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The Financial Crisis and Access to Financing

African Development Bank

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AFRICAN DEVELOPMENT BANK GROUP

PANEL 4

The Financial Crisis and Access to Financing

Ministerial Round Table Discussions and High Level Seminars

African Development Bank
Annual Meetings 2009

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EXECUTIVE SUMMARY

Africa's access to international capital has been substantially reduced as a result of the financial crisis. Foreign lines of credit have virtually closed. Local African banks that have relied on credit lines from the international capital markets have had to scale back operations or have turned to alternative sources of financing from regional development banks, such as the African Development Bank. Private capital flows, which have recently overtaken Official Development Assistance (ODA) in Africa (increasing from US$ 29 billion in 2000 to US$ 52.98 billion in 2007) are now severely at risk of drying up as a result of the financial crisis. Similarly, remittances have already started to decline significantly due to the economic down turn in developed and emerging economies.

The situation calls for increased efforts to improve domestic resource mobilization. This will require deepening domestic financial intermediation to mobilize savings, introduce instruments with longer maturity to meet long-term investment needs, and provide adequate incentives and capacities to banks to lend to traditional credit rationed sectors. To channel resources more efficiently, it is important to explore the use of innovative mechanisms for reducing risks, such as loan guarantees, which have proven to be effective in developed countries and several African countries. Moreover, developing national and regional bond markets can help channel excess banking sector liquidity into productive sectors. MDBs, and especially the African Development Bank have an important role to play in this process.

While posing serious challenges for the development of the African economies, the financial crisis presents some opportunities that need to be seized. Some proposals have been advanced on how the continent can forge ahead with these challenges but some questions still remain. The Concept Note therefore seeks to articulate these issues and develop key questions that will guide the panel discussions.

1. INTRODUCTION

As developed countries intensify their response to the economic crisis, there is renewed global commitment to assist Africa, in particular, and developing countries, in general, to minimize the impact of the crisis. Access to finance has become the most critical challenge faced by African countries. The continent faces a fall in foreign capital inflows, at a time when export earnings are declining due to weakening export demand and declining commodity prices, coupled with drastically falling tourism receipts. The challenges that the continent now faces include safeguarding the gains from decades of reforms, avoiding a deep recession and recovering its growth momentum, securing alternative sources of development financing, including domestic resource mobilization and revitalizing efforts at meeting the MDGs.

After an average growth rate of 5.6 percent during 2003-2007 period, the continent's economic growth is projected to decline to around 2.8 percent in 2009. While evidence of the impact of crisis on African countries is increasing, their capacity to respond effectively is limited, given the weak fiscal space. For most countries, macroeconomic balances have further weakened in 2008, as a result of the crisis.

The key challenges faced by the continent in this context are the shortage of financing for public investment, private investment, and trade. These are critical, not only for minimizing the impact of the crisis, but also for positioning the continent to take advantage of global recovery after the crisis.

2. INCREASING SCARCITY OF FINANCIAL RESOURCES

Credit crunch – While African banks survived the initial impact of the financial crisis due to lack of direct exposure to the American mortgage-related bad debts, their access to international capital has been severely curtailed., Short-term trade credit has, in particular, almost dried up as international correspondent banks raise thresholds for African banks, effectively disconnecting them off from credit facilities. This situation threatens African trade and its end is not in sight. This leaves the continent with a tremendous challenge of seeking alternative sources of trade finance in order to help the continent recover from the gloomy economic situation.

Capital inflows – The crisis is reversing the recent upward trend in capital flows. Bank credit and other private foreign capital flows are declining.

The G20 has given renewed hope to Africa for increased development assistance, with several pledges for new initiatives. The challenge will be to ensure that these pledges are followed by effective aid delivery.

Remittances to sub-Saharan Africa amounted to US$19 billion in 2007, an equivalent of 2.5 percent of GDP. The World Bank estimated Nigeria to have received US$ 3.3 billion in 2007, followed by Kenya with US$ 1.3 billion, and Senegal with US$ 0.9 billion. Remittances to developing countries peaked at around US$ 283 billion in 2008, but are expected to fall by between 1 and 6 percent in 2009. Remittances account for more than 15 percent of GDP in several African countries

Unfortunately, remittances are declining as a result of the crisis. According to the World Bank, remittances to sub-Saharan Africa will decline by between 4.4% and 7.9% in 2009, after a 6.3% increase in 2008. A fall in remittances will undermine access of small and medium enterprises to a once reliable source of financing. Beyond subsistence, remittances are instrumental in the education and healthcare sectors.

Shortage of infrastructure financing – The continent is facing severe infrastructure constraints; it is trailing behind other developing regions in access to infrastructure services, especially for rural areas. The Bank estimates that US$80 billion per year is needed to finance the infrastructure gap. This calls for scaling up and targeting development assistance to infrastructure investment.

Access to finance for SMEs – Sectors such as the SMEs are the worst affected, given that domestic and international credit flows are primarily to large established firms. The SME sector is considered risky either because of a lack of credit history of the enterprise or lack of adequate collateral. Further, SMEs tend to have a higher rate of failure, which can be as high as 40 percent in some countries. However, SMEs have been observed to be more innovative and more labor intensive. Therefore the worsening credit constraints faced by SMEs will have severe impacts on employment and living standards.

3. STRATEGIES FOR DOMESTIC RESOURCE MOBILIZATION

Since the 2002 Monterrey Consensus on financing for development, there has been increased attention on domestic resource mobilization as a source of finance for Poverty Reduction Strategy Paper (PRSP) implementation. This attention is now being renewed as the global financial cri-

sis is likely to lead to reduced aid and private capital flows into Africa. In this context, African countries need to strengthen domestic resource mobilization, more than ever, to supplement aid and pursue their development efforts.

The development of the domestic financial sector is a critical factor for improving domestic resource mobilization. The focus must be on promoting efficiency and deepening the financial system. Currently, access to financial services on the continent is very limited, with exclusion ratios as high as 54 percent in countries such as Tanzania. The lowest ratio is about 25 percent in South Africa. While financial education remains necessary to raise awareness among the populations, it is crucial to provide incentives for financial sector institutions to develop low cost services and products, and to expand coverage especially in the rural sector. The use of modern technology can improve access by reducing transactions costs.

Domestic resource mobilization is severely constrained by the lack of depth by most African financial systems. The bank deposits/GDP ratio is 29 percent on average for the continent, compared to 65 percent for the rest of world. In spite of commendable strides in mobilizing insurance savings, such savings only constitute a small proportion of domestic resources, at a meager 0.03 percent of GDP. Africa also has poorly developed stock and bond markets. The sum of public and private bond market capitalization to GDP amounts to only 42 percent, compared to a 76-percent average for the rest of the world. Moreover, the lack of innovative mechanisms to increase participation rates in these markets has excluded potential players that could contribute to a greater mobilization of domestic savings.

Recent evidence in Kenya reaffirms that some flexibility in setting the rules in the ***bond market*** can yield significant benefits. Following a downward adjustment in the thresholds for public participation, Kenya's infrastructure bond was oversubscribed by 152 percent in January 2009. This experience in Kenya refutes the notion that low participation in the financial sector in Africa is due to low per capita income. It is clear from this experience that the full potential of Africa's domestic bond markets to contribute to the raising of financial resources for development needs is under-utilized. Domestic savings may turn out to be significant and, possibly, a cheaper alternative to external sources of financing.

In most African countries, the ***tax base*** is narrow. Fiscal reforms are needed to expand the tax base and improve the efficiency of tax collections. In most countries, ***private pension schemes*** are of

limited coverage, dysfunctional or absent altogether while social security schemes remain underdeveloped. In the face of declining foreign capital inflows and mounting pressure for governments to finance infrastructure development, revitalizing domestic sources of revenue should be a priority. Also, given projected declines in ODA, it is imperative to enhance revenue earning capacities of governments, while also exploring mechanisms for greater private sector involvement notably through public-private financing arrangements.

Finally better mobilization and maximization of the development impact of remittances is crucial in Africa as it can promote business opportunities and stimulate job creation. More importantly, remittances can become a reliable and predictable source of financing for small and medium enterprises, respond to social needs in the health and education sectors, and provide safety nets for augmenting subsistence for the poor.

Stabilization funds – African countries need to examine the role of stabilization funds as a source of countercyclical resources. An example is the Nigerian Excess Crude Oil Account that collects revenue accruing above a pre-determined level. Such resources would only be drawn upon for financing development projects or when the price falls below a certain threshold. This can provide additional comfort in adverse times.

4. THE ROLE OF THE AFRICAN DEVELOPMENT BANK

New financing initiatives – The Bank has responded to the crisis by setting up special initiatives to alleviate the credit constraints faced by the private sector and African governments. In this context, it has launched an *Emergency Liquidity Facility* (ELF) and a *Trade Finance Initiative* (TFI). The ELF is an exceptional multi-purpose facility (US$ 1.5 billion) providing financial support to AfDB-eligible countries and non-sovereign operations in all RMCs facing financial constraints due to the global financial crisis. This objective is achieved through the flexibility of instruments to adapt to the changing environment. The instrument also covers a broad range of beneficiaries, including Medium Income Countries (MICs) and/or their Central Banks, public and private finance institutions and corporations in all RMCs. The facility provides bridging finance, with a fast-track disbursement, but with strict eligibility criteria.

In addition, the US$ 1 billion Trade Finance Initiative is initially meant to provide lines of credit that will allow African commercial banks and Development Finance Institutions (DFIs) to use Bank resources to support trade finance opera-

tions. Ultimately, the Bank intends to make the trade financing part of its financial instruments along the lines of the programs developed by the International Finance Corporation (IFC) and other regional MDBs. The focus of these interventions will be on providing guarantees in support of weak banking institutions to access trade financing for African exporters.

Similar initiatives have been put in place by the International Monetary Fund and the World Bank. The World Bank has even called for the allocation of at least 0.7 percent of any stimulus package in developed countries to a *Vulnerability Fund* for Africa. The G20 April meeting reiterated the need for scaling up crisis response initiatives and commitments have been made in this regard. The basic objectives of these initiatives are to ensure macroeconomic stability and provide counter-cyclical finance to mitigate the impact of the crisis. It is imperative to ensure that these commitments are met in a timely fashion.

Leveraging funds for SMEs – The Strategy Update for the Bank's Private Sector Operations listed SME support as one of the private sector development strategic priorities. While the Bank has been supporting SMEs by availing credit through lines of credit, Partial Credit Guarantees (PCGs) have been identified as one of the core financial instruments to mobilize financial resources for economic and social development of the Bank's regional member countries (RMCs). In 2008, the Bank approved five PCGs worth US$ 60 million to ease SME access to finance in Cameroon, Ghana, Kenya, Tanzania and Zambia. Given that SMEs face a greater challenge in accessing finance, especially within the context of the current financial crisis, this raises the urgency for timely interventions to avoid enterprise closures. However, it has also been recognized that the Bank needs to minimize moral hazards. Thus, the risk sharing requirement of approved PCG schemes guarantee of 50 percent of the principal of investment loans, with guarantees delivered through a portfolio model to maximize on the number of SMEs that access bank credit.

Bond market development and infrastructure financing – There is an urgent need to develop domestic capital markets in Africa as a complementary source of development financing. Well-functioning, deep and liquid bond markets can help countries access long-term debt in local currency thereby providing much-needed financing for the constantly growing housing and infrastructure needs. This is particularly important as countries are unable to access international capital markets and are faced with a likely decrease in aid financing in the face of the global financial crisis.

Indeed, it is estimated that Africa will need an estimated US$ 80 billion of infrastructure investment per year, in order to narrow the gap with its developing country peers and show faster progress toward the Millennium Development Goals. Moreover, in Africa, corporate bond markets are either nonexistent or in their infancy, with the public sector dominating debt issuance, mainly with debt instruments of very short tenor and activities focused on the domestic primary market with limited secondary trading. Although several countries have listed their bonds on the stock exchange, secondary market trading remains virtually non-existent due to the "buy and hold" strategy of domestic banks that hold about 70 percent of bonds issued. This outcome is a result of limited lending opportunities and prudential requirements.

Several stakeholders have made some efforts to develop bond markets in Africa, but with limited success, due to the fragmented nature of these efforts. The Bank is now leading efforts to harness the potential of national and regional bond markets, paying particular attention to identifying and lowering market risks, volatilities, and uncertainties. Under the African Financial Markets Initiative (AFMI), which falls within the framework of Making Finance Work for Africa (MFW4A) Partnership, a study covering five regions on the continent has just been completed.

Further initiatives for resource mobilization – The Bank is currently preparing a strategy to support remittance mobilization through the *migration and development initiative* which aims at maximizing the development impact of remittances by reducing their cost, increasing their productive use, and promoting business opportunities and job creation at the grassroots level. A trust fund for this initiative is being created to which France has already committed Euro 6 million. Furthermore, in cooperation with the World Bank, the Bank has undertaken a study on migration and remittances which will improve our understanding of the dynamics of remittance flows and migration, and strengthen the capacity of policy makers, researchers, banks, financial institutions and donor agencies to enhance the development impact of migration and remittances in Africa.

Finally, the Bank is also supporting *fiscal reforms* for improved domestic resource mobilization. The Bank is a founding member of the *African Tax Administration Forum*, envisaged as a focal point for sharing good practices and setting strategic direction for African Tax Administration.

Supporting financial sector reforms – The African Financial Markets Initiative (AFMI) complements the Bank's advisory role, through its continued support in financial sector reforms, and indeed policy reforms, in general, to ensure financial stability and increase the resilience of African economies. This involves institutional capacity building and strengthening to ensure efficient management of the transformative process.

Prudential regulation and supervision – One of the pillars in the Bank's Medium-Term Strategy involves institutional and human resource capacity building. Regulatory institutions in many African countries lack the capacity to adequately regulate and supervise financial institutions., Together with other international institutions involved in this area, the Bank can play an important role in helping to develop an appropriate regulatory and supervision framework best suited to the needs and conditions of the continent.

The way forward – While these Bank initiatives are timely and critical for minimizing the impact of the crisis, they remain insufficient in terms of responding to increasing resource requirements. The continent will need up to USD 50 billion in 2009 just to sustain the pre-crisis growth rates. To achieve the growth rates needed to reach the MDGs, the continent would require as much as USD 117 billion. Clearly, commitments by the G20 to increase resources could not have come at a more opportune time. The challenge now is how to deliver on these commitments.

DISCUSSION QUESTIONS

1. Is the international response well tailored to the different requirements of the African countries?

2. Is the response commensurate to the challenges faced by the countries?

3. What additional measures should be considered by the MDBs to increase access to finance?

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