

# LEGISLATIVE ALERT

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## URGENT POLICY INTERVENTIONS ARE NEEDED TO FOSTER FINANCIAL INTERMEDIATION AND REDUCE THE HIGH COST OF CREDIT IN GHANA

by  
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### Summary

The Ghanaian financial sector has been growing rapidly in terms of the number of institutions and products offered. Financial institutions contribute to economic growth by channeling surplus resources from savers to borrowers/investors. With the rapid growth of the financial sector, an important question to ask is how “*financial intermediation*” and “*financial deepening*” in terms of access to financial services and the use of financial resources in the economy have been evolving. The higher the level of financial intermediation/financial deepening, the greater is the contribution of the financial sector to economic growth. This is because high financial intermediation and financial deepening increase the scope and pace of turning financial resources into real resources. There is not enough empirical evidence on this evolution. Meanwhile, it is known that the cost of credit has been persistently high. In fact, the cost of credit is placed high in the World Competitive Index Reports and Surveys by the Ghana Association of Industries among the obstacles to doing business in Ghana and it is considered to be a major impediment to investment and economic growth. This problem has also not been fully investigated.

**IEA  
Ghana**

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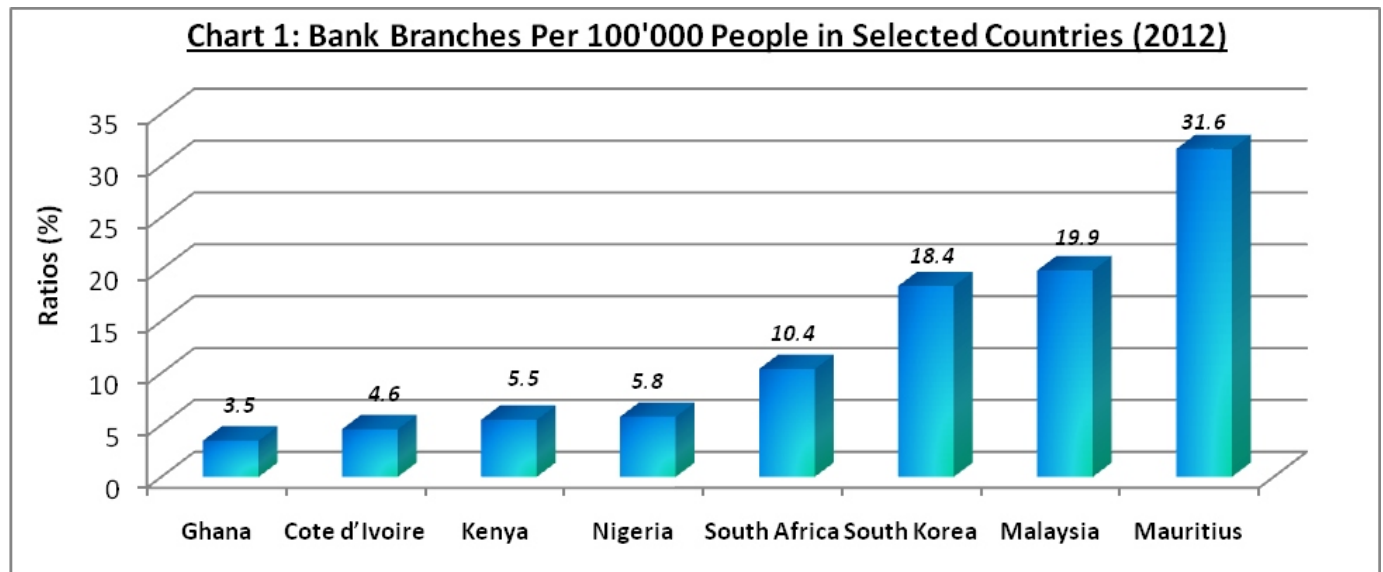
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The IEA has carried out a study of financial intermediation and the cost of credit in Ghana. The first part of the study involved measurement of financial intermediation/financial deepening using a number of standard indicators. The second part involved a survey of banks to investigate how industry costs, competition, efficiency, borrower risks, and credit allocation decisions, among others, affect the cost of credit.

### **The results of the study**

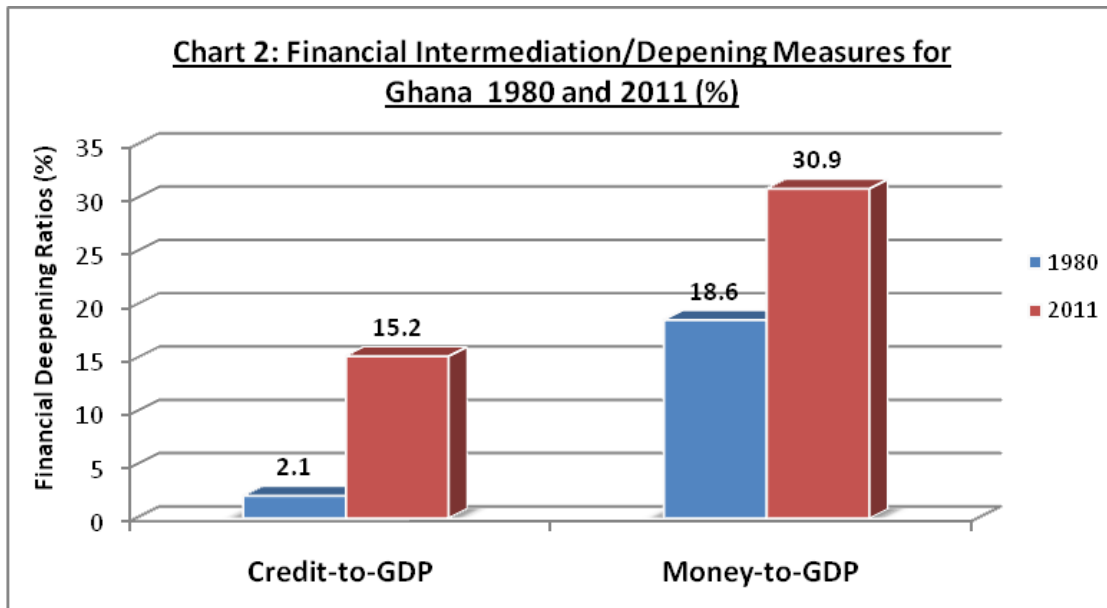
The study determined that the number of bank branches per 100,000 people as of 2012 was

about 3.5. This ratio is a standard measure of access to bank services and varies from country to country. By this measure, Ghana falls behind Cote d'Ivoire, Kenya, Nigeria, South Africa, South Korea, Malaysia and Mauritius (See Chart 1). Clearly, Ghana's bank-to-population ratio is low even by the standards of our African peers let alone our non-African middle-income peers. Moreover, as in other countries, to the extent that the concentration of banks tends to be higher in urban areas, the ratio will be lower in rural areas. The low number of bank branches per population suggests that financial intermediation/financial deepening is low.



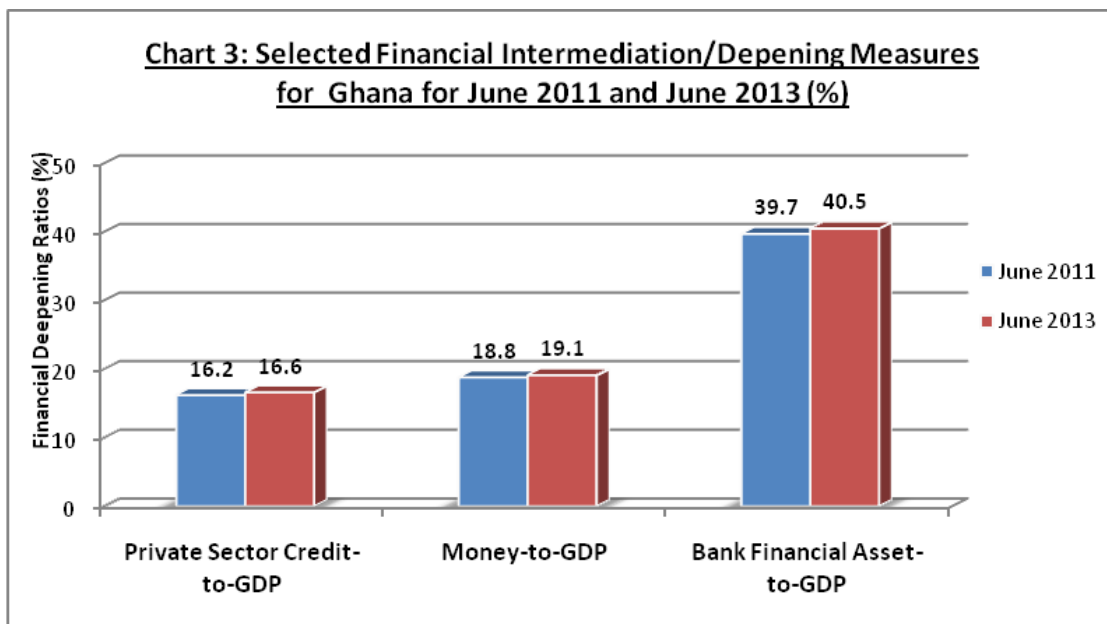
Other measures of financial intermediation/deepening include: credit-to-GDP, money-to-GDP and bank financial assets-to-GDP ratios. The study measured private sector-credit-to-GDP and money-to-GDP ratios for Ghana for 1980-2011. The

private sector-credit-to-GDP ratio increased from 2.1% to 15.2% during the period while the money-to-GDP ratio rose from 18.6% to 30.9%. (See Chart 2).



The study also measured private sector credit/GDP, total credit/GDP and bank financial assets/GDP for a more recent period,

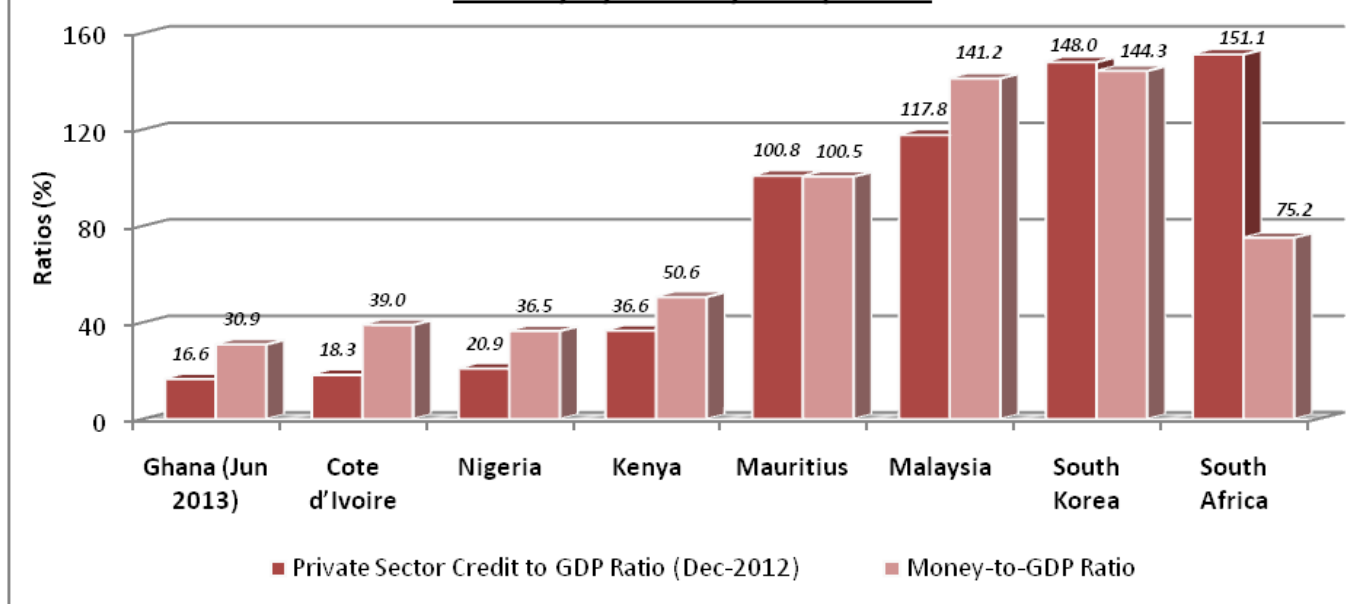
June 2011-June 2013. The first indicator rose from 16.2% to 16.6%, the second from 18.8% to 19.1%, and the third from 39.7% to 40.5%.



Ghana's private sector credit-to-GDP ratio, which stood at 16.6% in June 2013 lags behind the ratios (as of end-2012) for Cote d'Ivoire, Nigeria, Kenya, Mauritius, Malaysia, South Korea and South Africa. For the money-to-GDP ratio, Ghana's figure of 30.9% as of end-2011, lags behind the ratios (as of end-2012)

for Nigeria, Cote d'Ivoire, Kenya, South Africa, Mauritius, Malaysia and South Korea (See Chart 4). Again, Ghana's ratios clearly are low by our African and non-African middle-income peer standards. They generally further confirm the shallowness of Ghana's financial sector.

**Chart 4: Selected Financial Intermediation/Deepening Indicators:  
Country by Country Comparison**



The bank survey found that the number of deposit customers for the reporting banks ranged from 77,904 to 616,178, while the number of loan customers ranged from 988 to 25,398. The fact that the number of deposit customers is much higher than loan customers suggests that many depositors do not use loan facilities. This is largely due to lack of access. It is known that many individuals and small-sized businesses do not have access to credit, ostensibly due to their perceived low credit - worthiness and high borrowing risks issues that the study also sought to investigate. The low level of loan use may also be due to a culture of loan aversion due to the distaste for indebtedness.

The survey found that banks consider interest payments as the most important determinant of their costs, while loan default costs come in a close second. The surveyed

banks consider the Treasury Bill rate as the most important determinant of the cost of credit in the country. This confirms the widely-held view that Government borrowing plays a major role in driving up the cost of borrowing in addition to crowding out the private sector. When it comes to their own (high) lending rates, however, the banks blame their cost of funds as the most important determinant.

On (low) deposit rates, the banks consider low customer awareness/education as the most important cause. It is interesting to note banks blaming depositors for the low rates they pay them. While they may not admit it, low competition and collusive practices in the industry are believed to be important reasons for low deposit rates. On the level of borrower risks, banks consider it to be high. This tends to be factored into lending rates, which differ from borrower to borrower. On

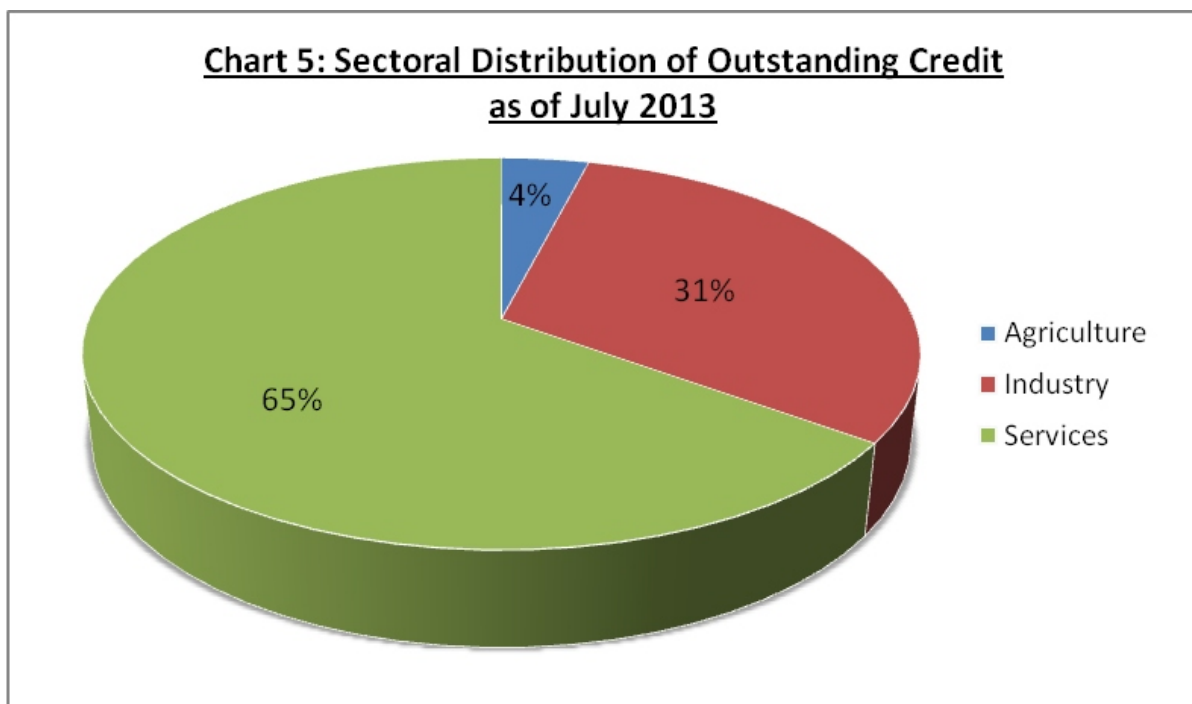
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loan defaults, banks consider inadequate borrower identification, inadequate credit reference on borrowers and inadequate loan recovery mechanisms as the important causes. On low access to credit by the private sector, banks blame it on high loan default rates, inadequate bankable projects and competition from Treasury Bills.

In the banks' view, competition in the industry is high. The question did not, however, state the measures of competition, which could range from quality of services to range of products to the milieu of prices. Banks indicate that education of customers so that they can be more selective is the most important requirement for increasing competition in the banking industry. Banks admit that efficiency in the industry is low. They suggest that improving management, reducing operational costs, improving labour quality and more modernization would help increase efficiency. Asking an

industry to assess itself may have an element of bias due to self-interest. A future study would seek external opinions on competition and efficiency in the industry.

On the most-preferred lending sector, banks select the services sector, while agriculture is least-preferred. Banks' lending to a particular sector is influenced by both return/profitability and risk. A snapshot of sectoral distribution of outstanding credit as of July 2013, confirms the banks' view. Services dominates with 65%, followed by industry with 31% and then agriculture with a mere 4% (See Chart 5). Banks indicate that they prefer to lend to services because of the low risk, low loan default rates, and good business prospects in the sector. Banks regard their reluctance to lend to agriculture as being influenced by high risk in the sector and the low market potential of agricultural produce due to reliance on the weather.



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## Policy recommendations

Following from the results of the study, we offer the following policy recommendations:

### 1. Financial intermediation/financial deepening

Access to and the use of financial services in Ghana are low. This constrains the financial sector in contributing to the growth of the economy. There is a need to promote further physical growth of the financial sector. Appropriate incentives should be introduced to encourage banks to locate in rural areas. Banks must also actively promote savings and expand lending services by extending their reach and introducing innovative products.

### 2. The cost of credit

The cost of credit has been persistently high. This is the result of competitive government borrowing, structural inefficiencies in the banking industry that lead to high operational costs, and high lending risks and associated loan defaults. There is a need to restrain government borrowing by entrenching fiscal discipline. There is a need to improve efficiency in the financial sector through improved management practices, engagement of qualified and well-trained staff and more modernization. There is a need for safety nets to reduce lending risks, including through effective Credit Reference Bureaus and Borrower Identification Systems.

### 3. Access to credit by the private sector

Banks' sectoral lending preferences and the low access to credit by the private sector and the agricultural sector in particular represent a market failure in the financial sector in the context of liberalization. This requires remedial intervention measures. There is a need to ensure availability of affordable credit for small-scale and informal private enterprises and for the agricultural sector. This can be done by creating a special bank or fund, with steps taken to limit potential government contingent liabilities.

### 4. Financial regulation

There is a need for vigilant and robust financial regulation. In particular, it is necessary to ensure that banks do not engage in collusive practices in dealings with customers. Regulators must ensure that banks pay fair rates to depositors and avoid charging unjustifiably prohibitive rates for their services.



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