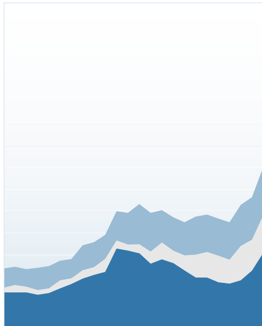
Overview

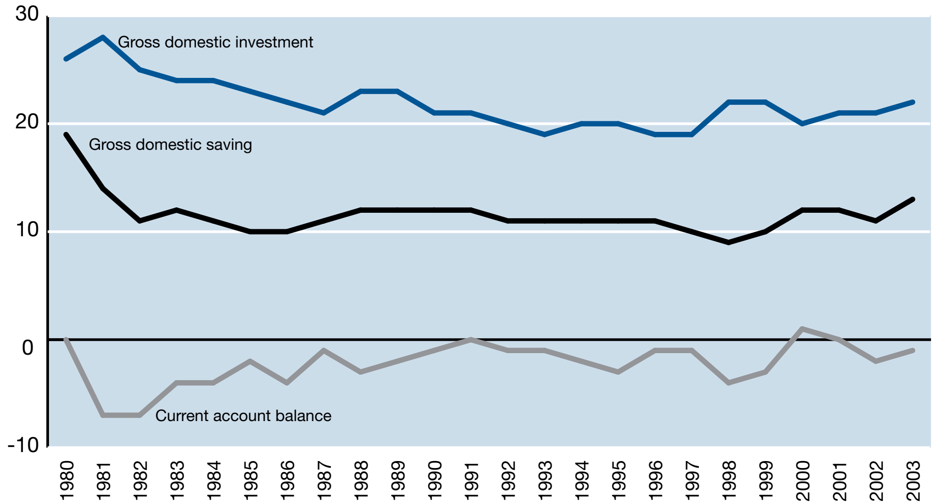


African countries continue to face a perennial shortage of resources to finance public and private investment, which constrains their ability to accelerate growth. The chronic resource gap arises from imbalances between exports and imports, between resource inflows and debt payments, and between domestic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

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

Figure 1

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



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

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

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

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

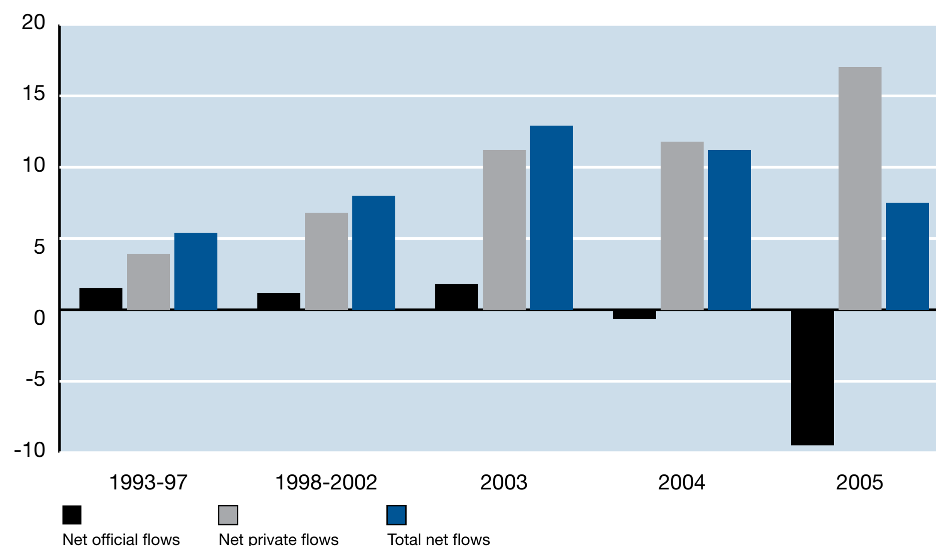
While African countries still depend heavily on official aid, it is encouraging to note that they are attracting more private capital. Indeed, net flows of private capital have risen while net official flows have declined and turned negative over the past years (figure 2). Net private flows rose from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

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

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

Figure 2

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



***Source**: UN 2006.*

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

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

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

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

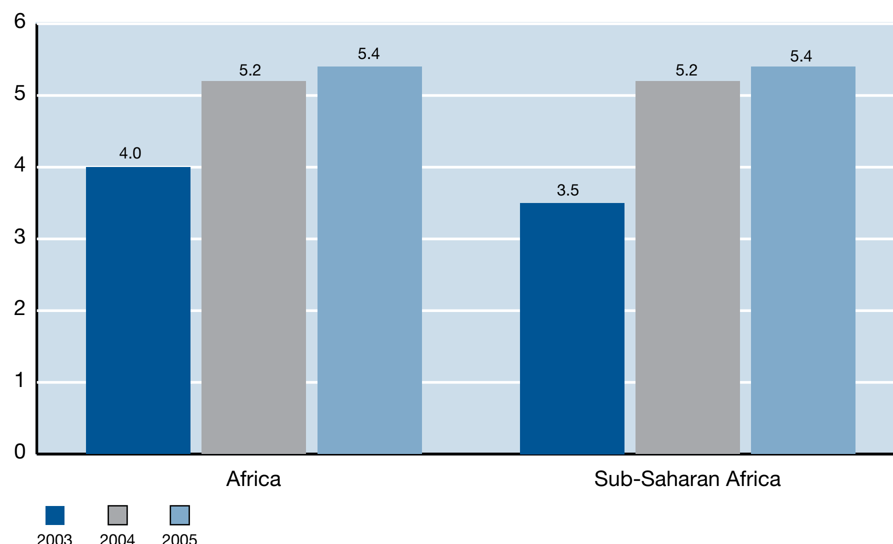
Macroeconomic performance

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

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

Figure 3

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



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

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

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

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

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

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

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

Despite recent robust growth, important development challenges remain

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

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

"*Growth rates have been insufficient to generate employment*"

Table 1

Summary of growth performance over 1999-2005

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

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

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

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

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

Post-conflict countries face myriad policy priorities

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

"Conflict-driven insecurity threatens economic activity"

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

Capital flows and development financing

The challenge of chronic resource gaps

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

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

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

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

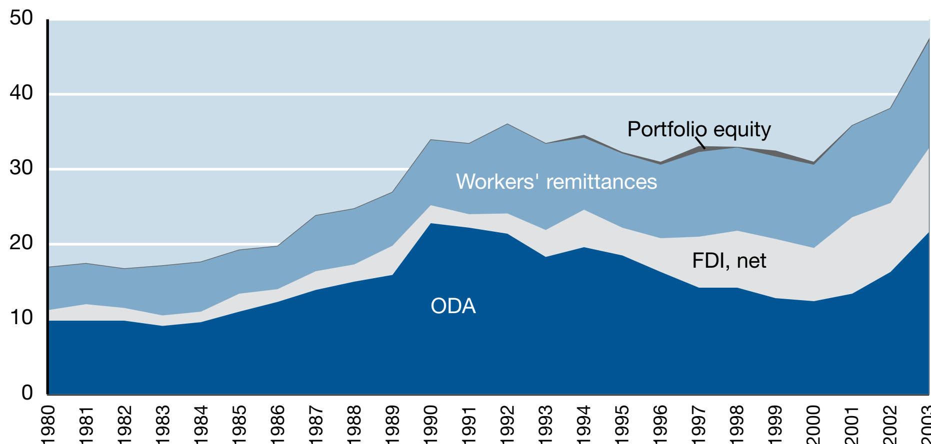
Underdeveloped equity markets limit portfolio flows to Africa

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

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

Figure 4

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



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

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

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

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

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

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

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

Remittances constitute an important potential source of external capital

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

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

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

Capital flight constitutes a drain on national resources

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

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

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

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

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

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

Capital flows can influence domestic factor markets and conversely

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

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

Labor market conditions are an important determinant of capital inflows

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

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

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

FDI can crowd domestic investment in—or out

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

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

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

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

But FDI also follows domestic investment

Governments should encourage investment in labour intensive sectors

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

The foregoing discussion suggests several policy recommendations:

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

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

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

Economic reform has helped many African countries improve growth records

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

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

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

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

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

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

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

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

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

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

"Africa remains largely on the sidelines of financial globalization"

Capital flows have not responded to macroeconomic reforms

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

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

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

The weak institutional environment is a major hindrance to capital inflows

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

"Attracting capital flows requires a sound institutional environment"

Box 2

Export Processing Zone in Mauritius

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

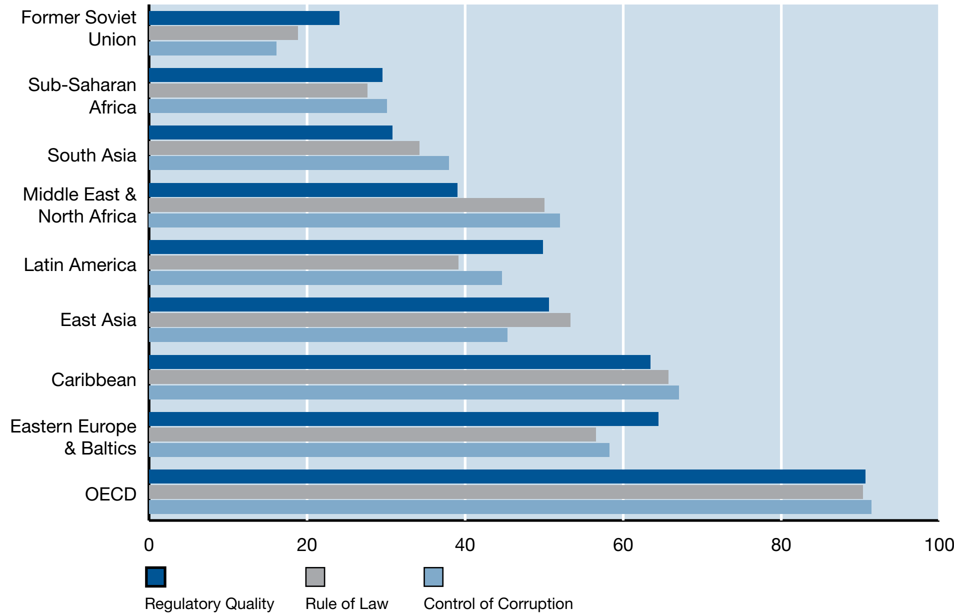
***Source**: Rodrik 2000.*

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

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

Figure 5

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



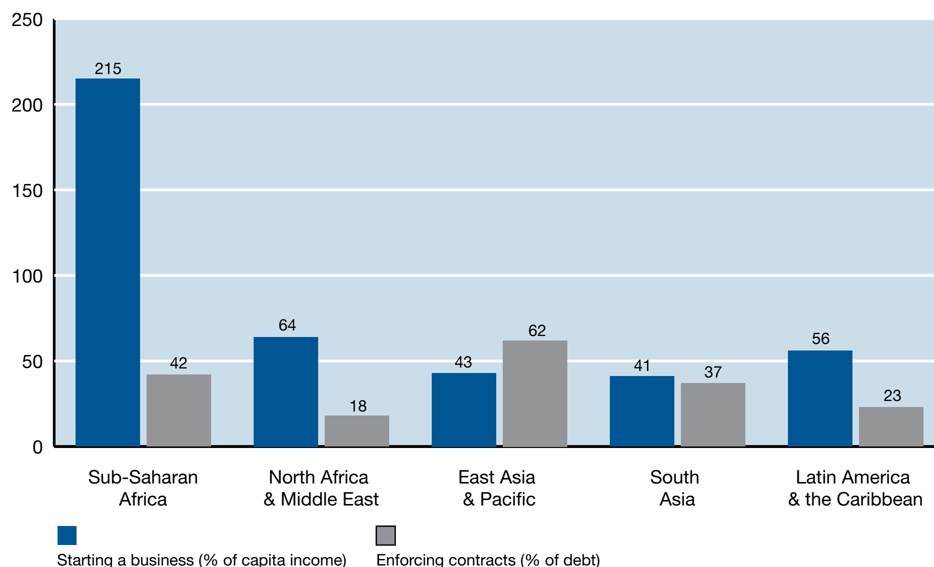
***Source**: Kaufmann, Kraay, and Mastruzzi 2005.*

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

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

Figure 6

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



Source: *World Bank 2006.*

Microlevel institutional reform has improved investment climate

Institutional reform is thus a key to attracting capital flows

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

Financial deepening enhances the capacity to attract and absorb capital flows

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

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

Box 3
Micro-level institutional reforms are improving but more is needed to encourage investment

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

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

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

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

"Lack of access to finance severely constrains business formation"

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

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

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

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

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

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

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

Table 2
Interest rate spreads and interest rate differentials in selected African countries

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

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

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

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

Equity markets remain undeveloped on the continent

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

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

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

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

Box 4

ECA's contribution to capacity building for capital market development

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

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

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

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

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

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

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

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

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

Box 5

Aid inflows and the exchange rate in African countries

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

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

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

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

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

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

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

Capital management strategies are needed to retain savings

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

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

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

Box 6

South African experience with capital and exchange rate management

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

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

Conclusion

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

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

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

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

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

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

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

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