THE ROLE OF CENTRAL BANK IN ECONOMIC DEVELOPMENT AND TRANSFORMATION: BEYOND MACROECONOMIC AND FINANCIAL STABILITY

RESERVE BANK OF MALAWI 50TH ANNIVERSARY

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The Focus

- Economic development and transformation requires:
  - Heavy infusion of public investments
  - Accessibility to markets
  - Strong institutions to develop and protect markets
- The Reserve Bank of Malawi:
  - Is an agent of market development
  - Focus on financial inclusion for financial development
  - Market for long term finance – bond market
  - Reform the Pension and insurance sectors to deepen the bond market

I. Malawi, Like any other African Economy:

- Is landlocked and natural resource poor and so has all the challenges that such an economy face in SSA
- But it can take advantage of its location and its relative comparative advantage
- The economy just like others in the region have generated growth in several sectors but this growth has not been sustained: what is needed now is a:
  - A long term vision and strategy for development – with policy 'follow through'
  - An economic transformation for growth and employment generation to eradicate poverty
  - Strong institutions to develop and protect markets
  - Accessibility to markets will produce an inclusive growth environment
  - A heavy infusion of public investments to open up production areas, complement private investments and create capacity for future growth.

II. Short-run Instabilities and shocks complicate economic management

- So what are required are buffers to protect markets:
  - Fiscal buffers – but we are far from fiscal surplus, seek budget support?
  - Foreign exchange buffers: accumulate in good times and seek credible BoP support programs
  - Food security buffers: This can be done and Malawi has been a good example
  - Energy buffers – more investments required to harvest clean energy – solar and wind.
- Invest in sectors with relative comparative advantage and with quick wins – agriculture has been a shining example – Maize was exported to the neighbouring countries in need including Kenya
- Huge roll out public investments in road networks, railway networks for the small holder farmers, firms and SMEs to reach the market:
  - Close the infrastructure gap – to lower transactions costs – enhance enterprise profitability and household savings
  - Encourage complementary private investments

III. The Reserve Bank and Financial Market Development

- The Reserve Bank has core mandates, but they revolve around monetary policy and market developments
- The Reserve Bank must be an agent of market development – financial market
- The Reserve bank must create an environment conducive for financial innovation that will encourage financial inclusion and market development
- The Reserve Bank must develop to be a strong institution:
  - Strong institutions define the rules of the game
  - Strong institutions will adequately define the appropriate incentives/penalties
  - A combination of the rules of the game and appropriate incentives/penalties will encourage prudent behaviour in the market place.
- Strong banks develop due to capacity in the intermediation process, this is where the role for financial inclusion becomes important.
- Strong banks can weather shocks.

IV. Financial Inclusion (FI) is consistent with Inclusive Growth

- A sustainable poverty reduction strategy must have market accessibility as a major component
- Financial inclusion is making financial market accessible; it has been recognized as a public policy that can fight poverty sustainably: so financial inclusion is consistent with inclusive growth
- The poor would like to save and accumulate capital to escape cycles of shocks and poverty in future (consumption smoothing story) – they are efficient in savings-investment cycles – capital accumulation story.
- Financial inclusion has enabled an endogenous demand to complete the domestic financial infrastructure.
- Financial inclusion has allowed banks to develop capacity to grow and to serve their market niches – strong banks can weather shocks and roll out competitive products - even for SMEs
- Financial inclusion has driven financial development and this will ensure financial stability

IV.1 We Need then to Reverse the Factors that Sustain Financial Exclusion

- Barriers to entry into the banking system
  - Minimum balance requirements
  - Cost of maintaining accounts – high ledger fees
  - Restrictions on number of withdrawals from savings accounts
- Low levels of income and irregular income flows
- History of weak regulatory technology and capacity that led to collapse of banks: a dark history of institutional failure, policy failure leading to market failure
- Weak legal framework and incomplete financial infrastructure – e.g. no deposit insurance or information on borrowers
- Information asymmetry on how banks operate/presence of segmented markets and preference of informal market – run away from costly formality
  - The operators in these market segments, especially the poor, are sensitive to financial products and their delivery mechanism
- Distance to the financial service access points: A trip to the bank is expensive – either to deposit or to withdraw; - Adds to the barriers to entry

IV.2 Financial Inclusion has a Growth and Transformation Component

- Inclusive growth can only work with access to markets – financial markets are critical: savings; investments; poverty reduction, trade finance, etc
- Banks need deposits to grow their intermediation capacity and lower unit costs
- Developing economies with nascent financial sectors have recognized that different market participants in different market segments are sensitive to costs as well as the delivery mechanism of financial services
- Then what viable solutions – deliver these services via a viable technological platform - the mobile phone – beginning of DFS revolution 8 years ago and now showing very positive results
- DFS solves the problem of physical distance, mass market will solve the unit costs issues but more importantly it is a platform to innovate and reach the target market niches required.
- In short DFS has become a platform for a menu of financial services to reach the low income as well as the well-to-do populace at the same time
- We have seen in recent years massive economic rents generated and distributed via this technological platform and more importantly massive reduction in transactions costs – the poor, the smallholder farmers and SMES in developing countries are cash-transactions heavy!

IV.3 Financial Market development will pull the economy with it

- Make financial markets accessible – the banking sector is the first entry point for financial inclusion: the poor would like a safe haven for their savings
    - Accumulate savings/capital for consumption smoothing
    - Efficient in savings/investment cycles – they can escape poverty in future
    - If the market develops affordable credit channels accumulation of capital is faster
- Effective and efficient Payments and settlement system will support all markets
- This development will allow an endogenous demand to complete financial infrastructure: information capital, deposit insurance, capital markets, insurance markets
- Monetary policy will work better to drive the economy

IV.4 Malawi - Financial Inclusion 2014 Survey

- 40% of the adult population included (female 28% and male 37%)
- 33% in the formal banks
- 28% in informal financial services
- 46% excluded – female 49% and male 45%
- What dominates banking services?
  - 68% transactions, 52% savings products, 30% remittances, 0nly 5% credit
- What about savings trends:
  - 54% of adults do not save, 14% keep their savings at home, 13% on informal channels and only 17% save in banks
- There is a chance that more financial inclusion drive is required to reach to the excluded 46% and those served by informal markets – 28%

V. Reserve Bank Should drive FI and now Digital Financial Services

- The entry points is accessibility to banks – open savings accounts in banks
- Banks can be encouraged to adapt technology to manage micro accounts:
- The starting point is payments and settlement technology – the M-Pesa product in Kenya
- These two will encourage strong banks by increasing their level of deposits and thus power and capacity for intermediation process in the market
- FI will thus create strong banks and so an endogenous demand to complete the financial infrastructure:
    1. Information capital – credit reference/rating bureaus to improve the quality of participants in the market
    2. Transactions and information capital that can be used to improve and monitor the market – also improve the AML/CFT regime
    3. Deposit insurance – to give faith and confidence in the market
    4. SME finance departments in strong banks: infrastructure and capacity for SMEs to grow – in general banks will develop their market niches.
- African economies are characterized by segmented markets - Digital Financial Services will support communication across these segmented markets.

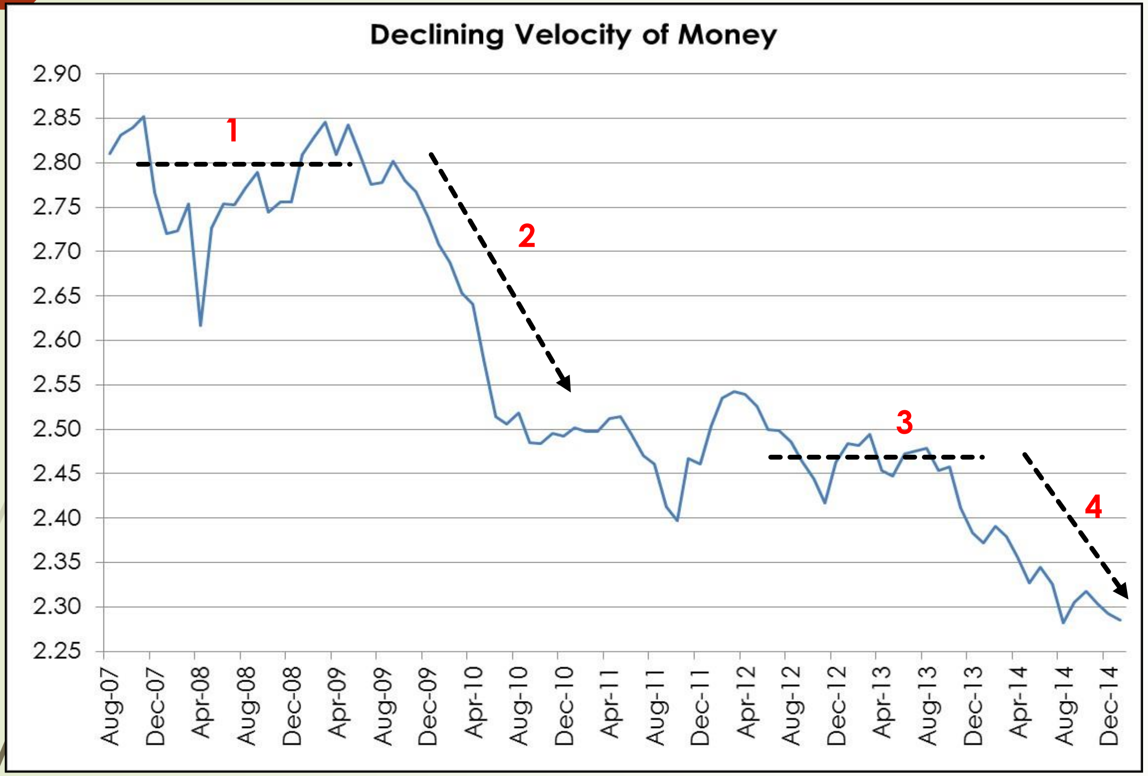
VI. The Next Frontier is market for long term finance – Bond market is Required

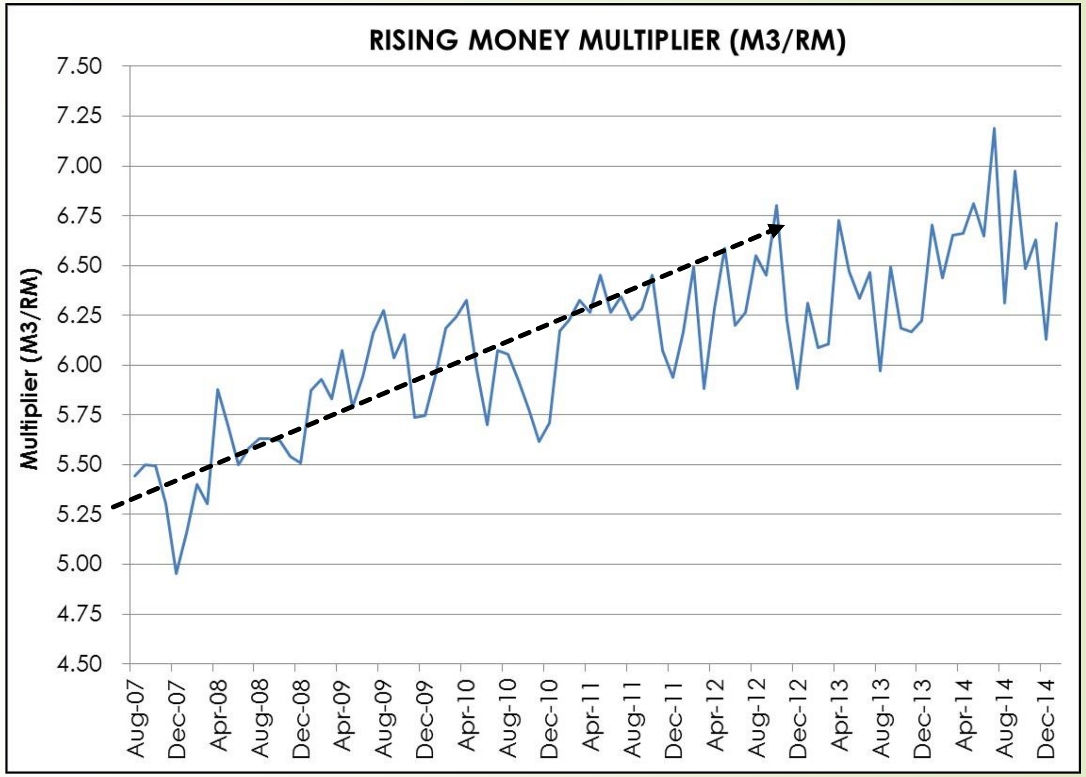
- Current resource mobilization trends in regional economies constrained by
  - National savings are very low
  - Stock market capitalization as a share of GDP weak
  - Tax revenue share of GDP fairly constant at 17% for resource scarce countries & varies for resource rich countries
- Most African economies have used government securities to develop a domestic bond market
- A yield curve has developed via secondary trading and formed a basis for pricing long term finance
- Different products can be used to deepen the market and provide long term financing options for public investments
- So new avenues and instruments to mobilize domestic resources via long term bonds:
  - Bond markets that also allow private sector participation in corporate bonds

VI.1 Bond Market and Domestic Resource Mobilization

- Bonds with long term maturity profiles would be supported by :
  - Targeted Infrastructural Bonds (Kenya case)
  - Diaspora bonds & Sovereign Bonds – can be traded domestically(?)
  - Role of pension funds and insurance – deepen domestic financial markets
  - Use of development finance institutions
  - The mismatch between short term deposits and long term loans is solved by tradeable instruments/securities/bonds in the secondary bond market.
- Required Policy Paradigm shift
  - Market development reforms for long term financial development and increase national savings (credit reference bureaus, legal system reforms, collateral process & contract enforcement)
  - Market enabling policies for private sector development (financial sector innovation, targeted SME financing, deepening scope of pension funds and Insurance funds)

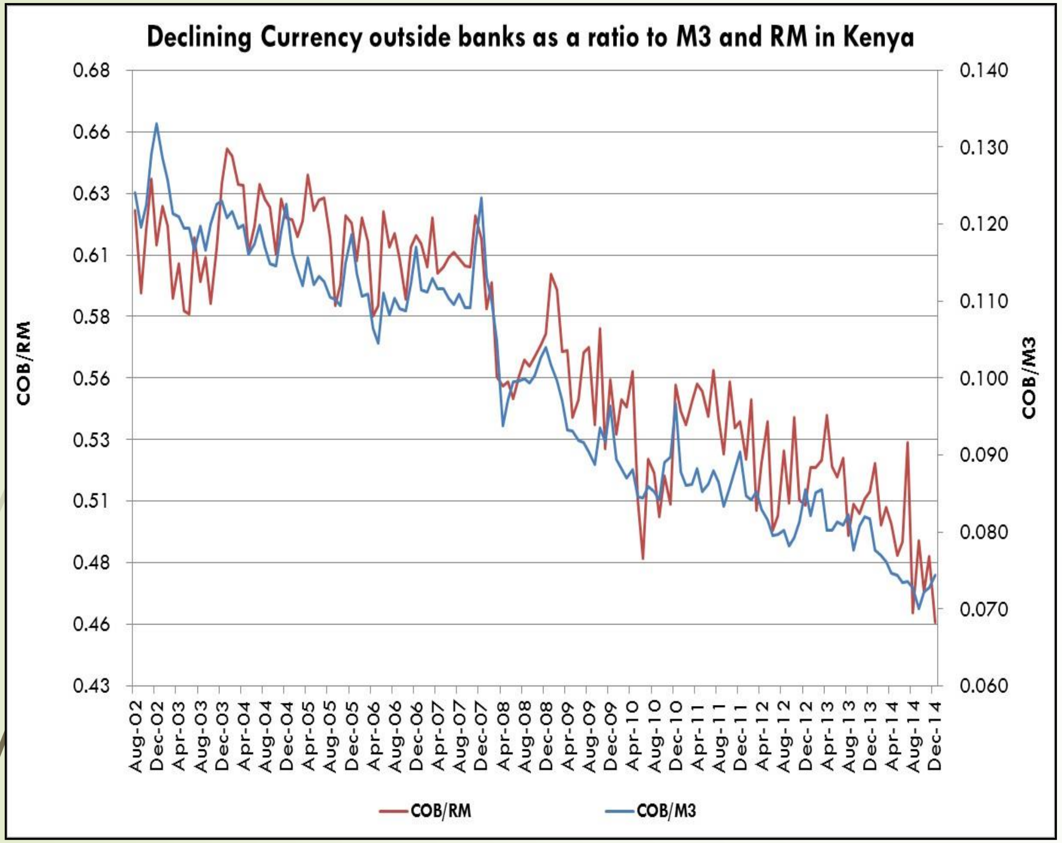
VII. Impact of Financial Innovations on Monetary Policy – Example from Kenya

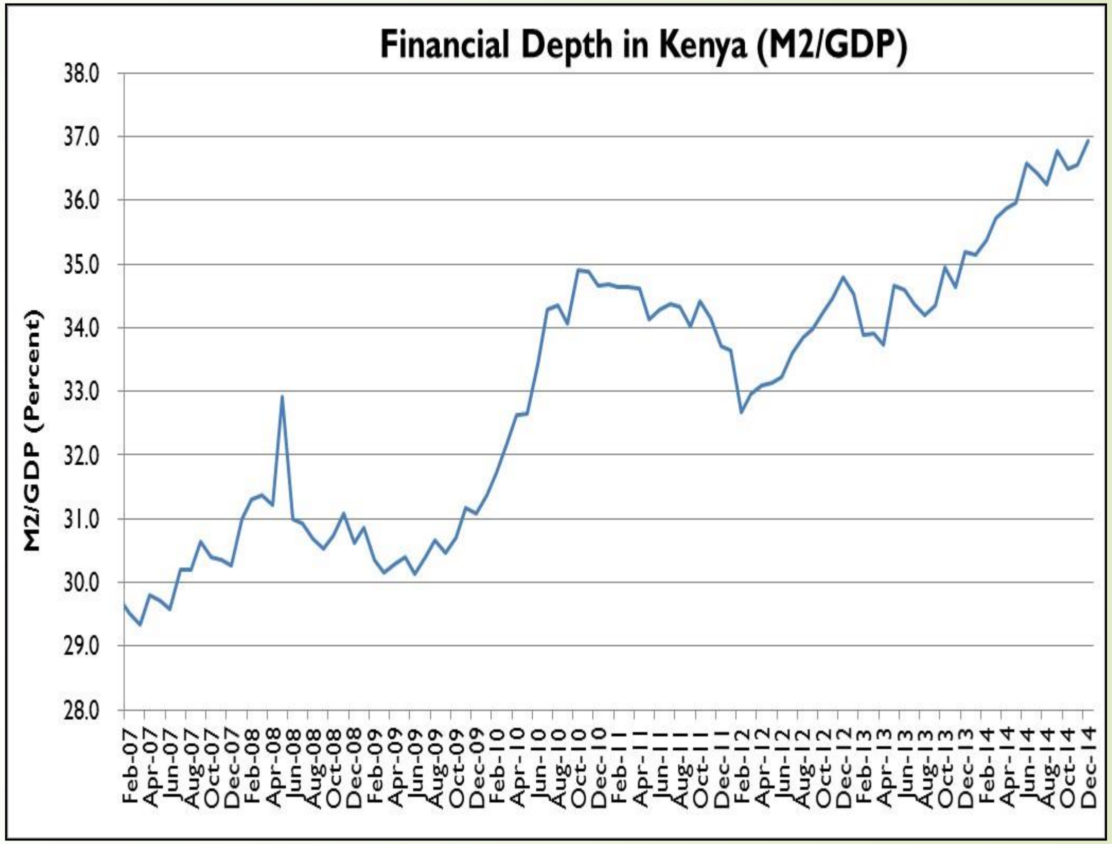




- The evolution of the velocity depicts different regimes – financial development and less cash changing hands.
- Money multiplier rising - the CBK may have lost the money supply process? No! financial innovation.
- The declining velocity and the unstable money multiplier imply that the money demand is unstable —this has implications for the monetary policy frameworks.

Impact of Financial Innovations on Monetary Policy…





- A declining ratio of currency outside banks to M3 and Reserve Money (RM) has been observed — this has improved efficiency of monetary policy instruments.
- Changes in behaviour of holding cash - people are keeping less and less money outside of banks.
- Kenya’s Financial depth has been rising with increasing financial inclusion.

VIII. Some Points to Take into Consideration

- Financial innovation is important for increased financial inclusion, which ensures capital accumulation for the poor to escape poverty.
- Financial inclusion encourages access, it increases the number of participants – reducing the unit cost of financial services hence more financial inclusion.
- Digital finance has improved payments and settlement system – lowered transactions costs – has overcome physical distances to the market place.
- Financial institutions are increasingly embracing innovations, implying, **regulation** and **supervision** must continuously evolve to keep pace with innovations in the market place.
- Innovations generate appropriate products for the market and different market segments are served – keeps the market vibrant.
- Regulatory capacity and regulatory technology must improve too and be in step with market developments and innovations
- FI will create strong banks – Not Big Banks!! – strong banks can weather shocks and serve the market efficiently.

IX. Some Lessons too

- **For the Reserve Bank of Malawi,** it should be a strong institutions that will define the rules of the game as well as appropriate incentives (penalties) to encourage prudent behavior in the market thereby ensuring financial system stability and integrity – **Better Regulation**
- **Better regulation –** we should know the financial system vulnerabilities and be able to deal with them appropriately – especially risk assessment and appropriately pricing the risks
- Financial inclusion encourages innovation that is followed by **financial deepening and financial development,** which is welfare improving, enhances efficiency as well as the evolution of monetary policy
- **Digital finance can be looked at using mobile phone technological platform in three stages:**
  - **First Generation – mobile phone technological platform for Payments and settlement – M-Pesa type of products**
  - **Second Generation – savings accounts using the same mobile phone technological platform**
  - **Third Generation: - use the transactions and savings data to generate credit scores for use as the basis for affordable credit – RBA - The Celebrated M-Shwari type of products**

IX. Some Lessons too…

- Regulators should allow financial innovation to take place - allow the market and the regulator to partner and achieve **sustainable public policy outcomes.**
- But now the core mandate of central banks is fighting inflation – price stability – what has happened to Monetary policy environment with financial inclusion – a **better environment for monetary policy**
- Monetary policy works thru' instruments and signaling in the market – there must be participants in the market! **– Financial Inclusion is to bring participants on both sides of the market**
- **The Reserve Bank of Malawi for 50 years has been an agent of development and can move the financial market to the next level – financial sector growth will pull the economy with it.**