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KEY POINTS

- The services sector presents an opportunity for African countries to diversify their exports.
- The use of innovation and technology in the services sector can strengthen productive capacities, leading to high-quality and more diversified exports of goods.
- African countries can diversify exports through intensifying forward and backward linkages with services sectors and increasing export of services.
- A policy brief on how the roles of financial services and private businesses can be leveraged to strengthen productive capacities and diversify into high-quality exports.

Financial services: Unlocking the potential for export diversification

The services sector presents an opportunity for African countries to diversify their exports through two key facets: (a) the use of innovation and technology in the services sector can strengthen productive capacities, leading to high-quality and more diversified exports of goods; and (b) African countries can diversify exports through intensifying forward and backward linkages with services sectors and increasing export of services.

This policy brief, based on the *EDAR 2022*[1], presents recommendations on how the roles of financial services and private businesses can be leveraged to strengthen productive capacity and diversify into high-quality exports.

Introduction

Over 80 percent of African countries are commodity-dependent, accounting for 45 percent of commodity-dependent countries worldwide.[2] While African countries have taken steps to counter commodity dependence, implementation of these policies has been fraught with difficulties.

[1] This policy brief is based on the UNCTAD's *Economic Development in Africa Report 2022*. https://unctad.org/webflyer/economic-development-africa-report-2022.

[2] The UNCTAD's *State of Commodity Dependence 2021 Report* (United Nations publication. Geneva) defines commodity dependence as a situation where commodities represent more than 60 percent of total merchandise exports.

Nonetheless, opportunities abound for African countries to diversify their economies to the desired levels. For instance, AfCFTA trading, a growing middle class, an emerging market, increased use of financial services and technology, and the performance of dynamic entrepreneurs have been listed as some of the key drivers of export diversification and therefore, sustainable economic growth.[3] Moreover, the role that services can play in contributing more effectively to diversification and growth on the continent is groundbreaking. High-knowledge-intensive services can be decisive in the overall diversification process that African countries should prioritize to build resilience and promote sustainable development. Technology and smart services provide conducive platforms for efficiently linking producers with markets, transcending processes from an assimilation of intensive service-based intermediate inputs in production to facilitating complexity and diversity of manufacturing outputs.

At $124 billion in 2019, Africa's service exports were scant, accounting for 17 percent of total exports. Be that as it may, in 2020, COVID-19 had adverse impacts on trade in services, resulting in a reduction by about a third to $82.7 billion in 2022.[4] An in-depth country analysis in the *EDAR 2022* shows that only eight African countries exported more services than they did goods, with the trade in services exports predominantly in travel and transport, accounting for more than two-thirds of total trade in services.[5]

In contrast, high knowledge-intensive services, which require highly skilled labor, only accounted for about 20 percent of services exports for African countries in 2019. The report notes that since trade in services requires the movement of persons, policies that hinder free movement are the key barriers to trade in high knowledge-intensive services.

Therefore, it is imperative that African countries analyze and identify barriers to trade in services and take appropriate policy action to eliminate barriers. An increase in the export of financial services, an example of a high knowledge-intensive service, could foster SME and private sector opportunities both within and across borders, thereby strengthening productive capacities and export diversification.

This policy brief focuses on and briefly analyses the potential role the financial services sector could play in strengthening export diversification in Africa.

Leveraging the financial services sector

Over the last two decades, the use of technology and innovation has disrupted the traditional financial services sector. Within the banking sector, the use of technology to strengthen financial access (fintech) has greatly improved the ability of the private sector to access services that they previously could not access in the traditional banking sector. Similarly, fintech has enabled innovative insurance products to provide a lower-risk operating environment for start-ups, small and medium enterprises (SMEs), and other private sector firms.

The developments in the financial services sector offer an opportunity for African private sector firms to strengthen productive capacities, and to diversify products including products that require highly skilled labor and the use of innovation and technology (see Box 1).

However, the current banking and finance structure in many African countries inhibits export growth and diversification for African SMEs and other private sector firms, as traditional credit requirements are often a barrier. Bank supervision laws, meant to ensure financial stability in the economy, provide perverse incentives for bank lending to the SME sector, with banks often perceiving SMEs as risky due to information asymmetry on the one hand, and lending products designed for larger, more structured firms on the other.[6]

Similarly, SMEs, because of their size, lack the advantage of specialized expertise in the financial services sector, unlike large multinational firms, which often have expert personnel dedicated to financing aspects of the firm. In addition, limitations due to lack of collateral and information asymmetry often mean that SMEs are locked out of crucial financing, which not only inhibits growth, but also investment in technology and innovation to strengthen product development and diversification.

Financial technology, therefore, has the potential to improve exporting firm's access to credit through, for instance, capital venture and private equity firms, business angels, and other private debt mechanisms, thereby raising the ability to increase the share of manufacturing relative to primary exports, leading to greater export diversification.

3 UNCTAD (2022). *Economic Development in Africa Report 2022: Rethinking the Foundations of Export Diversification in Africa: The Catalytic Role of Business and Financial Services* (United Nations publication. Geneva).

4 Ibid.

5 Countries with export of services more than export of goods: Cabo Verde, Central African Republic, Comoros, Ethiopia, the Gambia, Mauritius, Sao Tome and Principe, and Seychelles, with the majority of the countries being either renown tourist destinations or countries with strong travel sectors, such as Ethiopia (Ethiopian Airlines).

6 UNCTAD (2022).

According to International Finance Corporation (2017)[7], there are about 50 million formal micro, small and medium-sized enterprises in Africa with an unmet financing need of $416 billion every year.[8] Nigeria represents about 38 percent of the financing needs of micro, small and medium-sized enterprises in Africa.

UNCTAD 2022 identifies three key areas that would unlock financial services potential for export diversification:

1. De-risking financing for small and medium-sized enterprises, for instance through guarantee programs by governments to the financial services sector, development bank loans designed specifically for SMEs, and risk pooling, such as two-tier structures of credit supplementation for SMEs.
2. Facilitating innovations in private sector finance through a supportive policy environment.
3. Addressing the legal, regulatory and financial infrastructure uncertainties.

Box 1: The relationship between finance, private sector development and export diversification in Africa

Empirical analysis suggests that multidimensional financial sector development is directly related with macro-level export diversification. Intuitively, where the level of financial inclusion is high, the private sector (including SMEs) tends to exhibit strong performance. Access to finance enables firms to expand through improved access to technology, factors of production, and raw materials.

UNCTAD (2022) finds that alternative financing can help to bridge the investment gap for start-ups and SMEs. While banking services strongly encourage countries to specialize in the production and export of commodities for which they enjoy a comparative advantage, alternative finance provides countries with a cushion to diversify their export portfolio. Therefore, financial sector development allows firms to increase their share of manufacturing relative to primary export, leading to greater export diversification.

The private sector, in particular SMEs, has the potential to diversify exports, attract investment in growth sectors and stimulate innovation in domestic industries, and as a result, could strengthen growth and economic development. The private sector needs a well-functioning financial sector to exploit its full potential. Online trading, infrastructure, and lending platforms, such as Smart Trade Africa Marketplace and Twiga market, are seen as successful examples of unlocking financial services potential.

The Smart Trade Africa Marketplace is a digital ledger platform that brings together all the elements of a trade transaction: finance, logistics, customs and taxes, regulation, and insurance.

Twiga market is a mobile-based cashless business-to-business platform in Kenya that links farmers to markets, reducing post-harvest losses that arise from handling, high transport costs and agricultural produce market information asymmetries. Based on the orders from the vendors placed through the platform, the company makes deliveries and receives payment from vendors through mobile money. Twiga market allows farmers to have easy access to a wider market, and low transportation costs for smallholder farmers and vendors, as they are not restricted by distance.

Source: UNCTAD Economic Development in Africa Report (2022), Twiga (https://twiga.com/), Smart Trade Africa (www.smarttradeafrica.com)

Financial technology: As innovation in the sector grows, so to do the risks

Just as financial technology has positively disrupted the financial sector, it has presented some downsides. The nature of financial technology business models, that is, innovativeness, opacity, and complexity, in addition to lack of proper regulation in the sector, often heightens the risk of loss from fraudulent activities or misconduct by operators and/or other third parties.
The following risks are identified in the UNCTAD *Economic Development in Africa Report 2022*:

1. Poor governance or process control, which can disrupt provision of financial services or critical infrastructure.
2. Cyberattacks on financial activity and risk contagion effects on other interconnected financial institutions.
3. Uncertainty concerning liability for losses, especially in the absence of sound legal and regulatory arbitrage systems, which can negatively affect the confidence of investors and businesses in the system.
4. Excessive volatility of some financial technology services or business models, which can easily alter the overall functioning of asset and credit markets (Financial Stability Board, 2017)[9].

[7] International Finance Corporation (2017). MSME [Micro, Small, and Medium Enterprises] Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small, and Medium Enterprises in Emerging Markets. Washington, D.C.

[8] Calculations based on International Finance Corporation, 2017 and updated data 2018–2019 (www.ifc.org).

[9] Financial Stability Board (2017). Financial stability implications from fintech [financial technology]: Supervisory and regulatory issues that merit authorities' attention. 27 June.

Policy options to strengthen the financial services sector for export diversification

UNCTAD's *EDAR 2022* has shown the crucial role of services in Africa's export diversification. Services represent a milestone in trade and by serving as key inputs to production, they are an important component of regional and global value chains. In the case of financial services, the current structure does not always foster the flexibility and resources needed to help firms address the drivers of exporting, thereby undermining their ability to export and diversify their export basket. The policy recommendations to catalyze the roles of financial services in export diversification focus on strategies to meet the financial needs of domestic firms and to build innovative and effective financial services and business models. The *EDAR 2022* recommends the following policies for greater involvement of financial services in the diversification process:

- Facilitate SME access to specialized financial and non-financial products and services through new policies and programs adopted by African policymakers with the involvement of financial institutions and market participants.
- Develop alternative financing mechanisms based on financial technology. This alternative financing should be done within an appropriate regulatory framework and allow SMEs to access funds easily without information asymmetry inherent in financing decisions for them.
- Encourage African regulators to facilitate cooperation with financial service providers, and harmonization of technologies, rules, and standards for digital services and products across national and regional jurisdictions.
- Greater collaboration between African regulatory, supervisory and standard setters and African financial technology companies to establish coherent frameworks for the testing of financial service technology, and to adopt appropriate rules and standards to ensure broad access to financial technology and other innovations.
- The establishment of training centers and information-sharing mechanisms to help African regulatory and supervisory bodies develop their skills and knowledge on the use of appropriate financial services technologies. In addition, the capacity of these actors should be strengthened to enable them to reduce the concentration, operational, and systemic risks that arise from the application of the technologies involved.
- The promotion of regional integration and convergence of systems, regulations, and platforms necessary for the use of financial technologies by governments, financial institutions, national and regional regulators.

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