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FINANCING FOR MANUFACTURING

Financing conditions in Sub-Saharan Africa

Phyllis Papadavid

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LIST OF ACRONYMS

AfDB	African Development Bank
AGOA	African Growth and Opportunity Act
CBK	Central Bank of Kenya
DFI	Development Finance Institution
DRC	Democratic Republic of Congo
EAC	East African Community
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFC	International Finance Corporation
IMF	International Monetary Fund
KIPPRA	Kenya Institute for Public Policy Research and Analysis
LDC	Least Developed Country
MINICOM	Ministry of Trade and Industry (Rwanda)
MSMEs	Micro, Small and Medium-sized Enterprises
NEER	Nominal Effective Exchange Rate
ODI	Overseas Development Institute
OPIC	Overseas Private Investment Corporation
RCA	Received Comparative Advantage
RDB	Rwandan Development Board
REER	Real Effective Exchange Rate
SET	Supporting Economic Transformation
SMEs	Small and Medium-sized Enterprises
SOE	State-owned Enterprise
SSA	Sub-Saharan Africa
SWF	Sovereign Wealth Fund
UNCTAD	United Nations Conference on Trade and Development
UNECA	United Nations Economic Commission for Africa

EXECUTIVE SUMMARY

This paper focuses on the financing environment for manufacturing in Sub-Saharan Africa (SSA) and is a companion paper to 'Mobilising Private Financing for Manufacturing in Sub-Saharan Africa' (Tyson, 2017). Real sector issues represent the major constraints in manufacturing, but financial constraints are also important given the lack of sustained investment and domestic capacity to channel financial flows to the sector. The paper is somewhat narrow in its focus: it assesses the importance of finance and examines some key financing and macroeconomic constraints for manufacturers. It then examines three financing pathways in SSA that have been an obstacle to manufacturing growth: the real effective exchange rate (REER), the domestic cost of finance and access to global capital markets.

The paper examines these three financing constraints in three countries (Kenya, Rwanda and Liberia) in order to assess one aspect of why manufacturing growth may have fallen behind services in three countries at various stages of development. Compared with its East African neighbours, Kenya has a developed financial system that has contributed to economic growth. And yet growth has been concentrated in services with little momentum in manufacturing, restraining overall growth prospects. The paper finds that Kenya's financing constraints may be hurting its manufacturing sector and therefore, its overall growth prospects: the shilling real exchange rate has shown signs of overvaluation, manufacturers' cost of domestic finance remains high, and access to FDI in manufacturing is low.

Rwanda is one of the fastest-growing economies in SSA, and yet it has not seen its manufacturing sector expand substantively (although some of the reasons are real constraints, such as high transport costs, small market size and the fact that it is landlocked). This is important because the manufacturing sector is holding back overall growth prospects. In terms of the three key financing constraints, the trade-weighted franc has stabilised in real terms, though it remains elevated; the cost of domestic finance remains high due in part to operating costs and informational asymmetries; and the country's access to global capital markets has improved owing to the streamlined processes of the Rwandan Development Board though it could yet see further improvement in terms of inward FDI.

Liberia's economic growth is largely driven by natural resource production, with both its manufacturing sector, and the financial sector that supports it, still underdeveloped. Tackling financing for manufacturing could help improve Liberia's longer-term growth prospects. In terms of its exchange rate developments, Liberia is heavily dollarised, making it vulnerable to external shocks. Its REER is overvalued, suggesting rigidity in domestic prices. The cost of domestic finance remains persistently high, in part a reflection of the financial system's lack of depth. Finally, Liberia's access to global capital markets is limited. Liberia's access to finance is analysed with a particular focus on external development finance institutions where there is little evidence of sustained support for manufacturing.

The paper's closing policy section suggests that regional SSA banking coordination could increase competition and lower the cost of finance. Regional coordination could also help introduce new financial instruments to provide finance to small and medium-sized enterprises. Kenya's manufacturing sector could benefit from lowering the cost of investing and improving the investment climate, through both lowering effective tax rates and strengthening institutions that streamline investment processes. Rwanda could both increase financial depth and facilitate access to global markets through further privatisation and further sovereign wealth fund investments. In Liberia, the introduction of mobile banking could lower the cost of finance, and tackling macroeconomic uncertainty could facilitate inward investment. In all three studies, REER overvaluations should be reduced, through exchange rate intervention and/or lowering inflation, to support manufacturing competitiveness.

1. INTRODUCTION

This paper focuses on the financing environment for manufacturers in Sub-Saharan Africa (SSA) and is a companion paper to 'Mobilising Private Financing for Manufacturing in Sub-Saharan Africa' (Tyson, 2017). Finance is an important consideration. Although manufacturing production in SSA more than doubled between 2005 and 2014, there is scope to achieve more growth in order to support broader economic growth and development (Balchin et al., 2016). There are a number of reasons for the failure to achieve more growth, including lack of competitiveness, small market size, lack of sustained investment and low capacity to channel financial flows to manufacturing. This section briefly takes stock of the literature on the importance of finance in SSA in order to be able to examine the key financing and macroeconomic constraints for manufacturers. Although it is common knowledge that lack of economic fundamentals such as infrastructure hamper manufacturing, in SSA financing constraints have also been an obstacle to the sector's growth. These have included overvalued real effective exchange rates (REERs), the high costs of domestic finance and variable access to foreign investment.

1.1. Benefits of financial development

A number of SSA economies have liberalised their financial markets for the purpose of accessing finance, promoting growth and stability and supplementing fiscal finances, largely through issuing debt. Some have been particularly successful in doing so in the context of global investors' search for returns in emerging market economies (AfDB, 2013; Wheatley, 2017). Others, such as Mozambique and Ghana, have encountered obstacles as a result of idiosyncratic public sector developments (Hill, 2016; Dontoh and Dzawu, 2017) such as undisclosed public debt. Some have been successful notwithstanding domestic macroeconomic uncertainty, as in the case of Nigeria's recent Eurobond issuance, which was eight times oversubscribed, owing in part to the yield offered, and despite investor uncertainty regarding naira devaluation risks (Pronina and Wallace, 2017). However, the positive growth impact of finance on manufacturing remains limited, given the multiple constraints, such as inadequate allocation and the high cost of credit. This paper argues that the financing landscape is not supportive of manufacturing and that particular attention should thus be paid to key financing constraints.

It is important to consider financial and macroeconomic constraints in SSA, given that alleviating these, and addressing shocks, supports growth (IMF, 2016b; Anderson and Johnson, 2017). Among the benefits of financial sector development, is that it helps mitigate the impact of adverse shocks by alleviating firms' and households' borrowing constraints and promotes the management of risk. At the same time, however, a more liberalised financial system is more vulnerable to financial shocks and global spillovers. In particular, the financial accelerator mechanism propagates and amplifies the impact of real shocks, particularly in economies that have limited institutional capacity to deal with shocks. The next subsection maps out the key pathways between finance and manufacturing sector growth. Section 1.3 then outlines the structure of this paper.

1.2. Key financing pathways and constraints for manufacturers

Financial market development, through financial market liberalisation, that leads to a deep and diversified domestic financial market, can be good for SSA manufacturing. This is based on, for example, the premise that effective liberalisation occurs under deeper banking systems and financial institutions. There are multiple pathways between financing and manufacturing to consider. In this section, we examine three key pathways for SSA manufacturers: the REER, the cost of domestic finance and the ability to access external finance.

1.2.1. Real effective exchange rate dynamics

The REER¹ can be thought of as one key measure for export competitiveness. The nature of any exchange rate misalignment is likely to affect the country's export outlook, which is key to economic transformation. A change in the REER can affect a firm through different channels, which include its export sales and its import purchasing power. Currencies that are undervalued have typically helped growth (Rodrik, 2008; Habib et al., 2016). By contrast, currencies that are fixed or managed at an overvalued level function as a tax on exports and a subsidy on imports; an example is Nigeria's current naira regime, which is exacerbating its 'transformation deficit' (Papadavid, 2017). In Ethiopia and Tanzania, empirical results suggest that REER undervaluation has boosted both export supply and diversification, with a trade-off, or cost, that the undervaluation can also boost inflation (Wondemu and Potts, 2016).

Therefore, the nature of the pathway is the same for all countries. The benefits of over- or undervaluation depend on the structure of the economy. For example, the benefits depend on how heavily factor import-dependent an economy is, given economies' varying abilities to domestically source the required inputs for the manufacturing sector. For example, in Nigeria, Ehinomen and Oladipo (2012) recommend that exchange rate management lean towards appreciation in order to reduce manufacturers' costs, given the country's dependence on foreign inputs. And yet this is not always a credible policy if there are declining foreign exchange reserves, as has been the case in Nigeria. In other economies, such as Zimbabwe, the REER has played a secondary role to sound macroeconomic policies (Brixiova and Ncube, 2014). Finally, others argue that the fragmentation of production across countries weakens exchange rate impacts (IMF 2015b). In our country studies of Kenya, Rwanda and Liberia, we examine the REER as a pathway separating nominal exchange rate dynamics and relative price dynamics.

1.2.2. The domestic cost of finance

The cost of finance in many SSA economies remains prohibitively high and lending rates have not declined in an appreciable manner. A number of factors can explain this rigidity. In Kenya, for example, higher interest rates are explained by an imperfect lending market that is characterised by credit, interest rate and liquidity risk and limited diversity of banks' asset portfolios. Additionally, macroeconomic and monetary policy/financial regulation factors are even more important determinants of commercial banks' interest rate levels than bank-level factors. Domestic inflation, gross domestic product (GDP) growth, financial deepening and reserve requirements have also been key. At a broader level, interest rates are also inherently linked to risk and how it is managed. Interest rate spreads are positively related to a bank's market power, operating costs and credit risk (Akinlo and Owoyemi, 2012).

The cost of finance is important for manufacturers, particularly those that are dependent on long investment periods (such as extractive industries). Typically, manufacturers depend on global value chains, and their viability in the value chain is tied to their ability to access loans for working capital (although this may not always be the case given that in some value chains, some firms provide finance to suppliers). A higher cost of finance has typically exacerbated limited access to loans for working capital; higher interest rates for small firms and extended payment terms will mean buyer firms are paying suppliers more slowly (Helper et al., 2014) slowing the production process. A high and variable cost of capital could result in sub-optimal inventory decisions, if the high cost is the result of inefficiencies, thus disrupting production. This differs from in the financial sector, where the prospect of higher interest rates could be mitigated through the use of other financial instruments.

1.2.3. Access to global financial markets

Successful access to global financial markets is the third financing pathway examined in this paper. This centres on the ability of financial market institutions in developing countries to increase credit provision. One mechanism for this is that liberalisation in developing countries may increase the availability of finance, by means of competition among financial institutions and the presence of stronger accounting,

¹ We define the REER as the nominal effective exchange rate multiplied by the ratio of domestic to foreign prices. The nominal effective exchange rate is the country's trade weighted exchange rate relative to its major trading partners.

disclosure and corporate governance rules that help firms overcome adverse selection and moral hazard problems. Rajan and Zingales (1998) have long found that countries with developed financial markets see faster industrial sector growth when they are more dependent on external finance. And yet the evidence is still mixed as to whether financial liberalisation increases access to finance. As in the instance of Malawi, liberalisation brought significant increases in interest rates owing to higher non-financial costs, debt provision and higher reserve requirement ratios (Mlachila and Chirwa, 2002).

The type of foreign investment finance matters for growth in manufacturing. Foreign direct investment (FDI) has been catalytic in terms of boosting growth and central to the development strategy of some least developed countries (LDCs) (Farole and Winkler, 2014), whereas debt-based investments have improved productivity (Dube, 2013). Of particular importance is the degree to which liberalisation increases industrial concentration and firm entry by boosting financial institutions' ability to make credit more available. One obstacle is that small and medium enterprises (SMEs) are informationally opaque entities, with the costs for banks of investing in informational capital high and not deemed worthwhile. This suggests that financial institutions may provide credit mostly to larger clients with long-standing relationships, thus perpetuating entry barriers for other SMEs. To the extent that liberalisation boosts financial institutions' lending capacity and makes credit more widely available to firms, it will encourage the creation of new firms (Kabango and Paloni, 2010) and could benefit manufacturing.

1.3. Structure of the paper

In exploring the importance of the financing landscape for SSA manufacturers, we isolate and analyse three financing pathways in order to be able to examine the constraints to manufacturing growth: the REER, the cost of domestic finance and access to global markets. After assessing these pathways for SSA as a whole, the paper looks to three countries. It first considers Kenya, which has the most developed financial system of the three economies and yet has not seen significant expansion in its manufacturing sector. Rwanda is the second country studied, where overall GDP growth has outpaced that of the manufacturing sector. In Liberia, financial depth in the domestic economy is a key obstacle.

Section 2 examines these financing pathways for SSA. It seeks to draw links between these pathways, on the one hand, and SSA manufacturing sector developments on the other. The subsequent sections analyse these for Kenya (Section 3), Rwanda (Section 4) and Liberia (Section 5). This analysis is followed by a brief discussion of policy options in Section 6 that includes country-specific suggestions for reducing financing obstacles for manufacturers in these countries. Section 7 concludes.

2. FINANCING CONDITIONS IN SUB-SAHARAN AFRICAN MANUFACTURING

In light of the multiple challenges manufacturers in SSA face, this section analyses key financing pathways in order to better understand these. There are multiple lenses through which we can examine the link between manufacturing and finance. The subsequent sections look at three key pathways. First, we assess SSA manufacturers' competitiveness through real exchange rate developments, in the form of currency misalignment and volatility (Section 2.2.1), with the REER inversely correlated with trade. We then analyse the cost of accessing domestic finance and its negative impact on SSA manufacturers' (Section 2.2.2). Finally, we consider complications pertaining to manufacturers' ease of access to international capital markets, and to foreign investment (Section 2.2.3).

2.1. The manufacturing sector in Sub-Saharan Africa

SSA growth has, on average, been driven by services, with its' share rising from 45% to 50% of GDP from 2000 to 2015. By contrast, manufacturing has seen mixed developments. The real value of SSA manufacturing production grew from \$73 billion in 2005 to \$157 billion in 2014. Despite this, the share of manufacturing in GDP has remained at roughly 10% of GDP. At the same time, manufacturing exports doubled from \$50 billion in 2005 to more than \$100 billion in 2014, and, while many countries have seen an increase in FDI, this is largely concentrated in the services sector. SSA countries are increasingly exporting manufactures to each other, with 34% of total SSA manufacturing exports in 2014 intra-SSA, up from 20% in 2005; Asia has also become an important strategic destination (Balchin et al., 2016).

Growth in manufacturing has occurred despite SSA manufacturers have been hit by multiple shocks in recent years, including sluggish global trade. The knock-on effect from the downturn in global commodity and oil prices has put a number of fuel-exporting economies at risk of external debt distress (IMF, 2017a). Other shocks have also influenced SSA manufacturing; these have included, for example, electricity supply constraints and mining strikes in a number of economies, and other unexpected shocks such as Ebola. Some countries were severely affected by the Ebola epidemic. Conversely, strong growth in other low-income and fragile countries, such as in Côte d'Ivoire, Ethiopia and Mozambique, was driven by investment in mining and infrastructure and by strong consumption (IMF, 2015a).

2.2. Macroeconomic and financing conditions in Sub-Saharan Africa

2.2.1. SSA manufacturing competitiveness

If they are to strengthen current trends of economic recovery, SSA countries need to make further progress in terms of promoting manufacturing growth according to their respective comparative advantage. This should involve a substantial improvement in their international competitiveness. Comparative advantage can include measures of the average output per employee, calculated by the manufacturing value added per employee. Or, it can be measured by a country's revealed comparative advantage (RCA), as the share of that economy's manufactured exports in the country's total exports, divided by the share of manufactured world exports in total world exports (Balassa, 1965). The Overseas Development Institute (ODI) Supporting Economic Transformation (SET) portal includes RCA calculations for a wide sample of developing economies, including Rwanda, Kenya and Liberia.²

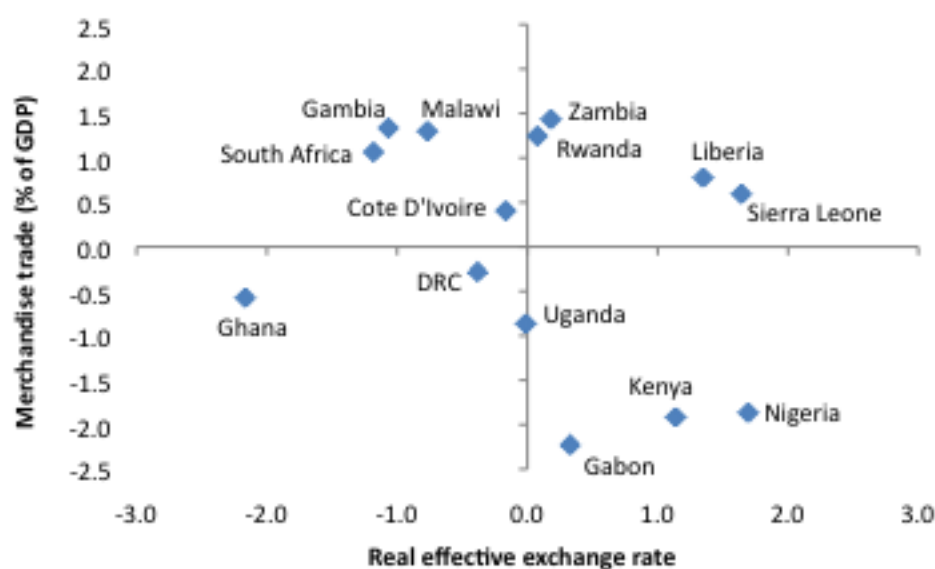
An economy engaging in foreign trade can use it to transform the structure of its domestic production. The three ways a currency can influence a country's manufacturing export landscape include through REER changes, real exchange rate volatility and real exchange rate misalignment (Polodoo et al., 2016). Appropriate exchange rate management reduces relative costs and therefore competitiveness and export performance. Most Sub-Saharan African countries have experienced substantial real exchange

² <http://set.odi.org/data-portal/>.

rate misalignment and volatility, as a result of misconceived macroeconomic policies. This has reduced competitiveness and weakened manufacturing exports.

Typically, REER dynamics are closely associated with developments in trade: a lower, more competitive, REER has an export-boosting trade impact, though the relationship is not always clear and the magnitude tends to vary between countries depending on the elasticity of exports and imports (Figure 1). This reflects, in part, that devaluation has also been a key part of industrial policy (Rodrik, 2008) and has been used as a tool by a number of emerging and developing economies, including China and India, and a number of SSA economies, such as Uganda and Tanzania, to increase export share, with varying degrees of success. Other economies' trade is more reactive to non-price measures of competitiveness (Giordano and Zollino, 2015).

Figure 1. Exchange rates and trade shares across Sub-Saharan Africa



Notes: Both the trade and the REER variables denote standardised average values relative to their mean and standard deviation for 2000–2015.

Source: World Bank World Development Indicators.

Temporary income growth in SSA has been spurred by adjustments relating to the exchange rate, enhanced macroeconomic and political stability or reductions in distortions in the foreign exchange market. Although such adjustment measures are necessary for economic development, they are not sufficient to ensure long-term sustainable growth. Durable improvement in income can come about only in conjunction with significant structural change and productivity increases. Stable exchange rate policies should be geared to support diversification and more emphasis should be placed on wider industrialisation through production linkages with the rest of the economy and through lower costs of credit (UNCTAD, 2016a).

2.2.2. Cost of accessing domestic finance in Sub-Saharan Africa

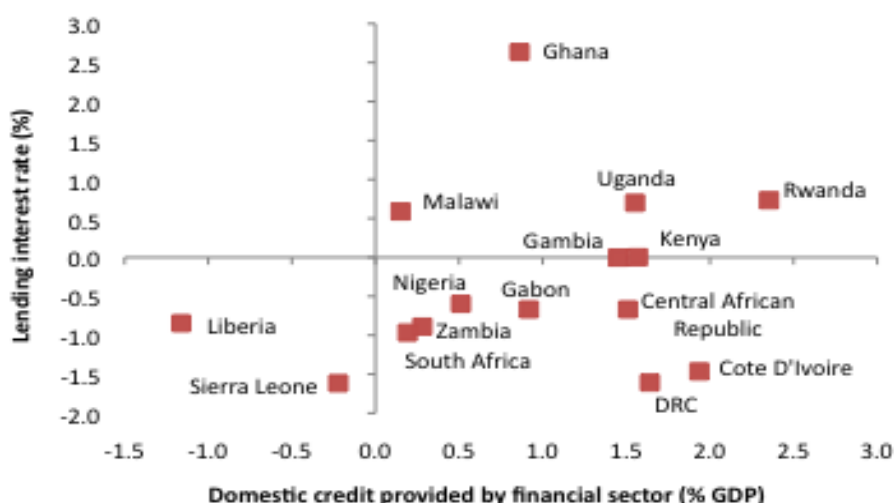
The ability of SSA economies to raise finance has increased significantly (Tafirenyika, 2012; IMF, 2016a). This is in part the result of increased access to global markets and improved institutional capacity to obtain finance domestically. Despite this, financial institutions remain underdeveloped, especially following the 2008–2009 financial crisis (Beck et al., 2009; Fowowe, 2017). In fact, lending rates in SSA have increased appreciably in economies that have had unexpected debt accumulation owing to crises and fiscal mismanagement (as in the case of Ghana, Mozambique) while others have simply remained high (as in the case of Rwanda and Uganda).

Parameters of financial market development influence the cost of finance, both directly and indirectly. One such characteristic of a financial sector, with a high cost of finance, is the use and prevalence of overdraft facilities. Compared with firms in South-East Asia and China, SSA firms are more likely to either self-finance or use overdraft facilities; they therefore have lower access to credit and are less likely

to purchase inputs on credit or finance investment with bank loans (Dinh and Clarke, 2012). The increase in the number of commercial banks in SSA is indicative of some improvement. And yet, on average, there are roughly five commercial banks per 100,000 adults, suggesting limited presence of such finance. This contrasts with Indonesia's 17.8, Malaysia's 10.7 Thailand's 12.6 banks per 100,000 adults, according to the World Bank World Development Indicators.

SSA's financial sectors, with little breadth of financial instruments, have insufficient liquidity and turnover to make financial products inexpensive, and this could elevate interest rates. Equally, economies with little financial depth, or a small financial sector compared with the size of the economy, dominated by a small number of banks, generally carry a higher cost of borrowing, given the lack of competition in the domestic market. In SSA, the domestic credit share provided by the financial sector has increased moderately in the past decade, to 35%, and yet it is below its 38% share in 2000. This signifies mixed developments across SSA that have coincided with wide dispersion of lending rates (Figure 2). Idiosyncratic domestic developments, such as those in Ghana, have partly accounted for this.

Figure 2. Credit provision and lending rates across Sub-Saharan Africa



Notes: Both the credit share and the lending rate variables denote standardised average values relative to their mean and standard deviation for 2000–2015.

Source: World Bank World Development Indicators.

Further financial deepening in the region will better support growth. Financial market development, in depth and in breadth, would alter the longer-term structural determinants of the cost of finance. Financial market development has been crucial in lowering the cost of finance and has varied across the SSA economies over the past decade. There is room for more improvement in this area: in its study of 152 countries between 1980 and 2013, the International Monetary Fund (IMF) (2016b) finds there is scope for financial development to sustainably support growth, especially for countries at lower levels of financial development. Although the potential introduction of volatility is a risk, this is offset by the positive spill-over effects of a more developed financial market to alleviate borrowing constraints.

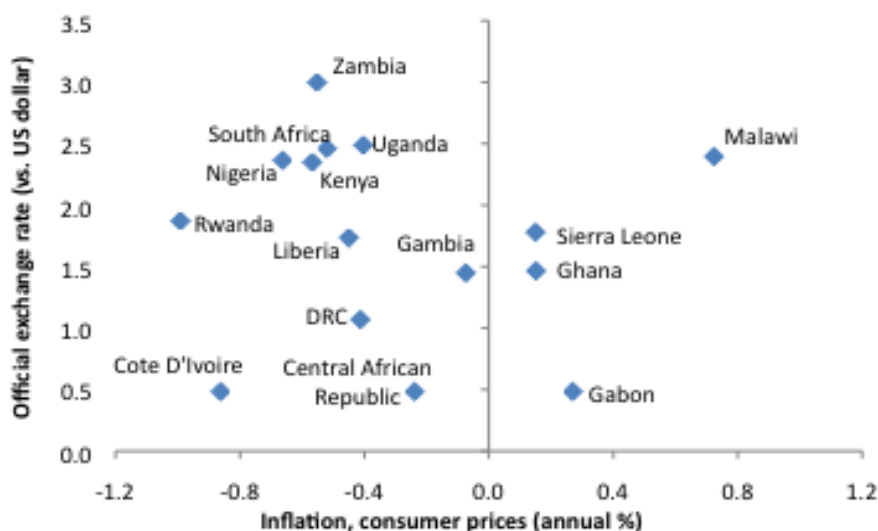
2.2.3. Access to international capital markets in Sub-Saharan Africa

Access to global finance is increasingly important for all manufacturers, including those in SSA, though the nature of the benefit has varied according to the nature of the investment inflow. The share of FDI into SSA has been increasing important. And yet 51% of this has flowed to the services sector, with more moderate 20% and 28% shares into the manufacturing and primary goods sectors, which, more recently, have been affected by the weakness in commodity prices, particularly in Nigeria and Democratic Republic of Congo (DRC) (UNCTAD, 2016b). Increasingly, other types of investment flows, such as in private equity, are playing a greater role in supporting growth. Additionally, state-owned and partially state-owned enterprises (SOEs) are issuing bonds tied to certain commodities, which helps particular sectors (such as Mozambique's tuna bonds and Ghana's coco bonds).

Often, pre-mature liberalisation has meant that SSA economies' access to global markets has not been particularly smooth, and accessing global finance for the purpose of promoting manufacturing industry has been complicated. This has been because many SSA economies have liberalised their financial systems without the appropriate amount of accompanying deepening in their financial systems. In other words, although few African countries have had financial crises, premature liberalisation has led to financial volatility, alongside boosting SSA economies' growth. Financial liberalisation, with the aim of supporting manufacturing, needs deeper policy management and domestic institutions to reduce volatility.

Domestic macroeconomic volatility poses a key constraint to SSA manufacturers accessing foreign investment. This type of uncertainty tends to reduce investors' risk appetite. Having the right policies to identify and stem fragility is country-specific yet often misses the mark in terms of proactively stemming this uncertainty (IMF, 2014b). Additionally, there are multiple sources of volatility. Both exchange rate uncertainty and the volatility that stems from variation in a country's inflation rate are important factors undermining investor risk appetite. Macroeconomic instability is also a key source of uncertainty for manufacturers; this uncertainty inhibits capital accumulation (Awounang and Foning, 2014). Over the past decade, exchange rate volatility has been greater than inflation volatility (Figure 3).

Figure 3. Exchange rate and inflation trends across Sub-Saharan Africa



Notes: Both the credit share and the lending rate variables denote standardised average values relative to their mean and standard deviation for 2000–2015.

Source: World Bank World Development Indicators.

3. FINANCING CONDITIONS IN KENYAN MANUFACTURING

Compared with other East African countries, Kenya has a developed domestic financial system that has contributed to its economic development and to its growth. And yet, the bulk of the growth that has stemmed from its financial sector has been concentrated in services rather than in manufacturing, which latterly comprises a small share of Kenya's GDP. This section first gives some background on Kenya's manufacturing sector (Section 3.1). It then seeks to further analyse the three key financing constraints in Kenya (Section 3.2). These pertain to its real exchange rate, which has shown signs of overvaluation, the cost of domestic finance, which remains high for SMEs, and Kenya's access to global capital markets and its ability to access FDI for manufacturing.

3.1. Kenya's manufacturing sector

Kenya's manufacturing sector developments have not been as positive as those in its broader economy. Despite Kenya's economy having registered an average annual growth rate of 5.3% in 2016, over the past three decades average annual manufacturing growth has decelerated. Manufacturing growth has fallen from 11.24% in 1970–1979 to 4.8% in 1980–1989 and to 3.2% in the 2000–2015 period. Its share of GDP has remained stagnant and its contribution to value addition in exports is approximately 19%, compared with an approximate 50% share of communications and a 30% export share for the transport sector (Khanna et al., 2016). Kenya's manufacturing sector continues to constitute a small share of the overall economy (13%) compared with services (52%) and agriculture (28%), for 2000–2015.

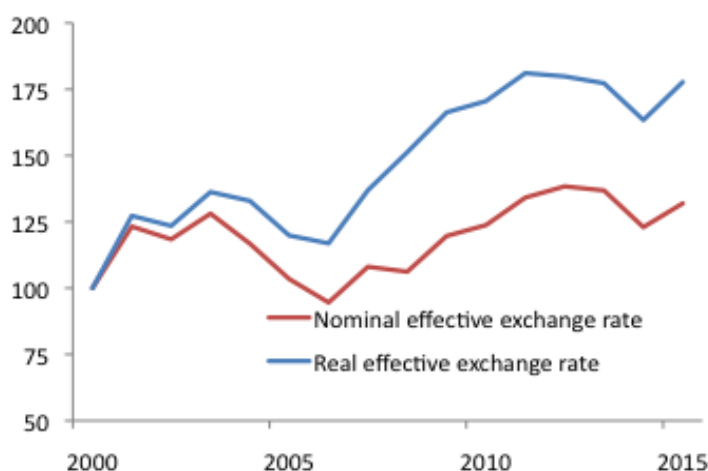
Kenyan manufacturing has been concentrated in textiles, food processing and metal industries. The promotion of these three subsectors has largely failed to catalyse broader-based industrialisation. There have been some silver linings: the textiles industry, which accounts for approximately 15% of the sector, benefited from the African Growth and Opportunity Act (AGOA), which initially helped expand garment exports, with the government offering tax incentives, such as cheaper electricity, to textile firms in export processing zones and partial sales tax exemptions (AGOA, 2017). Other areas of growth have been in low value-added manufacturing goods: Kenya's food processing industry comprises a significant (32%) share of manufacturing production, in part because of the country's agriculture sector.

3.2. Kenya's macro-economy and financing conditions

3.2.1. Kenya's exchange rate and competitiveness

The stagnancy in Kenya's manufacturing sector has coincided with a significant appreciation in Kenya's REER, which continues to be above its long-term average. Kenya's nominal NEER and REER have appreciated by 40% and 52%, respectively, between 2006 and 2015 (Figure 4). In 2015, its REER was 20% above its long-term (15-year) average, suggesting it is overvalued, though it has since stabilised somewhat. Shilling strength has been linked to a number of factors, including the high level of remittances, investment flows to the country's services sector and to its domestic real estate sector (Khanna et al., 2016).

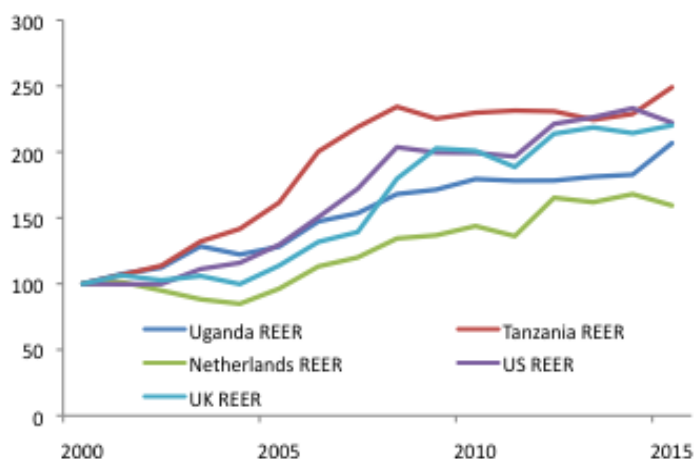
Figure 4. Kenya's nominal and real effective exchange rate (2000=100)



Source: Author's calculations, World Bank World Development Indicators and IMF Direction of Trade Statistics.

Kenya's elevated exchange rate has coincided with largely stagnant developments in its manufacturing sector and with a loss of export competitiveness. The shilling's appreciation in its REER has been broad-based *vis-à-vis* its major export trading partners, including its top five export markets of Uganda, Tanzania, the Netherlands, the US and the UK (Figure 5). Its REER and NEER have both appreciated when compared with Tanzania and Uganda, indicating both a higher nominal exchange rate and higher prices as key drivers behind the appreciation. Developments relating to Kenya's developed trading partners have differed. The discrepancy between the NEER and the REER is illustrative. Though Kenya's NEERs have fallen relative to the US and the Netherlands, its REERs have appreciated, signifying higher relative domestic prices; and a real appreciation in the exchange rate.

Figure 5. Kenya's bilateral REERs: top five export markets (2000=100)



Source: Author's calculations, World Bank World Development Indicators and IMF Direction of Trade Statistics.

REER and macroeconomic volatility continue to be a significant constraint to investing in Kenya's manufacturing sector. In particular, inflation and inflation volatility have also been problematic in Kenya, and a constraining factor for financing conditions given the intermittent spikes in inflation (to 26% year-on-year in 2008 and to 14% in 2011). There are also broader upside pressures evident in its price indices with consumer price inflation registering a year-on-year increase of 11.7% as of May 2017³ and failing to sustainably decline given the average inflation rate of approximately 10% between 2006 and 2016, according to the World Bank World Development Indicators.

³ <https://www.knbs.or.ke/release-cpi-rates-inflation-may-2017/>

3.2.2. Kenya's cost of accessing domestic finance

Kenya's overreliance on overdraft facilities is costly and exposes micro, small and medium-sized enterprises (MSMEs) to further interest rate rises. According to the Central Bank of Kenya (CBK), the average annual interest rate on overdrafts was 18% as of June 2016.⁴ To safeguard profit margins, there is little incentive for commercial banks to reduce firms' reliance on overdrafts. In a joint study with the World Bank, the CBK (2015) found that the average annual interest rate was as high as 20.6% for microenterprises, 18.5% for small enterprises and 17.4% for medium enterprises. Even in municipalities such as Kakamega, which have seen 90% of SMEs successfully obtain formal financing, financing costs were cited as a major impediment (Kihimbo et al., 2012).

Limited competition in Kenya's banking system has likely prevented further cost reductions. Although its private sector credit share of GDP has been on a rising trend (increasing from 36% in 2009 to 45% in 2015, according to the World Bank) credit allocation may be too concentrated. Kenya's six largest banks own approximately 53% of total assets, compared with the 11% share controlled by the country's small banks. Assets owned by domestic mid-sized banks (21.6%) are at par with those owned by large foreign institutions (23.2%). This is important: it is the former that offer low rates to micro and small firms, whereas Kenya's foreign banks offer lower rates only to the larger firms (CBK, 2015).

Financial market breadth, or the diversity of Kenya's financial instruments and products, also matters for the cost of finance. Despite the early initiation of Kenya's treasury bonds in the market in the 1980s, the government has largely used treasury bills to finance domestic debt and the corporate bond market initially did not gain momentum. Firms have not yet reached an important tipping point: in the presence of information asymmetry, firms prefer internal to external finance. However, as they grow, self-funding will increasingly become insufficient to finance their investment projects and they will turn to the markets for equity and debt-based finance.

Bond market finance may provide lower-cost funding for firms compared to traditional banking loans, with greater transparency and better governance in a similar vein to economies with a developed corporate bond market. Both the absence of developed bond markets (which provide longer-term funding), and banks' preference for short-term credit, imply higher risks for businesses. Commercial feasibility depends on a funding structure that minimises risks. This requires long-term funding (typically over 20 years) with flexible or fixed interest rates and attractively priced debt instruments, which can be provided only through liquid traded bonds (Ngugi and Afande, 2015).

The reintroduction of Kenya's interest rate cap, effective since September 2016, put into place through banking legislation regulating how much lenders can charge for loans and pegging lending costs at 400 basis points above the benchmark central bank rate (Ouma and Genga, 2016), has largely been deemed counterproductive. Although the cap aimed to lower the cost of credit, there was concern that it would lead to a contraction in liquidity, particularly for SMEs, which was subsequently borne out in the lending data (Were, 2017). This has been driven by banks not having sufficient expected yield to compensate them for the risk in investing in smaller companies. The IMF too has stated that the cap reduces monetary policy effectiveness and adversely affects credit access for SMEs (IMF, 2017b).

3.2.3. Kenya's access to international capital markets.

Fostering further foreign investment in Kenya's manufacturing sector could constitute a key source of finance for manufacturing MSMEs. Both FDI and portfolio investment could be an important means of financing Kenya's manufacturing sector. And yet macroeconomic volatility could hold back both types of investment. Such macroeconomic volatility, stemming in part from inflation, interest rate and exchange rate volatility, has created an uncertain financing climate. Exchange rate depreciations, most recently in 2015–2016, have meant that loan growth has slowed as banks have become more cautious, with incidences of fraud also likely to reduce investor confidence (Miriri, 2015).

⁴ <https://www.centralbank.go.ke/index.php/balance-of-payment-statistics/interest-rates-2>

Kenya's inward FDI has been robust: between January and November 2015, FDI rose nearly 37% compared with in 2014 (Porter, 2016). And yet the increases have not been linked with manufacturing. More recently, as of May 2016, the 47% annual rise in inward FDI comprised large-scale investments in Kenya's infrastructure, real estate, renewable and geothermal energy sectors (Kariuki, 2016). Portfolio investment in Kenya's domestic debt and equity markets has facilitated new sources of finance for firms and for MSMEs. However, these flows have been sensitive to crises. In the aftermath of the 2009 crisis, although SME lending (as a share of total loans) rose for domestic banks, foreign bank lending was stagnant, falling from 16.6% year-on-year in 2009 to 16.1% in 2013 as foreign banks took a more cautious approach in their activities (CBK, 2015).

More sizeable sources of external finance for Kenya's businesses remain limited to larger-sized firms, leaving the smaller and medium-sized firms outside of the scope of their financing activities. In 2013, 12 new deals, worth a total of \$112m, were signed in Kenya. Since then, the sectors of focus have been diverse (ranging from financial services to agriculture), with Kenya considered the most favoured destination following South Africa and Nigeria for private equity investment. Notwithstanding this, the majority (of approximately 15–20 active private equity funds) are largely focused on larger SMEs, with financing needs of between \$50,000 and \$5m (Deloitte & Africa Assets, 2014), leaving out Kenya's smaller SMEs. According to the Business Council for Africa, the majority of private equity investments have fallen outside of manufacturing, according to the Business Council for Africa, which has limited Kenya's longer-term growth prospects.

3.3. Financing conditions in Kenyan manufacturing: Conclusion

Kenya's manufacturing sector developments have not been as positive as those in its broader economy. Manufacturing continues to constitute a small share of the overall economy compared with services and agriculture. This is in part because of some of its finance-related constraints. Although Kenya's REER has declined somewhat, it remains elevated compared with its long-term average, suggesting a lack of competitiveness. Second, Kenya's cost of finance remains high for its entrepreneurs, despite the reintroduction of the interest rate cap, which has been counterproductive in its triggering a lending slowdown. Finally, although Kenya's financial markets are one of the most developed in East Africa, its sources of external finance remain limited to larger-sized firms and FDI has not been targeted towards the country's manufacturing sector.

4. FINANCING CONDITIONS IN RWANDAN MANUFACTURING

We next study Rwanda, selecting this country because it is one of the fastest-growing economies in SSA, with manufacturing sector growth at 8–10% per year. Despite this, manufacturing's share of the total economy remains small and the country has not seen the sector contribute in a substantive manner to its economic growth compared with other sectors. This section first outlines recent macroeconomic developments and characteristics of Rwanda's manufacturing sector (Section 4.1). It then further analyses the three key financing constraints in Rwanda (Section 4.2), regarding the overvalued Rwandan franc, which continues to look elevated in both real and nominal terms, the cost of domestic finance, which has remained persistently high, and Rwanda's access to global capital markets, which has improved amid the streamlined processes of the Rwandan Development Board (RDB) and yet could see further improvement in terms of targeted FDI into key sectors.

4.1. Rwanda's manufacturing sector

With an average 8% annual growth rate over the past two decades, Rwanda has been one of the fastest-growing economies in SSA, according to the World Bank World Development Indicators. Manufacturing value added increased significantly between 2000 and 2012, almost four-fold, from \$120.9m to \$421.3m. And yet its share in GDP declined slightly over the same period, from 7% to 5.9%. In absolute terms, Rwanda's manufacturing exports increased significantly between 2000 and 2012, rising nearly tenfold. The biggest increase occurred between 2009 and 2012, when exports rose by more than 250%. And yet, as a share of the economy, exports remain small, since most of Rwanda's manufacturers still largely produce for the domestic market. This performance also owes in part to the dominance of services, with a 50% share of GDP (AfDB, 2013).

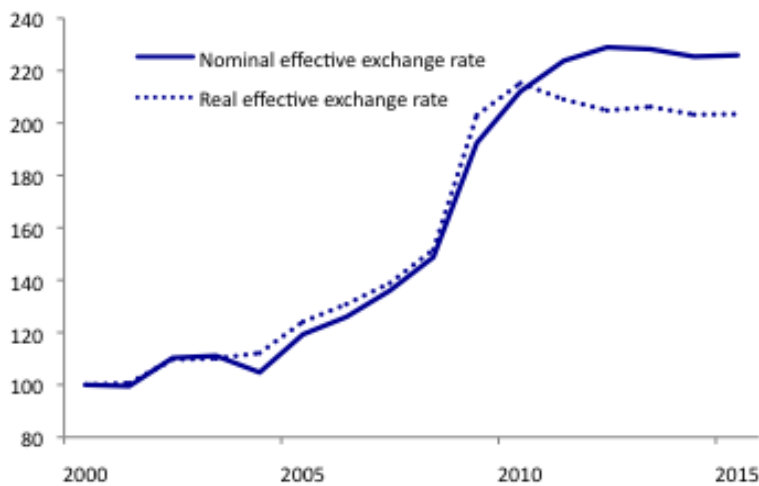
Rwanda's manufacturing sector is largely undiversified and concentrated in one subsector: food; beverages and tobacco. The other sector comprise textiles and clothing; wood, paper and printing; chemicals, rubber and plastics; non-metallic minerals; and furniture. Food, beverages and tobacco products accounts for more than 70% of total manufacturing output (World Bank, 2015). By far the strongest rise has occurred in food output, increasing its share in total manufacturing from 23% in 2000 to 44% in 2012. Rwandan microenterprises comprise the significant majority of manufacturing firms, accounting for 94% of total manufacturing firms. The share of exporting firms is small, accounting for only 14% of all manufacturers. For large firms (more than 100 employees), 40% have some form of foreign ownership; for SMEs (10–100 employees), this figure is lower, at 13%.

4.2. Rwanda's macro-economy and financing conditions

4.2.1. Rwanda's exchange rate and competitiveness

In this section, we examine developments in Rwanda's real and nominal exchange rates. As with Kenya, Rwanda's manufacturing sector, as a share of its economic output, has been largely stagnant. Rwanda's NEER and REER both appreciated between 2005 and 2009, by roughly 18% (Figure 6). The appreciation coincided with the EAC's 2005 establishment of a customs union, with its aim of establishing a monetary union by 2024 and an EAC single currency area (UNECA, 2012). Rwanda's NEER and REER strength has turned since 2009, with the REER depreciating between 2009 and 2014. The difference between the NEER and REER dynamics stems from the deceleration in overall inflation in Rwanda, with declines in both consumer prices and its GDP deflator pronounced but largely influenced by food and oil prices (Charry et al., 2014).

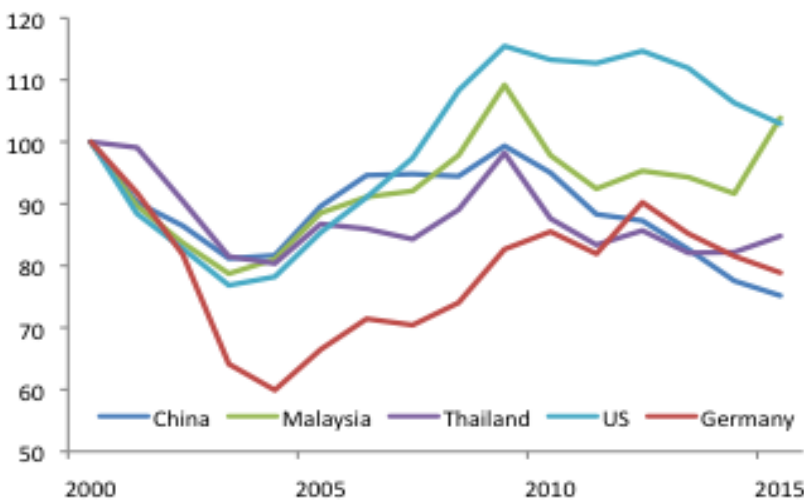
Figure 6. Rwanda's real and nominal effective exchange rate (2000=100)



Source: Author's calculations, World Bank World Development Indicators and IMF Direction of Trade Statistics.

The franc's recent REER depreciation has been broad-based *vis-à-vis* Rwanda's major export trading partners; this has included its top export markets of China, Malaysia, Thailand, Germany and the US (Figure 7). And the decline in its bilateral REERs has been driven by appreciation in all of its top five trading partners' nominal exchange rates. The appreciation of both the renminbi and the US dollar has meant a relatively more competitive and depreciating Rwandan franc. This has masked the fact that Rwanda's domestic prices have not fallen significantly against its top trading partners. Developments between Rwanda and its second largest export market – DRC – have also been significant: relative domestic prices and the relative nominal exchange rate have meant Rwanda's REER and NEER turned lower.

Figure 7. Rwanda's bilateral REERs: top 5 export markets (2000=100)



Source: Author's calculations, World Bank World Development Indicators and IMF Direction of Trade Statistics.

4.2.2. Rwanda's cost of accessing domestic finance

Rwanda's cost of finance has been high. Lending rates over the past decade have remained stagnant at around 17%, with this lack of flexibility and weak credit growth continuing to be reflected in a number of SSA economies (World Bank, 2017). Rwandan manufacturers' access to finance also remains problematic, with manufacturers complaining about high interest rates and onerous collateral requirements as key constraints. The Rwandan authorities acknowledge that this reflects a structural problem of higher operating costs incurred by banks in the country, as well as the limited bargaining power of individual borrowers, largely due to a lack of information (Rwangombwa, 2015). That said, credit provided by the financial sector since the financial crisis of 2008–2009 increased from 7% in 2009 to 18% of GDP in 2015, according to World Bank statistics, which has been encouraging. And yet, at

around 16–17% of GDP on an annual basis, the level of credit in the economy is still not conducive to high levels of private sector investment in manufacturing.

Part of Rwanda's structural rigidity in lending rates is the result of a lack of financial depth and weak financial intermediation. For instance, the current credit to GDP ratio in Rwanda is lower than in fast-growing developing countries like China, where credit was three to four times higher during comparable stages of development (UNECA, 2015). The more rudimentary measure of broad money as a percentage of GDP is 22%, roughly half of Kenya's 42% ratio. Although it has made strides in terms of modernising its financial sector through banks, microfinance institutions and capital markets, roughly 90% of Rwanda's workforce is not served by a long-term saving scheme, which would provide the mechanism for longer-term investments (Ministry of Finance and Economic Planning, 2016). And commercial banks continue to hold the largest combined share of financial sector assets, at slightly over 50%. Moreover, despite recent growth, Rwanda's banking sector is the second smallest in the EAC region (World Bank, 2015).

The lack of Rwanda's financial market breadth, or of diversity of financial instruments and products, also matters for its cost of finance. The government of Rwanda has increasingly focused its attention on deepening capital markets. This led to a directive to the Rwandan Capital Market Authority to produce a plan to sustain high levels of private sector growth, thereby aiming to meet the Vision 2020 pillar of private sector-led development for locally based businesses, aided by adequate financial sector development (MINICOM, 2012). This is in line with the government's strategic agenda for deepening debt markets, expanding listings on the Rwanda Stock Exchange and developing an enabling environment for more financial sector intermediaries. There has been both eurodollar bond issuance in 2013 (Pronina and Kay, 2013) and local debt bond issuance in 2014 in order to pay for infrastructure projects. The development of both bond markets, primary and secondary, will bring down the cost of finance and yield spreads.

4.2.3. Rwanda's access to international capital markets.

The third pathway we consider is the degree of openness and manufacturers' access to international capital markets and foreign investments. This section examines the nature of Rwandan manufacturers' access to international capital markets as a dimension of financing conditions for the sector. Rwanda's financial sector encompasses a broad range of institutions that have promoted openness. These include the Rwanda Stock Exchange, with eight listed companies. The Capital Markets Authority was established in 2011 (under the Capital Market Act of 2011) to guide the development of Rwanda's capital market. Additionally, the RDB has been instrumental in developing incentives and marketing investment opportunities abroad to attract foreign investors.

Improving access to long-term capital, particularly for SMEs, remains difficult, despite the successes of the RDB. The continued policy goal is, in large part, to alleviate financing constraints. There is a need to explore options for using capital markets to develop equity- and debt-based financing to support access to more affordable funds for expansion. This would also aid risk-sharing and diversification. Large regional conglomerates have brought longer-term capital investment, skills and technical expertise. Some of them find Rwanda to be a good strategic location for targeting the Rwanda–Burundi–DRC markets. There are also domestic investment and holding groups that control significant portions of the Rwandan industrial sector. By contrast, small domestic enterprises often struggle to raise capital and have a hard time finding skilled staff – a key reason why the manufacturing sector has not been able to generate a great deal of jobs over the past decade (Gathani and Stoellinga, 2013).

Elements of the Vision 2020 spell out a Private Sector Development Strategy to facilitate Rwandan entrepreneurship. A credit guarantee scheme has been implemented and the Credit Expansion Programme has a multi-pronged approach, including a significant expansion of the current Credit Guarantee Scheme, which reduces the risk to banks while assisting enterprises to establish a reputation for creditworthiness. It also facilitates greater use of structured finance products, providing the potential to move from collateralised loan products to other forms of security for debt finance (MINICOM, 2013). And yet, of its seven programmes, only one is devoted to ensuring adequate private sector credit provision, and there are no explicit policies to boost instruments for bank lending.

4.3. Financing conditions in Rwandan manufacturing: Conclusion

Rwanda has been one of the fastest-growing economies in SSA over the past two decades. However, the share of manufacturing in the total economy remains small and largely undiversified, which limits the country's longer-term growth prospects. The financing environment remains challenging, although it has improved somewhat. Although the country's real and nominal effective exchange rates showed significant appreciation between 2005 and 2009, they have since shown signs of stabilisation, with a notable reduction in the pace of domestic inflation. Rwanda's cost of finance has been high, with lending rates over the past decade remaining stagnant, in part because of a lack of financial depth and weak financial intermediation. In terms of Rwanda's access to global capital markets, the country has developed a broad range of institutions that have promoted and facilitated openness, including the RDB, which has streamlined investment processes. Despite this, access to long-term capital, particularly for SMEs, remains challenging.

5. FINANCING CONDITIONS IN LIBERIAN MANUFACTURING

Liberia is an example of an LDC where economic growth is largely driven by natural resource production, with both its manufacturing sector and the financial sector that supports it still underdeveloped. This section first outlines recent macroeconomic developments and characteristics of Liberia's manufacturing sector (Section 5.1). It then further analyses the three key financing constraints (Section 5.2). In terms of its exchange rate developments, Liberia is heavily dollarised, making it vulnerable to external shocks. Its REER is overvalued, suggesting rigidity in its domestic prices. Liberia's cost of domestic finance remains persistently high, in part in reflection of the domestic financial system's lack of depth. Third, Liberia's access to global capital markets is analysed, with particular focus on external FDI and other forms of finance such as long-term bond and equity flows.

5.1. Liberia's manufacturing sector

Liberia's economy has recovered from the significant contraction in GDP associated with its political conflict. Its cumulative 91% decline in GDP between its peak in 1979 and its trough in 1996 was the largest of the many protracted GDP declines in SSA over the past several decades. The decline was uniform across all sectors: agricultural production dropped as farmers fled and, when the supporting infrastructure collapsed, production halted and manufacturing essentially stopped. Production of iron ore and timber and work in mining and panning ceased completely. Between 1987 and 2005, rice production fell 73%, financial services fell by 93% and transportation and communication, trade and hotels and construction all fell around 70%. Only the production of charcoal and wood increased as Liberians turned to these products to meet their basic energy needs (Radelet, 2007).

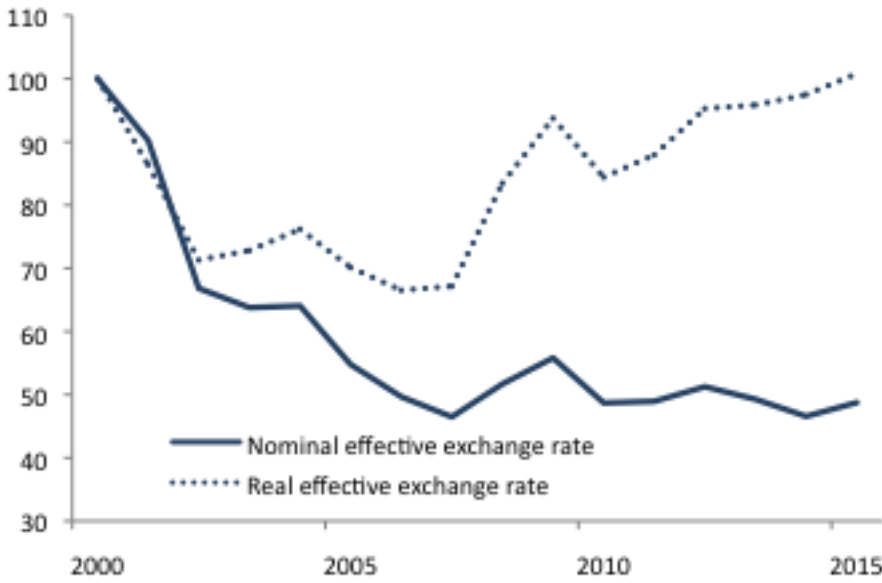
Since then, the bulk of Liberia's efforts have been geared towards the management of natural resource production. At 7% of GDP Liberia's manufacturing production is small when compared with services (46%) and agriculture and fisheries (24%) (IMF, 2016c). Given this, the domestic growth gains from diversification could be substantial. A one standard deviation increase in LDCs' export diversification boosts the growth rate by about 0.8 percentage points. For Liberia, this would imply that, if export diversification were as high as in its neighbouring countries (Côte d'Ivoire, Guinea and Sierra Leone), its annual GDP growth could be between 0.6 and 1.5 percentage points higher (IMF, 2014a). Notwithstanding this, given the strong relationship between growth in agricultural productivity and poverty reduction, efforts in Liberia have been focused on productivity-enhancing measures with a pro-poor focus that increase incomes.

5.2. Liberia's macro-economy and financing conditions

5.2.1. Liberia's exchange rate and competitiveness

Liberia's REER looks overvalued given that it has appreciated significantly since 2008, and has remained above its long-term (15-year) REER average. Between 2002 and 2015, Liberia's REER saw an appreciation of approximately 41%. By contrast, the NEER declined by 27% during that time period (Figure 8). This indicates that Liberia's relative domestic prices remain high compared to its trading partners, suggesting a lack of competitiveness. Liberia's elevated REER has coincided with and may have constrained competitiveness in supporting its manufacturing sector, and in relation to its trading partners.

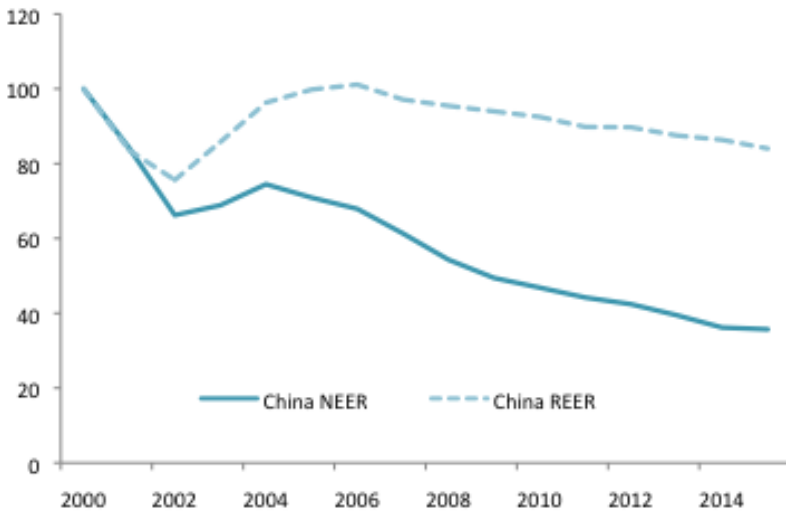
Figure 8. Liberia's real and nominal effective exchange rate (2000=100)



Source: Author's calculations, World Bank World Development Indicators and IMF Direction of Trade Statistics.

The Liberian dollar's appreciation in its REER has been broad-based *vis-à-vis* its major export trading partners; this has included its top five export markets of China, Poland, Greece, the US and Germany. The REER and NEER depreciation against China's renminbi has been particularly pronounced (Figure 9). Liberia's top five export markets are developed economies that have seen either disinflation or outright domestic deflation in some instances (e.g. in Greece).

Figure 9. Liberia's REER and NEER with China (2000=100)



Source: Author's calculations, World Bank World Development Indicators and IMF Direction of Trade Statistics.

Liberia's real exchange rate developments pose a financing constraint for manufacturers through the rigidity in domestic prices. There are some price pressures evident in the gap between the NEER and the REER. That said, the more recent relative deceleration in its price indices, both in terms of consumer prices and in its GDP deflator, has been noteworthy. Liberia's economy-wide GDP deflator registered a moderate annual increase of 1.9% in 2015, according to the World Bank World Development Indicators. This suggests that domestic inflation, and inflation volatility, could no longer pose a significant financing constraint. However, notwithstanding these developments, inflation volatility has been high, in part because of the partial dollarisation of the economy.

5.2.2. Liberia's cost of accessing domestic finance

Liberia's financial depth, measured by means of its bank deposits as a share of GDP, is higher than that of its fellow members within the Economic Community of West African States. However, its domestic financial institutions are few, which limits financial intermediation, and it is limited in the degree to which the cost of finance can be sustainably reduced for enterprises, particularly in new and undeveloped sectors, that are in need of finance. Over the past couple of years, roughly 35% of small firms, 27% of medium-sized firms and 30% of large firms have viewed access to finance as a major constraint to their growth prospects, according to Liberia's Ministry of Commerce and Industry (2014).

There are additional elements of institutional weakness. Liberia's World Bank 'Doing Business' rankings for enforcing contracts, resolving insolvency, trading across borders and obtaining credit features are among the lowest in the World Bank's survey data.⁵ Foreign companies – Liberia's main exporters of its natural resources – rely on offshore foreign banks for their main financial transactions rather than domestic institutions. Commercial banks serve mainly domestic businesses by providing short-term trade credit, generally in the services sector, with the bulk of MSMEs not able to easily access finance (IMF, 2016c). This means Liberian firms could continue to find borrowing difficult and continue to face significant financing constraints.

For the majority of Liberian entrepreneurs, non-bank financial institutions such as credit unions far outnumber commercial banks as loan providers. This is problematic given that lending rates by non-bank financial institutions are higher than those of Liberia's commercial banks. Although there are no systematic statistics, according to a recent IMF review, the average borrowing rate of commercial banks is around 14%, compared with 40% for Liberia's credit unions (IMF 2016c). The high cost of borrowing is exacerbated by the fact that only a small proportion of Liberia's population has access to electronic payment systems, even though mobile banking could substantially lower costs (Adams, 2014).

5.2.3. Liberia's access to international capital markets

As a highly dollarised economy, increasingly, as it accesses global capital markets, Liberia could be subject to extra transmission of shocks. Domestic exchange rate and inflation volatility would reduce inward investment as a result of investor risk aversion. Since 2008, some progress has also been made towards ensuring macroeconomic stability. Inflation, which spiked at 17.5% in 2008, has been reduced to single digit rates, reaching a low of 6.8% in 2012 before rising to 11.9% at the start of 2017, according to the Central Bank of Liberia. Public debt has also reduced substantially, from over 655% of GDP in 2009 to less than 20% of GDP in 2012; this was driven in part by the earlier debt buy-back and external debt relief after reaching the Heavily Indebted Poor Countries completion point in 2010 (IMF, 2010). Notwithstanding the improved economic prospects, the Liberian economy remains vulnerable to external shocks, given its undiversified economy and its dependence on imported food products and fuel.

Liberia has slowly started to develop its domestic capital market, which has in turn helped to start building some breadth into the domestic financial system. Most notably, it has developed its bond market, offering its first treasury bills at an auction in 2013, with 91-day notes yielding 2.22%, one the lowest among African debt of that duration at the time (Zoker, 2013). Expanding to corporate bond issuance will facilitate the mobilisation of longer-term capital for firms and manufacturers. This could also aid in the government's attempts to step up efforts to tackle bottlenecks to project implementation and to prioritise projects that successfully translate investment funds into productive capital in manufacturing. This is necessary to successfully implement the government's Agenda for Transformation (Clark and Rosales, 2013).

Liberia's economy has also benefited from private equity investment inflows, though these have been targeted to the fewer larger enterprises (CNBC Africa, 2014). A familiar problem in fragile and conflict-affected economies is the challenge facing SMEs – particularly their need for risk capital, which can take the form of loans or equity that involve a higher risk tolerance than bank loans. The International Finance Corporation (IFC) SME Ventures programme was designed to address some of the key financial constraints that hold back high-potential small firms in Liberia's markets, combining the provision of risk

⁵ <http://www.doingbusiness.org/rankings>

capital with technical assistance.⁶ Building on the private equity model, in which fund managers carefully select and cultivate high-potential firms, IFC is an anchor investor providing fund managers with capital to invest in Liberia's small businesses in recognition that they are the most catalytic in generating the largest share of economic activity and employment in the economy.

Development finance institutions (DFIs) such as the US Overseas Private Investment Corporation (OPIC) have also played an active role in providing and facilitating foreign investment into Liberia. OPIC has provided long-term investment funding to support industries from agriculture to financial services in the country, most recently in 2010, 2011 and 2012. It does so, crucially, in coordination with Liberia's local governments and businesses. And among its programmes, OPIC supported initiatives to build broader-based investment banking services through projects such as in the Pan African Capital Group in 2016.⁷ Other DFIs, such as CDC in the UK, has also invested in microfinance and in regional funds to support SMEs, committing \$50 million in 2014 through the Atlantic Coast Regional Fund.⁸ However, despite these investments, there has been little DFI involvement in targeting or aiming to expand Liberia's manufacturing sector enterprises.

5.3. Financing conditions in Liberian manufacturing: Conclusion

Liberia's economic growth has been driven largely by natural resource production; its manufacturing sector remains underdeveloped and therefore needs to be a focus of attention. Its financial and macroeconomic environment remains challenging. Although its NEER has stabilised, its real, or inflation-adjusted, exchange rate continues to appreciate, signifying a loss of competitiveness. In terms of the cost of finance, Liberia's few financial institutions limit financial intermediation, and it is limited in the degree to which the cost of finance can be sustainably reduced for enterprises in new and undeveloped sectors that are in need of finance. Finally, Liberia's access to global capital markets is dominated by its dollarisation, which could make it more vulnerable to shock transmission. Liberia has started to develop its bond market, helping build some breadth in its financial system. It has also benefited from development finance and private equity investment inflows, though these have been targeted to the fewer larger enterprises, with little involvement in manufacturing.

⁶ http://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Funds/Priorities/SME+Ventures

⁷ <https://www.opic.gov/opic-action/all-project-descriptions>

⁸ <http://www.cdcgroup.com/Media/News/CDC-announces-new-US184m-commitment-to-Atlantic-Coast-Regional-Fund/>

6. LOOKING AHEAD TO POLICY OPTIONS FOR FINANCING MANUFACTURING

This section explores SSA policy options (Section 6.1). These include reducing exchange rate volatility and maintaining exchange rate flexibility to promote manufacturing. In order to lower the cost of finance, it proposes that regional SSA banking coordination could lead to more competitive lending rates and innovative financial instruments to provide finance. The subsequent sections (6.2–6.4) propose country-specific policy recommendations. Section 6.2 suggests that Kenya's manufacturing sector would benefit from lower effective tax rates and streamlined investment processes and that developing local debt markets would improve its access to global markets. Section 6.3 proposes that Rwanda both increase financial depth and facilitate access to global markets through further privatisation and sovereign wealth fund (SWF) investments. Section 6.4 proposes that a scaling-up of mobile banking could lower Liberia's cost of finance, and tackling macroeconomic uncertainty could facilitate inward investment. In all three studies, REER overvaluations should be reduced to better support manufacturing competitiveness.

6.1. Policy options for alleviating key financing constraints

6.1.1. Improving exchange rate management

Introducing exchange rate flexibility is important. Authorities could foster a sense of two-way risk in the exchange rate – that the currency may either appreciate or depreciate – to encourage market participants to take both short and long positions. However, this should be executed with a view to limiting volatility and increasing liquidity. Turnover typically increases in the foreign exchange markets of countries that adopt more flexible exchange rate regimes. Such a strategy could improve domestic liquidity. Additionally, reducing the central bank's market-making role to allow scope for other market-makers is important in building liquidity; it would improve the market's microstructure by reducing market segmentation, increase the effectiveness of market intermediaries and secure reliable and efficient settlement systems (Polodoo et al., 2016).

Reducing exchange rate volatility through targeted central bank involvement, as a strategic priority, can help a country improve the depth and efficiency of its financial system. Equally, central bank intervention should be monitored in relation to the exchange rate's price action to avoid maintaining an unsustainable rate. Up to a point, increased flexibility of the real exchange rate acts as a shock absorber and helps insulate the economy against shocks. But extreme exchange rate flexibility can itself become a source of volatility. This can arise if exchange rates display overshooting behaviour and thereby become sources of shocks themselves, especially if exchange rate movements exacerbate the structural vulnerabilities, such as currency mismatches (Gadanecz and Mehrotra, 2013).

Real exchange rate overvaluations need to be eliminated, either through lower inflation or a lower nominal exchange rate, to promote expansion, transformation and growth in the manufacturing sector. Countries that are looking to transform their manufacturing sectors should maintain slightly undervalued exchange rates, particularly if the tradable goods sector is affected by market failures or institutional weakness (Rodrik, 2008). There are concerns that devaluations hit smaller, more vulnerable economies harder owing to the loss in purchasing power and the required purchasing power necessary to purchase capital goods. However, with a competitive REER, the stimulus to exports will be an offsetting factor and will protect the economy against the impacts of external shocks through its countercyclical role.

6.1.2. Lowering the cost of finance

Governments need to continue to play an activist role to build stronger institutions, so as to boost financial intermediation. This can be partly achieved through prudential regulation with the aim of improving the conditions that will support the flow of credit to manufacturing enterprise, particularly in countries with low credit shares, such as Liberia's. Creating a savings system and other financial institutions to support greater financial intermediation is of primary importance. This could facilitate entry of solid intermediaries, thereby enhancing competition. If they are to be independent, the banking regulator and the monetary authority need to have commensurate skills, administrative capacity and independence from political influence.

Enhancing regional banking coordination could increase competition and lower the cost of finance. There are potential benefits from pooling resources for a multi-country region so that they can be deployed quickly in a crisis to where they are most needed. The experience of the two regional banking commissions and the regional insurance commission in the CFA franc zone are an example of this. The Southern African Development Community and the Common Market for Eastern & Southern Africa have also taken steps towards harmonising banking regulation and supervision, though these initiatives have not progressed very far. If a regional regulatory approach is extended to allow cross-border banking on the 'single-passport' principle (as adopted in the EU), this could enhance bank competition for the more uncompetitive economies within the regulatory region; banks could provide services across borders without incurring all of the costs of separate incorporation in each jurisdiction, thus lowering the cost of finance; and enhancing Africa's varying levels of banking competitiveness (Nyantakyi and Sy, 2015).

New financial instruments geared towards SMEs, such as the IFC venture capital fund, should be a key policy tool to increase the provision of finance to small firms, which constitute a majority of the businesses on the continent but remain largely confined to the informal sector. In LDCs, new tools could include the wider usage and promotion of mobile technologies. In the wider deployment of mobile technologies, once policy-makers shift their thinking about access to finance, the cost of finance can be reduced. The use of innovative product design and modern technology has allowed other intermediaries to find ways of generating profits from mobile banking. As these innovators scale up, so too the larger players and traditional banks begin to reassess and to aim to share in the profitability. Increasing demand for low-cost and convenient products has proved there is a client base for deposit and payment products and has pushed providers to source new ways to reach untapped markets.

6.1.3. Improving global market access to capital

Sustainably tackling macroeconomic imbalances is key to accessing global financial markets and mitigating risk aversion towards SSA investments. Hausmann et al. (2004) have found that fundamental economic reform, including in investment, helps sustain growth accelerations. Reducing volatility in inflation and the domestic exchange rate, and avoiding fiscal crowding-out of the financial sector, which drive up the rate of interest, are a key part of this. On a broader level, building confidence will follow from transparent and predictable monetary policy frameworks. Similarly, developing bond markets for long-term financing needs, by setting up adequate guarantee schemes against risks, will also help effectively change the investment climate for manufacturers.

Improving liquidity provision is important in facilitating access to financial markets and foreign investment. As with mortgage-related bonds, investors are more reluctant to buy long-term instruments where there is no liquid securities market to provide them with an exit in case they need liquidity. This has led to suggestions that a public liquidity SSA facility might be set up to provide a refinancing option, mitigating long-term refinancing risk. This could also be used for bank loans and could equally provide liquidity for private equity investors. However, on a broader macroeconomic and fiscal perspective, these arrangements entail sizable contingent risks for the domestic authorities and would need to be carefully structured to mitigate risks of accumulating unwanted liabilities.

Further involvement of foreign DFIs can facilitate the flow of foreign capital into SSA, as seen with the experience of Rwanda and Liberia in particular. Private foreign institutions see the manufacturing sector as costly to service and as offering returns that are not adequate given the risks. Although state-owned SSA DFIs have been largely unsuccessful in channelling funds, the reasons for the failure are related to macroeconomic shocks, gross political interference and under-priced lending. By contrast, foreign DFI involvement should be scaled up, with government involvement to underwrite some of the risk. Already, there is significant investment by DFIs that is catalytic in terms of its impact on manufacturing. CDC's \$140m investment in ARM Cement, which operates in Kenya, Tanzania and Rwanda, is an example of this.⁹ Having the institutional mechanisms in place to invite this type of longer-term capital would further catalyse manufacturing enterprise.

⁹ <http://www.cdcgroup.com/Media/News/New-US140m-CDC-investment-in-ARM-Cement-will-help-support-East-Africas-growth/>

6.2. Kenya: Policy options for financing manufacturing

6.2.1. Improving exchange rate management in Kenya

Reducing Kenya's REER overvaluation is key to the health of its manufacturing sector. Shilling REER dynamics suggest that domestic price rigidities need to be tackled in order to sustainably reduce the REER rate. Inflationary episodes have been found to influence Kenya's private sector credit growth (Washington, 2014) and have stemmed from monetary and financial service sector credit expansion (Durevall and Sjo, 2012; IMF, 2012). There is also evidence that piracy needs to be tackled: proceeds of piracy in Somalia are laundered through investments in Kenya's real estate, transportation and hotel services, boosting the exchange rate accordingly (World Bank et al., 2013). The key factor in Kenya's stagnant manufacturing sector could be the shilling, but it is unlikely to be the only one. The recent drop in the REER reflects the NEER rather than a competitive shift in relative prices. One could conclude that long-term policies aimed at productivity, price competitiveness and investment finance, rather than weakening the currency, would support Kenya's manufacturing exports (Okado, 2013).

6.2.2. Lowering Kenya's cost of finance

Achieving structurally lower interest rates will continue to remain difficult, given banks' unwillingness to give up their profit share and to take on new risks (Njini, 2016). Banks are hesitant to lend at a lower rate when there has not been a commensurate decline in the risk of lower returns, or in risk in general when making loans. Further initiatives aimed at not financing the sector itself but improving the business environment will be key. The aim of policy-makers should be to facilitate the ability to access long-term finance for manufacturers affordably. For example, the African Development Bank currently does not directly finance manufacturing but provides support to local banks through partial guarantee facilities, which enhance the capacity of banks to provide financing and increase opportunities for businesses to access financing (Were, 2016). The new financing package thus represents an effort to tailor existing fund facilities to specific insurance needs and could be targeted to manufacturing sector-specific financing (IMF, 2015d). Ultimately, these types of investments would continue to create an enabling environment by changing the risk profile of projects and encourage investment.

6.2.3. Enhancing Kenya's access to global markets

Much of the progress that is to be made in enhancing Kenyan manufacturers' access to global finance has to do with mitigating domestic macroeconomic volatility, particularly the kind that is stemming from its exchange rate and inflation dynamics. A policy that makes debt- and equity-based finance more accessible for Kenyan manufacturers would further facilitate access to finance. Altering minimum listing requirements to enable smaller and newer enterprises to list and raise finance through local government bond markets could be a useful step. Second, broader-based FDI needs to be effectively channelled into Kenya's manufacturing sector. This could be done through lowering the cost of investing and improving the investment climate, through both lowering effective tax rates and strengthening institutions that streamline investment processes. Third, Kenya has one of the more developed equity markets in East Africa and in SSA. Tailoring tax and listing requirements and prudential and supervisory regulations for manufacturing companies will enable them to more successfully raise alternative forms of affordable finance through equity-based means.

6.3. Rwanda: Policy options for financing manufacturing

6.3.1. Improving exchange rate management in Rwanda

Rwanda's REER is uncompetitive compared with its major developed country trading partners, such as China and the US, as well as its neighbouring trading partner, DRC. Given this, the authorities could pursue other measures to increase the competitiveness of Rwandan manufacturers when compared with their main export markets. Rwanda's central bank should continue to monitor exchange rate volatility and enact measures to counter it. This is important given evidence that EAC exchange rates mostly absorb real asymmetric shocks, highlighting the need for additional tools to stabilise the EAC economies once country-specific (nominal) exchange rates are no longer available under the proposed monetary union. Exchange rate shocks are also a source of disturbance to inflation. This suggests Rwanda should move forward in modernising its monetary policy frameworks, to further anchor inflation expectations, particularly before the proposed currency union is established (Drummond et al, 2012).

6.3.2. Lowering Rwanda's cost of finance

Rwandan manufacturers are facing a multitude of costs, above financial costs. Entrepreneurs face high lending costs, high operating costs, weak savings schemes and a lack of ability to access and channel funds into their enterprises. Some of Rwanda's key financing constraints should be tackled by increasing financial sector depth. One aspect of increased financial depth could be through increased bank deposits and more formalised savings and insurance schemes. Rajan and Zingales (1998) have long shown that industrial sectors with greater links to external finance develop faster in countries with deeper capital markets. This is because of the ability of financial markets to generate credit and facilitate savings, both of which boost growth. This is important for start-ups, particularly those facing difficulties raising capital. Supporting the creation of further financial depth will also effectively promote greater information sharing about borrowers. As the costs of acquiring information about borrowers decrease, it will become easier to fund them. This, in turn, will reduce the information asymmetry and limited assets that have been absent for potential entrepreneurs.

6.3.3. Enhancing Rwanda's access to global markets

Foreign investment into Rwanda has been mixed. FDI, a key link to emerging regional and global value chains, has increased substantially in the past decade. In 2005, FDI was less than 5% of gross fixed capital formation; in 2015, it amounted to 24%. This was some 8–10 percentage points higher than in other countries in the EAC (National Bank of Rwanda, 2015). Rwanda can further promote FDI and portfolio flows by streamlining administrative investment procedures through the RDB to mitigate inconsistent application of tax, investment and immigration rules. Second, SWF investments in infrastructure and agriculture could enhance access to finance for Rwanda's manufacturing sector. The New Economic Partnership for Africa's Development and the Organisation for Economic Co-operation and Development are developing a project in partnership with the government with the aim of improving the business climate and enhancing capacity for SWFs. Finally, the government should privatise its industries further and instil a strategy targeting manufacturing FDI. Since 1995, Rwanda has been carrying out a privatisation programme in strategic areas ranging from telecommunications and banking to tea production and tourism. Though these have generally been deemed successful, there is no mandatory screening or strategy for foreign investment.

6.4. Liberia: Policy options for financing manufacturing

6.4.1. Improving exchange rate management in Liberia

Liberia's dollarisation could inhibit competitiveness and expose the economy to exogenous shocks. On this basis, it should pursue market-based mechanisms to de-dollarise. Liberia's growth model has relied on the extractives industry, with high import demand for staple commodities. This has placed pressure on the Central Bank of Liberia to intervene to support importers (Siaplay et al., 2016). Liberia should look to successful attempts to de-dollarise that have combined sustained economic stability with micro-based policies to promote use of the local currency. Successful de-dollarisation is difficult given that dollarisation tends to be persistent. Further introduction of local currency instruments, indexed to inflation or the exchange rate, should be employed as a means to help encourage economic agents to hold local currency assets, rather than dollar-denominated assets.

6.4.2. Lowering Liberia's cost of finance

The introduction of more domestic banking coverage in Liberia could increase financial depth and financial inclusion in the longer term. Increasing mobile banking access would be a useful first step in this. Implementation of mobile money regulations in 2014, and a national working group on digital finance in 2016 via mobile money for the poor,¹⁰ has laid the groundwork. Policy plans to make further financial services available, such as insurance and savings services, will support entrepreneurs and particularly market traders. Two further ways in which Liberia's policy-makers can increase financial depth lie in its domestic institutions. First, banks typically report difficulty in obtaining information about potential borrowers that they can use to adequately assess creditworthiness. More development of credit

¹⁰ <http://mm4p.uncdf.org/where-we-work/liberia>

information sharing, through credit bureaus, could help (Anderson and Johnson, 2017). Second, it is important to address difficulties in enforcing creditor rights. Liberia is a signatory to global conventions that protect foreign investments, and has a commercial court, and the legal passage of the Bankruptcy, Insolvency and Restructuring Act is particularly important in protecting creditors' rights.¹¹ However, weakness and corruption remain in Liberia's domestic judicial institutions. Without stronger domestic financial institutions, banks will be left with costly, time-consuming and unreliable procedures that serve as a disincentive to lending.

6.4.3. Enhancing Liberia's access to global markets

Despite its relatively low GDP per capita, Liberia has a location-specific coastal advantage in terms of attracting FDI. A key policy priority in attracting inward investment should lie in tackling its domestic macroeconomic uncertainty, with a particular aim of reducing exchange rate and inflation volatility. Experience has shown that the LDCs that have become resilient, and that have successfully fostered investment inflows, are those that have typically instituted a stable domestic macroeconomy and a strong regulatory and institutional environment. This, in turn, has contributed to higher investment, including better access to credit (IMF, 2015c). Building stronger institutional practices in Liberia will be conducive to fostering FDI, particularly market-seeking opportunities in manufacturing (Sauvant and Mallampally, 2015). These could include a strengthened inflation-targeting mandate for the central bank. Additionally, from a strategic perspective, the Liberian National Investment Commission, could be employed as proactively as the RDB, to streamline procedures and tax treatment for inward investment; this would be important in supporting Liberia's manufacturing sector.

6.5. Policy options for alleviating key financing constraints: Conclusion

This concluding section first puts forward policy options to alleviate financing constraints for SSA. These include fostering greater regional banking coordination. A greater degree of regional SSA banking coordination could increase competition and lower the cost of finance. It could also help introduce knowledge spill-over and new financial instruments to provide finance to small and medium-sized enterprises. In the subsequent country sections, policy options to alleviate financing constraints for Kenya's manufacturing sector could include lowering the cost of investing and improving the investment climate; this could be supported through both lowering effective tax rates and strengthening institutions that streamline investment processes. Rwanda could both increase financial depth and facilitate access to global markets through further privatisation and further sovereign wealth fund investments. Finally, Liberia's policies could focus on tackling domestic macroeconomic volatility and strengthening its institutions. The introduction of mobile banking could lower the cost of finance, and tackling macroeconomic uncertainty could facilitate inward investment. In all three studies, REER overvaluations should be reduced, through exchange rate intervention and/or lowering inflation, to support manufacturing competitiveness.

¹¹ <https://www.export.gov/article?id=Liberia-Dispute-Settlement>

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