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Extending MSMEs’ access to trade finance under the AfCFTA

Sone Osakwe

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Extending MSMEs' access to trade finance under the AfCFTA

The African Continental Free Trade Area (AfCFTA) provides opportunities for financial sector development across the continent, but it also poses a real test for the region's financial system. An effective and functional financial sector is crucial for facilitating economic growth and integration; however, the ability of Africa's financial sector to perform this crucial function at the required scale to support the capacity of small firms to contribute to and maximize the benefits of the one African market remains shaky. The financial systems in African member countries have historically struggled to effectively mobilize funds and allocate capital. Small sized firms and low-income individuals have been the most affected as they are the most financially excluded. Only 32% of Africa's population have access to a formal bank account, as opposed to the global financial inclusion rate of 68%, even though the global rate is considerably very low. More recently though, financial technologies have contributed to a gradual improvement in financial inclusion and declining trade finance gap in the region, however, continued progress is being threatened due to the impact of the covid-19 pandemic.

In terms of opportunities, the elimination of inhibitive regulations under the AfCFTA is expected to ease cross border trade, enable capital and information flow, attract greater foreign and intra-continental investments, potentially increase capital funds, and provide a much larger customer base for financial institutions to serve. This potential new market base includes traditionally excluded micro, small and medium enterprises (MSMEs) that constitute a large share of the African economy, and are expected to be a major catalyst for increasing intra African trade and shared economic growth. However, the constraint to MSME financing is still real, requiring a more supportive business environment and collective/harmonised policy reforms across the continent to eliminate these constraints. Such intervention(s) is essential, as effective economic integration and development depends on easily accessible and affordable capital, being an important factor of production.

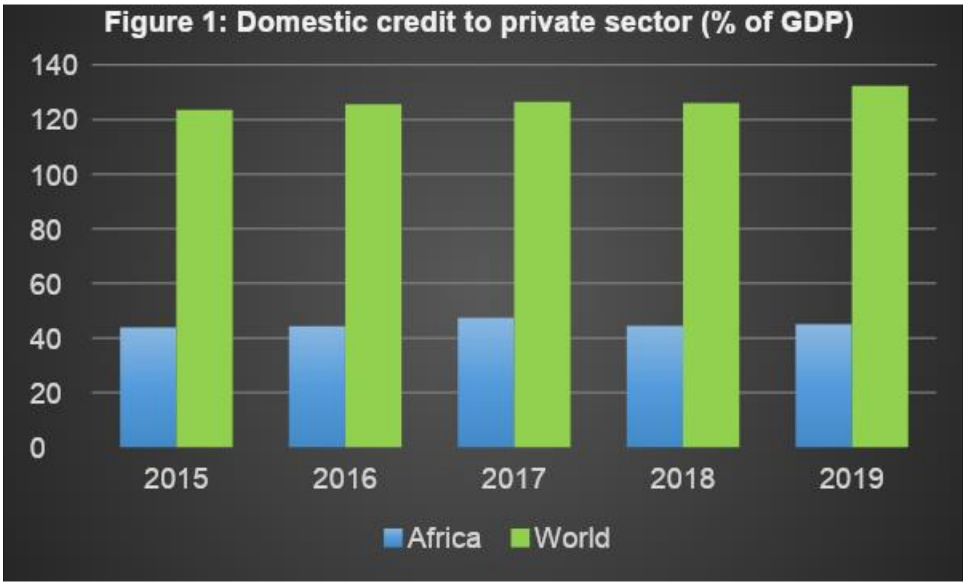
Gauging the MSME finance shortfall in Africa

About 90% of African business fall into the MSME category, accounting for at least half of total employment. Such small informal firms conduct a sizeable share of Africa's regional trade. MSMEs are therefore extremely relevant for achieving the AfCFTA goals, due to their potential for driving inclusive growth of local industries through extending capacity for exports within Africa and to international markets; such that the gains from economic integration would be more evenly distributed across the region's population.

Also, growth in the MSME sector can create a greater number of job opportunities for Africa's unemployed population, and result in a multiplier effect that boosts income for consumption, encourages vulnerable groups to save/invest, allows these groups to build assets and be more productive, increases national outputs and generally improves livelihoods. However, MSMEs operating in African countries typically struggle throughout the business lifespan, rarely transitioning into maturity phase, hence unable to attain full capacity and maximum impact on the economy.

To compete globally, financial support is required to modernize domestic industries. Business financing deficit is one of the major limitations for MSME expansion. Large companies are generally able to explore different finance options, whereas, MSMEs have limited alternatives beyond bank debts that are usually short-term, with mismatched maturity tenors. Informal enterprises in rural communities, and those owned by women, face even stiffer financing difficulties and risk slower integration into the continental market. It is therefore necessary to assess the level of financial exclusion to understand the factors that reinforce these financing gaps, to be able to successfully reduce or eliminate these credit barriers:

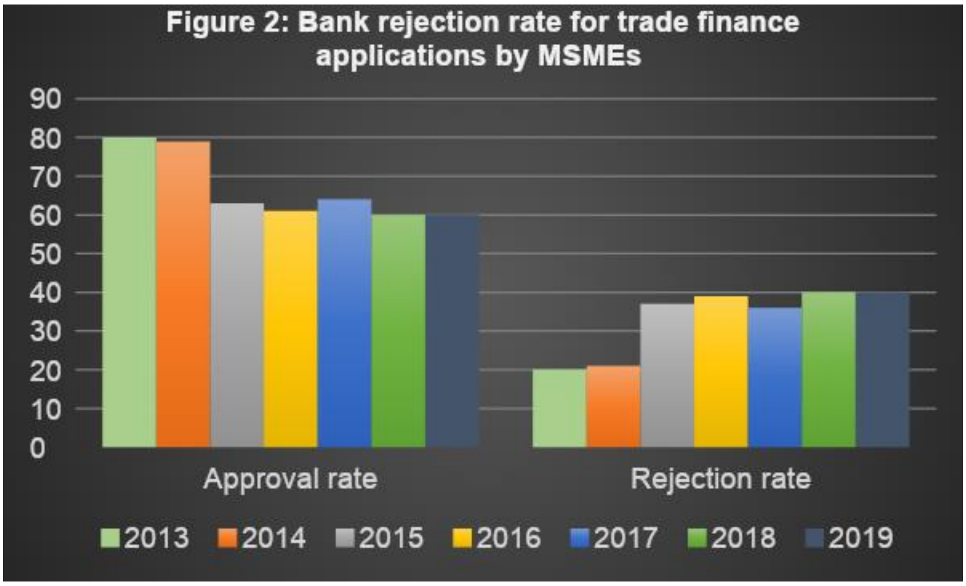
- On the average, total domestic credit granted to the private sector in Sub-Saharan Africa was below 50% of gross domestic product (GDP) in 2019, much lower than the global average of 1.3 times of GDP.



Source: World Bank datasets

The above average masks the degree of shortfall in individual countries. For instance, in Nigeria, the region's largest economy, private sector funding from domestic financial institutions was 10% of GDP. Further, the limited financing made available to the private sector on the continent continues to be skewed towards larger corporations that are considered stable and less risky.

- According to the African Development Bank's trade finance report for 2011 to 2019, bank intermediated trade-financing remains consistently insufficient across Africa, with annual unmet demand for trade financing averaging $91 billion. Although the trade finance gap is declining, the trend relating to SMEs is seemingly getting worse as shown below:



Source: African Development Bank

Specifically, bank rejection rate for applications by MSMEs for trade finance doubled from 20% to 40% in the past six years.

- The World Bank Enterprise Survey suggests that one of the factors that contributes to the growing finance gap and high rejection of applications submitted by MSMEs operating within Africa is that MSMEs are far less able to meet collateral requirements and other necessary requirements for accessing investment funding. Value of collateral required is excessive, at least twice the loan sum to mitigate credit risks. This is significantly higher when compared to other regions such as Latin America, Central Asia and Europe. The survey further reveals that usage of financial services by MSMEs with existing bank accounts is very low, due to these constraints.

- MSMEs tend to be less familiar with alternative formal financing such as venture capital or private equity, due to low financial literacy. This restricts the options available, making MSMEs resort to short-term bank loans, other forms of high-yield debt and informal sources of funds that are usually costly and insufficient.

Financial system shortcomings across the continent

Financial sector inclusiveness and maturity varies significantly at country level. An example is Democratic Republic of Congo that has only about 26% of its population able to access financial products, while the financial inclusion rate is 89% in South Africa. The size and depth of capital markets also differs; some African countries have no stock exchange while others have relatively established stock exchange. Despite the variations, there are common weaknesses of the region's financial systems that prevent the financial sector from effectively supporting MSMEs.

First, there is a poor understanding of the MSME market, which results in financial product offerings that are not suitable or tailored to their needs. One reason for this is information asymmetry as financial institutions rarely have all of the necessary information on the potential risks associated with the investments MSMEs mobilize funds for, or how the funds granted would actually be utilised; thereby creating uncertainties which could negatively impact the decision to grant appropriate credit facilities. African MSMEs scarcely have reliable credit history or assets for collateral; this makes them less creditworthy. Financial intermediaries are also reluctant to provide services to MSMEs due to the limited volume and value of transactions, making it relatively unprofitable to serve such customers.

Further, the financial system is fragmented and lacks homogeneous products. The structure of some of the financial markets in member countries, and regulatory landscape can be a deterrent to expanding services to supposedly riskier clientele. Poor risk management, limited financial infrastructure, and inefficient pricing models affect the capacity of local financial institutions to meet MSME financing. Integration with the global capital and financial markets is also limited, causing a strain on correspondent banking relationships.

Strengthening existing sources and creating new channels for MSME trade financing

For a more inclusive and stronger financial system, development stakeholders need to assess the efficiency of current regulations, laws and policies in-country and across the continent. This is necessary to determine areas requiring practical reforms that would enable the financial sector better serve MSMEs, while also building the capacities of the financial sector to maximize the opportunities from AfCFTA. Despite the downside of the covid-19 pandemic, an upside to it is reduced bottlenecks associated with decision-making at industry and national levels.
This can be used to fast track approval of financial policies and reform initiatives that might otherwise have taken longer. Policies targeted at improving credit reporting, collateral registries for movable

assets, borrower identification, information sharing, among others should be high priority. Collaboration, risk sharing, coordinated efforts and interventions would be necessary to ensure that MSMEs are not disadvantaged, but rather, are fully integrated into Africa's revamped economy and can participate favourably.

Some other considerations include adoption of financial technologies and financial advisory support. Financial technologies have so far proven to be instrumental in increasing access to finance. It holds potential for further increasing MSME access to finance through easier cross-border payments, offering unique solutions to address constraints related to asymmetric information and lack of collateral, reducing transaction cost and pooling of resources for long-term investment. To encourage greater technologically driven financial service innovations, digital inclusion is important. Investment in digital infrastructure and harmonised data governance regulations is essential to build customers' capacity and trust. Creating new and innovative finance vehicles would broaden the range of financing instruments available to different categories of MSMEs, and provide alternative and innovative finance mechanisms. In addition, financial literacy training programs and initiatives to upskill MSMEs' financial competencies could reduce the knowledge gap regarding trade finance products, and support MSMEs in identifying the right forms and means of raising capital to speed up expansion ideas and innovations that would promote efficiencies and business performance.

The AfCFTA already puts Africa on the right path to prosperity. Knowledge sharing and policy coordination, combined with unified development interventions to boost financial access for MSMEs is a continuous process. Member countries would need to be bold and willing to take calculated risks and learn from each other for faster financial sector development in order to better support local MSMEs to improve their capacity to compete in the regional and global market.