MINISTÈRE DE L'ÉCONOMIE, DES FINANCES ET DE LA RELANCE
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Tresor-Economics

No. 278 • March 2021

Direction générale du Trésor

Development finance in Sub-Saharan Africa in the time of Covid-19

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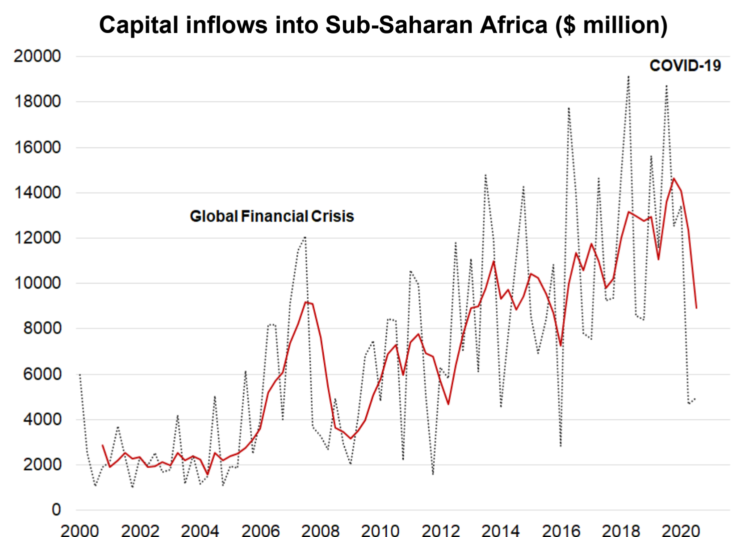
- Meeting the 2030 Sustainable Development Goals requires a significant scale-up in development finance, particularly in Sub-Saharan Africa (SSA). The COVID-19 global health crisis has made this even more difficult since it triggered unprecedented capital outflows from emerging markets and developing economies (EMDE), including in Africa where it amounted to $95bn in March. The pandemic has further amplified concerns about fiscal and debt sustainability in SSA, and some heavily indebted countries are experiencing financial difficulties. The International Monetary Fund (IMF) estimates that Sub-Saharan Africa could face a financing gap of $290bn between 2020 and 2023 (i.e. 16% of SSA's GDP in 2019).
- Financing the long-term recovery in the wake of COVID-19 and re-launching countries on a path towards sustainable and inclusive growth requires significant efforts. These include: domestic reforms to enhance sustainable growth and domestic revenue mobilisation; attracting and crowding-in the private capital flows; and stepping up official financial flows.
- The global pandemic however also offers some important lessons for development finance, particularly as regards to new technologies and financial innovation. During the crisis, countries with digital, contact-less processes and procedures have fared better in terms of tax collection and business continuity; a move to accelerate digital transformation in tax administration would thus help mobilise domestic revenue more generally.
- The demand for COVID-19 bonds, issued by multilateral development banks to raise funds for vulnerable health systems and critical infrastructure, underscores the growing importance of a socially conscious, impact-oriented investor base which could be leveraged post crisis to finance the SDGs. With the right governance framework, private equity, pension and sovereign wealth funds could play a greater role in financing development.

Capital inflows into Sub-Saharan Africa ($ million)



Source: World Bank, Dealogic, Loanware and Bondware; French Treasury calculations.
Note: International bond issuance and cross-border syndicated Lending in Sub-Saharan Africa, 2000Q1-2020Q3 ($ million), 4-quarter moving average (red line).

1. Impact of COVID-19 pandemic on private capital flows in Sub-Saharan Africa

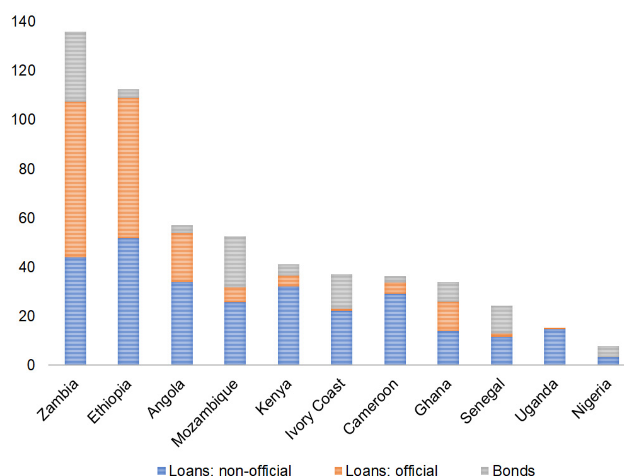
1.1 Macroeconomic context

Despite milder outcomes in terms of reported COVID-19 infections and mortality rates than other regions, most SSA countries experienced a sharp decline in economic growth in 2020 under the combined effects of lockdowns on economic activity and fall-offs in commodity prices, tourism, and remittances. According to the World Bank,[1] economic activity is set to decline by 3.7 percent in 2020 and to only gradually recover in 2021 (+2.7%, equal to population growth). After South Asia, SSA is expected to be the second most affected region in terms of poverty, with about 34 million more poor people due to COVID-19.[2]

Increases in fiscal deficits and debt levels, which were already unsustainably high pre-COVID-19 in several countries, have significantly raised the risk of debt distress and prompted record sovereign downgrades and a sharp increase in bond spreads.[3] With greater spending and borrowing needs, and a sharp drop in revenue, the government debt-to-revenue ratio of African countries that are eligible for the G20/Paris Club Debt Service Suspension Initiative (DSSI) is expected to increase from about 360 percent in 2019 to 480 percent in 2020.[4]

International Financial Institutions (IFIs), including the IMF and the World Bank, have significantly stepped up financing as government revenues and economic activity have collapsed. The International Development Association (IDA) and the Bank for Reconstruction and Development (IBRD) spent $59bn in 2020, more than during the 2019 financial crisis year.[5] External financing needs, however, remain large and the IMF estimates that Sub-Saharan Africa could face a financing gap of $290bn between 2020 and 2023,[6] i.e. the amount of financing that exceeds projected capital inflows from private investors, international financial institutions and bilateral donors (Chart 1). Large-scale liquidity support from central banks in advanced economies has stabilised financial markets since May 2020, and recent breakthroughs in effective COVID-19 vaccines have fueled investor optimism in November, prompting strong increases in equity and oil prices.

Chart 1: Financing needs from July 2020 to December 2021 (share of foreign reserves, percent)



Source: Bloomberg Finance L.P., French Treasury calculations.
Note: Official flows include bilateral and multilateral loans.

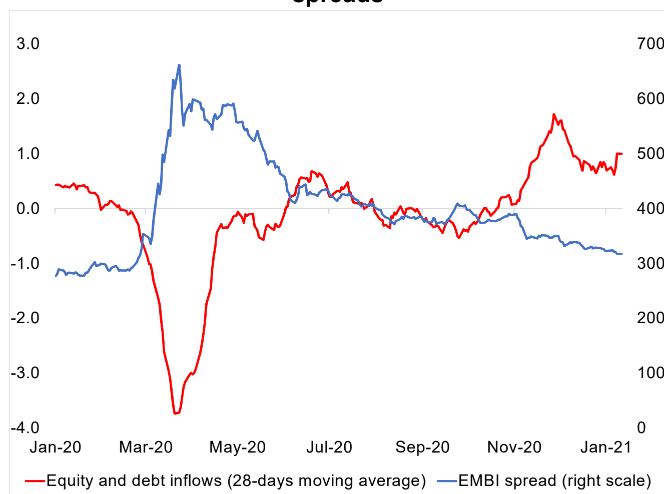
1.2 Impact on Capital Flows[7]

The COVID-19 outbreak triggered unprecedented capital outflows from emerging markets and developing economies (EMDEs). According to the Institute of International Finance (IIF), non-resident portfolio outflows from EMDEs amounted to $95bn in March alone – more than double the outflows recorded at the peak of the global financial crisis in 2008 (see font page

(1) Global Economic Prospects, World Bank, January 2021.
(2) World Bank (2020a) simulations shows that of the 124 million of people worldwide expected to be pushed into poverty by covid, almost half are expected to be in Sub-Saharan Africa; this is explained by the anticipated high impact on economic activity and the large number of people that are already living close to the international poverty line, defind as less than 1.9 dollar per day. Source: Lakner *et al.* (2020): Updated estimates of the impact of COVID-19 on global poverty: Looking back at 2020 and the outlook for 2021, World Bank, January 2021.
(3) Fitch Ratings (2020), "Sub-Saharan Africa Sovereign Credit Overview: 3Q20", Special Report. October 27, 2020. Available at https://www.fitchratings.com/research/sovereigns/sub-saharan-africa-sovereign-credit-overview-3q20-27-10-2020
(4) IIF Market Snapshot, All Eyes on Africa's External Financing Needs, IIF, November 5, 2020.
(5) World Bank COVID-19 Response, World Bank, October 14, 2020.
(6) Abebe Aemro Selassie (2020), "Sub-Saharan Africa's Difficult Road to Recovery", IMF blogs, October 22, 2020.
(7) Since official balance of payments data for 2020 were not available at the time of publication, the analysis of capital flows during the COVID 19 pandemic had to rely on daily real-time portfolio flow data (IIF) and quarterly data on international bond issues and cross-border syndicated loans (Loanware and Bondware). These data are subject to certain caveats. First, equity portfolio flows account for less than 20 percent of total capital flows to EMDEs. In addition, IIF data cover only a limited number of countries, and in the case of Sub-Saharan Africa, South Africa is the only country included. Debt issuance data cover a wider range of countries, but also represent only a subset of total capital flows.

Chart). Portfolio equity flows have also bounced back in EMDEs (Chart 2), but volatility is likely to remain high until the global pandemic is fully contained.

Chart 2: Daily net capital inflows and emerging markets spreads

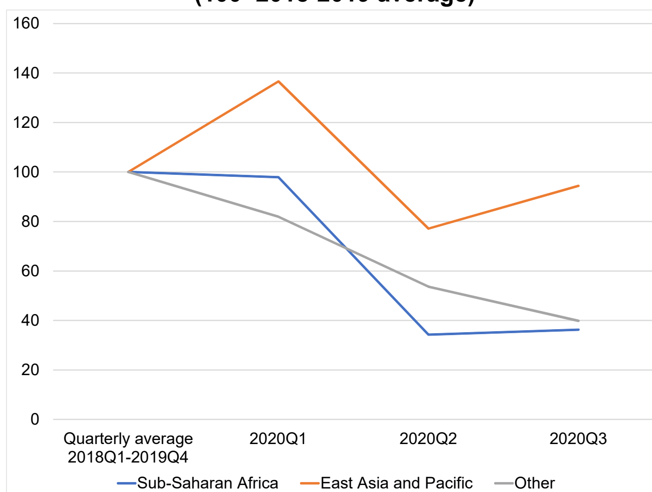


Source: Institute of International Finance.
Note: Flows combine equity and debt investments in developing countries ($bn, net purchases). Spreads are based on the JP Morgan Emerging Market Bond (EMBI) Index, basis points).

Bond issuance and cross-border syndicated lending have also dropped in Sub-Saharan African as in most regions, with the exception of East Asia, and China in particular (Chart 3).

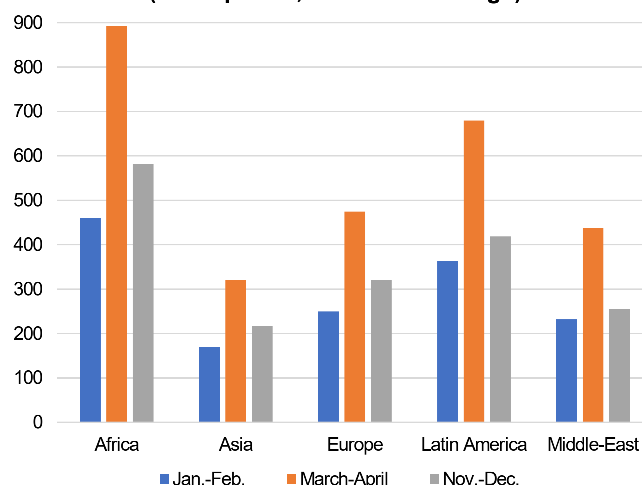
With the sudden stop in capital flows in March, borrowing costs in Emerging Markets increased sharply and average bond spreads in SSA reached about 670 bps in March, compared to below 300 bps in early 2020 (Chart 2). Bond spreads have since broadly recovered their pre-pandemic levels. Sub-Saharan Africa bond spreads reached a peak in March at 1,100 bps and remain about 100 bps above 2020 Q1 levels (Chart 4). Oil-exporters and lower-rated countries experienced the sharpest increase in borrowing costs.

Chart 3: Accumulated international bond Issuance and cross-border syndicated lending by region, 2018-2020 (100=2018-2019 average)



Source: Bloomberg Finance L.P., French Treasury calculations.
Note: Other: Latin America and Caribbean, Europe and Central Asia, Middle East and North Africa, South Asia.

Chart 4: EMBI bond spreads by EMDE region in 2020 (basis points, 2-months average)



Source: Bloomberg Finance L.P., French Treasury calculations.
Note: The chart illustrates the EMBI spread (JP Morgan Emerging Market Bond Index). The EMBI index for SSA covers 11 Sub-Saharan countries with have a share of about 63% of regional GDP.

Concerns about fiscal and debt sustainability in SSA have both restricted foreign capital inflows and raised borrowing costs to the region during the pandemic.

2. Long-term development finance in a post COVID-19 era

Long-term development financing in the wake of COVID-19 as well as near-term stimulus funding in EMDEs require significant efforts on several fronts, ranging from (i) domestic reforms to enhance sustainable growth and domestic revenue mobilisation; (ii) attracting and crowding-in private capital flows and (iii) stepping up official financial flows.

2.1 What can emerging and developing countries do to increase development finance?

Promote Domestic Revenue Mobilisation. In the light of decline role of overseas development assistance (ODA)[8] as a source of finance, domestic revenue mobilisation will have to become a critical source for domestic development financing. Tax policy and tax administration reforms will be critical for extending the tax base, increasing taxpayer compliance and rationalising tax exemptions. Resource-rich countries will also stand to gain from strengthening the governance and transparency of natural resource revenues. The use of new technologies (e.g., e-filing, payments through mobile phones or use of satellite technology for property taxation) can be effective tools to support these objectives; during the COVID-19 pandemic, countries with digital, contact-less processes and procedures have reportedly fared better in terms of tax collection and business continuity.[9]

Improve the business environment for local and foreign investors by increasing social and private returns to economic activity. Weak institutions, infrastructure gaps, low human capital, macro-economic instability and insufficient access to finance often explain low returns to private investment and lack of appropriability of private returns. Comprehensive reforms to the overall business environment are needed to promote economic activity and attract domestic and foreign investors; this is confirmed in many studies that show a clear link between institutional quality and FDI in non-primary sectors (Ali *et al.*, 2011).[10] Cross-cutting reforms on digitalisation can also help improve governance, public service delivery, and financial inclusion (Machasio, 2020).[11]

2.2 What can the multilateral and the international donor community do?

Support upstream sector reforms to the business climate and de-risking. MDBs could more effectively combine donor- and market-funded resources to arrive at pricing packages for concessional borrowers in a way that stretches donor resources more efficiently. In this context, building on the World Bank Group's Forward Look (WBG, 2016),[12] would seem relevant as it seeks to prioritise private finance over public finance through the cascade principle. This implies that official and public resources should only be applied when *market solutions* cannot be achieved through upstream sector reform and/or de-risking. A harmonised approach to applying the cascade principles across the international donor community and innovations in de-risking, through guarantees and other risk-sharing instruments, could help crowd-in further private sector investment.

Leveraging the balance sheets of MDBs, export credit agencies and Sovereign Wealth Funds. Exposure exchange agreements (EEA)[13] between MDBs, first developed in 2015 and endorsed by the G20 Ministers of Finance in their paper "Optimizing MDB Balance Sheets", represents an important innovation in risk management as they substantially improve the collective financial capacity and development

(8) Despite increasing in nominal terms, total ODA as a share of developing countries' GDP has been declining since the 1960s. The relative weight of foreign aid in development finance has such been declining on a global scale. According to the OECD, France's gross ODA volume has grown constantly since 2014 and on a grant-equivalence basis reached 0.44% of gross national income (GNI) in 2019. France's new development law foresees a gradual increase in ODA spending to 0.55% as a share of GNI by 2022.
Sources: https://www.brookings.edu/blog/future-development/2018/01/19/the-end-of-aid/ ; OECD-DAC.

(9) The rapid digitalization of African economies presents a challenge and opportunity for tax systems; tax systems will have to adapt to protect and/or even extend their tax bases.

(10) Ali F., Fiess N. and R. MacDonald (2011), "Climbing to the top: FDI and property rights", *Economic Inquiry*, 49, 1, 289-302.

(11) Machasio, I. N. (2020), "COVID-19 and Digital Financial Inclusion in Africa: How to Leverage Digital Technologies During the Pandemic." Africa Knowledge in Time Policy Brief; World Bank, Washington, DC.

(12) WBG (2016) Forward look: a vision for the World Bank Group in 2030. Washington, DC: World Bank Group (http://pubdocs.worldbank.org/en/545241485963738230/DC2016-0008.pdf)

(13) The exposure exchange agreement is a risk management tool. Exchanging exposures between MDBs greatly enhances their flexibility and efficiency in capital management. By diversifying over a larger and geographically less concentrated group of sovereign borrowers, regional MDBs, in particular, can reduce their concentration risk and this freed-up risk capital can be used for additional lending.

effectiveness of the MDB community. The first three MDB EEAs signed between African Development Bank (AfDB), the Interamerican Development Bank, and the World Bank (IBRD) provided the potential to increase financial support towards achieving the 2030 SDGs by between US$15 and US$20bn (Belhaj *et al.*, 2017).[14] There is scope for additional exposure exchange agreements between MDBs, one upcoming EEA has just been announced between the Asian Development Bank (ADB) and IaDB.[15] Future EEAs could further explore the exchange of non-sovereign exposure and expanding exposure exchanges to Export Credit Agencies or Sovereign Wealth Funds, which also hold significant amounts of sovereign exposure.

Box 1: The Debt Service Suspension Initiative (DSSI) and implications for development financing post-covid

To alleviate pandemic related liquidity needs, the G20 and the Paris Club granted a debt service suspension to the world's 73 most vulnerable countries on 1 May 2020. While the initiative was initially until end-2020, it recently has been extended until June 30, 2021 and a further 6-month extension may be considered. So far 46 countries have requested the DSSI from the G20 and the Paris Club, which is estimated to provide about $5.7bn of 2020 debt service deferral. The IIF estimates that private-sector creditor participation in the DSSI could free up at least an additional $13bn. While some DSSI-eligible countries expressed concerns about adverse ratings impact and market access, rating agencies have since clarified that the implementation of the DSSI by official bilateral creditors will not negatively impact the rating or access to markets of eligible countries. The initiative however, does, not mandate the participation of private sector creditors (which would have had a negative ratings impact for beneficiary countries), and the G20 and the Paris Club have only called for their voluntary participation; to date, there has been no private sector participation in the DSSI. Multilateral development banks have decided not to suspend debt service and have committed instead to providing net positive flows to DSSI-eligible countries.

Although the ISSD is an important tool for improving the fiscal space of vulnerable countries, it is foremost a liquidity tool and does not address the situation of countries with debt sustainability concerns. The G20 and the Paris Club adopted on November 13 a common framework for countries with unsustainable debt levels.

2.3 What can private investors do?

Leveraging local institutional investors, such as pension funds, for long-term investment. Before the COVID-19 pandemic, local pension sectors had been growing rapidly across the African region since the late 2000s. Faced with limited fiscal space, some African governments turned to pension funds and other asset managers for fiscal support during the crisis, asking for temporary reductions in yields on holdings of government securities (Ghana, Kenya) or seeking to leverage pension assets to combat the COVID crisis (e.g., Ghana's Corona Alleviation Program) (Irving, 2020).

While creative solutions may be needed to raise financing for the COVID-19 response in the short-term, it is critical that the long-term sustainability of institutional investors is not compromised. Assets under management in SSA are currently low compared to other regions, but African pension funds and other institutional investors could take on a greater role in development financing in the future; particularly if measures are taken now to increase the levels of domestic savings and to extend participation beyond the formal sector.[16] Long-term investment opportunities are currently limited by under-developed, illiquid local capital markets, while the lack of alternative investment opportunities and restrictive regulatory limits contribute to a high concentration of African pension fund assets is in short-term government securities, time deposits, and cash. As a result, the share of assets under

(14) Belhaj R., Baroudi M., Fiess N., Campino J., Sperling F. and T. Turner (2017), "Exposure exchange agreements among multilateral development banks for sovereign exposures: an innovative risk management tool", *Journal of Risk Management in Financial Institutions*, 10.

(15) https://www.adb.org/news/adb-approves-policy-framework-exposure-exchanges-multilateral-development-banks

(16) On average, 15 percent of the working population is covered by pension schemes in African countries (compared to 51 percent in middle-income countries). Source: Irving, J. (2020), "How the COVID-19 crisis is impacting African pension fund approaches to portfolio management", *International Finance Corporation*, October 6, 2020.

management held in local domestic securities is well below regulatory limits.[17]

Greater geographic integration of African institutional investors, through cross-listings and cross-border investments, would further allow firms and governments to tap a larger investor base to finance infrastructure and other long-term financing needs. Efforts to deepen regional financial integration however, need to be proceeded by adequate progress in developing domestic financial markets, (Irving, 2020.)

Within the proper governance framework, domestic Sovereign Wealth Funds (SWF) could also play a greater role in channeling investment into the national economy to stimulate economic diversification, innovation and structural change.[18] To maximise benefits and mitigate risks from such SWF investment, Gelb *et al.* (2014) suggest that SWFs should pool funds with other SWFs or co-finance with private investors and IFIs; confining SWF investments to minority stakes would reduce risk, bring in additional expertise and enhancing the credibility of investment decisions.[19]

Tapping Private Equity investors. Private Equity Fund (PE Fund) investments play an increasing role in supporting private sector development in Emerging Markets (EMs).[20] While the industry has been hit hard by the reduction in activity and growth prospects of their portfolio companies,[21] PE has a place in post-COVID-19 development financing.[22] According to International Finance Corporation (IFC), the PE business model is well equipped to help companies respond to crises and to support the rebuilding of sectors by closing funding gaps and leveraging their strategic and operational know-how. The IFC considers PE Funds to be well positioned to benefit from significant shifts in production and investor patterns that are expected to emerge post-COVID-19 (so-called mega trends mentioned by the IFC).

These include (i) a re-orientation of global supply chains towards greater localisation of strategic sectors and the diversification of the supply base for products with complex value chains; (ii) an acceleration in digital transformation (increased digital adoption by businesses, uptake of digital platforms and innovative digital business models, rise in the digital urban consumer); and (iii) an increased appetite for impact-oriented investments which are defined as investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return[23] (with a focus on businesses related to COVID-19 response; economic and environmental resilience; and supporting SDGs).

Social Bonds and Diaspora investors: building a community of dedicated, impact-oriented investors. With the publication of the Social Bond Principles by the International Capital Market Association (ICMA) in 2017, social bonds have been growing as a fixed-income product and their popularity has accelerated with the COVID-19 pandemic. The African Development Bank (AfDB) and the Inter-American Development Bank (IaDB have issued multiple COVID-19 bonds in recent months to raise funds for vulnerable health systems and critical infrastructure in developing countries.[24] Post-crisis, socially conscious, impact-oriented investors could be targeted more directly to leverage financing for the SDG more broadly.

Diaspora bonds, which are targeted towards migrants and their descendants, could also play a greater role in development finance, particularly in times of restricted market access.[25] Diaspora bonds are sold in small denominations, which allow issuers to tap into the

(17) This compares to a weighted average of about 40% of the share of equities in total pension fund investments in OECD countries. Source: OECD (2011), "Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries." OECD Editions, Paris. Available at https://doi.org/10.1787/pension_glance-2011-en.

(18) Weiss, Miriam and Clara, Michele (2016), "Unlocking domestic investment for industrial development." *Inclusive and Sustainable Industrial Development Working paper series*, *Working Paper* 12/2016, UNIDO

(19) Gelb, A. *et al.* (2014), "Sovereign Wealth Funds and Long-Term Development Finance Risks and Opportunities". *World Bank Working Paper*, 6776.

(20) Compared to developed markets, the scale of PE in EMDEs remains limited, and is mostly concentrated in Asia. Only 23 percent of PE global fundraising went to EMs in 2018. Prior to the COVID-19 pandemic, investment and fundraising of PE funds in Africa accounted for only 4% of total PE fund activity in EMDEs, respectively. Source: Strusani D., Verma P. and G. Manenti (2020), "Impact of the COVID-19 Crisis on Private Equity Funds in Emerging Markets", International Finance Corporation, August 24, 2020.

(21) In July, 88% of investors based in the Middle East & Africa region expected a 50% drop in the PE activity during the second half of 2020. Source: Skornas, E. and L. Whitmore (2020), PE Mid-Year Survey, S&P Global Market Intelligence.

(22) See also African Private Equity and Venture Capital Association and Oxford Business Group (2020), Covid-19 Response Report.

(23) According to the Global Impact Investing Network (GIIN).

(24) With a $3bn social bond issue, the AfDB launched the largest "social bond" on the international capital markets in March 2020. Source: Peeters, Schmitt, and Volk (2020), "Social Bonds Can Help Mitigate the Economic and Social Effects of the COVID-19 Crisis", Note 89. International Finance Corporation, August 28, 2020.

wealth of relatively poor migrants, and at lower yields, as diaspora investors are amenable to "patriotic discounts". The attractiveness of diaspora bonds can further be enhanced through tax breaks and other types of credit enhancement. According to Ratha (2020), diaspora bonds could generate about $50bn per year in development financing.[26] Beyond diaspora bonds, there are other investment vehicles that could be used more widely to mobilise diasporas to invest in their country of origin, these include deposit accounts, the securitisation of remittance flows, and mutual funds.[27]

Facilitating remittances flows. Due to the global health crisis, remittance flows to low- and middle-income countries are expected to decrease by 7 percent in 2020 (at $508bn) and by 7.5 percent in 2021 (at $470bn), according to the World Bank.[28] Uganda, Nigeria and Mozambique have been most affected in SSA to date, experiencing a more than 30 percent decline in 2020 Q1 compared to the same quarter the previous year. Sub-Saharan Africa continues to have the highest transaction cost for remittances, averaging about 8.5 percent.[29] Greater competition and increased transparency in international money transfer markets, e.g., through tools that allow for direct comparison of agents' fee structures, would help lower remittances costs.[30] The record drop in remittance flows during COVID-19 calls for more efficient facilitation of these private-to-private transfers which in many African countries account for well over 10 percent of GDP; implementing the G20 roadmap to enhancing cross-border payments will be critical in this regard.[31]

(25) Ratha and S. Ketkar (2010), "Diaspora Bonds: Tapping the Diaspora During Difficult Times", *Journal of International Commerce, Economics and Policy* (JICEP), October 2010.
(26) Ratha, D. (2020), Pandemic could fuel demand for 'diaspora bonds', Reuters.
(27) Terrazas, Aaron (2010), "Diaspora Investment in Developing and Emerging Country Capital Markets: Patterns and Prospects", *Migration Policy Institute*, August 2010.
(28) COVID-19: Remittance Flows to Shrink 14% by 2021, World Bank, October 2020.
(29) Migration and Development Brief 33, Phase II: COVID-19 Crisis Through a Migration Lens, World Bank and KNOMAD, October 2020.
(30) Measures introduced by the UK Department for International Development (DFID) to increase transparency and competition for transfers have helped to reduce costs of money transfers considerably from the UK to Ghana, Kenya, Nigeria and particularly in India with a 20% drop 2005 and 2008. Source: Rocher, Emmanuel and Pelletier, Adeline (2008), "Migrant workers' remittances: what is the impact on the economic and financial development of Sub-Saharan African countries?" Quarterly Selection of Articles No. 13, Banque de France, Autumn 2008.
(31) The G20 has made enhancing cross-border payments a priority during the Saudi Arabian Presidency. Faster, cheaper, more transparent and more inclusive cross-border payment services, including remittances, while maintaining their safety and security, would have widespread benefits for citizens and economies worldwide, supporting economic growth, international trade, global development and financial inclusion.

Publisher:
Ministère de l'Économie, des Finances, et de la Relance
Direction générale du Trésor
139, rue de Bercy
75575 Paris CEDEX 12

Publication manager:
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English translation:
Centre de traduction des ministères économique et financier

Layout:
Maryse Dos Santos
ISSN 1962-400X
eISSN 2417-9698

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