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LET AFRICA ENTER ITS BELLE ÉPOQUE

FINANCING ON THE A-LIST

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EULER HERMES

EXECUTIVE SUMMARY

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- Africa's attractiveness is strong since the continent's growth is driven by capital intensive needs, particularly infrastructure. Therefore financing (both levels and sources) is among the key questions that need to be answered in order to properly channel funds to the right projects. Let's make it work through a mix of formal solutions (FDI, fiscal resources) and innovative ones (mobile banking). Some of the important highlights from this report include:
- Because of the large current account deficits that many African countries currently face, even an uptick in FDI would not necessarily solve all issues related to improving infrastructure. For example, Ethiopia attracted USD 3.2 billion (bn) in FDI in 2017 but this only covered 32% of its current account deficit.
- Debt and equity will surpass Foreign Direct Investment (FDI) in 2018, as FDI continues to weaken, particular in Central and Southern Africa. Eurobond issuance saw its best start to year in 2018, with roughly USD 22bn in issuance across the continent. While Eurobond issuance is a welcome antidote to countries with low import covers, it is not the best way to finance infrastructure or social spending.
- This decrease in FDI is noteworthy since there are still strong infrastructure gaps to fill-in, particularly when it comes to electricity. The 15 main African economies would need to spend roughly USD 1000bn to 2030 in order to close their power generation gap. Considering governance structures and debt sustainability levels, about USD 330bn is likely (e.g. USD 70bn in Nigeria).
- Chinese investment on the continent is expected to continue, but there are concerns, particularly with regards to whether China will extend the maturity of some of its loans, as may be desperately needed in some commodity exporters (Angola, Republic of Congo, Mozambique).
- Increasing taxes along with increasing spending is a recondition in many countries that could decrease the odds sustainability problems associated with quick growth.
- Increasing the amount of Days Sales Outstanding (DSO) by an extra 30 days would allow African nations to focus on supporting growth. A 30 day lengthening of payment terms would result in freeing up about USD 33bn in 2018 (USD 45bn in 2020) throughout the continent.
- Financial depth and literacy need to improve on the continent as a means to access credit, with less than 30% of the Sub-Saharan adult population owning a bank account. Mobile banking may be a solution to these issues, particularly with the proliferation of mobile phones on the continent.
- This report thus concludes that while there are reasons for optimism with many African economies, there are also number of roadblocks and pitfalls that are preventing the continent from reaching its true potential.

Additional working capital freed up in 2018 for African companies if suppliers grant a payment term of 30 days on imports paid in cash

USD 33.5 billion

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Is Africa still following the same financing model?

Financing needs have increased and are financed differently

Back in 2015, Africa experienced a common financial stress, as a result of a commodity price slump and falling exports. It triggered a USD -141 billion (bn) current account deficit, with the -86bn not covered by workers remittances financed mainly through debt (bilateral and IMF loans).

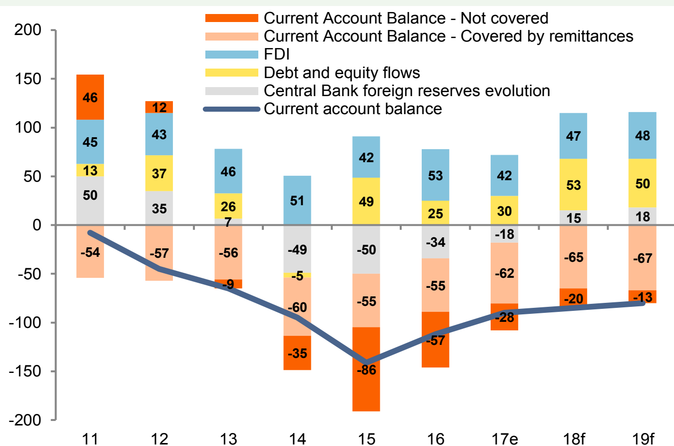
The drop in exports led to lower private capital flows to the region. However, this symmetric liquidity shock is now over and the landscape has changed quite a bit. Growth is on again, but the overall current account deficit still prevails, mirroring remaining deficits in key oil exporters (Algeria, Angola mainly). These persistent deficits mean that the main African economies avoid growth collapses. The adjustment was less severe than in the eighties. Yet, since domestic demand kept growing, the current account deficit is still present following the market shock.

Financing has changed as well, since debt and equity flows should top Foreign Direct Investment (FDI) in 2018 and reach an all-time high, as a result of growing bond issuance. Weakening FDI inflows mirror regional divergence with Central and Southern Africa still growing less than before the crisis and exhibiting attractiveness problems, whereas North, West and East Africa are not experiencing similar difficulties.

I've got the power: A USD 1000bn issue? No, no, but one third is still big

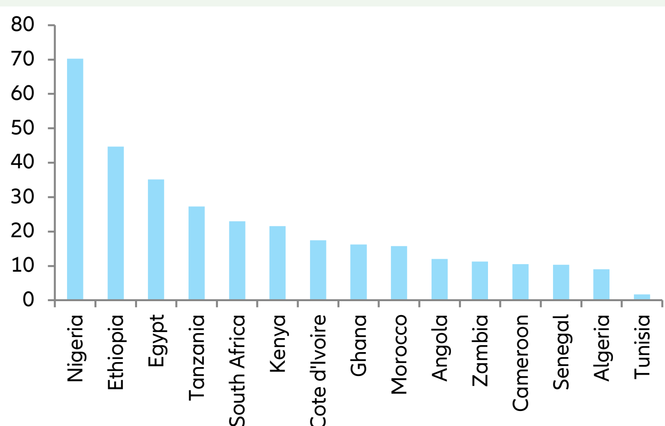
Financing through FDI, bilateral loans and Eurobonds is not neutral given the current investment pattern in the region. Current expenditure is one key aspect, since many African economies fell in a deficit trap as a result of decreasing commodity prices. Moreover, infrastructure projects were put under scrutiny particularly in economies with the poorest governance scorecard.

Figure 1 Aggregate current account financing excl. offshore centers, per source (USD bn)



Sources: IMF, World Bank, UNCTAD, Euler Hermes Forecasts

Figure 2 Likely spending through 2030 for power generation infrastructure in the main 15 African economies (USD bn)



Sources: World Bank, Euler Hermes

Power generation is one of the key infrastructure areas needed in order to fuel a catch-up process. Countries unable to close their resources gap often fall in to the so-called "middle income trap". A common pattern is electricity blackouts nurturing premature deindustrialization, a phenomenon well-known in South Africa.

East Asian economies did not fall prey to this particular problem, since they managed to reach their potential. Comparing African economies with an Asian one (Thailand) shows that African economies would need to spend about 20% of their current GDP to close their power generation gap by 2030. In dollar terms, the 15 key African economies would need about USD 1000bn in order to finance it.

However, countries with poor institutions (Angola, Nigeria) or already high debt levels (Angola, Tunisia, Ethiopia, Kenya…) will likely inhibit infrastructure financing. This is particularly true in large economies with difficult relationship between sovereign and sub-sovereigns (Nigeria, Ethiopia mainly). Despite these bottlenecks, Nigeria would still rank 1st given the size of its economy, but the missed opportunity to improve its infrastructure will see a potential loss (about USD 200bn) to its overall growth potential.

Financing Africa: Fashionable issues

African Eurobonds: The new frontier

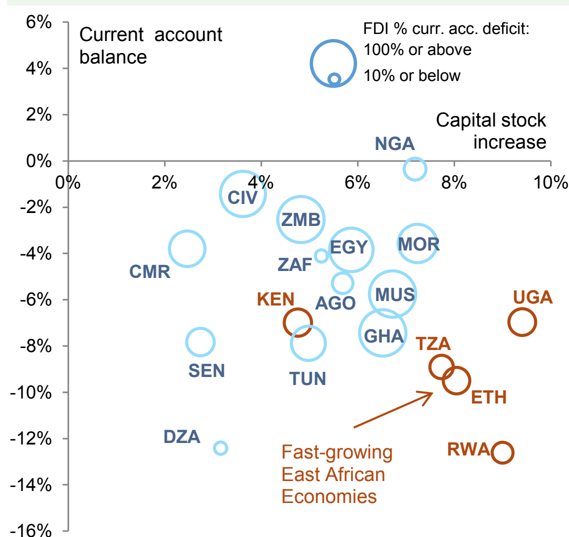
African economies made their best start in 2018 in terms of overall Eurobond issuance, with about USD 22bn issuance. There is one good reason behind that: Some African economies did a good job in terms of policy choices during the low commodity price period and now see their perceived creditworthiness improved. No surprise, given that our four country risk upgrades decided in 2018 (Egypt, Ghana, Côte d'Ivoire and Senegal) all issued a Eurobond in 2018H1.

The overall trend was not affected by bouts of financial volatility (Italian risk) and higher interest rates in the US. Only the most vulnerable economies did feel the shock, those with low foreign reserves: E.g. Tunisia had to delay an issuance given a low appetite triggered by its high external debt (84.5% of GDP) and low import cover of foreign reserves (2.5 months of imports).

This is the first set of problems: only some economies in Africa have access to this sort of financing and shutdowns are likely. South Africa was the only key sovereign to keep continuous access to the market during the commodity price shock.

When available, Eurobond issuance is a welcomed fix for countries with low import covers, since its size is large enough to upgrade the import cover to the safe zone, as e.g. in Egypt. But it increases the reliance of the country on foreign currencies, making repayment quite expensive when the country suffers from exchange rate depreciation. Moreover, there can be a maturity mismatch between financing and expenditure: Eurobonds are not the best way to finance infrastructure or social spending needs. The bottom line is obvious: this kind of inflow will reverse itself sooner or later depending on investors' risk appetite.

Figure 3 Capital stock increase (annual average growth, last 10 years), current account balance (% of GDP, 5-year average), and share of the deficit financed through FDI



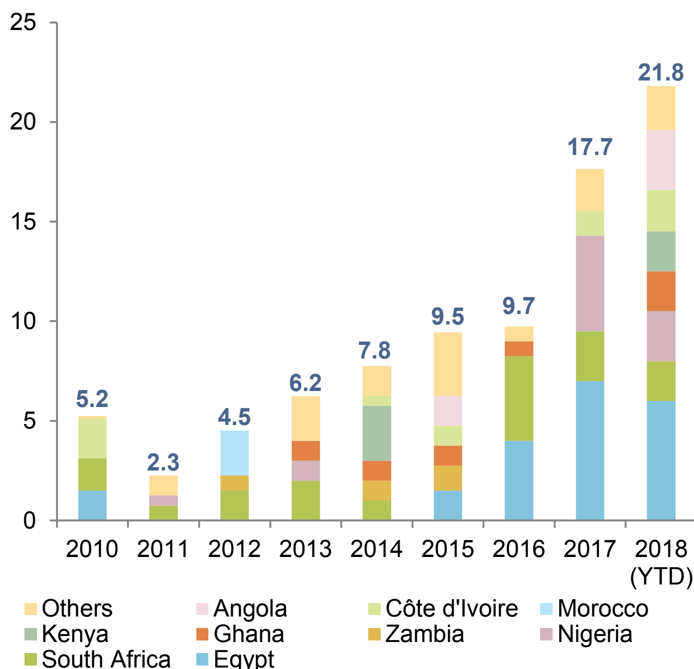
Sources: Penn World Tables, IHS, Euler Hermes

Sons-in-law, rather than Chinese Children

The region is the first Chinese outward investment destination outside of Asia, following two distinct goals. From the Republic of Congo to Mozambique and Angola, the access to commodity resources is still the main rationale. As is the case on the Mainland, China delivered many loans in order to secure its access to these commodities. Part of these loans were used to finance new investments, and part was used in crony financing of current spending, allowing a narrowing link between fiscal revenues and expenditures.

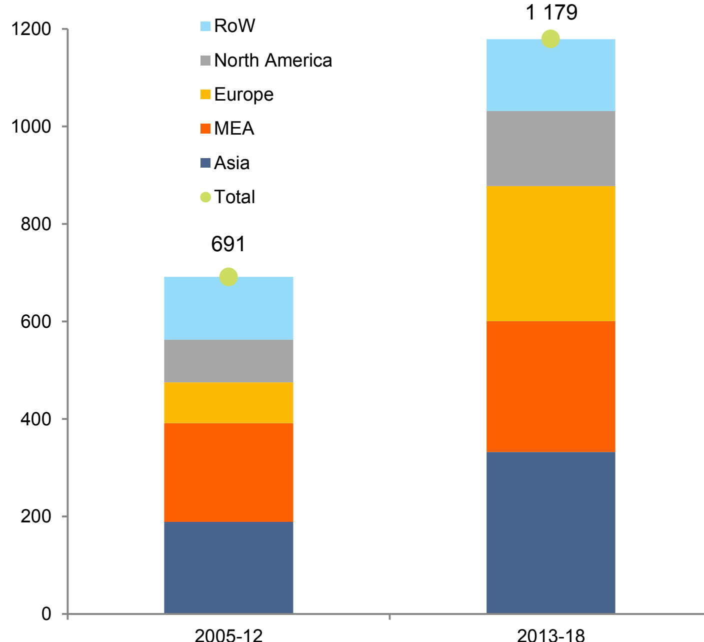
Debt has increased in many economies and decreased access to overall credit has put some of these economies in a credit crunch. China may extend the maturity of the loans… or not. But, obviously a public debt restructuring (rescheduling) plan that works for Mozambique (117% of GDP), Republic of Congo (115% of GDP) or Angola (76% of GDP) would involve Chinese bilateral loans.

Figure 4 Eurobonds issuance (USD bn)



Sources: Bloomberg, Euler Hermes

Figure 5 China's overseas investment and construction activity by region (USD bn)



Sources: AEI. China global investment tracker

The second kind of relationship is driven by One Belt One Road (OBOR) motives and channels funds mainly to East Africa in order to increase and improve production with the goal of re-exporting the output. As a result, Chinese corporates are also financing infrastructure development (road, railway, ports, power generation…) in order to improve countries' ability to re-export through the development of a new trade route from Djibouti to Mozambique.

From being a world leader in infrastructure building to using low cost / improving countries' logistics in order to raise low-valued output (textile), the growing Chinese presence is driven by several rationales, but is not unbiased. As a result, social discontent may eventually materialize and Chinese financing in countries with far worse governance may not be as smooth as it was in Mainland China.

Obviously, some projects were financed since China was in the country, including when Chinese investors were not involved in the project. But, overall, there is no explicit Chinese guarantee on African sovereigns, sub-sovereigns or State-owned Enterprises debt (SOEs). Also, there is no proof that China will roll-over its bilateral loans as it was done in the past for Chinese mainland corporates.

Go one step beyond to overcome fundamental African bottlenecks

Public sector enhancement

African economies have the twin goal of developing planning capabilities to follow a sustainable development path while also improving their infrastructure and raising living standards within their countries. This kind of spending needs to be more insourced. The need to raise fiscal income levels is obvious in Africa, particularly in the biggest economies, where sub-sovereigns may lack the resources needed to finance it. In Nigeria, the governorate of Imo State lost its access to power after unpaid bills.

Resources are low and are often not spent in timely fashion, since policymaking processes are too slow, e.g. again in Nigeria where H1 usually does not see many projects implemented because of late financing and H2 benefits from more funding.

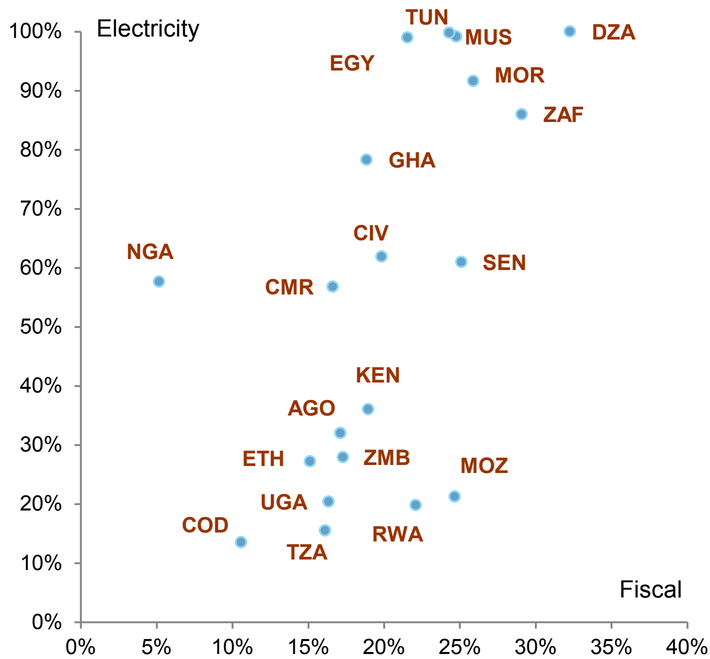
More generally, a plan that works needs to provide the young labor force with enough skills and jobs in order to have a peaceful transition to a higher income level. In a nutshell, the risk is that inequalities create protests and division and therefore pose a risk to the overall developmental momentum, as e.g. in Ethiopia.

Based on the Chinese example, a plan that works sets goals and priorities for two distinct time periods: In the very long-term (30-40 years) with final targets, and the medium-term with intermediate objectives based on 5-year planning. That is exactly the approach developed in the Emerging Senegal Plan launched in 2014. The overarching goal is urbanization and focuses a set of priorities on construction (output grew by +11.2% in 2017), as well as on health and education (+9.7%).

Along with soft governance skills (e-government as e.g. in Rwanda, government effectiveness…), it supposes a growing share of taxes in % of GDP in order to match rising expenditure. Spending growth has to be matched with recurrent revenue growth in order to limit sustainability issues. The imbalance between the two is the main weakness observed in Nigeria where fiscal revenues remain too marginal to sustain the effort, as opposed to the Senegal situation where fiscal revenues should reach 25% of GDP quite rapidly.

Photo by Marlinn Jackson on Unsplash

Figure 6 Fiscal revenue (% of GDP) and access to electricity (% of population)



Sources: World Bank, IMF, Euler Hermes

Africa's corporate DSO: Let it be!

In many places, economies are suffering from too long Days Sales Outstanding (DSO). Big players are often bad payers, whereas small players have no opportunity to pay late. There is a paradox when observing key SOEs able to postpone their payments by several years (e.g. in Angola or in the past in Egypt) and others with no choice but cash payment. E.g. Moroccan main corporates have 84 days of DSOs

In 2015, Euler Hermes estimated that if a payment term of 30 days were granted on the share of imports paid in cash (cash in advance), then it would free up over USD 40bn dollars of working capital for companies. The commodity shock that hit resource-rich countries sliced their export revenues reducing further their capacity to finance imports.

This contributed to the 22% fall in African import values from USD 800bn in 2014 to USD 623bn in 2016. Taking into account the new trade picture, our new estimate stands at USD 33.5bn for 2018. This still represents large amounts that could be used to support growth. Decreased imports combined with lower payment terms (64% of imports paid in advance) lead to this result.

As we expect imports to grow at an 8% annual rate, if suppliers were to lengthen their payment term by 30 days, this would free about USD 45bn in 2020. This is a non-negligible opportunity cost for Africa. This huge amount of money wasted each year is a clear argument to develop a domestic capacity to produce the necessary inputs, since imports come with a cost related to low DSOs:

- Oil exporters (Algeria, Nigeria, Angola, Libya…) account for USD 14bn wasted in cash vaults as a result of poor DSOs, with Algeria (5bn, 3% of GDP) at the top of this ranking. Republic of Congo for instance would free up the equivalent of 11% of its GDP (USD 0.9bn) with longer DSOs.
- More DSOs should also be a non-negligible growth factor in fast growing East African economies. In Kenya, it would free USD 1.6bn (2% of GDP), and about the same amount in Ethiopia.
- Potential gains are weaker in value in West Africa (USD 0.4bn in Senegal, 0.7bn in Côte d'Ivoire) but range from 2 to 2.5% of GDP. These gains are weaker in relative terms in countries with the highest income level: South Africa (0.4% of GDP), Morocco (1% of GDP).

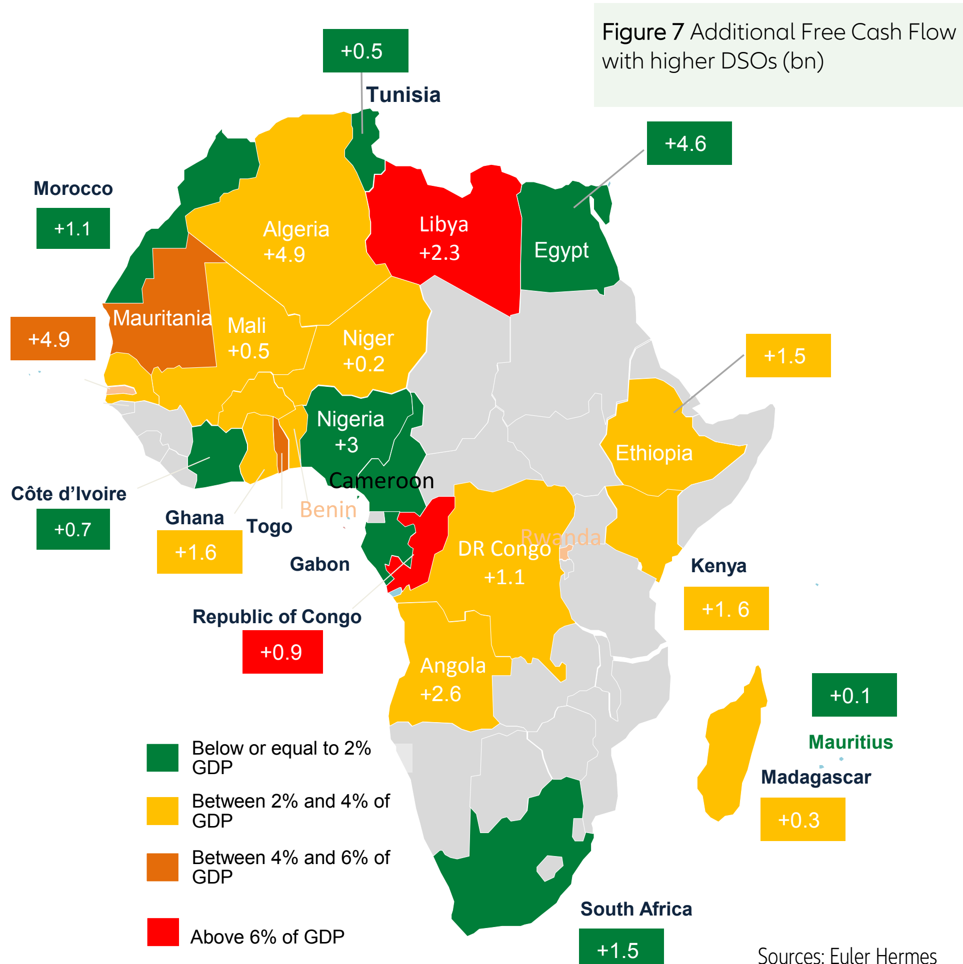


Figure 7 Additional Free Cash Flow with higher DSOs (bn)

Sources: Euler Hermes

Leapfrogging: Make growth more inclusive through mobile banking

Financial depth and financial literacy are among the bottlenecks impeding Africans access to credit, a key inhibiting factor on growth. Southern and North Africa have the most developed banking systems, but less than 30 % of the sub-Saharan (excl. High income countries) adult population has a formal bank account.

Informality is quite present in the region and mobile banking appears to be well suited since it reduces the distance between people and banks to zero, and limits both management costs and administrative requirements. Large penetration rate of mobile phones in Africa is an opportunity to include households and give them access to insurance services.

Following the success of the M-PESA experiment, launched in Kenya in 2007 and led by the operator Safaricom, many new initiatives emerged across the continent. Banks and insurance companies developed new strategies to tap into this huge market.

Ecobank for instance, which covers 36 countries in West, Central, and East Africa, reoriented its strategy through the development of mobile tools created for people without bank accounts. In September 2017, it launched Xpress Cash, which allows users to retrieve cash thanks to a mobile app, without the need for opening a traditional bank account.

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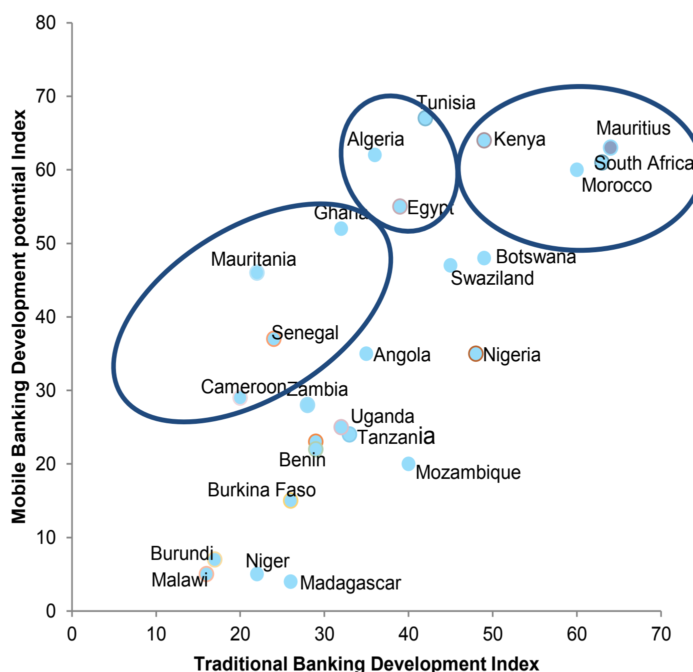
Figure 8 Banking development indices, traditional[1] vs. mobile[2]



Sources: World Bank, GSM Association, Euler Hermès

[1] Traditional Banking development index: the index evaluates the state of traditional banking development in 32 African countries according to 3 dimensions (equally weighted): Penetration (Bank accounts per 1000 adults, Account at a formal financial institution (% age 15+), ATMs per 100000 adults), Depth (Bank deposits to GDP, Liquid liabilities to GDP, Domestic credit to private sector) and Competition (Lerner Index, Boone indicator). The data used are taken from the World Bank Global Financial Development database.

[2] Mobile Banking Development potential index: the index tries to capture the development potential of mobile banking in 36 African countries according to 3 dimensions (equally weighted): Infrastructure (Access to Electricity) Mobile banking current popularity (Mobile phone used to pay bill, Mobile phone used to send money (% age 15 +), Mobile penetration rate. The data used are taken from the World Bank database for the first two dimensions and the GSM Association reports for the third (The Mobile Economy Sub-Saharan Africa 2017 and 2016).

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