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Deutsches Institut für
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Discussion Paper 2/2012

The Politics of Central Banking and Implications for Regulatory Reform in Sub-Saharan Africa

The Cases of Kenya, Nigeria and Uganda

Florence Dafe

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This Discussion Paper is part of a wider study on the political economy of financial reforms within the research project "Making Finance Work for Africa" commissioned by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ). The views expressed in this paper are those of the author alone and do not necessarily represent the views of GIZ.

Bonn 2012

Discussion Paper / Deutsches Institut für Entwicklungspolitik
ISSN 1860-0441

Die Deutsche Nationalbibliothek verzeichnet diese Publikation in
der Deutschen Nationalbibliografie; detaillierte bibliografische
Daten sind im Internet über http://dnb.d-nb.de abrufbar.

The Deutsche Nationalbibliothek lists this publication in the
Deutsche Nationalbibliografie; detailed bibliographic data
is available in the Internet at http://dnb.d-nb.de.

ISBN: 978-3-88985-545-9

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Acknowledgements

A number of people from the GIZ programme "Promoting Financial Sector Dialogue in Africa: Making Finance Work for Africa" and the GIZ financial sector development programmes in Nigeria and Uganda provided generous assistance and feedback during the preparation of this study. I would particularly like to thank Gabriela Braun, Robin Hofmeister and Saliya Kanathigoda. Special thanks are also due to Kathrin Berensmann, Birgit Schmitz and Peter Wolff for comments on an earlier draft and to Mick Moore, Stephen Spratt and Ulrich Volz for their consistent guidance and support for my larger research project on the comparative political economy of central banking in developing countries. Finally, while in the field, I benefited from the insights of a number of individuals, and I am very grateful to those who took the time to share some of their knowledge with me.

Bonn, February 2012 Florence Dafe

Abstract

As regulators, central banks can play a stabilising role, using prudential regulation to ensure financial system stability, and a transformative role, using regulation to promote financial system development and so encourage financial deepening and inclusion. While there are strong arguments for central banks seeking to strike a balance between their stabilising and transformative roles in financial regulation, African central banks have had difficulties in this respect. This paper presents case studies from Nigeria, Uganda and Kenya that show how central banks have historically tended to emphasise one role rather than the other. Reforms that seek to improve the balance between the stabilising and transformative roles of central banks in financial regulation are difficult because interest groups with the power to shape central bank behaviour tend to prefer the regulatory status quo and may try to capture regulatory reform processes. As facilitators of financial reform processes in many African countries, donors should systematically address the challenges posed by regulatory capture with a view to maximising the effectiveness of their support for regulatory reforms.

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Abbreviations

AFI	Alliance for Financial Inclusion
BMOs	business member organisations
BoU	Bank of Uganda
CBK	Central Bank of Kenya
CBN	Central Bank of Nigeria
DFID	Department for International Development
EFInA	Enhancing Financial Innovation and Access
FSD	Financial Sector Deepening
FSS 2020	Financial System Strategy 2020
GDP	Gross Domestic Product
GNI	Gross National Income
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
IFIs	international financial institutions
IMF	International Monetary Fund
ODA	Official Development Assistance
SMEs	small and medium-sized enterprises

1 Introduction

Central banks are key institutions to govern finance and the economy more generally. They may play a stabilising role by using monetary policy to ensure price stability and prudential regulation to ensure the stability of the financial system. They may also play a transformative role and use their regulatory powers to promote the development of a financial system that focuses on channelling financial resources into productive investment by actively encouraging financial deepening and inclusion.

In the aftermath of the global financial crisis, there has been an intense debate in African[1] countries on the direction – promoting stability, economic transformation or both – their central banks as regulators should be taking. Advocates of a stabilising role seem to be dominating the discussion about the future role of central banks after what is deemed to have been the worst financial crisis ever. And yet a view emerging among African policy-makers and development practitioners is that central banks should play a role that goes beyond safeguarding monetary and financial stability and seeks to develop a responsible financial sector, particularly through regulation that provides an enabling environment for the outreach of financial services (De la Torre et al. 2007; CGAP 2011; CGAP 2010; Beck et al. 2011). This view is based on two important arguments. The first is that, by playing a transformative role, central banks can reduce risk in the financial sector: while prudential regulation may go some way towards precluding banking distress, the recurrent nature of financial crises around the world suggests that such regulation is not enough to prevent crises (New Economics Foundation 2009). From this perspective, prudential regulation should be complemented by measures that seek to encourage a different structure for the financial system. As regulators, central banks are best placed to create an institutional environment that supports the transformation to a financial system which diversifies risk by providing a broad range of financial services for different customers rather than engaging in a narrow range of short-term, possibly speculative activities (Hannig / Jansen 2010; Hawkins 2011). The second argument is that, where central banks' stabilising and transformative roles complement each other, this may help to ensure that financial systems fulfil their original purpose of mobilising long-term capital and allocating it to the most productive sectors, firms and individuals in the economy (Epstein 2005; Epstein 2006; Maxfield 1990). Although these arguments have convinced many policy-makers that central banks should seek to balance their stabilising role with a more transformative role, African countries have had difficulty striking such a balance and reforming financial regulation accordingly.

The purpose of this paper is twofold: first, to illustrate and explain the political challenges faced by African central banks in striking a better balance between their stabilising and transformative roles in financial regulation; second, to recommend to donors ways of making their support for financial regulatory reform more effective by addressing these political challenges.

1 Unless otherwise stated, the term *Africa* in this paper refers to sub-Saharan Africa.

This paper adopts a political economy approach to explain the variation of central bank roles across Africa and their stickiness over time. What little research has been conducted into central banking in Africa has largely been technical and so has little to say about the political challenges to financial regulatory reform. The paper therefore builds on both political economy theory and data derived from interviews with key political decision-makers, donors and researchers in three African countries, Nigeria, Uganda and Kenya. Both theory and the findings of field research in these three countries suggest that the financial needs of powerful interest groups have shaped their central bank policies, and that such groups seek to maintain the status quo in financial regulation. Reforms of financial regulation that aim at improving the balance between the stabilising and transformative roles of central banks are difficult because these interest groups have an incentive to capture regulatory reform processes. Based on these insights, the paper recommends that donors, as facilitators of financial reform processes in Africa, should systematically address the challenges posed by regulatory capture with a view to improving their support for regulatory reforms.

The remainder of the paper is divided into five sections: section 2 outlines the research design and methodological issues to provide a background to the context in which the research has taken place. Section 3 illustrates, from a historical perspective, the extent to which African countries have managed to strike a balance between the stabilising and transformative roles of central banks in financial regulation, taking Nigeria, Uganda and Kenya as examples. Section 4 explains the ways in which powerful interest groups may pose a challenge to reforms that seek to improve the balance between the stabilising and transformative roles of central banks in financial regulation. Section 5 puts forward a number of recommendations for improving the effectiveness of financial regulatory reform where there is a risk of capture. Section 6 concludes the paper.

2 Research design and methodology

As this is the first phase of a larger research project on the comparative political economy of central banking in Africa, this paper focuses primarily on setting the scene by illustrating the political challenges to reforms of financial regulation aimed at improving the balance between the stabilising and transformative roles of central banks. It is less concerned with developing the underlying theory. In particular, it places less emphasis on reviewing the relevant theory, giving precise definitions of terms and hypotheses, testing propositions against alternative explanations or making generalisable claims. Rather, it seems important in the first phase of the multi-country study to set the scene by illustrating and explaining the political challenges to regulatory reforms aimed at improving financial stability or financial deepening and inclusion, taking three African countries as examples. As a result, the conclusions drawn remain locally specific.

The decision not to provide precise definitions of terms at the present stage is also apparent from the broad sense in which the terms ‘stabilising’ and ‘transformative’ are used to describe the roles of central banks in financial regulation. A central bank is considered to play a stabilising role where it uses prudential regulation to improve financial system sta-

bility. The extent to which a central bank plays this stabilising role is reflected in the stringency of prudential regulation. Prudential policies typically seek to build up sufficient capital in financial institutions for them to cover expected and unexpected losses, achieve or maintain a manageable level of non-performing loans, address maturity or currency mismatches and strengthen the powers of financial supervisors. In contrast, a central bank is considered to play a transformative role where it uses regulation to encourage financial deepening and inclusion with a view to promoting financial intermediation, i.e. an increase in the level of financial resources that the financial sector channels into productive investment. The extent to which a central bank plays a transformative role is reflected in how activist it is in formulating regulation to encourage financial deepening and inclusion. In developing countries, central banks trying to play a transformative role typically use a variety of regulatory policies to promote better and more efficient access to financial services for un- or underserved segments of the private sector, such as small and medium-sized enterprises (SMEs), micro-entrepreneurs and agriculture (Soludo 2009, 12; Epstein 2006; CGAP 2010, 16-22; Claessens et al. 2009). Thus the distinction made in this paper between the stabilising and transformative roles played by central banks serves to show how they occupy different positions on a spectrum of the stringency of prudential regulation and on a spectrum of regulatory activism in pursuit of financial deepening and inclusion. Besides financial regulations, strategy documents and technical units within central banks mandated to promote financial stability or financial deepening and inclusion indicate how far they pursue their transformative and stabilising roles (Čihák 2010; Cukierman et al. 1992; CGAP 2010).

The distinction made between a central bank's stabilising and transformative roles is therefore not binary: a central bank can play both roles at the same time, to varying degrees. However, there are not only synergies but also trade-offs between the two roles in financial regulation, at least in the short and medium term. Table 1 gives some examples of regulatory policies that central banks in developing countries have been pursuing, with varying levels of success, to improve financial stability and/or financial intermediation. In some cases, the regulatory policies adopted to promote one objective also help the other to be achieved. Regulation designed to develop credit reporting through credit bureaus, to take one example, is likely to have the effect of directly promoting both financial stability and financial intermediation. In other cases, regulatory policies pursued to achieve one objective may pose risks to achieving the other objective. For instance, spurring competition through the lowering of barriers to entry may have a positive effect on financial intermediation, but pose a risk to financial stability if regulators do not address the trade-off in the design of policies.

The roles that central banks play as they seek to promote financial intermediation may vary in activism from providing a framework for financial deepening and inclusion that also helps to improve financial stability to providing a framework for financial deepening and inclusion that so encourages financial market activities that stability is put at risk.

Table 1: Transformative and stabilising roles: examples of regulatory policies

Regulation to…	Expected contribution to the objective of promoting: financial deepening and inclusion	Expected contribution to the objective of promoting: financial stability
… promote financial literacy	+	+
.. . promote consumer protection	+	+
… develop credit reporting	+	+
... allow non-financial firms (e.g. telecom providers) to provide banking services	+	-
… lower barriers to entry to spur competition	+	-
… specify lending requirements for banks to increase credit to private sector	+	-
… keep interest rates low through credit ceilings		-
…establish credit guarantee schemes	+	
… ensure robust monitoring and enforcement of rules by the central bank (e.g. right to revoke banking licences)		+
…specify high minimum capital adequacy requirements	-	+
… limit short-term funding of domestic banks	-	+

Source: Author's compilation. Notes: + = Policymakers expect positive contribution; this usually provides the rationale for implementing the respective regulatory policy; - = Policymakers expect negative contribution if regulators do not address the trade-off between promoting financial deepening and inclusion and promoting financial stability in the design of policies; empty cell: no or indeterminate contribution expected

If more ambitious transformative approaches are not implemented satisfactorily (e.g. because of a lack of technical capacity, corruption or regulatory capture), effects on financial stability may be highly negative. Better technical capacity and a supportive political environment may allow countries to become more activist without posing undue risks to financial stability. Similarly, roles that central banks seeking to promote financial stability play may vary in the stringency of their prudential regulation from providing a framework for financial stability that also promotes financial intermediation to providing a framework for financial stability that so restricts market activities that financial intermediation is put at risk and becomes costly. Reforms aimed at improving the balance between the stabilising

and transformative roles of central banks may operate in both directions: on the one hand, they seek to detect deficiencies in the regulatory framework designed to promote financial deepening and inclusion and so to improve it that it takes better account of risks to financial stability. On the other hand, these reforms seek to detect deficiencies in prudential regulation and so to improve it that it takes better account of risks to financial intermediation.

The specific positions that central banks occupy along the spectra largely reflect the views held on how financial and economic systems work and political economy factors. For instance, the fact that a central bank emphasises its stabilising rather than its transformative role does not necessarily indicate that the government or central bankers are indifferent to growth and development. Rather, it may indicate that they regard the assurance of financial stability as the best way to generate sustainable growth. From this perspective, proactive attempts to generate development are likely to fail and damage long-term growth prospects. Alternatively, the view held may be that ensuring financial stability will not lead to a successful, market-led development process, but that that process needs to be encouraged by more activist financial development policies. Thus central banks in different countries may be equally committed to promoting economic development and yet behave very differently because they have different 'models' of economic development. Taking three country cases, this paper illustrates the diversity of positions occupied by central banks along the spectra of the stringency of prudential regulation and of activism in regulation aimed at financial deepening and inclusion. It also demonstrates how political and economic factors combine to encourage the creation and maintenance of a central bank that reflects a particular 'model' of how economies work and occupies a particular position on the spectrum.

Nigeria, Uganda and Kenya have been selected as the country cases by the diverse case method (Seawright / Gerring 2008, 300-301). Based on this method, the research identified a set of cases of sub-Saharan African countries that encompasses a wide range of values with respect to two proposed key explanatory variables, namely the level of development of the domestic financial sector and the sources of public finance. Nigeria was chosen because of the little research so far conducted on its central bank policy despite the importance of the economic and political weight the country carries in Africa. Nigeria does not have a well developed financial system, considering the level of its national income: financial intermediation is limited because the financial system is not well diversified, but focuses on the higher end of the market and offers a limited range of products (Sanusi 2010). Moreover, the unsound conduct of banks has repeatedly caused banking distress in past decades. Oil is the major source of revenue for the Government of Nigeria, because the non-oil productive sector is weakly developed. Nigeria therefore allows to explore the effect that natural resource dependence has on central bank behaviour. Uganda and Kenya were chosen because they differ from Nigeria where the proposed key explanatory variables of financial development and sources of public finance are concerned. Uganda's financial sector is among the least developed in Africa in terms of size, diversity, efficiency and financial intermediation (Egesa 2010; Beck / Hesse 2009, 195; Kasekende 2010a, 74-76). The Government of Uganda relies heavily on foreign aid to finance government expenditure. Taxes have yet to become the single most important

source of government revenue: the productive sectors are weakly developed, as is evident from the 'missing middle', with a small number of large enterprises, a large number of micro-enterprises and the prevalence of subsistence agriculture. In contrast, the financial system in Kenya is among the most developed in Africa in terms of diversity, size and financial intermediation. The Government of Kenya relies heavily on taxation as a source of revenue, since the productive sectors in Kenya are relatively well developed (African Economic Outlook 2011a). Kenya compares favourably with other African economies with respect to the commercialisation of agriculture and the diversity of the size of firms in the productive sector. As the financial systems in Nigeria, Uganda and Kenya are still, as elsewhere in Africa, very much bank-based, this research explores the political economy of financial regulation focusing primarily on the regulation of banking services.

Methodologically, the research is based on a combination of secondary literature, quantitative data and extensive interviews with policy-makers, donors and researchers in Nigeria, Uganda and Kenya. Secondary literature on African political economy and more technical literature on monetary and financial policy in addition to literature on the political economy of finance have been studied. The quantitative data present a detailed picture of the macroeconomic and financial development in the three case study countries over time. The data indicate that a combination of economic and political factors may pose challenges to regulatory reform. The interviews are a key research input because they have helped to ensure that the story told reflects an assessment of what those involved in financial reform processes consider to be key success factors for and challenges to effective regulatory reform.

3 Striking a balance between stabilisation and transformation: central bank policy trajectories in Nigeria, Uganda and Kenya

This section identifies the challenges African countries face where they seek to reform financial regulation in order to strike a better balance between the stabilising and transformative roles of their central banks. With Nigeria, Uganda and Kenya taken as examples, this section presents historical narratives to illustrate the diversity of the roles played by central banks and to describe how far these countries have sought to strike a balance between the stabilising and transformative roles of their central banks in financial regulation and how far they have succeeded. The historical perspective shows the difficulty of adapting the overall thrust of central bank regulation to changing circumstances, highlighting the path dependency of central banking.

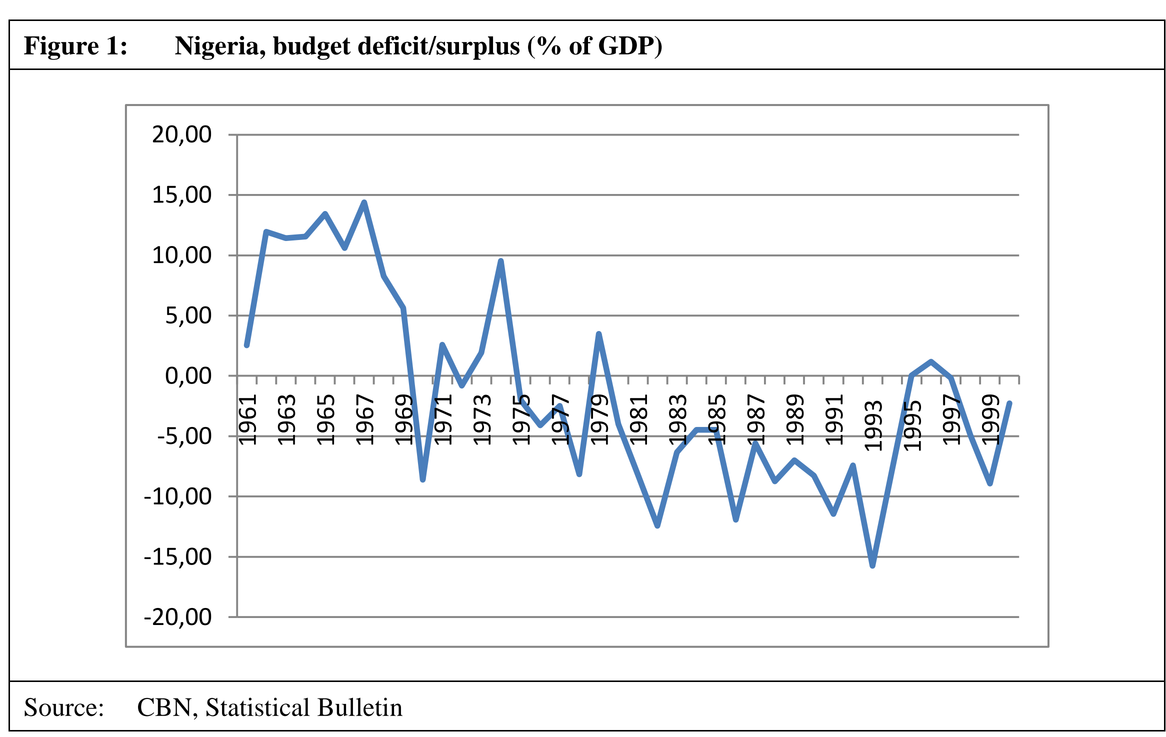
3.1 Continuity in the transformative mandate: the Central Bank of Nigeria

When Nigeria became independent in 1960, banks, both foreign and indigenous, played no role in financing the domestic private sector or economic development more generally: Expatriate banks focused on providing banking services for British commercial enterprises and short-term trading activities rather than mobilising long-term capital for development

and the growth of domestic business (Brownbridge 1998c, 106). As the indigenous banking system was weakly developed and in financial distress at the time of independence (Uche 1997, 224), it was in no position to finance Nigeria's development needs. After independence, the Central Bank of Nigeria (CBN) therefore focused increasingly on funding government financing needs and providing financial support for a weakly developed banking sector. Indeed, strengthening Nigerian banks and mobilising capital had been the key objectives of the CBN's establishment in 1958 (Uche 1997).

From the 1970s in particular, economic aspirations motivated developmental central bank policies that sought to influence the allocation of financial resources through extensive regulation of the banking sector. Allocative controls, such as interest rate controls and the direction of credit to development priority sectors and parastatal enterprises, rather than prudential controls, became the CBN's primary regulatory concerns (Brownbridge 1998c, 106). Until the CBN issued new prudential guidelines in 1991, banking regulation allowed banks, for instance, to conceal the true state of their balance sheets by not requiring them to classify loans according to quality or to make provisions for non-performing loans. Moreover, the CBN pursued "an implicit policy of not allowing banks to fail" (Brownbridge 1998c, 119): banks with liquidity shortages had recourse to the CBN, regardless of the quality of their management (Nigeria Deposit Insurance Corporation 2009). The CBN further neglected its stabilising role when oil prices fell in the early 1980s, and the government became increasingly unable to control the budget deficit, as Figure 1 shows. Between 1990 and 1994, 86 per cent of the federal budget deficit was financed by the domestic banking system, mainly by the CBN (Brownbridge 1998c, 122; Central Bank of Nigeria 1994, 17).

Figure 1: Nigeria, budget deficit/surplus (% of GDP)

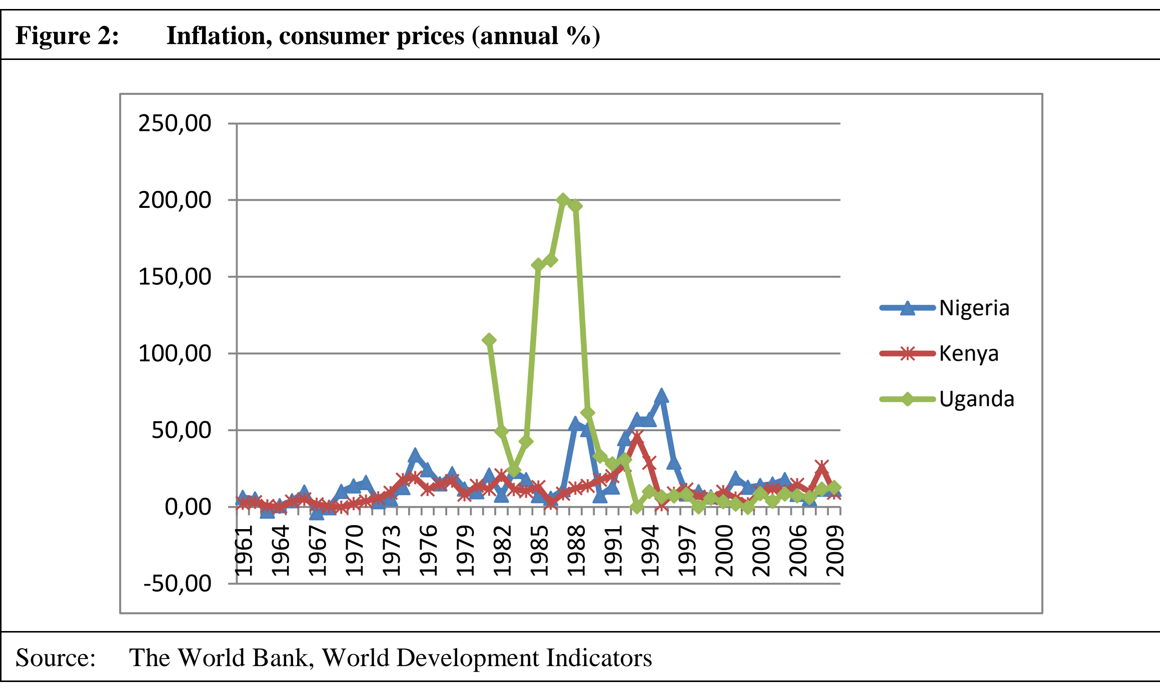


Source: CBN, Statistical Bulletin

The effects of the central bank policy, which placed the emphasis on the transformative role at the expense of the stabilising role, on the financial sector and the real economy

were devastating. By the mid-1990s, the Nigerian financial system was in a state of collapse: in 1992, eight banks were insolvent and 45 per cent of bank loans non-performing. In 1995, the CBN classified nearly half of the 81 local banks as distressed (Brownbridge 1998c, 116). Many banks suffered from distress because the requirements relating to lending to risk sectors, mismanagement and fraud, particularly lending to politically well connected, but uncreditworthy individuals, had increased the ratio of non-performing to total loans (Daumont et al. 2004, 38-40). Non-performing loan ratios were also high because higher interest rates stemming from rising inflation (see Figure 2) made it difficult for the real sector to service its debts (Brownbridge 1998c, 117). Nor were banks able to mobilise deposits because negative real interest rates had depressed saving rates and bank failures had destroyed confidence in the banking sector. Thus, after three decades of central bank policy emphasizing a transformative role, banks had become increasingly overdrawn on CBN accounts and dependent on government support for survival.

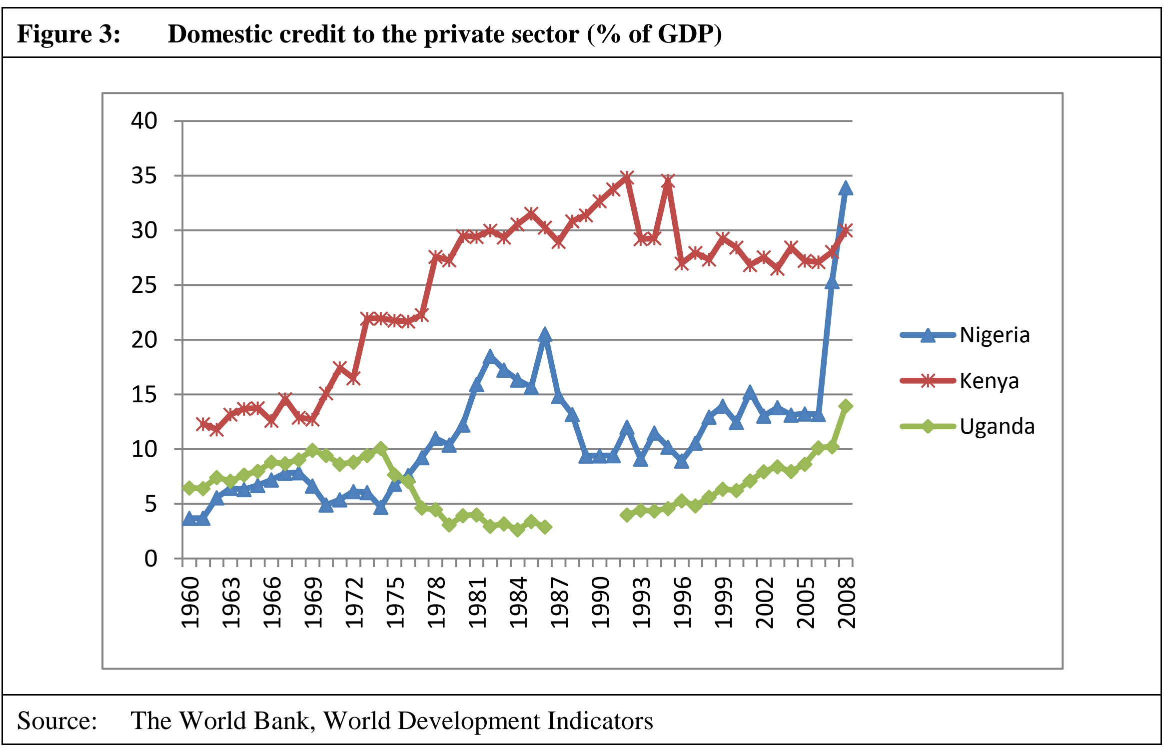
Figure 2: Inflation, consumer prices (annual %)



Source: The World Bank, World Development Indicators

The regulatory regime also hurt the real economy. While the oil boom of the 1970s had expanded investment opportunities and strengthened the small indigenous capitalist class, private sector development was stagnant by the mid 1980s: the growing disarray in the wider economy and the weakness of the banking sector starved the real economy of the credit necessary for investment and growth. Figure 3 shows that domestic credit to the private sector as a share of GDP, which had risen between 1970 and 1985, fell between the mid-1980s and mid-1990s. The government's revenue needs, the banking distress and the contraction of credit strengthened the constituency in both the public and the private sector for a transformative central bank that provided subsidised credit, credit guarantees and overdraft facilities for the government and banks.

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

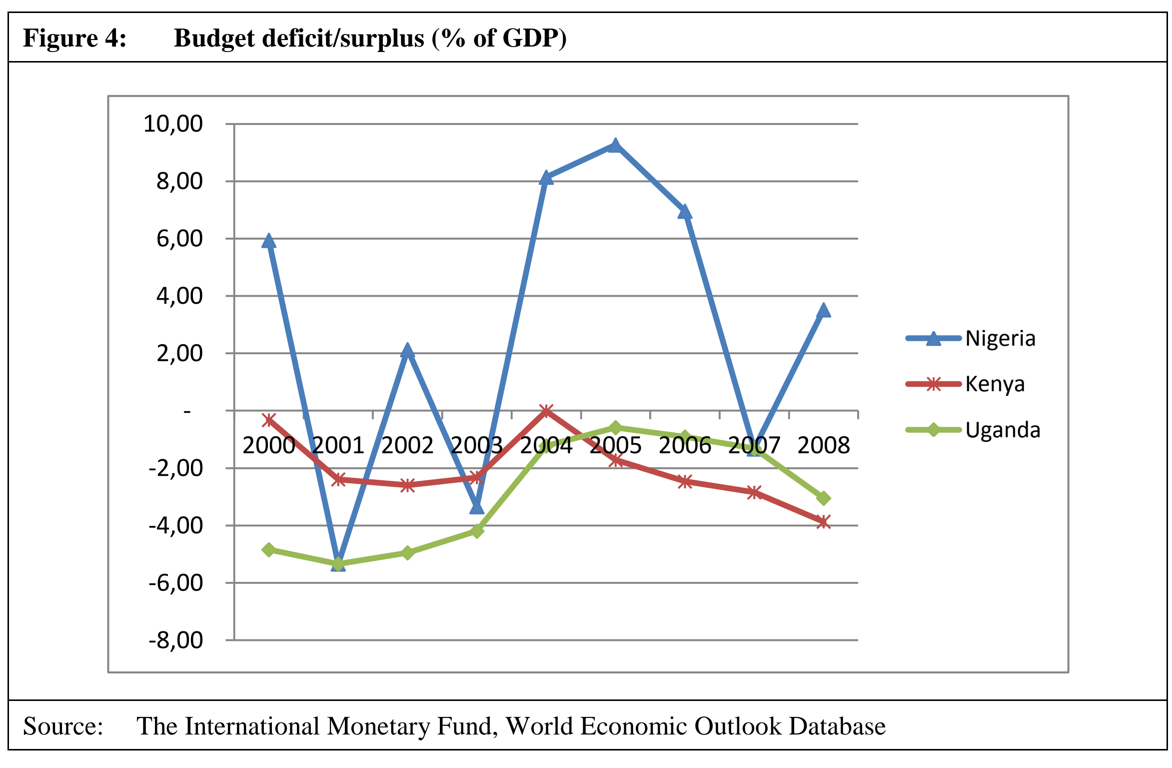


Source: The World Bank, World Development Indicators

As there was a strong domestic constituency opposed to changing the CBN's transformative mandate, the financial reform process was lengthy, inconsistent and limited in scope and effect. Hit by declining petroleum prices, macroeconomic instability and rising external debt, Nigerian leaders launched a financial reform programme in 1986 (Lewis / Stein 1997). Yet reforms designed to deregulate the banking sector and strengthen prudential regulation were deficient in many ways. For instance, the CBN removed and reintroduced some allocative regulations, such as interest rate and foreign exchange controls, several times during the 1980s and 1990s (Lewis / Stein 1997). The CBN also reformed prudential regulation and supervision, because it had become less willing to accommodate the financial needs of banks in distress, but the effects were limited: from the late 1980s, the CBN had applied a combination of a mechanism for dealing with distressed banks, limited deposit insurance and stricter prudential standards (Brownbridge 1998c, 120). In particular, it introduced higher capital adequacy requirements in 1990 and new prudential guidelines directing banks to classify loans according to whether they were being serviced, to make provisions for non-performing loans and to suspend unpaid interest from income (Brownbridge 1998c, 120). Yet the large number of financial institutions, limited supervisory capacities and collusion among regulators and banks combined to prevent the central banks from playing its stabilising role more effectively (Brownbridge 1998c, 121). Macroeconomic instability and the severe crisis in the real sector complicated the reform process and made it difficult to buy political support for regulatory reforms in the 1980s and 1990s. Nor did the reforms of financial regulation fulfil their primary purpose of reallocating credit from the public to the private sector: the increase in bank lending to the government to finance rising budget deficits and the risks inherent in lending to a weak business sector depressed private sector lending until the mid-1990s.

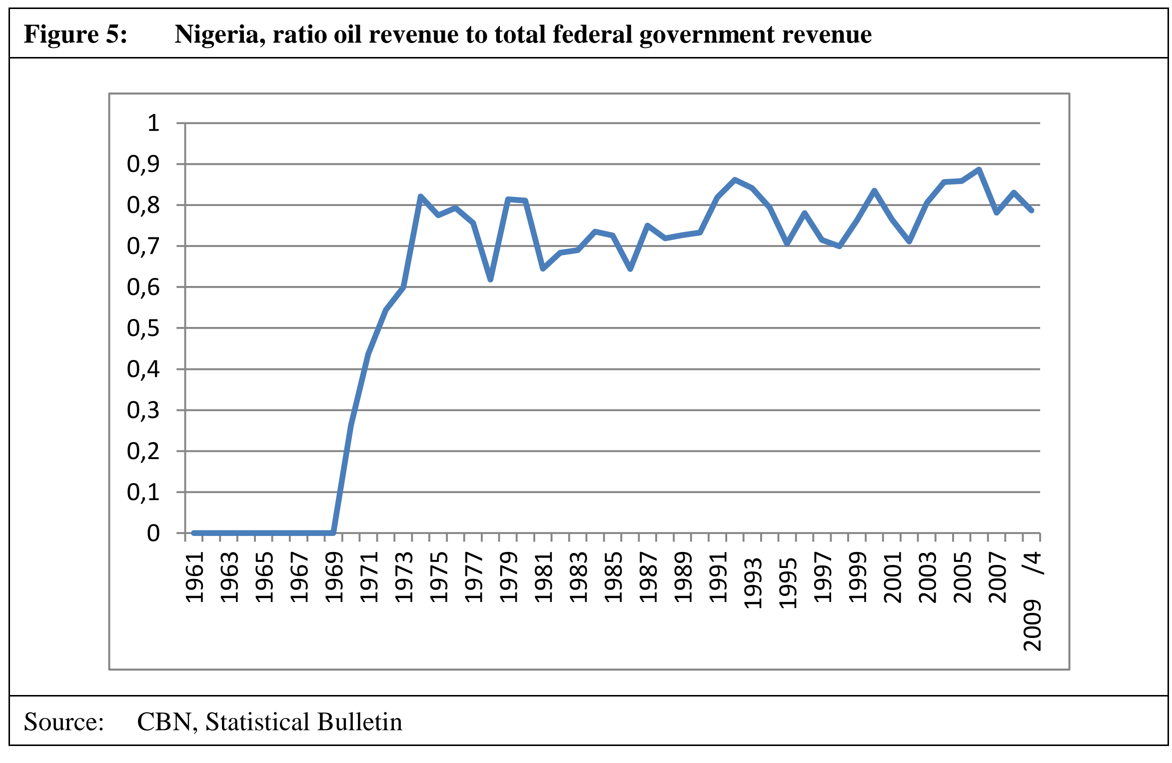
Over the past decade, Nigeria has experienced major changes in the political and economic spheres. First, military rule ended in 1999, with the transition to democracy under President Olusegun Obasanjo, and a number of reforms were implemented in the public service and economic spheres. Second, the macroeconomic environment improved remarkably: since 2000, Nigeria has experienced moderate growth and inflation has been more stable. Figure 4 shows that budget deficits have been shrinking. The strong economic performance is attributable in large measure to good rains and strong oil prices.

Figure 4: Budget deficit/surplus (% of GDP)



Source: The International Monetary Fund, World Economic Outlook Database

Figure 5: Nigeria, ratio oil revenue to total federal government revenue



Source: CBN, Statistical Bulletin

Policy-makers have realised that the foundations of Nigeria's growth are fragile because its economic prosperity and ability to satisfy key constituencies depend on a booming oil sector. Oil and gas production dominate the economy, accounting in 2009 for 90 per cent of exports and, as Figure 5 shows, over 80 per cent of government revenues (African Economic Outlook 2011c). Successive governments have therefore emphasised the importance of diversifying the export base. Nigeria's national development plan, Vision 2020, outlines a path to economic diversification aimed at transforming the country into one of the world's top 20 economies by the year 2020.

While entrepreneurs are in dire need of external financing to enable the transition to a diversified economy to be made, the banking sector does not yet seem prepared to provide the amount of credit necessary for structural transformation (Sanusi 2011). Although Nigerian banks have developed new products for consumer, corporate and project finance and there has been an upward trend in credit provision during the last few years, Nigeria's domestic credit as a share of GDP is, at an average of only 14 per cent between 2000 and 2004 and 21 per cent between 2005 and 2008, low compared to such African peers as South Africa and Kenya, where domestic credit between 2005 and 2008 reached 151 and 27 per cent respectively (Allen et al. 2010; Kasekende 2010a, 79). In addition, Nigerian banks concentrate their lending activities on the oil, gas, and communications sectors, which can be served by relatively low-risk, short-term loans, and tend to neglect other development priority sectors, particularly agriculture (Central Bank of Nigeria 2010, 71).

Furthermore, Nigerian banks have to some extent remained reliant on the government, both as a client and as a provider of capital in times of distress. As elsewhere in Africa, Nigerian banks tend to rely on the government as a client because they prefer to invest their resources in liquid, low-risk assets, such as government securities (Honohan / Beck 2007, 30, 34, 76). Between 2000 and 2009, for instance, claims on the government amounted to 14 per cent of total assets, whereas claims on the private sector constituted 38 per cent of total assets. Banks have continued to rely on the government as a provider of capital in times of distress because, in an environment of rapid credit growth, corporate governance problems have periodically caused some banks financial distress (Olayiwola 2010). In 2009, for example, the CBN bailed out nine banks and found that, in five of them, fraudulent practices and mismanagement had magnified the liquidity problems caused by the global financial crisis (Sanusi 2010, 14). The financial sector's weaknesses and the productive sector's limited access to finance explain the continued support within the public and private sectors for a transformative central bank that takes the lead in promoting financial and economic development.

The emphasis on the transformative role is also evident from recent regulatory reforms. While there have been far-reaching reforms in the area of stabilisation, such as the strengthening of risk-focused regulation, the adoption in 2009 of a common accounting year end for all banks, the aim being to improve data integrity and comparability, and the increase in central bank autonomy brought about by the CBN Act of 2007, the CBN has maintained a strong focus on financial sector development and outreach (Sanusi 2010; Soludo 2004; Soludo 2009, 10). For instance, the CBN has a Development Finance Department running various schemes to improve financial access for SMEs, the agricultural

and other development priority sectors. Moreover, the CBN's main objective of the consolidation of the banking sector in 2004/2005, to give an example of a major reform in the past decade, was to promote the development of an internationally competitive banking sector through more stringent capitalisation requirements (Soludo 2004). The CBN also hoped that this consolidation would increase competition and force banks to broaden their customer base, so that the banking sector might better serve the needs of the real economy (Soludo 2004). The CBN's transformative mandate is also evident from its long-term policy document, the Financial System Strategy (FSS) 2020, which complements Vision 2020. FSS 2020 emphasises that financial sector development is a key instrument for economic diversification and outlines the path to Nigeria's transformation into an international financial centre, with the CBN taking the lead in the financial development process.

3.2 Transformation towards stabilisation: the Bank of Uganda

While the setup of the Bank of Uganda (BoU) was orthodox when it began operations in 1966, the financing needs of the government and the private sector at the time of independence soon created a constituency for a more transformative central bank. Initially, the BoU's mission was conservative because the Ugandan government was seeking to create confidence in the currency and to encourage international lending to Uganda (Helleiner 2001, 14). However, soon after the founding of the BoU, the government's financing needs increased rapidly, partly because of the of the newly independent state's development needs, but also because financing a civil war strained government budgets under the regimes of Milton Obote (1962-1971 and 1980-1985) and Idi Amin (1971-1979). In addition, efforts to develop an indigenous business class required substantial external financing, because there were few Ugandan entrepreneurs at the time of independence and those with the potential to become entrepreneurs lacked private capital for investment (Moncrieffe 2004; Kasozi 1994). As the foreign-owned banking sector, being weakly developed in terms of size, diversity and inclusiveness, was failing to meet the government's and private sector's financing needs, it was generally agreed that economic development needed to be state-led and that the central bank must play a transformative role.

As time passed, the BoU increasingly emphasised its transformative and neglected its stabilising role. In its first decade of operation, it began to regulate the allocation of financial resources in the banking sector, particularly through interest rate and foreign exchange controls. The prudential regulation of banks was deficient in several respects. For instance, the Banking Act of 1969 did not impose clear restrictions on insider lending and was more explicit on allocative than prudential requirements. It did not grant the BoU the legal authority to force banks to improve management, lending practices and internal controls without support from the Minister of Finance (Brownbridge 1998a, 136-137). Bank supervision was also inadequate: the BoU did not conduct on-site inspections and sometimes failed to analyse the bank returns submitted to it (Brownbridge 1998a, 133). Until the 1990s, it automatically provided, at times of distress, liquidity support for public banks and the locally owned banks that had emerged in the 1980s (Brownbridge 1998a, 130).

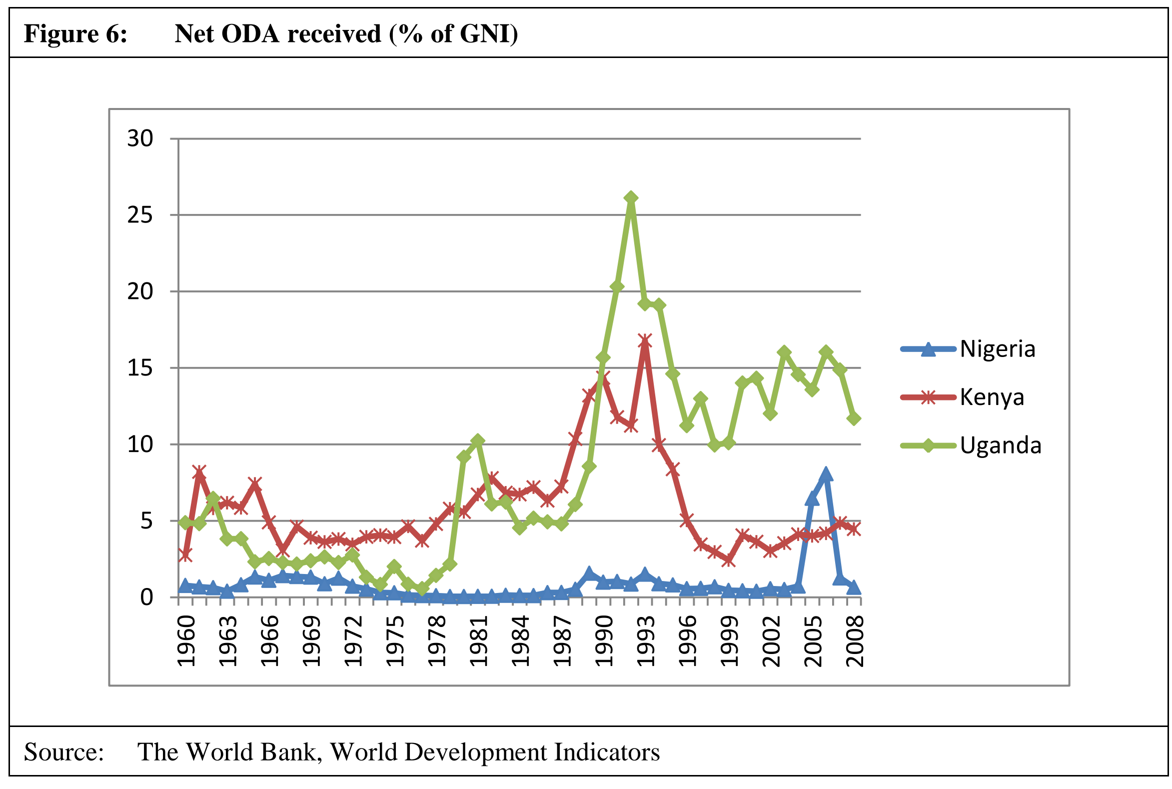
The central bank policy, which emphasised financial development and neglected stability, severely damaged the financial sector and the real economy. Uganda suffered a prolonged economic decline from the 1970s until the mid-1980s, attributable partly to the civil war, but also to economic mismanagement. As the BoU financed large government deficits, inflation skyrocketed in the 1980s, averaging 103 per cent between 1981 and 1990 (Brownbridge 1998a, 128-129). Negative real interest rates depressed saving and lending, further reducing financial depth and weakening banks. Banks became increasingly distressed from the 1980s onwards. By the early 1990s, the two public commercial banks, whose lending had been dictated mainly by political criteria, were insolvent because of high non-performing loan ratios. In 1994, half of the banking system had solvency problems, and by 1995 four of nine local banks had run into financial difficulties, forcing the BoU to close them down or restructure them (Brownbridge 1998a, 133). The distress in local banks was due to several factors: the tightness of financial markets, fraud and the lack of managerial capacity, the weakness of internal controls and deficiencies in the regulatory framework that allowed undercapitalised banks into the market. This environment was also difficult for private sector development: the productive sector continued to be excluded from bank finance because of tight liquidity, foreign banks' conservative lending policies and the channelling of a substantial amount of subsidised credit to individuals with political connections. Throughout the 1970s and 1980s, bank lending to the private sector averaged only 3.2 and 4.9 per cent of GDP respectively.

In the mid-1980s, Uganda underwent a major economic and political transformation. In 1986, Yoweri Museveni, the leader of the National Resistance Movement, came to power. A year later, the new regime launched a stabilisation programme and, in 1991, a financial sector adjustment programme. Uganda soon earned the reputation of being "a pioneer of macroeconomic stabilisation and structural adjustment in sub-Saharan Africa" (Collier / Reinikka 2001, xiii). Figures 6 and 7 show that, from 1987 onwards, Uganda experienced a massive increase in foreign aid: during the 1990s aid rose to an average of 15.9 per cent of GNI, the ratio being similarly high from 2000 to 2008 (14.1 per cent of GNI), with aid accounting for 79 per cent of central government expenditure. The change of political regime certainly facilitated a change of economic policy. Yet the main reason for the turnaround in economic governance was that the cost of continuing the transformative policies was too high for an economy close to collapse, whose only available source of foreign exchange and government revenue was aid. In a context of aid dependence, donor preferences for an orthodox central bank also acted as a strong incentive to the government so to reform financial regulation that the emphasis was on the stabilising rather than the transformative role of the BoU.

The financial reform process, which began in 1991, was therefore consistent and took place in the context of a reduction in domestic borrowing and falling inflation. The government repaid a substantial amount of its debt to the banking system between 1992 and 1994, and inflation fell from 63 per cent in 1991 to 16 per cent in 1994 (Brownbridge 1998a, 139). As a result, real interest rates became positive and increased the liquidity and profitability of the banking sector. By the mid-1990s, the government removed allocative and interest rate controls. It also strengthened the BoU's stabilising role by reforming pru-

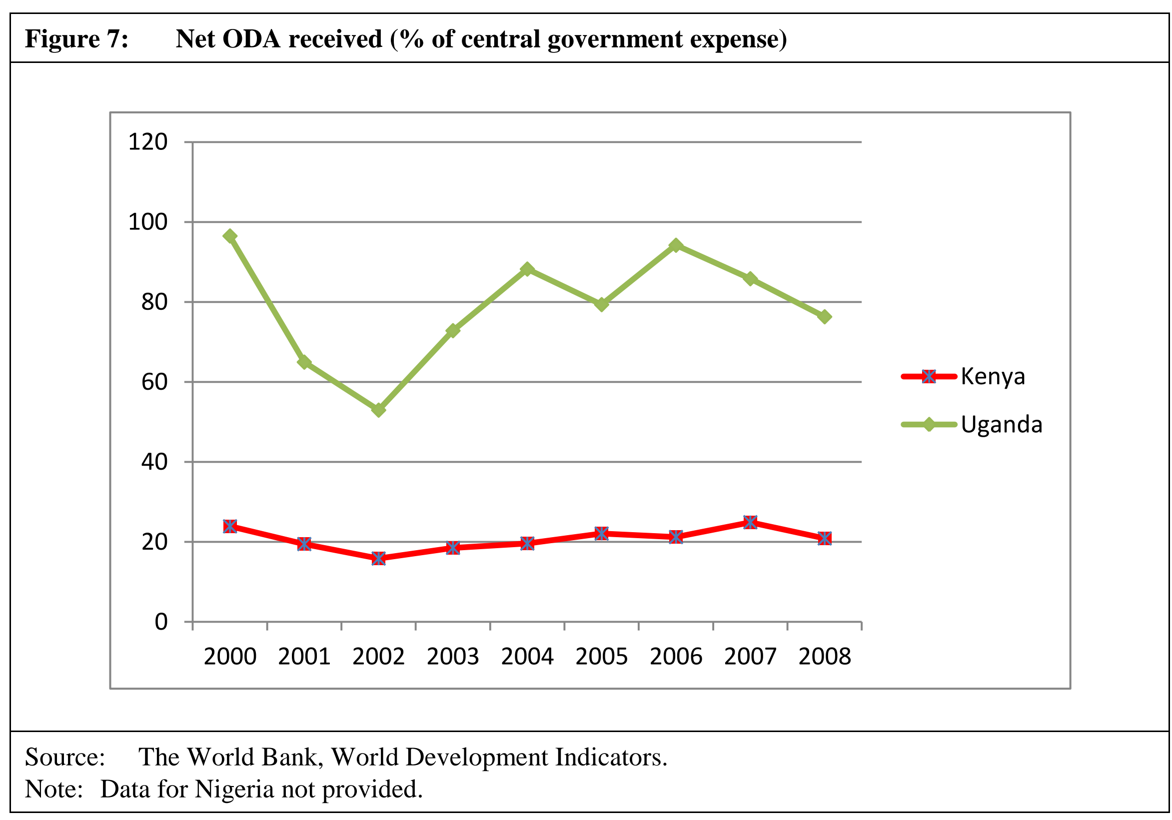
dential regulation and supervision and closing many regulatory gaps, as under the 1993 Financial Institutions Statute.

Figure 6: Net ODA received (% of GNI)



Source: The World Bank, World Development Indicators

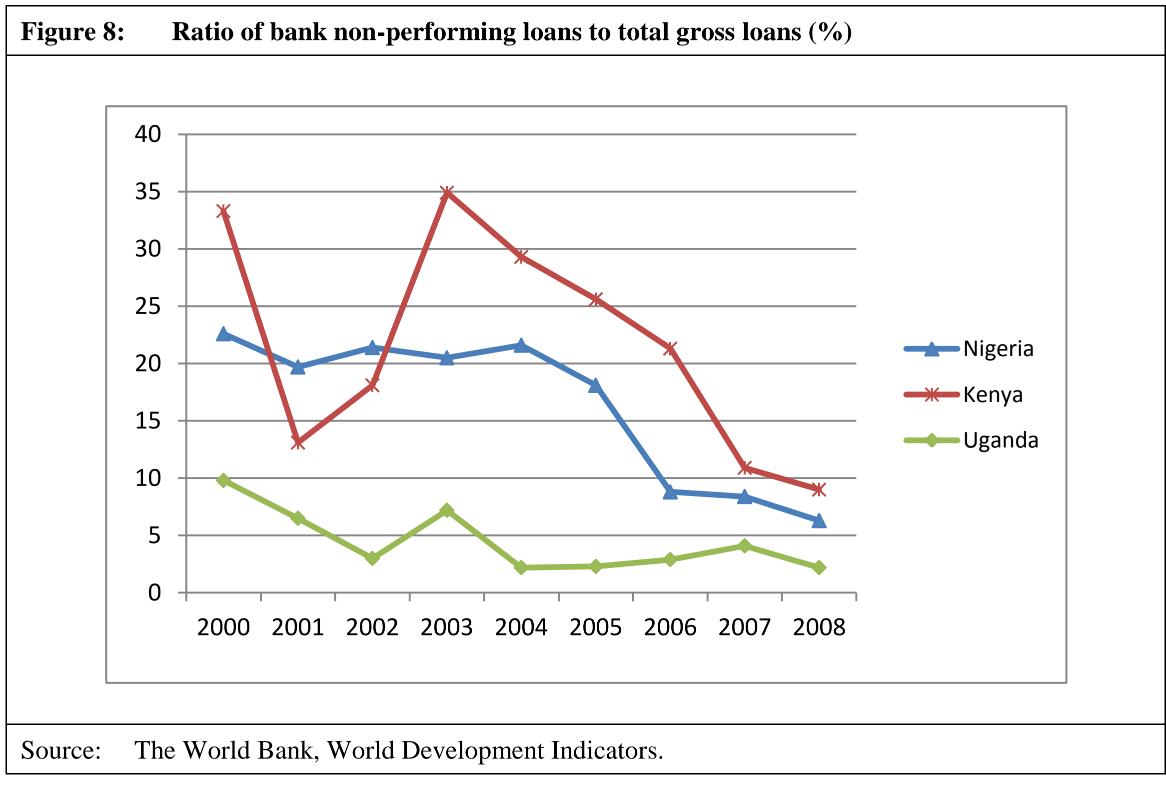
Figure 7: Net ODA received (% of central government expense)



Source: The World Bank, World Development Indicators.
Note: Data for Nigeria not provided.

Uganda has experienced a decade of relative stability since 2000: security has been restored in most parts of the country, macroeconomic stability has been exceptional, and the economy has responded to reforms with an average growth rate of six per cent in the 1990s and eight per cent since 2000. The budget deficit has been relatively stable and modest, although foreign aid still accounts for the majority of government revenue. Uganda's banking sector has recovered from a serious crisis in 1998 and 1999: the health of the banking system has improved remarkably, following the closure of several distressed banks and further improvements in regulation and supervision. The remaining banks are well capitalised, profitable and resilient. In particular, Uganda's banks have, as Figure 8 shows, a relatively low ratio of non-performing loans. However, while there has been an upward trend in lending to the private sector, banks tend to focus on serving the higher end of the market, prefer investing in low-risk government securities and are deficient in the areas of financial intermediation, outreach and competitiveness (Beck / Hesse 2009; Brownbridge / Tumusiime-Mutebile 2007, 200; Kasekende 2010a, 74).

Figure 8: Ratio of bank non-performing loans to total gross loans (%)



Source: The World Bank, World Development Indicators.

Although the BoU has become concerned about the limited degree to which the banking sector meets the financial needs of the still weakly developed real economy, the government and the BoU itself see the BoU's role primarily as the promoter of monetary and financial stability, rather than of financial deepening and inclusion (Bank of Uganda 2000). Aid seems to have reinforced the preference for a stabilising central bank over the years: as it does not depend on domestic bank credit or on private sector taxes to finance the state apparatus and economic development policies, the government seems to have

fewer incentives to push the BoU towards playing a more transformative role.[2] Because of their strong financial position, the dominant banks in Uganda also form a powerful constituency for a conservative central bank that controls inflation through tight monetary policy and does not overly interfere in operations through regulation that seeks to increase competition and consumer protection.

The central bank's emphasis on its stabilising role is also evident from major reforms in the past decade. Following the banking crisis in 1998/1999, the overall thrust of regulatory policy was directed towards "security, confidence and maintaining strong capitalisation rates" (Dzineku et al. 2009, 2). Further improvements were made in prudential regulation and bank supervision with the passing of the Financial Institutions Act in 2004 and the Financial Institutions Regulations in 2005. In particular, the BoU adopted unified accounting principles and standard reporting systems and introduced risk-based supervision. It also strengthened its technical capacity to perform its stabilising role by creating a financial stability department in 2007. At the same time, the BoU closed its development finance department so that it might concentrate more on its stabilising function (New Vision 2006).

Nevertheless, the BoU is becoming increasingly aware of the necessity of focusing more on the creation of an environment that enables access to financial services to be expanded if it is to better meet the needs of the real economy (Kagenda 2010). However, reforms to improve the balance between the BoU's stabilising and transformative roles in financial regulation have been difficult, interviews in Uganda revealing that the main dilemma for the BoU in recent years has been to find ways of increasing financial intermediation without contravening its model of a liberalised financial sector. Credit bureau reform, to take one example, has been a tedious, five-year process.[3] Initially, banks were reluctant to share credit information on their customers with private credit bureaus on a voluntary basis. Interview data suggest that this reluctance was due to the need for some banks to invest considerable resources in staff training and technical equipment for data-sharing and collective action problems among banks related to data-sharing.[4] Consequently, the BoU had to make it mandatory for banks to share information with credit bureaus. The BoU has also made an effort to promote consumer protection and financial literacy. However, critics within the BoU and in the private sector have argued that activities in these fields would stretch the BoU's mandate beyond its traditional stability concerns, and reforms have not yet reached implementation stage. Regulatory reforms in the area of consumer protection may also face resistance from banks, which, as interviews with aid officials and bankers

2 Moreover, aid-funded fiscal expansion has increased the volume of domestic liquidity, the BoU seeking, particularly between 1999 and 2002, to maintain monetary stability and a competitive exchange rate through the sale of government securities. This in turn crowded out private sector borrowing (Brownbridge / Tumusiime-Mutebile 2007; Killick / Foster 2011), reducing the scope for financial deepening and inclusion.

3 Credit reference bureaus may have a positive effect on both financial access and financial system stability by creating a credit history of borrowers and facilitating the screening of potential borrowers.

4 These problems are not confined to Uganda. Mylenko (2008) provides a systematic overview of similar challenges that other African countries, including Nigeria and Kenya, have faced in developing credit bureaus.

confirmed, tend to prefer industry self-regulation. While these examples of recent reform initiatives suggest that the transformative role of the BoU is gaining in importance, they also indicate that there is a strong domestic constituency, within both the government and the banking sector, for the BoU to play a stabilising role. This constituency believes that maintaining the focus of central bank policy on financial and price stability is the best way to generate sustainable growth and that proactive attempts to promote financial system development are likely to fail, as they have in the past. The resilience of the banking sector in the face of the global financial crisis, due primarily to high prudential standards, seems to have strengthened this argument (Kasekende 2010b).

3.3 In search of a balance between stabilisation and transformation: the Central Bank of Kenya

Originally set up as an orthodox central bank, the Central Bank of Kenya (CBK) soon became transformative in response to fiscal and economic pressures arising from a revenue-needy government, a weakly developed banking sector and the need to increase productive investment. At the time of independence, the Kenyan government faced the challenge of mobilising revenues to finance the development of the state apparatus, its economic development policies and the indigenous business sector. The banking sector, then consisting entirely of foreign-owned banks, did not play an important role in financing the development needs of the emerging Kenyan entrepreneurs: controlled by their overseas parent companies, the banks' lending policies were conservative and concentrated on prime business borrowers and short-term, trade-related financing (Brownbridge 1998b, 82). As there was no locally owned banking sector in the 1960s, the Kenyan government chose the route of developmental central banking to channel financial resources into productive investments in Kenyan enterprises (Brownbridge 1998b, 81).

While the CBK emphasised its transformative rather than its stabilising mandate, the degree and nature of its market interventions were more modest than in many other African countries. Like the Nigerian and Ugandan central banks, the CBK sought to direct the development of the financial sector and regulate the nature of its lending with interest rate and credit ceilings, but placed less emphasis on prudential controls and supervision. For instance, it rarely enforced mandatory requirements, although it had a number of instruments, such as cash reserve requirements and liquid assets ratios, at its disposal (Brownbridge 1998b, 95-97). Furthermore, from the 1970s onwards, financial policy in Kenya was increasingly driven by fiscal policy considerations and the financial needs of the emerging indigenous banking sector (Brownbridge 1998b, 93-97; Helleiner 2003, 14). However, despite extensive intervention in financial markets, CBK regulation did not interfere in lending decisions, except for the requirement that all commercial banks extend credit to agriculture amounting to at least 17 per cent of their deposit liabilities (Brownbridge 1998b, 82). Banks were thus able to continue lending primarily in accordance with commercial criteria (Brownbridge 1998b, 87).

As CBK interventions had been more selective, the effects of central bank policy were not as damaging as in many other African countries; yet macroeconomic instability weakened

the banking sector and the real economy. As Kenya's inflation was relatively modest until the mid-1980s, real interest rates were sufficiently high to promote saving and lending despite interest rate controls (Brownbridge 1998b, 83). As a result, the financial system expanded between independence and the mid-1990s in terms of diversity, liquidity and credit to the private sector as a share of GDP. However, while the foreign-owned banks remained relatively healthy, locally owned private banks experienced two major episodes of financial fragility: one between 1984 and 1986, the other in the early 1990s. Mismanagement and fraud, and particularly insider lending to politically connected individuals, were the primary causes of the banking distress (Brownbridge 1998b, 89-91; Daumont et al. 2004, 34-35). Growing macroeconomic instability, the loss of monetary control in 1992/93 and deficiencies in bank regulation and supervision explain the banking crises. However, the weakness of local banks and the increase in government borrowing to fund rising budget deficits did not crowd out private sector borrowing completely, given the considerable size of the domestic financial system and the access to foreign capital that larger, established firms enjoyed (Brownbridge 1998b, 84).

Although the fiscal crisis, balance of payment problems and banking sector distress made it increasingly difficult to sustain transformative policies, reforms in financial regulation stagnated during the 1980s and 1990s. To improve the balance between the central bank's stabilising and transformative roles, the government sought to reform regulation in three major areas: first, the conduct of monetary policy to reduce budget deficits and government reliance on domestic bank borrowing; second, the lifting of allocative controls; third, the strengthening of prudential regulation and supervision. Yet, on the whole, the reforms had only limited success. For instance, bank regulation and supervision were not effective in Kenya until 1993: although the CBK strengthened prudential legislation and supervisory capacity between 1984 and 1989, political interference in the monitoring and enforcement of regulation limited the effectiveness of the reforms. As the CBK's stabilising role had remained weak, Kenya experienced a major banking crisis in 1993, which finally led to more effective prudential regulation (Brownbridge 1998b, 96-97). The reform process was difficult, because the regulatory status quo had the support of several stakeholders: the financially distressed local banking sector wanted to leave regulation as it was, since it relied on the central bank to provide it with liquidity support and sought to retain its business models and management methods. The revenue-needy government had a preference for the regulatory status quo because it relied on the domestic banking system, including the central bank, to provide it with funds for the state apparatus and election campaigns, and to reward political supporters (Isaksson 2001, 503-504; Brownbridge 1998b, 99).

In the past decade, Kenya has undergone political and economic regime change. When Mwai Kibaki won the presidential election against Daniel Arap Moi in December 2002, the new government inherited a weak economy and financial system. Supported by donors, the Kenyan government set out a programme of economic reform, the Economic Recovery Strategy for Wealth and Employment Creation for 2003-2007. The immediate objective was to improve the macroeconomic environment, primarily through a reduction in the government's domestic borrowing. In the ensuing years, the economy experienced a sustained recovery, and budget performance has improved remarkably as a result of an increase in aid and, foremost, tax revenue and the dismissal of excess public sector workers.

The new government has faced the challenge of having to satisfy constituencies with diverging preferences with respect to the CBK's role. On the one hand, the government's immediate political and economic concern has been to secure credibility in the eyes of foreign investors, creditors and donors, who would prefer a central bank that focused on stabilisation. On the other hand, the government has had to strengthen its domestic political and economic power base. Because of the diversity of the domestic private sector, its preferences with respect to central bank regulation are not uniform. The large, established banks, which have been financially sound throughout the past decade, have a preference for a central bank that concentrates its activities on stabilisation. Large and medium-sized enterprises also tend to prefer a central bank that focuses on stabilisation, because they have access to a wide range of financial services. In contrast, the smaller, local banks and firms, particularly agricultural producers, form a strong constituency for a central bank that plays a transformative role, especially by means of enabling regulation that provides incentives to improve the intermediation of financial resources into the real economy. Access to external financial resources is still limited for micro and small enterprises and for the agricultural sector, which accounts for about a quarter of Kenya's GDP (African Economic Outlook 2011b). These groups constitute a powerful constituency for reform in Kenya, because they form the backbone of the economy and the government relies on private sector growth for the expansion of its tax base. Smaller, local banks also constitute a powerful constituency for reforms that seek to promote both development and stabilisation. These banks benefit from enabling regulation in that, in an environment where large banks already serve prime borrowers, they are forced to reach out to previously unserved segments, since the newly elected Kibaki government reduced domestic borrowing and so that t-bill rates fell. In interviews public officials pointed out that they are trying to support the efforts being made by small banks to increase outreach for two major reasons: first, greater outreach helps to reduce the informality of business[5] and tax evasion by small-scale, but prosperous enterprises; second, these efforts encourage firms to grow and so further enlarge the tax base and promote economic development. To satisfy all the major constituencies in Kenya, the government has developed its financial sector policy around three major objectives: expanding access, increasing efficiency and improving stability (Arora / Ferrand 2007).

As a result, the reforms of financial regulation of the past decade have sought to promote both development and stabilisation. The CBK has become a model of a regulatory body that seeks to promote financial deepening and inclusion. Examples of recent reforms include the licensing of credit reference bureaus and, in 2010, the approval of agent banking, which allows banks to engage such third parties as small shops, petrol stations and other retail outlets to provide certain banking services. Vision 2030, Kenya's long-term national development plan, outlines the goal of building an inclusive financial system and determines the CBK's overall policy thrust (Ndung'u 2010). In general, the CBK has avoided direct interventions in the banking sector and tries to use moral suasion or to improve incentives for private sector-led financial inclusion. For example, the CBK has reduced the

5 The informal sector in Kenya is large, accounting for about 18 per cent of GDP (African Economic Outlook 2011a).

policy rates several times since 2007 to incentivise banks to lower interest rates, but has not given in to the consistent public pressure for interest rate caps, even when banks failed to respond with lower lending rates. The CBK has also earned a good reputation for banking supervision and regulation. In particular, its risk-based approach to mobile banking has become a model, since the CBK did not rush to regulate telecom providers developing banking services before the model had been tested (Alliance for Financial Inclusion 2010). Thus, while the cases of Nigeria and Uganda highlight the tension between a stabilising and a transformative role, the Kenyan case more generally suggests that there are huge benefits to be gained by economies whose central banks strike a balance between safeguarding financial stability and actively promoting the development of a financial system that serves the real economy.

4 Challenging reformers: the power of groups with an interest in the status quo

Although there are strong arguments for balancing the transformative and stabilising roles of central banks in financial regulation, African countries have had difficulty striking this balance. Many central banks across the continent have strengthened financial systems significantly over the past decade, and today most African banking systems are stable, well-capitalised and liquid. However, the development of the financial sector continues to present some major challenges. In particular, financial systems do not yet adequately perform their main function of mobilising long-term, patient capital and allocating it to the most dynamic and productive sectors, firms and individuals in the real economy. There seems to be a consensus that it is time for regulators to be as successful in the areas of financial deepening and inclusion as they have been in achieving financial stability (Kasekende 2010b; Kasekende 2010a; Beck et al. 2011).

The historical narratives illustrate the difficulty of striking a balance between the stabilising and transformative roles of central banks in financial regulation. Nigeria's and Kenya's experience in the 1980s and 1990s demonstrates how the continued financial weakness of private banks, the revenue needs of the government and the need to increase the intermediation of financial resources to raise investment levels boosted the preferences for a transformative central bank, despite the rising cost of maintaining this regulatory regime. On the contrary, Uganda's recent experience reveals the challenge of strengthening the central bank's transformative function in a situation where banks are operating very profitably by serving prime borrowers and the government is not dependent on domestic bank finance or private sector taxes. These historical case studies reveal an element of path dependence in regulatory reform and the difficulties encountered in deviating from historical paths.

Why is it so difficult to change the roles central banks play? Understanding the determinants of central banks' roles is essential if a change in their policy is to be promoted and a better balance struck between their stabilising and transformative roles. Most of the literature on financial regulation in developing countries is technical and points to the lack of technical capacity in reform-implementing organisations to explain difficulties in regulatory reform. While the lack of technical knowledge poses a major challenge to effective

reform, this paper suggests a more political approach to explain those difficulties, since both the historical narratives and the lessons learned from financial reform programmes in other developing countries (Brownbridge et al. 1998; Boone 2005; Haggard / Lee 1993; Rodrik 2008) identify the role of politics as another, less well understood key determinant of reform success. In particular, the historical narratives illustrate how powerful interests in the public and private sectors are able both to frustrate and to promote regulatory change. Whether particular interest groups seek to frustrate reform and maintain the status quo at the expense of wider society or whether they act as agents for change seems to depend on their financial needs. The purpose of this section is to describe in greater detail how financial needs influence the preference for a particular central bank role, and under what conditions interest groups can pose a challenge to reforms that seek to improve the balance between the stabilising and transformative roles of central banks in financial regulation.

4.1 Financial needs and central bank behaviour

The historical narratives of Nigeria, Uganda and Kenya illustrate how the financial needs of powerful groups, especially of the government and the banking sector, have shaped central bank policy trajectories. These three country cases suggest that two factors are particularly important in shaping the financial needs of different groups of actors and, as a consequence, the roles of central banks in financial regulation: first, the level of development of private financial markets, and second, the sources of public finance. The proposition that the combination of financial market development and sources of public finance shape central bank roles follows the logic of political economy models and organisational theories of finance. This work argues that the nature of state institutions is shaped by the government's fiscal base and by the relationship between the public and private sectors (Moore / Schmitz 2008; Bates / Lien 1985; Pfeffer / Salancik 1978; Maxfield 1991).

The Level of Financial Market Development and Central Bank Behaviour

The level of private financial market development determines the opportunities that interest groups in the public sector with the power to influence central bank behaviour have to meet their financial needs. Governments, which are in a key position to determine central bank policy, lack an important source of finance where the domestic financial sector is weakly developed in terms of size, efficiency and maturity structure and where banks are not financially sound. In this situation, governments whose financial needs exceed revenues have a strong interest in pushing for a central bank that lends money to finance government deficits, promotes the development of financial markets and adopts regulation that promotes the allocation of capital to parastatal enterprises, economic development projects and the private sector, whose growth will also increase the tax base. In other words, when the government's financial needs exceed revenues and are beyond what private financial markets offer, it typically wants a central bank that is not inflation-averse (Cukierman 1992, 450) and focuses less on its stabilising role and more on its transformative role (Maxfield 1994).

The financial needs of interest groups in the private sector may also shape central bank policy. In general, governments may have two reasons to take into account the interests of private investors in the policy-making process: first, they depend on the inflow of financial resources to perform their functions, and private investors providing tax income, party donations or, if they are banks, credit are often the primary source of funds. Second, politicians need private investors to invest in their own jurisdictions in order to maintain a minimum level of economic prosperity that assures the government of popular acceptance and increases its chances of staying in power (Bates / Lien 1985; Winters 1996). Compared to producers, banks tend to exert a particularly powerful influence on policy-making because of their ability to withhold much needed financial resources from the government and because they influence macroeconomic performance more generally by channelling resources to the real economy (Thurow 1989; Zysman 1983; Maxfield 1990).

The central bank policy that private sector interest groups, prefer depends on their financial needs. Private investors in productive sectors tend to form an interest group opposed to a conservative, stabilising central bank where financial markets are weakly developed and where they themselves lack adequate access to investment finance. In contrast, where the financial sector is well developed and willing to meet their financial needs, producers are less reliant on a transformative central bank. Similarly, banks tend to form an interest group opposed to a central bank that emphasises its stabilising and neglects its transformative role where the banking sector is weakly developed in terms of size, efficiency and liquidity and not financially sound. In such a situation, banks are likely to form a constituency that supports a transformative central bank, providing recourse to central bank overdraft facilities or adopting enabling regulation. In contrast, where the banking sector is well developed and financially sound, banks are less reliant on a transformative central bank. Such banks are likely to form a strong constituency for a stabilising central bank because they fear the cost of inflation due to loose monetary policy, pressure to lend funds based on political criteria or unfair competition from banks that receive public support.

Sources of public finance and central bank behaviour

The level of domestic financial sector development alone cannot explain government preferences for particular central bank roles: sources of public finance are also important determinants. Although financial markets have remained weakly developed in terms of size and inclusiveness in both Nigeria and Uganda, to take two examples from the historical narratives, government preferences as regards the role played by central banks in financial regulation differ: historically, the Nigerian government has shown a preference for a transformative central bank, whereas the Ugandan government has, for almost two decades, preferred a stabilising central bank. This suggests that the level of development of the domestic financial sector explains only part of the story. There is empirical evidence that public policy is also determined by the nature of major sources of public finance, such as private sector taxes, international aid and natural resource exports, the last two sources being particularly important in many African countries (Winters 1994; Bräutigam et al. 2008; Moore 2004). The sources of public finance matter for policy-making because the suppliers of financial resources may attach conditions to their use (Winters 1994, 447). This implies that government discretion over the end use of funds varies with their

sources. For instance, there are indications that states dependent on taxes as a major source of government revenue (as opposed to such other sources as aid or natural resource rents) are more likely to bargain with their citizens over what goods, policies and services (e.g. regulation to promote financial development) the state provides in exchange for tax payments (Bräutigam et al. 2008). In those countries, policies are more likely to reflect taxpayers' preferences for particular economic policies or to be oriented towards widening the tax base because of the lack of alternative sources of public revenue.

In contrast, where countries depend on aid inflows as a source of public finance, the state's need to bargain over policies with citizens as taxpayers seems reduced. Yet government discretion over the end use of aid may still be restrained where donors are in a position to impose conditions on governments in exchange for the funds they provide. Since many donors and international financial institutions (IFIs), such as the World Bank and the International Monetary Fund (IMF), tend to have a preference for a central bank that plays a stabilising role, it is more likely to play that role in countries which are highly dependent on aid to finance public expenditure. Donor preferences, combined with less pressure on the government to widen the tax base and develop deep and inclusive financial markets because it has access to finance from donors and the domestic banking system, may thus partly explain Uganda's historical tendency to favour a stabilising central bank in the context of a weakly developed banking sector.[6]

Government discretion over the end use of natural resource revenues tends to be high. As a result, domestic factors seem to be the main determinants of government preferences regarding central bank roles in natural-resource-dependent economies. In these countries, the government's preference for a particular central bank role depends on the quality of its management of natural resource revenues: in many countries, reliance on natural resources as the sole source of public finance, combined with the volatility of natural resource export revenues, has led to considerable budget deficits, their magnitude due to a tendency to increase public spending at times of high oil revenues, which has been difficult to reverse at times of lower revenues. Where budget deficits are large, governments tend to prefer a central bank that meets the need to finance the state apparatus and development more generally.

Natural-resource-dependent developing countries have two other features that increase the likelihood of their governments preferring a central bank that emphasises its transformative rather than its stabilising role. First, such countries tend to be lacking in economic

6 Learning from global experience, donors and IFIs (particularly the World Bank) have more recently changed their set of ideas on financial regulation in developing countries and increasingly accepted that the role of regulators may go beyond stabilising the financial system and institution-building and include more actively creating an enabling environment for financial sector development (De la Torre et al. 2007; Beck et al. 2009). In Uganda the new set of ideas on the role of regulators in the international community, combined with the influence of donors on macroeconomic and financial policy, may partly explain the BoU's recent move to more active promotion of the development of a banking system that better meets the needs of the real economy. However, if this conjecture is to be confirmed, more systematic research needs to conducted into the role of various donors and IFIs in shaping central bank policy in different types of countries with varying levels of aid-dependence and domestic political competition.

diversification. As this makes them vulnerable to negative commodity price shocks, their governments are likely to push for a transformative central bank that promotes diversification by improving the channelling of financial resources to the non-oil sectors of the real economy. The case of Nigeria and its FSS 2020 Strategy demonstrates these dynamics. Second, many natural-resource-dependent economies are rentier states. Where natural resource revenues are abundant and local business is weakly developed, access to government funds and protectionist policies tend to constitute the only, or the easiest, route to wealth (Winters 1996; Moore / Schmitz 2008, 40-41; Karl 1997; Utomi et al. 2007). As political supporters expect governments to reward them by sharing natural resource rents or at least implementing preferential policies, governments endeavouring to secure power are likely to push for a transformative central bank that promotes financial development and access to finance for their constituencies.

4.2 Financial needs and incentives for regulatory capture

The proposition that the financial needs of powerful interest groups shape central bank roles implies an element of path dependency in central bank policy trajectories. Together with sources of public finance, financial structures create incentives for powerful interest groups to encourage or discourage reforms that seek to improve the balance between the stabilising and transformative roles of central banks in financial regulation. Table 2 gives an overview of these dynamics in Nigeria, Uganda and Kenya in the past decennium.

The historical narratives suggest that the particular role a central bank plays in financial regulation reinforces the nature of financial markets and dependence on particular sources of public finance. Where central banks emphasise their transformative rather than their stabilising role by directing credit to sectors deemed important for development or by constantly bailing out banks, they are likely to increase inflation and financial instability, particularly by reducing the incentives within banks to control credit risks internally (moral hazard). Both high inflation, which erodes interest rate earnings, and moral hazard constrain the development of a sound banking sector, which forms the basis of financial deepening and inclusion. At the same time, a weak banking sector encourages politicians, banks and producers to push central banks towards a more transformative role. This scenario reflects the experience of Nigeria, Uganda, Kenya and many other developing countries during the 1970s and 1980s. Where central banks emphasise their stabilising rather than their transformative role by adopting regulation that far outweighs the risks it is intended to mitigate, they may create an environment that favours the emergence of profitable and resilient banks which target low-risk segments at the higher end of the market; however, such central banks create an environment that may impede the emergence of innovative financial service providers who target more risky segments, such as agriculture. A lack of risk-based, proportionate supervision, indicating room for innovation, may constrain the development of a banking sector that meets the financial needs of the real economy. At the same time, a sound financial sector reinforces the preference of politicians and banks for a conservative central bank. In particular, banks may form a strong constituency for the regulatory status quo if they fear new competitors.

Table 2: Central bank roles in Nigeria, Uganda and Kenya in the past decennium

Country	Banking sector development	Main source of public finance	Challenges to striking a balance between the stabilising and transformative roles	Key features of central banking
Nigeria	Weakly developed in terms of size, diversity, efficiency and intermediation, given level of national income Banks have repeatedly suffered from financial distress	Natural resource exports	Banks have remained reliant on the central bank as provider of capital at times of distress and on the oil, gas telecommunication and public sectors as clients Weakness of banking sector, need for economic diversification and availability of oil rents encourage public sector, banks and productive sectors to promote a transformative role for CBN	Major reforms in the area of stabilisation, but emphasis on transformative role continues: - FSS 2020 highlights financial sector development as a key instrument for economic diversification, with the CBN leading the financial development process - Development Finance Department to run various schemes to improve financial access - Major reforms to promote financial development, e.g. banking sector consolidation through increase in minimum capital requirements to promote banking sector development and competitiveness
Uganda	Weakly developed in terms of size, diversity, efficiency and intermediation Banks have been stable and financially sound	Foreign aid	Dilemma of finding ways of increasing financial intermediation without contravening preferred model of private sector-led financial development Sound banking sector reinforces preference of politicians and banks for a conservative central bank Government reliance on foreign aid to finance state apparatus and economic development policies, reduces incentives to promote a more transformative role for BoU	More recently, efforts to play more transformative role, but emphasis on stabilising role continues: - BoU has strengthened technical capacity to play stabilising role by creating a Financial Stability Unit - Major reforms in prudential regulation and bank supervision such as adoption of unified accounting principles and standard reporting systems; more recently, systematic efforts to promote financial literacy and inclusion, e.g. credit bureau reform
Kenya	Well developed in terms of size, diversity and intermediation compared to other sub-Saharan African countries Banks are stable, financially sound	Taxation	Dilemma of finding innovative ways of further increasing financial intermediation without compromising financial stability Government dependence on international actors with a preference for a stabilising central bank and on domestic private sector with mixed preferences constitutes a challenge and provides incentives for efforts to strike a balance between the stabilising and transformative roles of CBK	Emphasis on financial stability and development: - Vision 2030 outlines goal of building inclusive and stable financial system and determines overall policy thrust of CBK - Major reforms to promote financial development, e.g. credit reference bureau and agent banking regulation, risk-based approach to mobile banking; avoids direct interventions in financial markets, which may threaten financial stability

Source: Author's compilation.

The cases of Nigeria, Uganda and Kenya also demonstrate how the sources of public finance reinforce central bank behaviour. The case of Nigeria shows how oil-dependence has strengthened the preference for a transformative central bank. The case of Uganda indicates the difficulties of fostering the transformative role of a central bank in a context of aid-dependence and a powerful, but exclusive, banking sector. The Kenyan case illustrates how government dependence on both international actors with a preference for a stabilising central bank and on the domestic private sector with mixed preferences regarding central bank policy has led to and reinforced the preference for a central bank that promotes both development and stabilisation. The historical perspective reveals that, once embarked on, it is hard to deviate from a particular path of financial regulation.

Regulatory capture

The powerful interest groups that have shaped specific central bank roles have strong incentives to maintain the regulatory status quo and capture reforms, even at the expense of society as a whole. The experiences of Nigeria, Uganda and Kenya illustrate how capture, defined as "the control of the regulatory process by those whom it is supposed to regulate or by a narrow subset of those affected by regulation" (Mattli / Woods 2009, 13), has shaped central bank policy trajectories and prevented regulatory reform processes from fully attaining their objectives and intended scope.[7] Regulatory capture by banks and other groups has been a major challenge to reforms designed to improve the balance between the stabilising and transformative roles of central banks, not only in the three African case study countries, but globally (Mosley / Singer 2009; Beck et al. 2003). Typical results of such capture are: absence of regulation where capture groups would otherwise incur costs (for example, credit bureau legislation would require banks to pay fees for accessing credit information and to invest in credit reporting capacities); absence of regulation where rules would eliminate privileges of particular groups (for example, regulation that would preclude subsidised credit schemes primarily to the benefit of politically connected groups); regulation that is not enforceable or enforced (for example, increases in prudential requirements without corresponding increases in supervisory capacity).

Empirical evidence suggests that three main factors encourage regulatory capture: a lack of information about regulatory reform processes; the secretive and closed nature of regulating agencies; and the existence of small, powerful groups with a shared interest in maintaining the regulatory status quo (Mattli / Woods 2009).

Groups will be more likely to capture regulatory reforms where detailed information on the deficiencies of the regulatory status quo is absent or biased, since adversely affected constituencies have no motivation to demand change. Regulatory change will be less

7 The rest of this chapter and the next chapter build on the work of Mattli and Woods (2009), who explore the factors that encourage the capture of economic and human rights regulation at global level. The following sections complement their work by examining regulatory capture at national level, focusing on the domestic regulation of finance and on the specific features of developing countries that affect regulatory capture.

likely, for example, where society at large lacks information on the cost to taxpayers of bailing out banks or on the effectiveness of subsidised credit schemes even if there is a public consensus that current regulation is deficient. Biased information, such as a study produced by the banking sector on the economic cost of stricter prudential regulation, will also reduce the motivation of groups affected by poor regulation to demand change. Similarly, groups will be more likely to capture regulatory reforms where central banks are closed and secretive institutions. The lack of transparency of regulators and regulatory processes reduces the information available on the cost and benefits of regulatory change. Moreover, where the central bank is not transparent about the groups involved in or consulted on regulatory reform, outsiders have difficulty establishing how far interest groups have opportunities for capture. Finally, capture is more likely to occur where interest groups are small and powerful and have a set of shared ideas on the advantages of maintaining the regulatory status quo: small size helps interest groups to overcome collective action problems. If they are key players in concentrated markets (like banks with the largest market share in a typical African country), they tend to carry substantial economic and political weight. Power based on financial resources helps them to reward supporters outside the group or, if they are private investors, to threaten government with the reallocation of business elsewhere. Power based on technical expertise helps such groups to assess the cost and benefits of regulatory change and to develop informed strategies to frustrate reforms. A set of shared ideas helps interest groups to rationalise and justify action.

While banking crises and public outrage tend to lead to the formation of alliances to put pressure on those who have captured regulation, once the damage has been done, it is usually difficult to reverse. To reduce the risks and cost of regulatory capture, it is essential to influence the conditions which entrench capture. The next section recommends some ways in which donors, as facilitators of reform processes in Africa, can mitigate the risk of the capture of reforms that seek to improve the balance between the stabilising and transformative roles of central banks.

5 Supporting reforms of financial regulation in contexts of capture

To make donor support for the reform of financial regulation more effective, it is essential to address the challenge of regulatory capture in four key areas: the availability of information; the transparency and openness of central banks; the engagement in the reform process of concentrated groups with a stake in better regulation; and the use of political economy analysis in programme design. Measures in the first three areas help to address regulatory capture directly by changing conditions that encourage regulatory capture. Measures in the last area, the use of political economy analysis, help to address political capture indirectly and imply a more general change in the ways donors work and manage political risks. Working in all four areas helps to ensure that concentrated groups defending the status quo do not succeed in distorting or hijacking the process of regulatory change.

5.1 Making information available

Addressing the challenge of regulatory capture requires donors to motivate public demand for change by improving the quality and availability of public information on the cost and benefits of regulatory reform. Information that reveals the cost of capture to society may generate a demand from the wider public for remedial regulation. The greater the scale and scope of the externality, the broader and more insistent will be the demand for regulatory change. However, high information costs discourage many from assessing the social damage done by capture. Therefore, usually only a small circle of experts know how much poor regulatory regimes cost. In contrast, the general public, who are also affected by poor prudential or enabling regulation, do not have precise or independent knowledge of these costs. More accessible and timely information is thus key to the motivation of a large and sustained group to act for change. In Nigeria, for example, the CBN strengthened prudential regulation in 2009/2010, when the level of fraud within banks and the cost of bailing them out became public and was widely debated.

Donors have begun to put more effort into providing the public and the financial sector with high-quality information and evidence-based policy advice. Carrying out or commissioning research and ensuring the timely sharing of findings with regulators, public agencies and financial service providers has become one of the core activities undertaken by donors. In Kenya, for instance, a number of development partners have set up a trust, the Financial Sector Deepening (FSD) Programme, one of whose main objectives is to provide policy advice on regulatory reform based on financial market analysis. The trust has been quite successful in raising awareness and making information available about issues on the regulatory reform agenda, such as financial consumer protection and credit bureau development. In Nigeria, the UK's Department for International Development (DFID) and the Bill & Melinda Gates Foundation have set up the organisation Enhancing Financial Innovation and Access (EFInA), which disseminates information and identifies regulatory obstacles with a view to encouraging reform. In interviews in Nigeria, Uganda and Kenya both central bank officials and groups representing reform-minded constituencies, such as consumer protection organisations, stressed the value of "on-the-ground information" and micro data. Recent GIZ research on the organisation and viability of microfinance banks in Nigeria and the EFInA and FSD financial access surveys[8] are just two examples of this kind of information. Donors have also launched activities to improve the quality of public information. In Nigeria, for instance, the GIZ cooperates with the radio station Deutsche Welle in offering training in financial reporting.

As donors have taken many important steps to improve the information available to the public, they should build on existing activities: to minimise capture, they should widen the focus by targeting and working with a wider range of actors and by evaluating the impacts of existing regulation. Thus far, much of the information that donors have assembled or generated is accessible to the public, but the main targets are financial service providers

8 Both the EFInA and the FSD financial access survey rely on the Finscope consumer survey methodology, which has been widely used to measure financial access in Africa. It was developed by FinMark Trust, a non-profit, independent trust, mainly funded by DFID.

and regulators. Targeting the wider public or interest groups outside the government and the financial sector will help to minimise capture. There may also be additional benefits of partnering with a wider range of institutions that carry out research within and outside the public sector. Such institutions may be statistical services and central bank research departments, but they also include academic bodies. In many cases regulators have set up schemes and passed laws aimed at fostering financial system development or stability, without keeping the public informed of their impacts. Donors should motivate public demand for regulatory change by evaluating such initiatives and publishing the results.

5.2 Promoting central bank transparency and openness

Mitigating the risk of regulatory capture requires donors to promote the transparency of regulatory reform processes by enhancing central bank transparency and openness. The more transparent and open the regulatory reform process is, the fewer will be the opportunities for capture and the more likely the central bank will be accountable to societal demands. Transparency and openness in the reform process reduce opportunities for capture because the public are more readily able to determine whether interest groups are interfering in the reform process. In contrast, secretiveness and exclusiveness of reform processes may leave central banks open to being bullied by interest groups without the public being aware. Transparency and openness in the regulatory process are also likely to increase central bank accountability to society at large because the latter can effectively demand a response to its concerns only where it is able to provide evidence of the cost and benefits of regulatory reform.

Although there is room for improvement, central banks have enhanced transparency and openness significantly over the past decade. African regulators have made a number of changes to the ways they work and present themselves publicly. They have enhanced transparency and openness by maintaining internet websites, on which they make abundant material, particularly working papers, statistical datasets and new regulation, available to the public. Central banks have also increased private sector consultation at various stages of reform processes. In Nigeria, Uganda and Kenya, for example, central banks meet the commercial banking sector regularly and frequently. While the central banks tend to set the agendas for these meetings, banking officials emphasised in interviews that the meetings were essential if reforms were to be influenced at the design stage. In Uganda, for instance, credit bureau regulation was designed in close consultation with the commercial banking sector.

While central bank transparency and openness have improved, broadening the private sector consultation process and improving transparency at all stages of the reform process, from rule-making to enforcement, will further reduce the risk of regulatory capture. Consultations between central banks and the commercial banking sector have become well institutionalised in the process of regulatory change. In contrast, consultations between central banks and business member organisations (BMOs) in the productive sector, representing the consumers of financial services, have remained deficient in many ways. In particular, communication with BMOs in the productive sector is much less frequent and

regular. Nor are smaller businesses, the backbone of many African economies, effectively represented in consultations: as central banks tend to invite mainly large umbrella organisations, which are dominated by large enterprises, the interests of small enterprises receive less attention. Establishing channels that make central banks more open to smaller businesses and public groups will help to mitigate risks of regulatory capture by large banks and other powerful interests. Oversight offices that offer individuals and groups a forum to provide feedback on or challenge central bank policy may be a promising route. More generally, donors should ensure that there is more openness with respect not only to rule-making but also to the implementation and enforcement of rules. Central banks tend to be secretive organisations by nature, but there are ways of holding them accountable for rule implementation and enforcement. Publishing the names of beneficiaries of particular central bank schemes and evaluations of central bank regulatory activities are just two examples of ways of reducing a central bank's vulnerability to capture.

5.3 Strengthening the engagement of interest groups with a stake in change

Addressing the challenge of regulatory capture requires donors to strengthen the engagement of concentrated interest groups with a stake in change in the reform process because the wider public lack the means of effectively demanding such change. The public are at a distinct disadvantage relative to concentrated groups with a stake in the regulatory status quo. This disadvantage arises from three major factors. First, the public's resources tend to be more modest (particularly when compared to banks' resources). Second, public knowledge of regulatory issues, which are often technical, is limited. Third, there are too many members of the public for collective action problems to be easily overcome. For these reasons, the public are unlikely to be effective in demanding regulatory change on their own. They will need the support of concentrated interest groups that have a stake in regulatory change and the resources, power and expertise necessary to challenge the regulatory status quo. To support regulatory change, these groups may seek to sustain public interest by providing information at critical junctures of the regulatory process. Alternatively, they may seek to empower poorly resourced groups adversely affected by the regulatory status quo by offering technical expertise or finance during the process of change. Subsets of two types of groups may have the interest and the power to support the wider public in demanding change and should be strengthened and involved in the reform debate: public officials and private corporations.

Public officials, including regulators, have long been at the core of discussions on regulatory reform. While some public officials are subject to capture, others have an interest in regulatory change and become powerful supporters of the wider public and use their resources, expertise and authority to shape regulation. Whether particular public officials support change depends to a significant degree on their personal preferences, constraints and incentives. However, public officials also tend to be more susceptible to the idea of change where they are embedded in a network of policy-makers who share a set of ideas favourable to regulatory change, ideas that provide a basis for the formation of coalitions pressing for regulatory change (Mattli / Woods 2009, 37). Regulators interviewed in Kenya and Uganda, for instance, emphasised the importance of exchanging knowledge

with reform-minded public officials in neighbouring countries. Knowledge exchange across borders helps to encourage regulatory change because it facilitates learning about and the development of new sets of ideas on the framing and justification of reforms. Peer-learning among members of the East African Community may have been an important motive for the greater emphasis recently placed by the BoU on financial system development issues and financial literacy. In 2010, for instance, the Kenya's Central Bank Governor, who has put considerable effort into promoting financial inclusion in Kenya and other developing countries, delivered a speech on financial inclusion at the BoU that sparked a discussion within both the BoU and the wider public about the role of regulators in promoting financial development and intermediation (Juuko 2011; Bank of Uganda 2010).

While private corporations have long been neglected in discussions on regulatory reform, they can form powerful reform coalitions. Among both providers and consumers of financial services there are groups with an interest in regulatory change who can effectively support the wider public, because they have both the resources and the technical expertise to shake up financial regulation. Both newcomers and established banks among financial service providers may be powerful supporters of regulatory change. Newcomers entering the sector after regulation has been captured will oppose the regulatory status quo if established banks enjoy privileges under the current regulatory regime. Established banks will be powerful supporters of regulatory change if they have suffered from poor regulation and regard a new regulatory regime as a means of restoring credibility and trust. Among consumers of financial services, established firms tend to be more concentrated than the general public and may become powerful supporters of regulatory change if they rely on bank finance and have suffered as a result of financial instability and/or the provision of a limited range of financial services.

Donors have come to realise the importance of systematically strengthening groups of concentrated actors in the public and financial sectors and encouraging them to address regulatory capture. It has become a core activity of donors to provide technical and financial support for public officials at federal level and for financial service providers with a view to improving their engagement in regulatory change. Over the past decade, donors have sought to involve concentrated interest groups with a stake in reform in the debate on regulatory reform by providing fora for dialogue and the exchange of ideas. The GIZ, for instance, administers the Alliance for Financial Inclusion (AFI), a knowledge network of central banks and other financial regulatory bodies in developing countries. AFI provides a platform for exchanges on reform strategies and allows reform-minded actors to form coalitions centred on a set of shared ideas. AFI also identifies and promotes "policy champions", outstanding policy-makers who have substantially contributed to increasing access to financial services for the unbanked population. In particular, AFI facilitates the participation of policy champions in global and regional events, where they can share their knowledge and experience, and equips them with tools for presenting their regulatory experiences (Alliance for Financial Inclusion 2009). Another outstanding example of an effort to engage actors with a stake in reform in the debate on regulatory reform is the Partnership for Making Finance Work for Africa, which was founded by a disparate group of donors. This initiative supports the development of African financial sectors by providing a platform for African governments, development partners and the private sector to coor-

dinate financial sector development policies across the continent. Donors have also increasingly targeted microfinance institutions and commercial banks that seek to reach out to unserved market segments. In Kenya, for instance, DFID has given considerable support to Equity Bank, which targets the lower end of the market and has now the largest client base of all banks in Kenya (FSD Kenya 2010, 9). In alliance with other banks targeting the same segment, Equity Bank has become a powerful supporter of regulatory change to create a more enabling environment and to foster macroeconomic stability.

Donors should build on existing activities to strengthen the engagement of concentrated interest groups with a stake in change and target a broader range of groups that have an interest in challenging the regulatory status quo and have the necessary resources. Thus far, donor activities have focused on involving reform-minded public officials at federal level and financial service providers in the debate on regulatory reform. Targeting further actors, such as public officials at lower tiers of government and private corporations, will help to address the challenge of capture more effectively. State governments offer an entry point for collaboration with public officials at local level. In a federal state like Nigeria they account for the largest proportion of public expenditure and probably for the worst abuses of public office (Utomi et al. 2007, 15). Supporting reform-minded public officials at state level will help to make regulatory reforms in contexts of capture more effective. BMOs offer an entry point for collaboration with private corporations that represent the interests of firms that would benefit from regulatory change. Donors should leverage their resources to help build the capacity of BMOs in policy analysis and advocacy of regulatory change. In this context, it is important to acknowledge that promoting transparency and accountability through BMOs is not a risk-free strategy, since some BMOs may be linked to those concentrated interest groups that prefer the regulatory status quo. Yet key lessons learnt point to the need to work with a wide range of partners in reform programmes, including BMOs, with a view to both broadening the support base for reforms and maintaining flexibility in case one group of partners is no longer willing or able to support the reform process.

5.4 Using political economy analysis in programme design

Addressing the risk of regulatory capture in reform programmes requires donors to use political economy analysis systematically in programme design. While regulatory reform programmes have become successful and sustainable operations in many African countries, they have encountered political obstacles to the attainment of their objectives and intended scope in the majority of countries. Donors have therefore come to the conclusion that technically sound knowledge of financial regulation and development is not enough for programmes to succeed. Interviewees in the domestic private and public sectors in Nigeria, Uganda and Kenya were unanimous in emphasising the need for donors to improve their understanding of the political context and of the constraints faced by domestic actors in processes of regulatory change. Aid officials also referred to political risks and regulatory capture as key challenges to effective support for reform processes. Political economy analysis is a key instrument for improving the effectiveness of regulatory reform programmes, because it allows donors to identify political risks and reform-minded actors. In

particular, political economy analysis helps donors to understand and predict policy decisions of central banks and other public institutions by revealing the links between political and economic processes and their social, cultural and historical context.

Donors have realised that using political economy analysis to inform the design of financial reform programmes can mitigate political risks; yet systematic evidence on the political economy of financial regulation in African countries has still to be gathered. Donors have conducted political economy studies at country level, and for some donors political economy analysis has had far-reaching implications for policy, programming and management. DFID's Nigeria office, for instance, has adopted political economy analysis as a routine part of its working methods (DFID 2009, 15). To a more limited extent, donors have also conducted political economy studies at sectoral level, but have not yet published studies on the political economy of financial reform in specific African countries. Instead, most donors assess political risks at the beginning of a financial reform programme cycle, but the assessment is not based on a systematic analysis of political risks and opportunities for the reform programme. Political risk management is based less on formal analysis than on the tacit knowledge of senior staff in the country offices and on "learning by doing".

If political economy analysis is to be used to maximise the effectiveness of reform programmes, donors must adapt their work routines and management of political challenges accordingly. Using political economy analysis will help financial reform programmes to achieve their full scope and objectives and implies that donors must change their working methods in two major respects: first, if political economy analysis and monitoring capacities are to be strengthened, donors must place greater emphasis on in-depth country knowledge, rely more on in-country expertise and avoid the rapid turnover of country office staff, since that prevents them from developing the necessary country knowledge. Second, if the roles of relevant stakeholders in the reform process are to be analysed from a political economy perspective, donors must become more aware of their own role as political actors. Donors should explore and address the incentives to which they themselves are exposed and which may prevent the risks of capture from being mitigated in the longer term. Examples of such incentives are the disbursement of more funds, the fulfilment of expectations of quick wins, and the failure to withdraw support from prestigious government partners if they have not demonstrated adequate willingness to support change. More generally, donors should use a political economy perspective to reflect more deeply on how they can best exercise influence in contexts where capture may pose a challenge and where dependence on aid is limited or decreasing.

6 Conclusion

There are strong arguments for countries to seek to strike a balance between the stabilising and transformative roles of their central banks in financial regulation. Yet African countries have had difficulty implementing reforms that strike such a balance, because interest groups with the power to shape central bank behaviour tend to prefer the regulatory status quo and have incentives to capture regulatory reform processes.

Asked for their views on how to make the support of such reforms more effective in contexts of capture, some aid officials suggested during the field research for this paper the creation of “a world of technical details” through the drafting of more intricate technical reform plans under the leadership of foreign experts, who are more insulated from the domestic political process.

This paper suggests an approach that is markedly different from this. On the basis of empirical evidence collected in Nigeria, Uganda and Kenya, it argues that donors should systematically address the challenges arising from regulatory capture by strengthening domestic countervailing actors and coalitions and using insights from political economy analysis. “Creating a world of technical details” in the reform process is unlikely to work in contexts where the roles played by the central bank are determined not only by the interests of society at large, but also by powerful interest groups in the public and private sectors. Experience at country level suggests that the interest groups which have shaped specific central bank roles over an extended period have strong incentives to maintain the regulatory status quo, even if this is at the expense of society as a whole. Supporting public officials and private corporations with a stake in regulatory reform and engaging them in reform debates may therefore be a promising route for donors to follow, not least because these groups often have greater legitimacy and carry more political weight in the domestic arena.

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