The Mundell-Brenner Thesis

A very thoughtful and stimulating piece relevant to where we think Africa is headed this decade appeared in *Forbes* last week co-authored by **William Mundell**, the former CEO of the **WEFA Group** who is developing a banking franchise in Africa to fund small and mid-sized businesses and Economist **Reuven Brenner** who holds the **Repap Chair at McGill's Desautels Faculty of Management**, serves on the Board of McGill's Pension Fund and Investment Committee and who has advised large funds, corporations and executed entrepreneurial ventures of his own.

We include the food-for-thought article below, inserting our commentary and references to past client pieces.

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Can Africa Become The Land Of Milk And Honey?

(http://www.forbes.com/sites/leapfrogging/2011/08/04/can-africa-become-the-land-of-milk-and-honey/)

At a recent Townhall event, under Republican pressure to cut spending, President Barack Obama defended foreign aid. He made the point that it allows "Americans to be a leader in the world, to have influence, to help stabilize countries, create opportunity for people so that they don't breed terrorists or create huge refugee populations flows." Yet, we have just seen the destabilization of some of the biggest recipients of foreign aid while endemic poverty and corruption persist, particularly in Africa.

*** [Comment:** In President Obama's words lie the *only* rationale that has existed behind U.S. foreign aid in Africa. We explain in our ***APB*** **April 14, 2011, "Assessing The FY2012 Budget For Africa"** in coverage of the **U.S. Senate Committee on Foreign Relations**

Subcommittee on African Affairs that the approach documented in an August 1958 **National Security Council** memorandum has been overwhelmingly guided by Cold War-era military objectives that have never been questioned until this past decade. No wonder the **Corporate Council On Africa** is based in Washington D.C. with no competing presence from the investment community in Wall Street.**]**

The timing may be just right for a new approach and Africa is the right place to begin. First, neither the U.S. government nor Western European ones have much money to give right now. This actually presents opportunities for African countries to put their houses, and their capital markets, in order and on solid foundations.

The global commodity boom over the last seven years has provided Africa greater flexibility to make financial reforms. These countries' young populations and emerging entrepreneurial class, along with greater political and social stability, provide incentives to invest in the continent. This is already happening in spite of self-serving perceptions shaped by the UN, aid agencies, and myriad charities in search of desperate causes. By highlighting data on illnesses and poverty, they suggest that Africa is still crumbling and massive aid is the solution.

[Comment:** A sharp point which we elaborate on in our ***APB **August 5, 2011, "9 Reasons Why 2011 Isn't 2008"** in terms of how the Africa narrative has changed over the last 30 years.**]**

We have no doubt that much of Africa is poor or that children, especially in war zones, are suffering and in need of aid. Of course, in times of crises, be they due to epidemics or natural disasters (malaria and AIDS are still big disasters in Africa), or due to disastrous political experiments, wars and monetary mismanagement, aid is needed. But that is not what we are talking about. The point is to learn the lessons from our recent failures in providing aid, and how the aid often contributed to poverty.

Gambling has brought riches to U.S. and some Canadian Indian tribes. Before the gambling, poverty persisted for decades, with rampant alcoholism, obesity, and suicide, in spite of transfer of hundreds of billions of dollars to the tribes, or rather to their chiefs. The chiefs then allocated the money, and if members of the tribes left the reservation, they left it penniless. Top down aid did not bring prosperity to groups within Western countries: Why would it bring any in African countries?

*[**Comment**: Though not their point, gambling and casino presence may *eventually* become part and parcel of African development projects in order to make them more lucrative. And as kinship system ties weaken and governments look for revenue sources to replace state-to-state aid this will become more attractive and culturally acceptable. Currently the development of

massive mixed-use communities on the continent lacks this component and no value added magnet for foreign tourism, which is primarily monetized via hotel and sight-seeing (i.e. **Lagos State in Nigeria** and **Nairobi, Kenya**). Connecting African urban development to gaming and live entertainment (currently too many stadiums are only monuments to vain leadership) timed for when a emerging domestic middle class comes on line could be explosive. Once sanctions on **Zimbabwe** are lifted we envision **Victoria Falls** as a possible destination for something like this. To get a better idea as to where mixed-use city-communities are on the continent see our ***APB* June 27, 2011, "Tatu City: The Development of The Decade?"**]

But history shows clearly that where there was no foreign aid, and yet conditions were set for entrepreneurs to be financed, places started to thrive. 18th century Scotland went from being the poorest place in Europe to becoming the richest within few a decades. The Dutch Republic, suffering from natural disasters, including being under sea level, became the "miracle" of the 17th century. More recently India and China came from behind to catch up, again without external monetary aid. "Hybrid" financial institutions have been keys to their rapid development. There are no examples of any country "making it" without accessing capital to expand medium size companies and start new ones.

Scotland had "banks" which combined under one roof the roles of micro-credit, venture capital, and normal lending services. China's recent success was jump-started by the 55-million Chinese Diaspora, mainly through Hong Kong's financial center.

And let us not forget that the Wild West was tamed by "soft" banks (a combination of VC and a bank) rather than traditional ones, three of which only existed at the time, all on the East Coast. Perhaps it is thus not surprising that the rapidly growing "sovereign wealth funds" (China's in particular) may turn out to be well-suited to jump-start Africa. They know from their own recent experience that countries going through political transitions must rely on the type of hybrid financial institutions listed above, but with strong expertise in doing due diligence since traditional collateral may be lacking.

*[**Comment:** Strong historic points which hardly anyone acknowledges. The only thing not mentioned is the emphasis on 'investment-aid.' China's policies in Africa are largely modeled after those it was on the receiving end of from Japan, namely investment-for-resource swaps and 'compensatory' trade known as *buchang maoyi.* Sovereign wealth funds and 'soft' banks are entirely different and neither of these is responsible for China's current success in Africa. As we make clear in ***APB* April 14, 2011, "Assessing The FY2012 Budget For Africa"** it is 'policy banks' like the **China Development Bank**, **China Export-Import Bank** and **China Agricultural Development Bank** - operating on commercial principles, though still tools of government, that have provided a formula of joint venture investments and concessional lines of credit to African nations and state-owned enterprises (SOEs) as well as other forms of support,

at a micro and macro level. As we described in ***APB* April 14, 2011 "China As Saviour To Africa's SMEs"** it is the China Development Bank which has been at the hub of the effort which has extended $1 billion to SMEs in over 20 African countries.

The Mundell-Brenner presentation of "'Hybrid financial institutions" is seminal though not fully flushed out in this piece. Africa is a few years off of what is described in regards to receiving capital from its own, who living abroad, in that its diaspora community has no efficient process or a critical mass of fund pools by which it can invest in equities back in the mainland or fund start-ups – here a series of 'soft banks' and 'hybrid financial institutions' could be part of the solution. But more is needed to lessen risk – like popularizing the use of formalized business organizations (partnerships and corporations) among African entrepreneurs and some form of uniform commercial code and process by which disputes between investors and entrepreneurs can be addressed. Moreover 'diaspora bonds' though attracting more interest from African immigrants in America only represent the debt side of the equation and pass through government hands which are not best at allocating. And it will take years before Black Americans – the biggest potential source of risk finance in the African diaspora are re-connected. But again, what Mundell-Brenner propose could definitely help unlock this.

Whether a 'soft bank' or sovereign wealth fund can allocate risk capital more efficiently than a policy bank is yet to be seen, as it is not clear how profitable Chinese-financed African SMEs truly are. But certainly a soft bank or 'hybrid financial institution' as implied in what Mundell-Brenner describe should be more *nimble* in allocating capital across the continent. It will be interesting to learn if they see soft banks investing behind *policy banks* in Africa, separately, or in tandem with them.**]**

Abdoulaye Wade, President of Senegal, wrote that "a contract that would take five years to discuss, negotiate and sign with the World Bank takes three months when we have dealt with Chinese authorities. I achieved more in my one hour meeting with President Hu Jintao at my hotel in Berlin during the recent G8 meeting in Heiligendamm than I did during the entire, orchestrated meeting of world leaders at the summit, where African leaders were told little more than that G8 nations would respect existing commitments." Meanwhile, Robert Zoellick, World Bank President,suggested too that Sovereign funds should invest a fraction of their U.S. $3 trillion of assets in Africa as equity, not aid.

Of course, speed has costs and benefits. The Chinese and other sovereign funds can make quick decisions, some of which will turn out to be bad ones. Western countries' separation of powers and special interest groups interested in perpetuating aid slow down decisions.

***[Comment:** It can also be said as we have noted in ***APB* May 12, 2011 "India Exports A Sunset Industry"** and ***APB* June 13, 2011 "China As Saviour To Africa's SMEs"** that the investment in Africa is also a strategy to offshore declining or saturated sectors in China (or India). Almost every ounce of investment-aid China gives Africa is with the objective that those dollars produce not just an equal amount but a *multiple* in measurable economic growth – for both China and Africa. And perhaps, most importantly this investment-aid is also a critical form of evangelization on behalf of geopolitical interests (support for the **'One China'** policy is an unwritten condition of African investment, for example).**]**

Perhaps the West will miss a few bad apples. But they will miss opportunities too. Countries comfortable in their riches may neglect this consideration. Ambitious newcomers less likely. The Chinese use an 81 B.C. text (a discourse about whether having or not state monopoly on salt), saying "A country is never as poor as when it seems filled with riches."

An inadvertent effect of less reliance on aid and more reliance on functional domestic capital markets would disperse domestic power within African countries, diminishing chances of future conflicts. Financial crises are the Mother of Invention, in politics as in business. The young and Africa's emerging middle class population would be provided with incentives to collaborate rather than bribe or fight.

*[**Comment**: This is already emerging in nations like **Ghana** and **Uganda** who are encouraging secondary listings of foreign companies exploiting opportunities in their countries. We see this trend continuing as a way for African governments to 'democratize capital' (a phrase Brenner has helped popularize) and in their preference to avoid directly distributing oil revenues through government agencies (which eventually will be bet on by an African political entrepreneur). See our ***APB*** **June 14, 2011 "Tullow's Ghana IPO And The Rise Of Secondary Listings In Africa."**]

Anticipating stability and growth, government officials and police could be paid salaries that required fewer "side payments." All these combined means that more people get stakes in the future and have access to collateral with diminished corruption. Thus, the investment cycle starts from the bottom up. Entrepreneurship is then further enhanced, and with it the foundations of lasting prosperity.

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