



## **CAPE VERDE, NAMIBIA, AND KINGDOM OF SWAZILAND**

September 2013

### **SELECTED ISSUES PAPER ON THE CHALLENGES OF SMALL MIDDLE-INCOME COUNTRIES IN SUB-SAHARAN AFRICA**

This selected issues paper on Cape Verde, Namibia, and Kingdom of Swaziland was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member countries. It is based on the information available at the time it was completed on January 23, 2013. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the governments of Cape Verde, Namibia, and Kingdom of Swaziland or the Executive Board of the IMF.

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January 23, 2013

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#### KEY POINTS

Small middle-income countries (MICs) in sub-Saharan Africa (SSA) share broadly similar policy challenges. A cross-country clustered look should provide an opportunity to discuss the common policy challenges facing them and to facilitate peer learning.

Thus, this background paper associated with the 2012 Article IV consultations with Cape Verde, Namibia and Kingdom of Swaziland (hereinafter "Swaziland") summarizes the analytic underpinnings that support the staff's advice on policies to strengthen macroeconomic stability, foster more inclusive growth, and enhance the resilience of their financial systems.

Among the key policy lessons for small MICs in SSA that could be drawn from the analytic work in this background paper are the following:

- Macroeconomic policies should aim to rebuild policy buffers to help cushion against large external shocks especially given the prevalence of pegged exchange rate regimes in these economies.
- Although growth has continued to benefit majority of their populations, it has become less inclusive in recent years. Policies that target income inequalities at their sources have the potential to lead to significant gains in terms of increasing the duration of growth spells. Small MICs cannot grow their way out of their enormous unemployment challenge; putting a significant dent on their high level of unemployment would require carefully designed structural and wage policies.
- Financial sector policies need to be cognizant of the concentration risks for banks, regulatory risks for nonbanks given weaknesses in their supervisory frameworks, and potential vulnerabilities owing to cross-linkages between banks and nonbanks.

Approved By  
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## EXECUTIVE SUMMARY<sup>1</sup>

This background paper associated with the 2012 Article IV consultations with Cape Verde, Namibia and Swaziland aims to highlight the policy commonalities and the potential for synergy among the small middle-income countries (MICs) in sub-Saharan Africa (SSA). The paper distills the key lessons that can be drawn from the critical common policy challenges facing these economies with a view to strengthen Fund policy advice and make it more focused and issues oriented.

The economy of a small MIC in sub-Saharan Africa (SSA) is often characterized by the following features: (i) low population (ii) per capita income in the range of \$3000–\$10,000 (PPP basis); (iii) somewhat undiversified; and (iv) structural and institutional weaknesses that often resemble those of low-income countries (LICs). Beyond the narrow criteria of per capita income level, there are a number of areas including macroeconomic policy implementation capacity, where small MICs in SSA are a lot stronger than the low-income countries in the region and are in fact closer to large MICs elsewhere.

This selected issues paper has three chapters:

**Chapter I. Macroeconomic Vulnerability in small Middle-Income Countries in SSA—Reserve Adequacy and Fiscal Policy:** This chapter asks the question of whether the level of international reserves is adequate for these economies to withstand large shocks especially given that most of them used part of their policy buffers during the 2008–09 global financial crisis. Using self-insurance models, the analysis finds that international reserves held by the some of the MICs are broadly adequate to smooth large shocks. However, in Cape Verde and Namibia, both with pegged exchange rate regimes, reserves remain either too close to or below adequate levels suggesting the need for further fiscal consolidation over the medium-term as emphasized in their bilateral consultations reports.

**Chapter II. Enhancing Inclusive Growth and Employment in Small MICs:** Despite their positive growth record over the last few decades, the benefits of this strong growth have not been evenly shared across the population. Trend growth in many small MICs in SSA has also generally declined in recent years, while unemployment remains high. A key policy lesson drawn from this analysis is that reducing income inequalities has the potential to lead to significant gains in terms of increasing the duration of growth spells in small MICs. Moreover, policies that lead to a more sustained reduction in structural unemployment would also help to enhance more inclusive growth.

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<sup>1</sup> While this is a background paper that accompanies the 2012 Article IV consultations for Cape Verde, Namibia and Swaziland, the results of the cross-country analysis employed in the paper are applicable to other small MICs in SSA and could generate peer learning among these countries. Although this is not a homogenous group of countries given their idiosyncratic features, they do share a few critical common policy challenges among themselves.

**Chapter III. Financial Stability Issues in Small MICs:** While these MICs in SSA have relatively more developed financial systems compared with LICs in the region, they are still challenged by lingering financial sector vulnerabilities, most notably concentration risks for the banking sector. Specifically, Cape Verde's banking system has a sizable component of emigrant deposits and Namibia's banking system is highly exposed to the property market. Beyond this, the financial landscape in many of these economies is changing rapidly with nonbank financial institutions becoming a dominant part of the financial system, while their supervisory and regulatory frameworks lag behind. The interplay of concentration and regulatory risks is a key source of potential vulnerability to financial stability in small MICs given the cross-linkages between the banking and the non-banking system.

# I. MACROECONOMIC VULNERABILITY IN SMALL MIDDLE-INCOME COUNTRIES IN SUB-SAHARAN AFRICA—RESERVE ADEQUACY AND FISCAL POLICY<sup>1</sup>

## A. Introduction

**1. The turbulence in global markets in the last few years underscores the importance of reassessing the adequacy of international reserves, including for small middle-income countries (MICs) in SSA.** Many of them tend to be much more susceptible to global shocks and outward spillovers given their less diversified economies, open capital accounts, and lower fiscal policy buffers (Figure 1). Reflecting the fixed costs of operating an independent monetary policy or weaker monetary transmission mechanisms in small MICs, they have mostly opted for intermediate regimes, soft or hard pegs, and therefore do not have domestic policy levers beyond fiscal policy to react counter-cyclically to shocks.<sup>2</sup> Without the buffer of nominal exchange rate flexibility, and given their higher exposure to macroeconomic volatility, maintaining adequate reserves is of particular importance in small MICs. At the same time, some of the small MICs are also working on closing their infrastructure gaps and are grappling with the best practice macroeconomic and fiscal policy framework to help address this challenge, while preserving macroeconomic stability. How to address this issue with a less-than-adequate level of reserve coverage in a pegged exchange-rate regime, amidst the current fragile global environment, is a key policy challenge.<sup>3</sup>

**2. In the last decade, reserves of MICs in SSA increased five times in dollar terms.** The desire of countries to hold more reserves is driven by the important role of reserves in both preventing crises and mitigating their impact. However, holding reserves is costly and the utility of reserves has diminishing returns. It is important to strike a balance between reserves' crises prevention and the mitigation feature and their cost.

**3. This chapter has applied a new framework, developed by the IMF, to determine the adequacy of reserves for selected MICs in SSA.**<sup>4</sup> Using self-insurance models, the analysis finds that international reserves held by the some of the MICs are broadly adequate to smooth large shocks. However, in Cape Verde and Namibia, both with pegged exchange rate regimes, reserves remain either too close to or below adequate levels which suggests the need for more medium-term fiscal consolidation as emphasized in their bilateral consultation reports.

<sup>1</sup> Prepared by Ara Stepanyan drawing on the work done by Marcio Ronci on Cape Verde and Olivier Basdevant on Swaziland.

<sup>2</sup> Note that both Namibia and Swaziland are members of the Common Monetary Area along with Botswana, South Africa and Lesotho"

<sup>3</sup> Crispolti and Tsiouris (2012) find that, even when reserve coverage is at levels normally considered adequate, island states may suffer persistent macroeconomic costs in the aftermath of an external shock.

<sup>4</sup> For more detail discussion of the new approach see IMF paper on "Assessing Reserve Adequacy" prepared in 2011.

## B. Empirical Analysis

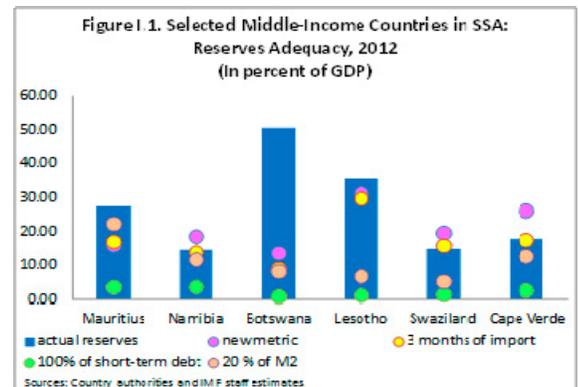
**4. The first methodology employed here uses a metric-based approach, which focuses on potential balance of payments pressures.** The new metric is based on the weighted average index of export earnings, two separate external liability shocks, and capital flight risk. In general, this approach suggests that reserve coverage in the neighborhood of about 100–150 percent of the metric is broadly adequate. Table I.1 shows that Botswana, Lesotho, and Mauritius have comfortable amount of reserves, while the level of reserves of Cape Verde, Namibia, and Swaziland were somewhat too close to the 100 percent suggested by the metric in 2007–12.<sup>1,2</sup>

	2006	2007	2008	2009	2010	2011	2012*
	(Actual reserves versus metrics suggestion, in percent)						
Mauritius	187.1	213.2	109.8	144.7	145.3	159.4	169.5
Namibia	39.9	69.7	98.0	118.8	67.7	86.5	78.7
Botswana	445.7	474.2	502.9	516.4	393.1	359.2	366.6
Lesotho	209.2	258.1	301.5	260.6	205.1	220.3	114.2
Swaziland	72.3	124.8	149.3	143.3	97.6	73.2	76.2
Cape Verde	77.0	92.8	99.4	93.7	87.8	75.9	75.4

Sources: Country authorities, WEO database, and IMF staff estimates.

\* Data for 2012 are estimates.

**5. The chapter also presents other estimates of optimal level of reserves for MICs based on standard methodologies.**<sup>3</sup> We show estimates of how much reserves would be required to satisfy simple rules of thumb that have been widely used for measuring reserves adequacy. The comparison of the results from traditional rules of thumb and the new metrics against the actual holdings of reserves for MICs in SSA is presented in Figure I.1.



<sup>1</sup> Given the role of the current account in most of MICs in SSA, we reduced the weight on short-term debt relative to exports by 10 percentage points for all countries except for Mauritius and Cape Verde.

<sup>2</sup> Note that other more traditional methodologies of reserve adequacy suggest that both Cape Verde and Swaziland were broadly in the range of what would be considered adequate.

<sup>3</sup> Box I.1 describes the various methodologies used to assess reserve adequacy in this chapter. The data used here is based on the Fund’s World Economic Outlook (WEO) and Government Finance Statistics databases.

**6. Considerable developments have occurred in the theoretical literature on the determinants of reserves.** The literature identifies two main motives for holding reserves: the precautionary and mercantile motives, and it uses different type of variables to measure the size of these motives. We have grouped the determinants of international reserves into two broad categories: (i) describing countries' external position, and (ii) describing countries' macroeconomic policy.

**7. A long-run relationship between reserves and their macroeconomic determinants is identified for small MICs in SSA.** We used annual

data from 1990 through 2011 and employed panel cointegration techniques. Seven statistics are used to identify the cointegrating relationship between gross reserves and its determinants. The statistics below presents the results of our cointegration analysis among reserves, exports plus current transfers, and government spending adjusted for external budgetary grants. Three statistics out of seven reject the hypothesis of no cointegration with a 95 percent confidence interval, and one statistics rejects the null hypotheses with 90 percent confidence interval. It is worth noting that the group-mean ADF tests, which tend to have a better performance in short panels, rejects no cointegration hypothesis with 95 percent confidence interval. A fully modified ordinary least squares method is used to estimate coefficients of the cointegration vector. This method deals with both serial correlation and endogeneity.<sup>1</sup>

### Cointegration Analysis Results

panel v-stat	=	1.38591
panel rho-stat	=	-1.06914
panel pp-stat	=	-2.22092**
panel adf-stat	=	-1.74045*
group rho-stat	=	0.39500
group pp-stat	=	-2.47184**
group adf-stat	=	-2.16855**

\* Rejection with 90 percent confidence interval

\*\* Rejection with 95 percent confidence interval

Panel stats are weighted by long run variances

Source: IMF staff estimates.

Dependant Variable: Log(Reserves)		
Panel Group FMOLS Results		
	Coefficient	t-statistic
Log(export +current transfers)	1.55	( -2.90 )***
Log(expenditure – grants)	-1.22	( -2.20 )**

\*\* Rejection with 95 percent confidence interval, \*\*\* Rejection with 99 percent confidence interval.  
Source: IMF staff estimates.

<sup>1</sup> We added current transfers to exports because the series for current transfers has negative numbers, which do not allow the use of a logarithm specification for the series. We adjusted the expenditure variable for external budgetary grant to eliminate the impact of grants both on expenditures and reserves.

### Box I.1. Standard and Modern Approaches for Estimating Reserve Adequacy<sup>1</sup>

Standard measures are based on a simple ratio of gross official reserves. They do not have a theoretical or empirical underpinning. Four measures are typically identified:

- For a country with a fixed exchange rate, the level of reserves should be at least three months of prospective imports of goods and services.
- Another metric is to ensure full coverage of short-term debt service by remaining maturity. Specifically, reserves should be sufficient to cover the payment of debt service outflows over the next 12 months in full.
- The ratio of gross official reserves to base or reserve money (typically M0) gives a measure of the backing of currency in circulation. This measure is most relevant in currency boards, where the law requires the central bank to maintain a high percentage of reserves (60–100 percent) to be freely available to be exchanged for domestic currency in circulation.
- The reserve coverage of broad money (typically M2) is another popular measure. The metric is intended to capture the risk of capital flight, and a ratio of 20 percent is commonly used as the minimum threshold for countries with a fixed exchange rate regime.

Model-based approaches derive the adequate level from a cost/benefit analysis. The benefits of holding reserves (i.e., reducing the probability of a crisis and smoothing consumption) are assessed against the cost of holding reserves, in terms of foregone investment in the economy. The benefits are typically defined in two broad categories:

- Protecting the economy against a sudden stop in capital flows (Caballero and Panageas, 2004, Jeanne and Rancière, 2006).
- Reducing the probability of a crisis and its cost (Garcia and Soto, 2004).

Along these lines, Dabla-Norris et al. (2011) have proposed a new methodology to assess reserve adequacy for low-income countries and small island developing states. Dabla-Norris's model takes into account both costs and benefits of holding reserves. In this framework, a crisis is defined as a sharp drop in absorption, and the optimal level of reserves is determined when the crisis prevention and mitigation benefits of reserves are balanced against the net financial cost of reserves, defined as foregone investment opportunities measured by the marginal product of capital.

A new model-based approach has also been developed by the IMF (2011b) to derive the optimal reserve holdings. Since 2002, emerging market and low-income countries have outpaced the traditional reserve adequacy metrics. Subsequently, during shocks, these reserves have provided a useful cushion against economic crises, including during the 2008–09 global financial crisis.

This new model-based approach provides a framework for optimal reserves. For emerging market (EM) economies, a two-stage methodology is employed.

- The first stage estimates different potential losses of foreign reserves. The potential outflows during periods of exchange market pressure are estimated, when the specific sources of loss identified are (i) a potential loss of export earnings from a drop in external demand or a terms-of-trade shock; (ii) an external liability shock to short-term debt and medium- and long-term debt and equity liabilities; and (iii) a capital flight risk.
- In the second stage, the reserve coverage a country should hold is estimated based on the metric obtained from the first stage. For countries with a fixed exchange rate regime, it proposes to use the following risk weights, based on tail event outflows during exchange market pressure: 10 percent of export income, 30 percent of short-term debt, 15 percent of other portfolio liabilities, and 10 percent of broad money, which in this case is a proxy for liquid domestic assets.

<sup>1</sup> Drawn from IMF, 2011.

**8. The results show that while countries' reserves holdings increase with exports and current transfers, they decrease in response to an increase in government spending.** These results could be used by policymakers in small MICs in SSA to guide their macroeconomic policies to ensure the adequacy of reserves and the sustainability of those policies.

**9. Our analysis of reserves adequacy uses a multi-dimensional approach.** We employed a variety of methods for measuring optimal level of reserves based on the results obtained using the new metric. In particular, we used the Dabla-Norris and others (2011) and Ben-Bassat and Gottlieb (1992) methods that are based on cost-benefit models and provide a comprehensive framework to determine the optimal level of reserves. However, these models are sensitive to the assumptions about economic structure, costs and benefits of holding reserves. Thus, we also used Frenkel and Jovanovic's buffer stock model (1981) of assessing reserve adequacy.

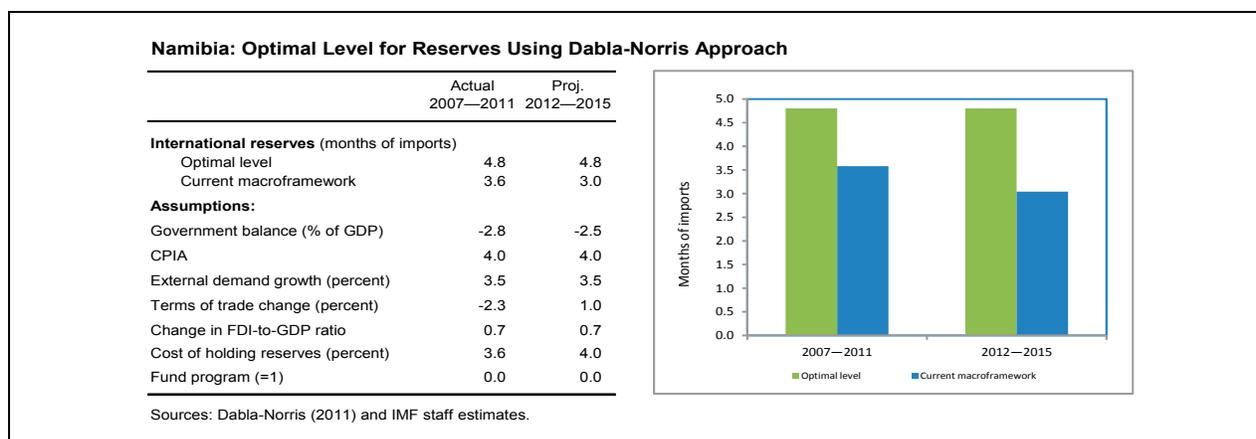
**10. We first apply these tools for assessing reserve adequacy on Namibia.** The calculations are extended based on the new metrics of reserves adequacy for Namibia through 2015 using the framework developed by Dabla-Norris and others (2011). The results suggest that, on average, in 2012–15 the projected gross reserves will be about 73 percent of the average level of reserves generated by the new metric. The results based on Dabla-Norris and others' methodology suggests that, on average, for 2007–11 the optimal level of reserves for Namibia was 4.8 month of imports, whereas the actual level for that period was 3.6 months. We also used the current projections until 2015 to assess whether over the medium term the level of reserves is expected to approach the optimal level. The results confirmed the outcome obtained using the new metrics and suggest that the current gap between the optimal and projected reserve levels based on current plans will widen over the medium term, which is a potential source of vulnerability for Namibia.<sup>1 2</sup>

**11. Similar analysis of reserve adequacy for Cape Verde suggests that current reserve levels are below what is considered adequate.** The estimates for the optimal level of reserves for 2009–11 are between 2.7 and 4 months of imports in line with actual outcome of 3.9 for the same period, suggesting that the central bank's reserve holdings were adequate. However, for 2012–15, estimates for reserve adequacy are between 3.7 and 5 months of imports compared with 3.4 months on average in the current macroeconomic framework. Given the increasing public debt, the minimally adequate level of reserves and uncertainties regarding external inflows, in staff's view strengthening of the international reserves position in Cape Verde would be appropriate.

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<sup>1</sup> Staff's additional simulation experiments show that in the event of a further worsening in the global economic environment compared to current WEO projections, which may lead to a decline in Namibia's exports prices and therefore a deterioration in its terms of trade, the gap between the optimal and projected level of reserves would widen further, in the absence of offsetting policy actions.

<sup>2</sup> Uncertainties about the completion of the economic partnership agreements add further vulnerabilities to Namibia's external accounts over the medium term.



**Table I.2. Cape Verde: Summary of the Results of Reserves Adequacy Estimates (months of imports)**

	Actual 2009-2011	Projected 2012-2015
Ben-Bassat and Gottlieb Approach	4.0	5.0
Buffer-stock model	3.3	5.2
Dabla-Norris' approach	2.7	3.7
<b>Macroframework</b>	<b>3.9</b>	<b>3.4</b>

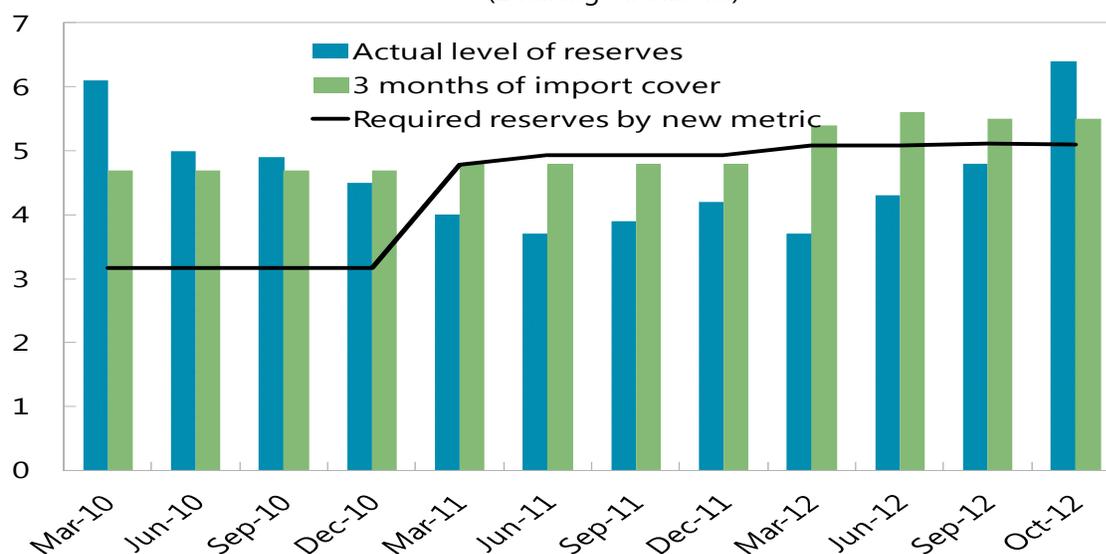
Sources: Country authorities and IMF staff estimates.

**12. Swaziland's level of gross official reserves is broadly adequate to protect the country against external shocks.**<sup>1</sup> By reflecting the relevant level of risk of the different possible sources of balance of payment pressures, it is estimated that the minimum level of reserves needed to cover the risk of potential balance of payments outflows in Swaziland is 17 percent of GDP (about E 5.1 billion for 2012). With the surge in Southern African Customs Union (SACU) transfers in 2012/13, the level of reserves at the central bank has improved and since October 2012 has been broadly adequate. However, between quarterly SACU transfers, reserves are decreasing rapidly as the government meets its budgetary obligations. The factor underlying the weakness is structural, and would require addressing the vulnerability of the whole balance of payments through a significant fiscal adjustment. Therefore, the recommended level of reserves of 17 percent of GDP should be viewed as a minimum. Swaziland is exposed to terms-of-trade shocks because it is an oil importer

<sup>1</sup> See also a forthcoming African Departmental Paper Series: "Restoring Stability in a Changing Global Environment: Options for Swaziland."

and a sugar exporter. In addition, it has a fully open capital account with South Africa, and is thus exposed to capital outflows, while Swaziland does not have access to international capital markets. Consequently, the central bank would be well advised to aim for a level of reserves beyond the recommended 17 percent of GDP. Specifically, the central bank needs a larger base of reserve coverage to address potential liquidity pressures faced by commercial banks while protecting the parity with the rand. Should portfolio outflows occur, the current level of reserves may not be sufficient for the central bank to be in a position to provide liquidity to commercial banks.

Figure I.2: Swaziland: Actual and Adequate Level of Reserves  
(Emalangenzi billions)



Sources: Country authorities and IMF staff estimates.

**13. In general, macroeconomic policies in these small MICs should aim to rebuild policy buffers to help cushion against large external shocks.** Given the pegged exchange-rate regime in Cape Verde, Namibia and Swaziland, the role of monetary policy is constrained. The only active policy tool left, therefore, for counter-cyclical purposes is fiscal policy. Our analysis suggests that further fiscal policy consolidation could possibly help to accumulate reserves faster.

**14. Specifically, our results suggest that for Namibia, a more ambitious fiscal effort beyond the authorities' current plans would be advisable to rebuild reserves to its adequate levels.** Specifically, fiscal consolidation should be accelerated through reducing the expenditure-to-GDP ratio by an additional six percentage points by 2015 over and above current plans. In order to achieve the adequate level of reserves for Namibia, the annual growth rate of reserves should increase by 6 percentage points on average until 2015 compared with current projections. Given the estimated elasticity of -1.22 percent between government expenditure and gross reserves, to achieve accelerated reserves accumulation, the average annual growth rate of government

expenditure should be reduced by about 5 percentage points, which implies 6 percentage points reduction in the expenditure-to-GDP ratio by 2015 compared with current projections.<sup>1</sup> Given the possible impact of further fiscal consolidation on growth, Namibia needs to undertake a fiscal consolidation process that increases government savings and reprioritize the composition of public expenditure in favor of development spending to enhance productivity. Thus, reining in spending would have to focus on the government sector wage bill as well as transfers and subsidies to loss-making state-owned enterprises. Beyond fiscal consolidation, structural reforms to strengthen export competitiveness should also help the needed reserves buildup.

**15. For Cape Verde, similar analysis suggests that rebuilding reserves above minimally adequate levels would involve significant fiscal consolidation over the medium term.** To ensure above minimally adequate level of reserves by 2015, reserve holdings of Cape Verde should grow by 14 percent annually, while currently they are projected to grow by 3.4 percent. Applying our estimated elasticity between government expenditure and gross reserves on the difference of needed and projected reserves accumulation suggests that the expenditure-to-GDP ratio for Cape Verde should decrease by 2.5 percentage points by 2015. Thus, Cape Verde's efforts to ease the significant infrastructure bottlenecks in the economy would need to continue following a good practice macroeconomic and fiscal policy framework to help address these challenges in a growth-promoting manner and thus avoid non-productive spending. This will help to preserve fiscal and external stability over the medium term. In recent years, Cape Verde's tax reform agenda has aimed to yield a more neutral tax system that is less reliant on incentives, boost export competitiveness and rebuild the fiscal buffers following efforts to close the infrastructure gap, which entailed an increase in capital spending.

## C. Conclusions

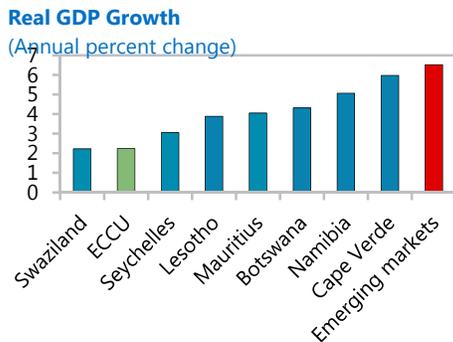
**16. The analysis of reserve adequacy for selected small MICs in sub-Saharan Africa suggests a mixed picture.** Although international reserves held by some of the MICs are broadly adequate to smooth large shocks, however, in Cape Verde and Namibia, both with pegged exchange rate regimes, reserves remain either too close to or below adequate levels, suggesting the need for further fiscal consolidation over the medium term. The results of this analysis are however, sensitive to both the assumptions of the medium-term external outlook, which is based on the Fund's latest WEO projections, as well as the model assumptions on the opportunity costs of holding reserves. Finally, the debt levels in some of these small MICs, a detailed analysis of which is beyond the scope of this chapter, also remain relatively low.<sup>2</sup>

<sup>1</sup> For analysis of wage bills within the Southern African Customs Union, see Chapter 4 of the recent regional work in a forthcoming book "Building a Common Future in Southern Africa," Mongardini, J., (ed. 2013), IMF, Washington, D.C.

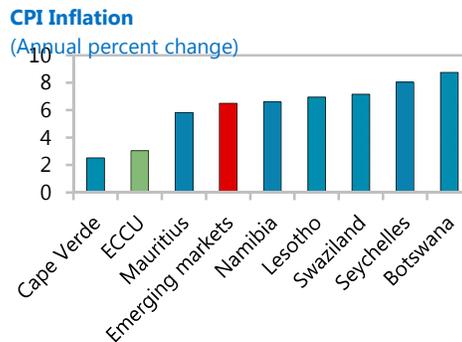
<sup>2</sup> For example, despite the recent increase in the debt level due to the temporary fiscal expansion under the TIPPEG program in Namibia, the debt ratio is expected to decline over the medium term. Namibia has always been a low debt upper middle-income MIC and staff do not envisage the debt path to be explosive given the potential of the economy and its diversified nature compared to other predominantly mineral based MIC economies. Namibia's sovereign credit rating also continues to be investment grade quality.

**Figure I.3. Small Middle-Income Countries in sub-Saharan Africa, the Eastern Caribbean Currency Union (ECCU) and Emerging Markets Average: Cross-Country Comparison (Average 2002–11, unless otherwise indicated)**

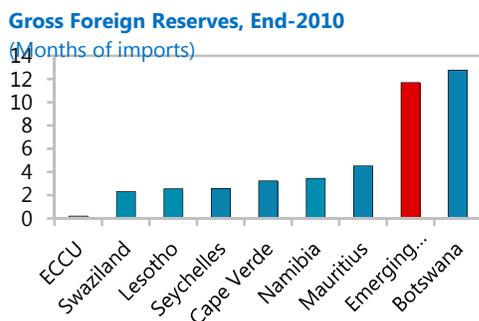
All the small MICs in SSA grew at a slower pace compared with emerging markets on average...



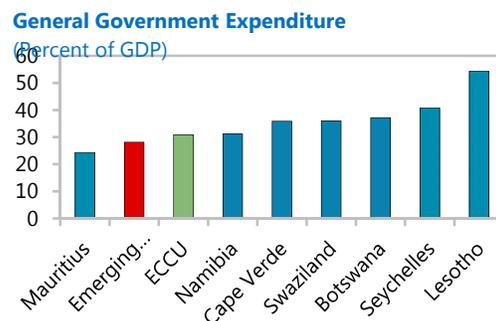
... with inflation above their emerging market peers.



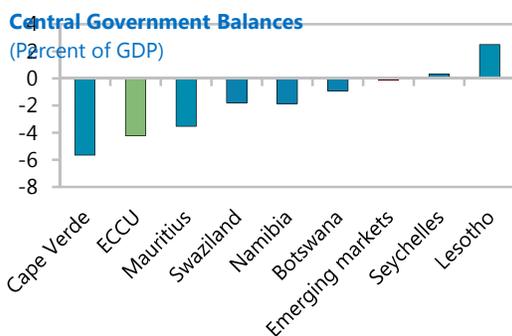
Majority of the small MICs in SSA have much lower policy buffers than an average emerging market economy...



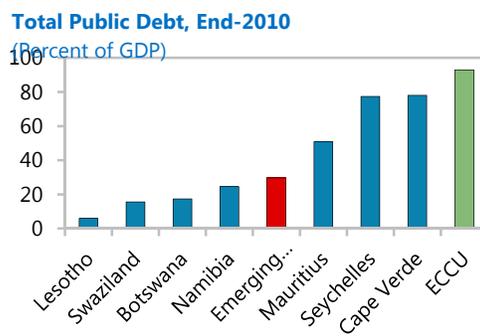
...owing to higher government expenditures ...



...which led to wider underlying fiscal balances...



... and, thus in some cases a high debt burden.



Sources: Country authorities and IMF staff estimates.

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## II. ENHANCING INCLUSIVE GROWTH AND EMPLOYMENT IN SMALL MIDDLE-INCOME COUNTRIES<sup>1</sup>

### A. Introduction

**1. Despite registering sustained high growth over the past decades, poverty, income inequality, and unemployment remain high in many MICs in SSA.** This chapter provides the analytic underpinnings of staff's assessment of the extent to which economic growth has been inclusive in small MICs and the factors that could explain their high unemployment. A key policy lesson that emerges from this analysis is that reducing income inequalities has the potential to lead to significant gains in terms of increasing the duration of growth spells in small MICs. Moreover, policies that lead to more sustained reduction in structural unemployment would help to enhance more inclusive growth.

### B. Empirical Analysis

#### Long-Term Growth Dynamics

**2. Although historically growth has been strong in many small MICs in SSA, it has not been sufficiently broad-based.** The experiences of these countries' growth dynamics and trends are not uniform reflecting individual country-specific idiosyncratic factors. This said, staff's analysis using a traditional Solow-growth accounting exercise shows that initial high levels of growth in many small MICs in SSA reflect capital deepening with relatively lower contribution from structural reform based total factor productivity (TFP) (Figure 1).<sup>2 3</sup> As a result, once the pace of capital accumulation decelerated and stabilized at a lower level, the overall growth trend in these economies generally decelerated. Despite high level of unemployment, the contribution of labor to the growth was broadly stable probably reflecting the capital intensive nature of the growth. Another important factor contributing to the growth trends in these countries particularly in the case of Namibia and Swaziland was the high prevalence of HIV/AIDS that negatively affected population growth and labor productivity.

**3. Despite the sustained period of growth in GDP per capita for MICs, the growth was not strong enough to lead to a fast transition to high-income status.** Comparison of the share of middle-income countries' GDP per capita as a share of U.S. GDP per capita suggests that for most of

<sup>1</sup> Prepared by Ara Stepanyan, Rodrigo Garcia-Verdu, Antonio David, Floris Fernancho Fleermuys and Patrick Gitton.

<sup>2</sup> The growth accounting results should, however, be treated with some caution given the varying quality of the national accounts data for some of these countries as illustrated by recent revisions to historical GDP data. Cape Verde has not yet been included in the analysis given revisions underway on post 2007 national accounts data.

<sup>3</sup> Mauritius has experienced a similar pattern of its growth development.

the MICs this ratio has been stagnant for a long time (Figure II.2).<sup>1</sup> Although the ratio of GDP per capita in US GDP per capita for some of the small MICs in SSA has increased, the pace of growth was low as seen in other small economies in the Caribbean Islands. In contrast, Chile managed to grow fast enough and long enough to increase the ratio about fourfold (Figure II.2 continued). For small MICs in SSA, it took more than 25 years to increase this ratio by 50 percent. More generally, the analysis by Aiyar and others<sup>2</sup> suggests that many MICs seem to be facing the middle-income trap after experiencing a substantial growth slowdown. The middle-income trap is the phenomenon of hitherto rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income as predicted by a conditional convergence framework. Structural characteristics of the economy, outward orientation, the state of infrastructure, financial depth and labor market characteristics could exercise independent effects on such a growth slowdown.<sup>3</sup> The analysis of Aiyar and others shows that MICs face a higher probability of experiencing growth slowdowns than low- or high-income countries. The main factors contributing to this high probability of a growth slowdown in MICs are the level of infrastructure development, degree of regulation, and the size of governments. The extent of government involvement in the economy also hampers the capacity of the private sector to expand. Figure II.2 shows the results of a middle-income trap map for Botswana and Namibia suggesting some risk of a growth slowdown, in contrast to Chile, which is experiencing a relatively faster transition to high-income status.

**4. Consistent with past advice in Article IV consultations, to reverse the declining growth trend, existing structural impediments to productivity growth should be addressed.**

Governments should focus on increasing the quantity of high-quality human capital and reducing the skill mismatch in the labor market through efficient investments in education and health care. Furthermore, given the relatively low levels of financial intermediation, increasing access to finance in these countries could provide an important boost to productivity. Also, the relatively large size of governments in many of these small MICs in SSA, with inefficient state-owned enterprises (SOE), crowds out the private sector and impedes its capacity to grow and innovate. In addition, the occupation of a significant portion of available factors of production by SOEs for low-productive activities, contribute to a low economy-wide productivity, which in turn constrains overall growth.

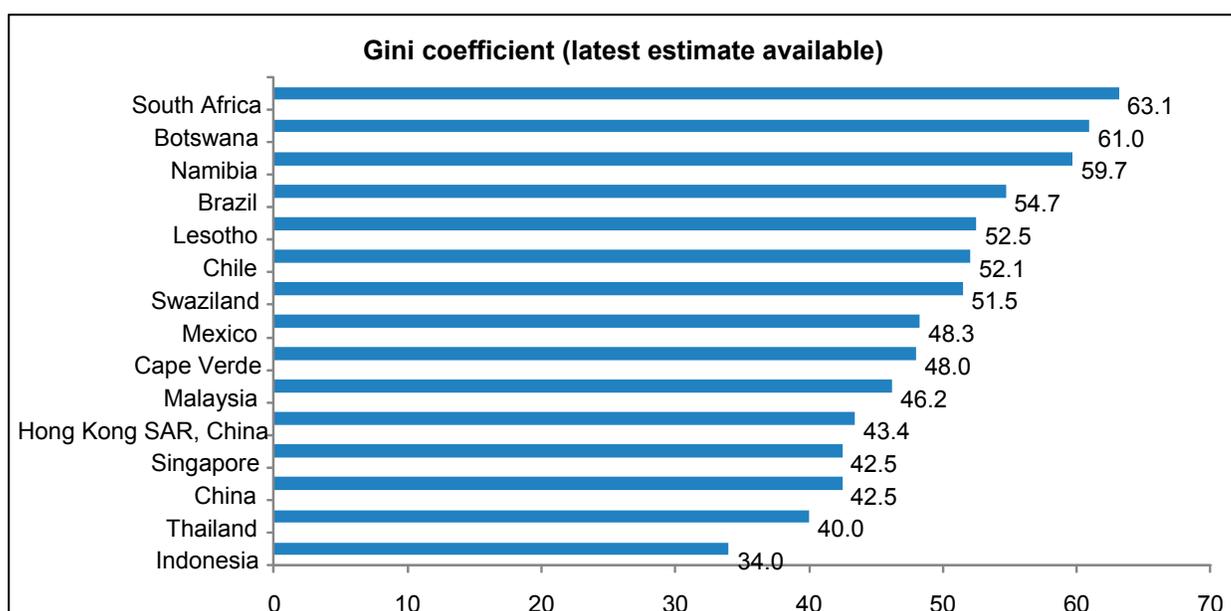
<sup>1</sup> The results are robust to the use of different types of variables representing countries' income, including gross national disposable income per capita.

<sup>2</sup> Shekhar Aiyar, Romain Duval, Damien Puy, Yiqun Wu, Longmei Zhang "Growth Slowdowns and the Middle-Income Trap," forthcoming IMF working paper.

<sup>3</sup> Also Favaro and Peretz (2008) reviewed growth studies in Africa, the Caribbean, Europe, and the Pacific over two periods and found that annual growth among small states slipped by about a ½ percentage point. The growth decline was particularly marked among the Pacific island states, but was also observed in Africa and the Caribbean.

## Inclusive growth analysis

**5. Many small middle-income countries in SSA continue to face challenges in reducing income inequality.** Despite the progress achieved in overall economic development, income inequality in Namibia and Swaziland remains among the highest in the world, and the rate at which inequality has declined in recent years has slowed down relative to earlier periods. For example, while the Gini coefficient in Namibia declined from 0.70 in 1993/94 to 0.6 in 2003/04, the decline slowed to just 0.59 in 2009/10.



Source: World Development Indicators.

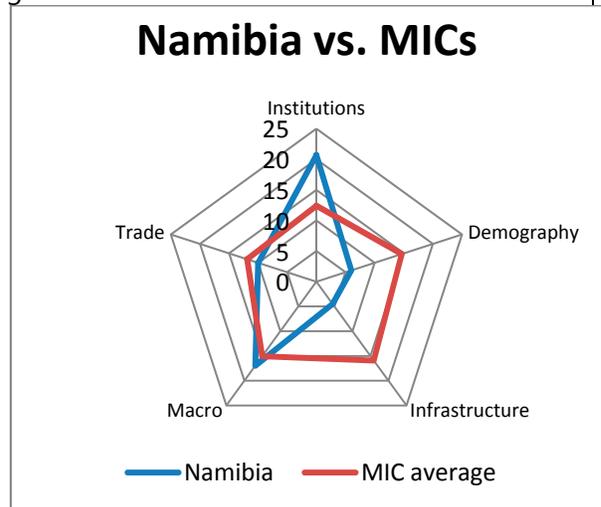
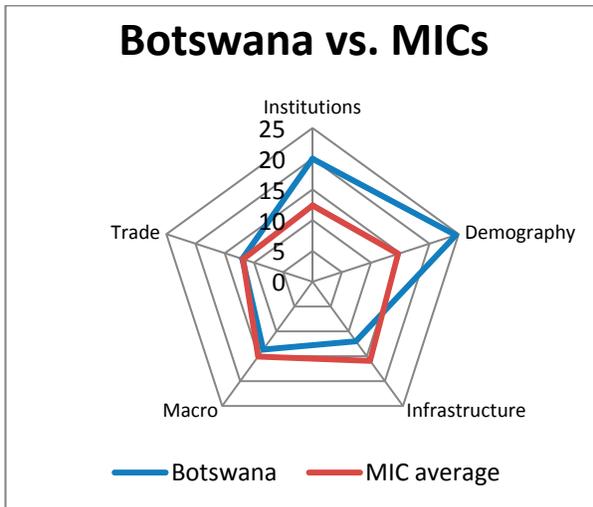
**6. Income inequality and unemployment are inextricably linked in small MICs.** Given that labor income is the main source of household income, the issue of income inequality is related to the other main challenge facing small MICs in SSA, namely, the high and persistent rate of unemployment. According to the latest national labor force survey data, the unemployment rate remains high at about 11 percent in Cape Verde, 34 percent in Namibia and 29 percent in Swaziland.<sup>1</sup> Youth unemployment statistics are even higher than the national unemployment rates in these small MICs (Box 3), thus creating a major policy challenge for governments in these countries.

<sup>1</sup> The quality of labor market statistics vary across countries. In the case of Namibia, there are various estimates of the unemployment rate. The latest national labor force survey (2008) found the unemployment rate to be 51.2 percent (broad definition) and 37.6 percent (strict definition). The income and expenditure survey (2009/10) found unemployment to be 33.8 percent (broad definition) and 22.1 percent (strict definition).

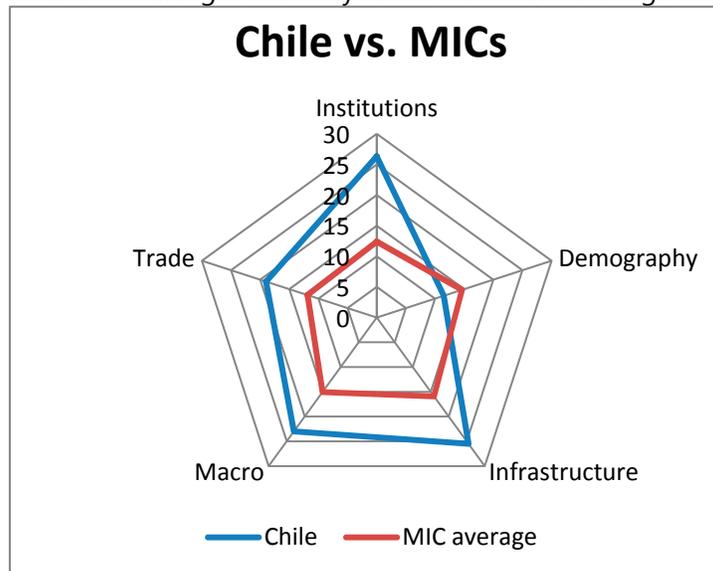
**Figure II.1. Selected Small MICs—Growth Drivers**

Botswana is relatively strong on institutions compared with other MICs, notably its management of natural resources.....

....and although Namibia has somewhat similar strength in terms of institutions, other productivity growth drivers such as demographics pose some risks for potential growth.



In contrast, Chile outperforms the average MIC in almost all dimensions of growth-promoting determinants and is making a relatively faster transition to a high-income status.

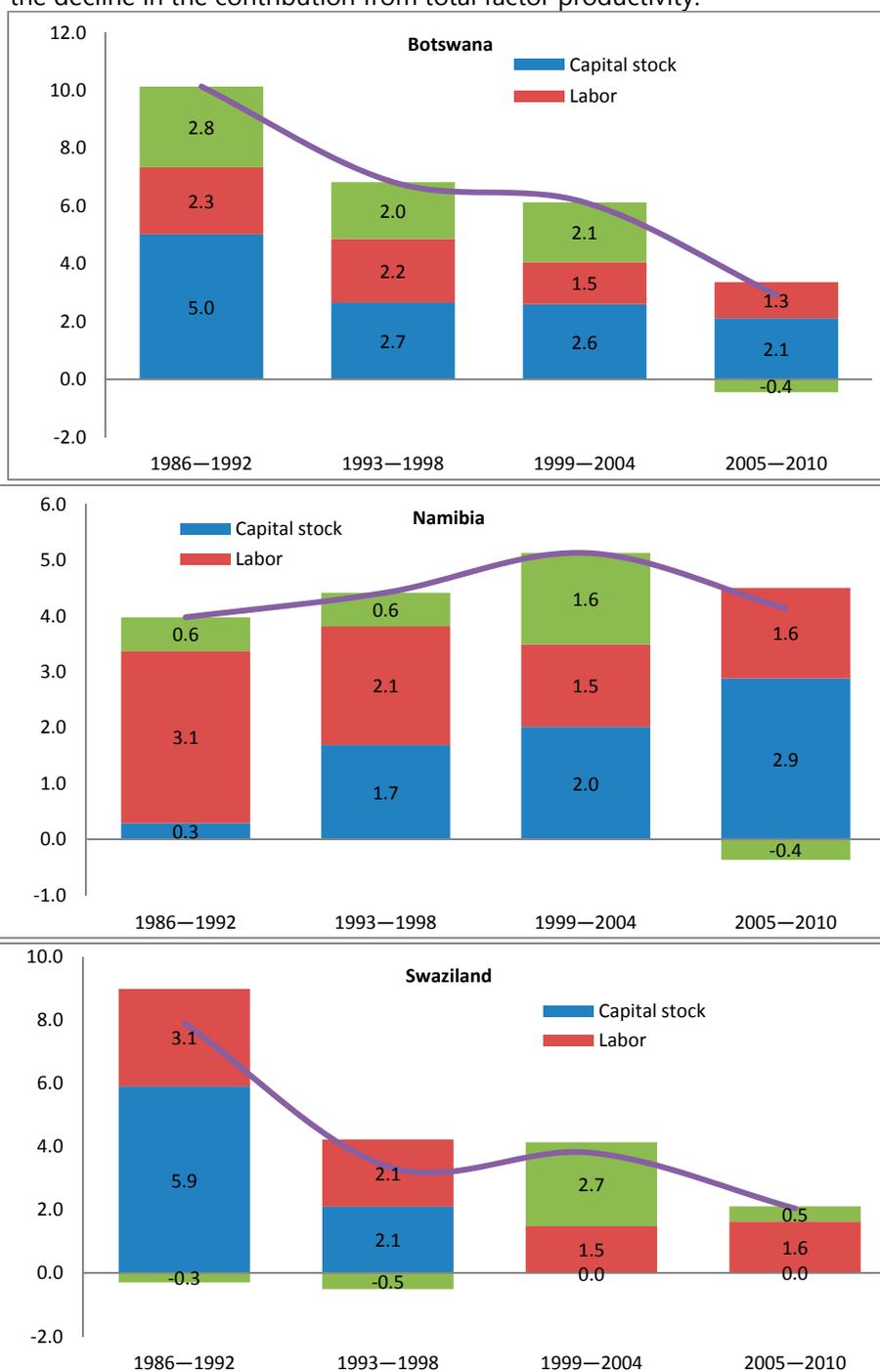


Source: World Bank and World Development Indicators.

*Institutions refer to government size, rule of law and regulation; trade refers to regional integration, GDP weighted distance with trading partners; macro refers to gross capital inflows, investment to GDP ratio, trade openness; Infrastructure refers to telephone lines, power generating capacity and demography refers to age-dependency and gender ratio.*

**Figure II.2. Selected Middle-Income Countries in SSA: Traditional Solow-Growth Accounting**

The deceleration in the rate of capital accumulation amplified by declining total factor productivity, led to a decline in trend growth in Botswana and Swaziland. In the case of Namibia, the recent decline in growth was driven by the decline in the contribution from total factor productivity.

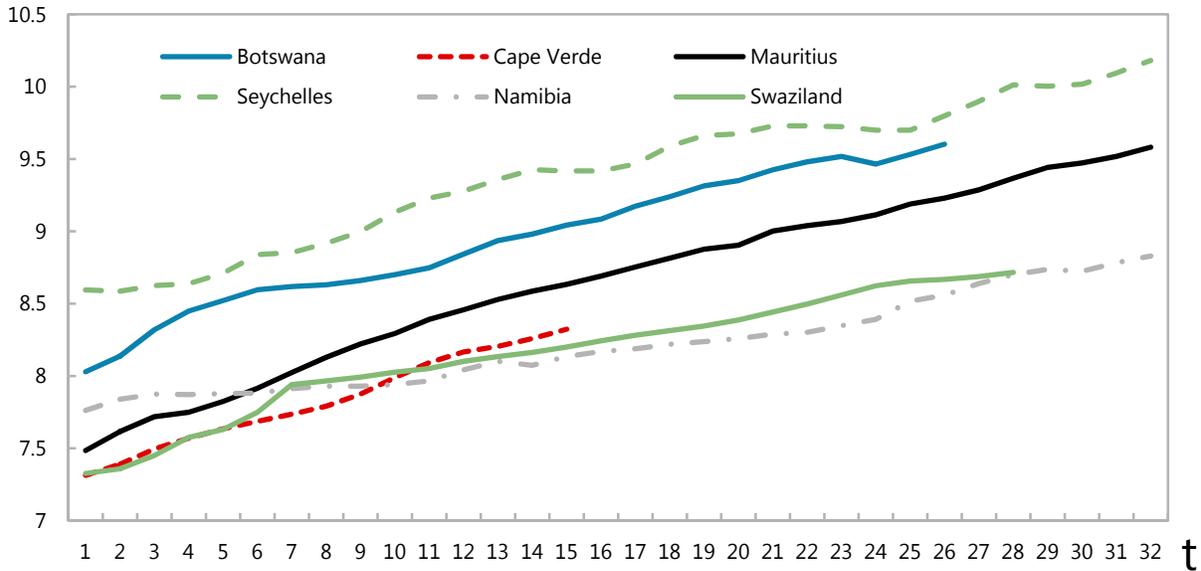


Sources: World Development Indicators and IMF staff estimates.

**Figure II.3. Evolution of Per Capita GDP (PPP terms)\***

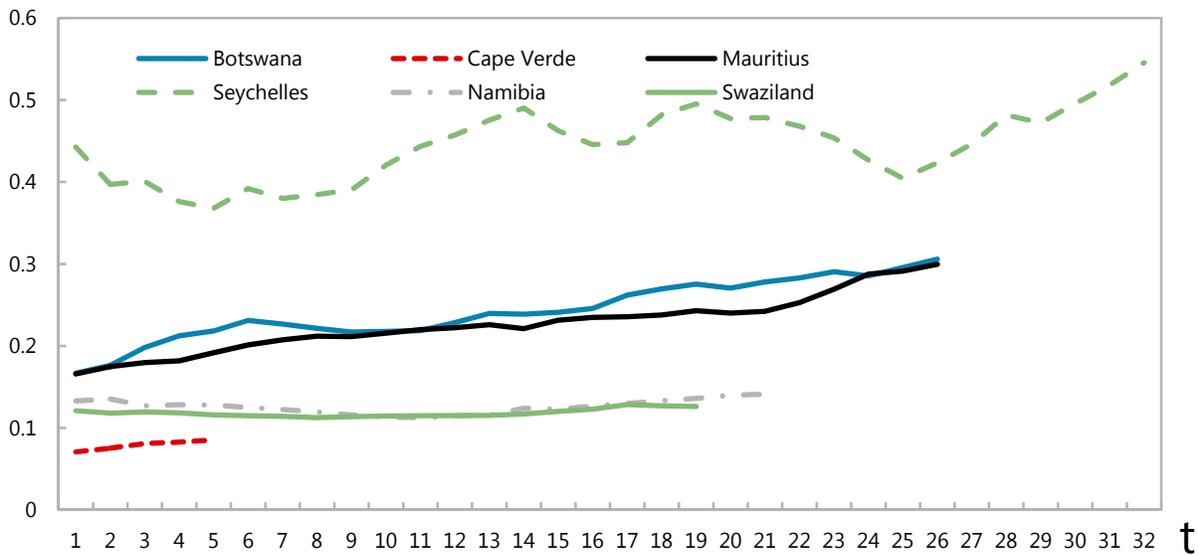
Despite sustained period of growth in GDP per capita for small MICs in sub-Saharan Africa....

**Log GDP per capita**  
(PPP, t=0 corresponds to GDP per capita of \$3000)



...the growth was not strong enough to escape from the middle-income trap as their GDP per capita stagnated as a share of US GDP per capita.

**GDP per capita as percent of US GDP per capita**



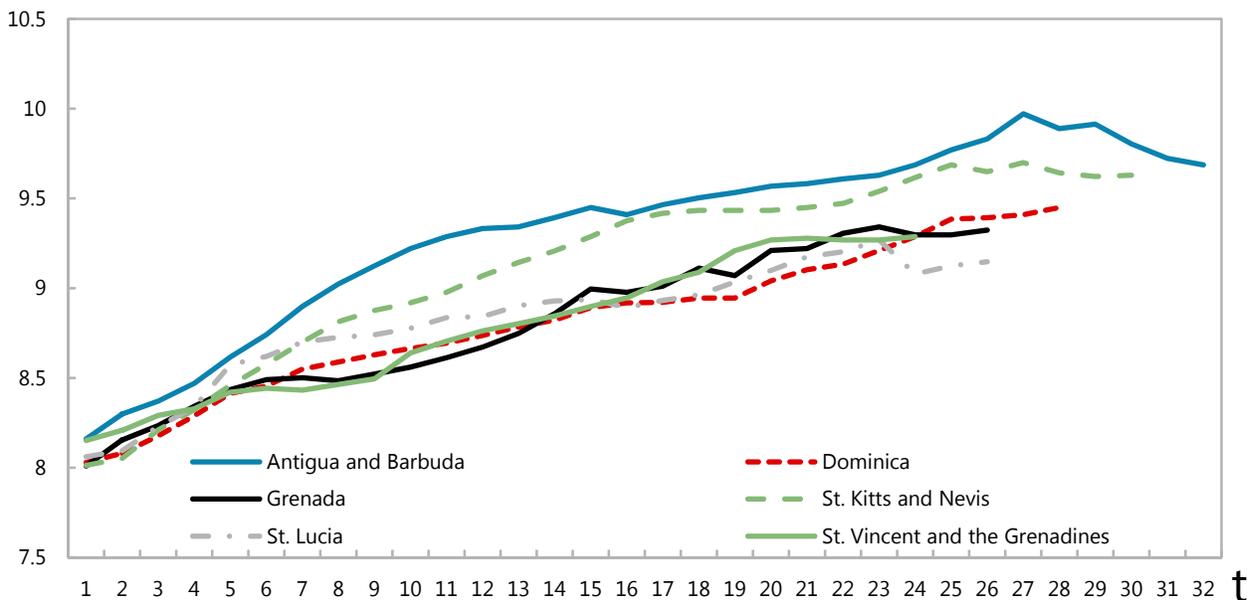
Source: World Bank World Development Indicators

\* t=0 is defined as the year when GDP per capita for a particular country reached US\$ 3000 in PPP terms or the earliest data available if the starting value is already higher than 3000.

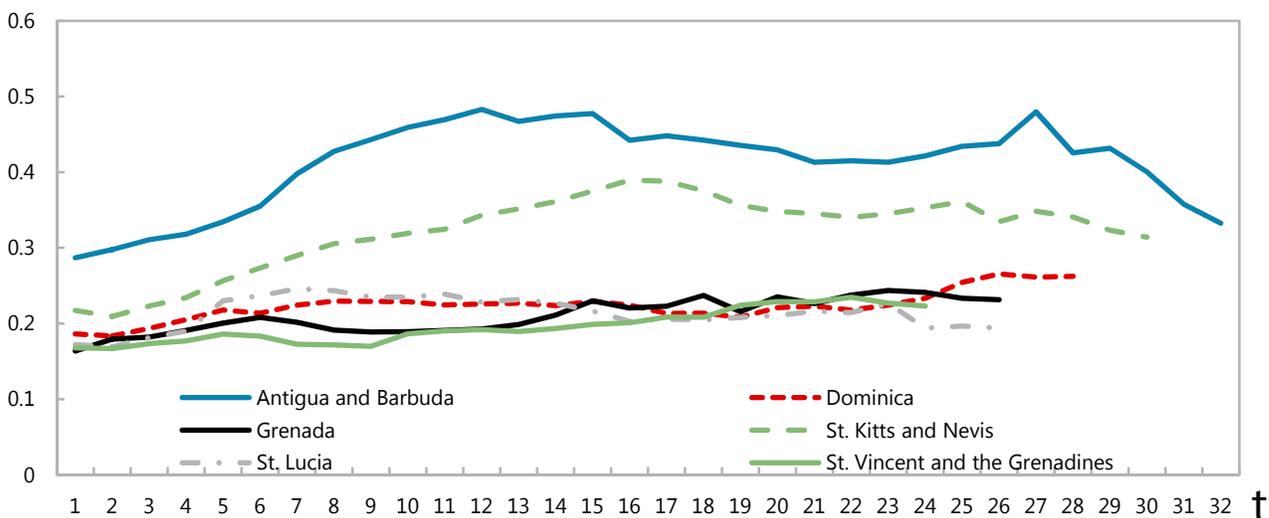
**Figure II. 3. (continued): Evolution of Per Capita GDP (in PPP terms)\***

The experience of countries in the Eastern Caribbean Currency Union is broadly similar to small MICs in sub-Saharan Africa.

**Log GDP per capita**  
(PPP, t=0 corresponds to GDP per capita of \$3000)



**GDP per capita as percent of US GDP per capita**  
(PPP, t=0 corresponds to GDP per capita of \$3000)

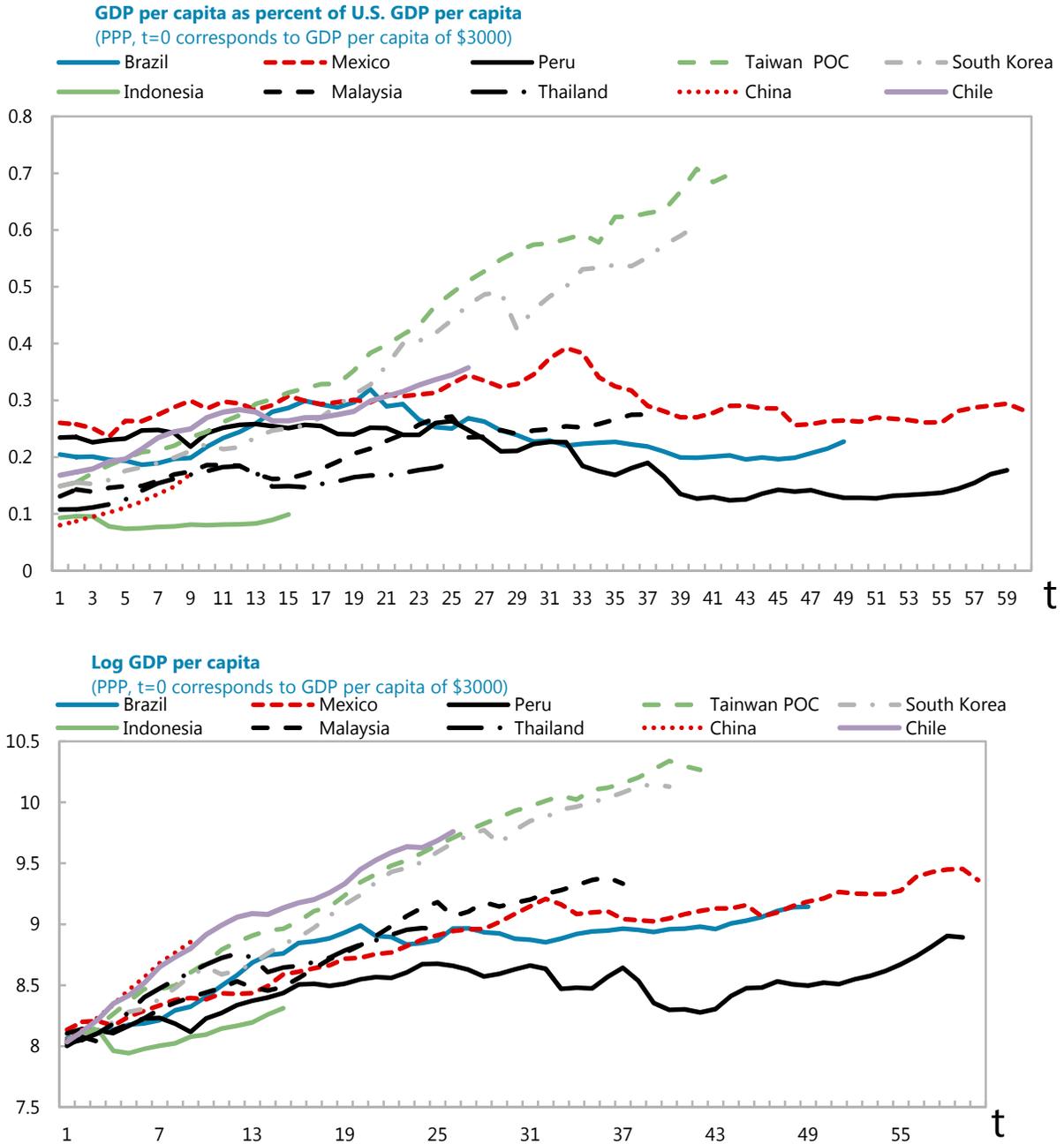


Source: World Bank World Development Indicators

\*t=0 is defined as the year when GDP per capita for a particular country reached US\$ 3000 in PPP terms or the earliest data available if the starting value is already higher than 3000.

**Figure II. 3. Evolution of per capita GDP (in PPP terms) (concluded)**

While countries such as Chile have registered both growth acceleration in log income terms as well in share of US GDP per capita and made some progress toward transitioning to high-income status.



Source: IMF staff calculations.

**7. Thus, one of the key challenges facing many small MICs in SSA is how best to sustain high growth, while decreasing income inequality and unemployment.** Thus, this section of the chapter draws upon previous studies to answer the following three questions: (i) what has been the incidence of growth in small MICs? (ii) to what extent has growth been inclusive in recent decades in small MICs? and (iii) what would be the impact of reducing income inequality on the lengthening of growth spells in these countries?

**8. The methodology that was used in Chapter 2 of the Fall 2011 Regional Economic Outlook (REO) for sub-Saharan Africa is applied here to assess the inclusiveness of growth in Namibia and Mauritius.**<sup>1</sup> In particular, we estimate growth incidence curves for real expenditure per capita and compare them with those of the previous survey (i.e., between 2003/04–2009/10 for Namibia and 1996/1997–2006/2007 for Mauritius). Using this analysis, we make an assessment of the incidence of growth and the extent to which growth over the period has been inclusive.

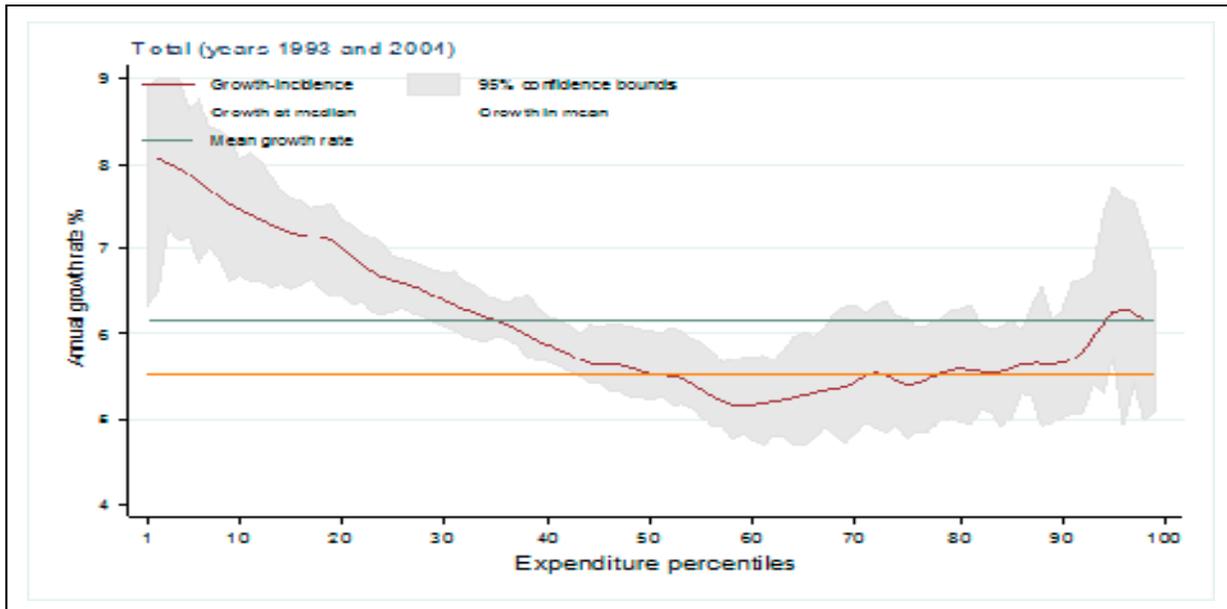
**9. The results suggest that compared to other African countries analyzed by the IMF (2011), overall Mauritius and Namibia have performed relatively well.** Figures II.4–6 show estimates of the growth incidence curves of real consumption per capita for the period 1993/1994–2003/2004 and 2003/2004–2009/2010, respectively for Namibia. Comparing the two figures it is apparent that there has been a slowdown over time in the growth in mean consumption per capita (green line), which is consistent with the slower economic growth rate of real GDP.

**10. The estimated incidence curves suggest that growth has become somewhat less inclusive in recent years.** Specifically, although growth has continued to benefit most of the population in Namibia, the shape of the incidence curve shows that over time it has become significantly less pro-poor or less inclusive in the relative sense. This is supported by the fact that poorer households, while continuing to experience positive growth, are no longer experiencing higher growth than households with higher consumption per capita. The pattern of growth of consumption per capita in 1993/1994–2003/2004, in which poorer households experienced faster growth than households with higher consumption per capita, is consistent with the rapid decline in income inequality: the Gini coefficient declined from 0.701 in 1993/1994 to 0.603 in 2003/2004. In 2003/2004–2009/2010, however, this growth pattern was largely lost (except that households in the highest decile of the distribution experienced lower growth than the rest), consistent with the modest reduction in the Gini coefficient, which declined marginally to 0.5971 in 2009/2010.<sup>2</sup>

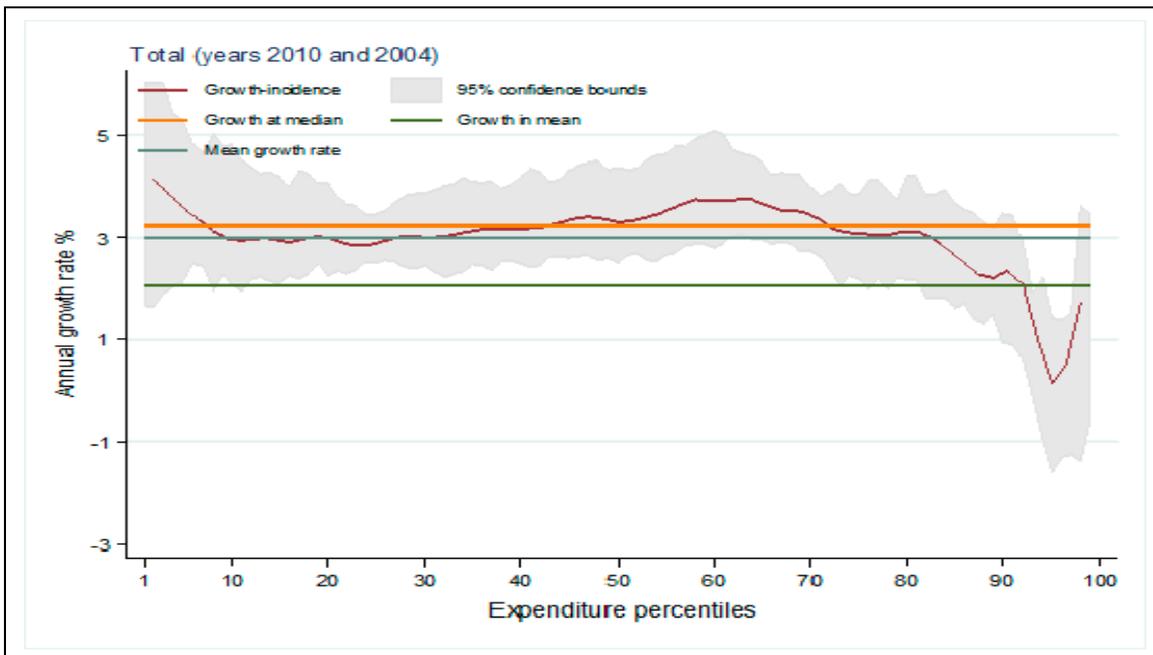
<sup>1</sup> Analysis of growth incidence curves requires more detailed micro data of two comparable household surveys; at this stage the staff does not have such a detailed micro dataset for both Cape Verde and Swaziland.

<sup>2</sup> An alternative country-specific interpretation of the growth incidence curves would argue that the relative boost of consumption per capita of the poorest groups of the economy during the early years just after independence reflected the Namibia government's targeted effort to address the less-inclusive pre-independence regime. More recently, however, a strong growth of the Namibian middle class, with more flexible budget constraints than the very poor, has marginally increased the middle class relative position vis-à-vis the low income class in terms of consumption per capita growth. A rising middle class could bode well for long-term growth. The analysis also depends on the marginal propensity to consume and save which could vary across the various income brackets.

**Figure II.4. Namibia: Growth Incidence Curve of Real Consumption per capita: 1993/1994–2003/2004**



**Figure II.5. Namibia: Growth Incidence Curve of Real Consumption per capita: 2003/2004–2009/2010**



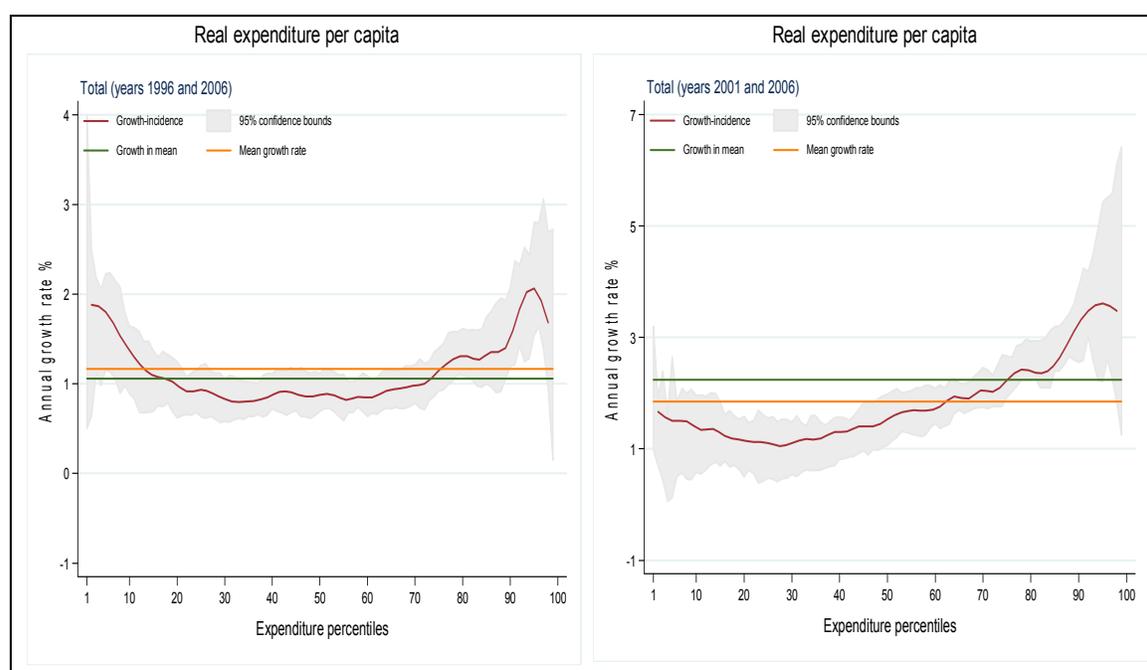
Sources: Country authorities and IMF staff estimates.

**11. The less inclusive growth could suggest that government expenditure has become less progressive in recent years.** This could reflect either weaker targeting or leakage of social programs and expansion of expenditure in non-inclusive programs. While testing this hypothesis

requires detailed disaggregated data on income by source (labor earnings, rental income, pensions, social transfers, etc.)<sup>3</sup>, further reductions in inequality are proving more difficult. This should be a source of concern because the level of inequality in Namibia is still among the highest in the world.

**12. For Mauritius all groups have experienced positive growth in expenditure per capita in real terms when comparing the different waves of the surveys (Figure II.8).** When one considers data from the 1996/1997 survey compared to the 2006/2007 survey, it is clear that both the poorest percentiles and the richest percentiles have experienced growth well above the mean (both in terms of the growth rate in mean and mean growth rates). Nevertheless, when one compares the 2001/2002 survey with the latest survey, richer groups have experienced higher growth in expenditure, pointing to a more unequal distribution of the benefits of growth in recent years.<sup>4</sup>

**Figure II.6. Mauritius: Growth-Incidence Curves for Per Capita Household Expenditures**



Source: CSO-HBS Surveys; and authors' estimates.

<sup>3</sup> Future work will use such a detailed disaggregated dataset to assess the robustness of this result.

<sup>4</sup> For Cape Verde, data provided by the authorities show that the Gini coefficient declined from 0.55 in 2002 to 0.48 in 2010. Cape Verde's human development index is the 5th best in sub-Saharan Africa reflecting the government's efforts on social protection and social spending over the years.

**Table II.1. Contributing Factors to the End of Growth Spells in the SACU Region<sup>1</sup>**

	Spell Dates		GDP per capita growth		Hazard Ratio	Contributing factors (Percent of total hazard)					
	Start	End	During Spell	Next decade		Inequality	Low FDI	Increased	More	Over-valuation	Trade openness <sup>4</sup>
							Inflow	External Debt	Autocracy		
Botswana	1968	1988	8.3	1.9	0.7	67.5	0.0	0.0	0.0	5.8	14.1
Lesotho <sup>2</sup>	1972	1978	4.9	2.6	7.5	48.0	0.0	0.0	24.5	0.0	20.2
Lesotho	1992	1998	5.6	1.4	3.5	71.5	0.0	0.0	0.0	0.0	28.1
Namibia <sup>3</sup>	1995	...	2.2	...	2.6	72.5	0.0	0.0	0.0	0.0	24.6
South Africa <sup>3</sup>	1998	...	3.0	...	2.6	73.0	9.9	0.0	0.0	0.0	0.0
Swaziland <sup>2</sup>	1971	1979	7.2	-0.2	7.4	45.2	3.2	0.0	26.4	0.0	17.2
Swaziland	1985	1990	4.6	2.2	6.3	42.8	0.0	0.0	35.6	0.0	18.1

Source: IMF Staff estimates and computations.

<sup>1</sup> Growth spells, hazard ratios, and contributing factors, are based on a minimum duration of 5 years, with a p-value of 25 (see Berg, Ostry, and Zettelmeyer, 2012). The contributions are rescaled so that they would sum to 1 if all factors were included. Shown here are only the main factors for these particular observations.

<sup>2</sup> In the case of Lesotho and Swaziland, two separate growth spells have been identified.

<sup>3</sup> In the case of Namibia and South Africa, the growth spell periods are ongoing, while statistical procedure was able to detect the upbreak. In these two cases the hazard of spell ending was estimated as hypothetical in the end of the sample, i.e. 2006.

<sup>4</sup> Trade openness is measured 0 when high trade barriers exist, and 1 when economy is fully integrated to the world trade and has no restrictions. The results suggest the contribution of trade restrictiveness on the probability of spell ending. For example, South Africa, which has trade fully liberalized, had seen no impact from trade restrictiveness.

**13. Lowering income inequality has a potential to lengthen growth spells.**<sup>5</sup> Basdevant, Benicio, and Yakhshilikov (2012) applied the results of the empirical model of correlates of duration of growth spells developed by Berg and Ostry (2011) and Berg, Ostry, and Zettelmeyer (2012). The results show that income inequality, as measured by the Gini coefficient, is one of the main determinants of the duration of growth spells in SACU. They show that growth spells could be lengthened significantly if income inequality were to be reduced. Specifically, in Namibia, the duration of growth spells could triple if income inequality was to be reduced to those levels prevailing in a group of middle-income countries with the same level of development.

**14. Redistributive policies need to be carefully crafted to avoid a negative impact on work and investment incentives.** There are two main considerations to bear in mind when implementing redistributive policies.

- Reducing inequalities in human capital should be at the core of policy intervention aimed at reducing future income inequalities and promoting growth.
- In parallel to promoting human capital investment, innovative policies could also help private sector development, so that new skills available are matched with corresponding vacancies. Otherwise the economy could well be trapped in structural imbalances between labor supply and demand.<sup>6</sup>

<sup>5</sup> Berg, Ostry and Zettelmeyer (2012) define growth spells as periods of real GDP per capita growth of at least 5 years, identified as beginning with an upbreak of per capita growth in excess of a minimum of 2 percent and ending with a downbreak followed by a period of an average growth of less than 2 percent, or simply the end of the sample.

<sup>6</sup> The cost of public intervention would nonetheless need to be carefully assessed. Public systems can be very costly (e.g., programs of education for all), in terms of buildings, teachers trainings, and overall cost for the budget. Therefore, caution would need to be exercised to mitigate fiscal risks and facilitate quality goals.

## Unemployment issues

**15. According to Leigh and Flores (2012), the high unemployment rate in SACU, reflects structural rather than cyclical factors.** Structural factors here include the skill mismatch in the labor market; low effective cost of capital which tends to bias production toward capital intensive sectors; and wage policies in the public sector with rapid wage growth above productivity increases.

*Unemployment and growth—employment-output elasticity*

**16. Thus, one key policy question is, whether small MICs can grow their way out of their unemployment problem.** This assumes that unemployment is largely a cyclical rather than structural. Staff's estimates of the employment-output elasticities for selected small MICs in sub-Saharan Africa using the equation below show that the employment-output elasticity  $\beta$  averaged about 0.35 while the constant term  $\alpha$  was consistently negative in the estimated panel regressions. The latter result, which was found to be robust, based on additional experiments that dropped countries from the baseline sample, is significant because it suggests the role of other factors in employment creation beyond GDP growth.

$$\log(\text{employment})_{it} = \alpha + \beta \log(\text{real GDP})_{it} + \varepsilon_{it}$$

**17. The other question is to what extent does the low cost of capital influence labor market outcomes in small MICs?** Specifically, whether the roles of capital and labor in small MICs have been distorted over the years as large sections of the population have been excluded from economic activity and production has become more capital intensive given the low cost of capital. Figure II.7 shows that the lower the cost of capital, the higher the unemployment rate in small MICs. Thus, the implicit bias of some policies in many small MICs (including the tax incentive regime) toward capital-intensive sectors need to be carefully reviewed and addressed to mitigate their impact on job creation.

**18. Overall, therefore, our empirical results suggest that structural distortions may be contributing to the persistently high unemployment rate in small MICs.** This reflects the highly significant intercepts in the estimated panel regressions coupled with the low effective cost of capital in small MICs. This could also explain why the labor market is not clearing in many small MICs in SSA with high wages in the midst of high unemployment. Below we summarize the results of additional experiments aimed at exploring the likely role of such structural distortions in labor markets in small MICs through empirical analysis.

*Wage policy and labor market outcomes*

**19. Our analysis shows that real wage growth in excess of productivity is closely correlated with the unemployment rate in small MICs (Figure II.8).**<sup>1, 2</sup> In fact, real wages in excess of productivity gains are significantly large in many small MICs in sub-Saharan Africa. The size of the public sector and higher public sector wage awards do influence labor market outcomes in an economy including the private sector's ability to create jobs. A bloated public sector, which lures job seekers with greater job security and higher wages, tends to distort labor market outcomes, in addition to its impact on medium-term fiscal sustainability.

**20. The high real wage growth, which outpaced the growth of labor productivity in many small MICs, partly reflects the outcomes of its centralized collective bargaining framework.**<sup>3</sup> Many of the small MICs in SSA have more centralized bargaining framework relative to the median for SSA as a whole. This wage bargaining system not only contributes to the weak link between pay and productivity, but also reduces the response of the real wage to the business cycle fluctuation. Additionally, higher real wage puts upward pressure on labor costs and cause firms to substitute capital for labor, thereby increasing the marginal productivity of labor. In Mauritius, the centralized wage bargaining framework results in wage compression and limits the skill premium, leading to job destruction in the traditional sector and insufficient job creation in the new technology sector (Box II.3).

*Union density and unemployment*

**21. Over the years, unions have played a pivotal role in many of the small MICs in sub-Saharan Africa.** Their emphasis on workers' rights is well placed and bodes well for enhancing more inclusive growth. This said, if the job market is mainly dominated by a highly unionized government sector, sometimes this tends to give rise to unemployment in the broader economy (including through insider-outsider effects). The high degree of correlation between unionization and unemployment (Figure II.10) suggests that high union density in many small MICs may be associated with the high unemployment outcomes.<sup>4</sup>

<sup>1</sup> This paper uses the CPI-based real wage measure instead of the GDP deflator-based real wage, while productivity growth is proxied by an adjusted output per capita for the manufacturing and construction sectors. While the authors acknowledge the limitations of this measure of productivity, the latter proxy was used given the lack of reliable data to measure productivity from factor costs based national accounts measure across our entire cross-country sample.

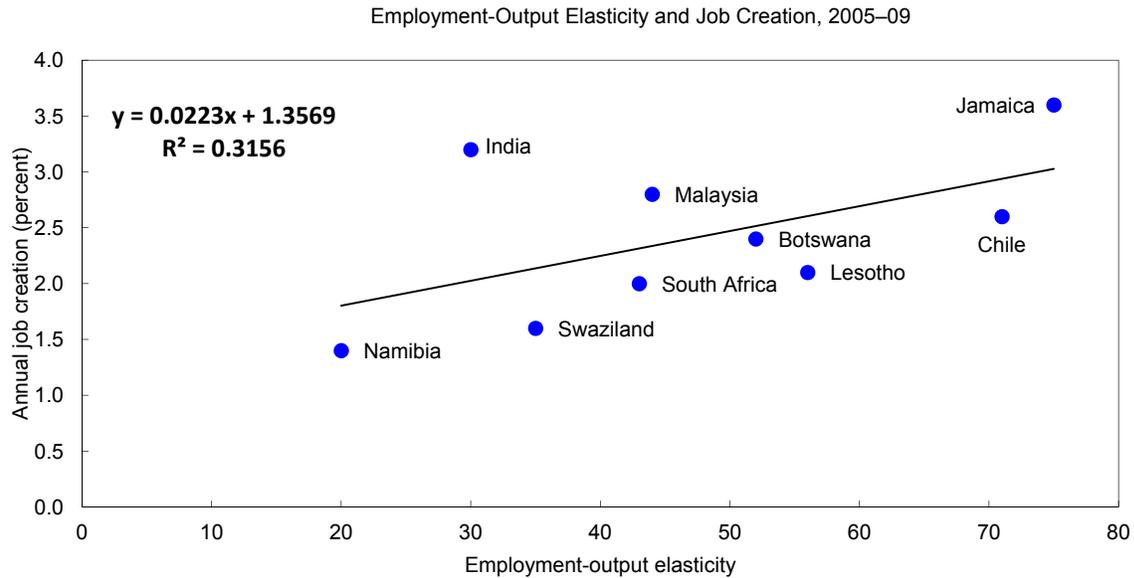
<sup>2</sup> Leigh and Floris (2012) also estimated panel VAR regressions which support these results based on a bivariate correlation analysis.

<sup>3</sup> See supporting econometric evidence in Klein (2012) using micro/industry-level data.

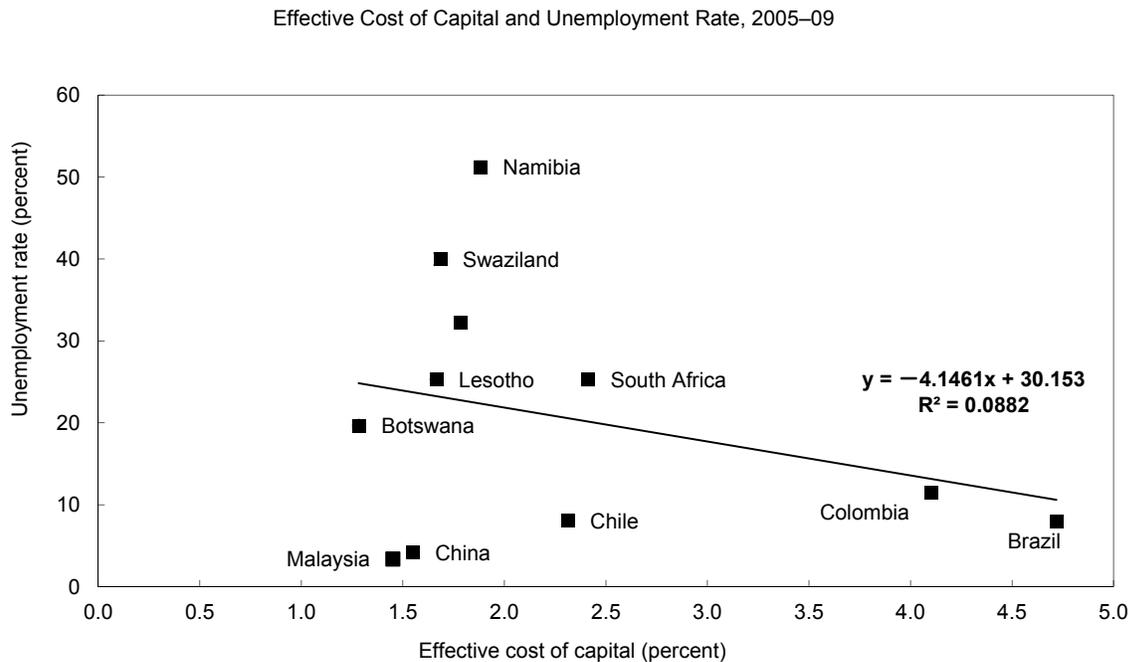
<sup>4</sup> One caveat here is that while Mauritius has a broadly similar level of union density as countries in Southern Africa Customs Union (SACU), it has a significantly lower unemployment rate.

**Figure II.7. Employment-Output Elasticity, Job Creation, and the Effective Cost of Capital**

*Small MICs cannot grow their way out of the unemployment, given employment-output elasticity.*



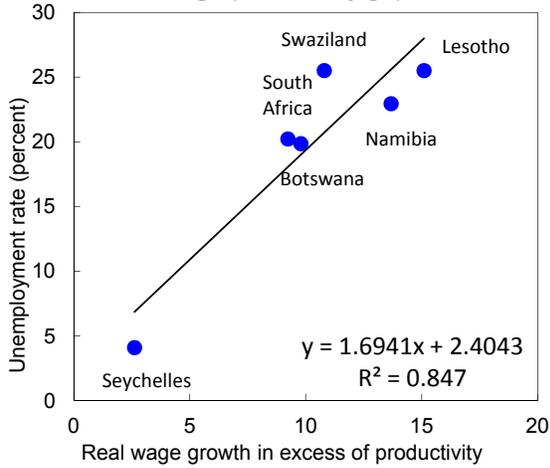
*They also have generally lower effective cost of capital, which seems to be associated with high unemployment rates across MICs.*



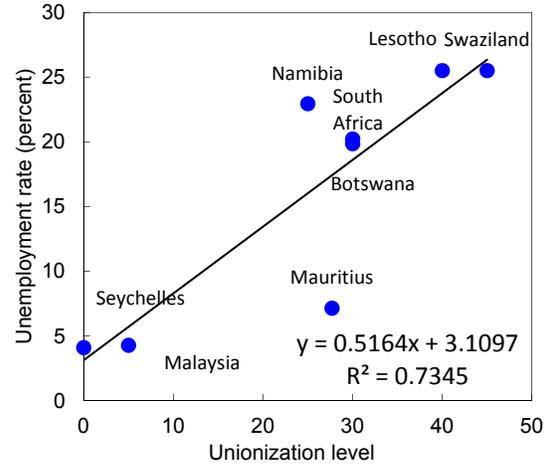
Sources: ILO database; and IMF staff calculations.

**Figure II.8. Unemployment Rates and Labor Market Indicators-Correlation Analysis**

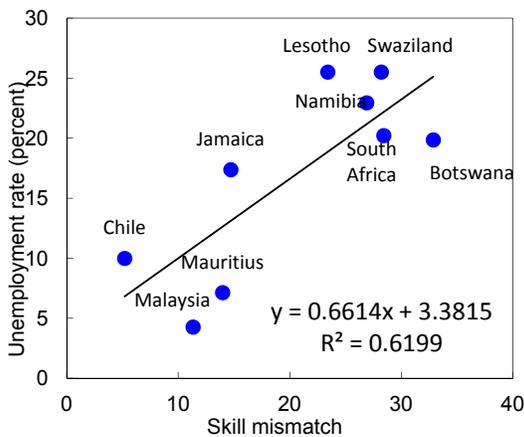
The unemployment rate seems to be positively correlated with wage-productivity gap...



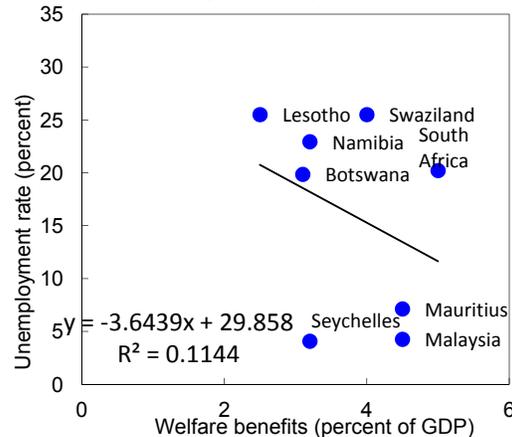
...and positively correlated with union density...



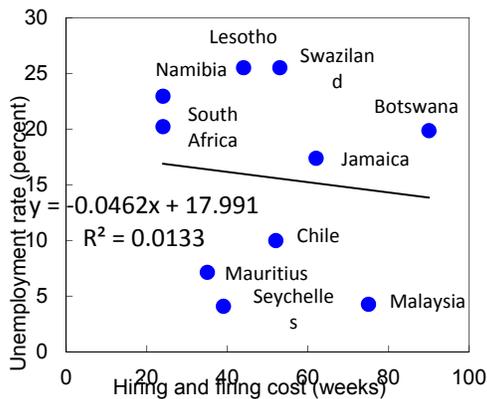
...as well as skill mismatch in the labor market..



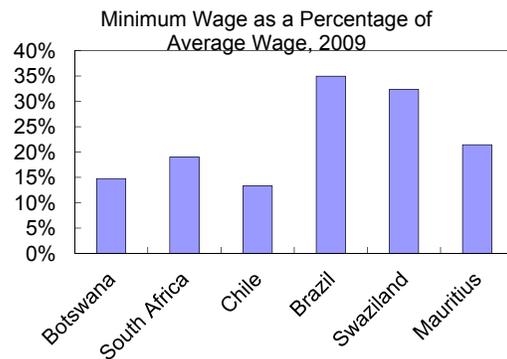
However, the unemployment rate seems have little association with welfare benefits ....



...as well as restrictiveness of labor laws....



while minimum wages remain relatively low.



Sources: ILO database; and IMF staff calculations.

*Skill mismatch in the labor market and unemployment*

**22. Our analysis also shows that skill mismatch is highly correlated with the unemployment rate for some MICs.** Our skills mismatch index (SMI) is calculated by taking the difference between the skill demand and supply for each country in the sample. Following Estevao and Tsounta (2011), the SMI for each country  $i$  at time  $t$  is constructed using the following formula:

$$SMI_{it} = \sum_{j=1}^3 (S_{ijt} - M_{ijt})^2$$

where:  $j$  is the skill level;  $S_{ijt}$  is the percent of population with skill level  $j$  at time  $t$  in country  $i$  (skill level supply),  $M_{ijt}$  is the percent of employees with skill level  $j$  at time  $t$  in country  $i$  (skill level demand).

- *Skill level supply.* We use the World Bank educational attainment data to construct skill level supply using primary education (as low skilled), secondary education (as semiskilled) and college and tertiary education (as high skilled).
- *Skill level demand.* We approximate skill level demand by the percent of employees in three key sectors: construction (to proxy low-skilled workers), manufacturing (for semi-skilled workers) and government and financial services (for high-skilled workers).

**23. The results support the basic conclusion that skill mismatch is an important factor that explains unemployment outcomes in small MICs (Figure II.8).**<sup>5</sup> Reflecting large spending on education, many of the small MICs generally have a high rate of schooling for primary and secondary education compared to the rest of SSA. However, this high rate of schooling has not yet translated into greater private sector skills because it has produced graduates whose skills are not in demand in the private sector. A high level of tertiary education for a prolonged period would generally enable a country to meet the demands of the private sector and thereby gradually reduce the skill mismatch in the labor market. This type of tertiary education closely mimics specialized advanced education which supplies firms with the necessary high-skilled workers to create more employment.

**24. The skill mismatch in many small MICs in SSA calls for aligning the education curricular to the needs of industry.** While governments in many small MICs have spent a lot in educating their youth, firms regularly cite the lack of suitable skills among job applicants as a constraint to hiring. Unemployment in Botswana is highest among college graduates, although for South Africa it is the highest among unskilled workers. The former suggests that the education system has not been very successful in producing graduates with marketable job skills. This skill mismatch can be reduced by improving the quality of education spending to support public-private partnerships for skills development, vocational and technical training, information and

<sup>5</sup> While acknowledging the limitations of the skill mismatch measure used in this chapter including its inability to capture the informal sector of the economy and the inherent identification problem involved in the measure, Leigh and Floris (2012) also estimated panel VAR regressions that support the results of this bivariate correlation analysis.

communications technology (ICT) skills, and graduates' internship programs in relevant industries in these economies.

*Welfare benefits, labor market regulations, and unemployment*

**25. Our analysis suggests that welfare benefit spending is not significantly correlated with the unemployment rate in small MICs (Figure II.8).** The results are consistent with the findings of Kingdon and Knight (1998) who also rejected the voluntary unemployment hypothesis through the impact of the replacement ratio (benefit-wage ratio) on the unemployment rate. This is an important result that has implications for public policy in many small MICs. If unemployment is not positively associated with welfare spending, then welfare programs can be used to help the unemployed, without fear of the policy leading to an increased unemployment rate.

**26. While labor market regulations typically tend to hamper job creation, they are not the key factor that explains the high unemployment rate in small MICs in SSA.** Specifically, high level of hiring and firing costs can negatively influence employers' decision to hire new employees. However, Figure II.8 suggests a low degree of correlation between hiring and firing costs<sup>6</sup> and unemployment rates in many small MICs. The estimated panel regressions (Leigh and Floris 2012) also show that hiring and firing costs are not a significant determinant of the overall level of unemployment in many small MICs.<sup>7</sup> The result suggests that the high unemployment rate in many small MICs is not closely associated with labor market rigidities. In fact, minimum wages (as a share of average wages in the economy) in small MICs in SSA are generally relatively on the low side when compared to those in other countries.

**27. High levels of structural unemployment in many small MICs have hindered the ability of governments to achieve a more inclusive growth.** The analysis in Leigh and Floris (2012) on the link between structural unemployment and income inequality suggests that a sustained GDP growth in small MICs cannot by itself improve income inequality if it is not accompanied by a reduction in long-term structural unemployment. The results show that reductions in structural unemployment substantially improve income distribution. To the extent that better education outcomes in small MICs contribute to a reduction in structural unemployment (as partly inferred from our unemployment-skill mismatch estimated function), they reduce income inequality which has the potential to make growth more inclusive.<sup>8</sup> The policy implication is that for many small MICs and countries with similar structural unemployment-income equality dynamics, policies that lead to

<sup>6</sup> Hiring and firing costs are based on the World Bank's data.

<sup>7</sup> Cape Verde may be an exception here among small MICs in SSA because labor laws are generally perceived as very restrictive and could be playing some role in employment outcomes (Box II.2).

<sup>8</sup> These results are broadly consistent with the results of the growth incidence curves (GIC) in the Regional Economic Outlook (October 2011) for in sub-Saharan Africa which found changes in the coefficients on the level of education are broadly consistent with changes in per capita consumption of the poorest quartile of the distribution for a selected group of economies in the region.

more sustained reduction in structural unemployment would help to enhance more inclusive growth in these economies.

## C. Conclusions

**28. Despite the sustained period of growth in GDP per capita for small MICs over the years, the growth was not strong enough to lead to a faster transition to high-income status.**

More recently, trend growth has also declined in many of these economies. The analysis in this chapter tends to suggest that some MICs in SSA face significant probability of a growth slowdown. The relatively large size of governments in many small MICs in SSA with inefficient state-owned enterprises crowding out the private sector and occupying a significant portion of available factors for low productive activities, contributes to lower economy-wide productivity and thus overall GDP growth. Reversing the declining growth trend would require reducing the size of government and removing the existing structural impediments to economy-wide productivity growth.

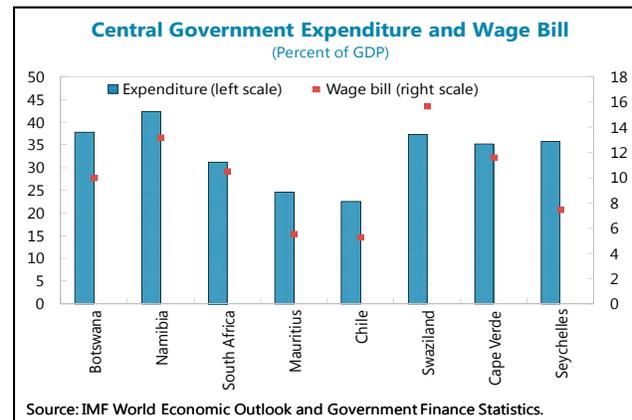
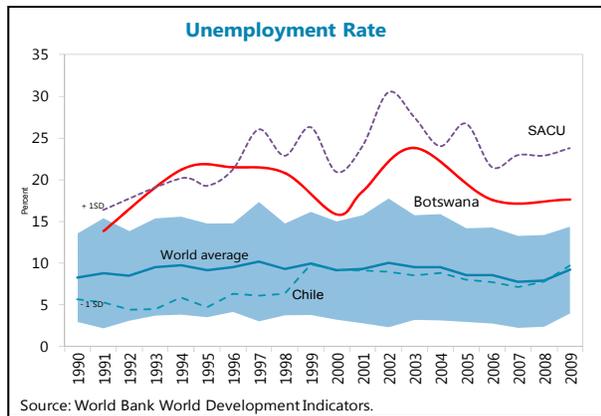
**29. Relatedly, enhancing more inclusive growth and job creation are key challenges for policymakers in many middle-income countries in SSA.** A key policy lesson drawn from the analysis in this chapter is that reducing income inequalities has the potential to lead to significant gains in terms of increasing the duration of growth spells in small MICs. The chapter's analysis of the factors that might have contributed to the high unemployment rate in these countries suggest that while there is some diversity in labor market conditions within these selected MICs, the broad conclusion from the empirical analysis suggest that there is no single measure available to address the unemployment problem in these economies. The analysis suggest that these economies cannot grow their way out of their unemployment problem and only a combination of carefully designed initiatives including prudent government employment and wage policies and measures that address the skill mismatch in the labor market are likely to make significant inroads into the unemployment problem. Furthermore, policies that lead to more sustained reduction in structural unemployment would help to enhance more inclusive growth in these economies.

**Box II.1. Botswana and Chile: What Explains the Divergent Unemployment Rates**

Botswana and Chile are two natural-resource rich economies that are deemed to be success stories for prudent economic management, but with different unemployment outcomes. Both economies are characterized by relatively low inflation, fiscal discipline, institutional strength, good infrastructure and high standards of governance. Despite these similarities in economic fundamentals, Botswana continues to have a double-digit unemployment rate, well above the world average, while Chile has generally kept its unemployment rate below 10 percent (text Chart).

*SACU's (including Botswana's) unemployment rate is well above the global average in contrast to Chile's.*

*Chile also has maintained a small size of government.*



What explains this divergence between the two economies in terms of unemployment outcomes?

- Through sound fiscal policy, Chile has reduced the size of the government and has maintained a composition of government spending that favors growth. Public sector wage growth has been broadly in line with economy-wide productivity levels. The limited size of the government and pro-growth government expenditure, suggest that less public sector dominance in Chile might have contributed to private sector led job creation.
- In relative terms, Chile has delivered better education outcomes in terms of quality of its skilled employees compared to Botswana. Chile has over the years made relatively more progress in implementing policies to address the skill mismatch in its labor market. The Chilean labor force is able to perform in a variety of occupations (not only governmental and agricultural sectors). Chile also has a 30 percent enrollment in tertiary education which is high compared to countries in sub-Saharan Africa.
- Unlike Botswana, Chile has made a lot of progress in diversifying its economy away from copper and thereby making the economy more resilient to shocks and limiting the Ballassa-Samuelson effect from the tradable to nontradable sector through wages. In particular, over the years, its service sector has expanded in terms of its share in value added and its share of total employment.

### Box II.2. Cape Verde: Unemployment, Education, and Labor Market Institutions

Cape Verde's labor market is characterized by persistently high unemployment, particularly among youth. Total unemployment fell from 20 percent in 2005 to over 10 percent in 2011, while among the youth it fell from 37 percent to over 25 percent (Figure II.11). Part of the decline in unemployment was due to growth and improved employment-output elasticity. Strong economic growth helped to reduce unemployment—output grew 46 percent between 2005 and 2011. Also, employment-output elasticity increased from

0.57 in 1991–1995 to 0.73 in 1999–2003 and from 0.35 to 0.70 among youth in the same period.<sup>1</sup>

Nevertheless, persistent unemployment rate above 10 percent reflects also structural features of the labor market most notably the shortage of skilled labor and rigid labor market regulations.

During the past decade Cape Verde has made efforts to improve the skills and quality of its labor force through substantial investment in education. The adult literacy rate has risen from just 37 percent in 1975 to 85 percent in 2008, while gross enrollment in primary education is now more than 100 percent, and two-thirds of students entering the first year of primary school have previously attended preschool programs. Gross enrollment in secondary education is at 70 percent and expanding rapidly. Also, government's Growth and Poverty Reduction Strategy Papers (I and II) included supporting the establishment of several new universities and other post-secondary institutions.

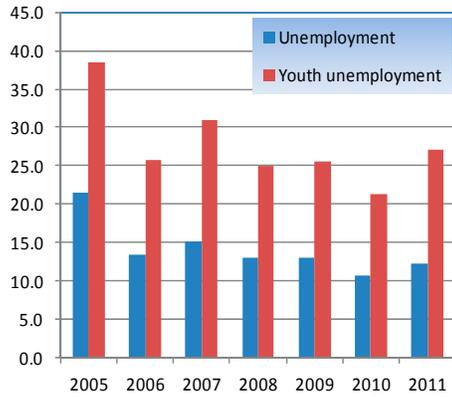
These policies have been broadly successful in improving basic educational indicators. However, much still needs to be done, particularly regarding technical and vocational training necessary to build workforce skills. Most of the population has less than 9 years of formal education, and workers with primary or basic secondary education make up the vast majority of the unemployed (Box text table).

Given that human capital, labor-market institutions are largely responsible for employment patterns in the long run, reforms to the labor-market regulations will be necessary to foster stronger labor demand—particularly in the formal sector—and to make labor markets more flexible to adapt to changing economic circumstances. Although designed to protect workers' interests, Cape Verde's current regulatory structure is among the most restrictive in the world. According to World Bank's Labor Market Efficiency index, Cape Verde's labor market efficiency is among the lowest in sub-Saharan Africa. Its score is 3.75, and it is ranked 30th out of 35 countries. In particular, restrictive hiring and firing regulations have an immediate impact on employment and the flexibility of the labor market. At the same time, the relatively high social security payroll tax reduces incentives to hire low-skilled employees.

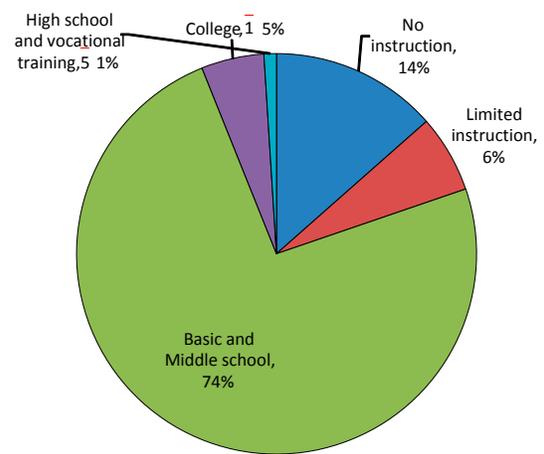
<sup>1</sup>/ Kapsos, Steven, 2005, "The employment intensity of growth: trends and macroeconomic determinants," International Labor Office, Employment Strategy Papers, 2005/12.

**Figure II.9. Cape Verde: Unemployment and Education**

*Unemployment has declined, but remains high particularly among youth.*



*Literacy is high, but opportunities are limited for technical and vocational training\**



Source: National Institute of Statistics (INE).

\* Official data does not distinguish whether technical and vocational training is included in categories other than "high school and vocational training".

**Cape Verde: Education and Unemployment**

Education	Unemployed Population
<b>No Formal Education</b>	934
(%)	4.4
<b>Primary Education</b>	8,358
(%)	39.6
<b>Basic Secondary</b>	9,860
(%)	46.8
<b>Advanced Secondary</b>	1,328
(%)	6.3
<b>Tertiary</b>	1,248
(%)	5.9
<b>Total</b>	<b>21,081</b>
(%)	<b>100</b>

Source: Instituto Nacional de Estatística, Censo 2010.

**Box II.3. Mauritius: Unemployment Issues**

**Can Mauritius grow itself out of its unemployment problem?** There has been limited job destruction during periods of economic slowdown, suggesting that cyclical adjustments do not take place through massive labor lay-offs. According to McDonald and Yao (2003), unemployment is largely structural in nature through skill mismatches on the supply side and rigidities on the labor demand side through wage setting institutions and laws. Staff's preliminary estimate indicates a baseline employment-output elasticity of 0.28 percent.

**Role of public sector wage policies:** For the public sector, the *Pay Research Bureau (PRB)* recommends every five years an increase of the wage bill; the recommendation is 23 percent for 2013. PRB recommendations typically have implications for wage-setting negotiations in the private sector. The wage bargaining process is centralized. The introduction of a *National Pay Council (NPC)* in 2006 has helped link wage growth to productivity advancements, with wages adjustments differentiated across sectors, thereby reducing wage rigidity and containing the wage-price spiral. World Bank (2010) calculated that average annual real wage growth was 2 percent between 2006 and 2009. Real wages grew much faster than labor productivity under the previous regime which linked wage increase to the consumer price index (CPI) only during 2000–06.

**Structural aspects of unemployment dynamics:** McDonald and Yao (2003) and Porter (2004) argue that rising unemployment has two main causes: (i) a highly centralized wage determination system, which results in wage compression and limits the skill premium, resulting in job destruction in the traditional sector and insufficient job creation in the new technology sector; (ii) the Mauritian education system cannot sufficiently provide to the low-skill-based labor force the higher skills that are needed by the emerging sectors. Growth and competitiveness are being hampered by skill mismatches as Mauritius transitions towards a more knowledge-based economy. The shortage results from an increased demand for skilled labor in the banking, health care, ICT and tourism sectors, relative to the low-skilled textile and sugar sectors. Only 13.5 percent of total primary school entrants obtain their school certificate, which is very low compared to 90 percent of students graduating from primary to secondary education in Mexico, Turkey, and Vietnam (World Bank, 2011). Mauritius needs to introduce drastic measures to increase the scale and quality of its labor force.

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### III. FINANCIAL STABILITY ISSUES IN SMALL MIDDLE-INCOME COUNTRIES IN SUB-SAHARAN AFRICA<sup>1</sup>

#### A. Introduction

**1. Although financial systems in small MICs in SSA are more developed than LICs in the region, they continue to be challenged by lingering financial sector vulnerabilities.** These include concentration risks for the banking sector. In addition, the financial landscape in many of these economies is changing rapidly with nonbank financial institutions becoming a dominant part of the financial system while their supervisory and regulatory frameworks lag behind. The interplay of concentration risks for the banking sector and regulatory risks for nonbanks is a key source of vulnerability to financial stability, given the cross-linkages between banking and the non-banking system. The growing sophistication of small MICs' financial systems toward emerging markets standards in an environment where supervisory frameworks still need to be strengthened in some areas, with limited capacity to use monetary and exchange rate policies, also affects their resilience to shocks. This chapter examines these issues.

#### B. The Structure of the Financial Systems and Potential Source of Vulnerabilities

**2. The financial landscape in small MICs varies from country to country.**

- The degree of sophistication of the financial system across small MICs is not homogenous. While Mauritius's financial system is much closer to emerging markets in terms of the degree of sophistication, and Botswana's pension system is relatively more advanced and closer to those of large MICs, Cape Verde and Swaziland are not as equally advanced in these areas.
- Despite this variance among small MICs, their financial systems are more advanced than those of LICs in the region and some of them have financial systems whose depth resemble those of large emerging markets. For example, Cape Verde and Mauritius have banking system assets that are at least 75 percent of GDP. While some of these MICs have relatively smaller banking size in relation to GDP, they have relatively large non-banking sectors with significant linkages to the banking sector. Second, capital adequacy and leverage ratios in these countries are relatively high in comparison to the Basel III standards and so are their deposit-to-loan and deposit-to-total-assets ratios. Third, foreign banks dominate the ownership of local banks in many of these countries. Fourth, a number of small MICs (e.g., Cape Verde and Mauritius) have a large offshore banking sector.

<sup>1</sup> Prepared by Ara Stepanyan, Seok Gil Park, Yibin Mu, Borislava Mircheva and Farayi Gwenhamo.

**Table III. 1: Key Banking Sector Indicators across Small Middle-Income Countries**

(In Percent)

	Botswana	Cape Verde	Lesotho	Mauritius	Namibia	Seychelles	Swaziland
Banking size/GDP	38.8	75.0	32.0	107.1	67.8	58.5	30.0
CAR(capital adequacy ratio)	19.9	13.4	18.1	16.3	14	24.2	18.9
Equity to assets (leverage ratio)	10.6	7.1	10.2	7.3	8.4	9.0	12.2
Deposit/Loan ratio	155.6	121.5	201.2	128.1	132.4	143.0	133.6
Deposit/Asset	84	74.9	74.6	70.3	91.3	92.0	79.0

Note: onshore banks.

Sources: websites of central banks in these countries and staff reports of these countries.

Data: End of 2011

### 3. While aggregate financial indicators remain broadly sound in many small MICs (Table III.1), potential sources of vulnerabilities to financial stability are emerging particularly on concentration and regulatory risks.<sup>2</sup>

- In Cape Verde, the high level of asset concentration and funding sources, along with the economy's dependence on the external environment, particularly the euro area, are risk factors for the financial system. While the banking system is heavily dependent on non-resident deposits (mostly from expatriate Cape Verdeans) for its funding, the banks' credit exposure is concentrated in the real estate sector, which is linked to a volatile external environment through tourism investment and remittance flows. Non-performing loans in real estate have been rising recently. Non-resident deposits and remittances have so far been resilient to negative developments in euro area economies. The offshore sector has limited risks for the domestic system, because it takes deposits only from nonresidents and mainly invests internationally in markets with favorable taxation regimes (Box III.6).
- In Namibia, the combination of a rapid buildup in residential property prices, the growing level of household indebtedness, and the concentration of large institutional investors in bank funding, pose potential vulnerabilities to financial stability. Since 2000, the Namibia residential property prices have more than quadrupled, with more moderate increases in 2012. The interplay of supply side factors relating to restrictions on land supply by municipalities and demand side forces relating to the rising middle class in urban areas and historically low interest rates are together giving rise to a boom in the property market. The Bank of Namibia's (BoN) March 2012 financial sector stability report noted that a reversal of this trend could have negative effects on the financial sector (Box III.3).

<sup>2</sup> Concentration risk is a type of credit risk where the vulnerability is embedded in the exposure of banks to one or more large borrowers or a particular sector.

- For Swaziland, the concentration risk is related to exposure to one or more large creditors usually in agriculture and in particular in the sugar industry which also plays a very big role in the economy. The concentration risk is sizable enough to serve as a potential source of vulnerability in the event that such creditors face large shocks (Box III.4).

**4. Concentration risks for the banking systems warrant close monitoring.** In these cases, if the top five largest debtors were to fail, the banking system could potentially face distress. In other cases, a high degree of borrower concentration could pose a major risk for the domestic banking system.<sup>3</sup> In some cases, the high credit risk dissuades banks from lending to small and medium size enterprises, resulting in all banks competing for a few prime borrowers. In other cases, high banking sector concentration—despite very active foreign participation in many small MICs—can also contribute to persistently high lending-deposit margins and high real lending rates hindering investment.

**5. The financial landscape is changing rapidly in many small MICs in SSA with increasing dominance by nonbank financial institutions.** Nonbank financial institutions' assets continue to grow rapidly in an environment with thin capital and money markets and low global interest rates.

- In Botswana, the rapid expansion of these institutions (with a consolidated balance sheet equivalent to 50 percent of GDP) and their systemic importance to the financial system warrants careful monitoring. This said, the NonBank Financial Institutions Regulatory Authority (NBFIRA) is not yet fully equipped to discharge its mandate owing to delays in building a skilled and experienced staff. Yet there are cross-linkages between the two parts of the financial system. Thus, any large shock to the nonbanking system could reverberate through the banking system and pose systemic stress across the financial system and thus the broader economy.
- In Namibia, given the growing size of the nonbank sector, the Financial Institutions Supervisory Authority (NAMFISA) is preparing regulations, guidelines and standards to accompany new NBFIs sector legislation (Financial Institutions and Markets Bill) and to support capacity building for staff in the regulatory agency.
- In Swaziland, the nonbank financial sector has been growing rapidly and nonbank financial institutions could pose a significant risk to financial stability. Nine savings and credit cooperatives (SACCOs) are currently facing financial difficulties owing to tight liquidity, poor lending practices, and governance issues. Although representing a small share of total assets of the financial system, a failure of one or more SACCOs could potentially spread to other deposit-taking financial institutions, given the lack of a crisis resolution mechanism and a deposit

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<sup>3</sup> However, concentration risk is not so dire in Namibia and the Bank of Namibia monitors the top 25 large exposures. The top 25 exposures makes up 10 percent of total private sector credit. Through a Bank of Namibia regulation, the top 25 percent exposure may not exceed 30 percent of total loan portfolio of a bank. The Bank of Namibia has also adopted Basel II standards.

insurance scheme. Moreover, capital market institutions have grown rapidly in recent years without adequate regulation and supervision.<sup>4</sup>

**6. The rapid increase in the asset size of nonbanks in many small MICs in SSA in an environment with thin capital and money markets also poses potential vulnerability.** Low global interest rates, coupled with the general lack of investment opportunities to match the maturity profile of their assets and liabilities, increases pressures on nonbanks to invest in localized high-risk—potentially high-return—sectors such as the property market, thus contributing to the property price buildup in these economies. The development of such an investment profile by nonbanks in a financial system where they are becoming a dominant player with weak regulatory and supervisory systems is an emerging risk to financial stability in these economies that warrants close monitoring. The ongoing global regulatory reforms (such as the G-20 initiatives) could likely have some impact on these small MICs with relatively significant non-banking sectors because of strengthened oversight on the interconnectedness between banks and non-banks.

### C. Conclusions

**7. The financial system in many middle-income countries in SSA is facing both old and emerging new challenges.** This chapter has highlighted some of these old and new challenges and the associated vulnerabilities they could give rise to.

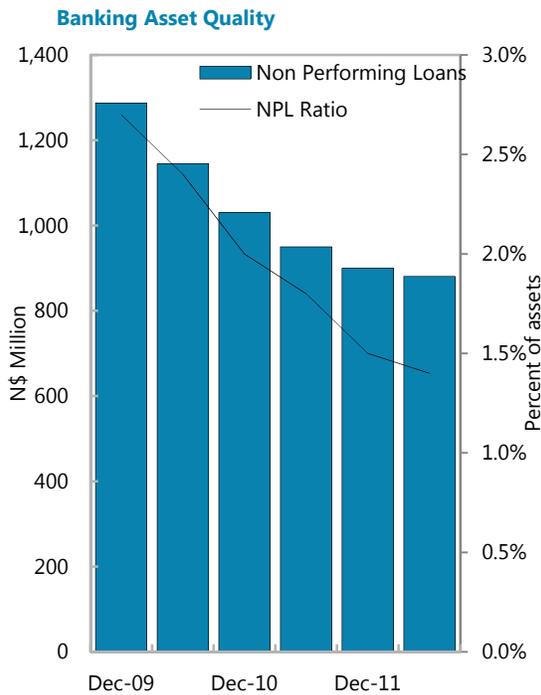
- The growing sophistication of financial systems of many of these MICs towards emerging markets standards in an environment where regulatory and supervisory frameworks still need to be strengthened in some areas, with limited capacity to use monetary and exchange rate policies, affects their resilience to shocks.
- Given this, a number of measures could be explored to minimize these risks and safeguard financial stability in these economies. Concentration risks for the banking systems warrant close monitoring. Namibia for example already imposes a 5 percent investment limit on non-banks investments in the property market thereby limiting their direct exposure. It is also critical to strengthen the regulatory and supervisory framework of non-bank financial institutions to enhance risk management of these NBFIs and contain the risk amplifications between banks and NBFIs as being done in Namibia. It is important to develop new mechanisms and instruments to channel the long-term savings of NBFIs to long-term finance for growth. Potential commendable mechanisms and instruments include the development of more public-private partnership projects and infrastructure bonds.

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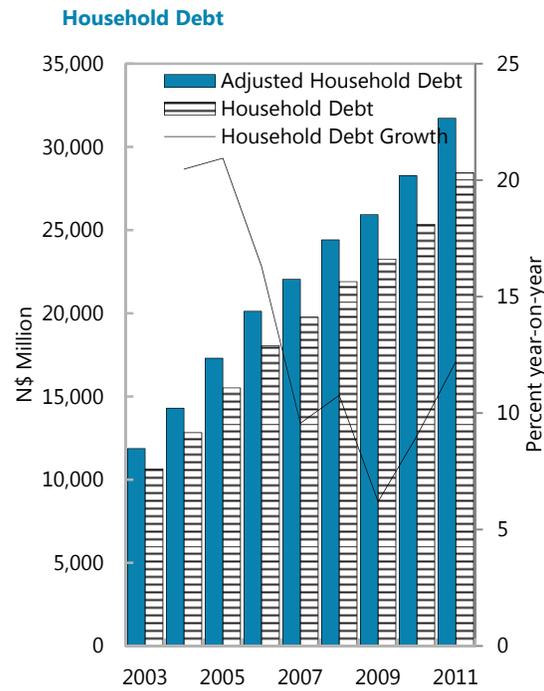
<sup>4</sup> See also a forthcoming African Departmental Paper Series: “Restoring Stability in a Changing Global Environment: Options for Swaziland”.

**Figure III.1. Namibia: Financial Sector Indicators**

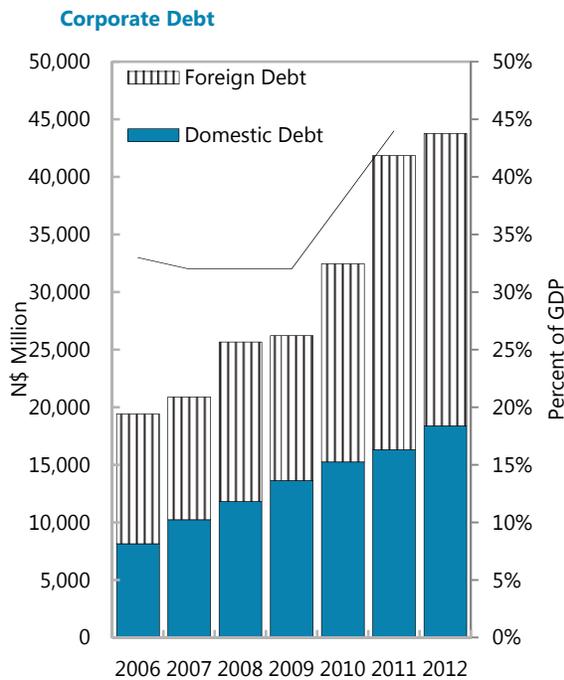
*While banking system indicators remain sound....*



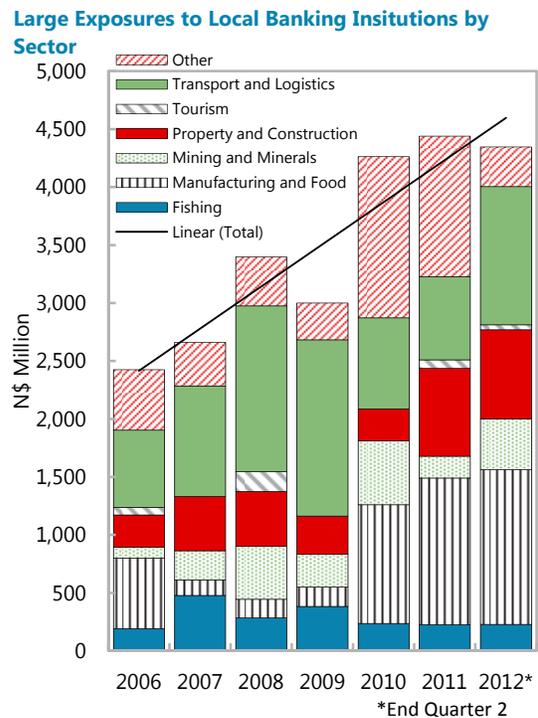
*Household indebtedness is rising....*



*as well as corporate debt...*



*with bank lending highly concentrated ....*



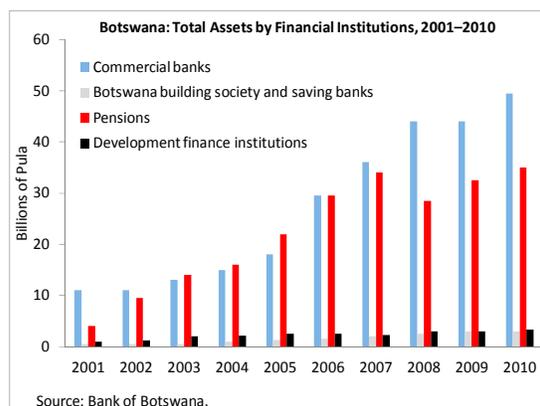
Sources: Country authorities and IMF staff estimates.

**Box III.1. Botswana: Structure and Performance of the Financial Sector**

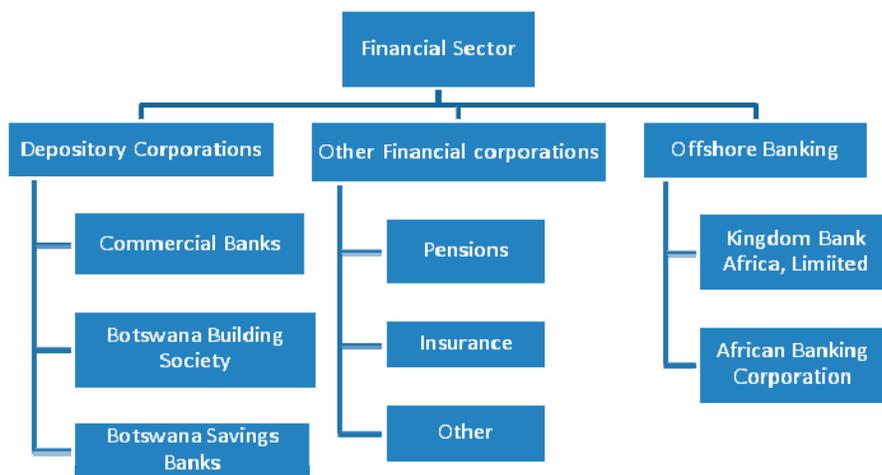
Botswana’s financial sector has evolved over the years, and featured new entrants, mergers and acquisitions, and orderly exits. The banking sector has expanded from two to eight banks serving the domestic market and two banks operating as offshore banks. The banking system is profitable, liquid, and well capitalized with capital adequacy ratios well above prudential norms. In addition to institutional movements, there has been a progressive widening of services, coverage and innovation with the context of the authorities’ financial sector development strategy and regulatory oversight, as well as global developments regarding the banking business model and information and communications technology. Although financial exclusion decreased by 13 percentage points in 2009 compared with 2004, access to financial services remains low with estimates of financial exclusion at about 33 percent (number of adults without access to financial services).

Botswana’s financial sector features three broad categories: depository corporations (commercial banks and other deposit taking institutions), other financial corporations (OFCs), and the offshore banking sector. OFCs, which are supervised by the NonBank Financial Institutions Regulatory Authority (NBFIRA), include insurance companies, pension funds, and other institutions such as the Botswana Stock Exchange and stock brokerage firms, asset managers, micro finance institutions and collective investment undertakings.

In addition, there are statutory development finance institutions, and the Motor Vehicle Accident Fund. The depository corporation segment of the financial sector (excluding Bank of Botswana) is historically dominated by commercial banks, which on average held 98



percent of total deposits and 92 percent of total advances from 2001 to 2010. In the nonbanking sector, life insurance companies and pension funds provide a wide range of savings and protection products and collectively constitute one of the largest and deepest nonbank financial sectors in sub-Saharan Africa.



Source: Bank of Botswana

### Box III.2. Cape Verde: Structure and Performance of the Financial Sector

Overall structure. The Cape Verdean financial system is dominated by the banking sector, whose assets constitute about 98 percent of total financial sector assets. A noticeable feature of the Cape Verdean financial sector is a significant offshore banking sector. While four of the eight onshore banks are controlled by foreigners (mainly Portuguese institutions), all banks are registered locally as independent legal entities. Capital adequacy and leverage ratios are relatively high in comparison to the Basel III standards. Deposit-to-loan and deposit-to-total-assets ratios are also relatively high. Cape Verde has relatively high reserve requirements given the underdevelopment of other monetary instruments. The share of nonbank financial institutions in the financial sector is negligible except the state-owned pension fund (INPS), which holds about half of total domestic public debt.

Surveillance framework. The Financial Sector Assessment Program (FSAP) analysis in 2009 recommended the authorities strengthen Cape Verde's financial sector surveillance framework with stronger compliance measures, risk-based supervision, and reform of the offshore banking sector. The authorities implemented a number of measures to strengthen the surveillance framework. First, the Bank of Cape Verde and the Ministry of Finance jointly have created a financial stability committee to enhance the institutional arrangements on crisis prevention and management. Second, they are shifting their financial supervisory philosophy to a risk-based approach by introducing stress tests and regularly issuing a Financial Stability Report. Third, they are revising the financial sector and banking laws to strengthen the legal and regulatory framework.

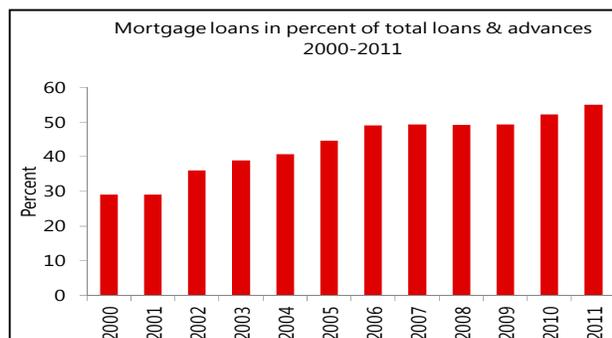
Risk factors. High level of asset concentration<sup>1/</sup> and funding sources, along with the economy's dependence on the external environment, particularly the euro area, are risk factors for the Cape Verdean financial system. While the banking system is heavily dependent on non-resident deposits (mostly from expatriate Cape Verdeans) for its funding, the banks' credit exposure is concentrated in the real estate sector<sup>2/</sup> which is linked to the external environment through tourism investment and remittance flows. Non-performing loans (NPLs) in real estate have been rising of late. Non-resident deposits and remittances have so far been resilient to negative developments in euro area economies. The offshore sector has limited risks for the domestic system, because it takes deposits only from non-residents and mainly invests internationally in markets with favorable taxation regimes. However, global regulatory reforms will likely have some noticeable indirect impact on Cape Verde's banking system through offshore banks owing to strengthened transparency requirement and the increased competition for deposits.

<sup>1</sup> The two largest onshore banks hold some 70 percent of loans.

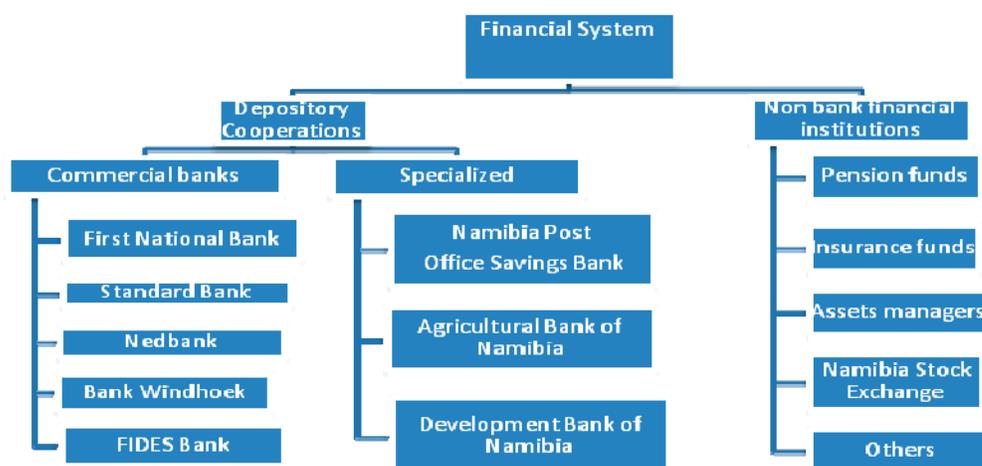
<sup>2</sup> Credit to mortgage loan, construction, and real estate companies amounts to about 40 percent of total credit.

### Box III.3. Namibia: Structure and Performance of the Financial Sector

The Namibian financial system is relatively well developed compared to most financial systems in African countries. It was ranked 7th position in Africa by the 2009 World Economic Forum (WEF) report. The banking system is profitable, liquid, and well capitalized with capital adequacy ratios well above prudential norms. Though the system is sound and functions well, there is limited competition and limited access to financial services. Recent local surveys (2007–09) have shown that more than half of the Namibian bankable population is unbanked and that small and medium-sized enterprises (SMEs) have restricted access to formal financing. Considering these shortcomings, the government recently launched the 2011–21 Namibia Financial Sector Strategy with the objective of steering Namibia toward a more diversified financial sector characterized by efficiency, effectiveness, stability and improved access.



Although aggregate financial indicators are broadly sound, potential sources of vulnerabilities arise from commercial banks’ large exposure to the property market where there has been a price buildup in recent years, high household indebtedness, and the concentration of large institutional investors including nonbank financial institutions in commercial banks funding. The rapidly growing nonbank financial institutions (NBFIs) —assets are about 100 percent of GDP—warrant close monitoring given cross-linkages with commercial banks.



Namibia’s financial sector features two broad categories: depository corporations (commercial banks, mostly subsidiaries of South African banks and other specialized deposit taking institutions) and a range of nonbank financial institutions such as insurance companies and pension funds, stockbrokers, asset managers and the Namibian Stock Exchange. The Government Institutions Pensions Fund (GIPF) constitutes about 80 percent of total NBFIs.

#### Box III.4. Swaziland: Structure and Performance of the Financial Sector

The financial sector in Swaziland comprises commercial banks and nonbank financial institutions. While the banking sector is represented by four commercial banks and has been stable over the years, nonbank financial institutions (NBFIs) have been growing rapidly without completely adequate regulation and supervision.

- All commercial banks are well capitalized and have maintained strong risk-adjusted capital adequacy ratios (CARs) over the years. The CAR positions of the four banks range from 11.5 to 35.7 percent (end-September 2012), well above the minimum statutory requirement of 8 percent. In addition, banks have been profitable and have maintained a strong position. However, stress tests of commercial bank balance sheets point to some underlying risks for the banking system in Swaziland. Specifically, exchange rate, credit, liquidity, and concentration risks could potentially pose a challenge to commercial banks.
- NBFIs include insurance and retirement funds, savings and credit cooperatives (SACCOs) and capital market institutions. The Financial Sector Regulatory Authority (FSRA) is the supervisory and regulatory body of NBFIs. The FSRA became operational in the last quarter of 2012 and is starting to take upon its supervisory duties while still putting in place a regulatory framework.
- Insurance and retirement funds are supervised and regulated by the Registrar of Insurance and Retirement Funds (RIRF). They are liquid, well capitalized and profitable. The RIRF is part of the newly established FSRA.
- Savings and credit cooperatives have become increasingly popular, comprising 67 institutions serving about 37,000 members (out of a total population of 1.2 million) and holding about 2 percent of the assets of the whole financial system. According to the Swaziland authorities, nine SACCOs are currently facing financial difficulties owing to tight liquidity, poor lending practices, and governance issues. Although, they represent a small share of total assets of the financial system, a failure of one or more SACCOs could potentially spread to other deposit-taking financial institutions, given the lack of a crisis resolution mechanism and of a deposit insurance scheme. Therefore, making the FSRA operational has been a positive step in the adequate supervision and regulation of SACCOs.
- Capital market institutions comprise a small number of institutions; four collective investment schemes (CIS) and two licensed stock brokerage firms. Capital market institutions have grown considerably in the past five years, currently managing about 14 percent of all assets in the financial system, equal to about 16 percent of GDP. In addition, of the four CIS, one controls about 70 percent of the total funds under management. Capital market institutions are yet to be properly regulated and supervised, thus posing potential risks to the stability of the financial system.

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