Private Sector & Development

A blog coordinated by Proparco

Rethingking finance for Africa’s small firms

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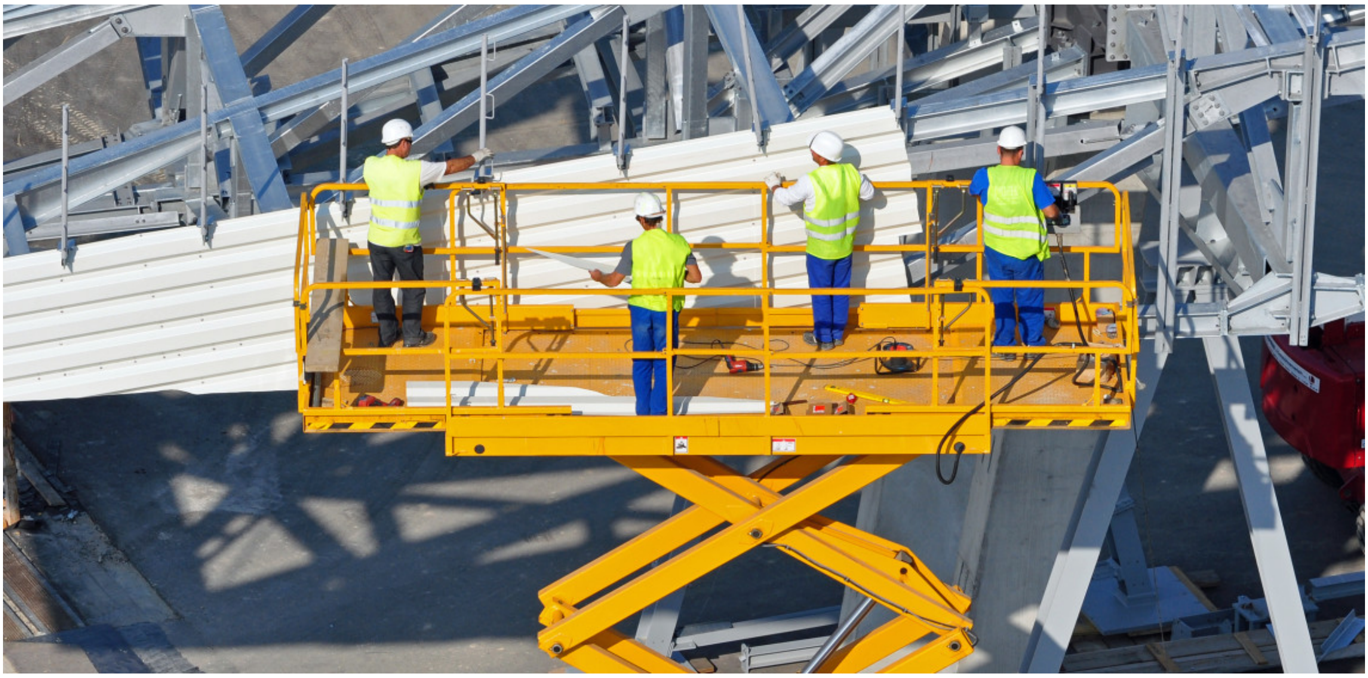
May 11 2009



African banks had just started to show interest in SMEs when the global crisis reversed the tide. The risk for SMEs is that they will suddenly be barred access to credit whereas they need long-term financing more than ever before and Africa’s financial systems are unable to meet this demand. This situation will only improve if there is a better dissemination of information on SSA’s markets that would make it easier for investors to identify high-quality SMEs.

PS&D

This article is an excerpt from Issue 1 – SME financing in Sub-Saharan Africa

I start with two brute facts of finance. Providing finance for Africa is generally rated as riskier than for other regions. Providing finance for small firms is globally rated as riskier than for large firms. The provision of finance for small African firms unfortunately brings together these two high-risk characteristics. During the recent global economic boom investors chasing returns in the face of high asset prices became willing to accept higher risks. Small African firms were just beginning to benefit from this reassessment when the boom collapsed, inducing a massive reaction in the opposite direction: the appetite for risk evaporated and with it the scope for private finance for Africa’s small firms. Does this matter and, if so, what can be done about it?

Banks’ reluctance to lend

For many years Africa’s formal banking system faced both high risk and high transaction costs in lending to small enterprises. Such impediments largely precluded their access to formal finance. For example, a survey which tracked bank borrowing by manufacturing firms in six African countries during the 1990s found that among those firms which wanted a loan, small firms had had substantially worse chances of getting one (Bigsten et alii, 2003). The study controlled for many firm characteristics such as profitability and concluded that systematic bias by lenders was the most likely explanation. Indeed, banks in Africa did not need to develop the business of lending to small firms: they were operating profitably via the easier and safer role of lending to large firms, and by holding high-yielding government debt.

As long as African economies were stagnant, this lack of finance for small firms was not that important. Growth was constrained primarily by a lack of investment opportunities so that the lack of finance was not a binding constraint. However, the extensive reforms of the 1990s in the real economy substantially raised the return on capital. Recent research compares the return on capital around the world using three different sources – firm surveys, company reports for firms listed on stock markets, and data on American foreign direct investment (Collier and Warnholz, 2009). All three sources find that Africa now has the highest return on private capital in the world. In this context, finance is likely to matter more for growth.

Paradoxically, it is when firms are growing that they are least able to finance investment opportunities from retained earnings because while growth may expand investment opportunities, it also squeezes cash flow. The deterioration in cash flow occurs because growth implies that next-period output is larger than previous-period output meaning that financing needs for future inputs are large relative to the revenues received from past sales. During the boom African economies were briefly growing at around 6 percent, finance was therefore likely to be a binding constraint for many small firms. The global recession has punctured this phase of rapid growth but Africa is still projected to keep growing: the March 2009 IMF forecast predicts a region-average growth rate of 3.2 percent in 2009, markedly higher than the negative growth projected for the OECD.

Global crisis bites

While the recession has clipped African growth it is probably squeezing the finance for small firms much more drastically. The African financial sector largely avoided the first round of the financial crisis, but second-round repercussions are now starting to matter. Many of the banks are foreign-owned and, as in other countries with foreign banks, are reallocating liquidity from their overseas branches to their home economy. This is compounded by the rapid fiscal deterioration of many African governments caused by the fall in revenues from commodity exports. Governments will need to borrow and, with the collapse of the international appetite for risk, will have to rely upon selling debt to their domestic market. Public borrowing from the banks will consequently crowd out private borrowing.

Both of these effects imply that banks will lend less to firms. Yet this reduction in the availability of credit is occurring at a time when firms are themselves being squeezed. During this squeeze, large firms will be in a better position to meet their financing needs than small firms. Some large firms hold substantial deposits in the banking system and can simply run them down.

Further, as noted above, large firms are better-placed to borrow. There is already anecdotal evidence that they are scooping up available finance from the banks. Finally, in normal times large firms extend trade credit to small firms. This is a reflection of their superior financial position: they lend to small firms because they face a lower cost of credit. However, when their own need for credit increases, large firms have the power to reduce trade credit: they protect themselves from catastrophe while small firms are forced into bankruptcy. This suggests that the global crisis will lead to a deterioration in the already limited access to credit for small firms and that this in turn will reduce growth. The lack of finance for small firms does matter, so the question is what can be done about it.

System ill-equipped

Manifestly, a global recession of uncertain magnitude during which the appetite for risk has collapsed is the worst possible moment to expand investment finance for small African firms. Further, Africa's current financial system is ill-equipped to mediate such flows: it is designed to provide large firms with short-term loans. This is not a viable contractual form for high-risk investment financing. From the perspective of banks, if the investment fails they are exposed to the risk of default whereas if it succeeds they have little participation in the returns. From the perspective of firms, to finance a long-term commitment by means of a short-term facility at a time when banks are likely to be curtailing lending is a recipe for bankruptcy. In a high-risk environment what is most needed is long-term equity.

In turn, the provision of equity needs a supporting institutional infrastructure within which risks can be assessed and contained. I see no alternative to building these institutional foundations for risk capital.

Information technologies the way ahead

The institutional foundations involve improving information and the legal protections of investors. Verification systems that record small firms' transactions are needed so that they can build a track record. This information can then be linked to promising innovations in the international organization of microfinance such as those implemented by Kiva. The innovative use of information technologies applied to the linkage between firms and finance also needs to be harnessed in order to build the foundations of information.

Despite the global recession there is considerable potential for finance from the social enterprise sector: Grameen and BRAC have both demonstrated this potential. However, it is important that these flows should not become quixotic. While microenterprises show the most evident social needs, the widest scope for impact on the economy is, I think, at the next level up: small firms that could potentially grow into large ones.
If social enterprise finance confines itself to those tiny enterprises that are socially most appealing, and even worse if it ends up with poor returns on invested funds, it will reinforce the perception that Africa's small firms are not appropriate recipients of private capital.

The key role of social enterprise finance is not to provide subsidized money, but to pioneer and demonstrate that new channels are viable for private investors. Information technology potentially enables these costs of information on firm performance to be sharply reduced. That, to my mind, is the key missing link.

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