

The Financial Sector in Burundi

An Investigation of its Efficiency in Resource Mobilization and Allocation

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Abstract

This study investigates the performance of the financial system in Burundi in mobilizing and allocating resources. Although the study does not presume that finance is the most binding constraint to growth and socio-economic development in Burundi, it takes the view that unlocking the financing constraint could alleviate other impediments to growth and poverty reduction. We use a blend of methodological approaches drawing from: (1) industrial organization in examining the structure of the banking sector, and the behavior and profitability of financial intermediaries; (2) macroeconomic analysis with a focus on the effect of economic performance and policy framework on the performance of the financial sector; and (3) political economy analysis highlighting the role of political governance and political instability, as well as ownership of financial institutions on allocative and distributional inefficiencies. The paper finds that the core of the financial sector that has survived the worst of the economic and political crises of the last decades is highly profitable. Bank profitability, however, hides several weaknesses of the financial sector: a high level of fragmentation; a narrow credit market that favors “insiders” who are mostly affiliated with the political elites, at the expense of “outsiders”; a severe shortage of long-term stable resources; inefficient allocation of resources relative to social returns and risk; and weak supervision and regulation which largely explain the failure of several financial institutions in the past and the fragility of the banking sector today. Access to finance remains an important challenge, especially for the “stranded middle” (middle income households and medium size firms) due to the “missing middle credit market” which is not filled by either banks or microfinance institutions. Recent developments in the financial sector, particularly the increasing penetration of foreign banks, may potentially boost competition, financial innovation, and access to finance with positive effects on growth and poverty reduction.

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1. Introduction

The post-independence period in Burundi has been characterized by low and volatile growth, which has made it difficult for the country to achieve national development goals, especially poverty reduction. Factors that account for the sluggish and volatile growth range from physical constraints (e.g., Burundi is land-locked) that raise the costs of production and trade, to political instability (Nkurunziza and Ngaruko, 2008). The country's political and economic instability have constrained the mobilization of public and private domestic resources, thus limiting investment, entrepreneurship, and growth in productivity. Yet private investment and enterprise development are important drivers of employment creation, poverty reduction, long-term growth, and economic resilience through diversification and expansion of the growth base.

Access to finance affects poverty through direct and indirect channels. The direct channel relates to income generated by job creation following new investments. The indirect channel is the wealth effect of economic growth resulting from an increase in investment. This study investigates the extent to which the financial sector contributes to the process of growth and poverty reduction through financial resource mobilization and efficient allocation of resources to activities and sectors with the highest economic and social returns.¹ The study acknowledges the importance of demand-side factors as impediments to accessing finance, especially sluggish growth and the resulting stagnation of incomes.

Due to the complexity of the topic, the study adopts an eclectic approach, drawing from macroeconomic analysis, political economy, and industrial organization. On the one hand, the paper discusses the impact of economic performance, and shocks to economic activity, on financial intermediation. On the other hand, the paper discusses the failure of the financial sector to fuel an increase in investment and growth. The study examines the sectoral and temporal allocation of resources and attempts to explain banks' revealed preference for short-term credit and specific sectors. By comparing the distribution of resources by sector and term structure to the risk profile measured by default rates, a risk-efficiency index is constructed to assess the efficiency of resource allocation from a risk perspective.

The main finding of the study is that poor governance and political instability have affected the behavior and performance of financial intermediaries. In particular, the paper shows that the highly centralized and monolithic regimes that have ruled the country over the past five decades used the financial sector and the economy in general for rent seeking and consolidation of power rather than economic development (Ndikumana, 1998, 2005; Nkurunziza and Ngaruko, 2000, 2008). As a result, the need to control economic and political power determined or influenced the ownership of banks, undermined the independence and regulatory capacity of the central bank, impeded the management of public financial institutions, and perpetuated inefficiencies in the allocation of resources, particularly of credit. Hence, the credit market is segmented between "insiders" who benefit from preferential credit terms and "outsiders" who are relatively

¹ One key indicator of social returns to investment in a poor country like Burundi is the extent to which it reduces poverty.

penalized. The inability and unwillingness of the central bank to enforce appropriate regulation and supervision is considered one of the main factors that explain the weakness of the financial sector.

The study contributes to the literature on the effect of political economy factors on economic performance. Most studies on the effect of political factors on firm and industry performance in developing countries have focused on Asia (Wurgler, 2000; Khwaja and Mian, 2005; Hsien and Klenow, 2009; Fisman, 2001; and Leuz and Oberholzer-Gee, 2003).² Faccio (2006) provides a cross-country analysis of 47 countries with only two from Africa (South Africa and Zimbabwe) and the analysis is not disaggregated enough to provide detailed evidence on the situation in these countries. This paper is one of the few detailed studies on the subject in Africa. Moreover, unlike most countries where privatization in the 1980s and 1990s reduced the influence of the public sector in the management of financial institutions, the state in Burundi is still very influential in the financial sector despite some progress towards its liberalization. As Shleifer and Vishny (1994) show, the state can still exert a high degree of control over privatized firms in cases of privatization without commercialization. In Burundi, most financial firms have only been partially privatized, and the state is still the most important shareholder either directly or through state-owned companies. The state has representatives on the boards of almost all major financial institutions. The problem is that the loyalty of state representatives lies with their political backers, not the firms they are supposed to manage.

The influence of the state in the financial sector is also transmitted through the state's pervasive presence in other sectors of the economy. The state has never favored the emergence of a strong private sector, so it remains a dominant economic actor. As a result, there are private enterprises – including in the financial sector – that owe their existence to government contracts and hence political connections. Given that transactions with state entities are not necessarily based on competitive bidding, privileged firms often collapse when the country's political leadership changes (Nkurunziza and Ngaruko, 2008). In this environment, many firms strive to be in state representatives' good graces in order to survive. Similar to Khwaja and Mian (2005), the present study uses disaggregated data to identify some of the reasons why the financial sector in Burundi has had a very limited effect on development.

The next section provides the context of the study by presenting the political economy of growth and poverty reduction. Section 3 begins with a brief overview of financial liberalization and proceeds to examine the structure and characteristics of the financial sector. Section 4 examines the term structure and sectoral credit allocation and the contribution of banks to economic activity. This leads, in Section 5, to an analysis of the performance of the sector both at the firm level (bank profitability) and sectoral level. The section discusses the fragility of financial intermediaries and the risk of bank failure. The analysis of a unique microeconomic dataset uncovers features of credit allocation that are motivated by political objectives rather than profit maximization. The section ends with a discussion of the role of the financial sector in poverty reduction, which is probably the most pertinent dimension of financial sector efficiency in a poor country like Burundi. Section 6 concludes the paper with a summary of key findings.

²According to Hsien and Klenow (2009), capital misallocation due to political factors could explain 30% to 50% of TFP difference between Chinese and American firms, and 40% to 60% of TFP difference between Indian and American firms.

2. The political economy of growth and poverty

2.1 A history of political instability and poor governance

Knowledge of Burundi's political economy is essential for understanding the performance of the country's financial sector over the past four decades.³ Burundi's post-independence history has been marked by political violence. Since independence in 1962, the country has experienced five episodes of civil war: 1965, 1972, 1988, 1991, and from 1993 to 2003. These civil wars claimed more than half a million lives and generated more than one million refugees (Nkurunziza and Ngaruko, 2005). These conflicts have been characterized as opposing the country's two main groups, the Hutu and Tutsi, despite the fact that it is difficult to objectively delineate the boundaries separating them. These two groups share the same language and culture, and live in mixed communities across the country.⁴ A deeper analysis of conflict in Burundi shows that political violence resulted from a combination of three key factors (Nkurunziza and Ngaruko, 2005, 2008; Ntibazonkiza, 1993; Ndikumana, 1998; Lemarchand, 1994).

The first factor relates to the divisive policies instituted by the Belgian colonial authority in the 1920s and 1930s, which opposed Hutu and Tutsi, destroying a regulatory system that had been used to keep a balance between the two groups. The second factor is the 1959 social revolution in Rwanda, a neighboring country with a similar ethnic configuration to that of Burundi. The Hutu in Rwanda captured power through a violent rebellion against the traditional Tutsi monarchs. This had a negative demonstration effect on Burundi where Hutu elites made several attempts to emulate the Rwandan revolution, arguing that their majority should guarantee them *de facto* control of political power. Tutsi elites responded by deploying their political, military, and diplomatic power to prevent a Rwandan-type revolution from happening. This created and perpetuated tension between Hutu and Tutsi elites. The third factor is the failure of post-independence elites to put policies in place that could re-establish and safeguard mechanisms that guarantee peaceful coexistence between the different groups. Most particularly, the unwillingness to punish the state officials who were responsible for masterminding the bloody civil wars instilled a sense of mistrust of the state by the majority of the population. Indeed, Burundi's post-colonial political elite have invested in instituting a political system aimed at capturing the state in order to conserve power. We discuss this latter factor in some detail as it has had the most profound effect on the country's economy, including the performance of the financial sector.

From the mid-1960s until 2005, political power and, to a large extent, economic power, were controlled by a Tutsi-dominated group from the southern province of Bururi. The three presidents who ruled Burundi from 1966 to 2003, except for the period between July 1993 and

³ This section draws from Nkurunziza and Ngaruko (2005, 2008), Nkurunziza (2010a, 2010b) and Ndikumana (1998, 2005). Also see Ntibazonkiza (1993) and Lemarchand (1994) for more detailed historical accounts of ethnic conflicts in Burundi.

⁴ There are two additional small groups: the Twa and the Ganwa. The former are loosely integrated into Burundi's society. The latter are mostly descendants of Burundi kings who ruled the country until the monarchy was abolished in 1966. The Hutu are considered to be by and large the majority of the population and the Tutsis a very large minority.

July 1996, took power through a military coup d'état. They were Tutsis from the Rutovu commune in the Bururi province. Through a system of patronage, they ruled the country with an iron fist, under the protection of a strong army and security apparatus totally dedicated to their protection and that of their associates. Indeed, security was fully controlled by Bururi natives (Nkurunziza and Ngaruko, 2005). The political elite and their private sector associates enjoyed all the spoils of power while excluding the majority of the population from political and economic participation. In addition to dissuasive methods used by the army and state security to ensure that power remained fully controlled by the ruling elite, several other tactics were used. For example, Bururi had the best schools that prepared the future elites. Entry to the state-controlled University of Burundi – which until recently was the country's single institution of higher education – was filtered to limit the number of non-Bururi students, who were seen as future potential political challengers (Nkurunziza and Ngaruko, 2008; Ndikumana, 1998).

In order to extract and appropriate maximum rents from the population, several methods were employed. For example, the state controlled the economy directly through pervasive interventionist measures, and indirectly through a large number of state enterprises, including major banks and other financial institutions. The allocation of employment in these enterprises was an important source of rents as the best jobs were reserved for the members of the ruling class. Most of these firms were poorly managed and were only kept afloat by large government subsidies. For example, state firms produced only 9 percent of Burundi's GDP in 1990 but accounted for 31 percent of formal sector employment, 25 percent of outstanding domestic credit, and benefited from 3.4 percent of GDP in subsidies from the government. In 1995, equity capital of 36 firms with majority state participation amounted to 20 percent of the country's GDP. In the same year, these firms recorded a net loss equivalent to 6 percent of GDP or 14 percent of government revenue, excluding grants (Ngaruko and Nkurunziza, 2006).

Essentially, the losses in state-owned enterprises (SOEs) represented appropriation of public resources by firm managers and their employees. Subsequent subsidies to such loss-making firms, which were not conditional on good management, could be considered taxes levied on the general public and transferred to members of the elite. Another indirect way of levying rents from the population was the pricing of cash crops, especially coffee, the country's main export which was largely produced in the North of the country. Traditionally, the government allocated a small portion of the international price to producers (only 40 percent in the 1970s and 1980s), transferring the remainder to government-controlled institutions and well-connected intermediaries. Economic controls such as import licenses and access to foreign currency were also used to favor selected individuals and enterprises.⁵

As could be expected, policies based on exclusion, state capture by a small group, and rent extraction created economic and social inequalities, breeding resentment from the excluded. It is not surprising that these politically motivated inequalities caused violent reactions from the excluded segments of the population, and, ultimately, a cycle of civil wars. Hence, rather than alleged ethnic antagonisms, these wars are best characterized as the outcome of distributional conflict (Ndikumana, 2005).

⁵ Today, foreign currency allocation is mostly liberalized and the coffee sector is in the process of liberalization. As a result, in 2009 and 2010, producer prices substantially increased.

In 1993, pressure from the international community forced the ruling elite to organize democratic elections which were overwhelmingly won by Melchior Ndadaye who was inaugurated on 10 July 1993. This was the first time since the first military coup in 1966 that a non-Bururi civilian and Hutu became president. Less than four months into his term, President Ndadaye was assassinated by members of the old elite. The reaction of the Hutu population was immediate: they engaged in blind killings of innocent Tutsis to “avenge” the assassination of “their” president, sparking a ten-year long civil war that claimed about 300,000 lives and generated a large number of refugees. The country and its economy are yet to recover from the devastating effects of this war.

The year 2005 brought a fundamental change to Burundian politics. CNDD-FDD (Conseil pour la Défense de la Démocratie-Force de Défense de la Démocratie), the main Hutu-dominated rebel group which waged the ten-year rebellion following the assassination of Melchior Ndadaye in 1993, forced the ruling elite to negotiate a political settlement in order to stop the war. It is in this context that elections were organized in 2005 and won by CNDD-FDD. This victory was celebrated by most Burundians as heralding a new era of a more democratic and inclusive political system. The new leaders were among the prominent victims of exclusionary policies under previous regimes, so these new leaders were expected to have a higher sense of responsibility and adopt a better governance system than their predecessors. After the first five-year term, the same team from CNDD-FDD won another term as a result of elections organized in June-August 2010.⁶

Having won the elections two consecutive times, CNDD-FDD is now challenged to fulfill the promise of improvement in the political system as has been expected since 2005. The 2005 transition mainly consisted of a power transfer from the southern Tutsi elite to the Hutu elite, but so far there has been little positive impact on the population. The current leadership is a replica of the old one, with the difference being that rents are now controlled and channeled through CNDD-FDD party structures, a mirror image of the old one-party system.⁷ Despite this important change in Burundian politics, most members of the traditional elite, particularly those in the private sector, are still better off than other segments of the population. The assets they were able to accumulate over several decades under monolithic regimes are shielding them from the deep poverty that afflicts the majority of Burundians. Most bank executives and employees belong to or are connected to this group.

2.2 Effect of poor governance on the financial sector, economic growth, and poverty reduction

Bad governance has had direct nefarious effects on the financial sector. Traditionally, the state in Burundi either fully owned or had controlling shares in most Burundian financial institutions. As was the case with other state-owned enterprises (SOEs), these institutions were used as sources of rents. Managers and employees were carefully selected to ensure that financial institutions remained in the hands of the ruling elite. Bank credit was often issued on the basis of political

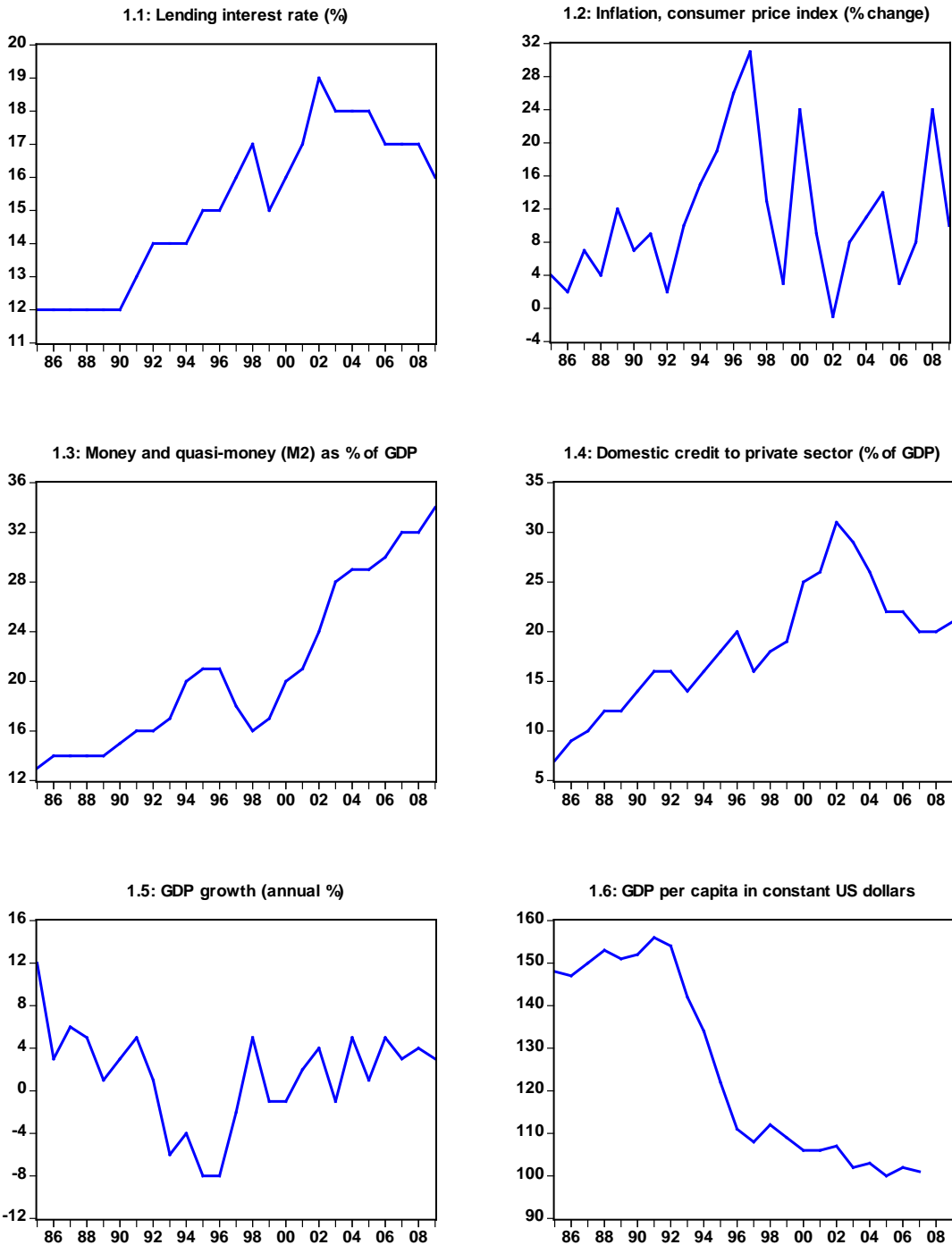
⁶ CNDD-FDD’s victory was largely contested by the opposition, with all but one opposition party pulling out of the presidential elections in protest against claims of vote rigging in the local (commune-level) elections.

⁷ For example, the government is beset by several cases of alleged corruption that have never been credibly investigated.

connections rather than projects' expected returns. A large fraction of bank loans were never paid back and poor management led many banks to the brink of collapse, prompting the central bank to bail them out. This was indirect resource transfer from the public to the defaulting customers, bank managers, and employees. In many cases, banks that were bailed out kept their management team who continued to use these institutions to extract rents. In other cases, mismanagement led to the collapse of several financial institutions (see discussions in section 6). To date, the financial sector in Burundi remains fragile partly as a result of political interference.

Political instability and poor governance affected the financial sector through supply and demand factors. High inflation, for example, increased the average nominal interest rates in order to maintain high real interest rates. Figure 1 shows that during the war period (especially 1994-96) there was a jump in inflation and lending interest rates and the two variables remained persistently high. For most of the period between 1985 and 2009, inflation remained over 10 percent per year while the average lending rate reached 19 percent in the early 2000s. As expected, the high lending rate restricted access to credit. The demand for credit was also negatively affected by the erosion of consumers' purchasing power due to high inflation and steady decline in real income per capita. In constant 2000 US dollars, GDP per capita declined from about \$150 in the mid-1980s to \$101 in 2007.

Figure 1: Trends of key macroeconomic variables



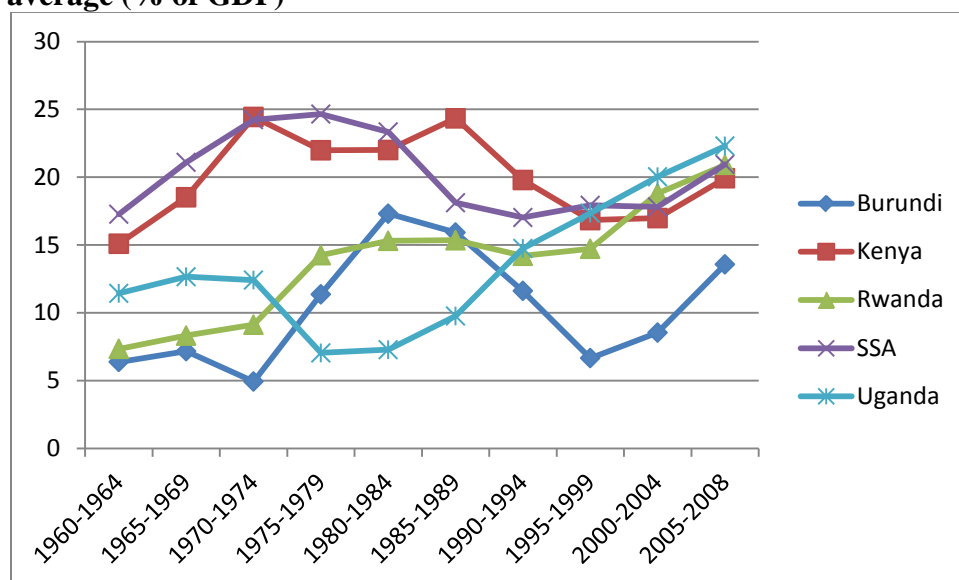
Source: Based on data from BRB.

The collapse in GDP per capita was associated with patronage and the policies of exclusion that hindered economic growth and poverty reduction. Since independence in 1962, annual real GDP growth has reached the 6 percent mark 9 times only and GDP growth was negative for a large

part of the 1990s. In the 2000s, GDP growth turned positive albeit at low values but its volatility increased. As a result, per capita GDP growth rates remained low given the high population growth rate of about 3 percent per year. Slow growth of GDP has prevented meaningful reduction in poverty as discussed below.

The empirical literature shows that robust and sustained investment is a fundamental driver of long-term economic growth (Barro, 1991). In Burundi, gross capital formation has remained below 15 percent of GDP for most of the post-independence period, dropping below 5 percent over the war period between 1994 and 2003. Burundi's investment performance is much below the sub-Saharan average and below its peers in the East African Community (Figure 2). In addition to the failure to mobilize domestic savings, Burundi has also attracted little private capital and continues to depend heavily on official development assistance.⁸

Figure 2: Gross capital formation in Burundi compared to other EAC countries and SSA average (% of GDP)



Source: World Bank, *World Development Indicators*

Note: SSA = sub-Saharan Africa

While Burundi has managed an unprecedented political transition with institutionalized albeit imperfect mechanisms for power sharing that help alleviate the risks of ethnic antagonisms (Bertelsmann Stiftung, 2009), it still faces the critical challenge of initiating and sustaining a robust post-conflict economic recovery. The failure to mobilize private finance for long-term investment has prevented Burundi from exploiting its growth potential.⁹ In particular, mineral

⁸ The government has been receiving about \$450 million of aid per year from all sources (AfDB Database). The African Development Bank report on infrastructure in Burundi (AfDB 2009) estimates that an additional 30 percent of that amount would be needed to complement financing from government and the private sector to fill the country's infrastructure financing deficit.

⁹ The country possesses substantial mineral resources including nickel, cassiterite and columbo-tantalite (coltan), and reasonable amounts of other minerals, notably phosphate and gold, as well as potential for substantial production of ceramics (from kaolinite and feldspar) and cement (from carbonate rocks). Nickel is the largest mineral resource,

resources have not been exploited due to the inability to mobilize the needed \$4.6 billion for infrastructure investments. The country also lacks a comprehensive natural resource development plan, which must include a major scaling up of energy supply.¹⁰ According to the AfDB (2009), the country could achieve a real GDP growth rate of about 7.4 percent over the 2010-2030 period by implementing an infrastructure investment program that would allow, among other things, full exploitation of Burundi's nickel mines.

Moreover, patronage policies which allocated economic resources based on political considerations rather than efficiency have contributed to the erosion of the country's productivity, lowering the rate of growth. Taking 1960 as the base year, total factor productivity – a measure of efficiency – had divided by 25 in 1997 while GDP per capita had declined by 40 percent. This is despite the fact that physical capital per capita had multiplied by 58 from an extremely low initial stock. In fact Burundi recorded, on average, negative productivity growth in the period from 1960 to 1997. From 1989 to 1997, a period of high political instability, negative productivity growth (-5.25 percent annually, on average) was the main cause of the negative average economic growth rate of -2.8 percent per year (Nkurunziza and Ngaruko, 2008).

Low productivity prevented a structural transformation of the economy that could have generated higher and stable levels of economic growth. While the share of services in GDP has increased substantially, the Burundian economy is still heavily dependent on the primary sector which is dominated by rain-fed agriculture (Figure 3), explaining the high volatility of growth. Low productivity in the agriculture sector is illustrated by the steep decline in the contribution of the primary sector to GDP without any decline in the share of the population dependent on primary sector activities.

with about 284 million tons in Musongati, Waga, Nyabikere, and Murera, which represent some of the world's largest nickel deposits (AfDB 2009). It is believed that the actual reserves could be even higher.

¹⁰ Despite a dense hydrographic network which could supply up to 6,000 GWh/year of hydroelectric power, electricity consumption in Burundi (20 KWh per capita per year) is among the lowest in the developing world. Only 2 percent of the population has access to electricity, compared to 16 percent in sub-Saharan Africa and 41 percent in low income countries.

Figure 3: Structure of Burundi's economy



Source: Authors' calculations based on data from the Central Bank of Burundi, Annual reports

Other constraints to growth in Burundi range from physical factors including unfavorable geography, poor infrastructure, and high production and transport costs, as well as policy and institutional constraints. The country is landlocked and depends on poor regional infrastructure and logistics networks, resulting in high production and transportation costs. It is estimated that transport costs account for 30 percent of import prices and as much as 40 percent of export prices for agricultural products in Burundi (AfDB, 2009).

Slow growth and low productivity, particularly in the agriculture sector which is the primary source of employment and livelihood for the majority of the population, have resulted in persistently high levels of poverty.¹¹ To date, Burundi has one of the highest levels of poverty incidence in the world. The proportion of the population below the \$1.25/day poverty line declined only slightly from 84.5 percent to 81 percent between 1990 and 2005. By comparison, the poverty rate in Uganda declined from 69 percent to 51 percent during the same period. In terms of human development, Burundi in 2010 was ranked as 166th out of 169 countries (UNDP, 2010). The development of human capital was hindered by the exclusionary policies that marginalized the majority of the population, in addition to slow growth. By keeping large

¹¹ Agricultural value added per square kilometer of land declined from \$14,812 (in constant 2000 dollars) in 1992 to \$9,936 in 2005 (World Bank, 2005).

sections of society out of the reach of the educational system and other socio-economic opportunities, Burundian leaders ultimately engineered a form of politically induced poverty.

Wealth and employment creation to reduce poverty will require a change in the mindset of the leadership. To some extent, the latter will have to accept losing some control over the economy by encouraging the expansion of the private sector and empowerment of private entrepreneurs because the public sector seems to have reached its job generation capacity. In turn, private sector development will require a massive mobilization of financial resources to support investment. Indeed inadequate access to finance has been identified by firms as a key constraint to investment in business environment surveys (see Table A1 in Annex II). This paper argues that despite the high levels of poverty in the country, there is substantial untapped potential in savings mobilization that may be harnessed to the extent that the financial system is efficiently organized, managed, and regulated. The issue of efficiency of the financial system is therefore central to the objectives of increasing growth and reducing poverty in Burundi.

3. Structure and characteristics of the financial sector

The Burundian financial sector is dominated by commercial banks and includes a handful of formal non-bank financial institutions, mainly development banks and a growing microfinance network. The insurance and pension sector is underdeveloped, which is an impediment to resource mobilization and maturity transformation. As the country does not have a stock market, this section focuses on commercial banks, development banks, and microfinance institutions. The discussion begins with a brief account of the financial liberalization experience of the 1980s.

3.1 The financial liberalization experiment

In an effort to improve the efficiency of the financial system, the government initiated its liberalization in 1987 in the context of the second phase of the Structural Adjustment Program (SAP).¹² The period leading to the adjustment program was characterized by strict controls of interest rates and credit allocation across sectors. In addition, some financial institutions were granted monopoly in the mobilization of deposits (especially from parastatals) and the allocation of credit (especially for coffee trade financing). Details on the key controls prior to financial liberalization and the chronology of the reforms are provided in Annex I (Boxes 1 and 2; also see Nyamoya, 2004).

The liberalization of the financial system was meant to correct market distortions and create a level playing field, improve resource mobilization and achieve efficient allocation of resources across sectors. The results fell below expectations. On the positive side, liberalization succeeded in opening up the sector to entry of new banks. In 1987, the financial system was comprised of only 3 commercial banks, 4 non-bank financial institutions (including Caisse d'Épargne du Burundi - CADEBU), and a nascent network of microfinance institutions. The sector was

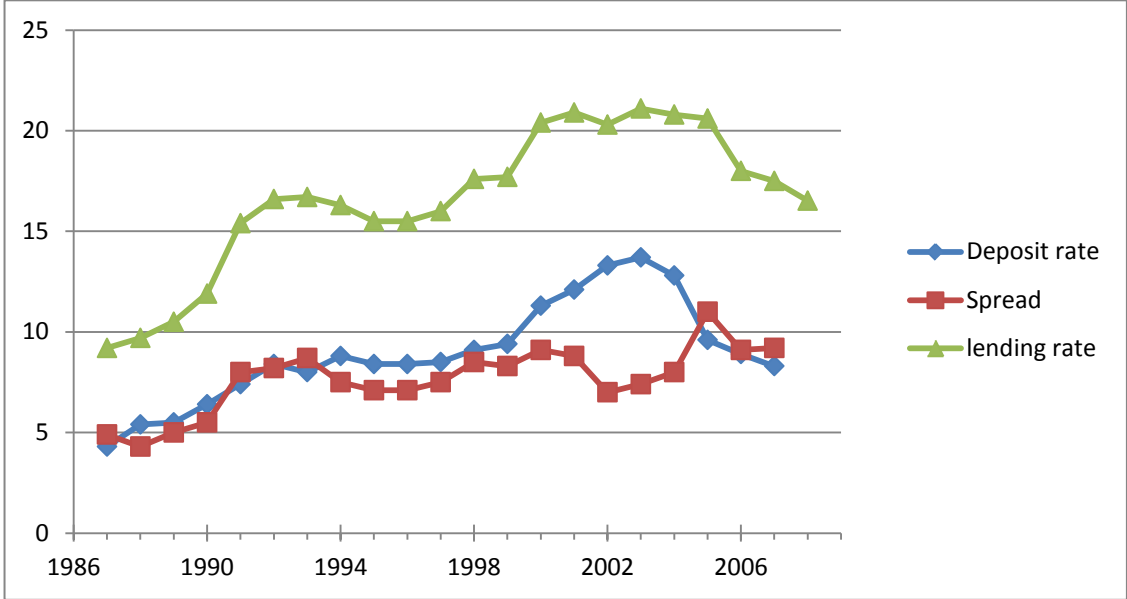
¹² The first phase of the SAP, implemented starting in July 1986, focused on: (1) trade and industrial policy, (2) privatization and restructuring of state owned enterprises, and (3) agricultural policy. The second phase extended the liberalization program to other activities: export promotion, the labor market, and the financial sector. In addition, the program began to consider the social dimensions of the adjustment program.

dominated by the state and public enterprises that held the lion’s share of the assets. Following liberalization, new commercial banks were established, and some of the previously protected institutions succumbed to competition (CADEBU, CAMOFI). Over time, commercial banks were partially privatized though the government kept a relatively strong influence in their management.

Despite these positive developments, the effects of financial liberalization remained limited. Until 2004, the central bank continued to exercise control over credit allocation by imposing ceilings on credit disbursed by each institution and on credit supply to selected activities such as trade of coffee, tea, and cotton. At the same time, monetary policy was marked by lax control vis-à-vis prudential regulation and reserve requirements. There was also a lack of coordination in the management of liquidity and foreign exchange (IMF, 2005). The reforms undertaken starting in mid-2004 included the abolition of credit ceilings, the abolition of the discount rate as a tool of monetary policy in April 2005, and the adoption of a systematic method of liquidity management as a means of controlling money supply. In addition, the central bank began to strengthen prudential regulation and banking supervision.

Overall, financial liberalization failed to correct the underlying structural deficiencies in the system. The increase in the number of institutions did not translate into an increase in savings and lending nor did it reduce the interest rate margin. While both the lending and deposit interest rates increased during the liberalization period, the lending rate rose faster, resulting in higher interest rate margins. Moreover, when interest rates declined in the early 2000s, the deposit rate declined faster than the lending rate, resulting in an increase in the spread (Figure 4). Furthermore, despite the removal of interest rate controls, credit allocation did not improve. Actual interest rate setting showed preference for high turnover activities and the bulk of credit continued to go to import and export activities and the public sector.

Figure 4: Interest rates in Burundi in the post-liberalization period: deposit, lending, spread



Source: Central Bank of Burundi database

Several factors contributed to the limited effectiveness of financial liberalization. They mainly relate to institutional deficiencies, structural features of the economy, and inappropriate implementation of the reforms. One important shortcoming was that the reforms were implemented over a very short period (18 months) which did not allow for the development of the institutional capacity to manage the new system. It was impossible for the existing monetary institutions to absorb such wide ranging reforms in such a short period of time. As a result, there remained very strong temptations to revert to the pre-reform system. As recently as June 2010, for example, the central bank changed its relatively liberal foreign exchange policy adopted several years ago by re-imposing new controls.¹³ The measure was revoked after a public outcry.

The failure of financial sector reforms reflected the failure of state institutions, which were serving interest groups rather than national interests. Financial sector liberalization was expected to drastically reduce the pervasive presence of the government in the sector and its associated rents. Excessive controls over credit and foreign exchange allocation, interest rate repression, and high default rates on loans to the public sector and to politically connected individuals were channels used to extract rents from the sector. As liberalization would naturally remove these privileges, it is not surprising that the reforms were resisted and did not produce the intended results (Ngaruko and Nkurunziza, 2006).

The limited and delayed results of financial sector reforms were also due to the economic downturn in the wake of the debt crisis of the 1980s and 1990s. Financial intermediaries retreated even further from long-term lending and borrowers shied away from long-term investment. While inefficient financial intermediation undermined economic activity, weak economic activity also constrained financial deepening.

3.2 The commercial banking sector

Currently, the banking sector comprises 8 commercial banks, including Diamond Trust Bank which opened in 2009. Table 1 gives the key characteristics of the banks. The banking sector is highly concentrated with the two mature banks, the Banque de Crédit de Bujumbura (BCB) and the Banque Commerciale du Burundi (BANCOBU) accounting for a commanding share of the market. These two banks account for 43 percent of deposits, 42 percent of total assets, and 42 percent of credit allocated in 2008. Together with the Interbank Burundi (IBB) created in 1992, the three largest banks represented 76 percent of total assets, 74 percent of credit, and 79 percent of deposits in 2008, as well as most bank branches in the country.

¹³ For details, see: http://www.brb-bi.net/se/docs/rglt_chge_scn.pdf

Table 1: Characteristics of commercial banks in Burundi, 2008

	Year of creation	Branches	State's share (%)	Public share (%)*	Total assets (million BIF)	Deposits (million BIF)	Loans (million BIF)	Loan /Deposits (%)	Employment
1. BBCI - Banque Burundaise pour le Commerce et l'Investissement	1988	5	4	47.9	31,703	18,103	17,840	99	152
2. BANCOBU - Banque Commerciale du Burundi	1964	10	3	75	94,161	66,028	47,840	72	275
3. BCB - Banque de Cr�dit de Bujumbura	1964	10	10.6	45	143,122	114,548	69,322	61	286
4. BGF - Banque de Gestion et de Financement	1996	8	0	0	32,723	22,703	20,141	89	146
5. FINBANK - Finalease Bank (taken over by Access Bank Nigeria)	2002	4	0	0	41,516	28,943	21,440	74	93
6. IBB - Interbank Burundi	1992	24	0	0	187,630	148,084	90,262	61	350
7. SBF - Soci�t� Burundaise de Financement (ECOBANK starting in 2008)	1983	3	0	35.6	28,657	17,335	13,259	76	107
TOTAL (million BIF)		64			559,069	415,746	280,106	67	1,409
TOTAL (equivalent in USD)					471.8	350.6	226.8		

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

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

State ownership in the banking sector is low, representing only 3.6 percent of total capital of commercial banks. However, the government still has substantial influence in the banking sector through its public entities that own up to 31.6 percent of the capital of all banks combined. The government is also a majority shareholder in two out of the three most important banks (BANCOBU and BCB). Hence, the government is still able to influence the management of banks through the nomination of its representatives to the board of directors. The government's presence also has implications in the allocation of credit, directly through borrowing by state entities and indirectly through political pressure on bank management.

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

Development banks

Created in 1964, the Banque Nationale pour le Développement Economique (BNDE) is the only genuine development bank with a statutory mandate to finance economic development. In particular, the BNDE contributes to the financing of small and medium enterprises and microfinance operations. However, several constraints hamper BNDE's ability to accomplish its mission. The most important constraint is the shortage of stable long-term resources. As a public institution, BNDE relies primarily on donor funding through the government. Consequently, BNDE's lending capacity is adversely affected by volatility and unpredictability of donor funding. In the past, BNDE also relied on direct refinancing via an automatic rediscount facility at the central bank, which was abolished in the context of monetary policy and financial sector reforms. The lack of stable long-term resources forces BNDE to concentrate on short-term and medium-term lending, and on commerce to the disadvantage of agriculture and industry. This has induced BNDE to focus on the same market segments as commercial banks.

The other financial institution that participates in development financing is the Fonds de Promotion de l'Habitat Urbain (Fund for the Promotion of Urban Housing, FPHU) which specializes in urban housing. Although it supplies a larger amount of loans than BNDE (Table 2), FPHU is also a public institution confronted with the same challenge of limited access to long-term stable resources. Thus FPHU is unable to meet the needs of the expanding urban population.

Table 2: Characteristics of non-bank financial institutions in Burundi, 2008

	Year of creation	State share %	Total assets (million BIF)	Loans (million BIF)	Loans/ Assets (%)	Employment
1. BNDE Banque Nationale pour le Développement Economique	1967	65.5	21,109	10,800	51	77
2. FPHU Fonds de Promotion de l'Habitat Urbain	1990	82	13,137	20,486	156	52
3. INSS Institut National de Sécurité Sociale	1962	100	22,572	0	0	3,488
4. RNP Régie Nationale des Postes	1991	100	6,011	NA	NA	800
5. MFP Mutuelle de la Fonction Publique	1980	100	17,933	NA	NA	524
TOTAL			80,762	31,286		4,992

Sources: Annual reports of these financial institutions and the Central Bank.

Note: RNP: 2006 figures ; INSS: 2007 figures; NA = not applicable.

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

To illustrate the deterioration of workers' purchasing power and hence their limited access to financial resources, we consider the case of a married couple of two university degree holders employed in the civil service. We assess their ability to service a 15-year mortgage at the mortgage interest rate of 18% for a modest 10mx12m house. The salary in the civil service for a university degree laureate increased from about 30,000 Burundi Francs (BIF) in 1993 to 100,000 BIF in 2010.¹ This amounts to a 233 percent increase in nominal wage, but a 58 percent decline in purchasing power, adjusting for inflation. In 2010, housing construction costs in middle-income suburbs of Bujumbura (e.g., Kanyosha) were about 6 times higher than in 1993. The calculations in Table 3 show that while the couple labored to cover the mortgage with 80 percent of their combined salary in 1993, in 2010 the mortgage payment is completely out of reach, representing 178 percent of the couple's combined nominal monthly salary!

¹ The example considered here overestimates the real repayment capacity of the household. In particular, the maturity of mortgage loans is typically less than 15 years as is assumed here. Moreover, only some sectors in the civil service offer a monthly salary of 100,000 BIF following recent wage increases (education, justice, state inspection).

Table 3: Cost of housing construction vs. civil service wages: pre-crisis compared to 2010

	1993	2010		Change (%)	
		nominal	real	nominal	real
<i>Elements of housing costs</i>					
Lending interest rate (annual %)	14	18	9.7	28.6	-30.7
Unit cost of construction (per square meter)	30,000	184,000	23,018	513.3	-23.3
Cost of a 8mx10m house (BIF)	3,600,000	22,080,000	2,762,141	513.3	-23.3
<i>Income and mortgage payment capacity</i>					
Monthly payment (BIF)	47,942	355,581	44,482	641.7	-7.2
Salary of couple of two BA holders (BIF)	60,000	200,000	25,019	233.3	-58.3
Monthly payment/salary (%)	79.9	177.8	177.8	122.5	122.5

Source: The information on housing costs is from the Fonds de Promotion de l'Habitat Urbain (the 2010 value is obtained by applying the inflation rate of 8.3%, a conservative assumption, to the 2009 value of BIF 170,000/square meter). Information on the interest rate and the price index is from the Central Bank of Burundi. At the 1993 base, the implicit consumer price index used to deflate nominal values to real values in 2010 is 799.38.

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

Microfinance, a relatively new phenomenon

Microfinance is relatively new in the Burundian financial system. Apart from BNDE's microfinance operations dating from the 1960s, genuine microfinance began with the creation of the savings and credit cooperatives (Coopératives d'Épargne et de Crédit, COOPECs) in 1985. However, starting from the mid-1990s, many institutions were created with diverse legal status, ranging from NGOs to cooperatives. In addition to COOPECs, as many as 19 organizations have been created since 2000, of which 5 were created in 2005 alone.

Microfinance institutions (MFIs) have experienced rapid growth over recent years (Table 4). The increase in the cost of living and the deterioration of purchasing power due to the war and the economic crisis have made it increasingly difficult for people to survive on regular wage incomes. At the same time, formal banking services have become increasingly inaccessible. The explosion of microfinance can therefore be interpreted as an attempt to fill a financial intermediation vacuum.

Table 4: Summary indicators of microfinance institutions in Burundi, 2004-09

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

Source: Réseau des Institutions de Microfinance (RIM). Note: BIF = Burundi Franc.

The Finance Ministry adopted the microfinance law in 2006, whose objective is to protect savers and borrowers while minimizing risk taking by MFIs. A clearly defined legal framework is indispensable for the development of microfinance. Nonetheless, evidence from countries that have been successful in this area indicates that, more than the formal legal framework, it is the ability of MFIs to create an environment of trust between institutions and clients that determines the success of MFIs. A well known example is the case of the Grameen Bank (see Yunus, 2003). While increasing access to financial services for clients, such a strategy also contributes to financial sustainability of the MFIs by improving loan recovery.

The success of microfinance rests on the ability to navigate the complexity of the “triangle of microfinance,” which calls for attention to not only outreach to the poor (both breadth and depth of outreach) but also financial sustainability of the institutions as well as impact on growth and poverty (Zeller and Meyer, 2002; Robinson, 2001). Burundian microfinance institutions face several constraints in their attempts to reach this triple objective. The key constraint is the lack of stable resources, forcing MFIs to both ration credit and charge high interest rates, hence making it difficult to achieve sufficient outreach. Interviews with BNDE Senior Management reveal dwindling support from donors especially since the early 1990s at the beginning of the civil war. MFIs also face critical capacity constraints due to the shortage of experienced experts in the field. This exposes MFIs to credit risk notably due to inefficient credit assessment and weak loan recovery mechanisms. Nonetheless, the sector has substantial potential to increase access to finance for a large part of the population and thus contribute to poverty reduction.

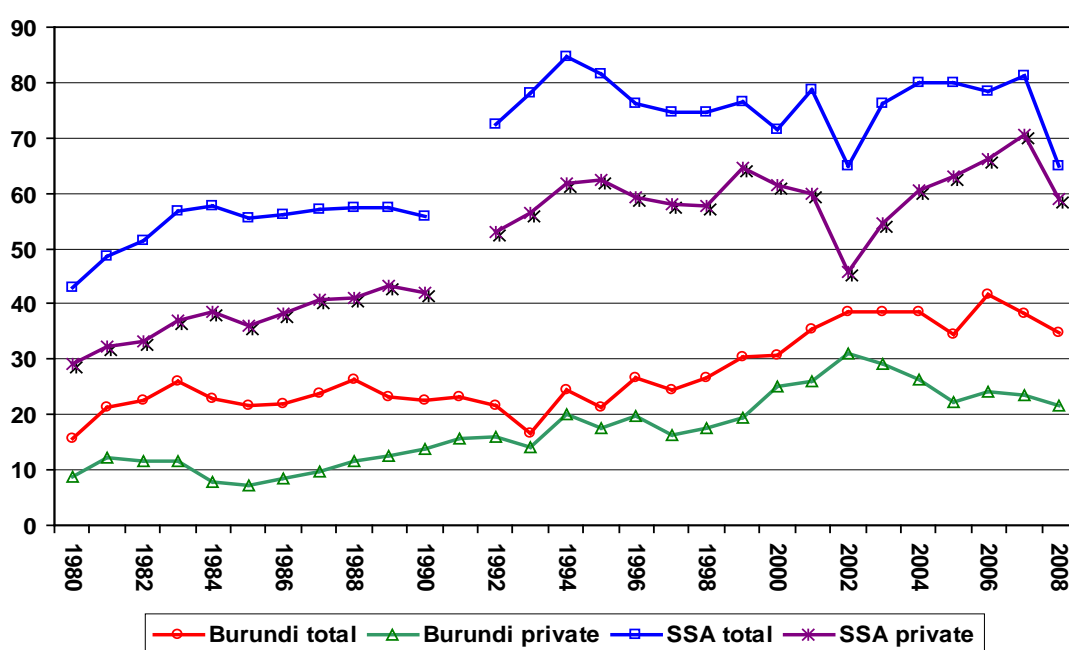
4. Credit allocation and the contribution of banks to economic activity

This section analyses credit allocation to the private and public entities and across economic sectors. It also discusses the term structure of credit and derives some indicators of inefficiency of sectoral and temporal allocation of credit.

4.1. Credit by the banking sector

Credit from the banking sector to the economy is very limited in Burundi. As Figure 5 shows, over the period 1980-2008, domestic credit from the banking sector represented 27 percent of GDP on average per year, which is less than half of the average for Sub-Saharan Africa (67.5 percent of GDP) and only 17 percent of the ratio in high income OECD countries (160 percent of GDP).² Credit to the private sector is even smaller. At 17 percent of GDP, it represents one-third of the average ratio for Sub-Saharan Africa (51 percent of GDP); the latter compares very poorly with the figure for high income OECD countries at 126 percent of GDP (World Bank, 2010).³ These statistics suggest that even by the poor African standards, the contribution of Burundi's banking sector to economic activity in terms of credit provision is very limited.

Figure 5: Ratio of domestic credit to GDP in Burundi and SSA, 1980-2008



Source: Based on data from World Bank, *World Development Indicators* 2010.

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

² The apparent increase in the credit/GDP ratio since the mid-1990s is not necessarily an indication that the amounts of credit to the economy increased. Most of the period post-1993 was characterized by negative economic growth rates (as discussed earlier), which could explain the increase in the ratio to GDP without an increase in the flows of credit to the economy.

³ The drop in 2008 is most probably the result of the global economic and financial crises.

4.2. Credit to the government

Burundian banks allocate relatively more credit to the central government than in the rest of Sub-Saharan Africa. On average, bank credit to the government represents about 38 percent of total credit, compared to 25 percent in the rest of Africa. Although governments are not necessarily wasteful,⁴ cross-country evidence has shown that higher state ownership of the economy – as is the case in Burundi – is positively associated with high capital misallocation (Wurgler, 2000; Khwaja and Mian, 2005). In turn, capital misallocation leads to low total factor productivity and output per worker as is typically the case in developing countries (Hsien and Klenow, 2009; Bartelsman et al., 2009).⁵ In Burundi, as discussed in the previous sections, financial resources were allocated to SOEs on the basis of political considerations, resulting in very low productivity. The managers of the SOEs drove some of them to collapse, and often used assets stolen from these firms to create their own private companies.

While credit to public institutions is misused, private firms are severely credit constrained. According to the World Bank's *Doing Business* report, about half of Burundian firms identify finance as a major constraint, ranking second only to the lack of electricity (Table A1 in Annex II). Evidence from a detailed firm survey carried out in the 1990s also shows that access to credit is a constraint to firm growth and investment in Burundi (Bigsten et al., 2003). Hence, the crowding out of the private sector and inefficient use of credit by the government has negatively affected the performance of the private sector. The financing of inefficient state-owned enterprises displaced valuable resources from productive investment. In the 1980s, as much as 30-35 percent of gross domestic investment went into state-owned enterprises, but the sector accounted for less than 10 percent of total output (Ngaruko and Nkurunziza, 2006).⁶

4.3. Allocation of credit to economic sectors

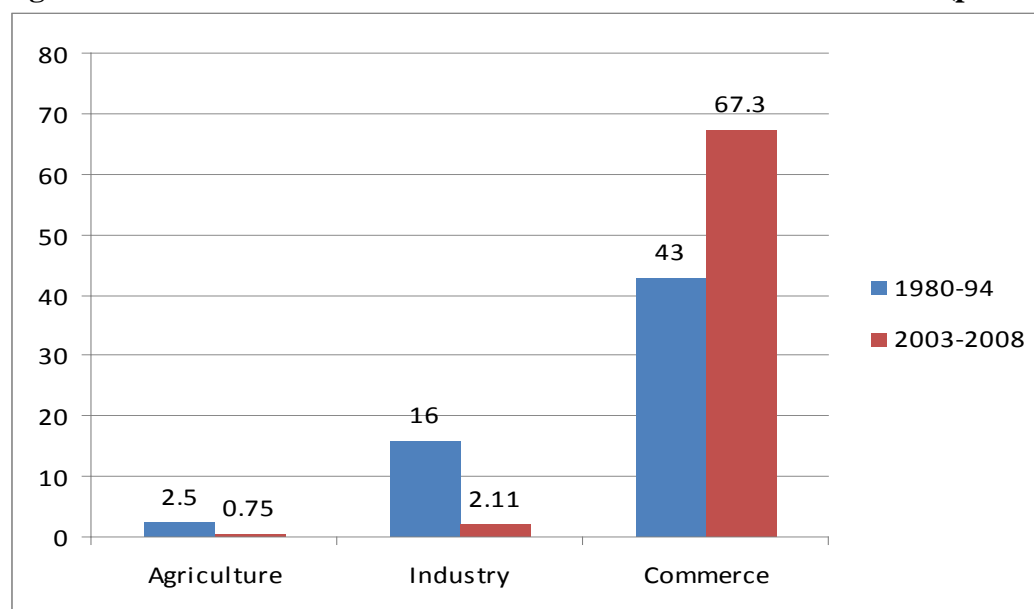
Sectoral misallocation of credit is the second source of inefficiencies. Given the importance of agriculture in terms of employment creation, food supply, and production of inputs for other sectors, agriculture should receive the lion's share of financial resources. This is not the case as Figure 6 shows.

⁴In India, for example, an analysis covering the period 1986-2000 found that although private banks were more productive than public banks due to technical progress, the latter were more efficient than the former (Sensarma, 2006).

⁵According to Hsien and Klenow (2009), capital misallocation could explain 30% to 50% of TFP difference between Chinese and American firms, and 40% to 60% of TFP difference between Indian and American firms.

⁶The link between capital misallocation and slow economic growth is observed in other developing countries as well. In Pakistan, for example, politically connected firms borrow 45 percent more than other firms and their default rates are 50 percent higher. Such preferential treatment, practiced solely by government-controlled banks, costs the economy between 0.3 percent and 1.9 percent of GDP every year (Khwaja and Mian, 2005).

Figure 6: Sectoral allocation of commercial banks' credit in Burundi (percentage of total)⁷



Source: Based on data from BRB, Annual Reports.

Clearly, the allocation of credit does not reflect Burundi's development priorities as articulated in the government's medium-term objectives: (i) five per cent annual rate growth of the agricultural sector; (ii) reduce the rate of people with insufficient food or unbalanced diet from 84 per cent of the population to 20 per cent; and (iii) reduce the rate of poverty from 67 per cent to below 50 per cent (République du Burundi, 2007).⁸ In fact, the government of Burundi considers that the performance of the agricultural sector will not only determine the growth of other sectors but also economic development in general.

In spite of its importance for the national economy, agriculture not only attracts an insignificant amount of credit but the share has declined over time, from 2.5 percent of total credit in the period 1980-1994 to 0.75 percent in the period 2003-2008. Yet in 2005, agriculture contributed 42.4 percent of GDP and employed 84 percent of the active population (ISTEEBU, 2008; République du Burundi, 2008). Moreover, agriculture is the main source of economic growth. According to some conservative estimates, a 10 percent increase in agricultural production, excluding coffee, leads to a 3.5 percent increase in GDP (Lim and Rugwabiza, 2009). In general, agriculture-led growth has been shown to have the highest impact on poverty reduction (World Bank, 2008). Therefore, the resources allocated by the banking sector to agriculture do not reflect the economic importance of the sector, preventing Burundi from reaching its potential in terms of growth and poverty reduction. The neglect of the agricultural sector, despite the large number of people who depend on it, is yet another illustration of a narrow-based system of governance which was not interested in the well-being of the majority of the population.

⁷ Banks did not provide data on the sectoral distribution of their credits from 1995 until 2002, probably as a result of the war that raged in this period. Since 2003, the data provided follows a different classification, but our sectors of interest – namely agriculture, industry and commerce – are clearly identified. In this figure, commerce includes the coffee trade sector.

⁸ The rate of poverty incidence used here is the \$1 a day measure, which explains the difference with the statistic in Table 1 that uses the \$1.25 a day measure.

The decline in credit allocation has been even more dramatic in the industrial sector. The share of credit to this sector collapsed from 16 percent of total credit in 1980-1994 to only 2 percent in 2003-2008. In contrast, commerce, including coffee trade, is the most preferred sector although it represents only 6.8 percent of GDP and accounts for 2.5 percent of total employment (République du Burundi, 2008). The sector absorbed 67 percent of credit in 2003-2008, up from 43 percent in 1980-1994.

These statistics call for a number of observations. First, the economic transformation needed for the country to achieve its development priorities, notably poverty reduction, requires massive investments in agriculture and industry. However, the current allocation of financial resources makes this objective hard, if not impossible, to achieve. Second, the excessively high concentration of credit on one sector, trade, increases bank vulnerability. Negative shocks to the trade, particularly its import-export segment, can severely undermine the stability of the banking sector. Indeed, when Burundi was placed under a total economic embargo from 31 July 1996 to 23 January 1999, this affected the portfolio of banks, as traditional bank clients, particularly those relying on import and export activities, saw their activities seriously curtailed (World Bank, 1999). This may explain the drop in lending interest rates during this period (Figure 1) and the decline in credit to the private sector in 1997 and 1998 (Figure 5).⁹ Third, it could be argued that credit allocated to trade has an indirect positive effect on agriculture and the rural economy if it finances trade of agricultural inputs and outputs, and the provision of agriculture-related services, leading to job creation. In fact, a dynamic agricultural sector is often associated with high rural non-farm activity (Nkurunziza, 2007). In Burundi, due to the rudimentary state of technology in the agricultural sector and the dominance of informal subsistence activities, agriculture is detached from other sectors of the economy. Hence, the small share of trade activities in GDP and employment creation, as shown earlier, suggests that the indirect effects of trade on agriculture and the rural economy are very limited.

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

To derive proxy measures of these inefficiencies, two indexes are computed on the basis of the sectoral allocation and term structure of risk. They measure the gap between the actual distribution of credit and the risk-adjusted distribution. If credit were allocated on the basis of the level of risk, the rate of default (amount in default relative to current credit) should be equal to the sector's proportion in total credit. For example, the rate of default in the agriculture sector should be equal to the proportion of credit to agriculture in total credit. The index of allocative inefficiency is the ratio of the two proportions (multiplied by 100). If the index is equal to 100,

⁹ The actual decline in credit to the private sector was more pronounced than shown by the GDP ratios in Figure 6. The reason is that the rates of GDP growth in 1996 and 1997 were negative (-8% and -2%, respectively).

the amount of credit allocated to the sector reflects the risk level in the sector. If the index is less than 100, the interpretation is that credit is too low considering the level of risk. Conversely, an index greater than 100 indicates that the allocation of credit to that sector is too high relative to the level of risk.

Figure 7: Index of sectoral allocative inefficiencies of credit, 2008 (in percentage)

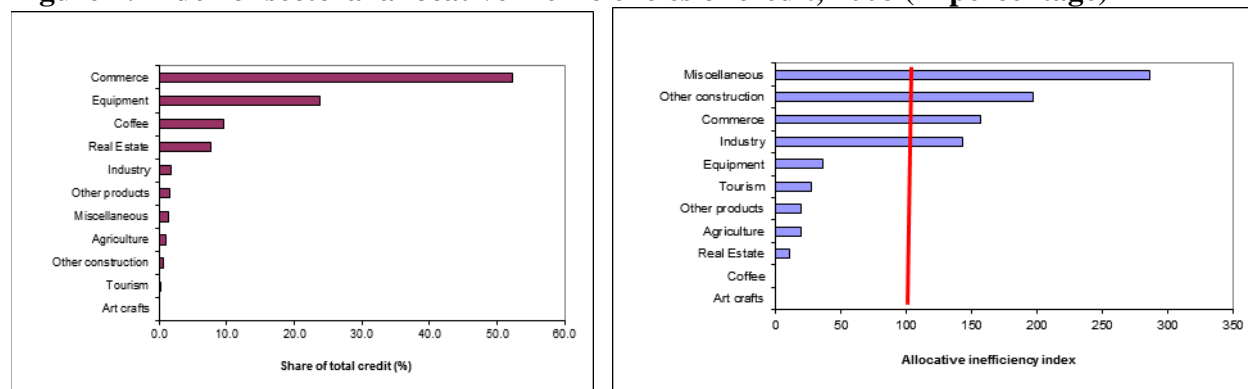


Figure 7 confirms that it is riskier to lend to commercial and industrial activities than to agriculture. With a value of about 20, the allocative inefficiency index in agriculture means that too little resources are invested in the agricultural sector given the level of risk in the sector. In contrast, commerce has a value of 157, implying that the sector receives 57 percent more resources than warranted by the level of risk.

Why do agriculture and industry in Burundi attract so little credit? The main reason is related to the political economy of agricultural development. Burundi's agriculture is dominated by smallholder farmers who have little political voice to lobby politicians in order to defend their interests (Bates, 1981; Nkurunziza and Ngaruko, 2008). Moreover, 94.5 percent of all agricultural activities in Burundi are in the informal sector which is typically cut off from modern financial services (ISTEEBU, 2008). The lack of collateral and the high cost of loans to informal economic activities in the rural areas put agriculture at the fringes of the financial sector. Also, the fact that agriculture is mainly rain-fed makes it vulnerable to weather shocks. This, combined with rudimentary production technologies, render agricultural production uncertain. Therefore, even if banks had the capacity to intervene, they might shy away from financing projects in the agricultural sector due to high uncertainty. Finally, over the last few years, banks have been so profitable that they have had no incentive to lend to activities perceived to be too risky.¹⁰

The low proportion of credit to industry may be explained by low profitability, in addition to uncertainty. The demand for credit to industrial activities is very low because the investment climate is poor (Annex II). Moreover, as discussed earlier, high transport costs and unreliability of input supply substantially increase production costs, reducing profitability and the risk-adjusted rates of return on investment. Furthermore, financing industrial activities requires medium- to long-term loans but banks in Burundi have a strong preference for short-term

¹⁰ The issue of bank profitability is discussed in some detail later.

lending. Hence, the mismatch between the needs of the industrial sector and banks' lending capacity and preferences contributes to explaining the low level of credit to the industrial sector.

We should acknowledge the possibility of endogeneity. On one hand, agriculture and industry may attract low credit because they are not developed; on the other hand, the two sectors are not developed maybe because they do not attract credit. A poor country like Burundi, which is heavily dependent on agriculture, ought to have an explicit policy to channel financing into the sector and, eventually, build a basis for industrial development. In Burundi, agricultural development is too important and too strategic to be left to market forces alone.

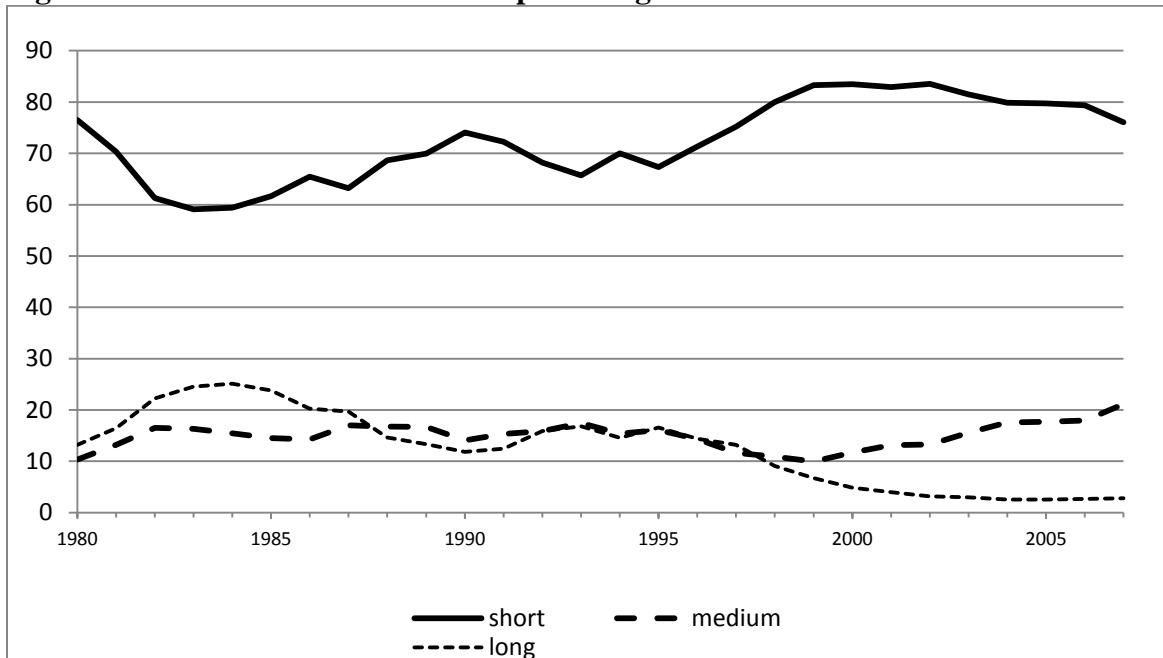
4.4. Term structure of bank credit

In addition to the lopsided sectoral allocation of credit, its temporal allocation is also incompatible with the long-term needs of industry as well as the need to build a basic production infrastructure as discussed earlier. The term structure of credit is characterized by the predominance of short-term credit (Figure 8) which hampers resource mobilization for long-term development projects. To illustrate, assuming that the \$4.6 billion needed over the next 20 years to build Burundi's infrastructure would be evenly spread over 20 years,¹¹ \$230 million would be needed every year. Even if all credit disbursed in 2008 were allocated to the implementation of these infrastructure projects, it would not be enough to cover the needs (see Table 1). Adding to the basic infrastructure financing the investments needed to upgrade technologies in the agricultural and industrial sectors, as well as other needs such as consumer credit, it is clear that the financial sector in Burundi does not have the capacity to meet the country's needs in development financing.¹²

¹¹ This is a minimalist scenario because a large part of investments of this nature have to be frontloaded.

¹² Another way of illustrating the limited capacity of the financial sector in Burundi to raise the resources required for the country's development is the fact that the volume of gross fixed capital formation is greater than total bank credit. According to IFS data, in 2008, it was 284.9 billion BIF or 101% of total bank credit.

Figure 8: Term structure of credit in percentage of total credit



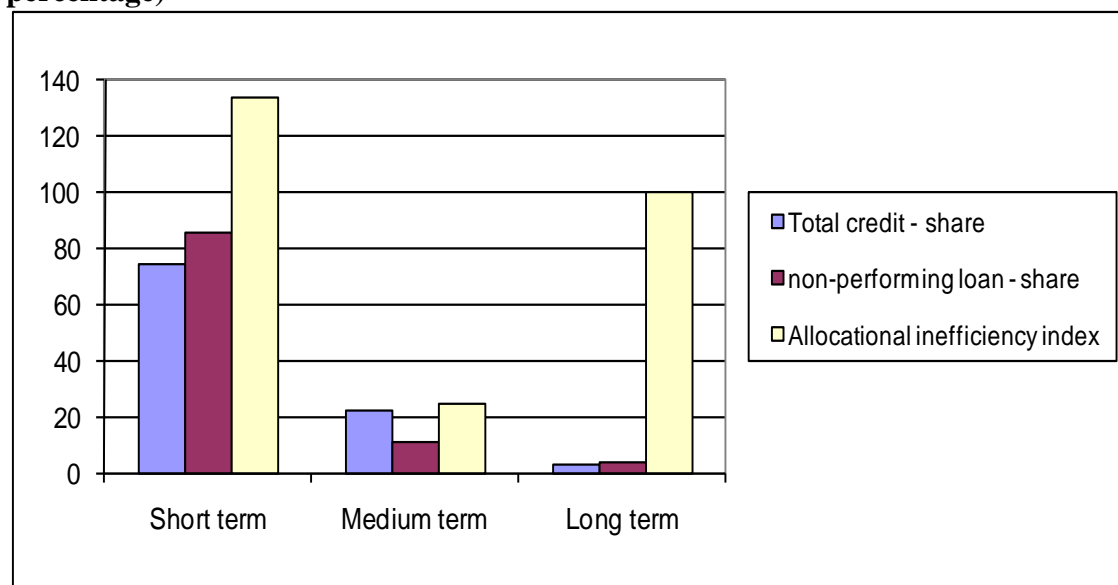
Source: Data from BRB, Annual reports.

Note: Short-, medium- and long-term refer to periods of less than one year; one to less than three years; and equal to or more than three years.

The share of short-term credit in total domestic credit has steadily increased since the mid-1990s from 67 percent to over 80 percent thereafter. The share of short-term credit reached its highest values during the war period (1993-2003) with a peak of 83.5 percent in 2002. Most of this increase was in the form of working capital to firms faced with major cash-flow difficulties. The increase in short-term credit was at the expense of long-term credit. The latter declined from about 17 percent of total credit in 1995 to less than 3 percent in 2007. Medium-term credit oscillated between 10 percent and 21 percent of total credit over the sample period, with an increasing trend since 2000 (from 12 percent to 21 percent of total credit).

The investment needs underlying Burundi's development objectives require scaling up of resources on medium-term and long-term credit. Analyzing the term structure of credit in light of the risk associated with different terms shows that there are also temporal allocative inefficiencies (Figure 9). Despite banks' concentration on short-term credit, these loans are riskier than long-term credit. Medium-term loans are associated with the lowest level of risk but they account for the lowest share of total loans. Keeping the risk level constant, medium-term loans should be about five times higher than the current level.

Figure 9: Term-structure of allocative inefficiencies of credit, average 2003-2008 (in percentage)



Why do banks concentrate on short-term loans despite the inefficiencies associated with short-term lending? According to our interviews with Bank managers, this is justified by the lack of long-term resources in their portfolio. This is correct to some degree. Incentives for saving are weak, as illustrated by low savings interest rates relative to lending rates (Figure 4). However, the lack of long-term resources does not fully explain limited long-term lending because the lending pattern does not reflect the term structure of available resources. According to data from the central bank, between 2003 and 2007 short-term bank loans were 110 percent of short-term deposits per year, on average. In contrast, medium- and long-term loans represented only 53 percent of medium-term and long-term savings, each. This means that medium-term and long-term savings are used to finance short-term loans, implying a bias against medium- and long-term lending.¹³

This bias may be explained as follows. First, most of the period under analysis was characterized by extreme political and economic instability, translating into high inflation, currency devaluations, and high interest rates (Figure 1).¹⁴ The resulting political and economic uncertainty and risk induced financial institutions to be extremely cautious in their lending practices, privileging short-term loans. Second, the small proportion of long-term lending could be the result of limited demand due to high costs. As Figure 4 shows, the liberalization of interest rates in the late 1980s resulted in their steady increase, making it difficult for firms to borrow and invest profitably. Third, the steady increase of money supply in the context of a shrinking economy over the 1990s and 2000s (Figure 1) contributed to increasing inflation, discouraging

¹³ For further investigation it would be interesting to compare the case of Burundi to other countries with regard to the “transformation ratio,” i.e., MT & LT loans/MT & LT savings.

¹⁴ Political instability led to frequent changes of political leaders, which created instability in the private sector as new political leaders established their own connections in the private sector in order to take advantage of the opportunity of using the state for personal gain as a strategic supplier and client. Between 1st October 1987 and 11 January 2000, Burundi had a new government every nine months; over the last three years, there has been a change in government every six months, on average.

profitable investment and borrowing. The long-run semi-elasticity of inflation to real money in circulation trebled between the pre-war to the war period (Nkurunziza, 2005). Fourth, the industrial organization of banking where competition is limited allows financial institutions to extract maximum rents from the public. This enables them to generate high profits without the need to widen their market and take more risk. Fifth, banks are reluctant to take risk due to the absence of adequate information on prospective borrowers. The lack of credit bureaus, timely and reliable reporting of company financial statements, and modern systemic audits of firms explains the high risk aversion of banks.

Despite these constraints, there are untapped opportunities for the mobilization of long-term domestic financial resources. If a fraction of the sizable profits of commercial banks (see Section 5) and the major private and semi-public companies – which are currently held as cash – were pooled to constitute an investment fund, they would provide important long-term investment resources that are currently lacking (Nyamoya and Nkeshimana, 2005). In 2004, for example, the combined profits of the 8 commercial banks, the 2 development banks (BNDE and FPHU), the largest insurance company (SOCABU), and two semi-public companies (BRARUDI and SOSUMO)¹⁵ amounted to 18.8 billion BIF, which represented 15.7 percent of the country's gross capital formation in that year. If half of these funds had been committed to investment, the country's average gross capital formation would have increased from 15.3 percent of GDP to 23.1 percent of GDP.

5. Performance of the financial sector and access to credit

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

5.1. Banking profitability

The banking sector in Burundi is highly profitable by standard measures of return to investment. The average return on equity ratio stands at 19.4 percent, with returns as high as 53 percent for BANCOBU and 39 percent for BCB (Table 5). This high performance does not reflect the fundamentals in the real economy as indicated by the low economic growth rate (Figure 1) and high poverty incidence. The high performance is even more surprising given the inadequate management of the financial sector and the often disruptive state intervention in the management of banks. It is more appropriate to say that the banking sector remains highly profitable despite serious institutional and structural constraints. The question is, therefore, what explains the high performance of Burundian financial intermediaries as business firms?

¹⁵ SOCABU = Société d'Assurance du Burundi (an insurance company); BRARUDI = Brasserie et Limonaderie du Burundi (a brewery); SOSUMO = Société Sucrière du Moso (a sugar production and processing company)

Table 5: Performance indicators of financial intermediaries in Burundi, 2008¹⁶

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

Source: Data from individual banks' reports.

Notes: BBCI = Banque Burundaise pour le Commerce et l'Investissement; BANCOBU = Banque Commerciale du Burundi; BCB = Banque de Crédit de Bujumbura; BGF = Banque de Gestion et de Financement; Finbank = Finlease Bank; IBB = Inter Bank Burundi; SBF = Société Burundaise de Financement; BNDE = Banque Nationale pour le Développement Économique; FPHU = Fonds de Promotion de l'Habitat Urbain.

(1) ratio of total credit to total deposits; (2) amount of equity capital in millions of Burundi francs; (3) amount of net profits in millions of Burundi francs; and (4) return on equity, which is the ratio of (3)/(2); (5) number of accounts opened in each bank. Note that BNDE and FPHU have neither branches nor accounts; they are not commercial banks so do not take deposits from clients.

All the numbers with an asterisk are for 2007.

High profitability of financial intermediaries in Burundi may be explained by several factors. The first is the oligopolistic nature of the banking sector, which facilitates rent extraction. As earlier noted, three commercial banks, namely BANCOBU, BCB, and IBB, control the banking sector in Burundi.¹⁷ They have implicitly divided up the market so they do not need to compete to attract clients. If there was competition, some banks would charge lower interest rates and fees and register lower but still comfortable profits. Banks extract rents from their clients through high lending interest rates and charges as well as low savings rates.¹⁸ Banks use deposits and savings, which are poorly remunerated, to lend at very high rates that do not reflect the cost of

¹⁶ The figures on profitability are most likely underestimated as banks are not comfortable communicating the right figures which would show the extent of rent extraction. This hypothesis is confirmed by an IMF-World Bank (2009) study which calculated, on the basis of more accurate data, an average return to equity of 33.15 percent in 2008.

¹⁷ The case of Inter Bank Burundi (IBB) is particular. It is the youngest of the three largest banks (created in 1992, several decades after the oldest two banks were created) but has outperformed its older peers in terms of equity capital, savings and credit. This is the result of its better management. The bank is fully privately owned by Burundi-based shareholders, unlike the other two banks which until recently were largely state controlled but with a sizable foreign shareholding. This, in a way shows that BANCOBU and BCB could have performed better had they been better managed.

¹⁸ Interviews with management of financial institutions revealed that the production cost of a check book is about BIF 400-500. However, banks sell it for BIF 4,500, ten times the production cost. This is an important source of revenue for banks with large numbers of customers such as IBB, BBCI, BCB and BANCOBU.

these funds. On average the cost of funds to banks declined from 4.8 percent to 2.8 percent between 2005 and 2008.¹⁹ This low cost is mainly due to the fact that banks do not pay interest on short-term deposits, which represent more than 50 percent of total deposits from clients (IMF and World Bank, 2009). In contrast, lending rates are very high (see Figure 4) even though they have declined over the last few years to reach 16 percent in 2010. The question is whether the large interest rate spreads reflect the actual level of risk faced by banks or whether, owing to the lack of competition, the high spreads are a manifestation of rent extraction.

Detailed account-level data on the credit portfolio of one of the largest banks covering the period from January 2004 to August 2009 illustrates that the rents extracted from their clients are allocated to bank executives and employees through interest-free loans or very low interest rates (Table 7). The median interest rate on short-term and medium-term loans to bank employees is only 4 percent, almost one-fifth of the average interest rate of 19 percent used for external clients. Cheap credit encourages bank employees to borrow. Although they represent a small number relative to the client base (the largest bank employs only about 350 persons), out of 6,182 total loans accorded, employees accounted for 17.5 percent of this number. The lack of competition among financial institutions makes banks and their employees the main beneficiaries of the resources extracted from the public.²⁰

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

The high level of profitability combined with the new equity capital requirements have contributed to attracting foreign banks to Burundi. In order to respond to the central bank's requirement for higher capital, a number of domestic ailing banks have been forced to seek external investors and partnerships with stronger African banks. In 2008, SBF was saved by ECOBANK, a West African multinational bank with operations in 30 African countries.

¹⁹ This cost is the ratio between total interests paid by the banking sector and total deposits by clients as well as interbank deposits.

²⁰ The Minister of Finance acknowledged before the country's Senate that the cartelization of commercial banking in Burundi was one of the reasons why interest rates were so high. However, the Minister did not offer any government plan to address the problem. She suggested, rather, that the promotion of microfinance, regional integration, and more political stability were likely to force banks to reduce their lending rates (see <http://www.senat.bi/spip.php?article1122>).

Finlease Bank, another bank facing difficulties, was acquired by the Nigeria-based Access Bank Plc.

Other investors were attracted by the potential of making high profits as well. In 2009, Diamond Trust Bank (DTB), an East African bank belonging to the Aga Khan Group, entered the Burundian banking sector. Bank of Africa, another successful West African bank, has acquired shares in the capital of BCB, one of Burundi's most solid banks. Other foreign banks are considering opening branches in Burundi or participating in joint ventures with existing banks. They include Kenya Commercial Bank (KCB), Union Bank of Nigeria (UBA), FINABANK of Kenya, Barclays Bank of the United Kingdom, and Actis, a private equity investor in emerging economies (Lienart, 2010).

Burundi is currently going through the most important transformation of its banking industry. ATMs have been introduced for the first time and it is expected that opening the market to external banks will create opportunities for innovation which in turn will improve efficiency and increase financial deepening. New payment instruments such as mobile banking and internet banking have already been introduced and higher use of ICT in banking operations is expected. This new era could also see the emergence of new savings/investment instruments such as equity funds which are now missing. These new developments have also been influenced by the country's recent entry into the East African Community (EAC). The Burundian authorities are aware that as the East African regional market opens up, the country's banks will have to strengthen their capital base and improve efficiency if they are to survive competition from more solid financial institutions within the region.

5.2. Financial sector fragility and risk of bank failures

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

5.2.1. Undercapitalization of financial banks

The increase in required minimum equity capital for banks has been a positive development for the stability of the banking sector. High equity capital makes banks more resilient when faced with short-term shocks. Properly capitalized banks are also more able to credibly engage in long-term relationships with their clients and partners; this is critical given the central importance of reputation for financial institutions. However, undercapitalized banks run the risk of insolvency, which has far-reaching effects on the credibility of the financial system as a whole. In Burundi low capital requirements have enabled a small group of shareholders to extract rents from the public while limiting their involvement in development-oriented activities.

Undercapitalization of the financial system in Burundi affected banking in two ways. First, it limited banks' lending capacity, particularly credit to large clients. Indeed, central bank regulations require that credit to one client should not exceed 20 percent of a bank's capital (République du Burundi, 2003). If enforced, this prudential requirement penalizes poorly

capitalized banks. Second, the low level of capital combined with bad lending practices resulted in insolvency of several financial institutions, leading to their failure.²¹ In this light, monetary authorities should carefully watch banks' practices particularly if the recent increases in profitability from a return on equity of 9.9 percent in December 2004 to 29.4 percent by November 2008 are due to increases in credit disbursements. If the new competition is pushing banks to issue more credit, commercial banks will need to consider increasing provisions for bad loans beyond the legal minimum just in case these loans become non-performing (IMF and World Bank, 2009).

5.2.2. Political pressure, mismanagement, and poor central bank supervision have led to the collapse of several financial institutions

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

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

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

The failure of CADEBU and CAMOFI was mainly the result of bad management. The ruling elites perceived them as sources of rents and managed them accordingly, as was the case with

²¹ Since the 1990s, five financial institutions have collapsed. They are: Meridien Bank Burundi (MBB), *Caisse d'épargne du Burundi* (CADEBU), *Caisse de mobilisation et de financement* (CAMOFI), *Banque de commerce et de développement* (BCD), and *Banque Populaire du Burundi* (BPB). The absolute number of bank failures may appear small but in a shallow financial system like Burundi, this has had a profound effect on banking in general.

other state enterprises. It is likely that the failure of these two institutions benefited their managers and their friends, as well as a few politically connected people who had been given large loans.²² It is even possible that this group of influential people could have pushed these institutions over the cliff in order to ensure that the loans they had contracted would never be paid back. Almost 20 years after the collapse of CADEBU, its liquidation process is still ongoing. While very little success has been achieved in recovering loans from CADEBU debtors, its liquidators were quick to repossess other assets, particularly real estate, which was hastily sold in obscure circumstances. The political economy of financial sector management in Burundi requires a deeper analysis beyond the scope of the current project.

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

Banque de commerce et de développement (BCD) was created on 14 January 1999 as a limited liability company with a capital of BIF 1.016 billion. Paradoxically, the bank's CEO was the same politician who had led CAMOFI to failure. His appointment was in flagrant violation of Article 17 of the banking law (République du Burundi, 2003) which stipulates that a person cannot be allowed to manage a bank if he (she) has played a key role in a company which, under his (her) leadership, was declared bankrupt. This, clearly, should have applied to CAMOFI's former CEO given that the company under his watch had collapsed just two months earlier. This exceptional treatment was not unrelated to the fact that the individual was a highly influential political figure, thus defying central bank regulations. This example illustrated the lack of independence of the central bank and its weakness in upholding the law governing banking in Burundi. As should have been expected, BCD was very badly managed. The bank lasted only four years and its problems appeared well before it went bankrupt. An audit report established that by 23 March 2004, the date on which the central bank finally decided to put BCD under receivership after a long period of inaction despite warnings that the bank was collapsing, there

²² In her communication on 10 October 2003, the first deputy governor of the central bank acknowledged that CADEBU and CAMOFI collapsed as a result of "*gestion laxiste*" or lax management, a diplomatic term meaning that they were plundered.

were severe problems that would have been difficult to address in order to save the bank. For example, to continue its operations, the bank needed to raise BIF 7.5 billion through recapitalization, loan recovery, sale of assets, etc. It was impossible to raise this amount of money in a relatively short period because BCD was known to be poorly managed. The audit report also uncovered several cases of fraud that give a glimpse of the internal management of the bank. For example, there was reference to advances of BIF 3.185 billion made to purchase a plot to build a branch in Quartier Buyenzi, one of the poorest neighborhoods in Bujumbura. Not only was this amount exorbitant but also the plot was never bought. The advances had not been recovered by the time the bank collapsed and it is unlikely that they will ever be.

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

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

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

Clearly, the central bank of Burundi has faced severe constraints that have limited its ability to effectively regulate and supervise the banking industry. First, effective regulation requires independence of the central bank from political interference. In Burundi, as the case of BCD illustrates, the central banks failed to intervene due to political pressure. Another constraint to effective regulation is inadequate capacity, especially in the area of information technology. In particular, the fact that bank operations are not managed by a fully digitized system precludes speedy and timely examination. Lack of adequate training for the staff responsible for banking supervision and regulation is a critical barrier to effective regulation. This constraint is exacerbated by the fast-changing nature of the regulatory framework, especially in the wake of

the recent financial crisis which has placed a premium on modernization and harmonization of national banking regulations in line with global standards.

In addition to the lack of independence, probably due to the lack of technical capacity, the central bank left loopholes in monetary policy that were exploited by commercial banks to increase their profits. For example, the central bank relies on liquidity management as the main tool of monetary policy used to control inflation. Under normal circumstances, it supplies liquidity to banks that are in need of extra funds and takes liquidity from those that have excess cash. In 2001, 2002, and 2003, commercial banks borrowed from the central bank at 14 percent, 15.5 percent, and 14.5 percent interest rates, respectively. They reinvested these funds into treasury bills issued by the same central bank and earned interest rates of 19 percent, 20 percent, and 16 percent, respectively. Hence, commercial banks used public resources to lend to the government, earning up to 5 percentage points of net interest. This was not illegal at the time because the central bank had not excluded commercial banks with central bank debt to participate in the treasury bills market. The anomaly was eventually corrected. Overall, these cases show that weak capacity and lack of independence from political influence severely hamper the efficiency of banking regulation and exacerbate the fragility of the financial system.

5.2.3. Credit concentration

Account-level information from one of the major commercial banks illustrates how banks compete to capture the biggest clients, even when this exposes them to high risk. For example, one account had a loan balance of BIF 1 billion on 27 October 2008, then 2 billion on 24 November 2008, and 3 billion on 25 May 2009. This last amount represented half of the bank's equity capital. Out of 6,180 loan contracts totaling BIF 69.8 billion over the period from January 2004 to August 2009, there were 132 loans of BIF 100 million or higher. These loans represented 60 percent of total bank credit and they were held by only 62 accounts.²³

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

5.3. The challenge of access to credit

Despite some recent positive developments in the banking industry, such as competition and the introduction of new technologies, access to credit remains a major challenge for the majority of people and firms in Burundi.

²³ Several accounts had more than one loan over the period.

5.3.1. Limited access to credit and banking services

Burundi has an extremely low rate of bank penetration. With less than 2 accounts per 100 persons,²⁴ the banking sector in Burundi is narrowly focused on a small urban elite and business community, which together represent a tiny proportion of the population. The rural economy is not covered by financial institutions despite the fact that it represents the largest part of economic activity. By the end of 2008, only 7 of the 73 bank branches or 9.5 percent were located in rural areas despite an urbanization rate of only 10 percent (Table 6). Moreover, most of the branches were in Bujumbura, with the remainder located at provincial capitals. Until recently, there were provinces without any bank presence. The strong concentration of banking services on a narrow segment of the population and business community could help explain why banking in Burundi has remained underdeveloped. Only 17 percent of the adult population in Burundi uses formal financial services, compared to an average of 20 percent for sub-Saharan Africa. Clearly the country faces the challenge of providing incentives for financial institutions to increase their presence in rural areas.

Table 6: Access to financial services and ICT in Burundi and selected SSA countries, 2009

Country	Adults using formal financial services (%)	Deposit accounts per 100 adults	Bank branches in rural area (%)	Rural population (% of total)	Mobile phone subscribers (%)	Internet subscribers (%)	Poverty head count (at \$1.25/day)
Burundi	17	2	9.5	90	6	0.8	81.3
Botswana	47	48.1	40.8	40.4	78	4.2	31.2
Madagascar	21	3.4	6	70.5	25.3	1.7	67.8
Mauritius	54	210.9	52.9	57.5	81.4	29.9	..
Mozambique	12	11.2	5.4	63.2	20.2	1.6	74.7
Rwanda	23	20.2	26.1	81.7	13.6	3.1	76.6
Uganda	20	15.4	56.8	87	27	7.9	51.5

Source: World Bank, *World Development Indicators*; Financial Access Initiative (online data); UNDP, *Human Development Report 2009*.

Note: The average usage of formal financial services by adults is 20% in SSA, 35% in Latin America, 41% in East Asia, 42% in South Asia, 51% in Central Asia and Eastern Europe, and 92% in high income OECD countries.

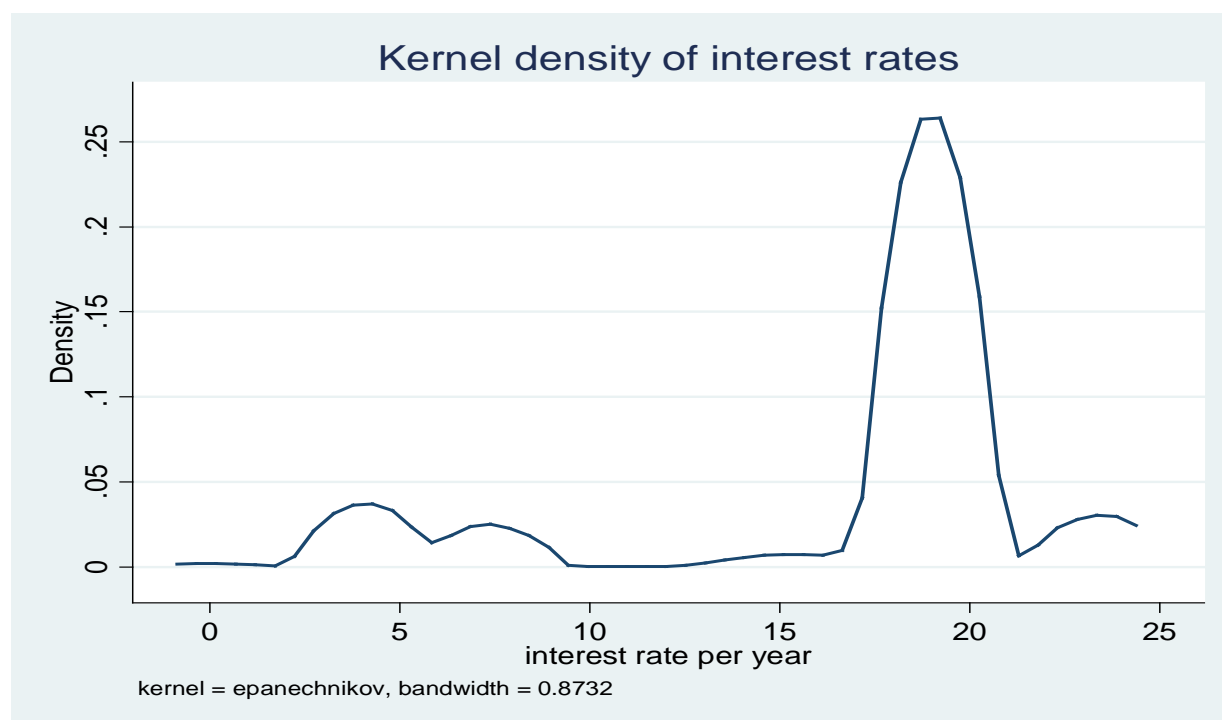
Access to finance can be increased substantially by promoting non-bank institutions, especially microfinance institutions, which are more flexible and better equipped to serve the informal sector and the rural areas. Microfinance covers 431,000 people (Table 4), which is more than three times the number covered by commercial banks. Despite high poverty in Burundi, savings mobilization is below potential. This is illustrated by the success of microfinance institutions in mobilizing rural savings which, in five years, increased by 176 percent (Table 4).

²⁴ The number of accounts is from Table 6 and the data on population size from WDI.

5.3.2. Credit allocation skewed in favor of “insiders”

The cost of credit is highly differentiated according to the identity of applicants. The small group of credit recipients may be divided into two categories: “outsiders” who pay high interest rates and “insiders” who pay no or very low interest rates. The distribution of interest rates in Figure 10 distinguishes these groups.

Figure 10: Distribution of lending interest rates



Source: Based on account-level data provided by a major commercial bank

The distribution of interest rates is bi-modal, with the upper part of the distribution – with the highest mode – showing interest rates paid by “outsiders” who are the regular bank clients. This group pays interest rates between 18 and 23.5 percent. The lower tail of the distribution corresponds with the low interest rates paid by “insiders,” who are bank executives and employees and a small group of special “clients” who have interest-free credit. They pay interest rates between zero and 7.5 percent, with a mode of 4 percent. Other indicators also confirm that the credit market excessively favors insiders at the expense of the majority of borrowers (Table 7).

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

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

Source: Computed by the authors based on data provided by one major commercial bank

Note: ST and MT outsider refer to short-term and medium-term credit to external clients, respectively.

Credit to “Outsiders”

At a 19 percent interest rate, the majority of borrowers cannot invest in profitable projects, explaining why the range of projects that can be funded is so limited. Moreover, the high interest rate could be associated with high default rates as borrowers may fail to generate profits that are high enough to cover debt service obligations. Adding to this the weak purchasing power, few Burundians can rely on the financial sector to pursue relatively large projects. The earlier example of the inability of a graduate couple to service a 15-year mortgage for a relatively small house illustrates this point. Therefore, high interest rates contribute not only to the creation of a difficult business climate but also perpetuate low living standards.

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

Credit to “Insiders”

Using the account-level data, we identified a group of “special” clients represented by 32 interest-free loans given to “outsiders”. Bank executives explained the presence of these accounts as cases of restructured loans where the beneficiaries renegotiated repayment terms that excluded the payment of interest. However, the amounts involved were so large – the median

interest-free loan was 9 million francs, which was six times the median loan given to external clients and employees – that the beneficiaries do not seem to be just any normal external clients. Such loans were more prevalent in 2009 and in 2008 to a lesser extent. Indeed, there were only two interest-free loans in 2004, one in 2005 and none in 2006 and 2007. The number increased to 7 in 2008 and 22 in 2009.

As it is impossible to know the exact identity of these privileged credit recipients we may only speculate as to who they could be on the basis of some discussions held with people knowledgeable about recent developments at the bank under review. In June 2008, the appointment of a new management team by the government was contested by several shareholders, particularly the group of private shareholders, who argued that the new candidates did not represent their interests. Apparently, the government imposed its candidates even though public institutions controlled only 49 percent of the bank's capital. Our guess is that once in place, the new management might have decided to buy off those who opposed their appointment by offering them interest-free loans. Otherwise, as they sat on the executive board of the bank, representatives of private shareholders would continue to pose problems to the new management of the bank.²⁵ Assuming that these were the conditions under which the loans were granted, it would not be surprising if they were not reimbursed.²⁶

Bank employees hold 17 percent of all credit contracts (short-, medium- and long-term loans). Even though, on average, they borrow the same amount as external clients, they have a privileged access to credit as illustrated by information in Table 7. Most importantly, they pay very low interest rates as their median rate of interest is only 4 percent, which is almost one-fifth of the normal interest rate paid by external clients. Secondly, by reimbursing their loans over longer periods of time (48 months instead of 12 months for external clients), their monthly payments represent almost a quarter of the amount required from external clients. These privileges illustrate two levels of discrimination in the credit market. The first is the fact that only a very small proportion of the population has access to bank credit. The second is that even among those accessing credit, bank employees enjoy by far the best conditions in terms of credit repayment. This has important implications for income inequality and economic equity. Indeed, access to cheap loans enables bank employees to profitably invest in projects that turn out to be unprofitable if undertaken by external clients.

The comparison between the 4 percent interest rate charged to employees' loans and the 19 percent paid by “outsiders” suggests that banks either recoup their cost with a 4 percent interest rate or they take losses by lending to their employees. If the latter case holds, banks then set high interest rates on loans to “outsiders” to cover the losses incurred on loans to employees and the few interest-free loans. In both cases, “outsiders” who constitute the most important client base are unduly penalized. By imposing high interest rates to extract maximum rents from their clients, banks may be responsible for the high rate of default and the narrow market for credit.

²⁵ See for example http://www.omac-afrique.org/article.php3?id_article=1029

²⁶ The largest interest-free loan (300 million francs) is already in default.

What about the argument that the low interest rates paid by bank employees are a reflection of their low level of default risk?²⁷ Information in Table 7 shows that, indeed, bank employees have a very low default risk. Three factors may help explain why. First, the close proximity between banks (lenders) and their employees reduces information asymmetry between the two actors, which in turn reduces employees' default. Secondly, by being both employers and lenders, banks have a strong control over their employee-borrowers. Defaulting could be too costly as the concerned employees could also lose their job. Thirdly and most importantly, the way loans are structured encourages default by external borrowers while reducing employees' default. Bank employees have some of the highest wages in the country but pay only a fraction of their monthly income to reimburse their loans (given that they pay on longer periods). In contrast, external clients have much lower incomes but, at the same debt level, they are required to make monthly payments 4 times larger than that of bank employees. The example of the couple of university graduates who cannot afford to service their mortgage contrasts with the fact that a young couple of university graduates working in a bank at entry wages would be required to pay about 4 percent of their monthly income to service the same mortgage.²⁸ This is one reason why access to jobs in the banking sector has traditionally been and still is considered the domain of members of the political elite. Normally, it should be the responsibility of the central bank to prevent these lending anomalies through its supervisory and regulatory role.

5.3.3 Using innovative products to mobilize financial services for poverty reduction

The discussion in the preceding section raises an important question: what should be the role of the financial sector in helping to reduce poverty in a poor country like Burundi? In addition to the inefficiencies in the financial sector documented in this paper, and partly because of these inefficiencies, the financial system has had a limited impact on poverty reduction. Could innovations in the financial sector help the country to mobilize more resources in order to make progress in the fight against poverty? By all measures, access to finance in Burundi is lower than in other countries with comparable levels of income. This implies that there is untapped potential that can be harnessed to increase access. As in other African countries, more savings could be mobilized and more financial services supplied by using innovative products that have proved to be better adapted to the needs of the rural population. Mobile banking is a case in point. Although mobile telephony coverage is still low in Burundi (Table 6), it has grown fast over the past years. Regional integration will accelerate the rate of penetration of mobile telephony even further with the involvement of the dominant mobile networks in the region such as Safaricom.

Mobile banking, which has just been introduced in Burundi, has demonstrated its remarkable power to expand access to finance in African countries as seen in South Africa and Kenya, two countries that are leading the digital revolution in the financial system in Africa. The mobile payment service known as M-Pesa (M for mobile and Pesa for money in Swahili) introduced by Safaricom in Kenya is transforming a cellular phone into a powerful payment tool, bringing the bank to the unbanked. This new banking technology allows the cellular handset to perform four important financial services: (1) a virtual bank card that stores basic information on the customer

²⁷ In a regression where default, the identity of the borrower, and year dummies are used as the determinants of the log of nominal interest rates, bank employees still pay lower interest rates, suggesting that low default alone does not explain why bank employees pay such low interest rates (results can be provided upon request).

²⁸ We assumed a salary of 500,000 Burundi francs for a young university graduate who joins a commercial bank.

and the financial institution, thereby saving on costs for bank card distribution; (2) a point of sale terminal, allowing execution of transactions with the bank, the buyer, and the seller, thus facilitating payment for goods and services; (3) an ATM serving as cash collection and distribution point; and (4) an internet banking terminal providing instant access to the account and the ability to make remote payments and transfers. In Burundi where physical infrastructure is underdeveloped in the rural area, with a high population density (306 inhabitants per square km in 2010), and where bank penetration is low, mobile banking has the potential to help bridge the financial service gap in the rural area. In addition to providing financial services, mobile banking is also a source of employment creation and income generation. The experience in Kenya suggests that mobile banking retail operators can earn up to \$1,000 per month in revenue (Eijkman, Kendall, and Mas, 2010). With increased mobile telephony penetration, this experience can be replicated in Burundi with substantial gains in employment creation and income generation.

More generally, poverty reduction in Burundi will require an increased contribution from the private sector through employment creation and income generation. In this context, a key component of the strategy is to increase access to finance for small and medium enterprises (SMEs). Given that traditional commercial banks are not particularly interested in lending to this segment of the private sector, the role of microfinance institutions and innovative payment and credit services is critical to building a vibrant SME sector. Bringing financial services to the traditionally “unbanked” and meeting the needs of SMEs can enhance the contribution of the financial sector to growth and poverty reduction.

6. Conclusion

The objective of this paper was to study the financial system in Burundi and examine its efficiency in mobilizing and allocating financial resources within the economy. Analyzing the relationship between the financial sector and the real economy in Burundi helps to shed light on some of the bottlenecks preventing the country from reaching higher levels of economic growth that will substantially reduce poverty. Access to financial services encourages investment and enterprise development, which have a direct effect on poverty reduction, notably through employment creation, and an indirect effect through economic growth. Hence, in Burundi, where most economic agents – particularly firms and households – do not have access to financial services, their contribution to economic growth and poverty reduction remains below their potential.

The study showed that the financial system in Burundi is very shallow and highly concentrated. Three traditional commercial banks, namely BANCOBU, BCB, and IBB, together represent three-quarters of total bank assets, credit, and deposits and savings. The lack of competition in the banking industry has prevented the sector from modernizing and offering products that reflect the needs of the market. For example, lending interest rates are so high that investors find it difficult to borrow and invest profitably. But even if investors were able to pay the current rates, other dimensions of the investment climate deter long-term investment. Indeed, within the East African community, Burundi not only has the highest proportion of firms identifying access to credit as a major constraint but also the highest level of policy uncertainty. Demand for credit

is also limited by the low and deteriorating purchasing power of the population. Therefore, the financial market in Burundi is constrained by both the demand for and supply of credit. This explains why credit rationing coexists with excess liquidity in the banking sector.

The concentration of bank lending on short-term activities, particularly trade, is a major source of inefficiency in the financial system. Agriculture and industry, the two sectors with the highest growth and employment creation potential, require medium- to long-term credit, so they are out of the credit market. The study finds that credit allocation is subject to three forms of inefficiencies. First, relative to other African countries a large proportion of credit is allocated to the government despite its inherent inefficiencies in Burundi. Second, less than one percent of total credit goes to agriculture, the backbone of Burundi's economy that has been identified as a development priority. This is problematic in a country where agriculture is the source of livelihood for the majority of the population. The lack of credit to agriculture limits the contribution of the financial system to growth, employment creation, and poverty reduction. Third, contrary to the basic principle of modern portfolio theory, credit is not allocated according to the distribution of risk. Commerce has among the highest levels of default risk; yet the sector has the largest share of credit. Similarly, credit defaults are highest with short-term credit but the bulk of lending is short-term. One of the reasons why banks do not diversify their credit portfolios is that they have so far been very profitable so they have no incentive to change their lending strategies.

Among the root causes of the inefficiencies observed in Burundi's financial sector are important political economy dimensions. The country has been led by groups seeking to advance and preserve their own interests. So they used the financial sector and the economy in general to extract rents. Banks and other financial institutions were put in the hands of incompetent managers who used them to offer employment to their relatives and political associates, eventually ruining them to appropriate their assets. Moreover, the central bank failed to regulate and ensure compliance in the financial sector mostly due to political pressure, the limited instruments for intervention, and the limited technical capacity to deal with the challenges of financial sector supervision in a changing international environment. In addition, persistent political and economic instability created high uncertainty that discouraged long-term credit and investment needed to address the country's structural challenges. One of the consequences has been a succession of failures of financial institutions over the years. Even the current banks are fragile, in spite of their apparent high profitability. Credit and deposits are so concentrated on a few clients and very few activities that in the event of economic or political shocks to the economy, the whole banking sector could be seriously affected.²⁹

Despite the serious challenges facing the financial system in Burundi, there are some positive developments that will contribute to defining the future of the sector. First, the central bank has realized that Burundian banks were substantially undercapitalized and it decided to gradually raise the required equity capital. Since 2004, the minimum required capital has been raised eightfold. The second positive development has been the opening of the financial sector to

²⁹ Rwanda, a neighboring country, is just recovering from such a shock. According to interviews with Rwandan banking officials, the Rwandan banking system was facing serious difficulties when a few clients withdrew their deposits and savings from the system to buy Safaricom stocks on the Kenyan stock exchange. As a result, liquidity was so low that banks decided to ration the amount that could be withdrawn.

competition from banks in the region. The traditional banks in Burundi never faced real competition until 2007 when the country joined the East African Community. Burundian banks have to adapt to this new reality if they are to compete with more established financial institutions, particularly from Kenya. In this regard, the entry of new banks such as Diamond Trust Bank and Bank of Africa, as well as the large number of other banks considering entry into the Burundian market, are going to transform the financial sector in Burundi. Already, the introduction of ATMs in 2009 and the decline of bank interest rates from 22 percent in 2005 to 17 percent in 2008 could be considered a result of increasing competition and diversification. As part of this diversification process, telephone banking has already been introduced as a cheaper and more efficient form of banking. It is expected that new savings and investment instruments such as equity funds will be offered as competition increases.

The third positive development is the expansion of microfinance. In terms of client base, microfinance has outperformed the traditional banking sector by a factor of three to one. By increasing savings collection by 176 percent in just five years, microfinance has also demonstrated that there were substantial savings that were out of reach of the traditional banking sector. This is remarkable considering that microfinance is a relatively new phenomenon in Burundi. Even though microfinance issues small loans relative to the banking sector, it is in a better position to address the needs of a large market segment which is not covered by commercial banks. This has opened up opportunities for entrepreneurship particularly in rural areas. As a result, given that poverty in Burundi is by and large a rural phenomenon, microfinance is more responsive towards the objective of fighting poverty in the country. Over time, some microfinance institutions could grow and compete with banks, which would benefit borrowers and savers. Alternatively, some microfinance institutions could become so important that traditional banks will seek partnerships with them to cover a larger and more diversified market, including the currently "stranded middle" whose financial needs are beyond the capacity of microfinance but at the same time too small to be of interest to traditional banks. Either way, the financial sector in Burundi will contribute more to the economy if it is more diversified and more integrated.

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ANNEX I: Highlights on the financial liberalization in Burundi

Box 1: Key control measures in the financial sector before liberalization

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

Box 2: Chronology of financial sector liberalization in Burundi

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

Phase 1: Starting in April 1988

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

Phase 2 : Starting in September 1988

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

Phase 3: Starting in December 1988

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

Phase 4 Starting in October 1989

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

Sources: Compiled by authors from various reports of the Central Bank and the Ministry of Planning.

Annex II

Table A1: Indicators of the investment climate, Burundi and EAC (average 2000-08)

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

Source: World Bank, *Doing Business* database.