



Contemporary Issues in African Trade and Trade Finance

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Foreword

If the Founding Fathers who conceived the idea of establishing the African Export-Import Bank at the height of the sovereign debt crisis, which elevated risk aversion towards developing countries in the 1980s and set the African continent on a path of extended economic difficulties, were to revisit the international financial architecture and the state of African economies today they would undoubtedly feel vindicated by the Bank's contributions towards Africa's economic renaissance.

They would discover that the institution whose birth was inspired by the economic and social costs of the debt crisis in the 1980s has become an important force for development in Africa, helping its member countries weather the adverse effects of global volatility and commodity price cycles while at the same time supporting the transformation of African economies.

They would discover an institution that has become a major actor in the process of economic development in Africa, going beyond the maximisation of shareholder value to actively supporting the diversification of sources of growth through trade, especially intra-African trade and South-South trade as articulated by the founders of the Bank. Indeed, with a strong growth of membership approaching full continental coverage, the Bank has become a major continental player in the area of trade finance and economic integration. It has been working closely with the African Union Commission to fast-track implementation of the African Continental Free Trade Agreement (AfCFTA). It recently instituted a US\$1 billion AfCFTA Adjustment Facility to enable countries to adjust in an orderly manner to sudden significant tariff revenue losses as a result of their membership of the Continental Free Trade Area. An initiative that will go a long way to smooth the implementation of the AfCFTA.

They would also discover that the African Export-Import Bank has become a leader in financial innovation and risk management. They would discover an institution that is capitalising on the ongoing digital revolution to address the liquidity constraints and mitigate exchange risks to drive investment and boost African trade and deepen the process of economic integration. They would welcome the power of financial innovation and the capacity of the Bank to adapt to a rapidly changing global financial and trading environment.

In this Volume 5 Issue 1 of CIAT we take advantage of the Founders' Day, instituted by the Bank as a day of remembrance and celebration of the Bank's Founders for their vision and foresight, to revisit the state of implementation of the intergenerational development contract between the Bank and its Founders as well as between it and its shareholders who ultimately inherited ownership of the Bank after the Founders. We share our reflections on the significance of Afreximbank Founders' Day which is an attempt to institutionalise the process of intergenerational transfer of knowledge and history of the Bank to preserve its original vision and soul during its growth and transformation.

But the Founders' Day is also an opportunity to document Afreximbank's history and celebrate its successes while learning from its mistakes to remain on a financially sound growth path. In this regard, we highlight the leadership role played by the Bank in the area of financial innovation and the potential implications of such innovations in enhancing its relevance and support to its member countries and mitigating the adverse impact of global volatility.

After my reflections on Afreximbank's Founders' Day, the second paper highlights a wide-range of innovative financial instruments that the Bank has developed to de-risk African transactions

and crowd in funding in support of economic growth and structural transformation of African economies.

The third paper reviews the macroeconomic and financial implications of Afreximbank's Trade Debt-Backed Securities (AFTRADES), another innovative financial instrument introduced by the Bank at the height of the currency crisis in Zimbabwe.

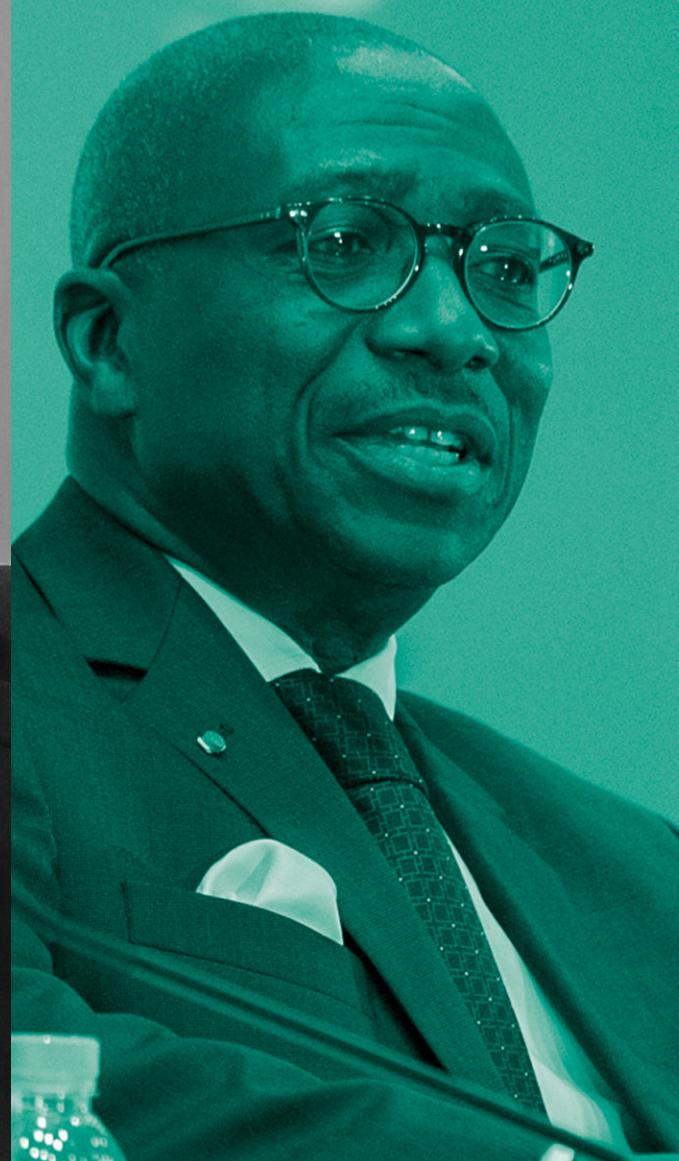
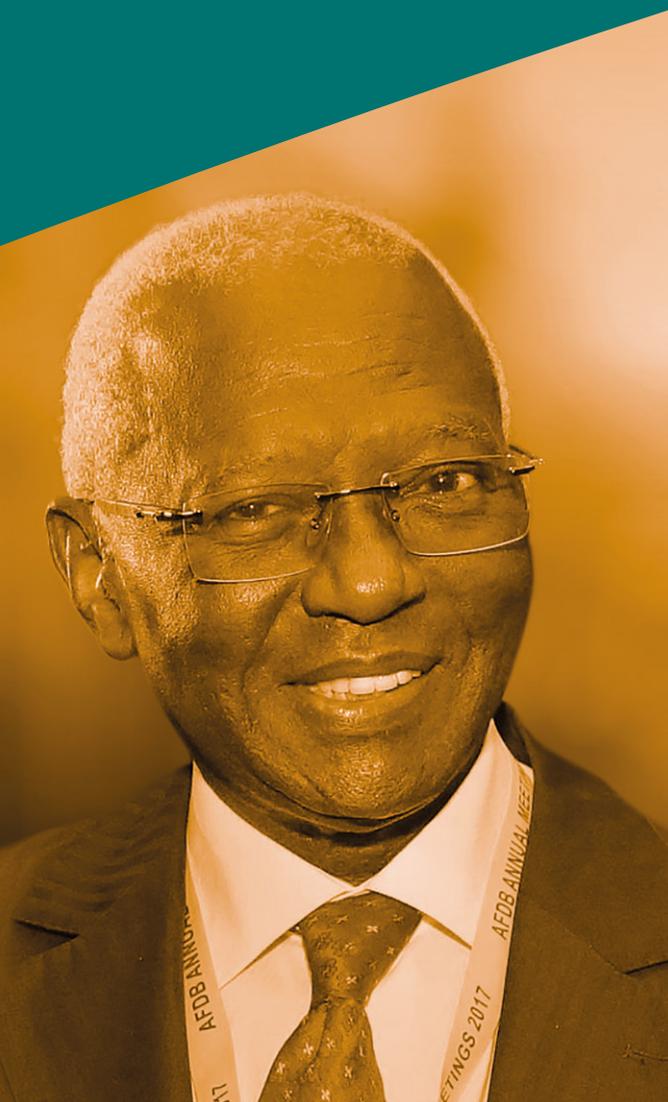
The last paper reviews recent developments in the Renminbi which is increasingly used for payment and settlement of international trade transactions with China and assesses the potential implications for African economies at a time when China has become Africa's single-largest trading partner.

I had the opportunity to peruse the different articles published under this issue of CIAT and would like to recommend them to readers. The articles are very topical and will introduce the readers to the power of financial innovations in the promotion of investment and trade in support of structural transformation of African economies. I wish you an enjoyable reading experience.

Professor Benedict O. Oramah
President and Chairman
of the Board of Directors

The African Export-Import Bank

Celebrating our Pioneering Founding Fathers



Afreximbank's Founders' Day

Professor Benedict Oramah shares his reflections and insights on the significance of Founders' Day.

Almost 25 years after the establishment of the African Export-Import Bank (Afreximbank), the Bank instituted its Founders' Day celebrations. The inaugural Founders' Day was celebrated on May 12, 2018. A subsequent celebration was held on May 8, 2019. The Founders' Day, which will henceforth be celebrated annually, provides the opportunity for reflection and introspection, to form the basis for projection into the future, while preserving the Bank's institutional memory and ensuring continuity across generations. It is also an opportunity to remember and celebrate the Bank's founders for their vision and inspiring commitment to the expansion of African trade and transformation of African economies.

In this interview with Dr. Hippolyte Fofack, the Afreximbank Chief Economist and editor-in-chief of Contemporary Issues in African Trade and Trade Finance (CIAT), the Bank's policy journal, Professor Benedict Oramah, President of the Bank, reflects on the significance of the Founders' Day. Professor Oramah joined the Bank at its inception as one of the founding staff members, and previously served as Executive Vice President for Business Development and Corporate Banking.

CIAT: Mr. President, you often talk about the critical role in the creation of

Afreximbank played by Latin America's sovereign debt crisis, which had three countries—Mexico, Brazil and Argentina, the so-called MBA trio—at the epicenter. Could you please share your thoughts about all the major forces that played a key role in the establishment of the Bank?

BO: The debt crisis only brought to the fore the symptoms of problems that Africa already had, fundamental problems that one way or the other had to be addressed if Africa was and still is to become a major actor in the global economy. In the 1980s, Africa was heavily commodity-dependent. For many countries, commodities accounted for more than 80 percent of total exports and more than 50 percent of fiscal revenues. In fact, for some countries, commodity prices defined the key macroeconomic variables, namely fiscal revenues, export earnings, reserves, and current account.

The second challenge was that of over-dependence on a few markets, with Europe accounting for more than 75 percent of total African trade. Such excess concentration exposed the continent to extreme shocks. It was the Latin American debt crisis that revealed those weaknesses. The consequence of the crisis was a collapse in commodity prices and the withdrawal of international banks from African trade finance on account of perception of excessive country risk.

When the founding fathers decided to create Afreximbank, they envisaged an institution that would be well-positioned to deal with challenges related to excessive

dependence on primary commodities, a deficit of value addition, and market concentration. They foresaw an institution that would draw on improved management of risks and global volatility to enhance Africa's integration into the global economy. The emphasis in the charter of the Bank on promoting intra-African trade and Africa-South trade reflects these considerations. The debt crisis brought these challenges to the fore and shaped the contours of the institution that emerged from it.

CIAT: The Bank that was inspired by the debt crisis became an important tool for crisis mitigation and economic transformation. It celebrated its inaugural Founders' Day last year, almost 25 years after its establishment. Twenty-five years may seem long, but we checked recently and noticed that across the continent there are very few countries or institutions where the founders are celebrated. How important is the Afreximbank Founders' Day to you and more generally, to the Bank and the continent?

BO: We are always mindful that you can only meaningfully define your future if you know your history. We use the lessons of history to shape our vision for tomorrow. If we do

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not have in place mechanisms that enable the current generation of Bank staff to systematically pass on information to those who will be running it tomorrow about what led to the Bank's creation, the institution will lose its soul. It will lose direction and potentially become a visionless and purposeless institution. The basis for addressing the challenges the Bank must tackle with courage will no longer be there.

Founders' Day is important because it gives us the opportunity to reflect on the history of Afreximbank; it gives us the opportunity to ask ourselves, "Are we actually delivering on what the founding fathers had in mind?" It gives us the opportunity to say or ask the question, "If the founding fathers who may no longer be with us rise today, would they be proud of the decisions they took 27, even 30 years ago?" It gives us the opportunity to continue to appreciate the value of visioning and commitment to Africa so that we are encouraged to take difficult decisions in dealing with challenges before the Bank and Africa today. That is the importance of Founders' Day.

Founders' Day also makes it imperative that every day when we make history, we take the time to document it. Both celebrating our successes and learning from our failures and mistakes is part of the same process and should strengthen the foundation for growth laid by the founding fathers of the Bank. We are able to celebrate our successes, we are able to highlight our failures and commit to correct any errors we may have made. Hence, Founders' Day is an opportunity to look at ourselves in

the mirror and be honest with ourselves. It is an opportunity to take stock.

So, I think it is an important day for us. Just as countries celebrate independence days, we in Afreximbank must remember our founders and the reason for our founding every day to continuously define who we are. As we invest in strengthening the process of historical accountability toward the founders, Founders' Day will become even more meaningful and useful to the work we do and to the aspirations of our continent.

CIAT: Talking about historical accountability, history has told us that it is much easier to create institutions than to preserve and sustain their philosophical and ideological foundations. For Afreximbank, which has been praised for its relevance, what are some of the risks you foresee on the path to continued relevance, especially in an increasingly competitive and zero-sum-game global economic environment?

BO: The more successful you are, the more risks you face. The risks come from so many angles. As a Bank, as you grow bigger, you need more capital. Because you want more capital, you look for more investors, public and private. When you bring in more investors, you bring different ideas into the organisation. Unless you are vigilant, the original philosophy that led to the creation of the institution becomes increasingly diluted over time. That is one of the major risks Afreximbank will face. Hence, just as we hold dear the things we believe in, every staff member,

The game of international trade is not a game of love. It is a game of survival of the fittest.

every participating state must remain true to the ideals of Afreximbank.

Otherwise, the success of the Bank can become the reason for its failure especially from the point of view of the development imperatives it was created to deal with. The success of the Bank and its continued growth will bring all those demands, whether attracting new partners or raising capital. It also will attract the attention of others. As you said, we are in an increasingly competitive world. The world may look normal to the ordinary mind, but I can tell you, it is a jungle out there. Africans must guard their own. Afreximbank is the institution that will play the critical role of helping Africa compete. The game of international trade is not a game of love. It is a game of survival of the fittest. We should never expect that any group of people will love us more than they love themselves. We must always strive to earn a seat at the table and not expect to beg to be invited to the table!

We should not expect anybody to treat us in a way that will make that person lose. We can only get what we fight for. That is why Afreximbank remains and will become an even more important tool for the continent in its quest for growth and increased competitiveness in the future. Because it is going to be a critical instrument, it should



“A collective and visionary effort to pursue results-oriented success for our beloved continent”

Christopher Edordu
Pioneer President



“This novel institution, founded on the basis of international as well as private-public partnerships, took its functional form”

Dr. Babacar Ndiaye
Former AfDB President and
Champion for the establishment
of Afreximbank

also be ready to confront global challenges and risks. How these risks are managed depends on those who run the Bank, depends on those who own it, depends on the countries that call it their instrument.

CIAT: As Afreximbank grows, so does its risk, and the positive correlation between growth and increased risk exposure should be frightening for an institution on a strong growth trajectory. Over the last 25 years, the Bank has become a global player and a key stakeholder in the development of Africa. It is praised for its innovations in trade finance and exceptional relevance and contribution to the development of its member countries. How do you feel, Mr. President, as someone who has been intimately associated with that remarkable transformation and impressive growth achieved by the Bank?

BO: Yes, thank you. I think it is not about how I feel, but about how an African citizen feels. Every African that spares a moment to look at the history of the Bank should be very hopeful about the future of our continent: a Bank that was created at the height of Afro-pessimism; a Bank that was created at the height of an unprecedented economic crisis, the type of which Africa had not witnessed until today; a Bank that

was created when many countries that were supposed to support it were struggling to survive. When I look at the statistics, I feel extremely proud. I praise the wisdom, strength of character and vision of my predecessors, the Board of Directors and, of course, the shareholders and staff.

I think every African, every child born in Africa, should take the time to look and study the history of the African Export-Import Bank. A Bank that had assets of just about US\$140 million some 25 years ago, has assets and contingent liabilities of about US\$17 billion today. A Bank that was making gross revenues of about US\$12 million in its first year of operation is about to hit gross revenues of about US\$1 billion.

But beyond creating value, we are talking about a Bank that has been able to consistently deliver on its mandate and to innovate to effectively help its member countries deal with global volatility and uncertainty. The Counter-Cyclical Trade Liquidity Facility conceived by the Bank at the height of the 2015/2016 commodity crisis, helped its member countries deal with a crisis of even greater proportion than the crisis of the 1980s. Afreximbank intervened forcefully and disbursed about US\$10 billion to key economies that helped avert the crisis. If not for Afreximbank, today we would not say that Côte d'Ivoire is the economy with the largest cocoa-processing capacity in the world. We would not talk today of Africans implementing a project of great magnitude in Tanzania, a dam constructed by Egyptian companies amounting to US\$2.9 billion financed by

Africans. If we did not have Afreximbank, the project probably would not have happened. Without the Bank being in existence, the challenges of implementing the AfCFTA would have been even greater. Africa will not be looking forward to a Pan-African Payment and Settlement System. The Bank was a child of necessity, but today it is a source of pride.

CIAT: The impressive growth achieved by the Bank was realised in a challenging global economic environment. You mentioned the commodity crisis of 2015/16, but before that we had the Euro sovereign debt crisis, we had the 2008/09 global financial crisis and the East Asian financial crisis of 1997. What have been the major drivers of that sustained growth performance and what will be the future drivers? And how do you foresee the role of intra-African trade?

BO: I would not call it rocket science, because what drove the growth was anticipated by the founding fathers of the Bank. The founding fathers expected that African governments would support the Bank, that they would give it preferred creditor treatment, which is required to operate in a difficult environment. The founding fathers expected that the Bank would be staffed by knowledgeable people, especially Africans, who understand the continent.

The founding fathers expected that a combination of all these factors would make it possible for Afreximbank to successfully tackle the problems it was created to solve, but to do so commercially and profitably. The uniqueness of its establishment

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construct means that it pursues trade development using commercial disciplines. I will tell you that the main drivers of the Bank's success have been support from its shareholders and the participating countries, plus the commitment, dedication, and hard work of the Board of Directors as well as the men and women that have worked in Afreximbank all these years.

You mentioned many crises. Afreximbank was created as a market failure institution. Each time the continent experienced a crisis, the Bank expanded its operations to support its member countries. It is to the credit of its staff that on every occasion, the Bank carried out those operations successfully, without suffering losses. All our staff members have devoted and continue to devote long hours every day to the service of the motherland, Africa.

These sacrifices and the unwavering support of member states are a testament to their commitment. Over the years, this commitment has been reflected in member countries' continuing to provide the equity capital the Bank needs and reflected in Bank staff innovating to create products that are risk-efficient and consistently relevant to member countries' needs. It is those factors that have made it possible for the Bank not only to thrive, but also to flourish. When I say flourish, I mean flourish in the delivery of its mandate and flourish in delivery

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of financial returns to shareholders.

CIAT: Returns to shareholders is the only attribute that brings you closer to Wall Street CEOs who are driven by a single mandate—raising shareholder value. In addition to raising shareholder value, you are committed to transforming African economies. In essence, you are the CEO with a dual mandate. Yet, despite the challenges associated with demands from competing stakeholders, you still find the time to enjoy music. Bob Marley and Fela Ransome Kuti's music are very prominent in your musical repertoire. Some have referred to these two great leaders as revolutionaries. What is so special about these great African artists?

BO: There is an American author and philosopher whom I like to read, Professor Frank Heywood Hodder. People say that it is revolution that brings change, but Hodder disagrees with that. He says that if nothing changed, there would be no revolution. In other words, it is change, drastic change, that brings about revolution. Bob Marley and Fela Kuti did not arise by chance, they arose because of the drastic change they saw in the African continent.

A continent that was great, a continent that had Mansa Musa, that had great kingdoms, the Kingdoms of Mali, the Kingdom of Zimbabwe, the Kingdom of Dahomey. A continent that had these great kingdoms and the great pharaohs was brought to its knees by colonialism, by slavery, and has as a result, been reduced to the periphery of the global scheme of things. Those destructions brought the drastic change. It

The game of international trade is a game of harsh competition, in which courage is needed.

is that drastic change that made Bob Marley and Fela Kuti revolutionaries, for those who want to call them revolutionaries.

But for some of us, these musicians are great and inspiring leaders. They remind us, through music, about who we are, remind us about our responsibilities to our continent. They tell us the truth about what we must do. They make sure that those who listen to them leave with some knowledge of what identity means. The identity you own, not the identity you acquire by trying to belong. It is that knowledge that helps any human being of character determine the type of contributions that he or she will make in life. Because of that, those two men are great and inspiring leaders.

I listen to them because every piece of their music has a meaning and will teach you a big lesson. A lesson on how to continue the struggle to make our continent better for those who are coming after us, because we cannot pretend that things are okay. Those of us who are in a privileged position must use that position for the good of our people. We should not be blind to the difficulties many others are facing. It is the music of Fela Kuti and the music of Bob Marley that tell it to us in our bedrooms, in our sitting rooms and in our cars.

CIAT: The importance of telling the truth. "Tell the children the truth," as Bob

Marley said in one of his famous songs. Bob Marley and Fela Kuti were both very courageous and faced adversity, at home and abroad, and yet persisted in promoting their vision for change. What role does courage play in the process of economic development, and more generally, in your commitment to making Africa great again?

BO: The game of international trade is a game of harsh competition, in which courage is needed. That takes me back to the music of Fela Kuti. When you face a big challenge, there are two options: either you summon the courage to confront the challenge, or you look for excuses and abandon the problem.

But the problem will not go away. We think we have escaped it, but it will wait for us, and pose even greater difficulties in the future. Regarding the game we are playing in international trade and development, we must consider, what are the obstacles? Unless we develop a platform to overcome obstacles, we will remain underdeveloped. Africa must have the courage to challenge the status quo and challenge the incumbents. Africa was disrupted and brought down to the lowest rungs of global development. To rise again it must find ways of economically disrupting today's established order. That will require innovation, hard work and a strong sense of purpose as an important toolkit.

Challenging incumbents is not for the faint-hearted. We must have the courage to challenge them. Unless we do that, we will remain subservient. It is only when we rise to the challenges before us that

the world will treat us with respect. It is then that we can make a better world for ourselves and others. We can have a better world for everybody on earth.

CIAT: You talked about the importance of change in the process of development. Changes are happening quite rapidly in the technological space. We have seen the rise of digitalisation, which is changing the way trade and payment systems are made. We have seen the rise of artificial intelligence, which is changing the global economic and financial landscape and the way business is conducted. How are these developments shaping the future directions of the Bank under your leadership?

BO: In today's world, any institution that ignores technology does so at its own peril. Any African institution that ignores technology faces an even worse peril. This is a continent of very young people. By 2030, almost 60 percent of the population will be younger than 25. This is a continent of 55 fragmented countries. This is a continent that is so huge that it could fit Europe, China, and the United States and still have extra land. A continent that has a combined total of 80,000 kilometers of borders.

Technology is the only way to bring the continent together, and the only thing that can bring value to any institution in the next five to ten years. That is why Afreximbank has decided not to be left behind in that race. We are investing heavily in technology because we believe that we need it for our own efficiency. That's why we have changed our core

banking system to make things much easier for all of us. And we are delivering other technological products as tools for use in implementing our mandates.

A few months ago, we launched our customer due diligence repository platform, dubbed the MANSA Platform which we hope will become a central repository for customer due diligence in Africa. We are currently populating that platform. We have just completed the testing of a Pan-Africa Payment and Settlement System (PAPSS). A platform that will make it possible for intra-African trade to be settled in African local currencies, thereby reducing the foreign currency content of the trade. That platform will make it possible for Afreximbank to clear multiple currencies.

The PAPSS will reduce transaction costs in intra-African trade and will return to the continent trade that is currently diverted out of Africa because of exchange and liquidity constraints. We also will launch this year a Trade Information Portal that will be enabled by artificial intelligence. The portal will make it possible for every business to identify customers and to know what is going on in different countries and markets. It will also identify entities in the supply chain that businesses can work with.

By next year, we plan to launch a regulatory platform to pull together all the regulatory requirements for trade and investments in the 55 African countries. We have seen examples of how technologically-driven products can accelerate intra-African trade. These innovations will

ultimately enable Afreximbank to grow faster, while remaining relevant to the African continent and its shareholders.

CIAT: As the Bank becomes more relevant, demand for its services has been growing proportionately. More recently, this has been reflected in the increasing level of cooperation between the Bank and the African Union Commission to advance implementation of the African Continental Free Trade Agreement (AfCFTA). Under your leadership, the Bank supported the launch of the AfCFTA, in Kigali, Rwanda, on March 21, 2018. The Bank also initiated several strategic initiatives to support implementation of the continental trade

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agreement. You talked about the payment systems and the Trade Information Portal, but another major initiative is the Intra-African Trade Fair, launched last year. What are the remaining key actions that should be undertaken to ensure the success of the AfCFTA?

BO: The launch of the AfCFTA is a political act. It creates a framework that will make other very critical things possible: realisation of the vision of integrating the continent through trade and investments. What we need to do now is to ensure that

more countries ratify the agreement. I am pleased that the 22 countries threshold of ratification has been crossed to make it effective. However, the few remaining holdouts should also come forward and ratify it, to complete the first phase and achieve universal coverage.

That is on the political side. The business side is even more critical and for it to work, the negotiations on tariff concessions must be done in a way that would accelerate the transformation of African economies to diversify their sources of growth and boost both extra- and intra-African trade. The rules of origin currently under negotiation are an important aspect of private sector development and will greatly enhance implementation of the AfCFTA. At the same time, it is critical to directly mobilise the business community, which will drive the process of structural transformation.

The African private sector must be fully informed about the AfCFTA and its potential implications for growth and economic development. The countries must also realise that the benefits of the AfCFTA could come slowly and the ongoing process of deepening integration could be fraught with episodic difficulties. But countries and governments should not use these difficulties as an excuse to delay or slow the implementation of the AfCFTA.

Financing is also critical for the success of the AfCFTA, and Afreximbank is playing its part in the continental drive to deepen the process of economic integration. The Bank has arranged to disburse on a revolving basis US\$25 billion worth of

Financing is also critical for the success of the AfCFTA, and Afreximbank is playing its part in the continental drive to deepen the process of economic integration.

intra-African trade by the end of its Fifth Strategic Plan in 2021. These resources will reduce the trade finance gap that has constrained the growth of African trade and will strengthen the capacity of banks to respond to the expected growth in demand boosted by increasing economies during the implementation of the AfCFTA.

Another critical factor in successful implementation is improving the quality and availability of trade information. The highly fragmented nature of Africa and its markets has made it difficult for people to know what is produced and sold across their borders. However, trade is triggered by information and cannot occur in a vacuum. Afreximbank is investing heavily in the development of a Trade Information Portal and Regulatory Portal to consistently generate and improve the content of trade information within the region.

These will stand out as the strategic investments and initiatives that drove change and accelerated the implementation of the AfCFTA, which has been the dream of the founding fathers of the Organization of African Unity and is being carried out by the Bank's shareholders, both sovereigns and corporates. We must all

work hard to ensure that the historical and development aspirations that became a reality last year begin to yield benefits and drive growth across the region. Only then will Africa become stronger and respected in the global marketplace.

CIAT: President Obasanjo once said, “Good leaders are good readers.” Mr. President, we have always been amazed at the volume of documents that flow in and out of your office on a daily basis. Many colleagues have asked, how have you sustained such high-octane energy for almost two and a half decades?

When you have committed staff with a passion for their continent, motivation can reach stratospheric levels.

BO: The key question is, what gave our officers the energy to produce all those papers I have had the opportunity to review? Our staff is working very hard. When you have committed staff with a passion for their continent, motivation can reach stratospheric levels. Africa is a continent of great opportunities and potential that have not been fully realised over the past decades. We cannot afford to hand over to the next generation a continent with potential that is never realised. Hence, perhaps the motivation

driving these staff members is borne of their commitment to secure a better future for their children, and more generally, for future generations of Africans.

The Africa generation to which I belong—born during the period of independence in the early 1960s—entered the world in a continent liberated by their fathers and grandfathers, who made tremendous sacrifices, including paying the ultimate price. These fathers had great expectations for our generation and beyond. We are working hard to deliver on those expectations. But I am even happier that the dot.com generation is smarter and working even harder to make sure that the African continent operates at the same level as others.

CIAT: Founders’ Day is also about celebrating successes. It was another year of great achievements, with increasing memberships and global recognition. The Bank now has 51 member countries, out of 55 total countries, and is nearing its goal of full continental coverage. The Bank won several awards, including the 2019 African Bank of the Year, the 2018 Trade Finance Bank of the Year, the 2018 African Impact Investing Partner of the Year, the Global Banking and Finance Awards, and the Best Project Finance Bank of the Year, just to name a few. These achievements are gratifying, and they confirm the Bank’s status as the centre of excellence in African trade and development matters.

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Welcome to Founders' Day



Development Finance Institutions Becoming Key Players in Infrastructure Financing Innovations Across Africa

Hippolyte Fofack

Chief Economist and Director Research & International
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Abstract:

Persistent fiscal deficits and challenges to private participation in infrastructure financing have widened infrastructure financing gaps across Africa and undermined the expansion of infrastructure networks to drive both productivity growth and intra-African trade. This paper outlines the increasing role of financing innovations undertaken by development finance institutions to de-risk infrastructure investments in Africa and to leverage more resources toward the sector, at a time when closing infrastructure gaps is emerging as critical for a successful implementation of the African Continental Free Trade Agreement.

Keywords: AfCFTA, DFIs, ICA, PPI

1. Introduction

From transportation to electricity networks to Internet connectivity, infrastructure deficits remain a pressing constraint to intra-regional trade, productivity growth, and economic development across the African continent. Increasingly, development finance institutions (DFIs) are stepping in to address the gaps. In some cases, they are directly financing the construction of major infrastructure networks. In others, they are leveraging resources to connect countries with

international investors willing to take risks. Together, their efforts are playing a key role in a region where population growth is driving the strong demand for infrastructure services and utilities.

The growing commitments of government-financed lending institutions are significant, but they do not come close to meeting the region's needs. Africa's road network, for example, is woefully inadequate. According to the World Bank's Rural Access Index (RAI), a key global indicator for measuring accessibility to transport in rural areas, only 34.9 percent of people living in rural Africa can reach a road within two miles of where they live, compared with 90 percent in East Asia and the Pacific. Likewise, most recent estimates show that only 6 percent of farmland in Africa is irrigated, even though irrigation has been a key driver

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of productivity growth in the agricultural sector for centuries. In Asia, by contrast, irrigation is employed in more than 37 percent of land used for agriculture.¹

Shortcomings in the power sector are estimated to drain 2 percent to 4 percent of African countries' GDP every year, perhaps reflecting the cross-cutting nature of energy in powering growth across all sectors of economic activities. But African governments, especially those in the early stages of economic development, face significant challenges in generating and distributing power enough to meet the needs of rising populations and expanding industrial activity.

According to the World Bank, some 48 countries in Africa, with a combined population of more than 800 million, generated 90GW in 2012, roughly the same amount of power as Spain, a country of 45 million. Even South Africa—the most industrialised economy on the continent—recently resorted to rotational blackouts and load-shedding in response to increasing demand for power and a deficit of available capacity.

In recent years, the need to upgrade and expand infrastructure networks on the African continent has run headlong into the challenge of persistent budget deficits, prohibitively high financing costs, and inflated risk perception. According

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to the World Bank, Africa's infrastructure financing needs will exceed US\$93 billion annually in the next decade. That is US\$48 billion more than African nations will be able to fund on their own. Other estimates of Africa's infrastructure financing needs are even higher; McKinsey Global Institute put it as more than US\$1 trillion between 2016 and 2030. However, the same institute evaluates infrastructure financing needs in Asia as more than US\$1.7 trillion annually—even though that region has significantly better infrastructure than Africa.²

Although African nations face much larger infrastructure deficits than other regions of the developing world, those gaps are not commensurate with their infrastructure financing needs as calculated by the World Bank and other major development institutions. Indeed, that disconnect may well suggest that the region's infrastructure financing gap is highly underestimated.³

1. Not only is the area of irrigated farmlands very low in Africa, its geographical distribution is also heavily skewed. Of a total area of roughly 13,000 hectares of irrigation-equipped land available in the region, about two-thirds is concentrated in just five countries, most of which are in North Africa: Egypt, Morocco and Sudan. Madagascar and South Africa also have large irrigated areas. 2. Asia is home to eight of the ten longest bridges in the world. Six are in China. The Hong Kong-Zhuhai-Macau bridge-tunnel complex connecting Hong Kong to mainland China is the longest sea crossing and longest fixed-link on earth.

This could make it still more challenging for countries contemplating raising additional resources domestically to close the infrastructure financing gap, especially in lower-income countries with narrow tax bases and persistent fiscal deficits.⁴ Alternatively, development partners have promoted increased private participation in infrastructure financing and infrastructure financing innovations led by DFIs to narrow the infrastructure financing gap and to boost infrastructure investment with a view to driving economic growth and structural transformation across Africa.

This paper outlines the increasing role of DFIs in infrastructure financing across Africa and reviews the innovation in infrastructure financing undertaken by development finance institutions across the region. After this introduction, Section 2 reviews the challenges to private participation in infrastructure financing in Africa. Section 3 discusses the increasing role of DFIs in infrastructure financing in the continent. Section 4 reviews the set of infrastructure financing innovations undertaken by DFIs to close infrastructure financing gaps and to expand infrastructure networks in Africa. Section 5 provides concluding remarks.

2. Challenges to Private Participation in Infrastructure financing across Africa

During the quantitative easing programme instituted by major central banks following the global financial crisis of 2007 and 2008, some developing countries in Africa with investment grade ratings attempted to

The number of infrastructure projects financed by private investors in Africa is significantly lower than in other regions.

close their infrastructure financing gaps by issuing sovereign bonds denominated in foreign currencies.⁵ But among most developing countries, especially lower-income countries lacking investment grade credit and where infrastructure financing needs dwarf the level of public financing available, governments more often sought to attract private financing for infrastructure development. Those governments were encouraged by the financial wherewithal of international commercial banks and institutional investors, which had more than US\$120 trillion in assets under management.

However, while governments in other regions of the world have been generally successful at tapping into this immense pool of global private savings to bridge infrastructure financing gaps through public-private partnerships and capital markets, most African countries have been less successful. Yet the limited fiscal space and narrow tax base confronting African countries makes it more difficult for them to tap domestic resources to address the infrastructure financing gap and accelerate the structural transformation of their economies.

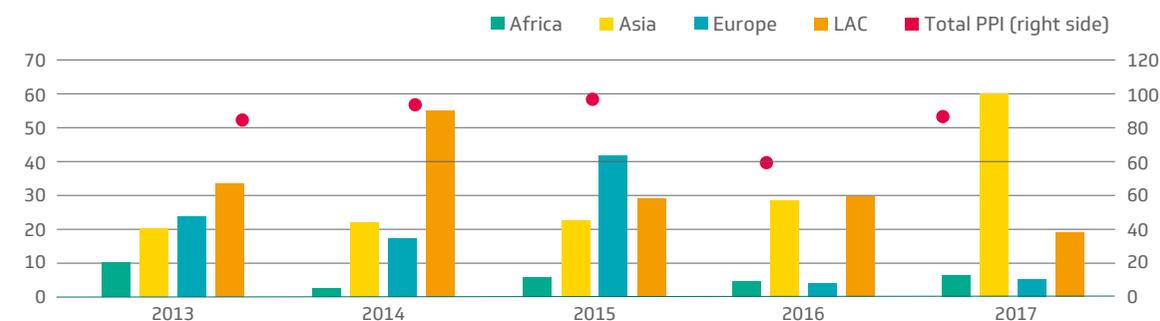
The financing difficulties African countries face are stark. Private Participation in

Infrastructure (PPI) numbers remain significantly lower in Africa than in comparable developing regions. Figure 1 highlights the distribution of PPI financing across regions during the five years ending December 2017. Both the total amount attracted, and the number of infrastructure projects financed by private investors in Africa, are significantly lower than in other regions. Asian nations received commitments for 168 infrastructure projects totaling US\$60.6 billion, 66.3 percent of global PPI investment; Latin American and Caribbean nations received commitments for 68 infrastructure projects totaling US\$19.2 billion and representing 21 percent of global PPI investments. In Africa, 49 infrastructure projects garnered

commitments totaling US\$6.2 billion—just 6.8 percent of global PPI investment.

Still, estimates of PPI investments in infrastructure projects derived from the 2017 distribution do not provide the full picture of infrastructure financing in the last five years. Granular information which takes geographical concentration and trends into account shows an even starker picture for Africa. The US\$6.2 billion of PPI investment in the region in 2017 represented a 38 percent decline from PPI investment in the region in 2013, when African countries received US\$9.95 billion. Though the largest annual cumulative investment to the region in the last five years, it pales in comparison with maximum levels recorded during the same

Figure 1: Private Participation in Infrastructure (2012-17) USD



Sources: Infrastructure Consortium for Africa (2018).

3. The World Bank calculation appears to underestimate some key components, including urban infrastructure needs which have been growing rapidly, fuelled by rapid migration from rural areas. 4. Except in a few countries, public financing of infrastructure remains very low across Africa. For instance, natural resource-rich countries such as Nigeria and South Sudan have allocated less than 1 percent of GDP to infrastructure development. 5. Several countries in the developing world took advantage of lower long-term interest rates offered as part of the quantitative easing program adopted by major central banks after the 2007/2008 global financial crisis, raising more resources for infrastructure financing through bond issuance. Over the last decade (January 2009 –January 2019) 19 African countries issued a total of US\$101.5 billion in international sovereign bonds of at least three years maturity, primarily for the financing of infrastructure.

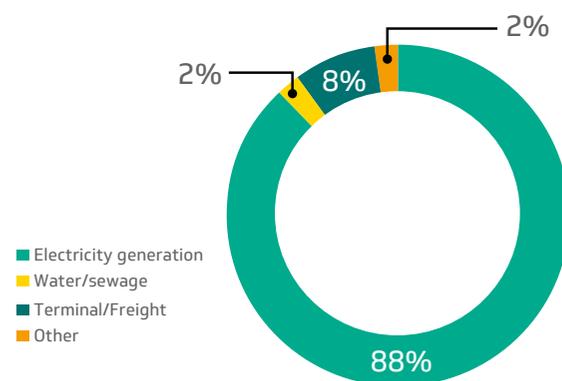
period in Asia (US\$60.6 billion) and Latin America and Caribbean (US\$55.7 billion).

At the same time, Egypt alone was the destination of 25 PPI projects in 2017, accounting for more than 51 percent of total PPI projects and 47 percent of total PPI funds invested in the region that year. The remaining 24 projects were distributed across 14 countries. The total number of African countries funded in previous years was even lower (10 countries in 2016 and 7 in 2015).

Altogether, the 49 projects targeted 15 countries, representing less than a third of the 55 countries in Africa, and perhaps indicating an uneven geographical distribution as well. In terms of sectoral distribution, power and electricity generation alone represent 88 percent of total private investment in African infrastructure, perhaps also pointing to a sectoral bias in private financing of infrastructure across the region (see Figure 2).

Part of the problem relates to the shallowness of the region's private sector and capital markets. Those constraints have limited the prospects of mobilising domestic financial resources and made it difficult to facilitate international inflows of capital for long-term infrastructure financing. Although the development impact of capital markets is increasingly recognised within the region, including by the African Union Agenda 2063, which prioritises the importance of financial markets to strengthen domestic resource mobilisation and raise development

Figure 2: Sectoral allocation of infrastructure financing in Africa



Sources: Infrastructure Consortium for Africa (2018).

The demand for infrastructure services and utilities is set to grow... as the population is projected to double in the coming decades.

financing, many challenges remain [Fofack (2019), OMFIF (2019)]. With few exceptions, most notably the Johannesburg Stock Exchange, securitised debt and derivative markets are still virtually non-existent in the region. Existing stock markets are thin, with few listed companies, and market capitalisation at alarmingly low levels of liquidity.

Another challenge is the highly-inflated perception of risk attributed to the region by investors who tend to set unrealistically high targets for returns [Fofack (2018)].

Furthermore, country and sector risks are magnified by the long-term nature of infrastructure investments, which require a proper mechanism for assessing the effectiveness of political, regulatory, and institutional arrangements. Still other challenges relate to project design and implementation, most notably the limited number of fully defined projects sufficiently developed with appropriate pre-feasibility and feasibility studies to lower risk perception and strengthen confidence among potential lenders and investors.

3. Increasing role of Development Finance Institutions in infrastructure financing

These challenges notwithstanding, infrastructure development is known to yield high returns to investors, providing relatively long periods of stable cash flows. In Africa, the demand for infrastructure services and utilities, already high, is set to grow even more as the population is projected to double in the coming decades. Reflecting this favorable risk-return trade-off, along with strong growth prospects and development impacts associated with infrastructure investment, DFIs are making investment in underserved sectors and geographical areas that would not otherwise attract significant capital. In so doing, they play an increasingly important role in the financing of infrastructure in the developing world.

Boosted by a strong commitment from these policy lending institutions and the risk-mitigating nature of their interventions, the financing of

infrastructure projects in Africa has increased significantly in the last decade, accelerating most notably since 2016. Such financing totaled US\$81.6 billion in 2017, a 21.9 percent increase from 2016, according to the Infrastructure Consortium for Africa (ICA). DFIs were the main drivers of the impressive growth. Policy lending institutions now account for more than 95 percent of external financing of infrastructure projects on the continent, up from 83 percent in 2013 [ICA (2018)].

Indeed, the exceptional increase witnessed in 2017 is driven largely by external financing, which amounted to US\$47.2 billion that year, a 30.3 percent increase from 2016. The growth of external financing greatly exceeds the rate of growth of domestic financing, which increased by 12 percent to US\$34.4 billion. The difference may suggest that development partners remain major actors in the African infrastructure landscape. China, which dramatically raised its level of infrastructure financing in the region from US\$6.4 billion in 2016 to US\$13.4 billion in 2017, has become the single most important player in the African infrastructure financing landscape. More than half the estimated

Policy lending institutions now account for more than 95 percent of external financing of infrastructure projects on the continent, up from 83 percent in 2013.

US\$19 billion of Chinese outbound loans to infrastructure projects in Africa were made in 2017 [ICA (2018)].

China alone accounted for more than 40 percent of all infrastructure finance in Africa during 2017. Its policy lending institutions—most notably China Development Bank and China Export-Import Bank were particularly active in channeling excess reserves from China’s large surplus towards infrastructure financing in Africa. Although other bilateral and multilateral policy lending institutions were also active, China accounted for almost four-fifths of all lending by DFIs towards infrastructure financing on the African continent that year. Other major policy lending institutions in the African infrastructure finance landscape include DFIs from advanced economies and multilateral institutions with the capacity to undertake large regional infrastructure projects.⁶ These institutions also have the capacity to structure principal investment matching the region’s needs and to attract international investors to distribute risks.⁷

In terms of instruments, most of these policy lending institutions primarily rely on debt financing to promote infrastructure development in developing countries, and Africa is no exception. But a few are also drawing on equity investment, the second most popular instrument after debt

financing. The CDC Group, a DFI owned by the government of the United Kingdom, is the main user and promoter of equity financing, which accounts for more than 70 percent of its total portfolios [Kenny et al. (2018)]. Equity financing by other DFIs is much lower, accounting for a marginal share of their portfolios. Equity investments represented less than 1 percent of total portfolios of infrastructure finance across Africa in 2017.

Meanwhile, a sizable amount of resources invested by these policy lending institutions in private equity funds or other financial institutions are generally passed on to sectoral investments and infrastructure development. In 2016, PROPARCO, the DFI of Agence Française de Développement (AFD) committed to investing with the CDC Group in a EUR 600 million investment fund to finance infrastructure investment projects mainly in Africa through long-term equity investment [ICA (2017)]. Nonetheless, equity commitments are typically smaller than debt commitments. They are primarily

China ... has become the most important player in the African infrastructure financing landscape

6. Most state actors are members of the Infrastructure Consortium for Africa (ICA)—an initiative launched at the G8 Gleneagles summit in 2005 to accelerate progress to meet Africa’s infrastructure needs in support of economic transformation. While constitutive membership at inception primarily included G8 countries, membership was expanded in 2011 to include G20 countries. In 2013 South Africa joined the ICA as the first G20 country non-G8 and first African country member of the ICA. 7. Among the leading multilateral institutions, the most active in the African infrastructure space include: The World Bank Group, IFC, European Investment Bank, African Development Bank, Development Bank of Southern Africa (DBSA), Banque Ouest Africaine de Développement (BOAD), and the African Export-Import Bank.



used in higher-income developing countries perceived as lower-risk destinations.

Unlike private investment, which has been limited both in terms of geography and sectoral focus, DFIs financing of infrastructure is broad. These institutions are important sources

DFIs are also playing an important role in leveraging private funding towards infrastructure financing within the region.

of direct financing in both higher and lower-income developing economies, but also in underserved sectors (water and sewage, railways as well as economic and social infrastructure). And they tend to complement each other's interventions both geographically and sectorally for convergence towards universal coverage within a given country, region or sector.

Along with power generation and utilities, Chinese DFIs are major players in financing roads, railways and economic infrastructure such as industrial parks and special economic zones. The US\$7.6 billion committed in 2016 by China Export-Import Bank in the form of concessional loans for the construction of the Standard Gauge Railway (SGR) linking Burundi and Rwanda with Tanzania, is by far the largest single infrastructure financing deal in Africa. In addition to utilities, DFIs

from other major development partners are focusing their interventions on other critical areas, most notably information, communications and technology networks, water, and transportation. Some are also financing healthcare infrastructure (CDC, AFD, OPIC) as well as manufacturing and industrial development (OPIC, JICA, FMO and China Export-Import Bank).

Co-financing among DFIs has helped mitigate risk and enhance development impact, enabling the financing of projects that no DFI would have undertaken alone. Through co-financing, smaller European DFIs can increase their investments in infrastructure projects in Africa while reducing individual portfolio exposure. Among all Western DFIs, about 45 percent of co-financed projects are regional investment projects, and most are in lower-income developing countries [Kenny, Kalow, Leo, Ramachandra (2018)].

DFIs are also playing an important role in leveraging private funding towards infrastructure financing within the region. They are raising the quantity of investment projects by partnering with private investors they can leverage either through syndications, guarantees or policy additionality. Their interventions

Co-financing among DFIs has helped mitigate risk and enhance development impact, enabling the financing of projects that no DFI would have undertaken alone.

Afreximbank has drawn on a wide range of innovative financial instruments to improve risk management and leverage more resources towards the financing of trade and trade-enabling infrastructure in its member countries.

in traditionally underserved geographical areas and sectors dubbed as too risky is deflating perceived sovereign and sector risk and aligning it with actual risk, which tends to be much lower. In the process, they are leveraging more resources from private investors to raise the quantity of investments. These institutions are also speeding up the rate of implementation of infrastructure projects through policy additionality. Their ability to provide cheaper, longer-term financing and to mitigate financial, regulatory and sovereign risks has emerged as a key incentive to leverage more private sector funding and increase project viability.

4. Innovation in infrastructure financing in Africa and outlook

DFIs are also raising more resources for infrastructure financing through innovative financing mechanisms. At the global level, one such innovative financing scheme is the International Finance Corporation's (IFCs) new Infrastructure

Initiative to scale up debt mobilisation from institutional investors and expand infrastructure networks in developing countries. Under that plan, the IFC provides credit enhancement through its first-loss tranche that creates an investment grade risk-return profile, clearing a key capital constraint in the process. Other innovative financing options involve structuring infrastructure projects as an "infrastructure asset class" to attract institutional investors, along with using securitisation techniques to lower banks' regulatory costs and free up capital availability.

At the regional level, the African Export-Import Bank (Afreximbank) has drawn on a wide range of innovative financial instruments to improve risk management and leverage more resources towards the financing of trade and trade-enabling infrastructures in its member countries. These have included transaction structuring to effectively de-risk underlying deals by providing 'first loss' capital as a catalytic risk buffer to

Afreximbank is drawing on effective international partnerships to leverage more financing in support of infrastructure development, both hard and soft infrastructure.

8. A recent review of infrastructure challenges in developing countries by the banking industry concluded that the most important binding constraint to raising infrastructure investment in emerging and developing market economies was the absence of a robust and consistent pipeline of bankable infrastructure projects ready to be implemented.

attract investors in more senior share classes; the use of insurance products to shift and distribute risks to insurance markets; a suite of guarantee products to de-risk African transactions and crowd in funding; and the use of supply chain financing to optimise cash flow and improve efficiency. For instance, they allow buyers of infrastructure equipment to optimise working capital and suppliers to generate additional operating cash flows.

More recently, Afreximbank established a Fund for Export Development in Africa (FEDA) to attract more private equity with a view to improving gearing ratios and attracting more investors. Afreximbank also launched its Project Preparation Facility (PPF) to strengthen national capacity in project development and management. The PPF is designed to fast-track the supply of bankable infrastructure projects with adequate depth and breadth of preparation.⁸ Over time, it plans to seek more private sector funding to bridge the financing gap and speed the delivery of infrastructure projects in the region.

Innovative financing schemes are also emerging from enhanced partnerships and co-financing arrangements. In this regard, Afreximbank is drawing on effective international partnerships to leverage more financing in support of infrastructure development, both hard and soft infrastructure. The partnership with German Development Bank KfW has enabled the African Export-Import Bank to expand the production and distribution of energy, especially renewable energy,

within the region. Likewise, through its partnership with China Export-Import Bank, it is supporting the development of economic infrastructures, most notably Industrial Parks and Special Economic Zones to address supply-side constraints and promote industrialisation and expansion of manufacturing infrastructure for increased value addition and structural transformation of African economies.

In addition to increasing the supply of infrastructure, innovative financing schemes developed by DFIs are also reducing the overall costs of infrastructure projects and raising the prospects of higher returns on public investment. However, these innovative approaches undertaken by DFIs and other development partners to boost infrastructure financing have several other ancillary economic benefits besides cost reduction. The diversification of sources of growth associated with the expansion of economic infrastructure and productivity enhancement will broaden the tax base. That will ultimately enable countries to mobilise more domestic resources towards infrastructure financing in the medium and long term, while at the same time reducing exposure to external financing volatility.

Expanding the tax base to raise infrastructure financing will also improve the competitiveness of African economies and accelerate structural transformation by allowing investors to take advantage of economies of scale associated with the implementation of the African Continental Free Trade Agreement (AfCFTA) [Fofack

In Africa the deployment of global excess reserves to address infrastructure development could accelerate the process of structural transformation, boost cross-border trade, and set the region on the robust and sustainable growth path needed to make a dent in poverty reduction.

[2018]]. A full ratification of the agreement will establish one of the largest single markets for goods and services in the world, with a total population of more than 1.2 billion, tapping into a broad consumer base to drive domestic demand. But growth will depend largely on the speed of development and expansion of infrastructure networks for cross-border trade and expanded industrial production.

The contribution of regional DFIs and multilateral institutions to ongoing efforts to foster innovation in the infrastructure financing landscape is narrowing the region's large infrastructure financing gap. This reflects the increasingly important role played by DFIs in infrastructure financing across the developing world, especially in lower-income countries where infrastructure financing needs largely dwarf levels of public financing and domestic resources available for infrastructure development. The trend is likely to continue, especially with a growing number of current account surplus nations drawing on DFIs to bridge infrastructure

financing gaps beyond their borders.

China's immense Belt and Road Initiative (BRI), an ambitious investment plan for trans-national and trans-continental infrastructure projects, is drawing on leading Chinese DFIs, most notably China Export-Import Bank and China Development Bank, to reshape global infrastructure financing by narrowing the infrastructure financing gap. It is already increasing the supply of utilities and infrastructure services. The number of infrastructure projects financed by the BRI increased from 31 in 2012 to 105 in 2017. It is set to grow even more in the coming years with the increasing demands for infrastructure financing associated with the implementation of the AfCFTA. Other nations, including most notably Japan, have also drawn on regional and bilateral DFIs to channel resources towards infrastructure development in lower-income countries, primarily in Asia, and more recently in other regions of the developing world.

In addition to deepening the process of globalisation and sustaining the flow of international goods, the potential development impact associated with the alternative use of excess reserves could be significant for growth and economic transformation, especially in emerging and developing market economies, where returns on productive public investments generally outperform returns on financial assets. In Africa the deployment of global excess reserves to address infrastructure development could accelerate the process of structural transformation, boost cross-

border trade, and set the region on the robust and sustainable growth path needed to make a dent in poverty reduction.

Despite its positive implications for economic growth and structural transformation, infrastructure development has a darker side. It has recently emerged as one of the main drivers of public sector debt within the region [IMF (2018), Coulibaly (2019)]. In this context, the main challenge for African governments competing for the global pool of excess reserves and savings could lie in tapping these resources and effectively deploying them to maximise their development leverage without altering the profile of debt sustainability inherited from debt relief extended to low-income and developing nations under the Highly Indebted Poor Country (HIPC) initiative.

For highly leveraged economies in Africa, a secure path to expanding infrastructure networks in support of long-term growth and structural transformation without undermining the debt sustainability profile of the post-HIPC era is to draw more on DFIs' concessional windows as well as innovative and risk-mitigating financial instruments. Blended finance, which enables concessional finance to leverage on non-concessional finance to reduce high costs related to risk-return expectations usually associated with investing in underserved markets and sectors, should be part of the financing mix. It has the potential to augment private sector engagement to narrow the growing infrastructure financing gap within the

region. At the same time, African countries should also strive to systematically follow the policy golden rule in debt contractual obligations; prioritising infrastructure investment projects generating enough income to fully clear principal and interest payments on underlying loans.

Still, financing is just one piece of the African infrastructure development puzzle. The effectiveness of public investment and returns on infrastructure financing depends on a host of factors, including the capacity to develop objective criteria for selecting the right projects, and abiding by their outcome. It is also important to develop the capacity for project implementation and evaluation throughout project life cycle. Further, while support from DFIs is speeding infrastructure development in the short term, it may well be doing so at the expense of national ownership, which could negatively affect overall returns on public investment post-implementation. It is therefore important to have strong project implementation and management teams at national levels, with expertise in optimisation of public investment in a resource-constrained environment and maintenance of infrastructure projects post-implementation to sustain high cash flows throughout the project life cycle.

5. Conclusion

The widening infrastructure financing gap across Africa has highlighted the limits of private participation in infrastructure financing. This is advocated as a possible alternative to public financing in region

where governments are confronted with persistent fiscal deficits and where the domestic private sector still lacks the financial resources to lead the financing of long-term infrastructure investment. A highly inflated perception of risk also has deterred foreign investors and led to widening infrastructure financing gaps. Over time, it has undermined the expansion of infrastructure networks to drive both productivity growth and cross-border trade.

On the other hand, development finance institutions' increasing role in infrastructure financing innovations across the region is encouraging. These financing innovations are improving risk management and, in the process, leveraging more resources toward the financing of trade and trade-enabling infrastructure across the region while at the same time reducing their costs. However, despite the benefits of these innovations, infrastructure financing remains the leading driver of public sector debt in Africa. In this context, the main challenge for African governments that are competing for the global pool of excess reserves and savings could be tapping these resources and effectively deploying them to maximise their development leverage—without altering the profile of debt sustainability that emerged in the post-HIPC era.

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African Export-Import Bank Trade Debt-Backed Securities: Restoring Confidence in Zimbabwe's Banking Sector¹

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Abstract:

An innovative financial instrument introduced by the African Export-Import Bank (Afreximbank) at the height of the currency crisis in Zimbabwe in 2015, Afreximbank Trade Debt-Backed Securities (AFTRADES) restored confidence in the Zimbabwean banking system and enhanced the role of the Reserve Bank of Zimbabwe (RBZ) as lender of last resort. By unlocking liquidity held by banks, the securities stimulated activity in the interbank market. This paper outlines what led to the success of AFTRADES and discusses implications for other countries.

Keywords: Reserve Bank of Zimbabwe, AFTRADES

1. Introduction

In the 17 years since the European Union and the United States began imposing sanctions on Zimbabwe, the nation has endured a series of punishing economic and financial crises. Aggregate output has plummeted, the economy has stagnated, and persistent macroeconomic management challenges—marked by structural balance of payment crises and episodes of hyperinflation—have led to a sharp depreciation of Zimbabwe's currency. The currency crisis, which took serious hold after 2014, engendered a sustained liquidity crunch. This further weakened the financial soundness of banks and financial institutions already affected by persistent economic contraction and defaults in the real sectors of the economy.

As the currency crisis deepened and financial sector defaults rose, Zimbabwe's financial system, previously integrated, became a two-tier system. The first tier consisted of banks that were well capitalised and supported by foreign investors. The second tier were poorly capitalised and therefore more exposed to crisis and outright bankruptcy. The emergence of that two-tier system, along with decreasing confidence that the Reserve Bank of Zimbabwe could assume its role as the lender of last resort, brought Zimbabwe's interbank market—previously one of the most vibrant on the continent—to a virtual halt, raising liquidity challenges and undermining the financing of trade and economic development.

Against this background, the African Export-Import Bank (Afreximbank), the

Trade Finance Bank for Africa, known for its leadership in financial innovation, developed Afreximbank Trade Debt-Backed Securities (AFTRADES). The securities instrument was designed to address short-term liquidity gaps and improve the soundness of Zimbabwean banks and financial institutions in support of economic growth and trade (Oramah, 2019). The instrument was introduced in 2015 at the height of a period of hyperinflation that had eroded the real value of the local currency, the Zimbabwean dollar. This paper examines the impact of AFTRADES on financial and macroeconomic management and, more generally, on the Zimbabwean economy. It also reviews lessons learned and discusses potential implications for other countries.

The next section provides an overview of the Zimbabwean banking sector at the height of the currency crisis, which eroded the real value of the Zimbabwean dollar and set the stage for a multi-currency system. Section 3 provides an overview of AFTRADES. Section 4 reviews the performance of AFTRADES and the key achievements of the securities instrument, highlighting how it helped raise confidence in the banking system. Section 5 reviews both success factors and risk mitigating measures considered by the Bank in a challenging economic and financial environment. The last section concludes.

2. Overview of the Zimbabwean Banking Sector

For years, Zimbabwe's banking system was characterised by a vibrant interbank market. Banks engaged in interbank money market activities were protected from short-term liquidity gaps, either by overnight accommodation from other banks or by the central bank, the Reserve

Beginning in 2009, persistent hyperinflation eroded the real value of the Zimbabwean dollar.

Bank of Zimbabwe (RBZ), which acted as lender of last resort and liquidity support provider. But beginning in 2009, persistent hyperinflation eroded the real value of the Zimbabwean dollar, and a multi-currency system was adopted.²

The currency crisis and the introduction of the multi-currency system severely constrained the ability of the central bank to continue to play the role of lender of last resort and liquidity support provider. As bank clients minimised their holdings in local currency and switched to more stable foreign currencies—most often US dollars to hedge against inflation—demand for foreign reserves exploded. Meanwhile, RBZ reserves dwindled,

1. This Paper draws largely from Concept Note, Operational Guidelines and Credit Studies developed by staff of the then-Trade Finance and Branches (Kanayo Awani, Gift Simwaka), Risk Management (Jetro Chitereka), Legal (Gerald Chihota), and Credit Assessment (Samuel Loum, Desire Chafa) departments of Afreximbank, with guidance from Professor Benedict Oramah (then Executive Vice President – Business Development and Corporate Banking). 2. The inflation at the time is estimated to have peaked at 79,600,000,000%.

The persistence of the currency crisis and its implications for macroeconomic instability and uncertainty.

making it difficult for the central bank to defend the Zimbabwean dollar.

Over time, the persistence of the currency crisis and its implications for macroeconomic instability and uncertainty created a two-tier market. The first was made up largely of local subsidiaries of international banks, perceived to be well capitalised and strongly supported by their foreign shareholders (the “Tier I banks”). The other consisted of locally-owned banks perceived to be poorly capitalised and susceptible to liquidity stresses (the “Tier II banks”).

As the currency crisis deepened, affecting the soundness of financial institutions, Tier I banks increased their share of banking deposits. The shift towards them was referred to as a “flight to quality”, as depositors, wary of losing their funds in the event of bank failures, moved their deposits out of Tier II banks.³ The capacity of the central bank to intervene as the lender of last resort was severely constrained by the limited amount of reserves available. The absence of Treasury bills on the market, coupled with the lack of other generally acceptable securities that might have allowed Tier II banks to access money market funds from Tier I banks, further exacerbated the problem.

The severity of the liquidity constraints facing Tier II banks in the absence of an effective lender of last resort raised the risk of a full-blown solvency crisis. The financial soundness of relatively solvent Tier II banks was also threatened by their inability to provide support to trade and other sectors of the economy and to meet short-term commitments such as customer withdrawals.

The liquidity crisis resulted in a severe gridlock in the interbank Real Time Gross Settlement System (RTGS), as Tier II banks struggled to honour their customers’ instructions to move funds to merchants and other recipients largely banking with Tier I banks in a generalised flight to quality.

There were also delays in processing payments, which in the absence of cheques in the market was largely reliant on the system for large payments.⁴ As the currency crisis morphed into the real sector, economic and social costs become even more significant. Trade shrank by 21% between 2012 and 2016 in the face of falling aggregate output and economic contraction. Social indicators, most notably the poverty rate, increased amid sustained economic contraction and widening fiscal and trade deficits.

Trade shrank by 21% between 2012 and 2016 in the face of falling aggregate output and economic contraction.

To ensure continued availability of trade finance with the view to promoting extra and intra-African trade, Afreximbank developed Afreximbank Trade Debt-Backed Securities (AFTRADES) to alleviate the liquidity challenges in Zimbabwe’s financial sector. Created in consultation with the Government of Zimbabwe (GOZ), acting through the Ministry of Finance and Economic Development (MOFED), the Reserve Bank of Zimbabwe, and the Zimbabwean banking sector, AFTRADES was designed to unlock deposits held by surplus banks, allowing access to, and use of, much-needed liquidity to stimulate activities in the interbank market.

3. Afreximbank Trade Debt-Backed Securities (AFTRADES)

The AFTRADES instrument is a United States dollar-denominated facility to promote interbank dealings amongst Zimbabwe’s banks during the currency crisis. It was designed as a collateral swap, whereby Afreximbank loans own-name debt securities to Participating Banks (PBs) against eligible collateral. The PBs obtain liquidity by pledging the related securities for interbank borrowings. Operationally, the securities can be presented for encashment at any time and are tradeable as a financial market instrument used in place of Treasury Bills (TBs) for collateralising interbank placements.

3. This fear was well founded given that 9 banks, largely locally owned, had closed down between 2011 and 2015 with many depositors losing their life savings. 4. During the period of hyperinflation, cheques had fallen into disuse, because their value would plummet between the time they were deposited and when they were processed, or cleared, into accounts. The cheque clearing system also inherently creates intrabank net exposures. Given the liquidity constraints of Tier II banks, Tier I banks became reluctant to accept deposits of cheques drawn on Tier II banks.

The operational philosophy of AFTRADES is anchored in the expectation that Afreximbank’s Securities are acceptable to the market, given Afreximbank’s investment grade credit rating and the market’s familiarity with the Bank. Afreximbank has for years worked closely with Zimbabwean banks and financial institutions, both Tier I and Tier II, directly through facilities and indirectly through syndications. The Bank’s continued support of these institutions, particularly during economic crises, has strengthened confidence in Afreximbank and the formulation for long-term engagement.

Afreximbank developed AFTRADES to alleviate the liquidity challenges in Zimbabwe’s financial sector.

In the event of default by PBs in meeting their money market obligations under the programme, the securities issued by the Bank are redeemed, and the resultant exposure is repaid from proceeds of assigned eligible assets.

The range of eligible assets include export loans, domestic loans granted to prime Zimbabwean companies, and domestic credit granted to mid-tier Zimbabwean corporations, where a PB originated the



assets. The Government of Zimbabwe, through the Ministry of Finance, is a partial guarantor to the Bank, contributing US\$20 million to supplement the Bank's resources required to liquidate any Securities presented prior to maturity.

As originally outlined, AFTRADES instruments were issued by Afreximbank directly to PBs (via RBZ as its agent). Securities were issued at the request of PBs. The PBs could either use the AFTRADES instrument as collateral to borrow funds from banks with a liquidity surplus or sell them outright to raise funds. Each PB was required to provide eligible collateral directly to Afreximbank in the form of trade-related loans or security assets, together with any associated security.

To the extent that eligible collateral had not, by the time a call was made on Afreximbank in relation to any AFTRADES instrument, generated sufficient funds to pay a claim in full, a loan for the deficit amount would be booked by Afreximbank against the PB which had requested the issuance of the AFTRADES instrument. However, during negotiation of draft documentation with surplus banks, which were mostly subsidiaries of international banks, concerns related to this structure arose. In the view of the surplus banks, the structure prohibited the use of the AFTRADES instrument as part of a repo transaction. The surplus banks either had no limits or had exhausted their internal exposure limits in relation to each of the PBs, especially given that most of these banks had liquidity

The AFTRADES facility was effective in dealing with the liquidity constraints that had adversely impacted the national payment system.

challenges and, in some cases, the liquidity constraints were the path to insolvency.

To address this concern, Afreximbank began issuing AFTRADES instruments directly to RBZ, which would then sell those instruments to surplus banks to raise funds. RBZ would then use the funds to issue loans to PBs. RBZ would accept eligible collateral from PBs for those loans as security for the obligations of PBs to RBZ. In turn, RBZ would assign the security to Afreximbank as reimbursement in the event of any call on an AFTRADES instrument.

4. Facility Performance and Key Achievements

The introduction of AFTRADES in February 2015 resuscitated the interbank market. Surplus banks grew increasingly comfortable holding Afreximbank-issued instruments. In this regard, the AFTRADES facility was effective in dealing with the liquidity constraints that had adversely impacted the national payment system, the Real Time Gross Settlement System ("RTGS"). In addition, AFTRADES brought relative stability and confidence to the banking sector, significantly contributing to the restoration of RBZ's function as the lender of last resort. Reflecting on the

impact of the facility, Dr. John Mangundya, Governor of the Reserve Bank of Zimbabwe, described AFTRADES as a "game changer".

Among the attributes and benefits of the AFTRADES facility for the Zimbabwean economy were the following:

- Afreximbank did not outlay cash directly. Contingent liabilities could be treated as off-balance sheet items.
- The introduction of AFTRADES did not conflict with the other direct lending programmes by Afreximbank in the country.
- The ease of unlocking deposits held by international banks as a result of AFTRADES provided a mechanism to utilise the country's much needed liquidity, which was otherwise lying idle.
- The facility strengthened confidence in the banking system, triggering the return of funds that had been held offshore either as a result of deepening economic crisis or lack of viable instrument.
- The securities made use of RBZ infrastructure and administrative capacity already in place, facilitating speedy deployment.

Specific benefits related to the introduction of AFTRADES for all parties and stakeholders involved in its implementation were as follows:

- Implementation of AFTRADES facility enabled Afreximbank to carry out its mandate of financing and promoting trade to help create a self-sustaining solution to Zimbabwe's currency crisis and liquidity challenges, while making use of local financial resources and capacity.
- The introduction of the facility mitigated the risks to Tier I banks of lending excess cash to Tier II banks. It was also not in the national interest for these institutions to

hold deposits offshore amidst a growing liquidity challenge threatening the entire banking system and the overall economy.

- AFTRADES became the survival lifeline for Tier II banks, as without access to liquidity, insolvency loomed.
- The facility enhanced the mandate of the Reserve Bank of Zimbabwe to ensure stability in the financial system and enhance the intermediary functions of banks.
- The deployment of AFTRADES helped Zimbabwe resolve the liquidity crisis and channel more funds to productive sectors of the economy.

5. Key Success Factors and Risk Mitigation

Among factors critical to the successful implementation of AFTRADES were the following:

- The presence of collateral swap, whereby the Bank would loan own name debt securities to PBs against assigned eligible collateral assets.
- Granting the securities a Liquid Asset status and a Prescribed Asset status in Zimbabwe enhanced their attractiveness.⁵
- The ability of third-party holders to present the securities to Afreximbank for encashment at any time, while PBs which originally issued the securities could only encash up to the value of cash in their collection accounts.
- The quality control mechanism by which Afreximbank pre-approved each PB making use of reports from the RBZ on the bank's standing as solvent and viable. The Bank also approved eligible assets.
- The appointment by Afreximbank of an acceptable local bank as the agent responsible for paying out funds under the facility.

- The designation of the RBZ as Security Registrar and Trading Platform Provider to administer the transfer of the securities via its automated clearing system.
- The Government of Zimbabwe, through the Ministry of Finance, was guarantor to the Bank for its US\$80 million participation. The GOZ contributed US\$20 million to Afreximbank to supplement resources required to liquidate securities presented prior to maturity.

The success of the facility was achieved in a challenging, risk-prone environment, and the Bank had to devise a set of instruments to mitigate a wide-range of risks, including (i) credit risk of PBs, (ii) systemic risk, (iii) paying agent bank risk, and (iv) guarantor risk.

The credit risk was the risk that PBs, which had assigned eligible assets to the Bank against AFTRADES, would default on their obligations, including money market obligations, under the programme as they fell due. This risk was mitigated through the implementation of a number of measures, including rigorous screening. The PBs were subjected to stringent approval processes whereby only solvent and viable banks were enlisted. AFTRADES resources were issued against collateral of sufficient quality and quantity to reduce downstream risks associated with eligible assets. Partial guarantees by the GOZ in the event of loss provided another risk mitigating measure.

The systemic risk was the risk that the failure of some banks could spread to others, leading to the collapse of the entire banking system. This risk was

The Zimbabwean government ... aided the success of the venture by adopting the 2015 Banking Act.

real, especially given the challenges being faced by the Zimbabwean banking system. Those challenges included:

- Medium to high counterparty and credit risk due to significant exposure to the financially distressed central bank, the drought-prone agricultural sector, and the continued economic slowdown that could lead to a significant increase in non-performing loans.
- High liquidity risk, as the deteriorating balance of payments had the potential to reduce the foreign assets of banks. The banking system was also ill-equipped to deal with temporary liquidity shocks, given there was no lender of last resort, statutory reserves deposited at the Reserve Bank of Zimbabwe were not available, there was virtually no interbank lending, and the relatively high level of country risk and sanctions precluded liquidity support from abroad.
- Solvency risks, already high, were exacerbated by liquidity and credit risks, as well as the banking system's difficulties in generating positive incomes, all challenging conditions which could lead to a rapid erosion of capital.
- Vulnerabilities specific to Tier 2 banks, stemming from poor corporate governance, prevailing liquidity crunch, low capitalisation levels, and persistent poor asset quality.

The Zimbabwean government also aided the success of the venture by adopting the 2015 Banking Act, strengthening the banking regulatory system [Denya (2018)]. The Banking Act empowers the RBZ to set prudential limits and standards for the operation of banks, impose penalties, and enforce sanctions. It also empowered the central bank to establish curatorship where appropriate in distressed banks and financial institutions, and to take necessary corrective action where banks and financial institutions were operating in an unsafe and unsound manner.

Another important challenge the Bank had to deal with was the paying agent bank risk. This risk related to ensuring that a selected paying bank would be well capitalised and supported by strong shareholders. It also mandated a strong and qualified management team, expected to safeguard the interests of the Bank. Although the facility was deployed in the context of a currency crisis and a deteriorating business environment, the default rate of participating banks was low, reflecting both the structure of the facility and a rigorous approval process.

As the final set in the series, guarantor risk would materialise if PBs defaulted on their obligations. To mitigate this risk, the Bank would call upon Zimbabwe's Ministry of Finance to repay outstanding commitments. Despite the economic challenges facing the country, this risk was considered moderate,

⁵ Zimbabwean regulations require that insurance and pension companies hold at least 10% of their assets as prescribed assets. Instruments given this status are usually deemed to be in the national interest. Liquid asset status means the instrument can be accepted by the Reserve Bank as security, especially for overnight repo purposes.

and was deemed adequately mitigated by Zimbabwe's status as a participating state and shareholder of the Bank. As such, it had ratified the agreement that paved the way for the Bank to enjoy preferred creditor status. The status guaranteed the Bank would be repaid outstanding amounts due by the government.

6. Conclusion

Afreximbank Trade Debt-Backed Securities epitomise Afreximbank's approach of applying innovative financial solutions to the unique development challenges of the African continent. The facility was particularly effective at addressing short-term liquidity constraints and promoting interbank dealings during the period of hyper-inflation and currency crisis in Zimbabwe. The success of the facility was driven by its structure,

notably the use of collateral swaps whereby Afreximbank would loan own-name debt securities to participating banks against assigned eligible assets, and rigorous eligibility criteria in the selection of participating banks.

In recognition of its innovation and uniqueness, the facility was named one of the Trade Finance "Deals of the Year" for EMEA in 2015 by Trade Finance Magazines. AFTRADES was among more than 200 nominated. This recognition further enhanced the Bank's reputation for innovation among other international financial institutions. Although the facility was developed to address specific challenges in Zimbabwe, it can be employed in other Afreximbank member countries to promote financial soundness and support economic growth and trade.

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Recent Developments in the Renminbi and Potential Implications for Africa

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Abstract:

The ascension of China to the pinnacle of global trade has raised demand for its currency, the renminbi, since it was admitted into the reserve currency basket of the International Monetary Fund in 2016. A growing number of countries, in Africa and elsewhere, use the renminbi for payment and settlement of international trade transactions with China, whose trade in goods has led the world for the past two years. The majority of African countries are also establishing currency swap arrangements with China to reduce exchange risks and further boost trade with the Asian giant, which has become their single largest trading partner.

Keywords: Renminbi, China-Africa, Reserve Currency

1. Introduction

When the International Monetary Fund (IMF) admitted the Chinese renminbi (RMB) to its Special Drawing Rights basket of reserve currencies alongside the US dollar, euro, British pound sterling and Japanese yen in October 2016, the move reflected the rise of China as a global economic powerhouse and confirmed the expanding role of China's currency in global trade.¹ Since the Chinese government introduced major market reforms four decades ago, China's economy has grown at a rapid pace, attaining its current status as the second largest in the world.² With a population of more than 1.4 billion, China is also the largest single consumer market. As its

trade in goods has surpassed even that of the United States, China has become the single largest trading partner of Africa.

Even though the use of the renminbi by governments and financial institutions is still sparse—it accounts for less than 2 percent of the IMF portfolio of global reserve currencies³—a growing number of countries are using the Chinese currency in international transactions and trade. Renminbi payments and settlements during the second quarter of 2019 accounted for 14.2 percent of China's total trade. The number of international financial institutions using the renminbi grew to 2,214 in July 2019, up from 1,989 two years before, an increase of

1. The renminbi (RMB) is the official currency of China. The yuan is the base unit of the renminbi in which transactions are denominated. Yuan also refers to the Chinese currency. For the sake of this paper, we use renminbi to refer to the Chinese currency.

2. The world's largest economy when purchasing power parity is taken into consideration. 3. IMF's Currency Composition of Official Foreign Exchange Reserves (COFER).



11.3 percent. According to the Society for Worldwide Interbank Financial Telecommunication (SWIFT), that increase is mainly the result of Chinese efforts to promote the use of its currency in Africa and other developing regions.

The use of the renminbi in international payments and settlements is on the rise in Africa.

Accordingly, the use of the renminbi in international payments and settlements is on the rise in Africa. Many African countries already use the renminbi to settle their transactions with China, and several more plan to introduce the use of the currency in trade and financial payments and settlements in the near future. The central banks of Nigeria, Angola, and Egypt have taken the significant step of including the renminbi in their portfolios of reserve currencies. The internationalisation of the renminbi has also been reflected in the increasing use of short-term reciprocal lines of credit arrangements between the People's Bank of China (PBOC) and African central banks.

While the decision by the IMF to include the renminbi in its basket of reserve currencies has played a role in the increased level of confidence in the Chinese currency, the surge in its use for international payments and settlements also reflects the relative success of financial market reforms

undertaken by Chinese authorities. The pace of such reforms to liberalise the country's capital accounts and adopt a more flexible exchange rate regime has accelerated over the last few months. Earlier this year, the PBOC took the important step of improving the allocation of capital by replacing benchmark lending rates with market-based alternatives that reward low-risk companies with lower interest rates. Other major reforms taken by Chinese monetary authorities this year include scrapping limits attached to the Qualified Foreign Institutional Investor (QFII) cross-border investment programme and allowing the US-based credit ratings firm S&P Global to start scoring domestic Chinese bonds. These reforms not only allow licensed international investors to invest as much as they want in Chinese stocks and bonds, but they also deepen Chinese capital markets by reducing liquidity risk. In so doing, they are likely to further raise the profile of the renminbi in global trade and finance.

This paper is organised as follows: Section 2 provides an overview of the changing composition of global reserve currencies. Section 3 reviews the growing role of the renminbi in the international payments system. Section 4 discusses the potential drivers of increasing demand for the renminbi in Africa. Section 5 concludes.

2. The Changing Composition of Reserve Currencies

The rise of China as a global powerhouse over the past two decades is perhaps the

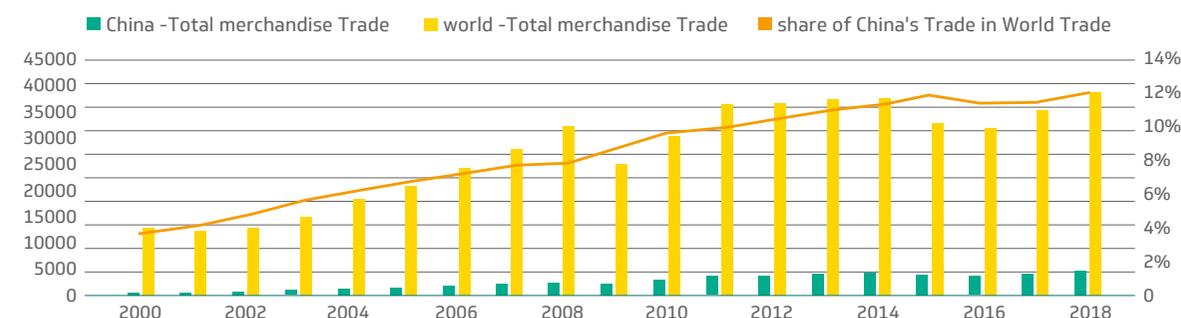
The rise of China ... is perhaps the most important economic and political development in modern history.

most important economic and political development in modern history. The export-led growth model successfully adopted and implemented by China over three decades has fundamentally changed both the structure of its economy and the global economic landscape. The country has achieved tremendous productivity gains and accumulated substantial foreign reserves. This export-led growth model fuelled Chinese GDP growth rates averaging more than 10 percent between 1991 and 2013, before slowing down to an average of 7 percent since 2014.⁴

China's GDP grew from about US\$400 billion in 1990 to US\$13.4 trillion in 2018.⁵ And in

the past two years, China has become the world's leading trading nation. According to estimates by the United Nations Conference on Trade and Development (UNCTAD), China's total merchandise trade increased from US\$474 billion in 2000 to US\$4.10 trillion in 2017 (Figure 3), compared with US\$4 trillion for the United States.⁶ In 2018, China accounted for about 12 percent of global merchandise trade compared to 4 percent in 2001, the year China acceded to the World Trade Organization (WTO). Becoming a member of the WTO allowed China to integrate into the global trading system and leverage its comparative advantage of abundant and cheap labour to attract investment and drive export-led growth. Although growth rates have decelerated over the past few years as its economy rebalances, China is still experiencing robust output expansion, with growth expected to average around 6 percent per annum in the medium term.

Figure 3: China Trade with the World, in US\$ billion (2000-2017)



Source: UNCTADStat

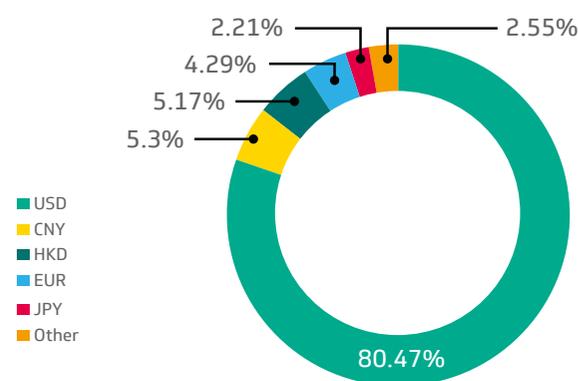
4. IMF's World Economic Outlook Database, April 2019. 5. In current prices.

6. Estimates available on <https://unctad.org/en/Pages/Statistics.aspx>.

China is still experiencing ... expansion with growth expected to average around 6 percent per annum in the medium term.

This remarkable economic and trade performance has raised the status of China's currency and boosted its use internationally. According to the PBOC, the renminbi was used for trade in more than 100 countries in 2018.⁷ The value of trade deals settled in renminbi stood at approximately US\$620 billion in 2016, accounting for 17 percent of China's total trade. Most of China's top trading partners are increasingly using the

Figure 4: Global usage of currencies in payments ending in China, 2017



Source: SWIFT Watch (2017)

renminbi in their trade with China. South Korea uses the renminbi in more than 85 percent of its trade with China. Canada,

Singapore and the United Arab Emirates use the Chinese currency in more than 30 percent of their trade with the Asian giant.⁸ However, the share of payments in renminbi for trade with the United States, China's single-largest trading partner, accounting for about 14 percent of China's total trade, remains below 5 percent.

Reflecting the status of the renminbi in the international monetary system, the IMF in 2016 admitted China's currency into its Special Drawing Rights basket (SDR), alongside the US dollar, the euro, the Japanese yen and the British pound sterling. The move reflects the important role of China in global financial and trading systems as well as reforms made by monetary authorities in the country.

The IMF in 2016 admitted China's currency into its Special Drawing Rights basket.

The inclusion of the renminbi in the SDR enhances its attractiveness as an international reserve asset and is likely to boost global demand for the currency.

For a currency to be included in the SDR basket, it must be issued by a leading export nation playing a major role in the global economy and be freely usable for international payments and on global exchange markets. According to the IMF, the renminbi's inclusion in the SDR basket

recognises efforts by China to move to a managed floating exchange rate and to institute financial reforms. These reforms include the relative opening of the country's capital account and improvements related to the infrastructure and accountability of its financial markets.

At the end of the first quarter of 2019, the Chinese currency accounted for about 2 percent of global reserves, according to the IMF. About 61 percent of global reserves (US\$6.6 trillion) are held in US dollars and about 20 percent (US\$2.2 trillion) in euros. Although that makes the US dollar the dominant reserve currency worldwide, its share has been steadily decreasing over the past few years, reflecting a drive towards diversification by central banks and reserve institutions. In addition to reaping the dividends of better diversification of their reserve portfolios, the increase of the share of other reserve currencies, including the renminbi, in the portfolios of central banks reflects the growing use of those currencies in settling international trade payments.

3. The Renminbi in the International Payment System

As China increasingly promotes and encourages the use of its currency in settling transactions with its trade partners, the renminbi is gaining a more prominent position as a payment currency in global transactions. Large banks

and corporations around the globe are already setting up strategies to facilitate the use of the Chinese currency.

Most of China's top trading partners are increasingly using the renminbi in their trade with China.

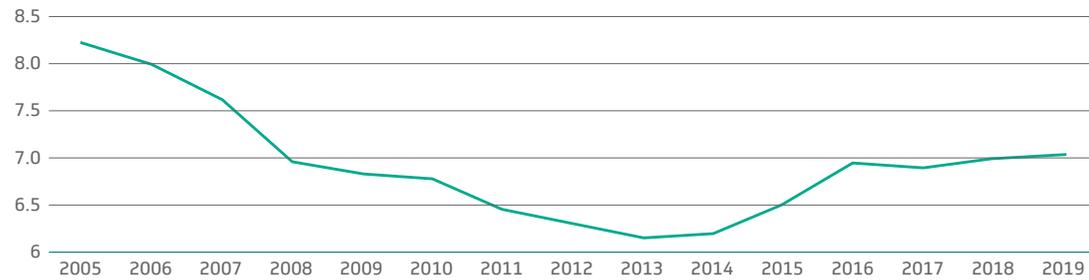
The use of the renminbi has expanded to a wide range of activities, from payments and collections to liquidity and cash management. Although Hong Kong remains the global hub for renminbi transactions, a growing number of cities around the world are also becoming offshore renminbi centres. For instance, Frankfurt is emerging as a European hub of renminbi-related activities, such as clearing and cash management. Given the complexity associated with settling and clearing transactions in renminbi, the dissemination of information about the currency has also improved significantly and helped create better understanding for entities to make decisions about managing a portfolio of currencies which includes that of China.

On global foreign exchange markets, the renminbi is increasingly serving as a roadmap for other major currencies, which tend to track movements of the Chinese currency against the US dollar.

7. The People's Bank of China (PBOC) is the central bank of China.

8. SWIFT (2018): RMB internationalization: Where we are and what we can expect in 2018.

Figure 5: Exchange Rate RMB per one USD (Jan.2005-Nov.2019)



Source: Bloomberg (2019)

A stronger renminbi often implies the US dollar is weaker against other currencies. The appreciation of the renminbi since 2017 partly reflects ongoing efforts by Chinese authorities to gradually boost the currency as a global player (Figure 3). However, the PBOC has maintained a balanced approach so the renminbi does not surpass a certain “psychological” threshold (estimated by markets at around 7 per USD).

The gradual appreciation of the renminbi, as well as its restriction within a certain range, is also designed to promote macroeconomic and financial stability in the Chinese banking system. Major factors perceived by international investors to have significant influence on the renminbi foreign exchange markets are the capital and currency controls in China. As these continue to relax, the currency’s prospects on those markets will become even brighter. Already, the renminbi is the most traded currency among emerging market economies and the world’s eighth most actively traded.

Another major factor affecting the progression of the Chinese currency is the rapid rise of large Chinese technology corporations. Huawei, Alibaba, Tencent, Xiaomi and Baidu are successful Chinese technology firms with global operations. In addition to their active role in global and regional value chains, these companies are fostering the widespread use of payment systems globally. For instance, Alipay, the digital payment arm of Alibaba, the world’s second largest e-commerce company, has more than one billion users worldwide. With a strong and well-established domestic presence, Chinese technology companies are expanding their international networks rapidly. Alipay has agreements with Asian countries, as well as the United States, to allow Chinese citizens to make payments through the platform when travelling abroad. WeChat Pay, the digital payment platform of Tencent, which accounts for about 40 percent of the Chinese market, is accepted in more than 15 countries.

Together, Alipay and WeChat Pay processed US\$2.9 trillion of digital payments in 2017, up from US\$82 billion in 2012.

The Belt and Road Initiative (BRI) could also contribute to a wider acceptance of the renminbi internationally. As BRI projects span many countries in Asia, Africa and Europe, China has the motivation and leverage to impose the use of its currency to finance BRI-related projects. Given the substantial investments required to undertake these projects, estimated at about US\$1 trillion, Chinese banks are stepping in to close transactions denominated in renminbi. Chinese authorities are also encouraging financial institutions to use renminbi in their overseas funding of BRI-related projects.

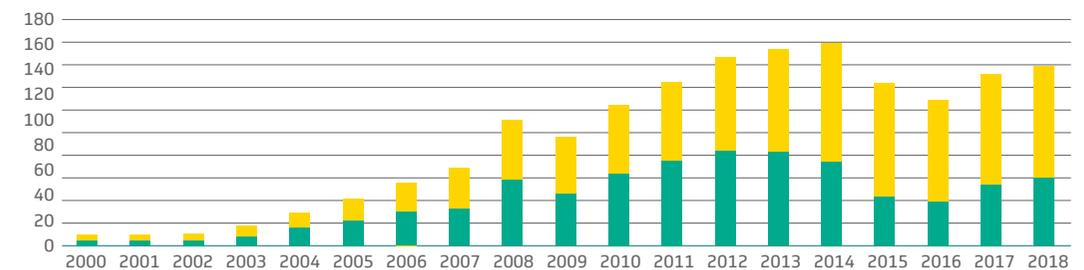
Commodity trading is another area in which the Chinese currency is playing an increasingly prominent role. In the oil sector, for instance, Russia has shifted towards the use of renminbi in settling its oil transactions. Other countries could potentially follow suit, given that China

is the world’s biggest importer of the commodity. After launching renminbi-denominated crude oil futures contracts on the Shanghai International Energy Exchange (INE) in March 2018, China is aspiring to price more oil contracts in its currency.

4. The Use of Renminbi in Africa

Over the past two decades, China has become Africa’s leading trade partner. Trade between Africa and China increased by more than fifteenfold between 2000 (US\$8.4 billion) and 2018 (US\$182.5 billion). Despite its surge of exports to China, Africa’s trade balance with the Asian powerhouse has been persistently in deficit throughout the period, given the dominance of value-added imports from China and pre-eminence of natural resources and primary commodities, which are subject to price volatility, in African exports. The trade growth has also been uneven within African countries, with four countries, Angola, Egypt, Nigeria, and South Africa accounting for about 50 percent of total African trade with China in 2018.

Figure 6: Trends in Africa-China Merchandise Trade, 2000-2017, in US\$ billions



Source: UNCTADStat.



The growth in trade between the two partners has translated into a substantial increase in investments and financial inflows from China to Africa. China has become the continent's fourth largest investor, with its total foreign direct investment valued at US\$72 billion between 2014 and 2018. Net cross-border mergers and acquisitions by Chinese companies in Africa were US\$1.3 billion in 2017, a decrease from 2016 but still second largest after those of United States firms. China is a strong investor in both industrial parks and special economic zones across the continent, and has invested in an estimated 230 existing facilities, with plans to commit more funds to others under construction.

Between 2001 and 2017, Chinese loans to African countries grew from less than US\$1 billion to more than US\$10 billion per year. Through various initiatives, including the BRI and the Forum on China-Africa Cooperation (FOCAC), among others, the government of China has pledged substantial financing to support African economies. Total pledges by China to Africa amounted to US\$80 billion in 2018, with US\$20 billion in the form of lines of credit, US\$15 billion in direct aid and interest-free loans, US\$10 billion in development financing, US\$10 billion in direct investments, and US\$5 billion in import financing. Chinese lending has played an instrumental role in supporting infrastructure development, as well as in many other strategic economic sectors across the continent.

The transformation of the China-Africa relationship over the past two decades has been significant both in depth and breadth. Given the expanding scale of trade and investment, an increase use of renminbi across the continent should be the natural outcome. Yet the renminbi is not the preferred currency of payments and settlements for transactions between China and Africa. Moreover, even though renminbi-denominated bonds offer higher returns than US and European bonds, they are not as popular. This is due to uncertainty over the full liberalisation of the country's capital account, the prohibitive costs of switching US-dollar-denominated African foreign reserves into renminbi, and the potentially higher transaction costs of holding renminbi compared with US dollars, given the unmatched depth and liquidity of US capital markets.

In early 2010, the Bank of China (BOC) successfully closed its first African trade finance loan denominated in renminbi. Through its operations in Zambia, BOC was the first Chinese bank to provide commercial banking services in renminbi in Africa. These services included, among others, renminbi-denominated accounts, deposits, loans, and trade finance. Since then, BOC and other financial institutions have stepped up their use of the renminbi in Africa. In July 2015, the BOC established the first African renminbi clearing house, in South Africa. This was followed the same year by another, in Kenya. In August 2016 the clearing house of the Common

Market for Eastern and Southern Africa (COMESA) included the renminbi for the first time in its Regional Payment and Settlement System (REPSS).

In order to further encourage the use of the renminbi in Africa, many Chinese exporters are offering discounts of up to 5 percent to their African counterparts to encourage them to invoice in the Chinese currency. The adoption of the renminbi to settle transactions between African and Chinese entities will reduce the costs of trade, as well as mitigate foreign exchange losses due to risks associated with converting African currencies to renminbi through a third currency, typically the US dollar. In addition to reducing the severity of US dollar shortages, recurrently faced by African countries,

Trade between Africa and China increased by more than fifteenfold between 2000 (US\$8.4 billion) and 2018 (US\$182.5 billion).

direct usage of the renminbi in trade transactions reduces the cost of currency hedging related to futures contracts.

In 2012, African central banks and other investors were allowed access to renminbi-denominated assets, after the China Development Bank allocated a purchase quota for the currency in its 3-year bond

issuance. Since then, the central banks of Nigeria, Rwanda, Tanzania, and South Africa have included the renminbi in their foreign exchange reserves. The Bank of Tanzania holds about 5 percent of its total reserves in renminbi. Other countries, such as Kenya and Zambia, have announced their intent to include the renminbi in their baskets of official reserves, while others signed swap agreements with China. Following a three-year US\$30 billion arrangement with South Africa in 2015, and a three-year US\$2.62 billion arrangement with Egypt in 2016, Nigeria and China signed a three-year US\$2.4 billion (CNY15 billion / NGN720 billion) arrangement in June 2018.

By including the renminbi in their reserves, African countries could lower the costs of trade transactions, improve working capital management and attract investment flows from China. Buying Chinese bonds denominated in renminbi also offers better investment returns for African central banks than bonds issued by the US or Europe. For obvious reserve management reasons, African central banks are targeting top quality bonds issued by the Chinese government and Tier 1 Chinese banks. However, the development of Chinese corporate bond markets will create new investment opportunities, especially for African reserve managers.

Wider adoption of the renminbi as a reserve currency by African central banks would not be without challenges, however. In addition to competing with well-established reserve currencies, such as the US dollar and the

euro, the renminbi faces competition from other countries looking to expand the presence of their currencies across the continent. Japan, Russia, and South Korea have all shown great interest in boosting economic and trade ties with their African counterparts, with the possibility of them pushing for the use of their currencies in payments and settlements of trade transactions. Geopolitics could also slow the process of switching to the renminbi as a reserve currency by African countries.

The lack of liquidity on Chinese bond markets in comparison to the US and Europe is another factor that could limit recourse to the renminbi as a reserve currency. Central banks usually value the ability to easily adjust the composition of their reserve portfolio at low spreads, reflecting high liquidity. While progress has been made recently with investments in Panda bonds, one of the main vehicles to invest in renminbi-denominated assets that would count as reserve currency, they remain associated with uncertainty and low liquidity. However, currency swap agreements between central banks could ease potential liquidity problems linked to investment in renminbi. In addition, major global index providers, such as JPMorgan, MSCI and Bloomberg, have included or plan to include renminbi bonds in their emerging markets government bond indexes. Such moves would boost demand for Chinese bonds by foreign investors who wish to match the performance of these indices in their portfolios.

5. Conclusion

The remarkable rise of China as a global economic powerhouse has raised demand for the renminbi on currency markets. Since its admission in the IMF reserve currency basket, the renminbi has gained prominence among central banks, international institutional investors, exporters, and importers. The currency is increasingly being adopted in global payment and settlement systems and now accounts for a large proportion of international trade. Several African central banks have included the renminbi in their foreign exchange reserve baskets. The proliferation of swap arrangements between China and African

By including the renminbi in their reserves, African countries could lower the costs of trade transactions, improve working capital management and attract investment flows from China.

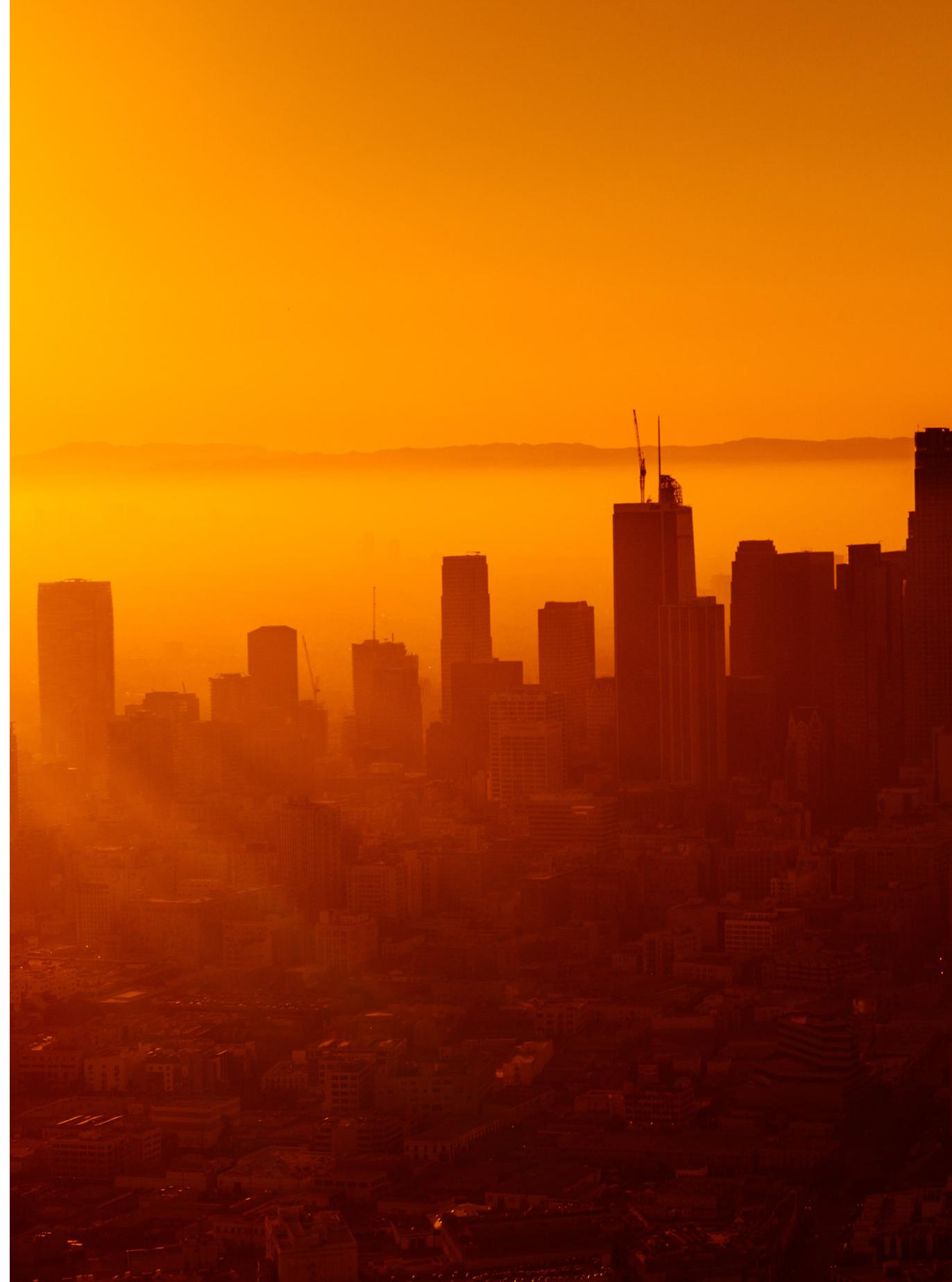
countries is also increasing the alignment of trade and financial flows between the Asian giant and its African partners.

The benefits of expanding the reserve basket holdings of African nations to include the renminbi are significant, especially in terms of reduction of trade costs, higher returns on renminbi-denominated bonds, as well as foreign exchange and liquidity risks. However, the use of the renminbi in Africa remains relatively low compared with other regions. That said, the prospects are positive, especially in light of increasing investment and capital flows between China and Africa.

Ongoing efforts by the PBOC to liberalise China's capital account and move toward a more flexible exchange rate regime are positive steps. The successful launch of renminbi-denominated oil futures contracts also could increase prospects of pricing other commodities, which account for the lion's share of African exports, in renminbi. At the same time, increasing the network of Chinese banks operating in Africa also could serve as a catalyst.

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