Transcript of IMF podcast:

Luc Eyraud on Wooing Investors to Africa's Development

Bruce Edwards:

Welcome to this podcast produced by the International Monetary Fund. In this program, how to attract more private investment in Africa.

Luc Eyraud:

First, you need to address the risks, the project risk, the currency risk the facility to exit. But sometimes it's not enough. Sometimes just fixing the business environment is not enough.

Bruce Edwards:

With public finances stretched to the limit and the pandemic making things worse by the day, new IMF research looks at innovative ways to get the private sector more involved in financing Africa's development needs.

Luc Eyraud:

Incentives can be quite controversial. But I think at the same time, the truth is that many projects in development sectors in Africa won't happen without the government's support.

Luc Eyraud:

My name is Luc Eyraud, I'm mission chief for the west African currency union. I work with a team of IMF economist on this project on Private Finance for Development. The paper was published last month at the time of the Paris Summit on Financing African Economies. It was a summit that gathered African heads of state, donors and international organizations. And the main topic of the discussion was the COVID crisis, of course, and its terrible social consequences.

Bruce Edwards:

So much for the development we've seen in Africa in recent years has been largely driven by public investment. But now with the pandemic, having put so much pressure on public finances, to what extent will governments need to rely on private investment for development strategies from here on in?

Luc Eyraud:

Well, that's a very good question. I mean, I think what you mentioned here is not... There've always been tensions between, I would say the very large development needs in Africa and the very scarce public resources to cover them. There has been very significant progress, I think in past decades but development gaps remain very large. Education enrollment rates are low. Infant mortality is high. There's a lack of basic infrastructure outside the big cities, power outages, et cetera. So the development needs are very large, but the resources provided by the public sector and the donors are limited. As you know, on the public sector side, governments are small, countries are poor and so their tax bases are limited. So Africa relies a lot on donor financing, but donor money is itself is also not unlimited. So there's a tension, I would say between the size of these development needs and the public resources. The COVID pandemic has made the situation actually even worse.

Luc Eyraud:

The crisis, as you know has led to a contraction in domestic revenues and access to global financial markets has become more difficult for these countries at a time where the expenditure on health and income support has increased. So I think the scale of these needs that has been aggravated by the COVID pandemic, will require efforts from all stakeholders, including private investors.

Bruce Edwards:

So how much private investment has there been in Africa in recent years?

Luc Eyraud:

Well, I think there is not much private investment going to development sectors in Africa. There is of course a lot of private investment, but private investment going specifically to infrastructure, to education, to health. There is little. 95% of the projects in infrastructure in Africa are carried out by the public sector, like line ministries or state-owned enterprises. In fact, the volume of infrastructure projects with a participation of the private sector has declined quite significantly in the past decade, following the commodity price burst.

Luc Eyraud:

And you can also see that at the international level. When you look at the foreign direct investment, only 2% of global flows of foreign direct investment go to Africa. And when investment goes to Africa, it's predominantly to natural resources, extractive industries, not to health road or water.

Bruce Edwards:

So obviously private investment is going to be super important. But with interest rates such as they are, especially in the United States, there is no lack for investors looking for higher yield. Why does Africa struggle so much to attract these private investors?

Luc Eyraud:

Well, that's indeed quite puzzling at first glance because Africa holds immense opportunity for investors. It has young growing population, abundant resources, the cities are seeing massive growth. There are important digitalization processes under way. So a large part of our research has been to try to understand why international investors are not coming more. We talked to many investors in London, in New York, in Africa, and what the discussion shows is that three main risks really dominate investors' mind. The first risk is what we call the project risk. Africa presents a lot of opportunities that many of them are not sufficiently developed. They're not what investors call investor ready, bankable.

Luc Eyraud:

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Projects are in the books of ministries of economy or planning, but they have not really gone through all the feasibility studies and preparatory analysis that would make the project sufficiently advanced to be appealing to an investor. And the problem is that investors, they don't know well Africa and they don't want to invest in very early stage or unfamiliar concepts.

Bruce Edwards:

So potential investors in public infrastructure projects in Africa, you're saying, hesitate because of the risks?

Luc Eyraud:

Yes, absolutely. They hesitate and they see risk as being elevated. I mean, some of the risks that they are mostly concerned about relate a lot to exit, interestingly. So, you know, if you want to come to a country, you need to be sure that you can exit the country and make money out of it.

Bruce Edwards:

Right.

Luc Eyraud:

So a lot of the problems relate to exit risk and the ability of investors to leave the country, recoup their gains and go back home. And there, I mean, there are important risks in Africa. First one is currency risk. You know, if you make a return of 10% a year, but your currency depreciated by 5% a year, this eliminates half of your profits. And so when investors leave the country, they need to convert their gains into their own currency. And so the currency risk is very important. But there are also other constraints on exiting. I mean sometimes capital controls, sometimes legal framework that create legal battles for investments to have their property rights recognized, sometimes also narrow and undeveloped financial markets, which prevent them from issuing shares in order to exit so that they can sell the shares of the project to other investors. So yes, there are definitely risks and concerns on the investors side.

Bruce Edwards:

So, just to put this into context for people who might not completely understand how investors make money in public investment, could you give us a bit of a primer on how it works for investors. Say, they invest in a public road or a bridge, for example, how do they get a return on that investment and what might the return be on average?

Luc Eyraud:

There are many ways of investing, actually. One, the simplest way to invest is to do direct investment. So meaning you are an investor in Germany, for instance, and you select a company in Africa that you think is a good company and you buy your share of this company or you lend to this specific company, but this is not always possible. For instance, you can maybe buy your share of an infrastructure company in road, but it may be more difficult to do that for a school or hospital.

Luc Eyraud:

A lot of companies actually working in development are non-listed, they're not listed on stock markets, and you also need very specialized expertise or competence in order to select a specific company. So that's why most investors, they rely on, I would say a two tier structure where they don't invest directly in a project, but they invest in a specialized fund. And the fund itself knows well Africa and knows the context, the environment, and is going to invest in infrastructure project. And you've probably already heard about these funds that are called private equity funds or debt funds or infrastructure funds. These are the type of channels of investment for international investors.

Bruce Edwards:

So, there's another type of investor that your research identifies as having great potential. And that is the global institutional investor, like pension funds and insurance companies and alike, and even philanthropists to a certain degree. Why is it such a good idea to bring them in and what's holding them back?

Luc Eyraud:

Well, I think it's a good idea because there are really large and Africa needs more private finance. So there is a big potential here, mostly unrealized. On the institutional investor side, it is true that there have been a lot of debate involving these type of investors. Here we are talking about big pension funds, big insurance companies at the global level. These institutional investors have a lot of money. They manage $100 trillion of assets and almost nothing of this money goes to Africa, actually only half a percent of the total foreign investments of global pension funds goes to Africa.

Bruce Edwards:

Why is that?

Luc Eyraud:

I think there is interest on their side. As you mentioned, the low interest rate environment. I mean, infrastructure in Africa can offer higher returns. And for them also, one thing that they could appreciate is the fact that this infrastructure investment yield cash flows over very long period of time. Institutional investors, they have liabilities, they owe money to people and they're also very long period of time, so like if you're a pension fund, your pension liabilities are quite long.

Luc Eyraud:

So for them, this matching between the length of the assets and the length of the liabilities could be a big benefit. So then why are they not coming more to Africa? First, because they are a risk adverse. They do not want to invest in very new projects at the original construction phase. They prefer what we call brown field projects, projects that are already well developed, advanced and less risky. Another issue also is that I think institutional investors have very little expertise on Africa, and capacity to assess projects. So that's why they need to rely on funds to invest in Africa. And these funds are not really developed as well. And finally, there are a lot of prudential regulation that in some cases constrain the ability of institutional investors to invest in Africa. So I think that's why they are not coming more.

Bruce Edwards:

And the report also examines the efficacy of incentives offered by governments to potential investors. And we hear a lot about tax breaks, for example, to corporations where the benefits to those countries are not always that obvious. What types of incentives do you see as being effective and mutually beneficial, and how common are those incentives in Africa?

Luc Eyraud:

Yes. In a sense, I think the way I would see this question is to say that first you need to improve the business environment. You need to address the risks that we discussed, the project risk, the currency risks, this facility to exit, but sometimes it's not enough and that's a problem. Sometimes just fixing the business environment is not enough. And we have plenty of examples of African countries that have made a lot of effort on improving their business environment, but still private investors do not come, even in the most favorable business environment. And that's when, in this condition, you need this extra push to make infrastructure project attractive to private investors.

Luc Eyraud:

So what do we mean by government incentives? I mean, there're many forms, but basically there

So what do we mean by government incentives? I mean, there're many forms, but basically there are variations of subsidies and guarantees. Subsidies are here to improve the returns of investors and guarantees are here to reduce the risks for investors. But as you mentioned, I think these incentives can be quite controversial, not least because they are very costly and risky for governments. And you've probably heard of these experiences with public private partnerships that were poorly designed. And in these contracts sometimes, these contracts can lead to renegotiation. So activation of special clauses that are very costly and bad for government or for public finances.

Luc Eyraud:

But I think at the same time, the truth is that many projects in development sectors in Africa won't happen without the government's support. So for instance, in east Asia, 90% of infrastructure project with private sector participation receive government support.

Bruce Edwards:

Wow!

Luc Eyraud:

So these incentives are important, but they need to be well-designed to make sure that they are efficient, but they are not too costly or too risky. So a lot, a big part of our work at the IMF is to assist countries in the design of these incentives to make them very efficient. So what does it mean in practice actually? It means that incentives should be targeted. They should not be given to everybody. They should be temporary, because if you start subsidizing a sector or project forever is probably that this project is not a good project. They should be granted on the basis of proven market dysfunction to be transparent. And most importantly, they should show something that is called additivity. Meaning that incentives should make worthy projects happen that would not have happened otherwise. So, they're not here to subsidize projects that would have happened otherwise.

Bruce Edwards:

You look at an interesting aspect of this in terms of what it might cost for governments to provide those incentives and whether or not governments can actually afford to do that. And where aid money sometimes is used to help governments provide those incentives that they need to attract these investors. Talk to us a little bit about blending. How does this work?

Luc Eyraud:

Yes, absolutely. Incentives are costly. So government has to face the reality that if they want to attract private investments, there will be a cost attached to it. And the idea that you could shift these costs from the public to the private sector is not going to work so easily, actually. So one possibility that is currently discussed and quite promising, is to shift some of these costs from governments to donors. And the idea would be that donors could provide some of these incentives to the private sector. So that's what is called the blending model. And many advanced economies have developed blending mechanisms to provide support to the private sector. It's also the case of international organizations like the World Bank, that has developed something called the private sector window.

Bruce Edwards:

Yeah. And that's essentially a sea change in the way that aid money is going towards development in these countries.

Luc Eyraud:

Yes, absolutely. It's a change actually, because traditionally aid money goes to public investment and finances budgets. And the idea of course is not to say that all aid money should be reallocated from public investment towards incentives for private investment. It depends on the income level of the country, of its governance structure, on the quality of its institutions. But in some cases, some relocation of aid money from traditional use towards blending could be considerous and beneficial.

Bruce Edwards:

Luc Eyraud, economist and Advisor in the IMF, African department and coauthor of Private Finance for Development, the subject of our talk today. Thanks Luc.

Luc Eyraud:

Thank you very much.

Bruce Edwards:

The Private Finance for Development study is published on the IMF website. That's imf.org. There's also a blog based on the research, check it out at blogs.imf.org.

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