

# African Financial Sectors and the European Debt Crisis:

## Will Trouble Blow across the Sahara?

Financial Sector Policy Note

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WORLD BANK

AFRICA FINANCIAL AND PRIVATE SECTOR DEVELOPMENT<sup>1</sup>

### Will African financial sectors stay out of harm's way again? – Some key messages

**The exposure of African<sup>2</sup> financial sectors to global risks, including the likely fall-out of the on-going European debt crisis, continues to be limited.** African financial sectors have received much recognition for their steady growth performance and resilience during and after the 2008 global financial crisis. Many of the transmission channels for global risks and financial contagion to financial sectors in Africa are narrow or of limited potential influence. This note analysis the recent performance of African financial sectors, the degree of their exposure to European banking sector risks, the observable impact of a decline in global investor confidence, as well as the link between fiscal and monetary policy and financial sector development. The analysis in this paper focuses primarily on the potential impact of the European debt crisis on the performance of African financial sectors and the credit intermediation channel. The analysis both assesses how a transmission channel affects the stability and solvency of African financial institutions and how it affects the ability of African firms and governments to access funding.

**The impact of the European debt crisis – assuming a crisis scenario characterized by a significant deleveraging of the European banking sector, a reduction in trade with Europe and a significant but still *contained* decline in global investor confidence – will pose some challenges to financial sector development in Africa, but not on a systemic scale.** Under this scenario the overall growth impact of the European debt crisis on African financial sectors will be limited. Effects will be constrained primarily to direct financial transmission channels, while the indirect impact of declining global growth on the earnings and performance of the investment and credit portfolios of African financial institutions will be

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<sup>2</sup> This note focuses exclusively on Sub-Saharan Africa. For the ease of reference, "Africa" will be used synonymously to "Sub-Saharan Africa".

of less relevance. This scenario is in line with the current World Bank Africa region baseline projections of 5.2% growth in 2012 and 5.5% in 2013, and market analyst projections<sup>3</sup>.

**African financial sectors are significantly less exposed to European banking sector risks than other regions.** European banks have a limited presence in Africa. Notable exceptions are Portuguese banks in Angola, Cape Verde and Mozambique, French banks in West Africa and the subsidiaries of internationally operating banks in South Africa, but these subsidiaries mostly fund themselves locally and not via their European parents and are often of strategic importance to the parent banks given their high profitability and growth prospects.

**The growing depth of domestic financial markets has reduced the importance of European bank funding for African borrowers.** Cross-border lending from European banks accounts for less than 25% of total credit to the African private sector<sup>4</sup>. Borrowers are increasingly able to borrow from local banks and fund themselves on local markets.

**Nevertheless, a number of countries and sectors are large borrowers from European banks and the impact of reduced European bank lending will depend on the ability of these sectors to find alternative financing.** Regional telecom operators, the commodities sector and South African banks are large recipients of European bank funding. Most of these can be expected to find alternative means of funding. Average lending from foreign banks as a share of GDP is limited in most African countries, but accounts for more than 20% of GDP in Mozambique, Senegal and South Africa and some smaller African countries.

**The impact on trade financing is expected to be limited.** European bank exit from African export financing – the more important direction of trade financing – is likely to be compensated by the entry of other financiers. African importers of European goods will be exposed to a cut-back of credit lines for letter of credit confirmation by European banks, though. Such credit could not be easily compensated for by non-European financial institutions, but, as of now, no significant impact has been observed by market participants.

**A decline in global investor confidence has reduced portfolio inflows to some African countries, impacted equity market performance, reduced liquidity in a number of fixed income markets and led a number of African Governments to postpone international bond issues.** The performance of local equity markets is closely linked to portfolio flows from foreign investors. More importantly, liquidity in a number of local bond markets has been highly dependent on foreign portfolio investor participation. Recent yield volatility arising from increased inflation and exchange rate depreciation has acted as a drain on local bond market liquidity.

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<sup>3</sup> World Bank (2011a) *Africa's Pulse, An analysis of issues shaping Africa's economic future*, Sept 2011, Vol. 4, Deutsche Bank (2011), Standard Chartered Bank (2011)

<sup>4</sup> Volume of lending by foreign banks to Africa as reported by the Bank of International Settlement (BIS) as a share of the sum of the volume of credit to the private sector extended by domestic banks (reported to IMF International Financial Statistics – IFS) and the volume of lending by foreign banks (reported by BIS).

**Medium-term prospects remain positive, though, as international investors are still looking to increase investment allocations to Africa. Namibia and Senegal accessed international markets successfully in 2011 for the first time and the recent track record of African financial market stability has reduced Africa's risk premia significantly.** Market observers emphasize that Africa is affected by contagion through global investor confidence, but that the impact is now in line with that observed in other emerging markets. Investor perceptions of African risk have improved in recent years and an emerging dedicated investor base is reducing price volatility of African securities. A recent global survey of major institutional investors found that Africa will benefit from higher investment allocations over the coming years.

**The most significant risk for Africa associated with the European debt crisis is that it might trigger domestic, home-made financial sector risks.** African credit markets were growing at a fast pace prior to the global crisis and, after a temporary period of slow-down, credit growth has picked up again through 2011. In an environment of weak risk management and limited supervisory capacity fast credit growth is likely to contribute to a build-up of risks in the sector. The example of the 2008/9 global financial crisis should be heeded as a warning. A new round of external shocks emanating from the European debt crisis could again expose or exacerbate prevailing risks in African financial sectors.

**The ability of African Governments to counteract the economic impact of a global recession has been diminished significantly and is limited by the lack of depth of domestic financial markets.** In 2008 and 2009, African policy makers, in line with other developing countries, made use of expansionary fiscal policy and monetary easing to counteract the impact of the global recession. As a result, fiscal space has been reduced significantly and, given the shallowness of some government bond markets, increased government borrowing could further diminish banks' appetite to lend to the private sector. At the same time, increased inflation has reduced the scope for monetary easing. The effectiveness of monetary policy is questionable in underdeveloped financial sectors where the transmission between central bank rates and commercial lending rates has proven to be very weak. Banks react asymmetrically to changes in policy rates – being more willing to raise than lower their lending rates in response to a change in policy rates.

**So far, African financial sectors have performed well through the global financial crisis and during the unfolding of the European debt crisis, but potential transmission channels warrant close monitoring. A number of key policy priorities should be considered:**

- While recognizing the continued need for external funding sources to address the significant development challenges, *funding strategies for the continent need to be firmly grounded in developing the ability of domestic financial sectors to mobilize and intermediate resources.*
- Authorities need to establish systems and processes to *monitor and evaluate systemic and global risks and their possible impact on domestic financial sector stability.*
- *Strengthening supervisory capacity and risk management capacity* need to remain at the core of the reform agenda.
- *Cross-border supervisory issues are increasingly important for African regulators* and institutional frameworks need to be strengthened on a regional and international level.

- The development of local capital markets and strengthening of the domestic institutional investor base will be essential to deepen liquidity in African capital markets, strengthen domestic funding capacity and expanding the scope for monetary policy.
- Governments need to carefully review the effectiveness of their macroeconomic policy instruments, especially in view of reduced fiscal space and new inflationary pressures arising from higher fuel and food prices.

Key facts on African financial sectors in this box are adopted from “Financing Africa: Through the crisis and beyond” by Thorsten Beck, Samuel Munzele Maimbo, Issa Faye and Thouraya Triki (2011), which provides a comprehensive and up-to-date review of financial sector development in Africa. [Link to publication on www.mfw4a.org](http://www.mfw4a.org)

### **Africa’s Financial Systems in International Comparison – key facts**

- Africa’s banking systems are small in absolute and relative size. The median of private sector credit as a share of GDP for African countries was 19% in 2009, compared to 49% for non-African developing countries.
- African banking systems intermediate, on average, only 74% of their deposits, while banks in non-African developing intermediate 109 % of their deposits.
- There were significant improvements across African financial systems in the years leading to the global financial crisis. Most African countries experienced financial deepening with a persistent increase in the ratios of liquid liabilities to GDP, bank deposits to GDP, and private credit to GDP.
- African banking is mostly short term. More than 80% of deposits and nearly 60% of loans have a maturity of less than one year.
- Consistent with their small size, Africa’s banking systems are mostly concentrated and competition among banks is weak.
- At the time of independence, Africa’s banking systems were mostly dominated by colonial banks. International banks subsequently played a big role in the region. However, in the last 10 to 15 years there has been a transition from international to regional banks. After the end of Apartheid, several South African banks, most notably Absa and Standard Bank, started expanding throughout the continent. More recently, two West African banks – Bank of Africa and Ecobank – have started expanding throughout Sub-Saharan Africa. Similarly, Moroccan banks started to expand south. Finally and as consequence of the recent consolidation wave in Nigeria, Nigerian banks started expanding throughout West Africa, but increasingly also throughout the rest of the continent.
- With the exception of the stock exchange in Johannesburg, South Africa, African stock exchanges are small as gauged by the ratio of market capitalization to GDP and they are dominated by few stocks.
- Primary bond markets are small and dominated by issues made by governments and financial institutions. Short-term securities dominate most African bond markets.
- Seventy-five percent of funding for enterprises comes from private commercial banks, while less than 12 percent comes from nonbank sources.
- The insurance sector is in its infancy in most African countries. With the exception of Lesotho and South

## Diversity of risk profiles across the Africa region

Africa includes a broad variety of countries with different stages of financial sector development, risk profiles and exposures to the European debt crisis. The following groups of countries can be distinguished:

- **South Africa**, by far the largest economy in the region with a well-developed and globally integrated financial sector, is the most important destination for portfolio inflows and the largest borrower from European banks in the region. It experienced a large reduction in portfolio inflows in late 2011, which impacted stock market performance and the currency. European banks provide a significant share of South African banks' syndicated loan funding, but a reduction of lending from Europe is expected to be balanced by other international banks and investors.
- The other Southern African Currency Union (SACU) countries – **Namibia, Botswana, Swaziland and Lesotho** - are highly integrated with the South African financial sector and more exposed to its performance than that of European banks, notwithstanding home-made problems such as the fiscal crisis in Swaziland. Subsidiaries of South African banks and insurance companies dominate their financial systems and a very high share of pension and insurance assets is invested on the Johannesburg stock exchange.
- **Mozambique and Angola** have a strong presence of subsidiaries of Portuguese banks. However, these subsidiaries fund themselves on local markets and provide significant profits to the parent banks, making them less prone to disinvestments or funding cuts triggered by a Portuguese banking crisis. The most significant risk in both luso-phone countries arise from the substantial deposits held with Portuguese banks.
- **The Seychelles, Cape Verde, Sao Tome and Principe, Sierra Leone and Liberia** form a group of very small economies with small and underdeveloped domestic financial markets that fund their outsized investment needs in specific sectors with high to very high cross-border lending from European banks. This includes hotels and tourism (Cape Verde, Sao Tome and Principe and Seychelles), which are also dependent on European tourism and therefore at a high risk, as well as the shipping industry (Liberia) and minerals (Sierra Leone), which can be expected to continue to perform well in the medium-term and are likely to attract lending from other international banks, if European banks withdraw.
- The **new frontier markets**, including **Ghana, Kenya, Nigeria, Uganda, Zambia, Rwanda, Gabon, Tanzania**, have benefited to a larger or smaller extent from the additional liquidity provided by portfolio inflows and, given the shallowness of local bond and equity markets, the withdrawal of international investors will impact on market liquidity, equity market performance and their ability to mobilize Government funding. Some of these countries have experienced rapid credit growth through the recent boom phase with a significant build-up in risks that has already materialized in pressures on portfolio performance and (near) crisis situations in Ghana, Nigeria and Zambia during the 2008 global financial crisis. These are the countries most vulnerable to the European crisis triggering domestic structural weaknesses.
- The fourteen **West African** economies in the **two CFA franc zones, CEMAC and WAEMU**, including large economies such as **Senegal, Cote d'Ivoire and Cameroon** had a significant

presence of French banks in the past, but this is no longer the case and the role of the large African regional banks, in particular, Ecobank, Attijariwafa Bank and Access Bank is as strong by now. Senegal still is a comparatively large borrower from French banks and their withdrawal from large project financing will impact the Government's ability to fund large infrastructure projects. French banks provided a good share of the pre-export finance of agricultural commodity exports (cocoa, cashews, cotton) in West Africa. However, given the positive market prospects for these commodities, this pre-export financing is likely to be replaced by other international banks. The peg of the CFA to the Euro is not expected to be challenged, as macroeconomic fundamentals, including high commodity prices, are not putting pressure on the peg and foreign exchange reserves remain comfortable.

- **East African countries**, including **Kenya, Uganda and Ethiopia**, are facing additional challenges from high inflation, which is driven by high oil and food prices, partially as a result of the drought in the Horn of Africa, and currency depreciation. Kenya and Uganda increased interest rates significantly. This is expected to attract foreign inflows and curb inflation fears, but is likely to put pressure on the costs of private sector borrowing.

***ANGOLA – Different from the rest of Africa: Large investments in Portugal, high currency risk on bank balance sheets and a significant direct impact of the global financial crisis***

The Angolan economy grew on average by 15% from 2003 to 2008, driven by strong growth of oil revenues and the Government funded a large reconstruction and infrastructure program. The sharp drop in oil prices and revenues after the 2008 global financial crisis increased the budget deficit significantly and resulted in Government defaults on payment obligations to domestic suppliers and banks that led to marked increase in non-performing loans.

Portuguese banking groups account for roughly half of the Angolan financial system, but are much more dependent on funding from their Angolan subsidiaries than the other way around. Angolan banks hold up to US\$ 3 billion in the Portuguese banking system that are at risk in case of default by the Portuguese sovereign or an individual bank and would undermine liquidity in the Angolan banking system.

The Angolan financial system is dollarized with over 50 percent of deposits and loans denominated in foreign currency that introduce significant currency risks, which are largely absent in other countries of the region.

The following table summarizes potential transmission channels and their current empirical relevance in Africa.

## Summary of major transmission channels of the European debt crisis to African financial sectors

	Channel	Mechanics	Current Exposure	Probability of channel activation	Impact on financial sector	
Financial Contagion	Losses on investments in Europe	Debt Crisis causes lower prices of sovereign bonds (including haircuts in Greece) and European equities	Share of European assets in investment portfolios of African banks, insurance and pension funds still very low, with a significant exception of Angolan bank investments in Portugal.	Medium - High	Very low	
	Portfolio flow reversals	Need for liquidity and increased risk aversion causes global reduction of portfolio flows to Africa: Decline in bond and equity prices and market liquidity.	African equity market performance is linked to portfolio flow volumes. Bond markets are driven more by domestic investments, but some frontier markets (i.e. Ghana) have significant foreign participation. The largest share of portfolio flows goes to South Africa, where they are less significant as a share of total investment.	High in the short-run, but strong investor interest supports good medium term prospects	Low - Medium	
	European bank downsizing or failures	European banks reduce direct cross-border lending	European banks reduce direct cross-border lending	Direct cross-border lending by banks from outside Africa to African private and public sector borrowers accounts for only a quarter of domestic credit supply in the region (a third outside South Africa). The share has declined due to strong credit growth from domestic financial institutions. The overall share of cross-border lending from European banks is small with a couple of exceptions: Senegal, Mozambique and a few small countries. Larger domestic credit has provided a good “hedge” against tighter credit from foreign sources.	High	Low
		European banks reduce trade finance lines	European banks reduce trade finance lines	African importers are reliant on European banks to provide trade finance lines to African banks for Letter of Credit confirmations. Industry observers emphasize a learning effect from the last crisis and lines remain open, so far.	Medium	Low-Medium
		European banks withdraw from African subsidiaries.	European banks withdraw from African subsidiaries.	Limited presence of European banks in Africa. Notable exceptions are Portuguese banks in Angola and Mozambique and, to a lesser extent, French banks in West Africa or the South African subsidiaries of internationally operating banks. Importantly, these subsidiaries do not depend on funding from parent banks and are often outperforming the groups.	Low	Very low

	<b>Currency devaluations</b>  (as a result of reduced capital flows or exports)	Currency mismatches result in balance sheet risks (i.e. foreign currency debt has to be repaid from local currency income), which either affect banks directly or via the credit channel.	African Governments, financial institutions and firms have very limited exposure to currency mismatches. Banks and Governments have limited foreign currency debt. Foreign currency borrowing predominantly by firms with foreign currency earnings (commodities). Possible, but generally well managed, risk concentrations in telecoms and South African corporate sector.	<b>Medium - High</b>	<b>Low</b>
		Trust in local currency / capital flight	Financial sector deepening benefitted from increased trust in local currency deposits and reduced capital flight in recent years. Inflation and currency devaluation could undermine this trend (East African community, Nigeria).	<b>Medium</b>	<b>Low -Medium</b>
<b>Real sector risks</b>	<b>European / Global recession reduces demand for African exports</b>	Credit risk of (commodity) exporters increases. Demand for financial services decreases.	African banks have limited exposure to commodity producers, which account for a large share of exports and are banked by international financial institutions. Indirect exposures, such as to the employees of mining companies, have proven to be the bigger risk.	<b>Low-Medium</b>	<b>Low-Medium</b>
		Indirect growth effects on financial sector	Overall, Europe accounts for 28% of total export value and 37% of non-oil exports. Projected African growth reductions suggest a limited overall effect on financial sector performance. However, reduced growth could trigger domestic structural weakness in some sectors.	<b>Low</b>	<b>Low-Medium</b>
	<b>Reduced Remittances</b>	Increase in unemployment in developed countries reduces remittances.	Remittance flows to Sub-Sahara Africa were resilient during the global financial crisis and are expected to hold-up through the European crisis	<b>Low</b>	<b>Low</b>
	<b>Reduced Foreign Direct Investments</b>	Anemic growth and heightened risk perceptions weaken foreign firms' capacity and propensity to invest in Africa.	After declines in 2009 and 2010, FDIs are up by 25% in 2011 and projected to grow further in 2012. Commodities, Telecoms, energy demand and other growth sectors continue to attract foreign direct investments.	<b>Low</b>	<b>Low</b>



## African banking sectors continue to grow

Most African banking systems continue to benefit from low leverage, high levels of capitalization as well as ample liquidity, and have even strengthened their position following the 2008/9 financial crisis. Banks increased regulatory capital ratios in 2009 and despite rapid credit growth, banks' balance sheets continue to be underleveraged and liquid. There is still too little rather than too much bank activity in Africa. Banks' profitability remains high.

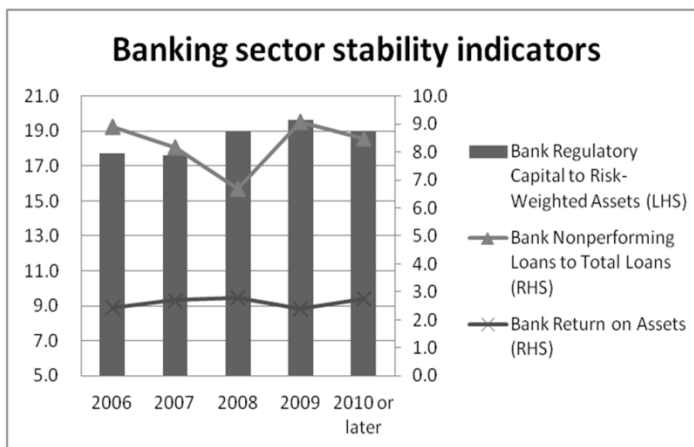
**Reported portfolio quality deteriorated only slightly following the crisis and the global recession. This applies with a few important, but predominantly domestically driven, exceptions. Overall portfolio quality has improved in the last 18 months.** More than a third

of (50 out of a sample of 128) large African banks that report loan loss provisions increased reserves as a share of gross loans, but the majority of banks reported stable non-performing loans or even reduced provisions. The increase in non-performing loans and loan loss reserves in 2009 was predominantly driven by Nigerian, Zambian, Angolan and Ghanaian banks and was caused by domestic factors largely unrelated to the global crisis (see country examples in text boxes).

**Growth in nominal credit volumes, which slowed in 2009 from very high - and potentially unsustainable - levels following the global financial crisis, has picked up since the middle of 2010.** In mid-2011 the majority of credit markets are growing at 15-30% with average growth across all countries above 20%. While current credit growth is clearly in a more sustainable range than prior to the 2008/9 global financial crisis, when almost half of all African banking

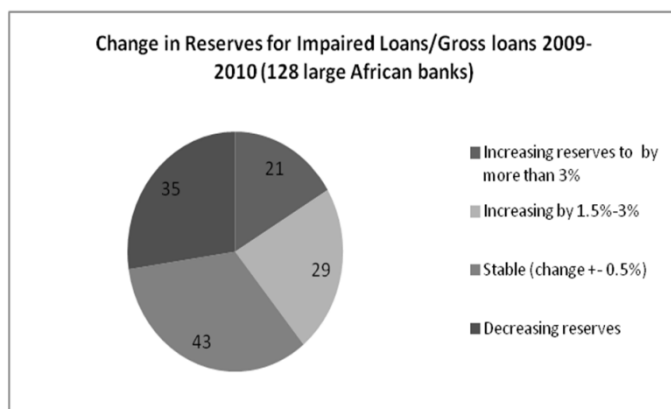
systems were expanding nominal credit volumes<sup>5</sup> at rates faster than 30% and often above 80%, developments still need to be monitored very closely. In an environment of weak risk management,

Figure 1 – African banking systems remain stable



Source: IMF Financial Soundness Indicators (*fsi.imf.org*)

Figure 2 – Loan loss reserves stable or declining

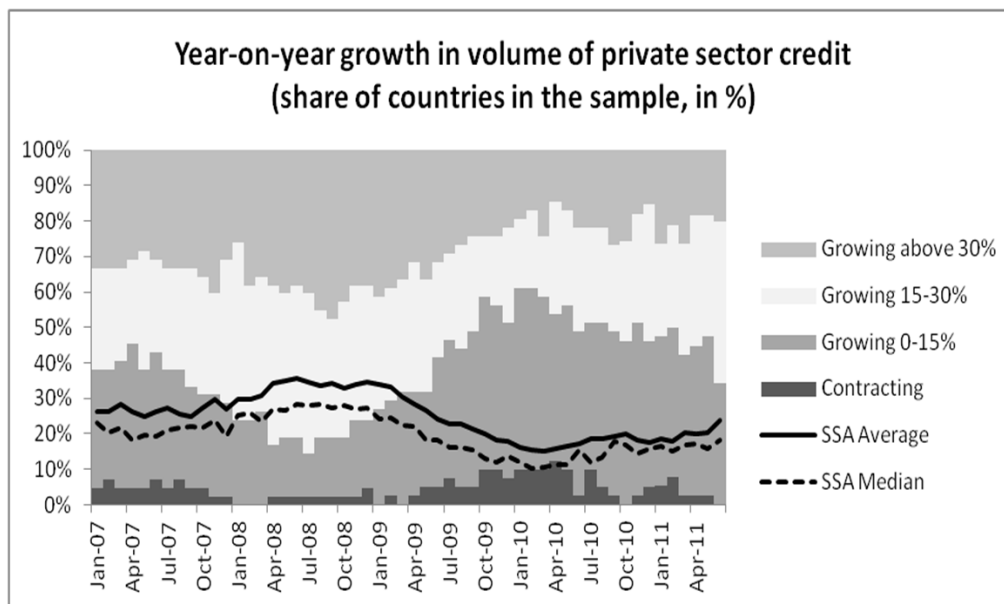


Source: BankScope

<sup>5</sup> GDP-weighted average inflation reduced from 12.6% in 2008 to 8.7% in 2009 and 7.2% in 2010. Recently, some important differences across the region can be observed as food price pressures caused inflation to peak in East Africa at levels of 20%-25% at the end of 2011.

poor accounting, disclosure and reporting, and limited supervisory capacity, fast credit growth may contribute to a build-up of risks in the sector that could be exacerbated by external factors. The most significant risk of the European debt crisis is as a trigger of domestic, home-made financial sector risks.

**Figure 3 – Fast-paced credit growth is picking-up again**



Source: IMF, International Financial Statistics 2011

***NIGERIA, GHANA and ZAMBIA – Global risks trigger domestic dislocations***

Non-performing loans remained stable across the region and actually declined for most countries and most banks in 2010. Most of the increase in non-performing loans was driven by domestic weaknesses in a small number of countries, including Nigeria, Ghana, Zambia and Angola that were triggered by the indirect effects of the 2008 global financial crisis. All four banking systems had grown rapidly before 2008.

In 2009, **Zambia**, Africa's top copper producer experienced an 18% decline in revenue earnings from copper sales. The slump in copper prices led to a closure of mines, which rendered thousands of people jobless. Banks and micro-lenders that had extended large numbers of loans in a short period of time to the mining communities and – as salary loans – to mine workers, who were made redundant, suffered significant loan impairments.

In **Ghana**, non-performing loans almost doubled from 7.7% in 2008 to 17.2% in May 2011 as a new government, elected in December 2008, had to rein in a large fiscal deficit of 24.2% of GDP in the midst of the global economic recession. The large fiscal deficit is driving the performance of banks' credit portfolios: it translated into impaired loans due to the build-up of government arrears to contractors and state-owned enterprises (SOEs), which, in turn, caused arrears by their suppliers who have not been paid.

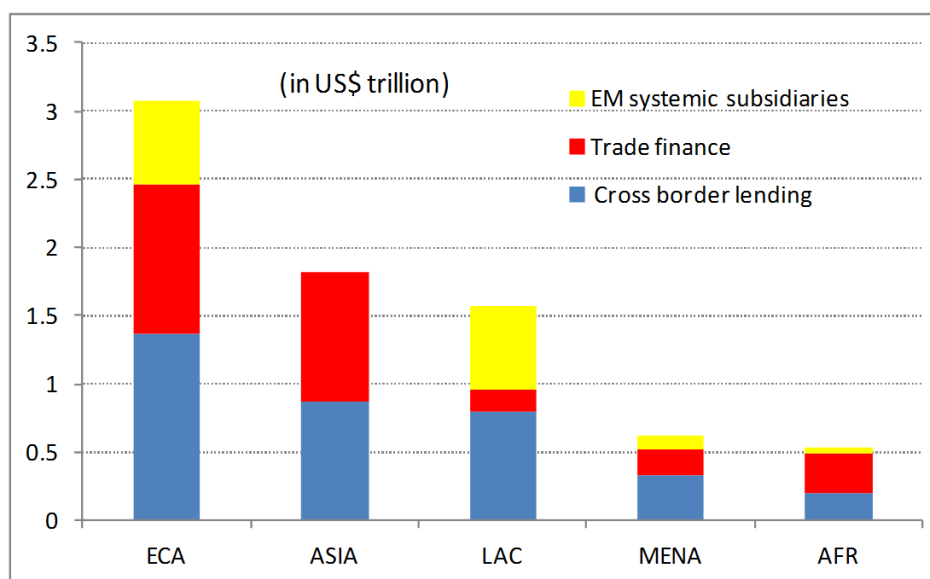
In **Nigeria**, much of the increase in lending was connected lending and margin loans to retail customers who borrowed to buy banks shares. Weaknesses in risk management, corporate governance and lack of consolidated supervision facilitated a widespread practice of bank lending through brokerage subsidiaries to retail customers for purchases of parent bank shares, which were then used as margin collateral for the loan. With the withdrawal of foreign capital flows during the global financial crisis, the Nigeria Stock Exchange All Shares Index lost close to 80% of its value. As share prices plummeted, borrowers were unable to service an estimated US\$10bn of margin loans. The Central Bank of Nigeria injected subordinated debt in the amount of 2% of GDP in ailing banks. Non-performing loans in the banking system increased from 9.5% in 2007 to 29.1% in 2009. After write-offs they decreased to 17.2% in December 2010. Three banks have been nationalized in the second half of 2011. Total cost of the entire bail-out amounted to 3 trillion Naira.

## Decreasing reliance on foreign bank lending

**African financial sectors are significantly less exposed to European banking sector risks than those in other regions.** Three channels of direct financial contagion from a contraction in the European banking sector can be identified:

- Potential impact of losses and reduced funding from a European parent banks to their Sub-Saharan African subsidiaries.
- Provision of trade finance credit lines for African banks
- Cross-border lending from European banks to African borrowers.

**Figure 4 – Emerging Market Linkages with Western European Banks**



Source: IFC, BIS

Chart taken from “Deleveraging Outlook – Emerging Economies and ECA Region”, World Bank ECA Region, Nov 2011.

### *European bank subsidiaries in Africa*

**European banks have a limited physical presence in terms of subsidiaries and branches in Africa.** Most lending from European banks is cross-border and is not mediated through the local financial sector. Notable exceptions are Portuguese banks in Angola and Mozambique and, to a lesser extent, French banks in West Africa or the South African subsidiaries of internationally operating banks. Importantly, these subsidiaries do not depend on funding from parent holdings. The operations of Portuguese banks in luso-phone Africa - and especially in Angola - have an outsized significance on their overall profitability. With the crisis now looming in Portugal, the relative importance of the African operations is likely to increase and the Portuguese parents are likely to try to protect and not undermine their value (see country examples in text boxes).

### *Trade finance*

**The potential impact on trade finance will be different for imports and exports.** The volume of trade finance is substantial as Europe remains Africa's largest trading partner. In 2010, African importers imported US\$ 79 billion worth of goods (including machinery, chemical and pharmaceuticals, cars, building materials etc.) from Europe and exported US\$ 62 billion, primarily commodities. Importantly, exports and exporters from Africa are less exposed than importers.

- **African importers** of European goods are reliant on European exporters' banks to provide trade finance lines to African banks for payment guarantees (letters of credit (LOC) confirmations). European exporters are less likely to be able to switch to non-European banks as guarantors, if European banks reduce their trade finance lines. As regards financing of imports, industry observers emphasize that African banks have built a good track record during the global financial crisis and that trade finance lines – many of which are cash-collateralized anyway – have largely remained in place.
- **African exporters**, which are primarily exporting commodities and agricultural products, are expected to be able to compensate the exit of European banks from the pre-export finance market as other international banks and African banks are ready to step into the gap. The availability of funding for exporters of cocoa and cotton from West Africa or flowers from Kenya will depend more on the performance of markets for these commodities than on the participation of single group of funders from Europe.

### *Cross-border lending from European banks*

**Domestic financial sector deepening has significantly decreased reliance on foreign cross-border lending, but some risks remain.** The strong growth of domestic African credit markets has significantly decreased the exposure of African financial systems and borrowers to the potential fall-out of the European debt crisis. Lending volumes are expected to contract, because European banks have to absorb losses from sovereign debt and are to hold more capital prompted by crisis response measures by the European authorities. Over the medium-term the requirements of new Basel III rules to increase regulatory capital are expected to have a similar impact.

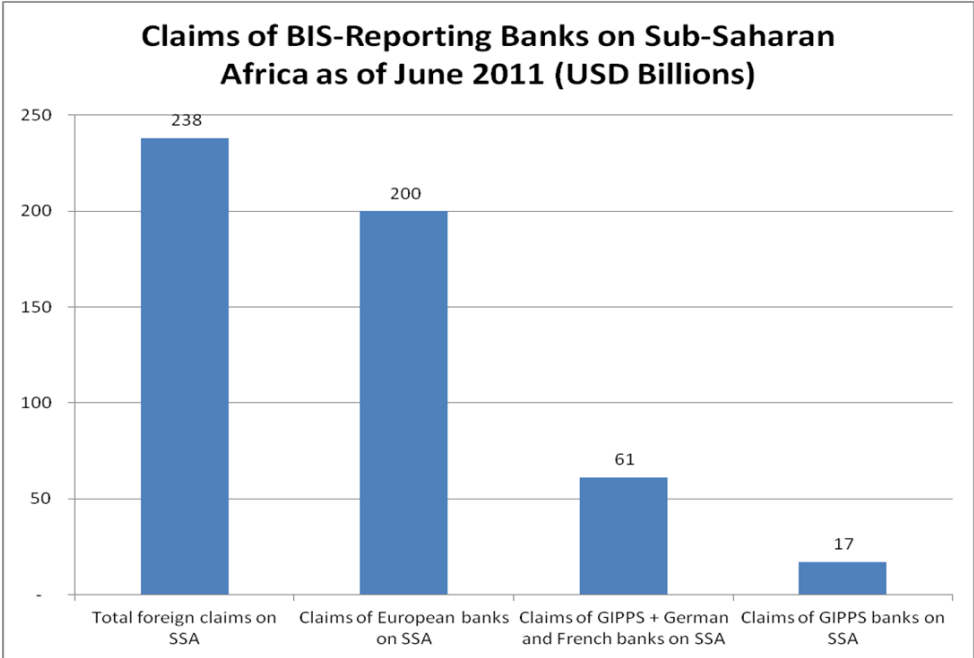
**European banks account for the largest share of foreign cross-border lending to Sub-Saharan Africa.**<sup>6</sup> As of June 2011, European banks extended US\$ 200 billion out of total of US\$ 238 billion outstanding

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<sup>6</sup> The analysis of cross-border lending and domestic lending is based on three separate data sets. (i) Foreign cross-border lending is reported on the basis of the Bank of International Settlement (BIS) Consolidated Banking Statistics, which documents lending by banks domiciled in Europe and other non-African regions to borrowers in Africa (including firms, financial institutions and governments). (ii) Domestic credit is reported on the basis of the returns of banks domiciled in Africa to national regulators and captured by the IMF International Financial Statistics (IFS). There is a potential of double-counting, if European banks erroneously count loans by their African subsidiaries as cross-border lending in reporting to BIS. Given the small number of European subsidiaries with active lending operations in Africa the potential error is expected to be limited, though. (iii) The analysis of the structure of foreign lending by sector is complemented by a separate dataset from Dealogic on syndicated loans to African borrowers – the dominant form of cross-border lending to Africa by foreign banks. The analysis of all syndicated loans recorded by Dealogic provides a breakdown of the type of borrowers. Note: African banks are increasingly participating in syndicated loans themselves and therefore the total volume of syndicated loans in Africa is higher than the lending volume from foreign banks.

foreign bank loans to Sub-Sahara Africa. Key Eurozone countries account for a much smaller share of lending to Sub-Sahara Africa according to BIS data. US\$ 61 billion out of the US\$ 200 billion cross-border lending from European banks come from banks in Germany, Greece, France, Italy, Ireland, Spain, and Portugal. The total volume of lending from the most affected European countries (esp. Greece, Italy, Portugal and Spain) is even smaller (US\$17 billion). Most lending to Africa is channeled through banks domiciled in the United Kingdom. London is the dominant financial hub for finance into and out of Africa and most of the non-European banks and some Eurozone banks record their lending to Africa through their London-based subsidiaries. This inflates the lending figures from the UK reported in the BIS data substantially.

**Figure 5 – European banks account for majority of foreign lending**



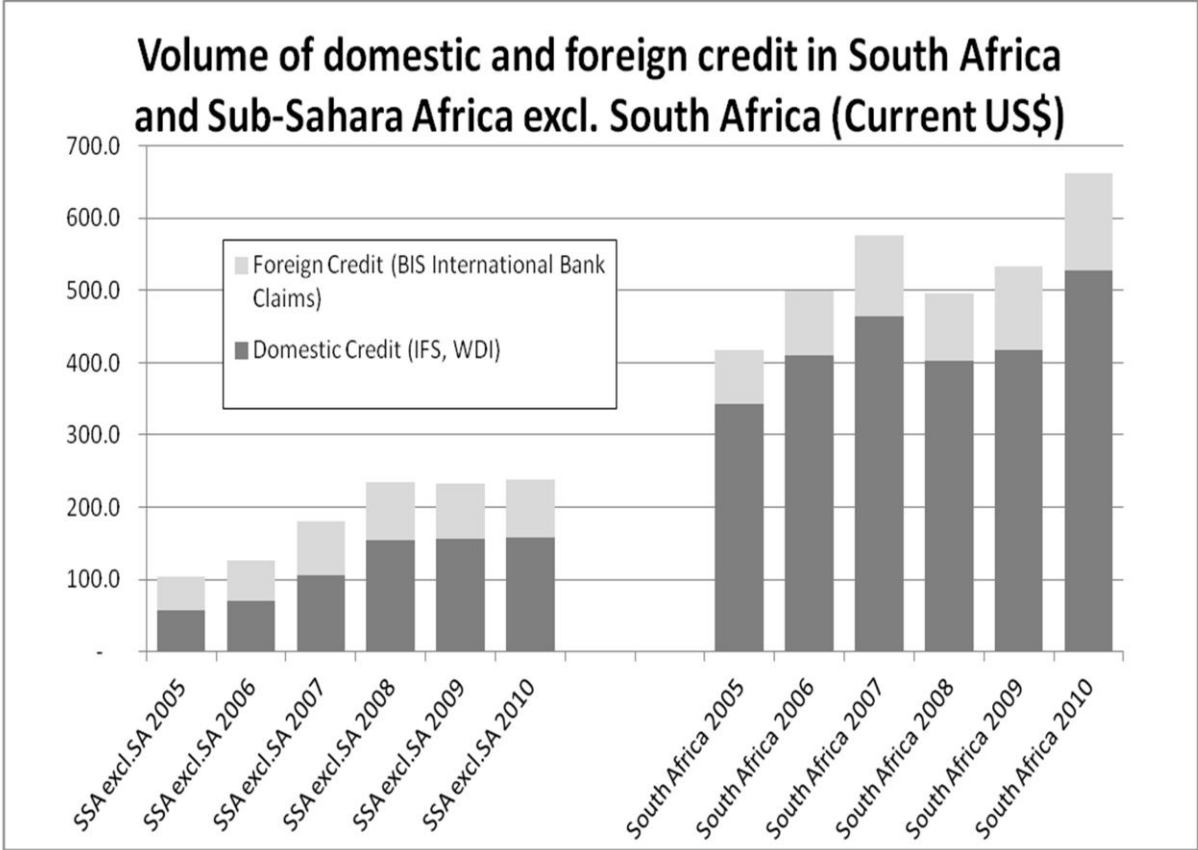
Source: BIS Consolidated Banking Statistics

**Importantly, the share of foreign cross-border lending to the African private sector and governments is below 25% of total borrowing region-wide and the relative share of foreign lending has decreased significantly in recent years.** The volume of foreign lending to Sub-Sahara Africa, excluding South Africa, almost doubled between 2005 and 2011, but credit provided by domestic banks tripled in the same period. Foreign banks accounted for 45% of credit extended to Sub-Sahara Africa in 2005. In 2011, this share was reduced to less than 34%.

**The considerable deepening of domestic credit provision provides a natural hedge against the reduction in credit from European banks.** African banks today have the size and balance sheet to absorb a good part of the foreign lending flowing into Africa and have increasingly done so in recent years. This has also been evidenced by the increasing participation of African, in particular Nigerian banks, in large syndicated loans, which used to be the domain of European and international banks. African financial sectors already demonstrated their potential in mobilizing domestic resources during

the 2008 crisis. To balance dwindling sources of external funding African borrowers were increasingly able to turn to local financial markets. Only in the case of an outsized and very rapid contraction of European bank lending over a broad front would the impact on African borrowers be significant.

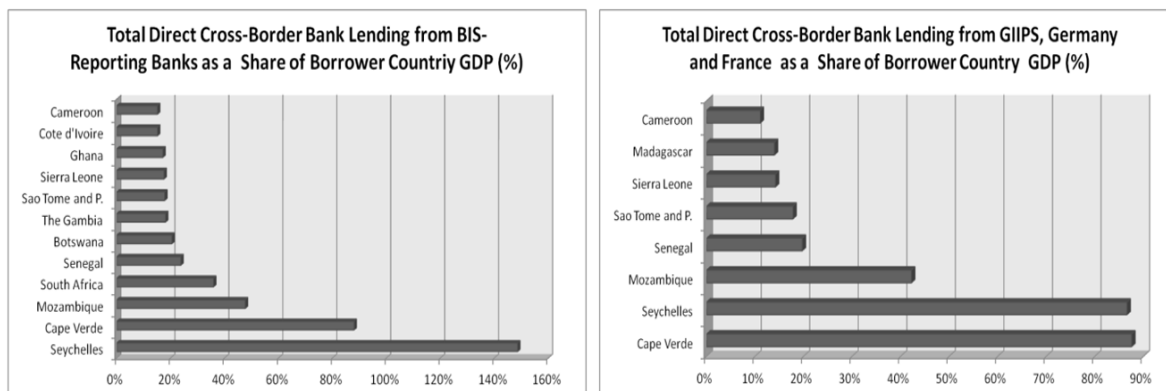
**Figure 6 – Domestic credit growth: Share of foreign lending is declining**



Source: BIS Consolidated Banking Statistics, IMF International Financial Statistics / WDI

**Some African countries have a proportionally large share of foreign lending from Euro zone countries, including Mozambique, Senegal, South Africa, Cape Verde, the Seychelles and Liberia.** Foreign funding accounts for 36% of South African GDP, but lending from key Euro zone countries (i.e. GER, FR and the GIIPS) amounts to only 4% of GDP. Countries with a large share of funding from European banks are likely to be affected by a reduction in lending, especially since other international banks are still unfamiliar with some of these economies and are unlikely to step into the funding gap quickly, if domestic markets aren't able to fill the funding gap (see country examples in text boxes).

**Figure 7 – Large borrowers from European banks**



Source: BIS, Consolidated Banking Statistics, ultimate risk basis

***MOZAMBIQUE – Food and fuel more problematic than Portuguese troubles***

Portuguese-owned banks in Mozambique have been in the market for well over ten years and have established long-running business relationships with large corporate borrowers and government. Their operations are profitable and largely funded through local deposits. Mozambique has been very active in licensing new banks in the past few years so that the banking system now includes banks from South Africa, the UK, Belgium and Mauritius. This limits the impact that trouble in the Portuguese parent banks would have.

The effects of rising fuel and food prices in 2009 and 2010 and a significant depreciation of the local currency have been much more important for financial sector performance. To rein in inflation and defend the currency against further depreciation, the authorities sold foreign currency and raised interest rates significantly resulting in the crowding-out of credit to the private sector and exacerbating further the high cost of finance for firms. Aid flows from Europe and in particular Portugal, Spain and France, still fund a large part of development in Mozambique. If European countries cut back their aid to deal with domestic needs, Mozambique, still dependent for 40% of its budget funding on donors, will be affected. Remittances from Mozambique migrant workers are an important source of income for the country, but most of them work in South Africa and not in Europe.

***LIBERIA – A safe haven for ship financing?***

Liberia is one of the largest flag countries for the international shipping industry and registers more than 1,700 foreign-owned ships under its flag. These carry everything from containerized cargo to cruise ship vacationers. The maritime registry, through fees and taxes, generates an important share of the country's foreign exchange revenue. As flag country it attracts more than US\$ 7 billion in ship financing – a large multiple of the countries' GDP – mainly from German, British and Greek banks, the largest financiers for the global shipping industry. These funds never reach Liberia, though, but remain offshore like the ships they are funding and - short of a collapse of global shipping - Liberia will not be affected by a disruption in these flows.

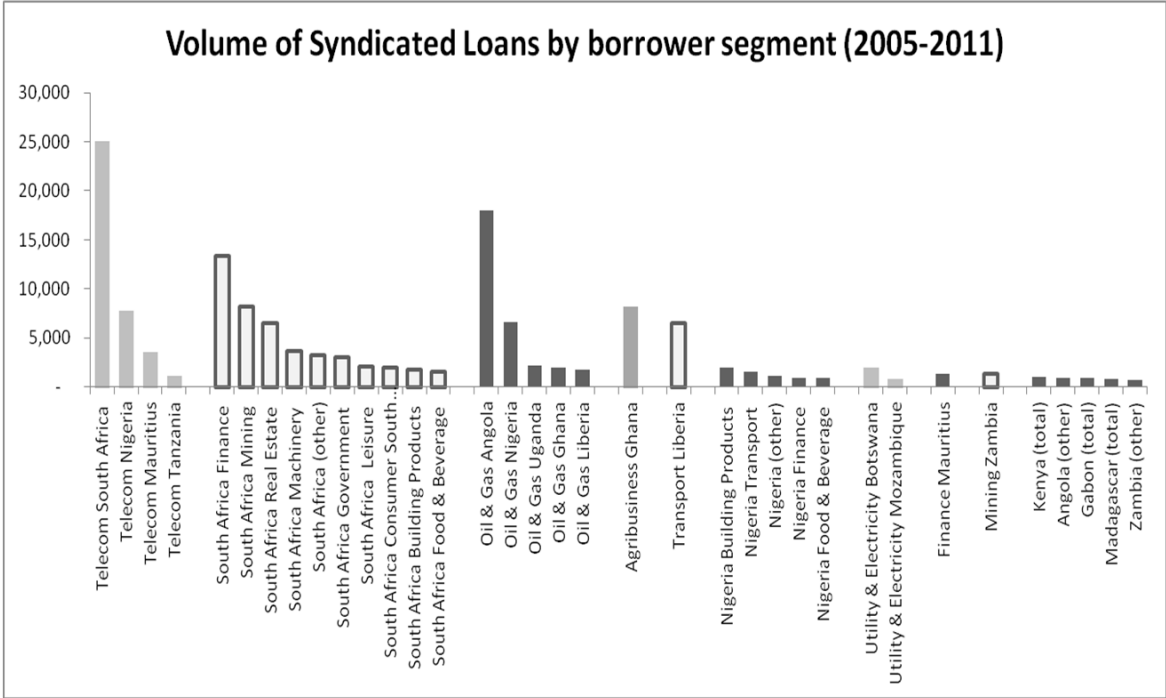
***CAPE VERDE - Considerable exposure to the slowing real estate and tourism sectors***

Despite some increase in competition, the financial sector in Cape Verde remains highly concentrated. The largest two financial institutions account for about 70 percent of credits. They are effectively majority owned and controlled by the same parent company, the Portuguese state-owned bank, Caixa Geral de Depósitos (CGD), which is currently being privatized as part of the Portuguese Government's adjustment program. Banks are undertaking efforts to increase capital. Regulatory capital reached 14.8 percent June 2011. Solvency of the financial sector is considered strong.

The financial sector is highly exposed to the real estate and construction sector (34 percent of total credit) and tourism (11 percent), which in turn are vulnerable to a European slowdown. The recent worsening of conditions in the Euro zone and the expected deceleration of the economic activity would further deteriorate the quality of the banks' portfolios

**The structure of foreign bank lending to Africa is geared towards commodities and the telecom sector and plays a limited role in funding the breadth of domestic private sector activity.** As opposed to other regions, foreign bank lending to Africa is concentrated in specific sectors that are still likely to attract funding, even in an economic downturn. An analysis of syndicated loans – the predominant mode of foreign bank lending in Africa – shows that lending to the telecom (25%), oil & gas (20%) and mining sector (7%) accounts for over half of lending volumes. The Ghanaian cocoa board and ship owners funding ships operating under Liberian flag are also large borrowers from European banks. As they should be able to attract funding from alternative sources, it seems less likely that these sectors and borrowers will be affected by a cutback in European lending. South African banks are also large borrowers from international banks and rely on the participation of European banks in syndicated loan funding. This exposure is tempered by quite rigorous regulation in South Africa that limits individual bank exposure to foreign funding and is small in comparison to the size of the South African economy and financial sector.

**Figure 8 – Loans are concentrated in telecoms, oil & gas and other resources**



Source: Dealogic



#### ***SOUTH AFRICA – Domestic economic downturn slows financial sector growth***

South African banking sector assets have tripled in the past ten years, significantly ahead of its BRICS and emerging market peers. In 2010, domestic credit provided to the private sector stood at a high 145% of GDP. This impressive growth trajectory has, however, been thrown off track with the economic downturn. Growth in banking assets was flat throughout the past three years and recovered only slightly in 2011. Restrictive growth in credit to the private sector has impacted short-term growth prospects, especially in the SME sector. In 2010, one in three formal sector SMEs considered access to finance a “major or very severe” obstacle for their business. By contrast, in 2007, the ratio was nearer to one in ten. The recent recovery in credit growth suggests that some of these effects are a cyclical – and from a financial stability perspective – healthy response by commercial banks to the macroeconomic downturn.

South Africa’s banking sector is sound and well-regulated and is expected to be able to withstand constraints in funding, if European banks withdraw from syndicated loans that refinance parts of bank balance sheets. Industry estimates put exposure to European sovereign debt at less than 1% of the banking system’s total credit exposure (Standard Chartered Bank 2011).

Much credit growth in South Africa was in consumer lending and recent low interest rates have aided a relatively quick growth of unsecured credit lines to lower income retail customers. This development, however, coincides with a significant increase in credit impairments. In December 2010, the National Credit Regulator (NCR) reported that of the 18.35 million credit-active consumers, more than 8 million (>46%) had impaired records. Over the last two years, this number has increased by an average of 7% per year. The South African National Debt Mediation Association (NDMA) reports that 160,000 cases of over-indebtedness have already been registered with the NCR and approximately 8,000 additional cases are recorded each month. Industry views differ on the significance of these trends. Low interest rates allow consumers to carry a higher debt burden in the short-term, but further job losses as a result of worsening economic performance could trigger an adverse scenario.

#### ***CEMAC and WAEMU - Less French in the franc zones***

The fourteen economies in the two franc zones, CEMAC and WAEMU, differ in many respects: some are industrialized, some are oil exporters and others oil importers, some export minerals, others export crops, such as cotton, coffee and cocoa. The two zones share a common currency pegged to the Euro via an arrangement with the French treasury. Both zones have a single central bank and a single bank supervisor. Overall, a weaker Euro would benefit most of the countries with dollar denominated exports and strengthen their competitiveness. On the other hand a decline in commodity prices as a result of a lesser global demand would have a detrimental impact on portfolio performance.

The presence of French banks, with the exception of Société Générale, has declined significantly in both zones. French banks played a significant role in CEMAC and WAEMU, but this is no longer the case and the role of the large African regional banks, in particular, Ecobank, Attijariwafa Bank and Access Bank is as strong by now. Credit Lyonnais recently sold all its subsidiaries to Attijari Bank. International and regional banks are prepared to pick-up market share, if French banks would withdraw further. In October 2011, eleven regional and international banks – among them two French banks – filed expression of interest for the purchase of four Togolese banks accounting for 65% of the local banking market.

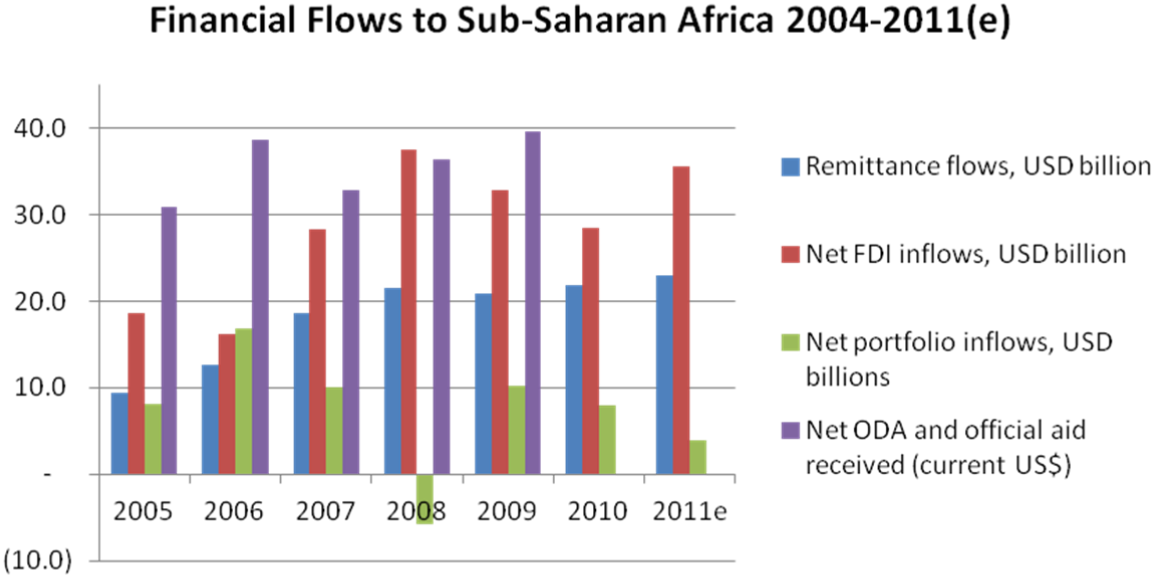
## **Impact on global investor confidence: Volatile portfolio flows, but Africa has built a good track record**

**The impact of the European debt crisis on global investor confidence is the least tangible and predictable transmission channel. Portfolio flows continue to be volatile, but market observers report a new robustness in investor sentiment towards Africa.** Overall, African financial markets have benefited from increased investor interest over the past decade. In their search for yield international investors look to Africa as the ‘last frontier’ and capital inflows have quadrupled in the period since the start of the new Millennium. A first wave of largely short-term oriented and more speculative flows arrived in Africa from 2005 driven by the global liquidity glut. The most significant direct impact of the 2008 financial crisis on African financial sectors was through outflows of these flows. Net equity portfolio flows reversed from US\$ 10.1 billion inflows in 2007 to US\$ -5.7 billion outflows in 2008. In 2009, inflows of US\$ 10.2 billion marked a second wave of flows into the continent, that are largely driven by more specialized investors with a longer-term horizon and a heightened confidence in the continent, which a number of high profile analyst reports referred to as new ‘Africa optimism’. Inflows

declined slightly in 2010 and are estimated to fall further to about US\$ 4 billion in 2011 as a result of the European crisis.

**A recent survey of 158 large institutional investors undertaken in August and September 2011 by the Economist Intelligence Unit (EIU) documents significant interest of foreign investors in Africa<sup>7</sup> and highlights a structural shift in medium term investor sentiment towards the region.** Two-thirds (66%) of the surveyed investment managers see African frontier markets holding the greatest opportunity (ahead of frontier Asian markets (44%) and Latin America (29%). Their projections are that the share of investors allocating more than 5% of their overall allocation to assets in Africa will increase from 13% in 2011 to 33% in 2016. In terms of constraints, 36% of the surveyed investors view market development and liquidity as the biggest obstacle after bribery and corruption (41%) and concerns about weak institutions (40%). Those funds that are specialized in Africa view liquidity as the biggest obstacle. The survey confirms that investors are adopting longer-term investment strategies for Africa, rather than more speculative, short-term bets: two-thirds of investors state that market volatility and limited liquidity require a longer-term investment approach.

**Figure 9 – Volatile portfolio flows, stable FDI and remittances**



Source: World Bank, Development Prospects Group, ODA data: WDI/GDF Sep 2011

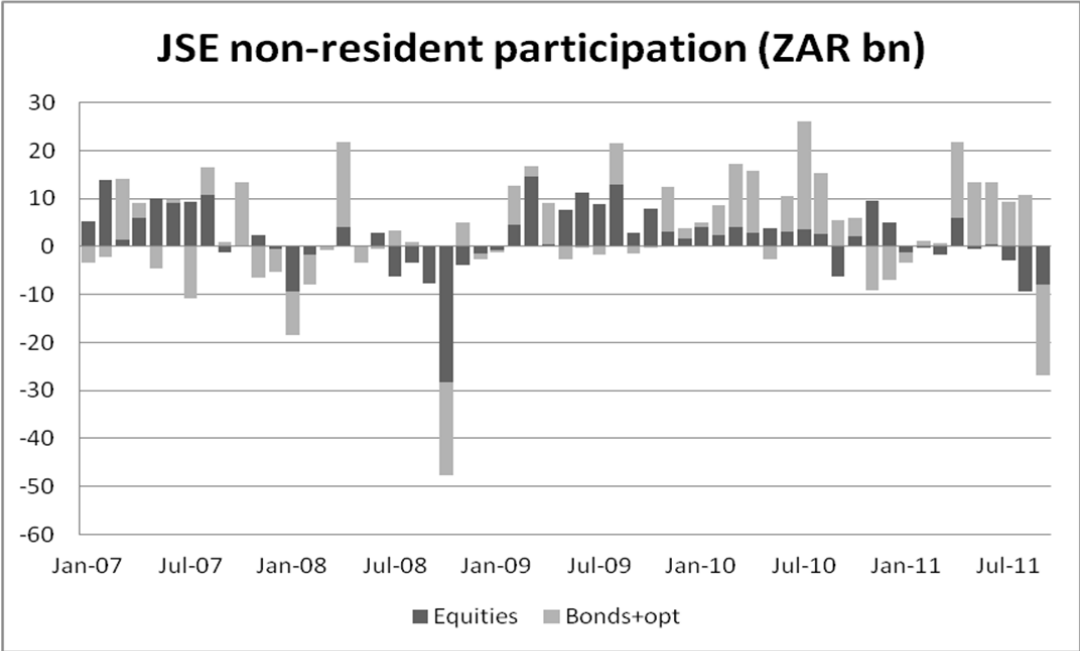
**Portfolio flows are important drivers for some, but not for all markets.** The bulk of portfolio investment flows is directed to South Africa, but it accounts for only a small share of liquidity in South African capital markets. On the other hand, some key frontier markets depend on portfolio flows for liquidity. For example, 60% of market volumes on the Kenyan equity market are driven by foreign funding and foreign investors frequently buy more than 80% of the primary issuance on Ghanaian Government bond auctions. Government bond markets in a number of other smaller African financial

<sup>7</sup> Economist Intelligence Unit (2012), Into Africa: Institutional investor intentions to 2016, 2012

systems, such as in Zambia and Malawi, have periodically also been dominated by foreign investor activities.

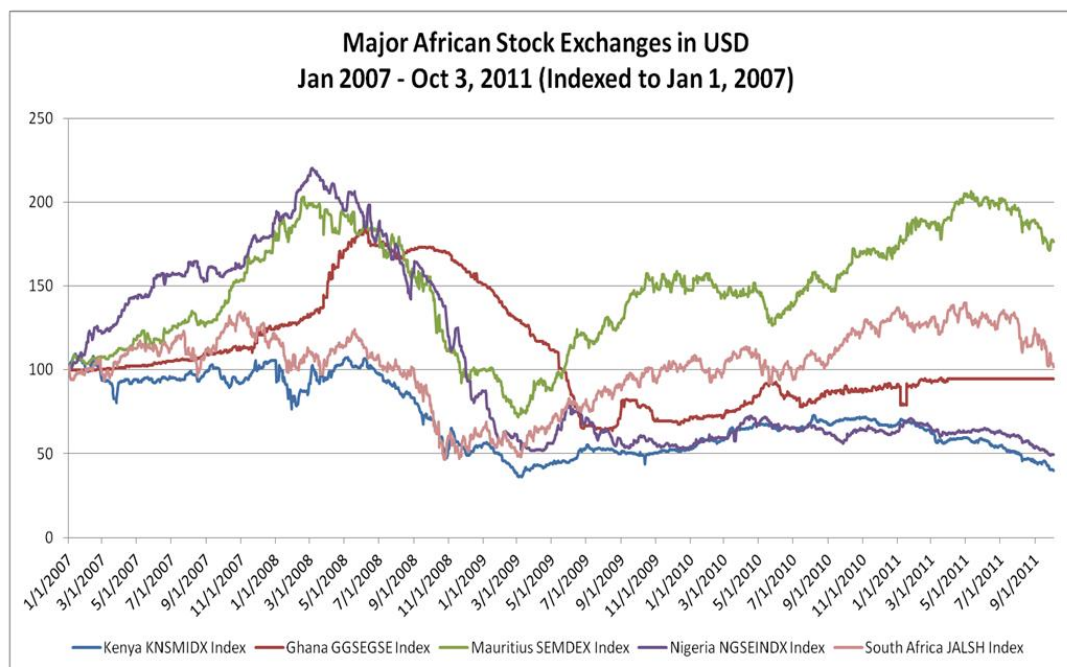
**Decreasing portfolio inflows or even portfolio outflows, as observed recently in South Africa, are likely to impact stock market and currency valuations and the ability of Governments to fund themselves through domestic bond markets.** Portfolio inflows to Africa are expected to decline in 2011 and 2012, but market observers do not expect significant outflows as in 2008. Although total portfolio flows for the year are still positive, South Africa, the major destination of international investment flows experienced substantial portfolio outflows in September 2011, resulting in a decline in stock market values and currency depreciation. In recent months foreign investors have also significantly reduced their participation in the primary issuance of Ghanaian Government securities.

**Figure 10 – South Africa: Recent portfolio outflows**



Source: Johannesburg Stock Exchange, October 2011

**Figure 11 – African stock market performance**



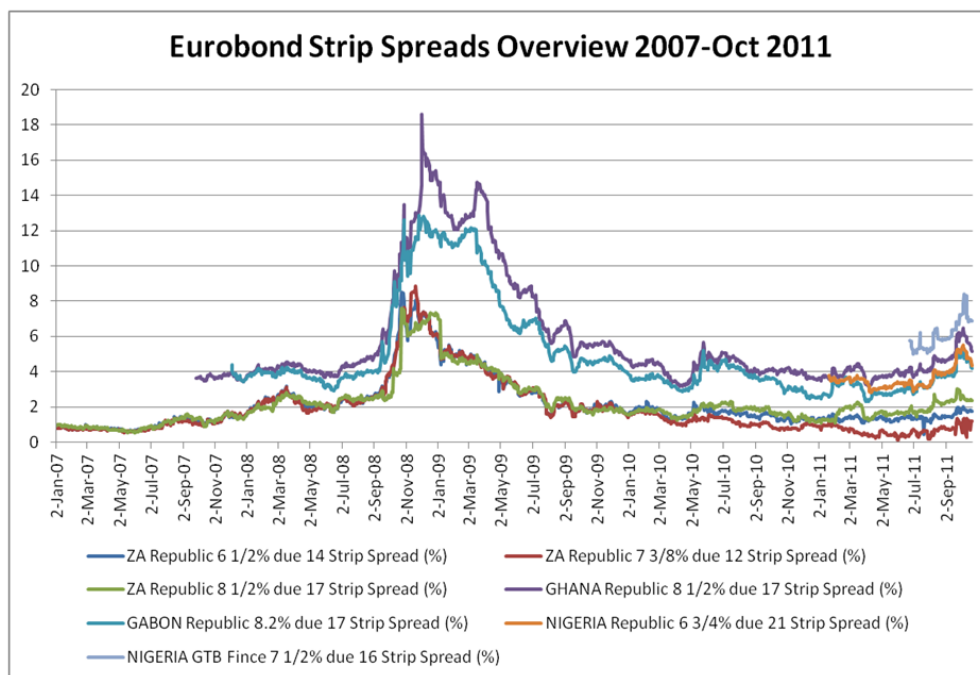
Source: BLOOMBERG

**Smaller African markets will be most affected by a reduction in portfolio flows.** In addition to significant counterparty and country risks associated with African markets, lack of size, market transparency, cumbersome custody and settlement arrangements, access to information and market depth continue to add considerable transaction costs and liquidity risk premia to investing on security markets. Most of the returning flows after the crisis were concentrated on South Africa and other more developed markets. Stock market performance over the past three years has differed between key markets. While South Africa and Mauritius recovered to pre-crisis levels. Ghana, Nigeria and Kenya remained significantly below their pre-crisis boom levels.

**Africa's recent track record strengthens the attractiveness of African markets with institutional investors.** The recent more robust performance of African economies has moved risk perceptions and explains the less pronounced impact of the European crisis on risk spreads for Africa securities (see figure below). Rather than selling off African investments at the first sign of a crisis – as happened in 2008 – African bond spreads are now moving more in line with bonds issued by other emerging market sovereigns.

**The change in risk perceptions also reflects the emergence of a significant dedicated investor base that invests purely in African assets.** In the past three years the number of investment funds with an Africa focus has increased significantly. Today more than 25 investment funds with assets above US\$ 100 million – many of them above US\$ 300 million and more - invest in Africa.

**Figure 12 – Smaller spike in risk spreads**



Source: BLOOMBERG

## Funding development – Adding China and international capital markets to the mix

**The financing needs in Africa remain large and cannot be met by the domestic financial sector alone, despite the good growth record and significant further intermediation potential.** Foreign direct investment, remittances and official development aid remain significant sources for the funding of development in the region. They cannot be replaced fully by domestic resource mobilization. Low local savings rates and weak resource mobilization remain a constraint to financial sector growth in the medium term.

**Unlike portfolio flows, other sources of external financing have proven to be resilient in the global crisis. Remittances and foreign direct investment are expected to remain relatively stable sources of funding.** Remittance flows dipped only slightly from US\$ 21.6 billion in 2008 to US\$ 20.8 billion in 2009 and exceeded pre-crisis levels in 2010. Estimates for the current year show that remittances continued to grow in 2011 and are forecast to reach more than \$US 24 billion in 2012. The impact on foreign direct investment came with a time lag: inflows declined from a peak of US\$ 37.5 billion in 2008 to US\$ 28.5 billion in 2010 but rebounded quickly and are expected to increase by 25% in 2011. Given the growth potential in mining and telecom sectors, FDI can be expected to remain high.

**Official development assistance (ODA) has been growing throughout the global financial crisis, offsetting part of the drop in other financial flows.** However, the renewed commitment of European Governments to cutting their fiscal deficits and reduce debt levels as part of the collective response to

the European debt crisis will put ODA budgets under severe pressure. Most African countries that rely on ODA to fund Government budgets lack domestic markets of sufficient depth to provide alternative financing.

**The efforts of many African countries to access international capital markets through foreign-currency denominated bond issues ('euro bonds') have been delayed by international market turmoil.** Kenya, Uganda, Rwanda, Tanzania, Angola and Mozambique delayed plans for international issuance, but are likely candidates once market conditions improve. Kenya has recently initiated a US\$ 600 million short-term syndicated loan to bridge financing expected from the postponed international bond issue. Besides South Africa, which frequently accesses international capital markets, only seven other Sub-Saharan African countries have issued foreign-currency denominated bonds in recent years (Gabon, Congo, Ghana in 2007; Senegal 2009 and 2011, Seychelles and Cote d'Ivoire in 2010 and Nigeria and Namibia in 2011)<sup>8</sup>.

**Market analysts and rating agencies remain positive as regards the market prospects for African sovereign issues.** Namibia successfully issued a Eurobond for the first time even in October 2011. More than half of all African sovereigns are rated and rating changes in 2011 were either a result of new ratings (Zambia, Namibia, Senegal) or rating upgrades.

**Funding from China and other emerging markets is likely to gain in importance going forward.** The recent US\$ 3bn China Development Bank loan to Ghana exemplifies the potential that the entry of new investors such as China, Brazil or India has for funding African growth and reducing the reliance on European financing<sup>9</sup>.

## Limited role of traditional transmission channels

### *Trade and commodities*

**While the impact of the recession in Europe and the U.S. through the trade channel was substantial for a number of countries, it was tempered by increasing diversification of African exports to new emerging markets and intra-regional markets.** A review of the composition of exports reveals that African exports benefit from a robustly diversified customer base – including a 16% share of exports within Sub-Saharan Africa. As China and other emerging markets weathered the storm, so did African exporters and their bankers.

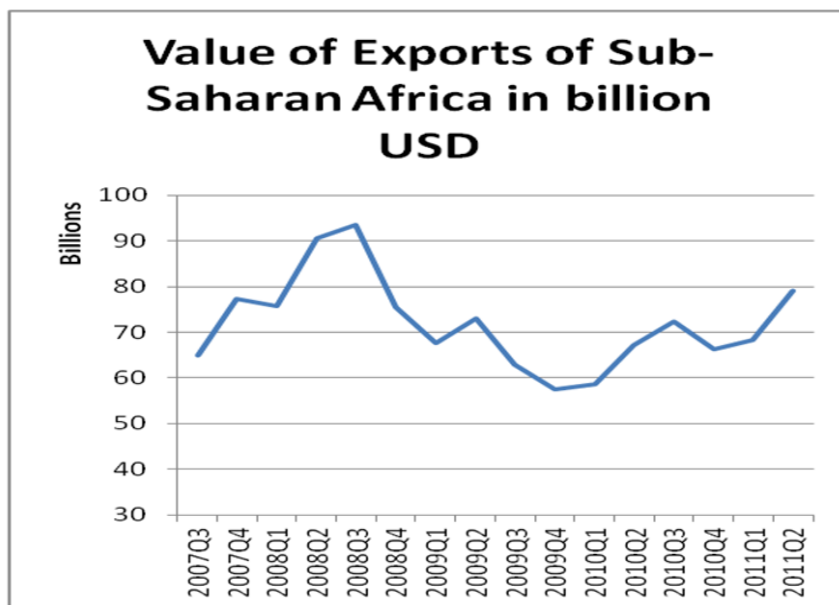
**Europe remains the largest trading partner with a share of 28% of total export value (37% of non-oil exports). However, the effects of an economic slowdown in Europe will vary across African countries.** While the share of exports to the hardest hit European economies like Greece, Ireland, Portugal, Spain and Italy accounts for only 9% across the region, some countries like Cape Verde (92%), Guinea (25%) and Mauritania (19%) have a significantly higher exposure. Further, as China's growth is showing signs of a slowdown – albeit from very high levels – the compensatory effect in export demand from East Asia may not provide as much of a buffer as it did in the 2008/9 crisis.

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<sup>8</sup> Moody's (2011), Deutsche Bank (2011)

<sup>9</sup> See also Standard Chartered Bank (2011)

Figure 13 – Exports are holding up



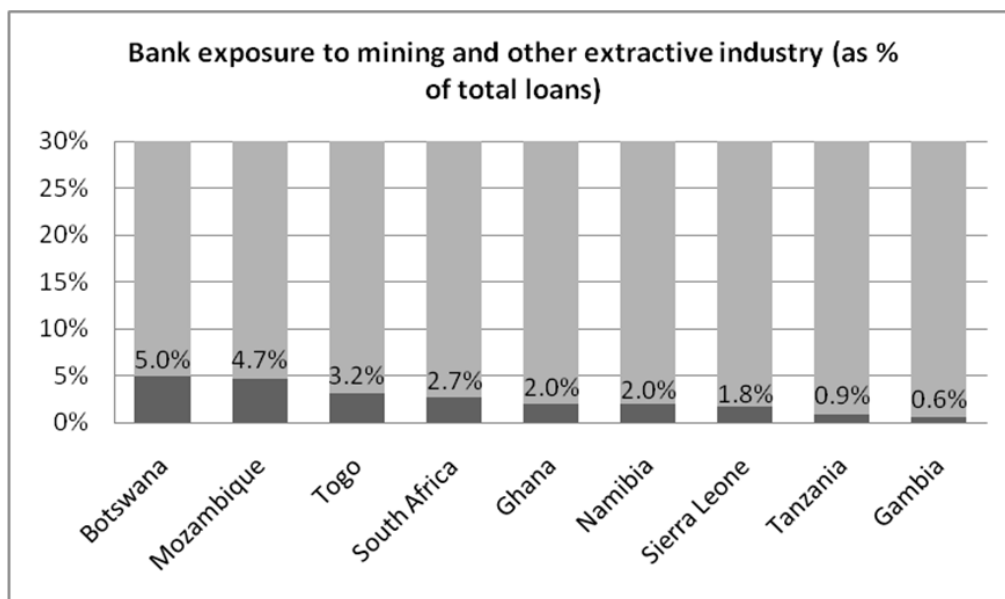
Source: UNSTATS

**The risk exposure of African financial sectors to commodity price volatility – still the main driver of African export earnings – is limited for the simple reason that most African banks do not do much business with mining companies or the oil and gas industry.** The commodity sector is dominated by large, mostly international, firms that fund themselves on international markets, are listed on international stock exchanges and revert to local financial markets only for smaller working capital and local currency cash-flow requirements. Nonetheless, looking at different country experiences it is apparent that some major commodity exporting countries also experienced financial sector distress. For example, in Zambia the fall in copper prices triggered the closure of copper mines with high marginal production costs impacting their local suppliers and resulting in more pronounced effects on overall economic performance and a significant increase in non-performing loans (see country examples in text boxes).

#### *Currency depreciation and external debt service*

**Currency depreciation is the most pronounced immediate concern in the region. The currencies of most large economies never quite recovered from the impact of the global financial crisis.** In South Africa and Mauritius, recent capital outflows prompted by the European debt crisis resulted in a repeat sharp depreciation. Low foreign reserves compound the potential build-up of future currency risks. In about a quarter of the region (12 countries), reserves provide cover for less than three months of imports and the median coverage in Sub-Sahara Africa stands currently at 3.9 months, down from 4.6 in 2009.

**Figure 14 – African bank exposure to resource industry**



Source: Central Banks

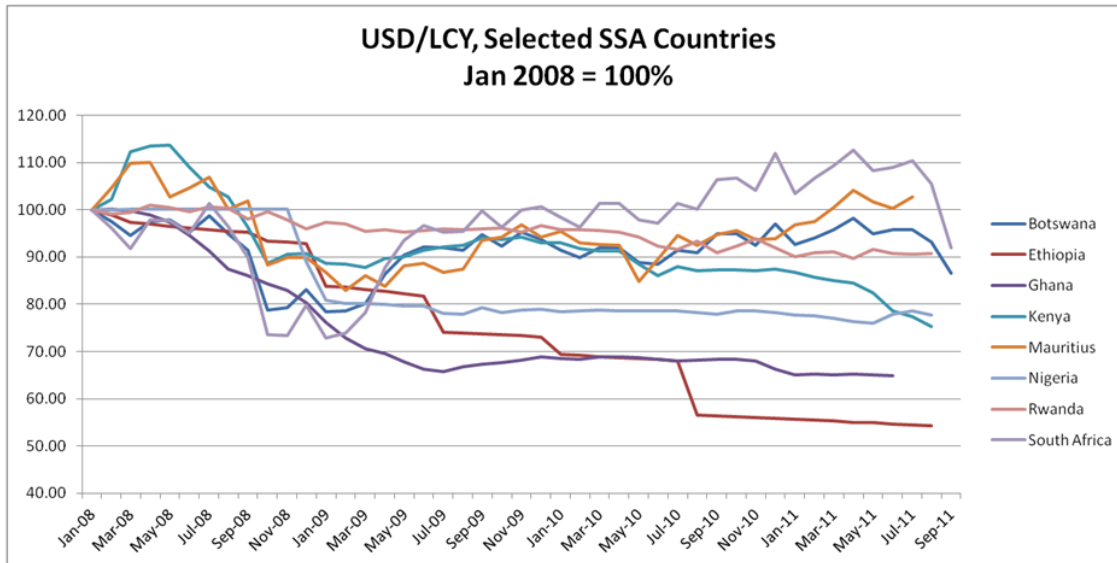
**Currency depreciations have not significantly affected bank balance sheets – and are unlikely to do so in the medium term. Governments and banks are not significantly exposed to the risks that come from mismatches between foreign currency borrowing and local currency earnings.** Currency mismatches that make it hard for banks and governments to service foreign currency obligations from a declining relative value of local currency receipts are limited as debt relief has reduced most Governments’ foreign borrowing positions and Governments and banks have not re-entered foreign capital markets on a significant scale. Moves in Nigeria, Kenya and Tanzania to cut net open positions were interpreted by market participants as measures to encourage FX sales and support local currencies rather than a response to currency risks on bank balance sheets<sup>10</sup>.

**However, increased currency volatility carries other risks for the financial sector. Although relative local currency stability has encouraged lower levels of dollarization, Africa remains the region with the highest share of deposits held in foreign currency.** Over the past decade, local currencies have become more trusted stores of value, thereby encouraging investors to increase the share of their wealth held in domestic currency. The increase in remittances to Africa can, in part, be explained by the returning confidence of the African Diaspora in the value of local currency denominated investments. A return to old habits of storing value in hard currency could hamper prospects for domestic resource mobilization and overall financial sector development.

<sup>10</sup> Standard Chartered Bank (2011)



**Figure 15 – Currencies are weakening**



Source: BLOOMBERG

**In the wake of the European debt crisis the sustainability of the CFA franc peg to the euro has become a focus of discussion and is the likely source for an additional risk premium on euro bond issues from the two francophone monetary unions.** Overall, CFA franc countries are expected to benefit from a weak euro and analyst reports consistently point to the fact that macroeconomic fundamentals, including high commodity prices, are not putting pressure on the peg and that foreign exchange reserves remain comfortable<sup>11</sup>.

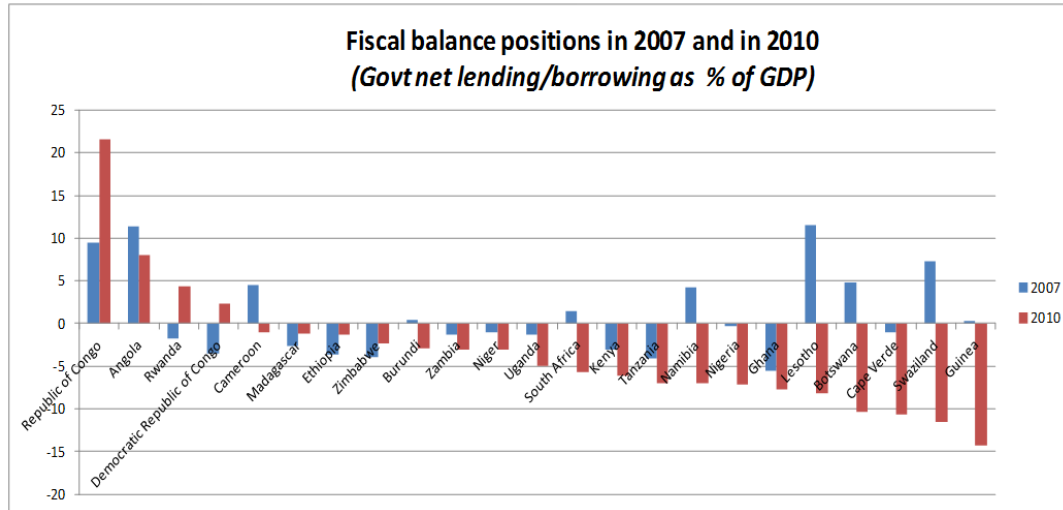
#### *Fiscal policy and monetary policy options*

**In contrast to the global financial crisis, the scope for policy options for African Governments to counteract the impact of a global recession on African economies – and by extension the indirect effect on African financial sectors – has narrowed.** Overall, Sub-Saharan Africa is currently in a less favorable position than at the onset of the global financial crisis in 2007/2008, in particular regarding the scope for countercyclical fiscal and monetary policy interventions to counterbalance the effects of a drop in demand.

**African countries are entering the new crisis phase from a weaker fiscal position. Fiscal space has narrowed.** Due to policy interventions in the aftermath of the 2007/2008 crisis, 43% of the countries have now a fiscal deficit greater than 5% of their GDP, compared to only 11% of the countries being in a similar position in 2007. The figure below shows the fiscal balance positions in 2007 and in 2010 (as as % of GDP) for select African countries, illustrating how most of them are entering the new crisis in a weaker fiscal position than at the time they entered the previous one.

<sup>11</sup> Standard Chartered Bank (2011), Citi (2011)

**Figure 16 – Declining fiscal space**



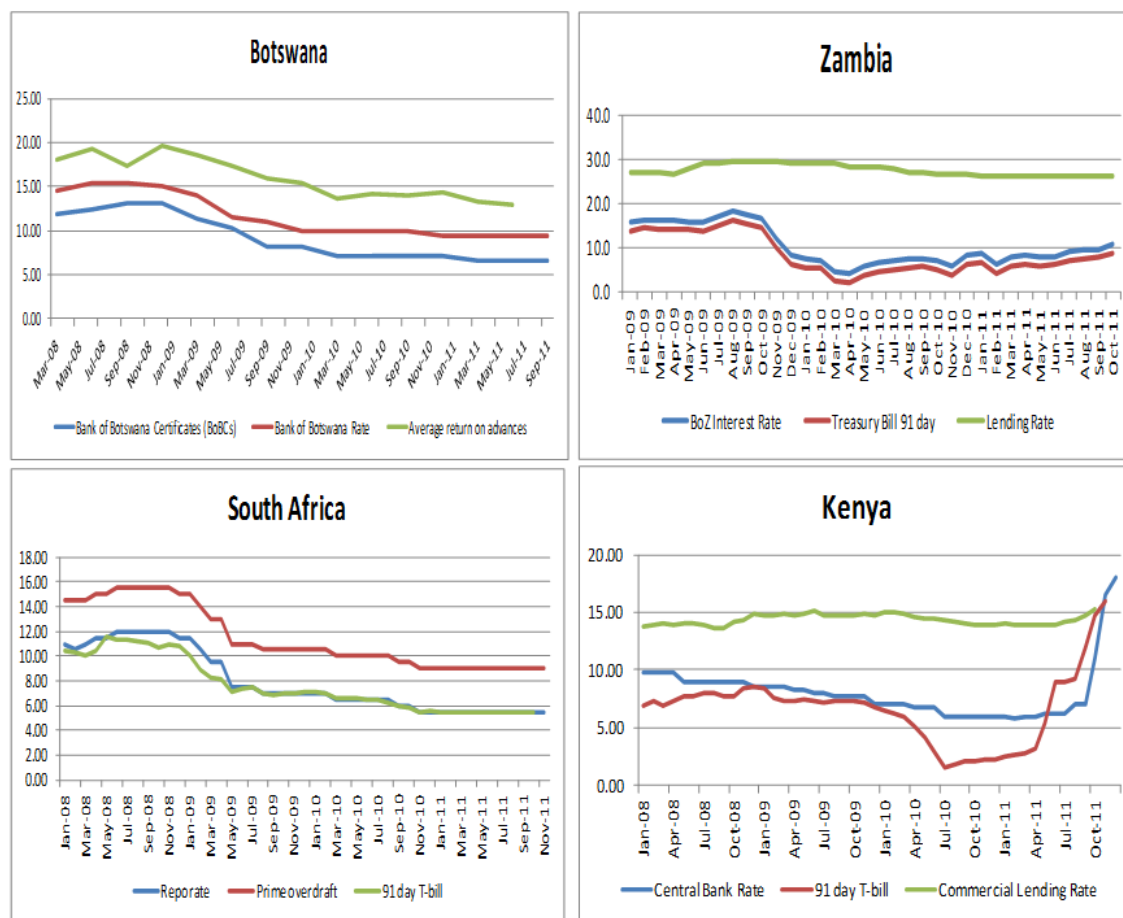
Source: IMF, World Economic Outlook database,

**Reduced fiscal space may result in crowding out of lending to the private sector as Government debt levels rise.** Were African countries to borrow to boost demand in an attempt to limit the impact of the crisis on domestic demand, they would face increasing borrowing costs thereby encouraging banks to invest in high-yielding Government debt and to limit their lending to the private sector. As debt servicing costs rise, especially in countries where there is reduced interest by foreign investors, debt sustainability concerns are likely to emerge.

**Monetary easing has proven to be a futile policy instrument in many African countries due to the ineffective transmission of monetary policy.** In the aftermath of the previous crisis, central banks of many African countries took appropriate measures to increase liquidity in their banking systems with a view to stimulating private credit expansion. However, in some countries (e.g. Zambia, Kenya) monetary policy easing proved to be ineffective, as banks did not respond by lowering their lending interest rates, suggesting limited competition in the financial sectors of these countries. More recently the fact that lending rates are reacting to higher policy rates suggests that there is asymmetry in the way the monetary policy transmission mechanism works in some countries.

**While monetary policy tightening can help to stabilize the exchange rate, higher bank lending rates may negatively impact the provision of credit to the private sector and eventually result in an overall decrease of bank portfolio quality.** Current account and inflationary pressures (resulting from global food and fuel prices and a region-wide drought in the Horn of Africa) are weakening domestic currencies and several African central banks are reacting by (sharply) increasing policy rates. Comparing the policy options available to African governments at the onset of the 2007/2008 crisis with those currently available, there is a higher probability that the real and financial sectors in Africa will be impacted by the ongoing European crisis as a result of reduced fiscal space as well as due to asymmetries in the transmission of monetary policy.

**Figure 17 – Transmission of monetary policy**



Source: Central Banks

**KENYA – Inflation dries up domestic markets, Government turns to foreign funding**

During the global financial crisis, Kenya benefited from developed domestic markets that allowed Government to borrow domestically. Government was even able to issue sizeable local bonds with 25 year maturities in 2010. The impact of rising global food and fuel prices and the region-wide drought in the Horn of Africa on inflation has diminished this source of funding stability. The annual average inflation rate increased to 12.8%, and the month-on-month inflation rate hit almost 20% in November 2011. Increasing current account deficits and inflationary pressures contributed to the continued depreciation of the Kenyan Shilling (declining by 30 percent from Q1 to Q3 2011), which reached an all-time low against the dollar in October 2011.

In response, investor demand for longer-dated instruments dried up and bond market liquidity tightened significantly. Government delayed a planned local bond issuance to avoid higher financing costs. Kenyan authorities turned to foreign sources, instead. A new large syndicated loan with foreign banks is intended to ease pressures on the local markets.

The central bank increased the policy rate in four consecutive months from 6.25 percent in August to 18 percent in December 2011 and undertook open market operations that put further upward pressure on Treasury interest rates. Liquidity in the interbank market tightened. The response as regards the interest rate on lending to the private sector and the volume of private sector credit is unclear. One of the surprising lessons from monetary easing in response to the global crisis in 2008/9 was that transmission of policy rates to lending rates broke down, indicating financial sector inefficiencies. So far, bank lending rates have not responded to the higher policy rates and credit growth continues at above 30%.

## Key policy recommendations

- **While recognizing the continued need for external funding sources to address the significant development challenges in Africa, funding strategies for the continent need to be firmly grounded on developing the ability of domestic financial sectors' to mobilize and intermediate resources.** Over the past decade, the strong performance of African financial sectors in mobilizing increased domestic funding has reduced exposure to global risks and will support higher economic growth rates going forward. Still, African financial sectors are not operating at the maximum of their intermediation capacity. They are still small in absolute and relative terms. Surveys evidencing the persistent lack of access to finance by households and firms testify to this. Moreover, while much of the focus of the discussion and this note is on the provision of credit from domestic and foreign banks, other financial services like savings, payments and transaction services are of equal importance to households and firms. Other financial institutions, including microfinance institutions, insurance, leasing companies as well as capital markets have their role to play in mobilizing domestic resources.
- **The development of local capital markets and strengthening of the domestic institutional investor base will be essential to deepen liquidity in the markets.** Deeper local markets will provide a natural source of domestic funding. They will also facilitate external funding as foreign investors require liquid markets to take longer-term investment positions. Illiquid capital markets are one of the top risks cited by global investment managers limiting their investments in Africa. In this context setting up the institutional and regulatory structure for market-based investment of domestic pension savings is of high priority in many African countries. Given the small scale of many African economies, regional approaches for capital market development will be vital.
- **Strengthening supervisory capacity and risk management capacity need to remain at the core of the reform agenda.** The most significant risk for Africa associated with the European debt crisis is that it might trigger domestic, home-made financial sector risks resulting from rapid credit growth. Supervisory resources, including qualified staff and availability of analytical tools, are limited. Enforcement capacity is weak, as many regulators are not independent in their decision-making. Legal frameworks often limit the corrective and remedial powers of supervisors. Supervisory processes focus on compliance with regulatory standards, but are not set up to identify and manage the changing risks in the banking system. The ability to monitor risks on the institutional and systemic level is hampered by insufficient data quality and reporting processes. When defining the regulatory and supervisory reform agenda in Africa, policy-makers need to carefully assess the costs and benefits of implementing international standards. Rather than applying these wholesale, appropriate sequencing and prioritization of different “building blocks” that correspond to the country-specific implementation environment, needs and risks might offer a more successful approach.
- **Cross-border supervisory issues are increasingly important for African regulators and institutional frameworks need to be strengthened on a regional and international level.** The emergence of pan-African regional banking groups has significantly increased cross-border banking activity, but effective supervision of regional financial institutions is in its infancy. Especially in the cases of

Angola and Mozambique, close coordination will also be required with Portuguese supervisors and strategies should be developed to safeguard funds held with Portuguese banks.

- **Authorities need to establish systems and processes to monitor and evaluate systemic and global risks and their possible impact on domestic financial sector stability.** This is especially important in those countries that have high systemic risk concentrations such as high exposure to the volatility of commodity exports, a high share of foreign lending or rely on portfolio inflows to add liquidity to domestic markets. Most regulators in Africa view macro-prudential regulation as a key challenge and the development of macro-prudential supervisory capacity – with the exception of very few countries – is in its infancy.
- **Governments need to carefully review the effectiveness of their macroeconomic policy instruments, especially in light of reduced fiscal space and new inflationary pressures arising from higher fuel and food prices.** The experience with policy responses to the global financial crises in African low-income countries has demonstrated the limited efficiency of the transmission of expansionary monetary policy in reducing lending rates to promote investment and the potential side-effects of expansionary fiscal policies on crowding out private sector investment. Policy interventions in the current environment of reduced fiscal space and inflationary pressures from oil and food prices need to factor in the impact on financial sector development even more.

## Conclusion and Outlook

The exposure of African financial sectors to global risks remains limited. The European debt crisis might pose some challenges to financial sector development in Africa, but not at a systemic scale. The region is significantly less exposed to European banking sector risks and the growing depth of domestic financial markets has reduced the importance of European bank funding for African borrowers. The impact of reduced global investor confidence will be more important, especially in those countries where portfolio flows add to local market liquidity.

Reduced fiscal space, inflationary pressures from higher fuel and food prices and the limited efficiency of some African financial sectors in the transmission of monetary policy limit the policy options of African Governments in responding to an economic downturn compared to the previous crisis.

Most factors that helped financial sectors in Sub-Saharan Africa withstand the impact of the global financial crisis are likely to continue to keep the region out of harm's way, but the more extended and deeper the international crisis, the weaker Africa's ability to withstand its impact – for example, further contagion that hits other large emerging markets (the BRICs) will inevitably impact African financial systems.

The most significant risk for Africa associated with the European debt crisis is that it might trigger domestic, home-made financial sector risks and the experience in Nigeria, Ghana, Angola and Zambia in the previous crisis should be heeded as a warning signal. Strengthening supervisory capacity and risk management capacity needs to remain at the core of the reform agenda.

This will be even more important as many of insulating factors that limit the exposure of African financial sectors to global risks will disappear. Banks will grow, leverage their capital more, put liquidity to work, fund themselves on international markets, integrate with global financial markets and compete with international banks for the big commodity business.

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