EUROPEAN INVESTMENT BANK

Banking in Africa:
Delivering on Financial Inclusion, Supporting Financial Stability

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Banking in Africa:

Delivering on Financial Inclusion, Supporting Financial Stability

October 2018

Banking in Africa: Delivering on Financial Inclusion, Supporting Financial Stability

About the Report
At its fourth edition, this report provides an analysis of recent development in the African banking sectors and specific structural topics of relevance. It combines in house research with contribution from leading market experts from commercial banks operating in the region, IFIs and other institutions.

About the Economics Department of the EIB
The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in the definition of its positioning, strategy and policy. The Department, a team of 30 economists, is headed by Debora Revoltella, Director of Economics.

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Chapter 2 - Banking Sector Trends in West Africa: Claudio Cali, Emmanouil Davradakis, Nina Fenton and Amine El Kourchi

Chapter 3 - The Banking Sector in the Central African Economic and Monetary Community (CEMAC): Great Potential in the Face of Enormous Challenges: Jean-Philippe Stijns, Jad Benhamdane and Said Hidane

Chapter 4 - The Banking Sector in East Africa - Responding to Market Shocks: Ricardo Santos, Jared Osoro

Chapter 5 - Banking in Southern Africa: Sanne Zwart and Stuart Theobald

Chapter 6 - Banking Sectors in North Africa: Improving Slowly but Noticeably: Andreas Kappeler, Samia Azzabi and Jad Benhamdane

Chapter 7 - Ready for the Recovery? How Crowding out by Public Debt Affects Lending to Private Sector across Africa: Sanne Zwart and Vivian F. de O. Schmidt

Chapter 8 - The State of Bank Recovery and Resolution Laws in Africa: Alan Bainbridge, Simon Lovegrove and Jack Prettejohn

Chapter 9 - Financing Infrastructure in Africa: Andreas Kappeler, David Ashiagbor, Arthur Minsat, Rodrigo Deiana and Thang Nguyen-Quoc

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Published by the European Investment Bank.

EXECUTIVE SUMMARY

Sub-Saharan Africa (SSA) is recovering from the most severe growth slowdown in two decades. Yet, the recovery is expected to remain uneven across countries, and while the region's growth in per capita gross domestic product (GDP) has been positive since 2017, it will remain insufficient to significantly reduce poverty. The recovery remains vulnerable. Rising public debt burdens are fuelling debt sustainability risks, while tighter global financing conditions and weaker than expected commodity prices pose additional downside risks. In some countries, sovereign debt holdings by local banks are crowding out private credit, which could hold back growth, while the declining number of correspondent bank relationships is becoming a cause for concern as it could complicate international transactions required in cross-border trade.

North African countries are currently undergoing a prominent economic transformation. The macroeconomic situation should continue to benefit from the implementation of economic and social reforms and ongoing efforts towards regional integration. The geographical position also gives the region a considerable advantage in attracting foreign direct investment. Many countries also see this transformation as an opportunity to make economic growth more inclusive. Constituting the vast majority of firms in North Africa, microenterprises and SMEs still need to have better access to financial products and services, despite the notable progress already made. Non-bank financial institutions are still at an early stage of development, limiting the choice of financial instruments available for small firms.

In many SSA banking markets, the last two years saw a pause in financial deepening but systemic crises have been successfully averted, demonstrating the improved resilience of SSA's financial systems. However, non-performing loans are on the rise and capital adequacy and asset quality have deteriorated since the last full edition of this study in 2016. Advanced economies' banks have been withdrawing from the region, and regional banking groups have consolidated their presence. Smaller domestic banks have been too preoccupied by the difficult economic situation to take advantage.

Despite more than a decade and a half of financial deepening in nearly all SSA countries, banking sectors still have a long way to go to catch up with other regions. Indeed, access to finance still tops the list of constraints for SMEs in SSA, according to the World Bank's Enterprise Survey. One reason for the limited access to finance of SMEs is that banks have increased their lending to the public sector in recent years. Higher issuance of public debt reduces lending to the private sector by providing a potentially attractive alternative investment, and, as observed throughout Africa, offering higher lending rates. Based on our analysis, crowding out has increased throughout Africa during 2014-18, and its prevalence is elevated in Ghana, Niger, Tanzania and Zambia. When growth picks up further, demand for loans from SMEs will rise while crowding out by public debt could reach elevated levels in several more countries. Banking groups that we surveyed report that the lack of adequate collateral and high default rates are reported by banking groups to be the most important obstacles to SME lending in SSA. IFIs have developed programmes to offer portfolio guarantees to commercial banks for SME lending, but a significant portion of banks' needs for portfolio guarantees is still unmet.

On the supply side, however, the 2018 EIB Survey of banking groups in SSA reveals a push for new technologies. A rising share of banks plan a structural expansion of their operations in SSA in the longer term. In the short run no banking group plans to consolidate operations in SSA any more. Half of the banking groups report being fully deployed in terms of general IT infrastructure but the majority of them are in deployment and planning deployment in terms of internet-banking technology, mobile banking and FinTech.

The importance of strengthening the legal, regulatory and supervisory super-structure of SSA's and North Africa's financial sectors to promote financial intermediation cannot be overstated. Working out NPLs and resolving banks that cannot return to profitability will be key to underpinning the confidence that is necessary for private investment in SSA. Improving recovery and resolution laws in Africa would help to bring down funding costs and facilitate financial intermediation. Requiring banks to prepare recovery and resolution plans, which would subsequently need to be approved by regulators and maintained would be an important step forward. Similarly, introducing a well-defined recovery floor would also reduce uncertainty for investors as they would have a clear understanding of how their investment may be affected in a crisis management scenario.

As financial inclusion for individuals and microenterprises advances, new challenges will emerge that will need to be addressed to ensure that financial deepening is fair, broad-based and sustainable. Consumer protection will be key to maintaining the confidence of first-time depositors and financial service users and to ensuring a level-playing field with regulated players.

As SSA economies continue to recover, the opportunity to deepen the region's financial sectors should not be missed even though some of the lowest hanging fruit have already been picked. Bringing down the financing needs of governments through fiscal consolidation and structural reform is key to freeing up space on banks' balance sheets. In addition, continuing the broadening of the investor base for government paper through, for instance, developing local bond markets, would also reduce pressure on banks to hold large amounts of public debt. Enhancing banks' capacity to assess risk and monitor their clients would reduce the perceived risks and facilitate financial intermediation. Helping clients to identify and present bankable projects would also raise lending to the private sector.

Private sector development will require technical assistance and knowledge transfers, not just financing. This is a long-term investment that banking groups will ultimately find to their economic and financial advantage as they groom tomorrow's larger and stronger clients - but the work needs to begin now. Development partners could help to crowd-in capital and support private sector development by offering innovative financial and policy instruments, including FinTech, portfolio guarantees and bankers' academies.

Moreover, financial sector sophistication can help to address the continent's important infrastructure bottlenecks. Infrastructure needs are particularly high in energy and transport and new needs arise from rapid urbanisation, population and economic growth. Private investors can play an important role in financing vital infrastructure in Africa. Many African countries have made progress on removing regulatory barriers to infrastructure investment by institutional investors. Yet, many needs still need to be structured into bankable investment opportunities and financial markets still have to be developed. Financial instruments that seem particularly promising for attracting private investors include risk mitigation instruments and debentures.

Debora Revoltella
Director
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Introduction

An Uneven Recovery Amid Concerns Over Rising Debt

While moderate growth is forecast for 2018 and subsequent years for sub-Saharan Africa (SSA), the region's recovery is expected to be uneven. Rising oil and mining output combined with stable oil and commodity prices are projected to lift economic activity in some countries, but growth will be moderate in the region. In some oil exporters, the recovery will be slower than previously expected, due to the need for continued fiscal consolidation, as they adjust to high debt levels and low external buffers. Correspondingly, while growth is forecast to accelerate from 4.4% in 2017 to 4.7% in 2019 in oil-importing countries, it is expected to rise from 0.5% to only 2.1% in oil-exporting countries over the same period (IMF, 2018).

The pace of recovery varies significantly across Africa's regions. East Africa remains one of the best economic performing regions in SSA. Regional economic growth is projected to pick up to 5.8% in 2018 and to accelerate further to 6.2% in 2019, assuming a more stable political environment and a gradual increase in oil prices. Economic activity in the West African Economic and Monetary Union (WAEMU) remained robust, expanding by 6% for the sixth consecutive year in 2017. Meanwhile in Southern Africa, annual growth has fallen from around 5% during 2010-14 to around 2.5% in recent years, as the many commodity exporters in the region have been hit by falling international demand and the subsequent decline in prices. The recovery is expected to be slow. Overall, the macroeconomic situation in the Central African Economic and Monetary Community (CEMAC) is improving after the marked slowdown under the combined effect of the fall in the prices of raw materials and security threats. In 2018, these economies are starting to recover, with growth reaching 1.7% thanks to rising oil prices and production combined with reforms. GDP growth in North Africa reached 3.4% in 2017, moderately higher than in earlier years. The economic outlook remains positive, thanks to considerable structural and macroeconomic reforms, although GDP growth is expected to moderate to below 3% in 2018.

Even within regions, recent economic performance has reflected the diversity in economic structures and the differing dependence on oil and mineral exports. In West Africa, Nigeria exited recession in 2017 thanks mainly to rising oil prices, growing by 0.8%, whereas Ghana registered a significant pickup in real GDP growth (to 8.4%) after the slowdown experienced two years before. In the CEMAC, all countries except Equatorial Guinea are projected to enjoy positive growth in 2018 but projected growth ranges from 4.0% in Cameroon to a meagre 0.7% in the Republic of Congo. In East Africa, Kenya (4.8%) and Uganda (4.5%) will underperform their regional peers both in 2018 and 2019, albeit less than in 2017. In Southern Africa, only Madagascar (4.1%) and Mauritius (3.9%) recorded higher growth in recent years than during 2010-14.

While risks to the outlook have become more balanced, **downside risks predominate, particularly because rising public debt burdens are fuelling debt sustainability risks.** Public debt accumulation started to outpace economic growth in 2008 and public debt-to-GDP ratios deteriorated substantially in 2015 and 2016. The earlier fall in commodity prices in particular affected the debt position of commodity exporters, but also that of many other countries in the region. More than 80% of African countries recorded an increase in the public debt-to-GDP ratio during 2014-17, and the increase was more than 10% of GDP for more than half of those countries. About 37% of African countries have high or distressed public debt levels according to the IMF and the World Bank as of June 2018, and rating agencies have downgraded many of them over the past few years. Other downside risks to Africa's recovery include tighter global financing conditions and a slowdown of the commodity price recovery on the back of a trade war.

Generally Resilient Financial Sectors and Improving Financial Inclusion, but Emerging Pockets of Risk in Some Banking Sectors

The diversity of stages of financial market development and market potential mirror the diversity of economic structures and performances across the region. A few of SSA's and North Africa's banking sectors have reached a depth approaching that of Upper Middle Income Countries (UMICs). South Africa, Mauritius, Morocco and Tunisia are a case in point, Cape Verde and Namibia as well - albeit to a lesser extent. Several markets are nearing a level of development characteristic of Lower Middle Income Countries (LMICs), such as Kenya and Côte d'Ivoire. Yet many countries still struggle with some of the shallowest banking sectors in the world, such as the DRC, Guinea-Bissau, Malawi, Sierra Leone and Sudan, while some other countries are punching below their income categories. Countries like Cameroon and Nigeria, both LMICs, and Gabon, a UMIC, are still below the average financial depth for Low Income Countries (LICs) globally, despite experiencing financial deepening over the last decade.

Financial inclusion of individuals has kept on improving throughout the recent economic slowdown, thanks to a rethink by banking sector players and their regulatory authorities. Digital financial inclusion is on the march: it has clearly spilled out of Eastern Africa and is improving access to finance in all of Africa's regions now. While a large part of the population in SSA remains unbanked, notable progress has been achieved since 2011. SSA has the largest deployment of mobile payment services in the world, but the use of financial services has not evolved as fast as account ownership. Most success stories highlight the importance of strategic partnerships between banks and telecoms, and of an accommodating regulator.

Banks dominate the financial sector and therefore financial intermediation in SSA and North Africa, with the exception of South Africa. The size of stock markets remains small even in the most advanced financial markets in SSA and North Africa. South Africa is a notable exception: relative to the size of its economy, the value of stocks traded on the Johannesburg Stock Exchange (JSE) is above that of its peer UMICs and not far from that of advanced country markets. In contrast, even in Mauritius, Kenya and Nigeria, the next most developed capital markets in SSA, the volume of traded stock did not reach 3% of GDP in 2017, even though Mauritius is a UMIC and Kenya and Nigeria are LMICs. Since 2007, the volume of traded stocks has decreased in all three countries as a share of their respective GDP, casting doubt that significant progress is being made with stock market deepening in SSA. With the exception of a handful of countries, bond markets are also under-developed in the region.

SSA's banking markets are typically oligopolistic and are characterised by high lending rates and low deposit rates, or, in other words, wide lending margins. However, thanks to intensifying competition, these margins have generally been trending down since 2000. For instance, in Kenya, the interest margin came down from 14% in 2000 to 6% in 2017, and in Mauritius, down from 11% in 2000 to 5% in 2017. Still, the DRC, Mozambique, Rwanda and Sierra Leone saw double-digit interest margins in 2017. Banks tend to invest deposits in "risk-free" government bonds paying a relatively high yield, contributing to crowding out private sector credit and SME financing in particular.

High issuance of public debt at attractive rates provides a favourable alternative investment for banks vs lending to the private sector, leading to a substantial crowding out. In Africa, as a share of GDP, banks' holdings of public debt increased on average from 8% in 2008 to 12% in 2017. In almost 80% of the countries, banks increased their holdings during the last three years. Banks' holdings of public debt have increased faster than their balance sheets, and they now account for around 19% of banks' assets compared to some 14% in 2008. During the last three years, this share has increased in around three-quarters of the countries, and in a quarter government paper now accounts for more than 25% of banks' assets.

In most SSA countries, capitalisation levels and profitability remain comfortable but in recent years, NPLs have increased and returns on assets (RoA) have been under pressure in some markets. The median capital-asset ratio stands around 12%, whereas the median return on equity is 21%. Yet, the median non-performing loans (NPLs) to gross loan ratio has risen above 10% in recent quarters. In North Africa, NPLs are above 10% in Algeria and Tunisia. Banks in the region have experienced an improvement in their profitability, reflecting a strengthening of economic growth in recent years.

Indeed, banks' capacity to support private sector activity is crucial for a sustainable recovery. In Africa, bank credit to the private sector peaked around 2009 when it reached some 37% of GDP. The subsequent decline was modest in North Africa and has been more than offset by recent credit growth. In SSA, however, the drop in bank lending to the private sector was more pronounced. Notwithstanding some recent improvement during 2014-16, it remains about a quarter below its 2009 level. In both regions, the volume of bank loans to the private sector is smaller than in Latin America and the Caribbean and in South Asia, where it stands at 45% of GDP. Economic growth typically goes hand-in-hand with an expanding banking sector, but, crucially, depressed bank lending holds back growth. Hence, to support the economic recovery, banks need the capacity to step up lending to the private sector, SMEs in particular.

Access to finance still tops the list of constraints for SMEs, and most SME investment is self-financed, resulting in an SME financing gap (World Bank's Enterprise Surveys). Banking groups report that the lack of adequate collateral and the fear of high default rates are the most important obstacles to SME lending in SSA. In that context, International Financial Institutions (IFIs) have developed programmes to offer portfolio guarantees to commercial banks for SME lending, but a significant portion of banking groups' needs for SME portfolio guarantees is still unmet.

The good news from the EIB survey of banking groups in SSA is that a rising share of banking groups plan a structural expansion of their operations in SSA and that no banking group plans to consolidate operations in SSA any more. There is growing optimism with respect to overall access to funding. Banks principally plan to raise funds in local currency, with the emphasis on deposits and long-term funding, such as subordinated debt. Half of banking groups report being fully deployed in terms of general IT infrastructure. The majority of them are in deployment and planning deployment in terms of internet-banking technology, mobile banking and FinTech.

Banking groups report improving market conditions in terms of origination accompanied by rising NPLs and declining margins. Rising competition amongst banks is prodding banking groups to move out of their comfort zone and to seek growth by financing more and different types of SMEs and professionals. Accordingly, banks are investing in their IT infrastructure, digital and bricks-and-mortar networks, and strengthening their risk management and credit origination processes. The share of banking groups compliant with Basel II and Basel III standards has risen since the last edition of our survey, but the overhaul of risk management and compliance capacity is still in progress.

Ultimately, SMEs are the only employers that can deliver Africa's much needed demographic dividend. All stakeholders need to remain fully engaged. They should coordinate on the private sector development agenda or risk counting tomorrow the hundreds of millions of young Africans whose opportunity to make a contribution to their country goes to waste for lack of decent and productive employment opportunities. The stakes are high and require the attention of all development partners.

About This Report

This fourth full edition of the EIB's study of banking sectors in SSA casts light on recent developments in the region's banking sectors and the policy options for all stakeholders. Indeed, the chapters devoted to banking sector development in each sub-region have been enhanced, with an augmented focus being placed on MSME financing and financial inclusion. In addition, the joint West and Central Africa chapter of earlier editions has been split so as to cover both regions in more detail and pay due respect to the rich variety of challenges and opportunities of their respective banking sectors.

Another objective of the 2018 edition of this study is to contribute to the EIB's Africa Day on 22 November 2018, in Addis Ababa, Ethiopia, **in partnership with UNIDO**. A chapter on North Africa has been included, to match the continental approach to Africa of our partner. The rest of this study is organised as follows.

The first part of this study is devoted to the study of banking sectors across SSA per se. The first chapter examines recent trends in the SSA banking sectors, relying on a survey of banking groups operating in the region. Chapters 2-5 respectively analyse recent trends in banking sectors in Western Africa, Central Africa, East Africa and Southern Africa.

The second part of this study consists of thematic chapters that address transversal challenges and opportunities with regard to financing investment in SSA. Chapter 7 analyses how crowding out by public debt affects lending to the private sector across Africa. Chapter 8 portrays the state of bank recovery and resolution laws in Africa. Chapter 9 maps out policy options on how infrastructure development can be financed and what the most appropriate contribution by development partners can be, with a particular focus on development finance institutions. The study ends with a section explaining the type of financial support and technical assistance offered by the EIB to financial sectors in SSA.

1. Sub-Saharan African Banking Sectors: Results from a Survey of Banking Groups

Adeline Pelletier[1] and Jean-Philippe Stijns[2,3]

Executive Summary

- This chapter takes stock of trends and strategic issues affecting banking groups in sub-Saharan Africa (SSA). Besides publicly available data, including from the IMF and the World Bank, this chapters relies on the results of the third edition of the EIB's survey of banking groups in SSA.

- Despite more than a decade and a half of financial deepening in nearly all SSA countries, banking sectors still have a remarkably long way to go in terms of depth, breath and sophistication. The share of banking groups compliant with Basel II and Basel III standards has improved since the last edition of our survey but the overhaul of risk management and compliance capacity is still in progress.

- In many SSA countries, the last two years have been characterised by a pause in financial deepening. In contrast, a rising share of banking groups are planning a structural expansion of their operations in SSA in the longer term. In the short run, no banking group is planning to consolidate operations in SSA anymore. Half of banking groups report being fully deployed in terms of General IT infrastructure but the majority of them are in deployment and planning deployment in terms of internet-banking technology, mobile banking and FinTech.

- Banking groups report improving market conditions in terms of origination but also rising NPLs and declining margins. There is growing optimism with respect to overall access to funding in general but less so in terms of pricing and maturity. Banks are mainly planning to raise funds in local currency, with emphasis on deposits and long-term funding, such as subordinated debt and bond issuance.

- On the demand side, access to finance still tops the list of constraints for SMEs, and most SME investment is self-financed, resulting in an SME financing gap. On the supply side, banking groups report that the lack of adequate collateral and the high default rates are the most important obstacles to SME lending in SSA. In that context, International Financial Institutions (IFIs) have developed programmes to offer portfolio guarantees to commercial banks for SME lending,

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[2] Senior Economist, European Investment Bank.

[3] The authors gratefully acknowledge that this chapter has benefited from feedback from EIB colleagues. However, the views expressed here are those of the authors and do not necessarily reflect those of the European Investment Bank. All remaining errors remain the authors'.

but a significant portion of banking groups' needs for SME portfolio guarantees is still unmet.

- While a large part of the population in SSA remains unbanked, notable progress has been achieved since 2011. SSA has the largest deployment of mobile payment services in the world, but the use of financial services has not evolved as fast as account ownership. Most success stories highlight the importance of strategic partnerships between banks and telecom companies.

1.1. Introduction

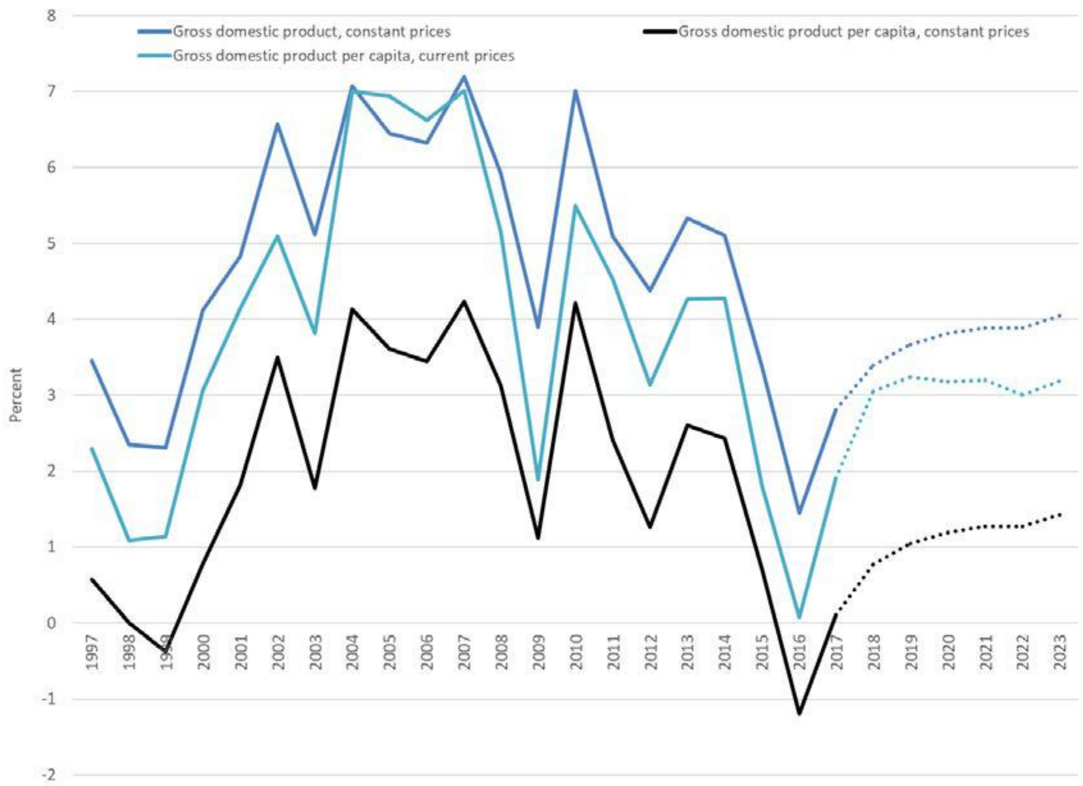
This chapter takes stock of trends and strategic issues affecting banking groups operating in sub-Saharan Africa (SSA), relying on the results of the third edition of the EIB's survey of banking groups in SSA (annexed)[4]. A first pilot edition of the survey was launched in 2015. The second edition of the survey was conducted in 2016 and was expanded in two ways. First, the sample of banking groups that accepted to participate in the survey grew from 10 to 17 banks and it included some global banks with a wide footprint in SSA. Second, the set of questions put to banking groups was expanded from 10 to 20 questions, covering an enhanced set of strategic issues, including demand and supply of local currency loans and technological deployment.

For this third edition, the sample of banks and the questionnaire were expanded. Eight banking groups dropped out from the sample while 16 joined, with therefore a net gain of eight banks. An effort was also made to broaden the sample to cover more local regional banks. The result is a sample comprising 25 banking groups. The number of questions increased from 20 to 25, with new questions focusing on SME lending, FinTech, collaboration between banks and telecom companies, banks' competitors, regulatory capital, subordinated debt and strategic sectors for lending.

This introduction discusses the macroeconomic context characterising SSA economies, as it affects directly the landscape of banking groups operating across the region. The rest of chapter is organised as follows. The second section takes stock of the medium-term trends in the financial sectors in SSA. The third illustrates the strategic positioning of banking groups operating in SSA. The fourth analyses market and funding conditions for banking groups in SSA. In the fifth, access to finance in SSA is discussed. The sixth section provides a conclusion and an appendix documents the questionnaire behind the EIB survey in detail.

[4] IT support from Tomasz Olejnik and Rafal Banaszek is gratefully acknowledged. The authors are also grateful to Sanja Blatt from the EIB's Transaction, Monitoring and Restructuring Directorate and to colleagues based in the EIB's Dakar, Pretoria and Nairobi regional offices for their valuable comments and feedback.

Figure 1.1. - GDP Growth in SSA (1997-2023)



Source: World Economic Outlook (April 2018).

SSA is recovering from a growth slowdown, a development that it had not experienced in almost two decades (Figure 1.1.). It is necessary to go back as far as 1999 to find a year when real income per capita decreased in the region. The 2016 slump acts a stark reminder of how dependent on commodity prices many of SSA economies still are. At constant prices, economic growth in SSA is estimated to have picked up to 2.8% in 2017 from 1.5% in 2016 (IMF, 2018). This upturn is due to firming commodity prices and improving agricultural production following droughts (World Bank, 2018). There has also been a recovery in fixed investment for oil and metal exporters. Moderate inflation has also supported growth through a rebound in consumer spending. Economic growth is projected to accelerate to 3.4% in 2018 and to 4.0% by 2023, reflecting a gradual pick-up in growth in Nigeria, South Africa, and Angola - the region's largest economies.

Yet, the current recovery comes with significant caveats and downside risks:

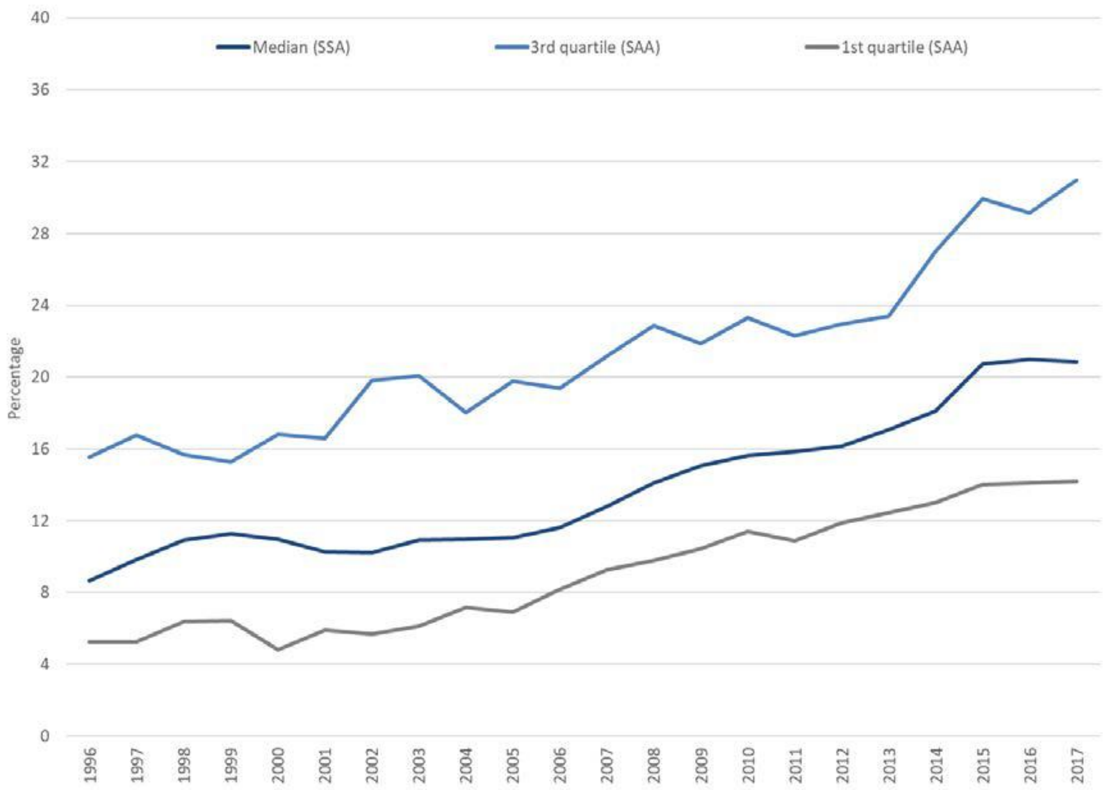
1. **First, while moderate growth is projected for the region, there is considerable variation across the countries and an uneven recovery is under way.** Rising mining output combined with stable commodity prices are expected to lift growth in some countries, but growth will be moderate elsewhere in the region. In some oil exporters, the recovery will be slower than previously expected, due to the need for continued fiscal consolidation, as they adjust to high debt levels and low external buffers. Correspondingly, growth is forecast to increase from 4.4% in 2017 to 4.7% in 2019 in oil-importing countries and from 0.5% to only 2.1% in oil-exporting countries over the same period (IMF, 2018).

2. **Second, the region's growth in per capita gross domestic product (GDP) will remain insufficient to reduce poverty significantly.** Policy looks set to remain tight, constrained by the need to tackle rising debt levels and rebuild buffers to enhance resilience. Growth in real GDP per capita is estimated at 0.11% in 2017 and is expected to rise to only 1.42% by 2023.
3. **Third, while risks to the outlook have become more balanced, downside risks prevail**. Rising debt sustainability heads the list of domestic risks. The main external risks include tighter global financing conditions and weaker-than-expected commodity prices, while the incipient trade war between the US and its trade partners spells uncertainty for the global economy and would eventually affect SSA through trade and investment channels.

1.2. Trends in Financial Sectors in SSA

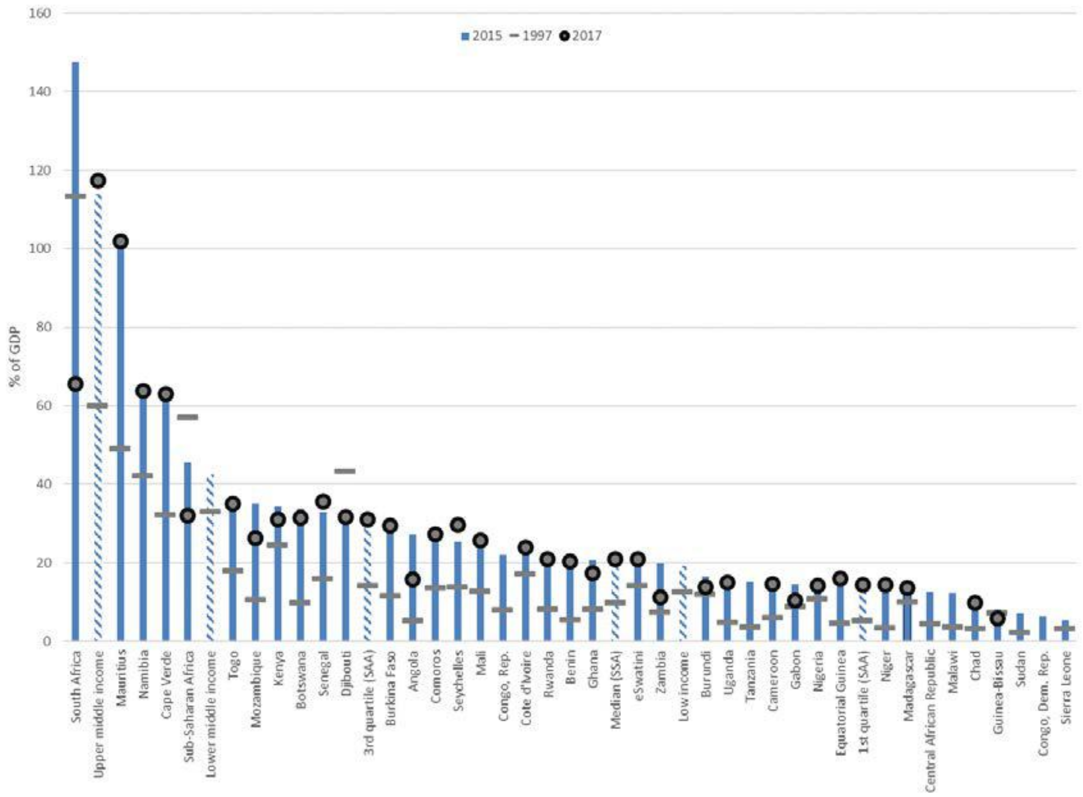
In many SSA countries, the last two years have been characterised by a pause in financial deepening (Figure 1.2. below)**.** This retrenchment is noticeable for both the median and some of the less developed countries. In contrast, the more developed markets generally continued to deepen in 2017.

Figure 1.2. - Credit to the Private Sector by Groups of Countries (1996-2017)
(share of GDP)



Source: World Bank FINDEX.

Figure 1.3. - Credit to the Private Sector
(2017/2015/1997)

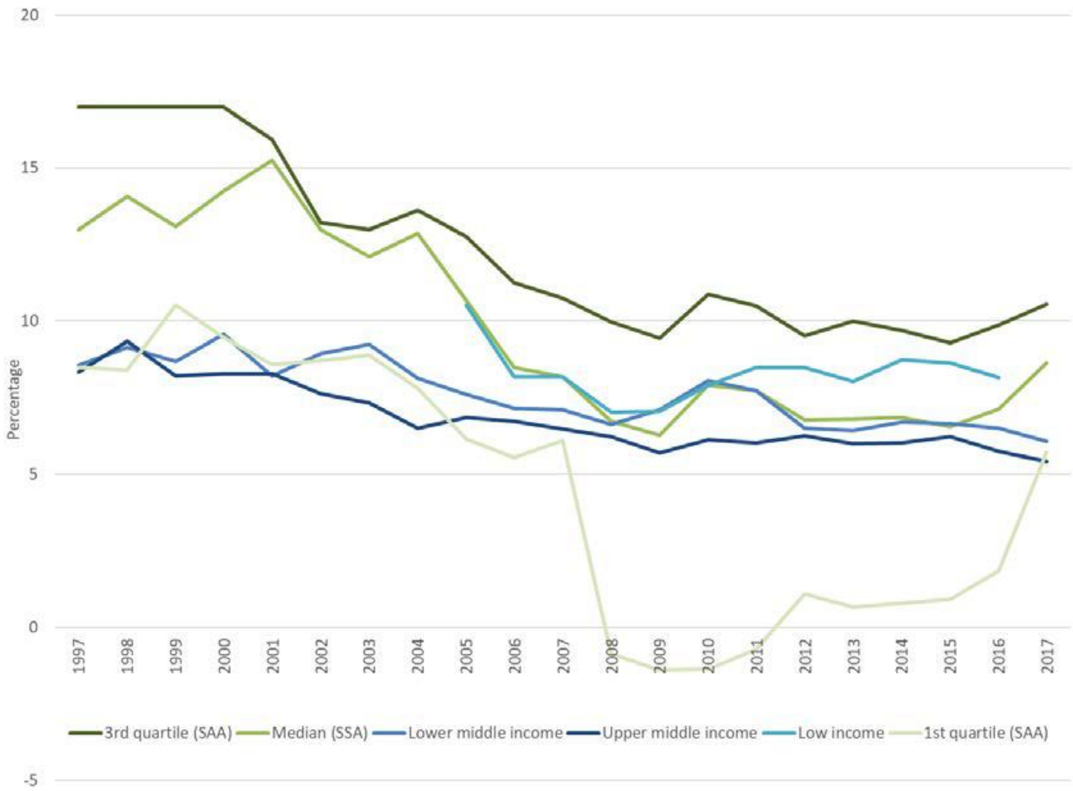


Source: World Bank.

Note: Upper-Middle-Income Countries (UMICs), Lower-Middle-Income Countries (LMICs), and Low-Income Countries (LICs) figures refer to the average for the corresponding income categories at the global level. For the current 2019 fiscal year, low-income economies are defined as those with a GNI per capita, calculated using the World Bank Atlas method, of USD 995 or less in 2017; lower-middle-income economies are those with a GNI per capita between USD 996 and USD 3 895; upper-middle-income economies are those with a GNI per capita between USD 3 896 and USD 12 055; high-income economies are those with a GNI per capita of USD 12 056 or more.

The diversity of stages in financial market development and market trends remains a striking structural characteristic of SSA and several banking markets display financial depth that is still below the level implied by their income level (Figure 1.3.). Banking sectors in SSA can be roughly sorted into three types. First, there are a few outliers with a banking sector of the depth approaching that expected from an Upper-Middle-Income Country (UMIC). South Africa and Mauritius clearly fall within this category, and Cape Verde and Namibia to a lesser extent. Second, roughly half of the rest of the distribution is made up of banking markets with depth ranging from that of an LMIC to that of a LIC. For instance, Kenya and Côte d'Ivoire fall into this intermediate category. Third, the last category is made up of countries with some of the shallowest banking sectors in world. The DRC, Guinea-Bissau, Sierra Leone and Sudan fall into this category. Cameroon, an LMIC, and Gabon, a UMIC, are still below the average financial depth for LICs globally, despite experiencing financial deepening over the last decade.

Figure 1.4. - Interest Rate Spread
(1997-2017)



Source: World Bank Indicators / International Monetary Fund.
Note: Interest rate spread is the interest rate charged by banks on loans to private sector customers minus the interest rate paid by commercial or similar banks for demand, time or savings deposits. The median, second and fourth quartile are reported across countries of SSA for which data is available (between 19 and 37 countries depending on the year). A similar pattern is observed if a constant panel of 15 countries is considered over 2007-2017.

Banking markets are characterised by high lending rates and low deposit rates. Interest margins across the region are thus generally high though on a downtrend (Figure 1.4.). For instance, DRC, Mozambique, Rwanda and Sierra Leone were characterised by double-digit interest margins in 2017. However, these margins have generally been trending down since 2000. In Kenya, the interest margin came down from 14% in 2000 to 6% in 2017 and, in Mauritius, it was down from 11% in 2000 to 5% in 2017.

Table 1.1. - Financial Soundness Indicators in Selected SSA Banking Markets
(as percentage, latest available date)

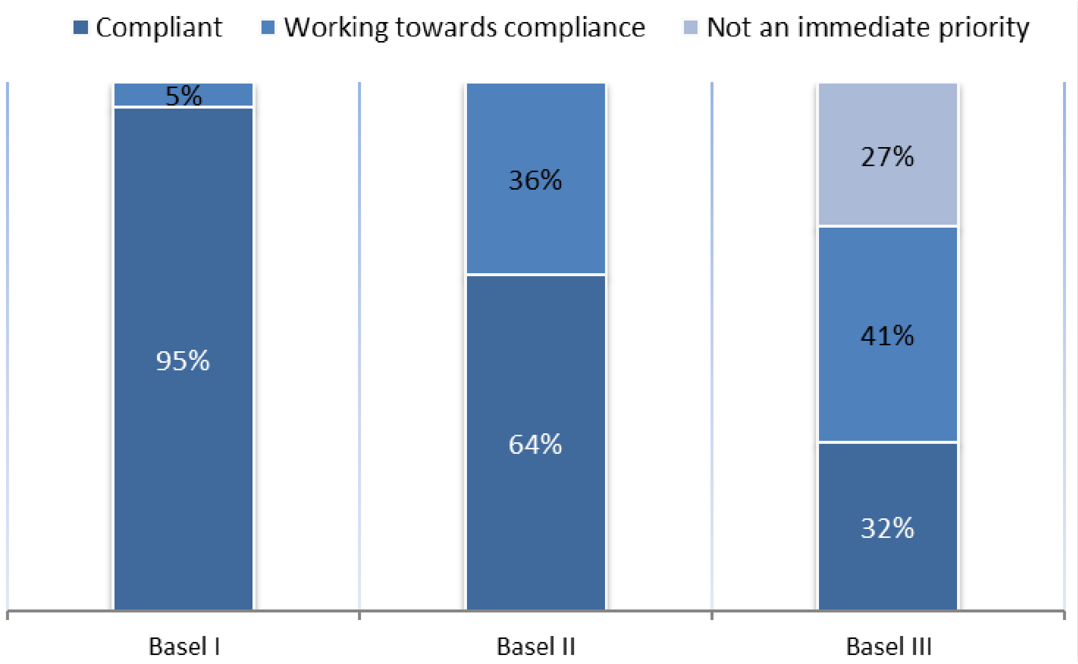
Country	Date	Capital to Assets	NPLs to Total Gross Loans	Return on Assets	Return on Equity
Angola	2015A1	8.42	10.61	2.11	21.6
Botswana	2017Q4	8.77	5.28	1.93	16.28
Burundi	2017Q3	12.21	13.61	2.9	20.51
Cameroon	2018M2	8.28	12.14		
Central African Republic	2017M11	18.9	22.65	8.63	45.85
Chad	2017M11	11.99	25.1	1.87	17.22
Congo, Republic of	2017M11	17.79	13.4	8.33	52.52
Djibouti	2018Q1	5.77	14.09	0.35	5.29
Equatorial Guinea	2017M11	15.46	27.33	5.32	35.2
eSwatini	2017Q4	13.45	7.92	0.01	0.04
Gabon	2017M11	9.15	10.04	13.04	134.64
Gambia, The	2016Q2	15.04	7.6	3.46	20.62
Ghana	2017A1	13.11	21.59	4.29	18.58
Guinea	2017Q4	11.86	10.68	2.05	16.74
Kenya	2017Q4	15.28	10.08	3.24	21.38
Lesotho	2018Q1	12.12	4.16	3.92	31.06
Madagascar	2018Q1	10.72	7.9	4.5	43.16
Malawi	2017Q4	15.6	8.55	5.06	31.11
Mauritius	2017Q4	10.08	7.03	1.55	15.16
Namibia	2017A1	11.73	2.49	3.02	28.01
Nigeria	2017Q3	7.43	15.13	2.43	20.54
Rwanda	2017Q1	14.28	7.73	2.71	14.88
Seychelles	2017M1	12.11	7.03	3.37	27.85
South Africa	2018M2	8.77	3.10	1.70	19.78
Tanzania	2018Q1	12.72	11.13	1.71	11.37
Uganda	2017Q4	13.81	5.51	3.85	22.84
Zambia	2017Q4	11.23	11.98	2.64	22.68
Median		**12.11**	**10.08**	**2.96**	**21.00**

Source: IMF/Financial Soundness Indicators. Countries selected according to data availability.

Given the market concentration, weak - though rising - competition and low levels of intermediation, it is not surprising that banks are generally well capitalised, liquid and profitable (Table 1.1.). The median capital-to-assets ratio stands around 12% whereas the median return on equity is a towering 21%. In most SSA countries, capitalisation levels remain above regulatory floors. Profitability is high because banks tend to invest relatively cheap deposits in “risk-free” government bonds paying a relatively high yield, thereby crowding credit to the private sector[5]. However, in recent years capital buffers have been somewhat eroded and returns on assets (RoA) have come down in some markets. The median ratio of non-performing loans (NPLs) to gross loans has risen above 10% in recent quarters.

[5] Cf. Schmidt and Zwart (2018), Chapter 7 in this study.

Figure 1.5. - State of Basel Standard Compliance
(share of survey respondents)



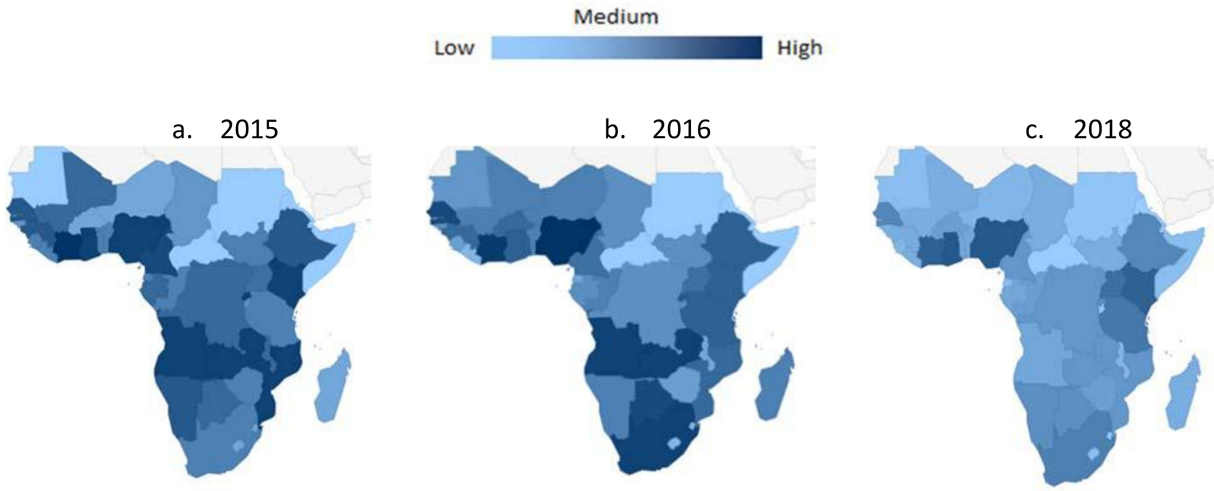
Source: 2018 EIB survey of banking groups in SSA.
Note: Question 20 (see Appendix).

The share of respondents to our survey reporting to be compliant with Basel II and Basel III standards has risen since the last edition of our survey (Figure 1.5.)**.** Practically all banking groups consider themselves to be compliant with Basel I, although there is a perception that single exposure limits/concentration ratios are not always respected. With respect to Basel II standards, two thirds of banking groups consider themselves compliant, with the rest reporting that they are working towards compliance. That is an improvement compared with the 2016 edition of our survey where only 46% of banking groups reported being Basel II-compliant. When it comes to Basel III standards, around one banking group out of three reports being compliant, while two out of five are working towards compliance and less than one in three does not consider Basel III a priority. In other words, the responses to our survey illustrate the efforts by regulatory and supervisory authorities to apply more rigorous standards and by banking groups in Africa to increasingly align with global best practices.

1.3. Recent Trends in Strategic Positioning of Banking Groups in SSA

Market potential is now considered much lower than in 2015 although relative market potential as reported by banking groups has been fairly stable despite the diverse way the last economic downturn has affected economies in the region (Map 1.1. below)**.** There is high correlation in rankings between market potential scores reported by banking groups across the three editions of our survey. This correlation is as high as 86.5% between 2018 and 2016, 69.0% between 2016 and 2015 and 70.4% between 2018 and 2015. As at 2018, Ghana, Nigeria, Kenya and Côte d'Ivoire are regarded by respondents as the markets with the highest potential. In the 2016 edition of our survey, Nigeria, Côte d'Ivoire, Angola and South Africa topped the rankings, while in the 2015 edition, banking groups considered Côte d'Ivoire, Ghana, Kenya and Nigeria to be the top potential markets.

Map 1.1. - Market Potential Perceived by Banking Groups in SSA

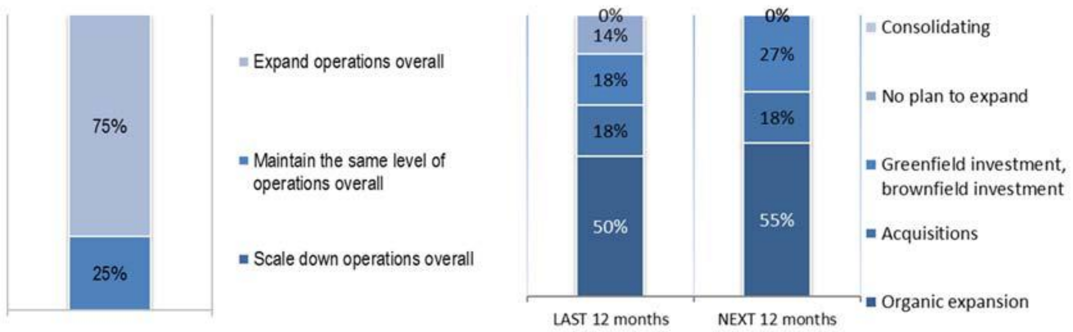


Source: 2015, 2016 and 2018 EIB survey of banking groups in SSA.
Note: Question 1, perceived market potential (high, medium, low).

Figure 1.6. - Current and Prospective Positioning of Banking Groups in SSA
(share of survey respondents)

a. Long-term strategic approach (beyond 12 months)

b. Short-term strategic approach

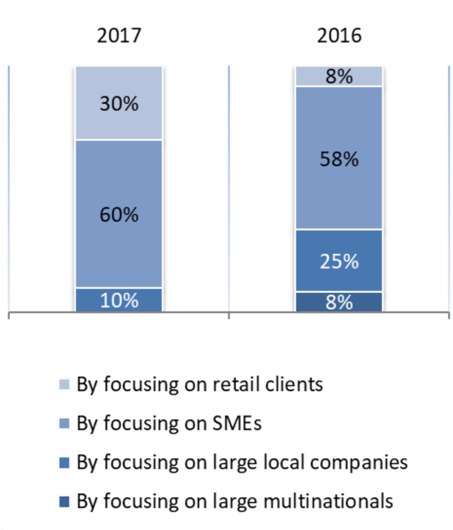


Source: 2018 EIB survey of banking groups in SSA.
Note: Panel a refers to Question 4.a; panel b refers to Question 16 (see Appendix).

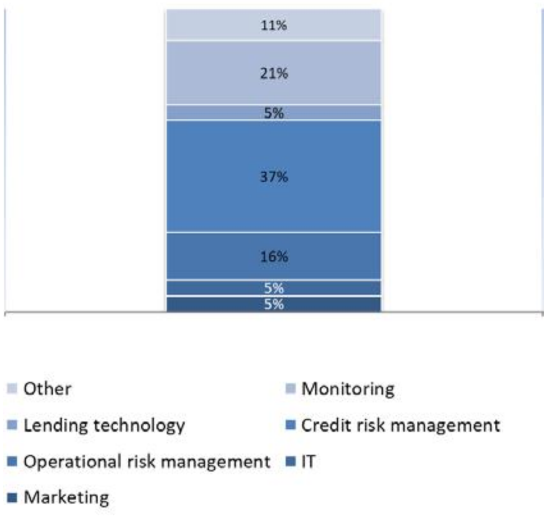
Banking groups have stabilised internally and are contemplating expanding their operations anew. Close to four banking groups out of five still report planning a structural expansion of their operations in SSA in the long term (Figure 1.6.a.), whereas in the short run no banking groups are planning to consolidate their operations in SSA (Figure 1.6.b.). 14% report that they consolidated their activities during the previous 12 months, but no banking groups project this for the following 12 months. More than half of the banking groups are planning to expand organically. A growing share, more than a quarter, are planning some brownfield and greenfield investments. A constant share, about one fifth, are planning some acquisitions.

Figure 1.7. - Strategic Focus and TA Needs
(share of survey respondents)

a. Long-Term Market Focus



b. Technical Assistance Needs

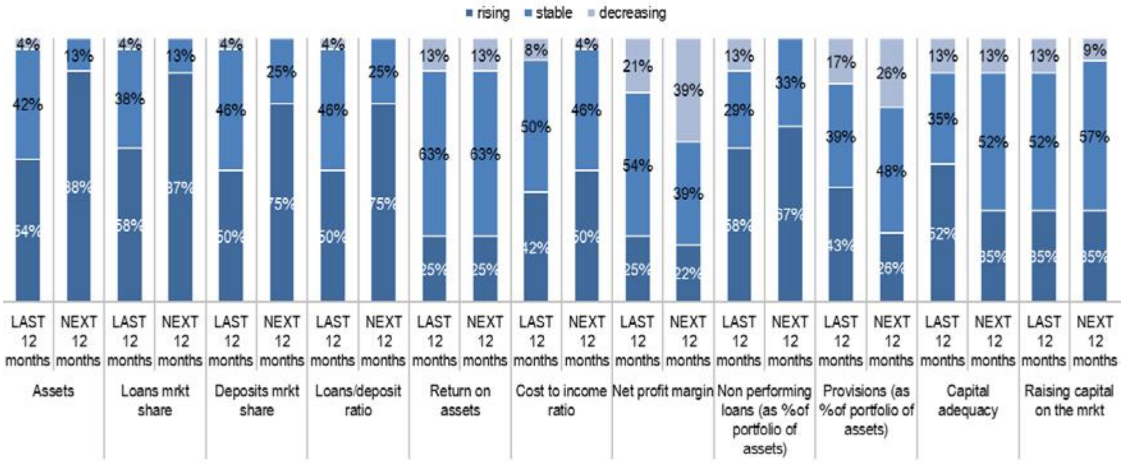


Source: 2018 EIB survey of banking groups in SSA.
Note: Panel a refers to Question 4 (market focus); panel b refers to Question 18 (see Appendix).

A growing share of the surveyed banking groups reports a long-term focus on SMEs and on retail clients. As shown in Figure 1.7., 60% of banking groups now report a long-term focus on SMEs. 30% of groups report a focus on retail clients, compared to 8% in 2016. In our 2018 sample, groups do not report a focus on large multinationals, while the share of groups focusing on local large companies declined from one in four to one in ten. Groups also report that their main medium-term need in terms of technical assistance (TA) relate to credit risk management (37%) and credit monitoring (21%). This is consistent with a growing focus on SMEs and with rising NPLs.

1.4. Recent Trends in Market and Funding Conditions for Banking Groups in SSA

Figure 1.8. - Banking Groups' Assessment of Ongoing and Prospective Market Conditions
(share of survey respondents - as %)

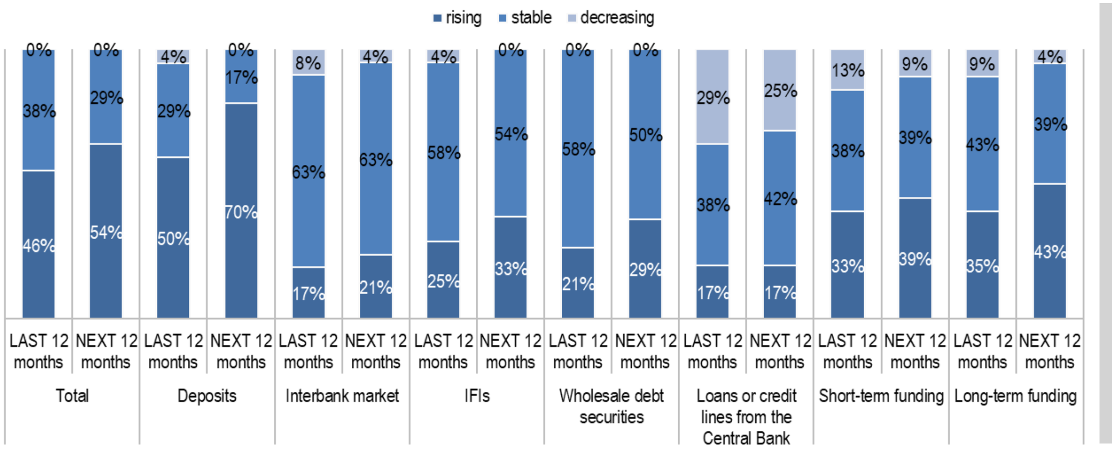


Source: 2018 EIB survey of banking groups in SSA.
Note: Question 2 (see Appendix).

Banking groups report improving market conditions in terms of origination and market share but also rising NPLs and declining margins (Figure 1.8.). The vast majority (89%) of respondents expect assets to grow in the short run. They also expect a pickup in their loans and deposits market shares, which is indicative of sharpening market competition. Expanding market shares for large banking groups, if they materialise, will come at the expense of smaller banks that are not covered by the survey. Indeed, close to two banking groups out of five expect their net profit margins to fall in the short run and half-expect a rising cost-to-income ratio. Three quarters of banking groups are planning an expansion of their loan-to-deposit ratio and a slowdown in capital adequacy. Only about a third of banking groups are planning to raise capital on the market.

Figure 1.9. - Group Access to Funding in SSA

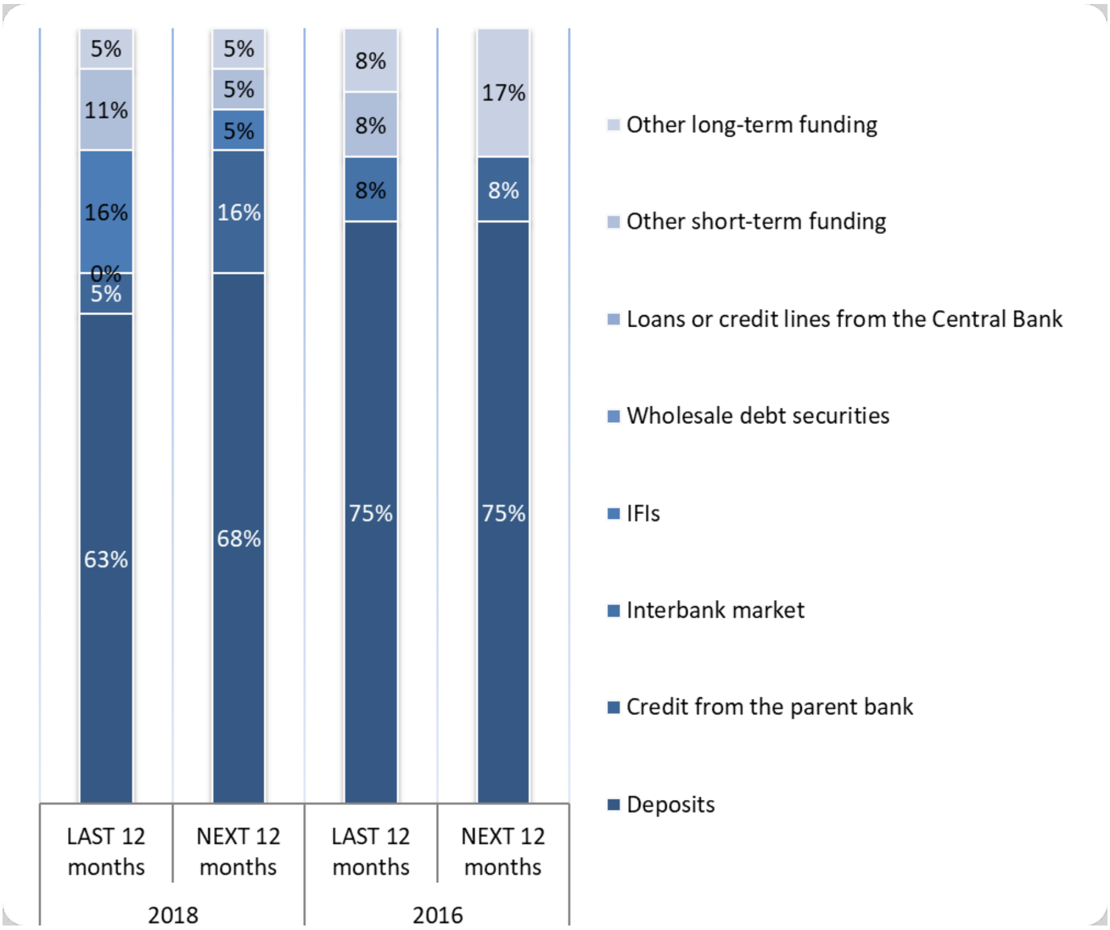
(share of survey respondents)



Source: 2018 EIB survey of banking groups in SSA.
Note: Question 3 (see Appendix).

The majority of banking groups expect rising access to funding at group level with the emphasis on deposits and long-term funding (Figure 1.9.). Only a quarter of respondents intend to tap the interbank market and less than a fifth credit from the Central Bank. One group out of four is planning to curb the use of Central Bank funding. However, two groups out of five are planning to tap short-term funding. A third of groups are planning to use wholesale debt securities, roughly the same proportion as for funding by IFIs. An uptick is reported in terms of intentions to turn to IFIs for funding but this proportion is, however, lower than in 2016 (50%).

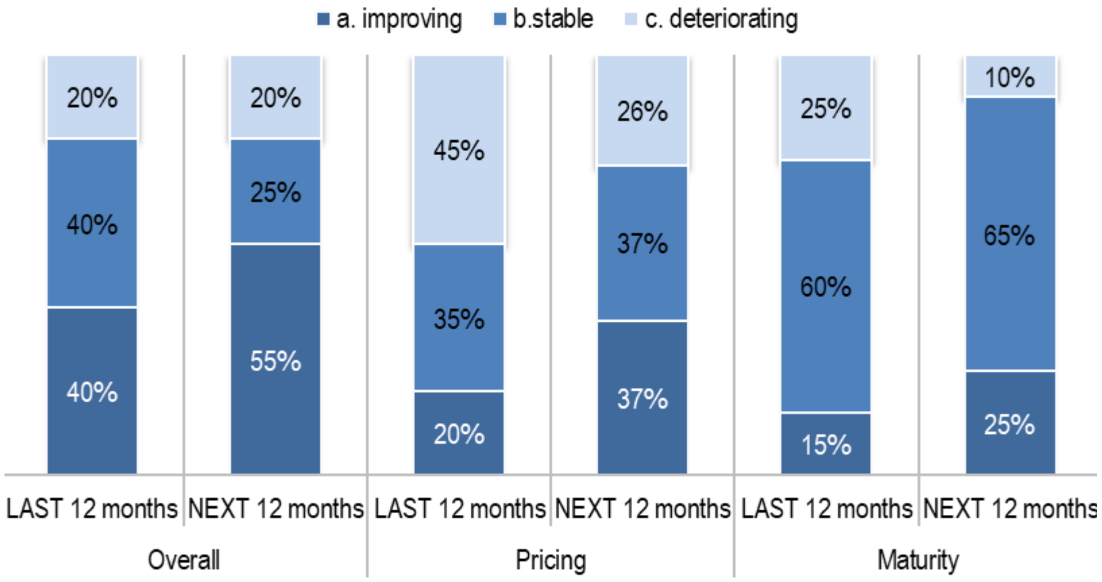
Figure 1.10. - Subsidiary Access to Funding
(share of survey respondents)



Source: 2018 and 2016 EIB survey of banking groups in SSA.
Note: Question 8 (see Appendix).

The funding structure at the subsidiary level is still heavily reliant on deposit collection but less so than two years earlier (Figure 1.10.). Back in 2015, 60% of banking groups reported and expected deposits to be the main source of funding for their subsidiaries. In the 2016 edition, this share rose to 75%. In 2017, this share decreased to 63% but is set to increase to 68% in the short term. In other words, reliance on deposits at subsidiary level seems to be returning to the pre-crisis level - dominant but no longer overwhelming. A rising share of banking groups (16%) are planning to finance their subsidiaries. Other marginal sources of funding in the short run include IFIs, and other short and long-term funding sources.

Figure 1.11. - Trends in Funding Conditions at Subsidiary Level
(share of survey respondents)

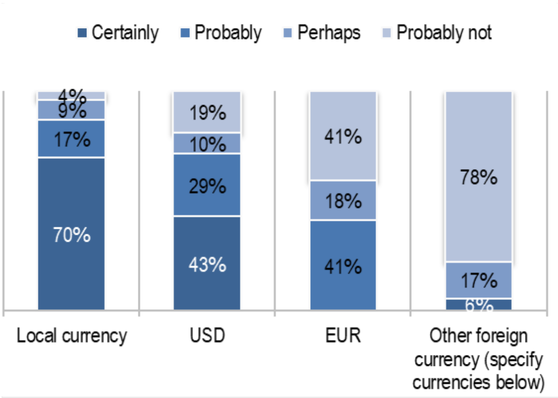


Source: 2018 EIB survey of banking groups in SSA.
Note: Question 9 (see Appendix).

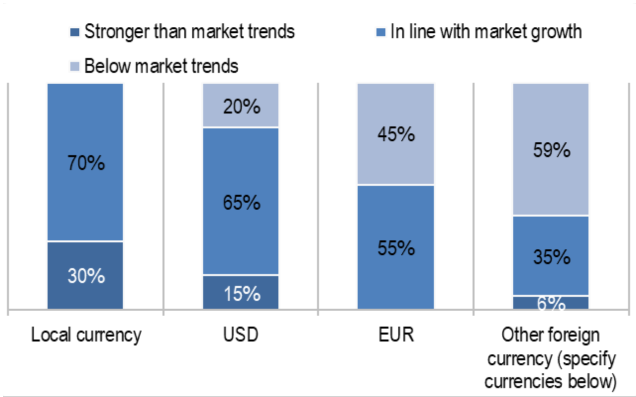
Banking groups report growing optimism with respect to overall access to funding conditions but they are less hopeful in terms of pricing and maturity (Figure 1.11.). In the short run, the majority of banking groups (55%) expect an improvement in overall funding conditions at subsidiary level. A growing share of banking groups expect an improvement in pricing and maturity conditions for funding at subsidiary level but the majority of banking groups expect pricing and maturity conditions either to remain stable or to deteriorate. Nevertheless, while, in the recent past more banking groups expected pricing and maturity conditions to deteriorate than to improve, going forward, more banking groups expect an improvement than a deterioration. Although banking groups are not as sanguine about the funding situation as even two years ago, their opinion indicates that the worst seems to be over given the improving outlook.

Figure 1.12. - Local Currency and Foreign Exchange Funding and Lending
(share of survey respondents)

a. Plans to raise funds



b. Perceived demand for loans



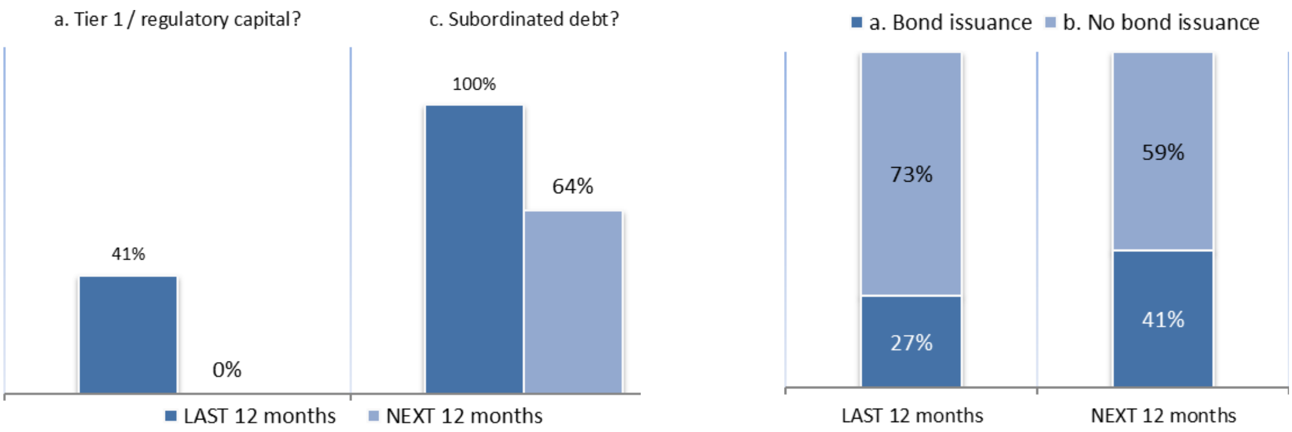
Source: 2018 EIB survey of banking groups in SSA.
Note: Question 11 (see Appendix).

Banking groups are mainly planning to raise funds in local currency (Figure 1.12.a.) **and correspondingly they perceive demand for loans in local currency to be either stronger** (30%) **than or in line** (70%) **with market trends** (Figure 1.12.b.). Banking groups also report plans to raise funds in USD, albeit with less certainty than in local currency. They also perceive loans in USD to be in demand although less so than those in local currency. Two banking groups out of five indicate that they are probably more inclined to raise funds in EUR and the majority (55%) of them report that demand for loans in EUR is in line with market trends. Four banking groups out of five are not planning to raise funds in other currencies and three groups out of five consider demand for loans in other currencies to be below market trends.

Figure 1.13. - Capital, Subordinated Debt and Bond Issuance
(share of survey respondents)

a. Tier 1 vs. subordinated debt

b. Bond issuance



Source: 2016 EIB survey of banking groups in SSA.
Note: Panel a refers to Question 14; panel b refers to Question 15 (see Appendix).

While no banking groups are considering raising Tier 1 capital over the next 12 months, subordinated debt issuance is prominent (64%) **and, to a lesser extent, bond issuance** (41%) **also** (Figure 1.13.)**.** While two groups out of five declare they have issued regulatory capital in the past 12 months, the share falls to zero for the next 12 months, suggesting groups have exhausted their needs for Tier 1 capital per se. In contrast, subordinated debt issuance is reported to have been undertaken recently by all banking groups and the majority of them are planning to issue some more in the near future. Two groups out of five are planning to issue a bond in the near future, compared to 27% in the 2016 edition of the survey.

1.5. Medium-Term Trends in Access to Finance in SSA

While a large part of the population in SSA remains unbanked, notable progress has been achieved in terms of financial access since 2011 and even the formal banking sector is showing signs of progression. However, the use of financial services and active financial inclusion has not evolved as fast as account ownership, and access to finance is still limited for SMEs in SSA. There is a real opportunity for mobile money services to fill the gap by offering financial services at low cost. Many existing success stories highlight the importance of strategic partnerships between banks and telecom companies.

1.5.A. Financial Inclusion Indicators

Table 1.2. - Financial Access in sub-Saharan Africa
(as %)

Financial access	Sub-Saharan Africa			Developing countries		
(as % of population, age 15+)	2011	2014	2017	2011	2014	2017
Account*	23	34	43	42	55	63
Financial institution account	23	29	33	42	54	61
Saved at a financial institution	14	16	15	17	22	21
Debit card ownership	15	18	18	24	32	40
Credit card ownership	3	3	3	7	10	10
Borrowed from a financial institution	5	6	7	8	9	9
Borrowed from family or friends	40	42	31	26	29	29

Source: Global Findex.
*Note: The Global Findex defines account ownership as having an individual or jointly owned account either at a financial institution (accounts at a bank or another type of formal, regulated financial institution, such as a credit union, a cooperative or a microfinance institution) or through a mobile money provider (mobile phone-based services, not linked to a financial institution, that are used to pay bills or to send or receive money).

In 2017, 43% of the adult population was estimated to have an account[6] compared to only 23% in 2011 (Table 1.2.). This rapid evolution is partly due to the fast penetration of mobile payment services. When looking only at the figure for financial institution accounts, the progression has been much slower: 33% of the adult population had an account at a financial institution in 2017, up 10 percentage points from 2011 (compared to a 20-percentage point increase for all accounts). Bank account ownership in SSA is still much lower than in developing countries on average, where 61% held a financial institution account in 2017 (63% including mobile money accounts).

However, SSA still has a long way to go in terms of use of financial services, and active financial inclusion has not evolved as fast as account ownership. The percentage of adults with savings at financial institutions remains low, as does the percentage of individuals with a debit card (Table 1.4.). Improvements have also been very limited since 2011. It is possible, though, that the rapid penetration of mobile banking services has limited the need for more traditional banking products, such as debit card and saving accounts at banks, given the limited access of the population to these products and the fact that some of these services are accessible through a mobile money account. Only 7% of the population in SSA has borrowed from a financial institution. This is only slightly lower than the average for developing countries, which stood at 9% in 2017. In contrast, over a third of the population in SSA has borrowed from family or friends but, notably, this share has fallen since 2011 when it was 40%. In any case, informal borrowing mechanisms are still predominant in SSA.

[6] Global Findex defines account ownership as having an individual account at a financial institution or through a mobile money provider.

Table 1.3. - The State of the Banking Sector in SSA

Year	2012	2013	2014	2015	2016	2017
Commercial bank branches (per 100 000 adults)	3.7	3.8	4.2	4.9	5.3	.
Borrowers from commercial banks (per 1 000 adults)	21.5	23.3	34.2	34.7	.	.
Depositors with commercial banks (per 1 000 adults)	206.9	245.0	242.6	292.1	.	.
Domestic credit to private sector by banks (% of GDP)	29.3	27.9	27.7	28.8	28.9	31.8
Firms using banks to finance investment (% of firms)	.	.	.	.	20.8	22.9

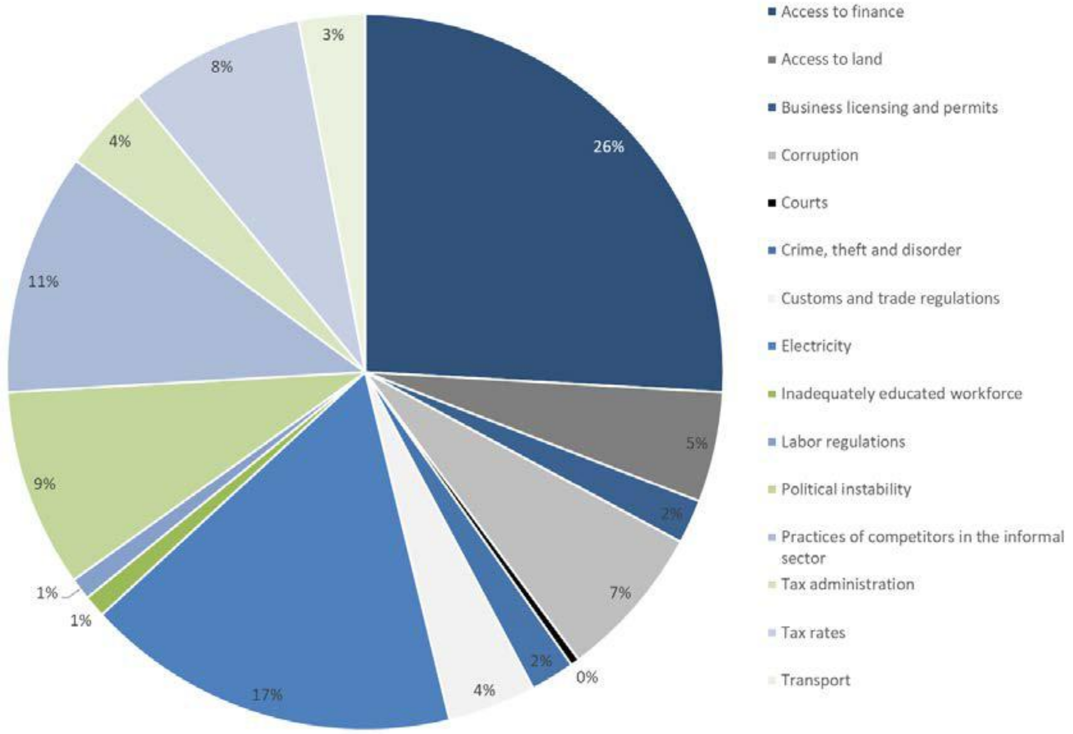
Source: World Bank, World Development Indicators.

Despite the low percentage of formally banked individuals, even the formal banking sector is showing signs of progression (Table 1.3.). The number of commercial bank branches has increased slightly from 3.7 to 4.9 per 100 000 adults. For comparison, the group composed of low and middle-income countries recorded 9.8 branches per 100 000 adults in 2016. Given the cost of opening brick-and-mortar branches in countries with limited transport infrastructure and sparsely populated areas, it is not surprising that banks are reluctant to develop their branch network in many SSA markets, particularly outside large urban centres. The number of borrowers and depositors also increased over the 2012-2015 period but is still below the low and middle-income countries' average, with 292.1 depositors per 1 000 adults in 2015 compared to 742.6 for low and middle-income countries on average, and 34.7 borrowers per 1 000 adults in 2015 compared to 105.9 for low and middle-income countries on average.

There is a real opportunity for mobile money services, including those provided by banks, to fill the gap by offering financial services at low cost. Domestic credit to the private sector by banks stood at 31.8% of GDP in 2017, compared to 104.9% for the low and middle-income group. In fact, only 22.9% of firms reported using banks to finance their investment in 2017, compared to 29.1% for low and middle-income countries.

1.5.B. ADVANCES IN FINANCING SMEs: OPPORTUNITIES AND CONSTRAINTS

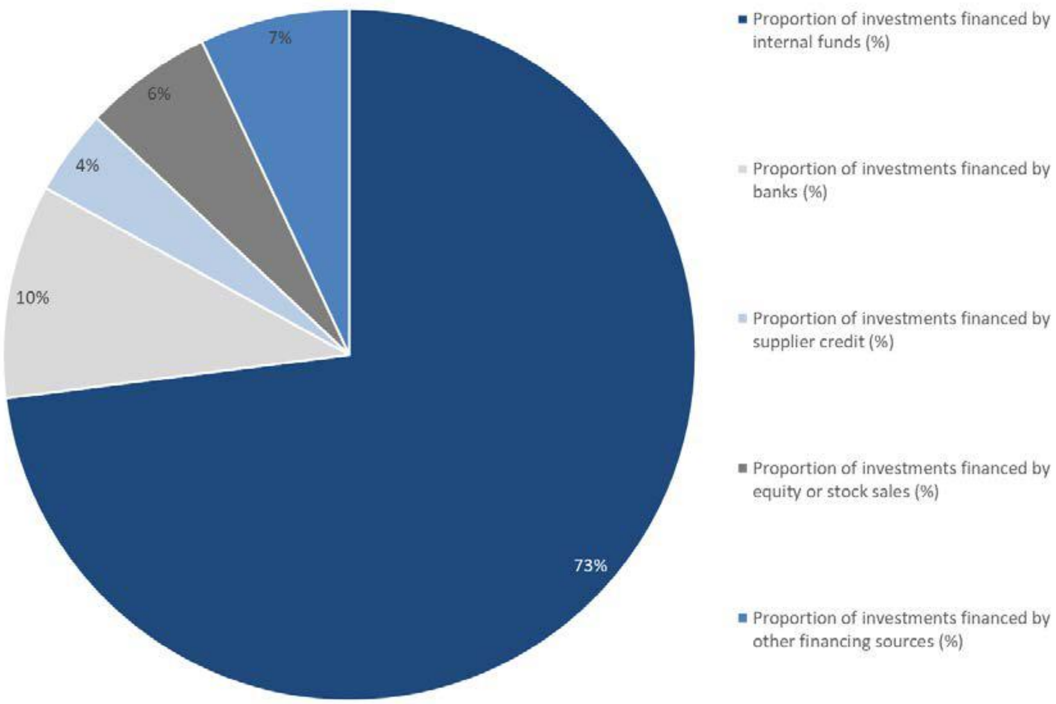
Figure 1.14. - Biggest Business Obstacles for SME firms in SSA



Source: World Bank Enterprise surveys. N=13 722 (number of enterprise-years). Survey years: 2011-2017 in sub-Saharan Africa.

Bank financing of the private sector is still insufficient. 26% of SME firms in SSA surveyed over the period 2011-2017 declared that access to finance was the biggest obstacle to their business (Figure 1.14.). Electricity comes second with 17% of firms considering it as their biggest obstacle, illustrating the fact that infrastructure issues and power cuts are also making business operations more difficult on the continent. Informality, and in particular the practices of competitors in the informal sector, is also an obstacle that was reported by 11% of the firms surveyed. This is not surprising given that the share of the informal economy in SSA is among the largest in the world, reaching almost 38% of GDP over 2010-2014, only surpassed by Latin America, at 40% of GDP (Medina et all, 2017). On average, 49% of the firms surveyed in SSA considered that access to finance was a major constraint, along with corruption (37% of firms), political instability (33% of firms) and business licensing and permits (15%). On average, surveyed firms in SSA reported operating for a year without formal registration, indicating the difficulties faced by firms to start a formal business in the region.

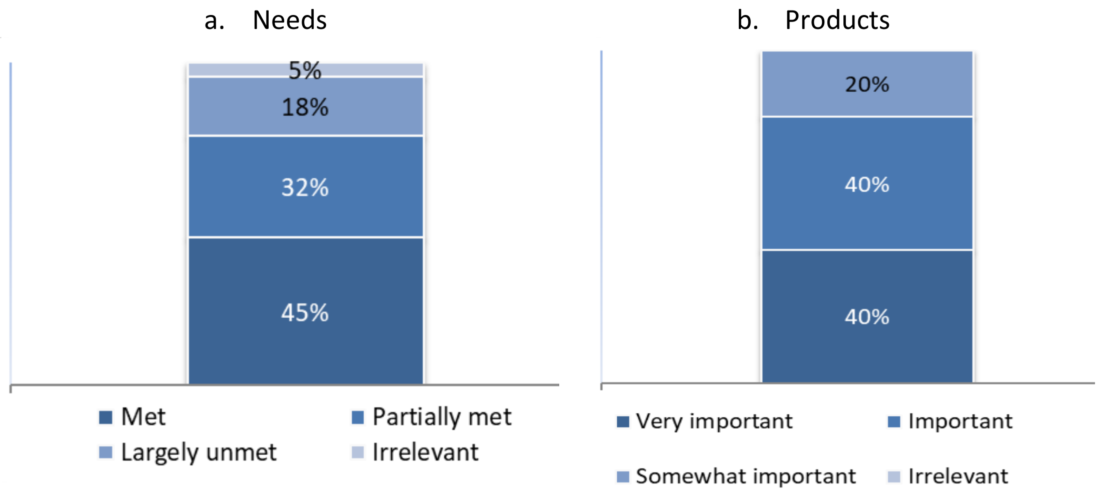
Figure 1.15. - Source of Financing for SMEs



Source: Enterprise surveys. N=4 779 (number of enterprise-years). Survey years: 2011-2017.

Access to finance is still limited for SMEs in SSA and most SME investment is self-financed, resulting in a large SME financing gap (Figure 1.15.)**.** Given the difficulty in accessing bank finance, 73% of the investments made by the SMEs surveyed by the World Bank in its Enterprise Survey were financed by internal funds, and only 10% by banks, the rest being financed by supplier credit (4%), equity or stock sales (6%) and other financing sources (7%). The SME Finance Forum (2018) estimates that 20% of SMEs in SSA are fully constrained by financing and 26% partially constrained, implying that close to one SME out of two is partially or fully constrained by access to finance.

Figure 1.16. - Portfolio Guarantees
(share of survey respondents)

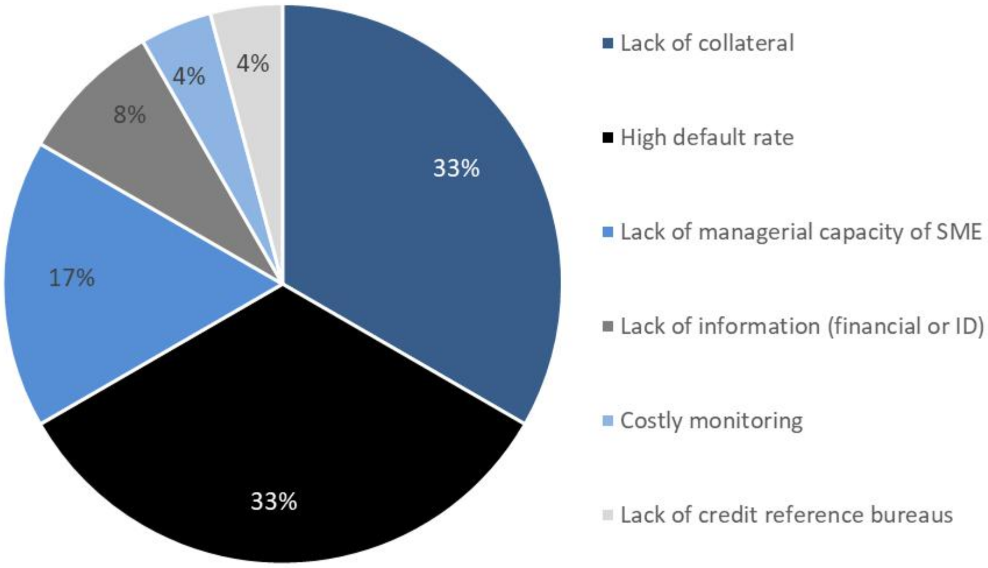


Source: 2018 EIB survey of banking groups in SSA.
Note: Panels a and b refer to Question 12 (see Appendix).

In that context, IFIs have developed programmes to offer portfolio guarantees to commercial banks when lending to SMEs, but a significant portion of the needs for portfolio guarantees is still unmet (Figure 1.16.)**.** 45% of banking groups report their portfolio needs are met, and 32% partially met. In addition, 80% consider that portfolio guarantees are important or very important. This suggests that more has to be done as the majority of banking groups report that their need for guarantees are either largely or partially unmet - in fact as many as one out of five respondents indicate their needs are largely unmet. The supply of guarantees represents, however, only one side of the equation, as there are also constraints on the demand side, from the SMEs themselves. In fact, 35% of banking groups in our survey consider that the lack of demand for bank loans from bankable SMEs was a key factor in limiting lending, and another 35% responded that it was partially a key factor[7]. Indeed, identifying which SMEs are bankable to begin with is already a challenge.

[7] Question 22 (see Appendix).

Figure 1.17. - Main Obstacle to SME Lending
(share of survey respondents)



Source: 2018 EIB survey of banking groups in SSA.
Note: Question 23 (see Appendix).

According to banking groups, the lack of adequate collateral (33%) **and high default rate** (33%) **constitute the largest obstacles to SME lending in SSA** (Figure 1.17.). Lack of managerial capacity within SMEs comes third (17%) and lack of information (8%) fourth. This suggests that managerial capacity building for SMEs is an important tool for development partners. With firms often operating informally and lacking proper accounting and financial reporting documents, it is difficult for banks to assess credit risk and to monitor borrowing entities (4%). Credit bureau deficiencies (4%) also play a role and highlight the important role technical assistance can play in this area. Credit reference bureaus help mitigate the asymmetry of information and increase transparency in the system. In addition, for good borrowers, positive information from credit reference bureaus can help them negotiate their borrowing rate, which is often in the two-digit bracket. However, only a handful of countries in SSA have fully functioning credit bureaus. The lack of branch networks and regulatory and legal barriers are not cited by banking groups as important obstacles.

1.5.C. The Advent of Fintech and its Impact on Financial Inclusion and the Banking Sector

Cheap and easily accessible financial services through a mobile phone is providing access to finance to a broad range of clients across an increasing number of developing countries. Historically, lack of customer information, small transaction size, and higher risks have led financial organisations in developing economies either to refrain from offering formal financial services to large segments of the population or to charge high fees for the services they do offer (Claessens 2006, Banerjee and Duflo 2011). Consequently, more than half of the world's population is not integrated in the formal financial system (Beck et al. 2008, Demirgüç-Kunt et al. 2015). While people in developing countries have limited access to banking services, the penetration rate of mobile phones has grown rapidly, nearing 80% in Africa[8]. This is facilitated by the availability of cheap feature phones and smartphones that are affordable even to low-income populations.

Table 1.4. - Deployment of Mobile Payment Services by Region

Deployment by region (# MPS)			
East Asia and Pacific	41	Middle East and North Africa	18
Europe and Central Asia	8	South Asia	39
Latin America and the Caribbean	34	Sub-Saharan Africa	135

Source: GSMA, March 2018.
Note: figures include payment services offered by banks.

The success story of M-Pesa in Kenya is now well known, but the market has evolved far beyond this initial success story. Providers are now extending their services to micro-loans and saving products. SSA has the largest deployment of mobile payment services in the world. As of March 2018[9], 135 companies were offering mobile payment services in SSA (Table 1.4.). A good example is M-Shwari, which offers a combination of savings and loan products and was launched in 2012 through a strategic partnership between Commercial Bank of Africa (CBA) and Safaricom. In 2015, it was estimated that one in five Kenyans were active M-Shwari customers[10].

Many existing success stories highlight the importance of strategic partnerships between banks and telecom companies. 78% of the banks in our survey consider that telcos can usually form effective partnerships with banks to provide mobile money services, and only 17% of the banks consider telcos to be direct competitors to banks in the mobile money sector[11]. Even though regulations tend to be open to telecom groups offering mobile payment services in SSA, these groups may still not offer products such as loans and savings without partnering with a bank, due to the fact that they do not have a bank licence allowing them to provide these services directly. Another advantage of telecom-bank partnerships is that, by integrating more economic activities within the formal financial system and providing financial services to formerly unbanked people, major benefits may be generated in terms of national economic growth and development (Levine 1997 and Raj 2015). The high cost for brick-and-mortar bank branches is another reason why telcos and banks cooperate (EIB, 2017).

[8] The GSMA estimated a penetration rate (in terms of SIM connection) of 77% in 2017.
https://www.gsma.com/mobileeconomy/archive/GSMA_ME_SubSaharanAfrica_2015.pdf
[9] Source: GSMA database, Mobile Money around the World.
[10] Source: http://www.cgap.org/blog/top-10-things-know-about-m-shwari.
[11] Question 25 (see Appendix).

Table 1.5. - Use of Digital Payments

Financial access	SSA		Developing countries	
(as % of population, age 15+)	2014	2017	2014	2017
Made or received digital payments in the past year	27%	34%	32%	44%
Made digital payments in the past year	23%	29%	26%	36%
Received digital payments in the past year	21%	25%	25%	27%

Source: Global Findex.

There is growing and widening use of digital and mobile payment services in SSA (Table 1.5.). In 2017, over a third of the population made or received a digital payment in the preceding year, a 7-percentage points increase compared to 27% in 2014 (Table 1.5.). In 2017, 23% of the adult population paying utility bills used a mobile phone to do so compared to 10% in 2014. Similarly, 19% of adult wage recipients received their wages through a mobile phone in 2017, compared to only 8% in 2014[12]. As a result, the use of mobile payments is having a profound impact on the economic lives of both the unbanked and banked populations in SSA, by offering an affordable and efficient way of conducting transactions and receiving money. While airtime top-up, cash in/cash out and peer-to-peer transfers are the dominant services offered by mobile payment providers, 84% of the providers in SSA also offered international bill payment services, 79% had merchant payment facilities, and 45% allowed customers to conduct international remittance operations.

With a few notable exceptions, banks have taken a backseat when it comes to the provision of mobile money services in SSA. This is due partly to the fact that they do not have the retail agent networks that telcos have and that their typical business model is based on fees from intermediation, not on small commission/large transaction business. Some banking groups can be found among the top mobile payment providers, such as FirstRand Bank (South Africa), which offers mobile payment services in Botswana, eSwatini, Lesotho, Namibia, Zambia, and in its home country South Africa. However, generally speaking, banking groups tend rather to offer mobile payments on a case-by-case basis. For instance, the French group Société Générale, which operates as a bank in 18 African countries, only offers mobile payment services in two of them (Cameroon and Senegal). Banks are focusing both on internet-banking technology for their existing clients and on mobile banking technology. Indeed, 42% of surveyed banks report that their internet-banking technology is fully deployed and another 42% that they are in the process of deploying it. As regards mobile banking technology, 25% report that it is fully deployed and 63% that it is in deployment[13].

1.6. Conclusion

This study comes at a time when most SSA economies are still recovering from a severe slowdown in 2016. Wounds to many of the region's financial sectors are noticeable, especially in terms of rising NPLs and diminishing returns on assets. Financial development has been on the rise in SSA since the early 1990s but has paused in several of the region's countries over the past two years. This pause has a lot to do with the 2016 slowdown and sluggish recovery

[12] Source: Global Findex, World Bank.
[13] Question 19 (see Appendix).

in 2017. Many banking groups in SSA are either directly exposed to the minerals and energy sectors or indirectly via loans to the Government or its suppliers. Yet, SSA cannot afford such a pause given the need for shared and sustainable growth to achieve the Sustainable Development Goals (SDGs).

The good news from the EIB survey of banking groups in SSA is that a rising share of banking groups are planning a structural expansion of their operations in SSA and that no banking group is planning to consolidate operations in SSA anymore. There is growing optimism with respect to overall access to funding. Banks are mainly planning to raise funds in local currency, with emphasis on deposits and long-term funding, such as subordinated debt. Half of banking groups report being fully deployed in terms of general IT infrastructure. The majority of them are in deployment and planning deployment in terms of internet-banking technology, mobile banking and FinTech. The share of banking groups compliant with Basel II and Basel III standards has risen since the last edition of our survey, but the overhaul of risk management and compliance capacity is still in progress.

The importance of sustaining efforts to strengthen the legal, regulatory and supervisory superstructure of SSA's financial sector cannot be overstated. Working out NPLs and resolving banks that cannot return to profitability will be key to underpinning the confidence that is necessary for private investment in SSA. In order to attract risk-friendly capital, banking sectors and their players will need to demonstrate credibly that capital is put wisely to work and that, if investors wish to do so, they can retrieve their investment in normal conditions and be treated fairly in case of resolution.

In a subtle way, fortunately, it is remarkable how financial intermediation has kept on improving throughout the recent economic slowdown, thanks to a rethink by banking sector players and their regulatory authorities. Digital financial inclusion in on the march: it has clearly spilled-out of Eastern Africa and is now improving access to finance in all of Africa's regions. Even SME financing, while still representing an enormous gap, is beginning to improve. Rising competition amongst banks is prodding banking groups to move out of their comfort zone and to seek growth and returns by financing more SMEs and professionals. Accordingly, banks are investing in their IT infrastructure, digital and brick-and-mortar networks, and strengthening their risk management and credit origination processes.

As SSA economies continue to recover, the opportunity to deepen the region's financial sectors should not be missed even though the lowest hanging fruit have probably been already picked. Outside of banking sectors per se, financial markets are still shallow, with a few notable exceptions. Step-by-step capital market development is the necessary pre-condition for channelling the region's long-term domestic savings towards long-term investments, not just short-term commerce. IFIs and DFIs can and should provide local currency resources and de-risk long-term investment but ultimately, it is the region's own local currency resources that need to be mobilised in order to ensure the region's economic future sustainably, and not just plug gaping fiscal deficits.

As financial inclusion advances, new challenges will emerge that will have to be addressed sooner than later. Consumer protection will be key to maintaining the confidence of first-time depositors and financial service users and ensuring a level playing field with regulated players. Private sector development will require technical assistance and knowledge transfers, not just financing. This is a long-term investment that banking groups will ultimately find to their economic and financial advantage as they groom tomorrow's larger and stronger clients but the work needs to begin now.

Meanwhile, rising competition should result in improved financing conditions for SMEs, which will increase the share of SMEs that finance their growth through bank financing rather than retained income. Ultimately, SMEs are the only employers that can deliver SSA's much-needed demographic dividend. All stakeholders need to remain fully engaged and coordinated on the private sector development agenda or risk counting tomorrow the hundreds of millions of young Africans whose opportunity to make a contribution to their country go to waste, due to the shortage of decent and productive employment opportunities. Nothing less is at stake.

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Pelletier, 2014

World Bank, Global Findex

World Bank, Enterprise surveys

World Bank, World Development Indicators

Appendix 1: The Survey Questionnaire, 2016 Extended Edition

Q1 | What is your bank's positioning in each country[14]…

		… current positioning	… perceived market potential	… strategic positioning
1	Angola			
2	Benin			
	…			
49	Zimbabwe			

In Q1, for current positioning, the following answers are possible: a. active with subsidiary or branch - with significant market share (among top 3 market players); b. active with subsidiary or branch - with medium market share; c. active with subsidiary or branch - with niche market presence; d. active with representative office; e. inactive. For perceived market potential, the following answers are possible: a. low; b. medium; c. high. The corresponding map illustrates the weighted sum of the answers of African banking groups for a specific country with a weight of one for answer a, two for answer b, and three for answer c. For strategic positioning, the following answers are possible: a. increase presence with new acquisition; b. increase presence with new capital provided by parent company/reinvested earnings; c. increase presence with new funding from parent company; d. increase presence via cross-border lending activity; e. remain stable; f. decrease presence via reduced cross-border lending activities; g. decrease presence with lower funding from parent company; h. decrease presence by selling assets/subsidiaries.

Q2 | In sub-Saharan Africa, key indicators have been/are expected to be …

	LAST 12 months	NEXT 12 months
Assets		
Loan applications		
Loans market share		
Deposits market share		
Loans/deposits ratio		
Return on assets		
Cost-to-income ratio		
Net profit margin		
Non-performing loans (as % of portfolio of assets)		
Provisions (as % of portfolio of assets)		
Capital adequacy		
Raising capital on the market		

[14] The full list of countries covered by the survey is: Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Côte d'Ivoire, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Republic of the Congo, Rwanda, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, Somalia, South Africa, South Sudan, Sudan, eSwatini, Tanzania, Togo, Uganda, Zambia, Zimbabwe.

Q3 | In sub-Saharan Africa, group's access to funding...

	…How has it changed over the LAST twelve	…How do you expect it to change
Total		
Deposits		
Interbank market		
IFIs		
Wholesale debt securities		
Loans or credit lines		
Short-term funding (<=1 year)		
Long-term funding (>1 year)		

For each variable in Q2 and Q3, the following answers are possible: a. rising; b. stable; c. decreasing.

Q4 | Longer-term strategic approach (beyond 12 months): looking at operations in sub-Saharan Africa, your group intends to…

Overall	
To which of the following new products/services does your group give the highest priority for the next 12 months?	
Market segment focus	

For Q4, overall, the following answers are possible: a. expand operations overall; b. maintain the same level of operations overall; c. scale down operations overall. The corresponding figure illustrates the net sum of the answers of all African banking groups with a weight of +1 for answer a, 0 for answer b, and -1 for answer c. As for new product and service focus, the following answers are possible: a. by rolling out mobile banking; b. by rolling out mortgage financing; c. by rolling out consumer credit/credit cards; d. by rolling out leasing products; e. by rolling out e-banking services; f. other, please specify below. The following answers are possible with respect to market segment focus: a. by focusing on large multinationals; b. by focusing on large local companies; c. by focusing on SMEs; d. by focusing on retail clients.

Q5 | Group total medium-term exposure to sub-Saharan Africa: concerning cross-border operations to SSA countries, your group has/intends to…

	LAST 12 months	NEXT 12 months
Total Exposure		
Exposure to subsidiaries - intra-group debt funding		
Exposure to subsidiaries - capital		
Direct cross-border lending booked in the balance sheet of the parent company		
Funding to banks and other financial institutions (e.g. MFIs) not part of the group, booked in the BS of the parent		

For Q5, the following answers are possible: a. expand(ed) exposure; b. maintain(ed) the same level of exposure; c. reduce(d) exposure.

Q6 | Profitability of operations in SAA region: the contribution of activities in SSA in total ROA of the group has/is expected to…

	LAST 12 months	NEXT 12 months

For Q6, the following answers are possible: a. increase(d); b. be(en) stable; c. decrease(d).

Q7 | Compared to the overall group and corrected for the cost of risk, profitability of operations in SSA region: ROA of your SSA operations has been/is expected to be …

	LAST 12 months	NEXT 12 months

For Q7, the following answers were possible: a. lower; b. equal; c. higher.

Q8 | What has been/is expected to be the most relevant form of funding for your subsidiaries in SSA…

	LAST 12 months	NEXT 12 months

For Q8, the following answers are possible: a. deposits; b. credit from the parent bank; c. interbank market; d. IFIs; e. wholesale debt securities; f. loans or credit lines from the Central Bank; g. other short-term funding; h. other long-term funding.

Q9 | Funding conditions in your own subsidiaries in sub-Saharan Africa have been/are expected to be…

	LAST 12 months	NEXT 12 months
Overall		
Pricing		
Maturity		

For Q9, overall, the following answers were possible: a. improving; b. deteriorating; c. stable. For Q9, pricing, the following answers were possible: a. less pricey; b. pricier; c. stable. For Q9, maturity, the following answers were possible: a. longer; b. shorter; c. stable.

Q10 | What share of your operations in SSA lie outside your base country…

	...assets	...revenues

For Q10, the following answers are possible: a. below 10%; b. 10 - 25%; c. 25 - 50%; d. 50 - 75%; e. above 75%.

Q11 | In SSA, in which currency do you...

	… plan to raise funds	… perceive demand for
Local currency		
USD		
EUR		
Other foreign currency (specify currencies below)		
Other foreign currency (specify currencies below)		

For Q11, plan to raise funds, the following answers are possible: a. certainly; b. probably; c. perhaps; d. probably not. For Q11, perception of loan demand, the following answers are possible: a. stronger than market trends; b. in line with market growth; c. below market trends.

Q12 | With respect to the development of your SME lending business,

	... to be
do you consider your portfolio guarantee needs …	
do you consider portfolio guarantee products …	

For Q12, portfolio guarantee needs, the following answers are possible: a. met; b. partially met; c. largely unmet; d. irrelevant. For Q12, portfolio guarantee products, the following answers are possible: a. very important; b. important; c. somewhat important; d. irrelevant.

Q13 | In SSA, who was/were typically your strongest competitor(s) over the last 12 months for lending to…

	... SMEs	... mid-caps
Specify other if applicable:		

For Q13, the following answers are possible: a. domestic state-owned bank(s; b. domestic private bank(s); c. foreign bank(s); d. cross-border lender(s); e. other.

Q14 | Group funding strategy: has your group raised/is planning to raise…

	... during the next 12 months?
Tier 1/regulatory capital?	
Subordinated debt?	

For Q14, about Tier 1 and regulatory capital, the following answers are possible: a. yes; b. no. For Q14, subordinated debt, the following answers are possible: a. certainly; b. probably; c. perhaps; d. probably not.

Q15 | Have you/do you plan to issue(d) bonds?

	LAST 12	NEXT 12
If no: why is it the case? Too expensive, no need, no capacity? Local capital market constraints? Lack of access to capital market?		
If yes: what is the strategy? Diversify sources of funding? Lengthen the maturity of funding?		

For Q15, the following answers are possible: a. yes; b. no.

Q16 | In SSA, how are you/how do you plan to expand(ing) mainly?

	LAST 12 months	NEXT 12 months

For Q16, the following answers are possible: a. organically; b. acquisitions; c. greenfield / brownfield investment; d. no plan to expand; e. consolidating.

Q17 | In SSA, which sector of the economy do you most value for lending?

For Q17, the following answers are possible: a. Agriculture, forestry and fishing; b. Mining and quarrying; c. manufacturing; d. Electricity, gas, steam and air conditioning supply; e. Water supply; sewerage, waste management and remediation activities; f. Construction; g. Wholesale and retail trade; repair of motor vehicles and motorcycles; h. Transportation and storage; i. Accommodation and food service activities; j. Information and communication; k. Financial and insurance activities; l. Real estate activities; m. Professional, scientific and technical activities; n. Administrative and support service activities; o. Public administration and defence; compulsory social security; p. Education; q. Human health and social work activities; r. Arts, entertainment and recreation; s Other service activities; t. Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use; u. Activities of extraterritorial organisations and bodies.

Q18 | With respect to lending in SSA, what are your main medium-term technical assistance (TA) needs seen from HQ level?

Specify other needs if applicable:	

For Q18, the following answers are possible: a. marketing; b. IT; c. operational risk management; d. credit risk management; e. lending technology; f monitoring; g. other (please specify).

Q19 | Where does your group stand …

	… with respect to:
a. investing in general IT infrastructure?	
b. deploying internet-banking technology?	
c. deploying mobile banking technology?	
d. deploying FinTech to streamline credit decisions?	
e. deploying gender-inclusive products and services?	
f. deploying islamic finance products and services?	

For Q19, the following answers are possible: a. fully deployed; b. in deployment; c. planning development; d. not an immediate priority.

Q20 | Do you consider your banking group …

	… to be:
Basel I	
Basel II	
Basel III	

For Q20, the following answers are possible: a. compliant; b. working towards compliance; c. not an immediate priority. The corresponding figure illustrates the breakdown of the percentages of answers in each category.

Q21 | To what extent is SME lending a priority for your business in SSA?

For Q21, the following answers are possible: a. high priority; b. moderate priority; c. low priority; d. not a priority.

Q22 | Do you perceive that (lack of) demand for bank loans by bankable SMEs plays a key factor (to explain lending)?

For Q22, the following answers are possible: a. Absolutely; b. Partially; c. Not so much; d. Not at all.

Q23 | What do you perceive as the main obstacles to SME lending in SSA?

Please choose the most important:	
Please choose the second most important:	
Please choose the third most important:	
Specify other obstacles if applicable:	

For Q23, the following answers are possible: a. lack of collateral; b. high default rate; c. lack of credit reference bureaus; d. lack of managerial capacity of SMEs; e. lack of branch network; f. costly monitoring; g. lack of information (financial or ID); h. high competition; i. regulatory/legal barriers; j. quality of asset portfolio; k. other.

Q24 | In which area of Fintech are you currently investing the most in SSA?

Specify other area if applicable:	

For Q24, the following answers are possible: a. Cybersecurity; b. Blockchain; c. Data analytics; d. Personal finance; e. Financial services software; f. Lending; g. Payment and settlements; h. Regulatory technology; i. Virtual currencies; j. Cross-border payments; k. Mobile money/e-transfers; i. Other.

Q25 | In general, what is your perception of telcos in the mobile money space (please choose the most important)?

Specify other perception if applicable:	

For Q25, the following answers are possible: a. telcos are typically direct competitors to banks in the mobile money area; b. telcos can usually form effective partnerships with banks to provide mobile money services; c. telcos are often better positioned than banks to offer mobile money services; d. other.

2. Banking Sector Trends in West Africa

Claudio CALI[1], Emmanouil DAVRADAKIS[1], Nina FENTON[1,2] and Amine EL KOURCHI[3]

Executive Summary

- West Africa is a diverse region consisting of four middle-income and twelve low-income countries. Some are natural resource-rich: Nigeria, the region's largest economy, has the eighth-largest proven oil reserve in the world and Ghana is one of the largest gold producers in the world. Others are major agricultural markets: Côte d'Ivoire, for example, is the world's largest supplier of cocoa beans.

- Recent economic performance has reflected the diversity in economic structures and particularly the differing dependence on oil. In 2017, Nigeria exited recession thanks mainly to rising oil prices, while Ghana registered a significant pickup in real GDP growth after the slowdown experienced two years before. Economic activity in the West African Economic and Monetary Union (WAEMU), of which Côte d'Ivoire is a member, remained robust, expanding by more than 6% for the sixth consecutive year in 2017.

- Buoyant economic activity and a strong presence of pan-African and foreign banks are supporting a sound and growing banking sector in WAEMU. The Central Bank of West African States (BCEAO) is implementing an accommodative policy, while the Basel III standards introduced in January 2018 are expected to boost the banking system's soundness.

- Banks in Nigeria and Ghana, though, are still challenged by the consequences of the economic slowdowns experienced in 2014-2016 and by spillovers from difficult fiscal situations. A systemic crisis was successfully averted, indicating the significant resilience of the financial systems. However, financial soundness indicators related to capital adequacy and asset quality have deteriorated on average in both markets since 2014. In addition, the financial sectors are failing to effectively intermediate finance to the real economies.

- Access to finance is either the biggest or the second biggest challenge to firms' growth in West Africa, with smaller enterprises most likely to encounter insufficient external funding.

[1] European Investment Bank.

[2] Responsible for inputs on Ghana and Nigeria.

[3] Economist, Institute of Africa - Launched in 2016, Institute of Africa was designed to meet the increased information needs regarding Africa and the will to better understand economic evolution and development opportunities on the continent.

The views expressed here are those of the authors and do not necessarily reflect those of the European Investment Bank or Institute of Africa. All remaining errors remain the authors'.

2.1. Recent Macroeconomic Trends

West Africa is a diverse region, home to around 366 million people. Average GDP per capita stood at USD 5,130 in 2017 (Purchasing Power Parity, PPP) and ranged from less than USD 1,200 in Niger to almost USD 6,000 in Nigeria. The countries of the French-speaking WAEMU zone (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo) have a common currency, with the exchange rate pegged to the euro, and an average per capita GDP of USD 2,716 (PPP). The countries outside the WAEMU zone are mainly English-speaking. The analysis that follows treats the WAEMU zone as a sub-region and adds detailed discussion of Nigeria, Ghana and Côte d'Ivoire as the major markets in the region.

While the region has significant economic potential, human development is still low: the average country ranking on the UN's Human Development Index was 155 in 2016 out of the 188 countries covered. This includes the wealthier countries (Nigeria ranked 152). Besides, several countries are well endowed with natural resources (Nigeria, Ghana, Niger, Burkina Faso, Guinea, Liberia, Mali) and gold (Ghana, Mali, Burkina Faso, Guinea). Other commodities produced include cocoa (Côte d'Ivoire, Ghana).

The region is not wholly dependent on commodities, however. For example, Lagos, Nigeria is rapidly becoming an important tech hub, and "Nollywood" is recognised as the world's second largest producer of films. The region also has a young and growing population, presenting the opportunity to benefit from a "demographic dividend". However, sustained economic diversification and private sector development are challenged by numerous difficulties, including registering property, dealing with construction permits, getting credit and electricity, paying taxes, and protecting minority investors. The West African economies ranked 143 on average in 2017, out of 189 countries, on the World Bank's Ease of Doing Business Index.

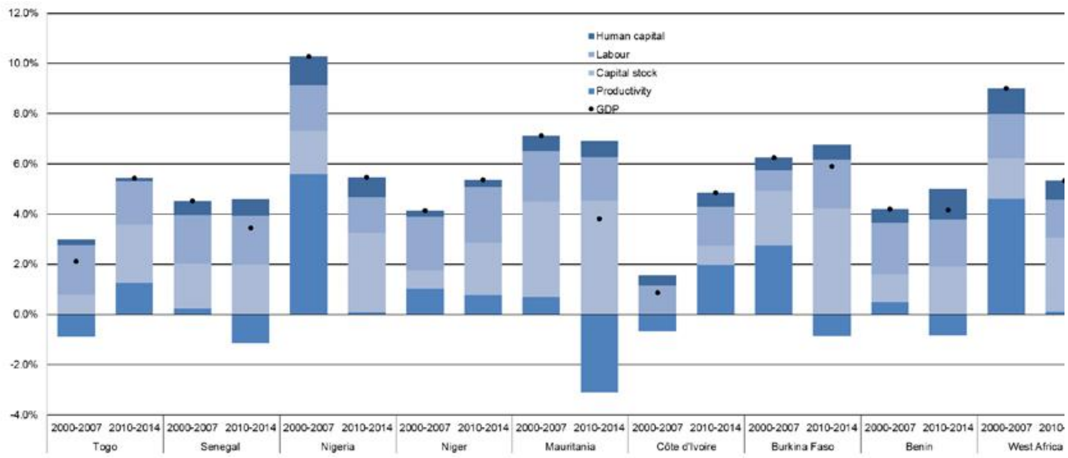
Real GDP growth in West Africa increased to 2.6% in 2017, from 0.4% in 2016. This upturn was driven by the largest economy in the region, Nigeria, which slowly exited recession. Ghana bounced back from a slowdown in 2014-16 with growth of 8.4% in 2017, while Côte d'Ivoire and Senegal also grew by over 7%. Growth in the other economies was either moderate (2.5% in Liberia and 3.5% in Sierra Leone) or strong. The average growth rate for the WAEMU economies in 2017 was 6.6%: above 6% for the sixth consecutive year, despite the adverse terms of trade shocks in the agricultural sector and security concerns. West Africa's economic growth is expected to accelerate to 3.3% in 2018 with WAEMU's economic activity expanding by 6.4% and that of the other countries by 2.7% on average.

Inflation in the WAEMU zone accelerated to 1% in 2017 from 0.1% in the previous year. Outside the WAEMU zone, inflation averaged 15.7% in 2017, up from 15.4% in the previous year mainly due to the inflation pass-through of past currency depreciation in Nigeria. The low and stable rate of inflation in the WAEMU zone reflects the success of the fixed exchange rate arrangement in safeguarding price stability. The average fiscal deficit in the West African economies was 5.3% of GDP in 2017, rising from 4.4% in the previous year.

Box 2.1. - Economic Convergence in West Africa

Economic convergence, also known as catching up, is the phenomenon whereby economies with a low per capita income will tend to grow at faster rates than richer economies. Economic activity in emerging markets, for example, expanded by 5.3% annually in 2010-2017 while the GDP of advanced economies grew by 1.9% on average. West African economies were growing at a rate of 4.7% per year on average over the period 2010-2017, with economies in WAEMU leading the pack with 5.5% average annual growth. Before the Global Financial Crisis (GFC), growth rates were even higher: countries were growing at annual rates of 6.9% on average with non-WAEMU members leading the way in the region.

Figure 2.1. - Real GDP Growth Decomposition in West Africa



Source: Authors' calculations and Penn World Tables.
Note: The chart does not include the 2008-2009 period of global recession in order to avoid biasing the results.

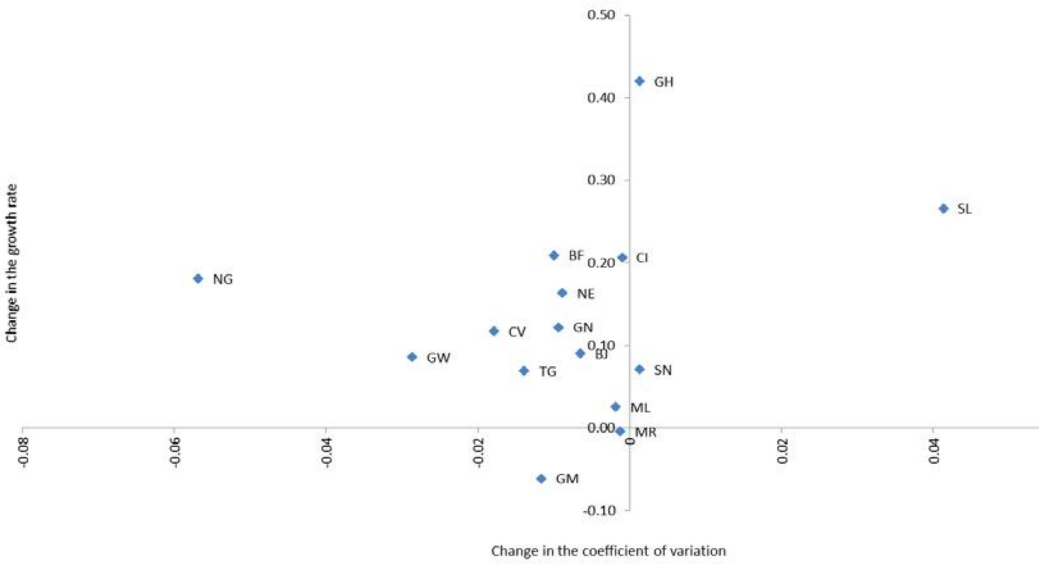
A significant drop in the contribution of productivity explains weaker growth in West Africa after the GFC. Decomposing economic growth into its principal long-term inputs reveals that productivity contributed almost 5pp to real GDP growth pre-GFC, before dropping to 0.1pp during 2010-2014 (Figure 2.1.)[4]**.** Higher capital stock contribution to economic growth during 2010-2014 relative to the pre-crisis period was not sufficient to offset the drop in productivity's contribution to economic growth. There are significant differences between countries, with some countries registering a negative productivity contribution to growth (Senegal, Mauritania and Benin) while others recorded a significant improvement (Togo and Côte d'Ivoire).

The drop in productivity's contribution to growth, however, did not prevent West African economies from growing faster and catching up with advanced economy peers amidst

[4] The latest available data point in Penn World Tables is 2014.

declining productivity in the advanced world. US productivity growth stood at 0.9% in 2017, up from -0.6% in 2016[5] as part of a long-term trend. Economist Robert Gordon[6] has shown that US productivity growth slowed from a pace of about 3% per year over 1930-1970 to an average of about 1% since then - excluding a brief spurt in the late 1990s and early 2000s.

Figure 2.2. - West Africa, Percentage Change in GDP Per Capita (Advanced Economies = 100) and Change in the Coefficient of Variation between 2006 and 2017



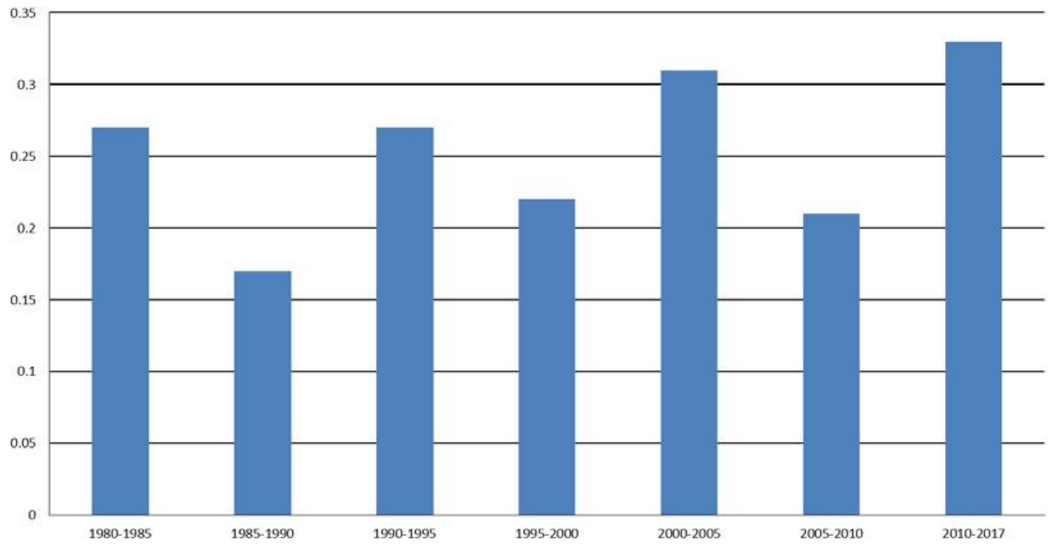
Source: Authors' calculations and IMF.
Note: Benin: BJ; Burkina Faso: BF; Cape Verde: CV; Côte d'Ivoire: CI; Gambia: GM; Ghana: GH; Guinea: GN; Guinea-Bissau: GW; Liberia: LR; Mali: ML; Mauritania: MR; Niger: NE; Nigeria: NG; Senegal: SN; Sierra Leone: SL, and Togo: TG.

WAEMU economies converged faster to advanced economies in 2017 relative to a decade before and in a less volatile manner, attributed to the significant efforts the economies took in macroeconomic management. Growth in per capita GDP (in USD PPP) relative to advanced economies increased, while volatility in the growth of per capita GDP relative to advanced economies, proxied by the coefficient of variation[7], dropped between 2006 and 2017 (Figure 2.2.). There are differences, though, between countries with regard to the improvement in growth towards advanced economies and the drop in volatility.

[5] Latest data from the Bureau of Labor Statistics.
[6] Gordon R. (2010), "Revisiting US productivity growth over the past century with a view of the future", NBER Working Paper 15834, March.
[7] The coefficient of variation of a variable is the ratio of its standard deviation to its mean.

Econometric analysis confirms that the speed with which the West African economies converged to their advanced peers has accelerated significantly since 2005 and is currently at its highest level since 1980 (Figure 2.3.)[8]. The improvement in convergence towards advanced economies witnessed between 2005-2010 and 2010-2017 was the highest since 1980.

Figure 2.3. - Speed of Convergence Relative to Advanced Economies



Source: Authors' calculations and IMF.

The increase in WAEMU's fiscal deficit was relatively small (increase to 4.6% of GDP from 4.5% in 2016) and was caused mainly by public investment in infrastructure under multi-annual development programmes. The increase in the average deficit was driven by a continued rise in Nigeria's deficit, while Ghana successfully consolidated. Nigeria's public debt is relatively low as a percentage of GDP, but it is on an upward trajectory, rising to 23% in 2017. This drove an increase in the regional average for public debt, from 27% of GDP in 2016 to 34% of GDP in 2017. West Africa's fiscal deficit is expected to be 4.6% of GDP in 2018 with WAEMU's deficit at 4% of GDP and that of non-WAEMU economies averaging 4.7% on the back of a planned fiscal consolidation.

Higher commodity prices in 2017 boosted the current account for oil exporters, including Nigeria, and this brought the average current account deficit in the region to 0.5% of GDP in 2017, down from 1.9% in the previous year. The significant import component in

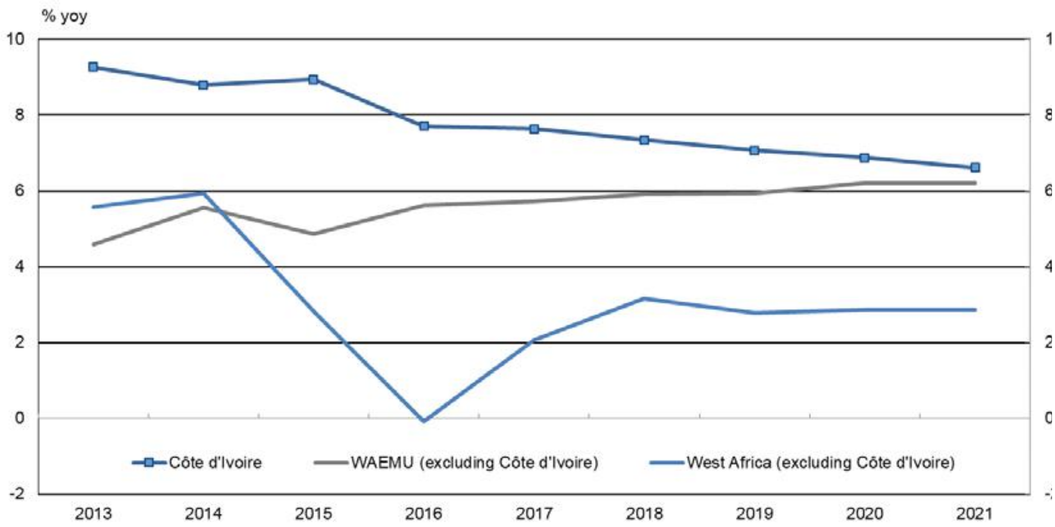
[8] We estimate the following model $\Delta ln\left(\frac{Y_{it}}{Y_{dt}}\right) = \alpha \quad + \beta_i + \gamma ln\left(\frac{Y_{it-1}}{Y_{dt-1}}\right) + \varepsilon_{it}$, where Y_{it} (Y_{dt}) is the GDP per capita in USD PPP of West African (advanced economies) at time t; Δ is the first difference operator; ln is the natural logarithm; α and β_i are constant and country fixed effects respectively, and ε is the error term. i = Benin; Burkina Faso; Cape Verde; Côte d'Ivoire; Gambia; Ghana; Guinea; Guinea-Bissau; Liberia; Mali; Mauritania; Niger; Nigeria; Senegal; Sierra Leone; and Togo. Annual data were retrieved from the IMF spanning 1980-2017, while a panel data estimation with country fixed effects was performed. Figure 2.3 illustrates the estimated coefficient $-\gamma$ when the panel estimation was performed in the time periods in the x-axis of the chart.

WAEMU's capital expenditure contributed to an increase in the average current account deficit to 6.1% of GDP in 2017 from 5.7% in the previous year.

2.1.A. SPECIAL FOCUS: CÔTE D'IVOIRE, GHANA AND NIGERIA

Côte d'Ivoire's real GDP growth is expected to be 7.3% in 2018, down from 7.8% in 2017 and 8.3% in 2016 with the economy expanding faster than its regional peers (Figure 2.4.). Yet, the past downturn in the cocoa sector, which employs a quarter of the population, will weigh on the outlook. The fiscal deficit widened to 4.3% of GDP in 2017 from 3.9% in the previous year and is expected to drop to 3.7% in 2018 and converge to the WAEMU regional norm of 3% of GDP by 2019. Public debt inched down to 46% of GDP in 2017 from 47% in 2016 with the IMF[9] assessing the risk of debt distress as moderate. State-owned enterprises' debt, estimated to amount to around 3-6% of GDP, is not included in the debt calculation. The low cost of refinancing the operations of the WAEMU zone´s central bank (Banque Centrale des Etats de l'Afrique de l'Ouest - BCEAO) and the high profitability of government bonds attracted WAEMU banks into the primary government bond market. Yet, BCEAO decided at the end of 2016 to tighten monetary policy, raised its main policy rate to 4.5% and limited the refinancing of banks to twice their own funds. These measures reduced the attractiveness of government bonds for commercial banks and challenged the ability of governments to issue debt. Côte d'Ivoire's current account deficit widened to 1.2% of GDP in 2017 from 1.1% in 2016 due to the fall in cocoa proceeds and high investment-related imports, but remains comfortably financed by foreign direct and portfolio investment.

Figure 2.4. - Annual Real GDP Growth



Source: Authors' calculations and IMF

[9] The IMF approved in December 2016 two three-year arrangements totalling USD 674.4m under an Extended Credit Facility (ECF) and an Extended Fund Facility (EFF) that was topped up by USD 224.8m in June 2017.

Nigeria and Ghana experienced slowdowns or recessions between 2015 and 2016. The slowdowns were triggered by the international fall in commodity prices. However, they were exacerbated by domestic issues (including security problems and disrupted oil production in Nigeria and a domestic energy crisis and uncertainty related to the political cycle in Ghana), and by the nature of the policy response. In particular, the government of Nigeria stopped short of full liberalisation of the exchange rate when the naira came under increasing pressure in 2016, which resulted in the emergence of a multiple exchange rates regime, capital controls and a shortage of foreign exchange. Nigeria entered recession in 2016. Growth in Ghana dropped to around 4% in 2014-2016, from over 7% in 2013.

Recoveries are underway in both countries, but at very different paces. In Nigeria, the availability of foreign currency has improved since early 2017, with the introduction of new foreign exchange measures as well as higher inflows thanks to the recovery in oil prices and production. However, there are still numerous distortions in the foreign exchange market, combined with other underlying challenges facing the private sector. Recovery has been slow, with growth just below 1% in 2017, and the non-oil sector has yet to register a significant recovery. Ghana's recovery has been faster: GDP growth was over 8% in 2017. Growth in Nigeria is expected to remain relatively weak, at around 2%, in 2018-2019 while the Ghanaian economy is expected to expand by over 6% yearly during the same period.

In both Ghana and Nigeria, underlying weaknesses in domestic resource mobilisation became obvious during the slowdowns, with fiscal deficits rising to 9.5% and 3.9% in Ghana and Nigeria respectively. Although Nigeria's public gross debt is relatively low, at 23% of GDP in 2017, it is on an upward trajectory. Interest payments on federal government debt already account for around 72% of revenues and the IMF warns that they will rise to unsustainable levels on the current path. Ghana is already assessed as being at high risk of debt distress, with gross government debt of around 72% of GDP, although on a downward trajectory. In both countries, the fiscal situation has major spillover effects for the financial sector and the real economy, including the crowding out of the private sector via high yields on government paper. Ghana achieved significant fiscal consolidation in 2017, and the deficit is expected to shrink to 3.6% by the end of 2019. In Nigeria, by contrast, the deficit has continued to rise (5.8% of GDP in 2017) and prospects for consolidation are unclear, with elections scheduled for early 2019: the IMF expects the deficit to fall only slightly in 2018-2019.

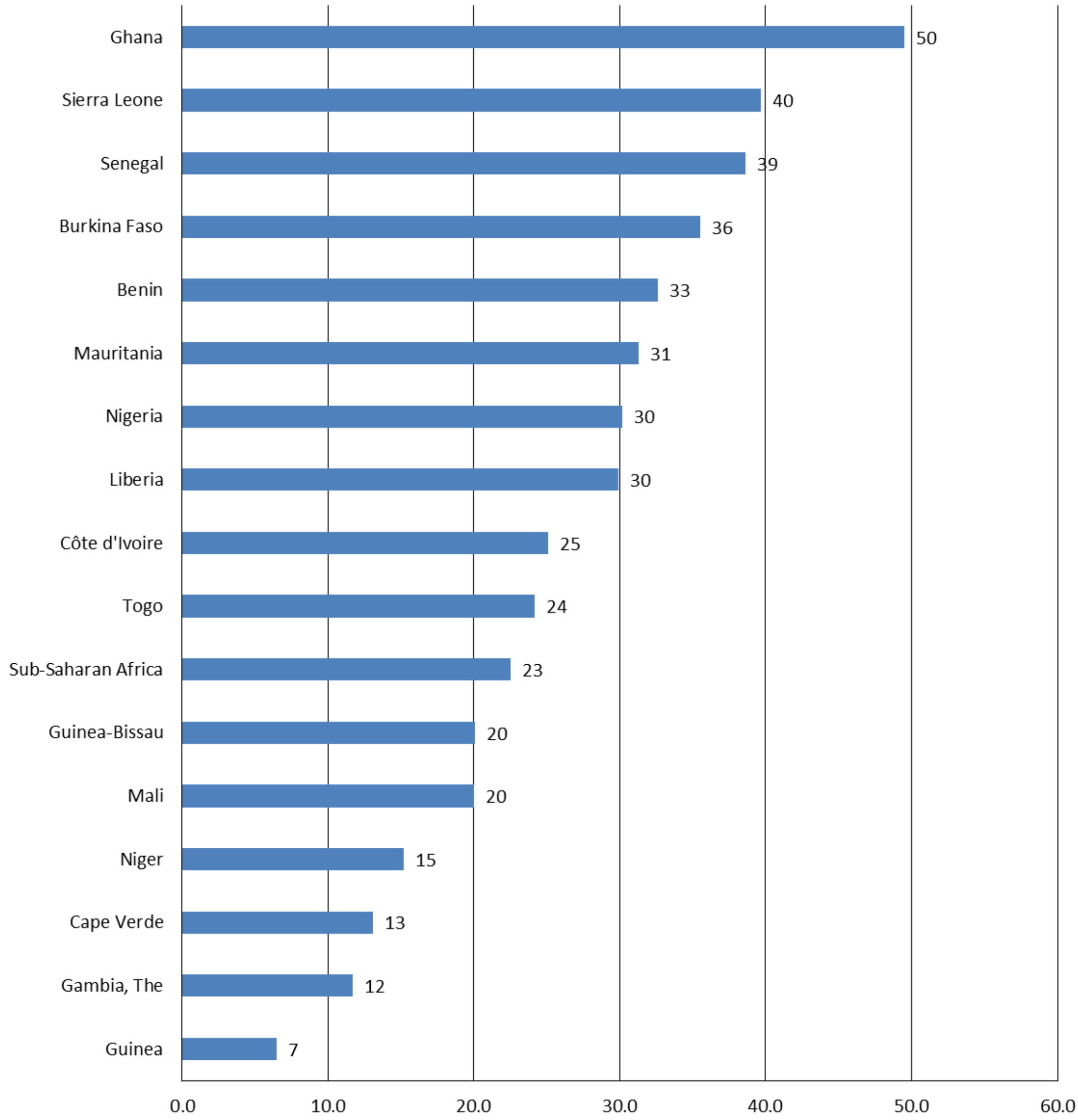
2.2. Access to Finance and Financial Inclusion

Companies in the region face a number of obstacles to their growth, including access to financial resources. According to the World Bank Enterprise Surveys (various editions), the majority of surveyed companies in West Africa ranked financing as their biggest or second biggest obstacle, out of a list of fifteen challenges ranging from transport to taxes. Ghanaian companies were the most likely to perceive finance as their biggest constraint (Figure 2.5.) (49.5% of companies surveyed) but rates were high in all countries. Typically, smaller enterprises are more likely to report a lack of external funding (Figure 2.6.): for example, in Côte d'Ivoire almost 30% of small companies with 5-19 employees identified access to finance as a severe or major bottleneck, compared to 20% of medium-sized companies and 9% of companies with more than 100 employees.

Most banks recognise the importance of SMEs in West African economies and understand that extending loans to SMEs can help the banks diversify the risk of their portfolios. An increasing number are putting SMEs at the heart of their strategies. However, inefficiencies in both demand and supply of credit make it difficult in practice for banks to increase credit to SMEs. On the supply side, smaller firms tend to be perceived, often wrongly, as riskier. This perception is heightened and exacerbated by, for example, high levels of informality, lack of collateral and the low ability to bring forward bankable projects. This means that many banks end up lending either to a few high-quality corporates or to the government via Treasury bills and bonds (which are usually issued at attractive rates). In addition, as described in Chapter 7, overexposure to sovereign debt can further hamper lending to the private sector. When banks do provide loan products to SMEs, the value of collateral is usually twice the amount of the requested loan, reaching almost three times in countries such as Senegal. This makes loans inaccessible for many companies.

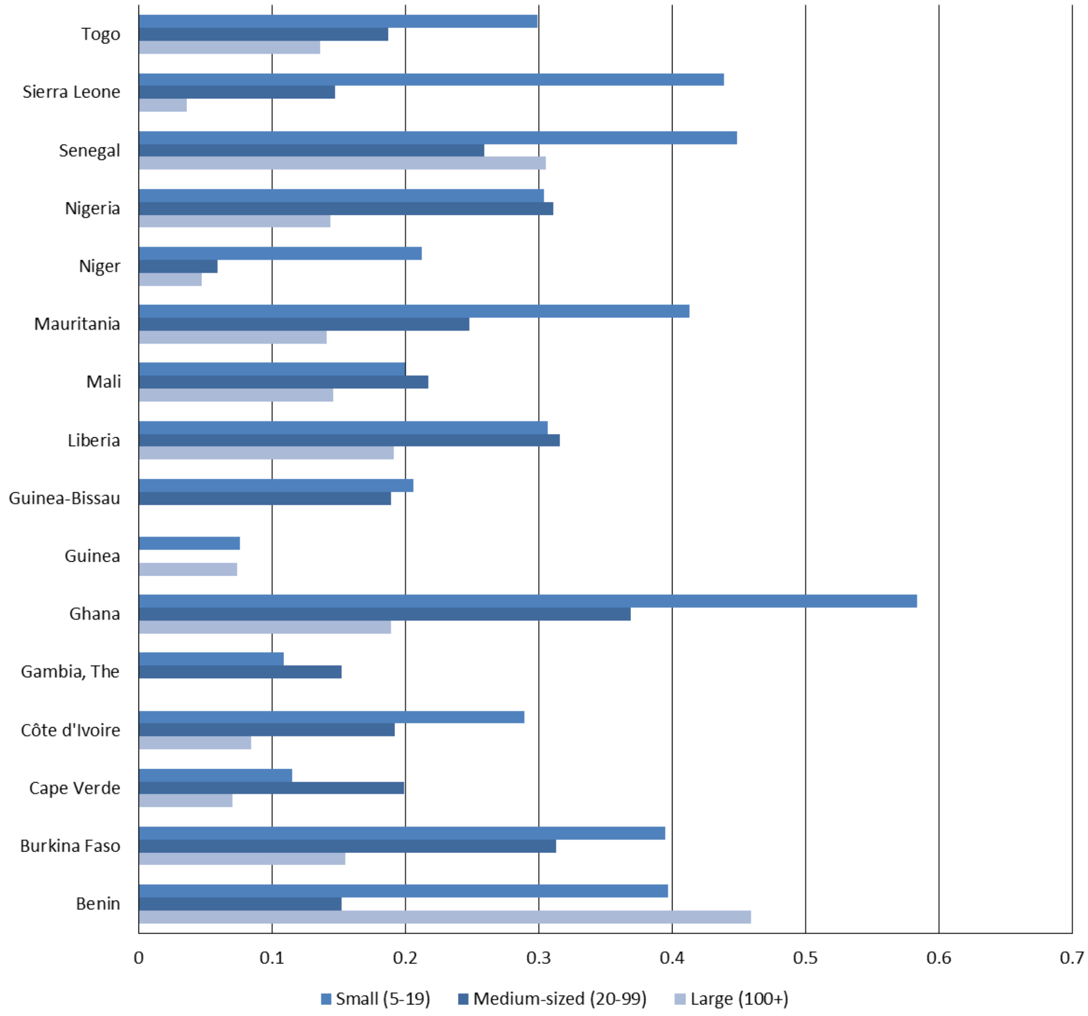
As a result, only 22% of enterprises in Western Africa have an outstanding bank loan and/or line of credit. Many companies, including larger firms that manage to access financial markets, are unable to cover all their needs. Generally, banks in West Africa provide lending primarily to cover shorter-term working capital expenditures rather than investments in fixed assets (25% vs 10%), with 75% of companies declaring they have to use internal resources to cover costs associated with the latter (Table 2.1.).

Figure 2.5. - Firms that Consider Access to Finance to be the Biggest Obstacle
(% of total surveyed companies)



Source: World Bank Enterprise Surveys, various editions

Figure 2.6. - Percentage of Firms Identifying Access to Finance as a Major Constraint
(by company size)



Source: World Bank Enterprise Surveys, various years

Table 2.1. - Main Indicators of Financial Access for Enterprises

	Firms with a bank loan/credit line (%)	Loans requiring collateral (%)	Value of collateral needed (% of loan amount)	Firms using banks to finance investments (%)	Investments financed internally (%)	Investments financed by banks (%)	Firms using banks to finance working capital (%)	Firms identifying access to finance as a major constraint (%)
Benin	24	79	231	12	91	4	26	43
Cape Verde	42	90	176	35	57	24	50	37
Côte d'Ivoire	21	86	157	24	72	15	15	69
Gambia, The	17	86	193	8	79	10	14	40
Ghana	23	80	240	21	76	13	25	62
Guinea	4	100	n/a	9	92	3	11	30
Guinea-Bissau	3	n/a	n/a	1	85	1	1	72
Liberia	19	83	172	19	72	11	20	39
Mali	26	86	233	55	75	19	52	64
Mauritania	33	76	111	13	77	9	29	52
Niger	28	88	160	22	73	14	29	27
Nigeria	11	89	228	7	53	3	17	33
Senegal	23	79	272	19	72	7	20	52
Sierra Leone	9	87	356	7	91	1	9	65
Togo	42	91	226	26	65	18	40	51
Sub-Saharan Africa (average)	22	85	215	21	74	10	23	38

Source: World Bank Enterprise Surveys

Financial inclusion of individuals remains a challenge, despite improvement over recent years. Approximately 75% of individuals remain financially excluded, although the population covered by formal financial institutions in the region increased by almost 10% between 2011 and 2017. All countries in West Africa face major challenges in extending financial services to the bulk of the population. However, the situation varies by country. In Nigeria almost half of the adult population has an account at a bank or other institution, but in countries such as Côte d'Ivoire, Benin and Senegal levels of financial inclusion are below 20%. Financial exclusion affects women and the poor in particular: average inclusion rates among these groups are 13% and 9% respectively in the region[10]. As a result of lack of access to formal institutions,

[10] Data source: World Bank Financial Inclusion Database.

credit behaviours in the region are in line with the rest of sub-Saharan Africa, the majority of individuals borrow money from family and friends (35%) and only 4% borrow via a financial institution.

Box 2.2. - E-Money: a Promising Future in WAEMU

E-money related activities – provision of mobile payment services – are booming in WAEMU. At end-2016, there were seven e-money institutions (EMIs) active in four countries: Benin, Côte d'Ivoire, Mali and Senegal.

EMIs have only recently been approved in the region and preliminary data show that there were over 36.5 million subscribers in the Union in 2016 compared to 25.6 million in 2015.

Nevertheless, the provision of mobile phone-based financial services also serves to substantially increase the overall rate of use of financial services. According to available data, this rate was 50.2% in 2015 and the rate of bank account penetration was 16.1%. Furthermore, e-money helped to increase the rate of financial inclusion to 65% compared to 60.4% one year before.

Developed as part of a participatory approach in accordance with BCEAO (Central Bank of West African States) Instructions, e-money activities continue to be regulated and subject to various conditions. Accordingly, in March 2017 the Central Bank prohibited Orange Telecom from transferring money between WAEMU and France: unless it is in a partnership with an approved credit institution a telecommunications company is not allowed to issue e-money without first requesting permission to do so. This activity is reserved for banks, decentralised financial systems and EMIs with a minimum share capital of FCFA 300m.

2.3. The Financial Sector in WAEMU

2.3.A. A Constantly Evolving Banking Environment, Driven by Increased Interest from International and pan-African Players

At end-2016, the number of credit institutions in WAEMU was 138 compared to 132 in 2014, broken down into 123 banks and 15 financial institutions specialising in banking. Thanks to the economic environment, which is conducive to the expansion of the internal banking network, there are also 2,542 branches, offices and retail outlets and 3,010 ATMs in the eight member countries. Total assets in the sector amount to EUR 49.8bn, i.e. 56% of GDP (compared to an average of 58% in sub-Saharan Africa and a median of 44%).

In business terms, 27 banking groups are active in WAEMU. Among the key players, the Ecobank (14.9% of total assets) and BMCE Bank of Africa groups (11.4%) play leading roles (Table 2.2.). The microfinance sector, whose total assets are valued at EUR 1.9bn, numbers 130 institutions operating principally in Senegal (41 institutions) and Burkina Faso (25).

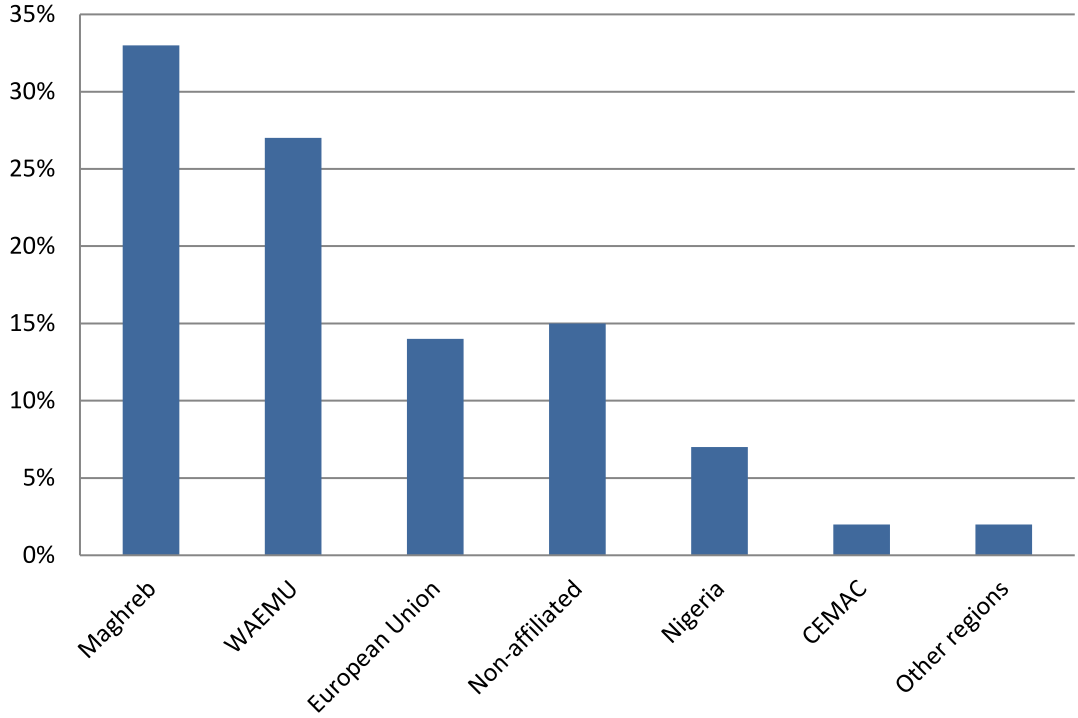
Table 2.2. - Leading Banking Groups in WAEMU at End-2016

	Number of banks	Market share	Counters	ATMs/cash dispensers*
Ecobank	8	14.9%	252	626
BMCE Bank of Africa	8	11.4%	269	304
Atlantic Business International (ABI)	8	9.4%	216	217
Société Générale	5	9.2%	150	259
Attijariwafa Bank	9	8%	254	259
BNP Paribas	4	4.4%	99	166
Coris Bank International	4	4.1%	66	45
Oragroup	8	3.9%	99	90
Diamond Bank	4	3.8%	46	51
United Bank for Africa (UBA)	4	2.7%	64	81

Source: WAEMU Banking Commission
* Automated teller machines (ATMs) and cash dispensers

Analysis of the geographical origin of active banking operators illustrates the interest shown by Maghreb banking groups (Figure 2.7.) - more specifically Moroccan groups - towards the region. These groups have the largest market share (29%) and hold 28% of customer deposits and 29.3% of loans granted. Local banking groups account for 27% of market share and 25.6% of both customer deposits and loans granted.

Figure 2.7. - WAEMU: Breakdown of Banking Operators by Geographical Origin



Source: WAEMU Banking Commission

2.3.B. Balance Sheet Analysis: Credit Institutions Increasingly Involved in Financing the Economy

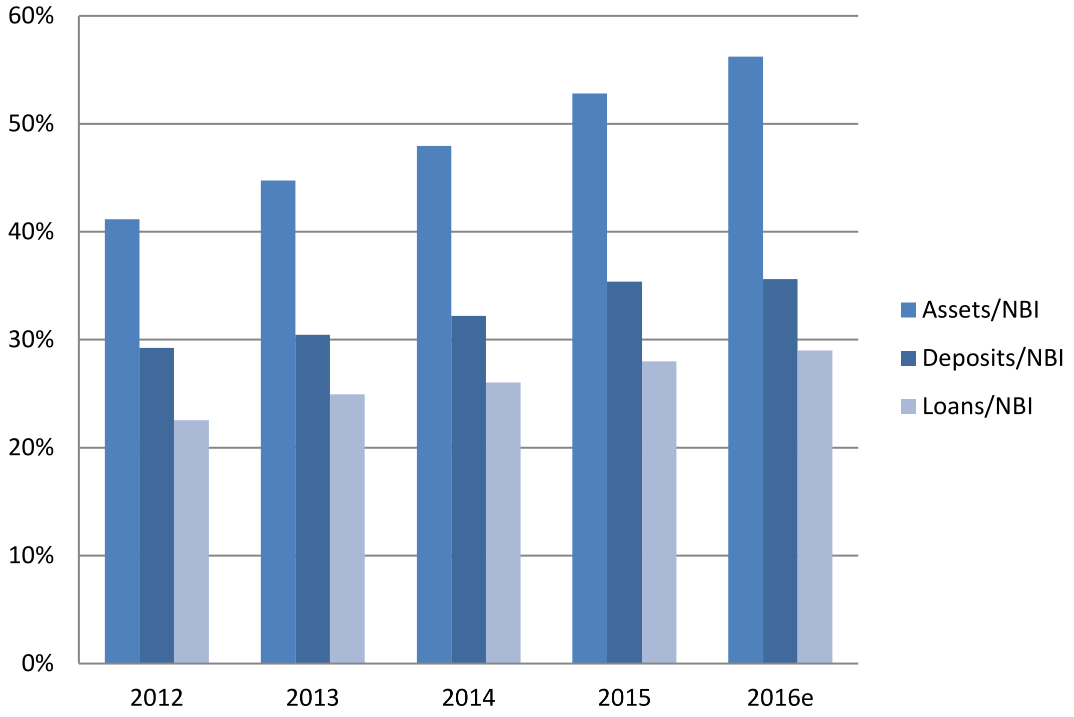
2.3.B.1. A Marked Improvement in Banks' Sources and Uses of Funds

The banking sector in WAEMU is developing at a faster pace. Data from the last five years shows that the aggregate balance sheet total more than doubled (Figure 2.8.) from EUR 23bn in 2012 (41% of GDP) to EUR 49.8bn in 2016 (56% of GDP).

More recently, in 2016 the sector continued its upward trend with the balance sheet total increasing by 16% compared to the previous year. Côte d'Ivoire accounts for 30% of the balance sheet total with 24 banking institutions, followed by Senegal (19.4% with 23 institutions), Burkina Faso (13.7% with 13 institutions) and Mali (13.3% with 13 institutions). Guinea-Bissau has the least developed banking sector with just four banks.

Hence, bank resources rose by 9.6% in 2016 to FCFA 24,500bn (EUR 37bn). This uptick is chiefly attributable to a 9.5% rise in customer deposits to FCFA 20,688bn (EUR 31.5bn), which accounted for 36% of GDP in 2016.

Figure 2.8. - WAEMU: Banking Penetration Trend



Source: WAEMU Banking Commission

Uses of funds increased by 16.8% in 2016 to FCFA 27,603bn (EUR 42bn) due to 12.6% growth in bank loans to FCFA 16,847bn (EUR 25.7bn).

The share of bank loans in financing the economy has increased steadily – they accounted for nearly 29% of GDP in 2016 compared to 22% five years earlier. The rise in lending has been beneficial for all business sectors, specifically the "trade, restaurants and hotels" sector (33% of commitments reported to the Central Credit Risk Register in 2016), manufacturing industries (17%) and local authority services (16%).

2.3.B.2. Easing of Monetary Conditions Facilitated by the Regional Economic Climate

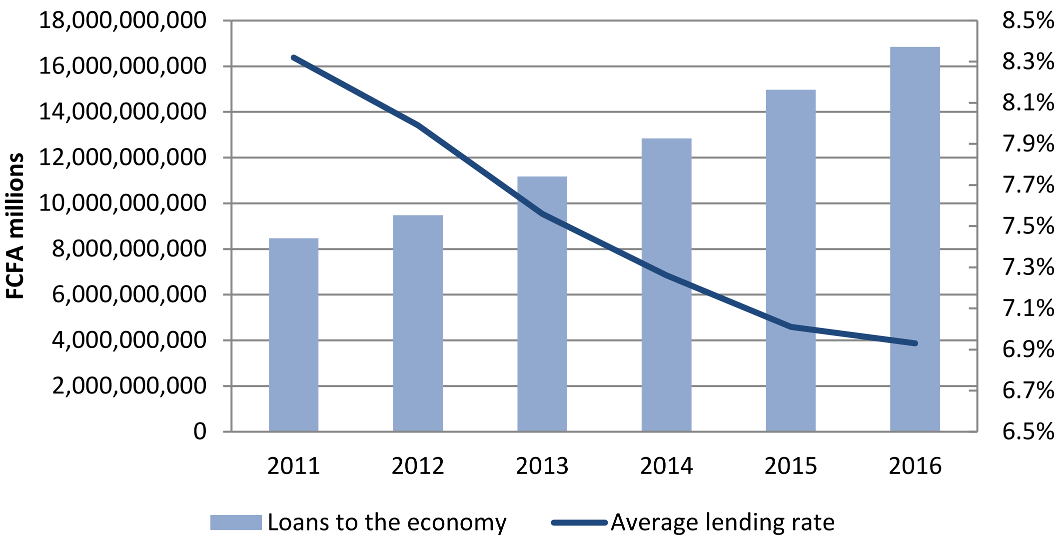
BCEAO is pursuing an accommodating policy in the WAEMU zone, going hand in hand with the overall improvement in macroeconomic conditions. The economic climate and the easing of monetary conditions by BCEAO have helped bring down the average lending rate.

As a reminder, the lending rate established by BCEAO is broken down as follows:

- Minimum bid rate: 2.5% compared to 4.25% before 16 September 2013
- Marginal over-the-counter lending rate[11]: 4.5% compared to 3.5% before 16 December 2016.

[11] Highest interest rate at which banks will always obtain the liquidity they need.

Figure 2.9. - WAEMU: Average Lending Rate Trend



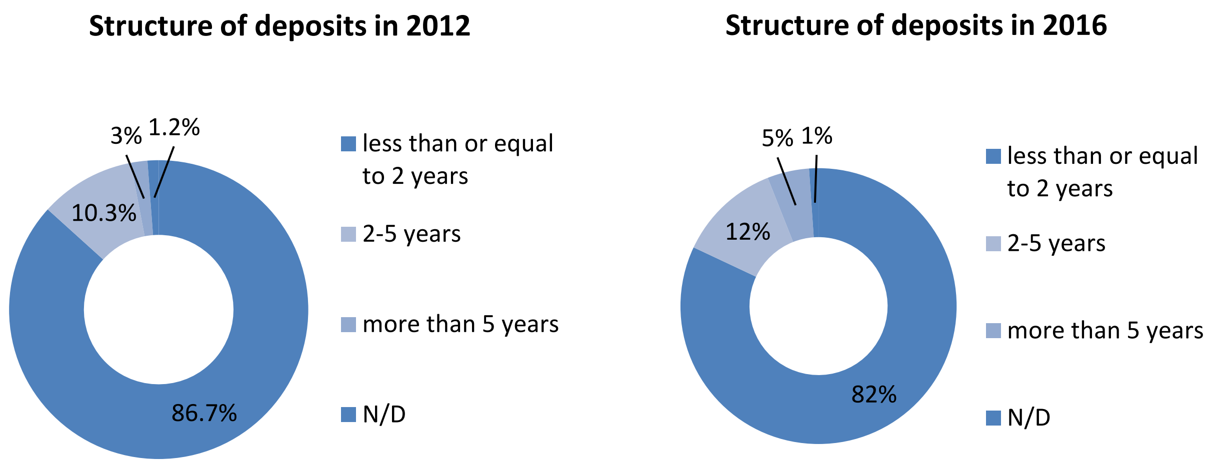
Source: WAEMU Banking Commission

The average lending rate (Figure 2.9.) charged by the banks to their customers was therefore 6.9% in 2016 compared to 7% in 2015 and 7.3% in 2014. Although this drop in lending rates was greater in Burkina Faso, Guinea-Bissau and Mali, it remained constant across the sub-region, so reducing the variability between the eight member countries. Even though all customers have benefited from the lower rates applied by credit institutions, export credits (-1.96 percentage points) and housing loans (-0.50 of a percentage point) remain the products most impacted.

2.3.B.3. Improved Bank Financing in the Long Term

Outstanding loans in WAEMU are increasing at a sustained pace, although they are still mostly short-term loans geared to large corporates; and for good reason – the breakdown of deposits is similar: in 2016, for example, 82% of total deposits (EUR 31.5bn) received by commercial banks had maturities equal to or less than 2 years (Figure 2.10.). This sizeable share, which limits banks' ability to create long-term assets and build up savings adapted to their needs, is more than 4 percentage points higher than in 2012. This trend demonstrates the growing desire of commercial banks to participate in the financing of corporate and household investment and infrastructure projects in the region.

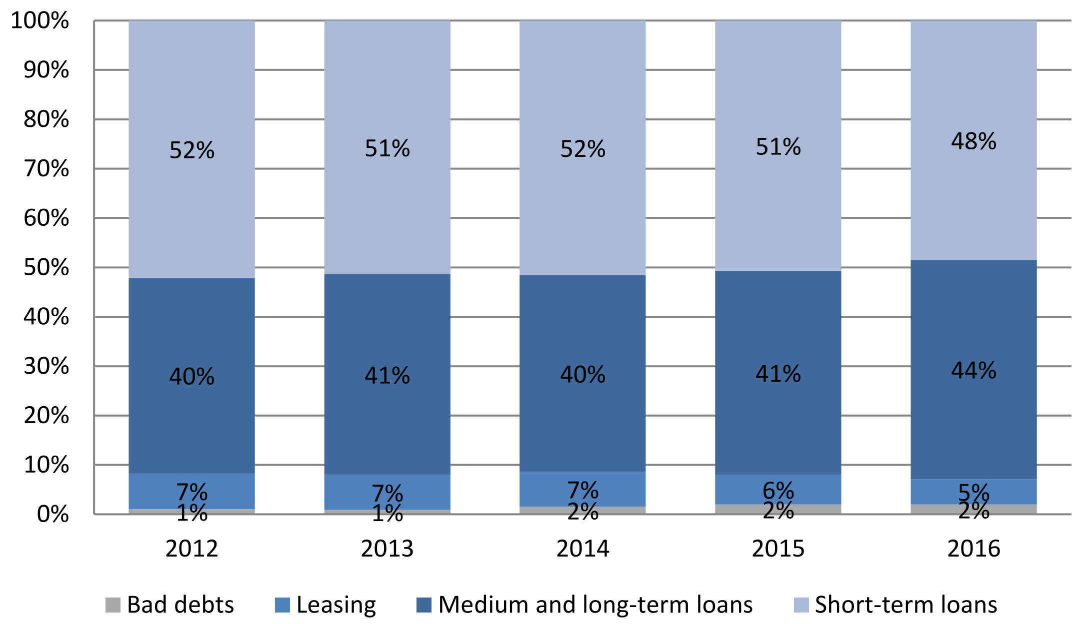
Figure 2.10. - WAEMU: Change in Structure of Deposits by Maturity
(% of total)



Source: WAEMU Banking Commission

Consequently, short-term loans, which accounted for 48% (Figure 2.11.) of the total amount in 2016 compared to 52% in 2012, still make up the lion's share of outstanding bank loans. This proportion is falling as the policy of monetary easing decided by BCEAO has reduced the rate of coverage of medium and long-term uses of funds by long-term resources to 50% (compared to 75% previously). Furthermore, the increase in the marginal lending rate (from 3.5% to 4.5% at end-2016) will curb commercial banks' investments in government securities, which accounted for 25% of the market's aggregate use of funds in 2016.

Figure 2.11. - WAEMU: Change in Structure of Loans Granted by Banks



Source: WAEMU Banking Commission

2.3.B.4. Analysis of Results: the Sector has Become more Profitable

WAEMU's banking sector generated a substantial return on equity (ROE) after tax of 16.1% in 2016 compared to 9.9% in 2015 (Table 2.3.). This performance is essentially attributed to the strength of economic growth in the region, combined with an increase in customer loans and the rationalisation of operating expenditure in the sector. In 2016, NBI (net banking income) totalled FCFA 1,643bn (EUR 2.5bn) compared to FCFA 1,520bn (USD 2.3bn) in 2015, i.e. twice the amount generated by banks in Central Africa. This positive trend was principally driven by the increase in customer loans.

The operating result was thus 12.8% higher, partly thanks to better management of general expenses. The net operating ratio, which measures the level of coverage of NBI by general expenses, improved by 0.6 percentage points year-on-year to 66.3% in 2016.

WAEMU's banking sector produced a net result of EUR 646m (25% of NBI) in 2016, up 93% on the previous year. The banking sector's overall margin follows the general trend, with a ratio of 6.8% in 2016 versus 6.5% in 2015.

Table 2.3. - WAEMU: Key Profitability Ratios
(%)

	2012	2013	2014	2015	2016
Gross margin (Return on loans - cost of capital)	7.3	7.9	6.7	6.5	6.8
Net operating ratio (general expenses + depreciation)/NBI	69.6	68.8	66.4	66.9	66.3
Net margin ratio (Net result/net banking income)	13.6	15.6	12.8	14.4	25.8
Return on equity (ROE) (Net result/own funds)	9.1	10.1	8.6	9.9	16.1
Net non-performing loans ratio (Net bad debts/total net loans)	6.7	6.7	6.5	6	5.2
Non-performing loans provision ratio (Provisions/gross bad debts)	64.1	60.9	61	60.1	64.9

Source: WAEMU Banking Commission

2.3.C. Regulatory Reforms and Other Policy Developments

In prudential terms, and on the basis of available data, the average solvency ratio was 12.4% in 2016, i.e. higher than the standard of 8%. All WAEMU countries meet regulatory requirements, ranging between 8.4% in Togo and 30% in Guinea-Bissau.

The WAEMU Banking Commission first decided to increase minimum capital requirements from FCFA 5bn (EUR 7.6m) to FCFA 10bn (EUR 15.3m) - with a maturity date of 1 July 2017 - to strengthen the banking sector and contend with the concentration of risk and rise in non-performing loans.

The actions undertaken by the WAEMU Banking Commission form part of the reforms initiated by BCEAO which, accordingly, has transposed the Basel II and III standards into law. Migration will take effect as of 1 January 2018, which will enable the tools and the prudential approach to be revised. The minimum solvency ratio will be set at 10.5%.

This should enable BCEAO to:

- better coordinate and closely monitor the banks responsible for regulation and prudential matters;
- assist, within the established deadlines, credit institutions in difficulty;

- anticipate and address potential failures.

Apart from the technical aspects mentioned, the new regulation will require banks to report their financial situation each quarter by submitting prudential statements to BCEAO in accordance with a new accounting plan. BCEAO has recast its accounting plan, incorporating new securities registration and recognition elements as well as modernising the electronic reporting tool.

2.4. Comments on Selected Markets

2.4.A. Special Country Focus: Côte d'Ivoire

Côte d'Ivoire's banking sector comprises 29 banks holding 45% of GDP in assets, with 27 branches per million inhabitants. Côte d'Ivoire has the largest number of banks in the WAEMU region and is among the countries with the largest population coverage by banks, as proxied by the number of branches per million inhabitants. Credit penetration in Côte d'Ivoire, at 25% of GDP in 2017, is well below that in Togo, Senegal and Burkina Faso. Annual credit growth declined to 12.5% in 2016 and 20% in 2017 from 34.3% in 2015, a trend observed in most WAEMU economies. Credit is mostly concentrated in the retail, transportation and other services sector where Ivorian banks combined record almost 57% of their loans. Banks fund their credit expansion by their domestic deposit base, which consists mostly of sight deposits that are insufficient to fund loans at maturities exceeding 3-5 years. Five-year maturity is the term most preferred by clients looking to finance a capex investment.

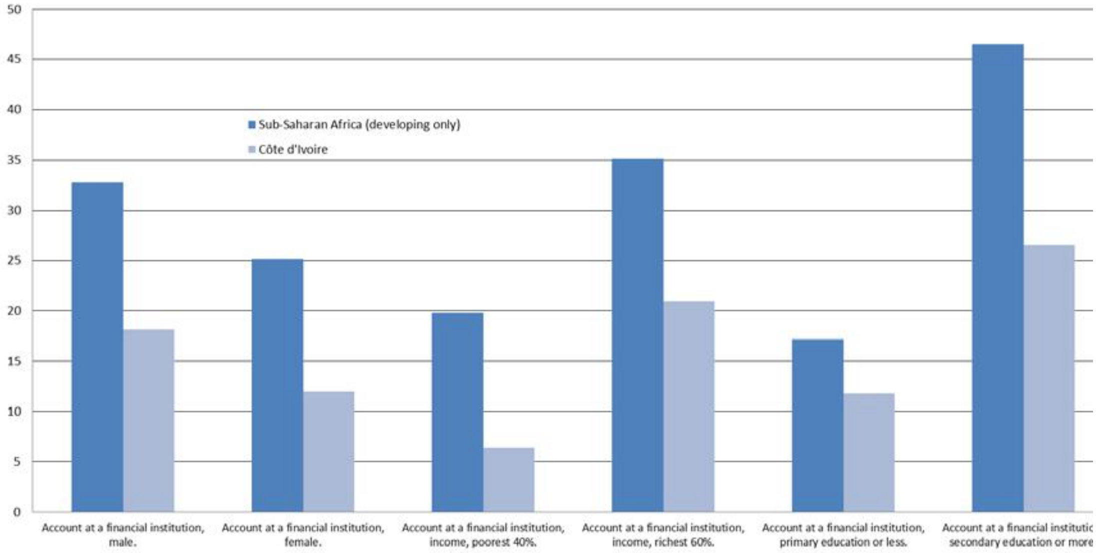
Credit hovers at 82% of deposits, almost at par with most WAEMU peers (excluding Niger). Profitability of banks in Côte d'Ivoire is elevated and improving with a return on equity of 22% in 2016, up from 20% in the previous year, supported by an interest rate margin of 7% at par with its WAEMU peers. Foreign exchange risk is inexistent, as bank regulations do not allow banks to grant a loan in foreign currency[12]. Non-Performing Loans (NPLs) stood at 11% of total loans at end-2017, versus 9.3% of total loans in June 2017 and 10.3% in March 2017. The capital adequacy ratio improved to nearly 10% at mid-2017 from the regulatory minimum of 8% at end-2016. Côte d'Ivoire is witnessing the phased introduction across the region of an ambitious reform package in preparation for the implementation of Basel III. The latter was introduced in January 2018 with full compliance expected within five years.

Côte d'Ivoire's access to finance is lower than for sub-Saharan African frontier market economies with considerable gender and rural/urban disparities. According to the World Bank's data on Global Financial Inclusion, 18% of men have access to an account at a financial institution compared to 12% for women, revealing a gap of 6 percentage points in financial inclusion compared to an average gap of 8 percentage points in sub-Saharan Africa (Figure 2.12.). Poorer and less educated individuals are less likely to have a bank account than wealthier and more educated individuals. The financial inclusion gap between rural and urban

[12] 80% of the foreign exchange proceeds of exporters has to be maintained at the central bank, opening of deposit accounts in foreign exchange is prohibited and importers are allowed to pay their suppliers only via the central bank.

areas is even higher at 10 percentage points, as access to financial services in rural areas is very limited and most banks and microfinance institutions are located in urban areas.

Figure 2.12. - Financial Inclusion, 2014

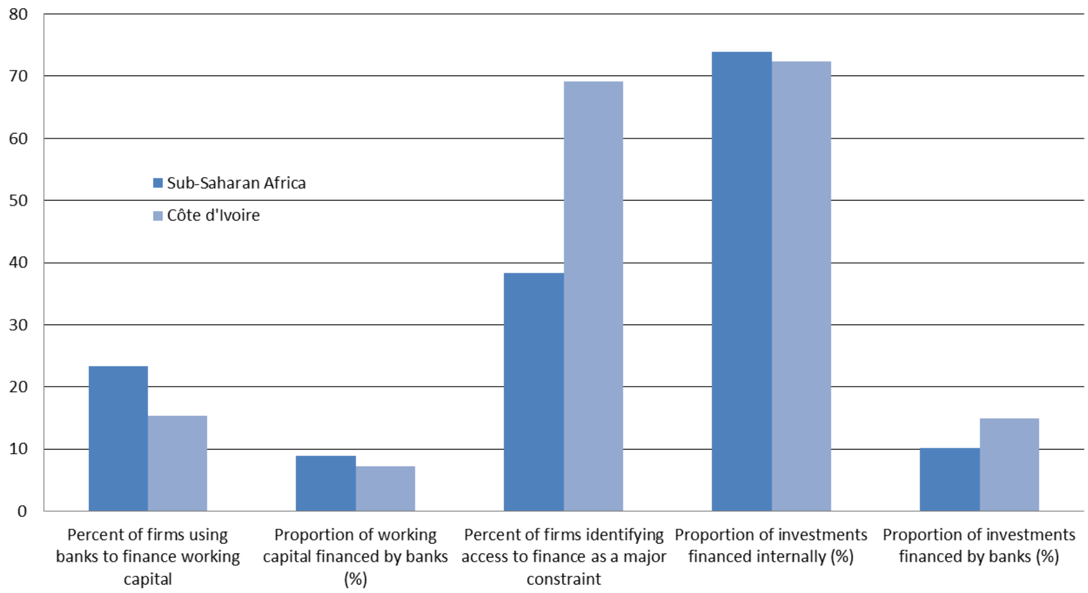


Source: World Bank

Côte d’Ivoire has more scope for improvement in extending financing to SMEs than its neighbours. Difficulties in obtaining financing are the most frequently mentioned obstacles to doing business (Figure 2.13.). Specifically, fewer SMEs in Côte d’Ivoire are using banks to finance their working capital than in other sub-Saharan African economies, while the proportion of working capital financed by banks is lower than elsewhere in sub-Saharan Africa. The proportion of SMEs financing investments internally is equivalent to that in other sub-Saharan African economies, while the proportion of investment financed by banks is higher. Hence, SMEs’ access to finance relates mostly to financing working capital rather than investment.

There are almost 700 microfinance institutions in the WAEMU zone countries. Côte d’Ivoire is the second largest market for microfinance behind Senegal. Deposits with microfinance institutions stand at 6.9% of total deposits with credit institutions (including banks and microfinance institutions), while outstanding loans amount to 7% of credit from all credit institutions in the WAEMU region.

Figure 2.13. - Indicators of Access to Finance, 2016



Source: World Bank

The ratio of equity to assets for microfinance institutions is 4.5% in Côte d'Ivoire, below the minimum requirement of 15% and the regional WAEMU average of 19.5%. Outstanding credit by microfinance institutions remains below deposits in Côte d'Ivoire. Microfinance institutions provide mostly cash advances and working capital, with the former accounting for more than half of the total lending issued. According to the latest report published by the Microfinance Association of Côte d'Ivoire, more than 90% of the client base (40% of whom are women) consists of individuals and informal micro-entrepreneurs, the rest being smaller enterprises and groups. Applied interest rates are in the range of 11-24%, below the sub-Saharan Africa average. Loans from microfinance institutions predominantly fund trade, light manufacturing and services, with the agricultural sector receiving only about 5% of credit despite the fact that it contributes a quarter of the country's GDP.

2.4.B. Special Country Focus: Nigeria and Ghana

Both Nigeria and Ghana have relatively large and sophisticated financial sectors, and systemic crises have been avoided in recent years, demonstrating significant resilience of the banking sectors along with proactive actions from their central banks. However, economic events in 2014-2016 have left the financial sectors facing a variety of challenges. Financial soundness indicators related to capital adequacy and asset quality have deteriorated on average in both countries since 2014, and several banks are under enhanced supervision or have been placed in administration. In addition, the financial sectors are failing to effectively intermediate finance to the real economies.

Nigeria's commercial banking sector consists of 25 deposit-taking banks and one non-interest bank. Of the deposit-taking banks, four are foreign-owned, accounting for roughly 13% of total banking sector assets. **The Ghanaian banking sector is more fragmented,**

consisting of 34 banks. The top three banks account for around 41% of total operating assets and 42% of deposits, but even the largest banks are small by international standards.

In both countries, deposits are the main source of funding, accounting for around 60% of sector liabilities. There are large gaps between deposit and lending rates, which makes deposits a highly attractive source for banks, and competition to attract deposits is fierce. The smaller banks are less able to attract deposits and end up relying more on more expensive interbank funding. Large international banks can access intergroup funding, and the largest banks can access market finance. Several of the larger Nigerian banks have successfully issued bonds in the last few years. The differences in financing structures lead to differences in cost of funds between small and large banks. Both countries display a large mismatch between funding and lending tenors, with a lack of longer-term finance even in Nigeria.

Nigerian banks were affected by the economic crisis directly through their exposure to the oil and gas sector and to enterprises impacted by the recession and slow recovery. They have also been impacted indirectly, via spillovers from the fiscal situation, limited foreign currency liquidity, and exchange rate distortions. Capital adequacy stood at over 17% of risk-weighted assets in 2013, but rapidly eroded to 10.6% in Q3 2017. Four banks are widely reported to be undercapitalised, of which one is insolvent. Asset quality deteriorated, in particular among the banks that were highly exposed to the oil sector. NPLs rose from 5% of total loans in Q4 2015 to 15% in October 2017, without an increase in provisioning[13]. In Ghana, the impacts of the challenging economic climate were exacerbated by the gradual realisation that much of the debt owed to the financial sector by energy sector State-Owned Enterprises (SOEs) would be difficult to sustain. Capital adequacy declined from 18.5% in 2013 to 15.0% in late 2017. In the asset quality review exercise undertaken in 2016, nine banks were found to be significantly undercapitalised. While some have been put back onto a stable footing, and much of the SOE debt has been restructured, the Bank of Ghana intervened in relation to two banks in 2017 and one in early 2018[14]. One of these was among the largest banks in the country (in terms of assets). The decline in asset quality has been steep, and driven only partly by SOE debt. By late 2017, following a second asset quality review, NPLs accounted for 22.7% of gross loans versus 12% in 2013 (Table 2.4.)[15]**.** Profits remain healthy in both countries, partly because of high returns on government securities, and liquidity is adequate on average[16].

The smaller Nigerian banks in particular are exposed to the oil and gas sector and thus to commodity price shocks. Many banks are exposed to the largest corporates, representing a concentration risk. NPLs can be expected to rise further, although outside commentators find it unlikely that they will reach the levels that followed the 2008-09 crisis. In Ghana, NPLs are

[13] It should be noted that pre-emptive loan restructuring carried out by banks may be masking a larger underlying deterioration than is reflected in these official figures.

[14] The two banks whose licenses were revoked in 2017 were both taken over by Ghana Commercial Bank, which is majority-owned by the State Social Insurance Fund, in addition to around 20% direct government ownership. The Bank of Ghana announced that the bank put into administration in early 2018 will be handed back to private owners once it is restored to financial health.

[15] While a large portion of energy sector SOE debt was restructured in 2016-2017, some banks still have significant NPLs from this sector, and from other SOEs, on their books.

[16] Nigerian banks experienced liquidity problems in hard currency during 2016-17, with some struggling or failing to honour letters of credit, but the situation has now improved.

on a downward trajectory. However, future consolidation of the Ghanaian banking sector can be expected, particularly as the banks will need to meet an increased minimum capital requirement by December 2018. The sector is also exposed to further problems with SOE debt, to problems in dominant sectors or the largest companies, and to foreign exchange risk (in September 2017, the IMF reported the overall net open position as 3% of capital).

Nigerian and Ghanaian banks aspire to improve their involvement in financing the real economy. Domestic credit to the private sector stood at 16% of GDP in Nigeria and 20% in Ghana in 2016 (World Bank Development Indicators). This is well below the average for sub-Saharan Africa (46%) even though the two economies are among the more developed in the region. There are a number of factors behind this, including the poor business climate and infrastructure deficiencies, which raise the risks and challenges of lending to the private sector. Strong crowding out of the private sector is another major challenge in both economies, reflecting the fiscal challenges discussed above. This is explored in Chapter 7 of this volume.

Table 2.4. - Financial Soundness Indicators, Nigeria and Ghana

	Q4 2013	Q4 2014	Q4 2015	Q4 2016	Q3 2017
Nigeria					
Regulatory capital to risk-weighted assets	17.1	18.6	17.7	14.8	10.6
Tier 1	17.1	15.5	18.1	16.3	10.8
NPLs net of provisions to capital	5.9	3.8	5.5	36.2	43.0
NPLs to total gross loans	3.4	3	4.9	12.8	15.1
Return on assets	2.3	2.5	2.5	1.3	2.4
Return on equity	18.9	21.2	19.7	10	20.5
Liquid assets to total assets	16.8	11.4	18.5	16.2	17
Ghana					**Q4 2017**
Regulatory capital to risk-weighted assets	18.5	17.9	17.7	17.8	15.0
Tier 1	14.7	15.3	14.5	14.4	12.8
NPLs net of provisions to capital	8.3	11.2	14.9	15.8	16.1
NPLs to total gross loans	12	11.3	14.9	17.3	22.7
Return on assets	4.5	4.7	3.1	2.5	2.2
Return on equity	31.1	32.3	21.4	18	16.7
Liquid assets to total assets	21.7	26.8	34.3	35.1	41.5

Source: IMF Country Reports, 2018 for Ghana and Nigeria, drawing on Central Bank data.

Diversification of lending away from the largest corporates and oil and other commodities would be in the interest of banks, as it would reduce concentration risks and increase resilience to economic fluctuations. The governments and Central Banks are also keen to encourage the banks to lend to smaller enterprises and the non-oil economy (including larger firms), and have been promoting lending to agriculture and agri-business in particular. However, the challenges banks face in diversifying their portfolios should not be underestimated. For example, most of the smaller enterprises in the two countries lack collateral and experience in drawing up business plans, and many are fully or partly informal.

Both countries have active microfinance sectors: almost 1,000 microfinance institutions (MFIs) are registered in Nigeria and over 300 in Ghana. However, the MFIs are vulnerable to instability and, like the banks, have been challenged by the economic climate. Oversight is much weaker than for the deposit banks, particularly given the large number of institutions and the limited staff capacity of the regulators. Most Nigerian MFIs have high or even excess liquidity, but many have high and rising portfolio at risk ratios, and some have fallen below the minimum capital adequacy ratio. The IMF reported in September 2017 that many Ghanaian MFIs fall below minimum regulatory paid-up capital levels. In early 2018, customers of four institutions were reportedly unable to access their funds. In both countries, stronger oversight of the microfinance sector is urgently needed to increase efficiency and provide better protection for clients.

Even leaving aside the risk considerations, it is clear that MFIs alone are unable to reach all areas and sectors of the economy. The outreach of MFIs in Nigeria (2.3 branches per 100,000 adults) actually lags behind that of traditional banks (5.6 branches per 100,000) and is far behind the government’s financial inclusion aims. Further, MFI services are concentrated in wealthier, more secure and more densely populated areas. In Ghana, much of the improvement in access to finance and financial inclusion since 2010 has been driven by the expansion of microfinance. Nonetheless, only 41% of adults had a formal account in 2014.

Developments such as the recent introduction of a collateral registry in Ghana, the increasing use of mobile technologies by both banks and microfinance institutions and the issuance of individual banking IDs in Nigeria should help to improve the situation. In Ghana the proportion of adults with a mobile account (13%, 2014) exceeds the average for sub-Saharan Africa (12%) and for lower middle-income countries (2.5%). In Nigeria, by contrast, only 2.3% of adults had a mobile account in 2014, indicating clear scope for expansion.

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3. The Banking Sector in the Central African Economic and Monetary Community (CEMAC): Great Potential in the Face of Enormous Challenges

JAD BENHAMDANE[1], SAID HIDANE[1], JEAN-PHILIPPE STIJNS[2,3]

Executive Summary

- The macroeconomic situation in the countries of the Central African Economic and Monetary Community (CEMAC) is picking up following a sharp downturn in their economic momentum, under the combined effect of falling raw material prices and heightened security threats in several countries in the sub-region. The macroeconomic anchorage of the region's countries is also recovering, in terms of both inflation and fiscal position. Economic growth is expected to improve quite significantly from 2018 onwards. On the other hand, the situation with regard to public debt and foreign exchange reserves is more worrying and the expected upturn is not guaranteed. Indeed, diversification measures are essential to reduce the countries' vulnerability to oil price shocks.

- As regards the banking sector, the progress made by the Central African Banking Commission (COBAC) has raised hopes of increased resilience and potential despite a difficult economic climate. COBAC is currently implementing a more risk-based surveillance system, while capital requirements will gradually be increased. The activity of financial institutions has grown slightly, albeit fluctuating considerably from one market to another. In contrast, banking activity in CEMAC in 2017 resulted in a decline in balance sheet totals, customer loans and customer deposits. Non-performing loans (NPLs), which are already very high, are on the rise and the fall in deposits is putting pressure on bank liquidity. As regards concentration risk, one third of solvent banks are failing to comply with the CEMAC regulation.

- Financial inclusion in the sub-region has improved significantly since 2011, although there is still scope for developing financial inclusion further in Central Africa when benchmarking on developing countries. Mobile banking services are making a significant contribution to increasing the use of bank services in Central Africa and the recent acceleration in the growth of active accounts and operators suggests that a catching-up or convergence phenomenon is taking place between the region and sub-Saharan Africa. The needs of micro-enterprises and

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[3] The authors wish to thank Emmanouil Davradakis and Barbara Marchitto of the EIB's Economics Department, Samia Azzabi and Amine El Kourchi of Institute of Africa, for their valuable comments which have been taken into account in this chapter. However, the views expressed here are those of the authors and do not necessarily reflect those of the European Investment Bank or Institute of Africa. Any residual errors are the responsibility of the authors.

SMEs in terms of access to bank financing are such that the region still has a great deal of potential to be tapped over the next few years, particularly in Cameroon.

3.1. Introduction

CEMAC has several assets that distinguish it from the continent's other regions. It enjoys a strategic position enabling it to establish itself as a privileged transit area. It also possesses important high-value oil and mining resources, and considerable agricultural, forestry and hydraulic potential[4]. Moreover, the region's population has expanded significantly in recent decades, doubling to more than 48 million between 1990 and 2017 (Table 3.1. below). More than 40% of this population is concentrated in Cameroon, which has over 24 million inhabitants.

Table 3.1. - CEMAC: General Characteristics of Member Countries in 2017

	Area (in km²)	Population (in millions of inhabitants)	GDP at constant prices (in USD bn)	As % of CEMAC total	GDP per capita (in USD¹)	GDP per capita (PPP²)	HDI³ (of 188 countries)
Cameroon	475 442	24.3	34	42%	1 400.7	3 334.0	153th
Central African Republic	622 984	5.0	1.9	2.7%	386.8	616.6	188th
Republic of the Congo	342	4.3	8.5	11%	1 958.2	6 049.8	135th
Gabon	267 667	1.9	15.2	19%	7 971.6	17 537.9	109th
Equatorial Guinea	28 051	0.8	10.7	13%	12 727.0	32 807.0	135th
Chad	1 284 000	12.2	9.9	12%	810.2	2 134.7	186th
CEMAC - 6 countries	3 020 144	48.5	80.3	100%	4 209.1*		-
WAEMU - 8 countries	3 508 048	118.4	108.3	-	850.6*		-

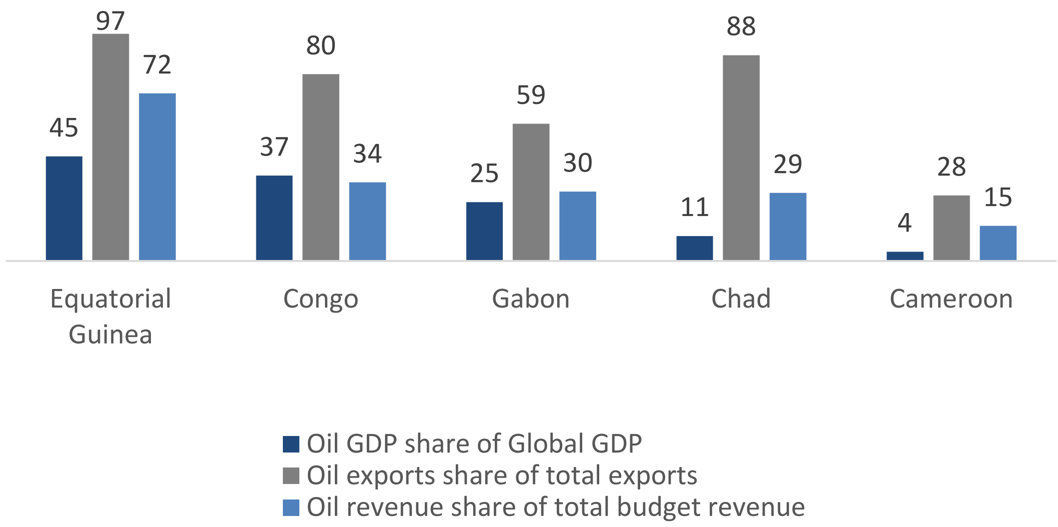
Sources: IMF, UNDP.
Note: *On average; ¹ Current USD; ² Constant 2011 USD in Purchasing Power Parity (PPP); ³ UNDP Human Development Index in 2016.

Against a backdrop of high population growth, governments in the region are now facing major challenges with regard to access to basic social services, rapid urbanisation and pressure on natural resources. In addition, they must meet the growing demand for jobs from new entrants to the labour market. With 45% of its inhabitants under 15 years of age (compared to 40% for the whole continent and 44% for West Africa), the region as a whole also has the youngest population in Africa, and it has the highest fertility rate (average number of children per woman of childbearing age) on the continent (about 6.0 compared to 5.4 for West Africa)[5]. By 2050, the population of CEMAC is expected to reach about 110 million[6].

[4] The Congo Basin is the second largest river basin in the world, after the Amazon.
[5] State of Africa's Population 2017, African Union, March 2017.
[6] World Population Prospects, 2017 Revision, United Nations.

The Community authorities must also address other issues related, in particular, to the stabilisation and inclusiveness of volatile economic growth in a climate of fluctuating commodity prices. The fall in oil prices, for instance, resulted in a drop in average per capita income to USD 4 209.1 in 2017, compared to USD 7 364.5 three years earlier. Despite this decline, some countries in the region, such as Gabon and Equatorial Guinea, still have per capita income levels that are significantly higher than the CEMAC average, thanks to income from the oil sector.

Figure 3.1. - Share of Oil in CEMAC Economies
(as % - 2016)

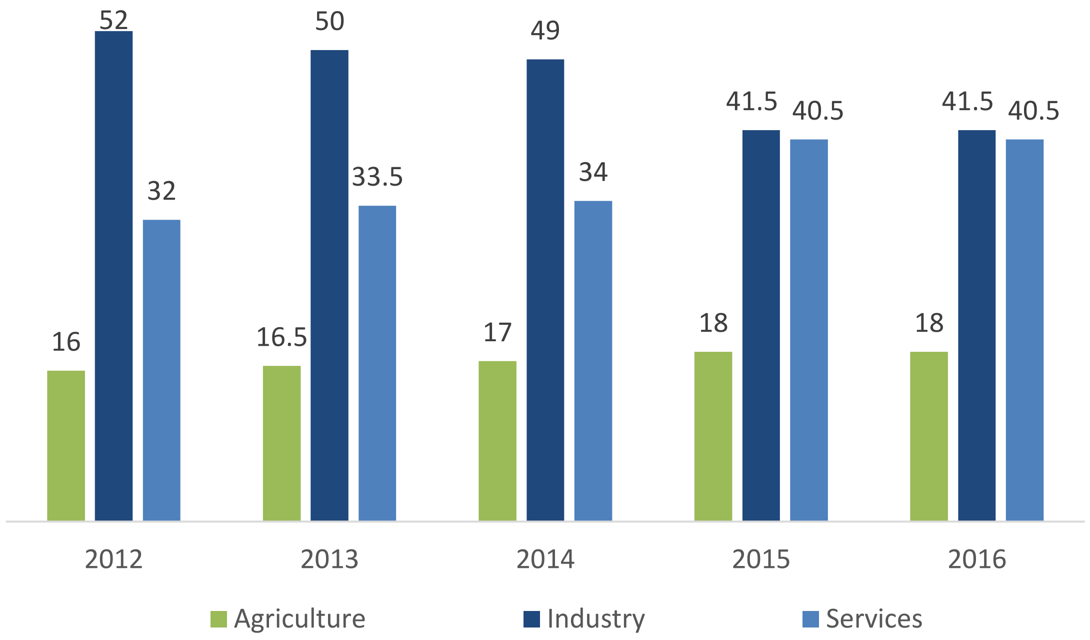


Sources: Banque des Etats de l'Afrique Centrale (Bank of Central African States – BEAC), BP, Bank of France.

Since oil is a main driver of the sub-regional economy, the countries of the sub-region have been compelled to adopt austerity measures and to enter into bilateral negotiations with the IMF in order to agree on adjustment programmes[7] for restoring macroeconomic balances. Indeed, oil revenue, which represented 60.5% of total revenue in 2013, accounted for only 30% in 2016, plunging the sub-region into a cash flow quagmire and thus resulting in a decline in foreign exchange reserves. Excluding the Central African Republic, the other five CEMAC States are all oil-producing countries. However, the contribution of oil to economic growth varies from one country to another depending on the level of economic diversification (Figure 3.1.). While crude oil accounted for almost 4% of Cameroon's GDP in 2016, it contributed around 45% for Equatorial Guinea, 36% for Congo and 25% for Gabon. This resource also represented 97% of Equatorial Guinea's total exports in the same year, 88% of Chad's, 80% of Congo's and 59% of Gabon's.

[7] Three countries (Cameroon, Chad and Gabon) adopted new IMF-supported programmes, while the Central African Republic adjusted an existing programme.

Figure 3.2. - Contribution to Regional GDP in Central Africa by Sector, 2012-2016
(average across countries - as %)



Source: African Development Bank.

Diversification measures are therefore essential to reduce the vulnerability of the countries in the sub-region to oil price shocks, unlock their full economic potential and restore more sustainable growth. Nevertheless, the analysis of the sectoral breakdown of major economic activities in Central Africa as a whole (Figure 3.2.) indicates that industry continues to dominate the region's economy, contributing about 41% to regional GDP[8], even despite its decline since 2012. It is followed by the service sector, which contributes 40.5%, and agriculture (18%). The Bank of Central African States (BEAC) also estimates that the secondary and tertiary sectors were the driving forces behind CEMAC's growth in 2017, with each of them contributing +0.4 percentage points, against -0.9 and +1.3 respectively in 2016. The dynamics of secondary activities were driven by the manufacturing (+0.3 points, compared to +0.2 points in 2016) and other industries (+0.2 points as in 2016), and those of the tertiary sector by market services activity (+0.3 points, compared to +1.0 points in 2016). However, the primary sector reigned in growth with a contribution of -0.9 points in 2017, against -1.3 points a year earlier.

3.2. Macroeconomic Situation

Overall, the macroeconomic situation in the CEMAC countries is picking up following a sharp downturn in their economic momentum, under the combined effect of falling raw material prices and heightened security threats in several countries of the sub-region. According to the IMF, economic growth in the region slipped slightly into the red at -0.1% in 2017 (-2.2% for the oil sector and +0.3% for the non-oil sector), compared to 4.7% in 2014. This slowdown

[8] Central African Economic Outlook 2018, AfDB.

is thought to be due to the decrease in public spending[9] as well as to the continued decline in oil production. In 2018, on the other hand, the region's economies are expected to begin a fairly significant economic recovery. The IMF forecasts growth of 1.7% for this year. This renewed vitality can be explained in particular by the increase in oil prices and production, the accelerated implementation of economic, monetary and financial reforms in the countries of the sub-region and the stabilisation of foreign exchange reserves thanks to the funds injected by the IMF and other international donors under adjustment and financial aid programmes aimed at reviving the economies of this sub-regional community and stabilising the CFA franc (XAF).

Table 3.2. - CEMAC: Main Macroeconomic Indicators
(2014-2018)

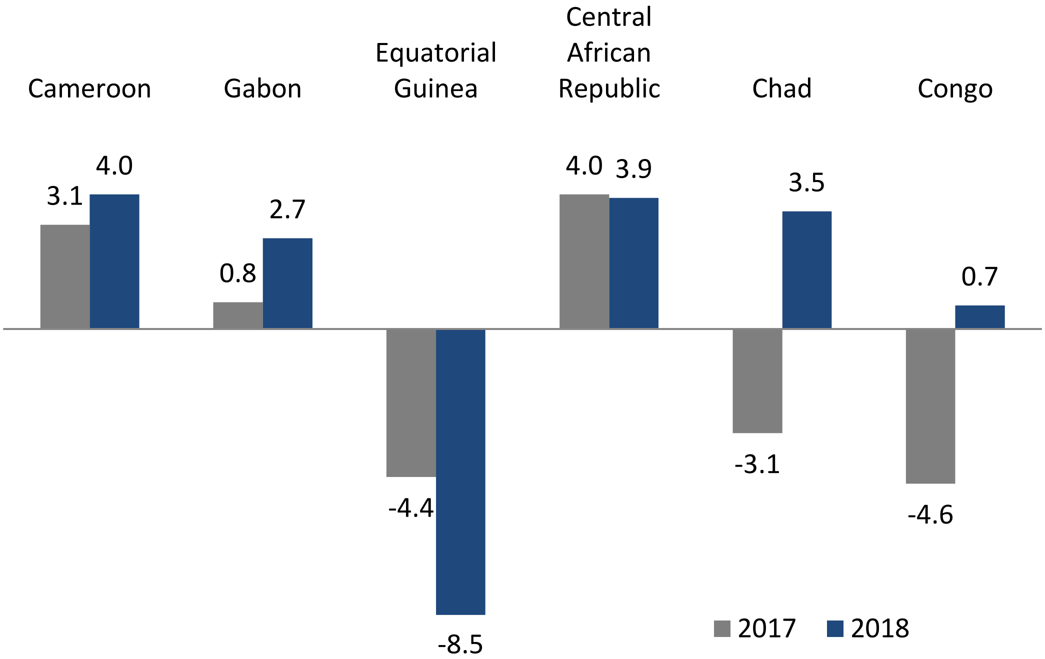
	2014	**2015**	**2016^e**	**2017^e**	**2018^p**
Real GDP (year-on-year change as %)	4.7	2.0	-0.5	-0.1	1.7
Consumer prices* (year-on-year change as %)	2.7	2.7	1.3	0.9	1.6
Overall fiscal balance** (% of GDP)	-4.7	-8.1	-7.6	-3.5	-0.3
Public debt (% of GDP)	28.9	43.9	51.6	52.0	51.1
Current external balance (% of GDP)	-2.0	-13.2	-13.8	-4.3	-1.9
Gross official reserves (months of imports)	5.8	4.3	2.4	2.5	3.3

Source: IMF
Note: ^{e} Estimate; ^{p} Projections; * Average for the period**;** ** Including grants.

The macroeconomic anchorage of CEMAC countries is improving, in terms of both inflation and fiscal position (Table 3.2.). Inflation remains low in the region, well below the regional convergence ceiling (3%), mainly as a result of the contraction in economic activity and the system of fixed exchange rate against the euro. The annual average inflation rate is thus expected to be 1.6% in 2018 according to the IMF, compared to 0.9% a year earlier. Fiscal and current account deficits are projected by the IMF to gradually decrease in 2018, in particular as a result of successful fiscal consolidation efforts and the recovery in oil prices. The overall budget deficit is expected to shrink from 3.5% in 2017 to 0.3% in 2018, while the current account deficit is projected to go down by 1.9% in 2017, compared to 4.3% a year earlier.

[9] According to BEAC, these expenditures dropped drastically by CFAF 4 000bn (about USD 7.2m) between 2014 and 2017.

Figure 3.3. - Economic Growth of Countries in the CEMAC Region
(2017-2018** - as %)*



Source: IMF.
Note: * Estimate; ** Projections.

In this context, economic growth in the CEMAC countries should improve significantly from 2018 onwards and continue to strengthen over time. Thus, with the exception of Equatorial Guinea, all the countries in the regional bloc should record an upturn in their growth rates this year (Figure 3.3.). Economic growth in the majority of CEMAC countries should accelerate in the medium term to over 3% by 2019, according to IMF projections, and then stabilise at around 3.7%.

However, this recovery is not guaranteed and its achievement will require the countries in the region and their partners to monitor developments closely. Performance is conditional upon continued diversification efforts, the completion of fiscal consolidation programmes, a better allocation of public investment and an improved business climate. However, there are significant risks linked in particular to trends in international raw material prices, the implementation of adjustment programmes and commitments made by the Governments, as well as the security situation, which remains precarious in certain areas, including the Central African Republic, the Lake Chad region and Congo's Pool area. In addition, continued political tensions in some countries in the region could disrupt the proper application of government economic policies.

Moreover, the macroeconomic situation is worrying with regard to public debt and foreign exchange reserves. In fact, the total public debt-to-GDP ratio estimated for the sub-region rose from 29% at end-2014 to 52% in 2017. Over the same period, the outstanding external debt of the CEMAC countries rose from 18% to 28% of GDP, as a result of the continuation of public investment programmes in certain countries in a fairly difficult environment. In addition, the downward trend in external assets led to a significant fall in foreign exchange reserves to below three months of imports between 2016 and 2017. However, these reserves are expected to climb above this level in 2018 owing to aid from international organisations and improved oil revenue. According to the IMF, by 2021, the region's public debt, estimated at 52% of GDP in 2017, should gradually decline to 47% of GDP, the external current account deficit should narrow to around 1.5% of GDP, and reserve coverage should be around 4.5 months of imports.

Table 3.3. - Gross FDI Flows to CEMAC Countries
(in USD m, 2011-2017)

Country/Year	2012	2013	2014	2015	2016	2017	16/17 change (as %)
Cameroon	739	567	727	627	664	672	1.2
Central African Republic	70	2	3	3	7	17	142.9
Chad	580	520	-676	559	244	335	37.3
Congo	-283	609	1 659	3 802	3 565	1 159	-67.5
Equatorial Guinea	985	583	168	233	54	304	463.0
Gabon	-221	771	1 048	990	1 241	1 498	20.7
CEMAC	1 870	3 052	2 929	6 214	5 775	3 985	-31.0
West Africa*	15 485	13 354	11 647	9 677	12 423	10 977	-11.6

Source: UNCTAD (World Investment Report, 2018).
Note: * Excluding Mauritania.

A recovery is expected for foreign investment in the sub-region, whereas, in 2017, low commodity prices curbed investors' appetite for Central Africa (Table 3.3.). According to UNCTAD estimates, gross FDI flows to CEMAC fell by around 31% in 2017 compared to the previous year, to almost USD 4bn. These inflows plummeted, for instance, by 68% to USD 1.2bn in Congo, mainly due to the country's economic difficulties, combined with volatile oil investments and weak FDI in non-oil sectors. On the other hand, they increased substantially in Gabon and Equatorial Guinea to USD 1.5bn (+21%) and USD 304m (+463%) respectively, at a time when they were virtually stagnant in Cameroon (+1.2% to USD 672m). As far as outlook is concerned, FDI in the sub-region should, according to the IMF, begin to grow again as raw materials prices recover and structural reforms are implemented. However, these flows will remain subject to cyclical swings due to Central Africa's dependence on basic commodities.

Table 3.4. - Business Climate Ranking of CEMAC Member Countries
(*Doing Business Ranking - 2016-2018)*

Country	2016	2017	2018
Cameroon	172	166	163
Gabon	162	164	167
Equatorial Guinea	180	178	173
Republic of the Congo	176	177	179
Chad	183	180	180
Central African Republic	185	185	184

Source: World Bank.

Progress has been made in improving the business climate (Table 3.4.). In order to improve their business environment, CEMAC governments have initiated a series of structural reforms, enabling four out of the six countries in the sub-region to move up in the latest World Bank Doing Business ranking. Cameroon, for instance, has implemented the OHADA reform[10], while strengthening the prerogatives of the Investment Promotion Agency (IPA). The Central African Republic has set up some thirty focal points, attached to its Permanent Technical Secretariat of the Joint Business Improvement Framework (CMCAA) and tasked with proposing measures to improve the country's ranking. For its part, Congo has developed a user guide and a manual of procedures for administrations in order to modernise the public sector. Numerous reforms have also been carried out in Gabon, in particular with a view to simplifying procedures, and via the introduction of a National Investment Charter and the establishment of an arbitration centre for the management of commercial disputes. Chad has created a National Investment and Export Agency (ANIE) and a one-stop shop to simplify procedures. In addition to the adoption of a National Investment Charter, it has set up a Public-Private Dialogue Forum (FODEP), and fixed tariffs for the creation, modification and renewal of business certificates. Finally, and with a view to improving the economic environment in the region and fostering the development of a dynamic and competitive private sector, the countries of the region intend to set up a sub-regional business climate observatory in the near future.

Sub-regional economic integration in the CEMAC region[11] **has been supported by a fairly advanced institutional framework**. A common currency, the CFA franc, was adopted and issued by an independent monetary authority, BEAC, which steers the Member States' monetary policy. A harmonised public financial management framework has been put in place. A financial institution has been created to finance the development of the countries in the sub-region, Banque de Développement des États de l'Afrique Centrale (Central African States Development Bank – BDEAC). This integration process is also based on compliance with a number of economic convergence criteria, which have been in place since 2001 and were redefined on 1 January 2017. This recent reform mainly concerns (i) the revision of the fiscal balance criterion, which now takes better account of each country's oil revenue, (ii) the introduction of a debt brake in order to limit the accumulation of medium-term debt, and (iii) the adaptation of the inflation criterion, now based on a three-year average.

[10] Organisation for the Harmonisation of Business Law in Africa.

[11] Founded in 1994, the Economic and Monetary Community of Central African States (CEMAC) is made up of six countries: Cameroon, Chad, Congo, Equatorial Guinea, Gabon and the Central African Republic. Its purpose is to promote the harmonious development of the Member States and the establishment of a genuine common market based on the free movement of persons, goods, capital and services.

Table 3.5. - Indicative Position of the Member States in Relation to Multilateral Surveillance Criteria
(Primary surveillance criteria)

	Cameroon		Central African Republic		Republic of the Congo		Gabon		Equatorial Guinea		Chad	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
Basic fiscal balance, positive or zero	+	-	-	-	-	-	+	-	-	-	+	-
Benchmark fiscal balance ≤ -1.5%*	-	-	+	+	-	-	+	-	-	+	+	+
Average annual inflation rate ≤ 3%	+	+	+	-	+	-	+	+	+	+	-	+
Total public debt/nominal GDP ≤ 70%	+	+	+	+	+	-	+	+	+	+	+	+
Arrears variation ≤ 0	-	-	-	-	-	-	-	-	-	-	-	-
Number of criteria fulfilled	3/4	2/4	2/4	1/4	2/4	0/4	3/4	2/4	2/4	2/4	2/4	2/4

Notes: + = Fulfilled; - = Not fulfilled; * For information.
Sources: CEMAC Commission, Bank of France

The analysis of the state of convergence of the Community region reveals widespread non-fulfilment of the associated criteria in 2016, in connection with an unfavourable economic context (Table 3.5.). For instance, none of the six countries met the basic budget deficit criterion (whereas three countries had met it in 2015) in a context of declining oil revenue. In addition, both the Republic of the Congo and the Central African Republic recorded an inflation rate above the Community standard. Congo's debt ratio was also well in excess of the 70% threshold.

3.3. Recent Trends in the Financial Sector

Despite adverse economic conditions, vulnerabilities in the CEMAC financial system had little impact on its stability. According to the IMF, bank profitability remains intact and banking regulation continues to be strengthened. Although there is still room for improvement, financial inclusion has been considerably strengthened in the region thanks to the development of microfinance activity and the expansion of mobile banking. The sub-region's capital market should benefit from the positive effects expected from the project for its unification, and therefore constitute an alternative source of financing for SMEs in the region.

CEMAC's banking sector remains relatively strong despite the slowdown in its dynamics in 2017. In the same period, the activity of other financial institutions increased slightly despite the sluggish environment. The situation in the region also varies considerably from one market to another. Non-performing loans (NPLs), which are already very high, are on the rise and the decline in deposits is putting pressure on bank liquidity. COBAC is currently implementing a more risk-based surveillance system, while capital requirements will gradually increase. As regards concentration risk, one third of solvent banks are contravening the CEMAC regulation. Financial inclusion has improved in recent years but it is still too early to talk about convergence with the rest of Africa and the rest of the developing countries.

3.3.A. BANKING SECTOR

Table 3.6. - The Banking Sector in the CEMAC Region
(as at 31 December 2017, in USD m)

10 Largest Banks in Terms of Assets		Assets	Equity	Deposits	Foreign majority	Public majority
1	BGFIBANK	1 966.13	223.71	1 563.04	No	No
2	Afriland First Bank	1 784.41	200.59	1 318.85	No	No
3	SGBC	1 575.31	163.38	1 289.31	Yes	No
4	BICEC	1 416.89	9.61	1 112.01	Yes	No
5	CCEI BANK	1 337.86	321.75	782.88	Yes	No
6	BGFIBANK Congo	1 053.97	174.85	653.30	Yes	No
7	CA-SCB	978.12	96.91	811.34	Yes	No
8	Ecobank Cameroun	859.99	74.71	636.59	Yes	No
9	BANGE	757.53	65.26	669.58	No	Yes
10	BICIG	732.43	110.22	575.02	Yes	No
Total for Whole Banking Sector		23 213.66	2 807.77	17 091.24		

Source: COBAC.

CEMAC's eight largest banks are currently privately owned institutions, majority-owned by foreign investors, with the exception of the first two (Table 3.6.)**.** On 31 August 2017, CEMAC had 65 credit institutions[12] including 11 financial institutions[13]. They are spread across the Member States as follows: 15 banks and eight financial institutions in Cameroon, four banks in the Central African Republic, 11 banks in Congo, ten banks and three financial institutions in Gabon, five banks in Equatorial Guinea and nine banks in Chad. The total assets of the banking sector in the zone amounted to CFAF 12.7 quadrillion as at 31 December 2017, or USD 23.2 billion. As regards the microfinance sector in the region, in 2016, there were 825 microfinance institutions (MFIs) approved by COBAC, 700 of which are actually active (COBAC, 2017).

[12] Credit institutions are entities which carry out banking operations as a regular activity, in particular the receipt of funds from the public, loan operations and the management and provision to customers of means of payment. They are classified into two categories: banking institutions and financial institutions.
[13] CEMAC financial institutions differ from banks in that they are prohibited from receiving demand funds from the public and funds with less than two years of maturity, and in that they require a minimum share capital of CFAF 2 billion, compared to CFAF 10 billion for banks. There are two main categories: financial companies (consumer credit, leasing, factoring, etc.) and specialised financial institutions with a public policy mandate (loans, guarantees, equity investments, advice, etc.).

Table 3.7. - Changes in Banking Sector Resources and Uses of Funds
(in USD m, 2014-2017)

	2014	2015	2016	2017
Customer deposits	18 748.20	16 461.70	15 081.80	17 091.20
of which, demand customer accounts	14 261.33	12 873.74	12 334.12	14 107.16
of which, term deposits	3 285.75	2 966.06	2 841.73	3 250.23
Debts owing to credit institutions	892.40	793.10	669.91	705.87
Bond debt	3.08	1.82	0.00	0.00
Own funds	2 463.78	2 438.65	2 419.68	2 975.43
Other liabilities	179.79	158.65	281.64	218.14
Net profit	266.10	208.08	140.51	105.25
Total liabilities	**22 553.36**	**20 061.96**	**18 593.51**	**21 095.94**
Core Tier 1 capital	13 565.17	13 538.34	13 606.07	15 491.92
Customer loans	239.87	266.53	243.77	420.64
of which, long-term debt (> 5 years)	4 929.58	4 942.09	5 207.17	5 807.57
of which, medium-term debt (1-5 years)	3 251.71	3 325.49	3 243.26	3 802.18
of which, short-term debt (< 1 year)	5 338.95	3 735.31	3 054.55	4 210.76
Loans and advances to credit institutions	13 565.17	13 538.34	13 606.07	15 491.92
Central Bank Investments	10.88	150.91	52.24	0.07
Treasury bills	679.02	862.29	1 852.54	1 715.09
Other assets	2.92	14.73	18.24	10.28
Total assets	**19 596.94**	**18 301.58**	**18 583.63**	**21 428.11**

Source: COBAC.

Overall, CEMAC's financial system remained resilient in 2017. While vulnerabilities increased in the financial sector in 2017, the profitability of banks remained stable and the average capital adequacy ratio increased (IMF 2017). At 31 December 2017, banking activity in CEMAC (Table 3.7.) showed a rebound in total assets of USD 2.5 billion (corresponding to a contraction of 0.80% in CFAF) between December 2016 and December 2017, an increase in customer loans of USD 1.89 billion and an increase in customer deposits of USD 2.00 billion (corresponding to a decline of -0.45% in CFAF). However, this upward trend when the amounts are expressed in USD corresponds to a contraction in assets of around CFAF 840 billion, visible in all CEMAC countries except Cameroon and the Central African Republic[14].

According to the IMF[15], significant progress has been made in banking regulation and supervision thanks to COBAC's sustained efforts, even though CEMAC's financial sector continues to display some vulnerabilities. Weak economic activity and the stabilisation of public finances are having an impact on both sides of commercial banks' balance sheets, thus contributing to a further rise in non-performing loans from already high levels, and a fall in deposits. The banking sector continues to feel the negative impact of the oil price shock through its direct exposure to the sector and through its indirect exposure to public spending.

[14] COBAC (2017), Situation of the banking system of CEMAC, as at 31 August for banks and 30 June 2017 for financial institutions respectively.
[15] IMF (2017) Country Report No. 17/389, December.

Table 3.8. - Banking Sector Resilience Indicators and Credit Ratios in CEMAC
(Percentages 2014-2017)

	2014	2015	2016	2017
Regulatory capital				
Regulatory capital/risk-weighted assets	17.8	18.2	17.7	21.5
Core Tier 1 capital/risk-weighted assets	12.6	13.2	12.4	15.2
Equity/assets	3.1	3.8	3.6	3.6
Profitability[16]				
Return on assets (ROA)	1.15	0.95	0.66	0.42
Return on equity (ROE)	13.53	10.28	7.32	4.47
Net interest margin/net banking income	58.0	54.9	57.3	115.2
Staff costs/net banking income	20.7	21.2	22.0	46.7
Bad debts				
Doubtful debts/total loans	8.0	8.9	9.8	11.0
Specific provisions/doubtful debts	86.0	82.0	86.4	90.4
Doubtful debts net of provisions/total loans	1.1	1.6	1.3	1.1
Liquidity				
Liquid assets/total assets	29.4	25.4	23.6	26.1
Liquid assets/short-term liabilities	156.3	151.9	141.3	158.2
Liquid assets/customer deposits	36.5	33.2	32.7	35.5
Deposits/loans	138.2	121.6	110.8	110.3
Sensitivity to market risks				
Net open foreign exchange position/core Tier 1	215.2	101.6	82.0	75.2
Foreign currency assets/total assets	12.9	5.0	4.1	4.2
Foreign currency liabilities/total assets	19.9	9.1	7.3	7.2
Credit ratios				
Loans/assets	58.4	63.1	65.0	66.7
Private sector credit/GDP	11.43	13.65	14.51	13.54
Growth in private sector credit	8.8	10.6	4.9	0.4
Foreign currency loans/total assets	0.2	0.3	0.3	0.6

Source: COBAC

Non-performing loans (NPLs), which are already very high, are on the rise and the decline in deposits is putting pressure on bank liquidity (Table 3.8.). Several banks across all countries in the region are in breach of key prudential indicators, and credit growth could put pressure on future profits. The accumulation of arrears by large national administrations, which is continuing in some countries, has played an important role in the increase in NPLs. Doubtful debts accounted for the largest share of bad debts, at 63% in August 2017, compared to 60% a year earlier (COBAC, 2017). Provisions for impairment of customer accounts are also increasing and the cover ratio of doubtful loans by provisions was 90% at end-2017, compared to 86% twelve months earlier. Return on assets and equity declined in 2017. The average solvency ratio, on the other hand, rose over the same period.

COBAC is currently implementing a more risk-based surveillance system, while capital requirements will gradually be increased from 8% to 10.5% in 2019. To this end, the banking

[16] For 2017, the ratios relating to profitability are calculated as at 30/06/2017.

regulator is preparing additional capital requirements to cover counter-cyclical risks and systemically important banks, as well as capital charges for operational and market risks. The IMF also welcomed the adoption of the new regulatory framework for microfinance, which will strengthen and stabilise this sector. The international institution recommends that the rules governing the operation of the Deposit Insurance Fund (FOGADAC) be adopted rapidly to make it fully operational, and that the conditions and procedures for reimbursing depositors in various circumstances be well defined.

As regards concentration risk, one third of solvent banks are failing to comply with the CEMAC regulation. If fully implemented, the envisaged major increase (from 75% to 90%) in the risk weightings applied to the debts of Member States that have failed to meet the regional convergence criteria would probably lead to even more banks not complying with this prudential risk concentration ratio. As a result, COBAC recently specified the conditions under which banks could be temporarily (for 1 to 2 years) exempted, on a case-by-case basis, from implementing these additional risk weightings. In particular, exemptions will only be granted for government securities issued by countries involved in programmes with the IMF.

Table 3.9. - Breakdown of Loans by Sector
(as percentage of value of loans, 2014-2017)

	2014	2015	2016	2017
Finance	0.4	0.4	0.0	0.5
Private companies	31.4	32.8	34.5	33.9
Other sectors	17.8	25.0	27.8	22.9
Public authorities	8.2	9.5	10.6	12.4
Non-residents	42.2	32.3	26.6	30.4

Sources: COBAC; authors' calculations.

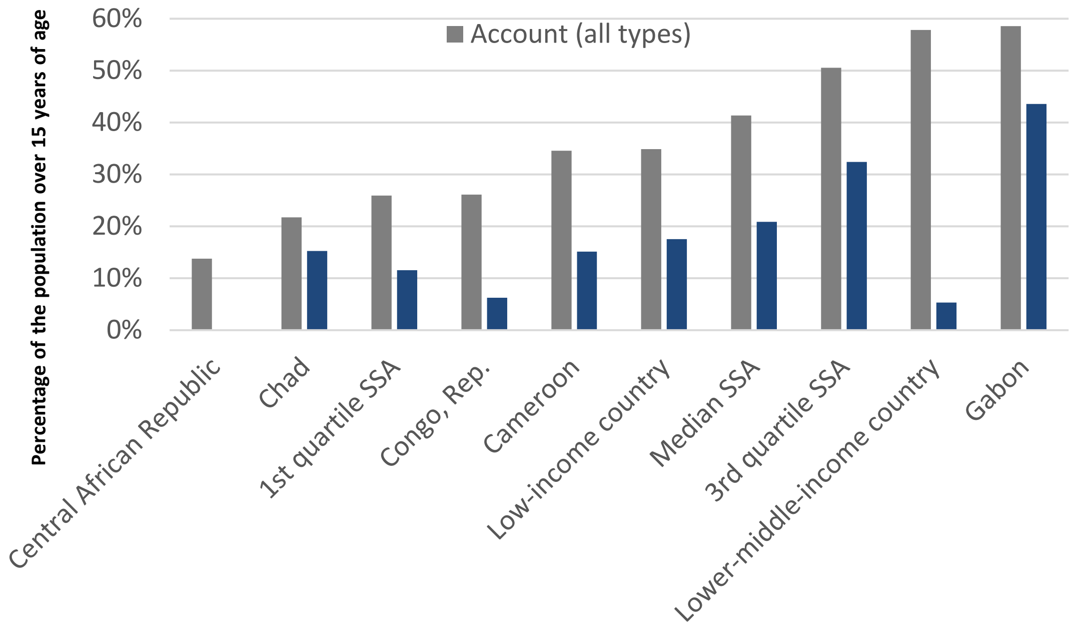
In line with the IMF's recommendations, we believe that measures should be taken to reduce the high and growing level of NPLs and to rapidly rescue banks in difficulty in order to restore the banks' capacity to lend to the economy and maintain confidence in the financial sector. Indeed, the longer banks remain in distress, the higher the potential fiscal costs of restructuring may prove to be. The high volume of NPLs absorbs capital and liquidity and hampers banks in financing the economies of the CEMAC countries. If these conditions were to persist, the banking sector would not be sufficiently able to support CEMAC's diversification away from the oil and public sectors (Table 3.9.).

The situation of several banks in difficulty has, in fact, been dragging on for a long time, with supervisory authorities delaying resolution in many cases until recently. These banks are not systemic, but their continued non-compliance with prudential rules undermines COBAC's credibility in terms of its ability to apply the rules consistently. Fortunately, COBAC has taken decisions concerning all these institutions, ranging from appointing liquidators for two of them, to requesting other banks to provide restructuring plans. On the other hand, several banks have had delays in finding recapitalisation solutions.

From a banking point of view, the monetary policy stance is appropriately calibrated for now**. If the accumulation of reserves should fall short of BEAC's objectives, further tightening will probably have to be considered. BEAC eliminated statutory advances at the end of 2017. This reform should help restore fiscal discipline in CEMAC and contribute to strengthening monetary policy transmission over time.

3.3.B. Financial Inclusion

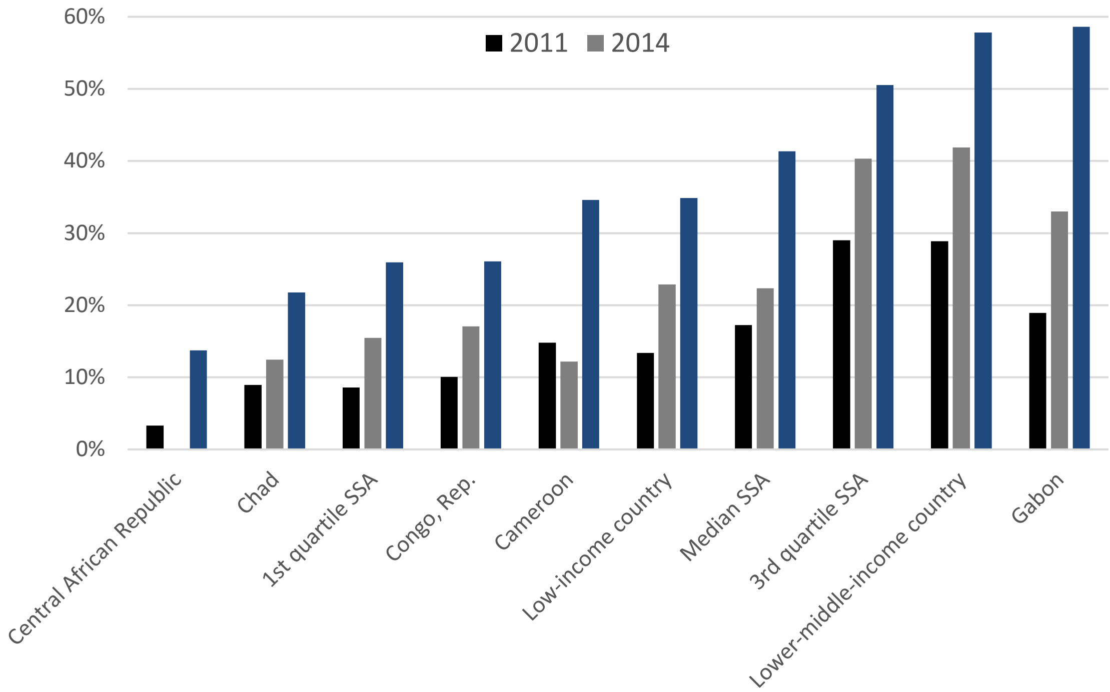
Figure 3.4. - Share of Adult Population with an Account in CEMAC
(age 15+, 2017)



Source: FINDEX.
Note: FINDEX does not report data for Equatorial Guinea.

Financial inclusion in CEMAC still leaves room for improvement, even according to developing country standard. The Central African Republic, Chad and the Republic of the Congo all have an account ownership rate not only below 30% of the population over the age of 15 but also lower than the average for weak countries (Figure 3.4.). Although Cameroon has a level of account ownership above 30%, it still scores below the median of sub-Saharan African countries and significantly below the average for the lower-middle-income country category, to which it belongs.

Figure 3.5. - Development in Share of Adult Population with an Account in CEMAC
(age 15+, 2017)

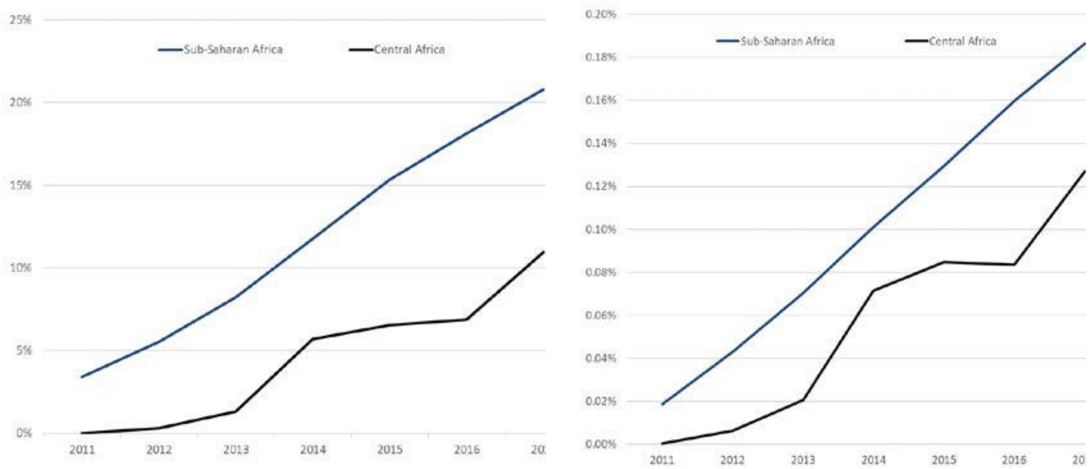


Source: FINDEX.

On the other hand, there has been a sharp upward trend in financial inclusiveness in CEMAC since 2011 (Figure 3.5.). The Central African Republic, Chad, the Republic of the Congo, Cameroon and Gabon all recorded sustained growth in the number of bank and mobile accounts between 2011 and 2014 and 2014 and 2017. This development is consistent with the trend observed for the rest of the countries spread across sub-Saharan Africa, as well as for low- and lower-middle-income countries. The absence of FINDEX data for Equatorial Guinea suggests, however, that the country is lagging significantly behind the rest of the region, let alone the overall continent and the countries in its income category (lower-middle income), in terms of financial inclusion.

Figure 3.6. - Active Financial Inclusion in Central Africa
(2011-2017)

A. Active accounts per capita B. Active agents per capita



Source: GMSA (2018).

Similarly, a deeper analysis points to the beginning of the convergence of financial inclusion in Central Africa with the rest of sub-Saharan Africa (Figure 3.6.). In particular, the growth in the number of active accounts and agents seems to have been accelerating since December 2016, recently surpassing the rest of the region in terms of momentum. The share of the adult population in Central Africa having used a bank or mobile account in the preceding three months rose from 0% in 2011 to 11% in 2017. The ratio of active banking agents to the adult population rose from 0.00% to 0.13%, i.e. 13 active banking agents per 1 000 inhabitants, over the same period. An acceleration in this trend can be observed in 2014 and 2017. In terms of financial inclusion, the sub-region still clearly has a long way to go to catch up with sub-Saharan Africa as a whole, but the closing of the gap that appeared impossible at the turn of the decade (EIB, 2016) now seems to be perfectly feasible.

In this respect, mobile banking is currently making a significant contribution to increasing the level of bank usage in the region. The majority of accounts consist of mobile accounts in Chad and Gabon. Cameroon, for its part, has a mobile banking rate that is close to the average of low-income countries, even if though it is below the median for sub-Saharan African countries. Accordingly, the role played by the mobile banking sector in Cameroon is proportionally less important than in the other countries of the sub-region but nevertheless significantly higher than the average of countries in the lower-middle-income bracket, in which it belongs.

As a result, banks in the sub-region have been forced to begin their digital transformation within a context of rapidly evolving, innovative technologies, the boom of electronic portfolios (Orange Money, MTN Mobile Money, etc.) and the growing demands of customers in terms of response times. Faced with these challenges, these institutions are starting to deploy a wide range of digital services, like Ecobank Cameroon which launched "Ecobank Mobile" in February 2017, an application enabling customers to send and receive money instantly across 33 African countries. In addition, the BGFIBank Group is relying on digital technology to implement its "Excellence 2020" project. The Gabonese bank has therefore developed several innovative solutions, including a new-generation dynamic code card, mounted on the back of the bank card to secure transactions, particularly those made via the Internet.

Table 3.10. - Financing Requirements of Micro, Small and Medium-Sized Enterprises (MSMEs) in Central Africa

	Number of MSMEs	**Current offer** (USD m)	**Financing requirements** (USD m)	**Total MSME financing requirements/ GDP**	**Investments financed from own funds** (%)	**Investments financed by a bank** (%)
Angola	27 603	2 707	34 178	33%	91.5 (2006)	2.6
					88.8 (2010)	3.9
Cameroon	93 030	1 662	8 715	30%	75.6 (2009)	5.1
					65.3 (2016)	2.4
Central African Republic	22 326	31	242	16%	70.8 (2011)	4.1
DRC	319 090	447	9 305	26%	88.0 (2010)	0.6
					92.9 (2013)	0.6
Chad	5 170	282	1 134	10%	89.3 (2009)	1.7
					72.8 (2018)	0.5

Note: countries selected for data availability.
Source: SME Finance Forum (2018), World Bank Enterprise Surveys.

The needs of micro-enterprises and SMEs in terms of access to bank financing are such that, in some countries in particular, the region still has a great deal of potential to be tapped over the next few years (Table 3.10.). The country with the highest proportion of investments by small businesses (5–19 employees) undertaken on the basis of bank financing is Cameroon, at only 2.4% in 2016, down from 5.1% in 2009. The financing gap for MSMEs ranges from 10% of GDP in Chad to 33% in Angola. In Cameroon, this gap represents 30% of GDP, suggesting an enormous potential in the context of a relatively well-diversified economy enjoying sustained growth. In order to facilitate access to finance for this type of enterprise, the Cameroon authorities recently announced the reinforcement of the National SME Agency, the strengthening of the financial capacities of Banque Camerounaise des PME (Cameroon SME bank) and the creation within it of a Credit Guarantee Fund for these structures.

3.3.C. Development of the Capital Markets

Although still at an embryonic stage, the activity of financial institutions - outside the banking sector - is beginning to play an important role in financing the economy in the CEMAC region. However, according to COBAC, only four of the eleven financial institutions operating in the sub-region met all prudential standards in 2016 (Table 3.11. below). More specifically, four institutions complied with the minimum capital representation requirements, while seven institutions reported a ratio of weighted-risk coverage by net equity of greater than or equal to the minimum of 8%. With regard to the liquidity ratio, eight institutions had liquid assets on demand, or at less than one month, greater than or equal to the regulatory minimum of 100% of liabilities of the same term. The same applies to the long-term conversion factor: eight institutions managed to finance at least 50% (regulatory threshold) of their applications of funds with a residual term of more than five years from long-term resources.

Table 3.11. - Number of Financial Institutions Complying with Prudential Standards

Prudential standard	2015	2016
Minimum capital	6	4
Risk coverage	8	7
Overall risk ceiling	8	7
Individual risk ceiling	8	7
Fixed asset coverage	8	7
Liquidity ratio	8	8
Conversion factor	8	8
Related-party commitments	8	7
Total number of financial institutions	8	8

Source: COBAC.

CEMAC's capital market offers a definite growth potential and activity is up slightly despite the sluggish environment. Given the sub-region's strengths - economic potential, ambitious development plans, major infrastructure projects, membership of a monetary union with a common currency, the existence of a substantial legal framework in the financial sectors and financial institutions with access to regional mandates - this market has considerable untapped growth potential.

In Central Africa, the capital market is divided into two main segments: a short-term money market and a financial market centralising the supply and demand of long-term capital. The first market was opened in the sub-region on 1 July 1994, following the monetary and financial reforms launched after the severe economic crisis in the sub-region in the mid-1980s. The financial market was only officially established in 2003[17], the year in which the regional Central African Stock Exchange (BVMAC), based in Libreville, was created. At the same time, Cameroon set up its national Douala Stock Exchange (DSX).

[17] The BVMAC only began its administrative activities on 13 August 2008.

Table 3.12. - Comparison of Interbank Interest Rates in CEMAC, WAEMU and Eurozone
(annual average as %)

	2012	2013	2014	2015	2016
TIMP[1] (CEMAC)	2.66	4.42	5.00	4.12	5.00
1-day rate (Central Bank of West African States - BCEAO)	4.20	3.93	3.92	3.72	4.42
3-month rate (BCEAO)	5.10	5.66	5.15	4.72	4.68
EONIA[18] (overnight)	0.07	0.091	0.094	-0.108	-0.320
3-month EURIBOR[19] rate	0.19	0.221	0.209	-0.020	-0.265

Sources: BEAC and Bank of France (BDF).
Note: [1] Weighted average interbank rate.

The CEMAC money market is organised in two compartments and has enjoyed sustained activity. The first compartment is the interbank market - Level 1 - on which credit institutions and public financial institutions exchange liquidity in accounts at the Central Bank on freely negotiated amount, rate, duration and possibly guarantee conditions. In 2016, this compartment experienced some recovery with transactions of around USD 48.9m (CFAF 30.4bn), compared to USD 44.8m (CFAF 27bn) a year earlier. These national and sub-regional operations were carried out with interest rates ranging from 2.50% to 5.00% and maturities ranging from one day to one year (Table 3.12.)

The second compartment - level 2 - also enjoyed an upsurge. It corresponds to BEAC operations implemented through two windows (A[20] and B[21]), in favour of eligible credit institutions. In 2016, the average outstanding amount of advances from the issuing institution to these institutions rose sharply to nearly USD 1.04bn (CFAF 646.1bn) in 2016, compared to USD 473.5m (CFAF 280.8bn) a year earlier, i.e. an increase of +123%[22]. This upturn was mainly due to the sharp rise in the cash requirements of the region’s banking system against a backdrop of tightening resources due to the fall in oil-related budgetary revenue.

The average volume of lending to credit institutions has increased considerably. In BEAC’s main window of operation (Window A), this increase is due to the fourfold increase in BEAC lending to Chad's banking system and the doubling of lending to Cameroon's banks. This volume grew by 136% to USD 964.2m (CFAF 600bn) in 2016 compared to USD 408.4m (CFAF 246bn) in 2015. As regards Window B, the average volume of facilities granted to the Central African States Development Bank (BDEAC) through this channel reached, according to COBAC, USD 76.2m (CFAF 47.4bn) on 31 December 2016, compared to USD 57.8m (CFAF 34.8bn) on the same date of the previous year.

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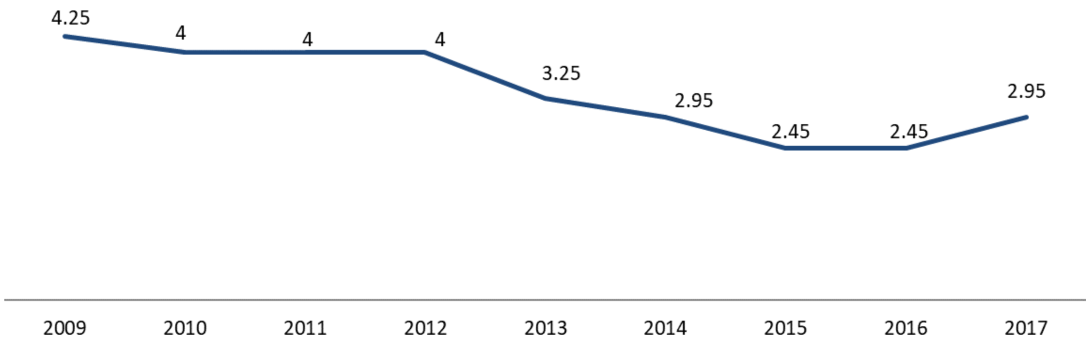
[18] EONIA (Euro Overnight Index Average). This the overnight rate for transactions on the Eurozone interbank market.
[19] EURIBOR (Euro Interbank Offered Rate). This is the arithmetic average of the rates at which banks are willing to lend money on the interbank market for terms of one to twelve months.
[20] Window A corresponds to the money market sphere where all liquidity injection and withdrawal operations are processed.
[21] Window B is for refinancing productive investments for periods of two to seven years, particularly those of BDEAC.
[22] The level of annual variation varies according to CFAF (BEAC)/USD exchange rate fluctuations.

Figure 3.7. - Developments in Official BEAC Interest Rate
(TIAO[1] end of period, as %, 2009-2017)



Source: BEAC.
Note: [1] Bid interest rate.

With regard to its official rates, BEAC's Monetary Policy Committee decided to tighten up monetary policy (Figure 3.7.). On 22 March 2017, the Committee raised the bid interest rate (TIAO) by 50 basis points to 2.95%, in order to contain inflation and replenish the region's foreign exchange reserves.

Finally, it should be noted that BEAC has, for several years, been implementing a series of reforms aimed at stimulating the CEMAC money market. These include, in particular, the granting of greater flexibility to credit institutions in the management of their liquidity, the revitalisation of interbank trade[23] and the launch of an emergency liquidity provision facility for banks and another facility for the management of minimum reserves[24].

There is increased market demand for government securities issued by auction. Launched in November 2011, this market consists of two compartments: a primary market where newly issued government securities are placed and a secondary market where securities are traded after they have been issued. The securities issued on this market are Fungible Treasury Bills (BTA)[25] and Fungible Treasury Bonds (OTA)[26]. In 2016, this market was in high demand among the public treasuries of the Community's Member States in relation to the previous year, due to the fall in oil revenue. On the primary market, 110 tendering procedures for treasury bills and bonds were launched in the same year (of which 103 were successful, raising almost USD 1.6bn/CFAF 992.4bn), compared to 77 a year earlier.

In terms of transactions, the secondary market for government securities was very subdued over the above-mentioned period with only two purchase/sale operations recorded. On the other hand, there was a significant increase in operations for pledging of securities with the central bank, the total outstanding amount of which reached a record level in 2016, made up

[23] Decision No. 11/CPM/2017.
[24] Decision No. 02/CPM/2016.
[25] 13, 26 and 52-week discount bills with a face value set at CFAF 1 000 000.
[26] Public securities issued with maturities of two years or more, a face value of CFAF 10 000 and interest payable annually.

of 222 135 BTA and 32 800 700 OTA with a total value of USD 884m (CFAF 550.1bn) and 21 420 000 treasury bonds (OT) with a face value of USD 345.8m (CFAF 208.3bn).

The sub-regional financial market in Central Africa is dominated by the bond compartment. The low volume of activity on this market indicates in fact that there is considerable potential for investment opportunities. According to BEAC, market and bond capitalisation on the BVMAC market on 31 December 2016 reached almost USD 515.4m (CFAF 320.7bn), or 0.7% of CEMAC's GDP, up 19% on 2015. The highlight of bond market activity was the registration of two public offerings in the bond compartment: the first bond issue by the Government of Congo, "EOCG 6.5% Net 2016-2021", for USD 309m (CFAF 192.3bn), and an issue by the Government of Gabon, "EOG 6.50% Net 2016- 2021", for USD 216.8m (CFAF 134.9bn).

The number of bonds listed at the sub-regional level remains limited, suggesting untapped potential. The number of bonds listed on the BVMAC remained unchanged in 2016 compared to 2015: eight after the Chad Government bond issued in 2011 matured on 20 July 2016. At end-2016, the bond compartment reached almost USD 506m (CFAF 314.9bn) market capitalisation, up 16.9% on end-2015. The secondary market or the shares compartment had only one company listed on the stock market (SIAT Gabon[27]) with a market capitalisation of approximately USD 9.2m (CFAF 5.7bn) at 30 December 2016, down 1.7% compared to a year earlier.

In Cameroon, the financial market enjoyed an increase in transactions despite the decline in capitalisation. As at 31 December 2016, the market and bond capitalisation of the DSX amounted to USD 531.9m (CFAF 331bn), or about 2% of Cameroon's GDP, down 21% on the previous year. In the bond compartment, there were five debt securities listed on this exchange compared to six in 2015, following the repayment of the first Cameroon Government bond entitled EMCR (5.6% net 2010-2015), which matured in 2015. As a result, bond capitalisation fell to USD 292.5m (CFAF 182bn) from USD 422.3m (CFAF 254.4bn) a year earlier. Despite this decline, transactions in this segment increased significantly, reaching a cumulative value of almost USD 4.7m (CFAF 2.9bn) in 2016, compared to USD 76 000 (CFAF 45.8m) the previous year. Bonds issued by the Government of Chad (Chad Government 6% net 2013-2018) and the Government of Cameroon (Cameroon Government 2014-2019) were the most traded securities on this market.

The recovery of the CEMAC financial market is expected to accelerate. After nearly a decade of existence, these markets have made some encouraging progress, but still have to face up to many challenges (co-existence of two stock exchanges, capitalisation, liquidity, depth, critical size and attractiveness) in order reach levels comparable to regional financial centres. The sub-region’s financial market is characterised by a dichotomous organisation based on the existence of two stock exchanges: one regional, based in Libreville, the BVMAC, and the other national, located in Cameroon, the DSX. By launching these markets, the authorities of the sub-region were aiming to develop alternative financing for their economies. Bearing this in mind and taking into account the constraints linked to both the structural adjustment of public finances and to external debt, the leaders of the CEMAC countries recently decided to

[27] Gabonese investment company for tropical agriculture, responsible for rubber-growing and livestock production activities.

accelerate the unification of the stock exchanges in order to equip their Community with a new instrument for financing the sub-regional economies and to make it a strong financial hub in Africa[28].

The convergence of the sub-regional financial market is therefore seen as the first step of a comprehensive reform. In Central Africa, the establishment of a financial market has without doubt contributed to unlocking regional financial resources at competitive costs for the benefit of businesses and to securing financing for governments through various public bond issues. BVMAC alone raised funds amounting to nearly USD 1.6bn (CFAF 800bn) on the CEMAC sub-regional market over the period 2008-2017[29]. Despite this progress, this market is still confronted with several challenges that hamper its development.

The market could also be deepened through a project with a more structuring effect, namely the convergence of the two stock exchanges, the BVMAC and the DSX. Under this plan, Libreville would become the place of regulation and Douala the financial centre, given that Cameroon possesses the Community's densest economic fabric. To this end, on 11 April 2018, COSUMAF and CMF (Cameroon financial market supervisor) set out in a cooperation and information exchange agreement the procedures to be applied during the transition period leading up to the formation of a single stock exchange in the CEMAC region by 30 June 2019.

The implementation of this convergence project should help to stimulate the financial market in the sub-region. According to Roland Berger's estimates, this merger could generate almost USD 1.8bn (CFAF 1 000bn) of issues by 2020. Led by BEAC, which launched a study to organise this integration, the unification process first involves the creation of a single regulatory authority, called the "Commission de Surveillance du Marché Financier de l'Afrique Centrale", with headquarters in Libreville, Gabon. The agreement then requires the establishment of a single market company, "Bourse des Valeurs Mobilières de l'Afrique Centrale (Central African Stock Exchange)", in Douala, Cameroon, which will de facto absorb the DSX. The unification of the markets will also result in the establishment of a single Central Depository - temporarily BEAC - pending the approval of an independent structure dedicated to this activity. While the unification of the Douala and Libreville stock exchanges represents a major step in the development of a more efficient sub-regional financial market, there remains an even greater need to work towards the achievement of stronger regional economic and financial integration.

3.4 Conclusion

On balance, even if the various economic and financial reforms currently undertaken by the CEMAC countries still need to be reinforced, they should already unlock part of the growth potential of the region's economies and accelerate their structural transformation. The financial system can therefore play a crucial role in the economic development of countries in

[28] Announcement made at the Extraordinary Session of the CEMAC Heads of State Conference on 23 December 2016 in Douala and at the Session on 31 October 2017 in N'Djamena.
[29] According to the President of COSUMAF (supervisor of the Central African financial market) Rafael Tung Nsue, May 2017.

the sub-region, in particular by supporting their economic diversification, enhancing the financial inclusion of their populations and improving access to finance for their businesses.

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4. The Banking Sector in East Africa - Responding to Market Shocks

Jared Osoro[1], Ricardo Santos[2]

Executive Summary

- East Africa is a diverse region with common development challenges such as a high population growth that exerts upward pressure on youth unemployment and a financially constrained private sector. Economic growth remained subdued in 2017, mostly due to the impact of adverse weather conditions, but is expected to recover already in 2018.

- Public finances have deteriorated in recent years. The deceleration in economic activity and the impact of electoral cycles have led to an increase in budget deficits in the region and to a corresponding increase in public debt. Most countries, even those with more comfortable debt positions, remain highly vulnerable to shocks.

- Risks to the outlook are rising. Over the short run, the main risks stem from potential external shocks: i) further depreciation of local currencies; ii) increase in oil prices that would impact all the countries but especially the ones less dependent on commodities exports; and iii) normalisation of monetary policy in the developed economies that could lead at some stage to a sudden halt in the capital flows to these countries.

- Access to finance remains a bottleneck for companies (particularly for SMEs and micro-enterprises) throughout the region, although less so in the bigger economies. In some countries, lending to the public sector is crowding out private credit. Mobile accounts and financial inclusion is improving unevenly across the region. In some countries, still less than 5% of the population uses digital banking or payment systems.

- In the recent past, East Africa has experienced both policy and market shocks. Interest rate regulation in Kenya and a spate of bank failures have put the market in the spotlight. That has provided a warning for both market regulators and players to be vigilant as opportunities for growth are pursued.

- The banking industry has been characterised by mixed performance in terms of efficiency and soundness. The low level of market competition is often masked

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The views expressed here are those of the authors and do not necessarily reflect those of the European Investment Bank or the Kenya Bankers Association Centre for Research on Financial Markets and Policy . All remaining errors remain the authors'.

by the extent of market concentration, country-specific regulatory issues, such as business climate, and country-specific economic developments.

4.1. Economic Overview and Recent Trends

East Africa is a diverse region with common development challenges. The East Africa region comprises a diverse group of countries that share, however, significant common development challenges. With the exception of Kenya, they are low-income and low-human development economies, heavily dependent on agriculture. The unweighted average GDP per capita in the region is USD 2 528 (in PPP-adjusted terms) but it ranges from USD 735 in Burundi to USD 4 586 in South Sudan.

Countries in the region also vary widely in population size, with Ethiopia being very populous with 93 million inhabitants, followed by Tanzania with 49 million and Kenya with 47 million, while other countries are sparsely populated. The rate of population growth is relatively high, exerting upward pressure on youth unemployment. On a more positive note, the private sector has great potential for development and job creation, but faces several constraints, of which access to finance is a major one.

Table 4.1. - Macroeconomic Overview

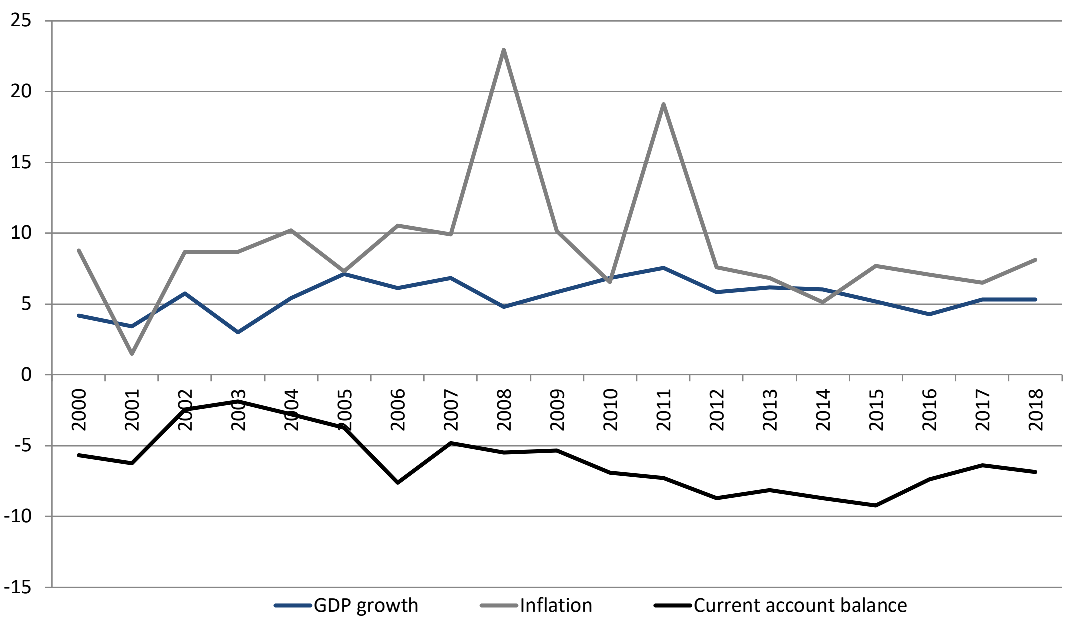
	Population	GDP	GDP per capita
	million	USD bn	PPP[1]-adjusted international dollar
Burundi	10.9	3.4	735.2
Eritrea	5.9	5.8	1581.3
Ethiopia	92.7	80.8	2160.8
Kenya	46.7	79.5	3491.1
Rwanda	11.8	9.1	2079.9
South Sudan	12.6	2.9	4586.0
Tanzania	48.6	51.7	3240.4
Uganda	37.6	26.3	2353.7
Average[2]	***33.5***	***32.4***	***2528.6***

Source: IMF World Economic Outlook database (April 2018).
[1]PPP = purchasing power parity.
[2]Unweighted average.

Economic growth remained subdued in 2017 but is expected to recover. Over the past decade, East Africa has been one of the best-performing regions in sub-Saharan Africa. However, more recently GDP growth has decelerated. In 2017, regional GDP growth reached 5.3%, still below the average of the last 10 years (6.5%) (Figure 4.1.). This deceleration was a consequence not only of the severe drought that affected the region but also a consequence of the political instability felt in East Africa, and that continued in 2017. Kenya and Uganda were the worst performers, with GDP growing 4.8% and 4.5% respectively. Growth in Rwanda remained stable at close to 6%. Regional economic growth is projected to pick up to 5.8% in 2018 and then accelerate further to 6.2% in 2019, assuming there is a more stable political environment and a gradual increase in oil prices. Still, Kenya and Uganda will underperform their regional peers both in 2018 and 2019, albeit less than in 2017. Economic developments during the first part of 2018 indicated a gradual strengthening of activity.

Inflation accelerated across the region because of the weather conditions. Severe draughts in 2016 and 2017 led to poorer crops and less agricultural production. Still, this increase in prices was much more subdued than in the past as macroeconomic policies implemented across the region were able to contain second-round effects so that inflation remained substantially below the levels registered for previous episodes of spikes in the price levels. External balances are still negative but improving due to weaker economic activity and lower oil prices. The (unweighted) average current account deficit reached 7.4% of GDP in 2017.

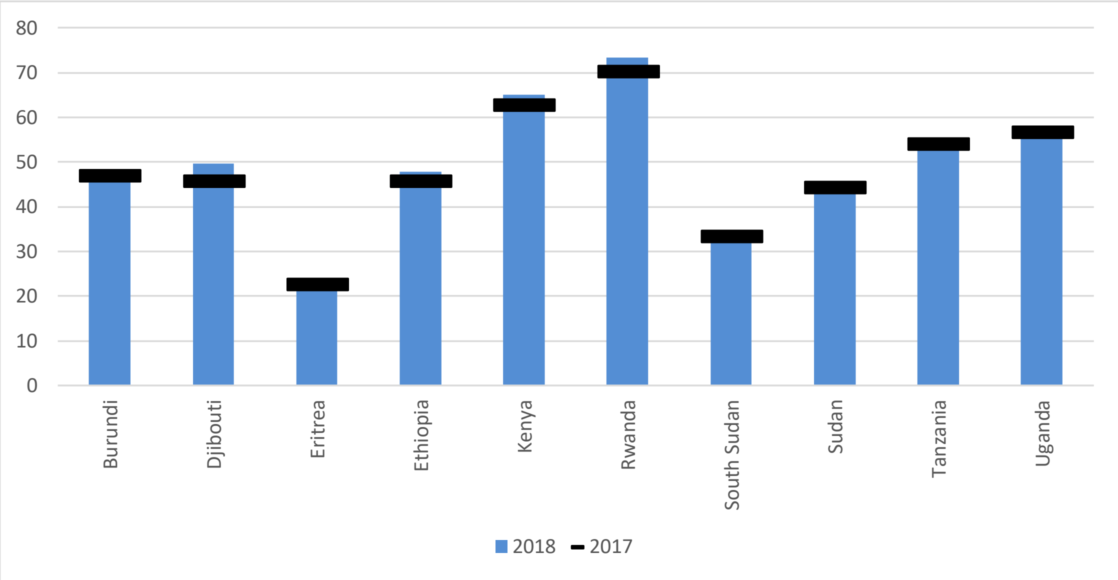
Figure 4.1. - Recent Economic Developments in East Africa[1]
(as percentage)



Source: IMF World Economic Outlook database (April 2018)
[1] Unweighted average

The business climate is uneven across the region. Business conditions in Rwanda and Kenya are already better than most of the countries in Africa and improved further in 2018 as some of the World Bank's recommendations, particularly regarding land registration, have been implemented. In Tanzania and Uganda, business conditions are lagging behind and barely improved in 2018. Ethiopia, Sudan, South Sudan and especially Eritrea are lagging even further behind. Business conditions in these countries are among the least supportive on the continent and barely improved in 2018. Improving business conditions is critical for attracting foreign investment, which remains subdued at 2% of GDP (even in Kenya, it only reached 0.8% of GDP in 2017).

Figure 4.2. - Doing Business (Distance to Frontier)

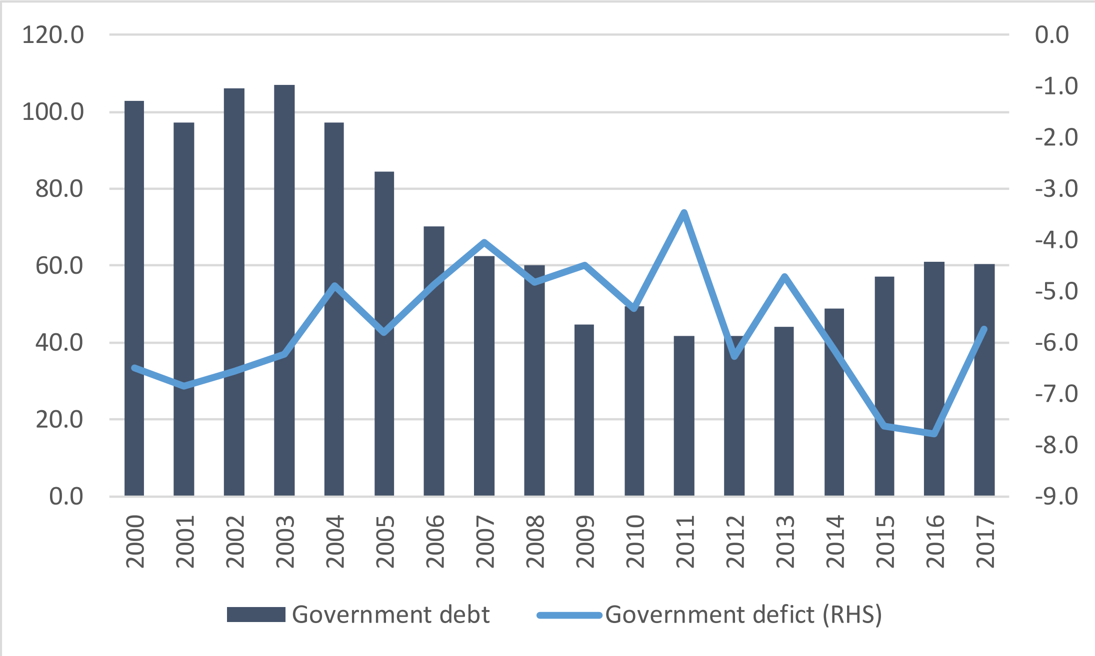


Source: World Bank

Most countries in the region are members of the East African Community (EAC) and could further benefit from even greater integration. Burundi, Kenya, Rwanda, South Sudan, Tanzania and Uganda form the East African Community (EAC). It is comprised of a customs union and a common market. In addition, the EAC countries signed in 2013 a protocol including economic and fiscal targets, and are aiming to form a monetary union by 2023. More recently, in 2017, the EAC members agreed to form a Political Confederation as a transitional model for the East African Political Federation. There is still room for progression as intra-regional trade accounted for only 10% of the total trade in the region in 2016 (the same share as in 2010). Many countries in East Africa have already signed the agreement, which will deepen integration of the African continent and increase the potential economic impact of further integration.

Public finances have deteriorated in recent years. The deceleration in economic activity and the impact of electoral cycles led to an increase in the average budget deficit in the region to close to 8% of GDP in 2016. The fiscal deficit declined in 2017, but at 5.7% of GDP, it remains higher than in the recent past. This trend is common across the region with exception of Kenya, Burundi and Ethiopia, where the fiscal deficit is still expected to increase in 2018. Bringing down fiscal deficits, preferably by broadening the tax base and increasing the efficiency of expenditure, is necessary to make public finances more sustainable and create room for much-needed structural investments. The sustained fiscal deficits have increased the average public debt by 20 percentage points since 2011. It now stands at 60% of GDP. And while this level is still substantially below the maximum of 100% reached in the early 2000s (before the debt relief under the HIPC initiative), this recent trend already undoing some of the positive outcomes of the HIPC. Furthermore, the level of debt is subject to significant risks. According to the IMF, debt sustainability risks are higher in Kenya, Ethiopia, Rwanda and Sudan. Most countries, even those with more comfortable debt positions, remain highly vulnerable to shocks, emanating from exchange rates, interest rates or the price of oil. Therefore, the long-term sustainability of public finances in the region depends on the implementation of fiscal reforms.

Figure 4.3. - Public Finances
(% of GDP)



Risks to the outlook are rising. The economic and political challenges of the various countries are significant. Political risk remains elevated, although less than it has been in the past. In the wake of the elections that took place late in 2017 in Kenya, the political background of the region's main economy is now less volatile following the acceptance of the election results. In the short run, the main macro-risks stem from potential external shocks. The first potential shock could come from the continued depreciation of local currencies due to further spikes in inflation. The second relates to a further increase in oil prices, which would impact all the countries but especially the ones less dependent on commodities exports such as Uganda and Rwanda. Finally, the normalisation of monetary policy in the developed economies and the continuing increase in government debt stocks across this region could at some stage lead to a sudden halt in capital flows to these countries.

Political risk is less pronounced than in the past but tensions remain. Recent years have been marked by electoral uncertainty but without the conflicts that affected the region in the past. More specifically: following the elections that took place late in 2017 in Kenya, the political background remained volatile but is now somewhat more stable as the new cabinet has assumed office. Uganda could become politically more volatile in the near future as the incumbent Government and Parliament attempt to increase the duration of their terms in order to remain in power. In Rwanda, the authorities have successfully ensured order since the 1994 civil war, but there is still a risk of political instability. President Kagame was re-elected for a third presidential term (extending his 17-year rule) in the August 2017 election. As for Tanzania, while there are no elections on the horizon, growing polarisation between rival political factions could become a source of volatility and concern for external investors, although this is unlikely to intensify to a level that could threaten the country's underlying stability.

On a positive note, the recent peace agreement between Ethiopia and Eritrea brings welcome prospects of resolving the long-lasting conflict between the two countries and reducing the risks in the region as a whole.

4.2. **Access to Finance and Financial Inclusion**

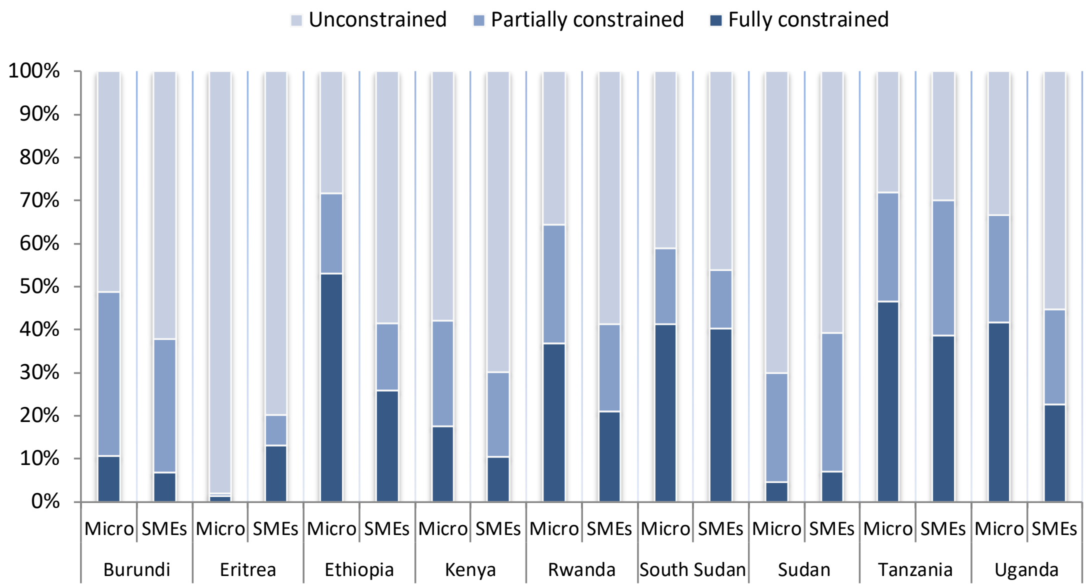
4.2.A. ACCESS TO FINANCE FOR SMEs

SMEs and micro-enterprises are an important driver of economic activity in East Africa, even more so than in other regions. East Africa is less resource-dependent than other regions on the continent, and therefore the private sector plays a more critical role, generating on average more than 30% of the different countries' economic output and roughly the same share of average gross value-added. The contribution of this sector to employment is substantially more important as it is estimated to account for more than 80% of total employment[3].

Access to finance remains a bottleneck for investment particularly for micro-enterprises. In Eritrea and to a lesser extent in Kenya, SMEs and micro-enterprises can obtain credit when needed (Figure 4.4.). However, in the other countries the situation is not supportive of investment and economic activity in general. Micro-firms face the largest difficulties, particularly in Ethiopia where 70% of these businesses report difficulties in accessing credit, whereas only 40% of SMEs report the same impediment. In Tanzania, both micro and small enterprises report large constraints in accessing credit (almost 70% in both cases). As asset quality deteriorated due to the economic slowdown, banks tightened their credit standards. In addition, many increased lending to the public sector. In some countries, the higher interest rates on sovereign paper reduced the attractiveness of lending to the private sector. The risk that lending to the public sector will crowd out private credit is particularly prevalent in Kenya and Uganda (see Chapter 7).

[3] These figures are an average of the statistics available for the different countries in the region. The most recent data relate to Kenya (2016) and reflect broadly the same picture as the regional average.

Figure 4.4. - Access to Credit for Micro-Enterprises and SMEs
(last available year)



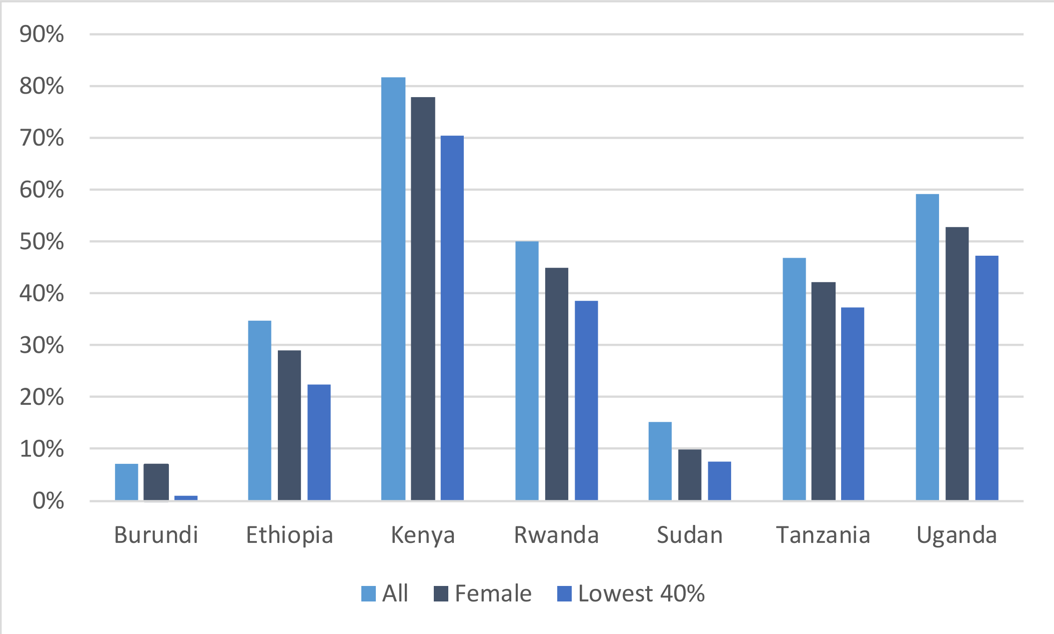
Source: SME Finance Forum database

4.2.B. ACCESS TO FINANCE FOR INDIVIDUALS

Digitalisation has helped financial inclusion in some countries in the region. Given the low level of development and high population growth in most of these economies, rapid access to new technologies has allowed some of these countries to skip some steps towards improved financial inclusion. However, access to financial services varies significantly across the region and in some countries it still only barely exists**.** In Kenya, more than 80% of the population older than 15 years has an account at a bank or at another kind of financial institution, but in many countries this share is much lower, even below 10% in Burundi or below 20% in Sudan (Figures 4.5. and 4.6.). In all the countries, women have less access to bank accounts than men and the difference in access between the poorest and the richest sections of the population remains substantial across the region

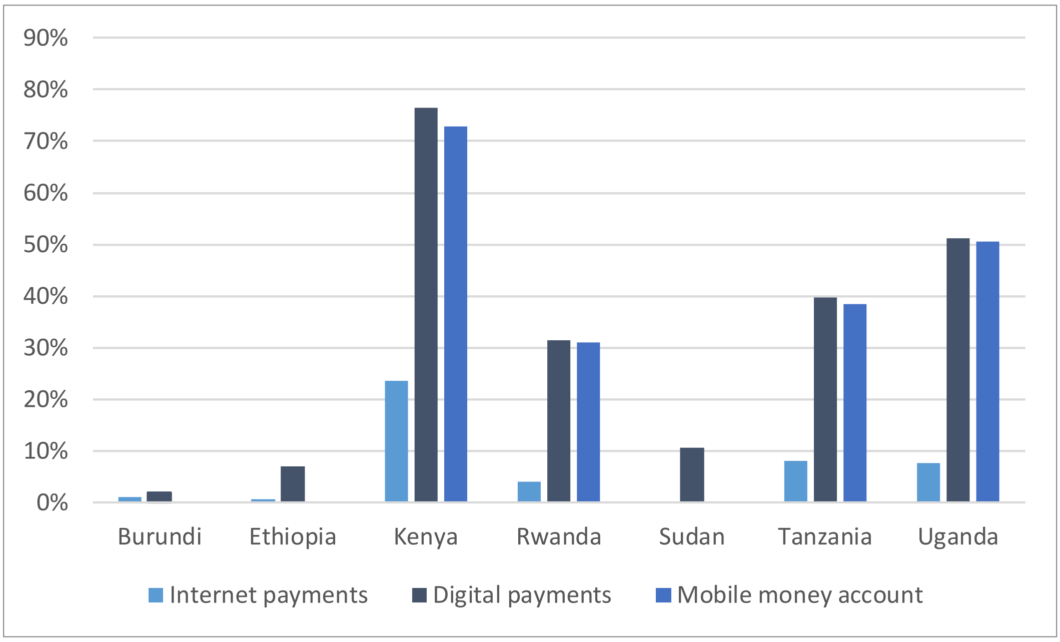
The regional differences in access to mobile payment systems is even more striking. In Kenya, often quoted as one the main references worldwide for digitalisation, almost 80% of the population older than 15 years uses digital payment systems or has a mobile bank account. This contrasts with the other countries in the region. In Tanzania and Uganda, around half of the adult population uses mobile banking or mobile payments. In Rwanda, the share drops to 30% and in the remaining countries it is is considerably smaller and sometimes almost negligible with less than 5% of the population using digital banking or payment systems.

Figure 4.5. - Accounts at Banks or Other Financial Institutions
(population age 15+)



Source: World Bank Global Findex database

Figure 4.6. - Mobile Accounts
(population age 15+, as percentage)



Source: World Bank Global Findex database

4.3. Structure and State of Banking Systems in East Africa

The six East African Community (EAC) partner states[4] enjoy varied levels of financial sector development. However, all EAC countries share a common feature: bank-led financial sectors (Osoro and Osano, 2014). The relative dominance of the Kenyan banking system in the EAC is reflected in the level of domestic credit as a share of GDP, which is substantially higher than in the other economies (Table 4.2.).

Table 4.2. - Domestic Credit to the Private Sector

(share of GDP)

	2011	2012	2013	2014	2015	2016
Burundi	20.3	18.9	17.4	16.7	16.4	16.7
Kenya	30.6	29.5	31.7	34.1	34.4	32.8
Rwanda	16.0	18.5	19.2	20.8	21.1	21.2
South Sudan	0.4	1.3	1.6	1.9	2.7	-
Tanzania	12.6	13.0	13.0	13.8	15.2	14.3
Uganda	15.8	14.0	13.9	14.9	15.6	15.9

Source: World Development Indicators, World Bank.

The market dynamics in each of the EAC economies - and especially how they relate to the cross-border operations of banks - are indicative of the unique nature of the market. Typical cross-border banking is seen, in the context of international banks, entering new, often less-developed markets and leading to enhanced competition, financial stability and increased access to credit (World Bank, 2018). Even when the spotlight has been on sub-Saharan Africa (for instance Mecagni, Marchettini and Maino, 2015), the nuances that make the East Africa market distinct from the general narrative are not highlighted. For instance, the implicit assumption that the leading pan-African banks - notably East Africa's Standard Bank and Togo's Ecobank - are the core drivers of cross-border banking momentum in East Africa is countered by the reality that Kenyan domiciled banks have the biggest footprint in the region. In that respect, the role that Kenyan banks play in the region is relatively more significant than that of the Pan-African banks. The size of the Kenyan economy has provided Kenyan banks the necessary scale to play a key role in the EAC region. The Kenyan Banks have a dominant status in South Sudan, an economy, the size of which makes the number of banks operating there arguably unjustifiable (Table 4.3.)

[4] The EAC Members are the Republic of Burundi, the Republic of Kenya, the Republic of Rwanda, the United Republic of Tanzania, the Republic of South Sudan, and the Republic of Uganda.

Table 4.3. - Number of Banks Relative to Size of the Economy

	Nominal GDP - USD bn (2017)	Number of Banks
Burundi	3.4	10
Kenya	79.5	43
Rwanda	9.2	11
South Sudan	2.9	22
Tanzania	51.7	40
Uganda	26.3	24

Source: IMF World Economic Outlook Data, Respective Economies' Central Banks.

The strong presence of the Kenyan banks in the region is not reciprocated by the presence of banks from other EAC economies in Kenya. This issue has been a subject of recent studies (Kodongo, Natto and Biekpe, 2015; and Njoroge and Ouma, 2014)[5]. These studies conclude that intense competition in the local market has motivated banks from Kenya to seek cross-border opportunities, taking advantage of the market openness promoted by the EAC integration process. Underpinning the position of the Kenyan banking sector is the dominance of the local players, unlike in Uganda and Tanzania where the banking systems are dominated by foreign bank ownership.

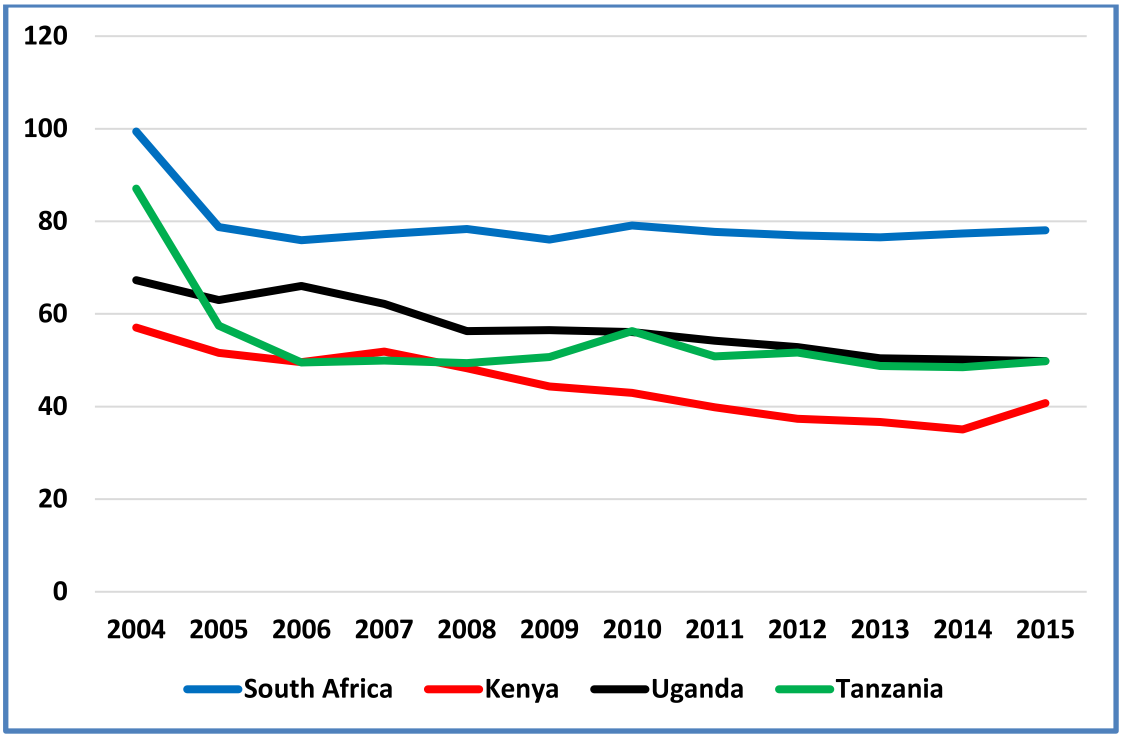
EAC banking industry has a low concentration. If we take the concentration ratios - defined as the share of banking assets held by the largest three banks in a given economy - the three largest EAC economies' banking sectors are less concentrated than the most advanced market in Africa (Figure 4.7.)[6]. Less concentration is by no means an indication of relatively more market competition given that the nexus between concentration and competition has been established to be tenuous (Berger, et. al., 2004). The competition-enhancing measures continually being put in place in East Africa include regulatory measures to enhance pricing transparency, and legal reforms to address, property rights, and freedom to compete in the economy.

[5] Subsequent to these studies, the entry of the State Bank of Mauritius (SMB) into the Kenyan market in November 2017 through a 100-percent acquisition of Fidelity Bank - one of the Tier III banks - and its subsequent takeover in April 2018 of Chase Bank (in receivership), a hitherto fast-growing Tier II bank, are interesting developments. Meanwhile Tanzania domiciled banks are venturing into Burundi and Uganda, while a Uganda-domiciled bank ventured into Rwanda, only for the parent institution to be closed by the regulator and the subsidiary acquired by a Kenya-domiciled bank.

[6] Notably, whilst the financial systems of Tanzania and Uganda are considered relatively less developed than that of a middle-income country such as South Africa, they are less concentrated.

Figure 4.7. – Market Concentration

(%)



Source: World Bank Financial Structure Database (June 2017 version).

4.4. Recent Banking Sector Performance

The performance of the banking industry in East Africa in terms of efficiency and soundness is mixed. A number of factors played a role in shaping this performance. These include the low level of competition that is often masked by the extent of market concentration, country specific regulatory issues, such as business climate, and country-specific economic developments. A historical perspective of banks' Return on Assets (ROA) and Return on Equity (ROE) shows a banking industry that is generally profitable, albeit with a mixed performance over time and across countries (Table 4.4.). Instances of very high ROE during the earlier part of the new millennium in Rwanda, Uganda and Tanzania are attributed to market imperfections associated with relatively limited depth compared to Kenya where such returns have been fairly consistent, except in 2002 when economic shocks jolted banks' performance.

Table 4.4. - Profitability Indicators

(%)

	Burundi		Kenya		Rwanda		Tanzania		Uganda	
	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE
2000	3.82	30.84	0.82	13.99	6.98	112.12	3.73	35.18	5.51	63.80
2001	3.12	23.50	2.16	19.79	4.30	56.62	3.18	35.47	5.31	54.18
2002	2.00	15.72	0.44	3.06	2.46	32.33	3.27	39.68	1.95	20.13
2003	1.51	13.54	2.04	16.77	3.34	55.43	3.17	44.18	3.21	37.87
2004	1.40	12.29	2.36	19.67	1.98	28.26	4.40	59.37	4.18	49.03
2005	2.46	19.86	2.80	22.74	0.96	11.88	2.94	37.48	3.42	36.51
2006	2.69	24.48	3.02	23.39	2.44	29.59	2.96	33.45	3.44	32.97
2007	1.85	19.36	3.18	23.74	1.24	11.76	3.66	36.45	3.64	33.04
2008	3.78	39.47	2.69	19.85	2.42	20.32	2.76	26.66	3.34	26.41
2009	3.26	29.66	2.85	20.52	1.19	9.11	2.09	19.71	3.55	23.96
2010	2.84	23.09	3.98	25.98	2.00	13.55	1.31	11.84	2.69	18.50
2011	3.66	26.86	3.50	23.10	2.30	14.00	1.60	15.11	3.98	27.87
2012	1.99	13.55	3.32	21.99	2.13	12.03	1.73	16.65	3.93	24.88
2013	1.28	9.26	3.40	20.94	1.85	10.71	1.62	13.98	2.67	16.32
2014	1.25	9.17	3.32	20.88	2.40	14.96	2.04	15.97	2.74	16.81
2015	0.48	3.25	2.63	17.39	2.20	13.67	1.66	12.61	1.88	11.44

Source: World Bank Financial Structure Database (June 2017 version)

Over the past two years, the EAC banking system has been characterised by both opportunity and risks. Economic growth remained strong, albeit with headwinds resulting in a slowdown across the board in 2017. Over the same period, even though inflation rose mainly due to increasing oil prices and the poor performance of the agricultural sector due to dry weather conditions, it remained benign and even started easing during the second half of 2017.

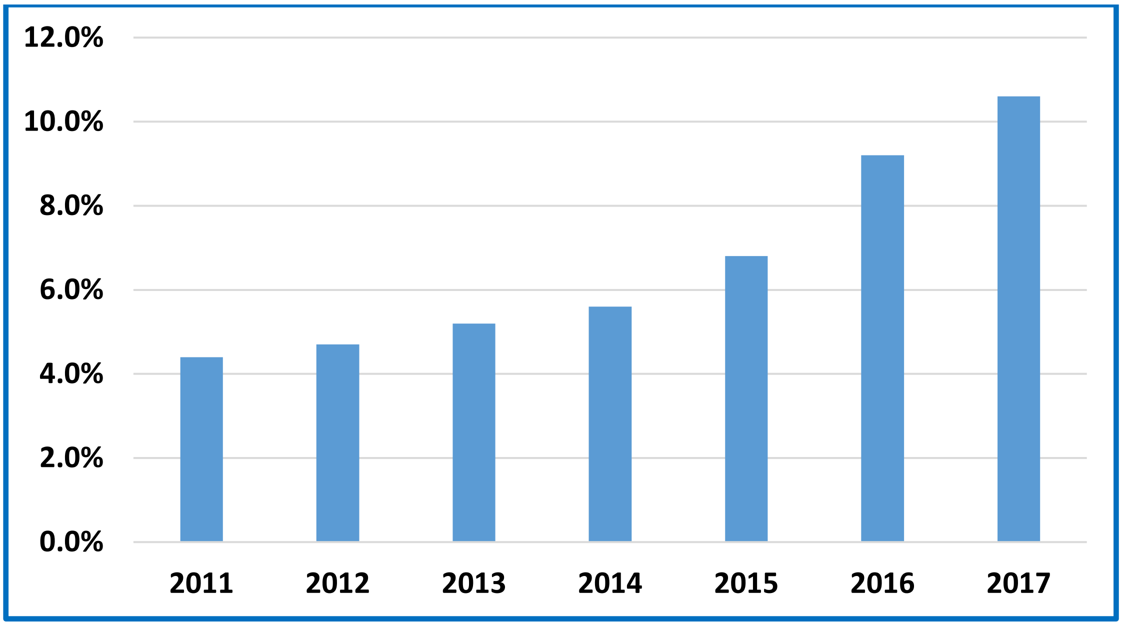
The downward trend in inflation provided the central banks in the region with an opportunity to ease monetary policies with varying speeds and timing. This, however, did not translate into increased lending owing to the interplay between demand and supply conditions. Indeed, bank lending to the private sector in EAC countries slowed down further on account of subdued demand. In the case of Kenya, for instance, the Central Bank of Kenya (CBK) commenced an easing monetary policy stance in September 2016 when it lowered the Central Bank Rate (CBR) from 10.5% to 10.00%; the CBR was reduced further to 9.5% in March 2018 and 9.0% in July 2019. Over this period, growth in credit to the private sector remained at the lower single-digit level and is evidently unresponsive to the monetary policy signal. The subdued pace of private sector credit growth was accompanied by a deterioration in the quality of assets, and the lagged effect of the economic activities slowdown.

The slow pace of private sector credit growth was accompanied by heightened credit risk as measured by the ratio of non-performing loans (NPLs) to gross loans, which increased across the region except in Uganda. According to data from the EAC central banks, by June 2017, Burundi had the highest NPL ratio at 17.4% followed by Kenya with 9.9%, and Tanzania and Rwanda with 8.2%. Uganda had the lowest NPL ratio at 6.2%. The drivers of the increase in NPLs include poor credit assessment processes, delayed payments to contractors for government-funded projects, drought and subdued economic performance.

The high level of NPLs in Burundi is worrisome. Not only is the Burundian economy small by regional standards, but it has been growing at the slowest pace in East Africa on the back of political challenges and uncertainty. Notable too is the rapidly rising level of NPLs in Kenya, the biggest economy in the EAC block, which also has a relatively deeper banking sector than the other economies in the region. Just like Burundi, the NPL ratio in Kenya has shown a rising trend from 9.9% in mid-2017 to 10.6% by the end of the year (Figure 4.8.).

Rising NPLs in Kenya have largely stemmed from the fast decline in the rate of private sector credit growth (Figure 4.9.). The latter has been compounded by the impact of the 2016 Banking (Amendment) Act: the new law that came into effect in September 2016 introduced interest rate controls whereby banks may not charge more than “4% above the base rate set and published by the Central Bank of Kenya (CBK)”. Additionally, the law stipulates a floor on interest-earning deposits, of 70% of the base rate set by the CBK.

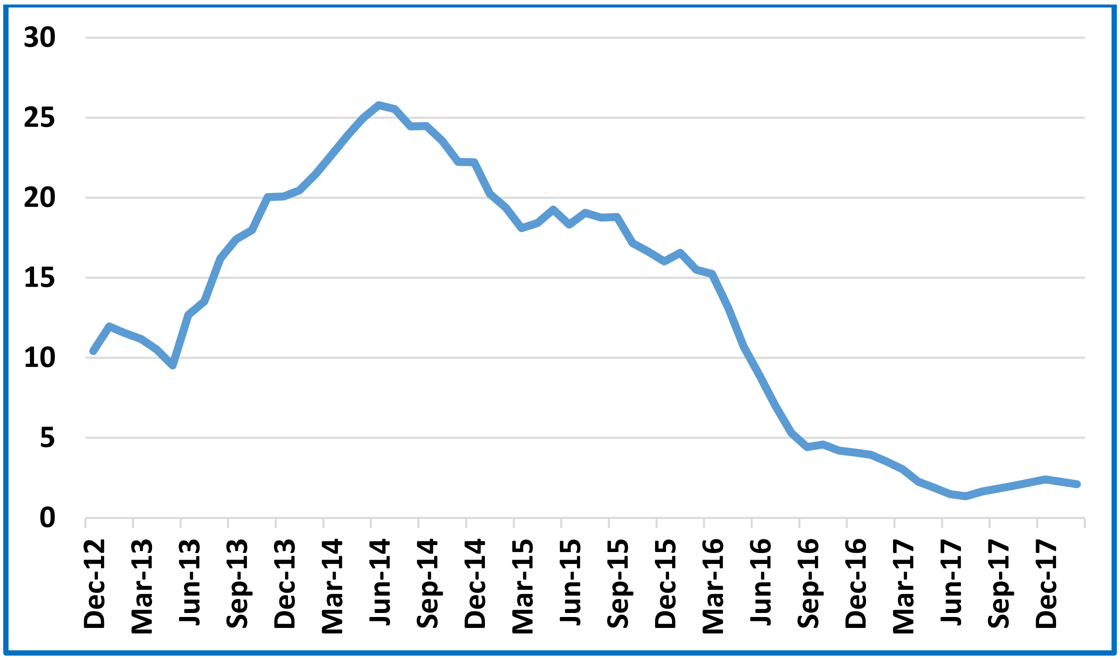
Figure 4.8. - NPLs/Gross Loans



Source: Central Bank of Kenya

Figure 4.9. - Banks' Claims on Private Sector

(12-month % growth)



Source: Central Bank of Kenya

The application of the interest rate cap in Kenya was motivated by the perception that lending rates in Kenya were too high, even relative to other economies in East Africa. In reality, nominal lending rates are much higher in Uganda and relatively comparable in Tanzania; so are the interest rate spreads that have been at single-digit level in Kenya since 2005 (**Table 4.5.**) (**Box 4.1.**).

Table 4.5. - Average Lending Rates and Spreads

	Interest rate spread (lending rate minus deposit rate, %)			Average Lending rate (%)		
	Kenya	Uganda	Tanzania	Kenya	Uganda	Tanzania
1995	15.20	12.55	18.21	28.80	20.16	42.83
1996	16.20	9.68	20.37	33.79	20.29	33.97
1997	13.52	9.53	18.44	30.25	21.37	26.27
1998	11.09	9.51	15.14	29.49	20.86	22.89
1999	12.83	12.82	14.14	22.38	21.55	21.89
2000	14.24	13.08	14.19	22.34	22.92	21.58
2001	13.03	14.19	15.25	19.67	22.66	20.06
2002	12.97	13.53	13.11	18.45	19.10	16.40
2003	12.44	9.09	11.47	16.57	18.94	14.52
2004	10.10	12.86	9.94	12.53	20.60	14.14
2005	7.80	10.85	10.52	12.88	19.65	15.25
2006	8.50	9.61	8.93	13.64	18.70	15.65
2007	8.18	9.84	7.39	13.34	19.11	16.07
2008	8.71	9.78	6.73	14.02	20.45	14.98
2009	8.84	11.20	7.06	14.80	20.96	15.03
2010	9.81	12.49	7.92	14.37	20.17	14.54
2011	9.42	8.49	8.19	15.05	21.83	14.96
2012	8.15	9.35	6.01	19.72	26.15	15.56
2013	8.67	11.17	5.89	17.31	23.28	15.86
2014	8.14	10.77	6.43	16.51	21.58	16.29
2015	6.90	9.83	6.21	16.09	22.60	16.10
2016	7.87	10.65	5.46	16.56	23.89	15.96
2017	5.99	11.58	-	13.67	21.28	-

Source: Respective Central Banks

Box 4.1. - Interest Rate Capping - Still a Blunt Tool

A recent comprehensive study on interest rate regulation (Maimbo and Gallegos, 2014) points to two key findings. The first is that that interest rate capping is still popular, with over 60 countries globally having such regulation in one form or another. The second is that, notwithstanding their popularity, interest rate caps are not only ineffective at addressing the root causes of high rates - such as lack of market competition, market inefficiency, large fiscal deficits and legal bottlenecks that prevent customers from switching banks - but they also introduce additional distortions in the system as banks try to circumvent caps (for instance by increasing other fees). Analytical work carried out following the enactment of the capping law in Kenya law (for instance World Bank, 2017; Central Bank of Kenya, 2018; and Safavian and Husnain, 2018) confirm that it is indeed a blunt tool. The law effectively regulates the risk that a bank can take, in the sense that any potential borrower whose risk profile would be priced above the cap is unable to access credit. Moreover, these studies confirm that rate caps also interfere with the conduct of monetary policy. The declining trend in credit growth to the private sector, occurring on the back of banks' heightened risk sensitivity given the rising levels of NPLs, has compounded the challenges of the credit market and consequently hindered the economy's growth. Ultimately, the intention of the law to provide access to credit for low-income households and small and medium-sized enterprises has not been realised; indeed, the effect has been the exact opposite. Enterprises and households with a risk profile that is considered high are typically more constrained by access to credit than the cost of credit, as much as the latter is still important.

4.5. Market Stability

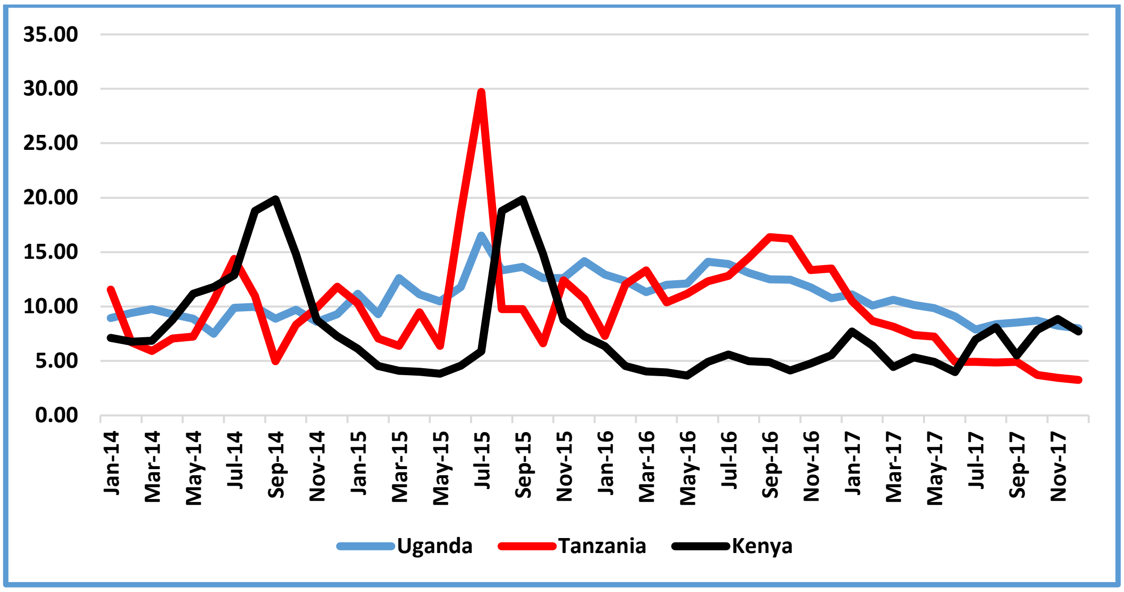
Even with the increasing exposure to credit risk, the banking industry in East Africa remains stable. Market stability is confirmed by various financial stability analyses as well as the IMF's financial sector assessment programmes undertaken at both local and regional economic levels. The market remains well capitalised with the banking industry meeting its minimum core and total capital adequacy ratios. In Kenya, the minimum core and total capital adequacy ratios required are 10.5 and 14.5 respectively, while in Uganda they are 8.0 and 12.0% respectively. In Tanzania, the minimum core and total capital adequacy ratios required are 10.0 and 12.0% respectively. Overall, capital adequacy ratios, which measure how effectively banks can sustain a reasonable amount of loss, remain above the prudential limits across the region; the capital buffers that have been built into the requirements provide an extra measure of safety in the event of unexpected loss.

However, risks persist and the region has in the recent past demonstrated instability in the form of bank failures. During the period 2015-2016, Kenya experienced the failure of three banks including one with a regional presence. Uganda also had a bank failure, with the collapsed bank having a presence in Rwanda and thus having regional implications. In January 2017, the Bank of Tanzania (BOT) - the economy's central bank - closed five community banks that it considered to be inadequately capitalised. Commercial banks have remained well capitalised (they are subject to a different regulatory framework) and thanks to the BOT intervention they were shielded from possible contagion effects from the affected institutions.

Bank failures in East Africa have largely stemmed from structural weaknesses. A study by Waweru and Kalani (2009) tracks bank failures in Kenya: between 1986 and 1998, Kenya saw 37 banks fail. The study finds that the bankruptcies were due, inter alia, to customers' failure to disclose vital information during the loan application process and the lack of an aggressive debt collection policy as a bank-specific factor that contributes to the NPL debt problem in Kenya, which then affects vulnerable banks. Studies on the recent bank failures such as Gathaiya (2017) argue that, unlike past episodes, the recent bank collapses are largely due to governance and regulatory lapses. Subsequently, the supervisory role of the CBK has been enhanced and the three affected institutions have not generated any systemic challenges. The only weakness that the recent bank failures have exposed is the segmentation of the interbank market.

Pursuant to the "lender of last resort" function, the central banks have provided sufficient liquidity to the market. Such intervention has tended to give the appearance of normal conditions on the interbank market as witnessed by the interbank rates (**Figure 4.5.**). Nevertheless, the interbank market remains segmented and inefficient (Sichei, Tiriongo and Shimba, 2012). In these circumstances, the interbank rate cannot pick up the distress signal since the lenders avoid each other given the high risk aversion that usually follows a banking crisis (**Box 4.2.**).

Figure 4.10. - Interbank Market Rates (%)



Source: Respective Countries' Central Banks

Box 4.2. - The Interbank Market in Kenya - The Alternative Signal

The role of the interbank market in any economy is critical in allocating liquidity from banks with a surplus to banks facing a liquidity deficit. In the event of a shock, such as the collapse of three banks in Kenya, there is limited interbank lending between big banks (often with surplus liquidity) and small bankers (often victims of liquidity flight to big banks). This characteristic of a segmented and inefficient market implies that the interbank rate has no signalling effect as to the state of market liquidity; nor does it have the ability to signal market distress. Given that banks with surplus liquidity will be seeking investment opportunities, the nearest attractive proposition is the 91-day Treasury Bill market, which offers both liquidity and risk-free attributes. Therefore, the behaviour of the 91-day Treasury Bill rate in the Kenyan money market where the interbank rates are only for overnight trading fulfils a signalling role for possible liquidity stress in the system. Implicitly, this is a pointer to the extent to which fiscal policy filters into monetary policy conduct, given that Treasury Bills are one of the monetary instruments used for implementing Open Market Operations (OMO). Interbank market segmentation is often underpinned by the “small bank - big bank” dichotomy. The liquidity flow from the small bank to the big bank during a market shock, often assumed to be a “flight to quality” while in reality it could merely be a “flight to size”, points to a structural problem. Empirical evidence indicates that interbank market shocks are long-lasting rather than transitory. Consequently, interventions by the central bank through liquidity allocation does not address the structural weaknesses of the market.

Source: Osoro and Muriithi (2017)

4.6. Policy Highlights

East Africa’s banking industry continues to experience policy developments that have changed its evolution over time. In the case of Kenya, a milestone was the Banking (Amendment) Act of 2016, the effects of which were outlined above. In Uganda, the Financial Institutions (Amendment) Act of 2016 led to the introduction of Islamic banking, bancassurance and agent banking in the banking system. During the same year, another Act - the Tier 4 Microfinance Institutions and Money Lenders Act, 2016 - was introduced, establishing the Ugandan Microfinance Regulatory Authority, providing for the licensing and management of Tier 4 microfinance institutions, regulating money lending and establishing the Savings and Credit Cooperative Organisations (SACCO) Stabilisation Fund and SACCO Savings Protection Scheme. In Tanzania, the central bank has issued a number of regulations including the Banking and Financial Institutions Capital Adequacy (Amendment) Regulations 2015, the Guidelines on Agent Banking for Banks and Financial Institutions 2017 and the Foreign Exchange (Amendment) Act 2017.

The implementation of IFRS9 brings a new dimension to banking. With IFRS9, the most fundamental changes are expected, particularly in light of the recognition of credit risk losses, as banks are now expected to recognise a loan’s risk at the beginning of and during the loan’s entire life cycle and make the necessary provisions as opposed to at the point of default as was the norm before coming into effect of IFRS9. This change will have a significant impact on banks' profitability and capital provisioning. During the early implementation of the new reporting standard, the market is grappling with the different interpretations of the standard by the central banks and the tax authorities. At the same time, the issue of the treatment of banks' exposure to the Government remains unresolved, especially since a common risk rating methodology has not been determined for assets such as government securities.

4.7. Conclusion

Economic activity has remained subdued across the region over recent years but is expected to recover already in 2018 as adverse weather conditions are no longer a drag on growth. However, public finances have deteriorated in recent years. The deceleration in economic activity and the impact of the electoral cycles led to an increase in the budget deficits in the region and to a corresponding increase in public debt. Most countries, even those with more comfortable debt positions, remain highly vulnerable to shocks. Risks to the outlook are rising and, in the short run, stem from potential external shocks.

Access to finance remains a bottleneck for companies throughout the region, although less so in Kenya, particularly for SMEs and micro-enterprises. In some countries, lending to the public sector is crowding out private credit. Mobile accounts and financial inclusion is improving unevenly across the region. In some countries, less than 5% of the population uses digital banking or payment systems.

The overall economic trends in East Africa have shaped the growth of the financial sector generally and the banking industry in particular. In the recent past, the region has experienced both policy and market shocks. Interest rate regulation in Kenya and a spate of bank failures have put the market in the spotlight. This has provided a wakeup call for both market regulators and players to be vigilant as opportunities for growth are pursued. Nonetheless, even with increasing exposure to credit risk, the banking industry in East Africa remains stable.

The banking industry has been characterised by mixed performance in terms of efficiency and soundness. The low level of market competition is often masked by the extent of market concentration, country-specific regulatory issues, such as business climate, and country-specific economic developments. Overall, the EAC banking system is characterised by both opportunity and risks. Economic growth remained strong, albeit with headwinds resulting in a slowdown across the board in 2017. The key policy message is that sustainable growth can only be achieved by macroeconomic and regulatory stability.

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5. Banking in Southern Africa

Stuart Theobald[1] and Sanne Zwart[2,3]

Executive Summary

- Economic growth in Southern Africa has been lacklustre recently, but a cautious recovery is underway. The pick-up in growth is supported by rising commodity prices, structural reforms that improve the business climate and ongoing regional integration.

- Public finances remain the Achilles' heel of most countries in the region. However, external risks are also rising as concerns are mounting about global trade conditions, while interest rates are set to rise further.

- Access to finance remains a bottleneck for companies throughout the region. In some countries, lending to the public sector is crowding out private credit. Mobile accounts are spreading rapidly throughout the region, enhancing access to finance for individuals.

- Slower GDP growth, weaker currencies, increasing public debt and reduced tax collection led to a deterioration of sovereign credit ratings, constraining the funding and liquidity of banks operating in Southern African markets. Managing heightened sovereign indebtedness is becoming the main challenge for many banks.

- Despite distress in some markets, asset growth has remained positive and non-performing loans have remained manageable. On the whole the region's banks have remained strongly profitable.

- Advanced economies' banks have been withdrawing from the region, but regional banking groups have consolidated their presence. Given the conditions, more cross-border expansion could be expected. The declining number of correspondent banking relationships is a reason for concern.

- Regulatory development has proceeded at a steady pace in the region particularly under the guidance of the IMF. Several markets are busy with redrafting legislation to improve oversight of banks and other financial

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[3] The authors would like to thank Sanja Blatt, Vivian F. De O. Schmidt, Barbara Marchitto and Ricardo Santos for their valuable comments on earlier drafts. The editorial closing date was 30 June 2018. However, the views expressed in this chapter are those of the authors and do not necessarily reflect those of the European Investment Bank or Intellidex. All remaining errors remain the authors'.

institutions, and various aspects of Basel III have been implemented in the larger markets.

5.1. Recent Macroeconomic Trends

Southern Africa is a diverse region. It covers countries with relatively high incomes per capita such as Botswana, Mauritius and the Seychelles, but also countries with very low incomes such as Comoros, Madagascar, Malawi and Mozambique (Table 5.1.). Countries in the region also vary widely in population size, with South Africa being the most populous, followed by Mozambique, Angola and Madagascar, while other countries are sparsely populated. Though each is unique, Southern African countries have many development challenges in common, including the need for economic diversification, supporting entrepreneurship and financial sector development.

Table 5.1. - Selected Macroeconomic Statistics
(2017)

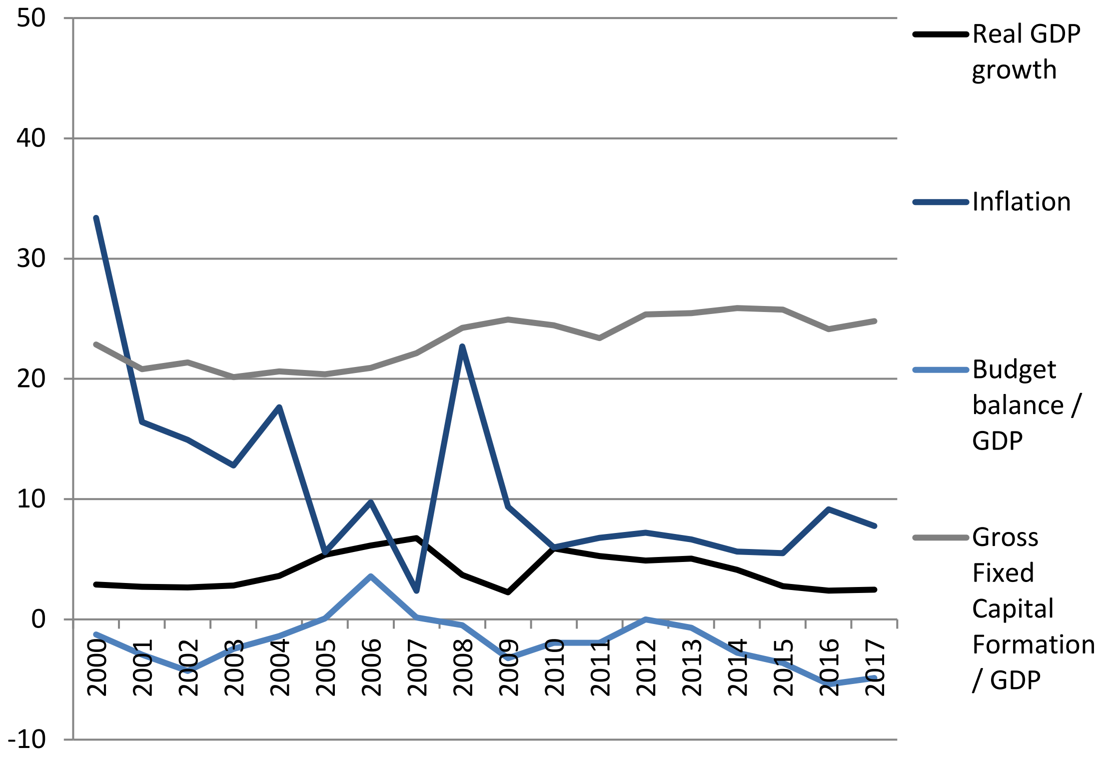
	Population	Nominal GDP	GDP per capita
	million	USD billion	PPP[1]-adjusted international dollar
Angola	28.2	124.2	6,151
Botswana	2.2	17.2	16,239
Comoros	0.8	0.7	1,447
eSwatini	1.1	4.5	9,003
Lesotho	1.9	2.8	3,262
Madagascar	25.6	11.5	1,413
Malawi	19.2	6.2	1,063
Mauritius	1.3	12.4	19,711
Mozambique	29.5	12.7	1,133
Namibia	2.3	12.7	10,303
Seychelles	0.1	1.5	26,214
South Africa	56.5	349.3	12,337
Zambia	17.2	25.5	3,640
Zimbabwe	14.9	17.5	2,079
Average[2]	***14.4***	***42.8***	***8,143***

Source: IMF World Economic Outlook database (April 2018).
[1]PPP = purchasing power parity.
[2]Unweighted average.

Economic growth has been lacklustre recently, but a modest recovery is underway in several countries. Annual growth has fallen from around 5% during 2010-14 to around 2.5% in recent years (Figure 5.1.), as the many commodity exporters in the region were hit by falling international demand and subsequent decline in prices. In some countries, domestic developments also contributed to the growth slowdown, while lower demand from neighbours further weighed on growth. Only Madagascar and Mauritius recorded higher growth in recent years than during 2010-14. Lower commodity prices caused weaker foreign exchange earnings and tax receipts, contributing in many countries to sharply higher budget and current account deficits. That led to weaker exchange rates, contributing to inflation, which soared to almost 10% in 2016, but has recently started to normalise. Investment fared relatively well, even expanding as a share of GDP, which partly reflects the fact that governments kept their spending levels stable to help absorb the economic shock. The result, however, has been a deterioration of the average budget position from balanced in 2012 to a deficit of 5% of GDP in 2016 and 2017. Economic developments during the first part of 2018 indicated a gradual strengthening of economic activity.

Figure 5.1. - Recent Economic Developments in Southern Africa[1]

(in per cent)

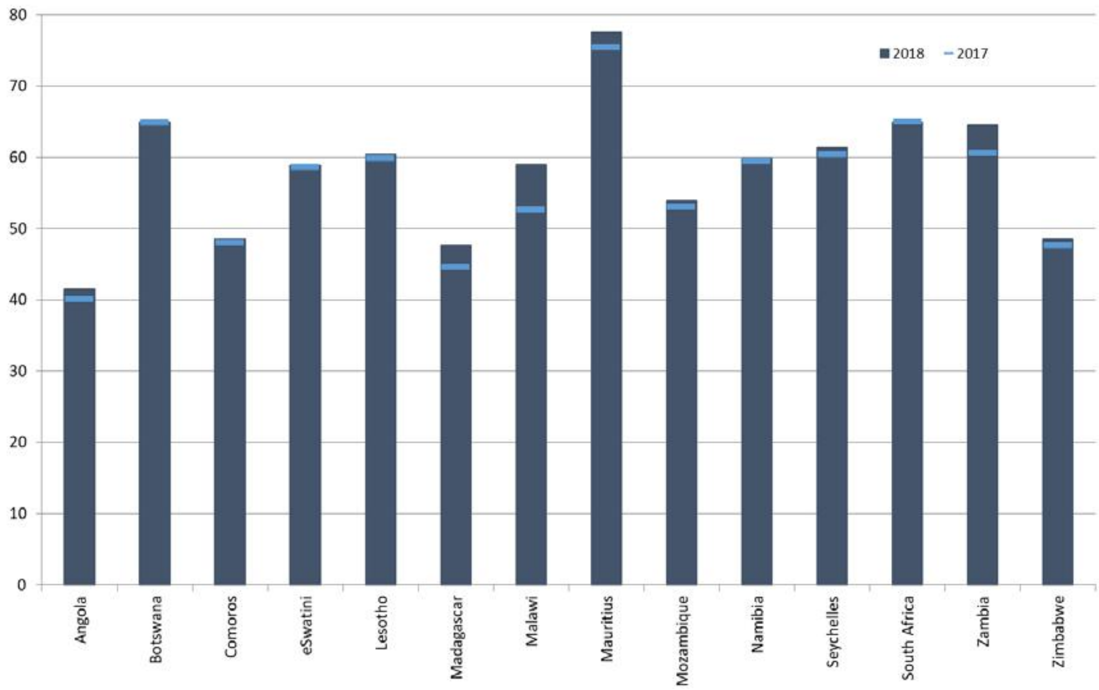


Source: IMF World Economic Outlook database (April 2018).
[1]Unweighted average.

With the moderate revival of commodity prices, heavy reliance on natural resources is no longer a drag on growth. The increasing oil price has been supporting the mild recovery in Angola, which depends on oil for 95% of its exports and a third of GDP, and continues to bolster the growth outlook. Similarly, Zambia benefitted from the recovery in copper prices, while rising gold and diamond prices supported growth in Botswana, Namibia and Zimbabwe. Nevertheless, the fall in commodity prices that extended from 2011 to 2016 highlighted the need for resource-rich countries to diversify their economies. Turning the increased awareness into actual changes is key for sustainable development. Similarly, Mozambique is making slow but steady progress towards the exploitation of off-shore gas fields, but these future revenues should not distract from creating the conditions for growth in other sectors of its economy. As the region's commodity exports are set to strengthen, while imports related to the extractive industry will remain high, current account deficits are expected to remain elevated.

Structural reforms are improving the overall business climate throughout the region. Business conditions in Mauritius are already the best in Africa and were further improved by the new Business Facilitation Act (Figure 5.2.). Madagascar, Malawi and Zambia have also implemented several reforms to support private sector activity[4]. In Zimbabwe, political changes have stabilised business sentiment, which bodes well for improvements in the regulatory environment going ahead. Only in South Africa have business conditions slipped somewhat recently, although political changes there have also contributed to improved sentiment. Strengthening business conditions will help to attract foreign investment, which remains subdued.

Figure 5.2. - Doing Business (Distance to Frontier)



Source: World Bank

Further regional itegration would boost growth and is supported through several supranational organisations. The five southernmost countries are part of the Southern African Customs Union (SACU). The four African countries in the Indian Ocean together with Réunion form the Indian Ocean Commission, which promotes co-operation and development. The Southern Africa Development Community (SADC) supports further socio-economic cooperation and integration as well as political and security cooperation among 16 Southern African countries. Several countries are members of the Common Market for Eastern and Southern Africa (COMESA), a free trade area. SADC and COMESA together with the East

[4] In Zambia, the overall Doing Business indicator improved despite the recent step-up in tax claims on foreign miners.

African Community launched the Tripartite Free Trade Area Agreement, which provides preferential treatment for selling goods and services in the 26 countries that are expected to participate. Many countries in Southern Africa have already signed the agreement which will deepen integration on the African continent.

Public finances have stabilised, but remain the Achilles' heel of the economic outlook of most Southern African countries. A mild increase in commodity prices, some fiscal reform and consolidation and a resumption of growth helped support government revenues. Although on average budget deficits stopped deteriorating in 2017, they remain high at almost 5% of GDP. Bringing down those deficits, in particular through broadening the tax base and increasing the efficiency of social expenditure, is necessary to make public finances more sustainable and to create fiscal space for structural investments. Reducing deficits is also needed to bring down public debt, which reached over 50% of GDP in 2017 – an increase of 12 percentage points in just three years. According to the IMF, Mozambique and Zimbabwe are in debt distress, with debt sustainability risks being high (and rising) in Zambia and moderate in the Comoros, Lesotho, Madagascar and Malawi. In addition, most countries, including those with more comfortable debt positions, remain highly vulnerable to shocks, for example to the exchange rate or the oil price, while significant improvements crucially depend on the implementation of fiscal reforms.

External risks to the outlook are rising. Trade prospects are less bright than they were a few years ago and might deteriorate further. Commodity prices have increased, but a slowdown in growth in advanced economies or the rebalancing of China might weigh on price developments, depressing export receipts and fiscal revenues. Brexit could also cause a reduction in exports, as technical and political complexities could delay arrangements to replace lapsing agreements with the EU. Botswana, Mauritius and the Seychelles are among the countries with the highest export dependence on the United Kingdom.

Most currencies performed better than last year, and several countries managed to increase their foreign exchange reserves. The rand regained some ground after the sizable depreciation in 2015, which worked through currencies throughout the region. Most countries experienced less volatility and a stronger performance of their currencies than in previous years. As a result, several countries, including Mozambique, were able to increase reserves. Zambia on the other hand saw an early-2017 rally reversed as concerns mounted about the sustainability of public finances. Most countries still have overvalued exchange rates, which reduces competitiveness and hampers exports.

Foreign exchange rate policies remained largely unchanged, but developments in some countries are noteworthy. In Botswana, the Ministry of Finance did not revise the weighting of the pula basket but changed the direction of the crawl from upwards to downwards as inflation in main trading partners was lower. The targeted weakening of the pula against the basket of currencies will be very small (0.3%) and actual exchange rate development will remain largely determined by the value of the rand versus hard currencies. In Mozambique, new regulation created a more open market for capital flows as exporters and investors are allowed to keep all proceeds in foreign currency. In Zimbabwe, the shortage of foreign currency led the government to introduce controls over capital and current account transactions, with import rationing as a result. Persistent cash shortages gave rise to several quasi-currencies that complement the US dollar, with the informal market continuously searching for equilibrium pricing. A sustainable currency situation is likely to be accompanied by a devaluation of the quasi-currencies to improve the competitiveness of Zimbabwean exports.

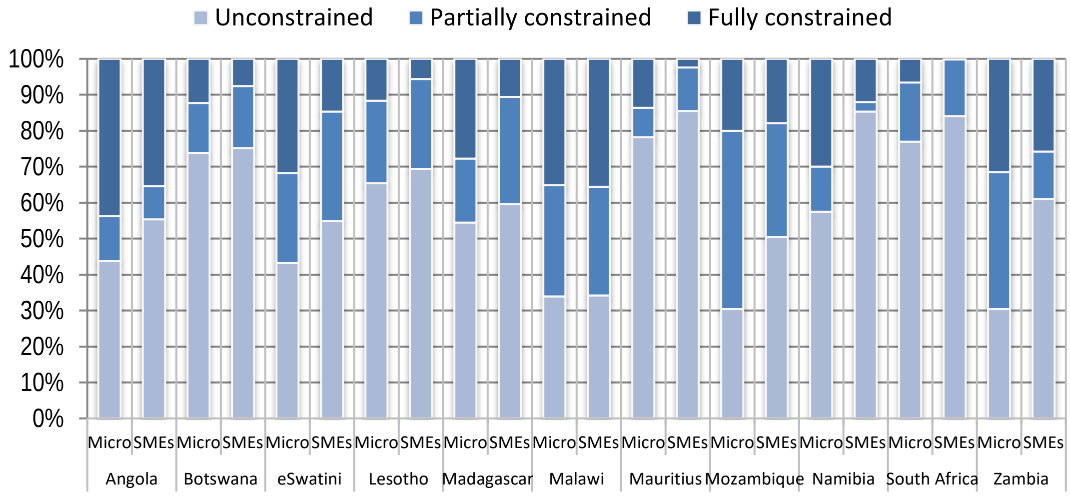
Several major leadership changes bolstered political stability. Until mid-2017, several countries in the region were facing imminent or inevitable leadership changes, without the assurance of these taking place smoothly. However, a year later several new leaders were in power following peaceful, albeit not necessarily straightforward, events. In South Africa, a long legal battle over corruption allegations caused Jacob Zuma to resign as president under threat of being dismissed by his party. The new president, Cyril Ramaphosa, has vowed to combat corruption and to reverse the eroding trust in government, the criminal justice system and business. Some months earlier, Robert Mugabe, the long-time president of Zimbabwe, stepped down after mounting political and military pressure. The country's population hopes that with a new president, a new era has begun with improving economic conditions and a normalisation of international relations. After elections in Angola, the ruling party kept its majority but João Lourenço took over from José Eduardo dos Santos who had been the president since 1979.

The risk of instability remains tangible in some areas. The main risk relates to unrest in the Democratic Republic of the Congo, as a slide into anarchy would have repercussions for the wider region. Political and social unrest in Lesotho culminated in the deployment of a SADC military contingent in December 2017. The preventive mission has been successful in stabilising the political and security situation. In Madagascar, tensions were rising ahead of the presidential elections taking place in late 2018 as changes to the electoral law could result in several opposition leaders being barred from standing as candidates. On the positive side, the peace process in Mozambique is progressing despite continuing instability in the northern part of the country, and life in the affected areas has been normalising.

5.2. Access to Finance and Financial Inclusion

Access to finance remains a bottleneck for companies throughout the region, and recent years have not brought significant improvement. In Mauritius, Namibia and South Africa companies can rather easily obtain credit when needed (Figure 5.3). However, in several other countries the situation is much less conducive to economic activity. Unsurprisingly, micro firms face the largest difficulties. As several countries faced an economic slowdown, banks tightened their credit standards. At the same time, many also increased lending to the public sector, which needed to fund the increasing budget deficits. In some countries, high interest rates on sovereign paper decreased the attractiveness of lending to the private sector and bearing the related credit risk. The risk that lending to the public sector might crowd out private credit is particularly present in Zambia and Mozambique (see Chapter 7).

Figure 5.3. - Access to Credit of Micro Enterprises and SMEs
(last available year)

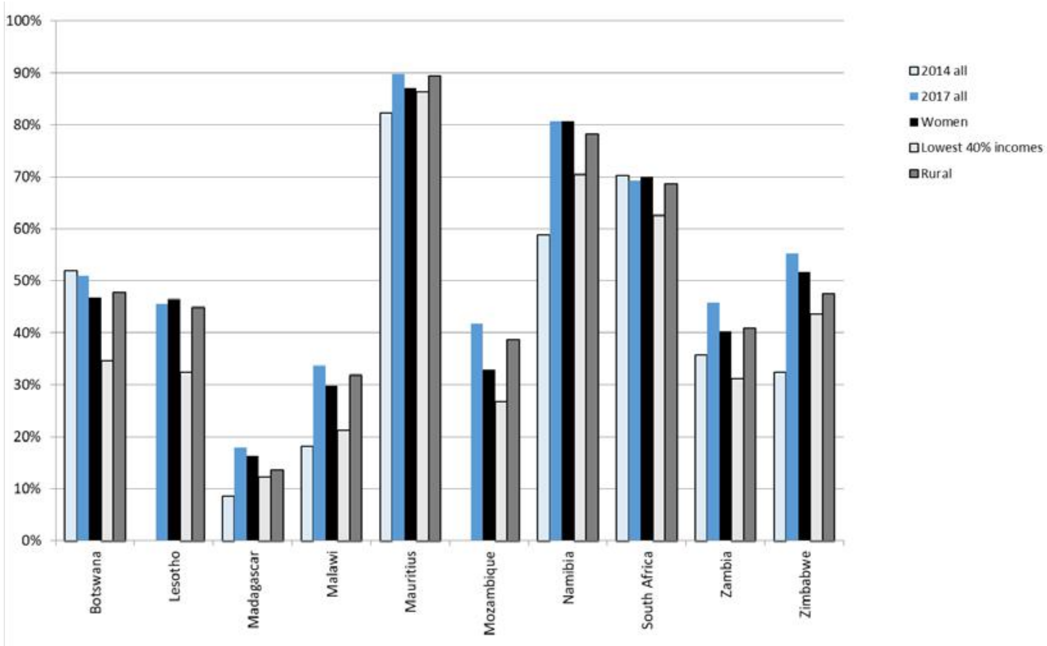


Source: SME Finance Forum database

Access to financial services varies greatly throughout the region, but is in general improving. In Mauritius, 90% of the population over 15 has an account at a bank or another kind of financial institution, but in many countries this share is much lower, sometimes even below 25% (Figure 5.4.). In most countries, accounts have become more widespread, but in Botswana and South Africa there has been a modest decline. Women have an account almost as often as men, and in some countries even more often, while in many countries the rural population has caught up with the urban population. However, the difference in access between the poorest and the richest part of the population remains substantial in many countries.

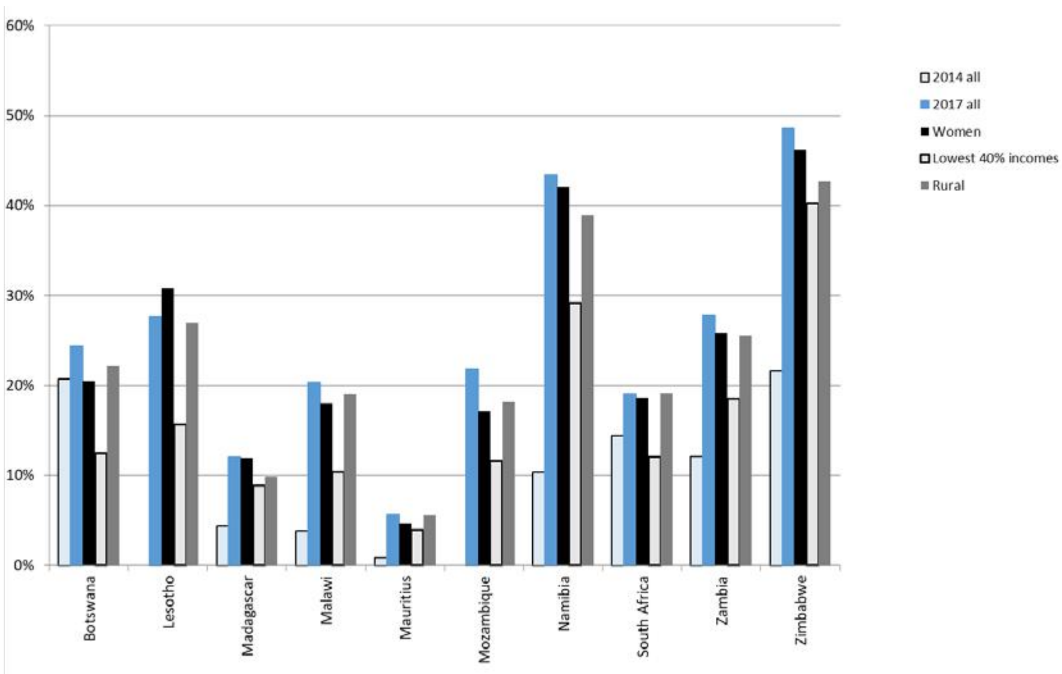
Mobile accounts are spreading rapidly throughout the region. The use of mobile payment services has increased, particularly in Zimbabwe (Figure 5.5.), where cash shortages have spurred the digitalisation of transactions. However, the use of mobile accounts has also increased rapidly in other countries, particularly Namibia. Compared to normal bank accounts, differences between men and women are more pronounced for mobile bank accounts, and the same holds for residents of urban and rural areas, and for the rich and the poor.

Figure 5.4. - Accounts at Banks or Other Financial Institutions
(population Age 15+)



Source: World Bank Global Findex database

Figure 5.5. - Mobile Accounts
(population Age 15+, in per cent)



Source: World Bank Global Findex database

5.3. The Financial Sector

The region's banking sectors faced heightened international regulatory scrutiny, generally weaker liquidity levels, and significant credit distress triggered by the slump in commodity prices from 2011 onward. The region's banks vary widely in size, balance sheet structure and sophistication so conclusions about general performance features are difficult to draw

(Table 5.2.). However, many markets continued to see the ongoing effects of the commodity slump. A clear theme is sovereign credit weakness brought on by weaker GDP growth; depressed currencies and reduced tax collection led to deteriorating sovereign credit ratings that constrained the funding and liquidity of banks operating in Southern African markets. Several banking sectors redirected lending out of their private sectors and into the public sector to support sovereign finances, crowding out lending to the private sector (see Chapter 7). Tight foreign currency conditions made it difficult for some banking industries to support their customers' foreign currency needs or to service their own foreign currency liabilities. Overall, there was weaker loan growth, heightened client debt distress and constrained profitability growth. While conditions in 2017 showed signs of improvement compared to the exceptionally weak 2016, banks are having to contend with several regulatory interventions including stringent anti-money laundering rules, the implementation of Basel II or III, and the imposition of IFRS 9 to standardise provisioning for credit defaults, while the economic recovery remains tepid. Some markets in the region, particularly Angola, have had to contend with the risk that their banks may lose key correspondent banking relationships, leaving them outside of the international banking circuit.

Table 5.2. - Selected Financial Statistics
(2016)

	Bank capital to assets ratio	**Domestic credit to private sector**	**Gross domestic savings**	**Interest rate spread (lending rate minus deposit rate)**
	per cent	per cent of GDP	per cent of GDP	per cent
Angola	NA	21.1	9.0	10.2
Botswana	8.4	31.7	37.6	5.2
Comoros	NA	26.5	-6.9	8.8
eSwatini	13.0	21.6	9.3	7.3
Lesotho	13.2	16.8	-12.6	10.5
Madagascar	10.7	13.1	13.0	45.0
Malawi	NA	10.5	3.3	32.5
Mauritius	10.6	96.4	7.3	3.4
Mozambique	NA	34.5	0.3	10.4
Namibia	11.1	67.2	2.0	4.2
South Africa	8.2	144.4	19.5	3.3
Seychelles	11.9	26.9	NA	8.9
Zambia	12.1	15.4	34.7	4.7
Zimbabwe	NA	NA	-1.8	NA

Source: World Bank

On the whole the region's banks have remained strongly profitable. Certain markets have experienced distress, particularly Angola where at least three banks are currently subject to support by the central bank, but in general asset growth has remained positive and non-performing loan ratios have remained manageable. The bigger challenge now is managing heightened sovereign indebtedness.

Developed market banks have been withdrawing from markets in the region. In particular, Barclays has concluded the disinvestment of its majority interest in Barclays Africa Group, which is now broadly held through its listing on the Johannesburg Stock Exchange and renamed Absa Group. The Barclays brand will be replaced with Absa in its African markets up until 2020. Insurance giant Old Mutual also intends to reduce its controlling stake in South Africa's Nedbank to a minority strategic interest. Other global banks have also shown less interest in African networks, with Deutsche Bank due to shut down much of its operations in South Africa after Credit Suisse did so last year. Only Standard Chartered appears to remain committed to its African network among developed market banks. The loss of appetite from developed market banks for African assets has been driven by home market capital rules that have increased the costs of holding international subsidiaries, particularly for those banks deemed to be systemically important.

Regional banking groups have, however, stabilised after a difficult 2015 and 2016 on the continent. Standard Bank, the largest on the continent by assets, grew profits from its regional network in 2017, as did Absa, the next largest regional player. Ecobank, the West and Central African banking network that has an alliance with South Africa's Nedbank, recovered its profitability during the year too. Regional banking groups have become the main form of cross-border bank and we expect more cross-border expansion as banks grow from their domestic bases, particularly among Nigerian, Angolan and East African banks, which will gradually move into SADC markets.

Regulatory development has proceeded at a steady pace in the region, particularly under the guidance of the IMF. The larger markets have all now introduced some form of macroprudential regulation to monitor the riskiness of the system as a whole and have adopted various stress testing methodologies to assess the riskiness of their banks. Several markets are busy with redrafting legislation to improve oversight of banks and other financial institutions. Various aspects of Basel III have been implemented in the larger markets including risk-weighted capital levels and, less often, net stable funding ratio requirements. Anti-money laundering regulation has also been a key feature of regulatory development in most markets as countries have urgently sought to protect their relationships with international providers. One country - Angola - has lost all of its US-based dollar clearing correspondent relationships over concerns regarding money laundering while several others have seen some of their banks similarly frozen out of US relationships. While these markets can rely instead on European or South African corresponding banks to maintain links to the international financial system, these are usually more cumbersome and expensive.

Capital markets in the region remain dominated by South Africa, which has the largest and most sophisticated stock exchange and bond market by a considerable margin. Next largest Mauritius has been developing well, attracting new listings especially of regionally active investment vehicles. Smaller markets like Zambia have been attempting to accelerate capital market development by compelling international companies to list on domestic exchanges. However, liquidity is often so poor that such listings fail to see any appreciable volumes. Given the funding demands of the state in those markets, there is little investment appetite for equities. Pension funds are still mostly channelled through state-owned fund managers who direct flows into government paper, property or cash, and hold little equity. Reforms to pension industries have attempted to address this pattern, but while the state remains the major recipient of funding there is unlikely to be much progress. Namibia and Botswana also have small but active stock exchanges while eSwatini, Mozambique and Malawi operate fledgling markets. Angola has long planned to launch a stock exchange but has continually delayed doing so. The Johannesburg Stock Exchange has seen the most active number of new listings with 37 companies in 2016 raising a total of USD 2.7bn of capital. Mauritius had two new listings and Botswana three, while Zambia and Zimbabwe had one each, collectively raising less than USD 300m.

5.4. Country Comments

5.4.A. ANGOLA

Angola's banking market faces difficult conditions, with a shortage of foreign currency, significantly deteriorating credit performance, and several banks surviving on central bank support. The sector has had its access to international funding substantially curtailed amid concerns over money laundering with US banks no longer willing to clear dollars for Angolan banks since October 2016. Angolan banks are also unable to raise funding on any international markets. There is a serious foreign currency shortage with workers in Angola's oil sector no longer able to be paid in dollars without substantial difficulty. Some European banks are clearing dollars but at higher cost and with delays. Some progress has been made toward addressing the issue, with the Financial Action Task Force having removed Angola from its blacklist last year and an agreement with the International Monetary Fund for technical assistance to strengthen banking supervision and anti-money laundering oversight.

Table 5.3. - Major Banks in Angola

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
Banco de Poupança e Crédito, S.A.	1	1	0	10,193	3.0
Banco Angolano de Investimentos, S.A.	2	3	1	8,232	1.6
Banco Fomento Angola	3	2	-1	7,914	-12.9
Banco Económico S.A.	4	5	1	6,648	5.0
Banco BIC Português, S.A.	5	4	-1	6,191	-14.3
Banco Millennium Atlântico	6	6	0	5,717	51.1
Banco Sol	7	8	1	2,392	-1.0
Standard Bank Angola, S.A.	8	11	3	2,217	0.3
Banco de Desenvolvimento de Angola	9	10	1	1,947	-12.7
Banco Caixa Geral Angola, S. A.	10	9	-1	1,888	-19.4
Banco de Negócios Internacional, S.A.	11	12	1	1,560	-7.8
Banco de Comércio e Indústria, S.A.	12	14	2	1,112	18.2
Banco Regional do Keve SARL	13	13	0	848	-12.3
Standard Chartered Bank Angola S.A.	14	17	3	292	65.6
Banco Angolano de Negócios e Comércio, S.A.	15	16	1	279	-3.3
BCA-Banco Comercial Angolano, SARL	16	15	-1	265	-23.6
Industry				**57,695**	**2.2**

Source: Fitch Connect

Three of the country's largest banks are receiving support from the central bank, according to media reports. The country's largest bank, state-owned BPC, has been undergoing extensive restructuring since September 2016, with the media reporting a capital hole of around USD 1.4bn, some 14% of the bank's total assets. According to the central bank, as much as 30% of its loan book may have to be impaired. The ninth largest bank, Banco de Desenvolvimento de Angola, a development bank that reported large losses in 2015 and 2016, and the 12th largest, Banco de Commercio e Industria SA, are also being reorganised under the supervision of the central bank. According to ratings agency Fitch, the fourth largest player, Banco Economico, is relying on central bank liquidity. After a controversial recapitalisation, Economico does however appear to be stabilising, and recently received a B3 credit rating from Moody's, only the second Angolan bank to do so (BAI is the other).

Despite the Angolan economy facing significant obstacles, there are pockets of strong profitability in Angola. BAI, the largest private sector bank, reported a return on equity of 28% in 2017 with a net interest margin of 8.9% that has been growing for three years. Standard Bank Angola, the subsidiary of the South African group, has the highest ROE in the market at 46% in 2017. Liquidity in the banking system has been constrained due to efforts to bring inflation under control while the public sector sucked up available credit, causing total credit to the private sector to fall by 1.8% in 2016, the first decline in many years. The central bank has introduced tough new capitalisation levels, increasing the capital requirement three-fold. The higher capital levels have to be met by end-2018 and are expected to lead to consolidation in the fragmented industry. The central bank is also determined to boost anti-money laundering supervision with the aim of improving banks' international relationships.

5.4.B. Botswana

Botswana has a relatively well-developed and stable banking system that remains highly profitable despite economic weakness in 2015 brought on by lower diamond prices. A strong economic recovery on the back of higher diamond prices since, along with high government spending during the downturn, has ensured that the banking sector is healthy. The industry is dominated by four banks, three of which are subsidiaries of South African firms and one British. Average capital adequacy is close to 20% of risk-weighted assets, returns on equity among the big four are in the high 20% range, averaging 23% for the industry, while private sector credit extension has been growing at around 9% a year since 2015. Non-performing loans have however ticked upward, from 3.5% of gross loans in 2013 to 5.3% at end-2017.

Table 5.4. - Major Banks in Botswana

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
First National Bank of Botswana Limited	1	1	0	2,001	-5.5
Barclays Bank of Botswana Limited	2	2	0	1,445	10.8
Standard Chartered Bank Botswana Ltd.	3	3	0	1,303	11.5
Stanbic Bank Botswana Limited	4	4	0	1,127	5.6
African Banking Corporation of Botswana (Pty) Ltd.	5	5	0	781	10.2
Letshego Holdings Limited	6	6	0	740	11.4
Bank Gaborone Limited	7	7	0	405	2.6
Botswana Building Society	8	8	0	347	-7.2
Capital Bank Limited	9	10	1	153	27.5
Bank of Baroda (Botswana) Limited	10	9	-1	148	1.0
Bank of India (Botswana) Limited	11	11	0	17	-31.4
Industry				***8,468***	***5.3***

Source: Fitch Connect

Government policy is focused on diversifying the economy from diamond mining, which includes an international financial centre to attract regional financial services groups to base themselves in Botswana. These efforts have had limited success, but the government has renewed its diversification plans which includes plans for increased minerals beneficiation, tourism, financial services, education and cattle farming. These plans are export-led and focused on developing the private sector, with extensive investment in infrastructure. The government is also privatising several state assets including the national telecommunications company and a power station. All of these efforts hold promise for the banking sector both directly in funding new development and indirectly through the resulting growth of a middle-class consumer base in the small country.

The central bank is actively strengthening oversight. In line with international standards, the central bank is developing a macroprudential policy function to improve the management of risk in the banking system while pushing ahead with delayed efforts to implement full Basel II compliance. It is also improving its anti-money laundering regulations and monitoring to bring Botswana into line with international standards.

5.4.C. MAURITIUS

Along with Botswana and South Africa, Mauritius is the most developed banking market in the region with the highest banking services penetration. It is somewhat unique in having relatively little exposure to commodity prices as a net commodity importer, though its services-based economy does feel the secondary effects of the economic performance of other African markets. It maintained relatively strong economic growth during the commodities down cycle of 2011-2015. Credit growth to the private sector has been improving and stood at 7.5% in mid-2017, although the banking sector's non-performing loan ratio is high compared to South Africa and Botswana at 7.1%. Profitability is reasonable, averaging 13.8% at end-2016.

Table 5.5. - Major Banks in Mauritius

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
MCB Group Limited	1	1	0	8,937	12.2
SBM Holdings Ltd.	2	2	0	4,079	7.5
Barclays Bank Mauritius Limited	3	3	0	3,000	-13.1
Standard Chartered Bank (Mauritius) Limited	4	4	0	2,787	-19.2
AfrAsia Bank Limited	5	5	0	2,491	17.0
Standard Bank (Mauritius) Limited	6	7	1	1,535	8.2
ICICI International Limited	7	6	-1	1,457	0.5
SBI (Mauritius) Ltd	8	8	0	1,092	2.0
Bayport Management Ltd.	9	9	0	1,074	9.9
Maubank Ltd.	10	NA	NA	801	NA
Bank One Limited	11	13	2	702	24.2
HSBC Bank (Mauritius) Ltd	12	11	-1	681	-5.4
Banque des Mascareignes Ltee	13	12	-1	619	-1.6
Deutsche Bank (Mauritius) Ltd	14	10	-4	605	-16.7
ABC Banking Corporation Ltd	15	14	-1	425	21.3
Warwyck Private Bank Ltd	16	16	0	206	73.7
Industry				***30,492***	***4.6***

Source: Fitch Connect

Mauritius is reorienting its financial sector and has been increasingly successful in attracting regional financial services companies to base operations on the island. Various advantageous tax regimes, including for financial services, have at times brought the country into conflict with other jurisdictions over tax leakage. These now account for about half of the country's banking assets. However, Mauritius has signed OECD and G20 agreements to prevent base erosion and profit shifting which will require it to implement rules to prevent the abuse of tax treaties, but may also weaken Mauritius's ability to attract global businesses. Mauritius's Global Business Companies (GBC) sector has been a major source of credit and deposit growth for the banking system and represents some risk if the tax incentives that underpin the GBC regime are reversed. To counter that risk, Mauritian authorities are intent on evolving the rationale for establishing regional businesses in Mauritius from tax incentives to value-adding services and efficient access to markets, particularly in Africa.

The Central Bank of Mauritius has been steadily improving the bank supervision regime. It is introducing several elements of Basel III including capital adequacy and liquidity regulations, while creating a macroprudential policy regime. The international character of the financial services industry creates specific risks, particularly of currency mismatches in deposits and assets. The IMF has encouraged Mauritius to stress test for these risks and to implement Basel III net stable funding ratios to address them. Is has also provided technical assistance to strengthen the bank resolution framework.

5.4.D. NAMIBIA

Namibia has a vibrant and sophisticated banking sector that is closely tied to South Africa's. The four largest banks are all South African. Asset growth has been consistently above 10% for several years and ROE above 20%, coming in at 21.1% last year. The industry is well capitalised with a 15.5% risk-weighted capital ratio, which is high given the sophistication of the industry. Non-performing loan ratios are among the lowest in the region at 2.5% at end-2017, though this was the highest level since mid-2010.

Table 5.6. - Major Banks in Namibia

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
Capricorn Investment Holdings Limited	1	1	0	2,623	-5.8
FNB Namibia Holdings Limited	2	2	0	2,314	-5.2
SBN Holdings Ltd.	3	3	0	1,980	28.3
Standard Bank Namibia Limited	4	4	0	1,979	28.2
NedNamibia Holdings Limited	5	5	0	1,172	31.8
Nedbank Namibia Limited	6	6	0	1,144	32.5
Agribank of Namibia	7	7	0	203	15.6
Bank BIC Namibia Limited	8	NA	NA	22	NA
Industry				***11,435***	***14.2***

Source: Fitch Connect

Credit extension is substantial with a household debt-to-income ratio of 83%, comparable with several developed economies and ahead of South Africa's 71%. The banking sector is highly exposed to Namibia's housing market with residential mortgages accounting for 40%

of all loans in the banking system and commercial real estate a further 12%. This relatively high exposure has been flagged as a risk by the central bank which is concerned about the potential impact of a property market contraction.

Namibia's central bank has been working with the legislature to upgrade legislation for the financial sector, ranging from deposit insurance to financial markets laws. These will bring Namibian banking oversight in line with international standards. Bank supervision is already of high quality with robust inspections. The Bank of Namibia has, however, been lagging in macroprudential supervision according to an IMF assessment, with a Financial Stability Council planned for the task of macroprudential supervision but not yet established. Legislation is also being amended to increase domestic investment allocations for institutional investors from 35% to 45% of their portfolios. This is expected to deepen domestic capital markets and increase liquidity in the financial system.

5.4.E. South Africa

South African banks have had a reasonably good few years, benefitting from a stronger credit performance following a difficult period after the global financial crisis. Stringent credit management and higher pricing then led to a recovery in the performance of loan books, though credit metrics have begun a new downturn. Underlying growth was moderate over the last year, with growth in total assets of 5.1% in the year to end-January 2018, while total profits grew 6.6% and return on equity averaged 16.0% (2017: 17.5%). Improving profitability was achieved largely thanks to stronger net interest margins, while credit performance reversed several years of improvements, with impaired advances growing by 9.2%. Capital levels continued to improve, now averaging 16.1%, suggesting that banks are prepared for the credit cycle to continue a downward phase.

Table 5.7. - Major Banks in South Africa

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
Standard Bank Group Limited	1	1	0	142,642	11.6
Barclays Africa Group Limited	2	2	0	80,458	9.3
Nedbank Group Limited	3	3	0	70,593	18.5
Nedbank Limited	4	4	0	65,773	18.8
PSG Group Ltd.	5	5	0	6,300	41.0
Capitec Bank Holdings Limited	6	6	0	5,632	43.7
African Bank Holdings Limited	7	NA	NA	2,715	0.0
RMB Holdings Limited	8	7	-1	2,678	-10.6
Toyota Financial Services (South Africa) Limited	9	8	-1	2,612	25.6
SAHL Investment Holdings (Proprietary) Limited	10	9	-1	2,271	27.0
Grindrod Bank Limited	11	11	0	1,108	53.3
Mercantile Bank Holdings Ltd.	12	14	2	893	38.3
Mercantile Bank Limited	13	15	2	854	37.7
Transaction Capital Limited	14	12	-2	799	14.2
Sasfin Holdings Ltd.	15	10	-5	745	-16.4
Sasfin Bank Limited	16	13	-3	611	-11.6
Industry				**386,683**	**14.7%**

Source: Fitch Connect

The country's difficult economic conditions had repercussions on the banking sector. Consumer and business confidence have been seriously damaged by perceptions of rampant corruption, which is now widely discussed under the label "state capture". The precarious financial situation of some large state-owned enterprises (SOEs) contributed to serious concerns about the sustainability of public finances as the budget deficit ballooned and credit metrics of key government balance sheets deteriorated sharply. The Reserve Bank, which oversees the banking system, was itself subjected to attacks as part of the state capture efforts, but fended these off robustly. Two of the three major international rating agencies downgraded South Africa's sovereign debt to junk for both local and foreign currency issues in 2017. This constrained funding access for South Africa's banks, though they were able to protect margins by front loading issuance before the downgrades. The installation of new president Cyril Ramaphosa led to a resurgence in confidence, but this has yet to result in tangible investment and resumption of solid economic growth, and the ongoing difficult economic situation will thus continue to hamper the credit performance of banks.

The Reserve Bank's role as a supervisor of the banking system was changed dramatically in April this year with the launch of the Prudential Authority as a replacement for the previous bank supervision department. This represents the culmination of the "Twin Peaks" regulatory authority which sees systemic stability fall under the authority of the Prudential Authority, while an external Financial Sector Conduct Authority focuses on market conduct issues, incorporating what had been the Financial Services Board. The Prudential Authority will now oversee risk in all financial institutions, including insurance companies, at both macroprudential (system wide) and microprudential (individual institution) levels. To combat money laundering, a risk-based rather than rules-based system has been introduced to limit financial crime by banks, aligning South Africa with global best practice.

The sector is set to face much more competition in the years ahead, with the entry of new banks for the first time in several years, as well as a reorientation of several older banks. The Post Bank, a part of the country's Post Office, has been corporatised and is expected to become a more aggressive competitor. African Bank, the result of the curatorship and rescue plan of the old African Bank that collapsed in 2015, is profitable and ramping up activities to become a full-fledged retail bank. Three new banks have been granted licenses, Discovery Bank, Bank Zero, and TymeDigital, a subsidiary of Commonwealth Bank of Australia, that are each promising radical innovations for the consumer market. These will spur innovation in the industry, which is already world class.

South Africa's large banks also all have aspirations to grow in the rest of Africa. During the first part of the year, Barclays concluded its majority disinvestment from Barclays Africa, which has been renamed Absa. Absa now needs to develop its go-it-alone strategy through the 12 African markets where it has banks or representative offices. Standard Bank, which rivals Absa for the biggest African network, has operations in 17 African markets, and uses its strategic relationship with the Industrial & Commercial Bank of China to leverage off the China-Africa trade corridor. Nedbank owns banks in neighbouring markets and has a strategic shareholding in Ecobank, which is widely active in West and Central Africa. FirstRand has been following a slower organic growth strategy, starting new businesses in key markets to grow its African network to ten other African countries. As discussed under other country headings, South Africa's banks are often the largest banks in the rest of SADC's markets.

5.4.F. Zambia

The banking system is dominated by foreign-owned banks, a feature that has ensured its continued integration into the global financial system. Domestic-owned banks have been losing correspondent banking relationships amid concerns over anti-money laundering regulation. The two largest banks are subsidiaries of South African banks followed by Britain's Standard Chartered, while fourth-ranking Zanaco is the largest domestic bank by some margin. Last year Zanaco's largest shareholder, the Dutch lender Rabobank, transferred its 46% stake into a new entity, Arise BV, which is backed by Norfund, Rabobank and the Dutch Development Bank.

Table 5.8. - Major Banks in Zambia

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
Stanbic Bank Zambia Limited	1	1	0	1,062	7.8
Barclays Bank Zambia PLC	2	3	1	877	6.2
Standard Chartered Bank Zambia Plc	3	4	1	828	5.5
Zambia National Commercial Bank Plc	4	5	1	807	11.5
Bank of China Zambia Limited	5	7	2	611	43.5
First National Bank Zambia Limited	6	6	0	547	9.5
African Banking Corporation Zambia Limited	7	9	2	336	42.4
Citibank Zambia Limited	8	10	2	230	16.2
Bayport Financial Services Limited	9	11	2	180	21.3
Ecobank Zambia Limited	10	13	3	153	26.9
Investrust Bank Plc	11	12	1	130	2.3
Cavmont Bank Limited	12	14	2	96	-13.2
Cavmont Capital Holdings Zambia Plc	13	15	2	96	-13.2
First Alliance Bank Zambia Limited	14	16	2	68	8.3
Access Bank (Zambia) Limited	15	17	2	58	-0.7
United Bank Africa Zambia Limited	16	19	3	55	54.1
Industry				***6,133***	***14.1***

Source: Fitch Connect

The Zambian banking sector has struggled to recover from the 2015 collapse in copper prices as public finances have been worsening. Non-performing loans have remained stubbornly high and increasing, at over 12% in mid-2017, despite a moderate recovery in copper prices since mid-2016. Growing government arrears to suppliers have filtered through into NPLs, which also suffered from electricity blackouts in 2016 on the back of a long drought that compromised hydroelectric supply.

Despite the poor conditions in the banking sector, it remains fairly profitable with ROEs of around 15%, although these have been declining from over 30% in 2011. Profitability is helped by high interest rates, which were at 24.5% on average in December 2017 as well as over 10% on government paper and the relatively passive deposits available in the domestic market. With inflation at around 7%, real interest rates are high. Lending margins were steady at around 14.5% during 2017. As the government's need for funding has drained much liquidity out of the market, bank appetites for further private sector lending have been constrained (see also Chapter 7), which in turn is hampering growth. The microfinance sector now comprises 34 lending institutions, though most have small balance sheets and focus on payroll lending.

Banks are grappling with the implementation of IFRS 9, which imposes an expected loss model for the calculation of provisions in place of the incurred loss model that applied

previously. According to PricewaterhouseCoopers, Zambian bankers have raised the lack of quality forward-looking data as a major impediment to the implementation of IFRS 9, a problem that several other markets in the region will also experience.

The Bank of Zambia undertakes regular stress tests of credit and liquidity vulnerabilities and generally ensures good macroprudential oversight of the sector. However, the IMF last year criticised the central bank for falling behind international best practice, citing staff shortages that lead to insufficient bank inspections and cumbersome and outdated legal frameworks.

5.4.G. Zimbabwe

Despite the difficult conditions toward the end of Robert Mugabe's presidency, the banking sector managed to grow dollar-denominated assets, though the inability to monetise these assets makes the figures more notional than real. Political change in the last quarter of 2017 had an immediately positive impact on the banks, with average ROE increasing to 15.5% from 11.15% in the previous quarter. Net profit was 33.6% higher in the last quarter compared to a year earlier. Capitalisation is strong at over 27% while the non-performing loan ratio also trended downward in the last quarter to 7.1%. However, the major dollar shortage of the country hampers the convertibility of assets and complicates understanding banks' health. This has clear consequences for consumers who are limited to ATM withdrawals of USD 20 in the form of bond notes. Physical cash trades at a 40% premium to electronic cash on the black market, and government bonds and notes at some 20%. As most banks hold large amounts of government paper or have large central bank balances, any recognition of their lower real value could have substantial repercussions for banks' health.

Table 5.9. - Major Banks in Zimbabwe

	2016 Rank	2015 Rank	Rank change	Total assets (2016)	Asset growth (2016)
				USD million	per cent
ABC Holdings Ltd.	1	2	1	2,040	12.7
CBZ Bank Limited	2	1	-1	1,913	5.4
Central Africa Building Society	3	3	0	1,073	2.9
Stanbic Bank Zimbabwe Ltd.	4	4	0	846	42.1
FBC Holdings Limited	5	5	0	610	24.4
Standard Chartered Bank Zimbabwe Ltd.	6	9	3	504	31.5
Barclays Bank of Zimbabwe Limited	7	12	5	476	59.1
FBC Bank Limited	8	8	0	470	21.4
ZB Financial Holdings Ltd	9	7	-2	439	5.2
Ecobank Zimbabwe Limited	10	14	4	395	69.0
NMB Bank	11	10	-1	321	-3.9
NMBZ Holdings Ltd.	12	11	-1	321	-3.8
MBCA Bank Limited	13	13	0	299	22.6
Steward Bank Limited	14	16	2	226	34.0
Metbank Limited	15	17	2	201	27.1
People's Own Savings Bank	16	18	2	164	22.9
Industry				***10,299***	***18.9***

Source: Fitch Connect

Once the liquidity problem is dealt with and the resulting balance sheet issues are fully digested, Zimbabwe's banks are set for radical transformation as they step up to playing a bigger role in an economic recovery. Substantial foreign lending is required to restore liquidity in Zimbabwe, though it needs to tackle legacy debts in order to regain access to large-scale development assistance. While most international lenders are waiting for the elections scheduled for July, a USD 100m loan from Britain's CDC and Standard Chartered was already secured beforehand, making it the first time since 1999 that the country could tap international capital markets. After the liquidity problem is fully dealt with, the presence of several foreign-owned banks may help to reintegrate Zimbabwe into the international economy, restoring its once vibrant agricultural sector, tourism and natural resources industries. More generally, the banking sector is sophisticated with a diverse set of products, and is well positioned to service a strong recovery in Zimbabwe's economy.

5.5. Conclusion

The region is slowly recovering from the economic slowdown, but banks, although in general in good shape, are still grappling with the fallout. Profitability has remained solid, and capital positions are in general strong. However, in some countries several banks had to be taken over by the supervisor. NPL levels remain elevated, as the impact of the commodity price slump of 2011-2015 works its way through the system. Banks' funding costs have increased due to the downgrades of their sovereigns on the back of their deteriorating budget situation. As lending to the public sector increased, crowding out of the private sector has been intensifying in several countries. As foreign banks have reduced their presence, the economic recovery could provide opportunities for local and regional banks provided that they can arrange the liquidity required to step up lending activities.

As the region looks to regain the growth rates of a decade ago, it will require its banks and financial systems to support development. That is feasible if governments are able to stabilise their own finances and work to create the enabling environment that will see banking systems financing productive areas of their economies. Higher commodity prices can underpin a broad economic recovery, but sustainable improvements in the financial systems of the region will require political will to align regulation with global standards to ensure their banks form a part of the global financial system.

6. Banking Sectors in North Africa: Improving Slowly but Noticeably[1]

Samia Azzabi[2], Jad Benhamdane[2] and Andreas Kappeler[3]

Executive Summary

- Being the most industrially advanced region in Africa, North African countries are currently undergoing a more prominent economic transformation to avoid the middle-income country gap. Many countries see this transformation as an opportunity to also make economic growth more inclusive and improve the business environment.

- The economic outlook for North Africa remains positive, thanks to considerable structural and macroeconomic reforms. GDP growth in North Africa reached 3.4% in 2017. Besides, the fiscal policy is improving thanks to the introduction of new taxes and rising oil prices. It should also support the creation of sustainable and quality jobs.

- Building on notable progress in recent years, the business environment is quite competitive, especially in Morocco and Tunisia. However, more efforts are expected to be made regarding certain specific infrastructure needs, notably to better connect rural areas and upgrade trade links.

- Financial sectors in the region are still dominated by traditional banking activities. Banks are well developed and have a pan African vision. Non-bank financial institutions are still at an early stage of development. This represents an opportunity in terms of enhancing SME financing and financial inclusion.

- Banking supervision improved across the region over the past few years. Internationally accepted prudential standards have been adopted in several countries. Continued efforts are under way to comply with the Basel III regulatory framework.

[1] North Africa refers in this chapter to Algeria, Egypt, Morocco and Tunisia. Libya is not included in most of the analysis in this chapter because some of its economic and political characteristics and current macroeconomic and banking sector dynamics are significantly different from those of other economies in the region. The situation in Libya is addressed separately within this chapter but Libya's outlier figures are not used in regional averages and tables.

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[3] Andreas Kappeler is an economist at the European Investment Bank.

The views expressed here are those of the authors and do not necessarily reflect those of the European Investment Bank or Institute of Africa. All remaining errors remain the authors'.

6.1. Recent Macroeconomic Trends

The events of the "Arab Spring" led to a process of political change in several countries in the region. The results of this economic and political change were different depending on the country in North Africa:

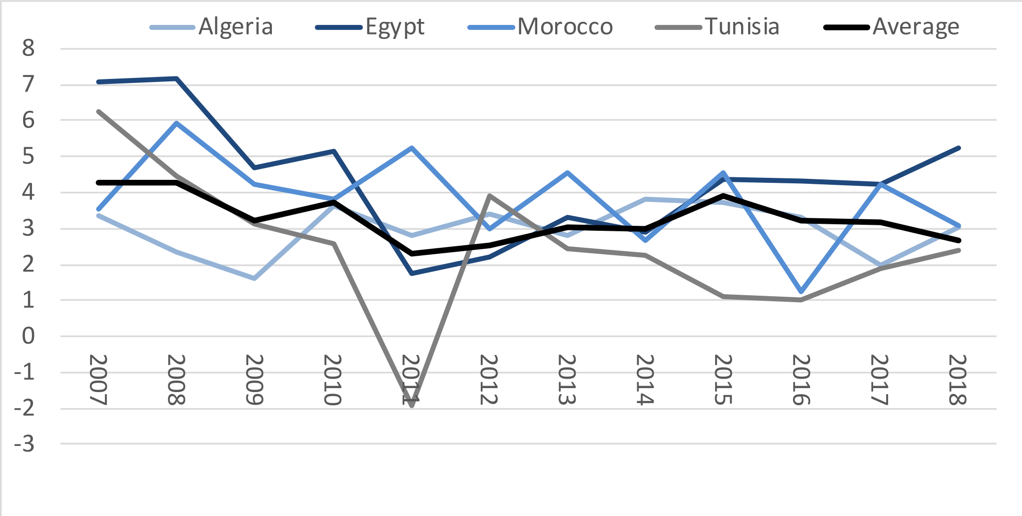
- In Egypt, the election in 2014 of Abdel Fattah el-Sisi marked the return of political stability, and the transition process continued following the Parliamentary election in January 2016.
- Morocco reformed its Constitution in 2011, radically overhauling the country's institutions. King Mohammed VI launched a political, economic and social modernisation of the country marked by greater openness, which was recognised by international observers.
- In Tunisia, seven years after the Jasmine Revolution, the transition to democracy is reaching fruition with the adoption of the new constitution and the organisation of free elections.
- Algeria seems to be the only country where the uprising in 2011 did not bring about major institutional change. The implementation of important social policies – wage increases and a far-reaching social assistance plan – helped contain protests.

To successfully pursue this political transformation process, the countries in the region have launched initiatives designed to promote financial inclusion and inclusive growth. This must include creating opportunities for all social groups, by promoting access to financing and education and ensuring that increased prosperity is shared fairly across society (AfDB, 2017).

6.1.A. Economic Activity: Favourable Outlook

Although down, economic growth in North Africa remained robust in 2017 at 3.4% (Figure 6.1. below). A good harvesting season, strong external demand and structural reforms in certain countries underpinned economic growth.

Figure 6.1. - Change in GDP Growth
(in %)



Source: IMF

The major economic turning points in the region over the last decade concerned the international financial crisis, the events of the Arab Spring and the instability of raw material prices. The international trade vacuum, combined with a decline in foreign direct investment, resulted in a slower pace of growth and the need to support the economy in a number of countries in the region. Public accounts and current balances therefore deteriorated. Adjustments related to the Arab Spring also limited the region's growth prospects.

Since 2012, the region's economic environment has stabilised. Egypt's economic growth has benefited from the development of new gas resources and from budgetary reforms (IMF, 2018). The floating of the pound at the end of 2016, coupled with support for international lenders and budgetary reforms, have helped correct the macroeconomic imbalances experienced since 2011. Until 2015, Algeria managed to curb the impact of reduced hydrocarbon prices and generated GDP growth of more than 3%. Nevertheless, the difficulties encountered in terms of financing public investment severely impacted the rate of economic growth, which fell to 2% in 2017 (IMF, 2017a). The outlook is still favourable, however, with the IMF projecting growth of 3% in 2018.

Table 6.1. - Macroeconomic Indicators
(2017)

	Regional average*	Algeria	Egypt	Morocco	Tunisia	Libya
GDP growth (constant prices; annual %)	3.4	2.0	4.2	4.2	1.9	70.8
GDP (current prices; USD bn)	180	178	237	110	40	31
GDP per capita (current prices; USD)	3331	4292	2501	3348	3913	7411
Government gross debt (% GDP)*	69	26	103	64	71	n.a.
Fiscal balance (% GDP)	-7.9	-6.4	-11.4	-3.6	-6.0	-43.2
Current account balance (% of GDP)	-8.1	-12.3	-6.5	-3.8	-10.1	2.2
External debt (% of GDP)*	27.1	2.3	33.3	35.0	78.1	n.a.
Inflation, CPI (% change)	12.2	5.6	23.5	0.8	5.3	28.0
Unemployment rate (% of labour force)	11.9	11.7	12.2	10.2	15.3	n.a.

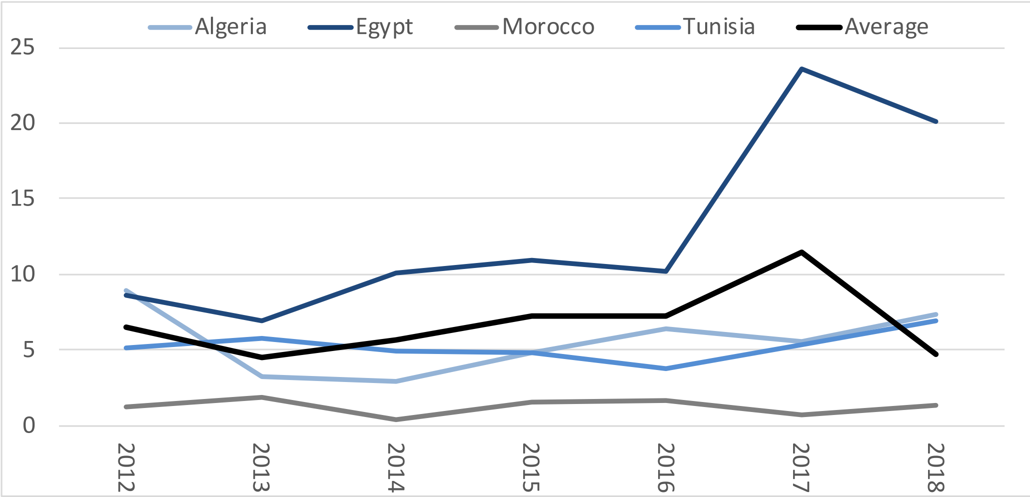
Notes: * Regional average excludes Libya.
Source: IMF

The impressive budgetary consolidation efforts undertaken must continue (Table 6.1.)**.** Sustainability of public finances suffered in 2017, with North Africa showing the highest deficit on the continent (7.9%). This imbalance was essentially caused by the widening of Algeria's budget deficit from 7% in 2014 to 13% in 2016 due to the drop in hydrocarbon prices. In 2017, the uptick in oil prices helped improve this deficit to 6%.

Ongoing budgetary stabilisation efforts suggest that budget deficits in the region will continue to improve. For example, as from 2018, Egypt's tax revenue is expected to benefit from improved economic growth, the effect of the new 14% VAT rate that has been in force since end-2016, and the revision of excise duties and charges on certain goods and services.

The unemployment rate of the countries in the region has stabilised but remains high. Over the past five years, the unemployment rate in Algeria and Tunisia has remained at 11% and 15% respectively, whilst in Morocco it fell from 10% in 2014 to 9.5% in 2018 and in Egypt it decreased from 13% in 2014 to 11% in 2018. Egypt aims to reduce its unemployment rate to 4% as part of its "Egypt 2030 Vision" strategy whilst the Tunisia 2016-2020 Development Plan aims to reduce the unemployment rate to 12%.

Figure 6.2. - Change in Inflation
(in %)



Source: IMF

Inflation in the region was mostly driven by the rise in raw material prices in Algeria and the forced liberalisation of the Egyptian pound (Figure 6.2.)**.** Inflation in North Africa rose from 7.2% in 2016 to 11.5% in 2017, driven chiefly by events in Egypt, whose currency depreciated and whose certified electricity tariffs increased. In Algeria, the inflation rate was nearly 7% in 2016 and 5.5% in 2017 following the increase in prices of manufactured and imported products and the fluctuation of food prices. In recent years, Morocco and Tunisia have managed to keep their inflation rates below 4%.

The drop in prices of basic products has widened the current account deficits of countries in the region. Countries in the region are characterised by large current account deficits, except Morocco which has a current surplus of 3.8%. Deteriorating terms of trade are contributing to this trend.

Table 6.2. - Evolution of Foreign Direct Investment Inflows
(USD millions)

	2011	2012	2013	2014	2015	2016
Algeria	2 580	1 499	1 684	1 507	584	1 546
Egypt	- 483	6 031	4 256	4 612	6 925	8 107
Morocco	2 658	2 728	3 928	3 561	3 255	2 322
Tunisia	1 148	1 603	1 117	1 064	1 002	958
North Africa	7 548	15 759	11 952	12 089	12 981	14 472
West Africa	18 926	16 822	14 479	12 176	10 189	11 433
Africa	66 018	77 501	74 551	71 254	61 495	59 373

Source: World Investment Report, UNCTAD 2017.

Foreign direct investment (FDI) can be a powerful engine of growth and innovation thanks to the transfer of knowledge (UNCTAD, 2017)**.** North Africa's inflows rose by more than 11% to USD 14.5bn in 2016 (Table 6.2.). Over 50% of these inflows - representing on average 2% of GDP in the countries of the region in 2016 - concerned Egypt. This reflects the discovery of new gas reserves in the west of Egypt and reforms of the exchange rate regime, which made the exchange rate more flexible and the country more competitive. Egypt is gradually positioning itself as an attractive hub in the region. Morocco is ranked second for FDI thanks to the development of its high-tech industry - especially in the aeronautics and automotive fields. By contrast, foreign investment in Algeria and Tunisia remains weak, amounting to USD 1.5bn and USD 1bn respectively in 2016.

Table 6.3. - Doing Business Ranking 2016-2018

	2018 rank	2017 rank	2016 rank	Number of reforms undertaken 2016-2018
Algeria	166	156	163	6
Egypt	128	122	126	4
Morocco	69	68	68	11
Tunisia	88	77	75	3

Source: World Bank Group.

In recent years, North African countries have made major changes to improve their business climate (Table 6.3.)**.** Algeria has adopted a number of reforms aimed at removing a minimum capital requirement for setting up a company and reducing the rate of tax levied on business activities. Morocco is the top ranked country in the region in the World Bank's Doing Business ranking. Morocco simplified its procedures for setting up a business. Notwithstanding their different socio-economic backgrounds, Tunisia and Egypt have also made substantive changes, principally aimed at facilitating the creation of businesses and improving cross-border trade.

Nonetheless, the position of North African countries in the Doing Business ranking has remained unchanged in recent years. Sustained efforts are required to make the region more competitive. For example, political instability is considered to be a major obstacle by nearly half of all companies in Egypt and Tunisia. Moroccan businesses lament the fact that, despite the considerable improvements that have been made, red tape and an inadequately trained workforce represent the prime obstacles to improving the country's business climate (EIB, EBRD and WBG, 2016).

Libya, which is not included in the regional averages presented in this chapter, is characterised by instability and substantial macroeconomic fluctuations (World Bank Group, 2018)**.** GDP growth in Libya reached 71% in 2018 and is expected to moderate to 16% in 2018, according to the IMF. Sustaining growth requires bold reform efforts to resolve political strife and a comprehensive programme to rebuild the economic and social infrastructures. Both the fiscal and current account balances will significantly improve. However, high inflation coupled with weak basic service delivery are likely to have raised inequalities. Inflation hit a record level of 28% in 2017 reflecting acute shortages in the supply chains of basic commodities, speculation in the expanding black markets and the strong devaluation of the Libyan dinar (World Bank Group, 2018).

6.1.B. REGIONAL INTEGRATION: OPENNESS ON THE AFRICAN CONTINENT

Regional integration in North Africa is less developed than in other regions on the African continent. The achievement of the objectives of the Arab Maghreb Union has never come to fruition. The Union is an economic and political organisation formed by the five Maghreb countries in 1990 with the goals of establishing a free trade area and boosting the economic development of its Member States. The Maghreb region is estimated to lose 2-3% of GDP each year due to a lack of openness and regional integration (AfDB, 2012).

In recent years, North African countries started to search for new commercial opportunities. Following the slowdown observed in Europe, the region's traditional partner, North African countries showed an increasing interest in opening up to sub-Saharan economies. North African countries' membership of the African Continental Free Trade Area (ZLECA) and their closer ties with both the Common Market for Eastern and Southern Africa (COMESA) and the Economic Community of West African States (ECOWAS) now offer genuine prospects to this region and foster deeper commercial ties with other African regions.

- **Morocco** re-joined the African Union in 2016 and took its first steps towards joining ECOWAS. The country also stepped up its operations on the continent, particularly in West and East Africa, in sectors such as banking, insurance, pharmaceuticals, logistics, etc.

- **Algeria** has formed closer ties with countries such as Nigeria and South Africa under the New Partnership for Africa's Development (NEPAD) principally for projects in the infrastructure and hydrocarbons sectors.
- **Egypt** is also deeply committed to opening up the region to the rest of the continent, and in 2015 oversaw the signature of a tripartite free trade agreement between the Southern African Development Community (SADC), the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA), advocating the development of intra-African trade as a driver of growth in North Africa.
- **Tunisia**, with 10% of intra-regional trade according to the Economic Commission for Africa (ECA), is the best-performing North African country in terms of regional integration.

6.2. Financial Inclusion

Financial inclusion in North Africa has made substantial progress, but gaps remain (Table 6.4. below). Countries in the region have progressed in a number of areas. The share of adults with an account is relatively high in Algeria and Tunisia. A relatively large share of adults in Tunisia and Egypt borrow from financial institutions and the use of debit cards is relatively widespread in Egypt. Nonetheless, the gap with upper middle-income countries remains notable in a number of aspects.

Table 6.4. - Financial Inclusion Indicators
(*% of population aged 15+, 2017)*

	North Africa	Upper middle income	Algeria	Egypt	Morocco	Tunisia
Account	34.7	73.1	42.8	32.8	28.6	36.9
Account, female	26.0	69.3	29.3	27.0	16.8	28.4
Digital access bank account	3.8	30.0	2.0	1.3	1.2	3.7
Debit card ownership	25.4	58.8	20.0	24.8	21.1	23.5
Outstanding housing loan	4.8	11.1	4.7	3.9	2.8	8.0
Borrowed from a financial institution	5.4	9.9	3.0	6.3	2.6	8.5
Saved at a financial institution	10.1	26.9	11.4	6.2	6.3	18.3

Source: World Bank Group: The Global Findex Database 2017.

Box 6.1. - The Digital Sector and Islamic Finance, Engines of Opportunity for the Region

The region's banks are not shying away from developing new products and services. The use of mobile payment methods and remote banking services offers a real opportunity for development. Currently, just 3% of the adult population use e-payment services.

In terms of innovation, the banking sector in the region has numerous assets. Remote banking services and e-banking are emerging against a backdrop of high internet penetration (49%) and mobile internet access throughout the region. Banks are increasingly using low-cost digital distribution channels that require innovative technologies.

Mobile payment is growing at a slower pace in North Africa than in the rest of the continent, except in Egypt where the service has been available since 2013. Tunisia has officially adopted mobile payment services under its "Digital Tunisia 2020" national strategic plan. Morocco has announced that mobile payment services will be available this year. The Algerian authorities are still opposed to the introduction of these kinds of services.

Islamic finance also contributes to financial inclusion. The development of Islamic finance in the region could represent a driver of financial inclusion as part of the population does not use banks for religious reasons. This type of finance could also support the emergence of new facilities for financing public investment and alternatives to microfinance (Demirgüç-Kunt, Klapper and Randall, 2013).

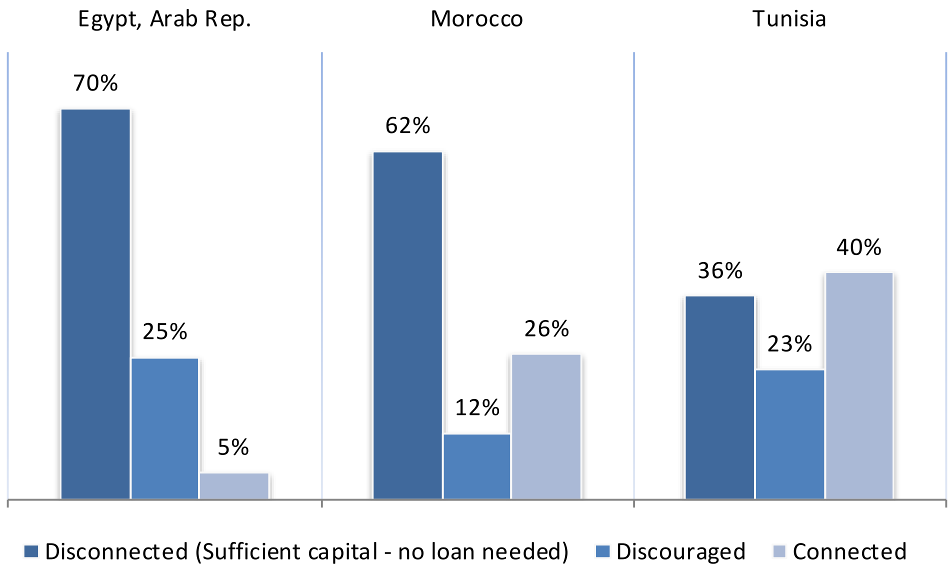
For some countries, Islamic finance serves as a solution to make up their budget deficit. The Algerian government plans to introduce sovereign issues of Sukuk on the Islamic financial markets. In Tunisia, despite numerous efforts made since 2013 to put in place a suitable regulatory framework for the emergence of Islamic finance, its share of the local financial market is below 5%. In Morocco, the growth of Islamic finance is most recent. In 2017 the Central Bank issued five "participation" banking licences and Islamic finance accounted for up to 10% of Morocco's banking assets. On the other hand, Egypt has experienced very slow growth in Islamic finance. Of the country's 40 banks, only three are entirely dedicated to Islamic finance and 12 universal banks offer "sharia-compliant" products.

Currently, Islamic finance activity is less developed in North Africa than in Asia and Europe (Demirgüç-Kunt, Klapper and Randall, 2013). Just 3% of adults in Egypt and Algeria, 2% in Tunisia and 1% in Morocco are consumers of "sharia-compliant" products. Worldwide, the Islamic finance market is worth USD 2tn and is growing at an annual rate of 15-20%.

Banks in the region have made considerable efforts to develop the density of their branch networks. Moreover, the provision of banking and financial services is increasingly adapted to each customer segment, for both individuals and businesses, although challenges remain. This ensures a better match between supply and demand. Financial institutions also invest in the digitalisation of their products and services. Coupled with a high rate of penetration of mobile telephony and the internet, this should further improve access to financial services (Box 6.1.).

Financial intermediation is fairly developed in North Africa and provides a solid basis to further strengthen financial inclusion. The ratio of private credit to GDP in the region is well above the average for peer economies. Morocco and Tunisia have made substantial progress in expanding access to credit (IMF, 2017b; IMF, 2016). However, Egypt lagged behind in the percentage of firms with a bank loan or line of credit. One reason is that bank lending in Egypt seems to be highly concentrated, with credit targeting only a limited number of companies. In 2010, the top 20 exposures accounted for more than half of total loans in the economy, implying that credit is absorbed primarily by large corporate clients.

Figure 6.3. - Firms' Credit Relationship with the Financial Sector
(% of firms, 2013)

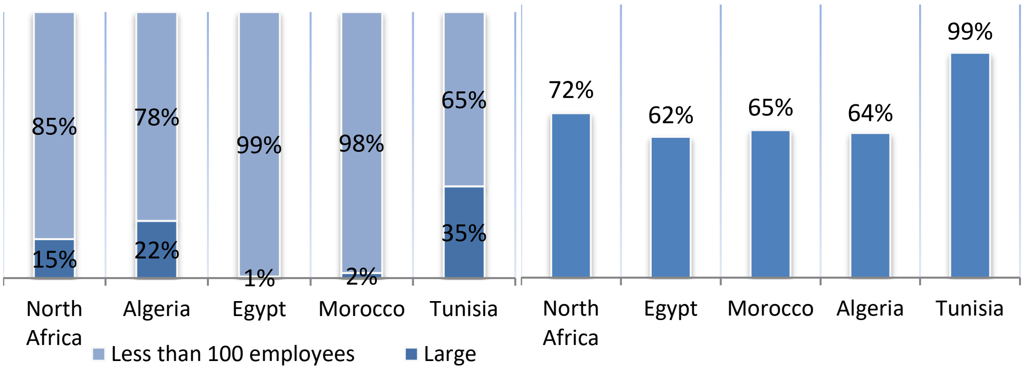


Source: EIB, EBRD and WBG (2016). "What's holding back the private sector in MENA? – Lessons from the Enterprise Survey".

Despite the provision of high volumes of credit to the private sector, access to finance for small firms needs to be strengthened (Figure 6.3.). In Egypt, for example, firms seem to have adjusted production strategies and expectations to the reality of limited involvement with the financial sector. In practice, these firms have become disconnected by shutting themselves off from the formal financial sector. Disconnected firms may have enough capital to operate but not enough to invest, expand and create new jobs. While still needing to improve, the share of firms reporting that they are connected to the financial sector is substantially higher in Morocco and Tunisia, according to the 2016 MENA Enterprise Survey report (EIB, EBRD and WBG, 2016).

Figure 6.4. - Small Firms and Informality

Panel A: Share of small firms *Panel B: Share of informal enterprises*



Source: IFC Enterprise Finance Gap Data.

Note: Small firms means enterprises with fewer than 100 employees. North Africa is the simple average over the four countries. Numbers refer to 2010.

Constituting the vast majority of enterprises in North Africa, MSMEs are more dependent on bank financing than large firms, since their access to alternative forms of financing (e.g. bonds or equity) is limited (Figure 6.4.). However, information problems are more important in the case of MSMEs and may therefore constrain their access to finance. The majority of enterprises in North Africa are MSMEs: small firms with fewer than 100 employees account for roughly 85% of businesses; many of them are informal, which makes it difficult for them to access external funding sources.

SMEs also often find it difficult to access bank funding due to intrinsic limitations. For instance, SMEs often have limited liquidity and difficulties in providing consistent financial and business plans or the necessary regulatory documents. This is why in some countries in the region, such as Morocco and Tunisia, governments and banks are increasingly supporting capacity building for SMEs. Banks are increasingly equipped with guarantees to back credit lines granted to SMEs, including for movable property, real estate and cash and deposit collateral. Banks are therefore increasingly adapting to the needs of SMEs, maintaining a strong focus on SMEs’ projected cash flows.

Policy leaders have recognised the importance of access to finance and are increasingly strengthening their efforts to promote financial inclusion. Accordingly, a number of governments in the region have taken initiatives to reinforce the links between banks, companies and individuals and to promote diversification of the financial sector, including through efforts to shift to digital and online financial services:

- **In Morocco, the Caisse Centrale de Garantie (CCG) facilitates access to financial services.** It stands as guarantor for MSMEs and individuals with little income, or co-finances projects considered to be “non-bankable”. Over the period 2013-2018, CCG's guarantee benefited nearly 18,000 MSMEs and more than 112,000 households. In the early 2010s the Central Bank limited the amount of collateral to be provided by banks to obtain refinancing for loans granted to MSMEs.

- **In Algeria, the Fonds de Garantie des Crédits aux PME (FGAR) and the Caisse de Garantie du crédit d'investissement pour les PME (CGCI-PME) provide guarantees to banks for SME loans.** They thereby facilitate access to bank financing for these enterprises. The 2015-2022 Financial Sector Modernisation Plan launched by Tunisia's Finance Ministry targets reforms designed to benefit financial inclusion, digitalisation, microinsurance and financial education, in particular (OECD, 2018).
- **At the beginning of 2016, the Central Bank of Egypt (CBE) launched an initiative encouraging banks to set aside 20% of their lending portfolio for SMEs.** Each participating bank must create an entity specifically dedicated to dealing with loan applications from SMEs. The interest rates must not exceed 5% for enterprises whose yearly net profit is between EUR 50,000 and EUR 1m. Experience in Kenya has shown though that such an interest rate cap can reduce banks' incentive to provide loans to small enterprises given that SME loans are high-risk. The CBE will authorise banks participating in this initiative to reduce their mandatory reserves. Egypt has also launched other initiatives to promote financial inclusion, e.g. by improving its bankruptcy law.

SME lending in North Africa could benefit from reformed secured transaction frameworks and better credit information systems. Capacity building for banks to strengthen their credit risk assessment would help those interested in lending to SMEs, without putting financial stability at risk. Moreover, efforts to build capacity for SMEs to improve their transparency would help to overcome information asymmetries and facilitate access to finance for SMEs. Further steps to improve access to finance should include the establishment of modern secured transaction laws, an efficient collateral registry, and credit guarantee schemes to alleviate collateral constraints.

6.3. Financial Sector Overview

The region's banking sectors are relatively large and generally well regulated. Non-banking financial institutions and capital markets in the region are still at an early stage of development and only account for a small share of the financial sector's total assets.

6.3.A. Structure and State of the Banking Sector

North Africa's banking sector is one of the most developed on the continent. This was evidenced by its resilience during the most recent international financial crisis and the raw materials crisis in 2014. In Tunisia and Egypt the banking systems maintained their support for the economy despite a delicate macroeconomic and political climate. Public banks continue to play a key role in Algeria

Operators in the sector have also demonstrated a strong ability to adapt. Moroccan banks have distinguished themselves by seeking out potential sources of growth on the continent: BMCE BANK acquired stakes in the Bank of Africa Group in 2008; more recently, Barclays Bank Egypt was taken over by Attijariwafa Bank and BIA Niger was obtained by Banque Centrale Populaire.

North Africa's banking sector contributes substantially to financing the economy. The Egyptian, Moroccan and Tunisian banking sectors are important engines of their respective economies; Algeria's banks principally finance public investment although their share in terms of financing the private sector remains considerable, at 75% in 2016.

Table 6.5. - Key Banking Sector Indicators

Country	Number of banks	Number of branches	Loans/GDP	Loans/Deposits
North Africa - 2016	111	13546	59%	101%
Algeria - 2016	29	1,489	47%	87%
Egypt - 2017	40	4,000	57%	114%
Morocco - 2017	19	6,283	76%	91%
Tunisia - 2016	23	1,774	77%	80%

Sources: IMF, Central Banks (latest available data).

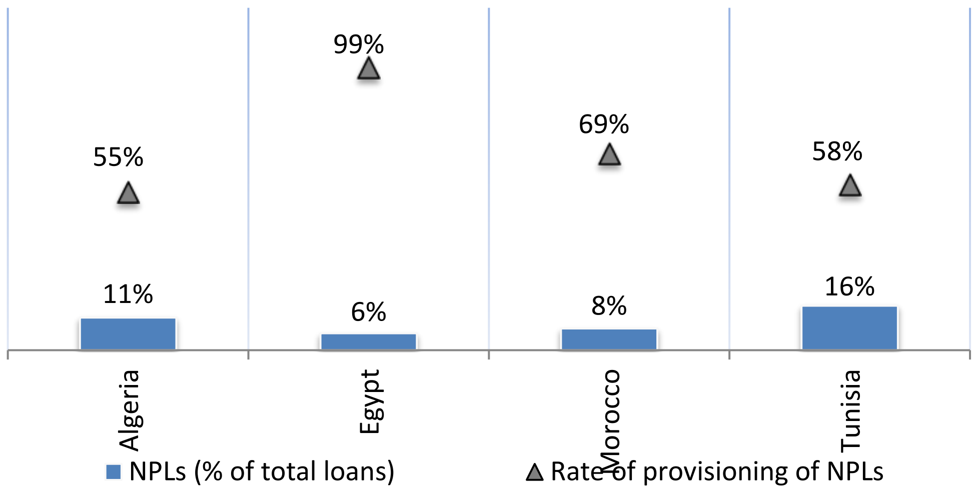
Financial intermediation is well developed in North Africa, as reflected by a wide network of branches (Table 6.5.)**.** The region's banking sector comprises 111 banks and 13,000 branches, offering a broad range of financial products and services, with a strong presence of international groups. Consolidation of the sector, particularly in Egypt where the number of banks fell from 62 to 43 between 2003 and 2006, remains a decisive factor to increase the profitability of North Africa's banking system.

There is a high level of banking concentration in the region. In Morocco, the three leading banks - Attijariwafa Bank, Banque Centrale Populaire, and BMCE Bank - capture 81% of assets. Algeria's banking system continues to be dominated by public banks, which account for 87% of total banking assets. Egypt's top five banks account for 64% of the sector's balance sheet total. The banking sector in Tunisia is more fragmented. Four banks - BIAT, BNA, Attijari Bank and STB - share 47.5% of total deposits.

6.3.B. OVERALL THE SECTOR IS SOUND AND SOLID

North African banks operate within a complicated context but continue to show strong resilience. In 2016, five years after the events of the Arab Spring, the rate of non-performing loans (NPLs) remained uneven across the region (Figure 6.5. below). In Algeria, the fall in hydrocarbon prices resulted in longer payment terms for public sector enterprises, which caused the level of NPLs to deteriorate to 11.4% in 2016. Lastly, in Tunisia the level of NPLs remains high: 50% of NPLs concern loans to the industrial and tourism sectors. At the same time, the North African countries have made improvements in the areas of provisioning and credit risk management. The loan loss provisioning rate in Egypt is close to 100%.

Figure 6.5. - Non-Performing Loans (NPLs) and Rate of Provisioning of NPLs by Country
(2016)



Sources: IMF, Central Banks.

The level of liquidity remains disparate. In Algeria, the reduction of liquidity in the banking sector has caused banks to seek refinancing from the Central Bank to meet their liquidity requirements, including for the maintenance of mandatory reserves. In Tunisia, the growing use of government bonds for financing purposes and the widening of the current deficit have reduced the level of liquidity in the banking sector. By contrast, Egypt's banking sector is highly liquid, with an average liquidity ratio of more than 800% (local currency) at end-June 2017 while the regulatory minimum required is 80%. In Morocco, despite the upturn in lending, banks' liquidity ratios are expected to remain at acceptable levels.

Table 6.6. - Profitability Ratios
(2016)

	North Africa	EGYPT	ALGERIA	TUNISIA	MOROCCO
Return on assets (ROA)	1.4%	1.5%	1.8%	1.0%	0.8%
Return on equity (ROE)	19.3%	24.4%	18.0%	10.8%	8.6%

Sources: IMF, Central Banks.

Profitability ratios of the region's banking sector have improved following the stabilisation of the countries' economic fundamentals (Table 6.6.)**.** With a rate of 20%, the return on equity of the region's banking sector is favourable. For example, the return on equity in West Africa is 16.1% (see Chapter 2). Tunisia and Morocco, which operate in more competitive environments and strive to achieve wider access to credit, have lower levels of profitability.

6.3.C. NON-BANK FINANCIAL SECTOR

Non-bank financial institutions and capital markets are still at an early stage of development and account for only a small share of total assets of the financial sector. This represents an opportunity for further development and for enhancing access to finance for the private sector, especially MSMEs. Effective regulation helps non-bank financial institutions to develop and thereby provide a larger variety of financial options to MSMEs.

Microfinance in the region is operating below potential and plays a minor role in financing small firms in North Africa (EIB et al., 2016; World Bank, 2016**).** Lending by microfinance providers in 2011 reached only 1.8% of the adult population. Even in Morocco, the country that has made most progress in developing the industry, microcredit loans barely exceed 1% of total bank credit. Algeria does not have a conventional microcredit sector comparable to that of its regional peers. A number of government programmes target microenterprises (ANGEM), young self-employed individuals (ANSEJ) and unemployed adults (CNAC). These subsidised programmes leave little space for conventional microfinance providers in Algeria (IMF, 2014).

Table 6.7. - Microfinance Regulations

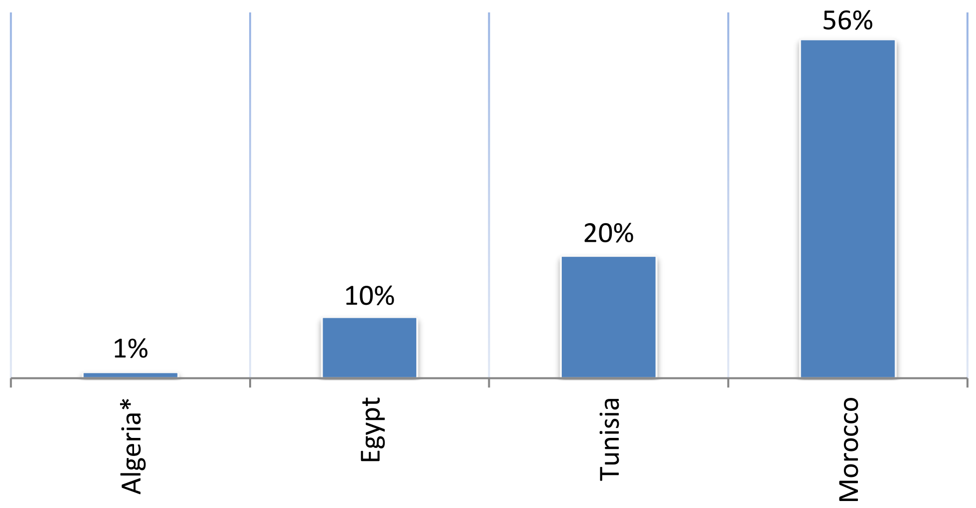
	Introduction of specific legislation	Deposit taking allowed by MFI/ Post Bank	Regulator
Algeria	No	Yes	No
Egypt	2014	Yes	Egyptian Financial Supervisory Authority (EFSA)
Morocco	1999	Yes	Bank Al-Maghrib (BAM)
Tunisia	2011	Yes	Microfinance Control Authority (AMC)

Source: CGAP (2017). Financial Inclusion Measurement in the Arab World, CGAP Working Paper; Douglas Pearce (2011), Financial Inclusion in the Middle East and North Africa, World Bank Group, Policy Research Working Paper 5610.

Governments have recently strengthened their efforts to promote microfinance (Table 6.7.). For instance, in Tunisia, a rapid transformation of the microfinance market is under way, with the passing of a new microfinance law in 2011 and creation of a new supervisory body (World Bank, 2016). Recent efforts to strengthen the microfinance sector have focused on the provision of microcredit to individual entrepreneurs. Egypt has introduced new legislation to facilitate the involvement of investment funds in the microfinance industry.

Further efforts are needed to promote the non-bank financial sector in North Africa. To boost microfinance in the region, regulatory frameworks need to be reviewed and the financial infrastructure upgraded. In addition, financial literacy amongst entrepreneurs needs to be strengthened. Private equity and venture capital markets also remain shallow in the region, with a limited product range and investor base. Moreover, the leasing and factoring industries in North Africa are small. In the region, leasing is most prevalent in Tunisia. Most leasing firms are banks or bank-related institutions, reflecting their easy access to deposit funding.

Figure 6.6. - Market Capitalisation of Listed Domestic Companies
(% of GDP, 2016)



Sources: WBG Development Database.
Notes: * IMF (2017a), 2017 Article IV Consultation – Staff Report for Algeria, IMF Country Report No. 17/141.

Capital markets in the region have experienced significant growth but still have room for improvement. Tunisia's capital market is growing, with a large number of equity listings in recent years. The continuing development of Casablanca Stock Exchange makes Morocco a regional financial centre and Africa's third most important capital market after Johannesburg and Lagos. Conversely, market capitalisation is particularly low in Algeria, where only four listed companies exist (Figure 6.6.). Fixed-income markets in the region are dominated by government securities, although corporate bond trading is growing rapidly. Corporate bond trading thus represented 25% of the Moroccan bond market in 2017.

The region has the top financial centre in Africa - Casablanca - which is ranked 33rd worldwide. Since it was created in 2010, the Casablanca Finance City (CFC) financial hub has helped enterprises, financial companies, multinationals, etc. to develop their activities in Africa. The CFC status and label give members access to advantages including tax incentives, exchange control facilitation measures and other procedures for doing business. To date, CFC has thus attracted 144 companies operating in 46 African countries. The cumulative amount of investments by CFC members in Africa is nearly EUR 2.7bn (MAD 30bn).

6.4. Regulatory Reforms to Strengthen Financial Stability Make Progress

Regulation of the financial sector is converging, albeit slowly, towards best international standards. Banking supervision has improved across the region over the past few years, owing to the strengthening of risk-based bank rating systems and adoption of internationally accepted prudential standards. Authorities remain committed to preserving financial stability by further strengthening regulation and supervision as well as the macro prudential framework. Central banks in North Africa have gained the necessary independence and built up the required expertise to supervise the banking sector. In terms of prudential norms, Basel III is being implemented in Egypt and Morocco (Table 6.8. below) and other countries are taking steps to comply with it.

Table 6.8. - Financial Sector Regulation

	ALGERIA	EGYPT	MOROCCO	TUNISIA
Supervisory authority	Central Bank of Algeria	Central Bank of Egypt	Bank Al-Maghrib	Central Bank of Tunisia
Implementation of Basel regulation	I	III	III	II
Leverage ratio ceiling	No	No	No	No
Minimum risk-based regulatory capital ratio	9.0%	11.3%	12.0%	8.0%
Single borrower maximum share		25.00%	20.00%	25.00%
Bank resolution framework	No	No	No	
Deposit insurance protection system	No	No	Yes	Yes
Number of professional bank supervisors		460	36	22

Source: IMF, 2014; WBG, Bank Regulation and Supervision Database, 2012; Fitch.

Likewise, the region's central banks have beefed up the regulatory framework on capital. Egypt's banking law, for example, provides for minimum capital of EGP 1.5bn (EUR 71m) compared to EGP 500m (EUR 24m) previously, whilst the minimum capital adequacy and liquidity ratios are expected to reach 12.5% and 100% respectively in 2019. In Algeria, public banks' capital has been gradually increased since 2009. Although public banks' capital comfortably exceeds the regulatory threshold, the Government nevertheless increased the capital of three of these banks in 2015 and 2016.

The countries in the region continue to step up their anti-money laundering/combating financing of terrorism (AML/CFT) measures. According to the Basel AML Index 2017, this region is ranked highest on the African continent in terms of anti-money laundering. North African countries also work in close cooperation with GAFIMOAN (Middle East and North Africa Financial Action Task Force) to correct existing failures and implement AML/CFT action plans.

At the same time, the banks must strengthen their supervisory capacity in order to comply with international standards and deal with the emergence of new risks. The countries must reinforce their supervisory capacity and make it sufficiently risk-based. The initiatives taken by certain central banks to promote regulatory harmonisation with other central banks in the region are welcome (IMF, 2016; IMF 2017a; IMF 2017b; IMF, 2018).

6.5. Conclusion

North African countries have demonstrated their ability to evolve and transform themselves in a sometimes difficult environment. The macroeconomic situation should continue to benefit from the implementation of economic and social reforms in the majority of countries, as well as the maintenance of political stability and ongoing efforts towards regional integration. The geographical position gives the region a considerable advantage in attracting foreign direct investment.

Financial inclusion is progressing in the region. Non-bank financial institutions and capital markets are still at an early stage of development and account for only a small share of total assets of the financial sector in a number of countries. However, central banks have put in place financial inclusion strategies and more specifically SME-focused policies to facilitate their access to financial services. The growing development of mobile banking should also improve financial inclusion over time.

Constituting the vast majority of enterprises in North Africa, microenterprises and SMEs still need to have better access to financial products and services. SME lending in North Africa could benefit from reformed secured transaction frameworks and better credit information. Capacity building for banks to strengthen their credit risk assessment would help those interested in lending to SMEs, without putting financial stability at risk. Moreover, efforts to build capacity for SMEs to improve their transparency would help to overcome information asymmetries and facilitate access to finance for SMEs. Further steps to improve access to finance through regulatory reforms include the establishment of modern secured transaction laws and more efficient collateral registries and the introduction of credit guarantee schemes to alleviate collateral constraints.

Access-to-finance constraints in North Africa build a rationale for intervention by International Financial Institutions (IFIs). Limited availability of long-term funding, unsophisticated financial markets and the need for specific assistance in several countries in the region undermine firms' access to finance. Moreover, banks' large exposure to government debt in some countries may crowd out the provision of credit to the private sector (see chapter 7).

IFI interventions can help to enhance the availability of long-term funding, equity finance and well-targeted guarantee schemes. Banks in the region often provide long-term lending with loans backed by credit lines from IFIs or national development banks. Moreover, the depth of private equity and venture capital markets remains insufficient in the region and the product range and investor base too limited. Intermediate IFI investment in equity funds and support for microfinance can contribute towards promoting private sector development and diversification of financial markets in the region. IFIs can also help to encourage banks to build SME lending capacity through well-targeted guarantee schemes.

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7. Ready for the Recovery? How Crowding Out by Public Debt Affects Lending to the Private Sector across Africa

Vivian F. de O. Schmidt[1] and Sanne Zwart[2,3]

Executive Summary

- With the economic recovery in Africa underway, banks' role as financial intermediaries is as important as ever. However, the recent economic slowdown resulted in increased public debt on banks' balance sheets, higher interest rates on sovereign paper in many African countries and failing banks.

- Higher public debt holdings and interest rates could hold back banks' lending to the private sector, which is a cause for concern as public debt levels are likely to remain high in the coming years. However, more insight is needed to understand the extent to which a country's banking sector will be able to support the recovery and the role played by banks' holdings of sovereign paper.

- A stylised index is constructed to provide a quantitative assessment of the extent to which public debt crowds out lending to the private sector. The index allows for comparisons across countries and over time, leading to a deeper understanding of the drivers of crowding out. Besides considering the supply of public debt and the demand for private credit, the index explicitly assesses banks' behaviour towards lending to the private sector and lending in general, including pricing considerations.

- According to the index, crowding out has increased throughout Africa during the period 2014-18, and its prevalence is elevated in Ghana, Niger, Tanzania and Zambia.

- On average, the higher supply of public debt was initially the main factor behind the increase of crowding out, but has now been taken over by banks' decisions towards lending. In 2018, the economic recovery and higher demand for private credit also started to push up the index in many countries.

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[3] The authors would like to thank Sanja Blatt, Claudio Cali, Nina Fenton, Andreas Kappeler, Barbara Marchitto, Farshad R. Ravasan, Ricardo Santos, Robert Schmitz and Christoph Weiss for their valuable comments on earlier drafts, and Morgan Ferriter and Nathalie Gilson for editorial support. The editorial closing date was 30 June 2018. However the views expressed in this chapter are those of the authors and do not necessarily reflect those of the European Investment Bank. All remaining errors remain the authors'.

- Additional analysis indicates that when growth picks up further, the extent of crowding out could reach elevated levels in several more countries. Importantly, the impaired capacity to lend to the private sector would in turn make it less likely that sustainably higher growth rates can be attained.

- Facilitating lending to the private sector by reducing the extent of crowding out could be achieved in various ways. Bringing down the financing needs of governments through fiscal consolidation and structural reform is key to free up space on banks' balance sheets. In addition, continuing the broadening of the investor base for government paper by, for example, developing local bond markets, would also reduce pressure on banks to hold large amounts of public debt. Enhancing banks' capacity to assess risk and monitor their clients would reduce the perceived risks and facilitate financial intermediation. Finally, helping clients to identify and present bankable projects would also raise lending to the private sector.

7.1. Introduction

Bank lending to the private sector is crucial to sustain the firming of economic activity. Most African countries, including non-resource intensive ones, experienced a difficult period recently, with lower growth rates and a deterioration of public finances. Banks have faced challenging lending conditions and a rise in non-performing loans, which led to more numerous collapses and interventions by public authorities. At the same time, the larger funding needs of governments and the lower private demand for credit caused a shift in banks' balance sheets towards sovereign paper. As economic activity has started to recover, the need for sustainable lending to support economic growth is increasing, and the question arises as to whether the banks are ready to step up their role as financial intermediaries.

Banks' rising exposure to the sovereign holds back other lending activities. Notably, banks are exposed to the sovereign through the sovereign debt on their balance sheets. Banks can use these exposures for various purposes, including investment, liquidity management and credit risk mitigation. At the same time, these sovereign debt holdings are essential for the operationalisation of monetary and fiscal policy. However, high yields and "risk-free" sovereign debt can intensify the crowding out of credit to the private sector.

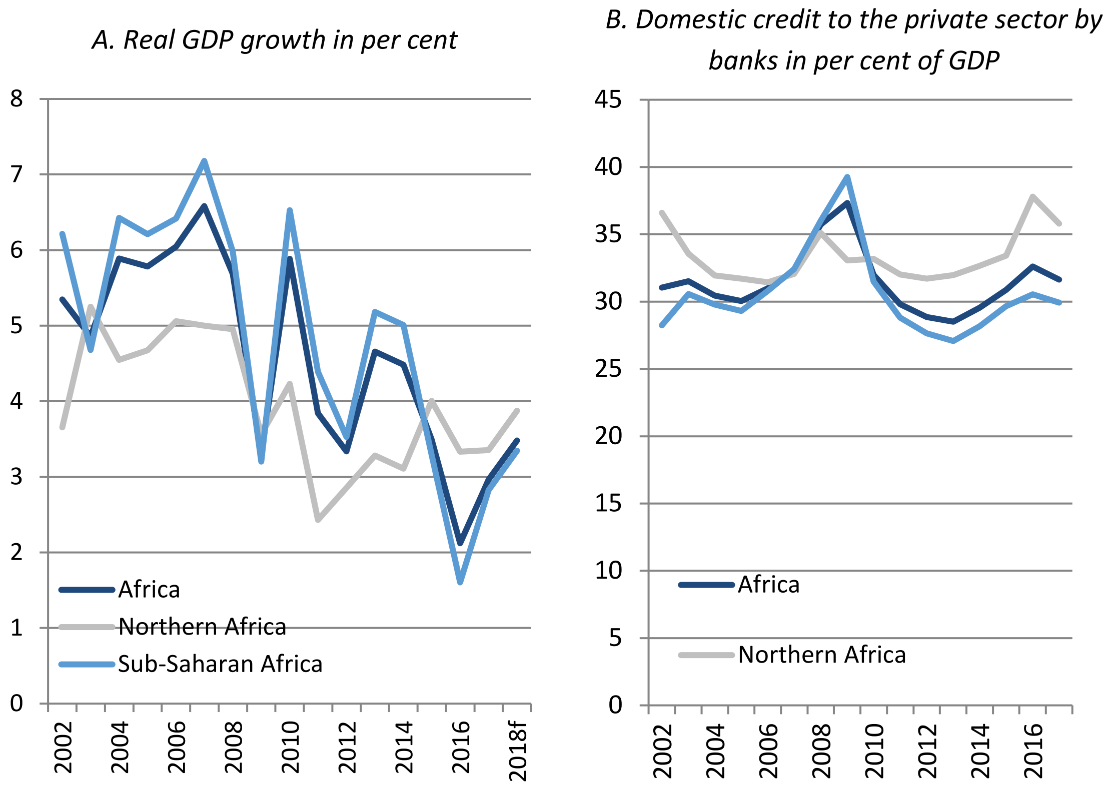
The severity of public debt crowding out is assessed by a stylised index which is used to analyse trends over time and across countries, while also providing insights into the underlying drivers. Rising public debt, lower private demand for credit and the increasing share of government securities on banks' balance sheets are closely related, and understanding how each of them affects banks' lending activity is rather complex. Scholars have estimated crowding out in various ways (Bouis, forthcoming; Fayed, 2012; Shetta & Kamaly, 2014), but the various contemporaneous effects and the disentangling of causes and reactions have proved daunting. Hence, a different approach is followed here: an index has been developed to gauge the Severity Of Crowding Out (SOCO). The SOCO index is based on annual data and aggregates three sub-indices which assess (i) the supply of public debt, (ii) the availability of investment opportunities and (iii) the state of banks' balance sheets. The SOCO index adds to the literature in three ways: it shows the severity of crowding out over time and across countries; it allows for drilling down to understand the underlying factors; and besides including the usual explaining variables it specifically captures banks' lending decisions.

The remainder of the chapter considers the question posed in the title from various angles. The next section focuses on the nascent economic recovery and recent domestic credit developments. The subsequent section discusses the deterioration of public finances during the last few years and how this is affecting banks' balance sheets and lending conditions. The extent of crowding out of lending to the private sector is then assessed based on the SOCO index. The last section presents conclusions.

7.2. The Economic Recovery Has Started, and Bank Lending to the Private Sector is Slowly Picking Up

Many countries in Africa were hit hard by the global financial crisis and the collapse in commodity prices. Until 2009, Africa enjoyed a prolonged period of strong economic expansion, supported by an improving business and macroeconomic environment, high commodity prices and highly accommodative global financial conditions. However, the tightening global financial conditions caused a growth slowdown in 2011-12. The subsequent cautious rebound was ended by the decline in oil and other commodity prices. Moreover, these external strains were compounded by domestic macroeconomic imbalances, electricity shortages and droughts, and in the case of northern Africa by the Arab Spring. As a result, the growth rate fell from an average of 6% during 2005-08 to just over 3% during 2014-17 (Figure 7.1., Panel A). The growth slowdown was widespread, but it hit commodity exporters particularly hard. In some countries growth held up well, supported by ongoing infrastructure investment and solid private consumption in oil-importing countries, but overall only seven countries recorded average annual growth above 6% over the last four years (Djibouti, Côte d'Ivoire, Ethiopia, Mali, Rwanda, Senegal and Tanzania).

Figure 7.1. - The Recovery Has Started, but Lending to the Private Sector is Lagging



Source: IMF WEO Database April 2018; World Bank World Development Indicators Database (Panel B only); authors' calculations.
Note for Panel A: Libya is excluded due to data limitations; 2018 is a forecast.

The global financial crisis hit financial sectors in Africa at different times. The repercussions of the global financial crisis for northern Africa were rather synchronised with those in advanced countries (Moriyama, 2010; Rocha, Arvai & Farazi, 2011). However, in sub-Saharan Africa, the impact was distinctly different from that experienced by advanced and many other merging and developing countries and regions (IMF, 2011; ADBG, 2009; Allen & Giovannetti, 2011). The first wave of the financial crisis, characterised by the rapid spread of financial turmoil in the United States to other developed economies and some emerging markets via closely interconnected financial systems, left sub-Saharan Africa comparatively unscathed. South Africa was an exception, on the back of high integration in international financial markets and its large banking sector (with assets equal to 125% of GDP): the country went into recession in 2008/09 for the first time in 19 years. Other countries were much less affected due to weak integration of the region's underdeveloped financial markets, virtually no exposure to assets immediately affected by the fallout, and only limited reliance on capital inflows. However, the second wave of the turmoil, when disorder in the financial sector began to have an impact on the real economy, had profound consequences for financial sectors on the continent. Nigeria went through a full-blown banking crisis (10 banks closed in 2009/10), and financial stability only returned once the central bank injected USD 1.7bn (0.6% of GDP) to ensure liquidity and enforced leadership changes in eight local banks.

Growth bottomed out in 2016, but the recovery is tepid. In 2016, economic activity contracted in seven countries, including Angola and Nigeria, while growth in South Africa came to a standstill. Growth picked up in 2017 as oil production rebounded and a good rain season boosted agricultural production, and the recovery continued in 2018. Nevertheless, the current growth rate of about 3% is just in line with population growth, and stronger growth is needed to improve living conditions across the continent. Moreover, economic performance differs widely across countries, and the below-trend growth of the two largest economies in the region, Nigeria and South Africa, weighs on prospects for the region.

Banks' capacity to support private sector activity is crucial for a sustainable recovery. Bank credit to the private sector peaked around 2009 when it reached some 37% of GDP (Figure 7.1., Panel B). The subsequent decline was modest in northern Africa and has been more than offset by recent credit growth. In sub-Saharan Africa, however, the drop in bank lending to the private sector was more pronounced. Notwithstanding some recent improvement during 2014-16, it remains about a quarter below its 2009 level. In both regions, the volume of bank loans to the private sector is smaller than in Latin America and the Caribbean and in South Asia, where it stands at 45% of GDP. Economic growth typically goes hand-in-hand with an expanding banking sector, but, crucially, depressed bank lending could hold back growth. Hence, to support the economic recovery, banks would need to have the capacity to step up lending to the private sector.

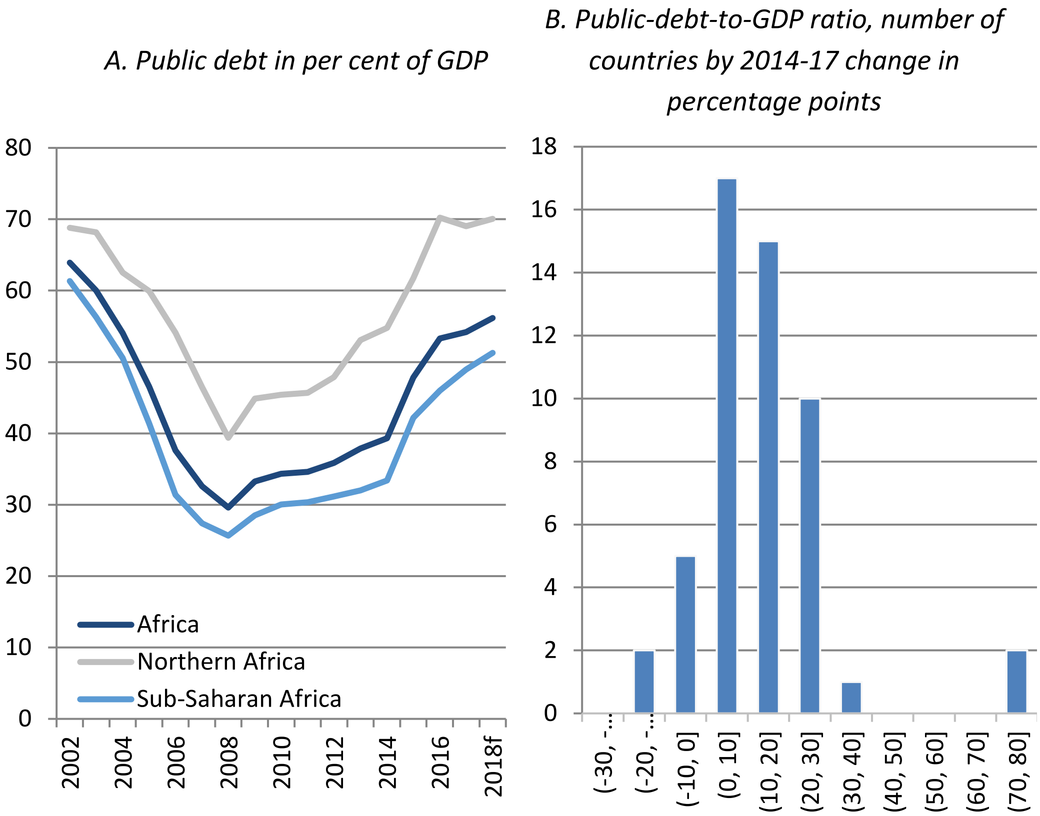
7.3. The Deterioration in Public Finances is Affecting Banks' Balance Sheets and Lending Conditions

7.3.A. Banks Hold Larger Amounts of Public Debt than Before the Crisis

Public debt has increased substantially across the continent since 2008. High growth, better public financial management and debt relief led to a significant reduction in public debt relative to GDP in the early 2000s (Figure 7.2., Panel A). However, in 2008 public debt accumulation started to outpace economic growth, and especially during 2015 and 2016 public-debt-to-GDP ratios deteriorated substantially. The recent fall in commodity prices in particular affected the debt position of commodity exporters, but also that of many other countries in the region: more than 80% of African countries recorded an increase in the public-debt-to-GDP ratio during 2014-17 (Figure 7.2., Panel B) and the increase was more than 10 percentage points of GDP for more than half of those countries. About 37% of African countries had high or distressed public debt levels as of June 2018 according to the IMF and the World Bank, and rating agencies have downgraded many of them over the past few years[4].

[4] Of those countries which, based on their low income per capita and limited capacity to access international financial markets on a durable and substantial basis, are eligible for concessional financial resources under the IMF's Poverty Reduction and Growth Trust, the share is somewhat higher, namely around 40%.

Figure 7.2. - Public Debt Has Been Growing Rapidly until Recently in Most Countries

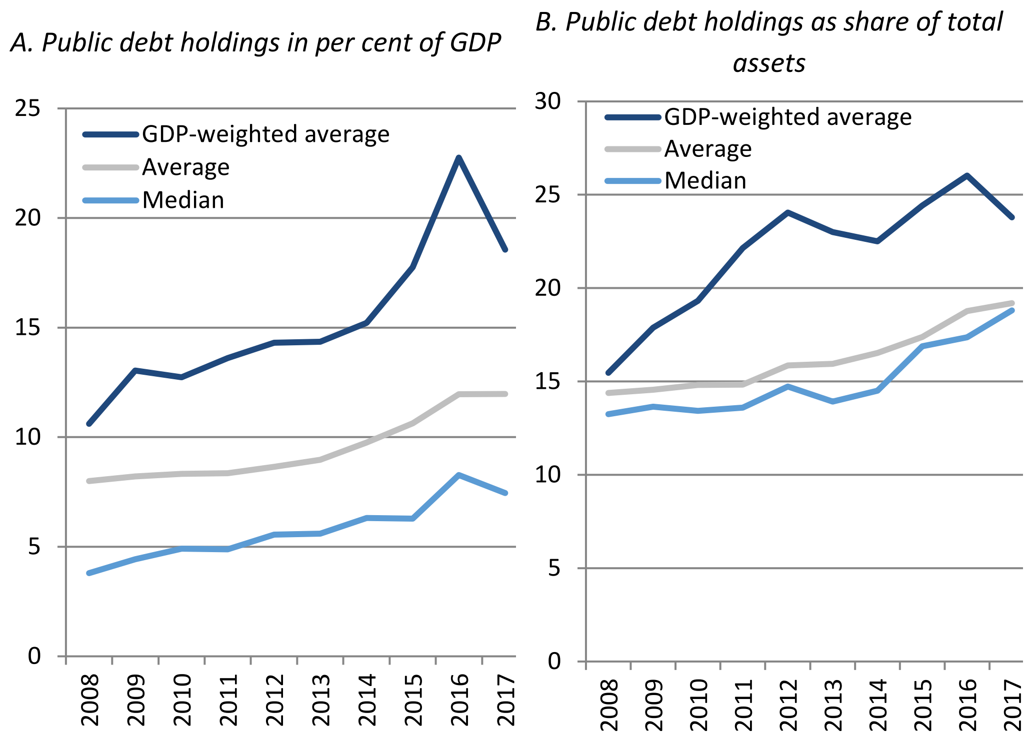


Source: IMF WEO Database April 2018; authors' calculations.
Note: Libya and Somalia are excluded due to data limitations; 2018 is a forecast.

The financing of public debt has shifted towards domestic sources. The importance of domestic debt has been growing since 2013, reflecting the decline in concessional external borrowing and countries' wish to develop domestic debt markets (IMF, 2017). Moreover, international bond issuances came to a standstill during the crisis and only resumed, albeit cautiously, recently. Banks remain the main holders of domestic debt (although the share of central banks' holdings has declined due to legal limits), but the investor base has been broadening with the rise of non-banking institutions (e.g. from the pension and insurance sector) and domestic debt markets progressively opening up to non-resident investors (Unctad, 2016).

Banks have raised their holdings of public debt in recent years. As a share of GDP, banks' holdings of public debt increased on average from 8% in 2008 to 12% in 2017 (Figure 7.3., Panel A). In almost 80% of the countries, banks increased their holdings over the last three years. The GDP-weighted average is structurally higher than the simple average as banks in some of the larger countries, in particular Algeria and Egypt, hold large amounts of sovereign paper. These countries are also driving the decline observed in 2017. Banks' holdings of public debt have increased faster than their balance sheets, and they now account for around 19% of banks' assets compared to some 14% in 2008 (Figure 7.3., Panel B). During the last three years, this share has increased in around three-quarters of the countries, and in a quarter government paper now accounts for more than 25% of banks' assets.

Figure 7.3. - Public Debt Holdings of Banks



Source: IMF International Financial Statistics database; IMF WEO Database April 2018; authors' calculations.
Note: Panel A covers 46 countries; Panel B 40; missing data approximated by last available observation.

Public debt will remain high in the medium term, providing limited room in banks' balance sheets for lending to the private sector. Debt levels have continued to rise on average, with some pronounced increases in several countries. For all countries, a sizeable decline in the debt burden crucially depends on improvements in fiscal stance and growth performance, which highlights the importance of prudent fiscal management and the implementation of structural reforms. Both in turn require political commitment and time to bear fruit. Although the improved macroeconomic conditions would make debt securities more attractive for foreign investors, this effect is probably outweighed by concerns over debt sustainability in the context of tightening global financial conditions. Therefore, a major shift from domestic to foreign financing sources is unlikely soon, which implies that local banks will continue to hold large amounts of government paper.

7.3.B. Banks Increased their Sovereign Debt Holdings for Various Reasons

At any point of the economic cycle, banks use public debt securities for several purposes (BCBS, 2017). Sovereign securities can be useful for banks' balance sheet and liquidity management, as they are usually the most liquid assets (although the extent to which they are liquid varies widely among countries and maturities). Banks also hold such securities to meet regulatory liquidity requirements, while legislation often provides for more favourable capital treatment or even requires a share of assets to be held in government paper. Banks can also hold sovereign debt as part of their role as primary dealers or market-makers for such exposures.

Various reasons can explain the recent build-up of public debt holdings by banks during the economic slowdown. The downturn reduced the number of good investment opportunities. At the same time, the increased offering of sovereign debt (combined with fewer foreign investors) has been providing a way for banks to make a return on their assets. The relative attractiveness of investing in private sector or government securities is determined by their relative (risk-adjusted) interest rates, and the high interest rates on government paper have been a decisive factor for many banks to increase their debt holdings, particularly during an economic slowdown. In some countries, banks' purchases of government securities have been facilitated by the central bank refinancing operations of commercial banks (e.g., in Gambia and Togo), with banks taking advantage of the spread between interest rates on government debt and refinancing rates (IMF, 2017). Sometimes, some form of financial repression leads to banks holding larger amounts of public debt than they would have preferred.

7.3.C. Large Public Debt Holdings and the Associated High Interest Rates Could Make Crowding Out more Severe

The rise in public debt and the higher public debt holdings of banks can have various macroeconomic implications. An economic slowdown is in general associated with a reduction in bank lending, reflecting limited investment opportunities and a diminished ability of banks to raise market funding (Agarwal, Duttagupta & Presbitero, 2017). Higher issuance of public debt would further reduce lending to the private sector by providing a potentially attractive alternative investment. Government borrowing also affects private lending through higher lending rates, which is observed throughout Africa. Alternatively, administrative controls can limit the impact on interest rates (Reinhart, Kirkegaard & Sbrancia, 2011), but with the consequence that banks are no longer able to reflect risks fully in the price, which in turn also hampers lending. Kenya is a case in point, as a well-intended interest rate cap on loans and a floor on deposits have been in place since September 2016, holding back lending activity. Finally, higher public debt levels and increasing public debt holdings by banks increase risks, including systemic risks, but so far these risks have remained manageable (Box 7.1.).

Box 7.1. - Rising Public Debt and Higher Holdings by Banks Increase Risks

Taking on more public debt holdings can be optimal for a bank with a profit-maximising perspective, but could also reduce its performance and stability. When banks become more exposed to the sovereign, this could raise risks related to credit, interest rates and refinancing - especially if the increased public debt holdings reflect a deterioration of public finances.

A weakening of the sovereign can affect banks through the following channels (BCBS, 2017):

- Direct exposure: arrears, or even non-payments, could inflict losses, weakening banks' balance sheets.
- Collateral: a lower value of sovereign collateral used by banks could raise funding costs and liquidity needs.
- Sovereign credit rating: as the sovereign rating is often a ceiling for other entities in the economy, a downgrade of the sovereign could precipitate downgrades of banks.
- Government support channel: implicit and explicit government guarantees are worth less, raising funding costs.
- Macro-economy: unanticipated, higher inflation could generate losses, while the smaller fiscal space and the weaker sovereign make an economic downturn more likely, thereby increasing borrowers' riskiness and banks' fragility.

The interconnectedness of banks and sovereigns could also lead to a negative feedback loop. When public financing needs increase, banks' willingness to invest in sovereign debt helps to absorb the shock. However, if banks subsequently reduce their lending to the private sector (for example because of a worse risk-return profile or the impact of the above channels), this could worsen economic conditions and ultimately the fiscal position. If problems are so large that banks require public financial support, this would further erode the sovereign's creditworthiness.

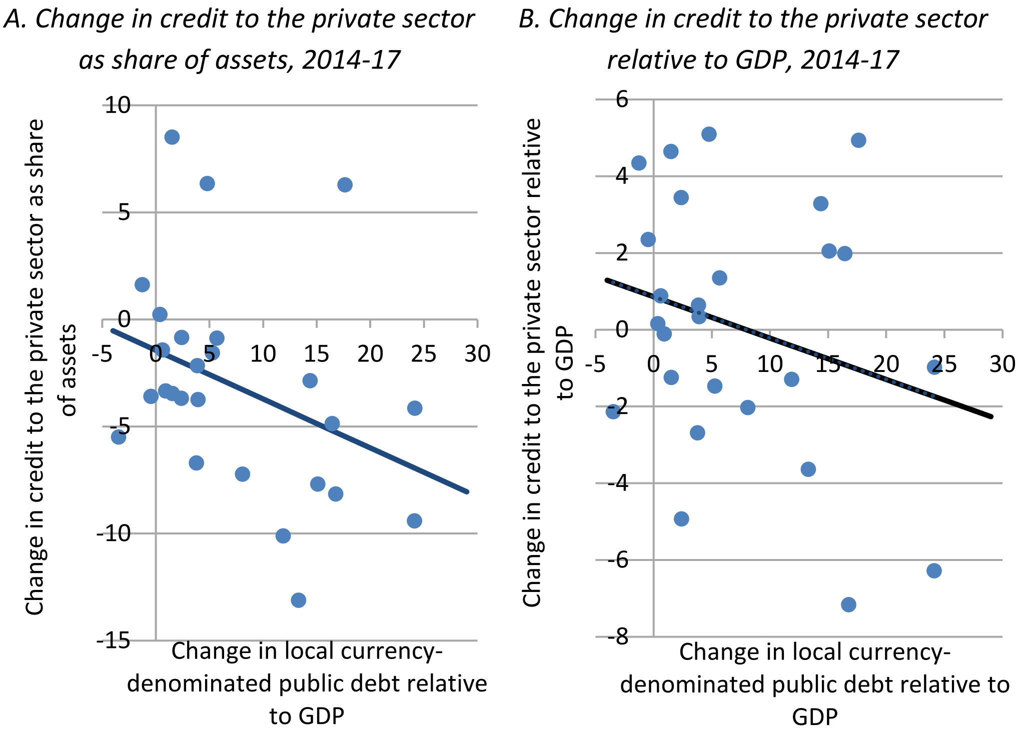
Although debt levels have increased considerably in several countries, the increased financial sector risks have been managed rather prudently so far. Government arrears have increased in many countries, while many sovereigns have been downgraded. These developments compounded the effects of the growth slowdown, and financial sector vulnerabilities have increased. Nevertheless, bank failures have only become somewhat more numerous, and their repercussions on the overall stability of the financial sectors have been limited. A case in point is Mozambique, where the government's default on commercial debt triggered large rating downgrades. Interest rates on domestic public debt reached 20% in the first quarter of 2018, while economic growth dropped substantially from over 7% during 2011-15 to just over 3% during 2016-17. The central bank had to take control of two banks with problems, but its interventions were successful in containing the potential fallout and maintaining overall financial stability.

In its broadest sense, crowding out refers to reduced lending to the private sector due to sovereign debt holdings. Its severity tends to increase when the supply of public debt increases, as it could then lead to higher interest rates and/or a reduced capacity of banks to provide credit. The increase in the supply of government securities - that are widely perceived to be risk-free - to finance budgetary deficits usually results in rising interest rates. To the extent that the increase in supply is met by higher demand by banks, this reduces the appetite and resources that banks have available to lend to the private sector. These effects tend to occur simultaneously, which makes it difficult to disentangle them. Crowding out hampers private sector activity, and the effect on longer-term growth will be most pronounced if governments use the obtained resources for non-productive purposes.

Given the various reasons banks have to increase their public debt holdings, assessing the extent of the related crowding out requires careful analysis (Shetta & Kamaly, 2014). If banks have excess liquidity, there is not necessarily any effect on banks' lending activities. If liquidity is not abundant, the low risk of sovereign lending could (theoretically) allow banks to take more risk and increase lending to the private sector. The opposite can also happen if banks are discouraged from lending to the risky private sector given the limited additional return. According to this "lazy bank model", higher public debt holdings will thus crowd out private sector lending.

A simple analysis provides some tentative evidence of crowding out and highlights the need for a more thorough examination. In many African countries, the increase in local currency-denominated public debt during 2014-17 occurred simultaneously with a decline in credit to the private sector as a share of banks' assets and as a share of GDP (Figure 7.4.). The shift in banks' asset composition away from private sector credit is statistically more significant than the reduction in private sector credit relative to GDP (note of Figure 7.4.). This negative relationship confirms research on recent private credit growth in Africa (Bouis, forthcoming). The various ways of assessing the impact on private credit (e.g. considering the relative composition of the balance sheet, changes in credit relative to GDP or growth of nominal lending) together with the many contemporaneous developments (e.g. a reduction in GDP growth, an increase in interest rates and inflation, and changes in exchange rates) highlight the complications of conducting an empirical analysis.

Figure 7.4. - An Increase in Local Currency-Denominated Public Debt often Occurs Simultaneously with a Decrease in Credit to the Private Sector



Source: IMF International Financial Statistics database; IMF WEO Database April 2018; authors' calculations.

Note: In panel A, the trend line has a coefficient of -0.23 with a standard error of 0.12 (10% significance level); in panel B the coefficient is -0.11 with a standard error of 0.08 (around 20% significance level). The R^2 coefficients of determination are 0.13 and 0.06. The analysis is based on 26 countries due to data limitations and the removal of outliers.

7.4. The SOCO Index Points to more Severe Crowding Out Throughout Africa

7.4.A. The Extent of Crowding Out can be Assessed with a Stylised Index

With the economic recovery underway, it is important to gain a better understanding of the extent to which crowding out is occurring in individual African countries. Growth is picking up, and banks will need to increase financial intermediation to sustain the recovery. When banks' capacity to do so is limited, growth could remain tepid. Given the large differences between countries, crowding out will be more of a concern in some countries than in others.

To analyse the Severity of Crowding Out for individual countries across Africa, a stylised SOCO index is developed. A vast literature analyses the causes and impact of public debt on private lending (see Box 7.2.). However, while some studies undertake an in-depth analysis of a single country and others perform a cross-country analysis, no study simultaneously assesses the extent of crowding out in various countries. Doing so would require a uniform methodology that provides sufficient room for country-specific developments, building upon commonly used indicators such as institutional quality or business conditions and the level of financial intermediation, but also upon multiple measures for both the supply of public debt and the demand for credit, as single measures only tell part of the story. This approach is followed for the SOCO index, which can be calculated annually for the years 2014 to 2018 for the 39 African countries for which sufficient data is available.

Box 7.2. - Estimating Crowding Out of the Private Sector by Public Debt: Approaches and Findings

Various approaches have been followed to estimate the extent of crowding out. In order to measure the degree of crowding out of private credit by government spending in individual economies, researchers have examined the impact of public debt on interest rates. Nonetheless, since credit markets rarely reach equilibrium solely through changes in interest rates, estimating changes in the quantity of credit may give a more precise indication of the effect of rising government borrowing. Therefore, several economists have approached the problem by regressing the amount of credit to the private sector or its growth rate on government borrowing, while controlling for relevant variables such as the level of financial intermediation, institutional quality, GDP, lending and inflation rates, as well as other relevant prices, such as commodity prices in the case of natural resources-dependent economies.

Given the complicated nature of the issue, all approaches have advantages and disadvantages. Using credit-to-GDP instead of the growth rate of lending as dependent variable avoids issues related to inflation, but instead makes the assessment lean more towards explaining financial deepening. In addition, specific variables that may capture the demand and supply of credit to the private sector, such as interest rates and proxies for investment needs, are often not included, probably due to data limitations. However, including these variables and proxies, as well as those related to banks' balance sheets, is essential for understanding how all the factors come together.

Empirical evidence indicates that increased public debt can lead to crowding out of private sector lending. Various studies provide empirical evidence on the negative effect of government borrowing on private lending. According to research conducted with data of 60 developing countries from 1975 to 2006, one additional dollar borrowed by the government reduces private credit by 1.40 dollar (Emran & Farazi, 2009). The findings of a study conducted with data of 27 sub-Saharan countries over the period 1980-2000 support the crowding-out hypothesis, suggesting a 1 percentage point increase relative to broad money in government borrowing decreases private sector lending by 0.15 percentage points of broad money (Christensen, 2004). More recent research for sub-Saharan Africa finds that a 1 percentage point increase in banks' exposure to the government is associated with a 0.6 percentage point decrease in the annual growth of credit to the private sector (Bouis, forthcoming).

Country-specific studies also find evidence of crowding out in Africa. For example, in Egypt a 1 pound increase in government borrowing was found to reduce private credit by approximately 4 pounds during the period 1998-2010, which was assumed to be the result of "lazy banks" which prefer to invest excess liquidity in low risk return investments (Fayed, 2012). For Kenya, a study using data from 1966 to 2014 provides evidence on the crowding out effect of private sector lending if government debt rises persistently, with a 1% increase in government debt as a share of GDP reducing credit to the private sector by 0.143 percentage points the following year (Makambi, Muhindi & Nduku, 2017).

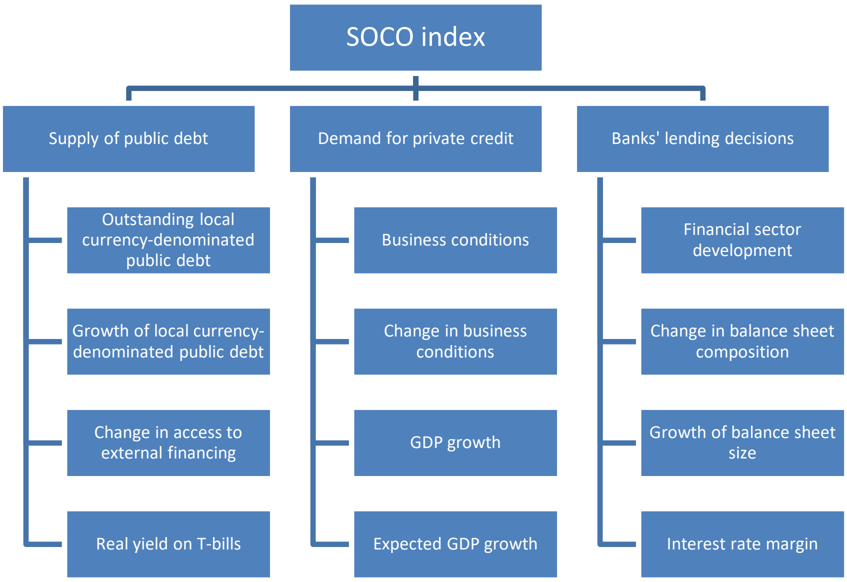
The SOCO index aggregates 12 indicators related to the supply of public debt, the demand for private credit and banks' lending decisions. The choice of indicators was guided by empirical findings in the literature on the key determinants of crowding out. The selected indicators capture either cross-country or country-specific elements so that the SOCO index allows both for a comparison across countries and over time. The construction of the indicators is done in such a way that spurious impact of inflation and exchange rate developments is avoided. The index is built following a standard approach: the 12 indicators are standardised and divided into three groups; three sub-indices are computed as the unweighted average of each group's indicators; the unweighted average of the sub-indices constitutes the SOCO index (Figure 7.5.). The three sub-indices and their underlying indicators are as follows (the appendix contains the details):

- **Supply of public debt:** Most researchers measure the supply of public debt by including the level of public domestic debt in their regressions (Ali, Ahmad & Ur-Rahman, 2016; Anyanwu, Gan & Hu, 2017; Christensen, 2004), implicitly assuming that the supply is exogenous and independent of (equilibrium) interest rates. The SOCO index follows this approach by including the level of local currency-denominated public debt in per cent of GDP, but in addition also includes its growth rate to have a full picture of the financing needs of the public sector and hence the amount of sovereign debt potentially supplied to domestic banks. Changes in access to external financing sources are gauged by the difference between the growth rate of foreign currency-denominated public debt in USD and the growth rate of local currency-denominated public debt. This indicator gauges the pressure on domestic banks to finance public debt. In addition, the real return on government securities is included as a fourth indicator to assess the return, and hence attractiveness, of holding public debt.
- **Credit demand by the private sector:** In the literature, the demand for private credit is captured by general business conditions and by macroeconomic developments (Fayed, 2012; Anyanwu, Gan & Hu, 2017). An economy's regulatory environment and rule of law can be important determinants of private credit demand and thus investment. A similar approach is followed by the SOCO index, which includes the World Bank's Doing Business distance to frontier as a proxy for the ease of doing business and hence the demand for

investment (the Doing Business indicator also covers the ease of access to credit). The change in the distance to frontier is included as well to indicate whether conditions improved or worsened, which would point to a likely increase or decrease in credit demand. Similarly, high current GDP growth would point to rising levels of investment and a higher demand for credit, and the same holds for next year's expected growth.

- **Banks' lending decisions:** Very often, this part of the analysis is the least well developed, as many researchers focus only on credit provided by the banking system to the private sector without putting this in the broader context from the banks' perspective (Fayed, 2012; Ali, Ahmad & Ur-Rahman, 2016). The SOCO index expands on the literature by explicitly evaluating the extent to which banks' balance sheet size, risk preferences and profitability affect the amount of private credit provided. Overall financial sector development and access to credit are captured by credit to the private sector as a share of GDP. The change in banks' asset composition and total asset growth are used to measure banks' behaviour towards lending to the private sector and lending in general. The spread between the lending rate and the T-bill yield is an indication of the attractiveness of lending to the private sector compared to investing in government paper.

Figure 7.5. - The SOCO Index, its Sub-Indices and the Underlying Variables



The SOCO index provides an assessment of the relative extent of crowding out across countries and over time. To evaluate developments in the last few years, the SOCO index is calibrated over a long period, namely 2004-13, that captures both episodes of rapid economic expansion and slowdown. For each indicator, the value is transformed into a score from 0 to 1 based on the quintiles[5] of the 2004-13 data in such a way that higher scores are associated with a higher extent of crowding out. Hence, the index

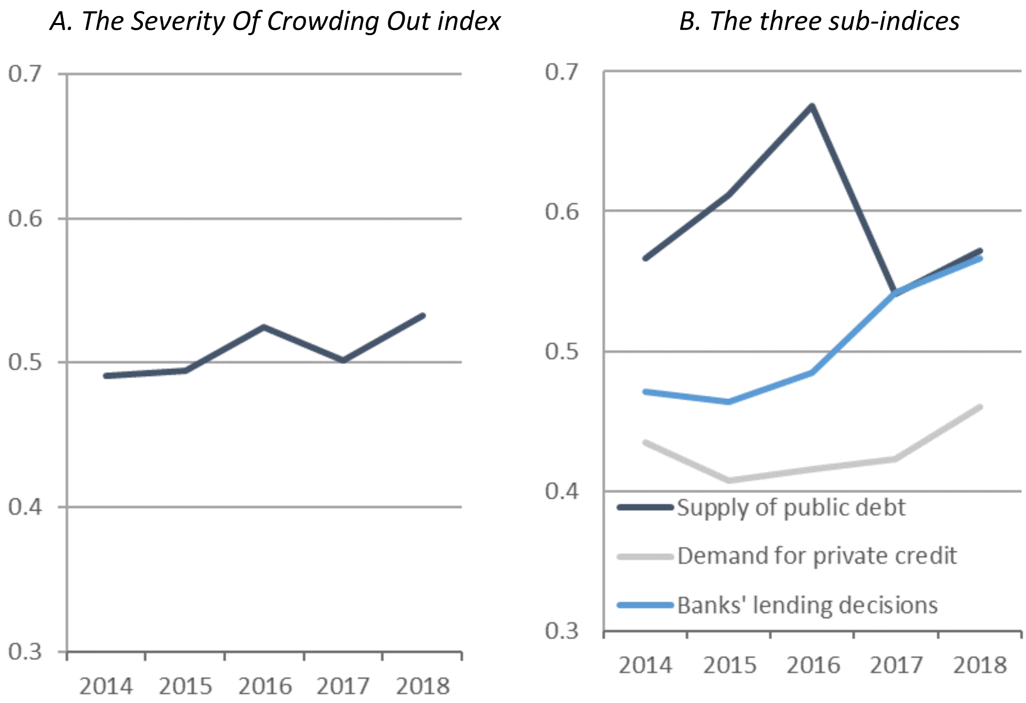
[5] Using quintiles ensures that for countries with complete 2004-13 data, no threshold is uniquely associated with a single observation, which improves robustness.

assesses the relative extent of crowding out compared to the calibration period but does not provide an absolute assessment of the extent. Nevertheless, the SOCO index provides an assessment of how the severity of crowding out has evolved over time and how a country performs relative to its peers. In particular, the average score of 0.5 during 2004-13 and the maximum score of 1 provide references for interpreting the result.

7.4.B. The Extent to which Public Debt Crowds Out Lending to the Private Sector Has Increased in Many African Countries

The extent of crowding out has increased in Africa. In 2014 and 2015, the SOCO index - covering 39 countries - was slightly below its 2004-13 average of 0.5 (Figure 7.6., Panel A). However, in each of the subsequent years it was higher. In 2018, based on the available data at mid-year, the SOCO index stood at 0.53. The increase is quite substantial given the number of countries and their different economic situations.

Figure 7.6. - The Extent of Crowding Out in Africa Has Increased According to the SOCO Index



Source: Authors' calculations based on publicly available data.
Note: 0 indicates low severity; 1 high severity; 0.5 is the average for 2004-13.

Initially, the increased supply of public debt increased the severity of crowding out, but since 2016 banks' lending decisions have become the main driver. The sub-index measuring the supply of public debt increased rapidly between 2014-16, driven by the increase in local currency-denominated public debt, but came down in 2017 (Figure 7.6., Panel B), as the pace of debt accumulation slowed down while access to external financing improved. The sub-index characterising banks' lending decisions contributed the most to the rise of the SOCO index. Banks shifted their asset composition somewhat towards public securities, but more importantly balance sheet growth was very low or even negative. The demand for private credit has remained broadly stable, reflecting the combination of a gradual improvement in business conditions and a decline in growth. Interestingly, with the recovery underway, the demand for private credit index started to rise in 2018.

The SOCO index points to increased levels of crowding out for many countries. The severity of crowding out is higher in 2018 than in 2014 for 25 out of 39 countries (Table 7.1.). Ghana, Niger, Tanzania and Zambia stand out as countries where crowding out is most severe. These countries, as well as Burkina Faso, Egypt, Kenya and Mozambique have seen considerable increases in recent years that have pushed up the SOCO index to elevated levels.

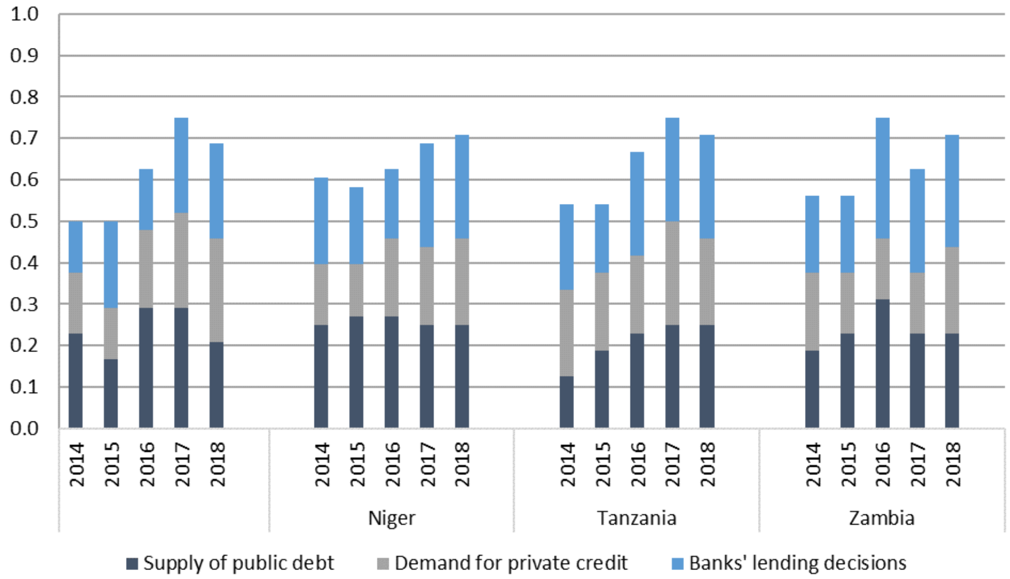
Table 7.1. - The Extent of Crowding Out across Africa according to the SOCO Index

Country	2014	2015	2016	2017	2018	5.5% growth scenario	7% growth scenario
Algeria	0.33	0.33	0.40	0.46	0.46	0.56	0.60
Angola	0.40	0.40	0.54	0.48	0.42	0.54	0.58
Benin	0.56	0.65	0.60	0.65	0.65	0.65	0.69
Botswana	0.40	0.38	0.42	0.42	0.50	0.54	0.58
Burkina Faso	0.46	0.60	0.67	0.56	0.65	0.65	0.69
Burundi	0.52	0.50	0.40	0.33	0.33	0.46	0.50
Cameroon	0.44	0.48	0.40	0.46	0.50	0.56	0.60
Chad	0.35	0.52	0.42	0.50	0.35	0.46	0.50
Comoros	0.34	0.15	0.33	0.39	0.47	0.55	0.59
Djibouti	0.53	0.53	0.65	0.40	0.53	0.53	0.58
Egypt	0.50	0.56	0.50	0.48	0.63	0.67	0.71
Equatorial Guinea	0.40	0.40	0.40	0.38	0.42	0.54	0.58
Eritrea	0.49	0.41	0.51	0.42	0.40	0.48	0.52
eSwatini	0.38	0.48	0.48	0.54	0.54	0.67	0.71
Gabon	0.42	0.44	0.48	0.35	0.46	0.56	0.60
Ghana	0.50	0.50	0.63	0.75	0.69	0.67	0.71
Guinea-Bissau	0.56	0.58	0.63	0.56	0.58	0.63	0.67
Kenya	0.48	0.67	0.67	0.65	0.65	0.67	0.71
Lesotho	0.46	0.46	0.44	0.48	0.48	0.60	0.65
Madagascar	0.44	0.25	0.50	0.40	0.44	0.48	0.52
Mali	0.60	0.54	0.58	0.58	0.60	0.65	0.69
Mauritius	0.50	0.54	0.58	0.50	0.56	0.65	0.69
Morocco	0.54	0.60	0.60	0.63	0.52	0.60	0.65
Mozambique	0.54	0.42	0.56	0.54	0.65	0.75	0.79
Namibia	0.63	0.48	0.65	0.56	0.63	0.73	0.77
Niger	0.60	0.58	0.63	0.69	0.71	0.75	0.79
Nigeria	0.48	0.48	0.33	0.44	0.52	0.65	0.69
Rwanda	0.58	0.52	0.50	0.52	0.58	0.54	0.58
Senegal	0.42	0.58	0.67	0.52	0.52	0.52	0.56
Seychelles	0.58	0.71	0.65	0.44	0.52	0.60	0.65
Sierra Leone	0.48	0.42	0.44	0.42	0.44	0.50	0.54
South Africa	0.46	0.40	0.54	0.50	0.48	0.60	0.65
South Sudan	0.57	0.62	0.30	0.35	0.63	0.76	0.80
Sudan	0.55	0.47	0.47	0.35	0.35	0.44	0.48
Tanzania	0.54	0.54	0.67	0.75	0.71	0.71	0.75
Togo	0.60	0.60	0.63	0.52	0.54	0.58	0.63
Tunisia	0.38	0.38	0.42	0.46	0.35	0.46	0.50
Uganda	0.56	0.56	0.50	0.54	0.63	0.65	0.69
Zambia	0.56	0.56	0.75	0.63	0.71	0.77	0.81
Africa	0.49	0.49	0.52	0.50	0.53	0.60	0.64

Note: The intensity of the blue highlighting increases with the SOCO index, with the thresholds being 0.60, 0.70 and 0.80. In the two growth scenarios, GDP growth and expected growth are both set to either 5.5% or 7%, while all other indicators are kept at their 2018 values.

Due to the way the SOCO index is constructed, the drivers of the recent increase can be analysed for individual countries. Especially for the four countries with the highest SOCO scores in 2018 and large increases in the preceding years, this analysis is useful to understand the underlying factors (Figure 7.7.). In all these countries, the supply of public debt has been making a large contribution in recent years, confirming that governments' high funding needs are weighing on financial intermediation. Indeed, in all countries the resulting gradual increase in the contribution of banks' lending decisions has been driving the overall increase. Importantly, the severity of crowding out remains high even though the contribution of the supply of public debt has receded to earlier levels. In Ghana and Niger, additional pressures have been coming from higher demand for credit.

Figure 7.7. - Drivers of the Rising SOCO Index for Countries with the Highest Scores



Source: Authors' calculations based on publicly available data.

With the current conditions, a sustained recovery is likely to increase the extent of crowding out. In many countries, the subdued economic growth of recent years has held back demand for private credit, resulting in relatively low values of the second sub-index. Assuming that growth picks up to some 5.5% or 7% (e.g. due to external developments), which for most countries is achievable given past growth rates and population growth, and that, although unlikely, all other conditions remain the same, the SOCO index would increase for almost all countries (Table 7.1.). In particular, countries which already have high SOCO scores and where growth is subdued would see a pronounced increase in the severity of crowding out. Countries affected include again Ghana, Niger, Tanzania and Zambia, but also Egypt, eSwatini, Kenya, Mozambique, Namibia and South Sudan. These scenarios highlight the need for fiscal consolidation, continued broadening of the investor base for public debt, and ensuring that banks are aware that their financial intermediation is essential to support sustainable growth.

7.5. Conclusion

The SOCO index shows that the severity of public debt crowding out private lending has been rising throughout Africa and is high in several countries. The severity of crowding out is higher in 2018 than in 2014 for 25 out of 39 countries. On average, the supply of credit to the government was initially the main driver of the increase, but has now been taken over the banks' decisions towards lending. In 2018, the recovery and the increased demand for private credit has started to push up the index as well. Ghana, Niger, Tanzania and Zambia stand out as countries where crowding out is most severe. The SOCO index makes it possible to analyse the underlying drivers, which are found to differ considerably between countries.

The economic recovery is underway, but in many countries the banking sector could struggle to perform its role as financial intermediary during this crucial period. Banks in several countries are so exposed to the sovereign that they have only limited capacity to gear up lending substantially and support an economic revival. Further analysis based on the SOCO index shows that, should growth pick up further to some 5.5% or 7%, the extent of crowding out would reach elevated levels in several more countries. Importantly, the impaired capacity to lend to the private sector would in turn make it less likely that such growth rates are attained.

In many countries, the public finances situation will continue to weigh on banks' balance sheets. The still high government deficits in various countries together with a very gradual reduction in public debt indicate that banks' balance sheets will continue to have a high share of public debt. Even if deficits were to decrease soon, refinancing of the various international bonds that will start maturing from 2021 onwards could continue to put pressure on banks' balance sheets.

Lending to the private sector could be facilitated in various ways. Bringing down government financing needs through fiscal consolidation and structural reform is key to free up space on banks' balance sheets. Continuing the broadening of the investor base for government paper would also help in this regard, in particular fostering the development of local bond markets (IMF, 2018). In addition, enhancing banks' capacity to assess risk and monitor their clients would reduce the perceived risks and facilitate financial intermediation. Finally, helping clients to identify and present bankable projects would also increase lending to the private sector.

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Appendix: Details of the Severity Of Crowding Out (SOCO) Index

The indicators are constructed according to the definitions in Table 7.2.

Special care is given to the public debt indicators to ensure that the local currency-denominated and foreign currency-denominated public debt add up to the total. In case of data inconsistencies, the share of foreign currency-denominated debt is applied to the total public debt, after which the level of local currency-denominated debt is obtained. The change in access to external debt is calculated such that changes in the exchange rate do not affect the value of the indicator. To calculate the real yield on the (one year) T-bill, the average of past and future inflation is used, as half of the maturity period is in the current year and half in the next year. The indicators for banks' balance sheets are standardised such that inflation is filtered out. The lending rate is the annual average of the short-term lending rate to businesses, or the closest publicly available alternative.

Missing values before 2014 are left blank. From 2014 onwards they are approximated by the first or last available value, or the average if values for the preceding and subsequent year exist (if both the level and growth rate are needed, the growth rate is approximated and the level is subsequently derived). For public debt, these approximations are performed on the raw data; whilst for the other indicators, at the last step of their derivation in order to account for the strong correlation in the underlying series.

The quintiles are derived from the available (non-approximated) data from 2004-13. For cross-country indicators all data is pooled and the quintiles are identical for all countries; for country-specific indicators each country has different quintiles as they are based on the data of each country. Using quintiles ensures that for countries with complete data, no threshold is uniquely associated with a single observation, which improves robustness. For indicators for which less than five data points exist for the period 2004-13, the average of all countries' quintiles is used. In case of a positive correlation with crowding out, values below the first quintile are attributed a score of 0, those below the second but above the first quintile are assigned a score of 0.25, and so on until a score of 1 for the highest quintile. In case of a negative correlation, the scores are assigned in reverse order. An exception is the change in distance to frontier, as based on the three observations available before 2014 the quintiles cannot be constructed. Hence, the mean is used as a threshold and values below the mean are assigned a score of 0.25 and those equal or above a score of 0.75.

The definitions of the Doing Business indicator typically change every couple of years, and the thresholds thus have to be adapted as well. The adaptation of the thresholds is possible as for those years in which the definition changes, both the old and the new distance to frontier measures are provided. The new threshold is then set such that the share of countries with a lower new distance to frontier measure is equal to the share of countries with an old distance to frontier measure below the corresponding old threshold.

Table 7.2. - Definitions of Indicators

Indicator	Reference	Formula	Correlation with SOCO index
Supply of public debt			
Outstanding local currency-denominated public debt	Cross-country	$\frac{Public\ debt, LC_t}{GDP, current\ prices_t}$	↑
Growth of local currency-denominated public debt	Country-specific	$\frac{Public\ debt, LC_t}{GDP, current\ prices_t} - \frac{Public\ debt, LC_{t-1}}{GDP, current\ prices_{t-1}}$	↑
Change in access to external debt	Country-specific	$\frac{Public\ debt, FC\ (in\ USD)_t}{Public\ debt, FC\ (in\ USD)_{t-1}} - \frac{Public\ debt, LC\ (in\ USD)_t}{Public\ debt, LC\ (in\ USD)_{t-1}}$	↓
Real yield T-bills	Cross-country	$i_t^{T-bill} - \frac{i_t^{inflation} + i_{t+1}^{inflation}}{2}$	↑
Demand for private credit			
Business conditions	Cross-country	$Doing\ Business\ distance\ to\ frontier_t$	↑
Change in business conditions	Country-specific	$Doing\ Business\ distance\ to\ frontier_t - Doing\ Business\ distance\ to\ frontier_{t-1}$	↑
GDP growth	Cross-country	$\frac{GDP, constant\ prices_t - GDP, constant\ prices_{t-1}}{GDP, constant\ prices_{t-1}}$	↑
Expected GDP growth	Cross-country	$\frac{GDP, constant\ prices_{t+1} - GDP, constant\ prices_t}{GDP, constant\ prices_t}$	↑
Banks' lending decisions			
Financial sector development	Cross-country	$\frac{Banks'\ claims\ on\ private\ sector_t}{GDP, current\ prices_t}$	↓
Change in balance sheet composition	Country-specific	$\frac{Claims\ on\ private\ sector_t}{Total\ assets_t} - \frac{Claims\ on\ private\ sector_{t-1}}{Total\ assets_{t-1}}$	↓
Growth of balance sheet size	Country-specific	$\frac{Total\ assets_t}{GDP,\ current\ prices_t} - \frac{Total\ assets_{t-1}}{GDP,\ current\ prices_{t-1}}$	↓
Interest rate margin	Cross-country	$i_t^{lending\ rate} - i_t^{T-bill}$	↓

Source: T-bill yields from African Financial Markets Initiative appended by data from the IMF Monetary and Financial Statistics (MFS) database; Doing Business distance to frontier from the World Bank's Doing Business database; banks' claims on private sector and balance sheet data from the IMF MFS database; lending rates from central bank websites appended by data from the IMF MFS database; other variables from the IMF World Economic Outlook database April 2018, if necessary complemented by data from IMF reports to derive local currency-denominated and foreign currency-denominated debt shares.
Note: Debt, GDP, claims and assets are expressed in national currency unless indicated otherwise.

8. The State of Bank Recovery and Resolution Laws in Africa

Alan Bainbridge[1], Simon Lovegrove[2] and Jack Prettejohn[3,4]

Executive Summary

- Improving recovery and resolution laws in Africa would help to bring down funding costs and facilitate financial intermediation.

- Benchmarking the Financial Stability Board's Key Attributes of Effective Resolution Regimes shows that the state of recovery and resolution laws varies considerably across countries and whilst recovery and resolution is generally more developed on the continent than originally anticipated there remains scope for improvement.

- Requiring banks to prepare recovery and resolution plans which would subsequently need to be approved by regulators and maintained would be an important step forward. Similarly, introducing a well-defined recovery floor would also reduce uncertainty for investors as they would have a clear understanding of how their investment may be affected in a crisis management scenario.

8.1. Introduction

In general, financial intermediation benefits from strengthening recovery and resolution frameworks. An adequate recovery and resolution framework facilitates private sector lending by reducing uncertainty and creating a more equal playing field among banks. In Africa, strengthening the framework will in particular have beneficial effects on funding costs through supporting banks' access to international debt markets, credit ratings and correspondent banking relations.

The Financial Stability Board's Key Attributes of Effective Resolution Regimes are aimed at facilitating orderly resolution and maintaining the continuity of failed banks' vital economic functions without exposing taxpayers to losses flowing from bank failure, and have become international standards. A recent study undertaken by Norton Rose Fulbright LLP benchmarks recovery and resolution laws in Africa against the Key Attributes to identify gaps. The Key Attributes relate to, e.g. the scope of laws, the resolution authority, resolution powers, aspects of cross-border cooperation,

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[4] The authors would like to thank the European Investment Bank for its valuable comments on earlier drafts. Sanne Zwart provided editorial assistance. The editorial closing date is 30 June 2018. However the views expressed in this chapter are those of the authors and do not necessarily reflect those of the European Investment Bank or Norton Rose Fulbright. All remaining errors remain the authors'.

recovery and resolution planning and access to information. The study covers 17 countries throughout the continent.

8.2. Further Developing Bank Recovery and Resolution Laws would Help to Sustain the Economic Recovery in Africa

Financial intermediation will be supported if funding costs come down due to further improvements in recovery and resolution frameworks. There are important reasons as to why it is important to develop and articulate a credible approach to recovery and resolution and how this affects funding costs. There is ample literature on this. For example in 2013 a member of the Board of Governors of the United States Federal Reserve Board, Daniel Tarullo, explained the reasons at a conference for systemically important financial institutions (Tarullo, 2013).

First, a credible recovery and resolution framework reduces uncertainty. Unless creditors and counterparties have well-grounded expectations as to how they will be treated in a resolution setting, they may need to charge a premium to compensate for the additional uncertainty associated with the disposition of their claims, which can lead to a mispricing of risks. In some cases, particularly in periods of increasing stress in the financial system, they may be unwilling to deal with certain firms altogether. Parties that have short-term lending to or contractual arrangements with these firms may “run” as those loans or contracts lapse, thereby potentially crippling the ongoing business of the firm and creating adverse effects in other parts of the financial system.

Second, a credible framework creates a more equal playing field among firms. If creditors and counterparties do not believe that a firm can be successfully resolved, they may not price in the potential for losses that should be incorporated in their dealings with large firms. Investors and other market actors who think that the prospects for orderly resolution are low may assume that the firm will be rescued by the government and the moral hazard in these markets will continue.

The Financial Stability Board (“FSB”) has set out features for effective resolution of financial institutions. A year after Mr Tarullo’s speech the FSB published its *Key Attributes of Effective Resolution Regimes* (“Key Attributes”), which have become the international standards for resolution regimes (see Box 8.1.). The Key Attributes were produced in response to the 2008 global financial crisis, adopted by the FSB in October 2011 and subsequently endorsed by the G20 a month later in November 2011. The FSB added additional guidance to the Key Attributes in October 2014.

Box 8.1. - FSB's Key Attributes of Effective Resolution Regimes

The Key Attributes (FSB, 2014) aim at facilitating orderly resolution and maintaining the continuity of failed banks' vital economic functions without exposing taxpayers to losses from bank failures. The Key Attributes set out twelve essential features that should be part of the resolution regimes of all jurisdictions. Each essential feature is further described in the Key Attributes, and when taken together they comprise 35 components in total. The essential features relate to:

1. Scope
2. Resolution authority
3. Resolution powers
4. Set-off, netting, collateralisation, segregation of client assets
5. Safeguards
6. Funding of firms in resolution
7. Legal framework conditions for cross-border cooperation
8. Crisis management groups
9. Institution-specific cross-border cooperation agreements
10. Resolvability assessments
11. Recovery and resolution planning
12. Access to information and information sharing.

The Key Attributes prescribe a range of resolution tools to facilitate the objectives. Resolution authorities should have the power to take control of distressed banks and appoint administrators to restore to viability as much of the bank's business as possible (FSB, 2014). The continuation of critical banking functions is essential. The Key Attributes set out several options for resolution authorities to ensure that a bank's essential functions are continued, including procuring third party services or establishing bridge institutions. Cross-border cooperation is also an important issue. For the African context, these issues are discussed in more detail in the next section.

The Key Attributes are guiding principles for many African countries, but in varying degrees. South Africa is the only country in Africa to be a member of the G20 and the FSB and is therefore committed to implementing the framework contained in the Key Attributes[5]. Many other countries on the continent are part of an FSB Regional Consultative Group ("RCG") which has been established so that financial authorities from FSB member and non-member countries may exchange views on vulnerabilities affecting their financial system and on initiatives to promote financial

[5] The National Treasury of the Republic of South Africa published a position paper, the Resolution Framework for Financial Institutions, on 13 August 2015, which provides a proposed updated framework for bank resolution in South Africa. The position paper was intended to solicit public comment in preparation for a Special Resolution Bill. However, a draft of the Bill has not yet been made publicly available.

stability[6]. However, the moral suasion and peer pressure that the FSB applies to its members to implement international standards like the Key Attributes may be significantly less on non-FSB members.

Turning the current economic recovery in Africa into sustained strong growth requires a stable and strong financial sector, and bank recovery and resolution laws play an important role in this regard. The IMF notes that structural reform needs to continue in order to reduce market distortions and shape an environment that fosters private investment, and points out that "improving the resolution framework for banks" would be among the measures that could encourage exposure to the private sector (IMF, 2018). In terms of reducing funding costs of African banks, it will in particular have beneficial effects through supporting banks' access to international debt markets, credit ratings and correspondent banking relations.

For the time being, save for the largest pan-African banking groups, funding by local banks tends to be focused on locally sourced deposits. However, to the extent that long-term growth in local economies drives appetite amongst local banks to access international debt capital markets to facilitate that growth, the question to be posed is whether the status of the recovery and resolution regime could impact accessibility to those markets, particularly considering questions of bail-in and the comparative position of debtholders in a resolution versus insolvency scenario.

To the extent that debt capital markets begin to play a more significant role in the funding cycle for local banks, the relevance of rating agencies and any impact on pricing of that funding may become more relevant. It is not particularly clear the extent to which rating agencies are influenced by the existence or absence of a recognisable recovery and resolution regime in a jurisdiction when allocating a credit rating to local banks or even to a sovereign. However, it is noteworthy that on previous occasions rating agencies reviewing the banking sector elsewhere have expressly stated that one of their considerations is the protection offered to senior creditors by subordination of bail-inable securities. In addition, the presence of a government support framework as well as the ability and propensity of the government to provide support has been listed among the factors considered by rating agencies. Access to international debt capital markets is one of the key drivers for seeking a rating and therefore the impact of the views of rating agencies will really only be relevant to the extent that local banks seek to turn more regularly to the international debt markets.

[6] There are two RCGs covering Africa, namely the FSB RCG for the Middle East and North Africa ("MENA") and the FSB RCG for sub-Saharan Africa. Membership of the MENA group includes financial authorities from Algeria, Egypt, Morocco and Tunisia. Membership of the sub-Saharan group includes financial authorities from Angola, Botswana, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa and Tanzania, as well as the Central Bank of West African States (BCEAO) and the Bank of Central African States (BEAC).

The drivers for the ongoing withdrawal of correspondent banking services to a number of emerging market countries have been well documented by both the IMF and the FSB. The availability of such services in Africa has been tested over the last few years as the largest international groups have continued their "de-risking" strategies in relation to certain jurisdictions. Although the latest correspondent bank due diligence questionnaire produced by the Wolfsberg Group[7] does not touch directly on recovery and resolution, the development and implementation of a recovery and resolution regime may bring a number of benefits to the relevant country and its banks, including potentially facilitating alignment with international best practice across a number of areas, including those covered by the correspondent bank due diligence questionnaire used by international banks to determine their provision of these services.

8.3. The State of Bank Recovery and Resolution Laws: an In-Depth Study across the African Continent

Earlier this year, working with offices and correspondent law firms across Africa, Norton Rose Fulbright LLP undertook a review[8] concerning the state of recovery and resolution laws for banks in selected African jurisdictions against the Key Attributes[9]. Geographically, the review undertaken was wider than those countries in the FSB MENA group and the sub-Saharan group and included coverage of Zambia, Uganda, Lesotho and Zimbabwe among others (in total 17 countries were assessed). One of the outputs from the study was to assign an overall grading to each jurisdiction that was reviewed[10] against each of the essential features of the Key Attributes (including the sub-components).

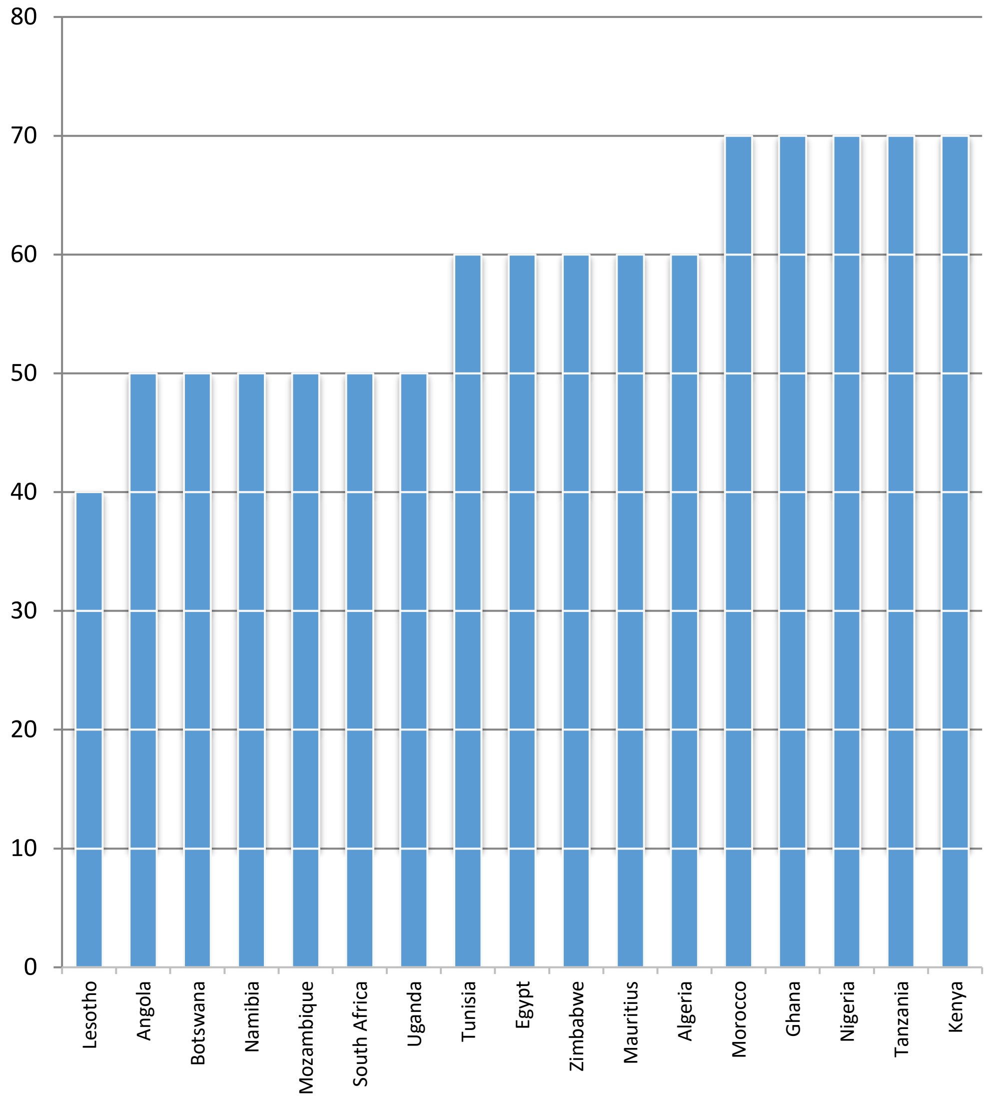
[7] The Wolfsberg Group due diligence questionnaire was designed to satisfy the Financial Action Task Force's recommendation that for cross-border correspondent banking additional due diligence requirements must be undertaken.

[8] State of bank recovery and resolution laws in Africa (May 2018) – A Norton Rose Fulbright LLP comparative guide and report. The guide and report can be found here: http://www.nortonrosefulbright.com/knowledge/publications/167329/state-of-bank-recovery-and-resolution-laws-in-africa

[9] When conducting our study colleagues and local law firms were also provided with the FSB's Key Attributes Assessment Methodology for the Banking Sector (October 2016).

[10] The study and its findings are those of Norton Rose Fulbright LLP. Institutions reviewing the state of recovery and resolution regimes in Africa may come to different conclusions.

Figure 8.1. - Recovery and Resolution Regimes Compared to FSB Key Attributes
(overall alignment with FSB Key Attributes in per cent)



Source: Norton Rose Fulbright LLP review of recovery and resolution frameworks.

The study finds that recovery and resolution regimes across Africa vary widely when compared against the Key Attributes. Overall Morocco, Ghana, Nigeria, Tanzania and Kenya were found to have highly developed (60%+) regimes (Figure 8.1.). Countries such as Tunisia, Egypt, Zimbabwe, Mauritius and Angola had an average-high level of development (50%-59%), Algeria, Botswana, Namibia, Mozambique, South Africa[11], and Uganda had low-average development (40%-49%) and Lesotho had a low level of development (0%-39%).

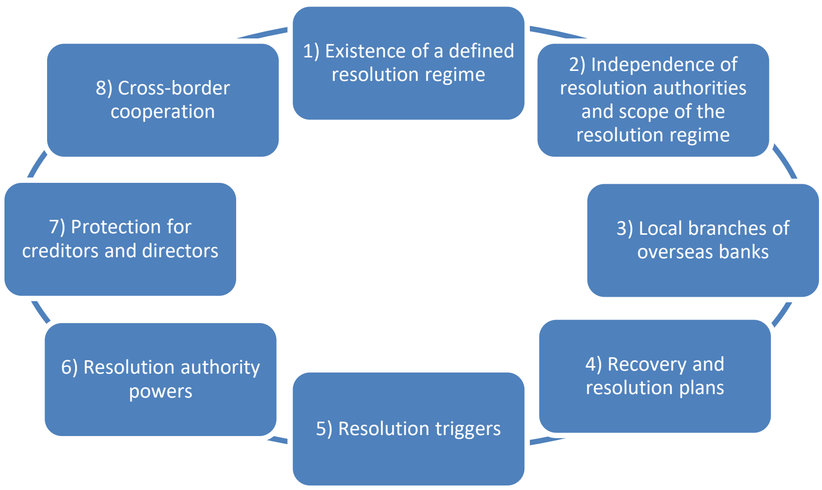
[11] As the recovery and resolution regime currently stands. See footnote 5.

Quantifying how recovery and resolution frameworks relate to a country's development is very difficult, if not impossible. This is not the place for an extensive analysis of the relationship between the review's results and GDP per capita, but at first glance, at least for Africa, there appears not to be any link. However, the impact of not having an effective recovery and resolution regime can be significant. For example, the European Commission impact assessment for the proposed Bank Recovery and Resolution Directive mentioned that between October 2008 and October 2011, the Commission approved EUR 4.5 trillion (equivalent to 37% of EU GDP) in state aid measures to financial institutions, of which EUR 1.6 trillion (equivalent to 13% of EU GDP) was used in 2008-2010. As the Commission noted expenditure on this scale was not sustainable from a fiscal point of view and imposes a heavy burden on present and future generations.

African countries are not alone in having deficiencies in their resolution regimes, although the extent is relatively large. Only a subset of FSB jurisdictions home to global systemically important banks have implemented bank resolution regimes with comprehensive powers broadly in line with the Key Attributes (FSB, 2017). The regulatory powers most often lacking are bail-in and powers to impose a temporary stay on the exercise of early termination rights. In light of the FSB's findings it may be that the lack of progress of some of the countries in the FSB MENA group and the sub-Saharan group may be viewed less critically.

The systematic assessment of recovery and resolution frameworks brought several broader patterns to the fore. The findings are grouped in eight themes based on the authors' view of the most significant areas (Figure 8.2.) and deal with topics ranging from general issues like the existence of a defined resolution regime to more detailed factors related to protection of creditors and directors and cross-border issues. These themes and country-specific findings (Table 8.1.) are discussed in more detail below.

Figure 8.2. - Recovery and Resolution Regimes



Source: Norton Rose Fulbright LLP review of recovery and resolution frameworks.

Table 8.1. - Extent of Alignment FSB Key Attributes in Specific Jurisdictions

	Defined resolution regime	Scope of regime	Branches of overseas banks	Recovery plans	Resolution triggers	Resolution authority powers	Protection of creditors/ directors	Cross-border cooperation
High	Algeria Botswana Ghana Kenya Mauritius Namibia Nigeria Tanzania Togo Uganda Zambia Zimbabwe	Egypt Kenya Mauritius Namibia Nigeria	Algeria Botswana Ghana Kenya Lesotho Mauritius Namibia Nigeria Tanzania Togo Uganda Zambia Zimbabwe		Algeria Angola Egypt Ghana Kenya Mauritius Mozambique Namibia Nigeria South Africa Tanzania Togo Tunisia Uganda Zambia Zimbabwe	Ghana Togo Tunisia		
High-Moderate		Algeria Angola Botswana Ghana Morocco Mozambique South Africa Tanzania Togo Tunisia Uganda Zambia		Kenya Morocco Nigeria		Egypt Mauritius Morocco Nigeria South Africa Tanzania Zambia Zimbabwe	Ghana Nigeria	Angola Egypt Kenya Mauritius Nigeria Tunisia Zimbabwe
Moderate	Angola Lesotho Morocco Mozambique South Africa Tunisia	Lesotho Zimbabwe				Angola Kenya Mozambiqu e		Algeria Ghana Lesotho Morocco Mozambique Namibia Tanzania Togo Uganda Zambia
Low-Moderate				Tanzania		Algeria Botswana Lesotho Namibia Uganda	Egypt Mauritius Mozambique South Africa Togo Tunisia Zambia	Botswana
Low	Egypt		Angola Egypt Morocco Mozambique South Africa Tunisia	Algeria Angola Botswana Egypt Ghana Lesotho Mauritius Mozambique Namibia South Africa Togo Tunisia Uganda Zambia Zimbabwe	Botswana Lesotho Morocco		Algeria Angola Botswana Kenya Lesotho Morocco Namibia Tanzania Uganda Zimbabwe	South Africa

Source: Norton Rose Fulbright LLP review of recovery and resolution frameworks.
Note: Assessments of compliance are based upon expert judgement. The overall level of compliance is determined by an average level of compliance across applicable attributes of resolution regimes.

1) *Existence of a defined resolution regime*

African governments and banking sector regulators alike have taken the issue of bank recovery and resolution seriously. All of the African countries reviewed in the study had a defined resolution regime except for Lesotho[12]. Governments and banking sector regulators[13] recognise the need for greater oversight and powers in order to mitigate the impact of a disorderly banking collapse or more broadly of a significant stress event in the local banking sector. In this respect it is telling that a country with a well-developed financial sector like Mauritius is reviewing its current regime with the assistance of the IMF to address a lack of clarity.

The existence of a defined resolution regime enables depositors and investors on international capital markets to assess their risk exposure. This is especially the case for regimes in which the roles and powers of banks, resolution authorities and supervisors and governments are identified, and a clear hierarchy of claims exists. A defined resolution regime also enables rating agencies to more accurately assess the credit risk of banks[14], further assisting depositors and investors, and potentially increasing the willingness of other banks to operate using correspondent banking services.

2) *Independence of resolution authorities and scope of the resolution regime*

As the FSB itself recognises in its Key Attributes, adequate independence and accountability is important to safeguard against undue political or industry influence. This is a relevant consideration for investors as they will want to have comfort that there is a predictable and transparent framework for decision-making that would apply in a stress scenario and that ensures there is fair and equitable treatment of claims. A lack of independence and accountability can undermine the benefits which would arise through the existence of a defined resolution regime.

[12] Local counsel reported that Lesotho does not have a resolution regime. However, they confirmed that where Lesotho's central bank is of the opinion that a bank's business is being conducted in an unsafe or unsound manner or that it is in an unsound financial condition, it may require the bank to take such measures as it considers necessary to rectify the situation.

[13] It is worth noting that the Central Bank of Nigeria hosted the training workshop on "Crisis Management and Banking Resolution" in Abuja Nigeria on 16-20 January 2017. The workshop was organised with the technical support of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa and was part of the activities of the Community of African Banking Supervisors, a joint initiative of Making Finance Work for Africa and the Association of African Central Banks.

[14] In some cases it may provide for an upgrade of ratings. For example on 16 November 2017 Moody's Investors Service placed on review for upgrade the ratings assigned to the subordinated Tier-2 point of non-viability securities and/or related programme components of DBS Bank Ltd, DBS Group Holdings Ltd , Overseas-Chinese Banking Corp and United Overseas Bank Limited. The rating action was driven by Moody's opinion that Singapore banks' subordinated Tier-2 contractual point of non-viability securities would represent a lower credit risk score once the Monetary Authority of Singapore introduced an enhanced bank resolution regime.

The relevant jurisdiction's central bank tends to fulfil the role of resolution authority in most countries[15]. Examples are Mozambique, Morocco, Ghana and Botswana. On the important question of independence and accountability, almost all jurisdictions were confident that the resolution authority was sufficiently independent and accountable in the fulfilment of its resolution role even though in many cases appointment to the board of a central bank was a political decision[16]. Some jurisdictions like Tanzania argued that an important safeguard was the fact that the resolution regime provided for judicial review. One jurisdiction, Morocco, went further noting that new draft legislative measures were being introduced to enhance the central bank's independence. Such draft measures included the central bank governor not seeking or taking instructions from the government.

3) Local branches of overseas banks

Respondent jurisdictions reported that their resolution regime generally applied to holding companies, subsidiaries and local branches of overseas banks. The latter being within the scope of the resolution regime was fairly unsurprising as the jurisdictions covered in the review reported that these branches had to be licensed with the host central bank before conducting any business.

Extending the resolution regime to local branches of overseas banks is noteworthy but perhaps of limited application. The key benefit of retaining resolution powers over local branches of foreign firms is to support a resolution carried out by a foreign home authority (for example, by ordering a transfer of property located in its jurisdiction to a bridge institution established by the foreign home authority; FSB, 2014). It would be a more exceptional case for a resolution authority to take measures on its own initiative (for example, where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability).

4) Recovery and resolution plans

It is surprising to find that banks are not generally required to prepare recovery and resolution plans[17]. Although there are some notable exceptions to this (for instance Kenya) it does point to a potentially systemic weakness in the recovery and resolution

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[15] The Financial Stability Institute has noted that in most cases central banks are the primary resolution authority (FSI, 2018). It also noted that this is especially true in cases where the central bank is the primary micro-prudential supervisor for banks. When central banks are the micro-prudential supervisor of banks, it is also the authority in charge of resolving banks in almost 90% of cases.

[16] The appointment process is usually political: for example, the current Governor of the Bank of England was appointed by Her Majesty the Queen on the "advice" of then Prime Minister David Cameron. He was advised by the Chancellor of the Exchequer, who oversaw the appointment process, and, as with other public appointments, consulted the Deputy Prime Minister. In addition, in January 2018 the US Senate approved the appointment of Jerome Powell as the new chair of the Federal Reserve System. The BBC reported on 24 January 2018 that the appointment marked the end of a decades-long tradition that saw Presidents stick with the Federal Reserve chair who was in charge when they took office.

[17] However, this problem is not limited to Africa. For example, in October 2017 the Bangladesh Institute of Bank Management published a research paper "Addressing Disaster Risk by Banks: Bangladesh Perspective" noting that 78% of banks in Bangladesh do not have a disaster recovery plan in place.

regimes in the region. Having recovery and resolution plans in place for banks that could impact local financial stability in the event of their failure is an important risk mitigation strategy for regulators. Such plans facilitate ongoing review of resolvability issues for the bank concerned, taking account of its specific circumstances and reflecting its specific complexity, interconnectedness, level of substitutability and size. Without this discipline in the system, it may be more difficult for local regulators to address issues quickly in the event of a sudden stress in the system.

Whilst the existence of a resolution regime is critical to being able to conduct a resolution, having a plan for how this regime would be used for each bank is clearly of almost equal importance. Though recovery and resolution plans are usually private, knowing that these have been developed adds credibility to the resolution regime for depositor and investor creditors, rating agencies and correspondent banks.

Even if a recovery and resolution plan is required by a resolution authority it still needs to be effective. The European Banking Authority ("EBA") considered that in order to be effective, a recovery plan needs clear governance arrangements, both in terms of the processes and procedures that govern its development, maintenance, implementation and execution (EBA, 2016). Whilst noting that clear improvements had been made to the recovery plans of EU banks, the EBA argued that improvements were still required, not least involving local management more in developing and updating group plans. This may be of relevance to pan-African banks.

5) Resolution triggers

Clear identification of the actual triggers[18] allowing resolution powers to be invoked is important from a market and creditor certainty perspective. Although all jurisdictions except Lesotho reported that they had a clear trigger and effective arrangements for a bank's entry into resolution, there were instances where the lack of definition around one or more trigger events could give rise to interpretation issues coming into play which could possibly create further doubt about the institution involved or, ultimately, lead to an unnecessary resolution.

The lack of a recovery and resolution plan may delay a resolution authority in triggering its powers. The authority needs to identify whether the relevant statutory thresholds have been met, followed by an examination of credible recovery options and their possible impact and feasibility. A decision to trigger resolution has two aspects (Huertas, 2016): a determination that the bank meets the criteria for entering resolution, and the selection of the resolution strategy and tools to be employed. According to Huertas these two decisions need to be taken together, stating that "it

[18] For international papers on triggers generally see for instance the Financial Stability Board paper, Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Recovery Triggers and Stress Scenarios (July 2013) and the Bank for International Settlements' Guidelines for identifying and dealing with weak banks (July 2015).

makes no sense to make a determination that a significant bank should enter resolution unless the authorities have a resolution plan in mind and are ready to execute it."

The timing of triggers is critical. Entering resolution at the end of a business day after payment systems and other financial market infrastructures have completed settlement greatly simplifies resolution. However, entering into resolution in the middle of a business day will create significant settlement risk and reduce the possibility that stabilisation measures will be successful. In drawing up resolution plans, authorities and banks need to think through what needs to be accomplished during and after a "resolution weekend" in order to avoid significant adverse effects on the economy.

6) *Resolution authority powers*

It is important that a resolution authority has a full suite of available powers in order to conduct a resolution that is adequate in the circumstances of any particular bank failure. Not surprisingly, most jurisdictions permit resolution authorities to access such information from a bank necessary for the preparation for, and conduct of, resolution. In some cases the power granted is very broad. It may be that the very broad nature of some of the information gathering powers granted may assist both the bank and the resolution authority in overcoming obstacles to data sharing, including confidentiality and secrecy requirements which can sometimes be a significant hindrance.

Most jurisdictions reported that their resolution authority has powers to control the actions of the relevant bank. For example, even where the resolution regime is less developed the resolution authority has important discretionary powers. For instance in Algeria the resolution authority has powers to impose an administrative penalty, issue cease and desist orders, and prohibit the bank from such transactions it deems necessary. In Zimbabwe, the resolution authority has powers to place a bank under curatorship whereby a curator will manage the affairs of the bank for a definite or indefinite period.

The ability to establish a bridge bank has been a valuable instrument for resolution authorities outside of Africa. Bridge banks operate a failed bank until a buyer is found and transfer to it the assets and liabilities of the affected bank. Responses to the study show that a significant number of resolution authorities have the power to establish a bridge bank. In some cases the power is explicitly provided for in legislation. South Africa reported that under its current regime the central bank can transfer a bank's shares and/or assets to a bridge bank or private purchaser although this is subject to ministerial consent. In Egypt the central bank previously merged four distressed banks into a bridge bank which is now undergoing a privatisation plan. In other cases (for example Botswana and Namibia), it is arguable that the power to establish a bridge bank can be inferred from existing legislation (although this has so far not been tested). In such cases, however, the absence of an express legislative authority could give rise to legal challenges if and when the relevant resolution authority were to seek to rely on its wider discretionary powers. On reflection, those countries may seek to revisit this issue and consider whether the introduction of specific legislation could avoid potentially protracted legal arguments at the point of resolution if the resolution authority were to seek to invoke a bridge bank solution[19].

A more fragmented picture emerged as regards bail-in power, confirming the findings of the FSB's recent review among its members[20]. While some countries in Africa simply do not have any bail-in powers (for example Mauritius), other countries (for example Algeria) have a power that is only contemplated where it is included in a resolution plan approved by the resolution authority. Arguably, bail-in of a bank's debtholders is a more likely route in many instances. The absence of a regularised approach across many jurisdictions in Africa suggests that this is an area where resolution authorities may look to develop their position more definitively through legislation to ensure that they can be certain of having a valuable resolution tool available to them in the event of a stress scenario in their banking system (see also Restoy, 2018).

Most jurisdictions reported that their resolution regime has an effective mechanism for contractual stays upon resolution action being taken. This is an important power in that it reduces the risk of triggering chains of early contractual terminations and realisation of collateral, which can have an immediate effect on financial markets and financial stability (as seen in connection with the failure of Lehman Brothers). However, banks in Africa face a number of challenges, not least the fact that the scope of the relevant rules, where implemented, differs across jurisdictions in the region, and as always with regulatory rules there will be questions of interpretation that need to be considered on a jurisdiction by jurisdiction basis. In addition, timing for compliance with the relevant rules may differ across jurisdictions and be tight.

Addressing issues simultaneously might be most effective. Generally speaking, to reduce the problem that resolution tools like bail-in may be unworkable in a given situation, authorities may also adopt a parallel work stream when developing/refining their resolution tools with the aim of improving insolvency procedures.

7) *Protection for creditors and directors*

Although respect for creditor hierarchy is provided for in many jurisdictions, there are usually no rules regarding compensation for those losing out. Most jurisdictions noted that their resolution regime is silent as regards compensation available where creditors are worse off under resolution than insolvency (for example Algeria, Angola, Botswana, Ghana, Kenya and Nigeria,). This is an area where countries may seek to develop a more investor-friendly approach. Introducing a recovery "floor" might go some way towards incentivising support from investors and creditors in a resolution

[19] Inserting a specific bridge bank power into legislation has been observed in other non-FSB jurisdictions. For example, in the case of Argentina "while authority to employ the bridge bank and the open bank process is broadly derived from existing legislation, the use of those tools should be formalised in regulation to specifically address conditions for their use." (IMF, 2016).

[20] The FSB stated that "powers most often lacking in FSB member jurisdictions are bail-in and powers to impose a temporary stay on the exercise of early termination rights" (FSB, 2017).

scenario where they have comfort that they could not be put in a worse position than if the bank were to go into liquidation.

An important component of increasing investor rights in the event of a disadvantageous resolution will be the rules or principles that guide the valuation of the failing bank. Valuation before resolution is critical to the resolution process since it informs the resolution authority's decision as to whether the conditions for resolution are met and, if so, which resolution tools should be used. Valuation after resolution is also important as it establishes whether the no-creditor-worse-off safeguard has been breached by the resolution action and whether any compensation is payable to creditors and shareholders[21].

In relation to the important area of safe harbours for the bank board, most jurisdictions reported that a bank's directors and officers are potentially protected from liability for decisions taken by the resolution authority. This is usually based on the principle that the resolution authority assumes the management, control and conduct of the affairs and business of the bank.

8) Cross-border cooperation

With the emergence of pan-African banking groups, and more generally African banks' increasing presence across several countries, cross-border cooperation of resolution authorities is becoming more important. As per the Key Attributes, if a jurisdiction is home to a bank that is required to undertake recovery and resolution planning and has operations in foreign jurisdictions that are material to the group, the home resolution authority should establish or undertake reasonable efforts to establish appropriate and proportionate arrangements for cross-border cooperation and coordination with the relevant host resolution authorities to support the process of recovery and resolution planning. The home resolution authority should seek to establish a cross-border coordinating forum (e.g. a crisis management group, which would sit alongside any existing supervisory college) with a mandate to cover cross-border recovery and resolution for the bank.

In this context, even where legislation is silent on the issue, jurisdictions in Africa reported that cooperation arrangements with overseas resolution authorities are permitted. Outside of membership of international bodies however, it remains unclear to what extent resolution authorities in most of the countries have active cooperation arrangements with other countries in place. The lack of legally binding cooperation arrangements places too much emphasis on trust between resolution authorities and would be severely tested under crisis conditions.

Cross-border supervision needs to catch up with the increased internationalisation of African banks. Over the last decade Africa has seen a rise in domestic and regional

[21] From an EU perspective the Bank Recovery and Resolution Directive is supplemented by various so-called Level 2 measures which include regulatory technical standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under the Directive.

banks that have sought to challenge the dominance of international banking groups. In a much cited IMF report published in 2015 there were seven major pan-African banks which had a presence in at least ten African countries, with three headquartered in Morocco, two in Togo and one each in Nigeria and South Africa (IMF, 2015). The growth of pan-African banks offers a number of opportunities and benefits, not least increasing economic integration within Africa more generally and improving competition, financial inclusion and greater economies of scale. However, the IMF also warned that the expansion of pan-African banks may increase systemic risks in the region. The study suggests that the IMF comment in 2015 that "cooperation on cross-border supervision has started[22], but enhanced collaboration is critical" remains broadly true today for the region.

However, the lack of progress with cooperation arrangements may not be confined to Africa and appears to be a wider problem. According to the FSB in 2017, significant work remained to be done to put cooperation arrangements in place and remove any impediments to the sharing of resolution-related information between relevant resolution authorities (FSB, 2017). Data privacy and bank secrecy laws were highlighted as sometimes making information sharing difficult.

8.4. Conclusion

The study finds that the state of recovery and resolution laws varies considerably across the continent. Overall Morocco, Ghana, Nigeria, Tanzania and Kenya were found to have highly developed recovery and resolution regimes when compared against the Key Attributes. Countries such as Tunisia, Egypt, Zimbabwe, Mauritius and Angola follow. Algeria, Botswana, Namibia, Mozambique, South Africa and Uganda have low-average development, while Lesotho has a low level of development.

Several important messages emerging from the study could help make recovery and resolution frameworks more conducive to private sector lending. Although the main components of the FSB's Key Attributes are present in a number of the African countries looked at, the absence in many regimes of the need to prepare and maintain approved recovery and resolution plans (and update these regularly to reflect the current state of the bank), together with the absence in most cases of any recovery "floor", potentially present the most substantial challenges in a situation which is often fast moving. The result is ultimately that, without additional strengthening of the existing frameworks, some African countries would continue to look to (unpredictable) emergency legislation in a case of stress.

[22] For example, Bank Al-Maghrib (Central Bank of Morocco) has improved its coordination (through, e.g. joint on-site supervision missions) with several sub-Saharan regulatory and supervisory agencies (e.g. the BCEAO and the Commission Bancaire in West Africa)

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9. Financing Infrastructure in Africa[1]

David Ashiagbor, Rodrigo Deiana, Andreas Kappeler, Arthur Minsat and Thang Nguyen-Quoc[2]

Executive Summary

- Infrastructure investment in Africa stood at approximately USD 63 billion or 3.5% of the continent's GDP in 2016. Financing for infrastructure development in Africa is highly dependent on the contributions of national governments, which account for 42% of total infrastructure financing. IFIs can play an important role in covering riskier segments of infrastructure projects and crowding in private investors.

- Annual infrastructure investment needs in Africa are estimated to range between USD 68 and 152 billion over the coming decade. These amounts would cover both maintenance and replacement costs as well as the construction of new infrastructure assets. Needs are particularly high in energy and transport. New needs arise from rapid urbanisation, population and economic growth as well as making infrastructure resilient to climate change.

- Key constraints to infrastructure financing in Africa include a perceived lack of well-structured bankable investment opportunities, underdeveloped financial markets, and regulatory barriers and weaknesses in the enabling policy environment.

- Promoting the involvement of institutional investors, including domestic pension funds, is key to addressing Africa's investment gaps. However, these investors are constrained by limited experience and capacity to deal with infrastructure as an asset class. Many countries have made progress in removing regulatory barriers to infrastructure investment by institutional investors.

[1] The authors would like to thank Arnaud Floris and Yves Kra for research support and comments on the section on mobilising private investors (9.5.C.); Yosra Elchinnawy and Clémence Pougué Biyong (OECD) for research support; Kei Yoshizawa (JICA) for inputs into the box on Quality Infrastructure Investment (Box 9.2.); Nomfundo Ngwenya (Ntsele Insights) for inputs into the box on the Johannesburg Development Agency (Box 9.3.); and Giulia Gaspari (EIB) for valuable contributions to the box on China's infrastructure financing activities in Africa.

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- Financial instruments that seem particularly promising for attracting private investors include risk mitigation instruments and debenture structures. African countries should make the best use of existing experience in establishing infrastructure as an asset class.

- Promoting quality infrastructure development can contribute to inclusive and sustainable growth. Infrastructure investments should ensure a reliable supply of basic services, while promoting safety, job creation, local empowerment through technology and knowledge transfer, and climate change mitigation. All of this should occur within the framework of national strategies to provide wider social and economic benefits.

9.1. Introduction

An adequate supply of infrastructure services has long been viewed as a key ingredient for economic development. A comprehensive review of the linkages between infrastructure and economic growth shows a positive contribution of infrastructure development to aggregate income. In particular, an increase in physical capital as well as in the provision of infrastructure services such as transport, power supply and telecommunications can lower production costs and increase productivity (Calderón and Servén, 2014; European Commission, 2014). Under the right conditions, infrastructure development can play a major role in promoting growth and equity and, through both channels, help reduce poverty (Bhattacharya et al., 2016).

Physical infrastructure investment can be defined as investment into the physical structures from which goods and services are produced that enter directly as common inputs into many economic activities. They primarily have the characteristics of networks - typically transport, water and sewerage, energy and communications. A broader definition also covers social infrastructure, including the education and health sectors (Wagenvoort et al., 2011).

Without adequate infrastructure, Africa's economies cannot realise their full potential. Inadequate infrastructure - mainly energy, transport, telecommunications, water and sanitation, and irrigation - has contributed to the continent's low economic performance, low intra-African trade (11.9% of total trade in 2017) and weak integration into global value chains (Juma, 2015). The poor state of infrastructure in sub-Saharan Africa reduces firm-level productivity by as much as 40% (Ondiege, Mbabazi Moyo and Verdier-Chouchane, 2013).

Meeting the infrastructure needs would have a catalytic impact for Africa's development. Bringing Africa's infrastructure on a par with best performers on the continent could boost GDP growth by an additional 2.2% per year (Foster and Briceño-Garmendia, 2010). Hulten (1996) found that the efficiency of infrastructure has a larger impact on economic performance than the total stock. For example, over 25% of the growth differential between Africa and East Asia could be explained by the difference in effective use of infrastructure. Mauritius and South Africa partly owe the strong performance of their manufacturing export sectors to investments in world-class infrastructure (Ncube, 2017). From a sample of 45 sub-Saharan African countries, Kodongo and Ojah (2016) find that increasing investments in and access to infrastructure has a positive effect on growth. Specifically, a 10% increase in public gross fixed capital formation can raise GDP per capita growth rates by up to 0.74 percentage points, with the effect being strongest for low and lower-middle income countries.

Infrastructure development also has a long-run impact on economic development. Investment in transport infrastructure leads to stronger economic growth and higher living standards, according to a study conducted for five middle-income African countries (Damijan and Padilla, 2014). The study also indicates that more transparent processes for budgeting and project selection (i.e. stronger institutions) and higher shares of FDI in infrastructure projects (i.e. lower financing from public budgets) lead to greater long-term sustainability and positive socio-economic spillovers. Understanding infrastructure quality as a multidimensional concept in Africa's infrastructure development is key to ensuring the strongest social, environmental and economic impact (Box 9.2.).

The objective of this chapter is to present African policymakers with a number of options for how infrastructure development can be financed. The chapter also looks at what the most appropriate contribution by development partners can be, with a particular focus on development finance institutions. For the purposes of the analysis, infrastructure is narrowly defined as physical "economic infrastructure" - assets that have a direct impact on economic activity. The chapter builds on previous studies looking at the financing gap in Africa. In doing so, it also combines multiple data sources to provide a more comprehensive analysis of the sources and modalities of financing Africa's infrastructure development.

The rest of the chapter is structured as follows: section 2 presents infrastructure targets for Africa according to different development agendas and studies. Section 3 will provide a snapshot of recent financing trends, taking a close look at the sources, actors and destinations of infrastructure investment in Africa. Section 4 will build on this to analyse infrastructure needs, investment requirements and the financing gap for the whole continent. Section 5 provides recommendations on possible financing mechanisms, instruments and actors to bridge this financing gap. The final section sums up the findings and policy recommendations.

9.2. Africa's Infrastructure Development Targets

Infrastructure development represents an important part of the objectives set for Africa's development. According to the OECD, more than 80% of the SDGs rely on infrastructure development in some form (Egler and Jurik, 2017). In Agenda 2063, drawn up by the African Union and enshrining the continent's development aspirations over the coming five decades, Goal 10 consists of building "world-class infrastructure that criss-crosses Africa". This goal is one of the pillars of "an integrated continent, politically united, based on the ideals of Pan-Africanism and the vision of Africa's renaissance". The infrastructure development objectives are designed to help Africa accelerate its integration and growth by facilitating trade and the adoption of new technologies. Intra-African trade stood at 11.9% in 2017 and is expected to increase to 50% in 2045 with the combination of world-class infrastructure and trade openness (AUC, 2015). Complementing Agenda 2063, the Programme for Infrastructural Development of Africa (PIDA) sets out a common roadmap for African governments and investors to develop cross-border infrastructure, thus promoting trade and growth and creating more jobs on the continent. Initiatives such as the 2017 Lomé Declaration[3] establish more concrete steps and priorities to achieve infrastructure development targets.

Sectors that attract the most attention in infrastructure development goals are transport, energy, water and e-connectivity. Table 9.1. summarises all infrastructure development targets set by Agenda 2063 and the corresponding indicators.

[3] Declaration of the First Ordinary Session of the African Union Specialized Technical Committee on Transport, Transcontinental and Interregional Infrastructure, Energy and Tourism held in Lomé, Togo, on 13-17 March 2017. See https://www.icao.int/Meetings/iwaf2017/Documents/AU-1st-STC-Lome-Declaration-en.pdf.

Table 9.1. - Goal 10 in Agenda 2063 "World Class Infrastructure that Criss-Crosses Africa"

Field	Priority area	Target indicators
Transport	· Connect all African capitals and commercial centres through the African High Speed Train Network (AHSTN); · PIDA transport corridors; · Improve the efficiency and connections of the African aviation sector; · Implement the Yamoussoukro Declaration, aimed at deregulating air services and promoting transnational competition; · Strengthen the African port and shipping sector as regional and continental assets.	· The African skies will be open to all African Airlines · 80% preservation (maintenance and rehabilitation) ; 20% development (upgrading and new construction) · 50% increase in electricity generation to serve industrialisation and private consumption
Energy	Harness all African energy resources to ensure modern, efficient, reliable, cost-effective, renewable and environmentally friendly energy for all African households, businesses, industries and institutions.	· Reach 100% urban electrification and 95% rural electrification · Develop an additional 7,000 megawatts a year of new power generation capacity (about half through multipurpose water storage schemes)
ICT	Develop an information society where all governments, businesses and citizens have access to reliable and affordable ICT services by : · Increasing broadband penetration and connectivity; · Providing access to ICT for children in schools · Providing venture capital for young ICT entrepreneurs and innovators	· Broadband accessibility is increased by 70% · Digital broadcasting will be the norm · Mobile universal coverage: every adult/youth will have access to a mobile phone · 50% of population within 25 km of a fibre backbone · Fibre to home/premises internet penetration rate (10%)
Water	· "Africa Water Vision 2025," which promotes, equity, sustainability and efficiency of water resources · Framework for action: Strengthening governance of water resources; Improving water wisdom; Meeting urgent water needs; Strengthening the financial base for the desired water future.	· Reach 100% access in both urban and rural areas · Increase water productivity of rain-fed agriculture and irrigation by 60% · Increase size of irrigated area by 100%

Source: AUC (2015) and NPCA, AUC, AfDB (2017).

Agenda 2063 and its PIDA Priority Action Plan are not the first initiatives to set goals and targets for Africa's infrastructure development. It is worth highlighting that the African Union approved the PIDA, emphasising the value of ownership and the explicit buy-in from all African countries, as a prerequisite for the proper prioritisation and implementation of infrastructure projects and programmes. Bilateral and multilateral investors also help define targets for helping African governments and businesses to build and improve their infrastructure, often quantifying the investment needed. For example, the World Bank defined targets for building and improving Africa's infrastructure over ten years (2006-15). The targets included increasing the continent's power generation capacity by 7,000 megawatts a year, developing connections between capitals, ports, border crossings and intermediary cities with a good quality road network and providing global systems for mobile voice signal and public access broadband to 100% of the population (Foster and Briceño-Garmendia, 2010).

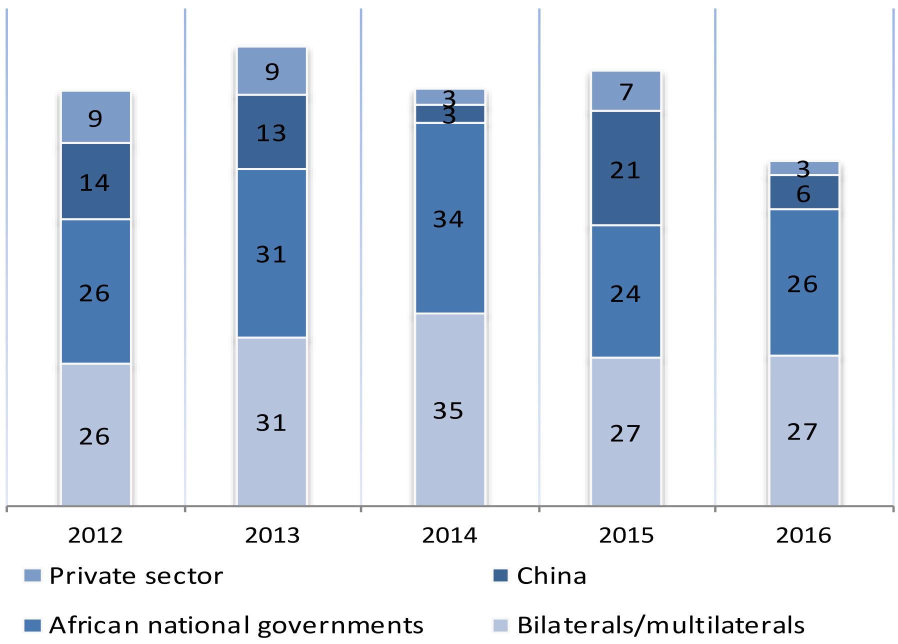
9.3. Recent Financing Trends, Modalities and Key Investors in African Infrastructure

Infrastructure financing in Africa represented 3.5% of GDP in 2016. Only five countries assigned more than 4% of their GDP to infrastructure spending (Kenya, Malawi, Togo, Zambia and Zimbabwe). In absolute terms, South Africa stands out with USD 5.8 billion (2% of GDP) spent on infrastructure in 2016. This country alone spends almost as much as the rest of southern Africa combined.

African national governments and bilateral/multilateral institutions are the main source of infrastructure finance in Africa. In 2016, the contributions from national governments represented 42% of total infrastructure financing, at over USD 26 billion (Figure 9.1.). The contributions of institutions and governments to infrastructure financing varied between 2012 and 2016. China plays an important role in the continent, with its investments ranging from 15% to 26% of the total between 2012 and 2016 (see Box 9.1.).

Figure 9.1. - Total Infrastructure Financing in Africa

(USD bn, 2012-2016)

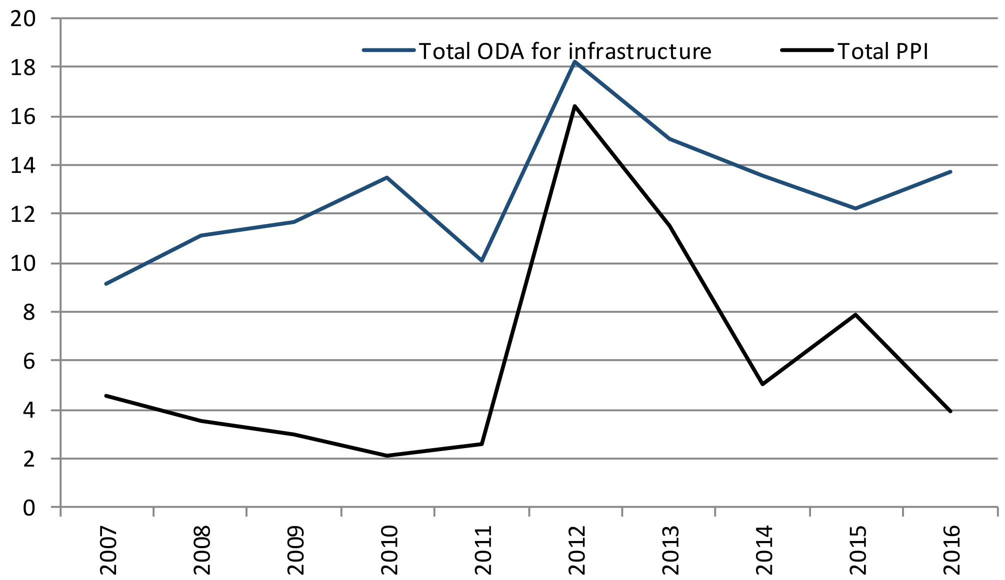


Source: ICA, 2017.

Note: Bilaterals and multilaterals include contributions from the BRICs, RDBs, G20, World Bank, African Development Bank (AfDB), European Commission, European Investment Bank (EIB), Development Bank of Southern Africa, Arab Fund for Economic and Social Development (AFESD), Islamic Development Bank (IDB), Kuwait Fund for Arab Economic Development (KFAED), Abu Dhabi Fund for Development (ADFD), OPEC Fund for International Development (OFID), Arab Bank for Economic Development in Africa (BADEA), and Saudi Fund for Development (SFD).

Private capital has played a very limited role in financing Africa's infrastructure. In 2016, private flows reached USD 2.6 billion, representing only 4% of total infrastructure investment on the continent (ICA, 2017). Total private flows to infrastructure are significantly lower than Official Development Assistance (ODA) contributions, which amounted to USD 13.7 billion in 2016 and USD 128.3 billion over the period 2007-16. Investment in public infrastructure projects with private participation (PPI) have also remained limited. Only in 2012, thanks to exceptionally high PPP inflows for greenfield projects in four African countries (South Africa: USD 5.7 billion; Morocco: USD 1.9 billion; Zambia: USD 1.6 billion; and Senegal: USD 1.4 billion) did these investments surge to a level close to ODA (Figure 9.2.).

Figure 9.2. - ODA and Private Participation in Infrastructure in Africa
(USD bn, 2007-16)



Source: the World Bank PPI database and OECD-DAC database.
Note: PPI measures the investment in public infrastructure projects in which the private sector has at least a 20% participation.

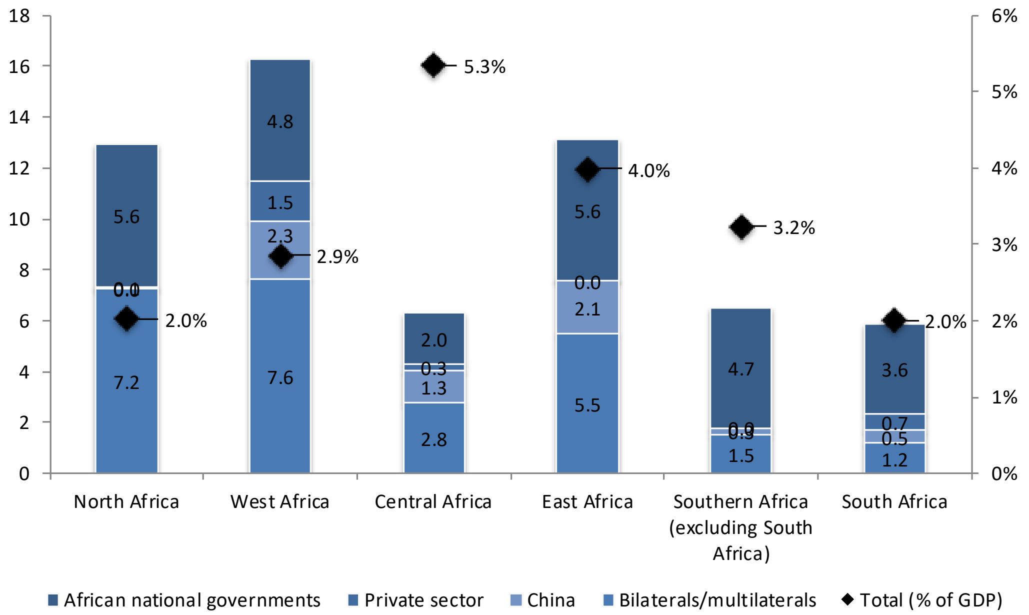
ODA's ability to mobilise private funds for infrastructure projects is very weak. Between 2012 and 2015, private capital mobilised by ODA and invested in infrastructure projects was USD 8.7 billion (around 11% of the total private sector mobilisation by ODA). Private funds mobilised by ODA increased to reach the second-highest level in 2013, at USD 2.5 billion, with the help of three water and sanitation projects in Angola, Kenya and Ghana.

In absolute terms, public investment is highest in North and East Africa (Figure 9.3.). In the past decade, a number of East African countries such as Ethiopia, Kenya, Mauritius and Rwanda have significantly increased public investment to address bottlenecks, especially in the electricity and transport sectors. Many investments are in large projects such as the Grand Ethiopian Renaissance Dam, the East African Power Pool and Kenya's Silicon Savannah. Similarly, North African countries have relied on FDI-friendly investment codes that encourage public and private inflows, often into targeted areas. For instance, transport infrastructure in Morocco is supported by the Industrial Acceleration Plan 2014-20 with a USD 2.2 billion fund (AUC/OECD, 2018).

West African countries attract the highest share of private investment into infrastructure (Figure 9.3.). Several West African countries have made strides in improving the business environment, according to the WEF Global Competitiveness indicators. Good examples are the Ohada Treaty and Uniform Acts' reforms to attract private investment in infrastructure. In 2014, the Konan Bédié Bridge in Abidjan, Côte d'Ivoire, was completed and co-funded by various private companies, led by the Bouygues Group. In 2016, Azura IPP was the first fully privately funded company to offer power generation in Nigeria by virtue of raising USD 190 million in equity plus USD 686 million in debt (BCG/AFC, 2017).

In southern Africa, public spending accounts for the bulk of infrastructure investment. Public funding represents 60% of infrastructure investment in South Africa and 72% in the rest of the region. This share is the highest among the five African regions. In South Africa for example, the government has actively invested into infrastructure to attract businesses and develop business clusters (AUC/OECD, 2018).

Figure 9.3. - Sources of Financing and Destination Regions
(2016)

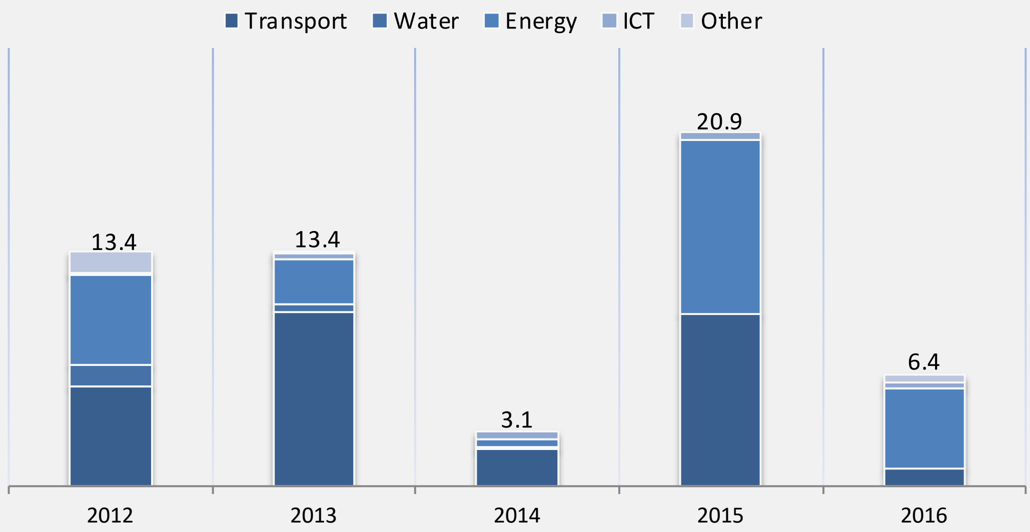


Source: ICA, 2017.
Note: The graph excludes the unallocated amount of infrastructure investment of USD 1.4 billion. Bilaterals and multilaterals include contributions from the BRICs, RDBs, G20, World Bank, African Development Bank (AfDB), European Commission, European Investment Bank (EIB), Development Bank of Southern Africa, Arab Fund for Economic and Social Development (AFESD), Islamic Development Bank (IDB), Kuwait Fund for Arab Economic Development (KFAED), Abu Dhabi Fund for Development (ADFD), OPEC Fund for International Development (OFID), Arab Bank for Economic Development in Africa (BADEA), and Saudi Fund for Development (SFD).

Box 9.1. - China's Infrastructure Financing Activities in Africa

China is an important financier of infrastructure in Africa. Chinese financing of infrastructure in Africa has fluctuated substantially over recent years. In 2016, China invested USD 6.4 billion into infrastructure in Africa, compared to USD 20.6 billion in 2015 (Figure 9.4.). In 2016, China provided roughly 10% of total infrastructure financing in Africa. Chinese companies are backing ports, connectivity projects, submarine cables[4], hydropower plants, highways, telecommunications and railways. Infrastructure projects in Africa with Chinese involvement tend to be implemented by Chinese contractors.

Figure 9.4. - Infrastructure Investment Commitments for Africa by Chinese Investors
(USD bn)



Sources: ICA, 2017.

Investment in infrastructure in Africa by China is set to remain substantial, also because China's Belt and Road Initiative (BRI) will cover Africa. The inclusion of Africa in the BRI can help China to ensure the supply of natural resources for boosting its growing economy and secure access to markets for its products. The maritime silk road component of BRI is intended to go past the coast of East Africa, where several ports are being built[5]. Moreover, port projects are planned on the coasts of Central and West

[4] For instance, China is backing the *South Atlantic Inter Link (SAIL)* (USD 0.5bn), the first submarine cable linking Africa and South America (Brazil).

[5] *Doraleh multi-purpose port* (USD 590m) and *Tadjourah port* (USD 90m) in Ethiopia. *Bagamoyo port* in Tanzania is a flagship project set to be the largest and most modern port in Africa, including a 34 km road between Bagamoyo and Mlandizi linking the port to Tanzania's internal railway network and Zambia's railway network.

Africa[6]. Some of the ports are also planned to be connected to Africa's hinterland by road and railways[7]. China also intends to revitalise the 1,900 km-long Tanzania-Zambia railway built in the 1970s, at that time already with the help of China (Breuer, 2017).

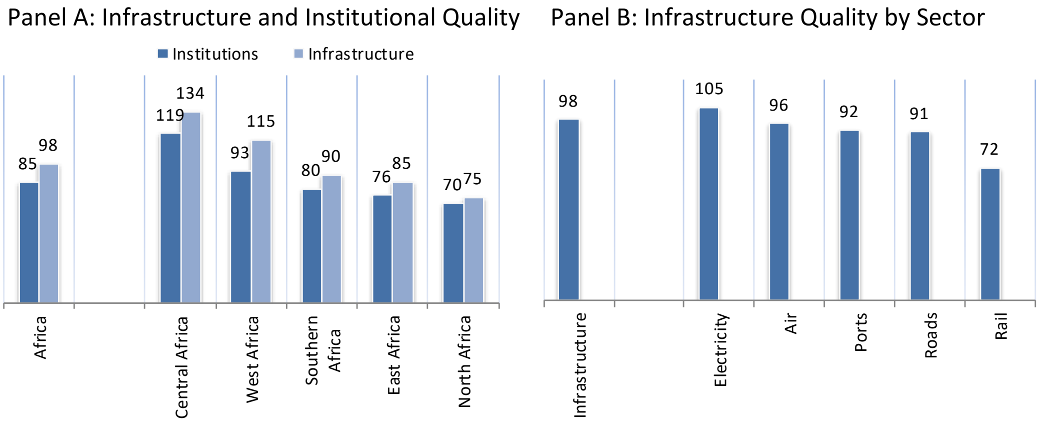
9.4. Infrastructure Gaps and Financing Needs in Africa

Low investment in infrastructure over an extended period of time has translated into poor infrastructure quality in Africa (ICA, 2016; Calderón and Servén, 2010). On average, infrastructure in African countries ranks 98th based on a sample of 137 countries included in the World Economic Forum's World Competitiveness Index database (Figure 9.5., Panel A below). Infrastructure quality is particularly poor in East and Central Africa, based on the countries included in the World Economic Forum's Global Competitiveness Index Database (WEF, 2017). Electricity stands out as the sector with the poorest quality assessment (see Figure 9.5., Panel B below). The quality of infrastructure scores worse than overall competitiveness. Investment in maintaining, upgrading and rehabilitating infrastructure therefore remains important for many countries on the continent. Moreover, understanding infrastructure quality as a multidimensional concept in Africa's infrastructure development is key to ensuring the strongest social, environmental and economic impact (Box 9.2.).

[6] *Kribi Deep Sea Port* (USD 0.5 – 1bn), Cameroon's first deep-water port, which will help China access the resource-rich Congo basin. Abidjan Port (USD 400m), Côte d'Ivoire.

[7] Central and East Africa: *Chad Rail Network* (USD 5.6bn), Libreville - Port-Gentil Road Project (USD 0.6bn), Grand Bassam highway, Côte d'Ivoire. West Africa: the *Standard Gauge Railway* remains the most prominent project backed by Chinese financing. The "Uganda leg" of the *Standard Gauge Railway* is planned to connect the country to the Indian Ocean through the Port of Mombasa. China is also backing the *Madaraka Express Railway and the 32-berth Port of Lamu* (USD 25bn), the starting point of the so-called LAPSSET - Lamu Port, South Sudan, Ethiopia Transport Corridor comprising railway lines to South Sudan and Ethiopia, a crude oil pipeline, international airports, resort cities and a multipurpose dam along the Tana river. The Entebbe-Kampala express highway in Uganda, the Addis Ababa-Djibouti railway (USD 490m) and TAZARA railway in Tanzania.

Figure 9.5. - Infrastructure Quality Rank out of 137 Countries



Sources: World Economic Forum 2017, World Competitiveness Indicators.
Note: Higher rank indicates poorer infrastructure quality.

Box 9.2. - Quality as a Multidimensional Concept in Africa's Infrastructure Development

A more selective, sustainable and long-term oriented approach to infrastructure is making its way in the global debate, as also embodied in SDG Objective 9.1: "Develop quality, reliable, sustainable and resilient infrastructure, including regional and cross-border infrastructure, to support economic development and human well-being, with a focus on affordable and equitable access for all."

Quality Infrastructure (QI) can be defined as infrastructure addressing five elements: economic efficiency, resilience against natural disasters, safety, environmental and social sustainability, and contribution to society and the economy. This means that QI investments should align with long-term country strategies for economic development in a way that improves the flow of services, builds local capacity and drives job creation (Runde, 2017). In spite of the challenges, measuring impact is also very important. In this respect, NEPAD and GIZ have devised the PIDA Job Creation Toolkit to estimate the employment effects of PIDA infrastructure projects as a proxy for support to the local economy[8].

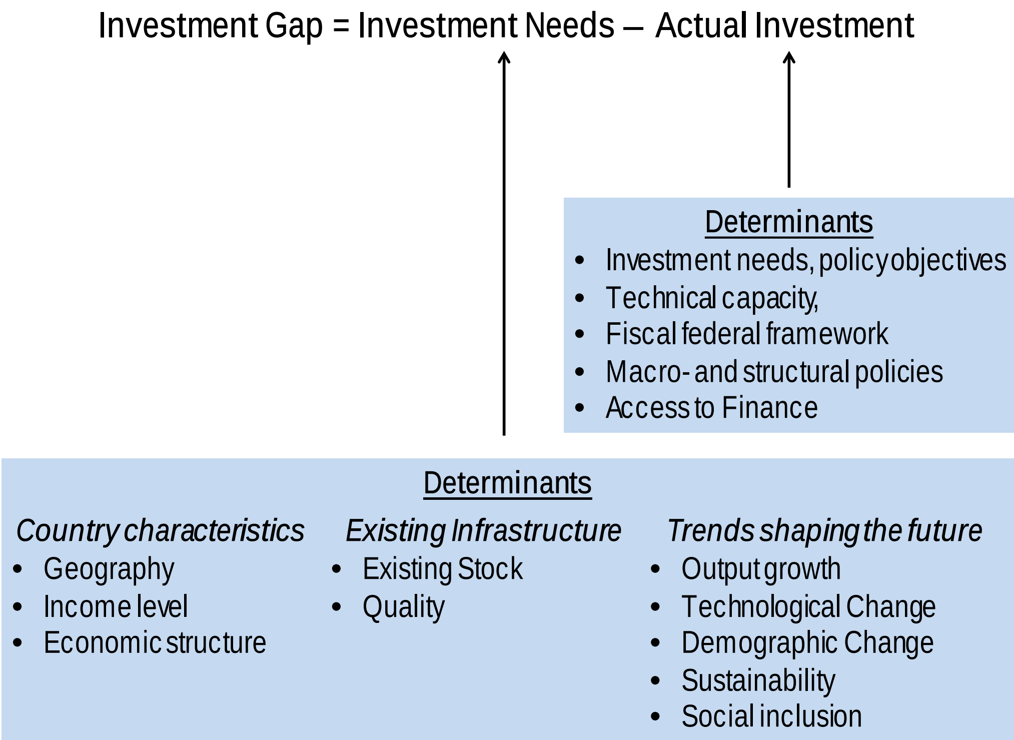
QI investment entered the global debate during Japan's presidency of the G7 in 2015. Both the G7 and G20 summits in 2016 committed to promoting investment in quality infrastructure in Africa. The G7 drew up the Ise-Shima Principles for Quality Infrastructure Investment (QII). The G20 launched the Initiative on Supporting Industrialisation in Africa and LDCs, which looks at building resilient infrastructure among other interventions. Finding a nexus between the G7 and G20 principles for QII and the priorities for Africa enshrined in Agenda 2063 and the PIDA Priority Action Plan remains difficult.

QI approaches should integrate short-term priority projects with long-term development policies and outcomes. An example of such an approach is the Japan

[8] For further information on the PIDA Job Creation Toolkit, see http://www.au-pida.org/job-creation-and-pida-projects/

International Cooperation Agency's (JICA) Corridor Development Approach, which focuses on cross-border transport infrastructure networks (JICA, 2018). These networks can facilitate intra-regional trade and promote regional development. Through this approach, JICA finances infrastructure assets that integrate regions and countries, fostering local economic activities. A second aim is to attract private investment, notably FDI, which in Africa follows the prospective creation of regional markets, a better business environment and better infrastructure (AUC/OECD, 2018).

Figure 9.6. - Definition and Determinants of Infrastructure Investment Gap



Source: EIB.

Infrastructure investment gaps are typically defined as the difference between investment needs and actual investment (Figure 9.6.). Data on actual infrastructure investment are not readily available but can be estimated based on existing macro and project-level data. Investment needs, that is how much countries should be spending on infrastructure, are determined by the need to maintain the infrastructure stock, new needs deriving from changes in income levels and the economy's structure, and future needs deriving from mega trends including technological, demographic and climate change (AUC/OECD, 2018). The relevance of these determinants can substantially change over time, with far-reaching implications for infrastructure needs. Moreover, the long life cycle of infrastructure projects, often beyond 30 years, requires an assessment of infrastructure needs far into the future, which further complicates the task of quantifying needs.

Africa's needs for investment in urban infrastructure are substantial and increasing (Lall et al., 2017). Between 2015 and 2030, Africa's urban population is expected to grow at a rate of approximately 3.5% annually. This will increase the total urban population by about 332 million over the same period (UNDESA, 2018). Urbanisation is often uncontrolled, putting an additional strain on urban infrastructure. Rapid urbanisation, compounded by social and environmental challenges, creates enormous investment needs in terms of sustainable urban infrastructure in Africa.

Making best use of available financing for infrastructure projects requires a deep understanding of Africa's infrastructure context and needs:

- **Energy:** Infrastructure quality in the electricity sector is particularly poor (Figure 9.5.). Infrastructure investment needs in electricity amount to up to 6.6% of GDP over the coming decades (Table 9.2.). The share of the population with access to electricity in 2016 reached 42.8% in sub-Saharan Africa, and almost 100% in North Africa. This compares to 85% across all low and middle income countries, according to the World Bank WDI database. Frequent electricity outages force companies in many countries to rely on expensive electricity from generators, increasing costs and disrupting operational efficiency. On average, firms in sub-Saharan Africa experience 8.5 electricity outages per month, according to the WBG Enterprise Surveys. Electricity production has expanded but remains at the same per capita level as in 2007 reflecting strong population growth (WEF, 2017). With the current investment trends, it will take Africa until 2080 to achieve full access to electricity (UNEP, 2017; Sy and Copley, 2017).
- Africa's enormous potential in renewable energy can help address its energy shortage crisis: 325 days of strong sunlight, 15% of the world's hydropower potential and good potential in wind and geothermal energy (AfDB, 2017). In Morocco, the NOOR solar power plant project will increase the share of renewable energy in the electricity mix up to 42% by 2020. These projects will contribute to addressing energy crises in the region. Therefore, investments that drive the transition to a low carbon economy play an important role.
- The IEA estimates that "increasing the electrification rate in sub-Saharan Africa from around 30% today to 70% in 2040 would cost USD 205 billion in capital investment". It would depend on a combination of on-grid, mini-grid and off-grid access in urban and rural areas. This sum is less than one-fifth of total power sector investment in the region. Achieving this level of investment requires steadily improving the investment conditions for electricity access-related projects, while rapidly increasing capacity and ensuring effective coordination among the various actors involved (AfDB/OECD/UNDP, 2016: 220).
- **Roads:** Poor transport infrastructure holds back intra-regional trade activity, undermining firms' competitiveness. In fact, the cost of trading is about 1.5 times higher for landlocked than for coastal countries (AfDB, 2017). Roads are the main mode of transport in Africa, carrying 80% of goods and 90% of

passengers, yet only 53% of roads are paved (AfDB, 2014). Apart from the importance of strategic regional transport corridors, only one third of Africans living in rural areas are within two kilometres of an all-season road.

- **Rail:** The large number of landlocked countries and small-sized economies in Africa necessitates the development of an efficient rail network. Most of the rail lines are low-speed and small-scale and carry low axle loads. Passenger services account for only about 20% of rail traffic in Africa (EXIM Bank, 2018).
- **Ports**: Africa has around 90 major ports, stretching along a coastline of 30,725 km. African ports currently handle only 4% of global container traffic. African ports also suffer from underdeveloped hinterland infrastructure (EXIM Bank, 2018).
- **Airports:** Although Africa has over 4,000 airports and airfields, a significant number of them do not meet International Civil Aviation Organization (ICAO) standards. Only one in four airports has paved runways. Intra-African air transport growth has been subdued, partly due to underdeveloped infrastructure. In 2015, African airlines carried 79.5 million passengers, representing 2.2% of total air passenger transport (EXIM Bank, 2018). Recent commitments to liberalise air transport and travel, such as the Single African Air Transport Market and removal of visa requirements, can pave the way for improvements in airport infrastructure thanks to increased air travel. Air traffic in Africa is expected to grow at above the world average rate, by 5.9% annually, according to Boeing's Current Market Outlook 2017-2036.
- **Urban transport**: Rapid urbanisation requires substantial investments in public urban transport to promote inclusive and sustainable economic growth. African cities are physically fragmented and dispersed, with a lack of connective infrastructure. Local promoters and the private sector should be supported in exploring wider mobility and public transport concepts. These start from an effective main backbone, for example Bus Rapid Transits or light rail systems where appropriate, complemented by reforms to the public transport system, including route optimisation and institutional and technical organisation and management (Lall et al., 2017).
- **Water:** Infrastructure investment needs in water and wastewater treatment amount to up to 4.1% of GDP over the coming decades (Table 9.2.). Africa's water resources are abundant, but owing to an absence of water storage and irrigation infrastructure, they are grossly underutilised. Over 300 million Africans do not have access to clean drinking water, and over 700 million live without access to good sanitation, according to ICA. Each year, Africans spend an average of 40 billion hours collecting water. A high level of hydrological variability in many African countries makes investments in water storage and irrigation particularly important.
- **ICT:** Infrastructure investment needs in ICT amount to up to 1.4% of GDP over the coming decades (Table 9.2.). Access to the internet can play an important role in promoting skills, entrepreneurship and SME development. However, only 15% of households in Africa have internet access, compared to more than two thirds in Central Asia (AfDB, 2018). The availability of broadband is even more limited. Flows of private investment into ICT in Africa have benefited

only a small number of countries, where the required infrastructure is already well-developed.

Table 9.2. - Infrastructure Investment Needs
(% of GDP)

	Total	Transport	Electricity	Water	ICT
AfDB (2018)	6.9	1.9	2	2.7	0.3
Global Infrastructure Hub (2018)	6.9	2.1	2.2	1.3	1.3
Woetzel et al. (2016)	3.1	0.7	1.3	0.5	0.6

Source: Woetzel, J., Garemo, N., Mischke, J., Hjerpe, M., and Palter, R. (2016). Bridging Global Infrastructure Gaps. McKinsey & Company; AfDB (2018), African Economic Outlook 2018: Chapter 4 - Financing Africa's infrastructure: New strategies, mechanisms, and instruments; Global Infrastructure Hub (2018) Global Infrastructure Outlook - Infrastructure investment need in the Compact with Africa countries, June 2018.
Note: Procedures, assumptions, coverage and time-span vary substantially across the studies included in Table 9.2. The estimates should therefore be interpreted cautiously.

Infrastructure investment needs in Africa are huge, with estimates ranging from USD 68 to 152 billion (3.1% of GDP and 6.9% of GDP) over the coming decades (Table 9.2.)[9]. These amounts cover both maintenance and replacement costs as well as the construction of new infrastructure assets. Infrastructure investment needs reflect a limited infrastructure capital stock in place, which is of poor quality. Moreover, new needs arise from rapid urbanisation, population and economic growth as well as making infrastructure resilient to climate change. Current infrastructure investment of USD 62.5 billion or 3.5% of GDP in 2016 (see section 9.3.), implies a considerable investment gap of up to 11.5% of GDP, according to the studies included in Table 9.2.

9.5. Bridging the Financing Gap

9.5.A. Regulatory Reforms and Capacity Improvements for Africa's Public Sector

Policy interventions can address weak government capacity and low levels of domestic resource mobilisation, which hamper public sector investment in infrastructure. Furthermore, there is an imbalance between the largely centrally financed projects and the sub-national dimension of the beneficiaries of such projects. Two policy actions could help solve these issues. Firstly, greater and better coordination between levels of government could improve local governance and result in more efficient public investment and use of infrastructure assets (AUC/OECD, 2018). Secondly, improving domestic resource mobilisation through increased tax compliance

[9] Estimating infrastructure investment needs is challenging, as they are unobservable and highly state- and time-dependent. The complexity of estimating infrastructure needs is reflected in the broad range of methods used in the literature. Most studies in the field are based on projected GDP growth and country-level elasticities of infrastructure spending to growth. Such studies are highly dependent on the assumptions underlying projected GDP growth. In contrast, simulations based on global models often lack country-specific characteristics and priorities. Referring to declared policy objectives is a straightforward way to capture infrastructure needs, but this approach is highly dependent on the way these policy objectives are set.

and more efficient tax administration systems could help governments finance infrastructure projects more freely (OECD/ATAF/AUC, 2017).

Box 9.3. Central and Local Government Coordination:
The Case of the Johannesburg Development Agency

There are three critical components for successful infrastructure development: adequate financing, institutional capacity to deliver and the state's responsiveness to the needs of citizens or infrastructure users. Coordination between national and local government could significantly enhance all three components.

Administrative bottlenecks can constrain local infrastructure development and reduce the ability of local institutions to finance their operations. The Johannesburg Development Agency (JDA) manages capital projects in the city of Johannesburg. In 2016-17, it undertook 91 projects with a budget of ZAR 1.7 billion (around USD 124 million). To date, approximately 40% of the JDA's work has been funded by the City of Johannesburg, but the agency also charges development fees to fund its operations. By relying on such fees, the JDA often finds itself with very limited cash flow whenever projects are slowed down due to poor planning and administrative burdens by the local administration. Securing more direct funding from the central government has allowed the JDA to plan and implement projects circumventing bureaucratic bottlenecks. Today, the agency receives capital expenditure grants from the National Treasury and the National Departments of Transport and Human Settlements.

Consultations and collaboration with the private sector and civil society can increase the outreach and impact of local infrastructure development projects. The JDA has also effectively mobilised funds from the private sector: for every ZAR 1 million invested by the JDA, private investors have put ZAR 18 million into the inner city of Johannesburg since 2001. Moreover, the JDA's mandate allows the agency to support local small and medium-sized enterprises (SMEs) through public procurement, awarding contracts worth 30% of its procurement budget to SMEs. Finally, the JDA has engaged in partnerships and consultations with the local private sector and civil society to receive feedback on infrastructure projects that it carries out or that are needed by the community.

Improved and better tailored regulatory frameworks can create a more favourable environment for private and institutional investors, helping governments achieve the objectives of the Dakar Agenda for Action[10]. **Specific policy reforms include:**

- **Adopting the PIDA Model Law for infrastructure investment.** Presented at the African Union Summit in January 2018, this initiative devised by UNECA and

[10] See https://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/The_Dakar_Agenda_for_Action__DAA__-_Moving_Forward_Financing_for_Africa%E2%80%99s_Infrastructure.pdf

NEPAD aims to harmonise investment frameworks across the continent. The Model Law introduces regulations specifically tailored to infrastructure investment. Greater legal homogeneity will result in more policy certainty for investors.

- **Enacting regulations allowing pension funds (both African and international) to invest in infrastructure projects across Africa.** If required, DFIs or governments can put in place guarantee systems or absorb greater risk (see also section 9.5.E.).
- **Building public sector capacity for infrastructure project preparation.** As a critical phase (which includes feasibility studies, contract negotiations, project management) of a project's life cycle, adequate design and preparation capacity is vital to generate the bankable projects investors are looking for.
- **Improving procurement rules to reward and promote competitiveness.** Governments should improve their contract awarding procedures and their criteria to reward quality, competitiveness and efficiency, rather than merely rewarding low costs. They should also better prepare public investment projects and enhance transparency, monitoring and evaluation mechanisms.
- **Tailoring investment modes to local institutional capacity and project types.**
    - Public-private partnerships (PPPs) can increase the efficiency of the design and implementation of projects, thus creating substantial savings. However, PPPs require careful public involvement and expertise. The PPP model used in Morocco's solar power station in Ouarzazate provides a good example of ways to engage key players (see Climate Policy Initiative, 2012).
    - Governments can opt for modes of governance for infrastructure projects other than PPPs. These can range from direct delivery, where governments fully manage all aspects of a project, to procurement for specific phases and operations, to privatisation, where governments only retain their regulatory role. More complex project governance requires empowering regulators and ensuring that an independent judiciary can handle disputes (Kappel, Pfeiffer and Reisen, 2017).
- **Strengthening the intellectual property rights regime to promote infrastructure investment.** This is particularly valid for green infrastructure: in African markets very few climate mitigation and adaptation technologies are protected under IP regimes (OECD, 2015a).

9.5.B. Constraints to Private Participation in Infrastructure Delivery

African governments, donors and other multilateral development organisations together finance almost all of the continent's infrastructure today (see Section 9.3.). To satisfy their infrastructure investment needs, African countries would greatly benefit from attracting financing from other sources, including private investors.

Although infrastructure investment opportunities are plentiful across developing countries, investors are not fully seizing them. The infrastructure sector presents specific risks to private investors, and since private participation in infrastructure delivery is a relatively recent form of procurement in many countries, governments do not necessarily have the experience and capacity needed to effectively manage these risks. They often require support to increase their capacity to procure project components in line with internationally recognised, best practice procurement principles.

Three sets of constraints generally limit infrastructure financing in Africa:

- **First, from the demand side, there is a lack of well-structured bankable investment opportunities, especially due to higher perceived risk, market fragmentation and information asymmetries.** Sub-national governments, particularly smaller cities, face challenges in developing local infrastructure due to the smaller size of infrastructure projects and limited capacity of local officials.
- **Second, underdeveloped financial markets and regulatory barriers limit the supply of funding, especially for local long-term finance.** For example, the banking sector in Africa does not cater for infrastructure investments. Bank loans with long maturities are very rare (20-year loans are available in only six of the 24 African countries included in a 2009 World Bank cross-country analysis). Interest rates are excessively high (in three of these six countries the loan interest rate was above 20%). Infrastructure-related bonds are issued in only a few countries, with various levels of success (Irving and Manroth, 2009).
- **Third, the overall business environment can undermine infrastructure investment due to the lack of capacity, transparency and an enabling policy environment.**

9.5.C. Attracting Pension Funds and Institutional Investors

Pension funds can play a major role in financing infrastructure in Africa (Samuels and Danso, 2017a). The need to invest and diversify portfolios for pension funds is high. Assets under management grow at close to 30% per annum in some countries like Nigeria. In sub-Saharan Africa, less than 10% of the population is covered by pension plans, reflecting an enormous need to scale up pension fund and investment opportunities for them (Stewart and Yermo, 2009).

Projects presented to African institutional investors and pension funds, but also other national and international investors today, often do not meet all their requirements. Sometimes, this even includes project proposals from countries with sophisticated financial markets, such as South Africa. Key barriers to stronger involvement of institutional investors and pension funds in financing infrastructure investment in Africa include:

- **Uncertainty:** High uncertainty continues to undermine the willingness of pension funds to engage in infrastructure projects. The risk premium is also significantly higher, with a required internal rate of return of 16-20%, compared to 11-15% elsewhere (Samuels and Danso, 2017b). One reason is that the reported success rate of African projects (i.e. reaching financial close and ability to provide services) is on average only 20%, compared to 46% in advanced economies. Moreover, the ability to price risks appropriately does not always meet international standards.

- **Mismatch between demand and supply:** A mismatch exists between demand and supply of infrastructure financing, depending on the maturity and quality of infrastructure assets. Most of the demand for infrastructure finance is for new infrastructure assets (greenfield). This includes the higher risk initial development phase of projects, including construction before revenues are established. However, as a result of their strict investment strategies, pension funds and other institutional investors are mainly interested in investing in low-risk infrastructure projects that are already operating and evidencing profits with steady revenues (brownfield) (Samuels and Danso, 2017a).
- **Fragmentation:** In many African countries, fragmentation of the financial market is a major issue, with assets split across dozens of small banks, insurance firms and pension funds. Small pension funds may not be able to cope with the minimum ticket size of many infrastructure projects.
- **Regulation:** Regulation is often perceived as the main obstacle to investment in infrastructure by African pension funds. However, reforms in some key markets now allow pension funds to invest in the asset class, albeit with some restrictions. In Nigeria for example, pension funds have been allowed to invest up to 5% of assets under management in infrastructure funds and 15% in corporate infrastructure bonds since 2012. Nonetheless, as of March 2018, only 0.09% was invested in infrastructure bonds or funds (PenCom, 2012, and PenCom, 2018). Even in South Africa, with its sophisticated financial markets, few pension funds have experience in investing in infrastructure. The low levels of investment in these asset classes may reflect regulatory barriers such as a ban on direct equity stakes and limitations on cross-border investments. Unrestricted access of pension funds to new asset classes and markets which are also unfamiliar to regulators, entails risks, as the global financial crisis has clearly shown. The majority of African regulators have demonstrated a willingness to work with the industry to gradually open up new investment options whilst protecting system stability.
- **Capacity building:** A strategic and timely approach to planning and proposing infrastructure opportunities is needed to attract pension funds as investors. Pension funds, regulators and other stakeholders must be empowered with the right information which enables them to evaluate if and how infrastructure fits within their investment strategies and objectives. Moreover, they require sufficient availability of investable assets and appropriate vehicles through which to invest. However, until recently, there has been little effort to understand the specific risk appetite, regulatory regime and return expectations of African pension funds.

9.5.D. FINANCIAL INSTRUMENTS FOR MORE PRIVATE SECTOR INVESTMENT

Successfully crowding in private investors in infrastructure financing in Africa requires the availability of effective financing instruments. Some of the characteristics of these financing instruments may be unfamiliar to investors due to the specific nature of project finance. In project finance, lending arrangements are based solely on the cash flow generation of the project. Structures for sharing risks amongst financiers, managers and the public sector are allocated on the basis of who can bear them best. Liability is limited to the contributed equity capital (OECD, 2015b).

Table 9.3. - Taxonomy of Instruments and Vehicles for Infrastructure Financing

Asset Category	Instrument	Examples
Fixed Income	Bonds	Project Bonds Municipal, Sub-sovereign bonds Green Bonds, Sukuk Bonds, Diaspora Bonds
	Loans	Direct/Co-Investment Lending, Syndicated Project Loans
Mixed	Hybrid	Subordinated and Convertible Loans/Bonds, Mezzanine Finance
Equity	Listed	Shares, YieldCos (contracted tariffs for power generation)
	Unlisted	Project Equity, PPP

Source: OECD (2015b), Infrastructure Financing Instruments and Incentives, OECD Publishing, Paris.

The OECD has developed a taxonomy of instruments for infrastructure financing, covering debt, equity and hybrid instruments (Table 9.3.). Debt instruments can take the form of direct loans held on the balance sheets of financial institutions or may be structured for resale. Equity finance refers to all financial resources that are provided to firms in return for an ownership interest. They are crucial in the financing of infrastructure investments as the providers of risk capital to initiate a project or refinancing. Listed equity shares are indirect participation rights, with limited ability to influence management. Instead, unlisted equity often confers direct ownership, control and operation of the corporate entity or project asset. The attractiveness of equity instruments also depends on other features, such as availability of exit options. Hybrid instruments such as mezzanine finance are debt instruments with, at times optional, equity-like participation in projects.

Not all of the instruments included in the OECD taxonomy meet the economic, institutional and social characteristics of African countries. Substantial institutional and economic differences across African countries are one reason. Advanced financial instruments such as hybrid debt funds, syndicated loans and listed infrastructure equity funds may require further financial market deepening as well as strengthening of the institutional environment and collaboration with international institutions in a number of African countries to be successful. Moreover, perceived risks of institutional investors in Africa may be higher than elsewhere, because in many African countries experience with infrastructure as an asset class is still limited.

Learning from the experience of other African countries and international investors active in the region in using novel financing instruments is a viable approach. For such new financial instruments to meet the needs of private investors, they should be developed in close collaboration with finance experts, investors and project developers in the country. Also, country-specific economic and institutional circumstances have to be taken into account.

The experience of some African countries, including Nigeria and South Africa, suggests that risk mitigation instruments can be useful in crowding in private investors. The long-term nature of infrastructure projects combined with important institutional and political uncertainty in many African countries and a lack of expertise of infrastructure as an asset class imply high perceived risks for private investors. Moreover, under current economic projections, many countries will not be able to sustain current levels of public investment (AUC/OECD, 2018). Finally, currency risks often impede investment in (cross-border) infrastructure in Africa. The public sector can kick-start private infrastructure investment through effective financing and risk mitigation instruments. The following instruments seem to be particularly useful in crowding in private investors:

- **Guarantees:** Guarantees may be particularly effective in overcoming the high risks associated with the initial phase of infrastructure projects. Guarantees may also help to attract investors from abroad: OECD pension funds are required by law to hold assets rated at least A-, which is well above the rating of many sovereigns in Africa (Samuels and Danso, 2017b).
- **Debenture structures**: Debenture structures can eliminate the elevated risks associated with the initial phase of a project. Governments buy debentures or convertible bonds to finance a project. After construction and after some of the initial risks have subsided, the government can sell the bond to private investors. Thereby government interim finance is used at the time that it is most expensive for the private sector. Investors, against a reasonable price of the debenture structure, can benefit from any upside risks in the projects, if bonds are convertible. MDBs can support such initiatives by providing short-term, flexible loans for governments to buy debentures or convertible project bonds (AfDB, 2018).
- **Project puttable bonds:** These bonds are designed to mobilise pension and life insurance funds as well as sovereign funds. They finance long-term investment funds from the beginning to the closing of a project, avoiding the refinancing risk. An MDB can provide a put option against a guarantee premium. After a predefined period, the private investor has the option to sell the bond to the MDB, on the condition that the projects do not meet predefined specific minimum conditions. Such bonds can also make greenfield projects attractive for institutional investors (AfDB, 2018).
- **Diaspora bonds**: Dedicated institutions and investment projects can attract savings from the diaspora. Morocco has quite successfully enacted policies to handle investment issues for its diaspora, particularly for the housing sector (see OECD, 2017). Likewise, Ghana has established a new dedicated unit to handle investment issues for its diaspora (UNIDO, 2013). Mauritius has set up a Diaspora Scheme to encourage diaspora members to return and invest in the

country. Ethiopia and Nigeria have created diaspora-indexed bonds, but subscriptions remained limited.

- **Infrastructure asset market**: To support the creation of an infrastructure market, IFIs could sell existing infrastructure assets to institutional investors from host countries. This process would help to jumpstart the required transformation in the investment ecosystem of the main sources of institutional investment (Samuels and Danso, 2017a; AfDB, 2018).

9.5.E. Development Finance can Crowd In Long-Term Investment

Official Development Finance (ODF) remains an essential tool to finance investment gaps in infrastructure. First, it is still an important source of finance for infrastructure development in Africa, averaging USD 13 billion a year between 2009 and 2016. ODF is particularly important for aid-dependent governments and sectors where domestic resource mobilisation capacity is weak and private sector contributions are insufficient. Moreover, development partners can provide seed capital as they have a higher tolerance of risk associated to high initial investment. They can pursue operations with higher quality standards and impact criteria, which may positively affect project outcomes and improve the local environment.

ODF can support the policy framework and institutional capacity to provide an enabling environment for infrastructure development. Almost 20% of ODF for infrastructure in developing countries was allocated to improving the policy framework relating to infrastructure sectors in 2014, particularly energy (Miyamoto and Chiofalo, 2016). For example, development partners can help strengthen regulatory authorities, share expertise in financial and operational restructuring of state-owned enterprises, and support capacity building of municipalities in sustainable use and management of water resources.

Multilateral development banks (MDBs) also remain key players in financing infrastructure. Globally, MDBs' commitments to infrastructure more than doubled between 2005 and 2014 at a compounded annual growth rate of 10%. MDBs play a central role in the recently established Global Infrastructure Forum, designed to help bridge the financing gap and achieve the goals of the Addis Ababa Action Agenda for financing sustainable development (UN, 2015). Other relevant initiatives include the Public-Private Infrastructure Advisory Facility (PPIAF), which provides both financial and technical support to central and local governments to increase private sector involvement in infrastructure development.

A large number of initiatives by MDBs are underway to increase the stock of infrastructure in Africa. In Africa, the AfDB identifies infrastructure as a major pillar of its High 5 strategy, especially in energy. USD 34 billion was invested in energy sector operations, while over USD 440 million was approved in 2016 alone for regional transport and ICT projects. Other facilities such as the Infrastructure Consortium for Africa (ICA) and Africa50 facilitate and mobilise infrastructure investment across the continent. The EIB has, through its External Lending Mandate, invested EUR 3 billion into infrastructure in Africa between 2015 and 2016. Moreover, North Africa benefits from the new EIB Economic Resilience Initiative.

Donors can use development finance to attract additional private finance into infrastructure development projects. Development Finance Institutions (DFIs) and MDBs have already initiated and scaled up 167 funds and facilities for blended finance interventions between 2000 and 2016. Among them, more than 39 funds and facilities have already integrated affordable and clean energy development as one of their objectives, 36 have prioritised clean water and sanitation, and 41 have supported industry, innovation and infrastructure (OECD, 2018).

Development partners have broadly taken three approaches to blended finance (OECD, 2018):

(1) **Governments and bilateral aid agencies typically provide grants and other forms of concessional financing for blended finance.** MDBs finance and manage blended finance funds and facilities. The World Bank Group's "cascade approach", for example, prioritises blending to cover the finance needs of development projects.
(2) **The process of lending is in itself an intermediary step towards unlocking further private finance for development projects.** For instance, the EIB has, through the EU-Africa Infrastructure Trust Fund, unlocked for each euro invested a total of EUR 18.1 of new infrastructure investment (EIB, 2018).
(3) **Other private sector-oriented DFIs take a pathfinder and market leader role, especially in countries where there are few alternative sources of financing.** By doing so, they reduce uncertainty and accelerate market development. While blended finance offers potential, a survey of existing facilities shows that blended finance transactions will have to adapt to local contexts to ensure long-term sustainability and effectiveness.

ODF can also support infrastructure development through various instruments. Guarantees remain an important tool, but they do not solve the issue of low project bankability (50% of projects fail at the preparation stage). Development partners can also directly target specific project phases and shield investors from risks associated to high initial investments. Direct financing of project design, preparation and implementation, or technical assistance to support these, can help create more bankable projects, attracting private investors and benefiting local economies. Repayment of (at least part of) these costs can help "recycle" this initial financing.

9.6. Conclusion

Low investment in infrastructure over an extended period of time has translated into a lack of key infrastructure and poor infrastructure quality in many African countries. On average, African countries rank 98 out of 137 countries in terms of infrastructure in the World Economic Forum's Global Competitiveness Index. Best performers include Mauritius (ranked 40th), Seychelles (50th) and Morocco (54th). Various studies estimate infrastructure needs in Africa to range between 3.1% and 6.9% of the continent's GDP.

Africa's infrastructure deficit is a major impediment to the continent's growth because it hinders domestic private development, deters FDI and limits the provision of economic and social services. Moreover, it is important to understand infrastructure quality as a multidimensional concept to ensure the strongest social, environmental and economic impact.

Three key constraints limit infrastructure financing in Africa. On the demand side, there is a perceived lack of well-structured bankable investment opportunities, especially due to higher levels of real and perceived risk and of market fragmentation. Underdeveloped financial markets and regulatory barriers also limit the supply of financing. Moreover, the overall business climate undermines infrastructure investment due to the lack of capacity, transparency and an enabling policy environment. This also applies to public infrastructure investment, which would benefit from strengthened government capacity and domestic resource mobilisation.

To meet infrastructure investment needs, African countries must attract more private capital. Currently, African governments, donors and other multilateral development organisations together provide over 85% of financing for the continent's infrastructure. If financing from China is included this share increases to 96%. International and domestic institutional investors have specific requirements and limited experience in financing infrastructure projects in Africa. Crowding in private investors requires a strategic and timely approach to planning and proposing infrastructure opportunities to donors and investors. African countries can learn from each other and international investors active in the region in implementing new financial instruments that seem to be able to attract private investors. Such instruments include risk mitigation instruments, convertible bonds, and creating an infrastructure investment market with the support of international financial institutions.

Multilateral development banks (MDBs) can play a key role in upgrading Africa's infrastructure and crowd in private investors. MDBs' global and multi-sector expertise in infrastructure projects and their flexibility in terms of investment horizon, financial structuring and contract renegotiation can be viable means of crowding in private investors. Well-targeted guarantees or subsidies alongside the use of co-financing could help to implement viable projects in vulnerable countries. Infrastructure investment platforms have further extended the practice of co-financing, whereby MDBs, DFIs and private lenders join forces and coordinate where possible to support infrastructure investments. Moreover, DFIs and MDBs can often provide technical assistance to increase the quality and impact of projects along the project cycle and to make them bankable and attractive for private investors.

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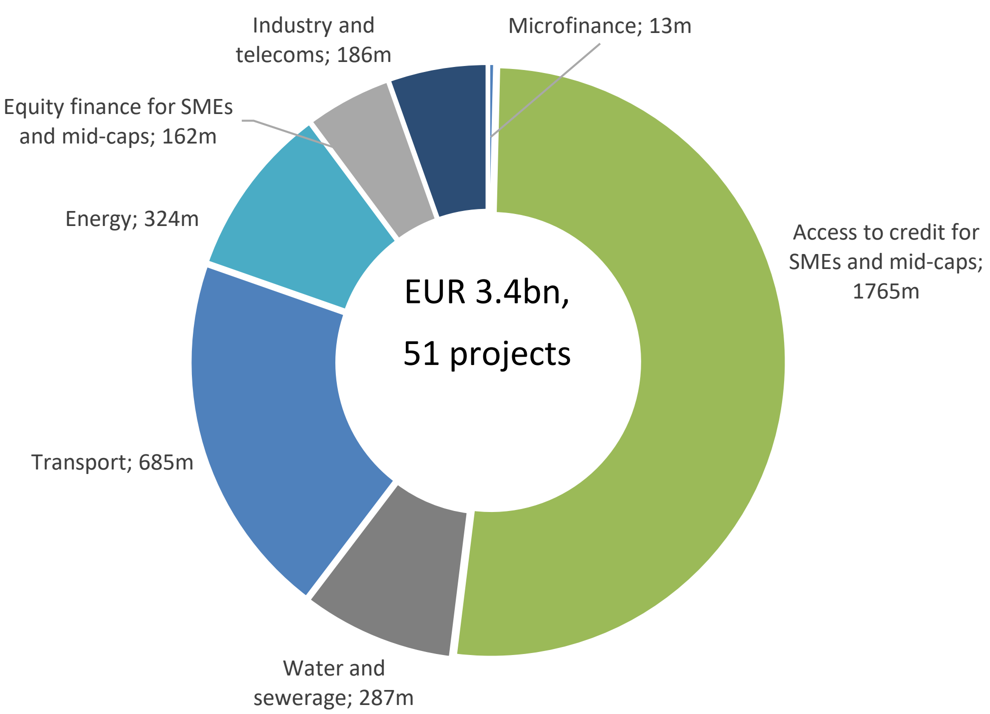
Afterword[1]

Boosting the Financial Sector for Sustainable Development in Africa

The European Investment Bank has been active in Africa since 1963, and is among the leading financiers on the continent, supporting private and public sector projects. In 2017, 51 projects in a variety of sectors were supported with over EUR 3bn of funding (Figure 1.). Around 56% of these projects focused directly on the financial sector. Operations in other sectors help to create the conditions for inclusive and sustainable economic growth and private sector development, which in turn complements the EIB´s financial sector-focused operations.

Figure 1. - EIB Lending for New Projects Signed in 2017 in Africa
(EUR)



The EIB's financial sector operations target two complementary objectives: promoting financial sector development and **enhancing access to finance**. Achievement of these objectives will boost the prospects of private sector development, contributing to the elimination of poverty and to sustainable

[1] This chapter was drafted by Tim Bending, Claudio Cali, Nina Fenton, Andreas Kappeler and Sónia Leonardo. The authors gratefully acknowledge that this chapter has benefitted from feedback from EIB colleagues, especially Robert Schofield. However, the view expressed here are those of the authors and not necessarily reflect those of the European Investment Bank. All remaining errors remain the authors'.

development, in line with EU priorities for the region and the Sustainable Development Goals.

On top of its own resources, the Bank finances projects in Africa under the External Lending Mandate (ELM) and the Africa, Caribbean and Pacific Investment Facility (ACP-IF), a revolving fund established under the ACP-EU Partnership Agreement (Cotonou). The EIB also mobilises third-party donor financing from EU member states and others, and works with private sector partners, International Financial Institutions and other financiers to support projects across Africa. With these resources, the EIB employs a wide range of financial instruments in support of the financial sector, tailoring its support to reach final beneficiaries with different needs and facing different constraints.

Channelling Funds to Private Enterprises through Intermediated Lending

As this publication has highlighted, private enterprises across Africa struggle to access finance for productive investment, particularly at longer tenors. Smaller, younger firms and innovative companies are often the most affected. Many of the affected firms are likely to grow, innovate, and sustain and create employment if they can access appropriate finance. The EIB supports financial intermediaries reaching out to African private sector firms. Most of the intermediaries are local or regional banks, financial institutions or funds, and many receive support such as Technical Assistance (TA) alongside an EIB loan. This means that these operations help to strengthen both the firms receiving funding and the local and regional financial sectors.

- **Intermediated lending to support access to credit for SMEs and mid-caps is the largest single activity for the EIB in Africa**. This lending takes place principally through credit lines to local banks, sometimes in local currency. The banks on-lend these funds to eligible clients, providing much-needed long-term funding for private businesses. Such credit lines are also an important way to help strengthen local banking sectors, helping local banks to expand into the SME segment and to under-served markets. New credit lines provided in 2017 will enable local banks to provide around 5 000 loans to African SMEs and mid-caps. The average tenor of these loans is expected to be almost five years - a significant increase relative to typical loan durations available in local markets. Beneficiary companies are expected to sustain over 160 000 jobs.

- **Credit lines to microfinance institutions enable the EIB to channel funds to even smaller enterprises**. EIB lending to microfinance institutions in Africa in 2017 is expected to support over 44 000 micro-entrepreneurs. Whenever possible, the EIB makes these investments in local currency, removing the foreign exchange risk facing both the institutions and end borrowers. This is particularly important when targeting the under-served: the poor and the smallest micro enterprises tend to do most of their business in domestic markets, and can least afford to deal with the risks of hard currency exposure.

The ability to provide such local currency loans has been a key factor in enabling the EIB to extend its outreach in countries where this was previously limited, including through recently signed operations in Mali and Senegal.

- **Participation in equity funds enables the EIB to reach a further set of high-potential firms.** The investee companies of private equity funds supported by the EIB in 2017 are expected to create almost 25 000 jobs. The underlying businesses supported are often at an early stage or moving into innovative industries or new markets, and they are generally perceived as risky. As a result, these firms often struggle to access appropriate and affordable funding from banks, even though they may have high potential for scaling their businesses, generating revenue and employment, and providing goods and services to local consumer markets. EIB participation in private equity funds helps them to support these firms. It also helps to deepen and strengthen young or nascent equity markets. Many of the funds supported by the Bank invest in high tech, tech-enabled or innovative industries. The EIB's ability to engage with these funds has been enhanced in particular by the risk-absorption capacity of the Impact Financing Envelope (IFE). This special envelope was established under the ACP-IF to support projects expected to generate high development impacts, but which could not usually go ahead because of their risk profiles. As an example, in 2017 the Bank signed an EUR 8m equity stake, using IFE resources, in Cepheus Capital, an Ethiopian-based growth fund. Run by two experienced Ethiopian partners, the Fund plans to invest in around 12 businesses in sectors such as telecommunications and Information and Communications Technology, helping them to diversify and grow by accessing new African markets. Moreover, it will provide patient capital in a country where even shorter-term loan financing is scarce.

Technical Assistance and Capacity Building for Financial Sector Development

Advisory and TA services play a vital complementary role alongside finance in enabling EIB projects to go ahead, to be successful and to be sustainable. In financial sector-focused operations, TA is often used to address gaps in the capacity of the intermediaries and the enterprises they support. This enhances the impact of these operations for both clients and the financial sector. In 2017, the EIB approved almost EUR 15m for 15 TA operations in Africa.

The EIB also supports selected capacity building initiatives at sector level. For example, the EIB is working with the International Monetary Fund (IMF) to support financial sector development across sub-Saharan Africa (SSA). Under an agreement signed in early 2018, the EIB provided EUR 3m to support IMF capacity development activities up to the end of 2020. Activities supported range from identifying gaps in financial sectors with the goal of designing a TA roadmap to strengthening the reporting on financial sector statistics in targeted countries. The IMF and the EIB will also launch a joint online course on financial intermediation and inclusion under this initiative. As part of its TA work in Southern Africa, the Bank has joined forces with the Frankfurt School of Finance to provide capacity building through banking training courses for the staff of EIB financial sector clients. In addition, by working with local universities and establishing a Banking and Finance Academy, the Bank aims to make banking and finance courses readily available in targeted countries.

Creating the Conditions for a Thriving Private Sector

The EIB's investments in infrastructure and essential services in Africa support private sector development and hence inclusive and resilient growth and sustainable development. In 2017, the Bank signed 23 new infrastructure projects in Africa for a total of EUR 1.5bn, all of which helped the countries to tackle constraints to social and private sector development. For example, 13% of enterprises in SSA identify access to electricity as the main constraint to their development (World Bank Enterprise Surveys, various years). Addressing this challenge, five EIB energy projects signed in 2017 are expected to achieve clean and renewable generation capacity of almost 3 000 GWh/year - sufficient to supply 1.9 million households. The EIB is also helping to tackle gaps in transport infrastructure: seven road and urban transport projects were signed in 2017. The widening of the busy Mombasa port access is expected to benefit the users of up to 38 000 vehicles a day and bring considerable safety improvements, 179 000 passengers a day are expected to benefit from rapid transit bus services and around 22 000 vehicles a day will drive on improved roads.

As in the financial sector, TA resources often play vital role in complementing EIB infrastructure financing, including under the EU-Africa Infrastructure Trust Fund. Donors to the Trust Fund, which was initiated in 2007, include the European Commission and several EU Member States. Over the past decade, the fund has supported more than 85 infrastructure projects, and each euro provided has unlocked EUR 18.1 of new infrastructure investment.

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eBook: QH-06-18-177-EN-E ISBN 978-92-861-3848-5 doi:10.2867/318727
pdf: QH-06-18-177-EN-N ISBN 978-92-861-3846-1 doi:10.2867/4399