



**FINANCING
AFRICA'S
GROWTH:**

THE ROLE OF DEVELOPMENT FINANCE



What financial tools do African countries have at their disposal to finance, say, infrastructure projects, small business expansion or household assets? **Prof Charles Adjasi**, associate professor and head: Development Finance Programmes at the University of Stellenbosch Business School, explores the role of development finance in supporting Africa's growth.

Too many gaps, too little money

A critical challenge facing African countries is that of closing substantial development gaps such as financial exclusion and financial constraints. For example, more than 50% of individuals in Africa have no access to formal financial institutions. Only about 30% of small and medium-scale enterprises, which form close to 90% of firm tissue in these countries, have access to credit from banks. In addition, there are gaps in educational attainment, access to healthcare and infrastructural gaps in transportation, energy and water resources.

According to Africa Infrastructure Country Diagnostic (AICD) estimates, Africa's total infrastructure financing needs amounted to \$93 billion a year in 2008, with only \$45 billion financed. It is obvious that colossal financial resources are needed to finance developments to close these gaps. Traditionally, African governments have budget constraints which make them unable to finance such developments out of government purses. Private financial institutions are typically underdeveloped or they are not structured to finance such developments. These institutions have used traditional methods of pricing financial interventions based on perceived or real risk, which have resulted in them primarily catering narrowly for the needs of the small corporate sector and the few privileged rich individuals. Consequently, it is not surprising that there is substantial poverty of close

to 60% and high inequality in Africa even though some gains have been made in poverty reduction.

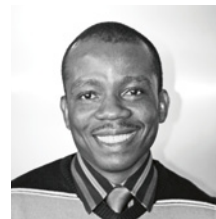
Enter development finance

It is clear that new financing plans and strategies are needed. Here, development finance offers a promising way. Development finance relates to a wide range of financing mechanisms that target environments in which the public sector has limited financing resources and in which private financial markets fail due to risks or high costs.

The first critical element of development finance is the provision of capital to individuals, firms and projects that fail to attract funding for reasons such as poor and underdeveloped financial markets, transaction costs, information asymmetry and risk. The second critical element of development finance is the provision of inclusive financial services – such as credit, insurance, saving and payment services – to the poor. The attractiveness of development finance lies in its ability to innovatively reduce or cover transactions costs, risk and information asymmetry, and to mobilise and pool large financial resources in a less costly manner while financing SMEs, infrastructure, social development and inclusive finance.

Development finance interventions can be structured in various ways. For instance, government can work with private financial

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institutions to reduce market imperfections by creating alternative institutions and programmes to directly supply capital to those markets, projects and firms that private institutions cannot serve. Development can also be financed by private institutions or by Development Finance Institutions (DFIs).

Specific development finance modes of intervention include microfinance, project finance, mobile banking, FDIs, agricultural value chain finance and structured trade finance. Each mode of intervention is unique and addresses specific developmental goals. I will highlight two examples, namely microfinance banking and project finance.

Growth through microfinance banking

Microfinance (microcredit, microinsurance and microsavings), made popular by the Nobel laureate Mohammed Yunus, offers huge promise in terms of financing the poor as well as SMEs. A typical reason for failure to finance the poor or micro enterprises is the perceived non-creditworthiness of such individuals or SMEs. Contrary to this, the poor are creditworthy. It is through the ability to reduce the information problems and risk through properly designed financial covenants that one can finance the poor. For instance, joint liability within a group of borrowers has helped to minimise information problems and risk through peer monitoring, and this has resulted in successful microcredit schemes with very high repayment rates globally.

Microfinance can help poor households optimise severely constrained resources across their lifetime. For instance, by insuring households against future welfare losses, microinsurance helps to reduce asset loss, vulnerability and poverty. The indemnity enjoyed by the insured prevents the liquidation of essential assets at below market prices. This facilitates the financial stability of households and the steady build-up of essential assets by families. The long-term effects are sustained poverty reduction and reduction in asset inequality among low-income households.

Innovative banking technologies such

as mobile banking have grown extensively within the microfinance banking industry and have gained ascendancy from the success story of MPESA and recently MSHWARI pioneered by Commercial Bank of Africa and Safaricom in Kenya. Unique products have also proliferated in Brazil, Columbia, Bangladesh and India.

Mobile and agency banking has reduced the transaction costs of the traditional “brick and mortar” approach to banking by employing simple but powerful GPS, POS and other technological devices to extend and deepen banking services primarily to serve SMEs which previously had no access to banking. Equity Bank in Kenya, for example, runs over 6 000 branch outlets while a bank in Columbia has 700 branches and 900 correspondent outlets through mobile money. In Africa, microfinance clearly has the potential to address the problems of access to finance by individuals and SMEs.

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An added advantage is that this intervention could shape and rapidly expand the poor and underdeveloped financial markets on the continent, thereby improving financial markets. Microfinance also offers the promise to enable households to finance their educational and health expenditures through microsavings and microinsurance.

Using project finance to make progress

Project finance has the ability to raise funds to finance most if not all infrastructural projects. Major challenges in financing infrastructural developments in Africa include fiscal pressure by governments, underdeveloped financial markets and perceived risk and high transaction costs in typical straight debt or aid financing of such projects.

Yet, project finance by design obviates

most of these problems. For instance, project finance can raise large financial resources which are difficult to raise in poor and undeveloped financial markets. It can allocate capital effectively to finance infrastructure projects such as energy, transport and water.

Project finance also helps to reduce transactions costs from information asymmetry and risk. Indeed, the design of project financing is based on effectively dealing with risk. It is flexible in this regard as specific project finance modes, like public-private partnerships, deal with effective pricing and risk sharing across the private and public partners. If most African governments pay attention to this intervention, a significant amount can be achieved by way of financing energy and transport infrastructure projects.

Development finance as a way forward

To conclude, the benefits of just two development finance interventions, namely microfinance and project finance, show massive potential if such interventions are harnessed and cultivated well. Unfortunately, not much has been done in most African countries.

Between 2003 and 2013, the World Bank reports that only 158 project finance deals valued at \$59 billion (representing a mere 3% of the 5 000 deals globally valued at \$2 trillion) have been closed in sub-Saharan Africa. On the microfinance side, though there are a number of microfinance institutions in Africa, these mostly operate in a vacuum with no proper institutional, legal or regulatory support.

While some banks have ventured into microfinance not many of them have been successful due to the poor understanding of the design of microfinance. Training in this area is also limited.

It is time that governments and private financial institutions in Africa realise the potential of development finance and upscale the deployment of development finance as a tool to finance growth and socioeconomic development. ^a

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