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Finance for Development in Africa

— An Issues Note —

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Finance for Development in Africa

The aim of this *Issues Note* is to review the mix of actions necessary to finance the developmental goals of Africa and to present policy options for the consideration of African Finance Ministers. This *Issues Note* focuses on measures to increase domestic savings and channel it efficiently into productive investment, switch domestic resources from external debt service to development, increase the effectiveness of ODA, attract private capital flows, encourage foreign direct investment and stem capital flight. The main developmental goal of Africa is poverty alleviation. At the UN Millennium Summit, the world's leaders agreed that the incidence of poverty in Africa should be halved by 2015. This implies that the *per capita* consumption of over half of Africa's population should rise to a minimum of \$1 per day. To achieve that level of consumption, African countries must, on average, grow at 8% per annum for the period. This high growth rate requires a much faster rate of investment than these countries have enjoyed in the past. Indeed, it is estimated that the investment/GDP ratio will have to rise to a minimum of 25% from the current 19%. However, it is unlikely that African countries can find the resources to finance such investment growth from the traditional sources, i.e., domestic savings (both private and public) and foreign savings (Official Development Assistance and Private Capital Flows). This makes it essential to identify immediately sources of additional financing, while boosting the capacity to generate further resources.

This *Issues Note* first establishes how much financing will be required to achieve the required investment rate. It then traces historical trends in the flows from various sources of finance, both domestic and external. The reason for the discussion of these historical trends is to show that growth in them has been very slow for most countries, largely as a consequence of various structural characteristics of African economies and their relationships with other economies. It then briefly discusses what future trends are likely to be, in the absence of planned action to change the *status quo*. It finally introduces various suggestions for enhancing the flow of resources from a number of sources.

Regarding the magnitude of financing required, the *Issues Note* relies on estimates made by UNCTAD (2000) and ECA (2000) for achieving similar growth objectives. After making allowance for domestic savings, current annual total capital inflows of \$9.5 billion have to be doubled over the next ten years in order to raise the investment/GDP ratio to 25% while the savings/GDP ratio goes up to 24% to achieve annual growth rates of 6-8%. This assumes that the proportion of capital inflows used for real resource transfers would be around 62% with the rest going to finance various financial transactions and reserves. Raising the net capital inflows to \$20 billion will raise the investment ratio to 27%, which is what Malaysia used to achieve an average annual growth rate of 8% in the 1980s, Africa's desired growth rate. An argument for raising the net capital inflows to \$20 billion instead of UNCTAD's \$18 billion is currently justified by the devastating effect that the HIV/AIDS menace will have on the cost of development.

This *Issues Note* also argues that while it is essential to mobilise all domestic re-

sources to reduce the resource gap, this will only be feasible in the long term. Hence there is an urgent need to mobilise external resources to finance Africa's development. In order to first reduce the resource gap and then attract the required external resources, African governments should take the following measures.

Measures to increase domestic savings and channel it efficiently into productive investment: The average savings rate in Africa (18 percent) is well below the rates observed in countries that have managed to make significant reductions in poverty. With a large majority of the African population engaged in the agricultural sector, one of the most direct methods of increasing savings is to increase household incomes because the propensity to save depends on the level of income. Sustainable increases in household incomes can be achieved by transforming the current subsistence agriculture to a market based commercial activity. Agricultural modernisation will reduce the high risks associated with rural production through improved irrigation, the adoption of appropriate technologies and high-yielding varieties.

Policies that have proven effective in stimulating private savings and investment include those that keep the rate of inflation low, reduce macroeconomic uncertainty, promote financial deepening, and lower the external debt burden. Recent experience has demonstrated that measures that promote structural reforms and reduce the budget deficit without lowering government investment also helps to raise private investment. African countries should be encouraged to sustain the sound economic reforms that are already in place, and intensify their efforts to carry out second generation reforms.

Rural lending is plagued by problems of returns to scale (small size of loans), adverse selection and moral hazard. These problems cause transaction costs to be so high that credit rationing occurs. Informal financial markets can be used to mitigate the problems of rural financial intermediation. For instance, imperfect credit markets force households to use their own savings for investment. Profitable activities often require lumpy investments making it harder for poorer households to enter such activities. Rotating Savings and Credit Associations (ROSCA's) provide an important avenue for intermediating credit in rural environments and can be used to start or promote small business

African countries need to strengthen and improve the reliability of thrift (Bank and Non-Bank) institutions. Effective financial systems evaluate prospective entrepreneurs, mobilise savings to finance the most promising productivity enhancing activities, and diversify the risks associated with these innovative activities. As a result better financial systems improve the probability of successful innovation and thereby accelerate economic growth. The authorities should continue to reduce government intervention in the banking sector, which will intensify market forces and thereby improve capital allocation. The authorities should strengthen the regulatory and legal infrastructure for non-banks. This will provide competition for banks ---through the development of bond and securities markets---which will boost financial services and deepen the menu of financial instruments available for saving. Innovative measures to increase the reward, the security and the liquidity of savings such as privatising national social security funds, should be considered. Due regard should be given to the adequacy of the regulatory framework because effective supervisory oversight of financial systems is indispensable for the development of sound financial systems.

Measures to Facilitate the Growth of Exports in the Short-Medium Term.

Most African countries have pursued export policies consistent with their static comparative advantage in abundant natural resources and unskilled labour. Despite this, Africa has lost its share of World trade in primary commodities primarily because of inefficient agricultural practices, weak marketing, poor infrastructure, civil conflicts and increased competition from new primary commodity producers. While urgent actions should be taken to reverse the decline in Africa's traditional exports, efforts should be taken to move into higher value-added resource based industries. African countries should continue efforts to move up the ladder of comparative advantage by using industrialisation strategies based on vertical diversification into processing of primary commodities. Such an industrialisation strategy promotes exports of labour-intensive manufactured exports. However, a significant impediment to this strategy is a combination of protection and subsidies in the advanced countries.

An export promoting exchange rate policy is crucial if Africa is to exploit its comparative advantage because the exchange rate plays a crucial role in providing incentives for exporting. All countries, which have successfully promoted manufactured exports, experienced real exchange rate depreciation, leading to a significant increase in the domestic relative price of tradables to nontradables. In this regard, misalignment and volatility of the real exchange rate should be avoided. Actions should be taken to recover Africa's share of World Trade in primary commodities, which has declined due to the entry of new primary commodity producers in South East Asia.

African countries should vigorously pursue regional trade arrangements because the small size of African economies do not permit the realisation of economies of scale necessary for an economy to be competitive in the global economy. Regional integration provides access to a wider trading and investment environment, induces backward and forward linkages, encourages foreign direct investment and promotes diversification of exports to regional and global markets. The open regionalism strategy is crucial because it acts as an external agency of restraint by locking in welfare improving trade reforms. This is important because regional integration initiatives have yielded modest results in Africa largely due to implementation failures. In sum, the integration process within Africa is essential not only to achieving international competitiveness for the continent, but also as a mechanism for diversifying risk, reducing the shocks of an uncertain global and African economic environment and reducing poverty by increasing household incomes.

Measures to Attract Additional Official Development Assistance. With the increasing numbers of reforming African countries aid is crucial to sustain these reforms. Furthermore the policy environment for a more effective utilisation of aid is promising. Notwithstanding the importance of aid, African countries should undertake an orderly transition from the current high levels of ODA for financing economic and social development. Official assistance will need to play a bridging role before private investment can provide the needed resources and before public investment can be financed on commercial terms. It is envisaged that foreign aid will provide about 95% of the new required external finance after the resource gap is reduced through trade, with the remainder drawn from the private capital flows. At the end of the 15-year period, a combination of debt relief, reforms of the current aid regime and enhanced policy environment should allow a managed transition to a mixed menu of ODA and private capital flows.

To expand aid inflows, African governments and their development partners should improve the effectiveness of aid by making donor programmes more coherent and focused on poverty eradication. Likewise, recipient countries should co-ordinate and manage public expenditures more effectively. For this, the general policy environment will have to be strengthened; institutions for managing aid have to be made transparent. In this regard, the introduction of the Poverty Reduction Strategy Paper (PRSP) offers significant opportunities to place truly comprehensive country-owned programmes aimed at reducing poverty at the heart of aid relations between Africans and their external partners.

There is a need for Africa's external partners to take the lead in specific strategic sectors. For instance, the World Bank, African Development Bank, and the European Union could pay greater attention to the finance of regional infrastructure projects. The rationale for this is that regional infrastructure projects — roads, railways, ports — will reduce the costs of doing business in Africa by facilitating cross-border trade, widen market access for goods. These regional initiatives will help transform the economic structures in the region. Finally, innovative measures such as encouraging the private provision of infrastructure through concessions and Build-Operate-Transfer projects should be considered.

Measures to Attract Foreign Direct Investment and other Private Capital Flows. FDI is the predominant form of capital flows to low and middle income countries with insufficiently developed capital markets. FDI plays an important role in sustaining equity-financed capital investments, contributes to technology spillovers through learning-by-doing, leads to improvements in productivity and facilitates the transfer of human capital skills. Africa has to tap private foreign capital in order to raise the productivity levels necessary for sustained increases in living standards. While FDI can immediately make up for the remaining 5% of required external funds, the objective is to make private capital flows provide 70% of external finance in the medium term and 100% in the long term. For this, countries will need to take concerted action on many fronts including improving infrastructure, strengthening banking systems, developing capital markets by accelerating the pace of privatisation and broadening the domestic investor base, developing an appropriate regulatory framework and a more liberal investment regime, introducing competitive labour market policies while creating and maintaining institutions for upgrading human capital, reforming the judiciary system and containing corruption. It is important that these are carried out in a comprehensive framework and not in a piecemeal manner.

Measures to Reduce External Debt Burden. The enhanced HIPC initiative provides for countries to continue to borrow even as they receive debt relief in order to settle other obligations in the pursuit of poverty-reduction goals. It is important that payments on these do not slow down growth. The main issue is how to make debt relief growth enhancing in order to facilitate the achievement of sustained poverty-reduction. It is suggested that debt-relief is recognised by creditor countries as additional to new and increased ODA with a focus on enhancing and sustaining both growth and poverty-reduction explicitly. Making debt-relief pro-growth requires that relief must come early rather than later. Presently, there is a tension between quick debt relief and comprehensive country-owned poverty-reduction strategies, which take quite long to prepare.

African governments should consider channelling resources freed-up from debt relief to the private sector for job creation purposes. To further reduce the external debt

burden governments should exploit such mechanisms as debt-equity swaps inasmuch as they promote private investment. Future borrowing should be closely monitored to prevent a re-occurrence of the debt overhang problems.

Measures to Encourage A New Financial Architecture that Addresses Africa's Problems. It is recognised that current attempts to design a new international financial architecture do not adequately consider the peculiar difficulties of Africa's fragmented markets in attracting private capital. While the need to reform domestic financial institutions and make their operations more transparent is endorsed, the reform of international financial institutions should be done with a view to developing a more level playing field in the implementation of a rule-based system for managing international capital flows. African countries should have a greater say in the functioning of a more transparent IFI structure. The main priority for African governments is to ensure that the new IFI facilitates efficient capital flows from developed to African countries. With regard to the future role of the IMF, the view that the Fund should restrict itself to the three tasks of short-term liquidity lending to all countries affected by macroeconomic crises, advising through policy dialogue, and collecting macroeconomic and financial market information on countries, is supported.

However, it is noted that Fund-supported adjustment programs have often been flawed by a lack of attention to the incidence of poverty and by poor sequencing of reforms, notably premature financial liberalisation. These policies have caused avoidable hardships. In this respect African countries have appreciated the introduction of the Poverty Reduction and Growth Facility (PRGF) and the opportunity for countries to develop their own Poverty Reduction Strategy Papers (PRSP). This new modality enhances country ownership of development programs, focuses attention on poverty reduction and encourages broad-based participation in the design and monitoring of these programs. However, some concerns have been raised about the dangers of additional conditionalities creeping into the PRSP process.

Measures to Mitigate the Impact of the HIV Epidemic on Growth: It has now become clear that the HIV epidemic will have serious implications for Africa's rate of economic growth and consequently on its financing development requirements. Half the AIDS victims in the world are in East and Southern Africa, where adult seroprevalence was 11.4 percent in 1997 and over 25 percent in two African countries. The HIV disease is estimated to cost the region 1-2% of GDP annually due to demographic changes through increased mortality. For instance, changes in the demographic structure will lead to a greater dependency ratio (larger numbers of orphans) and significant shifts in the age and sex composition of the population. According to the Life-cycle model of savings such changes in the demographic structure will have important influences on household savings behaviour. There is therefore an urgent need for innovative multi-sector policies for preventing the spread of HIV and for helping AIDS patients to cope with the disease. Policies aimed at reducing HIV transmission can significantly reduce the prevalence of AIDS. For instance a rise in condom use from 0 to 10 percent cuts AIDS prevalence nearly in half, from 31 percent to 19 percent of the population. It is estimated that \$10 billion is needed to address this crisis but the current levels of official development assistance targeted towards the disease are woefully inadequate. African governments along with the private sector and donor agencies can play an important role in facilitating the required behavioural changes, recognising social and sexual realities and changing attitudes.