

Country Partnership Strategy 2009-2011

South Africa

The French Development Agency (« AFD ») is a state owned company with a mandate of general interest, set by the French authorities, to finance development in the world. The AFD is a specialised finance institution and provides financing for economic and social projects sponsored by local public authorities, public companies, the private sector and associations across the five continents. However the main activity of the AFD is in Africa which represents almost two thirds of its commitments. These projects are for urban development and development of infrastructure, rural development, industry and financial systems, as well as education and health.

The AFD is the **central body through which French public aid and cooperation for development is channelled**. The AFD conducts its activities within the framework of the Millenium Development Goals, at the crossroads of economic growth, reduction of poverty and environmental protection. The AFD is guided in its strategy by the principles of sustainable development and accordingly builds up financial and intellectual partnerships with other financial institutions and contributes, in co-ordination with its governing bodies, to the elaboration of public policies and the promotion of French influence in the field of development.

◆ Executive Summary

Diversification of our Partners and Risks

The AFD's partners and its risks are currently concentrated on the financial sector. Therefore, **whilst wishing to consolidate the financial partnerships** it has built up after 15 years of operations in south Africa, the AFD group now seeks to **diversify its partners** as well as its risks by offering the widest range possible of financial instruments and making measured use of concessionality. South Africa has recently entered a downgraded macro-financial cycle under the dual effects of the international monetary crisis and internal tensions which represents a challenge to the pursuit of the national policy of accelerated shared growth and the objective of renewed public investment. In the current climate of increased aversion to emerging country risks as evidenced by a drop in capital flows and the increased cost of credit, **support for growth drivers** should be reinforced by in particular contributing to the financing of large parastatals which have been affected by the current lack of liquidity in the South African market. Direct partnerships with large municipalities may also be developed.

... Strengthening our Capacity for Innovation and our Technical Expertise

Due to the fast evolving nature of each sector, it is necessary in dynamic economies to have **in-depth knowledge of the characteristics of each sector**. This in-depth knowledge guarantees the capacity for innovation of the AFD and that the projects and financial instruments offered by the AFD will correspond to the needs of South Africa, either in substitution for but not in competition with the traditional banking sector or in co-operation with the traditional banking sector. It is also **the financial and technical innovation, the provision of specialised expertise and the capitalisation and sharing of French know-how** which has been gained through the variety of different projects it has been involved in that gives the AFD its added value, legitimacy and high profile in the South African economy which is an economy comparable in many respects to the BRIC economies (Brasil, Russia, India, China).

In order to maximise its impacts and in a rationale of good coordination an harmonisation with other cooperations, the AFD must **limit the number of sectors where it is present** to be able to deliver its added value. Accordingly, to capitalise on the expertise it has acquired after nearly 15 years of

operations in this country, **the main sectors of the previous country partnership strategy** will be maintain but deepened, as follows : **(i) basic local services ; (ii) productive sector , (iii) the environment with a particular accent on energy and the climate, (iv) regional economic development.** The AFD will refine its approach in these 4 sectors by capitalising on the previous experience it has gained and will open up its strategy to embrace professional training and the financing of large public production infrastructure projects in South Africa and its neighbouring countries.

The AFD also considers itself to be **complementary to the other international aid and financial organisations** present in South Africa and currently providing financing for development. This principle of complementarity in line with the Paris Declaration together with the need to focus our resources on certain sectors, explains why we consider that we should not be present in certain sectors, as these sectors where we are not present, although essential for the development of the country, already benefit from financing and technical expertise provided by other lenders, multilateral funds, NGOs and foundations.

... To be better able to contribute to public debate

This operating model and AFD's financial weight means France is currently one of the main international lenders in South Africa. This positioning should be used in contribution for **public policies dialogue, sharing of experience, promotion of intellectual expertise as well as exchanges of know-how** focused on our main areas of intervention and in line with the new Government expectations

Accordingly, the AFD plans to focus its research on **knowledge creation** on the following subjects:

-**Affordable housing** : the AFD will take a more active role in the reformulation of affordable housing public policies in South Africa by encouraging closer cooperation with the main players in this field, sharing experiences with France and promoting exchange of knowledge with emerging countries;

-**Incorporation of environmental challenges at the world wide level in the financing of development** : the AFD would in particular be able to contribute to current debate on the integration of policies relating to energy efficiency and renewable energies into urban development planning, in particular at the level of the large municipalities;

- **Regional policy** : based on its regional partnership with the DBSA, a debate should be provoked and driven with the relevant countries centred on priority projects by closer cooperation with the large lenders and by taking greater advantage of the network of AFD offices.

◆ Abbreviations

ACSA	Airport Company of South Africa
AFD	French Development Agency
ASGISA	Accelerated Shared Growth Initiative for South Africa
ARIZ	AFD Guarantee Scheme
BBBEE	Broad Based Black Economic Empowerment
BEE	Black Economic Empowerment
CBSF	Capacity Building and Study Fund
CCAO	Cooperation and Cultural Action Office
CPS	Country Partnership Strategy
DBSA	Development Bank of Southern Africa
DOE	Department of Education
EC	European Commission

EIB	European Investment Bank
EPA	Economic Partnership Agreement
EU	European Union
FCCI	French Chamber of Commerce and Industry
FPA	Framework Partnership Agreement
GDP	Gross Domestic Product
GPG	Global Public Goods
HDP	Historically Disadvantaged Populations
IFC	International Finance Corporation
IMF	International Monetary Fund
INCA	Infrastructure Finance Corporation Limited
JIPSA	Joint Initiative for Priority Skills Acquisition
KfW	<i>Kreditanstalt für Wiederaufbau</i>
MDG	Millenium Development Goals
NEPAD	New Partnership for the Development of Africa
NGO	Non Governmental Organisation
PAD	Public Aid for Development
PPP	Public Private Partnership
RSA	Republic of South Africa
SADC	Southern Africa Development Community
SAIA	South African Insurance Association
SARB	South African Reserve Bank
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
UNDP	United Nations Development Program

1 Determining factors for the strategy of the AFD over the period 2009-2011

1.1 *Analysis of the challenges of sustainable development*

With a per capita income of 5 760 dollars, South Africa (48.5 million people, 1 214 000 km²) is a middle income country and is one of the main powers on the African continent. South Africa accounts for nearly 40% of Sub Saharian GDP, far ahead of Nigeria (15%), the other main power. In terms of purchasing power parity, GDP by habitant is estimated at 11 110 dollars and places South Africa at the same level as Russia and ahead of the other « BRIC » (Brasil, Russia, India, China). However South Africa ranks only 121 (out of 177) according to the index of human development published by the United Nations Development Program (UNDP), behind Gabon. Inequality in this country is one of the greatest in the world and the equilibrium is fragile.

Increased growth post-apartheid, which accelerated from 2004

Since the transition to democracy in 1994, South Africa has adopted a vigorous policy of **macroeconomic stabilisation** (stabilisation of public finances, reduction of debt and inflation) and gradual liberalisation, leading the way for increased growth. Between 1994 and 2006, actual GDP has progressed at an annual average rhythm of 3.4%. Between 2004-2007, Growth has even accelerated reaching approximately 5%, staying nonetheless under the average level of growth of the other middle income countries during the same period. In 2007, the international notation agencies which rate South Africa had given the macroeconomic performance of South Africa the same note as for Thailand and Poland : Standard & Poor's **BBB+**/n, Moody's Baa1/p.

On the supply side, this renewed growth was characterised by an evolution of the tertiary level of the productive sector (transport, stockage and communication, financial intermediation, real estate and services to companies), which reached 66% of GDP in 2006 and is driving growth in South Africa. With a consolidated balance sheet which reached 120% of GDP in 2006, the banking sector in particular, very strong and dynamic, managed, in a first period, to be shielded from the direct consequences of the financial crisis compared to other emerging markets, even if the current slowdown in the economy creates new risks. Its level of sophistication has been inherited from the apartheid political system, at which time economic activity was concentrated on the rich part of the population : the five main banks are all rated investment grade despite the recent degradation in outlook and notation. The banks are also capable of playing a proactive role in the definition of framework policies aimed at extending banking facilities to historically disadvantaged populations (3.5 million people in South Africa still do not have access to banking facilities), whilst at the same time maintaining prudent ratios which comply with legal requirements.

As for demand, the increase in household consumption which has been boosted by an increase in disposable income and the availability of credit has driven growth over the period 2004-2006. We are now witnessing an emerging middle class which has been living on credit for several years due to low interest rates, and an increase in wealth generated by the increase in the value of financial assets and house prices for the wealthiest households.

Sustainable growth ?

However, a certain number of conjunctural problems which have been aggravated by the financial crisis and structural problems darken the picture. In the short term, growth forecasts are down with

GDP falling from 5.1% in 2007 to 3.1% in 2008 and then recession for 2009 (IMF forecast). This change risks increasing social tensions.

At the macroeconomic level, the main risk factors are the following:

- A **high current deficit** (-7.3% of GDP in 2007 et -9% of GDP in 2008) generated mainly by capital outflows which are by nature more volatile than direct foreign investment. Investment needs for infrastructures are keeping the deficit at the current high levels making the economy vulnerable to a a loss of confidence by investors, although there has been a slight reduction of the deficit. In view of the current international financial crisis which is characterised by tighter conditions for obtaining foreign [public] financing and a general aversion to emerging country risks, a fall in capital flows will put pressure on the rand which in turn will fuel inflation, thereby limiting the ability of the authorities to reduce interest rates and having a negative effect on investment and growth.
- **Inflation under pressure** : inflation which is strictly controlled by the independent central bank (South African Reserve Bank - SARB), rose from 5% in 2006 to 8.6% in 2007, exceeding the threshold of 6% fixed by the SARB. Inflation reached 10.6% in 2008 as a result of the increase in food prices, raw material costs and transport costs.
- A **worrying rise in the level of household indebtedness**, which rose from 50% to 78% of disposable income between 2003 and 2007. As home loans were taken out at variable interest rates, the level of repayments made by households has increased since 2006 due to the tightening of monetary policy by the SARB. This trend could continue in the current context and have a negative effect on consumption which explains why growth forecasts have been reduced.

Despite these weaknesses, the economy has certain strengths which should insulate it from external shocks. Its external debt is low (26.6% of GDP in 2007) and its long-term dynamics are considered viable by the IMF. 40% of this debt is in rand and international reserves represent 178% of short term debt. The aim of the authorities is to increase their reserves (3.2 months of importations) to cover the combined amount of their current deficit and short term debt (currently 70%). **The challenge therefore is more the need for short term liquidity rather than there being any risk of the country becoming insolvent.**

Other structural problems directly affect growth and its durability.

The **Aids** epidemic which has reduced South African life expectancy by 12 years affects 5.5 million people, 20% of whom are aged between 15-49, and its macroeconomic cost is estimated to be between 0.5 and 2.5 points of GDP.

Unemployment, although down from 30.4% in 2002 to 23% in 2007¹, remains at a very high level for a middle income country (the average being 6%) and it is mainly the black population (26.8%), coloureds (20.7%) and Asians (9.4%) who are unemployed, compared to only 3.4% of the white population. The fall in unemployment is now being hampered by a structural **lack of qualifications of the majority of the population** which is the heritage of limited access to higher education and professional training under the apartheid regime. This shortage of skills is felt most strongly in management and engineering. As a result, it is often difficult to recruit and there is high turnover generating higher costs but also affecting versatility and the quality of goods produced due to limited R&D.

Accounting for 50 % of GDP, 25 % of investment and 60 % of employment, small and medium enterprises (SMEs) which play a leading role in employment in South Africa, are still mainly

¹ This rate would undoubtedly be higher at around 40% if workers who have given up looking for a job and workers not counted by South African official statistics were included.

controlled by the white minority. « **Black SMEs** » which are fairly recent and small², have high levels of bankruptcy. Inadequate access to bank financing and the continuing high aversion of banks to risk helps to explain why their capital structures are rarely optimised.

South Africa has been going through an **unprecedented energy crisis** since 2008 with nationwide rationing being implemented which is likely to continue for several years. This situation has arisen because of the lack of public investment in energy production infrastructures over the last twenty years and some of the lowest tariffs in the world. Eskom, the public electricity distribution and production company, must now invest massively to be able to face up to growing demand.

Insufficient growth to have an impact on poverty and inequality

Certain advances which have been made in social policy deserve to be highlighted: 1.7 million houses have been built since the end of apartheid, 88% of households have access to running water, 65% to improved sanitation and 70% to electricity. The financing of these infrastructures has been made possible by significant transfers from the national treasury to local authorities together with the progressive reform of the South African local authorities who are the foundation stone of the policy of decentralisation decided on by the Government.

Despite the progress made in the matter of economic growth, South Africa remains one of the most unequal countries in the world : 45% of national income goes to the richest 10%, over one third of the population and mainly the black live under the poverty line (threshold of 2 dollars a day), and the Gini coefficient, which has deteriorated since 2000, is 0,68³. **Inequalities are becoming greater with the percentage of the population living under the poverty line increasing over recent years.**

Furthermore, the situation regarding **access to basic services and housing for the poorest remains critical**. In the face of rapid urbanisation (60% of the population lives in urban areas), the geographical disparities have increased : rural local government where the majority of the poor population lives suffers from a lack of technical and financial capacity, and access to basic services in these areas is much lower than the national average. The number of families waiting for an acceptable housing solution now amounts to 2.2 million which is responsible for the increase in informal and insalubrious housing in the townships of the large metropolitan areas as well as the high demand for affordable housing programs and on the housing market.

Hardly any progress has been made in the **agricultural reform** which was announced in 1994 and is a particularly sensitive political subject : 84% of land still belongs to the white minority and only 3% of land has been transferred which is far below the target announced of 30%. This failure no doubt shows the limits of the purely voluntary approach employed by the Government to date as well as the weakness of the local government administrations in charge of implementing the reform.

A regional power

As the first power on the continent (40% of Sub Saharian Africa's GDP and 70% of GDP of SADC), South Africa is capable of driving the whole sub region in both real and symbolic terms. According to an IMF estimation, an additional percentage point in South African growth results in an increase in growth of between 0.5-0.75 percentage points in the rest of Africa⁴ due to increased intra-regional exchanges and investment : investments by South African companies are rising across the continent

² 51 % have been in existence between 2 to 5 years and 62 % have turnover of less than €20 000

³ As opposed to 0.66 in 2006 and 0.57 in 1994.

⁴ Arora et Vamvakidis (2005), *The Implications of South African Economic Growth for the Rest of Africa*, IMF Working Paper, 05/58.

in particular in the financial sector where strong competition in the domestic market makes it necessary to seek out new opportunities.

The so called « Rainbow Nation » is often held up as a political and economic model of success by the rest of the continent which makes its evolution over the coming years of particular importance.

1.2 Summary of the country strategy

The Accelerated Shared Growth Initiative for South Africa (ASGISA)

Launched in 2004 by the vice-presidence of the Thabo Mbeki government, ASGISA sets out the framework of the South African state's new priorities. The results hoped for are average growth of at least 4.5% between 2005-2009 then 6% up until 2014 ; unemployment below 15% and poverty limited to less than one household out of six.

The main elements of this initiative can be summarised as follows : **improvement of large public infrastructures, promotion of the private sector** in high potential sectors which are conducive to SMEs, **education and development of professional skills** with the launch of JIPSA (Joint Initiative for Priority Skills Acquisition).

After the major change in 1994 and the adoption of an orthodox economic policy, the Asian *developmental State* model (where the State « guides » the market) now seems to be favoured and has openly inspired the new industrial policy put in place by the Ministry of Commerce and Industry.

Black Economic Empowerment, the cornerstone of social upliftment

The policy of **positive discrimination in favour of « historically disadvantaged populations »**, put in place at the end of apartheid to rectify the inequalities of the past and guarantee social harmony, is at the heart of the Government's economic and social policy. It aims to structure the informal or second economy by leveraging on growth in the first economy.

After a first phase which has produced mixed results and which has allowed the creation of a black elite but which has not led to any significant redistribution of wealth, a new more comprehensive legal framework (**Broad Based Black Economic Empowerment Act**) was adopted in 2004 which introduced, inter alia, sectorial charters and codes of good conduct. Each company in each economic sector must comply with BBBEE with companies being noted according to seven criteria : ownership of capital, management, employment, training, purchasing and suppliers, development of the company, social programs. The BEE Charter of the Financial Sector also sets target figures for the **financing of black SMEs** and home loans for low income households. Companies that are interested in obtaining public contracts are also encouraged to have a good score to increase their chance of winning tenders.

Fight gainst climate change

South Africa is the 14th largest polluter in the world with **7.5 tons of CO2 emissions by inhabitant per year** and its emissions are set to rise by 30% over the course of the next ten years. The authorities, who ratified the Kyoto Protocole in 2002, have become more sensitive to both climatic

and energetic challenges. South Africa has adopted targets for economising energy⁵ and for the development of renewable energies.

However, low energy prices do not make such investments attractive and the **structural energy crisis** which gathered pace at the end of 2007 has prompted Eskom, the national electricity company, to draw up a 10 year investment plan based mainly on burning of coal and the possible development of nuclear power.

Influence and regional responsibility

The Republic of South Africa (RSA) has chosen a multilateral approach which is evident from several of its foreign policy priorities : the RSA is very **active in international forums** for the resolution of major issues such as climate change, food safety, nuclear non-proliferation and the regulation of trade relations.

South Africa is a **regional lender** through the **African Renaissance** Cooperation Fund, the Development Bank of Southern Africa (DBSA) and the Industrial Development Corporation (IDC), who have made investments throughout the whole austral region as well as through tripartite partnerships (in particular with India and Brasil) aimed at creating greater support for the development of the region and the continent. South Africa also supports the **NEPAD initiative** and is home to its secretariat.

South Africa has been involved in the political resolution of conflicts in Ivory Coast and the Democratic Republic of Congo, and militarily in Burundi and Sudan. On the other hand, President Mbeki's mediation in the Zimbabwean crisis has been criticised by certain members of the international community.

As regards trade relations, South Africa is a member of the regional economic **SADC** organisation (Southern Africa Development Community), which has its seat in Gaborone in Botswana and which converted to a regional free trade zone from January 2006. An interim agreement was reached in 2008 with 5 countries of the SADC zone (Mozambique, Botswana, Lesotho, Namibia, Swaziland) as part of the negotiations with the EU of an Economic Partnership Agreement, but South Africa did not ratify the agreement preferring to continue with its bilateral exchanges.

1.3 Other lenders' main areas of intervention

In view of the economic importance of South Africa, total Public Aid for Development (PAD) granted to South Africa represents an **insignificant part of the State's annual budget** and is estimated at between 1 and 1.5%. Although South Africa receives PAD, it is also provides funds (cf section 1.2).

The **Government's strict policy of controlling debt** and the exclusive use of international finance markets to cover its foreign currency requirements is reflected in the structure of PAD received by the RSA.

With engagements of 360 million euros between 2000 and 2005, **France is the third provider of PAD behind the European Commission** (EC, 760 million euros) and the United States. The World Bank has a program devoted to knowledge creation⁶ as it is not authorised to give grants nor to make non-sovereign loans in middle income countries.

⁵ With the implementation of a Demand Side Management Fund financed directly from electricity users bills

⁶ With the exception of the loan accepted from international lenders by the South African Government in 2002 in an amount of 15 million dollars devoted to capacity building of local government

As all lenders have a **common mandate to fight poverty and reduce inequalities**, the main bulk of lending both in terms of the number of financings and in volume of financing is directed mainly towards social issues such as the fight against AIDS and the development of basic services. Job creation and professional training, the protection of the environment and management of natural resources, good governance including in particular capacity building for local government and the support of regional integration, also figure amongst the programmes of a certain number of lenders. The South African Ministry of Finance actively controls the management of PAD by centralising information and organising regular meetings with lenders.

The vast majority of governmental lenders traditionally favour the **granting of subsidies** as a way of financing cooperation and development. Only the **German KfW has an operating model which is similar to the AFD's**, making use of subsidised loans which qualify for PAD granted to public companies and municipalities, mainly in the areas of renewable energies, energy efficiency and urban development.

Apart from the traditional governmental lenders, there are **several private foundations** active in South Africa (the Ministry of Social Development has counted more than one thousand), mainly in the area of health.⁷

Last but not least, the dynamic private sector and the strength of the South African financial system create several interesting opportunities for **international institutions financing** the development of the private sector similar to Proparco : the International Finance Corporation (IFC), the European Investment Bank (EIB), the German DEG and the Dutch FMO.

=> The AFD is therefore one of the rare lenders capable of offering a **complete range of financial instruments**, from grants to loans at commercial rates in favour of both public and private bodies, which enables the AFD to **adapt to the needs of an emerging economy** by encouraging the financing of more risky operations through risk sharing, whilst at the same time being a provider of technical expertise and funds.

1.4 Guidelines for the French strategy

South Africa is a unique case in many respects as compared to other countries aided by French cooperation as a result of its history and the dual nature of the economy which is the legacy of this history, and the political decision taken by the Government not to become indebted to international lenders in the interests of preserving its independence.

Based on the above, a Framework Partnership Agreement (FPA) setting out the main principles of French cooperation in the RSA and the methods to be used, was signed on 11 September 2006 by the French and South African authorities.

The structure of aid granted by France is characterised by a **relatively low level of subsidies** and the **non-sovereign** status of AFD's borrowers. France's intervention strategy is centred around **three large areas of intervention** :

- **Development of infrastructures.** There are two types : firstly basic infrastructures (basic services : water, education, health, electricity) and affordable housing, and secondly economic infrastructures in particular those with a regional dimension.

⁷ Most of the large foreign foundations are present and in particular the anglo-saxon philanthropical foundations such as the *Bill et Melinda Gates Foundation* and the *Ford Foundation* as well as the German and Scandanavian political party foundations, but also several care foundations started by large companies and well-known South Africans (Nelson Mandela, Desmond Tutu, De Klerk, Mark Shuttleworth). These foundations invest large amounts of money in many different areas, in particular the fight against AIDS.

- **The productive sector.** Action taken in this area will focus on job creation and stimulation of business.
- **The environment.** Action taken in this area will focus on the fight against global warming and the protection of biodiversity.

2 AFD Intervention Strategy

2.1 *Review of past interventions and main lessons learnt*

Since 1994, the main priority of the AFD through its intervention in South Africa has been to **support public policies in favour of social upliftment of historically disadvantaged populations (HDP)**. This has resulted in two main priorities being pursued : the financing of essential community services (water, education, health and affordable housing) and job creation via the development of SMEs and support of BEE. It was already suggested in the last CPS (2005-2007) that the AFD's historical mandate be extended to include support for the South African public policy of fighting global warming, in line with the global AFD strategy of protection of global public goods. The AFD operates in South Africa through **soft loans with limited concessionality**. Only feasibility studies and technical assistance can be financed by grants.

Municipal Development : at the heart of the AFD's activity in South Africa

Over the period 1994-2007, the AFD committed nearly **300 million euros for the development of basic community infrastructures**. Initially, funding was provided through credit lines extended to public financial institutions (DBSA) and private financial institutions (INCA : a financial institutions specialised in the financing of South African municipalities). More recently, we have accepted to share risk on medium sized municipalities together with INCA, and make direct loans to large municipalities (loan to the city of Johannesburg in 2005 for a project to improve water distribution in Soweto).

A study conducted jointly by the post implementation assessment department of the AFD and the DBSA which reviewed the impact made by the first four credit lines granted to the DBSA has drawn the following initial conclusions : more than 1.5 million people have been connected to the electricity network and over 800 000 to water ; 100 000 people have benefited from public works to drain rain water ; 65 000 students use infrastructures financed by the Technology Universities ; 400 000 people benefit from municipal primary health care infrastructures.

These investments are backed up by the **dedicated capacity building fund for municipalities** created in 1998 together with INCA thanks to the subsidies provided by AFD on its financings. Almost 3 000 managers and municipal officers have received basic accounting and financial skills training and a hundred elected officers and South African managers from 44 different municipalities have taken part in study trips to France to see at first hand how public services are managed by French local and regional authorities.

=> South African municipalities are still characterised by high poverty, insufficient basic services, lack of technical capacity and lack of management of their administrations, in particular those which do not have access to bank financing. The principal mission of the AFD in South Africa remains the provision of financial support to South African municipalities to assist them in achieving their basic infrastructure investment programs. However, the AFD must adjust its financing strategy to the different categories of risk that exist in view of the growing appetite of the South African financial community for the financing of local authorities, to ensure that it does not compete with the private sector but works in co-operation with the private sector or in substitution therefor.

Support for affordable housing policy : the limits of a pure banking approach

In South Africa, the AFD granted a loan of €40 million to each of the **three main commercial banks** between 2005 et 2007 to develop long-term housing loans for families with income falling within the limits defined by the Financial Sector Charter. By using the « financial comparative advantage » method for the first time, this funding aims to make modest households eligible for mortgage backed funding by offering them guarantees and loans at subsidised rates.

The implementation of these three projects in accordance with the original criteria has however turned out to be more difficult than first contemplated mainly due to the **increase in building costs and the cost of land**, which is evidence of the downgrade in the environment which existed at the time the projects were put in place. The projects are faced with the following difficulties : the banks personal loans business only manages to attract the higher end of the households targeted by the Financial Sector Charter and they struggle to finance affordable housing projects due to the inherent institutional complexities and the less favourable economic environment.

=> The absence of a public policy to stimulate the provision of social and intermediate housing has triggered an inflationary real estate cycle. Combined with increased interest rates, access to mortgage backed credit for families in the lower end of the range fixed by the Financial Sector Charter was restricted and the policy of stimulation of demand rapidly reached its limits. This shows the limits of the banks when it comes to financing people with the lowest incomes. Further, from an urban and environmental point of view, this approach does not give the public authorities the opportunity to manage urban development. The AFD therefore proposes to redirect its strategy by engaging in **greater dialogue with the relevant institutions and forming a closer cooperation with the South African public authorities** to develop innovative approaches for the **design and realisation of affordable housing programs within the framework of a sustainable urban development policy**. The seminar on the different institutional approaches to affordable housing in South Africa, Brasil and France which was organised by the AFD in Johannesburg in November 2008 has paved the way for this dialogue.

Job creation through support of BEE and professional training : re-engineering of the mechanisms for incentivising commercial banks

To facilitate the implementation of the Financial Charter and in support of the BBBEE program, the AFD has been offering South African financial institutions **credit lines and guarantees (ARIZ) aimed at developing « black SMEs »** since 2003. By sharing risk with banks and helping them to put in place specific teams and support services, the AFD has helped to make credit more accessible for these SMEs.

Since the launch of the BBBEE, the value of capital transfers to groups with black interests has increased significantly rising from 40 billion ZAR in 2003 to 75 billion ZAR in 2006. Businessmap estimates that 15% of the capital of companies listed on the Johannesburg Stock Exchange is held by blacks. Over and above these figures, the issue of the **economic impact of BEE is a sensitive subject in the South African context**. Certain negative effects of BEE and BBBEE are criticised such as the exodus of qualified white workers, high turnover of employees and exaggerated pay demands. However these criticisms are levelled mainly at capital sharing and the policy of positive discrimination for the recruitment of historically disadvantaged populations. The issue of support given to small black entrepreneurs is not contested. Nevertheless, there continues to be a high incidence of refusal by banks to grant loans to SMEs in particular if they are black. Moreover, South African micro-finance institutions tend to concentrate on consumer loans.

=> There is therefore still a lack of liquidity for the risky SME market segment. A recent study made by our partner Standard Bank shows that **banks still have a strong aversion to the financing of the development and creation of small enterprises and to the provision of guarantees**, such as

performance bonds. To promote a culture of black entrepreneurship and leverage the financial sector charter more effectively, the AFD should therefore refocus its partnerships with the South African banks on these type of operations.

Professional training, for which there is currently a very high need, is a crucial instrument for job creation. However, as it is restricted by its financial instruments, the AFD has only been involved in one project relating to the professional training sector⁸ : a portfolio guarantee to Edu-Loan, the South African financial institution specialised in the granting of loans for continuing professional education and which has assisted nearly 500 000 students to date.

=> Although projects to support the public field of professional training are not easy to undertake, the AFD's has given itself the task of systematically **including an element of training and capacity building** in its different projects. Whilst striving to the extent possible to develop innovative approaches to **contribute to the financing of this key sector for the future of the South African economy**, the AFD should continue to manage this issue transversely in its projects.

The environment : protection of biodiversity and the fight against global warming

In the field of **biodiversity**, the AFD participates through the **FFEM** (*Fonds Français pour l'Environnement Mondial* or the French Fund for the Global Environment) which was created in 1994 by the French Government to assist in protecting the environment in developing and transitional countries. The FFEM has built up a partnership with the public body that manages South Africa's nature parks which has resulted in two projects to support the management and conservation of natural resources and the development of services for tourists in **Table Mountain Park** in the Western Cape province (1998- 2006, 915 000 euros) and **Addo Elephant** near Port Elizabeth (2008 - 2010, 980 000 euros).

In the energy sector, the AFD financed its first renewable energy project in 2004 with a project which is currently being implemented to **produce electricity from methane from Durban's municipal rubbish dumps**. In addition, a technical assistant has been provided to the Central Energy Fund, which is a public structure which reports to the Ministry of Energy and is responsible for the creation and financing of energy efficient projects. The technical assistant has been given the job of identifying initiatives which could be financed in cooperation with the banking sector (financing of solar water-heaters, cogeneration in industry). The AFD initiated a partnership with Eskom, the national electricity operator, in February 2008 to finance a 100 MW eolian farm in South Africa.

=> Given the current energy crisis in the RSA and the pro-active posture adopted by South Africa in the post-Kyoto negotiations, **the development of energy efficiency and of renewable energies is becoming of greater relevance both economically as well as politically**. However, as the outline of the financial and institutional frameworks to achieve this are still embryonic, the AFD could use its financial and technical expertise to help to define the details. In addition to Eskom, the large municipalities with which the AFD is well acquainted are potentially also important players in this domain. These types of projects could also arise in the housing sector as it offers significant energy savings and is an area in which the AFD is already very involved.

⁸ The AFD also became very involved in a Public Private Partnership (PPP) for the construction and renovation of schools in the province of Free State, for which it largely financed the feasibility studies. This project was intended to provide improved access to and quality of professional secondary teaching by participating in a provincial program to recapitalise schools. The AFD planned to finance the project in an amount of fifty million euros. However, the decision to use PPP meant that the project never materialised due to the additional costs and lengthy delays in implementation that this generated.

Regional economic development : a promising partnership with the DBSA

The AFD supports South African efforts aimed at the economic integration of the continent, in particular with the DBSA and IDC whose mandates extend to SADC. In 2003, the AFD and the DBSA established a 2.8 million euro **Professional Training Programme in Regional Infrastructure Project Management Facility** financed equally by both parties. The aim is to undertake feasibility studies for NEPAD projects which could then be co-financed by the AFD and the DBSA together with other financial partners. The whole of the facility had been committed after three years and the financing renewed by both lenders. The results have been encouraging : several projects are now entering into the financing phase and the legitimacy and effectiveness of the two institutions in the promotion of NEPAD infrastructure projects has been proven, attracting new studies and leveraging of other financial partners.

Conclusion : very strong growth in activity over the last four years

The AFD Group's activity in South Africa demonstrates its commitment to accompanying the delicate economic and social transition that this country has been going through since 1994 but also the problems encountered when financial intervention is other than through sovereign debt. It is also apparent that the driving force of the dynamic South African economy across the region represents an additional challenge for the AFD.

Further to its establishment in 1994, the AFD group rapidly consolidated its activities by seeking to build long lasting partnerships with certain leading financial institutions specialised in development (DBSA, INCA, IDC), thereby allowing the AFD to centre its strategy in South Africa essentially on the financing of basic services at the local level (water, education, health), until such time as it becomes possible to grant sovereign financing.

The AFD extended its activity from this starting point to the financing of the main banks, using this leverage to bring its influence to bear on the public challenges consisting of job creation, the development of SMEs and affordable housing as part of the BBBEE. Sub-sovereign financing was then added to these limited concessionality activities, firstly with the city of Durban and then the city of Johannesburg, together with the implementation of other non-financial tools available within the AFD group, in particular the FFEM and study funds. More recently, the specific problems relating to the conservation of the global environment and the fight against global warming have been integrated into the AFD's strategy for the financing of development in the RSA.

By developing technical expertise and entering into different kinds of partnerships in the affordable housing sector and in support of SMEs and energy, thereby progressively expanding on its traditional core activities, **there has been very strong growth in the AFD's activity in South Africa over the last four years**, increasing from an average of 20 million euros by commitment and an average of one project being approved by year over the period 1994-2003, to a **current capacity to commit 200 million euros**, spread on average over four projects a year.

2.2 New strategic direction

With the launch of a new strategic cycle, the AFD proposes the adoption of a three pronged strategy : i) the maintaining of a critical financial mass to be better able to respond to the economy's need for liquidities whilst diversifying its risk and broadening its base of counterparties, ii) reinforcing its capacity for innovation and its added value in its main sectors to be able to iii) contribute to knowledge creation and political dialogue in those areas which are crucial for the development of the country and the sub-region.

This strategy is intended to make the priorities of French cooperation and the AFD, as enumerated during the visit of the President of the French Republic in February 2008, coincide with the areas of intervention that the future South African government will most probably concentrate its efforts on.

Increase the diversification of our partners...

The AFD's partners and its risks are currently largely concentrated on the financial sector. Therefore, **whilst wishing to consolidate the financial partnerships which it has built up**, the AFD now seeks to **diversify its partners** as well as its risks by offering the widest range possible of financial instruments and making measured use of concessionality. **Support for growth drivers** should be reinforced by in particular contributing to the financing of large [parastatals]. Direct partnerships with large municipalities should also be developed.

By maintaining careful management of its risks, the AFD could **play the role of counter-cyclical investor** and support the drivers of South African growth whose liquidity needs have been increased by the international financial crisis. **Our target is to have annual engagements of 200 million euros of which approximately 20% would be in the form of grants.**

This approach would allow us to meet **the AFD's ambitious funding targets and the presidential initiative for the private sector and growth in Africa.**

... Whilst Strengthening our Capacity for Innovation and our Added Value...

Due to the fast evolving nature of each sector it is necessary in emerging economies to have **in-depth knowledge of the characteristics of each sector**. This in-depth knowledge guarantees the capacity for innovation of the AFD and that the projects and financial instruments offered by the AFD will correspond to South African needs as well as being aligned on public policies, either in substitution for but not in competition with the traditional banking sector or in co-operation with the traditional banking sector. It is indeed **the financial and technical innovation, the provision of specialised expertise and the capitalisation and sharing of French know-how** which has been gained through the variety of different projects it has been involved in and not just from the volume of its financings which give the AFD its added value, legitimacy and high profile in an economy whose financial sector is comparable to that of other emerging countries.

To be able to provide this added value the AFD must **limit the number of sectors that it works in**. Accordingly, to capitalise on the expertise it has acquired after nearly 15 years of operations in this country, the AFD will consolidate its first strategic cycle by accentuating its support for growth in the current context of shortage of liquidity by financing large public production infrastructure projects and developing its activities dedicated to professional training.

In line with the Paris Declaration, the AFD considers itself to be **complementary to the other international aid and financial organisations** present in South Africa. Accordingly the AFD should become more closely involved in the consultation process taking place amongst the different players. This logic together with the need to focus our resources on certain sectors means that the will not be present in certain sectors which although essential for the challenges of development already benefit from financing from other lenders, NGOs and foundations.

... To be better able to contribute to public debate

This operating model and the AFD's financial weight means France is currently one of the main international lenders in this country. This positioning should be used to **open up dialogue on public policies and promote intellectual exchanges as well as exchanges of know-how** focused on our

main areas of intervention. Our intention to play an active role in the drafting of public policies is all the more relevant today as the new government is reviewing the merits of obtaining [public] foreign financing.

Accordingly, the AFD plans to focus its **knowledge creation** on the following subjects :

- **Affordable housing** : further to the seminar held in November 2008 and to meet the needs expressed by the South Africa authorities, the AFD proposes to provide support for the reformulation of affordable housing public policies in South Africa by encouraging closer cooperation with the main players in this field and by taking inspiration from the French model ;
- **Incorporation of environmental challenges at the world wide level into the financing of development** : by leveraging its partnerships with the South African financial institutions, by encouraging the exchange of technical expertise through decentralised cooperation and by financing additional studies, the AFD would be able to contribute to current debate on the integration of policies relating to energy efficiency and renewable energies into the principles of urban economic development planning, in particular at the level of the large South African municipalities;
- **Regional policy** : based on its regional partnership with the DBSA (NEPAD study facility, CEFEB platform), the AFD should now provoke and drive a debate centred on priority projects by approaching locally the large lenders who are open to such an initiative and by taking greater advantage of the network of AFD offices.

2.3 Direct objectives and activities 2009-2011

2.3.1 Reinforce the productive sector

Provide financial support to BBBEE SMEs through banking intermediation

After the experience gained from extending credit lines to banks to finance black SMEs in the framework of BBBEE, the new projects currently being reviewed aim to **encourage the commercial banks to take more risk**, whether horizontally by developing their activity in **riskier areas** or vertically by **financing more smaller businesses**.

To reach micro-entrepreneurs and very small businesses, greater focus should be placed on the microfinance sector which is still underdeveloped in the RSA and more importantly, is dominated by consumer loans, as well as the mesofinance sector, and new projects identified in these areas.

Banking intermediation and ARIZ type guarantees seem particularly suitable for favouring access to credit for SMEs with the aim of fighting against their lack of access to banking facilities.

Develop our activities in the professional training sector

The increased intervention of the AFD in support of professional training, which is the main obstacle for the upliftment of HDP, will be achieved by i) a transversal approach consisting of the inclusion whenever possible of an element of training and capacity building in our different projects, ii) **new projects** dedicated to this sector.

By way of example, the SMEs that benefit from the credit lines referred to above often lack not only financing and guarantee schemes but also training and support. This is why the **AFD will seek to introduce a specific component in its financing structures** to help fill this deficit (financing of the strengthening of the banks teams and external service providers to ensure the provision of legal advice, technical training and administrative and accounting support for SMEs who receive financing).

It is however by using its traditional instruments, in particular loans with limited concessionality and guarantees, that the AFD will be able to make a strong impact. By way of example, our partnership with the financial institution Edu-loan, which is currently being reviewed by our post implementation assessment department, could be strengthened. Besides, an education sector which is midway between schools and university exists in South Africa called the "**Further Education and Training**" sector comprising 50 colleges managed by the Provinces. The Ministry of Education is currently directly involved in the process of restructuring these colleges to turn them into viable entities, with the aim of rapidly increasing their capacity from 400 000 to 1.2 million students. These colleges of which around twenty are financially independent today, could benefit from concessional bank financing in addition to government subsidies.

Finally, in accordance with the Memorandum of Understanding signed by the AFD and the DBSA during the visit of the French President to South Africa in February 2008, a **joint Masters programme in development will be put in place by the CEFEB and the equivalent body of the DBSA**, the Vlulindela Academy, to build skills at the regional level. With the ambition of launching the first intake in 2010, the long term target will be to train 100 African managers a year in financing and management of infrastructure projects, in particular in the water, energy and transport sectors.

Financing large public production infrastructures : energy, transport, telecommunications

In support of South African growth, the AFD will seek to **provide financial support for the investment programmes of the parastatals** (energy, transport, telecommunications), by making available to them non-concessional loans to compensate for the current lack of liquidity that they are faced with.

The AFD will seek to strengthen its partnership with **ESKOM** through two complementary approaches: the granting of a non-concessional loan to contribute to the financing of ESKOM's investment plan, and the support of its renewable energies and energy efficiency programmes through concessional financing and the provision of technical assistance.

Due to its contra-cyclical support and as a provider of long-term resources, the AFD has a role to play and intends to build partnerships with the main parastatals to support them in their ambitious investment programmes.

2.3.2 Improve access to basic services for HDP

Develop basic community services : water, sanitation, primary education...

Access to basic services remains a priority for the AFD in South Africa. Since the end of apartheid, this responsibility is entrusted to local authorities, especially the municipalities. To bridge the gap faster, the AFD strategy consists of the **financing of municipal investments** and the provision of expertise and of technical assistance for the creation and implementation of innovative projects.

In view of the target (disadvantaged populations) and the nature of the beneficiary of the financing (local authorities), the financial instrument of choice for these investments is the **concessional non-sovereign loan**. The choice of the method of intervention, either directly or through an intermediary, will be determined according to a precise strategy to be put in place for approaching South African municipalities :

Partnership strategy with South African local authorities

The AFD has endeavoured to provide financial support for the development of South African local authorities since 1994. The local authorities have reinforced powers in South Africa in areas of intervention which are coherent with the AFD's mandate : basic infrastructures, urban development, transport and affordable housing. As a result and over and above a strictly sectorial approach, the AFD intends to define the main principles of its technical and financial partnership with South African local authorities.

Deployment of multiple tools

Support for South African municipalities will be organised around the following main themes : (i) support for the identification and review of projects with strong social and environmental impacts and financing of feasibility studies for such projects through our Capacity Building and Study Fund (CBSF), (ii) playing the role of catalyser in the provision of technical expertise and capacity building in local government, in particular through decentralised cooperation, the CEFEB, but also through the provision of technical assistance (CBSF) and the organisation of seminars (iii) provision of the necessary funds for investments with strong social and environmental impacts.

An approach to the financing of structured investments according to the type of risk

Investments will be financed (i) directly for projects with a strong impact on the development of the most important municipalities such as Johannesburg, Durban and Cape Town (size of the projects and borrowing capacity, implementation and adequate management), (ii) through banking intermediation (with INCA and the DBSA in particular, in view of their in-depth knowledge of the sector) with the weaker municipalities to help bridge the gap on the provision of basic services ; and (iii) through more complex and innovative structures (PPP, SPV, Funds) involving the private sector, the municipalities and public institutions, dedicated to the financing of municipal infrastructures.

Support increased access to affordable housing through integrated urban development programmes

The review of the interventions undertaken in this sector (cf 2.1) tend to underline the important need today for the creation of a stock of affordable housing for disadvantaged populations, not only for rent or rent with an option to purchase but quite simply to facilitate their acquisition. The bank financings previously granted by the AFD were designed to give the final purchaser access to subsidised and affordable financing.

The AFD will now concentrate on giving financing at concessional rates **through public and non-banking bodies** (NHFC, TUHF, JOSHCO, AFHCO etc.) to permit the building of houses at affordable prices. It will also be our objective to approach public authorities at either the national or provincial level to be able to **influence public policies**. Such a cooperation would provide an opportunity to look for innovative technical approaches, reduce costs and take account of energy efficiencies, as well as allowing us to influence the design of housing programmes by encouraging the implication and participation of the municipalities (concerted development and integrated social and public services) to privilege an integrated approach to affordable housing programmes and improved integration into the urban landscape and labour markets.

2.3.3 Protect Global Public Goods

In the framework of the proactive French international policy in terms of the fight against global warming, the AFD has undertaken to promote the protection of global public goods in South Africa which is responsible for 65% of greenhouse gas emissions on the continent, priority will be given to

the fight against global warming. The FFEM will provide support for the protection of biodiversity in the numerous nature parks in the country which create jobs and generate revenue for the tourist sector.

Promote sustainable urban development of the large municipalities

- **environmental aspects of our housing actions**

To promote sustainable development, it is necessary to ensure that the AFD's counterparties/partners systematically comply with internationally recognised environmental and social standards. For example, there will be a requirement in the affordable housing projects that we finance for the **building sites** to comply with environmental quality and social criteria and specific procedures applicable to building sites relating in particular to noise pollution, management of waste water and solid waste, security measures for the workers and site pollution control. In addition, to qualify for AFD financing, the **buildings themselves** must comply with energy efficiency standards, be thermally insulated and sound proofed and have waste water and solid waste systems.

- **waste management**

Waste management has become a priority for South African municipalities. Old waste dumps are full up, towns are spreading and available land for new waste dumps is rare and far away increasing the cost of transporting waste significantly. In addition, waste management is closely linked to the issue of pollution and the environment. This is why municipalities are currently looking for strategies to **reduce the amount of waste** thrown into waste dumps (sorting, recycling,...) but also to optimise **waste management** (recovery of methane) and **transporting of waste**.

On this theme, it is very important to promote and develop decentralised cooperation so that technical expertise can be exchanged with the support of the French competitiveness clusters. The AFD can then become involved through the provision of technical support and/or subsidies (CBSF) in the financing of feasibility studies and the financing of investments through **non-sovereign concessional loans** in this key sector for the municipalities.

- **energy efficiency and renewable energies**

In pursuit of the objective of supporting the Government's strategy of developing renewable energies and the promotion of energy efficiency, the AFD made a technical assistant available to work in the Central Energy Fund in 2008 (cf 2.1), financed by CBSF. This technical assistant who is being made available for a two year period is intended to speed up the implementation of an energy control policy combining energy efficiency and renewable energies, and determine the investment programmes in this area.

Given the urgency arising from the current energy crisis in South Africa, the projects which have been identified by the technical assistant should result in financing opportunities. The AFD may also finance either **municipal projects and national energy efficiency programmes** (public buildings, housing) and renewable energies (solar water heaters), or **cogeneration projects** in the industrial sector through banking intermediation.

Furthermore, the AFD may support « Independent Power Producer » projects, i.e. projects for the generation of electricity by independent companies (which would create additional capacity in parallel to ESKOM) in the renewable energies field (mini hydro, eolian windmill farms, ...), if such projects comply with regulatory conditions.

These projects could be **financed at market conditions or with concessional financings**, depending on the identity of the final beneficiary. Moreover, for public type projects, the AFD could propose financing any feasibility studies which may be necessary through CBSF. The South African office will try to provoke discussions around this theme with the South African players backed up by French expertise in the framework of its **knowledge creation** programme.

- **clean urban transport**

The main objective of the AFD group in the area of public urban transport in South Africa, well beyond the considerations of the world football cup in 2010, is to **support the creation of an efficient and sustainable integrated transport network in the cities** which will meet the needs of all the inhabitants and lead to a major reduction in carbon emissions from transport.

The AFD has a CBSF for the financing of any studies which may be required. Such studies may be cofinanced by or undertaken in coordination with the FFEM. The AFD will then be able to propose concessional financing to municipalities and provinces, either directly or through financial institutions, to be used for the financing of transport infrastructures.

Provide support for the management of South African nature parks

South Africa is particularly attentive to the management of its nature parks and the AFD wishes to provide its support therefor by sponsoring innovative solutions through the FFEM (such as public private partnerships) which combine social and environmental objectives. The AFD also seeks to promote the provision of technical expertise and encourage exchanges between France and South Africa in specific technical areas (conservation of protected marine areas, marketing and communication aimed at the public, the promotion of its nature assets...).

Finally, it is clearly the role of the South African office of the AFD to support the development and management of cross border parks in view of the regional competence of the office beyond the borders of South Africa. It is therefore possible that projects to assist in the management of **cross border parks** could be considered.

2.3.4 Promote regional economic development

As the majority of the areas of intervention of the AFD have a regional dimension and as South Africa plays an essential role in the zone, the regional competence of the Johannesburg office is largely justified ; moreover this competency has recently been extended to **Zambia** and **Botswana**. The AFD has been present in **Namibia** since 1994 and also monitors the political and economic evolution in Zimbabwe. The main instrument favoured by the AFD in these neighbouring countries is the **non-sovereign loan**, with little or no concessionality. The granting of sovereign loans with limited concessionality could also be contemplated in Namibia and Botswana. In view of the limited human resources available to the AFD to cover this zone, any intervention by the AFD will whenever possible be the product of **existing partnerships** with those South African economic players who are present in these countries (DBSA, South African banks) and with other lenders (in particular the KfW and the EIB). Identification missions **targeted at parastatals** could also be conducted.

Contribution to the financing of regional infrastructures : energy, transport, telecommunications

In support of growth in the sub-region and by taking advantage of the existing study fund (cf 2.1), the AFD will seek to support financially large regional public infrastructure projects by proposing **non-concessional loans**. Subsidised loans would only be considered in the case where there are proven positive spillovers for the environment or regional integration, or for projects with a strong social impact. Contributions could be sought from European trust funds.

With regards more specifically to the energy sector, the AFD is particularly interested by infrastructure projects which take account of environmental challenges. By way of example, the AFD together with the EIB and the KfW, approved financing to Nampower for the construction of an electrical interconnection between Namibia and Zambia which will result in electricity produced mainly from fossil fuels being substituted by electricity produced hydroelectrically and therefore with low CO2 emissions.

Take part in the development of the regional financial sector, in support of the South African players

The South African financial sector is built around a few groups who combine banking activities with stock exchange operations and insurance. Five main players represent 85% of banking assets in South Africa and over 10% of banking assets in SADC: Standard Bank, Absa, Nedbank Group, FirstRand Group and to a lesser degree Investec. These large banking groups all have in common that the insurance companies Old Mutual Life Insurance and Sanlam Life Insurance count amongst their main shareholders. These groups all have a strategy to develop at both the African and global level.

In view of their size and their stock of know how which can be valuable for other African countries, the AFD will seek i) to provide support to certain of these large South African financial groups **in their strategy of expansion in other African countries** ; ii) and to use their network of subsidiaries **to undertake regional projects through banking intermediation** (financing of affordable housing, SMEs, energy efficiency projects) and set up guarantee schemes.

These financings would in principle be on a commercial basis save in respect of any project identified containing a particular social element which may, on a case by case basis, justify the granting of limited subsidies. Furthermore, the **ARIZ tool** would be largely used.

