Capital flows to the African continent: The development finance challenge

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In the 1960s and early 1970s Africa's future looked bright and promising. Economic growth and development on the continent was considerably higher than in other developing regions. However, during the middle 1970s political instability increased and economic development started to deteriorate, both contributing to the marginalization of the continent. The continued marginalization constitutes a serious threat to Africa's participation in the global economy. Nepad calls for a reversal of this process through a new partnership between Africa and the international community (Nepad, 2001: 1 & 2).

The Nepad document (2001:10), within the context of the United Nations Millennium Declaration adopted in September 2000, recognizes the fact that the continent's underdevelopment and marginalization could be addressed by improvements in trade, aid and capital flows. To achieve the outcomes of Nepad and the UN millennium goals, quantitative goals are set such as the achievement of an average annual economic growth rate of 7 per cent per annum to fill the annual resource gap of US$ 64 billion (Nepad, 2001:36). Although it is recognized that the so-called resource gap could partly be filled by increases in domestic savings and improvements in public revenue collection, the bulk of the needed resources would have to be obtained from external sources, and in particular debt relief as well as increases in aid, trade and FDI flows.

The Nepad framework (Nepad, 2001: 36-53) envisaged that the mobilization of resources would be undertaken through two mainstream initiatives – namely, the capital flows initiative and the market access initiative. The market access initiative emphasizes the importance of the diversification of production, the promotion of the role of the private sector, the removal of non-tariff barriers and the promotion of African exports through intra-African trade and to the rest of the world. The capital flows initiative emphasizes the importance of increases in domestic resource mobilization, debt relief, official development assistance and FDI flows as measures to enhance the mobilization of resources.

The aim of this paper is to provide a broad overview of the composition of and trends in the four stated dimensions of the capital flows initiative in order to establish if it will indeed be one of the solutions to reverse the marginalization of the continent. The literature overview discusses the historical and current debate on African growth by highlighting the significance of capital flows as determinants of growth. This is followed by an analysis of the volatility of capital flows since the 1970s. With the literature review and volatility of capital flows as background, the composition of and long-term trends in the various capital flow components as identified by Nepad are discussed. In this respect the recent research on particularly the efficiency of official development assistance and determinants of foreign direct investment are discussed. The paper concludes with a summary.

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1. Capital flows and growth in Africa: A literature overview

Over the years economic theory and literature has emphasized the importance of capital flows to developing countries. Capital flows, in combination with trade flows, are seen as prerequisites for sustainable growth and development.

Explaining Africa's growth performance has been the focus of a large number of empirical studies in recent years. Some of the studies included African countries by using an African dummy in cross-national data that spans the whole world, while others mainly focused on African countries, and particularly on sub-Saharan Africa. Almost all models attempting to explain Africa's historical growth performance (or the lack thereof) have included one or more proxies for capital flows. However, mixed results were obtained on the statistical significance of various capital flow measures. This brought into question the historical role and importance of capital flows as an explanatory variable in the growth and development process of the continent.

The literature on the historical determinants of growth in Africa is vast. The most prominent contributions are from Easterly and Levine; Sachs and Warner; Rodrik; Collier and Gunning; Devarajan, Easterley and Pack; and Dollar and Easterley.

Three influential studies, by Easterly and Levine (1997), Sachs and Warner (1997) and Rodrik (1998) did not find any capital flow-related determinant to be statistically significant in explaining the historical growth pattern in Africa. The first two studies used cross-national data for countries that span the whole world, including an African dummy. Easterly and Levine covered the period 1960–1989 and concluded that growth rates in Africa are low as a result of ethnic fragmentation and poor quality institutions. Sachs and Warner analyzed the period 1965–1990 and concluded that African growth is constrained by closed trade policies and Africa's geographical location – in other words, a so-called "tropics" dummy. Rodrik focused on long as well as shorter-period growth determinants for sub-Saharan Africa. He used a sample of 31 countries and concluded that for the period 1965–1990 per capita growth was determined by the initial (1965) per capita income level (-), life expectancy (+), public savings (+), export taxes (-) and the average growth in the economically active population relative to the total population (+). For the growth determinants over shorter periods, he used pooled data for three respective periods, namely 1964–1974, 1975–1984 and 1985–1994. The only significant determinants of growth for these three periods are initial income (-), life expectancy (+) and the average terms of trade (+). Rodrik (1998:21) concluded that long-run growth rates tend to be predictable on the basis of a small number of exogenous and policy variables, in contrast with growth rates over shorter time horizons, where they tend to be unstable and unpredictable. In none of these three studies, covering the sixties until 1990, did any capital flow variable proved to be statistically significant in explaining growth (or the lack thereof) in Africa.

In contrast with the mentioned studies, Collier and Gunning (1999) covered a similar period (1960-1989) and find one capital flow variable to be statistically significant in explaining Africa's historical growth experience. They modelled growth by using a

sample of 84 countries, including 21 African countries. After controlling for initial income, landlocked status, life expectancy and schooling, the only significant policy variables were an openness measure and the investment/GDP ratio (see Collier and Gunning, 1999:66). Taking into account that only 25 percent of the sample was African countries, they specifically tested for the African investment to GDP ratio. It also proved to be statistically significant, implying that African countries with a higher investment ratio proved to be higher growth achievers. Collier and Gunning (1999:65-74), after comparing various growth regressions, further observed that Africa's slow growth can partly be explained in terms of particular variables that are globally important for the growth process, but are lacking in Africa. Although they included in their list of lacking variables aspects such as a lack of financial depth and high aid dependence, the only capital flow-related variable explaining Africa's growth performance was the investment to GDP ratio.

As regards the importance of investment in explaining growth, Devarajan, Easterley and Pack (2001) conducted a cross-section regression for 29 African countries covering the period 1970–1997 to establish firstly whether investment is too low or too high, and secondly, whether private or public investment is the strongest factor. They concluded that, after controlling for population growth and initial 1970 income, private investment has a significant and strong effect on growth, while public investment has no discernible effect (R^2=0.50). However, when Botswana is omitted from the regression, none of the variables proved to be statistically significant, implying that the favourable impact of private investment on growth depends largely on Botswana (Devarajan *et al*., 2001:8,9). To test whether macroeconomic stability matters in Africa, they conducted a second regression for the period 1970–1992 by using pooled data for four-year averages. The independent variables – the black market premium and the public sector balance/GDP – are statistically significant, an indication that good policies are indeed beneficial to growth. When investment is added to the model, it still proves to be statistically insignificant. They finally concluded that higher investment in Africa would not by itself produce faster economic growth and "unless some or all of the underlying factors that made investment unproductive in the past are addressed, the results may be disappointing" (Devarajan *et al*., 2001:23).

Dollar and Easterley (1999) also endeavoured to find the so-called *key* to growth. They tested whether aid-financed investment and/or aid-induced policy reform could unlock Africa's development potential. For the aid-financed investment exercise, they regressed investment on aid and growth on investment by using bivariate models for the period 1965 to 1995. On the aid-investment relationship only eight out of a total of 34 countries showed a positive and significant relationship between aid and investment. In the regression on the investment–growth relationship, where the investment/GDP ratio lagged one year, only seven of the 35 countries included proved to be positive and significant. Even if four-year averages in the data are used in the regression, investment is still not statistically significant (Dollar and Easterley, 1999:6,7). They conclude that the short- to medium-term linkages between aid, investment and growth are not very robust. Aid does not necessarily finance investment and investment does not necessarily promote growth.

Most of these studies covered the period up to the late 1980s or early 1990s. A more recent shorter-period study on the growth determinants for Africa, covering the period 1995 to 2000, revealed contrasting evidence. Loots (2003, 22-25) included 46 African countries in a cross-country panel analysis and concluded that four significant variables – FDI inflows, official development assistance flows, debt flows and a dummy variable representing oil-exporting countries – proved to be statistically significant in explaining the African growth pattern during the late 1990s. The adjusted R^2 of 0.61 indicates that 61% of the variance in per capita growth over this period could be explained by capital flow-related variables as well as the fact that oil-exporting countries are better growth performers. In contrast with the earlier studies that covered periods till the late 1980s and early 1990, this model reveals that capital flows in the form of increased foreign direct investment and official development assistance flows as well as debt restructuring have become increasingly important in explaining growth in Africa since the latter part of the 1990s.

Mixed results were obtained on the significance of capital flows in explaining the growth pattern in Africa. In most of the studies covering the period up to 1990, capital flow variables did not prove to be statistically significant. In the latter part of the 1990s capital flows became more prominent in explaining growth on the continent. Although a standard explanatory variable such as investment, and especially foreign direct investment, is significant in African growth regressions, non-traditional explanatory variables such as official development assistance and debt restructuring are also increasingly becoming more important in explaining the growth pattern on the continent. It is therefore important to take an in-depth look at composition and trends in these capital flows variables as well as at the underlying factors that could make them more productive to promote and ensure a sustainable growth pattern for the continent.

2. Capital flows to Africa

As was mentioned in the introduction, Africa needs to fill the annual resource gap of 12 percent of its GDP, or US$ 64 billion. Nepad acknowledges that, although increased domestic savings as well as improvements in the public revenue collection systems are required, the bulk of the resources required will have to be obtained from external resources. As a short- to medium-term objective, debt reduction and increases in official development assistance will be targeted, while increases in and sustainable private capital flows will be a long-term goal. The volatility, composition and trends in these flows will now be discussed.

2.1 Volatility in flows

A disturbing aspect of capital flows in Africa is the fact that these flows generally tend to be extremely volatile. The volatility of a specific type of flows also tends to vary over time. The volatility of debt flows, official development assistance (ODA) flows and foreign direct investment (FDI) flows, as measured by the coefficient of variation, is shown in Table 1. The flows are decomposed for the three decades since 1970. In comparison with the 1970s, external debt flows became less volatile after 1990. The high

volatility in these flows in the 1970s can predominantly be ascribed to two oil price shocks and the subsequent debt that countries incurred. The volatility of ODA flows has also declined quite sharply since the 1970s. A possible explanation is that donors became more sensitive to local policy environments and instead committed themselves to multi-year commitments.

Due to the long-term nature of FDI flows, it is generally expected that these flows tend to be less volatile. In contrast with this general perception, net FDI flows to the continent proved to be extremely volatile. The volatility of these flows increased from 33.5 percent in the 1970s to 95.6 percent in the 1990s. The volatility in these flows could be ascribed to factors ranging from political instability to the fact that foreign investors are prepared to take high risks for shorter periods in Africa than on other continents. A problem is that high volatility is associated with low predictability, which may discourage investment and create uncertainty. These and other factors will be discussed subsequently.

Table 1: Volatility of capital flows

Type of flow	**1970s**	**1980s**	**1990-2002**
Net external debt	74.4	29.5	7.9
ODA flows	56.5	23.8	17.2
Net FDI flows	33.5	86.6	95.6

Source: Own calculations

2.2 Composition and trends in capital flows to Africa

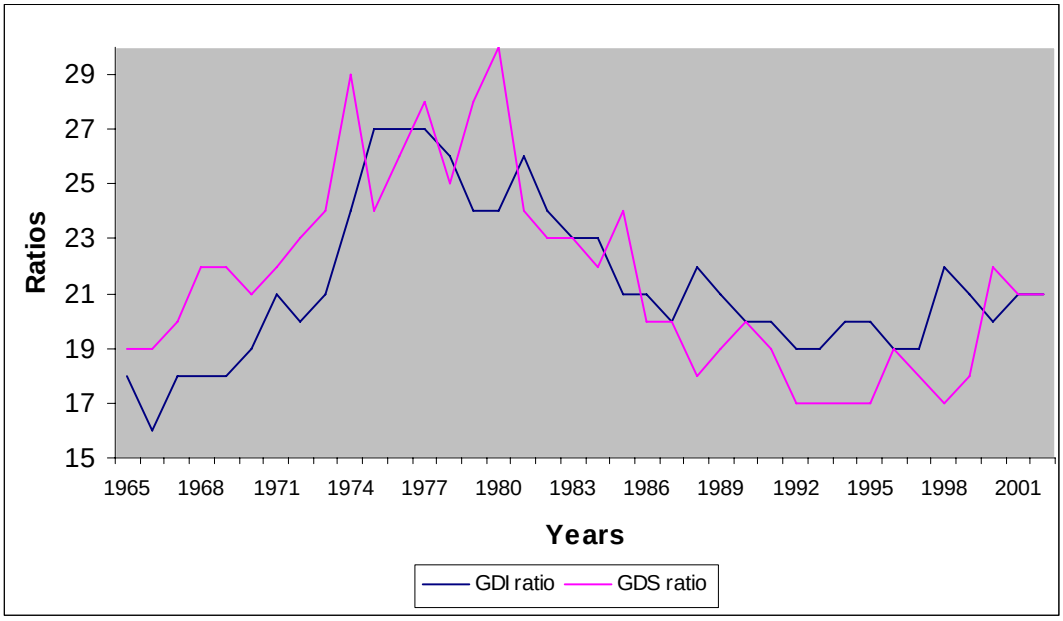
2.2.1 Domestic resource mobilization

Domestic resource mobilization through substantial increases in savings and domestic investment in Africa is seen by Nepad as crucial in achieving higher levels of growth and more effective poverty reduction (Nepad, 2001:36). The domestic savings and investment ratios for the period 1965 to 2002 are shown in Figure 1, indicating the increasing trend until the late seventies. The saving to GDP ratio reached a peak in 1980 at 30 percent, while the investment ratio peaked earlier in 1977 at 27 percent. These two periods represent a clear structural break in the long-term trend of these two variables. An interesting observation is that between the periods 1965 to 1987 investment and savings moved in tandem, with investment lagging the savings trend by more or less one year. From 1987 a change in pattern is evident in both investment and savings. Firstly, the investment ratio leads the savings ratio, in contrast with the previous period where it was the lagging ratio. Secondly, the pattern of savings and investment also changed. These two ratios now tend to move as mirror images of one another. From 1998 the declining trend in both ratios was reversed as they started to increase marginally to reach the same level in 2001 and 2002. It is too early to judge whether this implies another structural break and a subsequent reversal of the long-term declining trend, however.

In his well-known dual-gap or two-gap analysis, Holis Chenery (see Thirlwall, 1994:304-308) emphasized the importance of an inflow of capital to solve either the savings

constraint and/or foreign exchange constraint experienced by developing countries. The long-term relationship in both the investment–savings gap and the import–export gap is shown in Figure 2. The investment–savings gap was negative for most of the 1960s and 1970s, except for the years 1975, 1976 and 1978, implying that domestic savings could facilitate domestic investment. The fact that savings exceeded investment also allowed African countries to import more than their respective exports, as can be seen in the dominance of the import–export gap. It was only in 1981 that the investment–savings gap became zero and positive, proving that domestic savings declined to such an extent that they could not facilitate domestic investment. This illustrates the need for foreign borrowing in Africa since 1981, which served as a trigger for the debt crises in Africa. Simultaneously, the import–export gap, which was the dominant gap until 1990, narrowed. It coincided with the second oil price shock in the late 1970s, the recession in the world economy in the early 1980s and the subsequent debt crises. Between 1991 and 1999 the investment–savings gap became the dominant gap, illustrating the foreign exchange constraint of African economies. Since 2000 these two gaps have coincided and have also become negative. For the first time in many years savings exceed investment and exports exceed imports. If this positive trend can be sustained, it could decrease the need for both foreign borrowing and foreign assistance.

Figure 1: African gross domestic savings and gross domestic investment ratios, 1965–2002



Source: World Bank, 2004: African Development Indicators

The current savings and investment ratios of 21 percent, respectively, are still too low to ensure sufficient investment in human capital and social and physical infrastructure. The Economic Commission for Africa (2003:34) in its 2003 Economic Report on Africa also emphasized that an investment to GDP ratio of 25% or more is needed to accelerate growth in Africa. Measures such as increased private and official capital flows as well as institutional reforms to reverse capital flight are needed to fill the current investment gap.

It should be kept in mind, however, that the composition of investment in Africa is a more fundamental problem for economic growth than its level. Adam and O'Connell (1997:5,10) concluded in this respect that aggregate investment in Africa is markedly less efficient than in other developing regions.

Figure 2: Africa's dual gap, 1965–2002

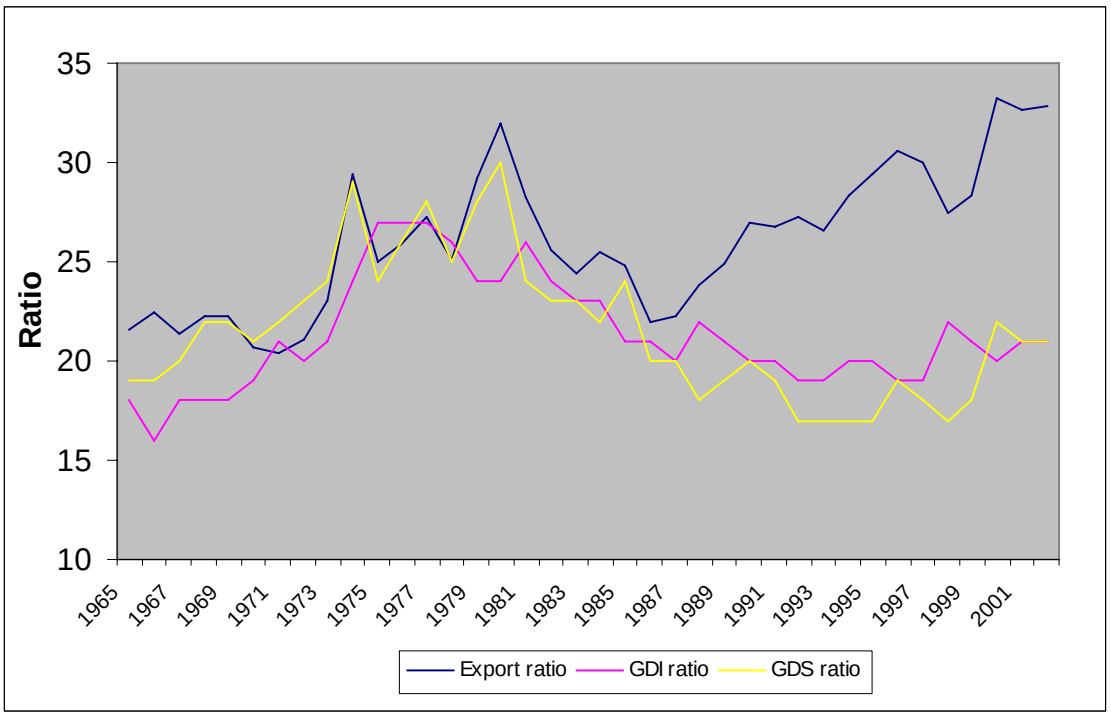
Source: World Bank, 2004: African Development Indicators

Apart from the fact that investment and savings are mutually reinforcing, investment and exports are also reinforcing. According to UNCTAD (2001:12), export growth supports investment through the earning of the foreign capital needed to finance the import of capital goods and advanced technology. Investment supports growth through increases in productivity and competitiveness. Successful examples of industrialization and growth are therefore underpinned by rising rates of savings, investment and exports. The long-term relationship between savings, investment and exports is illustrated in Figure 3. An interesting observation is that the export and saving trends, respectively, followed the same path until 1987, followed by a lagged investment ratio. From 1988 onwards the divergence between the export path on the one hand and the saving–investment path on the other became evident. The export ratio started to increase from 1988 and has reached new heights during the past four years. The strength in export performance could be attributed partly to an inflow of private capital, and especially FDI, to the continent. The relative strength in selected commodity prices, especially oil and diamonds, could also be a contributing factor.

From the analysis it is clear that domestic resource mobilization on the continent is still a key constraint in facilitating long-term growth and development. Although a reversal in the trends in gross domestic saving and investment ratios is evident, the savings and

investment levels are still too low to fill the resource gap. At this point in time Africa will still largely have to depend on the inflow of foreign funds to facilitate the resource gap.

Figure 3: African Export, GDS and GDI Ratios, 1965–2002



Source: World Bank, 2004: African Development Indicators

2.2.2 Debt relief

Since the emergence of the so-called Third World Debt Crises in the early 1980s, it is predominantly African countries, and to a lesser extent countries in Latin America and South Asia, that still struggle to come to terms with their external debt. Africa's external debt stock in nominal terms increased from $11 billion in 1970 to $112 billion in 1980, and from $270 billion in 1990 to reach a peak of $337 billion in 1995. Since 1995 the nominal value of Africa's external debt started to decline to reach a level of $295 billion in 2002, a decline of 14 percent (World Bank, 2004). This decline could predominantly be explained by debt write-offs in the context of the Highly Indebted Poor Country (HIPC) initiatives and by the Paris Club (UNCTAD, 2001:23).

Despite the decline in the nominal level of African debt, the conventional debt indicators – as shown in Table 2 – remain highly unfavourable. The external debt per capita increased from $51 in the early 1970s to reach a peak of $455 in the early 1990s, before declining to the current level of $363. The debt to GDP ratio also increased from a mere 15 percent in the early 1970s to an all-time high of approximately 63 percent in the early 1990s. It then declined gradually to the current level of approximately 53 percent. The average debt to export ratio peaked earlier than the former two indicators at a staggering 322 percent in the late 1980s. It has since declined quite dramatically, but remains

extremely high at 161 percent, much higher than the average ratio for all developing countries. The reversal in the debt to export ratio can be attributed to the general increase in the export performance on the continent, while the decline in the remaining ratios can predominantly be ascribed to the HIPC and Paris Club initiatives.

Table 2: External debt trends, 1970–2002

Period	External debt per capita (US $)	Debt to GDP ratio (%)	Debt to export ratio (%)
1970-1974	51	15.4	85.4
1975-1979	158	25.8	123.9
1980-1984	303	37.8	184.8
1985-1989	425	58.0	322.7
1990-1994	455	62.6	288.5
1995-1999	441	61.4	213.3
2000-2002	363	52.7	160.9

Source: World Bank, 2004: African Development Indicators

African countries are also experiencing difficulties in reaching their debt service obligations (including principal and interest payments). Although the debt service ratios of African countries are lower than those of other developing regions because of the concessional nature of a large portion of the debt, the problem of arrears has grown to unmanageable proportions. The share of arrears in total debt of sub-Saharan African countries increased from 15 percent in 1990 to 26 percent in 1999, in comparison with the average of a mere 5 percent for all developing countries (UNCTAD, 2001:25). The increase in debt stock over the past two decades can partly be attributed to the conversion of arrears on interest liabilities into debt accounts.

Currently, 34 African countries are eligible under the HIPC initiative. According to the Jubilee Research (2003) only seven countries or 20 percent of the countries (Benin, Burkina Faso, Mali, Mauritania, Mozambique, Tanzania and Uganda) can be classified as completion point countries. Completion point countries under the HIPC initiative have reached the point at which they receive a reduction in their stock of debt. Fifteen African countries are between decision point (a point reached after three years of structural adjustment programmes) and completion point. However, countries such as Cote D'Ivoire, the DRC, Central African Republic and Burundi are still in conflict and are regarded by western creditors as too corrupt to be eligible for debt relief (Greenhill and Blackmore, 2002:5). Interim relief on debt service payments has been suspended in countries such as the Gambia, Malawi, Guinea and Guinea-Bissau because of failures to comply with IMF conditionalities.

Despite the fact that it received considerable support from the international community, the HIPC initiative is flawed. The shortcomings include under-funding, excessive conditionality, restrictions over eligibility and inadequate debt relief (UNCTAD, 2001:25). Debt restructuring in general is also bureaucratically costly and creates uncertainty about the status of upcoming debt service claims and the timing and amount

of concessions (O'Connell & Soludo, 1998:14). So far the HIPC initiative has not succeeded in removing the debt overhang from the majority of highly indebted African countries.

More recently, the Commission on Capital flows to Africa (2003:21) also emphasized that the international community should go further than the HIPC initiative. Their recommendations include: firstly, that debt service should be capped at one percent of GDP rather than tied to a debt–export ratio of 150 percent as a prerequisite for it to be classified as an HIPC; the provision of additional debt relief when a country's debt situation worsens due to external shocks; and the establishment of a special debt relief programme for countries emerging from conflict. Fall (2003:1) also mentioned the importance of increased market access for countries affected by debt overhang. In some circles observers are even calling for a total shift from rescheduling to outright cancellation of debt service and more recently to debt stock cancellation.

An aspect that is often overlooked in highly indebted countries is the second-round effect of debt, namely that of capital flight. According to Ndikumana and Boyce (2002), external borrowing appears to be the single most important determinant of capital flight, suggesting widespread debt-fuelled capital flight. In the period 1970–1996 approximately 80 cents of every dollar that flowed into 30 highly indebted African countries from foreign loans flowed out again in the same year. In addition to debt-fuelled capital flight, debt-driven capital flight also occurs when capital flees a country in response to economic circumstances attributable to the external debt itself (ECA, 2003:46). In Africa it is estimated that every dollar added to the stock of external debt added approximately 3 cents to annual capital flight in subsequent years. The prevalence of debt-fuelled capital flight as well as the subsequent debt-driven capital flight complicate and intensify the external debt problem of countries. Debt-relief strategies will only be successful if they prevent a new vicious cycle of external borrowing and capital flight. In this regard improving broader macroeconomic stability reform and institutional reform can reduce capital flight.

Whatever the solution and the progress made in rescheduling the debt, the debt overhang remains large for the majority of highly indebted African countries, and this contributes to their vulnerable status and prevents long-term sustainable growth and development. If the evidence of the New Economics Foundation (Greenhill and Blackmore, 2002), which shows that debt relief to highly indebted poor African countries indeed resulted in large increases in spending in education and health in Africa, is taken into account, debt relief could truly contribute to poverty alleviation on the continent.

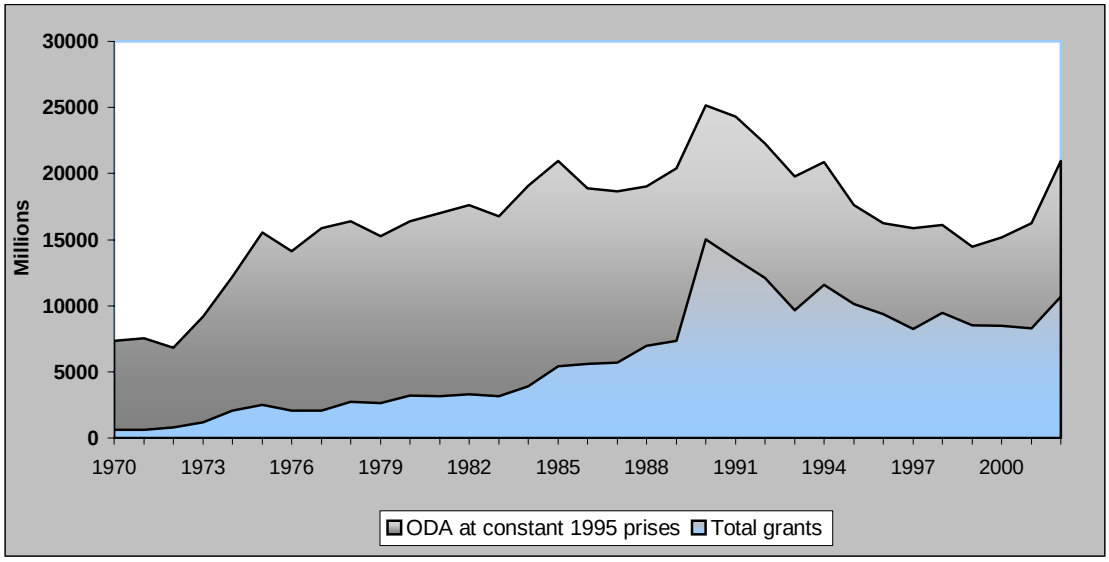
2.2.3 Official development assistance

The objective of official development assistance (ODA) or aid flows to countries may vary between the rebuilding of conflict societies, to meet humanitarian emergencies or to support the strategic or commercial interests of the donor or donor country (Collier and Dollar, 2002:1475). However, one core objective is poverty reduction. In this regard the role of ODA within Nepad is seen as crucial for African countries to reach the stated UN

Millennium Development Goals. Sachs *et. al.* (2004:4) also emphasizes the crucial role of ODA as part of the *big push* that Africa needs.

ODA flows to African countries increased from $7.4 billion in 1970 to $15.5 billion in 1975 and from $20.9 billion in 1985 to reach a record of $25.1 billion in 1990 – see Figure 4. After 1990 ODA flows to African countries started to decline to reach a low of $14.4 billion in 1999 – a decline of 74 percent over the past decade. The 1999 level is more or less on the level already reached in 1975.

Figure 4: Official development assistance and total grants, 1970–2002



Source: World Bank, 2004: African Development Indicators

The decline in ODA after 1990 can predominantly be ascribed not only to policy failures in African countries, which led to *donor fatigue*, but also to concerns about the adequacy of African political and economic institutions, known as the *institutional failure diagnosis* (Adam and O'Connell, 1997:1). However, due to international pressure and the initiatives towards policy restructuring in a number of African countries, the decline in ODA flows was reversed to reach a level of $20.9 billion in 2002 – a recovery of 45 percent. The reversal in ODA flows after 1999 can also be attributed to debt restructuring. If non-concessional or non-developmental loans from the private sector or official creditors are converted or restructured, they form part of ODA figures (O'Connell and Soludo, 1998:6). However, the current level is still far short of the $50 billion a year needed to meet the UN Millennium Development Goals in 2015 (Economic Commission for Africa, 2003:29).

Figure 4 also shows the increase in the grant element of ODA flows.[2] Whereas the grant element constituted only 11.5 percent of total ODA flows in the early 1970s, it gradually increased to approximately 59 percent in 1999, followed by a decline to 52 percent in 2002. The fact that the grant element forms such a large part of the total ODA is

[2] ODA has two components: grants and concessionary loans.

indicative of fact that donor countries and institutions are aware of the inability of African countries to repay their loans and debt and instead provide assistance in the form of grants.

What should also be kept in mind is the challenge facing donors to improve and expand existing programmes without creating dependencies. How dependent is African countries on ODA? On average, African countries receive aid to the value of 3.4 percent of their GDP – see Table 3. However, the 15 countries listed in the table are heavily dependent on ODA and can be classified as high aid intensity countries. The single most dependent recipient country during the 1990s was Sao Tome & Principe, where donor funding equaled the average GDP for the 1990s. Three other countries – Somalia, Guinea-Bissau and Mozambique – receive ODA valued at more than 40 percent of their respective GDPs. All of these countries are conflict-ridden, highly indebted, and/or extremely poor. Countries such as Mozambique, Rwanda and Burundi emerged out of conflict and civil war and ODA could contribute to rebuilding their respective economies. In almost all of these aid-dependent countries the ODA to GDP ratio declined during the period 2000 to 2002, except for Mauritania, Eritrea and in Sierra Leone, where increases were experienced. The increase in aid to these countries is predominantly linked to debt relief.

Despite the large amounts of official development assistance flows to certain African countries, a weak correlation exists between ODA per capita (or the ODA to GDP ratio) and growth in Africa.

Table 3: High aid intensity countries (ODA as percentage of GDP), 1990–2002

Rank	**Country**	**1990 – 1999**	**2000 – 2002**
1	Sao Tome & Principe	100.2	69.5
2	Somalia	53.8	-
3	Guinea-Bissau	48.9	32.1
4	Mozambique	43.0	36.0
5	Rwanda	29.8	18.6
6	Cape Verde	27.1	15.2
7	Malawi	26.2	23.3
8	Zambia	24.4	17.2
9	Djibouti	23.6	12.9
10	Equatorial Guinea	23.7	1.1
11	Mauritania	22.7	28.5
12	Eritrea	21.9	34.3
13	Burundi	19.6	19.1
14	Gambia	18.6	14.1
15	Sierra Leone	18.0	40.0
	All Africa	5.2	3.4

Source: World Bank, 2004: African Development Indicators

Wangwe (2002:3) mentioned the fact that aid tends to be biased in favour of countries with small populations, which is indeed the case in the countries listed in Table 3. Boone (as quoted by O'Connell & Soludo, 1998:12) referred to the fact that aid intensity could be ascribed to the *friends of France effect* or similar *friends of the US* or *friends of OPEC effect*. In the list below it is evident that these effects, in conjunction with debt relief, might be an important driving force of large aid flows to these small economies.

Table 3 also shows that, on average, African countries are becoming less aid-dependent. The average aid intensity for Africa during the 1990s was 5.2 percent. This figure declined to 3.4 percent in the early 2000s. However, this figure is still higher than the 2.5 percent of GDP received from the U.S. by Western Europe under the Marshall plan after World War II (O'Connell & Soludo, 1998:11).

Economic theory has played an important role over time in influencing both the perceptions about how aid impacts on growth and the necessary conditions that have to be in place for this impact to be positive. In the 1960s and 1970s aid was, according to Wangwe (2002:2), allocated to broad agreements to development philosophies. This so-called first-generation analysis of aid was based on Harrod-Domar growth models, where aid was seen as an exogenous net increment to the capital stock of the recipient country, and particularly through an increase in savings. The evidence from these studies shows that aid leads to an increase in savings, and, given the underlying Harrod-Domar model, the implication is that aid spurs growth (Hansen and Tarp, 2000:383).

In the 1980s aid was allocated according to detailed prescriptions of policy reforms, based on simple neo-classical growth models (particularly the Solow model). These second-generation studies turned from the aid–savings relation to the direct link between aid and growth, or in some cases to the link via investment (Hansen and Tarp, 2000:282,392). The focus remained on capital accumulation. The evidence from these studies shows that the link between aid, investment and growth is positive.

The third-generation studies on aid since the 1990s draws on new growth theory and is concerned about aid effectiveness. These studies go well beyond standard first- and second-generation analysis and break novel ground in four areas: first, they cover a larger sample of countries and period than earlier studies by using panel data analysis. Second, inspired by new growth theory, measures of economic policy and the institutional environment are included in the reduced form regressions alongside traditional macroeconomic variables. Thirdly, the endogeneity of aid and other variables are addressed explicitly, and, finally, the aid–growth relationship is explicitly seen as non-linear (Hansen and Tarp, 2000:385, 386). In these studies on the effectiveness of aid, the following debates receive prominence in the literature:

- Firstly, the debate on whether foreign aid accelerates growth, poverty reduction and investment in developing countries that pursue sound or quality economic policies is still an ongoing one.
- The second debate is whether the quantity of aid systematically affects the quality of policies.

- The third debate refers to the importance of a good institutional environment and the fungibility[3] of aid.
- Fourthly, the efficiency of tied aid[4] is questionable.

The most prominent of these debates is whether aid is effective only in a good policy environment. The most influential studies in this respect are by Burnside and Dollar (1997) and the *Assessing Aid Report* by the World Bank (1998). Both of these studies conclude that aid works in a good policy environment. By including 56 developing countries, they conclude that with a one percent increase of GDP in aid the growth rate of the good policy performer increases by 0.4 percentage points. They also conclude that in a good policy environment aid amounting to one percent of GDP leads to a 0.9 percent reduction in infant mortality – an important indicator of poverty. The World Bank (1998:2,3) estimated that a $10 billion increase in aid would lift 25 million people a year out of poverty – but only in circumstances of sound economic management. On the investment front Burnside and Dollar (1997:5) conclude that aid attracts private investment in a good policy environment, whereas in a poor policy environment it displaces private investment.

More recently, three studies – by Lensink and White (2000), Hansen and Tarp (2000) and Easterly, Levine and Roodman (2004) – questioned the good policy prerequisite of aid effectiveness. Lensink and White (2000:399) criticized the *Assessing Aid Report* of the World Bank and concluded, firstly, that aid can affect growth through channels other than growth, second, what constitutes so-called good policies are debatable, and third, the empirical estimates are very sensitive to changes in the model specification and sample. Hansen and Tarp (2000:375) reexamined the various aid relationships in the literature and concluded that a coherent and positive picture of the aid–growth relationship emerges, even in countries hampered by an unfavourable policy environment. Easterly, Levine and Roodman (2004) updated the Burnside and Dollar study by adding additional countries to the Burnside and Dollar data set and extending the data to 1997. They concluded that this exercise raises doubts about the Burnside and Dollar conclusion because they found that aid no longer promotes growth only in good policy environments. This also raises new doubts about the effectiveness of aid.

The effectiveness of aid in Africa and especially the link with good policy environments are questionable. In the top 15 aid recipients listed in Table 3, countries such as Burkina Faso, Cape Verde, Equatorial Guinea, Gambia and Mauritania showed selected improvements in their policy environments. The remainder of the countries on the list have weak policy environments, which is more in line with the viewpoint of Collier and Dollar (2002:1497) on the effectiveness of aid to reduce poverty, where they concluded that although aid is allocated as an inducement to policy reform, it produces a pattern in which aid is directed at a weak policy environment. This is indeed the case in countries such as Sao Tome & Principe, Somalia, Burundi, Malawi, Eritrea, Sierra Leone, Guinea

[3] The fungibility of aid refers to circumstances in which a donor gives aid for a project that the recipient government would in any case have undertaken; in such cases the aid is financing some expenditure other than the intended project.
[4] Tied aid refers to the requirement to purchase exports from the donor country in return for ODA.

Bissau and Zambia. If selected macroeconomic policy stability measures[5] are taken into account, none of the aforementioned countries comply. This conclusion is also in accordance with evidence from Sachs *et. al.* (2004:37), who concluded that the overall level of ODA for well-governed African countries are a limiting factor.

Concerning the second debate, evidence cited by Alesina and Dollar (2000) shows that the quantity of aid does not systematically affect the quality of policies, even when conditionalities are present. In contrast with this evidence, initiatives to strengthen policies are seen in a small number of high aid recipient countries such as Mozambique, Rwanda, Cape Verde, Djibouti, Mauritania, Equatorial Guinea and Gambia (Loots, 2003:12-15). In three of these countries – Mozambique, Cape Verde and Equatorial Guinea – the relatively high levels of ODA and initiatives to strengthen policies coincided with high and sustainable real per capita growth over the past decade. These countries could be examples of the efficient use of aid allocations. Apart from the fact that the impact of aid on growth depends on the quality of policies, it is also subject to diminishing returns (Collier and Dollar, 2002 and Burnside and Dollar, 2000). It is therefore important that these countries gradually decrease their aid dependency.

The third debate refers to the importance of a good institutional environment and the fact that aid finance is typically fungible (Devarajan, Rajkumar and Swaroop, 1999; World Bank, 1998). In this regard it is important that, apart from a good policy environment, the strengthening of the institutional capacity is an important focus of project aid in particular (World Bank, 1998:60). Where institutions and policies are weak, aid tends to be fungible. Wangwe (2002:12) also argues that fungibility is likely to persist in cases where donors and recipients pursue different agendas. If the number of donors increase, aid is likely to become more fungible. In such cases it would be advisable for aid to be directed at so-called *pockets of reform*.

As regards the fungibility of aid, Devarajan, Rajkumar and Swaroop (1999:19,20) observed in cross-country and country-specific studies that aid to Africa is partially fungible. They also concluded that little evidence exists that aid leads to greater tax relief in Africa. Every dollar of aid leads to an increase in government spending of 90 cents, but it increases current and capital expenditure in equal amounts. In the education sector preliminary evidence shows that fungibility is increasing over time. This could hurt countries if the level of aid is reduced.

Table 4 shows the changes in the sectoral distribution of ODA to Africa. Where the focus during the late 1970s was on programme assistance such as balance of payment and budget support with low conditionalities, it shifted to the supporting of social infrastructure and services with higher conditionalities. The fact that social infrastructure and services – including education, health and water supply – are currently receiving 37 percent of all ODA flows reflects donor interest in social programmes aligned with Poverty Reduction Strategies. In this regard it is important to note that education now receives the most bilateral assistance. Some of the disturbing trends are the decline over

[5] These measures include the average government deficit to GDP ratio, inflation rate and debt to GNI ratio for the period 1990-2001. See Loots (2003) for a detailed analysis.

the two comparative periods in ODA for economic infrastructure and services, programme assistance and ODA for production sectors such as agriculture, manufacturing, trade, banking and tourism. Actions relating to debt relief have also doubled from 7 percent in the 1970s to the current 14 percent, indicating the use of aid resources to meet debt service payments in order to avoid a complete cut-off from foreign capital.

Table 4: Sectoral distribution of ODA to Africa

Sector	**Period 1975 – 1980**	**Period 1995 – 2000**
Social infrastructure and services	11%	37%
Economic infrastructure and services	23%	15%
Debt relief	7%	14%
Programme assistance	38%	12%
Production sectors	17%	11%
Emergency assistance	1%	6%
Multisector	3%	3%

Source: Economic Commission for Africa, 2003: Economic Report on Africa 2003.

The fourth debate refers to the efficiency of tied aid. According to the Economic Commission for Africa, tied aid is a major concern. It is estimated that it reduced the value of aid by 25-40 percent by forcing recipient countries to purchase uncompetitively priced imports. However, a definite shift away from tied aid is discernible – only 20 percent of OECD aid is in the form of tied aid (World Bank, 1998:6).

Seen within the changing context of development as well as the partnership in development in Africa, international peer pressure is being applied to improve the effectiveness of aid. The role of Millennium Development Goal-linked Poverty Reduction Strategies (PRS) and appropriate budget management systems could improve the effectiveness of aid. However, concerns have been raised in relation to the ownership of PRS programmes if these programmes have to be endorsed by the IMF and the World Bank. To date, nine African countries have finalized their PRS (ECA, 2003:46).

The unresolved issue in assessing aid effectiveness is not whether aid works, but, according to Hansen and Tarp (2000:394), "how and whether we can make the different kinds of aid instruments at hand work better in varying country circumstances". The effectiveness of aid and the policy dialogue are therefore intimately related. However, foreign aid can only support a strong domestic movement towards reforms in policies and institutions that in turn foster economic growth.

2.2.4 Foreign direct investment

In the last few decades FDI has been the most dynamic factor in international trade, increasing at a faster rate than world GDP or the volume of international trade (Anderson

& Pereira, 2003:3). The general trends in FDI worldwide are as follows: during the first part of the 1990s when the forces of globalization began to spread to the developing world, developing countries received 39 percent of world flows. During the period 1997–2002 FDI inflows to developing countries declined to 27 percent of world flows (UNCTAD, 2003). However, average world flows in nominal terms increased by a staggering 235 percent from the first to the latter part of the decade. For developing countries, these flows increased by 130 percent in nominal terms.

Table 5: FDI flows to developing regions, 1991–2002

Region	**Share 1991-1996**	**Share 1997-2002**
Africa	4.6%	5.1 %
Latin America and the Caribbean	27.2%	36.2%
Asia and the Pacific	60.0%	48.1%
Central and Eastern Europe	8.2%	10.6%

Source: UNCTAD, 2003: World Investment Report

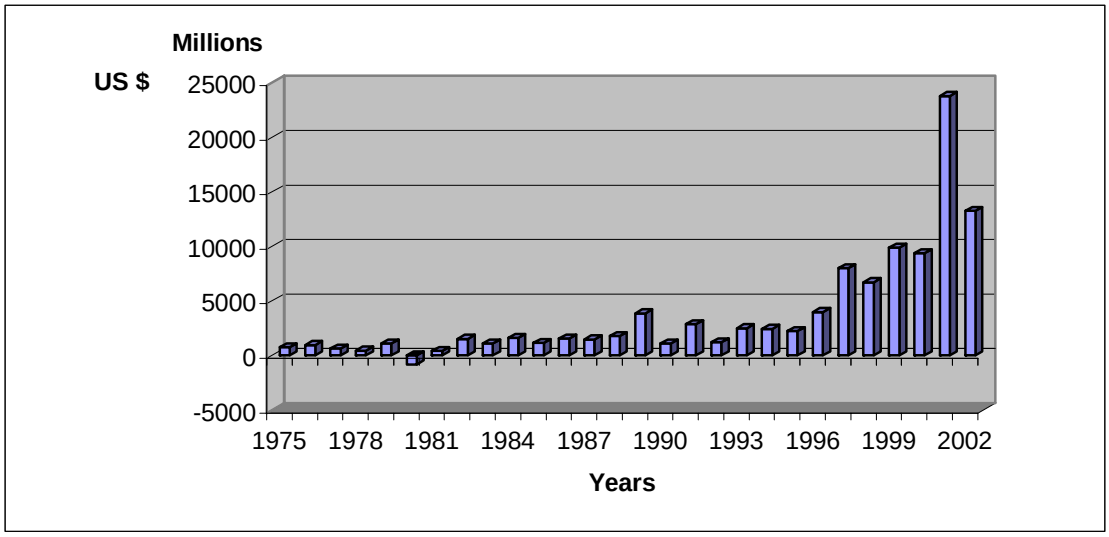
The distribution in flows to the developing world is shown in Table 5. During the first part of the 1990s Africa received 4.6 percent of all FDI inflows to developing countries. For the period 1997–2002 these flows increased to 5.1 percent. This is in contrast with the seventies when the African continent received 19 percent of FDI flows to developing countries, which made Africa the second-largest recipient after Latin America of all FDI flows to the developing world. The average flows to Africa declined to 9 percent in the 1980s. The FDI scene in the developing world is largely dominated by flows to Latin America and the Caribbean, and to Asia and the Pacific. These two regions receive approximately 84 percent of all flows to the developing world. The rest of the flows go to Central and Eastern Europe, which currently receives 10.6 percent of all developing country flows.

Despite the fact that Africa's share of FDI is declining, net nominal inflows to the continent increased from $1.1 billion in 1990 to $13.2 billion in 2002 – see Figure 5. Although an all-time high of $23.8 million was reached in 2001, it can mainly be ascribed to two cross-border mergers and acquisitions in South Africa and Morocco.[6]

Since 1975 two important structural breaks can be identified in the net FDI inflows data. During the first period – 1975 to 1987 – net FDI inflows averaged approximately $1 billion, followed by the second period – 1988 to 1994 – with average flows of $2.3 billion. The most pronounced structural break is between 1994 and 1995, with net flows during the period 1995 to 2002 increasing to an annual average of $9.7 billion.

[6] Approximately 80 percent of this growth can be explained by the unbundling of cross-share holdings involving the London-listed Anglo American and De Beers of South Africa. Anglo purchased De Beers sales by paying the South African owners in Anglo shares. The other project involved the sale of 35 percent of Maroc-Telecom to a foreign investor, boosting inflows to Morocco by $2.7 billion (UNCTAD, 2002:48,49).

Figure 5: Net FDI inflows to Africa, 1975–2002



Source: World Bank, 2004: African Development Indicators.

Although the literature on the determinants of FDI to developing countries is vast, the literature on Africa is still limited. More recently, three influential studies in this regard appeared, namely those by Morisset (2000), Asiedu (2003) and Naudé and Krugell (2003). Morisset (as cited by Naudé and Krugell, 2003:5) concludes that aggressive liberalization, modern investment codes and strong economic growth are important prerequisites in attracting increased flows of FDI to Africa. Asiedu (2003) used panel data for 22 countries in sub-Saharan Africa over the period 1984–2000 to examine the impact of political risk, the institutional framework and government policy on FDI flows. She concluded that macroeconomic stability, efficient institutions, political stability and a good regulatory framework have a positive effect on FDI on the continent. In her study she also refers to several investor surveys that revealed that, firstly, factors that attract FDI to Africa are different from those that work in other regions, and, second, that the region is also structurally different from the rest of the world (Asiedu, 2003:4). Naudé and Krugell (2003) covered the period 1970–1990 in their cross-country analysis on whether institutions and geography matter as determinants of FDI in Africa. They concluded that geography does not have a direct influence on FDI flows to Africa. They used a number of specifications on policy instruments to demonstrate that neither market-seeking nor re-exporting motives for FDI seem to dominate. In critically reviewing the claims of earlier studies on the dominance of economic policies, they concluded that good policies are only significant if they are made by good institutions. As an institutional measure, political stability proved to be a significant determinant of FDI.

The question to be answered is whether the most prominent of these determinants are present in the major FDI recipient countries in Africa. The top ten recipient countries for the period 1995 to 2001 are shown in Table 6. South Africa is the largest net FDI recipient in Africa, followed by Nigeria, Angola, Egypt and Morocco. These countries achieved an average growth rate of 4.3 percent during this period. However, no correlation exists between the nominal inflows and the respective growth rates of the

major recipient countries. The top ten countries – representing 18 percent of the countries on the continent – are receiving approximately 78 percent of all net inflows to Africa. This is indicative of the uneven spread of FDI flows to the continent. Other interesting facts are that the SADC as a regional integration grouping receive 38 percent of all flows to the continent. Thirty-three percent of FDI flows to Africa's highly indebted poor countries.

Table 6: Growth and net FDI inflows to Africa: Top ten recipient countries, 1995–2001

Ranking	**Country**	**Percentage share**	**Average economic growth rate**
1	South Africa	14.4	2.8
2	Nigeria	14.1	2.3
3	Angola	11.4	7.6
4	Egypt	11.4	4.8
5	Morocco	8.1	2.9
6	Algeria	5.0	3.3
7	Tunisia	5.0	5.2
8	Cote d'Ivoire	3.0	2.9
9	Tanzania	2.7	4.6
10	Sudan	2.4	6.6
Total	Top ten recipients	77.5	4.3

Source: UNCTAD, 2002 and 2003: World Investment Reports

Mixed results are also obtained on the good policy front. Only five of these countries – Algeria, Egypt, Morocco, South Africa and Nigeria – comply with one or two general macroeconomic stability measures[7]. If the legal structure and the security of property rights are taken as proxies for good institutions, only Morocco, South Africa and Tanzania are in line to qualify. On the political stability determinant, high FDI recipient countries such as Cote d'Ivoire, Nigeria and Sudan have a long history of political instability. It therefore appears that although the literature provided significant determinants for Africa, if would be dangerous to generalize, given country-specific circumstances.

Included in this list of top ten recipient countries are eight of the largest economies in Africa. This could be indicative of the market-seeking motive of FDI. The only smaller countries included in the list are Tanzania and Cote d'Ivoire. Five of the countries – Nigeria, Angola, Egypt, Algeria and Tunisia – are all oil-producing countries. FDI to these countries is predominantly resource-seeking or rent-seeking in nature. If it is taken into account that Nigeria, Egypt, Algeria and Angola are the four major crude-oil-producing economies in Africa, it is evident that FDI inflows to these countries are predominantly focused on the petroleum industry. However, FDI in natural resources,

[7] These measures include the average government deficit to GDP ratio, inflation rate and debt to GNI ratio for the period 1990-2001. See Loots (2003) for a detailed analysis.

especially oil, has shortcomings as a force of development in host countries notably because of its limited linkages to domestic enterprises (UNCTAD, 2003:37).

The major source countries over the past decade are still France, the UK and the US (UNCTAD, 2003:37). In this regard a similar *friends of France/UK/US effect* is present as in the case of aid flows to Africa. South Africa and China, as developing countries, are also becoming major investors on the continent.

The impact of FDI on the various economies can be measured by looking at the FDI as a percentage of the GDP of these countries. The top 15 recipient countries according to this measure are listed in Table 7. Equatorial Guinea is receiving FDI inflows to the value of 38 percent of its GDP, followed by Angola with 14.5 percent, Lesotho with a ratio of 11.5 percent and Chad with 11.3 percent. The majority of these countries are also high growth achievers. The correlation coefficient between FDI (as percentage of GDP) and the respective economic growth rate for all African countries for the period 1995–2002 is a moderate 0.71. However, the correlation coefficient for the top 15 recipients of FDI (as percentage of GDP) is 0.91, which represents a strong correlation. The strong correlation is indicative of the fact that large inflows of FDI relative to the size of the economy stimulate economic growth. It is not clear, however, whether FDI lags or leads economic growth in these countries.

Table 7: Top 15 recipient countries according to FDI as percentage of GDP, 1995–2002

Rank	Country	FDI as % of GDP	Average real growth rate
1	Equatorial Guinea	38.2	24.5
2	Angola	14.5	7.6
3	Lesotho	11.5	3.3
4	Chad	11.3	4.0
5	Congo	8.3	3.1
6	Sao Tome & Principe	5.9	2.6
7	Cape Verde	5.4	6.1
8	Seychelles	5.4	3.7
9	Eritrea	5.1	2.6
10	Namibia	4.9	3.3
11	Mozambique	4.6	8.1
12	Swaziland	4.4	3.2
13	Zambia	4.3	2.4
14	Nigeria	3.6	2.3
15	Tanzania	3.2	4.6

Source: World Bank, 2004: African Development Indicators

FDI flows to Africa differ from flows to other developing regions in various respects. Firstly, although the continent receives only a fraction of flows to the developing world, the profitability of these flows on average is higher. Since 1990 the rates of return of US FDI were above 20 percent, in comparison with average rates of return of between 12 to 16 percent in other developing regions (DBSA, 2003:109). In this respect the rates of

return in the petroleum industry are the highest. Secondly, a tendency exists amongst investors to look at Africa as a single investment destination by adopting a so-called *blanket* approach to the continent. In this respect the regional dimension as determinant of FDI are becoming more pronounced (Loots, 2000:23).

Increases in and sustainable FDI flows to Africa are seen by Nepad as long-term goals to ensure growth and development on the continent. At this point in time nominal flows to the continent are on the increase despite a declining trend in Africa's share of flows to the developing world. The flows to the continent are also unevenly spread and are concentrated in the largest economies and/or in petroleum export countries. Since the FDI to GDP ratio for Africa is greater than in other developing regions, the potential growth benefits are large. This explains the strong correlation existing between high FDI to GDP recipients and their respective growth performance since 1995. Because factors attracting FDI to Africa are also different from those in other regions, good policies within a stable institutional framework are vital prerequisites to attract more FDI.

3. Summary and conclusion

The Nepad initiatives are indicative of the fact that Africa may be rethinking its approach to development management. The capital flows initiative has been identified as one of the two pillars to achieve the Nepad outcomes.

On all four identified capital flow measures - namely domestic savings and investment, debt reduction, ODA and FDI flows - reversals in declining trends and/or improvements are discernable. On the gross domestic savings and investment levels, respectively, reversals in trends are evident from the late 1990s onwards. However, these levels – currently at 21 percent of GDP respectively – are still too low, suggesting that the continent still largely have to depend on the inflow of foreign funds for the foreseeable future. Despite the shortcomings of the HIPC initiative, progress has been made in rescheduling debt on the continent. However, the debt overhang remains large for the majority of highly indebted African countries, and this contributes to their vulnerable status and prevents long-term sustainable growth and development.

The declining trend in ODA flows was also reversed since 1999. Although the current ODA levels are still below the 1990 level, a large number of small economies are heavily dependent on these flows. Mixed results are also obtained on the link between the effectiveness of aid and a good policy environment. Aid to the continent also tends to be partially fungible. However, progress are made in certain countries to develop and implement Poverty Reduction Strategies and appropriate budget management systems, which could improve the effectiveness of aid. Evidence shows that the effectiveness of aid and the policy dialogue are intimately related. However, foreign aid can only support a strong domestic movement towards reforms in policies and institutions that in turn foster economic growth.

FDI flows to the continent are increasing despite the declining trend in Africa's share of flows to the developing world. The flows to the continent are also unevenly spread and

are concentrated in the largest economies and/or in petroleum export countries. Since the FDI to GDP ratio for Africa is greater than in other developing regions, the potential growth benefits are large. This explains the strong correlation existing between high FDI to GDP recipients and their respective growth performance since 1995. Because factors attracting FDI to Africa are also different from those in other regions, good policies within a stable institutional framework are vital prerequisites to attract more FDI.

The importance of the reversal in capital flows to the continent is evident in the increased importance of these variables in explaining the more recent growth experience in Africa. However, over the past decade it has been realized that development in general and in Africa in particular is a complex process with interactions between economic and non-economic variables. Simply using past experiences as indicators of future performance could be dangerous, given the interrelationship between capital flows, the macroeconomic policy environment, the role of institutions in development and the political economy. If Africa wants to succeed in its Nepad goals, these interrelationships are of crucial importance. In order to walk to walk, the continent has to address policy-generated uncertainty and political instability and strengthen the institutional environment.

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