Cameroon: Policies to Mobilize Financial Savings

Hafez Ghanem

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CAMEROON: POLICIES TO MOBILIZE FINANCIAL SAVINGS

by

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October 1985

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ABSTRACT

This paper is written as an input to the Cameroon financial sector review. It analyzes the determinants of financial savings using an econometric model and proposes a reform package which would lead to an increase in their rate of growth. It demonstrates that financial savings are sensitive to interest rates, and that the changes in the differential between domestic and international interest rates lead to real exchange rate fluctuations, and thus may jeopardize macro stability. Therefore, it argues for the adoption of a more flexible interest rate policy that reflects changes in the international environment. In Cameroon, taxes on financial savings and intermediation impede the goal of financial deepening and are an insignificant portion of government revenue. An analysis of the effects of those taxes is carried out. It is recommended that they be eliminated. Cameroonian banks are currently facing a solvency crisis. The paper studies the impact of this crisis on the supply of credit and recommends government actions that would help resolve it. Policies that would increase the competitiveness of the banking industry and make financial services available to wider segments of the population are also analyzed.
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I. INTRODUCTION

This report is written as an input to the Cameroon financial sector review. It analyses the determinants of financial savings using an econometric model, and proposes a reform package which would lead to an increase in the rate of growth of those savings. The interest in financial savings stems from the theoretical and empirical literature that links financial deepening to real economic growth. The most influential work in this field was carried out by Goldsmith [1969], McKinnon [1973] and Shaw [1973]. More recent contributions are due to Spellman [1976], Fry [1978, 1980, 1982] and Gupta [1984]. Those analysts have argued that financial deepening has a positive effect on real growth. This effect is achieved via two mechanisms: (i) an increase in the total volume of saving (defined in the national accounts sense); and (ii) a rise in the efficiency of investment.

Financial policies affect total saving in two ways. First it is often argued that total saving is interest elastic. That is, interest rate reforms that are usually associated with financial development would, by raising the reward to savers, lead to a rise in aggregate saving. Second, such a rise may also be brought about by structural changes in the financial system. The development of this system and the concomitant increase in the array of savings instruments that are made available to the public, as well as the improvement in the quality of bank services are thought to encourage private saving. This increase in
saving would, by raising the volume of investment, lead to faster real economic growth.

Even if it has no effect on the volume of savings, financial development could still have a positive impact on real growth. This is the case because, it will affect the allocation of savings. Improvement in financial deepening are usually associated with an increase in the private sector's demand for domestic financial assets, and a fall in the demand for other assets. Inasmuch as all domestic financial savings are lent out for investment purposes and that the increase in those savings comes at the expense of nonproductive assets, financial development will increase the volume of productive investments. For example, as the financial system develops, private agents may shift from holding foreign to domestic financial assets. Thus, the volume of resources that is invested domestically would increase without a change in consumption patterns.

Financial development also leads to a better allocation of investment and thus to higher real returns and faster economic growth. In a financially shallow economy characterized by the predominance of self finance, rates of returns on investment in different sectors and geographic locations will be different. The rise in intermediation (associated with deepening) will tend to equalize those rates, thus increasing the economy-wide marginal return to investment and leading to a rise in productivity.

The Government of Cameroon seems to be convinced that a faster rate of financial development would improve the country's long term
growth prospects. This conviction was made apparent by their request for the Bank's assistance in the area of financial reform. The financial sector review referred to earlier is being prepared at the request of the government. Therefore, the present report will not attempt to present further evidence supporting the view that financial growth leads to faster real growth. Instead, it will focus exclusively on trying to identify policy measures that will enhance the development of the Cameroon financial system.

Cameroon is a member of the Franc Zone. Together with the Central African Republic (CAR), Chad, Gabon, Congo and Equatorial Guinea, Cameroon shares a common currency—the CFA Franc—issued by a common central bank, Banque des Etats de l'Afrique Centrale (BEAC). The BEAC began operations on April 2, 1973, replacing as bank of issue the Banque Central des Etats de l'Afrique Equatoriale et du Cameroon (BCEAO). The CFA Franc is fully convertible into French Francs at the rate of CFAF = FF 0.02. This membership in BEAC imposes some constraints on the national authorities ability to make financial policy changes. Therefore, care was taken to ensure that all the changes advocated by this report can be undertaken by the Cameroon government without violating any of BEAC's rules.

The report reviews the present structure of the financial system and the policies affecting financial development. It points out that commercial banks are currently facing a solvency crisis. This crisis poses a threat to future financial development and therefore should be resolved. The econometric analysis carried out here indicates
that interest rates are important determinants of financial development, and that the differential between foreign and domestic rates has an important effect on long run growth and short run macro stability. The present interest rate regime is too rigid and is based on the mistaken assumption that Cameroon is a closed economy. This regime needs to be changed. The Cameroonian government taxes both savers and borrowers. It is shown here that the repeal of those taxes could, at a minimal cost to the treasury, bring about an increase in the return to savers and in bank margins without significantly increasing the cost of borrowing. It is also argued that the system of requiring commercial banks to purchase bons d'équipement has a negative effect on financial deepening. Furthermore, the revenue generated by the sale of those bonds is not being used to finance productive investments. This system has to be eliminated. Policies which help link the formal and informal financial sectors or improve the quality of the postal savings complex would, by making financial services available to a wider segment of the population, lead to a faster rate of financial development.

Based on the above, a six point program of financial reform is proposed. The six points are:

(i) An immediate recapitalization of commercial banks;
(ii) The elimination of taxes on savers and borrowers;
(iii) A gradual liberalization of interest rates;
(iv) A gradual elimination of the system of bons d'équipement;
(v) Linking the formal and informal financial sectors; and
vi) Improving the postal savings facilities.

An understanding of the interrelationships between those recommendations is essential for Cameroonian policy makers. In the past, Cameroon has relied too heavily on piecemeal solutions to financial sector problems. A comprehensive reform program is now needed. It is also important for them to understand the links between domestic financial policies, the international environment, long run growth and short run macro stability. Cameroon is a relatively open economy. It cannot continue setting financial policies without reference to international occurrences.

This report is divided into six chapters. After this introductory chapter, Chapter 2 looks at the trends in Cameroon's financial development and compares it with other LDCs. A description of current and past interest rate policies is presented in Chapter 3. Chapter 4 studies the institutional factors affecting financial deepening. An econometric analysis of the determinants of financial savings and of the relationship between financial policies and short run stability is presented in Chapter 5. The concluding chapter of the report, Chapter 6, presents an outline of the proposed reform package.
II. TRENDS IN FINANCIAL DEVELOPMENT

1. Introduction

This chapter studies the evolution of the financial system in Cameroon and compares it with other LDCs. The cross country comparison shows that the Cameroonian financial system is slightly underdeveloped relative to its income class. The discussion in the preceding chapter has indicated that this relative financial shallowness may jeopardize the country's prospects for future growth. Therefore, it is argued that policy measures that would bring about an increase in financial intermediation are needed. The present low level of financial development does not imply that the Cameroonian financial sector has been stagnant in the past. As a matter of fact, this sector has been growing at relatively stable rates since the early 1960's. Furthermore, an acceleration of the rates of growth of various financial indicators occurred during the latter part of the 1970's. This has probably been due to the improvement in the structure of the banking system associated with the creation of BEAC. However, the rate of financial development started faltering after 1980. Hence, it seems that the government's present concern with the health of the financial sector is well founded. The relationship between government deposits with commercial banks (which have been increasing as oil revenue was rising) and financial development is also discussed. It is not clear that those deposits have had any effect on financial deepening.
2. A Comparative Perspective

The depth of the Cameroonian financial system is compared with that of eight other LDCs, which have similar levels of GNP per capita, using three important measures of financial development.\footnote{See Goldsmith [1969] for a review of such measures.} This comparison is presented in Table 1. It indicates that the Cameroonian financial system is underdeveloped relative to its income class. The ratio of $M_2$ to GDP $\frac{NM_2}{GDPO}$ in Cameroon, although roughly in line with that of other Franc Zone countries, is only 75 percent of the average for the entire sample. The ratio of bank deposits ($M_2$-currency outside the banking system) to GDP ($LB/GDP$) is 79 percent of the average, and the ratio of quasi-money to GDP ($QM/GDP$) is 64 percent of the average. A comparison with Thailand, a country with the same level of per capita GNP, yields more striking results. $\frac{M_2}{GDP}$, $\frac{LB}{GDP}$ and $\frac{OM}{GDP}$ in Thailand are respectively 100, 52 and 300 percent greater than the corresponding ratios for Cameroon. It may be argued that this comparison with Thailand is inappropriate. Although they have the same level of per capita GNP, the economic structures of the two countries are vastly different. Therefore, a similar comparison is carried out with Nigeria, a country with a roughly similar economic structure as Cameroon but a lower GNP per capita. $\frac{M_2}{GDP}$, $\frac{LB}{GDP}$ and $\frac{OM}{GDP}$ in Nigeria are respectively 54, 37 and 67 percent greater than in Cameroon.
Table 1: CAMEROON: COMPARATIVE MEASURES OF FINANCIAL DEVELOPMENT: 1983

<table>
<thead>
<tr>
<th>Country</th>
<th>GNP/capita</th>
<th>M₂/GDP</th>
<th>LB/GDP</th>
<th>OM/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cameroon</td>
<td>$820</td>
<td>0.24</td>
<td>0.19</td>
<td>0.09</td>
</tr>
<tr>
<td><strong>Other Africa</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>$340</td>
<td>0.27 a/</td>
<td>0.22 a/</td>
<td>0.10 a/</td>
</tr>
<tr>
<td>Nigeria</td>
<td>$770</td>
<td>0.37 a/</td>
<td>0.26 a/</td>
<td>0.15 a/</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>$710</td>
<td>0.26 b/</td>
<td>0.17</td>
<td>0.08</td>
</tr>
<tr>
<td>Senegal</td>
<td>$440</td>
<td>0.31 b/</td>
<td>0.21 b/</td>
<td>0.08 b/</td>
</tr>
<tr>
<td><strong>Average Africa</strong></td>
<td>$565</td>
<td>0.30</td>
<td>0.22</td>
<td>0.10</td>
</tr>
<tr>
<td><strong>Other LDCs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Morocco</td>
<td>$760</td>
<td>0.44 a/</td>
<td>0.29 a/</td>
<td>0.10 a/</td>
</tr>
<tr>
<td>Thailand</td>
<td>$820</td>
<td>0.48</td>
<td>0.42</td>
<td>0.39</td>
</tr>
<tr>
<td>Indonesia</td>
<td>$560</td>
<td>0.20</td>
<td>0.16</td>
<td>0.10</td>
</tr>
<tr>
<td>Philippines</td>
<td>$760</td>
<td>0.25</td>
<td>0.20</td>
<td>0.17</td>
</tr>
<tr>
<td><strong>Average Others</strong></td>
<td>$725</td>
<td>0.34</td>
<td>0.27</td>
<td>0.19</td>
</tr>
<tr>
<td><strong>Overall Average</strong></td>
<td>$645</td>
<td>0.32</td>
<td>0.24</td>
<td>0.14</td>
</tr>
</tbody>
</table>

SOURCE: WDR, IFS and Bank staff estimates.

\[a/\] 1982 data

\[b/\] 1981 data
Table 2: NUMBER OF BANK BRANCHES PER 10,000 OF THE POPULATION (1977 data)

<table>
<thead>
<tr>
<th>Country</th>
<th>GNP/Capita</th>
<th>Permanent Bank Branches/10,000 persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cameroon</td>
<td>$340</td>
<td>0.149</td>
</tr>
<tr>
<td>Ghana</td>
<td>$380</td>
<td>0.204</td>
</tr>
<tr>
<td>Kenya</td>
<td>$270</td>
<td>0.209</td>
</tr>
<tr>
<td>Tanzania</td>
<td>$190</td>
<td>0.188</td>
</tr>
<tr>
<td>Somalia</td>
<td>$110</td>
<td>0.087</td>
</tr>
<tr>
<td>Average</td>
<td>$238</td>
<td>0.172</td>
</tr>
</tbody>
</table>

SOURCE: Ministry of Finance, WDR and Kwarteng [1982].

The number of bank branches per 10,000 persons is a measure of the physical accessibility of banks, and therefore is often used as an indicator of financial depth. Table 2 compares this ratio for Cameroon and four other African countries.\(^1\) Once again, the results of this comparison indicate that the financial system in Cameroon is underdeveloped relative to its income class. The ratio of bank branches per 10,000 persons in Cameroon was 13 percent below average; it was 27 percent lower than that of Ghana, although GNP per capita for both countries was roughly equal.

The above analysis clearly indicates that the Cameroonian financial system is relatively shallow. This shallowness is cause for

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\(^1\) The choice of comparator countries was based on data availability.
concern. Financial underdevelopment may become a binding constraint on future economic growth. Hence, the government's current preoccupation with the financial sector seems to be warranted. Measures that will bring about a greater level of financial intermediation are needed to ensure that Cameroon's impressive record of economic achievement will continue into the future.

3. The Evolution of Financial Deepening


<table>
<thead>
<tr>
<th>Year</th>
<th>M₂/GDP</th>
<th>LB/GDP</th>
<th>OM/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1963</td>
<td>14.3</td>
<td>6.5</td>
<td>1.2</td>
</tr>
<tr>
<td>1970</td>
<td>15.1</td>
<td>9.7</td>
<td>2.4</td>
</tr>
<tr>
<td>1973</td>
<td>17.6</td>
<td>11.1</td>
<td>3.7</td>
</tr>
<tr>
<td>1976</td>
<td>20.2</td>
<td>14.6</td>
<td>5.8</td>
</tr>
<tr>
<td>1980</td>
<td>23.3</td>
<td>17.5</td>
<td>7.9</td>
</tr>
<tr>
<td>1982</td>
<td>22.4</td>
<td>17.5</td>
<td>8.6</td>
</tr>
<tr>
<td>1983</td>
<td>24.0</td>
<td>19.0</td>
<td>9.2</td>
</tr>
</tbody>
</table>

SOURCE: IFS

The evolution of the three financial ratios discussed earlier over the past twenty years is presented in Table 3 above. This table indicates that the Cameroonian financial system was growing steadily during the period 1963-73, the rate of financial development accelerated after 1973, and then declined during the period 1980-83. The average annual growth rate of M₂/GDP for the period 1963-73 was 2.1 percent, it nearly doubled to 4.1 percent during the 1973-80 period. The rapid financial growth which characterized this latter period was also
associated with a change in the structure of $M_2$. The share of currency in $M_2$ was falling while that of bank deposits was rising, and the average term structure of those deposits was increasing (quasi money was growing at a faster rate than demand deposits). This acceleration of financial development may have been due to the creation of BEAC which occurred in 1973. The new institutional structure, and the concomitant rise in the number of banks operating in Cameroon,\textsuperscript{1/} seem to have been conducive to a faster rate of financial deepening. A statistical test of this hypothesis is presented in Chapter 5.

The situation changed dramatically after 1980. The rate of growth of $M_2$/GDP during the period 1980-83 fell to 1.0 percent. Although the structure of $M_2$ continued to change favoring bank deposits, the change was not as marked as in the earlier period. Some analysts have speculated that this may be linked to the rapid increase in government deposits with commercial banks which was associated with the rise in oil revenues. During the early seventies those deposits averaged around 10 percent of total bank liabilities. This figure jumped to 30.1 percent in 1976, peaked at 57.2 percent in 1981 then fell to 26.3 percent in 1983.\textsuperscript{2/} A priori, the direction of the effect of those deposits on financial development cannot be determined. By increasing banks' liquidity and, hence, their ability to make loans they exert a

\textsuperscript{1/} Eight of the ten banks currently operating in Cameroon were incorporated after 1973.

\textsuperscript{2/} If banks' long term liabilities (time and savings deposits) are considered separately, the state's share will appear much larger. Currently, public and parapublic deposits account for more than 60 percent of banks' long term liabilities.
positive effect. On the other hand, if at the institutionally set margins, banks consider an increase in loans unprofitable, this rise in liquidity would reduce their incentive to mobilize private deposits, and thus have a negative impact on financial development. In Cameroon, neither of those two effects seems to have been dominant. The econometric analysis presented in Chapter 5 indicates that there has been no significant relationship between government deposits and financial deepening.

The discussion presented in this chapter has shown that the Cameroonian financial system is shallow relative to that of other LDCs and that recent years have witnessed a decline in the rate of growth of that system. Therefore, policies that would bring about faster rates of financial development seem to be needed. The remainder of this report will be devoted to an analysis of such policies.
III. INTEREST RATE POLICIES

1. Introduction

This chapter presents a discussion of interest rate policies in Cameroon. It argues that the present structure of interest rates is too complicated, that nominal rates have been too rigid and that real rates have been too low. Most analysts would agree that the present system of interest rate determination needs to be changed. At present, credit rationing exists, interest rates on the curb market are too high, and some banks avoid lending rate regulations by requiring borrowers to hold compensating balances.

The first best solution would have been to let interest rates be market determined. However, due to the thinness of the Cameroon insurance financial market it may have been appropriate for the authorities to administer them. Under such circumstances there are two rules of thumb that should be followed by the Central Authorities. The first rule is that real interest rates not be allowed to be negative over an extended period of time, and the second rule is that short run variations in nominal rates should reflect supply and demand conditions. Due to its membership in the Franc Zone, Cameroon has a relatively open economy, and a fixed exchange rate vis-a-vis the French Franc. Therefore, this second rule of thumb implies that domestic rates should reflect changes in international rates. In the past, the Central Authorities did not follow either of those two rules. Real interest rates were negative throughout the period under study, and domestic nominal rates were out of line with international rates.
2. **Interest Rate Structure**

In the BEAC zone, the Central Bank sets three base rates: the base deposit rate (taux de base créditeur), and the base lending rates to privileged and non privileged operations (taux de base debiteur privilégié at taux de base debiteur ordinaire). The actual interest rates paid or received by the public are equal to the base rates plus some margins which are determined by each country's national authorities. In Cameroon they are set by the Ministry of Finance (MOF). That is, BEAC only determines an interest rate floor. MOF can, by changing the margins, set domestic rates at any level above this floor. Table 4 presents average deposit rates in Cameroon and three other zone members. It shows that as a result of this institutional arrangement the various BEAC countries have been maintaining slightly different interest rates. Although the differentials have been very small, their existence in the past indicates the Cameroon can alter its interest rate policies without needing to modify the international agreements governing its membership in the zone.

**Table 4: NOMINAL DEPOSIT RATES a/**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cameroon</td>
<td>4.5</td>
<td>5.5</td>
<td>6.0</td>
<td>6.5</td>
<td>6.5</td>
<td>6.5</td>
<td>7.0</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Gabon</td>
<td>5.5</td>
<td>5.5</td>
<td>6.5</td>
<td>6.5</td>
<td>6.5</td>
<td>6.5</td>
<td>7.5</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Congo</td>
<td>4.0</td>
<td>4.5</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
<td>6.5</td>
<td>6.5</td>
<td>6.5</td>
</tr>
<tr>
<td>CAR</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
<td>5.5</td>
<td>7.5</td>
<td>7.5</td>
</tr>
</tbody>
</table>

**SOURCE:** BEAC

*a/ Average rates calculated by BEAC."
An important feature of Cameroon's interest rate policies is their rigidity. This can be seen from the first row of Table 4. Changes in nominal rates have been both infrequent and of very small magnitudes. Macroeconomic conditions change continuously. Therefore, interest rates need to be adjusted relatively frequently if they are to reflect those conditions. The government seems to be starting to realize this fact. Since 1982 interest rate schedules have been adjusted twice: in January of 1983, and in June 1984. In the future, such adjustments should occur regularly at relatively short intervals (e.g., at the beginning of every quarter).

In order for a more flexible policy to be feasible the current interest rate schedules need to be simplified. At the moment, MOF has to set some 49 deposit rates (including rates on the bons de caisse and on savings deposits) and 21 lending rates. Deposit rates increase as either the size or the maturity of the deposit rises. Deposits are divided into ten categories according to size and into three categories according to maturity. Lending rates are divided into short and medium term. The number of medium term rates seems reasonable. There are 4 medium term rates corresponding to ordinary and privileged, rediscountable and nonrediscountable loans. However, since short term loans are used to finance a wide range of commercial activities, MOF sets 17 different short term lending rates. This complicated structure is not really needed to ensure that the financial sector operates efficiently. Furthermore, it makes it virtually impossible for MOF to carry out a flexible interest rate policy.
3. **Real Interest Rates**

Most analysts argue that the level of real deposit rates is an important determinant of financial development. In general, a rise in the real return on financial assets is expected to raise total savings (defined in the national accounts sense) as well as the share of financial savings in that total. Inasmuch as they reduce total savings artificially low real deposit rates will obviously have a negative impact on real growth. Even if total savings are interest inelastic, as argued by some writers, deposit rates will still have an important impact on economic development. Artificially low deposit rates provide an incentive for the private sector to hold less financial assets in favour of other assets some of which may not be productive (e.g. foreign assets). In this case raising deposit rates will lead to a shift from nonproductive assets to bank deposits and thus have a positive effect on real growth.

A recent Bank report studying interest rate policies in a representative sample of LDCs \(^1\) noted that on average: (i) nominal rates were adjusted very infrequently with the result that real rates were mainly determined by inflation, and (ii) real rates were negative through most of the seventies. This is an accurate description of what was taking place in Cameroon. From Table 5 (above) it is noted that deposit rates were negative throughout the period 1975-82. This

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\(^1\) See World Bank Report No. 5391.
Table 5: REAL (BEFORE TAX) INTEREST RATES

<table>
<thead>
<tr>
<th>Year</th>
<th>ex post real deposit rate a/</th>
<th>ex ante real deposit rate b/</th>
<th>ex post real lending rate c/</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>-7.2</td>
<td>-2.4</td>
<td>-2.4</td>
</tr>
<tr>
<td>1976</td>
<td>-3.5</td>
<td>-2.8</td>
<td>0.8</td>
</tr>
<tr>
<td>1977</td>
<td>-7.2</td>
<td>-3.3</td>
<td>-3.4</td>
</tr>
<tr>
<td>1978</td>
<td>-5.2</td>
<td>-4.3</td>
<td>-1.4</td>
</tr>
<tr>
<td>1979</td>
<td>0.1</td>
<td>-5.0</td>
<td>3.9</td>
</tr>
<tr>
<td>1980</td>
<td>-2.1</td>
<td>-5.2</td>
<td>2.9</td>
</tr>
<tr>
<td>1981</td>
<td>-4.5</td>
<td>-5.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>1982</td>
<td>-7.9</td>
<td>-6.3</td>
<td>-3.4</td>
</tr>
</tbody>
</table>

SOURCE: IFS, MOF and BEAC.

a/ The nominal deposit rate used here is the average on different types of deposits calculated by BEAC.

b/ Expected inflation is estimated from a model where agents form their expectations on the basis of the current CPI and inflation in the two preceding periods.

c/ The nominal lending rate is defined as the rate on medium term ordinary nonrediscountable loans.

Conclusion remains unchanged whether actual inflation is used to deflate the nominal rate or whether some measure of expected inflation is used instead. If the effect of taxation (to be discussed in detail in the next section) is calculated, those rates will be even more negative. That is, MOF was violating the first rule of thumb for setting interest rates. It allowed real rates to be negative for an extended period of time. As will be shown in Chapter 5, this has had an adverse effect on the mobilization of financial savings. It should also be noted that the increase in deposit rates which occurred in June 1984 may still be insufficient to generate a positive real return on savings.
The last column in Table 5 shows that real lending rates were negative for 5 out of the 8 years studied here. They averaged -0.4 percent for the period under study (in this case taxes tend to raise the real rate). Artificially low lending rates impede the goal of economic development because they reduce the volume of investment and lower its efficiency. Many LDC policy makers argue that low lending rates encourage investment. Ex ante they would. In Cameroon they probably have had the opposite effect, ex post. Most Cameroonian entrepreneurs cannot obtain credit from the formal market at any interest rate. That is, the main factor limiting private investment is the volume of available credit and not the price of that credit. Artificially low lending rates reduce bank margins and, hence, lower the volume of credit available for investment via two mechanisms: (i) they encourage banks to hold excess liquidity (which is currently the case in Cameroon), so that the amount of loans forthcoming at any level of financial savings is reduced; and (ii) they do not provide banks with a sufficient incentive to mobilize deposits thus reducing financial savings. At the moment, a bank providing a medium term nonrediscountable ordinary loan has a margin of around 1.75 percent. If the loan is to a privilege activity the bank's margin is actually negative (the method used in calculating margins will be discussed later in this report). An increase in those margins will cause an increase in financial development and a rise in real domestic investment. Another argument against artificially low lending rates is that they lead to the use of rationing mechanisms, which typically allow relatively inefficient firms to raise their capital stock at the expense
of more efficient ones that are crowded out of the financial market. Hence, they lead to a misallocation of investment. That is, in addition to raising the volume of investment, an increase in lending rates will improve its overall efficiency.

4. Domestic and International Interest Rates

In a relatively open economy, changes in domestic interest rates should reflect international conditions. Hence, a rule of thumb for the Central Authorities administering interest rates is to let changes in domestic rates reflect movements in international rates. Once more, MOF has failed to follow this rule. Interest rates in Cameroon were consistently below those that prevailed in international markets. During the period 1975-82 Cameroonian nominal deposit rates were on average 4.8 points below the yield on French government bonds.\footnote{1} Furthermore, this interest rate differential was not stable: it fell from 4.0 points in 1975 to 2.5 points in 1978 then rose again to 8.1 points in 1982. Exchange controls do exist in Cameroon. Therefore, it may be the case that MOF assumed that they were effective and, hence, Cameroon is a relatively closed economy. In practice, however, this does not seem to be true. Commercial banks regularly exceed the limits on external transfers despite the penalty rates imposed by BEAC. Given Cameroon's membership in the Franc Zone: its freely convertible currency and close economic ties with other Zone members, it is virtually

\footnote{1}{The yield on French government bonds was used here because it is a long term rate that can be compared with the deposit rates, and because a secondary market in those bonds exists which makes them a safe liquid asset attractive to foreign (in this case Cameroonian) investors.}
impossible to conceive of a set of controls that will be completely effective in halting all capital flows.

No capital inflows or outflows would occur if nominal domestic interest rates plus the expected rate of currency depreciation and transaction costs were equal to foreign rates. The expected rate of depreciation of the CFA Franc vs the French Franc is zero by definition. Hence, some capital inflows or outflows would occur as long as nominal Cameroonian rates are vastly different from these prevailing in Paris. Deposit rates that are consistently lower than French rates will encourage some economic agents to hold foreign rather than domestic financial assets, thus reducing the amount of private savings that is used to finance domestic investments. That is, the practice of keeping domestic deposit rates at much lower levels than foreign ones impedes the goal of financial development and lowers the rate of domestic investment.

The fact that domestic rates are virtually constant while foreign ones vary, implies that the interest rate differential will be unstable. That is, the amount of net foreign inflows will be varying and unpredictable. Variations in net foreign inflows lead to variations in aggregate demand and the real exchange rate. Hence, wide fluctuations in this variable can be destabilizing. That is, in addition to impeding the long run goal of financial development, the practice of setting domestic interest rates without reference to the international environment jeopardizes short run economic stability.
IV. INSTITUTIONAL FACTORS AND FINANCIAL DEEPENING

1. Introduction

This chapter presents a description of the structure of the Cameroonian financial system and analyses the relationship between institutional factors and financial development. Other than interest rates which were discussed in the previous chapter, it is argued that the main factors affecting the mobilization of financial savings in Cameroon are the structure of the banking sector and the system of taxing financial savings and intermediation. The banking system is characterized by a high degree of concentration. This fact poses problems for any liberalization efforts. At present, Cameroonian banks are facing a solvency crisis. Therefore, they tend to be more risk averse than otherwise. At current margins they do not find many projects to which lending will be attractive. As a result they are overliquid, and do not have an incentive to mobilize deposits. The formal financial sector also includes insurance companies and the postal savings and checking systems. Insurance companies were studied by other mission members and therefore will not be discussed here. Although it could play a potentially important role in the mobilization of financial savings, the postal system is only responsible for a very small portion of total deposits. This is mainly due to the low quality of the services offered. There are three types of taxes that affect financial development: taxes on new borrowing, the withholding tax on interest income and the requirement that commercial banks use a portion of all deposits to purchase low yielding bons d'équipments. The first tax
raises the cost of borrowing. The second is a direct tax on savers and the third is a hidden tax on intermediation. An extensive curb market (tontines) exists in Cameroon. The size of this informal sector provides an indication that formal institutions are not functioning smoothly. At the same time it does offer a rare opportunity. Policies that provide a link between the formal and informal sectors could lead to a large increase in the level of financial deepening.

2. Commercial Banks and Postal Savings

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SOURCE: Ministry of Finance.

a/ Defined to include long term financial assets only.

Table 6 (above) indicates that commercial banks are by far the most important institutions responsible for savings mobilization. In 1984 they were responsible for 80 percent of all financial savings. Total private deposits with commercial banks are divided evenly between firms and households. Those banks offer three types of savings instruments: time deposits, savings deposits and bons de caisses (nonnegotiable certificates of deposit). The latter instrument is only offered to
households while the other two are offered to both households and firms. Savings accounts (comptes sur livrets) are the most important savings instrument, accounting for 51 percent of private savings with commercial banks, followed by term deposits and bons de caisse which account for 29 and 20 percent of those savings, respectively.

Perhaps the most important feature of the Cameroonian banking system is its high degree of concentration. In theory, there are 10 commercial banks operating in Cameroon, but in practice there are only 9. The 10th bank (Cambank) has not published any financial statement in 3 years and cheques (even cashier's cheques) drawn on that bank are not accepted by most private individuals and firms. Among the remaining nine, four banks (BIAO, BICIC, SGBC and SCB) are responsible for 89 percent of all bank branches, 85 percent of loans and 83 percent of deposits. This situation may start to change as the newer banks, which were incorporated in Cameroon after 1979 (BOAC, BCC, CBC, BBC and Paribas), start increasing their share of the market. However, at the moment this high degree of concentration poses a problem for any interest rate liberalization plans. If interest rates are liberalized now, the post liberalization rates will probably reflect the oligopolistic structure of the market. That is, they will not reflect an efficient competitive solution—deposit rates will probably be too low and lending rates too high. For a complete liberalization to be effective either the domestic banking system will have to develop further or the government will need to open the capital account completely so that foreign banks can compete with domestic banks. It is not realistic to
expect such changes to occur in the short run. However, a successful interest rate liberalization should be the government's medium term goal. As was shown in the previous chapter past interest rate policies were not conducive to long term growth or short run stability. Market determined rates are the best guarantee that past errors will not be repeated. If the institutional reforms outlined in Chapter 6 of this report are carried out it should be possible to have a successful liberalization within 3 to 5 years.

The main obstacle facing the development of the banking sector at the moment is the de facto insolvency of most commercial banks. The banks have in the past made possibly politically motivated loans to some Cameroonian traders. Those loans were never repaid. Faced with huge bank losses and the threat of several bank failures, the state increased its deposits with the banking system (currently public and parapublic deposits account for more than 60 percent of commercial banks' long term liabilities). Thus, those banks have ended up having insufficient equity (due to past losses), but are highly liquid (due to state deposits).

Given their rather precarious financial situation, banks are reluctant to lend except to their safest customers--which usually means foreign enterprises. This reluctance to lend can be easily explained. With the weakening of their equity base, banks have become more risk averse (this commonly occurs since absolute risk aversion usually rises when wealth declines). That is, they require higher risk premia than before. At present, a bank using deposits to finance its loans (so the
margin is calculated as the difference between the lending rate and the cost of deposits—the maximum rate on 6 month deposits is used here) earns margins of -2.5 and 1.75 percent on medium term privilege and nonprivilege loans, respectively. The negative margin on nondiscountable privilege loans implies that the banks will never willingly provide such loans. The low margin on the ordinary loans is not sufficient to cover the banks' costs and risk premia. Therefore, it does not provide an incentive for them to mobilize savings. It is more profitable for banks to use BEAC's rediscount facilities. In this case they earn margins of 2.25 and 3.25 percent on the two types of loans, respectively.

The present crisis presents a serious threat to future financial development. Given the low administratively fixed margins, the rise in banks' risk aversion associated with this crisis has reduced their incentive to lend and to mobilize savings. This would reduce the rate of financial development. Moreover, since many of the newly established banks were especially hard hit by this crisis, the possibility of their expanding and competing more vigorously with the big 4 banks has been greatly diminished. Therefore, a solution to this problem should be an integral part of any program for financial reform. Increasing government deposits is not an alternative to raising equity. The government has also tried to raise bank profits by eliminating interest on demand deposits (in fiscal 1984/85). This action lead to a shift from demand to time deposits. Therefore, the rise in bank profits was relatively small. Furthermore, the rate on demand
deposits is not the banks' marginal cost of funds and therefore changes in that rate will not affect their supply of loans or their incentive to mobilize savings.

The post offices may be another vehicle for the mobilization of financial savings. In 1984 postal savings only represented 3 percent of total financial savings. This is a substantial decline from its 8 percent share in 1975. This fall is due to the fact that bank deposits were rising steadily while postal savings deposits were stagnating through most of the seventies. Recent years have witnessed a change in this trend. Postal savings deposits more than doubled in value between 1981 and 1984. As a result, their share of total financial savings did not change substantially during this period.

The financial complex associated with the Ministry of Post and Telecommunications is divided into two distinct entities: postal savings and postal checking. The poor performance of this complex in the mobilization of savings is due to the relatively low interest rates paid to depositors and to the poor quality of services offered. Currently, postal savings accounts pay an interest rate of 7.5 percent free of taxes (i.e., the return on those accounts is negative in real terms). No interest is paid on postal checking accounts. This makes those deposits unattractive to relatively large savers who can earn a higher return by holding bons de caisse.

In addition to negative real returns, post offices offer services that are of a very poor quality. All 220 post offices in Cameroon can take savings deposits. However, when a saver needs to
withdraw a portion of his savings, he is often turned down on the grounds that the post office does not have sufficient liquid funds. The money is eventually repaid after some delays. Such occurrences greatly undermine the public's trust in this system, and are probably a major cause of its relatively poor performance. Therefore, the first step towards encouraging postal savings should be to institute reforms that will ensure that savers have immediate access to their money at all times.

Another method of increasing postal savings is to widen the array of services offered by post offices. An interministerial decree allowing them to provide credit facilities to depositors has been passed but is yet to be implemented. The linking of savings and credit facilities would certainly provide a greater incentive to savers. However, before providing this new type of service, the post office should first try to improve the quality of the ones it already offers. The provision of a wide array of low quality services would not be conducive to savings mobilization. After the basic objective of improving the quality of present services is achieved, new ones can be offered. In addition to the provision of credit, those new services could include linking postal savings and checking facilities. Currently, there are three postal savings and checking centers in Cameroon. They offer a limited array of services. As a result, the share of postal demand deposits in $M_2$ is virtually zero. Linking postal savings and checking, and allowing post offices to supply loans may provide a greater incentive for small savers to use postal facilities. Since typically those savers
have no access to commercial banks this may be one method of increasing financial intermediation. It should be noted, however, that if the increase in postal deposits is simply transferred to the state no intermediation will occur. Post offices can participate in the process of financial development only if they act as intermediaries between savers and borrowers, or between savers and commercial banks.

3. **Taxing Financial Intermediation**

Financial intermediation in Cameroon is subjected to three forms of taxes: taxes on lending rates, taxes on interest income and a tax on banks in which it is disguised in the form of the requirement to buy bons d'équipement. The first two types of taxes enter directly as income to the treasury, but are an insignificant proportion of total government revenue. The bons d'equipment are used to finance the Société Nationale d'Investissements (SNI—a public holding company).

Two taxes are imposed on borrowers: (i) the tax on the distribution of credit (TDC); and (ii) the tax on business transactions (ICAI—impôt sur le chiffre d'affaire). The former is equal to one percentage point which is added to the lending rate, and the latter is equal to 10.998 percent of that rate. Those taxes increase the cost of funds to investors and deprive banks of possible margins. For example, consider an investor receiving a medium term ordinary loan which is not rediscountable. He pays an interest rate of 13.5 percent plus 0.25 percent as an engagement commission to the commercial bank. He then pays a tax equal to one percent plus 10.998 percent times 13.5—A total of around 2.5 percent. In other words, the actual cost of the loan to that in-
vestor is 16.25 percent. The commercial bank's margin is a meagre 1.75. That is, the repeal of those taxes (which will be at an insignificant cost to the treasury) would make it possible to nearly double bank margins, and hence, raise their incentive to mobilize deposits and to lend without raising the cost of credit to firms.

Savers are also heavily taxed. All income from savings and time deposits at commercial banks is subject to two taxes. First, there is the proportional tax (tax proportionelle sur le revenu des capitaux mobiliers--TPRCMO) of 16.5 percent which is retained at the source. Then, it is also subject to the progressive income tax. For example, a saver who receives 12 percent interest on a 6-month deposit and is in the 33 percent income tax bracket receives an after-tax interest rate of only 6.7 percent. That is, his return is highly negative in real terms. If the TPRCM is eliminated his after-tax return would rise by about 2 percentage points without any effect on bank margins, and at a negligible cost to the treasury. This tax system, which penalizes saving, is certainly contradictory with all the government rhetoric about savings mobilization. If, in fact, the government was serious about its desire to increase financial savings, it would adjust the tax system so as to reward rather than penalize savers. A repeal of the TPRCM would increase the rate of financial development. It will raise the reward to saving without reducing bank profits or increasing the cost of borrowing.

Commercial banks are obliged to use 10 percent of the savings they collect for the purchase of bons d'équipement which finance SNI's
operations. Those bonds have a 5-year maturity and pay 4 percent interest. In theory, SNI is supposed to use those funds to assist Cameroonian entrepreneurs in the financing of productive investments. However, in recent years it has been simply redepositing those funds with the commercial banks at 10 percent interest. This is equivalent to a tax of 0.6 percent on new deposits collected by the banking system. This is another tax on savings mobilization, but this time it is shouldered by the banks. As will be shown in Chapter 6, it is possible to devise methods that will eliminate part of that tax without any negative effects on real investment.

4. The Informal Sector

The Cameroonian financial system is characterized by the existence of a large and dynamic informal sector (tontines). Estimates using flow of funds analysis indicate that this informal market is at least as important as the formal banking system. The typical tontine consists of a group of individuals who deposit a certain sum in a common pot at regular intervals (usually each month). The money is then lent out to one member. The terms of the loan varies according to the type of tontine. In large businessmen's tontines very high interest rates are charged, while in most other tontines all loans are interest free. The tontines play a social as well as an economic role. They provide their members with a form of social insurance. Many tontines have a

1/ The minimum interest rate for one month loans is usually ten percent per month. Paradoxically, interest rates seem to fall as the maturity of the loan increases. The maximum recorded interest on a one-year loan is 40 percent.
solidarity fund which is used to help members at times of need. They also act as savings and loans associations providing financial services to a large portion of the population which does not have access to formal institutions.

For the purposes of the present exercise two characteristics of the tontines are worth noting. The first is that at any point in time the typical tontine possesses a relatively large amount of liquidity, and the second, is that they have a very impressive collection record. Loans made by tontines are almost always repaid. In a typical businessmen's tontine, at the beginning of each month the sum of the individual's contribution are lent out to one person who has to pay interest in advance. Interest payments are left in the pot (with the treasurer). That is, the pot always contains the sum of past and present interest payments made to the tontine. In many consumption tontines, members deposit their monthly contributions with the treasurer, but the money is not paid out until the end of the tontine period (usually one year). The fact that the tontines usually possess relatively large sums of cash implies that policies which provide them with incentives to use financial institutions as treasurers will lead to an increase in financial savings.

One of the main factors discouraging banks from lending is the high risk involved in lending to small Cameroonian businesses. The bank's collection record is dismal. As stated earlier, bad loans which were made in the past are the cause of the present crisis. The tontines do not face this problem. One never hears of instances where loans were
not repaid to the tontines. This impressive collections record is due to two factors: (i) the tontines are usually in an excellent position to assess members' creditworthiness; and (ii) the penalties of nonrepayment to the tontine are extremely harsh. Given the relatively under-developed structure of the financial system, banks are only able to get very limited information on prospective borrowers. As a result, they often find it impossible to make a careful assessment of their creditworthiness. The cost to the tontines of obtaining the necessary information are relatively low. Tontine members are also usually members of the same extended family or of the same profession. They are, therefore, familiar with each other's financial and social situations. Hence, they are able to ration their lending so as to minimize the probability of default. Furthermore, the cost of default to the borrower is extremely high. In addition to not being able to obtain any further credit he also faces a business boycott and social shame. The defaulter and his immediate family members are ostracized from their community. The ability of the tontines to limit default risk offers an excellent opportunity. A system where the banks can lend directly to the tontines who then distribute the credit among their members would lead to a decline in the banks' perceived risks and would increase the tontines' liquidity. This will enable a wider segment of the population to benefit from bank services and thus lead to a greater level of intermediation.
V. THE IMPACT OF VARIOUS POLICY INSTRUMENTS ON FINANCIAL DEEPENING AND SHORT RUN STABILITY

1. Introduction

In this chapter an empirical analysis of the determinants of private financial savings is carried out. It is shown that increases in permanent income, in the domestic real interest rate or in the accessibility of commercial banks (and improvements in the quality of services they offer) have a positive effect on domestic financial development. On the other hand, an increase in the differential between foreign and domestic interest rates leads to a decline in the demand for domestic financial assets i.e. financial shallowing. Due to the relative openness of the Cameroonian economy, in addition to their impact on financial development, interest rate policies will have a nonegligible effect on relative prices—the real exchange rate.

Total private saving (defined as nonconsumption) appears to be insensitive to changes in the rates of return on different assets. Yet, it is argued that by reducing capital outflows increases in the return on domestic assets would raise the proportion of total savings that is invested domestically. Furthermore, by raising financial intermediation increases in domestic interest rates would have a positive impact on the efficiency of investment.

2. The determinants of financial development

This report does not attempt to present a "new" theory explaining the process of financial deepening in Cameroon. Its aim is to empirically analyze the effects of changes in certain variables on
financial development in this country using existing theoretical work. The equations estimated here are derived from the work of Tobin [1982], McKinnon [1973] and Shaw [1973]. Similar equations have been estimated for other countries by Fry [1978 and 1984] and Gupta [1984]. The analytical model from which the estimating equations are derived is as follows:

\[ L = L(Y, d, f, r, x) \]  \hspace{1cm} (1)

\[ C = C(Y, d, f, r, x) \]  \hspace{1cm} (2)

\[ F = F(Y, d, f, r, x) \]  \hspace{1cm} (3)

\[ V = V(Y, d, f, r, x) \]  \hspace{1cm} (4)

\[ T = L + C + F + V \]  \hspace{1cm} (5)

\[ x = x(g, n) \]  \hspace{1cm} (6)

where L, C, F, V, and T are the demand for: the liabilities of domestic banks, currency, foreign assets, real assets and total assets, respectively, all expressed as ratios to GDP. Note that according to the above definitions the change in total assets is equal to private savings in the national accounts sense. The variables Y, d, f, r, x, g and n are permanent income, the real interest rate on domestic deposits, the real return on foreign assets, the return on real assets, the quality of

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services offered by commercial banks, the ratio of government to private deposits at commercial banks and the number of commercial banks, respectively.

Following Tobin, the demand for any asset is let to be a function of income, the real rate of return on that asset as well as the rates of return on other assets. It is also assumed here that improvements in the quality of services offered to bank customers leads to an increase in the demand for domestic financial assets. A priori, one would expect that as income rises the demand for all types of assets will increase; hence total private savings will increase too. A rise in d or in x will lead to an increase in L but a fall in C, V and F. Thus, the effects of such changes on T will be ambiguous. The same is true for increases in f and r which will lead to a rise in F and V respectively and a fall in the demand for other assets. Equation 6 postulates that the quality of the services offered by commercial banks is a function of the number of banks operating in Cameroon and of the relative importance of government deposits in their portfolio. Increases in the number of banks and the concomitant rise in competition will lead to improvements in the quality of services. As stated in Chapter 2 the effect of government deposits on x is ambiguous.

The two estimating equations explaining financial deepening in Cameroon are obtained by substituting (6) in (1) and (2) then adding to obtain:

\[ L = f(Y,d,f,r,g,n) \]  

(7)
\[ M = m(Y, d, f, r, g, n) \]  

(8)

Where \( M \) is the ratio of \( M_2 \) to GDP. Permanent income was estimated using a distributed lag of real per capita GDP. That is, \( Y \) is defined in per capita terms. The above equations were estimated using the variables \( l, m \) and \( y \) which are defined as the natural logarithms of \( L, M \) and \( Y \). The real return on domestic financial assets is defined as the interest rate on six month deposits minus ex post inflation. Similarly, the real return on foreign assets is defined as the yield on French government bonds deflated by ex post inflation in Cameroon. Finding a measure of the return on physical assets is not that straightforward. Ideally, a time series on the rate of return on marginal private sector projects or on interest rates charged in the informal market should be used. However, such data was not available for Cameroon. Therefore, the inverse of the incremental capital output ratio was used as a proxy for this variable. The variables \( g \) and \( n \) are defined as the ratio of government to private deposits with commercial banks and the number of commercial banks operating in Cameroon, respectively. The equations were estimated using data from 1965 to 1982 (18 observations). Later on in this chapter sensitivity analysis will be presented where measured income is used instead of permanent income, interest rates are deflated by an estimate of ex ante inflation and the variables \( r, g \) and \( n \) are dropped from the specification.
Due to the existence of first order serial correlation the above two equations were estimated using the Cochrane-Orcutt procedure. The results were as follows:

\[ l = -7.8 + 1.1y + 0.03d - 0.04f + 0.08r - 0.05g + 0.04n \]
\[ (-9.7) (6.4) (4.7) (-4.5) (1.5) (-0.03) (3.1) \]

\[ R^2 = .98 \quad \text{D.W.} = 2.5 \quad \rho = -0.49 \]

\[ m = -4.1 + 0.47y + 0.02d - 0.03f + 0.07r + 0.17g + 0.03n \]
\[ (-4.9) (2.5) (3.2) (-2.7) (1.3) (0.94) (2.3) \]

\[ R^2 = .96 \quad \text{D.W.} = 2.4 \quad \rho = -0.31 \]

(numbers in parentheses are t statistics).

From the above, it is noted that both measures of financial development are sensitive to income changes. The coefficient on permanent income is positive and statistically significant in both equations. It is also interesting to note that the income elasticity of the ratio of bank deposits to GDP is higher than that for the ratio of \( M_2 \) to GDP (1.1 and .47, respectively). This is to be expected because \( M_2 \) also includes holdings of currency which should decline relative to demand and time deposits as income grows. Both measures are sensitive to changes in the real deposit rate—the coefficient on \( d \) is positive and statistically significant in both equations. Whereas this implies that interest rate policies are important determinants of financial development in Cameroon it does not necessarily mean that such policies will affect total savings. It may be the case that as interest rates rise agents substitute domestic financial assets for other types of assets without significantly changing their consumption patterns. The fact that the coefficient on \( f \) is negative and statistically significant
indicates the Cameroon cannot continue to set its interest rates without reference to the international environment. By virtue of its membership in the Franc zone, Cameroon cannot be considered as a closed economy. Therefore, the closed economy model which is implicitly assumed when domestic interest rate policies are determined independently of international conditions and the balance of payments situation is not appropriate for that country. The return on real assets does not seem to have an effect on those two measures of financial development. However, it may be the case that this result is obtained simply because the inverse of the ICOR is not an appropriate proxy for this variable. Government deposits with the banking system do not seem to have any impact on financial deepening. On the other hand, the coefficient on the number of banks is positive and statistically significant in both equations. This seems to indicate that the quality of services offered by banks is an important determinant of financial development. However, since the number of banks in Cameroon is positively correlated with the creation of BEAC in 1973, it is not clear whether the apparent improvement in bank services is due to the increase in competition between banks, or simply to the creation of a new institutional structure that was more conducive to financial development. In either case the evidence presented here indicates that the structure of the banking system is an important determinant of financial development. Policies that improve the efficiency of that system seem to have a strong positive effect on both measures of financial depth.
An attempt to analyze the effects of the above financial variables on total savings was carried out by substituting equations 1-4 and 6 in 5 to yield:

$$T = T(Y, d, f, r, g, n)$$  \hspace{1cm} (9)

Because data on the total value of all assets held by the private sector was not available the ratio of private savings in the national accounts sense to GDP (S) was used as a proxy for the change in T. Since private savings is exactly equal to the change in total assets held by the private sector, S and the first difference of T would be very highly correlated. For a constant level of GDP those two variables will be exactly equal. To maintain consistency, the first differences of all explanatory variables were also used. As in the above equations the estimation procedure was carried out using the natural logarithms of S and Y. The estimates obtained from this equation were not satisfactory. None of the explanatory variables, except income, was statistically significant. As a matter of fact, private savings as defined in the Cameroonian national accounts seems to be best described by a Keynesian savings function with measured income as the only explanatory variable. The estimation of such a function yielded the following results:

$$RS = -13.5 + .24*RY$$

$$R^2 = .61 \hspace{1cm} D.W = 2.0$$

(numbers in parenthesis are t statistics)
Where RS is defined as real per capita private savings and RY is defined as real per capita GDP. Attempts were made at including financial variables, such as the real deposit rate, in the Keynesian saving function. However, none of those variables turned out to be statistically significant.

The above discussion indicates that financial policies have little or no impact on the volume of private savings in Cameroon. However, this does not mean that they are unimportant. It was shown earlier that they affect the allocation of savings. Inappropriate financial policies would lead to a reduction of the volume of savings invested domestically and thus have a negative impact on economic development. Furthermore, as was argued earlier, an increase in financial deepening which the above regression analysis indicates could be brought about by a rise in domestic real interest rates or by an improvement in the quality of services offered by banks will increase the efficiency of investment and thus lead to faster economic growth.

3. Financial policies and the real exchange rate

The analysis presented above has indicated that the demand for domestic financial assets is negatively correlated with the return on French assets. This implies that despite the existence of exchange controls, private capital movements between Cameroon and France do exist and seem to respond to profit incentives. Therefore, the central authorities in Cameroon should be cautious in implementing changes in their financial (interest rate) policies. This is the case because,
such changes would affect the level of net foreign inflows which may be destabilising in the short run.

The relationship between the real exchange rate and net foreign inflows has been extensively studied in the development and trade literatures. McKinnon [1976] has shown that an increase in such inflows leads to a real appreciation. This occurs because a rise in foreign inflows is usually associated with an immediate increase in the demand for both tradeables and nontradeables. In a small open economy, like Cameroon's, the supply of tradeables is perfectly elastic while that of nontradeables is fixed (in the short run). Hence, this increase in demand will bring about a rise in the relative price of nontradeables; i.e., a real appreciation. Ghanem and Kharas [1985] present empirical evidence supporting this hypothesis using data from 30 LDC's.

In order to point out the effects of interest rate policies on short-run stability an analysis of the relationship between those policies and the real exchange rate is presented below. The real exchange rate used here is defined as the purchasing power parity real exchange rate vis-à-vis France. Since the nominal rate is fixed, it simply becomes the ratio of the French to the Cameroonian CPI. The model for real exchange rate determination which is used to derive the estimating equation is based upon the work of Edwards [1985]. The real exchange rate is postulated to be a function of net foreign assets, the difference between the domestic and foreign rates of growth of real GDP, and the terms of trade. Net foreign assets are, in turn, assumed to be a function of the interest rate differential between France and
Cameroon. This yields a reduced form equation for the real exchange rate where the interest differential replaces foreign assets in the structural equation.

This reduced form equation was estimated for the period 1965-82 using the Cochrane-Orcutt procedure. The results were as follows:

\[ e = 0.08 + 0.08i - 0.00gd - 0.04t \]
\[ (0.19) \quad (2.5) \quad (-1.1) \quad (-0.46) \]
\[ R^2 = 0.73 \quad D.W. = 1.4 \quad \rho = 0.83 \]

(numbers in parentheses are t statistics)

where \( e, i \) and \( t \) are the natural logarithms of the real exchange rate, the interest rate differential (foreign rate minus domestic rate), and the barter terms of trade, respectively. The variable \( gd \) stands for the difference between the domestic and foreign rates of growth. It is noted that the coefficient on \( i \) is positive and statistically significant. This indicates that a fall in domestic relative to international interest rates leads to a decrease in net capital outflows and, hence, to a real depreciation. This result provides further evidence to support our previous conclusion that the demand for domestic assets is sensitive to changes in international interest rates. If domestic rates are maintained below foreign ones, there will be a fall in the demand for domestic financial assets; i.e., less financial deepening will take place. This will have a negative effect on long run growth. On the other hand, a sudden increase in domestic rates relative to foreign ones will bring about an increase in net foreign inflows and a real apprecia-
tion, thus jeopardizing the goal of short run stability. Therefore, the appropriate policy for Cameroon is to link domestic interest rates to foreign ones such that over a long period of time domestic rates will be roughly equal to those prevailing in Paris. At the same time the interest rate differential should be monitored carefully. Dramatic fluctuations in this differential are to be avoided in order to maintain short run stability.

4. **Sensitivity Analysis**

Before using the above results to provide policy advice, it is necessary to test whether they are robust to changes in model specification. Therefore, in the remainder of this chapter the two equations explaining financial development in Cameroon will be estimated under several different assumptions. The first possible problem with the above estimates is that the real returns on domestic and foreign assets are calculated using the same deflator and, hence, may be highly colinear. In such circumstances, it is common to observe both variables being statistically significant but having opposite signs. In order to test whether the effect of foreign and domestic interest rates on financial development reported above is not simply a statistical fluke due to multicollinearity, the equations for \( l \) and \( m \) were reestimated after imposing the constraint that their coefficients are of equal magnitude but opposite signs. This is done by using the interest rate differential, \( i \), instead of the variables \( d \) and \( f \). A negative and statistically significant coefficient on \( i \) is an indication of the
The robustness of the results reported earlier. The estimates obtained from this run were as follows:

\[ l = -8.4 + 1.3y - .03i - .00r - .26g + .03n \]
\[ (-9.4) (6.6) (-3.6) (-0.03) (-2.1) (2.1) \]

\[ R^2 = .98 \quad D.W. = 2.3 \quad \text{rho} = -1.1 \]

\[ m = -4.4 + .55y - .02i + .03r + .07g + .03n \]
\[ (-6.2) (3.5) (-3.2) (.90) (.66) (2.1) \]

\[ R^2 = .95 \quad D.W. = 2.4 \quad \text{rho} = -1.2 \]

(numbers in parentheses are t statistics)

The above equations support earlier conclusions. The coefficient on i is negative and statistically significant. The interest rate differential between France and Cameroon seems to have a negative effect on financial development in that country. Also, note that the coefficient on n is positive and statistically significant in both runs. That is, this change in model specification does not alter earlier conclusions regarding the effect of structural improvements in the banking system on financial development.

When using time series data it is common to try estimating the equations after first differencing them. The choice between level equations and first differences depends upon the assumptions regarding the error terms in the equations. Since the original model was specified in levels, the use of first differences implies an assumption of positive serial correlation with rho = 1. This is not the case for the present model where negative serial correlation was detected in most equations. That is, in this case, first differencing aggravates the
problems with serial correlation. Nevertheless, the two equations were estimated after first differencing. Although all coefficients continued having the right sign, as shown below, none of them (except the coefficient on income) was statistically significant.

\[
dl = 1.0*dy + .01*dd - .02*df + .05*dr - .00*dg + .03*dn \quad 1/
\]

\[
(2.3) \quad (8.4) \quad (-1.3) \quad (7.0) \quad (-.02) \quad (1.3)
\]

\[
R^2 = .29 \quad D.W. = 2.2 \quad \text{rho} = -1.2
\]

\[
dm = .4*dy + .01*dd - .01*df + .04*dr + .07*dg + .02*dn
\]

\[
(9.2) \quad (4.1) \quad (-.70) \quad (6.4) \quad (3.6) \quad (9.3)
\]

\[
R^2 = .26 \quad D.W. = 2.2 \quad \text{rho} = -.61
\]

(numbers in parenthesis are t statistics)

The poor results obtained from first differencing may be due to either of two reasons: (i) the original model may have been misspecified; or (ii) since the true model is in level form first differencing yields results that are unbiased but inefficient. Since the original model (in level form) was based on sound economic theory, and since first differencing did not result in a change in the sign of the coefficient nor in a significant change in their magnitudes, but simply resulted in larger standard errors (implying inefficiency), the second explanation seems more plausible. The results of this sensitivity run do not seem to significantly damage our original conclusions.

In addition to the above sensitivity runs the equations were reestimated after introducing the following changes: (i) nominal interest rates were deflated by a measure of ex ante inflation and the

1/ A "d" before a variable denotes its first difference.
ensuing real returns (dl and fl) were used. Expected inflation in this run was calculated as a function of the current CPI and a distributed lag of past inflation; (ii) measured income was used instead of permanent income; and (iii) the variables r, g and n were dropped from the specification. The results of those runs are presented in Table 7. None of the earlier conclusions seems to have been seriously affected by those changes.

Table 7: THE ESTIMATION RESULTS UNDER DIFFERENT ASSUMPTIONS a/

<table>
<thead>
<tr>
<th>dep. var.</th>
<th>y</th>
<th>ry</th>
<th>d</th>
<th>dl</th>
<th>f</th>
<th>fl</th>
<th>r</th>
<th>g</th>
<th>n</th>
<th>R²</th>
<th>D.W.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.5</td>
<td>.06</td>
<td>-.02</td>
<td>.00</td>
<td>.00</td>
<td>.03</td>
<td>.98</td>
<td>2.4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(6.4)</td>
<td>(3.0)</td>
<td>(-1.9)</td>
<td>(.01)</td>
<td>(.04)</td>
<td>(2.1)</td>
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<td></td>
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<tr>
<td>m</td>
<td>.57</td>
<td>.02</td>
<td>-.02</td>
<td>.03</td>
<td>.09</td>
<td>.03</td>
<td>.95</td>
<td>2.4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(2.8)</td>
<td>(1.3)</td>
<td>(-2.4)</td>
<td>(.85)</td>
<td>(.48)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>.80</td>
<td>.04</td>
<td>-.06</td>
<td>.08</td>
<td>-.03</td>
<td>.08</td>
<td>.97</td>
<td>2.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(3.3)</td>
<td>(3.2)</td>
<td>(-3.8)</td>
<td>(.96)</td>
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<td>(5.1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>m</td>
<td>.33</td>
<td>.03</td>
<td>-.03</td>
<td>.08</td>
<td>.15</td>
<td>.05</td>
<td>.93</td>
<td>2.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.6)</td>
<td>(2.2)</td>
<td>(-2.5)</td>
<td>(1.2)</td>
<td>(.87)</td>
<td>(3.6)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>1.6</td>
<td>.02</td>
<td>-.03</td>
<td></td>
<td></td>
<td></td>
<td>.97</td>
<td>2.0</td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td>(19.0)</td>
<td>(2.6)</td>
<td>(-3.0)</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>m</td>
<td>.90</td>
<td>.02</td>
<td>-.02</td>
<td></td>
<td></td>
<td></td>
<td>.93</td>
<td>2.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(11.7)</td>
<td>(2.0)</td>
<td>(-1.7)</td>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

a/ All equations were estimated with an intercept term whose estimate is not reported here. Whenever serial correlation was present it was corrected for by using the Cochrane-Orcutt procedure. Numbers in parentheses are t statistics.

The analysis presented above has indicated that earlier conclu-
sions are fairly robust to changes in model specification. Financial
development in Cameroon is negatively correlated with the differential
between foreign and domestic interest rates. Changes in this differenti-
tial have to be carefully monitored. In addition to their effect on
long run development, they have an impact on relative prices and short
run stability. Structural improvements in the commercial banking system
have a nonnegligible effect on financial deepening. Those conclusions
are based on existing economic theory, and seem to be supported by the
Cameroonian data. Therefore, they must be considered by policy makers
undertaking financial reform.
VI. A PROGRAM FOR FINANCIAL REFORM

1. Introduction

This report has indicated that the Cameroonian financial system is relatively underdeveloped. Since this financial shallowness may jeopardize the country's future growth prospects, policy measures that would lead to an increase in the rate of financial development are needed. There are several measures that may induce financial deepening. Commercial banks are currently facing a solvency crisis. This crisis poses a threat to the future development of the banking system and, therefore, should be resolved. Past interest rate policies were too rigid and were based on the fallacious assumption that Cameroon is a closed economy. Those policies were not conducive to long run financial development or short run stability. Any program for financial reform should include a change in the interest rate regime. The Cameroonian government taxes both savers and borrowers. Those taxes impede the goal of financial development and have a minimal impact on public revenues. Therefore, they should be repealed. The system of requiring banks to purchase bons d'équipement imposes a tax on intermediation. SNI has not been using the revenues from those bonds to promote productive investments. This system should be changed. Linking the formal and informal sectors may lead to an acceleration of the rate of financial development. Measures that would provide such a link ought to be explored on an experimental basis. The postal saving complex can play an important role in the mobilization of financial savings. At present, the low quality of services impedes it from playing that
role. Therefore, it is necessary to institute changes that would lead to an improvement in the quality of those services.

2. Recapitalizing Commercial Banks

The econometric analysis presented in the preceding chapter has indicated that financial development is sensitive to changes in the structure of the banking system. The present solvency problem faced by the commercial banks impedes the development of the banking system and thus jeopardizes future financial development. Moreover, one of the goals of the proposed reform program is to increase competition between banks. An increase in competition will lead to an improvement in the quality of services offered by the banks and will enable MOF to relax interest rate restrictions without the threat of oligopolistic price setting behavior. Such an increase in competition could be achieved by providing a climate where the five new banks can increase their activities and their market shares. This increase in the activities of newer banks will not occur as long as the present crisis persists.

Any resolution of the present problem should consist of two parts: (i) an immediate recapitalization of the banks; and (ii) a change in interest rate policies aiming at providing them with wider margins and increasing their profitability. Interest rate policies will be discussed in the following section; therefore, the present discussion will focus exclusively on the first point. An ideal way of resolving present problems would be to increase the banks' capital while maintaining the proportionate shares of all shareholders. The state is a major shareholder in all banks (it owns at least one third of the stocks of any
bank operating in Cameroon). In addition to the state, the banks' shares are held mainly by foreign enterprises. The formula whereby all shareholders increase their exposure may work for some banks. For example, negotiations along those lines are currently being conducted with Paribas. However, some of the foreign partners are unwilling to increase their exposure in Cameroon. In this case another solution exists. The state can transform a portion of its deposits with the bank into a ten-year loan (prêt participatif). If the other policy measures listed in this report are implemented the bank should be in a position to repay this loan at the end of the ten-year period. An agreement along those lines has been recently concluded with Société General. By using those two formulae MOF can resolve the current crisis. Agreements have to be reached with all the banks in Cameroon (with the possible exception of Cambank which, for all practical purposes, is already bankrupt). Such agreements are necessary for the short run stability of the financial system as well as for its long run growth prospects.

3. Taxes and Interest Rates

The taxes on the distribution of credit and on the chiffre d'affaire as well as the withholding tax on interest income have to be eliminated. Such an action will allow an increase in the return to savers and in bank margins and profits without a significant increase in the cost of borrowing. This action will lead to a less than 4 percent fall in government revenue. That is, if such a step were undertaken in 1983, the budgetary surplus will not have fallen by more than 10
percent. The return to the economy in terms of faster financial development would have more than offset the cost to the treasury.

A first best policy solution is to liberalize interest rates completely. Market determined interest rates will provide the best stimulus for financial development. However, a complete interest rate liberalization at present may lead to suboptimal results due to the thinness of the financial market and the high degree of concentration in the banking system. The reform package presented here would lead to a deeper financial market and to a rise in competition. Thus, this liberalization can occur within 3 to 5 years after the implementation of the program.

During the interim period, MOF will have to set minimum deposit and maximum lending rates, thus allowing some competition between banks, but avoiding the danger of oligopolistic price setting. The statistical analysis presented in the preceding chapter has indicated that the level of interest rates is an important determinant of financial development. Therefore, the practice of setting artificially low deposit rates should be discontinued. This analysis has also shown that changes in the differential between foreign and domestic rates have a strong effect on long run financial growth and short run stability. MOF cannot continue setting domestic rates without reference to the international environment. This means that future interest rate policies must be more flexible. Such a flexibility will be impossible unless the present interest rate schedules are greatly simplified. Changes in deposit rates have to be accompanied by similar adjustments in lending
rates that aim at maintaining bank margins. Moreover, it was noted earlier that the structure of current margins encourages banks to rely mainly on BEAC's rediscount facilities to finance loans rather than mobilize savings. This structure should be changed.

The first step in the interest rate reform would therefore be to redefine interest rate schedules. They should no longer present fixed rates to be applied by the banks, but rather minimum deposit rates and maximum lending rates. The second step is to set fixed time intervals at which they are to be adjusted. An appropriate interval would be once a quarter. As far as deposit rates are concerned, it is suggested that MOF reduces the number of rates which it sets from 49 to 13. This would occur by dividing deposits according to size into large and small only, instead of the present structure which divides them into 10 different categories. The term structure will remain unchanged. The average interest differential between deposits of different maturities and between large and small deposits which exists in the present system can be maintained. The average after-tax differential between savings deposits, bons de caisse and time deposits will also be maintained. However, since time and savings deposits will now be exempt from withholding taxes, the nominal (pretax) differential between interest rates on those assets and the rates on the bons de caisse will be narrowed to reflect the change in tax treatment.

The minimum rate on large (over 5 milion CFAF) 3 to 6 month deposits will be used as a base from which all other rate floors are to be calculated. This base has to be set equal to the interest rate which
would have prevailed in a competitive market. Due to membership in the
Franc Zone, this would be equal to the rate prevailing in Paris. The
yield on French government bonds (f) can be used as a base rate. Thus
the schedules of minimum deposit rates will look as follows:

<table>
<thead>
<tr>
<th>Minimum Rates On Time Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 to 6 mos</td>
</tr>
<tr>
<td>Less than 5 million</td>
</tr>
<tr>
<td>More than 5 million</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Minimum Rates On Bons de Caisses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5 million</td>
</tr>
<tr>
<td>More than 5 million</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Minimum Rate on Savings Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>All deposits</td>
</tr>
</tbody>
</table>

It should be made clear that the actual schedules published by MOF will
not refer to foreign interest rates. All minimum deposit rates will be
defined as BEAC's base rates plus a margin. However, those margins are
to be calculated so that the actual minimum rates received by savers
will be equal to the ones presented above.

The minimum deposit rate schedules presented here are designed
so as to minimize net foreign inflows. In periods where inflows are
desirable, the base rate can be increased so as to be 2 or 3 points
above the foreign rate and vice versa. Thus, interest rate policies can
also be used as an instrument for economic stabilization.

In order to maintain bank margins, lending rate ceilings have
to be adjusted whenever minimum deposit rates are changed. It is
suggested that the number of lending rates manipulated by MOF be reduced from 21 to 6. The distinction between short and medium term loans and between rediscordable and nonrediscordable credit will be maintained. However, the distinction between privileged and ordinary credit will only be maintained for rediscordable loans. At present, bank margins on privileged nonrediscordable loans are too low. Thus, they have very little incentive to provide this type of loan. As was pointed out earlier, the present practice of giving banks higher margins on rediscordable loans discourages saving mobilization and therefore should be discontinued. Under the proposed scheme the banks will earn higher margins on nonrediscordable than on rediscordable loans, on privileged than on nonprivileged loans an on medium term than on short term loans. Thus, in addition to encouraging banks to mobilize resources, the proposed system will provide them with an incentive to supply more rediscordable priority loans and to increase their medium term lending.

For rediscordable privileged and ordinary loans the appropriate margins to consider are the differences between the lending rates and BEAC's privileged and ordinary rediscount rates (TBDP and TBDO), respectively. For nonrediscordable loans the appropriate margins are the difference between the lending rates and the base deposit rate. The new margins were calculated so that on average they will be equal to the present margin on short term ordinary rediscordable loans (5.75 percentage points). However, the differential between the various margins were adjusted. Those adjustments were made so as to achieve the goal of

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increasing resource mobilization and medium term lending to productive investments. The new maximum lending rates should be as follows:

- privileged rediscountable short term loans = TBDP + 5.0
- ordinary rediscountable short term loans = TBDO + 4.0
- privileged rediscountable medium term loans = TBDP + 7.0
- ordinary rediscountable medium term loans = TBDO + 6.0
- short term nonrediscountable loans = F + 5.0
- medium term nonrediscountable loans = F + 7.0

As in the case of deposit rates, the actual schedules published by MOF will not refer to foreign interest rates. The current practice of expressing all rates as functions of BEAC's base rates will be continued.

The advantages of the proposed system can be demonstrated by comparing present, after-tax, interest rates with those which would prevail if it is immediately adopted.\footnote{At present the yield on French government bonds is around 12 percent.} This comparison is presented in Table 8. It shows that minimum deposit rates after adjusting for taxes will increase by around 3 percent, the after tax maximum cost of borrowing will fall for short term rediscountable loans, but rise by an average of 2 points for medium term rediscountable loans. As far as the maximum cost of nonrediscountable credit is concerned it will rise by 2 and 3 percentage points for short and medium term credits, respectively. That is, the proposed structure would raise the return to savers and increase bank margins without a major increase in the cost of borrowing. The rise in the return on deposits will encourage financial savings, and the overall increase in bank margins will, by raising their profits, help in resolving the present solvency crisis and encourage
smaller banks to become more active in Cameroon, thus raising competition. Furthermore, the change in the structure of those margins will provide a greater incentive for banks to mobilize savings and to increase medium term lending.

<table>
<thead>
<tr>
<th>Table 8: Comparing Present Interest Rates with Those That Would Prevail Under the Proposed Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Deposit Rates:</strong></td>
</tr>
<tr>
<td>new minimum rate</td>
</tr>
<tr>
<td>Large 6 to 12 mos deposits</td>
</tr>
<tr>
<td>Large 6 to 12 mos bons de caisse</td>
</tr>
<tr>
<td>Savings deposits</td>
</tr>
<tr>
<td><strong>B. Lending Rates:</strong></td>
</tr>
<tr>
<td>new maximum rate</td>
</tr>
<tr>
<td>(i) Rediscountable Loans</td>
</tr>
<tr>
<td>-privileged short term</td>
</tr>
<tr>
<td>-ordinary short term</td>
</tr>
<tr>
<td>-privileged medium term</td>
</tr>
<tr>
<td>-ordinary medium term</td>
</tr>
<tr>
<td>(ii) Nonrediscountable Loans</td>
</tr>
<tr>
<td>-short term</td>
</tr>
<tr>
<td>-medium term</td>
</tr>
</tbody>
</table>

SOURCE: Ministry of Finance and Bank staff estimates.

a/ Refers to rates after taking account of financial taxes only.
4. Bons d'Equipment

This report has argued that the system of bons d'équipements represents a tax on the mobilization of deposits and therefore impedes the goal of financial development. Moreover, SNI has not been using the revenues from those bonds to finance productive investments. Therefore, those bonds should be eliminated. In order to avoid a sudden disruption of SNI's operations a gradual phasing out of this system is proposed. This could be achieved in three stages as follows:

(i) The first stage will consist of raising the interest rate on new bonds from 4 to 10 percent. That is, the rate on bons d'équipment will be equal to the rate payable on SNI's deposits with the commercial banks. Thus, the marginal tax on deposits imposed by the present system will be nearly eliminated. Moreover, this proposed change will not affect the cost of SNI's present resources. Hence, it avoids precipitating a financial crisis in this organization. Such a crisis could occur if the cost of its present resources were suddenly increased. During this phase there will be no change in the amount of resources made available to SNI. It would still be able to sell bonds to the commercial banks up to a maximum of 10 percent of new deposits. Given the low yields on its existing investments, it is probable that SNI would not want to reach this limit.
(ii) The second stage will consist of reducing the upper limit on new bonds to 5 percent of the increase in deposits. SNI would be allowed to borrow additional funds from commercial banks by selling a different type of bond that yields a market rate of return.

(iii) Finally, the last stage will consist of removing the requirement that commercial banks purchase bons d'équipment. Any additional resources obtained by SNI would be at nonconcessional interest rates.

The elimination of those bonds is necessary for the future development of the financial system. Therefore, the Cameroonian government should act swiftly on the above proposal. The third stage of that proposal should be reached prior to the complete liberalization of interest rates which ought to be feasible within 3 to 5 years.

5. **Increasing the Accessibility of Financial Institutions**

Econometric evidence which was presented earlier in this report has shown that the structure of financial institutions has an important impact on the mobilization of financial savings. That is, an increase in the accessibility of those institutions will lead to a higher level of financial deepening. Chapter 2 has shown that the number of bank branches per capita in Cameroon, a commonly used measure of accessibility, is relatively low. This seems to imply that policy measures that would make financial services available to a wider segment of the population are needed. In addition to the reform of the banking system and the change in interest rate regimes, this goal could be achieved via two
mechanisms: (i) improving the postal savings system, and (ii) linking the formal and informal sectors.

The financial complex associated with the Ministry of Post and Telecommunications (MPT) with its network of 220 post offices can potentially play an important role in financial savings mobilization. At the moment the poor quality of the services offered by this complex preclude it from playing such a role. Since the promotion of this complex may prove to be a low cost method of making financial services available to a large portion of the population, the Cameroonian government should undertake a program aimed at improving its operations. Such a program could include merging postal savings with the postal checking centers into one organization which would be independent of the director of the post but under the control of MPT. This organization should be managed as a financial institution rather than a postal institution. Naturally, this would involve the retraining of some staff and changes in recruitment policies. Once a marked improvement of the quality of services offered by this organization is achieved, it can widen the scope of those services. It may start by selling a high yielding financial asset similar to the bons de caisse (bons de poste). At a later stage, the interministerial decree allowing postal savings to provide small loans can be put into application. Postal deposit and lending rates should be set equal to commercial bank rates. In order to increase intermedia-
tion, deposits made at post offices should either be lent out or re-
deposited with the banking system. They should not be transferred to the treasury.

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Commercial banks would benefit from cooperation with tontines. The use of commercial banks as tontine treasurers could lead to an increase in bank deposits. Moreover, the perceived risk on their loans could decrease if they are allowed to lend directly to tontines. Those latter institutions could then distribute the loans among their members according to their creditworthiness assessments. Given the tontines' impressive collections records there is no doubt that such an arrangement would greatly reduce default risks. When trying to encourage the tontines to use formal institutions it is important that the government avoid imposing new regulations on them. Trying to regulate the informal sector could lead to its disappearance. Since the tontines provide important social and financial services to a large segment of the population such an occurrence will be associated with a decline in welfare. The only step that the government can take to increase the possibility of cooperation between the formal and informal sectors is to allow tontines to incorporate. Once they have a legal entity it would be easier for those institutions to enter into enforceable agreements with commercial banks. The banks can then be encouraged to use tontines as retail outlets. This encouragement could take the form of providing them with technical assistance and maybe an area where donor participation could be useful. At the moment BIAO-Guinea is considering entering into agreements with informal institutions on an experimental basis. Similar experiments should be encouraged in Cameroon. The recapitalization of the banks and the
changes in their margins that were proposed earlier, will put them in a better position to undertake such a venture.

6. **Concluding Remarks**

The financial reform program presented here consisted of the following six points:

(i) A recapitalization of commercial banks;
(ii) The elimination of taxes on savers and borrowers;
(iii) A gradual liberalization of interest rates;
(iv) A gradual elimination of the system of bons d'équipement;
(v) Improving the quality of the financial complex associated with MPT; and
(vi) Linking the formal and informal sectors.

The analysis presented earlier in the report has indicated that changes along the lines presented above would have a positive impact on financial development in Cameroon. It should be noted that the above changes are interrelated. Applying one or two changes without the others would not have much of an impact. For example, interest rates cannot be liberalized unless commercial banks are recapitalized. Otherwise, the banking system will continue having the present oligopolistic structure and the post liberalization rates will not represent an efficient competitive equilibrium. The changes in interest rate policies should also be accompanied by eliminating taxes on borrowers and savers. The elimination of those taxes would allow MOF to raise the return to savers and bank margins without significantly increasing the
after tax cost of borrowing. Similarly, the link between the formal and informal sector could not be achieved without the change in interest rate regime.

An understanding of the interrelationships between those recommendations is essential for Cameroonian policy makers. In the past Cameroon has relied too heavily on piecemeal solutions to financial sector problems. A comprehensive reform program is now needed. It is also important for them to understand the link between domestic financial policies, the international environment, long run development and short run macro stability. Cameroon is a relatively open economy. It cannot continue setting its domestic financial policies without reference to international occurrences.
References


