AGCI COMPONENT 3 – KSA BRIEF – December 2007

INCREASE ACCESS TO FINANCIAL SERVICES FOR TRADE AND INVESTMENT

The target of this African Global Competitiveness Initiative (AGCI) component is to expand private sector access to finance by one percent of GDP in target countries, and reduce the intermediation margin.

DEVELOPMENT CHALLENGE

Access to financial services in Africa is impaired by deficiencies in the enabling environment. These deficiencies include a lack of reliable financial data, lack of minimally adequate legal support for contract enforcement and collateral recovery, a lack of information on credit histories, and impediments to doing business that undermine the ability of real sector borrowers to be competitive. These structural deficiencies make lending to all but the soundest borrowers unwise, leaving the banking systems liquid and unwilling to mobilize additional financial resources. This lack of credit-worthy clients has been compounded by government borrowings at high interest rates to compensate for inadequate fiscal revenues, which have provided the banking system with a convenient least risk alternative to lending.

This lack of access to finance to a broader base prevents leveraging of productive resources, impairs income generation capacity, and reduces the benefit of being part of the formal economy, all of which discourages growth. The lack of a growing formal sector impairs the tax base and perpetuates under-funding of government services and reliance on borrowing from high-cost domestic and international financial institutions to fund budget deficits.

African governments have inherited a control system based on permits, licenses, and other bureaucratic procedures. Whereas the countries

AGCI IMPLEMENTATION

AGCI's financial sector objectives will be achieved using the most effective instruments available for implementing the market reforms envisaged and stimulating a market response. This includes, but is not limited to:

1. Using existing or new USAID agreements with contractors with proven track records of successful financial sector project implementation;
2. Drawing on USAID and other United States Government (USG) staff and technical expertise, where appropriate;
3. Cooperating with other bi- and multilateral agencies to leverage impact, including within the framework of G8 (Group of Eight) collaboration and the Partnership for Making Finance Work for Africa; and
4. Stimulating accelerated market response through use of USAID's Development Credit Authority and/or OPIC (Overseas Private Investment Corp.) programs to lessen market entry risks for new financial products or services that expand access to finance.

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where these procedures originated have moved toward simplifying the administrative burden and making it easier to do business, African countries have in general moved in the other direction, adding complexity, cost, and delays. The results are demonstrated in the *Doing Business* analysis performed by the World Bank and International Finance Corporation (IFC), and more directly by the poor economic performance of these countries.

Foreign banks–typically from South Africa and from countries with past colonial ties–cream off the best business and serve as a safe haven for depositors whenever there is domestic instability. This impairs the market for locally based financial institutions, both by depriving them of the best lending opportunities and by making their funding more expensive. Yet sound locally based financial institutions can provide competition that can restrain pricing on financial services to the small and medium enterprises that form the backbone of most countries' economies, and can help lessen dependence on foreign-controlled financial institutions.

Many countries tried resolving this two-tier market by nationalizing the foreign banks. This resulted in mismanagement and misallocation of resources for political purposes, while depriving the countries of the expertise available from foreign banks. Support for development of the real sector actually declined. This nationalized option has been tried and failed.

A key impediment to expanding access to finance has been the inability of potential borrowers to use land as a source of collateral to lower the lending risk. This is the result of problems in the land titling and registry scenario as well as traditional land ownership customs that do not readily accommodate modern practices.

A further key impediment is the inability to identify borrowers with reasonable certainty due to the lack of a national ID system and low levels of registration of enterprises. These issues, while critical to expanding access to finance, are outside of the scope of financial sector work.

The challenge, then, is to lower market risks to financial intermediation so that prudently managed financial intermediaries will find that the risks of expanding access to finance are acceptable in light of their obligation to protect depositor funds, and that expanding their engagement with the small and medium enterprise (SME) market is a financially viable use of their resources.

DEVELOPMENT HYPOTHESIS AND PROPOSED PROGRAM

Each country in Africa has a core of banking expertise that fully understands the local market and what makes viable business sense, given the current lending environment. This expertise can be expanded and deepened as needed through contacts with sources of training within and outside of the country whenever the lending environment improves sufficiently to justify the expense of expanding capacity and the range of services offered.

Expanding access to technology is lowering the cost of services and reducing the cost disincentive for new product development as market risks become more manageable. Expanding access to finance generally cannot be done at the level of the lending institution, and most certainly not by causing lenders to abandon prudent credit practices that reflect market-lending risks.

Strengthening access to finance will depend primarily on actions taken by governments to improve the investment climate and lower market risks. Governments can stimulate economic growth by minimizing restraints on business activity while balancing removal of impediments against maintaining rational consumer protection and public confidence in fairness and the rule of law. Governments can also reduce lending institutions' alternate investment opportunities in high-priced government securities through improved fiscal and budgetary management, thus increasing the pressure on lending institutions to lend to the private sector to meet investor goals. In addition, governments can require restructuring and recapitalization of the sector, where that is necessary, in order to improve sector stability and competition.

The Financial Sector Component of the African Global Competitiveness Initiative (AGCI) is focusing

on identifying market risks that governments are willing to address and assisting willing governments to remove or at least minimize them. This requires close collaboration with the other objectives of the AGCI to ensure a holistic approach, since in many ways the financial sector is a reflection of the real sector and will quickly adapt to changes in the lending environment and the available customer base. Assistance is provided in a limited number of countries and focuses only on those changes that will expand lending and investments leading to near-term exports.

The Financial Sector Objective of the AGCI is implementing activities that:

1. Identify the most productive opportunities for lowering market-lending risks to justify expansion of access to finance in combination with select countries.

2. Identify the countries that are most willing to engage in market risk reduction programs in collaboration with regional and bilateral missions that are engaged in the related intergovernmental discussions and know their host countries.

3. Coordinate with other donors to ensure a collaborative, mutually reinforcing approach that maximizes the impact of U.S. Government (USG) involvement. Specifically, the Private Enterprise Partnership (PEP) for Africa, International Development Association (IDA/IFC) SME pilot and International Monetary Fund (IMF) structural programs have addressed financial sectors across the region.

4. Design and implement individual programs that achieve measurable results, within the context of fostering regional harmonization on best international practices, and that leverage expertise where the USG has a comparative advantage.

5. Promote liberalization of trade in financial services in order to stimulate foreign investment, which will increase competition, accelerate transfer of banking technologies and best practices, and increase liquidity.

6. Integrate the use of information communications and technology (ICT) applications where analysis shows they will provide a net increase in results, sharing applications across the region where practical to increase harmonization and reduce up-front and on-going costs.

Expanding access to finance will address the AGCI objective of improving stakeholder competitiveness, both in domestic and world markets, which will increase the country's ability to successfully expand its trade capacity.

The selection process for receiving technical assistance includes gaps in existing donor programs and the country's level of commitment to achieving the objectives identified as part of the financial sector objective of AGCI.

SUSTAINABILITY OF IMPACT

The number of countries and individual activities under the financial sector component of the AGCI are focused so that sufficient resources are applied in each case to ensure that a sustainable level of improvement occurs in the enabling environment for access to finance and economic efficiency. Activities are closely coordinated with other objectives of the AGCI effort to promote leveraging and complementarity with other donors' engagements.

As the financial sector work focuses on assisting local stakeholders to implement financial sector strengthening and does not include any disbursements of cash, opportunities for diversion of funding can be tightly controlled.

Some countries lack stable and rational foreign exchange and domestic interest rate policies to diminish market uncertainties, complexities, and seasonal swings. By lowering market volatility and uncertainty, lending institutions will be more willing to lower market-based (as opposed to borrower-based) risk premiums, so lowering lending rates, and increase acceptability of higher maturity transformation levels, leading to greater access to longer term finance. However, assistance in these areas would be beyond the scope of this initiative.❖