INNOVATIVE FINANCE FOR PRIVATE SECTOR DEVELOPMENT IN AFRICA

HIGHLIGHTS FOR ACADEMIA/THINK TANKS

ECONOMIC REPORT ON AFRICA 2020

United Nations
Economic Commission for Africa

CHAPTER 1: RECENT ECONOMIC AND SOCIAL DEVELOPMENTS IN AFRICA

RECENT NUMBERS:

- Africa is the second fastest growing region in the world, estimated to have grown 3.4% in 2019
- COVID-19 pandemic will impact growth to decelerate to between 1.8% and -4.1% in 2020
- Growth in Africa is projected to rebound to 5% in 2021, supported by the effective implementation of COVID-19 response measures and global economic recovery.
- Refer to Figure 1.1 for data on Global Economic Growth.

COVID-19: The impact of the pandemic 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 (p.11). Moreover, in a best-case scenario, $44 billion would be required across Africa for testing, personal protective equipment and treatment of COVID-19 patients requiring hospitalization and intensive care treatment (p.20). Due to the resources being redirected to COVID-19, Africa's existing health challenges will face spillover costs, as happened in the Ebola crisis. Thus, non-COVID-19 health issues should be kept in view (p.4).

CLIMATE CHANGE: 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. Increasing seasonal variability, 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 and fiscal imbalances (p. 5).

FINANCING: 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 (p. 8).

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), (p.20).

Bank financing to the private sector remains low, and usually does not fit the needs of the private sector since about 60% is short-term (with a tenor of less than one year), (p.14).

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 (p.28).

SMALL AND MEDIUM ENTERPRISES (SMES): 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% faster than non-exporting SMEs. (p.29)

AGRICULTURE: The financial sector (mainly through bank loans) accounts for about 3% 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. (p.31)

INNOVATIVE FINANCING: Moreover, these [innovative financial] 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. (p.31)

EXTRACTION: 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. (p.32)

MANUFACTURING: 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. (p.35)

SERVICES: 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. (p.38)

FINANCING: The sources of finance can constrain firms. Even if 40 % of large firms have access to credit, 60% of the credit is short-term—that is, with a term of less than one year. (...) Short-term credit is not suitable for infrastructure projects, which require long-term financing. Unless the infrastructure gap can be overcome, firms' financing alone may be insufficient to develop businesses. (p.43)

CHAPTER 3: ACCESSING FINANCING FROM THE CORPORATE BANKING SECTOR IN AFRICA

Most financing mechanisms in Africa are bank-based, and banks are a major source of innovative financing in Africa.

ACCESS TO FINANCING: Access to financing: Large firms tend to benefit more from bank financing than SMEs do, 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. (p.59)

INCLUSION: 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. (p.62)

RISKS: 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. (...) 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. (p.65)

AGRICULTURAL SECTOR: 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 % of bank loan portfolios. To encourage banks to lend to farmers, some governments provide credit guarantees through agricultural development banks or microfinance institutions. (p.67)

MANUFACTURING AND SERVICE: 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 small and medium enterprises (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 (p.68)

POTENTIAL: The SME financing gap remains and unleashing the potential of the private sector to contribute to sustainable development requires strengthening the supporting structures for financial development. (p.70)

CHAPTER 4: TAPPING INTO THE POTENTIAL OF AFRICAN MARKETS

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EQUITY MARKETS: in addition to capital markets, private investments, crowdfunding platforms and other alternative methods of financing are gaining momentum. Currently, Africa represents less than 1% of worldwide private equity markets, but this can be expected to change given the increasing interest of private equity funds in the continent. (p.74)

OBSTACLES FOR STOCK MARKETS IN AFRICA: high transaction costs and fees, lengthy listing procedures, binding and difficult listing conditions, lack of knowledge about stock markets and, in some exchanges, lack of transparency (p.77). In many developing markets around the world, transaction costs are below 1% of the value of the trade, but African exchanges usually charge well over that. (p.76)

INITIAL PUBLIC OFFERING (IPO): With more than 1,200 public offerings completed in 2019, the African IPO market represented 1.4% 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 (p.79). Refer to Figure 4.2: Initial public offerings by selected African exchanges, 2014-2019, p.78.

SOVEREIGN AND CORPORATE BONDS: Although the debt market in Africa is dominated by the sovereign bond market, which accounted for more than 80% of all issuances in 2019, a corporate bond market is timidly emerging, with South African companies accounting for more than 40% of corporate bond issuances in 2019. (p.81)

AGRICULTURAL 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, such as corruption, bureaucracy, weak logistics, inadequate infrastructure and limited value addition. (p.89)

FINANCIAL PRODUCTS: 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. (p.94)

CHAPTER 5: LONG-TERM FINANCING FOR SUSTAINABLE DEVELOPMENT IN AFRICA

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% over 2015–2030.

FINANCING GAPS: 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. (p.98)

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. (p.103)

DOMESTIC FRAMEWORKS: Regulatory and governance frameworks for green, social and sustainability bonds are critical to developing the market. Several African governments have recognized this and have introduced green bond governance frameworks, including independent certification and monitoring of proceeds, that align with international best practice. (p.104)

PUBLIC-PRIVATE PARTNERSHIP (PPPS): Only a few African countries have embarked on PPPs to tap private capital for fi¬nancing infrastructure. Kenya, Nigeria, Uganda and South Africa account for almost 50%. (...) African countries could also learn from other emerging countries that have unlocked flows of private capital into PPPs, including India, China and Brazil. (p.109)

DEVELOPMENT BANKS: 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 (p.110). 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. African national development banks have considerable scope for expanding their scale, which would let them contribute more to financing infrastructure. Refer to the case study “Development bank of Southern Africa operations in South Africa (p.111)

CHAPTER 6: LEVERAGING GLOBAL INNOVATIONS IN FINANCIAL TECHNOLOGY IN AFRICA

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.

MOBILE MONEY: 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. (p.125)

INCLUSION: 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. (p.127)

SMES: Fintech has the potential to overcome some of the financial constraints faced by Small and Medium Enterprises (SMEs) as a consequence of the complexity of SME financing. (...) Fintech, including data analytics, is closing the financing gap in the SME sector through innovation in credit appraisal, underwriting, origination and servicing (p.131).

FINANCIAL INCLUSION: 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. (p.132)

FRAUD CONTROL: 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. (p.121)

CHAPTER 7: REGULATIONS TO SUPPORT FINANCING

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.

FINANCIAL REGULATION AND INCLUSION: 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). (p.136 and p.142)

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. Read more about that on p. 137.

MACROPRUDENTIAL REGULATIONS: By emphasizing collective behaviour, they can tighten the link between prudential regulation and development policy. (...) Macroprudential policy can boost economic growth to enhance the financial sector's contribution to a country's development. (p.139)

REGULATORY CHALLENGES: 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. (p.143)

RISKS: 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. (p.146)

MACROPRUDENTIAL MEASURES: 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, p.147.

CHAPTER 8: CONCLUSIONS AND POLICY RECOMMENDATIONS

This chapter summarizes the key aspects of innovative financing for the development of the private sector in Africa. Five elements are key (refer to Figure 8.1)

1 - **Financing innovations can arise from multiple sources simultaneously.** Businesses need to consider leveraging different sources according to their financing needs (banks, fintech, financial markets, capital markets, development banks)

2- **A transparent and effective regulatory institution** is mandatory to minimize risk and oversee the financial operations of firms and peer institutions.

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

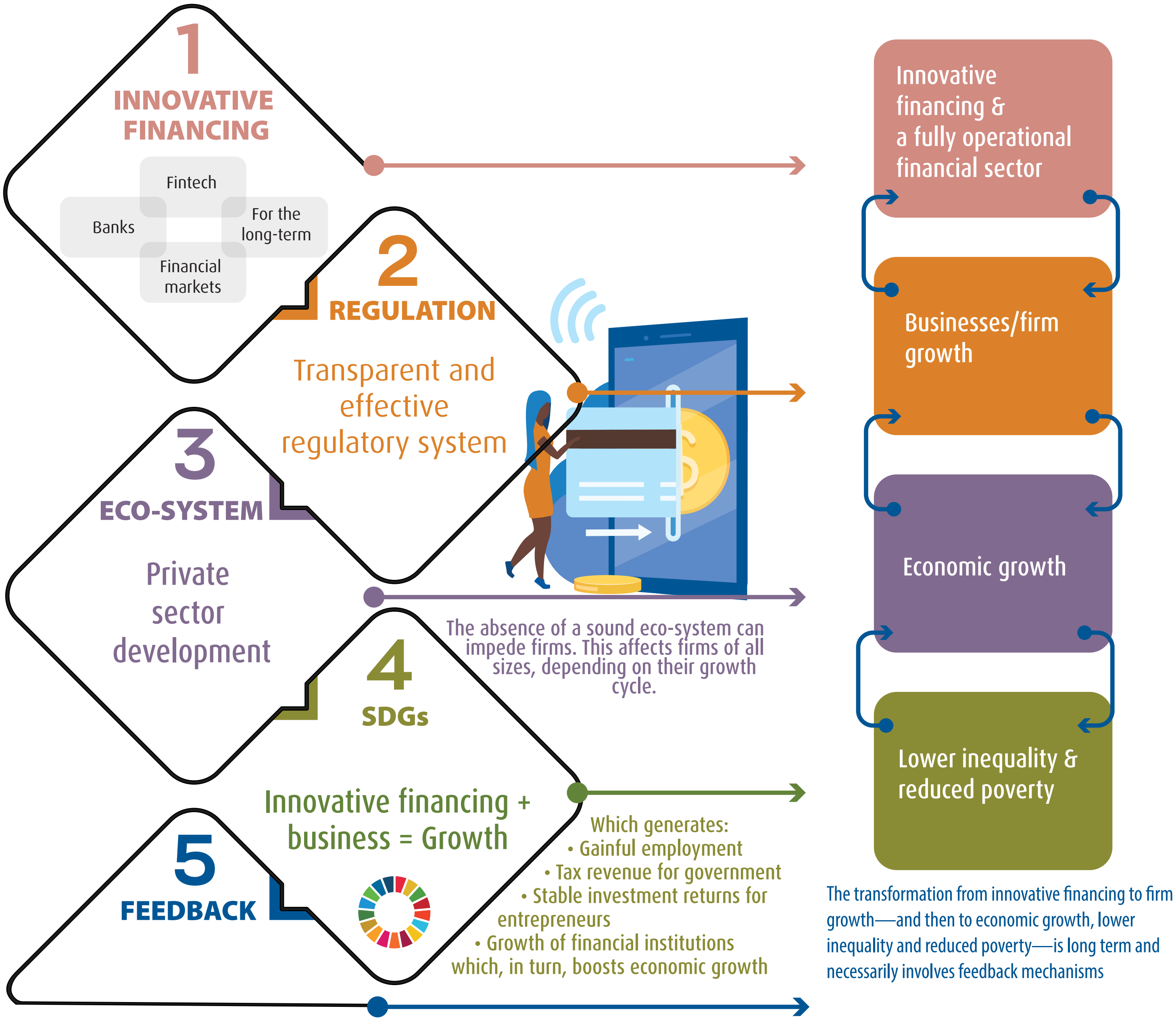
4- **Innovative financing** of the private sector and business growth **generates**: firm value added, gainful employment, tax revenue for government, stable investment returns for entrepreneurs, growth of financial institutions.

5- 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**.

INNOVATIVE FINANCING: 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. (p.155) Addressing the huge financing gaps will require more innovative financing solutions in retail and corporate banking, plus robust legal, institutional and regulatory frameworks to unlock bank credit to Small and Medium Enterprises (p.160).

REGULATION: 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. (p.164)

PRIVATE SECTOR DEVELOPMENT AND SDGS



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