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Attracting international private finance for African infrastructure ☆

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Abstract

Africa's trade is impeded by poor infrastructure. Inadequate transport infrastructure raises costs analogous to trade barriers, while inadequate power discourages investment. Yet Africa's infrastructure needs greatly exceed its capacity to finance them. There is therefore a need, and an opportunity, for substantial foreign private finance. However, to date, while private finance routinely finances infrastructure elsewhere in the world, in Africa it has been very limited. This article sets out the chain of impediments to scaling up private finance and suggests ways of addressing them.
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1. Introduction

International trade is highly dependent upon infrastructure. Without it, private initiatives are constrained by their inability to draw on essential contributions of transport, communications, energy, and water services. They are held back by the absence of the essential arteries through which the lifeblood of an economy flows to the veins of the private sector.

Africa needs far more infrastructure than its governments can afford to finance through tax or aid. Its infrastructure deficiency is a major impediment to the expansion of exports. Yet, while the region's infrastructure needs exceed its existing funding sources, the costs are trivial relative to the size of world capital markets. The inability of Africa to finance its infrastructure requirements is not therefore a capacity constraint. It is an institutional and organizational one. As such it is therefore soluble but it needs an imaginative approach which goes beyond what has been attempted to date.

This article sets out the basis of conceiving a different way of addressing Africa's infrastructure deficiency. It suggests that it can be tackled through a combination of public and private initiatives which address the public and private market failures which have existed to date. Only once it is recognized that both existing public and private sector arrangements are deficient will it be appreciated that each party should cease attributing blame to the other and instead recognize that it is in the interests of both of them to work together in innovative ways to combat the defects. If they do then the consequences for the region's development will be profound.

1.1. The actors to date

To date there have been four key players in the provision of infrastructure in Africa — governments, donors, private sector institutions in OECD countries, and China. African governments are very conscious that they need to attract private investment for infrastructure. There has been a gradual process of recognition that public monopolies have been dysfunctional, and the lobbies that benefit from them have increasingly been on the defensive. Usually, however, the desire for private financing has not advanced

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much beyond long wish-lists of desired projects. African governments have little capacity to design and present projects in detail in a form that is financially attractive to investors. For example, at the investor conferences at which African governments commonly pitch projects, the political risk of hold-up once the investment has been made, which is probably the biggest single impediment to private finance, is seldom acknowledged let alone addressed.

Historically aid has been a major source of infrastructure financing. However, over the past 15 years donors have switched from infrastructure to social spending. The trend began during the Wolfensohn presidency of the World Bank and reflected two concerns. One was that the rise of private capital markets would rapidly make donor lending and grants for infrastructure irrelevant. The other was that OECD tax payers were often ambivalent about paying for modern infrastructure due to environmental and social concerns; something most evident in respect of dams. There was much stronger acceptance of expenditures that were directly child focused, such as health and education. In attempting to make infrastructure projects more acceptable to their critics, agencies then encumbered themselves with a demanding range of procedural checks which raised costs and slowed implementation. A significant exception to this trend has been the establishment of the Private Infrastructure Development Group (PIDG) by a consortium of donors led by DFID, which we will discuss later.

The private sector in OECD countries has been disengaged from investing in African infrastructure projects, perceiving them as being a hassle to undertake, risky both financially and in respect of reputation, and individually too small to warrant the costs of developing the necessary skills to assess. This is despite global capital markets being in a phase of exceptional liquidity with the real interest rate on risk-free assets hovering around zero. Large sums were directed to emerging market economies, but little to Africa. In contrast to the zero real return on safe OECD assets, the return required for private investment in African infrastructure is very high. For example, InfraCoAfrica, a PIDG-funded company which initiates infrastructure projects, struggled to raise finance for a Ghanaian electricity project despite a projected yield on equity of 20%. Since Ghana is rated as one of the best-governed countries in Africa, this massive wedge between the risk-free rate of interest acceptable to financial markets, which is currently around zero, and the risk-corrected rate demanded for African infrastructure, suggests that managing risk is central to the provision of private finance. Nor is this Ghanaian project in any way exceptional. A World Bank analysis of the African electricity sector undertaken in 2011 found that despite several attempts, virtually no privately financed projects were actually operating.[1] Up to 2011, new spending on PPI in African power was averaging around $0.5bn per year, against a target of $40bn.

China has filled the resulting vacuum through a distinctive package in which infrastructure is financed and built in return for rights to resource extraction. This offers speed and a full range of services in which the infrastructure is designed, built, financed and transferred. It also provides a commitment technology whereby an African government can lock into using natural asset depletion to accumulate infrastructure, thereby avoiding pressures to dissipate resource revenues in recurrent expenditure. However, the Chinese proposals are often difficult to evaluate. They are opaque and so are hard to price, and since China is a near monopolist in this type of package they are not subject to direct comparison. Further, Chinese projects are usually not well-integrated into larger development strategies. A radical approach would be for the bilateral OECD donors either to partner with Chinese approach, encouraging better integration into development planning, or to copy it, using aid to catalyze a consortium of private firms. Several OECD donors used to work in this way, and indeed China appears to have modelled its approach on aid it received from Japan in the 1950s. It would, however, require a cultural revolution in OECD aid agencies and is probably not feasible let alone desirable.

1.2. If private finance for African infrastructure is a good idea why hasn't it happened already?

Since private capital markets are designed to seek out attractive opportunities to finance investment, a reasonable question is why, if private capital should finance African infrastructure, has it not happened already? Economics is rightly wary of arguments that depend on sophisticated private financial actors making prolonged and systematic errors.

A compelling response would be if the overall social return on African infrastructure was inherently too low to warrant private investment.[2] In that case arguably investment in infrastructure should not occur. We say arguably because a shortfall of social returns below private required rates of return may also result from private costs of capital being greater than their social equivalents, *i.e.* the costs at which society as a whole, as against particular private sector investors, would be willing to invest.

For the reasons mentioned at the beginning, it is unlikely that the social returns to African infrastructure investment are low. It is difficult to envisage Africa becoming a developed region without substantially improved infrastructure. But it is quite likely that the valuation of benefits by private investors is substantially different for private investors from public institutions. There are two reasons for this. The first is the obvious point that there are significant externalities associated with the provision of infrastructure projects of which private investors can only capture a small component. One only has to think of the array of private sector enterprises which typically spring up around major transportation hubs to appreciate the difference between social and private rates of return.

Second, the risks and therefore costs of capital are fundamentally different between private and public sector providers. Referring back to the arteries analogy used earlier, one piece of infrastructure is inherently dependent on another — a bridge on a road and the road on the bridge. In addition the profitability of

[1] See Eberhard et al., (2011), and Eberhard et al., (2012).

[2] In some African countries this is likely to be the case. See Collier, (2013).

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