FINANCE AND BANKING IN AFRICA

Extracts from the Africa Progress Report 2014

POLICY BRIEF

AFRICA PROGRESS PANEL

EXTRACTS FROM THE AFRICA PROGRESS REPORT 2014

Finance and banking in Africa

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Shaking up Finance and Banking in Africa

Africa stands at a crossroads. Economic growth has taken root across much of the region. In many countries, exports are booming, foreign investment is on the rise and dependence on aid is declining. Governance reforms are transforming the political landscape. Democracy, transparency and accountability have improved, giving Africa's citizens a greater voice in decisions that affect their lives.

At the same time, many African governments are failing to convert the wealth created by economic growth into opportunities that all Africans can exploit to build a better future. Inequality is increasing. Poverty is not falling nearly as fast as it should, and Africa's share of global malnutrition and child deaths is rising fast.

Africa needs long-term growth that benefits all Africans. That requires nothing less than an economic transformation. This policy brief focuses on a vital ingredient of such a transformation: sustainable and inclusive financing. The brief draws on the analysis of financing and banking in Africa in the Africa Progress Report 2014.

The lack of access to formal financial services is a major obstacle to the advent of transformative growth on the continent. No region has a lower level of access to financial services. Only one in five Africans have any form of account at a formal financial institution; the poor, rural dwellers and women face the greatest disadvantage. Such financial exclusion undermines opportunities for reducing poverty and boosting growth that benefits all.

No sector suffers more from financial exclusion than agriculture. Farmers need access to finance – including credit, savings, insurance – to insure themselves against risks such as drought, and invest more effectively in better seeds, fertilisers and pest control. But Africa's farmers lack access to insurance, so they have to put their meagre savings into contingency funds to deal with emergencies, rather than investing them in boosting productivity. Similarly, lacking access to loans and saving institutions, they are often unable to respond to market opportunities.

The region's financing environment must be transformed. Ten years ago, countries across Africa were still emerging from the Heavily Indebted Poor Countries initiative. Today, many of the same countries have entered sovereign bond markets. But Africa cannot meet its financing needs in infrastructure and skills development through aid and commercial market debt financing alone. That is why there is no substitute for domestic financing. Unfortunately, economic growth has done little to increase either the rate of savings or the proportion of GDP that is collected in domestic tax revenues – outcomes that point to the need for institutional reforms.

Greater financial inclusion will allow the continent to tap into the vast potential of its domestic resources to finance its huge infrastructure and energy deficits. As the Chair of the Africa Progress Panel, Kofi Annan, has repeatedly said, "One of the greatest barriers to the transformation of the power sector is the low level of tax collection and the failure of governments to build credible tax systems. Domestic taxes can cover almost half the financing gap in Sub-Saharan Africa."

Some countries are harnessing pension funds for energy financing. Ghana, Mozambique and Nigeria, for example, have used their pension funds to engage in a more active financing strategy of their energy sectors. In general, the scale of pension-fund investment remains limited but illustrates the potential for tapping into a deeper pool of savings.

Speaking at the World Economic Forum in Davos in January 2016, our panel member Tidjane Thiam rightly emphasised that "there is capital in Africa; it's an aberration that we don't have pension funds …When you have a positive demography, it's the right time to put into place pension funds".

Africa's banking and finance sector needs a shake-up. The good news is that this is starting to happen – as we explain in this policy brief. Peer-to-peer banking and mobile banking are beginning to thrive. More and more Africans are embracing the power of domestic savings – and insurance markets will soon emerge as an exciting and effective means to invest those savings.

Mobile technology is becoming pivotal in addressing the needs of the 80 per cent of citizens who are excluded from the financial system. Local banks must now begin to function more as "real" banks to serve the demands of small and medium-sized enterprises, many of which are run by dynamic "agropreneurs." Pension funds will be increasingly seen as an essential and exciting means to provide long-term capital.

Transforming the financing environment is the way to unleash Africa's full potential, for the benefit of all Africans for generations to come. Let's start now.

Caroline Kende-Robb
Executive Director
Africa Progress Panel, March 2016

Finance and Banking in Africa

Extracts from the Africa Progress Report 2014

If Africa is to make the transition from high growth to transformative growth that we have described, with agriculture at its heart, then it must overcome three major obstacles. The first is a lack of access to formal financial services. Two-thirds of adult Africans do not have a bank account, let alone access to savings, credit or insurance. The second obstacle is the weakness of Africa's infrastructure: its poor roads and ports, its lack of electricity, sanitation and water. The third is the lack of funds for public investment. To close the region's vast deficits in infrastructure, governments must mobilize the tax revenues and external finance needed to underpin public investment. This would support the development of agriculture and a skilled workforce.

Overcoming these three deficits is a condition not just of rising prosperity but also of shared prosperity. Agriculture is the key to the kind of growth Africa needs, but no sector suffers more from financial exclusion, infrastructural weaknesses and lack of public investment.

Inclusive finance plays a vital role in development. Without access to financial services, poor people and small enterprises have to rely on their own limited resources to invest in entrepreneurial activity, or to insure themselves against risk. As we saw in the previous section, uninsured risk is part of the poverty trap in which millions of smallholder farmers are caught. Springing that trap will require changes in financial regulation and exploitation of new opportunities created through technological innovation, such as mobile banking.

Like financial systems, infrastructure occupies a pivotal position in social and economic life. Companies use energy to produce the goods and services on which employment depends. Transport systems link people and markets. Social infrastructure – such as water and sanitation – enables people to avoid health risks. But Africa's poor infrastructure acts as a bottleneck constraining growth, driving up the costs of producing and marketing goods. The costs are spread across society, but the poor, smallholder farmers, and small and medium-sized enterprises bear the brunt.

This section of the report is divided into three parts. Part one highlights the limited access to financial services evident across much of Africa. Part two asks why Africa finds it so difficult to attract investment for infrastructure programmes that offer high returns, in a world awash with liquidity. Part three shows that while external finance such as foreign direct investment and eurobonds can play an important supplementary role, no country can afford to neglect the development of domestic revenues and the accompanying social contract between governments and citizens.

1. A lack of financial services is holding Africans back

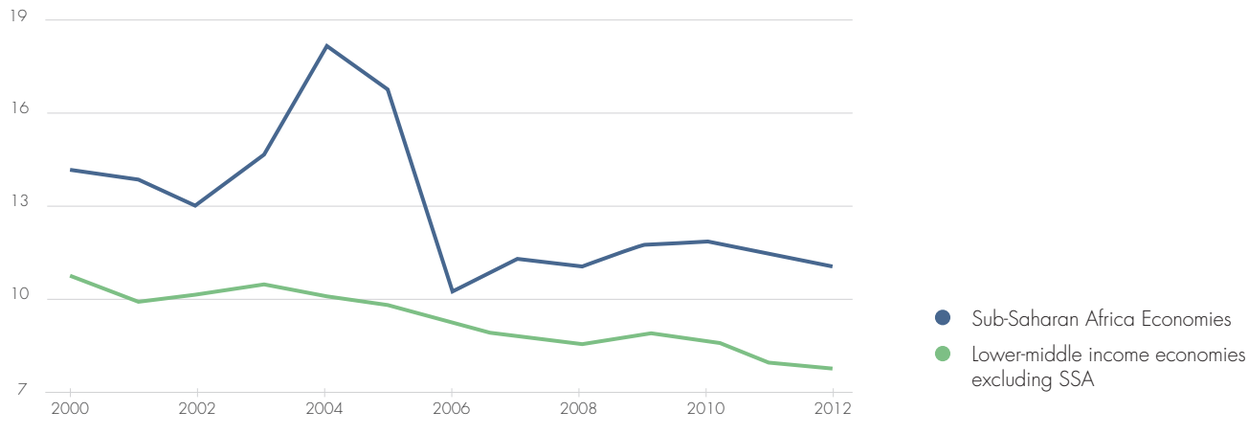
Developing the financial sector is one of the most urgent challenges facing Sub-Saharan Africa. As the governor of Ghana's central bank has put it: "An efficient financial sector provides the rudiments for income growth and job creation [and] … financial development contributes to the reduction of poverty and inequality."[1]

Despite the robust growth of the past decade, the poor coverage of the region's financial systems remains a brake on growth. The vast majority of low-income households, agricultural producers and firms lack access to financial services. The resulting deficit traps people in poverty and restricts market opportunities. While low average income is a constraint, in much of Sub-Saharan Africa the policy environment is not conducive to the development of efficient and equitable financial systems.

Financial systems cover far too few people

Africa's banks typically serve a minority of the population. One way of measuring the coverage of the financial system – or "financial depth" – is by the ratio of private credit to GDP. That ratio averages 31 per cent in lower-middle income countries. In Uganda and Zambia it is less than 20 per cent, and in Chad it is just 5 per cent. In addition, only a third of African countries have stock markets, most of which are small and illiquid. The weak role of banks in Africa is reflected in interest rate spreads – the gap between the borrowing rates and lending rates of financial institutions – which are among the largest in the world (Figure 1). The spread matters on several counts. Low interest rates for savers deter the development of deposits, while a combination of high interest rates and the domination of short-term credit limit investment opportunities. Although individual country circumstances vary, the following are among the primary factors behind large interest rate spreads:

FIGURE 1 AFRICA HAS SOME OF THE WORLD'S LARGEST INTEREST RATE SPREADS (LENDING RATE MINUS DEPOSIT RATE, %)



Source: The World Bank Group (2014), World Development Indicators.

Market concentration: Market power and the "too big to fail" syndrome are characteristics of many banking systems around the world. However, international comparisons suggest that Africa is home to some of the most concentrated banking systems. In Mali, five banks account for over two-thirds of assets and 70 per cent of deposits.[2] Ethiopia's banking sector comprises one state-owned bank and 18 commercial banks, with one state-owned entity accounting for 70 per cent of the commercial market. Around 85 per cent of Mozambique's banking system assets are held by three banks.[3]

Reach and size: Most of Africa's banking systems operate as small enclaves in the wider economy. In Mozambique and Tanzania, over half of the population has no access to financial institutions. Financial services are dominated by informal providers. The vast majority of Africans access services through microfinance companies and rotating savings and loans groups. Out of a population of 90 million, only 7 million Ethiopians have deposit accounts[4] (and only 112,793 reported borrowing from a bank in 2012). By contrast, the country's 31 microfinance institutions serve 3 million clients. Patterns of provision vary across countries. In Nigeria, the northwest has one-quarter of the formal banking coverage of the southwest; rural coverage is less than half of urban coverage. The limited reach of banks restricts people's access to savings and drives up the costs of delivering services and providing loans. Reinforcing the problems that come with a limited reach, many individuals and companies are unable to meet the formal eligibility requirements for opening an account.

The regulatory environment: Governments use banking systems for a variety of objectives, not all of which are conducive to developing more efficient and equitable financial systems. In Ghana, commercial banks operate a highly lucrative trade in government securities, reducing incentives to seek investment opportunities in the private sector. In Ethiopia, banks are required to hold the equivalent of 27 per cent of their lending in national bank bills. The lower returns on these bills lead to banks raising fees and commission charges. In Zambia, the government holds a stake in 39 state-owned enterprises[5], most of which are unprofitable – and many of which borrow from commercial banks with government guarantees. Many banks are structured principally to secure large profits on trade in treasury bills, rather than to develop wider saving and lending systems.

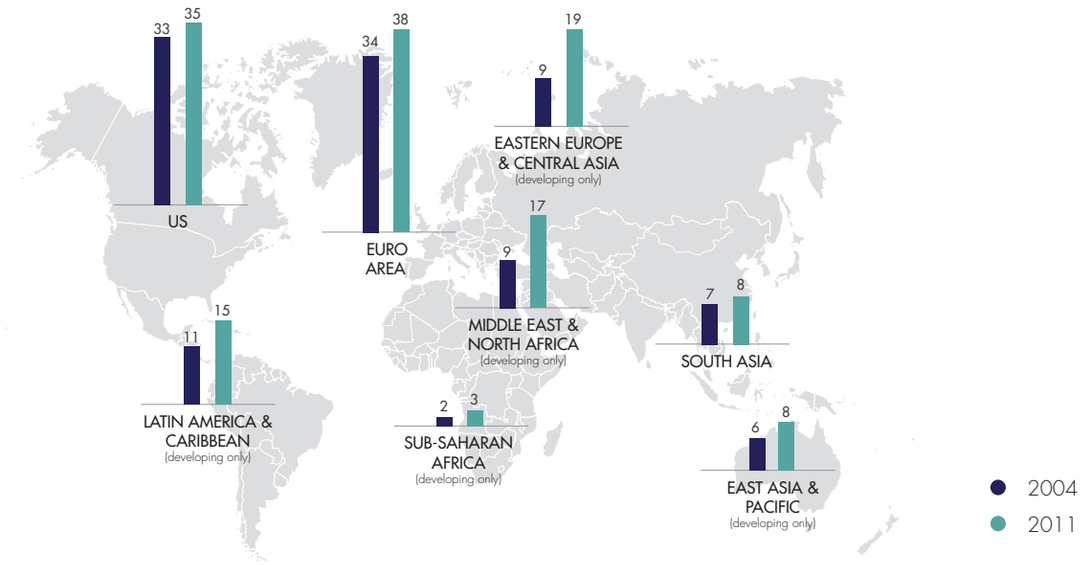
Macroeconomic conditions: While macroeconomic management has strengthened, uncertainties continue to hamper financial development. The inflationary risk associated with Ghana's large fiscal deficit has led to a squeeze on credit and a sharp increase in interest rates. In February 2013, Ghana's central bank authorities raised interest rates to 18 per cent – a prohibitive level for potential investors.

Financial sector weaknesses have far-reaching implications for the real economy. Less than one-quarter of African businesses hold a loan or line of credit – and the problems do not end there. Most banks reprocess savings in the form of short-term loans rather than the long-term credits that companies need to finance investment. Almost 60 per cent[6] of the loans extended by African banks have a maturity of less than one year. Over half of companies surveyed by the World Bank in Burkina Faso, Cameroon, the Democratic Republic of the Congo (DRC), Côte d'Ivoire, Mozambique, Malawi, Niger and Nigeria cited access to finance as a major constraint on investment. In Nigeria, a survey by the World Economic Forum identified access to financing as the single biggest constraint, ahead of corruption and infrastructure.

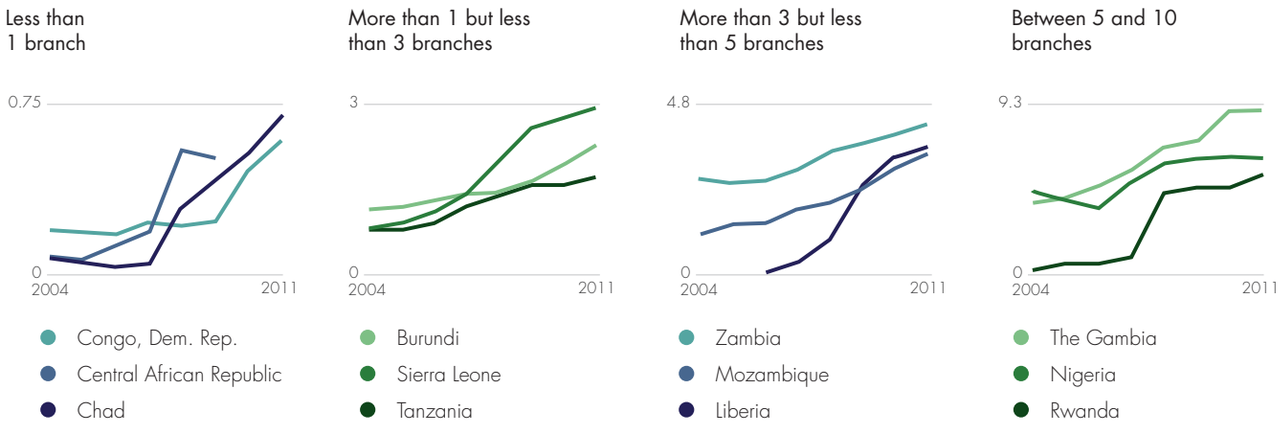
Mapping the gap in financial services

The social and geographic reach of Africa's financial system is increasing. The number of commercial bank branches per head of population, for example, is rising (Figure 2). This trend has to be placed in context, however: Africa's bank branch-to-population ratio is still only 3 to 100,000 – half the level in South Asia. Moreover, there are 4 countries in the region with less than 1 branch for every 100,000 people.

FIGURE 2 AFRICANS LACK ACCESS TO BANKING: COMMERCIAL BANK BRANCHES PER 100,000 ADULTS



BANK PRESENCE IS GROWING FROM A LOW BASE: COMMERCIAL BANK BRANCHES PER 100,000 ADULTS



Source: The World Bank Group (2014), G20 Financial Inclusion Indicators.

Most Africans are disconnected from the formal financial system. Over two-thirds of the adult population – 316 million people – have no bank account. Coverage rates vary enormously across Africa. In half of the countries for which data is available, fewer than 15 per cent of adults have accounts at a formal financial institution.

Financial system coverage tends to rise with economic growth, as measured by per capita income, but the relationship is far from straightforward (Figure 3). Zambia and Senegal have comparable GDP per capita, for example, yet in Zambia penetration of formal institutional accounts is four times higher. At a lower level of average income, Liberia has a far higher level of coverage than Niger. Such facts graphically illustrate that factors other than income are determining financial penetration.

Behind the national numbers there are marked disparities within countries; inequalities in access to financial services both reinforce and reflect wider disadvantages, including wealth, the rural-urban divide, gender and education (Figure 4):

The wealth divide: As might be expected, poorer people are far less likely to have a financial account than their wealthier counterparts. Almost half of Africans in the richest 20 per cent are registered with a formal financial institution. That is four times the rate for the poorest 20 per cent. But the relationship is not automatic. This can be illustrated for a large group of countries by ranking countries on their levels of coverage and dividing their populations into the top 60 per cent and the bottom 40 per cent. Ghana and Rwanda have comparable rates of account coverage. Yet the poorest 40 per cent in Rwanda are twice as likely to have an account as their Ghanaian counterparts. Such disparities show that there is scope for governments to implement policies that improve the access of the poor to basic services.

The rural-urban divide: While almost half of urban dwellers have a bank account, among rural Africans the share is only 20 per cent. Given that most Africans live and work in rural areas, this disparity represents a major barrier to more inclusive growth.

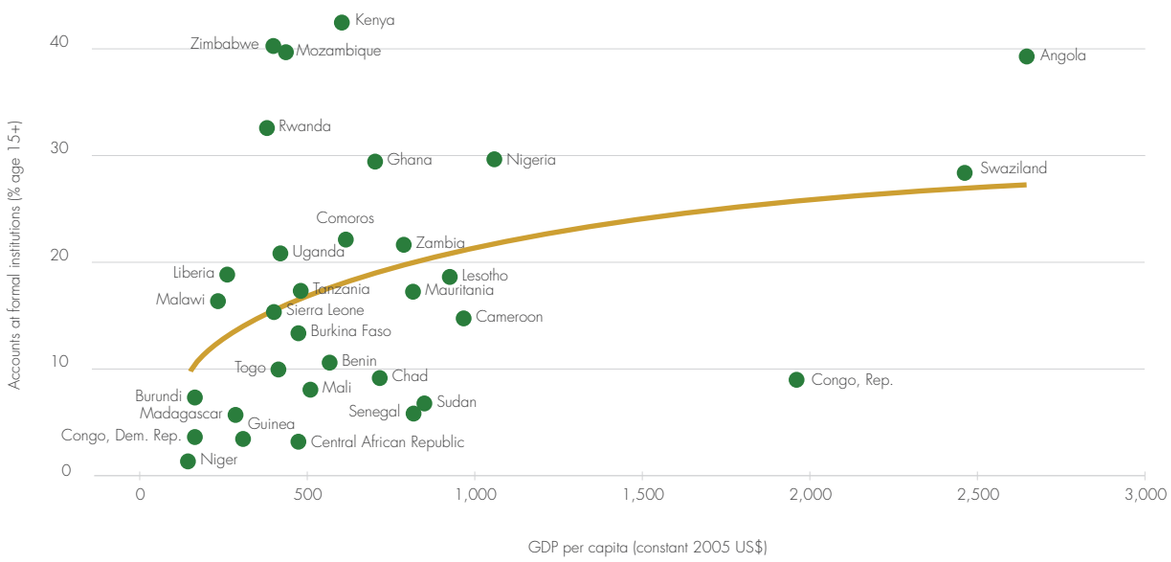
The gender divide: Women are less likely than men to have an account at a formal institution. There are only three in which the disparity favours women. The gender gap is particularly marked in Cameroon, Mauritania, Mozambique and Nigeria. Gender disparities reflect a mix of social, cultural and legal barriers to women's participation in the financial system.

The education divide: Having a secondary education increases the likelihood of people holding a bank account. In Zambia, those with a secondary education tend to be three times as likely to have an account, and in Tanzania five times as likely.

What are the forces blocking access to financial services? In an innovative global survey, adults without formal accounts were asked why they do not have one. Respondents could give more than one reason. In Sub-Saharan Africa, five factors stood out (Figure 5). By far the most important is poverty: not having enough money was cited by 81 per cent of respondents. But around one-third also cited the cost of holding an account, distance or lack of necessary documentation. Another important factor, cited by 16 per cent, was lack of trust.

Survey evidence of this type helps to turn the spotlight on underlying problems. For

FIGURE 3 FINANCIAL SYSTEMS DEEPEN WITH GROWTH – BUT THE RELATIONSHIP IS NOT AUTOMATIC: GDP PER CAPITA AND ACCOUNT AT FORMAL FINANCIAL INSTITUTIONS, SELECTED COUNTRIES 2011



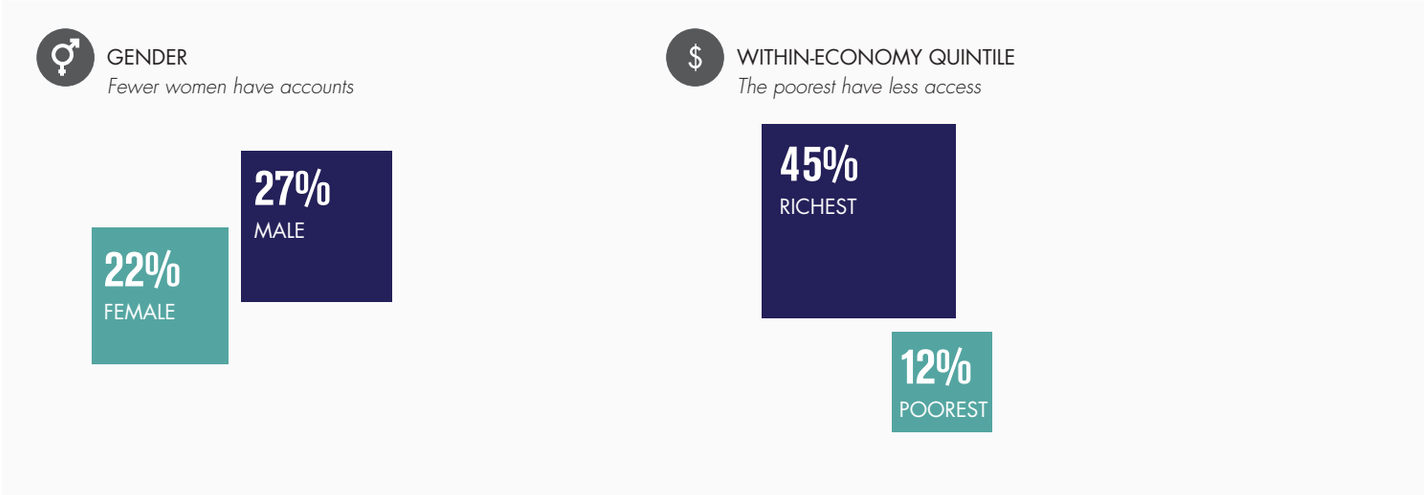
Source: The World Bank Group (2014), G20 Financial Inclusion Indicators and World Development Indicators.

example, fixed transaction costs and annual fees can make banking unaffordable. Maintaining a cheque account in Sierra Leone can cost the equivalent of 27 per cent of GDP per capita in annual fees alone.[7] Even where fees are lower, they often represent a large share of the income of the poor. There are many reasons why the cost structure of banking varies. Yet common themes in Africa are a lack of competition, regulatory frameworks that deter the establishment of rural branches, and an undeveloped institutional infrastructure.

Documentation requirements can pose another barrier. Formal financial institutions typically require evidence of income and assets as a condition for opening accounts. This often excludes people in the rural sector and the informal economy, including potentially viable small enterprises. On one estimate, documentation rules reduce the share of adults with an account by 23 per cent in Sub-Saharan Africa.[8]

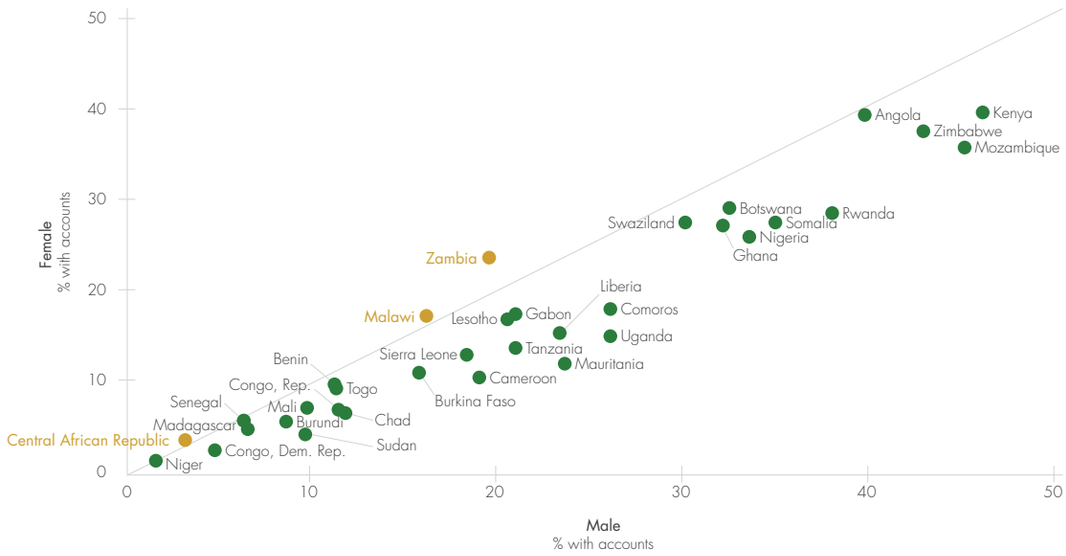
Distance from a financial institution is a major barrier, especially in rural areas. Almost half of Tanzanians without an account cite distance as a reason– and the country has one of the world's lowest levels of branch penetration, with 0.5 branches per 1,000km. Technology and other innovations can help to overcome the distance barrier.

FIGURE 4 UNEQUAL ACCESS: ACCOUNT AT FORMAL FINANCIAL INSTITUTIONS BY GENDER, WEALTH, EDUCATION AN



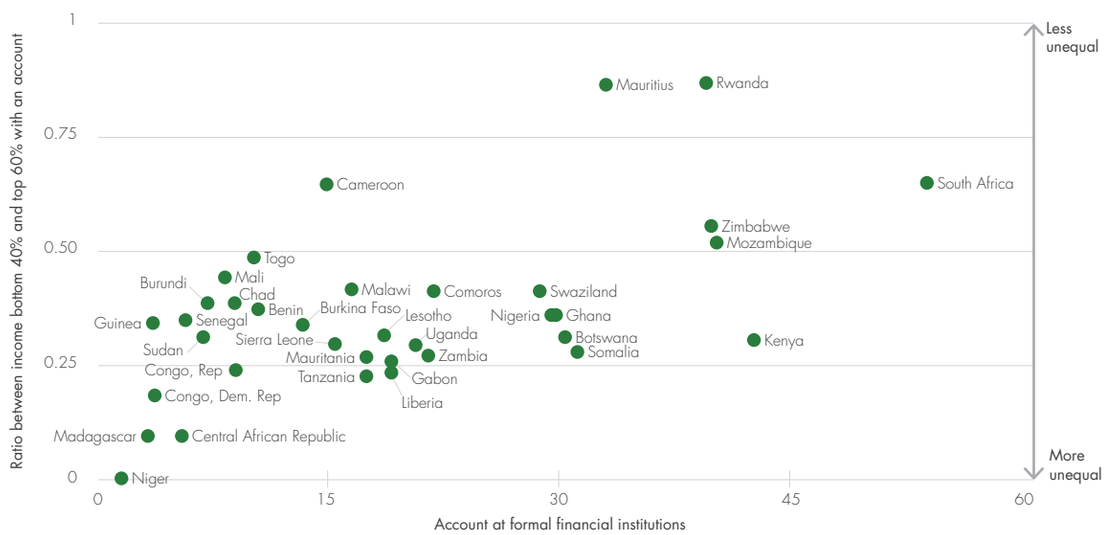
There is a large gender divide in most countries (% age 15+, 2011)

Source:
The World Bank Group
(2014), Global Findex

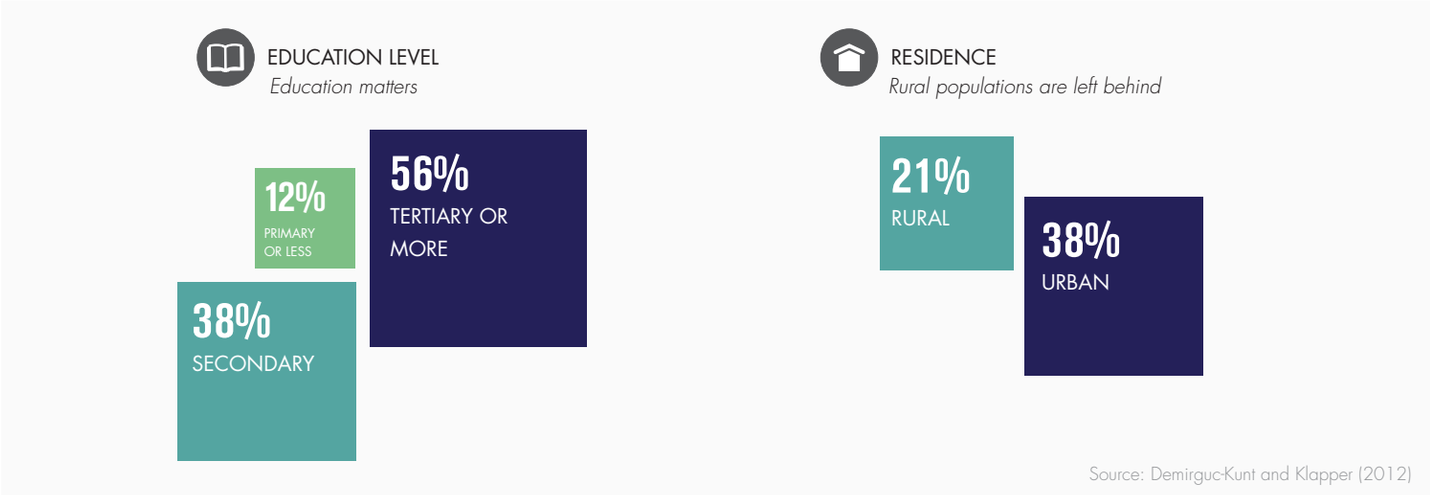


The wealth divide: Ratio between income bottom 40% and top 60% with an account (% age 15+, 2011)

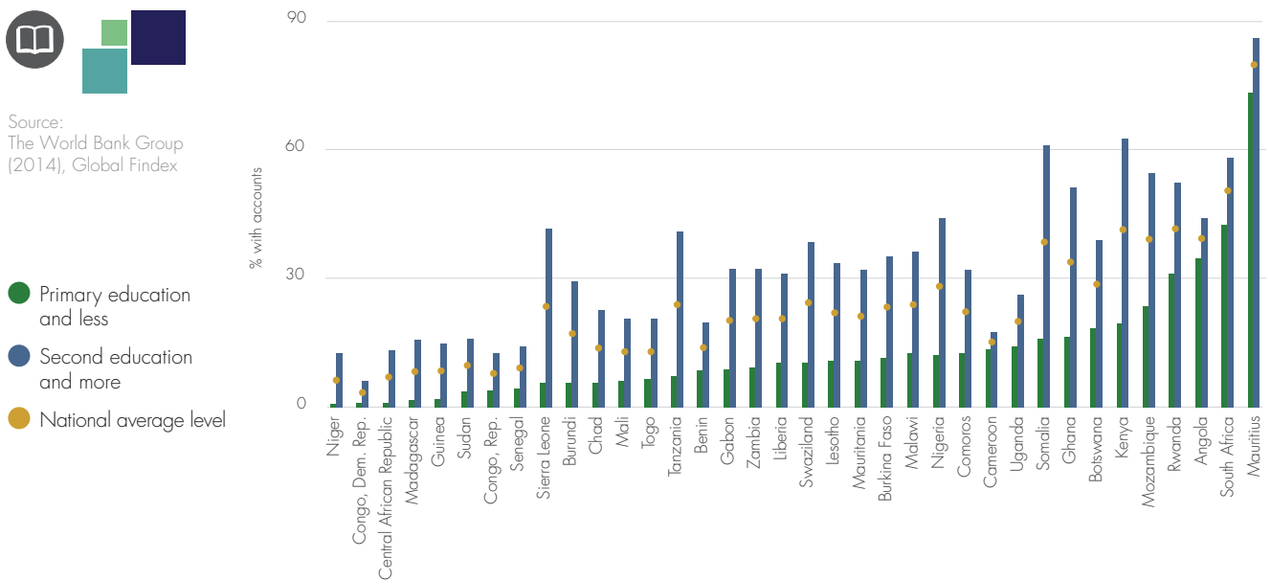
Source:
The World Bank Group
(2014), Global Findex



ION AND RESIDENCE (% AGE 15+, 2011)



Education matters for financial accounts (% age 15+, 2011)



The rural-urban divide: Ratio between income for rural and urban areas (% age 15+, 2011)

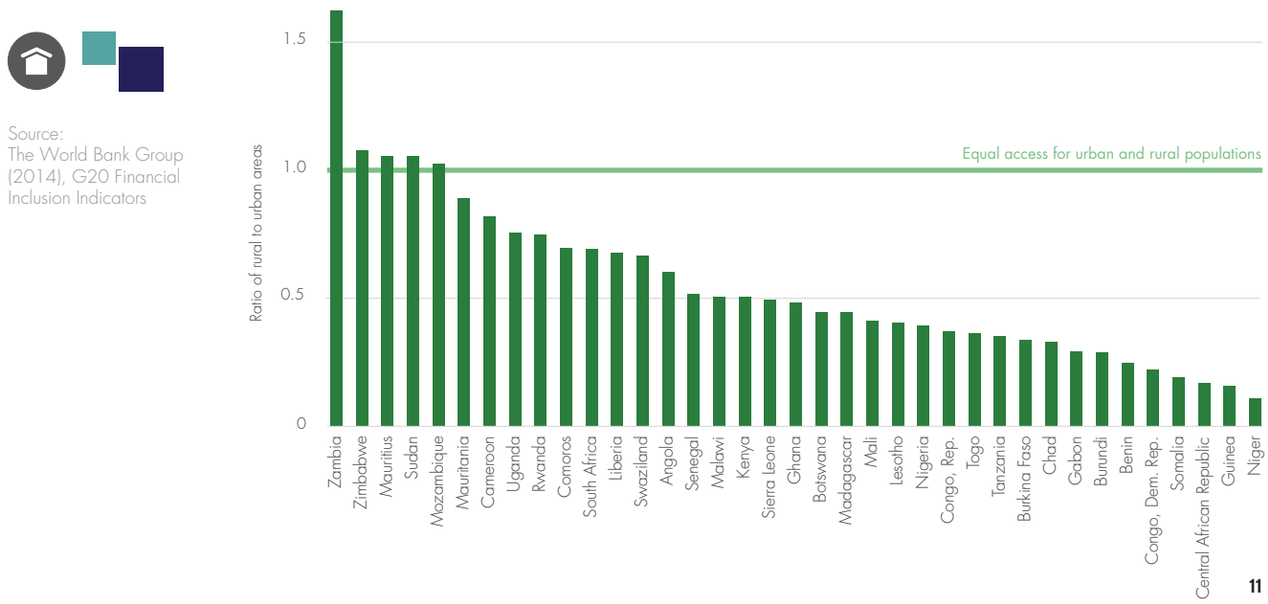
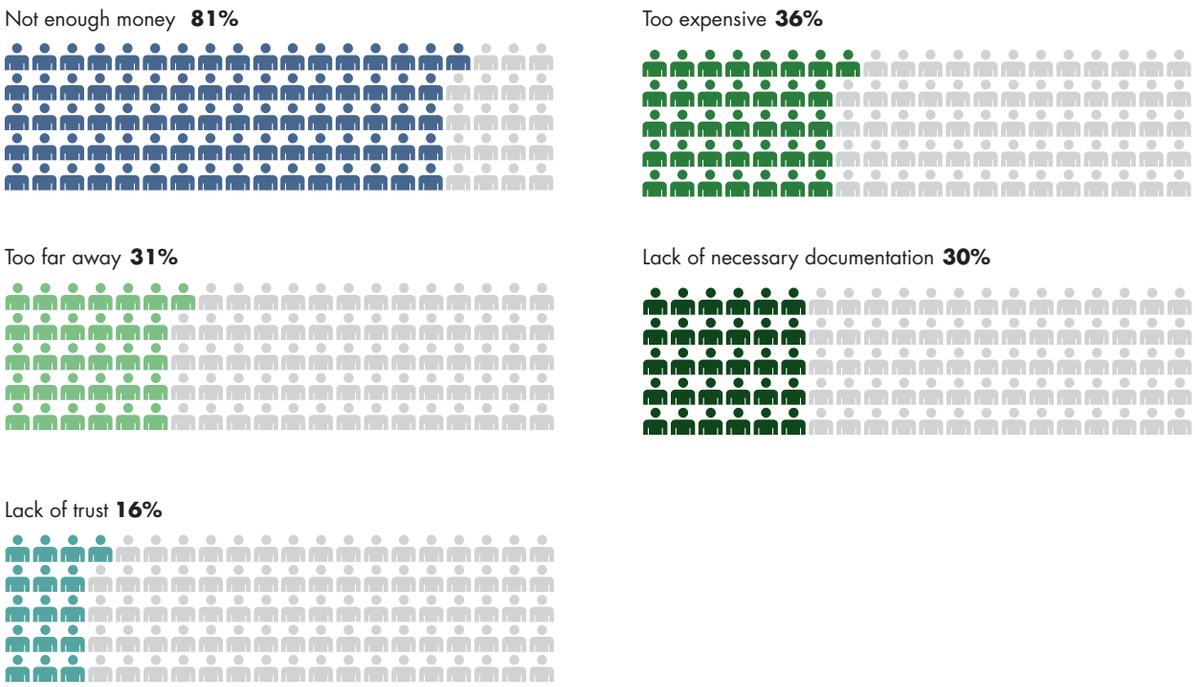


FIGURE 5 MONEY AND DISTANCE ARE THE BIGGEST BARRIERS TO FORMAL ACCOUNT OWNERSHIP: NON-ACCOUNT HOLDERS REPORTING ON REASONS FOR NOT HAVING AN ACCOUNT (%) IN 2011



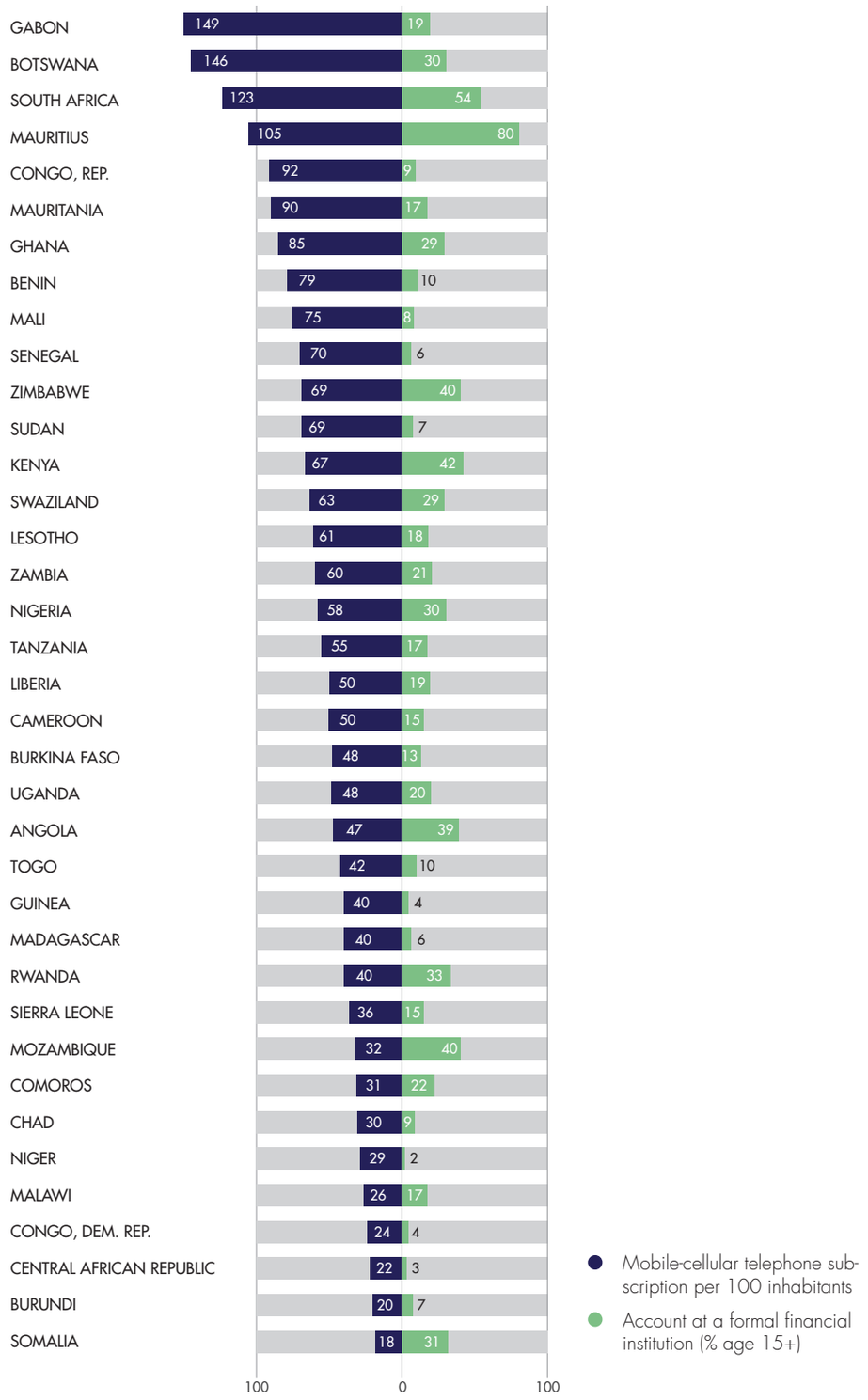
Source: Demirguc-Kunt and Klapper (2012).

The mobile banking revolution – and its limits

Sub-Saharan Africa has emerged as the global growth centre for mobile telecommunications. Mobile phone subscriptions have risen from 90 million to 650 million over the past seven years. The spread of mobiles has changed not only the nature of communication, but also opportunities for banking, commerce and investment (See infographic, Africa's Applied Tech Innovations: Developed by Africans, For Africa and the World). Commentators point to extensive opportunities for "technological leapfrogging," or skipping the development of branch networks by exploiting opportunities for mobile banking. The opportunities are real. Yet the gap between potential and delivery remains large.

The potential is evident from the extraordinary story of M-PESA (Box 1). In just six years, this mobile payments system has enabled more than 15 million Kenyans to send and receive money electronically for the first time. One recent survey found that 86 per cent of households in Kenya report using mobile phones to make payments, or send and receive money – one of the highest rates in the world. Yet the very success of M-PESA raises its own set out questions. Why is it that while three-quarters of Africans have access to a mobile phone, just one-quarter have a bank account (Figure 6)? Does being able to send and receive money using mobile phones equate to access to a country's financial system?

FIGURE 6 MOBILE PHONE COVERAGE IS RUNNING AHEAD OF FINANCIAL INCLUSION: MOBILE SUBSCRIPTIONS AND ACCOUNTS AT FORMAL FINANCIAL INSTITUTIONS, SELECTED COUNTRIES 2011



Source: The World Bank Group (2014), Global Findex, and UN ITU.

AFRICA'S APPLIED TECH INNOVATIONS:
DEVELOPED BY AFRICANS, FOR AFRICA AND THE WORLD

Mobile technology can accelerate Africa's productivity in farming and fisheries. Innovation hubs are springing up all over Africa, incubating the next generation of technologists.

COMMUNITY SURVEILLANCE PROJECT
Helps fishing communities fight against illegal, unreported and unregulated fishing through the use of mobile phones and GPS-enabled cameras.

MLOUMA
Connects farmers to food purchasers by displaying real-time market prices and localizations.

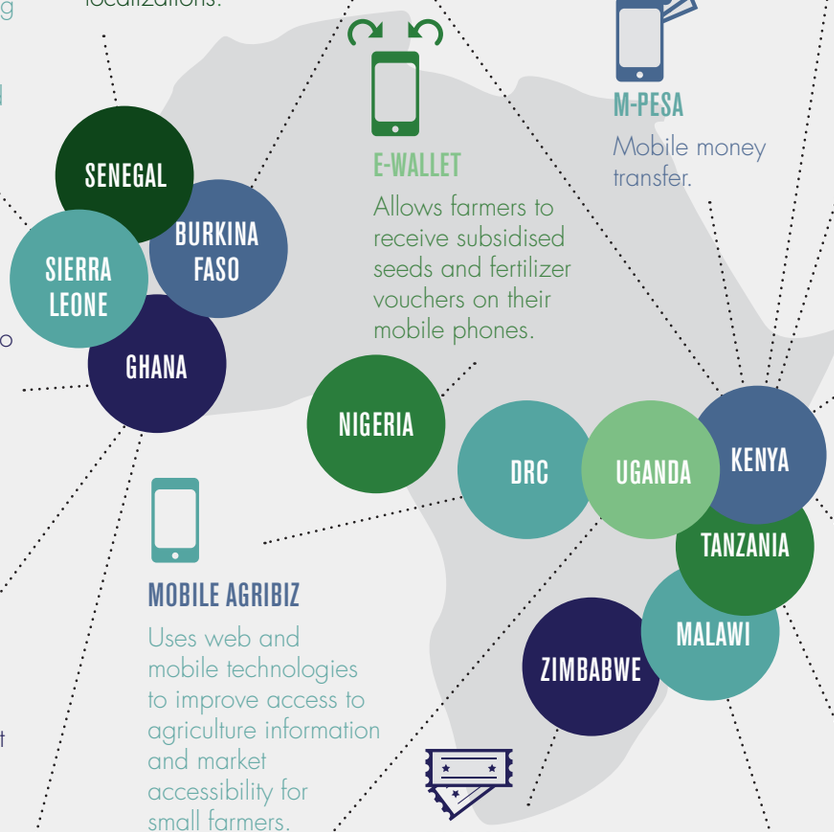
TEXT TO CHANGE MAGRI
Provides best practice information on planting, harvesting, and pest and disease management to farmers.

ICOW APP
Uses mobile phones to encourage best practice for dairy farmers and increase milk production.

M-FARM
Connects farmers with each other in a virtual space. Helps farmers collectively buy inputs directly from manufacturers and sell produce to the market.

E-WALLET
Allows farmers to receive subsidised seeds and fertilizer vouchers on their mobile phones.

M-PESA
Mobile money transfer.



ESOKO
Enables farmers to collect and send out market data using simple text messages.

EFMIS-KE
Provides fisherfolk with greater access to market information.

INTELLECT TECH
Helps farmers and insurance firms track compensation claims in real time.

COCOALINK
Connects cocoa farmers with information about good farming practices.

MOBILE AGRIBIZ
Uses web and mobile technologies to improve access to agriculture information and market accessibility for small farmers.

E-VOUCHER
Helps cash-strapped small scale farmers access agricultural inputs.

FARMING INSTRUCTOR
Provides online and offline agricultural information to farmers and their communities.

FARMERLINE
Uses voice and SMS to collect data, share new farming techniques, and better link smallholder farmers to other actors along the agricultural value chain.

POULTRY GUIDE
Provides poultry farmers with information and market linkages to improve their productivity and profits.

M-MALAWI
Supports and advances the growth of mobile money in Malawi through a series of coordinated interventions.

BOX 1 M-PESA PROVIDES BANKING SERVICES FOR KENYA'S UNBANKED

M-PESA was introduced in Kenya in 2007 by the mobile phone company Safaricom. Originally, it was intended to be a service that allowed microfinance borrowers to conveniently receive and repay loans using the network of Safaricom airtime resellers – who would later play a critical role to the services success. However, teething difficulties with microfinance applications led to M-PESA being launched as a simple money-transfer system to make it easy for urban-rural transfers of money.

At the time of its launch, M-PESA faced questions from Kenyan authorities and the banking sector. Banks – the largest tax-payers at the time – claimed that M-PESA would be an unregulated banking system. Government action, led by the Ministry of Information and Communication and Ministry of Finance, led to a custodial arrangement being agreed with the regulator of banking (the Central Bank of Kenya, CBK). The way forward for Safaricom was thereby cleared and M-PESA started operations

Today, the M-PESA system allows users to deposit and withdraw cash, transfer funds to other users, and make payments by using a simple text-based menu accessible on even the most basic mobile phones. Users can also repay loans made by microfinance institutions and make deposits in their bank accounts. Safaricom deposits the full value of its customers' balances in two regulated banks.

Safaricom, which is 40 per cent owned by the British telecommunications company Vodafone, makes its money by charging a small transaction fee when customers withdraw or transfer cash through one of the 40,000 M-PESA agents operating across the country. The cost of making remittances via M-PESA is about half that of other formal domestic remittance services.

M-PESA has more subscribers than Kenya's top five banks combined. Safaricom airtime resellers were its first M-PESA agents and continue to be its most valuable resource. Stringent Know Your Customer requirements are another M-PESA success factor. Banking regulators oblige banks to collect identification documents of clients and then to have those documents verified by banks. Safaricom avoided this bureaucracy by making it a requirement that the Kenya Government-issued national identity card, which every Kenyan must possess by law, be presented as a pre-requisite to clients being able to open an M-PESA account. This is one of the reasons that M-PESA grew so rapidly.

New product lines have been brought to the market. Safaricom partnered with the Commercial Bank of Africa (CBA) to pilot M-KESHO, a mobile lending service that led to M-SHWARI, a savings and loan service launched in 2012. M-SHWARI has signed up 2.3 million subscribers. While most of the transactions are very small (the median is just $1), around one-third of customers have applied for small loans. This suggests that M-SHWARI may be the answer for many farmers and other small and medium-scale entrepreneurs seeking small amounts of capital to start or grow their business.

Another promising offshoot is 'Linda Jamii', a micro-insurance health cover service that allows subscribers to contribute to health insurance via M-PESA. Nearly 40 million Kenyans (more than 97 per cent of the population) lack access to healthcare because they are uninsured. Bob Collymore, Safaricom's CEO, describes 'Linda Jamii' as being "to medical insurance what M-PESA is to financial services".

M-PESA has been a groundbreaking success in Kenya because it facilitates transfers of relatively small amounts of money when compared to the formal banking system. One study[9] indicates that the volume of transactions effected between banks using the RTGS (Real Time Gross Settlement) method is nearly 700 times the daily value transacted through M-PESA. On the other hand, the average mobile transaction is about 100 times smaller than the average transaction by cheque, and half the size of the average ATM transaction.

M-PESA will ultimately bring more and more Kenyans into the formal economy, in ways they can afford. Filling the unmet need for inclusive financing will be critical in unlocking the transformative potential of agriculture and other key sectors. This calls for a wide range of innovative financial products and services, ranging from mobile-enabled micro-finance and micro-insurance all the way to equity financing. Entrepreneurs typically need very small amounts of money to breathe life into their business ideas, and innovations like M-PESA, M-SHWARI and 'Linda Jamii' provide a powerful indication of the way forward.

While Africa has emerged as a global growth pole for mobile telecommunications, outside Kenya and South Africa the spread of mobile phones has not increased access to financial services. In Uganda, a survey on financial inclusion has found that the majority of adults (54%) used mobile money services to withdraw cash, while 46% used the service to send money. Usage of other mobile-enabled products and services was relatively low (see Box 2). In several West African countries, including Mali and Senegal, the share of the population with cellular phone subscriptions is even higher than in Kenya. Yet while in Kenya there are 1.6 mobile phone subscriptions for every formal financial account, in Mali the ratio is 9.4 and in Senegal it is 11.7.

BOX 2 IN UGANDA, MOBILE MONEY DOESN'T YET MEAN FINANCIAL INCLUSION

A recent study by a Ugandan think tank reported that there had been a "remarkable improvement" in access to financial services in Uganda since 2009. However, the improvement has been in the non-bank formal sector, largely driven by the growth of mobile telephone money services.[10]

Mobile services are used largely for money transfers, the FINSCOPE III study found, rather than for borrowing, saving, investing or insurance. If the data on mobile money are excluded, the study concludes, formal financial inclusion in Uganda remains low, particularly when compared with African countries where similar studies have been carried out, including Kenya, Namibia, South Africa and Swaziland.

The study found that use of formal banking services by the adult population had remained static, despite growth in the number of commercial banks and branches. Furthermore, use of formal banking services was skewed heavily towards the richest 20 per cent of adults; concentrated in urban areas and other more developed regions; and dominated by middle-aged, better-educated men. Overall, access to formal banking in Uganda tended to reinforce patterns of wider inequality.

The study concluded that although much has been done to increase the supply of formal financial services, much more needs to be done to spur demand and access. Key policy recommendations include:

- targeting underserved and neglected areas by improving road and energy infrastructure;
- promoting broad-based long-term savings and investment;
- improving financial education and dissemination of financial information;
- ensuring that mobile technologies are harnessed for services beyond money transfer, including savings and credit.

These disparities point toward regulatory failure. In Kenya, mobile banking spread because central bank authorities allowed mobile service providers to compete with established banks. Rules and safeguards were developed to protect consumers against fraud and to regulate deposit and payment systems. In other countries, regulations have not kept up with mobile technology – governments are failing to open banking systems to more competition.

The low rate of digital payment means Africans lose opportunities at many levels. It contributes to high charges for remittances. It deprives Africans of access to competitive banking services, driving up the profits of inefficient commercial banks. It means people have to travel long distances to make payments for bills and insecurity in having to store and carry money: many customers in Sub-Saharan Africa live and work too far from a branch office to use a bank. It imposes processing, security and transport costs on companies.

There are also losses for the financial sector. If other countries achieved Kenya's level of mobile money transactions, the revenues of financial service providers could rise by at least US$6 billion and up to US$15 billion. In Ethiopia and Nigeria, revenues could more than double. These findings underline the opportunities that Sub-Saharan Africa presents for financial service providers, mobile operators and others seeking new markets.

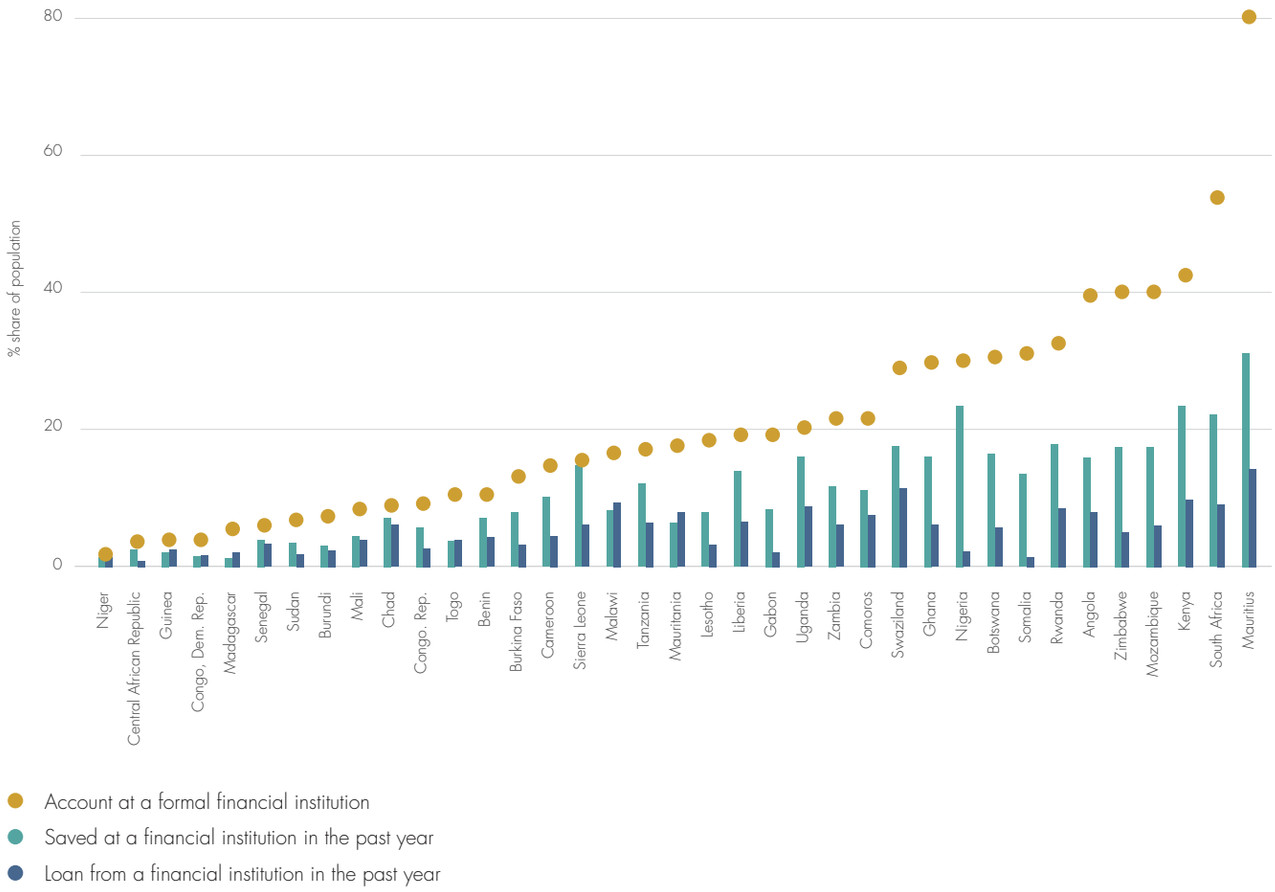
Beyond account registration: savings, credit and insurance

To enjoy the benefits of financial inclusion, people need not just a bank account but also to be able to save and borrow. But data for Africa suggest that savings and loan activities carried out through formal financial institutions are far more limited than implied by account registration data (Figure 7). A few populous countries – principally Kenya, Nigeria and South Africa – report relatively high levels of savings at formal institutions, but across Sub-Saharan Africa only 12 per cent of adults are covered – half the level for account registration. Savings clubs and traditional associations are the common alternative to formal institutions: roughly one in five Africans report using a savings club.

Loan activity is even more restricted than savings. Credit plays a vital role not just in unlocking productivity gains and expanding markets, but in enabling people to invest in their homes, educate their children and cope with emergencies. In no region do formal financial institutions account for a smaller share of loans than Sub-Saharan Africa. Almost one-third of adults report family and friends as their only source of new loans, while just 2 per cent report a formal institution as their sole source. Emergency and health loans are the most commonly reported reason for borrowing among the poor in Africa. However, outstanding credit for school fees is the most commonly reported source of loans for adults across the region.

Small and medium-sized enterprises (SMEs) make limited use of formal savings institutions (Figure 8). At one level this is something of a paradox. Business surveys consistently identify limited access to finance as a major constraint among SME operators. The implication is that many companies are unable to exploit market opportunities because of credit shortages, regulatory barriers or interest rates in the formal financial sector.

FIGURE 7 HAVING AN ACCOUNT DOES NOT MEAN IT IS USED FOR SAVINGS AND LOANS: FORMAL FINANCIAL INSTITUTION DATA (% AGE 15+, 2011)



Source: The World Bank Group (2014), Global Findex.

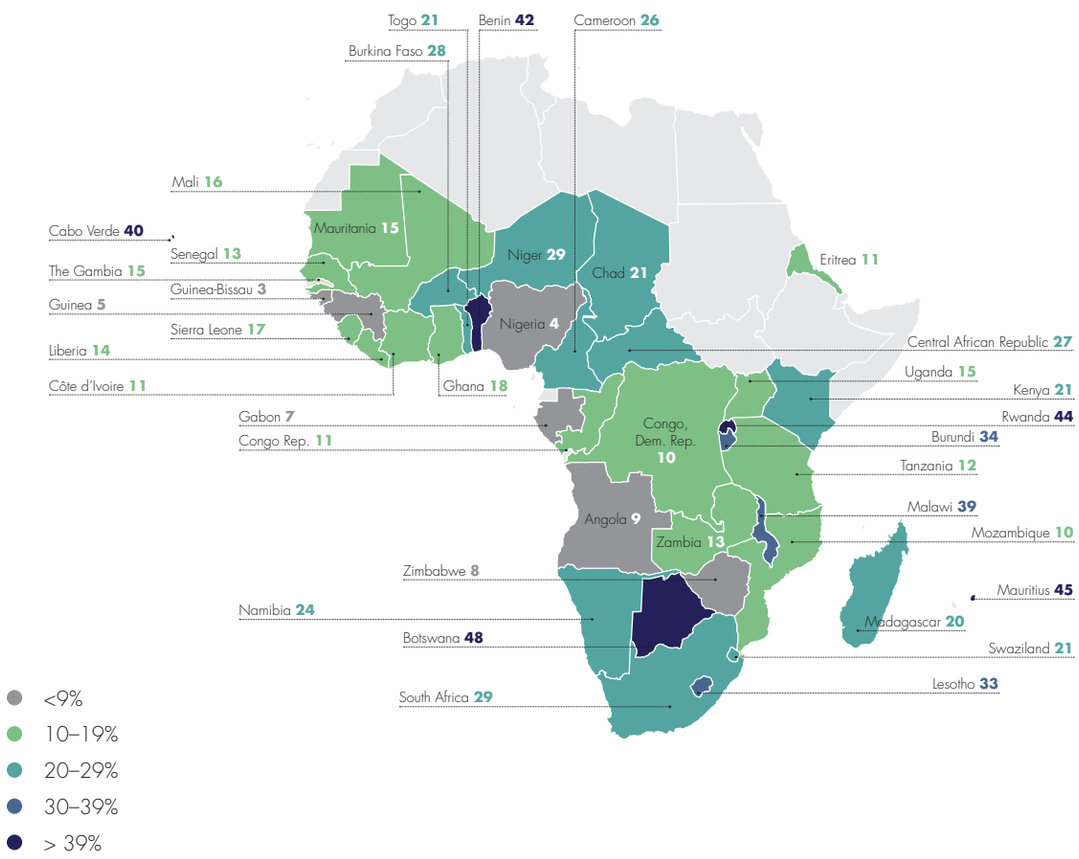
Savings and loan activity is marked by the same social disparities as financial account registration in general: the poor, women, the less educated and rural dwellers all have significantly less access. The rural-urban divide is particularly marked. This has far-reaching implications for the place of agriculture in boosting growth and reducing poverty. While informal savings and loans institutions offer advantages, including flexibility, informality comes with risk of fraud and collapse. Moreover, when loans and savings are pooled across small groups, the cyclical nature of local economies can restrict the funds available during key periods.

Nowhere are the social and economic consequences of financial exclusion more evident than in insurance. As we showed in Part II, the ability to mitigate risk is vital in agriculture, where people are particularly vulnerable to severe weather events and climate variability. But only 6 per cent of Africans working in agriculture and fisheries report purchasing insurance. Once again there are marked disparities (Figure 9).

Insurance provision is most limited where it is most needed. Of the poorest 40 per cent of the rural population in Tanzania, just 1 per cent purchases agricultural insurance. That compares with 15 per cent among the wealthier population group. Gender gaps are also marked, with women having less access to insurance than men.

Lacking access to larger and more diversified risk insurance pools, people are left with no alternative but to self-insure. As a consequence, resources that could be deployed in productive investment are put aside to mitigate risk. In 34 out of 36 countries for which data is available, money put aside to cover emergencies accounted for over half of total savings, rising to over 80 per cent in Kenya, Nigeria and Tanzania. Such numbers underline the case for developing institutionalized insurance as a way of unlocking productive investment.

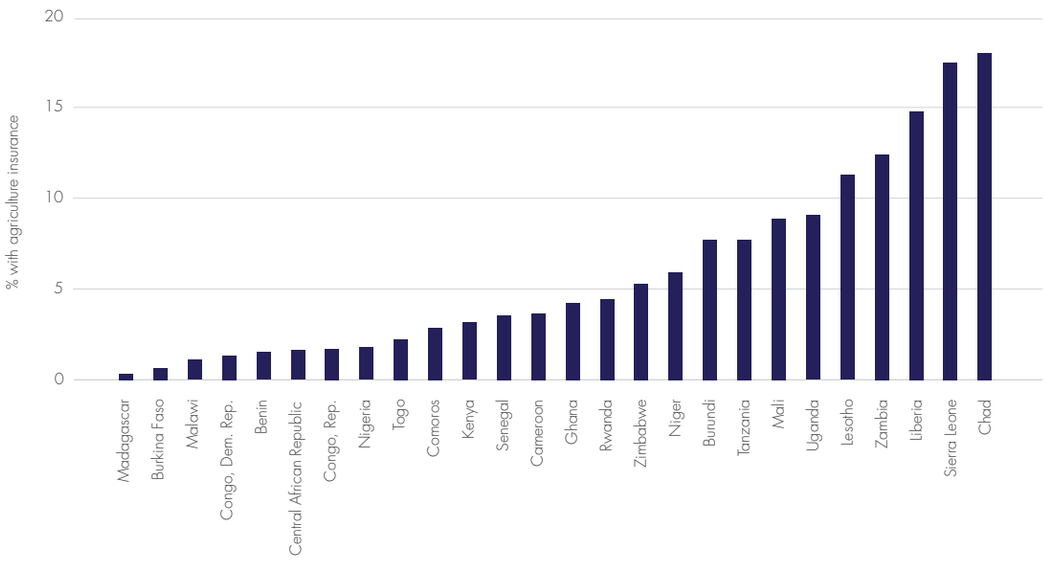
FIGURE 8 FEW SMALL AND MEDIUM ENTERPRISES HAVE ACCESS TO FORMAL FINANCIAL INSTITUTIONS: PERCENTAGE OF COMPANIES WITH AN OUTSTANDING LOAN OR LINE OF CREDIT (5-99 EMPLOYEES, LATEST AVAILABLE YEAR)



Source: The World Bank Group (2014), G20 Financial Inclusion Indicators.

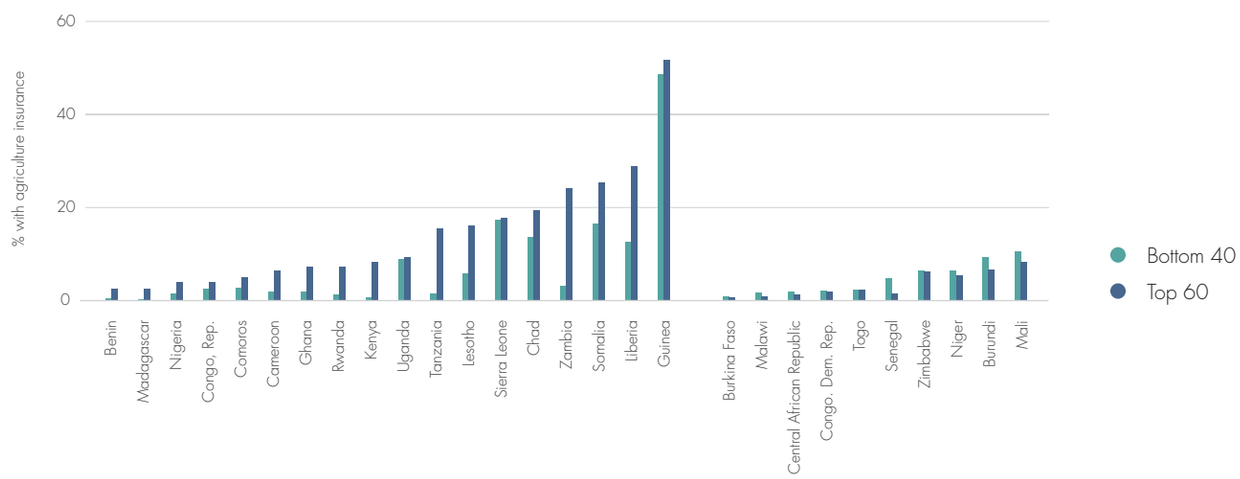
FIGURE 9 AFRICA'S FARMERS FACE HIGH RISK WITH LITTLE INSURANCE

1. Few farmers have access to formal insurance: Purchase of agriculture insurance (% working in agriculture, age 15+, 2011)



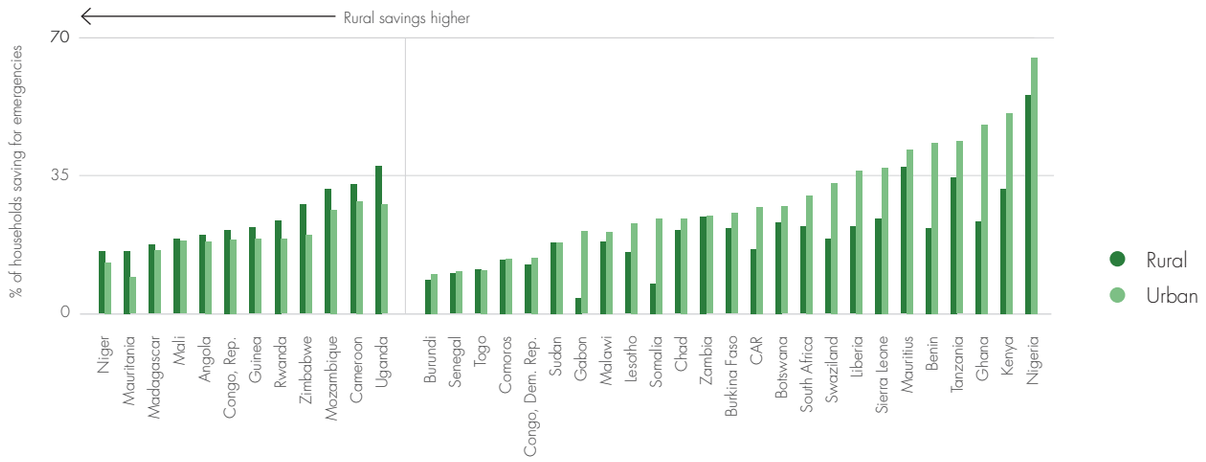
Data source: The World Bank Global Findex

2. The poorest households have the least access: Purchase of agriculture insurance by wealth group (% working in agriculture, age 15+, 2011)



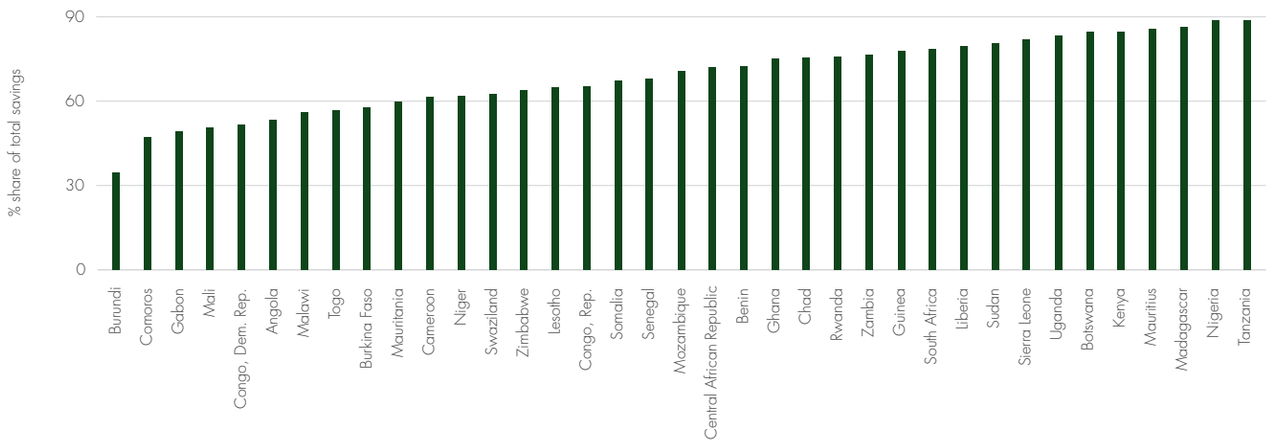
Data source: The World Bank Global Findex

3. Many households save for emergencies: Rural and urban areas (% age 15+, 2011)



Data source: The World Bank Global Findex

4. Preparing for emergencies absorbs a large share of total savings (age 15+, 2011)



Data source: The World Bank Global Findex

2. Lighting the road to growth for all: the infrastructure challenge

Africa must tap into global markets for infrastructure financing.

Although Africa has one-sixth of the world's population, it accounts for just 3 per cent of the world's electricity generation. Africa's energy deficit is a vivid instance of the huge infrastructure gap that undermines the region's competitiveness in global markets, diminishes prospects for economic growth, and reduces the power of growth to alleviate poverty. The infrastructure deficit also reinforces wider problems identified in this report. One reason Africa's farmers struggle to compete against imports in urban areas is that their produce faces such high transport costs. High energy costs restrict investment opportunities for small and medium-sized enterprises, holding back the development of off-farm employment and of markets. Poor physical access and infrastructure deters rural branch bank expansion, increasing the cost of credit and reducing access to financial services.

Closing Africa's infrastructure deficit will require significant financial resources. Domestic financing will have to play a critical role, which is why we highlight the importance of strengthened tax efforts below. Regional integration would help by creating the economies of scale lacking in small countries with low average incomes. Yet even in the most optimistic scenario, domestic financing alone will be insufficient – the financing requirements for energy, roads and port systems are simply too large relative to the size of national economies. The implication is that Africa must compete for financing in a global market.

That market is changing in important ways. Estimates of the financing requirements for global infrastructure are necessarily imprecise. The McKinsey Global Institute puts the figure at US$57 trillion between now and 2030. Despite the surfeit of global liquidity, all countries are struggling to harness the required investment. Part of the problem is that new banking rules are discouraging banks from undertaking the type of long-term loans needed to finance infrastructure. This has created new opportunities for insurers, pension funds and sovereign wealth funds. But currently only a tiny fraction of their assets – around 0.8 per cent – are invested in infrastructure, and Africa barely registers on the market radar screen. Private equity firms are taking up some of the slack, but they provide finance on terms likely to prove unaffordable for low-income African countries.

All of this begs the question of how Africa can tap into global markets for infrastructure finance. The answer varies by country. One problem facing the region is that international investors often view the whole of Africa as an equivalently high-risk investment market, failing to differentiate between conditions in specific countries. Even so, there are several interlocking systemic problems to be addressed simultaneously:

Project design and the need to develop bankable proposals that are "debundled" into planning, construction and operating stages. This matters because Africa's pipeline for bankable projects is limited, in part because of a failure to recognize that public finance has a key role to play in planning, while construction and operations create opportunities for public–private partnerships.

Capacity to pay and responsibility for oversight. It is critical to look at demand as well as supply. Who will pay for these projects? Who will pay for their maintenance? While the development of telecommunications infrastructure has demonstrated a capacity to pay, full private cost-recovery may prove unfeasible in areas such as energy and transport.

Intra-African trade could attract investment by expanding markets and raising returns. However, intra-African trade remains very low as a result of tariffs, customs procedures and rules of origin. This leads to long and costly wait times for transit and shipping, especially for smaller companies.

Political risks linked to corruption, breach of contract and unforeseen policy changes. These are especially important given the long time frames and amount of capital involved in infrastructure financing.

Expansion of insurance could help to unlock foreign investment and reduce the returns demanded. There are currently large insurance gaps for dealing with foreign exchange risks and catastrophic risks.

The scale of the infrastructure deficit

On any measure of infrastructure coverage and quality, Sub-Saharan Africa falls far behind the rest of the world.

Total power generation for the region (minus South Africa) is 28 gigawatts (GW) – roughly equivalent to that of Argentina. Half of the world's population without access to electricity lives in Sub-Saharan Africa, with 80 per cent of people relying for cooking on traditional stoves that burn wood.

Africa has the world's least developed network of paved roads. On one standard measure, the density of the region's network of paved roads is one-third the level in South Asia.[11] Only 14 per cent of rural households have access to a paved road. Companies using Africa's ports face the world's longest delays in delivery: transit typically takes 15 to 20 days, compared with three days in East Asia.

Social infrastructure is equally underdeveloped. Only 31 per cent of the region's population has access to improved sanitation facilities. Behind that figure there are marked differences between richer and poorer households, and between rural and urban areas. The richest households are more than 10 times as likely as the poorest to have access to improved sanitation – no other region has such a large equity gap. Around half of the rural populations of countries such as Ethiopia and Mozambique practice open defecation, rising to over 80 per cent in countries such as Burkina Faso and Niger. Despite the urban advantage in sanitation, one-third of Africa's urban population does not have access to improved facilities.

There is compelling evidence that infrastructure shortfalls undermine investment opportunities. Companies in Africa face higher power costs than any other region – and they lose more working days as a result of power outages. In some African economies, losses from power outages amount to more than 10 per cent of sales. More than 80 per cent of companies in Ghana, Tanzania and Uganda cite concerns with power reliability and affordability. While port delays have been declining, they remain excessive and transport costs are rising.

Infrastructure deficits have equally marked effects on people's daily lives. Restricted access to energy results in mainly girls and women walking long distances to collect firewood, often at the expense of education and other activities. Poor sanitation is major cause of ill health, especially when combined with inadequate access to clean water.

Why is the financing gap for infrastructure so large?

It might have been assumed that a decade of high growth would have transformed financing for Africa's infrastructure. The backdrop could hardly be more encouraging. Economic growth is increasing demand for energy, water, sanitation, transport, and information and communications technology (ICT). For instance, power generation capacity – currently 68,000MW in Sub-Saharan Africa – will need to grow by more than 7,000MW a year to keep pace with demand. Trade opportunities are expanding and the business environment is improving. Population growth is adding to demand.

High levels of regional growth have coincided with a propitious international environment. Since 2008 the world has been awash with liquidity. While returns to investment in secure assets in OECD countries have been close to zero, the potential social and economic returns to investment in Africa's infrastructure are very high. Reported returns to foreign investors in power projects in Sub-Saharan Africa are higher than in any other developing region.[12] Investments in cross-border power transmission have exceptionally high returns, typically paying for themselves in less than a year.[13]

Moreover, the G8 and the G20 have identified African infrastructure financing as a priority – and aid donors have developed a range of mechanisms aimed at leveraging private finance for Africa's infrastructure. The G8 established the Infrastructure Consortium for Africa (ICA) at the G8 Gleneagles Summit in 2005. Another initiative, the Private Infrastructure Development Group (PIDG), is a large coalition of donor agencies and development finance institutions that pool financial resources for investment in infrastructure (Box 3).

Returns to foreign investors in power projects in Sub-Saharan Africa are higher than in any other developing region.

None of this appears to have materially reduced the financing gap in African infrastructure. That deficit was estimated in 2009 at US$48 billion annually for the next decade. Since then, economic growth and urbanization have almost certainly widened the gap, despite increased public investment. As an approximation, Africa needs to double investment in infrastructure.

Translated into national financing terms, the deficit is very large. Public finance dominates infrastructure investment in Africa, accounting for around two-thirds of the total. Private investment in Africa represents another 20 per cent. The African Development Bank estimates that to meet infrastructure investment requirements, low-income countries would have to spend around 15 per cent of GDP a year.

Disbursements of official development finance (ODF) – a broad category including development lending as well as aid – have increased, but there is little evidence of a strong leveraging effect. In real terms, ODF increased from US$7.3 billion in 2008 to US$10.1 billion in 2010.[14] Donor reporting systems make it difficult to unravel leveraging effects. However, flows other than development assistance decreased between 2010 and 2012.

Emerging markets are an increasingly important source of investment in infrastructure. Reporting on non-OECD development finance for Africa is fragmentary, so data are incomplete, but China is now probably the single largest source of infrastructure finance – commitments were reported at US$13 billion in 2012.[15] China uses a mix of grants, export credits, resource-backed loans and other instruments. The China-Africa Development Fund provides equity finance to ventures backed by Chinese enterprises,

the China Development Bank provides non-concessional finance, and the Export-Import Bank provides export credits and risk guarantees. There has been considerable criticism of the "package financing model" provided by China. Many of the criticisms are not well supported by evidence, however[16] – and OECD financing is coming to resemble the Chinese model with respect to infrastructure. Brazil also has a growing presence in infrastructure, with its National Bank for Social and Economic Development (BNDES) supporting Brazilian business ventures in Mozambique and other countries.

Why does the infrastructure financing gap remain so large despite apparently favourable macroeconomic conditions for an investment boom? Part of the answer can be traced to domestic and regional market conditions. Financial markets in Africa remain far too shallow to support investment on the required scale. High interest rates and a low rate of saving are not conducive to the long-term public investments needed for infrastructure. There are some exceptions: Kenya has successfully issued three infrastructure bonds since 2009, raising over US$1 billion. Incentives played an important role. Bonds could be used as collateral to acquire bank loans, and banks could count them as reserves.

Private sector participation is unlikely to prove more than a supplement to domestic public investment. Specialized infrastructure funds have emerged in some countries. Yet private equity funds remain limited in scope, typically generating amounts ranging from US$5 million to US$120 million per project in equity, various forms of debt and foreign currency financing.[17] For the private sector, the perceived risks of investment are typically far too high to attract investment on a sufficient scale. Uncertainties over the capacity of governments to develop and implement projects, the regulatory environment, and the macroeconomic environment can act as a powerful barrier to investment.

Structural market conditions are also unfavourable. In some areas – such as power and transport – Sub-Saharan Africa's markets are small in relation to the large up-front capital investments required to deliver projects on the required scale. Moreover, despite a decade of growth, average incomes are low and poverty levels remain high. Both factors constrain the potential for generating commercial returns.

International initiatives are failing to unlock sufficient finance

The effectiveness of international initiatives on infrastructure financing depends partly on the domestic and regional policy environment created by African governments. Even so, there is worrying evidence that despite a proliferation of "new and innovative" approaches to development finance for infrastructure, these approaches are failing to deliver on the anticipated scale. The accompanying hype and complexity appear to be obscuring fundamental design flaws.

Private investment for infrastructure is flowing to Africa as a trickle. Figures on commitments can overstate the real money transfers involved. For example, the Africa Infrastructure Consortium reported private sector commitments to infrastructure projects under the Programme for Infrastructure Development in Africa (PIDA, See Box 3) at US$3.5 billion in 2012. Actual disbursements in the same year were US$81.7 million.[18] The OECD put total investment in Sub-Saharan Africa's infrastructure at US$13 billion in 2012, with over 90 per cent directed to the ICT sector.[19] But investments in new projects in 2009 added up to just US$1 billion, partly reflecting the impact of the financial crisis. For every US$1 of private equity capital raised for investment in China in 2012, just 8 cents was raised for Africa.[20]

These disappointing outcomes occurred despite highly propitious background conditions. Global capital markets have been in a state of exceptional liquidity, with the real interest rate on risk-free assets hovering around zero. Large sums have been directed to emerging market economies, but little to Africa. Projects in the region are perceived as financially risky and too small to warrant the costs of initial investments in assessment. This is true even for countries with better governance – and despite donor efforts at leveraging. For example, InfraCo Africa, a PIDG-funded company that initiates infrastructure projects, has been unable to raise finance for a Ghanaian electricity project despite a projected yield on equity of 20 per cent.[21]

The Ghanaian project is not exceptional. A World Bank Group analysis of the African electricity sector undertaken in 2011 found that despite several attempts, few privately financed projects were operating. As the Oxford University economist Paul Collier has observed: "This massive wedge between the risk-free rate of interest acceptable to financial markets, which is currently around zero, and the risk-corrected rate demanded for African infrastructure, suggests that more effectively addressing risk is central to private finance."[22]

Current international initiatives are doing little to lower the angle on this wedge. At the heart of these initiatives is a concerted drive to use official aid to catalyse long-term private investment. Investment funds managed by development finance institutions (DFIs) play a central role. Targeting African infrastructure projects, these funds provide capital either directly to private investors or indirectly to intermediary financial institutions in the form of equity, loans or risk mitigation instruments. For example, the Netherlands Development Bank (FMO) manages Dutch government funds such as the Access to Energy Fund and the Infrastructure Development Fund (IDF), which has so far invested in nine projects in the power sector. Proparco, France's development finance institution has provided capital to the Africa Infrastructure Investment Fund, a privately managed equity fund.

Another example of the investment fund approach is the Commonwealth Development Corporation (CDC). Operating on a commercial basis, CDC is privately managed but owned by the United Kingdom's Department for International Development (DfID). In 2011, DfID established a new investment policy for CDC, giving it a tighter geographic focus and limiting investments to poorer countries. New investments in Africa in 2012–2013 included an agribusiness project in the Democratic Republic of the Congo, a recycling project in Kenya and banking in Nigeria.[23]

Investment funds can also serve as multidonor vehicles. One prominent example is the Africa Infrastructure Fund created in 2002 with equity from the PIDG group of donors. The fund, managed by a division of Standard Bank, provides long-term project financing. By the end of 2011 it had financed 35 projects. InfraCo, also financed under the PIDG structure, undertakes initial project assessment and preparation activities.

The closest US counterpart to the European development finance institutions is the Overseas Private Investment Corporation (OPIC). In 2012, OPIC committed US$907 million to projects in Sub-Saharan Africa, providing a mixture of loans and risk guarantees. Reflecting priorities outlined by the current US administration, projects in Africa now account for nearly a quarter of OPIC's global portfolio – up from 6 per cent a decade ago.

Some new approaches to development financing have aimed to use aid to attract private investors and soften borrowing terms. "Blending" is an umbrella term covering a vast array of instruments that mix concessional finance (grants, or loans with a grant element) with debt finance and other investment flows. While specific arrangements are often enormously complex, they typically combine interest rate subsidies that reduce the debt burden on borrowers, including governments; technical assistance to cover preparatory work and project supervision; direct grants to finance project components that have social and environmental benefits over and above their commercial returns; and insurance premiums to share risk.

The European Union has been in the forefront of developing blended finance. Since 2007 it has established eight blending facilities, including the EU-Africa Infrastructure Trust Fund. An ITF interest rate subsidy for a project to finance rehabilitation of the Beira Corridor in Mozambique, for example, enabled the government to undertake investments without breaching the debt sustainability provisions of the Heavily Indebted Poor Countries (HIPC) initiative. However, not all blended finance demonstrates a leverage effect. An evaluation of the ITF found that an interest rate subsidy and grant to the Central African Republic had crowded out other sources of finance.

Risk mitigation has emerged as another pillar of infrastructure financing. Infrastructure projects often require large up-front investment in physical assets that once constructed, cannot be moved in the event of unanticipated problems. The long gestation period involved in many projects and complex financing arrangements, such as the creation of special purpose vehicles for public–private partnerships, add to the risks facing foreign investors, as do foreign currency risks. Alongside these commercial risks are the political risks in an uncertain governance environment.

"Blending" and risk mitigation are emerging as pillars of infrastructure financing.

Development finance institutions and multilateral development banks have developed a range of risk instruments that are widely deployed in Africa infrastructure projects. These include credit guarantees that can lower the cost of borrowing by covering losses in the event of a default, and partial risk guarantees (PRGs) that cover losses from a debt default occurring as a result of a political event. The Multilateral Investment Guarantee Agency (MIGA), which is part of the World Bank Group, provides guarantees against non-commercial risks and technical assistance. Sub-Saharan Africa accounts for around one-quarter of MIGA's overall portfolio, a figure that has risen rapidly.

Currency risk insurance is less widely available, even though this is arguably the single greatest risk for equity investors. The African Development Bank's Currency Exchange Fund provides a range of products that mitigate currency risks through medium-term and long-term swap arrangements. The hedging effects have in some cases moved infrastructure projects up four levels in credit rating.

Box 3 provides an overview of some of the most prominent blending and risk mitigation initiatives. It is difficult to determine whether such arrangements achieve the desired leverage effects, given the uncertainties over whether or not loans and private investment would have materialized in the absence of concessional aid. However, there are strong grounds for concluding that leverage effects have been seriously overstated by donors and DFIs concerned to signal the effectiveness of their approaches.

The EU-Africa ITF, for example, claims to have generated US$12 for every US$1 in grants. No evidence has been presented to substantiate this claim, other than reference to the size of the projects to which the Trust Fund contributes. The same approach has been applied by the PIDG and by Power Africa. Ultimately, this is unhelpful because it deflects attention from the need to collect evidence that can inform public opinion and guide policy. What is clear is that aggregate private financing falls far short of the level required to close Africa's infrastructure financing gap.

Underinvestment in risk mitigation may be contributing to that shortfall. Risk is probably a greater barrier to private investment than the terms of loans and anticipated returns on private investment. According to the Infrastructure Consortium for Africa (ICA), the most comprehensive source of reporting on infrastructure finance, total private investment in infrastructure has fallen since 2008 from US$4.5 billion to US$522 million.[24] Private investors responding to an ICA survey cited partner risk, political risk and the regulatory environment as the main deterrents to investment, ahead of profitability.

Globally, there is evidence that foreign investors are increasingly concerned over risk and that emerging market risk insurance premiums are rising. New political insurance issued by members of the Berne Union – the leading association of public, private and multilateral insurance providers – increased by 33 per cent in 2012, even as foreign direct investment fell. The US$100 billion of investment insurance issued in 2012 represented a historic high and over three times the volume issued in 2005. Investor surveys by MIGA highlight concerns over macroeconomic stability, political risk and 'resource nationalism'.

BOX 3 INNOVATIVE FINANCE: THE MAJOR INITIATIVES

While it is beyond the scope of this report to review of the proliferation of often overlapping programmes that have emerged over the past decade, we can provide a snapshot of major initiatives and approaches:

African Development Bank (AfDB): Over the past five years, the AfDB has delivered over US$5.4 billion in critical infrastructure investments through private sector and PPP financing. The bank has developed a range of financing instruments aimed at leveraging private sector investments. These include long-term debt financing to private equity funds; the Currency Exchange Fund, designed to help investors hedge interest rate risks; and the First Loss Investment Portfolio Guarantee, a country risk management instrument. In 2013 the AfDB approved two major energy-related partial risk guarantee (PRG) programmes. The first was for the Lake Turkana Wind project in Kenya. The second, a US$184 million programme and associated loan of US$3.1 million, was provided to support the Nigerian power sector privatization programme.

Programme for Infrastructure Development in Africa (PIDA): Led by the African Union, the New Partnership for Africa's Development (NEPAD) and the African Development Bank, PIDA has identified 51 core projects aimed at transforming Africa's infrastructure. Costs are estimated at around US$360 billion between 2011 and 2040, with investments of US$68 billion by 2020. Attracting private sector participation through public–private partnerships (PPPs) is seen as essential to the delivery of various infrastructure projects envisioned under PIDA.

Infrastructure Consortium for Africa (ICA): Hosted by the African Development Bank, the ICA plays the role of a catalyst for projects rather than a funding agency. Its members include all G8 and G20 countries and a range of regional and multilateral banks. Through its Energy Platform, the ICA has carried out diagnostic surveys of power purchase agreements in Ghana, Kenya, Mozambique and Tanzania, providing technical assistance and advice on risk management.

Private Infrastructure Development Group (PIDG): Established in 2003, PIDG is a multidonor organization governed by development agencies.[25] Its members commit funds through a range of mechanisms, including a technical assistance facility; a mechanism that supports the preparation of projects for private sector involvement (DevCo); InfraCo Africa, which invests in bankable projects not being developed due to high risks in the early stages; the Emerging Africa Infrastructure Fund (EAIF), which provides long-term loans to private-sector infrastructure projects; and GuarantCo, which provides local currency guarantees. The scale of PIDG's operations illustrates the infrastructure financing problem: in 2012 just US$98 million was committed to the EAIF and nothing to InfraCo, reflecting a slowdown in the project pipeline.

Emerging Africa Infrastructure Fund (EAIF): Created in 2002, the EAIF pools funding from DFIs and private commercial banks. By the end of 2011, it had financed 365 projects, which were co-financed by an additional US$2.5 billion in private equity and development finance. The fund had grown to US$705 million by the end of 2011. Projects supported by EAIF include Seacom, the undersea fibre optic cable along the coast of East Africa; a 25-year concession to operate three container ports in Senegal; and the Rabai power plant in Kenya. EAIF provides lending on longer terms than loans from commercial institutions, averaging 12 years and often topping up projects that have already secured funding from other sources.

Power Africa: President Barack Obama's Power Africa initiative is one of the most ambitious plans for regional infrastructure development. The five-year strategy envisages doubling electricity access in Sub-Saharan Africa, providing access to 50 million people by 2020. It has an initial focus on six countries.[26] For the first, five-year phase, through 2018, the U.S. government has committed more than US$7 billion in financial support and loan guarantees. The framework includes financing from commercial banks, private equity firms and major energy companies. The initiative is seen as a focal point for the energy infrastructure activities of a range of US agencies, including the Export-Import Bank, the Agency for International Development (USAID) and the Overseas Private Investment Corporation (OPIC).

EU-Africa Infrastructure Trust Fund: Supported by 12 EU member states, the EU-Africa Infrastructure Trust Fund uses its grants to leverage additional finance from EU development finance institutions. In 2012 the fund disbursed 35 million euros (US$48.5 million) in grants for 35 projects. Interest rate subsidies have accounted for 60 per cent of these grants and technical assistance 25 per cent, with energy and transport dominating the portfolio. Examples of EU-Africa ITF supported projects include 18 million euros (US$25 million) in grants and interest rate subsidies for the Itezhi-Tezhi Hydropower Project in Zambia, and a 22 million euro grant (US$30.5 million) for technical support and interest rate subsidies for the West African Power Pool initiative.

Project development – a weak link

Current approaches to "new and innovative" financing are not achieving their aims partly because they are failing to address what may be the single greatest barrier to infrastructure financing in Africa – a shortage of bankable projects. The private sector is unlikely to play more than a marginal role in developing, assessing and preparing projects, given the uncertainties, costs, risks and long-time horizons involved. That means governments, donors and regional development banks have to be heavily involved, but so far they have been paying far too little attention to this initial stage.

The underlying problem is one of systemic failure. The preparation stage of project development is open-ended and may lead nowhere, as indicated by the lack of success in African electricity projects. The transition from initial planning to project completion can take many years. Institutions with risk capital, such as investment banks, do not have the appetite for ventures entailing unquantifiable and uncontrollable risks, especially when they come with long periods of preparation. Governments lack the resources and, in many cases, the expertise needed to fill the gap.

Bringing a large-scale infrastructure project to the market is a complex exercise, especially when the project spans several countries. Consider the Central African Interconnection. One of the PIDA priority projects, this envisages a 3,800km transmission line from the DRC to South Africa. Another priority project, the North-South Multimodal Corridor, envisages a transport network across five countries in Southern Africa, plus the DRC. The viability and potential returns from both projects are contingent on a regulatory framework and policies on pricing involving all of the governments, some of which have a weak record on infrastructure governance. Elsewhere in the region, regulatory complexity and political factors can represent barriers to projects with potentially very large rates of return, such as the West African Power Pool (Box 4) and the Kazungula Bridge project in southern Africa (Box 5).

BOX 4 ENERGY COOPERATION ON THE MANO RIVER

The four countries in the Mano River region graphically illustrate the overwhelming case for regional cooperation on infrastructure – and the complexity of moving from project conception to delivery.

Access to electricity is around 2 per cent in Liberia and Sierra Leone, and 10 per cent in Guinea. The unavailability and high cost of electric power are among the main obstacles to developing the economy and reducing poverty in these countries. Côte d'Ivoire enjoys a more favourable situation, with an electrification rate of 34 per cent and a low-cost production capability.

The Côte d'Ivoire, Liberia, Sierra Leone and Guinea Interconnection Project (CLSG) envisages the construction of 1,400km of high voltage power lines so that Liberia, Sierra Leone and Guinea can import electricity from Côte d'Ivoire. If successful, the CLSG project will increase the average rate of access to electricity in the four countries from 28 per cent to 33 per cent, electrifying 125 locations along the transmission line as well as 70 schools, 30 health centres and nearly 1,500 small commercial and industrial units. The long-term aim is to develop a regional electricity grid and market by gradually integrating isolated and small-scale national grids into a unified system.

The CLSG is part of the West African Power Pool, which was created in 1999 under the auspices of ECOWAS. It took a decade for momentum towards project development to emerge, but there are now signs of progress. Design, financing and progress towards implementation have been complex. Pre-investment studies were funded by the EU-Africa Infrastructure Trust Fund. The African Development Bank is providing around one-third of the US$204 million in total finance through a complex mix of loans and grants, with the World Bank, the European Investment Bank, the German government agency KfW and the EU-Africa Trust Fund providing the balance of external financing. The four countries are providing around 12 per cent of the finance.[27]

The project is underpinned by a complex technical agreement. The governments of the four countries have established, by treaty, a supranational special purpose company to finance, build, operate and own the electric interconnection line. The share capital will be owned equally by the national power corporations of the four countries. The power link is expected to begin operating in 2017.

BOX 5 THE MISSING LINK OVER THE ZAMBEZI

Southern Africa's transport system has long been recognized as having a missing link in the form of a bridge over the Zambezi River at Kazungula, a crucial transit point where the borders of four countries almost meet: Botswana, Namibia, Zambia and Zimbabwe. The absence of a road or rail bridge increases delays and costs for goods being transported across Southern, Eastern and Central Africa. The only crossing point is a ferry between Botswana and Zambia associated with restrictive business practices.

Bridge projects have been on the drawing board since the early 1980s. But their implementation has been dogged by political differences and competing territorial claims, notably on the part of Zimbabwe. The African Development Bank has now developed a US$260 million project proposal as part of a wider transport corridor. An economic analysis of costs and benefits points to a rate of return of 23 per cent. The Kazungula Bridge project is now planned for completion by the end of 2017 – four decades after initial plans were drawn up.

The bird's-eye view of the emerging institutional map for infrastructure suggests that the planning environment is improving. One recent survey found that 67 project preparation facilities are operating in Africa. However, only 12 of these have even the most basic technical capabilities. Moreover, most focus on later stages of the project cycle, whereas the biggest gaps are in the early stages. To make matters worse, financing of project development has stagnated. After rising sharply between 2005 and 2010, it has now dropped back to 2008 levels. Project preparation is heavily under-resourced – and under-resourced preparation tends to lead to protracted delays and a high rate of failure.

Fragmentation tightens the project planning bottleneck. Currently, the 12 major facilities involved in project preparation largely duplicate one another's operations. Coordination often occurs by accident rather than design. The multi-donor PIDG underinvests in project development for Africa, especially in the early stages. The same is true of the European Union. The World Bank's International Finance Corporation has a high level of expertise in complex project development, but the Bank has invested far too little in project development capacity in Africa. The same charge might be levelled at the wider donor community, much of which continues to demonstrate a preference for "home country" technical expertise and consultancy firms.

The weak capacity of African governments and institutions is also evident at many levels. The AfDB-hosted Infrastructure Project Preparation Facility (IPPF) has played an important role in preparing landmark projects, including a complex power interconnection project involving Benin, Ghana and Togo. But the impact of the IPPF has been limited. Until recently it has been a predominantly grant-processing facility. Insufficient attention has been directed to early stage project development, and to following projects through to financial closure and implementation. These issues have been addressed via a business plan developed for 2011–2015, though the resources needed to implement that plan – around US$147 million – have yet to be mobilized.

Regional economic communities are now setting up their own project preparation facilities and coordinating their efforts. For example, the Common Market for Eastern

and Southern Africa (COMESA), the East African Community (EAC) and the Southern African Development Community (SADC) have now joined forces to establish a joint unit, and the Economic Community of West African States (ECOWAS) is creating its own Project Preparation and Development Unit. These are encouraging developments but are underfunded and lack high-level political backing.

The current patchwork of fragmented national, regional and multilateral initiatives is failing to mobilize the critical mass of financing needed for infrastructural transformation. There is a growing danger, captured in economic assessments across the region that infrastructure constraints will act as an increasingly powerful brake on growth.

An agenda for closing Africa's infrastructure financing gap

To solve Africa's infrastructure financing problems, far-reaching institutional reforms are required that combine action at the national level with initiatives that add value to the current regional and global architecture. We identify seven priorities:

To solve Africa's infrastructure financing problems, far-reaching institutional reforms are required that combine action at the national level with initiatives that add value to the current regional and global architecture

1. Promote the role of the African Development Bank as the primary one-stop agency for investors

The deficit in international economic governance is reflected in the fact that a standard contract suitable for many low-income countries in Africa has not yet been provided: no authority has played the coordinating role. For Africa, the most likely agency would be the African Development Bank, since it is governed by Africans and provides infrastructure finance itself.

2. Strengthen the role of MIGA

MIGA's operations in Africa need to be scaled up and for this it needs more public capital. Further, if the infrastructure project is strategic, covering the cost of the insurance premium should be regarded as a legitimate use of finance from the World Bank's International Development Association (IDA): currently there is no mechanism for a country's IDA allocation to be used in this way. One of MIGA's most valuable attributes is the ability to offer large amounts of coverage over extended periods, and to be able to do this in high-risk destinations. MIGA's ability to cover a 20-year power off-take agreement, for example, often represents an essential criterion in making sure a project in a difficult environment goes forward. MIGA has recently quadrupled its portfolio in Africa.

3. Broaden and deepen risk mitigation instruments

Risk mitigation financing has been developed in a fragmented and haphazard fashion. No systematic analysis has been undertaken of the type of risk instruments needed to unlock private investment, or of the specific risks holding back investments. These are areas in which the G20's multilateral development bank working group might have been expected to provide policy guidance. Several multidonor initiatives – including the PIDG – appear to be investing too little in risk mitigation.

Within this broad picture, the limited provision of foreign currency risk mitigation instruments is a cause of particular concern. As noted above, the AfDB's innovative Currency Exchange Fund (TCX) has helped investors to hedge interest rate risks associated with financing in local currency, but the TCX facility is limited. It could be expanded with support from development finance institutions operating through the AfDB private sector window. More should be done to encourage finance from local investors, thus avoiding currency risk at source.

4. Going to scale – strengthening Africa's capacity and voice
Donors often stress the importance of coordinated action in support of national plans and national capacity, but coordination among development finance institutions is often weak and haphazard. African governments and institutions have an insufficient voice on a number of multidonor initiatives. And donor alignment behind regional priorities is sometimes limited. The PIDG has some but not all the elements of public action that are needed, and it lacks scale. There is a danger that, while recognizing the opportunity, public agencies will respond with a plethora of small, uncoordinated and incomplete initiatives. While the goal of attracting private finance into African infrastructure has become sufficiently compelling to trigger action, there is no agreed analytic foundation around which actions can be guided.

5. Mobilize African resources for Africa's infrastructure
Economic growth has enhanced African governments' own capacity to finance public investment in infrastructure, but national efforts need to be supplemented by regional initiatives. There are some promising examples. For example, The Africa50 Infrastructure Fund that the AfDB recently launched with the Made In Africa Foundation will not only finance projects but also help develop bankable projects. Africa50 aims at raising US$500 million by the first half of 2014 to help shorten this time to less than three years. The bank also plans to launch a pan-African infrastructure bond to raise about US$22 billion that will be used solely to finance Africa's infrastructure development.

6. Build a hub-and-spokes model for project preparation
Building a pipeline of bankable projects to unlock investment in Africa will require a greatly strengthened focus on project preparation, with an emphasis on developing African capacity. The focal point for this effort should be the AfDB's Infrastructure Project Preparation Facility. This will require a significant expansion of the currently underfunded resource envelope for 2011–2015, from US$147 million to around US$500 million. However, effective delivery requires two measures. First, with the support of development partners, the AfDB needs to identify the technical, legal and financial requirements for a successful scale-up. Second, a strengthened central hub will only operate effectively if it is linked to strong regional hubs, building on the initial investment in project preparation undertaken by regional economic groupings. We therefore propose that African donors and governments jointly finance the development of technical units in these groupings.

7. Win-win scenarios for investors and African infrastructure
Currently Africa is largely excluded from the very deep pool of savings contained in pension funds. None of the exclusion can be traced to a rational assessment of risk. Currently, OECD pension funds are required by law to hold assets of at least A- quality. A rule adopted by the rating agencies, which is of considerable importance for African infrastructure, is that an African project cannot be rated more highly than the sovereign debt of the country. Most African governments are far below this threshold and there is no realistic prospect of getting them to A- in the near future.

Given the questionable performance of ratings agencies, the current institutional arrangements may be less than ideal. Infrastructure projects with the backing and insurance of MIGA, AfDB and established development finance institutions could prove less risky than some investments in OECD markets. This is an area in which the G8 could take the lead in piloting the development of new ratings approaches.

3. Harnessing the power of domestic tax and savings

Taxation not only underpins public finance, it is also at the heart of the social contract between citizens and states. For countries facing large infrastructure financing deficits, fair and efficient taxation – allied to the mobilization of domestic savings – is a precondition for long-term growth that benefits all.

Strengthening tax collection is critical

In last year's *Africa Progress Report*, we highlighted the losses incurred by African revenue authorities as a result of tax evasion by foreign companies. Those losses remain large, principally because of transfer pricing – the practice of shifting profits to lower-tax jurisdictions. Africa is estimated to lose over 5 per cent of GDP per year as a result of illicit financial outflows[28] – an amount that exceeds public spending on health.

International cooperation to tackle tax evasion in Africa has stepped up over the past year. Largely as a result of leadership by the Prime Minister David Cameron of the United Kingdom, the G8 summit in June 2013 provided impetus to efforts aimed at strengthening multilateral tax rules. At the G20 summit in September 2013, countries agreed to adopt automatic exchange of tax information as the new global standard. In an effort to subject anonymous shell companies to the sunlight of transparency, the UK government has also committed to establish the world's first public registry of corporate beneficial ownership. There is an opportunity to build on these initiatives at the 2014 G20 summit in Australia.

These are encouraging developments – but the pace of progress is too slow. Revenue authorities in Africa are seldom able to estimate, let alone stop, the outflow of funds through the complex webs of shell companies and offshore accounts, and the invoicing of transactions across tax jurisdiction by multinational companies.

More effective sharing of information across OECD tax jurisdictions will not resolve these concerns. Insufficient attention has been paid to the development of Africa's capacity to monitor and investigate practices such as transfer pricing. Moreover, wealthy countries have moved too slowly to address their own global tax evasion loopholes. An OECD study reveals that 27 of its 34 member countries are either "non-compliant" or only "partially compliant" with recommendations on transparency of corporate ownership established by the Financial Action Task Force, the anti-money laundering standard-setting body – and none are "fully compliant."

Tax revenue levels are rising – but slowly

Robust growth has been accompanied by modest increases in domestic revenue mobilization. The average tax-to-GDP ratio increased from 18 per cent in 2000/2002 to 21 per cent in 2011/2013. To put the figures in the wider public finance context, that increase was equivalent to half of the 2013 aid receipts. But governments across the region have been increasing public spending far more rapidly than they have been increasing revenue collection. While public spending has increased by 3 per cent to 4 per cent of GDP, the median increase in revenue is just 1 per cent.

Current tax-to-GDP ratios for many countries suggest there is scope for increasing tax revenues. There are still 17 countries in the region with tax-to-GDP ratios of less than 15 per cent. Only three of the eight countries in the West African Economic and Monetary Union (WEAMU) reached their "convergence target" of a 17 per cent tax-to-GDP ratio in 2011.[29]

Average tax-to-GDP figures for Sub-Saharan Africa conceal as much as they reveal. Tax ratios have tended to increase more in resource-rich middle-income countries than in low-income countries. In fact, much of the increase in the average tax ratio can be traced to a marked increase in revenue from natural resources. This has been accompanied by a downward trend in trade taxes, an increase in indirect taxes and stable income taxes.[30] Given that indirect taxes are often regressive, with the poor paying a higher proportion of their income in tax, this is worrying.

So too is the wider failure of governments in resource-rich countries to broaden and deepen the national tax base. Analysis by the IMF, covering 20 "resource-intensive" countries in Africa, suggests that every 1 per cent increase in resource revenues lowers non-resource revenues by up to 0.12 per cent of GDP. That evidence suggests that easy revenues from extractive industries may deter political leaders from embarking on deeper tax reforms.[31]

Persistently high poverty and the domination of the informal sector restrict the tax base. In Senegal, the tax base comprises 500 large enterprises, 10,000 medium-sized enterprises and 40,000 small businesses. Overcoming non-compliance with tax rules among small enterprises, traders and informal sector firms poses a challenge. Efforts to overcome that challenge and extend personal income taxes in Mozambique, Tanzania and Zambia have met with limited success, with non-compliance of employers in registering their employees an additional barrier.[32]

Informal sector taxation is often neglected. The sector may appear to offer limited potential for revenue increases, and collection costs are high. However, the potential benefits include building a culture of tax compliance among small and medium-sized enterprises, reducing a sense of unfairness among formal companies and hence encouraging tax compliance, and increasing the economic growth of small companies through the benefits associated with formalization.[33]

Tax reform is urgent

In addition to a country's economic and labour market characteristics, tax policy design and administration matter. Many countries in Africa pay a high price for poor design.

Large amounts of tax revenue are routinely given away in the form of what are euphemistically described as "tax incentives." In the 1980's about 80 per cent of African countries provided tax incentives.[34] Evidence of the benefits in attracting investors is at best unclear. While taxation matters for foreign investors, considerations such as infrastructure and rule of law matter more.[35] Exemptions also create opportunities for corruption.[36] As we highlighted in last year's report, mining companies have been showered with exemptions at a time when Africa's resources are rising in value.

Tax evasion through transfer pricing and the under-reporting of profits by transnational corporations is a major drain on revenues.[37] While difficult to quantify, illegal, unreported and unregulated export activity in sectors such as forestry and fisheries generates multimillion-dollar losses for revenue authorities (see Part III).

The ingredients of successful tax reform include developing a unified tax administration system, improving information and accounting systems, and putting in place governance systems that tackle fraud. Clear rules, including the simplification of tax codes and minimization of exemptions, are vital. While taxing the informal sector is difficult, incentives and measures aimed at reducing the cost of compliance can make a difference.[38] Strengthening the demand side of tax accountability by encouraging broader citizen engagement is a reform priority. Burundi illustrates the potential benefits of reform. Far-reaching administrative reforms helped to increase the tax-to-GDP ratio from 14 per cent in 2009 to 17 per cent in 2012.[39]

Reversing the proliferation of tax incentives is another reform challenge. Although renegotiating mining contracts is controversial, tax exemptions have been overturned in some countries. In Mozambique, a 2009 law ended the special low-rate regime for large projects and established increases in the taxation of mining and petroleum companies.[40] In addition to national initiatives, regional agreements may be particularly helpful in combating excessive incentives and blocking downward tax competition.

Tax policy involves more than technical design and implementation. Taxation is at the heart of the accountability relationship between states and citizens. This idea is central to the social fiscal contract: a pattern of regular and routine accountability based on the principle of reciprocity and mutual obligations.[41] When taxation is accompanied by effective and fair public services, it can strengthen the legitimacy of states. Improving tax diversification is critical in this respect. In countries where government budgets rely predominantly on natural resources or aid, there is a danger that political leaders may be less accountable to their citizens. Efforts to strengthen personal and corporate income tax can have important consequences since it is direct taxes that are particularly effective in institutionalizing state-citizen relations.[42]

Redirecting subsidies that drain public finance

While strengthening revenue mobilization is vital, the amount of resources available for public investment in priority areas such as infrastructure and basic services is also determined by budget priorities – and there is considerable scope for making more money available by reordering these priorities.

Energy subsidies illustrate the scope for reform. The IMF estimates that governments in Africa spend around 2.8 per cent of GDP on subsidies aimed at reducing the cost of fuel, with around half of that amount accounted for by losses in state power utilities. These subsidies disproportionately benefit higher-income people, who consume the most power. In Senegal, energy subsidies exceed public spending on health and education – and just 12 per cent of the benefits go to the poor.

Subsidies in agriculture can have similar effects. Zambia is an example. During 2010–13, subsidies for maize farmers averaged close to 3 per cent of GDP, with large-scale commercial farmers capturing the lion's share of the benefits.

Redirecting subsidies can be politically challenging, as several governments in Africa have discovered to their cost. Successful reform requires the development of political constituencies. Public information campaigns have facilitated successful reform in several countries. But governments can also redirect energy subsidies and pro-rich farm subsidies into programmes that have a visible payoff for the poor, including social protection, health coverage, education and public transport.

Tapping savings for investment: domestic bond markets

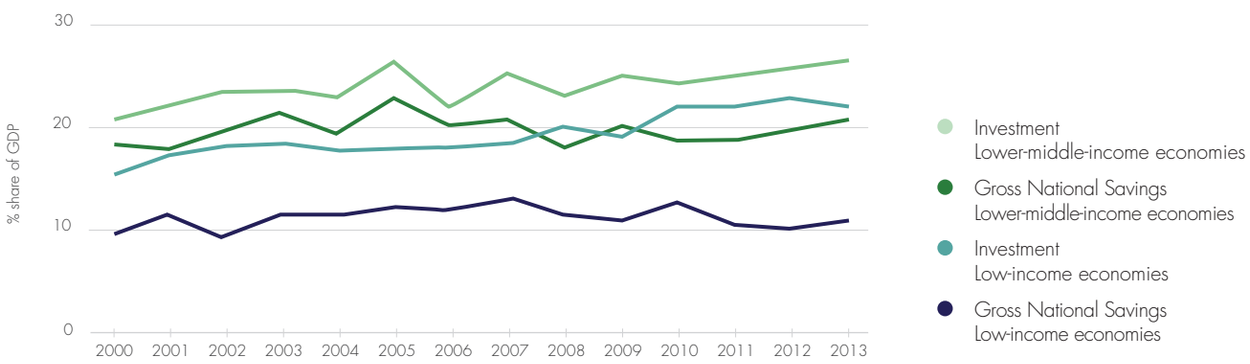
Developments in savings mirror those in taxation. High-growth developing countries in East Asia were able to finance increased investment out of higher levels of savings. In Africa, economic growth has yet to translate into a regional shift in savings. The savings-to-GDP ratio in 2013 was below the level reached in 2006. The widening gap between savings and investment (Figure 10), which is filled by external resource flows, is a major constraint on both public and private investment.

Several governments have sought to secure access to domestic savings through bond markets. Some have mobilized considerable amounts through this route for infrastructure financing. For example, Kenya has issued three infrastructure bonds since 2009, valued at US$1 billion.

The problem is that Africa's banks are very poor at intermediating between savings and investment. Almost without exception, their commercial activity focuses on short-term deposit and loan activity – usually at high interest rates. The shallowness of regional financial systems is reflected in the cost of government borrowing. Last year Uganda issued a US$32 million domestic bond, principally to finance infrastructure, at a yield of 15 per cent. Kenya and Tanzania similarly issued 15-year bonds priced respectively at 14 per cent and 17 per cent. Despite these high returns, neither issue was fully subscribed, although Tanzania's central bank accepted US$7 million of the bond issue.

FIGURE 10 THE GAP BETWEEN SAVINGS AND INVESTMENT

Low-income and lower-middle income countries in Sub-Saharan Africa



Source: IMF (2014), World Economic Outlook database.

There are some indications that local currency debt markets may be strengthening. The International Finance Corporation has launched a domestic bond programme that will issue local currency debt in several countries, including Ghana, Kenya, Nigeria, Uganda and Zambia. In 2013, the scheme launched its first naira-denominated bond in Nigeria, raising US$76 million at a rate of 10 per cent. This was followed by the launch of a four-year bond in Zambia for US$150 million at 15 per cent. The issue was five times oversubscribed. While there may be important lessons, the IFC operates with the authority of a triple-A rated lender.

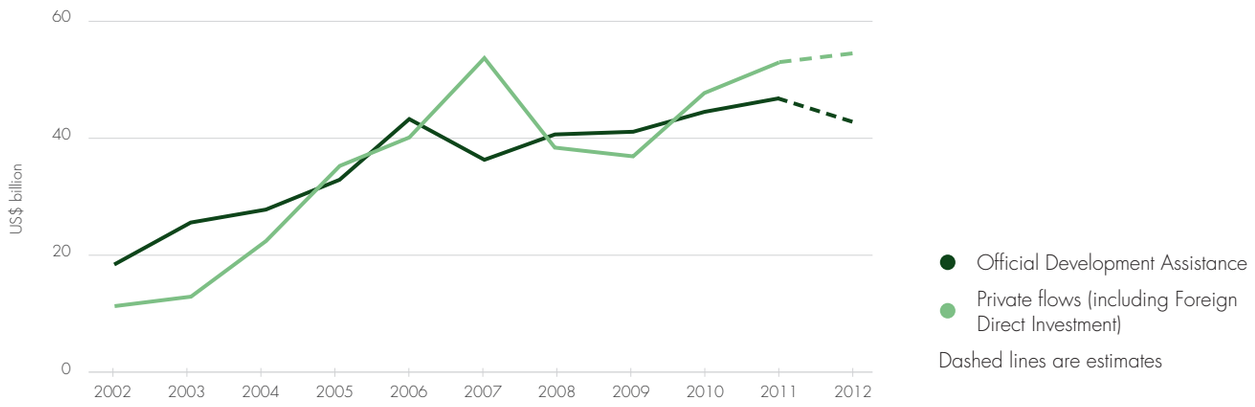
4. Balancing the risks and opportunities of external finance

This section examines the opportunities as well as the risks presented by a wide range of sources of external finance – including aid, "blended" finance, foreign direct investment, private equity and bond financing. The challenge, both for African governments and aid agencies, is to develop policies and financing instruments that mobilize the full range of external resources that can underpin inclusive and transformative growth.

Aid will remain important for many countries

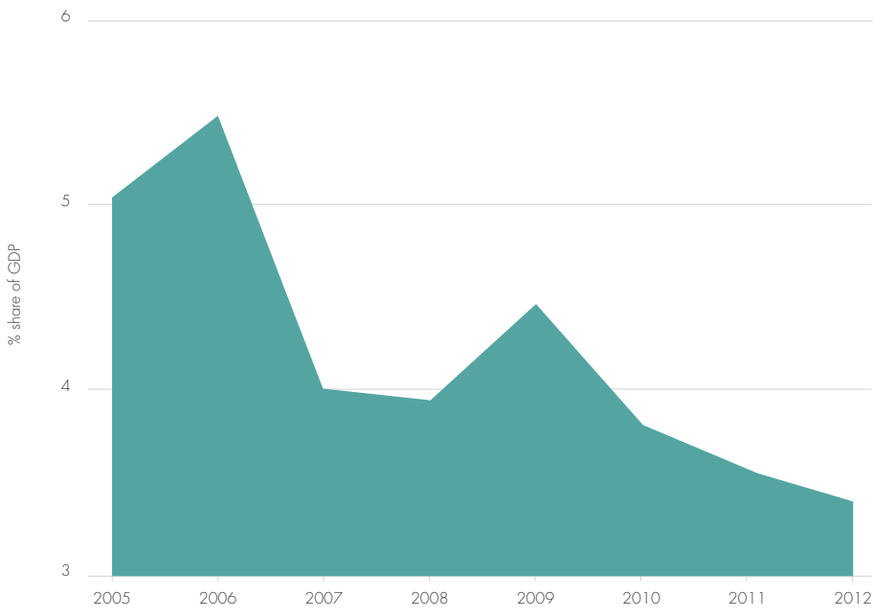
After rising through to 2008, partly as a result of debt relief under the HIPC initiative, bilateral aid to Sub-Saharan Africa fell 8 per cent in real terms between 2011 and 2012. Including multilateral development assistance, total aid was US$48.2 billion or 3 per cent of regional GDP, compared with 5 per cent in 2005 (Figures 11 and 12).

FIGURE 11 PRIVATE FLOWS HAVE OVERTAKEN AID: DEVELOPMENT ASSISTANCE AND PRIVATE CAPITAL TRANSFERS (US$ BILLION)



Data Sources: OECD and UNECA (2013), Mutual Review of Development Effectiveness and the OECD-DAC International Development Statistics database

FIGURE 12 FROM PEAK TO PLATEAU: AID FLOWS ARE FALLING AS A SHARE OF AFRICA'S GDP



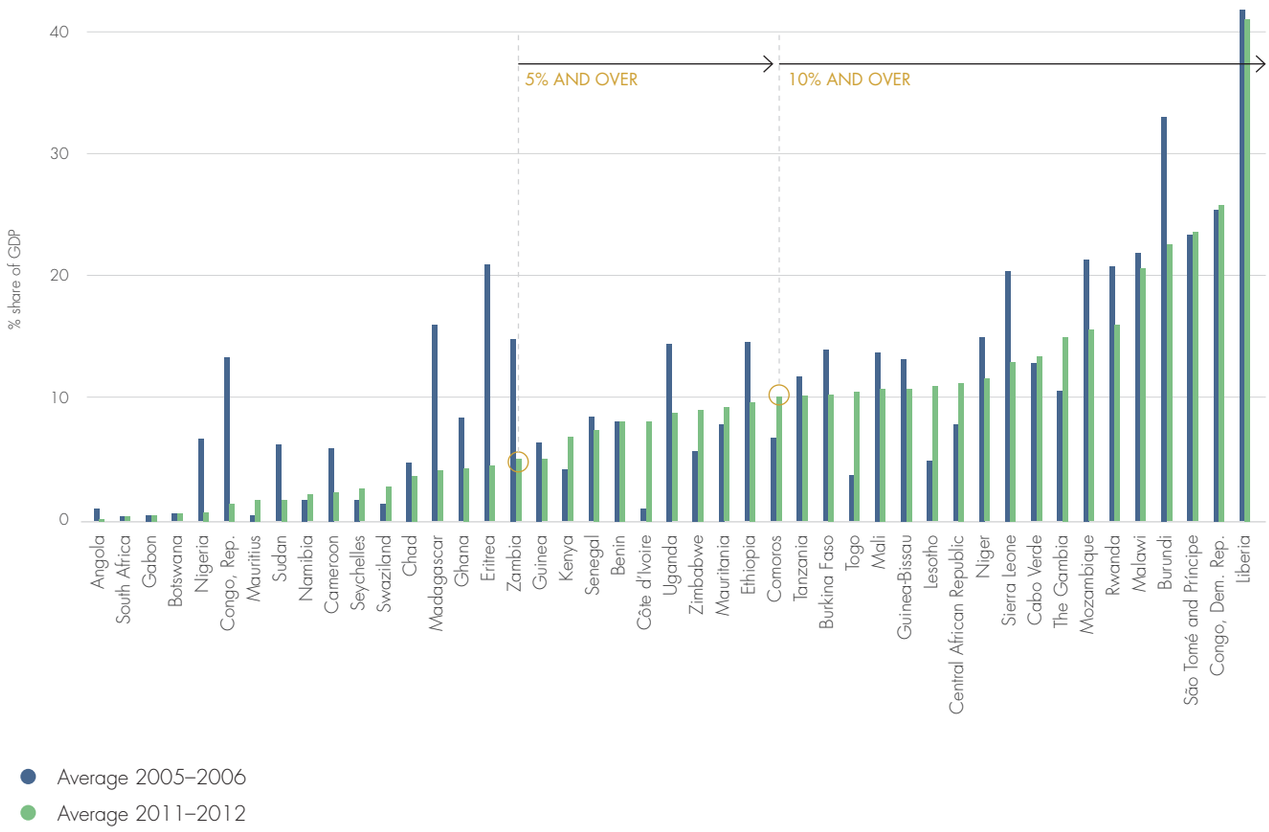
Source: OECD DAC and the World Bank Group's World Development Indicators (2014).

Patterns of aid are also changing. Emerging markets are a growing source of concessional finance. Direct comparisons between OECD and emerging market aid are fraught with difficulties because of different reporting conventions, and disputes over what should – and should not – be scored as aid. The best recent estimate for Chinese support to Africa, encompassing both concessional flows and other official finance, is that it is comparable to US development assistance – around US$9 billion to US$11 billion annually. Private philanthropy is also growing. Non-traditional aid represented 9 per cent of overall aid in Ethiopia in 2009, and 7 per cent in Zambia.[43]

Private flows have moved in the opposite direction to aid. Sub-Saharan Africa weathered the mid-2013 turmoil in financial markets better than other regions. Net private capital flows to the region continued to rise, reaching 5.3 per cent of GDP, significantly above the developing country average. Private inflows of capital now exceed aid by 28 per cent. That gap is set to widen. With the OECD anticipating a shift in aid resources towards middle-income countries in the form of soft loans, and net private capital flows set to rise to US$75 billion, development assistance will be less than external flows by 2014.[44]

The regional overview obscures some marked variations. In 26 Sub-Saharan Africa countries, aid represents more than 7 per cent of GDP (Figure 13). In about half of these countries it represents more than 10 per cent of GDP.

FIGURE 13 AID REMAINS CRITICAL FOR MANY COUNTRIES: AID AS A SHARE OF GDP



Source: OECD DAC and the World Bank Group's World Development Indicators (2014).

Such figures suggest that reports of the demise of aid as a development resource may be premature. For many countries in the region, aid will remain a vital source of development finance, especially for basic services. Over one-third of aid to Africa is directed towards social sectors.[45] But aid also plays a critical role in supporting development more broadly. While there is considerable scope for improving aid efficiency, claims that aid hinders growth and poverty reduction are refuted by the experiences of Ghana, Rwanda, Tanzania, Uganda and many other countries.

Aid helps to finance investments in health, education, water and sanitation, and national institutional capacity that are needed to make growth inclusive and sustainable. That is why OECD projections that aid is likely to stagnate in countries such as Burundi, Chad, Madagascar, Malawi and Niger represent a major cause for concern.

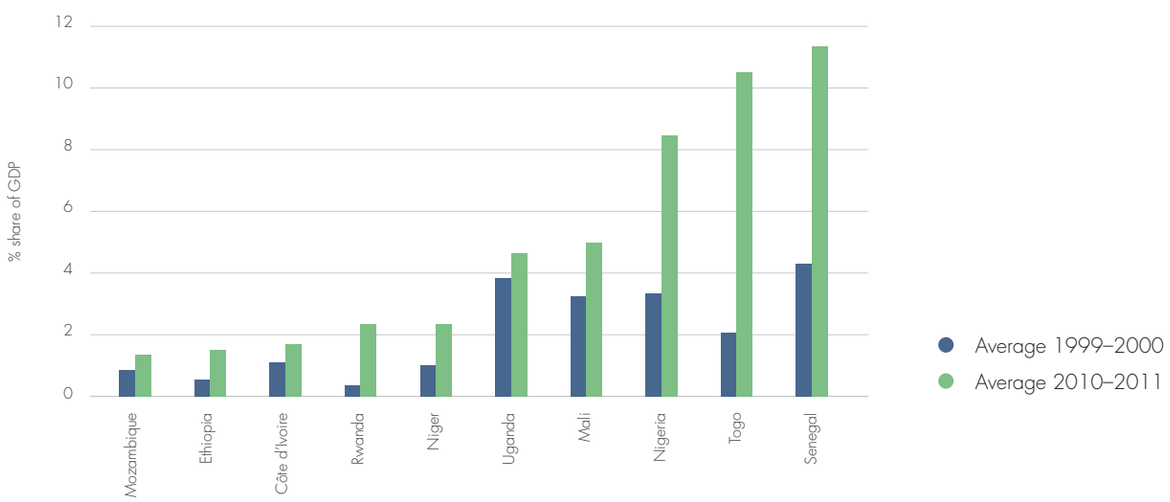
Reducing remittance charges: an urgent priority

Remittances from African migrants are on the rise (Figure 14). Unlike aid, remittances go directly to households. They provide a financial lifeline for families facing hardship, as well as a source of investment for agriculture, housing and education. Remittances also play a vital role in the balance of payments of many countries, helping to finance current account deficits and stabilizing currencies. World Bank projections suggest that remittances to Sub-Saharan Africa could reach US$41 billion by 2016.

Unfortunately, the full development potential of remittance transfers has yet to be realized. This is because charges on remittances to Africa are far higher than for any other region (See Infographic, The Remittance Super Racket). Research by the Overseas Development Institute ODI[46] suggests that the region could be losing US$1.4 billion to US$2.3 billion a year as a result of what has been termed a "remittance super tax" on Africa – the charges levied by what amounts to a 'duopoly' of money transfer operators (Box 6). Sending remittances to Sub-Saharan Africa currently costs around 2.3 per cent. US$1.4 billion would be saved if this cost (fee plus foreign exchange margin) was reduced to the global average of 7.8 per cent. If the 12.3 per cent was reduced to the G8 and G20 suggested level of 5 per cent instead, the reduction would generate an additional US$900 million. This implies that the total loss of sending remittances to Sub-Saharan Africa is in the range US$1.4 to US$2.3 billion, averaging US$1.85 billion each year.

While there are many technical and regulatory issues to be addressed, the charges imposed on African remittances are fundamentally indefensible. The international community and African governments should seek as a matter of urgency to put the reduction of remittance charges at the centre of the international development agenda.

FIGURE 14 REMITTANCES ARE INCREASING IN MANY COUNTRIES: TRANSFERS AS A SHARE OF GDP, SELECTED COUNTRIES

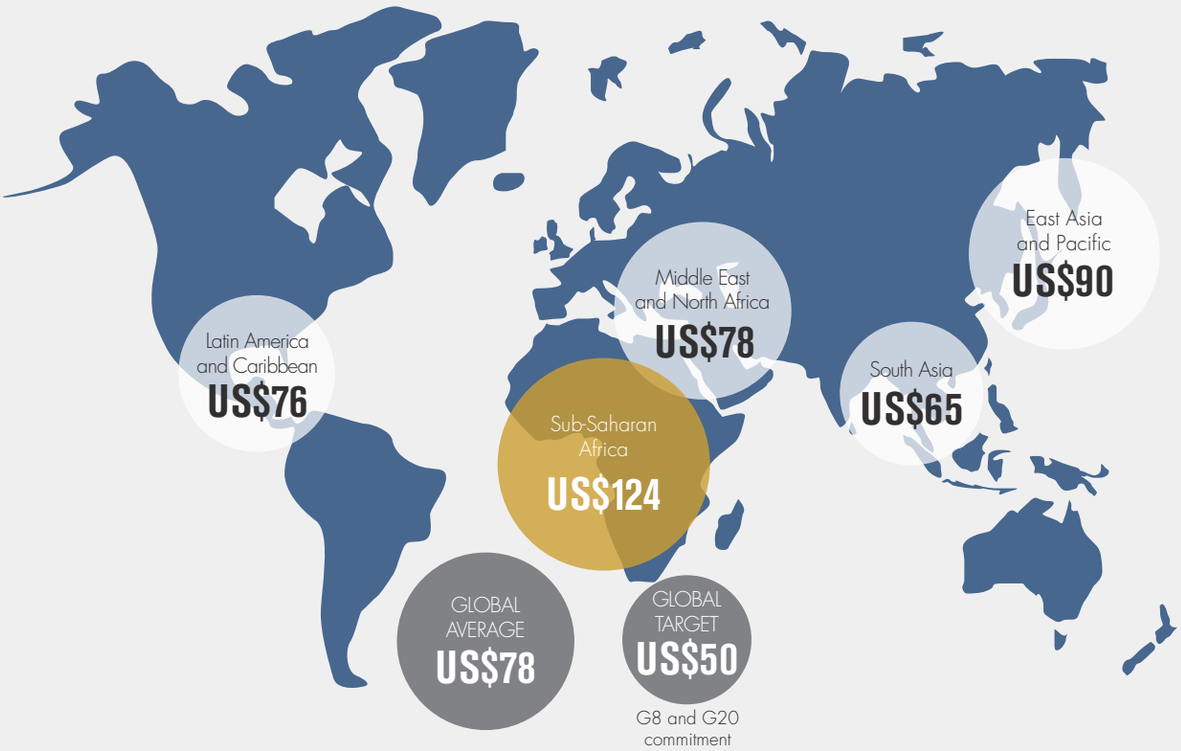


Source: The World Bank Group (2014), World Development Indicators.

THE REMITTANCE SUPER RACKET

Global money transfer operators and Africa's banks are overcharging Africans

CHARGE TO SEND US$1,000 TO...



THE TOTAL OVERCHARGE OF SENDING REMITTANCES TO SUB-SAHARAN AFRICA AVERAGES

US$1.85 BILLION

PER YEAR

WHAT COULD US$1.85 BILLION FINANCE IN SUB-SAHARAN AFRICA?

14

MILLION CHILDREN

of primary school age could go to school – almost half of the region's out-of-school population

8

MILLION PEOPLE

could have access to improved sanitation through Ventilated Improved Pit (VIP) latrines

21

MILLION PEOPLE

could have access to safe water through the construction of boreholes

Sources:
The World Bank Group (2014), Remittance Prices Worldwide.
Quattri, M. and Watkins, K. (2014), Lost in Intermediation: How excessive charges undermine the benefits of remittances for Africa.

BOX 6 AFRICA'S "REMITTANCE SUPER RACKET"

Migrants from Africa, the world's poorest region, pay the world's highest remittance fees. On average, someone sending US$200 home to pay for the education of a brother pays US$24.8 – a charge of 12.3 per cent.

Why are remittance charges so high? And why, in an era of mobile banking and internet transfers, do they show no sign of falling? The Overseas Development Institute in London has identified several barriers to lower charges:

The power of money transfer operators (MTOs): Global MTOs account for 80 per cent of transfers to Africa. Just two companies – Western Union and MoneyGram – account for two-thirds of this amount. Both companies operate exclusivity agreements with their agents and commercial banks, which raises the cost of market entry. MTOs account for US$900 million taken from African migrants and their families through excessive charging.

Questionable pricing practices: Many MTOs appear to charge an "African fee" that is uniform and unrelated to underlying conditions in the receiving countries. There is also evidence that MTOs are able to manipulate exchange rate variations. In March 2011, Malawians remitting money from the United Kingdom faced a foreign currency conversion fee in excess of 5 per cent.

Financial regulations: Regulatory authorities in many countries require remittances to pass through national banks, many of which are characterized by high costs.

Low levels of financial inclusion: Few Africans, especially in rural areas, have access to accounts in formal financial institutions – and such institutions have a limited presence in many areas.

Intra-African remittances are also subject to excessive charges, some of which are the highest in the world. Malawian labourers working in South Africa, Ghanaians sending money home from Nigeria, and Rwandans sending remittances from Tanzania all face charges of more than 20 per cent.

Governments could take several steps to reduce the costs of remittance transfers:

- review the practices of global MTOs , especially the transparency of the information they provide on foreign currency conversions;
- authorize post offices and microfinance institutions to play an expanded role in remittance payouts;
- challenge exclusivity arrangements involving MTOs and undertake reforms aimed at increasing competition;
- promote mobile banking. Kenya has seen remittance transfers double since 2004, to US$1.2 billion, partly because of the growth of the mobile payment service M-PESA (Box 1), which enables people without a formal bank account to receive remittances.

"Blending" aid and loans carries risks for the poorest countries

A central feature of new development assistance arrangements is "blending," which aims to use aid to leverage private finance. Blended finance links an aid grant with loans from publicly owned institutions or commercial lenders, to public or private sector borrowers in developing countries. As the discussion above of infrastructure financing shows, the primary source of blended finance has been European development finance institutions and the World Bank Group.'s low-income country lending arm, the International Development Association (IDA).

There are compelling grounds to develop blending, along with some causes for concern. When aid can unlock private investment through risk guarantees, equity stakes and other mechanisms, blending can have powerful financial multiplier effects. With high returns available in many areas of infrastructure financing, blending can help to mitigate the market failures that limit investments. Moreover, sustained high growth means that blended finance is not an immediate threat to debt sustainability for many countries.

Set against these benefits are several potential downside risks. One is that blended finance could divert aid towards higher-growth countries better able to leverage private investment, and away from countries with weaker governance. Another is that at a time when aid budgets are under growing pressure, there will be a trade-off between blending and access to basic services.

Another concern is that blending could make development finance less affordable and less available to the poorest countries. As donors reallocate aid towards leveraging private finance, there is a danger that recipient countries will have to fund infrastructure through more expensive loans.[47] Further question marks hang over the degree to which blending produces the leveraging effect that is sometimes claimed.

The focus on blending may also have diverted attention from other pressing issues. One concerns what is reported as development assistance. Donors in the OECD are required by convention to provide aid as a resource that is "concessional in character."[48] However, a former chair of the OECD's Development Assistance Committee has raised concerns over donor practices that appear to allow for non-concessional transfers to be counted as aid.[49] These concerns have to be taken seriously not just because of their source, but also because of the amounts involved. On one estimate, since 2008 US$32 billion that has been registered as aid fails to meet the OECD's own rules, with France, Germany and Japan the principal over-reporters.[50] There is an urgent need to clarify the rules and their application, not least in the light of the rise of aid blending.

The second issue also relates to concessionality. Most low-income and lower middle-income countries in Africa are eligible for aid in the form of grants by bilateral donors, by the International Development Association, or by the African Development Fund (the concessional arm of the African Development Bank).[51] In theory, lower middle-income countries are also eligible to borrow from the International Bank for Reconstruction and Development (IBRD), the World Bank Group's non-concessional facility.[52] Some countries – India, Pakistan and Indonesia are examples – are also eligible for a blend of IDA and IBRD support. In Sub-Saharan Africa, however, no countries currently draw on either the IBRD or the IBRD/IDA blend option; and only a handful draw on the African Development Bank's non-concessional facilities.

These apparently technical distinctions matter. Several Sub-Saharan African countries are now mobilizing resources through international bond markets. Reported interest rates since 2012 have varied between 8 per cent and 12 per cent on 10-year bonds. Meanwhile, loans from the IBRD currently carry an interest rate of 1 per cent to 2 per cent on 20-year loans, reflecting the World Bank's triple A credit rating in bond markets.[53] These interest rate differences could translate into very large potential savings. There are compelling grounds for African governments, the World Bank and the African Development Bank to reconsider whether the existing architecture is appropriate for potentially high-growth economies with large unmet infrastructure financing needs.

Foreign direct investment: beyond extractives

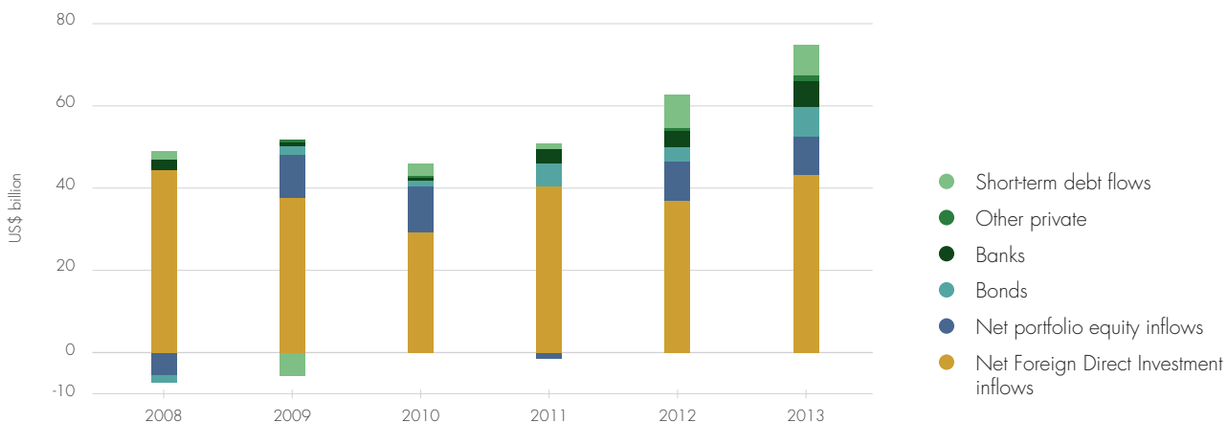
For investors seeking returns, emerging markets and "frontier markets" (as countries in Africa are often described) have become an attractive option as slow growth and loose monetary policy have lowered returns in equity and bond markets in the United States and Europe. This has provided African governments with access to a global pool of savings in a period of historically low interest rates, though this may soon be reaching an end. Sustained rapid growth and strengthened macroeconomic management in Africa have also favoured greater private investment.

Around 70 per cent of private capital flows to Africa arrives in the form of foreign direct investment (FDI) (Figure 15). This is important since FDI is the least volatile type of inflow and the least likely to experience abrupt outflows if market conditions change.

The mining and oil sectors continue to account for the bulk of FDI, but investment is also flowing into other areas. Around one-third is now directed to domestic markets. Between 2008 and 2012, the share of consumer-related industries in the value of new investment ventures in Africa grew from 7 per cent to 23 per cent.

Much of this domestic market investment has been directed towards public–private partnerships. Growing energy demand, regulatory reform and infrastructure investment have prompted an increase in partnerships between foreign and domestic investors. In November 2013, for example, the US energy company AES purchased a majority

FIGURE 15 FOREIGN DIRECT INVESTMENT DOMINATES PRIVATE CAPITAL FLOWS: PRIVATE TRANSFERS BY CATEGORY (US$ BILLION)



Source: The World Bank Group (2014), Global Economic Prospects.

stake in Cameroon's power utility, Société Nationale d'Électricité (SONEL). Partnerships between global and national companies are also becoming more common: during Nigeria's recent US$2.5 billion privatization process, local companies that had formed consortia with foreign players – including Siemens, Manila Electric, Symbion Power and KEPCO – emerged as winners of most projects. Investments in manufacturing remain the exception rather than the rule. Even so, during 2013 Nigeria became the first Sub-Saharan African country outside South Africa to attract a new investment from a global car maker: Nissan will build cars and light duty trucks in the country.

One of the most important FDI events of 2013 was the purchase by Prudential, one of the world's largest global insurance companies, of a Ghanaian insurer.[54] Prudential's purchase signals that high levels of poverty and low average incomes are not an automatic barrier to insurance. Nine out of 10 of the customers of the Ghanaian insurer bought by Prudential earn less than US$10 a day, while one-fifth live on less than US$2.50 a day.

Alongside FDI, private equity – capital that is put into new or growing businesses in return for part ownership or a profit share – has taken off, albeit from a low base. On one estimate, private equity firms invested US$1.13 billion across Sub-Saharan Africa in 2012. While the industry is still in its infancy, political stability, infrastructure investment and the growth of consumer markets have made Sub-Saharan Africa a hotspot. African private equity firms are playing an expanding role alongside established global players, across a wide range of sectors. Consumer industries, infrastructure, banking and agro-processing all figure prominently. So do real estate and, to an increasing extent, private health insurance. Another shift has been the spread of private equity firms to new markets. While the East African market is dominated by Kenya, growth has also taken place in Ethiopia, Rwanda and Tanzania.

Recognizing the critical role of small and medium-sized enterprises in African markets, several private equity firms are gearing their operations towards specialization in that area. As ever, growth has to be placed in perspective. There were only 58 private equity deals reported in Sub-Saharan Africa in 2012. The scale of the investments remains modest: in 2013 half of the private equity flows into Africa were valued at less than US$10 million. However, volumes are growing.

Africa's return to international bond markets

Sub-Saharan Africa's transition from intensive care under the HIPC initiative to a presence on the eurobond market is a remarkable turnaround. Since Ghana's initial highly successful bond offering in 2007, there has been a steady wave of new entrants and return issues. Low international interest rates, high domestic growth and low levels of public debt have made the region's bonds an attractive proposition. However, participation in eurobond markets carries significant risks – and it does not offer a magic bullet solution to infrastructure financing problems.

Between 2007 and 2013, Sub-Saharan African countries raised US$14 billion from sovereign bond issues, of which US$6.5 billion or 50 per cent was raised in 2013 alone. In some cases, African countries have borrowed at rates below those applied to eurozone economies. Zambia's 2012 yields were below those of Spain; Nigeria's rates were lower than those for Ireland. Among the major bond issues:

Zambia issued a heavily oversubscribed 10-year US$750 million eurobond in September 2012, with the funds earmarked for a number of infrastructure projects with a yield of 5.6 per cent.

Nigeria made its debut on the bond market in 2011 and returned with a US$1 billion issue in 2013. Yield rates were 5 per cent to 6 per cent on an issue that was four times oversubscribed.

Rwanda issued a US$400 million bond paying a coupon of 6.8 per cent that was nine times oversubscribed.

Ghana issued a US$750 million bond in 2013, in its second foray into the eurobond market, which was three times oversubscribed at a rate of 7.8 per cent. The bond's proceeds were earmarked for capital investment and reducing public debt.

Mozambique entered the market for the first time with a US$500 million seven-year bond issued by a government-backed agency at an 8.5 per cent yield.

Gabon raised US$1.5 billion from an oversubscribed 10-year eurobond issue and debt exchange.

Several countries have indicated an intention to either enter or return to eurobond markets in 2013, including Angola, Cameroon, Kenya, Mozambique, Tanzania and Uganda. While Sub-Saharan Africa has yet to participate on any scale in Islamic bond markets, this could be about to change (Box 7).

BOX 7 ISLAMIC BANKING IS GAINING GROUND[55]

The global market for Islamic bonds – or sukuk – is estimated at US$140 billion, and Islamic banks have emerged as a significant force in global finance. Yet Sub-Saharan Africa does not figure with any prominence in the world of Islamic finance. That could be about to change – and the effects will be significant.

Sukuk already figure in government operations. Structured to pay a fixed profit rate rather than an interest dividend, these bonds could supplement other sovereign debt operations. The Nigerian state of Osun issued a US$62 million sukuk in 2013. The government of Senegal has announced plans for a US$200 million issue in 2014, geared towards infrastructure and energy.

Other financing vehicles that comply with sharia, or Islamic law, are becoming more common. The central banks of Mauritius and Nigeria are shareholders in the Malaysia-based International Islamic Liquidity Management Corporation. Meanwhile, the Islamic Development Bank is providing investment for the new port of Lekki in Nigeria.

Other countries are making moves to encourage the growth in this area: In 2013 South Africa amended its tax laws to make definitions of sharia-compliant products more transparent. Yet there are calls for even faster change, with banks in South Africa pushing for greater lucidity in terms of tax legislation. Concerns remain that conventional banking laws continue to dictate Islamic finance. Zambia is formulating a new Islamic banking framework. Uganda, with a 12 per cent Muslim population, is also making regulatory changes.

Several major conventional banks are now also planning moves into the Islamic banking sector in Africa. Standard Chartered announced in July 2013 that it would soon start offering Islamic banking products in Kenya, before moving into other countries in the region.

Challenges remain. These include the need for Islamic banking institutions to appeal to non-Muslim customers, greater transparency and the availability of attractive products that are offered at the same standards of service delivery as conventional products.

Comparisons with aid illustrate the scale of Africa's eurobond issues. Ghana's 2013 issue was equivalent to around one-half of average development assistance inflows over the previous three years. For Zambia, the 2012 issue represented over two-thirds of aid levels. While development assistance and bond finance are very different, the comparison illustrates the attraction of the latter for governments seeking to mobilize additional finance for infrastructure.

It is not only governments that are borrowing. Some corporate entities have successfully issued eurobonds, including Guarantee Trust Bank and Ghana Telecom.[56] Nigeria's Guaranty Trust Bank issued US$400 million in bonds at 6 per cent at the start of 2013. Kenya's ARM Cement, Nigeria's Sterling Bank and Kenya Power are all expected to issue eurobonds in the near future.[57] While municipal bonds are a rarity, the municipalities of Lagos in Nigeria and Lusaka in Zambia have entered sovereign debt markets.

Conditions have been highly favourable. Excess liquidity has given African governments access to a deep pool of international savings. The average cost of bond financing fell in 2012, to its lowest level ever.[58] With high income countries gradually withdrawing the monetary stimulus measures adopted in the wake of the financial crisis, notably the tapering-off of the US Federal Reserve's quantitative easing policies, investors have turned to emerging markets and "frontier markets" to secure returns. From an African government perspective, the desire to tap the flood of money from rich countries is understandable. The region has large infrastructure financing needs, a scarcity of local savings, inefficient banking systems and a history of high inflation – all of which serve to keep domestic interest rates high in many African countries. Yields on eurobonds are significantly lower than those on domestic market bond issues (Figure 16).

African governments have turned to bond markets for a variety of reasons. Apart from raising long-term finance for infrastructure, bond issues can set benchmarks for corporate debt and facilitate debt restructuring (the substitution of lower-interest for higher-interest debt stock).

Recourse to bond markets comes with several risks, however. Although Sub-Saharan African bond yields were only modestly affected by the tapering-off of the US Federal Reserve's quantitative easing policies, this picture could change with deeper tapering.

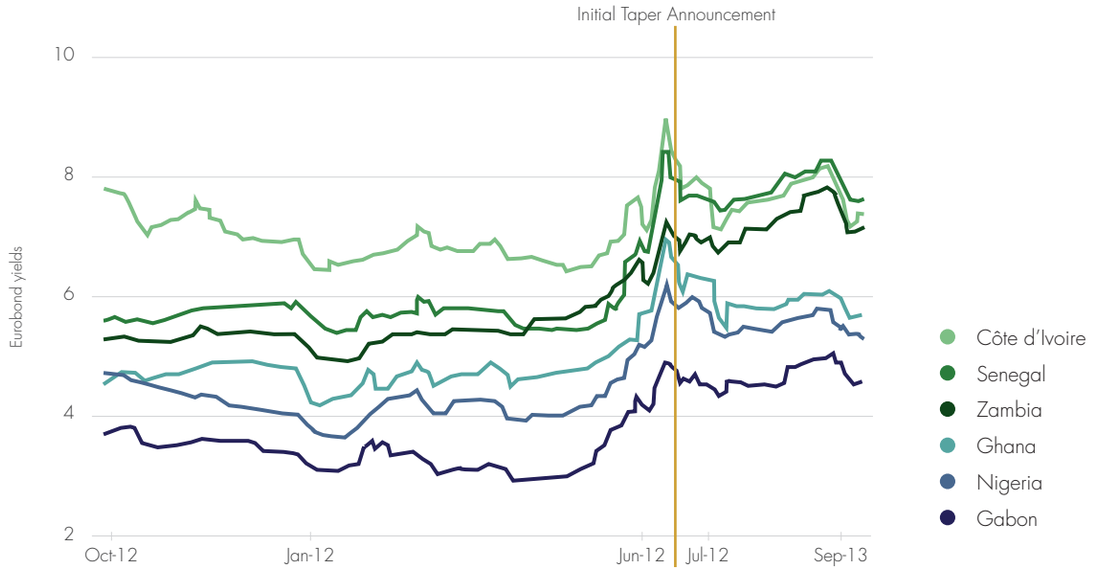
Not all of the risks are external. Large current account and fiscal deficits carry the risk of devaluation, which can in turn make an apparently sustainable debt burden unsustainable overnight. Devaluation is not the only threat. Where bonds are issued to finance major infrastructure projects, governments need to ensure that debt liabilities are offset against productive investments. Long delays between borrowing and the initiation of projects can erode the benefits of bond finance. This appears to have happened in Zambia. One year after the successful (and heavily oversubscribed) issue of the US$750 million bond on euromarkets, few of the planned investments had taken place. The problems associated with the design of major infrastructure investment projects, which we identified above, appear to have been a major factor behind the delay.

Several governments have attempted to draw on the savings of diaspora communities. For example, Ethiopia adopted this approach with the Millennium Corporate Bond in 2008 and the Grand Ethiopian Renaissance Dam bond in 2011 with mixed results.[59]

Conclusion

Finance and infrastructure are sometimes viewed as technical issues of concern principally to financial regulators, engineers and companies linked to banking, insurance and construction. Nothing could be further from the truth. In this report we have highlighted the consequences of the deficits in finance and infrastructure for the most important development challenge facing Africa – strengthening the bridge that connects economic growth to the wellbeing of people. More inclusive financial systems, expanded infrastructure and healthier domestic revenues, will enable Africa's farmers, to realize their potential and to contribute to inclusive growth and food security and nutrition.

FIGURE 16 AFRICAN BOND ISSUES WERE AFFECTED BY THE US TAPER ANNOUNCEMENT: YIELD DATA 2012 (SELECTED COUNTRIES)



Source: Bloomberg as quoted by Standard Chartered (2013), Standard Chartered Africa Focus: A wealth of diversity.

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