INNOVATIVE FINANCE FOR PRIVATE SECTOR DEVELOPMENT IN AFRICA

HIGHLIGHTS FOR POLICY MAKERS

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: Africa depends on imported medicinal and pharmaceutical products. In 2020, spending on health will increase as governments set aside funds to sustain their health systems and absorb costs related to the COVID-19 lockdowns. In a best-case scenario, $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).

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, reduced demand due to COVID-19 has depressed the prices of agricultural commodities such as coffee, tea and cocoa, which is expected to affect vulnerable small-scale farmers in Africa (p.11).

INVESTMENT: Investment is key to build infrastructure and foster innovation. Despite Africa's growth, many economies remain unsophisticated or undiversified (Figure 1.5), due to low levels of innovation, limited productive capabilities, low investment and poor quality of education. Building capabilities will require investments in human and physical capital (p.8).

FINANCING GAP: A new estimate suggests a financing gap of $2.5 trillion for all emerging and developing countries and $200 billion–$1.3 trillion for Africa. Because Africa's population is expected to grow by 43% over 2015–2030, the gap could reach $19.5 trillion by 2030 (p.20). Check out "THE ROLE OF FINANCIAL REGULATION" on p.21.

CLIMATE CHANGE: 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. For instance, cyclone Idai, which hit Mozambique in March–April 2019, weakened the economy, took 1,000 lives and caused $700 million–$1 billion in damage (p.5).

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 (...). (p.28).

FINANCING INNOVATIONS by banks and non-bank financial institutions, including financial technology (fintech) firms, are needed to respond to private sector financing challenges (p.29).

AGRICULTURE: The agricultural sector in Africa accounts for 20–40% of the continent's GDP. Africa is still at the first stage of mechanization (p.30) (...) Agriculture-based African countries should prioritize mechanization to double agricultural productivity and eliminate hunger and malnutrition in Africa by 2025. This 21st-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. (p.30) (...) Although under the Maputo Declaration of 2003 African governments committed to allocating 10% of their national budgets to agricultural development, few have done so. (p.31)

EXTRACTION: Geological databases at the national geological surveys are inadequate since Africa has not fully been geologically surveyed at an appropriate scale. Basic geological information, particularly in digital format, is essential to attract investments in exploration. Refer to the case study "Mining value addition in Australia". (p.32)

INDUSTRIALIZATION: Fast growth in Africa's labour force and widespread poverty make job creation in high-productivity sectors a top priority. Transforming African economies through industrialization will be key to economy-wide productivity improvements, job creation and sustained progress in growth and poverty reduction. (p.35) (...) 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. (p.35)

THE ENERGY CHALLENGE: The high cost and unreliability of electricity in Africa debilitates private sector development in several ways. (...) Energy demand in Africa is expected to increase dramatically due to population growth, a growing middle class, urbanization and climate change. Such challenge can be overcome, since the continent has sufficient resources and limitless opportunities to develop clean or renewable energy. (p.39)

ECA recently developed a methodology 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 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. (p.39 - 40)

GOVERNANCE: 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. (p.41).

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.

ASSETS: The retail and corporate banking sector in Africa holds more than 90% of the assets in the financial sector, but it is comparatively underdeveloped when benchmarked against those in emerging market economies in Asia and other industrializing countries. (p.58)

GROWTH: Though still small, the African banking sector is one of the fastest growing and most profitable in the world (FIGURE 3.2), making it one of the key sectors propelling economic growth on the continent. (p.61)

INCLUSION: Although financial inclusion is low in Africa (35% in 2017), the bancarization rate, defined as the proportion of the population that uses banking services, is projected to rise to 48% in 2022, with more than 450 million banked Africans - see FIGURE 3.3. (p.63)

FINANCIAL LANDSCAPE: During the past 20 years, the African financial sector has changed dramatically. The financial liberalization policies of the early 1990s greatly increased cross-border financial flows, which became an important component of the African financial landscape p.63 (see FIGURE 3.4, see page 64).

RISKS: As financial markets open, risks of contagion and the transmission of financial instability increase, requiring prudential regulation and other preventive measures to avoid or mitigate financial crises. (...) Striking a healthy balance between safeguarding the economy from financial contagion and allowing financial institutions to conduct their business will depend on a careful weighing of macroprudential measures and an arm's length approach to financial service trade transactions. (p.65)

AGRICULTURE: Increasingly, African countries are developing and adopting innovative financing mechanisms to support the Agricultural sector (read more on p. 67). Traditional banks may not be able to close the financing gap in the agricultural sector alone but may need to coordinate with the public sector, as in the European Union. (p.68)

GOVERNANCE: From a policy perspective, a regulatory framework that strikes an optimum balance between ensuring financial stability and offering innovative financing schemes for all is key to developing a strong and robust private sector and ultimately to accelerating economic development. (p.70)

INVESTMENT: Investment is key to build infrastructure and foster innovation. Despite Africa's growth, many economies remain unsophisticated or undiversified (Figure 1.5), due to low levels of innovation, limited productive capabilities, low investment and poor quality of education. Building capabilities will require investments in human and physical capital (p.8).

A new estimate suggests a financing gap of $2.5 trillion for all emerging and developing countries and $200 billion–$1.3 trillion for Africa. Because Africa's population is expected to grow by 43% over 2015–2030, the gap could reach $19.5 trillion by 2030 (p.20). Check out "THE ROLE OF FINANCIAL REGULATION" on p.21.

CHAPTER 4: TAPPING INTO THE POTENTIAL OF AFRICAN MARKETS

In other parts of the world, financial markets complement bank finance as another source of financing to the private sector, but in Africa they are small and underveloped, largely dominated by commercial banks.

CHALLENGES: The underdevelopment of African financial systems constricts credit for firms and produces low investment rates. (...) The low level of credit in Africa shows the limited services financial institutions provide the private sector. (p.74)

STOCK MARKETS: They allow domestic firms to raise funds in developed economies and mobilize domestic savings by offering a variety of instruments for investors to diversify their savings. In developing and emerging economies, two constraints of stock exchanges are the limited diversity of financial instruments and the limited number of listed stocks. (p.75)

OBSTACLES FOR STOCK MARKETS: 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)

BOND MARKETS: There is a growing local currency bond market in Africa with increased appetite among local investors. Local currency bonds make up 78% of outstanding debt in Africa (including government and corporate bonds). In South Africa, the biggest bond market on the continent, local investors hold 62% of government bonds (p.81).

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.

INVESTMENT GAPS: A central challenge for Africa to meet the SDGs and achieve sustainable and inclusive development is to mobilize the investment needed in key sectors such as health, energy, transport, construction, agriculture, education and manufacturing (p.98). The continent's infrastructure needs amount to $130-$170 billion a year until 2025, with a yearly financing gap of $67.6-$107.5 billion. Refer to p.106 for more information.

CLIMATE CHANGE: An estimated $18-$30 billion a year will be needed over the next two decades for climate action and climate change adaptation in Africa, with nearly $1 trillion worth of investments and projects ready to be financed (p.98).

GREEN BOND MARKET: Sovereign ssuers are typically financing the greening of public infrastructure, including energy, water and transport, including major emerging economies such as Brazil, China and India, as well as smaller countries such as Fiji, Seychelles and Thailand. (p.101). The African green bond market emerged in 2010 - South Africa and the African Development Bank (AfDB) took the lead, followed by Morocco, Nigeria and Seychelles. Refer to "Box 5.1 - Examples of green bonds programmes in Africa", on p.102.

SUSTAINABILITY FINANCING: Private non-foreign direct investment cross-border capital flows to Africa being dominated by high risk-high return investors, such as private equity funds, and investors with a longer-term investment horizon, such as sovereign wealth funds or non-traditional bilateral investors (for instance, China), (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): In Africa, as in many other developing countries, the infrastructure sector does not attract much private investment and funding. Private financing accounted for only 11% of infrastructure funding in Africa in 2018 (p.107). Check out "figure 5.3 - Infrastructure investment by international lenders and donors, national governments and the private sector in Africa" on p.108. 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%. (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)

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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.

DIGITAL PAYMENTS: The biggest component of fintech transactions In Africa, with mobile money transactions accounting for close to 10% of GDP, compared with 7% in Asia and less than 2% in other regions. Africa accounts for more than 60% per cent of mobile money transactions in the world—more than $450 billion in 2019 (p.121).

MOBILE FINANCE: With the spread of COVID-19 and its impact on economies, the use of fintech, including mobile money, is expected to increase even more. For instance, one study estimated that the spread of COVID-19 and related government lockdowns have led to a 24–32% increase in the relative rate of daily downloads of mobile finance applications in 74 sampled countries around the world (p.121).

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)

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)

CROWDFUNDING: Africa accounts for less than 1% of global crowdfunding activities and reasons for that include low internet penetration rates, high internet service cost and weak regulations and standards (p.123).

CHAPTER 7: REGULATIONS TO SUPPORT FINANCING IN AFRICA

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.

CRISIS PREVENTION : African countries need to regulate their bank sector to limit the possible harm from banking crises or from more general system-wide misallocation of resources. For the sake of private sector development, the regulation of banks and other sources of capital for funding private industry—such as equity and debt capital markets and digital platforms— needs to be strengthened. (p.136)

CONFIDENCE FOR BUSINESSES: Appropriate, effective and enabling regulatory frameworks for all financial intermediaries operating in Africa will give confidence to a new breed of fit and proper entrepreneurs. The frameworks will introduce new financial service platforms and innovative products, whose competitive arena will become more transparent and will open up to new players. (p.137).

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.

MARKET REGULATORS: African countries also need sound and appropriate regulatory environments and frameworks to enable the development of stable and resilient capital markets. All countries with established securities markets or stock exchanges have appropriate rules, regulations and regulatory bodies. (p.140)

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)

COVID-19 CRISIS: Some African countries have limited fiscal space and international reserves and thus lack the necessary resources to implement COVID-19 responses (p.149) (...) According to IMF data, African countries will record fiscal deficits averaging 5.8% in 2020 and 4.4% in 2021, compared with 3% in 2019. (...) However, African policymakers' and regulators' experience with the 2008–2009 financial crisis and use of various measures to cushion its impact give them an advantage in rapidly responding to the COVID-19 crisis (p.151).

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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 messages 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.

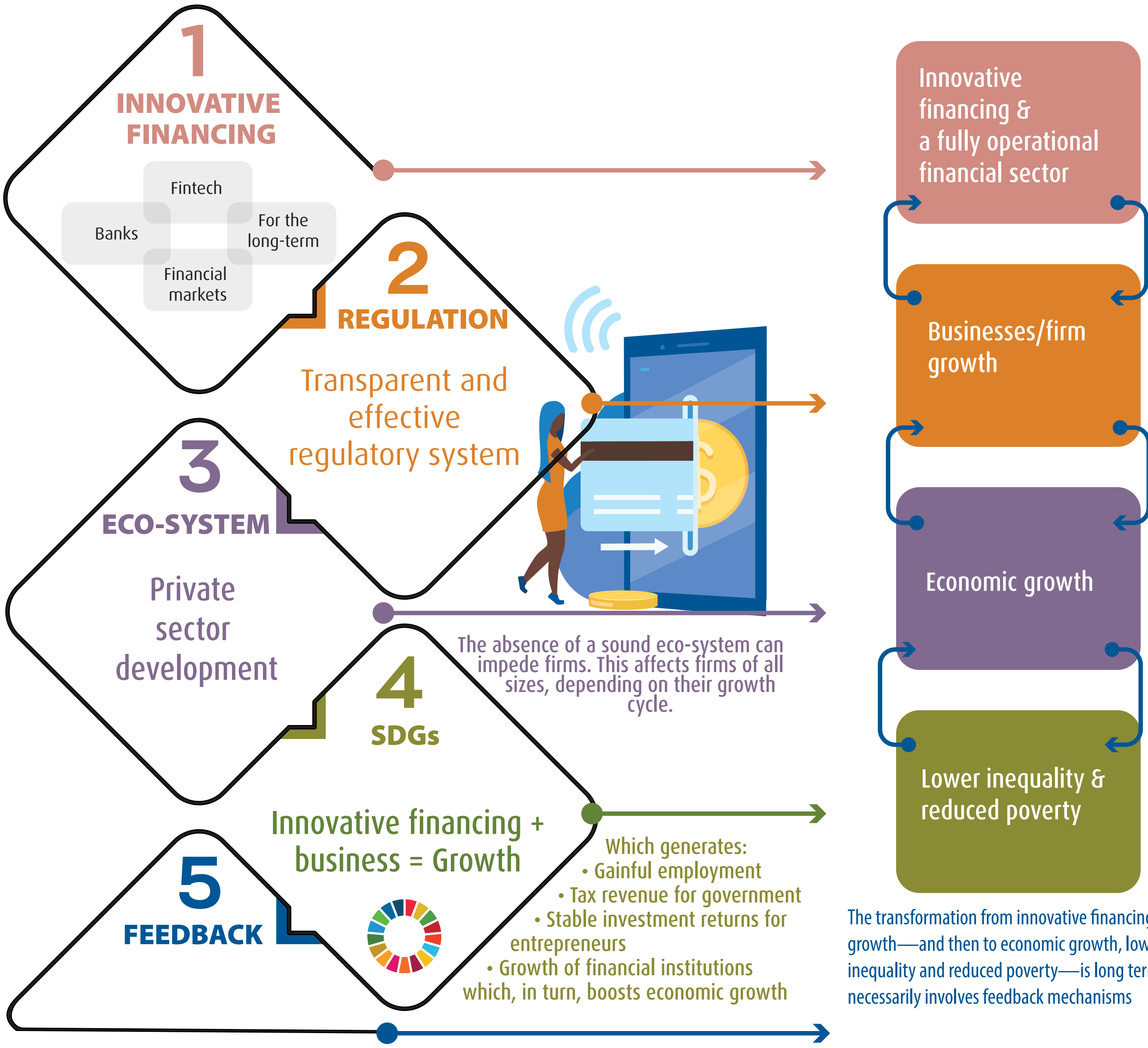
4. Innovative financing of the private sector and business growth generates: firm value added, gainful employment, tax revenue for government, stable investment returns for entrepreneurs, growth of financial institutions.

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.

COVID-19 CRISIS: To enable economic recovery and reasonable SDG progress, African economies should fully explore innovative financing for the private sector and enhance the eco-system for private sector development. Efforts should include raising investment to 35–40% of GDP, enhancing competitiveness and supporting regional integration. A key strategy is the African Continental Free Trade Area (AfCFTA), signed by 54 African countries - see Figure 8.2 on p.157 and read more on p.158.

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



The transformation from innovative financing to firm growth—and then to economic growth, lower inequality and reduced poverty—is long term and necessarily involves feedback mechanisms

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