Financial Markets in Africa: Opportunities & Challenges

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AGENDA

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* There has been an “Africa is Raising” narrative in headlines, in business forums and geo-political conversations – what is my take on this narrative? -- I think there are flaws in this narrative:

- At Africa growth of 6-7% = US$ 160 billion p.a. is one fifth that of China (currently at 7% & is said to be in recession) -- adding US$ 750 billion p.a., at a slightly higher population level

- Yes Africa has enough virgin arable land = but would it constitute growth if there is poor usage of technology to improve its yield i.e. produce per hectare of cone in Africa averages 2 tonnes, it is 10 tonnes in the U.S.A

- Yes Africa has the youngest population on earth i.e. enough manpower to pump-in growth = but is it useful and beneficial if it is of poor skills and can’t be fully intergraded into the current global competitive environment? University graduate per capita in Africa averages 3 per cent; it is about 70 per cent in South Korea whose level of development in just half a century ago was similar to Africa
What about infrastructure? It costs about US$ 50 moving a tonne of cargo from the U.S port to Dar es Salaam (over 12,000 km away); and it costs more than 3 times as much to move the same cargo to Lusaka – Zambia (just under 2,000 km away from Dar).

How is Africa using its conducive environment (enough rainfall, many rivers and lakes) to support agricultural growth? Irrigation usage for farming in Africa is just 6%, compared to Asia with similar climate which is at about 35% and global average of 20%

And what about the use of electricity to power growth? Currently, the total power capacity installed in Africa is about 150 GW. This is equivalent to total capacity installed in Belgium and what China installs every 1-2 years. France, with its 65 million people or Italy with 61 million people consumes 40 times more electricity than an African today.

And Governance and accountability? -- the tenets for a civil, responsible and transparent society. How is Africa fairing up? Sabotage, corruption, theft, wars are almost common tunes.
Preface

- So, if we were to step back and ask ourselves -- should we continue to embrace an idea that Africa is on the rise? Or should we revisit our understand of this narrative?
- What I am trying to say – I am not saying we can’t grow. What I am saying is that for us to grow to our potential, it requires that we take a deep look into our selves, and take a stock of our approaches, learn out of history and change our behavior.
- We need to address the key question – which is my topic today: How should we finance Africa’s growth? – what strategy should we deploy? Should we continue to rely on aid-powered growth? Which hasn’t worked despite 60 years of aid injection, averaging US$ 16 billion p.a. (US$ 1 trillion) -- with almost nothing much to show for it OR should we go for the Financial Markets Solution?
I believe that Financial Markets (among other approaches such as FDIs, Trade & Investments, etc) should be the alternative to aid-powered growth to ensure real development happens.

Financial markets bring about discipline, transparency, accountability and responsibility in the way the society governs itself.

It allocates available financial resources to the best available productive investment needs.

Therefore efforts to ensure: we are banking the unbankable, we provide access to alternative and diversified financing needs to both public and private sector have merits and should be embraced.

Now, what is the status of Africa’s Financial Markets today?
Deep, transparent, and accessible financial markets are vital to supporting economic growth, rising consumer demand, for productive innovation and political stability.

Robust financial markets allows countries to move beyond short term, volatile capital flows by attracting longer-term investments that strengthen a country’s economic stability by providing more resilient foundation of capital flows.

To be able to sustainably achieve the level of deep, diversified and liquid markets -- a good mix of both banks, capital markets and private equity finances, is critical.

Given the fragmented nature of players in the African financial markets and the level of risk associated with Africa, the investment capacity of institutional investors remains limited among stringent capital allocation decision process and financial markets are still small, narrow and illiquid.
State of African Financial Markets

* However, the current situation is far better compared with the last two decades:
* The financial systems of most African countries have undergone substantial changes
* However, most countries traditionally still depend on the banking system
* Capital markets and private equities are also gaining a prominent role
* The potential for Africa to develop its financial market is large, given its growth and development requirements, improving peoples’ socio-economic prosperity and reduce the size and magnitude of poverty
State of Financial ...[Banking]

* Average bank credit to the private sector is about 25 per cent of GDP: however, Other Asian and Latin America emerging economies, the level is above 50 per cent and more than 100 per cent in developed economies

* African banks have limited role in the economy – they mainly finance trades and related activities, without much intermediation into financing of manufacturing, infrastructure, agricultural, extractive and energy projects

* Banking services penetration is as low as 10% in some countries, and access in most countries is limited to urban centres
State of Financial …[Banking]

* On the positive side:

✓ despite the size and model of the banking sector in Africa, when compare with other economies, the banking system in Africa is reasonably sound

✓ Better macroeconomic conditions, privatization initiatives as well as less governments’ intervention in the banking sector, have generally diminished the ratio of non-performing loans and the level of capital adequacy is also relatively sound.

✓ Banks are relatively profitable, even though they are less efficiency

✓ Banking sector is very much concentrated and dominated by foreign banks
State of Financial ...[Stock Markets]

* Growth, from 5 stocks markets in 1990s, to about 30 stock exchanges
* Assets and listings have grown significantly in the past two decades. Total market capitalization has increased by more than 10 times
* Total capitalization is estimated at around US$2 trillion; up from $113 billion in 1990s. [however, almost 65 per cent of the total market capitalization, 25 per cent of the total listings are in South Africa]
* Markets are still relatively small, most capitalized below $50 billion, with fewer than 10 listings in some markets
State of Financial ...[Stock Markets]

* There has rapid growth, more exchanges are using software systems to boost efficiency, operating speed and reduce costs

* Returns on African markets have been relatively high

* There are diversification opportunities that are minimally correlated with global financial systems

* The attractiveness of African equity markets can be attributed to the continent’s fast-paced economic growth and development, political stability, stabilizing and growth-oriented policies and initiatives, liberalized business environments, increasing regional collaboration, and positive engagement with multilateral agencies
State of Financial …[Stock Markets]

Despite this positive experience:

✓ Africa’s stock markets are still illiquid; Turnover ratios are very thin, less than 1 per cent in many market. Africa’s share of the global equity turnover is less than 0.05 per cent

✓ Low liquidity implies more difficulty in supporting a local market own trading systems, market analysis, and brokers as volume is too low

✓ African stock markets also suffers from infrastructural bottlenecks --Trading, clearing, and settlement systems are so slow, and some exchanges still operate manual systems
Some markets do not have central depository systems, and some restrict foreign participation - inducing inactivity in markets.

Therefore, much more needs to be done to improve liquidity and attract more company listings.

Key steps include:

- Promoting transparent and accountable institutions
- Providing shareholder protection and investor education
- Strengthening regional collaboration, and encouraging financial innovation
- Governments continuance to support the exchanges by: privatizing public enterprises via exchanges, providing enabling environment, tax incentives to encourage more listing
State of Financial …[Private Equity]

* There has been a significant increase in private equities

* However, the level is lower: Investments in private equity are currently estimated at less than 1 per cent of the region GDP

* Growing interest from PEs resulted in a significant increase in fund-raising numbers; aggregate deal value of African deals in 2013 was US$3.3b; a significant increase from the US$1.6b in 2012

* PE landscape in Africa continues to be dominated by domestic and regional firms. However, large global PE firms are also looking at the market to capitalize on the growing investment opportunities available
Better macroeconomic environment characterized by high GDP growth and the relatively low inflation rate has been the primary factor in the growth of PEs

Factors such as political stability, cheap and young labour, little competition, newer markets, low rents, higher margin also attributes to growth in PE activities in Africa

While global investor interest has begun shifting back in favour of the growing developed economies, away from emerging economies, Africa's strong long-term growth fundamentals should continue to drive the development of the PE industry on the continent

With small and illiquid stock markets, private equity is another way for investors to take advantage of the opportunities in African emerging economies.
The market for long-term debt instruments is one of the least developed segments in Africa.

According to BIS and SIFMA, as a proportion of the Global GDP, bonds market was about 140 per cent of the Global GDP, as of 2013. In most African countries, size of the bonds market is less than 10 per cent of country’s GDP.

Factors such as: economic size, openness of the countries’ capital account, size and concentration of the banking sector, bureaucratic practices, interest rates spread, exchange rates volatility, fiscal balance challenges, corruption, quality of accounting standards, and size of domestic credit – all impact the development of local bonds market.
State of Financial …[Bonds Market]

* Despite the low level of bonds market development, existing bonds market is also skewed towards Government bonds
* Issuance of local currency debts by private corporation is erratic and small in volume
* Only three countries have bonds issued by municipals and local government bonds (Cameroon, Senegal and South Africa)
* Benchmarking with developed economies – Government bonds composition to the overall bonds market is less than 50 per cent, Corporate bonds, Mortgage backed bonds, Municipal bonds and other forms of bonds makes about 50 per cent
* Historically, most of sub-Saharan Africa has been heavily dependent on FDIs, external grants and concessional loans for funding capital spending and government deficits
State of Financial …[Bonds Market]

* As a result, they have developed limited capacity to tap in and develop local bonds markets and have limited access to global capital markets for bonds issuance

* However, as development partners and donors continue to scale back their funding assistance

* Without access to alternative sources of finance, African governments and private sector may find it difficult to finance their development projects and business enterprises

* Therefore there is strong argument for development of the bonds market in Africa – there are several projects that are in pipeline seeking for such funds i.e. infrastructure projects requires more than US$ 25 billion per annum, while the current capacity is only US$ 10 billion cumulative for the past 10 years
As part of the solution:

- Some countries have been making efforts to improve their ability to access international capital markets or developing their domestic debt markets. However, even in such situations, local currency debt in most markets is mainly short-term with maturities usually less than a year. Local currency markets have been used extensively for recapitalizing banks, setting benchmarks for the pricing of financial assets and risk management tools, and helping governments to finance their deficits. Commercial banks use these opportunities to increase their profits by transferring their excess liquidity into government securities.

- Several countries have managed to issue debt securities in their own currency to foreign investors -- non-resident holdings of domestic debts are typically low.

- Countries such as Ghana, Zambia, Rwanda, Kenya, Gabon have recently entered the international capital market to help funding new public infrastructure spending.
**State of Savings & Investments rate**

* According to UN National Data, domestic savings in most African countries is less than 30 per cent of GDP, which is largely less than investment rate (about 50 per cent of GDP)

* These data indicates that the statistical difference between domestic savings and investment rate is accounted for by Africa’s ability to tap in foreign (savings) fill in their investment gaps

* Official loans and grants, accounting for at least 30 per cent of GDP p.a. for most countries, represents the major reason why countries have been able to consistently invest much more than their ability to save – or tap into foreign savings to supplement the limited savings of the domestic system

* Foreign direct investment, which in recent years has been about US$ 50 billion p.a. also plays the key role in bridging the gap
In the short term – un-intermediated domestic savings, foreign grants and loans as well as FDIs will continue to provide the foundation on which the long term finance of Africa’s development projects will rely on.

In the long term -- the structure, magnitude, composition and relative importance of these three key sources of long term financing will change and/or realign.

Domestic savings will continue to be relevant and command most attention. The challenge remains as to how savings will largely be intermediated through the financial system? Intermediation in many countries in Africa is still low; banking sector penetration is low, and the capital market usage is insignificant.

Accessing finance through borrowing from both domestic and international markets will be a key element in the financial markets in Africa.
Summary of Opportunities & Challenges

* Inadequate regulatory framework resulting into a highly concentrated banking sector, very low intermediation activities, and inefficient collateral registration system that impede businesses and individuals’ access to credit

* A banking sector that doesn’t efficiently exercise its role of intermediation due to relatively very high interest rates spreads, which makes credit expensive

* Underdeveloped capital markets that remain narrow and illiquid, thereby limiting access to long term financing and hindering countries’ capacities for local equity and debt financing

* A lack of innovative financial instruments, notably those geared towards SMEs, which constitute a majority of the businesses on the continent but remain too often confined to the informal sector due to inadequate financial services
Proposed Solutions

Addressing the institutional and regulatory framework

* A well functioning financial market (and system) requires strong institutions and a sound legal framework, Investors and consumers protection, legal enforcement laws and good corporate governance are key elements for increasing the depth of markets and creating an enabling business environment

* There is therefore a need to enhance:

  ✓ Registration systems for both movable and immovable assets;
  ✓ Credit guarantees for specific borrowers i.e. SMEs, Exports, Agriculture, etc;
  ✓ Law enhancement and regulatory capacity, so as to make it easier doing business in Africa and improve its competitiveness in the global space.
Banking Sector Reforms

* The African banking sector thus needs to be reformed to effectively accommodate the demand for credit from both public and private sector

* Savings resources has to be properly intermediated and channelled towards productive investment

* African bankers should seek not only to provide SMEs with appropriate savings and borrowing instruments, but also banks should increase ability of their staff to cater to different markets and the diversity around these markets
Proposed Solutions

Capital markets development

* increasing the number of actors through regional integrations
* creating second-tier/alternative markets and increasing portfolio options
* provide firms with incentives to list their shares on the local stock markets
* addressing the information scarcity challenges -- by using different platforms to communicate with the outside world
* collaborations with developed stock markets for technical assistance to help African stock markets with comprehensive regulatory and legislative frameworks and skills capabilities
* increase institutional investments by developing tools and outreach events to institutional investors to address the misconceptions and knowledge gaps of operating in the continent and to mitigate risks associated with deploying capital in the continent
Proposed Solutions

Innovative Approaches to Finance and Domestic Resource Mobilization

* Given the importance of financial markets in the economy and the reality that SMEs are not only less likely to access funding but pay more for accessing it -- It is essential that policy makers and financial institutions in Africa create financial products that are geared towards SMEs products and services such as:

- guarantees to commercial banks that lends to SMEs
- financial literacy training to SMEs
- capital markets and stock exchanges introduce alternative markets segments for SMEs
- scale up MFIs activities to fill the SMEs financing gap
- using mobile technology to increase the level of outreach and access to financial products and services
Conclusion

* Overcoming access to finance challenge is critical if Africa is to increase its investment rate and its growth potential, as financial intermediation is the key to channeling resources into productive activities

* Major reforms are required in diversifying the supply of financial products and services in the financial markets, regionalization of financial markets through harmonization of legal and regulatory framework as well as systems and market infrastructure is also critical

* To achieve significant milestones in such reforms, it requires intense cooperation among African governments and Africa’s development partners as well as innovative solutions among key players along side sound macro economic policy management
Closing Comments

* It is important to note that Africa is diverse; made up of 54 independent sovereign state that are different from each other politically, socially and economically

* Each of these countries have their own opportunities and challenges – their history, culture and social set-ups also differs from one another

* Some countries have enjoyed good leadership, good governance and a relatively good pace of socio-economic prosperity while some countries have passed -- and still -- go through dire conflict situations, i.e. perpetual wars and economic regression

* Therefore, it is important that discussions around Africa’s opportunities and challenges take these facts into proper perspective
Most Africa countries have changed from the gloomy picture of the past and are on the rising – with political stability and socio-economic growth. Many African countries are in different forms of reforms. These reforms have resulted to economic growth of about 5 per cent (some countries have commended growth rate of 7-8 per cent) in the past one or two decades.

Mostly, Africa is therefore quite different from the past and is attracting a very different form of attention. Africa is now a continent of hope and opportunity. And it is rising.

Existing and potential opportunities in Africa are many: there are abundances of fertile arable land, many rivers and lakes with fresh water, all sorts of natural resources, good sources of renewable and non-renewable energy, immense varieties of flora and fauna, the youngest population in the global, etc – therefore GDP growth rate of above 10 per cent can be easily tenable.
But these can only become a possibility if the following issues are properly addressed:

- good governance – accountability, responsibility and transparency;
- enhanced democratization of business, trade and investment;
- encouraging entrepreneurial spirit among its people through set up of proper social infrastructure investments;
- encouraging industrialization within the continent;
- improve business environment to facilitate competiveness and enable easy of doing business in the continent;
- encourage more intra and inter-trade, and investments coupled with more regional integrations; and
- Develop, grow and encouraging accessing local and international financial markets for funding of projects and enterprises rather than over-reliance of aid and assistance

Closing Comments
Changing from aid and assistance dependence, as the core model and engine for propelling economic development, towards creating relationships and partnerships with developed countries that hinges on partnerships embedded on trade and investment – is key to unlock economic potentials and opportunities in Africa.

Development partners should therefore consider reducing aid as development assistance into Africa.

Relationships based on aid has created misconceptions within leadership and societies in Africa.

Aid has facilitates growth of poverty and corruption.

Experience tells us that – aid has failed to alleviate systematic poverty in Africa (currently, many African countries still live in less US$ 2 per day, situation less than that 50 years ago).
Closing Comments

* aid fuels corruption growth
* results into poor governance practices and systems and it continues to kill innovation and entrepreneurship
* Africa can do better with minimal or with only necessary forms of aid
* As governments and businesses enterprises needs funds to finance social economic infrastructure projects as well as to finance private business enterprises -- financial markets should be a significant part of the capital solution
* Governments in Africa should seriously participate and focus on developing local capital markets and banking systems by introducing regulatory frameworks and infrastructures
* This market approach will enhance the level of accountability, responsibility and transparency – factors which are cornerstone for sustainable development in the society
Closing Comments

* Apart from focusing in developing domestic financial markets, Africa can also access international financial markets -- global investors can easily be accessible and they currently have appetite for the African raising and growth story.

* It is therefore for Africans to shift our thinking and start seizing existing potential and opportunity in order to further our growth.

* The positive signs have already been seen – there are a plentiful of African countries that have started this journey – South Africa, Ghana, Gabon, Zambia and recently Kenya and Rwanda have accessed international financial markets for bonds issuances. Others should follow.