Economic development in Africa report 2024

Chapter IV

Building resilience in African businesses and cross-border transactions

United Nations

Introduction

In many countries in Africa, situations of vulnerability to polycrisis shocks that prevail in the economic and connectivity domains, such as high non-tariff trade costs, weak infrastructure connectivity, low levels of participation in trade networks, high concentration of exports and a low degree, or lack of, economic complexity, can contribute to a shrinking appetite for business operations and capital flows to countries in Africa and further undermine the already challenging business and investment environments on the continent (see chapters II and III). Such structural downside factors may affect the ability and willingness of businesses and investors, both foreign and domestic, to venture into Africa or move their goods, services and capital across frontiers. This also concerns investors seeking business partnerships beyond windfall profit expectations (Hartwich and Hammer, 2021). Ultimately, barriers to the flow of goods and capital across borders, whether tariff-based or structural, culminate in regional market vulnerability, which may place African companies at a disadvantage and breed inconsistency in their ability to reap the economic benefits and growth potential of regional trade blocs such as the African Continental Free Trade Area.

However, the private sector's potential to leverage regional market advantages is offset by deficits in the financial system; scarcity in the factors of production, such as capital and entrepreneurship; regulatory compliance challenges and insufficient infrastructure integration in most African countries (see Economic Commission for Africa, 2020; UNCTAD, 2023a; Hartwich and Hammer, 2021).

These are clearly factors that derive from or can further contribute to the economic, connectivity and energy vulnerabilities faced by many countries in Africa (see chapter I), affecting their ability to mitigate the trade and investment risks presented by the global polycrisis. As outlined in previous sections of the report, key structural factors of economic and connectivity vulnerabilities, such as a lack of adequate infrastructure and technological solutions, limited trade logistics and high trade costs, can erode stability and growth prospects in African economies. This chapter will assess key financial and operational enablers and instruments that can help businesses in Africa, especially SMEs, better manage various and often contiguous crises.

Firm-related risks and opportunities

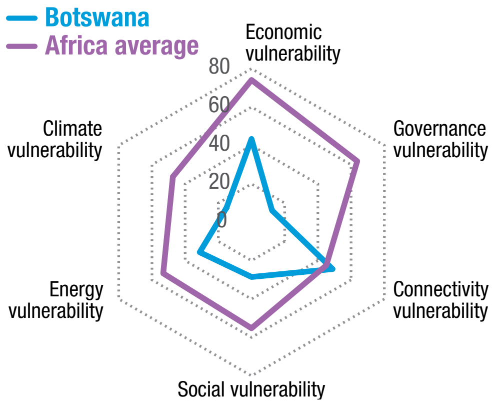
The general narrative overemphasizes the risks of trading and investing in Africa, as the region continues to score poorly in critical areas, including access to finance, infrastructure, bureaucratic red tape and governance. For instance, in 2023, the Economist Intelligence Unit Operational Risk Services painted a picture of entrenched political instability and democratic recession across most of Africa. The region scored 74/100 for political stability and governance effectiveness, which represents the largest operational risk in Africa (Economist Intelligence Unit, 2023).[1] The five countries in Africa with the lowest rating for operational risks in mid-2023 due to their "comparatively business-friendly tax and trade policies and relative political stability and government effectiveness" were Mauritius, Cabo Verde, Botswana, South Africa and Morocco (Economist Intelligence Unit, 2023).

Situations of vulnerability to polycrisis shocks can contribute to a **shrinking appetite for business operations and capital flows** to countries in Africa

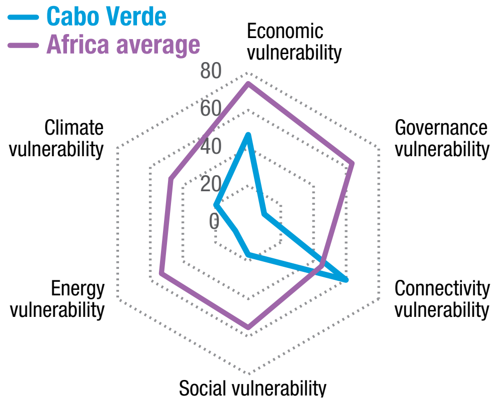
[1] The Economist Intelligence Unit operational risk model assesses 180 countries according to overall operating risk. The model evaluates business conditions in the markets covered against the changing political and economic landscape to rank countries by operating risk. It produces scores quarterly across 10 key operational risk categories and 70 subcategories. Risk levels are based on a score out of 100, with 100 being the highest risk.

Figure IV. 1
Resilience to shocks in selected countries

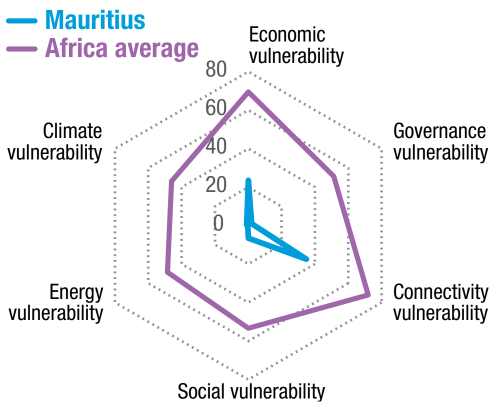
(a) Botswana



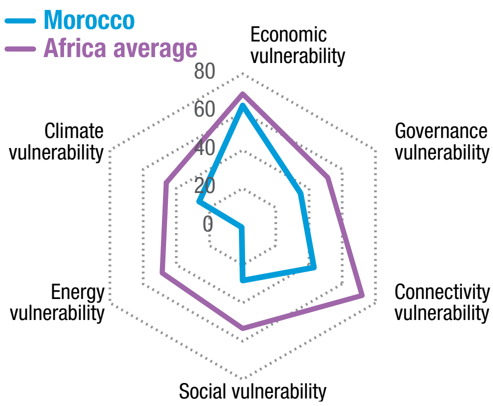
(b) Cabo Verde



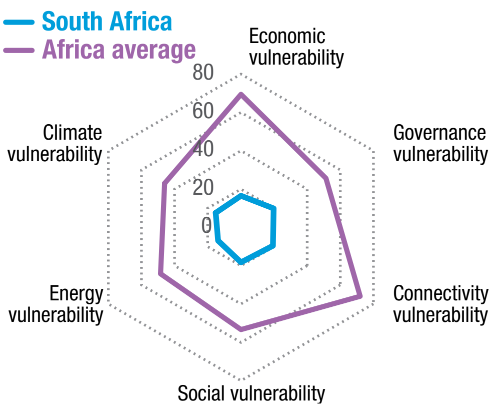
(c) Mauritius



(d) Morocco



(e) South Africa



Source: UNCTAD.
Note: Values represent a score out of 100.

These are also countries that demonstrated resilience across many of the six domains of vulnerability identified in chapter I. Figure IV.1 shows that the level of vulnerability of these five countries across at least five of the six identified domains is low, compared with the general average in Africa. Their overall and comparatively low levels of vulnerability to shocks can help explain their ability to mitigate entangled shocks and recover from the adverse effects of the polycrisis, which are attributes that businesses and investors look for in a market when making an entry or investment decision.

Exceptions can be observed for Botswana and Cabo Verde, in the area of connectivity vulnerability and for Morocco, in that of economic vulnerability. In a country such as Botswana, vulnerability in supplying reliable electricity can further reduce a firm's productivity when exposed to a market or supply chain disruption emanating from external shocks and related economic downturns. In the 2023 World Bank Enterprise Survey, 64 per cent of the firms surveyed in Botswana had experienced failures in the provision of electricity, which resulted in higher operational costs, disrupted some of their production and decreased their profitability (World Bank, 2023b).

Despite the existence of sound frameworks and capabilities in some of the most resilient African economies and an improved business environment in a growing number of countries, most private companies in those countries are left unprepared in the event of internal or external shocks, with limited capacity and resources for emergency responses to a crisis. In other countries in Africa, firms operate in complex and uncertain macroeconomic and geopolitical environments, which can pose high risks to their finance, products, operations, compliance and conduct. These challenges are not specific to African firms. In many parts of the world, the effects of global crises, such as the COVID-19 pandemic and geopolitical tensions, have brought additional challenges to SMEs, including limited financial and managerial resources, low international exposure, serious informational constraints and heavy regulatory burdens (UNCTAD, 2024d). To embrace the vast opportunities offered by African markets, such as good returns, greening investment, economies of scale under the African Continental Free Trade Area, burgeoning services and middle-class-based consumption (Hruby and Arditti, 2022), it is important for companies to understand the rules and requirements concerning compliance, regulatory issues, tax challenges and financing conditions related to business practices, cross-border trade and capital movements in Africa. It is also essential that firms identify these key issues and acquire adequate knowledge of the landscape of African markets. This can help them pre-empt potential risks and successfully manage risk exposures.

Most private companies in Africa are left unprepared in the event of internal or external shocks, **with limited capacity and resources for emergency responses to a crisis**

This section will examine some of the risks that can threaten business and trade activities across Africa and exacerbate disruptions to production, uncertainties and service liabilities, namely regulatory risks and currency risks.

Legal and regulatory risks

Firms face multiple, complex and changing regulatory risks that affect their performance and compliance behaviour (Vincent and Ntim, 2021). Compared with large multinational enterprises, SMEs face distinctive bottlenecks, including limited access to finance, skills and technology constraints, low institutional quality and international exposure, regulatory complexities and international competition (UNCTAD, 2024d). There is a strong correspondence between institutional quality and the regulatory environment. The regulatory risks faced by firms are often in the form of unclear and inconsistent legal and institutional frameworks. For instance, not having access to clear information about the specific legal and regulatory provisions of a given Government can undermine the ability of a firm, especially a foreign one, to comply effectively with domestic policies and laws pertaining to its operations or investment in a specific sector, such as mining. The legal and regulatory clarity surrounding resource-based investments is critical in linking the extraction and sale of resources for broad-based economic development. Existing quality and price provisions contained in most of the policies and legislation of countries in Africa may provide an excuse for non-compliance (White, 2017). In addition, quality requirements and the inspection of standards are enforced differently between registered and unregistered firms, with the latter establishments skirting the enforcement efforts of government authorities.

Another obstacle that firms face with regard to laws and regulations concerns the unpredictable and stop-start nature of regulations, rules and procedures. If a given legal and regulatory framework is unpredictable, unclear and inconsistent, it opens a door for interpretation and is often considered a disincentive to entrepreneurs' investment intentions. The disincentive to investment or production by firms is not restricted to domestic investment but to foreign direct investment as well. The certainty of legal and regulatory frameworks is necessary for investment decisions made by firms. In practice, a Government can establish a coordinating framework or council that involves responsible bodies across the whole public administration to implement clear, well-coordinated legal and regulation frameworks. This helps firms plan for the future and clarify decisions made with regard to investment and company growth.

> One way of de-risking operational and growth opportunities is **to raise the level of trust with regard to the protection of property rights**

Owing to the changing regulatory landscape, complying with rules and regulations brings high transaction costs for SMEs, hampering their growth and internationalization process (UNCTAD, 2024d). In particular, tax compliance can be especially burdensome for SMEs, due to complex and evolving tax laws, resulting in high transaction costs. In many African countries, tax collection and revenue systems are characterized by significant complexity, extensive face-to-face interactions between tax collectors and taxpayers and informal payments (Dom et al., 2022). This indicates that African SMEs need more time spent on tax compliance, which increases their transaction costs and may hinder their ability to thrive in the market. Moreover, the number of documents and processes that firms must comply with to make tax payments – both inland and at border crossings – and register or renew a business licence can be costly and hence serve as a disincentive for traders and investors alike. Tax administration efficiencies are generally weak in Africa and can lead to tax avoidance, evasion behaviour (Abdu et al., 2020; Otusanya et al., 2022), informality (that is, with a strong incentive to not register firms) and a lack of transparency. Investors may perceive these challenges as risks to their investments. However, many countries have introduced two tools developed by UNCTAD, the Automated System for Customs Data and the Debt Management and Financial Analysis System, which are aimed at increasing efficiency, transparency and accountability in revenue administrations and helping address the complexity and high cost of complying with tax regulations.

In addition to complex tax rules and structures, which can present a considerable burden for businesses (World Bank and Pricewaterhouse Coopers, 2019), many countries have inadequate domestic legal frameworks and enforcement mechanisms for protecting intellectual property rights. Although regional institutions have been established to manage intellectual property in 37 countries, namely the African Regional Intellectual Property Organization and the African Intellectual Property Organization, their limited capacity and resources raises the likelihood of the proliferation of applications for intellectual property rights (UNCTAD, 2023i). The lack of protection exposes foreign investors to the risk of piracy, counterfeiting and unauthorized use of their intellectual assets. One way of de-risking operational and growth opportunities, especially for firms in the process of internationalization – firms with exporting and investment ambitions abroad – is to raise the level of trust with regard to the protection of property rights. Limited awareness among businesses and government agencies about the importance of intellectual property rights and insufficient institutional capacity to enforce these rights undermines investor confidence. At the global level, compliance with the Agreement on Trade-related Aspects of Intellectual Property Rights of the World Trade Organization, acknowledged as the most comprehensive standard for intellectual property rights in the multilateral trading system, can also be constrained by reduced resource capacities in some countries in Africa. The enhanced alignment of domestic and regional intellectual property right frameworks with multilateral rules can contribute to increased investment and innovation in Africa. For instance, the dispute-settlement mechanism under the Agreement Establishing the African Continental Free Trade Area, which is modelled on that of the Agreement on Trade-related Aspects of Intellectual Property Rights, will help diminish intellectual property right risks related to cross-border trade and investment (UNCTAD, 2021c).

However, registering and enforcing intellectual property rights can be lengthy and bureaucratic, which can discourage innovation and investment. Delays in dispute resolution can increase costs for investors and undermine contractual certainty. While international arbitration and alternative dispute-resolution mechanisms offer alternatives to domestic courts, their availability and effectiveness vary across Africa. The enforceability of arbitration awards and mediated settlements depends on the legal framework and adherence to international conventions on arbitration. Moreover, inconsistencies in enforcement procedures across jurisdictions can weaken the credibility of dispute-settlement mechanisms. The limited access to affordable and impartial dispute-settlement mechanisms, particularly for SMEs, poses challenges for investors seeking a timely resolution of commercial disputes.

Addressing issues associated with tax, intellectual property rights, the judicial system and dispute-settlement mechanisms with investors requires concerted efforts by Governments in Africa to reform tax systems, strengthen intellectual property rights protection, improve judicial efficiency and independence and enhance access to effective dispute-settlement mechanisms. Such reforms can create sound institutional frameworks and conditions for good economic governance, especially in the areas of regulations, business licencing and taxation, which are fundamental pillars of a favourable business and investment climate and, hence, a lever to promote business resilience and sustainable economic development on the continent.

Many countries in Africa have simplified procedures on the entry and sustainability of foreign investment with incentives, such as repatriation, investment allowances and a wide range of tax incentives and in some cases, protection from competition. These simplified procedures and incentives were adopted to facilitate investment and contribute to the diversification of investment instruments on the continent, with the signing of various bilateral and multilateral investment treaties and the domestication of foreign investment laws (see box IV.1 on intra-African investment and related instruments). However, tax exemptions and incentives, when not properly administered, can undermine revenue potential through artificial profit shifting and tax avoidance (African Tax Administration Forum, 2024; International Monetary Fund, 2022). Notably, enhanced frameworks protecting investments or contributing to the proliferation of investment promotion agencies, special economic zones and other targeted mechanisms aimed at prompting foreign investment inflows into the region could be introduced or strengthened in countries in Africa to protect against harmful tax regimes or the risk of tax avoidance, base erosion and profit shifting, profit misalignment and the race to the bottom in corporate income taxation (Etter-Phoya et al., 2022).

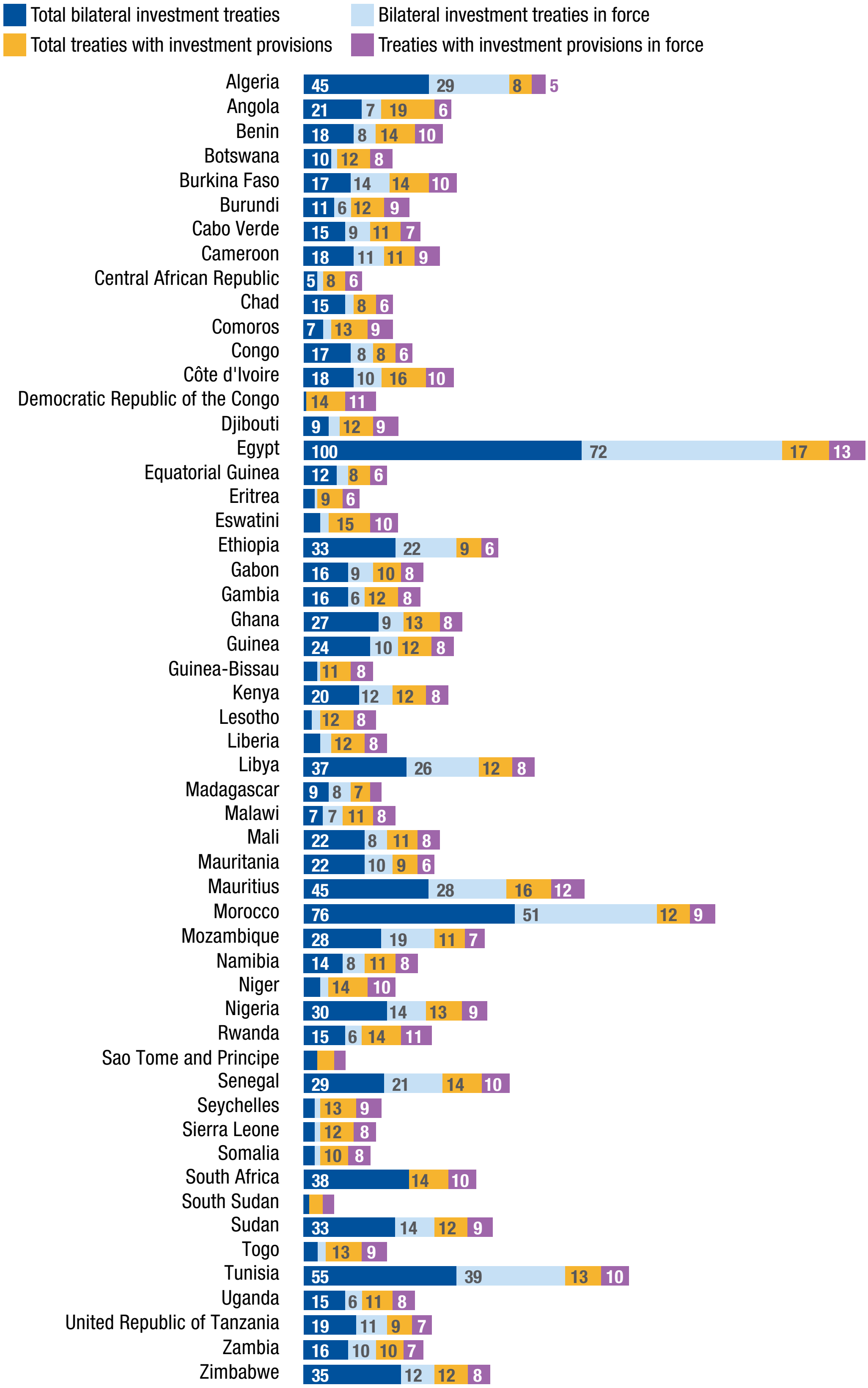
Simplified procedures and incentives were adopted **to facilitate investment and contribute to the diversification** of investment instruments on the continent

Africa is a signatory to several bilateral and international trade and investment agreements that minimize the risks of trading and investing in the region (figure IV.2). However, old-generation treaties and most international investment agreements concluded by countries in Africa carry their own risks. They fail to balance investment protection with the State's right and obligation to regulate in the public interest. Countries can be liable for damages amounting to billions of dollars, awarded by ad hoc tribunals.

Bilateral investment treaties are among the key instruments used globally to minimize investment risks associated with factors such as trade and investment disputes, employment and wages, ownership and control of businesses, expropriations and transfers. Egypt leads the region in this respect, having signed 100 such treaties, 72 of which are in force with countries in Africa and elsewhere (figure IV.2). Morocco follows with 76; Tunisia, with 55; Algeria, with 45; Mauritius, with 45; and South Africa, with 38. Given the large number of outdated international investment agreements established by these countries, reform of the international investment regime is urgent to ensure that investment is further protected, while safeguarding the regulatory space of countries in Africa to act in the public interest. The Protocol on Investment to the Agreement Establishing the African Continental Free Trade Area, adopted by African Heads of State in February 2023, is a modern international investment agreement that is more comprehensive than previously established investment policies in most countries in Africa, building on decades of investment policy reform on the continent, integrating innovative principles from other relevant international investment instruments, agreements and frameworks, such as the UNCTAD Investment Policy Framework for Sustainable Development, and providing provisions that protect or enhance legitimate public morals, public health, climate action and investor–State security (Danish et al., 2023).

Figure IV. 2

Bilateral investment treaties and treaties with investment provisions signed by countries in Africa



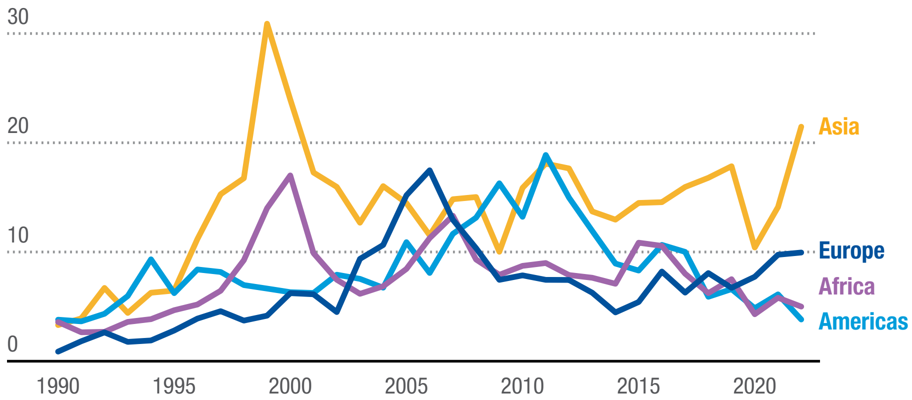
Source: UNCTAD, based on data from UNCTAD, 2024l.

Box IV. 1
Opportunities in intra-African investment and related instruments

Africa offers significant investment opportunities across sectors. Its rich natural resource base provides a wide spectrum of investment opportunities in precious minerals, renewable resources, alternative energy and food and beverages. Other prominent sectors with growing investment options include infrastructure, financial and business services, health care and education. These opportunities are underpinned by a growing youthful population and emerging middle class. Moreover, the region also accords its traders and investors access to the largest free trading market in the world measured by the number of countries participating.

While the domestic environment plays a role in domestic and foreign investments, global shocks also account for many investment decisions across regions. The UNCTAD World Investment Report 2023 reported a declining trend of 2 per cent in 2023 for global foreign direct investment flows, partly due to weakening and uncertain global economic trends, including trade and geopolitical tensions, and supply chain disruptions. Flows of foreign direct investment to Africa were also on a downward trend in 2023, falling by 3 per cent to a total stock of $53 billion. In developing Asia and in Latin America and the Caribbean, foreign direct investment inflows decreased by 8 per cent and 1 per cent, respectively. The figure shows the extent to which such inflows to Africa (as a share of gross fixed capital formation) resonate with general global trends, underscoring that it is not only the investment environment in Africa that plays an important role in influencing international investors' decisions. Specifically, shocks that affect the liquidity of its top foreign investors will generally be reflected in its foreign direct investment inflows. For instance, except for in the Americas in 2001, foreign direct investment inflows to all regions grew following the global price boom of certain commodities in the early 2000s (figure). Similarly, except for in the Americas, there was a decline in foreign investments in Africa, Asia and the European Union following the global financial crisis in 2008 and a general decline in 2020 due to the pandemic. This downward trend may be primarily a function of a series of global shocks, including spikes in food and energy prices and rising debt. With Europe accounting for the bulk of foreign direct investment in Africa, followed by China and the United States, all shocks affecting their liquidity will compress their investment portfolios in Africa and affect its development prospects.

Regional foreign direct investment inflows as a percentage of gross fixed capital formation, 1990–2022
(Percentage)



Source: UNCTAD calculations, based on data from the UNCTADstat database.
Note: Data are only available up to 2022.

Therefore, the increased volatility and, most importantly, the current dip in global foreign direct investment flows, is a wake-up call for firms in Africa to champion growth and development aspirations by broadening their geographical footprint. Expanding intra-African investments with a wider geographical spread across the continent remains a key channel for consolidating the gains from deeper regional integration and a major driver of value and resilience under the African Continental Free Trade Area. It is expected that the implementation of the Protocol on Investment to the Agreement Establishing the African Continental Free Trade Area will facilitate further intra-African investment. Of the $64 billion of international projects financed in Africa in 2023, 20 per cent of the projects in the services sector and selected manufacturing industries, and 13 per cent of the projects in resource-based processing industries, were funded by investors from Africa. This indicates the market attractiveness of countries in Africa and intra-African investment opportunities for African investors, which can be further increased with the aforementioned Protocol and other regional investment agreements.

Progress is being made at the subregional level to diversify investment instruments and partners, better align investment laws with inclusive economic development needs and offer more incentives and opportunities to minimize the potential impact of economic, social and political risks on investment. For example, there is a new generation of investment treaties and related instruments adopted by regional economic communities as part of their commitment to promoting greater economic integration on the continent. Most of these regional economic communities have adopted legal frameworks to encourage the development of intra-African investment, including the Common Market for Eastern and Southern Africa Common Investment Area, the Economic Community of West African States Common Investment Code and Policy and the Southern African Development Community Investment Protocol. For instance, the Economic Community of West African States Common Investment Code and Policy identifies key policy dimensions that can help mitigate financial risks in cross-border trade and business activities in the subregion, including investment dispute resolution, financial infrastructure development, investment-related tax policy, responsible business conduct and environmental protection (Economic Community of West African States, 2018; UNCTAD, 2024m).

In 2017, the African Union Commission adopted the Pan-African Investment Code, which served as a drafting model for the Protocol on Investment to the Agreement Establishing the African Continental Free Trade Area. Many of these new investment-related instruments include provisions for the domestication of investment treaties and their contribution to sustainable development. For instance, African bilateral investment treaties and intra-African investment treaties are increasingly required to provide a more balanced distribution of rights and obligations between States and investors. In addition, some investment laws have provisions encouraging foreign investment to be conducted through joint ventures with a domestically established company or for investment disputes involving African States to be administered by African dispute resolution centres.

Source: UNCTAD, based on Pricewaterhouse Coopers, 2023; UNCTAD, 2023a; UNCTAD, 2024c; United Nations Development Programme, 2022; United Nations Development Programme, 2023; World Bank, 2020a.

Currency risks

As price takers, firms in Africa are vulnerable to swings in the exchange rate. The impact of currency volatility on trade flows is well established (Bahmani-Oskooee and Gelan, 2018). The recent macroeconomic instability in many countries in Africa shows the degree to which international reserves have been depleted in those countries. Since there is no direct indicator of exchange rate volatility, a proxy variable (another measurable and accessible variable) is used to capture exchange rate volatility, namely macroeconomic instability.

Challenges relating to foreign exchange liquidity and restrictions are major obstacles **limiting new investors from investing and fully optimizing opportunities in African markets**

The macroeconomic fundamentals that play a role in explaining some of the impacts of exchange rate volatility, including uncertainty in the economic environment, which can affect decisions relating to trade and capital flows by businesses and financial institutions, is examined in chapter II (Audi, 2024; Caporin et al., 2024; International Monetary Fund, 2003). The transmission of such exchange rate volatility or economic uncertainty through cross-border financial channels, such as capital flows, credit and asset prices, can have an impact on the level of risk aversion (Glebocki and Saha, 2024), including firms in both advanced economies, and emerging and developing countries. For instance, in South Africa, about 35 per cent of firms (out of a total sample of 2,002 surveyed in 2007 and 2020) stated that macroeconomic instability was a major concern. Many macroeconomic challenges faced by developing economies include a high premium attached to foreign currency-denominated assets and/or loans (for example, high interest rates in a tight monetary policy environment). Most African currencies are weakening in the current global macroeconomic climate. This exposes firms to exchange rate risks that could affect demand for their goods, financial performance and competitiveness (Salomao and Varela, 2022).

Given the vulnerability of African firms to international markets, exporters face various types of exposure, as follows:

- Transaction exposure, which is directly associated with the value of their cross-border or international trade transactions.
- Translation exposure, also known as translation risk or accounting exposure, which is an exchange rate risk faced by multinational corporations when they consolidate financial statements from subsidiaries or foreign operations denominated in foreign currencies into their reporting currency (usually the home currency). It is a risk that a company’s equities, assets, liabilities or income will change in value as a result of exchange rate changes. This occurs when a firm denominates a portion of its equities, assets, liabilities, or income in a foreign currency.
- Economic exposure, which is faced by foreign investing firms hosted in a country with severe currency volatility. An African firm with foreign subsidiaries and investments is exposed to fluctuations in exchange rates that can have an impact on the valuation of assets and liabilities denominated in foreign currencies. A survey conducted by the African Private Equity and Venture Capital Association (2022) found that 56 per cent of limited partners[2] perceive currency risk to be a key challenge when investing in the private equity market in Africa, while 44 per cent of general partners[3] consider macroeconomic risk, particularly currency volatility and political instability,

2 A limited partner, also known as a silent partner, invests money in exchange for shares in a partnership but has restricted voting power on company business and is not responsible for the day-to-day management of the fund and related businesses. The limited partner has at least one general partner and one other limited partner.

3 A general partner is part-owner of a business that is structured as a partnership and assumes a day-to-day role in managing it. Unlike limited partners, general partners can have unlimited liability for the debts of the business.

to be a major challenge when managing the operations of a private equity fund on the continent. Challenges relating to foreign exchange liquidity and restrictions are major obstacles limiting new investors from investing and fully optimizing opportunities in African markets (see box IV.2 on some of the instruments that can be deployed at a scale to manage currency risk in Africa).

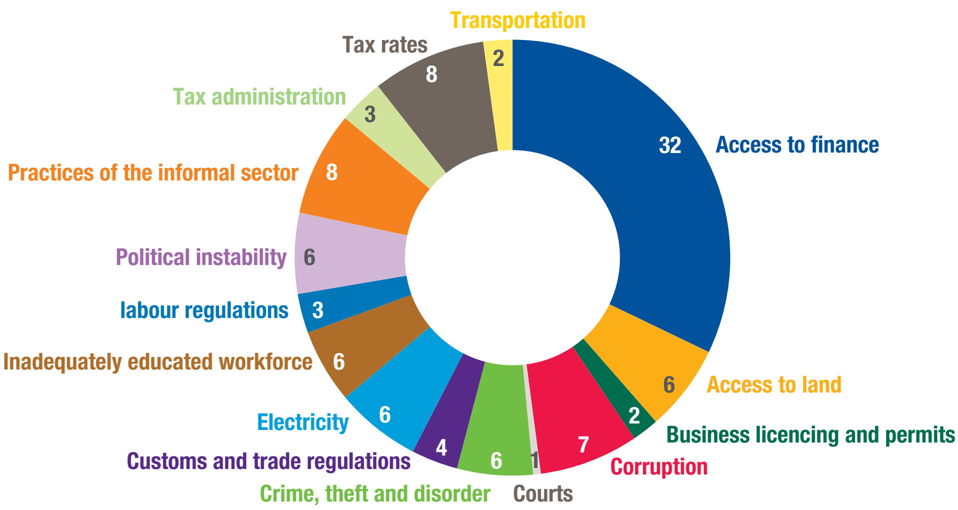
In 2023, 32 per cent of the African firms that took part in an enterprise survey conducted by the World Bank in 13 countries in Africa[4] identified finance and investment opportunities as a principal challenge to their operational, financial and trading performance (figure IV.3). In South Africa, where the enterprise survey was last carried out in 2020 (World Bank, 2020b), about 240 exporting firms (12 per cent of the firms surveyed) were found to be vulnerable to translation risk. Their competitiveness is limited in a host economy with long-term currency appreciation.

Equally, an economy with a depreciating currency increases the cost of servicing debt, which is often held in major currencies such as the dollar and exposes firms to funding and financing risks. For instance, a study by the International Monetary Fund (2023b) shows that a total of 84 per cent of exports, 67 per cent of imports and 60 per cent of external debt are priced in dollars in the median country in Africa.

Firms holding debt in local currency or trading within a monetary union, such as the West African Economic and Monetary Union, may still face exchange rate risk but the nature and extent of that risk can differ, as opposed to firms operating in countries with floating exchange rates. Firms holding debt in local currency are generally less exposed to exchange rate risk, compared with firms holding debt denominated in foreign currency. This is because their debt obligations are in the same currency as their revenue streams, reducing the risk of currency mismatches.

SMEs could enter into a forward contract with a bank or financial institution **to protect themselves against a potential depreciation of the local currency**

Figure IV. 3
Business environment obstacles faced by African firms, 2023
(Percentage)



Source: UNCTAD calculations, based on data from the Enterprise Survey database (World Bank).
Note: The latest available data for the 13 countries covered are from 2023.

4 The countries surveyed are as follows: Botswana, the Central African Republic, Cote d'Ivoire, the Gambia, Ghana, Lesotho, Mauritius, Morocco, Rwanda, Seychelles, Sierra Leone, Togo and the United Republic of Tanzania.

However, firms holding debt in local currency may face exchange rate risk if they have significant operations or revenues in foreign currencies and, as such, their portfolio flows can exhibit greater sensitivity to fluctuations or volatility in foreign currency-denominated debt markets (Bertaut et al., 2024). Exchange rate movements can have an impact on the competitiveness of their exports or the cost of imported inputs, affecting their profitability and ability to service debt. Furthermore, if there are concerns about currency depreciation or inflation in the local currency, firms may face increased borrowing costs or difficulty in accessing credit markets. Firms trading within a monetary union such as the West African Economic and Monetary Union share a common currency, the West African CFA franc, eliminating exchange rate risk among member countries. Since member countries of the Union peg their currencies to the euro, exchange rate fluctuations between those countries and the euro are minimal. While exchange rate risk within the West African Economic and Monetary Union is mitigated, firms operating in the Union may still be exposed to external shocks that have an impact on the value of the euro, such as changes in European Union policies or global economic conditions (Santillán-Salgado et al., 2019).

For SMEs, careful financial planning based on mechanisms for robust risk management **could provide a strong buffer**

There is not much room to alleviate exchange rate risks in Africa, as firms have limited opportunities to implement hedging strategies, such as forward contracts, options and hedging practices. SMEs could enter into a forward contract with a bank or financial institution to sell dollars and euros forward at an agreed-upon exchange rate, locking in the exchange rate for the futures transaction. By doing so, they can protect themselves against a potential depreciation of the local currency, ensuring that they receive the expected amount of local currency when converting dollar and euro receivables into the local currency.

Firms engage in natural hedging practices and can use them as leverage. For instance, in the tourism sector, a company in Kenya generates revenue from domestic tourists (paying in Kenya shillings) and foreign tourists (paying in dollars or euros). The company incurs expenses, such as staff salaries and utilities, in Kenyan shillings. As a strategy, the company can use natural hedging practices to offset its foreign exchange risk. By diversifying its revenue streams across multiple currencies, the company can reduce its dependence on any single currency and mitigate the impact of currency fluctuations on its financial performance. Additionally, the company can align its expenses with the currency composition of its revenue to naturally hedge its exposure. For example, it could negotiate supplier contracts and payables in the same currency as its primary revenue source, reducing the need for currency conversion and minimizing exchange rate risk. See box IV.2 on some of the currency hedging practices in Africa and related regulations and policies that can help firms mitigate their exposure to financial risks.

For SMEs, careful financial planning based on mechanisms for robust risk management could provide a strong buffer. This should be complemented by closely monitoring exchange rate movements and tailoring trading and investment decisions accordingly to soften the impact of currency volatility, for example, reversing entry decisions to certain markets and reshoring business relationships. Furthermore, as SMEs face a vicious cycle of limited capital access, worsening creditworthiness and higher borrowing costs – which could lead to insolvency and smaller sales margins – policy interventions promoting financialization, credit-guarantee schemes and SME support can palliate these effects on trade and investment and foster business resilience.

Box IV. 2
Creating opportunities through foreign exchange hedging practices

While predicting the trajectory of domestic and foreign currencies can be challenging, and unforeseen fluctuations can have an impact on the cost of goods and transactions, disrupt company balance sheets and potentially raise their investment risk premium, there are practical measures that can help diminish such currency-related risks. The need for a currency risk premium is more prevalent in a flexible exchange rate regime than in a fixed exchange rate regime where currency fluctuations are generally minimal. For instance, when currency fluctuations become excessive, investors risk earning negative risk-adjusted returns on the foreign assets in their portfolios, forcing them to require a premium commensurate with the perceived risk of volatile exchange rate fluctuations.

In other circumstances, investors prefer to hedge currency risk by diversifying the investment portfolio across investment assets, stages, vintage years,[a] sectors and/or by investing in the exporting companies to mitigate currency depreciation risk. However, many SMEs and investment funds, especially in African markets, may need more liquidity, market access and fund management experience than others, all essential requirements of such portfolio diversification. According to the African Private Equity and Venture Capital Association, 94 per cent of general partners in the private equity industry do not hedge against currency risk because of the high cost of hedging facilities. Only a few stock markets in Africa, such as those in Egypt, Kenya, Morocco, Nigeria and South Africa, offer sophisticated currency-hedging products, for example, foreign exchange options and cross-currency swaps. Commercial banks on the continent mainly offer foreign exchange forwards but with limited tenors or periods of the forwards contract (12–36 months), often subject to liquidity. Moreover, the administrative costs and the regulatory and compliance challenges related to the use, monitoring and supervision of currency hedging instruments can discourage African firms, especially SMEs, from taking advantage of financial instruments and tools to hedge against currency fluctuation risks, stabilize revenue flows and reduce uncertainties in cross-border and international transactions. Robust policies and regulatory frameworks governing not only the trading and hedging instruments in the securities and derivatives markets but also the protection of funds and assets belonging to financial institutions and corporations are essential. Such measures will contribute to enhanced financial stability, increased market liquidity and improved cross-border de-risking across the continent.

Regional banks, such as the African Export–Import Bank, the Ecobank and the Standard Bank, are increasingly addressing the currency hedging gaps on the continent. For instance, the African Export–Import Bank and the African Continental Free Trade Area Secretariat established the Pan-African Payment and Settlement System, a centralized payment and settlement system for intra-African trade in goods and services. It allows companies in Africa to pay for intra-African trade transactions in their local currency, thus reducing the costs of trade transactions. The network comprises 8 central banks, 28 commercial banks and 6 switches.[b] As a partner of the Pan-African Payment and Settlement System, a leading pan-African commercial bank, such as Ecobank, can leverage the capabilities of the aforementioned system through its local offices in 33 countries in Africa and hence diminish the cost and risks of funds transfers in African currencies. The investment arm of commercial banks, such as the Standard Bank, also offers currency-hedging products and provides equity investors with information and advice on foreign exchange regulations and risks in cross-border transactions.

Source: UNCTAD, based on African Private Equity and Venture Capital Association et al., 2022; Kenton, 2022; Kodongo and Ojah, 2018; Opus, 2024.

[a] A vintage year is the year in which the first influx of investment capital is delivered to a project or company, marking the moment when capital is committed by a venture capital fund, a private equity fund or a combination of sources.

[b] A payment switch platform is a technology that connects system participants and supports the passing of financial transaction data. Switches enable dynamic payment transactions among acquirers and endpoints of payment services providers, in cross-border payments, electronic-commerce platforms, online billers, banks and other service providers.

Value and resilience through the energy, infrastructure and trade nexus

The current state of energy, infrastructure and trade in Africa leaves economies and businesses vulnerable to adverse global and domestic events, affecting their growth prospects. Energy, infrastructure and trade are three enablers of economic development; when lacking, this results in binding constraints on development in Africa. Moreover, with the interdependencies between them, shortcomings in either one can accentuate and worsen shortcomings in the other. In recent decades, countries in Africa have made great strides in building up their energy, infrastructure and trade capabilities. However, any trend in the global economy with an impact on energy, infrastructure and trade investments implies both costs and benefits for Africa. In the context of the global polycrisis and the levels of exposure and vulnerability of countries in Africa to the polycrisis shocks described in chapter I, the energy, infrastructure and trade nexus serves as a bulwark against the risks that the polycrisis represents for African economies and businesses.

The risks inherent in the polycrisis require a major upgrading of infrastructure in Africa, failing which, **the economic risks of doing business will grow substantially**

Energy capabilities

One of the main risks perceived by many countries and businesses is that of energy security and costs. Two global trends have increased uncertainty. The war in Ukraine led to raised energy prices, but more importantly, it led to the European Union moving away from the Russian Federation as a source of natural gas and fossil fuels. The agreement of the twenty-eighth Conference of the Parties to transition away from fossil fuels is inspiring many regions, including the United States and the European Union, to quickly seek access to renewable energy and the minerals and materials necessary for renewable energy production.

These trends raise risks to investment and trade in Africa in that they create both costs and benefits. For instance, the European Union renewable energy plan, known as "REPowerEU", aims to accelerate its green transition,[5] reduce reliance on fossil fuels from the Russian Federation and diminish its energy consumption[6] (European Union, 2022). This will have an impact on the global energy market in terms of price, sourcing and supply. There is a risk that these shifts in the global energy landscape may increase the strains on African economies (International Energy Agency, 2023c) and diminish the energy supply in Africa, which is already low in absolute and relative terms. In 2022, 43 per cent of the population in Africa lacked access to electricity and fossil fuels accounted for more than 50 per cent of its energy supply; only 3 per cent of its energy supply was being sourced from renewables (International Energy Agency, 2023c).

However, the global shift in energy security and strategy also creates an opportunity for those countries in Africa that can supply gas to Europe. The shift of China, the United States and the European Union, as well as other countries, towards renewables, including green hydrogen, creates a potential cost in terms of a new rush for African minerals and the diversion of clean energy away from addressing local energy poverty towards providing resources for the global North. However, the rise of the green hydrogen economy also generates opportunities for countries in Africa to supply energy-related minerals and green hydrogen to domestic and external markets.

However, there is much expansive potential in Africa, both in terms of its rich natural resource base and the potential to fully meet its energy needs and significantly contribute to global energy systems.

[5] The European Union seeks to obtain 45 per cent of its energy from renewable sources by 2030.

[6] For example, the European Union plans to lower its gas consumption by 30 per cent by 2030.

For instance, Africa has 60 per cent of the world's solar resources. Yet the region has only 1 per cent of this solar potential in use, notwithstanding its increasing affordability (International Energy Agency, 2023c). Moreover, Africa is utilizing only about 8 per cent of its hydropower capacity, and about 60 per cent of the hydropower infrastructure is outdated (over 60 years old) and in need of modernization to enhance its efficiency. Similarly, the International Finance Cooperation estimates that Africa has an onshore wind energy potential of 180,000 terawatt hours per year, enough to meet its electricity demand by more than 250 times or supply the current levels of global wind energy 90 times. However, the region accounts for only 1 per cent of the 650 gigawatts of installed global wind energy capacity. Overall, at least 40 per cent of the total electricity that Africa generated between 2020 and 2022 was from natural gas, followed by coal, water, oil, wind and solar energy (International Energy Agency, 2023c; Pricewaterhouse Coopers, 2023). Industrial productivity and growth are being undermined by low electricity generation in more than 80 per cent of Africa (figure IV.4). Access to electricity is also limited; 43 per cent of the total population lacked access to electricity in 2022.

Notably, for most African firms, the low level of energy generation entails both intermittent power supply and high per capita energy costs. The limited access of SMEs, in particular, to a reliable energy supply has adverse impacts on their productivity and competitiveness, which in turn undermines their profitable involvement in national and regional value chains. Minimizing energy costs and maximizing the benefits of renewables would require that countries in Africa fundamentally address the weaknesses in their energy and related infrastructure capabilities.

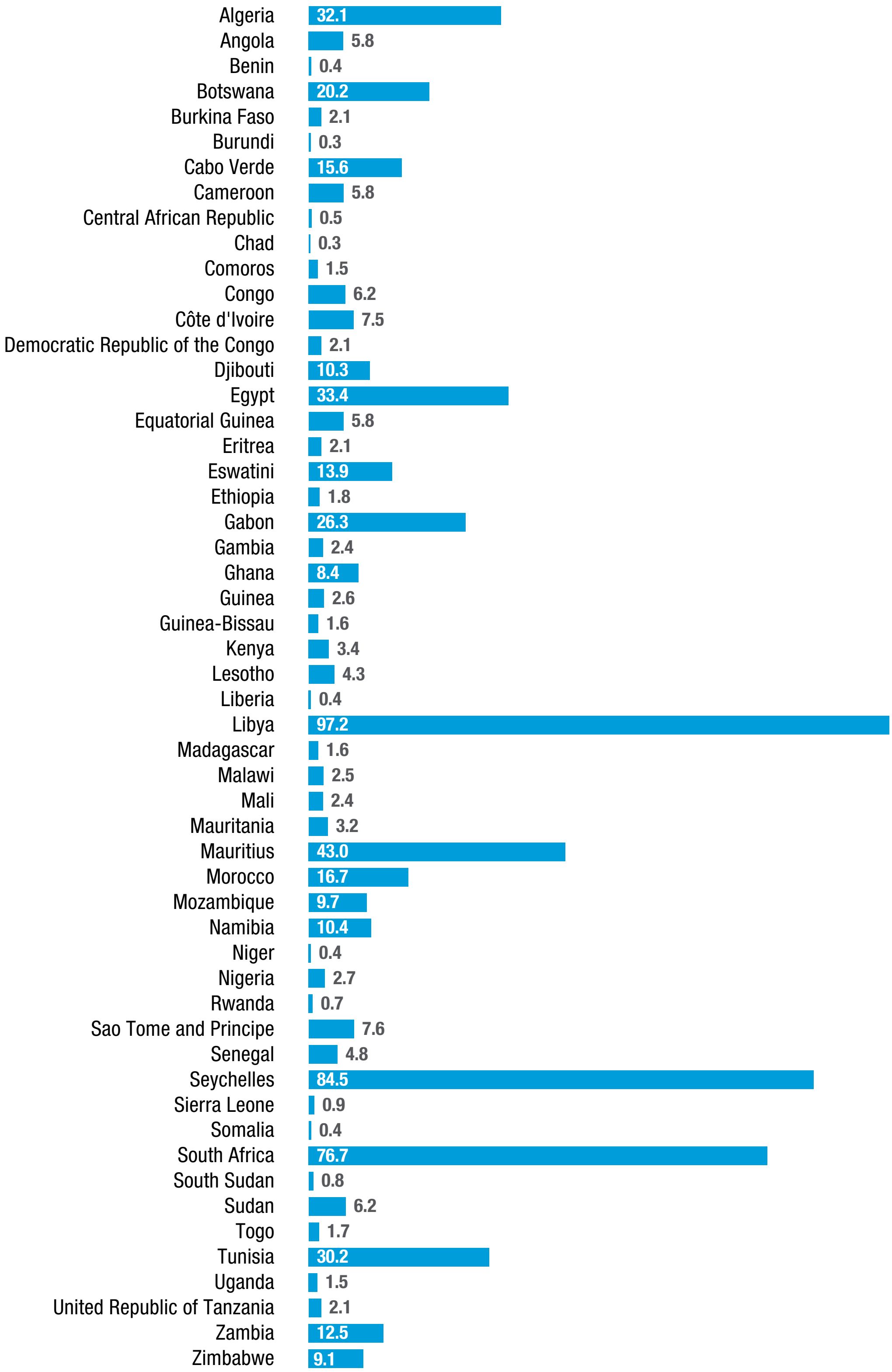
Infrastructure capabilities

The risks inherent in the polycrisis require a major upgrading of infrastructure in Africa (see chapter III), failing which, the economic risks of doing business will grow substantially. To spur infrastructural investment, it is necessary to improve, upgrade and diversify infrastructure, especially energy infrastructure required to extend connective infrastructures to facilitate regional economic integration and bridge the digital divide. A major obstacle to the ability of Africa to invest in and build the additional infrastructure required to deal with the costs and benefits created by the global context is being able to finance such investment. At least $190 billion will be required annually between 2026 and 2030 to address energy needs and risks, implying energy investment equal to 6.1 per cent of GDP by 2030 (International Energy Agency, 2023c).

The energy transition can increase economic risk in Africa if the costs it imposes outweigh the benefits with regard to infrastructure needs and capabilities. Under the Sustainable Africa Scenario, in which Africa transitions to renewable energy-related development goals, triples the rate of access to affordable electricity and achieves its climate pledges, the projected expansion of energy-generating capacity across Africa will require an additional investment of $80 billion per year over the period 2021–2030 (International Energy Agency, 2023c). Given growing domestic energy needs, however, the benefit is that supply for local use may be more abundant and perhaps cheaper. Realizing this benefit requires the development of appropriate energy infrastructure, including storage and distribution infrastructure, to meet domestic demand for transport fuels and liquid petroleum gas. Moreover, rolling out such infrastructure, as well as upgrading and extending existing grids and installing new solar-based local grids across Africa to provide universal access to electricity, can create millions of new jobs. Infrastructure is also central if regional integration is to be a source of resilience in the face of the polycrisis (see chapter III).

The rise of the green hydrogen economy generates opportunities for countries in Africa to supply energy-related minerals and green hydrogen to domestic and external markets

Figure IV. 4
Access to electricity, by country, 2022



Source: UNCTAD, based on data from the African Infrastructure Development index.
Note: The index is measured in millions of kilowatt hours per inhabitant. It captures the total of domestically produced and imported electricity. It takes values between 0 and 100, with higher values reflecting higher levels

Moreover, infrastructure investment in ICT is needed to underpin the expansion of the data-driven economy; digital platforms and artificial intelligence-enabled businesses are sorely needed to prevent the digital divide between Africa and the rest of the world from widening. To minimize these costs and maximize the benefits, it is necessary for countries in Africa to address the fundamental weaknesses in their infrastructure capabilities, namely, those related to roads, transport and ICT. Infrastructure investment in ICT requires complementary investments in skills and research and development, areas in which Africa is lagging.

Trade capabilities

Underlying the polycrisis is a world in which the nature of trade has changed in significant ways. Polycrisis-induced instabilities have had a bearing on developments in international trade, including a tighter monetary stance by central banks in advanced countries, a more geostrategic policy approach to international economic relations, the growing influence of industrial policy on the trade strategies of major economies and multiple geoeconomic risks (UNCTAD, 2023h). This is reflected in waning growth in trade, as well as a decline in foreign direct investment and in participation in global value chains (see chapters II and III). Driving this are various factors: mounting conflict, geopolitical fragmentation within and between countries, inequality and secular stagnation in some of the advanced economies. The impact of the polycrisis on the external position of Africa is further compounded by unfavourable external factors, for example, weak export demand from its principal trading partners (China and Europe); restrictive monetary policy in the leading developed economies, resulting in higher borrowing costs and associated debt vulnerabilities for African borrowers; and negative pressures on African currencies and related foreign exchanges (UNCTAD, 2024h).

These changes in the nature of trade hold costs and benefits for countries in Africa. As industries across the advanced and emerging economies attempt to reduce their carbon emissions, they may move production closer to mines and input sources or closer to where renewable energy carriers, such as green hydrogen, may be used. In addition, the global shipping industry, which is responsible for 2 to 3 per cent of greenhouse gas emissions, will undergo structural changes that affect international shipping, the means by which the bulk of African goods is transported.

Thus, the potential cost is that demand for many African exports (outside of green technology minerals) will decline as these carbon-reducing measures are adopted in its main markets (China, the United States and the European Union) and that global transport costs may increase as the shipping industry adjusts.

With regard to benefits, the changes discussed here offer potential opportunities for countries in Africa where critical resources, including energy-related minerals, are available and where green hydrogen production can be economically scaled up. They also offer an opportunity to expand intraregional trade. Indeed, intraregional trade is, from this point of view, a bulwark against the risks of adverse trade and changes in the global shipping industry. Minimizing trade costs and maximizing the benefits requires countries in Africa to tackle the weaknesses in their energy and infrastructure capabilities, as discussed previously.

Other aspects of trade that need to be strengthened to allow the enhancement of the cost–benefit ratios in energy and infrastructure include fostering the integration of African economies into global value and supply chains; diversifying their exports and ensuring appropriate governance where a country’s exports are concentrated in commodities and fuels, the prices of which may increase and lead to earning windfalls; and supporting intraregional trade by investing in regional infrastructure and reducing trade barriers in intra-African trade.

Intraregional trade is a bulwark against the risks of **adverse trade and changes in the global shipping industry**

The next section will assess the impact of these capabilities on the export performance and resilience of firms by discussing the case of South Africa. Box IV.3 provides an empirical analysis of the factors that can affect the performance of the country's exporting firms, and hence underscore the significance of the energy and infrastructure capabilities in facilitating trade and building resilience to shocks and stressors

Insights from South Africa: Dynamics of risks and capabilities for exporting firms

The most common means of financing SMEs are from their own resources, followed by credits from suppliers (purchases on credit) or customers (advance payment for merchandise)

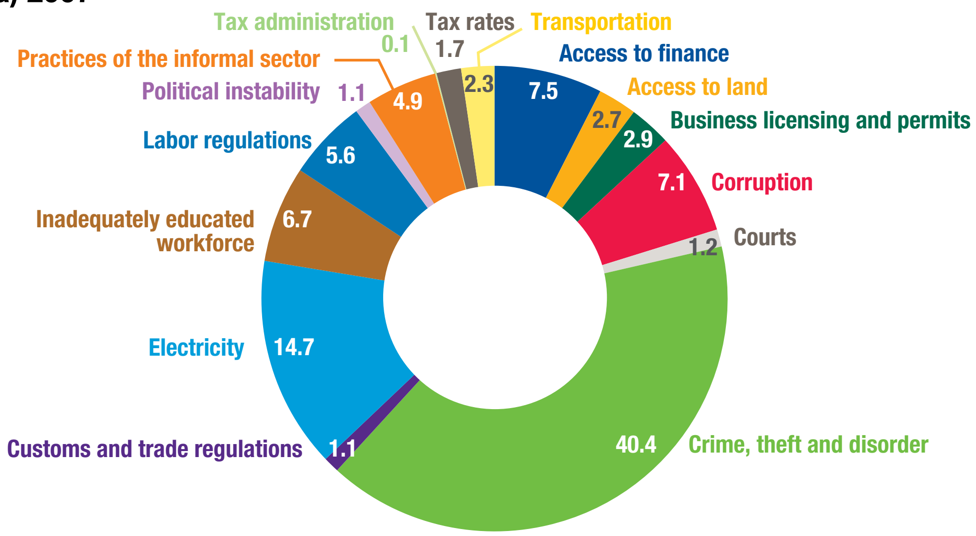
South Africa is the third-largest country in Africa in terms of electricity generation, suggesting minimal energy-related hindrances to the productivity and growth of firms relative to most countries in Africa (figure IV.4). While South Africa has a more developed multimodal transport network, compared with many countries in Africa, a score below 30 in the transport component of the Africa Infrastructure Development Index suggests that pertinent gaps persist in ensuring the smooth flow of goods and services within and across its borders. Moreover, as regards cross-border trade, the net effectiveness of good transport and logistics infrastructure goes beyond the domestic economy to include transit cities and countries, as well as trading partners to some extent. Such infrastructure is largely underdeveloped in most of its trading partners based in Africa. Figure IV.5 shows the perception of South African firms of key obstacles that can affect their activities. Some 54 per cent of firms interviewed in 2020 found lack of access to electricity to be the biggest obstacle they faced in South Africa, compared with only 15 per cent of those interviewed in 2007. This can be partly explained by the recent energy crisis experienced in the country and which the Government of South Africa has been actively addressing by investing in new energy generation capacity and promoting the development of renewable energy mixes. This is particularly the case for microenterprises and SMEs in South Africa, which represent over 98 per cent of formal businesses and have recently experienced two-digit growth (UNCTAD, 2023j).

To assess the factors and risks that may have an impact on the export status of South African firms, export data from the world enterprise survey of 2,028 firms was collected for the years 2007 and 2020 (792 firms in 2007, 958 firms in 2020 and 278 firms surveyed in both years). The survey is a comprehensive assessment tool designed to gather data on the business environment from the perspective of firms operating in various countries worldwide. Conducted by the World Bank, the survey collects information on key aspects of the business environment, including business regulations, access to finance, infrastructure and labour market conditions. The firm-level micro data consist of a stratified random sample of non-agricultural formal private sector businesses, which are stratified by firm size: small (5–19 employees), medium (20–99 employees) and large (over 100 employees). The sectors in which those South African firms operate are the following: manufacturing, construction, motor vehicle sales and repair, wholesale, retail, hotels and restaurants, storage, transportation, ICT and other services. See box IV.3 for the model used to estimate the effects of obstacles on the export status of firms in South Africa.

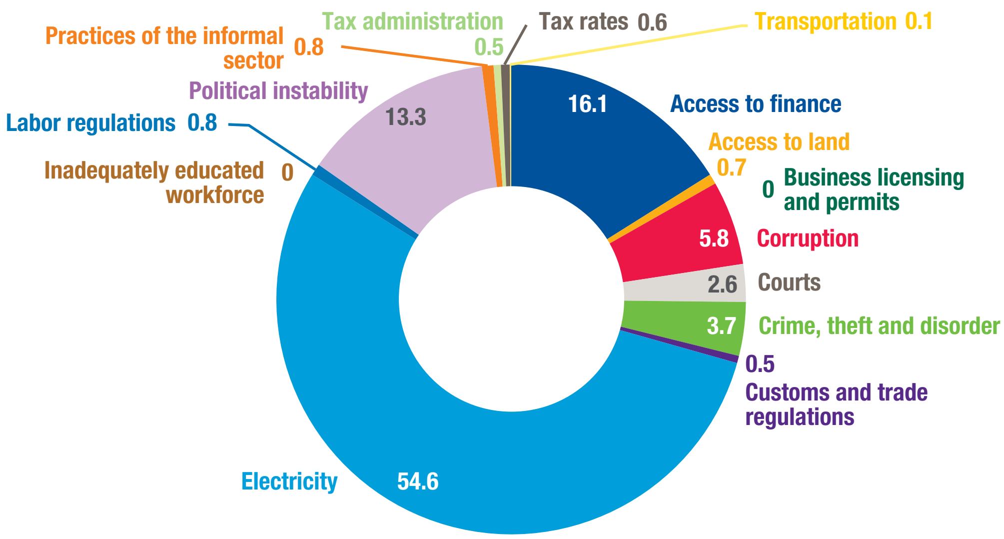
Figure IV. 5

Main obstacles faced by South African firms, selected years
(Percentage)

(a) 2007



(b) 2020



Source: UNCTAD, based on data from the enterprise survey database (World Bank).

Box IV. 3

Random-effects probit estimates of the export status of firms in South Africa

It is hypothesized that factors and risks associated with trading within Africa, as well as firm-specific characteristics, are correlated with a firm's export status (the dependent variable). The dependent variable is used as a dummy variable, which takes on the value of 1 if the South African firm engages in exports and 0 if the firm serves the domestic market only.

The explanatory variables included in the regression are as follows:

- Women's ownership (a dummy variable related to whether the firm has at least one woman owner).
- Foreign ownership (a dummy variable related to whether the firm is foreign- or domestic-owned).
- Power outage (a numerical variable related to the number of power outages experienced by the firm in a typical month in the past fiscal year).
- Transport (a dummy variable that takes the value of 1 if the firm identifies transport as an obstacle).
- Trade and customs regulations (a dummy variable that takes the value of 1 if the firm identifies trade and customs regulations as an obstacle).
- Informal competition (a dummy variable that takes the value of 1 if the firm has competed against unregistered or informal firms).
- Breakage in transit (a dummy variable that takes the value of 1 if the firm has incurred a loss of value in transit due to breakage or spoilage).
- Theft in transit (a dummy variable that takes the value of 1 if the firm has incurred a loss of value in transit due to theft).
- Working capital (share of the firm's own resources or retained earnings used to finance operations and manage the business).

A random-effects probit model is estimated to analyse the probability that each firm-specific factor and risk contributes to a firm's export status, as follows:

$$Pr(y_{it} \neq 0 \mid X_{it}) = \Phi(X_{it}\beta + v_i)$$

where y is a dummy variable that takes the value of 1 for exporting firms and 0 for non-exporting firms, X_{it} denotes a vector of explanatory variables capturing firm-level characteristics and risk factors associated with firm i at year t and v_i represents the error term. The regression estimates of the export statuses of South African firms are provided in the table.

Random-effects probit estimates of the export status of South African firms

Explanatory variable	Coefficient	Standard error
Women's ownership	0.1349015	0.1028234
Foreign ownership	0.4757686[a]	0.1324881
Quality certification	0.9629764[a]	0.0881171
Power outage	0.003825	0.0045893
Transport	0.0734484	0.0949082
Trade and customs regulations	0.4412665[a]	0.1001962
Informal competition	-0.3256052[a]	0.0965716
Breakage in transit	-0.3234966[a]	0.1077387
Theft in transit	0.1906519	0.1197621
Working capital	-0.0058727[a]	0.0013858
Contant	-0.9513529[a]	0.1339498
Observations	1 915	
Number of firms	2 028	

[a] p<0.01(statistically significant at the 0.01 level).
Source: UNCTAD.
Note: Direct information on firm productivity based on a single or proxy variable is not available. Another caveat is the data availability and relevancy for all factors of production, which prevents the consideration of productivity as a variable in the regression. However, the availability of data on working capital can be considered as proxy for input of capital used in the measure of total-factor of productivity at a firm level.

Source: UNCTAD.

One potential solution is to **facilitate the utilization of cross-border financial de-risking instruments**

As shown in box IV.3, the gender dimension of business ownership does not significantly limit a firm's potential to engage in exports in South Africa. In particular, the results suggest that the odds of a firm's involvement in international trade do not increase with either the proportion of men or women owning and/or managing the business. This is aligned with the contention of generally higher productivity in firms, regardless of ownership, that are engaged in international trade, as it increases their odds of exploiting economies of scale and enhancing their productivity. While the findings suggest that the gender dimension does not limit export potential in South African firms and is aligned with the importance of productivity and economies of scale, it remains a debatable topic. There are nuanced considerations of gender dynamics, context-specific factors and broader definitions of success (for example, qualitative aspects of business management and leadership) that could merit further exploration but are beyond the scope of this report. Engaging with these complexities can lead to a more comprehensive understanding of the interplay between gender, firm characteristics and international trade.

However, these dynamics differ with regard to the extent of foreign ownership in a business. In general, the literature indicates a higher propensity to export with some level of foreign ownership. The foreign-direct-investment component of these firms makes them more competitive, including through capital, technology and specialized skills that come with the foreign-investment component of the firm that is potentially not competitively available for firms with full domestic ownership (Boddin et al., 2017; UNCTAD, 2020; Vinh and Duong, 2020). Accordingly, some studies have shown that the higher the foreign-share component, the better the export outcomes in terms of complexity and diversity of goods and services for export. In this context, firms with 100 per cent foreign ownership are seen to be more productive and with more competitive exports relative to joint ventures (Vinh and Duong, 2020; Wakasugi and Zhang, 2012).

The potential of better access to business financing is also considered to be a key indicator of a firm's export performance. In South Africa, only 19 per cent of the companies surveyed indicated that they used bank loans, while 3 per cent and 4 per cent indicated that they had borrowed from family and friends and used other non-bank sources of financing for their businesses, respectively. The most common means of financing SMEs are from their own resources (98 per cent), followed by credits from suppliers (purchases on credit) or customers (advance payment for merchandise). However, these two modes of business financing are inadequate for the effective growth of most businesses in Africa and in other regions. South Africa has also been affected; as shown in box IV.3, the odds of a firm's export growth diminish with increased reliance on the owners' credit and funds to finance a business.

The negative and significant coefficient of informal competition suggests that pervasive informality is a principal factor affecting the ability of firms to export. Notably, informal firms often operate outside the regulatory framework, allowing them to undercut prices, avoid taxes and bypass regulations. This distorts the optimal functionality of markets through unfair competition for formal firms and may squeeze their profit margins. Lastly, notwithstanding its potential effect on the overall revenue of firms, incidences of theft in transit are not a deterrent to the export drive of firms in South Africa.

Trade rules and quality certification are related in that a common principle guiding international trade pertains to the quality of products being sold in different markets. All regional and international agreements have specified standards for traded goods and services. These are essential in raising the quality of markets and eliminating information asymmetry and associated market failures. Notably, stringent trade rules, including strict quality standards, could be a potential market entry barrier for most

SMEs. On the other hand, the fairly set trade rules that accommodate the capabilities of SMEs could enhance their participation in regional and global markets as more SMEs meet the quality requirements. This also applies to South Africa, as the trade regulations and quality certification coefficients are positive and significant, highlighting that they are not among the market entry barriers undermining a firm's ability to export. South Africa is one of the few countries in Africa whose indicators on trade facilitation and logistics are generally above the global average (see chapter III).

Maximizing the benefits of cross-border transactions in Africa through financial hedging and enterprise risk management

Global shocks and crises can create market vulnerabilities and heighten companies' exposure to financial risks, including volatility in foreign exchange rates, interest rates and commodity prices (Holman et al., 2013). In response, one potential solution (among the available options discussed earlier in this chapter) for African countries is to facilitate the utilization of cross-border financial de-risking instruments. Companies and financial institutions can employ a range of derivative instruments to hedge against commodity price volatility, currency exchange risks, credit defaults and interest rate fluctuations. This strategic approach aims to mitigate potential losses, reduce financial distress, alleviate the impact of earnings and cash flow volatility, lower transaction costs and minimize the overall costs associated with external financing. Moreover, the implementation of supportive policies and regulatory frameworks is essential in promoting the effective use of these instruments, thereby fostering greater financial stability within the region.

Effective risk-management tools can contribute to risk diversification, thereby enabling businesses and investors to channel investments toward high-risk-adjusted return projects, especially in high-risk perception regions such as Africa (Economic Commission for Africa, 2020). Financial risk-management instruments, such as derivatives, can allow companies to lower their exposure to volatility in exchange rates, interest rates and commodity prices (Holman et al., 2013), thus allowing investors to unbundle and transfer financial risk. In Africa, the development of derivatives markets could enable companies to self-insure against volatile capital flows and lower their dependence on bank financing (Adelegan, 2009). Other risk-management tools and practices, such as strategic planning and business continuity, are also driving forces behind firms' resilience to shocks and disruptions (Kalia and Muller, 2019). This section will explore some of the risk-management solutions that can be used by African firms, particularly those involved in cross-border trade, to foster resilience, stability and growth.

Managing financial risks through derivatives

In many countries around the world, Governments and central banks responded to the global financial crisis and the COVID-19 pandemic with significant fiscal stimulus and moratoriums on debt to support the survival of households and businesses and facilitated buffers to enable markets to provide foreign-exchange liquidity and financing for economic recovery.

Financial shocks and the resulting volatility in stocks and interest rates have spurred demand for financial instruments to unbundle risks (Prabha et al., 2014). In many of the advanced countries, derivatives are used to manage such risks. Derivatives are financial instruments used by banks, investors and businesses to insure against potential risks on their portfolios, advance or postpone cash flows[7] or accumulate wealth (Jarrow and Chatterjea, 2019).

Underdeveloped or poorly structured de-risking instruments can hinder the ability of companies **to self-insure against volatile capital flows**

[7] This includes borrowing or lending and earning or scaling a return on investment.

They are financial contracts that derive their value from the price of an underlying asset (Jarrow and Chatterjea, 2019). The underlying asset can be a commodity, a stock or an interest rate. Firms use derivatives to manage risks associated with cash flow volatility arising from adverse changes in interest rates, exchange rates and commodity and equity prices (Prabha et al., 2014). This section will focus on using derivatives for insurance or hedging purposes, especially for use by firms and financial institutions to protect against unfavourable outcomes of the polycrisis.

Forwards, futures, options and swaps are the most common types of derivatives (see box IV.4). The underlying assets are usually stocks, bonds, commodities, currencies and interest rates. The use of over-the-counter derivatives in global markets has been growing, and companies are being increasingly exposed to both internal and external risks. They are deploying such financial risk instruments for hedging (for example, price risk, revenue stabilization), risk management (such as financial, climate, insurance and counterparty), leverage and credit enhancement, price discovery and transparency, agricultural financing (for instance, commodity derivatives), portfolio diversification and product standardization (see box IV.4). According to the Bank for International Settlements (2023), the notional value of outstanding over-the-counter derivatives reached $715 trillion at end-June 2023, up by 16 per cent ($97 trillion) since end-December 2022. In South Africa, which provides the most attractive African market for over-the-counter derivatives, the value of those derivatives traded on the Johannesburg Stock Exchange at end-July 2024 stood at R166.5 billion, equivalent to $9 billion. Although this is relatively low, compared with the world value of over-the-counter derivatives, trade in derivatives on the Johannesburg Stock Exchange rose sharply, from $14 million in 2005 to $264 million in 2018 and about $9 billion in mid-2024 (Bekale et al., 2023; Johannesburg Stock Exchange, 2024).

By entering into interest-rate swaps, companies can exchange fixed-rate and floating-rate interest payments **to manage their exposure to interest-rate fluctuations caused by political events**

However, when markets are underdeveloped (for example, small, less liquid or providing unsophisticated hedging instruments), these de-risking instruments are poorly structured or unavailable, which can hinder the ability of companies to self-insure against volatile capital flows and take other risk measures. This is the case in many countries in Africa (for example, underdeveloped financial markets), which can result in limited access to credit for firms, especially SMEs; low investment rates; and high cost of production and supply (see UNCTAD, 2023f). Alabi et al. (2023) note that financial markets in Africa are characterized by volatility, regulatory shortcomings, illiquidity, high prevalence of non-performing loans and inadequate risk-management frameworks, which, when combined, render their ability to mitigate shocks difficult and costly. The relatively limited depth and low liquidity of most financial markets in Africa, which offer few ranges of financial products, restrict the ability of firms to diversify their portfolios and manage financial risk effectively.

By adopting derivatives, African financial markets can gain more influence and help enhance financial and economic stability, while fostering bank lending towards the business sector (Bekale et al., 2023). While the use of derivatives offers lucrative opportunities that can incentivize speculative behaviour (many analysts have linked this function of derivative markets to systemic risk formation in banking ecosystems), the hedging function of derivatives, rather than speculation, has been effective in maintaining a negative relationship towards risk-taking (Cyree et al., 2012). The use of this risk management function of derivative markets is also growing in Africa. For example, the Johannesburg Stock Exchange, the Nairobi Securities Exchange and the Central Bank of Nigeria are among those developing derivatives markets. On the Johannesburg Stock Exchange, companies can use trade-bond derivatives, interest-rate derivatives, equity derivatives, commodity derivatives and currency derivatives. Box IV.4 provides a description of these various types of derivatives.

Box IV. 4
Derivatives

Derivatives are an increasingly common method used for hedging against commodity price volatility and providing protection against various types of risk, including currency exchange risks, credit defaults and interest rate risks. They are also used to mitigate losses and manage exposure to shocks. These financial instruments, whose value is derived from an underlying commodity, enable market participants to speculate on price movements, hedge against price risks or gain exposure to commodity prices without physically owning a commodity.

Three principal types of derivatives are as follows:

- Forwards and futures contracts. These are agreements between two parties to buy or sell an asset such as a specific commodity, currency or other product at a specific date at a price agreed upon in advance. For instance, by entering into a forwards contract, companies can lock in an exchange rate and hedge against potential adverse movements in currency exchange rates. Futures contracts are settled through established clearing houses, while forwards contracts are settled between counterparties, and mostly over the counter. Banks and non-financial firms use futures contracts to help manage risk, enabling banks to extend more loans and firms to invest more capital. Derivatives commodity exchanges facilitate the trading of derivatives contracts based on commodities.
- Options contracts. These give the right, rather than an obligation, as in forwards and futures contracts, to buy or sell an underlying asset (for example, a specific quantity of commodities, currencies or other product) at a pre-determined price known as the strike price. Options can be traded either as a call option (the right, not an obligation, to buy an underlying asset) or a put option (the right, not an obligation, to sell an underlying asset).
- Swaps contracts. These are agreements between counterparties to exchange a series of cash flows at a specific rate and date in the future. These series or streams of cash flows are known as legs of the swap. Interest rate swaps are used to hedge against risks that may have an impact on interest rates, such as changes in monetary policies or government regulations. By entering into interest-rate swaps, companies can exchange fixed-rate and floating-rate interest payments to manage their exposure to interest-rate fluctuations caused by political events. Banks also make use of interest-rate swaps to lower their exposure to risks generated by market interest rates. Credit-default swaps are also used by investors to protect themselves against the risk of default on debt securities issued by Governments or corporations. By purchasing credit-default swaps, investors can hedge against the potential negative impact of political events or policy changes that may lead to a government or corporate default.

Source: UNCTAD, based on African Development Bank, 2013; Bekale et al., 2023; Chidaushe, 2019; Chui, 2012; International Monetary Fund, 1998; Jarrow and Chatterjea, 2019; Prabha et al., 2014.

The benefits and value creation of risk management is evident, yet the practice remains underdeveloped among many firms, especially SMEs

As the use of derivatives, especially when used for speculation, can expose businesses, banks and economies to shocks, cross-border contagion and systemic distress (Bekale et al., 2023), it is important that certain characteristics of the derivatives market be in place. Several requirements are necessary for the effective use of derivatives instruments and the development of a derivatives market. These include a well-developed financial infrastructure, robust clearing and settlement systems, appropriate legal and regulatory frameworks that can facilitate the trading of derivatives, sound institutional frameworks and governance that can enforce derivatives contracts and protect investor rights and skilled personnel using sophisticated financial instruments to perform back-office tasks such as compliance, structuring, clearing and settlement, as well as a diverse pool of knowledgeable investors (Chidauche, 2019; Jarrow and Chatterjea, 2019). When used for hedging, instead of speculation, derivatives increase efficiency in financial markets by allowing more interbank trading of sophisticated financial products, increasing the capitalization potential of banks and improving private sector access to resources. Bekale et al. (2023) note that derivatives contribute to deepening financial markets by enabling a self-efficient process that reduces risks related to bank insolvency and systemic risk formation, and hence promote banking diversification and market-based financing. Policy efforts should be aimed at enhancing financial conditions in Africa to facilitate the development and use of financial innovations such as derivatives. See box IV.5 on the case of Viet Nam in developing its financial market and facilitating cross-border transactions.

As derivatives strengthen the ability of firms to raise capital and insure their assets against adverse effects of shocks or market uncertainties, it is important for firms to extend the valuation of such hedging instruments by ensuring that their overall portfolios and operations are well safeguarded against downside risks.

The next section will explore some of the risk management practices that can help African firms better identify and navigate the risks of doing business in Africa.

Risk management practices at the firm level

In an increasingly globalized and integrated world where geopolitical tensions, economic crises and political instability are merging to create a challenging risk environment (Pillai-Essex et al., 2024) that can curtail a firm's financial and operational performance, the systemic identification, assessment and mitigation of such uncertainties or threats is becoming a critical process for the growth and survival of firms across the world. For instance, analysing the likelihood and impact of shocks emanating from the polycrisis and developing strategies to minimize the harmful effects of such shocks on firms' goods and services can help prepare such firms to enhance their ability to anticipate or control market uncertainties and crisis-proof their portfolios in the event of disruption or failures. The benefits and value creation of risk management is evident, yet the practice remains underdeveloped among many firms, especially SMEs in developing countries. Gius et al. (2018) found that non-financial corporate board members spent only 9 per cent of their time on risk management, mainly because of their lack of capabilities in aligning risk-management operating models with their corporate and performance strategies. Developing risk-management capacities across all sectors or departments of a company is important to raise awareness, understand and prioritize risks, measure and recalibrate performance against these risks and reduce the company's overall exposure to threats from imminent or future events. In addition to assessing and mitigating threats or uncertainties, risk-management practices can also be a catalyst for a firm's pursuit of growth opportunities (Gibson, 2023).

Box IV. 5
Insights from Viet Nam: Reaping the benefits of private capital flows

Since the 1980s, one of the most crucial developments in Viet Nam has been the attraction of cross-border capital inflows, mainly in the form of foreign direct investment. A 1997 report by the World Bank noted that foreign-invested operations contributed to nearly 10 per cent of the county's GDP, over 30 per cent of its gross capital formation, 8 per cent of its total exports and the creation of more than one million direct and indirect jobs at the time. This was facilitated in part by a number of reforms and policy measures aimed at liberalizing the banking sector and financial market and allowing foreign credit institutions to establish a commercial presence in the country or engage in joint ventures. The financial market reform programmes included the restructuring of joint stock banks, the restructuring and equalization of State-owned commercial banks and the improvement of regulatory frameworks, including greater transparency. Such measures opened the banking market to full foreign competition. The series of reforms brought forth sizeable gains for the country, which attracted substantial foreign capital inflows for a period of sustained growth.

The significant amounts of foreign capital inflows can also be reflected in the provision of loans by local banks. As capital demands of Vietnamese firms rose sharply, local banks and foreign financial institutions cooperated to provide offshore loans, making it more attractive and profitable to do business in the country. A multitude of local banks[a] collaborated with international banks and financial institutions to provide syndicated loans to SMEs. In 2019, banks in Viet Nam provided syndicated loans worth over $2 billion. The increasing integration in the international finance market is poised to improve the country's capital mobilization structure and meet the demand of local firms and consumers for foreign currency.

Another transformative force within the financial landscape of Viet Nam was the development of the derivatives securities market, which provides investment opportunities and risk-mitigation tools for investors and businesses. In August 2017, Viet Nam opened a derivatives market, with financial derivatives instruments trading on the Hanoi Stock Exchange and the Ho Chi Minh Stock Exchange. The dimensions and liquidity of the derivative securities market in the country have expanded considerably, with the average trading volume of Viet Nam 30 (commonly known as VN 30) Index Futures contracts[b] reaching 225,178 contracts per session in mid-2024, compared with 10,954 contracts per session in 2017. Such transactions experienced significant growth – up by 79.9 per cent from 2019 to 2020, followed by 43.8 per cent growth between 2021 and 2022 – demonstrating the strength and resilience of the derivatives market in Viet Nam during global shocks such as the pandemic. Moreover, the fact that transactions by foreign investors account for a relatively small share of the total volume of financial products traded on the derivatives market in Viet Nam (3.47 per cent in 2023, compared with 0.1 per cent at the end of 2017), demonstrates that the derivatives market plays an important role in risk hedging and leveraging investment avenues for traders, investors and businesses in the country.

The Viet Nam case study suggests that attracting cross-border capital inflows can be essential to a country's sustainable development. The many policies behind the success, including those that facilitate regional and global trade integration, enable financial market liberalization and promote cooperation with international lending organizations, have profound and replicable significance for many emerging markets and developing countries such as those in Africa. For instance, countries in Africa can learn from the experience of Viet Nam in implementing the types of reforms that create a stable and predictable policy environment, with more transparent regulations, predictable taxation regimes and stronger private investor rights. Moreover, the success of Viet Nam in improving infrastructure (such as transport, energy and ICT), which has been a critical factor in attracting private capital and fostering sector-specific export-oriented industries in manufacturing and agriculture, contributing to raising its levels of productivity and competitiveness, are other lessons learned that may be applied in countries in Africa.

Source: UNCTAD, based on Asian Development Bank Institute, 2008; Viet Nam Chamber of Commerce and Industry, 2023; Hanoi Stock Exchange, 2024; Jun et al., 1997; Thanh and Quang, 2008.
[a] LP Bank, Saigon–Hanoi Commercial Joint Stock Bank, Orient Commercial Bank, Viet Nam Prosperity Joint Stock Commercial Bank, Tien Phong Commercial Joint Stock Bank and Viet Nam Technology and Commercial Joint Stock Bank.
[b] These are derivatives securities products representing potential stocks listed on stock exchanges in Viet Nam.

Several conceptual frameworks serve as guidelines for firms, especially SMEs, in their strategies and practices of managing risks. Internationally standardized, recognized and widely used guidelines include the United States-based Committee of Sponsoring Organizations of the Treadway Commission enterprise risk-management framework, the International Organization for Standardization 31000 standard and the Australia and New Zealand standard 4360, known as AS/NZS 4360.

The enterprise risk-management framework defines risk management as the culture, capabilities and practices, integrated with strategy-setting and its performance, that organizations rely on to manage risk in creating, preserving and realizing value. The framework comprises five interrelated components:

- Governance and culture.
- Strategy- and objective-setting.
- Performance.
- Review and revision.
- Information, communication and reporting (Society of Corporate Compliance and Ethics and Health Care Compliance Association, 2020).

Lack of resources and expertise in implementing enterprise risk management, makes it difficult **for SMEs to prioritize tools and practices that can reduce risks**

Australia and New Zealand standard 4360 provides a four-pronged systematic approach to risk management that aims to establish the context, identify the risks, assess the risks and treat the risks (Dioubate, 2023). The International Organization for Standardization 31000 standard enables firms to integrate risk-based decision-making into their governance, planning, management, reporting, policies, values and culture. Its principles-based system can be applied by all organizations, regardless of type, size, activities and location, and covers all types of risk (International Organization for Standardization, 2018). The enterprise risk-management framework and the Australia and New Zealand 4360 standard can be applied to any organization, regardless of its size or sector (Dioubate, 2023).

While enterprise risk-management guidelines and structured approaches to risk management have proven effective in helping organizations develop sustainable business processes to mitigate risk and improve performance, their use by SMEs in many developing countries, especially in Africa, has been limited. Dioubate (2023) and Al-Tarawneh and Al-Smadi (2018) note that many SMEs in Africa are constrained by the lack of resources and expertise in implementing enterprise risk management, which makes it difficult for them to prioritize tools and practices that can reduce risks, such as conducting risk assessments, developing risk-management strategies and applying risk controls. In Nigeria, for instance, Akinyomi et al. (2020) found that the implementation of enterprise risk management by SMEs operating in the country is mostly constrained by inadequate capital, lack of access to credit and poor infrastructure. In other countries, such as Burkina Faso, Sawadogo and Zerbo (2018) observe the lack of knowledge, limited resources and cultural factors as significant barriers to the adoption of risk-management tools by SMEs. If SMEs are to implement enterprise risk management and better understand its different components – risk identification, risk assessment, risk response and monitoring and reporting – there is a need to build a risk-management culture within an organization, by promoting awareness of the benefits of such a strategy and ensuring that all employees in the company are involved in the risk-management process (Ziemska and Ciesielska, 2018). Beasley et al. (2016) argue that the effective implementation of enterprise risk management requires addressing cultural and organizational challenges associated with risks, which can be facilitated through effective leadership, management of organizational change and staff training.

If SMEs adopt effective risk-management frameworks and integrate the approach into their business processes, they can reduce the impact of risks on their operations and enhance their resilience to unforeseen events (Chen et al., 2020). The value of enterprise risk management was also argued by Brustbauer (2014), who stated that adopting risk management gave a competitive advantage to firms by facilitating mechanisms that could lessen potential losses in the event of market disruption or failures, or simply when exploiting growth opportunities. For instance, more effectively planning, organizing, directing and controlling resources – risk management, in essence – can help SMEs reach their growth or expansion objectives in an environment where unexpected positive or negative events occur (Crovini et al., 2021).

In a sense, enterprise risk management not only contributes to the ability of SMEs to mitigate the effects of unexpected threats or shocks on a specific project or investment, but it can also be a catalyst that drives SME performance, particularly in revenue growth and profitability. Such contributing factors of enterprise risk management were shown by Odubuasi et al. (2022) in their investigation of the effect of enterprise risk management on the earning capacity of African banks. A significantly positive correlation was established between effective risk-management practices and the enhanced earning capacity of selected financial firms in Africa. In developing countries in Asia, such as Indonesia, Malaysia and Pakistan, it was found that enterprise risk management increased the value of firms and shareholders, enhanced corporate governance and improved the quality of internal audits, which together contributed to the overall performance of non-financial firms (Husaini and Saiful, 2017; Nasir, 2018; Ping et al., 2017). In the Middle East, for example, in Bahrain, Jordan, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, Altanashat et al. (2019) and Rao (2018) found that the adoption of enterprise risk management by selected firms in those countries boosted their institutional performance and corporate governance. In conclusion, risk-management practices can help firms in Africa, especially SMEs, develop sustainable business processes to mitigate risk and build resilience to shocks.

Conclusion

In Africa, firms face a unique set of risks that distinguish them from their counterparts in other regions. One of the most prominent challenges is the volatile political and regulatory landscape, which undermines investor confidence, hinders long-term planning and increases the cost of doing business. Moreover, inadequate infrastructure, including unreliable electricity supply, poor transport networks and limited access to finance, constrain the operational efficiency and competitiveness of firms. These challenges are compounded by external factors, such as climate change, resource scarcity and global economic volatility, which further exacerbate risks for African firms.

Managing cross-border transaction risks in Africa requires a comprehensive approach that involves collaboration between Governments, businesses and financial institutions to address structural and financial constraints, enhance institutional capacities and foster an enabling business environment that builds resilience to shocks and promotes sustainable growth and development. Moreover, the development of deep and liquid financial markets that provide a platform for companies, Governments and individuals to raise capital, manage risks and trade securities is necessary to erect a bulwark in Africa against the global polycrisis.

Considering the positive and sustainable effects of enterprise risk-management practices on the financial performance of SMEs, stakeholder relations and strategic planning, it is important to overcome resource and infrastructure challenges and identify the key drivers for the successful adoption and implementation of these practices by SMEs in Africa.

Enterprise risk management can also be a catalyst that drives SME performance, **particularly in revenue growth and profitability**

The benefits of enterprise risk management extend beyond identifying, assessing and mitigating potential threats or losses, and hence building resilience and reliability in unpredictable risk environments such as that of the polycrisis. It is increasingly becoming a valuable tool for sound performance, sustained growth and competitive business outcomes in new markets and industries. Chapter 5, the final chapter of this report, will set forth some practical recommendations that can help the public and private sectors in Africa navigate complex and uncertain environments while building resilience and stability in economies, markets and businesses.