CHAPTER 8

CONCLUSIONS AND POLICY RECOMMENDATIONS

The private sector is the engine of economic growth and sustainable development in Africa. But most African private businesses are small, and the sector has few firms in the medium and large categories—the “missing middle” and “missing large.” Mainly due to financial constraints, small and medium enterprises (SMEs) in Africa struggle to survive and grow into large firms, with most collapsing within the first three years—the “valley of death.”

Even so, SMEs are the backbone of African economies, mainly because they represent about 90 per cent of private businesses and account for more than 60 per cent of employment in most countries. The number of large firms listed on national and regional capital markets is limited. A productivity gap between SMEs and large firms is common, explained by the low-value-added and labour-intensive sectors in which SMEs mostly operate, their limited use of technology and their low participation in foreign markets. The exceptions are SMEs that export or operate internationally, which are more productive, contribute more to higher-paying jobs (especially in low-wage segments of the economy) and grow 4 per cent faster than non-exporting SMEs.

The lack of access to finance, especially for SMEs, is among the main impediments to private sector development in Africa. This report focuses on innovative finance. It examines innovative financial instruments, practices and policies to underpin a step-change in growing the gamut of businesses from start-ups to micro and small enterprises, social enterprises, professional businesses (such as lawyers and doctors), exchange-listed corporates and public-private companies—all of which will drive inclusive economic growth, create jobs and lead to better livelihoods. The report’s timing fits this digital age, when some African countries are already embarking on the financial technology (fintech) revolution to pave a bright new path for the unbanked population, while uncertainty hangs over the continent due to the COVID-19 global pandemic and associated lockdowns.

As the report points out, the financial services sector is still dominated by commercial banks. It features rudimentary forms of non-bank financial institutions (such as insurance firms and housing finance houses) and nascent capital markets (which do not provide the full mix of equity, company bonds and government bonds). It lacks tailored financing mechanisms for start-ups and young enterprises (such as venture capital) and for company restructuring (such as leveraged buyouts).

> "The lack of access to finance, . . . , is among the main impediments to private sector development in Africa"

The recent growth of fintech start-ups in such countries as Ghana, Kenya and Tunisia is impressive. And microfinance institutions have paved the way of providing both financing and training to small enable firms to escape the valley of death in their first three years.

Even so, the financial system in Africa needs faster diversification. A full range of financial institutions should offer innovative financial products tailored to the specific needs of the business eco-system—such as start-ups, marketing, transportation and payment collection.

African countries have increasingly ventured into innovative sources of finance, such as issuing sovereign bonds (in foreign currencies like Eurobonds) and green bonds, though in some circles these practices have ignited discussions about debt sustainability. Africa continues to deepen its financial markets and build its financial institutions for long-term economic growth. For instance, despite concerns over debt sustainability, 11 countries had issued bonds, whose total value rose from about $1 billion at the end of 2011 to $11.2 billion by the end of 2019.

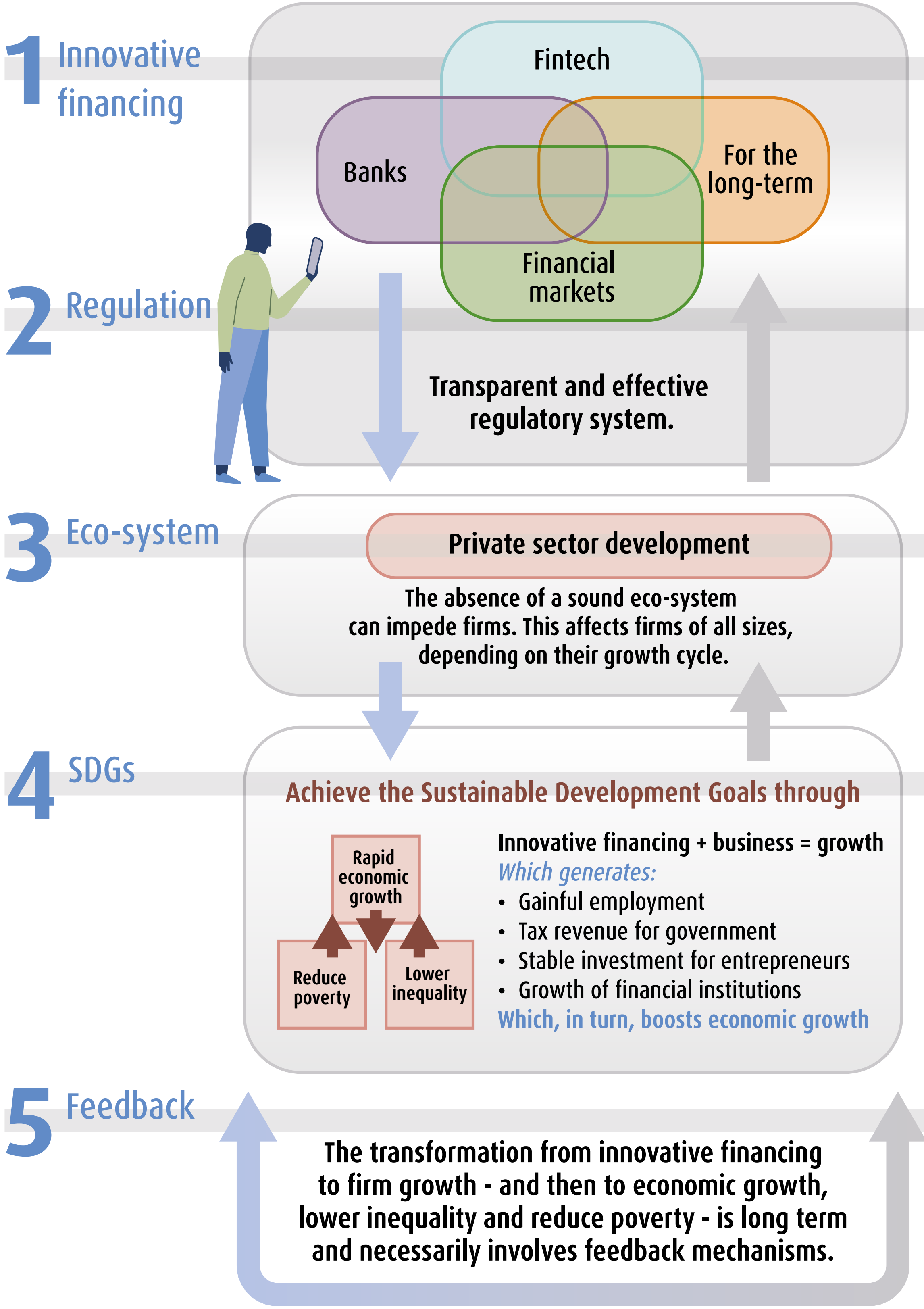
The report builds on earlier foundations showing a strategic role for finance in inclusive development. The Third International Conference on Financing for Development (2015) identified finance as a key means of implementing the United Nations 2030 Agenda for Sustainable Development and the African Union's Agenda 2063. The Addis Ababa Action Agenda (AAAA), endorsed by the Third International Conference, offers African countries an opportunity to articulate the continent's priorities for development finance. It makes specific recommendations on commitments by member states and partner institutions for financing a transformation of African economies to create inclusive growth, decent jobs and economic opportunities for all. Further, the Addis Ababa Action Plan on Transformative Financing for Gender Equality and Women's Empowerment, also endorsed by the Third International Conference, outlines expanding government fiscal space to address the economic and financial gender gap and all types of inequality between women and men in sustainable development. Other continental and global campaigns for financing development include the 2002 Monterrey Consensus on Financing for Development (FfD) and the 2008 Doha Declaration.

This report builds on these underpinnings to explore innovative finance for business sector development in Africa. And the report advances the discussion of finance beyond focusing on the flow of funds—the sources and uses of finance—to link Africa's development financing to the broader issues of structural transformation through the business sector, supported by capable, inclusive and accountable institutions at the national, regional and global levels.

A rich selection of secondary data and on primary data informs the report. Collected from more than 30 African countries, they cover firm-level details as well as institutional and policy factors in innovative financing for private sector development in Africa. This chapter summarizes the key aspects of innovative financing for the development of the private sector in Africa and presents the salient findings. The chapter proposes a policy framework for African countries (**FIGURE 8.1**). Its menu of policy options, best practices and strategic guidance supports decisionmakers and policymakers in creating and using innovative finance to support business sector development in pursuing sustainable economic development and meeting the goals of Africa's Agenda 2063.

Five messages are key. First, financing innovations can arise from multiple sources simultaneously. So, businesses need to consider leveraging the different sources according to their financing needs and can call upon a mix of financing by banks, fintech, financial markets, and long-term sources such as capital markets and development banks (as featured in the top part of **FIGURE 8.1**). The intersection of sources indicates possible leverage. Policymakers should develop all four sources. Otherwise a firm might, for instance, lack long-term finance or be unable to combine bank finance for short-term working capital with capital market bonds for long-term expansion of plant and equipment. Also, in many African countries, a firm's business financing needs change as it goes through its growth cycle. Large mature firms use capital markets to raise additional funding via initial public offerings (IPO)s, as happens in North Africa and in Côte d'Ivoire, Ghana, Kenya,

FIGURE 8.1 INNOVATIVE FINANCING FOR PRIVATE SECTOR DEVELOPMENT AND SDGS



Source: ECA.

FIGURE 8.2 THE AFRICAN CONTINENTAL FREE TRADE AREA (AFCFTA)

THE AFRICAN CONTINENTAL FREE TRADE AREA (AfCFTA)

AfCFTA aims to:

- Accelerate continental integration and increase intra-African trade
- Unlock manufacturing potential and facilitate industrialization
- Enhance competitiveness and support economic transformation

TOP 3

intra-African importers
South Africa, Ghana, Botswana

intra-African exporters
South Africa, Nigeria, Egypt

If successful, the agreement will create a single African market of over 1.2 billion consumers with a total GDP above $2.5 trillion by 2030.

Nigeria and South Africa.

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

Third, the absence of a sound eco-system can impede firms even when financing is readily available (see the middle part of **FIGURE 8.1**). This affects firms of all sizes, depending on their stage in the growth cycle. The AfCFTA aims to play an important role in enhancing the eco-system for firms and connecting local firms to regional and global value-chains (see **FIGURE 8.2**).

Fourth, innovative financing of the private sector and business growth generate firm value added, gainful employment, tax revenue for government, stable investment returns for entrepreneurs and the growth of financial institutions, which together boost economic growth. For African countries with transparent industrial policy and clear government support for firms and businesses, high economic growth will reduce poverty and inequality, especially if the government channels increased tax revenues from a booming company sector to key sectors such as health and education (see the bottom of **FIGURE 8.1**). The growth–poverty reduction–inequality reduction triangle represents both the three key targets and the mechanisms through which the 17 Sustainable Development Goals can be achieved, in contrast to the case of fragile states in Africa, which confront challenges of growth, poverty and inequality and find the SDGs unattainable.

Fifth, the transformation from innovative financing and a fully operational financial sector to firm growth and so to economic growth, lower inequality and reduced poverty is long term. It necessarily involves feedback mechanisms (indicated by the reverse arrows **FIGURE 8.1**).

AFRICA HAS A HIGH ECONOMIC GROWTH TRAJECTORY, BUT COVID-19 HAS UNLEASHED NON-TRIVIAL UNCERTAINTY

Africa is the second fastest growing region in the world, with economic growth estimated at 3.4 per cent in 2019. In 2020, mainly due to the COVID-19 global pandemic and associated lockdowns, growth is projected to fall. In a best-case scenario average growth will fall between 1.4 per cent to 1.8 per cent for the year, while in the worst-case scenario the average could decline down to -4.1 per cent. Growth on the continent is projected to rebound to 5 per cent in 2021, supported by the effective implementation of COVID-19 response measures and global economic recovery.

Exceptional times call for exceptional initiatives. To enable economic recovery and reasonable SDG progress, African economies should fully explore innovative financing for the private sector and enhance the eco-system for private sector development. Efforts should include raising investment to 35–40 per cent of GDP, enhancing competitiveness and supporting regional integration. A key strategy is the African Continental Free Trade Area (AfCFTA), enacted by a March 2018 agreement and signed by 54 African countries (see **FIGURE 8.2**). For service-based economies, the AfCFTA provides an opportunity to move from consumption-based growth to more durable sources of growth and to shift from relying on subsistence and non-tradeable services to services that generate greater value addition, productivity and growth. AfCFTA also creates opportunities for internationalization by supporting the development of regional and global value chains in which manufacturers that rely on embedded and embodied service inputs can source such inputs locally in the continental market, creating jobs, adding value and expanding their share of the global market.

Multidimensional poverty and inequality persist in Africa. There is a danger that the COVID-19 global pandemic could push 27 million Africans into extreme poverty, exacerbate existing income inequalities, especially in health and education, and ignite the first recession in Africa in 25 years with a GDP loss of $62.8 billion.

Unleashing the private sector to contribute to sustainable development requires strengthening the structures supporting financial development. For example, policies for financial innovation should support financial inclusion, thereby increasing firm and household opportunities and translating economic growth into decreased inequality and reduced poverty.

> "Unleashing the private sector to contribute to sustainable development requires strengthening the structures supporting financial development"

THE PRIVATE SECTOR IN AFRICA IS THE ENGINE OF GROWTH AND THE PATHWAY TO SUSTAINABLE DEVELOPMENT

A key message of this report: The private sector is the engine of growth in Africa. As agriculture-based economies modernize to increase productivity, farms will need finance to purchase inputs and machinery. A large proportion of Africa's manufacturing firms are small, leading to poor export performance. Manufacturing-based economies must scale up and expand their firms to catch up with other developing countries, such as those in Asia. Africa's service industry presents immense potential for growth and economic development.

Over 2020–2030, the private sector in Africa is expected to play an important role in enabling economic recovery from the COVID-19 pandemic, increasing economic prosperity and achieving the SDGs. Two main channels will make this possible. First, the private sector will generate productivity and enhance economic participation by households and businesses. That will in turn drive inclusive economic growth, providing pathways to reduced inequality in key sectors such as health and education and to employment that gradually reduces prevailing poverty levels. Second, financial sector innovations will connect savers to borrowers and manage financial uncertainty and business risk through well-functioning systems. Bank financing must meet private sector needs better than current bank offerings, in which 60 per cent of credit to the private sector is short-term—this will require readjusting existing policies and practices.

The business eco-system must be developed because infrastructure services such as transport, water, energy and information and communication technologies are important for private sector development. Although the huge deficits needed to support eco-systems hinder private sector development, infrastructure improvements also present opportunities to the private sector, including through private-public partnerships.

As highlighted throughout the report, lack of access to finance is one of the major impediments to private sector development in Africa. In this context, the recent outbreak of COVID-19 threatens the private sector in Africa and aggravates its already major challenge in finding financing. Other challenges to private sector financing include information asymmetry, many countries' lack of a credit rating, the domination of the financial service sector by commercial banks and the mismatch of financing with firms' growth cycle. The banking sector, non-bank financial institutions, financial markets and fintech providers have important roles in the required innovations for private sector financing. But governments could play a complementary role, both in supporting the growth of the business eco-systems and in guaranteeing the enabling regulatory environment for new financial innovations to benefit businesses at all stages of the entrepreneurship growth cycle.

BANKS ARE A MAJOR SOURCE OF INNOVATIVE FINANCING IN AFRICA AND THERE ARE HIGH EXPECTATIONS FOR PAN-AFRICAN BANKS

Since most financing mechanisms in Africa are bank-based, banks are potentially a major source of innovative financing for private sector development. Retail banking and corporate banking in Africa hold more than 90 per cent of financial sector assets. By expanding the breadth of financing instruments and enhancing financial inclusion, innovations in retail and corporate banking provide opportunities for savers and borrowers alike.

Africa's banking sector is underdeveloped when benchmarked against those in Asian emerging market economies and other industrializing economies. Its assets represent less than 60 per cent of GDP, compared with more than 100 per cent in other emerging and advanced economies.

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

Addressing the huge financing gaps facing the private sector and hindering infrastructure development will require more innovative financing solutions in retail and corporate banking, plus robust legal, institutional and regulatory frameworks to unlock bank credit to SMEs. The SME financing gap remains despite innovations and technological advances expanding the reach of bank lending, reducing regulatory and geographic obstacles, bringing more people and more savings into the financial system and increasing banks' ability to make loans.

The growth of pan-African banks, with hubs in Kenya, Morocco, Nigeria and South Africa, has fundamentally changed the banking sector in many African economies. Among these indigenous African banks are some with humble origins serving local SMEs, but they now conduct business in multiple countries. And significant advances in mobile banking and marketplace lending have connected unserved and underserved communities to the financial sector. The resilience and continued development of the banking sector in the face of external shocks or crises such as COVID-19 offer the promise of more progress to come so banks can provide needed funding, channel savings into investments and participate more actively in the formal economy to support private businesses.

RISING AFRICAN FINANCIAL MARKETS HAVE GREAT POTENTIAL TO FINANCE HIGH-GROWTH FIRMS

Financial markets might be expected to complement bank finance as another source of financing to the private sector. But in Africa (except South Africa) the markets are small and undeveloped, largely dominated by commercial banks and with few investment banks. As of 2020, stock exchanges exist in only 28 African countries, offering both primary issuance and trading on the secondary markets. Most remain underdeveloped, with small market capitalizations, few listed companies and less liquidity than exchanges in other emerging economies. For example, the proceeds raised from initial public offerings in Africa between 2014 and 2019 reached $27.1 billion, less than 1.4 per cent of global IPO proceeds during that period. The report notes great potential for tapping into the capital markets, which offer a gateway for investors—both retail individuals and institutional investors—to participate in the financial economy. They could provide not only an alternative to borrowing for the private sector to raise funds, but also an alternative to bank deposits for investors to save and gain returns.

Although Africa currently represents less than 1 per cent of worldwide private equity markets, growth is likely given private equity funds' increasing interest in the continent. The value of private equity fundraising in Africa increased to $2.7 billion in 2018, up 10 per cent from 2017. The total transaction value in global crowdfunding was $6.9 billion in 2019 and is expected to grow 14.7 per cent a year between 2019 and 2023, and capital raised through crowdfunding amounted to $16.5 million in 2019 and is expected to grow 11.6 per cent a year to reach $27.4 million by 2023. In addition, the African bond market is also growing, with a total value of $500 billion in 2019. The African Continental Free Trade Area (AfCFTA) provides great opportunities for African capital markets to expand by creating enlarged markets, economies of scale, increased competitiveness in regional and global value-chains and more opportunities to invest in African markets and firms. Although there is new uncertainty arising from the COVID-19 global pandemic, current developments in African financial markets promise innovative business financing and growth.

> "The African Continental Free Trade Area (AfCFTA) provides great opportunities for African capital markets to expand by creating enlarged markets, economies of scale, increased competitiveness in regional and global value-chains and more opportunities to invest in African markets and firms"

LONG-TERM FINANCING FOR SUSTAINABLE DEVELOPMENT

Africa is at a development juncture. It is amid the COVID-19 global pandemic and efforts to accelerate economic growth to meet national goals in line with the Sustainable Development Goals (SDGs), the African Union's Agenda 2063 and the climate change initiatives. Its main challenge is to mobilize the investment needed in key sectors such as health, transport, energy, construction, education, agriculture and manufacturing. Large investment gaps particularly affect sectors such as infrastructure, even while that sector has immense potential to drive economic growth. Increasing the role of the private sector in such investments is widely advocated, especially given governments' and bilateral donors' low levels of investment. In this context the availability of long-term finance becomes a top factor.

As the report indicates, development banks at the multilateral, regional and national levels can play key roles to help African economies meet infrastructure challenges. Innovations in long-term financing are crucial for the private sector to play a leading long-term role in transforming sustainable development in Africa. Three areas of recent innovations are relevant: long-term financing instruments for climate risk, such as sustainability bonds for private sector financing; innovations in public-private investment in infrastructure; and the role of development banks in long-term financing of the private sector to maximize sustainable and inclusive growth. Development banks have encouraged private investment, including in infrastructure in some African economies as well as other developing economies. Climate vulnerability increased the average cost of debt to African countries by an estimated at 0.63 per cent from 1991 to 2017. And the indirect effect through climate vulnerability's impact on firms' financial leverage, which contributed an additional 0.05 per cent, is seen in a large sample of firms from developing countries, including in Africa (Kling et al., 2021).

After taking stock of the sustainability bond market, infrastructure investment needs and the new roles of long-term capital from development banks, the report finds that Africa's participation in the global market for sustainability bonds has been muted, although that market has seen exceptional growth since 2007. This is a missed opportunity. The sustainability bond market could offer a source of incremental capital alleviating financing constraints and allowing the scarce finance available, including that from public resources, to go to other uses. Strengthening relationships with partners such as international financial institutions and global financial hubs could mitigate risks for private investors and so crowd finance into the region. At present, private finance and private investment go only to certain infrastructure subsectors, such as energy, and to certain countries, especially the richer ones, such as those in Southern Africa, and those with deeper capital markets, such as those in North Africa.

African development banks, in combination with other actors, can increasingly finance infrastructure by leveraging private resources. The development banks must be large enough and enabled to fund infrastructure investment, and the financial markets must be relatively well developed and deep. Institutional investors (pension funds and insurance companies) must be large and regulated so they can invest a portion of their assets in infrastructure. Funding in local currency can avoid currency exchange risks and other fiscal imbalances.

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

FINTECH IS INCREASING PRIVATE SECTOR FINANCING WITH VARIED FINANCIAL SERVICES AND PRODUCTS

In Africa, the use of Financial Technologies (FinTech) is reducing costs, reducing risk and extending service to unbanked populations. Innovations include paperless banking and insurance services, disruptors such as non-bank institutions and mobile network operators, and financial exchange platforms (blockchain) and models such as branchless distribution, mobile banking, big data credit scoring and machine-to-machine lending. Africinvest expects the global fintech revolution to triple access to financial services in Africa, creating a new market of 350 million customers. Telecommunication companies also provide mobile money services in several African countries, including Ghana, Kenya, Rwanda, South Africa and the United Republic of Tanzania. Africa accounts for about 45 per cent of mobile money transactions in the world, estimated at $26.8 billion in 2019.

The spread of the COVID-19 global pandemic is expected to expand the use of fintech, including mobile money. Globally, the spread of COVID-19 and related government lockdowns have led to a 24–32 per cent increase in daily downloads of mobile finance applications in 74 countries sampled. So, fintech can provide alternatives and revolutionize how companies access finance, increasing activity during COVID-19.

Africa can deepen and broaden financial markets by supporting the digital payment systems and platforms that underlie electronic payments and transfers through two important continental integration initiatives: the Digital Transformation Strategy and the AfCFTA. The initiatives promise to streamline policies and regulations on critical aspects of digital payment systems and platforms and to further open markets to e-commerce, the reason for digital electronic payments and transfers, across Africa.

POLICYMAKERS MUST CONTINUE TO IMPROVE THE REGULATION OF THE FINANCIAL SERVICE SECTOR, INCLUDING BASEL III, AND SUPPORT INNOVATIVE FINANCING IN THE PRIVATE SECTOR

Although innovative finance receives a lot of attention in this report, the banking sector remains the most important source of capital for loans and funding to the private sector in most African countries. So, the banking sector remains the most important intermediary of African household savings, to which Africa's private sector needs access. African 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, for example equity and debt capital markets and digital platforms, needs to be strengthened and rendered more transparent.

> "So, the banking sector remains the most important intermediary of African household savings, to which Africa's private sector needs access"

The development of well-functioning financial systems requires not only sound regulations but also supervisory mechanisms for banking, capital markets and other financial services. In African countries, central banks are at the heart of regulation for the financial services sector. Most are mandated to provide the regulatory framework for economic transactions and monetary policy, helping to channel public and private savings into growth-promoting investment.

Most African countries were resilient to the financial crisis, mainly because their linkages with global banks and investment services were limited. But the policymakers must continue to improve the regulation of the financial service sector and support innovative financing in the private sector. The current debate on adopting the Basel III guidelines for financial regulation gives African countries a chance to decide whether those guidelines fit the supervision and oversight of the financial sector across Africa and to ask how they could be modified to work for Africa.

The report recommends that public policymakers (including central banks) consider amending banking and financial services legislation to enable innovative private sector funding. The process could lead to lobbying, opening for debate a range of banking and financial service issues, including the Basel III financial regulation guidelines. Like Basel I and II, the Basel III guidelines have been driven by the OECD countries, with input from larger emerging markets such as India and China but little input from smaller emerging economies with underdeveloped capital markets, many of which are in Africa.

African institutions such as the Association of African Central Banks and UN Economic Commission for Africa should review existing financial regulatory policies in Africa further, identifying what works best in each subregion and country, given the different stages of capital market development across the continent. Possibilities include digital platform regulation, macroprudential tools for managing risks associated with commodity booms and strengthened regulation to enable capital markets to be more effective in resource allocation.

At the time of writing this report, the end of the COVID-19 pandemic is uncertain, but African governments must explore the full range of policy measures to stabilize the financial system and enable continued funding of the private sector. To do so, critical activities include continuing to increase African government capacity, strengthen financial sector resilience and support all financial innovations that could mitigate the impact of the global pandemic on African economies.

The unavailability of detailed and comparable micro level data for firms and financial institutions for many African countries limited the analysis in this report. The availability of data has steadily improved since a decade ago, but Africa greatly needs greater attention to data gaps and data inaccessibility at both the micro and macro levels to promote more detailed analysis of African countries, businesses and financial institutions.

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