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WHY IS THE FINANCIAL SECTOR IN BURUNDI NOT  
DEVELOPMENT-ORIENTED?

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**EUROPEAN UNIVERSITY INSTITUTE, FLORENCE**  
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## **Abstract**

The financial sector in Burundi has had a very limited effect on the country's development. High political and economic risks have prevented banks from engaging in long-term lending, constraining long-term investment. Moreover, the industrial organisation of the financial sector is not conducive for development lending because the sector is used more as a source of rents than development finance. As a result, the financial sector has been unable to address the needs of the core drivers of growth in Burundi, namely, agriculture and industry. Therefore, increasing the financial sector's participation in Burundi's economic development will require an improvement in political and macro-economic stability, as well as an increase of financial institutions' long-term re-sources. Most particularly, development banking should play its role of fostering the development of agriculture and the rural economy. In addition, more competition in the financial sector should be encouraged with the aim of diversifying financial services and pushing the sector's boundaries beyond the traditional urban market to embrace the rural economy where most economic activities take place.

## **Keywords**

Financial sector, Burundi, development



## 1. Introduction\*

It is now widely acknowledged that the development of the financial sector is important for economic growth. At the macro-economic level, financial development affects growth through different channels. The development of the financial sector affects growth through its intermediation of savings and capital accumulation (King and Rebelo, 1993). This channel is crucial for economic growth as it allows an economy to mobilise the financial resources needed to fund growth-related activities. Furthermore, better financial systems increase innovation and, hence, growth (King and Levine, 1993). Moreover, the deepening of financial systems through the development of stock markets, for example, helps to monitor the management of firms, creating a more transparent environment that fosters better governance both within the financial system and in the economy at large (Levine, 2005).

In Africa, despite the conventional wisdom that the creation of stock markets would increase investment and, hence, economic growth, there is no clear evidence of an independent effect of the structure of the financial system on investment and growth. However, the development of the financial system makes investment more responsive to output growth. Therefore, the development of the financial system in general is more important than the promotion of a specific form of financial market, such as stock markets (Ndikumana, 2005). In addition, if the development of financial systems makes credit more accessible to the poor, this has the potential to reduce poverty levels, particularly in Africa where poverty is widespread.

At micro-economic level, it has been established that credit affects the investment in firms (Fazzari *et al.*, 1988; Hubbard *et al.*, 1995; Hubbard, 1998) and, hence, growth. The availability of credit and its transformation into investment depends, to a large degree, on the quality of the financial sector. In Africa, firms that fail to mobilise credit postpone or curtail their investment plans, and this has a long-term effect on the capacity of the firm to operate efficiently and grow. Moreover, access to credit allows flexibility in the allocation of resources within a firm. For example, when a firm's clients fail to pay on time, firms use credit lines to bridge the temporary resource gap until payment is made. Firms without such facilities may face operational difficulties with negative consequences on their performance. These mechanisms explain why access to credit is a key determinant of firm growth (Nkurunziza, forthcoming).

Burundi's financial sector went through important reforms in the late 1980s and early 1990s. However, despite these changes, the financial sector has always had a very limited effect on the country's economy. This paper attempts to explain what has inhibited Burundi's financial sector contribution to economic development. On the basis of detailed published and unpublished financial and economic data, the paper shows that the financial sector in Burundi has served different personal and group interests, but has not been considered as an instrument that should help to fuel economic development. The financial literature has very limited detailed evidence to explain the failure of developing countries' financial systems to contribute to economic development. Consequently this paper is a step towards bridging this knowledge gap.

Section 2 briefly presents Burundi's economic structure in order to highlight the relative economic importance of each sector. Section 3 discusses the country's financial reforms and their effect on the financial sector. Section 4 explains why the financial sector has not had a significant effect on economic development, and Section 5 concludes with some policy suggestions.

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\* Paper prepared for the Conference on "Financial markets, adverse shocks and policy re-sponses in fragile countries", organised by the European Report of Development in Accra, Ghana, 21-23 May, 2009.

## 2. Structure of Burundi's economy

While it is not the objective of this paper to discuss the structure of Burundi's economy in detail, a brief description is necessary to highlight the most important sectors that account for the country's economic activity. Even though the informal sector is very large, representing 77 per cent of GDP in 2005 (ISTEEBU, 2008), official statistics give a clear picture of the most important sectors of the economy.

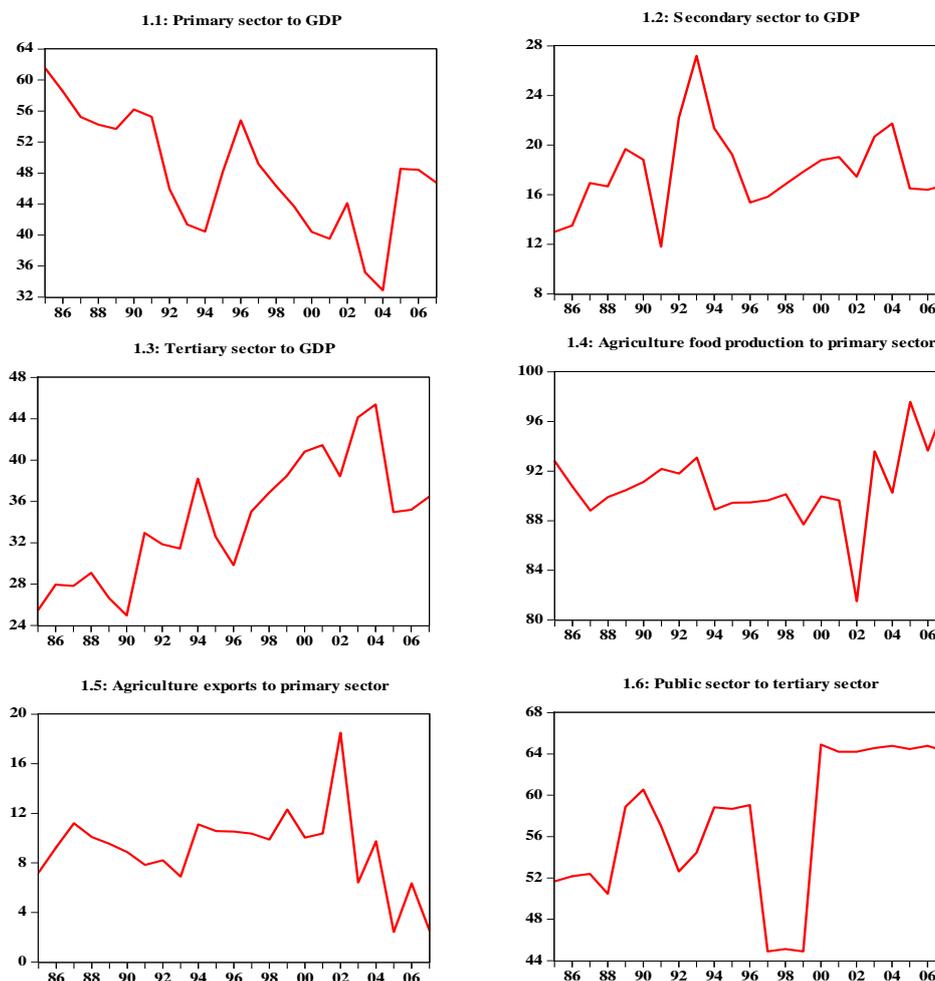
Burundi has a rural-based agricultural economy. The primary sector has dominated economic activity, but its share has been steadily declining over time (Figure 1.1). From 62 per cent of GDP in 1985, the primary sector represented 47 per cent of GDP in 2007. This decline can be explained by two main factors. First, although agricultural food production shows a U-shape when considered as a ratio of the total primary sector (see Figure 1.4), its share in GDP declined from 57 per cent in 1985 to 45 per cent in 2007. In the same connection, revenue from exporting cash crops collapsed from an average of about 10 per cent of the primary sector in the 1980s and 1990s, to 2.5 per cent in 2007 - the peak of 18 per cent was reached in 2002 (see Figure 1.5). Considering that agriculture constitutes the backbone of the primary sector, the crisis in the agricultural sector explains most of the decline of the primary sector.

The second reason which explains the decline of the primary sector's share in GDP is the increase in the tertiary sector during a period when GDP growth was either negative or close to zero. The tertiary sector grew from 25 per cent of GDP in 1985 to 45 per cent of GDP in 2004, but the trend was reversed in 2004 (Figure 1.3). The fact that two-thirds of the tertiary sector is accounted for by public sector activities (Figure 1.6) suggests that the increase in this sector could mainly be the result of the massive hiring in the public sector since the early 2000s.<sup>1</sup> The secondary sector, as illustrated in Figure 1.2, has stagnated around 17 per cent of GDP over the sample period.

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<sup>1</sup> Burundi went through a long civil war (1993-2003) which was ended by an agreement, signed in 2000, to include former rebels in state structures, including security institutions. As it was politically difficult to fire incumbents in order to accommodate the new comers, the latter were added to the existing public service. This increase in the public sector combined with the decline in private sector activity due to the war could explain the remarkable increase in the public sector relative to the tertiary sector.

**Figure 1: Structure of Burundi's economy over time**



Source: Based on data from BRB, Annual reports.

These trends do not reflect the desired economic transformation pattern that was followed by the developed economies or by the recently industrialised countries of Asia and Latin America. Generally, the successful transformation of these economies started with a rapid increase in the share of manufacturing in the economy, associated with a decline in the share of agriculture. The share of the labour force involved in agriculture declined, but the share in other economic sectors rose. These changes shifted economic activities from rural to urban centres, increasing urbanisation (Breisinger and Diao, 2008).

In Burundi, the collapse of the agricultural sector has not been accompanied by an increase in manufacturing, as shown by the stagnation of the secondary sector in Figure 1.4. Moreover, despite its decline over the years, agriculture remains by far the most important sector of the economy, particularly in view of the large share of employment that it represents. In 2005, employment in food crop agriculture represented 78 per cent of total employment (ISTEEBU, 2008). Even the increase in the share of the tertiary sector has not been associated with employment creation. Indeed, despite the fact that it represented 36 per cent of GDP in 2007, the tertiary sector accounted for only 2.5 per cent of total formal employment. In addition, Burundi has not experienced the type of structural

transformation that results in higher urbanisation. Only 9 per cent of the country's population live in urban centres, making Burundi the third least-urbanised country in the world.<sup>2</sup>

Burundi's economy is, therefore, mainly agrarian. Agriculture involves 1.2 million households, and accounts for the bulk of employment opportunities. In this light, the government of Burundi considers that the performance of the agricultural sector will not only determine the growth of other sectors but also economic development in general. In this respect, the government's medium-term objectives include: (i) Five per cent annual rate growth of the agricultural sector; (ii) reducing the rate of people with insufficient food or unbalanced diet from 84 per cent of the population to 20 per cent; and (iii) reducing the rate of poverty from 67 per cent to below 50 per cent (République du Burundi, 2007).

Achieving these developmental objectives will require important resources both from the private and the public sectors. Making agriculture more productive through public and private investments would indirectly raise the standards of living of a large majority of the population who depend on this sector for their livelihoods. One of the questions to be asked is to what extent Burundi's financial sector will help to achieve these objectives? Traditionally, the financial sector has been a marginal actor in the development process. In 2007, this sector contributed a mere 2 per cent of GDP and 0.05 per cent of total formal employment despite the efforts deployed to liberalise the sector in the last two decades.

### **3. Financial reforms and their effects**

In order to contextualise the financial reforms that were undertaken to modernise Burundi's financial sector, it is relevant to describe the situation that prevailed before the reforms were put in place. This section draws from Nyamoya (2004).

#### ***3.1 The financial sector in the mid-1980s***

Before the adoption of financial reforms, Burundi's financial system was very shallow. In addition to the central bank, the financial sector consisted of two commercial banks, three non-banking financial institutions, one savings institution, and one network of micro-finance institutions. The public sector was at the heart of the system, given that the state was the major shareholder of all these institutions. There was also strong state control through direct interventions and other policy instruments as the following examples illustrate.

First, deposit interest rates were fixed by the government. Before the introduction of measures to liberalise the determination of interest rates, minimum deposit rates were fixed at 8 per cent, while lending rates were limited to a maximum of 10 per cent. The relatively high deposit rate discouraged banks from accepting deposits, and, in 1986, they stopped accepting deposits altogether. On the other hand, fixing the maximum lending rate at 10 per cent discouraged banks from engaging in risky lending activities. The reason was that an interest rate spread of two percentage points was not judged by banks to be a reasonable risk premium on their lending operations.

Second, banks were required to apply lower lending rates to "priority sectors" identified as such by the government. This policy did not work well because it was difficult to identify the end-users of the credit accorded. Moreover, requiring banks to lend to specific sectors at preferential rates was against the principle of efficient resource allocation, especially given that the choice of the priority sectors tended to be arbitrary. Hence, the banks continued to find ways to allocate credit to the sectors that maximised their profits.

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<sup>2</sup> The statistic on urbanisation is from <http://www.nationmaster.com/country/by-burundi/peo-people>, accessed on 19 June 2009.

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Third, the government instituted a system of control which required banks to seek approval from the central banks when they lent beyond a certain threshold amount fixed by government - 10 million Burundi francs in 1987. Administering this system proved to be difficult, and the practice turned out to be more constraining than helpful for the economy. To circumvent this constraint, credits were divided into small portions below the threshold, hence not requiring central bank approval. In any case, these measures created more bureaucratic procedures without presenting any notable advantage.

Fourth, the creation of a government bonds market was supposed to deepen the financial system by increasing competition among market participants and offering alternative investment opportunities to bank deposits. This system was also expected to replace the central bank financing of public institutions by private financing, a system that was supposed to be more efficient. However, the market was poorly conceived. Most particularly, it was discriminatory as it excluded from participation key actors such as commercial banks which needed such an opportunity in order to invest in their excess liquidity.

Fifth, the financial sector was closed to competition. For example, only the central bank and the *Caisse de Mobilisation et de Financement* (CAMOFI), another state institution, were allowed to manage deposits from public enterprises which were important economic actors.<sup>3</sup> Moreover, only the government allocated lending quotas to all lending institutions engaged in the lucrative business of coffee-buying from smallholder producers and its export. This stifled competition among financial institutions.

These rigidities and the arbitrary government controls explain why Burundi's financial system was far from being efficient, dynamic and competitive. As a result, the organisation of the financial sector prevented it from playing its expected role of boosting Burundi's ailing economy. It is on this basis that Burundi undertook to reform its financial sector.

### **3.2 Objectives of financial liberalisation**

A package of financial reforms was put in place in the late 1980s with the aim of liberalising the financial sector. This was the second phase of the structural adjustment programme which had been ongoing since 1986 with a focus on the liberalisation of the real sector of the economy in its first phase.

Financial liberalisation focused on the following 4 key objectives:

1. Allowing the determination of lending and deposit interest rates on the basis of market fundamentals;
2. Creating a bonds markets open to all key financial operators, particularly commercial banks;
3. Introducing prudential measures for risk management by instituting and enforcing commercial bank reserve ratios;
4. Opening the financial sector to competition.

### **3.3 The Results of financial liberalisation**

The measures put in place to liberalise the financial sector produced some positive results. Introduced in 1988, the measures to liberalise the determination of lending interest rates led to their doubling a few years later. In December 1992, for example, the average lending and deposit rates stood at 16.6 per cent and 8.4 per cent, respectively. It was common to observe interest rate spreads which were as high as 10 percentage points. In December 2005, the average lending rate was 20.6 per cent and the

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<sup>3</sup> In 1990, state firms represented 31 per cent of formal sector employment, 25 per cent of outstanding domestic credit but they produced only 9 per cent of the country's GDP (Nkurunziza and Ngaruko, 2008).

deposit rate 9.6 per cent, showing a nominal spread of 11 percentage points (BRB, several issues). This shows that, while lending rates doubled, deposit rates did not increase much, illustrating the fact that liberalisation benefited lenders much more than depositors and borrowers. This asymmetric result of financial liberalisation helps to explain why financial interest groups have a vested interest in maintaining the *status quo*.

With regard to the bonds market, the main objective of its liberalisation policy was to make it more open by allowing the country's commercial banks to participate in the trading of bonds. Improved legislation governing the functioning of this market was enacted in April 1988, and the market started to function upon a more competitive basis. It has been improved over time and is now open even to non-institutional actors.

In order to improve prudential rules governing the banking sector, the central bank instituted a system of mandatory reserves in May 1991. This system required all banks that were collecting savings from the public to keep, at all times, a certain proportion of their liquidity in the form of reserves, the level of which was to be determined by the central bank. At the beginning, this level was determined according to the banks' shares of short-term and long-term holdings. In March 1992, the policy was refined and a unique level of reserves amounting to 7.5 per cent of total liabilities was instituted. This proportion has been adjusted over time, depending on prevailing economic circumstances.

In order to create a more competitive environment, the government took a number of measures. Key among them was the opening of the financial sector to new actors. Allowing public enterprises to place their assets in the financial institutions of their choice, rather than the central bank, was another measure that corrected the discriminatory treatment of financial operators. Moreover, the traditional monopoly enjoyed by the *Caisse d'Epargne du Burundi* (CADEBU), a state institution tasked with collecting mandatory savings from all formal sector employees, was terminated. In addition, the discriminatory provisions of the land code which gave the state a privileged status over other creditors in cases where credit guarantees and collateral were to be realised were also changed to put all creditors at the same level. Financial sector liberalisation also led to the development of micro-finance in Burundi. The legal text organizing the microfinance sector was adopted in July 2006 although microfinance institutions started operating in the 1990s.

As a result of these changes, the financial sector is currently more competitive than it was before the beginning of financial liberalisation 20 years ago. Eight new commercial banks and two insurance companies have been created over this period. As CADEBU lost state protection, it eventually collapsed, as did three commercial banks. Most recently, foreign banks have established branches in Burundi mainly through mergers with, or the acquisitions of, local banks.

Currently, Burundi has eight commercial banks, one development bank, one housing bank, three insurance companies and several micro-finance institutions. The banking sector directly employs about 1,500 persons serving 130,000 accounts. With 2 accounts for every 100 persons, this makes Burundi one of the most under-banked countries in the world. Burundi has no stock market, so the role of financial intermediation is limited to banks. The fact that banking in Burundi has remained limited to a very small group of people is an indication that the results of financial liberalisation have not gone far enough. Table 1 provides a bird's eye view of the current state of the banking sector in Burundi.

**Table 1: Key data on Burundi's financial sector, 2007.**

<b>Bank</b>	<b>Credit/Deposits (1)</b>	<b>Equity (2)</b>	<b>Net profit (3)</b>	<b>% ROE (4)</b>	<b>Employees (5)</b>	<b>Branches (6)</b>	<b>Accounts (7)</b>
BBCI	124	4,690	455	9.7	152	5	28,900
BANCOBU	69	6,413	1,867	29.1	275	10	19,563
BCB	43	8,816	3,445	39.0	286	10	26,199
BGF	84	3,433	736	21.4	146	8	13,632
FINBANK	82	3,757	832	22.1	93	4	1,041
IBB	66	12,404	3,265	26.3	350	24	40,000
SBF	108	783	-1,588	-202.8	107	3	1,154
BNDE	0	6,900	513	7.4	77	1	0
FPHU	0	5,150	636	12.3	52	1	0
<b>Total / Average</b>	<b>76</b>	<b>52,346</b>	<b>10,161</b>	<b>19.4</b>	<b>1538</b>	<b>66</b>	<b>130,489</b>

Source: Data communicated by individual banks.

Notes: BBCI = Banque Burundaise pour le Commerce et l'Investissement; BANCOBU = Banque Commerciale du Burundi; BCB = Banque de Cr dit de Bujumbura; BGF = Banque de Gestion et de Financement; Finbank = Finlease Bank; IBB = Inter Bank Burundi; SBF = Soci t  Burundaise de Financement; BNDE = Banque Nationale pour le D veloppement  conomique; FPHU = Fonds de Promotion de l'Habitat Urbain.

(1) is the ratio of total credit to total deposits; (2) is the equity in millions of Burundi francs; (3) is the amount of net profits in millions of Burundi francs; (4) is return on equity, which is the ratio of (3)/(2); (5) is the total number of employees; (6) is the number of branches; (7) gives the number of accounts opened in each bank. Note that BNDE and FPHU have neither branches nor accounts; they are not commercial banks so do not take deposits from clients.

One clear message from this table is that commercial banks are highly profitable. With the exception of SBF, which has had serious problems and has now been taken over by Ecobank, a West African multinational bank, net profits range from 10 per cent to 39 per cent of equity. As the discussions in Section 4 will attempt to show, the fact that banks make such important returns with minimum exposure to risk implies that they have no incentive to accord more credit to riskier borrowers. In other words, the fact that banks are so profitable prevents them from widening their credit base to seek more opportunities.

#### **4. Why is the financial sector in Burundi not oriented to development activities?**

The first question of interest is to determine where credit should be directed if its allocation reflected the importance of economic sectors.

##### **4.1 What sectors should credit be directed to?**

If the distribution of productive financial resources within the economy reflected Burundi's economic structure and development priorities, agriculture would account for the lion's share of such resources. Indeed, meeting all the three medium-term development objectives identified in Section 2 will require important investments in the agricultural sector.<sup>4</sup> Surprisingly, agriculture is the sector that attracts the lowest amount of financial investments, as Table 2 illustrates.

<sup>4</sup> These are: 5 per cent annual growth of agriculture production; achieving food security; and reducing poverty from 67 per cent to 50 per cent.

**Table 2: Sectoral distribution of credit (percentage of total credit)**

	1980-1994	2003-2005
Agriculture	2.50	0.68
Industry	16.00	3.80
Commerce, including coffee	43.00	72.00

Source: Raw data from BRB, Annual reports.

Table 2 shows that credit to agriculture is not only very low, but also that it has collapsed over time. The same trend can be observed with regard to credit to industry. In contrast, credit to commerce, including coffee-trading activities, has increased remarkably. Commerce, part of the services sector which, as a whole, accounts for only 2.5 per cent of total employment, accounts for 72 per cent of total domestic credit. This pattern of resource allocation shows how difficult it is to expect that the current distribution of resources can create the jobs necessary to reduce poverty.

The distribution of resources depicted in Table 2 is suggestive of an economy in which the financial system favours short-term activities with immediate gain. Indeed, credit for trading is rarely medium- or long-term loans. Trading means import and export operations which rarely last for one year. The question, therefore, is why banks are not interested in lending towards transformative activities in the agricultural and industrial sectors? There are three inter-related reasons: high political risk; high economic risk and the industrial organisation of the banking sector.

#### 4.2 High political risk

Burundi's post-independence history has been marked by extreme political instability in the form of civil war. Since its independence in 1962, the country has experienced five episodes of civil war (Table 2).

**Table 3: Some key data on Burundi's civil wars**

	1965	1972	1988	1991	1993-2003
Duration (months)	2	4	2	1	108
Deaths (Thousands)	5	200	15	1-3	300
Refugees (Thousands)*	0	300	50	38	687
Ratio of Deaths plus refugees over total population (%)**	0.2	14.0	1.3	0.7	17.1
Years from previous war	-	6	16	3	2
Provinces affected	Muramvya	Whole country	Ngozi, Kirundo	Cibitoke, Bubanza, Bujumbura	Whole country

Source: Ngaruko and Nkurunziza (2005).

\* Number of Burundi refugees in DRC, Rwanda and Tanzania due to a specific conflict (UNHCR data). It is the difference between the total number of refugees and the number a year before the crisis (In 1965, there were displaced people within Burundi, but no refugees outside the country). \*\* Population at the beginning of war, except for the 1993 conflict, for which the population of reference is the mean of the 1993-2003 period.

Burundi's wars have been devastating as illustrated by their long duration, the large number of deaths and refugees that they have caused, as well as their prevalence across the country. In addition to this cycle of violence, there have been several known and unknown, successful and unsuccessful, *coup* attempts. For example, out of 43 years covering the period from the first military *coup* in 1966 to date, Burundi was under military rule for 34 years or for 79 per cent of the time. Four "successful" *coup* attempts brought leaders to power who were more interested in extracting rents than in developing the

country (Nkurunziza and Ngaruko, 2008). This political uncertainty constrained economic activity, especially inter-temporal trade such as long-term credit.

The cyclical nature of civil wars in Burundi has heightened uncertainty over the future. Financial institutions operating in such an environment have become extremely cautious, privileging less risky short-term activities. To illustrate how political instability has affected lending patterns, Nkurunziza and Ngaruko (2002) show that, in 1992, just before the beginning of the latest episode of civil war, medium-term and long-term lending represented each 16 per cent of total credit to the economy. In 1998, each of the rates had declined to 11 per cent of total credit. In contrast, short-term lending, especially in the form of working capital, increased from 62 per cent to 78 per cent of total lending.

The most recent situation is even worse. In 2006, domestic credit to the private sector was 21 per cent of GDP, half of Africa's average. Long-term credit represented about only 3 per cent of short-term credit. The lack of long-term credit has led to very low levels of investment, among others. Burundi's gross domestic investment in 2006 represented 17 per cent of GDP, which is less than the average for Africa, which stood at 21 per cent of GDP. For Burundi, this was a remarkable improvement from the previous years. Until 2005, the rate was oscillating around 10-12 per cent of GDP, which was almost half of the rate for Africa (World Bank, 2007). If these investment rates do not increase, it will be difficult for Burundi to reach its development objectives in the planned time-frame.

#### **4.3 High economic risk**

Political instability has gone hand in hand with economic instability, as expected, creating an environment of high economic uncertainty and risk. In addition, over the last few decades, economic uncertainty in Burundi has also been the result of ill-advised policy choices, including some discussed earlier in this paper. For example, exchange rate controls and currency devaluations created uncertainty over the level of prices in the future, limiting the involvement of businesses in medium- and long-term activities. There has been progress in terms of policy choices. Interest rates have been liberalised and exchange rate controls largely removed.

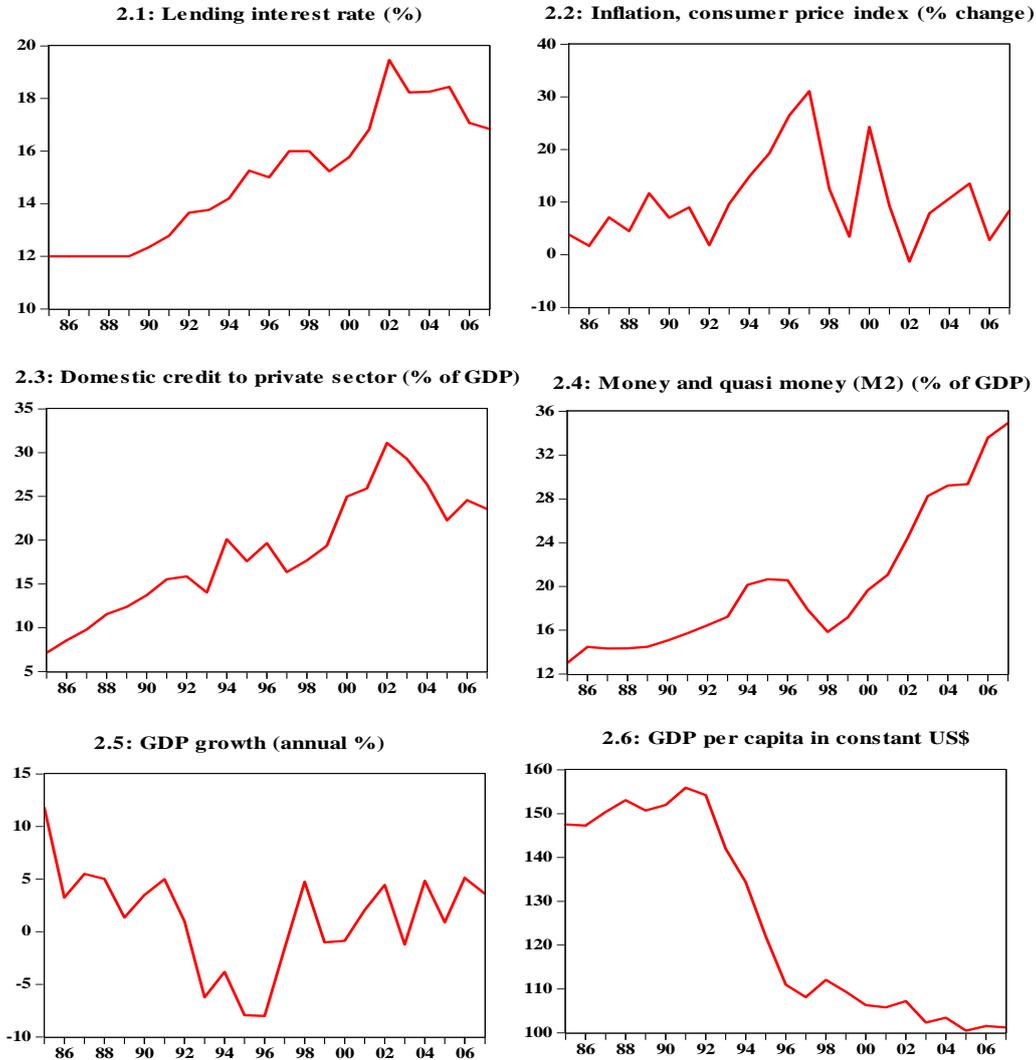
However, interest rate liberalisation in the late 1980s resulted in a steady increase (Figure 2.1) and reached levels that discouraged borrowers, penalising economic activity. With regard to inflation, it increased from below 10 per cent before the 1990s, to values well above 10 per cent for most of the period since the early 1990s (Figure 2.2). High inflation was due to domestic and external factors. Possible domestic factors include the destructive effect of war on the economy, droughts, and a decline in agriculture production as illustrated in Figure 1. The steady increase in money supply in the context of a shrinking economy may also have contributed to increasing inflation. The long-run semi-elasticity of inflation to real money in circulation trebled between the pre-war to the war period (Nkurunziza, 2005). The main potential external cause of inflation was the increase in the prices of imports, particularly oil imports. The high level of inflation is one of the genuine reasons explaining commercial banks' relatively high lending rates.

Caution is needed when interpreting the increasing trend of credit to private sector and broad money. It is important to keep in mind that these variables are scaled by GDP, which declined from the mid-1980s to the mid-1990s and then oscillated around zero (Figure 2.5). This implies that part of the apparent steep increase in domestic credit to the private sector and broad money is due to the decline in GDP (the denominator). Notwithstanding this caution, the current ratios of credit to the private sector and broad money are much lower than the average for Africa: 43 per cent and 54 per cent, respectively (World Bank, 2007).

Thus, despite the efforts to liberalise the financial sector, gains in terms of financial deepening and monetary stability have remained limited. It is also clear that, using the evolution of GDP *per capita* as a measure of the effect of these policies on economic development, there is no discernible positive

effect that could be attributed to these policies. Indeed, as Figure 2.6 shows, GDP *per capita* has continued to decline from the early 1990s, when financial reforms were introduced, to date.

**Figure 2: Variation in key macroeconomic variables**



Source: Raw data from World Bank (2007).

It is also relevant to note that Burundi's geographical isolation from its economic partners increases uncertainty. As a landlocked country, Burundi depends heavily on its neighbouring countries' ports, railways and roads, which are in a state of decay. The poor quality of this transport infrastructure renders delivery unreliable, taking much longer than in normal circumstances. Hence, in order to prevent the danger of running out of stocks due to the unpredictability of supplies, firms invest in larger than optimum stocks, which is costly. A survey of manufacturing firms conducted in the 1990s found that the stocks held by firms at the time of the survey represented 87 per cent of total raw material needs for a full year (Nkurunziza and Ngaruko, 2008).

#### **4.4 The industrial organisation of the financial sector**

There is still a lack of competition in the financial sector, despite the progress made since the beginning of financial liberalisation in the late 1980s. The financial sector is oligopolistic, with three banks, namely, IBB, BCB and BANCOBU, accounting for 60 per cent of the credit allocated and 78 per cent of the total deposits. Together, these banks' share 84 per cent of the total net profits in the credit market. The weighted average rate of return on equity in the sector is 19.4 per cent but the rates of return on equity for IBB, BCB and BANCOBU are 26 per cent, 39 per cent and 29 per cent, respectively (see Table 1). This high profitability is realised on the back of undiversified activities which are concentrated around credit to trading (Table 2) and other basic banking services (overdrafts, bank charges, sales of cheque books, *etc.*). The fact that banks make up to 39 per cent return on equity by just offering these basic services does not push them out of their comfort zone to seek other alternative, albeit riskier, sources of income.

It is also relevant to note that the pervasive presence of the state in the financial sector makes it prone to political influence. Until very recently, the state controlled 75 per cent of BANCOBU; 59 per cent of BCCI; 45 per cent of BCB and 36 per cent of SBF, but the picture is changing in favour of more private capital. The dominance of financial institutions by the state has turned it into an important source of economic rents. Therefore, instead of building financial institutions that foster long-term economic development, the actors of Burundi's predatory state have been more interested in maximising the short-term gains derived from their control of the financial sector. Most of the banks that failed over the last years were looted by politically-appointed managers who allocated large amounts of credit to themselves, their friends and their associates which they failed to re-imburse. The same phenomenon could explain the currently high default rate. Bad debts represent 18 per cent of total loans, which is well above the threshold ratio, fixed at 10 per cent of loans.<sup>5</sup>

Even the country's development bank, BNDE, is failing in its mission of focusing on development financing. The first reason is that, as key shareholders of BNDE, commercial banks have a strong influence in the management of the development bank (BCB is the second most important shareholder). This strong proximity between commercial and development banks may have biased the development bank's mission by pursuing its shareholders' interests. In this sense, BNDE may be suffering from the same problems afflicting commercial banks discussed earlier. Moreover, the fact that the state is the main shareholder of BNDE is an additional possible justification for the bank's poor performance in terms of promoting development financing.<sup>6</sup>

The second possible reason which may explain BNDE's failure to live up to expectations in terms of long-term development lending is related to external factors. External shareholders such as the *European Investment Bank*, *Agence française de développement* and Belgium's *Direction générale de la coopération internationale* were important sources of BNDE's long-term funds essential to finance medium-term and long-term development projects. Starting from the early 1990s, as a result of the political turmoil in Burundi, these institutions stopped assisting BNDE, which, in turn, ran out of long-term funds. As a result, BNDE, like the commercial banks, turned to short-term and medium-term lending, which currently represent 94 per cent of its lending portfolio.

The housing bank is also controlled by the state, which owns 83 per cent of its equity. The bank's lending activities are handicapped by the population's low purchasing power and the lack of long-term resources, as is the case with other banks. One of the consequences of instability in Burundi has been a continuous decline in real GDP *per capita*, resulting in a deterioration in the purchasing power of the population. Hence, apart from a small group of people with relatively high incomes, access to housing

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<sup>5</sup> Information from the Central Bank (*Banque de la République du Burundi*).

<sup>6</sup> To its credit, Burundi has succeeded in maintaining its development bank in operation even when similar banks were collapsing in other African countries throughout the 1980s and 1990s. This shows that BNDE has built some resilience and that it needs to be strengthened, not dismantled.

credit has become very difficult. Problems of access have been compounded by a scarcity of long-term resources, as in the case of BNDE. This resource constraint has induced FPHU to impose very drastic conditions on its lending.

## 5. Conclusion and policy recommendations

The financial sector in Burundi has made a very limited contribution to the country's development. The analysis of financial resource allocation shows that the financial sector privileges short-term lending, concentrating its resources on trading activities. The primary sector, which is dominated by agriculture, is the backbone of the economy, in which 80 per cent of employment is located. Despite its central importance, agriculture receives only a small amount of credit. Industry, the channel through which economic transformation occurs, only marginally benefits from the credit from the financial sector.

There are three main factors that help to explain the lack of long-term investments in productive sectors. First, the country's cycle of civil wars has not only destroyed the economy but also created a risky environment in which it is difficult to obtain loans in order to finance long-term investment. Economic agents, particularly banks, have difficulty predicting the future with some level of certainty, as a result of which lenders do not lend and investors do not invest.

Second, despite efforts towards macro-economic stability, the financial sector remains underdeveloped. Also, there still is relatively high macro-economic instability as illustrated by a constantly high inflation rate. This discourages long-term trading, including investment and credit.

Third, the financial sector is organised in such a way that banks have no incentives to provide long-term credit. The three banks that control the financial market make profits in the range of 26 per cent to 39 per cent of equity. Why should they take on too much risk if they are comfortable with the *status quo*? Even development banking does not provide the solution. The country's development bank has strayed from its development mission, partly due to the lack of long-term financial resources to fund development activities, but also partly due to its ownership structure.

Increasing the contribution of the financial sector to Burundi's development will require more than a few economic measures. First, the country needs more political stability to reduce its endemic political risk. The recent political progress in bringing an end to the country's cycle of civil wars should be consolidated in order to have a long-term effect on the economy. Second, the central bank has an important role to play in ensuring that the financial sector works on the basis of competition principles. While acknowledging that important progress has been achieved since the late 1980s, in terms of opening up the financial sector to new actors, the very high rates of return on equity currently observed, and the large interest rate spreads, are indications that more needs to be done to create a truly competitive environment. Most particularly, banks should be encouraged to diversify their lending portfolios in order to reach credit-rationed borrowers.

In market segments in which commercial banks cannot competitively intervene, particularly in rural areas or in the "small borrower" market, micro-finance should be encouraged. It has been established that commercial and development banks incur loan administration costs that are up to 10 times higher than micro-finance institutions (Steel *et al.*, 1997). There has been an impressive growth in micro-finance activities since 2000. Currently, micro-finance directly serves more than 300,000 clients, more than twice the number of commercial bank account holders. However, micro-finance institutions suffer from a lack of resources to satisfy all their clients' needs. Hence, creating a micro-finance fund with stable financial resources from the private sector and external aid would help to address this resource constraint. At the same time, such a fund could reduce the exorbitant interest rates applied in micro-lending.

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Finally, Burundi's development bank should be re-energised as it is the country's only institution devoted to financing development economic activities. Considering the current financial constraint of the state and its inability to re-invest in BNDE, the bank should be re-capitalised using external aid. If the bank's three European traditional partners (see Section 4.4), who are also among Burundi's key development partners, re-engage with BNDE by providing it with long-term resources, it could be able to reclaim its traditional role as a "national bank for economic development".<sup>7</sup>

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<sup>7</sup> This is the literal translation of BNDE (*Banque Nationale pour le Développement Économique*).

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