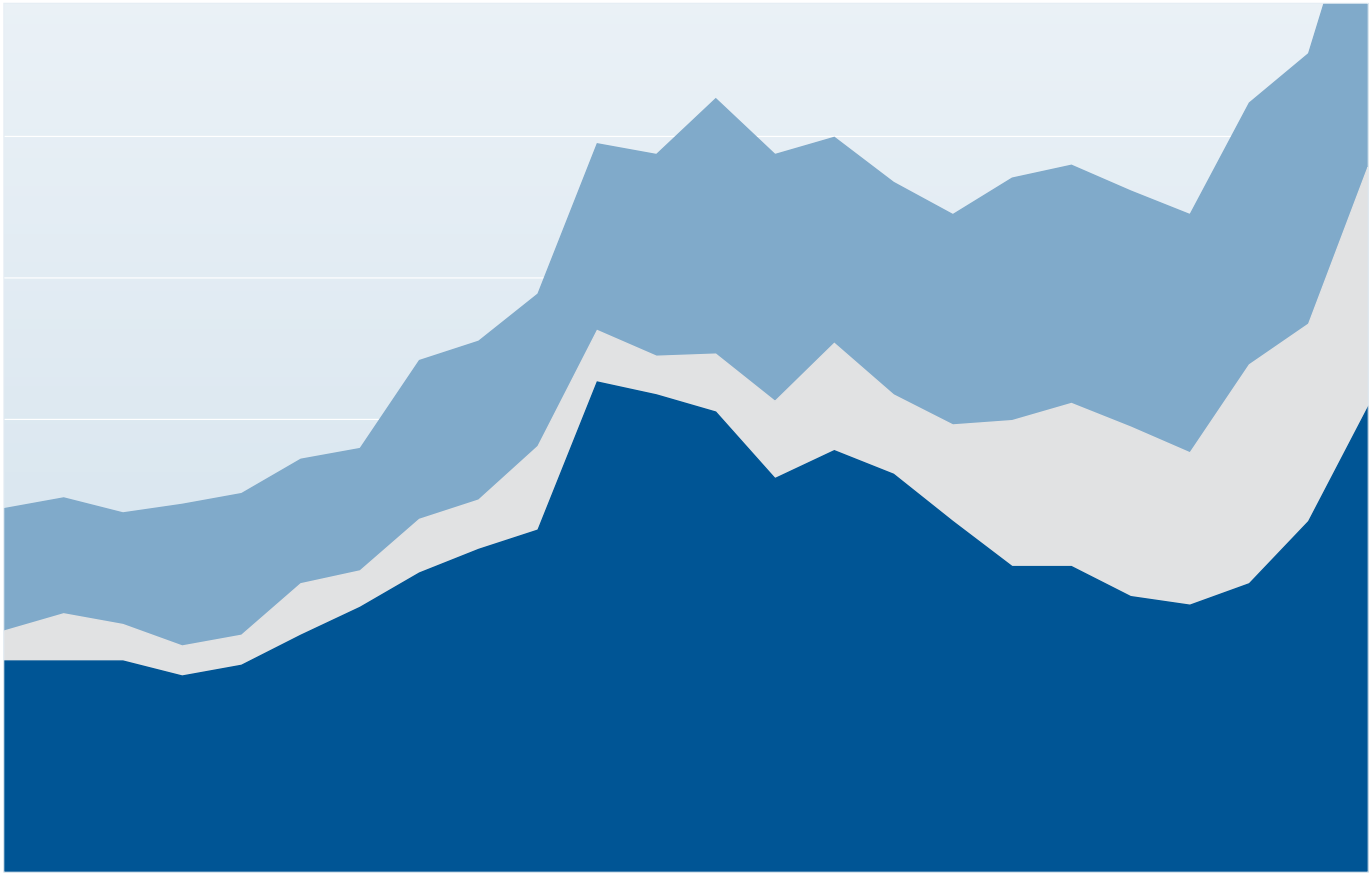
Economic Commission for Africa

Economic Report on Africa 2006

Capital Flows and Development Financing in Africa



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Acronyms

AATIC	Asia-Africa Trade and Investment Conference
ACGD	African Centre for Gender and Development
AfDB	African Development Bank
AGOA	African Growth and Opportunity Act
AIDS	Acquired Immunodeficiency Syndrome
APRM	African Peer Review Mechanism
AU	African Union
BoP	Balance of Payments
CMA	Common Monetary Area
COMESA	Common Market for Eastern and Southern Africa
COSATU	Congress of South African Trade Unions
CSO	Civil Society Organization
DAC	Development Assistance Community
DRC	Democratic Republic of Congo
DFID	Department for International Development/UK
ECOWAS	Economic Community of West African States
EIC	Ethiopian Investment Commission
EIU	Economist Intelligence Unit
EPZ	Export Processing Zone
EU	European Union
FAO	United Nations Food and Agriculture Organization
FONDAD	Forum on Debt and Development
GCF	Gross Capital Formation
GDI	Gross Domestic investment
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GIPC	Ghana Investment Commission
GNI	Gross National Income
HDI	Human Development Index
HIV	Human Immunodeficiency Virus
HDI	Human Development Index
HIPC	Heavily Indebted Poor Country

ICT	Information and Communication Technology
IDA	International Development Association/WB
ILO	International Labour Organization/UN
IMF	International Monetary Fund
LDC	Least Developed Country
MENA	Middle East and North Africa
MNC	Multinational Corporation
NEPAD	New Partnership for Africa's Development
NER	Net Enrolment Rate
M&A	Mergers and Acquisitions
MDG	Millennium Development Goal
MSE	Medium and Small Enterprise
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
NEPAD	New Partnership for Africa's Development
NGO	Non-governmental Organization
NICI	National Information and Communication Infrastructure
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
REC	Regional Economic Community
R&D	Research and Development
REER	Real Effective Exchange Rate
SAP	Structural Adjustment Programme
SME	Small and medium enterprise
SRO-CA	Subregional Office for Central Africa/ECA
SRO-WA	Subregional Office for West Africa/ECA
SRO-NA	Subregional Office for North Africa/ECA
SRO-SA	Subregional Office for Southern Africa/ECA
SSA	Sub-Saharan Africa
UN	United Nations
UNDP	United Nations Development Programme
UNEP	United Nations Environmental Programme
UNHCR	United Nations High Commission for Refugees
UNICEF	United Nations Children's Fund
UNCTAD	United Nations Trade and Development Conference
UNU	United Nations University
WAEMU	West African Economic and Monetary Union
WFP	United Nations World Food Programme

Foreword

Continuing the economic recovery since the mid-1990s, African countries generally recorded strong growth in 2005, a major turnaround after decades of economic stagnation. However, growth remains uneven across countries, and in many countries, fast growth has not been accompanied by substantial gains in employment or poverty reduction. The African continent thus continues to face challenges of achieving and sustaining higher growth rates as well as translating growth into employment and poverty reduction.

Constraining the ability of African countries to accelerate and sustain growth are various imbalances, between exports and imports, between resource inflows and debt payments and between domestic savings and domestic investment. African countries thus need to mobilize more domestic and external financial resources, including official and private capital flows, to fill the financing gaps in order to accelerate growth and sustain higher levels of growth.

This year's *Economic Report on Africa* places capital flows at the centre of the debate on development financing and examines how external capital can help countries accelerate growth and reduce poverty. The Report's objective is to shed light on how more and better-managed capital flows could help African countries achieve their development goals.

The Report notes that African economies are still on the sidelines of financial globalization. Capital flows have not responded significantly to macroeconomic reforms since the mid-1980s, and the volume of capital inflows – official and private – still falls short of Africa's needs to fill its resource gaps. Moreover, capital flows to Africa are highly volatile and unpredictable, increasing macroeconomic uncertainty and undermining government's ability to design and sustain long-term development plans.

Foreign capital inflows are concentrated in extractive industries, explaining in part their limited impact on employment and economic transformation. Efforts to attract additional external capital to Africa must be accompanied by strategies to encourage more sectoral diversification of foreign investment, especially targeting activities with high potential for employment generation.

Even as African countries seek ways to increase the inflows of official and private capital, they need to be aware of the potential negative effects of a surge in these inflows on their economies. The Report points out that with appropriate capital

management strategies, African economies could absorb higher external capital with minimal adverse effects. In other words, there is ample room for scaling up external resources to support Africa's efforts to accelerate growth and reduce poverty.

It is my belief that the analysis and recommendations in this year's Report will be a valuable input to policymakers in Africa and the international development community, in their efforts to mobilize the increased financial resources needed to achieve the internationally and nationally mandated development goals.

Abdoulie Janneh
Executive Secretary

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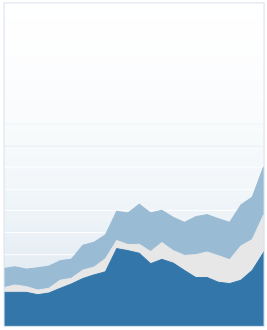
Overview

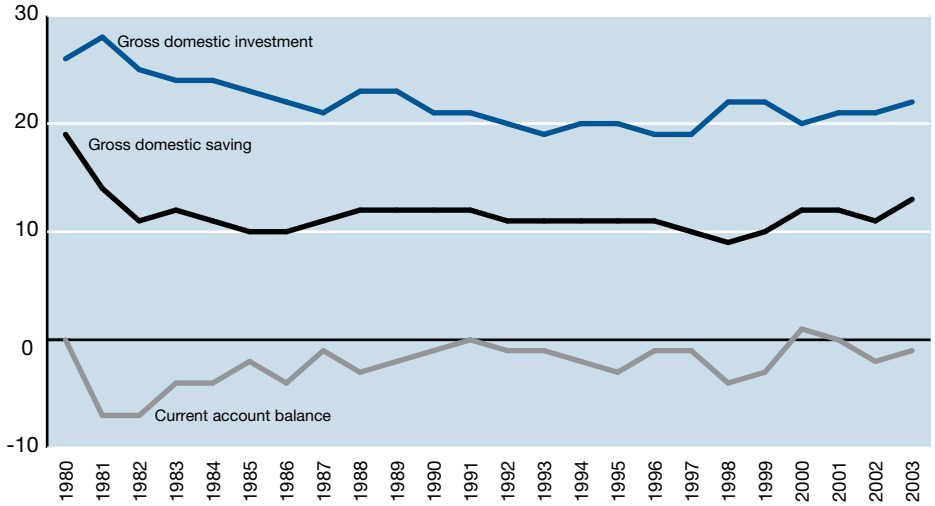


African countries continue to face a perennial shortage of resources to finance public and private investment, which constrains their ability to accelerate growth. The chronic resource gap arises from imbalances between exports and imports, between resource inflows and debt payments, and between domestic savings and domestic investment (figure 1). Resource shortages limit the ability of governments on the continent to undertake public expenditure in infrastructure and social services needed to boost domestic demand, encourage private sector activity, and sustain high levels of economic growth.

> *The perennial shortage of investment constrains Africa's ability to accelerate growth*

Figure 1

Resource gaps in African countries, 1980-2003 (% of GDP)



***Source**: World Bank 2005a.*

***Note**: The ratios are GDP-weighted averages for 36 African countries with data for all indicators and all years.*

To fill the financing gaps and accelerate growth, African countries need to mobilize more domestic and external financial resources. While official development assistance (ODA) has increased recently in nominal terms, the resources received excluding emergency aid and debt relief increased only marginally from the past decade (UN 2006). And real aid inflows are still below the 1990 levels. Aid to Sub-Saharan Africa has declined both as a percentage of gross national income (GNI) and as a percentage

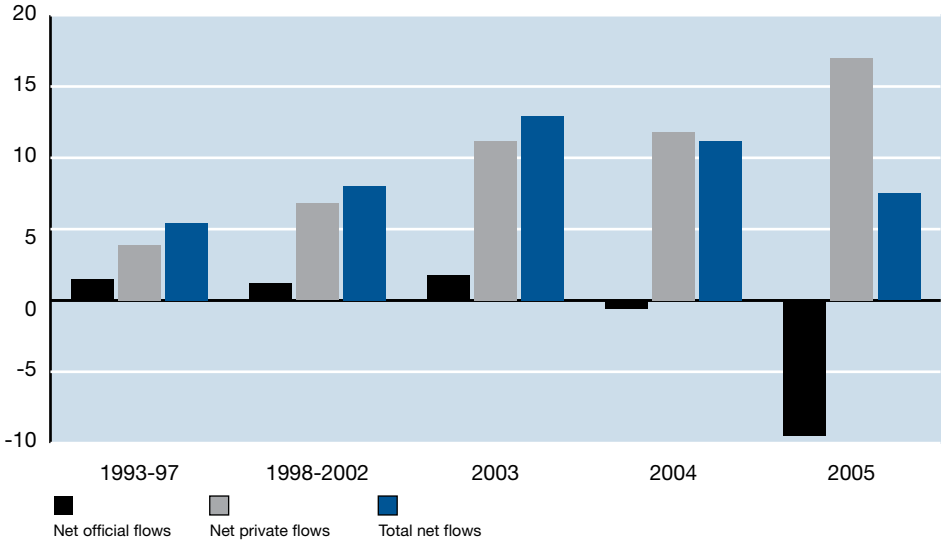
of gross capital formation (GCF) since the early 1990s. From 6.5% in 1990-94 the aid/GNI ratio declined to 5.3% in 2000-03. The aid/GCF ratio fell from 40.7% to 27% during the same period (McKinley 2005).

While African countries still depend heavily on official aid, it is encouraging to note that they are attracting more private capital. Indeed, net flows of private capital have risen while net official flows have declined and turned negative over the past years (figure 2). Net private flows rose from an average of $6.8 billion in 1998-2002 to $17 billion in 2005, while net official flows declined from a net inflow of $1.2 billion to a net outflow of $9.5 billion.

"Still dependent on foreign aid, Africa is attracting more private capital"

Note, however, that private capital flows are unequally distributed across the continent, with oil-rich countries taking the lion's share. During 2002-04 Angola, Chad, Equatorial Guinea, and Nigeria accounted for a combined 39% of total foreign direct investment (FDI) to the continent. The oil sector alone accounted for more than 90% of FDI in Angola (UNCTAD 2005a).

Figure 2
Net financial flows to Africa, 1993-2005 (billion USD)



***Source**: UN 2006.*

Africa's share in global private flows remains very small, and private capital flows are still insufficient to compensate for the shortage in official financing. With private flows heavily concentrated in extractive industries, which are naturally capital intensive, the effect on employment creation remains limited. The concentration of foreign investments in extractive industries also perpetuates African countries' dependence

on primary commodities and exposes them to the adverse effects of fluctuations in international commodity prices.

The year 2005 was marked by positive developments in the international community's commitment to support national and regional development efforts in Africa. Noteworthy developments include the global review of the Millennium Development Goals (MDGs) by the United Nations General Assembly, the report of the Commission for Africa led by Prime Minister Tony Blair, of the United Kingdom, and the G8 meeting on development financing for Africa. These efforts need to be supported by strategies for enhancing efficiency of aid utilisation and better targeting of poverty reduction in national development agendas.

This year's *Economic Report on Africa* (ERA 2006) places capital flows at the center of the debate on development financing and examines how these flows can help African countries to accelerate growth and reduce poverty. The objective is to shed light on whether and to what extent more and better managed capital flows will help African countries achieve their development goals. The report first presents evidence on the recent and medium-term macroeconomic performance of African economies. It then evaluates the trends and volatility of capital flows and their effects on economic growth. Next, it explores the linkages between capital flows and domestic factor markets – labor markets and investment – with a view to drawing lessons on strategies to harness the effects of foreign capital on host economies. The report also explores the potential of capital flows in promoting diversification of production and exports and in facilitating the overall transformation of African economies. It further examines the role of domestic conditions, including the macroeconomic policy framework and the institutional environment, in both attracting and absorbing capital flows. After discussing strategies for minimizing financial fragility through appropriate capital management techniques, ERA 2006 closes with a summary of the main findings and key policy recommendations.

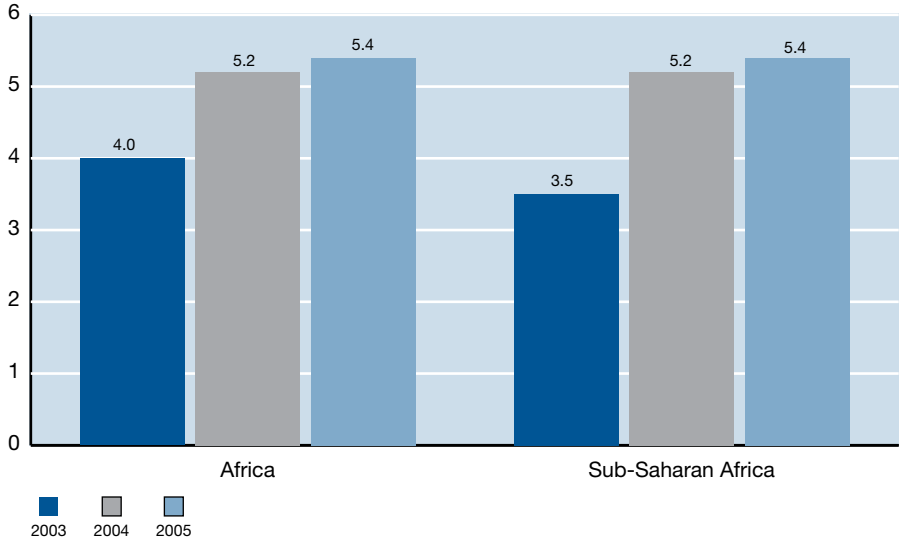
Macroeconomic performance

In 2005 African economies recorded another high GDP growth rate of 5.4%, following the record 5.2% in 2004, the highest in almost a decade (figure 3).[1] Africa's growth in 2005 was the same as that of transition economies, higher than Latin America's (4.3%), but lower than Asia's (6.5%, excluding Japan). On a disaggregated level, as many as 25 African countries recorded faster growth in 2005 relative to 2004.

1 The data used in this document are based on statistics revised in September 2006.

In 2005 the international community mobilized to support Africa's development

Figure 3
Real GDP growth rate in Africa, 2003-2005 (%)



***Source**: Economist Intelligence Unit (EIU), September 2006.*

The strong growth performance in 2005, as in recent years, represents a major turnaround from decades of economic stagnation. What explains the strong performance of the past two years? A favourable global economic environment was characterized by high demand for (and prices of) Africa's major export commodities. Performance was good in such sectors as agriculture and services. Macroeconomic management continued to improve, resulting in lower inflation and better fiscal and current account balances. African countries also received substantial inflows of external resources—including aid, debt relief and foreign direct investment—which should contribute to higher growth in coming years.

As in past years, growth in 2005 was uneven across countries and sub-regions. Benefiting from high oil prices, oil exporters continued to dominate, growing faster (6.2%) than non-oil economies (4.5%). Despite the high growth rates generated by the oil boom, two big questions remain. How can oil revenues be translated into sustainable growth? And how can the oil boom be converted into higher living standards for the majority of the population?

Africa is expected to continue with the strong growth posted over the past two years–5.7% in 2006, with North Africa leading all sub-regions with 6.6%. As many as 31 countries are anticipated to post higher growth rates in 2006 than in 2005.

In the medium term African countries are expected to continue to benefit from continuing improvements in macroeconomic balances owing to consistent economic reforms and from continuing strong world demand for African export commodities. Savings from debt relief will also boost the growth of eligible countries.

But African countries will continue to face challenges that are likely to hamper growth: higher world interest rates, weather shocks, inadequate infrastructure and energy, and terms of trade shocks accentuated by a lack of diversification. And while the expected high oil prices will benefit oil exporters, they will compromise growth prospects for oil-importing countries through higher production costs and inflation.

Despite recent robust growth, important development challenges remain

One disappointing feature of the recent strong GDP growth rates is that they have not been accompanied by meaningful gains in job creation, raising serious concerns about the continent's ability to reduce poverty (UNECA 2006). The main causes:

> *Growth rates have been insufficient to generate employment*

- Growth rates have not been high enough in many countries to generate sufficient demand for labour. Indeed since 1999 only five African countries (9% of the total) have achieved average growth of real GDP of 7%, the rate deemed as required to reach the goal of halving poverty by 2015 (table 1).
- The high volatility of GDP growth reduces incentives for job creation in the private sector due to the uncertainty of future profitability.
- Economic activity has shifted away from agriculture into capital-intensive sectors, such as mining and oil production.
- In most African countries, employment creation is not integrated into macroeconomic policy frameworks as an explicit goal of macroeconomic policy. It tends to be given less importance than other narrower policy goals, such as controlling inflation and managing budget deficits (Pollin and others 2006).

Table 1

Summary of growth performance over 1999-2005

GDP growth rate	Number of countries	Share of total (%)
Less than 3%	15	28.3
Between 3% and 5%	25	47.2
Between 5% and 7%	8	15.1
7% or more	5	9.4
Total	53	100.0

***Source**: Compiled from Economist Intelligence Unit, September 2006.*

Also constraining poverty reduction is the high inequality in many African countries. Inequality manifests itself in various forms: in incomes, in assets, and in access to education, health services, and labour markets. In addition to vertical inequality (across income groups), country evidence continues to show substantial horizontal inequality (across social groups and regions).[2] Empirical evidence suggests that high inequality sub-

2 For evidence on regional inequality in Uganda, see Ndikumana and Nanyonjo (2006) and Deninger and Mpuga (2005). For an illustration of the political economy dimension of regional inequality in Burundi, see Ngaruko and Nkurunziza (2000).

stantially reduces the rate of transforming growth into poverty reduction (Fosu 2006). Therefore, in addition to strengthening strategies for accelerating growth, achieving broad-based development must remain a priority of national economic policy.

Post-conflict countries face myriad policy priorities

Post-conflict countries face particular challenges arising from the effects of war and the immense financial needs associated with reconstruction, forcing policymakers to confront myriad policy priorities. Even so, many post-conflict countries have recorded high growth rates in recent years, due primarily to the restoration of peace but also to government efforts to invest in reconstruction, often with generous support from the donor community.

"Conflict-driven insecurity threatens economic activity"

Countries still in conflict face even bigger challenges in development, employment creation, and poverty reduction. Insecurity in these countries also threatens economic activity and political stability in neighbouring countries and the region. National, regional, and international efforts must be initiated and sustained to achieve peaceful settlement of conflicts and establish institutional mechanisms of democratic governance as a way of preventing future conflicts (Fosu and Collier 2005).

Capital flows and development financing

The challenge of chronic resource gaps

African countries face large resource gaps characterized by large domestic saving and investment discrepancies and chronic current account deficits (see figure 1). Low domestic savings are a result of low private income, high and chronic budget deficits, and the inefficiency of domestic financial systems in mobilizing resources. The narrow export base combined with the deterioration of the terms of trade has made it difficult for exports to keep pace with imports, resulting in current account deficits.

The shortage of resources constrains investment and growth on the continent. In 2000 UNCTAD estimated that the investment rate in Sub-Saharan Africa had to increase to 22-25% from 20% in the 1990s to reach a sustainable growth rate of 6% (UNCTAD 2000). Very few countries have achieved those investment rates. Of 46 countries with adequate data, only nine achieved investment rates of at least 25% of GDP during 2000-03 (World Bank 2005a).[3]

3 The nine countries with investments rates of at least 25% of GDP in 2000-03 are Tunisia (25%), Gabon (27%), Seychelles (29%), Mozambique (32%), Angola (34%), São Tomé and Príncipe (36%), Mauritania (36%), Lesotho (38%), and Chad (46%).

The resource gaps need to be filled by capital flows from abroad, including official development assistance (ODA), debt and private capital flows, such as foreign direct investment (FDI), portfolio investment, and remittances, with ODA remaining the dominant source of external capital in most African countries (figure 4). Aggregate figures obscure significant cross-country variations within Africa. The top five largest recipients of aid over the 1995-2003 were Egypt with $1.6 billion a year, Mozambique $1.1 billion, Ethiopia $911 million, the Democratic Republic of Congo $864 million, and Uganda $752 million (World Bank 2005a). These five countries as a group received an average of 32% of the annual aid inflows to the continent over this period. The top 10 recipients received more than 50% of the continent's total aid.

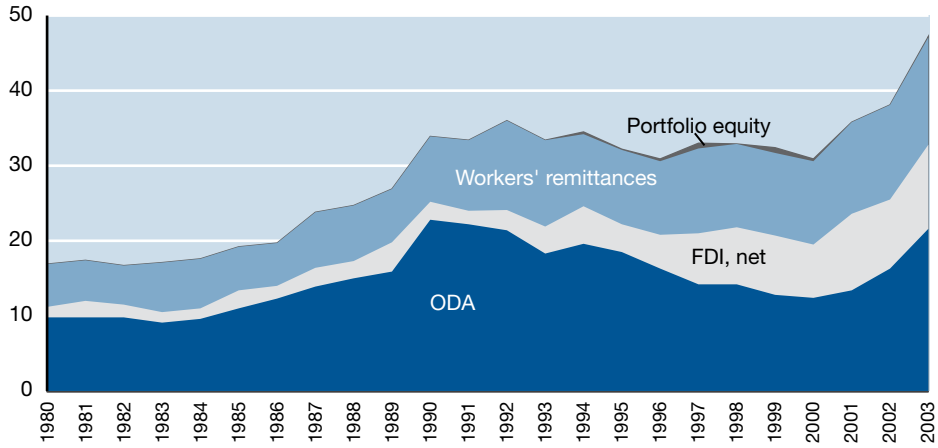
Underdeveloped equity markets limit portfolio flows to Africa

Although ODA is the largest inflow for most African countries, FDI has been more important since 1980 for several countries, including Angola, Equatorial Guinea, Nigeria, Seychelles, and South Africa. For North African countries, as well as Lesotho and Swaziland, worker remittances have become the most important source of external capital.

Portfolio flows to Africa are very low because of underdeveloped equity markets. Only South Africa receives a meaningful volume because of its developed stock market. Portfolio flows to South Africa increased especially after the democratic transition of 1994, peaking at $9 billion in 1999 (World Bank 2005b).

Figure 4

Resource inflows to Africa, 1980-2003 (current USD billion)[4]



***Source**: World Bank 2005b.*

***Note**: The figure includes 46 African countries with adequate data. Angola, Cape Verde, Eritrea, Libya, Mozambique, Namibia, and South Africa are excluded due to lack of data.*

4 Total capital flows to the continent are higher than those reported in figure 4. For example, total ODA to the continent stood at $26 billion in 2003, while ODA flows to the 46 countries included in figure 4 amounted to $21 billion in that year.

10 countries received more than 50% of the continent's total aid from 1995 to 2003

There are signs of increasing diversification of the source and destination of FDI

While foreign direct investment to Africa has risen over the recent years, most investments are still concentrated in the primary sector, especially oil and minerals. Even so, there are signs of increasing diversification in the sectoral allocation of FDI, especially towards manufacturing, agro-industries, textiles, and services. For example, 46% of Chinese investments on the continent for 1979-2000 went into manufacturing (World Bank 2004). And FDI to non-oil producing countries has increased, especially since the mid-1990s (Ndikumana 2003a). For example, between 1994 and 2003, FDI to Mozambique increased from $35 million to $336 million and that to Tanzania from $50 million to $243 million (World Bank 2005b).

Traditionally foreign investors to Africa came from Europe and to lesser extent from North America. Lately, Asian investors from China, India, Malaysia, and South Korea have been increasingly engaged in African countries. Intra-Africa FDI is also increasing, led by South African company investments, particularly in Southern Africa. All this is desirable from a development perspective since it provides opportunities to diversify the sources of FDI. Moreover, investors from the South are more familiar with a developing country's environment.

Remittances constitute an important potential source of external capital

Remittances have been recognized only recently as a potential source of financing for development. The amount of reported remittances to Africa has increased from $5.9 billion in 1980 to $14.9 billion in 2003, with more than two-thirds going to North Africa (IMF 2005a). In some countries, remittances are large relative to GDP or other financial flows. For example, remittances exceeded 5% of gross national income in Egypt, Gambia, Lesotho, Morocco, and Swaziland over 1980-2003 (World Bank 2005b). In Cape Verde worker remittances represented almost eight times the volume of inward FDI over the same period. For Africa as a whole, remittances amounted to 2.5% of gross national income in 2003, but unlike other regions, its ratio has not increased significantly over the past 25 years (World Bank 2005b). Actual remittances are much higher than the official figures suggest, though, given that an important part of the remittances is transferred informally and not recorded.

Worker remittances are a particularly attractive form of foreign capital because they are more stable than other forms. Targeted to reach the final recipients, they are immune from the risks of diversion that may occur with official development aid (Adams and Page 2003; Lucas 2005). They are also a net financial gain to the recipient country. And they help mitigate the effects of economic shocks and shortfalls in household income, allowing households to smooth their consumption. Remittances may help households undertake greater risk and move out of subsistence. African countries thus need to design strategies for attracting and directing remittances as part of their

broader national agenda for mobilizing development finance and increasing domestic investment.

Capital flight constitutes a drain on national resources

The analysis of capital flows to and from Africa reveals a curious paradox. African countries have accumulated large volumes of debt, presumably to fill their resource gap and finance their development needs. But they continue to experience massive capital flight, some financed by borrowed funds. Indeed, empirical evidence suggests quite ironically that Sub-Saharan Africa is a "net creditor" to the rest of the world—in the sense that the private assets held abroad by Africans exceed the continent's liabilities to the rest of the world (Boyce and Ndikumana 2001; Ndikumana and Boyce 2003). This capital flight deprives Africa of a sizable portion of the resources it needs for development financing. It also undermines domestic investment and thus reduces long-term growth. Debates on development financing and financial stability must pay attention to domestic and international strategies for curbing capital flight and repatriating stolen funds as well as enticing the repatriation of legitimate private capital held abroad.

> *Despite large volumes of debt, African economies experience massive capital flight*

The observed trends of capital flows to Africa raise concerns about Africa's ability to meet its long-term development goals. The volume of capital inflows – official and private – still falls short of Africa's needs to fill its resource gaps. And the volatility and unpredictability of external resources increases macroeconomic uncertainty and undermines government's ability to design and sustain long-term development plans. Indeed, by introducing instability into private investment or imports, such volatility may adversely affect growth (Fosu 2001a).

The foregoing discussion suggests that African countries need strategies to close the resource gaps, especially by pursuing efforts in four areas.

- First, they need to design and implement strategies to increase the flow of private capital, especially targeting long-term stable flows, while encouraging sectoral diversification in the allocation of foreign investment.
- Second, they need to forge multi-actor and multi-dimensional partnerships with both developed countries and advanced countries in the South to increase the volume of non-debt-generating external resources. An increase in external funding in the form of grants is essential to African efforts to achieve higher growth rates while avoiding new rounds of debt crisis.
- Third, they need to design and implement strategies to retain capital at home and prevent capital flight as a prominent part of the national agenda for resource mobilization.
- Fourth, they need to raise domestic revenue collection. This will involve measures for reducing corruption in tax administration, increasing autonomy of the tax authority, establishing clear and measurable performance targets in

revenue mobilization, improving technical capacity of the tax authority, and broadening the tax base.

Capital flows can influence domestic factor markets and conversely

> *Market rigidities constitute a major deterrent to foreign investment*

The relationship between capital flows and domestic factor markets can run both ways. While domestic factor markets influence capital inflows, the volume and nature of capital inflows also affect factor markets.

Labor market conditions are an important determinant of capital inflows

Because foreign direct investment in Africa has largely been concentrated in the capital-intensive natural resource sectors, wages and other characteristics of the labour market have a limited impact on foreign investment (Asiedu 2004). However, labor market conditions will play an increasing role in the future given the observed trend towards diversification of the destination of foreign capital. Indeed, investment in manufacturing and service sectors is sensitive to labor market conditions.

Market rigidities constitute a major deterrent to foreign investment. African countries appear to have a higher degree of labour market regulation than other regions. The average employment rigidity index in the 38 African countries with adequate data is 53.2 on a scale from 0 to 100, the highest of all regions (World Bank 2006). Compare that with the average index of 26.2 for East Asia and the Pacific and 40.3 for Latin America and the Caribbean. For the Sub-Saharan region the index ranges from 10 in Zambia, the African country with the most flexible labour market, to 90 in Niger and the Democratic Republic of Congo, the countries with the most rigid labour regulations.

Endowments in human capital are important for attracting foreign capital, especially foreign direct investment (Noorbakhsh and others 2001). Foreign investors seek markets with highly qualified workers to maximize the productivity of investment. In many African countries the lack of skilled labour impedes foreign capital, especially in manufacturing and service sectors (Asiedu 2002, 2005). The quality of human capital also influences the productivity and overall growth impact of FDI (Borensztein and others 1998), and low endowments of human capital in Sub-Saharan Africa may explain the limited gains from FDI.

FDI can crowd domestic investment in—or out

One issue that has received some attention in the literature is whether foreign investments increase or decrease domestic investment activity (UNCTAD 1999). Foreign direct investment has higher potential for stimulating domestic investment than other forms of private capital inflows (Mody and Murshid 2005; Bosworth and Collins

1999). The effects of FDI on domestic investment may occur through downstream or upstream linkages.

In many African countries the bulk of FDI flows into the natural resource sector, though there are signs of gradual shift towards services and manufacturing sectors (UNCTAD 2004). Given that the natural resource sector has few linkages with the rest of the economy, the concentration of FDI in this sector may explain the limited effect of FDI on domestic investment in Africa.

Foreign investment can crowd out domestic investment in various ways. One possible mechanism is the preferential treatment often provided to foreign investors in tax breaks, cash grants, duty exemptions, and subsidies, which are not available for local investors. FDI may also crowd out domestic investment indirectly through adverse effects on financial markets and exchange rate appreciation. If multinational companies borrow in domestic financial markets, this can raise interest rates and depress investment. Moreover, large inflows of FDI may lead the exchange rate to appreciate and reduce the competitiveness of export-oriented domestic investors (UNCTAD 1999; Agosin and Mayer 2000). However, FDI in non-extractive sectors in Africa tends to crowd domestic investment in rather than out (Agosin and Mayer 2000).

> *Governments should encourage investment in labour intensive sectors*

But FDI also follows domestic investment

The relationship between FDI and domestic investment can run both ways. High domestic investment signals high profitability and a conducive domestic climate, which stimulates foreign investment (Mody and Murshid 2005). Moreover, foreign companies may seek joint ventures with domestic investors, which is often the initial form of foreign investment encouraged by governments in developing countries. The implication is that policymakers should aim at improving incentives for investment generally, to promote both domestic and foreign investment. Because FDI has good potential for technological advancement, it may be desirable to provide special measures to attract it. But the complementarity with domestic investment should be the basis for tax and other incentives (Fosu 2001b).

The foregoing discussion suggests several policy recommendations:

- Through the use of targeted policies and incentives, governments should encourage investments in more labour-intensive sectors, such as food processing, manufacturing, and services (Pollin and others 2006).
- Labour market regulations should be streamlined to encourage investment by both domestic and foreign firms, while protecting workers' rights.
- African governments should invest more in education and skill development and adopt measures to retain human capital, in order to attract investments in higher value-added activities.

- They should also ensure that favourable treatment of foreign investment does not provide unfair advantage to foreign investors over domestic investors.

Capital flows have had a limited impact on economic transformation in Africa

Economic reform has helped many African countries improve growth records

To achieve sustainable growth, African countries need to transform their economies. They also need to diversify their economic base and limit their dependence on primary commodities to reduce their vulnerability to shocks. So far, the pace of structural transformation in Africa has been very slow. Although the share of agriculture in GDP has declined over the last four decades, the decline was mainly the result of increases in the shares of sectors other than industry – mainly services – and reflects the lack of effective policies and incentives to direct investment towards domestic industrial activities. In many African countries oil and mineral resources account for a large part of the increase in industry's share in GDP. Having revenues from natural resources contribute to economic transformation depends on using those revenues to finance investment in other sectors, specifically manufacturing and human and physical infrastructure.

Many factors explain the slow economic transformation in African economies. The first factor is the lack of coherent national trade and industrial policies specifically aimed at promoting diversification. Indeed, successful economic transformation in emerging economies, especially in Asia, was the outcome of concerted national efforts to boost growth and international competitiveness. While many African countries have also engaged in industrial policies, including import substitution strategies, the outcomes have not been encouraging (box 1). In more recent years, economic reforms have focused on macroeconomic stabilization, which helped many African countries improve their growth records. But, there has generally been no clear integration with sectoral policies to promoting eco-

Box 1
Import Substitution Strategies (ISSs) and Africa's failed transformation

From independence to the early 1980s, most African countries adopted a range of ISSs accompanied by restrictive policies, including tariff and non-tariff protection, exchange control and import licensing. Initially ISSs produced positive effects on manufacturing output and employment. During the 1970s, Africa maintained an average annual rate of industrial growth of 5.5%, but the industrial growth rate declined to 2.5% during 1980-1984 and 0.4% in 1985-1987. Eventually, ISSs failed because of poor economic management. The production of final goods relied heavily on imported inputs, adding pressure on the balance of payments. Moreover, the small size of domestic markets limited the scope for expansion of new industries. In the end, instead of increasing productivity, ISS strategies insulated local firms from international competition and induced rent-seeking behaviour. Source: UNECA 2004.

nomic transformation. So the reform dividends in structural transformation have been very small, with African countries remaining vulnerable to fluctuations in primary commodity prices.

Other important constraints to structural transformation include the lack of skilled labour, inadequate physical infrastructure, unreliable energy supply, and small size of domestic markets that limits potential demand for new products.

An appropriate policy mix is needed to enhance capital flows for economic transformation

Official development assistance, the dominant form of capital inflows to Africa, has been directed primarily towards the social sector rather than the "productive" sectors, such as infrastructure. While investment in the social sector can contribute to sustainable growth (Ranis, Stewart, and Ramirez 2000), economic transformation requires significant investment in the productive sectors. Furthermore, FDI to Sub-Saharan Africa is directed mainly to extractive sectors, especially oil. Given the limited linkages between extractive industries and the rest of the economy, FDI to these sectors is unlikely to engender economic transformation.

To promote structural transformation and maximize the contribution of capital flows to this process, African countries need to:

- Adopt an appropriate policy mix to direct ODA and FDI towards directly productive activities, especially non-extractive sectors.
- Mainstream economic transformation objectives in industrial and trade policies and in the overall development agenda.
- Ensure that trade liberalization strategies are supported by measures that build trade capacity and raise productivity and competitiveness through technology transfer and adoption.
- Upgrade the physical infrastructure, which now hampers economic transformation.
- Enhance regional integration to facilitate the intraregional movement of capital and labour and expand markets for local producers.

> *"Africa remains largely on the sidelines of financial globalization"*

Capital flows have not responded to macroeconomic reforms

The macroeconomic reforms since the 1980s were expected to induce higher capital inflows by raising risk-adjusted returns on investment. However, so far African countries have not reaped substantial benefits. They have received only a small share of the substantial rise in private capital flows to developing countries since the 1990s

(UNCTAD 2005a, 2005b). Indeed, Africa remains largely on the sidelines of financial globalization.

What factors explain Africa's limited success in reaping the benefits of macroeconomic reforms in terms of greater capital inflows? Most African countries have small markets, poor physical infrastructure, unreliable energy supply, unskilled labor, macroeconomic instability, inefficient legal systems, high political instability, and poor governance, especially with high corruption—all deterring foreign investment (Asiedu 2002, 2004). It is clear that macroeconomic reforms alone are not enough to entice foreign capital inflows into African countries.

The weak institutional environment is a major hindrance to capital inflows

In addition to sound macroeconomic policy, attracting capital flows requires a sound institutional environment. Institutions can affect capital flows directly by providing an enabling environment, especially through good governance. For example, the success of Mauritius in attracting capital flows into its Export Processing Zone activities was partly due to institutional reforms that promoted social and political stability, thus minimizing uncertainty (box 2).

"Attracting capital flows requires a sound institutional environment"

Box 2
Export Processing Zone in Mauritius

In creating the Export Processing Zone (EPZ), the government of Mauritius recognized that there would be winners and losers, especially industrialists who for years had been favoured by protectionist arrangements. By addressing the needs of the industrialists through negotiation, the government earned their support for the reforms. The EPZ generated new trade and employment opportunities, while protecting interest groups. As a result, Mauritius benefited from high levels of capital flows that boosted trade and investment.

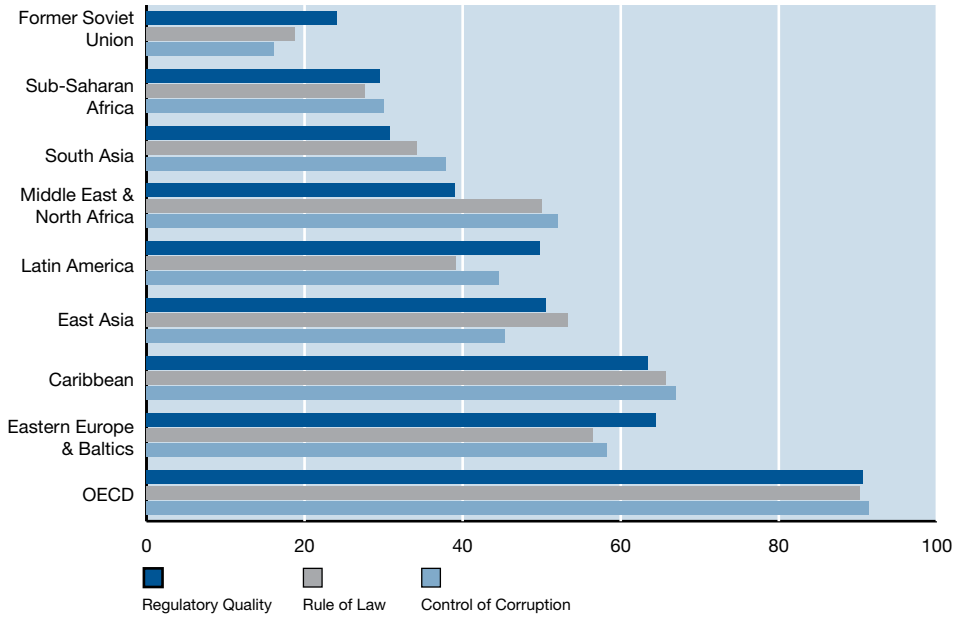
***Source**: Rodrik 2000.*

Institutions affect capital flows indirectly through their impact on other variables, particularly economic growth and the quality of the business environment. Sound institutions promote growth and improve the quality of the business environment, which in turn attracts capital.

African countries generally score very poorly on institutional quality, and this may partly explain why they have had little success in attracting capital flows. Sub-Saharan Africa ranks toward the bottom in standard measures of institutional quality (figure 5). High corruption, weak enforcement of the rule of law, and inefficient regulation increase the cost of doing business, which discourages both domestic and foreign investment.

Figure 5

Corruption, Rule of Law and Regulatory Quality in Africa and other regions, 2004



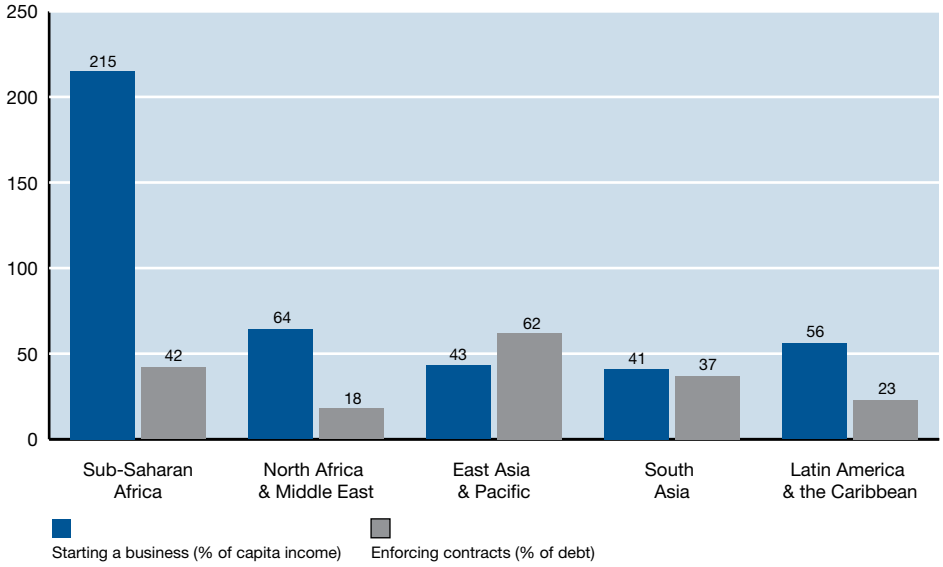
***Source**: Kaufmann, Kraay, and Mastruzzi 2005.*

> *The cost of doing business is significantly higher in Africa than in other regions*

The cost of doing business is significantly higher in Africa than in other regions (figure 6). The cost of starting a business is 215% of per capita income in Sub-Saharan Africa, the highest in the world, more than five times that of South Asia (41%), which is the lowest in the developing world. The cost of enforcing debt contracts is also among the highest among developing regions. These institutional inefficiencies partly explain why Sub-Saharan Africa has lagged behind in both domestic and foreign direct investment.

> *Microlevel institutional reform has improved investment climate*

Figure 6
Cost of starting a business and enforcing contracts: Sub-Saharan Africa and other regions



***Source**: World Bank 2006.*

Institutional reform is thus a key to attracting capital flows

To increase capital flows, African countries must develop effective institutions that minimize transaction costs associated with international capital and alleviate information risks and other market imperfections, thus improving market efficiency. So, institutional reforms at the macroeconomic and microeconomic levels should be a key part of national strategies for attracting foreign private capital and encouraging domestic investment (box 3).

Financial deepening enhances the capacity to attract and absorb capital flows

The financial system influences both the volume of foreign capital flows and the impact of foreign capital on economic growth. Three relationships are worth emphasizing (Lehman and others 2004; Feldstein 1994; Di Giovanni 2005).

- Financial development is a determinant of capital inflows because the deeper the financial system, the broader the range of investment opportunities and therefore the higher the incentives for foreign investors to enter the country.
- Financial development is a major component of the host country's absorption capacity.

Box 3

Micro-level institutional reforms are improving but more is needed to encourage investment

Some African countries have made substantial progress in micro-level institutional reforms aimed at improving the investment climate. For example, reforms of the tax system in Ghana, Kenya, and Uganda have increased transparency and reduced the complexity of tax procedures (Ndikumana and Nannyonjo 2006). Such reforms contribute to improving the investment climate while increasing compliance and boosting government revenue. But, extensive reforms of tax systems are still needed in many countries to reduce business costs and uncertainty (UNECA 2005). Moreover, African countries need to deepen reforms that address other micro-level constraints to private investment, such as poor infrastructure and unreliable energy supply.

- Financial development is a key channel of the growth effects of foreign capital.

These three relationships are essential in understanding both the poor performance of Africa in attracting foreign private capital and the limited effects of foreign direct investment on economic growth.

Financial development is important to a country's absorption capacity for two reasons. First, the depth of the financial system allows the country to intermediate foreign capital with minimal strain on monetary and exchange rate policy. A large and deep financial system minimizes the exchange rate appreciation effects of capital inflows and gives more degrees of maneuver to the central bank in sterilizing the inflows to minimize the inflationary impact. In many African countries, the bond market is either nonexistent or very thin, which limits the number of tools by which the central bank can control the inflationary and exchange rate appreciation effects of foreign capital inflows. For example, the large increase in domestic interest rates in Uganda between 1998 and 2000 (from 5% to almost 20%) was partly a result of large aid inflows that could not be absorbed given thin financial markets (Nkusu and Sayek 2004). Evidence from other African countries shows similar effects (Buffie and others 2004).

"Lack of access to finance severely constrains business formation"

Second, and more important, an efficient financial system allows a country to maximize technology transfers and spillover effects of foreign capital in the host economy. In the absence of adequate finance, these effects may not materialize at all, and sectors receiving FDI may remain economic islands, with few effects on overall economic activity. In the majority of African countries the lack of access to finance has been identified as an important constraint to business formation and expansion (Bigsten and Others 1999; Gunning and Mengistae 2001). Indeed, according to a firm survey of transnational corporations, 28% of the firms identified lack of finance as one of the

most important constraints to FDI in Sub-Saharan Africa, ranking third after corruption (49%) and access to global markets (38%) (UNCTAD 2000).[5]

In many countries financial reform is accompanied by less efficiency in intermediation

By facilitating the absorption of foreign capital, financial intermediation enhances the growth effects of foreign private capital. There is growing consensus that FDI affects economic growth less through direct investment effects and more through efficiency (or total productivity) effects (Mody and Murshid 2005; Durham 2004; Omran and Boldol 2003). The productivity effects of FDI on growth occur through two main channels. First, marginal productivity of capital increases in sectors directly receiving foreign direct investment. Second, the positive effects on the marginal productivity of capital in other sectors in the economy—the "social productivity" effects—compound these "private productivity" effects (Mody and Murshid 2005; Alfaro and others 2004).

Despite substantial efforts to reform and liberalize African financial systems, the evidence still points to important impediments to the efficient mobilization and allocation of domestic and foreign resources (Senbet and Otchere 2006; Nissanke and Aryeetey 1998; Ndikumana 2003b; Kane and Rice 2001; Senbet 2001). Financial systems in most African countries are dominated by a small number of banks that command heavy market power, undermining efficiency in resource allocation. For example, in Burundi three leading banks account for over 70% of deposits, loans, and assets (Nzobonimpa, Nkurunziza, and Ndikumana 2006). The market share of the top four banks is as high as 75% in Uganda, 65% in Ghana, and 49% in Tanzania (Senbet and Otchere 2005).

The oligopolistic structure of the banking system contributes to high costs of funds, evident in high interest rate spreads. Contrary to expectations, reforms in the banking system have been accompanied by a rise in the spread between the lending interest rate and the deposit interest rate—as well as an increase in the gap between domestic interest rates and world interest rates. The interest rate spreads in 1996-2003 were twice those in the 1980s in some countries (table 2). It is clear that financial reforms in many African countries have been accompanied by less efficiency in financial intermediation—and not more.

5 Also see Asiedu (2002, 2004), Asiedu and Lien (2004), and Morisset (2000) for further empirical evidence on constraints to FDI in Africa.

Table 2

Interest rate spreads and interest rate differentials in selected African countries

	Interest rate spread			Interest rate differential with the US		
	1980-89	1990-95	1996-2003	1980-89	1990-95	1996-2003
Algeria	n.a.	3.0	3.0	-9.1	-17.1	2.7
Kenya	3.5	9.0	13.3	-3.1	-2.0	5.8
Malawi	7.6	7.6	20.4	-9.2	-9.9	9.2
Nigeria	2.4	6.6	8.2	n.a.	-37.8	0.0
Seychelles	5.8	6.3	6.5	2.9	12.3	2.3
Sierra Leone	7.0	14.9	15.7	-53.4	-21.9	4.5
South Africa	3.8	4.0	5.0	-5.1	0.8	4.3
Swaziland	5.8	6.2	7.4	-5.9	-1.9	1.1
Tanzania	9.7	15.9	15.3	n.a.	5.0	-2.5
Uganda	7.9	7.4	11.4	-94.3	1.4	4.9
Zambia	5.7	15.4	18.1	-52.8	-43.7	7.2
Zimbabwe	7.9	3.2	22.3	-8.4	-4.1	-10.3

***Source**: Calculated using data from IMF 2005.*

***Note**: The averages are computed from quarterly series. The interest rate differential for an African country is obtained by subtracting the US real interest rate from the African country's real interest rate.*

Inefficiency in the financial system reduces both the flow of foreign capital and the impact of capital flows on economic growth. So, national strategies for increasing the gains from financial integration must include policies for improving financial intermediation.

> *Equity markets remain undeveloped on the continent*

Regional financial integration will allow the continent to attract and absorb more foreign capital

A developed capital market is essential for attracting a diversified pool of investments. Yet many African countries do not have equity markets, and even those that exist are still very shallow and illiquid (Ndikumana 2003b). One way to increase the viability of capital markets is to promote regional equity markets, especially by drawing on existing economic regional integration. Financial integration will provide more investment opportunities, increasing the scope for portfolio diversification. By expanding the scope of investment opportunities, regional capital markets will attract more global investors interested in the higher returns that African markets offer but who now are discouraged by the illiquidity of national capital markets and the exposure to sovereign risk. The emergence and consolidation of regional financial markets

will facilitate the establishment and exploitation of crucial synergies between capital markets and national banking systems.

One constraint to development of national and regional financial markets is the lack of capacity of market operators and regulators (Senbet 2001). Governments, in collaboration with their development partners, need to initiate strategies for overcoming this constraint through training and learning from experience in countries with more advanced financial markets. Initiatives such as ECA's capital market development projects need to be strengthened and multiplied (box 4).

Box 4

ECA's contribution to capacity building for capital market development

To alleviate the capacity constraint in capital market development, ECA launched a capital markets development project in 2002. The main objectives are to:

- Strengthen the capacity of African capital market regulators and operators.
- Strengthen the capacity of African capital markets to achieve regional integration.
- Enhance the capacity of capital market associations to promote regional integration.
- Increase awareness of African countries of the role of capital markets in national development and poverty reduction.

The main activities are trainining workshops for market operators and regulators. In addition, the project organizes expert meetings and conferences bringing together researchers, captial market practitioners, and policy makers to assess progress and draw policy recommendations on the way forward in the area of capital market development at the national and regional levels.

"Developing financial markets requires greater capacity of market operators and regulators"

The adverse effects of scaling up external resources are real but avoidable

As African countries seek to increase the inflow of both official and private capital, they also need to be aware of the potential negative effects of a surge in foreign capital on the receiving economy. One set of effects that has been emphasized in the literature is the "Dutch disease," whereby inflows raise inflation and cause the real exchange rate to appreciate, thus undermining domestic production and international competitiveness.

But there are many reasons for African countries to sustain and benefit from a "scaling up" of external resources (McKinley 2005). Given the substantial idle capacity in African economies, if external resources are appropriately used to stimulate both

public sector and private sector production, the inflationary and exchange rate effects will be minimal. In particular, if external resources finance the import of capital goods as well as public investment, the supply-side effects will offset the demand-side effects, minimizing the inflationary and exchange rate appreciation impact. Indeed, a study of five African countries that have received large volumes of aid (Ethiopia, Ghana, Mozambique, Tanzania, and Uganda) found that these experienced exchange rate depreciation rather than appreciation (IMF 2005b) (box 5). In other words, the study found no Dutch Disease.

> *Africa needs strategies that tilt the structure of capital flows in favor of long-term capital*

Box 5

Aid inflows and the exchange rate in African countries

The effects of aid inflows on the exchange rate are influenced by decisions in the recipient country on the absorption and spending of aid. For example, in Ethiopia, aid supported an exchange rate peg against the dollar through international reserve accumulation. In Ghana, aid increased foreign exchange reserves, which constituted a buffer against volatility of inflows. In both cases, absorption and spending of aid were low. In Mozambique, Tanzania, and Uganda by contrast aid financed higher government spending, causing a surge in domestic liquidity. This led to inflation, especially in Mozambique. In Tanzania and Uganda, inflation was contained by sterilization through Treasury Bill sales, but this caused interest rates to rise. During aid surge episodes, real exchange rate depreciation ranged from 1.5% in Mozambique in 2000 to 6.5% in Uganda in 2001. Only Ghana observed a mild real exchange rate appreciation. The exchange rate depreciation helped boost exports, including non-traditional exports in Uganda and Ethiopia.

***Source**: IMF 2005b.*

A problem with high inflows of resources to Africa seems to be that the resources either have been allocated to unproductive uses or have not been absorbed in the system—but instead tucked away in idle reserves (McKinley 2005; IMF 2005b; Rodrik 2006). The debate on development financing therefore must pay special attention to strategies for efficiently managing resources to maximize growth effects of foreign resources. Strategies to improve the predictability of inflows will also minimize macroeconomic and financial instability in the receiving economies.

African countries need to establish capital management and monitoring mechanisms to minimize financial risk

Given the increasing pace of financial globalization and the implied larger risks of financial crisis, African countries need to establish prudential regulation mechanisms for minimizing the exposure to such risks. They need strategies that tilt the structure of capital flows in favor of long-term capital, [6] as a means of accelerating economic

6 Evidence suggests that appropriate capital control measures can alter the composition of capital flows even when they cannot affect the volume of flows (Montiel and Reinhart 1999; Ahmed and others 2005).

growth and structural transformation through the diversification of economic activity. They also need to minimize exchange rate volatility arising from the instability of capital inflows and outflows. And they need to minimize the risk of financial crisis through controls of capital inflows aimed especially at lengthening the debt maturity (Calvo 2001; Fosu and Senbet 2001).

Capital management strategies are needed to retain savings

Appropriate capital management strategies can insulate the current account from the effects of financial market volatility. One strategy is to establish a dual exchange rate system consisting of differential treatment of financial transactions and current account transactions. This has beens effective at least in the short run in South Africa (box 6).

Appropriate capital management strategies can also reduce the likelihood of debt crises by reducing the risk of excessive devaluation of the national currency, especially by minimizing the risk of excessive foreign currency borrowing by domestic private actors (Epstein, Grabel, and Jomo 2005; Le Fort and Lehman 2003). Finally, capital management strategies are needed to retain savings in African countries, especially by preventing capital flight both through increased financial stability and enforced transparency in international capital movement.

Capital management strategies need to be complemented with domestic financial regulation to minimize the risk of financial distress (Senbet 2001). African countries need sound banking regulation to enforce adequate bank capitalization, promote competition, ensure speedy and transparent reporting on the health of individual financial institutions, and prevent contagion of banking distress through timely bank restructuring by capitalization, merger, or liquidation (Kane and Rice 2001). Building sound domestic banking systems will enhance the ability of African countries to sustain shocks to international capital flows.

Box 6

South African experience with capital and exchange rate management

The South African capital and exchange rate regime has undergone five major phases since the 1960s (Aron, Elbadawi, and Kahn 2000). Until 1978, the rand was pegged alternatively to the dollar and the pound, and capital account transactions were strictly controlled. In 1979, the government adopted a dual exchange rate system whereby current account transactions were executed at a controlled-float exchange rate, the *commercial rand,* while equity capital was transacted at a freely floating exchange rate, the *financial rand*. The system was abolished under a controlled float system in 1983 and reintroduced in 1985, lasting until 1995. The exchange rate regime was unified again in 1995 during a systematic move toward a market-based exchange rate system. Foreign exchange and capital controls were motivated by the need to retain domestic savings, prevent the loss of foreign exchange through transfer of assets abroad by residents, and encourage repatriation of capital. The evidence suggests that the dual exchange rate system to some extent insulated the current account from volatility of the rand (Farell 2001).

Three main categories of financial risk require managing: currency, flight, and fragility risk. A series of warning indicators (*trip wires*) and appropriate policy interventions (*speed bumps*) can address each type of risk (Grabel 2004). It is important for each country to design these policy tools in such a way that they are flexible enough to allow adaptation to changes in macroeconomic and financial circumstances. African countries need systematic monitoring mechanisms and a set of warning signs to hedge against financial risk and guide appropriate policy responses to financial shocks.

Conclusion

Africa's growth in the last two years is an important turnaround from decades of stagnation. But the growth rates remain below the levels needed to achieve national development goals, especially employment creation and poverty reduction. So, African countries still face the challenges of achieving and sustaining higher growth rates, as well as translating the growth into poverty reduction and human development.

To meet these challenges, African countries need, among other things, to attract, retain, and efficiently manage higher volumes of external resources to fill their chronic resource gaps. The evidence reviewed in this report shows that the continent remains on the sidelines of financial globalization, heavily indebted and dependent on official development assistance, while private capital flows remain volatile and concentrated primarily in extractive industries. Capital flows have had little impact on economic transformation, and their effects on domestic labor markets have also been limited.

> *"At the micro level, the goal is to minimize factor costs"*

The report identifies strategies to increase both the volume of capital flows and the benefits from these flows in economic growth and transformation. Some areas that deserve particular attention from policymakers are highlighted here.

- *African countries need to improve the investment climate to encourage both domestic and foreign investment.* This will involve actions at the political, macroeconomic and microeconomic levels. Consolidation reforms at the political and macro levels will alleviate political and macroeconomic uncertainty and reduce sovereign risk. At the micro level, the goal is to minimize factor costs, especially through reliable energy supply and adequate public infrastructure. African countries also need to streamline the regulatory environment to reduce market rigidities while protecting workers and enforcing property and creditor rights.
- *Macroeconomic frameworks need to be more flexible and expanded to include the goals of accelerating growth and creating employment.* Within an expanded macroeconomic framework, capital flow policies will serve as an instrument for achieving the broader goals of a coherent national development strategy.
- *Capital flow policies need to be better integrated into national industrial policy.* To enhance the impact of capital flows on economic transformation, African

countries need to provide incentives for greenfield foreign direct investments, especially those that are export oriented and have large positive effects on employment creation.

- *Each country needs to identify and target sectors that have high potential for employment creation.* To maximize the effects of capital flows on employment creation, countries need quantitative measures of the employment impact of investment across sectors. Governments can then use this information to design incentive mechanisms that will help channel foreign capital into sectors with the highest employment creation potential.
- *Promoting regional financial integration will help overcome the constraint of underdeveloped financial markets.* African countries need to capitalize on existing regional integration arrangements to foster financial integration, which will expand the scope for investment and resource mobilization, increasing the attractiveness of African markets in the eyes of foreign investors.
- *African countries need mechanisms for monitoring and managing capital flows to minimize the risks of financial instability.* To achieve this, African governments should develop adequate statistical capacity to track capital flows and monitor warning signs of financial fragility.
- *African countries need to design strategies to increase the contribution of the diaspora to economic development.* African governments should establish mechanisms and incentives to increase the volume of remittances and encourage higher allocations of remittances to investment. In addition, improving the returns to human capital is crucial for retaining human capital, which is essential for achieving and sustaining higher levels of economic growth.

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Recent Economic Trends in Africa and Prospects for 2006

1.1 Introduction

In 2005, African economies recorded another strong performance, continuing the momentum of strong growth achieved in 2004.[1] The continent benefited from rising global demand for primary commodities, including oil, which resulted in high export earnings for resource-rich countries. In addition, African economies continued to reap the benefits from macroeconomic reform, which translated into consolidation of macroeconomic balances with low inflation rates, declining budget deficits, stabilization of exchange rates and improvements in current account balances.

"Africa needs more external funding to increase growth rates and achieve poverty reduction"

The continent also benefited from substantial inflows of external financing in the form of official development assistance (ODA), including debt relief, and foreign direct investment (FDI), which should boost economic growth in the coming years. The Multilateral Debt Relief Initiative (MDRI) announced at the G8 Summit in Gleneagles in 2005 provided much needed relief for 13 sub-Saharan African (SSA) countries. However, it is clear that this debt relief package is not enough and that more external funding will be needed to help African countries increase growth rates and achieve meaningful reduction in poverty.

Indeed, while the recent consecutive high growth rates represent a major turnaround, the levels of growth recorded are still not enough to achieve the Millennium Development Goal (MDG) of halving poverty by 2015. In 2005, only ten countries realized growth rates of 7 per cent or higher: Angola (19.1%), Burkina Faso (7.5%), the Republic of Congo (7.7%), Equatorial Guinea (9.3%), Ethiopia (8.9%), Liberia (8%), Libya (8.5%), Mozambique (7.5%), Sierra Leone (7.3%), and Sudan (8%). Of the ten countries that recorded high growth in 2005, only three maintained an average growth rate of 7 per cent in the medium term (over the 1998-2005 period): Angola, Equatorial Guinea and Mozambique. It is clear that while high growth rates are recorded in several countries, very few are able to sustain high performance for an extended period. Thus, the volatility of growth remains an obstacle to the goal of accelerating poverty reduction.

1 The data used for recent macroeconomic performance in this chapter are mainly from the International Monetary Fund (IMF) and the Economist Intelligence Unit (EIU). Data on social and human development are from various sources, including the World Bank's *World Development Indicators* 2005 and United Nations Development Programme's (UNDP) *Human Development Report* 2005.

Volatility of growth is an obstacle to poverty reduction

A major weakness of the recent growth performance in Africa is that it is mainly driven by extractive industries, especially oil and minerals. This exposes resource-rich economies to the adverse effects of fluctuations in international commodity prices, in addition to the negative effects of exchange rate appreciation on export competitiveness. The future of resource-led growth remains uncertain given the vagaries of international commodity markets. Moreover, given the weak employment gains from resource-based economic expansion, the recent patterns of growth are not likely to generate meaningful increases in living standards for the majority of the population.

A major challenge for African countries is the ability to sustain reasonable levels of Gross Domestic Product (GDP) growth over an extended period. With erratic growth rates, African countries will not be able to generate enough decent employment opportunities to increase per capita income and reduce poverty.

The objective of this chapter is to provide an overview of the recent performance as well as future growth prospects for African economies at the continental and subregional levels. The chapter discusses the main factors behind the recent performance and factors that are likely to influence the medium-term growth prospects. It also identifies key challenges in the area of social development and suggests policy responses.

1.2 The global economy was largely favourable in 2005

Although the world economy slowed down in 2005 relative to 2004 (from 5% to 4.3%), it displayed resilience in the face of the increase in energy prices. The strong performance was driven by rising domestic demand in the United States, Canada, China and India. This partly helped to offset weaker growth in Japan (2.8%) due to slow inventory accumulation, the Euro zone (1.2%) due to weak household spending, and in the United Kingdom (1.75%), which experienced a deceleration of private and government consumption. Growth in Latin America slowed in 2005 relative to 2004 (from 5.8% to 4.2%), due to lower import demand from China and industrialized economies. Growth also decelerated relative to 2004 in transition economies (from 6.7% to 5.3%) and in Asia (from 7% to 6.5%).

The strong overall global growth performance has fuelled large increases in oil and commodity prices. However, the high oil prices have not spilled over into higher wage demands and long-term inflation expectations appear well anchored. As a result, contagion of oil price hikes to non-oil prices has remained minimal. Indeed, core inflation has remained stable in the United States (around 2%) and has trended down in the Euro zone.

Many developments witnessed in 2005 in the world economy have important implications for African economies in the short to medium term. The sustained rise in

oil prices will continue to put pressure on energy costs for all the countries and on the import bill for oil-importing ones. The rising short-term interest rates driven by monetary policy tightening, especially in the United States, imply higher costs of debt servicing, especially for countries with high proportions of short-term debt in total foreign liabilities. While the widening US trade deficit will contribute to weakening the dollar, this may be offset by the effects of rising interest rates and strong recovery, which will cause the dollar to appreciate, resulting in higher import costs and a worsened debt service burden for African countries.

> *Strategies are needed for enhancing the efficiency of aid utilization*

Another major concern is the current account imbalances which are predicted to widen over the next two years (OECD 2005; UN 2006). The US external deficit is set to rise to 7 per cent of GDP in 2007, while Japan and China will register very high surpluses. These imbalances raise the risks of disorderly adjustments, with risks of large exchange rate fluctuations, asset price collapse, and interest rate hikes. These risks put into question the sustainability of current world growth rates.

The year 2005 was marked by a substantial increase in ODA, with aid from the Development Assistance Community (DAC) of the Organization for Economic Cooperation Development (OECD) rising by 31.4% to a record high of $106 billion. This increase reflected debt relief, including large sums to Iraq (about $14 billion) and Nigeria ($5 billion) as well as aid to countries affected by the tsunami in 2004 (about $2.2 billion).

The year 2005 was also marked by a number of positive developments in the international community with regard to commitment to support national and regional development efforts in Africa. Noteworthy developments include: the global review of MDGs by the United Nations General Assembly, the report of the Commission for Africa led by the Prime Minister of the United Kingdom, Tony Blair, and the focus of last year's G8 meeting on development financing for Africa. These efforts to increase growth need to be supported by strategies for enhancing the efficiency of aid utilization and better targeting of poverty reduction in national development agendas.

1.3 Overall growth performance in Africa remained strong

Many countries registered better performance in 2005 than in 2004

In 2005, African economies recorded another strong performance (5.4%), exceeding the record growth achieved in 2004 (5.2%), and more than a percentage point above that of 2003 (4%). See figure 1.1.[2] Comparatively, Africa's growth was the same as

2 The data used in this document are updated to September 2006.

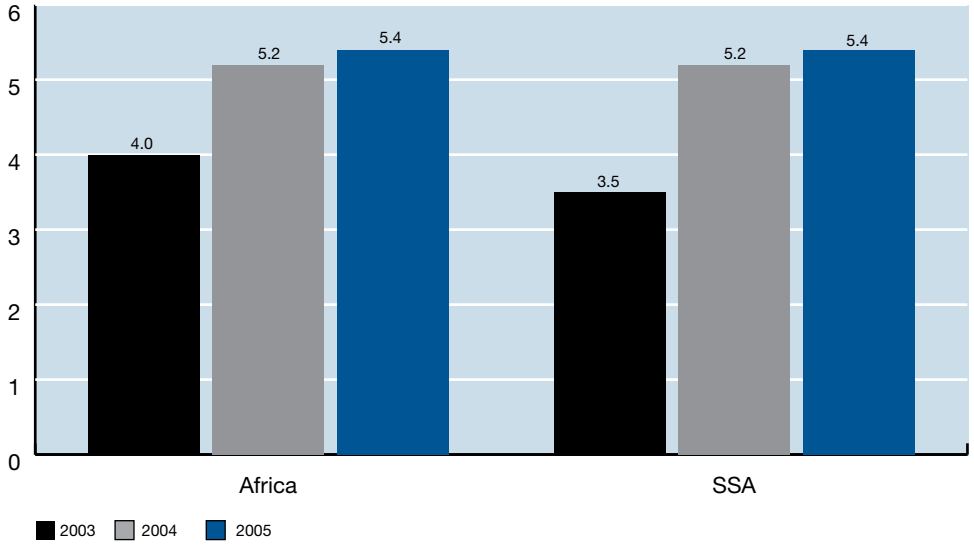
that of transition economies, higher than that of Latin America (4.3%) and lower than that of Asia (6.5%, excluding Japan). On a disaggregated level, as many as 25 African countries recorded improvements in growth rates in 2005 relative to 2004.

"Improvements in macroeconomic management have resulted in lower inflation rates and consolidation of fiscal balances"

The strong growth performance achieved in 2005, as in recent years, represents a major turnaround from decades of economic decline and stagnation. A key driver of this recovery is the improvement in macroeconomic management in many African countries, which resulted in lower inflation rates and consolidation of fiscal balances. Another favourable factor is the increase in international prices of key export commodities for Africa, especially crude oil, due to strong growth in global demand.

The total commodity price index increased by an average of about 30 per cent in 2005 relative to 2004, led by crude oil prices, which rose by more than 40 per cent compared to 13 per cent for non-energy commodity prices. Among non-energy commodities, the prices of metals and minerals increased by 25.4 per cent while those of agricultural products, raw materials and fertilizers rose by 7.6, 7.1 and 6.6 per cent respectively. In contrast, export prices of cotton, tea, and cocoa continued to decline, mainly due to global excess supply.

Figure 1.1
Real GDP growth rate in Africa, 2003-2005



Source: *Economist Intelligence Unit (EIU), September 2006.*

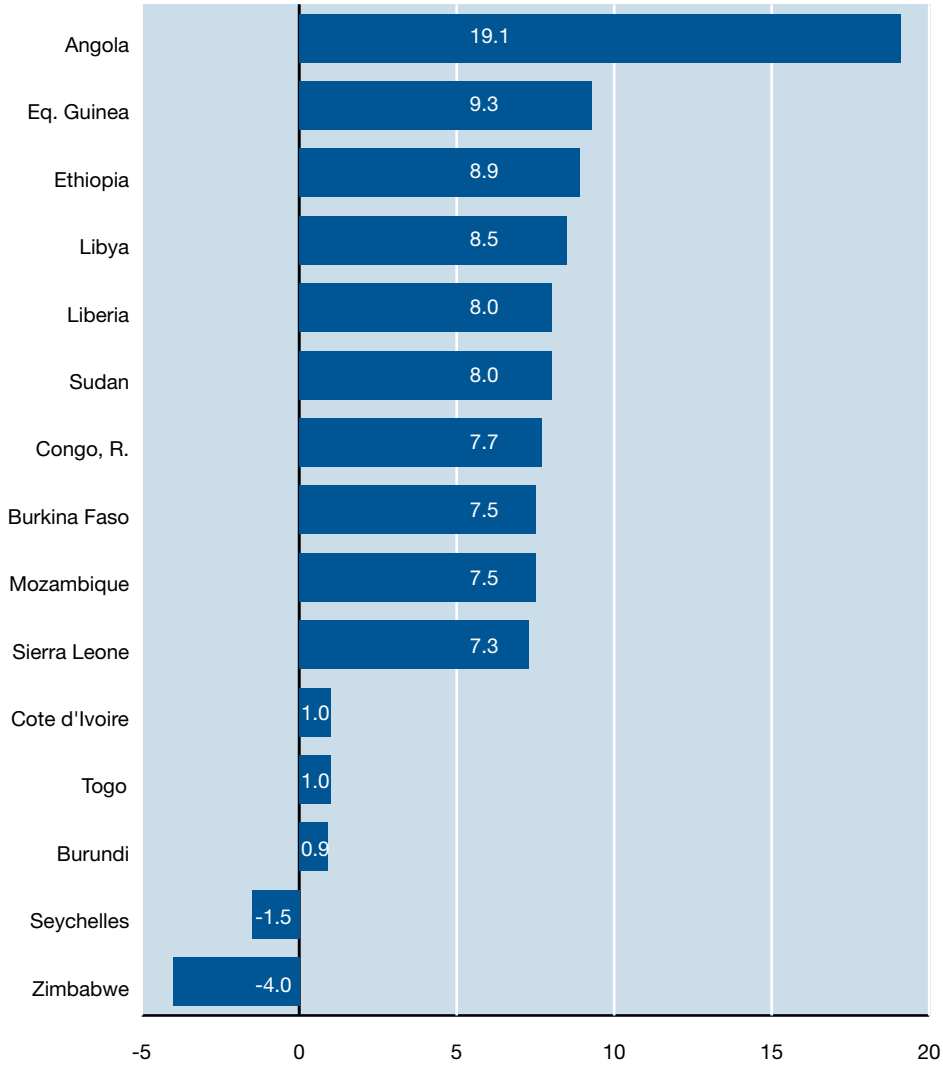
In 2005, the top 10 growth performers achieved the 7 per cent growth rate threshold needed to achieve the MDGs (figure 1.2). One half of the high performers are oil-exporting economies, reflecting the impact on export revenues of high oil prices and production. However, it is notable that the other half are non-oil economies: Burkina Faso, Ethiopia, Liberia, Mozambique, and Sierra Leone. High growth in these coun-

tries was mainly due to strong performance in the agricultural sector (Burkina Faso, Ethiopia, Mozambique, and Sierra Leone), the service sector (Sierra Leone and Mozambique), and recovery in the mining sector (Sierra Leone).

Zimbabwe and Seychelles exhibited the weakest performances in 2005 as in 2004, as a result of continuing instability in Zimbabwe and the adverse effects of the tsunami and weak performance in tourism and in tuna exports in Seychelles. Slow growth in Togo was attributable to political crisis and a decline in phosphate and cotton production. Political instability adversely affected overall growth performance in Côte d'Ivoire.

Figure 1.2

Top 10 and bottom 5 performers in Africa in 2005 (% real GDP growth)



Source: *Computed from EIU data, September 2006.*

The gains from Africa's oil boom are still limited

Oil production is playing an important role in Africa's overall growth performance

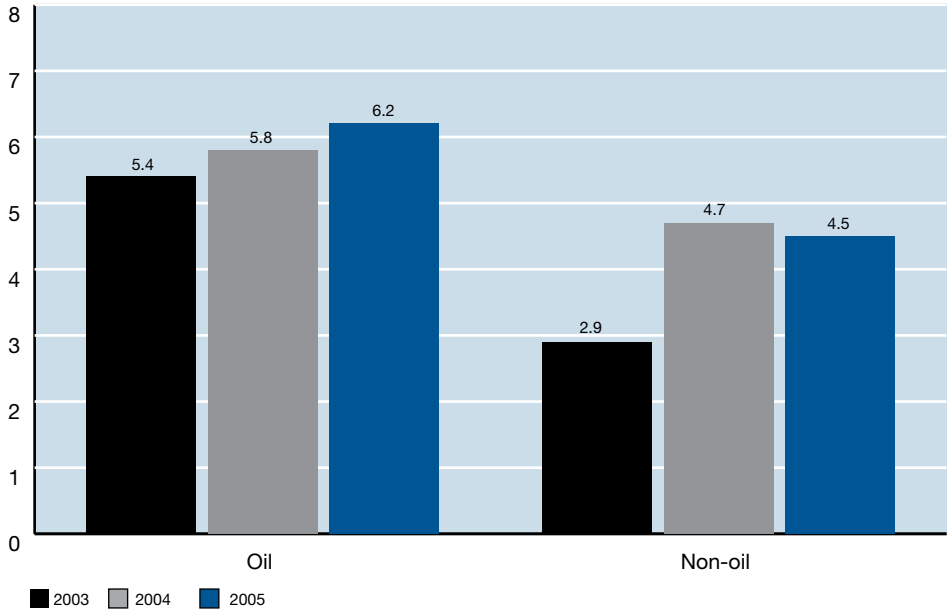
Over the last few years, Africa has been in the midst of an oil boom, resulting both from large increases in oil prices and the substantial influx of investments in petroleum exploration and production (US Department of Energy, 1999). This new oil boom spread across the continent, with all subregions coming out as net crude oil exporters, with the exception of East Africa. The dominant producers and net oil exporters are (in descending order of shares in total production) Nigeria, Libya, Algeria, Egypt, and Angola. Gabon, Congo, and Cameroon are also net oil exporters. Oil production also started recently in Mauritania.

African oil has been the subject of substantial interest from major oil consumers, especially the US and the fast-growing Asian economies led by China and India. Oil exploration in Africa is expanding faster than in any other region of the world and African oil producers enjoy large gaps between potential reserves and current output. The continent is therefore seen as a viable alternative to traditional sources such as the Middle East. The world's largest consumer of oil, USA is deriving 15 per cent of its oil imports from Africa. China, the second largest consumer of oil, buys 28 per cent of its oil from African countries, especially Angola, Nigeria and Sudan. In 2004, China's investments in Africa – mostly in oil exploration and production – represented $900 million out of the continent's total of $15 billion.

The massive export revenues and FDI in the oil sector explain the high growth rates recorded by oil-producing African economies. In 2005, as a continuation of the recent trend, African oil economies as a group grew at 6.2 per cent compared to 4.5 per cent for non-oil economies (figure 1.3). The oil producers as a group contributed 53.4 per cent of the continent's 5.3 per cent growth rate. Therefore, it is fair to say that oil production is playing an important role in the continent's overall growth performance.

Figure 1.3

Growth of real GDP in African oil- vs. non-oil economies, 2003-2005



Source: *EIU, September 2006.*

However, despite the high growth rates generated by the oil boom, several questions remain, especially the sustainability of these growth rates and the overall impact on economic development. For high oil prices to translate into higher growth rates – even in the short run – it is necessary that the revenues be spent to boost overall economic activity and production capacity in a wide range of sectors. If the higher revenues are stored in idle foreign exchange reserves at the central bank or spent on unproductive imports, then the effects on growth will be minimal. The bigger challenges are:

> *"Africa's oil boom needs to be translated into poverty reduction"*

- How to translate oil revenues into sustainable growth; and
- How to convert the oil boom into higher living standards for the majority of the population.

To translate the oil boom into sustained high growth rates, the oil revenues need to be used to finance domestic investment, including infrastructure, and to diversify economic activity by financing new investments in non-oil activities. Moreover, the sustainability of oil-driven growth requires efficient management of oil revenues to hedge against the adverse effects of price fluctuations.

The biggest challenge is to translate the oil boom into poverty reduction. Even the largest oil-producing countries in Africa still face abject poverty despite the massive oil revenues collected over the years. In Angola, 70 per cent of the population lives below the poverty line. In Gabon, with one of the highest per capita incomes on the

continent, high income inequality has kept half of the population in poverty. The development of *rentier economies* has prevented the expansion of employment-generating activities, thus keeping the majority of the population on the sidelines of the oil-led prosperity.

Oil revenues should promote economic diversification

An important issue for oil-rich economies is the efficiency of the management of oil revenues. In some of these countries, lack of transparency and accountability on the part of both governments and oil companies has perpetuated embezzlement and misuse of oil revenues. Overall, while oil resources are a potent source for economic prosperity for the continent, specific measures are needed to ensure that the induced growth is sustained over an extended period, that the high oil revenues are invested to promote diversification of economic activity, and that the gains are broadly shared among all segments of the population.

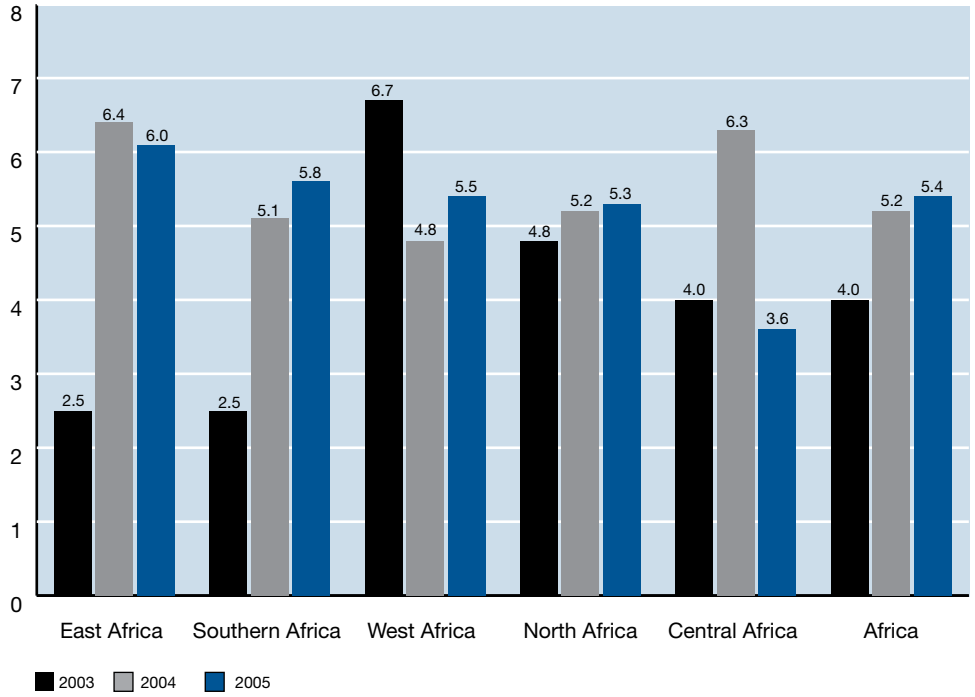
Subregional growth performance remains uneven

Aggregate economic performance exhibits substantial variations across subregions. East Africa led subregional growth performance for the second consecutive year with real GDP growth at 6 per cent in 2005, down from 6.4 per cent in 2004 (figure 1.4). In 2005, one half of the twelve countries of the subregion (with adequate data)[3] showed improved growth over that of 2004. The top performers were Ethiopia (8.9%), Tanzania (6.8%), the Democratic Republic of Congo (DRC) (6.5%), Kenya (5.2%), and Uganda (5.5%). Growth was driven by agricultural production, both in traditional cash crops such as coffee in Ethiopia, Rwanda and Uganda and in other products such as horticulture in Kenya.

Other factors of strong performance include high mineral production (DRC), and gains from improved political stability (Burundi and DRC). In Comoros, growth was sustained by donor support while growth in Djibouti was boosted by public and private investments in new port facilities. Eritrea's economic growth was low partly because of droughts that adversely affected agricultural production.

3 Excluding Somalia for which there are no adequate data.

Figure 1.4
Growth by sub-region, 2003-2005



Source: *EIU, September 2006.*

Growth in North Africa remained strong in 2005, improving slightly from 5.2 per cent to 5.3 per cent relative to 2004. Growth in the subregion was driven mainly by the strong performance of the oil sector in Algeria, Egypt, and Sudan. North Africa suffered from unfavourable weather conditions (especially in Mauritania, Morocco, and Tunisia). Furthermore, the end of the Multifibre Agreement on Textile and Clothing ended in January 2005. Morocco, the only non-oil producer in the subregion, experienced considerable slowdown in real GDP growth from 4.2 per cent in 2004 to 1.5 per cent in 2005 due to sharp contraction in agricultural output. Egypt and Sudan were the least affected by bad weather conditions. Weak export growth of textiles impacted negatively on GDP growth in Tunisia, which declined from 6 per cent in 2004 to 4.2 per cent in 2005. However, the subregion exhibited strong performance in the service sector, especially in Mauritania, Morocco, and Tunisia.

Central Africa was the worse performing subregion in 2005, with growth declining from 6.3 per cent in 2004 to 3.6 per cent in 2005. Growth decelerated in four countries: Cameroon (the largest economy that accounts for more than 50 per cent of the subregion's output), Chad, Equatorial Guinea, and São Tomé and Príncipe. The Central African Republic, the Republic of Congo, and Gabon recorded improvements (from 1.3% to 2.2%, 3.6% to 7.7%, and 1.4% to 2.9%, respectively). The

modest gains in performance in the Central African Republic are partly attributable to improvement in political stability. Growth in the Republic of Congo was driven by the oil sector. Gabon benefited from good performance in the tertiary sector (telecommunications) and timber exports (UNECA, SRO-CA, 2006). Chad and Equatorial Guinea both experienced marked slowdowns, from 29.7 per cent to 5.9 per cent and from 32.9 per cent to 9.3 per cent, respectively, due to the completion of major investment projects in the oil sector.

Growth in Southern Africa picked up from 5.1 per cent in 2004 to 5.8 per cent in 2005 owing mainly to higher growth in Angola, Mozambique, South Africa, and Zambia. At 19.1 per cent, Angola was the fastest-growing economy in Africa in 2005, thanks to higher oil revenues. South Africa's higher growth was due to higher domestic demand and exports as well as better performance in tourism. Growth in Zambia improved relative to 2004 (from 5.4% to 5.8%) as the adverse effects of droughts in the agricultural sector were offset by positive outcomes in other sectors such as increased copper production. Zimbabwe's economy continued to contract (-4%), bringing the real GDP level to 38 per cent below that of 1999.

Growth in West Africa improved in 2005 from 4.8% to 5.5%, marked by a predominance of the tertiary sector (UNECA, SRO-WA, 2006). At a disaggregated level, substantial increases in growth were registered in a number of countries: Burkina Faso (4.6% to 7.5%), Cape Verde (4.4% to 6.8%), Liberia (from 2.4% to 8%), Mali (from 2.2% to 6%), and Niger (from 0% to 4.5%). High GDP growth rates were also recorded in Senegal (6.1%), Sierra Leone (7.3%), Nigeria (6.5%), and Gambia (5.0%). Two countries experienced notable declines in growth rates: Côte d'Ivoire (from 1.6% to 1%) and Guinea Bissau (4.3% to 2.3%). Social and political tensions in Togo, Côte d'Ivoire, and Guinea Bissau were partly responsible for the poor economic performance.

"Post-conflict countries have moved from recovery to genuine growth"

Some countries have maintained high growth over the medium term

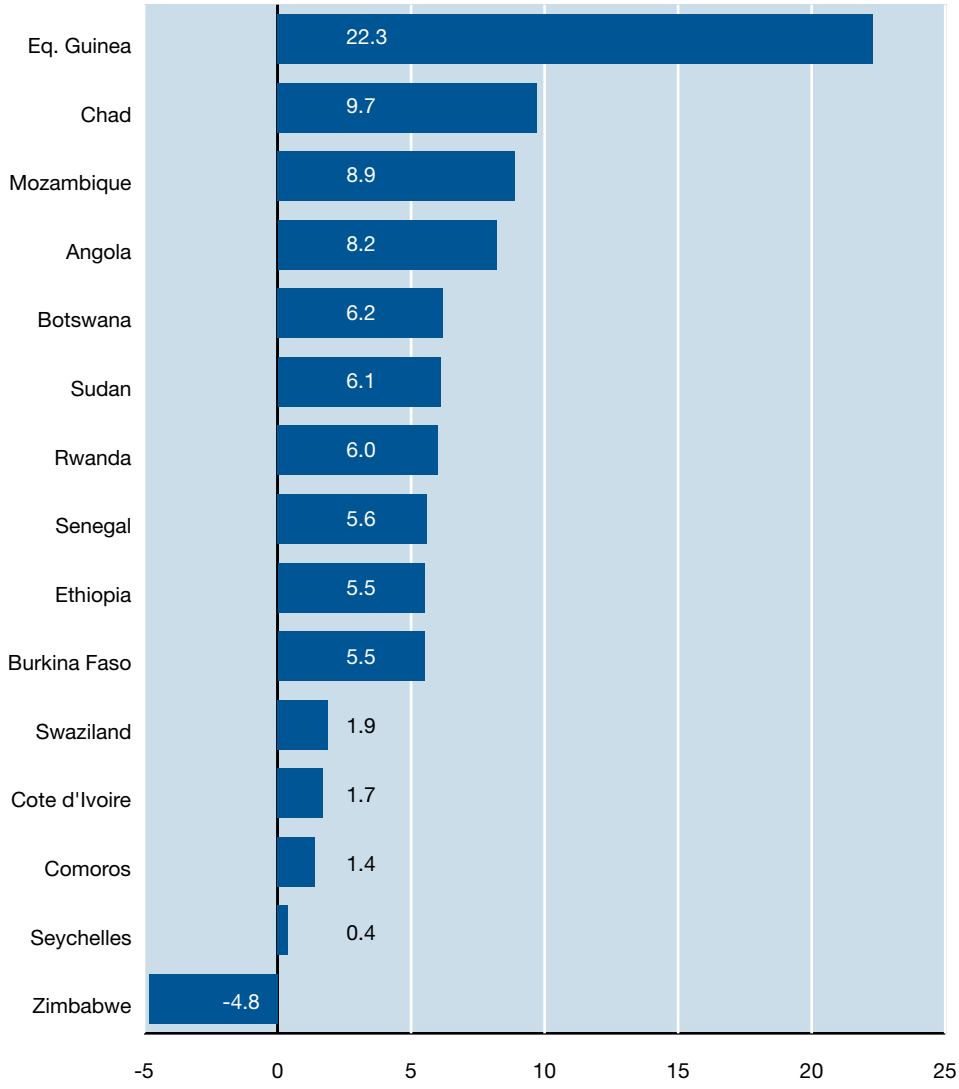
Figure 1.5 presents average growth rates over the 1998-2005 period.[4] Six of the top ten performers in 2005 are also among the top ten performers over the past eight years: Angola, Burkina Faso, Equatorial Guinea, Ethiopia, Mozambique, and Sudan. Côte d'Ivoire, Seychelles and Zimbabwe are among the weakest performers in 2005 and over the past eight years. The medium-term evidence also indicates that high growth is not restricted to oil-rich countries. Six out of the top ten performers are non-oil exporters: Botswana, Burkina Faso, Ethiopia, Mozambique, Rwanda, and Senegal. Growth in these countries was driven by the effects of comprehensive and sustained economic reforms as well as political stability in post-conflict countries such as Mozambique and Rwanda. These post-conflict countries have moved from recovery to genuine growth as a result of these reforms.

4 The choice of this period is governed by data consistency.

The group of least developed countries (LDCs)[5] in Africa has performed particularly well, recording an average growth rate of 5.3 per cent during the 1998-2005 period, higher than the SSA average (3.7%) and the average for the continent (4%) (UNECA 2006a). At a disaggregated level, oil-producing African LDCs outperformed non-oil producers (7.5% and 4.3%, respectively) while landlocked African LDCs performed worse in terms of growth (3.8%).

Figure 1.5

Top 10 and bottom 5 performers in Africa, 1998-2005 (% average annual growth)



Source: *EIU, September 2006.*

5 34 of the 53 African countries are LDCs.

1.4 Macroeconomic balances continue to improve

Fiscal consolidation must remain high on Africa's economic reform agenda

Fiscal balance has improved

One of the positive features of recent economic growth in Africa is improvement in the fiscal balance in many countries. The average fiscal position on the continent improved from a deficit of one per cent of GDP in 2004 to a surplus of 0.6 per cent in 2005. The number of countries with fiscal surpluses increased from 9 in 2004 to 12 in 2005 (table 1.1). The continent's improvement in fiscal position was mainly driven by the sizeable fiscal surpluses recorded by oil producers: Libya (20.6% of GDP), Equatorial Guinea (13.6%), the Republic of Congo (13.7%), Algeria (13.8%), Gabon (8.3%), Cameroon (3.4%) and Nigeria (0.3%). However, five non-oil economies also recorded fiscal surpluses: São Tomé and Príncipe (44.8%), Seychelles (8.0%), Botswana (2.6%), Lesotho (2.0%), and Kenya (0.3%).

Nevertheless, fiscal imbalances remain a critical problem in a large number of African countries. As many as 28 countries recorded fiscal deficits in 2005 compared to 31 in 2004. Moreover, many countries still depend heavily on ODA to finance their budgets, which raises concerns with regard to the sustainability of their development programmes. Therefore, fiscal consolidation, including strategies for increasing domestic revenue mobilization, must remain high on the agenda for economic reforms on the continent.

Table 1.1
Distribution of fiscal deficits in Africa, 2004 and 2005 (number of countries)

	2004	2005
Countries with surpluses	9	12
Less than 5 per cent	4	6
5 per cent to 10 per cent	3	2
More than 10 per cent	2	5
Countries with deficits	31	28
Less than 5 per cent	22	17
5 per cent to 10 per cent	8	11
More than 10 per cent	1	0
Total number of countries	40	40

Source: *EIU, June 2006.*

Single-digit inflation was contained in most countries

In 2005, the inflation outlook remained satisfactory with a majority of countries recording single-digit inflation rates (table 1.2). After declining from 10.8 per cent to 8.1 per cent between 2003 and 2004, the mean inflation for the continent increased slightly to 8.5 per cent in 2005. Inflation results were driven by pressures from oil prices, effects of weather shocks on agricultural production, and high domestic demand. Inflationary pressures were contained by the effects of macroeconomic policies aimed at containing public expenditures and money growth. These policies helped to contain the effects of the surge in oil revenues and development assistance inflows.

"Inflation pressures mitigated by macroeconomic policies"

In 2005, 16 countries experienced inflation above 10 per cent, compared to 17 in 2004. Nonetheless, inflation increased in 33 out of 51 countries, including eight of the 13 oil-producing countries: Cameroon, Chad, Côte d'Ivoire, Egypt, Equatorial Guinea, Libya, Nigeria, and Sudan. Inflation remained high in Angola at 23 per cent, but this represented a major improvement from 2004 (43.6%) and a major achievement from the triple-digit inflation rates experienced until 2002. Guinea and DRC experienced spikes in inflation (from 17.5% to 31.4% and from 4.0% to 21.4%, respectively) due to, among other factors, continued depreciation of the Guinea franc and international oil prices, and supply-side bottlenecks, a legacy of the civil war in DRC.

Table 1.2

Distribution of inflation rates in Africa, 2003-2005 (number of countries)

Range	2003	2004	2005
Less than 5 per cent	25	30	21
Between 5 and 10 per cent (10% excluded)	14	6	14
Between 10 and 20 per cent (20% excluded)	7	12	12
20 per cent and higher	5	3	4
Total number of countries	51	51	51

***Source**: IMF, 2006. **World Economic Outlook Database**, September 2006.*

Developments in the balance of payments are positive

The continent's trade surplus (goods and services combined) has increased since 2003, mainly because of rising international oil prices coupled with expansion in crude oil production. Africa's trade surplus increased to $31.6 billion in 2005 from $13.0 billion in 2004 as a result of a 49.2 per cent increase in the region's oil trade surplus (IMF 2005). Strong performance in merchandise trade and net current transfers resulted in a current account surplus for the continent for the second consecutive year.

Overall performance at the continental level shows substantial variations across countries. Non-oil economies in particular continue to experience current account deficits, which are accentuated by rising oil prices. Indeed, out of the 37 non-oil economies with adequate data, only 11 experienced an improvement in current account balance from 2004 to 2005. It is clear that the aggregate trade surplus at the continental level is largely driven by oil revenues, which raises concerns about the sustainability of such a surplus.

"Debt service obligations are a major drain on social services, such as education and health"

External debt remains high

Africa's total external debt stock stood at $282 billion in 2005, down from $305.8 billion in 2004 (IMF 2006). Debt service obligations are on the rise since 2002 and stood at $34.6 billion, following a decline from $32.8 billion in 1997 to $21.3 billion in 2002. However, in relative terms, the average debt burden for the continent has been declining since the early 1990s. From a peak of 31 per cent in 1992, the debt service/exports ratio declined to 11.2 per cent in 2005. The debt/GDP ratio declined from 74 per cent in 1994 to 35 per cent in 2005.

These aggregate measures mask wide cross-country variations and are influenced by movements of debt and exports among large countries, especially oil exporters such as Algeria and Nigeria. At the disaggregated level, debt service obligations continue to represent a major drain on national resources, with many African countries spending more on debt service than on social services such as education and health. Thus, debt is still very much a critical constraint to development of the continent.

To alleviate the debt burden, the G8, at its Summit in Gleneagles in 2005, committed to cancellation of the debt of 14 African countries that had already reached the Highly Indebted Poor Countries (HIPC) completion points. These were Benin, Burkina Faso, Ethiopia, Ghana, Madagascar, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda and Zambia. These countries were expected to start benefiting from complete debt cancellation beginning by early 2006, which should improve their debt position in the coming years. However, while these measures are a step in the right direction, they are insufficient to meet the development financing needs of African countries. Many low- and middle-income countries are not beneficiaries of the MDRI. The debt owed by SSA countries that qualify for debt write offs under the MDRI represents only 25 per cent of the continent's debt stock.

Addressing Africa's debt problems requires a comprehensive strategy. Such an integrated approach would enhance growth, increase exports, and raise domestic savings. It would thus reduce the need of African countries for more aid or borrowing in the future. The strategy should include:

- Extending debt relief to all poor countries (especially those recovering from conflict);

- Increasing new development aid so that debt relief is additional to, not a substitute for conventional development aid (Ndikumana 2004);
- Strict mechanisms that guarantee that the resources released by debt relief are invested in directly productive activities (especially infrastructure and social services); and
- Increasing access of African exports to Western markets, including preferential treatment arrangements and, most importantly, the removal of trade barriers in Western countries (e.g., removal of farm product subsidies).

"Africa needs to increase domestic revenue to prevent excessive dependence on aid"

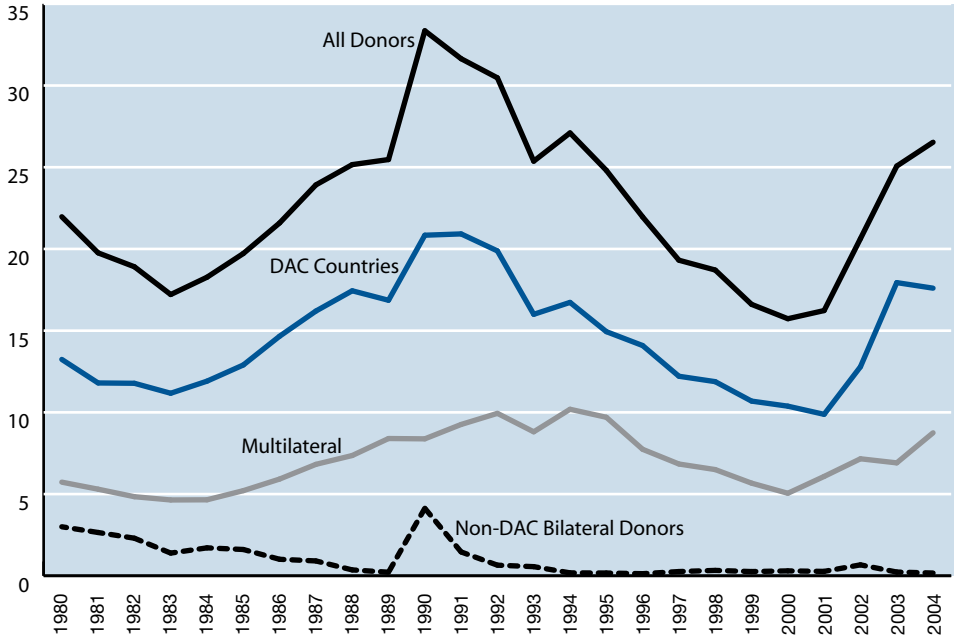
Official development assistance is rising but more is still needed

Total ODA to Africa continues its recovery from the long decline experienced between 1990 and 2001 (figure 1.6). ODA from all development partners stood at $26.5 billion in 2004 compared to $15.7 billion in 2000 (in constant 2000 dollars). The increase in aid since 2001 came from DAC and other multilateral donors. However, the rise in aid from 2003 to 2004 derived mostly from multilateral organizations, notably the World Bank, the African Development Bank and UN Agencies, including World Food Programme (WFP), United Nations Children's Fund (UNICEF) and United Nations High Commission for Refugees (UNHCR). This group contributed $2.2 billion (in nominal value) to the 2003-2004 aid increase. DAC donors disbursed a meagre $146.1 million while non-DAC bilateral donors have actually reduced aid to Africa for three consecutive years.

While ODA has increased recently in nominal terms, the resources received excluding emergency aid and debt relief increased only marginally from the past decade (UN 2006). Moreover, in real terms, aid inflows are still below the 1990 level of $33.3 billion. Aid to SSA has declined both as a percentage of Gross National Income (GNI) and as a percentage of Gross Capital Formation (GCF) since the early 1990s. From 6.5% in 1990-1994, the aid/GNI ratio declined to 5.3% in 2000-2003. The aid/GCF ratio declined from 40.7% to 27% during the same period (McKinley 2005).

To achieve and sustain higher levels of GDP growth rates and to accelerate poverty reduction, African countries will need higher volumes of aid in the coming years. With improvements in macroeconomic policies and institutions, and strong commitment by governments to target growth and poverty activities in the allocation of aid, it is possible for African countries to absorb higher levels of aid and reap more benefits from aid (see Commission for Africa, 2005; Millennium Project, 2005). Therefore, scaling up aid is not only necessary to achieve development targets but it is also feasible with regard to absorption capacity in receiving countries. New aid, however, should be in the form of grants to prevent a new round of external payment crisis. To prevent excessive dependence on aid, African countries also need to boost efforts to increase domestic revenue mobilization.

Figure 1.6
Official development assistance to Africa (constant 2003 $billion)



***Source**: OECD. 2005. International Development Statistics online databases*

Foreign direct investment remains low and concentrated

"Appropriate regulation is needed to address the detrimental impact of extractive industries on the economy and the environment"

During 2002-2004, Africa received a little over 2 per cent of FDI inflows in the world and less than 10 per cent of flows to developing economies (see chapter 2). FDI to Africa amounted to $30 billion, up from $18.1 billion in 2004. The distribution of FDI flows was uneven across subregions, with North Africa receiving about 30 per cent of the total compared to 10 per cent for East Africa. East Africa saw the largest increase in FDI (54.1%), while Southern Africa recorded more than 31.5 per cent decline in FDI from 2003 to 2004. Natural resource-rich countries continued to dominate in FDI inflows, with oil exporters capturing over 65 per cent of the annual FDI inflows to Africa between 2002 and 2004.

The heavy concentration of FDI in extractive industries raises concerns with regard to the impact on employment and poverty reduction as well as potential adverse effects on the environment. Given that production technology in these sectors is highly capital intensive, investment is generally accompanied by little job creation. Moreover, production in these sectors carries insufficient spillover effects on the rest of the economy as output is exported with little value added. Investments in extractive industries, especially oil, also tend to create environmental hazards with detrimental effects on the well being of local populations. These adverse effects to the economy, the environment and society need to be addressed by appropriate regulation.

Exchange rates remained stable in 2005

Most African currencies remained stable in 2005. In particular, the CFA franc was stable in 2005, with an appreciation of only 0.2 per cent against the US dollar. Only three currencies experienced an appreciation of more than 5 per cent: the Egyptian pound (6.8%), the Sudanese dinar (5.5%), and the Zambian kwacha (6.6%). The appreciation of the Egyptian pound was due to strong foreign exchange inflows and major improvements in the policy framework that boosted confidence in the national currency (SRO-NA, 2006). The Zambian kwacha appreciated because of high copper exports, and growing investor confidence, especially following the country's qualification for debt relief. The Sudanese dinar appreciated because of liberalization of the exchange rate regime, oil export revenue, and substantial capital inflows in the form of FDI and remittances.

> *"High interest rates, lack of access to credit and the cost of doing business discourage domestic investment and FDI"*

The stability of exchange rates is an important achievement given the number of appreciation risks faced by many countries. In particular, the surge in oil revenues and the high inflows of aid put pressure on national currencies, causing them to appreciate. The observed results are partly attributable to efforts by monetary authorities to sterilize the inflows through appropriate market interventions.

1.5 Despite high growth performance, important development challenges remain

Saving and investment rates remain low

Among the factors explaining the inability to achieve and sustain high growth rates in many African countries is low domestic investment. Average gross domestic fixed investment for the continent was only 20 per cent in the 2000-2003 period. Domestic investment has not recovered from the decline in the early 1980s and has not responded to economic reforms aimed at macroeconomic stabilization. Out of 46 countries with adequate data, only nine achieved high investment rates, that is, at least 25 per cent of GDP during 2000-2003 (figure 1.7).

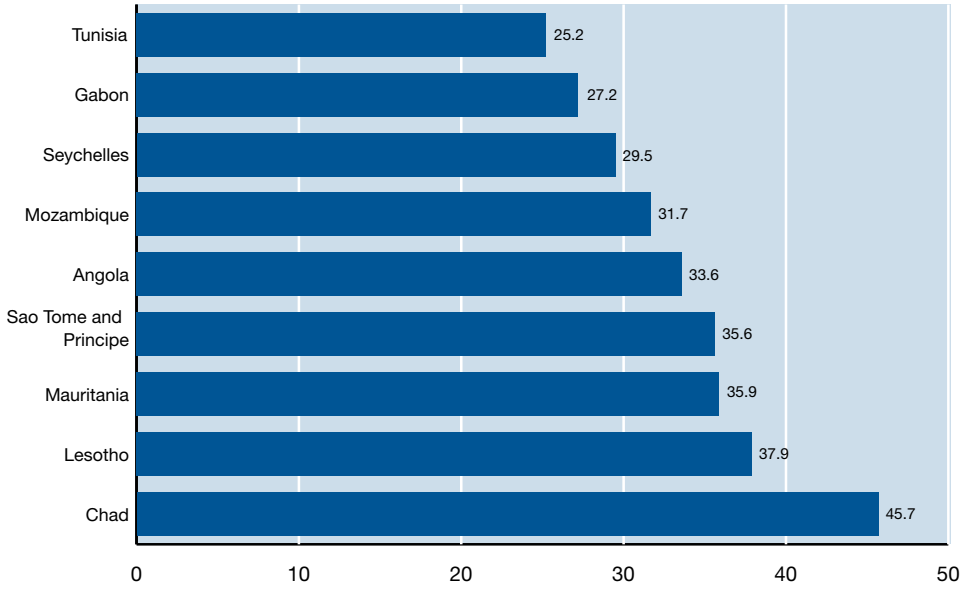
Major constraints to investment are high interest rates and general lack of access to credit, especially for medium and small enterprises (MSEs). The cost of doing business in African economies is also generally perceived as being much higher than in other regions, thus discouraging both domestic investment and FDI (UNECA 2005).

Saving rates are also low in most African countries, mostly due to low incomes and inefficiencies in savings mobilization by financial systems. Only seven countries recorded an average saving rate of 25 per cent or higher during 2000-2003. However, low saving rates provide only a partial explanation for the low levels of investment.

While saving rates have increased since the mid-1990s, this has not been accompanied by substantial recovery in investment (figure 1.8). In addition to the cost of doing business, another cause of the weak linkage between saving and investment in Africa is that financial systems are inefficient and fail to allocate capital optimally in the economy (Senbet and Otchere 2005).

Figure 1.7

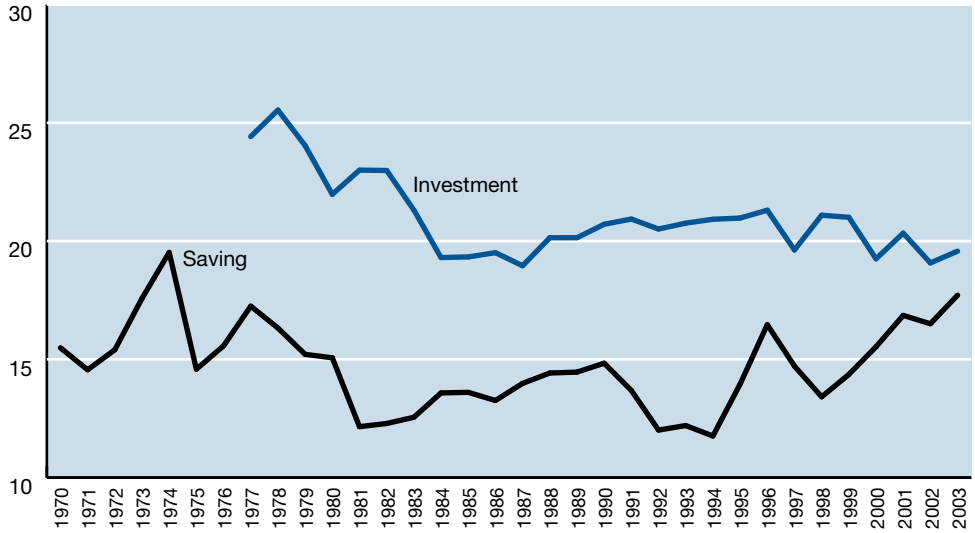
African countries with at least 25% investment-GDP ratio, 2000-2003



***Source**: World Development Indicators 2005.*

Figure 1.8

Gross domestic fixed investment and saving (% of GDP) in Africa, 1975-2003



***Source**: World Development Indicators 2005.*

***Note**: This figure includes 26 African countries with adequate data on savings and fixed investment over 1975-2003.*

Job creation remains a challenge

Another disappointing feature of the recent growth record in Africa is that growth has not been accompanied by substantial gains in job creation, which raises serious concerns about the continent's ability to achieve meaningful poverty reduction (UNECA 2006b). The first cause of the low employment performance on the continent is the inability to sustain high growth over an extended period. High volatility of GDP growth reduces incentives for job creation in the private sector due to the uncertainty of future profitability.

"Africa's economic growth has not been accompanied by substantial gains in job creation"

The second cause is that growth rates have not been high enough in many countries to generate enough demand for labour. In addition, in many countries, GDP growth has not kept pace with growth of the labour force. Indeed, the strong average performance at the continental level masks wide disparity across countries, with many countries stuck in a low-growth equilibria.

The third cause of poor employment performance is the shift of economic activity away from agriculture into capital-intensive sectors such as mining and oil production. From 1994 to 2003, 35 out of 51 countries (with adequate data) experienced a decline in the share of agriculture in GDP (World Bank 2005). This shift of economic activity away from agriculture has been accompanied by little or no increase in productivity in the agricultural sector and very low absorption of labour into the non-agricultural sector, resulting in high under-unemployment in the rural/agricultural sector.

The human development record is still low

While the developing world in general has made significant progress towards achieving the MDGs over the past decade, most African countries are still lagging behind in both investments and outcomes in key areas of social and economic development (UNECA 2005a). SSA is the only region of the developing world where the poverty headcount has increased since 1980 (UNECA 2005b). SSA also has the highest number of people lacking access to clean drinking water (269 million) and sanitation (407 million), (UNDP 2006). In the 2005 *Human Development Report*, 30 of the 32 countries classified in the "low human development" category based on the Human Development Index (HDI)[6] are from SSA (UNDP 2005). The level of human development in SSA is not only lower than in other parts of the world, but it is also progressing at a slower pace since the mid-1980s.

Despite recent strong growth, there are concerns about its impact on social development and its sustainability in the medium term. While African countries have achieved higher growth rates than in previous decades, these rates still fall short of the threshold required to accelerate poverty alleviation and achieve the MDGs. On a medium-term basis, only four countries met the seven per cent growth threshold (figure 1.5): Equatorial Guinea, Chad, Angola, and Mozambique. Overall, very few African countries have been able to sustain sufficiently high economic growth rates, which largely explains the slow progress in social development.

"Africa's growth rates still fall short of the MDG threshold"

An important cause of the slow progress in human development is the fact that growth has not been accompanied by significant job creation. The concentration of growth in capital-intensive sectors such as oil and mining and the shift away from agriculture without absorption of the displaced labour, have contributed to job losses and the worsening of living standards.

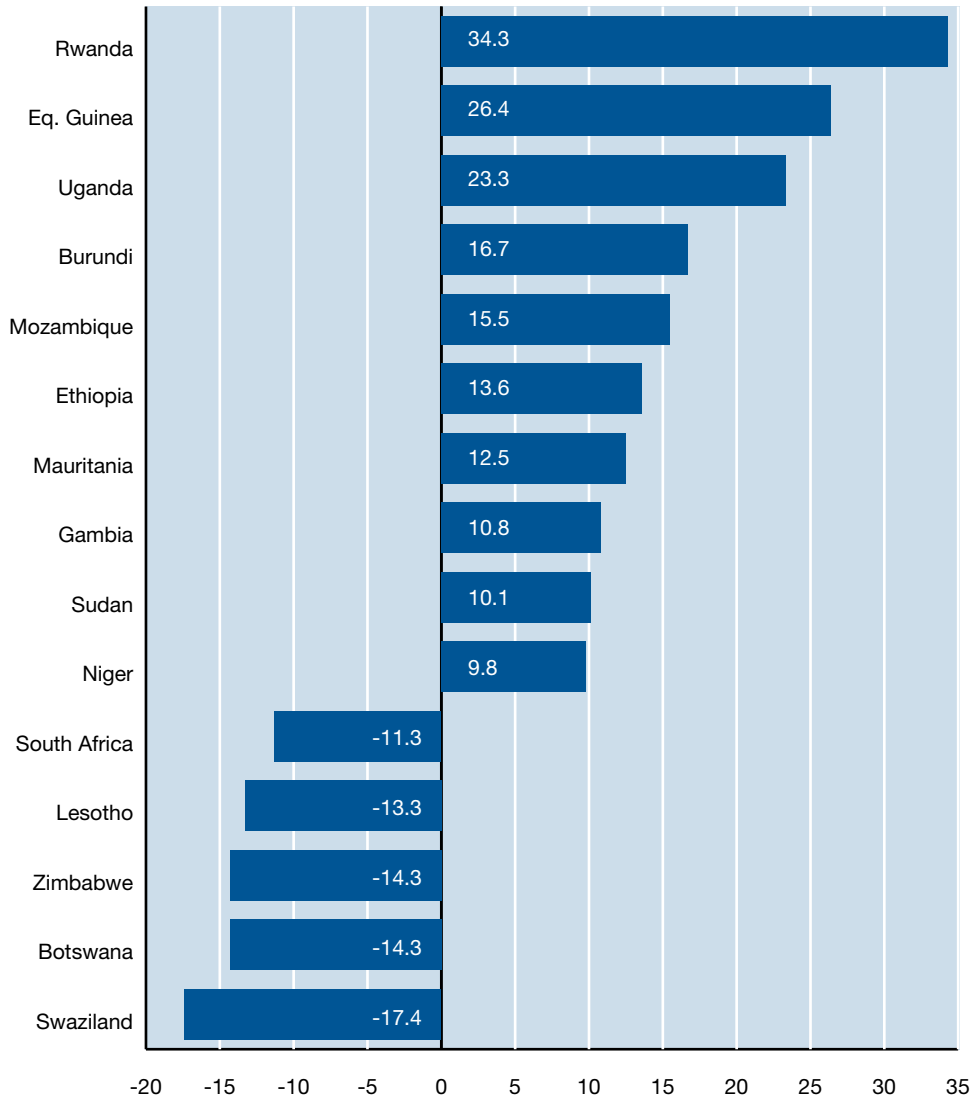
Nevertheless, there are large variations in performance in human development across the continent. Many African countries registered substantial increases in HDI over the past years, while others experienced deterioration in living standards (see figure 1.9). Note that six of the top performers in human development also rank among the top performers in medium-term growth as indicated in figure 1.5 (Equatorial Guinea, Ethiopia, Mozambique, Rwanda, Sudan, and Uganda). Top performers in human development include post-conflict countries, such as Rwanda, Uganda, and Mozambique, which also posted high growth rates in the past few years. The decline in HDI in Southern African countries as shown in figure 1.9 can be attributed to the worsening health situation due to HIV/AIDS.[7]

6 HDI measures a country's achievements in three aspects of human development: longevity, knowledge, and a decent standard of living. Longevity is measured by life expectancy at birth; knowledge is measured by a combination of the adult literacy rate and the combined gross primary, secondary, and tertiary enrolment ratio; and standard of living, as measured by GDP per capita.

7 In 2003, southern African countries exhibiting high HIV/AIDS prevalence rates were: Botswana (37.3%), Lesotho (28.9%), South Africa (21.5%), and Swaziland (38.8%).

Figure 1.9

Top 10 and bottom 5 performers in human development, % change in HDI between 1995 and 2003



***Source**: UNDP, Human Development Report 2005*

While many African countries are experiencing worsening social conditions, several have made progress toward meeting the MDGs, as measured by gains in various dimensions of social development, such as higher access to clean water and sanitation, increase in literacy, reduction in maternal and child mortality, and overall improvement in life expectancy (UNECA 2005). For example, out of the 51 countries with adequate data, child mortality declined in 34, stagnated in 9, and increased

Progress in social development is hampered by inequality

in 8 countries (table 1.3).[8] Progress in social development is hampered by inequality, with poorer families experiencing slower progress than rich households. For example, about 38 per cent of children from the poorest 20 per cent of African households do not go to school, compared to 12 per cent for the richest 20 per cent of the households (UN 2005). Similar disparities are observed in the area of immunization and access to basic social services (UNDP 2005). The evidence suggests that while progress has been made in some countries, all African countries still need to increase efforts to accelerate progress towards achieving the MDGs.

Table 1.3
Progress in achieving the MDGs in Africa

Goals	Countries that are likely to achieve the targets
Goal 1: Eradicate extreme poverty and hunger	Poverty: Botswana, Burkina Faso, Cameroon, Ghana, Lesotho, Mauritius, South Africa, Uganda and North African countries except Mauritania and Sudan. Child malnutrition: Botswana, Chad, Egypt, Gambia, and Tunisia. Overall undernourishment: Angola, Ghana, Malawi, Mauritius and North African countries except Sudan.
Goal 2: Achieve universal primary education	Net enrolment and completion rates: Algeria, Botswana, Cape Verde, Egypt, Gabon, Mauritius, Namibia, Swaziland, Rwanda, São Tomé and Principe, Seychelles, South Africa, Togo, Tunisia, and Zimbabwe
Goal 3: Promote gender equality	Primary level education: Botswana, Lesotho, Mauritius, Namibia, Rwanda, Swaziland, South Africa, Malawi, Zambia and Zimbabwe. Secondary level: Algeria, Botswana, Lesotho, Libya, Namibia, Zimbabwe, Mauritius, Swaziland, South Africa, Rwanda and Tunisia
Goal 4: Reduce child mortality	Cape Verde, Mauritius, Malawi, Seychelles and North African countries except Mauritania and Sudan.
Goal 5: Reduce maternal mortality	Botswana, Cape Verde, Gambia, Mauritius and North African countries except Mauritania and Sudan.
Goal 6: Combat HIV/AIDS, malaria and other diseases	HIV/AIDS: Botswana, Uganda and Zimbabwe. Malaria: Benin, Cameroon, Central African Republic, Comoros, Gambia, Guinea-Bissau, Kenya and Rwanda. Tuberculosis: Angola, Gabon, Gambia, Madagascar, South Africa, Swaziland, Zambia and North African countries except Mauritania and Sudan in all the three cases (HIV/AIDS, Malaria, and Tuberculosis)

8 Note that the progress report in table 1.3 is based on performance over 1990-2000 and does not take into account progress and setbacks thereafter. For example, Mauritania and Sudan experienced regression in child health status due to the effects of political instability.

Goals	Countries that are likely to achieve the targets
Goal 7: Ensure environmental sustainability	Sustainable development (forest area): Cape Verde, Gambia, Swaziland and North African countries except Mauritania and Sudan. Access to safe drinking water (rural): Algeria, Botswana, Burundi, Central African Republic, Egypt, Gambia, Ghana, Mauritius, Malawi, Sudan, Tanzania, and Namibia. Access to sanitation (urban): Algeria, Benin, Cameroon, Egypt, Ghana, Libya, Malawi, Mauritius, Morocco, South Africa and Tunisia.

***Source**: UNECA, 2005. **Survey of Economic and Social Conditions in Africa 2004-2005**. Addis Ababa, Ethiopia.*

Inequality remains high and hampers progress in poverty reduction

Another important challenge that limits progress in poverty reduction is the high levels of inequality in many African countries. Inequality manifests itself in various forms: income inequality, asset inequality, and inequality in access to education, health services, and labour markets. Moreover, in addition to vertical inequality, evidence continues to show substantial horizontal inequality across the continent. Empirical evidence suggests that high inequality substantially reduces the rate at which growth is transformed into poverty reduction (Fosu 2006). Therefore, in addition to strengthening strategies for accelerating growth, achievement of broad-based development must remain one of the priorities in debates over national economic policy.

> *Accelerating growth and broad-based development must remain a priority*

Progress in closing the gender gap is still not enough

African countries continue to exhibit pervasive gender inequality in basic rights, access to productive resources and economic opportunities, and lack of political voice. The international development community has come to the realization that the issue of gender inequality can no longer be relegated to the domain of advocacy, but must occupy the centre stage in the economic development policy discourse (World Bank 2001). The focus on gender inequality is illustrated by the large and growing number of national and international declarations and conventions on the issue. However, actual implementation of these declarations remains weak, perhaps because of the lack of effective institutional backing.

There are important reasons why African policymakers should pay attention to gender inequality and seek ways to eliminate it. One overriding reason is that while gender inequality harms women primarily, it also imposes heavy costs on society as a whole. Inequalities in basic rights and access to schooling, credit and jobs affect not only women and girls but the entire society.

Inequalities in basic rights and access to schooling, credit and jobs affect not only women and girls but the entire society

It is encouraging that throughout the continent, there are visible gains in closing the gender gap, especially in education. Girl enrolment rates in elementary and secondary schools have increased substantially, and often faster than those of boys (table 1.4). Consequently, the ratios of female to male enrolment and primary school completion rates have increased in many countries.

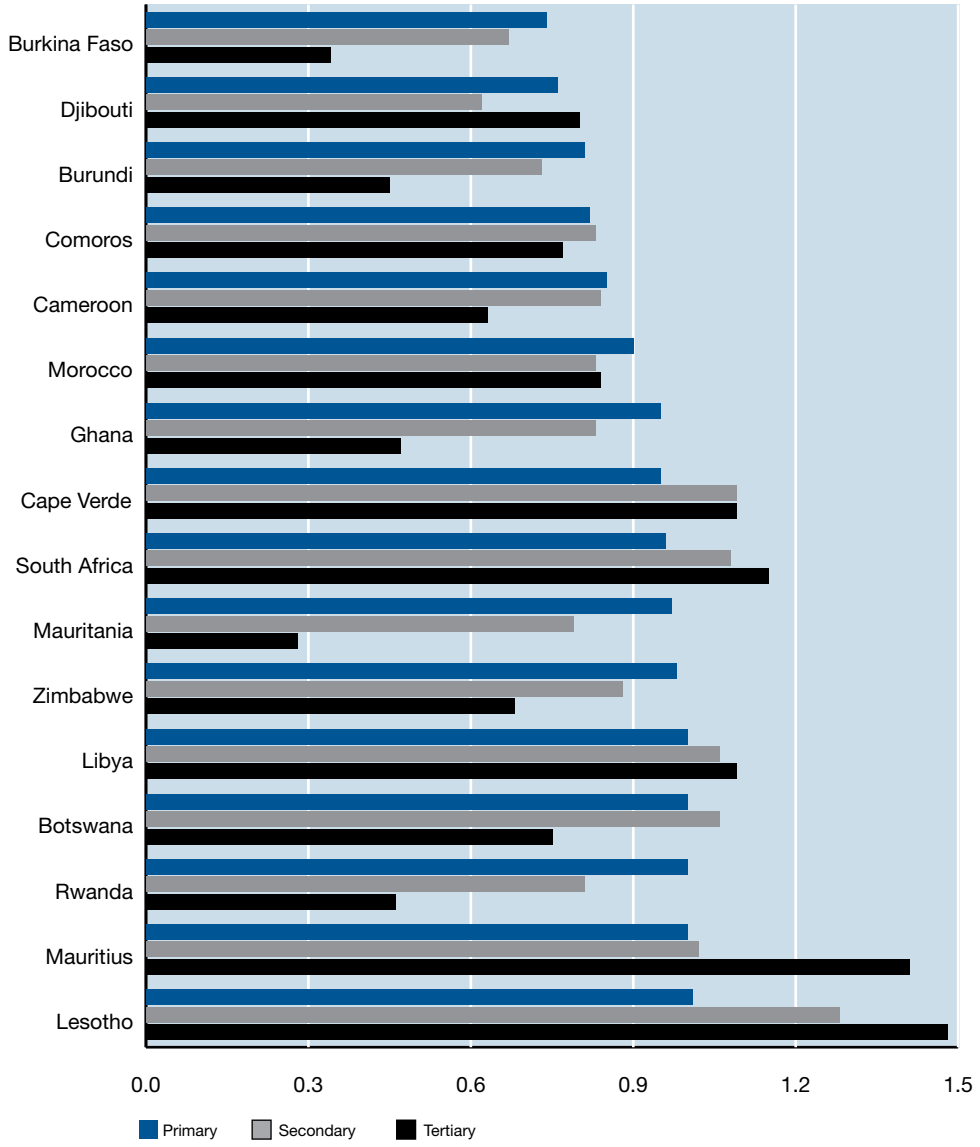
It is also clear that some countries still exhibit large gender gaps in education regardless of the progress achieved over the past years. Women are especially lagging behind in higher education, with only a few countries reaching gender parity in recent years (figure 1.10).

Table 1.4
Gender gap in education, 1990-2002

	Ratio of girls to boys in primary school		Ratio of young literate females to males (% of age 14-25)		Ratio of female to male primary completion rate	
	2002	% change 1990-2002	2002	% change 1990-2002	2002	% change 1990-2002
Algeria	98.6	18.3	91.1	15.1	0.99	16.3
Burundi	79.4	-2.9	96.9	26.3	0.72	-16.0
Chad	58.8	41.9	84.4	30.7	0.47	108.4
Comoros	82.2	15.7	79.5	2.2	0.89	n.a.
Djibouti	71.2	1.7	91.2	16.7	0.84	n.a.
Ethiopia	n.a.	n.a.	82.1	24.3	0.54	n.a.
Ghana	91.0	18.5	95.7	11.9	1.05	38.7
Madagascar	n.a.	n.a.	92.5	8.1	1.03	-0.4
Malawi	92.5	14.7	76.7	13.5	0.96	23.6
Mali	71.3	22.5	n.a.	n.a.	0.64	-0.7
Mauritania	93.8	38.9	72.7	12.0	0.90	38.1
Morocco	87.8	25.2	79.2	28.2	0.89	30.8
Mozambique	79.0	8.2	64.3	34.2	0.67	3.0
Niger	69.0	24.0	44.4	18.8	0.71	25.3
Rwanda	94.8	-1.6	96.9	12.1	0.95	-5.3
Senegal	87.1	27.2	72.5	20.1	0.81	n.a.
South Africa	100.4	-2.7	100.0	0.2	1.06	n.a.
Sudan	85.8	10.9	88.5	23.7	0.85	4.5
Swaziland	94.4	-2.1	101.8	0.9	1.05	-3.3
Uganda	96.3	24.7	85.7	13.1	0.86	n.a.
Zimbabwe	95.4	-0.7	97.3	2.9	0.94	0.0

***Source**: World Bank, **World Bank African Database** 2005 CD ROM and **World Development Indicators** 2005 CD ROM*

Figure 1.10
Gender gap in enrolment (female/male ratio) in 2002.



***Source**: World Bank, **World Development Indicators 2005**.*

***Note**: The figure includes only countries with adequate data.*

The case of conflict and post-conflict countries

Post-conflict countries face particular challenges arising from the effects of war and the immense financial needs associated with reconstruction. These countries are faced with the challenge of making myriad policy priorities, from infrastructure and energy

to social service delivery and from macroeconomic stabilization to micro-level and regulatory reforms. Nonetheless, many post-conflict countries have recorded high growth rates in recent years, due primarily to the restoration of peace, but also to government efforts to invest in reconstruction often with generous support from the donor community.[9] Countries such as Mozambique, Rwanda, and Uganda are good examples of economies achieving strong performance in their post-conflict era.

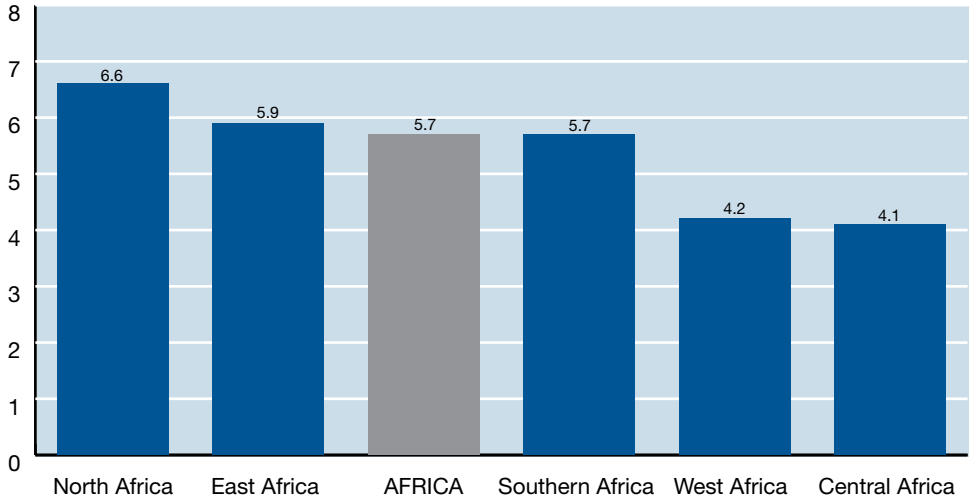
"Peaceful settlements of conflicts must be initiated and sustained for meaningful development and poverty reduction"

Countries that are still in conflict face even bigger challenges with regard to development, employment creation and poverty reduction. Insecurity in these countries also threatens economic activity and political stability in neighbouring countries and beyond. Efforts at the national, regional, and international level must be initiated and sustained to achieve peaceful settlement of conflicts and also to establish institutional mechanisms of democratic governance as a way of preventing future conflicts (Fosu 2005).

1.6 Growth prospects for 2006 are positive

Africa is expected to continue with the strong growth performance posted over the past two years. The growth rate is projected at 5.7 per cent in 2006, with North Africa leading all the subregions with a growth rate of 6.6 per cent (figure 1.11). As many as 31 countries are anticipated to post higher growth than in 2005. Growth performance will be driven by several factors, which are discussed below.

Figure 1.11
Projected real GDP growth rates by subregion, 2006 (%)



***Source**: EIU, September 2006.*

9 A.K. Fosu, and P. Collier, eds. (2005). *Post-Conflict Economies in Africa*. New York: Palgrave Macmillan.

Favourable factors for growth

Oil export revenues are expected to remain high

Oil-rich countries are expected to benefit from continued strong performance in exports thanks to high international oil prices. However, the gains from the oil boom accruing to oil economies will be counterbalanced by the adverse effects of higher energy costs on growth among non-oil economies.

Global demand will support higher exports

Global demand for African products – especially oil, minerals and agricultural – is expected to remain upbeat due to economic recovery in major industrial countries. Tourism will also benefit from strong growth in industrialized countries. While growth in the Euro area is expected to be moderate, the United States and emerging Asian economies – led by China – are likely to experience substantial growth in the coming two years (Board of Governors of the Federal Reserve System, 2006).

Delivery of promised new aid and debt relief will boost domestic expenditure

Delivery of the promised aid and debt relief will allow African countries to boost expenditures in key sectors including infrastructure and social services. Higher investments in public infrastructure will contribute to lowering private production costs, which will improve the investment climate. This will boost private investment and lead to higher economic growth rates.

Better macroeconomic fundamentals will serve to contain long-term inflation expectations

Success in consolidating macroeconomic management will help not only in containing inflation in the short run, but also in containing long-term inflation expectations. This will in turn help in maintaining low long-term interest rates, thus reducing the cost of long-term borrowing for the government and the private sector. Containing long-term inflation expectations is also necessary to minimize the lasting effects of short-term shocks to the price level, such as energy price hikes.

Improved political stability

Some countries such as Burundi, the DRC, Liberia and Sierra Leone, are expected to benefit from improvements in political stability. Consolidation of political stability will necessitate support from the international community both financially and

politically. The dividends from such support are high in terms of economic recovery and peace building, both at the country and regional levels.

Constraints to medium-term growth

The rise in world interest rates will increase the cost of debt servicing

To contain inflationary pressures, the United States and other major industrial countries will likely pursue their "prudent" tightening of monetary policy by raising short-term interest rates (FRB 2005). Higher world interest rates will raise the cost of external debt service for African countries, which will dampen growth.

Droughts remain a threat to agricultural production

Agricultural production is expected to be severely affected by climatic shocks, including droughts, floods, and desertification in the Sahel.

The HIV/AIDS pandemic remains a threat to labour supply and labour productivity

Economic growth in many countries will be compromised by the increasing spread of the HIV/AIDS pandemic, which undermines labour supply and labour productivity.

Insufficient economic diversification remains an important source of vulnerability to shocks

Lack of diversification of production and exports constitutes an important source of potential instability and vulnerability to shocks. Oil economies are particularly vulnerable to swings in international prices. Competitive pressure from emerging economies, such as China and India, is a challenge to manufacturing sector growth.

Inefficient and inadequate public infrastructure remains a constraint to private sector growth and economic diversification

Lack of efficient public infrastructure and unreliable energy supply undermine productivity and international competitiveness, which ultimately slows down economic growth.

1.7 Conclusion and policy recommendations

The evidence surveyed in this chapter calls for a number of policy recommendations, including the following:

Consolidating macroeconomic management

At the macroeconomic policy level, African countries need to continue to pursue fiscal discipline and prudent monetary policy to consolidate macroeconomic stability. Efficient macroeconomic management will, among other gains, reduce inflation expectations, which will minimize long-term effects of supply shocks such as oil price increases.

Promoting economic diversification

The concentration of growth in natural resource sectors exposes African countries to terms-of-trade shocks. Efforts must be enhanced to promote new investments in manufacturing and service sectors to reduce vulnerability to these types of shocks and dependency on commodity exports.

Alleviating energy and public infrastructure bottlenecks

The provision of public infrastructure and reliable energy sources is essential for unlocking the potential of the private sector and increasing access to social services and markets for the poor; it is an important element of the poverty eradication agenda. Improvement of the stock of infrastructure and creation of reliable energy supply sources must then rise to the level of national priority to increase economic growth in the medium term.

Achieving greater gender equity

Efforts to increase gender equity in basic rights, access to productive resources and economic opportunities, and political voice must be supported and intensified at the national, regional and international levels.

Intensifying efforts at regional integration

Efforts at regional integration need to be intensified as a means of expanding trade opportunities and increasing the continent's leverage in world trade negotiations.

Addressing climate shocks

African countries need to invest in strategies for managing climate risk in order to increase their preparedness in handling climate shocks.

Curbing the spread of the HIV/AIDS pandemic

Public investments in preventive and educational programmes to fight the spread of HIV/AIDS will help to curb the upward trend of the epidemic while at the same time creating jobs for those who will be employed in those programmes.

Emphasizing job creation as a means of accelerating poverty eradication

In addition to raising the overall rates of economic growth, African countries need to design strategies for increasing the employment gains from growth. This will require both higher public investments in labour-intensive infrastructure and service-delivery programmes as well as providing incentives to the private sector to increase the overall labour intensity of production.

In addition, policymakers must integrate job creation in national macroeconomic frameworks. This will require, among other things, systematic tracking of the effects of monetary and fiscal policy on employment at the economy-wide level and at the sectoral level.

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Capital flows to Africa and their impact on growth

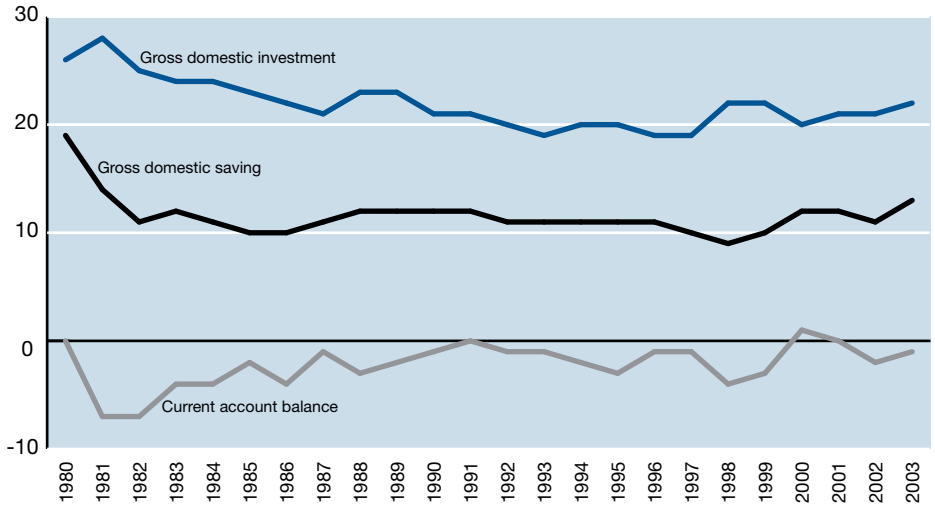
2.1 Introduction

Although inflows of capital to Africa have increased recently, they still fall short of the resources needed to fund attainment of the internationally agreed development goals. In both 2004 and 2005, average GDP growth in Africa reached 5 per cent, still falling short of 7 per cent, the rate required to meet the MDGs. Thus, the mobilization and more effective use of both domestic resources and international flows have been given top priority in the Monterrey Consensus. As African economies are increasingly interwoven with the global economic system, national development efforts need to be supported by an enabling international economic environment (UN 2002).

"Average GDP still falls short of the rate required to meet the MDGs"

Figure 2.1 illustrates the resource gaps in Africa. Due to low private savings and chronic government budget deficits, many African countries face a shortage of funds to meet their investment needs and more generally, their development goals. United Nations Conference on Trade and Development (UNCTAD 2000) estimated that the investment rate in SSA has to increase to 22-25 per cent from the levels below 20 per cent during the 1990s to reach a sustainable growth rate of 6 per cent.

Figure 2.1
Resource gaps in 36 African countries, 1980-2003 (% of GDP)



***Source**: World Bank 2005b.*

***Note**: GDS = Gross Domestic Savings, GDI = Gross Domestic Investment. The aggregation is based on 36 countries for which all indicators were available for all years. Weighted averages were used to calculate shares of GDP.*

Efficient utilization of financial flows to Africa is key to maximum input on growth and welfare

Changes in saving rates have mainly been driven by the public sector, which showed a deteriorating performance in the 1990s, and only recently improved for some countries (see chapter 1). The fact that private savings are low is not only due to low national income but also to the underdevelopment of the financial system. Household surveys show that many households have assets of around 30 per cent of their incomes but they are mainly in the form of durable goods such as gold (i.e. jewellery) and fabrics, and not in the form of bank savings, which could be used for productive investment (Aryeetey 2005).

Another dimension of these resource gaps is the substantial current account deficits arising from failure of export revenues to keep up with imports (figure 2.1). Current account problems are especially pronounced among countries that depend on raw material exports (UNECA 2005b).

The resource gaps need to be filled by capital flows from abroad, including development aid, debt relief and private capital flows, such as FDI, portfolio investment, and remittances. The debate on promoting sustainable development in Africa must therefore include a discussion of strategies to attract capital flows to the continent.

Several attempts have been made to estimate the resources necessary to achieve the MDGs. They range from $50 billion a year in the "Zedillo Report" of the High-Level Panel on Financing for Development to more than $76 billion a year by the World Bank and UNDP (Reddy and Heuty 2005).[1] As government revenues and private savings remain too low to cover these expenses, external finance is needed. However, it is not sufficient to increase financial flows to Africa in order to accelerate growth and reduce poverty. It is necessary to allocate and utilize these resources efficiently to maximize their impact on growth and welfare.

In order to form a basis for the remainder of this report, this chapter examines the trends and patterns of capital flows to Africa and the extent to which these capital flows meet the financing needs of African countries. The chapter also investigates the determinants of flows and their impact on African economies. The main findings are summarized below.

Since 2000 capital inflows in the form of aid, workers remittances and FDI have increased considerably, by 54 per cent until 2003. Their volatility, which is highest for private flows, hampers their growth effects. The continent has also experienced substantial resource outflows in the form of debt service, capital flight and profit remittances.

Aid is the most important inflow for most African countries and is mainly used for social services. However, it has also contributed to Africa's indebtedness. Thus, cur-

1 These estimates are not very reliable as they are based on poor quality data and do not take into account interlinkages between the different goals or economies of scale or scope. In addition, resource requirements might be changed considerably by future shocks (Reddy and Heuty 2005).

rent debt reduction efforts have to ensure that the resources freed are used to boost productive activities to make debt levels sustainable.

While most FDI is still concentrated in the primary resource sector, some diversification in terms of sectors and origin is observable. Africa is still outside of the foreign investors' radar screen much more than other regions, despite relatively high rates of return on investment in Africa. Remittances are also concentrated in a few African countries, mainly in Northern Africa. They are relatively stable, countercyclical and directly reduce poverty. Currently, they are mainly used for consumption but they also can increase productivity through investment in schooling, better agricultural inputs and small businesses.

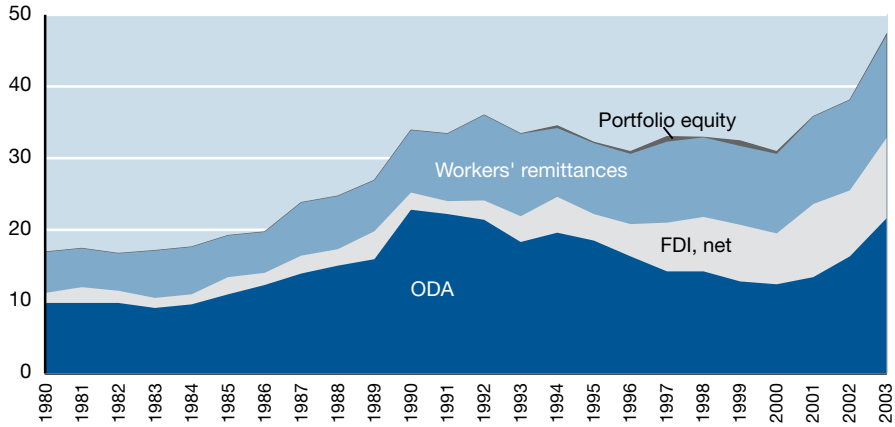
> *Remittances can increase productivity through investment in schooling, better agricultural inputs and small businesses*

2.2 Trends in capital flows to Africa

All major capital flows to Africa have increased considerably since 1980, especially FDI, which increased eightfold over the period 1980 - 2003 (figure 2.2). For most of the time, ODA has been the most important source of capital inflows, followed by workers' remittances and FDI. Portfolio investment accounts for a minor share in capital flows, except for South Africa, which is excluded from figure 2.2. In 2003, ODA accounted for 46 per cent of all capital inflows to Africa, whereas workers remittances accounted for 30 per cent, FDI for 24 per cent and portfolio flows for only 0.15 per cent (excluding South Africa).

Figure 2.2

Resource inflows to Africa, 1980-2003 ($ billion)

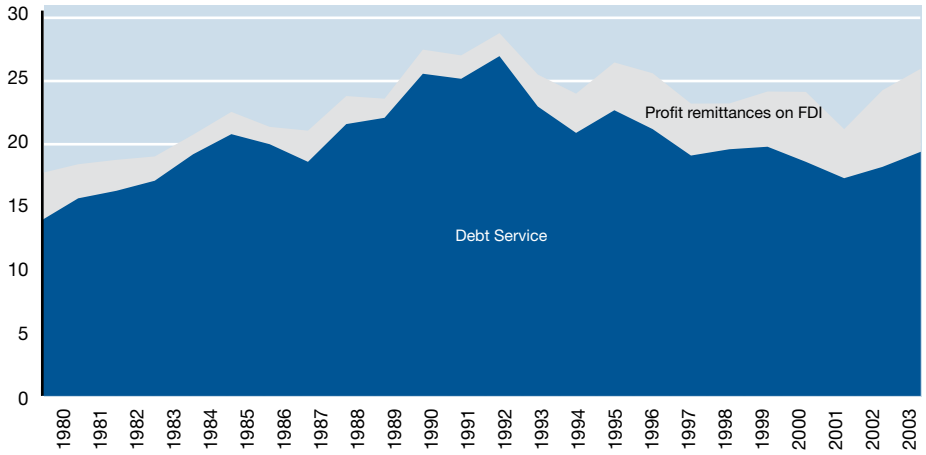


***Source**: World Bank 2005a.*

***Note**: 46 countries are included in the figure: Seven countries (Angola, Cape Verde, Eritrea, Libya, Mozambique, Namibia and South Africa) were dropped from this calculation due to missing data.*

Figure 2.3

Resource outflows from Africa, 1980-2003 ($ billion)



***Source**: World Bank 2005a.*

Note: forty-six countries are included in the figure: Seven countries (Angola, Cape Verde, Eritrea, Libya, Mozambique, Namibia and South Africa) were dropped from this calculation because there are missing data.

The main outflow from most countries is debt service (figure 2.3). Between 1984 and 1986, debt service payments were higher than the inflows of ODA, FDI, remittances and portfolio investment combined. Other outflows consist of profit repatriation from FDI, which accounted for approximately one third of debt service payments in 2003, but has been increasing rapidly since the beginning of the 1990s. In addition to these officially registered flows, there is capital flight, which is estimated to amount to between $3 and $13 billion per year.

These aggregate figures obscure significant cross-country differences within Africa. Although ODA is the most important inflow for most African countries, FDI has been more important between 1980 and 2003 for several countries, namely Angola, Equatorial Guinea, Nigeria, Seychelles and South Africa. For North African countries, as well as Lesotho and Swaziland, workers' remittances are the most important inflows.

The role of aid in external financing varies considerably

After a decline in the 1990s, ODA to Africa has been increasing again since 2002 (see chapter 1). At Gleneagles, the G-8 countries committed an additional $50 billion, of which 50 per cent should go to Africa. ODA has already increased from 0.25 per cent of GNI in 2004 to 0.33 per cent in 2005 and is estimated to increase further to around 0.4 per cent by 2010 (OECD 2006).

In 2003, per capita ODA to Africa was $31, third to Oceania and Europe and twice the average for all aid recipients.[2] In absolute terms, the top five recipients between 2000 and 2004 were the Democratic Republic of Congo (8 per cent of all ODA to Africa), Mozambique Ethiopia, Egypt, and Tanzania (6 per cent each). However, in terms of per capita ODA, the five countries with the highest allocation were Cape Verde, São Tomé and Príncipe, Seychelles, Djibouti, and Mauritania (OECD 2006), all countries with small populations.

"ODI to Africa is estimated to increase to 0.4% by 2010"

In general, ODA is not equally distributed among the African subregions (figure 2.4). For most of the 1980 to 2003 period, Southern Africa was the largest recipient both in terms of ODA as a share of GNI and in per capita terms ($38 in 2003). It was followed by East Africa with $24 per capita. West and Central Africa both received 6 per cent of GNI as ODA with the former getting $20 per capita and the latter getting $32 per capita. North Africa received the lowest share, both as a share of GNI and on a per capita basis (average of $18).

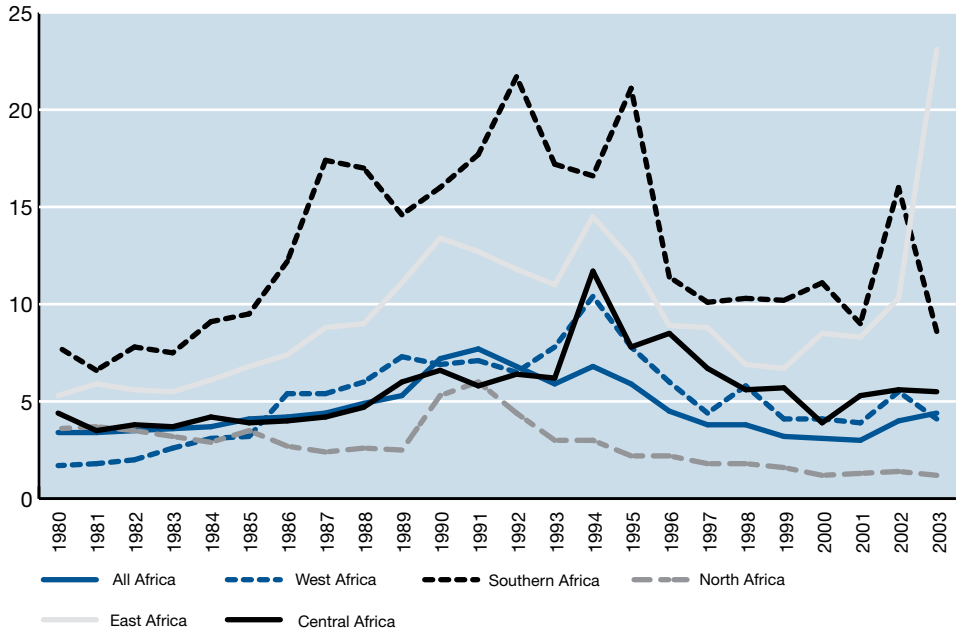
With respect to the sectoral distribution, the largest percentage of ODA to Africa in 2002/2003 went to social infrastructure and services (34 per cent), including education and health. Another important sector was economic infrastructure and services (21 per cent), including transport and energy. Together with support for production (12 per cent), aid allocation to these sectors was expected not only to reduce the financing gap but also contribute to future growth perspectives.

About half of the total aid to basic health and education was targeted towards gender-specific concerns, such as empowerment of women. However, only a relatively small share of aid projects for infrastructure had gender equality as a principal or significant objective (OECD 2005, 2006). Increasingly, ODA is given in the form of budget support instead of project and programme aid, making its use more flexible for recipients and reducing the problems of tied aid.[3]

2 The amount of grants reported by donors partly includes debt forgiveness, which is not associated with an actual transfer of resources (Birdsall, Claessens and Diwan 2002).

3 Tied aid means that at least part of the amount received has to be spent by purchasing goods and services from the donor country. This reduces the efficiency of aid.

Figure 2.4
ODA receipts by African subregion, 1980-2003 (% of GNI)



***Source**: World Bank 2005b.*

In many African countries, a large share of public investment (e.g. in infrastructure) and social expenditure (especially education and health) is financed by aid, making these crucial sectors vulnerable to aid volatility. In general, the volatility of programme aid is higher than that of project assistance.4 As the latter is designed to promote investment in physical and human capital, its volatility is likely to have severe negative effects on long-term development (Fielding and Mavrotas 2005).

FDI is the most volatile form of capital flows

High volatility of capital flows causes severe balance-of-payment problems, increases macroeconomic uncertainty, and undermines government's ability to design and sustain long-term development plans. Indeed, by introducing instability into private investment or imports, such volatility may adversely affect growth (Fosu 2001). On average, FDI flows are the most volatile, followed by workers remittances, whereas ODA flows are the least volatile (table A1).[5] Other private capital inflows (excluding FDI) are more volatile than FDI (Morrissey and Osei 2004; IMF 2005a). In the 1990s, the volatility of capital inflows generally increased (Osei, Morrissey and

4 Aid volatility is measured by shocks to aid, based on expectations about the change in aid as a result of the change in some macroeconomic variables.

5 Volatility is measured by the average coefficient of variation, defined as the standard deviation expressed as a percentage of the mean value over time. Portfolio investment is excluded here as it is not very relevant for most African countries and therefore data are scarce.

Lensink 2002). The volatility of the combined inflows of aid, FDI and remittances is smaller than the individual volatilities, meaning that the individual volatilities offset each other to some extent.

As FDI to the continent is largely driven by investments into natural resource exploitation in a limited number of very large projects, the volatility of FDI is quite high. For Chad, for instance, the coefficient of variation is 205 (table A1). Other causes of high volatility include the low level of FDI itself, the small number of FDI projects, and political instability.

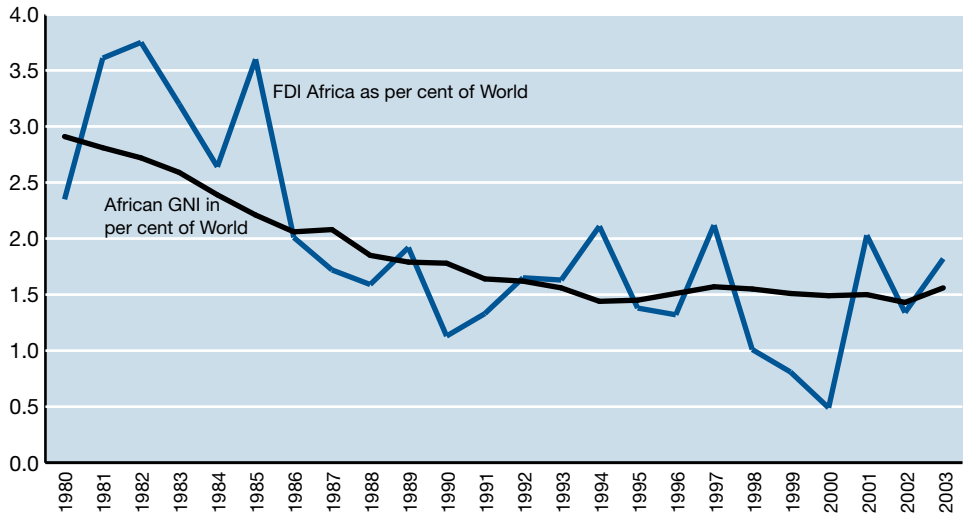
"Political instability and the small number of FDI projects contribute to high FDI volatility"

The volatility of capital flows varies greatly across countries (appendix A, table A.1). In general, the volatility of aid is lowest for most countries when compared to remittances and to FDI. However, for countries such as Cape Verde, Lesotho, or Swaziland, which have a relatively high share of remittances in GNI, the volatility of remittances is lowest. Aid volatility is higher for countries that depend heavily on aid (Bulir and Hamann 2003), but that seems to be true for other flows as well, at least in the case of African countries.

Equity flows remain unevenly distributed

In general, equity flows (FDI and portfolio investment flows) to Africa remain low. Africa's share in world FDI remains at around 3 per cent, with a peak at 4 per cent in the mid-1980s. This share has followed the same trend as Africa's economic weight, as measured by its share in world GDP (figure 2.5).

Figure 2.5
Inward FDI and GNI, Africa compared to World, 1980-2003 (%)



***Source**: World Bank 2005b.*

***Note**: The figure includes only 39 countries with consistent data.*

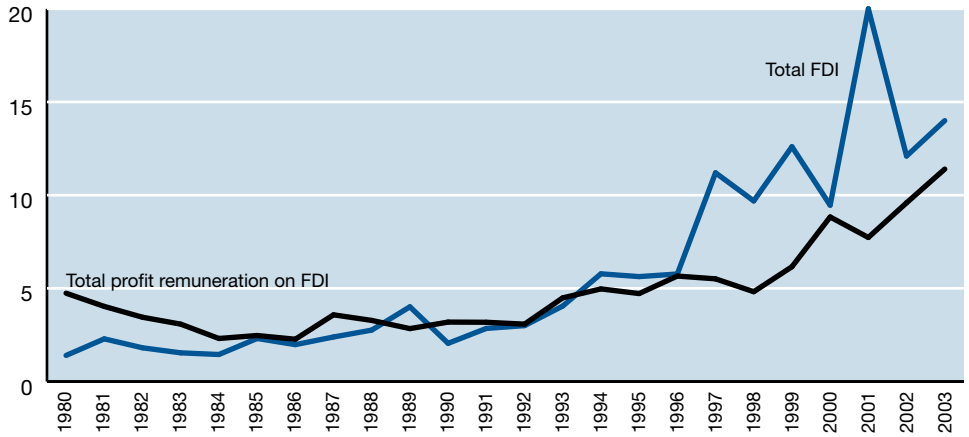
Asian investors will help Africa diversify FDI sources

In 2004, FDI inflows to Africa increased by 2 per cent from the previous year and stood at $18 billion. However, FDI to Africa in 2004 was more natural resource driven than ever before. The sub-sectors "Mining", "Oil and Gas" and "Petroleum Refining" taken together accounted for $4 billion out of $4.6 billion in FDI to the continent in the form of cross-border mergers and acquisitions (M&As). A few oil-rich countries benefited from large FDI inflows. Over the 2002-2004 period, investments in Angola, Chad, Equatorial Guinea and Nigeria alone accounted for 39 per cent of overall FDI to Africa. The oil sector accounted for 90 per cent of FDI inflows or more in Angola, Equatorial Guinea and Nigeria (UNCTAD 2005).

However, in some African countries, such as Egypt, Morocco, Lesotho and Mozambique, FDI has recently risen in manufacturing, agro-industries, textiles and services. Some of these investments are driven by preferential access to developed-country markets, such as the African Growth and Opportunity Act (AGOA) of the United States and the Cotonou Agreement of the European Union (EU), which raises concerns about sustainability (UNECA 2005a).

Traditionally, foreign investors to Africa came from Europe and, to a lesser extent, from North America. Lately, Asian investors from countries such as China, India, Malaysia and South Korea have increasingly engaged in African countries. For example, 46.3 per cent of Chinese investments on the continent for the period 1979-2000 went into manufacturing (World Bank 2004). South African companies are also investing increasingly in other African countries, particularly in Southern Africa. These are desirable developments from a development perspective since they provide chances to diversify the sources of FDI. Moreover, investors from these countries are familiar with a developing-country environment and are more likely to use appropriate technology and tailor their products and services to low-income country customers.

Figure 2.6
Net FDI inflows and profit repatriation on FDI, 1980-2003 ($ billion)



***Source**: World Bank 2005a.*

FDI is associated with outflows of profits, which can be quite high. Figure 2.6 shows that, for some years, profit repatriations were even higher than the net inflow of FDI. Only since the second half of the 1990s were net FDI inflows into African countries markedly higher than profit repatriations from the continent. Thus, the challenge is not only how to attract more FDI but also how to encourage sustained investment in African economies, so as to increase the positive effects on employment creation, technology transfer and linkages with domestic investment.

In general, portfolio investments are negligible in Africa compared to other flows (figure 2.2). Note that figure 2.2 does not include data for South Africa, which on its own accounted for around $3.2 billion in portfolio investment inflows annually over the period 1994-2003 (World Bank 2005a). South Africa's equity investment structure is dominated by portfolio investment, an investment category that is negligible for other African countries and even atypical for countries with similar risk attributes (box 2.1).

Remittances: a form of private capital flows on the rise

Remittances have been recognized only recently as a potential source of financing for development. The amount of reported remittances to Africa has increased from $5.9 billion in 1980 to $14.9 billion in 2003.[6] Africa received about 15 per cent of global

Box 2.1
Equity flows to South Africa - an exception

For the period 1994-2002, FDI inflows into South Africa totalled about 1.5 per cent of GDP per year, whereas portfolio inflows amounted to about 3.5 per cent of GDP. In fact, portfolio flows to South Africa dominated the overall portfolio flows to Africa, with its share being 89 per cent or more in eight out of the ten years between 1994-2003. However, for most of the years since 1990, South Africa has recorded net outflows of portfolio investment.

The weak FDI performance of South Africa can be explained by a number of unfavourable policies, especially insufficient trade liberalization, exchange rate volatility and capital controls. However, in 2005, FDI inflows were larger than portfolio inflows, going into the banking, commodities and equipment sectors, due to increased sales of state-owned assets.

South Africa is the third largest foreign investor in Africa. Geographically, this investment is highly concentrated in Southern Africa, which accounts for 90 per cent of South African FDI within Africa. In seven Southern African Development Community (SADC) countries, South Africa is the number one investor and in five countries, South African FDI makes up more than 50 per cent of all FDI. The strong engagement of South Africa in this regard should give some impetus to regional integration. South African FDI to the rest of the continent is targeting natural resources and basic industries (including steel and other non-ferrous metals) and utilities.

***Sources**: Ahmed, Arezki and Funke 2005; World Bank 2005a; Page and te Velde 2004; South African Reserve Bank 2006.*

6 However, remittances to all countries grew five-fold over the same period (IMF 2005a).

remittances, with more than two thirds going to North Africa. This trend is expected to continue for two reasons. First, as populations are aging in industrial countries, these countries will need to meet their excess demand for labour with higher immigration from developing countries. Second, unemployment in developing countries will continue to exert pressure on migration to the industrial countries.

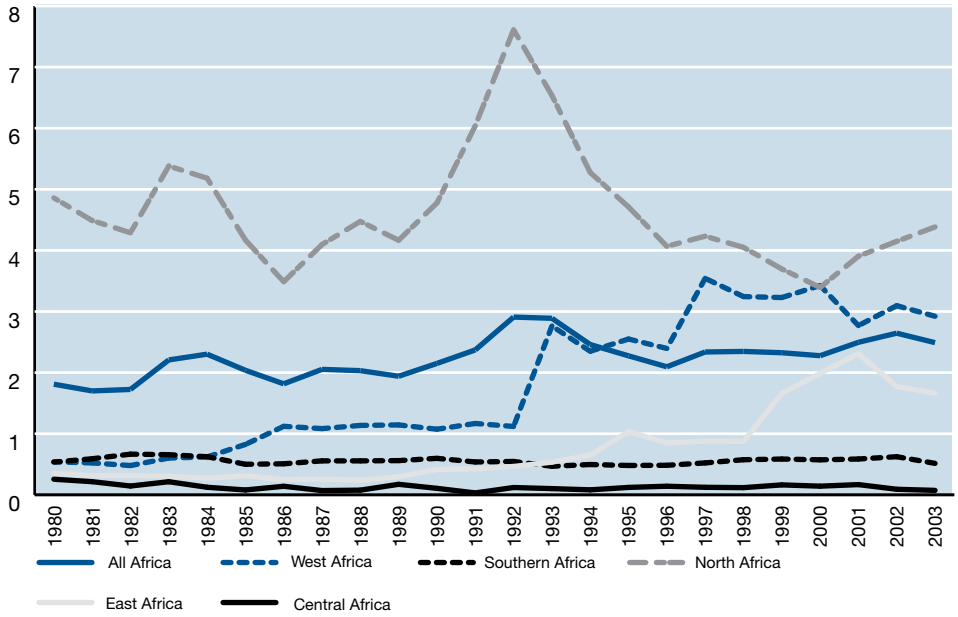
For Africa as a whole, remittances represented 2.5 per cent of GNI in 2003, but unlike other regions, this share has not increased significantly over the past 25 years (World Bank 2005a). With an important part remitted through informal channels and therefore unreported, it is estimated that actual remittances are at least twice the official figures (IMF 2005a; World Bank 2005a; Docquier and Rapoport 2004).

In a number of African countries, workers' remittances are large relative to other financial flows (table A1). For some countries, such as Egypt, Gambia, Lesotho, Morocco and Swaziland, remittances exceed 5 per cent of GNI, representing a multiple of inward FDI. For example, workers' remittances represented almost eight times the volume of inward FDI in Cape Verde over 1980-2003. Egypt ranks among the top five largest recipients of remittances in the developing world (World Bank 2005a).

There are considerable variations across subregions with respect to the volume of remittances. North Africa has the highest remittance/GNI ratio, with a peak of almost 8 per cent in 1992, led by Egypt whose remittances increased by one third. Since 1996, the ratio for the subregion fluctuated around 4 per cent. For East Africa and even more so for West Africa, the ratio of remittances to GNI has substantially increased since the beginning of the 1990s, reaching 3 per cent in West Africa. However, for Southern Africa and Central Africa, the ratio has been very low and flat (figure 2.7).

Figure 2.7

Workers' remittances by African subregion, 1980 - 2003 (% of GNI)



***Source**: World Bank 2005a.*

Workers' remittances are important for a number of reasons. Remittances are more stable than other private capital flows. Remittances directed at productive activities are also relatively stable since migrants are less likely than foreign investors to withdraw their investments, even in the presence of economic adversity. Unlike other private flows, remittance inflows are counter-cyclical, which allows recipient households to smooth consumption. Finally, remittances do not increase a country's indebtedness. (Chami, Fullenkamp and Jahjah 2005; IMF 2005a).

> *"Migrants are less likely than foreign investors to withdraw their investments"*

Around 80 per cent of remittances in Africa are used for consumption and schooling and help loosen the budget constraints of their recipients. Thus, remittances contribute to increased human capital accumulation. There is also evidence that remittances are used for private investment and infrastructure at the community level (UNECA 2005a; IMF 2005a).

Capital flight deprives the continent of much needed resources

The analysis of capital flows to and from Africa reveals a curious paradox. On the one hand, African countries have accumulated large volumes of debt, presumably to fill their resource gap and finance their development needs. On the other hand, the continent continues to experience heavy financial haemorrhage in the form of capi-

tal flight, some of which is financed by borrowed funds. Indeed, empirical evidence suggests quite ironically that SSA is a "net creditor" to the rest of the world in the sense that the private assets held abroad by Africans exceed the continent's liabilities vis-à-vis the rest of the world (Boyce and Ndikumana 2001; Ndikumana and Boyce 2003). Compared to populations in other developing regions, Africans tend to exhibit a significantly higher preference for foreign assets relative to domestic assets, with 40 per cent of private assets held abroad (Collier, Hoeffler and Pattillo 2001).

Capital flight deprives Africa of a sizable portion of the very resources it needs for development financing

Capital flight deprives Africa of a sizable portion of the very resources it needs for development financing. Table A.2 shows the estimated amounts of capital flight from SSA. The estimates vary substantially, reflecting differences in methodology and sample coverage. Ajayi (1997) estimates capital flight to be around $6 billion per year between 1980 and 1991, whereas Salisu (2005) estimates the annual amount at $13 billion between 1991 and 2004. The difference in capital flight as percentage of GDP is much smaller: 5.1 per cent in Ajayi's calculations and 7 per cent in Salisu's calculations.

External debt: relief is progressing

Africa's debt accumulation has quite a long history. At independence, African economies were mainly dependent on primary commodities and external finance. At the time of the first oil shock, African governments had just increased public expenditure, financed by revenues from commodities. When commodity prices subsequently declined, they were unable to sustain expenditure levels. Loans were easily available due to large oil revenues, low interest rates in international markets and increased creditworthiness based on expected increases in commodity prices. As the terms of trade of African countries deteriorated and real international interest rates increased, debt servicing started to become difficult, leading to accumulation of arrears.

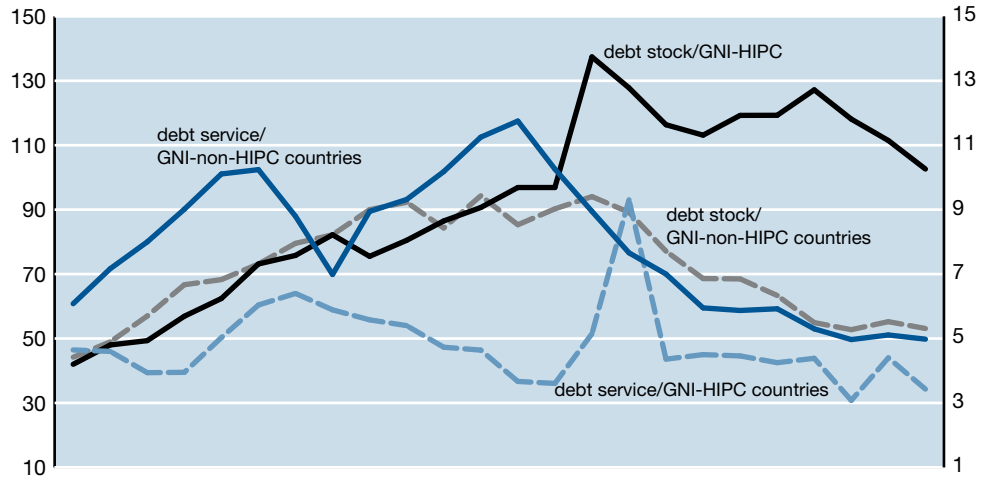
The rescheduling of debt due to inability to pay all debt services also contributed to the increase in debt stocks. As many African countries faced severe macroeconomic difficulties at the beginning of the 1980s, they had to rely on IMF and World Bank structural adjustment loans to finance their imports. In addition, bilateral donors continued lending, partly to enable African countries to service their debts and partly to promote their own exports. Despite these debt relief efforts, absolute debt service payments by Africa increased 1.7 times during the 1890s and 1990s, which is about half the increase for all developing countries (Abrego and Ross 2002).

The 1996 HIPC initiative and the subsequent enhanced HIPC initiative provided debt relief of approximately two thirds of the net present value of debt and reduced debt service payments of 27 decision-point countries by about half to less than 8 per cent of exports in 2004 (see appendix B). Almost all African LDCs are eligible for HIPC debt relief if they have a satisfactory track record of policy performance under respective IMF and International Development Association (IDA) supported programmes and a poverty reduction strategy (IMF/IDA 2006). The exceptions are Cape

Verde, Djibouti, Equatorial Guinea and Lesotho, which are not highly indebted (see table A1), as well as Angola, which had 64 per cent of private debt in 2003.

Figure 2.8

Debt stocks and debt service payments of African HIPC and non-HIPC countries, 1980-2003 (% of GNI)



***Source**: World Bank 2005a.*

***Note**: The figures are weighted averages of 18 African non-HIPC countries and 19 African HIPC countries that had reached their decision point by 2003.*

The debt service ratio for decision-point HIPC countries was higher than for other HIPC countries as they generally serviced their debts to fulfil the conditions. For African decision-point countries, the ratio of poverty-reducing expenditures to government revenue has increased from 33 per cent in 1999 to 49 per cent in 2004 (Abrego and Ross 2002; World Bank 2005d). The debt stock as a percentage of GNI was considerably higher for African HIPC countries in the mid-1990s, which was itself a criterion for participating in the initiative (figure 2.8). Despite this fact, the debt service to GNI ratio was lower for HIPC countries as they did not fulfil their obligations.

> *"The shift from loans to grants contributed to the decline in the debt burden since the mid-90s"*

Between 1994 and 2000, there was not much change in the ratio of debt stock to GNI for African HIPC countries but, thereafter, it declined from 127 per cent to 103 per cent in 2003. The shift from loans towards grants contributed to the decline in the debt burden since the mid-1990s (Birdsall, Claessens and Diwan 2002). However, the experience of different African countries with HIPC relief was quite diverse as the examples of Uganda and Mozambique show (box 2.2). Over the same period, the ratio of the debt stock to GNI for African non-HIPCs only declined by 7 per cent. However, it had declined much more in the period before, indicating that non-HIPC

Box 2.2
Experiences with debt relief: Uganda and Mozambique

Uganda and Mozambique were among the first recipients of debt relief under the HIPC initiative, reaching the decision point in 1997 and 1998, respectively. Whereas Mozambique's net present value of debt has declined from over $6 billion in 1998 to $4.4 billion in 2005, Uganda's debt stock has continued to increase, reaching $4.8 billion or 60 per cent of GDP in June 2005. Uganda's debt service reached 18 per cent of exports of goods and services in June 2005, compared to only 3 per cent for Mozambique. What explains these different experiences?

Mozambique reached the completion point of the enhanced HIPC initiative in September 2001. More than $2 billion of debt were cancelled. In 2000, a banking crisis led to the temporary suspension of HIPC debt relief and to an increase in debt as the Government had to bail out banks. The debt stock to exports ratio is still expected to be around 150 per cent for the period 2002-2010, which is the threshold for unsustainability.

Uganda reached the completion point of the enhanced HIPC initiative in May 2000 and was granted debt relief of $1 billion. But while bilateral creditors provided debt relief quickly, debt relief by multilateral creditors was slower and the debts of non-Paris Club members such as Libya, India and China as well as commercial creditors were not significantly reduced. In addition, new loans from multilateral donors were needed to cope with exogenous shocks, such as droughts and deterioration of the terms of trade.

***Source**: EIU 2006a,b; IMF/IDA 2000, 2005.*

countries had benefited much more from traditional debt relief. This is partly due to their debt structure, with a considerably lower share of multilateral debt.

The structure of debt has changed considerably over the past decades. The share of debt owed to multilateral institutions (World Bank, African Development Bank and IMF) increased from 15 per cent in 1980 to 25 per cent in 2003, whereas private non-guaranteed debt only amounted to 5 per cent of the total debt stock for SSA in 2003 (Alemajehu 2002).

In 2005, the HIPC initiative was supplemented by the MDRI of the G-8, which allows for 100 per cent multilateral debt relief (see appendix B). It is estimated that the net present value of debt as a percentage of exports for the 18 completion-point countries would fall from 140 per cent (after HIPC relief) to 52 per cent starting from January 2006 (IMF 2005c). As of June 2006, the 14 African countries that have reached HIPC completion point have already had their debt to the IMF cancelled and are eligible for immediate debt relief by the World Bank and the African Development Bank (IMF 2006). However, as this initiative only deals with debt owed to multilateral institutions, it cannot be expected to solve all of Africa's debt problems. African countries need to explore other strategies for dealing with external debt. An example of debt reduction without HIPC debt relief is Nigeria, which used oil revenues to buy back its debt (box 2.3).

Box 2.3
Nigeria's debt deal

In 2005, Nigeria signed an agreement leading to the settlement of its debt with the Paris Club. As a first step towards the cancellation of $18 billion of Nigeria's debt under the Naples terms, Nigeria paid the first instalment of $6.3 billion in 2005 to clear its arrears. In April 2006, the remaining Paris Club debt was bought back at 24 cents on the dollar, amounting to another $4.6 billion. The money for these payments comes from foreign-exchange reserves that covered almost two years of imports due to the increase in oil prices. By this agreement, Nigeria's debt was reduced from $34 billion in 2005 to approximately $5 billion in 2006, mainly towards the World Bank and the private sector. In 2006, expenditure on education increased as a result of lower debt service payments. The country's credit ratings have already improved, which will allow the Government to borrow at more favourable terms and attract more FDI. Nigeria's debt deal represents a best practice in debt management and the use of windfall revenues from commodity exports.

***Source**: UNECA 2005b; EIU 2006c.*

> *"Nigeria used oil revenues to buy back its debt"*

Although the level of debt has declined, especially for the HIPC countries, debt sustainability in the long term remains an issue. In particular, the need for new borrowing will be higher for countries with low GDP growth rates (Cerra, Rishi and Saxena 2005). The degree of structural transformation will determine a country's future repayment capacities, e.g. through exports. In this respect, second generation Poverty Reduction Strategy Papers (PRSPs) that are expected to lay the foundations for pro-poor growth play a crucial role.[7] In addition, the terms of new borrowing play a role for the sustainability of future debts. However, there are also factors beyond the control of African governments such as commodity price shocks and armed conflicts that will affect debt sustainability (Abrego and Ross 2002). Thus, African countries need to have a "prudent strategy for future borrowing tailored to country-specific circumstances, especially the quality of its institutions, and its vulnerability to shocks" (UNECA 2003).

2.3 Determinants of capital flows to Africa

The observed trends in volume and composition of capital flows to Africa raise some important empirical and policy questions. The factors that drive the level and composition of capital flows are a basis for the discussion of policy implications in the remainder of this report. The empirical literature identifies several factors that drive capital flows, which are often classified into two broad categories: pull factors, which are related to domestic conditions; and push factors, which are related to external conditions. In this report, we focus on the pull factors, which include the size of the

7 On the side of creditors and donors, there is a need to ensure that debt relief is additional to aid flows in order to really free resources for spending on education, health and infrastructure, that are supposed to improve the conditions for faster growth (Abrego and Ross 2002).

economy, GDP growth, the quality of public infrastructure, the depth and efficiency of capital markets, openness to trade and finance, political stability and the quality of institutions in general, labour costs, and exchange rate and price stability.

Aid allocation is driven by donor priorities

> *Donors applied less selectivity for countries with high multilateral debt*

The empirical literature suggests that the major determinants of bilateral aid disbursement are per capita GDP, HDI, civil liberties, openness and the size of the economy (Alesina and Dollar 2000). There is wide consensus that the geo-political interests of bilateral donors have had a relatively high impact on aid allocation among recipients (Alesina and Dollar 2000; Riddell 1992). In addition, there exists a double standard concerning the use of good governance as a precondition for development aid. Countries with economic importance are less likely to be subject to standards set by the donor community, while these criteria are more often enforced for small and less strategically important countries (Wolf and Spoden 2000).

There is also evidence that more aid is given to countries with higher debt to enable them to service their debts. Birdsall, Claessens and Diwan (2002) find that countries with high multilateral debt but bad policies receive about 2.5 percentage points more in net aid transfers than the average. Thus, it seems that donors have applied less selectivity for countries with high multilateral debt.

As aid volatility can cause significant problems for recipient countries, it is important to look at the factors that determine aid volatility. There is empirical evidence that these factors differ according to the type of aid. The volatility of sector-specific aid tends to decline with an increase in aid as a proportion of GNI and an improvement in the institutional quality of the aid recipient. It increases with per capita income and trade openness. In contrast, the quality of institutions and the degree of openness have no significant effect on the volatility of programme aid that is not allocated to a specific sector. However, the volatility of programme aid is negatively associated with the aid to GNI ratio and positively associated with per capita income, as in the case of sector-specific aid (Fielding and Mavrotas 2005).

Beyond natural resources: Africa's attractiveness to equity flows

Portfolio investments respond to the market size and sophistication of the financial market. A study on portfolio investment flows between a set of 14 industrialized countries for the period 1989-1996 shows that portfolio diversification is not an important determinant of such flows (Portes and Rey 2005). Moreover, the size of the targeted market as well as the sophistication of the financial markets in source and destination country contribute to portfolio investment. In addition, information frictions seem to be the dominant force shaping the international distribution of portfolio investment flows.

In the same vein, a recent examination of factors influencing the investment decisions of US mutual fund managers suggests that open developing-country markets with strong accounting standards, shareholder rights and legal framework attract more investment (Aggarwal, Klapper and Wysocki 2005). All of these findings provide some insight into why Africa has not received large amounts of portfolio investments. While portfolio diversification would be a major advantage for African equity markets, poor technology and information frictions prevent African economies from attracting large flows of portfolio investments.

> *Improving institutions and policy environment can attract FDI*

Determinants of FDI include a sound macroeconomic environment, political stability and a favourable business climate. However, it is only recently that empirical studies have focused specifically on the determinants of FDI in Africa. Asiedu (2002) argues that the determinants are indeed different for Africa in comparison to other regions. Results from panel data analysis suggest that a higher return to investment and better infrastructure have a positive impact on FDI to countries outside SSA, but have no significant impact on FDI in SSA.

Similarly, although openness to international trade promotes FDI in the overall sample, the impact of openness on FDI is less pronounced for African countries. In a recent paper, Asiedu (2006) extends the analysis by looking at institutional, policy and political variables and concludes that natural resources and large markets promote FDI. However, lower inflation, good infrastructure, an educated population, openness to FDI, less corruption, political stability and a reliable legal system have a similar effect, suggesting that even small or natural resource-poor African countries can attract FDI by improving their institutions and policy environment.

For the African continent as a whole, resource-seeking FDI is the dominant type of foreign investment. The recent increase in FDI to Africa is driven to a large extent by attempts by industrialized countries and China to diversify away from their dependence on the Middle East region for oil. Market-seeking FDI has been insignificant for Africa in the past because its markets are very small. FDI has increased considerably in recent years in the services sector, especially in energy and information and communication technology (ICT). (UNECA 2005a). Efficiency-seeking FDI has been growing in the recent past due in part to preferential trade agreements such as AGOA of the United States. It remains to be seen how sustainable these investments are in the long run when trade preferences are removed.

According to the evidence gathered by the World Bank (2005c), the business environment is less conducive for investment in SSA than in any other developing region in the world. For instance, the costs for starting a business amount up to 225 per cent of GNI per capita, more than three times the level for the next developing region (Latin America and the Caribbean with 60 per cent). Other obstacles include property rights and labour regulations (see chapters 3, 4 and 6). The evidence suggests an urgent need to complement macroeconomic reforms with microeconomic reforms aimed at improving the business environment.

Foreign investments in the natural resources sector tend to be better insulated from political instability as well as from macroeconomic turbulences and the weak business climate in Africa. The dominance of resource-seeking FDI is therefore also a reflection of the poor macroeconomic environment and the weak business climate. For instance, trade barriers and other obstacles posed by African countries have little effect on resource-seeking FDI, but they have a negative effect on efficiency-seeking FDI (Faini 2004:8).

"There is an urgent need to compliment macroeconomic reforms with microeconomic reforms aimed at improving the business environment"

Workers' remittances: between altruism and investment

The main determinant of workers' remittances is the number of migrants living abroad. The characteristics of these migrants, especially their level of education and the destination country will also affect their earnings and therefore their ability to remit. The distance between source and destination countries also has a negative impact on both migration and remittances, as long distances make it more difficult to maintain extensive economic and social links (Adams and Page 2005).

Theoretically, the determinants of remittances depend on the motivation to transfer funds in the country of origin - altruism or investment.[8] In general, remittances are higher when negative shocks occur in the home country as needs are greater and people are pushed to emigrate. Therefore, GDP growth in the home country negatively affects remittances, if the main motive is to help the family in the home country.

However, the "portfolio" choice theory implies a positive relationship between remittances used for investment and GDP growth as higher growth implies better business opportunities, but a negative relationship with macroeconomic and political instability. Economic policies and institutions such as exchange rate restrictions can also discourage remittances. In contrast, greater financial sector development will make remitting easier and encourage remittances. However, the empirical evidence is scant, especially in the case of African countries (Chami, Fullenkamp and Jahjah 2005; IMF 2005a).

Capital flight responds to risky environments and financing opportunities

In theory, capital flight may be viewed as a portfolio decision by individuals who choose to hold assets abroad instead of investing domestically. The determinants of capital flight identified in the literature belong to one of the following groups of factors (Ndikumana and Boyce 2003; Cerra, Rishi and Saxena 2005:5; Salisu 2005):

8 The literature proposes two explanations for transfers by migrants to their country of origin. The "altruism" approach is based on the economics of the family. Under this view, remittances are driven by concerns of the migrant for the welfare of his family in the country of origin. The "portfolio" approach suggests that migrants allocate their savings between home country and host country. Thus, remittances are driven by an investment motive (IMF 2005b).

- Macroeconomic environment: low growth and high inflation trigger capital flight;
- Fiscal policies: Poor government performance, as expressed, for instance, by a large budget deficit, is associated with greater capital flight. Moreover, the uncertainty associated with government tax policies is positively linked to capital flight (Hermes and Lensink 2001);
- Risks and returns to investment: Studies that test the theory of capital flight as a portfolio choice have used interest rate differentials, exchange rate overvaluations, and measures of risk perception. However, the evidence for African countries remains scant;
- Capital inflows, particularly debt: The empirical literature contains strong evidence of the "revolving door" relationship between external borrowing and capital flight, whereby debt inflows tend to stimulate capital flight by changing expectations about future returns to domestic investment while providing resources for capital flight. However, causality might also run the other way, i.e. the flight of domestic savings, for example, due to weak institutions, increases the resource gap and thus triggers the need for additional borrowing. While most studies focus on debt flows, the magnitude of the debt stock was found to be the more important cause for capital flight (Collier, Hoeffler and Pattillo 2001). Another capital inflow associated with capital flight is development aid (Lensink, Hermes and Murinde 2000); and
- Political factors and the quality of institutions: Political risk and corruption have been found to affect capital flight. Reducing the outflow of capital thus requires the building of appropriate institutions to promote stability and reduce investment risk (Fosu, Krishnan and Ndikumana 2004; Commission for Africa 2005). In addition, Cerra, Rishi and Saxena (2005) find that the link between capital flight and debt inflows is stronger for countries with weak institutions and high-income inequality.

"Corruption reduces inward FDI"

Good governance plays an important role in the composition of capital flows

Good governance is found to be an important determinant of both private and public capital flows (chapter 5). Specifically, the level of corruption can have an impact on capital inflows and outflows through different channels. One important effect of corruption is that it decreases the ability of governments to collect tax revenue. This will in turn lead to greater needs for financing public expenditure through other sources, mainly aid and government loans, which might contribute to the accumulation of debt.

Empirical evidence shows that more corrupt countries are more likely to impose capital controls, which will then reduce private inflows and might induce more capital

flight (Bai and Wei 2000). There is strong empirical evidence that corruption reduces inward FDI considerably and that it induces foreign investors to favour joint ventures over wholly owned subsidiaries (Wei 2000).[9] However, in the extractive industries, weak governance might attract FDI as foreign investors might get more favourable treatment (Commission for Africa 2005).

"FDI involves sunk costs, which weakens bargaining power and makes FDI more prone to payment of bribes"

In addition, the extent of corruption in a country may skew the composition of capital inflows towards more short-term flows, which will increase its vulnerability to international financial crises and might increase the risk of a currency crisis. Since the negative effects of corruption increase with the frequency of interactions between the investor and local bureaucrats, FDI is likely to be more affected by corruption than portfolio investment. FDI involves greater sunk costs, which weakens the investors' bargaining power and makes FDI more prone to payment of bribes. Empirical evidence from developing and developed countries shows that corruption reduces the share of FDI in private capital inflows relative to portfolio investment (Wei 2000).

2.4 Impact of capital flows on African growth and economic development

The ultimate goal of increased capital flows is to enhance development. One important empirical challenge is to determine the channels through which capital flows affect economic performance. An understanding of the exact channels is essential to designing policies to maximize the effects of capital flows on the economy. One possible channel is through the linkages between different capital inflows and domestic investment. Other potential channels of the positive effects of capital flows on growth and development include exports, diversification of economic activity, increase of employment and wages, improvement of human capital, technological progress, and increase of the corporate tax base.

However, capital inflows can also have negative effects on African economies. The most important effects are the reduction of competitiveness through "Dutch Disease" effects and increased vulnerability caused by the high volatility and unpredictability of capital flows. An inflow of capital increases the demand for the domestic currency. The increased demand for non-tradables can lead to an appreciation of the real exchange rate. This in turn could reduce the competitiveness of a country's export industry and make imports cheaper, which deteriorates the country's external position (see chapter 6).

These effects of capital inflows on competitiveness can be mitigated by specific features of the host economy. As unemployment is relatively high in most African countries, an increase in demand for non-tradables does not necessarily increase the production

9 Different measures of corruption based on the perception of experts in international consulting firms or business executives are used in these studies.

costs of export goods. If imports, especially of capital goods, are increased, the pressure on the exchange rate will be lower. If capital inflows are invested in public goods the productivity in the private sector will increase. Whether a real appreciation will have a negative effect on the growth potential depends on the production structure and on productivity growth (McKinley 2005; Heller 2005). Moreover, with regard to specific types of capital flows, particular channels also come into the picture.

Aid can increase growth but has diminishing returns

Aid is expected to increase long-term growth as it can fill both the savings-investment gap and the foreign exchange gap. In addition, it can increase productivity by facilitating technology transfer and human capital formation. The main channels through which aid might have an impact on growth are through investment and imports. If aid finances productive investment, this will contribute to growth. If aid enables imports of capital goods and imported inputs it increases production. However, if aid is fungible so that funds intended for investment are used for consumption its effectiveness will be reduced (Gomanee, Girma and Morrissey 2005).

However, there are various reasons why larger amounts of aid do not necessarily increase economic growth. Aid may allow governments to put off necessary reforms such as reforming the tax system. Countries depending largely on aid tend to be vulnerable to sudden changes of donor policies. In addition, high levels of aid in general imply that a large number of donors are involved (more than 40 for Kenya and Zambia). Negotiations with many donors are a burden on the limited capacity of recipient governments and the lack of aid coordination on the side of donor and recipient can hamper the success of programmes (Lancaster 1999).

> *Larger amounts of aid do not necessarily increase economic growth*

Over the past decade, a heated debate on the effects of aid on growth and development has emerged. The study by Burnside and Dollar (2000) whose results entered the *Assessing Aid* report (World Bank 1998) stresses that the effect of aid depends on the policy environment. The authors argue that aid adds to investment whereas policy determines the productivity of this investment. Good governance in recipient countries also increases accountability of aid utilization (Commission for Africa 2005).

However, the study by Burnside and Dollar (2000) has been criticized by a large number of researchers.[10] A number of recent studies find a positive and statistically significant effect of aid on growth, largely through aid-financed investment (Lu and Ram 2001; Hansen and Tarp 2001; Gomanee, Girma and Morrissey 2005). Several studies find decreasing returns to aid, as the impact of aid on growth becomes negative after a certain threshold level is reached. In terms of ratio of aid to GDP, this threshold level lies between 15 and 45 per cent and has been reached by a substantial number of African countries (table A1; also see McGillivray, Feeney, Hermes and

10 Researchers argue that the econometric results are highly driven by the econometric specification, definition of variables and the time span of the data used and are therefore too fragile to support Burnside and Dollar's argument (for a summary of this debate see McGillivray, Feeney, Hermes and Lensink 2005).

Lensink 2005). Thus, an improvement in the efficiency of aid is as important as an increase in the volume of aid.

FDI can provide a bundle of capital, technology and know-how for development

"Resource seeking FDI, such as in oil prevents many African countries from reaping employment benefits"

FDI has recently been praised for being a desirable form of foreign capital in developing countries. Its contribution to narrowing the capital and foreign exchange gaps is notable. FDI has the potential to do much more, because it is not only a flow of financial capital, but consists of a bundle of capital, technology and know-how. There is evidence that FDI increases growth in developing countries, primarily through improvements in total factor productivity (Collins 2004).

Even though physical capital accumulation through FDI is obvious, its size varies with the mode of entry into a country. In the case of greenfield investments, i.e. when an affiliate is built up as a new company without any predecessors, physical capital accumulation has to take place. In contrast, in the case of a takeover, i.e. when a foreign investor buys an existing company in the host country, no investment in physical capital takes place. Nevertheless, in the long run, there seems to be no significant difference in terms of physical capital accumulation between the two types due to significant follow-up investments in the case of takeovers.

Since technical progress is the most important driver of long run economic growth, FDI has a major advantage over other forms of capital inflows in terms of contributions to growth, because of its potential to upgrade existing technologies and introduce new ones (Lall and Narula 2004). This transfer of technology will be limited to the affiliate of the investing foreign company in the first place, but over time, production technology, knowledge about market access and management techniques will spill over to other companies in the host country. Chapter 3 of this report provides a more in-depth discussion of the linkage between foreign investment and domestic investment.

In the case of African countries, the dominance of resource-seeking FDI may explain the weak linkages between FDI and domestic investment. Natural resource extracting companies tend to have extremely few linkages with the domestic economy. Foreign oil companies operate 'economic islands' in an economy, sometimes even literally islands, when one thinks about offshore oil platforms from which the oil is exported directly via large transport vessels. The dominance of resource-seeking FDI and its limited interaction with the domestic economy also prevents many African countries from reaping one of the most desirable outcomes of FDI, namely employment. FDI into other sectors tends to have sizable indirect employment effects, often estimated to be twice as high as the employment generated in the foreign affiliates (Asiedu 2004). One positive effect of all forms of FDI is their potential to broaden the tax base of a country.

Remittances reduce poverty

There are a number of channels through which remittances might affect growth and development. As they are targeted to meet specific needs of the recipients, they reduce poverty directly. For example, in Egypt they account for 15 per cent of total income of poor households (Adams 1991). In Burkina Faso, one third of all households, especially the poorest, receive remittances and almost 20 per cent of household incomes are from remittances (Konseiga 2005). In Lesotho, the poverty headcount would increase by more than 10 per cent if remittances were completely removed. As travel costs to Europe and North America are quite high, most migrants come from income groups above the poverty line and their remittances will not directly benefit the poorest most (Adams and Page 2003).

> *Remittances reduce vulnerability to shocks*

If remittances are used for consumption there will also be a multiplier effect. Through increased demand especially in the rural areas growth could increase and poverty be reduced. As a considerable portion of remittances is used for school fees, this should increase productivity through human capital accumulation. In addition, remittances contribute to better health and therefore improve long-term growth prospects (Özden and Schiff 2005).

Although data on the use of remittances in Africa are not available, there is some anecdotal evidence that shows that remittance flows are increasingly being used for investment purposes, especially for financing SMEs. For example, in their study on SSA, Russell, Jacobsen and Deane (1990) found that once subsistence needs have been met, remittances are used for investment purposes including education, livestock, farming and small-scale business development. Similar findings have been reported for Mali where remittances finance irrigation schemes (Finley and Sow 1998). This is also corroborated by the findings by Chilivumbu (1985) in Zambia where remittances have been used to finance agricultural inputs. Recent evidence confirms that investment increases with remittances, including housing construction (Özden and Schiff 2005).

Remittances contribute to alleviating the credit constraint, thus allowing increasing investment (UNECA 2005a). Remittances need not be invested by the recipients themselves. Saved remittances could improve access to capital for other businesses if the banking system fulfils its role of intermediating funds (see chapter 6). Remittances can also have a positive impact on technological change in agricultural production and therefore increase growth through higher productivity. Evidence from Burkina Faso indicates that remittances are used to improve agricultural and natural resource management (Konseiga 2005).

Remittances significantly reduce poverty in developing countries. In a study of 71 countries, Adams and Page (2005) find that a 10 per cent increase in workers remittances per capita leads to a 3.5 per cent decline in the share of people living in poverty. In addition, remittances reduce the vulnerability to shocks as well as the volatility of

countrywide output, consumption and investment and thus help to stabilize economic activity.

External debt hampers private investment

If the reduction in debt service is offset by a decrease in aid it might even reduce investment rates

Theoretically, it can be argued that external debt can promote growth to the extent that the public investment financed by these loans is complementary to private investment. However, a heavy debt burden creates the expectation of higher taxes in the future and thus reduces the incentive to invest (Chowdhury 2001).

Large debt burdens are usually associated with negative effects on growth. Debt is likely to reduce public investment in both physical and human capital, which reduces the productivity of private investment and slows down total capital accumulation. In addition, high debt service can reduce the capacity to import, which reduces output through a shortage of imported inputs and constrains investment because of a lack of capital goods.

A reduction in debt service payments has a positive impact on investment. Patillo, Poirson and Ricci (2001) find that debt reduction under HIPC might increase per capita growth by one percentage point, mainly through increasing the efficiency of investment. However, debt service reduction has a positive effect on investment and growth only if it is not offset by a reduction in aid inflows. If the reduction in debt service is offset by a decrease in aid it might even reduce investment rates. This confirms the importance of additionality in debt relief efforts (Hansen 2004).

Debt has a negative effect on growth in SSA not primarily through a reduction of investment but through its negative effect on the productivity of investment (Fosu 1996). Furthermore, debt has a significant negative effect on growth for both HIPC and non-HIPC countries (Chowdhury 2001). Consequently, there is a need to broaden the debt forgiveness initiative.

Instability of capital flows reduces growth effects

The effect of aid uncertainty on growth is well established (Lensink and Morrissey 2000). Foreign aid is not likely to have a direct impact on growth but rather aid will affect determinants of growth like investment, government revenue and expenditure. The level as well as variability or uncertainty of aid are likely to affect investment. The instability of aid disbursements may alter fiscal behaviour, possibly causing a decrease in public investment.

Instability of capital flows discourages investment and hampers the growth effects. Short-term portfolio investment is associated with the highest volatility and has significantly contributed to the Asian crisis at the end of the 1990s. However, the volatility of aid, remittances, and FDI, which are more important for African economies, can also affect growth as they might induce exchange rate volatility. The volatility of

all capital flows is negatively correlated with GDP growth in low-income countries (Aizenman and Pinto 2005; Osei, Morrissey and Lensink 2002).

2.5 Conclusion

> *African countries cannot continue to finance their resource gap by further accumulation of external debt*

The observed trends in capital flows to Africa raise serious concerns about the sustainability of external resources, and the implications for development financing. Development aid has not always been tailored towards the priorities of recipients and has had a limited effect on growth and poverty. Furthermore, African countries cannot continue to finance their resource gap by further accumulation of external debt. Debt service obligations are compounded by the problem of capital flight whereby a substantial fraction of borrowed resources are diverted into private assets held abroad. While the volume of private flows to Africa remains low, they also are more volatile, which compromises the sustainability of financing of the resource gap.

African policymakers need to improve conditions for capital inflows (UNECA 2005b and 2006):

- As local and foreign investors, including the African Diaspora, are looking for the same investment conditions, it is crucial to improve the business environment, infrastructure and governance to increase FDI and remittances. The portion of capital inflows that exceeds imports is likely to increase inflation and thereby reduce competitiveness. These relationships have to be closely monitored when managing capital inflows. As risk perception is also crucial, country risk ratings should be conducted for more African countries;
- With respect to remittances, strategies to channel more of them into investment have to be developed. The opening of representations of domestic banks in the main destination countries has been effective in Morocco to channel more workers' remittances through official channels;
- To increase the effectiveness of aid African countries need to improve institutions that increase the accountability towards their own people and thus ensure participation and ownership;
- The availability and quality of statistical data on external capital flows, debt, and other key economic variables have to be improved for policy makers to make timely and well-informed decisions that take account of internal as well as external factors influencing their policy options; and
- Corruption-fighting measures have to be stepped up or extended, as a goal of its own as well as a means to make countries more attractive for foreign investors and to increase the efficiency of aid allocated to it.

In addition, industrial countries have to honour their commitments with regard to the Monterrey Consensus and other international conventions to improve financing for development in Africa:

- As the flows of FDI towards developing countries remain unevenly distributed, developed countries should step up measures to facilitate the flow of FDI to African countries, through export credits, risk guarantees and business development services;
- As aid will remain important to finance spending on health, education and infrastructure to achieve the MDGs, developed countries should make every effort to reach the target of 0.7 per cent of GNI for ODA as soon as possible and to reduce aid volatility;
- Non-HIPC African countries with unsustainable debt levels should be considered for debt relief. It is also crucial that conventional resources are provided in addition to debt relief in order to accelerate growth and reduce poverty; and
- As corruption has a negative effect on capital flows and might skew the composition towards more volatile flows, the fight against corruption should have high priority in all countries as stated in the United Nations Convention Against Corruption. In this respect, industrial countries have to increase their efforts to reduce corruption of their firms in international transactions.

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Appendix A: Tables

Table A1

Level and variability of capital flows as per cent of GNI (1980-2003)

	Aid		FDI		Workers remittances		Debt service	
	Average	Coeff. Var	Average	Coeff. Var	Average	Coeff. Var	Average	Coeff. Var
Algeria	0.4	42.7	0.4	149.9	1.6	56.3	11.3	33.2
Angola	6.1	81.6	11.1	110.8			14.2	60.5
Benin	11.0	32.4	1.4	121.1	4.5	30.0	2.5	38.2
Botswana	4.7	74.9	2.7	132.1	2.5	79.1	2.2	46.4
Burkina Faso	13.9	23.1	0.2	104.1	4.9	47.3	1.6	22.6
Burundi	18.7	44.0	0.2	197.1			3.2	36.3
Cameroon	4.6	44.6	0.8	154.3	0.2	57.3	5.2	21.9
Cape Verde	26.9	31.6	2.2	115.8	16.5	18.0	2.6	24.0
Central African Republic	13.0	31.0	0.4	139.2			1.8	53.2
Chad	13.4	30.6	6.2	205.5			1.2	54.9
Comoros	22.7	45.5	0.4	209.8	4.1	40.8	1.2	58.0
Congo, Dem. Rep.	9.4	206.0	0.3	318.6			3.4	113.7
Congo, Rep.	7.5	87.3	5.1	141.8	0.1	148.0	12.9	67.4
Côte d'Ivoire	5.4	81.3	1.2	104.0	0.8	57.6	13.4	31.3
Djibouti	14.7	22.0	0.7	50.3	0.3	282.8	1.9	23.2
Egypt, Arab Rep.	4.9	65.3	1.8	59.0	8.2	46.4	5.3	44.7
Equatorial Guinea	26.5	67.2	43.1	142.1			3.7	94.5
Eritrea	22.6	31.4	3.7	130.4	0.1	175.0	0.5	100.4
Ethiopia	11.9	42.3	0.7	183.6	0.3	68.5	2.4	46.6
Gabon	2.0	56.8			0.0	132.6	7.8	35.5
Gambia, The	24.3	54.3	3.9	120.1	5.1	46.4	7.5	48.0
Ghana	8.8	38.0	1.1	105.5	0.3	100.5	5.9	38.4
Guinea	10.5	27.7	0.7	86.2	0.3	239.8	4.4	29.5
Guinea-Bissau	49.6	27.0	1.0	125.4	1.2	202.8	5.4	44.9
Kenya	7.9	51.6	0.4	81.5	2.2	61.6	8.3	30.1
Lesotho	10.7	37.8	6.2	128.6	34.7	28.0	3.3	52.7
Liberia	16.3	41.9	11.5	206.4			3.0	94.6
Madagascar	10.7	40.0	0.5	118.2	0.3	57.9	4.4	62.2
Malawi	22.5	35.6	0.6	160.2			6.4	45.4
Mali	18.2	23.7	1.3	156.8	3.9	20.6	3.0	36.8
Mauritania	24.8	18.9	2.5	174.7	0.6	142.9	10.2	27.5
Mauritius	2.1	74.6	0.9	132.8	1.7	119.4	7.3	40.1
Morocco	2.9	55.8	1.6	120.6	7.1	16.4	10.1	17.4
Mozambique	31.9	68.7	2.5	131.5	2.1	39.6	3.5	49.8
Niger	14.9	27.6	0.5	176.3	0.5	33.1	4.9	58.2
Nigeria	0.6	71.0	3.1	78.3	1.8	111.2	7.6	52.2
Rwanda	20.2	91.0	0.5	80.1	0.3	115.0	1.1	32.3
São Tomé & Príncipe	72.9	65.6	2.6	194.4	1.1	140.6	7.1	43.8
Senegal	12.5	23.5	0.9	132.1	3.5	36.5	6.2	28.1
Seychelles	6.9	64.7	7.2	27.5	0.4	193.0	6.2	79.4
Sierra Leone	18.8	66.2			0.9	147.4	5.5	76.2
Somalia	53.5	17.1			1.5	187.4	3.3	59.1
South Africa	0.3	25.1	0.6	250.4	0.1	59.7	3.3	23.6
Sudan	5.5	50.8	1.3	177.0	3.4	66.6	1.1	95.9
Swaziland	4.5	47.2	4.8	73.6	8.3	40.2	3.5	54.1
Tanzania	18.2	33.0	1.9	92.7	0.1	136.1	3.3	41.8
Togo	10.7	42.6	1.5	98.9	2.1	80.2	5.8	73.9
Tunisia	2.0	44.8	2.2	54.5	4.3	13.4	8.9	19.0
Uganda	11.7	47.9	1.2	111.3	1.2	207.2	3.2	38.4
Zambia	19.6	62.6	3.1	77.0			12.7	119.2
Zimbabwe	4.6	50.8	0.7	264.6	0.1	180.0	7.1	51.2
Average	4.4	49.5	1.4	152.4	2.6	65.9	6.2	38.3

***Source**: Calculated with data from World Bank 2005a and 2005b.*

***Note**: Averages are weighted by GNI.*

Table A2

Selected capital flight estimates for sub-Saharan Africa

	Ajayi	Hermes, Lensink and Murinde+	Ndikumana and Boyce	Salisu
Sample size (number of countries)	22	46	30	46
Period	1980-91	1976-97	1970-96	1991-2004
Definition	KF = CA + FDI + ΔRES + ΔDEBTADJ + ΔRESADJ + ΔFAB	KF = ΔDEBT + FDI – (CA + ΔRES)*	KF = ΔDEBTADJ + FDI – (CA + ΔRES) + MISINV	KF = ΔDEBT + FDI – (CA + ΔRES)
Average annual capital flight ($ billion)	5.8	2.9	10.1	13.1
Capital flight as per cent of GDP, annual	5.1	2.6	6.4	7.6

***Sources**: Ajayi, 1997; Hermes, Lensink and Murinde 2002; Ndikumana and Boyce 2003; Salisu 2005.*

Notes:

* The exact formula varies slightly by paper of these authors.
+++ Estimates are based on a dataset ECA gratefully received from the authors.

KF	estimated capital flight
ΔDEBT	stock of gross external debt
FDI	net foreign direct investment
CA	current account balance/deficit
ΔRES	change in the stock of international reserves
ΔRESADJ	change in total reserves minus gold
ΔFAB	change in foreign assets of banks
ΔDEBTADJ	change in the country's stock of external debt (adjusted for cross-currency exchange rate fluctuations, to take into account the fact that debt is denominated in various currencies and then aggregated in USD)
MISINV	net trade misinvoicing

Appendix B: Debt Relief under HIPC and MDRI

In 1996 the World Bank and the IMF launched the Heavily Indebted Poor Countries (HIPC) initiative, which for the first time involved debt relief from multilateral financial institutions. Heavily indebted countries are defined as having a net present value of debt above 150 per cent of exports or above 250 per cent of government revenues. The initiative was enhanced in 1999 (HIPC II) to provide faster and deeper debt relief to a larger number of countries. As of June 2006 33 African countries are in the process, of which 11 have reached their decision points (see table) and 14 have reached completion point.

In 2005, the HIPC initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI) of the G-8, which allows for 100 per cent debt relief by the IMF, the International Development Association (IDA) of the World Bank and the African Development Fund (ADF) of debt incurred before January 2005 for countries completing the HIPC process. In principle all 33 African HIPC countries are eligible but only the 14 post-completion point HIPCs are eligible for immediate debt relief.

The IMF has already delivered 100 per cent debt relief amounting to $2.6 billion to 14 African countries in the first half of 2006. As this relief only applied to debt outstanding at end-2004, all countries but Ethiopia still have small IMF debts now. On average, MDRI relief from the IMF had a limited impact on overall indebtedness. External debt stocks only decreased by 5 per cent on average, although for individual countries such as Zambia the rate was 17 per cent. The ADB has approved $8.5 billion for financing debt relief, which was expected to become effective by mid-2006. The International Development Association (IDA) of the World Bank has approved the cancellation of $37 billion for all HIPC countries over 40 years, starting in July 2006.

Although currently only 14 African countries have reached the HIPC completion point, this number is expected to increase in the near future. The pre-decision point countries and Eritrea, that has been included under the sunset clause, fulfil the criteria of low GDP per capita and high indebtedness. The Central African Republic, Côte d'Ivoire and Togo have also met the policy criterion and are preparing PRSPs or Interim-PRSPs. Comoros, Eritrea, Liberia, Somalia and Sudan have not had an IMF- and IDA-supported programme since 1996 and three countries have protracted arrears. Most of these countries have been affected by conflict, but have now also started to make progress towards decision point.

African HIPC countries (33)

HIPC completion point (14)	HIPC decision point (11)	HIPC pre-decision point (7)	Potential new HIPC countries (1)
Benin	Burundi	Central African	Eritrea
Burkina Faso	Cameroon	Republic	
Ethiopia	Chad	Comoros	
Ghana	Democratic Republic	Côte d'Ivoire	
Madagascar	of Congo	Liberia	
Mali	Republic of Congo	Somalia	
Mauritania	The Gambia	Sudan	
Mozambique	Guinea	Togo	
Niger	Guinea-Bissau		
Rwanda	Malawi		
Senegal	São Tomé & Príncipe		
Tanzania	Sierra Leone		
Uganda			
Zambia			

***Sources**: IMF 2006; IMF/IDA 2006; World Bank, AfDB.*

Capital Flows and Factor Markets

3.1 Introduction

Capital flows in the form of FDI, ODA, remittances, and to a much lesser extent, portfolio investments, have important implications for both domestic investment and local labour markets in Africa. Capital flows can stimulate domestic investment and productivity, resulting in job creation in the host country. Causality also runs in the other direction insofar as the characteristics of factor markets, especially labour market conditions, influence the type, the amount and the stability of inflows. In an increasingly competitive global economy, the level of education and skills of the labour force are important determinants of private capital flows.

"In an increasingly competitive global economy, the level of education and skills of the labour force are important determinants of private capital flows"

The aim of this chapter is to summarize these different linkages between capital flows and factor markets with a view to highlighting areas that African governments can target to harness the benefits of capital flows. The key messages emanating from this chapter are:

- Capital flows can potentially have significant effects on domestic investment and employment, and hence, on development in general;
- Factor costs and regulations are important determinants of capital inflows;
- African governments need to establish policies to enhance the effects of capital flows on overall development and poverty reduction including measures such as promoting foreign investment in labour-intensive sectors, improving the functioning of the domestic labour market, and investing in education and skills; and
- African countries also need to channel ODA flows and remittances towards investment-related activities, which stimulate economic growth and job creation.

The remainder of the chapter is structured as follows: in section 3.2 the relationship between domestic labour markets and FDI is explored, addressing both the impact of labour costs and institutions on capital flows, an issue also taken up in chapter 2 of this report. Conversely, the effects of FDI on the labour market in terms of job creation and wages are also explored. In section 3.3, the linkages between FDI and domestic investment are investigated. Section 3.4 examines the connection between ODA and domestic factor markets, while section 3.5 discusses the links between

remittances and factor markets. Section 3.6 presents the case studies of Ethiopia and Ghana to illustrate some of the relationships between FDI and domestic factor markets. Section 3.7 concludes and provides policy recommendations.

"The combination of labour costs, skills and productivity constitutes a decisive factor for foreign investors"

3.2 Foreign direct investment (FDI) and domestic labour markets

In this section, four aspects of the relationship between FDI and domestic labour markets are considered:

- How labour market conditions and regulations affect FDI;
- The role of human capital in determining FDI flows;
- The impact of FDI on the quantity and quality of employment; and
- The impact of FDI on the level and distribution of wages.

The impact of local labour market conditions and regulations on FDI

As summarized in chapter 2, empirical research has identified various factors that determine the type, magnitude, stability and destination of foreign investment. These include economic growth and per capita income, infrastructure, the degree of industrialization, government policies and incentives, and labour market conditions and regulations (Javorcik and Spatareanu 2005; Billington 1999).

The focus in this section is on the role of domestic labour markets, which consist of two components: the direct cost of labour (wage and non-wage remuneration, taxation, social security contributions and insurance); and the indirect costs stemming from labour market regulations such as legislation relating to hiring, firing, hours worked, and unionization.

Labour costs are an important determinant of foreign investment

Foreign investors can be attracted to a particular location because of low wages, which imply higher profitability of investment. A skilled labour force may also be a magnet for foreign companies as this translates into higher productivity of investment. The combination of labour costs, skills and productivity constitutes a decisive factor for foreign investors.

The importance of labour costs as a determinant also depends on the type of FDI. As discussed in chapter 2, there are two main types of FDI: vertical and horizontal FDI. In the first type, multinational corporations (MNCs) are attracted to a specific location because of factor price differences – in this context, relative wages. In the case of

horizontal FDI, MNCs invest in different locations as a consequence of costly trade barriers; that is, investments are market seeking. Thus, an increase in labour costs is expected to have a stronger negative effect on vertical FDI than on horizontal investments (Kucera 2002).

The empirical evidence for the impact of labour costs on FDI flows is, however, at best mixed. For example, Asiedu (2002) reports that different cross-country studies find that labour costs can have either a positive, negative or insignificant effect on FDI. However, as argued in Kucera (2002), the evidence "leans towards suggesting that higher labour costs negatively affect FDI"(Kucera ibid, p.4). The effects are even stronger in studies that have controlled for differences in labour productivity.

Excessive regulation may be an even greater deterrent of FDI

The cost of labour for investors is also influenced by the nature of labour market regulations in place, and in particular, the flexibility of employment. For example, employment protection can deter employers in general from hiring workers (OECD 2004). If legislation prevents or constrains dismissal, employers will subsequently have lower incentives to hire in the first place. These regulations can affect the incentives for foreign companies to invest in a specific location.

> *"Labour laws that reduce gender inequality or promote economic and political stability can increase economic growth"*

Labour laws can also potentially have a positive effect on economic growth and ultimately, on foreign investment. As summarized in Kucera (2002), labour standards (freedom of association, collective bargaining, prevention of child labour and gender discrimination) can impact economic growth through a number of channels. For example, labour laws that reduce gender inequality or promote economic and political stability can increase economic growth, and as a consequence, private capital flows. In terms of more direct linkages, preventing industrial disputes can help attract foreign companies to invest, which appears to be a barrier for investors in countries such as South Africa (Asiedu 2005).

Javorcik and Spatareanu (2005) offer one of the few studies that investigate the impact of labour-market regulations on FDI. Using firm-level data for 19 Western and Eastern European countries, these authors find that greater labour market flexibility in the host country in absolute and relative terms is correlated with higher FDI flows. In contrast, Kucera (2002) finds no support for the hypothesis that foreign investors favour countries with lower labour standards. The results in this study, in fact, indicate that unionization rates are not related to FDI flows, while the correlation between FDI and stronger civil liberties and political rights is positive. This evidence suggests that the benefits of sound labour standards outweigh the costs.

The relationship between labour market regulations and FDI in Africa

FDI in Africa has largely been concentrated in the natural resources sector, which is capital-intensive. Therefore, wages and other characteristics of the labour market are unlikely to have had a significant impact on investment. The empirical evidence for

the impact of labour market regulations is, unfortunately, scarce, especially for African countries.

Looking at available country-level data, African countries appear to have a high degree of labour market regulation compared with other regions. The average employment rigidity index in 38 African countries, where adequate data are available, is 53.2 on a scale from 0 to 100, the highest of all regions.[1] In comparison, the average stands at 26.2 in East Asia and Pacific and 40.3 in Latin America and the Caribbean. For the SSA subregion, the index ranges from 10 in Zambia, the African country with the most flexible labour market, to 90 in Niger and Democratic Republic of Congo, countries with the most rigid labour regulations.

"African countries need to focus investment policies to more labour-intensive industries"

Two other indicators of rigidities in the labour market compiled as part of the World Bank's *Doing Business Database* are hiring costs as a percentage of salary and firing costs in terms of number of weeks of wages. Hiring costs in Africa are, on average, 12.8 per cent of the salary, though it ranges from 0 in Botswana, Ethiopia and Lesotho to 27.4 in Benin and 27.5 in Algeria. Similarly, while the average cost of firing amounts to 55.3 weeks of wages, it varies from only 4 weeks in Nigeria to 176 weeks in Zambia and 188.3 weeks in Sierra Leone. High hiring and firing costs are a deterrent for foreign investors.

However, the enforcement of labour market regulations is typically weak in most African countries. For example, in Niger, the rate of compliance with the minimum wage and hours of work regulations is only 2 per cent, with only slightly higher rates for compliance with social security obligations and health and safety rules (Maldonado 1995). As a consequence, such policies may not have any discernible impact on capital flows.

FDI and labour market outcomes

One of the key benefits of foreign investment is job creation, though this is by no means guaranteed, since the impact of FDI on the domestic labour market can be positive, neutral or negative. Assuming that unskilled labour is the abundant factor in developing countries, FDI should theoretically be concentrated in sectors that use low-skilled labour intensively, such as textiles and simple assembly operations (Vivarelli 2004). This implies that foreign investment increases the demand for unskilled workers, and as a result, their wages.

However, as underscored in chapter 2 of this report, the majority of recent FDI flows to Africa have been concentrated in the natural resources sector. Therefore, the employment effects of such investments are unlikely to be large. Nonetheless, African countries need to be aware of the employment impact of FDI in order to focus poli-

1 See the World Bank's *Doing Business Database* for more information: http://rru.worldbank.org/DoingBusiness/. The index is an average of three sub-indexes: a difficulty-of-hiring index, a rigidity-of-hours index, and a difficulty-of-firing index.

cies on attracting investments to more labour-intensive industries. Specifically, the number of jobs created depends on a range of factors including the following:

- The proportion of foreign workers brought in by the foreign-owned company, which determines the potential number of jobs available for local workers;
- Greenfield investments, which entail an increase in the host country's capital stock, are more likely to create jobs, while mergers and acquisitions tend to result in redundancies (Lall 2004);
- The more capital-intensive the technology used in production, for example in the natural resource sector, the smaller the employment effects resulting from the investment;
- For vertical FDI, an important issue is the orientation of trade and industrial policies in the host country. In countries with export-oriented regimes and a ready supply of cheap labour, foreign investment is likely to generate a significant number of jobs (Lall 2004). Of course, these factors are important determinants of FDI in the first place;
- Higher productivity of foreign investment reduces the demand for labour; and
- The labour market conditions in terms of costs and regulations also influence the number of jobs created through foreign investment. If hiring costs are high, for example, companies generally will hire fewer employees and substitute capital for labour.

> *"Capital flows can also increase incomes, consumption and investment, which in turn stimulate job creation"*

Over the long-term, the direct employment effects of foreign investment hinge on such factors as how the company continues to invest in technology and capacity, the growth in product demand, the supply of skills, wage development, other input costs and labour market regulations, the availability of infrastructure, and changes to the global market (UNCTAD 1999).

Besides the jobs directly created by foreign-owned companies, FDI also contributes to employment through indirect channels, which can in fact be larger than the direct effects, resulting in large multiplier effects. Some examples include (see UNCTAD 1999 and Lall 2004):

- Jobs created in vertically linked firms and through sub-contracting, which depends on the demand by foreign-owned companies for materials, services and components sourced locally;
- There can be positive (technology spillovers) effects on domestic competition;
- At the same time, since foreign companies tend to be more efficient, their entry into the market could push domestic companies out of the market, resulting in job losses. The debate about the evidence for "crowding-out" is explored further in section 3.3 below;

- Over the longer term, more FDI could be attracted in order to supply the initial investment or to compete with the incumbent. These investments have corresponding effects on employment in the host country; and
- Finally, capital flows can also increase incomes and subsequently consumption and investment, which in turn stimulate job creation.

African countries with more FDI tend also to experience higher rates of employment growth

The employment effects of FDI

There is very little quantification of the impact of FDI on employment in African countries. A study by Iyanda (1999) on FDI flows in Namibia reveals that for every worker employed by a foreign affiliate, another 2-4 jobs were created. In comparison, the more general study by Aaron (1999) finds that FDI in developing countries created about 26 million direct and 41.6 indirect jobs in 1997, suggesting a multiplier effect of 1.6.

Using a sample of SSA in the *World Bank Development Indicators Database* reveals that there is evidence of a positive correlation between the growth of the labour force and the ratio of FDI to GDP over the 1990-2002 period. This suggests that African countries, which attract higher inflows of foreign investment, tend also to experience higher rates of employment growth.

Another question explored in the literature is whether FDI generates more employment than domestic investment. In this regard, Spiezia (2004) finds that the impact of FDI on employment is increasing with per capita income, and in low-income countries, the effect of FDI is in fact insignificant. However, our own evidence using a sample of SSA countries suggests that there is a significant impact of FDI on the growth of the labour force, though the magnitude of this effect is smaller than it is for domestic investment (table 3.1).[2]

Table 3.1
Estimates of employment effects of foreign versus domestic investment in sub-Saharan African countries, 1990-2002

Dependent variable: growth of labour force	
Covariate	Coefficient
FDI/GDP	0.036**
	(0.011)
DI/GDP	0.048*
	(0.015)
R2	0.11
F	3.64**
No. of observations	363

** - significant at 10%*

*** - significant at 5%; robust standard errors are provided in parentheses; the econometric specification includes time dummies; FDI = foreign direct investment and DI=domestic investment.*

2 However, once time-invariant effects such as country-specific factors are controlled for, the coefficient estimates for both variables FDI/GDP and DI/GDP become insignificant.

Capital flows have implications for both wages and inequality

In addition to their impact on employment, FDI flows can also affect the level and distribution of wages. It is possible that foreign companies pay higher wages and provide better conditions than their domestic counterparts. Alternatively, these companies could take advantage of lax regulations and excess supply of labour to keep wages down for certain types of workers, sometimes below the level in the local labour market. However, the literature finds quite unanimously that multinational corporations pay higher wages than their domestic counterparts (Lipsey 2002). The various hypotheses explaining the existence of a wage premium in foreign-owned firms are listed in box 3.1.

Using data on individual wages in the manufacturing industry for five African countries (Cameroon, Ghana, Kenya, Zambia and Zimbabwe) in the early 1990s, te Velde and Morrissey (2003) investigate whether foreign-owned firms pay higher wages. They find that foreign ownership is indeed associated with a wage premium of 20-40 per cent, though these figures drop to 8-23 per cent once sectoral and regional location are accounted for in the econometric analysis. Moreover, the wage premium increases with educational attainment suggested that skilled workers benefited the most. Asiedu (2004) presents evidence that suggests that the wage premium ranges from 10 per cent in Côte d'Ivoire to about 130 per cent in Morocco.

FDI can also result in higher wages in domestic firms as a consequence of spillovers, which are feasible in labour markets where the supply of labour is not perfectly elastic. The empirical evidence for this effect is mixed according to Lipsey (2002), but overall,

Box 3.1
Wage premiums in foreign-owned enterprises

There are a number of hypotheses put forward as explanations for a wage premium in foreign-owned firms:

- Foreign firms may pay wages that are higher than the market-clearing rate – referred to as efficiency wages – to ensure higher productivity of workers. Reasons for such efficiency wages include:
  - Higher wages increase worker's effort in a situation where monitoring is imperfect;
  - Higher wages can improve loyalty and reduce worker turnover;
  - Higher wages attract better workers; and
  - Higher wages ensure that workers are well fed and more productive.
- Foreign-owned firms pay higher wages because they acquire higher-wage plants or firms or because they are concentrated in high-wage industries or regions of a country (Lipsey 2002).
- MNCs are more profitable and share rents with their workers (Scheve and Slaughter 2003).

FDI activity tends to have a positive impact on average wages (including wages in both foreign- and domestic-owned firms). However, this could reduce competitiveness in the tradable sector and contribute to job losses in the domestic economy.

Foreign investment can affect the distribution of wages through its relative demand for skills, and so impact within-country on income inequality. For example, if FDI is more skill-intensive than domestic investments on aggregate in the host country, such investments increase the demand for the relatively skilled workers and, correspondingly, their wages. Vivarelli (2004) summarizes the empirical evidence from various studies and concludes that there is no clear link between FDI flows and within-country inequality.

> *Foreign investment can influence the conditions in the workplace*

Implications for the status of vulnerable groups

Related to this distributional aspect is how capital flows affect specific groups in the economy, particularly women. For example, some argue that capital flows such as FDI have improved the situation of women by creating jobs for them, particularly in export processing zones (EPZs), which in turn provide these women with a better status in society, besides assisting their families in getting out of poverty. In contrast, it has also been suggested that foreign investors seek low-cost locations and employ women because they are able to pay them lower wages and subject them to harsher working conditions (UNCTAD 1999).

More generally, foreign investment can influence the conditions in the workplace in such areas as job security, hours worked, provisions for holidays, sick/maternity/paternity leave, and occupational health and safety.

African labour markets are typically segmented such that a minority work in the formal economy, where conditions and salaries tend to be better, while the rest of the population are confined to the informal segment, which is characterized by lower wages, longer hours, less security and little protection. Since foreign companies are more likely to form linkages with domestic enterprises in the formal economy, foreign investment will help to improve opportunities in this segment of the domestic economy. This implies that FDI may contribute to increasing formalization of the economy. However, in the case of African economies, such formalization is constrained by over-regulation, poor infrastructure, lack of access to an educated labour force, and other constraints.

Human capital and FDI

Skills and education are important determinants of FDI

The importance of human capital for FDI has increased as economies have shifted more and more to knowledge-intensive production technologies. As a consequence, multinational corporations are increasingly looking for a well-educated labour force,

not just low labour costs. In fact, the availability and cost of low-skilled workers is now less relevant for FDI than the availability of high-skilled workers. Foreign investors are seeking the right combination of wages, skills and productivity. This may explain why countries such as India have attracted significant inflows of FDI in the IT sector, which requires a stock of well-trained scientists and technicians.

A number of studies have investigated the role of human capital as a determinant of FDI.[3] Borensztein et al. (1998) find that there is a strong complementary effect between FDI and human capital such that investments have high productivity only when the host country has a minimum threshold stock of human capital. Noorbakhsh et al. (2001) also find that human capital is one of the more important determinants of FDI inflows. The results show that the impact of education was the strongest in the early 1990s (the latest period in the study) reflecting the shift of investments to services and technology-intensive manufacturing. Asiedu (2005) finds that having an educated population helps attract FDI inflows to African countries, in addition to the presence of natural resources and large markets, low inflation, good infrastructure, openness to FDI, good governance, political stability and a reliable legal system.

"Foreign investors are seeking the right combination of wages, skills and productivity"

Human capital in Africa remains at low levels, though countries have made considerable progress in recent years. In particular, the literature suggests that governments need to focus on not only expanding access to education, but also on developing curricula that are aligned with the demands of employers.

FDI can also contribute to human resource development in the host country

In general, firms in both developed and developing countries under-invest in training because of market failures resulting from credit constraints, lack of information/awareness and labour turnover. These constraints are less binding for larger firms, implying that most foreign-owned companies are in a better position to train in comparison with domestic firms. MNCs are in particular keen on developing the skills of their local employees through education and training (Noorbakhsh et al. 1999; Miyamoto 2003).

Asiedu (2004) presents figures on the provision of formal training to workers in four Africa countries (Ghana, Kenya, Zambia and Zimbabwe), which illustrate that foreign-owned firms are more likely to train their employees than their domestic counterparts. For example, in 1995, 46.2 per cent of wholly foreign-owned firms in Kenya provided training compared with 16.1 per cent of wholly domestic-owned firms.

Governments should encourage multinationals to undertake human resource development in order to facilitate technology transfer. Such training spillovers can occur via vertical (backward and forward) linkages with domestic firms. Spillovers can also result from employees of multinational corporations (MNCs) seeking work in domestic enterprises (labour turnover) or from those starting up their own spin-offs (Miyamoto 2003).

3 See Miyamoto (2003) for a review of the literature

3.3 FDI and domestic investment

There has been a considerable debate about the relationship between foreign capital and domestic investment. In this debate, the two key questions asked are: (a) Does FDI "crowd-out" or "crowd-in" domestic investment? And (b) How does domestic investment influence foreign capital flows?

The impact of FDI on domestic investment

Crowding-in or crowding-out?

> *Crowding-out or crowding-in of domestic investment can occur via product markets or financial markets*

The question is whether foreign investment leads to a decrease in domestic investment activity, which is termed crowding-out, or in an increase, i.e. crowding-in (UNCTAD 1999). Crowding-out or crowding-in of domestic investment can occur via product markets or financial markets (UNCTAD, ibid). In the first case, foreign investment can stimulate domestic investment activity through downstream or upstream linkages. For instance, a multinational corporation may source raw materials from domestic suppliers or it may outsource particular activities to firms in the host country. However, in many African countries, the bulk of FDI has flowed into the natural resources sector, which has few linkages, and therefore, the indirect effect of FDI on domestic investment is likely to be marginal in such economies.

Foreign investment can also have adverse effects on financial markets in the host country. If MNCs borrow in the domestic financial market, this can push up interest rates, which subsequently crowds out borrowing by domestic companies. Moreover, if the capital flows coming into the country are relatively large, this may lead to an appreciation of the real exchange rate and reduce export competitiveness and incentives for domestic investment (UNCTAD 1999). This latter effect is stronger for M&As than for new investments (Agosin and Mayer 2000).

Agosin and Mayer (2000) suggest that if FDI in developing countries follows existing sectoral composition (investing in established sectors), foreign capital is more likely to result in crowding-out since the foreign investors will be competing with domestic producers. Crowding-in is more likely to occur when the investments are made in non-existing sectors, so that MNCs introduce new goods and services, which do not compete with domestic firms and displace them from the market.

Another possible mechanism for crowding-out stems from the preferential treatment provided to foreign investors in terms of tax breaks, cash grants, duty exemptions and subsidies, which are not available for local investors. The main justification for providing such incentives to promote inward FDI is to take advantage of spillovers of foreign technology and skills to local industry (Blomstroem and Kokko 2003). However, this differential treatment of investors can increase the competitiveness of foreign companies and contribute to crowding-out of domestic firms in the local market.

The 2003 UNCTAD *World Investment Report* highlights a number of mechanisms for crowding-out. Firstly, local firms are crowded out of the market because foreign-owned firms are more efficient and produce goods of better quality. Secondly, domestic firms are displaced because MNCs have better access to financial resources. Finally, foreign-owned firms may engage in anti-competitive behaviour (UNCTAD 2003b). The first scenario has a positive initial impact on welfare, while the second and third have a negative effect. Therefore, it is important to be able to distinguish between the two channels, though this is empirically difficult to identify. If FDI has a negative impact on domestic investment, African governments clearly need to consider the appropriateness of such projects.

If FDI has a negative impact on domestic investment, African governments clearly need to consider the appropriateness of such projects

Does foreign investment crowd-in or crowd-out

FDI tends to stimulate domestic investment (Spiezia 2004). Borensztein et al. (1998) find, for example, that for every dollar of FDI, there is a corresponding increase in total investment by between $1.5 and $2.3. The results presented in Bosworth and Collins (1999) indicate that FDI and international bank lending have the largest impact on domestic investment, while the effects of portfolio flows are weaker.

The *World Investment Report 2003* produced by UNCTAD (2003b) reviews the evidence for crowding-out and finds that it is mixed. In the earlier *World Investment Report 1999*, econometric evidence was presented showing that the effect of FDI is mostly neutral, with some cases of crowding-out and some of crowding-in (UNCTAD 1999).

Agosin and Mayer (2000) find a neutral impact of FDI on total investment in Africa, but crowding-in in the Asian region and crowding-out in Latin America during the period 1970-1996.

However, breaking down the period into smaller intervals does indicate, for example, that FDI in Africa crowded in domestic investments after 1975. Disaggregating the data to the country-level reveals even more heterogeneity in the impact of FDI on domestic investment. In terms of the African countries used in the sample, there is evidence of crowding-in in Côte d'Ivoire, Ghana and Senegal, crowding-out in the Central African Republic, Nigeria, Sierra Leone and Zimbabwe, while the effect is neutral in Gabon, Kenya, Morocco, Niger and Tunisia.

Capital flows, instability and domestic investment

Another channel for external capital flows to affect domestic investment is through the volatility of flows, in addition to the levels (Fosu 1991, 2001). An explanation for this effect is provided by the option value of theory of investment (Dixit and Pindyck 1994). This approach considers the impact of uncertainty on investment that is irreversible, which implies that it is easier to increase the capital stock than to sell it. Con-

sequently, there is an option value to waiting rather than investing. For example, if domestic suppliers base their (irreversible) investment decision on their expectations about FDI in a particular industry, uncertainty about these flows would deter them from carrying out such an investment.

Furthermore, instability in the exchange rate generated by external capital flows can have a negative impact on investment. Bleaney and Greenaway (2001) find supportive evidence for this effect in a sample of 14 SSA countries over the period from 1980 to 1995.

"Instability in the exchange rate generated by external capital flows can have a negative impact on investment"

The domestic investment climate influences capital flows

A good investment climate is essential for growth of the private sector, which plays a pivotal role in job creation and, hence, poverty reduction in all developing economies. Such an investment climate depends both on factors that governments cannot influence, such as geography and consumer preferences and those that are determined by government policies and laws. The latter includes macroeconomic and political stability, security of property rights, sensible regulation and taxation, provision of infrastructure, functioning finance and labour markets, a skilled labour force and good governance aspects such as low levels of corruption (World Bank 2005). The presence of such an investment climate will help promote domestic investment and, ultimately, economic growth. This subsequently acts as a positive signal for foreign investors and helps to attract FDI.

Besides this indirect link, it is also possible that foreign companies seek out joint ventures with domestic partners, which is often the initial form of foreign investment allowed by governments of developing countries.

3.4 Official development assistance and domestic factor markets

To identify the impact of ODA on domestic labour markets and investment activity, it is necessary to start with the general debate about aid flows and economic growth, before turning to specific linkages.

Aid can theoretically stimulate growth, investment and job creation

One of the most discussed and analysed issues facing governments, donors and researchers is whether aid promotes economic growth. This relationship was for a considerable time based on the two-gap model first proposed by Chenery and Stout (1966), in which the gaps between savings and investment and between foreign exchange earn-

ings and import requirements were shown to constrain economic growth (Dollar and Easterly 1999, Gomanee et al. 2005 and Gupta et al. 2006). In such a situation, flows of capital in the form of aid can finance these gaps, resulting in higher levels of investment and, ultimately, in increased economic growth.

Another mechanism for aid inflows to increase domestic investment is through the relationship between public investment financed by aid flows and private investment. Similar to the crowding-out hypothesis for FDI flows, it is possible that aid-financed public investment can stimulate or hinder private investment. For instance, aid could finance infrastructure investments, which in turn support private investors. There is empirical evidence to suggest that public investment in SSA tends to crowd in private investment, reflecting the complementarity of the two types of investment (Gupta et al. 2006). Evidently, the size of the effect will depend on how much aid is allocated to public investment. As discussed in chapter 2, only 14 per cent of ODA in Africa in 2001/2002 went to economic infrastructure and services.

Therefore, apart from the direct hiring of personnel in the host country, aid flows can potentially stimulate job creation through increased (public and private) investment and accelerated economic growth.

“Aid flows can potentially stimulate job creation through increased investment and accelerated economic growth”

Aid flows can also negatively affect the economy

However, aid may also have a negative impact on the recipient country’s economy. The general argument here is that aid inflows increase the demand for non-tradable resources such as skilled labour and public services including health care and education. If there is little excess supply of these inputs in the economy, the increased demand will push up prices of the non-tradables vis-à-vis tradables. The subsequent appreciation of the real exchange rate (RER) in turn damages the competitiveness of the tradable goods sector, an effect referred to as “Dutch Disease”. This loss of competitiveness leads to a fall in investment and job destruction in the tradable sector, and ultimately, to reallocation of resources to the non-tradable sector. This effect is likely to be stronger when trade is restricted, the economy is close to full capacity, and consumers are constrained in switching between domestic and imported goods (Gupta et al. 2006). Overall, the impact of aid will depend on the type of assistance, how it is spent and the efficiency of the expenditure.

Summary of the evidence on the aid-growth relationship

Burnside and Dollar (2000) find that the relationship between aid and growth is indeed positive, though more recent studies suggest that there is no clear association. Focusing on the investment channel, Gomanee et al. (2005) find that foreign aid has a significant positive effect on growth in a sample of 25 SSA countries over the

period from 1970 to 1997. The results indicate that a one percentage point increase in the aid/GNP ratio is associated with a one-quarter of a percentage point increase in growth.

Rajan and Subramanian (2005) explore the channel through which aid affects competitiveness and hence economic growth via wage inflation, which results from increased labour demand, especially for skilled labour. Based on this hypothesis, the authors investigate whether labour-intensive industries, i.e. those more affected by higher wages, grow relatively slower in countries with high aid inflows. The results indicate that aid inflows are indeed associated with a decline in the share of labour-intensive and tradable industries in the manufacturing sector.

Aid affects the real exchange rate and its subsequent impact on economic growth; (Gupta et al. 2006) report that the relationship between aid inflows and real exchange rate appreciation is ambiguous, with some studies showing positive effects, while others find negative effects. For instance, a study by the IMF found that a surge in aid in five African countries (Ethiopia, Ghana, Mozambique, Tanzania, Uganda) actually resulted in a depreciation, not an appreciation, in the real exchange rate in the following year, by between 1.5-6.5 per cent (IMF 2005a).[4]

Other studies have focused on the direct impact of real exchange rate appreciation on economic growth. Using a panel of 14 SSA countries over the period 1980-1995, Bleaney and Greenaway (2001) find that both growth and investment are negatively affected by an overvalued real exchange rate, while investment is also hindered by real exchange rate instability.

3.5 Remittances also play an important role in investment and job creation

Remittances can promote development

By reducing budget constraints, remittances can play an important role in financing development through their impact on savings and investment. The resources provided by remittances can subsequently support consumption, housing, education and small business formation (IMF 2005b). Moreover, remittances can serve as insurance against risk in carrying out new productive activities and setting up businesses (World Bank 2003). Overall, remittances can directly promote investment and job creation, and indirectly via its long-term positive effects on economic growth. Hence, remittances in Africa can contribute to poverty reduction, an issue discussed in chapter 2.

As also discussed in chapter 2 of this report, remittances are an important source of capital in Africa. Though approximately 80 per cent of remittances are used for

4 See Kasekende and Atingi-Ego (1999) for evidence on the situation in Uganda

consumption and schooling, they are also increasingly being allocated to investment. For example, the impact of remittances is now evident in the construction sector in many African countries, particularly in real estate, which is a major employer of unskilled workers in urban areas. However, even if remittances are used for consumption smoothing, they can increase the demand for local products, and through multiplier effects, promote employment and investment. Moreover, by investing in the human capital of family members through funding of education, the remittances can improve the productivity and employment chances of the next generation.

> *Remittances can improve the productivity and employment chances of the next generation*

Though most remittances target family members, it is also possible to mobilize remittances from a community of migrants, which can subsequently be used for more substantial projects. The Mexican hometown associations in the United States are a good example of how collective remittances can be used for both charitable purposes and to finance productive investments (box 3.2).

Potential adverse effects of remittances

One potential negative effect of remittances is through the "Dutch Disease" channel discussed above, in relation to the impact of aid on economic competitiveness. However, it is generally found that, unlike ODA or natural resource revenues, remittances do not have any adverse effects on a country's competitiveness (IMF 2005b). For instance, Rajan and Subramanian (2005) find that, contrary to the results for aid, there is no evidence that remittances in SSA reduce competitiveness of the tradable sector via an appreciation of the real exchange rate. Remittances can be distinguished from other forms of capital flows since they are not subject to conditionalities or repayments, and there are no leakages as the resources go directly to the targeted recipient.

The role of domestic factor markets in determining remittances

The conditions in the labour market and the availability of investment opportunities can act as a determinant of remittances. Firstly, if the domestic labour market is characterized by unemployment or underemployment, the incentive in the first place to migrate is higher. Once the migrants are located overseas, they continue to support family members remaining behind who lack decent employment opportunities. Secondly, higher returns to capital in the migrant's home country should encourage more investment-oriented remittances. This in turn requires a conducive investment climate and an efficient financial system to attract investments to the country.

Box 3.2
Mobilizing remittances through collective migrant organizations

Remittances are typically transfers from migrants to other individuals or families in their country of origin. However, through community associations, church groups, refugee organizations, ethnic professional bodies and even virtual organizations, migrants also transfer collective remittances, usually targeting their community as a whole back home.

The most prominent example of this type of initiative are the hometown associations established by Mexicans in the United States, which have financed projects in Mexico in a number of areas such as charity, infrastructure such as road construction and provision of water and other utilities, and human development.

Numerous African migrant associations have also emerged in recent years. For example, many French migrants originating from the Kayes region of Mali have formed such associations, which have contributed, in turn, to the development of villages and rural areas back in Mali. It is estimated that over a period of ten years, these organizations financed a total of 146 projects representing 16.6 million francs, and have funded around 64 per cent of the infrastructure in the villages of the Kayes region.

***Sources**: Inter-American Development Bank website; Libercier and Schneider (1996); Sander and Maimbo (2003)*

"Migrants also transfer collective remittances, usually targeting their community as a whole back home"

3.6 Case studies: FDI, domestic investment and job creation in Ethiopia and Ghana

This section presents two African case studies – Ethiopia and Ghana – to highlight in particular the relationship between FDI and domestic investment and job creation.

Ethiopia

Investment conditions in Ethiopia

As a resource-poor country that receives considerable external capital inflows, Ethiopia is a useful case study to discuss the effects of FDI on domestic investment and the local labour market.

Although the private sector remains undeveloped, the Government has made considerable attempts in recent years to attract private capital flows in the form of FDI. UNCTAD/ICC (2004) identifies three main positive factors that should attract foreign investment to the country: market size (Ethiopia is the second largest African country), climate, a reasonable business environment, and low levels of corruption. The key sectors for foreign investment are agriculture and agro-based industries (flo-

riculture and horticulture), mining and hydropower, light manufacturing including leather goods and ready-made garments, tourism, and other services.

The Ethiopian Government provides some incentives for foreign investors including some exemption from import and export duties and profit tax.

The Ethiopian labour market

Labour costs are on average low in Ethiopia. According to the *World Development Indicators*, the average GDP per worker in Ethiopia was $1,716.1 in 2004, well below the SSA average of $4,412.3.[5] However, adjusting for labour productivity reveals that other developing countries are more competitive in terms of labour costs. This is an important factor in determining labour-intensive foreign investment.

One of the primary causes of low productivity in Ethiopia is the inadequate level of human capital. In fact, in all dimensions of education, Ethiopia lags behind the African region. For example, the net enrolment rate (NER) in primary school is only 46.4 per cent in Ethiopia, compared with an average of 64.1 per cent in SSA.[6] Moreover, only 50.6 per cent of that age group finish primary school in Ethiopia, compared with 61.7 per cent in the whole region. In terms of outcomes, the adult literacy rate in Ethiopia was 41.5 per cent on average for the period 2000-2004, which is 23 percentage points lower than the rate for the SSA region.

As highlighted in section 3.2, another important determinant of foreign investment is labour-market regulation. The principle source of labour law in Ethiopia is the new Labour Proclamation adopted in 2004. Subsequently, the Labour Proclamation incorporates a number of articles that address dismissal protection, regulation of severance pay and compensation, disability payments and dependent benefits.[7] There is, however, no minimum wage legislation in Ethiopia, and thus, foreign investors are not constrained from setting low wages for unskilled workers, who are in excess supply in the country.

The Labour Proclamation also provides a full guarantee for freedom of association and introduces a system of collective bargaining and settlements of labour disputes. The Ethiopian legislation also regulates fixed-term contracts. Gender equality is guaranteed by the Constitution, while the Labour Proclamation has provisions for penalizing sexual discrimination in the workplace. Ethiopia has also ratified 21 ILO conventions.

With respect to the labour market rigidities stemming from the Labour Proclamation and other forms of legislation, Ethiopia fares quite well in comparison with the rest of

5 Note that this does not control for differences in sectoral composition of output. Figures are in constant 2000 international $ in purchasing power parity terms.

6 The net enrolment rate (NER) is the number of pupils in the theoretical age group who are enrolled expressed as a percentage of the same population. Figures are for 2004.
Source: World Development Indicators, online database.

7 See http://www.ilo.org/public/english/dialogue/ifpdial/ll/observatory/profiles/eth.htm

SSA. Ethiopia has a value of 41 for the overall rigidity of employment index, which is lower than the regional average of 53.1. The other sub-indexes (difficulty of hiring, difficulty of firing, and rigidity of hours) are all below the average for SSA. Hiring cost as a percentage of the salary in Ethiopia is zero while it is 11.8 per cent in SSA. Firing costs (weeks of wages) represent 40.2 weeks of salary compared with an average of 53.4 weeks for the SSA as whole.

"Since 2000, FDI is helping to raise GCF in the Ethiopian economy"

At least on paper, Ethiopia has put labour laws in place and standards that provide protection for workers without overly restricting the functioning of the labour market. However, as often is the case, in countries where legal systems and enforcement are weak, compliance with these provisions is typically lax. These issues raise the question of whether or not these laws are binding and, in turn, whether they create costs for foreign companies, thus deterring foreign investment in Ethiopia. Moreover, these laws only apply to the formal sector, which accounts for a small proportion of employment in Africa, particularly in Ethiopia.

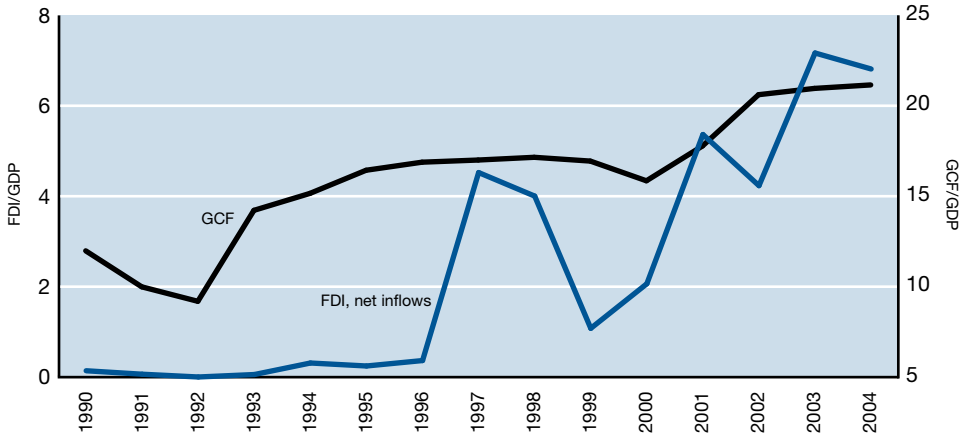
FDI and domestic investment in Ethiopia

Following the reforms undertaken in the early 1990s, net FDI inflows into Ethiopia accelerated in 1997 when it reached $289 million (4.5 per cent of GDP), before falling again in 1999.[8] Foreign investment has recovered since the war with Eritrea and as of 2004 inflows amounted to $545 million or 6.8 per cent of GDP. Figure 3.1 illustrates the trends in both net FDI inflows and gross capital formation (GCF) as a percentage of GDP over the period 1990-2004. There appears to be evidence that since 2000 FDI is helping to raise GCF in the Ethiopian economy.

8 The spike in FDI inflows in 1997 and 1998 was the result of a large hotel investment.

Figure 3.1

Net FDI inflows and gross capital formation in Ethiopia ($US), 1990-2004 (% of GDP)



***Source**: World Bank, 2006*

Turning to the data from the Ethiopian Investment Commission as reproduced in table 3.2, there were a total of 318 foreign projects in operation over the period July 1992-July 2005, with 272 (85.5 per cent) being wholly foreign owned and the remainder joint ventures with a domestic firm. This compares with 2,444 domestic private and 22 public investment projects. The average capital invested in foreign projects was 28.41 million birr ($3.28 million at current prices) per wholly foreign owned and 34.74 million birr ($4.01 million) for joint ventures. In comparison, domestic projects were much smaller, averaging 6.28 million birr ($0.72 million). Over the period 1998/1999 – 2004/2005, FDI in Ethiopia was concentrated in cash crops farming, accounting for 16 per cent of flows.

Table 3.2
Investment projects in operation in Ethiopia – July 1992 to July 2005

	Domestic	Foreign			Public	Grand total
		Wholly Foreign	Joint with Domestic	Total No.		
Total no. of projects	2,444	272	46	318	22	2,784
Average						
Capital (million birr)	6.28	28.41	34.74	29.33	211.04	10.53
Total employment (number of workers)	159.52	223.34	138.70	211.09	218.73	165.88
Permanent workers	37.17	120.08	104.33	117.81	192.23	47.61
Temporary workers	122.35	103.25	34.37	93.29	26.50	118.28
Share of temporary workers	76.70	46.23	24.78	44.19	12.12	71.30
Labour intensity (worker per million birr)	25.4	7.9	4.0	7.2	1.0	15.8

***Source**: Ethiopian Investment Commission (EIC); Capital in million of birr*

One direct channel of the impact of FDI on domestic investment is through joint ventures. According to EIC data, 14.5 per cent or 46 projects in Ethiopia over the period July 1992 to July 2005 were joint ventures. These investments with domestic partners averaged 34.7 million birr, generating 138.7 jobs per project.

FDI and job creation in Ethiopia

Foreign investment projects in Ethiopia created a total of 67,128 jobs from July 1992 to July 2005, representing 14.5 per cent of all jobs created during this period.[9] In comparison, domestic and public projects generated 389,876 and 4,812 jobs, respectively. On average, each foreign project generated 211 jobs, 118 permanent positions and 93 temporary jobs. Domestic investments resulted in fewer jobs (average 160), while public projects tended to employ more workers (219).

The labour intensity (the ratio of workers to capital invested) is highest in domestic projects (25.4 workers per million birr), which also have the highest share of tempo-

9 90.5 per cent were in wholly foreign-owned projects. Total number of jobs created (foreign, domestic and public) from July 1992 to July 2005 = 461,816.

rary workers, the majority of whom are unskilled. Foreign investment projects are less labour-intensive than domestic investment, though more so than public projects. For every million birr invested by a foreign company in wholly-owned projects in Ethiopia, 4 jobs are created, compared with 25 jobs in domestic-owned projects.

Over the period 1998/1999-2004/2005, FDI in Ethiopia created the most jobs (temporary and permanent) in the cash crops sector (79,338 jobs), followed by real estate development (37,397 jobs). Both these sectors are labour-intensive and largely employ unskilled workers.

> *Foreign investments in Ethiopia are an important vehicle for job creation*

Therefore, these figures indicate that, in general, foreign investments in Ethiopia are an important vehicle for job creation and may also contribute to decreasing inequality through increased relative demand for unskilled workers. However, domestic investment remains more labour intensive and therefore has a larger impact on employment in terms of quantity, though not necessarily in terms of decent jobs.

Ghana

Investment conditions in Ghana

In comparison to Ethiopia, Ghana is a country rich in natural resources, particularly gold. However, Ghana has had difficulties in attracting sustained inflows of FDI, in spite of the potential in the mining sector. Other promising but still undeveloped sectors for attracting FDI are agro-processing and agriculture, and light manufacturing for local and regional markets (UNCTAD 2003a).

The Ghanaian Government adopted a new mining law in 1986, which motivated a substantial increase of foreign investment in the mining sector. Subsequently, the Government promulgated the Investment Promotion Centre Act 1994 to regulate FDI in all sectors except in minerals, oil and gas, and free trade zones (FTZs), with the aim of facilitating the setting-up of businesses and attracting FDI. Incentives are also provided for would-be foreign investors in the form of tax holidays, capital allowances, location incentives, and customs duty exemptions. There are also special incentives for exporters and in the FTZs. However, investors, especially in the FTZs, have pointed out that these targeted incentives do not adequately compensate for the poor infrastructure and other constraining factors (UNCTAD 2003a).

Another important channel for attracting FDI in Ghana has been privatization, which reached its peak with the partial sale of the Ashanti Goldfields Corporation (AGC) to the South African mining company Lonmin for $233 million in 1994 (UNCTAD 2003a).

The Ghanaian labour market

Labour costs are higher in Ghana than in Ethiopia and in SSA on average. However, the Ghanaian labour force is also much more educated with the adult literacy rate reaching 74 per cent, compared with 41.5 per cent in Ethiopia (period 2000-2004). Nonetheless, foreign investors state that the level of education and skills is still too insufficient to meet their requirements (UNCTAD 2003a).

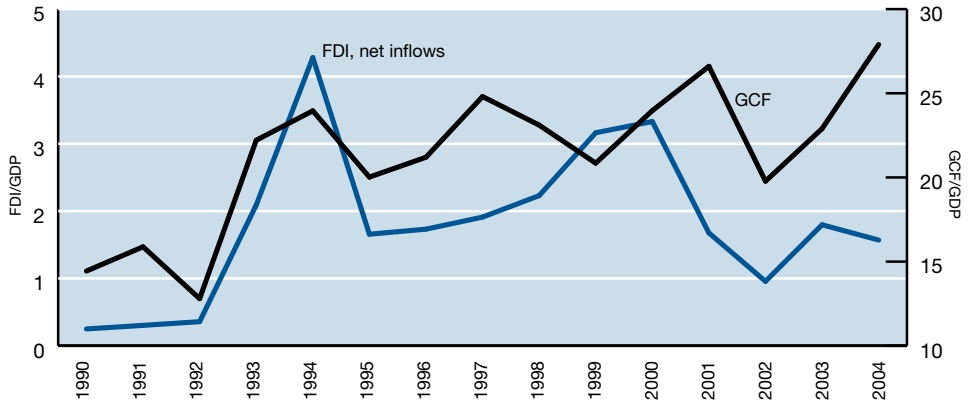
With regards to labour laws in Ghana, labour rights provisions are generally negotiated under firm-specific collective bargaining agreements, which can be complicated and lengthy (UNCTAD 2003a). Ghana also has in place a minimum wage, though its level is low (around US$1.30 per day in 2003) and is therefore unlikely to have a substantial effect on the demand for unskilled workers.

In general, Ghanaian employment regulations are less restrictive than the regional average. The employment rigidity index is 34 for Ghana, compared to 41 for Ethiopia and 53 for SSA. Specifically, hiring is more flexible and the number of hours worked less rigid in Ghana, though firing is more constrained in comparison with Ethiopia.

The impact of FDI on domestic investment in Ghana

After peaking at $233 million or 4.3 per cent of GDP in 1994, FDI in Ghana has fluctuated considerably (figure 3.2). As illustrated in figure 3.3, the contribution of FDI to gross capital formation in Ghana exceeded that of Ethiopia from 1990 to 1996, before the ratio in Ethiopia increased rapidly to over 25 per cent. FDI is now clearly a more important source of capital formation in Ethiopia than in Ghana.

Figure 3.2
Net FDI and gross capital formation in Ghana ($US), 1990-2004 (% GDP)



Source: *World Bank, 2006*

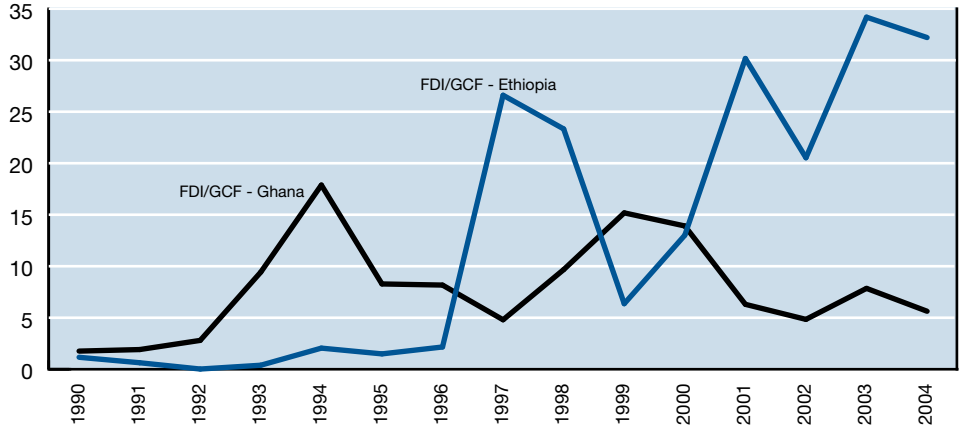
FDI and job creation in Ghana

Given that most of FDI in Ghana has been confined historically to the natural resources sector, it is not surprising that foreign projects have not resulted in significant job creation. Most jobs created by FDI in Ghana were therefore as a result of projects in other sectors. It is encouraging that recent data reveal that the manufacturing and service sectors have attracted the largest share of foreign investment (GIPC 2005). For example, over the period January 2001 to September 2005, the majority of jobs in new foreign projects were created in the manufacturing sector (table 3.3). In comparison, domestic projects resulted in more jobs in the service sector. Overall, these figures illustrate that though FDI created a total of 2,844 jobs over the almost 5-year period, the number is dwarfed by those created in domestic projects (38,562 jobs).

> *The majority of jobs in new foreign projects in Ghana were created in the manufacturing sector*

Figure 3.3

FDI's contribution to gross capital formation in Ghana and Ethiopia, 1990-2004 (% GCF)



***Source**: World Bank, 2006*

> *The impact of FDI on job creation also includes jobs created indirectly through linkages and multiplier effects*

Table 3.3
Employment creation in foreign versus domestic projects in Ghana, January 2001 – September 2005

Sector	Domestic		Foreign	
	Number of jobs	**Share**	**Number of jobs**	**Share**
Manufacturing	10,511	27.3	877	30.8
Services	11,517	29.9	587	20.6
Building and construction	4,185	10.8	341	12.00
Agriculture	4,375	11.3	217	7.6
Tourism	2,929	7.6	275	9.7
General trade	4,041	10.5	453	15.9
Export trade	1,004	2.6	94	3.3
Total	**38,562**	**100.0**	**2,844**	**100.0**

***Source**: GIPC (2005)*

The impact of FDI on job creation is not confined to its direct effect on employment, but also includes jobs created indirectly through linkages and multiplier effects. Box 3.3 provides an example of these direct and indirect effects in the case of Unilever's investment in Ghana.

Box 3.3
Unilever's subsidiary creates thousands of jobs in Ghana

Unilever Ghana Ltd. operates a highly integrated business in Ghana, involving the purchase of raw materials, the processing, packaging and subsequent distribution of soap and cleaning products. Altogether, Unilever employs around 1,200 farmers in Ghana in two oil palm plantations in addition to another 800 in their processing factory. Moreover, it is estimated that for every worker directly employed with Unilever, an extra three are employed indirectly through an independent entrepreneurs' distribution network.

***Source**: UNCTAD (2003a)*

3.7 Conclusion and policy recommendations

Based on the analysis in this chapter, a number of key findings can be highlighted:

- Since most FDI in Africa has been concentrated in the natural resources sector, few jobs have been created by such investments. There is some evidence that foreign firms pay a wage premium in Africa;
- Labour costs and regulations in African countries are important determinants of capital flows and a constraint to FDI;
- Undeveloped human capital is a major constraint to foreign investment in African countries;
- The investment climate in Africa remains a deterrent to both domestic and foreign investment; and
- Though official development aid and workers' remittances are important in Africa, evidence of their relationship with domestic labour markets and investment remains limited.

Overall, African governments need to promote capital flows to increase economic growth and job creation, and reduce poverty. The following policy recommendations are part of this agenda:

- The first and overriding priority is to develop a conducive investment climate through good governance, sensible regulation and taxation, infrastructure, access to finance and investment in education and skill development;
- Through the use of targeted policies and incentives, governments should encourage investments in more labour-intensive sectors such as food processing, manufacturing and services (tourism);
- Labour market regulations should be streamlined to encourage investment by both domestic and foreign firms, while protecting workers' rights;
- Governments should improve employment conditions especially in the informal sector;
- Governments should invest more in education and skills in order to attract investments in higher value-added activities. Training at the firm level and by private providers should also be encouraged;
- Governments should ensure that favourable treatment of foreign investment does not provide unfair advantage to foreign investors vis-à-vis domestic investors; and
- Governments should design incentives to encourage more investment-oriented remittances. Financial institutions may play an important role in facilitating transfers of remittances and in designing investment instruments targeting the Diaspora.

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Capital Flows and Economic Transformation

4.1 Introduction

Africa needs economic transformation in order to achieve sustainable growth and reduce its dependence on primary commodity production and exports. Economic transformation is a process that alters the relative contribution of economic sectors to GDP and employment over time. This process occurs through two main channels: first, reallocation of factors of production from less productive sectors to more productive ones; and second, diversification of the economy away from primary commodity sectors (agriculture, oil and minerals) into industry and services (Berthelemy and Soderling 2001).

"In many African countries increases in industry's share in GDP originate largely from production of oil and minerals."

Given the strong linkages of industry with other economic sectors, increases in the share of industry in GDP have the greatest potential to contribute to sustainable growth and structural change. We use the term economic transformation in this chapter to refer to a growth process associated with an increasing share of industry in GDP.[1] Economic transformation is more effective - in terms of employment creation and reducing vulnerability to shocks - when increases in industry's contribution to output are driven by increased manufacturing output rather than increases in the output of extractive sectors such as oil and minerals. Therefore, the shares of manufacturing output in GDP and total exports may be used as additional indicators of economic transformation.

The pace of structural transformation in Africa has been very slow. Although the share of agriculture in GDP declined over the last four decades, this decline was mainly the result of increases in the shares of sectors other than industry – mainly services – and reflects the lack of adequate policies and incentives to direct investment towards domestic industrial activities. Meanwhile, in many African countries increases in industry's share in GDP originate largely from production of oil and minerals. The contribution of revenues from these activities to economic transformation depends

1 Economic activity is expected to shift over time from the primary (agriculture and industry) sectors to the secondary (services and tertiary) sectors. Relative saturation in the consumption of industrial commodities normally induces expansion of the service sector, which requires high investment in such areas as information technology, export processing, and financial services (Hayami and Godo, 2005: 38). Typically investment in these areas is low in Africa, which limits opportunities for genuine economic transformation. While this chapter focuses on industry as a driver of economic transformation, we recognize that, in some countries, services may also play an important role.

crucially on the extent to which they are used to finance investment in other sectors, specifically manufacturing.

Sustained economic transformation depends crucially on the quality and quantity of physical and human capital

The chapter examines the key factors that enhance the role of capital flows in economic transformation. Sustained economic transformation depends crucially on the quality and quantity of physical and human capital. Factor accumulation, in turn, requires a conducive institutional framework and an investment climate that provides necessary incentives to attract both domestic and external capital. The same factors that constrain Africa's growth - such as slow accumulation of capital, slow productivity growth, weak institutional environment, and infrastructure deficiencies - also inhibit structural transformation.

Capital flows, official and private, have the potential to influence economic transformation mainly through capital accumulation and productivity enhancement. In fact, there is a two-way causation between capital flows and economic transformation. While official capital flows may enhance economic growth and transformation by facilitating the development of human and physical infrastructure, private capital flows are likely to follow economic transformation and go to countries with good industrial and trade strategies. Consequently, targeted policy interventions that foster economic transformation will indirectly help to attract these types of capital flows.

Experiences of successful transformation in East Asian economies as well as some African countries indicate that capital flows have to be adequately managed to generate positive spillover effects to the rest of the economy. The positive effects of capital flows arise from targeted strategies aimed at harnessing foreign capital, including investments in human capital accumulation, physical infrastructure and other measures that improve the investment environment.

The next section examines the state of, and need for, economic transformation in Africa[2]. The section then discusses the role of capital flows in economic transformation and provides a quantitative assessment of this role in the context of Africa. Section 4.3 analyzes the constraints that have to be addressed for strengthening the link between capital flows and economic transformation on the continent. Experiences of two relatively successful African countries, Mauritius and Tunisia, are highlighted in section 4.4 along with the case of Nigeria, where structural transformation failed to materialize despite huge economic potential. Section 4.5 summarizes key findings and policy recommendations.

2 Due to data limitations, the discussion in some parts of the chapter focuses exclusively on SSA. The main data sources, the World Development Indicators and the Africa Database of the World Bank, report aggregate data for North Africa as part of the Middle East and North Africa subregion.

4.2 Africa needs structural transformation: what can capital flows do?

Structural transformation is essential for reducing poverty and vulnerability to shocks

Among the reasons for African countries' failure in reducing poverty and eradicating hunger is their inability to diversify their economies and achieve sustainable economic growth. The majority of the labour force in Africa is engaged in agriculture, which is characterized by low productivity. Meanwhile, export earnings depend heavily on commodity exports and are highly volatile due to terms of trade changes and natural shocks.

> *The share of the value added of agriculture in GDP in Africa has not changed significantly over the last three decades*

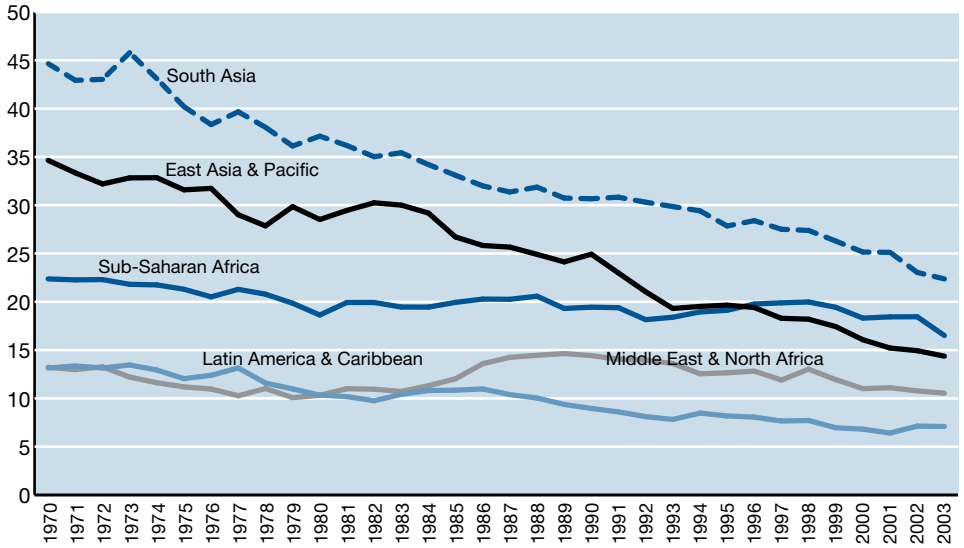
Although African economies are generally considered as agrarian, there is a large variation across countries in the role of agriculture. In many countries, mining and services play an even more important role. In 2003, the contribution of agriculture as a percentage to GDP in Africa varied between 2.4 per cent in Botswana and 60.8 per cent in the Central African Republic (World Bank 2005).

Unlike other regions, such as East and Southern Asia, the share of the value added of agriculture in GDP in Africa has not changed significantly over the last three decades (figure 4.1). Industry's share in Africa's GDP fluctuated between 29 and 34 per cent between 1970 and 2003 with no clear trend over time. In comparison, East Asia industry's value added rose from about 38 per cent to 48 per cent of GDP over the same period (figure 4.2). Further, the share of manufacturing in Africa has decreased slightly from around 16 per cent during the 1970s and 1980s to an average of 13.4 per cent between 2000 and 2004.

The share of manufacturing in Africa's merchandise exports almost doubled between 1970-1974 and 2000-2003, from 10 per cent to over 20 per cent. In comparison, the share of manufacturing exports in East Asia's merchandise exports rose from about 33 per cent in 1980-1984 to about 80 per cent in 2000-2003. Promoting manufactured exports is important in view of the fact that they have a positive impact on the growth of the non-export sector as well as overall GDP (Fosu 1990). In contrast, primary exports have been unable to stimulate growth in the non-export sector of a developing economy (Fosu 1996).

Figure 4.1

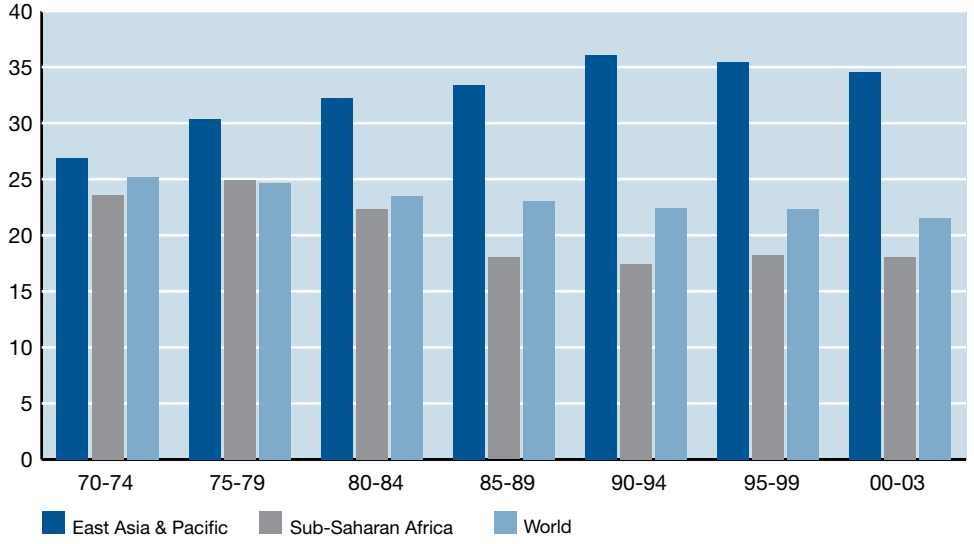
Agriculture's value added as a percentage of GDP in Africa and other regions, 1970-2003 (% of GDP)



***Source**: World Bank, 2005*

Figure 4.2

Industry's value added, 1970-2003 (% of GDP)



***Source**: World Bank, 2005*

Primary commodity dependence increases vulnerability to shocks, which raises uncertainty and retards growth. Primary commodity price volatility led to large terms of trade shocks that contributed to lower growth rates in many African countries. It is

estimated that a 44 per cent annual decline in the price of a primary commodity can generate a loss of almost 7 per cent of GDP (Collier 2003). Instability in the output of primary commodities and prices also generates uncertainties with regard to fiscal solvency, which undermines macroeconomic management, increases investment risks, and leads to debt overhang.

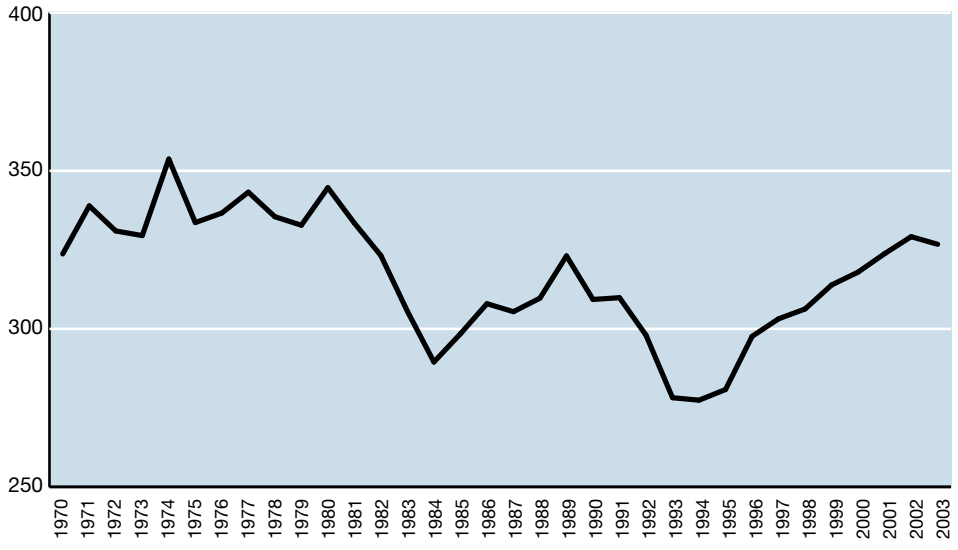
More importantly, in many African countries the rents generated by primary commodities, especially oil, have been associated with poor governance and policy environment because they enable corrupt governments to reward constituencies, fund inefficient public-works programmes and buy off opponents (Herbst and Soludo 2001). Availability of oil revenue reduces incentives for governments to initiate and sustain policies to encourage broad growth. Thus, agriculture and manufacturing are often neglected in oil/mineral-dependent countries.

> *Africa needs to improve agricultural productivity through more and better use of technology*

Productivity increases in agriculture paired with improved absorptive capacity in other sectors allow the release of farm labour to industry and other sectors, which is the starting point for economic transformation. This process could not happen in Africa because agricultural productivity per worker has not changed over time (figure 4.3). Among the reasons for this low productivity is minimum use of technology in agriculture. For instance, the use of tractors per worker has even decreased in Africa over time; in 1961, 417 agricultural workers shared one tractor compared with 806 agricultural workers in 2002. Over the same period, the use of tractors in South Asia has been multiplied by 25 times (figure 4.4). Policies to accelerate economic transformation in Africa should be accompanied with more efforts to improve agricultural productivity through more and better use of technology.

Figure 4.3

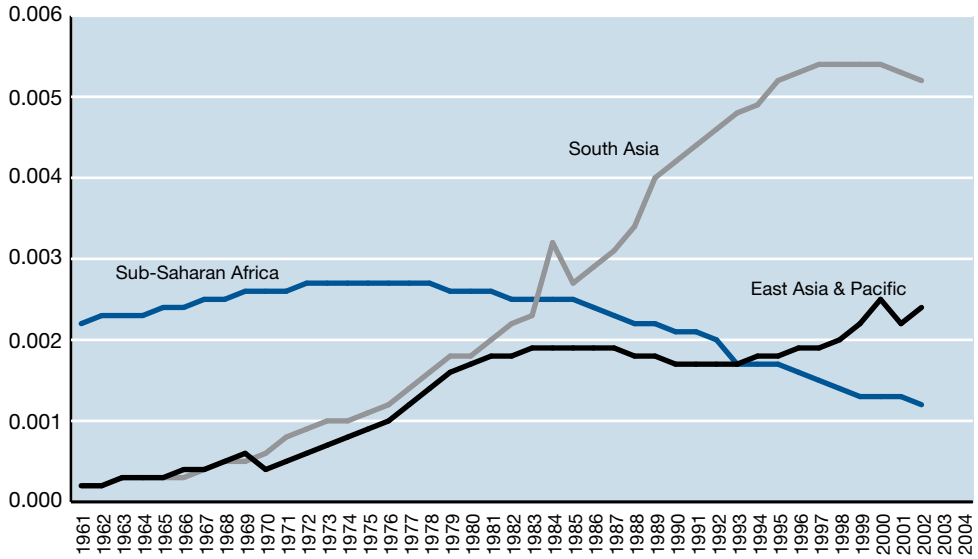
Agricultural value added per worker in Sub-Saharan Africa (constant $US 2000)



***Source**: World Development Indicators 2005*

Figure 4.4

Agricultural use of tractors per worker in Africa and other regions (1960-2004)



***Source**: World Development Indicators 2005*

Capital flows can boost economic transformation

"When poorly managed, ODA flows can have negative consequences"

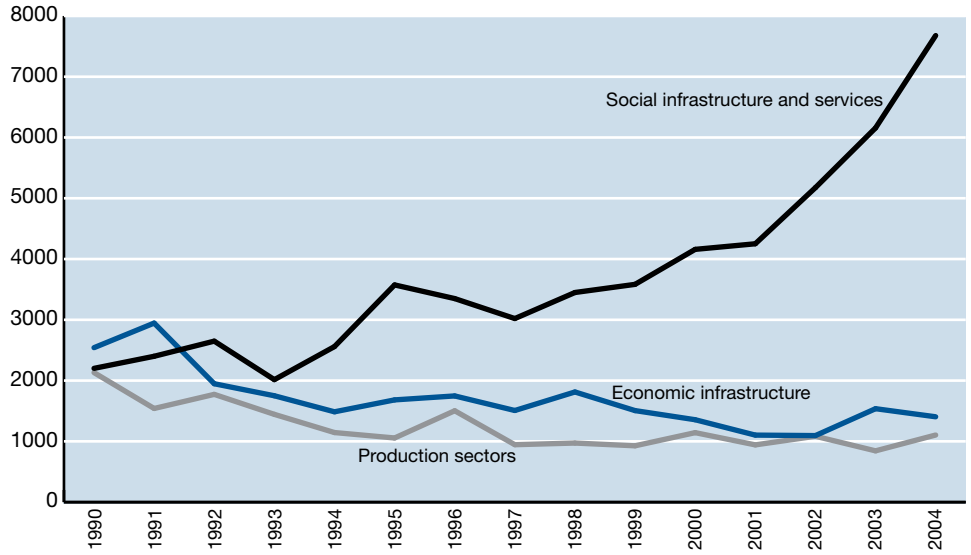
African countries face a shortage of funds to meet their investment and development needs. This resource gap must be filled by capital inflows, composed of FDI, portfolio investment, ODA, net borrowing, debt relief and remittances. These different types of capital flows have different impacts on the economy.

ODA flows can foster economic transformation by assisting recipient countries to finance physical, human and institutional infrastructure (see chapters 2 and 3 for further discussion). When poorly managed, ODA flows can have negative consequences including chronic current account imbalance, inflationary pressure, real exchange rate appreciation and declining exports - the "Dutch Disease" phenomenon (see chapter 5). This phenomenon is particularly likely in small countries with high ODA-GDP ratios (Laplagne et al. 2001). In addition, ODA may undermine or delay critical institutional and policy reforms and enable wasteful spending by corrupt governments (Erixon 2005).

Available data indicate that the current ODA structure is not likely to directly influence economic transformation in Africa. The bulk of these flows has been directed towards social infrastructure and services (mainly education, health and population, water supply and sanitation) and very little ODA has been directed to economic infrastructure and services and productive sectors (transport and communication, industry, mining and construction) (figure 4.5). In 2004, ODA flows to the energy

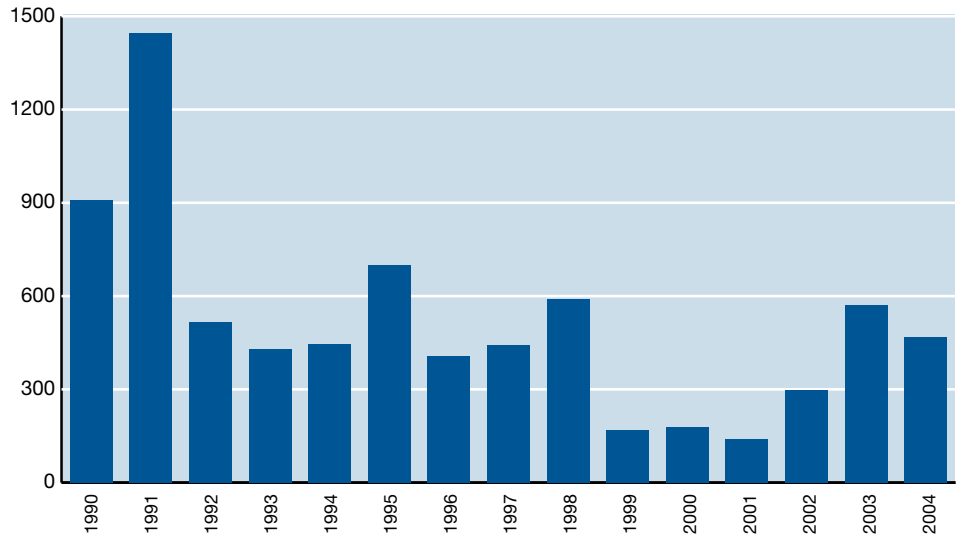
sector were only 30 percent of the 1991 level, when ODA flows to this sector peaked at about $1.4 billion (figure 4.6).

Figure 4.5
Bilateral ODA flows to Africa by sector (% of total)



***Source**: Development Assistance Committee, OECD, 2006*

Figure 4.6
Bilateral ODA flows to the energy sector in Africa ($ million)



***Source**: Development Assistance Committee, OECD, 2006.*

Infrastructure development is a key factor for enabling economic transformation

Infrastructure development is a key factor for enabling economic transformation. Therefore, Africa needs to mobilize more resources to upgrade its physical infrastructure. To this end, donors and African governments should reconsider their priorities with regard to ODA allocation taking into account potential synergies between investment in infrastructure and other sectors. For example, it has been observed that improving roads in remote areas has improved access to schools and healthcare facilities in some countries (AU/UNECA 2005).

When ODA flows are properly managed to build or strengthen infrastructure and institutions, private capital flows are likely to follow. Private capital usually flows to countries where the business environment and investment climate are perceived as attractive in terms of macroeconomic and political stability, infrastructure and availability of factors of production and access to markets. An exception is extractive FDI, especially in oil and mineral sectors, which can generate quick returns even in the absence of good infrastructure and institutions and in the presence of market failures (see chapter 3).

FDI is generally expected to enhance economic growth through improvements in technology, efficiency and productivity (Lim 2001), but the direction of causality can run both ways (Chowdhury and Mavrotas 2006). Moreover, while FDI flows might be associated with economic success, they do not exert an independent effect on growth (Carkovic and Levine 2002). FDI promotes growth in countries with sufficiently developed financial systems (see chapter 6), a greater degree of trade openness, and an adequate level of human resources development (Balasubramanyam et al 1999).

Indeed FDI has a greater potential than other forms of private capital flows to increase the rate of technical progress in the recipient country through knowledge diffusion. This can improve efficiency and productivity in local firms that can copy new technology or learn how to use existing technology and resources more efficiently in order to compete in global markets (Lim 2001). However, these spillover effects can only happen when the host country has an adequate level of human capital (see chapter 3).

The current sectoral distribution of FDI exacerbates natural resource dependence and undermines economic transformation on the continent. The 24 African countries classified by the World Bank as oil and mineral-dependent have on average accounted for close to three-quarters of annual FDI inflows to Africa over the past two decades. The primary sector accounted for nearly 50 per cent of FDI flows between 1996 and 2000. In 2005, the share of the petroleum industry exceeded 90 per cent of total inflows to Angola, Equatorial Guinea and Nigeria. In Egypt, a relatively more diversified economy, the share of FDI flows to the oil industry was still 64 per cent (UNCTAD 2005).

In brief, FDI flows to Africa have been below expectations in terms of both volume and composition (see chapter 2). Efforts to attract more FDI should be accompanied

with strategies to stimulate broad-based growth and economic diversification. In the absence of such strategies, FDI will continue to be concentrated in enclave sectors with no or little overall developmental impact (UNCTAD 2005).

With regard to other private capital flows, it has been observed that portfolio investments normally flow to countries with well-established capital markets in search of quick and higher returns and have no clear links with structural transformation. In SSA, only South Africa receives a meaningful amount of portfolio flows. As for remittances, they are mainly aimed at consumption and income support to families. Remittances represent a stable source of flows and are better distributed across and within countries. They can affect consumption and aggregate demand, which boosts growth through multiplier effects. However, there is still little evidence of direct effect of remittances on economic transformation.

Quantitative evidence on capital flows and economic transformation in Africa

Solid empirical evidence on structural transformation in Africa is scarce. O'Connell and Ndulu (2000) provide the only comprehensive empirical investigation of the process and factors influencing economic transformation in Africa. Two results from their cross-sectional study are worth emphasizing. First, the study finds that given income and population the size of the services sector is markedly smaller in SSA than in other regions, and that of industry and manufacturing is larger than expected. The share of agriculture in GDP is just slightly higher in SSA than in other regions, but the share of agriculture in total employment in SSA is markedly larger. Second, compared to other regions, Africa's movement out of agriculture and into industry has been significantly more rapid than would have been predicted on the basis of its growth performance.

> *Efforts to attract more FDI should be accompanied with strategies to stimulate broad-based growth and economic diversification*

There is also evidence that movement of labour out of agriculture has been slower despite sharp falls in agricultural output in SSA. Recently, notable diversification in favour of industry and manufacturing has taken place, but this diversification is not yet robust enough to stimulate significant structural change in Africa (Berthelemy and Soderling, 2002). The evidence underscores Africa's excessive dependence on agricultural employment and that low agricultural productivity and aggregate income are important constraints to economic transformation.

To examine the link between capital flows and economic transformation in Africa, we extended the O'Connell and Ndulu (2000) model by adding a capital-flow variable. Explanatory variables comprised initial capital flows, initial per capita income, initial population size, and the squares of these variables as well as regional dummies. Using data on 42 African countries[3], we calculated correlations between indicators of economic transformation and capital flows. For Africa as a whole, total capital flows were

3 The data are organized into six 5-year panels plus one 3-year panel covering the period 1970-2003.

insignificantly but positively correlated with structural transformation, as measured by the share of industrial output in GDP. This correlation was stronger for North Africa and negative for SSA (table 4.1). ODA dominates capital flows to Africa and seems to have a high positive association with the share of industry in North Africa's GDP, but a negative association for SSA. North Africa has generally received more aid than SSA and invested substantially in economic and human infrastructure with the help of donor funding.

> *North Africa has invested substantially in economic and human infrastructure with the help of donor funding*

The share of manufacturing in GDP is negatively correlated with total capital flows and ODA and not related to FDI (table 4.2). This is consistent with the fact that most FDI to Africa goes to extractive industries and very little is channelled to manufacturing. Both industry and manufacturing shares in GDP are weakly correlated with growth. Thus, for Africa as a whole, neither ODA nor private capital flows have been effective in triggering economic transformation.[4]

Table 4.1

Correlation between capital flows, growth and industry's share in GDP

Region	Total capital flows	FDI	ODA	Portfolio investment	Remittances	GDP growth
Africa	0.11	-0.02	0.11	-0.04	0.80	0.16
SSA	-0.24	-0.03	-0.24	-0.09	0.55	0.01
North Africa	0.36	0.29	0.90	-0.19	0.71	0.22

***Source**: Authors' computations using data from World Bank Africa Database 2005.*

Table 4.2

Correlation between capital flows, growth and manufacturing's share in GDP

Region	Total capital flows	FDI	ODA	Portfolio investment	Remittances	GDP growth
Africa	-0.80	0.01	-0.80	0.26	-0.05	0.02
SSA	-0.61	0.02	-0.61	0.22	0.37	0.03
North Africa	-0.76	0.14	-0.55	-0.03	-0.33	-0.30

***Source**: Authors' computations using data from World Bank Africa Database 2005.*

4 Panel data regressions yielded positive, but insignificant effects of capital flows on economic transformation. The results are not reported here.

4.3 Key constraints to structural transformation in Africa

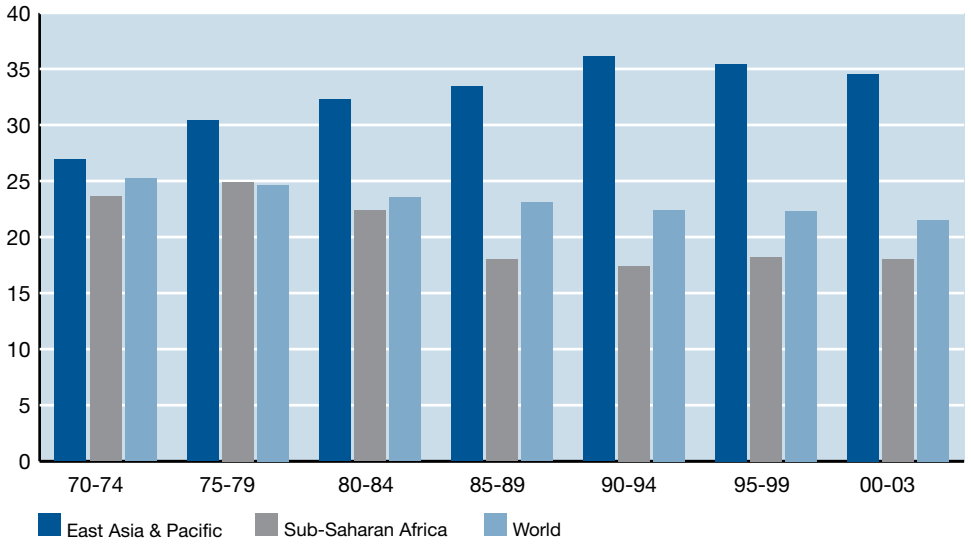
Low investment rates and low productivity growth hamper economic transformation

> *Reallocation of factors of production to more productive uses can permanently raise total factor productivity*

Relatively slow capital accumulation (figure 4.7), low saving rates and slow productivity growth are among the major reasons for disappointing growth performance and lack of structural change on the continent (Hoeffler 2000). Physical and human capital productivity are the lowest in SSA compared to other regions (table 4.3). In regions where accumulation of physical capital has a more prominent role in growth (South Asia, East Asia and Pacific, the Middle East and North Africa, and industrial countries), total factor productivity also has a greater contribution to growth. Low productivity growth in Africa is due to low quality of physical and human capital, poor policy environment and weak governance (O'Connell and Ndulu 2000).

Africa needs long-term strategies in order to increase productivity. While macroeconomic reforms that reduce waste can produce short-run productivity gains, sustained long-run productivity gains require a balanced mix of capital accumulation, human capital development and structural change. In addition, reallocation of factors of production to more productive uses can permanently raise total factor productivity.

Figure 4.7
Gross capital formation (% of GDP)



***Source**: World Development Indicators 2005*

Table 4.3
Growth accounting decomposition by region, 1960-2000 average

Variable	SSA	Latin America & Caribbean	South Asia	East Asia & pacific	Middle East & North Africa	Industrial countries	Total
Growth of real GDP per worker	0.51	0.76	2.18	3.89	2.37	2.23	1.63
Contribution of growth in physical capital per worker*	0.36	0.44	1.04	2.20	1.10	0.96	0.83
Contribution of growth in education per worker*	0.25	0.33	0.31	0.48	0.44	0.32	0.34
Residual (TPG)*	-0.09	0.00	0.82	1.21	0.84	0.96	0.47

***Source**: Ndulu and O'Connell (2003). Note: * Contribution to overall GDP growth*

Human capital: a key to economic transformation in Africa

"There is often a mismatch between school curricula and the skills that are demanded on the labour market"

Africa's labour force is less competitive compared with other developing regions because of lack of adequate education and relatively poor health, among other reasons. Africa also loses a higher proportion of their skilled labour force to the developed countries through the "brain drain" because insufficient opportunities on the continent. Therefore, improving human capital should feature prominently on the development agenda (UNECA 2004a).

Guided by the MDGs, many African countries have made notable progress towards achieving universal primary education (see chapter 1). However, educational indicators still remain low for Africa as a whole. SSA has the second lowest adult literacy rate (60.5 per cent) after South Asia with 58.9 per cent. In some African countries, such as Burkina Faso, Niger and Mali, adult literacy is extremely low, with rates of 12.8, 14.4 and 19 per cent, respectively. In contrast, Zimbabwe, Namibia and Mauritius had adult literacy rates of 90, 85 and 84.3 per cent, respectively, in 2003 (UNDP 2006). The African countries (e.g. Tunisia and Mauritius) with a better human capital base have also experienced substantial economic transformation over time.

It is worth noting that investment in education has not led to economic growth or improvements in total factor productivity because of the poor quality of education, poor utilization of skills, and low returns on education. There is often a mismatch between school curricula and the skills that are demanded on the labour market. Furthermore, university graduates are mainly absorbed in bloated bureaucracies or inefficient State enterprises, adding to low productivity and growth (Pritchett 1996).

Improving human capital requires not only increasing enrolment rates but also improving the quality of schooling and returns to education. High-quality secondary and tertiary education, adapted to the needs of a dynamic economy is important for

promoting innovations, which contribute to faster productivity growth and higher wages. The limited capacity of African States to enhance spending on education can be mitigated through joint regional efforts. For example, jointly designing, producing and distributing teaching materials and textbooks reduces costs. Harmonization of curricula facilitates transferability of high school degrees.

Although limited, some efforts of the regional economic communities (RECs) to jointly develop human resources are promising. The Francophone member States of the West African Economic and Monetary Union (UEMOA) and the Central African Economic and Monetary Community (CEMAC) are cooperating at all levels of education, especially in higher education. In the Economic Community of West African States (ECOWAS), member States cooperate in developing joint curricula, examination standards and degree requirements (UNECA 2004b)

"The limited capacity of African States to enhance spending on education can be mitigated through joint regional efforts"

In addition to educational efforts, building human capital requires improving the population's health status. The HIV/AIDS pandemic reduces the size of the active work force as well as productivity levels. According to ILO projections, the labour force in high-prevalence countries will be 10-30 per cent smaller by 2020 than it would have been without HIV/AIDS. Moreover, AIDS and other infectious diseases reduce labour supply and labour productivity in the agricultural sector, factors which undermine economic growth and increase poverty (UNECA 2004c).

The role of infrastructure in development and economic transformation

Inadequate infrastructure is a major constraint to investment and economic transformation in Africa. Relatively high transport costs are a major obstacle to improving Africa's competitiveness. For instance, freight cost as a percentage of total import value was 13 per cent for Africa in 2000 compared to 8.8 per cent for developing countries and 5.2 per cent for industrialized countries (UNCTAD 2002).

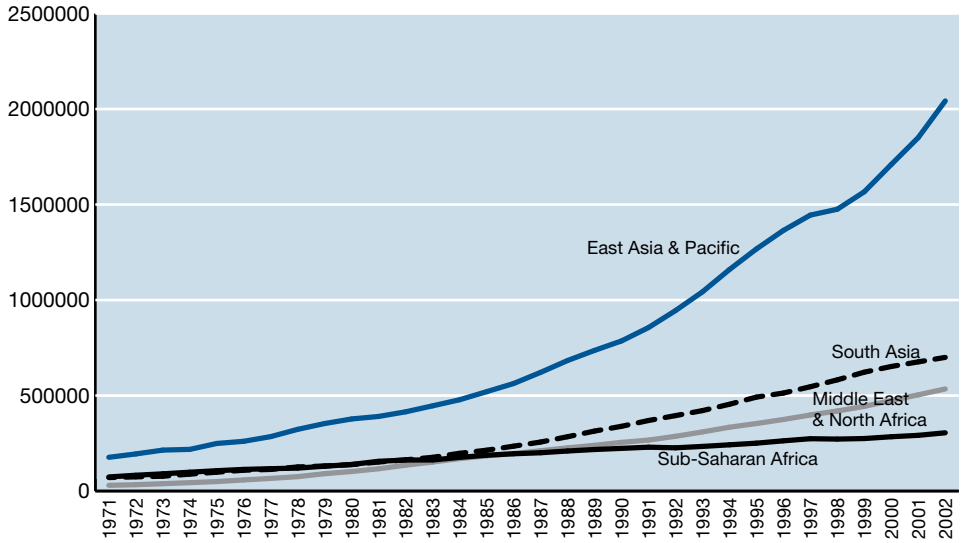
Land-locked African countries, in particular, suffer from high transport costs and transport delays through customs and legal and illegal roadblocks. Regional integration is especially important for land-locked countries since they depend on the efficiency of the transport and customs systems of the transit country. More needs to be done by African countries at the political level in order to harmonize cross-border regulations, customs and administration, improve infrastructure and speed up the process of regional integration. It is important to note here that efforts by RECs, such as the Common Market for Eastern and Southern Africa (COMESA), to facilitate customs clearance and abolish visa requirements among member States will facilitate border-crossing and foster trade.

Overall, infrastructure has improved in Africa over the last few decades, though most of these improvements are due to innovations in the telecommunication sector. Telecommunication coverage has significantly improved in SSA from 6.9 subscribers

per 1000 people in 1975 to 61.9 subscribers in 2003. Improvements in road infrastructure are mixed. Between 1990 and 1999, SSA's total road network has expanded from 1.107 million km to 1.488 million km. However, a few large countries (namely Nigeria and South Africa) accounted for the bulk of this expansion, while in some countries such as Angola and Zimbabwe, road infrastructure has been depleted. Electricity production in SSA quadrupled between 1970 and 2002, but energy supply still fell short of demand and improvements have been relatively small compared to improvements in other sub-regions (see figure 4.8).

"Infrastructure improvements in Africa over the last few decades are due to innovations in the telecommunication sector"

Figure 4.8
Energy production in Sub-Saharan Africa and other sub-regions, 1971-2002 (million kwh)



***Source**: World Development Indicators 2005*

Good energy supply is critical for economic transformation. Inability to provide reliable energy services has been a major constraint on export diversification and development of the manufacturing sector in many African countries (UNECA 2004a). Energy consumption varies by activity and some activities are more energy dependent than others. Many of the African countries that have reached meaningful levels of economic transformation (e.g. Lesotho, Mauritius and Tunisia) started with the manufacturing of textiles, which is a highly energy-consuming process. Energy consumption increases from yarn to fabric finishing and from synthetic to natural fibres (Schmidt 1999).

The role of industrial and trade policy

Lack of sound industrial and trade policies is among the major reasons why Africa has not been able to attract the type of capital flows that has more potential to promote economic transformation. Attracting capital flows to sectors such as manufacturing or exportable services requires deliberate policy decisions that change the incentive structure for investors. Good policies and institutions can be as much a pull-factor for FDI as natural resource endowment (Asiedu 2006).

In East Asia, substantial capital flows followed effective trade and industrialization strategies, resulting in improved business environment, policies, institutions and infrastructure (Aryeetey et al. 2003). Before the economic take-off of East Asia around the mid-1980s, Africa received more capital inflows relative to GDP than East Asia.[5] However, capital flows to East Asia more than doubled in the 1990s compared to the 1980s. Success in trade and industrialization strategies, together with increased capital flows, boosted growth and economic transformation in East Asia.

> *Attracting capital flows to manufacturing or exportable services requires a change in the incentive structure for investors*

In contrast, trade and industrialization strategies failed in many African countries, accounting partly for the weak growth performance on the continent (Soludo et al 2004).[6] Earlier attempts to promote economic growth and transformation in Africa through import substitution strategies (ISSs) were unsuccessful (box 4.1). Due to small domestic market size and poor governance, ISSs failed to promote competitive industries and most established firms could only survive on direct and indirect government subsidies. The cost of the support to these industries contributed to unsustainable external and domestic debt levels that led to exchange-rate depreciation and high inflation rates in many African countries.

The SAPs adopted by many African countries in the 1980s and 1990s to resolve these imbalances were focused almost exclusively on macroeconomic stabilization and trade liberalization with no clear industrial policy. A major deficiency in these SAPs were is that they left accumulation and growth to market forces without adequate attention to shortcomings in markets, institutions and physical and human capital (UNCTAD 2000). Consequently, freeing markets and privatization of public enterprises did not generate adequate private investment to expand output and employment. While macroeconomic stability improved in many countries, Africa's share in global exports saw a sharp fall from 4.1 per cent in 1980 to 1.6 per cent in 2000 before recovering to 2.3 per cent in 2003 thanks to oil and mineral exports. Likewise, Africa's share in world trade dropped from 8 per cent in 1980 to 1.3 per cent in 2000 and then rose to 2.3 per cent in 2003. More importantly, Africa's share in manufactured exports remained close to zero.

5 Total capital flows to Africa amounted to 112.7 per cent of capital flows to East Asia in 1970-1979, 97 per cent in 1980-1989, 37.6 per cent in 1990-1999 and 55 per cent in 2000-2003.

6 Per capita GDP growth has been below 1 per cent in Africa compared to over 5 per cent in East Asia.

Box 4.1
Import substitution strategies (ISSs) and Africa's failed transformation

From independence to the early 1980s, most African countries adopted ISSs aiming at producing consumer goods and moving towards producing intermediate and capital goods. ISSs were accompanied by restrictive policies, including complex systems of tariff and non-tariff protection, as well as exchange control and import licensing.

Initially, ISSs boosted manufacturing output relative to GDP and led to increased industrial employment. During the 1970s, Africa maintained an average annual rate of industrial growth of 5.5 per cent, but the industrial growth rate declined to 2.5 per cent during 1980-1984 and 0.4 per cent in 1985-1987.

Eventually, ISSs failed because of economic mismanagement and policy problems. The production of final goods relied heavily on imported inputs, adding to the recurrent balance-of-payments deficits. Small domestic markets did not generate sufficient demand for emerging industries to grow and take advantage of economies of scale. Instead of increasing the productivity of new industries, the strategies generated rent-seeking behaviour by firms that were insulated from international competition.

***Source**: UNECA (2004b).*

Options for industrial and trade policy to foster economic transformation

"Industrial and trade policy can improve the competitiveness of local industry and attract foreign investment"

Industrial and trade policy can stimulate economic growth and transformation by assisting new industries to emerge, improving the competitiveness of local industry and attracting foreign investment in industry. In particular, trade liberalization can promote economic transformation through shifts in domestic demand and private investment in favour of domestic industries – as a result of real exchange rate changes and removal of import restrictions and non-tariff barriers. Also, trade liberalization can encourage manufacturing and exports by reducing the waste stemming from rent-seeking behaviour and reforming the system of import and export licensing as well as the general institutional environment (Rodrik 2000). Improved institutional and policy environment would reduce costs, create comparative advantages for new industries, and lead to reallocation of resources in favour of more competitive industries.

As noted above, incoherent industrial and trade policies, compounded by control regimes and structural constraints, have led to meagre gains from trade liberalization and the slow economic transformation in Africa.[7] Africa needs coherent strategies and market-based reforms to address both demand- and supply-side constraints to industrialization and economic transformation. Industrial policy experiences in East Asia, in particular, provide a framework in which many African countries might be able to

7 Fosu and O'Connell (2006) argue that avoiding anti-growth syndromes, including control regimes, adverse redistribution, unsustainable public spending and State failure, could have boosted Africa's growth by between 1 and 2.5 percentage points.

design and implement successful industrial strategies. However, it would be too simplistic to advise African countries to replicate these experiences, given the differences between the conditions that prevailed in East Asia in the 1970s and 1980s compared to those in Africa today.

The process of industrialization in East Asia, like that in Africa, began with ISSs and gradually shifted to export promotion through a combination of policy, institutional and structural reforms. Policy choices aimed at promoting a stable macroeconomic environment, high education levels, efficient financial systems, and openness to foreign trade, were combined with selective interventions that included an export push, directed credit, and selective promotion of industries in East Asia.

Multiple policy tools may be needed for pursuing domestic and international goals at the same time

These policies worked within an institutional framework that was characterized by technocratic insulation from direct political pressure, high-quality civil service, and sound monitoring. This resulted in fast accumulation and efficient allocation of physical and human capital, improved mobilization of domestic and external resources, high returns on investment, and rapid technical progress through importation and adoption of technology (Aryeetey et al 2003). Large investments in human capital and new technologies brought about significant gains in productivity and international competitiveness in East Asia, where governments employed export promotion strategies that were regularly audited and reviewed according to well defined targets.

In addition to creating a sound macroeconomic environment, improved infrastructure and adequate incentive structure, the success of industrialization in Africa will require measures that promote entrepreneurship and address market failures. Entrepreneurial skills including accounting and management skills, risk-taking and the ability to perceive and exploit profitable opportunities are essential for starting and operating a successful firm (Noland and Pack 2003).

Firm surveys in Tanzania, Uganda and Zimbabwe show that an entrepreneurial attitude is the key to successful businesses (Trulsson 1999). Most of sampled firms were started because the business owner saw a good business opportunity. Entrepreneurship may partly be promoted through centralized technical support, by incorporating entrepreneurial skills in high school and university curricula and through training (UNECA 2005).

Depending on their specific endowments and opportunities, individual countries need to explore possibilities for industrial policy to accelerate growth through research and development (R&D) or output-subsidization schemes aimed at supporting new product development, innovation and growth.[8] The appropriate policy response could vary from export subsidies to export tax if price competition rather than quantity competition is assumed. Multiple policy tools may be needed for pursuing domestic and international goals at the same time. Since policy interventions involve costs, governments have to carefully weigh all possible alternatives for using scarce resources. However, the success of industrial policy will critically depend on the government's

8 Grossman and Helpman (1991) cited by Noland and Pack (2003).

human and financial resource capacity to implement and sustain the various components of the industrialization programme (Noland and Pack 2003:19).

In Nigeria, the lack of coherent and sustained strategies constrained economic growth and transformation

4.4 Experiences of capital flows and economic transformation in Africa

This section examines the experiences of Mauritius and Tunisia with the aim of highlighting the role of capital flows in their relative success in economic transformation compared to the rest of Africa. It also examines the experience of Nigeria, where lack of coherent and sustained strategies constrained economic growth and transformation despite its substantial endowment in natural resources. Table 4.4 summarizes indicators of economic growth and transformation in the three countries.

Table 4.4
Indicators of economic growth and transformation in Tunisia, Mauritius and Nigeria, 1970-2003

	Tunisia		Mauritius		Nigeria	
	1970-74	**2000-03**	**1970-74**	**2000-03**	**1970-74**	**2000-03**
Real GDP per capita (2000 $US)	976	2121	1667*	3974	386	338
Agriculture value added (% of GDP)	19.3	11.6	20.7	6.4	37.3	29.2
Industry value added (% of GDP)	21.9	28.7	26.0	31.1	22.3	46.2
Manufacturing value added (% of GDP)	9.2	18.3	15.3	23.1	3.7	4.1
Services value added (% of GDP)	58.8	59.7	53.3	62.5	40.4	24.6
Manufacture exports (% of merchandise exports)	19.9	80.2	5.0	75.3	0.5	0.2
Total capital flows (% of GDP)	9.8	8.4	3.5*	5.0	2.5	8.4

***Source**: World Development Indicators 2005. * Figures are for 1975-1989.*

Tunisia

Tunisia undertook many institutional and economic policy reforms in the last three decades which were aimed at opening up the economy, encouraging economic diversification and enhancing competitiveness (OECD and ADB 2005). Sound macroeconomic management, with small external debt in Tunisia, resulted in low and stable inflation and in an effective exchange rate regime (Elbadawi and Kamar 2005). A favourable business environment, strengthening of the financial sector, modern infrastructure, and human resource development strategies through education and training underpinned market-oriented reforms. Currently, Tunisia ranks 58th worldwide and 4th in Africa in terms of ease of doing business (World Bank 2006). Trade

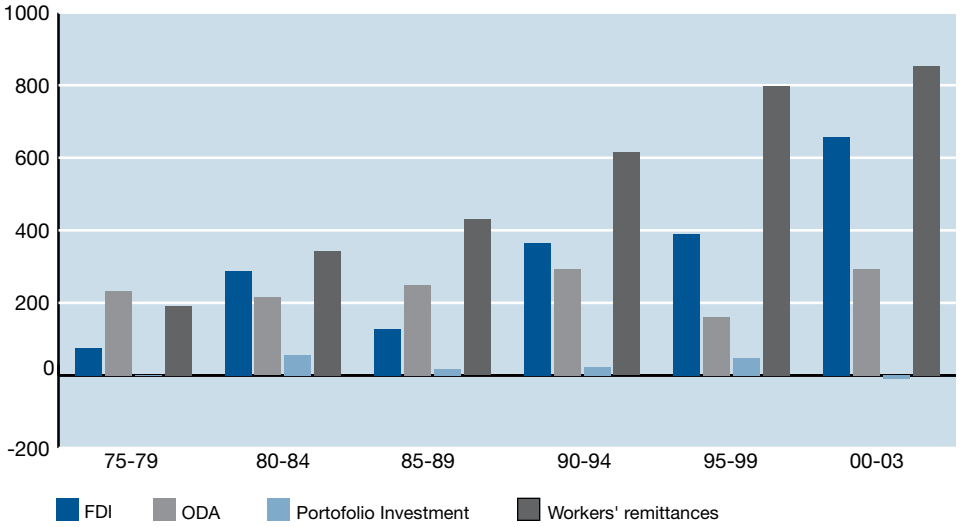
liberalization benefited from Tunisia's central position in North Africa, proximity and access to EU markets and industrial policies that encourage technology transfer and adoption, creativity and innovation.

Between 1970 and 2003, Tunisia's real per capita income grew at an average rate of about 3 per cent (table 4.4). This growth was associated with a steady, though slow, reduction in the share of agriculture in GDP. The share of industry rose from 22 per cent in 1970-1974 to 32 per cent ten years later, but declined to an average of 29 per cent during 2000-2003. A significant feature of structural change in Tunisia was the rise in industrial employment from 34.3 per cent of total employment in 1962-1969 to 45 per cent in 1995-2000. At the same time, agricultural employment declined from 45.9 per cent of total employment to 23 per cent (Ayadi et al 2005). Services and other sectors, including a booming tourist industry, accounted for the largest share in Tunisia's GDP in 1970-2003.

Manufacturing is the only sub-sector that experienced a sustained upward trend since 1970, increasing from 20 per cent of merchandise exports in 1970-1974 to 80 per cent in 2000-2003. This represents a remarkable success compared to Africa's average of 22 per cent during the same period. Despite signs of increasing importance, industry and manufacturing does not yet play a dominant role in Tunisia's economy.

As Tunisia's economy developed, capital inflows continued to rise at a high rate. The composition of these flows also changed over time in favour of private capital, especially FDI separate from workers' remittances (figure 4.9). However, portfolio investment flows remain very small, reflecting the underdevelopment of equity markets in Tunisia. The trend of overall private flows to Tunisia mirrors the East Asian experience in that substantial increases in capital flows seem to follow improvements in policies, institutions and physical and human infrastructure in an open export-oriented economy.

Figure 4.9
Average capital flows to Tunisia ($US million)



***Source**: World Development Indicators 2005*

"Further structural reforms are needed for Tunisia to improve the business environment and industrial competitiveness"

Over 2,600 foreign or jointly-owned firms operated in Tunisia in 2004, providing 243,000 jobs.[9] These firms operate predominantly in manufacturing in the areas of electrical and electronic products, automotive components, plastic and textile industries, leather and footwear, agricultural and food industry, packaging, ICT and tourism. They export 85 per cent of their output, mostly to Europe.

Policies to promote private sector development, expand markets, and harness resources to increase investment rates and productivity were associated with relatively high saving and investment rates in Tunisia compared to other African countries. Although these rates are lower than the rates that prevailed in East Asia during the same period, sustained growth reduced poverty in Tunisia to a level comparable to that in the best performing East Asian countries: Tunisia's poverty rate dropped from over 20 per cent in 1980 to 4 per cent in 2000 (Ayadi et al 2005).

Diversification strategies enabled Tunisia to cope with unfavourable changes in the external environment, such as high oil prices, and consecutive droughts in the early years of the millennium decade.[10] However, further structural reforms are needed for Tunisia to improve the business environment and industrial competitiveness and promote resource mobilization and investment.

9 FDI Magazine at www.fdimagazine.com/news/printpage.php/aid/1349/Taleoftunisiantransformation. [Date accessed: 02-01-2006].

10 Tunisia is an oil producer but it is still a net oil importer.

Mauritius

Mauritius has substantially transformed its economy, moving from a nearly single-good economy based on sugar to a more diversified economy based on manufactured exports and services. Over time, the share of agriculture in GDP decreased significantly, from 20.7 per cent in 1970-1974 to 6.4 per cent in 2000-2003, while the share of industry rose from 26 per cent to 31 per cent (table 4.4).

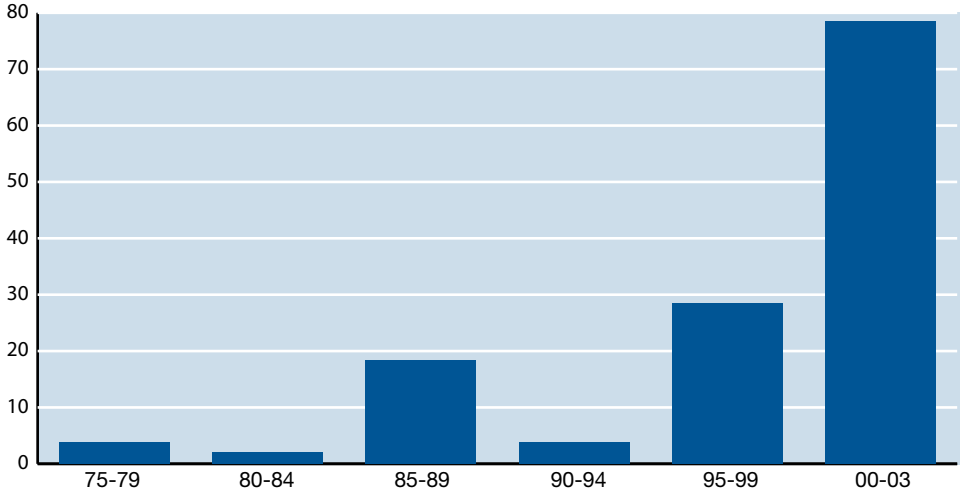
Mauritius has substantially transformed its economy, moving from a nearly single-good economy to a more diversified economy

The economic transformation of Mauritius was not influenced by capital flows, but capital flows increased after Mauritius had developed its manufacturing sector. Investment in export-processing zones (EPZs) was at the beginning dominated by domestic capital. The boom in sugar prices in the early 1970s led to substantial windfall gains. Sugar companies used unanticipated profits to invest in joint ventures with foreign investors in EPZs, taking advantage of promising conditions such as tax holidays and duty-free imports.

Mauritius had several growth phases, starting with the sugar-boom driven growth of the 1970s. The take-off phase started during this period with the establishment of EPZs and government programmes to improve human capital. Education was made free at all levels in 1976 and health services were significantly improved (Nath and Madhoo 2003). Mauritius started to stabilize the economy and expanded export-led industries after 1983. The new strategy led to an average per capita growth rate of 6.6 per cent between 1985 and 1989 (Nath and Madhoo 2003). After 1989, Mauritius further diversified its economic base with tourism becoming another pillar of the economic transformation strategy.

Mauritius received substantial FDI starting from the mid-1990s (figure 4.10). In 1989, an offshore centre was set up, attracting more than $4 billion of offshore funds. At the same time, the Stock Exchange of Mauritius (SEM) started to operate, setting the stage for further capital mobilization (Nath and Madhoo 2003). FDI increased from an average of $2 million between 1985 and 1989 to $78.4 million in 2000-2003.

Figure 4.10
Foreign direct investment in Mauritius (BoP, current million of $US)



***Source**: World Development Indicators 2005*

"Mauritius needs to diversify further in order to remain competitive"

As a result of successful reforms, Mauritius was classified as the most competitive economy in Africa in 1998 (Nath and Madhoo 2003). Currently, Mauritius ranks twenty-third worldwide and first in Africa in terms of ease of doing business (World Bank 2006). The essence of Mauritius's success has been a gradual and targeted openness associated with strong tax and other incentives to promote trade (Subramanian and Roy 2001).

In addition to good policies and democratic culture and practice since independence, with strong participatory institutions, Mauritius has benefited from its cultural diversity and geographic proximity to China. This proximity has attracted large FDI from China (Subramanian and Roy 2001). Moreover, many Chinese manufacturing producers moved to Mauritius in order to circumvent export quotas imposed on Chinese firms operating in China through trade agreements between the latter and other countries such as the United States.

However, Mauritius' economy has now reached a point where it has to diversify further in order to remain competitive. Increasing wages in Mauritius and stiff competition from Asia are threatening the textile sector's competitiveness. The economy also suffers from high unemployment (which reached 11 per cent in 2004-2005) and a large public debt (71.8 per cent of GDP in 2004-2005). The Government plans to attract greater private capital flows through privatization of parastatal enterprises in the sugar and textile sectors. The Government also plans to continue to focus on investment in education and telecommunication in order to further transform the economy to a service-oriented economy. The success of these efforts hinges on the ability of the Government to manage its high budget deficits.

Nigeria

Nigeria provides an example of a country which, because of policy failures, failed to achieve sustainable growth and economic transformation despite substantial FDI inflows combined with a sound human capital base. This failure stemmed from the rent-seeking and predatory behaviour of past regimes (Asadurian et al 2006; Herbst and Soludo 2001).

The Nigerian economy was dependent on agriculture until the early 1970s when oil revenues began to rise. The 1970s oil boom spurred massive government spending and investment in public sector projects and supported import substitution industrialization that depended heavily on imported inputs. Overvaluation of the exchange rate and expansion of expenditures on non-tradable goods undermined competitiveness of agricultural and manufactured goods.

The collapse of oil prices in the early 1980s and decreased oil exports, due to a cut in the OPEC production quota for Nigeria, led to a sharp decline in government revenue and a sizeable current account and fiscal deficits (Herbst and Soludo 2001: 657). These imbalances caused a decline in foreign-exchange reserves and an increase in external debt from 5 per cent of GDP in 1980 to 23 per cent in 1985. Real per capita income fell from $386 in 1970-1974 to $335 in 1980-1985 and remained almost stagnant ever since (table 4.4).

The share of industry in GDP more than doubled between 1970-1974 and 2000-2003 with notable fluctuations due largely to changes in oil prices and revenue. At the same time, the contribution of manufacturing to GDP fell sharply from a peak of 9 per cent in 1980-1984 to 4.1 per cent in 2000-2003. The share of agriculture in GDP fluctuated around 30 per cent, but that of the services sector declined rapidly from 40 per cent in 1970-1974 to about 24 per cent in 1990-2003. Contraction of the services sector in Nigeria contrasts sharply with the situation in developing countries in general and reflects the poor state of infrastructure, unfavourable business environment and other factors that hampered foreign as well domestic investment in this sector.

Following huge macroeconomic imbalances in 1981-1986, patchy economic policy in Nigeria concentrated on structural adjustment throughout 1986-2000, with limited scope for growth and transformation. In general, the broad objectives of the reform programmes were to restructure and diversify the economy; promote sustainable non-inflationary growth; reduce unproductive public investment, improve public sector's efficiency, and enhance the growth potential of the private sector (Herbst and Soludo 2001). These objectives were to be realized through a realistic exchange rate policy coupled with liberalization of external trade and the payments system, appropriate market-based pricing policies, reduction in administrative controls, and rationalization and restructuring of public expenditure and customs tariffs (Herbst and Soludo 2001).

The reforms were largely unsuccessful because of poor policy design, inappropriate sequencing, and lack of political will (Herbst and Soludo 2001; Asadurian et al. 2006). Consequently, the economy continued to depend on oil and agriculture, while privatization strategies failed to spur private sector development.

Further reforms as well as more time are needed for recent policy reforms to generate growth and transformation in Nigeria

With the return to civilian rule in 1999, Nigeria adopted a comprehensive plan aimed at achieving macroeconomic stability, reducing poverty and combating corruption (OECD and ADB 2005). Since 2000, policy reforms have been relatively more successful in reducing imbalances and in stabilizing the economy. Recently, high oil prices and improvements in the macroeconomic environment have led to higher GDP growth rates. Currently Nigeria ranks ninty fourth worldwide and ninth in Africa in terms of ease of doing business (World Bank 2006).

Further reforms as well as more time are needed for recent policy reforms to generate growth and transformation in Nigeria. Indeed, while democratization and liberalization processes have created a more favourable business environment, severe constraints continue to hamper private-sector development. These constraints include infrastructure deficiency (especially unreliable power supply), inadequate access to financing, insecurity, weak institutions, ill-defined property rights and enforcement of contracts and the unstable macroeconomic environment (OECD and ADB 2005: 373).

The above country examples clearly illustrate the good policies needed for an economy to move from commodity dependence to a wider base, dominated by manufacturing and services. Both Mauritius and Tunisia are relatively resource-poor compared with Nigeria. Yet, they achieved a state of economic transformation that will take Nigeria years to achieve. Initial economic transformation through manufacturing in Mauritius and Tunisia spurred further transformation through services. Conversely, inability to transform through manufacturing in Nigeria was accompanied with contraction in services. Many other African countries, e.g. Algeria and Libya, had both greater resources and similar or better trade opportunities than Mauritius and Tunisia. However, they failed to use them to trigger economic transformation, mainly because of the lack of sound macroeconomic policies and industrial strategies.

4.5 Conclusion and policy recommendations

Capital flows are neither a necessary nor a sufficient condition to trigger economic transformation. Lack of economic transformation in Africa is due to a combination of shortcomings in policy, institutions and physical and human infrastructure. Overcoming these constraints is important for economic transformation, which is critical for attaining sustainable growth and reducing Africa's vulnerability to shocks. The analysis of the links between capital flows and economic transformation in Africa indicates that:

- Capital flows to Africa during the last four decades have not been accompanied by economic transformation. In countries such as Mauritius and Tunisia, with relatively greater degrees of economic transformation, structural change was not due to capital flows but rather to a combination of sound policies and reforms that attracted domestic and foreign investment into sectors that were more conducive to export promotion and economic diversification;
- For most of the time, ODA has been the most important source of capital inflows to Africa. However, ODA flows to Africa have been largely channelled to primary education and other services with very little flow to infrastructure. ODA, in its current structure, has had limited impact on economic transformation. Higher flexibility in donor policy to ensure a more balanced and productive allocation of ODA flows among various sectors would enhance the effects of ODA on economic transformation;
- FDI to SSA is mainly directed to extractive sectors, especially oil and minerals. Such FDI will not induce economic transformation unless revenues from oil and minerals are adequately used to develop infrastructure and institutions and to spur investment in other sectors;
- Portfolio flows to Africa are unlikely to affect economic transformation as they are quite small in volume and go to countries with more diversified economies and active capital markets; and
- Research indicates that remittances have been largely driven by the motive to support family consumption and have had little impact on economic transformation.

"As the policy environment improves, private capital flows are likely to follow with a greater impact on growth and economic transformation"

The absence of a notable relationship between capital flows and structural change in Africa is attributable to lack of appropriate policies to influence the nature and allocation of these flows. As the policy environment improves, private capital flows are likely to follow with a greater impact on growth and economic transformation through productivity enhancement, technology transfer, greater access to foreign markets and reallocation of resources in favour of more competitive sectors.

To promote structural transformation and maximize the contribution of capital flows to this process, Africa needs to:

- Mainstream economic transformation objectives in industrial and trade policies as well as in overall development strategies, and actively design and implement measures to initiate and maintain industrialization to ensure structural transformation. However, in some special cases, it might be more feasible for countries to pursue structural transformation through the services sector rather than industry;
- Maximize the role of capital flows in economic transformation within a holistic industrial policy framework, which effectively addresses problems of market failures and promotes entrepreneurship. Appropriate interventions to

enhance the impact of capital flows on economic transformation might be country-specific;

- Ensure that trade liberalization strategies are supported by measures that build trade capacity and raise productivity and competitiveness through technology transfer and adoption;
- Develop a sound human capital base to enhance absorptive capacity and spillover effects from FDI;
- Upgrade the physical infrastructure, which presently hampers economic transformation. With a good human capital base and sufficient infrastructure, Africa could attract the type of capital flows, namely non-extractive FDI, that are more likely to promote economic transformation; and
- Enhance regional integration, which can be a major boost to industrialization by facilitating intra-regional movement of capital and labour and expanding markets for local producers.

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Economic Policy, Institutional Environment and Capital Flows

5.1 Introduction

According to conventional economic wisdom, capital should flow from developed countries where it has lower returns on the margin to Africa and other developing areas where it has significantly higher marginal returns. Unfortunately, this is not the case as capital flows to Africa have been low, unstable and concentrated in a few sectors and a few countries. There are many reasons for this phenomenon. First, both in terms of perception and reality neither the global nor the regional environment has been friendly to Africa.

Furthermore, many African countries have yet to take the proactive action and establish the preconditions, policies and strategies needed to attract more beneficial international capital. Indeed, the market has failed, at least in the conventional sense, to allocate capital to Africa. Nor have the macroeconomic policies adopted by African countries favoured the inflow of international capital. Non-market institutions and macroeconomic polices should, therefore, be used to address the shortcomings and imperfections of the international capital markets.

"For African countries to increase capital flows significantly, they must adopt appropriate macroeconomic policy measures"

The inadequate inflow of capital to African countries results not just from market failure but also from a fundamental policy failure, institutional inadequacy and failure. As with sound macroeconomic policies, the norms governing human interactions, including organizational entities, procedural devices, and regulatory frameworks[1] constitute an important determinant of capital flows. For African countries to increase capital flows significantly, to make them sustainable and minimize financial crises, they must adopt appropriate macroeconomic policy measures.

Next, they need to understand how to strengthen the process, substance and outcomes of macroeconomic policies to create a more attractive environment for capital flows. They must also establish strong institutions and improve the quality of existing ones. In particular, African countries need to develop institutions that enforce

1 Institutions come in a variety of dimensions and levels: economic, social, political, and corporate institutions; public and private institutions; and national and sub-national, subregional, regional and global. Notwithstanding their value, institutions are hard to grasp and have been defined in a variety of ways by different authors. Most notably, Douglas North (1990) defines institutions as the formal and informal rules governing human interactions (see also Kasper and Streit, 1998; World Bank, 2000; and Alfaro et al., 2003). Unlike institutions, policies are choices made within a political and social structure - within a set of institutions. Institutions might also explain differential capital-labour ratios in terms of differences in cultural context and technological capacity

property rights and the rule of law so as to minimize uncertainty about returns on investment.

African countries need to develop institutions that enforce property rights and the rule of law

This chapter examines the implications of macroeconomic policy regimes for capital inflows to Africa, and the problems that such inflows have posed for macroeconomic policy management as well as the different policy options pursued by African governments to deal with macroeconomic challenges of capital inflows. It also assesses the reform dividend— that is, whether economic and institutional reforms have been accompanied by increased capital flows to the region. Finally, the chapter discusses the importance of effective institutions for attracting capital flows and the need to identify, build or strengthen capital-friendly institutions.

The chapter is organized as follows: The next section discusses the orientation and evolution of macroeconomic policies in Africa. Section 5.3 examines the benefits of economic reforms, including macroeconomic policy reforms for capital flows. Section 5.4 analyses the macroeconomic effects of capital inflows and the policy responses pursued to deal with capital inflows. Section 5.5 highlights further measures needed to consolidate macroeconomic stabilization while section 5.6 discusses the important role of effective institutions for attracting capital flows and how to achieve such institutions. Finally, section 5.7 concludes the chapter.

5.2 A sound macroeconomic environment is essential for attracting capital flows

Following independence in the 1960s, most African countries pursued populist policies with an emphasis on expanding social services, especially education and health. They also undertook massive public investment projects in infrastructure often financed through expansionary policies. These policies led to rising inflation, budget deficits and mounting external debt. Capital inflows diminished as investors became wary of the ability of developing countries to meet their debt-servicing obligations. These policies slowed down economic growth in Africa considerably. The oil and debt crises and the ensuing recession in developed countries served to aggravate the economic crisis in Africa (World Bank 1981). The magnitude of the economic stagnation was so profound that the 1980s came to be known as 'the lost decade' for SSA.

The events of the 1970s and the first half of the 1980s have demonstrated the need for sound macroeconomic policy management as a necessary condition for resumption of growth and mobilization of external finance. It was against this realization that African countries implemented macroeconomic stabilization policies in the mid-1980s and early 1990s. The focus of macroeconomic stabilization was on demand management through expenditure reduction and domestic credit ceilings. The objective of stabili-

zation programmes was to correct balance of payments disequilibria and to contain inflation. They have included fiscal, monetary and exchange rate policy reforms.

Fiscal policy reform

Fiscal policy has been an important instrument for managing aggregate demand and alleviating imbalances in African economies. The objective of fiscal adjustment in Africa in the mid-1980s and early 1990s was to bring fiscal deficits under control and rationalize public investment (Husain and Faruqee 1996). To the extent that public investment programmes exerted significant pressures on the fiscal balance, fiscal reforms in many African countries also sought to reduce the size of public investment programmes. This was also to be complemented by public sector reforms, including privatization and restructuring of state-owned enterprises and tax reform.

> *Considerable efforts have also been expended at improving revenue mobilization and tax administration*

Apart from reducing fiscal deficits and achieving fiscal stability, another explicit objective of fiscal policy in recent years has been to support poverty reduction. This is the case particularly for countries that are implementing PRSPs. Mozambique, Tanzania and Uganda, have increased expenditures to priority social sectors such as health, education, and water provision (ADB 2005). Considerable efforts have also been expended at improving revenue mobilization and improving tax administration. For example, VAT exemptions for the government and its institutions have been abolished in Tanzania.

African countries have also implemented institutional reforms intended to increase the efficiency of tax collection, strengthen the independence of tax authority and curb corruption in the tax system. Ghana, Kenya, and Uganda have established autonomous tax authorities and have, as a result, experienced substantial improvements in tax collection (see Ndikumana and Nannyonjo 2005 for evidence on Uganda).

Monetary policy reform

The general focus of monetary policy has been to complement fiscal policy in taming inflation through controlling domestic credit (Husain and Faruqee 1996). The overall objectives of monetary reform undertaken in Africa were to reduce inflation, improve balance of payments and promote resource mobilization through stable real interest rates. However, with respect to monetary policy instruments used to achieve the defined objectives, there were some variations across countries, depending on the source of monetary growth. In Ghana, for example, the source of monetary growth was excessive lending from the central bank to public enterprises (Leechor 1996). Therefore, monetary policy sought to control bank lending. This was successful, as inflation fell to single digits in 1991. The improvement in fiscal balance made monetary policy manageable.

Since 1986, monetary policy in Kenya shifted from a direct monetary policy control system to indirect measures such as reserve requirements, variable liquidity ratios and market-based interest rates. Reform also sought to strengthen the central bank's control over non-bank financial institutions that have mushroomed in the 1980s.

"Inflation targetting involves tradeoffs between price stability and growth and employment creation"

In recent years, some African countries, notably South Africa, have adopted an inflation-targeting monetary policy framework in order to gain credibility[2]. Under an inflation-targeting regime, the overriding objective of monetary policy is the maintenance of stable prices (Agénor 2001). This has been a departure from the old tradition where monetary policy relied on intermediate targets such as monetary aggregates or exchange rates. South Africa has been relatively successful in stabilizing inflation (see box 5.1).

While inflation targeting contributes to price stability through building credibility and anchoring inflation expectations more rapidly and durably, it involves costly tradeoffs between price stability on the one hand and growth and employment creation on the other hand. Inflation-targeting countries are committed to hit a pre-defined inflation target, which may unnecessarily restrain growth (See Blanchard 2003). This has been the experience with inflation targeting in South Africa.

Box 5.1
Experience with inflation targeting in South Africa

South Africa adopted a full fledged, inflation targeting regime in February 2000. The motivation for this was the growing instability of money supply growth, and inflation following financial liberalization. The objective of inflation targeting was to instil monetary discipline and enhance the central bank's accountability. The inflation target was expressed in terms of headline CPI excluding mortgage interest costs. Since 2000, the inflation target has been set at 3 - 6 per cent. The institutional framework gives the Reserve Bank greater instrument independence in conducting monetary policy.

To enhance transparency in the conduct of monetary policy, the Reserve Bank publishes the monetary policy statements after each Monetary Policy Committee meeting. Monetary Policy Forums are also convened by the Reserve Bank twice a year and members of the public and important interest groups such as trade unions, businesses, and academia are invited to attend.

How has inflation targeting fared? When it was introduced in 2000, the actual inflation averaged 10 per cent, 4 percentage points above the upper limit of the target range. Thereafter, inflation declined to 5.4 per cent in September 2003 and then to 4.4 per cent in 2004. Consistent application of the inflation-targeting framework has strengthened the Reserve Bank's mandate to focus on price stability and has contributed to reducing inflation.

***Source**: Van der Merwe, E. J (2004).*

2 The shift to floating exchange rates in many developing regions, including Africa has necessitated the adoption of an alternative nominal anchor of price stability (Agénor 2001).

The country faces a serious problem of unemployment partly resulting from slow growth. The pursuit of inflation targeting takes away government's ability to boost growth through demand-side macroeconomic policy. The benefits of inflation targeting in terms of credibility and price stability should be carefully weighed against the losses in terms of employment creation.

Exchange rate policy reform

In addition to fiscal and monetary policy, exchange rate policy was a key element in macroeconomic stabilization (Husain and Faruqee 1996). The objective of exchange rate reform was to establish market-determined exchange rates and to eliminate parallel markets.[3] Although some African countries opted for a gradual approach to exchange rate reforms, most pursued an "overnight" approach, which essentially involved a shift to a floating exchange rate regime through the removal of foreign exchange controls (Agénor and Montiel 1996). In Ghana, for example, large and widely spaced devaluations were implemented in a four-year period (April 1983-September 1987) with an "overnight" float occurring in the last phase. In the case of Nigeria, currency devaluation was implemented overnight in September 1986.

Many countries have also moved towards greater capital account convertibility through relaxation or elimination of restrictions on capital-account transactions. Following its transition to democracy, the South African Government introduced measures to liberalize the capital account. This included the unification of the exchange rate system; immediate elimination of exchange controls on non-residents while those relating to domestic residents were to be removed gradually and eventually eliminated (Stahl, 1995).

5.3 The gains from economic reforms for capital flows have been small

Although performance has varied considerably across countries, the successful implementation of economic reforms, including macroeconomic stabilization, had brought positive results for a number of countries.[4]

Inflation rates have been reduced; twin deficits narrowed; exchange rates have stabilized, parallel market premiums have declined, and economic growth, albeit slow and erratic, has returned to many countries in Africa.

3 With respect to exchange rate policies in Africa, there has been a marked shift from soft pegs towards independently-floating and managed-floating exchange rate regimes. For example, out of 27 African countries that were in the soft-peg category in 1991, 15 were classified as independently floating regimes in 1999 (Ndikumana 2003).

4 See chapter 1 of this report for a detailed discussion of recent economic performance.

However, countries that have undertaken the most ambitious and sustained reforms, notably Ghana, Mozambique, Tanzania and Uganda, have experienced significant growth. In Uganda, for example, GDP growth has averaged 6 per cent per annum since the early 1990s while inflation has been brought down to single-digit levels. However, despite the improvement in growth, for most African countries, growth remains far below the 7 per cent target considered necessary for meeting the MDGs.

Macroeconomic environment remains weak in many African countries

Economic reforms, including macroeconomic stabilization, were expected to lead to increased capital inflows by raising risk-adjusted returns on investment. However, the evidence shows that African countries have not reaped substantial benefits from economic reforms. For example, over the period 1989-94 and 1995-1999, FDI inflows into Africa grew by an average 72 per cent. This is not that remarkable considering the very low base from which FDI grew. By comparison, FDI flows to Latin America and the Caribbean grew by nearly 200 per cent and to the Asia-Pacific region by 150 per cent (UNCTAD 2001, 2002 and 2005). Global inward FDI flows registered an average growth rate of 197 per cent over the same period.

The marginalization of Africa in global financial markets is manifested in the continent's stagnant share in global FDI flows. For example, over the period 1989-1994 and 1995-1999, and 2000-2004, SSA's share in the world's FDI flows averaged 1 per cent compared to 10 per cent and 17 per cent for Latin America and the Caribbean and Asia and the Pacific, respectively. Therefore, the surge in private capital flows to developing countries witnessed in the early 1990s did not reach most of the African countries (Ndikumana 2003).

A number of factors explain Africa's limited success in reaping the benefits of economic reforms in terms of capital inflows. Despite the implementation of macroeconomic reforms, the macroeconomic environment remains weak in many African countries. This is due to a number of factors, including low resource endowment, political conflict, and inappropriate macroeconomic policies that have accentuated the adverse effects of external shocks (Ndikumana 2003). In many countries, reforms were incomplete and were not underpinned by a strong institutional mechanism to sustain their implementation.

As a result, policy reversal was common, and this may have undermined the benefits of reforms for capital flows. For example, 150 foreign investors operating in East Africa ranked the risk of policy reversal as the most important risk factor (World Bank 1994). The impact of policy reversal is particularly more profound for FDI than for other types of capital flows given its irreversibility. Asiedu (2005) found FDI to Africa to be less responsive to trade liberalization than in other regions. A plausible explanation for this is that foreign investors perceive reforms as transitory and therefore subject to reversal.

Furthermore, institutional frameworks for macroeconomic policy management in Africa are weak. In most African countries, as in other developing regions, a triumvirate of institutions is responsible for the formulation and implementation of macr-

oeconomic policy. These include the central bank, Ministry of Finance and national planning bodies. Each of these institutions has a distinct mandate and power, and goes about implementing their mandates separately, with limited coordination in the formulation and implementation of macroeconomic policies.

Apart from policy coordination among the triumvirate institutions, coordination and policy harmonization between the triumvirate institutions and sectoral ministries is also weak. This complicates macroeconomic policy management. The lack of coordination leads to policy inconsistency, which undermines efficiency and institutional credibility in macroeconomic policy formulation and implementation. Therefore, African countries need to strengthen their institutional framework for macroeconomic policy management.

Another factor contributing to Africa's inability to attract capital flows relates to the "image problem" (Asiedu 2005). International investors have a negative perception of Africa that tends to undermine the effects of economic reforms on capital flows. For example, 56 per cent of firms surveyed in an UNCTAD study reported that the actual business environment in SSA is better than the continent's image would suggest (UNCTAD 2000). This is also corroborated by empirical evidence which suggests that credit-rating agencies tend to rate African countries as riskier than warranted by fundamentals (Haque et al. 2000).

As a result, SSA countries receive on average less FDI inflows than countries in other regions, even though the continent offers some of the highest rates of return on investment in the world[5]. Arguably, it is unlikely that economic reforms would lead to increased capital inflows as long as the investors perceive the region as risky.

"It is unlikely that economic reforms would lead to increased capital inflows as long as the investors perceive the region as risky"

Furthermore, due to lack of information on individual African countries and their investment opportunities, investment decisions are often based on inferences from the environment of neighbouring countries rather on country-specific conditions (Asiedu 2005). Thus, in the eyes of foreign investors, Africa is 'one big country' rather than a continent made up of different countries. This calls for more efforts on the part of individual African countries, international organizations and Africa's development partners to change the image of Africa and to develop among foreign investors a more differentiated view of the continent and its opportunities" (UNCTAD 1999).

Other factors having a positive impact on FDI include good physical infrastructure, an educated labour force, openness to FDI, an efficient legal system, low corruption and political stability. On this count, the majority of African countries do not fare well either. Physical infrastructure in most African countries is weak, energy supply is unreliable, corruption is rampant, and a number of countries suffer from political conflicts.

Despite the limited benefits of economic reforms for capital flows to Africa, capital flows have nonetheless posed considerable challenges for macroeconomic policy management in a number of countries.

5 For example, the average return on US investment in Africa was 30 per cent over the period 1991-1996 compared to 21 per cent and 14 per cent for Asia-Pacific and Latin America, respectively (UNCTAD 1999).

5.4 Capital inflows have posed challenges for macroeconomic policy management

While increased capital flows have had positive effects on the economies of developing countries, including Africa, they have also been associated with adverse effects. In general, policymakers have been confronted with three sets of problems:

- Excessive expansion in aggregate demand due to capital inflows, leading to overheating, thus undermining hard-won gains in macroeconomic stability;
- Vulnerability to abrupt reversal in capital flows due to changes in investor perception, especially for countries that have attracted sizeable amounts of short-term capital flows; and
- The premium that greater financial integration imposes on macroeconomic policy management (World Bank 1997).

The macroeconomic effects of capital flows have varied across countries depending obviously on the type of flows (private versus official, short versus long-term) and their associated volatilities, volume and magnitude in relation to domestic absorption of the recipient as well as the usage of inflows. Capital flows to Africa have been predominantly in the form of ODA, with FDI being the major component of private capital inflows to Africa (see chapter 2). The increase in capital inflows and their associated volatility has posed challenges for macroeconomic management. According to Osei *et al.* (2002), private inflows to Africa in the 1990s exhibited a higher degree of volatility than those to Asian and Latin American countries (see also chapter 2 of this report for measures of volatility).

One of the common effects observed in African countries has been an expansion in domestic credit and liquidity arising from financing of large budget deficits. For example, following successful adjustment in the mid-1980s in Ghana, net aid flows grew from nearly $1 million in 1984 to over $650 million in 1992 (Leechor 1996).[6] This led to an increase in Ghana's foreign exchange reserves, which were mainly used to finance government expenditures. Although foreign aid has played an important role in supplementing declining export earnings due to worsening terms of trade it also became an important source of monetary expansion. For example, the rate of growth in broad money supply rose from 40 per cent in 1983 to 52 per cent in 1992. Thanks to an aggressive credit restraint policy, inflation declined considerably from 122 per cent in 1983 to 10 per cent 1992 (Leechor 1986).

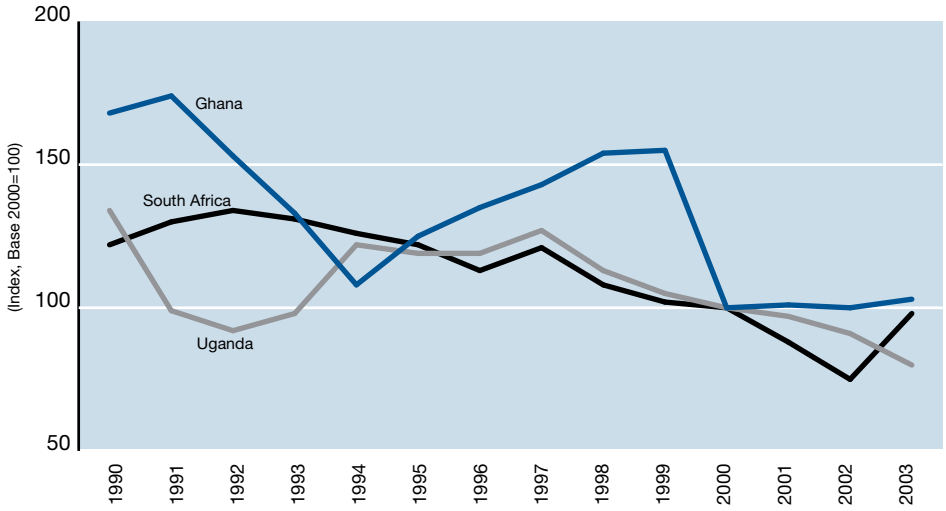
Since early 2000, some African countries, for example Mozambique, Tanzania and Uganda, have formulated and implemented PRSPs. These countries have also experienced increases in capital flows related to PRSPs and debt relief under the HIPC Initiative. These are mostly low-income countries with fledgling financial sectors which limit the menu of policy choices available to them to deal with massive aid inflows.

6 Foreign aid has been considered an important factor in Ghana's successful adjustment programme.

Since the public expenditure priorities embedded in country PRSPs are biased in favour of non-tradable goods and services, PRSP-related aid inflows exerted pressure on the real exchange rate while the simultaneous inflow of private capital has led to an expansion of the monetary base (Buffie, Adam, O'Connel and Pattillo 2004). Real Effective Exchange Rates (REER) are depicted in figure 5.1. That rate for the Ghanaian Cedi depreciated from 1990 to 1994 and thereafter appreciated until 1999. The same rate for the Ugandan Shilling showed considerable appreciation, especially from 1992 to 1997. According to Kasekende *et al.* (1997) real exchange rates appreciated by more than 11 per cent between 1994 and 1997. For Tanzania, the cumulative overvaluation was estimated at 20 per cent for the period 1994-1996 (Leape 1999). Real exchange rate appreciation tends to have a detrimental impact on the tradable sector.

> *The massive inflows of capital to South Africa since 1994 has made the economy vulnerable to sudden reversals of capital flows*

Figure 5.1
Real Effective Exchange rates for Selected African countries



***Source**: IMF, 2005*

***Note**: An increase in the rate means appreciation of the national currency.*

Capital flows expose countries to risk of currency crisis, especially arising from sudden reversal of capital. For example, the massive inflows of capital to South Africa since 1994, most of which were of short-term maturity, has made the economy vulnerable to sudden reversals of capital flows. This has led to a series of exchange rate crises. The first such wave occurred in February 1996 and lasted to July 1996. The main contributing factor was investor uncertainty about the direction of economic policy given the inherently conflicting policy objectives among key stakeholders, especially between the government and the labour movement represented by the Congress of South African Trade Unions (COSATU).

The second wave occurred in October 1996 and November 1997, caused largely by the contagion effects from the Asian financial crisis. The decline in the price of gold and other metals also contributed to the exchange rate crisis during this period. The third currency crisis came in April 1998 as rising current account deficits, coupled with poor growth prospects, dampened investor confidence in the South African economy (Aron and Elbadawi 1999).

Increased financial integration reduces the policy space for countries to conduct independent monetary and exchange rate policies

Another effect of capital inflows relates to the challenges that increased financial integration imposes on macroeconomic policy management. Increased financial integration reduces the policy space for countries to conduct independent monetary and exchange rate policies. This is the well-known policy trilemma, the observation that a country can attain only two of the three objectives of exchange rate stability, monetary independence and financial integration.[7] While these three objectives are worth pursuing, it is nearly impossible for policymakers to pursue them simultaneously. Therefore, if policymakers opt for exchange rate stability and capital mobility, they have to forego monetary independence. If monetary policy independence and capital mobility are opted for, then the country has to choose floating exchange rates and give up the objective of exchange rate stability (Taylor 2004).[8] Throughout history, policymakers have been preoccupied with finding choices to resolve this policy trilemma.

In some African countries, policymakers have opted for exchange rate stability and capital mobility at the expense of monetary independence. This is the case for CFA countries and the member countries of the Common Monetary Area [9] (CMA). A good number of African countries have opted to pursue the objectives of independent monetary policy and capital mobility. They have chosen to forego the objective of exchange rate stability by floating their exchange rates. Ethiopia, Ghana, Kenya, Nigeria, South Africa and Uganda are some of the countries that have floated their exchange rates.

With respect to policy responses to address the effects of capital inflows, African countries have pursued a wide range of options. For example, the Ghanaian Government introduced an aggressive domestic credit policy in 1989 to mitigate the macroeconomic effects of foreign aid inflows (Leechor 1996). The policy had a noticeable impact as it generated fiscal surpluses, which were used to repay the Government's debt at the Central Bank.

African countries have also used sterilized interventions through the sales of bonds to limit the effects of monetary expansion on aggregate demand. Given the shallowness of debt markets, this type of intervention is costly, as rising interest rates increased debt servicing costs for both the Government and the private sector. Rising interest rates also discourage private sector borrowing while investment in bonds by banks crowd out lending to the private sector. While sterilization is necessary and effec-

7 For a detailed exposition of this theorem, see for example Obstfeld, Taylor and Shambaugh (2004).
8 Taylor, A.M (2004), "Global Finance: Past and Present", *Finance and Development*, March 2004.
9 The members of the CMA are Lesotho, Namibia, South Africa and Swaziland.

tive in offsetting the potential expansionary effect of increased capital inflows on the economy, there is a limit to its application. The fiscal cost could be high due to rising interest rates needed to entice investors to hold more of the newly issued bonds (Aron and Elbadawi 1999).

In addition to bond sterilization, central banks resort to more direct intervention in the foreign exchange market to limit the pressure on the nominal exchange rate. The transfer of government deposits from the banking system to the central bank is also used as a means of containing exchange rate appreciation due to aid inflows. This method has been used in Mozambique, South Africa, Uganda, and many others.

5.5 African countries need to further consolidate macroeconomic stability

As indicated in the preceding section, the implementation of macroeconomic stabilization policies has contributed to macroeconomic stability in a number of countries. However, the macroeconomic environment remains weak in many African countries. A number of factors, including low resource endowment, political conflict, inappropriate macroeconomic policies and narrow export base with volatile terms of trade[10] combine to undermine macroeconomic stability.

> *African countries need to enhance their capacity for macroeconomic policy formulation and implementation*

Given their weak institutional framework for macroeconomic policy management (especially the limited degree of coordination among the triumvirate institutions responsible for macroeconomic policy management) African countries need to enhance their capacity for macroeconomic policy formulation and implementation. This should be complemented by granting central banks sufficient autonomy to resist the temptation of inflationary deficit financing. What makes this particularly important is the increasing tendency of countries to move towards inflation control as the primary goal of monetary policy. Central bank autonomy must become an essential precondition for the successful control of inflation.

Countries seeking to gain much needed credibility may consider adopting an inflation-targeting approach to monetary policy. Some African countries, including South Africa, have adopted inflation targeting in recent years and have had relative success in reducing inflation. While inflation targeting leads to price stability, it involves costly trade-offs between price stability, growth and employment creation. Therefore, in considering the choice of an inflation targeting approach to monetary policy, countries should carefully weigh the benefits of inflation targeting in terms of credibility and price stability against the cost to output and employment creation.

10 External shocks, especially trade shocks contribute significantly to macroeconomic fluctuations in African countries. Koze and Riezman (1999) estimate trade shocks to account for 44 per cent of variations in aggregate output.

While macroeconomic stabilization policies are necessary for attracting steady and predictable flows of external finance, they will be more entrenched and sustainable if underpinned by a sound institutional environment.

5.6 The institutional environment for increasing capital flows to Africa

Institutions are important for attracting capital flows

The importance of institutions and the mechanism through which institutions affect capital flows were not clear until recently. Empirical evidence suggests that institutional differences are a major source of the differences in economic performance across countries.[11] Acemoglu, Johnson and Robinson (2001) found that as much as three-fourths of the income gap between the top and bottom of the world income distribution may be due to differences in their institutions.[12] The argument is that the structure of incentives determines economic performance and institutions provide the incentive structure of the economy (Olson 1996). Moreover, institutions affect economic performance through their effect on investment decisions, by protecting the property rights of entrepreneurs and favouring the adoption of new technologies.

"Three-fourths of the income gap between the top and bottom of the world income distribution may be due to institutional differences"

Research shows that institutions play a key role in facilitating private investment and that institutional quality is the most important factor that explains why capital does not flow from developed countries, where it has a lower return, to developing countries where it has a higher return (Olson 1996). Institutions can affect capital flows directly by providing the enabling environment, good governance and sound financial institutions that encourage the flow of capital and facilitate long-term investments. Indirectly, institutions affect capital flows through their impact on other variables that affect capital flows, in particular their impact on economic growth and the business environment, including the quality of public infrastructure, policy environment, political stability, labour costs, exchange rates, and price and exchange rate stability.

Central to both institutional environment and capital flows is the role of governance, that is, the manner in which a government discharges its responsibilities in an effective, transparent and accountable manner that conforms with internationally accepted good practices. This determines the amount of capital that flows into a country. Good governance has been shown in the literature to affect economic growth positively, implying that

11 See for example, Knack and Keefer, 1995, or Hall and Jones, 1999.

12 The authors argue that the legacy of colonialism and the institutional differences it caused persisted even after colonialism ended. Using the exogenous variation in institutions across former colonies, due to mortality rates faced by Europeans at the time of colonization, they argue that Europeans introduced extractive institutions in colonies where they did not settle, while developing effective property rights in colonies where they settled in large numbers. This explains the better performance in the latter group relative to the former.

governance indirectly affects capital inflows.[13] This may occur as a result of productivity-enhancing effects exerted by good governance on inputs in the production process. However, an important challenge is how to establish the mechanisms of good governance, which characterize the capable State, including its ability to enforce contracts, property rights and the rule of law, all of which have been found to have positive effects on growth. The crucial issue is determining what institutional arrangements are capable of fostering a capable State and hence good governance. This task is undertaken in the next section.

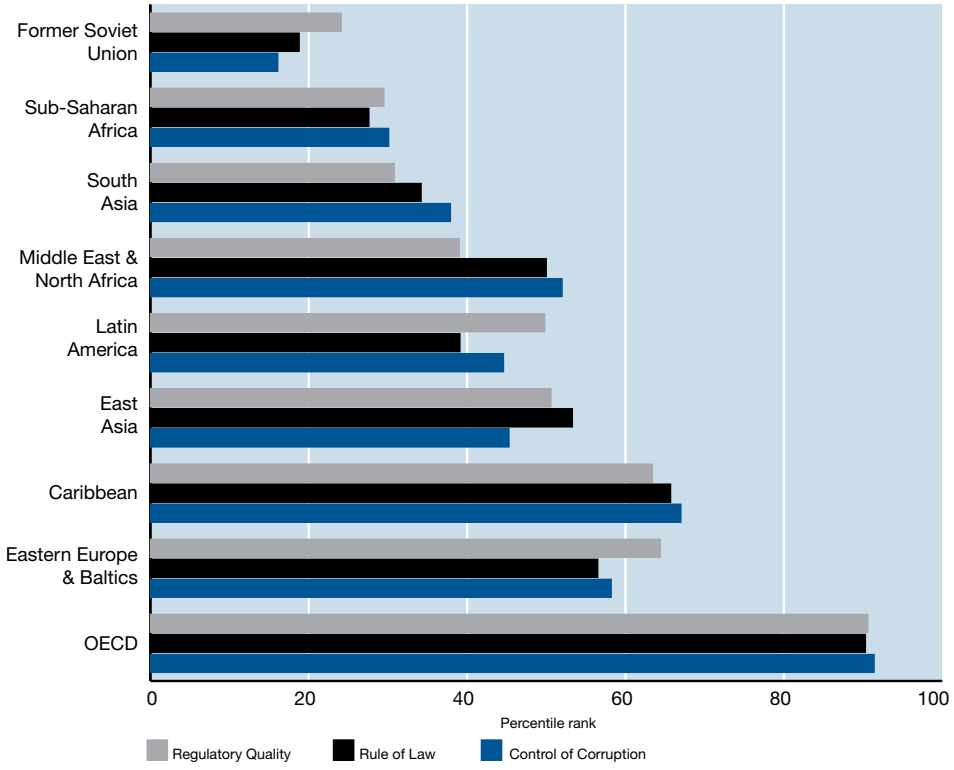
> *The crucial issue is determining what institutional arrangements are capable of fostering a capable State and hence good governance*

African institutions have not performed well in attracting capital flows

Institutional quality can be measured by the quality of governance, including the degree of corruption, political rights, public sector efficiency and regulatory burdens; the extent of legal protection of private property and how well such laws are enforced; and the limits placed on political leaders (Acemoglu, 2003).

Figure 5.2

Corruption, Rule of Law and Regulatory Quality in Africa and Other Regions, 2004



***Source**: Kaufmann et al., 2005.*

13 See Ndulu and O'Connell (1999) for evidence on the role of governance in economic growth in Africa. Also see Barro (1997) and IMF (2003).

> *Corruption has negative effects on capital flows and overall economic development*

Figure 5.2 depicts the percentile rank of the various regions with respect to three indicators of institutional quality: control of corruption, rule of law and regulatory quality. Higher values imply better governance ratings. Regions are presented on the chart ranging from 'best' (top of the chart) to the 'worst' (bottom of the chart) for year 2004. Sub-Saharan Africa scores worse than other regions (only higher than the former Soviet Union) in the three selected indicators of institutional quality. The quality of the business environment indirectly measures the quality of African institutions for the market. The World Bank's *Ease of Doing Business Index*, which ranks economies from 1 to 155, shows that African countries rank predominantly at the bottom of the scale. Twenty-five African countries rank between Zimbabwe, which ranked 126, and the Democratic Republic of Congo (which ranked 155 out of 155). It is not surprising that the countries with good institutions - the ones that, among other things, enforce contracts and property rights and protect investors - rank high on the list, with Mauritius ranking 23 and leading the way, followed by South Africa (28), Namibia (33) and Botswana (40).

Corruption is a serious problem in many African countries and, as in many other parts of the world, is the bane of good institutions. It has negative effects not just on capital flows but also on overall economic development. Corruption prevents the emergence and sustainability of strong institutions and deters foreign investment in countries where it is rampant. Corruption also constitutes a significant challenge to capital flows to Africa even though countries such as Nigeria, which has significant corruption problems, attract capital in the natural resource extraction sector.

However, FDI outside the natural resource extraction sector appears much more responsive to macroeconomic, political and institutional variables (Nnadozie and Osili 2005). Table 5.1 shows the *Corruption Perception Index*, with lower ranking indicating higher levels of corruption perception. The table shows that Africa has the second-lowest ranking after non-EU South and Eastern Europe and Central Asia.

Table 5.1
Comparison of Corruption Perception Index across Regions, 2005

Region	Index
Non-EU South and Eastern Europe and Central Asia	2.67
Africa	2.86
North and South America	3.86
Global Average	4.11
Asia and Pacific	4.28
Middle East	4.37
EU plus Iceland, Norway and Switzerland	6.67

***Source**: Transparency International, 2006*

Because the institutional environment, good governance and sound financial institutions directly play a positive role in encouraging the flow of capital, it is important to establish an institutional environment that will enhance the flow of good-quality capital and minimize the volatility of inflows that can cause severe macroeconomic imbalances.

In Africa, the preponderance of extractive institutions is the legacy of colonialism. Indigenous administrations could not modify this legacy, mainly because once they are entrenched, extractive institutions are hard to change. Yet, the key hindrance to effective institutions is the entrenched interests of the elites or particular groups favoured by the existing institutional arrangements. Hence, the problem of institutional reform and that of the persistence of bad institutions lie in the fact "that any major change creates winners and losers and the potential losers are often powerful enough to resist change" (Acemoglu 2003:130). Institutional change will occur when groups that favour change become powerful enough to impose it on the potential losers. Alternatively, societies can reach an agreement to compensate potential losers after the change takes place, or perhaps shield them from the adverse effects of these changes (Acemoglu 2003).

Because institutions define and enforce the economic rules of the game, they shape economic performance, which means that economic development depends heavily on the establishment of strong and stable political institutions (North, 2005). North argues that "Political institutions will be stable only if they are supported by organizations with an interest in their perpetuation" (North 2005: 7). The implication is that African countries must encourage and create such organizations as an essential part of political and economic institutional reforms within a participatory, consultative, and democratic framework.

There is a need to establish an institutional environment that will enhance the flow of good-quality capital

Effective institutions will enable African countries to increase capital flows

To increase capital flows, African countries must acquire and develop effective institutions—those "…that improve the market systems by improving information, lowering transaction costs and improving resource allocation and distributional equity" (Nnadozie 2005). The central challenge, therefore, is how to build and strengthen African institutions and make integration into the global economy work for African countries in achieving development goals through increased flow of stable long-term capital. Making institutions play their rightful role will require a two-pronged approach: identifying critical institutions and building them or improving upon their efficiency and effectiveness.

Identifying institutions that are critical for increasing the flow of beneficial international capital

Having understood and accepted the role of institutions, the logical next step is to identify the institutions that are critical for increasing capital flows. The institutions that will increase capital flows are likely to be the same ones that increase growth, especially those that protect property rights and enforce contracts. These are institutions that will minimize the transaction costs associated with international capital and alleviate information and sovereign risk, thus improving market efficiency. Institutions that will address domestic market imperfections are equally critical and include institutions for developing human capital and improving government policies.

First and foremost, African countries need institutions that will generate the right incentives for an increased flow of international capital by providing good information to investors, and promoting investment opportunities and political stability. Furthermore, they need institutions that will ensure better economic management and create a sound macroeconomic environment. They also need institutions that will not only provide an enabled business environment, including provision of quality infrastructure, and deepening and improving the efficiency of the financial sector in order to unleash the potential of the private sector. Finally, the sector needs institutions that enable its members to establish and implement a national strategy for attracting foreign capital.

"The financial sector needs to establish and implement a national strategy for attracting foreign capital"

- **Institutions for managing conflict and promoting political stability**. Because political stability is important for improving sovereign risk, it is necessary to build institutions that promote political stability and effectively manage conflicts. Examples of such institutions include a good constitution, the rule of law, an independent judiciary, representative political institutions, free elections, independent trade unions, social partnerships, and institutionalized representation of minority groups and social insurance (Rodrik 2000).
- **Regulatory and stabilization institutions.** A capital-friendly environment requires effective institutions to attract foreign capital. These include banks and stock markets and the institutions that regulate anti-competitive behaviour, including anti-trust laws. There is need for efficient prudential regulation and financial supervision such as the central bank. Securities regulation requires securities and exchange commissions. Likewise, institutions for macroeconomic stabilization, especially an independent central bank, will help to avoid financial crises when flows increase.
- **Legal institutions, the rule of law and property rights enforcement.** These are equally important for attracting foreign capital. Property rights enforcement is an important dimension of the rule of law. Incentives play an important role in enterprise formation and growth and property rights are at the heart of the incentive structure (World Bank 1999). For the flow

of capital to increase, these rights, including ownership and control, must be clearly defined by law through a combination of legislation, private and public enforcement, and custom and tradition (Rodrik 2000). Good laws must be passed, they must be applied fairly and transparently and even-handedly to all, by a politically independent judiciary. Above all, they must be enforced. Investors must be protected.

Because of weak and sometimes corrupt courts and regulators, underdeveloped capital markets and a shortage of skilled operators, lawyers and accountants, foreign investors often have difficulty in obtaining information on companies and are therefore wary of investing in African countries (World Bank 1996). There is a need for corporate law and better corporate governance to improve the investment environment, control corruption and increase the level of trust in the State. However laws are only as good as the institutions that enforce them.

> *Increasing capital flows to African countries will require a heavy dose of strategic institutional development*

Building and strengthening capital-friendly institutions

The issue is not just what type of institutions are needed to enable each African country to increase its capital inflows but also how they can be built, developed and strengthened. Significantly increasing capital flows to African countries will require a heavy dose of strategic institutional development. The options pursued in terms of desirable institutional arrangement will vary across and within countries over time within the historical realities (Rodrik 2000). Making institutions work for capital inflows requires a definition of national capital-flow objectives, a correct diagnosis of institutional deficiencies in achieving these objectives and a strategy for increasing capital inflow within a well-established national growth and poverty reduction framework.

Diverse initial conditions among African countries imply that their approach to institutional reforms and institution-building will vary from country to country. The strategies will be based on an assessment of the institutional gaps and capacities in each country. In acquiring functional, capital-friendly institutions and improving upon their quality, should African countries focus on best practices and copy existing models or should they engage in local experimentation based on local innovation. They must choose between ready-made blueprints or experiments using domestic historical, social, and political realities and knowledge of local needs and capacity.

Each choice has advantages and disadvantages and therefore entails trade-offs. There should be a country-specific approach. For some countries, it will be the establishment of new institutions. For others, it will be the harmonization of existing ones. There is also need for local experimentation, in recognition that this approach has its own dangers and is costly in terms of time and resources.

The blueprint approach may not be the way to go but use of local knowledge in adaptation of imported models has its own problems. Nonetheless, there is always some-

thing to learn from the institution-building experience or institutional arrangement prevailing elsewhere even if they are often "inappropriate or cannot be transplanted" (Rodrik 2000: 12). Sometimes, institution-building may require combination of orthodox and heterodox strategies in a participatory process. This approach has enabled Mauritius, a stable democracy with regular free elections, to attract considerable foreign investment and generate one of Africa's highest per capita incomes (see box 5.2). Besides, democracy helps build better institutions, which means that the economic strategy needs to be underpinned with social and political arrangements that encourage participation, representativeness and coalition-building (Rodrik 2000).

"African countries can learn from the experience of some of their Asian counterparts and from the success stories in Africa"

Certain steps are required to adapt policy and institutional change to local conditions and there is need for broad-based participation in the process of change. African countries can learn from the experience of some of their Asian counterparts and from the success stories in Africa. Botswana and Mauritius are two African countries that have consistently performed well despite facing many conditions similar to those of their African neighbours.[14] The difference, many studies conclude, lie in good governance, that is, the quality of institutions that encourage participation and transparency in these two countries has been much higher than those on the rest of the continent (Rodrik 2000; Acemoglu *et al.,* 2001).

Box 5.2
The Export Processing Zone in Mauritius

In creating the Export Processing Zone (EPZ), the Government of Mauritius recognized that there would be winners and losers, especially industrialists who for years had been favoured by protectionist arrangements. By addressing the needs of the industrialists through negotiation, the Government earned their support for the reforms. The EPZ generated new trade and employment opportunities, while protecting existing interest groups. As a result, Mauritius benefited from high levels of capital flows that boosted trade and investment.

***Source**: Rodrik 2000.*

Regional dimensions of institution-building

Aside from mobilizing internal and external resources to fund institutional change, there are also regional and global dimensions. African countries need to develop and strengthen regional organizations that enable them to attract and absorb higher volumes of private capital flows. In particular, subregional and continent-wide initiatives aimed at improving economic and political governance play an important role in improving Africa's image in the eyes of international investors.

For instance, as an integral part of the AU's New Partnership for Africa's Development (NEPAD), the African Peer Review Mechanism (APRM) aims to foster the adoption of policies, standards and practices that lead to political stability, high economic

14 Some of these common conditions include low human capital, commodity dependence, tropical climate and lack of access to the sea.

Box 5.3
China's success in attracting foreign capital

China offers more, incentives to attract FDI than any other country in the world but also offers more legal restrictions. Adopting a pragmatic strategy that has been adjusted over time, China was able to attract significant amounts of capital flows with a mix tilted in favour of FDI.

The country adopted an export-oriented approach targeting foreign capital that could help transmit technical and marketing know-how. It embarked on prudential capital-account liberalization, coupled with a mixed policy of simultaneously discouraging foreign debt and foreign portfolio investment and providing incentives for FDI.

Through the experience of the Asian crisis, China adopted an incentive mechanism and a step-by-step relaxation of restrictions. It promulgated laws governing capital investment at the start of the reform programme and used tax benefits for FDI and capital controls to limit other flows.

***Source**: Eswar Prasad and Shang-Jin Wei (2005).*

growth, sustainable development and accelerated subregional and continual economic integration. This is to be done through sharing of experiences and reinforcement of best practices, while identifying deficiencies and assessing the needs of capacity building in the areas of governance and socioeconomic development. It is believed that as a regional mechanism, APRM will encourage the emergence of sound national institutions and promote economic development in Africa by improving political, economic, and corporate governance.

5.7 Conclusion

African countries have undertaken a number of economic reforms since the early 1980s. Macroeconomic stabilization policies have featured prominently in 'the first-generation reforms' agenda. These policies have been complemented by trade, financial and capital account liberalization. Tax reforms were also included, generally in the later stages of stabilization programmes. Implementation of these policies has brought positive results for a number of African countries, as evidenced by falling inflation rates and narrowing of fiscal and current account deficits. Although growth has returned to a number of countries, it remains below the seven per cent target required for meeting the MDGs.

While Africa as a continent remains on the sidelines of financial globalization, some countries have been able to attract substantial volumes of external capital, including official aid and resource-seeking private capital. These flows have posed considerable challenges for macroeconomic policy management. The common effects observed across Africa have been inflationary pressures and real exchange rate appreciation.

In response to capital inflows, African countries have pursued a number of policy options. These have ranged from sterilization through bond issues, direct foreign exchange intervention and transferring government deposits from commercial banks to the central banks.

Properly managed, the benefits of international capital can outweigh the costs

Notwithstanding the challenges that capital inflows pose for economic policy management in general and macroeconomic policy in particular, they are important for the growth and development of African economies. Properly managed, the benefits of international capital can outweigh the costs. For instance, they can help to reduce the savings gap and provide the resources needed for infrastructure development and for social spending, (both of which are essential for private sector and human capital development) and poverty reduction. To increase capital flows while minimizing their potential negative effects, African countries must design strategies and institutions to reduce transaction costs and investment risk and develop human capital. Property rights must be secured through honest, competent, and reliable administration of justice. This will permit greater investment, which when allocated efficiently, can improve economic growth. Effective institutions can help African countries to pursue better and more sustainable policies, benefit from increased capital flows and maximize their benefits; competent institutions, and the public's trust in them, take a long time to grow.

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Absorption Capacity and Management of Capital Flows

6.1 Introduction

This last chapter of the report examines the capacity of African countries to absorb foreign capital and discusses policies to manage capital flows so as to maximize the benefits while minimizing the risks of financial fragility and other adverse effects. A country's capacity to absorb foreign capital depends on many factors, including the quality of the labour force, the availability and quality of the infrastructure, the depth and efficiency of the financial system, and the overall institutional and policy environment.

The discussion of the role of labour market factors was undertaken in chapter 3 while that of the institutional environment was examined in chapter 5. This chapter examines the role of the depth and efficiency of the financial system in absorbing capital flows and harnessing their direct and indirect effects on the host economy, including technological diffusion and crowding-in effects on domestic investment. It discusses the need for promoting regional financial integration as a means of attracting capital flows, and the mechanisms for monitoring and managing capital flows, including suggestions for warning indicators of financial risks and corresponding policy responses.

6.2 Financial Development and Absorptive Capacity

The depth and efficiency of the financial system influence a country's capacity to absorb capital flows, both private and official. The level of financial development also influences the extent to which a country is able to benefit from capital flows in terms of spillovers from targeted sectors to the rest of the economy, and the overall growth effects.

Efficient financial intermediation enhances absorptive capacity

Foreign direct investment and absorptive capacity

The financial system influences both the volume of foreign capital flows and the impact of foreign capital on economic growth. Long-term foreign capital or FDI is not only

the dominant form of private foreign capital in African countries but is also the form of private capital flows that is likely to have a substantial impact on economic growth. Three important relationships are worth emphasizing (Lehman *et al.,* 2004; Feldstein 1994; Di Giovanni 2005).

> *A more developed financial system allows foreign investors to borrow domestically to expand their activities*

First, financial development is a determinant of capital inflows because the deeper the financial system, the broader the range of investment opportunities and the higher the incentives for foreign investors to enter the country. Second, financial development is a key component of the host country's absorption capacity. Third, as a corollary to the second relationship, financial development is a key channel for the growth effects of foreign capital. These three relationships are essential in understanding both the relatively poor performance of Africa in attracting foreign private capital and the limited effects of FDI on economic growth on the continent.

Financial development, or more specifically, the depth and efficiency of the financial system, are an important condition for attracting capital inflows. Financial development exerts direct effects on capital flows by offering more opportunities for equity-based investments to foreign investors (Di Giovanni 2005). The deeper the financial system, the broader the range of investment opportunities and the higher the incentives for FDI into the country. A more developed financial system also allows foreign investors to borrow domestically to expand their activities.

Moreover, borrowing from local financial markets allows foreign investors to reduce their exposure to host-country currency risks (Lehman *et al.,* 2004; Feldstein 1994). Furthermore, financial development exerts indirect effects on FDI given that a more efficient financial system is associated with lower transactions costs and better information systems, all of which facilitate investment operations. Through the provision of systematic information on investment opportunities and returns to capital, an efficient financial system alleviates the problems of information imperfections, which are more acute for foreign investors than for domestic investors.

The importance of the financial system for a country's capacity to absorb foreign capital derives from the diverse functions that it plays in the economy. In addition to the traditional savings-mobilization role, the financial system also performs other functions that are vital to the proper functioning of a market economy, namely, information production, price discovery, risk sharing, liquidity provision, promotion of contractual efficiency, promotion of corporate governance, and facilitating global integration (see Senbet and Otchere 2006).

There are two important reasons why financial development is important for the country's absorption capacity. First, the depth of the financial system allows the country to attract intermediate foreign capital with minimal strain on monetary and exchange rate policy (Nkusu and Sayek 2004; Buffie *et al.*, 2004). A large and deep financial system minimizes the exchange rate appreciation effects of capital inflows and gives more degrees of manoeuver to the central bank in sterilizing the inflows, in order to minimize the inflationary impact. In many African countries, the bond market is

either nonexistent or very thin, which limits the number of tools by which the central bank can control the inflationary and exchange rate appreciation effects of foreign capital inflows. For example, the large increase in domestic interest rates in Uganda between 1998 and 2000 (from 5 per cent to almost 20 per cent) was partly a result of large aid inflows that could not be absorbed, given the relatively thin financial markets (Nkusu and Sayek, 2004). Evidence from other African countries shows similar effects (Buffie *et al.*, 2004).

Second, and most importantly, an efficient financial system allows the country to maximize the spillover effects of foreign capital in the economy. Such effects may occur through demonstration effects, competition effects, and downstream and upstream effects on domestic production. FDI provides incentives for expanding production partly through the creation of FDI-related demand for goods and services and also by pushing domestic producers to invest in innovation and skills acquisition to keep up with the competition.

Production expansion and technology diffusion need to be financed. Plans for expansion and technology acquisition may very well be frustrated by lack of appropriate finance in any country with an underdeveloped financial system. In the absence of adequate finance, FDI sectors may remain economic islands in the country, with minimal effects on overall economic activity. In the majority of African countries, lack of access to finance has been identified as an important constraint to business formation and expansion (see Bigsten *et al,*. 1999; Gunning and Mengistae 2001). Indeed, according to a firm survey of transnational corporations by UNCTAD in 1999/2000, 28 per cent of the firms identified lack finance. It is always one of the most important constraints to FDI in SSA, ranking third after corruption (49 per cent) and access to global markets (38 per cent) (UNCTAD 2000).[1]

> *In the absence of adequate finance, FDI sectors may remain economic islands in the country, with minimal effects on overall economic activity*

By facilitating absorption of foreign capital, financial intermediation will enhance the growth effects of foreign private capital. There is growing consensus that FDI affects economic growth less through direct investment effects and more through efficiency or total productivity effects (Mody and Murshid 2005; Durham 2004; Omran and Boldol 2003). The productivity effects of FDI on growth occur through the increase in the marginal productivity of capital in sectors that are directly receiving FDI. These "private productivity" effects are compounded by positive effects on marginal productivity of capital in other sectors in the economy – or "social productivity" effects (Mody and Murshid 2005; Alfaro *et al.,* 2004). FDI therefore creates positive technological spillover effects and managerial externalities in non-FDI sectors that raise total productivity in the economy.

However, these effects will materialize only if the financial system is able to intermediate resources efficiently and meet new demands for investment finance. The overall productivity effects will depend on the efficiency of the financial system in channeling

1 Also see Asiedu (2002, 2004), Asiedu and Lien (2004), and Morisset (2000) for further empirical evidence on constraints to FDI in Africa. See chapter 5 for further discussion of constraints to capital flows.

resources to investment activities with the highest returns on capital. The fact that FDI in Africa tends to be concentrated in extractive sectors (see chapter 2) contributes to limiting these productivity effects. In order to maximize the growth effects of FDI, African countries need to establish incentives for diversification of the sectoral allocation of FDI.

The conclusion from this analysis is that a country's absorption capacity, which is influenced by the depth of the financial system, is an important determinant of the growth effects of foreign capital. In countries with underdeveloped financial systems, FDI will have limited effects on growth. This may explain the weak link between FDI and economic growth observed in developing countries (Omran and Boldol 2003). The evidence suggests that African countries must aggressively pursue strategies for improving the efficiency of their financial systems in order to reap the maximum benefits from foreign capital flows.

The foregoing discussion implies that there may be a virtuous circle between FDI and growth arising from the reciprocal relationship between FDI and financial development. Foreign capital creates investment opportunities due to FDI-related spillover effects. This, in turn, induces credit expansion leading to an overall increase in financial intermediation. Therefore, to the extent that countries are able to establish an adequate institutional environment for financial intermediation, exposure to long-term foreign capital may have multiplier effects in both the real sector and the financial sector, eventually boosting the overall economic growth.

"A country's absorption capacity, which is influenced by the depth of the financial system, is an important determinant of the growth effects of foreign capital"

Other flows and the role of the financial system: aid and workers' remittances

The depth and efficiency of the financial system also influences the country's ability to absorb and take advantage of other forms of capital flows, namely, ODA, workers' remittances and short-term portfolio flows. Countries with underdeveloped financial systems have difficulty mitigating the negative effects of large inflows of foreign exchange, for several reasons. First, the lack of a developed bond market limits the degrees of manoeuver for the central banks, in sterilizing the effects of the inflows. This raises the risk for *Dutch Disease* effects whereby the unsterilized inflows cause an appreciation of the local currency, which undermines competitiveness (see Heller and Gupta 2002).

However, attempts to sterilize the inflows by Treasury Bill sales in a shallow domestic money market will lead to higher and more volatile interest rates, which have detrimental effects on private investment. Evidence from Uganda confirms these adverse effects of aid management on interest rates (Nkusu and Sayek 2004). Aid may indirectly crowd-out domestic investment in countries with underdeveloped financial systems. These adverse effects are likely to be more pronounced if aid inflows are spent on domestic non-tradable goods. In contrast, *Dutch Disease* effects are mitigated when the inflows are used to increase production capacity (including investment in public

infrastructure), in which case, positive supply effects offset adverse demand effects, thereby minimizing the impact on inflation and exchange rate appreciation.

Second, the lack of a diversified pool of financial instruments tends to direct private foreign capital into such speculative investments real estate, which causes price distortions and raises the risk for costly asset price crashes. As the volume of workers' remittances continues to rise in African countries, these risks of asset price instability will also continue to increase. The challenge is for African financial intermediaries to develop new instruments to direct these funds away from speculative markets. In this regard, it may be helpful that they initiate discussions with non-resident nationals and the Diaspora about the best options for channeling remittances into productive investments. While financial institutions have the knowledge of the local investment market, non-residents may contribute to the debate by drawing on their experiences of the financial systems in their host countries.

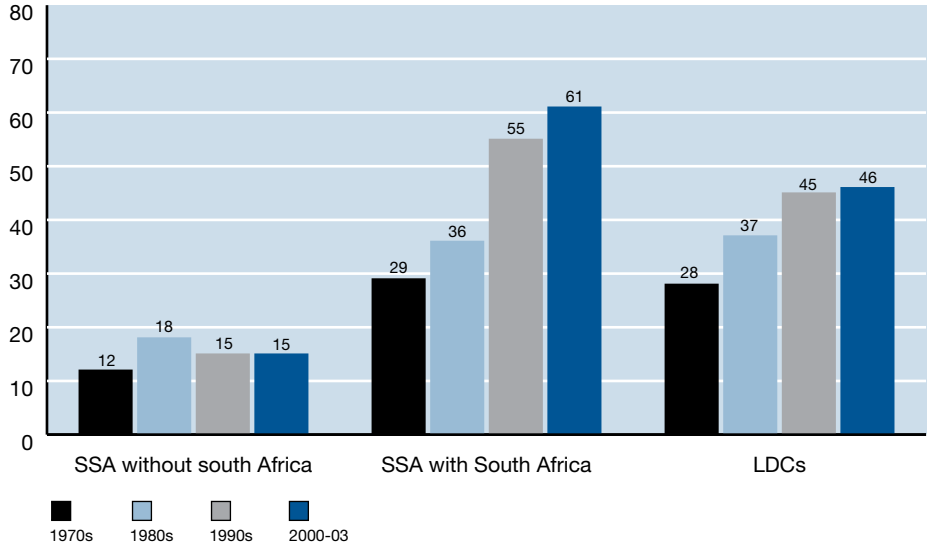
"As the volume of workers' remittances continues to rise in African countries, these risks of asset price instability will also continue to increase"

In addition to minimizing the risks of instability associated with official capital inflows, financial deepening also enhances the effectiveness of aid. ODA can contribute to economic growth, although the aid-growth relationship appears to depend on a range of conditioning factors, including the quality of institutions. One strand of the literature that is particularly relevant for the foregoing discussion suggests that the effectiveness of aid is enhanced by the depth of financial markets in aid-recipient countries (see Nkusu and Sayek 2004). In particular, deeper financial markets are able to intermediate external resource flows, thus maximizing positive indirect effects of aid outside the sectors that are directly targeted for aid. These indirect effects will enhance the overall effects of aid on economic growth.

Underdevelopment of African financial systems may explain the weak gains from capital flows

Most measures of financial development show that Africa in general, and SSA in particular, lag behind other regions in development, both in the banking sector and in the capital market. The record indicates that the performance of the financial sector has stagnated and even deteriorated in many countries since the 1990s. As can be seen in figure 6.1, the supply of credit by banks in SSA, excluding South Africa, was lower in the 1990s and early 2000s than in the 1980s. It is clear that the banking sector is not keeping pace with the growth of domestic demand for credit.

Figure 6.1
Bank credit to the private sector (% of GDP) in sub-Saharan Africa



***Source**: World Bank, 2005*

> *Financial systems in most African countries are dominated by a small number of banks that command heavy market power*

Moreover, despite substantial efforts to reform and liberalize financial systems in Africa, evidence still points to important impediments to efficient mobilization and allocation of both domestic and foreign resources (Senbet and Otchere 2006; Nissanke and Aryeetey 1998; Ndikumana 2003). Financial systems in most African countries are dominated by a small number of banks that command heavy market power, which undermines the efficiency of allocation of resources.

For example, in Burundi three leading banks account for over 70 per cent of deposits, loans, and assets (Nzobonimpa, Nkurunziza, and Ndikumana 2006). The market share of the top 4 banks is as high as 75 per cent in Uganda, 65 per cent in Ghana, and 49 per cent in Tanzania (Senbet and Otchere 2005). The oligopolistic structure of the banking system contributes to high costs of funds, as illustrated by high interest-rate spreads. Contrary to expectations, reforms in the banking system have been accompanied by a rise in the spread between the lending interest rate and the deposit interest rate and an increase in the gap between domestic interest rates and world interest rates. The interest rate spreads in 1996-2003 were twice as high as the 1980s levels in some countries (table 6.1). High spreads discourage savings mobilization due to low remuneration of deposits and depress borrowing due to the high costs of funds. It is clear that financial reforms in many African countries have been accompanied by less and not more efficiency in financial intermediation.

Table 6.1

Average interest rate spread and interest rate differential in African countries

Period	Deposit rate (%)	Lending rate (%)	Spread (%)	Differential with the USA (%)
1980-84	8.3	13.5	5.2	-19.3
1985-89	10.7	16.1	5.4	-26.5
1990-94	15.4	23.3	7.9	-8.9
1995-99	12.8	23.4	10.6	-0.9
2000-03	10.6	22.4	11.8	4.9

***Source**: IMF, 2005*

***Note**: The figures are averages for a sample of 22 African countries with consistent quarterly data over the 1980-2003 period. The interest rate differential for an African country is obtained by subtracting the US real interest rate from the African country's real interest rate.*

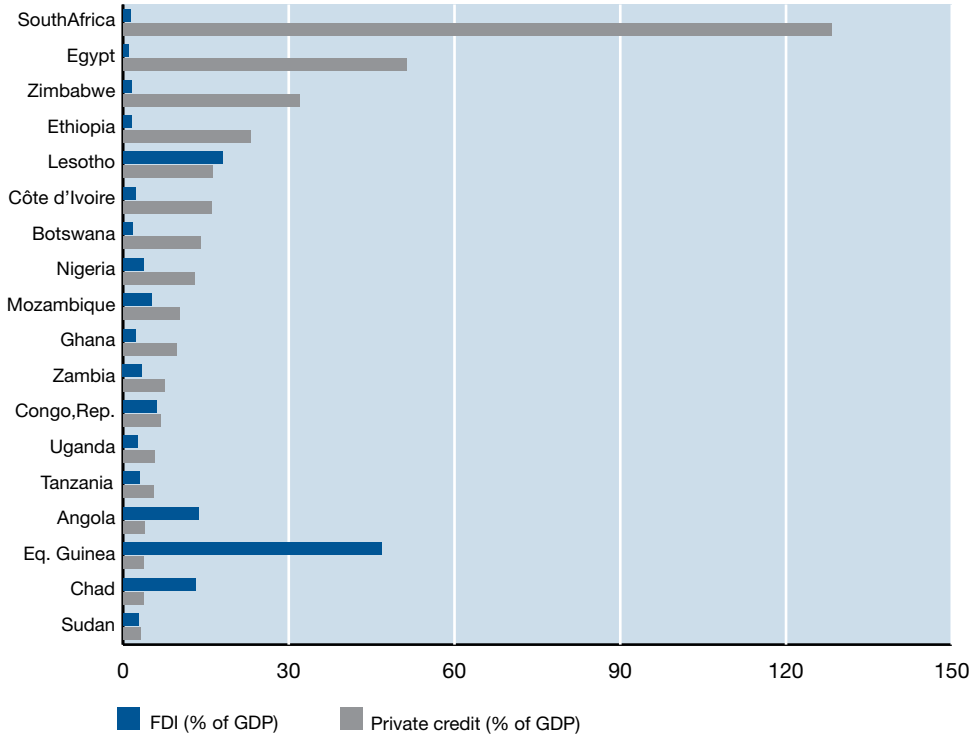
Financial reforms have moved African countries from an interest-repression regime to a high real-interest regime, both of which are detrimental to resource mobilization and investment. Moreover, African banking systems are excessively liquid as a result of risk aversion but also because banks are able to maintain comfortable profit rates by charging usury rates to their traditional borrowers (including the government) while hoarding risk-free government securities. Thus, African banking systems are engaged in *dysfunctional intermediation* (Senbet and Otchere 2006; Senbet 2001) that both wastes resources and keeps countries below their growth potentials.

> *"The critical question of how to enhance the impact of foreign capital on economic transformation must be addressed"*

FDI in Africa has traditionally been concentrated in resource-rich countries. These countries also happen to have the least developed financial systems (figure 6.2), implying very weak absorption capacity.

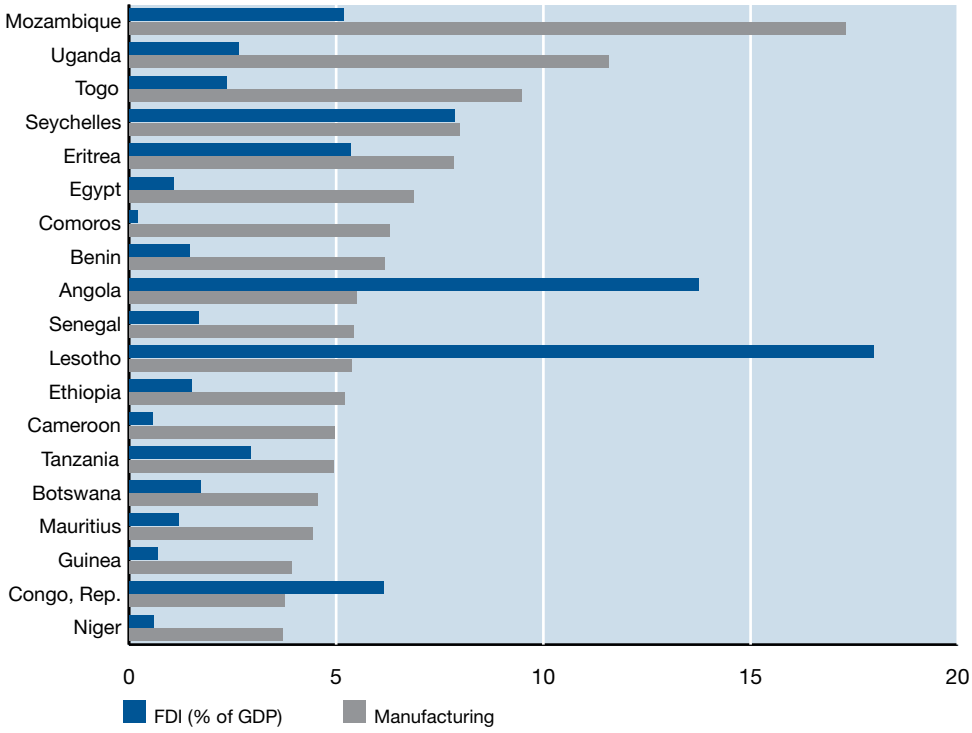
This partly explains the limited effects of FDI on economic diversification and transformation (see chapter 4) and overall economic performance (chapter 2). FDI has had little effect on the manufacturing sector, which may explain the low gains in terms of growth and employment creation. The data show that there is little relationship between the volume of FDI and manufacturing sector growth (figure 6.3). Leaders in manufacturing growth, such as Egypt, Mozambique, Togo and Uganda rank at the bottom in terms of FDI inflows. The debate on strategies to increase capital inflows in the continent must therefore address the critical question of how to enhance the impact of foreign capital on economic transformation.

Figure 6.2
FDI and financial development, 1994-2003



***Source**: UNCTAD, 2005; IMF, 2005.*

Figure 6.3
FDI and manufacturing sector growth, 1994-2003



***Source**: UNCTAD, 2005; World Bank, 2005.*

***Note**: Manufacturing sector growth = growth rate of the ratio of the manufacturing sector value added to GDP.*

African countries need to promote regional financial integration

> *Despite notable progress, African capital markets remain small and isolated and unintegrated in regional and global markets*

Capital markets constitute a vital complement to the banking sector in the process of developing an efficient financial system. The existing capital markets in Africa are still shallow and highly illiquid, with the exception of the South African stock market (table 6.2). Presently, there are 20 active stock exchanges in Africa and a regional capital market (BRVM) that covers all the eight West African Economic and Monetary Union (WAEMU) member States. Overall, African emerging markets have grown steadily in the last ten years in terms of market capitalization, value traded, and number of listed companies. Moreover, though illiquid, African markets are, nonetheless, quite profitable. In 2005, the average equity return was 34 per cent for Africa, excluding South Africa. However, despite notable progress, African capital markets remain small and isolated and unintegrated in regional and global markets.

Given the small size of national markets and the cost of the infrastructure that is required to run a vibrant capital market, it is clear that national capital markets are

not viable in many African countries. One way to increase the viability of capital markets is to promote regional equity markets by drawing on the experience of existing economic regional integration schemes. However, two points must be made clear from the outset. First, financial regionalism is not a substitute for financial reforms and other efforts at the national level aimed at developing national financial systems. In other words, countries cannot outsource financial development. In particular, the development of efficient national banking systems is indispensable for the success of regional financial integration.

Second, the gains from financial integration are likely to be uneven across countries due to differences in initial conditions. Relatively more advanced countries are likely to reap more benefits due to economies of scale and scope (Venables 1999). However, in the long run, these distributional effects will be outweighed by the gains from integration and may be mitigated through appropriate regional redistributional arrangements.

Table 6.2
African capital markets: key characteristics

Country	Levels 2004 or latest			10-year growth, 1995-2004 (or earliest 9 years)					
	Listed Cos.	Capitalization (m $)	Turnover	Listed Cos.	Capitalization (m $)	Turnover	Returns (US $)		
							2002 Index	2001-02	P/E
Algeria (2002)	3	145							8.8
Botswana	18	2548.3	2.3	4.1	20.4	40.2	41.4	96.1	13.0
Côte d'Ivoire	39	2082.6	2.7	2.3	9.2	2.7	27.4	58	9.9
Egypt	792	38515.9	17.3	0.6	16.9	-2.7	na	na	17.1
Ghana	29	2643.6	3.2	4.3	4.8	6.7	33.3	56.9	5.9
Kenya	47	3891.0	8.2	-1.7	7.5	45.4	7.7	3.9	8.7
Malawi (2002)	8	107.0	13.8	na	na	na	na	na	4.2
Mauritius	41	2378.8	4.5	3.9	6.0	7.7	30.8	22.5	6.0
Morocco	52	25064.3	9.1	1.7	15.5	-14.9	na	na	11.7
Namibia	13	442.3	4.8	2.7	8.9	11.7	-15.8	-44.5	5.4
Nigeria	207	14464.4	13.7	1.4	21.7	32.2	7.6	38	14.3
South Africa	403	455536.2	47.4	-4.5	4.9	22.0	27.9	5.7	11.2
Swaziland (2003)	5	172.0	0.0	2.3	-6.5	na	na	na	51.2
Tanzania (2002)	5	695.0	2.4	na	na	na	na	na	12.4
Tunisia	44	2641.1	9.2	5.4	-3.9	22.7	na	na	8.3
Uganda (2002)	3	52.0	na	na	na	na	na	na	15.2
Zambia (2002)	11	231.0	20.8	na	na	na	9.9	-17.1	5.8
Zimbabwe	79	1941.4	9.2	2.1	-0.5	2.0	-52.2	-59.9	47.1
Memorandum: comparison									
UK		2865200					-14.2	-28.3	
USA		16323500					-22.4	-31.6	
Emerging markets		5143000					-7.5		

***Source**: World Bank, 2005; UNDP, 2003. IMF, 2006.*

There are already some signs of interest in regional capital markets as illustrated by cross-listings in some markets, especially in Southern Africa. This is often a way for companies to raise their visibility in countries where they do business (UNDP 2003). The consolidation of capital markets at the regional level has important advantages for domestic and foreign investors. Financial integration will provide more investment opportunities, thus increasing the scope for portfolio diversification. The benefits from diversification at the regional level arise from the fact that business cycles are not perfectly correlated across member States. As a result, returns on investment will exhibit lower volatility as diversification reduces the effects of country-specific economic shocks on overall returns. By increasing the number of players in the market, regionalization of capital markets will also increase liquidity, which is a critical condition for the growth benefits from financial intermediation.

"Regionalization of capital markets will also increase liquidity, which is a critical condition for the growth benefits from financial intermediation"

By expanding the scope of investment opportunities, regional capital markets attract more global investors interested in the higher returns that African markets offer but who are currently discouraged by the illiquidity of national capital markets and the exposure to sovereign risk. Beyond portfolio diversification, the opportunity to maximize returns will be an attractive feature for foreign investors (Senbet 2001). Indeed, the evidence in table 6.2 shows that African stocks are highly profitable and substantially undervalued. The returns on equity are much higher in many African stock markets than in Western markets and the price-earnings ratios are significantly below those observed in mature financial markets (Senbet and Otchere 2006; Senbet 2001). Thus, African markets exhibit substantial unexploited profit opportunities.

The emergence and consolidation of regional markets in Africa allow for the establishment of the crucially needed synergy between capital markets and national banking systems. It is one component of a structural approach to addressing the problem of dysfunctional intermediation in the African banking system described earlier. Despite efforts to liberalize the financial system in African countries, banking systems are still plagued by pervasive inefficiencies. The high interest spreads are only one of the visible signs of lack of competition. Another form of dysfunctional intermediation is the tendency of banks to accumulate government securities, thus crowding out lending to the private sector.

Indeed, the lack of competition in the banking sector creates perverse incentives on the part of banks to maximize profits by investing in risk-free government securities, charging usury rates to the few borrowers that access credit, while discouraging savings. The development of alternative non-bank sources of finance through regional financial markets is a means to increasing both access to capital for firms and a way of promoting efficiency in the banking sector, notably through downward pressure on lending interest rates.

Another benefit from the development of regional capital markets in Africa is that it will increase pressure on countries to accelerate the reforms of the institutional environment that are critical for efficient financial intermediation. Regional integration

can serve as a tool to lock in national reforms and enhance the credibility of such reforms in the eyes of investors (Collier and Gunning 2000). In addition, financial regionalism accelerates exposure to and sharing of international and regional best practices and standards in financial intermediation, especially information-disclosure procedures and accounting standards. Thus, less advanced African countries will benefit from spillover effects from more advanced countries in the area of financial infrastructure, payments systems and regulation.

Regional financial integration contributes to overcoming one of the major constraints to capital-market development at the national level. This is the lack of capacity to manage operations and to regulate markets. This capacity constraint must be addressed through joint efforts between governments and their development partners (see box 6.1).

African countries need to attract more external resources and protect their economies from the adverse effects of unregulated capital flows

6.3 Managing capital flows

Given the increasing pace of financial globalization and the implied higher risks of financial crisis, African countries need to establish prudential regulation mechanisms for minimizing exposure to such risks. Indeed, while African countries need to attract more external resources, they also need to protect their economies from the adverse effects of unregulated capital flows.

Benefits of capital management for African countries

Box 6.1
ECA's contribution to capacity building for capital market development

To alleviate the capacity constraint in capital market development, ECA launched a capital markets development project in 2002. The main objectives are to:

- Strengthen the capacity of African capital market regulators and operators;
- Strengthen the capacity of African capital markets to achieve regional integration;
- Enhance the capacity of capital market associations to promote regional integration; and
- Increase awareness of African countries of the role of capital markets in national development and poverty reduction.

The main activities are training workshops for market operators and regulators. In addition, the project organizes expert meetings and conferences that bring researchers, capital-market practitioners, and policymakers together to assess progress and draw policy recommendations on the way forward in the area of capital market development at national and regional levels.

A number of reasons can be advanced for activist prudential regulation of capital flows and exchange rates in African countries. First, African countries need to adopt strategies that aim at tilting the structure of capital flows in favour of long-term capital,[2] as a means of accelerating economic growth and structural transformation through diversification of economic activity. They also need to design capital management strategies that encourage more green-field investments to promote new activities, especially export-oriented investments in the manufacturing and service sectors. In that sense, capital management can serve as a tool for resource allocation, a policy that was successfully used by Asian countries (e.g., South Korea). At the same time, by adopting preferential treatment for long-term capital, African countries can minimize the risk of instability as it has been demonstrated in other countries such as Chile (Epstein, Grabel, and Jomo, 2005; Le Fort and Lehman 2003).

The second reason for adopting active capital management policies in Africa is that African countries need to minimize exchange rate volatility arising from instability of capital inflows and outflows. High volatility of the exchange rate raises uncertainty, which discourages trade and long-term investment. Capital management policies can also prevent excessive appreciation or depreciation of the exchange rate. Excessive appreciation of the national currency has detrimental effects on the economy, including loss of output and export competitiveness. Firm failures or drastic drops in capacity utilization due to loss of export markets carry high costs in terms of employment. In South Africa, for example, episodes of appreciation of the rand have been accompanied by downsizing in the export-oriented sectors such as mining and winery, which have caused substantial losses in employment and firm profits. Any gains from appreciation in terms of cheaper imports are often outweighed by the effects of the loss of export competitiveness.

> *"By adopting preferential treatment for long-term capital, African countries can minimize the risk of instability"*

The third reason for active management of capital flows and exchange rates is to insulate the current account from the effects of financial market volatility. One of the strategies for achieving this objective is to establish a dual exchange rate system consisting of differential treatment for financial and current-account transactions. This strategy has shown some degree of effectiveness, at least in the short run, in the case of South Africa (see box 6.2). One advantage of this technique is that it allows full control for the monetary authority in determining when and how long to implement the measure.

The fourth motivation is that the integration of capital markets carries important constraints on macroeconomic policy choices at the national level. In particular, countries are faced with a classic policy trilemma. In the context of integrated financial markets, it is impossible for a country to pursue the following three major goals of monetary policy independently and at the same time (Obstfeld, Shambaugh, and Taylor 2005):

2 Evidence suggests that appropriate capital-control measures can alter the composition of capital flows even when they cannot affect the volume of flows (Montiel and Reinhart 1999; Ahmed et al., 2005).

- An autonomous monetary policy aimed at achieving a domestic goal such as an inflation target, an employment target or any other target;
- Maintaining a fixed exchange rate; and
- Free capital mobility.

African countries should limit the reliance on short-term debt instruments

Policymakers must choose two of the three goals. If a country is committed to price stability, say by adhering to an inflation target, then a policy of free capital mobility would require allowing unstrained fluctuation in the exchange rate, which would have costly real effects on the economy. Capital management can allow a country to maintain monetary policy autonomy, notably by maintaining a wedge between the domestic interest rates and foreign interest rates. Thus, capital controls enable African countries to preserve their ability to use monetary policy as a tool for promoting a national growth strategy, especially by boosting domestic investment in an era of global financial integration.

The fifth reason for active capital management is to reduce the likelihood of debt crises. In particular, controls of capital-account transactions allow African countries to minimize the risk associated with domestic private actors borrowing in foreign currency. Moreover, by stabilizing the exchange rate, capital management reduces the risk of excessive devaluation of the national currency, which would raise the cost of debt servicing. Furthermore, African countries need to minimize the risk of financial crisis through controls of capital inflows aimed especially at lengthening the debt maturity (Calvo 2001; Fosu and Senbet 2001). Given the high debt burden faced by African countries, it is essential to limit the reliance on short-term debt instruments in order to ensure solvency.

Finally, capital management strategies are needed to retain savings in African countries, especially by preventing capital flight. African countries have experienced heavy financial haemorrhage, which robs the continent of valuable resources that could be

Box 6.2
South African experience with capital and exchange rate management

The South African capital and exchange rate regimes have undergone five major phases since the 1960s (Aron and others 2000). Until 1978, the rand was pegged alternatively to the dollar and the pound, and capital account transactions were strictly controlled. In 1979, the Government adopted a dual exchange rate system, whereby current account transactions were executed at a controlled float exchange rate, the commercial rand, while equity capital was transacted at a freely floating exchange rate, the financial rand. The system was abolished under a controlled float system in 1983 and reintroduced in 1985, lasting until 1995. The exchange rate regime was unified again in 1995 during a systematic move toward a market-based exchange rate system. Foreign exchange and capital controls were motivated by the need to retain domestic savings, prevent the loss of foreign exchange through transfer of assets abroad by residents, and to encourage repatriation of capital. The evidence suggests that the dual exchange rate system, to some extent, insulated current accounts from the volatility of the rand (Farell 2001).

used for domestic investment. Africa as a region has the highest ratio of private assets held abroad, compared to other developing regions (Collier *et al.,* 2001). Sub-Saharan Africa is a net creditor to the rest of the world in the sense that private assets held abroad exceed the region's debt vis-à-vis the rest of the world (Ndikumana and Boyce 2003; Boyce and Ndikumana 2001). Consequently, the agenda for increasing financial resources in African countries must include strategies for curbing and reversing capital flight.

The ability of African countries to take advantage of these benefits of capital management depends critically on their capacity to undertake effective capital flow monitoring and controls. This capacity is currently limited in many countries. Therefore, with the support of development partners, African countries need to invest in capacity building for capital management, including both skills acquisition and improvements of technological capacity.

Strategies for managing capital flows and monitoring and addressing financial risk

It is difficult to determine what types of controls and incentive structures vis-à-vis capital flows should be implemented in a given country at a given time. The appropriate regime must be determined based on a country's particular economic circumstances and the issues faced at the particular moment. For example, emerging market economies are more exposed to financial risks because of their higher openness compared to other developing countries. The implication is that African countries with more open financial systems, especially those with stock markets, have an urgent need for capital controls to prevent financial fragility. However, all African countries need to design strategies for capital management for the purpose of influencing the term structure in favour of long-term capital, to influence sectoral allocation of capital, and to minimize exchange rate instability.

For each type of risk, there should be a particular set of instruments to prevent it and minimize its effects on the economy. The first task is for each African country to establish a monitoring mechanism that identifies the various types of risks associated with financial integration. Then, each country can identify the corresponding warning indicators and possible tools that may be used to address these risks.

There are three main categories of risk: currency risk, flight risk, and fragility risk (table 6.3). For each type of risk, a series of warning indicators (or *trip wires*) and appropriate policy interventions (or *speed bumps*) will be designed to prevent the risk of financial fragility (Grabel 2004). It is important for each country to design these policy tools to be flexible enough to allow adaptation to changes in the country's macroeconomic and financial circumstances.

Capital management strategies need to be complemented with domestic financial regulation in order to minimize the risk of financial distress (Senbet 2001). In particu-

lar, African countries need to develop sound banking regulations to enforce adequate bank capitalization, promote competition, ensure speedy and transparent reporting on the health of individual financial institutions, and prevent contagion of banking distress through timely bank restructuring by capitalization, merger, or liquidation (Kane and Rice 2001). Building sound domestic banking systems will enhance Africa's ability to sustain shocks to international capital flows.

"Sound domestic banking systems will enhance Africa's ability to sustain shocks to international capital flows"

One important constraint to effective capital management and financial regulation in African countries is the lack of efficient monitoring of capital flows. African countries, with the support of their development partners, need to modernize their statistical frameworks for tracking capital flows. This will allow them to establish specific warning indicators and to design the appropriate policy interventions for minimizing the risks of financial instability.

Table 6.3
Financial risks, and examples of warning signs and policy responses

Financial risks	Warning signs or "trip wires"	Policy responses or "speed bumps": targeted and gradual changes in policy based on warning signs
Currency risk Investors flee the national currency, inducing sudden and dramatic depreciation.	Ratio of official reserves to short-term external debt; Ratio of official reserves to current account deficit;	- Limit the fluctuations in the value of the domestic currency - Restrict currency convertibility
Flight risk *Portfolio investment* Portfolio investors sell off a country's assets, causing reduction in asset prices and increasing the cost of new finance.	Ratio of accumulated foreign-portfolio investment to gross equity-market capitalization or gross domestic-capital formation;	- Controls on inflows - Controls on outflows
Lenders Lenders call loans or stop disbursing new loans.	Ratio of official reserves to foreign-denominated debt;	- Stop new inflows of foreign loans (public and private) - Especially discourage foreign borrowing by private agents
Fragility risk Locational mismatch: Proliferation of debts in foreign currency.	Ratio of foreign currency denominated debt to domestic currency denominated debt;	- Impose ceilings and surcharges on foreign-currency denominated financing
Maturity mismatch: Proliferation of long-term debts financed with short-term credit.	Ratio of short-term debt to long-term debt.	Impose ceilings and surcharges on short-term borrowing and long-term debt rollovers

***Source**: Grabel, 2004.*

6.4 Policy Recommendations

The debates on capital flows and development financing should focus on policies and strategies aimed at increasing the volume of capital flows, enhancing absorption capacity – including policies to improve the efficiency of the financial system –, tilting the balance in favour of long-term capital, increasing the impact of foreign capital on diversification and transformation, raising the employment effects and the overall growth impact of foreign capital. The following policies should figure prominently on the national development policy agenda:

Improving the institutional and regulatory environment to promote financial deepening

The ability of African countries to absorb and take full advantage of capital flows depends on the depth and efficiency of their financial systems. To increase financial deepening, the financial reforms initiated over the past three decades need to be complemented by more vigorous reforms of the regulatory and legal environment, to remove distortions and increase efficiency in the financial system. These reforms must focus on increasing competition in the banking system, the range of savings instruments and the returns on savings, and on encouraging development of alternative tiers of banking institutions that are more equipped to operate at a smaller scale in the rural and informal sectors. The development of a liquid bond market is also essential to deepening of the financial system.

Promoting regional financial integration

Regional financial integration allows African countries to overcome constraints associated with the small size of their domestic markets. Integration allows those that do not have national capital markets to take advantage of regional markets to raise funds for investment. Regional financial integration will also enable the continent as a whole to attract more foreign capital. Therefore, African governments need to support and demonstrate effective commitment to new and existing initiatives for regional integration of trade and finance.

Encouraging investment-oriented remittances

Workers' remittances play an important role in increasing access to basic needs for the recipient households. However, given the observed increasing volume of remittances, it is necessary to design strategies to direct these funds into investment to minimize the inflationary effects of a potential remittance-led consumption boom, but also and most importantly to maximize the effects on economic growth through capital accumulation. Financial institutions need to play an important role in designing investment instruments to attract remittances. This alleviates information asymmetries

faced by non-resident investors, which tend to discourage long-term investment. Discussions between banks and Africans in the Diaspora may generate suggestions for new and creative means of channeling remittances into long-term investment. African governments also need to design schemes that explicitly target remittances, such as facilitating access to land for non-residents, either through purchases or fixed-term leasing arrangements.

Establishing systematic monitoring of capital flows to minimize instability

One of the objectives of financial policy is to prevent financial fragility especially by shielding the financial system and the real sector from the adverse effects of volatility of capital flows. Each African country needs to design mechanisms for monitoring the risk of instability and to establish the appropriate policy responses to impending instability. In other words, each country must identify a number of warning indicators to gauge the risk of instability and establish the appropriate measures to prevent instability. Policies for regulating capital flows must be conceived as an integral part of the national economic policy framework aimed at achieving macroeconomic stability and improving resource allocation throughout the economy.

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Economic Commission for Africa

African countries continue to face perennial shortages of resources to finance public and private investment. This constrains their ability to accelerate growth, seen as key to reducing poverty. Resource shortages limit the ability of governments to undertake public expenditure in infrastructure and social services needed to boost economic demand, encourage private sector activity, and sustain high levels of economic growth.

To fill the financing gaps and accelerate growth, African countries need to mobilize more domestic and external financial resources. The fact is, official development assistance (ODA) to Africa has grown only in nominal terms, and the resources received over the last decade - excluding emergency aid and debt relief - increased only marginally. But while countries on the continent still depend heavily on aid for development, it is encouraging to note that they are attracting more private capital. Indeed, net flows of private capital have risen, as net official flows have declined and turned negative over the past years.

However, private capital flows remain unequally distributed across the continent, with oil-rich countries taking the lion's share. The concentration of foreign investment in the extractive industries perpetuates Africa's dependence on primary commodities, and exposes the continent to the adverse effects of fluctuations in international commodity prices. For this reason, African must attract more foreign capital, and establish incentive mechanisms to encourage a more diversified allocation of capital across sectors. It is also urgent to monitor and manage capital flows effectively so as to minimize the risks of financial instability.

Economic Report on Africa (ERA 2006) debates capital flows in development financing and examines how they can help African countries to accelerate growth and reduce poverty. The report's objective is to shed light on whether and to what extent more and better-managed capital flows will help Africa achieve its development goals.

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