The Financial Sector in Burundi

An Investigation of its Efficiency in Resource Mobilization and Allocation

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Abstract

This study investigates the performance of the financial system in Burundi in the mobilization and allocation of resources. The study is motivated by the critical role played by finance in stimulating investment and growth. While the study does not presume that financial intermediation is the most binding constraint to investment and growth in Burundi, it takes the view that access to finance is an important constraint to investment, and that unlocking this constraint would alleviate other bottlenecks and allow the country to fully exploit its growth potential. The methodology used in this study borrows from various approaches, notably: (1) industrial organization in examining the structure of the banking sector, the behavior and profitability of financial intermediaries as firms; (2) macroeconomic analysis with emphasis on the implications of the overall economic performance and the macroeconomic policy framework for the performance of the financial sector; and (3) political economy analysis highlighting the role of political governance and ownership of financial institutions as potential sources of rent seeking and causes of mismanagement with implications for allocative and distributional efficiency. The analysis highlights key features of the Burundian financial system, including: high level of fragmentation; weak supervision and regulation leading to preventable bank failures; a banking sector facing excess liquidity with severe shortage of long-term stable resources; inefficient allocation of resources relative to social returns and risk. At the same time, the banking sector is highly profitable and its core has survived surprisingly well the worst of economic and political crises of the last decade. The study also highlights key elements of financial sector reforms, as well as important recent developments in the sector, including the increasing penetration of foreign banks as a potential boost to competition and financial innovation. This is likely to be enhanced by the country's integration in the East African Community. Nonetheless, access to finance remains the key challenge, especially for the rural sector as well as the "stranded middle" (middle income households and medium size firms) due to the "missing middle credit market" which cannot be filled by either the banks or the microfinance institutions.

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1. Introduction

The post-independence period in Burundi has been characterized by low and volatile growth, which has made it difficult for the country to achieve national development goals, especially poverty reduction. Several factors account for the sluggish and volatile growth, ranging from physical constraints (e.g., land-locked) that raise the costs of production and trade to political instability (Nkurunziza and Ngaruko 2008). These constraints have prevented an investment-led take off, a key condition to robust long-term growth (Barro 1991; Levine and Renelt 1992). In particular, the country's inability to mobilize sufficient domestic resources, both public and private, constitutes a critical constraint to investment and entrepreneurship. Yet, private investment and enterprise development are important drivers of long-term growth and economic resilience through diversification and expansion of the revenue and growth base. Indeed, consistent with its low growth record, Burundi also lags behind in terms of investment, with gross capital formation significantly below the sub-Saharan African average. This study focuses on one of the fundamental ingredients to igniting an investment-led growth and building a strong private sector, which is an efficient financial system.

In this study efficiency of the financial system is understood strictly as the efficiency by which financial institutions perform their functions of mobilizing and pooling financial resources on the one hand, and allocating these to activities and sectors with the highest returns (individual returns and social returns) on the other hand. On the resource mobilization side, the study investigates whether the financial system is harnessing the country's potential in savings. On the allocation side, the paper examines the performance of financial intermediaries in allocating credit to activities and sectors with the highest rates of economic returns. Specifically the study asks whether finance is channeled adequately to the sectors with the highest returns in terms of growth, employment creation, and poverty reduction. We also examine the temporal allocation of resources between short-term and long-term credit and attempt to explain the revealed preference by banks for short-term credit. By comparing the distribution of resources by sector and by term structure to the risk profile measured by default rates, we are able to construct a risk-efficiency index to assess the efficiency of resource allocation from a risk perspective.

The study pays acknowledges the importance of demand side factors of access to finance. In particular, sluggish growth and the resulting stagnation of incomes in the formal sector are a key constraint to borrowing capacity. A simple simulation exercise shows that the mortgage servicing capacity of a typical middle-class household has deteriorated over the past decade while construction costs have increased substantially. The analysis is quite revealing of the challenges faced by the population in terms of access to finance.

The paper also assesses the impact of efforts undertaken by the government with the support of development partners aimed at improving the efficiency of the financial sector as a means to boost investment and growth. Specifically, the study examines the performance of the financial sector against the benchmark of the stated main objectives of the financial sector reforms initiated at the end of the 1980s. It also discusses the potential impact of the increasing involvement of foreign banks as well as the potential gains from regional integration in terms of improved competition, financial innovation, and increased access to finance.

Recognizing the complexity of the topic under review, the study adopts a multifaceted approach drawing specifically from industrial organization, macroeconomic analysis and political economy. The paper examines the structure of the financial system, the behavior of financial intermediaries as profit maximizing firms, and the implications on financial intermediation. In particular, the paper discusses the sources and implications of the high profitability of banks for the incentives to lend to new activities, including industry, agriculture and the rural sector in general. In addition the paper examines the respective roles of segments of the financial system, namely commercial banks, non-bank financial intermediaries, and microfinance institutions. It discusses the issues of segmentation of the market and the "missing middle market" whereby middle-income households and medium sized firms are left stranded. While banks find lending to this sector too costly, at the same time, microfinance institutions lack the resources to meet the needs of this segment of the private sector.

From a macroeconomic perspective, the analysis discusses the impact of economic performance and shocks to economic activity on financial intermediation. The case of Burundi offers a perfect case for the argument of a two-way relationship between finance on the one hand and investment and growth on the other hand. A key ingredient of this relationship in the case of Burundi is the economic and political shocks to the economy that influenced financial intermediation as well as investment and growth. The political economy analysis allows to highlight the role of political governance and the structure of the polity for the behavior and performance of financial intermediaries. In particular, over the past decades, the country has been ruled by highly centralized and monolithic regimes that used government control over the economy for rent seeking and consolidation of power (Ndikumana 1998, 2005; Nkurunziza and Ngaruko 2000, 2008). In this context, government ownership of banks, the independence and regulatory capacity of the central bank, and the dominance of the public sector in general are all considered as key factors of the performance of the financial system in the mobilization and allocation of resources.

The paper is organized as follows: The next section provides the background and motivation of the paper, reviewing the country's growth record including the recent growth collapse. It describes the structure of the economy, key constraints to investment and growth, and the role of financial intermediation for investment and growth. The section also discusses financial sector reforms, their goals and their outcomes. Section 3 discusses the macroeconomic policy and regulatory environment and their relevance for financial intermediation. It focuses on monetary policy, fiscal policy and banking regulation. These aspects will be used further in the paper in explaining the performance of the financial sector and the failure of financial institutions. Section 4 examines the structure and characteristics of the financial sector, focusing on commercial banks, development financial institutions, and microfinance institutions. Section 5 examines credit allocation and the contribution of banks to economic activity. This leads, in Section 6, to the analysis of the performance of the sector both at the firm level (bank profitability) as well as the sector level. The Section discusses the fragility of financial intermediaries and the risk of bank failure; it attempts to explain past bank failures drawing on various dimensions ranging from ineffective governance of banks, to inadequate supervision and regulation to political interference. Section 7 concludes with a summary of the key findings and points out areas of potentially fruitful investigation.

2. Growth, Investment and Finance in Burundi

This section provides a background to the Burundian economy in order to motivate the focus of the study on the financial sector, positing that inadequate finance is one of the factors of slow growth. The study emphasizes the linkages between finance and investment or enterprise development more generally. The objective is not to demonstrate that finance is the "most binding" constraint to growth,[2] but that inadequate access to low-cost finance, especially long-term financing, is an important impediment to growth, and that alleviating this constraint would unlock other constraints and unleash growth opportunities. In this section, we also briefly review the record of financial liberalization and discuss some factors explaining its limited success.

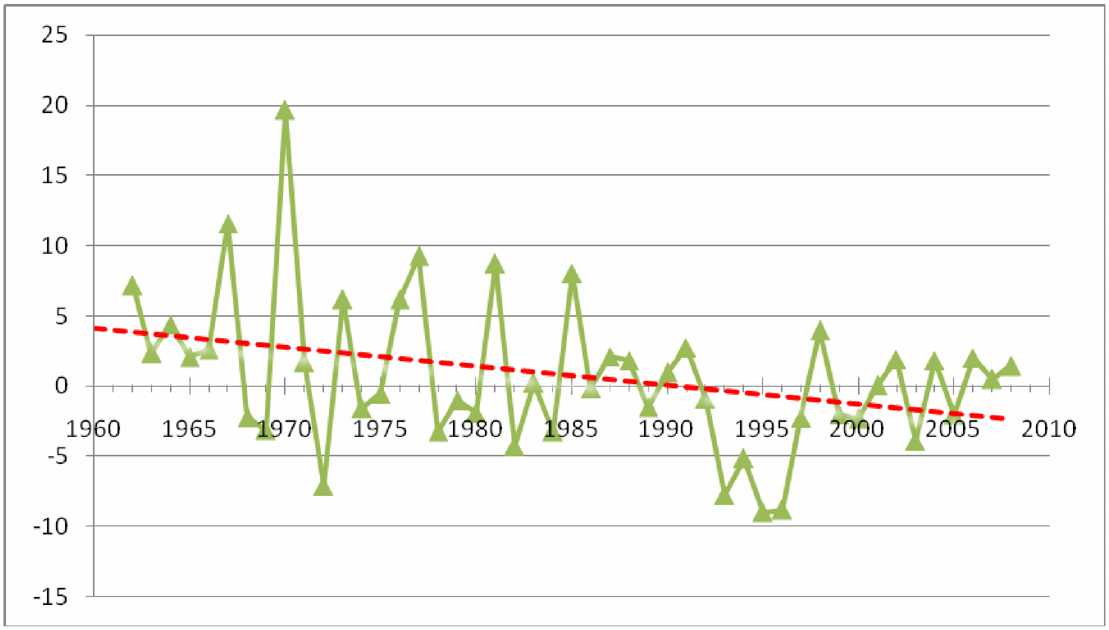
2.1 Growth – historical trend and most recent growth collapse

Long-term record: low and volatile growth

The historical record of the Burundian economy exhibits two key features: slow growth and high volatility of growth (Figure 1). Since independence in 1962, real GDP growth has rarely reached the 6% mark (9 times between 1961 and 2008). With a high population growth rate which oscillates around 3%, this implies low per capita GDP growth rates. Today's per capita GDP ($144 in 2008) is lower than its peak of $237 in 1986. Even before the recent war that erupted in 1993, per capita income was below the 1986 level ($201 in 1991). The slow growth in income has prevented meaningful reduction in poverty. The country faces much higher poverty rates than the average in Africa and in developing countries in general. From 1992 to 2006, the proportion of people below the $1.25/day poverty line declined only slightly from 84% to 81% in Burundi. By comparison, the poverty rate declined from 38% to just under 20% in Kenya, and from 70% to 51% in Uganda during the same period (World Bank 2010).

[2] The "growth diagnostics" methodology consists of a detailed investigation of possible constraints to growth to identify the most binding constraint (Hausmann, Rodrik and Velasco 2004). This is an especially challenging exercise in low-income countries such as Burundi where, in addition to the fact that growth drivers and constraints are typically interconnected, many constraints seem to be severe and can easily be claimed to be the most binding constraints. An application of this approach to Burundi is undertaken in Rodrigo Wagner (2009).

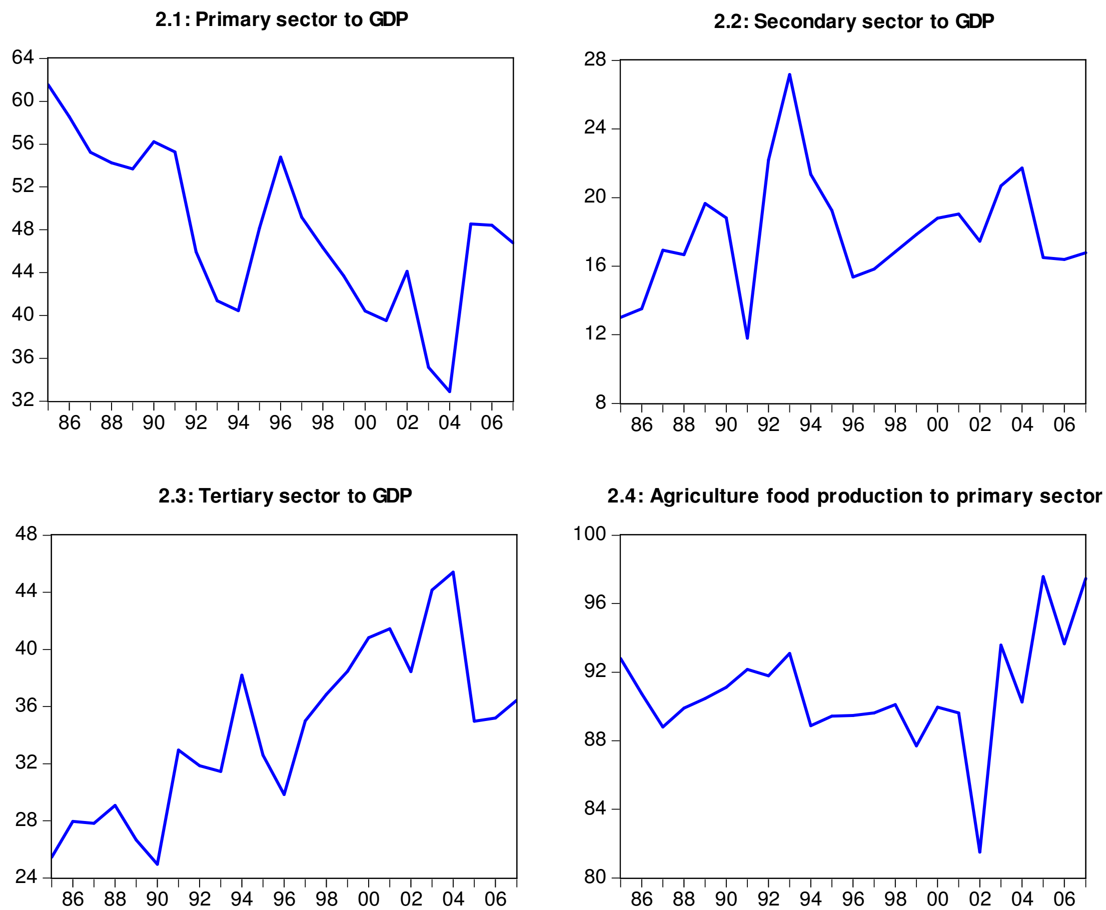
Figure 1: Real GDP growth rate (%)



Source: World Bank, *World Development Indicators*

The constraints to growth in Burundi range from physical constraints, including unfavorable geography, poor infrastructure and high production & transport costs; to policy and institutional constraints. The lack of structural transformation and low productivity are major underlying obstacles to reaching high and sustainable growth rates (see Nkurunziza and Ngaruko, 2008). Indeed, while the share of services in GDP has increased substantially, the Burundian economy is still heavily dependent on the primary sector which is dominated by agriculture (Figure 2). The economy's dependence on rain fed agriculture contributes to the structurally high volatility of growth.

Figure 2: Structure of Burundi's economy



Source: Based on data from the Central Bank of Burundi, Annual reports.

The slow growth in Burundi is attributable to the fact that the country has not exploited its potential to ignite a resource-led growth take-off. The country possesses substantial mineral resources including nickel, cassiterite and columbo-tentalie (coltan), and reasonable amounts of other minerals, notably phosphate and gold, as well as potential for substantial production of ceramics (from kaolinite and feldspar) and cement (from carbonate rocks). Nickel is the largest mineral resource, with about 284 million tons in Musongati, Waga, Nyabikere, and Murera, which represent some of the world's largest nickel deposits in the world (AfDB 2009). It is believed that the actual reserves could be even higher.

These mineral resources have not been exploited due to several factors. First, the country lacks a comprehensive plan, which must include a major scaling up of energy supply. Despite a very dense hydrographic network which could produce 1,200 MW of hydroelectric power corresponding with 6,000 GWh/year of energy supply, electricity consumption in Burundi (20 KWh per capita per year) is among the lowest in the developing world. Only two percent of the population has access to electricity, compared to 16 percent in Sub-Saharan Africa and 41 percent for low income countries. According to the AfDB (2009), the country could achieve a real GDP growth rate of about 7.4 percent over the 2010-2030 period by implementing an infrastructure investment program that would allow, among other things, full exploitation of the nickel mines. Obviously, the key challenge to such program for the country is the ability to mobilize the large sums needed to finance the $4.6 billion investments.

The second major structural constraint to Burundi's ability to achieve high growth rates is its unfavorable geography. The country is landlocked in one of the poorest regions in the world, and its dependence on poor regional infrastructure and logistics networks results in very high production and transportation costs, among other things. It is estimated that transport costs account for 30 percent of import prices and as much as 40 percent of export prices for agricultural products in Burundi (AfDB 2009). Most of Burundi's international trade and transit go through the ports of Dar-es-Salaam and Mombassa, with the latter traditionally taking the lion share.[3] Lack of maintenance of the rail road in Tanzania has progressively shifted freight from the railway to road transport which is more expensive.[4] Thus the weakness of the railroad has exacerbated Burundi's transport problems. As is commonly said, a logistics chain is as strong as its weakest link. In the case of Burundi, the railroad connection to the ports may be this weakest link. Naturally the solution to Burundi's problems in the transport logistics lies beyond the national borders and must involve coordination with the country's neighbors. The East African Community, which is making strides in regional integration among its members (Burundi, Kenya, Rwanda, Tanzania, and Uganda), offers an appropriate context for designing strategies to improve the transport logistics in the region.

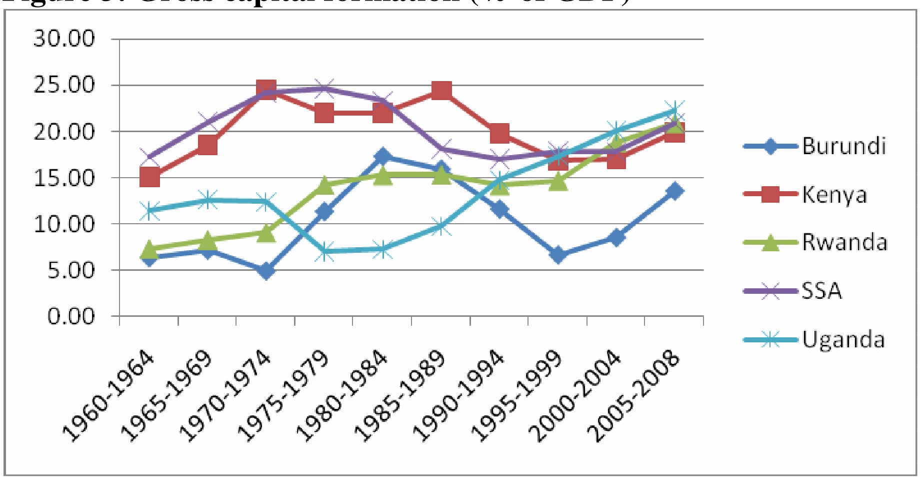
Another factor of low growth in Burundi is the inability to mobilize sufficient domestic financial resources, both public and private. This issue will be explored in more detail in the subsequent sections that deal with the financial system. As a result the country has failed to initiate an investment take-off and, like other low-income countries it is both heavily dependent on aid but still faces large financing gaps. As documented by the empirical literature, a robust and sustained investment performance is a fundamental driver of long-term economic growth (Barro 1991). Gross capital formation in Burundi has remained below 15 percent of GDP for most of Burundi's post-independence era, dropping below 5 percent in 1994-2003 period. Investment declined in the early 1980s, plummeting during the war to a low of 5.9% in 1999. Burundi's investment performance is much below the sub-Saharan average and below its peers in the East African Community (Figure 3). In addition to the inability to mobilize domestic savings, Burundi has also remained much below the radar screen for foreign investors and has failed to

[3] While the port of Dar-es-Salaam caters primarily for the Tanzanian economy, it is the main hub for Burundi's trade and transit. In 2006 about 40 percent of imports and exports that transited through Dar-es-Salaam were from and to Burundi. In the same year, 60 percent of Burundi's transit imports and exports passed through this port, down from 85 percent a decade earlier due to the shift of freight from railway to road transport.
[4] Cargo on the Tanzanian rail road has declined by half from 350,000 tons in 2003 to 174,000 tons in 2006. One of the biggest losers has been the port of Bujumbura where the traffic in 2008 was at 10 percent of capacity and a quarter of the 2000 level.

attract meaningful private capital inflows. It has depended heavily on official aid to finance both public investment and the recurrent government budget.

Despite the high level of aid dependence, the country still faces large financing gaps. Burundi has been receiving about $450 million per year from all sources (AfDB Database). The African Development Bank report on infrastructure in Burundi (AfDB 2009) estimates that an additional 30 percent of that amount would be needed to complement financing from government and the private sector to fill the country's infrastructure deficit. Meeting the country's investment needs will require substantial contribution from the private sector, including the domestic financial system.

Figure 3: Gross capital formation (% of GDP)



Source: WDI

While the above factors have been critical in determining Burundi's long-term growth performance, the country's economy has also been deeply influenced by civil war and extreme political instability. These are legacies of conflicts originating from ethnic and regional antagonisms initiated and nurtured by the political elites. Various approaches have been proposed to explain conflicts in Burundi. These range from the extreme view of conflicts as emanating from alleged age-old animosities between the Hutu and the Tutsi, to balanced and evidence-based political economy analyses emphasizing the role of institutional failure (Ndikumana 1998), distributional conflicts and inequality (Ndikumana 2005, Nkurunziza and Ngaruko 2000, 2005, 2008). Detailed historical accounts of conflicts are provided in Ntibazonkiza (1993) and Lemarchand (1995). These conflicts have undermined long-term economic growth in various ways. First and foremost, the successive monolithic regimes that led the country for most of the post-independence period invested in self-preservation through repression and promotion of private economic interests and failed to devise a consistent long-term development strategy for the country. Thus they failed to rally domestic and external support around a clear national development agenda. At the same time, national resources were managed inefficiently both due to the lack of a clear development vision and due to rent seeking. The financial sector also fell pray to rent seeking, especially undermining private initiative and distorting resource allocation. Secondly, the uncertainty associated with the political regimes discouraged private long-term investment, thus preventing the country from exploiting its growth potential. In this respect, a successful political transition to a democratic system and the establishment of institutionalized power sharing mechanisms are important for the country's future growth prospects.

Growth collapse starting in 1993

Burundi is currently recovering from a decade of civil war that has dealt a heavy blow to the economy, through the disruption of production – especially agriculture –, the decay of infrastructure and deterioration of institutions. The conflict caused a dramatic decline in output, with per capita GDP falling from $183 in 1992 to $85 in 2003. In addition to the collapse of production, economic sanctions imposed by regional leaders as a reaction to a military coup d'état in 1996 further suffocated trade by cutting off the country from global markets.

Even as the country was attempting to recover from the impact of the war, it was hit by the global economic crisis. Real GDP growth dropped from 4.3% in 2008 to 3.9% in 2009; it is expected to reach only 3.6% in 2010 and 4% in 2011 (AfDB, OECD, and UNECA 2010).

The key question is: what factors are preventing the country's speedy recovery from the war? The structural constraints discussed above in the context of long-term growth play an important role in also explaining sluggish post-war recovery. In particular, they explain why the country is unable to initiate an investment take-off that would boost domestic demand and trade. The key factors are the high production costs, shortage of long-term finance, and high investment risk. Indeed, while the country has managed an unprecedented political transition with institutionalized mechanisms for power sharing that serve to alleviate the risks of ethnic antagonisms (Bertelsmann Stiftung, 2009), economic transformation remains elusive. And this lack of economic transformation makes it impossible for the country to reach high and sustained growth. A substantial and sustained increase in investment is key to diversifying the production base, which is essential for the country to reach high and sustained growth rates. Finance constitutes a key ingredient to the investment take-off.

2.2 Investment, saving and finance

The economic literature has substantially documented the potent role of investment for long-term growth. Levine and Renelt (1992) singled out private investment as one of the few robust factors explaining cross-country variations in long-run economic growth. Empirical studies have also identified low investment as one of the factors explaining weak growth performance in African countries (Collier and Gunning, 1999; Khan and Kumar, 1997; Khan and Reinhart 1990; Collins and Bosworth, 2003).[5]

[5] Devarajan, Easterly and Pack (2003) contend that it is not the level of investment but rather the efficiency of investment that is a constraint to growth in Africa. In particular, the composition of investment between public and private investment matters.

Investment and enterprise development are especially critical for increasing not only the level of growth but also economic resilience through diversification and expansion of the growth base, resulting in lower volatility of growth. The empirical literature has identified several determinants of investment and enterprise development, including the rate of return to investment, the cost of finance, the quantity of finance (access), the term structure of finance (long-term vs. short term credit), the investment climate and the regulatory framework, the production costs (infrastructure, etc.), risk and uncertainty (economic and political/institutional uncertainty). Finance has been identified as an important constraint to investment and enterprise development.[6] The objective of this study is not to establish a hierarchy among these factors of investment and enterprise development (as is done in growth diagnostics studies). Most specifically, it is not the objective of the study to argue that finance is the most binding constraint to investment and enterprise development. The study recognizes that the constraints may be both from the finance side as well as the returns to investment side. But unlocking the financing constraint is essential to generating an investment take-off and boost enterprise development. This section also highlights the role of the investment climate with an emphasis on production costs and the regulatory framework.

By most standard measures, Burundi ranks poorly relative to countries with comparable levels of economic development with regard to the quality of the business environment. As may be seen in Table 1, firms in Burundi face a more challenging environment with regard to infrastructure and thus the cost of production, as well as access to finance. In this respect, the move towards deeper regional integration is both an opportunity and a challenge for Burundi in the sense that while integration opens up investment and market opportunities, it also increases competition for Burundian firms.

[6] A sample of studies on the role of finance for firm's growth includes: Beck and Demirguc-Kunt (2006); Sleuwaegen and Goedhuys (2002); Beck, Demirguc-Kunt, Laeven, and Levine (2008); Bigsten, Collier, Dercon, Fafchamps, Gauthier, Gunning, Söderbom, Oduro, Oostendorp, Pattillo, Teal, Zeufack (2000), and Nkurunziza (2010). Studies on the role of finance for investment at the aggregate level in Africa include Ndikumana (2000) and Ndikumana (2005).

Table 1: Indicators of the investment climate, Burundi and EAC (average 2000-08)

	Burundi	Rwanda	Kenya	Tanzania	Uganda	EAC
Electricity (% of firms identifying this as a major constraint)	72.3	55.0	48.2	73.7	64.3	62.7
Access to finance (% of firms identifying this as a major constraint)	50.9	36.0	44.1	44.5	46.4	44.4
Tax rates (% of firms identifying this as major constraint)	36.1	44.7	68.3	55.1	55.5	51.9
Transportation (% of firms identifying this as a major constraint)	21.1	27.4	37.4	18.5	22.6	25.4
Corruption (% of firms identifying this as a major constraint)	19.7	4.4	73.8	35.4	30.9	32.8
Policy uncertainty (% of managers surveyed ranking this as a major constraint)	14.5	0.9		0.5	0.3	4.0
Labor skill level (% of firms identifying this as a major constraint)	11.8	11.7	27.6	22.3	20.5	18.8
Labor regulations (% of firms identifying this as a major constraint)	3.9	2.8	22.6	8.5	6.0	8.7

Source: World Bank, Doing Business database.

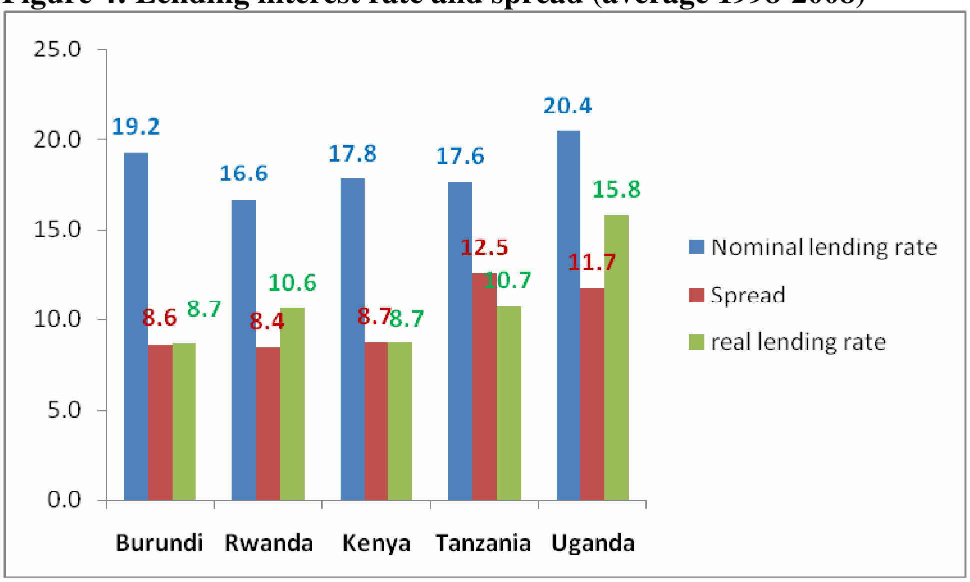
While the evidence from firm surveys clearly indicates that finance is a very important constraint to investment, from an empirical perspective, the question is whether the constraint to investment and enterprise growth is the availability of finance or the return to capital. That is, is Burundi facing excess demand for finance or is it facing insufficient investment opportunities with adequate rates of return? In practice, excess demand for finance implies that bankable projects are turned down by banks. If the issue was the shortage of bankable projects, there would be idle loanable bank funds even as banks are willing to supply loans. A related question is whether there is pent-up demand for equity-like instruments that firms can tap into to finance long-term investment. If that were the case, there would be some "curb" equity market out there not being catered for.[7]

In the case of Burundi, the binding constraint to investment is on both sides. There are bankable projects that are not funded because of high perceived risk (political and economic risk; sector specific and systemic risk) as well as lack of funds, especially long term funds. At the same time, there is idle capacity to lend on the banks side. However, a large share of bank's resources is in short-term instruments, which is a result of the failure of the financial system to adequately perform its function of resource pooling and maturity transformation. This issue is further discussed in the following sections.

[7]Although there is no consistent empirical evidence on this phenomenon, an informal equity market continues to evolve in the margins of the formal financial system in African countries. Private entrepreneurs raise funds from private individuals on promise of a return to equity. While the arrangements are informal (typically using family and clan relationships as a basis for trust and enforcement mechanism), the volumes involved are arguably high, according to anecdotal evidence (e.g., in Ethiopia). Our investigations revealed that there is a highly liquid and short-term informal credit market in Burundi where interest rates vary between 20-30 percent per month. This informal market is known under the name "Banque Lambert".

Naturally, a high cost of finance could also contribute to low investment performance. Compared to other countries in the region, Burundi exhibits relatively high interest rates. As in other African countries, high lending interest rates are attributable to banks' perception of high credit risk due to high and volatile inflation as well as political and economic instability. High lending interest rates are also a result of lack of competition in the banking industry. In the case of Burundi, once inflation is accounted for, interest rates are within the norm in the region (Figure 4). Over the period of 1998-2008, while the nominal lending interest rate in Burundi is the second highest in the region (19.2%, after 20.4% in Uganda), the real lending rate is the lowest in the region (8.7%, the same as in Kenya). The interest rate spread is also within the norm in the region, ranking second behind Rwanda (8.6% and 8.4 respectively). However, the nominal spread gives a misleading picture. Considering that banks in Burundi do not pay interest on short term deposits, which represent the bulk of bank deposits, the actual cost of funds to the banks is only 4% (IMF and World Bank, 2009). Hence, in reality, the spread is much more important than the number suggested in figure 4. This cursory analysis of interest rate levels provides some indication that the constraint in Burundi may be more about access to finance than the cost of finance per se. Specifically, it is the shortage of long-term finance that constrains investment.

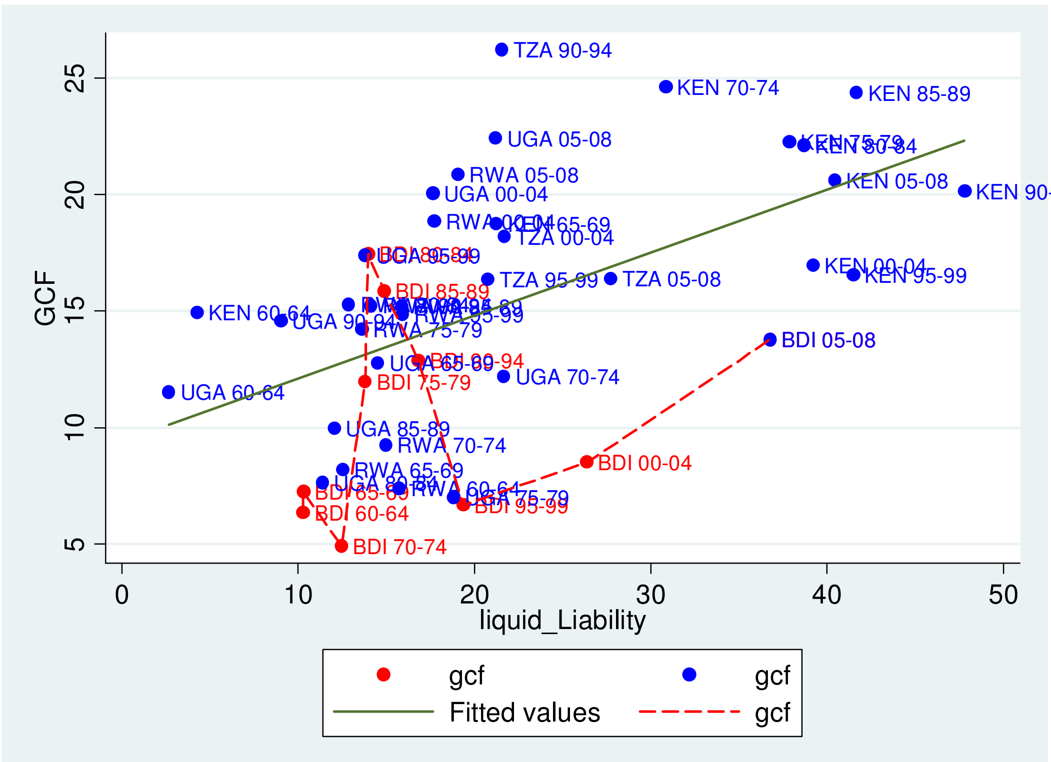
Figure 4: Lending interest rate and spread (average 1998-2008)



Sources: Central Bank of Burundi database; World Economic Indicators.

Beyond finance – access (quantity) and cost (interest rate) –, investment (hence growth) performance in Burundi has been affected by both economic and political shocks. One of the reasons why the country has underperformed relative to other countries is its volatile political history. In Figure 5, gross capital formation is plotted against a measure of financial development (total liquid liability as a percentage of GDP) with 5-year averages over the period 1960-2008 for Burundi and the other four members of the East African Community. The picture clearly shows two features of the Burundian economy. First, for similar levels of financial development, investment is typically lower in Burundi. Second, political instability has undermined investment: it declined in 1970-74 due to the 1972 civil war and slumped following the crisis that erupted in 1993. The debt crisis of the 1980s and the ensuing economic contraction explain the decline in investment during that period. The post-conflict recovery coincides with both an improvement in investment and financial development. The evidence suggests that both finance and economic and political stability are essential conditions for a robust investment performance and hence growth.

Figure 5: Investment and finance in Burundi and other EAC countries (5-year averages)



Source: authors' computations from World Economic Indicators.
Note: LLIA = liquid liabilities as percentage of GDP; gcf = gross capital formation as percentage of GDP

2.3 Financial liberalization

This sub-section reviews efforts to liberalize the financial sector and the strategies and instruments used to achieve this goal. It examines the outcomes of liberalization with an emphasis on the impact on the quantity, term structure, and cost of finance. It also attempts to explain the shortcomings of the liberalization experiment.

The liberalization of the financial system was initiated in 1987 in the context of the second phase of the Structural Adjustment Program (SAP).[8] The period leading to the

[8] The first phase of the SAP, implemented starting in July 1986, focused on: (1) trade and industrial policy, (2) privatization and restructuring of state owned enterprises, and (3) agricultural policy. The second phase

adjustment program was marked by poor overall economic performance due to a deterioration of the terms of trade, adverse impacts of an expansionary fiscal and monetary policy, and weather shocks. Thus per capita GDP growth in 1980-84 was very low (Figure 1) and external balances worsened. With regard to financial sector policy, the period was characterized by strict controls of interest rates and credit allocation across sectors. The central bank also followed a segregated policy with regard to financial institutions in terms of the ability to mobilize deposits (especially from public institutions) and allocate credit (especially for coffee trade financing). The key control measures were the following:

1. Administrative determination of the minimum deposit interest rate by the central bank: this discouraged the mobilization of savings, as banks often judged real deposit rates as too high. Indeed in 1986, banks nearly suspended acceptance of new deposits.
2. Administrative determination of the maximum lending interest rate by the central bank: this and the minimum deposit rates limited the banks' flexibility vis-à-vis their profit margin. This measure discouraged lending to activities judged as risky, which typically happened to be among the important drivers of growth, such as agriculture and industry.
3. Direct control of credit by fixing preferential lending interest rates and refinancing rates for priority sectors, thus establishing multiple refinancing interest rates. In practice this policy was ineffective due to the difficulty of tracking and enforcing the final destination of loans.
4. Pre-approval by the central bank of loans above a given threshold (10 million FBu in 1987): this policy was also ineffective in regulating aggregate domestic credit given the large number of small loans that did not fall under this regulation and most importantly, due to delays in the release of information on the loan portfolio of banks.
5. Arbitrariness in the Treasury bond policy whereby the state-owned Caisse de Mobilization et de Financement (CAMOFI) was the only deposit institution authorized to buy Treasury bonds.
6. Monopoly privileges accorded to selected institutions suffocated competition in the system. For example, CAMOFI and the central bank had the monopoly on the handling of deposits by state owned enterprises. Moreover, arbitrary quotas for banks in the financing of the coffee campaign undermined competition and efficiency in the system.

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extended the liberalization program to other activities: export promotion, the labor market, and the financial sector. In addition, the program began to consider the social dimension of the adjustment program.

Box 1: Financial liberalization

The liberalization of the financial sector was implemented in four phases:

Phase 1: Starting from April 1988

1. Removal of credit pre-approval by the central bank.
2. SOEs are allowed to deposit their liquidity in any institution of their choice.
3. Treasury bonds are open to all financial institutions.
4. Deregulation of the lending and deposit interest rates.

Phase 2 : Starting from September 1988

5. Introduction of Treasury bonds with variable interest rates.
6. Reduction of the number of refinancing rates from 7 to 3.
7. Reduction of the number of maximum lending rates from 8 to 3.
8. Removal of all minimum deposit interest rates except the rates on some special savings accounts (e.g., *comptes sur carnets*).
9. Revision of the use of the medium-term liquidity coefficient.

Phase 3: Starting from December 1988

10. Reduction of the number of refinancing rate to only two (normal rate and preferential rate).
11. Removal of ceilings on lending rates and floors on deposit rates.

Phase 4 Starting from October 1989

12. Complete liberalization of lending and deposit interest rates.
13. Reform of the national guarantee fund (Fonds National de Garantie).
14. Revision of the land law giving to the state preferential treatment in terms of repossession of guarantees in cases of land-backed credit failures.

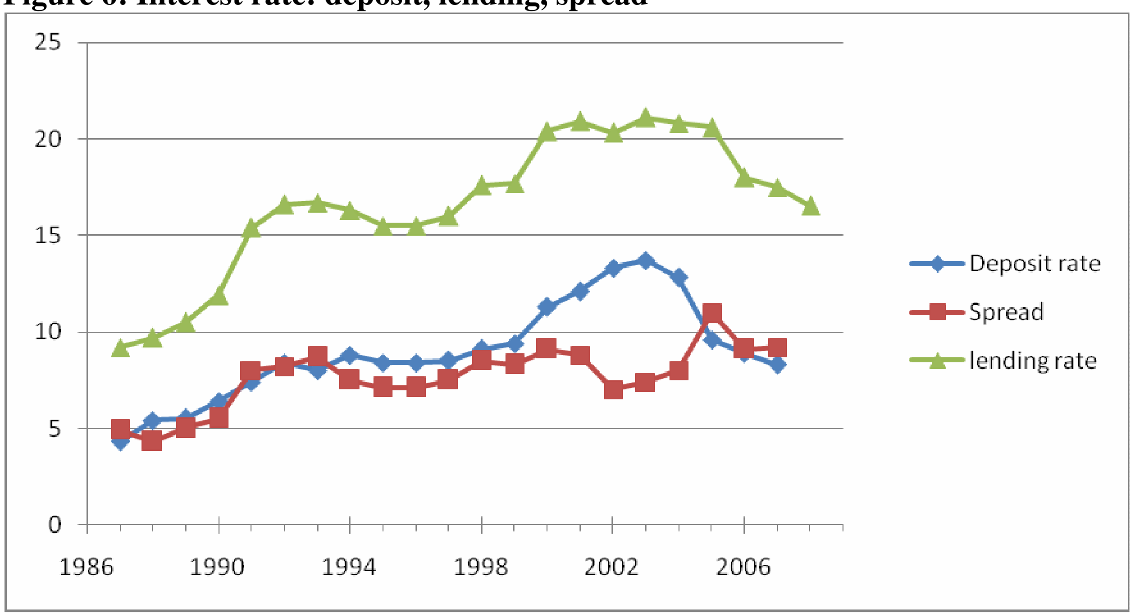
The liberalization of the financial system was meant to correct all these distortions in the system with the ultimate objective of creating a level playing field, improving resource mobilization and achieving efficient allocation of resources across sectors. This was to be achieved by removing direct controls and allowing the market to determine the quantity, price and destination of credit by fostering competition. Box 1 provides the phases of the financial liberalization process.

Did financial sector liberalization achieve these objectives? The answer to this question is mixed at best. While there were some visible effects of liberalization, by and large, the process failed to address key deficiencies of the financial system. On the positive side, the liberalization succeeded in opening up the sector to entry of new banks. In 1987, the financial system comprised only of the central bank, 3 commercial banks, 4 non-bank financial institutions (including CADEBU), and a nascent network of microfinance institutions. The sector was dominated by the state and public enterprises that held the lion share of the capital. Following liberalization, new commercial banks were created, and some of the previously protected institutions succumbed to competition (CADEBU, CAMOFI). Today the system comprises eight commercial banks, two development banks, insurance companies, postal services and a network of microfinance institutions.

Despite these positive developments, the effects of liberalization remained limited. Until 2004, the central bank continued to exercise control over credit allocation by imposing ceilings on credit disbursed by each institution and on credit supply to selected activities such as commercialization of coffee, tea, and cotton. At the same time, monetary policy was marked by lax control vis-à-vis prudential regulation and reserve requirements and lack of coordination of the management of liquidity and foreign exchange (IMF 2005). It is from mid-2004 that reforms of monetary policy got under way in a coherent manner under pressure from the donor community, especially the IMF. The most important changes undertaken include the abolition of credit ceilings, the abolition of the discount rate as a tool of monetary policy in April 2005, and the adoption of a systematic method of liquidity management as a means of controlling money supply. In addition, the central bank began to strengthen prudential regulation and banking supervision, applying strict measures to enforce penalties against violations of the regulations.

Overall, financial liberalization failed to correct important structural deficiencies in the system. The increase in the number of institutions did not translate in an increase in savings and lending. It did not reduce the interest rate margin. While both the lending and deposit interest rates increased during the liberalization period, the lending rate increased faster, resulting in higher interest rate margins. Moreover, when the rates declined in early 2000s, the deposit rate declined faster than the lending rate, resulting in an increase in the spread (Figure 6). Moreover, despite the removal of interest rate controls, credit allocation did not improve. Actual interest rate setting showed preference for high turnover activities and the bulk of credit continued to go to import and export activities and the public sector.

Figure 6: Interest rate: deposit, lending, spread



Source: Central Bank of Burundi database

Several factors contributed to the limited effectiveness of financial liberalization. They mainly relate to institutional deficiencies, structural features of the economy, poor sequencing and inappropriate implementation of the reforms. With regard to the institutional environment, the key cause of the failure of financial sector (and other economic) reforms is the generalized failure of state institutions to fulfill their expected functions of facilitating exchange, minimizing risk and uncertainty, and enforcing the rules of fair competition. Under the monolithic political regimes that dominated the post-independence period, economic policy making deviated from the goals of efficiency and distributional equity (Ngaruko and Nkurunziza, 2005, 2008). Thus the financial sector as well as the rest of the formal sector was regarded as a basis for rent extraction by leaders, explaining the pervasive presence of the government in the economy, excessive control over credit and foreign exchange allocation, and interest rate repression.

The limited and delayed results of financial sector reforms were due to the economic downturn which induced financial intermediaries to retreat even further from long-term lending and borrowers to shy away from long-term investment. The economic slump of the 1980s, which was characterized by aggregate demand depression, prevented expansion of financial intermediation both from the demand side and the supply side (see Figure 4 for investment). While inefficient financial intermediation undermined economic activity, weak economic activity also constrained financial deepening.

3. Macroeconomic Policy and the Regulatory Environment

A stable macroeconomic environment and a conducive regulatory environment are critically important for the financial system. The next section discusses these two dimensions and highlights the associated challenges that hindered financial intermediation in Burundi.

3.1 Monetary policy and implications for the banking sector

Although economists have difficulty agreeing on how exactly monetary policy should be conducted, most experts would agree that the most important attribute of effective monetary policy is predictability. Predictability in turn is achieved through a record of consistent, systematic and transparent actions by the monetary authority, allowing markets to be "in synch" with the authority's thinking about the appropriate policy direction (Poole 2006; Taylor 1993). Predictability ultimately allows the central bank to build credibility, which is a key condition for effectiveness of monetary policy.

The monetary policy regime in Burundi has undergone a series of reforms, especially starting with the 1980s in the context of market-oriented structural adjustment (see Nyamoya 2004). The reforms continue today in a transition from direct control of credit and interest rates towards market-determined interest rates and credit allocation (IMF 2005).

Liquidity management is currently the main tool of monetary policy for the purpose of controlling inflation. Under normal circumstances, the central bank supplies liquidity to banks that are in need of extra funds and takes liquidity from those that have excess cash. In addition, banks may borrow from each other in the interbank market. This normally establishes a market for liquidity where supply and demand eventually determines an equilibrium interest rate.

However, today Burundian banks operate in the context of an economy faced with severe structural problems that limit demand and supply of credit. Low aggregate demand, supply-side bottlenecks, including poor infrastructure and energy supply, and a fragile political environment contribute to rising risk aversion among lenders and borrowers, resulting in excess liquidity. Consequently, the market for liquidity is truncated and one-sided, making it impossible for a true equilibrium interest rate to arise.

After the abolition of the discount rate in 2005 and given the one-sided nature of the market for liquidity, there is basically no benchmark interest rate in the system, which affects the banking system and the economy in several ways. First, under normal circumstances, movements in the benchmark interest rate serve to signal to the public the stance of monetary policy. The lack of such a policy signaling mechanism increases uncertainty and induces a "wait and see" attitude on the part of the public and commercial banks, which discourages long-term lending and investment.

Secondly, the benchmark interest rate serves as a reference for the cost of funds, allowing commercial banks to determine the optimal lending rate. In Burundi, the absence of such an interest rate is compounded by the fact that there are few alternative investments that would allow banks to gauge the opportunity cost of deposits at the central bank and loans to the private sector. Currently, the reserves at the central bank are remunerated at 4%[9], which implies an inflation tax of 9.6% given the inflation rate of 13.6%. This is not an attractive option for banks for the purpose of portfolio management.

In the absence of a reference interest rate, there is a risk for commercial banks to engage in an interest-rate based competition to win and retain the few creditworthy borrowers – mainly big traders. Such a race to the bottom raises the risk of banking fragility, especially for small and newer banks that may be tempted to offer much lower rates than larger banks to survive in the thin market. In practice however, the dominant commercial banks in Burundi operate more like a cartel, colluding more than competing in setting interest rates.

Third, movements in the benchmark interest rate constitute a basis for the formation of inflation expectations by banks and the public. Inflation expectations in turn feed into the process of determination of long-term lending interest rates and are incorporated into savings and investment decisions. Today's monetary policy in Burundi, which is reduced to short-term liquidity management, offers no signals about medium to long-term interest rates and inflation expectations. There is no meaningful yield curve. This induces a bias in favor of short-term lending while discouraging long-term investment.

From the foregoing discussion, it is clear that the financial system (and the economy as a whole) is caught in an equilibrium of low demand for and low supply of credit, resulting

[9] The remuneration of reserves was introduced in October 2004 at a rate of 5% which was reduced to 4% in January 2006. The justification is to cover the opportunity costs of reserves at the BRB. This is a peculiar disposition in a "fractional reserve system." The required reserve ratio was reduced from 8% to 5% in January 2004 and raised again to 7% in December 2005.

in excess liquidity. Banks' preference for short term credit is partly induced and nurtured by the inability of monetary policy to provide a clear direction with regard to inflation and interest rate expectations, inducing banks to minimize long-term lending.

3.2 Fiscal policy and financial intermediation

Fiscal policy in Burundi faces two typical problems or "twin sins", also referred to as the "original sin" (Eichengreen and Hausman 1999; Eichengreen, Hausman and Panizza 2003; Khan 2005). The first problem is the inability of the government to borrow abroad in its own currency due to currency mismatches between revenue and debt service. The second problem – the "domestic original sin" – is the difficulty of borrowing long-term at home due to the lack of long-term fixed-rate debt instruments. This forces the government to borrow short-term, which is more expensive, while also limiting the government's ability to defend the currency. Normally, one option to prevent currency depreciation is to raise short-term interest rates. But in the absence of long-term debt instruments, raising short-term interest rates worsens the balance sheet conditions for the government, firms, and households. The only way out is to develop long-term saving and lending instruments, especially bond markets. Increasing the role of institutional investors such as pension funds also helps in expanding government's borrowing opportunities.

In addition to the two conventional "original sins" faced by all developing countries, Burundi faces a "third sin" resulting from past governments' failure to honor matured bonds, which caused a loss of credibility vis-à-vis the public. This severely limits the government's options for financing the deficit while also reducing the number of monetary policy instruments at the disposal of the central bank.

In the absence of bond financing, the Burundian government has heavily relied on free advances from the central bank to finance the deficit. To a certain extent, deficit financing has been a "free lunch" for the government. Monetization of the deficit increases the inflationary impact of the deficit and complicates liquidity management by the central bank. More fundamentally, the lack of a developed bond market is a constraint to maturity transformation function of the financial system, thus limiting saving and investment instruments and opportunities.

3.3 Banking regulation

The goal of banking regulation and supervision is to promote efficient functioning of the financing system, especially by preventing excessive risk taking by banks and minimizing contagion effects of individual banks' financial distress.

There are generally two main forms of supervision of the banking industry (Hubbard 2005): (1) direct supervision by the central bank; (2) indirect supervision by financial markets, or *financial market discipline*. In the case of Burundi, financial market discipline is not applicable due to the absence of an equity market that could help in pricing risk. Moreover, the information flow on the financial situation of corporations and banks is so slow that the public has no basis to judge the riskiness of banks. Regulation is therefore limited to direct intervention by the central bank.

Regulation and supervision in Burundi use three methods. The first consists of off-site monthly examinations of the soundness of banks' operations based on banks' reports. The second is a detailed on-site examination conducted every two years which focuses on financial soundness of banks. These two methods are supplemented by *ad hoc* inspections, which are prompted by information from off-site examination and any other relevant information obtained by the central bank that may motivate close attention to the financial conditions of a particular bank.

The central bank faces a number of constraints that limit its ability to effectively regulate and supervise the banking industry. First, effective regulation requires independence of the central bank from political interference. In Burundi, some cases of bank failure can be attributed to the lack of independence of the central bank (Section 6). In those cases, even when it was known to the central bank that a commercial bank had serious problems and that there was a very high probability that it could fail, the central bank was still unable to take appropriate action due to political pressure.

Second, effective banking regulation requires a sound regulatory environment of the private sector as a whole. In particular, the rules of fair competition need to be inspired by a national competition law. Such a law does not exist at the moment in Burundi, making it difficult to enforce competition in the banking sector alone when the regulation of the rest of the private sector is not clearly defined.

A third constraint to effective regulation is inadequate capacity, especially in the area of information technology. In particular, the fact that bank operations are not managed by a fully digitized system precludes speedy and timely examination. Thus it becomes difficult to catch signs of weakness in the banking system early enough to avoid financial distress and minimize contagion effects. Lack of adequate training for the staff responsible for banking supervision and regulation remains a critical barrier to effective regulation of the financial sector. This constraint is exacerbated by the fast-changing nature of the regulatory framework, especially in the wake of the recent financial crisis which has placed a premium on modernization and harmonization of national banking regulation in line with global standards.

Clearly the case of Burundi illustrates the critical role of the institutional environment, especially the regulatory framework for the development of a vibrant financial sector. Having set the stage and described the institutional context, the paper proceeds to the analysis of the structure of the financial sector and proceeds with an examination of its performance both from an allocative as well as profit maximization perspective.

4. Structure and characteristics of the financial sector

The Burundian financial system is dominated by commercial banks in terms of assets, resource mobilization and credit supply. The sector also comprises a handful of formal non-bank financial institutions, mainly development banks and a growing microfinance network. The insurance and pension sector is still underdeveloped, which is an impediment to resource mobilization. In particular, the lack of a pension fund system inhibits the capacity of the financial system to perform its functions of savings mobilization and maturity transformation. In view of the financial landscape in Burundi, the discussion in this section will focus on commercial banks, development banks, and microfinance institutions.

4.1 Commercial banking

The Burundian banking sector comprises 8 commercial banks, including Diamond Trust Bank which was created recently in 2009. Table 2 gives the key characteristics of the banks. The banking sector is highly concentrated with the two mature banks, the Banque de Crédit de Bujumbura (BCB) and the Banque Commerciale du Burundi (BANCOBU) accounting for a commanding share of the market (Table 2). These two banks account for 43 percent of deposits, 42 percent of total assets and 42 percent of credit distributed in 2008. Together with the Interbank Burundi (IBB) created in 1992, the three largest banks represented 76% of total assets, 74% of credit and 79% of deposits in 2008 as well as most bank branches in the country.

Table 2: Characteristics of commercial banks, 2008

	Year of creation	Branches	State's share (%)	Public share (%)*	Total assets (million BIF)	Deposits (million BIF)	Loans (million BIF)	Loan/Deposits (%)	Employment
1. BBCI - Banque Burundaise pour le Commerce et l'Investissement	1988	5	4	47.9	31,703	18,103	17,840	99	152
2. BANCOBU - Banque Commerciale du Burundi	1964	10	3	75	94,161	66,028	47,840	72	275
3. BCB - Banque de Crédit de Bujumbura	1964	10	10.6	45	143,122	114,548	69,322	61	286
4. BGF - Banque de Gestion et de Financement	1996	8	0	0	32,723	22,703	20,141	89	146
5. FINABANK - Finalease Bank (taken over by Access Bank Nigeria)	2002	4	0	0	41,516	28,943	21,440	74	93
6. IBB - Interbank Burundi	1992	24	0	0	187,630	148,084	90,262	61	350
7. SBF - Société Burundaise de Financement (ECOBANK starting 2008)	1983	3	0	35.6	28,657	17,335	13,259	76	107
TOTAL (million FBu)		**64**			**559,069**	**415,746**	**280,106**	67	**1,409**
TOTAL (equivalent in USD)					**471.8**	**350.6**	**226.8**		

(*) Public share: Shares owned by state-owned firms (public enterprises)

Note: The 8th bank is *Diamond Trust Bank* which was created in 2009; no data could be obtained on this Bank.

The state ownership in the banking sector is quite small, representing only 3.6 percent of total capital of commercial banks. However, the government still has substantial influence in the banking sector through its public entities that own up to 31.6 percent of the capital of all banks combined. Thus the government is still able to influence bank management through nomination of its representatives to the board of directors. The government's presence also has implications in the allocation of credit, directly through borrowing by state entities and indirectly through political pressure on bank management.

4.2. Non-bank sector: development banks and microfinance institutions

The non-bank financial sector is both underdeveloped and poorly integrated with the rest of the financial sector. As a result, substantial resources remain untapped for the purpose of resource pooling, maturity transformation and long-term lending. The non-bank sector comprises two development banks, saving and insurance institutions, microfinance institutions and the postal services (Table 3).

Development banks

Created in 1964, the Banque Nationale pour le Développement Economique (BNDE) is the only genuine development bank with a statutory commitment to financing economic development. In particular, the BNDE contributes to the financing of small and medium enterprises and microfinance operations.

However, several constraints hamper BNDE's ability to accomplish its mission. The most important constraint is the shortage of stable long-term resources. As a public institution, BNDE relies primarily on donor funding through the government. Consequently, BNDE's lending capacity is adversely affected by volatility and unpredictability of donor funding. In the past, BNDE also relied on direct refinancing via an automatic rediscount facility at the central bank, which was abolished in the context of monetary policy and financial sector reforms. The lack of stable long-term resources forces BNDE to concentrate on short-term and medium-term lending, and on commerce to the disadvantage of agriculture and industry.

The other financial institution that participates in development financing is the Fonds de Promotion de l'Habitat Urbain (Fund for the Promotion of Urban Housing, FPHU) which specializes in urban housing. FPHU is also a public institution confronted with the same resource constraints faced by BNDE. Thus FPHU is unable to meet the needs of the expanding urban population.

Table 3: Characteristics of non-bank financial institutions, 2008

	Year of creation	State share %	Total assets (million BIF)	Loans (million BIF)	Loans/Assets (%)	Employment
1. BNDE Banque Nationale pour le Développement Economique	1967	65,5	21,109	10,800	51	77
2. FPHU Fonds de Promotion de l'Habitat Urbain	1990	82	13,137	20,486	156	52
3. INSS Institut National de Sécurité Sociale	1962	100	22,572	0	0	3 488
4. RNP Régie Nationale des Postes	1991	100	6,011	0	0	800
5. MFP Mutuelle de la Fonction Publique	1980	100	17,933	0	0	524
TOTAL			**80,762**	**31,286**		**4 992**

RNP: 2006 figures ; INSS: 2007 figures

Another constraint that limits the contribution of development finance institutions is the low purchasing power of potential borrowers. This is primarily due to the stagnation of nominal wages combined with drastic increases in the cost of inputs especially in the construction sector. Recently the Government has raised salaries of civil servants in some line ministries, including justice, education, and state inspection. But the wage raises are inadequate to catch up with the rise in the cost of living and the cost of construction.

To illustrate the deterioration of workers' purchasing power, we consider the case of a married couple of two university degree holders employed in the civil service. We assess their ability to service a 15-year mortgage at the going mortgage interest rate of 18% for a modest 10mx12m house.[10] The salary in the civil service for a university degree laureate increased from about 30000 FBu in 1993 to 100000 FBu in 2010. This is a 233 percent increase in nominal wage, but a 58 percent decline in purchasing power, adjusting for inflation. In 2010, housing construction costs in middle-income suburbs of Bujumbura (e.g., Kanyosha) are 6 times higher than in 1993. The calculations in Table 4 show that while the couple labored to cover the mortgage with 80 percent of their combined salary in 1993, in 2010 the mortgage payment is completely out of reach, representing 178% of the couple's nominal combined monthly salary (Table 4)!

Table 4: Cost of housing construction vs. civil service wages: pre-crisis compared to 2010

	1993	2010		Change (%)	
		nominal	real	nominal	real
Elements of housing costs					
Lending interest rate (annual %)	14	18	9.7	28.6	-30.7
Unit cost of construction (per square meter)	30,000	184,000	23,018	513.3	-23.3
Cost of a 8mx10m house (FBu)	3,600,000	22,080,000	2,762,141	513.3	-23.3
Income and mortgage payment capacity					
Monthly payment (FBu)	47,942	355,581	44,482	641.7	-7.2
Salary of couple of two BA holders (FBu)	60,000	100,000	25,019	233.3	-58.3
Monthly payment/salary (%)	79.9	177.8	62.6	468.5	18.5

Source: The information on housing costs is from the Fonds de Promotion de l'Habitat Urbain (the 2010 value is obtained by applying the inflation rate of 8.3%, a conservative assumption, to the 2009 value of FBu170000/square meter). Information on the interest rate and the price index is from the Central Bank of Burundi. At the 1993 base, the implicit consumer price index used to deflate nominal values to real values in 2010 is 799.38.

These simulations show that today Burundian workers face a double tragedy: they qualify for less credit and the little credit they can secure buys them even less on the market. While the observed recent decline in interest rates is desirable, real improvement in access to finance would require a sizeable increase in workers' income.

Microfinance, a relatively new phenomenon

Microfinance is a relatively new component of the Burundian financial system. Apart from BNDE's microfinance operations dating from the 1960s, genuine microfinance began with the creation of the savings and credit cooperatives (Coopératives d'Epargne et de Crédit, COOPECs) in 1985. However, starting from the mid-1990s, many institutions were created with diverse legal

[10] The example considered here overestimates the real repayment capacity of the household. In particular, the maturity of mortgage loans is typically less than 15 years as is assumed here. Moreover, only some sectors in the civil service offer a monthly salary of 100,000FBu following recent wage increases (education, justice, state inspection).

status, ranging from NGOs to cooperatives. In addition to COOPECs, as many as 19 organizations have been created since 2000, of with 5 were created in 2005 alone.

Microfinance institutions (MFIs) have experienced rapid growth over the recent years (Table 5). The increase in the cost of living and the deterioration of the purchasing power due to the war and the economic crisis made it increasingly impossible for people to survive on regular wage incomes. At the same time, formal banking services became increasingly inaccessible due to high uncertainty. The explosion of microfinance can therefore be interpreted as an attempt to fill a financial intermediation vacuum. The creation of new MFIs is also a response to expectations of higher demand for credit and higher borrowing capacity in the post-conflict period. Another explanation for the rise in microfinance is the commitment by non-governmental players (including NGOs) to contribute to poverty alleviation during the crisis and in the post-conflict period.

Table 5: Summary indicators of microfinance institutions, 2004-09

Indicators	12/31/2004	12/31/2009	% change 2004-2009
Members/clients	272,340	430,842	58.2
Loans issued	9,603,149,000	40,632,884,853	323.1
Outstanding loans	13,897,427,000	41,270,650,703	197.0
Active borrowers	52,955	166,366	214.2
Average loan	181,345	244,238	34.7
Savings	12,067,087,787	33,282,113,196	175.8
Number of depositors	NA	384,609	NA
Service posts	138	184	33.3
Employees	352	926	163.1

Source: Réseau des Institutions de Microfinance (RIM)

The Finance Ministry recently adopted the microfinance law that sets the regulatory framework for the activities of microfinance institutions. The objective of the law is to protect savers and borrowers while minimizing risk taking by MFIs. Indeed speculators had occasionally taken advantage of the population, mobilizing savings on promise of high returns and guaranteed access to credit, to only disappear afterward without leaving any trace. A clearly defined legal framework is therefore indispensable for the development of the microfinance sector. Nonetheless, evidence from countries that have been successful in this area indicates that, more than the formal legal framework, it is the ability of MFIs to create an environment of trust between institutions and clients that determines the success of MFIs. A well known example is the case of the Grameen Bank (see Yunus 2003). This is also confirmed by interviews with managers as well as clients of the successful microfinance institutions in Burundi, such as Mutuelle d'Epargne et de Crédit (MUTEC) and Caisse d'épargne et de Crédit Mutuel (CECM). While increasing access to financial services for clients such a strategy also contributes to financial sustainability of the MFIs through high levels of loan recovery.

The success of microfinance today rests on the ability to navigate the complexity of the so-called "triangle of microfinance", which calls for attention to not only outreach to the poor (both breadth of outreach and depth of outreach) but also financial sustainability of the institutions as well as impact in terms of growth and poverty alleviation (Zeller and Meyer 2002; Robinson 2001). The Burundian microfinance institutions face several constraints in their attempts to reach this triple objective. The key constraints are the lack of stable resources, forcing MFIs to both ration credit and charge high interest rates, hence making it difficult to achieve sufficient outreach. Interviews with management of BNDE, the oldest and largest institution involved in microfinance, indicate dwindling support from donors especially since the early 1990s at the beginning of the civil war. MFIs also face critical capacity constraints due to the shortage of experienced experts in the field. This exposes the institutions to credit risk notably due to inefficient credit assessment and loan recovery mechanism. There is yet little evidence on the impact of microfinance on growth and poverty in Burundi. In any case, this impact is likely to be small at the moment given the high levels of poverty and the low coverage of microfinance in the rural area. Nonetheless, the sector has widened access to financial resources and the importance of microfinance will continue to increase as the resource and capacity gaps are progressively bridged.

5. Credit allocation and the contribution of banks to economic activity

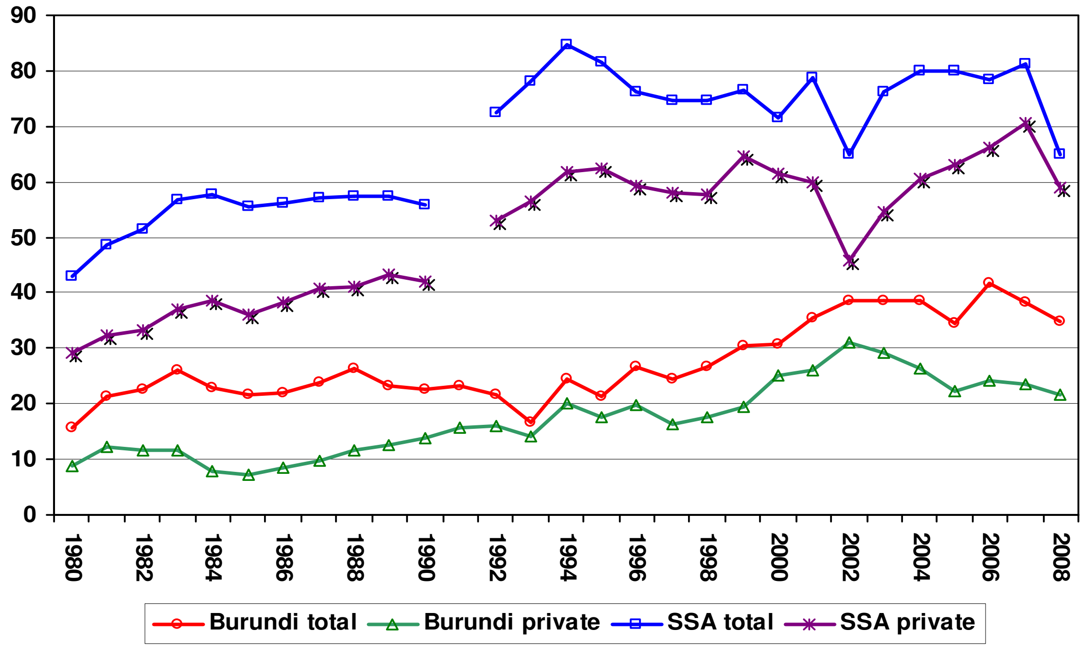
This section highlights the relative importance of the amount of credit allocated to the private and public entities and analyzes why credit is so unequally allocated to different economic sectors. It also discusses the term structure of credit and derives some indicators of inefficiency in sectoral and temporal allocation of credit.

5.1. Amount of domestic credit provided by the banking sector

In Burundi, credit from the banking sector to the economy is very limited. As figure 7 shows, over the period 1980-2008, the average share of total domestic credit from the banking sector represents 27 percent of GDP, which is less than half of the average for Sub-Saharan Africa (67.5 percent of GDP) and only 17 percent of the ratio in high income OECD countries (160 percent of GDP).[11] Domestic credit to private sector is even smaller. At 17 percent of GDP, it represents one-third of the share for Sub-Saharan Africa (51 percent of GDP); the latter compares very poorly with the figure for high income OECD countries at 126 percent of GDP (World Bank, 2009).[12] These statistics suggest that even by the poor African standards, the contribution of Burundi's banking sector to economic activity in terms of credit provision is very limited.

[11] The apparent increase since the mid-1990s is not necessarily an indication that the amounts of credit to the economy increased. Most of the period post-1993 was characterized by negative economic growth rates, which could explain the increase in the ratio to GDP without an increase in the flows of credit to the economy.
[12] The drop in 2008 is most probably the result of the global economic and financial crises.

Figure 7: Ratio of domestic credit to GDP



Source: Based on data from World Bank (2009).

In addition to the relatively small amount of credit available, these resources are not efficiently allocated in the sense of meeting the needs of the economy. First, a relatively important share of credit is allocated to the government. Second, the sectoral allocation of credit does not reflect the economic importance of different sectors of the economy. Third, there is a mismatch between the term structure of bank loans and investment demand. These issues are elaborated further below.

5.2. Credit to the government

Burundian banks allocate relatively more credit to the central government than in the rest of Sub-Saharan Africa. On average, bank credit to the government represents about 38 percent of total credit compared to only 25 percent in the rest of Africa. Although governments are not necessarily wasteful,[13] cross-country evidence has shown that higher state ownership of the economy, as has been the case in Burundi, is positively associated with high capital misallocation (Wurgler, 2000; Khwaja and Mian, 2005). In turn, capital misallocation leads to

[13]In India for example, an analysis covering the period 1986-2000 found that although private banks were more productive than public banks due to technical progress, the latter were more efficient than the former (Sensarma, 2006).

low total factor productivity and output per worker as is typically the case in developing countries (Hsien and Klenow, 2009; Bartelsman et al. 2009).[14]

The evidence on Burundi suggests that the state misallocates its resources, partly due to political considerations. Nkurunziza and Ngaruko (2008) document how the government has used public resources to allocate rents among the members of the political elite. For example, state-owned enterprises (SOEs) in 1990 accounted for 25 percent of outstanding domestic credit and in 1995, the equity capital of 36 such firms represented 20 percent of the country's GDP but, as a group, they posted a net loss representing 6 percent of GDP. Most of these firms survived thanks to large subsidies regularly transferred from the central government budget. The elite who ran these firms managed them as family owned institutions, hiring friends and relatives who were not necessarily qualified for their positions.[15] In many cases, the managers embezzled the assets of these enterprises and drove them to bankruptcy. Managers of these SOEs often used assets stolen from these firms to create their own companies.

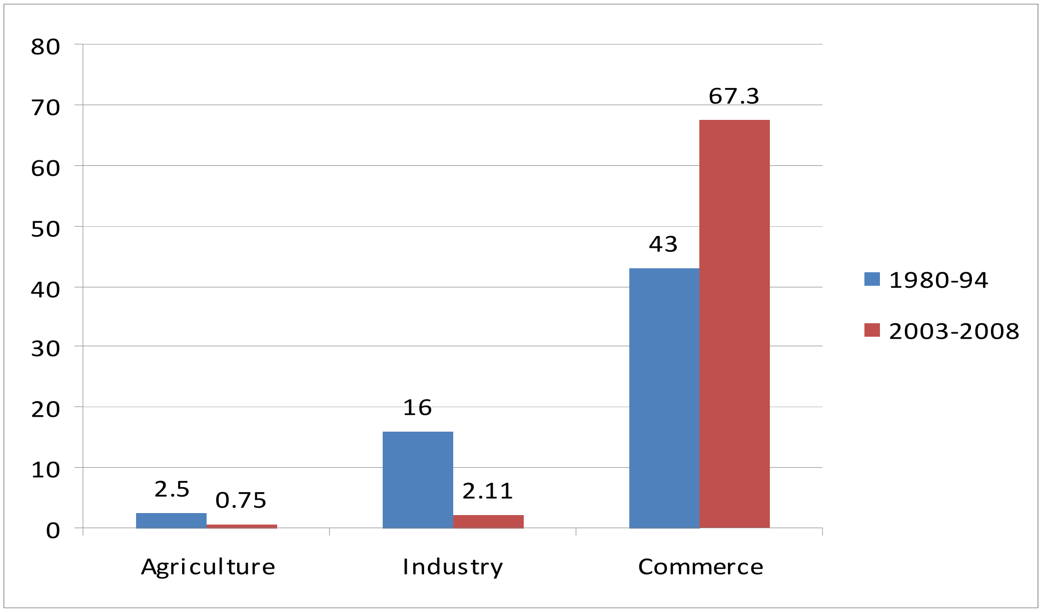
At the same time, private firms are severely finance constrained. According to the World Bank's Doing Business report, about half of Burundian firms identify finance as a major constraint, ranking second only to the lack of electricity (table 1). Evidence from a detailed firm survey carried out in the 1990s shows that access to credit is a constraint to firm growth and investment in Burundi (Bigsten et al, 2003). It follows that the crowding out of credit and its inefficient use by the government has negatively affected the performance of the private sector. The example of Pakistan illustrates the link between capital misallocation and slow economic growth. In Pakistan, politically connected firms borrow 45 percent more than other firms and their default rates are 50 percent higher. Such preferential treatment, practiced solely by government-controlled banks, costs the economy between 0.3 percent and 1.9 percent of GDP every year (Khwaja and Mian, 2005). This evidence is indicative of the substantial losses imposed on the Burundian economy by the skewed allocation of credit in favor of the government sector.

5.3. Allocation of credit to economic sectors

Sectoral misallocation of credit is the second source of inefficiencies. Given the importance of agriculture in terms of employment creation, food supply and production of inputs for other sectors, agriculture should receive the lion share of financial resources. This is not the case. Figure 8 shows that agriculture has been neglected by the banking sector.

[14]According to Hsien and Klenow (2009), capital misallocation could explain 30% to 50% of TFP difference between Chinese and American firms, and 40% to 60% of TFP difference between Indian and American firms.
[15] Many of these state firms have now collapsed due to mismanagement.

Figure 8: Sectoral allocation of commercial banks' credit (percentage of total)[16]



Source: Based on data from BRB, Annual Reports.

Clearly, the allocation of credit does not reflect Burundi's development priorities as articulated in the government's medium-term objectives: (i) five per cent annual rate growth of the agricultural sector; (ii) reducing the rate of people with insufficient food or unbalanced diet from 84 per cent of the population to 20 per cent; and (iii) reducing the rate of poverty from 67 per cent to below 50 per cent (République du Burundi, 2007). In fact, the government of Burundi considers that the performance of the agricultural sector will not only determine the growth of other sectors but also economic development in general.

In spite of its importance for the national economy, agriculture not only attracts an insignificant amount of credit but the share has declined over time, from 2.5 percent of total credit in the period 1980-1994 to 0.75 percent in the period 2003-2008. Yet in 2005, agriculture represented 42.4 percent of GDP and employed 84 percent of the active population (ISTEEBU, 2008; République du Burundi, 2008). Moreover, agriculture is the main source of economic growth. According to some conservative estimates, a ten percent increase in agricultural production, excluding coffee, leads to 3.5 percent increase in GDP (Lim and Rugwabiza, 2009). In general, agriculture-led growth has been shown to have the highest impact on poverty reduction (World Bank, 2008). Therefore, the resources allocated by the banking sector to agriculture do not

[16] Banks did not provide data on the sectoral distribution of their credits from 1995 until 2002, probably as a result of the war that raged in this period. Since 2003, the data provided follows a different classification but our sectors of interest, namely agriculture, industry and commerce are clearly identified. In this figure, commerce includes the coffee trading sector.

reflect the economic importance of the sector, preventing Burundi from reaching its potential in terms of growth and poverty reduction.

The decline in credit allocation has been even more dramatic in the industrial sector. The share of credit to this sector collapsed from 16 percent of total credit in 1980-1994 to only 2.11 percent in 2003-2008. In contrast, commerce, including coffee trading, is the most preferred sector although it represents only 6.8 percent of GDP and accounts for 2.5 percent of total employment (République du Burundi, 2008). The sector absorbed 67 percent of credit in 2003-2008, up from 43 percent in 1980-1994.

These statistics call for a number of observations. First, the economic transformation needed to achieve Burundi's development priorities in order to reduce poverty requires massive investments in agriculture and industry. However, the current allocation of financial resources makes this objective hard if not impossible to achieve. Second, the excessively high concentration of credit on one sector, trade, increases banks' vulnerability. Negative shocks to the trading sector, particularly its import-export segment, can severely undermine the stability of the banking sector. Indeed, when Burundi was placed under a total economic embargo from 31 July 1996 to 23 January 1999, this affected the portfolio of banks, as traditional bank clients, particularly those relying on import and export activities saw their activities seriously curtailed (World Bank, 1999). This may explain the decline of credit to the private sector in 1997 and 1998 (Figure 7).[17] Third, it could be argued that credit allocated to trading has an indirect positive effect on agriculture and the rural economy if it finances the trading of agricultural inputs and outputs, the provision of agriculture-related services, leading to job creation. In fact, a dynamic agricultural sector is often associated with high rural non-farm activity (Nkurunziza, 2007). In Burundi, the rudimentary state of technology in the agricultural sector and the dominance of informal subsistence activities suggest that the sector is detached from other sector of the economy. Hence, the small share of trading activities in GDP and employment creation, as shown earlier, implies that the indirect effects of trading on agriculture and the rural economy are very limited.

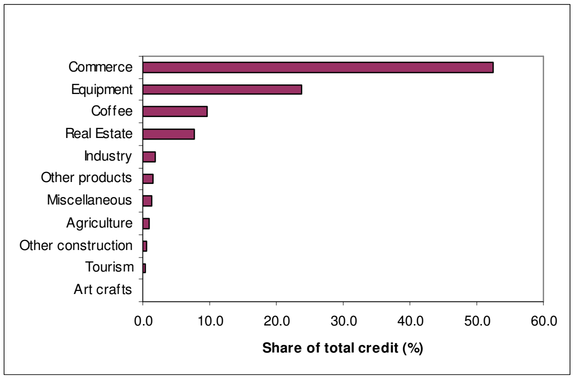
The picture depicted above suggests that there are allocative inefficiencies in the sectoral distribution of credit. These inefficiencies are analyzed from two different perspectives: ex-ante and ex-post analysis. The ex-ante analysis compares the distribution of credit to a pre-determined allocation rule. From this perspective, resources should be allocated to sectors where their marginal effect on development objectives is highest. In the case of Burundi, credit would produce more positive effects on development if it were mainly allocated to agriculture and industry. The ex-post analysis compares the actual distribution of credit to the distribution of an ex-post measure of risk with the assumption that resources should normally go where risk is minimum.

To derive proxy measures of these inefficiencies, two indexes are computed on the basis of the sectoral allocation and term structure of risk. They measure the gap between the actual distribution of credit and the risk-adjusted distribution. If credit were allocated on the basis of the

[17] The actual decline in credit to the private sector was more pronounced than shown by the GDP ratios in figure 2. The reason is that the rates of GDP growth in 1996 and 1997 were negative (-8% and -2%, respectively).

level of risk, the rate of default (amount in default relative to current credit) should be equal to the sector's proportion in total credit. For example, the rate of default in the agriculture sector should be equal to the proportion of credit to agriculture in total credit. The index of allocative inefficiency is the ratio of the two proportions (times 100). If the index is equal to 100, the amount of credit allocated reflects the risk level in the sector. If the index is less than 100, the interpretation is that credit to the sector should be increased. Conversely, an index greater than 100 indicates that the allocation of credit to that sector is inconsistent with the relative level of risk (Figure 9).

Figure 9: Index of sectoral allocative inefficiencies



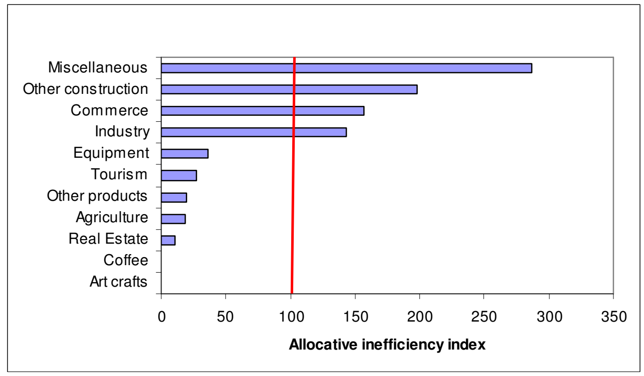


Figure 9 confirms that it is riskier to lend to commercial and industrial activities than to agriculture. With a value of about 20, the allocative inefficiency index in agriculture means that more resources could be invested in the agricultural sector if risk was the key determinant of where credit should go. In contrast, commerce has a value of 157, implying that 57 percent of resources allocated to commerce should be redeployed to other sectors with a lower level of risk.

Why do agriculture and industry in Burundi attract so little credit? The main reason why agriculture attracts little credit from the banking sector is related to the political economy of agriculture development. Burundi's agriculture is dominated by smallholder farmers without political voice to lobby politicians in order to defend farmers' interests (Bates, 1981; Nkurunziza and Ngaruko, 2008). Another reason is the fact that 94.5 percent of all agricultural activities in Burundi take place in the informal sector which is typically cut off from financial services (ISTEEBU, 2008). The lack of collateral and the high cost of loans to infomal economic activities in the rural areas put agriculture at the fringes of the financial sector. Also, the fact that agriculture is mainly rain fed makes it vulnerable to weather shocks. This combined with rudimentary production technologies makes agricultural production uncertain. Therefore, even if banks had the capacity to intervene, they may shy away from financing projects in the agricultural sector due to high uncertainty. Finally, over the last few years, banks have been very profitable so they have no incentive to embrace activities which are perceived to be more uncertain and riskier.[18]

The low proportion of credit to industry can be explained by low profitability in addition to uncertainty. As discussed in section 2, the demand for credit to fund industrial activities is very

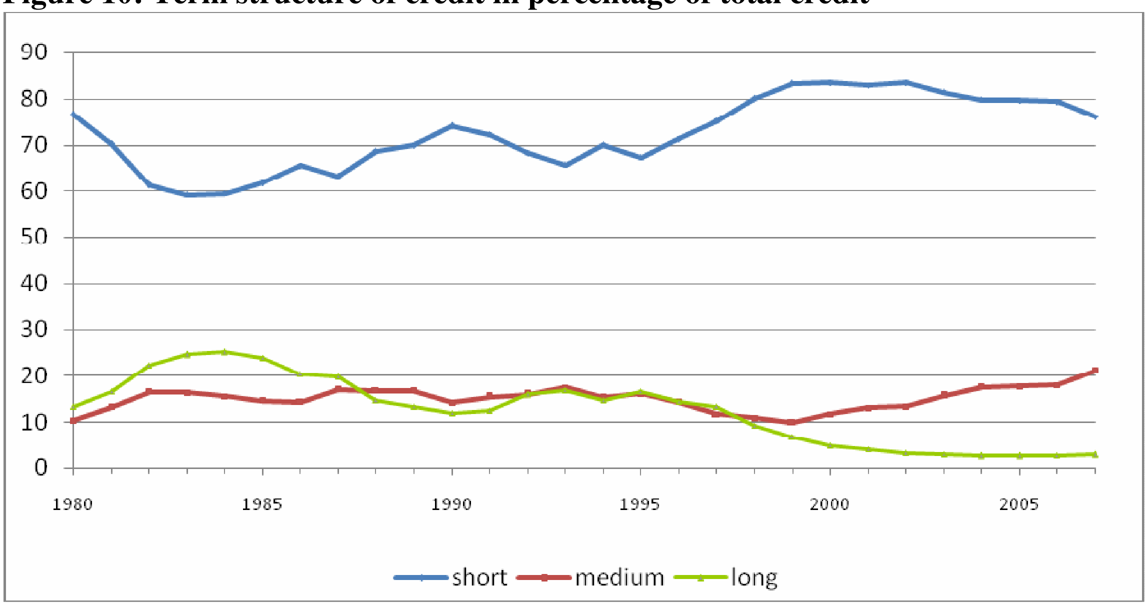
[18] The issue of bank profitability is discussed in some detail later.

low because the investment climate is poor (Table 1). Moreover, as discussed earlier, high transport costs and unreliability of supply routes substantially increase production costs, reducing profitability and the risk-adjusted rates of return on investment. Furthermore, funding industrial activities requires medium to long term loans but banks in Burundi have a strong preference for short-term lending. Hence, the mismatch between the needs of the industrial sector and banks' lending preferences partly explains the low level of credit to the industrial sector.

5.4. Term structure of bank credit

In addition to the lopsided sectoral allocation of credit, its temporal allocation is incompatible with the long-term needs of industry as well as the need to build a basic production infrastructure such as energy generation, transport and communications. The term structure of credit shows that the credit portfolio is by far dominated by short-term credit (Figure 10). The Burundian financial sector does not have the capacity to mobilize $ 4.6 billion needed over the next 20 years to build this infrastructure, as discussed in section 2. Assuming that these investments would be evenly spread over 20 years,[19] $ 230 million would be needed every year. Even if all credit disbursed in 2008 were allocated to the implementation of these infrastructure projects, it would not be enough to cover these needs (see table 2). Adding to this the investments needed to upgrade technologies in the agricultural and industrial sectors to increase their productivity, as well as other needs such as consumer credit, clearly shows that the financial sector in Burundi does not have the capacity to meet the country's development needs.[20]

Figure 10: Term structure of credit in percentage of total credit



Source: Data from BRB, Annual reports.

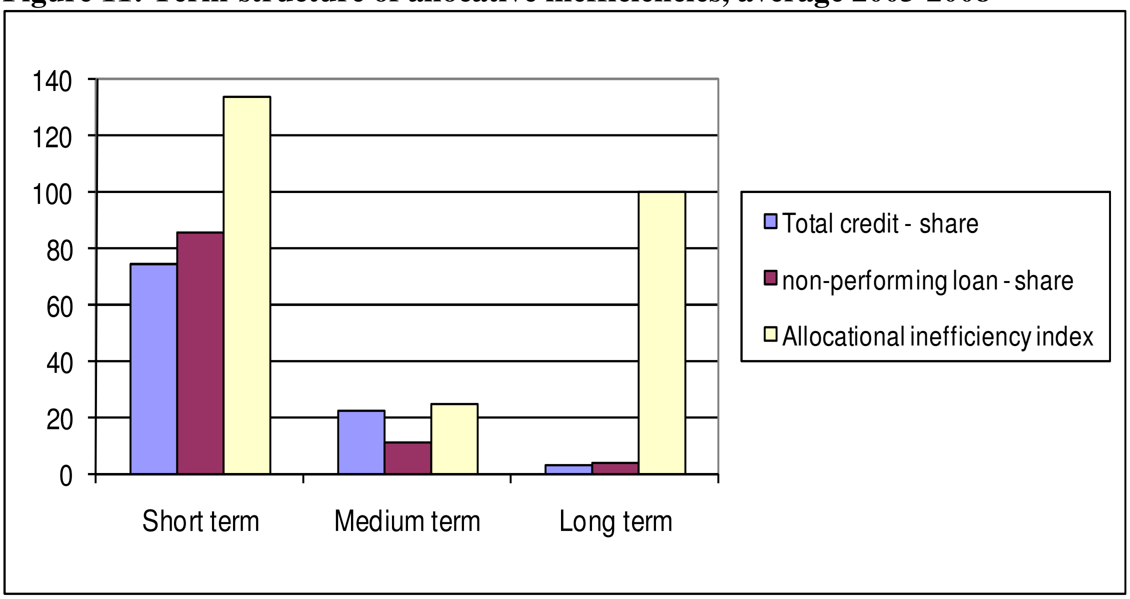
[19] This is a minimalist scenario because a large part of investments of this nature have to be frontloaded.

[20] Another way of illustrating the limited capacity of the financial sector in Burundi to raise the resources required for the country's development is the fact that the volume of gross fixed capital formation is greater than total bank credit. According to IFS data, in 2008, it is 284.9 billion FBu or 101% of total bank credit.

The share of short-term credit steadily increased since the mid-1990s from about 65 percent to over 80 percent for most of the period after 1995. This increase was at the cost of long-term credit. It declined from about 17 percent of total credit in 1995 to less than 3 percent in 2007. Medium-term credit oscillated between 10 percent and 20 percent of total credit over the sample period but the trend has been increasing since 2000 (from 12 percent to 21 percent of total credit). Figure 10 shows that the share of short-term credit shot to its highest values during the war period (1993-2003) with a peak of 83.5 percent in 2002. Most of this increase was in the form of working capital to firms faced with major cash-flow difficulties.

As in the case of sectoral allocative inefficiencies, there also are temporal allocative inefficiencies (Figure 11). Medium-term and long-term credit are considered to be more compatible with the investment needs underlying Burundi's development objectives. The term structure of allocative inefficiencies shows that despite the concentration of banks on short-term credit, these loans are riskier than long-term credit. Medium-term loans account for the lowest share of non-performing loans but only a small proportion of resources are allocated to medium-term credit relative to the risk level. Keeping the risk level constant, medium-term loans should be about five times higher than they currently are.

Figure 11: Term-structure of allocative inefficiencies, average 2003-2008



Why do banks concentrate on short-term loans despite the inefficiencies associated with short-term lending? Banks justify this by the lack of long-term resources in their portfolio. This is correct to some degree. Incentives for saving are weak, as illustrated by low savings interest rates relative to lending rates (Figure 6). However, unavailability of long-term resources does not fully explain the lack of long-term lending because the lending pattern does not reflect the term structure of available resources. According to data from the central bank, between 2003 and 2007, short-term bank loans were 110 percent of short-term deposits per year, on average. In contrast, medium and long-term loans represented only 53 percent of medium-term and long-term savings, each. This is an indication that medium-term and long-term savings are used as short-term loans. As a result, there seems to be a bias against medium and long-term loans.[21]

A combination of factors, discussed below, help explain this bias. First, most of the period under analysis was characterized by extreme political and economic instability translating in high inflation, currency devaluations and high interest rates. The resulting uncertainty and risk prompted financial institutions to be extremely cautious in their lending practices, privileging short-term loans. The effect of political instability on the economy has been amplified by the fact that the state in Burundi is the main economic agent through its ownership of state enterprises; its participation in the equity of financial institutions such as commercial banks and insurance companies, and its power to award contracts and create rents which benefit political elites.[22] The importance of the state to the economy is illustrated by the finding that a ten-percent increase in government spending increases GDP by 2.1 percent (Lim and Rugwabiza, 2009).[23]

Second, the small proportion of long-term lending could be the result of limited demand for such credit due to its high cost. As figure 6 shows, interest rate liberalization in the late 1980s resulted in their steady increase reaching levels that made it almost impossible to borrow and invest profitably. Third, the steady increase of money supply in the context of a shrinking economy over the 1990s and 2000s might have contributed to increasing inflation, discouraging profitable investment and borrowing. The long-run semi-elasticity of inflation to real money in circulation trebled between the pre-war to the war period (Nkurunziza, 2005). Fourth, the industrial organization of the banking sector in Burundi where competition is limited allows financial institutions to extract maximum rents from the public which enables them to be highly profitable without the need to widen their market and take more risk.

Despite these constraints, there are some untapped opportunities for the mobilization of long-term domestic financial resources. If a fraction of the sizable profits of commercial banks (see section 6) and the major private and semi-public companies, which are currently held as cash,

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[21] For further investigation it would be interesting to compare the case of Burundi to other countries with regard to the “transformation ratio”, i.e., MT&LT loans/MT&LT savings.

[22] Until very recently, the state and state-owned enterprises controlled 55.6 percent of BCB and 78 percent of BANCOBU. These are the two oldest banks, the second and third largest commercial banks, respectively, on the basis of their equity capital, deposits and credit allocated. These banks were managed by state appointees who at times behaved more as politicians executing political orders than business managers motivated by the success of their institutions. For example, in 2008, although he had been appointed by the government, the managing director of BCB opposed a government-sponsored deal to sell part of the bank's shares to private investors judging that it was not in the interest of the bank. He was promptly fired. This helps to explain why bank managers have little interest in the long-term viability of their banks. In the worst cases, the lack of political autonomy of management hampers lending decisions and undermines supervision and regulation. This was an important factor in the collapse of several financial institutions (Section 6).

[23]Changes of political leaders always lead to important changes in the private sector because some businesses in the private sector lose the privilege to use the state as a strategic supplier or client. Such changes have been frequent in Burundi: between 1st October 1987 and 11 January 2000, Burundi had an average of one government every nine months, and over the last three years, Burundi has had a new government every six months, on average. This political and economic instability has also destabilized the private sector, making it difficult to predict with some level of certainty the returns on long-term investments and hence reducing incentives for long-term credit.

were pooled to constitute an investment fund, they would provide important long-term investment resources that are currently lacking (Nyamoya and Nkeshimana, 2005). In 2004, for example, the combined profits of the 8 commercial banks, the 2 development banks (BNDE and FPHU), the largest insurance company (SOCABU), and two semi-public companies (BRARUDI and SOSUMO)[24] amounted to 18.8 billion FBu, which represented 15.7% of the country's gross capital formation in that year. If half of these funds were committed to investment, this would increase the country's average gross capital formation from 15.3% of GDP to 23.1%.

6. Performance of the financial sector and access to credit

The analysis of the performance of the financial sector in Burundi presents a contrasting picture. On the one hand, the analysis in section 5 has shown that banks inefficiently allocate their resources to the economy. On the other hand, individual banks are highly profitable. In fact, commercial banks' choice to concentrate resources on one segment of economic activity, namely commerce, is probably the reason why they are so profitable. The first part in this section discusses the profitability of banks. The second argues that the high profitability coexists with a high level of fragility of the banking system. The last part discusses the challenge of accessing credit in Burundi.

6.1. Banking profitability

The banking sector in Burundi is highly profitable by standard measures of return to investment. The average return on equity ratio stands at 19.4 percent, with returns as high as 53 percent for BANCOBU and 39 percent for BCB (Table 6). This high performance does not reflect the fundamentals in the real economy as indicated by the low economic growth rate (Figure 1). The high performance is even more surprising given the inadequate management of the financial sector and the often disruptive state intervention in the management of banks. In fact, it is more appropriate to say that the banking sector remains highly profitable despite serious institutional and structural challenges. The question is, therefore, what explains the high performance of financial sector intermediaries as business firms?

[24] SOCABU = Société d'Assurance du Burundi (an insurance company); BRARUDI = Brasserie et Limonaderie du Burundi (a brewery); SOSUMO = Société Sucrière du Moso (a sugar production and processing company)

Table 6: Performance indicators of the banking sector, 2008[25]

Bank	Credit/Deposits (1)	Equity (2)	Net profit (3)	% ROE (4)	# Accounts (5)
BBCI	99	4,690	796	11.2	28,900
BANCOBU	72	6,413	4,171	52.7	19,563
BCB	61	8,816	3,401	38.9	26,199
BGF	89	3,433	151	21.4*	13,632
FINBANK	74	3,757	1,173	24.2	1,041
IBB	61	12,404	3,265*	26.3*	40,000
SBF	76	783	-87	-2.2	1,154
BNDE	NA	6,900	513	7.4*	0
FPHU	NA	5,150	636	12.3*	0
Total/Average	**67**	**52,346**	**10,161**	**19.4**	**130,489**

Source: Data communicated by individual banks.
Notes: BBCI = Banque Burundaise pour le Commerce et l'Investissement; BANCOBU = Banque Commerciale du Burundi; BCB = Banque de Crédit de Bujumbura; BGF = Banque de Gestion et de Financement; Finbank = Finalease Bank; IBB = Inter Bank Burundi; SBF = Société Burundaise de Financement; BNDE = Banque Nationale pour le Développement Économique; FPHU = Fonds de Promotion de l'Habitat Urbain.
(1) is the ratio of total credit to total deposits; (2) is the amount of equity capital in millions of Burundi francs; (3) is the amount of net profits in millions of Burundi francs; (4) is the return on equity, which is the ratio of (3)/(2); (5) is the number of accounts opened in each bank. Note that BNDE and FPHU have neither branches nor accounts; they are not commercial banks so do not take deposits from clients.
All the numbers with a star are for 2007.

High profitability of financial intermediaries in Burundi may be explained by several factors. The first is the oligopolistic nature of the banking sector and its resulting rent-extraction. Three commercial banks control the banking sector in Burundi. As earlier noted, taken together, BANCOBU, BCB and IBB accounted for 75.5 percent of total deposits and 74 percent of total credit in 2008.[26] They have implicitly divided up the market so they do not need to compete to attract clients. If there was competition, some banks would charge lower interest rates and fees and register lower but still comfortable profits. Banks extract rents from their clients through high lending interest rates and charges as well as low savings rates.[27] Banks use their clients'

[25] It is more likely that the figures on profitability are underestimates as banks may feel uneasy communicating the true figures which might indicate the extent of their rent extraction. This hypothesis is confirmed by an IMF-World Bank (2009) study which calculated, on the basis of more accurate data, an average return to equity of 33.15 percent in 2008.

[26] The case of Inter Bank Burundi (IBB) is interesting. It is the youngest of the three largest banks (created in 1992, several decades after the oldest two banks were created) but has outperformed its older peers in terms of equity capital, savings and credit. This is the result of its good management. The bank is fully privately owned by Burundi-based shareholders, unlike the other two banks which until recently were largely state controlled.

[27] A personal interview with an important shareholder of a financial institution revealed that, for example, the production cost of a cheque book is about BIF 400-500 but banks sell it for BIF 4,500. This is an important source of revenue for banks with a relatively large number of customers such as IBB, BBCI, BCB and BANCOBU.

deposits and savings, which are poorly remunerated, to lend at very high rates which do not reflect the cost of these funds. On average the cost of funds to banks declined from 4.8 percent to 2.8 percent between 2005 and 2008.[28] This low cost is mainly due to the fact that banks do not pay interest on short-term deposits, which represent more than 50 percent of total deposits from clients (IMF and World Bank, 2009). In contrast, lending rates are very high (see figure 6) even though they have declined over the last few years to reach 17 percent in 2008. The question is whether the large interest rate spreads reflect the actual level of risk banks are exposed to or whether, owing to the lack of competition, the spreads comprise a rent component.

Detailed account-level data on the credit portfolio of one of the three largest banks covering the period from January 2004 to August 2009, illustrates how the rents extracted from their clients are allocated to bank employees through the very low interest rates they enjoy on their loans. The average interest rate on short-term loans to bank employees is only 6 percent, one-third of the average interest rate of 19 percent used for external clients. The difference in interest rates paid by the two groups is even larger for medium term loans. Bank employees pay only 4 percent interest rate or almost one-fifth of the 19 percent interest rate paid by external clients for similar loans. Cheap credit encourages bank employees to borrow. Although they represent a small number relative to the client base (the largest bank employs only about 350 persons), out of 6,182 total loans accorded, employees accounted for 17.5 percent of this number. The lack of competition among financial institutions makes banks and their employees the main beneficiaries of the resources extracted from the public.[29]

High ROEs are also a reflection of the under-capitalization of commercial banks. Until very recently, the banking law had very modest minimum capital requirements for the licensing of commercial banks. Until the late 1990s, the minimum capital was set at BIF 300 million, which at the time represented less than half a million dollars. In 2004, banks' minimum capital oscillated around US$ 1 million. For new banks, only one-third of this amount had to be paid up before the bank could operate allowing shareholders to start collecting deposits and savings from the public and engage in lending activities. In 2006, the central bank mandated trebling of the minimum capital over a two-year period. By 31 December 2008, all commercial banks were required to have a minimum capital of US$ 2.8 million (BRB, 2006). The most recent requirements are that commercial banks will need to have a minimum capital of BIF 5 billion (about $ 4 million) by 31 December 2009 and BIF 10 billion (about $ 8 million) by 31 December 2010. By 31 December 2008, all commercial banks had complied with the new capital requirements. It is highly likely that the increase in minimum equity capital will reduce the banks' returns on equity because profits are not expected to increase in the same proportion as capital.

The high level of profitability combined with the new equity capital requirements have contributed to attracting foreign banks to Burundi. In order to respond to the central bank's

[28] This cost is the ratio between total interests collected by the banking sector and total deposits by clients as well as interbank deposits.

[29] The Minister of Finance acknowledged before the country's senate that the cartelization of commercial banking in Burundi is one of the reasons why interest rates are so high. In this particular setting, the Minister did not offer any government plan to address the cartelization problem. She rather suggested that the promotion of microfinance, regional integration and more political stability are likely to force banks to reduce their lending rates (see http://www.senat.bi/spip.php?article1122).

requirement for higher capital, a number of domestic ailing banks have been forced to seek external investors and partnerships with stronger African banks. In 2008, SBF was saved by ECOBANK, a West African multinational bank with operations in about 25 African countries. Finalease Bank, another bank facing difficulties, was acquired by the Nigeria-based Access Bank Plc.

Other investors were attracted by the potential of making high profits. In 2009, Diamond Trust Bank (DTB), an East African bank belonging to the Aga Khan Group, entered the Burundi banking sector. Moreover, Bank of Africa, another successful West African bank, has acquired shares in the capital of BCB, one of Burundi's most solid banks. Other foreign banks are considering opening branches in Burundi or participating in joint ventures with existing banks. They include Kenya Commercial Bank (KCB), Union Bank of Nigeria (UBA), FINABANK of Kenya, Barclays Bank of the United Kingdom and Actis, a private equity investor in emerging economies (Lienart, 2010). Burundi is currently going through the most important transformation of its banking industry. For example, ATMs have been introduced for the first time. Over time, opening the market to external banks will create opportunities for innovation which will improve financial efficiency and increase financial deepening. It is expected that new payments products such as mobile banking will be introduced; there will be higher use of ICT in banking operations (including internet banking); and new savings/investment instruments such as equity funds which are missing now in Burundi will emerge.

Another important development that is having a profound effect on Burundi's financial sector is the country's recent entry into the East African Community (EAC). The Burundian central bank is aware that as the East African regional market opens up, the country's banks will have to strengthen their capital base and improve efficiency if they are to survive competition from more solid financial institutions within the region. Several regional banks have seized this opportunity to diversify their market by establishing branches in Burundi (e.g. Diamond Trust Bank) or by participating in the capital of local banks, including the healthy ones such as BCB. The recent decline in lending interest rates on short term credit (Figure 6) could be the result of this new competition.

6.2. Financial sector fragility and risk of bank failures

The positive developments highlighted in the previous section, particularly the high returns on equity, hide a serious problem of fragility of Burundi's financial system due to three main factors: (i) undercapitalization of banks; (ii) state involvement and mismanagement; and (iii) concentration of banks' credit portfolios.

6.2.1. Undercapitalization of financial institutions

Commercial banks capital increases constitute a positive development in the interest of the stability of the banking sector. High equity capital makes banks more resilient when affected by short-term shocks. Properly capitalized banks are also more able to credibly engage in long-term relationships with their clients and partners; this is very important given the central importance of reputation for financial institutions. On the other hand, undercapitalized banks run the risk of insolvency, which, when it occurs, has far reaching effects on the credibility of the financial system as a whole. In Burundi low capital requirements have enabled a small group of shareholders to extract rents from the public while limiting their involvement in activities with a strong impact on economic development.

Undercapitalization of the financial system in Burundi affected banking in two ways. First, it limited banks' lending capacity, particularly credit to large clients. Indeed, central bank regulations require that credit to one client should never exceed 20 percent of a bank's capital (BRB, 2003). Second, the low level of capital combined with bad lending resulted in insolvency of several financial institutions, leading to their failure.[30] In this light, monetary authorities should carefully watch banks' practices particularly if the recent increases in profitability from a return on equity of 9.9 percent in December 2004 to 29.4 percent by November 2008 are due to increases in credit disbursements. If the new competition is pushing banks to give more credit, commercial banks will need to consider increasing provisions for bad loans beyond the legal minimum just in case these loans became non-performing (IMF and World Bank, 2009).

6.2.2. Political pressure, mismanagement and weak central bank have led to the collapse of several financial institutions

Traditionally, the state and public sector entities have been directly involved in the creation and management of financial institutions (Chrétien and Mukuri, 2002). For example, the state and its affiliated public institutions had a controlling share in BANCOBU, BBCI, BCB, Banque Populaire, CAMOFI, SBF, etc. The dominance of state institutions gave them the power to nominate the managers as political appointees, who often had little managerial experience and were accountable to their political backers rather than the bank shareholders. Poor management caused several of these institutions to collapse. We briefly discuss five cases.

Caisse d'épargne du Burundi (CADEBU) was created in 1964 as a fully state-owned financial institution whose main role was to mobilize financial resources and allocate them to the economy through low interest rate credit. CADEBU had the monopoly over the collection of mandatory savings from public sector workers. In turn, these funds were used as low-interest loans to businesses and the public. Given the relatively low interest rates attached to CADEBU loans, securing credit there was a privilege. This gave leverage to CADEBU managers who at times extended credit to less deserving applicants while denying it to more promising projects either as a result of their own abuse of authority or political pressure. With the liberalization of the financial sector in the late 1980s, CADEBU lost some of its traditional privileges. Competition and bad management led to its collapse in 1992.

Caisse de mobilisation et de financement (CAMOFI) was created in 1977 as a fully state-controlled development bank providing funding for medium and long term projects. Its equity capital was BIF 200 million but it was so poorly managed that it never made substantial profits. In 1997, for example, its losses before subsidies amounted to BIF 560 million (IMF, 2000), almost three times its equity capital. Accumulated debt by CAMOFI resulted in its voluntary liquidation despite several attempts by the central bank to save it through injections of cash. The firm's poor management by a prominent politician, a former prime minister, led to its collapse in November 1998 with debts amounting to 5 times its equity.

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[30] Since the 1990s, five financial institutions have collapsed. They are: Meridien Bank Burundi (MBB), *Caisse d'épargne du Burundi (*CADEBU), *Caisse de mobilisation et de financement* (CAMOFI), *Banque de commerce et de développement* (BCD) and Banque Populaire du Burundi (BPB).

The failure of CADEBU and CAMOFI was mainly the result of bad management. The ruling elites perceived them as important sources of rents and managed them accordingly, as was the case with other state enterprises.[31] It is likely that the failure of these two institutions benefited their managers and their friends, as well as a few politically-connected people who had been given important loans.[32] It is even possible that this group of influential people could have helped these institutions to collapse in order to ensure that the loans they had contracted would never be paid back. Almost 20 years after the collapse of CADEBU, its liquidation process is ongoing. While very little success has been achieved in terms of recovering loans from CADEBU debtors, its liquidators were quick to repossess other assets, particularly real estate, which were hastily sold in obscure circumstances. The political economy of financial sector management in Burundi requires a deeper analysis beyond the scope of the current project.

Meridien Bank Burundi (MBB) was created on the 1st of August 1988 as a limited liability company but with some public shareholders. It was a subsidiary branch of Meridien-BIAO, a continental network of banks with headquarters in Zambia and spanning the African continent with branches in Burkina Faso, Burundi, Cameroon, Gabon, Gambia, Ghana, Kenya, Niger, Sierra Leone, Swaziland, Tanzania and Togo. MBB's initial capital was BIF 800 million but this amount was reduced to BIF 506.31 million in 1994 when the bank faced a severe liquidity shortage. MBB was finally put into receivership by the central bank on 3 May 1995. External auditors called in to probe the bank's financial position discovered a serious level of mismanagement, both inside MBB and within the Meridien-BIAO network. For example, even though MBB's management was flawed, the main cause of its collapse was a liquidity crisis following the failure of the parent company to pay back a large loan it had contracted from MBB. Meridien-BIAO had adopted a practice of financing its investments using large inter-group loans, with no clear repayment modalities. The pan-African bank eventually collapsed. Among the different unverified theories on the reasons of this failure is sabotage from Western banks which had traditionally controlled the African market. Even if this had been the case, it is clear that the poor management of the network played an important role in precipitating the failure of all its subsidiaries (see Wright, 1995).

Banque de commerce et de développement (BCD) was created on 14 January 1999 as a limited liability company with a capital of BIF 1.016 billion. Paradoxically, the bank's CEO was the same politician who had led CAMOFI to failure. His appointment was in flagrant violation of Article 17 of the banking law which stipulates that a person cannot be allowed to manage a bank if he (she) has played a key role in a company which, under his (her) leadership, was declared bankrupt. This, clearly, should have applied to CAMOFI's former CEO given that the company under his direction had collapsed just two months earlier. This exceptional treatment was not unrelated to the fact that the individual was a highly influential political figure who could not be bothered by central bank regulations. This example illustrated the lack of independence of the central bank and its weakness in upholding the law governing banking in Burundi. Expectedly,

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[31] Nkurunziza and Ngaruko (2008) explain some of the modalities used by political elites to extract rents from state enterprises, a process which in most cases led to their collapse.

[32] In her communication on 10 October 2003, the first deputy governor of the central bank acknowledged that CADEBU and CAMOFI collapsed as a result of "gestion laxiste" or lax management, a diplomatic term meaning that they were plundered.

BCD was very badly managed. The bank lasted only four years and its problems appeared well before it went bankrupt. An audit report established that by 23 March 2004, date on which the central bank finally acted to put BCD under receivership after a long period of inaction despite warnings that the bank was collapsing, there were severe problems that would be difficult to address in order to let the bank continue operating. For example, to continue its operations, the bank needed to raise BIF 7.5 billion through recapitalization, loan recovery, sale of assets, etc. It was impossible to raise this amount in a relatively short period because BCD was known to be poorly managed. The audit report also uncovered several cases of fraud that give a glimpse of the internal management of the bank. For example, there was reference to advances of BIF 3.185 billion made to purchase a plot to build a branch in Quartier Buyenzi, one of the poorest neighborhoods in Bujumbura. Not only is this amount excessively high but also the plot was never bought. The advances had not been recovered by the time the bank collapsed.

Banque populaire du Burundi (BPB) was established in 1992 largely with public funds through several public institutions, including the national pension fund, and the state which contributed 15 percent of equity capital. Just three years after its creation, the bank was rumored to be collapsing due to mismanagement. The government responded by appointing a professional banker as its new head. BPB was back on its feet but it eventually collapsed in 2006 when the central bank judged that BPB had failed to recover 40 percent of its loans representing BIF 4 billion, leaving the institution in a state of extreme fragility. The central bank launched an inquiry to determine if BPB's failure was the result of mismanagement or corporate malpractices. The results of this inquiry have never been made public.

One constant factor linking all the five cases reviewed above is the failure of the central bank to play its surveillance role and make prompt interventions whenever problems were detected. With respect to BCD, for example, according to interviews with central bank officials, the central bank had information that the bank was in a very bad financial situation and that it should have been ordered to stop its activities at least one year before the central bank's intervention. It appears that there were instructions from the highest political authorities ordering the central bank not to intervene.

In addition to the lack of independence, the central bank left loopholes in monetary policy that were exploited by commercial banks to increase their profits. For example, as discussed earlier (Section 3), the central bank relies on liquidity management as the main tool of monetary policy used to control inflation. Under normal circumstances, it supplies liquidity to banks that are in need of extra funds and takes liquidity from those that have excess cash. Between 2001 and 2003, commercial banks borrowed from the central bank at 14 percent, 15.5 percent and 14.5 percent interest rates, respectively. They reinvested these funds into treasury bills issued by the same central bank and earned interest rates of 19 percent, 20 percent and 16 percent, respectively. Hence, commercial banks used public resources to lend to the government, making up to 5 percentage points of net interest in the process. This was not illegal at the time because the central bank had not excluded commercial banks in debt to participate in the treasury bills market. The anomaly was eventually corrected.

6.2.3. Credit concentration

The information in table 7, based on account-level data of one of the three major commercial banks, illustrates how banks compete to capture the biggest clients, even when this exposes them to high risk. For example, one account had a loan of BIF one billion on 27 October 2008, then 2 billion on 24 November 2008, and 3 billion on 25 May 2009. This latter amount represented half of the bank's equity capital. Out of 6180 loan contracts totaling BIF 69.8 billion over the period from January 2004 to August 2009, there were 132 loans of BIF 100 million or higher. These loans represented 60 percent of total bank credit and they were held by only 62 accounts.[33]

Table 7: Characteristics of loans to different groups (amounts in Burundi francs)

	ST external	Employees	MT external	Others
Maximum amount	778,000,000	120,000,000	3,000,000,000	700,000,000
Minimum amount	68,867	6,390	508,146	200,000
Mean amount	4,253,439	4,604,983	104,000,000	55,900,000
Median amount	1,500,000	1,500,000	30,100,000	14,800,000
Median interest rate (%)	19	4	19	19
Median monthly payment	138,235	37,383	1,107,011	655,312
Loan duration (months)	12	48	36	24
Median grace period (months)	1	1	1	1
Average default rate (%)	14.5	0.3	17.6	17.9
Number of observations	4,598	1,078	359	145

Source: Computed by the authors based on data provided by one major commercial bank
Note: ST and MT outside refer to short-term and medium-term credit to outside clients, respectively.

Resilience tests of the banking sector based on 2008 (November) data show a relatively high fragility of the banking sector due to credit concentration. According to the data, a decline in the quality of debts owed by the five largest debtors of the banking sector could reduce the solvency ratios of 4 out of 7 commercial banks below the legal minimum (IMF and World Bank, 2009). That five debtors could have such an important destabilizing effect on a country's banking sector is a clear indication of its fragility. Indeed, as summarized in the previous discussion of bank failures in Burundi, the high concentration of loans on a few clients, often without requiring proper collateral, has been at the root of bank fragility in Burundi. The failure of the banks and other financial institutions discussed earlier was mostly the result of bad lending to "large" and politically connected clients.

6.3. The challenge of accessing credit in Burundi

Despite some recent positive developments in the banking industry such as competition and the introduction of new technologies, access to credit remains a major challenge for the majority of people and firms in Burundi. With less than 2 accounts per 100 persons,[34] Burundi has an extremely low rate of bank penetration. As developed earlier, the banking sector in Burundi is narrowly focused on a small urban elite and business community, which together represent a tiny proportion of the population. By the end of 2008, only 7 of the 73 bank branches were located in

[33] Several accounts had more than one loan over the period.
[34] The number of accounts is from table 6 and the data on population size from WDI.

rural areas. Most of the branches in urban centers were in Bujumbura, with the remainder located at provincial capitals. Until recently, there were provinces without any bank presence.

Table 7 provides detailed information on the distribution of credit in 4 main categories. Seventy-four percent of all credit contracts are short term loans to external clients confirming the discussions in section 5 relating to banks' preference for short-term loans. Only 6 percent of credit is in the form of medium-term loans to external clients which is insufficient to fund the necessary investments that are needed to increase the rate of growth. Seventeen percent of credit is allocated to bank employees (short, medium and long term credit). The remainder (2.5 percent) is an aggregation of different types of loans, including housing and furniture loans, loans to unidentified clients, etc. The information in table 7 also shows that most Burundians cannot rely on the financial sector to help them undertake important projects given their weak purchasing power and the high cost of credit. The deterioration of borrowers' purchasing power following persistently high inflation combined with the stagnation of nominal wages keeps most Burundians out of reach of bank lending. The earlier example of the inability of a couple of graduates to service a 15-year mortgage for a relatively small house illustrates that only a small group can afford borrowing from the banking sector.

Related to the declining purchasing power is the fact that a sizable portion of the population is in an income bracket which is not serviceable by either the banking sector or microfinance. Whereas the low extreme of the income distribution can rely on the informal and semi-formal credit institutions, and the highest end of the distribution on the formal banking sector, the needs of those in the income bracket in the lower middle are too high for the informal sector and too low to be of interest to the formal sector. Taking again the example of mortgage payment, the income level of the couple does not allow it to borrow and service the median loan of BIF 1,500,000 in one year at 19 percent interest rate. On the other hand, microfinance institutions' average loan of BIF 244,238 is probably too little to be of any help to this couple. Using these two indicators, we may conjecture that people seeking loans between BIF 250,000 and BIF 1,500,000 face a particular handicap in the financial market. Hence the "stranded middle" representing middle-income households and medium size firms remains underserved due to the "missing middle" in the credit market.

The analysis of credit records also suggests that by extracting maximum rents from the public, commercial banks' lending strategies are partly to blame for the high interest rates on loans and hence the narrow market for credit. Banks should not be allowed to grant loans to their employees at 4 percent interest rate when they require 19 percent from external borrowers. It is even more surprising that 22 "personal loans", many of them in hundreds of millions Burundi francs, were accorded at zero interest rate. These findings suggest that interest rates charged to external borrowers are deliberately set high to partly finance lending to internal borrowers and other special borrowers who borrow at zero interest rate. It is the responsibility of the central bank to prevent these anomalies through its supervisory and regulatory role.

7. Conclusion

The objective of this paper was to study the financial system in Burundi and identify its inefficiency in mobilizing and allocating financial resources within the economy. Analyzing the relationship between the financial sector and the real economy in Burundi helps to shed some light on some of the bottlenecks preventing the country from reaching higher levels of economic growth as illustrated by the sluggish and highly volatile growth rates recorded over the years. Access to financial services encourages investment and enterprise development, which in turn fosters economic growth. Hence, in Burundi where most economic agents, particularly firms and households, do not have access to financial services, their contribution to economic growth remains below their potential.

The study showed that the financial system in Burundi is very shallow and highly concentrated. Three traditional commercial banks, namely BANCOBU, BCB and MBB together represent at least three-quarters of total bank assets, credit, and deposits and savings. The lack of competition in Burundi's banking landscape has prevented the sector from modernizing and offering products that reflect the needs of the market. For example, lending interest rates are so high that investors find it difficult to borrow and invest profitably. But even if investors were able to pay the current rates, the investment climate is so difficult that profitable investment projects are very limited. Indeed, within the East African community, Burundi not only has the highest proportion of firms identifying access to credit as a major constraint but also the highest level of policy uncertainty. Demand for credit is also limited by the low and deteriorating purchasing power of the population. Therefore, the financial market in Burundi is constrained by both the demand for and supply of credit. This helps to explain why credit rationing coexists with banks' excess liquidity.

The concentration of bank lending on short-term activities, particularly trading, penalizes the economy given that agriculture and industry, the two sectors with the highest growth potential but requiring medium to long-term credit, are out of the credit market. Moreover, the study finds that credit allocation is subject to three forms of inefficiencies. First, relative to other African countries a large proportion of credit is allocated to the government despite its inherent inefficiencies in Burundi. Second, less than one percent of total credit goes to agriculture, the backbone of Burundi's economy that has been identified as a development priority. This is problematic in a country where agriculture is the most important economic sector. Third, credit is not allocated according to the distribution of risk which appears to be contrary to the basic principle of modern portfolio theory. Commerce has among the highest levels of default risk; yet the sector has the largest share of credit. In the same connection, credit defaults are highest with short-term credit but the bulk of lending is short-term. One of the reasons why banks do not diversify their credit portfolios is that they have so far been very profitable so they do not feel the need to change their lending strategies.

In addition to the industrial organization of the financial sector, several other factors help to explain these inefficiencies. First, Burundi has been characterized by high political and economic volatility which has created high uncertainty that discouraged long-term credit and investment. Second, the fact that the state in Burundi has traditionally owned important shares in the capital of almost all financial institutions has given it remarkable influence in the management of these institutions. Considering the rent seeking nature of the state in Burundi, some of the failings of the country's financial institutions may be directly attributed to the involvement of the state in the financial sector. Third, the country's central bank has often failed to play its supervisory role to ensure the stability of the financial system. This failure has been either due to state interference, the limited instruments for intervention available to the central bank, or the limited technical capacity to deal with the challenges of financial sector supervision in a changing international environment. One of the consequences has been a succession of financial institutions failures over the years. Even the current banks are quite fragile, despite their high profitability. Credit and deposits are so concentrated on a few clients and very few activities that in the event of economic or political shocks to the economy, the whole banking sector could be seriously affected.[35]

Despite the serious challenges facing the financial system in Burundi, there are some positive developments that will contribute to defining the future of the sector. First, the central bank has realized that Burundian banks were overly undercapitalized and it decided to gradually raise the required equity capital. Since 2004, the minimum required capital has been increased eightfold. The second positive development has been the opening of the financial sector to regional banks. The traditional banks in Burundi never faced real competition until recently in 2007 when the country joined the East African Community. Burundian banks have to adapt to this new reality if they are to compete with more established financial institutions, particularly from Kenya. In this regard, the entry of new banks such as Diamond Trust Bank and Bank of Africa, as well as the large number of other banks considering entry into the Burundian market, are going to transform the financial sector in Burundi.

The third positive factor is the development of microfinance. In terms of coverage, microfinance has outperformed the traditional banking sector by a factor of three to one. This is remarkable particularly in view of the fact that microfinance is a relatively new phenomenon in Burundi. Even though microfinance accords small loans relative to the banking sector, it is in a better position to address the needs of a large market segment which is not covered by the traditional banking sector. This has opened up opportunities for entrepreneurship particularly in rural areas. Over time, some microfinance institutions could grow and start competing with well established banks which will benefit those in need of financial services. Alternatively, some microfinance institutions could become so important that traditional banks will seek partnerships with them to cover a larger and diversified market, including the currently "stranded middle" whose financial needs are beyond the capacity of microfinance but also too small to be of interest to traditional banks. Either way, the financial sector will contribute more to the economy if it is more diversified. Already, the introduction of ATMs in 2009 and the decline of bank interest rates from 22% in 2005 to 17 percent in 2008 could be considered as a result of this diversification. It is expected that as the number of financial institutions increases, new savings and investment instruments such as equity funds will be introduced and competition will drive these institutions towards adopting new, cheap and more efficient banking methods, including mobile banking.

[35] Rwanda, a neighboring country, is just recovering from such a shock. According to interviews with Rwandan banking officials, the Rwandan banking system was on the verge of collapse when a few clients withdrew their deposits and savings from the system to buy Safaricom stocks on the Kenyan stock exchange. As a result, liquidity was so low that banks decided to ration the amount that could be withdrawn. The experience has left the reputation of the banking sector dented.

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