

Capital flows to Africa and their impact on growth



2.1 Introduction

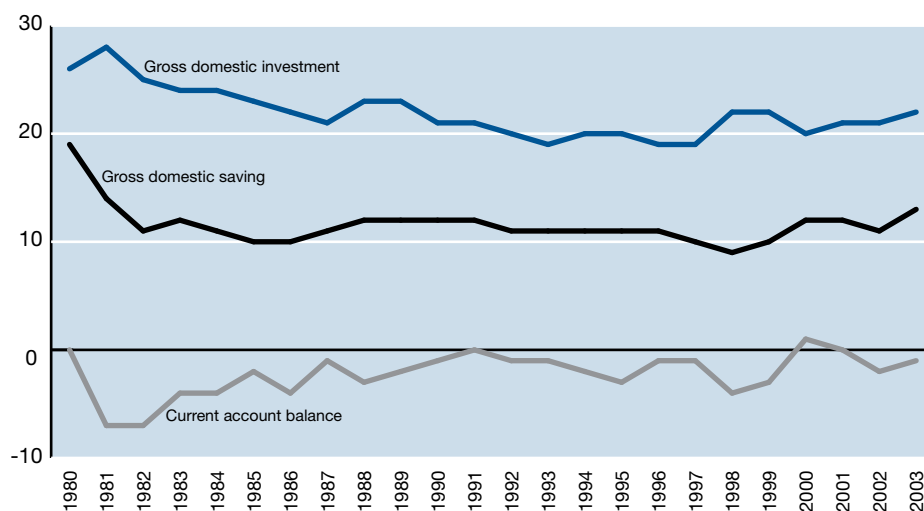
Although inflows of capital to Africa have increased recently, they still fall short of the resources needed to fund attainment of the internationally agreed development goals. In both 2004 and 2005, average GDP growth in Africa reached 5 per cent, still falling short of 7 per cent, the rate required 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 inter-linkages 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.

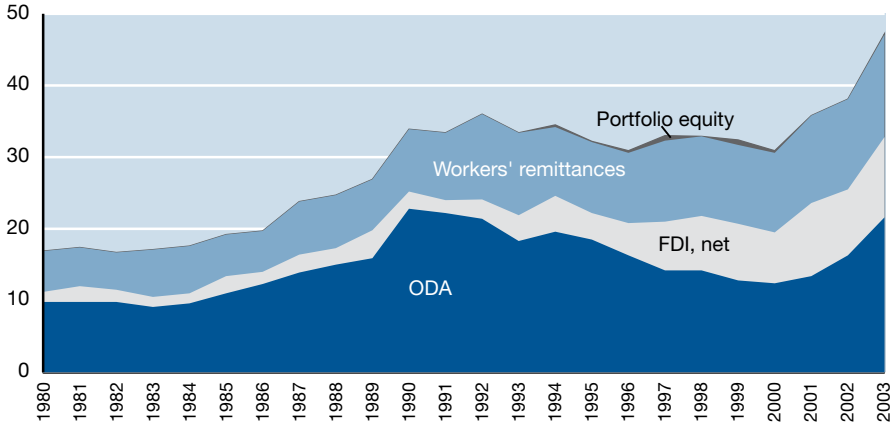
While most FDI is still concentrated in the primary resource sector, some diversification in terms of sectors and origin is observable. Africa is still outside of the foreign investors' radar screen much more than other regions, despite relatively high rates of return on investment in Africa. Remittances 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)

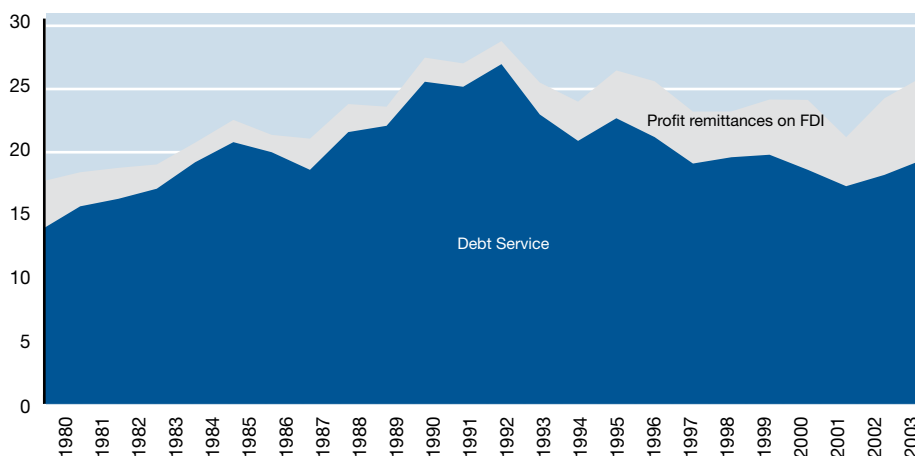


Source: World Bank 2005a.

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.

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.

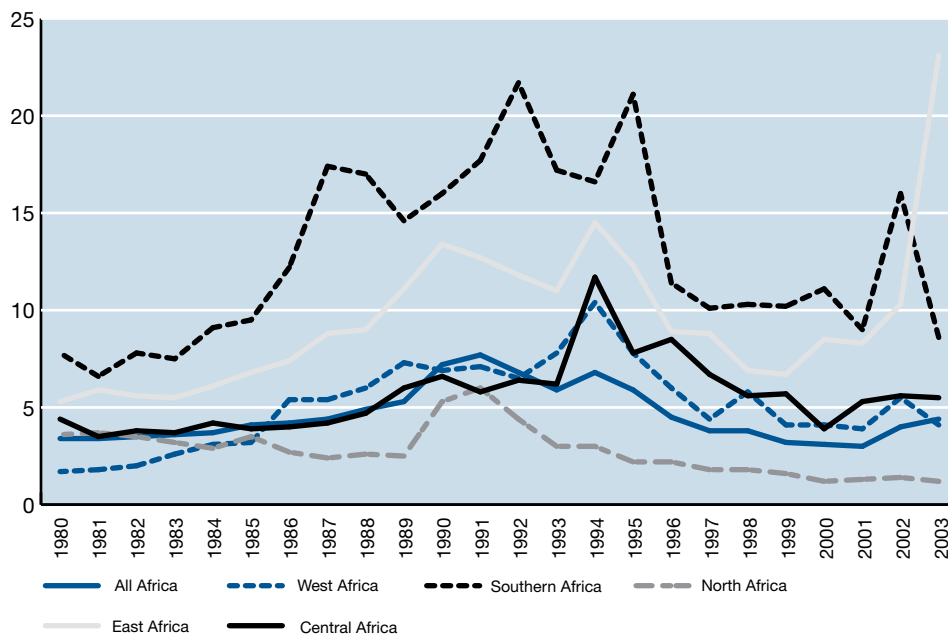
About half of the total aid to basic health and education was targeted towards gender-specific concerns, such as empowerment of women. However, only a relatively small share of aid projects for infrastructure had gender equality as a principal or significant objective (OECD 2005, 2006). Increasingly, 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

“ODI to Africa is estimated to increase to 0.4% by 2010”

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.

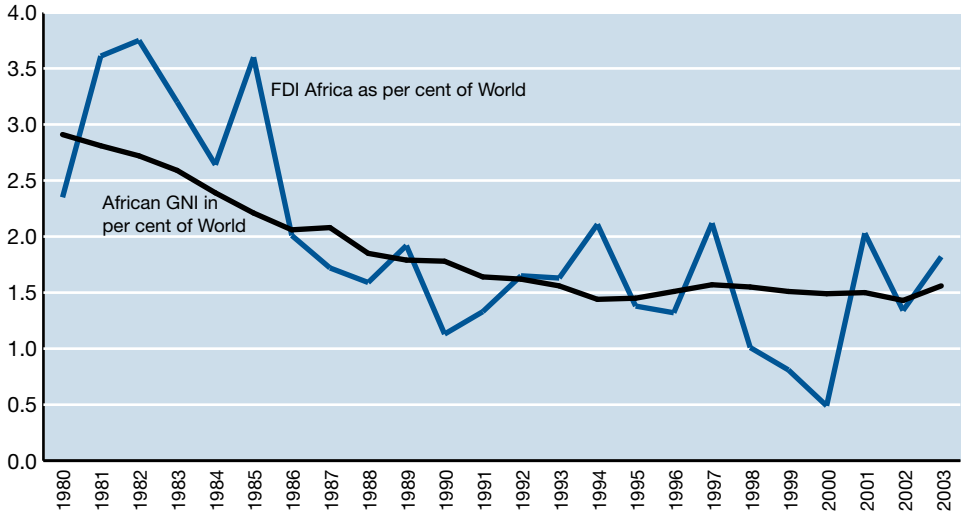
The volatility of capital flows varies greatly across countries (appendix A, table A.1). In general, the volatility of aid is lowest for most countries when compared to remittances and to FDI. However, for countries such as Cape Verde, Lesotho, or Swaziland, which have a relatively high share of remittances 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.

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

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.

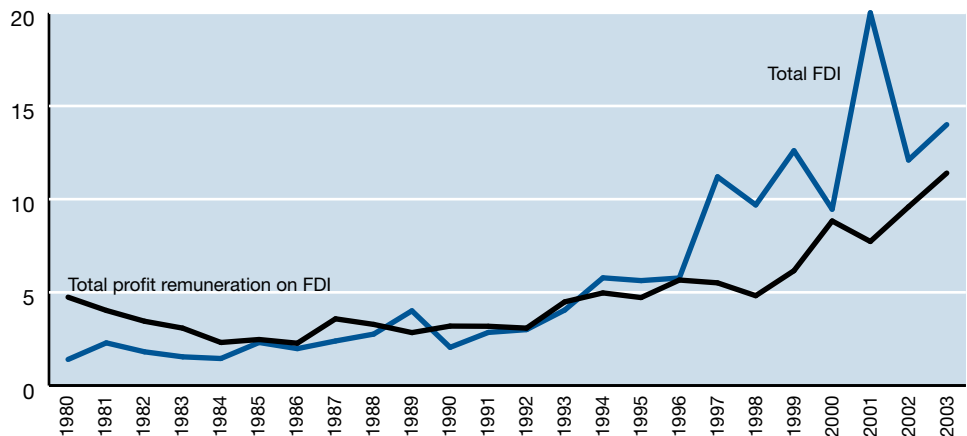
“ Asian investors will help Africa diversify FDI sources ”

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.

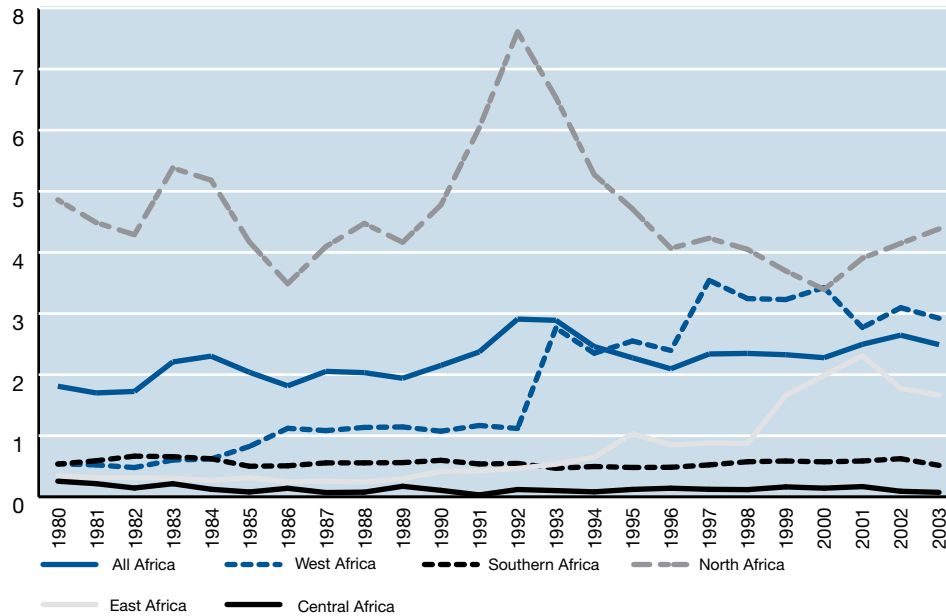
For Africa as a whole, remittances represented 2.5 per cent of GNI in 2003, but unlike other regions, this share has not increased significantly over the past 25 years (World Bank 2005a). With an important part remitted through informal channels and therefore unreported, it is estimated that actual remittances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

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).

“Migrants are less likely than foreign investors to withdraw their investments”

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-



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



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. 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.

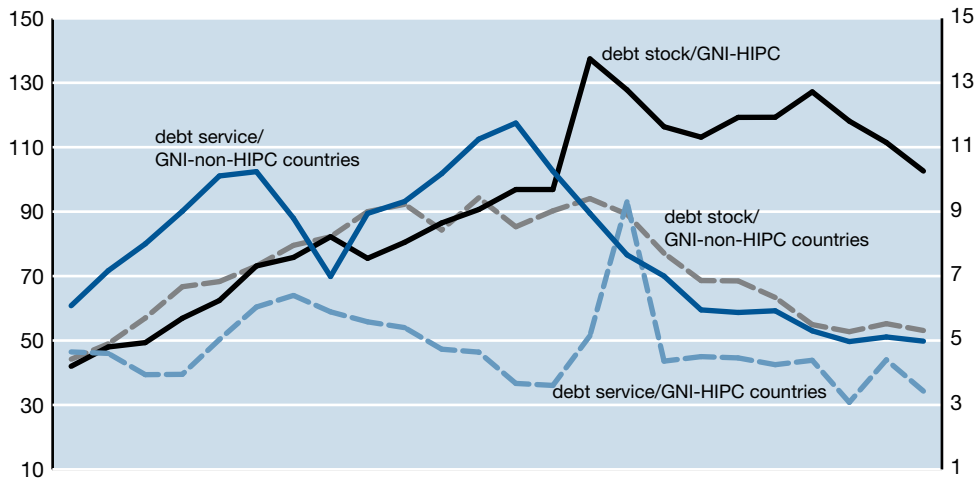
The rescheduling of debt due to inability to pay all debt services also contributed to the increase in debt stocks. As many African countries faced severe macroeconomic difficulties at the beginning of the 1980s, they had to rely on IMF and World Bank structural adjustment loans to finance their imports. 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 1980s 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.

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

“ The shift from loans to grants contributed to the decline in the debt burden since the mid-90s ”

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.

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Nigeria used oil
revenues to buy
back its debt
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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

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Donors
applied less
selectivity for
countries with high
multilateral debt
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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.

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.

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Improving
institutions and
policy environment
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There is an urgent need to compliment 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).

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).

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

“Larger amounts of aid do not necessarily increase economic growth”

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).

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

“Remittances reduce vulnerability to shocks”

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

External debt hampers private investment

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reduction in debt
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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

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.

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

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 Republic	Eritrea
Burkina Faso	Cameroon	Comoros	
Ethiopia	Chad	Côte d'Ivoire	
Ghana	Democratic Republic of Congo	Liberia	
Madagascar	Republic of Congo	Somalia	
Mali	The Gambia	Sudan	
Mauritania	Guinea	Togo	
Mozambique	Guinea-Bissau		
Niger	Malawi		
Rwanda	São Tomé & Príncipe		
Senegal	Sierra Leone		
Tanzania			
Uganda			
Zambia			

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