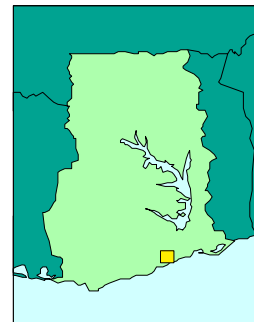
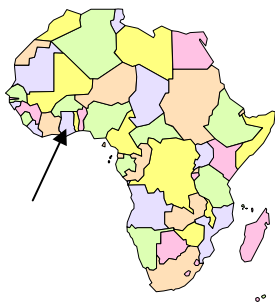

Financial Markets and Institutions:

Ghana's Experience



By

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Abstract

This paper reviews Ghana's experience with the development of financial markets and institutions. The review uses a framework which reviews various stages of financial development against three basic attributes of an effective financial system: a monetary system, the savings-investment process and a claims-to-wealth structure. The paper makes the observation that the financial system which was inherited at independence only satisfied the attribute of a monetary system. The recognition that there was a need for a more effective financial system in the immediate post-independence era led to an extreme solution under which the entire economy and the financial system was brought under a planned economy. By the early 1980s, the planned financial system had ceased to function because of macroeconomic instability and severe financial repression. The transition and reform period was ushered in by the Financial Sector Adjustment Program (FINSAP) in 1988. The program is a far-reaching effort to restructure the banking sector, encourage the growth of nonbank financial institutions and to liberalize markets.

The FINSAP process has been underway for close to a decade. It is, however, recognized that financial system development is a dialectical process whereby new structures emerge as a result of a dialectical confrontation between an initial set of conditions and an antithesis which renders the initial conditions untenable. In the Ghanaian context, FINSAP has represented the new synthesis after the financial repression period which followed the planned economy period. By the same logic, the financial system will continue to evolve in response to the new set of conditions which were ushered in by FINSAP.

Financial Markets and Institutions: Ghana's Experience

The objective of this presentation is to trace the evolution of Ghana's financial markets and institutions. This will be done within a framework which recognizes the attributes of an effective financial system. The extent to which Ghana's financial system satisfied these attributes at various stages in the country's development will be highlighted. A concluding section will identify the current constraints and the responses that are needed.

BASIC REQUIREMENTS FOR AN EFFECTIVE FINANCIAL SYSTEM

There are three basic requirements for an effective financial system:

- 1) An effective financial system must have an efficient medium of exchange for exchanging goods and services. Such a medium of exchange serves as a unit of account. The medium of exchange needs to be universally accepted and its value must be reasonably stable if it is to be widely used. Finally, the medium of exchange should be a convenient means of paying for goods and services provided.
- 2) The financial system must make it possible for the creation of capital on a scale large enough to satisfy the needs of the economy. In a developed economy, capital formation takes place indirectly. Surplus spending units deposit their funds with financial intermediaries who in turn transfer the funds to deficit spending units. The process works well only if proper legal instruments and financial intermediaries exist.
- 3) An effective financial system provides markets for the transfer of financial assets such as stocks, bonds and shares and for the conversion of such assets into cash. Markets support capital formation by providing investors with opportunities to quickly convert their investments to cash.

A summary of the attributes of an effective financial system is presented in Figure 1. The three attributes of an effective financial system are depicted as the monetary system, savings-investment process and the claims-to-wealth structure.

A *financial market* is a market in which financial assets (securities) such as shares and bonds can be purchased or sold. One party transfers funds to the financial market by purchasing a financial asset previously held by another party. A *financial institution* is an institution whose assets are financial assets or financial claims – stocks, bonds and loans. Financial institutions serve the purpose of facilitating the accumulation and allocation of capital by channeling individual savings into loans to governments and businesses. The transactions of financial institutions thus consist of making loans to customers and the purchase of investment securities in the market place. Financial institutions also offer a wide variety of other financial services ranging from insurance protection to the sale of retirement plans and the provision of a mechanism for making payments, transferring funds and storing financial information. When the institutions, markets and arrangements for transferring financial assets are put together, we have a *financial system* as in Figure 2.

Figure 1: Characteristics of an Effective Financial System

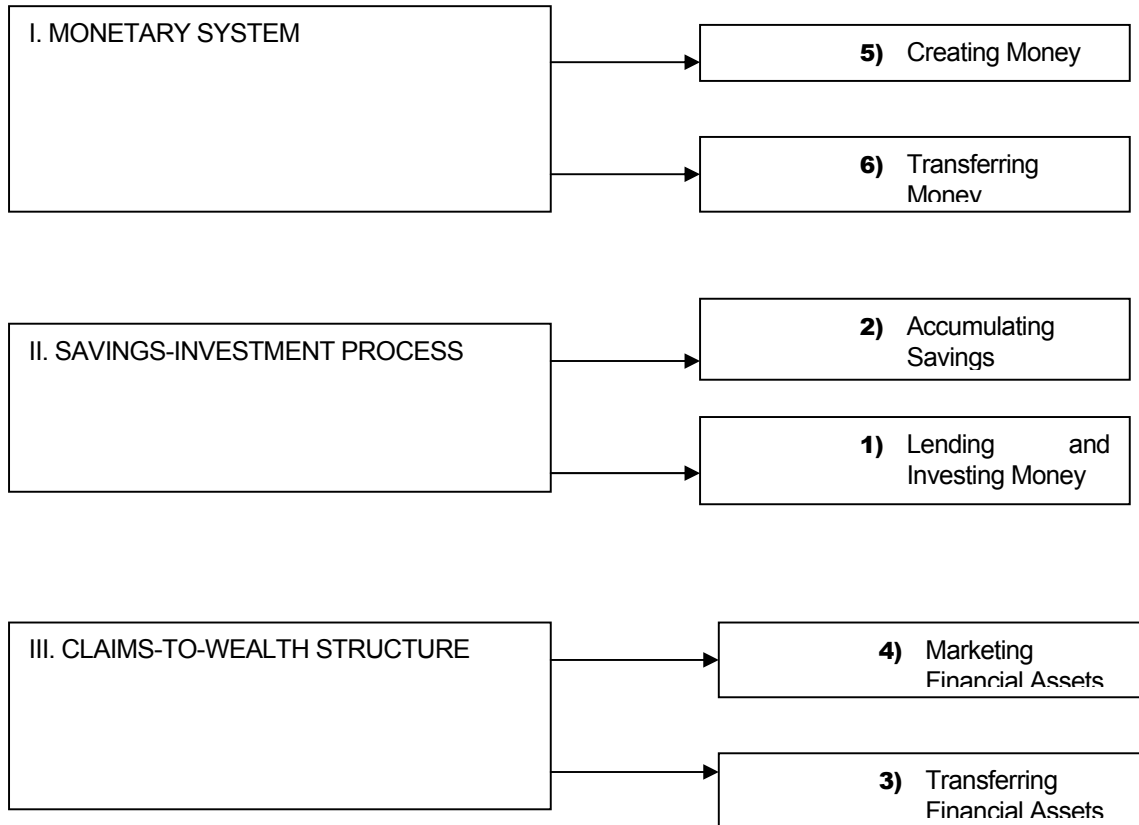


Figure 2: The Financial System

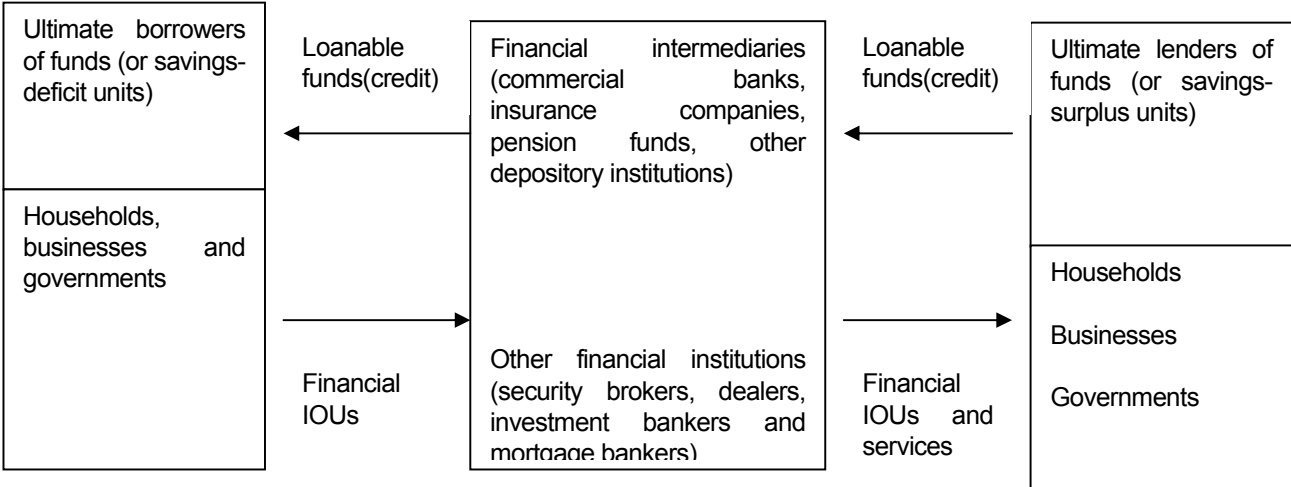


Figure 2 indicates that savings-surplus units transfer loanable funds to financial intermediaries such as banks, insurance companies, etc who in turn lend the funds to the ultimate borrowers of funds. Additionally, households, businesses and governments can transfer claims (IOUs) among themselves using the services of other financial institutions such as brokerage firms and investment bankers.

Because of the wide variety of services offered, there are several types of financial institutions. Table 1 provides a classification of financial institutions which recognizes both the source and the deployment of funds by each type of financial institutions.

Table 1: Types of Financial Institutions

- ❖ Depository Institutions
 - Commercial banks
 - Merchant Banks
 - Savings and Loan Associations
 - Credit Unions
 - Building Societies.
- ❖ Non Depository Institutions
 - Contractual Savings Institutions
 - Life Insurance
 - Pension Funds
 - Collective Investment Institutions
 - Mutual Funds
 - Unit Trusts
 - Finance Companies
 - Leasing
 - Securities Markets Institutions
 - Investment Bankers and Brokerage Companies
 - Organized Securities Markets
 - Government-related agencies

Depository institutions raise funds by accepting deposits in the form of current, savings and fixed deposit accounts from households and businesses. Non-depository institutions raise funds either from other financial institutions or by selling securities in the financial markets.

The typology presented in Table 1 is very general. Countries at different stages of development may not necessarily exhibit all the various types of financial institutions.

GHANA'S FINANCIAL SYSTEM DEVELOPMENT AS A DIALECTIC

The appendix to this paper provides a chronological summary of major events in the financial development of Ghana. Financial markets in Ghana have evolved in fairly identifiable stages as follows:

- 1) The Colonial Era (up to 1960)
- 2) The Centrally Planned and Closed Economy Period (1960-83)
- 3) The Structural Adjustment and Transition Period (1983-present)
- 4) The Post Adjustment Period

Financial sector development is the interactive outcome of a relationship between regulators and the regulated institutions. The exploration of this interaction enables us to put historical developments and potential changes in a proper perspective.

The development of a financial system and its regulatory regime may be viewed as a *dialectic* or change resulting through a process of action and reaction by opposing forces. In his classic presentation, the philosopher Hegel described a dialectical process as:

- 1) An initial set of arguments or rules (the thesis)
- 2) A conflicting set of arguments or responses (the synthesis)
- 3) A change or modification (the synthesis) resulting from an exchange or interaction between opposing forces.

The idea that regulation of a financial institution is a dialectic – one of a cyclical interaction between opposing political and economic forces was introduced by Professor Kane in the late 1970s.¹ The experience of Ghana will be reviewed during each of these periods.

The financial system of the colonial era was characterized by minimalist conditions in the sense that the colonial government concentrated on providing a basic currency infrastructure and banking services for the foreign trading enterprises within the colonial system. The post-independence era represented the first major attempt to establish a broader financial infrastructure. This period, also characterized as the period of a centrally planned and closed economy marked the use of state power to create a broad array of financial institutions. In the years following independence, the economic and political environment changed significantly. However, the regulatory structure of the financial system did not change.

¹ Kane, Edward J. "Good Intentions and Unintended Evil: The Case against Selective Credit Allocation", *Journal of Money, Credit and Banking*, 9 (February 1977): 55-69. See also Kane, Edward J. "Accelerating Inflation, Technological Innovation and Decreasing Effectiveness of Banking Regulation", *Journal of Finance*, 36(May 1981): 355-367

According to Kane, the existence of operating rules that are excessively restrictive or benefit a protected class provides strong incentives for individuals in the regulated institutions to find loopholes. In Ghana's case, the post-independence era was dominated by a strong central bank with control over foreign exchange, interest rates and credit allocations, and an array of state-owned banking institutions. At the same time, changes in the economy reflected in high inflation rates, low economic growth tended to render the initial set of arguments increasingly outdated. The antithesis to the centrally planned system of the post-independence era was driven by economic changes as well as underperformance by the banking sector resulting from excessive intervention by the government in the allocation of credit. Bureaucratic control of the credit allocation process severely compromised the quality of credit assessment and fraud and corruption became pervasive. These developments were part of the antithesis leading to the regulatory adjustments of the 1980s.

The synthesis which resulted from the weak financial structures of the planned economy period was the Financial Sector Adjustment Program (FINSAP). Launched in 1988, FINSAP provided for a comprehensive restructuring of the financial sector. The remaining sections of the paper are devoted to a presentation and evaluation of the detailed developments of each of the phases of Ghana's financial development.

THE COLONIAL ERA

During the colonial era, the colonial government restricted itself to monetary stability and monetary growth was tied to export performance. Banking was established with the object of providing banking services for the British trading enterprises and the British Colonial Administration. The first branch of a bank opened for business in 1896. Known as the Bank of British West Africa Limited (BBWA), its main object was to import silver coins from the Royal Mint. In spite of the objective of providing banking and currency services to expatriate companies and the colonial administration, the bank attracted the patronage of some indigenous African customers.

Between 1912–1957, the West African Currency Board (WACB) operated as a central bank operating a Sterling Exchange Standard through a guaranteed convertibility of the West African pound to sterling. There were no exchange controls. The West African Currency Board did not have any central banking functions. It did not exercise control over the volume of currency or issue; nor could the Colonial Administration exercise any control over the currency supply. WACB operated as a bureau exchanging West African currency for sterling and vice versa and accounting for such activities. It invested its surpluses in approved sterling securities.

In evaluating the financial system of this era relative to the attributes of an effective financial system, we can make the following observations:

- The financial system played a passive and limited role in promoting economic development.
- The primary function of the financial system was to provide essential currency infrastructure. The system put in place led to the transformation of the colonial economy from a barter system to a modern currency system.
- There were virtually no non-bank financial institutions. While there were insurance companies, they were established by British companies, trading houses and banks to support their trade with the U.K. The focus of the industry was generally on commercial risk coverage. There was no life insurance industry.

In terms of the attributes of an effective financial system, this system only satisfies the first attribute, i.e. the need for an efficient medium of exchange or a monetary system. Incidentally, the concept of a

currency board has been resurrected in a number of countries where the need is for a unit of exchange which has a stable value. In Argentina, the government tamed inflation by setting the peso at a fixed rate of exchange of one to one with the dollar and fully backed the issue with dollar reserves. Its money supply can increase only when foreign reserves grow, either because of capital inflows or an excess exports over imports. Using an arrangement similar to Argentina's, Brazil cut its inflation rate from over 900% in 1994 to 10% in 1996. Since 1993, the Hong Kong dollar has been tied to the American dollar at a rate of about seven to one and backed by foreign reserves of about \$70 billion. The difference between the financial system of the colonial era and today's dollar standards is that countries on the dollar standard have evolved a much wider range of financial institutions who are able to take on additional economic roles, particularly capital mobilization and the ability to transfer assets through financial markets.

The beginnings of a financial system which goes beyond a monetary system can be seen from the period following the Second World War. By 1957, there were three banks: The Colonial bank (now Barclays Bank), the British Bank of West Africa and the Bank of Gold Coast. In addition, the Colonial Post Office Savings Bank offered stiff competition in the mobilization of deposits from the non urban areas. The Bank of Gold Coast was chartered in 1952 and capitalized by the government of the Gold Coast. Its formation was in response to agitation from indigenous Africans for an indigenous bank that would be more serious to their borrowing needs. The three banking institutions offered traditional banking services which included:

- Documentary Credit (Letters of Credit)
- Discounting bills of exchange
- Collection
- Remittances.

We also see the beginnings of securitized finance during this period. In July 1954, on the initiative of the Bank of the Gold Coast, the first Treasury Bill issue was made with the bank acting as agents for the flotation. The bank also guaranteed to buy the bill at all times. This was the first attempt to create a securities market. The Treasury Bill issue was for a total of £500,000 of three-month Treasury Bills issued at 3/8 of 1%. Since the government budget was in a substantial surplus, the sole aim was to create a local market for government securities, rather than to finance a government deficit.

At independence, the Bank of Gold Coast was renamed to the Ghana Commercial Bank and a central bank, the Bank of Ghana started operations in July 1957.

FINANCIAL MARKETS AND INSTITUTIONS IN A PLANNED AND CLOSED ECONOMY 1960-83

In the immediate post-independence era, the government of Kwame Nkrumah adopted a socialist development strategy under which the state was to be predominant in all aspects of economic policy making and implementation. This period was characterized by:

- 1) Import Licensing: A comprehensive system of import licensing was instituted in November 1961. This regime of import licensing lasted until;
- 2) Exchange Controls: The Exchange Control Act of 1961 imposed all embracing exchange controls over the entire range of economic activities in Ghana.
- 3) Quantitative restrictions on interest rates

- 4) Forced lending programs including requirements for banks to lend to sectors of the economy which were considered priority sectors by the government

The implementation of the provisions of the Exchange Control Act together with a system of import licensing, turned Ghana into a closed economy.

Within the banking sector, the following developments were taking place

- 1) The Bank of Ghana became the pivot of all international banking activities, whether these related to remittances, letters of credit, collections, allocation of foreign exchange, travel or tourism
- 2) In response to the changing macroeconomic environment, The Bank of Ghana Act (1963) was passed. The Bank was required to submit a report to the government anytime the money supply growth exceeded 15% for any year, stating the reasons for such a rise and recommending measures to contain the associated inflationary pressures
- 3) The Bank of Ghana was empowered to set ceilings on advances or investments by commercial banks and given powers to control the banking system;
- 4) New credit control measures were introduced in 1964 to control and direct the granting of credit to be in accordance with the government's economic policy.

Development Banks

In the early 1960s, the Bank of Ghana provided capital for the establishment of development banks which were new banking institutions created with clearly specified roles. This was a response to the feeling that commercial banks – with their policies of “borrowing short and lending long” were not suited to the task of mobilizing funds to finance medium and long-term products. The following banks were incorporated to undertake the financing of specific projects in industry, agriculture and housing respectively:

- 1) National Investment Bank, 1963, (Industry)
- 2) Agricultural Credit and Cooperative Bank 1965 (Agriculture)
- 3) Bank for Housing and Construction, 1972 (Housing)
- 4) The Merchant Bank (1972) to offer one-stop corporate banking services: Its main functions were to
 - Taking wholesale deposit of corporate funds
 - Providing venture capital
 - Term lending to the corporate sector
 - Dealing in stocks and shares
 - Financing of imports and exports
 - Financial consultancy and advisory services

The development banks obtained long-term credit from the Bank of Ghana to support their lending operations. In addition the Bank of Ghana provided credit guarantees to the banks to cover loans and advances to industrial and agricultural enterprises.

Rural Banking

In 1964, a rural credit department was established at the Bank of Ghana to devise appropriate methods for financing the agricultural sector in line with the seven-year development plan. By the 1970s, it had become evident that the Agricultural development Bank which was designed to provide a vehicle for reaching the small scale farmer did not have the capability to provide adequate rural coverage. This realization led to the establishment of a rural banking system, modeled on the rural banking system in the Philippines. The first rural bank was set up in 1976. The objective was to extend banking services to the rural areas. By December 1987, there were 117 rural banks.

FALLOUT FROM THE 1960s AND 70s

The initial era of state banking was supported by an unstable macroeconomy:

- Real growth only occurred between 1959 and 1960 when GNP expanded in nominal terms by 10.2%.
- The period 1955-65 was marked by large increases in the money supply, reflecting mainly a large amount of government borrowing to finance the budget deficit.
- The state's domination of the banking industry was complete. The majority of banking institutions were either directly fully owned by the state or indirectly by agencies of the state. Even the expatriate foreign banks had 40% of their respective equities owned by the state.
- Nearly 70% of the credit granted by the banks were earmarked either to meet the Public Sector Borrowing Requirement (PSBR) or to satisfy the credit requirements of the state enterprises. Credit for the private sector was less than one-third of the total.
- By 1983, the large state-owned enterprises had run up large overdrafts with the state banking institutions, most of which had become non-performing

The sharp deterioration in Ghana's economy in the 1970s put severe pressures on the financial system. The 1970s were marked by low average GDP growth of about 2.6%, high inflation which peaked at 123% in 1983, low levels of savings, declining international trade. There were strong indications of severe financial repression. In McKinnon's² terms, the symptoms of "financial repression" are:

- Bank credit remains an appendage of certain enclaves
- Government deficits preempt the limited lending resources of banks
- Unduly low or negative real returns to depositors and savers reduce their holdings of money and near-monies far below what might be considered socially optimal.
- Scarce capital is underpriced by banks

² Ronald I. McKinnon, *Money and Capital in Economic Development* (The Brookings Institution, 1973) pp. 68-69

In Ghana's case, evidence of financial repression was reflected in:

- The high inflation rate had eroded the capital base of most banks
- Demand deposits constituted 64% of total deposits, thus constraining long-term lending
- Controls on interest rates had resulted in negative real rates of interest. There were high levels of currency outside banks with the currency/deposit ratio peaking at 77% in 1983
- A sharp depreciation in the domestic currency led to the creation of many unserviceable foreign loans administered by the banks.

In addition, due to excessive intervention by the government in the direction of credit, the quality of credit assessment had deteriorated with undue concentration of credit in section sectors and individual hands. Management problems were pervasive, with fraud and insider abuse of a cheap credit system. In effect, all the norms for prudential lending and capital adequacy had been thrown out the window.

The financial system as it existed then did not satisfy the three attributes of an effective financial system. First, the high rate of inflation and the sharp depreciation in the domestic currency violated the requirement that the medium of exchange must be reasonably stable. In effect, the monetary system had become ineffective. In a repressed financial system, the second and third attributes of an effective financial system cannot be satisfied. Specifically, the savings-investment process which supported the accumulation of savings and their allocation to investment had broken down. Under the officially mandated credit allocation system, capital could not be allocated to the most productive projects. Finally, the need a free transfer of financial assets (i.e. the claims-to-wealth structure) was evident because of official control of deposit and lending rates.

Nonbank Financial Sector

The nonbank financial sector was relatively undeveloped. The State Insurance Corporation(SIC) was set up in 1962 and given a monopoly over the government sector. The National Trust Holding Company (NTHC) was established by legislative instrument in 1976 to operate as a national mutual fund,. The objective was to use NTHC to support the government's indigenization programme. NTHC acquired the shares of foreign companies and sold them to Ghanaians in what was essentially an over-the-counter market, the first and only one of its kind in Ghana at the time.

THE STRUCTURAL ADJUSTMENT (TRANSITION) PERIOD 1983-95

In 1983, the Government adopted an economic recovery program which included:

- Devaluation of the currency
- Dismantling of most price and distribution controls
- Elimination of many subsidies
- Broadening of the tax base
- Improvement of tax collection
- Restoration of macroeconomic balance by:
 - Development of the foreign exchange market to maintain a free and flexible rate

- Fiscal policies designed to increase public savings
- Monetary policies to reduce inflation

From 1987, there was a gradual liberalization of the financial system:

- All sectoral credit allocations were phased out, with the last target for agriculture abolished in 1990
- Interest rate controls were gradually relaxed and full liberalization was achieved in February 1988
- In November 1990, the Bank of Ghana decontrolled all bank charges and fees
- A foreign exchange auction was introduced in 1986 and the establishment of forex bureaus were permitted in 1988.

Financial Sector Reform Programme 1988

By the late 1980s, the World Bank and the Ghana Government had agreed that a reform and restructuring of the financial system was indispensable to a successful economic recovery programme. With technical and financial assistance from the IDA, the government embarked upon a Financial Sector Reform Program in 1988. The objectives of the programme were:

- To undertake the restructuring of financially distressed banks;
- To enhance the soundness of the banking system through an improved regulatory and supervisory framework;
- To improve the mobilization and allocation of financial resources – including the development of money and capital markets

These objectives were supported by the IDA through a Financial Sector Adjustment Credit of US\$100 million.

FINSAC I (1988-90)

A. Restructuring Of Financially Distressed Banks

The IDA-supported study identified seven banks as “distressed”. The restructuring of these banks involved the following measures:

- Reconstitution and strengthening of Board of Directors of affected Banks;
- Closure of unprofitable branches;
- Reduction of operating costs through retrenchment of staff;
- Cleaning of balance sheets by offloading the following categories of loans: Non-performing loans to state-owned enterprises, loans guaranteed by the government of Ghana and non-performing loans granted to the private sector
- Upgrading of managerial capacity and deficiency of distressed banks

- Intensified staff training of affected banks
- Providing enough capital and adequate liquidity to enable the distressed banks to operate in a self-sustaining manner after restructuring.

B. Strengthening Of The Regulatory And Supervisory Framework Of The Central Bank

The Banking Act of 1970 did not provide sufficiently clear guidelines to the banks and the banking authorities on, *inter alia*, minimum capital requirements, risk exposure and prudential lending limits for banks, provisions for possible loan losses and methods for interest accrual on non-performing loans. A new Banking Law was passed which came into force on August 8, 1989. The features of the new banking law were as follows:

- It provided a sound prudential and regulatory base for the country's banking system.
- Banks were required to maintain a minimum capital base equivalent to 6% of risk-weighted assets.
- Uniform accounting and auditing standards were established.
- Limits were placed on bank risk exposure to a single group or individual to a percentage of net worth.
- Limits were placed on loans and advances to the directors and employees of a bank
- Restrictions on the extent of direct exposure in commercial, agricultural and real estate activities
- An improved reporting system for all banks
- Strengthening of Bank of Ghana's ability to effectively regulate the banking sector and to take remedial action if banks are not being managed in the interest of depositors and shareholders.

C. Recovery Of Nonperforming Assets

Part of the process of restructuring banks involved removing from the banks portfolios all nonperforming loans and other Government-guaranteed obligations to state-owned enterprises which totaled ₵31.4 billion at the end of 1989 and nonperforming loans to the private sector amounting to ₵21.9 billion at the end of 1989 through the issuance of bonds. The nonperforming assets of the distressed banks were transferred a newly created and wholly-owned government agency – the Non-Performing Assets Recovery Trust (NPART), whose mandate was to realize such assets to the extent possible. In return, the distressed banks were issued interest-bearing FINSAP³ bonds which were to be redeemed in annual installments. A sunset provision in the 1989 Law which set up NPART limited the life of NPART to a six-year time frame.

D. Other Finsac I Initiatives

- Corporate restructuring. A diagnostic study was undertaken to determine the extent of distress in Ghanaian enterprises in both the private and public sectors resulting from massive devaluation, high rates of inflation and structural shocks from the macroeconomic adjustment.

³ FINSAP is an acronym for the Financial Sector Adjustment Program (i.e. the program covered by FINSAC).

- The development of nonbank financial institutions
- Professional training for accountants and bankers

FINSAC II (1989)

The second Financial Sector Adjustment Programme – known as FINSAC II – was launched in 1989. Its objectives were:

- To reduce state shareholding in Ghanaian banks
- To continue the bank restructuring programme which was launched under FINSAC I
- To intensify the recovery of non-performing loans by NPART
- To enhance the effectiveness of a broad range of non-bank financial institutions.

In line with the policy of liberalizing the financial sector by reducing the state's direct involvement in the banking system, the Government embarked on a policy of privatizing state-owned banks.

Prior to implementing the divestiture programme, the government had initiated a bank restructuring programme in order to make banks attractive to investors. Under FINSAC II, steps were taken to strengthen respective bank managements and implement new procedures relating to credit risk management, financial management and human resource management. New and computerized operating procedures were to be introduced to generate public confidence and customer satisfaction.

By 1990, the FINSAC programs were beginning to show results:

- By 1990, banks were meeting capital adequacy standards because of recapitalization and offloading of nonperforming assets
- The privatization of state-owned banks was underway. The Social Security Bank(SSB) was listed on the Ghana Stock Exchange in October 1995. Prior to that in 1994, another state-owned bank, the National Savings and Credit Bank had been merged with SSB.
- Ghana Commercial Bank, the largest of the state-owned banks was listed on the Ghana Stock Exchange in May 1996.

NONBANK FINANCIAL INSTITUTIONS

A significant area of change has been the rapid growth of nonbank financial institutions with the structural adjustment and liberalization of the economy. Since 1987, 39 nonbank financial institutions have been licensed as follows:

TYPE	NUMBER
Discount Houses	2
Finance Houses	12
Leasing and Hire Purchase Companies	5
Venture Capital Funds	1
Mortgage Finance Company	1
Savings and Loan Companies	11
Stock Exchange	1
Stock Brokerage Companies	11

In 1993, the Financial Institutions (Non-Banking) Law was passed to provide a legal framework for a whole new set of financial institutions which were being established. These institutions included discount houses, finance houses, acceptance houses, building societies, leasing and venture capital companies.

Non-Bank Financial Institutions Assistance Credit (1995)

The growth of the nonbank financial sector was given a significant boost in 1995, when the Government of Ghana, with the support of a \$2\$ million IDA credit developed a program to enhance the capacity of the nonbank financial sector. The Non-Bank Financial Institutions Assistance Credit (1995) addresses gaps in the large formal sector nonbank Financial Sector:

- 1)** Capital Market Institutions (Ghana Stock Exchange, Securities Regulatory Commission and the Bank of Ghana NBFI Department)
- 2)** The Contractual Savings Industry (National Insurance Commission, State Insurance Company, Ghana Reinsurance Organization, Social Security and National Insurance Trust)
- 3)** Associated Financial Infrastructure (Domestic payments system, School of Administration of the University of Ghana, Institute of Chartered Accountants of Ghana, Home Finance Company)
- 4)** Diagnostic Studies at the Ministry of Finance and Economic Planning to prepare strategies for future actions in the area of informal, rural and consumer finance.

SECURITIZED FINANCE AND THE GHANA STOCK EXCHANGE

Until 1990, what was missing from Ghana's financial sector development was an active stock market. To the extent that there was a securities market, it was limited to governments bills and bonds which were sold in a primary market. Secondary trading was limited. Stock markets affect economic activity through the creation of liquidity. Investors are reluctant to relinquish their savings for long periods of time. Liquid equity markets make investments less risky (and more attractive) since they allow savers to acquire an asset which they can sell quickly if they need access to their savings or want to alter their portfolios. At the same time companies enjoy access to permanent capital raised through the equity markets. By facilitating longer-term more profitable investment, liquid markets improve the allocation of capital and enhance prospects for economic growth.

Evidence indicates that countries with both liquid stock markets and well-developed banks grow much faster than countries with both illiquid markets and undeveloped banks. However, greater stock market liquidity is associated with faster future growth regardless of the level of banking development. Similarly, greater banking development implies faster growth no matter what the level of stock market liquidity.

The first feasibility study on establishing a stock exchange in Ghana was conducted in 1968 (the Pearl Report). The Report recommended the establishment of a stock exchange. In 1971, the Stock Exchange Act was passed. However, because of frequent changes in government and political instability, the stock exchange envisaged in the Pearl Report was not established until 1989 when the Ghana Stock Exchange was incorporated under the Companies Code. The establishment of the Ghana Stock Exchange in 1990 was a landmark event in the financial sector development of Ghana.

SECURITIES INDUSTRY LAW

The most important legislation in this sector of the economy was enacted in 1993 as an umbrella legislation intended to cover all facets of the securities industry. Prior to the enactment of the Securities Industry Law, 1993 (P.N.D.C.L 333.) [SIL] dealings in securities were unregulated unless the dealer was a company in which case the Companies Code, 1963 (Act 179) applied; or the dealings occurred on the Ghana Stock Exchange where regulations have been enacted to regulate trading and the conduct of members of the Exchange.

The SIL provides for the establishment of a Securities Regulatory Commission (SRC) to serve as a watch dog over the industry. Its main functions include maintaining surveillance over the securities market to ensure orderly, fair and equitable dealings in securities; and to license and authorize stock exchanges, unit trust and mutual funds and securities dealers and investment advisers. An important role of the SRC is the formulation of principles for the guidance of the industry and the creation of the necessary atmosphere for the orderly growth and development of the securities market. The SRC is charged under the SIL with the responsibility of protecting the securities market against any abuses arising from the practice of insider trading. Takeovers, mergers, acquisitions and all forms of business combinations are subject to the review, approval and regulation of the SRC.

The SRC has been vested with significant powers to enable it acquire and gather information. The SIL gives it power to order production of books by stock exchanges and certain persons and imposes criminal sanctions on anyone who fails to obey such orders of the SRC.

The Securities Regulatory Commission is still in the process of being established. For the time being, the Governor of the Bank of Ghana has been appointed the sole commissioner and vested with the powers of the Securities Regulatory Commission.

OTHER LEGISLATION

Apart from the SIL there other laws which govern the securities market in Ghana; these are :

1. the Companies Code, 1963 (Act 179)
2. the Bank of Ghana Act, 1963 (Act 182)
3. the Banking Law, 1989 (P.N.D.C.L. 225)
4. the Financial Institutions (Non - Banking) Law, 1993, P.N.D.C.L 328

and two regulations enacted to regulate transactions on, and membership of the Ghana Stock Exchange (GSE). These are the Stock Exchange (Ghana Stock Exchange) Listing Regulations, 1990 L.I. 1509 and the Stock Exchange (Ghana Stock Exchange) Membership Regulations, 1991 L.I. 1510.

The Listing Regulations provides for three lists as follows:

First List	Stated Capital: At least ₵100 million Published Accounts: At least five years preceding the date of application for listing
Second List	Stated Capital: ₵50 million Published Accounts: At least three years preceding the date of application for listing
Third List	Stated Capital: ₵20 million Published Accounts: The GSE may determine a period during which accounts must have been published or waive this requirement depending on the circumstances of the applicant.

The government has supported stock market development by offering a favourable tax regime with the following elements:

- The GSE is tax exempt
- Generally capital gains are subject to a Capital Gains Tax of 5%. However following the establishment of the GSE, capital gains arising from disposal of securities listed on the GSE and capital gains in securities as a result of mergers, amalgamation and reorganizations were

exempted from capital gains tax for the first five years of the operation of the GSE.. In 1995, the exemption was extended for a further period of 10 years. The GSE has had some impressive achievements since its establishment.

- From an initial 11 listed companies, the exchange has grown to 21 listing as in Table 1.
- In 1991 the first Ghanaian registered company, Super Paper Products, voluntarily went public. Prior to this, the companies listed on the GSE were all public companies which had been forced to indigenise under an earlier indigenization policy. Since then, there have been 10 additional initial public offers (IPOs). These included the giant Ashanti Goldfields Company which is also listed on Stock exchanges in London, Toronto, New York and Zimbabwe.
- In 1994, exchange control regulations were amended to give non-resident investors access, with some conditions, to the market.
- In 1994, the government offloaded its shareholding, around \$25 million of seven companies on the stock exchange.
- Listing of the first Corporate Bond – a dollar-indexed bond of the Home Finance Company in 1996.

The GSE also faces a number of difficulties.

- Because of the small number of companies listed and the low volume of transactions, the exchange is still not self-sustaining.
- The official settlement period is five days compared with the international norm of three days.

Under the Nonbank Financial Institutions Assistance Credit, the GSE is expected to install a centralized clearing and settlement system

THE MONEY MARKET

The money market, broadly defined as the market for debt instruments with a maturity of one-year or less, plays the major economic role of providing a source of short-term funds to those needing liquidity and an income-yielding outlet for the short-term investment of funds. In addition, a well developed money market supports the central bank to achieve its monetary policy objectives. The central bank can intervene in the market to influence the amount of liquidity in the financial system, and it can use fluctuations in the money market rates as a barometer of the degree of tightness or ease in the money market.

Ghana's money market is continually being shaped by the ongoing reform of the financial sector. On a continuum of money markets with only a primary issue market to a full-fledged money market both primary and a secondary components, Ghana would probably fall closer to a primary market with only a limited number of dealers. Secondary activity with several dealers regularly quoting offer and bid rates is virtually nonexistent. This calls for new initiatives to stimulate secondary activity to enhance the effectiveness of central bank open market operations.

During the last ten years, financial sector reforms have resulted in a rearrangement of Ghana's financial landscape, creating new policy and regulatory challenges. Significant among these developments are the following:

- 1) *The emergence of several new nonbank financial institutions.* Of particular relevance to the money market is the creation of two Discount Houses: Consolidated Discount

House Ltd. and Securities Discount Company Ltd., new nonbank financial institutions with actual or potential money market role such as finance houses and the development of a securities industry reflected in the creation of the Ghana Stock Exchange with 11 Licensed Dealing Members.

- 2) *A blurring of the traditional distinction between money markets and capital markets.* Currently, merchant banks and securities firms deal across the entire spectrum of financial markets. In short, the beginnings of financial conglomerates can now be discerned.
- 3) *The emergence of an interbank market for excess reserves which has significantly impacted the discount houses.* At conception, the discount houses were seen as the “bankers’ bank”, reflected in the fact that the discount houses daily position with the Bank of Ghana was a reflection of the clearing result of all clearing banks. This original concept is no longer valid as banks have increasingly traded reserves with each other. The interbank market has created a competitive situation where the banks are now competitors of the discount houses for call deposits.
- 4) *Concerns about the effectiveness of instruments for achieving monetary policy targets.* With the shift to an increasing reliance on open market operations as the primary monetary control technique, the conduct of monetary policy becomes increasingly dependent in an active primary and secondary money market. Difficulties in achieving money supply targets and persistently high rates of inflation suggest the need for more effective monetary policy instruments.

In Ghana the money market consist of the following instruments:

- Treasury Bills
- Bank of Ghana Bills
- Negotiable Certificates of Deposit
- Commercial Paper
- Banker's Acceptances

The market is dominated by Treasury Bills maturing between 30 to 180 days. Treasury Bills are instruments employed to finance government expenditure whilst the Bank of Ghana instruments are employed as control mechanisms for money supply within the economy. The Bank of Ghana pursuant to the provisions of the Bank of Ghana Act 1963, serves as the treasurer and fiscal agent of the Government of Ghana. Negotiable certificates of deposit are issued by banks and sold to discount houses to raise funds. Dealing in money market instruments for the private sector is relatively small. The commercial paper and bankers acceptance markets have been constrained by the lack of a credit rating agency.

Presently there is only a limited secondary market in these instruments. However, it is the objective of the central bank to foster an active secondary market for money market instruments.

THE BOND MARKET

Until recently, the bond market consisted of government stocks which were sold to financial institutions and the general public. The first publicly traded debt instrument was the 5-Year Ghana

Stock Exchange Commemorative Registered Stock of 1990 which was issued to provide a foundation for active bond trading on the newly created Ghana Stock Exchange. The issue was a floating rate instrument pegged to the Treasury Bill Rate. However, the stock continued to be sold on tap by the dealers., there was be limited secondary trading during the life of the stock.

Since the maturity of the GSE Commemorative Stock, the only other bond to come to the market is the HFC dollar Housing Bond Series. Series A was issued in September 1996 and Series B is at the primary distribution sale. The bond is fixed rate dollar denominated bond with a 7% coupon and a 5-Year maturity.

The development of the bond market has been hampered by:

- The lack of a rating agency
- An unstable macroeconomic environment reflected in very high and volatile inflation rate. Because of the high inflation rate, investment horizons are short. The longest maturity government stock is a two-year note. Consequently we do not have a wide enough spectrum of government bonds to form the basis of a yield curve and to provide a benchmark long rate

THE CURRENT ERA

The macroeconomic changes implemented by the government of Ghana under the Structural Adjustment Program of the 1980s succeeded in arresting Ghana's economic decline of the 1970s and restored positive economic growth reflected in a 5% average annual GDP growth rate and a 1-2 per cent average annual per capita income growth from the mid-1980s. Table 1 summarizes the economic statistics for the last six years. While the current rate of growth is impressive by sub-Saharan African standards, it is generally accepted as too slow to have a noticeable impact on average standards of living. At the same time accelerated growth is impeded by several factors, many of which are structural.

- 1) Investment as a percentage of GDP is very low (16% in 1995) compared to the average for all developing countries(18%) and fast growing economies such as Thailand(32%).
- 2) The national savings rate in the formal financial sector as a percentage of GDP is low (12% of GDP compared to 28% for developing countries and 33% for Thailand).
- 3) The level of financial deepening as measured by broad money (M2) to GDP is low. At the end of 1995, M2/GDP was 18%. By contrast, the M2/GDP ratios for Indonesia, Malaysia and Thailand are 35%, 68% and 75% respectively.

It is estimated that an accelerated GDP growth rate of 8% would require an investment rate of 24% of GDP. This would also require the domestic savings rate to rise from the current 8 % of GDP to 16 % of GDP, assuming foreign savings stays at 8% of GDP. However, there is increasing evidence that over the longer term current levels of bilateral and multilateral sources of foreign saving are not sustainable. Sustainable sources of foreign savings would have to include significant infusions of private direct investment and portfolio flows.

Table 1: Recent Economic Statistics							
	1990	1991	1992	1993	1994	1995	1996
GDP Growth (in constant prices)	3.3	5.3	3.9	5.0	3.8	4.5	5.5*
Investment as a % of GDP	13.0	13.5	13.8	15.8	15.9	16.4	
Domestic Savings as a % of GDP	7.5	8.1	4.5	1.4	8.6	12.3	
Inflation	37.2	18.0	10.1	25.0	24.9	58.5	32.7
Average Exchange Rate ¢/US\$	326.3	367.8	500.2	750.9	956.7	1200.4	
M2 as a percentage of GDP	13.94	13.19	17.26	16.75	18.66	17.92	

Changes in Ghana's economy and new institutional and legal arrangements have acted as a magnet for new developments in the financial sector: These include:

- The dismantling of exchange controls
- A floating exchange rate
- The establishment of the Ghana Stock Exchange
- Market determined interest rates
- Removal of credit controls

It is rather early to talk about a post-adjustment period as several regulatory reforms are underway. However, the system seems to have generated its own momentum. Since 1988, the following new banks have been licensed:

- 1) Ecobank
- 2) CAL Merchant Bank
- 3) Meridien/Trust bank
- 4) First Atlantic Bank
- 5) Metropolitan and Allied Bank

6) Prudential Bank

As previously discussed, the growth of the nonbank financial sector has been even more phenomenal.

SUMMARY AND CONCLUDING REMARKS

From the above, it is clear that Ghana's financial system has undergone dramatic restructuring during the last decade and a half. There continue to be a number of areas within the financial sector which require further attention and support. The financial sector is small relative to the rest of Ghana's economy and financial depth as measured by the ratio of M2 to GDP is low in Ghana as compared to the fast growing countries such as Malaysia and Thailand. There is however clear evidence that the reforms of the last decade and a half have had a favourable. For example:

- The privatization of the banking sector is on course. Two banks have been privatized and listed on the Ghana Stock Exchange. The remaining banks are being prepared for privatization
- The licensing of several new banks has increased competition in the banking sector.
- The pace of innovation has increased. The rate of computerization of the banking system has increased. Currently, several banks have automated teller machines (ATMs) and one bank has just introduced a stored value card, the "Sika Card", an electronic purse which carries a fixed level of stored value on a card.
- New financial instruments are being introduced. Examples include:
 - Asset-Backed Securities
 - Dollar denominated bonds
 - Dollar indexed bonds

There is however a policy and regulatory drag. That is, the policy and regulatory agencies are slow to respond to new developments in the market. For example, there are currently three applications to the Bank of Ghana for unit trust licenses which have been pending for a year. The delay in this case has been attributed to the facts that the Securities Regulatory Commission has not yet been set up and the Bank of Ghana does not want to pre-empt the SRC. Capacity is much stronger in the private sector than in the public sector, thus slowing down the pace of change.

Reviewing the attributes of an effective financial system again, the system has the basic ingredients of what is needed to satisfy attributes 2 and 3, that is, the creation of capital on a large scale and the creation of a market for transferring financial assets. However, the rate of mobilization of funds is low and the existing financial market has limited capacity and liquidity. The monetary system (attribute 1) has also come under sever strain because of macroeconomic instability reflected in high rates of money growth and inflation and an unstable exchange rate.

The pace of change as reflected in the chronology of financial market developments (Appendix) has been dramatic. This indicates that any deficiencies are not a result of a lack of effort. The reality is that the development of a financial system is an ongoing process. We have characterized this process as a dialectical process through which an initial set of conditions become challenged by an antithesis thus rendering the initial conditions untenable and forcing out a new synthesis. In terms of Ghana's financial development, the initial set of conditions, as reflected in the planned and closed economy period ground to a halt by the late 1980s. The antithesis to the initial conditions was financial repression and

dysfunctional behaviour by key agents and institutions of the financial system. The adjustment exercise under FINSAP is the new synthesis. However, a synthesis in a dialectical process is only a temporary equilibrium as one cycle's synthesis becomes the next cycle's thesis in a developmental process that is timeless. We have clearly not seen the end of financial reform in Ghana.

APPENDIX

A CHRONOLOGY OF FINANCIAL MARKET DEVELOPMENTS

DATE	EVENT
1953	Bank of the Gold Coast (now Ghana Commercial Bank) established
1961	Promulgation of Exchange Control Act which puts the inflow and outflow of foreign exchange under Bank of Ghana regulation
1963	National Investment Bank set up to provide medium and long-term finance for the promotion of industrial, commercial, agricultural and other enterprises.
1965	Agricultural Development Bank set up.
1972	Bank for Housing and Construction set up to promote housing and civil engineering projects.
1972	Merchant Bank Ghana Limited Established. This was the first merchant bank in Ghana
1983	Ghana launches World Bank/IMF backed structural Adjustment Program
1985	Financial Institutions' Sector Adjustment Program (FINSAP) launched. The main objectives were: to deregulate interest rates and remove ceilings on deposit and lending rates to privatize government-owned financial institutions and commercial Banks to enhance the soundness of the banking institutions by improving prudential regulation and supervision by the bank of Ghana to improve deposit mobilization and increase efficiency in credit allocation to develop money and securities markets
September 1986	A weekly foreign exchange auction system was introduced
1986(September)	A TWO-TIER EXCHANGE RATE SYSTEM WAS ADOPTED. THE WINDOW 1 RATE WAS FIXED AT ₵90/US\$ WHILE THE WINDOW 2 RATE WAS DETERMINED AT THE WEEKLY FOREIGN EXCHANGE AUCTION.
1987	FINSAC I launched
September	Maximum lending rates a minimum deposit rates decontrolled
October	Weekly auction of Treasury Bills introduced
November	Consolidated Discount House starts operations
1988	The two foreign exchange windows were unified. Window 1 was abolished and the marginal rate established at the weekly auction became the rate for transactions for the week. Bank of Ghana could now authorize dealers other than banks to set up Bureaux de Change to buy and sell currency
February	Minimum bank savings rate decontrolled; Sectoral credit controls, except for agriculture removed
April	Foreign exchange bureaux established
September	90-day Bank of Ghana Bills for banks introduced
1989 July	Comprehensive restructuring plan for banks adopted
August	Banking Law PNDCL 225 passed. The law covered capital adequacy, reserve requirements, loan limits and reporting requirements. The new banking law strengthened the Bank of Ghana's supervisory role, including a) periodic on-site examination of banks, b) regular standard reporting, c) issuance of new accounting standards, d) audit guidelines and e) authority to impose fines and punitive actions in case of violations.
September	Insurance Law enacted
December	Non-rediscountable, medium-term Bank of Ghana instruments for banks with 180 day, 1 year and 2 year maturities introduced
1990	Ecobank (Ghana) Limited established. Ecobank is a subsidiary of Ecobank International Limited. The parent holds 58% of the shares while a number of institutions and individuals resident in Ghana hold the remaining 42%.
January	New managers for public sector banks appointed; two new merchant banks licensed

March	Bank cash reserve requirements on demand, savings and time deposits unified.
April	Foreign exchange market unified
May	Restructuring of three state-owned banks begun; SOE non-performing loans swapped with Bank of Ghana FINSAP bonds
September	NPART and the Non-Performing Assets Tribunal created
November	Ghana Stock Exchange Commences operations; 30-day BOG Bills and 180-Day, 1 and 2 year treasury bills introduced; 5 Year Government Stock introduced; BOG instruments made available to the non-bank sector; lending targets for the agricultural sector and prescribed bank charges and fees abolished; cash reserve ratio reduced to 22%; secondary reserves ratio increased to 20%; bank restructuring extended to three additional banks.
December	Payment of interest on cash reserves at 3% introduced; private sector non-performing loans of state-owned banks swapped with BOG-issued FINSAP bonds; capital adequacy standards enforced
1991 March	Private sector nonperforming loans in sound banks swapped for non-issued FINSAP bonds
June	Securities Discount House Commences operations
July	Cash reserve ratio reduced to 18%; secondary reserves increased to 24% and remuneration on cash reserves increased to 5%
1992 January	Leasing company licensed
October	Bank of Ghana Law (PNDC Law 291) providing for tougher supervisory and regulatory powers enacted
1993 March	Cash reserve ratio reduced to 10%; secondary reserve ratio increased to 32%
May	Financial Institution(Non-Banking) Law PNDCL 328 enacted to provide the supervisory and regulatory framework for nonbank financial institutions and to encourage competition among commercial banks; Home Finance Mortgage Law enacted to support development of housing finance.
June	Finance Lease Law enacted to further the development of the leasing industry
September	Cash reserve ratio reduced to 5%; temporary additional 15% secondary reserve ratio imposed bringing secondary reserve ratio up to 15%
1993	Securities Industry Law PNDCL333 promulgated
1994 May	NSCB merged with Social Security bank
August	Approval granted for 3 new banks; Approval granted for new leasing company
1995 January	Changes in payment arrangements for inter-bank dealings introduced by BOG
February	Appointment of advisor for the partial divestiture of SSB
March	Appointment of advisor for the partial divestiture of GCB
April	Appointment of advisors for the partial divestiture of NIB
October	SSB listed on the Ghana Stock Exchange
December	Bank of Ghana notice BG/GOV/SEC/95/29 – 11/12/95 “Remedial measures at GSE”. Foreigners participation in listed stocks permitted after the stock has been offered to the Ghanaian public for three consecutive days.
1996 May	Ghana Commercial Bank Listed on the Ghana Stock Exchange