

VALLIS COMMODITIES LIMITED

REPORT FROM

THE GLOBAL TRADE REVIEW (GTR)

EAST AFRICA TRADE AND COMMODITY FINANCE CONFERENCE 2017

1. INTRODUCTION

- 1.1 George Thrupp, who is part of the Operations and Reporting staff in the Vallis UK Head Office attended the GTR Conference in Kenya from 9th to 10th May 2017. The conference was held in the Windsor Golf Hotel and Country Club, Nairobi.
- 1.2 The purpose of this report from George is to highlight some of the key themes and talks attended during the conference.

2. OVERVIEW

- 2.1 The general theme of the conference was to consider 'what next' for African economies with a focus on the East African region.
- 2.2 A number of topics were discussed:
 - 2.2.1 The impact of Brexit and a Trump Presidency were high on the agenda. The consensus is a Trump Presidency will largely ignore Africa. The administration is hoping to push through cuts to the US foreign aid budget. Trump is a businessman; return on investment is at the heart of his philosophy and better opportunities lie elsewhere.
 - 2.2.2 The UK is the second largest investor in terms of projects across Africa. UK money has been behind successful schemes such as M-pesa. In the short term, the UK is going to be distracted with its split from the European Union (EU). In the long-term, the UK's role in Africa looks positive. A lot of focus is on the role of the Commonwealth. The Commonwealth has 52 member countries spread across the globe. It contains 2.4 billion people, 60% of whom are under the age of 29. The opportunities in this community are potentially immense.
 - 2.2.3 The entrenchment of political and economic institutions between countries in Africa will be central. Intra-African trade is viewed as a vital ingredient for long-term growth in African economies. The East Africa Community (EAC) has taken significant steps to integrate trade between its 6 member states. Removing tariffs has enhanced trade between countries in the region and is a way to offset dependence on exports to the global market. East Africa has some of the most dynamic economies on the continent and enhancing this regional trade will be highly beneficial to establishing industries.
 - 2.2.4 Africa needs far more financial inclusivity from the financial sector. Currently, most of the finance in the commodity industry is provided at the top of the chain. With over 60,000 small-holder farmers in Kenya alone it is extremely difficult for banks to target individual farmers. There is a huge emphasis in Kenya to help finance small holder farmers and mitigate risks using technology, which can play a powerful role in assisting those isolated in African societies and unlock \$126 billion of untapped potential.

3. INTEREST RATES, 'ZOMBIE BANKS', POLITICAL RISKS: WHAT'S KEEPING YOU AWAKE AT NIGHT?

- 3.1 This topic was a discussion between 4 panellists: Calvin Matundura – Senior Finance Manager at Safaricom, Vijay Kumar – CEO of Choppies, Robert Besseling – Executive Director at EXX Africa and Nicholas Oliver – Head of Business Development at NMS International Group.
- 3.2 Interest rates have a major impact on lending in Africa: too high and the borrowers as key drivers of economies cannot afford financing to help their businesses grow, but too low and financial institutions are reluctant to lend. A balance between these competing tensions is required.
- 3.3 The panel focused on the capping of interest rates by the Kenyan government at 14% in August 2016. Previously the rates had been 18%. The implications of this were discussed:
 - 3.3.1 The aim of the Kenyan Government in lowering interest rates was to increase financing and encourage people to borrow and drive economic growth. As the financial sector predicted, it has had the reverse effect and banks have become more reluctant to lend.
 - 3.3.2 The government intervention of fixing interest rates has threatened Kenya's reputation as a free financial market. Kenyatta has argued that banks in Kenya have some of the highest returns on equity on the African continent and so cuts to interest rates were necessary and would not have a damaging effect. Banks have a responsibility to do more to reduce the cost of credit and ensure that there is more inclusivity in the system.
 - 3.3.3 The verdict is that this has had a negative impact on Kenya and hampered economic growth. The concern is that Tanzania and Rwanda are closely watching the interest cap in Kenya and could follow suit by implementing similar measures. A cap on interest rates would be detrimental to both countries' economies and financial institutions are concerned that the wider region will follow. The worry is that government intervention in fixing interest rates will become the norm and hinder economic development in African countries.
- 3.4 Zombie banks was a term coined in 1987 by the prominent US economist Edward J. Kane. They are typically insolvent banks propped-up by government support. Zombie banks have injured economies in Asia and Europe, and Africa could be next. The slowdown in China has led to a fall in commodity prices, and a commensurate drop exports. This has left African banks searching for scarce liquidity.
 - 3.4.1 When banks encounter tough times initiated by economic slowdown, they hold back capital that stalls business growth and their profits. Bank failures pose a threat to state-owned enterprises and private businesses.
 - 3.4.2 The Mozambique and Angola banking sectors look particularly vulnerable. Mozambique is struggling to repay loans after the commodity slump reduced revenue. Nigeria and the Democratic Republic of Congo could be next.
 - 3.4.3 The question is whether zombie banks should be saved? After the 'Lost Decade' financial crisis in Japan in the 1990s, banks were saved and continued to hamper the Japanese economy. During the financial crash of 2008, several US banks were left to collapse and out of the ashes came far better functioning banks which appear to abide by the regulations.
 - 3.4.4 Kenya has over 50 banks. There is a consensus that failing banks should be forced to merge or collapse. Zombie banks will continue to hamper economic growth across Africa if they continue to operate.
- 3.5 Investors are learning to adapt to security risk in Africa. Political risk is an area that cannot be controlled. Below are 3 keys areas of political risk in Africa discussed by the panel:
 - 3.5.1 The change in leadership in Tanzania has led to more stringent laws on mining. President Magufuli wants to ensure Tanzania maximizes the benefits from the industry. However, his policies are thought to be detrimental for investors and consequently will

put off foreign companies, thus damaging the economy in the long run. It should be a warning to countries considering taking a similar stance.

3.5.2 The World Bank has downgraded Kenya's economic growth for 2017. The Presidential elections this year have added an element of doubt beyond August for investors. Elections in all countries generate uncertainty, which acts as a brake on economic growth.

3.5.3 There is real concern over the role of the International Monetary Fund (IMF) in Africa. Investors are worried about the IMF's waning interest in assisting countries in the developing world. Lack of dollar liquidity in African countries has led to a number needing financial support. If the IMF is not willing to help struggling economies in Africa, it will deter international companies from investing as returns may be in jeopardy.

4. THE IMPACT OF GREATER POLITICAL AND ECONOMIC UNITY ON EAST AFRICAN TRADE

4.1 This was a discussion between 4 panellists: Benjamin Mugisha – Senior Underwriter at African Trade Insurance Agency, Lloyd Muposhi – Head of Trade Finance at Trade & Development Bank, Argent Chuula – CEO of The Alliance for Commodity Trade in Eastern & Southern Africa (COMESA) and Sanjeev Anand – Group Managing Director at Atlas Mara Bank.

4.2 The East African Community (EAC) is a regional inter-governmental organization comprising Burundi, Kenya, Rwanda, South Sudan, Tanzania, Uganda. It was established on 7th July 2000.

4.3 The EAC has 4 key integration pillars:

4.3.1 Customs Union.

4.3.2 Common Market.

4.3.3 Monetary Union.

4.3.4 Political Federation.

4.4 The Customs Union established free trade between the member states and was ratified in 2005 and the Common Market followed in 2010. The next steps are to ratify the Monetary Union and Political Federation.

4.5 Since its inception, the EAC has grown to cover an area of over 2 million square kilometres with a population of 150 million people and has become one of the fastest growing trade blocs in the world.

4.6 The EAC is the most advanced trading bloc and the most integrated in Africa and contains a diverse array of economies producing different products. It has started from a small base but is slowly growing into something much bigger.

4.7 The Customs Union has increased regional trade tenfold since 2005. Fifteen years ago, the countries of East Africa were not trading with each other and most exports were onto the global market. Between 2010 and 2014, trade between member states grew from \$3 billion to \$5 billion.

4.8 The rise in trade has led to more financing by banks in the region and foreign direct investment (FDI). With this, transactions and the efficiency of how they are conducted have increased. It is extremely encouraging to see the number of regional banks and that they are lending to medium-sized enterprises in the region.

4.9 Of course, there are still challenges to overcome, particularly infrastructure. Doing business across borders has not come without its problems. East Africa has the second highest transport and logistic costs in the world. It is far cheaper to transport goods from Mombasa to Singapore, than from Mombasa to Kigali.

- 4.10 For financiers, banks and investors, trade blocs are extremely appealing. Countries in isolation are not attractive for investment. The EAC has succeeded in bringing together 6 economies to become a regional trade bloc. It has attracted FDI that might otherwise have gone elsewhere.
- 4.11 Where next for the community?
- 4.11.1 The next step for the EAC is a monetary union. A treaty was signed in 2013 paving the way for a single currency within 10 years.
- 4.11.2 The need for currency exchange across East Africa is a drag on regional trade. A trader travelling from Kenya through Uganda to Rwanda will lose 20% of the value of his initial currency. Monetary unions can ease congestion and make trading between countries more efficient.
- 4.11.3 The panel discussed at great length the impacts of a monetary union. The panellists urged caution when considering the consequences of deeper integration and pointed to the problems of the EU. The issues surrounded the Eurozone and Greece should be a warning to other trade blocs thinking about monetary unions.
- 4.11.4 The EAC would face similar problems to the EU as all 6 economies are at different stages of development.
- 4.11.5 Smaller economies in the community which depend on exports to the global market more than regional trade will be less competitive with a stronger performing regional currency. Exports will become more expensive but they will not have the specialized industrial base to trade regionally.
- 4.11.6 In the short-term, the USD and the Euro will remain far more attractive currencies to trade in. The USD and the Euro are the most sought-after currencies to hold in reserves. This will present a challenge for the deepening of a monetary union.
- 4.11.7 The advice from the panel was to let economies take shape through the customs union and common market before integrating further.
- 4.12 There is no doubt that the EAC has so far performed well. The fact that countries like Malawi, Zambia and Ethiopia are looking at opportunities to integrate with the bloc is credit to the EAC. Ethiopia would have a positive impact with its large industrial base and expanding exports. Zambia and Malawi both have good performing agricultural sectors.
- 4.13 The overriding message is: proceed with caution. The EAC has made huge strides with intra-African trade, increased investment, financing, and the diversity of its economies is something to applaud. However, the EU is a cautionary tale on how trade blocs evolving into political bodies can be a step too far and further political integration should not be rushed.