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Executive Summary

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

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

3. Regarding the magnitude of financing required, the *Issues Paper* relies on estimates made by UNCTAD (2000) for achieving similar growth objectives. After making allowance for domestic savings, UNCTAD reckons that the current annual total capital inflows of \$9.5 billion will have to be doubled over the next ten years in order to raise the investment/GDP ratio to 25% while the savings/GDP ratio goes up to 24% to achieve annual growth rates of 6-8%. This assumes that the proportion of capital inflows used for real resource transfers would be around 62% with the rest going to finance various financial transactions and re-

serves. Raising the net capital inflows to \$20 billion will raise the investment ratio to 27%, which is what Malaysia used to achieve an average annual growth rate of 8% in the 1980s, Africa's desired growth rate.

4. This *Issues Paper* also argues that while it is essential to mobilise all domestic resources to reduce the resource gap this will only be feasible in the long term. Hence there is an urgent need to mobilise external resources to finance Africa's development. In order to first reduce the resource gap and then attract the required external resources, African governments should take the following measures.

5. Measures to increase domestic savings and channel it efficiently into productive investment: The savings rate in Africa is well below the rates observed in countries that have managed to make significant reductions in poverty. Over the period 1991-96 the average savings rate for all African countries was 18 percent. However, the average obscures great variability in the saving rate across the continent. For instance, the savings rate for North Africa was 20.3 percent, for G5 African countries it was 24.1 percent, for the G-14 countries it was 9.2 percent and for other SSA countries it was 5.7 percent.¹ In contrast, over the same period, a group of South East Asian countries that reduced poverty and achieved resource-based industrialisation recorded average savings rates of 31 percent.² With a large majority of the African population engaged in the agricultural sector one of the most direct methods of increasing savings is to increase household incomes because the propensity to save depends on the level of income. Sustainable increases in household incomes can be achieved by transforming the current subsistence agriculture to a market based commercial activity. Agricultural modernisation will reduce the high risks associated with rural production through improved irrigation, the adoption of appropriate technologies and high-yielding varieties.

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

¹ The G5 countries are Botswana, Mauritius, Morocco, South Africa and Tunisia. The G14 countries are Benin, Burkina Faso, Cote D'Ivoire, Gabon, Mali, Senegal, Togo, Ghana, Ethiopia, Kenya, Mauritius, Mozambique, Uganda and Zimbabwe. Other SSA is 20 Sub-Saharan African countries excluding G5 and G14.

² The South East Asian countries are Malaysia, Indonesia and Thailand.

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

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

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

10. However, a significant impediment to this strategy is a combination of protection and subsidies in the advanced countries. The

tariffs African countries face are governed by arrangements under the Generalised System of Preferences and the (soon to be renegotiated) ACP-Lomé Convention.³ As a result of these agreements Africa enjoys preferential access to European markets. However, Africa does face barriers to international markets. For instance, the United States does not grant preferences on textiles and clothing so that African countries face the full average tariff of 16.75%. The European Union does grant tariff preferences to African textiles and clothing exports under the Lomé Convention but they are subject to strict rules of origin. These strict rules allow duty free access only if at least 85% of the products value originates from a beneficiary country. This has the effect of denying effective preferences even though it exists on the books.

11. The European Union applies tariff quotas to Sub-Saharan African agricultural products covered by the Common Agricultural Policy (CAP). Tariff quotas restrict the volume of imports that receive preferential treatment so that once a country has exhausted its quota the preference it receives on the next (marginal) exports is zero. In addition primary exports (agriculture, fish etc.) face ever stricter rules of origin than manufactures under Lomé. For example, 100 percent of all materials for manufacturing fish products and processed fish must originate from ACP countries.

12. An export promoting exchange rate policy is crucial if Africa is to exploit its comparative advantage because the exchange rate plays a crucial role in providing incentives for exporting. All countries, which have successfully promoted manufactured exports, experienced real exchange rate depreciation, leading to a significant increase in the domestic relative price of tradables to nontradables. In this regard, misalignment and volatility of the real exchange rate should be avoided.

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

³ With the exception of South Africa that has negotiated a free trade agreement with the European Union.

14. Measures to Attract Additional Official Development Assistance.

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

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

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

17. Measures to Attract Foreign Direct Investment and other Private Capital Flows.

FDI is the predominant form of capital flows to low and middle income countries with insufficiently developed capital markets. FDI plays an important role in sustaining equity-financed capital investments, contributes to technology spillovers through learning-by-doing, leads to improvements in productivity and facilitates the transfer of human capital skills. Africa has to tap private foreign capital in order

to raise the productivity levels necessary for sustained increases in living standards. While FDI can immediately make up for the remaining 5% of required external funds, the objective is to make private capital flows provide 70% of external finance in the medium term and 100% in the long term. For this, countries will need to take concerted action on many fronts including improving infrastructure, strengthening banking systems, developing capital markets by accelerating the pace of privatisation and broadening the domestic investor base, developing an appropriate regulatory framework and a more liberal investment regime, introducing competitive labour market policies while creating and maintaining institutions for upgrading human capital, reforming the judiciary system and containing corruption. It is important that these are carried out in a comprehensive framework and not in a piecemeal manner.

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

19. African governments should consider channelling resources freed-up from debt relief to the private sector for job creation purposes. Future borrowing should be closely monitored to prevent a re-occurrence of the debt overhang problem.

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

through policy dialogue, and collecting macroeconomic and financial market information on countries, is supported.

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

22. **Measures to Mitigate the Impact of the HIV Epidemic on Growth:** It has now become clear that the HIV epidemic will have serious implications for Africa's rate of economic growth and consequently on its financing development requirements. Between \$2 and \$10 billion per annum is estimated to be needed to address this crisis but the current levels of official development assistance targeted towards the disease are woefully inadequate. The magnitude of the financing requirement is reflected in the fact that half the AIDS victims in the world are in East and Southern Africa, where adult sero-prevalence was 11.4 percent in 1997 and over 25 percent in two African countries.

23. The HIV disease is estimated to cost the region 1-2% of GDP annually due to demographic changes through increased mortality. For instance, changes in the demographic structure will lead to a greater dependency ratio (larger numbers of orphans) and significant shifts in the age and sex composition of the population. According to the Life-Cycle model of savings such changes in the demographic structure will have important influences on household savings behaviour. As a consequence, investment may also decrease as domestic savings fall and external sources of finance may decline unless an increase in foreign aid offsets the likely decrease in foreign direct investment. Public savings will likely suffer from an increase in the public deficit (due to increased health expenditures, eroded tax revenue bases and increased pension related costs) and private (non-household) savings may suffer from a decrease in business profits due to lower labour productivity.

24. Poverty and inequality are likely to increase, because the epidemic creates a vicious cycle. The disease reduces economic growth, which leads to increased poverty, which in turn facilitates the rapid spread of HIV/AIDS as the household's food supplies and health declines, thereby reducing resistance to opportunistic infections. In addition to reducing income and wealth in households affected by HIV/AIDS, the epidemic is likely to increase income inequality by increasing the scarcity of skilled

labour.

25. The HIV/AIDS problem is of enormous dimension and it is clear that African countries will require considerable external assistance to address it. The following are some measures that can be taken to increase the flow of resources to combat the disease. First, the estimated \$2--\$10 billion per annum that is needed to address this crisis should be made available in the form of grants and not loans. The recent United States offer of \$1 billion in annual loans to finance the purchase of anti-Aids drugs in 24 Sub-Saharan African countries has been rejected by South Africa and Namibia. Other nations in the region have voiced serious reservations about the wisdom of incurring more debt on commercial terms (7 percent) at a time when many highly indebted countries in the region are seeking debt relief. Similarly, Malawi rejected a US\$ 40 million World Bank loan aimed at slowing down the spread of the disease.

26. Second, access to cheaper generic HIV/AIDS drugs should be facilitated. The problem is that patents on pharmaceuticals last 20 years from the date of patent application. Patent protection results in prices often ten times higher than the same generic drug. Under the WTO, pharmaceutical companies have become aggressive in enforcing patent rights around the world. However, international trade law does allow relief in some cases. For example, under "compulsory licensing" a government can respond to an emergency (such as HIV/AIDS) by permitting the use of a critical patent within the country under terms set by the government. These terms may include royalty to the patent holder. Furthermore, the compulsory licensing agreement can be reviewed by the World Trade Organisation. Africa's development partners should actively support the production of cheap generic drugs through compulsory licensing or the outright disregard of patents. These actions will do much to increase the flow of resources to combat the disease.

I. Introduction

The aim of this *Issues Paper* is to review the mix of actions necessary to finance the developmental goals of Africa and to present policy options for the consideration of African Finance Ministers. This *Issues Paper* will draw the attention of African policy makers and development partners to the need to develop new approaches to finance Africa's development.

2. The main development challenge facing Africa at the dawn of the new century is how to reduce the extent and depth of poverty in the region while transforming the structure of its economies. Making poverty reduction the focus of current development initiatives is justified by the extent and depth of poverty in the region and also by the fact that such poverty slows down all manner of social and economic progress. For illustrative purposes, the discussion of poverty in this section will draw on statistics from Sub-Saharan Africa (SSA). As Table 1 shows, currently 52% of the SSA population are living below a poverty line of \$1 per person per day measured in 1995 PPP. Poverty in rural SSA was wide spread with 59% of the rural population living below the poverty line of approximately \$ 26 per month per person. The depth of rural poverty is underscored by the fact that the average expenditure of the rural poor was only \$14 per person per month.

Table 1: Poverty in Sub-Saharan Africa

	Rural	Urban	Total
Head-count Ratio (%)	58.72	43.00	51.88
Poverty Line (\$)	\$25.9	\$43.4	\$31.4
Expenditure of the Poor	\$14.2	\$26.9	\$17.6
Elasticity*: Income growth	-0.80	-0.89	-0.85
Elasticity: Gini coefficient	0.535	1.616	

Source: Ali and Thorbecke 1998a, 1998b

Expenditure of the poor is expenditure per person per month in terms of PPP 1995 US dollar.

Elasticity*: Sectoral elasticity of poverty with respect to income in terms of head-count ratio

3. Table 1 also demonstrates the responsiveness of poverty to changes in income and income distribution (Gini coefficient). In SSA, both rural and urban poverty are sensitive to income growth - one percent in-

crease in income leads to 0.8 and 0.9 percentage point reduction in poverty in rural and urban sectors respectively (in terms of head-count ratio). According to these findings, rural poverty in SSA responds more sensitively to income growth than to income distribution, while urban poverty seems to be comparatively more responsive to changes in income distribution. The evidence is quite persuasive that Africa will have to devote a significant amount of its resources to fighting such humiliating poverty in the coming years.

What will it take to Halve Poverty by 2015?

4. In this section we first review past efforts to calculate the resource requirements needed to reduce poverty in half in Africa by 2015 then we describe a more recent attempts that groups African economies according to their level of development. Reducing by half the current poverty level in 15 years will require a complete overhaul of the region's production structures, in order to achieve on a more sustained basis, growth rates that have never been associated with the region. For *per capita* consumption to rise to a minimum of \$1 per day, it is reckoned by the ECA and others that African countries should, on the average, grow at 8% per annum for the period.⁴ This high growth rate requires a much faster rate of investment than countries are used to. Indeed, it is estimated that the investment/GDP ratio will have to rise to a minimum of 25% from the current 19%. But it is unlikely that African countries can find the warranted resources to finance such investment growth from the traditional sources, i.e., domestic savings (both private and public) and foreign savings (Official Development Assistance and Private Capital Flows). This makes it essential to identify measures that can be taken to increase the flow of resources from domestic and foreign sources.

5. UNCTAD (2000) has computed various scenarios of resource requirements to put Africa on a steady 6% growth path for a ten-year period and beyond. In the various scenarios, it uses varying investment/GDP ratios (22%-25%) and an initial savings rate of 13% (rising to 18%) to determine that net official capital inflows will have to, at least, double from the current \$9.5 billion in order to achieve growth rates that will see aid inflows reduce significantly over the ten-year period until total aid becomes less than at the starting point. This assumes that the proportion of the capital inflows used for real resource

⁴ A caveat is required. The calculations of the resource requirements needed to generate growth rates that will reduce poverty are based on the Harrod-Domar model which states that growth is proportional to investment by a constant that is the reciprocal of the ICOR. The intuition behind this model is that investment is low because of low domestic savings but that foreign aid (or private capital flows, FDI) will help finance additional investment. The idea is that increasing aid financing will increase investment, which will increase growth. The model rests on two short-run links: the link between aid and investment and the link between investment and growth. Unfortunately, none of these links appears to be robust in the short-run, Easterly (1997).

transfers would be around 62% with the rest going to finance various financial transactions and reserves. Raising the net capital inflows to \$20 billion, however, will raise the investment ratio to 27%, which is what Malaysia used to achieve an average annual growth rate of 8% in the 1980s, Africa's desired growth rate. For a more detailed look at the resources required to reduce poverty in half by 2015 we categorise African economies into three groups on the basis of a composite indicator developed by (Guillaumont, Guillaumont and Varoudakis 1999). The five good African performers (G5); the group of 14 potentially emerging SSA countries (G14); and the rest of SSA countries (G18). The sample of 37 countries was selected based on data availability.

6. ***The group of five good performers in Africa (G5)*** have demonstrated the ability to adopt sustainable reforms and achieved structural diversification, and thus can cushion themselves against possible external shocks. These countries show strong positive trends in core infrastructure, high and improving levels of education attainment, international competitiveness, as well as robust financial markets. The G5 benchmark countries are Botswana, Mauritius, Morocco, South Africa, and Tunisia. While Egypt and Algeria have demonstrated episodes of good performance they did not satisfy the requirement of sustained improvement in economic performance to be categorised as one of the G5 countries.⁵

7. ***The group of 14 potentially emerging SSA countries (G14)*** these countries show the prospect of a sustainable take-off during the forecast period of 15 years. They displayed significant progress in removing macroeconomic imbalances and relative price distortions – including inflation, budget deficits, black market foreign exchange premium and real exchange rate misalignment. Compared to other SSA countries, G14 countries also exhibit a potential for financial sector development with less distortion in their financial system. The G14 also show lower political instability, which could contribute to the implementation of more sound policies over the projection period. Half of these potentially emerging countries belong to the CFA zone: Benin, Burkina Faso, Côte d'Ivoire, Gabon, Mali, Senegal, Togo and the rest are: Ghana, Ethiopia, Kenya, Mauritania, Mozambique, Uganda, Zimbabwe.

8. ***The group of 18 other SSA countries (G18)*** does not meet the criteria for sustained improvement in economic performance. In addition to the above-mentioned differences with the G14, these SSA countries have two significant differences with the emerging G14. First, the forecast for G18 countries shows a significantly lower investment than that of G14 (14.2% compared to 20.5% for the forecasting period). Second, the G14 shows more appropriate macroeconomic policies and less structural imbalances (related to trade and finance) than that of the G18

⁵ The composite indicator used to group the countries was constructed from a set of 14 variables: five macroeconomic and structural policy variables, seven variables for economic performance and two indicators of domestic and external conflicts.

SSA countries.

9. For Sub-Saharan Africa, halving poverty by the year 2015 requires a decline in poverty at an annual rate of 4.5%. Given the overall income growth elasticity of poverty (-0.85) in SSA and for a fixed income distribution, the desired per capita growth rate for SSA to reduce poverty by half is 4.5% to 4.9% per annum. The required investment for SSA to generate 7.7% total GDP growth would be about 44% of GDP.

10. Given the average domestic savings rate of 11%, the G14 SSA face a serious challenge to fill the resource gap of more than 30% of GDP to maintain required investment of 44% to halve poverty by 2015. With the current flow of official development assistance (ODA), which averaged about 14.4% of GDP, the G14 SSA confronts a residual development finance gap of 18% of GDP which needs to be covered on an annual basis if the given goal is to be achieved.

11. In contrast, North Africa is not likely to face such a serious financing problem to halve its poverty, which requires an investment of about 21% of GDP to generate a necessary growth rate for a given horizon. Given domestic savings rate of about 19% and an average ODA flow of 2%, the sub-region will be able to support its necessary growth to attain the goal.

12. With respect to financing the resource gap, the most problematic countries are the G18 SSA. This is because of their lower rate of domestic savings, higher desired growth rate to halve poverty, higher required investment rate to support the higher growth rate coupled with higher ICOR (more investment to produce one unit of output). This results in large external resource requirements and residual financing gap for these G18 countries, which already recorded the highest level of aid flows (21% of GDP). Given their current rate of savings and ODA inflows of about 7% and 21% of GDP respectively, a residual-financing gap of 16% of GDP remains to be filled.

The Importance of External Finance

13. It is important to stress the role of external finance for sustainable growth and poverty reduction. To do so it is instructive to trace the link between economic growth, poverty reduction, international trade and external finance. We start by noting that economic growth is a necessary (but not sufficient) condition for poverty reduction. But how does an economy grow? The obvious answer is that economic growth is achieved by creating wealth. How does a nation create or increase its wealth? A nation can increase its wealth by accumulating capital (both physical capital like machinery and human capital through education) that is in turn used to create more productive assets. Therefore, broadly speaking, wealth is created through a virtuous cycle of investments in people and machinery that leads to more investments.

14. However, in a closed economy (an economy that does not trade with the rest of the world), the ability of a nation to invest will depend primarily on its own level of savings. In other words, in a closed economy a nation's saving must be exactly equal to its investments. However, when a country is open (i.e. it engages in international trade) the link between domestic savings and investments is broken. Indeed, a country need no longer rely on its own level of savings. It can enjoy the surplus savings from the rest of the world by importing capital i.e. borrowing.

15. How can a country best gain access to the surplus savings of the rest of the world to augment its low domestic savings? The answer is through international trade---the exchange of domestically produced goods and services for the goods and services produced in other countries. International trade enables a country to create wealth by producing goods in which it has a comparative advantage. Trade is related to external finance because the difference between a nation's gross domestic savings and gross domestic investment is reflected in its current account--- a measure of trade in goods and services. When savings are less than investment, a nation will experience a current account deficit. A current account deficit means that more goods and services are flowing into the country than are flowing out. This difference needs to be paid for, so the current account deficit must be matched by an equivalent amount of foreign borrowing (from foreign surplus savings) or foreign investment.

16. Without international trade, a poor country with low levels of capital accumulation will not be able to create sufficient wealth to grow out of poverty. By engaging in international trade a poor country can borrow to finance its growth. Over time the exports generated by the investment from external finance will generate a trade surplus as the country exports more and better goods and services. Herein lies the importance of trade for gaining access to external finance.

17. The recent development literature has attributed Africa's slow growth in the last three decades to low levels of capital accumulation. For the reasons expounded above, this has led to greater attention being paid to the low savings rate in the region (World Bank 1994). For the entire region, gross domestic savings averaged only 14% of GDP in the 1980s, compared to 23% for Southeast Asia and 35% in the Newly Industrialised Economies of Korea, China and Singapore. By 1997, the savings rate was only 9.5% in most of Africa after falling to 6.5% in 1995. Aside from being generally low, savings rates have shown consistent decline over the last thirty years in most countries, seldom exceeding 15% of GDP. Where increases in savings rates have occurred, these have been very modest.

18. Over the years, a number of explanations have been provided for the low levels of capital accumulation and slow growth in Africa (See East-

erly and Levine 1997; Sachs and Warner 1997; Bloom and Sachs 1998; Collier and Gunning 1999, etc.). What is common to all the various explanations for slow African growth is the fact that low levels of capital accumulation is associated with limited participation in world trade. This is in turn explained by many different factors, including unsound macroeconomic policies, inward-looking trade policies, weak institutional development, poor development of market structures, geography (landlockedness), conflicts, and disease.

19. Indeed, the issue of trade within the context of recent globalisation has gained considerable significance in explaining Africa's growth and development problems, particularly since it became clear that it has been the main springboard for putting East Asia onto a steady growth path. It is a growth path that has seen East Asia increasingly attract more external financial resources for its development. Radelet and Sachs (1998) have noted that despite the recent turmoil in South-east Asian economies, the basic structure for participating in world trade that has evolved in the last three decades remains essentially sound.⁶ In Africa, on the other hand, the weak foundation of many economies is reflected in their weak international linkages. By the early 1990s, the failure to diversify export structure and attract foreign direct and portfolio investment flows had left the continent virtually ignored by the dynamic forces that swept the international trading and financial systems with the aid of advanced information and telecommunication technology. The absence of active participation in world trade has meant the loss of significant opportunities for many countries to accrue foreign exchange, essential to building up the physical capital required for increased production. There is a genuine fear that Africa will continue to be "marginalised" in the process of global integration and formation of a new international order unless concrete actions are taken to put the region at the centre of world events through trade.

20. In sum, Africa needs to develop a framework and strategy for closing its resource gap in order to achieve the objective of halving poverty in 15 years. While the closure of the resource gap requires effective action to mobilise domestic resources, there are indications that in the short-medium term considerable attention will have to be paid to mobilising external resources. But the mobilisation of external resources will depend largely on how the region positions itself in the global market.

21. This document is an attempt to summarise the most important issues relating to how African countries can best position themselves as indicated above. It first looks at how the region has fared in the use of various financing possibilities and then considers what future trends will be in the absence of any strategic effort to influence them, before

⁶ It was the form and scale of financial integration into international capital markets that triggered the currency and general economic crisis and exposed the vulnerability and fragility of their financial systems.

discussing Africa's possible future line of action with a view to influencing those trends.

II. Past and Current Sources of Finance

The reliance by African countries on external resources to finance their investments is a relatively recent phenomenon. By 1980, Gross Domestic Savings (GDS) was 23% of GDP, while Gross Domestic Investment (GDI) was 22% of GDP leaving no gap to be filled. At the time, foreign direct investment (FDI) formed only 0.7% of the region's GDP. Incidentally, the East Asia and Pacific region was investing as much as 32% of GDP and saving 30% of GDP, creating a larger gap there for external resources to fill. The gross domestic investment figure for Africa in 1980 has been the highest in the last two decades but it was made up largely of public sector investments. In other words, until the mid-1980s, Africa financed most of its investments from domestic public resources, a fact that obviously limited the magnitude of investments that could be made, and the growth of such investments.

23. The question that is raised by the above observation is whether African countries were unwilling to use external resources to raise the level of investment or whether external resources were simply not available. Was it a demand problem or a supply problem? The answer would appear to be a combination of both (Aryeetey and Nissanke 1998). On the demand side, it may be noted that from the latter part of the 1970s through the first half the 1980s, many African countries were struggling with political instability in the wake of oil price shocks that made it difficult for them to pursue coherent macroeconomic and development programmes. That certainly made it difficult to establish any credible demand for private foreign capital. The sharp drop in ODA to the region between the 1970s and 1980s provides the evidence on the supply side. The growth of ODA fell from 25.1% between 1974-80 to 13.2% between 1981-90. Indeed, very little aid was going to many African countries prior to economic reform programmes.

24. After the mid-1980s when many countries began to pursue economic reforms, the resource composition changed significantly for the region, as did the structure of demand. By 1990, GDI had fallen to 14.6% of GDP, as the average annual growth was -3.8% for 1985-90. For the rest of the 1990s, however, investments grew by an average of 3.7% annually, reaching 17% in 1998. The gradual rise in investments as savings continued its slow growth, was largely made possible by external resources in many countries.

The Challenge of Domestic Resource Mobilisation

25. As mentioned above, in many African economies, there is not enough savings being generated to facilitate the required investment. Africa has low and stagnant savings. Some of the highest savings rates in Africa may be found in Angola where the domestic savings rate averaged 28% in 1980-96, and Gabon with an average saving rate of 38% for

the same period.⁷ These are by all accounts unusual in a region where a majority of countries have domestic saving rates of under 15% of GDP and sometimes negative savings. Their high saving rates can be attributed to there being relatively small economies with large oil exports. The public sector dominates saving in these two countries.

26. Despite the economic reforms that many African countries embarked on in the last decade, there is little evidence of these having a major impact on savings and investment in these countries (World Bank 1994). Over the reform period, only a few serious reformers saw a modest improvement in their savings performance. One of the more comprehensive reformers, Ghana, had a very low average domestic saving rate of about 5% of GDP throughout the 1980s. Ghana's savings rate only rose from 4% to 7% after a decade of reforms. By 1990, only five countries, including Kenya and Zimbabwe, had saving rates above 20%. One of the characteristics of all the data on domestic saving rates is that they declined for most countries in the period 1980-96 and has not seen a revival yet. (See Elbadawi and Mwegu 1998).

27. An interesting point about the performance of savings in Africa, in contrast with savings performance in the fast growing Asian economies during the reform period, is that changes in savings rates in Africa have been largely driven by the public sector (World Bank 1994). In Asia, private savings usually drove them. Srinivasan (1993) observed about largely East Asian savings that "public sector savings, if anything, do not appear to have increased significantly in the last four decades. One has to look for an explanation in the behaviour of the private sector for the measured rise in aggregate savings rates". In contrast private saving in Africa dropped from 11.4% of disposable income in the 1970s to 7.5% in the 1980s. By the mid-1990s it was still less than 9%. Public savings performed even worse, staying at under 3% of disposable income by the mid-1990s after falling from 4.5% in the 1980s. In many of the African countries where savings rates declined, they did so because public savings declined faster. Mwegu (1997) conducted a comparative analysis of average private savings rate in 15 African countries and found evidence that savings rates were unambiguously lower than in other developing countries. The important issue for Africa is why private savings, dominated by household savings, do not rise fast enough to offset the negative trends in public savings.

28. It may be observed that a low saving rate among households does not mean African households do not have assets. A major problem is indeed the non-financialisation of assets. From a number of household surveys carried out in several countries, households show assets that are in excess of 30% of their incomes (Aryeetey and Udry 1999). In the

⁷ Note that these figures are gross domestic savings, which include both private and public savings. It is likely that these large numbers can be attributed to large government savings arising out of the considerable oil wealth of these countries.

analyses of Ghanaian data, Aryeetey and Udry (2000) find that it is only among the wealthiest 10% of rural households that financial assets begin to move with income changes. What this reveals is that, there is a certain income threshold level that has to be crossed before households can afford to hold the financial assets required for generating most investments. In other words the high level of poverty makes relying on households to provide financial resources unrealistic at this stage.

Raising Incomes and Generating Resources from External Trade

29. For many countries, the largely negative current account balance for most of the last three decades shows relatively little change in the structure and composition of both exports and imports. Most countries are still heavily dependent for export earnings on a very limited number of primary commodities, which fail to provide either a stable or growing source of revenues.

30. With an average current account balance of -3.8% of GDP for the period 1990-96 for the whole of Africa, the need for external flows has remained significant. While the export of goods and services grew by only 1.9% in 1980-90 and by 2.5% in 1990-95 for the region, this grew by 8.8% in the earlier period and by 13.5% in the latter period for SE Asia. The figures for Africa show a significant drop from the figures for the 1960s when they grew by an average of 6% per annum. A number of the SE Asian economies managed to move from being primary export producers in the 1960s and 1970s to become major exporters of manufactured goods. Indonesia, Malaysia and Thailand raised the share of manufactured exports from less than 6% in 1965 to 41%, 61% and 77% respectively in 1992. In contrast, the share of manufactured exports for African countries hardly changed-- 7% in 1965 and 8% in 1990. By 1997, this was only 9.7%.

31. What is remarkable about the poor external performance of African economies is the fact that aside from being unable to match SE Asia in the area of manufactured exports, they also lost ground with the export of primary commodities, as Africa's competitiveness in world markets decreased. The export of traditional export commodities such as cocoa, coffee, rubber, spices, tin and tropical vegetable oils declined throughout the 1970s and 1980s. This happened at the same time as Malaysia, Indonesia and Thailand raised their shares in the export markets for the same items. While the export of primary commodities has declined in value for many African countries, they continue to dominate their external trade, accounting for 83% of all exports in 1970 and 76% in 1992. Africa's overall share in world exports fell from 3.7 % in 1970 to 2% in 1998.

32. Undoubtedly, one of the critical factors responsible for the unchanging structure of Africa's trade patterns has been the lack of openness in economic policies pursued over a much longer time span.

Countries did not invest in enhancing export performance in the 1960s and 1970s when many countries followed inward-looking import-substitution policies. By not investing in infrastructure to facilitate exports, and by not developing appropriate export-enhancing policies, the competitiveness of the marginal African exports became completely eroded by the early 1980s when many countries began to undertake economic reform programmes. Unfortunately the reform programmes of the 1980s did not address all the problems confronting export diversification. These need to be addressed now.

Foreign Direct Investment

33. African countries have not been able to offset the large negative current account balances with significant growth in capital flows. In the 1980s and the early 1990s, Africa's share of foreign direct investment to developing countries was under 1% of the estimated total of around \$200 billion per annum (Collier 1994). This was despite the fact that private capital flows into the developing world grew remarkably in the 1990s.⁸ FDI to low income countries rose from \$5,732 million in 1990 to \$53,517 million in 1998, an increase of over 800%. For sub-Saharan Africa, however, FDI only rose \$834 million to \$4,394 million, i.e. at half the rate of growth to the rest of the low-income world. By 1998, FDI formed only 7% of GDI in sub-Saharan Africa and 1.3% of GDP, compared to 12.4% and 3.9% respectively in East Asia. Trends in North Africa (classified together with the Middle East) showed trends that were better than for sub-Saharan Africa.

34. A number of studies have shown that FDI usually flows to countries that are experiencing growth (UNCTAD 2000). It is, however, important to observe that significant and consistent growth does not necessarily lead to equally significant growth in FDI, as the experience of Ghana in the second half of the 1980s and early 1990s quite clearly showed. Despite the fact that Ghana's GDP growth rate was on average 5.5% for the period 1984-91, FDI only moved from 0.4% of GDP to 0.7%. To show that a long period of growth may be essential to induce limited FDI, its growth in Ghana only went up from \$15 million in 1990 to \$56 million in 1998, significant by African standards but far less than in other developing regions. A lot more needs to be done to attract FDI than simple growth, as is shown in section 4.

35. But there were some new and interesting trends in FDI flows shortly before the Asian crises. The sources of new FDI had begun to vary

⁸ There is, however, a growing view that private capital flows to Africa are much more significant than some official data from international financial institutions would suggest. FONDAD (1999). FONDAD suggests that FDI flows to Africa more than tripled in the 1990s and that the growth rate was comparable to that in SE Asia and Latin America. They note that "FDI is diversifying its source and recipient countries and sectors, largely due to innovation by non-OECD investors". The under-reporting by countries is attributed to a poor-monitoring capacity.

considerably. Whereas for most countries, the sources have traditionally been the previous colonial powers, these seemed to have changed considerably for a number of countries. Thus Malaysia became a new source of FDI to a number of African countries, including South Africa. Australian and Canadian firms also become important sources of FDI in the mining sector, just as South African firms began to move into the brewery and service sectors in many African countries. Nigeria nevertheless remains the largest recipient of FDI, but this is not diversified and is mainly restricted to the extractive sector of the economy. One lesson from the new trend is the fact that countries will have to look at many more countries than they have traditionally dealt with. What remains equally important is the need to diversify the countries of origin as well as the economic sectors in which they operate. Using FDI to access technology remains crucial in the search.

36. The perception that Africa attracts far less private capital than it deserves has been attributed to its not being “structurally able to assimilate these large flows” (Aron 1996).⁹ From the mid-1970s, monetary and fiscal policy continued to be loose, while trade and exchange controls prevented the adjustment of the exchange rate. Unlike the situation in SE Asia, the deterioration in the terms of trade coupled with high inflation ensured that the real exchange rates appreciated rapidly, forcing significant macroeconomic instability. With the deterioration in national economic management in most of Africa, aggravated balance of payments problems and fiscal deficits, the continent saw considerable capital flight instead.

Other Private Capital Flows

37. Portfolio investment in sub-Saharan Africa in 1998 amounted to \$250 million worth of bonds and \$679 million of equity. This had dropped from almost five times the amount in 1995. For North Africa (together with the Middle East) equity holdings were only marginally higher than SSA while far more bonds were available. The East Asia and Pacific region attracted \$1,870 million of bonds and \$9,007 million of equity holdings. Africa’s share of private flows to developing countries has averaged 1.6% in the last decade.

Table 2: Private Capital Flows in Selected Countries

Country	Net Private Capital Flows		Foreign Direct Investment		Portfolio Investment				Bank and Trade-Related Lending	
	\$ millions		\$ millions		Bonds \$ millions		Equity \$ mil-		\$ millions	
	1990	1998	1990	1998	1990	1998	1990	1998	1990	1998
Cote d'Ivoire	57	181	48	435	-1	-23	0	6	10	-237
Ghana	-5	42	15	56	0	0	0	15	-20	-29
Indonesia	3235	-3759	1093	-356	26	-141	312	250	1804	-3512

⁹ But Bhinda et.al (1999) believes that this is due mostly to poor information being sent to investors all the time about Africa.

Kenya	124	-57	57	11	0	0	0	4	67	-72
Korea	1056	7644	788	5415	168	1220	518	4096	-418	-3087
Malaysia	769	8295	2333	5000	-1239	-314	293	592	-617	3017
Nigeria	469	1028	588	1051	0	0	0	2	-121	-25
Senegal	42	24	57	40	0	0	0	0	-15	-16
South Africa	--	783	--	550	--	303	0	619	--	-689
Thailand	4399	7825	2444	6941	-87	-632	449	2341	1593	-826
Uganda	16	198	0	200	0	0	0	0	16	-2
Zimbabwe	85	-217	-12	76	-30	-30	0	3	127	-266

Source: World Bank (2000), World Development Indicators.

38. It is evident from Table 2 that while bonds and equity capital are very much missing in African countries they seemed to diminish further after the East Asian crises. Indeed there are indications that portfolio investments were beginning to rise in Africa up to 1996, with FONDAD (1999) suggesting that they were the fastest growing source of private capital. Africa definitely was affected in no small way by the shrinking that has followed in the emerging capital markets.

39. The serious impediments and challenges facing African financial systems can be summed up as follows: fragmentation, illiquidity, informational inefficiency, limited size and capacity, underdevelopment of human capital, inefficient regulatory schemes, excessive risk factors, dearth of risk-sharing and hedging mechanisms, legal and contract enforceability issues. The irony of the developments in global capital markets is that they are occurring at precisely the time that many African countries are attempting to develop their own capital markets. Reforms of the 1980s yielded a positive outcome in terms of growth of the number of stock markets. There are about sixteen stock markets, and they have become a basis for the commensurate introduction of Africa – based funds trading in New York and Europe. The stock markets have emerged as a real potential for integration of Africa into the global economy. However, the markets remain the smallest of any region in terms of capitalisation, except South Africa and are very illiquid (Senbet 1997).

Official Development Assistance

40. Having benefited very little from the growth of private capital flows to the developing world in general in the 1990s, Africa has continuously had to use official development assistance to make up for the shortfall in resource flows. This is in spite of the fact that, as noted earlier, aid was insignificant up to the mid-1980s. Africa is currently, on a per capita basis of \$40, the largest recipient of ODA among the developing regions of the world. In current prices, net ODA for Africa from all donors more than doubled from \$7,395 million in 1980 to \$18,155 million in 1994. That was the peak. By 1997 current net ODA flows amounted to \$14,212 million. There is every indication of decline as net ODA, which amounted to 10.7% of GNP in 1990, fell to 5% of GNP in 1997. Incidentally ODA amounted to less than 1% of GNP for East Asia and Pacific, and only 0.8% for South Asia in 1997. While aid to most of

Africa was increasing in the 1980s, it was understandably shrinking in the high-performing SE Asian economies.

41. More than half of net ODA to Africa came from the DAC donors, while multilateral donors provided a little under a half, with the small remainder coming from non-DAC donors. It is interesting that in the 1990s, Japan emerged as one of the leading bilateral donors to Africa, having taken over that role from the traditional colonial powers in many countries. One of the lessons from the application of Japanese aid in Asian development is that it is possible to use aid as an instrument for jump-starting the growth process, so long as domestic conditions are made conducive to achieving aid effectiveness. In effect, ODA can and should play a useful role in the financing of African development, but there is a need to define the exact role that such assistance will play and a development of the necessary policy and institutional environment.

42. African governments need to address problems of aid effectiveness. These have to be seen within the context of permitting long-term growth and development. At the same time, the need to reduce aid dependence has to be confronted. All of these can only be meaningfully tackled if governments have strategic frameworks for achieving the longer-term objectives, which will then inform the use of aid.

Reversing Capital Flight

43. Capital flight refers to large private capital outflows from developing countries. It is a problem inasmuch as the outflows present major macroeconomic problems for those countries. Claessens and Naude (1993) carried out estimates of capital flight for various countries that suggested that capital flight in the preceding decade had been more of a problem for some African countries than it had been for SE Asia. In 1981-91, Nigeria was the seventh largest source of flight capital in the world, with an average annual flow of over \$2800 million. The stock of capital flight at the end of 1991 for sub-Saharan Africa represented more than 85% of the region's GDP. The situation was worse only in the Middle Eastern and North African region, with the region's capital flight stock equivalent to 118% of 1991 GDP. SE Asia had a capital flight of only 15% of 1991 GDP, which was the least in the developing world. More recent figures by Ajayi (1997) placed the stock of flight capital at \$22 billion, which is more than has been estimated as required to fill the resource gap. Collier and Gunning (1997) reckon that African wealth owners have chosen to locate 37 % of their portfolio outside Africa. This share is compared to 29 % for the Middle East, 17 % for Latin America, 4 % for South Asia, and 3 % for East Asia. For individual countries, we note that Gabon, Nigeria and Uganda were included in the top-ten countries for the ratio of capital flight stock to GDP in 1991. Gabon had a stock of capital flight that was almost triple its 1991 GDP. Nigeria and Uganda had the equivalent of about 150% and 140% respectively of

their 1991 GDP staying out. Other major sources of capital flight from Africa in the 1990s have been Zambia and Sudan.

44. Ajayi (1992) indicated that trade faking was an important vehicle for capital flight in Nigeria. For the period 1970-89, he suggested that "a significant amount of under-invoicing of exports and over-invoicing of imports took place" (p.59). Exports were under-invoiced to the tune of \$8.2 billion while imports were over-invoiced by up to \$5.96 billion. Most of this was related to Nigeria's oil trade. He concluded that domestic macroeconomic policy errors were largely responsible for the capital flight. These included high inflation, exchange rate misalignment, fiscal deficit and the lack of opportunities for profitable investment in the domestic economy. There are indications, however, that criminal transfers arising from political malfeasance and corruption are also a major source capital flight in many countries, and these have to be dealt with differently through the institution of sound governance structures.

45. Some recent studies have suggested that if there were to be a reversal of capital flight, the private capital stock of most of Africa would go up by as much 64% (Collier et.al 1999). The issue that this raises is how best to achieve such reversals. There are obviously policies as well as institutional issues to be taken care of. These are discussed in section 4.

Debt Relief

46. High debt stocks and high interest rates have combined with increasingly adverse terms of trade to make debt service unmanageable for Africa since the 1980s. Despite repeated debt rescheduling facilities, the total external debt of sub-Saharan Africa rose by 278% from \$60,820 million in 1980 to \$230,132 million in 1998 (the external debt of the whole of Africa stood at \$324.7 billion in 1998). That of East Asia and the Pacific went up faster by 609% from \$94,080 million to \$667,522 million for the same period. While African debt has been smaller in magnitude and grew far slower in the last decade than that of SE Asia, difficult debt management in Africa was reflected in the higher debt burden. The present value of debt as a proportion of the exports of goods and services exceeded 200% for most African countries in the 1990s. For Malaysia this was only 33.6% in 1995 and for Thailand 77.6%. Although the debt service ratio (to exports) of 30% did not vary much across the developing regions on the whole in the 1990s, the faster growing economies of SE Asia have been better able to sustain external debt with growing earnings from exports than African economies. Also, while most of African debt (77.5%) has been long-term debt and 74% of it is public, the problem is made grave by the capitalisation of interest and principal arrears. These make almost 25% of the total external debt currently.

47. The sustainability of most of African debt has for long been one of the critical issues on the international development agenda as most countries have had to continuously deal with several intractable external debt issues. The region's debt is judged to be unsustainable, particularly in relation to the current growth requirements.

48. Africa has not seen much debt relief over the years despite a lot of rhetoric in this area. The best known of the more recent initiatives is the HIPC initiative launched in 1996.¹⁰ While the original programme was the first comprehensive debt reduction programme from the donor community for highly indebted countries that satisfied a number of policy criteria, it was received with little enthusiasm in the region in view of the perceived difficult conditions for eligibility. In a revised version that has been agreed with African leaders, the enhanced HIPC initiative is generally regarded as more flexible.¹¹ The interesting thing about the enhanced initiative is its link to the preparation and implementation of Poverty Reduction Strategy Papers in countries. While it is true that African leaders have endorsed this new initiative and the link to poverty reduction, it also remains true that its operationalization would be problematic for many countries in view of the uncertainty associated with the road to poverty reduction and the medium-to-long term nature of it. There is also a tension between quick debt relief and comprehensive country owned poverty reduction strategies.

49. But beyond the issue of operationalization, some doubt has been expressed about the ability of the enhanced HIPC initiative to provide a lasting exit from debt problems (USGAO 2000). First, it has been argued that the HIPC Initiative will not free up resources for poverty reduction unless countries continue to borrow on highly concessional terms. This is because countries previously borrowed for several reasons, including debt payments, and they will need to continue borrowing after receiving debt relief in order to meet their remaining debt payments and to increase spending on poverty reduction. Second, the projections of debt-service ratios are sensitive to the assumptions made regarding export growth. Export earnings are assumed to grow at an annual average rate of 9 percent for 20 years in four of the seven countries analysed by the GAO. This assumption may be too optimistic, since these countries rely on primary commodities such as coffee for

¹⁰ Phase one of HIPC required a 3-year record of compliance with an IMF programme that leads to a decision point. Acceptance at this stage required countries to show they were beyond debt sustainability by having a debt service ratio of 20-25% of exports and a present value of debt to export ratio of 200-250%. This entitled them to a two-thirds reduction of all external debt stock. In Phase 2, another three years of an IMF programme and an acceptance into the category was expected to lead to an 80% reduction in debt stock.

¹¹ The requirement for the present value of debt to export ratio has been reduced to 150%, while debt relief commences from decision point and the length of the interim period is based on the achievement of specific development actions.

much of their export revenues. As a result, lower export growth than projected---due to the downward trend in primary commodity prices, natural disasters or conflicts---could threaten future debt sustainability. Furthermore, there is no guarantee that debt relief that provides resources for poverty reduction will automatically lead to sustained growth.

III. Expected Developments in Current Sources of Finance

There are a number of concerns that need to be expressed about likely trends in the various sources of finance discussed. A number of studies suggest that without any dramatic change in current approaches to the financing of investments and other expenditures in Africa, the current volumes and sources will shrink even further (Geda 2000).

51. With respect to **domestic financial resources**, it may be noted that rising rates of poverty would mean that the growth of financial assets among households will be far slower than it is presently and also than is required. The situation is worsened by the fact that structural and institutional factors also play a major role in keeping households from financialising their assets. There is ample evidence that financial sector reforms of the last decade have not resulted in significant resource mobilisation in most countries. While fragmented market structures provide little incentive to financial sector borrowers to seek marginal savers and borrowers in view of relatively high transaction costs, it is unlikely that those market structures will change independent of the structures of economies. In a sense, there is a vicious circle that makes it excessively difficult to mobilise domestic resources, particularly from households. In the case of public savings, there are indications from the structure of public accounts in most countries that the nature and weight of the expenditure burden on the African State make it extremely difficult for governments to consistently achieve some savings. This is not likely to change in the absence of steady and significant growth.

52. In terms of **export revenues**, while considerable hope can be held out on account of on going attempts to diversify exports through the development of non-traditional exports, the medium-term prospects are quite mixed because of changes in the world trading system. The creation of the World Trade Organisation (WTO) in 1995 has had serious implication for EU-ACP trade. The most immediate issue is the basic incompatibility of Lomé trade provisions with WTO rules. The cornerstone of the General Agreement on Tariffs and Trade is that WTO members extend most-favoured-nations (MFN) treatment to each other, it is associated with the concept of reciprocity in which non-discrimination among trading partners is an integral part. Since Lomé gave preferential market access to some but not all developing countries, Lomé trade arrangements were incompatible with WTO rules. The challenge is to find ways to adapt Lomé so that it becomes compatible with the WTO through one of the exceptions allowed under GATT. The Cotonou Agreement between the European Union and the ACP countries is the first step in this direction. The Cotonou agreement stipulates that negotiations for a successor to the Lomé IV agreement should begin in Sep-

tember 2002. Four options have been extensively debated 1) to retain the status quo 2) to apply the generalised system of preferences 3) to introduce uniform reciprocity and 4) to introduce differentiated reciprocity. The Cotonou agreement is different from the previous Yaounde and Lomé Conventions. The term “partnership” which characterises the new agreement bears testimony to this particular feature. The main aim of the agreement is the smooth integration of the ACP countries in the world economy based on the reinforcement of regional integration.

53. Other problems with the development of exports remains what may be seen as the protectionist stance of many African economies, despite the considerable liberalisation of trade and exchange rate regimes in the last 10-15 years (O'Brien 2000). Indeed trade regimes vary extensively across Africa and the degree of openness is lower than in other regions. Thus, "at present, despite considerable reductions in trade barriers over the past decade, most African countries impose fairly high barriers through tariffs and export taxes or through managed exchange rate arrangements" (Oyejide et al. 1997, p.16). Tariff levels in Africa are some of the highest in world trade. Even though there has been significant rationalisation of tariffs and the number of tariff categories, nominal average tariffs have not declined much in Africa, averaging 40% in the 1990s, which is not much different from what they were in the 1980s.

54. But while African countries may consider the lowering of tariffs in order to fall in line with WTO regulations, it is important to point out that, it will not necessarily lead to a rapid expansion in exports. The need to develop suitable production structures for facilitating exports development suggests that financing development from this angle should be seen as a medium-term engagement rather than an immediate one.

55. Can Africa expect increased **official development assistance** in the short-term? Despite the very strong case made by UNCTAD (2000) for a doubling of aid to Africa in the short-medium term in order to generate the growth that will attract private capital flows, there is still scepticism about the willingness and capacity of the donor institutions to respond positively to that gesture immediately. On the side of willingness, frequent references to *aid fatigue* and *aid dependency syndrome* in the popular press as well as in academic documents, are used as indicators of a perceived growing unwillingness to raise aid volumes significantly in the short-medium term (Cho 2000). This is tied to the growing perception among taxpayers in the western world that their governments commit enough already to African countries and the results from these endeavours are not significant (World Bank 1999). With respect to the capacity to provide additional funds, it may be noted that the US General Accounting Office (1999) raised doubts about the capacity of both bilateral and multilateral agencies to provide debt relief if they were to continue with their already agreed programmes of assis-

tance. They show that three of the four largest multilateral creditors face financing gaps while the bilateral donors face additional budget costs that have to be funded. The suggestion that the USGAO makes is that the capacity of aid institutions to provide additional aid is limited but requires review. This is not likely to take place immediately without sustained pressure from the entire region and its partners.

56. What are the prospects for **FDI and other private capital flows** in the short-medium term? The question that needs to be asked alternatively is whether African countries can position themselves to attract private capital. The UNCTAD (2000) argument that private capital will be attracted if there is significant and consistent growth in economies obviously requires careful scrutiny. While growth may attract private capital, there are obviously many other structural and institutional requirements that need to be fulfilled. A number of studies have suggested that “Africa is too risky” (Senbet 1997). What is the nature of the risk faced by private investors? At a more fundamental level, high macroeconomic instability leads to high volatility in the financial markets. The existing evidence suggests that country risk, by implication, macroeconomic risk, is the predominant source of variation in stock returns across countries (versus industry-specific shocks). However, macroeconomic or fundamental risk is not the only risk faced by African economies. Other categories of risk include political risk as investors are concerned about risk associated with the probability of adverse changes in government policies; foreign exchange risk as local currencies face unhedged currency exchange volatility; and the risk of Afro-pessimism or Afro-contagion arising out of the images of war, famine, massive corruption, failed projects, poor governance, etc. (Aryeetey and Senbet 1999). Unfortunately, perception becomes reality in an environment characterised by grossly imperfect information. Without an elimination of the high-risk perception it will be difficult to attract private capital.

57. Are there any prospects for **reversing capital flight**? Incidentally the conditions that will attract private foreign capital are the same ones that will lead to a reversal of capital flight. The evidence from other regions, such as Latin America and East Asia, suggests that globalisation of local markets leads to large reversals of flight capital. This is because integration into the global economy increases market size, providing access to a wider trading and investment environment. The size of the market will in turn encourage foreign direct investment because firms will be able to enjoy economies of scale. Capital flight will be reversed because integration into the global economy acts as an external agency of restraint by locking in welfare improving trade reforms, sound macroeconomic policies, respect for the rule of law and good governance. Given that Africa stands within the top tier of regions in terms of flight capital stock per GDP, there is a potential for significant reversal of flight capital, if the region becomes sufficiently integrated into the

global economy, of course mindful of the broader implications of such globalisation.

58. On the development of a **new international financial architecture**, following the East Asian crises of 1997-98, a number of proposals have been made. These are pinned on strengthening the surveillance of financial markets through requirements for greater transparency and the flow of information; strengthening financial regulation and supervision; assisting countries to overcome the difficulties in the implementation of international standards and regulations through capacity-building; improving liability management on the part of borrowers; encouraging the avoidance of dogma in exchange rate determination; sharing responsibility between private creditors, the international community and debtor countries in crises resolution; and finally a number of measures for dealing with emergencies, including imposing reserve requirements on short-term capital flows, withholding taxes on such short-term inflows and expansion of country reserves. The new architecture also involves the need for greater transparency in the functions of the international financial institutions. While the new measures are generally regarded as essential for bringing sanity into the operations of financial markets and limit the occurrence of crises, it is not clear whether such measures will necessarily attract and sustain private capital. Noting that the responses of other developing regions, (i.e., Latin America and East Asia) to financial crises have varied, it is important to consider the relevance of those experiences to potential crisis solution in Africa, and how these contribute to the fashioning of a new financial architecture.

IV. Measures to Increase Resources for Development

Five basic approaches are proposed here for consideration. This is done by asking and answering the following questions:

1. How can African countries increase savings and generate significant financial resources from domestic assets in order to finance the development needs associated with halving poverty levels in fifteen years?
2. How can African countries attract additional ODA on a scale far larger than they have been used to in the last decade over the next fifteen years, and what will it take to do that?
3. How can African countries attract increasing FDI and other private capital for long term development, and what specific conditions will need to be satisfied to make that possible?
4. What will it take to improve significantly the probability of debt relief leading to increased resources for investment?
5. What form should the new international financial architecture take in order to improve the chances of African economies to benefit from international capital flows while reducing the risk of crises?

Measures to Increase Domestic Savings and Channel it Efficiently into Productive Investment

60. With a large majority of the African population engaged in the agricultural sector one of the most direct methods of increasing savings is to increase household incomes because the propensity to save depends on the level of income. Sustainable increases in household incomes can be achieved by transforming the current subsistence agriculture to a market based commercial activity. Agricultural modernisation will reduce the high risks associated with rural production through improved irrigation, the adoption of appropriate technologies and high-yielding varieties.

61. The composition of household assets reflects the return on different assets, the covariance structure of risks associated with the different assets, liquidity constraints, transaction costs, and production interactions between the different assets. Hence it is possible to draw conclusions about the financial environment within which households operate by examining the composition of their portfolios. It may be noted that the economic turmoil that has characterised many countries in the last two decades has established the role of macroeconomic phenomena, as well as unstable politics, on household asset choice (Nissanke and Aryeetey 1998). The choice is also affected by the cultural, demographic and other socio-economic characteristics of their communities. The ag-

ricultural production cycle and the risky environment within which they live create an urgent need for liquidity. The need for liquidity puts a premium on relatively liquid assets, often dictated by the seasonality of agricultural activity and the associated rural household income.

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

63. Rural lending is plagued by problems of returns to scale (small size of loans), adverse selection and moral hazard. These problems cause transaction costs to be so high that credit rationing occurs. Informal financial markets can be used to mitigate the problems of rural financial intermediation. For instance, imperfect credit markets force households to use their own savings for investment. Profitable activities often require lumpy investments making it harder for poorer households to enter such activities. Rotating Savings and Credit Associations (RO-SCA's) provide an important avenue for intermediating credit in rural environments and can be used to start or promote small businesses. However for any increases in the financial assets of rural households to benefit the overall development the larger economy, it is important that the institutional developments that take place are linked to the rest of the financial system in an integrated manner. The microfinance institutions will need to have a link with both the banking institutions and the informal institutions where they exist in order to be effective (Nissanke and Aryeetey 1998).

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

the regulatory framework because effective supervisory oversight of financial systems is indispensable for the development of sound financial systems.

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

65. One of the more promising ways of increasing household incomes and thereby increasing savings which can mitigate the resource gap in the medium term is through the rapid increase in the volumes and value of exports. This can be done through an effective approach to trade sector reform that provides a more strategic view to the reform.

66. In particular, most African countries have pursued export policies consistent with their static comparative advantage in abundant natural resources and unskilled labour. Despite this Africa has lost its share of World Trade in primary commodities primarily because of inefficient agricultural practices, weak marketing, poor infrastructure, civil conflicts and increased competition from new primary commodity producers. While urgent actions should be taken to reverse the decline in Africa's traditional exports, efforts should be taken to move into higher value-added resource based industries. African countries should be encouraged to move into higher value-added resource based industries. African countries should continue efforts to move up the ladder of comparative advantage by using industrialisation strategies based on vertical diversification into processing of primary commodities. Such an industrialisation strategy promotes exports of labour-intensive manufactured exports. Partnerships between the public sector and the private sector in the initial stages, with a gradual transfer of total ownership to the private sector in the medium term would be an effective way of jump-starting the process. This is where public participation in venture capital arrangements can be most productive.

67. However, a significant impediment to this strategy is a combination of protection and subsidies in the advanced countries. The tariffs African countries face are governed by arrangements under the Generalised System of Preferences and the (soon to be renegotiated) ACP-Lomé Convention. As a result of these agreements Africa enjoys preferential access to European markets. However, Africa does face barriers to international markets. For instance, the United States does not grant preferences on textiles and clothing so that African countries face the full average tariff of 16.75%. The European Union does grant tariff preferences to African textiles and clothing exports under the Lomé Convention but they are subject to strict rules of origin. These strict rules allow duty free access only if at least 85% of the product's value originates from a beneficiary country. This has the effect of denying *effective preferences* even though they exist on the books.

68. The European Union applies tariff quotas to Sub-Saharan African agricultural products covered by the Common Agricultural Policy (CAP). Tariff quotas restrict the volume of imports that receive

preferential treatment so that once a country has exhausted its quota the preference it receives on the next (marginal) exports is zero. In addition primary exports (agriculture, fish etc.) face ever stricter rules of origin than manufactures under Lomé. For example, 100 percent of all materials for manufacturing fish products and processed fish must originate from ACP countries.

69. While rebuilding the commodity export sector, it is important to also raise the competitiveness and technological capability of industrial firms in view of the pressing need for export diversification. It may be noted that both Singapore and Malaysia opted for FDI-led industrialisation for export growth. Singapore pursued a consistent export-oriented industrialisation strategy, based on foreign direct investment, and also upgraded the country's industrial structure and comparative advantage by encouraging foreign MNCs to invest in high value-added industries. It also invested in upgrading technical skills to meet specific skill requirements by high-skill- and technology-intensive industries (Lall 1994). Malaysia replicated this by relying heavily on foreign direct investment, consciously trying to upgrade and diversify its industrial and export structure, which shifted its comparative advantage. This is what led to the introduction of export-processing zones (EPZs) on the West Coast of Peninsular Malaysia. Bonded warehouses in Thailand enjoyed similar conditions through double tax exemption of both input and output, so long as the goods were destined for exports.

70. A temporary and strictly time-bound protection for selected industries for the 'learning by doing' period on infant industry grounds can be justified if industries are selected based on dynamically evolving comparative advantage. It may be noted that in early African experience, protections provided were neither time-bound nor performance-linked. They could not be used as an effective means to graduate infant industries from protection. Little thought was given to a strategic dynamic path of the trade regimes which should be evolved as industrialisation and economic development proceeds.

71. An export promoting exchange rate policy is crucial if Africa is to exploit its comparative advantage because the exchange rate plays a crucial role in providing incentives for exporting. All countries, which have successfully promoted manufactured exports, experienced real exchange rate depreciation, leading to a significant increase in the domestic relative price of tradables to nontradables. In this regard, misalignment and volatility of the real exchange rate should be avoided.

72. African countries should vigorously pursue regional trade arrangements because the small size of most African economies do not permit the realisation of economies of scale necessary for an economy to be competitive in the global economy. Regional integration provides access to a wider trading and investment environment, induces

backward and forward linkages, encourages foreign direct investment and promotes diversification of exports to regional and global markets. The open regionalism strategy is crucial because it acts as an external agency of restraint by locking in welfare improving trade reforms. This is important because regional integration initiatives have yielded modest results in Africa, largely due to implementation failures. In sum the integration process within Africa is essential not only to achieve international competitiveness for the continent, but also as a mechanism for diversifying risk, reducing the shocks of an uncertain global and African economic environment and reducing poverty by increasing household incomes.

Measures to Attract Additional Official Development Assistance

73. The literature on aid to Africa suggests that there have been two main constraints to an expansion in aid to the region. These are (a) doubts about the effectiveness of aid to a number of countries, and (b) 'aid fatigue' which is the perception in donor governments and countries that Africa may have a bottomless pit for drawing aid.¹² But there are studies that show that different types of aid have varying levels of effectiveness, while different donor institutions are able to make varying impacts in different types of environments. What some of these studies and experiences suggest is that greater specialisation can help improve the effectiveness of aid (Carlsson et.al. 1998). It certainly stops the current situation of many donors running over one another and makes aid co-ordination even easier. Greater effectiveness following specialisation can also help place a lid at the bottom of the pit. This in turn can justify the needed expansion in ODA flows.

74. With the increasing numbers of reforming African countries aid is crucial to sustain these reforms. Furthermore the policy environment for a more effective utilisation of aid is promising. Notwithstanding the importance of aid, African countries should undertake an orderly transition from the current high levels of ODA for financing economic and social development. Official assistance will need to play a bridging role before private investment can provide the needed resources and before public investment can be wholly financed on commercial terms. UNCTA (2000) calculates that foreign aid will provide about 95% of the new required external finance after the resource gap is reduced through trade, with the remainder drawn from the private capital flows. At the end of the 15-year period, a combination of debt relief, reforms of the current aid regime and enhanced policy environment should allow a managed transition to a mixed menu of ODA and private capital flows.

¹² See *Journal of African Economies*, Vol.8 No.4, December 1999. This is a special issue based on papers commissioned by the Economic Commission for Africa on aid effectiveness. The papers recognise the fact that the effectiveness of aid is enhanced by the prevailing policy environment as well the appropriateness of the institutional environment in which aid is applied. In an inappropriate environment additional aid is much less useful.

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

76. There is a need for Africa's external partners to take the lead in specific strategic sectors. For instance, the World Bank, African Development Bank, and the European Union could pay greater attention to the finance of regional infrastructure projects. For 1999, total IBRD loans to Sub-Saharan Africa amounted to \$5 million while IDA credits came to \$2 billion. These were spread in 16 different sectors, from agriculture to water and sanitation. Some of the largest beneficiary sectors were agriculture and transportation. This is not surprising considering the difficulty that most countries have with financing road construction. The rationale for specialising in regional infrastructure projects---roads, railways, ports---is that it will reduce the costs of doing business in Africa by facilitating cross-border trade and thus widening market access for goods and services. These regional integration initiatives will help transform the economic structure of the region.

77. Bilateral aid agencies may continue to direct a greater share of their country assistance to social sectors. A number of studies (Carlsson et.al. 1997) show that bilateral assistance in the social sectors has tended to be more effective than multilateral institution interventions. In 1998, total assistance from DAC countries to Africa amounted to \$9.5 billion. About 50% of this went into education, health and population, other social infrastructure and economic infrastructure. The rest went into production, multisector activities, debt relief, programme assistance and emergency aid. Through interaction with various civil society organisations, some bilateral organisations have had a visible impact in social sector interventions. Again many of them have had greater positive impact in some countries than in others.

Measures to Attract Foreign Direct Investment and other Private Capital Flows

78. FDI is the predominant form of capital flows to low and middle income countries with insufficiently developed capital markets. FDI plays an important role in sustaining equity-financed capital investments, contributes to technology spillovers through learning-by-doing, leads to improvements in productivity and facilitates the transfer of human

capital skills. Africa has to tap private foreign capital in order to raise the productivity levels necessary for sustained increases in living standards. While FDI can immediately make up for the remaining 5% of required external funds, the objective is to make private capital flows provide 70% of external finance in the medium term and 100% in the long term.

79. The following suggestions are about some of the conditions that should prevail in both the banking sector and capital markets in order to facilitate the opening of capital accounts. It is important to emphasise at the outset the need for capital account opening to be incremental and based on the day-to-day experience of the countries, as well as the experiences of others. It is crucial that governments seek to improve the supervision and regulation of their banking sector by considering the appropriateness of such instruments or combinations of them, including

a) Deposit Insurance: given the already shaky state of African financial institutions, it is important that any such schemes introduced are incentive compatible and do not work to actually increase risk-taking incentives of financial institutions and hence enhance financial sector instability.

b) Asset Regulation: In regulating assets they should be designed not to homogenise all banks to some common pool of risk since banks are characterised by differential investment opportunity sets (e.g., rural banks versus urban banks).

c) Capital Regulation: Capital regulation is a useful scheme in terms of reducing risk-shifting incentives. When banks' incentives are regulated through capital requirements, this gives them the freedom to pursue the activities that are unique to their investment opportunity set with the attendant risk (unlike the asset regulation discussed above). However, capital regulation has only limited effectiveness in controlling risk incentives.

d) Market-Based and Incentivized Regulation: This may include incentive features of bank management compensation to make up for the deficiencies in the regulatory schemes involving bank capital and assets. Bank regulation can be more efficient if it takes account the incentive features of compensation in pricing deposit insurance and disciplining bank risk behaviour. Market discipline may also be a way to regulate banking systems. Market-based discipline may come from globalisation. The discipline of the global market forces governments to be more open and transparent. The policy implication is fairly straightforward. Encourage entry by foreign banks into Africa as a mechanism for pressure and market discipline. This is related to the issues of bank deconcentration and privatisation.

80. In order to enhance the capacity of fledgling capital markets to attract private capital, it is important that steps are taken to address the following:

a) Public Confidence and Informational Efficiency: Public confidence is fostered by an even playing field, with strict enforcement of existing rules. There ought to be an independent judiciary strongly enforcing and protecting rights. The government's role is vital in this regard in ensuring enforceability of private contracts and accounting procedures and legal standards.

b) Efficient Capital Market Regulation: At the heart of capital market regulation is investor protection, particularly small participants in the market. Small investors need to be properly protected through strict enforcement of securities laws and regulations. African stock markets can harmonise laws and regulations toward international standards. Government regulation of securities markets should be more of an oversight function over self-regulatory agencies, such as the stock exchanges and brokerage industry.

c) Capital Market-Based Privatisation: Capital markets can be an important avenue for privatisation. Such programmes obviously contribute to the depth of the stock markets through increased supply of listed companies. Capital market-based privatisation provides an improved chance of fair pricing of the enterprises, and hence serves as an important means of de-politicising the privatisation process. In addition, privatisation through local capital markets allows for local investor participation and hence enhanced diversity of ownership of the economy's resources.

d) Regionalisation of Capital Markets: *One way to address the thinness and illiquidity of African capital markets is for the various countries to pool resources for regional co-operation and capital market development. Regionalisation of African stock markets should enhance mobilisation of both domestic and global financial resources to fund regional companies, while injecting more liquidity into the markets. The francophone example is worth looking at.*

e) Human Capital Development: Global capital markets have become highly sophisticated in recent years with the advancing information technology. They are increasingly characterised by advanced and exotic securities, including a variety of derivative securities, demanding that market participants stay abreast of recent developments in financial theory and practice. Adequately trained financial manpower should be at the centre of capital market development in Africa.

Measures to Reduce External Debt Burden

81. The enhanced HIPC initiative provides for countries to continue to borrow even as they receive debt relief in order to settle other obligations in the pursuit of poverty-reduction goals. The main issue is how to make debt relief growth enhancing in order to facilitate the achievement of sustained poverty-reduction. It is suggested that debt-relief is recognised by creditor countries as additional to new and increased ODA with a focus on enhancing and sustaining both growth and poverty-reduction explicitly. Making debt-relief pro-growth requires that relief should come early rather than later. Presently, there is a tension between the desire for quick debt relief and the requirement to produce comprehensive country-owned poverty-reduction strategies, which take quite long to prepare.

82. African governments should consider channelling resources freed-up from debt relief to the private sector for job creation purposes. Future borrowing should be closely monitored to prevent a re-occurrence of the debt overhang problems.

Measures to Create A New Financial Architecture that Addresses Africa's Problems

83. The Asian financial crisis erupted just when a number of Africa countries were beginning to embrace global capital markets and becoming serious players in the emerging markets portfolio of major financial institutions. In the aftermath, there has been a shrinking of capital flows to Africa. While the proposals for a new financial architecture seek to minimise the risks that both lenders and borrowers face and how to avoid international crises, they do not necessarily address the problem of how to attract funds into Africa¹³. Most of the international discussions about a new international financial architecture have excluded African countries¹⁴. The exclusion of African countries suggests that the smallness of Africa in relation to the global market be taken to mean that it will not be affected by major global crises, which is erroneous, as seen by the decline in private flows to the region.

84. It is not clear how problems of Africa's fragmented financial markets are obviated by the current initiatives. It is also not clear what scope there is for African countries to ensure that in a rule-based system as

¹³ In response to the world financial crises that began in Asia, finance ministers and central bank governors from selected countries commissioned three reports on strengthening the financial architecture. These focused first on enhancing transparency and accountability, second on strengthening financial systems, and third on managing international financial crises, all published in October 1998.

¹⁴ Only South Africa was invited to participate in the G-22 working group meetings that prepared reports on the new international financial architecture. Cote d'Ivoire was later invited to attend a seminar to discuss the reports.

adopted by the G-7 in 1999, the leverage that all parties have in the enforcement of rules will be even. It is important to observe that in the financial world, there has never been a foolproof way to avoid financial crisis. The obvious thing for Africa to do is to push for a system that focuses more on levelling the playing field for private capital flows while protecting the owners of the capital against avoidable risks. The *Note* discusses first what can be done about minimising risk in the light of global financial developments and then the possible role of the international financial institutions.

a) *Financial Research and Information Pooling*: Aryeetey and Senbet (1999) have suggested that the *perceived* risk in Africa may be generally larger than the *fundamental* risk (e.g., the very low price-earnings multiples and low credit ratings of African countries). This could be attributed to what they refer as the “phenomenon of Afro-contagion” by which all-African countries are dumped together in one pool. They suggest a need to build information capacity which allows for more extensive, detailed and reliable data that captures the *diversity* of Africa, along with data capturing the financial circumstance of private institutions, listed companies, and banks. Here the *timeliness* and *reliability* of financial data are crucial so as to make reliable estimates of investment risks in Africa.

b) *Risk and Crisis Control Mechanisms*: African financial systems need to have the capacity to resolve or control financial crisis in an efficient fashion. The control of financial crisis calls for speedy measures, such as:

- Restructuring of the financial sector: speedy closure of failed banks or restructuring of their balance sheets is essential. Prolonging the life of failed banks transfers private losses to taxpayers and postpones the onset of banking crisis. Moreover, in a crisis environment, banks have incentives to take even larger risks.
- Restructuring of the corporate Sector: **speedy** restructuring of failing firms in the real sector is also important. The absence of bankruptcy codes in many countries is a problem that needs to be resolved.
- Maturity Structure: It is necessary to balance the maturity of debt denominated in foreign currencies with international reserves. The sudden collapse of capital flows could be aggravated by a maturity mismatch.
- Taxes on Capital Inflows: Taxes are sometimes used to control overshooting of short-term capital inflows, as in Chile. This is controversial, however. While taxes may discourage such inflows, they are incapable of stopping bank runs. Calvo (1998) suggests complementary policies that encourage investments of capital inflows in long-term assets. Note that restrictions on capital outflows are even harder to

administer, and more importantly, they discourage investors by curtailing exit strategies.

85. In addition to the suggestions for domestic financial system reforms, Mistry (1998) has made extensive proposals for strengthening the capacity of international financial institutions, particularly regional development banks like ADB to lead the process of securities exchange reform and transformation. He proposes that regional development banks should develop co-operative partnerships with major exchanges in order to build the capacities of the local exchanges. But in all this, the flow of capital to the small markets of Africa will be facilitated only if it was recognised that “regional capital and banking markets will fulfil ... needs and purposes better, more efficiently and more cost-effectively than national markets can”.

86. With respect to the role of the international financial institutions, the following points are made (See ODC 2000):

- The need for greater transparency in the operations of the International Monetary Fund (IMF) as already endorsed by the G-7 countries in October 1999 should be followed with greater say by member countries in the policies of the institution towards financial risk-taking by financial institutions and on the bail-out of such institutions;
- The role of the IMF should include resolution of financial crisis through internationally co-ordinated schemes so as to avert global contagion (e.g., through the promotion of international bankruptcy proceedings that are currently non-existent).
- There is a need to develop principles to guide capital account liberalisation among African countries, with a focus on the sequencing of such liberalisation and measures to strengthen the financial system.
- There is a need to enhance international co-operation and collaboration on financial sector issues. It is important to define more clearly the roles of the World Bank and the IMF. The Fund should restrict itself to the three tasks of short-term liquidity lending to countries in crises, advising through policy dialogue, and collecting macroeconomic and financial market information. The Bank should handle issues of long-term structural transformation of economies and financial markets.
- The World Bank’s new facility to provide a safety net for the vulnerable in poor countries that suffer extensively from financial crisis should be enlarged and made easier to access.

87. However, it is noted that Fund-supported adjustment programs have often been flawed by a lack of attention to the incidence of poverty and by poor sequencing of reforms, notably premature financial liberalisation. These policies have caused avoidable hardships. In this respect African countries have appreciated the introduction of the Poverty Reduction and

Growth Facility (PRGF) and the opportunity for countries to develop Poverty Reduction Strategy Papers (PRSP). This new modality enhances country ownership of development programs, focuses attention on poverty reduction and encourages broad-based participation in the design and monitoring of these programs. However, some concerns have been raised about the dangers of additional conditionalities creeping into the PRSP process.

Measures to Mitigate the Impact of the HIV Epidemic on Growth

88. It has now become clear that the HIV epidemic will have serious implications for Africa's rate of economic growth and consequently on its financing development requirements. Between \$2 and \$10 billion per annum is estimated to be needed to address this crisis but the current levels of official development assistance targeted towards the disease are woefully inadequate. The magnitude of the financing requirement is reflected in the fact that half the AIDS victims in the world are in East and Southern Africa, where adult sero-prevalence was 11.4 percent in 1997 and over 25 percent in two African countries.

89. The HIV disease is estimated to cost the region 1-2% of GDP annually due to demographic changes through increased mortality. For instance, changes in the demographic structure will lead to a greater dependency ratio (larger numbers of orphans) and significant shifts in the age and sex composition of the population. According to the Life-cycle model of savings such changes in the demographic structure will have important influences on household savings behaviour. As a consequence, investment may also decrease as domestic savings fall and external saving may decline unless an increase in foreign aid offsets the likely decrease in foreign direct investment. Public saving will likely suffer from an increase the public deficit (due to increased health expenditures, eroded tax revenue bases and increased pension related costs) and private (non-household) savings may suffer from a decrease in business profits due to lower labour productivity.

90. Poverty and inequality are likely to increase because the epidemic creates a vicious cycle by reducing economic growth which leads to increased poverty which, in turn facilitates the rapid spread of HIV/AIDS as household food and health declines thereby reducing resistance to opportunistic infections. In addition to reducing income and wealth in households affected by HIV/AIDS, the epidemic is likely to increase income inequality by increasing the scarcity of skilled labour.

91. The HIV/AIDS problem is of enormous dimension and it is clear that African countries will require considerable external assistance to address it. The following are some measures that can be taken to increase the flow of resources to combat the disease. First, the estimated \$2--\$10 billion per annum that is needed to address this crisis should be made available in the form of grants and not loans. The recent United States

offer of \$1 billion in annual loans to finance the purchase of anti-Aids drugs in 24 Sub-Saharan African countries has been rejected by South Africa and Namibia. Other nations in the region have voiced serious reservations about the wisdom of incurring more debt on commercial terms (7 percent) at a time when many highly indebted countries in the region are seeking debt relief. Similarly, Malawi rejected a US \$ 40 million World Bank loan aimed at slowing down the spread of the disease.

92. Second, access to cheaper generic HIV/AIDS drugs from India and Thailand should be facilitated. Patents on pharmaceuticals last 20 years from the date of patent application and result in prices often ten times higher than the same generic drug. Under the WTO, pharmaceutical companies have become aggressive in enforcing patent rights around the world. However, international trade law does allow relief in some cases. For example, under "compulsory licensing" a government can respond to an emergency by permitting the use of a critical patent within the country under terms set by the government which usually includes royalty to the patent holder and which can be reviewed by the World Trade Organisation. These actions will do much to increase the flow of resources to combat the disease.

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