KEY POINTS

- Among other regions of the world, Africa, particularly Sub-Saharan Africa remains less diversified in its external resource flows, and depends on Official Development Assistance (ODA) to finance public investment. Innovative finance is crucial to enhance efficiency but also mitigate volatility in the flow of external resources that characterize the traditional sources, including ODA.

- Remittance inflows to Africa were estimated around 37 billion USD in 2010 marking a significant jump from just under 10 billion in 1995 and have overtaken ODA. This figure is significantly understated due to prevalence of informal channels of remittances. Reducing remittance cost as well as increasing transparency in banking transactions could increase official remittances by about 3 billion USD every year over and above the trend.

- Securitization of future flows of remittances can generate an extra 2 billion USD annually for African countries.

- Diaspora Bonds have a rich history of bailing out countries in times of crisis and in some cases financing key development undertakings. Often Diaspora Bonds are long-term in nature only to be redeemed upon maturity, and are relatively cheaper to the issuer. There is little experience in Africa in exploiting Diaspora Bonds, but the potential is enormous. It is expected that close to 10 billion USD could be raised annually from the wealth of the Diaspora.

1 – Introduction

Despite Africa’s widening financing gap to address its core development problems traditional sources of finance have proved to be inadequate in quantity and composition. Official Development Assistance (ODA) and Foreign Direct Investment (FDI), one of the major sources of external finance continued to decline as a share of GDP over the last decades (Figure 1). Certainly, there have been relative improvements in the flow of net FDI and ODA since 2000. However, both are still lower than their level in 1995. On the other hand, remittances by migrants from Africa increased steadily from 2.2% of GDP in 1995 to about 3% of GDP in 2008.

Figure 1: Net Flow of ODA, FDI and Remittances in Africa: 1995-2009

Sources: Author’s computation using data from the African Development Bank.

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Diaspora Bonds and Securitization of Remittances for Africa’s Development

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The other underlying feature is that both FDI and ODA are subject to high degree of uncertainty denying policy makers much needed degrees of freedom in making investment plans. The coefficient of variation of FDI and ODA during 1995-2009 was respectively more than five and three fold compared to remittances.

In addition to predictability of aid its allocation and utilization are also important areas of concern. A comparison of optimal aid allocation versus actual flow of aid for selected African countries suggest that only 20% of global aid allocated to Africa is consistent with the objective of promoting growth and poverty reduction. If global aid were reallocated in such a way that donors’ ultimate objective is to promote growth by supporting countries that utilize effectively aid for development, then, existing aid would be sufficient to reach goal 1 of the MDGs. This result indicates that there is substantial leakage and wastage in the delivery, allocation, and utilization of aid for development.

Both for reasons of efficiency as well as predictability, Africa need to exploit the potential for innovative finance that can play a major role in sustaining and accelerating growth.

Figure 2: Optimal (simulated) Aid vs. Actual Aid Allocation in Selected African Countries

![Figure 2: Optimal (simulated) Aid vs. Actual Aid Allocation in Selected African Countries](image-url)

Source: Shimeles (2010)
2 – Innovative Finance for Sustained and Strong Growth in Africa

For reasons of efficiency and predictability of development financing, Africa needs to exploit the potential for various forms of innovative finance to accelerate and sustain growth. In this context, remittances deserve serious attention from policymakers and development practitioners.

2.1 Mobilization of remittances

Non-traditional sources of finance, such as remittances, have grown in importance in the last decade in many African countries. In 2010, Nigeria received close to 10 billion USD in remittances, ranking first in Africa followed by Egypt (7.7 billion USD) and Morocco (6.4 billion USD). The whole continent is estimated to have received close to 37 billion USD net remittance inflows in 2010. In terms of its impact on the economy, remittances make up more than 5% of GDP in at least 12 African countries in 2009 (Figure 3). For countries such as Lesotho (24%) and Togo (10%) remittances represent a lifeline contributing smoothing household consumption, boosting foreign exchange reserves, financing domestic investment.

![Figure3: Remittances in Selected African Countries in 2009 (% of GDP)](image)

Source: Authors’ computations based on Migration and Remittances Fact Book 2011.

Certainly these figures are understated due to prevalence of unofficial remittance inflows in most countries in Africa. Barriers include hefty transaction costs and concern on the transparency of banks where large transfers are involved. Studies show that while remittances in general are cost inelastic, often sent to rescue families under financial stress, still considerable gains can be expected if international norms for interbank transfers are gradually implemented across Africa. Existing studies show that the average cost of remitting money from London to Lagos is around 14%. It is even more costly to remit money within the continent. For instance the cost of sending money from Cotonou to Lagos is estimated at 17%.

2 Figures provided by World Bank (2011).
Perhaps it is more in other less developed regions of the continent. In addition, improved systems of regulation and transparency could encourage transfer of large funds for different purposes, including investment, retirement benefits or others. It is also important to note that remittances in recent years generally have competed very closely with that of Official Development Assistance, setting a different trend in the sources of external resources for African countries. The crisis caused a decline in ODA flows to African countries by almost 50% in 2009 while remittances remained resilient (Figure 4). In absolute terms, remittances actually continued to rise. There is therefore every reason for African countries to target seriously the mobilization of remittances for development purposes.

2.2 Securitization of future receivables

One of the innovative ways to capitalize on remittances as well as future receivables such as export revenues and tourism receipts is securitization. This will help countries in Africa access international capital markets, reduce convertibility risk, and obtain investment-grade ratings. Securitization is a transaction that involves a potential borrower pledging future hard-currency receivables as collateral to a special purpose entity that issues the debt. The flow of foreign currency from remittances, and other sources (oil revenues, airline ticket receivables, etc) are used to service the debt. Because remittances have become increasingly large and predictable, the benefit of securitizing them is substantial. The securitization potential for key receivables is estimated around 17 billion a year of which close to 2 billion USD can be raised from future flow of remittances.

The securitization of future revenues is not new in Africa. The African Export-Import Bank (Afreximbank) facilitated a number of future flow securitizations.

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Figure 4: ODA Flows in current millions of USD to Africa (net disbursements)

![Figure 4: ODA Flows in current millions of USD to Africa (net disbursements)](image)

Source: OECD data base

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4 This paragraph draws heavily from Ketakar and Ratha (2009).

5 The discussion in this and following paragraph draws from Ratha et al (2008).
It arranged for Ghana to borrow 40 million USD in favor of a development bank where the loan was backed by Western Union remittance receivables. In Nigeria Afreximbank facilitated a loan of 50 million USD against flow of remittances through Moneygram.

The potential of securitization in low-income African countries is unexploited for a number of reasons. Weak financial sector development, inadequate working relationship and experience in international banking, low capacity to enforce contracts and protect creditors, all contribute to the difficulty of implementing a complex instrument as securitization of future flows. But, given the urgent need to scale up development finance in the continent, it is important to bank on innovative debt instruments.

### 2.3 Diaspora bonds

“Diaspora Bonds” are debt instruments issued by a homeland government to raise capital mainly from the Diaspora as alternative to borrowing from the international capital market, multilateral financial institutions or bilateral loans from governments. The practice of the Diaspora Bond goes back to the early 1930s by Japan and China, continuing into the present day with the State of Israel Bond standing out as a unique example which mobilized close to 25 billion USD in the course of the last 30 years\(^6\). The Resurgent India Bond issued right after the sanction the country faced following its test of a nuclear bomb raised close to 11 billion USD from the Diaspora. Greece is all set to raise capital from the Diaspora as early as in 2011 as borrowing from the international market became costly and its financing needs becoming ever more acute.

Africa has little experience in tapping into the wealth and savings of the Diaspora to finance much needed development projects. The closest a country has come to raising significant capital through Diaspora Bond is Ethiopia’s recent attempt to finance its ambitious hydro-electric power generation project. The bond, aptly called Millennium Bond, was issued by the country’s power authority and underwritten by the National Bank of Ethiopia. Three types of bonds were issued according to their maturity date, 5, 7, and 10 years, each bearing an interest rate of 4%, 4.5% and 5%, respectively. The effort is certainly commendable especially given the country’s recent resurgence in growth, which requires adequate stable financing to support the growth momentum in the medium term.

Diaspora Bonds certainly have a huge promise for Africa. Currently it is estimated that close to 16 million African immigrants from Africa live in Middle East and OECD countries. Given assumptions about labor market participation (em-

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Employment rate) and earnings, it is estimated that migrants from Africa could potentially save approximately 10 billion USD annually which under the right conditions could be invested in Diaspora Bonds. This figure would be much higher if concerted effort is made to appeal to the 140 million-strong African Diaspora who currently lives in the Western Hemisphere.

Diaspora Bonds are generally cheaper as the motives for purchasing such bonds are not entirely for purposes of profit. The keen desire to be involved in development of home country is the key motive for the members of the Diaspora to acquire such bonds.

3 Conclusions

Africa’s financing gap to achieve strong and sustained growth is astronomical, and cannot be met only through traditional sources such as ODA and FDI. Particularly starved of finance is the private sector. The contribution of small scale businesses and informal sector operators in Africa for national development has received recognition in recent years. Surveys show that high cost of finance in general and lack of access to finance in particular for small scale and informal sectors operators is the highest in Africa. Removing this constraint certainly helps attain strong, sustained and shared growth in the years ahead.

The potential for non-traditional, innovative sources of development finance for Africa is impressive. In 2010, remittances are expected to overtake ODA flows by a significant amount and are also projected to increase steadily. Other sources of innovative finance such as securitization of future receivables, Diaspora Bond and others could bring in a combined additional 15 to 20 billion USD a year. But, there is much work to do so that the potential of innovative sources of finance can be realized.

Factors that generally allow for the flourishing of informal channels for the transfer of remittances need to be identified and dealt with adequately. Often, high fees charged by official money transfer agencies force migrants to seek alternative means of money transfer. Some studies report that a 1% decline in the cost of remitting money could increase the volume of remittances by about 0.22. Greater transparency and flexibility by local banks can also help increase the volume of remittances and encourage migrants to engage in investment activities. Securitization of future flow of remittances adds substantial capacity for national governments to raise capital cheaply from the international market to finance important development projects. Africa is expected to gain an additional 2 billion USD annually from such an instrument.

Diaspora Bonds are proven means of raising cheap and long term finance from migrants interested in the development of their home country. Africa has a substantial migrant population living in high income countries. Currently there are 16 million migrants with some form of attachment with the country of origin. Close to 140 million people also live in the Western Hemisphere with African descent that may not however be able to trace a specific country of origin but deeply interested in the development of Africa. Devising appropriate Diaspora Bond that responds to the sentiments of the migrant community could raise billions for purposes of development.

To tap the potential of remittances, it is necessary to address key impediments, notably: weak and non-transparent legal systems for the enforcement of contracts, lack of competent financial institutions that can facilitate the marketing of such financial instruments, general mistrust of local institutions to honor their obligations, lack of clarity on rules that govern Diaspora Bonds in the host country and poor communication with Diaspora networks which are crucial in reducing investor risk arising from information asymmetry.

The African Development Bank can play a pivotal role in alleviating some of the institutional constraints that African countries face to exploit the potential of innovative sources of development finance. Interventions could include: creating the platform to engage the Diaspora to participate in the development agenda of the African continent, assisting in establishing mechanisms for guaranteeing Diaspora Bonds, pushing reforms in the financial sector and supporting projects that enhance the performance of African private equity firms. This fits with the Bank’s strategy of supporting private sector development and economic governance reforms.

\footnote{Aig-Imoukhuede (2010) reports that more than 65% of firms in Africa reported that cost of finance is a major constraint for growth and about 45% said that access to finance is key for their development. Shimeles (2006) reported that informal sector operators in Ethiopia consider access to finance a major bottleneck for their growth.}
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