

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.

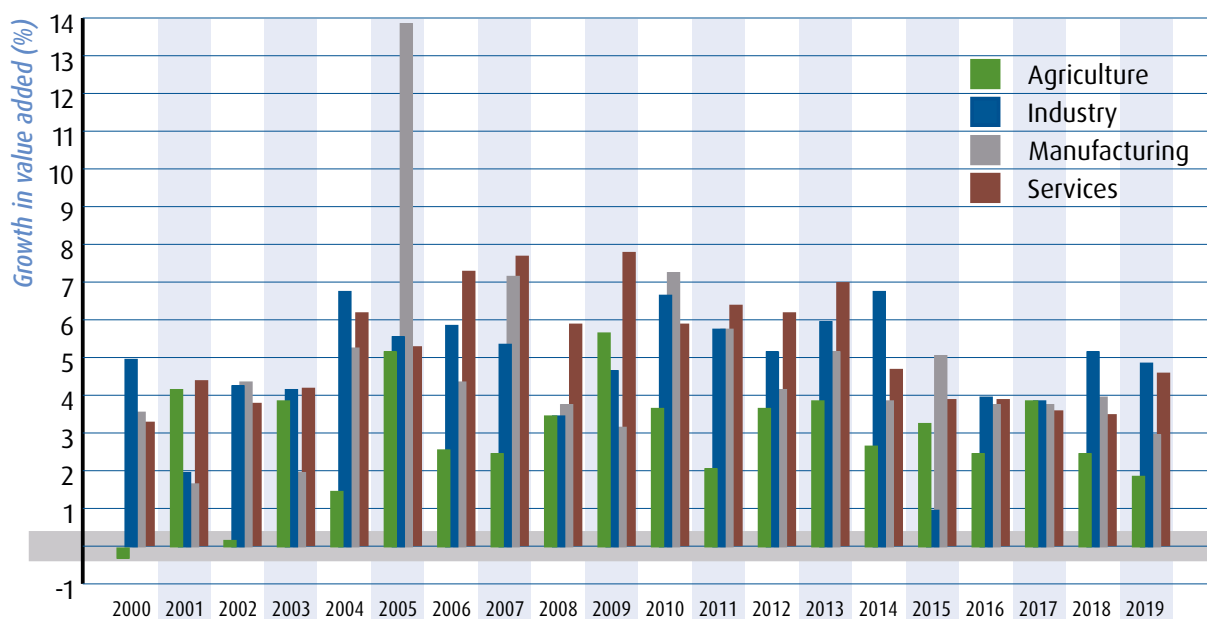
Although under the Maputo Declaration of 2003 African governments committed to allocating 10 per cent of their national budgets to agricultural development, few have done so (OSAA, 2017). The financial sector (mainly through bank loans) accounts for about 3 per cent of investments in the agricultural 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.

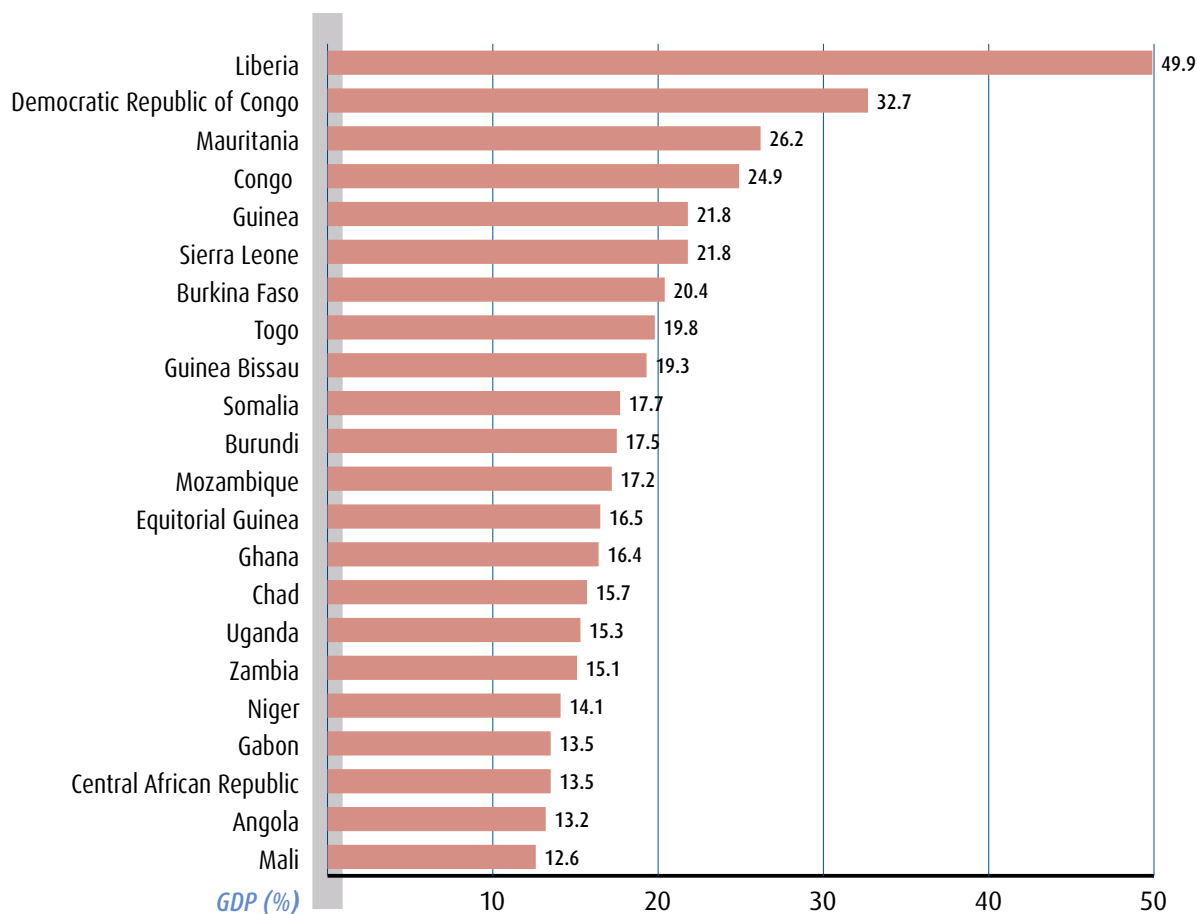
The development of Australia's natural resources was based on four key drivers: rents and taxes, beneficiation, upstream and cross linkages, and innovation and skills. Australia stands out for its policy innovations promoting cross-linkages with other economic sectors and for establishing itself

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.

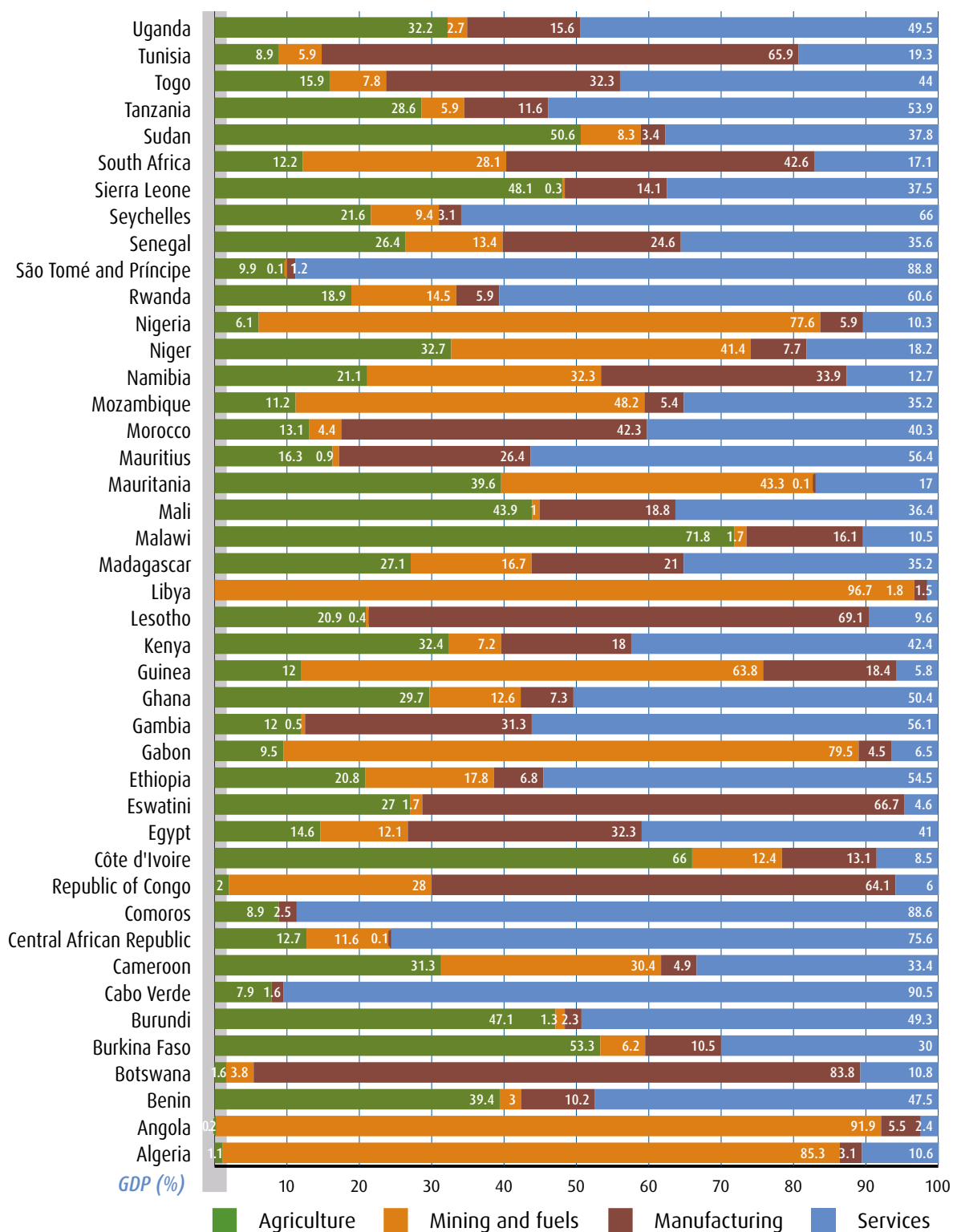
### LOGISTICS INDUSTRY

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

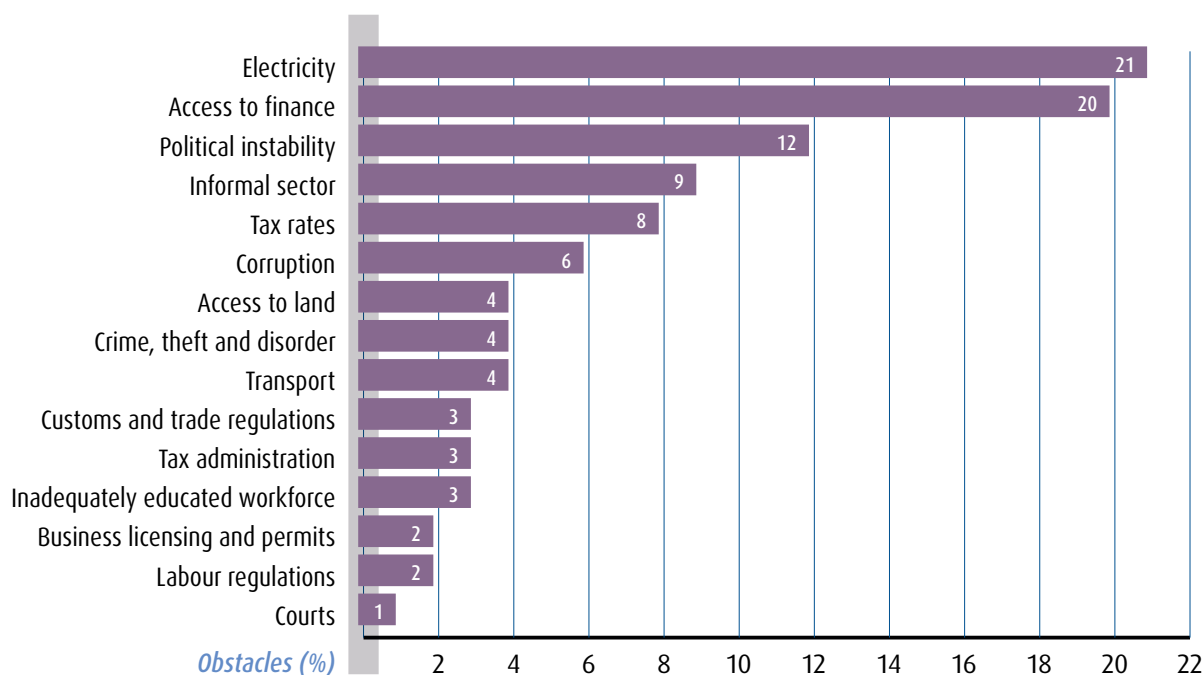
Transport is a catalyst for sustainable economic development and growth. Some 3.6 per cent of firms in Africa identified transport as the main obstacle to business (see **FIGURE 2.4**). Poor road, rail and port infrastructure increase cost, transit times and breakage or spoilage. Road freight tariffs 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](#)).

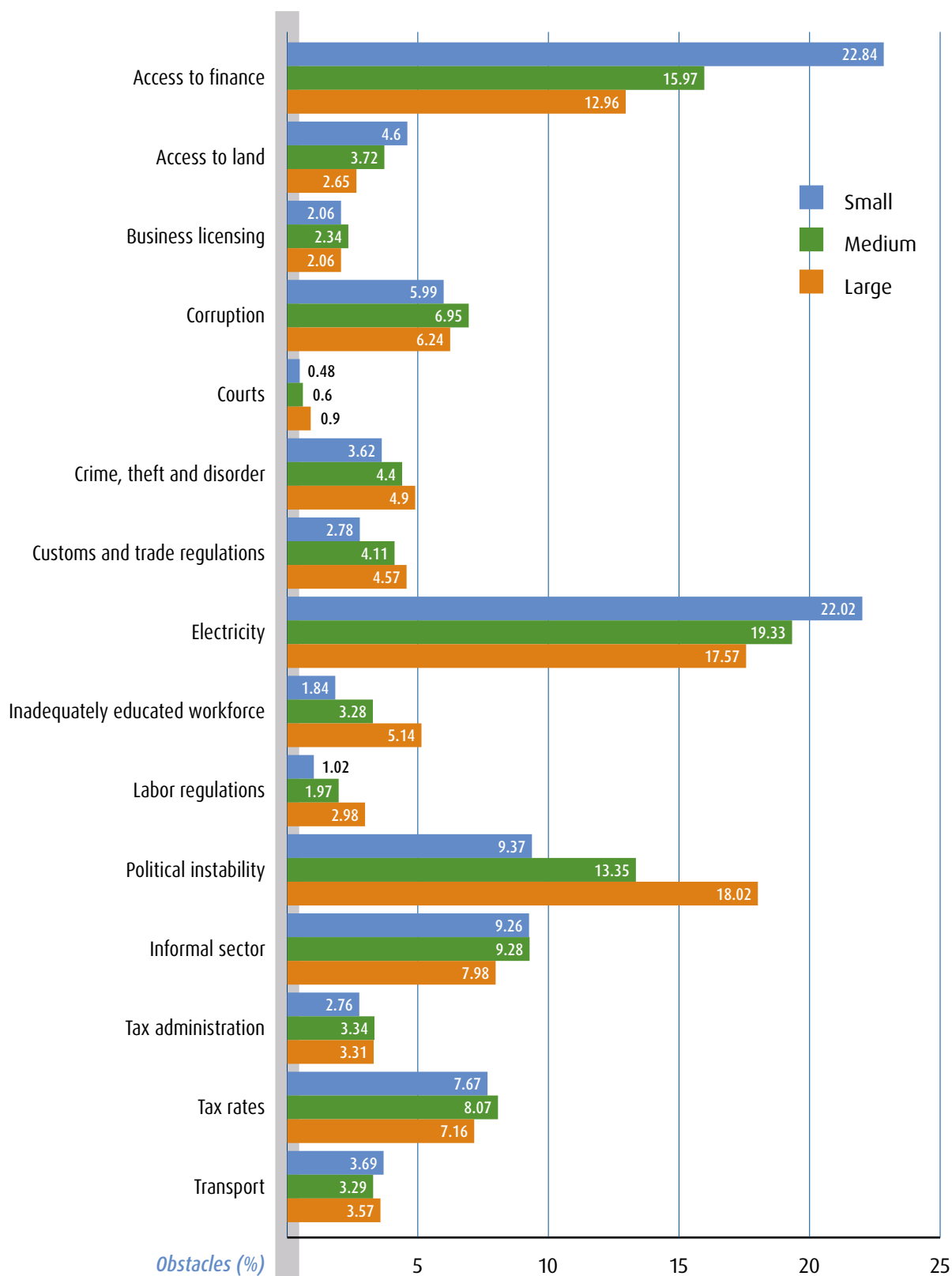
Almost 78 per cent of the working capital of small firms is financed from retained earnings or internal funds (World Bank Enterprise Survey, 2019). That proportion drops to 73 per cent for medium-sized firms and 70 per cent for large ones. Only 5 per cent of the working capital of small firms is financed 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.

