The Financial System in Burundi: An Investigation of its Efficiency in Resource Mobilization and Allocation

By
Janvier D. Nkurunziza
UNCTAD, Geneva, Switzerland

Léonce Ndikumana
African Development Bank, Tunis, Tunisia

Prime Nyamoya
OGI, Bujumbura, Burundi

Cambridge, December 11-12, 2009

Outline

- ***Introduction***
- ***Background***
- ***Financial sector reforms***
- ***Structure and characteristics of the financial sector***
- ***Savings mobilization and credit allocation by banks***
- ***The non-bank sector***
- ***Conclusion***

Introduction: Motivation and goals

- **Critical role of the financial sector in growth and development (macro and micro level)**
- **Global crisis has brought to the fore the interaction between the financial system and economic activity**
  - Failure of the financial system has severe real effects
  - Financial development and financial policy must be at the core of the development policy debate/making

Motivation (cont'd)

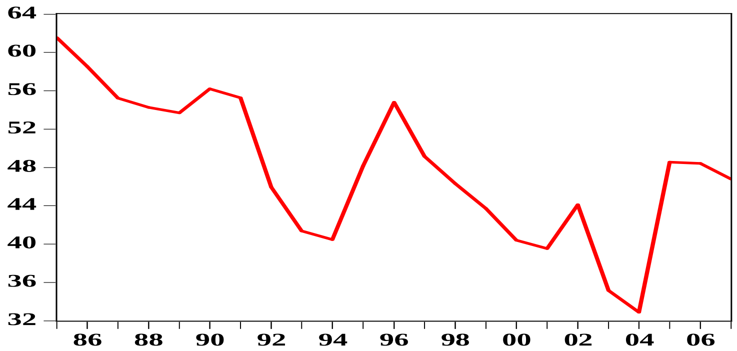
- This is even more relevant in the case of an LDC like Burundi:
  - Low growth, high poverty;
  - Limited employment opportunities;
  - Low investment (especially private);
  - Underdeveloped financial system:
    - Small size;
    - Undiversified;
    - Ineffective/inefficient in mobilizing, pooling, and allocating resources
- What should be the role of the financial system and financial policy in addressing those issues?

Background: 1 – Structure of the economy

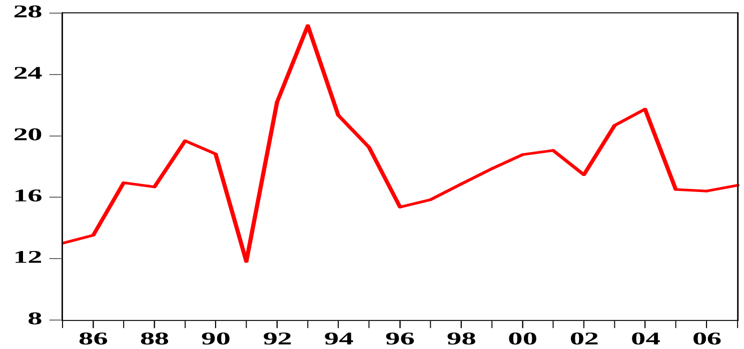
- An agriculture based economy: Early 80s, primary sector represented 60% of GDP with agriculture at 55% GDP
- By 2007:
  - Food crop agriculture contributed 38% of GDP & 78% of employment
  - Services accounted for 38% of GDP but only 2.5% of formal employment
  - Financial services contributed 2% of GDP & 0.05% of employment
  - Most employment is in the informal sector which accounts for 60% of GDP

Structure of Burundian economy – main sectors

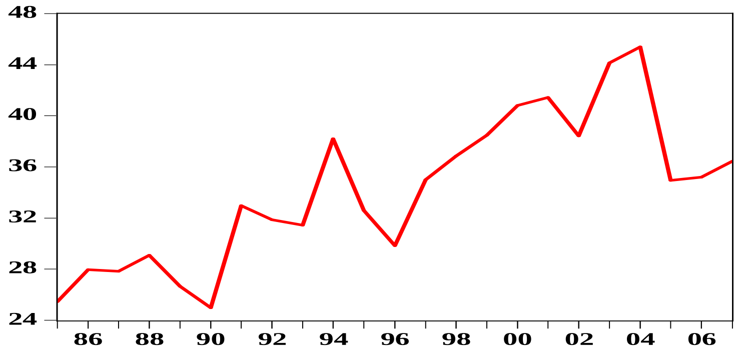
1.1: Primary sector to GDP



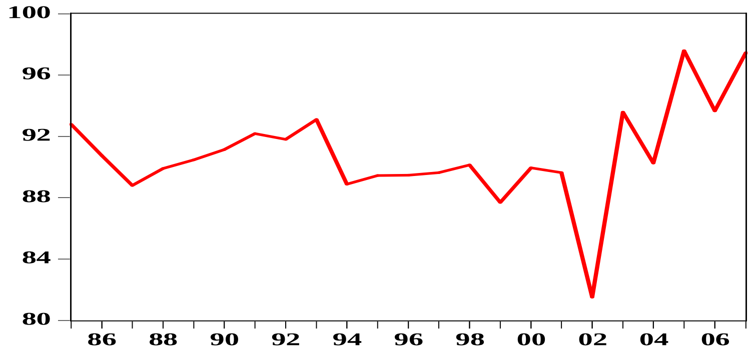
1.2: Secondary sector to GDP



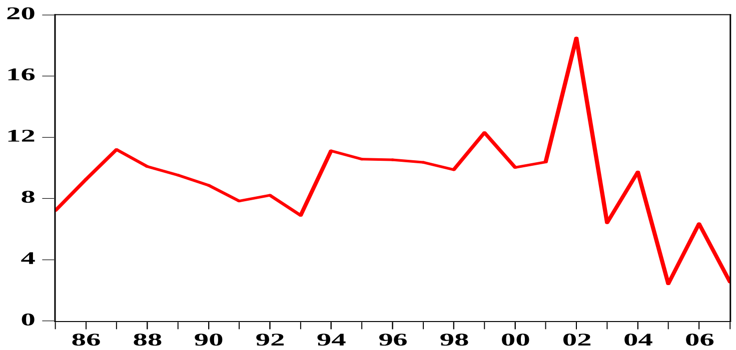
1.3: Tertiary sector to GDP



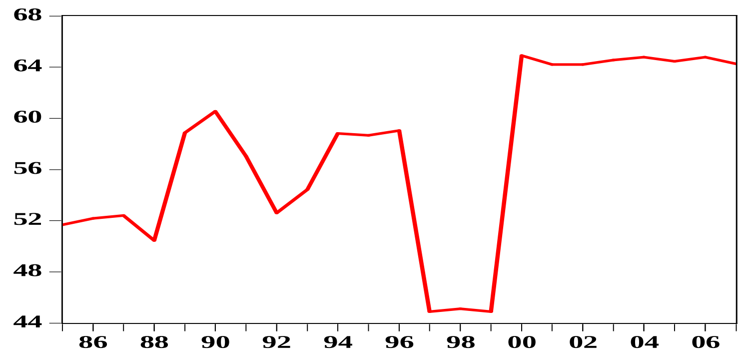
1.4: Agriculture food production to primary sector



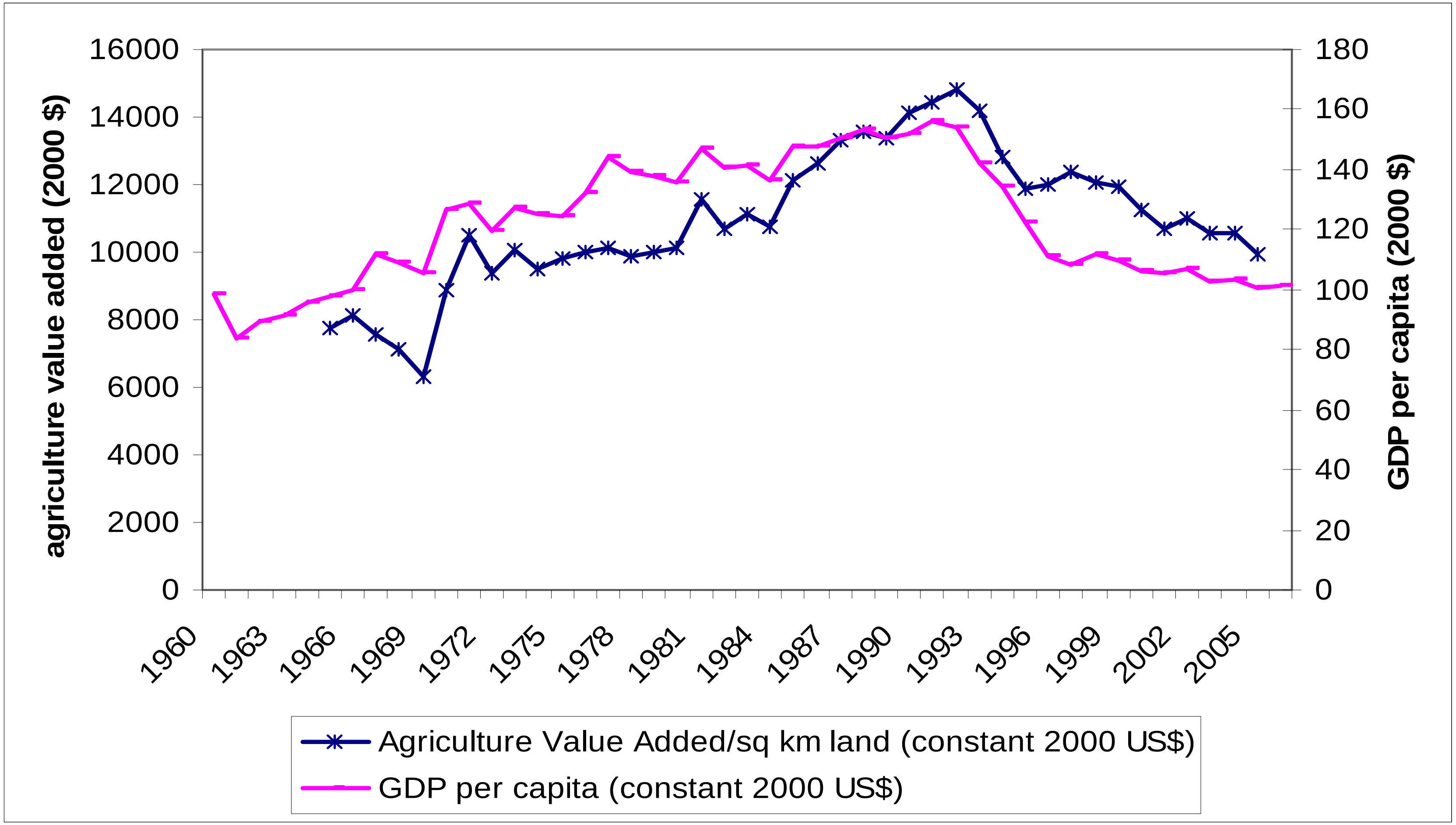
1.5: Agriculture exports to primary sector



1.6: Public sector to tertiary sector



Agriculture, the main driver of growth



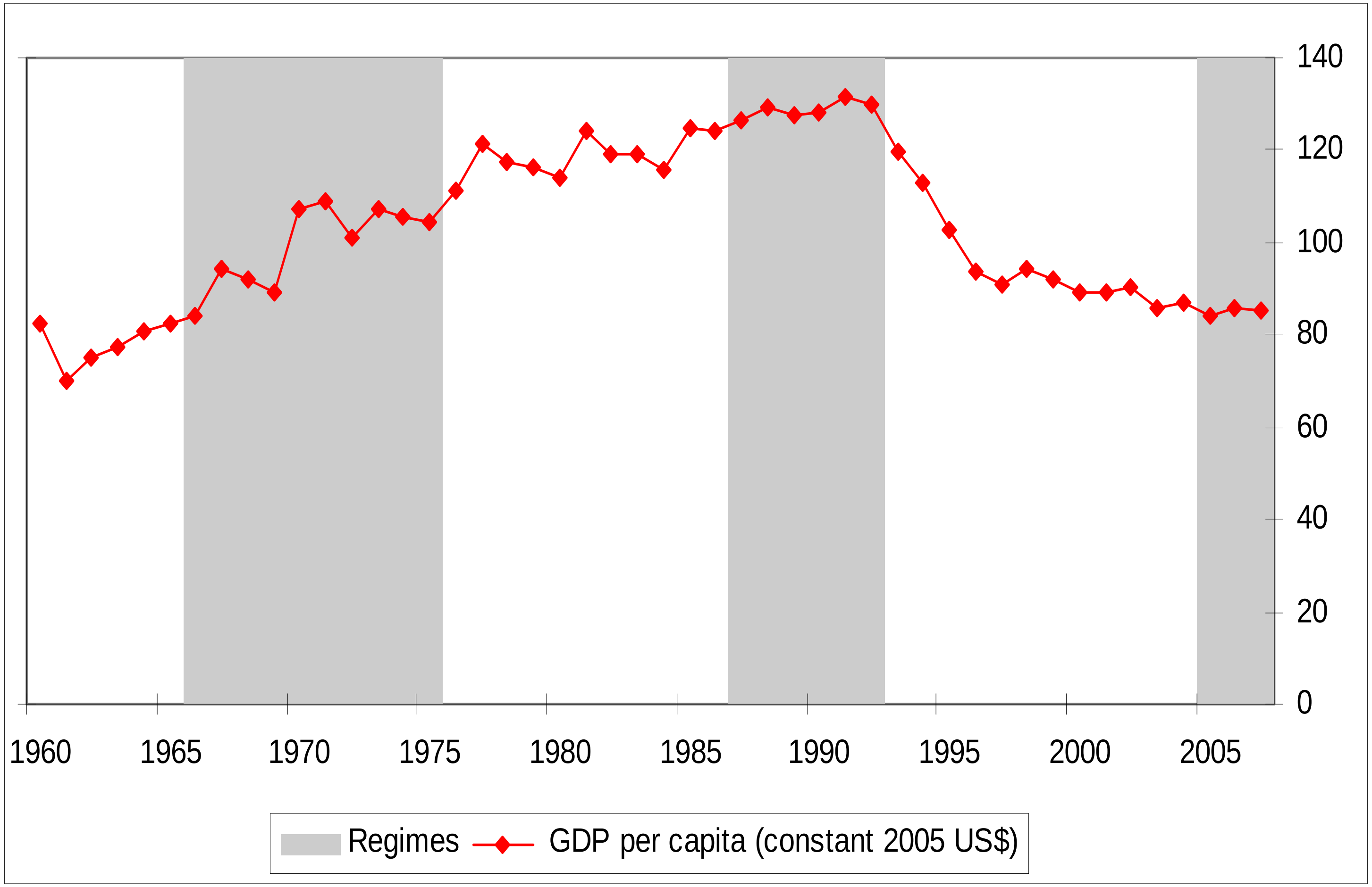
Background 2 – political instability

- Monolithic, interest-group based polity since independence in 1962
  - Undermines efficiency in policy making
    - Discourages private sector development;
    - Allocates resources inefficiently
  - Rent-seeking based policy making
    - In the real sector
    - In the financial sector
  - Thus the system perpetuates itself: maintains a type of “social equilibrium”.
- Prone to ethnic conflict: many episodes, same underlying causes of conflict

Background 3 – consequences of instability

- Severe economic consequences of political instability and conflict
  - Low level economic activity (low level equilibrium)
  - Precludes high growth
  - Increases growth instability and macroeconomic instability
  - Affects key drivers of growth: agriculture and public investment (decay of infrastructure), private investment (uncertainty, instability, risk, …)
  - Constraint to financial sector development

Sluggish and shock-prone growth



Background 3 – consequences of instability (cont'd)

- Difficult to get the economy out of the low-level equilibrium – need to "shock the economy" out of this "equilibrium"
- Justifies introduction of "deep" reforms
  - SAP
  - Financial sector reforms

Financial liberalization

- Initiated in April 1988, in the context of the Structural Adjustment Framework (2nd phase)
- Objective: to liberalize the financial system to increase its efficiency
- Instruments of liberalization:
  - move to market-based determination of interest rates
  - Create bond market
  - Institute & enforce bank reserve ratios
  - Liberalize entry in the sector (to increase competition)

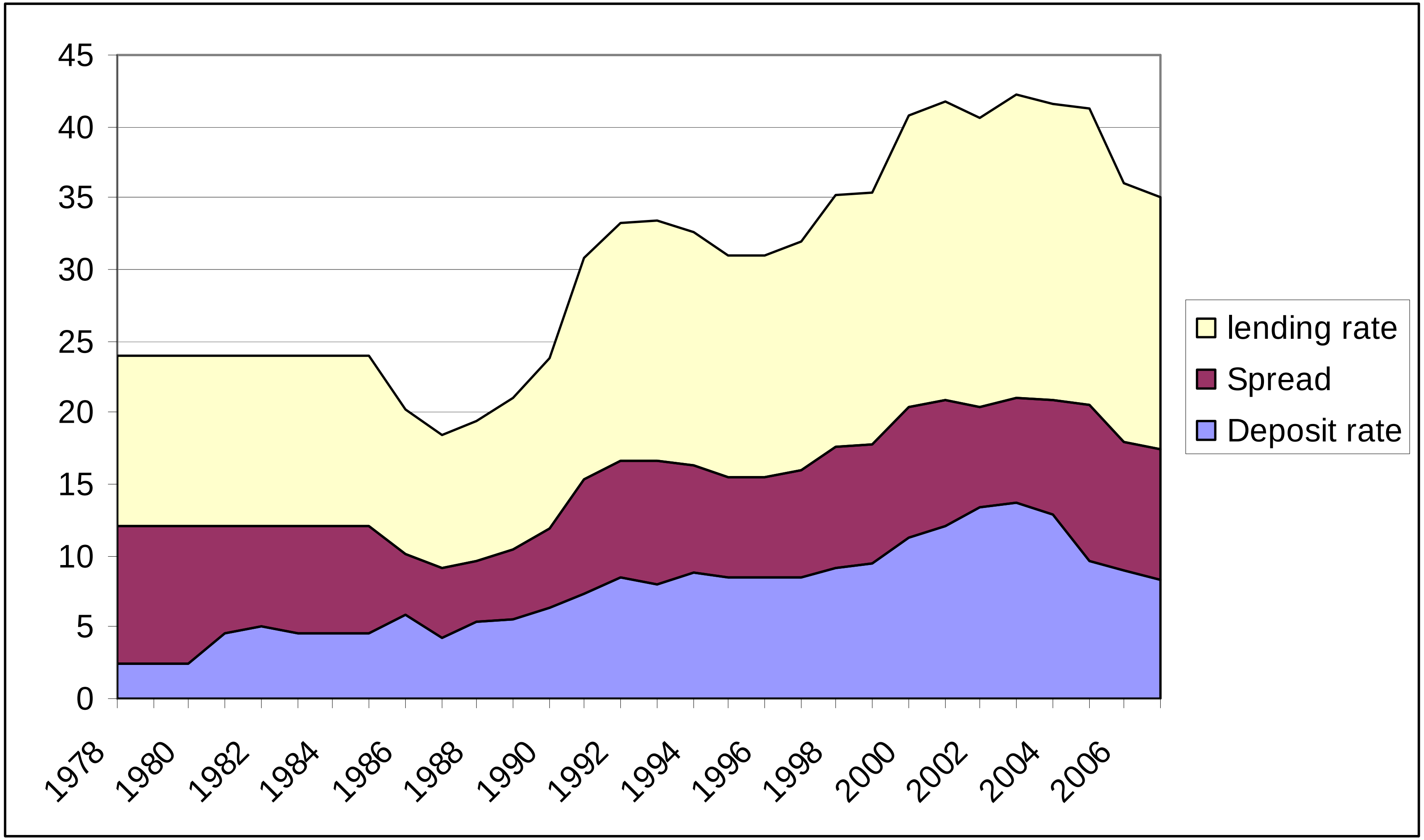
Implementation of financial sector liberalization

- Some positive results were achieved:
  - Introduced mandatory bank reserves at 7.5% in March 1992
  - Authorization to create new banks
  - End monopoly of CADEBU (a state institution) in collecting mandatory savings from employees
  - Dismantling of privileges accorded to the state (government and public enterprises) in access to credit (priority in access to credit; no collateral)
  - Creation of bond market in May 1988
  - Interest rate liberalization in August 1989

Results of financial sector liberalization

- Interest rates:
  - Rapid increase in the lending rate
  - Large spreads
  - Little impact on savings mobilization
- Reserve requirements
  - Effectively used as a monetary policy instrument (mostly to manage liquidity)
- Entry in the sector and competition:
  - Eight new commercial banks created
  - Two new insurance companies created
  - Three commercial banks collapsed
  - CADEBU collapsed as it lost state protection

Interest rates – lending & deposit rate



No visible impact on the spread; increase in the lending rate; benefits accrue to the banks, not to savers or investors/borrowers.

Impact of financial sector liberalization (cont'd)

- Bond market:
  - increased participation ("atomization" of coupon denomination)
- Most recently:
  - Foreign African banks establishing presence
  - Financial crisis has not had an important effect on banks

Current structure of the financial sector

- Structure of the financial sector:
  - From two commercial banks in the 1960s and 1990s, now there are 7
  - One development bank (BNDE)
  - One urban-housing promotion bank (FPHU)
  - Three insurance companies
  - Several microfinance institutions (see later slides)
- High concentration:
  - 3 largest banks account for 75 percent of total assets, 78 percent of total deposits, 69 percent of total loans.

Current structure (cont'd)

- Public/state ownership: substantial share of major private banks.
- Predominantly urban-based: 42 out of the 65 branches (2007 value) are in Bujumbura
- Penetration still low:130,000 accounts (2 accounts for 100 persons)
- Employment limited: About 1,500 persons directly employed

Profitability of banks, 2007 (million FBU)

Name	Assets	Deposits	Loans	Equity	Net Profits	Loans/ Deposits (%)	ROE (%)	ROA (%)
BCB	118997	95555	43207	10446	3400	45.2	32.5	2.9
BANCOBU	67798	45782	31563	7914	4171	68.9	52.7	6.2
BBCI	21804	12413	15367	7084	796	123.8	11.2	3.7
IBB	136618	105311	69488	12404	3265	66.0	26.3	2.4
BGF	29662	21594	16985	3433	736	78.7	21.4	2.5
FINBANK	30157	20694	16985	4855	1173	82.1	24.2	3.9
ECOBANK/ SBF	22856	14372	14032	3994	-87	97.6	-2.2	-0.4
Total/average	427892	315721	207627	50130	13454	65.8	26.8	3.1

Credit allocation by banks

- Sub-optimal mobilization of resources
  - Low volume of loanable funds;
  - Low volume of credit
  - Lack of long-term resources
- Sub-optimal allocation of credit, relative to resources
  - Term structure: mismatch with development needs (concentration on short-term credit)
  - Heavy sectoral concentration of credit (predominance of trade)
  - High state's share of bank credit (crowding out of private sector activity – investment and consumption)

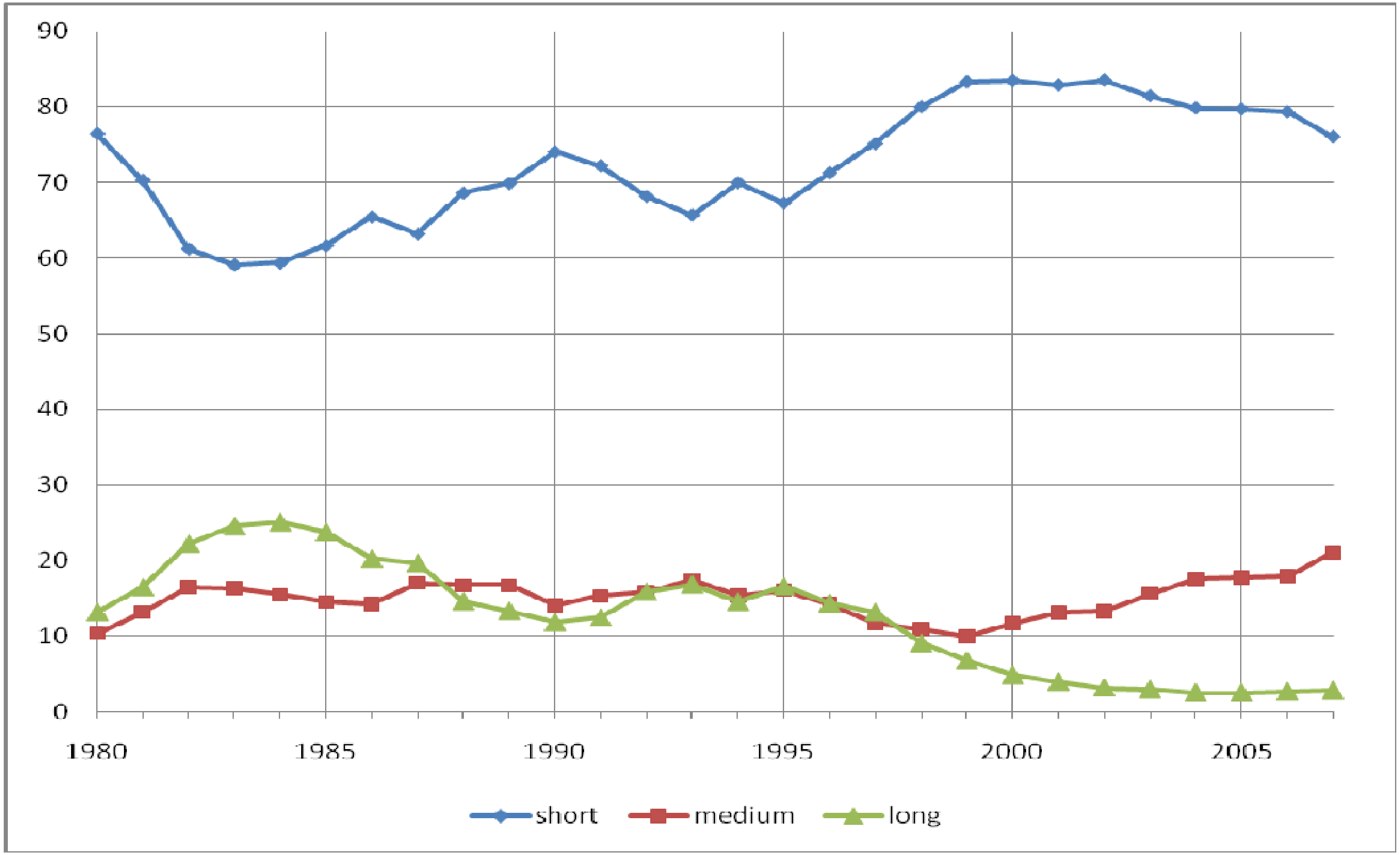
Key causes of low credit supply

- Demand factors
  - Low income
  - High level of informality (subsistence agriculture; informal sector accounts for 60% of GDP)
  - Lack of capacity for borrowers (in the conception of bankable projects and management of projects)
- Institutional factors
  - Property rights: poorly enforced
  - Political instability – high risk
- High transactions costs
  - Costly information
  - Imperfect screening and monitoring

Key causes of low credit supply (cont'd)

- High credit risk
  - Inadequate supervision and regulation
  - Political interference
  - High uncertainty – political and economic uncertainty
    - Economic uncertainty: macroeconomic instability; vulnerability to shocks; poor infrastructure
    - Political uncertainty: regime instability; conflict; bad governance
- Beyond risk: banks' rent-seeking behavior
  - Enjoying oligopoly power
  - Preserving "franchise value"

Structure of credit by term (percentage)

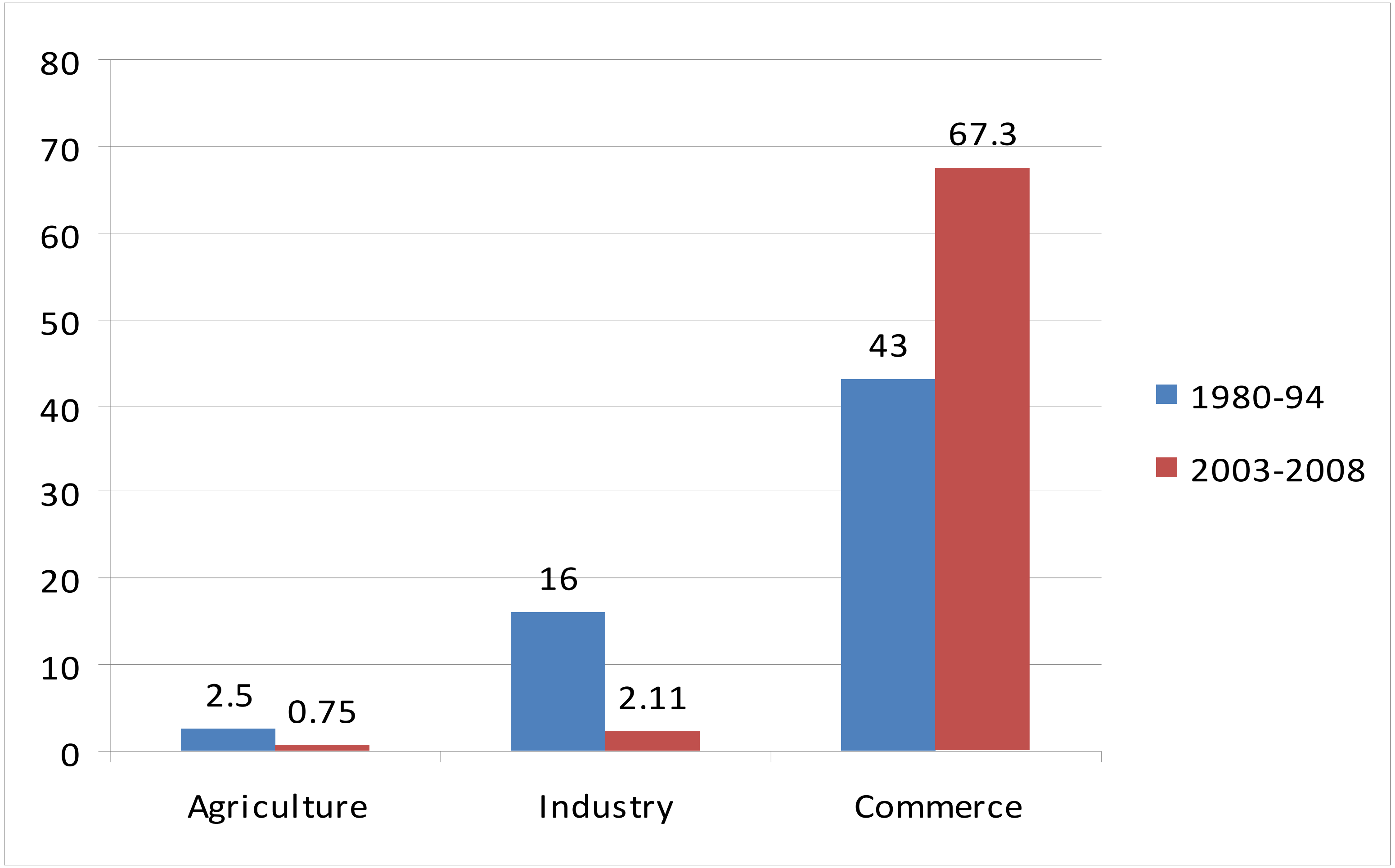


From 1993: increased risk causes decline in LT lending; rise in MT lending due to real estate boom ("new leaders")

Sub-optimal allocation of credit: Sectoral allocation

- Sectoral concentration of credit is indicative of inefficiency in resource allocation
- If resource allocation reflected economic structure, more resources would be allocated to agriculture; but not the case.
- In agriculture (and industry), the mainstay of economy, credit has declined over time
- Services sector, with 2.5% of employment, gets more than 72% of credit
- Coffee trading, not its cultivation and processing, receives an important share of total credit
- Misallocation has worsened over time

Allocation of commercial bank credit by sector



Impact of shortage of long-term credit

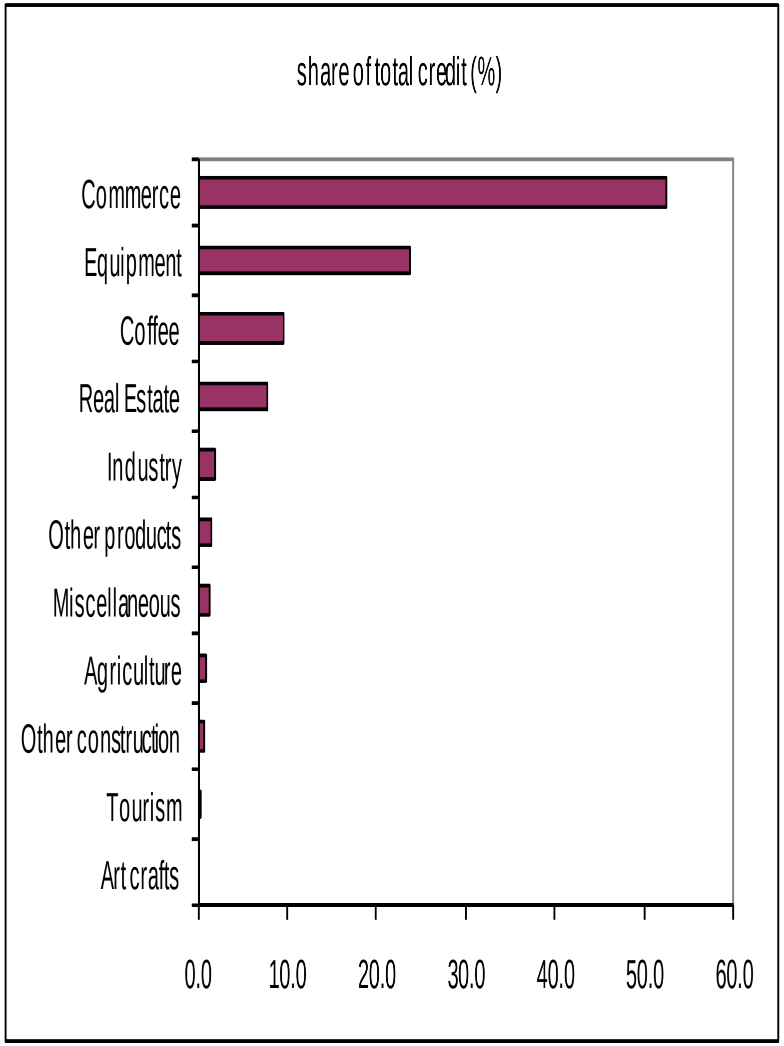
- Key challenge is availability of long-term credit for the financing of: infrastructure; industry; agriculture
- This is a key constraint to growth
- The economy is locked into a "low long-term credit" equilibrium
  - Banks have no incentives to change portfolio management (high profitability with current resource allocation)
  - The economic environment discourages long-term borrowing from banks
- One way out is to develop new market instruments: bond market; long-term investment funds; etc.
  - Question: do banks have incentives to engage in these new instruments given current high profitability levels?

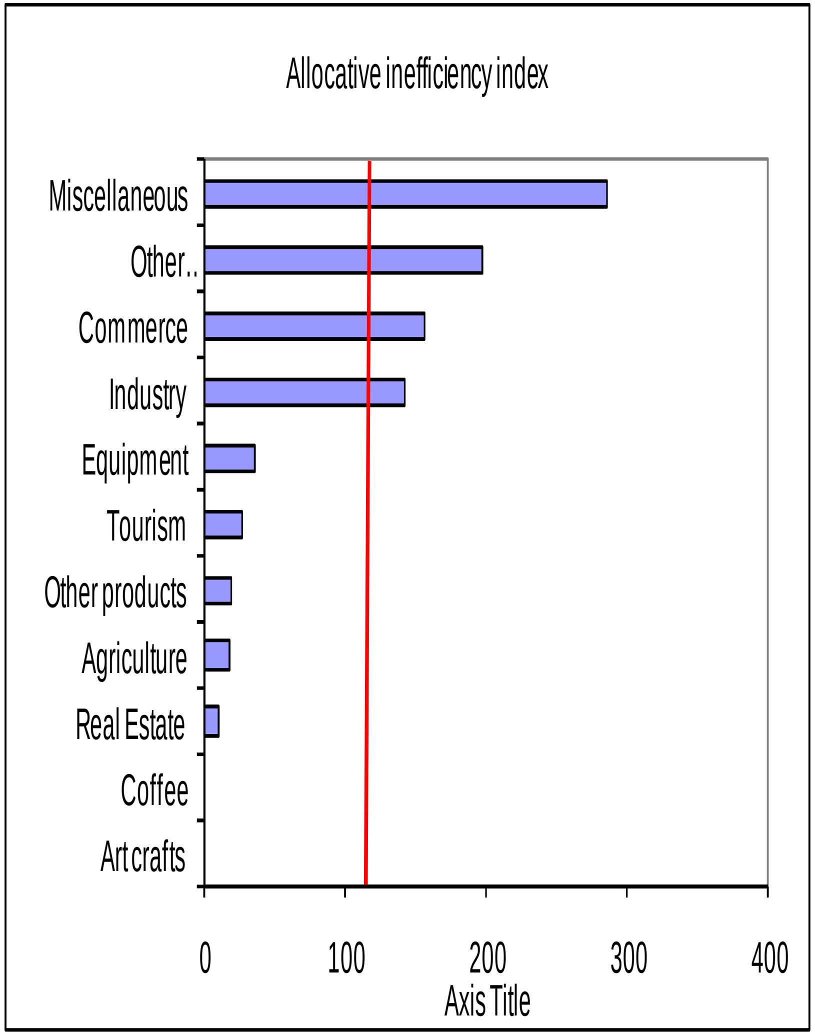
Implications: policy improvements at the margin will have limited effects

Implications of inefficient credit allocation

- Growth drivers are: agriculture; industry to some extent.
- But credit is concentrated in the international trade (primarily import of consumer goods): thus limited impact on domestic production (no spillover effects; no multiplier effects; little employment creation; …)

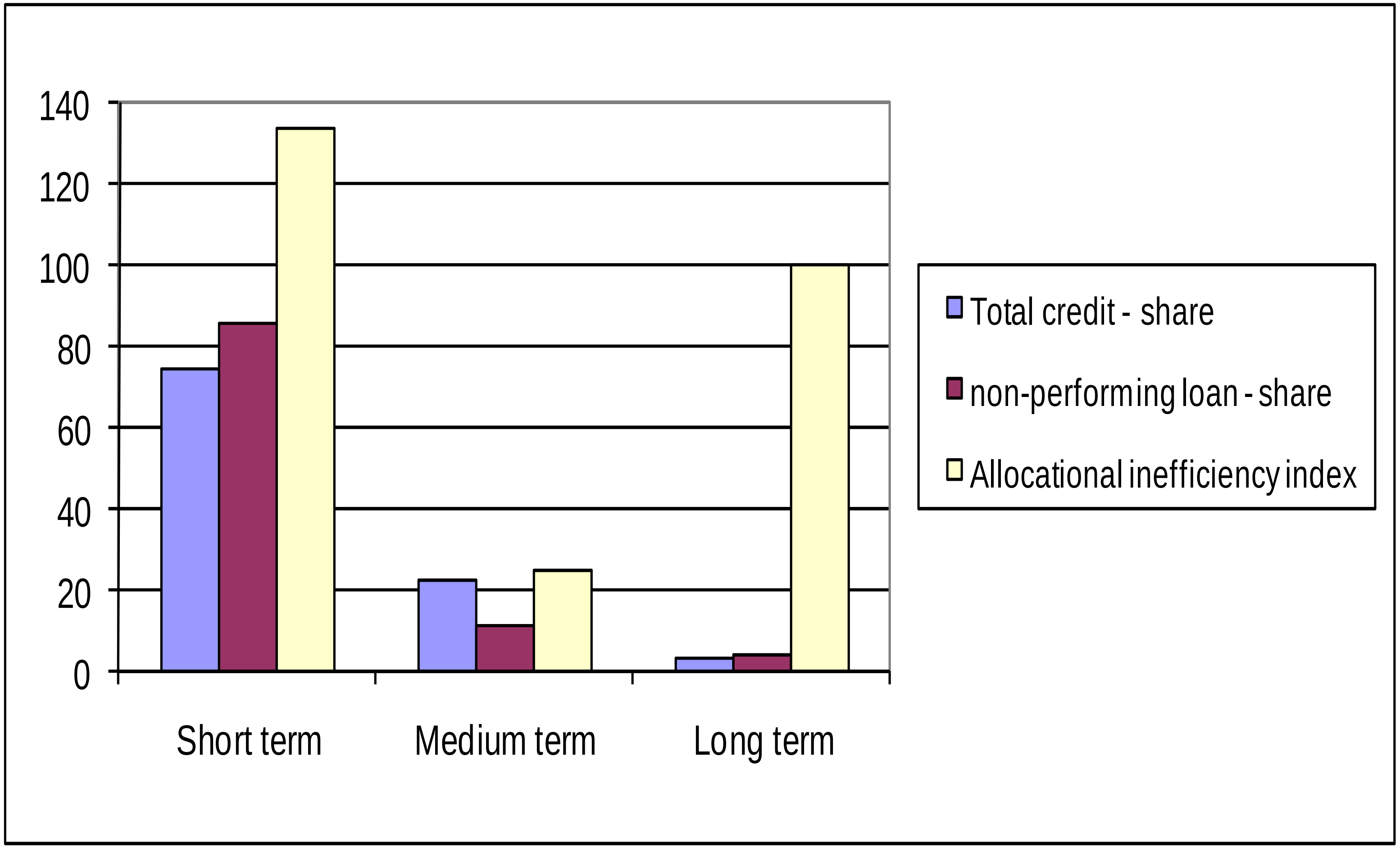
Proxy of inefficiency in credit allocation by sector





Miscellaneous loans include large share of consumer loans.

Proxy of inefficiency in credit allocation by term



Non-bank sector: Development Banks

- Mission
  - supply credit, giving priority to productive sectors; this includes micro-credit;
  - support the government in the design and realization of development plans and the management of public funds and special funds;
  - provide loan guarantees for priority projects;
  - provide technical assistance to companies in the area of financial management;

Development banks (cont'd)

- Strengths and opportunities
  - support from the shareholders, including the government;
  - support from external development partners through the provision of both funding and technical assistance;
  - government guarantees for exchange rate risk associated with external borrowing;

Development banks (cont'd)

- Challenges
  - lack of integration into the national development strategy, hence lack of a clear "vision".
  - lack of stable long-term financing;
  - inadequate integration with the banking system;
  - costly structure and inefficient operating procedures.
- As a result: no significant impact on access to credit and financial services in general
  - Concentration of credit towards the short term: in 2008, long term loans = 0.4%, medium term = 21%; short term = 78.6%
  - Also high share of trade

Credit by term and sector by BNDE (million FBu)

	1967-2002		2008		**1967-2008**	
	volume	percent	volume	percent	volume	percent
coffee sector	20,069	31.0%	0.00	0.0%	26,865.43	22.3%
industry, services, commerce	16,305	25.2%	2,439.75	20.3%	26,854.76	22.3%
tourism	675	1.0%	342.40	2.8%	1,676.50	1.4%
real estate	2,879	4.5%	245.48	2.0%	4,129.66	3.4%
agriculture	12,616	19.5%	5,495.96	45.7%	33,521.87	27.9%
small family equipment	11,655	18.0%	3,460.26	28.7%	26,670.34	22.2%
Miscellaneous	442.62	0.7%	55.44	0.5%	632.67	0.5%
Total with coffee	**64,643**	**100.0%**	**12,039.29**	**100.0%**	**120,351**	**100.0%**
Total without coffee	**44,574**	**69.0%**	**12,039.29**	**100.0%**	**93,486**	**77.7%**

Non-bank sector: Microfinance

- A relatively new component of the Burundian financial system.
  - Only BNDE's microfinance operations dating from the 1960s;
  - Genuine microfinance began with COOPECs in 1985.
  - However, starting from the mid-1990s, many institutions were created with diverse legal status, ranging from NGOs to cooperatives.

Non-bank sector: Microfinance

- Coverage of microfinance services has increased substantially although it is still inadequate and concentrated in the urban area.
- By the end of 2008:
  - the sector had about 317500 clients/members,
  - had mobilized savings amounting to 22.6 billion FBu (equivalent of USD22.6 million),
  - and had established 179 service points across the country
- Better penetration than commercial banks

Non-bank sector: Microfinance

- The formal micro-credit institutions fall in three sub-categories:
  - savings and loans mutualist institutions whose operating principles require savings as a precondition for access to credit.
  - microfinance enterprises that do not require savings as a precondition for access to credit.
  - microfinance programs and projects where micro-credit is not the principal activity but an element that supports other objectives of the institutions.

Non-bank sector: Microfinance

- Strengths and opportunities
  - a high demand for credit
  - fits fairly well within the context of key national development strategies, including *poverty reduction, community development, and decentralization;*
  - support from the government (could serve as an instrument to support the national development policy);
  - support from the donor community

Non-bank sector: Microfinance

- Challenges and constraints
  - Limited resources
  - Low purchasing power of the population
  - Difficult environment and high operating costs
  - Important weaknesses within the regulatory framework, the business climate, and the legal system.

Conclusion

- Large unexploited potential in:
  - Savings mobilization
  - Credit allocation
- Yet the sector is in a state of “stable” low equilibrium given incentive structure and institutional environment:
  - Supply side: high rents (profits);
  - Demand side: low purchasing power; difficult business environment
- Changing the system will require more than marginal interventions.

The End - Thank you