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Capital Flows and Current Account Sustainability in Africa

December 2005

Economic and Social Policy Division (ESPD)



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The views and opinions expressed herein are those of the authors and do not represent those of the United Nations Economic Commission for Africa.

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This booklet can be found at
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Foreword

One of the main objectives of the Economic and Social Policy Division (ESPD) of the United Nations Economic Commission for Africa (ECA) is to provide policy advice and training to help member states improve macroeconomic management and achieve sustainable growth. To fulfil its duty in this regard, ESPD undertakes rigorous policy research on pertinent economic issues in the continent and organizes research and training conferences and workshops involving policy makers, researchers and experts from within as well as from outside Africa.

Developing countries need external capital - including official development assistance, loans and foreign direct investment – to augment domestic investment. At the same time they need to manage capital flows in such a way as to ensure current account sustainability. Both current account deficits and surpluses can present serious policy challenges: policy response to current account imbalances or lack of it can have important repercussions for macroeconomic stability, resource allocation and economic growth. Thus, the surge in capital flows to developing countries since the 1990s has raised concerns about current account sustainability in these countries, particularly in light of rising international interest rates and the threat of volatility of capital flows. Recipients of capital flows can be vulnerable to sudden changes in the domestic or external environment.

While Africa's overall current account deficits have been falling recently, due largely to increased revenue from high oil prices, wide current account fluctuations symptomatic of extreme trade volatility and erratic capital flows continue to plague African economies. Only 14 African countries had current account surpluses in 2004, while 25 countries had deficits of more than 5 per cent of GDP. In this context, in September 2005, ESPD organized, in Accra, Ghana, a continent-wide workshop on "**Capital flows and current account sustainability in Africa**". While underscoring the fact that the effects and policy responses to current account imbalances may vary from country to country and over time, workshop presentations and discussions were designed to help member states establish a framework for timely and competent analyses as well as responses to capital flows and current account sustainability problems.

The deputy governor of the Bank of Ghana, Mr. Lionel van Lare Dosoo, opened the workshop, confirming that it was timely and very relevant to Africa. In his keynote address he stressed that the sustainability of the current account does not only depend on the existence of a surplus or a deficit but also on the structure of the current account, the nature of capital flows that are used to balance it, as well as on the underlying macroeconomic fundamentals and economic structure. The challenge of current account sustainability is especially important in relation to how deficits can be used to enhance real growth.

The workshop highlighted factors influencing the relationship between capital flows and current account sustainability, and served as a platform for sharing experiences among

African countries through country case studies, lessons learned, and best-practice examples. Participants included 65 professionals mainly from central banks and ministries of finance from 30 African countries. Other participants came from research institutions and private sector organizations.

The current publication presents summaries of various presentations and policy recommendations emanating from the above conference. It is hoped that the information contained herein will assist African policy makers, donors and other stakeholders establish the policy prerequisites that will allow them to maximize the benefits and minimize the risks associated with increased capital flows and financial integration.

Augustin Fosu
Director, ESPD

Capital Flows to Africa: Recent Evidence and Implications for Current Account Sustainability

Emmanuel Nnadozie and Adam Elhiraika

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As African countries desire and anticipate large inflows of capital in the form of debt relief, increased aid, and export revenues, there is a need to establish sound policies to manage the risks associated with such inflows. For example, a large capital inflow can lead to currency appreciation and a Dutch Disease-type syndrome. Thus, there is a problem of absorptive capacity to contend with. Also, capital inflows may be associated with rapid increases in money supply, which could lead to inflation.

It is important to examine the current account implications of increased capital flows to Africa because many countries suffer from recurrent, and in some cases excessive, current account deficits. Meanwhile persistent current account fluctuations symptomatic of extreme trade volatility in many African countries can have negative effects on aggregate demand and overall growth. A healthy balance of payments permits lower interest rates necessary for investment,¹ while current account imbalances—surpluses or deficits—affect the balance of payments and create an imbalance in government saving, borrowing and asset acquisition. This paper examines recent trends in various types of capital flows to Africa in an effort to highlight their implications for current account sustainability. The paper also discusses necessary policy and institutional changes to increase capital flows and at the same time enhance current account sustainability to promote sustainable economic growth.

This discussion is important because sustained growth, employment, and reduction in poverty necessary for attaining the MDGs and other NEPAD initiatives require mobilization of significant domestic and external capital. Moreover, the UN, the AU's NEPAD agenda for Africa, and the Commission for Africa have all called for significantly increasing financial flows to Africa in the spirit of the Monterrey Consensus and Paris and other Declarations. The main types of external flows to Africa are Official Development Assistance (ODA), debt flows and debt relief, Foreign Direct Investment (FDI), portfolio investment and remittances. In terms of composition, volume, and behaviour available data shows the following:

- Official Development Assistance (aid) is the most important source of capital flows to Africa in terms of volume. ODA to Africa rose in the 1980s, reaching a peak at \$25.3 billion in 1990, but declined thereafter to a low of \$15.3 in 2000. ODA flows to Africa recovered recently, reaching \$22.16 billion in 2003.

¹ McCombie and Thirlwall (1999) "Growth in an International Context." In Johan Deprez and John T. Harvey (eds.), pp.35– 90. *Foundations of International Economics: Post Keynesian Perspectives*. London: Routledge, p 82.

- Debt flows (largely official debt disbursement) to African countries have been generally fluctuating, from \$21 billion in 1993, for example, to \$13.5 billion in 1998 and \$16.01 billion in 2002. With mounting debt burden and debt sustainability problems, it has become increasingly difficult for African countries to get new loans. However, although Africa's external debt stock has continued to rise due mainly to accumulating arrears and interest payments, both the debt-GDP and debt-export ratios have fallen recently thanks to favourable weather conditions and increased export earnings resulting from the boom in commodity prices.
- Under the Highly Indebted Poor Countries (HIPC) initiative, USD 51.93 billion owed by 27 poor countries to bilateral and multilateral creditors would be forgiven. Africa's debt relief accounts for more than 82 per cent of total debt relief but only about 7 per cent of total Africa's debt (\$282 billion in 2004). Fourteen Sub-Saharan African (SSA) countries will receive 100 per cent debt relief as announced at G8 summit in Gleneagles (Scotland) in June 2005. The HIPC initiative has led to demonstrable social and economic gains as it reduced the debt burden of a number of African countries and freed resources for increased spending in social and economic sectors. However, the debt burden is still unsustainable for many HIPC countries, and the benefits of the program are limited because it does not cover many heavily indebted poor countries in Africa.
- Net direct investment has been rising over the years 1980-2001 to a high of over 14 billion in 2001. This increase came after the stagnation recorded from the mid-eighties to the mid-nineties. Notwithstanding this recovery, FDI to Africa accounts for just 2 per cent of global FDI flows and tends to be concentrated regionally (North Africa) and sectorally (extractive industries). Although extractive sectors still dominate, FDI composition has recently shifted in favour of other sectors such as telecommunication and power.
- Portfolio investment on the other hand shows a much different picture—that of net negative figures except for the period 1991 to 1999 which was a period of positive net portfolio investment. 1999 recorded the highest level of net portfolio investment of over 8 billion while 2001 showed the steepest decline of over \$6 billion.
- The African Diaspora have been increasing in number, and so remittances have been significantly rising over time, amounting to 50 per cent of aid flows and exceeding FDI by half a billion US dollars in 2002. Remittances are less volatile than other types of private flows and are better distributed across countries and within countries.

The relative importance of the different flows appears to vary from country to country. For instance in South Africa, the role of portfolio investment is higher than that of direct investment and other investment. The limited performance of the domestic economy and the related weak integration to global financial markets made African countries to depend heavily on the flow of official capital from developed countries.

However, ODA has, since the early 1990s, been relatively declining in importance as a source of capital flow. Many reasons have been cited for this decline. The end of the cold war reduced the competition between the East and the West to give aid for ideological

reasons and at the same time reduced the ability of recipient countries to influence donors' decisions. Budgetary difficulties and the perception that aid failed to spur development in recipient countries have also forced donors to decrease aid. Moreover, aid policies tended to promote liberal economic policies and encourage private capital flows as a substitute for official assistance. For Africa in particular the decline in ODA is attributable to additional factors including increased competition for ODA among transition economies, and increased diversion of resources to humanitarian and peacekeeping efforts.

The fall in ODA together with the need to increase private investment and employment signify the importance of private capital flows, in the form of private loans, portfolio investment, and foreign direct investment. However flow of private capital to Africa is limited by a number of factors including risk (real and perceived) due mainly to economic and political instability; relatively inefficient infrastructure and poor business environment in terms of regulatory framework and government services; lack of skilled labour; and policy constraints.

The relative importance of FDI in Africa appears to reflect the situation of the continent, characterized by high political risk with a few countries experiencing civil wars and others encountering political instability, inefficient and imperfect markets, and need for further reforms to improve the investment environment. Under these conditions, FDI becomes the least risky type of private flows since it gives the investor the opportunity to control the operation of its activities rather than leaving them to the operation of local financial markets, suppliers and legal arrangement. The volatility of capital flows to Africa is compounded by the volatility in growth which emanates from changes in weather conditions and dependence on commodity markets characterized by fluctuating demand and prices.

Another important issue concerning capital flows to Africa is their extreme levels of volatility. In general, remittances aside, ODA is the least volatile source of capital flows followed by FDI, the most important type of private flows. Fluctuations in capital flows and export earnings can lead to dramatic changes in the current account and balance of payment position of a country with important economic repercussions. Current account deficits have generally declined in Africa recently, from 1.6 per cent of GDP in 2002 to a surplus of 0.4 per cent in 2004 due largely to the effect of robust oil prices in oil-producing countries. Of the 51 African countries for which data are available, 14 had current account surpluses while 37 had deficits in 2003. 25 countries had a deficit of more than 5 per cent of GDP in 2003. The recent hike in oil prices is expected to influence current account sustainability in Africa in different ways. Many oil-exporting countries, as opposed to oil-importing countries, will have increased current account surpluses that need to be effectively managed in order to minimize risks of currency appreciation and loss of competitiveness.

Although economists do not agree on the role and importance of current account deficits, African governments need to be concerned about a large current account deficit or surplus including balance of payments for several reasons. First, prolonged current account deficits may become unsustainable, crowd out domestic saving or lead to macroeconomic instability, especially when financed with short-term debt or foreign exchange reserves and when it

reflects high consumption spending. Second, the surge in capital flows to developing countries since the 1990s has raised concern regarding the sustainability of current account in these countries, in light of rising international interest rates and the threat of volatility of capital flows. Third, while it is necessary for African countries to attract more capital flows, it is important to determine what role, if any, the latter plays, in current account sustainability and what policy measures should be introduced in order to exploit the gains and minimize the risks of these flows. This is particularly true when increased capital flows are associated with financial and exchange rate liberalization.

Some African countries have relatively liberal banking and interest rate policies as well as quasi-floating exchange rate regimes. Increases in capital flows, in this context, can lead to real exchange rate appreciation and an increase in domestic interest rate and inflation, which creates a need for policy response. Policy options include the following²:

- Sterilization (absorption by the central bank of large inflows of foreign capital) is a way to prevent exchange rate appreciation. This can result in accumulation of foreign reserves and preservation of competitiveness, but at a potential cost of higher inflation. Exchange rate appreciation on the other hand reduces debt-servicing cost and import prices at the cost of lower competitiveness and export revenue.
- Increasing reserve requirements is another policy option that imposes taxes on banks and can reduce credit to the private sector.
- Decreasing fiscal expenditure rather than raising taxes can also be effective but this is difficult in countries where public spending is already low and critical for maintaining public services.

Given the size of African economies, weak public finances, vulnerability to external shocks (induced by natural, political and market factors) and problems of information asymmetry, there is a need for strategies to control risks, including macroeconomic and financial instability, of private short term capital flows in particular. Possible policy measures include:

- Capital controls along with domestic institutional development in the financial sector and the regulatory and supervisory systems.
- Variable deposit requirements to manage the impact of capital flows on the domestic economy.
- Promotion of exports and management of potential trade deficits at times of large capital inflows.
- Establishment of adequate contingency financing facilities in collaboration with donors and international development partners to protect countries suffering from economic shocks. This will not only reduce cost resulting from volatile capital flows

² For a classic textbook policy discussion see Levacic, R. and Rebman, A. (1982) *Macroeconomics: An Introduction to Keynesian-Neoclassical Controversies*, The Macmillan Press, London, UK, and for discussion in the context of Africa see Morrissey, O. (2003) *Private Capital Flows to Sub-Saharan Africa*, Development Bank of South Africa, Johannesburg, South Africa.

but it can also help countries to attract more stable forms of private capital flows such as FDI.

- Enhanced debt relief to bring the debt levels of HIPC as well as other heavily indebted African countries that are not currently covered by the HIPC Initiative to sustainable levels. As the Commission for Africa proposes this should be done along with the establishment of a new International Financing Facility to ensure that these resources can be invested to ensure improved future growth in Africa.

Financial Liberalization and the Structure of Capital Flows in African Countries

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Since the 1980s, African countries have made efforts in economic reforms, including liberalization of domestic financial markets and the opening of the capital account. The financial liberalization drive was expected to achieve a wide range of objectives including: (1) the removal of market distortions in domestic financial markets to allow higher competition and more efficient allocation of capital; (2) alleviation of market segmentation in domestic financial markets; (3) increasing financial intermediation (saving and lending); (4) increasing access to external capital, especially long-term investment capital, thus reaping the benefits of international financial integration; (5) reducing capital flight; and even (6) reducing corruption through deregulation of the financial system.

However, after more than two decades of liberalization, most observers concur that the results of the experiment have been disappointing. Many reasons have been offered for why financial liberalization failed to produce the expected results in African economies. These include: (1) the lack of political anchoring and poor policy choices that undercut financial liberalization efforts; (2) persistence of government interference in financial markets and partial implementation of liberalization measures; (3) and macroeconomic uncertainty and instability, including inflation volatility. Most studies conclude that more needs to be done, especially in terms of accompanying economic and institutional reforms to support financial liberalization. It has become evident that financial liberalization is not a panacea.

Thus, the expectation that financial reforms would result in higher capital inflows was not fulfilled. The capital account of most African countries remains characterized by heavy dependence on external borrowing and aid, large outflows of funds in the form of debt payment, and low private inflows. Private external capital still makes a small contribution to domestic capital formation. Moreover, sectoral diversification of private external investment has traditionally been weak, with most investments targeting extractive industries, despite the fact that the returns to investment in the secondary and tertiary sectors are often higher. In addition, while countries face a heavy burden on debt, they also suffer substantial haemorrhage of resources in the form of capital flight.

While financial liberalization may have succeeded in removing interest rate repression, it has failed to improve competition in the banking sector and efficiency in resource allocation. Interest rate margins remain high, illustrating pervasive monopoly power of banks, which discourages lending. The high interest rate differentials have not attracted much foreign private capital.

The following key policy recommendations are derived from discussion in this paper

- The evidence shows that relatively high rates of returns as illustrated by high interest rate differentials have not attracted much foreign capital. Therefore, a broader set of strategies aimed at reducing country risk is necessary to induce more private capital inflows. These strategies include deepening macroeconomic policy reforms as well as institutional reforms to improve governance and political stability.
- Policy makers need to be creative in marketing African investment markets through direct contacts with prospective investors. These contacts will help alleviate information asymmetries and overcoming barriers that are often due to ignorance-based negative stereotypes about African economies.
- African countries have not been successful in attracting a diversified pool of private resources. However, the most important concern is the low overall level of capital flows. Attracting short-term capital is not (should not be) a priority of financial policy. Short-term flows are highly volatile and can cause substantial macroeconomic instability. In fact, the emphasis should be on controlling these types of flows to minimize the adverse effects on the economy.
- Efforts to increase the volume and stability of capital flows must involve strategies to attract more savings from the African Diaspora. African governments need also to establish incentives for allocating remittances into domestic investment. So, there is a need to tackle the problem of financial haemorrhage or capital flight through better rules of accountability and transparency in the management of government funds and in capital account transactions. To curb and reverse capital flight, African countries need to seek better cooperation with the international community to impose more responsible banking practices by Western financial institutions.

While African countries need to pursue efforts to attract more private capital flows, they must not be distracted from the need to foster domestic investment. The focus of policy should be on improving the overall investment climate to promote both domestic investment and long-term external capital inflows. Policy makers must especially avoid any bias in investment policy in favour of foreign investors that may put domestic investors at a comparative disadvantage. Accelerating growth will require a healthy rate of domestic investment complemented by sufficient inflows of stable long-term external capital flows.

The Role of Capital Flight and Remittances in Current Account Sustainability in Sub-Saharan Africa

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A plethora of studies in recent years have focused attention on the determinants and impact of capital flight and remittances in the development process. These issues are particularly pertinent to Africa in view of its relatively high incidence of capital flight in the presence of foreign exchange constraints, limited foreign capital inflows, external indebtedness and high dependence on overseas development assistance.

The main determinants of capital flight in Sub-Saharan Africa (SSA) include: macroeconomic instability, political instability, external borrowing, and lower levels of financial development, among others. The total capital flight from 46 SSA countries for which data exist amounted to nearly USD 184 billion for the period 1991-2004, averaging over USD 13 billion per annum. Capital flight from Sub-Saharan Africa almost doubled from around USD 15 billion in 1991 to just under USD 30 billion in the year 2003. In 2004, capital flight declined substantially to just USD 1.1 billion, from over USD 28 billion in the preceding year. This was largely caused by substantial capital flight ‘reversals’ in the oil and mineral rich countries of Nigeria, Congo, and Angola.

Empirical studies on the determinants of remittances in Africa are very scanty, and tend to yield mixed outcomes. Whilst most studies have found evidence of altruism as the principal motive for remittances (i.e. concern over the consumption or income levels of the family members left behind in the home country), for example, there is evidence in favour of self-interested behaviour (rather than altruism) of remittances in Botswana.³ In contrast to the volatile trend in capital flights, the trend in remittance flows to Africa since 1991 has exhibited a steady growth pattern rising from less than USD 2 billion dollars in 1991 to nearly USD 5 billion by 2003. Nigeria is by far the largest recipient of remittances in SSA, accounting for one-third of all remittance flows to the continent. Nigeria is followed by Kenya, Lesotho, South Africa, Mauritius, Uganda, Benin, and Cape Verde. Together, these eight countries accounted for nearly three-quarters of remittances in SSA.

The paper employs standard methodological approaches to estimating capital flight and remittances for selected sub-Saharan African countries and analyzes their relationships with current account balance and key economic indicators. The findings from the statistical exercises in the paper yielded a number of important results:

³ See Lucas, R.E.B. and O. Stark (1985). “Motivations to Remit: Evidence from Botswana.” *Journal of Political Economy*, 93, 901-918.

- The magnitude of capital flight from Africa has increased considerably in recent years, with widespread fluctuations and volatility.
- The volume of remittances into SSA has increased dramatically but steadily.
- There is a negative association between balances of current account and capital flight, implying that capital flights tend to worsen current account difficulties.
- There is a positive relationship between remittances and current account, suggesting that remittances could play an important role in mitigating current account problems
- The link between remittances and economic growth is positive, albeit insignificantly in the statistical sense, providing weak evidence for the positive role of remittances in the economic growth and development process.
- External debt and capital flight are positively intertwined, providing support for the so-called ‘round-tripping’ or ‘back-to-back loans’ hypothesis. In other words, “resident capital is dollarized and deposited in an overseas bank, and the depositor then takes a ‘loan’ from the same bank, for which the deposit may serve as collateral”.⁴

The main implications of these findings are that in spite of the good progress made by many African countries towards economic and political reforms, more innovative policy thinking and reform deepening must be initiated to create a conducive environment for private sector participation in general and foreign capital (including capital flight reversal) in particular. Similarly, there is a need for mainstreaming remittances into national development strategies with the view to promoting the growth enhancing effects of remittances.

The results also have important specific implications for policy:

- The huge estimates of capital flight suggest a huge potential for capital flight reversals. Efforts must be made towards the design and implementation of appropriate policy measures that would encourage flight capital to return to source countries. For ‘normal’ capital flight, this would require speeding up and deepening of economic and political reforms to create an environment conducive for both domestic and foreign private sector participation. With respect to the ‘abnormal’ component of capital flight, SSA governments should provide policy incentives towards attracting these resources. One such incentive is to declare an amnesty for such capital to return to the continent. For example, a period of say six months could be declared an amnesty period so that those who reverse their ‘abnormal’ flight capital within such a period would be spared punishment and/or given tax incentives on such capital. There is some conflict of interest, but it provides a way forward on this issue.
- Migrant remittances can undoubtedly play a crucial role in many SSA countries, but at present these remittance flows are largely directed to meeting the consumption needs of family members left behind rather than channeled towards directly productive investment activities. Also, the bulk of these remittances occur via

⁴ See Boyce, J.K. (1992). “The Revolving Door? External Debt and Capital Flight: A Philippine Case Study,” *World Development*, 20(3), 335-349.

informal channels thereby escaping the register books of the treasury. Attempts should be made by policy makers to recognise the importance of remittances by mainstreaming remittances in national development strategies through provision of less costly and hassle free methods of transmission. Efforts should also be made to encourage both remitters and recipients on the value-adding nature of their remittances through a number of initiatives, including micro-finance, small and medium sized enterprise projects, special and differential interest rate (or rate of return) on remittance deposits (or investment). It should be noted, however, that the success of these initiatives depends yet again on the existence of favorable macroeconomic and political environment. Hence the need for deepening reforms, especially on economic and political governance to allay the fears that remitters currently express about widespread problems associated with 'principal-agent' relationships in SSA.

- The recent G8 Gleneagles declaration on African aid, trade and debt issues, particularly the proposed 100 per cent debt cancellation of low income countries that have reached their HIPC (Heavily Indebted Poor Countries) completion point and the doubling of overseas development assistance, is a welcome idea. But African policy makers must focus more attention on addressing supply constraints that inhibit the growth of inter- and intra-African trade. In this regard, efforts should be made towards accelerating and diversifying exports, increasing the value-added content of Africa's exports, reducing the wide ranging trade barriers that militate against the emergence of real regional integration in Africa, strengthening the financial market to facilitate trade and monetary transactions and building a sustainable capacity to negotiate effectively in the international trading system. All these measures will contribute to improving the business environment for Africa to attract more remittances and direct them to more productive uses.

The Role of External Debt in Current Account Sustainability in Uganda, 1993/1994 – 2004/2005

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In the last decade a number of African economies have embraced market based pricing and allocation of resources, albeit in varying degrees. This has reduced macroeconomic imbalances and economic distortions and led to improved macroeconomic performance manifested in higher growth rates; lower inflation rates; increased foreign exchange reserves; and higher per capita income.

These improvements have been accompanied by increased inflows of aid as well as private capital. In some countries, however, these inflows have affected exchange rates causing problems for macroeconomic management while in others the aid was poorly managed given the poor systems of governance that promoted inefficient utilization of external resources. Indeed poor management of resources plunged most African countries into unsustainable current accounts and debt problems. It is therefore important to investigate the source of persistence of current account imbalances in African countries.

Identifying unsustainable current account balances is important in building institutional arrangements that can help an economy avoid macroeconomic problems. Countries that have suffered balance of payment or financial crises carried large imbalances e.g. Mexico (1994), the East Asian crisis (1998), Turkey (2001), and Argentina (2002). Leading indicators that can signal potential economic crises are summarised in Kaminsky et al⁵ and are derived from the capital account, the debt profile and current account variables. These indicators include:

- Capital account indicators including international reserves, foreign direct investment, and the differential between domestic and foreign interest rates.
- Debt profile indicators such as public foreign debt, total foreign debt, short-term debt, share of debt classified by type of creditor and by interest structure, debt service and foreign aid.
- Indicators relating to foreign debt to GDP ratio, the total debt or debt service to export ratios. A current account deficit in excess of 5 per cent of GDP should be closely watched.
- The real exchange rate, the current account balance, the trade balance, volume of exports relative to imports, the terms of trade, the price of exports, savings and investment.
- Fiscal variables such as the fiscal deficit, government consumption and credit to the public sector.

⁵ See Kaminsky, G, S. Lizondo and C. Reinhart (1997) "Leading indicators of currency crises". IMF Working Paper 79. July.

A wide array of variables is therefore important in the development and monitoring of early warning indicators for external sustainability. In line with these early warning indicators approach, this paper assesses the sustainability of Uganda's external debt and current account position with a view to deriving general policy implications for other African countries at a similar level of development. To do this, the evolution of the debt-to-export ratio, external debt, exports, imports, and interest payments within a framework of a dynamic debt model is assessed. Overall, the findings indicate unsustainable current account and foreign debt position. The attainment of sustainability has not been possible in Uganda due to two related parameters. First, because of the high level of debt stock accumulated in the past. Second, because import values are more than double those of exports. The results suggest that debt sustainability analysis remains a critical issue in Uganda.

Policies to enhance external debt and current account sustainability in Africa must include the following:

- The formation of a holistic debt strategy and sound debt sustainability analysis with improved mechanisms for data collection and analysis covering public as well as private debt stocks, disbursements and repayments.
- Need for regular analysis of the entire debt portfolio and for assessing both current account and debt sustainability and their implications for growth and competitiveness.
- Increased grants financing for debt distressed countries and countries with a potential to become debt distressed. Although more concessional resources are required to support Africa's development, access to concessional resources may not lead to sustainable debt levels.
- The establishment of special financing packages for Africa to attain multiple objectives and appropriately hedge against shocks. Creditors, including the World Bank and the IMF, have responsibilities in packaging finance for Africa that does not only take account of problems of debt sustainability but also provides critical support to engender growth in the continent.
- Increasing capacity to trade: Export promotion and diversification to reduce shocks, lower domestic resource costs, improve infrastructure and public services and enhance productivity of investment.
- Prudent macroeconomic management and consistency in monetary and fiscal policy. Prudent fiscal management makes external debt dynamics more manageable
- Attract long term flows (FTL) through improved business environment and investment climate.
- Promote policies to deal with external debt as a regional problem. This will help African countries to establish a common position on debt issues and improve country risk rating through regional integration.
- Financial reform and strengthened banking systems and capital markets could play an important role in attracting and managing capital flows to ensure current account sustainability and reduce vulnerabilities.

Capital Flows and Current Account Sustainability: The Ghanaian Experience

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The current account in Ghana has persistently been in a deficit since early 1975 (with the exception of 2003 where a surplus of 2.89 per cent of GDP was recorded), but with significant variation over the period. The average deficit for the period 1975 to 2004 was about 3.4 per cent of GDP with a peak of 12.5 per cent in 1999. This has consistently created a financing gap, which has traditionally been filled by capital inflows. While these significant capital inflows coupled with increasing remittances have been very crucial to the current stability of the economy, there has been a growing concern as to the sustainability of these inflows and Ghana's current account position.

Analysis of the size and trend of current account balance is important, as it could assist in predicting threats to macroeconomic stability. For instance, a persistent current account deficit could imply an excess of investment demand over national savings with the dangerous consequences of debt accumulation.

The paper used an Inter-temporal Benchmark Model⁶, an accounting approach as well as other institutional indicators of sustainability to determine current account sustainability in Ghana. The inter-temporal model is used to forecast the optimal time path of current account balances and that is compared with the actual balances to assess whether there are significant deviations and whether these deviations are systemic. The accounting approach⁷ to current account sustainability focuses on debt ratios' analyses. In this framework, a sustainable current account is defined as the one that does not generate excessive increases in the debt to GDP ratio. This is drawn from the general understanding that external indebtedness evolves from the trade balance as well as interest payments. A current account deficit in excess of 5 per cent of GDP should be seen as unsustainable.⁸

The following are the key findings for Ghana based on application of the above criteria of current account sustainability:

- Based on the inter-temporal model, for most of the period up to 2000, the actual current account was in excess of the optimal current account and this resulted in persistent deficits. This trend was however reversed for a greater part after 2000

⁶ See Obstfeld, M and K. Rogoff (1995) "The Intertemporal Approach to Current Account". *The Handbook of International Economics*, Volume III.

⁷ Hudson, S and R. Stennett (2003) "Current Account Sustainability in Jamaica" *Bank of Jamaica Working Paper*, WP 02/11.

⁸ Summers, L (1996) "Commenting," Ricardo Hausman and Liliana Rojas-Suarez (eds.) "Volatile Capital Flows". IDB, p.46. The World Bank.

- explained largely by effective policies, HIPC debt relief and considerable increases in net transfers of which remittances form a greater part.
- According to the accounting approach, the current account is sustainable if trade can generate surpluses sufficient to offset the growth in the debt stock as a result of high interest rate/GDP growth differential. Based on this approach, the current account balance has persistently been negative and thus contributing to the increased external debt in Ghana. However, after 2000 the negative trend has been reversing indicating a reduction in current account deficit.
 - Foreign capital inflows are very crucial in determining the sustainability of the current account deficit in Ghana. Aid inflows are pro-cyclical in nature and have been volatile. This however could be moderated by remittances, which are seen to be relatively stable and anti-cyclical. It is worth noting that over-dependence on large capital inflows have the potential of causing real exchange rate appreciation, which could cause a loss of competitiveness and further structural worsening of the trade balance.
 - The level of international reserves is another indicator of Ghana's current account deficit sustainability. An increasing level of international reserves ensures higher sustainability of the economy's liabilities more than a decreasing level of international reserves. The level of international reserves in terms of months of imports has increased in recent years reaching almost 4.0 in November 2004. This was considered close to the optimal level of 4.5 months. This improvement is not due mainly to trade gains as during this period of improvement the trade balance had rather worsened, but attributed to implicit savings from debt relief as well as remittances.
 - Deteriorating public savings have in most cases dictated the trend of current account deficits in Ghana.

In addition to it being excessively high, Ghana's current account deficit has been chiefly driven by trade deficit emanating mainly from falling exports. The trade deficit-driven current account deficit has been financed mainly by foreign capital inflows that are volatile and pro-cyclical. The paper argues that improving current account sustainability in Ghana requires a complete structural change aimed at increasing gains from trade.

The following are the key specific suggestions emanating from the analysis in this paper with regard to improving current account sustainability in Ghana:

- Ghana's current account deficit sustainability is contingent upon the sustainability of trade deficit, thus calling for complete structural change in the economy. This could be achieved through well-designed market-based initiatives to increase exports, substitute import goods with similar quality of locally produced goods, and through measures to improve international competitiveness.
- Creation and sustainability of stable economic and political environment as these are necessary ingredients for current account sustainability and better economic performance.

- Reduction in both the implicit and explicit cost of remittances into Ghana both from within and from the sending point.
- Prudent management of massive capital inflows in order not to harm the real sector as a result of real exchange rate appreciation since evidence from Ghana shows a close correlation between real exchange rate appreciation and trade deficit

Capital Flows and Current Account Sustainability: Nigeria

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This paper analyses Nigeria's current account and capital and financial account balances for the period 1970-2003. Nigeria, Africa's most populous country is the leading oil producer in Sub-Saharan Africa and a potential economic giant. A notable feature of the Nigerian economy since independence has been the recurrence of current account deficits. The analysis of Nigeria's current account and capital and financial account balances in this paper suggests that Nigeria's current account balances fluctuate between deficits and surpluses, depending on the price of crude oil, her major export product.

This sensitivity to oil prices is due to the limited diversification of the economic base. An earlier study of the size and sustainability of Nigeria's current account deficits between 1960 and 1997 showed that there were years marked by excessive current account deficits, and that current account deficits accompanied by macroeconomic instability and structural weaknesses can degenerate into an external crisis.⁹

The following conclusions can be drawn from the analysis of Nigeria's current account and capital and financial account balances:

- The current account deficits were not usually prolonged, averaging about three years before the current account swings into a surplus.
- The legacy of past levels of current account deficits was a large and rapidly growing external debt stock, rising to about USD 34-36 billion by 2005.
- Net capital inflows into Nigeria have been largely positive; however, net inflows have not been substantial as a proportion of GDP.
- Foreign direct investment has increased over time. As a proportion of GDP, it has not been substantial as it averaged only 3.4 per cent of GDP between 1970 and 1995. However, as a proportion of Gross Fixed Capital Formation, FDI inflows were more significant, averaging 22 per cent between 1970 and 1995.
- There is a growing negative balance on investment income. Profit repatriation from FDI has been very substantial as a proportion of GDP and especially as a proportion of merchandise exports.
- The balance of trade in services has been persistently negative for all the years under review, suggesting that Nigeria is a net importer of services.
- Nigeria is now benefiting from migrant workers remittances from abroad. The figures have become substantial over the years, especially since 1985, amounting to about 3 per cent of GDP in 2002 and 3.68 per cent in 2003.

⁹ See Adedeji, O.S. (2001), *The Size and Sustainability of Nigeria Current Account Deficits*, IMF Working Paper, WP/01/87, June, 2001.

In sum, Nigeria's current account deficits were fuelled by: rising investment income going to foreigners, deficits in non-oil exports, and a deficit on the balance of trade in services. Surpluses were due to rising export income from crude oil (when prices are favourable), and growing current transfers in the form of migrant workers' remittances. Nigeria's capital and financial account has recorded deficits since 1985 (except for 1994 and 1998 when surpluses were recorded), suggesting massive capital flight by domestic investors who have preferred to invest in foreign assets and by an outflow of FDI. Regression analysis of current account balances suggests that key determinants of whether Nigeria registers a deficit or surplus on her current account are the exchange rate arrangement, the domestic interest rate as well as the trade balance to export ratio.

Overall, the Balance of Payments has recorded deficits, especially since 1987. As a result, Nigeria has been drawing down her foreign reserves. However, since 2002, Nigeria has been building up her reserves, largely due to improved prices in the crude oil market. Currently, the foreign reserves stand at about USD 27 billion. Nigeria's external liabilities and debt inflows appear to have played a very significant role in the country's relatively poor overall economic performance.

These results imply that Nigeria needs to adopt policies to increase her exports and reduce her import dependence, and that key policy variables are the real exchange rate and the domestic interest rate. Overall, the analysis does not suggest that current account deficits are protracted or unsustainable in Nigeria, as they usually swing back to a surplus after a short interval (three years). What is required is effective management of resources borrowed from abroad to finance the deficits. The financial and capital markets should also be developed to boost the confidence of investors, both domestic and foreign, in the economy thereby encouraging domestic investment.

The Nigerian banking sector is relatively underdeveloped compared to some other African countries, although it has experienced tremendous growth since the liberalization of banking licensing in 1991. Banks were directed to raise their capital from N2 billion to N25 billion by December 31, 2005. Since then, banks have started to comply by exploring options such as: new capital raising programmes through the stock market, private placement, foreign equity participation, group consolidation, and outright mergers and acquisitions. Consolidation in the banking system is expected to lead to: improved capacity of local banks to finance major projects such as the oil and gas investments; raising the level of confidence in the banking system by curing the problem of financial distress; improve retaining capacity of financial capital through the promised retention of external reserve in banks, which could encourage the return flight of capital; ensure healthy competition on a level playing field and reduction in regulatory abuses and operating malpractices; increase in the value of the Naira, and lower real interest rates.

The main objective of the Debt Management Office (DMO), which was created in 2000, was to consolidate debt management functions under a single umbrella to ensure proper

coordination. The DMO centralizes and coordinates the country's debt recording and management activities, including debt service forecasts, debt service payments and advising on debt negotiations as well as new borrowing.

On 20 October 2005, Nigeria signed the agreement leading to the cancellation of Nigeria's debt to the Paris Club. As a first step towards the cancellation of USD 18 billion of Nigeria's debt under the Naples terms, Nigeria paid the first instalment of USD 6 billion in 2005 to clear its arrears. It is planned that the remaining Paris Club debt will be bought back at 24 cents on the dollar, amounting to approximately another USD 6 billion. By this agreement, Nigeria is to obtain a debt relief of about 67 per cent of her present debt of USD 34 billion. This significant debt relief would ensure long-term debt sustainability and represent an important contribution by Paris Club creditors to Nigeria's economic development. On the part of Nigeria, using its oil windfall revenues to finance an exit from debt is a more prudent use of her resources than spending it on consumption. This will help Nigeria escape her debt overhang, and in future release resources that would have been used to service her debt for investment purposes in subsequent years. The money to be saved was to be spent on critical areas such as education, health and agriculture and poverty reduction. This represents a best practice in debt management and the use of windfall revenues from export products.

In sum the following policy recommendations can be drawn from the analysis:

- Liberalization and improved regulation of the banking system can address several aspects of the balance of payments as it might reverse capital flight and attract FDI.
- In order to attract increased capital inflows, especially FDI and remittances, sound macroeconomic policies have to be in place. In addition there is a need for policies to ensure better channeling of workers' remittances.
- To reduce the volatility of export earnings, diversification of exports is essential. This can be promoted through low domestic interest rates that will encourage domestic investment.
- A favourable real exchange rate will also make exports more competitive. Thus the central bank has to play an important role in balancing inflation and interest rate goals, especially given the Dutch disease effects of oil revenues.
- The use of windfall income to build up foreign reserves and to buy back debt can help to reduce cyclical swings as the risk of inflation is reduced and more resources are freed for future investment. Thus better debt management is equally important as debt relief for Nigeria. Future borrowings have to be properly scrutinized to ensure that terms are acceptable and in the interest of the country.

Capital Flows and Current Account Sustainability in African Economies: Burkina Faso

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This study looks at Burkina Faso's current account situation in the context of developments in sustainability or viability criteria for addressing the country's current account deficit. It also deals with the choice of a foreign exchange regime, debt policy and the policy for attracting foreign capital. A current account deficit is reflective of development trends. It is either indicative of an inflow of capital for the financing of productive investments or of a potentially unsustainable imbalance between national savings, investment and foreign debt accumulation. Only if the current account deficit is a source of future economic growth and if it is related to higher private investment that it would not create problems. Otherwise the indebtedness will rise to unsustainable levels, which could ultimately lead to a depreciation of the exchange rate.

Burkina Faso's current account deficit is worsened by the structure of its foreign accounts, which are based on the export of a few primary products and import of equipment and intermediate goods. During the period 1995-2004, the balance of payments was put under considerable pressure by the sharp rise in the price of oil imports, domestic currency appreciation, continued adverse climatic conditions, and the establishment of a common external tariff. As a result, the country has recently recorded a substantial trade deficit. Export analyses show that the country is still relatively close and is therefore unable to make the most of its competitive advantages through increased marketing of its domestic products in international markets. Burkina Faso's exports fell from 10.3 per cent of GDP in 1995 to 8.9 per cent in 2004. However, the trade deficit was markedly reduced from 12.1 per cent of GDP in 2000 to 8.4 per cent in 2004.

Although, the current deficit (excluding grants) decreased from 15.2 per cent to 11.7 per cent of GDP during the period 2000-2004, it was still higher than the West African Economic and Monetary Union (UEMOA) standard of 5 per cent. Thus, the economy of Burkina Faso, unlike that of the other UEMOA countries, has been unable to benefit from the price competitiveness brought about by the 1994 devaluation of the franc CFA. For example, Mali's export rate rose from 16 per cent in 1998 to 24 per cent in 2003. This means that Burkina Faso also needs to find real sources of growth and export diversification.

Burkina Faso's terms of trade have deteriorated by an average of 10 per cent between 1995 and 2004. In principle the fixed exchange rate of the franc CFA against the Euro should bring about stability and reduced inflation rates. But it also limits the possibilities to react to external shocks. Thus the tendency of the real exchange rate to appreciate is a risk for the

competitiveness of the country, especially since the appreciation of the Euro against the dollar.

The ratio of the current debt value to export revenue is also widening, due to the increase in international interest rates, the rise in the value of the euro vis-à-vis the dollar and the fall in the international price of cotton. This means that, even with debt relief, the size of the external debt remains unsustainable. The ratio of the current net value of the debt to export is estimated at about 225.9 per cent as against the 193 per cent target. Our projections show that the decrease expected in 2007 will probably be impossible to achieve without further debt relief given that the ratio by that date would be in the region of 231.6 per cent.

Furthermore, in spite of the notably improved macroeconomic environment and the very good conditions for foreign direct investment (FDI) in the country (in terms of legal security of investment and the possibilities for repatriating profits and capital) brought about by the various reforms undertaken, the level of the FDI remains minimal. Partly FDI is restricted by the fact that Burkina Faso is a landlocked country, which means high transport costs. In addition, most state owned enterprises have been privatised by now, which had driven FDI over the past years. The low level of FDI could also be an indication that foreign investors lack long-term confidence in the country or are simply unaware of investment opportunities.

Net public and private transfers usually helped to minimize the current account deficit. Recently, increases in official transfers to Burkina Faso have assisted it to offset losses in workers' transfers, due to the conflict in Côte d'Ivoire) and improved the current account deficit, from 12.4 per cent of the GDP in 2000 to 8 per cent in 2004.

The following policy recommendations can be derived:

- In order to address the debt problem, the government needs to design strategies for obtaining more funds in the form of grants, or loans and loan guarantees with a grant element above 35 per cent.
- To increase and diversify exports political and macroeconomic stability has to be maintained along with policies to address trade limitations, domestic currency overvaluation and relatively high production costs in the country. One approach to promote exports is the establishment of the "Trade Point" that had collected 216 business opportunities in 2003. If the supply-side constraints are addressed Burkina Faso can benefit from trade preferences in the European (Cotonou Agreement) and USA (AGOA) markets.
- As the domestic market of Burkina Faso is relatively small better export opportunities in the regional and global markets could also help to attract more FDI for which the environment has already improved in recent years.

Main Policy Recommendations

Augustin Fosu

Director

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Economic Commission for Africa

The last session of the workshop was devoted exclusively to a discussion of policy recommendations. Chaired and led by Augustin Fosu, the panellists during that session were Mthuli Ncube and Louis Kasekende. There were robust and engaging discussions, including important contributions from the floor.

Workshop presentations, discussions and deliberations resulted in a number of key policy recommendations, which are summarized as follows:

- Both current account deficits and surpluses can be good or bad for current account sustainability and growth, depending on the nature of capital flows and the underlying economic conditions. If current account deficits are used for consumption smoothing rather than investment, as appears to be the case in many African countries, they are likely to add up to future debt commitments, with adverse implications for the ability of the country to sustain its current account and for its growth performance. Therefore, country-specific analysis is important for the design of measures to maximize gains and minimize risks associated with capital flows.
- The availability and quality of statistical data on external capital, debt, trade and other key economic variables have to be improved for policy makers to make timely and well-informed decisions that take account of internal as well as external factors influencing their policy options.
- Financial sector reform and development, especially the deepening of stock and bond markets, could help in mobilizing increased private resources, efficient absorption of capital flows and eventually reduce aid dependency. A reform of pension funds is crucial in achieving faster financial sector development. A reform of payment systems as undertaken in Uganda and Ghana has triggered large investments by commercial banks and helped to reduce transaction costs.
- To balance a current account deficit, capital flows that do not imply future obligations, such as FDI, grants and remittances, are preferred and should be encouraged. In addition to having relatively less impact on future repayment obligations, these types of capital flows are generally less volatile.
- The current initiatives on debt cancellation will help Highly Indebted Poor Countries (HIPC) to improve their balance of payments. But the initiative should be deepened to ensure debt sustainability in current HIPC countries and also extended to cover more heavily indebted African countries. Meanwhile, African countries need to establish a common position on debt issues to strengthen their negotiating position and adopt measures to influence the volume as well as the quality of capital flows.

- With respect to remittances, strategies to channel more of them into investment have to be developed. The opening of representations of domestic banks in the main destination countries has been effective in Morocco to channel more workers' remittances through official channels.
- As local and foreign investors, including the African Diaspora, are looking for favourable investment conditions, it is crucial to improve the macroeconomic and business environment, infrastructure and governance in order to attract increased FDI and remittances. But the portion of capital inflows that exceeds imports is likely to increase inflation and thereby influence macroeconomic stability. Furthermore there is a two-way causality between the current account position of a country and capital flows. For example, FDI is needed to balance current account deficits, but a high current account deficit is seen as a risk factor by foreign investors. In addition FDI has a potential for major future outflows in terms of interest payments, profits and dividends. These relationships have to be closely monitored when managing external flows. As risk perceptions are also crucial, country ratings should be conducted for more African countries.
- To increase the sustainability of the current account, diversification of exports is essential. This would reduce the risk generated by volatile commodity prices and improve repayment capacity. In order to achieve the competitiveness needed for diversification, the quality of both physical and social infrastructure has to be improved. Differences in human capital account for the bulk of the productivity differential between high and low income countries. Banks also play an important role in generating exports if they can provide working capital to facilitate the production and marketing of export goods.
- It is crucial for African countries to deepen regional integration. In the area of trade, regional integration could increase the division of labour and pooling of resources, which could benefit export diversification. As market size is one of the important determinants of non-resource-based FDI, regional integration could help to attract long-term investment. Regional integration could also contribute to increased investment through integration of national capital markets and improved payment systems in the continent.