

# INNOVATIVE FINANCE FOR PRIVATE SECTOR DEVELOPMENT IN AFRICA



ECONOMIC REPORT ON AFRICA 2020



United Nations  
Economic Commission for Africa

INNOVATIVE FINANCE FOR  
PRIVATE SECTOR  
DEVELOPMENT  
IN AFRICA

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# CONTENTS

Lists of Figures, Tables and Boxes . . . . .	v
FOREWORD . . . . .	viii
ACKNOWLEDGEMENTS . . . . .	xi
ABBREVIATIONS . . . . .	xiii
EXECUTIVE SUMMARY . . . . .	xvi
Recent economic developments . . . . .	xvi
Innovative finance for African business . . . . .	xviii
Corporate banking . . . . .	xx
Financial markets . . . . .	xxii
Equity markets . . . . .	xxiii
Debt markets and the private sector . . . . .	xxiv
Other opportunities for private financing . . . . .	xxv
Long-term financing for sustainable development . . . . .	xxvi
Infrastructure financing . . . . .	xxviii
Leveraging financial technology . . . . .	xxxi
Financial regulation to support private sector development . . . . .	xxxiii
KEY RECOMMENDATIONS . . . . .	xxxv
CHAPTER 1 Recent Economic and Social Developments in Africa . . . . .	1
Recent global economic performance and its implications for Africa . . . . .	2
Recent economic developments in Africa . . . . .	6
Socioeconomic development and implications . . . . .	11
Financial sector performance . . . . .	14
Financing opportunities for sustainable development in Africa . . . . .	19
Conclusions and policy implications . . . . .	21
ANNEX . . . . .	22
CHAPTER 2 The Private Sector in Africa . . . . .	27
Private sector development in Africa . . . . .	29
Private sector in agriculture-based economies . . . . .	30
Private sector in extraction-based economies . . . . .	32
Private sector in manufacturing-based economies . . . . .	34
Private sector in service-based economies . . . . .	36
Challenges to private sector development . . . . .	38
What solutions for financing private sector development in Africa? . . . . .	44
The potential role of the African continental free trade area in private sector development . . . . .	49
Conclusion . . . . .	51

CHAPTER 3	Accessing Financing from the Corporate Banking Sector in Africa	57
	An overview of retail and corporate banking	59
	The African banking sector	61
	The banking sector and financing of the real sector	67
	Implications of COVID-19 for the African banking sector	69
	Conclusion	70
CHAPTER 4	Tapping into the Potential of African Markets	73
	Equity markets in Africa and opportunities for the private sector	75
	Debt markets in Africa and the need to crowd in the private sector	81
	Other opportunities for private financing	85
	Financial market products for industrialization	89
	Threat of COVID-19 to African financial markets	92
	Conclusion	93
CHAPTER 5	Long-term Financing for Sustainable Development in Africa	97
	Sustainability bonds	99
	Development banks	110
	Institutional investors	113
	Conclusion	116
CHAPTER 6	Leveraging Global Innovations in Financial Technology in Africa	119
	Crowdfunding, crowdinvesting and crowdlending in Africa	121
	Electronic payments and e-commerce	125
	Insurance	129
	Fintech for private sector growth	130
	Conclusion	132
CHAPTER 7	Regulations to Support Financing in Africa	135
	Overview of financial regulation in Africa	137
	Financial innovation and regulatory challenges	142
	The future of financial regulation and need to support private sector development in Africa	145
	Africa's financial policy responses to the COVID-19 crisis	149
	Conclusion	151

CHAPTER 8	Conclusions and Policy Recommendations . . . . .	153
	Africa has a high economic growth trajectory, but COVID-19 has unleashed non-trivial uncertainty. . . . .	158
	The private sector in Africa is the engine of growth and the pathway to sustainable development. . . . .	159
	Banks are a major source of innovative financing in Africa and there are high expectations for pan-African banks . . . . .	160
	Rising African financial markets have great potential to finance high-growth firms . . . . .	161
	Long-term financing for sustainable development . . . . .	162
	Fintech is increasing private sector financing with varied financial services and products . . . . .	163
	Policymakers must continue to improve the regulation of the financial service sector, including Basel III, and support innovative financing in the private sector. . . . .	164

## LISTS OF FIGURES, TABLES AND BOXES

### LIST OF FIGURES

FIGURE 1.1	Global economic growth, 2015–2021 . . . . .	2
FIGURE 1.2	Select primary commodity prices, 2017–2019 . . . . .	3
FIGURE 1.3	Economic growth in Africa by regional group, 2015–2021 . . . . .	6
FIGURE 1.4	Components of economic growth in Africa, 2018–2021 . . . . .	7
FIGURE 1.5	Evolution of the Economic Complexity Index in Africa, by subregion, 2013–2017 . . . . .	8
FIGURE 1.6	Total investment, by subregion, 2015–2021 . . . . .	9
FIGURE 1.7	Total merchandise trade in Africa, 2017–2019 . . . . .	10
FIGURE 1.8	Multidimensional Poverty Index, 2007–2018. . . . .	12
FIGURE 1.9	Income shares of the top 10 per cent of the population, 2010–2017 . . . . .	13
FIGURE 1.10	Credit-to-GDP ratio by African region . . . . .	14
FIGURE 1.11	Net interest margins in select countries, 2017 . . . . .	15
FIGURE 1.12	Trend in bank regulatory capital to risk-weighted asset ratio . . . . .	16

FIGURE 1.13	Trends in banking sector stability . . . . .	17
FIGURE 2.1	Growth of value added in agriculture, manufacturing, industry and services . . . . .	31
FIGURE 2.2	Top 22 African countries natural resource rent, 2016 . . . . .	33
FIGURE 2.3	Commodity-based (agriculture, and mining and fuels), manufacturing-based and service-based economies in Africa, by exports value . . . . .	37
FIGURE 2.4	Main obstacles to businesses in Africa . . . . .	39
FIGURE 2.5	Main obstacles to the operation of businesses in Africa, by company size . . . . .	42
FIGURE 3.1	Access to a credit line or loan from a formal financial institution is highest among large firms and lowest among small firms(Per cent). . . . .	60
FIGURE 3.2	The African banking sector is one of the fastest growing and most profitable in the world, 2019 . . . . .	61
FIGURE 3.3	Historical and projected growth of the African retail and wholesale corporate banking sectors (revenue pools before risk cost in billions of US dollars) . . . . .	62
FIGURE 3.4	Map: The number of African cross-border banks had grown considerably by 2019 . . . . .	64
FIGURE 3.5	Interbank lending is more expensive in African markets than in mature markets, 2014–2019 Interest rates, percentage points . . . . .	66
FIGURE 4.1	Market capitalization of the top four stock exchanges in Africa and other emerging markets . . . . .	77
FIGURE 4.2	Initial public offerings by selected African exchanges, 2014–2019 . . . . .	78
FIGURE 4.3	Global corporate debt market capitalization (Per cent of GDP, 2019) . . . . .	82
FIGURE 4.4	African private capital fundraising, . . . . .	86
FIGURE 4.5	Global private capital fundraising, 2010–19 . . . . .	87
FIGURE 4.6	Share of African private investment deals by region, 2013–18 . . . . .	87
FIGURE 4.7	Evolution of assets under management in mutual funds in Africa, 2008–20 . . . . .	88
FIGURE 5.1	Sustainability bond issuers, 2019 . . . . .	100
FIGURE 5.2	Green bond issuances by region, 2007–19 . . . . .	101
FIGURE 5.3	Infrastructure investment by international lenders and donors, national governments and the private sector in Africa . . . . .	108
FIGURE 5.4	Private sector financing in infrastructure, by sub-regions, 2018 . . . . .	109
FIGURE 6.1	Blockchain wallet users have been rising globally, 2016–2019 . . . . .	124
FIGURE 7.1	Financial sector support measures put in place by African countries in response to COVID-19 . . . . .	150
FIGURE 8.1	Innovative financing for private sector development and SDGs . . . . .	156
FIGURE 8.2	The African Continental Free Trade Area (AfcFTA) . . . . .	157

## LIST OF TABLES

TABLE 1.1	Return on assets and return on equity, by region, 2012–2017 . . . . .	16
TABLE 1.2	Bank regulatory capital and non-performing loans ratios, by country(Per cent) . .18	
TABLE 1.3	Africa’s infrastructure financing needs . . . . .	19
TABLE 3.1	Overview of major types of financing mechanisms from banks . . . . .	60
TABLE 3.2	The 10 largest pan-African banks in 2019 (US\$ millions) . . . . .	63
TABLE 4.1	African stock exchanges with a market capitalization of more than \$1 billion	76
TABLE 4.2	Selected commodity exchanges in Africa . . . . .	85
TABLE 4.3	Value and number and African private investment deals, 2013–2019 . . . . .	86
TABLE 6.1	Alternative financing in Africa, 2017–2023 . . . . .	122
TABLE 6.2	Models of crowdfunding . . . . .	123
TABLE 6.3	E-commerce business models in Africa . . . . .	126
TABLE 6.4	Payment methods available on e-commerce platforms . . . . .	126
TABLE 7.1	Examples of instruments serving prudential aims . . . . .	147

## LIST OF BOXES

BOX 1.1	Digital solution and lending: Two examples from Kenya . . . . .	20
BOX 1.2	The role of financial regulation . . . . .	20
BOX 2.1	Transforming agriculture in the United States . . . . .	30
BOX 2.2	Mining value addition in Australia . . . . .	32
BOX 2.3	Manufacturing-based economy: The case of China . . . . .	35
BOX 2.4	Service-based economy: The case of Hong Kong . . . . .	36
BOX 2.5	Guarantee fund . . . . .	46
BOX 4.1	Adoption of the ELITE programme by the Casablanca Stock Exchange and the West African Economic and Monetary Union’s stock exchange . . . . .	79
BOX 4.2	The WACMIC initiative in the ECOWAS region . . . . .	80
BOX 4.3	African repurchase deals . . . . .	84
BOX 4.4	Derivatives markets and their potential in Africa . . . . .	90
BOX 5.1	Examples of green bonds programmes in Africa . . . . .	102
BOX 5.2	China best practice support for green bond markets . . . . .	105
BOX 5.3	Innovation in underlying asset classes in Africa . . . . .	106
BOX 5.4	Case study: Development Bank of Southern Africa operations in South Africa . . . . .	112
BOX 5.5	Pension fund systems in South Africa and Morocco . . . . .	115
BOX 6.1	Regional developments in e-commerce . . . . .	128
BOX 6.2	Examples of innovation in the African banking sector . . . . .	131
BOX 7.1	Macroprudential policy assessment in Africa . . . . .	139
BOX 7.2	Regulatory sandbox in Kenya . . . . .	144
BOX 7.3	Impact of regulations on small and medium enterprise funding . . . . .	145
BOX 7.4	The importance of living wills . . . . .	146



# FOREWORD

**A**frica today, in the wake of COVID-19, is facing an unprecedented threat to its hard-earned growth over the last decade. The pandemic is global, but the resilience of the African region depends on the strategies and policies countries adopt now, building on recent initiatives to accelerate economic growth to meet national development aspirations in line with the Sustainable Development Goals (SDGs) and the African Union’s Agenda 2063, and to do so in a financially and environmentally sustainable manner.

The cost to achieve the SDGs by 2030 in Africa is estimated at about \$1.3 trillion a year, according to the United Nations. It will increase dramatically due to population growth projected at 45 per cent over 2020–2030—a dynamic that could seriously undermine the efforts to end extreme poverty and inequality, tackle climate change and build resilient infrastructure in Africa.

Increasing the role of the private sector stands out among the widely advocated options for such investments, especially given the low levels of investment by governments and the donor community. This option resonates with African Continental Free Trade Area (AfCFTA) initiatives to harness the demographic dividend, grow the middle class, increase the use of technology, promote rapid urbanization and boost opportunities for regional and global value chains for African businesses as strategic drivers of economic growth in Africa. And the continent is endowed with a strong natural resource base, abundant human capital and, most important, strong entrepreneurial activity among its people, features that together signpost the road to private sector development.

The private sector in Africa is a powerful force for economic growth and has the potential to transition economies from low-income to middle-income status. At the global level, the private sector generates more than 70 per cent of jobs; invents, designs and produces most of the goods and services that translate into value added and contributes more than 80 per cent of government revenue in low-income and middle-income countries through company taxes and income tax on employees. But in Africa the unavailability of finance has been identified as the most severe obstacle to doing business. Some 19 per cent of small firms see it as the main obstacle, compared with 14 per cent of medium-size firms. It is viewed as a major obstacle in manufacturing and services. Such financial constraints worsen the “valley of death,” in which business start-ups in Africa do not survive their first three years. Innovative sustainable financing of Africa’s private sector is needed.

At a global level, a Task Force on Digital Financing of the Sustainable Development Goals (DFTF) was launched in November 2018 by the United Nations Secretary-General to identify opportunities, challenges, and ways to advance the convergence of digital technology, the financial ecosystem and the SDGs. For Africa, the United Nations Economic Commission for Africa has consistently highlighted financing challenges, culminating in the position paper for the 2015 Addis Ababa Action Agenda on Financing for Development.

The 2020 edition of the *Economic Report on Africa: Innovative Finance for Private Sector Development in Africa* examines the innovative financial instruments, practices and policies required to enable African countries to make a step-change in growing the gamut of businesses, including start-ups, micro and small enterprises, social enterprises, professional businesses (such as lawyers and doctors), exchange-listed corporates, and public-private companies—the businesses that will drive inclusive economic growth, create jobs and make pathways to better livelihoods for the African people. The idea is timely in this digital age, when some African countries such as Ghana, Kenya, Rwanda, and Uganda are already embarking on the financial technology (fintech) revolution to pave a bright new path for the unbanked population, including women entrepreneurs and youth-led small and medium enterprises.

Areas where policy and practice need to focus to engender innovations in private sector financing are identified in the report. For example, it notes that the financial services sector is still dominated by retail banking, with very rudimentary forms of such non-bank financial institutions as insurance firms and housing finance houses. The sector also features nascent capital markets, which do not provide the full mix of equity, company bonds and government bonds. It lacks tailored financing mechanisms for start-ups or young enterprises—for example, venture capital. And it lacks financing mechanisms for company restructuring, such as leveraged buy-outs. But the recent growth of fintech start-ups in many countries such as Ghana, Kenya and the United Republic of Tunisia is impressive. And for small firms, microfinance institutions paved the way in providing both financing and training to enable new firms to escape the valley of death.

The financial system in Africa needs to accelerate diversification to build a full range of financial institutions and offer a wide range of innovative financial products tailored to specific needs of the business eco-system, such as start-ups, marketing, transportation and payment collection.

African countries have increasingly ventured into innovative sources of finance, such as issuing sovereign bonds (Eurobonds) and green bonds, although in some circles this practice has ignited discussions about debt sustainability on the continent. Africa is continuing to deepen its financial markets and build its financial institutions for long-term economic growth. For instance, despite some concerns about debt sustainability, Africa's financial markets have continued to deepen significantly with 11 African countries issuing bonds with a total value that rose from approximately \$1 billion at the end of 2011 to \$11.2 billion by the end of 2019.

The report identifies five quick wins for African countries to scale up innovative financing for the private sector. First, a quick route to enhancing innovative private sector financing is for governments to support the financial sector in leveraging short-term financing (such as bank financing for working capital) with long-term financing (such as development bank finance for plant investment). At the same time governments should enhance the eco-system for private sector development, including raising investment to 35–40 per cent of GDP.

Second, governments could play a complementary role in financial innovations by all types of financial institutions and markets by creating a regulatory environment benefitting entrepreneurs at all stages of the business growth cycle. For example, governments could review bank supervision requirements and enhance transparency in credit information (as through credit bureaus).

Third, fast-tracking work on the AfCFTA would provide opportunities for African financial markets to expand. Enlarged markets under the AfCFTA would allow cross-listing, efficient pricing, increased competitiveness in regional and global value chains and more opportunities for innovative business financing.

Fourth, the use of domestic resources in local currencies should be absolutely required for increasing long-term private finance and investment in infrastructure. This step would deepen capital markets and increase the scale of development banks.

Fifth, the power of fintech can be leveraged to provide diverse financing alternatives and revolutionize how companies access finance. Fintech financing has increased in many African countries even during the COVID-19 pandemic.

Some African governments have embarked on considerable reforms, working closely with private sector executives. They have registered considerable progress in innovative financing of the private sector, especially in fintech. Examples include Burkina Faso, Côte d'Ivoire, Ghana, Kenya, Mauritania, Rwanda and Uganda.



**Vera Songwe**

**Under-Secretary General of the United Nations**

**Executive Secretary of the Economic Commission for Africa**

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# ABBREVIATIONS

AAAA	Addis Ababa Action Agenda
AACB	Association of African Central Banks
ABS	Asset-backed securities
ACE	Agricultural Commodity Exchange for Africa
AfCFTA	African Continental Free Trade Area
AfDB	African Development Bank
AfMX	Africa Mercantile Exchange
AGF	African Guarantee Fund
AGRA	Alliance for a Green Revolution in Africa
AHCX	Auction Holding Commodity Exchange
AIIB	African Infrastructure Investment Bank
AltX	Alternative Exchange market
AMCP	African Monetary Co-operation Program
ASCE	Abuja Securities and Commodity Exchange
ASEA	African Securities Exchanges Association
ATPC	African Trade Policy Centre
AU	African Union
AUABC	African Union Advisory Board on Corruption
AUC	African Union Commission
BCBS	Basel Committee on Banking Supervision
BCEAO	Central Bank of West African States
BEAC	Bank of Central African States
BMCE	Bank of Africa (Morocco)
BRVM	Bourse Régionale des Valeurs Mobilières
BVMAC	Bourse des Valeurs Mobilières de l'Afrique Centrale
CABS	Community of African Banking Supervisors
CAGR	Compound annual growth rate
CBI	Climate Bonds Initiative
CBK	Central Bank of Kenya
CBSE	Casablanca Stock Exchange
CDOs	Collateralized debt obligations
CFAF	Franc of the Financial Community of Africa
CFF	Climate Finance Facility
CMA	Capital market authority

CMOs	Collateralized mortgage obligations
CNSS	National Social Security Fund (Morocco)
COMESA	Common Market for Eastern and Southern Africa
COVID-19	Coronavirus 2019
DA	Designated adviser
DBs	Development banks
DBSA	Development Bank of Southern Africa
DFIs	Development finance institutions
DTCB	Diamond Trading Cooperation Botswana
EAC	East African Community
EAX	East Africa Exchange
ECA	United Nations Economic Commission for Africa
ECI	Economic Complexity Index
ECOWAS	Economic Community of West African States
ECX	Ethiopia Commodity Exchange
eFSC	Electronic financial supply chain
EGX	Egyptian Exchange
EIB	European Investment Bank
EIU	Economist Intelligence Unit
EONIA	Euro Overnight Index Average
ESG	Environmental, social and governance
ETFs	Exchange traded funds
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign direct investment
FfD	Financing for Development
FSCA	Financial Sector Conduct Authority (South Africa)
FX	Foreign exchange
GAAP	Generally accepted accounting principles
GBP	Green Bond Principles
GCX	Ghana Commodity Exchange
GDP	Gross domestic product
GFF	Green Finance Fund
GVCs	Global value chains
IATA	International Air Transport Authority
IBRD	International Bank for Reconstruction and Development
ICA	Infrastructure Consortium for Africa
ICMA	International Capital Market Association
ICT	Information and communications technology
IDC	Industrial Development Corporation of South Africa
IEA	International Energy Agency
IFC	International Finance Corporation
IFIs	International financial institutions
IIPP	Institutional Investor Public Partnership
IMF	International Monetary Fund
IPOs	Initial public offerings
ITC	International Trade Centre
JSE	Johannesburg Stock Exchange
LIBOR	London Interbank Offered Rate
M&A	Mergers and acquisitions

<b>MDBs</b>	Multilateral development banks
<b>MEX</b>	Mercantile Exchange of Madagascar
<b>MFIs</b>	Microfinance institutions
<b>MNOs</b>	Mobile network operators
<b>MPI</b>	Multidimensional Poverty Index
<b>NBFIs</b>	Non-bank financial institutions
<b>NCE</b>	Nairobi Coffee Exchange
<b>NDBs</b>	National development banks
<b>NEPAD</b>	New Partnership for African Development
<b>NEPAD-IPPF</b>	New Partnership for African Development Infrastructure Project Preparation Facility
<b>NIM</b>	Net interest margin
<b>NPLs</b>	Non-performing loans
<b>NSE</b>	Nigerian Stock Exchange
<b>OBOR</b>	One Belt, One Road
<b>ODA</b>	Official development assistance
<b>ODI</b>	Overseas Development Institute
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OSAA</b>	United Nations Office of the Special Adviser on Africa
<b>PBoC</b>	People's Bank of China
<b>PICI</b>	Presidential Infrastructure Champions Initiative
<b>PIDA</b>	Programme for Infrastructure Development in Africa
<b>PPPs</b>	Public-private partnerships
<b>PPPLRC</b>	Public-Private Partnership Legal Resource Center
<b>RMB</b>	Rand Merchant Bank
<b>S&amp;P</b>	Standard and Poor's
<b>SABOR</b>	South African Benchmark Overnight Rate
<b>SADC</b>	Southern African Development Community
<b>SAFEX</b>	South African Futures Exchange
<b>SBP</b>	Social Bond Principles
<b>SDGs</b>	Sustainable Development Goals
<b>SEC</b>	Securities and Exchange Commission (United States)
<b>SHS</b>	Solar home system
<b>SMEs</b>	Small and medium enterprises
<b>SOEs</b>	State-owned enterprises
<b>SPV</b>	Special purpose vehicle
<b>SRI</b>	Sustainable and responsible investment
<b>TCX</b>	Currency-exchange fund
<b>UN</b>	United Nations
<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>UNDP</b>	United Nations Development Programme
<b>UNESCO</b>	United Nations Educational, Scientific and Cultural Organization
<b>UNOSSC</b>	United Nations Office of South-South Cooperation
<b>US</b>	United States
<b>WACMIC</b>	West African Capital Markets Integration Council
<b>WAEMU</b>	West African Economic and Monetary Union
<b>WTO</b>	World Trade Organization



# EXECUTIVE SUMMARY

**T**his report explores innovative finance for business development in Africa, advancing the discussion of finance beyond just the flow of funds, detailing key aspects of innovative financing for the development of the private sector and proposing a policy framework for African countries. Its menu of policy options, best practices and strategic guidance supports decision makers and policymakers in creating and using innovative finance to support business development in pursuing economic growth, financial inclusion and the sustainable development goals (SDGs).

## RECENT ECONOMIC DEVELOPMENTS

The outbreak and spread of COVID-19 have led to containment measures such as lockdowns and physical distancing, disrupting normal economic activity around the world. Africa, the second fastest growing region in the world, grew at an estimated 3.4 per cent in 2019. In a best-case scenario, its average growth in 2020 will fall to 1.8 per cent, directly due to the economic impact of COVID-19. According to the International Monetary Fund (IMF), the continent's average growth is projected at -4.1 per cent in 2020. Growth on the continent is projected to rebound to 5 per cent in 2021, supported by the effective implementation of COVID-19 response measures and global economic recovery.

Furthermore, global GDP growth slowed to 2.8 per cent in 2019 from 3.5 per cent in 2018 - and is projected at -4.4 per cent in 2020, then rebound to 5.2 per cent growth in 2021. World trade is expected to fall by between 13 and 32 per cent in 2020, with services trade the most directly affected component due to transport and travel restrictions and the closure of many retail and hospitality enterprises. The sector had already slowed in 2019, when the value of

global merchandise trade fell by 3 per cent to \$18.9 trillion, weighed down by the slower economic growth and by trade tensions. However, global commercial services trade rose 2 per cent to \$6.0 trillion, though the pace of growth was slower than in 2018.

Although a global trade recovery is projected for 2021, the outcome depends on the duration of the COVID-19 outbreak and the effectiveness of policy responses. However, some services, such as information technology, for which demand has increased as people work from home and socialize remotely, may benefit from the crisis.

**“... prices plummeted for more than two-thirds of African exports”**

Africa benefited in 2019 from slight increases in some key primary commodity prices, but as the severity of COVID-19 escalated in early 2020, prices plummeted for more than two-thirds of African exports. The price of petroleum, which accounts for 40 per cent of African exports and 7.4 per cent of its GDP, crashed by more than 50 per cent to its lowest level since 2003. Metal prices fell 20 per cent from end-December 2019 values, while cotton fell 26 per cent. Tea and coffee prices have declined due to falling demand, particularly for away-from-home consumption in major import markets such as the United States and the European Union/ cocoa prices fell 6 per cent in April 2020 since the start of the year.

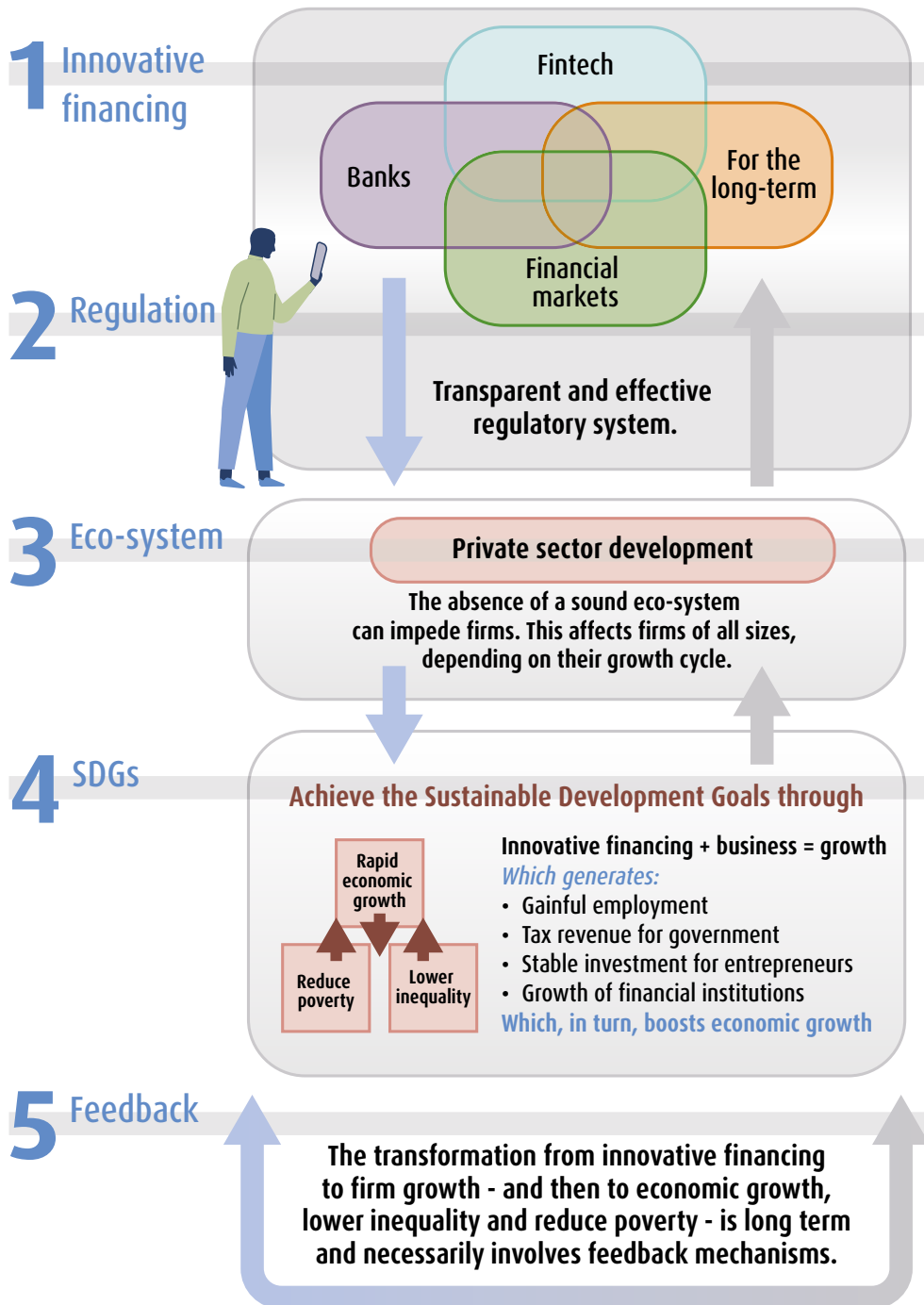
The African Continental Free Trade Area (AfCFTA) creates a single continental market and a customs union for capital and business travellers. It aims to unlock the potential for increased industrial capacity and provide major growth opportunities for African economies, expanding intra-African trade. AfCFTA also intends to play an important role in enhancing the eco-system for firms and connecting local firms to regional and global value-chains.

If successful, AfCFTA will create a single African market of more than 1.2 billion consumers with a total GDP above \$2.5 trillion, generating combined consumer and business spending

of \$6.7 trillion in 2030. The agreement is also expected to increase intra-African trade by 15 to 25 per cent by 2040. Implementation of the AfCFTA is expected to unlock manufacturing potential and facilitate industrialization, driving jobs and sustainable growth. For service-based economies, AfCFTA provides an opportunity to move from consumption-based growth to more durable sources of expansion, shifting countries from relying on subsistence and non-tradeable services to ones that generate greater value addition and productivity.

**“expected to increase intra-African trade by 15 to 25 per cent by 2040”**

# INNOVATIVE FINANCE FOR AFRICAN BUSINESS



THIS REPORT HIGHLIGHTS **FIVE KEY MESSAGES**  
REGARDING INNOVATIVE FINANCING IN AFRICA

**First,** **financing innovations can arise from multiple sources** simultaneously, such as banks, fintech, financial markets, and long-term sources like capital markets and development banks. Businesses need to consider leveraging different sources according to their financing needs - which may change as a firm goes through its growth cycle. In Africa, for example, large mature firms use capital markets to raise additional funding via initial public offerings (IPOs), but small new firms typically rely on retained earnings or informal borrowing.

**Second,** **a transparent and effective regulatory institution is mandatory** to minimize risk and oversee the financial operations of firms and peer institutions. For instance, the prevalence of high loan default rates in Africa is attributed to the lack of effective regulatory oversight, which eventually translates into high costs for loans.

**Third,** **the absence of a sound eco-system can impede firms even when financing is readily available**, which affects firms of all sizes, depending on their stage in the growth cycle.

**Fourth,** **innovative financing of the private sector and business growth generates firm value added, gainful employment, tax revenue for government, stable investment returns for entrepreneurs and the growth of financial institutions.** Those elements together boost economic growth, thus contributing to reduce poverty and inequality, and for achieving the Sustainable Development Goals.

**Fifth,** the **transformation** from innovative financing and from a fully operational financial sector to economic growth, lower inequality and reduced poverty **is long term and necessarily involves feedback mechanisms.**

To enable economic recovery and reasonable SDG progress, African economies should fully explore innovative financing for the private sector and enhance the eco-system for private sector development.

# CORPORATE BANKING

Banks are a major source of innovative financing in Africa and most financing mechanisms in Africa are bank-based. Over the past two decades, the banking sector has changed fundamentally in many African economies, and pan-African banks now conduct business in multiple countries. Moreover, significant advances in mobile banking and marketplace lending connect unserved and underserved communities to the financial sector.

The retail and corporate banking sector in Africa holds more than 90 per cent of the assets in the financial sector, but it is underdeveloped when benchmarked against emerging market economies in Asia and other industrializing countries. Its assets represent less than 60 per cent of GDP in Africa, compared with more than 100 per cent of GDP in other emerging and advanced economies. Addressing the huge financing gap for the private sector and infrastructure development will require more innovative financing solutions in the retail and corporate banking sector.

Despite an overall increase in banking activities, bank financing to the private sector remains low and ill-tailored to the needs of private firms. More than 90 per cent of bank loans are short- to medium-term, and private sector access to financing is impeded by government dominance of banking credit and difficult access for small and medium enterprises (SMEs) and for key sectors of the economy.

**“Though still small, the African banking sector is one of the fastest growing and most profitable in the world”**

Though still small, the African banking sector is one of the fastest growing and most profitable in the world, making it one of the key sectors propelling economic growth in the continent. The average return on equity for publicly listed banks is between 11 per cent and 22 per cent in Africa, compared with 14 per cent for emerging market economies and 8 per cent for developed economies in 2019. Between 2017 and 2022, the African banking sector is projected to grow at 8 per cent a year.

The low levels of financial inclusion in Africa mean that there is massive potential for growth if the banking sector can bring financial services to underserved and unserved populations. Expanding inclusion will lead to rising deposits, which banks can lend to retail and corporate customers, enhancing access to housing and assets for retail customers and to financing that can increase capacity for businesses.

**“With the establishment of the African Continental Free Trade Area (AfCFTA), and liberalization of financial services as one of the priority service sectors, African banks will have the opportunity to tap into a continental market of 1.2 billion consumers”**

## THE RISE OF PAN-AFRICAN BANKS

The financial liberalization policies of the early 1990s greatly increased cross-border financial flows, which became an important component of the African financial landscape. Deregulation has relaxed entry barriers, paving the way for competition in the banking sector. If domestic banks are not structured properly to compete on pricing, they are likely to face tough competition from new pan-African entrants.

With the establishment of the African Continental Free Trade Area (AfCFTA), and liberalization of financial services as one of the priority service sectors, African banks will have the opportunity to tap into a continental market of 1.2 billion consumers.

However, translating these potential gains into reality will require significant regulatory changes at national and subregional levels. As financial markets open, risks of contagion and the transmission of financial instability increase. Striking a healthy balance between safeguarding the economy and allowing financial institutions to conduct their business will depend on a careful weighing of macroprudential measures and an arm's length approach to financial service trade transactions.

# FINANCIAL MARKETS

In other parts of the world, financial markets (also known as “capital markets”) complement banks as another source of financing to the private sector. However, in Africa, financial markets are small and undeveloped, largely dominated by commercial banks, with the exception of South Africa. Some 28 African countries have stock exchanges, in contrast to 1989, when only five had them. Yet, stock exchanges in Africa remain underdeveloped, with small market capitalizations, few listed companies, and less liquidity than exchanges in other emerging economies. The proceeds raised from initial public offerings (IPOs) in Africa between 2014 and 2019 reached \$27.1 billion, less than 1.4 per cent of global IPO gains in that period.

Moreover, private investments, crowdfunding platforms and other alternative methods of financing are gaining momentum. The value of private equity fundraising in Africa increased to \$2.7 billion in 2018, up 10 per cent from 2017. The total transaction value in the global crowdfunding market was \$6.9 billion in 2019 and is expected to grow 14.7 per cent a year between 2019 and 2023. The African bond market is also growing, with a total value of \$500 billion in 2019.

**“private investments, crowdfunding platforms and other alternative methods of financing are gaining momentum”**

The underdevelopment of African financial systems constricts credit for firms, especially for small and medium sized enterprises (SMEs), and produces low investment rates. A well-developed system of financial markets can benefit both private sector constituents that need funding and investors who get more choice and opportunity to provide funding to the private sector and to the government.

Nonetheless, for financial markets to become well developed, many financial sector participants—asset managers, insurance companies, investment banks, sovereign wealth and pension funds, and other institutional investors—have to participate in the monitoring, price regulation and transfer functions.

Capital markets offer a gateway for investors participate in the financial economy and enhance the connection of savers and borrowers outside traditional banks. The growing African middle class will increasingly demand sophisticated financial products and more innovative ways to save and help them build wealth.

# EQUITY MARKETS

Equity markets serve as a fundraising platform for enterprises that require large amounts of capital to expand, and as a sales vehicle to let entrepreneurs lower their stake in the business. Equity markets often provide a business with higher name recognition, which gives access to public debt markets. Furthermore, equity market regulations ensure that businesses report their results prudently, adhering to generally accepted accounting principles.

**“Equity markets serve as a fundraising platform for enterprises that require large amounts of capital to expand”**

Although stock exchanges in Africa are less developed than those in other emerging economies, they present an opportunity for the African financial service sector to grow into the existing space. Growth is anticipated as financial inclusion and financial literacy increase and a growing middle class demands more advanced and innovative savings products.

Stock exchanges currently exist in 28 African countries. The oldest are the Egyptian Exchange, the Johannesburg Stock Exchange, the Casablanca Stock Exchange, the Zimbabwe Stock Exchange and the Nairobi Securities Exchange. There are two regional stock exchanges, in West Africa (Bourse Regionale des Valeurs Mobilières - BRVM) and Central Africa (Bourse des Valeurs Mobilières de l’Afrique Centrale - BVMAC).

In developing and emerging economies, two constraints of stock exchanges are the limited diversity of financial instruments and the limited number of listed stocks. In Africa specifically, main problems encountered are lengthy listing procedures, binding and difficult listing conditions, high transaction costs, lack of knowledge about stock markets and, in some exchanges, lack of transparency.

Moreover, transaction costs and fees are relatively expensive in Africa, mainly due to high brokerage commissions. The cost of trading on African exchanges can exceed 4 per cent of the value of the shares that are traded (as in Uganda and Zimbabwe), making short-term trading very expensive and thus reducing liquidity on exchanges.



# DEBT MARKETS AND THE PRIVATE SECTOR

Debt markets include government bonds and corporate bonds. In 2019, African governments issued over \$200 billion in sovereign bonds (denominated in local or foreign currency), compared with more than \$700 billion issued by China, the largest bond market among emerging markets and the third largest bond market globally. Local currency bonds make up 78 per cent of outstanding debt in Africa, and bond purchasers generally prefer medium-term bonds (maturity averaging 5.1 years).

The growing local currency bond market has increased appetite among local investors (predominantly banks, private self-administered funds and pension funds), currently the majority holders of government securities in Africa. For instance, in South Africa, the biggest bond market on the continent, local investors hold 62 per cent of government bonds.

Although the debt market in Africa is dominated by the sovereign bond market, which accounted for more than 80 per cent all issuances in 2019, a corporate bond market is timidly emerging, with South African companies accounting for more than 40 per cent of corporate bond issuances in 2019.

The corporate bond market has two types of bond quality: high-grade (or investment-grade) debt and high-yield debt. The high-yield bond market affords riskier firms the chance to raise debt financing. Despite the funding potential of bond markets for businesses, the digitalization of bond markets in Africa is in its infancy, and more is needed to harness the advantages of these markets. Mauritius had the highest corporate-debt-to-GDP ratio, 49 per cent, followed by South Africa (38 per cent) and Morocco (38 per cent).

# OTHER OPPORTUNITIES FOR PRIVATE FINANCING

## COMMODITY EXCHANGES

Commodity markets and exchanges offer a marketplace for basic products (mainly from agriculture, mining and oil). They enhance the efficiency of selling and buying commodity products, allowing countries to enhance their trade capabilities, and help farmers access finance and give fund managers a way to provide greater liquidity and participate in price formation.

In Africa, commodity exchanges are small, underdeveloped and unable to meet the growing needs of producers. Although African countries are dominant global producers of many agricultural and natural resource goods, the goods are traded or have their prices quoted on exchanges outside the continent. Therefore, opportunities for price discovery, access to finance, hedging opportunities and market information are limited for African farmers and small businesses in those sectors.

## PRIVATE INVESTMENT MARKETS

Private investments include private equity and venture capital. Private equity funds purchase a majority or controlling stake in a target company, while venture capital funds finance start-ups with high growth potential through a significant but generally non-controlling stake.

In 2019, \$106 billion in private capital was raised worldwide, but only \$1.1 billion in Africa. The number of deals in Africa increased from 158 in 2014 to match its 2013 historic high—186—in 2018.

# LONG-TERM FINANCING FOR SUSTAINABLE DEVELOPMENT

**“mobilize domestic resources and private sources, ensuring more efficient international development financing, and leveraging climate financing will help bridge the substantial development financing gaps”**

Africa seeks to accelerate economic growth to meet national development objectives in line with the Sustainable Development Goals (SDGs) and the African Union’s Agenda 2063. The cost to achieve the SDGs by 2030 in Africa is estimated at about \$1.3 trillion a year, according to the United Nations. This amount could increase to \$19.5 trillion as a result of population growth, which is projected to be 43 per cent over 2015–2030.

Another challenge is to deliver urgently needed climate change adaptation—at the same time that infrastructure expands while urban environments grow. An estimated \$18–\$30 billion a year will be needed over the next two decades for climate action and climate change adaptation in Africa, with nearly \$1 trillion worth of investments and projects ready to be financed.

Encouraging governments to mobilize domestic resources and private sources, ensuring more efficient international development financing, and leveraging climate financing will help bridge the substantial development financing gaps.

## THE GREEN BOND MARKET

The African green bond market emerged in 2010. South Africa and the African Development Bank (AfDB) took the lead, followed by Morocco, Nigeria and Seychelles. AfDB made its debut in 2013 with a AAA investment-grade green bond issuance of \$500 million. Between 2012 and 2018, cumulative issuances of green bonds by South Africa reached \$1.4 billion; Morocco, \$356 million; Nigeria, \$30 million and Seychelles, \$15 million.

Green bond issuances in Africa are limited in currency and tenor. Globally more than 90 per cent of green bonds are issued in hard currency, with the US dollar and euro dominating. Only a handful have been in the currencies of low-income or lower middle-income countries. In Africa, four green bonds were issued in South African rands, and others more recently in Moroccan dirhams and Nigerian naira.

## DEEPENING AFRICA'S PARTICIPATION IN SUSTAINABILITY FINANCING

Efforts at raising capital and financial investments have yet to accelerate the development of environment-friendly socially responsible and climate-resilient economies in Africa. First, Africa's engagement in bond capital markets is fairly weak—both in developing domestic markets and in issuing bonds in international capital markets. Second, the needs of the region, particularly for green infrastructure that requires long-term finance, are mismatched with the current average tenor of green bonds.

These factors put Africa in an unattractive position compared with developing countries in Asia and Latin America, for example, where investment risks are lower, including foreign exchange, political stability and macroeconomic stability. The volatility of some African currencies has hardened this aversion.

These issues have resulted in private non-foreign direct investment cross-border capital flows to Africa being dominated by high risk-high return investors, such as private equity funds, and investors with a longer-term investment horizon, such as sovereign wealth funds or non-traditional bilateral investors (for instance, China). Sovereign wealth funds and Chinese investors have made major investments in infrastructure and industrialization, supporting economic growth.

Deepening Africa's participation in sustainable bonds will then require closing the gap in investor appetite for African green and social assets, developing and enhancing domestic frameworks and engaging African issuers in capital markets.

**“Deepening Africa’s participation in sustainable bonds will then require closing the gap in investor appetite for African green and social assets, developing and enhancing domestic frameworks and engaging African issuers in capital markets”**

# INFRASTRUCTURE FINANCING

Overall, African governments accounted for 37 per cent of infrastructure investments in Africa in 2018, while private financing accounted for only 11 per cent. However, low government revenues have limited the success of this model, helping explain Africa's low investment in infrastructure.

Africa's infrastructure needs are vast - according to the 2018 *African Economic Outlook*, the continent's infrastructure needs amount to \$130-\$170 billion a year until 2025, with a yearly financing gap of \$67.6-\$107.5 billion. Non-traditional donors have significantly increased their infrastructure investment in Africa - China, for example, accounts for more than 25 per cent of all infrastructure funding in the continent.

**“the continent's infrastructure needs amount to \$130-\$170 billion a year until 2025, with a yearly financing gap of \$67.6-\$107.5 billion”**

## PRIVATE INVESTMENT IN INFRASTRUCTURE

**“Energy and ICT sectors represented more than 90 per cent of private sector investment . . . due to the heavy protection provided by guarantees from the host government or from multilaterals”**

Energy and ICT sectors represented more than 90 per cent of private sector investment - such concentration is partly due to the heavy protection provided by guarantees from the host government or from multilaterals. Those sectors can generate enough revenue through user fees to help service debt and provide a return on investment, which attracts private investors and private debt providers in Africa.

Except for the transport sector, where governments had the largest share, the vast majority of infrastructure funding in Africa during 2014-2018 came from international lenders and donors. Overall, private sector participation in infrastructure projects between 2013 and 2018 was marginal, providing only 7.5 per cent of funds. Nevertheless, private investment is far more meaningful in Southern Africa, accounting for 24 per cent of private infrastructure investment in Africa. For the other subregions, private sector investment represents a small proportion of total investment. In East and West Africa it is around 9 per cent, and in Central Africa around 6 per cent.

## STRENGTHENING PUBLIC-PRIVATE PARTNERSHIPS (PPP)

Only a few African countries have embarked on PPPs to tap private capital for financing infrastructure – Kenya, Nigeria, Uganda and South Africa account for almost 50 per cent. In both India and China, for example, policies and measures have created enabling environments for PPPs and expanded the pool of private developers and investors with experience and knowledge of the infrastructure market. If African countries imitate these models and have required policies and capabilities in place, they will gain the opportunity to attract increased capital from private investors and lenders, thus bridging the infrastructure gap.

## DEVELOPMENT BANKS

African regional and national development banks are pivotal in supporting infrastructure finance, and their growth will require deepening local and regional capital markets in Africa, as well as increasing support from the international community.

Countries viewed as having a stable macroeconomic environment with predictable infrastructure regulation have attracted private financing in Africa, as their risks are seen as lower. However, where misrule, project risk or macroeconomic instability is high enough to discourage private investors, multilateral or national development banks often step in. They may provide financial guarantees and help develop alternative regulatory frameworks or provide supplementary financing, which can create a halo effect that encourages private actors to invest.

Appropriate support mechanisms, such as project preparation, are needed to attract private investment, and some African development banks already play an important role in that. The New Partnership for African Development Infrastructure Project Preparation Facility—a consortium led by the African Development Bank with financial donors and major infrastructure consultancy firms—is a notable regional initiative. It has effectively identified and prioritized regional infrastructure projects needing more than \$6 billion in investment in the energy, transport, ICT and transboundary water sectors.

**“However, pension investments in Africa have been focused mainly on government securities, real estate and bank deposits, with smaller proportions in equities and corporate bonds”**

## INSTITUTIONAL INVESTORS

African pension funds have been expanding in recent years, though from a low base, thanks to the rise of the middle class and regulatory reforms that bring more people into the social security net. Pension funds in the six largest African markets could grow to an estimated \$7.3 trillion by 2050 (from \$800 billion in 2014). At that growth rate, if they invested about 20 per cent of their annual assets in infrastructure, they would add \$77 billion to help finance the continent’s infrastructure deficit. However, pension investments in Africa have been focused mainly on government securities, real estate and bank deposits, with smaller proportions in equities and corporate bonds.

Pension and sovereign wealth funds in Africa could play a catalytic role in mobilizing capital for infrastructure by dedicating a share of their assets specifically for that. Yet in Africa many constraints prevent the transformation of pension and sovereign funds assets into infrastructure investments.

African development banks, in combination with other actors, can increasingly work to finance infrastructure by leveraging private resources. Moreover, smaller economies, of which there are many in Africa, could create or deepen and enlarge regional institutions –development banks, institutional investors and capital markets.

National governments have an important role, not just in providing resources to capitalize development banks, but also in providing guarantees for development bank loans, which increases their credit rating. Such funding and guarantees can attract private finance to infrastructure projects that might not otherwise have been sufficiently attractive, especially in certain subsectors and countries.

# LEVERAGING FINANCIAL TECHNOLOGY

Financial technology (fintech) refers to a broad range of technological innovations that enhance or change the way financial services are provided. The innovations typically include crowdfunding, insurance, budgeting software, blockchain (and cryptocurrencies), electronic payments and transfers, and robo-advisors and trading applications.

The global fintech revolution is expected to triple access to financial services in Africa, creating a new market of 350 million customers. In Africa, fintech is reducing costs and risks, as well as extending service to unbanked populations. Africa's financing gap has provided a unique opportunity for fintech development to furnish alternative finance sources and investment mechanisms, particularly for start-ups and micro, small and medium-size enterprises.

Fintech seeks to improve speed, security and operating costs to democratize financial markets and reduce information asymmetries in financial markets.

**“Africa’s financing gap has provided a unique opportunity for fintech development to furnish alternative finance sources and investment mechanisms”**

## CROWDFUNDING, CROWDINVESTING AND CROWDLENDING IN AFRICA

Two key fintech activities, crowdfunding and crowdinvesting, grew over 2017–2019 and are projected to keep growing during 2020–2023. The amount of capital raised in Africa using crowdfunding platforms grew at an average annual rate of 38 per cent from 2013 to 2015, 118 per cent from 2015 to 2016, is estimated to have doubled from 2017 to 2020 and is projected to grow 13.6 per cent a year from 2020 to 2023.

However the control of fraudulent activities is a major challenge of this market. Crowd-based financing for business activities benefits markets only if borrowers and investors trust one another. Therefore, establishing binding rules and guidelines is essential to securing that trust.

Crowdfunding is currently more prominent than crowdinvesting in Africa. Crowdfunding raises funds by asking a large number of people to fund a project through an online platform. Donation-based and reward-based crowdfunding are non-investment-based funding because no financial return is expected. Out of the 57 crowdfunding platforms operating in Africa, 21 are based in South Africa and 9 in Nigeria. Total online alternative finance volume in Africa rose to \$209 million in 2018, with domestic sources accounting for 24 per cent of all alternative finance generated in Africa.



The fintech market also includes bank-independent loan allocation for Micro, small and medium-size enterprises (crowdlending) and for personal loans to freelancers and private borrowers (marketplace lending, also known as peer-to-peer lending) through private or institutional investors using online platforms, such as OnDeck, LendingClub and Prosper. In Africa, crowdlending for businesses rose from \$278 million in 2017 to \$417 million in 2019.

## BLOCKCHAIN AND CRYPTOCURRENCY

Among the most prominent fintech innovations is blockchain, which has paved the way for cryptocurrencies. Blockchain is essentially a public ledger that continually adds transactions that are verified by the network participants in the ledger. The public nature of blockchain means that it is decentralized and thus data do not reside in a single stored location that is vulnerable to hacking. Many traditional financial institutions are contemplating the use of blockchain technology to bolster their processes and increase efficiency, but banks have struggled to take full advantage of it, since its benefits are maximized only when there are enough users to create a network effect.

## ELECTRONIC PAYMENTS AND E-COMMERCE

Among fintech innovations, mobile money and digital payments are areas where Africa has made significant inroads. Almost half of total global mobile money accounts are in Africa, which had 396 million registered users and 1.4 million agents serving them in 2018. In 2017, Africa had 21 million online shoppers and business-to-consumer e-commerce was worth \$5.7 billion, or 0.5 per cent of GDP - value which is still much lower than the global average of 4 per cent.

**“Among fintech innovations, mobile money and digital payments are areas where Africa has made significant inroads”**

## INSURANCE

Fintech innovations are enabling insurance companies to use data analytics and artificial intelligence to underwrite insurance products and process claims, for more seamless engagement. Africa can deepen and broaden financial markets by supporting the digital payment systems and platforms that underlie electronic payments and transfers through two important continental integration initiatives: the Digital Transformation Strategy and the AfCFTA. Both initiatives promise to streamline policies and regulations on critical aspects of digital payment systems and platforms and to further open markets to e-commerce, the reason for digital electronic payments and transfers.

# FINANCIAL REGULATION TO SUPPORT PRIVATE SECTOR DEVELOPMENT

Africa needs to rethink its financial services regulation so that innovation is fully functional, the environment enables innovation, transparency is enhanced, and financing for private sector development is delivered. Any recommendations on Africa must take into account the narrow resources African countries provide or are committed to providing for regulation, which limit its technical and human capacity.

## IMPROVING THE MANAGEMENT OF MACROECONOMIC SHOCKS

Bank lending tends to concentrate on firms and households in a small number of sectors (including agriculture and natural resources), so great macroeconomic risks are associated with lending portfolios vulnerable to commodity risk.

Commodity downturns can easily lead to systemic financial risks and regulations to avoid the spread of financial instability should include minimal capital requirements, early warning systems and central bank mechanisms that monitor and oversee financial markets.

A healthy balance between safeguarding the economy from financial contagion and allowing financial operators to conduct their business will require carefully tuning and sequencing macroprudential measures.

## REGULATION OF DIGITAL FINANCIAL PLATFORMS

Mobile payment systems have expanded across Africa on the back of mobile telephone penetration. Given their wide reach expanding financial inclusion, their regulation is urgently required for both customer protection and monetary stability. Regulators, by ensuring a level playing field for providers, will encourage the emergence of service platforms as major parts of Africa's financial architecture.

Regulation must ensure that customers can redeem mobile units for cash on demand in order to build confidence and protect customers using mobile money platforms. Although mobile money units are a store of value for many households, the users of these platforms earn no returns on their savings. Regulators should seek to reclassify mobile units as stores of value on which interest can be earned.

Regulators evaluating the introduction or extension of deposit insurance schemes should determine whether or not to extend these schemes to mobile money customers across Africa as a direct or indirect safety net. In some countries, public policymakers (including central banks) might resist to amend banking and financial services legislation – but that would be a mistake.

African institutions can work on detailed country studies of aspects of regulation to determine what works best in each country’s context and subregion, given the different stages of capital market development across the continent.

Improved governance and disclosure standards and the right incentives should amplify the financial service sector’s role in allocating resources across Africa. Using regulation in this way will lay the foundation for further innovative financing of private sector development.

African policymakers’ and regulators’ experience with the 2008–2009 financial crisis and use of various measures to cushion its impact give them an advantage in rapidly responding to the COVID-19 crisis. They can put in place emergency policy measures to manage financial stability and create a sound pathway towards economic recovery.

But at the time of writing this report, the end of the COVID-19 pandemic is uncertain, so it is premature to claim the success of these policy measures in stabilizing the financial system and enabling efficient and sound economic recovery. Thus it remains critical to continue increasing African government capacity, strengthening financial sector resilience and supporting all financial innovations that could help mitigate the negative impact of the crisis.

# KEY RECOMMENDATIONS

**Regulating the banking sector:** Although innovative finance receives a lot of attention in the report, the banking sector remains the most important source of capital for loans and funding to the private sector in most African countries, which need to regulate it. Moreover, in order to develop the private sector, governments need to strengthen and make the regulation of banks and other sources of capital more transparent.

**Creating financial stability through effective policies:** The development of well-functioning financial systems requires not only sound regulations but also supervisory mechanisms for banking, capital markets and other financial services. Policymakers must continue to improve the regulation of the financial service sector and support innovative financing in the private sector.

**Amending and updating financial sector legislation and regulatory policies:** The report recommends that public policymakers (including central banks) consider amending banking and financial service legislation to enable innovative private sector funding. The process could lead to lobbying, opening for debate a range of banking and financial service issues. African institutions such as the Association of African Central Banks and UN Economic Commission for Africa should review existing financial regulatory policies in Africa further, identifying what works best in each subregion and country, given the different stages of capital market development across the continent.

**Promoting innovative private sector financing:** African governments must explore the full range of policy measures to stabilize the financial system and enable continued funding of the private sector. Critical activities include continuing to increase African government capacity, strengthen financial sector resilience and support all financial innovations that could mitigate the impact of the global COVID-19 pandemic on African economies.

**Embracing the Digital Transformation Strategy and the African Continental Free Trade Area:** The current global pandemic is expected to expand the use of fintech, including mobile money. Africa can deepen and broaden financial markets by supporting the digital payment systems and platforms that underlie electronic payments and transfers through two important continental integration initiatives: the Digital Transformation Strategy and the AfCFTA. These initiatives promise to streamline policies and regulations on critical aspects of digital payment systems and platforms across Africa.



CHAPTER 1

# RECENT ECONOMIC AND SOCIAL DEVELOPMENTS IN AFRICA



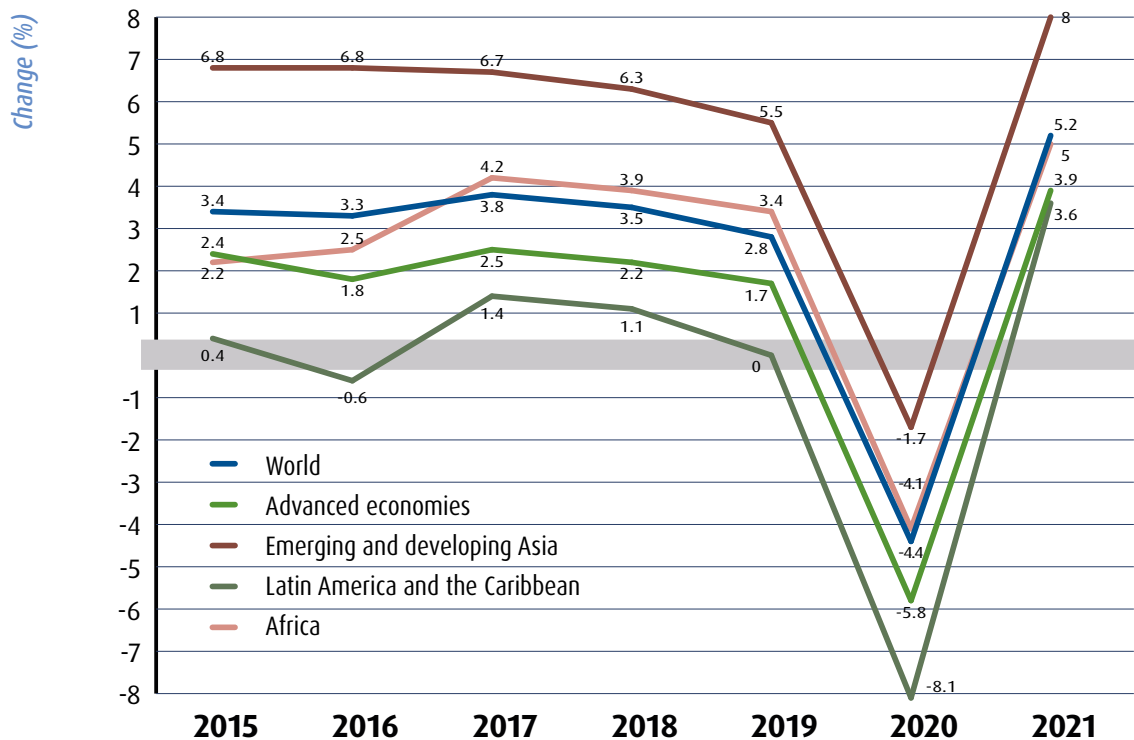
# RECENT GLOBAL ECONOMIC PERFORMANCE AND ITS IMPLICATIONS FOR AFRICA

Global GDP growth slowed to 2.8 per cent in 2019 from 3.5 per cent in 2018 (FIGURE 1.1). Trade also slowed in 2019, weighed down by the lower economic growth and by trade tensions. The value of global merchandise trade fell by 3 per cent to \$18.9 trillion. By contrast, global commercial services trade rose 2 per cent to \$6.0 trillion, though the pace of growth was slower than in 2018 (WTO, 2020). GDP growth in Asia<sup>1</sup> stabilized at almost 6 per cent a year during 2015–2018 and slowed

to 5.5 per cent in 2019. Lower growth in Asia was attributable to a decline in fixed investments and exports (IMF, 2019).

In 2020, global GDP growth is projected to contract to -4.4 per cent (see FIGURE 1.1). The outbreak and spread of COVID-19 have led to containment measures such as lockdowns and physical distancing disrupting normal economic activity around the world. World trade is expected to fall by between 13 per cent and 32 per cent in 2020, with services

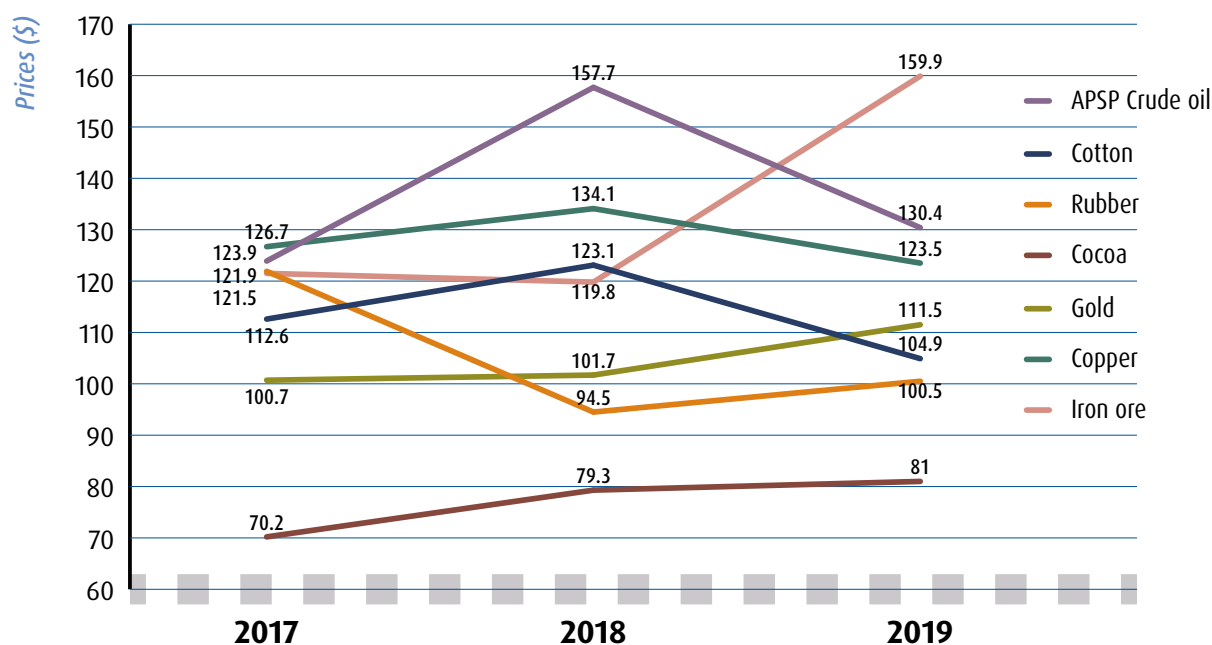
FIGURE 1.1 GLOBAL ECONOMIC GROWTH, 2015–2021



Note: The data reported for Africa and Asia are the average calculated from country raw data.

Source: Based International Monetary Fund World Economic Outlook Database data, October 2020.

**FIGURE 1.2** SELECT PRIMARY COMMODITY PRICES, 2017–2019



Source: ECA calculation based on data from IMF (2020).

trade being the most directly affected component due to transport and travel restrictions and the closure of many retail and hospitality enterprises. But some services may benefit from the crisis—for instance information technology services, for which demand has increased as people work from home and socialize remotely (WTO, 2020). Discretionary consumer spending has shifted from non-essential products such as clothes towards basic food and pharmaceutical products. Offline spending on apparel in the European Union has declined by an estimated 30–40 per cent, and in highly affected regions by as much as 80 per cent (ECA, 2020). GDP growth in Asia is expected to decelerate further in 2020 to 1.0 per cent, driven by global policy uncertainty and slower growth in China due to trade tensions, a decline in the working age population and the economic impact of the COVID-19 global pandemic.

Global GDP is projected to rebound to 5.2 per cent growth in 2021 (see **FIGURE 1.1**). Although a global trade recovery is projected for 2021, the outcome wholly depends on the duration of the COVID-19 outbreak and the effectiveness of policy responses to it (WTO, 2020). In Asia growth is forecast to

rebound in 2021 to 8.5 per cent following an expected resumption of political stability, projected high rates of savings and investment, and a shift from low-productivity agriculture towards manufacturing and services in some of the region's emerging economies (EIU, 2020).

Africa, the second fastest growing region in the world, grew at an estimated 3.4 per cent in 2019. In a best-case scenario simulation run by ECA, its average growth in 2020 will fall to 1.8 per cent, directly due to the economic impact of COVID-19. According to the International Monetary Fund (IMF) projections, Africa's economic growth is expected to contract to -4.1 per cent in 2020 (**FIGURE 1.1**). Growth in Africa is projected to rebound to 5.0 per cent in 2021, supported by the effective implementation of COVID-19 response measures and global economic recovery. In 2019, an increase in oil prices to \$68.30 in 2018 from \$52.80 in 2017 (**FIGURE 1.2**) accelerated economic growth in the top three oil-producing African countries: Nigeria (from 1.9 per cent in 2018 to 2.3 per cent in 2019), Angola (from -1.2 per cent in 2018 to -0.3 per cent in 2019) and the Republic of Congo (from 1.6 per cent in 2018 to 4 per cent in 2019).



Some countries reported economic contractions in 2019 despite their natural resource endowments, such as Equatorial Guinea (-4.6 per cent), Libya (-19 per cent), Sudan (-2.6 per cent) and Zimbabwe (-7.1 per cent). The economy of Equatorial Guinea is weakly diversified, and its oil production is decreasing due to reduced yields at working oil wells; economic activity is expected to continue contracting in the coming years. In Libya insecurity makes the environment highly uncertain, reducing oil production. South Africa, another major African economy, had low growth of 0.6 per cent in 2019 and is expected to face a contraction in 2020 due to COVID-19. In South Africa manufacturing and mining output shrank in 2019 due partially to labour strikes, while growth in retail sales trended downwards.

**“The globally coordinated response to COVID-19 provides a template for climate response in Africa”**

Africa benefitted in 2019 from slight increases in some key primary commodity prices. But as the severity of COVID-19 increased in February and March 2020, the commodity prices plummeted for more than two-thirds of African exports. The price of petroleum, which accounts for 40 per cent of African exports and 7.4 per cent of GDP in Africa, crashed by more than 50 per cent to its lowest level since 2003. Metal prices fell 20 per cent from end-December 2019 values, while cotton fell 26 per cent. The Economic Commission for Africa (ECA) projects a minimum \$65 billion loss to fuel revenue for 2020. The exception is gold, which rose up by 5 per cent in March 2020. Tea and coffee prices have declined due to falling demand, particularly for away-from-home consumption in major import markets such as the United States and the European Union. And cocoa prices in April 2020 fell 6 per cent from the start of the year (ECA, 2020).

Current accounts in 2019 were negative for most countries of the continent. The average current account deficit was estimated at 4 per cent of GDP in 2019, driven by increased domestic demand for investment and consumption. Total investment in Africa increased 10 per cent on average in 2019 and is expected to drop by 5 per cent in 2020.

The spread of COVID-19 in China and the resulting shut-downs of factories and other economic activities there further disrupted Africa's global trade value chains in 2020. A further challenge has been the shift of the COVID-19 epicentre from China—which accounts for 11 per cent of African exports and 16 per cent of African imports—to Europe—which accounts for 33 per cent of African exports and 32 per cent of African imports (ECA, 2020). In 2018 the value of China-Africa trade reached \$185 billion, up from \$155 billion in 2017 (UN Comtrade, 2020). Even if the spread of the coronavirus is suppressed in Africa, its economic damage is unavoidable (ECA, 2020). With China the world's biggest oil importer, the International Energy Agency (IEA) projected oil demand to fall by 435,000 barrels year-on-year in the first quarter of 2020 because of the coronavirus's impact in China.

COVID-19 has had a major effect on tourism in Africa, especially in the small island states. For instance, Seychelles reported a 38 per cent decline in annual economic output linked to the deterioration of its tourism industry. Tourism flows declined even before lockdowns and travel restrictions were imposed in American, Chinese and European cities. In 2018, 95 per cent of tourists in Africa were from outside the continent.

Air travel restrictions and the reduction of air travel routes has affected major African carriers. The International Air Transport Authority (IATA) projects a \$4 billion drop in revenue for African airlines. The effect is aggravated for airlines that were weak before the pandemic. They will likely end up filing for bankruptcy or seeking bailouts (ECA, 2020).

The health systems of most countries in Africa are weaker than those in other regions of the world. The continent depends on imported medicinal and pharmaceutical products. In 2020, spending on health will increase as governments set aside funds to sustain their health systems and absorb costs related to the COVID-19 lockdowns. In a best-case scenario (with suppression of coronavirus spread and intense early physical distancing measures) \$44 billion would be required for testing, personal protective equipment and treatment of COVID-19 patients requiring hospitalization and intensive care across Africa (ECA, 2020). Due to the resources being redirected to COVID-19, Africa's existing health challenges will face spill-over costs, as happened in the Ebola crisis. Thus, non-COVID-19 health issues should be kept in view.

Developed countries have injected trillions of dollars into COVID-19 health, social safety net and economic stimulus response. For example, the United States adopted a \$2.2 trillion dollar stimulus package for COVID-19 response (UNCTAD, 2020). Africa lacks the capacity to react similarly due to high fiscal deficits, costs of borrowing and debt-to-GDP levels and to the depreciation of many African currencies against the euro and the dollar. More than 50 per cent of African countries recorded fiscal deficits above 3 per cent in 2019. Some 22 African countries had debt-to-GDP ratios above the African average of 61 per cent—breaching the 60 per cent debt-to-GDP threshold defined by the African Monetary Co-operation Program (AMCP) as uncomfortable, especially for more advanced economies with larger debt-carrying capacity, such as South Africa. The 2019 spending increase resulted from development financing needs, especially for investment in infrastructure (ECA, 2020).

Climate change is another global condition that could affect economic growth in Africa. Increasing seasonal variability, an increasing frequency and intensity of droughts and floods, and shifting habitats and agro-ecological zones due to climate change can cause food insecurity, lower trade balances, raise inflation pressure (due to reduced supply) and raise fiscal imbalances (due to reduced revenues and increased investment in climate change adaptation). For instance, cyclone Idai, which hit Mozambique in March–April 2019, weakened the economy, caused \$700 million - \$1 billion in damage and resulted in 1,000 lives lost.

The globally coordinated response to COVID-19 provides a template for climate response in Africa. Since Africa's fiscal space has been further constrained by COVID-19, additional assistance such as debt relief and innovations in mobilizing private sector finance are required for African countries to fulfil their nationally determined contributions to climate action (ECA, 2020)

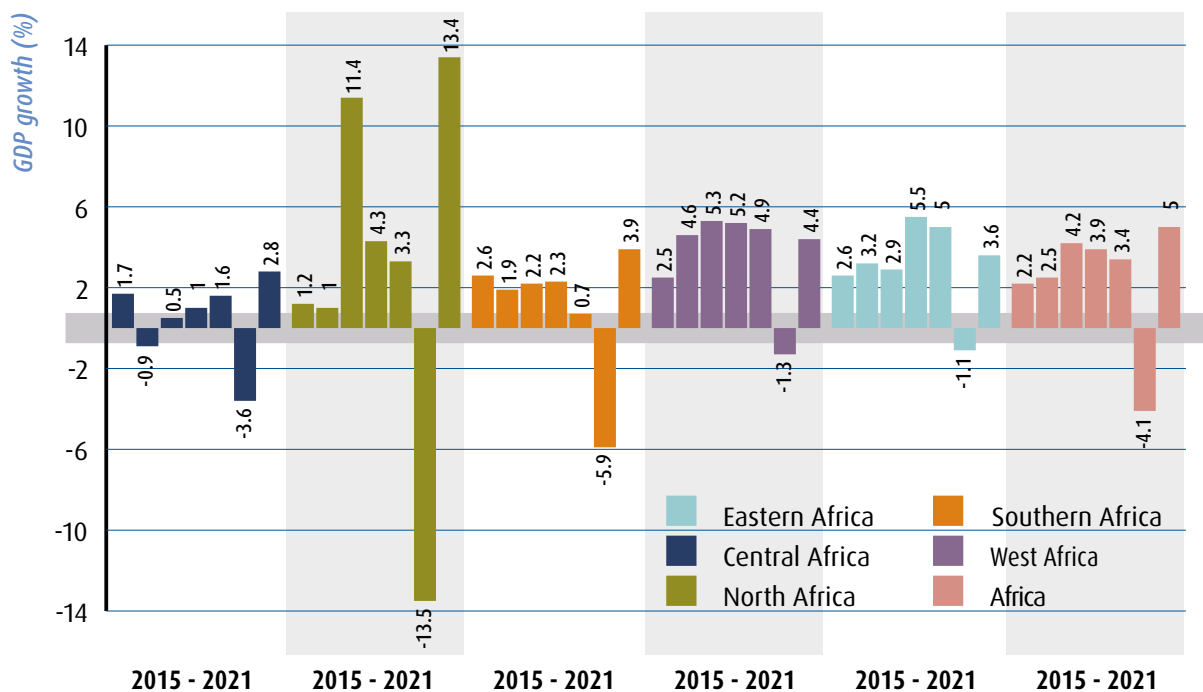
# RECENT ECONOMIC DEVELOPMENTS IN AFRICA

African economies are highly heterogeneous,<sup>2</sup> though some commonalities can be established on selected development indicators. Growth in North Africa is highly volatile, sparked by the changing political situation of Libya (FIGURE 1.3). For example, economic growth in Libya was negative from 2013 to 2016, turned positive from 2017 to 2019 and is expected to be negative (-66.7 per cent) in 2020. The 2011 collapse of the Libyan government and the incapacity of the public sector impedes effective and efficient governance. The fragile country needs more stable institutions to address pressing economic and social issues. Aside from Libya, growth in North Africa in 2019 was underpinned by growth in Egypt (5.6 per cent), Mauritania (5.9 per cent) and Morocco (2.2 per cent). Growth in Algeria declined from 1.4 per cent in 2018 to 0.8 per cent

in 2019. Since 2018, Sudan experienced an economic slump (-2.3 per cent in 2018 and -2.5 per cent in 2019). Its exports fell by 3 per cent in 2019, and its imports by 7 per cent. Private sector consumption in Sudan also declined (-2.8 per cent in 2018)—consumption was the main driver of economic growth in North Africa as of 2019.

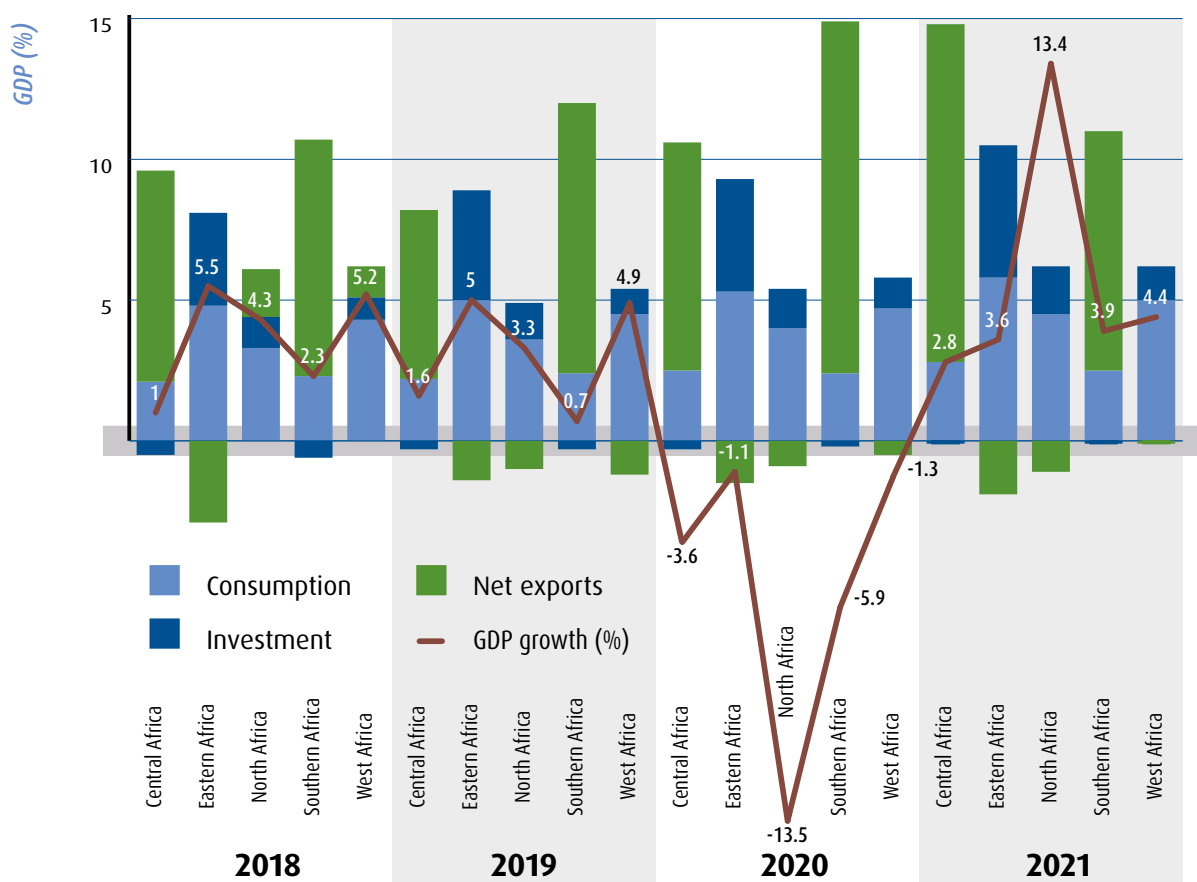
Growth in West Africa decreased slightly from 5.2 per cent in 2018 to 4.9 per cent in 2019 and is projected to drop to -1.3 per cent in 2020 but rebound by 5.7 percentage points to 4.4 per cent in 2021. The fast-growing economies of the region—Benin, Burkina Faso, Côte d’Ivoire, the Gambia, Ghana, Guinea, Niger and Senegal—recorded growth above 6 per cent in 2018 and above 5 per cent in 2019. Economic growth in

**FIGURE 1.3** ECONOMIC GROWTH IN AFRICA BY REGIONAL GROUP, 2015–2021



Source: Based on data from IMF (October 2020).

**FIGURE 1.4** COMPONENTS OF ECONOMIC GROWTH IN AFRICA, 2018–2021



**Source:** Based on data from World Development Indicators (October 2020). Data for 2020–2021 are projected.

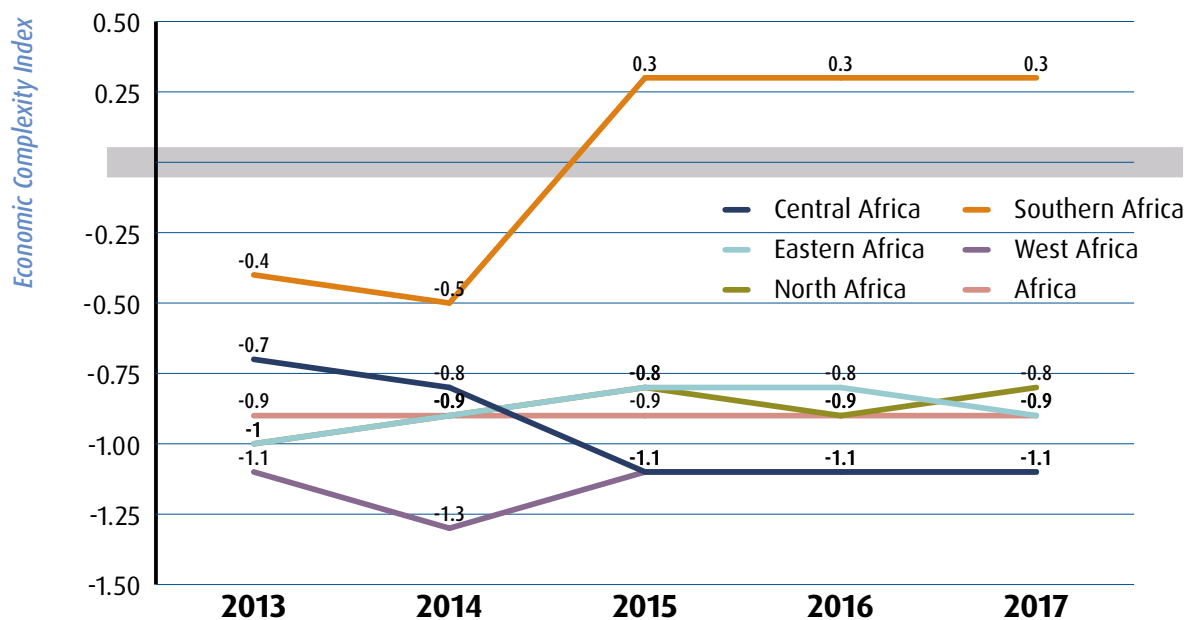
2019 in Nigeria (2.2 per cent) and Liberia (–2.5 per cent) were lower than in other countries of the region. Nigeria is recovering slowly from the negative commodity price shock in 2016, and the economy is projected to contract by 4.3 per cent in 2020. In West Africa, growth is driven by final consumption (households and government) and investment (FIGURE 1.4). Most countries had an investment-to-GDP ratio greater than 25 per cent in 2018, with investment oriented towards infrastructure, such as roads, port, and airports.

East Africa was the fastest growing region in 2019, with average growth of 5.0 per cent, a decline from 5.5 per cent in 2018 and is expected to further decline to -1.1 per cent in 2020. All East African countries grew at about the same rate in 2019 as in 2018. The growth rate in this region is also supported by consumption and investment.

Central Africa’s economic growth rose from 1.0 per cent in 2018 to 1.6 per cent in 2019 but is expected to decline to -3.6 per cent in 2020. Growth was estimated to be negative in 2019 in Equatorial Guinea (–6.1 per cent) and the Republic of the Congo (–0.6 per cent). With GDP growth of 4.4 per cent in 2019, the Democratic Republic of the Congo is leading the region. Growth in Central Africa is supported by consumption and trade, so, the region is relatively exposed to external adverse shocks.

The growth rate in the Southern region slowed from 2.3 per cent in 2018 to 0.7 per cent in 2019 and is expected to decline further to -5.9 per cent in 2020. Economic growth is expected to slow in 2020 in most countries of this region, but average growth is projected to improve in 2021 to 3.9 per cent. Exports

**FIGURE 1.5** EVOLUTION OF THE ECONOMIC COMPLEXITY INDEX IN AFRICA, BY SUBREGION, 2013–2017



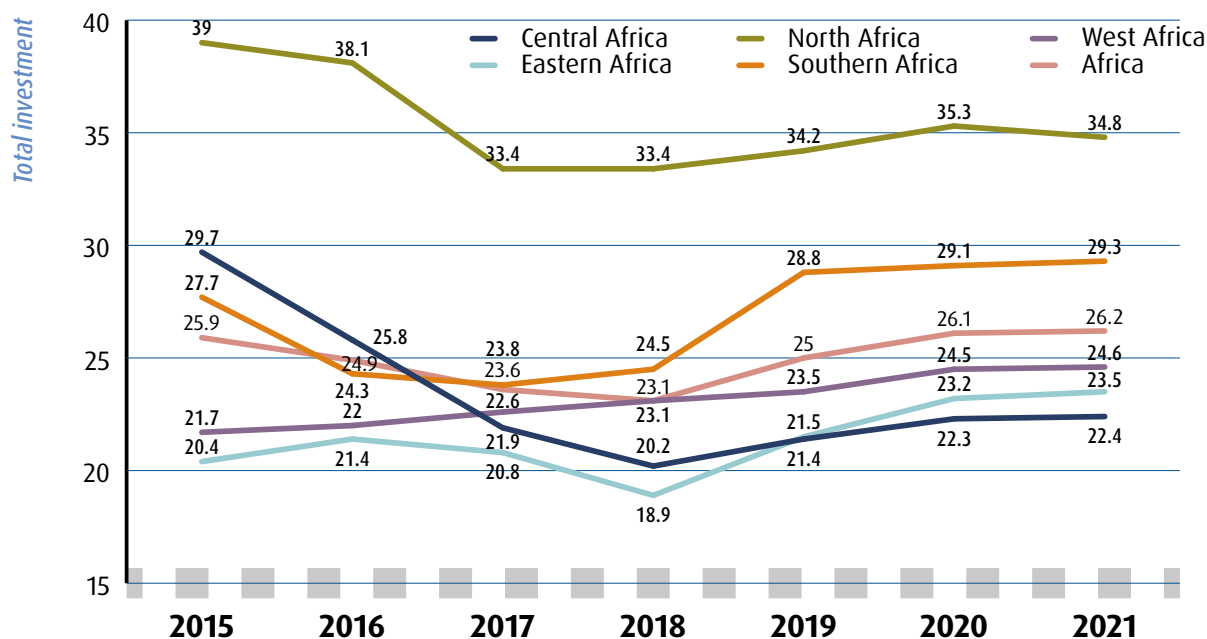
Source: Hausmann et al. (2019).

are the main driver of economic growth in Southern Africa, followed by domestic consumption. The projected growth relies on increased external demand, mainly from India and China, and increased commodity prices.

Despite Africa's growth, many economies remain unsophisticated or undiversified (FIGURE 1.5). The lack of economic sophistication is explained by low levels of innovation, limited productive capabilities, low investment and poor quality of education. The Economic Complexity Index (ECI) is only positive in Southern Africa after 2015.<sup>3</sup> Hidalgo and Hausmann (2009) suggest that countries tend to converge to an income level dictated by the complexity of their productive structures, meaning that development efforts should focus on generating conditions that would allow complexity to emerge and so to generate sustained growth and prosperity. In contrast, African economies on their current path could not guarantee sustainable growth in the long run to eradicate poverty or achieve the other Sustainable Development Goals (SDGs). Building capabilities will require investments in human and physical capital. But Africa has a lower investment rate

“Investment is key to build infrastructure and foster innovation”

**FIGURE 1.6** TOTAL INVESTMENT, BY SUBREGION, 2015–2021



**Note:** Investment or gross capital formation is measured by the total value of the gross fixed capital formation and changes in inventories and acquisitions less disposals of valuables for a unit or sector.

**Source:** ECA based on data from IMF.

(24 per cent of GDP) than China (40 per cent) or South Asia (28 per cent). Although the investment rate is higher in North Africa, it has been decreasing—from 39 per cent in 2015 to 34 per cent in 2019. Decreases were also observed in other regions, except West Africa, from 2015 to 2018 (FIGURE 1.6).

Investment is key to build infrastructure and foster innovation. South Korea, for instance, to reach its current level of innovation, has kept investment above 30 per cent of GDP on average since 1980. The evidence from China and India over the past decade is similar. The recent Continental Free Trade Agreement can play a critical role in identifying appropriate markets, improving the business environment, attracting investment and addressing key issues such as skills, infrastructure and competition.

## PROSPECTS FOR THE AfCFTA FOR TRADE AND REGIONAL INTEGRATION

The African Continental Free Trade Area (AfCFTA), under an agreement signed in March 2018 by 44 African countries, creates a single continental market and a customs union for capital and business travellers. It aims to unlock the potential for increased industrial capacity and provide major growth opportunities for African economies. Of 55 African Union (AU) member states, 54 had signed the agreement by 7 July 2019. The AfCFTA's scope goes beyond that of traditional free trade areas, since it will include free trade in services, investments, intellectual property rights, competition policies and even e-commerce. If successful, the agreement will create a single African market of over 1.2 billion consumers with a total GDP above \$ 2.5 trillion.<sup>4</sup>

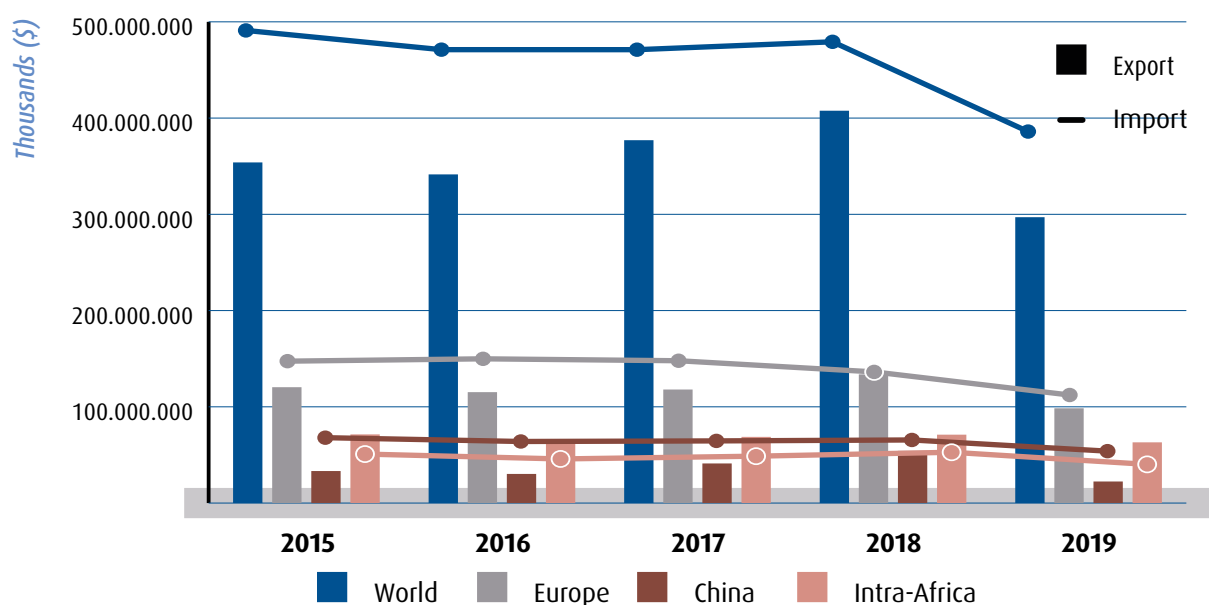
The agreement establishing the AfCFTA entered into force on 30 May 2019 for the 24 countries that had deposited their instruments of ratification. Five more countries deposited instruments of ratification during the 12th Extraordinary Session of the Assembly of the AU on the AfCFTA in Niamey, Niger, on 7 July 2019, which marked the launch of the operational phase of the AfCFTA agreement. Cameroon officially approved ratification on 31 October 2019, and Angola on 28 April 2020, and the deposit of their instruments of ratification is pending.

The AfCFTA aims to accelerate continental integration and increase intra-African trade. It is expected to increase intra-African trade by 15 to 25 per cent (or \$36–43 billion) by 2040 (ECA, 2018).<sup>5</sup> The cumulative effect could boost Africa’s GDP by up to \$44 billion. Once trade barriers are removed and services trade is further liberalized, the eventual benefits could be twice the aforementioned amounts.<sup>6</sup> In 2019, intra-African exports made up 20 per cent of total African exports, and intra-African imports were estimated at 12 per cent of total African imports (FIGURE 1.7). While intra-African trade is improving, its rate remains low compared with intra-regional trade in Asia, Europe or North America.

Implementation of the AfCFTA is expected to unlock manufacturing potential and facilitate industrialization, driving jobs and sustainable growth (Signé, 2018). For example, African countries are expected to use the AfCFTA over the long term to create regional value chains so Africa can better serve its own health market, estimated at \$259 billion annually (ECA, 2020). The private sector, as the engine of growth, will catalyse investment in infrastructure and industrialization and so contribute crucially to implementing the AfCFTA. The private sector can generate productivity and enhance the participation of households and business firms in economic activity, driving economic growth and prosperity.

The private sector also plays a key role generating government revenue, contributing more than 80 per cent of government revenue in low-income and middle-income countries through company taxes, resource rents and income taxes.<sup>7</sup> In Southern Africa tax revenue was 27 per cent of GDP in 2017 and in North Africa 22 per cent. The proportions are much smaller in Central Africa (9 per cent) and East Africa (14 per cent).<sup>8</sup>

**FIGURE 1.7** TOTAL MERCHANDISE TRADE IN AFRICA, 2017–2019



**Note:** Based on data from UNCTADStat.



# SOCIOECONOMIC DEVELOPMENT AND IMPLICATIONS

Although Africa is the world's second fastest growing region, poverty and inequality remain a concern. The poverty rate in Africa decreased from 54 per cent in 1990 to 41 per cent in 2015, but the number of African people living in poverty increased from 278 million to 413 million (Beegle and Christiaensen, 2019). And the impact of COVID-19 will push between 5 million and 29 million people below the extreme poverty line of \$1.90 per day, compared with a baseline 2020 African growth scenario, according to ECA projections. Vulnerable households affected by COVID-19 face a 17.1 per cent increased probability of shifting to transient poverty, a 4.2 per cent increased probability of staying in poverty for a decade or longer and a 5.9 per cent decreased probability of moving out of poverty (ECA, 2020).

Of the poor 82 per cent live in rural areas, primarily engaged in agricultural or poorly remunerated employment. Non-wage microenterprises are the main source of non-agricultural employment and income for the poor and near-poor. Reduced demand due to COVID-19 has depressed the prices of agricultural commodities such as coffee, tea and cocoa. The continued decline in prices is expected to affect vulnerable small-scale farmers in Africa (ECA, 2020).

Poor households may suffer from a lack of access to health services, education and a good standard of living. To include such dimensions in the analysis of poverty, the global Multidimensional Poverty Index (MPI) was developed. **FIGURE 1.8** plots the MPI for 46 African countries based on the latest available data. The proportion of multidimensionally poor in Africa varies from 0.5 per cent in the Tunisia to 59 per cent in Niger. On average, 26.4 per cent of people are multidimensionally poor in Africa, compared with 14.2 per cent in Asia and 11.4 per cent in developing countries (Alkire, Kanagaratnam and Suppa, 2019). Compared with the Asian region average, the multidimensional poverty rate is higher in 34 African countries. It is also higher than the average in Latin America and the Caribbean (3.3 per cent), East Asia and the Pacific (2.4 per cent) and Europe and Central Asia (0.4 per cent).

The MPI has three main components: living standard, education and health.<sup>9</sup> The living standard dimension is related to Sustainable Development Goals (SDGs) 6.1, 6.2 and 7.1. Education is related to SDG 4, focusing on access, and the health dimension is linked to SDG 2.

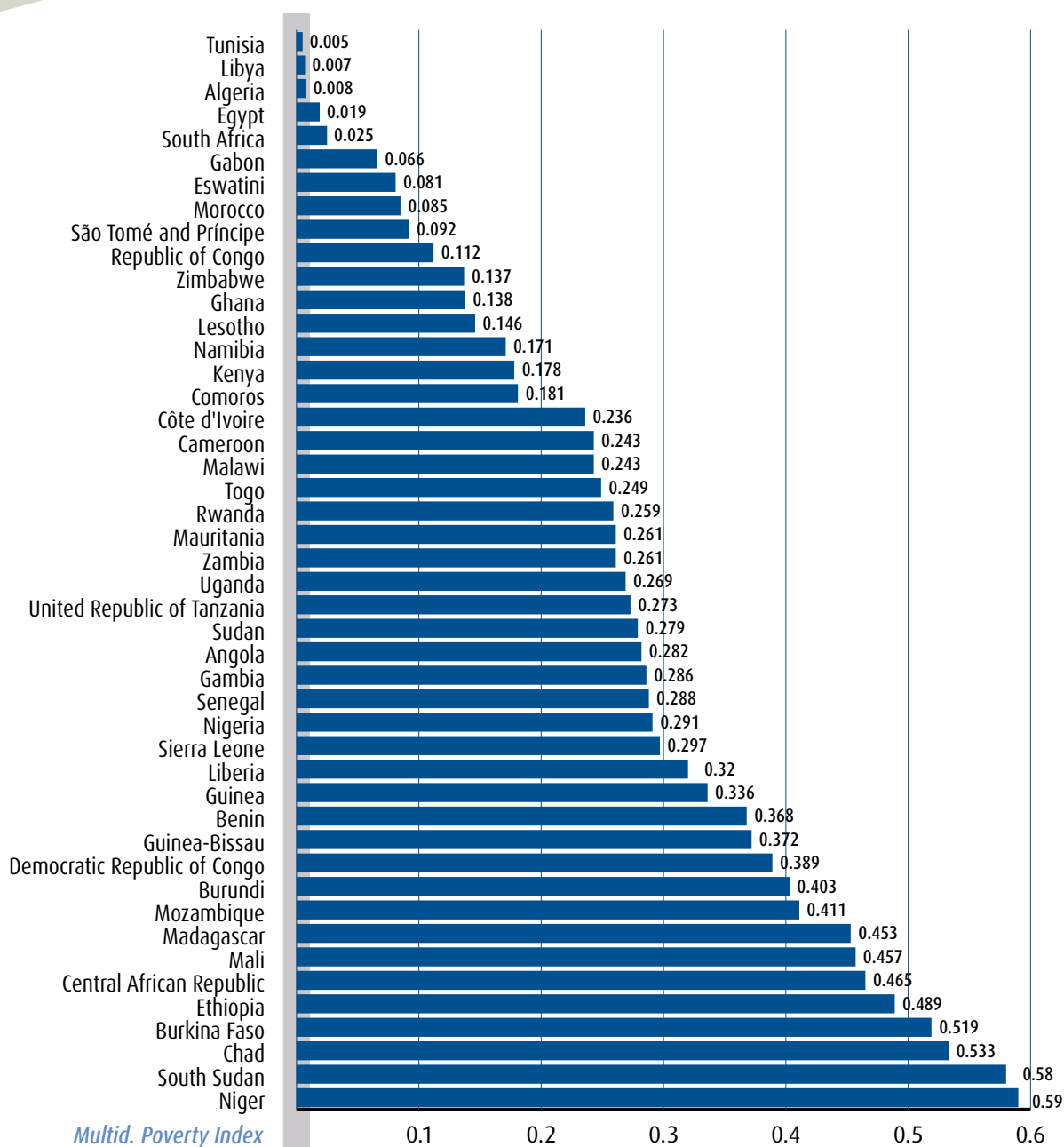
The living standard contributes the most to MPI in 37 of the 46 African countries covered by this study (the other nine are Algeria, Burkina Faso, Côte d'Ivoire, Egypt, Libya, Mali, Morocco, Senegal and the Tunisia). Education contributes the second most to the index, except in nine countries where the health dimension comes second. In the MPI analysis one size does not fit all. Although improving living standards should be the priority in most countries, improving access to education would help reduce poverty in others. Moreover, all countries should improve on the health dimension of the MPI, even though in most it contributes the least to multidimensional poverty.

The COVID-19 crisis has disrupted the global economy. It is first and foremost a health crisis, with adverse social impacts. Africa is particularly vulnerable, given weaker health systems, difficult living conditions (with over half of urban dwellers living in slums) and sparse access to sanitation. African health systems are weaker than those elsewhere in the world, with lower ratios of hospital beds, intensive care units and health professionals to their populations. Africa on average has 1.8 beds per 1,000 people, compared with 6.0 in France and 8.2 in the Russian Federation (ECA, 2020). More than 40 per cent of the population in Africa does not have access to potable water, and less than 30 per cent has access to electricity in rural areas. In South Asia, 88 per cent of the population has access to potable water, and 80 per cent of the rural population has access to electricity.

The global mean years of schooling improved from 5.8 in 1990 to 8.4 in 2018 but lagged considerably in Africa at 5.5. Other education challenges in Africa include low capabilities of students and limited number of teachers, especially in low human capacity developing countries (UNDP, 2018).<sup>10</sup> The



**FIGURE 1.8** MULTIDIMENSIONAL POVERTY INDEX, 2007–2018



Source: Alkire, Kanagaratnam and Suppa (2019).

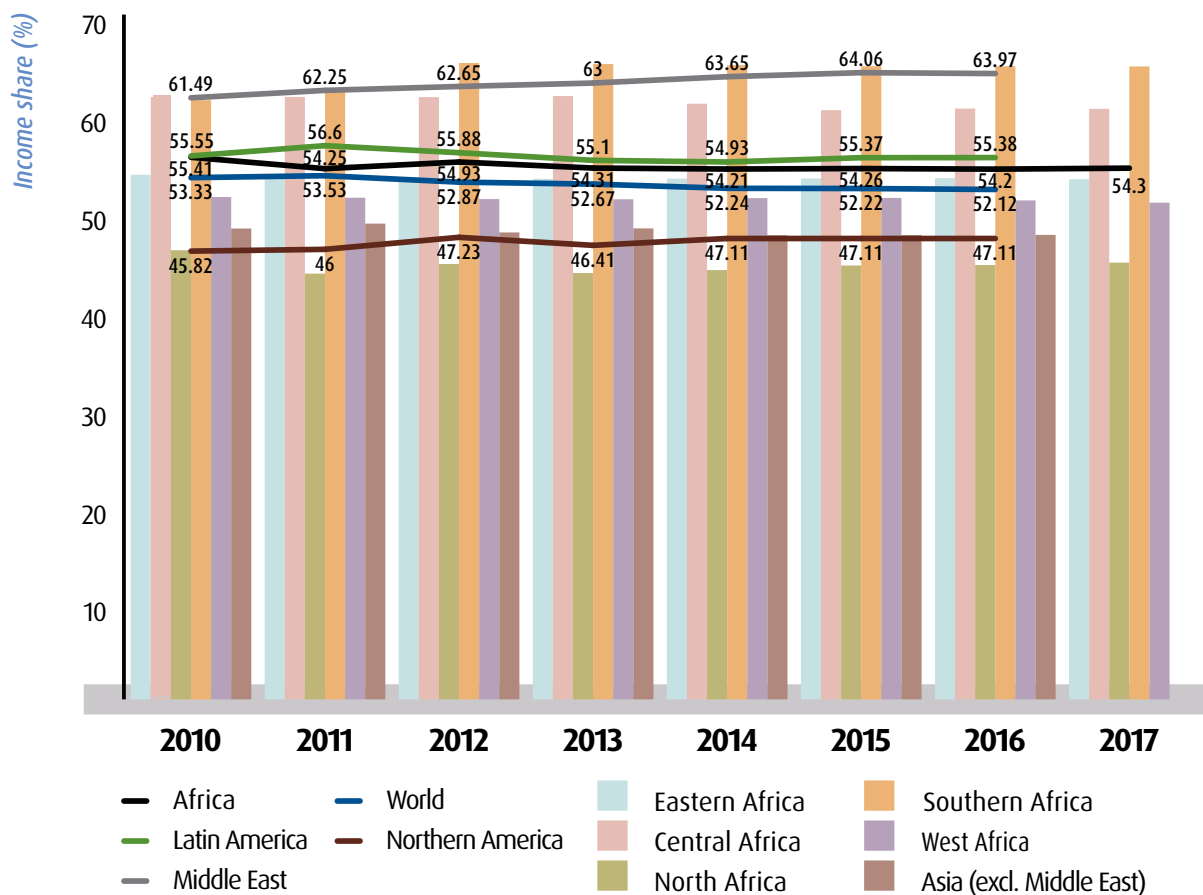
pupil-to-teacher ratio at primary schools in Africa varied from 16 in Tunisia to 70 in Malawi in 2017, revealing that many countries do not have enough teachers to effectively educate their students. The average pupil-teacher ratio in Africa is 35. More than a fifth of children ages 6–11 are out of school, and

a third of youth ages 12–14. According to UNESCO Institute for Statistics data, almost 60 per cent of youth ages 15–17 are not in school. Armed conflict is a major barrier to education on the continent.

Living standard and education are subcomponents of the SDGs, which African countries are far from achieving. Africa's overall MPI score is 55, suggesting it is on average 55 per cent of the way to the best possible outcome across the 17 SDGs. By country, African index scores range from 71 in Algeria to 39 in Central African Republic. Algeria, though the best performer in Africa, ranks only 53 of 162 countries globally, followed in Africa by Tunisia, Morocco, Egypt, São Tomé and Príncipe, Cabo Verde, and Gabon (see ANNEX TABLE 1.1). Other African countries fall below rank 100 in the world. North African economies seem to perform well compared with the rest of the continent. In Central Africa Republic, only the SDGs for climate action and responsible consumption and production have been achieved.

In addition to poverty and poor performance related to the SDGs, inequality remains a concern in Africa. Over the past five years, inequality in Africa slightly decreased: in 2017 the top 10 per cent of the population by income held 54.3 per cent of the national income, down from 55.3 per cent in 2013 (FIGURE 1.9). Inequality in Africa is higher than in Asia or North America, but lower than in the Middle East or Latin America. Income inequality appears lower in Algeria, Mali and Mauritania than in the rest of the continent. It is higher in the southern part of the continent, where more than 60 per cent of national income is held by the top 10 per cent of the population, than elsewhere. Increased poverty due to the impact of COVID-19 is projected to exacerbate income inequalities in Africa (ECA, 2020).

**FIGURE 1.9** INCOME SHARES OF THE TOP 10 PER CENT OF THE POPULATION, 2010–2017



**Note:** These figures plot the pre-tax national income share held by the top 10 per cent of the population.

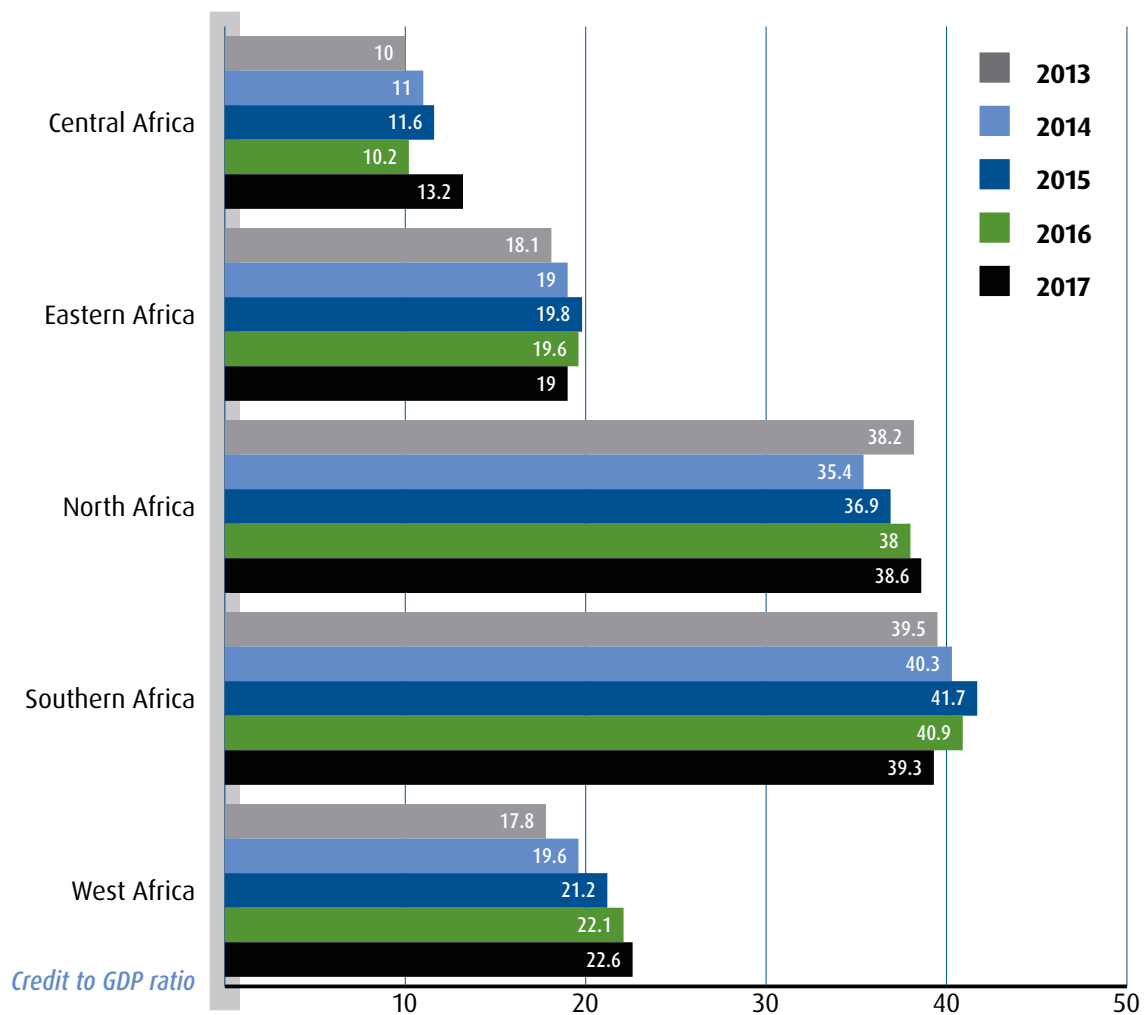
**Source:** Based on data come from World Inequality Database.

# FINANCIAL SECTOR PERFORMANCE

Financial sector performance in Africa is critical for sustainable development financing by both the public and private sectors. For instance, well-functioning banks and financial markets serve as intermediaries for savers and borrowers, monitor firms' and individuals' debt, provide mechanisms to manage financial risk and facilitate transactions (Levine, 2018).

Globally, banks dominate the financial sector. The credit-to-GDP ratio is very low in Africa—less than 30 per cent of GDP, compared with 138 per cent in East Asia and the Pacific (FIGURE 1.10). In North Africa and Southern Africa, the financial sector has slightly greater depth in such countries as Mauritius, Morocco, Namibia, South Africa and Tunisia,

**FIGURE 1.10** CREDIT-TO-GDP RATIO BY AFRICAN REGION



**Note:** Ratio of private credit by deposit money in banks and other financial institutions to GDP (%). Regional grouping based on countries with available data for select time frame.

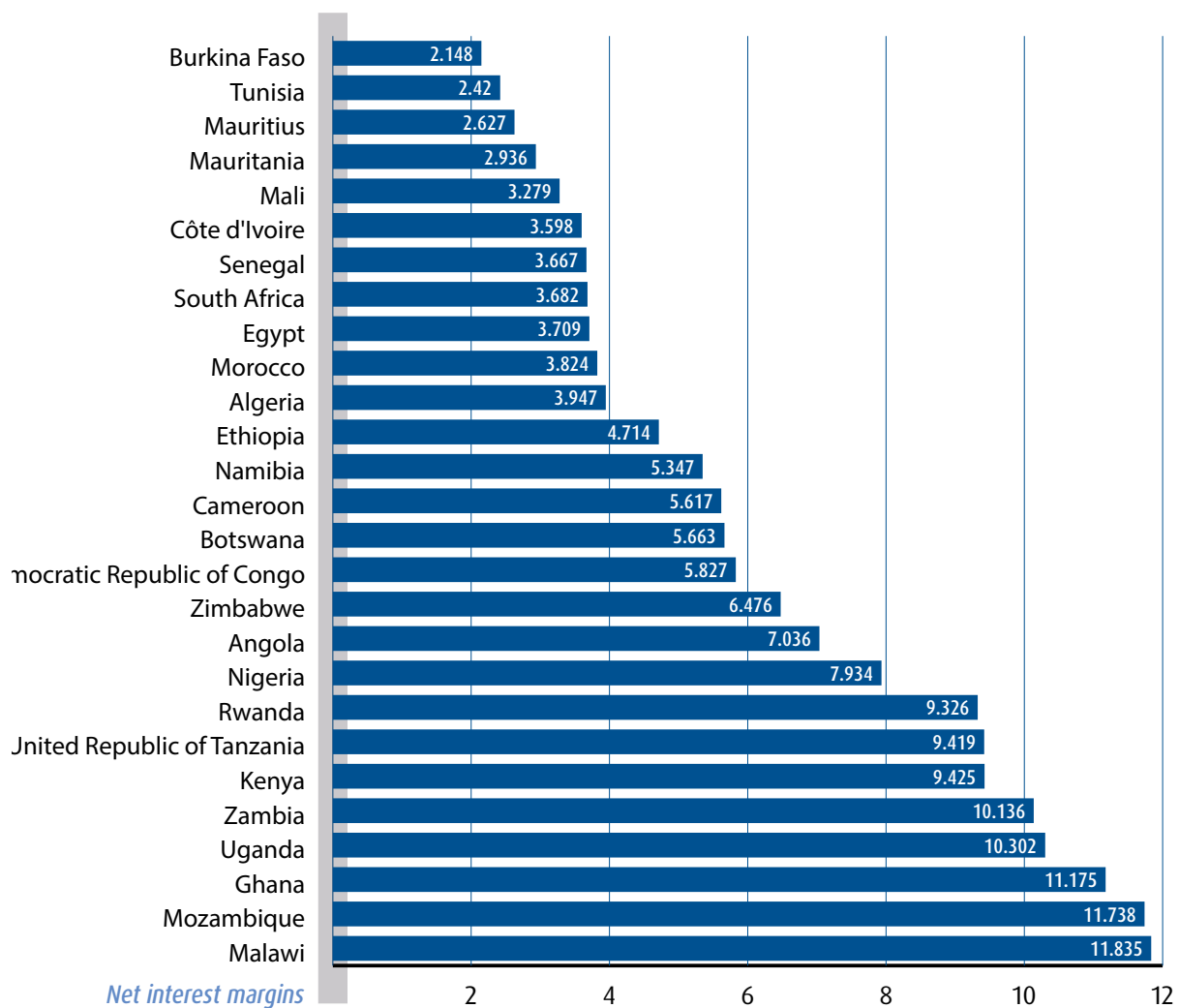
**Source:** ECA calculation based on data from the Global Financial Development Database (2019).

which had credit-to-GDP ratios ranging from 62 per cent to 98 per cent in 2017 (Global Financial Development Database, 2019). Bank financing to the private sector remains low. Even when it exists, it does not fit the needs of the private sector since about 60 per cent is short-term, that is, with a tenor of less than one year. And because banks have been inherently opaque, companies have been unable to access bank finance for many years (Leon, 2018; Fosu et al., 2017).

Central and West African countries are less financially developed than North and Southern ones. North and Southern

African banks are actively expanding continent-wide, with vast networks shaping the banking landscape of many African countries. They foster financial development and economic integration, which stimulate competition and efficiency, promote product innovation, boost modern management and information systems and introduce higher skills and expertise to host countries (Enoch et al., 2015; Pelletier, 2018). The increasing presence of pan-African banks is associated with improvements in firms' access to bank finance (Kanga, Murinde and Soumaré, 2018; Leon and Zins, 2020).

**FIGURE 1.11** NET INTEREST MARGINS IN SELECT COUNTRIES, 2017



**Source:** ECA calculation based on data from the Global Financial Development Database (2019).

**TABLE 1.1** RETURN ON ASSETS AND RETURN ON EQUITY, BY REGION, 2012–2017

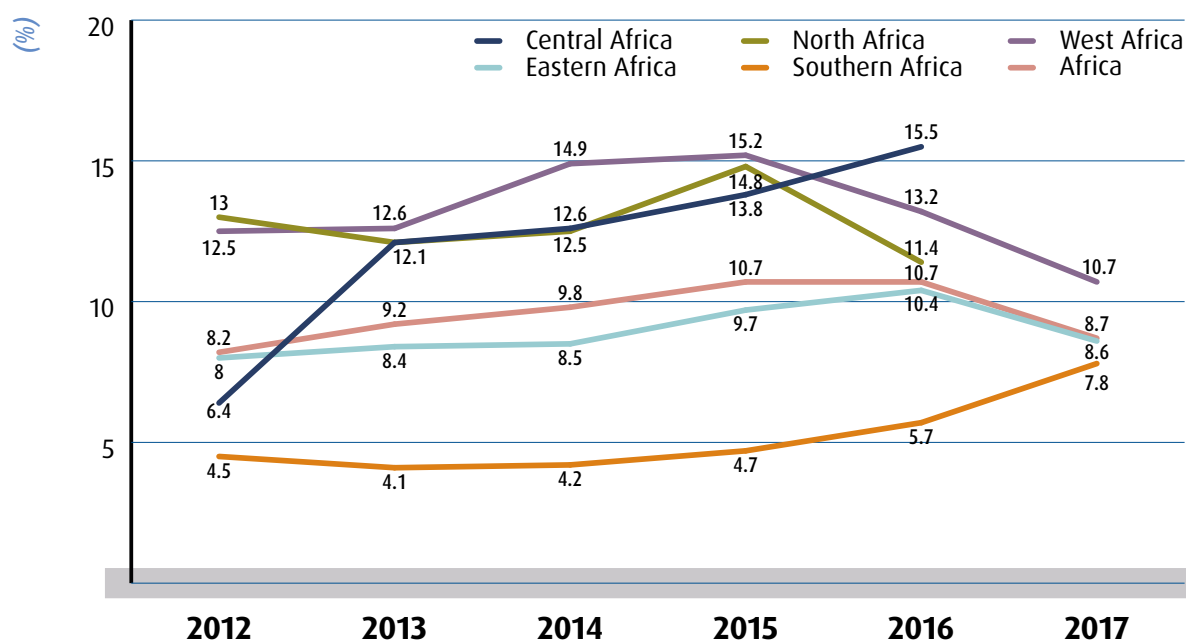
	RETURN ON ASSETS			RETURN ON EQUITY		
	MINIMUM	AVERAGE	MAXIMUM	MINIMUM	AVERAGE	MAXIMUM
<b>Central Africa</b>	-3.2	1.1	6.4	-10.2	10.8	40.7
<b>East Africa</b>	0.1	2.6	13.8	0.5	20.9	52.5
<b>North Africa</b>	-0.3	1.1	3.1	0.6	11.1	27.9
<b>Southern Africa</b>	0.6	2.4	6.8	5.9	19.5	42.5
<b>West Africa</b>	-3.9	1.5	8.8	-33.0	16.2	95.1
<b>Africa</b>	-3.9	1.8	13.8	-33.0	16.4	95.1

**Note:** Data from the Global Financial Development Database, October 2019.

Although underdeveloped, the banking sector is profitable, with high but varying net interest margins (NIM). The average NIM was 6 per cent in Africa in 2013–2017, higher than the 4.5 per cent average in South Asia in 2016. The low NIM in Asia (and hence low profitability) led some banks to venture into lesser developed neighbouring economies with robust economic growth, an emerging middle class, higher demand for innovative financial services and rising infrastructure

financing needs. Similar regional expansion has been observed in some African countries with declining NIM or decreasing domestic profitability, such as Morocco and South Africa. African countries that recorded high NIMs (above 10 per cent on average) include Ghana, Malawi, Mozambique, Uganda and Zambia, indicating banks are highly profitable in those countries (FIGURE 1.11). The high ratios can be explained by the structure of their balance sheets, the high interest rate

**FIGURE 1.12** TREND IN BANK REGULATORY CAPITAL TO RISK-WEIGHTED ASSET RATIO



**Note:** Calculations for the 2017 average figures for Africa and regional economic groups are based on the values from these countries: West Africa: Guinea; Southern Africa: Mauritius and Malawi; East Africa: Kenya, Madagascar, United Republic of Tanzania and Uganda.

**Source:** Based on data from the Financial Development and Structure Dataset (2019).

environment in which they operate or the high concentration of few banks in their respective countries. For instance, in both Malawi and Mozambique, bank concentration was very high, with the three largest banks in Malawi holding 86.8 per cent of total commercial banking assets in 2017, and the three largest in Mozambique holding 76.9 per cent (Global Financial Development Database, 2019).

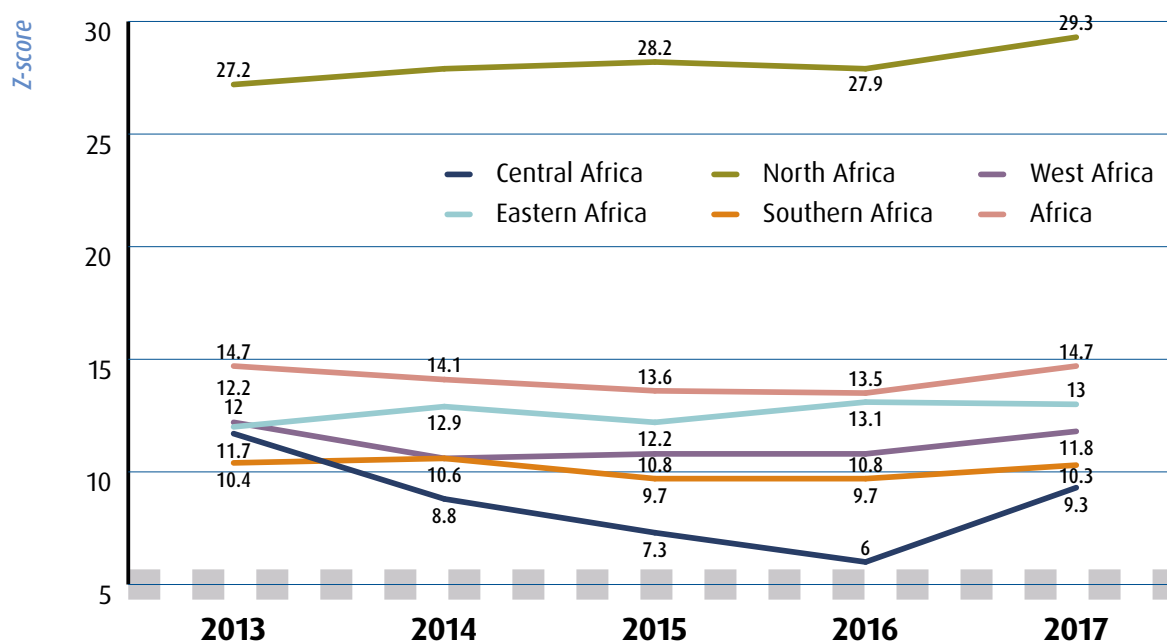
The net margins are consistent with average return on assets and return on equity in the African banking sector (TABLE 1.1). Throughout Africa, the banking sector generates profits, even if some countries in West, North and Central Africa show negative average returns. Negative returns are not concentrated in a specific country and do not appear systematic or systemic.

The banking sector in Africa is well capitalized. From 2010 to 2016 the ratio of regulatory capital to risk-weighted assets was greater than 13 per cent (FIGURE 1.12), mainly because the regulatory environment was pushing for greater capitalization, creating opportunities for private firms to invest in the financial industry (Allen, Otchere and Senbet, 2011). The banking sector in West Africa was better capitalized from 2010 to 2015 than in the rest of the continent, though downward

oil price trends can adversely affect Nigeria’s and Ghana’s banking sectors, as reflected in the 2016 West African figures. Although banks are well capitalized, the ratio of non-performing loans (NPLs) was higher in West Africa than in other part of the continent before 2016. Southern Africa showed strong financial soundness. Southern countries display very low NPLs and high capital ratios (TABLE 1.2). In contrast, Algeria and Tunisia in North Africa, Central African Republic in Central Africa and Mauritania and Sierra Leone in West Africa display high NPL ratios and capital to asset ratios at the same time—the banking sector in those countries probably uses capital to expand its loan portfolio by lending to risky customers.

Banking sector stability is greater in North Africa than in other regions of the continent—consistent with North African banks’ high capital-to-asset ratio and low ratio of NPLs (FIGURE 1.13). In Africa overall, banking sector stability improved slightly from 2016 to 2017, particularly in Central Africa (average bank z-score up 3.3 percentage points) and West Africa (up 1 percentage point). But Central Africa experienced a slight decline in banking sector stability between 2013 and 2016, as did West Africa between 2013 and 2014.

**FIGURE 1.13** TRENDS IN BANKING SECTOR STABILITY



Source: Based on data from the Global Financial Development Database (2019).

**TABLE 1.2** BANK REGULATORY CAPITAL AND NON-PERFORMING LOANS RATIOS, BY COUNTRY  
(Per cent)

	REGULATORY CAPITAL	NPLs	YEAR
<b>Algeria</b>	18.90	11.44	2016
<b>Botswana</b>	19.25	4.85	2016
<b>Burundi</b>	20.21	19.01	2016
<b>Cameroon</b>	9.09	10.65	2016
<b>Central African Republic</b>	32.02	25.61	2016
<b>Chad</b>	13.17	20.88	2016
<b>Congo</b>	19.09	4.85	2016
<b>Djibouti</b>	12.51	22.07	2015
<b>Egypt</b>	13.20	7.20	2015
<b>Equatorial Guinea</b>	27.27	24.64	2016
<b>Eswatini</b>	22.21	9.62	2016
<b>Gabon</b>	8.11	6.65	2016
<b>Ghana</b>	17.75	17.29	2016
<b>Guinea</b>	17.89	9.44	2016
<b>Kenya</b>	18.87	11.66	2016
<b>Lesotho</b>	18.05	3.59	2016
<b>Madagascar</b>	13.67	8.36	2016
<b>Mauritania</b>	23.10	27.60	2015
<b>Mauritius</b>	18.24	7.76	2016
<b>Morocco</b>	13.80	6.90	2014
<b>Mozambique</b>	17.10	4.30	2015
<b>Namibia</b>	15.15	1.54	2016
<b>Nigeria</b>	14.78	12.82	2016
<b>Rwanda</b>	23.05	7.08	2016
<b>Senegal</b>	16.70	18.80	2015
<b>Seychelles</b>	26.61	6.75	2016
<b>Sierra Leone</b>	33.98	31.73	2015
<b>South Africa</b>	15.93	2.86	2016
<b>South Sudan</b>	20.20	5.10	2015
<b>United Republic of Tanzania</b>	19.15	9.61	2016
<b>Tunisia</b>	12.10	14.50	2015
<b>Uganda</b>	19.83	10.40	2016
<b>Zambia</b>	26.16	9.66	2016

**Note:** Year is the last year for which data were available.

**Source:** Based on data from the Financial Development and Structure Dataset, 2019.

# FINANCING OPPORTUNITIES FOR SUSTAINABLE DEVELOPMENT IN AFRICA

A 2019 study concluded that financial inclusion is a promising channel for translating growth into lower inequality (Demir and Murinde, 2019). It found that financial inclusion could increase opportunities enabling firms to develop business, create jobs, increase the incomes of its employees and their households and in turn enable people to increase their investment in education and health. A study in Kenya found access to mobile money services increased savings by more than a fifth among women and allowed 185,000 women to develop business or retail activities (Demirgüç-Kunt et al., 2018).

Beyond growth and inclusion, Africa is seeking to cover other economic, social and environmental dimensions while achieving the SDGs. Huge financing needs for achieving sustainable development limit many countries' abilities to improve growth and prosperity. A new estimate suggests a financing gap of \$2.5 trillion for all emerging and developing countries and \$200 billion-\$1.3 trillion for Africa. Because Africa's population is expected to grow by 43 per cent over 2015-2030, the gap could reach \$19.5 trillion by 2030.

Further, African governments require additional funds to deal with COVID-19. In a best-case scenario, with suppression of the coronavirus spread and intense early physical distancing measures, \$44 billion would be required across Africa for testing, personal protective equipment and treatment of

COVID-19 patients requiring hospitalization and intensive care treatment (ECA, 2020).

By recent estimates Africa needs \$100 billion a year to close its infrastructure gap (McKinsey & Company, 2019). That figure aligns with African Development Bank estimates of the continent's infrastructure needs amounting to \$130 billion-\$170 billion a year, with a financing gap of \$68 billion-\$108 billion (AfDB, 2018). The gap is about 3-5 per cent of the continent's GDP. Key sectors are energy and transportation, accounting for about 55 per cent of the financing needs, and water supply and sanitation, accounting for about 40 per cent (TABLE 1.3).

Investing in infrastructure is key to boosting growth. Poor infrastructure reduces Africa's average per capita growth by up to 2 per cent every year (AfDB, 2018). Access to electricity is the biggest obstacle to business operations in Africa, with access to finance being the second.<sup>11</sup>

The digital revolution under way in Africa, mainly based on mobile phone networks, presents opportunities for sustainably developing finance. The infrastructure is suitable for developing prepayment systems. If telecommunications companies and banks collaborated, prepayment systems could be replaced by bank account transfers based on bank credit.

**TABLE 1.3** AFRICA'S INFRASTRUCTURE FINANCING NEEDS

INFRASTRUCTURE SUBSECTORS	ANNUAL COST (\$ BILLIONS)
Power	35-50
Water supply and sanitation	56-66
Information and communications technology	4-7
Road and other transport sectors (air, rail, and port)	35-47
<b>Total</b>	<b>130-170</b>

Source: AfDB, 2018.



### BOX 1.1 DIGITAL SOLUTION AND LENDING: TWO EXAMPLES FROM KENYA

M-KESHO, introduced by Safaricom in 2010, is a mobile account that allows users to receive small loans. Eligibility for a loan is based on a six-month history of M-Pesa mobile money transactions. Since the process is based on M-Pesa transactions, it is quicker than traditional screening by financial institutions.

Ovamba offers short-term funding for African small and medium enterprises (SMEs) in the trade and commodities sectors that cannot front the cost of trade or inventory purchases. SMEs can request financing via their mobile phone or computer. Ovamba then uses on-the-ground teams and technology to assess the risk and decides creditworthiness within 48 hours, using algorithms and information on local customs, including ethics, social norms and business practices.

Ovamba financing, following the Islamic model prohibiting interest, is based on risk-sharing on agreed terms. Rather than lend money, Ovamba purchases assets or receivables on behalf of its SME client. The assets or receivables are owned by Ovamba and sold to the SME client at a pre-agreed mark-up covering all costs incurred and a margin for Ovamba.

**Source:** Songwe, Kanga and Murinde, 2019.

Digital mobile phones help collect information on creditworthiness and can encourage commerce by reducing transaction costs. **BOX 1.1** provides two examples of lending based on mobile phone digital solutions.

Private equity financing is increasing in Africa, though Africa's share is still lagging. From 2013 to 2018, equity funding raised in Africa totalled \$18 billion (McKinsey Global Markets Review, 2019). Private equity capital in Africa in 2018 represented 0.7 per cent of the world total, compared to 3.5 per cent for Asia share of global private equity capital. Private equity funders and venture capital funds are active in countries with well-developed capital markets where they can liquidate their investment, take their profit and re-invest.

African stock exchanges, despite recent innovations, are less capitalized (representing 67 per cent of GDP in 2017) than those in high income countries (140 per cent) or East Asia

and the Pacific (112 per cent). They are also less liquid, and trading on them can be expensive. To develop a well-functioning capital market takes considerable time and a sound regulatory and supervisory framework (**BOX 1.2**). African stock exchanges are improving through demutualization, trading innovations, automated settlement and clearing systems, new trading instruments (such as derivatives, commodity exchange and mutual funds and other collective vehicles) and special windows for small and medium enterprises.

Alternative finance, especially crowdfunding, is another fast-growing market in Africa. The capital raised through nascent crowdfunding in Africa increased from \$44 million in 2013 to \$181 million in 2016 (Cambridge Centre for Alternative Finance, 2018). Crowdfunding presents some difficulties, since entrepreneurs must spend time building a base of contacts that will contribute capital and promote the fundraising campaign. Even so, it can have non-monetary benefits, such as increased credibility and market awareness.

### BOX 1.2 THE ROLE OF FINANCIAL REGULATION

Financial service suppliers collect credit information on investors and borrowers and any additional information required to match lenders and borrowers and to post accurate and timely financial instrument prices to facilitate fair trading (Mullineux and Murinde, 2014). To function effectively the financial system needs access to a database of credit standings, diligent data protection and appropriate freedom of access to non-confidential information. National development

banks, supported by regional agencies such as the African Development Bank, could help oversee the development of credit score databases.

Payment systems based on networks—mobile phone networks or the internet—need appropriate regulation. Regulators should identify the right rules for the right threats in the digital economy. The digital revolution breaks down the boundaries between

financial services and other industries (in telecommunications and beyond). To prevent internet-based fraud, regulators must prioritize supervision ensuring the protection and fair use of customer data. As cybercriminals launch more sophisticated and frequent attacks globally, data protection and security become more pertinent. So, regulators must require network-based financial service providers to use the most effective safeguards.

# CONCLUSIONS AND POLICY IMPLICATIONS

Africa is economically the second fastest growing region in the world, estimated to have grown 3.5 per cent in 2019. Growth is projected to slow in 2020, to 1.8 per cent in the best-case scenario and -2.6 per cent in the worst-case scenario. And even if the spread of COVID-19 is suppressed in Africa, its economic damage will be great. More effective measures aimed at addressing the socio-economic devastation that COVID-19 is causing could lead to economic recovery and contribute to a projected rebound of growth to 5 per cent in 2021. African economies, to enable economic recovery and

**“African economies, to enable economic recovery and SDG progress, should fully explore innovative financing by the private sector, raise investment to 35-40 per cent of GDP, enhance competitiveness and support regional integration”**

SDG progress, should fully explore innovative financing by the private sector, raise investment to 35-40 per cent of GDP, enhance competitiveness and support regional integration. The African Continental Free Trade Area (AfCFTA), enacted by a March 2018 agreement that has been signed by 54 African countries, is a key to this strategy.

For 2020–2030, the private sector in Africa will play an important role in enabling economic recovery from the COVID-19 pandemic, increasing economic prosperity and achieving the SDGs. In its primary role as the engine of growth, it will generate productivity and enhance economic participation by households and business firms, in turn driving inclusive economic growth. Financial sector innovations will support well-functioning systems connecting savers to borrowers. Bank financing must meet private sector needs, in contrast to current bank offerings, in which 60 per cent of credit to the private sector is short-term (see Fosu et al., 2017).

Multidimensional poverty and inequality persist, as shown by socioeconomic indicators. The COVID-19 pandemic could push additional 5–29 million Africans into extreme poverty and exacerbate existing income inequalities. But financial innovation to support financial inclusion appears promising for increasing opportunities for firms and households and thus for translating growth into decreased inequality.

# ANNEX

**ANNEX TABLE 1.1** AFRICAN COUNTRIES ON THE SDG INDEX, 2019

REGION	COUNTRY	SDG INDEX	SDG INDEX RANK
Central Africa	Angola	51.32	149
	Cameroon	56.02	127
	Central African Republic	39.08	162
	Chad	42.79	161
	Congo, Democratic Republic of the	44.95	160
	Congo	54.22	132
	Gabon	64.76	99
	São Tomé and Príncipe	65.48	95
East Africa	Burundi	51.55	145
	Comoros	52.98	137
	Djibouti	51.36	148
	Ethiopia	53.25	135
	Kenya	57.03	125
	Madagascar	46.70	158
	Malawi	51.38	146
	Mauritius	63.59	105
	Mozambique	53.03	136
	Rwanda	56.02	126
	United Republic of Tanzania	55.82	128
	Uganda	52.57	140
	Zambia	52.62	139
	Zimbabwe	59.67	121
North Africa	Algeria	71.10	53
	Egypt, Arab Rep.	66.21	92
	Morocco	69.07	72
	Sudan	51.36	147
	Tunisia	69.99	63
Southern Africa	Botswana	59.77	120
	Eswatini	51.69	142
	Lesotho	50.94	150
	Namibia	59.87	119
	South Africa	61.48	113
West Africa	Benin	50.85	151
	Burkina Faso	52.40	141
	Cabo Verde	65.05	96
	Côte d'Ivoire	55.70	129
	The Gambia	55.00	131
	Ghana	63.80	104
	Guinea	52.81	138
	Liberia	48.18	157
	Mali	50.21	152
	Mauritania	53.33	134
	Niger	49.45	154
	Nigeria	46.41	159
	Senegal	57.30	124
	Sierra Leone	49.24	155
Togo	51.60	144	

**Note:** Seychelles is not included in the 2019 ranking.

**Source:** Sachs et al., 2019.

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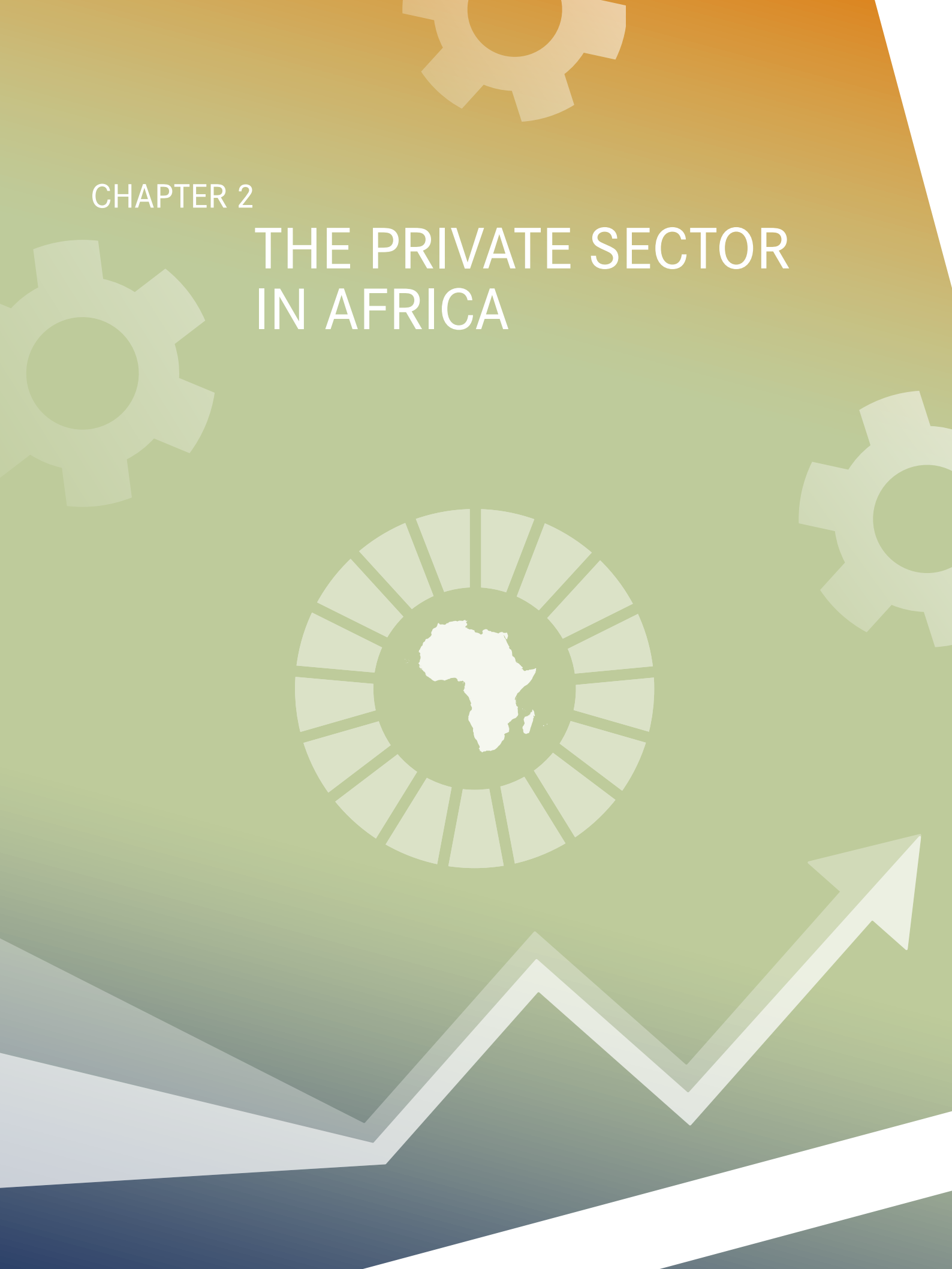
## ENDNOTES

- 1 In this report, Asia includes Asian emerging and development countries, namely Bangladesh, China, Hong Kong, India, Indonesia, Malaysia, Pakistan, Philippines, Singapore, Republic of Korea, Sri Lanka, Taiwan, Thailand and Viet Nam.
- 2 African regions are defined according to the UNSD (n.d.).
- 3 Economic complexity measures the knowledge intensity of an economy by considering the knowledge intensity of the products it exports (OEC, n.d.).
- 4 [https://www.uneca.org/sites/default/files/uploaded-documents/ATPC/updated\\_q\\_a\\_21jan2020.pdf](https://www.uneca.org/sites/default/files/uploaded-documents/ATPC/updated_q_a_21jan2020.pdf)
- 5 These projections are based on the sole removal of tariffs on goods and depending on liberalization effort.
- 6 [https://www.uneca.org/sites/default/files/uploaded-documents/ATPC/updated\\_q\\_a\\_21jan2020.pdf](https://www.uneca.org/sites/default/files/uploaded-documents/ATPC/updated_q_a_21jan2020.pdf)
- 7 Department of Foreign Affairs and Trade, Government of Australia (2014).
- 8 Average calculated from the World Development Indicators database.
- 9 Living standard covers the following components: (1) The household has no electricity. (2) The household does not have access to improved sanitation. (3) The household does not have access to an improved source of drinking water. (4) At least one of the household's three dwelling elements—floor, walls or roof—is made of inadequate materials: the floor is made of natural materials or the walls or the roof are made of natural or rudimentary materials. (5) The household cooks with dung, wood, charcoal or coal. (6) The household does not own a car or truck and does not own more than one of the following assets: radio, television, telephone, computer, animal cart, bicycle, motorbike or refrigerator. Deprivation in education means that no household member age 10 or older has completed six years of schooling, or that any school-age child is not attending school up to the age at which he or she would complete class 8. The health component covers malnutrition (any adult under age 70 or any child for whom nutritional information is available is undernourished) and child mortality (any child in the household has died in the five years preceding the survey).
- 10 Raw data from UNDP (2018).
- 11 Some 20.7 per cent of African firms report that access to electricity is the main obstacle affecting their operations, and 19.6 per cent of firms report access to finance as the main obstacle. These proportions are estimated from World Bank Economic Survey, June 2019.



CHAPTER 2

# THE PRIVATE SECTOR IN AFRICA





**A** robust and vibrant private sector is vital for inclusive and sustained economic growth. Indeed, the private sector is the engine of economic growth. In Africa, the private sector has an immense potential to contribute directly to Agenda 2030 of the Sustainable Development Goals (SDGs) and the African Union Agenda 2063—the Africa We Want<sup>1</sup>—through such basic pursuits as increasing productivity, creating jobs and improving service delivery (ECA, 2017a; Gronow, 2016).

This chapter begins by examining the development of Africa's private sector and illustrating the positive economic implications of a private sector-led development model. It discusses the development stages of African economies using three classifications: commodity-based, manufacturing-based and service-based, illustrating the best practices from advanced

and emerging economies in each. It also explores challenges facing private sector development in Africa, including those in infrastructure and finance. The infrastructure gap in Africa not only challenges private sector development but also offers Africa's private sector an opportunity to invest.

Inadequate finance hinders private sector development in Africa. The recent outbreak of COVID-19 (coronavirus) and its impact on many firms add stress to the continent's private sector development and finance. The chapter recognizes that sustainable financing is required to enhance the sustainable development of the private sector in Africa. Thus, innovations by banks and non-bank financial institutions, including financial technology (fintech) firms, are needed to respond to private sector financing challenges. The chapter also discusses the potential role of the African Continental Free Trade Area (AfCFTA) in private sector development by enhancing access to finance for businesses and increasing competitiveness through regional value chains.

# PRIVATE SECTOR DEVELOPMENT IN AFRICA

Private sector activities and investment are major sources of economic growth, job creation and sustainable development. On average, the private sector contributes more than 80 per cent of government revenues in low- and middle-income countries through company taxes, resource rents and income taxes on employees. It generates more than 90 per cent of employment in developing economies, including both formal and informal jobs (Avis, 2016; Department of Foreign Affairs and Trade, Australian Government, 2014). More than 700 private businesses in Africa are large enough to generate more than \$500 million a year in revenue (Leke, Chironga and Desvaux, 2018). Large companies (with 100 or more employees) generate between \$1 billion and \$1.4 trillion a year in profits.

Most African private businesses are small—too few are medium and large (“the missing middle” and “missing large”). Small firms are less productive than larger ones, particularly in manufacturing. Small and medium enterprises (SMEs) in Africa struggle to survive and grow into large firms, largely due to financial constraints (AfDB, 2019). Even so, SMEs are considered the backbone of African economies, since they represent about 90 per cent of all private businesses and account for more than 60 per cent of employment in most African countries (ITC, 2018).

The productivity gap between SMEs and large firms is explained by the low-value-added and labour-intensive sectors in which SMEs predominantly operate, their limited use of technologies and their low participation in foreign markets (ITC, 2018). Yet, SMEs that export or operate internationally are more productive, contribute more to higher paying jobs, especially in the low-wage segments of the economy, and grow 4 percentage points faster than non-exporting SMEs (Edinburgh Group, 2013).

Africa’s private sector plays an important role in agriculture, industry (including manufacturing) and services. To explore the role of the private sector in these three areas, the literature mostly uses revenue (sales) and employment (job creation and destruction), and the two measures require extensive micro panel data (Delmar, Davidson and Gartner, 2003; Mamburu, 2017). The growth of sectoral value added and sectoral employment rates proxy the growth of firms at the macro level.

# PRIVATE SECTOR IN AGRICULTURE-BASED ECONOMIES

Africa's agriculture and agribusiness sector comprises SMEs and large farms, and firms in the middle of the value chain and further downstream (AGRA, 2019). In Africa, the agricultural sector's main characteristic is the predominance of smallholders (Christiaensen and Demery, 2018). Agricultural growth is generally achieved by cultivating more land and mobilizing a larger agricultural labour force, steps that improve yields very little (NEPAD, 2013). The growth rate of agricultural value added, though positive on average, was flat across different regions in Africa between 2000 and 2018 (FIGURE 2.1). That growth rate is highly volatile due to volatility in global prices of primary commodities, the impact of climate change and other external shocks to productivity. The agricultural sector in Africa accounts for 20–40 per cent of the continent's GDP. Africa is still at the first stage of mechanization (FAO and AUC, 2018). BOX 2.1 sketches the experience of the United States in investing in the agricultural sector and transforming it.

Agriculture-based African countries should prioritize mechanization to double agricultural productivity and eliminate

hunger and malnutrition in Africa by 2025. This 21<sup>st</sup>-century mechanization must affect the entire agricultural value chain. It should be private sector-driven, environmentally compatible and climate smart and economically viable, particularly for small-scale farmers (FAO and AUC, 2018).

Credit and finance are critical for intensifying and investing in mechanization in agricultural production in Africa (FAO and AUC, 2018; NEPAD, 2013). A study in Malawi, Nigeria, United Republic of Tanzania and Uganda revealed that the use of credit for financing modern inputs is extremely low in Africa and that farmers primarily finance them with cash from non-farm activities and crop sales (Christiaensen and Demery, 2018). The current financing needs of Africa's 48 million smallholder farmers are estimated at about \$450 billion.<sup>2</sup> Addressing those needs through improved access to credit, savings, insurance and payment solutions will attract investment, improve yields and productivity, achieve food security, increase prosperity and reduce poverty.

## BOX 2.1 TRANSFORMING AGRICULTURE IN THE UNITED STATES

American agriculture and rural life underwent a tremendous transformation in the 20th century. In the early 20th century, agriculture was labour intensive. It occupied many small, diversified farms in rural areas where more than half the US population lived. Farms employed close to half the US workforce, along with 22 million work animals, with each farm producing an average of five different commodities.

The agricultural sector of the 21st century, by contrast, is concentrated in a small number of large specialized farms in rural

areas, where less than a fourth of the US population lives. These highly productive and mechanized farms employ a tiny share of US workers and use 5 million tractors instead of the horses and mules of earlier days (Dimitri et al., 2005).

The transformation made US agriculture increasingly efficient and contributed to the overall growth of the economy. US farm output grew dramatically, allowing consumers to spend less and less of their income on food and freeing a larger share of the population to enter non-farm occupations that

have supported economic growth and development (Dimitri et al., 2005). Technological progress and farm productivity growth permitted a small labour force to supply the agricultural needs of the country at a lower cost. By producing a wide variety of food inexpensively, American farmers and ranchers ensure a safe and reliable domestic food supply. This sector also improves energy security and reduces dependence on foreign oil by producing biofuels and developing other alternative energy sources. These new sources have reduced costs for businesses and consumers.

Source: Dimitri et al., 2005.

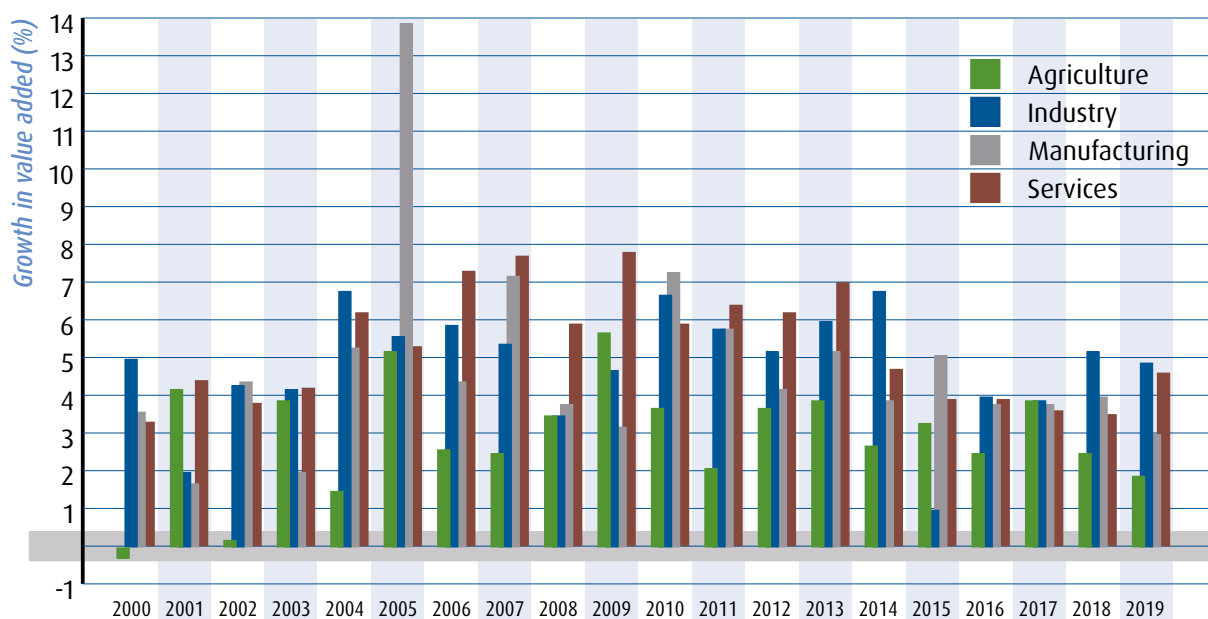
Although under the Maputo Declaration of 2003 African governments committed to allocating 10 per cent of their national budgets to agricultural development, few have done so (OSAA, 2017). The financial sector (mainly through bank loans) accounts for about 3 per cent of investments in the agricultural sector, a scantiness explained by the sector's perception as high risk by banks, mainly due to climate risk, and by the low mechanization and weak literacy of farmers, including financial literacy.<sup>3</sup> The private sector is expected to provide more than 70 per cent of the financing and investment needs of agriculture (OSAA, 2017). Promisingly, private sector interest has been growing in African agriculture and agribusiness, including interest from foreign investors and investment funds (World Bank, 2013).

Innovative financing mechanisms are needed, such as cooperative groups; value chain frameworks or outgrower schemes binding farmers to supply products to a particular firm, which can be linked to public-private partnerships (PPPs); and mobile money for the private sector—a game changer in the agriculture sector. For instance, the increased use of mobile money and mobile wallets such as M-Pesa in Kenya has reduced the high costs incurred by farmers in rural areas to

**“Mechanization . . . should be private sector-driven, environmentally compatible and climate smart and economically viable, particularly for small-scale farmers”**

distribute funds and collect repayments. Another innovative financial service is pay-as-you-go solar home systems (SHS), such as M-KOPA in Kenya, which provides rural smallholders easy and inexpensive access to energy. These innovative initiatives must include climate-risk control to increase investment and financing inflows. Moreover, these initiatives should consider World Bank, Food and Agriculture Organization (FAO), African Risk Capacity (ARC) and other development partners' support in risk transfer and insurance solutions to contribute to successful and sustainable climate-risk insurance projects in climate-vulnerable countries.

**FIGURE 2.1** GROWTH OF VALUE ADDED IN AGRICULTURE, MANUFACTURING, INDUSTRY AND SERVICES



Source: ECA calculated from World Development Indicators Database (2020).

# PRIVATE SECTOR IN EXTRACTION-BASED ECONOMIES

Africa is well endowed with natural resources such as minerals, oil and gas (FIGURE 2.2 and FIGURE 2.3). Despite the rich endowments and highly coveted resources, the mining sector has not contributed much to economic development and wealth creation in many countries. Most of Africa's minerals are exported as ores, concentrates or metals without significant value addition, and African countries continue to import inputs the mining sector needs (ECA, 2018a).

It is widely conceded that unknown mineral endowments in Africa might be larger than the current known mineral resources, according to ECA (2017b). The geological databases at the national geological surveys are inadequate since Africa

has not fully been geologically surveyed at an appropriate scale. But basic geological information, particularly in digital format, is essential to attracting investments in exploration (ECA, 2017b). African countries are trying to reorient their mineral policy frameworks towards development-focused strategies (ECA, 2016). Botswana is among countries pursuing a beneficiation policy, initiated in 2012 in the diamond industry. Diamond beneficiation in Botswana entailed transferring the sales of all its diamonds from London to Gaborone (the capital of Botswana) through the Diamond Trading Cooperation Botswana (DTCB) and cutting and polishing 18–20 per cent of rough diamond production domestically. These beneficiation processes contributed to job creation, since 94 per cent

## BOX 2.2 MINING VALUE ADDITION IN AUSTRALIA

Australia's abundant natural resources (the world's largest gold, lead, zinc, nickel, rutile and zircon, bauxite, cobalt, silver, copper, and iron ore reserves) have been major factors contributing to its robust economy, which has grown for 28 consecutive years. In 2019 Australia's nominal GDP was estimated at \$1.5 trillion and accounted for 1.7 per cent of the global economy (Australian Trade and Investment Commission, 2020). Australia's mining sector revenue reached \$279 billion in 2018/19 and is forecast at \$282 billion in 2019/20 (Reuters, 2019). The country is the world's third biggest exporter of mining and fuel merchandise goods.

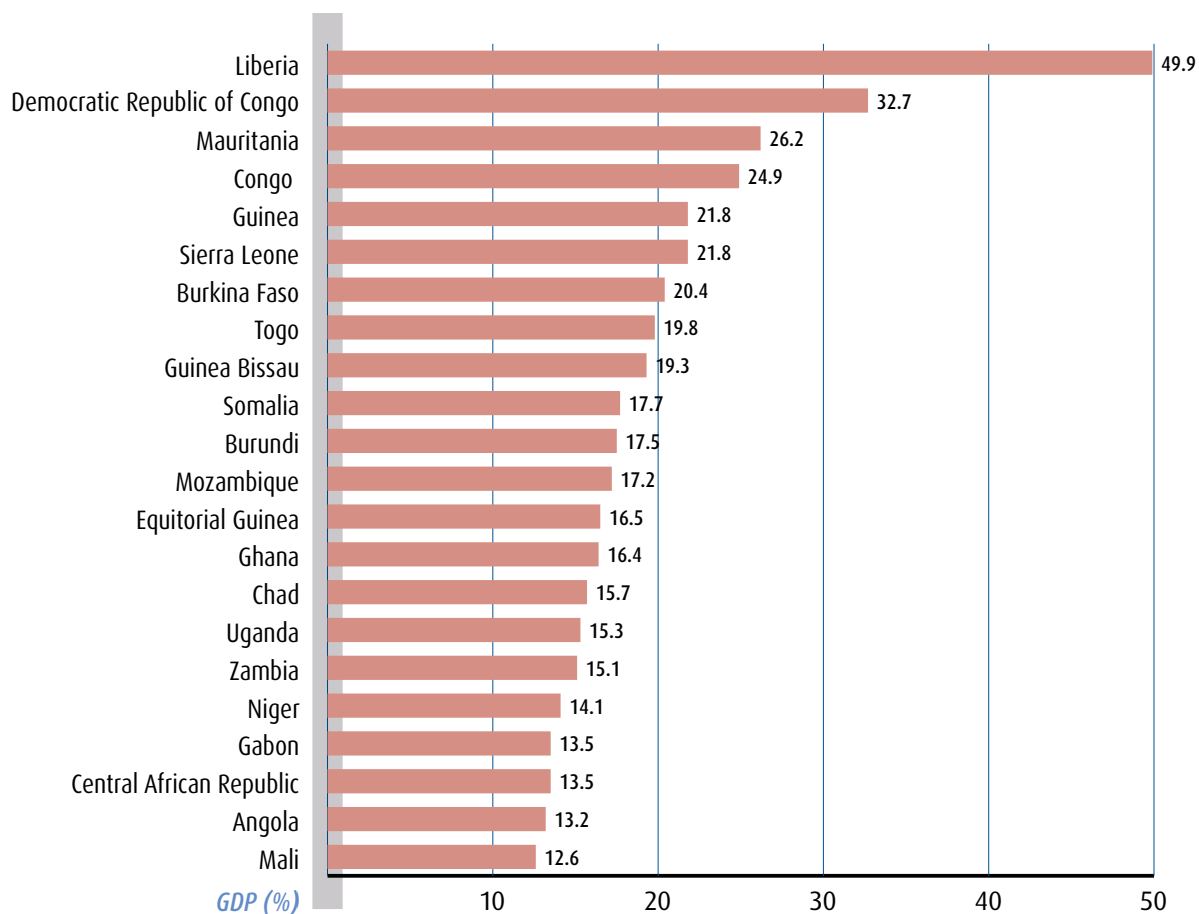
The development of Australia's natural resources was based on four key drivers: rents and taxes, beneficiation, upstream and cross linkages, and innovation and skills. Australia stands out for its policy innovations promoting cross-linkages with other economic sectors and for establishing itself

as a knowledge economy, especially in the natural resources sector. The gold mining project in Kalgoorlie, Western Australia, presents a notable example of innovative cross-linkages between mining and agriculture to promote structural transformation. To address the challenges of limited available water resources for domestic consumption and the high water demands for steam power, evaporation and condensation required for gold extraction, the state built a pipeline that pumped water 600 kilometres from coastal dams to provide water to Kalgoorlie and the intermediate region. The pipeline, supplemented by railway and agricultural innovation, transformed marginal grazing lands into very productive wheat growing areas and contributed to the increased production of wheat and its export around the world. Today Australia is among the world's top 12 exporters of agricultural products.

Australian government support for increasing local content in mining projects also contributed to a more diversified and service-oriented economy. Major economic reforms supporting the transformation included tax reforms; trade and investment liberalization; promotion of a flexible labour market; demand-responsive education and training; and market-based reforms to water, transport and energy. The promotion of a responsive, diversified and highly skilled labour market created a shift towards high rates of employment with higher wages. Today, Australia ranks fifth on global entrepreneurship, with about 50 per cent of private firms active in innovation and over 40 per cent of the labour force highly skilled, with a tertiary education. Australia's record of innovation and entrepreneurship was also supported by high investments in research and development (about \$21 billion on a purchasing power parity basis).

**Source:** Australian Trade and Investment Commission, 2020.

**FIGURE 2.2** TOP 22 AFRICAN COUNTRIES NATURAL RESOURCE RENT, 2016



**Source:** Based on World Development Indicators, World Bank (2020). <https://ourworldindata.org/grapher/natural-resource-rents>.

of workers in the cutting and polishing industry are nationals. The beneficiation policy requires rough diamond traders to move down the value chain to get access to rough diamonds. As a result of the obligation to process domestically, government revenues increased, including from the \$31 per carat implicit tax on companies on the De Beers Global Sightholder Sales’s list of authorized bulk purchasers of rough diamonds. This improved manufacturing and SME growth, especially in finished jewellery.

Extractive companies, mostly private and foreign in Africa, can play a lead role in supporting sustainable development. By facilitating industry clusters and backward/forward linkages, they can trigger technology spill overs, support human skill development, provide incentives for an improved business

environment and use improved local content policies to boost enterprise development. Many African resource-rich countries have put policies in place to stimulate value addition in the extractive industries, promote linkages with other economic sectors and support domestic entrepreneurial participation by bolstering local procurement of services.

However, opportunities to develop clusters of manufacturing and increase the local supply of inputs such as equipment, machinery and services for extractive industries have been hindered. Poor infrastructure, high transaction costs, inadequate skilled labour, inadequate legal and regulatory frameworks, limited financing for developing entrepreneurship and high borrowing costs due to perceived risks block these opportunities (Sigam & Iddrissu, 2013).

Even so, countries such as Angola, Ghana, Nigeria and South Africa have introduced measures to promote domestic procurement and the use of local intermediate products/supply in the extractive sector. The measures include increasing market capitalization, requiring the use of local banks by multinational corporations operating in the extractive industry, promoting an enabling environment for local financing and

entrepreneurial development, and developing local suppliers' capacity to provide the necessary quality and reliability in performance and services. **BOX 2.2** describes the experience of Australia, a richly endowed developed market economy that succeeded in the transformation and value addition of its natural resources.

## PRIVATE SECTOR IN MANUFACTURING-BASED ECONOMIES

Africa's manufacturing firms are generally small. According to the World Bank Enterprise Survey (2007–2018), 57 per cent of manufacturing firms in Africa are small (with 5–19 employees) and only 12.8 per cent are large (more than 100 employees), compared with 22 per cent small firms and 38 per cent large firms in China. Given Africa's large proportion of small manufacturing firms, it is unsurprising that the average proportion of total sales directly exported is only 4.3 per cent. Tunisia leads with 16.3 per cent. This poor export performance reflects the small percentage of exporting manufacturing firms as well as their small size (Dinh and George, 2012).

The growth rate in the manufacturing sector was positive between 2003 and 2005 (see **FIGURE 2.1**). This reflected a shift in resources, especially labour, from traditional agriculture and rural activities to low-productive informal activities in the urban centres, according to the UN Economic Commission on

Africa (ECA) (2014). A downward trend after 2005 indicates lower manufacturing output as resources shifted towards other sectors such as services and manufacturing firms showed limited competitiveness or low participation in global value chains. Other factors in manufacturing's downward trend are the aging of production capital and the closure of certain agro-food production units when less expensive products from emerging countries invaded or gained fraudulent access to African markets in a semblance of suicidal competition with local industries. The industrial sector, including construction, displays a pattern similar to manufacturing's, with a decline in the growth rate from 7.39 per cent to 0.69 per cent between 2014 and 2015. This sharp decline can be partly attributed to the 2014 decline in the global prices of oil and the resulting decrease in government revenues and investment in key infrastructure projects (including energy and transport).



### BOX 2.3 MANUFACTURING-BASED ECONOMY: THE CASE OF CHINA

In the 1990s the Chinese government realized the importance of manufacturing to economic development. One important strategy was attracting foreign direct investment by providing incentives to access its huge market. For example, the government started to open the automotive market by allowing foreign corporations to form joint ventures to assemble vehicles in China. Once the floodgates opened, all major global automotive manufacturers established footprints in various regions of the country. The Chinese government also systematically invested to upgrade its physical infrastructure—airports, shipping ports, railroad systems, and power plants and electric transmission lines. Today, China has one of the best physical infrastructures in the world.

Recently the Chinese government launched “Made in China 2025,” a national strategy to further advance the country’s manufacturing

competitiveness. It recognized that although China’s manufacturing output ranks first in the world, its core manufacturing competitiveness still lags behind that of some of the most developed countries, such as Japan, Germany and the United States. It put heavy emphasis on original innovations by Chinese manufacturing companies. The goal is to shift from “Made in China” to “Innovated in China.” Many progressive Chinese manufacturing firms have also started to merge with or acquire overseas companies, such as Lenovo’s acquisition of IBM’s PC business and Motorola Mobility’s smartphone business.

Chinese President Xi Jinping also proposed the One Belt, One Road (OBOR) strategy to collaborate with many of the nations in the geographical regions covered by the OBOR plan. And China launched an Asian Infrastructure Investment Bank (AIIB)

initiative. Under the OBOR strategy and AIIB umbrella, more investment and infrastructure construction projects will become possible for Chinese manufacturing firms. More recently the country has sought to extract greater benefits from its manufacturing sector by increasing its involvement in high-end activities and across all elements of the manufacturing value chain. China’s dominant position in mass production and fast growth in manufacturing output have benefitted from the Chinese macroeconomy and, at the firm level, from individual firm capabilities. Finally, Chinese private and public sector enterprises are under pressure to raise their manufacturing and innovation game. Upgrading manufacturing production technologies is necessary to achieve wider government goals, including energy efficiency and efficient resource consumption.

Source: Ni, 2016.

Fast growth in Africa’s labour force and widespread poverty make job creation in high-productivity sectors a top priority (AfDB, 2019). Transforming African economies through industrialization will be key to economy-wide productivity improvements, job creation and sustained progress in growth and poverty reduction (ATPC and ODI, 2018). Yet, although many African countries recognize the importance of manufacturing and industrial development and have adopted policies to enable those sectors to grow, they are overshadowed by the dark cloud of the lack of investments to implement such policies and strategies. The silver lining is the private sector’s potential and the opportunity to attract private investment (AfDB, 2019). China presents a best practice example that Africa’s manufacturing-based economies could learn from (BOX 2.3).

In Africa as in China (see BOX 2.3), policies to encourage foreign direct investment can speed industrial development,

so African governments should promote them. Foreign investment and foreign firms can allow African countries to improve their trade logistics and increase the knowledge and skills of local entrepreneurs. African countries such as Ethiopia, Mauritius and Rwanda are already successfully following that path (AfDB, 2018).

African firms need to industrially upgrade through participating in global value chains. The AfCFTA provides an opportunity for African countries to learn by doing how to develop competitive regional value chains, a much needed step towards participating in global value chains (ATPC and ODI, 2018; ECA, 2015). Some countries such as Ethiopia, Morocco and Rwanda are already participating in global value chains (AfDB, 2019). To further such participation, African governments should invest in upgrading their physical infrastructure (ATPC and ODI, 2018).



# PRIVATE SECTOR IN SERVICE-BASED ECONOMIES

Africa's service sector holds tremendous economic promise. It contributed on average more than half the value of exports in Cabo Verde, Central African Republic, Comoros, Ethiopia, the Gambia, Ghana, Mauritius, Rwanda, São Tomé and Príncipe and Seychelles (FIGURE 2.3). BOX 2.4 illustrates the case of Hong Kong, a service-based economy and a net exporter of services (Information Services Department, 2016).

The service sector in Africa has a vital role to play in industrial and manufacturing development, as well as in scaling up agricultural productivity. For instance, logistics and distribution could greatly benefit Africa's manufacturing and agriculture sectors, including agribusiness and food trade. Some African countries have already succeeded at tapping into opportunities offered by the service sector. Emerging regional services include the financial and banking industries of Mauritius and Nigeria, the commercial and cargo air transport industry in Ethiopia and South Africa and the port service industries of

**“The upsurge in telecommunication services in Africa over the past decade is another illustration of how service development can spur growth in other sectors”**

Djibouti, Kenya and Morocco (UNCTAD, 2015). The upsurge in telecommunication services in Africa over the past decade is another illustration of how service development can spur growth in other sectors. The information and communications

## BOX 2.4 SERVICE-BASED ECONOMY: THE CASE OF HONG KONG

### TELECOMMUNICATIONS INFRASTRUCTURE INDUSTRY

Hong Kong's role as a leading business centre in the Asia Pacific region owes much to its advanced telecommunications infrastructure. In 2016, the information and communications industry generated HK\$ 84.1 billion (US\$ 10.7 billion) in value added, contributing 3.5 per cent of GDP. To foster the ICT industry, Hong Kong government initiatives have included funding support, provision of infrastructure, international cooperation and human resources development. Besides, Hong Kong has a large pool of skilled ICT professionals, providing services to clients spanning a wide range of businesses.

**Source:** Hong Kong Yearbook, 2017.

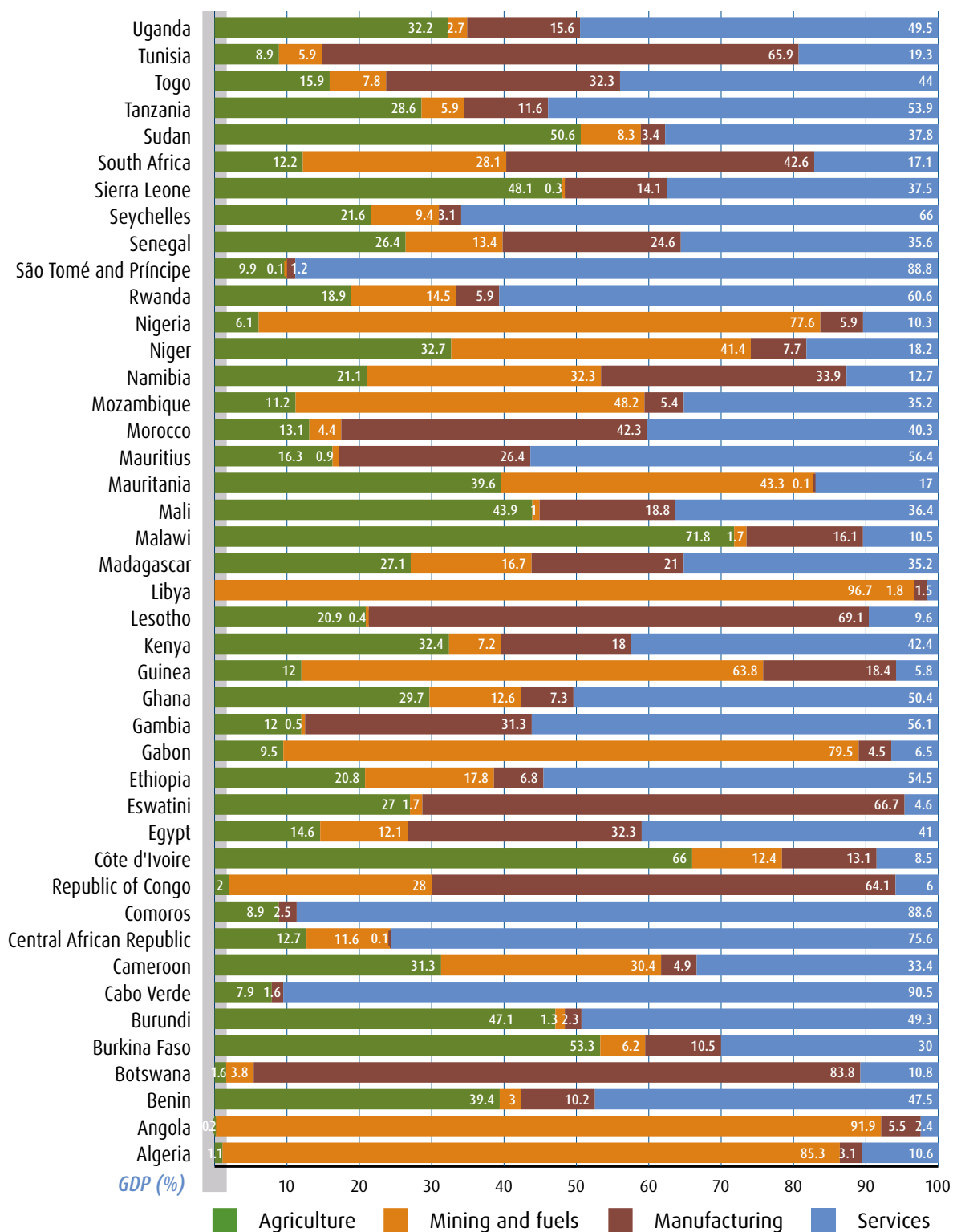
### LOGISTICS INDUSTRY

Air transport has become more important for Hong Kong's trade over the last few decades. Some 38 per cent of Hong Kong's exports and 45 per cent of its imports were transported by air in 2018, compared with 26 per cent of exports and 19 per cent of imports in 1980. The vibrancy of air transport is attributed to Hong Kong's efficiency in customs clearance and its status as a free port. Besides air cargo handling services, Hong Kong provides airport management services, especially in air cargo terminal operations, which can involve directly investing in overseas air cargo terminals or providing consultant services.

### FINANCIAL SERVICES INDUSTRY

Financial links between Hong Kong and the mainland have strengthened substantially over the years, thanks to increasing cross-boundary economic activities and the Central People's Government policy of enhancing Hong Kong's position as an international financial centre. As a major funding centre for mainland enterprises, Hong Kong saw 1,051 of them listed on its stock market as of the end of 2017. Of those, 55 were first listed in 2017, raising \$98.5 billion in equity funds, with \$365 billion in aggregate funds raised from initial public offerings and secondary financing.

**FIGURE 2.3** COMMODITY-BASED (AGRICULTURE, AND MINING AND FUELS), MANUFACTURING-BASED AND SERVICE-BASED ECONOMIES IN AFRICA, BY EXPORTS VALUE



**Source:** Based on World Trade Organization data.

**Note:** The classifications are based on the value of exports for each category (agricultural products, mining and fuels, manufactures, and service) as a share of the sum of the export value for the four categories. Figures for all countries are for 2016 except Comoros, Congo, Eswatini and Lesotho, where the figures are for 2013.

technology boom in Africa, particularly in mobile phones, has stimulated economic growth by, for example, promoting financial inclusion through mobile financial services and connecting farmers to markets (ECA, 2015).

Despite its promise, the service sector faces major challenges in moving from consumption-based growth to more durable growth and from subsistence and non-tradable services to services that generate greater value addition and growth (UNCTAD, 2015). Informality, a major feature of the economic and social landscape in Africa, also exists in such service sectors as health, construction, education and agricultural services. Regulatory barriers force service providers into informality, where they remain trapped, so governments lose the

beneficial interactions and linkages that would come from a better integrated domestic economy (Dihel and Goswami, 2016). Although the transition of firms from informality to formality offers opportunities for firms and governments, they may be too small to significantly reduce poverty or improve living conditions (AfDB, 2019).

As shown by the case of Hong Kong (see **BOX 2.4**), infrastructure is key in stimulating an economy's service sector. So, Africa needs to raise its investment in infrastructure, encompassing a range of subsectors, to diversify its economy and achieve its development goals. Strengthening input-output and demand linkages between agriculture, manufacturing and services is crucial.

## CHALLENGES TO PRIVATE SECTOR DEVELOPMENT

Easy, affordable and reliable access to infrastructure (particularly energy) and finance are the two most cited obstacles affecting the operation of businesses in Africa. Access to electricity is cited by 20.7 per cent of firms in Africa as the main obstacle, and finance by 19.6 per cent (**FIGURE 2.4**).

### TRANSPORT

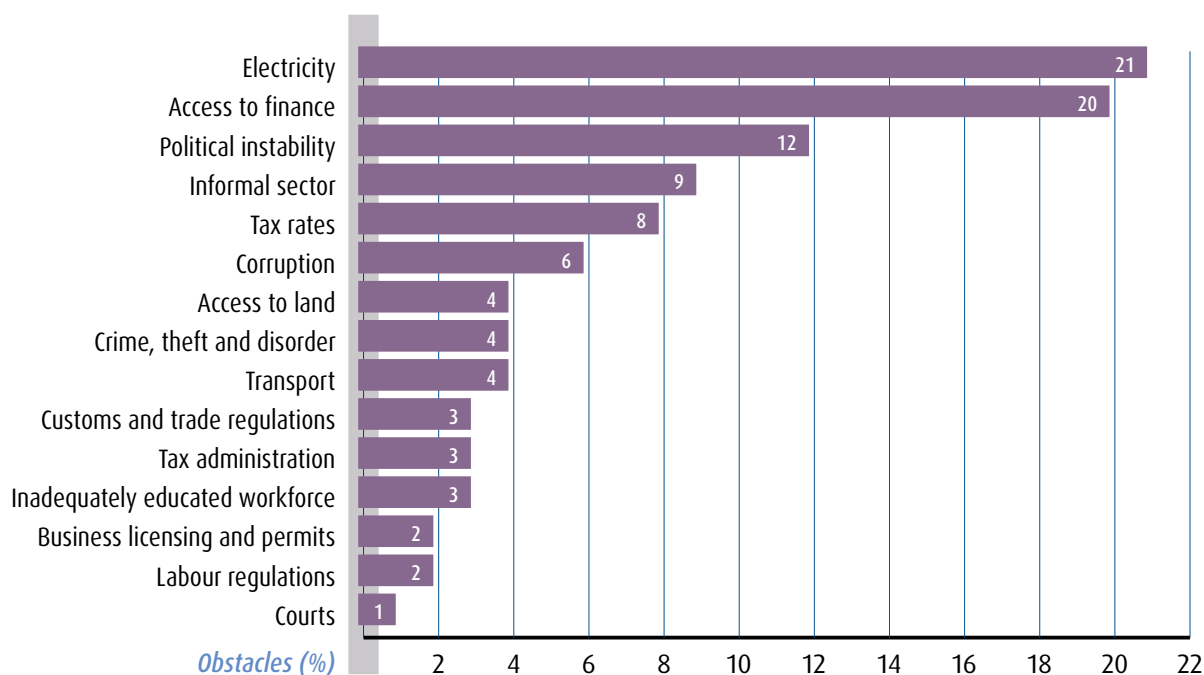
Transport is a catalyst for sustainable economic development and growth. Some 3.6 per cent of firms in Africa identified transport as the main obstacle to business (see **FIGURE 2.4**). Poor road, rail and port infrastructure increase cost, transit times and breakage or spoilage. Road freight tariffs in Africa are two to four times higher per kilometre than those in the United States, and travel times along key export corridors two to three times higher than those in Asia (AfDB, 2018). According to the World Bank Enterprise Survey (2007–2018), 1.9 per cent of the value of products is lost to breakage or spoilage during shipping to domestic markets in Africa.

Increased connectivity would facilitate and grow domestic, regional and international trade, lower the cost of doing business and make African nations more competitive, both within the continent and globally.

### ENERGY

About 590 million people in Africa lack access to electricity, and for those with access, the quality is generally poor and reliability unacceptably low compared with other regions of the world (ECA, 2020a). More African firms identify it than any other factor as their major constraint (see **FIGURE 2.4**). It is a greater obstacle for small firms in Africa than large ones (**FIGURE 2.5**). Some 79 per cent of firms in Africa experienced electricity outages between 2007 and 2018, and the average effective cost of electricity for manufacturing enterprises in Africa is close to 20 cents per kilowatt-hour, about four times higher than industrial rates elsewhere in the world (AfDB, 2018).

**FIGURE 2.4** MAIN OBSTACLES TO BUSINESSES IN AFRICA



Source: World Bank Enterprise Survey, 24 June 2019.

The high cost and unreliability of electricity in Africa debilitates private sector development in several ways. It affects manufacturing production, intensifies the cost of operating businesses, reduces government revenue, limits diversification among firms and forces them to focus on less energy-intensive activities (ECA, 2018b). Poor energy quality can impose additional costs due to idle workers, lost production or damaged equipment (AfBD, 2018). More reliable, affordable and efficient energy supplies enable firms to adopt new production techniques and technologies, raise productivity and facilitate the introduction of new economic activities (UNCTAD, 2017).

Energy demand in Africa is expected to increase dramatically due to population growth, a growing middle class, urbanization and climate change (ECA, 2020a). The energy challenge can be overcome, since the continent has sufficient resources and limitless opportunities to develop clean or renewable energy. The gap between demand and supply is a chance for the private sector to invest in the energy sector, to power industrialization and to stimulate growth, employment and trade, especially given the prospective benefits of AfCFTA (ECA, 2020a).

The UN Economic Commission for Africa (ECA) contributes to solving Africa's energy crisis by participating in regional initiatives that address energy insecurity and provides technical advisory services to member states by developing and assessing the regulatory environment for Africa's energy sector. Additionally, ECA recently developed a methodology

**“More reliable, affordable and efficient energy supplies enable firms to adopt new production techniques and technologies, raise productivity and facilitate the introduction of new economic activities”**

to assess the energy sector regulatory environment's effectiveness in Africa and trained officials from member states on energy modelling to improve energy performance (ECA, 2018b). ECA also conceived the SDG7 Initiative for Africa, which brings together countries' financiers and clean energy project developers to align their interests, combine scale and speed, and fast-track private sector financing for deploying clean energy projects (ECA, 2020a).

## **INFORMATION AND COMMUNICATIONS TECHNOLOGY**

Information and communications technology (ICT) is a transformational driver of economic and social progress. The growth of mobile telephony across Africa has been a notable success story improving people's lives in rural and urban areas. Although telecommunications costs in Africa have been falling sharply in recent years, they are still higher than in other developing regions. For instance, mobile and internet telephone charges in Africa are about four times higher than those in South Asia, and international call prices are more than twice as high (AfDB, 2018). It is estimated that 75 per cent of the population in Africa does not have internet access, and so does not have access to the knowledge, information and services that the internet can bring.<sup>4</sup> For example, affordable ICTs in agriculture could enable farmers to register their land, access credit, use land and water more efficiently and obtain weather, crop and market information (Sy, 2017).

To make internet connectivity as widespread and affordable as mobile telephones will require substantial public and private sector investment. But to date the flows of private investment into ICT in Africa have benefitted only a few countries where the required infrastructure is already well developed. An enabling environment needs to be introduced and managed so that the private sector delivers services equitably to all Africa's people, irrespective of age, gender, location or economic position. For example, uncompetitive pricing policies of mobile telephone operators—such as charging more for calls to competitor networks—that make ICT in Africa relatively expensive could be eliminated.

Encouragingly, sub-sea cable is experiencing a revival in Africa. Facebook Inc. and some of the world's largest telecom carriers, including China Mobile Ltd., are joining forces to build a giant sub-sea cable to bring more reliable and faster internet

**“Improved access to water and water-related services contributes to economic growth by increasing business productivity. It improves human health, productivity and dignity.”**

across Africa. The 37,000-kilometre long cable (referred to as “2Africa”) will connect Europe to the Middle East and 16 African countries. The project is expected to come into operation by 2024 and will have more capacity than all sub-sea cables currently serving Africa combined.<sup>5</sup>

## **WATER**

Water resources are essential in supporting all economic sectors—agriculture, manufacturing and services. Improved access to water and water-related services contributes to economic growth by increasing business productivity. It improves human health, productivity and dignity. But more than 300 million Africans do not have access to clean drinking water, and more than 700 million live without access to good sanitation.<sup>6</sup> The unavailability of clean water and sanitation results in approximately a 5 per cent loss of GDP in Africa annually, and people spend 40 billion hours a year of otherwise productive time just collecting water. The deficient water supply presents an opportunity for the private sector to upgrade and develop water and sanitation infrastructure and improve water system efficiency. But high capital intensity, large initial outlays, long pay-back periods, the immobility of assets and low rates of return generate high risks. The risks, combined with poor initial information and a weak investment environment, constrain private sector participation in water and sanitation infrastructure.

Governments should improve the enabling environment for investment in water-related infrastructure. For example, African governments should strengthen efforts to enhance macroeconomic stability—including fiscal, monetary and trade

policies—to attract private investments in water and sanitation projects. And they should regularly consult with the private sector to better understand the constraints hindering private sector investment and so determine how to address them. Such information is vital in designing effective policies. And transparency in dealings with the private sector and the inclusion of civil society in such dialogues is crucial to reduce corruption. Further, governments should create openness reducing information asymmetry and widening access to information on investing in water-related infrastructure.

## GOVERNANCE, POLITICAL INSTABILITY AND INSECURITY

Corruption deters private sector development and hence economic growth by discouraging foreign investments, increasing the cost of doing business, reducing the quality of services, distorting competitive markets and encouraging the misappropriation and misallocation of scarce resources (ECA and AUABC, 2011). Some 6.3 per cent of firms in Africa reported that corruption is a major challenge to their business operation (see [FIGURE 2.4](#)). To support private sector development, it is prudent for African governments to strengthen the capacity and enhance the independence of their anticorruption institutions. The fight against corruption requires coordinated efforts between governments, the private sector, civil society and international institutions.

Political instability and insecurity, among the critical challenges facing Africa, hinder private sector development. Political instability is a more pressing challenge for larger firms than for smaller ones ([FIGURE 2.5](#)). Insecurity takes various forms such as civil wars, criminal violence, political unrest and terrorism (UNCTAD, 2013). Inclusive growth

policies are required for preventing and resolving conflicts to promote peace and security and strengthen private sector development.

## PRIVATE SECTOR FINANCING

Although finance is the private sector's lifeblood (AfDB, 2011), in Africa its unavailability impedes private sector growth (UNCTAD, 2013). As reported by 19.6 per cent of firms (see [FIGURE 2.4](#)), it is a major obstacle to business operations (see also AfDB, 2019). Almost a quarter of small firms reported it as a major obstacle, as did about 13 per cent of large firms (see [FIGURE 2.5](#)).

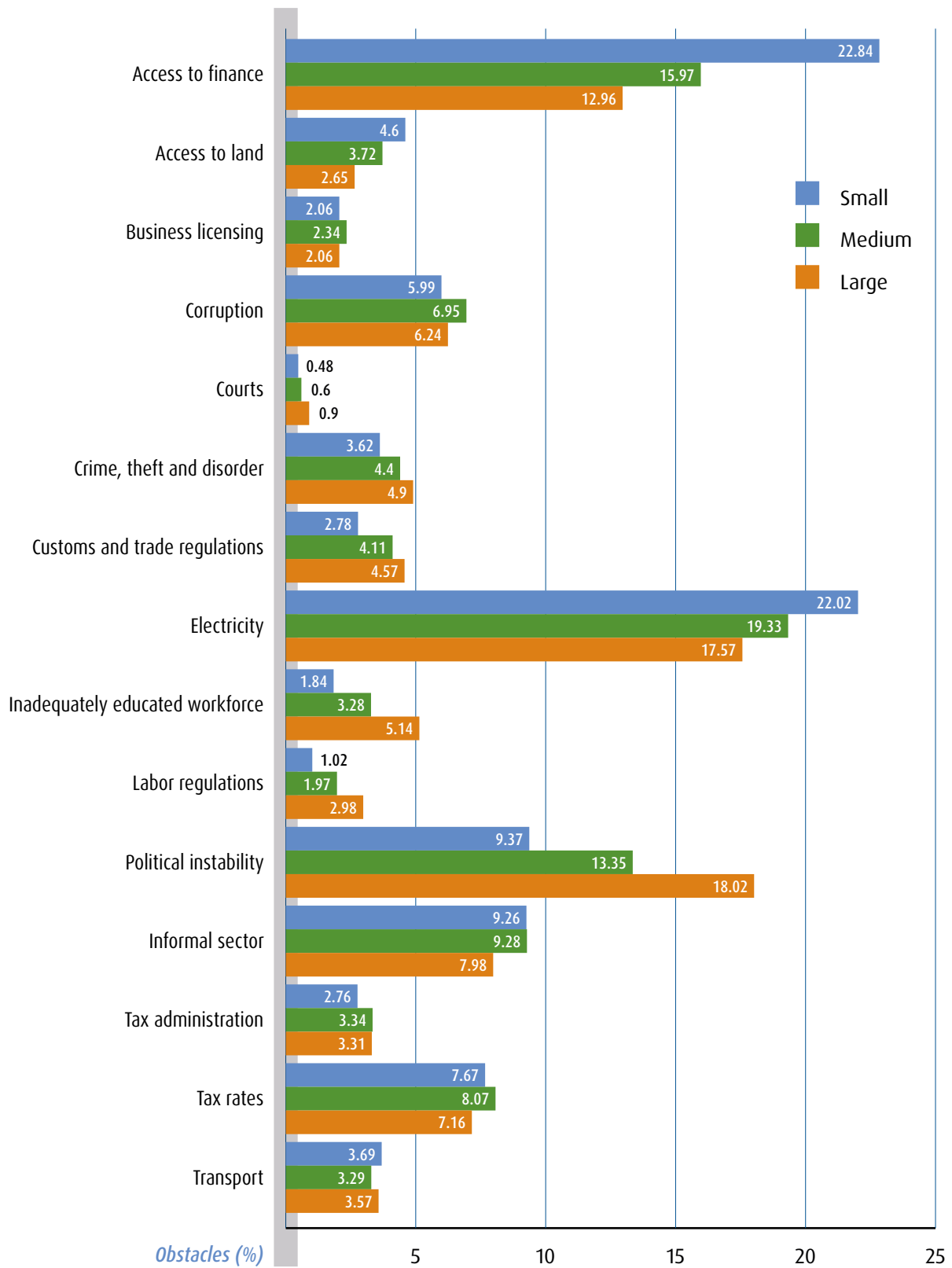
Almost 78 per cent of the working capital of small firms is financed from retained earnings or internal funds (World Bank Enterprise Survey, 2019). That proportion drops to 73 per cent for medium-sized firms and 70 per cent for large ones. Only 5 per cent of the working capital of small firms is financed by banks, but 13.7 per cent of the working capital of large firms—almost three times the proportion of the small ones—is financed by banks. Payables provide another important source of funding—meaning that working capital is financed by credit or advances from suppliers or customers. Among small firms the proportion of working capital financed from payables varies from 7.3 per cent in Central Africa to 15.8 per cent in Southern Africa. The proportion is higher among large firms.

The funding of such investments as machinery, vehicles, equipment, land or buildings follows the same pattern. On average, 40 per cent of firms purchased new or used fixed assets between 2007 and 2018.<sup>7</sup> The purchases were funded through internal funds or retained earnings (74.7 per cent for small firms and 67.9 per cent for large firms) or borrowing from banks (7.3 per cent for small firms and 18.6 per cent for large firms) (World Bank Enterprise Survey, 2019). Across all African regions, firms made very limited investments in fixed assets financed by non-bank financial institutions (1.8 per cent of the sources of funds), credits/advances from suppliers and customers (3.8 per cent) or equity (3.5 per cent).

So, internal funds and retained earnings are the main sources of firms' working capital and funds for purchasing fixed assets in Africa. They can be supplemented by borrowing from banks and by payables. The financing choices thus have a clear pecking order.

**“So, internal funds and retained earnings are the main sources of firms' working capital and funds for purchasing fixed assets in Africa”**

**FIGURE 2.5** MAIN OBSTACLES TO THE OPERATION OF BUSINESSES IN AFRICA, BY COMPANY SIZE



Source: World Bank Enterprise Survey, 24 June 2019.



The sources of finance can constrain firms. Even if 40 per cent of large firms have access to credit, 60 per cent of the credit is short-term—that is, with a term of less than one year. The wider provision of short-term credit stimulates entrepreneurship by allowing entrepreneurs to apply for a formal loan instead of relying exclusively on informal loans or internal funds (Leon, 2019). But short-term credit is not suitable for infrastructure projects, which require long-term financing. And unless the infrastructure gap can be overcome, firms' financing alone may be insufficient to develop businesses.

Africa's financial services sector is dominated by commercial banks, with very few investment banks. National development banks and specialized banks (such as agricultural banks) tend to be dysfunctional due to political intervention and limited ability to raise external finance. Commercial banks are therefore the main source of finance for businesses, households and governments. Africa's banking sector is underdeveloped, with 90 per cent of bank loans having short to medium terms (less than 5 years) (Fosu et al., 2017). The current structure of bank loans is unsuitable for innovation projects that require patient investors.

A second challenge is a mismatch between firms' financing and their growth cycles. The business life cycle is most commonly divided into five stages: launch, growth, shake-out, maturity, and decline. At launch, the business risk is the highest because the level of sales is the lowest. During this period, it is impossible for a company to finance its activity through debt, and so venture capital is more appropriate. During growth business risks decrease, while companies' ability to raise debt increases, so companies can use debt, as well as private equity such as development capital, to expand their market and diversify their business. During the shake-out or sales peak phase, companies prove their successful positioning in the market, exhibiting their ability to repay debt. Therefore, companies can finance their activities through debt. This is also true for mature firms. But in decline, a company's sales decrease at an accelerated pace, reflecting an inability to extend the life cycle by adapting to a changing business environment. Buy-out or buy-in funding is appropriate during decline. Technological innovations and banking and non-banking sector innovations are needed to overcome the shortage of funding for the private sector in Africa.

Financing the private sector is intimately connected with the work of rating agencies because the premium to be paid by companies that borrow money from banks or capital markets is related to their level of risk and/or the level of risk of the country in which they operate. In Africa, only 32 countries are rated by the three big agencies—Moody's Investor Services, Standard and Poor's (S&P) and Fitch Group. According to Moody's, only Botswana has an upper-medium grade, meaning low credit risk. Other countries bear moderate or (very) high credit risk. These ratings mean that African economies, in general, should not expect favourable credit conditions in the capital markets. Firms in the lower-rated countries must pay higher premiums for funding, which increases the cost of capital and can hinder the development of the private sector. Finally, information asymmetries between lenders and borrowers, a problem in financial markets, and how equilibrium can be reached in a market characterized by credit constraints and information asymmetries have been examined in theoretical and empirical literature, by Jaffee and Russel (1976) and Stiglitz and Weiss (1981), among others.

## POTENTIAL IMPACTS OF COVID-19 ON AFRICAN BUSINESSES

COVID-19's implications for overall socioeconomic development are undeniable. The pandemic's global effect on the supply chain, particularly on private sector survival, is huge. The negative implications for the private sector have been amplified by the restrictions countries have established to prevent, respond to and mitigate the pandemic's effects.

In Africa 42 countries had instituted localized or national lockdowns as of 4 May 2020, disrupting economic activities and affecting millions of people. The quarantines and lockdowns have affected African businesses (ECA, 2020b). For example, according to ECA and IEC (2020), Africa's small firms are operating at 30–40 per cent of capacity, and large firms at 50–60 per cent. In the services sector firms are operating at 40–50 per cent of capacity, and firms producing goods at 30–40 per cent. African businesses expect a slow recovery from the crisis and a drop in revenues by an average of 30–40 per cent, with small companies expecting to be affected worse. African firms have also been affected in sourcing raw materials from both local and international suppliers. Firms in goods have been affected almost twice as much as firms in services (ECA and IEC, 2020).



African businesses are burdened by fragmented and low-density economic activity, limited access to finance, government bureaucracy, shortage of skilled labour and market inefficiencies. But they are expanding efforts both to survive the crisis and to reduce its damage to African economies and societies. The private sector finds itself at the epicentre of the health, socioeconomic (including trade, travel and tourism, and employment) and finance (including fiscal risk) dangers and threats posed by COVID-19. Reduced productivity, trade and corporate earnings (as industrial firms operate at reduced capacity); investment and remittances flows; and investor confidence—with cautionary capital outflows—all affect the operations and the survival of businesses.

Many countries implemented stimulus packages to address these shortfalls. But they face revenue losses due to commodity price shocks and economic disruptions, which constrain their ability to finance public health expenditures to contain the virus and to finance stimulus packages to protect people and businesses. Targeted support for the private sector—which contributes more than 80 per cent of government revenues and generates more than 70 per cent of jobs in Africa—will help revitalize economies risking collapse or bankruptcy due to COVID-19. And the crisis provides businesses an opportunity to play a critical role in the recovery of African economies. The private sector, to counter the pandemic's effects, can guarantee continued employment, maintain productivity, stabilize supply chains, mobilize private capital to finance stimulus packages and leverage new business and financial models powered by technology (such as fintech and the cashless economy).

## WHAT SOLUTIONS FOR FINANCING PRIVATE SECTOR DEVELOPMENT IN AFRICA?

### **BANK AND FINANCIAL SERVICE RESPONSES TO PRIVATE SECTOR FINANCING NEEDS**

Pan-African banks are expanding rapidly across the continent, creating cross-border networks and establishing a systemic presence in the banking sector of many African countries. They foster financial development and economic integration, stimulate competition and efficiency, introduce product innovation and modern management and information systems and bring higher skills and expertise to host countries (Enoch et al., 2015; Pelletier, 2018). The increasing presence of pan-African banks is associated with improvements in access to bank finance (Kanga et al., 2018; Leon and Zins, 2020).

The expansion of Islamic banks is another opportunity for the private sector in Africa. Islamic finance has considerably

expanded with assets increasing from \$150 billion in the 1990s to \$1.8 trillion in 2013 (Kuwait Finance House, 2014). Islamic banks are particularly active in Middle East and North African countries and Southeast Asian countries. Recent analysis shows Islamic banking development improves access to credit where conventional banking development is low (Leon and Weill, 2018). Islamic banking can thus substitute for conventional banking. Further, Islamic banks can operate more easily in some countries sensitive to political risk, compared with conventional banks (Belkhir et al., 2018). The immunity of Islamic banks to those risks can be explained by risk sharing between financial institutions and their customers and by the prohibition of speculation in Islamic finance (Kammer et al., 2015), the higher level of capitalization of Islamic banks (Beck and Demirgüç-Kunt, 2013) and the higher deposit growth rates in Islamic banks (Khan, 2010) than in conventional banks.

Above all, the banking sector is undergoing a deep transformation by the use of new technologies, such as biometric technologies (fingerprint, iris, voice and face recognition technologies) and robo-advisors. The banking sector in Africa can use these new technologies to create more customers. First National Bank in South Africa developed a new mobile app that uses fingerprint-enabled logins and allows some customers to use secure chat to discuss their finances directly with a staff member, saving the customers time. Such an initiative should help banks tackle fraud and compete with other sources, including telecom providers.

## NON-BANK FINANCIAL INSTITUTIONS

Non-bank financial institutions are financial institutions not regulated by the central bank. The most active ones in Africa are microfinance institutions, savings and loan associations, insurance firms and housing finance companies.

Retirement fund accounts in Africa are estimated to hold more than \$380 billion, invested mainly in term deposits and other fixed income securities (Sy, 2017). If these institutions participated effectively in the capital market, as they do in developed economies, their assets could finance long-term private sector investments.

According to the African Insurance Organisation (2019), African insurance premiums amounted to \$66.7 billion in 2017, representing a very small share of \$4.89 trillion in global insurance premiums, and equal to an insurance penetration rate (ratio of insurance premiums to GDP) of 2.8 per cent (compared with a global rate of 6.1 per cent and a rate of 3.2 per cent for emerging markets). Despite its small size, the African insurance sector could grow fast and generate more profit by addressing timely issues such as climate financing, microinsurance for entrepreneurs and index-based insurance. Index-based insurance, for example, a fairly new approach, pays benefits based on a predetermined index such as rainfall, seismic activity or livestock mortality rates for asset and investment losses (primarily working capital) resulting from weather or catastrophic events. It does not require the traditional services of insurance claims assessors (World Bank, 2019). It aims to reduce risk and increase the investment and income of smallholders. The uptake of such products is still low in developing countries.

## ALTERNATIVE SOURCES OF PRIVATE SECTOR FINANCING

One alternative mechanism for long-term financing is public-private partnerships (PPPs). According to the World Bank, a PPP is “a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance.”<sup>8</sup> PPPs have been used to finance many infrastructure projects in Africa. But for a long time, they have been criticized and generally have not met expectations. In the poorest countries the use of PPPs has been limited due to higher than expected project costs and lower than expected profits (Leigland, 2018). To be effective the collaboration between public and private sectors should be based on embeddedness, discipline and accountability (Rodrik, 2013).

Another alternative financing source is financial instruments such as bonds. The bond market can include company bonds as well as government bonds. The corporate bond market remains underdeveloped or even non-existent in many African countries. The recent success of government bond issues in many countries shows huge potential for such instruments. Banks can finance themselves by issuing covered bonds—bank bonds that benefit from both full recourse to the issuer and security from a revolving pool of assets, typically mortgages or public-sector receivables.<sup>9</sup> One advantage of covered bonds is that they can address risks associated with maturity transformation. These allow banks to increase their lending to the private sector. There is no covered bond market in Africa. South Africa has approved a law for such a market, but it is not functioning yet, and Morocco has released draft covered bond legislation but has not yet approved the final law.

Green bonds are another alternative source for private sector finance. Green bonds are any type of bond instrument whose proceeds will be exclusively applied to finance or refinance projects aligned with the four core components<sup>10</sup> of the Green Bond Principles (ICMA, 2018). The green project categories include renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, sustainable water and wastewater management and climate change adaptation.

One way to improve funding to the private sector, particularly to alleviate the constraints facing SMEs in accessing finance, is the use of credit guarantee schemes, which provide guarantees on loans by covering a share of the default risk of the loan (EIB, 2014). Credit guarantee corporations (CGCs) provide financial institutions with credit guarantees on the repayment of SME loans; in return SMEs pay guarantee fees to CGCs to secure credit guarantees. Specialised guarantee funds also support finance for SMEs (BOX 2.5).

Finally, financial technologies (Fintech) offer an alternative source of private sector finance. Fintech refers to broad range of technological innovations in the financial sector that enhance or change the way financial services are provided (Philippon, 2016). Fintech firms target areas in the financial sector where traditional institutions are not providing services or are providing them poorly, perhaps due to regulatory challenges. Fintech developments have been fuelled by breakthroughs in mobile networks, big data, trust management, mobile embedded systems, cloud computing and data analytic techniques (Gai, Qiu and Sun, 2018). By leveraging mobile technology, they can significantly reduce financial market imperfections associated with banking for microenterprises (such as information asymmetries and transaction costs), making it easier to extend credit to these small businesses.

## TRADE FINANCE AND ITS IMPACT ON THE GROWTH OF BUSINESSES

Trade finance concerns financial activities involved when a buyer purchases goods or services from a seller in international and domestic trade transactions: the World Trade Organization has called trade finance a “lubricant” of trade. It is a huge driver of economic development by helping to maintain the flow of credit in supply chains. An estimated 80 to 90 per cent of global trade relies on trade finance, worth around \$10 trillion annually (WTO, 2016), though a \$1.5 trillion trade finance gap remains, half is attributable to emerging markets in Africa and Asia (Orbitt, 2019).

By providing liquidity to businesses, trade finance enables business growth in several ways. At its core, it provides more working capital for better cash flow management. Business owners can fulfil larger orders than ordinarily would be possible. And businesses can leverage the trade finance facility to buy supplies in bulk up front at lower cost, strengthening the relationship between buyers and sellers. Trade finance enables businesses to enjoy greater efficiency and productivity.

Trade finance also reduces payment risk for businesses by shifting the risk to a financial institution. Late payments from debtors, bad debts, excess stock and demanding creditors can quickly cripple SMEs, which depend on effective

### BOX 2.5 GUARANTEE FUND

A guarantee fund provides some form of guarantee to members investing in the fund, usually on the capital invested or on a minimum rate of return. Guarantee funds are created to facilitate lending to SMEs in the riskiest phases of their financing cycle. They allow financial institutions to share and reduce risk when lending to SMEs, thanks to support from governments and international organisations. The guarantee does not insure the borrower against the risk of default. The guarantor usually charges the borrowing SME a guarantee fee or reserve charge for

providing the guarantee. Guarantee funds operating in Africa include some incorporated in African countries—African Guarantee Fund, Agricultural Credit Guarantee Scheme Fund in Nigeria and others—and some incorporated abroad—among them NASIRA Risk-Sharing Facility, African Local Currency Bond Fund and Africa Green Co.

The African Guarantee Fund (AGF) was incorporated under the business laws of Mauritius in 2012. It is a public-private partnership offering partial guarantees and capacity

development to financial institutions to increase their financing to African SMEs. By December 2018 AGF had signed 261 guarantee agreements worth \$878 million. The banks used these guarantees to leverage up to \$1.8 billion in financing for 20,500 SMEs, of which \$1.33 billion has already been disbursed. The portfolio under management as of 31 December 2018 was \$515 million, once expired guarantees were excluded. AGF guarantees contributed to SMEs directly creating around 120,000 jobs by the end of 2018.

**Source:** AGF, 2018.

cash management. External financing or revolving credit facilities can ease these pressures and prevent an SME from succumbing to the risks. Where trade finance functions well, firms can participate in global value chains—buying cheaper inputs, supplying more competitive products and contributing to employment and productivity growth (Auboin and DiCaprio, 2017). According to Gajigo, Triki and Drammeh (2014), lack of access to trade finance is a key obstacle to low-income countries participating in global value chains.

In Africa, domestic and international banks account for more than 30 per cent of trade transactions, while bank-intermediated trade finance is estimated at just 20 per cent of the continent's total trade (Orbitt, 2019). Nearly all commercial banks in Africa engage in trade finance, generating an estimated 17 per cent of bank income, according to the African Development Bank. But Africa's large corporations absorb a huge share of this trade finance, while SMEs and first-time applicants face significant challenges in accessing credit from banks (Orbitt, 2019). Among the main obstacles limiting SME access to trade finance are the increasing compliance and regulatory burden.

Innovative approaches include using technology to help change the trade finance game. Digital solutions are being used to support the internal trade finance processes of African banks, development finance institutions and alternative lenders, with Ecobank's OMNI eFSC (electronic financial supply chain) software is of note. Even so, these solutions exist in silos with disjointed usage and application.

So, adequate trade finance provides opportunities for growth and greater participation in global value chains for businesses in developing countries. A trade finance gap, particularly burdensome for SMEs, presents an opportunity for African banks and other private credit markets. There is need to enhance the capacity of the local financial services sector to support trade in Africa.

## **MERGERS AND ACQUISITIONS AND IMPACT ON GROWTH OF BUSINESSES**

Mergers and acquisitions (M&A) continue to play key roles in the growth of businesses and serve important economic functions in rewarding competitive firms. In a merger two firms combine their operations to varying degrees, with both

firms retaining control. In an acquisition one firm obtains a controlling stake or the entirety of a target firm. Most recent M&A transactions occur in the same or related industries—unlike in the 1980s, when they often involved entities operating in different fields of business or industry (Kang and Johansson, 2000). Increased competition in the global market has promoted M&A as an important strategic choice (Bharara and Latwal, 2013) and reflects the need to restructure and strengthen global competitiveness in core businesses (Kang and Johansson, 2000).

The global M&A market remained strong in 2019 with announced transactions reaching \$4.1 trillion in value, a slight decrease of \$20 billion from 2018. Activity was largely driven by megadeals (greater than \$10 billion in size), which accounted for 31 per cent of 2019 deal value. But 2020 will likely see a drop in M&A activity as firms try to free up liquidity to weather the effects of the COVID-19 lockdown. In 2020 Q1 (first quarter of 2020), M&A activity dropped by 35 per cent year on year. Many announced deals are likely to be cancelled or postponed, such as Xerox's withdrawal from the \$35 billion acquisition of HP, and Sycamore Partners, a private equity firm, suing to walk away from its planned acquisition of a 55 per cent stake in Victoria's Secret from L Brands (Cristerna et al., 2019).

In 2019, the total value of announced deals in Africa decreased to \$23 billion from \$25 billion in 2018, an 8 per cent decrease. High value cross-border mergers and acquisitions have remained largely stable, while deals within countries are increasing. From 2018H1 (first half of 2018) to 2019H1 the total value of cross-border deals rose from \$13.7 billion to \$13.8 billion, but domestic activity rose 272 per cent from \$1.8 billion to \$6.7 billion.<sup>11</sup> And the recent launch of the operational phase of the AfCFTA agreement should additionally boost activity in coming years as businesses seek to scale up to capitalize on the free trade area's larger market.

M&A activity has varying impacts on business growth. For example, cross-border M&A activity can enhance efficiency in the target's country through technology transfer, industry restructuring and increased competition. According to a study of British firms, foreign take-overs raised productivity (output per employee) and real wages, mainly due to higher investment per employee by the new foreign owners. Firms acquired by foreign investors can create competition with incumbents

in the target's country with the help of parent company financial resources and advanced management know-how (Kang and Johansson, 2000).

Business performance may be improved by M&A activity. In 2018, Bayer AG acquired Monsanto Co. for \$63 billion, forming an agribusiness behemoth that captures a quarter of the world's seed and pesticide markets with over \$27 billion in annual sales. Savings from synergies due to the merger are expected to reach \$1.5 billion after three years. A study in East Africa (measuring firm performance by the return on equity and cumulative abnormal returns) also found that M&A activity improves firm performance, though it found that cross-border M&A activity is less effective than domestic M&A activity in doing so (Juma et al., 2017).

M&A activity enables firms to achieve economies of scale through specialization and bulk purchasing, lowering operating costs. It also enables firms to secure limited resources they otherwise could not obtain. Producers are more able to secure access to primary resources to enhance production. This has happened in Chinese-led acquisitions in foreign markets targeting agricultural companies or meat, pork and

poultry producers (M&A Worldwide, 2017). M&A activity enhances technological capacity. With technology allowing companies to develop a competitive edge, M&A activity has sped technological innovation in the target company due to knowledge transfer. But in some cases, the target transfers knowledge to its acquirer or partner. Both the acquired and acquiring companies can expand their marketing and distribution strategies, increasing earnings and profits.

Changes in corporate culture due to M&A sometimes lead to emotional and physical problems (Bharara and Latwal, 2013). Chance (2013) emphasizes that cultural integration issues sometimes disrupt plans for European acquisitions even though Europe is generally considered homogeneous and developed in economic and business culture. Another crucial drawback of M&A activity is acquiring firms crowding out smaller industry constituents, creating oligopolies. This practice stifles innovation and dramatically reduces competition, ultimately at the cost of the consumer. So, M&A activity can only be a boon for emerging markets and an opportunity for rapid development of industries if a strong trade competition regulation framework is in place to ensure that a M&A does not come at the expense of innovators and smaller businesses.

# THE POTENTIAL ROLE OF THE AFRICAN CONTINENTAL FREE TRADE AREA IN PRIVATE SECTOR DEVELOPMENT

## INCREASED PRODUCTIVITY AND COMPETITIVENESS THROUGH REGIONAL VALUE CHAINS

The African Continental Free Trade Area is expected to provide momentum towards consolidating regional economic communities and the Tripartite Free Trade Agreement, with more communities having to align themselves with the provisions and obligations of the agreement establishing the AfCFTA.

Under the AfCFTA, it is assumed that tariff and non-tariff barriers will be reduced, lowering the cost of doing business for African firms and so boosting their competitiveness. Through the AfCFTA, firms in Africa will have access to new or larger markets and thus greater revenue. More income will enable firms to invest in new technology, boosting their productivity and competitiveness. Access to new markets may also enable firms to source raw materials of better quality and in bulk. Through economies of scale, the final unit price of output will be reduced, boosting firm competitiveness. And firms obtaining new or better-quality raw materials can develop innovative and specialized products for various market niches, again boosting firm competitiveness. AfCFTA will provide firms with opportunities to learn by doing, enabling employees to acquire new knowledge and skills. For instance, such skills could include a better way of handling and processing customer orders, thus enhancing customer satisfaction and contributing to the firm's competitiveness.

Africa's service sector, dominated by low value added and informal transactions, does not exhibit sufficient competitiveness, sophistication or efficiency to act as a backbone of economic activity for industry and agriculture, except for a few subsectors in a few countries (ITC, 2017). AfCFTA could provide service suppliers the scale of operations they need

to boost competitiveness, in turn contributing to improved trade facilitation on the continent, increasing trade in goods and so strengthening the gains from AfCFTA (UNCTAD, 2019). By liberalizing trade in services, the AfCFTA promises to maximize the benefit of goods trade liberalization, since many goods traded embed or embody services in their production. Beyond creating additional jobs, these services not only contribute to completing the production of tradable goods, they also add significant value and thereby generate greater export revenue. More important, these services may create opportunities for regional value chain development, since several countries on the continent have become service economies, as discussed earlier. These economies would have the capacity to supply services widely in the continental market of the AfCFTA if non-tariff barriers are eliminated. The expansion would reduce the import dependency of the service trade in Africa in the long run and improve the continent's ability to compete in both goods and service trade.

**“Under the AfCFTA, it is assumed that tariff and non-tariff barriers will be reduced, lowering the cost of doing business for African firms and so boosting their competitiveness”**



Two backbone services are prerequisites for trade. They are transport, to bring produced goods from the farm and factory gates to ports and subsequently to markets, and financial services (such as letters of credit and trade insurance services) to allow importers and exporters to make and carry out trade transactions. In the AfCFTA's service trade liberalization, these two backbone services, as well as others with economic significance for Africa, are being frontloaded. Member states involved in service trade negotiations have agreed to prioritize five sectors: business services, communication services, financial services, tourism and transport services. Service liberalization in the continental market thus offers benefits from the AfCFTA on top of the expected gains from goods trade.

## **ENHANCED ACCESS TO FINANCE FOR BUSINESS**

SMEs have low chances of survival and expansion due to a range of constraints on their profitability. In the AfCFTA, the creation of new and larger markets, matched by possibilities to produce at a larger scale behind protective walls and to learn

by exporting, can raise the odds of SME survival and expansion in the regional and global markets. With larger markets SMEs will be able to generate more profits to plough back into the business to serve as finance in form of retained earnings.

Under the AfCFTA, it is assumed that tariff and non-tariff barriers to trade will be reduced and so reduce the cost of business operations. But that benefit may have less impact over time, and so firms will need to employ other, non-price strategies to remain competitive. The private sector may urge governments to support improvements to the investment climate to attract foreign direct investment, which would be a source of financing for business.

Also, under the AfCFTA, it is expected that firms will disclose information and that the execution of business transactions will be transparent. This reduces information asymmetry and thus minimizes uncertainty and the concern that would otherwise affect both local firms and potential investors. So, transparency can act as another lure to domestic and foreign investors, thus enhancing firms' access to finance (UNCTAD, 2019).

# CONCLUSION

This chapter's headline message is that the private sector in Africa is the engine of growth. The agriculture-based economies in Africa need to modernize to increase productivity, so finance will be needed to purchase farm inputs and farm machinery. A large proportion of Africa's manufacturing firms are small, translating to poor export performance. Manufacturing-based economies must scale up and expand their manufacturing firms to catch up with other developing countries, such as the Asian countries. The service industry in Africa presents immense potential for growth and economic development. The AfCFTA presents an opportunity for service-based economies to move from consumption-based growth to more durable sources of growth and shift from relying on subsistence and non-tradable services to services that generate greater value addition and growth. The AfCFTA can also support the development of regional value chains, where manufactures that heavily rely on embedded and embodied service inputs source such inputs locally in the continental market, creating jobs and adding value.

Infrastructure services such as transport, energy, ICT and water are important for private sector development. The huge deficits in these services hinders private sector development. At the same time, those deficits offer an opportunity for the private sector. This chapter emphasized that unavailable finance is one of the major impediments to private sector development in Africa.

The recent outbreak of COVID-19 threatens the private sector in Africa and aggravates its already major challenge in finding financing. Other challenges to private sector financing include information asymmetry, the lack of a credit rating for many countries, the domination of the financial service sector by commercial banks and the mismatch of financing with firms' growth cycle. The banking sector, non-bank financial institutions and fintechs have important roles in private sector financing. Finally, the AfCFTA presents an opportunity for firms to access finance and increase firm competitiveness and productivity.



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## ENDNOTES

- 1 UNOSSC, 2019.
- 2 Making Finance Work for Africa, n.d.
- 3 EURACTIV, 2018.
- 4 ICA, n.d.a.
- 5 Rascouet, Prinsloo and Seal, 2020.
- 6 ICA, n.d.b.
- 7 Fixed assets stand for further investments such as machinery, vehicles, equipment, land or buildings.
- 8 PPPLRC, n.d.
- 9 Definition taken from Euromoney (n.d.).
- 10 The Green Bond Principles have four core components: use of proceeds, process for project evaluation and selection, management of proceeds and reporting.
- 11 Africa on the Rise, 2019.



CHAPTER 3

ACCESSING FINANCING  
FROM THE CORPORATE  
BANKING SECTOR  
IN AFRICA



**M**ost financing mechanisms in Africa are bank-based, and banks are a major source of innovative financing in Africa. By expanding the breadth of financing instruments and enhancing financial inclusion, innovations in retail and corporate banking provide opportunities for borrowers and savers alike, enabling the private sector to improve economic prospects across the continent.

The retail and corporate banking sector in Africa holds more than 90 per cent of the assets in the financial sector. But Africa's banking sector is comparatively underdeveloped when benchmarked against those in emerging market economies in Asia and other industrializing economies. Its assets represent less than 60 per cent of GDP on the continent, compared with more than 100 per cent in other emerging and advanced economies. Addressing the huge financing gap for the private sector and infrastructure development will require more innovative financing solutions in the retail and corporate banking sector.

Despite an overall increase in banking activities, bank financing to the private sector remains low and ill-tailored to the needs of private firms. For example, more than 90 per cent of bank loans are short- to medium-term. Private sector access to financing is impeded by government dominance of banking credit and difficult access for small and medium-sized enterprises (SMEs) and for key sectors of the economy.

Over the past two decades, the banking sector has changed fundamentally in many African economies. Pan-African banks now conduct business in multiple countries. The African banking sector has also made significant advances in mobile banking and marketplace lending, connecting unserved and underserved communities to the financial sector. The resilience and continued development of the banking sector (especially in the face of external shocks or crises such as COVID-19) offer the promise of more progress to come, enabling banks to provide needed funding, to channel savings into investments and to participate more actively in the formal economy.



# AN OVERVIEW OF RETAIL AND CORPORATE BANKING

At the time of political independence, most African banks engaged mainly in traditional financial practices, operating as financial intermediaries transferring flows of funds from short-term deposits (from savers) to longer-term borrowers. Traditional banks generally serve two groups of customers: retail (individual) customers and corporate customers. This report focuses largely on corporate banking and the products and services available to the private sector.

The retail and corporate banking sector is a crucial source of funding for private sector investment. According to pecking-order theory, firms prefer sources of finance that dilute ownership and profitability the least. Thus, firms turn first to retained earnings and cash on hand, which have no inherent cost and do not change the ownership structure of the firm. If there are not enough internal funds, firms seek debt funding before turning to equity funding; debt funding leaves the ownership structure of the firm unchanged, and interest expenses are generally regarded as cheaper than the cost of equity, especially because interest expenses are often tax deductible. As a last resort, firms issue equity and dilute ownership in the company to secure funding.

Firms in Africa report that access to financing remains a key constraint to firm entry and growth, second only to a reliable source of electricity (see [CHAPTER 2](#)). Large firms tend to benefit more from bank financing than do SMEs, as their track record and scale reduce their risk profile. Smaller, newer companies and those in the informal sector often face higher borrowing costs, if they are able to borrow at all.

## CURRENT FINANCING MECHANISMS FOR BUSINESS FIRMS

Most bank loans to the private sector are short- to medium-term in tenor. Often, however, businesses need financing for longer-term projects, such as to purchase fixed assets or property to expand capacity. Common loan types are shown in [TABLE 3.1](#).

## HOW FIRM SIZE AFFECTS ACCESS TO FINANCING

Firm size can have pronounced effects on access to financing. Large companies are more likely to get loans and more likely to get favourable terms. SMEs can be effectively shut out of bank financing.

When considering a loan application, banks look at a variety of factors—reputation and credit history of the firm, management, ability to repay the loan, industry and current capital structure. A small business with little track record of profitability or a highly indebted firm is less likely to get favourable terms. Thus, bank financing tends to favour larger businesses with histories of profitability (American Express, 2019).

The psychology of management can also affect a firm's ability to access financing. Lines of credit are among the most common forms of bank financing because they give firms the flexibility to use cash most efficiently, without having to worry about the cash balance to fund working capital. The low interest rates are especially attractive for firms that can qualify. According to the World Bank Enterprise Survey (2019) database, 40 per cent of large companies have a line of credit or loan from a financial institution. The proportion drops to 26 per cent for medium-size companies and to 13 per cent for small companies ([FIGURE 3.1](#)). The higher proportion of large companies with access to finance may also be partly explained by their higher rate of loan applications, with 30 per cent of large firms applying for loans compared with 15 per cent of small firms.

Most companies do not apply for a credit line or a loan because they do not need one (49 per cent) or because the application procedures are too complex (13 per cent), interest rates are unfavourable (16 per cent) or collateral requirements are too high (10 per cent).

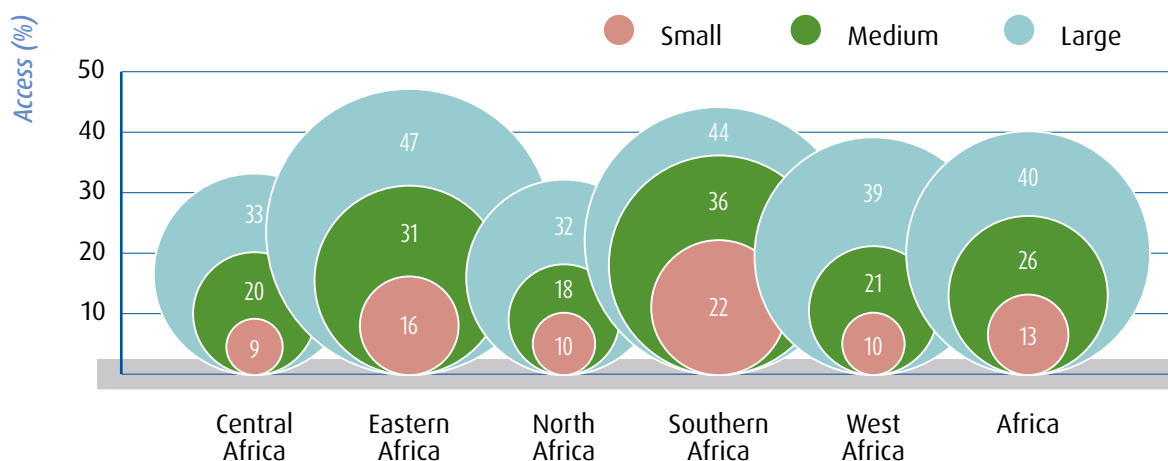


**TABLE 3.1** OVERVIEW OF MAJOR TYPES OF FINANCING MECHANISMS FROM BANKS

LOAN TYPE	LOAN TENOR	DESCRIPTION
<b>Commercial loan</b>	Short-term	<ul style="list-style-type: none"> <li>Generally requires collateral.</li> <li>Not typically used by smaller businesses.</li> </ul>
<b>Term loan</b>	Variable	<ul style="list-style-type: none"> <li>Has a pre-specified payment plan.</li> <li>Can have varying rates.</li> </ul>
<b>Lines of credit</b>	Short-term	<ul style="list-style-type: none"> <li>Have built-in flexibility and lower rates.</li> <li>Generally require collateral.</li> </ul>
<b>Equipment loan</b>	Variable	<ul style="list-style-type: none"> <li>Used to fund equipment purchases.</li> <li>Can have varying rates and tenors, based on pre-specified agreement with bank.</li> </ul>
<b>Real estate loan</b>	Variable	<ul style="list-style-type: none"> <li>Used to fund construction costs or property.</li> <li>Can be short-term for construction or longer-term for property purchases.</li> <li>Can take longer to process, with stricter terms and conditions.</li> </ul>
<b>Leasing</b>	Short-term	<ul style="list-style-type: none"> <li>Like an equipment loan, but no transfer of ownership from the seller.</li> <li>Cheaper than an equipment loan.</li> <li>More suitable for equipment with frequent technological updates.</li> </ul>
<b>Syndicated loan</b>	Variable	<ul style="list-style-type: none"> <li>Like a term loan, but with multiple creditors, which spreads out default risk.</li> <li>Administered by a bank.</li> <li>Usually preferred by companies with higher risk that may struggle to obtain term loans.</li> </ul>

Source: United Nations Economic Commission for Africa.

**FIGURE 3.1** ACCESS TO A CREDIT LINE OR LOAN FROM A FORMAL FINANCIAL INSTITUTION IS HIGHEST AMONG LARGE FIRMS AND LOWEST AMONG SMALL FIRMS (PER CENT)



Note: Large firms have 100 or more employees, medium-size firms have 20–99 employees and small firms have fewer than 20 employees.

Source: Based on data from World Bank Enterprise Survey, 24 June 2019.

# THE AFRICAN BANKING SECTOR

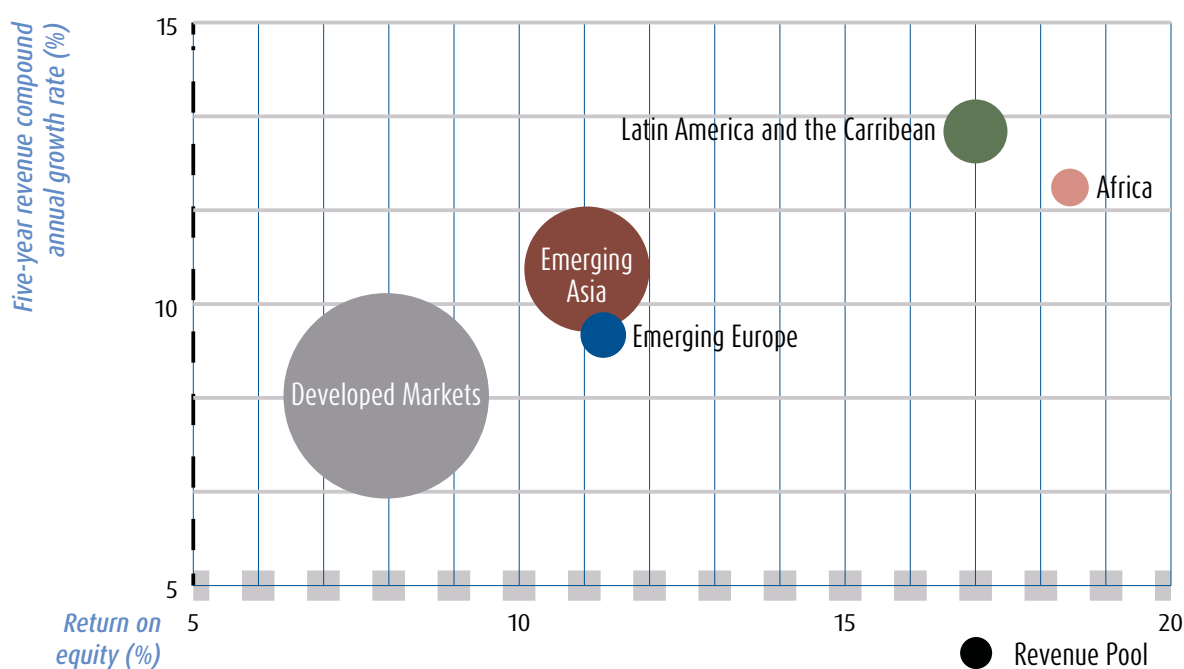
The banking sector is the main source of finance for the private sector in Africa, yet the ratio of bank credit to GDP is very low, less than 30 per cent in 2019, compared with 47 per cent in Latin America and the Caribbean and 94 per cent in Europe and Central Asia. There is considerable variability across the continent in financial sector development, however, with the average ratio of credit to GDP ranging from 60 per cent in North Africa to 9 per cent in Central Africa.

Credit to firms follows the same pattern. In most subregions, the largest share of credit goes to firms, with the exception of Southern Africa, which allocates a larger proportion of credit to households. The average ratio of firm credit to total credit varies from 92 per cent in West Africa and 88 per cent in Central Africa to 50 per cent in Southern Africa. The high

share of credit to firms implies that it can be difficult to stimulate economic growth on the demand side by expanding consumer credit, which is effectively unavailable in some countries.

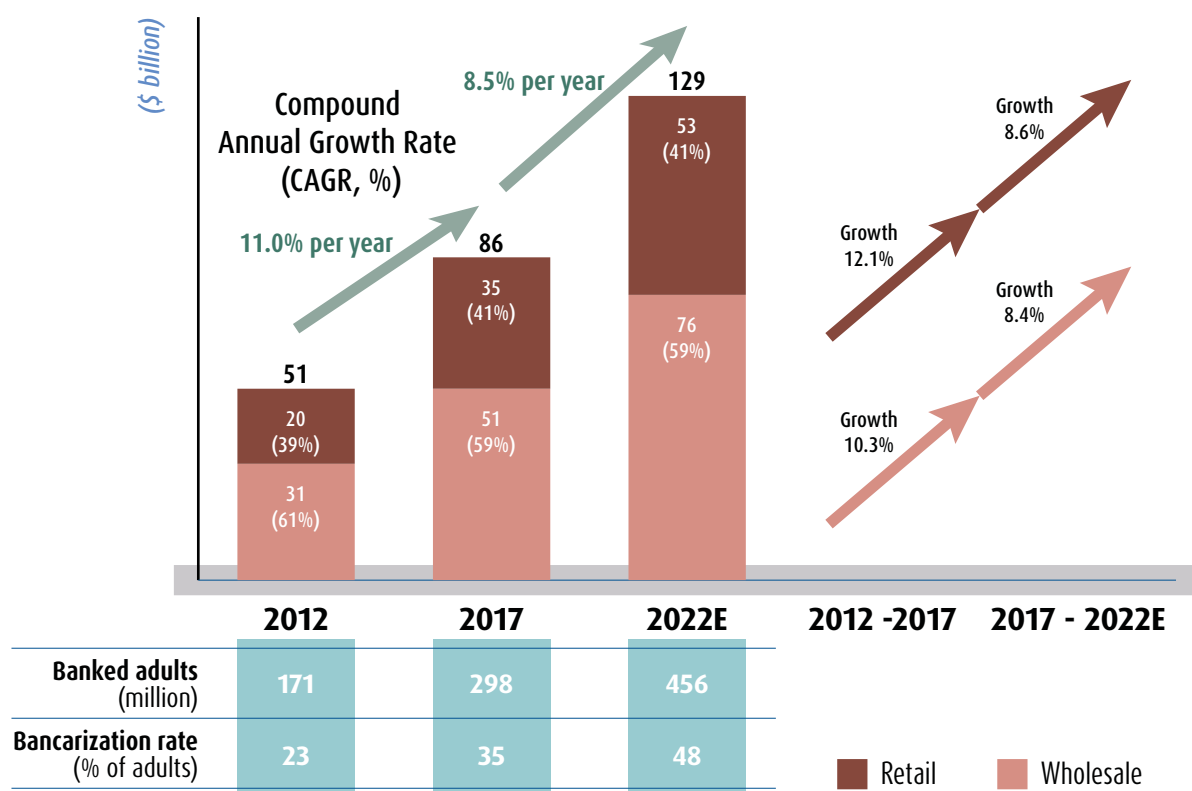
Though still small, the African banking sector is one of the fastest growing and most profitable in the world (FIGURE 3.2), making it one of the key sectors propelling economic growth on the continent this century. The average return on equity for publicly listed banks is between 11 per cent and 22 per cent in Africa, compared with 14 per cent for emerging market economies and 8 per cent for developed economies in 2019. Between 2017 and 2022, the African banking sector is projected to grow at 8 per cent a year (McKinsey, 2019; FIGURE 3.3).

**FIGURE 3.2** THE AFRICAN BANKING SECTOR IS ONE OF THE FASTEST GROWING AND MOST PROFITABLE IN THE WORLD, 2019



**Note:** Bubble size designates revenue pool.  
**Source:** Based on data from S&P Capital IQ.

**FIGURE 3.3** HISTORICAL AND PROJECTED GROWTH OF THE AFRICAN RETAIL AND WHOLESALE CORPORATE BANKING SECTORS (REVENUE POOLS BEFORE RISK COST IN BILLIONS OF US DOLLARS)



**Note:** Bancarization rate refers to the proportion of the population that uses banking services.  
**Source:** McKinsey & Company (2018).

The low levels of financial inclusion in Africa mean that there is massive potential for growth if the banking sector can bring financial services to underserved and unserved populations. Expanding inclusion will lead to rising deposits, which banks can lend to retail and corporate customers, enhancing access to housing and assets for retail customers and to financing that can increase capacity for businesses.

The success and profitability of the African banking sector are based on geography, segmentation, operating costs, digitization and innovation. Banks can leverage large fluctuations in macroeconomic conditions across countries to accelerate their growth and profitability. Segmentation also plays a large role: companies with annual revenue of \$6,000–\$36,000 are projected to contribute 70 per cent of retail banking growth

through 2025. Potential is high in all segments since fewer than 20 per cent of African banking customers have active bank accounts and products.

Bank operating costs are high, particularly since digital banking use is still limited by the low levels of internet connectivity and financial literacy, and thus control of costs will be crucial for profitability. The cost of borrowing is also high, and banks must sharpen their credit risk assessment capabilities to determine an interest rate spread that accurately reflects risk and is profitable for bank, as in Ghana (Owusu-Antwi, Banerjee and Antwi, 2017).

Digitization and innovation are vital for reaching new customers: since only 17 per cent of African banking

customers having taken out a consumer loan, the opportunities are enormous for banks that can successfully sign up new customers. When provided the opportunity, consumers prefer using digital and mobile money channels. In Kenya's Equity Bank, digital transactions accounted for 60–70 per cent of transactions in some product categories as early as 2017, and Kenya's M-Shwari, a mobile banking service, makes 80,000 consumer loans monthly (with only 1.9 per cent of loans categorized as non-performing).

Although financial inclusion is low in Africa (35 per cent in 2017), the bancarization rate, defined as the proportion of the population that uses banking services, is projected to rise to 48 per cent in 2022, with more than 450 million banked Africans (see [FIGURE 3.3](#)). The expansion of traditional banks

to reach more people and the entry of new banks are expected to create even more opportunities for the banking sector.

## THE RISE OF PAN-AFRICAN BANKS

During the past two decades, the African financial sector has changed dramatically. The financial liberalization policies of the early 1990s greatly increased cross-border financial flows, which became an increasingly important component of the African financial landscape ([FIGURE 3.4](#), see page 64).

Pan-African banks are concentrated in West, Southern and East Africa. Among the 10 key players ([TABLE 3.2](#)), Standard Bank Group alone represents 12 per cent of the total assets

**TABLE 3.2** THE 10 LARGEST PAN-AFRICAN BANKS IN 2019 (US\$ MILLIONS)

RANK	BANK	ORIGIN	NUMBER OF AFRICAN COUNTRIES IN WHICH BANK IS PRESENT	US\$ MILLIONS			PER CENT		
				TOTAL ASSETS	TOTAL REVENUE	NET PROFITS	CAPITAL ADEQUACY RATIO	RETURN ON ASSETS	RETURN ON EQUITY
1	Standard Bank Group	South Africa	18	162,627	8,830	1,881	16.7	1.4	15.0
2	Absa Group	South Africa	12	99,993	5,166	1,019	15.8	1.2	12.8
3	FirstRand Bank	South Africa	10	92,493	5,264	1,527	17.1	1.7	21.7
4	Nedbank Group	South Africa	8	81,710	3,575	858	11.5	1.2	13.5
5	Attijariwafa Bank	Morocco	14	55,727	2,290	609	12.7	1.3	13.3
6	Banque Centrale Populaire	Morocco	12	45,141	1,592	314	13.3 <sup>a</sup>	0.9	9.5
7	BMCE Bank of Africa	Morocco	17	33,038	1,221	201	12.6 <sup>b</sup>	0.8	10.0
8	Ecobank	Togo	36	23,641	1,489	194	28.8 <sup>a</sup>	1.2	14.9
9	Access Bank	Nigeria	7	19,742	1,019	267	n.a. <sup>c</sup>	1.6	17.7
10	Zenith Bank	Nigeria	5	17,533	1,313	577	23.0	3.4	23.8

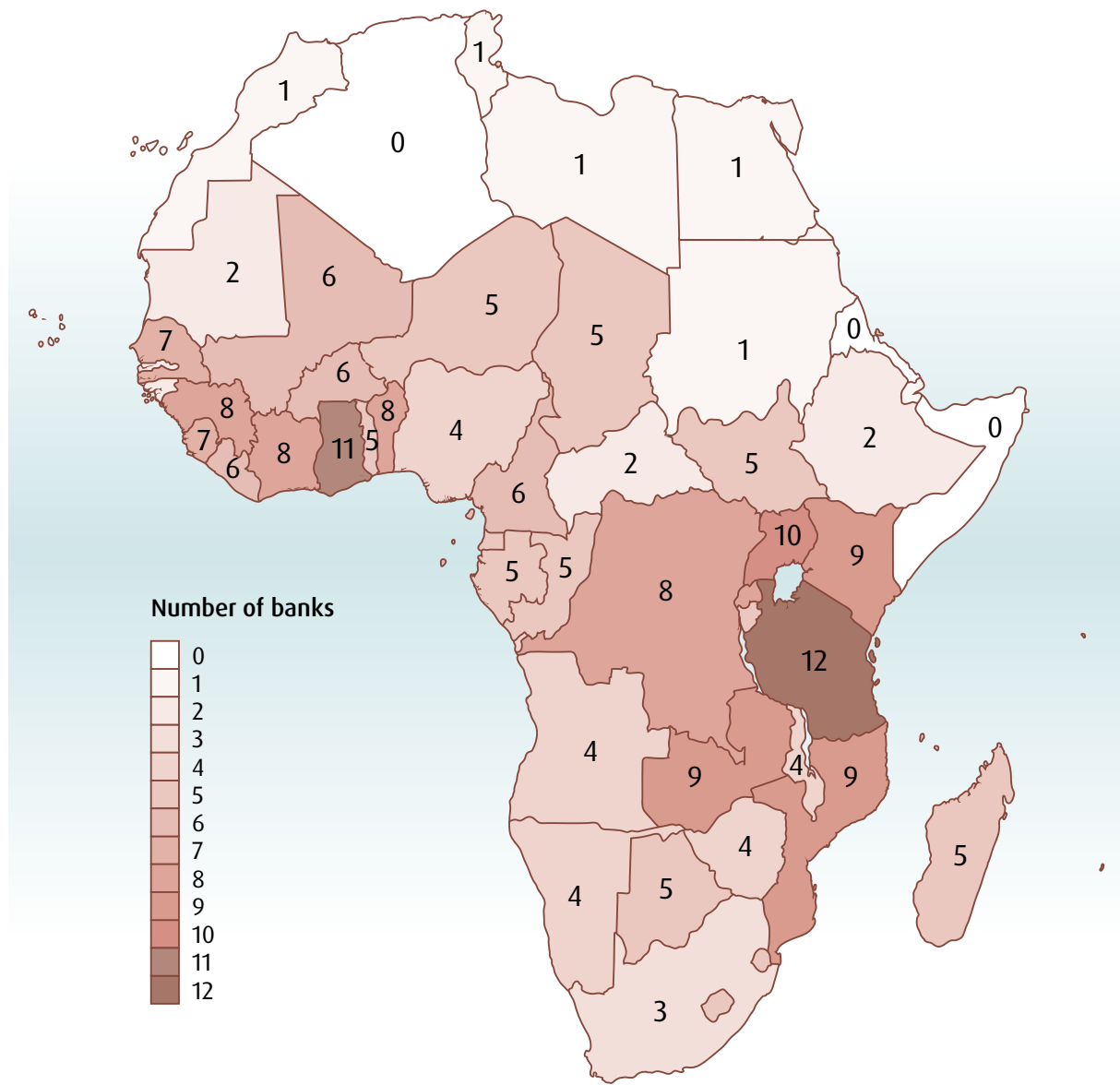
a. Data are for 2017.

b. Data are for 2018.

c. Data for 2017–2019 are unreported

**Source:** Publicly disclosed financial statements and company websites.

**FIGURE 3.4** MAP: THE NUMBER OF AFRICAN CROSS-BORDER BANKS HAD GROWN CONSIDERABLY BY 2019



**Source:** Adapted from Bankscope.

under management at the top 100 banks in Africa at the end of 2018. Three other banks represent 8 per cent.

Pan-African banks began building their own national identities and competed with global banks. They have collaborated—as did Ecobank and Nedbank in 2008—to manage regulatory costs and increase their presence in Africa and have created

a network of more than 2,000 branches in 39 African countries. Such collaboration allows both parties to leverage the local knowledge that each member of the alliance has on its region of influence. Some pan-African banks also have representative offices and branches in key financial centres outside the continent.

The increasing presence of pan-African banks is driven by the forces of globalization, deregulation and technology. The emergence of a global financial system has opened a wide range of financing options. Financial liberalization—a key component of the financial reforms undertaken by most developing countries—has widened the geographic domain in which competition operates. An empirical study of the impact of the liberalization of African financial markets on banking in Africa found that it not only spurred banking sector development but could also induce banking crises (Batuo and Mlambo, 2012). As networks expand, new channels may emerge for transmitting macro-financial risks and spill-overs between home and host countries. The 2008 financial crisis did not have a severe impact on African banking sectors, especially in less open economies, but as African banks integrate themselves into the global economy, future global financial crises are more likely to present a severe risk.

Deregulation has relaxed entry barriers, paving the way for competition in the banking sector. In addition, technology is eroding some entry barriers, such as the need for scale and physical branches, while competition and regulatory changes are eroding some strategic entry barriers, such as anti-competitive mechanisms. If domestic banks are not structured properly to enable them to compete on pricing, they are likely to face tough competition from new pan-African entrants.

A recent study found that the expansion of pan-African banks was associated with factors such as geographic and cultural proximity that are related to transaction costs (Mathieu et

al., 2019). Cross-border investments by pan-African banks are larger between countries that share a common language or border and diminish as geographic distance and exchange rate risks increase.

With the establishment of the African Continental Free Trade Area (AfCFTA), and liberalization of financial services as one of the priority service sectors, African banks will have the opportunity to tap into a continental market of over 1.2 billion consumers. As barriers to trade in financial services are dismantled, pan-African banks already operating across borders may have a head start in providing such services to African business operators, institutional clients and end consumers of the retail banking business. More important, as such services thrive, other banking and financial services providers that were unable to conduct cross-border transactions because of non-tariff barriers will be able to enter new markets in Africa. As the new entrants offer their services, complementing and diversifying those of current pan-African banks, opportunities will arise for the deepening and greater development of African financial markets.

However, translating these potential gains into reality will require significant regulatory change at national and sub-regional levels. As financial markets open, risks of contagion and the transmission of financial instability increase, requiring prudential regulation and other preventive measures to avoid or mitigate financial crises. Furthermore, financial liberalization will also require the elimination of measures that contravene the financial service trade liberalization commitments that African countries agreed to. Striking a healthy balance between safeguarding the economy from financial contagion and allowing financial institutions to conduct their business will depend on a careful weighing of macroprudential measures and an arm's length approach to financial service trade transactions.

## THE AFRICAN INTERBANK MARKET

Financial institutions use the global interbank market to trade currencies among themselves, mostly on behalf of the banks' own accounts, and to borrow and lend funds on a short-term, often unsecured basis. Banks with surplus liquidity lend it to banks that need liquidity. A well-functioning interbank market provides a ready source of funds for banks with temporary liquidity needs and provides a comparatively low-risk

**“A well-functioning interbank market provides a ready source of funds for banks with temporary liquidity needs and provides a comparatively low-risk destination for the funds of banks with a temporary liquidity surplus”**

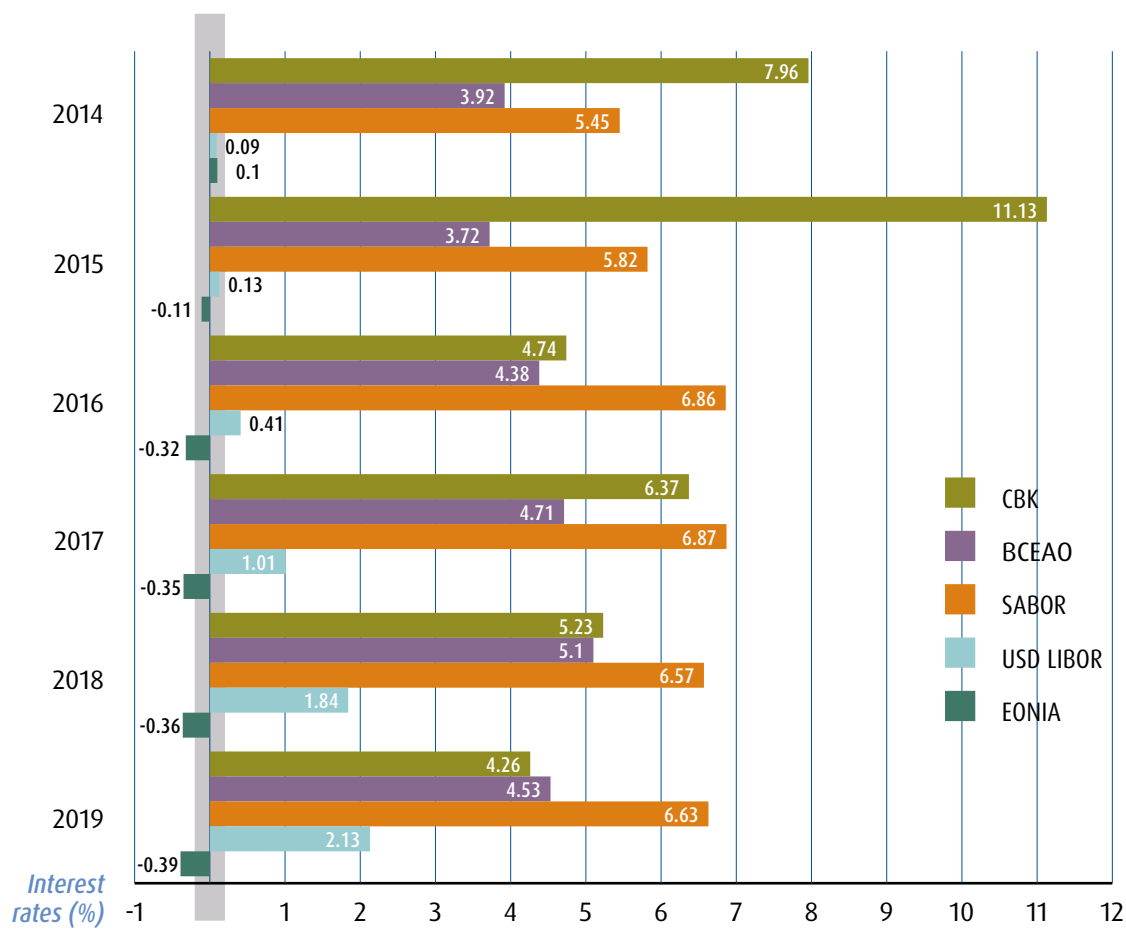
destination for the funds of banks with a temporary liquidity surplus. The interest rates in these markets are often used as a reference for the risk-free interest rate on various financial products that are tied to a variable interest rate.

In Africa, interbank markets are struggling to play their role. Because of limited participation by banks, interbank markets rely on the intervention of central banks. In African interbank markets, as in many emerging market economies, trading is too thin to fully support a monetary policy based on open market operations (Green et al., 2016). In part because of the small number of traders in these markets and the high policy

interest rates, interbank lending is more expensive in African markets than in mature markets (FIGURE 3.5). Most African interbank markets rely on a limited number of small banks. Large international banks can access intergroup funding, and the largest banks can access market finance, which reduces their participation in the interbank markets. Small banks are less able to attract deposits and end up relying on more expensive interbank funding.

Interbank markets in Africa are also segmented, fragmented and inefficient, compromising the effectiveness of monetary policy in the short run (Oduor et al., 2014). For example, there

**FIGURE 3.5** INTERBANK LENDING IS MORE EXPENSIVE IN AFRICAN MARKETS THAN IN MATURE MARKETS, 2014-2019  
INTEREST RATES, PERCENTAGE POINTS



**Note:** CBK is Central Bank of Kenya; BCEAO is Central Bank of West African States, SABOR is South African Benchmark Overnight Rate; LIBOR is London Interbank Offered Rate; EONIA is the Euro Overnight Index Average.

**Source:** Based on data from Benhamdane, Hidane and Stijns (2018).

is a strong borrowing relationship among small banks and a weak relationship between large and small banks in the interbank market in Kenya, marked by a 4.24 per cent interbank rate in November 2019. In the West African Economic and Monetary Union region, the interbank market recorded low volumes of liquidity trading and high interest rates, with an average volume of transactions of CFAF 276 billion (about \$466 million) and a weighted average interest rate of 5.1 per cent in 2018.

The structure of interbank markets in Africa implies that the interbank rate has no signalling effect on the state of market liquidity or market distress. Central banks often step in to provide liquidity to the market to give the appearance of normal

conditions on the interbank market (Osoro and Santos, 2018). For instance, when the volume of transactions in the interbank market in the Central African Economic and Monetary Community region fell to \$45 million in 2016, the central bank provided \$1 billion in liquidity to eligible credit institutions.

African bank lending activities depend primarily on deposits. When banks fail to attract adequate deposits, they try to fill the gap by participating in the interbank market or by relying on liquidity provided by the central bank. But because interbank markets in some African countries are not functioning properly, they are unable to support bank lending. Only large and listed banks can issue debt securities or raise equity on stock markets.

## THE BANKING SECTOR AND FINANCING OF THE REAL SECTOR

### AGRICULTURE SECTOR

Firms in the agricultural sector need financing for seed capital for production. Banks have stepped in to provide loans to farmers in need of capital to purchase seeds and livestock at the beginning of the farming season. Many land-owning farmers use their land as collateral. But African farmers are predominantly smallholders who operate in the informal sector and lack financial literacy and legally registered property that they can use as collateral. As a result, banks in Africa view agricultural activities as high risk, and agricultural loans account for only 4 per cent of bank loan portfolios. To encourage banks to lend to farmers, some governments provide credit guarantees through agricultural development banks or microfinance institutions.

The financial services sector recognizes the changes to the agricultural sector's landscape and the importance of maintaining a financially healthy agricultural sector. Increasingly, African countries are developing and adopting innovative financing mechanisms to support the sector. For instance, Standard Chartered Bank introduced innovative collateral mechanisms to promote access to finance by smallholder farmers and mitigate their risks. These included valorising the commodity or underlying asset being financed for use as collateral and offering advisory and monitoring services to ensure loan repayment and protect loan portfolios. Such services are well advanced in Canada, for example, where all major banks have units and specialists in agricultural economics to process and manage agricultural loans. Additionally, these specialists provide business consultation services to support farmers in the business aspect of farming. As of 2016, Canadian banks



have supplied more than Can \$36 billion to farmers across the country, and farmers account for 15 per cent of loans to SMEs.

Traditional banks may not be able to close the financing gap in the agricultural sector alone but may need to coordinate with the public sector, as in the European Union. Recognizing the importance of agriculture to the economy, the European Investment Bank and the European Commission, in cooperation with local banks in Croatia, France, Greece and Italy, announced a €1 billion loan program for the agricultural and bio-economy sectors. To attract young people to farming, the program allocates 10–30 per cent of funds to young farmers.

## EXTRACTIVES SECTOR

The extractives sector has expanded greatly in the last few decades in many African countries as demand has risen for electronics and their components, many of which require the use of rare earth minerals in their manufacture. For instance, lithium, a key component of long-life batteries, has Namibia and Zimbabwe among its top producers. Cobalt, another key component of batteries and corrosion-resistant alloys, is the chief export of the Democratic Republic of the Congo.

The heavy capital and investment requirements of the extractives industries (for exploration, production and export), the global price volatility of some metals and resource depletion in some countries limit the appetite of the African banking sector for financing the extractives sector. Financing has been mostly project by project rather than based on a balanced sector-wide approach. To support the growing mining subsector and to increase demand for rare earth minerals, the banking sector has expanded from generic equipment loans to more innovative products and production-based financing. Financing based on mining companies selling the rights to future revenues is becoming increasingly popular for higher-value mining projects and rare earth minerals such as nickel, cobalt and lithium.

For example, in 2018, the Australia-based mining company NQ Minerals signed an agreement with the commodities trading firm Traxys to access a \$10 million prepaid facility. The agreement grants Traxys the rights to all lead and zinc concentrate produced in NQ's Hellyer mine for the first five years of concentrate production, while enabling NQ to refurbish the mine, which it had purchased in May 2017.

**“The extractives sector has expanded greatly in the last few decades . . . as demand has risen for electronics and their components, many of which require the use of rare earth minerals . . . ”**

But as mining firms continue to grow, traditional banks in Africa may have to forgo financing for some of these projects because of perceived high risk and limitations imposed by international regulations. Similar dynamics are also observed in oil and gas firms. Innovative financing sources are emerging to more efficiently meet the industry's immense capital needs, with companies increasingly shifting from traditional bank loans to equity markets, bond markets and project finance. The natural next step for extractive industries is accessing additional financing from financial markets through the intermediation of an investment bank.

## MANUFACTURING AND SERVICE SECTORS

As economies develop and people have more disposable income, domestic consumption rises, spurring expansion of the private sector and a shift from agriculture to manufacturing and service firms. Traditional banks generally step in to meet the financing needs of these new firms. Conventional loans and lines of credit are common among SMEs, but banks can also provide other services, such as trade finance, as firms grow. This can be a critical service for SMEs seeking to grow their business in response to cross-border opportunities, such as those that will emerge as trade expands under the AfCFTA, with its dismantling of trade barriers in goods and services across the continent.

Globally, many traditional banks with experience providing loans to manufacturers and service providers now have divisions and programs to support SMEs. In China, for example, the government has pushed banks to provide more favourable

interest rates for SMEs. At the same time, the Chinese government recognizes the risk profile of these firms and the regulatory requirements that make it unattractive, especially for smaller banks, to lend to these smaller manufacturers and service providers. The government is looking into introducing less stringent regulations on smaller banks to allow them to provide the necessary financing in this space, particularly since smaller firms tend to be more geographically spread out, with some of them situated in areas not covered by large traditional banks. This is evidence, again, of policymakers coordinating with traditional banks and financial institutions to close the financing gap and support the growth of the private sector.

As these firms continue to grow, they turn to financial markets to finance their expansion. But this is not the end of these

firms' relationships with their traditional banks. The growth of private firms pushes traditional banks to establish investment banking arms to expand the breadth of the financial services they provide. At the same time, this growth expands the breadth and depth of financial markets, as more companies seek larger-scale financing, creating opportunities for smaller financial firms to diversify as well, especially in anticipation of opportunities under the AfCFTA. As SMEs scale up production to enter other markets in Africa and engage in cross-border activity, they will need trade finance and other types of credit to ramp up their business. Financial institutions can also take advantage of this increased demand by agglomerating activities and entering the cross-border financial markets in which larger pan-African banks that typically do not serve SMEs operate.

## IMPLICATIONS OF COVID-19 FOR THE AFRICAN BANKING SECTOR

As a consequence of the 2008–2009 financial crisis and new financial regulations under the Basel III regulatory framework that focus on increased capital buffers, many banks strengthened their balance sheets and lowered their lending ratios to build resilience to financial and macroeconomic shocks. These measures helped many banks, especially in advanced and emerging market economies, to better prepare and address the losses and liquidity challenges arising from the current COVID-19 crisis. In some countries, banks helped bail out governments and businesses. For instance, to help finance huge stimulus packages and address some of the challenges of the pandemic (such as large numbers of people at risk, increased health expenditure, heavy demands on public finance and financial markets in turmoil), governments have been selling bonds to banks to maintain levels of capital and

liquidity. In measures known collectively as quantitative easing, central banks lowered long-term interest rates and purchased sovereign bonds to tamp down yields at various maturities.

In Africa, many governments and central banks have also been addressing the economic and financial risks associated with the COVID-19 pandemic. They cut interest rates to encourage personal and business lending, lowered capital and liquidity requirements to support bank lending and meet the liquidity needs of governments and firms and introduced quantitative easing to pump money into the economy and boost aggregate demand. For instance, in early March, the Bank of Ghana cut key interest rates to 14.5 per cent and amended regulations to allow the government to borrow up to 10 per cent of tax

revenue from the central bank. The South African Reserve Bank lowered the liquidity ratio, which unlocked 320 billion rands in bank lending. The Central Bank of Nigeria cut interest rates from 9 per cent to 5 per cent on central bank intervention facilities and announced a one-year moratorium on principal repayment.

While vital to navigate the COVID-19 crisis and maintain lending to businesses, these policy measures pose a challenge to bank profitability and financial sustainability. Over time, the lower interest rates and flat yield curves will reduce the profitability of many banks, impeding their ability to raise new capital and support the economy through lending.

Another challenge to the African banking sector may come from the solvency crises created as the sharp slowdown in economic activity caused by COVID-19 and tightening in financial conditions lead to a rising share of non-performing loans. In many countries, the coronavirus outbreak and lockdown measures have significantly constrained the operations of firms, especially SMEs, even as they still bear the burden of paying wages and rent. This has constricted cash flows and reduced solvency in the short term and increased repayment pressures (Ernst & Young, 2020). In extreme cases, some firms might have to suspend operations, plunging them into financial distress, undermining their ability to guarantee debt repayment or forcing them to liquidate their assets, often at fire-sale prices (World Bank, 2020).

## CONCLUSION

The retail and corporate banking sector is vital to the economic development of Africa. To drive economic growth and job creation, the private sector needs better access to finance. Research suggests that robust legal, institutional and regulatory frameworks are key to unlocking bank credit to the SME sector.

Innovations and technological advances are expanding the reach of bank lending, reducing regulatory and geographic obstacles, bringing more people and more savings into the financial system and increasing the ability of banks to make loans. But despite these developments, the SME financing gap remains. Unleashing the potential of the private sector to contribute to sustainable development requires strengthening the supporting structures for financial development. That includes liberalizing trade in goods to facilitate cross-border trade for African SMEs seeking to expand their operations beyond domestic markets by tapping into the opportunities

that AfCFTA will usher in. At the same time, many African financial institutions could benefit from liberalization of trade in financial services, enabling them to offer trade finance and credit lines so SMES can up their game. Innovative lending activities to increase SME financing appear to be positively and significantly correlated with GDP growth.

From a policy perspective, a regulatory framework that strikes an optimum balance between ensuring financial stability and offering innovative financing schemes for all is key to developing a strong and robust private sector and ultimately to accelerating economic development. For their part, private firms need to take advantage of advances in technology to improve their business practices, particularly in bookkeeping and financial reporting, in order to access the new financing instruments.

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CHAPTER 4

# TAPPING INTO THE POTENTIAL OF AFRICAN MARKETS



**I**n other parts of the world, financial markets (also known as “capital markets”) complement bank finance as another source of financing to the private sector. But in Africa, except in South Africa, financial markets are small and undeveloped, largely dominated by commercial banks, with few investment banks and underdeveloped capital markets. Some 28 African countries have stock exchanges, in contrast to 1989, when only five had them (with limited equity and bond market trading). But today’s stock exchanges in Africa remain underdeveloped, with small market capitalizations, few listed companies, and less liquidity than exchanges in other emerging economies. The proceeds raised from initial public offerings (IPOs) in Africa between 2014 and 2019 reached \$27.1 billion, less than 1.4 per cent of global IPO proceeds during that period.

Capital markets offer a gateway for investors—both retail individuals and institutional investors—to participate in the financial economy. They enhance the connection of savers and borrowers outside traditional banks that serve retail and corporate customers. Capital markets provide not only an alternative for additional private sector fund raising, but also an alternative to regular bank deposits for investors to save and to gain returns.

In addition to capital markets, private investments, crowdfunding platforms and other alternative methods of financing are gaining momentum. Currently, Africa represents less than

1 per cent of worldwide private equity markets, but this can be expected to change given the increasing interest of private equity funds in the continent. The value of private equity fundraising in Africa increased to \$2.7 billion in 2018, up 10 per cent from 2017. The total transaction value in the global crowdfunding market was \$6.9 billion in 2019 and is expected to grow 14.7 per cent a year between 2019 and 2023. The African bond market is also growing, with a total value of \$500 billion in 2019 (RisCura, 2020).

The underdevelopment of African financial systems constricts credit for firms, especially for small and medium sized enterprises (SMEs), and produces low investment rates. The ratio of credit to the economy is very low in Africa, averaging less than 30 per cent of GDP, compared with 138 per cent in the East Asia and the Pacific region. The low level of credit in Africa shows the limited services financial institutions provide the private sector. But the new African Continental Free Trade Area (AfCFTA) provides great opportunities for African capital markets to expand by creating enlarged markets, economies of scale, increased competitiveness and more opportunities to invest in African markets and firms. Those factors will attract more investment for higher productivity.

Even so, the COVID-19 pandemic is an external shock. It creates a stress test for the hoped-for gains and opportunities of the AfCFTA and the deepening of African capital markets.



# EQUITY MARKETS IN AFRICA AND OPPORTUNITIES FOR THE PRIVATE SECTOR

Turning to equity markets is often a natural step for businesses at their maturity in the corporate life cycle. Those markets serve as a fundraising platform for businesses that require large amounts of capital to expand and as a sales vehicle to let entrepreneurs lower their stake in the business. Participating in equity markets often provides a business with higher name recognition, which also gives it access to the public debt markets. And equity market reporting regulations ensure that businesses report their results prudently, adhering to generally accepted accounting principles, which align a business with its domestic and international peers to truly gauge its financial performance.

Equity markets, whose traditional participants are local investors and the businesses that list on the exchanges, also provide international investors an opportunity to enter a local market and take stakes in companies they find attractive. Other participants include investment banks (which aid businesses in getting listed), institutional investors and fund managers—such as asset managers (which further democratize investment) and hedge funds (which provide greater liquidity)—and businesses that want to engage in mergers and acquisitions by purchasing publicly available stocks. Each of these participants has a unique role in enhancing the breadth and depth of a well-functioning equity market, one that provides enough liquidity for stock prices to reflect the intrinsic value of a company and enough opportunity for investors to profit from their investments. None of this would be possible without the most common and traditional type of equity market—the stock exchange.

## STOCK EXCHANGES

Although stock exchanges in Africa are less developed than those in other emerging economies, they present an opportunity for the African financial service sector to grow into the existing space. Growth is anticipated as financial inclusion

**“Equity markets, whose traditional participants are local investors and the businesses that list on the exchanges, also provide international investors an opportunity to enter a local market and take stakes in companies they find attractive”**

and financial literacy increase and a growing middle class demands more advanced and innovative savings products.

Stock exchanges currently exist in 28 African countries. The oldest are the Egyptian Exchange, the Johannesburg Stock Exchange, the Casablanca Stock Exchange, the Zimbabwe Stock Exchange and the Nairobi Securities Exchange (TABLE 4.1). There are two regional stock exchanges, the Bourse Régionale des Valeurs Mobilières (BRVM) in West Africa and the Bourse des Valeurs Mobilières de l’Afrique Centrale (BVMAC) in Central Africa.

In developed economies, stock markets finance the economy by allowing domestic firms to raise funds, and they mobilize domestic savings by offering a variety of instruments for investors to diversify their savings. In developing and emerging economies two constraints of stock exchanges are the limited diversity of financial instruments and the limited number of listed stocks. The financial instruments available in African financial markets are equity shares and government bonds, except in South Africa, where derivatives are also traded. With a limited number of companies and investment vehicles



**TABLE 4.1** AFRICAN STOCK EXCHANGES WITH A MARKET CAPITALIZATION OF MORE THAN \$1 BILLION

COUNTRY	EXCHANGE	HEADQUARTERS	DATE OF CREATION	MARKET CAPITALIZATION (US\$ MILLIONS)
<b>Botswana</b>	Botswana Stock Exchange (BSE)	Gaborone	1989	5,048
<b>Egypt</b>	Egyptian Exchange (EGX)	Cairo/Alexandria	1883	40,683
<b>Ghana</b>	Ghana Stock Exchange	Accra	1990	11,506
<b>Kenya</b>	Nairobi Securities Exchange	Nairobi	1954	23,000
<b>Malawi</b>	Malawi Stock Exchange	Blantyre	1995	1,870
<b>Mauritius</b>	Stock Exchange of Mauritius	Port Louis	1988	6,800
<b>Morocco</b>	Casablanca Stock Exchange	Casablanca	1929	71,100
<b>Namibia</b>	Namibia Stock Exchange	Windhoek	1992	2,540
<b>Nigeria</b>	Nigerian Stock Exchange	Lagos	1960	76,613
<b>Rwanda</b>	Rwanda Stock Exchange	Kigali	2008	3,589
<b>South Africa</b>	JSE Limited	Johannesburg	1887	1,036,689
<b>Sudan</b>	Khartoum Stock Exchange	Khartoum	1994	1,249
<b>United Republic of Tanzania</b>	Dar es Salaam Stock Exchange	Dar es Salaam	1998	7,337
<b>Tunisia</b>	Bourse de Tunis	Tunis	1969	9,501
<b>Uganda</b>	Uganda Securities Exchange	Kampala	1997	7,804
<b>Zambia</b>	Lusaka Stock Exchange	Lusaka	1994	6,223
<b>Zimbabwe</b>	Zimbabwe Stock Exchange	Harare	1948	21,660
<b>West African Economic and Monetary Union Countries</b>	Bourse Régionale des Valeurs Mobilières	Abidjan, Côte d'Ivoire	1998	12,486

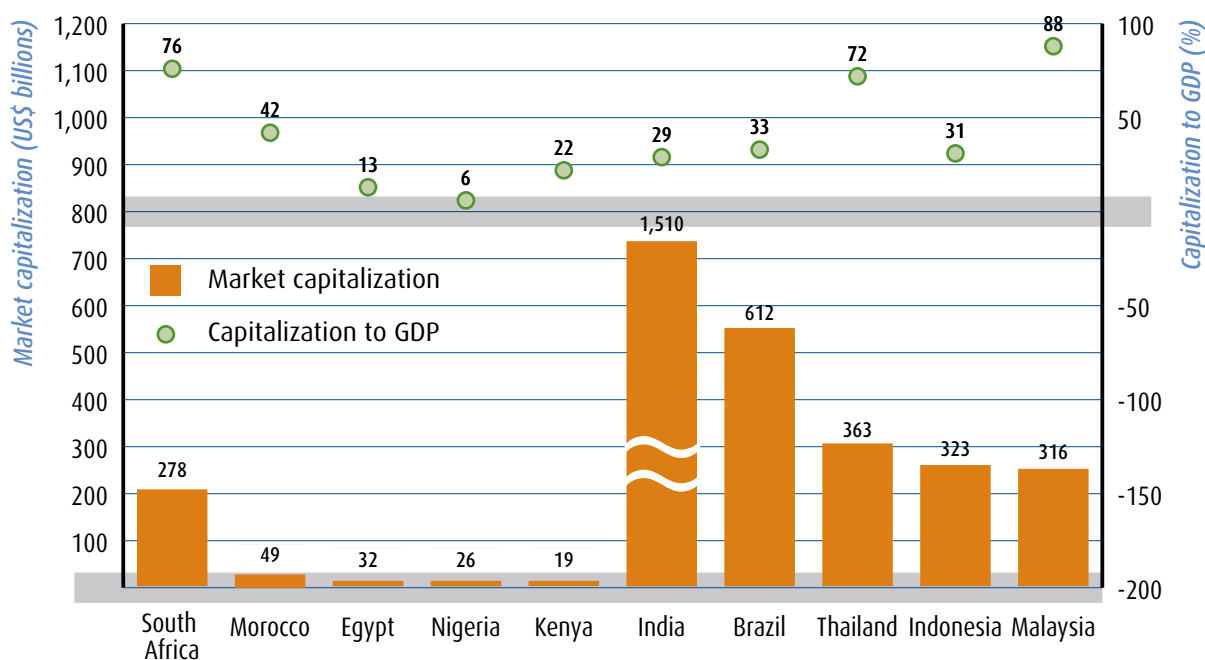
**Source:** Based on most recent data as of 2019–2020 from respective stock exchange websites.

listed and illiquidity partly due to fixed-quotation methods (which do not provide real-time stock price updates), stock markets in Africa attract few investors.

Except the Johannesburg Stock Exchange (JSE) in South Africa, the major exchanges in Africa are less capitalized as a percentage of GDP than markets in comparable emerging economies (FIGURE 4.1). The JSE is capitalized at the same level in relation to the size of the economy as other active emerging market exchanges—such as the Stock Exchange of Thailand and Bursa Malaysia.

High transaction costs, which include brokerage commissions, exchange fees and clearing and settlement fees, also prevent the further development of stock exchanges. In many developing markets around the world, transaction costs are below 1 per cent of the value of the trade. Explicit trading costs in Indonesia, Peru and Thailand are 0.68, 0.46 and 0.57 per cent, respectively. In developed markets, the cost is even lower, with Germany charging 0.32 per cent and the United States, 0.26 per cent (Ghosh, 2007). But African exchanges (except the JSE) charge well over 1 per cent, with Uganda charging the most, 4.1 per cent, and Rwanda the second most, 3.4 per cent (Anyazawa, 2020).

**FIGURE 4.1** MARKET CAPITALIZATION OF THE TOP FOUR STOCK EXCHANGES IN AFRICA AND OTHER EMERGING MARKETS



**Note:** Excludes all secondary listings. GDP data for 2018, market capitalization data as of 31 March 2020.

**Source:** FactSet.

The main problems encountered in African stock exchanges are lengthy listing procedures, binding and difficult listing conditions, high transaction costs, lack of knowledge about stock markets and, in some exchanges, lack of transparency. Fixed quotation methods also disincentivize trades and market makers—financial firms, such as hedge funds, that trade at high frequencies and volumes on narrow pricing gaps.

South Africa (JSE) and Egypt (EGX) have the first and second most liquid exchanges in Africa—JSE, with an average daily turnover of \$1.4 billion in 2019, and EGX, with \$35 million. The Casablanca Stock Exchange (CBSE), with an average daily trading value of \$13 million in 2019, and the Nigerian Stock Exchange (NSE), with \$11 million, are also dynamic. Between 2018 and 2019, turnover on African exchanges fell due to a challenging macroeconomic environment that affected many listed state-owned enterprises. For instance, liquidity on the EGX decreased by 43 per cent between 2018 and 2019.

## LISTING REQUIREMENTS

Stock exchanges often require that businesses meet certain thresholds before being listed. The listing requirements, which vary according to standards set by each exchange, typically measure the size of the firm and profitability of the security to be listed, as well as the financial viability of the issuing company. The size of the firm is defined by its annual income or market capitalization, and the profitability of the security by the number of shares already issued on exchanges. For instance, the Johannesburg Stock Exchange requires a minimum subscribed capital of 50 million rands, and the Nigeria Stock Exchange 50 million Nigerian naira. The EGX requires firms to have 5 million publicly traded shares outstanding with a collective market value of at least 50 million Egyptian pounds.

Businesses must also align their accounting practices with the regulations set forth by the stock exchange or regulatory authority. They are required to adhere to certain management rules to ensure that the listing benefits the business

and public retail investors who purchase shares once they are listed. These requirements aim to develop a good capital market for all participants and to maintain the reputation and visibility of the exchange.

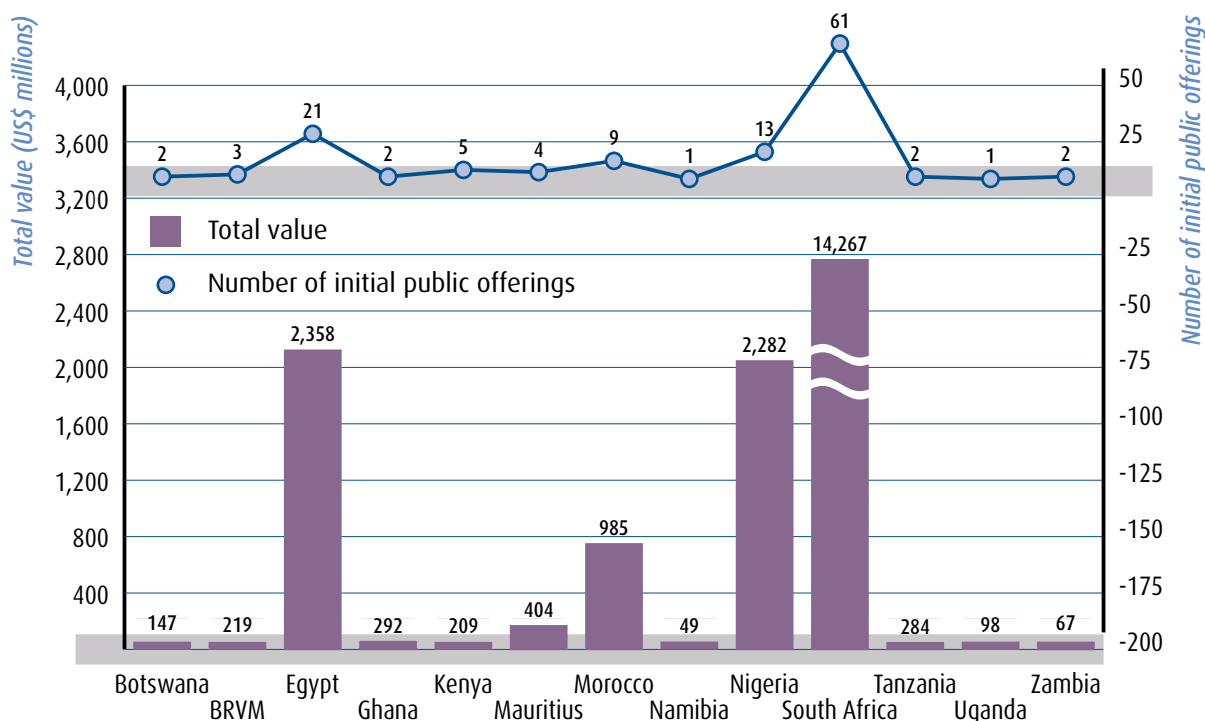
Profit and size requirements often focus stock exchanges on large businesses with a track record of profitability. But in recent years African stock exchanges have started setting up secondary boards to offer not-yet-profitable smaller companies and start-ups an opportunity to access equity markets for fund raising. The JSE's AltX (Alternative Exchange market) for small and mid-sized issuers has less stringent requirements than the main board. Conditions for smaller issuers listing on the AltX include appointing a designated adviser ("DA") and executive financial director, having a share capital of at least 2 million rands, producing a profit forecast for the remainder of the financial year and having the public hold at least 10 per cent of each class of equity securities. These smaller businesses can grow, reach the main exchange board listing requirements, and graduate to take advantage of the larger main board.

## INITIAL PUBLIC OFFERINGS IN AFRICA

In an initial public offering (IPO) a private company offers its shares to the public and formally lists itself on a public stock market, connecting it with the wider financial system. A functioning IPO market requires investment banks to help generate interest and connect companies with potential investors. To maximize the funds raised, IPOs may react to market sentiment and the economic outlook, with companies speeding up or delaying the offering. This adaptability makes the IPO market volatile.

The JSE, EGX and NSE were the most active markets in Africa for IPOs between 2014 and 2019, raising a combined \$18.9 billion (87 per cent of the total value of all IPOs in Africa in that period) (FIGURE 4.2). South African IPOs alone represented more than 65 per cent of the capital raised on African exchanges. The consumer services, financial services, real estate and telecommunications sectors were the drivers of the African IPO market, with consumer services accounting for 24 per cent and financial services for 19 per cent of total IPO value from 2014 through 2019.

**FIGURE 4.2** INITIAL PUBLIC OFFERINGS BY SELECTED AFRICAN EXCHANGES, 2014–2019



Source: S&P Capital IQ.

The overall African IPO market declined 67 per cent in value in 2019 due to stagnation on the JSE, where IPO fundraising dropped 77 per cent in value. But the North African exchanges in Egypt and Morocco experienced 18 per cent increases in IPO activity. And the resumption of IPO activity on the Nigeria Stock Exchange (after there were no new listings between 2014 and 2018) has enhanced African IPOs. With more than 1,200 public offerings completed in 2019, the African IPO market represented 1.4 per cent of the \$1.2 trillion worldwide value of IPOs. African markets are expected to experience more capital raising activity as exchanges continue to meet their commitment to capital requirements due to such changes as the Basel III regulatory framework.

## INNOVATIONS IN AFRICAN EQUITY MARKETS

In recent years, many equity markets worldwide have adopted innovations to attract more investors (both private and public). Some of those innovations can bring more liquidity and depth to African equity markets, and hence can enable increased investments.

Historically, most stock exchanges were not-for-profit organizations owned by their members. In a new trend the industry is adopting alternative governance structures to the traditional mutual or cooperative model. The transformation of an exchange into a for-profit shareholder-owned company is referred to as “demutualization.” It is generally associated with greater liquidity and a more efficient stock exchange (Abukari and Otchere, 2019).

In Africa, the Johannesburg Securities Exchange (JSE) was the first to demutualize, in July 2005. The Nairobi Securities

Exchange demutualized in 2014, followed by the Botswana Stock Exchange in 2018. In March 2020, the Nigerian Stock Exchange announced the approval by its members of the demutualization of the bourse to create a shareholder-owned company, turning the exchange into a limited liability company and renaming it Nigerian Exchange Group Plc, (they had passed the requisite resolutions to allow for demutualization in 2017). This latest reform aims to attract new listings, diversify the exchange’s revenue streams, and generate more profits. The global demutualization trend is likely to continue across the continent. It will bring more transparency and inclusiveness to stock exchange management.

Specific compartments can be set up within a stock exchange to allow companies that do not meet listing requirements. These new compartments target SMEs and specific sectors, and they can be coupled with a support programme for SMEs. The ELITE programme of the London Stock Exchange is a good example (BOX 4.1). ELITE helps companies gain access to capital, dedicated to those with a solid business model, a clear growth strategy, and a need for medium-term financing. Its innovative approach includes a training programme, marketing assistance and a dedicated community platform giving access to the financial community. ELITE is open to any financing opportunity, allowing access to private investment and debt products.

Transaction costs and fees are relatively expensive in Africa, mainly due to high brokerage commissions. Other trading costs include exchange fees (for clearing and settlement), securities transfer tax and other fees. The cost of trading on African exchanges can exceed 4 per cent of the value of the share that is traded (as in Uganda and Zimbabwe),

### BOX 4.1 ADOPTION OF THE ELITE PROGRAMME BY THE CASABLANCA STOCK EXCHANGE AND THE WEST AFRICAN ECONOMIC AND MONETARY UNION’S STOCK EXCHANGE

The London Stock Exchange’s ELITE programme has recently been adopted by the Casablanca Stock Exchange and the BRVM (the West African Economic and Monetary Union’s stock exchange). They have set up compartments dedicated to SMEs. In Morocco, more than 70 companies are enrolled with the programme, and 20 are certified, meaning they were able to raise

capital on the market at the end of 2018. In addition, the Casablanca Stock Exchange and the Moroccan Capital Market Authority agreed on a fast-track initiative to accelerate the access of ELITE-certified companies to the capital market.

The BRVM initiated a compartment for SMEs in December 2017. To help companies obtain access to this market segment, the BRVM ELITE LOUNGE programme began in March 2018. The programme started with 10 fast-growing SMEs and had 30 companies as of June 2019.

making short-term trading very expensive and thus reducing liquidity on exchanges. In all African markets except Kenya, Nigeria, Seychelles and South Africa, brokerage commission fees account for a substantial portion of the cost of trading. The high fees applied by brokers is due in part to the limited number of licensed brokers, which limits competition among them, and the low volume of trading on most African exchanges, which forces brokers to increase the fees on each trade to cover their costs. In general, exchanges set an upper limit for fees to companies for admission and issuance of securities. But at the BRVM and the Stock Exchange of Mauritius transaction fees are a percentage of the transaction value with no upper limit (except for government securities in Mauritius), which can dissuade investors and companies seeking to conduct a large transaction and so hamper the building of market depth. Technology could lower transaction costs in many of these markets.

Many stock exchanges across the continent have modernized their trading systems by moving towards automated clearing and settlement. They include the Botswana Stock Exchange, the Ghana Stock Exchange and the Nairobi Securities Exchange. In 2013 the Nigerian Stock Exchange adopted the Nasdaq X-Stream trading platform. In October 2019 the Johannesburg Stock Exchange partnered with Trading Technologies International, a global provider of high-performance

professional trading software, infrastructure and data solutions, to allow all derivative products listed on the JSE Derivatives Market to be traded using the TT platform.

Most stock exchanges in Africa are small in market capitalization and number of listings. An initiative aims to create a regional stock exchange in Central Africa like the one in West Africa by merging the BVMAC and the Douala Stock Exchange. It will help create economies of scale and scope to increase the size, depth and liquidity of the stock market.

Where possible, countries should coordinate regional efforts to mutualize their strengths. For instance, in West Africa the West African Capital Markets Integration Council (WACMIC) created a cross-border capital market in which a passport mechanism for brokers will coordinate with a single stock exchange listing system for companies. The passport will allow a registered broker in any of the jurisdictions to trade on the other stock exchanges, while the single listing will allow a company to be listed on a single stock exchange with its stock available for transactions by all brokers in the defined area. The passport system can start on a regional basis within the existing regional economic communities, with the Economic Community of West African States (ECOWAS) a prime example (BOX 4.2). Similar initiatives and discussions to link financial markets are ongoing in the East African Community (EAC).

#### BOX 4.2 THE WACMIC INITIATIVE IN THE ECOWAS REGION

The West African Capital Markets Integration Council (WACMIC) was inaugurated on 18 January 2013 as the governing body for integrating capital markets in the Economic Community of West African States (ECOWAS). The overarching objectives of the council are to establish a harmonized regulatory environment for issuing and trading financial securities across the West Africa region, and to develop a common platform for cross-border listing and trading of such securities. WACMIC is comprised of the directors general of the region's securities commissions and the chief executive officers of the securities exchanges in the eight West African Economic and Monetary Union (WAEMU) countries, Cabo Verde, Ghana, Nigeria and Sierra Leone.

The council is tasked with designing the policy framework and managing the process that will facilitate the creation of an integrated capital market in West Africa. Specifically, the council is to:

- Supervise the capital market integration programmes.
- Set up standards and validate all work by the technical committees.
- Coordinate relevant stakeholders, such as ECOWAS, WAEMU and the West African Monetary Institute.
- Monitor and assess the preparedness of the member states for the integration process.

- Source funds and other resources for the implementation of capital market integration.
- Monitor standards and compliance after integration.

The work carried out under the auspices of WACMIC will lead to the integration of financial markets in three major phases:

- Sponsored access trading (brokerage firms).
- Common passport for qualified West African brokers in the ECOWAS.
- Establishment of a common trading platform in the region.

# DEBT MARKETS IN AFRICA AND THE NEED TO CROWD IN THE PRIVATE SECTOR

Debt markets include government bonds and corporate bonds. In 2019, African governments issued over \$200 billion in sovereign bonds (denominated in local or foreign currency), compared with more than \$700 billion issued by China, the biggest bond market among emerging markets and the third biggest bond market globally. Local currency bonds make up 78 per cent of outstanding debt in Africa. Bond purchasers generally prefer medium-term bonds (maturity averaging 5.1 years). The higher proportion of local currency bonds over hard currency bonds reduces the risk of debt unsustainability, reduces exposure to currency exchange risks and increases governments' ability to manage their balance of payments in case of a distress scenario. The growing local currency bond market has increased appetite among local investors (predominantly banks, private self-administered funds and pension funds), currently the majority holders of government securities in Africa. For instance, in South Africa, the biggest bond market on the continent, local investors hold 62 per cent of government bonds.

In most African countries the ratio of bonds outstanding to GDP is below 40 per cent, indicating a low exposure to credit risk. Three countries have relatively high bonds-outstanding-to-GDP ratios: Egypt (60 per cent), South Africa (51 per cent) and Mauritius (47 per cent). The high concentration of debt outstanding in South Africa is due to its relatively stable and liquid market and its former investment-grade rating, which gave it a competitive advantage from the point of view of an investor assessing risks. Investment-grade country ratings are Baa3 (Moody's) or BBB- (S&P and Fitch's) and above, while non-investment-grade country ratings are Ba1 or BB+ or below. Only two countries in Africa, Botswana and Morocco, currently have an investment-grade credit rating. Before South Africa's credit downgrade in March 2020, around 35 per cent of the debt outstanding in Africa was rated Baa3, with South Africa accounting for most investment-grade debt. Egypt accounts for much of the 61 per cent of outstanding debt below investment grade (RisCura, 2020).

**“The higher proportion of local currency bonds over hard currency bonds reduces the risk of debt unsustainability, reduces exposure to currency exchange risks and increases governments' ability to manage their balance of payments in case of a distress scenario”**

## EMERGENCE OF THE CORPORATE BOND MARKET IN AFRICA

Although the debt market in Africa is dominated by the sovereign bond market, which accounted for more than 80 per cent all issuances in 2019, a corporate bond market is timidly emerging, with South African companies accounting for more than 40 per cent of corporate bond issuances in 2019. Although some countries are developing local corporate bond markets by raising millions through Eurobonds (bonds denominated in a currency not of the issuer's country, generally US dollars or euros), the corporate bond market on the continent is dwarfed by the sovereign bond market and remains underdeveloped, with very low capitalization.

African corporate debt market capitalization is small compared with that in other emerging and advanced markets. For instance, in 2018 the capitalization of China's corporate debt market was estimated at 154 per cent of GDP and that of the US market at 75 per cent. But in Africa, Mauritius had the highest corporate-debt-to-GDP ratio, 49 per cent, followed



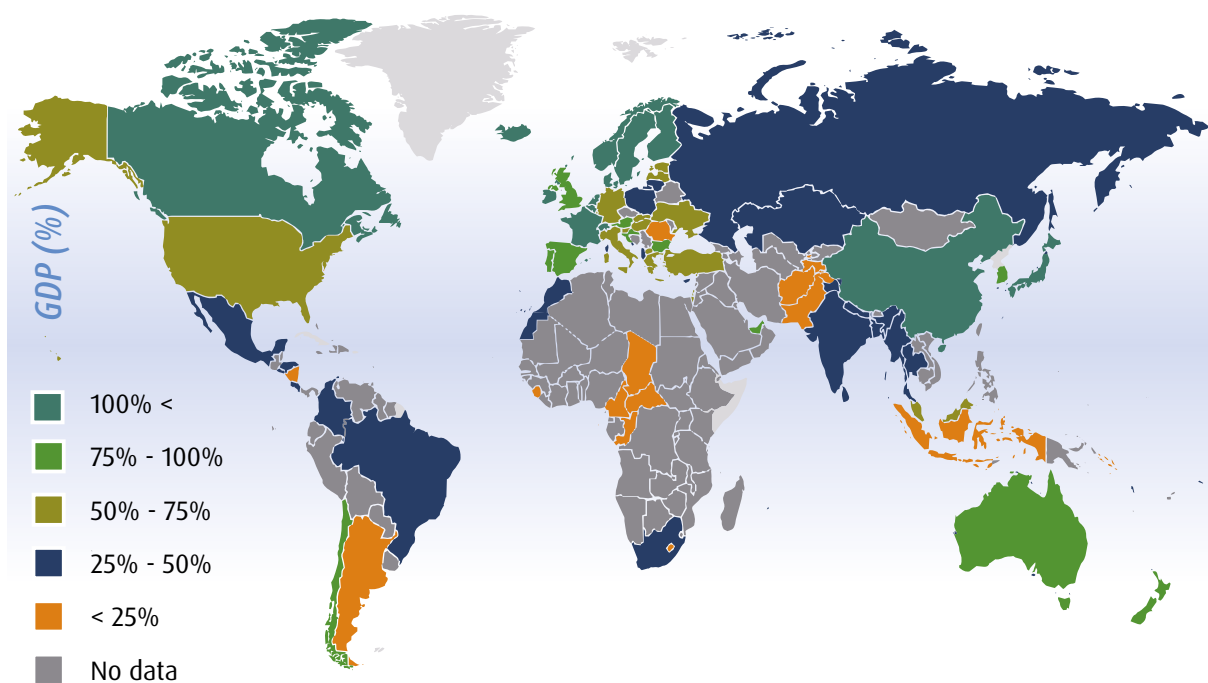
by South Africa (38 per cent) and Morocco (38 per cent) (FIGURE 4.3). The global capitalization of the investment-grade corporate debt market reached \$10 trillion in 2019, up from \$2 trillion in 2001. The corporate bond market has two types of bond quality: high-grade (or investment-grade) debt and high-yield debt. The high-yield bond market affords riskier firms the chance to raise debt financing. Despite the funding potential of bond markets for businesses, the digitalization of bond markets in Africa is in its infancy, and more is needed to harness the advantages of these markets.

Debt markets and their instruments are generally perceived as less risky than equity markets and stock purchases. Debt holders are compensated before equity investors in the bankruptcy hierarchy. But debt products have limited upsides, since their returns are dictated by their coupon (interest) rate when issued. So, debt instruments, being more predictable, match the risk profile of more risk-averse investors.

Debt market participants desire a guaranteed return over a defined time. Insurance companies, pension funds and some sovereign wealth funds are prime examples of institutional participants in debt markets. The deepening of debt capital markets with appropriate market mechanisms—a sound regulatory framework, transparent management structures and a safe business environment—present great opportunities for African pension funds. Those funds hold an estimated \$700 billion in assets, currently mostly invested in government or term deposit securities with low returns on investment, while little goes into African financial markets. And retail investors, particularly those closer to retirement who prefer less risk, may also choose to invest more in debt market products.

Financing private sector development in Africa depends on issuing new instruments through such bond markets. Training capital market participants and promoting collaborations between local corporations and global investment banks are

**FIGURE 4.3** GLOBAL CORPORATE DEBT MARKET CAPITALIZATION (PER CENT OF GDP, 2019)



**Note:** Total stock of loans and debt securities issued by non-financial corporations as a share of GDP.

**Source:** Adapted from IMF Global Debt Database, December 2019.

needed to capture the opportunities. The recent success of government bond issues in many African countries evinces the huge potential of such instruments. And growing global demand by yield-starved investors (particularly in emerging markets) combined with more investment-grade corporate bond issues will be key to the growth of the African corporate debt market.

## INNOVATIONS IN DEBT MARKETS AND OPPORTUNITIES FOR INCREASED LIQUIDITY

Debt markets have transformed plain bonds and regular debt into a variety of debt products to adjust risk profiles and tenors to those desired by investors. They have also improved liquidity and raised short-term funding for African firms. Zero-coupon bonds, asset-backed securities, and collateralized mortgage obligations are examples of non-generic debt products. Unlike traditional bonds, zero-coupon bonds do not pay periodic coupons, but are issued at steep discounts, so the value of bond rises to its face value as it approaches maturity. Zero-coupon bonds are promoted for their relative affordability, their guaranteed yield if the investor holds the bond to maturity and their relative ability to immunize—that is, to minimize interest risk by calibrating the maturity of the portfolio to fit the time horizon of the investor. Investors often view a corporation that issues coupon-paying bonds as being in good financial health.

Asset backed securities (ABS) are securities backed by loans (such as home equity loans, automobile loans and student loans), leases or instalment contracts on personal property, receivables (such as credit card receivables or remittance receivables) or royalties. The creation of an ABS entails three processes: collateralization, special purpose vehicle (SPV) and securitization. Collateralization means issuing loans that are each backed by collateral to provide protection against default. The collateralized loans are then placed in an SPV. A bankruptcy trust is then created to decouple the trust from the bankruptcy risk of the investment bank managing the SPV. Securitization pools the various loans in the trust into a sellable security or securities. Cash flows from the loans are then used to pay investors who purchased the securities. ABSs provide benefits unobtainable from conventional secured debt, such as allowing financial institutions to make new loans from otherwise illiquid assets (loans) and pooling and issuing loans that could not be sold individually.

**“Financing private sector development in Africa depends on issuing new instruments through such bond markets. Training capital market participants and promoting collaborations between local corporations and global investment banks are needed to capture the opportunities”**

Collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs) allow investors to purchase loans taken out by retail banking customers—further expanding traditional banks’ lending capacities. While the CMO market is generally underdeveloped in Africa, South Africa has a burgeoning securitization market other African countries can learn from. The asset securitization market in South Africa emerged when the then-United Building Society issued a R250 million mortgage-backed security in November 1989 and when Sasfin floated a R60 million issue backed by instalment rental loans in 1991. In the early 2000s four collateralized CDOs were issued in the South African market. In 2000 Rand Merchant Bank (RMB) collaborated with Morgan Stanley to originate a R3.9 billion CDO. In 2002 based on the success of that issue, RMB collaborated with Goldman Sachs to issue a R2.9 billion CDO. Three of the four deals illustrated in **BOX 4.3** were collaborations between South African banks and international investment banks. The lesson is that African firms do not have to reinvent the wheel. They can tap into the experience of global investment bank giants to develop their asset securitization markets.

A repurchase agreement (repo) is a simultaneous agreement for the sale and repurchase of an underlying security on different settlement dates. It entails the acquisition of funds through the sale of securities with the simultaneous claim to repurchase the securities at an agreed price and interest rate



at a specified date within a fixed time. A slight discount is often demanded by the lender—the spread between the repo price and the spot price.

Globally, about \$2–\$4 trillion in repurchase agreements are traded each day (Cheng and Wessel, 2020). In Africa in 2016, CNBC reported a record repurchase agreement deal of \$25 million between two banks (BOX 4.3). The size of the global repo market underscores its role in providing liquidity for market participants. Besides the dealer banks, money market mutual funds and hedge funds are major players in the repo market. Most central banks also use repos to conduct monetary policy, thus enhancing the size of the repo market and further contributing to market liquidity.

#### BOX 4.3 AFRICAN REPURCHASE DEALS

There is little data on Africa repo market since it is undeveloped—in most countries, virtually non-existent. So, there are very few success stories on repo transactions on the continent, especially outside South Africa.

But a success story worth highlighting is a \$25 million repo transaction between the Commercial Bank of Africa and Standard Bank of South Africa, reported by CNBC in 2016. In this deal, the Commercial Bank of Africa used Kenyan government bonds as collateral to secure \$25 million from

Standard Bank. This was the first deal of this kind ever in East Africa. The deal had a tenor of one year. It enabled the Commercial Bank of Africa to stabilize its balance sheet. The deal contributed immensely to developing the money market in Africa.

Most African countries lack organized repo markets, so efforts are needed to build and grow them. Training central banks and investors on the mechanisms of repo transactions can help establish strong repo markets. The International Capital Market Association

(ICMA) is forging several collaborations to build the capacities of potential participants in repo markets. It has worked with partners in Kenya and Nigeria to train the staff of central banks, commercial banks and capital market regulators. Such collaborations and capacity-building drives should be extended to other parts of Africa to ensure continent-wide repo market evolution and revolution.

# OTHER OPPORTUNITIES FOR PRIVATE FINANCING

## COMMODITY EXCHANGES

Commodity markets and exchanges offer a marketplace for basic products (mainly from agriculture, mining and oil) to be traded and can help developing a futures market and prices for such futures products. They enhance the efficiency of selling and buying commodity products, allowing countries to enhance their trade capabilities. They help farmers access finance and give fund managers a way to provide greater liquidity and participate in price formation. The major buyers of commodities are also major participants in commodity markets: food, industrial and petrochemical firms use these markets to purchase commodities at guaranteed prices.

In Africa, commodity exchanges are small, underdeveloped and unable to meet the growing needs of producers. Although African countries are dominant global producers of many agricultural and natural resource goods, the goods are traded or have their prices quoted on exchanges outside the continent. So, opportunities for price discovery, access to finance, hedging opportunities and market information are limited for African farmers and small businesses in those sectors (Umeano, 2017). The development and deepening of commodity exchanges are constrained in Africa by the lack of enabling laws, the lack of infrastructure (warehousing, transportation and processing plants), ill-designed government interventions, competition from commodity boards and commodity markets' inability to attract the mainstream financial sector. Even so, a few

**TABLE 4.2** SELECTED COMMODITY EXCHANGES IN AFRICA

EXCHANGE	LOCATION	DATE OF CREATION	MARKET	TRADED COMMODITIES	INSTRUMENTS
<b>South African Futures Exchange (SAFEX)</b>	Sandton	1995	Agriculture	Grains	Spot and futures
<b>Abuja Securities and Commodity Exchange (ASCE)</b>	Abuja, Nigeria	1998	Agriculture	Maize, millet and sorghum	Spot and futures
<b>Africa Mercantile Exchange (AfMX)</b>	Nairobi, Kenya	2005	Agriculture and energy	Ore, oil, sugar and coffee	Futures and options
<b>Ethiopia Commodity Exchange (ECX)</b>	Addis Ababa	2008	Agriculture	Coffee, sesame grains, beans, maize and wheat	Spot
<b>Mercantile Exchange of Madagascar (MEX)</b>	Antananarivo	2011	Agriculture, metals and energy	Wheat, grains and metals	Spot and futures
<b>Nairobi Coffee Exchange (NCE)</b>	Nairobi, Kenya	2012	Agriculture	Coffee	Spot
<b>East Africa Exchange (EAX)</b>	Kigali, Rwanda	2013	Agriculture	Maize, beans, coffee and rice	Spot and futures
<b>Ghana Commodity Exchange (GCX)</b>	Accra	2018	Agriculture	Maize, soya and sorghum	Spot and forward
<b>Agricultural Commodity Exchange for Africa (ACE) Auction Holding Commodity Exchange (AHCX)</b>	Lilongwe, Malawi	2004	Agriculture	Beans, maize, ground-nuts, rice, soya, peas, sorghum and sunflower	Spot and forward

**Source:** Based on compilation from various sources, including the websites of the exchanges.

commodity exchanges in Africa are worth highlighting, such as the Ethiopian Commodity Exchange, which traded 92,239 tons of commodities worth 4.6 billion birr (about \$14.2 million) in January 2020 (Ethiopian Commodity Exchange, 2020) (TABLE 4.2).

## PRIVATE INVESTMENT MARKETS

Private investments include private equity and venture capital. Private equity funds purchase a majority or controlling stake in a target company, while venture capital funds finance start-ups with high growth potential through a significant but generally non-controlling stake. These funds provide management and technical assistance that can add value to target

firms, intending to exit at a higher valuation than they entered. With venture capital, many firms shy away from any form of financing that requires giving up an equity interest and ceding some decision-making control.

The number of deals in Africa increased from 158 in 2014 to match its 2013 historic high—186—in 2018 (TABLE 4.3). Overall, 1,022 private investment deals took place in Africa from 2013 to 2018 for a total value of \$25.7 billion. Over the same period, private investment fundraising on the continent amounted to \$17.8 billion. The median size of final closed funds is \$123 million. The total value of private equity funds raised increased to \$2.7 billion in 2018 from \$2.4 billion in 2017, indicating investor confidence in Africa’s private equity industry.

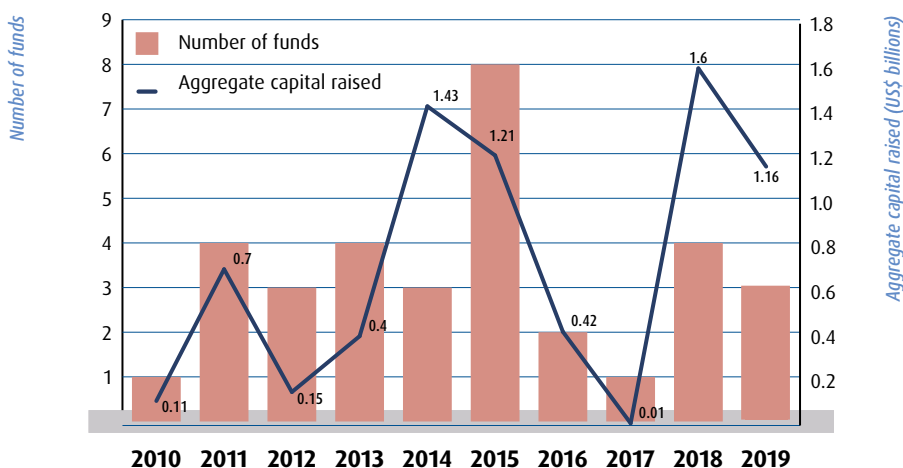
**TABLE 4.3** VALUE AND NUMBER AND AFRICAN PRIVATE INVESTMENT DEALS, 2013–2019

	2013	2014	2015	2016	2017	2018	2019H1
<b>Value of deals (US\$ billions)</b>	4.1	7.8	2.5	4	3.9	3.5	0.7
<b>Number of deals</b>	186	158	158	163	171	186	79

**Note:** 2019H1—most recent provisional data available at half year.

**Source:** 2018 Annual African Private Equity Data Tracker.

**FIGURE 4.4** AFRICAN PRIVATE CAPITAL FUNDRAISING,

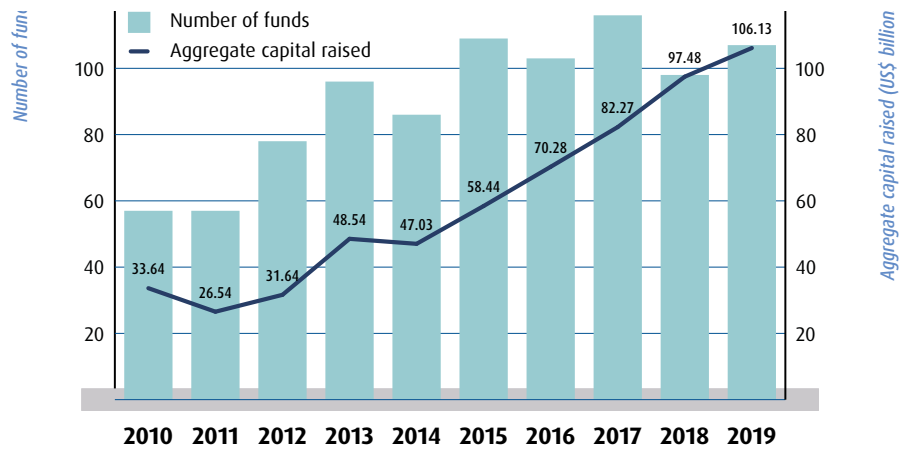


**Source:** Based on data from Preqin (2020)

In 2019 \$106 billion in private capital was raised worldwide, but only \$1.1 billion in Africa, with the continent representing only 1 per cent of the world total (FIGURE 4.4, FIGURE 4.5). Private capital funds in Asia (\$2.9 billion) were more than twice the size of those in Africa in 2019. In venture capital specifically, China’s information technology start-ups attracted approximately \$81 billion in 2018, 32 per cent of globally invested venture capital, compared with 47 per cent attracted by start-ups in the

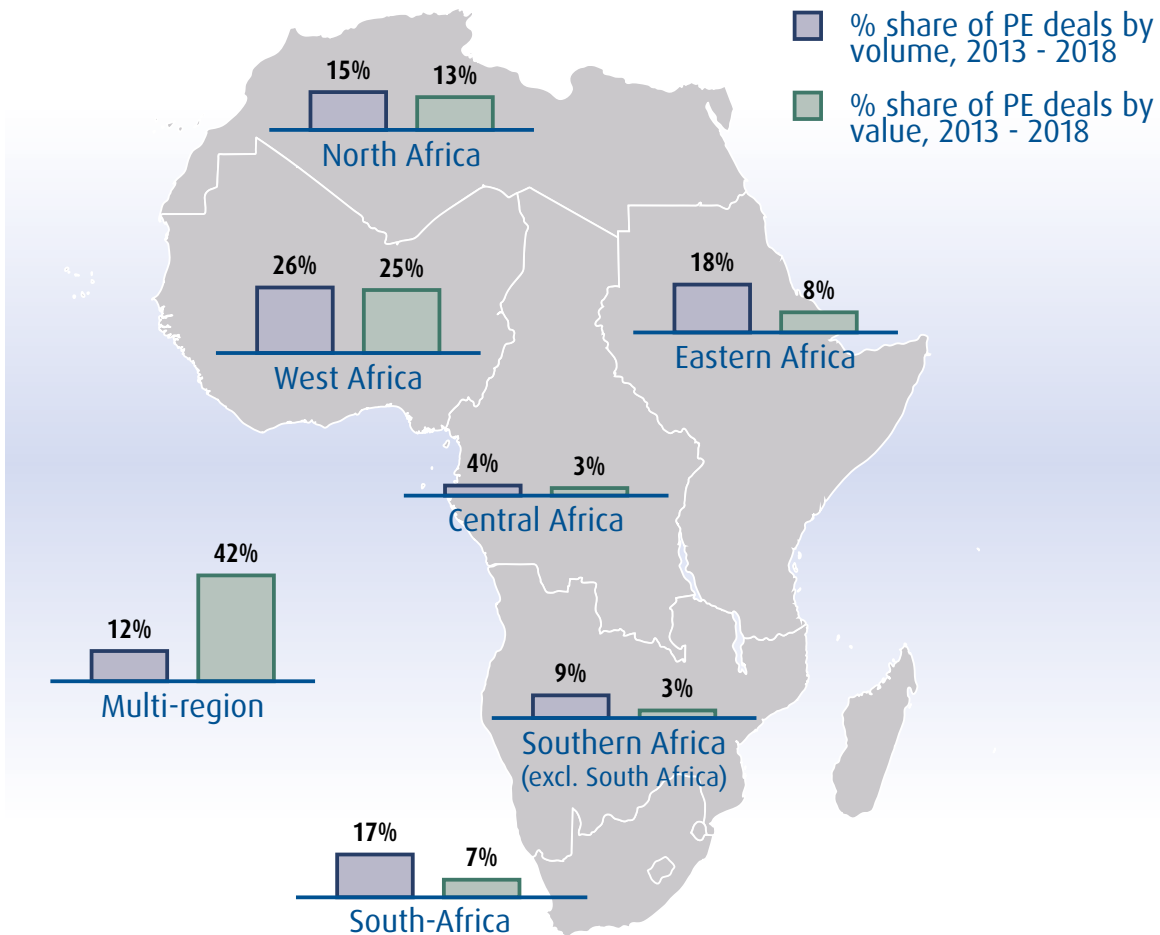
**FIGURE 4.5** GLOBAL PRIVATE CAPITAL FUNDRAISING, 2010–19

United States (Bain and Company, 2019). The distribution of investments by African private equity funds on the continent shows that the deals are concentrated mainly in West and North Africa (FIGURE 4.6), with the top receivers of private equity investment being Egypt, Ghana, Kenya, Nigeria and South Africa.



Source: Based on data from Preqin (2020).

**FIGURE 4.6** SHARE OF AFRICAN PRIVATE INVESTMENT DEALS BY REGION, 2013–18



Source: Annual African Private Equity Data Tracker (2018).

## COLLECTIVE INVESTMENT VEHICLES AND MUTUAL FUNDS

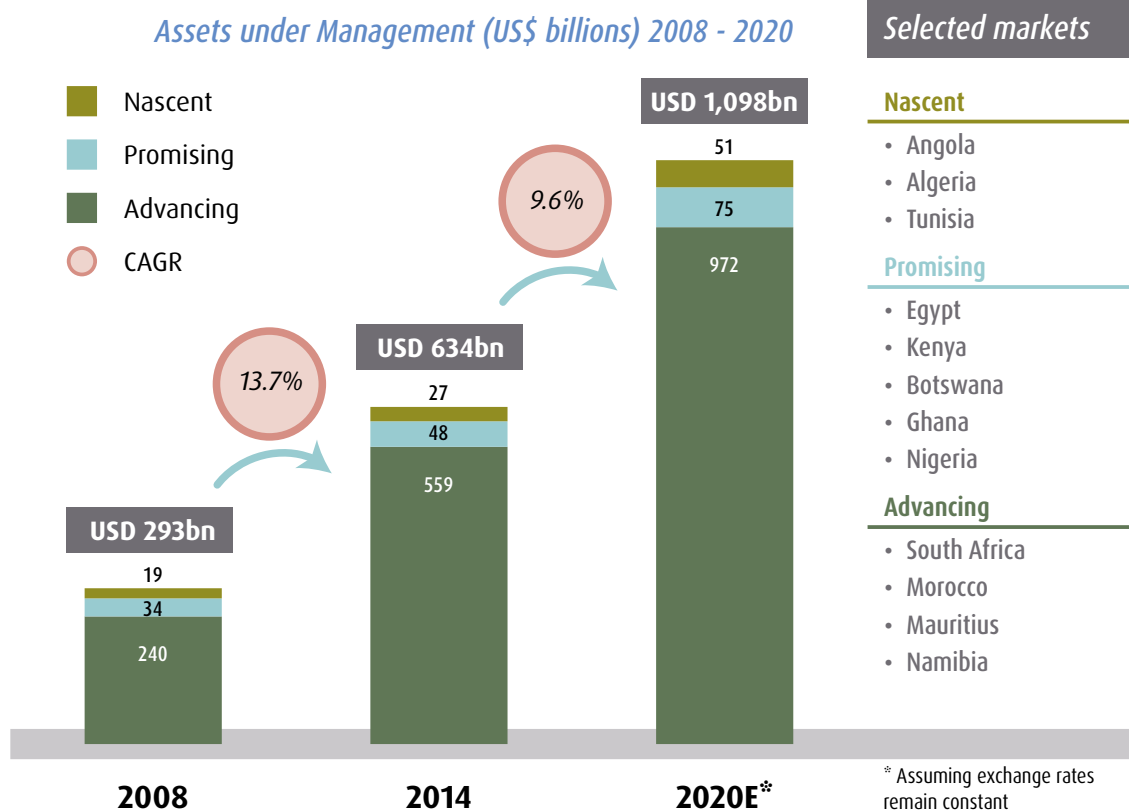
Many African exchanges, to enhance their development, have introduced new financial instruments such as mutual funds and other collective investment vehicles. These funds purchase stocks in many different companies and issue shares in the funds—allowing investors to buy stakes in multiple companies through one fund share. Investing in mutual funds offers investors a high degree of diversification and immunizes against company-specific risk.

Mutual funds operate in markets in Botswana, Kenya, Mauritius, South Africa and United Republic of Tanzania. The literature predicts a positive relationship between stock market returns and mutual fund flows in developing and emerging countries (Oh and Parwada, 2007). An increase in mutual fund flows can increase the size and depth of stock

exchanges in Africa. The value of assets under management in collective investment schemes or mutual funds in Africa is growing fast (FIGURE 4.7). The projected value in 2020 is \$1.1 trillion, up from \$293 billion in 2008. Exchange traded funds (ETFs), a type of mutual fund, are listed on stock exchanges and offer even lower transaction costs and fees, attracting more individuals and so further democratizing investing in the stock market. ETFs can cover stocks, commodities, debt instruments and other alternative investments, further expanding the breadth of investments for investors.

Asset management companies will rise, serving as platforms for investors to purchase mutual funds. Many global asset managers also monitor the components of a mutual fund on behalf of individual investors—since investors are unlikely to do so.

**FIGURE 4.7** EVOLUTION OF ASSETS UNDER MANAGEMENT IN MUTUAL FUNDS IN AFRICA, 2008–20



**CAGR:** Compound annual growth rate

**Source:** Africa Asset Management (2020).

Infrastructure funds—generally traded on a stock exchange—are a unique innovation to help finance infrastructure. In an infrastructure fund, an asset manager monitors and facilitates cash flow transfers to create a fund that invests in or provides funding for a specific piece of infrastructure, promising certain cash flows (from tolls or other fees) to the investors for a specified period. Infrastructure funds are often used to finance ground transportation networks, telecommunication infrastructure networks and even airports and seaports.

“Infrastructure funds are often used to finance ground transportation networks, telecommunication infrastructure networks and even airports and seaports”

## FINANCIAL MARKET PRODUCTS FOR INDUSTRIALIZATION

### FINANCING AGRO-INDUSTRY IN AFRICA

African agricultural productivity has been hampered by underinvestment, poor governance, climate change, lack of mechanization and low levels of irrigation, among other factors. The continent holds more than 60 per cent of the world’s arable land but contributes less than 2 per cent of global output. African agricultural output remains 95 per cent rain-fed, even though irrigated agriculture generates 3.5 times the yield and return on investment. In Africa, less than 5 per cent of government budgets are allocated to agricultural development, and traditional financing mechanisms such as taxes and bank loans have made little impact in addressing the needs of the sector. Transforming agriculture in Africa will require increased private investment in agricultural productivity value chains, scaling up agricultural innovation and an agricultural development-enabled infrastructure environment creating linkages with transport, energy, water and information and communications technology.

Africa’s growing population, emerging middle class, rising food prices and increasing value of the food market (projected to reach \$1 trillion by 2030) present investment opportunities for the private sector in both farmland and agribusiness. Agricultural and agribusiness investments are increasingly

taking the forms of private equity and venture capital business models. There are currently more than 80 investment funds financing agriculture and agribusiness (including SMEs) in Africa, with an estimated combined capital of close to \$20 billion (some investments may be multi-sector). Despite the increasing interest of private equity funds in investing in African agribusiness, the sector remains underfunded due to various factors that compromise investors’ returns. These include corruption, bureaucracy, weak logistics, inadequate infrastructure and limited value addition, and they reduce the competitiveness of the sector. Combined with the fragmented and undynamic nature of many African markets and the shallow depth of African capital markets, such factors make it difficult for many private equity funds to find exit options.

But private equity funds themselves are overcoming these challenges, for example by extending the lifetime of the fund, providing non-financial (physical) capital through equipment leasing, or partnering with development finance institutions. And by leveraging capital to local businesses in the agricultural sector, private equity funds support the development of domestic agribusiness value chains—the linkage between primary agricultural production and agro-industry—and

strengthen the capacity and performance of firms they invest in. They thus contribute to the growth of the agricultural sector and the development of the private sector. According to Equity for Africa, for every \$10 invested in agricultural processing, local businesses add one smallholder farmer to their supply chain (Ghosh and Revilla, 2007).

## PRIVATE FINANCING FOR MANUFACTURING IN AFRICA

African manufacturing sector dynamics are also uneven. Although the sector has been growing faster in Africa than in other regions, it remains concentrated in a few countries, with Egypt, Morocco, Nigeria and South Africa accounting for about 70 per cent of manufacturing value added.

Financing for manufacturing has mainly been domestic bank lending and foreign direct investment (FDI) concentrated in a few countries—Egypt, Ethiopia, Kenya, Morocco, Nigeria, United Republic of Tanzania and Zambia—that have relatively high ratios of manufacturing financing to GDP. Manufacturing is the second most attractive sector for FDI, after oil and gas (Otchere et al, 2016). In Ethiopia for example, about four-fifths of FDI flows to the country are destined for the manufacturing sector. This concentration aligns with the country's strategy to attract more FDI into productive sectors such as manufacturing, promote the growth of domestic firms and crowd in more local private investment. The development

and financing strategy followed by Ethiopia and other large manufacturing markets in Africa mirror China's experience in its early stages of industrialization.

But the Chinese industrial strategy included a mix of protectionism, export promotion, integration and upgrading of light manufacturing into global value chains (GVCs) and investment in capital- and technology-intensive sectors such as automotive and aeronautic industries. Many African manufacturing markets have focused their strategies on clothing export industries rather than diversify into equipment and other value chain intermediaries or invest in more knowledge-intensive sectors. That approach has reduced many African countries' competitiveness, especially compared with Asian and Latin American countries, and has further limited their ability to transition to more complex or higher-tech industries.

Even so, the transition of China and other Asian leading manufacturing markets to higher-technology- and knowledge-based industries has created a vacuum in light manufacturing. African countries, to take advantage of that vacuum, can shift labour, capital and entrepreneurship towards building a competitive and dynamic industrial base.

The prospects of industry in Africa also present opportunities to attract private investment and deliver private sector development. The potential growth of industry is projected to leverage \$666.3 billion in business-to-business spending

### BOX 4.4 DERIVATIVES MARKETS AND THEIR POTENTIAL IN AFRICA

Derivatives markets serve critical roles in many financial markets. They enhance market efficiency, diversify the array of financial instruments to manage risk and assist in price discovery. In developed markets, derivatives markets help to bring more participants in and enable more complex investment strategies, promoting more trades for equities, debt and commodities.

Derivatives markets would accelerate the development of non-bank financial institutions. Private funds and insurance

companies could invest in more types of financial instruments because they could purchase derivatives to mitigate risks. For example, combining a stock purchase with options would create a collar that limits the upside and downside, allowing firms seeking lower risk to invest anyway in riskier underlying assets such as equities.

Presently in Africa only JSE has a derivatives market. In 2018 it was ranked among the 20 largest derivatives markets globally, with 192 million contracts traded. Further

developments in financial markets are necessary for African derivatives markets to flourish. African stock exchanges must modernize their trading systems, reduce settlement lag times and transaction costs and implement continuous quotation methods. Well-functioning derivatives markets could deepen and broaden African financial markets and provide high growth potential for the financial services sector.



**“The prospects of industry in Africa also present opportunities to attract private investment and deliver private sector development”**

on manufacturing and transfer 100 million labour-intensive manufacturing jobs from China to Africa (Signe, 2018). To nurture industry increased investment will be required in productivity, transport infrastructure, electricity supply and skilled labour. Creating a business-enabling environment and addressing some of the obstacles to firms, such as a lack of bankable projects, low value addition and undeveloped value chains, will be critical to mobilize private investment in manufacturing in Africa.

Kenya is worth highlighting. It has adopted policy initiatives to liberalize the private financial service market, increased productivity through value chain development and enhanced skills and innovation. These steps have attracted private finance for manufacturing and promoted industrial growth and advancement. Kenya is one of the few African countries with a fairly strong industrial manufacturing sector in both size/annual output and competitiveness for investment. The manufacturing sector in Kenya accounts for about 20 per cent of GDP and contributes more than 12 per cent of formal employment. Close to 90 per cent of financing in the sector is from domestic bank lending. Kenya has a diversified industrial manufacturing sector including dairy, textiles, chemicals, furniture, leather goods, pharmaceuticals, motor vehicles and fabricated metals.

Kenya's example of financial service liberalization is paramount for Africa continent-wide, particularly in relation to the opportunities to be raised by liberalization under the AfCFTA. Financial services is one of the service sectors the AfCFTA prioritizes for upfront liberalization (together with tourism, transport, communications and business services). Member states are expected to offer market access and

national treatment to foreign financial service providers. When implemented, such commitments will lead to an elimination of current barriers. Since such barriers mainly come in the form of regulations, member states will need to undertake regulatory reforms as they implement the AfCFTA.

As liberalization dismantles entry barriers, foreign financial institutions will find opportunities to provide more diversified financial products, creating greater competition. This will lead to financial development through increased economies of scope, as financial service consumers demand more sophisticated products and services. Possible economies of agglomeration will reveal opportunities to blend in private capital from other sources, deepening the African capital market. From the demand side, businesses needing capital to expand beyond their domestic confines to the larger AfCFTA market will have access to more and, down the line, cheaper financial products and services. The greater private financing will support various sectors of the economy, including manufacturing and services. So, better financial market integration will have knock-on effects in further manufacturing sectors and throughout the economy, if the full potential of the AfCFTA is attained.

Furthermore, additional barriers to capital markets will be lifted under a protocol on investment to be negotiated in phase II of the AfCFTA. The investment protocol is expected to set up continental rules creating a common investment area. The free movement of capital will thus complement the three freedoms enshrined in the AfCTFA—free movement of goods, services and people—allowing financial services to move freely in the continental space and so relieve supply side constraints that have left the manufacturing and service sectors underfinanced.

If these positive knock-on effects are to gain traction, measures to remedy market failures reducing financial market competition will be required, including clear competition regulation and an oversight body. Otherwise unfair competition skewing opportunities towards a few vested financial sector operators could unduly concentrate market power and so divert the benefits of liberalized financial services expected for consumers and other operators.

In addition, regulations protecting consumers, especially in the realm of digitalized financial services, will be required.



To underpin these, the AfCFTA is to incorporate a protocol on competition and, later, a protocol on e-commerce regulating digital (financial) trade transactions, which will set out

a coherent legal framework complementary to maximizing the positive effects of liberalized financial services on private capital in Africa.

## THREAT OF COVID-19 TO AFRICAN FINANCIAL MARKETS

The impact of the COVID-19 outbreak on financial markets around the world started in early February 2020 with uncertainty and increased volatility across all markets, including equity markets, stock exchanges and debt markets. Equity markets entered the period of extreme COVID-related stress with about 30 per cent loss on market value, while stocks started declining in major exchanges—with the S&P 500 tumbling 4.4 per cent and the Dow Jones Industrial Average dropping 4.4 per cent—during the first weeks of the outbreak. In some advanced economies and emerging markets, equity and debt markets started to rebound following announcements and implementation of fiscal stimulus packages, central bank corporate credit facilities and other policy measures to support the economy.

Although the global integration of African capital markets remains low except for the emerging markets such as Egypt and South Africa, contagion from the global panic and stock slump in world markets will affect major African capital markets such as Egypt, Mauritius, Morocco, Nigeria and South Africa with:

- Irregularities in the commodity markets as demand recovers slowly while prices keep fluctuating.
- Collapses of equity prices and increased demand for bonds with higher yields.
- Declines in market capitalization.
- Downgrading by rating agencies.
- Currency risks and massive capital flight.

For instance, the main index of the Egyptian Stock Exchange, EGX30, declined by more than 30 per cent in February–March 2020. In some countries, the depreciation of local currencies against the strengthening US dollar had negative impacts on trade balances (with weak trade activity and reduced export revenues) and debt (with increased servicing costs of dollar-denominated or foreign-linked bonds). The depreciation combined with the drying up of domestic and external financial revenue sources and challenges to African governments seeking to borrow in an uncertain and less well capitalized global market. These factors contributed to record increases in government bond spreads—the difference between yields on bonds issued by a country and yields offered by governments with AAA ratings—of more than 700 basis points since February 2020 (Papadavid and Velde, 2020).

As the virus continued spreading and countries instituted confinement measures to contain it, slowing economic activity and increasing risk perception, investors started pulling out of developing markets. Capital flight from developing markets was \$59 billion between February and March 2020, more than double the capital flight recorded during the 2008 financial crisis. (UNCTAD, 2020).

Continued uncertainty regarding lockdowns, re-opening and economic recovery, combined with currency depreciation and the recent downgrade of major African economies to below investment grade by credit rating agencies, will further affect African equity and debt markets. As of 1 May 2020, equity analysts had adjusted revenues for major public companies

in Africa down by 24 per cent from previous consensus estimates, and profits by 12 per cent, since the beginning of the year. Although the cost of debt has fallen in developed markets, it is rising in developing markets, reducing the liquidity of the financial service sector. Notably, Eurobond-dependent countries with depreciating currencies face even higher effective costs of debt. Countries with high exposure to Eurobonds such as Angola, Côte d'Ivoire (in the public and private sectors) and Ghana are at risk of default, complicating efforts to deal with the pandemic.

## CONCLUSION

This chapter has examined various types of financial markets that can provide financing for the private sector and enhance financial participation and inclusion in Africa. A well-developed system of financial markets can benefit both private sector constituents that need funding and investors—who get more choice and opportunity to provide funding to the private sector and to the government. Properly structured, a capital market can also allow sovereign bonds to be issued in the local currency, if there is enough domestic demand, reducing foreign exchange risk for sovereign issuers.

But for capital markets to become well developed requires that many financial service sector participants—asset managers, insurance companies, investment banks, sovereign wealth and pension funds, and other institutional investors—have to participate in the monitoring, price regulation and transfer functions allowing investors to invest. Against this backdrop, harmonized continental rules stipulating common obligations and rights for this panoply of players would permit a standardized and streamlined approach to overseeing African financial markets and support their functioning. The AfCFTA could be instrumental in advancing such rules through service trade liberalization, as well as adopting an investment protocol, to

ensure the free movement of capital and investment. These steps would help the financial service liberalization, to which member states have committed, gain traction and would bolster Africa's financial integration and deepening.

Stock exchanges, even nascent ones, can receive support and stimulus from local governments. For example many governments in other regions have partially privatized state-owned enterprises (SOEs) by listing a minority stake in the SOE on an exchange to align it with international reporting standards and to share its profits with retail investors (Estrin and Pelletier, 2018). The December 2019 listing in Riyadh of 1.5 per cent of Saudi Aramco's outstanding shares for \$25.6 billion allowed the Saudi Arabian government to access funding while maintaining control of the company. Partial privatizations could reduce financing gaps for many African states.

Even so, financial markets bring risks. Stock exchanges and their investors have been shown to be motivated by price jumps when earnings are released, prioritizing short-term over longer-term profits. And tax treatment and accounting regulations that require companies to record their research and development expenses as they occur might discourage

companies from research and development needed to keep profits high. That risk needs to be managed so companies do not lose their competitive edge to more innovative firms. The success of financial markets relies on the stability and reliability of their regulatory institutions.

Capital markets can attract foreign investors, bringing in valuable foreign direct investment to further develop the private sector. FDI can also ease takeovers and mergers—allowing underperforming or non-performing firms to be taken over by those able to compete. But attracting FDI for such purposes depends on creating a regulatory environment that foreign investors, particularly asset management companies in high-income countries, would want to invest in and offering them risk-adjusted returns they are willing to take.

Capital markets are simply another way to connect borrowers with savers who are ready to take on more risk as they begin to save for retirement. The growing African middle class will demand more sophisticated financial products and more innovative ways to save—stocks, bonds and other investments—to help them build wealth. The demand for savings vehicles will especially grow as the world population ages and achieves higher levels of education. For Africa getting ahead of the demographic curve will be key to sustainable development.

**“Capital markets are simply another way to connect borrowers with savers who are ready to take on more risk as they begin to save for retirement”**

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CHAPTER 5

# LONG-TERM FINANCING FOR SUSTAINABLE DEVELOPMENT IN AFRICA



**A**frica is at a critical development juncture. It seeks to accelerate economic growth to meet national development goals in line with the Sustainable Development Goals (SDGs) and the African Union's Agenda 2063, and to do so in a financially and environmentally sustainable way. The cost to achieve the SDGs by 2030 in Africa is estimated at about \$1.3 trillion a year, according to the United Nations. That could increase to \$19.5 trillion as a result of population growth—projected to be 43 per cent over 2015–2030. African countries' capacity to achieve the SDGs by 2030 is estimated, on average, at 53 per cent of what is needed—particularly for the goals to end extreme poverty, hunger and inequality; tackle climate change and build resilient infrastructure.

A central challenge for Africa to meet the SDGs and achieve sustainable and inclusive development is to mobilize the investment needed in key sectors such as health, energy, transport, construction, agriculture, education and manufacturing. Large investment gaps exist, particularly in sectors such as infrastructure (even while that sector has immense potential to drive economic growth).

Another challenge is to deliver urgently needed climate change adaptation—at the same time that infrastructure expands while urban environments grow. Africa has “extreme vulnerability” to climate change, which threatens to undermine the continent's major development gains and gives it a high stake in meeting climate challenges (UNECA, 2015; World Bank, 2018). An estimated \$18–\$30 billion a year will be needed over the next two decades for climate action and climate change adaptation in Africa, with nearly \$1 trillion worth of investments and projects ready to be financed. One widely advocated option is to increase the role of the private sector in such investments, especially given the low levels of investment by governments and bilateral donors (in official development assistance, or ODA). The availability of long-term finance is a key factor in whether this can be done.

Encouraging governments to mobilize domestic resources and private sources, ensuring more efficient international development financing, and leveraging climate financing will help bridge the substantial development financing gaps. Advancing the private sector and mobilizing private capital presents a transformative approach for achieving development goals.

And development banks at the multilateral, regional and national levels can play key roles to help meet the infrastructure challenge of African economies.

To translate these aspirations into action is a long-term goal. This chapter examines innovations in long-term financing and how the private sector can transform sustainable development in Africa. The chapter focuses on three areas of recent innovation: long-term financing instruments for climate risk, such as sustainable bonds for private sector financing; innovations in public-private investment in infrastructure; and the role of development banks in long-term financing of the private sector to maximize sustainable and inclusive growth

in Africa. The chapter discusses in detail Africa's participation in green bonds. The chapter also examines different funding sources and outlines the key issues and obstacles for private sector investment in African infrastructure. The chapter then briefly examines how development banks (national, regional and global) have encouraged private investment, including in infrastructure. The chapter concludes with policy implications for deepening Africa's participation in sustainability bonds, encouraging private investment in infrastructure, and enhancing the role of development banks in financing private sector development and sustainable development on the continent.

## SUSTAINABILITY BONDS

Green, social and sustainability bonds are bonds whose proceeds are exclusively applied to eligible environmental or social projects, such as climate change and adaptation or socially responsible goals.<sup>1</sup> The issuance of these bonds must comply with frameworks embedded in the Green Bond Principles (GBP), Social Bond Principles (SBP) and Sustainability Bond Guidelines (SBG). This emerging asset class has grown exponentially to more than \$6 trillion in the past decade. The integration of environmental, social and governance (ESG) considerations and sustainability increasingly attracts environmentally and socially responsible investors. It also offers Africa a unique opportunity to mobilize private capital for financing infrastructure development and large-scale economic activities.

### THE GLOBAL LANDSCAPE

Before 2007, these types of bonds had essentially no market. But by 2019 the combined value of issuances for the green, social and sustainability bond markets amounted to \$321 billion, a record increase of 52 per cent from 2018, and it was forecast to reach \$500 billion in 2020 (Environmental Finance, 2020). About 37 per cent of green, social and sustainability bond issuances were directly aligned to the SDGs, particularly SDG 7, affordable and clean energy; SDG 11, sustainable cities and communities; and SDG 13, climate action. While all three markets saw strong growth in 2019, the green bond market recorded milestones, with total issues valued at \$257.7 billion, up from \$170.6 billion the previous year. Environmental Finance, a news and analysis service, projected the global value of green bond issuances would reach \$350 billion in 2020. The growth of the sustainability



bonds market was also impressive, with issuances more than doubling to \$48 billion in 2019 from \$18 billion in 2018. The social bonds market saw issues of \$17 billion in 2019, up from \$14 billion the previous year (Environment Finance, 2020). In emerging markets, green, social and sustainability bonds issued were valued at about \$57 billion, with the green bonds market accounting for about 80 per cent. Corporates and financial institutions dominate as issuers in the global green and sustainability bonds markets, while agencies issue a large share of social bonds (FIGURE 5.1).

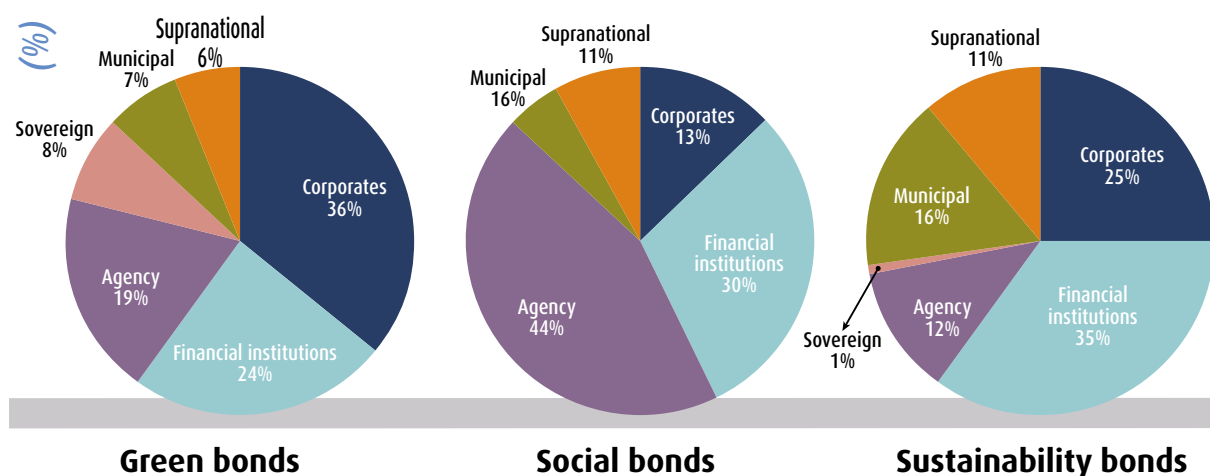
## THE GREEN BOND MARKET

As the economic cost of climate change-related disasters grows, countries are exploring new adaptation and resilience measures, opening new opportunities for investment. For instance, the investment opportunity to address climate change in emerging market cities is estimated at \$29 trillion by 2030 (IFC Analysis 2018). The key sectors of such an investment opportunity include green buildings, electric vehicles, public transport infrastructure, climate-smart water, renewable energy and municipal solid waste management. The global market for green bonds emerged in 2007, with the issuance of a €600 million AAA investment-grade green bond from the European Investment Bank (EIB). The market began to flourish in 2013 with the all-time record of one hour from issuance to sale for International Finance Corporation's \$1

billion green bond. In 2019, global green bond and green loan issuance reached \$257.7 billion, an increase of 51 per cent from 2018, representing about 2.5 per cent of the \$100 trillion global fixed income market (CBI, 2019).

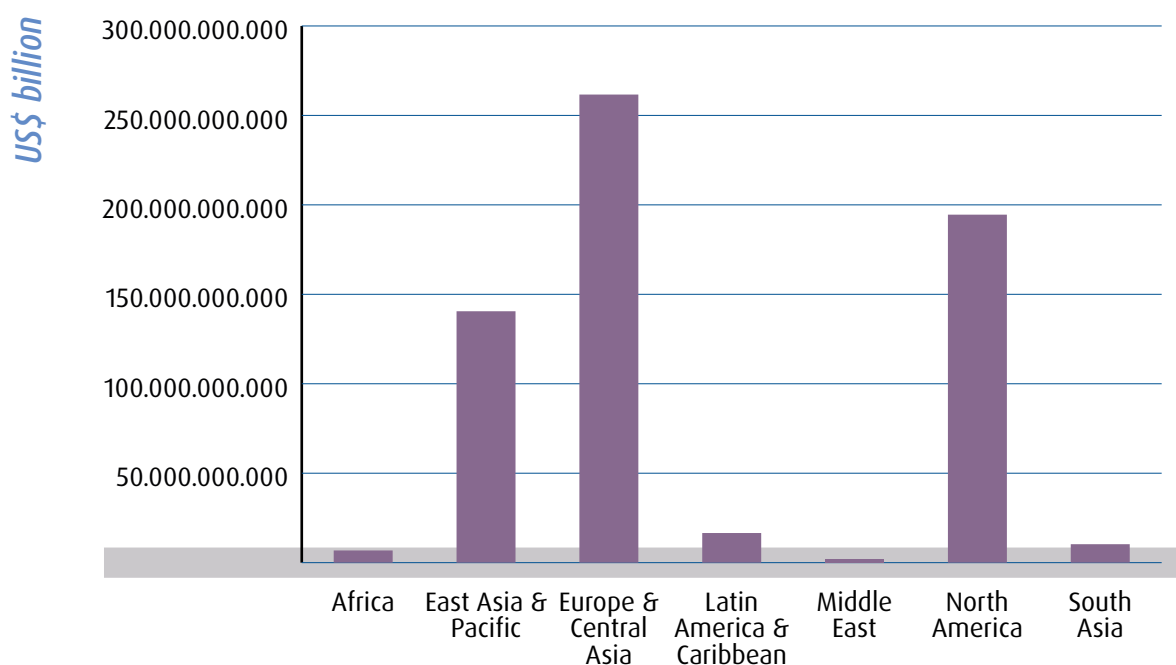
The largest issuing countries in the global green bonds market in 2019 were the United States (\$59 billion), France (\$31 billion), China (\$27 billion), Germany (\$22 billion) and the Netherlands (\$16 billion). Among emerging and developing economies, the most active participants were China and India, making East Asia and the Pacific the third largest regional issuer of green bonds and first among emerging and developing regional markets (see FIGURE 5.2). The market's development has been supported by international financial institutions (IFIs), which are among the top global issuers and are an important source of finance for developing countries for green and social projects. Top issuers include the World Bank's International Finance Corporation (IFC) and International Bank for Reconstruction and Development (IBRD), the European Investment Bank (EIB) and a few bilateral development institutions. Approximately 44 per cent of these funds have been applied to renewable energy, 25 per cent to green transport, and the other 30 per cent to green projects in land management, water and urban environments (World Bank, 2018). IFIs also actively engage private investors, including through blended finance and technical advice to issuers.

FIGURE 5.1 SUSTAINABILITY BOND ISSUERS, 2019



Source: Based on data from Environmental Finance (2020).

**FIGURE 5.2** GREEN BOND ISSUANCES BY REGION, 2007–19



**Source:** Based on Climate Bond Initiative Database (2019).

As the market and investor base have grown, issuers have increasingly diversified away from major IFIs and towards an increasing number of sovereign and corporate issuers. Sovereign issuers are typically financing the greening of public infrastructure, including energy, water and transport. The biggest sovereign issuers in 2019 included the Netherlands (\$6.68 billion), France (\$5.93 billion) and North Rhine-Westphalia state in Germany (\$2.76 billion). The increasing diversity of sovereign issuers includes major emerging economies such as Brazil, China and India, as well as smaller countries such as Fiji, Seychelles and Thailand.

Corporate issuance has also grown, particularly in green energy, where leading companies have acted repeatedly. Among the top 10 global issuers are TenneT, a leading European electricity transmission company, and Engie, a European-listed company investing in green power generation, which has issued green bonds several times to finance offshore wind farms. Engie's green bond issuance in 2019 was valued at \$4.66 billion (Environmental Finance, 2020). Transparency and governance frameworks for using bond

proceeds and a preference for having sustainable bonds listed in secondary markets have crowded in conventional private investors. These have included institutional investors such as pension funds and life insurers, which have been major investors in recent green and social bond issues, adding further dynamism to the growth of the market.

**“ . . . pension funds and life insurers, which have been major investors in recent green and social bond issues , adding further dynamism to the growth of the market ”**

## THE GREEN BOND MARKET IN AFRICA

The African green bond market emerged in 2010. South Africa and the African Development Bank (AfDB) took the lead, followed by Morocco, Nigeria and Seychelles. AfDB made its debut in 2013 with a AAA investment-grade green bond issuance of \$500 million. Between 2012 and 2018, cumulative issuances of green bonds by South Africa reached \$1.4 billion; Morocco, \$356 million; Nigeria, \$30 million and Seychelles, \$15 million. The issuers of green bonds in Africa were largely financial institutions, non-financial corporates, government agencies, sovereigns and municipals. In South Africa, key players in the issuance of green bonds include the Industrial Development Corporation, Nedbank and ACWA Power. Among sectors and projects for which proceeds were earmarked, renewable energy predominated (52 per cent), followed by

building (13 per cent) and transport (11 per cent). According to the Climate Bonds Initiative, cumulative green bond issuances in Africa reached \$2.6 billion as of September 2019, with the 2019 issuances totalling \$898 million. (See **BOX 5.1** for examples of recent bonds from leading countries in Africa.)

In Kenya, the Nairobi Securities Exchange is leading the development of a green bond programme with an accompanying regulatory and governance framework for issuing unlisted or listed green bonds in Kenya in conjunction with the National Treasury and Planning ministry, Central Bank of Kenya, Kenya Bankers Association, Capital Markets Authority and other private financial partners. Steps include training a pool of Kenya-based licence verifiers and seeking to issue a benchmark sovereign green bond. These partners have

### BOX 5.1 EXAMPLES OF GREEN BONDS PROGRAMMES IN AFRICA

#### SOUTH AFRICA'S JSE GREEN BOND PROGRAMMES (2014–2017)

South Africa has supported green bond issuances through the Johannesburg Stock Exchange (JSE), which has a dedicated sector for green bonds. Eligibility to be included in the JSE Green Bond Index requires an independent review of best practice methodology, including disclosure and independent monitoring of the use of proceeds. Examples include Johannesburg's \$137 million green bond programme in 2014, with proceeds financing projects that reduce greenhouse emissions, and Cape Town's \$74 million green bond programme in 2017 to finance water infrastructure.

In 2018 in the financial sector, South African-based property investment holding company Growthpoint Properties issued the first listed green bonds in South Africa, and Bank Windhoek issued the first in Namibia. Both were to finance projects to reduce environmental vulnerability and address climate change issues.

#### NIGERIA'S SOVEREIGN AND NSE GREEN BOND PROGRAMME (2017–2019)

In December 2018 Nigeria established governance frameworks for subnational and corporate issuers of green bonds listed on the Nigerian Securities and Exchange Commission. There had also been benchmark issues including, in 2017, when the government of Nigeria issued a naira-denominated sovereign green bond for \$29 million with a maturity of 5 years, listed on the Nigerian Stock Exchange. The proceeds are for forestation, environmental and renewable energy projects. The issuance was supported by a wide range of development partners. Although it was to be the first of a number of sovereign green bonds, no further issuances have been completed. In 2019 Access Bank, one of Nigeria's largest banks, issued a corporate green bond for \$41 million. Also issued in naira, it is listed on the FMDQ securities exchange, the largest securities exchange in Nigeria. The bond was fully subscribed and certified under GBP (Green Bond Principles) standards.

#### MOROCCO'S BMCE \$45 MILLION GREEN BOND (2016)

The Moroccan commercial bank BMCE is a financing facility for private sector companies investing in green energy projects. A one-stop shop for financing and advice, it has financed transport, manufacturing, property development and small-scale stand-alone energy projects. In 2016, its parent company BMCE Bank of Africa raised \$45 million to finance the facility, issued in a public offering with the approval of the Moroccan Capital Markets Authority. In governance the BMCE was GBP compliant and has specified minimum energy savings and amounts of avoided emissions for projects to be eligible.

#### KINGDOM OF MOROCCO \$118 MILLION GREEN BOND FOR SOLAR POWER (2016)

This bond, issued to finance three solar energy projects in Morocco, was GBP certified. It was issued in local currency and had a sovereign guarantee from the Kingdom of Morocco. The bond was completed through private placement to local banks with the authorization of the Moroccan Authority of Capital Markets.

**Source:** International Finance Corporation; Financial Sector Deepening (FSD) Africa.

also developed a financing facility that pools green assets for securitization, an interesting innovation for domestic markets (LSEG Africa Advisory Group, 2019a, 2019b).

Green bond issuances in Africa are limited in currency and tenor. Globally more than 90 per cent of green bonds are issued in hard currency, with the US dollar and euro dominating. Only a handful have been issued in the currencies of low-income or lower middle-income countries. In Africa, four green bonds were issued in South African rands, and others more recently in Moroccan dirhams and Nigerian naira. The tenors of bonds issued in Africa are also limited. Global markets since 2007 have generally seen bond maturity lengthening from an average of 5 years in 2007–2013 to consistently more than 10 years by 2019, with several bonds dated as long as 25 years. For developing countries the pattern is mixed, with South and West Asia's tenors being among the longest globally, while African bonds have the shortest, averaging 6–7 years.

## DEEPENING AFRICA'S PARTICIPATION IN SUSTAINABILITY FINANCING

Despite global, regional and national initiatives aiming to scale up sustainability financing in Africa, efforts at raising capital and financial investments have yet to accelerate the development of environment-friendly, socially responsible and climate-resilient economies on the continent. First, Africa's engagement in bond capital markets is fairly weak—both in developing domestic markets and in issuing bonds in international capital markets. Bond markets, which provide a deep investor base and an established regulatory and legal framework for issuances, are a prerequisite for developing such new instruments as green and social bonds. Second, the needs of the region, particularly for green infrastructure that requires long-term finance, are mismatched with the current average tenor of green bonds. So, infrastructure projects need to be repeatedly refinanced during their lifetime, exposing them to major risks of unfavourable changes in currency and interest rates.

These factors put Africa in an unattractive position compared with developing countries in, for example, Asia and Latin America, where investment risks are lower, including risks of foreign exchange, political stability and macroeconomic stability. Many investors avoid foreign currency risk in volatile emerging market currencies. The volatility of some African currencies, including in Ghana, Nigeria and Zambia, has

hardened this aversion. Investors' most common response to such foreign exchange risk is to require that securities be denominated in hard currency—thus transferring the risk to the issuer, possibly with negative consequences for the issuer's debt sustainability (Tyson, 2015a, 2018; PWC, 2019).

These risks are difficult to hedge—in some cases, impossible. Foreign exchange markets for hedging instruments are either absent or illiquid.<sup>2</sup> Political risk insurance is expensive and cumbersome, and making claims is difficult. The Multilateral Investment Guarantee Agency, for example, has reportedly paid on only seven claims in the past decade (Tyson, 2018). In addition, there are insufficient “bankable” green and social assets or projects suitable for bond financing. This is common in infrastructure, where projects in Africa take, on average, six years to plan and up to a decade to bring into operation. Financing early-stage project planning and construction through bond markets is particularly difficult because investors avoid the higher risk during development and prefer mature assets with income flows (Tyson, 2018).

These issues have resulted in private non-foreign direct investment cross-border capital flows to Africa being dominated by high risk-high return investors, such as private equity funds, and investors with a longer-term investment horizon, such as sovereign wealth funds or non-traditional bilateral investors (for instance, China). Sovereign wealth funds and Chinese investors have made major investments in infrastructure and industrialization, supporting economic growth.

**“Sovereign wealth funds and Chinese investors have made major investments in infrastructure and industrialization, supporting economic growth”**

These issues of risk are also acute for socially responsible and international institutional investors. Such investors have either high governance standards for green and social goals or fiduciary and regulatory responsibilities that limit the riskiness of assets in which they can invest—effectively excluding them from investing in green bonds in many African countries.

Mitigating these risks is essential to crowding more investment into the African sustainable bond market. Deepening Africa’s participation in sustainable bonds will then require closing the gap in investor appetite for African green and social assets, developing and enhancing domestic frameworks for them and engaging African issuers in capital markets.

### CLOSING THE GAP ON INVESTOR APPETITE

Risk pooling through funds, and innovation in asset classes could be important approaches to mitigating risk for African market investors. Institutional investors (pension funds and insurance companies) could find these methods especially helpful because they have huge pools of capital, a risk appetite allowing long-dated assets and a need for assets matching their long-term liabilities. Private investors typically manage investment risks through a portfolio that diversifies risks across many assets and so hedges risks. This increases the risk appetite of investors.

The development of hedging instruments tailored to the risks private investors face in bond markets offers another valuable approach to mitigating risk. IFIs and development finance institutions have supported innovations relating to foreign exchange. The finance institutions provide equity to seed-fund instruments for pooling hedging risk and allowing specialized hedging instruments so investors can benefit from portfolio

**“Risk pooling through funds, and innovation in asset classes could be important approaches to mitigating risk for African market investors”**

diversification. An example is the currency-exchange fund (TCX), which was seed-funded by a consortium led by FMO, a Dutch entrepreneurial development bank, and provides foreign exchange and interest rate hedging futures. Recent scaling up of TCX promises to provide hedging instruments more widely. Further TCX-type hedge providers in other risk dimensions—such as political risk, credit risk and interest-rate risk—would extend such ways of crowding in private investors (Tyson, 2018).

### DELIVERING ON DOMESTIC FRAMEWORKS

Regulatory and governance frameworks for green, social and sustainability bonds are critical to developing the market. Several African governments have recognized this, led by the region’s leading financial hubs in Kenya, Morocco, Nigeria and South Africa. They have introduced green bond governance frameworks, including independent certification and monitoring of proceeds, that align with international best practice. The stock exchanges in Kenya, Morocco, Nigeria and South Africa have established green bond segments, an important component of a country’s green bond market. Such segments give investors, issuers and third parties transparent governance and a specialized avenue for listing and investing, and they concentrate expertise in bond pricing, analysis and secondary market trading. These well-grounded initiatives should accelerate market deepening in social and green bonds.

Regulatory incentives could also be introduced to increase the attractiveness of green and social bonds. For example, the People’s Bank of China (PBoC) allowed green bonds as eligible collateral for central bank operations (BOX 5.2). Such measures could even provide preferential treatment of green bonds as collateral and include central banks holding green assets as part of macroprudential frameworks (several banks are considering this). Both measures would encourage the development of the investor base.

Finally, a stronger pipeline of projects is needed. This issue is not unique to sustainable bonds but applies to broader asset classes, particularly infrastructure. A full discussion of the difficulties of strengthening a pipeline is beyond the scope of this chapter (see Tyson, 2018). Even so, developing national infrastructure capacity should include green bond issuance, and green finance has provided an attractive and liquid source of finance for national infrastructure strategy.



## BOX 5.2 CHINA BEST PRACTICE SUPPORT FOR GREEN BOND MARKETS

The Chinese market's development is of interest to Africa because it has been particularly successful in developing domestic markets for local currency green and social bonds. Bonds have been issued on the China Interbank Bond Market and the Shanghai and Shenzhen stock exchanges. All domestic bonds have been issued in local currency. Sectors financed by green bonds include transport, water and energy.

Social bonds make up about 10 per cent of bonds issued. For example, in 2016, a social impact bond issued by the Shandong Yi Nan County targeted poverty alleviation, and in 2018 the Chinese Construction Bank issued a bond to raise funds for affordable housing, education and medical projects via the bank's small and medium enterprise and microfinance activities.

Policy measures led by the People's Bank of China (PBoC) have supported the development of this market. In the early stages, there

were concerns of "greenwashing"—using proceeds for "clean" coal projects that did not meet international standards. In 2015, the PBoC issued green bond guidelines, and financial regulators issued reporting requirements for listed bonds. These included monitoring progress in allocating the proceeds to green projects and quarterly and annual information disclosures on the use and impact of proceeds. Today 85 per cent of bonds by number and 92 per cent by value comply with these standards (CBI, 2018a).

PBoC policy also encouraged the market's development. In 2018 it announced that it would allow eligible collateral for its lending facilities to include green bonds and green loans. It has also enacted macroprudential regulations relating to green risks.

The China Securities Regulatory Commission (the regulator) presides over public bond issuances of listed companies. Both of the stock exchanges on which bonds are listed

have issued standards for disclosure and governance for listed green and social bonds, as well as broader environmental, social and government requirements for listed companies and other measures.

The market has broadened to use different types of financing structures beyond plain vanilla bonds. Since 2016, asset-backed securities (ABS) have been issued. In support the China Securities Regulatory Commission issued Q&A's to deepen knowledge about the products and allowed government subsidies to be used for the underlying assets in renewable energy, green buildings and electric vehicles. Subnational bodies have also issued ABS, including special-purpose vehicles for local government. Five provinces (Guangdong, Guizhou, Jiangxi, Xinjiang and Zhejiang) have begun pilot studies for the issuance of asset-backed securities.

Source: CBI, 2018a.

## DEEPENING NETWORKS WITH INTERNATIONAL CAPITAL MARKETS

Global financial hubs have been a critical factor in the growth of the sustainable bond market. Such hubs and their associated networks have provided established and sound regulatory and legal frameworks for primary issuances, specialist exchanges for public offerings and secondary trading and access to the investor base via private financial institutions that structure and market such products. For developing African sustainable bonds, African issuers must become integral to these hubs and networks.

Circulating greater information and increasing familiarity with African economies and assets can only help raise the profile of Africa as a potential investment destination. The sale of African Eurobonds has already led to extended analysis laying the groundwork for further investment. It has familiarized investors with sovereign risks in Africa, and the public listings provide transparent pricing benchmarks. Global financial centres are setting up support for green finance in Africa.

**“Global financial hubs . . . and their associated networks have provided established and sound regulatory and legal frameworks for primary issuances, specialist exchanges for public offerings and secondary trading and access to the investor base via private financial institutions that structure and market such products”**

For example, the London Stock Exchange has established an initiative to support green bonds in Africa.

Innovative thinking is needed about asset classes and financing structures for bonds going beyond conventional sectors such as infrastructure. Africa has the potential to

deliver a strong pipeline of assets with high social returns that green investors and sustainable and responsible investment (SRI) investors want, in sectors important for the region's policy goals, including achieving the SDGs. Recent bonds with new types of underlying assets illustrate such innovations (BOX 5.3).

### BOX 5.3 INNOVATION IN UNDERLYING ASSET CLASSES IN AFRICA

#### SEYCHELLES \$15 MILLION "BLUE BOND" (2018)

In 2018, Seychelles issued a sovereign "blue bond" for \$15 million to support marine conservation and fishery projects. The bond, financed by private institutional investors, was the first green bond earmarked for marine conservation. Although the amount raised was small, the bond illustrates the ability of policymakers to partner with development agencies and private institutional investors to deliver innovative green bonds. The World Bank provided technical assistance, and the projects will be co-managed

by the Development Bank of Seychelles and a leading conservation trust. The sovereign credit risk was also partially guaranteed by the IBRD, with concessional loans to cover interest payments. Private investors included the socially responsible investor Calvert Impact Management. Mainstream institutional investors—the Teachers Insurance and Annuity Association and Prudential Financial—also participated.

#### KENYA AND SOUTH AFRICA \$50 MILLION RHINO BOND (2019)

The proceeds of a \$50 million five-year impact bond will be used for a black rhino

conservation project in Kenya and South Africa. The proceeds are used for conservation with targets set for increases in the rhino population. If the targets are not met the investors take losses, and if they are met the investors are paid back their capital and a coupon. The bond was arranged by Conservation Capital and the Zoological Society of London. Investors included donors and some private wealth clients with philanthropic investment goals. The bond was not GBP (Green Bond Principles) certified.

Source: World Bank, Financial Times.

## INFRASTRUCTURE FINANCING

Africa's infrastructure needs are vast. According to the 2018 *African Economic Outlook* (AfDB, 2018), the continent's infrastructure needs amount to \$130–\$170 billion a year until 2025, with a yearly financing gap of \$67.6–\$107.5 billion. Global financing needs for renewable energy are estimated at more than \$22 trillion by 2050. Africa receives only 2% of the current annual global renewable energy investment of \$309 billion. Both governments and donors have invested

considerably in infrastructure. In most regions, governments have mainly funded infrastructure, but low government revenues in Africa have limited the success of this model, helping explain Africa's low investment in infrastructure. Overall, African governments are one of the largest sources of funding for infrastructure in Africa, with commitments accounting for 37 per cent of infrastructure investments in 2018. In most countries across the world, banks and bond markets

have traditionally been the intermediary between domestic private savers and private borrowers to help finance private investment in infrastructure. Recently, donors, particularly non-traditional ones, have significantly increased their infrastructure investment in Africa. For instance, according to data from the Infrastructure Consortium for Africa, China alone accounts for more than 25 per cent of all infrastructure funding in Africa (ICA, 2018). Some 80–90 per cent of the assistance China provides is in the transport and electricity sectors.

## PRIVATE INVESTMENT IN INFRASTRUCTURE

Private capital is increasingly mobilized to complement government revenues and official development assistance (ODA) for financing infrastructure development. Stand-alone private investment flows into infrastructure in developing countries started growing in 2008 and surpassed loans and credits from multilateral development banks and private co-financing since 2009. But private infrastructure financing was concentrated in countries with fairly good macroeconomic and investment environments (mostly middle-income countries), and in sectors that could provide strong returns or required capital-light infrastructure (such as energy and information and communications technology, or ICT).

In Africa as in many other developing countries, the infrastructure sector does not attract much private investment and funding. Private financing accounted for only 11 per cent of infrastructure funding in Africa in 2018, though private participation made it possible to fund large-scale investment and reportedly to make efficiency gains. The energy and ICT sectors represented more than 90 per cent of private sector investment. The concentration of private sector financing in those two sectors is partly due to the heavy protection provided by guarantees from the host government or from multilaterals (ICA, 2018). Those sectors can generate enough revenue through user fees to help service debt and provide a return on investment, explaining their attractiveness to private investors and private debt providers in Africa. Africa's ICT funding gap amount to \$4–7 billion per year. Investment commitment into the ICT sector was at \$7.1 billion in 2018, mostly from private sector financing.

Except in the transport sector, where governments had the largest share, the vast majority of infrastructure funding in Africa during 2014–2018 came from international lenders and

donors (FIGURE 5.3). In the energy sector governments spent weakly compared with their overall spending (20 per cent of investment during 2014–2018), while the private sector share of investment was larger than average (67 per cent, or \$98 billion). Overall, private sector participation in infrastructure projects between 2013 and 2018 was marginal, providing only 7.5 per cent of funds.

In Southern Africa, private investment is far more meaningful (FIGURE 5.4). Southern Africa receives 66.8 per cent of private infrastructure investment in Africa. The share of private investment in the region's total infrastructure financing is about 33 per cent, showing some of the countries (including South Africa) heavy reliance on non-private investment. For the other subregions, private sector investment represents a small proportion of total investment. In East and West Africa, it is around 9 per cent, and in Central Africa, around 6 per cent.

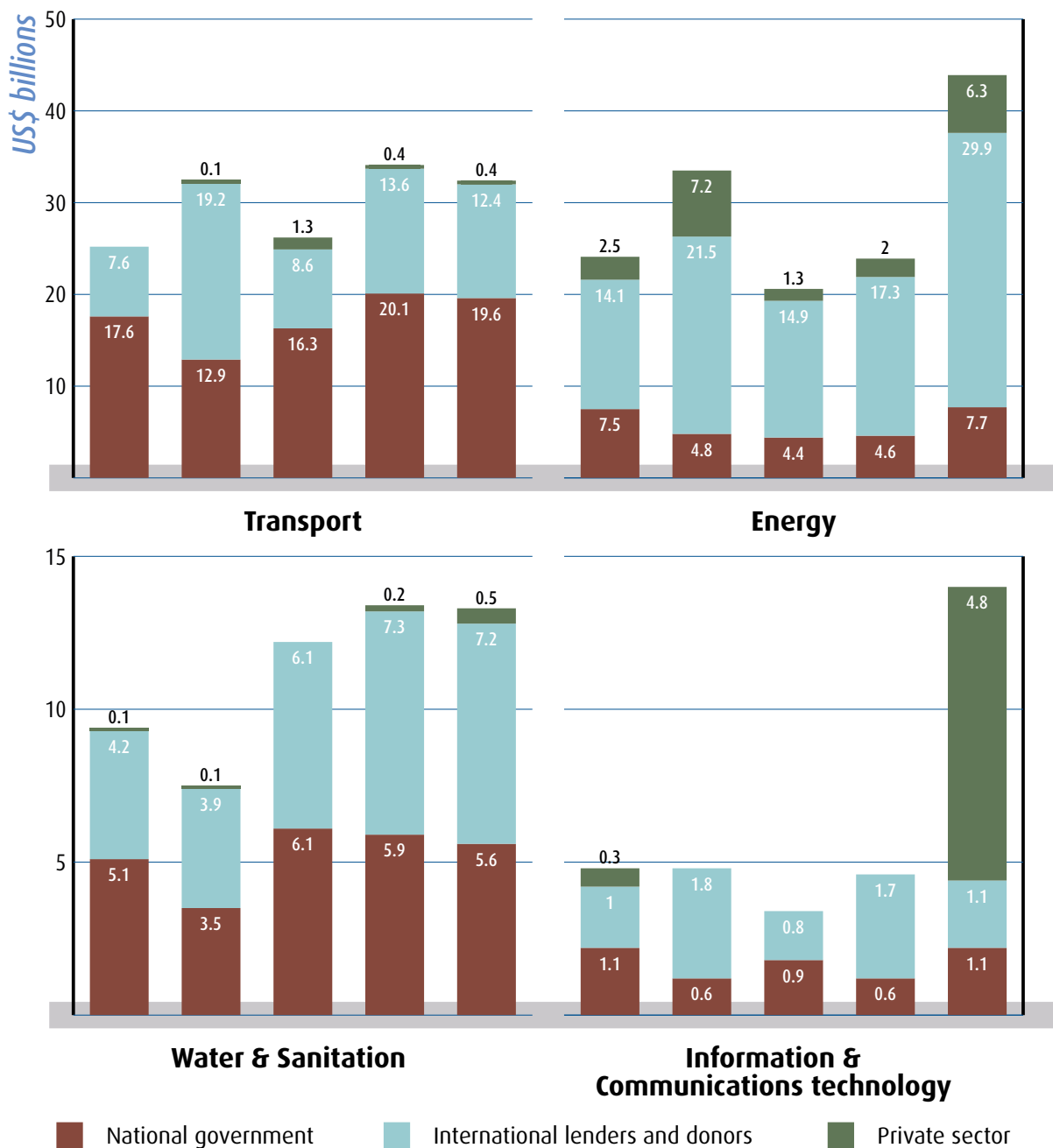
Private finance has concentrated in countries and sectors that offer “bankable” opportunities because it flows towards opportunities with commercially attractive returns and risks. That attractiveness is determined by both the project-level characteristics of the investment and the broader macroeconomic and investment environment. These fundamental aspects help explain the poor development of private financing for infrastructure in Africa, since an attractive investment must provide either steady flows of income or reasonable certainty of steady returns in the future. The private sector's ability and willingness to bear different categories of risk also determines an investment opportunity's attractiveness. The key is whether expected returns are commensurate with the expected risks.

## STRENGTHENING PUBLIC-PRIVATE PARTNERSHIPS

To help bridge their huge infrastructure financing gaps, some African governments have used public-private partnership (PPP) models. That is, they enter into an agreement with private sector partners to fund, deliver or operate an infrastructure project or asset, in exchange for a long-term financial benefit—recouped costs and further benefits from the asset for a set period. At the end of the period, the private partner returns the infrastructure asset to the government. In many developing countries, PPPs have financed the construction and operation of transport infrastructure (toll roads), railways, airports, healthcare centres and oil and gas exploration and production.

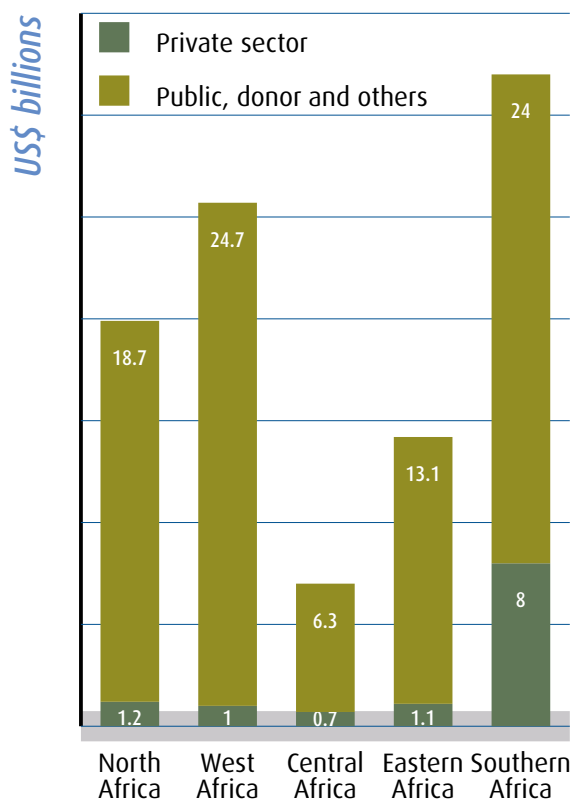


**FIGURE 5.3** INFRASTRUCTURE INVESTMENT BY INTERNATIONAL LENDERS AND DONORS, NATIONAL GOVERNMENTS AND THE PRIVATE SECTOR IN AFRICA



Source: Based on ICA database (2019).

**FIGURE 5.4 PRIVATE SECTOR FINANCING IN INFRASTRUCTURE, BY SUB-REGIONS, 2018**



**Source:** Based on data from ICA database (2018).

Only a few African countries have embarked on PPPs to tap private capital for financing infrastructure. Kenya, Nigeria, Uganda and South Africa account for almost 50 per cent. Energy represents 78 per cent of PPP infrastructure projects in Africa, transport 22 per cent and water and sanitation less than 1 per cent. In South Africa, PPP projects account for about 2.2 per cent of the public sector infrastructure budget. Since 1990, South Africa designed and brought to financial closure 110 PPP projects with a total committed investment of \$25.55 billion. They include the Gautrain light rail concession, with a total investment of \$3.48 billion, and the Mozambique–South

Africa gas pipeline, with a total investment of \$1.2 billion (PPP Knowledge Lab, 2020). In 2018/19, 33 PPP projects with a total value of R89.3 billion (about \$6.33 billion at the 30 December 2019 exchange rate) were completed, with more than 90 per cent realised within two to three years from the signing of the PPP agreement. The successful rollout and delivery of the South African PPP programme can be explained by bankable projects; good project preparation; the transparency, efficiency and effectiveness of procurement; conducive investment and regulatory environments; and adequate project and stakeholder management.

African countries could also learn from other emerging countries that have unlocked flows of private capital into PPPs, including India, China and Brazil. In India, PPP played a critical role in the development of infrastructure, including roads, railways, airports, seaports and urban transit. In restructuring railway infrastructure, 20 PPP projects with a total value of 140 million rupees (then about \$1.8 million) were undertaken to build and operate rail connectivity for ports, station redevelopment, rail-side logistics parks and warehousing, as well as satellite terminals (Dawra and Jagtap, 2016). The improvements contributed substantially to the boom of the Indian economy. At end of 2019, China had about 7,000 ongoing PPP projects with a total investment estimated at 9 trillion yuan (about \$1.3 trillion). About 90 per cent of that investment was allocated to transport, social affairs, urban infrastructure and ecological environmental protection projects.

In both India and China, the development of national PPP policy, the enforcement of PPP laws, the mechanisms coordinating different departments and the financial measures to support the growth of the PPP markets have been major contributors to capital projects and infrastructure upgrades. The policies and measures have created enabling environments for PPPs and expanded the pool of private developers and investors with experience and knowledge of the infrastructure market. African countries imitating these PPP models and putting the required policies and capabilities in place will gain the opportunity to attract increased capital from private investors and lenders and so bridge the infrastructure gap.

# DEVELOPMENT BANKS

Multilateral development banks and national development banks have traditionally been catalysts of private or semi-private infrastructure finance. In Africa, such lenders as the World Bank, the African Development Bank (AfDB) and regional development banks have been key (see the successful case of the Development Bank of Southern Africa in **BOX 5.4**). In Latin America national development banks have also been important, as recently highlighted by Griffith-Jones and Ocampo (2019).

African regional and national development banks are pivotal in supporting infrastructure finance, including by catalysing private finance. They should expand in countries where they are active (adding infrastructure finance to their business if they are not already participating in that sector) and should consider going into new countries. Their growth will require deepening local and regional capital markets in Africa (PricewaterhouseCoopers, 2019), as well as increasing international community support through multilateral and regional development banks, bilateral development finance institutions and international climate finance funds, such as the Green Climate Fund.

Countries viewed as having a stable macroeconomic environment with predictable infrastructure regulation have attracted the most private financing in Africa. Their risks are seen as lower, and the expected returns are correspondingly lower. Where misrule, project risk or macroeconomic instability is high enough to discourage private investors, multilateral development banks or development banks often step in. They may provide financial guarantees and help develop alternative regulatory frameworks or provide supplementary financing, which can create a halo effect that encourages private actors to invest. Concessionary resources that lower the cost of borrowing increase the attractiveness of infrastructure investment for private investors.

Infrastructure is generally expensive. Both capital costs and operation and maintenance costs are substantial. Capital costs vary by location, the number of users, the type of technology, and choices made during design. Operating costs vary

**“African regional and national development banks are pivotal in supporting infrastructure finance, including by catalysing private finance”**

according to usage and the technology chosen. For road, rail and air, operation and maintenance costs increase fairly little as traffic increases, but the cost per user decreases massively as the user base increases. Electricity generation can be nearly free (with renewable energy) or relatively expensive (with fossil fuels), depending on the technology chosen. But cell towers unconnected to the electrical grid or with unreliable electricity suffer high running costs since they require investment in electricity generation.

Considerable risks face infrastructure investment in Africa. Demand must be great enough to cover capital and operating costs, creating risk for those investing large amounts of money in hope of future demand. So, private investors willing to take the risk will demand a large risk premium for their investment, or else guarantees, for example, of traffic. Some infrastructure may never produce adequate return on investment. Appropriate support mechanisms are needed to attract private investment, which does not currently flow to Africa's infrastructure because of high risk and low expected return.

Project preparation is one such support mechanism critical for raising private capital. Since opportunities for profitability may not be easily visible to private investors, governments, development banks and donors may step in to conduct pre-feasibility and feasibility studies to assess the market opportunities. Some African development banks already play

an important role in project preparation. The New Partnership for African Development Infrastructure Project Preparation Facility—a consortium led by the AfDB in partnership with financial donors and major infrastructure consultancy firms—is a notable regional initiative. It has effectively identified and prioritized regional infrastructure projects needing more than \$6 billion in investment in the energy, transport, ICT and transboundary water sectors.

Government and donors have several tools available for financing to enable a project to start. They may provide direct loans to the private sector. They can co-finance with private lenders, which increases their leverage. Local actors such as national development banks or commercial banks can offer local currency loans, an important debt instrument that avoids currency mismatches. To ensure local currency loan availability, governments must support and help develop and deepen local capital markets, which can help development banks finance increased lending, or can directly fund bond issuance for projects.

**“Local actors such as national development banks or commercial banks can offer local currency loans, an important debt instrument that avoids currency mismatches”**

For financing during infrastructure operation, loan guarantees or revenue guarantees can ensure a low risk for private investors but impose on the guarantor—the government or the development bank—high risks and potential losses. Such guarantees can be useful in unlocking private investment when revenue risk is extremely high or the macroeconomic situation is weak, but they create contingent liabilities for the public guarantor. They can be a costly solution, given the higher cost of private financing together with the need for high returns.

Development banks can provide funds to the private sector through loans or equity. With a diversified portfolio integrating riskier and less risky projects, they can fund their operations through revenues and through funds levied on the market. Development banks coexist at the international, regional and national levels. At the international and regional levels, they may mainly focus on regional integration and trade, while at the national level, they focus more on nationally oriented infrastructure. Development banks have flexibility since they have more leeway to fund themselves through local sources.

Sovereign wealth funds can fund investment or capitalize national development banks. Accumulating revenues from the discovery and exploitation of natural resources, they can partly channel those resources to raise the capital of national development banks, increasing bank headroom for lending to infrastructure and other key sectors. The natural resource curse could thus become a resource blessing.

In South Africa, DBSA and Industrial Development Corporation of South Africa (IDC) mainly raise funds through commercial loans or bond issues in the domestic market. This is also the preferred method of funding for the Industrial Development Bank in South Africa, Worker’s Bank of Egypt and the Botswana Development Corporation. Funding for the Algeria Fonds National d’Investissement, the Development Bank of Ethiopia and Angola’s Banco de Poupança e Crédito are provided by government contributions. Further support to development banks is also provided by governments through capital increases. Other, less used approaches are domestic savings through customer deposits, soft loans from development actors and equity capital from actors other than governments.

Overall, smaller, less capitalized national development banks do not have the capability to invest in large and complex infrastructure projects, which would take up too much of their portfolio. Many African countries find it more practical to seek finance externally for infrastructure projects and direct their development banks to target less equity-intensive sectors of the economy (Bradlow and Humprey, 2016). African national development banks have considerable scope for expanding their scale, which would let them contribute more to financing infrastructure. Together with developing local capital markets, including by issuing bonds with long maturities, they could catalyse private investment and channel more private and public international finance to infrastructure.

International public finance, for example for green infrastructure, should be increasingly available. It could ideally be channelled through African national development banks, provided they have the scale and expertise to absorb it and

use it for their own loans—thus catalysing domestic private finance by blending private sector lending with public sector grants or by unlocking additional private market-rate lending.

#### **BOX 5.4 CASE STUDY: DEVELOPMENT BANK OF SOUTHERN AFRICA OPERATIONS IN SOUTH AFRICA**

The Development Bank of Southern Africa (DBSA) is among the most successful development banks in Africa. It was created in 1997 with a core mandate of financing infrastructure. It aimed to create regional and national prosperity and integrated resource efficiency by developing social and economic infrastructure and supporting regional integration and the sustainable use of economic resources. DBSA's primary mission is to promote infrastructure development in South Africa and the countries of the Southern African Development Community (SADC). About 54.4 per cent of DBSA's portfolio is in larger infrastructure, and the remainder mainly in loans to municipal authorities for local infrastructure. Given South Africa's priorities, the large majority (78.92 per cent) of assets held by DBSA are in electricity, with 9.78 per cent in transport, 1.12 per cent in ICT and 0.56 per cent in water and sanitation.

**Source:** ECA, DBSA, 2018 and OECD, 2019.

DBSA relies mainly on the bond market and targeted government funding as domestic funding sources. Bonds are issued in local currency in the domestic market (thus avoiding currency mismatches) and are most often purchased by domestic buyers. Such specificity may not be possible in most African countries, where savings are lower and capital markets less developed.

Having experienced risky infrastructure investments and their consequences, DBSA has shifted from being purely a financier to participating throughout the infrastructure value chain. It is active throughout the project cycle, offering advice and support in planning, preparing, financing, building and maintaining projects, thus ensuring better and more sustainable outcomes to its activities. Its shift towards project support reduces risks for private and other investors

and opens DBSA towards partnerships with private sector and financial institutions.

A new financial strategic objective for DBSA consists in leveraging other sources of funding, including private sector and other financing bodies. DBSA aims to become a catalyst for infrastructure finance by crowding in third parties. For example, to spur green infrastructure, the DBSA created the DBSA Climate Finance Facility (CFF). The first of its kind on the African continent, the CFF will fund sustainable infrastructure in SADC countries—initially those connected to the Southern Africa Power pool. It aims to co-finance green finance investment with local banks by leveraging equity from outside funds (the Green Finance Fund, or GFF, and other climate funds) as well its own financial capabilities.

# INSTITUTIONAL INVESTORS

In many countries around the world, various financial services are provided by non-bank specialist institutions, such as pension funds, sovereign wealth funds, insurance companies, microfinance institutions, export credit agencies, and so on. The emergence and growth of an array of institutional investors to meet the financing needs of firms and households is a mainstay of economic development and private sector growth. In Africa, “non-bank financial institutions” refers to financial institutions not regulated by the central bank. The most active in Africa are insurance firms, housing finance companies, microfinance institutions and savings and loan associations.

Globally, 22 major pension markets had \$46.7 trillion in pension assets and accounted for 69 per cent of the GDP of those economies at the end of 2019 (Thinking Ahead Institute, 2020). Of that, 92 per cent is owned by seven markets: Australia, Canada, Japan, the Netherlands, Switzerland, the United Kingdom and the United States. The money from pension funds is commonly invested in listed and private companies around the world to generate high returns for their contributors. But the pension fund industry may suffer a crisis, even globally. First, shifting demographics are lowering the ratio of workers to retirees, increasing the pressure on pension funds. And second, long-term interest rates have been falling since the global financial crisis, significantly reducing the profitability of pension funds and raising concerns about their liquidity. The negative interest rate policy in some countries is expected to further lower rates on bonds, financial instruments institutional investors commonly use.

African pension funds have been expanding in recent years, though from a low base, thanks to the rise of the middle class and regulatory reforms that bring more people into the social security net (ECA, 2019). Pension funds in the six largest African markets could grow to an estimated \$7.3 trillion by 2050 (from \$800 billion in 2014). At that growth rate, if they invested about 20 per cent of their annual assets in infrastructure, they would add \$77 billion to help finance the continent’s infrastructure deficit (ECA, 2018). But pension investments in Africa have been focused mainly on government securities,

real estate and bank deposits, with smaller proportions in equities and corporate bonds. Pension schemes differ across African countries. While the South African pension system is a mix of public and private financing, in other countries such as Morocco, the pension system is dominated by the public sector (BOX 5.5).

Pension and sovereign wealth funds in Africa could play a catalytic role in mobilizing capital for infrastructure by dedicating a share of their assets specifically to infrastructure as anchor and direct investors (AUDA-NEPAD-CBN 5% Agenda Report; Sy, 2017). That practice is common in other countries around the world. But in Africa many constraints prevent the transformation of pension and sovereign funds’ assets into infrastructure investments. In many African countries, institutional investors are kept from investing in infrastructure as an investable asset class, partly because their investment policy statements, investment mandates and adjusted risk return criteria are not aligned with that asset class. Their lack of expertise in structuring appropriate investment vehicles and instruments, the dearth of investable projects and the absence of a vibrant secondary market for infrastructure assets to facilitate exit compounds the problem in many cases.

To help Africa reduce its infrastructure financing gap, the 5% Agenda, an African Union Development Agency–New Partnership for Africa’s Development initiative, was developed

**“African pension funds have been expanding in recent years, though from a low base, thanks to the rise of the middle class and regulatory reforms that bring more people into the social security net (ECA, 2019)”**

under the guidance and recommendation of the Programme for Infrastructure Development in Africa (PIDA) Continental Business Network and the African Sovereign Wealth and Pension Fund Leaders Forum. The 5% Agenda is a pact in which African governments commit to collaborate on designing projects and aligning infrastructure investment policy regimes with African asset owners' investment mandates. It includes pursuing a new Institutional Investor Public Partnership (IIPP) model like those successfully used by pension funds and the governments of Australia and Canada. In return, African institutional investors agreed to increase their allocations to African infrastructure investment to 5 per cent of assets under management and to support the African Institutional Infrastructure Co-Investment Platform initiative, in which African sovereign investors and international pension and sovereign fund peers collaboratively co-invest in each other's markets across the continent.

The 5% Agenda's IIPP model, which was endorsed by African Union Heads of State, offers:

- World class, essential and well-maintained infrastructure assets for governments with limited funds and competing expenditure requirements.
- Reliable infrastructure delivery, budgetary discipline and long-term real investment returns for consumers and civil society.
- Institutional infrastructure investment over the full life-cycle of the asset or assets, not merely for an investment, economic or political cycle. So, the prospects for the assets to catalyse and increase economic and private sector development, job creation and regional and domestic trade and investment competitiveness are much improved.

The 5 per cent share of African institutional investment will also have the following key impacts on Africa's infrastructure development and financing:

- African institutional savings capital is unlocked to implement regional, domestic and trade-related infrastructure projects on the continent and industrial infrastructure projects that benefit the African Continental Free Trade Area (AfCFTA).
- PIDA and the African Union Presidential Infrastructure Champions Initiative (PICCI) projects are brought to financial close for improved energy, transport, digital and trade-related infrastructure.
- African primary and secondary capital markets, which are currently shallow, are broadened and deepened.
- Regional integration and job creation are boosted.
- Partnerships are formed with international institutional investors and financiers, which have been hesitant to allocate financing to African infrastructure in the absence of African anchor institutional co-investment partners.



## BOX 5.5 PENSION FUND SYSTEMS IN SOUTH AFRICA AND MOROCCO

### SOUTH AFRICA

The South African pension system is composed of a defined-contributory, means-tested public benefit programme, various pension and provident fund arrangements and voluntary savings. It includes private pension funds, provident funds, retirement annuity funds, umbrella funds, preservation funds, unclaimed benefit funds and beneficiary funds.

The public benefit insurance scheme consists of social assistance for persons resident in South Africa, over age 60, whose income and wealth are below a threshold. This scheme is financed by taxes and provides up to R1,410 per person per month.

In addition, a defined benefit pension fund has been established for public servants. The contribution of the employees is 7.5 per cent, while that of the employer (government or provincial government) varies from 13 per cent to 16 per cent of pensionable salary. At retirement, the employee with fewer than 10 years contributing to the fund receives a lump sum payment. After 10 years of contributing, the pensioner receives a lump sum payment plus a pension.

In the private sector there are many employer-sponsored pension funds with or without compulsory membership. The majority consist of funded defined contribution plans that

pay a lump sum or a pension upon retirement. Pension funds and their investments are regulated by law and enjoy a favourable tax on contributions paid into the fund and benefits paid. The legal retirement age is 60 years.

### MOROCCO

The legal retirement age in the public sector in Morocco is 63 years. The Moroccan pension system is based on a compulsory basic scheme managed by the Moroccan Pension Fund, the National Social Security Fund and the Group Retirement Allowance Plan. The Moroccan Pension Fund manages, on a pay-as-you-go basis, the retirement of civil and military officials, as well as officials of local governments and public institutions. Contributions to the fund, divided equally between the employee and the employer, amount to 14 per cent of the reference salary. In return, the pensioner receives a pension equal to 2.5 per cent of the earnings that constituted the contribution base times the number of annuities, with a limit of 40.

The National Social Security Fund (CNSS) is responsible for the pay-as-you-go management of the basic pension for employees in the private sector. Old-age insurance contributions amount to 11.89 per cent of salary up to 6,000 dirhams. The pension is granted to a worker who has ceased all activity and has accumulated at least 3,240

days of contributions to the fund. The basic amount is equal to 50 per cent of the reference salary, capped at 6,000 dirhams. The rate increases by 1 per cent per block of 240 days of contribution beyond the 3,240 basic days up to 70 per cent of the reference salary, for a maximum monthly pension of 4,200 dirhams in addition to the basic amount. Given the weakness of the basic pension service provided by the CNSS, the Moroccan Inter-Professional Retirement Fund, a mutual company for retirement savings, offers companies an additional optional pension scheme to support retirement by granting beneficiaries a fair pension.

The third institution is the Group Retirement Allowance Plan. It covers the staff of organizations subject to the financial control of the state, as well as non-permanent agents and contractors of the state and local communities. Contributions amount to 18 per cent of the reference salary, with a ceiling of four times the average salary of the scheme—16,600 dirhams a month in 2016. The contributions are borne two-third by the employer, one-third by the employee. The old-age pension is paid to participants who have accumulated at least three years of contributions to the plan. It represents 2 per cent of the revalued average career salary times the number of years of contribution to the plan.

**Source:** ECA's compilation.



# CONCLUSION

This chapter has addressed ways the private sector could tap innovative financing mechanisms and mobilize private capital for sustainable and long-term financing in Africa. It took stock of the state of the sustainable bonds market, addressed infrastructure investment needs and highlighted new roles of long-term capital from development banks. It reviewed the green, social and sustainability bond markets, finding that, although the global market has seen exceptional growth since 2007, Africa's participation has been muted. Although international investor appetite is generally strong, it is conservative in the face of political, macro and environmental risks in Africa.

The sustainability bond market offers a source of incremental capital that could alleviate financing constraints and put to other uses the scarce finance that is available, including that from public resources. Strengthening relationships with partners such as IFIs and global financial hubs can mitigate risks for private investors and so crowd finance into the region. Recent innovative funds and risk mitigation strategies are important in this regard but need increased asset allocations by the funds and other financing vehicles for Africa.

The chapter has shown the considerable gap in business infrastructure and the great importance of obtaining long-term private finance to cover that gap for future inclusive and sustainable growth on the continent. Currently, private finance and private investment flows go only to certain infrastructure subsectors, such as energy, and to certain categories of countries, especially the richer ones, such as countries in Southern Africa, and those with deeper capital markets, such as those in North Africa.

African development banks, in combination with other actors, can increasingly work to finance infrastructure by leveraging private resources. There are two pre-conditions: the development bank must have large enough scale and be able to fund

investment in infrastructure, and financial markets must be fairly well developed and deep. Institutional investors (pension funds and insurance companies) must be large and regulated so a proportion of their assets can be invested in infrastructure. Large development banks can then help catalyse significant amounts of private finance for both private, public and public-private investors to co-finance infrastructure. Such financing can be provided in local currency, avoiding the problem of currency exchange risks and other fiscal imbalances.

So, an absolute requirement for increasing private finance and investment in African countries' infrastructure—using mainly domestic resources—is to deepen capital markets and increase the scale of development banks. Smaller economies, of which there are many in Africa, could create or deepen and enlarge regional institutions—development banks, institutional investors and capital markets.

Clearly other actors need to be involved. National governments have an important role, not just in providing resources to capitalize development banks, but also in providing guarantees for development bank loans, which increases their credit rating. National governments also contribute through appropriate regulatory frameworks for infrastructure and for actors such as institutional investors. Foreign donors and multilateral development banks, including the AfDB, need to provide more financial resources and guarantees to encourage private investment in infrastructure. Donors, development finance institutions and specialized international funds such as the Green Climate Finance Fund can provide valuable grants, concessional resources or guarantees that can allow blending of resources. Such funding and guarantees can attract private finance to infrastructure projects that might not otherwise have been sufficiently attractive, especially in certain subsectors and countries.

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## ENDNOTES

- 1 Green taxonomies typically include renewable energy, energy efficiency, adaptation to climate change, waste management, pollution prevention, water management, biodiversity and ecosystem protection, sustainable transport, sustainable agriculture, and green buildings (CBI, 2018b).
- 2 Such as foreign exchange (FX) futures and options.

CHAPTER 6

# LEVERAGING GLOBAL INNOVATIONS IN FINANCIAL TECHNOLOGY IN AFRICA



**F**inancial technology (fintech) refers to a broad range of technological innovations that enhance or change the way financial services are provided. The innovations typically include crowdfunding, insurance, budgeting software, blockchain (and cryptocurrencies), electronic payments and transfers, and robo-advisors and trading applications. Fintech development has been fuelled by breakthroughs in mobile networks, big data, trust management, mobile embedded systems, cloud computing and data analytic techniques, which have changed service delivery for both personal and commercial finance (Gai et al., 2018).

Fintech seeks to improve speed, security and operating costs to democratize financial markets and reduce information asymmetries in financial markets. Technology such as credit scoring systems can help address these asymmetries.

Fintech has had remarkable influence since the 2008 financial crisis. Before 2008, fintech development was driven largely by traditional financial institutions to support their own operations and promote efficiency. But since then most fintech developments have taken place outside traditional financial institutions, providing alternative sources of finance

and investment to businesses and the public. Fintech operations are now ubiquitous in both developed and developing countries. For instance, large multinational companies have expanded their activities to include a wider range of financial services, such as credit facilities and payment systems.

In Africa, fintech is reducing costs, reducing risk and extending service to unbanked populations. Examples of fintech include paperless banking and insurance services, use of disruptors such as non-bank institutions and mobile network operators, and the introduction of financial exchange platforms (blockchain) and models such as branchless distribution, mobile banking, big data credit scoring and machine-to-machine lending. Africinvest expects the global fintech revolution to triple access to financial services in Africa, creating a new market of 350 million customers. Telecommunication companies also provide mobile money services in several African countries, including Ghana, Kenya, Rwanda, South Africa and United Republic of Tanzania (Africinvest, 2016).

Current and forecast fintech transactions suggest that the global fintech market will double its 2017 transaction values by 2023 (Statista, 2019). For instance, the value of global

transactions in the digital payments market—the largest fintech segment—is projected to grow at an annual rate of 17 per cent, for a projected total of \$8.3 trillion by 2024 (Statista, 2020). In Africa digital payments are the biggest component of fintech transactions, with mobile money transactions accounting for close to 10 per cent of GDP, compared with 7 per cent in Asia and less than 2 per cent in other regions (Sy, 2019). Africa accounts for more than 60 per cent of mobile money transactions in the world—more than \$450 billion in 2019 (Kazeem, 2020).

Although alternative financing is the smallest segment of fintech transactions, its compound annual growth is projected at 11.6 per cent and is expected to total \$9.4 trillion by 2024 (Statista, 2020). Crowdfunding accounts for more than 50 per cent of transactions in the alternative financing market.

With the spread of COVID-19 and its impact on economies, the use of fintech, including mobile money, is expected to increase even more. For instance, one study estimated that the spread of COVID-19 and related government lockdowns have led to a 24–32 per cent increase in the relative rate of daily downloads of mobile finance applications in 74 sampled countries around the world (Fu and Misrah, 2020).

## CROWDFUNDING, CROWDINVESTING AND CROWDLENDING IN AFRICA

Africa's financing gap has provided a unique opportunity for fintech development to furnish alternative finance sources and investment mechanisms, particularly for start-ups and micro, small and medium enterprises. Two key fintech activities, crowdfunding and crowdinvesting, grew over 2017–2019 and are projected to keep growing during 2020–2023 (TABLE 6.1). The amount of capital raised in Africa using crowdfunding platforms grew at an average annual rate of 38 per cent from 2013 to 2015 and 118 per cent from 2015 to 2016, is estimated to have doubled from 2017 to 2020 and is projected to grow 13.6 per cent a year from 2020 to 2023 (see TABLE 6.1). Crowd-based microfinance and donation-based crowdfunding contributed to the growth of the crowdfunding market in Africa.

So, growth projections and forecasts for alternative financing and other crowdsourcing instruments in Africa are very promising. But the market faces a major challenge: controlling fraudulent activities. Crowd-based financing for business activities benefits markets only if borrowers and investors trust one another. Establishing binding rules and guidelines is essential to securing that trust. Even so, financial regulation is complex and slows the dynamics of an evolving market.

Crowdfunding is currently more prominent than crowdinvesting in Africa, though Statista (2020a) forecasts that crowdinvesting will surpass crowdfunding in 2022. Crowdfunding raises funds by asking a large number of people to fund a project through an online platform. Crowdfunding has various models (TABLE 6.2). Donation-based and reward-based crowdfunding are non-investment-based funding because no financial return is expected. Other models that provide financial returns to investors or lenders proportional to their contributions are included in investment-based crowdfunding.

Of the 57 crowdfunding platforms operating in Africa, 21 are based in South Africa and 9 in Nigeria (Moed, 2018). Total online alternative finance volume in Africa rose to \$209 million in 2018, with domestic sources accounting for 24 per cent of all alternative finance generated in Africa (Cambridge Centre for Alternative Finance, 2020). Also, 45 per cent of all business funding came from equity-based models, and 52 per cent from debt-based models. West Africa was the leading market, with a market share of 41 per cent in 2016, followed by Southern Africa with 28 per cent and East Africa with 24 per cent. North Africa captured 5 per cent,

**TABLE 6.1** ALTERNATIVE FINANCING IN AFRICA, 2017–2023

	2017	2018	2019	2020	2021	2022	2023
<b>TRANSACTION VALUE (US\$ MILLIONS)</b>							
Crowdfunding	11.6	13.6	16.5	20	23	25.7	27.4
Crowdfunding	4.2	6.3	9.4	13.5	18.7	27.1	36.3
<b>Total</b>	<b>15.9</b>	<b>19.9</b>	<b>26</b>	<b>33.5</b>	<b>41.9</b>	<b>52.8</b>	<b>63.7</b>
<b>TRANSACTION VALUE GROWTH (PER CENT)</b>							
Crowdfunding		16.7	21.7	21	15.6	11	6.8
Crowdfunding		49.1	49.6	42.6	39.1	45	33.8
<b>Total</b>		<b>25.4</b>	<b>30.5</b>	<b>28.9</b>	<b>25.1</b>	<b>26.2</b>	<b>20.7</b>
<b>NUMBER OF CAMPAIGNS (THOUSAND)</b>							
Crowdfunding	24.9	27.1	32.9	38.7	41.2	42.3	42.8
Crowdfunding	0.1	0.1	0.2	0.2	0.3	0.3	0.4
<b>Total</b>	<b>25</b>	<b>27.2</b>	<b>33.1</b>	<b>38.9</b>	<b>41.5</b>	<b>42.6</b>	<b>43.2</b>
<b>FUNDING PER CAMPAIGN (US\$)</b>							
Crowdfunding	467	502	502	517	561	607	641
Crowdfunding	41,585	48,106	54,106	59,089	66,394	82,780	100,627

**Source:** Based on data from Statista, 2019.

and Central Africa 2 per cent. By comparison, Middle East-based businesses raised \$117 million in 2016, twice the capital raised by Africa-based businesses.

In Africa, fintech is also used as an alternative source of lending to traditional institutions. The alternative lending market refers to digital financial services for business customers and private borrowers. The market includes bank-independent loan allocation for SMEs (crowdlending) and for personal loans (marketplace lending, also known as peer-to-peer lending) through private or institutional investors using online platforms, such as OnDeck, LendingClub and Prosper. The market focuses on SMEs, freelancers and private borrowers.

In Africa, crowdlending for businesses rose from \$278 million in 2017 to \$417 million in 2019 (Statista, 2020a). Crowdlending platforms are beginning to use buyer ratings on e-commerce platforms such as eBay and Amazon as alternative

sources of credit information, along with shipping information harvested from DHL and data on utility consumption to verify whether a business seeking funding is as portrayed by the applicant. Crowdlending platforms are also examining data on businesses' social media activities from sources such as Klout Score to gauge the potential success of a fundraising activity. The underlying idea is that if a business has heavy online presence and a wide network, the fund raising drive will succeed. Klout Score provides information on a business's online presence, number of social networking connections and the geographic proximity of these connections. As technology improves and data management costs decline, innovative sources of credit information on SMEs are expected to emerge to aid in credit underwriting. Access to such information sources will enable the use of real-time data in making credit decisions rather than historical data, which is sometimes out of date and thus unreliable.

Uptake of crowdfunding has been slower in Africa than in



**TABLE 6.2** MODELS OF CROWDFUNDING

MODEL	DEFINITION
<b>Equity-based crowdfunding</b>	Individuals or institutional funders purchase equity issued by a company
<b>Donation-based crowdfunding</b>	Donors provide funding to individuals, projects or companies based on philanthropic or civic motivations with no expectation of monetary or material return
<b>Crowd-led microfinance</b>	Crowdlenders provide micro-loans to unbanked/low-income borrowers through an online microfinance platform, for zero or low-interest returns
<b>Peer-to-peer consumer lending</b>	Individuals or institutional funders provide loans to consumer borrowers
<b>Real estate crowdfunding</b>	Individuals or institutional funders provide equity or subordinated-debt financing for real estate
<b>Peer-to-peer business lending</b>	Individuals or institutional funders provide loans to business borrowers
<b>Profit sharing</b>	Individuals or institutions purchase securities from a company, such as shares or bonds, and share in the profits or royalties of the business
<b>Reward-based crowdfunding</b>	Backers provide finance to individuals, projects or companies in exchange for non-monetary rewards or products
<b>Balance sheet business lending</b>	The platform entity provides loans directly to a business borrower
<b>Invoice trading</b>	Individuals or institutional funders purchase invoices or receivable notes from a business at a discount
<b>Hybrid</b>	A combination of two or more of the above models

**Source:** Cambridge Center for Alternative Finance, 2018.

other regions: Africa accounts for less than 1 per cent of global crowdfunding activities. Reasons include low internet penetration rates, high internet service cost and weak regulations and standards (Berndt and Mbassana, 2016). Globally, some of the largest crowdfunding platforms are based in the United States (\$6.6 trillion in transactions in 2019) and China (\$1.5 trillion; Statista, 2020b). Crowdfunding in the United States is focused on the two largest platforms, Kickstarter and Indiegogo, which operate independently, while China’s platforms are generally linked to its e-commerce giants (Alibaba’s Taobao, JD and Xioami). Kickstarter is one of the most successful platforms, with more than 189,000 completed projects as of October 2020. Notable national Africa-based crowdfunding platforms include Yomken (Egypt); M-Changa (Kenya); Farmable.me (Ghana); Give (Nigeria) and Akobobo, FundFind and Thundafund (Uganda). Pan-African crowdfunding platforms include HOMESTRINGS, Lelapa and VC4Africa.

Entrepreneurial social capital such as social networks has a significant impact on crowdfunding performance in the United

States and China (Zheng et al., 2014). Furthermore, crowdfunding projects have generally been more successful when they provide an innovative product or service or an alternative solution to an everyday problem. Among some of the most successful crowdfunded projects are games, technology products and services and design projects. These projects are also generally well-marketed, and in many instances their success spreads through word of mouth or shares on social media.

The new role of information technology, changes in consumer behaviour, evolving financial eco-systems and new regulatory regimes are some of the drivers of alternative financing and lending. In Africa, the large and growing youth population, which is faster to adopt fintech technologies than older populations, and rapid smart phone penetration have been contributing factors. However, the growth of the market is inhibited by fraud and lack of trust, weak law enforcement and regulatory shortcomings.



# BLOCKCHAIN AND CRYPTOCURRENCY

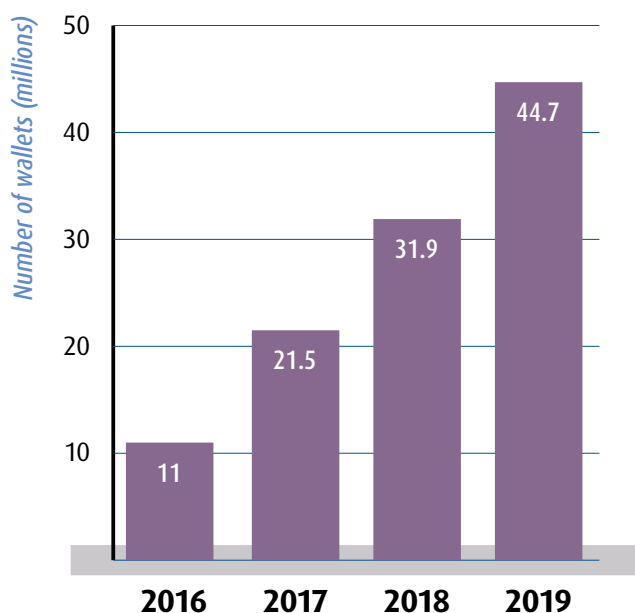
Among the most prominent fintech innovations is blockchain, which has paved the way for cryptocurrencies. Even traditional financial institutions are considering the use of blockchain technology in their operations. One of the biggest hurdles in financial transactions is safeguarding transactions involving fund transfers, which range from credit card purchases to overseas remittances. Blockchain is essentially a public ledger that continually adds transactions that are verified by the network participants in the ledger. The public nature of blockchain means that it is decentralized and thus that data do not reside in a single stored location that is vulnerable to hacking.

A survey by Accenture found that 90 per cent of bank executives are interested in blockchain and its applications in banking (Accenture Mobility, 2016). Many traditional financial

institutions are contemplating the use of blockchain technology to bolster their processes and increase efficiency, particularly in fund transfers, ranging from credit card purchases to overseas transfers. But since blockchain's inception, banks have struggled to take full advantage of it, since its benefits are maximized only when there are enough users to create a network effect.

Even so, blockchain is widely used in cryptocurrency applications, and the number of users has been rising (FIGURE 6.1). The top 100 cryptocurrencies together have more than \$169 billion in market capitalization, led by Bitcoin (\$112 billion) and Ethereum (\$14 billion). As of 2019, there were an estimated 44 million blockchain wallet users globally, though estimates vary greatly because some users have more than one blockchain wallet.

**FIGURE 6.1** BLOCKCHAIN WALLET USERS HAVE BEEN RISING GLOBALLY, 2016–2019



Source: Statista (2020c).

# ELECTRONIC PAYMENTS AND E-COMMERCE

Electronic payments and transfers are financial transactions that take place on digital platforms, including mobile money, and are an important part of the digital economy. Growth in electronic payment systems and platforms has been a major driver of fintech innovation. Electronic payment systems offer fast, convenient, cost-effective and reliable means of making payments and have become the preferred method across the globe. The growth in electronic and digital payments has been driven by the growth of mobile payments (mobile wallets, mobile-based merchant solutions); integrated billing (mobile ordering and payment apps, integrated mobile shopping apps); streamlined payments (geotagging, machine-to-machine payments) and next-generation security (biometrics, tokenization standards). These electronic payment systems capture and store transaction data, which can be used to build the profiles of SMEs, enabling new lending platforms to assess the creditworthiness of SMEs.

Among fintech innovations, mobile money and digital payments are areas where Africa has made significant inroads. Almost half of total global mobile money accounts are in Africa, which had 396 million registered users and 1.4 million agents serving them in 2018. In countries including Kenya and Zimbabwe more than 60 per cent of adults have mobile money accounts, highlighting the importance of mobile money as a financial service that is often a substitute for formal banking (GSM Association, 2020).

As a major component of the digital economy, electronic payment and transfer systems comprise both the firms that host and operate digital platforms for mobile applications and payment services and the produced goods and services embedded in such platforms, which rely on core digital technologies and infrastructures. Electronic payments and transfers provide critical financial services that form an integral part of e-commerce—the sale or purchase of goods or services over computer networks designed for receiving or placing orders.

In 2017, Africa had 21 million online shoppers.

Business-to-consumer e-commerce was worth \$5.7 billion, or 0.5 per cent of GDP, much lower than the global average of 4 per cent (UNCTAD, 2018). Despite this low base, both the number of online shoppers and the value of e-commerce are growing fast. Statista estimates that in 2020 African consumers will spend \$27.6 billion online on major product segments including fashion, electronics, furniture and appliances, toys, and food and personal care. It forecasts that business-to-consumer e-commerce revenue will rise at a compound annual growth rate of 14.2 per cent between 2020 and 2024, reaching \$47 billion by 2024 (Statista, 2020d).

As a result, Africa is now a centre of innovation and experimentation in e-commerce. A 2017 analysis by Disrupt Africa identified 264 e-commerce start-ups active in 23 African markets (Disrupt Africa, 2018). These start-ups enable trade in goods (MallforAfrica, an online marketplace) and services (Vezeeta, a digital healthcare booking platform) and operate either in their home markets alone (Konga in Nigeria) or in multiple markets (Jumia, headquartered in Lagos but operating in 11 African countries). They serve mainly business-to-consumer or business-to-business markets (TABLE 6.3). E-commerce start-ups are not spread evenly across the continent: the vast majority of entrepreneurship teams are based in West Africa (48.1 per cent), Southern Africa (27.3 per cent) and East Africa (18.2 per cent); (Artashyan, 2019). This pattern reflects the preference of businesses to operate close to consumers: more than half of online shoppers in Africa are in just three countries (Kenya, Nigeria and South Africa). Nigeria is the largest e-commerce market in terms of both revenue and number of shoppers (UNCTAD, 2018).

An important subset of cross-border electronic commerce is the digital services trade, sometimes referred to as mode 5. Digital payment platforms have the strongest bearing for digital services trade, since payment transactions are conducted on digital platforms themselves. For example, various services can be sourced via digital platforms (websites, apps, mobile text messaging) and delivered digitally or physically (ECA, 2019).

**TABLE 6.3 E-COMMERCE BUSINESS MODELS IN AFRICA**

MARKET	GOODS		SERVICES	
	BUSINESS TO CONSUMER	BUSINESS TO BUSINESS	BUSINESS TO CONSUMER	BUSINESS TO BUSINESS
<b>Local</b>	Konga (Nigeria), Takealot (South Africa), Kilimall (Kenya), Jiji (Nigeria)	Twiga Foods (Kenya)	SWVL (Egypt), SweepSouth (South Africa), Gokada (Nigeria), Zezeeta (Egypt)	MaxAB (Egypt), Sendy (Kenya)
<b>Regional</b>	Jumia, MallforAfrica	WasytoCap	GetSmarter, Mubawab	Kobo360

Source: ECA (2020, forthcoming).

The digital payment system in Africa is growing fast, along with e-commerce. Major e-commerce platforms offer multiple payment methods on their websites and apps (TABLE 6.4).

Despite the advance of mobile money, fewer than half of people over age 15 own an account at a financial institution or mobile money operator (Findex Index). Cash on delivery remains the only option for many online shoppers. However, bank and electronic fund transfers through payment gateways, credit and debit cards and mobile/digital wallets are also increasingly used and accepted. Additionally, PayPal is available

on MallforAfrica, a platform that lets African consumers purchase directly from international online retailers in the United States and Europe. In Nigeria, 25 per cent of e-commerce payments are through bank transfers, 24 per cent cash on delivery, 16 per cent credit and debit cards, 10 per cent mobile wallets and the rest other payment methods (African Payment Solutions, 2018). So, while most e-commerce firms operating in Africa are local, a substantial portion of payments processed on these platforms happen on foreign-owned card and payment schemes. This removes the opportunity for African countries to widen their tax base by taxing these

**TABLE 6.4 PAYMENT METHODS AVAILABLE ON E-COMMERCE PLATFORMS**

PLATFORM	PAYMENT METHODS AVAILABLE
<b>Jumia</b>	<ul style="list-style-type: none"> <li>▪ Cash on delivery</li> <li>▪ Credit and debit cards (Visa, Mastercard, Verve)</li> <li>▪ Mobile money and wallets (JumiaPay, mCash)</li> </ul>
<b>Takealot</b>	<ul style="list-style-type: none"> <li>▪ Cash on delivery</li> <li>▪ Credit and debit cards (Visa, Mastercard, American Express, Diners Club)</li> <li>▪ Payment gateways (PayFast, Ozow)</li> <li>▪ Loyalty programs (eBucks, Discovery Miles)</li> <li>▪ Non-credit card credit products (Mobicred)</li> </ul>
<b>Kilimall</b>	<ul style="list-style-type: none"> <li>▪ Credit and debit cards (Visa, Mastercard)</li> <li>▪ Mobile money and wallets (M-Pesa, LipaPay, Airtel Money)</li> </ul>
<b>MallforAfrica</b>	<ul style="list-style-type: none"> <li>▪ Bank transfers</li> <li>▪ Credit and debit cards (Webcard, Visa, Mastercard, Verve)</li> <li>▪ Mobile money and wallets (M-Pesa, Orange Money, Paga)</li> <li>▪ PayPal</li> </ul>

Source: Jumia, Takealot, Kilimall, and MallforAfrica websites.

types of transactions, and it widens the digital divide since only a few people are able to use such platforms for payments.

Other private platforms trying to fill the void have included mobile payments applications and tools. Possibly the most important and far-reaching of the fintech revolutions is the migration of banking functions and transactions into the mobile space, anchored by a financial institution's platform or through a telecommunications user account (more common in some African countries). Today, customers in many countries need not head to a physical bank branch to access traditional banking services. In addition to allowing people to access financial services more easily, the migration to mobile and online banking has expanded financial services to people who have long been unserved by financial institutions, whether because they live in an underserved area or because they lack the documentation to open a bank account.

Mobile banking has evolved beyond providing simple transaction services via a mobile or online platform. The rise of e-wallet apps like Venmo and Paypal allows people to send each other money immediately and without a fee, prompting traditional banks in many parts of the world to offer the same service. Traditional banks in Asia, Europe and the Americas are migrating services away from bank branches and now offer remittance services on their mobile banking platforms.

The Development Bank of Singapore is a pioneer in the mobile banking space, encouraging new customers to sign up online and use services via its mobile application without ever having to enter a bank branch office.

As the use of e-wallets has expanded, payment systems have emerged to compete with traditional payment companies. E-wallets offer small and local retailers quick and easy access to payments through credit cards. And as companies adapt to the changing financial landscape, e-wallet apps are becoming more popular, from Starbucks' mobile application to ApplePay and Alipay, which currently has more than a billion users.

Digital payments systems have also emerged to reduce the cost and time associated with cross-border trade. Examples in the private sector include Flutterwave, which connects various types of payments systems (bank transfers, mobile money) to enable cross-border payments. Platforms are emerging for digital-based investments into mutual funds and businesses, which potentially could scale across borders. Mobile money is also partially bridging the digital divide by bringing financial services to those without access to formal banking payment platforms.

In addition to such private endeavours, there have also been regional developments, as described in **BOX 6.1**.

## BOX 6.1 REGIONAL DEVELOPMENTS IN E-COMMERCE

To meet cross-border needs for e-commerce, Africa's regional economic communities have been engaged in providing solutions through regional payments systems such as the Common Market for Eastern and Southern Africa (COMESA) Regional Payment and Settlement System, the East African Payments System, and the Southern African Development Community (SADC) Integrated Regional Electronic Settlement System. At a continental level, Afreximbank has been developing a pan-African payments and settlement platform, which is expected to support cross-border payments in which sender and receiver transact in their local currency.

Recognizing the need for continental solutions to digital challenges, in January 2019 the Executive Council of the African Union (AU) directed the African Union Commission (AUC), the United Nations Economic Commission for Africa (ECA) and other stakeholders to develop a comprehensive digital trade and economy strategy. Subsequently, in partnership with the ECA and other institutions, the AUC prepared the Digital Transformation Strategy, which the AU Executive Council adopted in January 2020 (AU, 2020).

The Digital Transformation Strategy seeks to enable African countries to participate in the fourth industrial revolution and facilitate the operationalization of the African Continental Free Trade Area (AfCFTA). Countries are expected to implement the strategy through sectoral implementation plans in such areas as digital trade and digital financial services, which include payments, credit, savings, remittances and insurance. Digital channels identified for financial transactions are the internet, mobile phones, automated teller machines and point of sale terminals, among others.

Facilitating digital trade and finance through supportive infrastructure and platforms is vital to the operationalization of the AfCFTA. The African Trade Observatory of the AU Commission is intended to connect and serve as the interface for national and regional trade portals. Also, the AU Commission and the Universal Postal Union have proposed e-commerce marketplaces to enable cross-border trade.

Cooperation will be essential in multiple areas, including consumer protection, data collection and analysis, taxation and inter-operability of technology systems, to

enable digital work and business and to establish a level playing field for fair competition. Cooperation will ensure that the digital market is aligned with the vision of an integrated continental market. As the Digital Transformation Strategy is implemented, several areas will require regulation to promote cross-border trade in services under the AfCFTA, including taxation, standards, personal data protection, cybersecurity, consumer and worker protection and protection of digital innovations and technology (ECA, 2019). Negotiation of investment, competition and intellectual property rights protocols will be taken up as AfCFTA phase II issues. The development of regulations will need to be aligned with the continental regulations and policies being developed in the context of the Digital Transformation Strategy on aspects such as cybersecurity, privacy and interoperability in order to achieve consistent and integrated frameworks.

# INSURANCE

Fintech is also revolutionizing the insurance industry, which suffers from inefficiencies on both the provider and the purchaser sides. Insurance firms spend large sums of money to ensure that the parties they insure offer an appropriate risk, but information asymmetries arise, and insurance firms with lower capabilities struggle to balance the risk and cash flow. For purchasers, information asymmetries may create such inefficiencies as protracted verification periods and denial of insurance to many individuals who may not be true risks, resulting in coverage gaps.

Fintech innovations are enabling insurance companies to use data analytics and artificial intelligence to underwrite insurance products and process claims, for more seamless engagement. New York-based Lemonade, a property and casualty insurance firm valued at \$2 billion in January 2020, uses artificial intelligence to help process its claims. Lemonade leverages behavioural economics to split claims into two groups: those that can be processed automatically and almost immediately, without additional paperwork, and those that require a human decisionmaker. The firm has also introduced a second artificial intelligence routine to tailor and personalize insurance policies within seconds.

In the future, more insurance firms will be adopting fintech innovations to meet customer needs for customization of policies and faster processing of claims. As policies are increasingly personalized, allowing for usage-based insurance to grow, customers will interact more frequently with artificial intelligence and chatbots at all stages.

**“Fintech innovations are enabling insurance companies to use data analytics and artificial intelligence to underwrite insurance products and process claims, for more seamless engagement”**

# FINTECH FOR PRIVATE SECTOR GROWTH

Traditional financial institutions rely on personal trust built over time through longstanding business relationships between banks and customers. Banks accumulate data on transactions and information from different sources, mainly through physical encounters. In the case of SMEs, however, accumulating such information is more costly and therefore unattractive to banks and SME clients, who would have to pay higher costs for services. So, banks have concentrated on larger firms. The emergence of fintech is bridging the resulting financial gap for SMEs, creating opportunities for private sector growth. Fintech and data-driven analysis can inform the creation of risk profiles for SMEs and provide them with access to financial services. Fintech makes data collection and monitoring less costly, and the improved efficiency makes access to finance more inclusive. Moreover, online alternative financing providers use non-traditional information sources to ascertain creditworthiness, to the benefit of SMEs, which rarely have a long credit history.

The emergence of fintech across Africa has opened new avenues of funding for businesses and has led to the emergence of new financial service providers, new financial instruments such as crowdfunding and mobile money services, new currencies such as cryptocurrencies and even new ways of conducting conventional banking such as online banking and electronic payment systems. These changes widen saving, investment and payment avenues for both providers and consumers of financial services.

The African banking sector has developed many innovations to serve its customers, from innovative platforms that reach underserved regions and populations to pioneering credit scoring techniques for customers with little or no conventional banking history. Banks are transforming the way they interact with their customers, offering them digital solutions such as virtual in-branch investment advisors, online and mobile banking products and services, and increased use of social media and data analytics, lowering operational costs (IFC, 2017).

Banks are partnering with telecommunications and fintech companies to reach new customers. For instance, the Commercial Bank of Africa in Kenya partnered with Safaricom to launch M-Shwari in 2012, which combines interest-bearing savings, payment and microloan services. M-Shwari users reached 21 million in 2017, with loan disbursement of 430 billion Kenyan shillings (about \$4.2 billion) since its inception. In 2014 in Nigeria, Diamond Bank partnered with MTN, a South African multinational mobile telecommunications company, to launch Y'ello accounts, a mobile money product, enabling Diamond Bank to reach an additional 12 million customers by 2017. Diamond Bank's financial product offerings include an interest-bearing account, microloans, transfers, deposits, withdrawals and bill payments. These partnerships overcome some of the obstacles that banks face in trying to serve a mass market, such as the cost of deploying an extensive branch network and tellers and the cost of verifying customer information.

The ability of traditional banks to resolve agency problems by establishing close ties with smaller businesses makes it appropriate for them to adopt relationship lending to promote innovative financing for SMEs. According to a survey by McKinsey & Company (2018), African banks have implemented a wide range of innovations for managing credit risk, including advanced analytics and the use of non-bank data. Some banks use social media and telecommunications data in their underwriting. For instance, the Commercial Bank of Africa, Equity Bank and Kenya Commercial Bank have partnered with a telecommunications company to use borrower's mobile data, voice services and mobile money usage data as indicators of their income and ability to repay a loan. By turning to fintech companies, banks were able to digitalize and improve their delivery of financial services. And by providing cheaper and more accessible products and more flexible services tailored to consumer behavioural data, fintech companies are expanding their customer base. Fintech market penetration thus brings easier access to innovative products for savings, insurance, credit and payment transactions to more businesses and large segments of the population.



Fintech has the potential to overcome some of the financial constraints faced by SMEs as a consequence of the complexity of SME financing. In developed economies, the emergence of marketplace lending has increased the participation of institutional investors, creating opportunities to link marketplace lending to capital markets through secondary markets and securitization of loan portfolios. Fintech, including data analytics, is closing the financing gap in the SME sector through innovation in credit appraisal, underwriting, origination and servicing (OECD, 2019).

In Africa, mobile money offers an inclusive and innovative way of banking for SMEs. The mobile money platform M-Pesa has made significant strides in extending finance to women entrepreneurs. Before the advent of M-Pesa, women in rural Kenya needed their husband's consent to open a bank account for themselves and their business (Morawczynski, 2009). M-Pesa has also brought insurance products to smaller-scale farmers in Kenya. Salama, a micro-insurance product, employed M-Pesa to compensate insured small-scale farmers whose crops had failed (Sen and Choudhary, 2011).

Leveraging mobile technology reduces information asymmetries and transaction costs significantly, making it easier to extend credit to small businesses. For example, MTN Ghana,

in partnership with Afb Ghana, launched MTN Owikloan, an innovative financial product that has enabled thousands of small enterprises to access microloans with minimal documentation. **BOX 6.2** gives other examples in Africa of the use of new technologies in the banking sector.

Advanced data-sharing technologies are ushering in a new era in banking called open banking, which promotes competition in the payments and banking industry. Banks transmit customers' transaction data and access to customer accounts to third-party providers, enabling them to make payments on their customers' behalf. Open banking allows the provision of a much richer range of financial services and products. Open banking began in the United Kingdom in 2016, with the nine leading financial institutions developing standardized software to allow customers to securely share data with potential providers of payment and credit services.

To support the growth and spread of open banking, firms and regulators must do more to raise consumer awareness and enable services to reach scale. The creation of a safe and fully functioning cross-industry data-sharing system will take even longer. Although no African country has implemented a regime for open banking, Kenya, Rwanda and South Africa are leading in developing the necessary regulatory frameworks.

## **BOX 6.2 EXAMPLES OF INNOVATION IN THE AFRICAN BANKING SECTOR**

### **STANDARD BANK OF SOUTH AFRICA**

One of the most innovative banks in Africa, Standard Bank extends best-in-class banking technology throughout the continent. Pilot projects have automated several processes, including reporting foreign exchange transactions to the central bank and performing large parts of the extension of credit to existing business clients.

### **STANBIC BANK UGANDA**

With a new holding company structure, Stanbic Bank will have more flexibility in generating non-banking revenue, forming partnerships with emerging fintech companies and optimizing its real estate holdings. The bank operates a business incubator for micro, small and medium-size enterprises that has graduated some 500 entrepreneurs.

### **ECOBANK GAMBIA**

In partnership with retail agencies across the country, Ecobank Gambia has extended services to remote areas of the country. Ecobank's agency banking system enables its customers to deposit or withdraw funds from its accredited agents in their communities. In Togo and elsewhere, Ecobank Omni is an online platform offering a suite of online cash management solutions for corporate clients.

**Source:** ECA, based on compilation from <https://www.gfmag.com/magazine/may-2019/best-banks-africa-2019>.



# CONCLUSION

Financial technology will continue to play a large role as financial institutions and start-ups seek to ease some of the constraints of the financial services sector. Particularly in Africa, where so many people remain unbanked and transaction fees are high for many services, fintech can provide alternatives and revolutionize how people and companies access banking.

Crowdfunding, already popular in emerging market economies, will likely continue to expand in Africa. Further development of the platforms will open pathways for investors from around the world to participate in fundraising for innovative ideas and projects. As blockchain becomes mainstream, traditional financial institutions will be able to enhance the speed and security with which they process transactions and transfer funds across borders.

Africa can deepen and broaden financial markets by supporting the digital payment systems and platforms that underlie electronic payments and transfers through two important continental integration initiatives: the Digital Transformation Strategy and the AfCFTA. Both initiatives promise to streamline policies and regulations on critical aspects of digital

payment systems and platforms and to further open markets to e-commerce, the reason for digital electronic payments and transfers.

As more finance apps are launched for investing and budgeting, financial services will reach new segments of the population, deepening and broadening underdeveloped capital markets in many African countries. The expansion of mobile banking and mobile transactions to difficult-to-reach regions of the continent will provide services to the previously unbanked and integrate them into the formal economy.

Education and telecommunications infrastructure remain critical to greater financial inclusion in Africa. Higher literacy and educational attainment rates will make participation in the financial system easier and more attractive, increasing demand for more variety in financial services. This demand will open space for new entrants and products in the financial services industry. Meanwhile, better connectivity will promote the extension of banking services on mobile and electronic platforms. Africa can leverage current knowledge and development to advance its financial services sector and connect ever-more savers and borrowers.

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CHAPTER 7

# REGULATIONS TO SUPPORT FINANCING IN AFRICA



**A**lthough innovative finance has received a lot of attention in this report, the banking sector remains the most important source of capital for loans and funding to the private sector in most African countries. Banks are also the way most savers hold deposits and financial assets, including government securities. The banking sector remains the most important intermediary of Africa's households' savings, to which Africa's private sector needs access.

So, African countries need to regulate their bank sector to limit the possible harm from banking crises or from more general system-wide misallocation of resources. For the sake of private sector development, the regulation of banks and other sources of capital for funding private industry—such as equity and debt capital markets and digital platforms—needs to be strengthened.

The development of well-functioning financial systems requires not only sound regulatory rules but also supervisory mechanisms applicable to banking, capital markets and other financial services. In African countries the central bank is at the heart of regulation for the financial services sector. Most

of the central banks are mandated to provide the regulatory framework for economic transactions and monetary policy, helping to channel public and private savings into investment and so leading to growth. Two different approaches characterize analysis of how the development of financial regulation affects inclusion and growth. The “growth-enhancing governance” approach seeks direct evidence of financial regulation's impact on development outcomes. A less direct approach studies how regulations contribute to resource mobilization and allocating supporting investments, promoting inclusive development (ECA, 2019).

Economic shocks and financial crises test the strength of financial systems, the appropriateness of regulatory systems and the frameworks put in place. For instance, the importance of financial regulation and supervision became clearer in the wake of the 2008–2009 financial crisis due to the volatility of cross-border capital flows, which dropped to \$2 trillion in 2008 from a record high of \$12 trillion in 2007 (IMF Statistics). The experience led to more stringent financial regulation and to growing economic nationalism, especially among advanced economies.

Most African countries were resilient to the financial crisis, mainly because their linkages with global banks and investment services were limited. Yet, they must continue to improve the regulation of the financial service sector and support innovative financing in the private sector. The current debate on adopting the Basel III regulatory guidelines gives African countries a chance to decide whether those guidelines fit the supervision and oversight of the financial sector across Africa.

Appropriate, effective and enabling regulatory frameworks for all financial intermediaries operating in Africa will give confidence to a new breed of fit and proper entrepreneurs. The frameworks will introduce new financial service platforms and innovative products, whose competitive arena will become more transparent and will open up to new players. Regulation according to best practices can enable Africa's

financial service sector to stimulate growth and encourage the entry of innovative financial products. The example of financial regulation in Kenya and the emergence of M-Pesa is important in this context and will be discussed below.

This chapter examines issues policymakers should consider in evaluating the options for better regulating the financial service sector in Africa, so the sector can play its role in allocating resources and stimulating private sector development and economic growth. In addition to banking sector regulation, the chapter describes the regulation of other types of bank and non-bank financial intermediaries—equity and debt capital markets, digital platforms and microfinance companies—so they can promote resource allocation and investment opportunities and reduce costs and risks for financing private sector growth and sustainable development in Africa.

# OVERVIEW OF FINANCIAL REGULATION IN AFRICA

## BANKING REGULATIONS

Financial sector reform has had three distinct phases across Africa, and the evolution of the sector has shown a number of key trends (Murinde, 2012). First, in the pre-1960 colonial phase, before African countries established central banks, banking regulation was assigned to colonial administrators. Regulation was driven not by a desire to see the financial sector improve the colony's resource allocation and economic growth, but by overall colonial policy, which in some countries prohibited the local ownership of banks and in others actively encouraged lending only to foreign firms (Austin and Uche, 2007). During the colonial phase, the aims ascribed to financial services did not drive regulation or the design of financial sector policy.

The second phase (as identified by Murinde) took place between independence and the 1970s—this chapter extends

that phase to the 1980s, calling it the pre-Basel phase. In it, central banks replaced currency boards. Countries modelled the new central banks primarily on the Bank of England, despite early warnings not to. The new central banks were responsible for bank regulation and supervision, as well as for normal central bank functions—issuing currency, overseeing monetary policy and acting as bankers to governments. New financial institutions were established to remedy the perceived failure of the financial markets to provide capital to local entrepreneurs. Alternative lending institutions, such as agricultural and industrial development banks, cooperative banks and several state-owned banks, were created to address the market failure. At times, state-owned banks were created through the nationalization of foreign banks. In the main, these state-driven institutions aimed to address the shortcomings of the market and its credit rationing.

The third phase is what Murinde refers to as “the Basel regime.” It runs from when the Basel Committee initiated the Accords on Capital Adequacy in 1988, establishing the Basel guidelines (the so-called Basel Capital Accord that sets minimum capital standards for internationally active banks, known as Basel I) to the onset of the global financial crisis in 2008. In introducing Basel I, the Basel Committee was primarily concerned with managing credit risk in banks, so the initial discussions centred on capital adequacy and were originally designed for internationally active banks. Other concerns included making a level playing field for international banks operating across borders and creating regulations to support the financial service sector’s contribution to economic development—specifically, regulations to incentivize financial systems to stimulate economic growth.

Critics saw Basel I as limited in scope and hoped that revisions would cast a wider net. But an updated set of guidelines, Basel II, circulated in mid-2006, again focused narrowly on cross-border banking. It had three pillars. Pillar I dealt with the minimum capital requirements for credit risk. Pillar II concerned the supervisory review of capital adequacy. Pillar III improved market discipline by requiring that investors be given accurate and transparent information on the oversight of banks’ risk management. Basel II has been criticized for encouraging strong supervision, and questions were raised about whether its capital requirements and internal controls would constrict certain aspects of financing in developing countries. To date, only a few African countries have implemented the Basel II standards, including Cameroon, Egypt, Ghana, Kenya, Nigeria, Senegal, United Republic of Tanzania and Uganda (Ozili, 2019).

During the transition to Basel III, legislation introduced in several financial centres improves the prospect for private monitoring of financial intermediaries, which should be used to shape a new set of policy prescriptions on regulatory reform in Africa. This phase introduces macroprudential regulations in the Organisation for Economic Co-operation and Development (OECD) and in several African countries. Its approach to international financial regulation, which emphasizes private monitoring and other considerations, has direct lessons for African countries and other countries anxious to stimulate economic growth by providing capital to long-term and high-risk projects.

Basel III went beyond improving capital adequacy measures to emphasize building buffers to help banks recover from financial and macroeconomic shocks. Basel III also introduced specific macroprudential measures to address threats to systemic stability through a countercyclical capital buffer (Kasekende, 2015). When Basel III was launched in 2004, its aim was to increase the total capital ratio from 8 to 10.5 per cent in 2019 and the Tier 1 capital ratio from 4.5 to 6 per cent, as a new measure strengthening capital requirements. Other Basel III additions included goals to strengthen microprudential regulation to avoid systemic crisis.

But Basel III is, in turn, subject to criticism. The size of the equity buffer is debated, though its purpose is agreed: to reduce the probability of a banking crisis by capitalizing banks better. Even if a crisis occurred, it would do less damage since banks were holding more equity (Vickers, 2016). The mechanism for determining a bank’s equity capital in emerging African economies is of great interest because the equity buffer is fundamental to a country’s financial stability, particularly given concerns with commodity shocks and the levels of finance needed for small and medium enterprises (SMEs) and other forms of high-risk, long-term finance. Many African countries faced challenges implementing earlier capital and liquidity requirements, and the excessive complexity of the standards were ill-suited to less developed financial markets (Jones and Knaack, 2019). To date, South Africa is the only African country that has fully implemented the Basel III standards.

## MACROPRUDENTIAL REGULATIONS

Although many African countries tried to adopt financial standards (such as Basel’s) and financial stability policy regimes, the efforts were slow. Murinde (2012, p. 23) remarks, “African central banks have not fully adopted macroprudential supervision responsibilities, which involve supervision at systemic level (financial stability) to complement the supervision of institutions.”

Several African countries are tackling these shortcomings. Some have introduced financial stability boards and oversight committees as part of their regulatory architecture. The member countries of the Global Financial Stability Board’s Regional Consultative Group for Africa are Angola, Botswana, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa, United Republic of Tanzania, Uganda and Zambia as well as



the Central Bank of West African States (BCEAO) and the Bank of Central African States (BEAC). The regional consultative group is co-chaired by Lesetja Kganyago, governor, South African Reserve Bank, and Moses Pelaelo, governor, Bank of Botswana. Further, the Community of African Banking Supervisors (CABS), a subsidiary of the Association of African Central Banks (AACB), was established to contribute to ongoing efforts to strengthen banking regulatory and supervisory frameworks in Africa. The continent thus recognizes the importance of macroprudential supervision.

By emphasizing collective behaviour, macroprudential regulation can tighten the link between prudential regulation and development policy. As one study points out, in many African countries economic activity is concentrated in a few sectors—typically producers of specific cash crops or extractive

industries such as oil, gas, metals and mining. Bank lending tends to concentrate on these sectors, raising the macroeconomic risk associated with lending portfolios. Macroeconomic risks of financial stability tend to be high because commodity downturns easily cause systemic risks and can be more important than risks to individual banks.

Macroprudential policy can boost economic growth to enhance the financial sector's contribution to a country's development. Economists and central bankers expect macroprudential policy to evaluate the risks associated with various failures, particularly the effect that the failure of an institution would have on the economy due to size, for example, or customer markets. But does a macroprudential framework make a major contribution to enabling or hindering the financial system in promoting growth (BOX 7.1)?

### BOX 7.1 MACROPRUDENTIAL POLICY ASSESSMENT IN AFRICA

Four essential indicators are relevant to macroprudential analysis in Africa for explaining and predicting the build-up of systemic risk through the financial sector:

- *Ratio of broad money supply to GDP.* Historically, broad money supply has been largely expansionary and volatile in Africa. Although the ratio of the broad money supply to GDP has consistently risen over the past two years, it has done so more slowly than over the long term. The current annual growth rate is 0.06 per cent, while the long-run growth rate is 1.39 per cent. The current trend indicates a negative growth rate, hence a lower likelihood of systemic shocks through the broad money supply.
- *Ratio of domestic credit to the private sector by banks (percentage of GDP).* The ratio of domestic private sector credit to GDP in the continent has been falling consistently since 2016. For instance, in 2019, the credit-to-GDP gap for South Africa was set at -2.1 per cent (Bank for International Settlements database), indicating a fairly stable environment and

low probability of systemic risk build-up.

- *Ratio of bank non-performing loans to total gross loans (per cent).* Surprisingly, non-performing loan management has been outstanding in Africa, with the ratio falling 25 per cent over 2005–2015. In Nigeria for instance, the 2019 non-performing loan to total gross loans ratio of 6.03 per cent is below its 10-year average (2008–2018) of 11.32 per cent (World Bank data).
- *Portfolio equity, net inflows (current \$ millions).* GDP growth, market volatility, global oil price shocks and other structural vulnerabilities and instability have been largely responsible for the high volatility in portfolio equity flow. For instance in Egypt portfolio equity flows had great volatility in the aftermath of the 2011 Arab Spring, with net flows falling negative between 2011 and 2013; -\$711.3 million in 2011, -\$983.4 million in 2012 and -\$431.4 million in 2013 (World Bank data).

African countries need to develop a robust foreign reserves policy, especially for build-up of reserves for external shocks.

The adequate provision of essential services and facilities in Africa will enhance social well-being and further economic growth by providing an enabling environment and support for businesses. This support will address two challenges to financial stability: it will reduce the inflationary impact of the excessive money supply, and it will advance economic diversification. The excess money supply will be diverted and absorbed by latent productive capacity rather than feed into the prices of goods and assets, which would eventually lead to inflation and financial shocks. And shifting an African economy from a single foreign exchange income source towards multiple sources through exports will reduce the severity of financial shocks through devaluation. Increasing access to financial services, especially to capital market products, will both improve access to credit and enhance monetary policy effectiveness and transmission channels.



## THE ROLE OF REGULATORY AUTHORITIES

### CENTRAL BANKS

Central banks are critical to efficient and well-regulated capital markets, since the banks' financial stability objectives are affected by the markets' depth and liquidity. African central banks, like those elsewhere, have an important role in developing and marketing domestic government debt. They work closely with their ministries of finance to do so. Central banks also typically oversee the local payment infrastructure as part of their supervisory role in the local banking sector. The interest rate policies and prudential policies pursued by central banks are important drivers of the local debt and equity market.

Policy recommendations will be considered later in this chapter for creating an enabling environment for financial market development across institutions—banks, microfinance institutions (MFIs) and the capital market. Regulators and monetary authorities are well advised to create an environment that promotes low and stable inflation and sustainable debt and fiscal management strategies, for these will stimulate economic growth and reduce uncertainty, thus contributing to the development of capital markets by lowering the cost of raising capital.

Like other emerging markets, many African countries have taken steps to liberalize financial markets, including removing caps on interest rates and stopping the allocation of credit directly from central government departments. Governments also increased their reliance on securities auctions to determine the price of government debt and to raise funding. And they strengthened the legislation that supports the growth and functioning of domestic corporate securities markets. All these steps promoted the development of capital markets.

Funds raised through capital markets are secured on an arm's length basis. For this reason, these markets depend on a supportive legal framework whereby financial transactions are settled efficiently and financial transactions and contracts are enforced in a way seen as fair. A robust legal framework with strong disclosure rules is necessary so holders of securities can monitor a company's performance and if necessary, take action to keep company managers and controlling shareholders from using company resources for their own personal benefit. In addition, market regulations must be seen to protect

creditors' rights, particularly during corporate failures. That is when efficient and predictable insolvency regimes reassure creditors that outstanding debts will be paid in full and on time, and when the losses incurred by equity holders will be minimized.

### MARKET REGULATORS

African countries also need sound and appropriate regulatory environments and frameworks to enable the development of stable and resilient capital markets. All countries with established securities markets or stock exchanges have appropriate rules, regulations and regulatory bodies. The capital market regulatory authorities are then responsible for governing and monitoring the overall regulation of the activities of the stock market, protecting the rights of investors, ensuring the safety of the investments, preventing malpractice and fraudulent activities and developing a code of conduct for such intermediaries as dealers, investment funds, brokerage firms, securities exchanges and investment advisors. Developed capital markets in advanced economies and emerging markets are regulated by securities and exchange commissions or boards, which ensure that investors and savers are offered diversified opportunities to invest in projects in viable sectors capable of generating high rates of return. For instance, the United States established its first market regulatory authority—the Securities and Exchange Commission (SEC)—in 1934, responsible for protecting investors, maintaining fair and orderly functioning of the securities markets and facilitating capital formation.

In Africa, several countries have established either a capital market authority (CMA), as in Egypt, Kenya, Rwanda, Tunisia and Uganda, or a securities and exchange commission, as in Ghana and Nigeria. The CMA is a market-regulating body

**“Like other emerging markets, many African countries have taken steps to liberalize financial markets”**

responsible for supervising, licensing and monitoring the activities of market intermediaries, including the stock exchange, the central depository and settlement system and all the other persons licensed under the Capital Markets Act.

Kenya established its capital markets authority in 1989, charged with the prime responsibility to regulate and supervise the Kenyan capital markets industry and facilitate the mobilization and allocation of capital resources to finance long-term productive investments. The Kenyan CMA also introduced the “regulatory sandbox”—a regulatory framework to support innovation in the capital markets (BOX 7.2).

Nigeria’s securities and exchange commission was established in 1962, at first as an ad hoc consultative and advisory body. It was mandated to examine applications from companies seeking to raise capital from the capital market and to recommend the timing of such issuances to prevent them from clustering and overstressing the market’s capacity. That advisory body was made an SEC in 1980 with the full functions of regulating, supervising and monitoring the Nigerian capital markets (Nigeria SEC website).

In South Africa, the Financial Sector Conduct Authority (FSCA), formerly known as the Financial Services Board, regulates

the financial market. FSCA is a market conduct regulator of financial institutions aiming to enhance and support the efficiency and integrity of financial markets and to protect financial customers by promoting their fair treatment by the financial institutions licensed under financial sector law. The licensed institutions include banks, insurers, retirement funds and administrators, and market infrastructure (FSCA, n.d.).

Because stock exchanges have the potential to finance high-risk and high-return projects requiring long-term capital commitments, they are valuable in Africa’s arsenal of financial services. They must be regulated with that potential in mind. But many exchanges in Africa operate under weak regulatory environments, which have contributed to dismal stock exchange activity and shrinking foreign investor participation (CFA Institute, 2019). To develop and deepen exchanges to become significant drivers of economic and societal transformation in Africa, 26 stock exchanges created the African Securities Exchanges Association (ASEA) in 1993. The ASEA provides members opportunities to enhance their effectiveness through exchange integration as a means of deepening the markets and enhancing their liquidity. It offers capacity-building initiatives that equip members with skills and cultivates close liaisons with market stakeholders to develop an investor-ready environment (CFA Institute, 2019).

# FINANCIAL INNOVATION AND REGULATORY CHALLENGES

Sound regulation of a financial system encourages the development of the financial sector in ways that aid and support inclusive and sustainable growth. The relationship between finance and economic development has been widely debated and analysed. Research by Barth, Caprio and Levine (2012) describes and analyses the mechanisms through which financial intermediaries and markets stimulate and are affected by economic growth and development. Regulating financial markets in ways that stimulate, or at least do not impede, growth should be a policy objective in all African economies, particularly those with low incomes.

**“The recent growth of technological innovation in the financial service sector has the potential to spur economic growth and sustainable development, emanating mostly from emerging and developing markets”**

Since commercial banks are the dominant financial service institutions in Africa, much financial regulation in African countries comprises banking regulations. The regulation of other intermediaries and institutions (such as stock markets, digital finance platforms and microfinance institutions) is also relevant, since the growth of these alternative forms of finance is necessary if the system is to function as a whole. Currently, mobile money providers and platforms, the second most important financial service institutions in Africa, are regulated under banking legislation and so are required to

place deposits in custody or trust with commercial banks. Capital markets and non-bank financial institutions such as microfinance firms and savings and loan companies play a role in African economies but are not as systemically significant as commercial banks. Stock markets in most African countries are neither large nor highly liquid and so are rarely central to discussions of financial markets on the continent.

The evolution of financial services and the sophistication of financial products, particularly in developing countries, are shifting the dynamics around the institutions and international standards that define the global financial architecture. The key players in setting international financial standards are mostly advanced countries such as the European Union member states, Japan and the United States. They set standards reflecting their own economies' state of development. But now that China and other fast-growing developing countries are becoming more important in the global financial system, efforts to mainstream them have begun in key financial standard-setting bodies.

The 2008 economic and financial crisis was a wakeup call for the global financial system, with direct and indirect impact on developing countries. It demonstrated their close interconnectedness with the financial core, making them more vulnerable to financial crises and to regulatory changes in other jurisdictions. As a result, Basel Committee membership was extended to all G20 members. For the first time, developing countries such as Argentina, Brazil, China, India and South Africa will join the discussions and participate in decisions on international financial regulation and supervision.

The recent growth of technological innovation in the financial service sector has the potential to spur economic growth and sustainable development, emanating mostly from emerging and developing markets. In response, the global financial system will once again go through a series of reforms and adaptations. From simple technologies such as mobile money to more sophisticated ones such as big data analytics and

blockchain, such innovations can break new ground in enhancing financial inclusion. But current international financial regulations and supervision, focused mostly on financial stability, may not be appropriate for the new financial products and services pouring into the markets. And regulations that concern the banking sector alone may be insufficient to safeguard the financial system against some of the risks fintech services pose, such as data privacy, money laundering, mismatched risk and return, and systemic risk. These new risks call for financial regulation to be reviewed to provide a flexible environment for fintech to develop that is strict enough to limit the risks. Regulators and financial-standard setting bodies must also break down their own sectoral and geographical silos and put the protection and fair use of customer data at the top of their agenda.

## MOBILE MONEY AND REGULATORY CHALLENGES

The single most revolutionary change to the financial services landscape in Africa after the introduction of ATM machines has been the introduction of mobile money, which is the name of a range of financial transaction services accessed through mobile phone applications. As mobile money has spread across urban and rural communities, it has changed household cash management and the use of banking services. Access to banking services through digital finance platforms is improving in Africa. In 2018 almost half the world's 866 million mobile money users were in Africa (GSMA Intelligence, 2019). The region contributed about 65 per cent of the global value of mobile money transactions in 2018 (\$41 billion) (Techpoint Africa, 2019). In West Africa, mobile technologies and services generated \$52 billion in economic value in 2018, representing about 8.7 per cent of the region's GDP (GSMA Intelligence, 2019). In Uganda, it is reported that \$34 million moves through an intricate digital highway every day (Mawejje and Lakuma, 2019). The Central Bank of Kenya (2018) reported that Kenya's mobile financial structures had \$38 billion in transactions, a large share coming from M-Pesa, the country's mobile payment system.

The use of mobile payment systems is growing, helping to fill the vacuum in the unbanked segment of communities across Africa. Domestic transfers through mobile payment platforms pay for a wide range of services, from school fees and rent to utility bills and wages. The importance and extent of the

financial services provided through mobile platforms should not be underestimated. The highest uses of digital platforms in Africa are credit (29 per cent), payments (25 per cent), mobile banking (15 per cent) and group savings (12 per cent) (Vidal, 2017). Group savings and other forms of savings are held with commercial banks.

**“The single most revolutionary change to the financial services landscape in Africa . . . has been the introduction of mobile money”**

The commercial banks hold custodian accounts on behalf of the mobile payment operators. In this context, regulators may need to determine what types of assets the deposits can be invested in to ensure that they are not exposed to high risk. Regulators may also want to determine which banks are eligible to take deposits and could impose diversification requirements on mobile network operators to ensure that deposits are spread over several commercial banks. The mobile network operators whose platforms are used to provide these services are forbidden by current banking laws to intermediate the funds received from customers; they must transfer the funds that they receive to the commercial banks with which they partner.

Through the mobile money platforms cash from Africa's informal economy, including from people who are unbanked, can be pooled into bank accounts in the formal banking sector through partnerships between mobile network operators and traditional commercial banks. This activity benefits the economy as a whole and should be encouraged by regulators as a monetary policy so more of society's cash can be held in the formal banking sector. Digital money platforms have a positive capacity to bring currency into the formal banking sector and act as a mechanism for pooling a country's savings.

The pooled funds can be lent by custodial banks in the normal manner. So, the activity creates credit and, if banks allocate the capital efficiently, could improve capital allocation across the economy.

Further, the presence of mobile money platforms can increase remittances and so lead to the inflow of new money that was previously outside a country's economy. And if mobile money platforms are enabled to build customers' financial histories, enhanced credit scoring for those customers can start, which can lead to greater lending to the historically unbanked. All these benefits are deemed to have implications for monetary policy. Because customer deposits tend to be secured against liquid or near-liquid deposits at custodial banks, non-bank mobile platforms are expected to create little systemic risk.

No research so far has conclusively evaluated the impact of mobile money on financial stability or monetary policy (Kipkemboi and Bahia, 2019). Recent research is theoretically ambiguous, and the evidence is mixed. But central banks must be clear about the requirements for safeguarding the funds of companies and households. Central banks need to

enhance their effectiveness where mobile money penetration is high and where more cash enters the formal banking sector through mobile money platforms. The role of digital platforms in encouraging pooled savings should not be underestimated, and regulators ought to pursue supervisory and oversight mandates to encourage this segment of financial services to grow. To date, 14 African countries (Democratic Republic of the Congo, Ghana, Kenya, Lesotho, Liberia, Malawi, Namibia, Nigeria, Rwanda, Sierra Leone, United Republic of Tanzania, Uganda, Zambia and Zimbabwe) have enacted regulatory frameworks or guidelines for regulating and supervising their mobile money markets (see **BOX 7.2** for the case of Kenya).

As mentioned in **CHAPTER 6**, an Africa-wide approach could usher in more coherent and streamlined regulation as a common digital trade market advances in the AfCFTA. Countries could cooperate to create regulation to govern the digital realm of mobile money and electronic payment and transfer systems, assigning rights and obligations to digital platform operators at the continental level while addressing critical related issues, such as taxation, competition, cyber-security and digital identity.

### **BOX 7.2 REGULATORY SANDBOX IN KENYA**

Kenya is applying a “regulatory sandbox” approach to financial service innovations under which certain regulations are relaxed while the innovations are tested. Once the regulator can see the innovations in operation, the relaxed regulations can be re-introduced, modified or removed. This

approach allowed Kenya's flourishing mobile money sector to develop, leading to a substantial reduction in poverty and a boost in financial inclusion.

In general, the regulatory sandbox approach seems to support innovation and could improve the financial service sector's

ability to meet client needs. But regulators must closely supervise financial products or providers benefitting from the regulatory sandbox to prevent financial instability, weak consumer protection and illicit finance risks and to re-impose regulations quickly if particular innovations turn out undesirable.

**Source:** ECA, 2019.

# THE FUTURE OF FINANCIAL REGULATION AND NEED TO SUPPORT PRIVATE SECTOR DEVELOPMENT IN AFRICA

Africa needs to rethink its financial services regulation so that innovation is fully functional, the environment enables (rather than stifles) innovation, transparency is enhanced (through reduced information asymmetry, adverse selection and moral hazard), and financing for private sector development is delivered (BOX 7.3). The current discussions around the Basel III and global regulatory frameworks do not address several areas related to the oversight of Africa's financial markets.

As African countries seek financial service sector stability, inclusion and efficiency, their financial regulation and supervision priorities differ substantially from those put forward by the Basel Committee on Banking Supervision (BCBS), according to many practitioners and researchers. Any recommendations on Africa must take into account the narrow resources African countries provide or are committed to providing for regulation, which limit its technical and human capacity.

Improving stress-testing capacity in banks operating in Africa and in African supervisory bodies is necessary for introducing "living wills" for banks, also known as bank resolution plans. This procedure requires financial institutions to provide credible plans to regulators detailing how the institutions, if materially financially distressed, would be wound up quickly and neatly under national bankruptcy laws or other applicable insolvency regimes (BOX 7.4).

African banking crises have sometimes extended to the broad financial service sector. They occurred primarily because of corporate governance failures in banks and broader corporate governance failures.

For example, in Ghana's recent banking and financial sector crisis, the number of banks in the country fell from 36 to 23. Some 53 fund managers lost their licences to operate. And 23 savings and loan companies and 347 MFIs and non-bank financial institutions were deemed insolvent and closed. Two years into the crisis the government funded bailouts in local currency amounting to the equivalent of \$2.9 billion (about 5 per cent of the country's GDP). By contrast two years after

## BOX 7.3 IMPACT OF REGULATIONS ON SMALL AND MEDIUM ENTERPRISE FUNDING

Lending to small and medium enterprises (SMEs) has been considerably affected by regulations. African countries, like other emerging markets, rely on SMEs to generate incomes, employment and growth. Yet, SMEs are seen in emerging economies as risky asset classes since their lack of long track records and reliable, audited financial information hampers assessing their credit

risk. In emerging economies SMEs face the most pronounced credit rationing due to market failure.

Several initiatives try to counter the difficulties SMEs experience in seeking credit. Sinha (2012) highlights a number of these. Well over 2,000 SME credit guarantee schemes have been adopted in almost 100 countries—more than half the world's countries. The

guarantee schemes usually target a sector, a group of firms, a region or a group of individuals who ordinarily find it hard to access capital. In addition other instruments can boost SME financing, including interest rate ceilings and directed lending by government-backed banks and institutions.



#### BOX 7.4 THE IMPORTANCE OF LIVING WILLS

The introduction of resolution plans or “living wills” for banks is an important step in ensuring bank viability and stability in Africa. These plans tell regulators how the institutions, if financially distressed, could shut down quickly under national bankruptcy laws or other insolvency rules.

A regulator that determines a target financial institution’s plan is not credible should take steps to strengthen the institution’s prospect of recovery from any future financial distress. A regulator could, for instance,

require an institution to divest certain operations or assets. In Africa, Namibia and South Africa have progressed the furthest in introducing bank resolution plans, but most other countries’ banking regulations do not assign the central bank explicit responsibility and accountability for implementing such plans and are unclear about resolution objectives. This situation needs to be evaluated.

Living will legislation should be introduced at the same time deposit insurance is strengthened. But in poorly regulated African markets

with weak institutions and limited supervisory capacity, deposit insurance is likely to have distortionary and destabilizing effects. All deposit insurance schemes across Africa should be made explicit and should be introduced (or re-introduced) alongside toolkits strengthening overall supervision and specifying that the schemes are available only to banks that pass stress tests and have resolution plans acceptable to regulators.

the start of the last global financial crisis, analysts estimated that the direct cost to taxpayers of bailouts in most OECD countries was less than 1 per cent of GDP. Direct fiscal costs in the United States were unlikely to exceed an estimated 2 per cent and those in Germany, 1 per cent, while banking sector bailouts in the United States and France returned a net gain to their treasuries. The high cost to taxpayers of bailing out failing banks shows why African countries need to use regulation to incentivize financial institutions to adopt better governance, or else need to find ways of quickly identifying poorly governed institutions.

#### IMPROVING THE MANAGEMENT OF MACROECONOMIC SHOCKS

As mentioned earlier, many African economies are dominated by a small number of sectors, normally the producers of cash crops or natural resources, such as oil and gas. Bank lending tends to concentrate on firms and households in those sectors, so great macroeconomic risks are associated with lending portfolios vulnerable to commodity risk. Commodity downturns easily lead to systemic financial risks. African central bank governors take seriously the need for central banks to be able to execute macroprudential mandates in the face of such commodity shocks—for example, this topic was the subject of discussion during the 2013 Association of African Central Banks (AACB) annual meetings.

Global commodity prices, determined in global markets outside the control of most exporters, are volatile. Countries depending on commodity exports face price shocks from time to time and need to consider this volatility when implementing financial sector policies. African central banks can, for example, vary capital adequacy requirements with commodity cycles and introduce provisioning that brings forward the capital costs of lending decisions. And they can insist that when commodity prices are high, banks build adequate buffers to protect themselves when commodity prices fall and the financial system undergoes greater stress (Cohen and Edwards, 2017). African central banks are challenged to enact regulations that take commodity price cycles into account.

**“Regulations to avoid the spread of financial instability should include minimal capital requirements, early warning systems and central bank mechanisms that monitor and oversee financial markets**

The regulator's selection of an instrument or combination of instruments depends on circumstances (TABLE 6.1). A cross-country study by the International Monetary Fund (IMF) concluded that a combination often works best. But that is just one of the choices a regulator makes (Masson, 2014). The regulator must also decide whether to take a broad-based or a targeted approach, whether a rule-based or a discretionary application of policies is preferable and whether or not the instruments' use should be coordinated with other policies, such as monetary and fiscal policies.

Furthermore, with AfCFTA services trade negotiations frontloading financial service liberalization, accompanying measures to ensure financial markets function should include macroprudential regulation (see CHAPTER 4). Regulations to avoid the spread of financial instability should include minimal capital requirements, early warning systems and central bank mechanisms that monitor and oversee financial markets. In this regard the West African Capital Markets Integration Council (WACMIC), discussed in CHAPTER 4, offers an interesting regional institution experience.

Beyond these efforts, countries liberalizing their commitments will have to review existing banking regulations to learn what

reforms may be required. A healthy balance between safeguarding the economy from financial contagion and allowing financial operators to conduct their business will require carefully tuning and sequencing macroprudential measures. African central banks and academic economists must study which macroprudential instruments can combat the harm caused by shocks, and what circumstances call for particular instruments (TABLE 7.1).

## CENTRAL BANKS AND THE PROMOTION OF EFFICIENT CAPITAL MARKETS

As noted earlier, well-functioning equity and debt capital markets are widely recognized as playing an important role in funding the growth and expansion of private sector development in Africa and other emerging markets. The capital markets help allocate risk, transmit monetary policy and thus promote financial system stability and stimulate economic growth.

In October 2019, the Bank for International Settlements published the recommendations of a working group it had established on improving the functioning of capital markets (Acharya and Bo, 2019). Regulators in Africa should adopt

**TABLE 7.1** EXAMPLES OF INSTRUMENTS SERVING PRUDENTIAL AIMS

RULES GOVERNING FINANCIAL SERVICES	MEASURES
<b>Bank loans</b>	<ul style="list-style-type: none"> <li>▪ Caps on the ratio of loan to value for mortgages</li> <li>▪ Caps on the ratio of debt service to household income</li> <li>▪ Rules on the reference interest rate used for mortgage lending</li> <li>▪ Rules on currency mismatches of borrowers</li> <li>▪ Ceilings on credit growth (aggregate or by sector)</li> </ul>
<b>Bank balance sheets</b>	<ul style="list-style-type: none"> <li>▪ Countercyclical capital ratios (possibly including additional capital charges for any rapid increase in bank lending). Dynamic provisioning</li> <li>▪ Adjustment to asset risk weights</li> <li>▪ Rules on loan loss provisioning</li> <li>▪ Caps on loan-to-deposit ratios, core funding ratios and other liquidity requirements</li> <li>▪ Bank reserves deposited with the central bank</li> <li>▪ Limits on interbank exposures (domestic or cross-border)</li> <li>▪ Capital surcharges for systemically important institutions</li> </ul>
<b>Collateral used in wholesale funding</b>	<ul style="list-style-type: none"> <li>▪ Prevention of procyclical variation in minimum margins or haircuts (or making such variation countercyclical)</li> </ul>

Source: Turner, 2012.



the report's recommendations, which are:

- Promoting greater respect for market autonomy.
- Strengthening legal and judicial systems.
- Enhancing regulatory independence and effectiveness.
- Deepening the domestic institutional investor base.
- Pursuing two-way openings to international participation while preparing for spill-overs.
- Developing complementary markets and market infrastructures.

The report points out that its recommendations are to be implemented within the context of a given economy. Some are outside the scope of a country's central bank. But since an efficient capital market can help a central bank meet its objectives, central banks must have a seat at the table in implementing the recommendations.

## REGULATION OF DIGITAL FINANCIAL PLATFORMS

Mobile payment systems have expanded across Africa on the back of mobile telephone penetration. Given their wide reach expanding financial inclusion, their regulation is urgently required for both customer protection and monetary stability. In this context, regulations to promote a level playing field, regulations to protect customer accounts, and the revision of interest rate policies warrant attention.

### REGULATION TO PROMOTE A LEVEL PLAYING FIELD FOR FINANCIAL SERVICE PROVIDERS

Ensuring a level playing field for digital platforms and other forms of financial intermediation should be of highest concern to regulators. Mobile money expands in an economy when regulations permit both traditional banks and mobile network operators to provide mobile money services. Where the playing field is level, accounts opened at mobile network operators outnumber bank accounts. In Africa, some countries have followed Bank for International Settlements advice to put regulations in place distinguishing providers by type of service, not by the entity providing the service. In this way in

the number of countries that have levelled the playing field and permitted competition between mobile network operators and commercial banks for customer deposits has increased.

Perhaps AfCFTA services trade liberalization offers the most tangible opportunity for a blanket approach to regulation levelling the playing field for financial service providers. Financial service liberalization is being frontloaded in the AfCFTA as one of five service sectors being prioritized (see **CHAPTER 3** and **CHAPTER 4** for discussion). Together with the existing Protocol on Trade in Services, which sets out common rules for a continental market where services are to circulate freely, financial service liberalization will dismantle today's barriers keeping financial service providers from operating across borders.

Liberalization commitments under the AfCFTA focus on eliminating measures that restrict the service provision in a particular sector, not necessarily on the actual service provider. So, the AfCFTA will not only offer opportunities to existing traditional financial operators that, despite barriers, were already operating across borders, it will also open opportunities for other operators not traditionally categorized as financial institutions, such as those providing digital financial services. As new operators offer services complementing and diversifying those of traditional financial institutions, opportunities for financial deepening and greater financial development of African financial markets will grow.

So, regulating activities rather than types of providers will be necessary. Many regulatory and oversight approaches will need to be revised, and more countries in Africa need to adopt this approach.

The basic service of pooling capital and holding it in safe financial instruments can get poorer communities onto the first rung of financial benefits, as described above. Regulators, by ensuring a level playing field for providers, will encourage the emergence of service platforms as major parts of Africa's financial architecture.

### REGULATION TO PROTECT CUSTOMER ACCOUNTS

Regulation must ensure that customers can redeem mobile units for cash on demand in order to build confidence and protect customers using mobile money platforms. Regulators

should determine the types of asset deposits can be invested in or ensure that deposits are invested in low-risk instruments. They could also determine a list of banks eligible to take deposits from mobile network operator platforms and could require mobile network operators to diversify the banks holding those deposits. If the eligible commercial banks are subject to the country's standard prudential regulation, the mobile money system will also be fully protected under umbrella of that regulation.

### REVISION TO INTEREST RATE POLICIES

Across Africa, mobile money deposits do not earn interest. So, although mobile money units are a store of value for many households, the users of these platforms earn no returns on their savings. Regulators should seek to reclassify mobile units as stores of value on which interest can be earned. The introduction of partnership models, such as M-KESHO in Kenya, promotes the role of mobile money in savings. A joint

product of the mobile network operator Safaricom and the local commercial bank Equity Bank, M-KESHO pays interest to M-Pesa users and provides health insurance to its members. M-KESHO is seen as expensive since customers pay fees to transfer funds from the M-KESHO account at Equity Bank to the M-Pesa account and also to withdraw cash from M-Pesa—the two transaction fees largely cancel out any interest.

### EXTENSION OF DEPOSIT INSURANCE SCHEMES

In the event of bank failure, mobile deposits do not qualify under domestic deposit insurance schemes. Most deposit insurance schemes cover only single amounts, whose limit is often lower than the sums in mobile deposit schemes, placing customers of non-bank platforms at a disadvantage. Regulators evaluating the introduction or extension of deposit insurance schemes should determine whether or not to extend these schemes to mobile money customers across Africa as a direct or indirect safety net.

## AFRICA'S FINANCIAL POLICY RESPONSES TO THE COVID-19 CRISIS

Even though the COVID-19 outbreak has hit Africa slightly later than other regions, it has interrupted economic growth, eroded improvements in macroeconomic and debt sustainability and created devastating human and social cost. Many African governments responded rapidly by adopting targeted policy interventions or stimulus packages to reinvigorate growth, boost productivity and employment and offset the negative socioeconomic impact of the crisis.

Some African countries have limited fiscal space and international reserves and thus lack the necessary resources to implement COVID-19 responses. While financial assistance

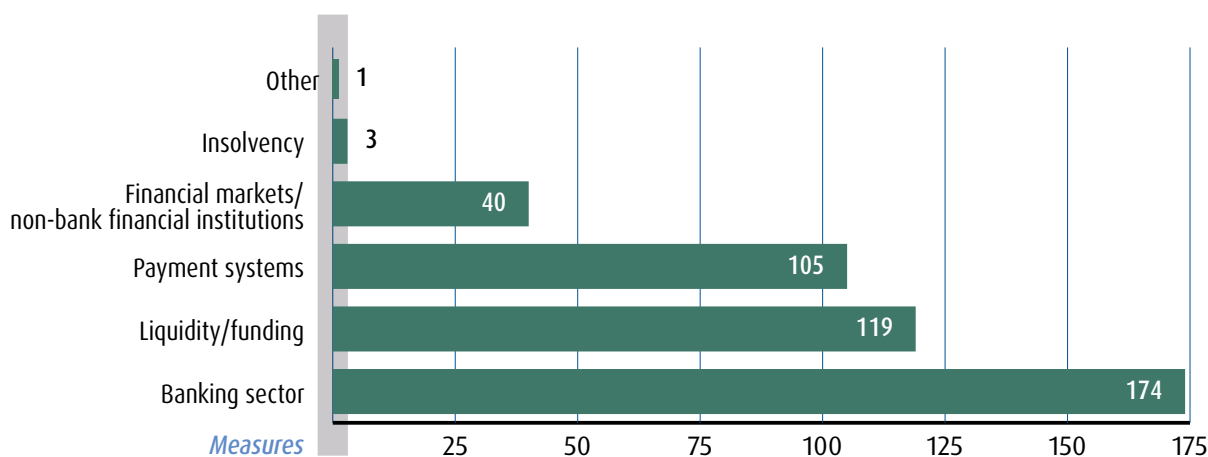
from advanced economies and international financial institutions remains crucial, domestic efforts to cushion the impact of the crisis have gained more traction among policymakers. African governments introduced various new fiscal, monetary and financial sector measures to increase fiscal space and reserves, raise additional capital and facilitate access to credit for firms and households.

African governments have incurred major revenue losses due to commodity price shocks and economic disruptions, which constrain their ability to finance public health expenditures to contain the virus or to finance stimulus packages

to protect affected people and businesses. According to IMF data, African countries will record fiscal deficits averaging 5.8 per cent in 2020 and 4.4 per cent in 2021, compared with 3 per cent in 2019. Their debt-to-GDP ratios will increase, with about 29 countries projected to record debt-to-GDP ratios above the 60 per cent threshold set by the African Monetary Co-operation Program (AMCP) as comfortable for developing countries, signalling a risk of debt unsustainability and negative impacts on growth. To address the deteriorating fiscal space and vulnerable debt positions, most African countries enacted emergency measures to provide liquidity, support domestic financial institutions, manage financial stability and reduce the risks of systemic failure in banking systems.

According to the World Bank dashboard on financial sector measures, 45 African countries have adopted a combined 442 measures to inject liquidity, ease monetary conditions, support the banking sector and its borrowers, stabilize financial markets, support non-bank financial institutions and underpin payments systems (FIGURE 7.1). Of the 45, 28 approved a combined 174 measures targeting the banking sector. Regulators and supervisors in those countries took prudential measures to temporarily relax key regulatory and supervisory requirements and support critical economic sectors and solvent borrowers facing the supply and demand shocks induced by the COVID-19 lockdowns. The measures include credit repayment moratoria, supporting or facilitating loan restructuring, relaxing the classification or provisioning of non-performing assets and releasing or deferring existing capital buffers (Mora, 2020).

**FIGURE 7.1** FINANCIAL SECTOR SUPPORT MEASURES PUT IN PLACE BY AFRICAN COUNTRIES IN RESPONSE TO COVID-19



Source: ECA, based on World Bank data (2020).

# CONCLUSION

This chapter has examined why effective and enabling oversight of the financial sector is important. Pooling a country's savings for investment, creating markets so those with unused productive financial assets can exchange them for financial instruments, making unused productive assets available to entrepreneurs through intermediaries and boosting firms' ability to raise funding through monitoring and improvement of governance standards are all ways Africa's financial service sector can stimulate economic growth. For this sector to provide capital to the continent's private sector effectively, oversee its productive firms and guard its savings and financial assets, financial intermediaries must be properly regulated.

This chapter has made several recommendations. In some countries, public policymakers (including central banks) might resist amending banking and financial services legislation. The process could lead to lobbying, opening for debate a range of banking and financial service issues that many regulators would prefer to consider settled. But avoiding new regulation would be a mistake, and the current Basel III debate provides an opportunity to pursue it.

The Basel III guidelines, like Basel I and II, have been driven by the OECD countries, with input from larger emerging markets such as India and China but little input from smaller emerging economies with underdeveloped capital markets, many of which are in Africa. But African institutions can work on detailed country studies of aspects of regulation to determine what works best in each country's context and subregion, given the different stages of capital market development across Africa. The possibilities include digital platform regulation, macroprudential tools for managing risks associated with commodity booms and strengthened regulation to enable capital markets to be more effective in resource allocation and monetary policy.

Some strategic proposals cover areas of regulation to shift from looking only at the safety of financial intermediaries towards introducing incentives to improve overall governance and disclosure, covering the private firms that raise funding

**“African policymakers’ and regulators’ experience with the 2008–2009 financial crisis and use of various measures to cushion its impact give them an advantage in rapidly responding to the COVID-19 crisis”**

from the intermediaries. Improved governance and disclosure standards and the right incentives should amplify the financial service sector's role in allocating resources across Africa. Using regulation in this way will lay the foundation for further innovative financing of private sector development.

African policymakers’ and regulators’ experience with the 2008–2009 financial crisis and use of various measures to cushion its impact give them an advantage in rapidly responding to the COVID-19 crisis. They can put in place emergency policy measures to manage financial stability and create a sound pathway towards economic recovery. The measures include prudent macroeconomic policies, fiscal stimulus packages, expansionary monetary policies, targeted sectoral assistance and new regulations to support financial institutions, firms and households (such as lowering the base rate, lowering bank cash reserve ratios and undertaking government bond buying programmes and a debt moratorium). But at the time of writing this report, the end of the COVID-19 pandemic is uncertain, so it is premature to claim the success of these policy measures in stabilizing the financial system and enabling efficient and sound economic recovery. It thus remains critical to continue increasing African government capacity, strengthening financial sector resilience and supporting all financial innovations that could help mitigate the negative impact of the crisis.

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CHAPTER 8

# CONCLUSIONS AND POLICY RECOMMENDATIONS



**T**he private sector is the engine of economic growth and sustainable development in Africa. But most African private businesses are small, and the sector has few firms in the medium and large categories—the “missing middle” and “missing large.” Mainly due to financial constraints, small and medium enterprises (SMEs) in Africa struggle to survive and grow into large firms, with most collapsing within the first three years—the “valley of death.”

Even so, SMEs are the backbone of African economies, mainly because they represent about 90 per cent of private businesses and account for more than 60 per cent of employment in most countries. The number of large firms listed on national and regional capital markets is limited. A productivity gap between SMEs and large firms is common, explained by the low-value-added and labour-intensive sectors in which SMEs mostly operate, their limited use of technology and their low participation in foreign markets. The exceptions are SMEs that export or operate internationally, which are more productive, contribute more to higher-paying jobs (especially in low-wage segments of the economy) and grow 4 per cent faster than non-exporting SMEs.

The lack of access to finance, especially for SMEs, is among the main impediments to private sector development in Africa. This report focuses on innovative finance. It examines innovative financial instruments, practices and policies to underpin a step-change in growing the gamut of businesses from start-ups to micro and small enterprises, social enterprises, professional businesses (such as lawyers and doctors), exchange-listed corporates and public-private companies—all of which will drive inclusive economic growth, create jobs and lead to better livelihoods. The report’s timing fits this digital age, when some African countries are already embarking on the financial technology (fintech) revolution to pave a bright new path for the unbanked population, while uncertainty hangs over the continent due to the COVID-19 global pandemic and associated lockdowns.

As the report points out, the financial services sector is still dominated by commercial banks. It features rudimentary forms of non-bank financial institutions (such as insurance firms and housing finance houses) and nascent capital markets (which do not provide the full mix of equity, company bonds and government bonds). It lacks tailored financing mechanisms for start-ups and young enterprises (such as venture capital) and for company restructuring (such as leveraged buyouts).



**“The lack of access to finance, . . . , is among the main impediments to private sector development in Africa”**

The recent growth of fintech start-ups in such countries as Ghana, Kenya and Tunisia is impressive. And microfinance institutions have paved the way of providing both financing and training to small enable firms to escape the valley of death in their first three years.

Even so, the financial system in Africa needs faster diversification. A full range of financial institutions should offer innovative financial products tailored to the specific needs of the business eco-system—such as start-ups, marketing, transportation and payment collection.

African countries have increasingly ventured into innovative sources of finance, such as issuing sovereign bonds (in foreign currencies like Eurobonds) and green bonds, though in some circles these practices have ignited discussions about debt sustainability. Africa continues to deepen its financial markets and build its financial institutions for long-term economic growth. For instance, despite concerns over debt sustainability, 11 countries had issued bonds, whose total value rose from about \$1 billion at the end of 2011 to \$11.2 billion by the end of 2019.

The report builds on earlier foundations showing a strategic role for finance in inclusive development. The Third International Conference on Financing for Development (2015) identified finance as a key means of implementing the United Nations 2030 Agenda for Sustainable Development and the African Union’s Agenda 2063. The Addis Ababa Action Agenda (AAAA), endorsed by the Third International Conference, offers African countries an opportunity to articulate the continent’s priorities for development finance. It makes specific recommendations on commitments by member states and partner institutions for financing a transformation of African economies to create inclusive growth, decent jobs and economic opportunities for all. Further, the Addis Ababa Action Plan on Transformative Financing for Gender Equality and Women’s Empowerment, also endorsed by the Third International Conference, outlines

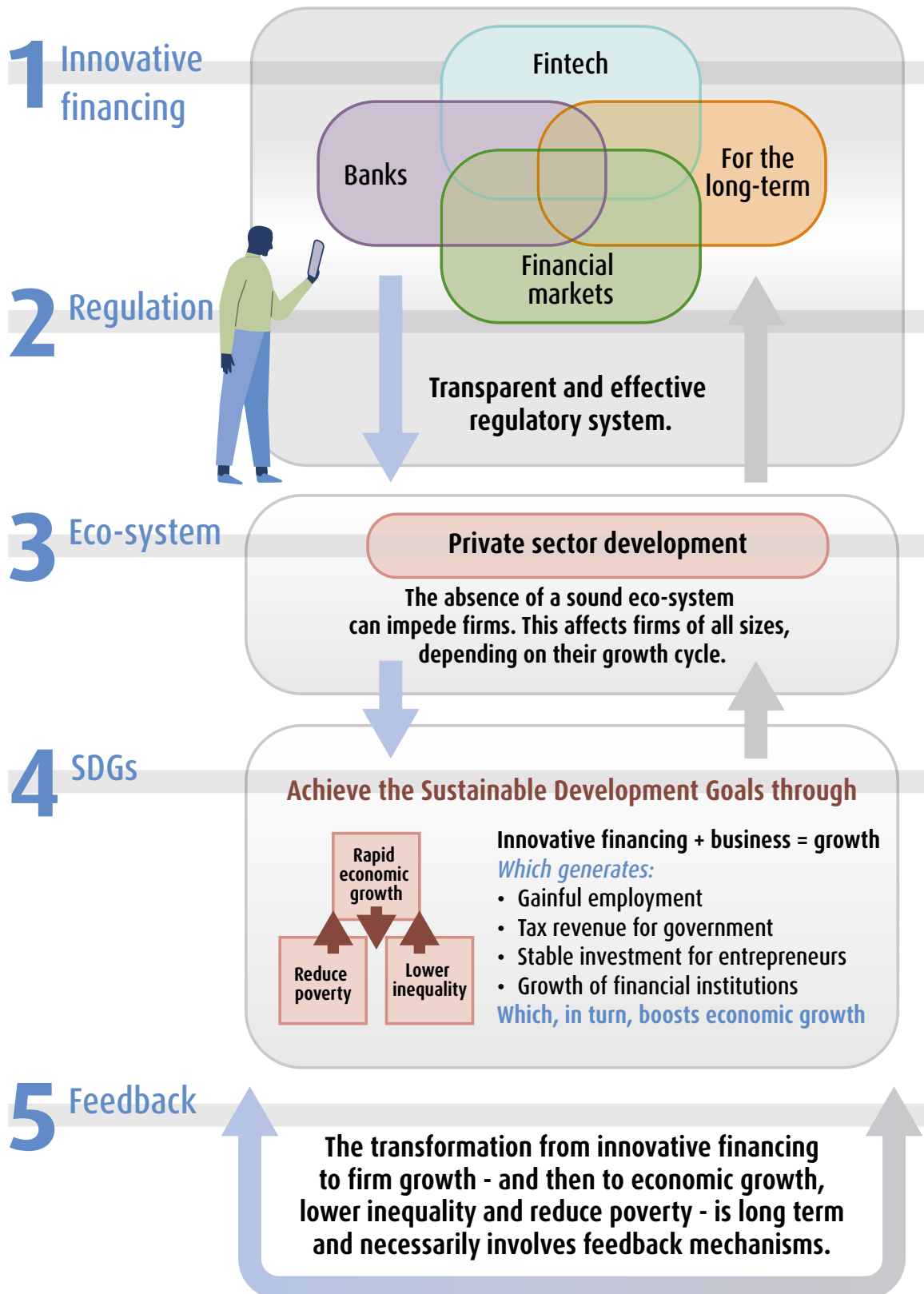
expanding government fiscal space to address the economic and financial gender gap and all types of inequality between women and men in sustainable development. Other continental and global campaigns for financing development include the 2002 Monterrey Consensus on Financing for Development (FfD) and the 2008 Doha Declaration.

This report builds on these underpinnings to explore innovative finance for business sector development in Africa. And the report advances the discussion of finance beyond focusing on the flow of funds—the sources and uses of finance—to link Africa’s development financing to the broader issues of structural transformation through the business sector, supported by capable, inclusive and accountable institutions at the national, regional and global levels.

A rich selection of secondary data and on primary data informs the report. Collected from more than 30 African countries, they cover firm-level details as well as institutional and policy factors in innovative financing for private sector development in Africa. This chapter summarizes the key aspects of innovative financing for the development of the private sector in Africa and presents the salient findings. The chapter proposes a policy framework for African countries (**FIGURE 8.1**). Its menu of policy options, best practices and strategic guidance supports decisionmakers and policymakers in creating and using innovative finance to support business sector development in pursuing sustainable economic development and meeting the goals of Africa’s Agenda 2063.

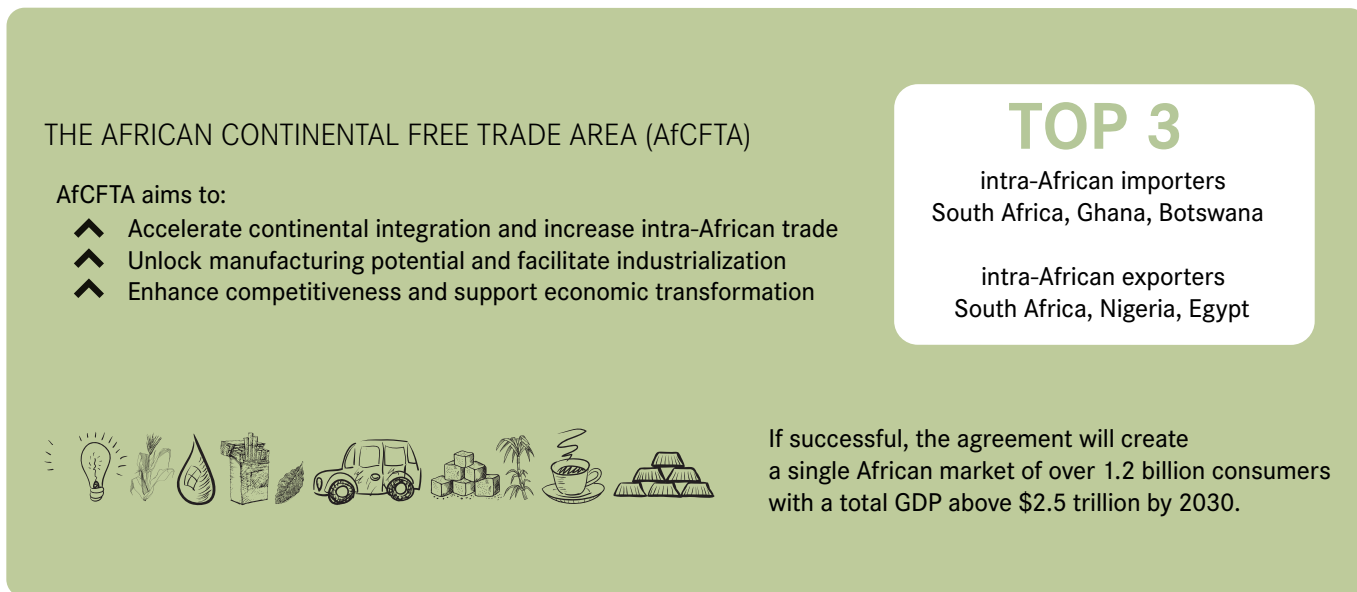
Five messages are key. First, financing innovations can arise from multiple sources simultaneously. So, businesses need to consider leveraging the different sources according to their financing needs and can call upon a mix of financing by banks, fintech, financial markets, and long-term sources such as capital markets and development banks (as featured in the top part of **FIGURE 8.1**). The intersection of sources indicates possible leverage. Policymakers should develop all four sources. Otherwise a firm might, for instance, lack long-term finance or be unable to combine bank finance for short-term working capital with capital market bonds for long-term expansion of plant and equipment. Also, in many African countries, a firm’s business financing needs change as it goes through its growth cycle. Large mature firms use capital markets to raise additional funding via initial public offerings (IPO)s, as happens in North Africa and in Côte d’Ivoire, Ghana, Kenya,

**FIGURE 8.1** INNOVATIVE FINANCING FOR PRIVATE SECTOR DEVELOPMENT AND SDGS



Source: ECA.

**FIGURE 8.2** THE AFRICAN CONTINENTAL FREE TRADE AREA (AfCFTA)



Nigeria and South Africa.

Second, a transparent and effective regulatory institution is mandatory for minimizing risk and overseeing the financial operations of firms and peer institutions. For instance, the prevalence of high loan default rates in Africa is attributed to the lack of effective regulatory oversight. That situation eventually translates into high costs for loans.

Third, the absence of a sound eco-system can impede firms even when financing is readily available (see the middle part of **FIGURE 8.1**). This affects firms of all sizes, depending on their stage in the growth cycle. The AfCFTA aims to play an important role in enhancing the eco-system for firms and connecting local firms to regional and global value-chains (see **FIGURE 8.2**).

Fourth, innovative financing of the private sector and business growth generate firm value added, gainful employment, tax revenue for government, stable investment returns for entrepreneurs and the growth of financial institutions, which

together boost economic growth. For African countries with transparent industrial policy and clear government support for firms and businesses, high economic growth will reduce poverty and inequality, especially if the government channels increased tax revenues from a booming company sector to key sectors such as health and education (see the bottom of **FIGURE 8.1**). The growth-poverty reduction-inequality reduction triangle represents both the three key targets and the mechanisms through which the 17 Sustainable Development Goals can be achieved, in contrast to the case of fragile states in Africa, which confront challenges of growth, poverty and inequality and find the SDGs unattainable.

Fifth, the transformation from innovative financing and a fully operational financial sector to firm growth and so to economic growth, lower inequality and reduced poverty is long term. It necessarily involves feedback mechanisms (indicated by the reverse arrows **FIGURE 8.1**).

# AFRICA HAS A HIGH ECONOMIC GROWTH TRAJECTORY, BUT COVID-19 HAS UNLEASHED NON-TRIVIAL UNCERTAINTY

Africa is the second fastest growing region in the world, with economic growth estimated at 3.4 per cent in 2019. In 2020, mainly due to the COVID-19 global pandemic and associated lockdowns, growth is projected to fall. In a best-case scenario average growth will fall between 1.4 per cent to 1.8 per cent for the year, while in the worst-case scenario the average could decline down to -4.1 per cent. Growth on the continent is projected to rebound to 5 per cent in 2021, supported by the effective implementation of COVID-19 response measures and global economic recovery.

Exceptional times call for exceptional initiatives. To enable economic recovery and reasonable SDG progress, African economies should fully explore innovative financing for the private sector and enhance the eco-system for private sector development. Efforts should include raising investment to 35–40 per cent of GDP, enhancing competitiveness and supporting regional integration. A key strategy is the African Continental Free Trade Area (AfCFTA), enacted by a March 2018 agreement and signed by 54 African countries (see **FIGURE 8.2**). For service-based economies, the AfCFTA provides an opportunity to move from consumption-based growth to more durable sources of growth and to shift from relying on subsistence and non-tradeable services to services that generate greater value addition, productivity and growth. AfCFTA also creates opportunities for internationalization by supporting the development of regional and global value chains in which manufacturers that rely on embedded and embodied service inputs can source such inputs locally in the continental market, creating jobs, adding value and expanding their share of the global market.

Multidimensional poverty and inequality persist in Africa. There is a danger that the COVID-19 global pandemic could push 27 million Africans into extreme poverty, exacerbate existing income inequalities, especially in health and education, and ignite the first recession in Africa in 25 years with a GDP loss of \$62.8 billion.

Unleashing the private sector to contribute to sustainable development requires strengthening the structures supporting financial development. For example, policies for financial innovation should support financial inclusion, thereby increasing firm and household opportunities and translating economic growth into decreased inequality and reduced poverty.

**“Unleashing the private sector to contribute to sustainable development requires strengthening the structures supporting financial development”**

# THE PRIVATE SECTOR IN AFRICA IS THE ENGINE OF GROWTH AND THE PATHWAY TO SUSTAINABLE DEVELOPMENT

A key message of this report: The private sector is the engine of growth in Africa. As agriculture-based economies modernize to increase productivity, farms will need finance to purchase inputs and machinery. A large proportion of Africa's manufacturing firms are small, leading to poor export performance. Manufacturing-based economies must scale up and expand their firms to catch up with other developing countries, such as those in Asia. Africa's service industry presents immense potential for growth and economic development.

Over 2020–2030, the private sector in Africa is expected to play an important role in enabling economic recovery from the COVID-19 pandemic, increasing economic prosperity and achieving the SDGs. Two main channels will make this possible. First, the private sector will generate productivity and enhance economic participation by households and businesses. That will in turn drive inclusive economic growth, providing pathways to reduced inequality in key sectors such as health and education and to employment that gradually reduces prevailing poverty levels. Second, financial sector innovations will connect savers to borrowers and manage financial uncertainty and business risk through well-functioning systems. Bank financing must meet private sector needs better than current bank offerings, in which 60 per cent of credit to the private sector is short-term—this will require readjusting existing policies and practices.

The business eco-system must be developed because infrastructure services such as transport, water, energy and information and communication technologies are important for private sector development. Although the huge deficits needed to support eco-systems hinder private sector development, infrastructure improvements also present opportunities to the private sector, including through private-public partnerships.

As highlighted throughout the report, lack of access to finance is one of the major impediments to private sector development in Africa. In this context, the recent outbreak of COVID-19 threatens the private sector in Africa and aggravates its already major challenge in finding financing. Other challenges to private sector financing include information asymmetry, many countries' lack of a credit rating, the domination of the financial service sector by commercial banks and the mismatch of financing with firms' growth cycle. The banking sector, non-bank financial institutions, financial markets and fintech providers have important roles in the required innovations for private sector financing. But governments could play a complementary role, both in supporting the growth of the business eco-systems and in guaranteeing the enabling regulatory environment for new financial innovations to benefit businesses at all stages of the entrepreneurship growth cycle.

# BANKS ARE A MAJOR SOURCE OF INNOVATIVE FINANCING IN AFRICA AND THERE ARE HIGH EXPECTATIONS FOR PAN-AFRICAN BANKS

Since most financing mechanisms in Africa are bank-based, banks are potentially a major source of innovative financing for private sector development. Retail banking and corporate banking in Africa hold more than 90 per cent of financial sector assets. By expanding the breadth of financing instruments and enhancing financial inclusion, innovations in retail and corporate banking provide opportunities for savers and borrowers alike.

Africa's banking sector is underdeveloped when benchmarked against those in Asian emerging market economies and other industrializing economies. Its assets represent less than 60 per cent of GDP, compared with more than 100 per cent in other emerging and advanced economies.

Despite an overall increase in banking activities, bank financing to the private sector remains small and ill-tailored to the needs of private firms. More than 90 per cent of bank loans are short- to medium-term. Private sector access to financing is impeded by government dominance of banking credit and difficult access for SMEs and for key sectors of the economy.

Addressing the huge financing gaps facing the private sector and hindering infrastructure development will require more innovative financing solutions in retail and corporate banking, plus robust legal, institutional and regulatory frameworks to unlock bank credit to SMEs. The SME financing gap remains despite innovations and technological advances expanding the reach of bank lending, reducing regulatory and geographic obstacles, bringing more people and more savings into the financial system and increasing banks' ability to make loans.

The growth of pan-African banks, with hubs in Kenya, Morocco, Nigeria and South Africa, has fundamentally changed the banking sector in many African economies. Among these indigenous African banks are some with humble origins serving local SMEs, but they now conduct business in multiple countries. And significant advances in mobile banking and marketplace lending have connected unserved and underserved communities to the financial sector. The resilience and continued development of the banking sector in the face of external shocks or crises such as COVID-19 offer the promise of more progress to come so banks can provide needed funding, channel savings into investments and participate more actively in the formal economy to support private businesses.

# RISING AFRICAN FINANCIAL MARKETS HAVE GREAT POTENTIAL TO FINANCE HIGH-GROWTH FIRMS

Financial markets might be expected to complement bank finance as another source of financing to the private sector. But in Africa (except South Africa) the markets are small and undeveloped, largely dominated by commercial banks and with few investment banks. As of 2020, stock exchanges exist in only 28 African countries, offering both primary issuance and trading on the secondary markets. Most remain underdeveloped, with small market capitalizations, few listed companies and less liquidity than exchanges in other emerging economies. For example, the proceeds raised from initial public offerings in Africa between 2014 and 2019 reached \$27.1 billion, less than 1.4 per cent of global IPO proceeds during that period. The report notes great potential for tapping into the capital markets, which offer a gateway for investors—both retail individuals and institutional investors—to participate in the financial economy. They could provide not only an alternative to borrowing for the private sector to raise funds, but also an alternative to bank deposits for investors to save and gain returns.

Although Africa currently represents less than 1 per cent of worldwide private equity markets, growth is likely given private equity funds' increasing interest in the continent. The value of private equity fundraising in Africa increased to \$2.7 billion in 2018, up 10 per cent from 2017. The total transaction value in global crowdfunding was \$6.9 billion in 2019 and is expected to grow 14.7 per cent a year between 2019 and 2023, and capital raised through crowdfunding amounted to \$16.5 million in 2019 and is expected to grow 11.6 per cent a year to reach \$27.4 million by 2023. In addition, the African

bond market is also growing, with a total value of \$500 billion in 2019. The African Continental Free Trade Area (AfCFTA) provides great opportunities for African capital markets to expand by creating enlarged markets, economies of scale, increased competitiveness in regional and global value-chains and more opportunities to invest in African markets and firms. Although there is new uncertainty arising from the COVID-19 global pandemic, current developments in African financial markets promise innovative business financing and growth.

**“The African Continental Free Trade Area (AfCFTA) provides great opportunities for African capital markets to expand by creating enlarged markets, economies of scale, increased competitiveness in regional and global value-chains and more opportunities to invest in African markets and firms”**



# LONG-TERM FINANCING FOR SUSTAINABLE DEVELOPMENT

Africa is at a development juncture. It is amid the COVID-19 global pandemic and efforts to accelerate economic growth to meet national goals in line with the Sustainable Development Goals (SDGs), the African Union's Agenda 2063 and the climate change initiatives. Its main challenge is to mobilize the investment needed in key sectors such as health, transport, energy, construction, education, agriculture and manufacturing. Large investment gaps particularly affect sectors such as infrastructure, even while that sector has immense potential to drive economic growth. Increasing the role of the private sector in such investments is widely advocated, especially given governments' and bilateral donors' low levels of investment. In this context the availability of long-term finance becomes a top factor.

As the report indicates, development banks at the multilateral, regional and national levels can play key roles to help African economies meet infrastructure challenges. Innovations in long-term financing are crucial for the private sector to play a leading long-term role in transforming sustainable development in Africa. Three areas of recent innovations are relevant: long-term financing instruments for climate risk, such as sustainability bonds for private sector financing; innovations in public-private investment in infrastructure; and the role of development banks in long-term financing of the private sector to maximize sustainable and inclusive growth. Development banks have encouraged private investment, including in infrastructure in some African economies as well as other developing economies. Climate vulnerability increased the average cost of debt to African countries by an estimated 0.63 per cent from 1991 to 2017. And the indirect effect through climate vulnerability's impact on firms' financial leverage, which contributed an additional 0.05 per cent, is seen in a large sample of firms from developing countries, including in Africa (Kling et al., 2021).

After taking stock of the sustainability bond market, infrastructure investment needs and the new roles of long-term capital from development banks, the report finds that Africa's participation in the global market for sustainability bonds has been muted, although that market has seen exceptional growth since 2007. This is a missed opportunity. The sustainability bond market could offer a source of incremental capital alleviating financing constraints and allowing the scarce finance available, including that from public resources, to go to other uses. Strengthening relationships with partners such as international financial institutions and global financial hubs could mitigate risks for private investors and so crowd finance into the region. At present, private finance and private investment go only to certain infrastructure subsectors, such as energy, and to certain countries, especially the richer ones, such as those in Southern Africa, and those with deeper capital markets, such as those in North Africa.

African development banks, in combination with other actors, can increasingly finance infrastructure by leveraging private resources. The development banks must be large enough and enabled to fund infrastructure investment, and the financial markets must be relatively well developed and deep. Institutional investors (pension funds and insurance companies) must be large and regulated so they can invest a portion of their assets in infrastructure. Funding in local currency can avoid currency exchange risks and other fiscal imbalances.

Deepening capital markets and increasing the scale of development banks is an absolute requirement for mainly using domestic resources to increase private finance and investment in African countries' infrastructure. Smaller economies, of which Africa has many, could create or deepen and enlarge regional institutions such as development banks, institutional investors and capital markets.

# FINTECH IS INCREASING PRIVATE SECTOR FINANCING WITH VARIED FINANCIAL SERVICES AND PRODUCTS

In Africa, the use of Financial Technologies (FinTech) is reducing costs, reducing risk and extending service to unbanked populations. Innovations include paperless banking and insurance services, disruptors such as non-bank institutions and mobile network operators, and financial exchange platforms (blockchain) and models such as branchless distribution, mobile banking, big data credit scoring and machine-to-machine lending. Africinvest expects the global fintech revolution to triple access to financial services in Africa, creating a new market of 350 million customers. Telecommunication companies also provide mobile money services in several African countries, including Ghana, Kenya, Rwanda, South Africa and the United Republic of Tanzania. Africa accounts for about 45 per cent of mobile money transactions in the world, estimated at \$26.8 billion in 2019.

The spread of the COVID-19 global pandemic is expected to expand the use of fintech, including mobile money. Globally, the spread of COVID-19 and related government lockdowns have led to a 24-32 per cent increase in daily downloads of mobile finance applications in 74 countries sampled. So, fintech can provide alternatives and revolutionize how companies access finance, increasing activity during COVID-19.

Africa can deepen and broaden financial markets by supporting the digital payment systems and platforms that underlie electronic payments and transfers through two important continental integration initiatives: the Digital Transformation Strategy and the AfCFTA. The initiatives promise to streamline policies and regulations on critical aspects of digital payment systems and platforms and to further open markets to e-commerce, the reason for digital electronic payments and transfers, across Africa.

# POLICYMAKERS MUST CONTINUE TO IMPROVE THE REGULATION OF THE FINANCIAL SERVICE SECTOR, INCLUDING BASEL III, AND SUPPORT INNOVATIVE FINANCING IN THE PRIVATE SECTOR

Although innovative finance receives a lot of attention in this report, the banking sector remains the most important source of capital for loans and funding to the private sector in most African countries. So, the banking sector remains the most important intermediary of African household savings, to which Africa's private sector needs access. African coun-

**“So, the banking sector remains the most important intermediary of African household savings, to which Africa's private sector needs access”**

tries need to regulate their bank sector to limit the possible harm from banking crises or from more general system-wide misallocation of resources. For the sake of private sector development, the regulation of banks and other sources of capital for funding private industry, for example equity and debt capital markets and digital platforms, needs to be strengthened and rendered more transparent.

The development of well-functioning financial systems requires not only sound regulations but also supervisory mechanisms for banking, capital markets and other financial services. In African countries, central banks are at the heart of regulation for the financial services sector. Most are mandated to provide the regulatory framework for economic transactions and monetary policy, helping to channel public and private savings into growth-promoting investment.

Most African countries were resilient to the financial crisis, mainly because their linkages with global banks and investment services were limited. But the policymakers must continue to improve the regulation of the financial service sector and support innovative financing in the private sector. The current debate on adopting the Basel III guidelines for financial regulation gives African countries a chance to decide whether those guidelines fit the supervision and oversight of the financial sector across Africa and to ask how they could be modified to work for Africa.

The report recommends that public policymakers (including central banks) consider amending banking and financial services legislation to enable innovative private sector funding. The process could lead to lobbying, opening for debate a range of banking and financial service issues, including the Basel III financial regulation guidelines. Like Basel I and II, the Basel III guidelines have been driven by the OECD countries, with input from larger emerging markets such as India and China but little input from smaller emerging economies with underdeveloped capital markets, many of which are in Africa.

African institutions such as the Association of African Central Banks and UN Economic Commission for Africa should review existing financial regulatory policies in Africa further, identifying what works best in each subregion and country, given the different stages of capital market development across the continent. Possibilities include digital platform regulation, macroprudential tools for managing risks associated with commodity booms and strengthened regulation to enable capital markets to be more effective in resource allocation.

At the time of writing this report, the end of the COVID-19 pandemic is uncertain, but African governments must explore the full range of policy measures to stabilize the financial

system and enable continued funding of the private sector. To do so, critical activities include continuing to increase African government capacity, strengthen financial sector resilience and support all financial innovations that could mitigate the impact of the global pandemic on African economies.

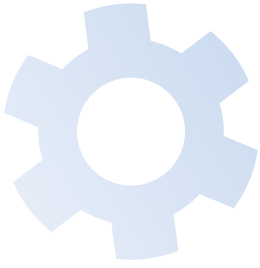
The unavailability of detailed and comparable micro level data for firms and financial institutions for many African countries limited the analysis in this report. The availability of data has steadily improved since a decade ago, but Africa greatly needs greater attention to data gaps and data inaccessibility at both the micro and macro levels to promote more detailed analysis of African countries, businesses and financial institutions.

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