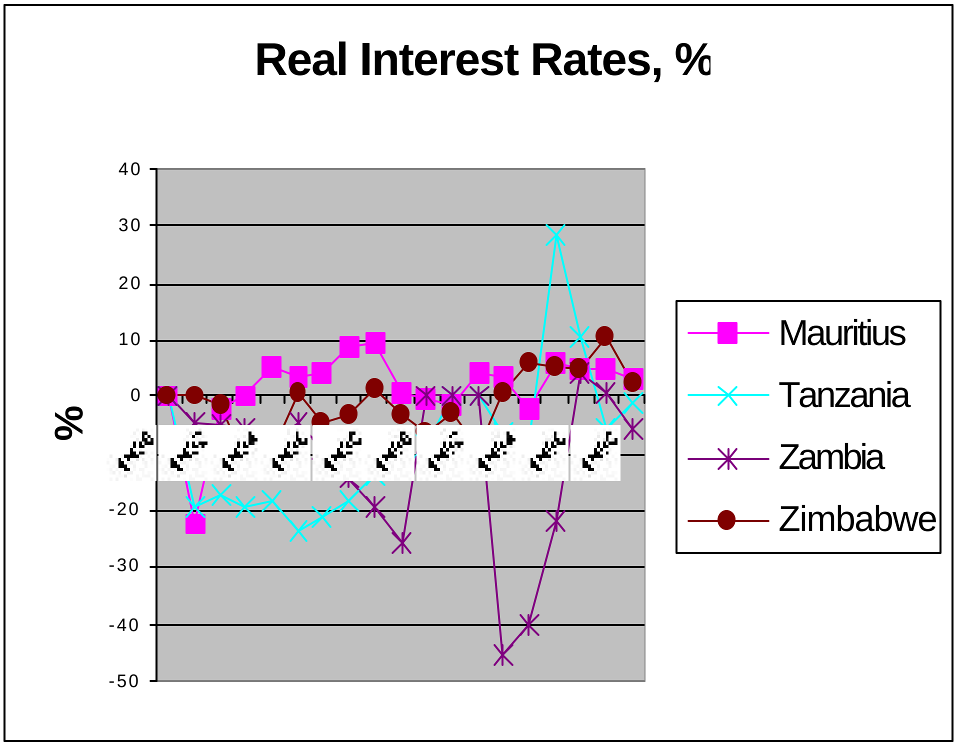
Source: SADC Stock Exchanges

Figure 7: Market capitalisation (1998)



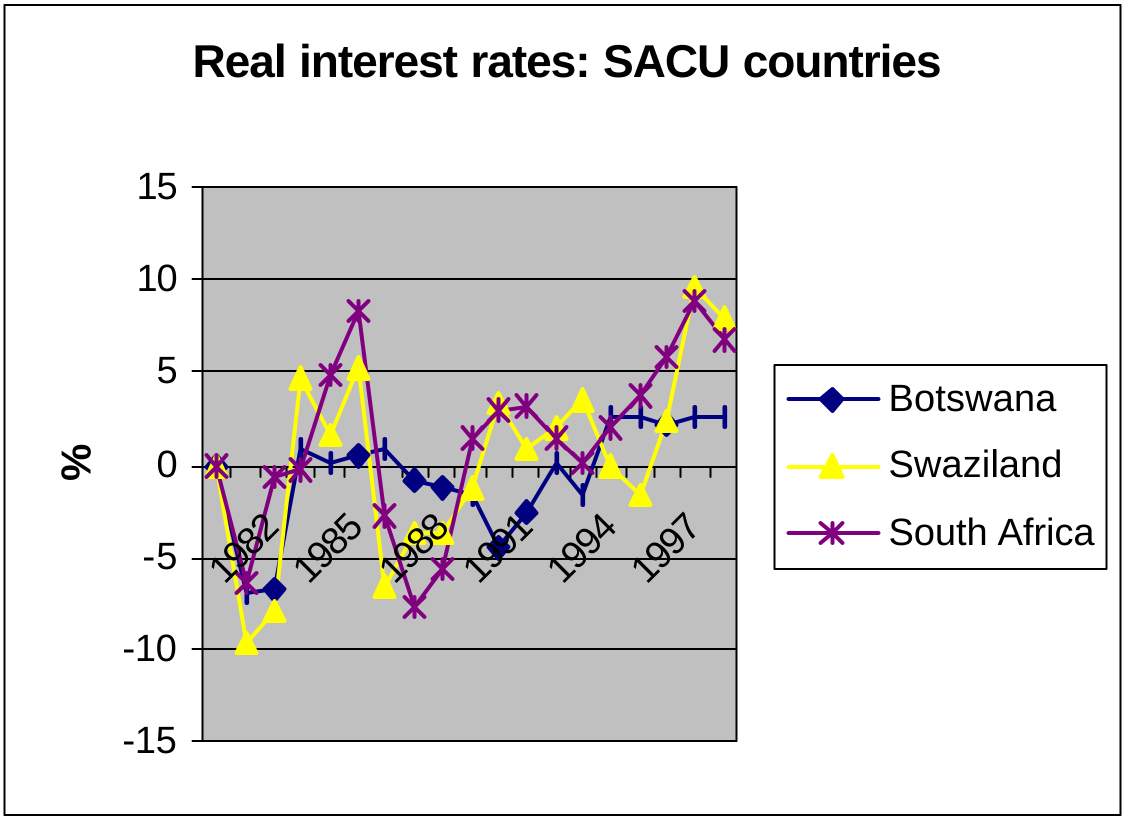
Source: SADC Stock Exchanges

Figure 8: Real interest rates



Source: World Development Indicators

Figure 9: Real interest rates, SACU countries



Source: World Development Indicators