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Africa's long-term financing shortfall

James King | 2/07/2019 9:00 am

As a continent, Africa is enjoying improving economic health but strong regional leadership is crucial to attract the long-term financing necessary to develop and sustain its growth. James King reports on current initiatives.

After a turbulent few years, Africa's overall economic outlook appears to be strengthening. Against a backdrop of higher commodity prices, improving agricultural production, increased investment and rising net exports, the continent is expected to register growth of 4% in 2019, according to the African Development Bank (AfDB). This is a marked improvement from the anaemic numbers of just a few years ago, when global oil prices slumped. But will such a rate of growth be sufficient to support a region that is expanding by almost every conceivable metric?

Demographic pressures are a case in point. By 2030, Africa's working age population is expected to hit 1 billion, up from the 705 million recorded in 2018. To simply prevent unemployment from increasing, about 12 million jobs must be generated every year, according to the AfDB. Supercharged economic growth will be required to meet the demands of this rising population, underpinned by investments in infrastructure, housing and the continent's small and medium-sized enterprises (SMEs), among other areas.

For this objective to be realised, Africa will require access to long-term finance (generally defined as capital provided for more than one year). As the bedrock of sustainable economic development, long-term finance provides two stabilising contributions to growth. First, it diminishes borrowers' rollover risks and, as a consequence, stretches both the scope and efficacy of their investments. Second, it permits public entities, corporates and even households to address an array of challenges over the duration of their operating lifetimes.

Funding mismatch

At present, however, Africa is suffering from a dearth of long-term financing. The reasons for this are complex and include the limited depth of regional financial markets, as well as perceptions of risk around long-term investments on the continent. It also concerns the nature of African banking systems' deposit bases, which are overwhelmingly short term in nature, making it expensive to mobilise long-term finance.

"The core problem is that African banking systems are generally funded by short-term deposits and therefore a mismatch exists between this and the long-term funding required for infrastructure, housing and small business finance," says Mark Napier, director of the financial sector development programme Financial Sector Deepening (FSD) Africa, funded by aid from the UK government.

The severity of the issue is growing. FSD Africa believes the long-term funding gap for infrastructure, housing, SMEs and agri-business across the continent amounts to some $300bn annually. On infrastructure alone, most estimates indicate that Africa will need about $90bn of funding every year to develop new investments and maintain what already exists. For many, the pressures linked to the continent's lack of long-term finance are of mounting concern.

"At the moment I wouldn't say it's a crisis. It's an emerging red flag with potential to disrupt the continent's development plans," says George Asante, head of global markets, excluding South Africa, at Absa, which was formerly Barclays' pan-African banking arm.

Indeed, the situation appears to be already having damaging real-world consequences for communities across the region. Many fear that industrialisation of the continent's economies, a requisite step in poverty reduction and employment generation, will lag if key markets lack the transport, water and power generation infrastructure needed to support the development of local and regional businesses.

Making up the shortfall

Addressing this challenge will require a balanced level of long-term investment from public and private sector actors, according to Alarik d'Ornhjelm, head of structured and trade finance at Deutsche Bank. He says: "Four years ago, sub-Saharan Africa's total power generation capacity was about the same as that of Spain. A balance between public investment and private investment is needed. Independent power producers are playing their part but they must be supported by appropriate power purchasing agreements from regional governments."

More broadly, however, the continent's domestic financial markets and local currency bond markets are viewed as particular weak spots. "The capital markets are underdeveloped: equity markets are shallow and there is usually limited secondary trading, while Africa's bond markets typically lack depth. In addition, the foreign exchange markets in most countries are heavily protected without credible interbank benchmark rates," says Mr Asante.

Indeed, nurturing a local corporate debt market would go some way to spurring long-term financing options for key sectors across the continent. This would also fit in well with Africa's burgeoning pension fund market. "Increasing corporate bond issuance is a good way of attracting pension fund money into the real economy," says Mr Napier. "Pension fund assets have quadrupled in Africa over the past decade. But these funds mostly flow into sovereign bonds. At the moment, there is limited interest from private asset managers in anything other than sovereign bonds."

An abundance of sovereign debt transactions, coupled with a limited supply of local corporate bond issuances, has meant that the continent's institutional investors have had little reason or incentive to explore alternative investment opportunities. Not only is this leading to a rising foreign currency-denominated sovereign debt profile, and exacerbating the risks linked to foreign currency-denominated debt, it is also stunting the development of alternative long-term financing options. To give this dilemma some context, Africa's Eurobond market passed the $100bn mark in March 2019 for the first time in its history.

“The continent is generally dependent on long-term finance from the foreign currency markets and not from local currency alternatives. It creates a situation where a country’s debt stock and the ability to repay becomes quite sensitive to volatility in the foreign exchange market,” says Mr Asante.

Risky perceptions

To compound these challenges, long-term investments in Africa are often perceived as having a high degree of risk. “Providers of long-term finance, such as pension funds, are institutions who we rightly trust to take limited risk. Banks, in a way, can price for risk because they understand the markets in which they operate quite well and they have built the capacity to assess risk. Pension funds generally don’t have that capacity but the pressure on them to reduce risk is high. Risk is what is top of mind for them,” says Mr Napier.

If Africa is to develop long-term financing markets, work must be done to ease concerns around issues such as the political and security risks that can be linked to projects with an extended investment horizon. Research from Mercer, a global consultancy, has found that a significant perception gap exists between the perceived risks of long-term investments in Africa and the reality.

African project debt, for example, has a lower default rate than a number of developed market regions including North America. Between the 1990 and 2016 review period, Mercer found that only western Europe and the Middle East experienced lower default rates when it came to project finance, with every other major region recording a higher default rate than Africa. These numbers may be influenced by the fact that Africa-linked project finance deals have, traditionally, been highly selective and focused on the continent’s largest and most stable markets. Even so, it is a message that merits dissemination and further discussion.

And, just as the provision of information offers hope for improving perceptions of risk, it could also spur important changes in other ways. In November 2018, FSD Africa launched its Africa long-term finance initiative, billed as a tool for policy-makers, investors, regulators and donors to access information on the continent’s long-term finance markets in a central repository. The initiative, also known as the 'long-term finance scoreboard', covers the depth and inclusiveness of these financing markets, as well as offering a benchmarking capability for specific indicators across countries.

The scoreboard aggregates a number of data sources, including from the World Bank and AfDB, onto one platform. Important data points highlighted include the sources of long-term finance, the size and liquidity of intermediaries, as well as the destination of long-term finance. Information is presented through a multi-country scoreboard, as well as through specific in-country diagnostics.

“We are creating a portal where useful financial market data is available in one place,” says Mr Napier. “There are some indicators that are just missing generally [to investors]. Leasing volumes to gross domestic product [percentages] are one example. We think there is a big role for leasing on the continent. So it’s a combination of bringing data that’s already available to one place while adding useful new indicators.”

Cutting bureaucracy

Meanwhile, by benchmarking Africa’s financial markets, it is hoped that a potential peer pressure effect will contribute to positive, market-friendly changes among rule-making and regulatory bodies. This, in tandem with the scoreboard’s investor-focused information base, could add further impetus to the continent’s long-term finance agenda. “What we are really trying to do is figure out how finance can be better used to support the real economy in different markets. We are in the business of helping people get access to a job and basic services,” says Mr Napier.

Thoughtful initiatives of this calibre should go a long way to solving Africa's long-term financing gap. It will also demand work on the part of individual jurisdictions to act on the recommendations highlighted by these efforts, and others. This is because even when financing is available, through a bank loan for instance, it can often be delayed by onerous bureaucracy.

“African markets typically have a long lead process in terms of mandating a bank and issuing a loan. Navigating bureaucracies [on the continent] can be difficult. This long process [will be] important to shorten. For a start, it is vital that a project sponsor works with the right bank and one that has a good knowledge of local market regulators and conditions,” says Deutsche Bank’s Mr d’Ornhjelm.

These challenges, and others, will take time to overcome. But the continent’s direction of travel is encouraging. At present, a mix of domestic and international actors, from local banks and regulators to multilateral development agencies and international lenders, are working in various ways to address Africa’s long-term financing deficit.

The G20 Compact with Africa, initiated under the German G20 presidency, is an example of a global effort to promote private – and long-term – investment in Africa through improvements to the continent’s macro, business and financing frameworks. The compact involves partnerships between associated African countries, G20 countries and international organisations to coordinate reform efforts. At present, the compact includes the participation of Benin, Burkina Faso, Côte d’Ivoire, Egypt, Ethiopia, Ghana, Guinea, Morocco, Rwanda, Senegal, Togo and Tunisia.

Pushing best practice

Nevertheless, this still leaves a lot of countries that have not adopted this kind of reform-minded approach to their development. “Things are heading in the right direction but the pace of change is slow. Many of the reforms to the region’s capital markets have focused on the low-hanging fruit. More needs to be done to open up Africa’s financial markets to international best practices,” says Mr Asante.

This process of adopting international best practices will take time, and the provision of expertise. For its part, FSD Africa is working with partner countries on its capital markets programme, a function of which includes developments in the green bond space. Work on its Nigerian and Kenyan green bond programmes has produced green bond listing guidelines approved by regulators in both markets, a sovereign green bond transaction from Nigeria, an expected issuance from Kenya in 2019, as well as two private sector green bond deals in Nigeria, among other achievements.

Looking ahead, strong regional leadership will be required to develop Africa’s long-term financing markets. Complex and potentially difficult reforms will be needed to ensure the continent is capable of attracting and allocating sources of long-term investment. By acting quickly, legislative and regulatory bodies across the continent will do much more than just transform the financial markets of their respective jurisdictions. They will also go a long way to improving the wellbeing and livelihoods of individuals and communities across the wider region and ensure that Africa’s economic and social potential is realised.

This is part one of two articles covering financing in Africa. Next month we look at capital market dynamics.

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