

TAKING STOCK OF SUSTAINABLE DEVELOPMENT FINANCE IN SUB-SAHARAN AFRICA*

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EXECUTIVE SUMMARY

Taking stock of long-term finance for sustainable development in Sub-Saharan Africa (SSA) involves several tasks. This paper addresses these by reviewing the broad trends in investment and savings in Africa, examining the investment-savings gap that suggests the need for external resource inflows, and identifying the key components of external resource flows to SSA. Finally, the paper discusses the impact and the effectiveness of external resource inflows and draws some policy conclusions.

The paper builds on the observation that the economic growth performance of SSA countries has been poorer than that of other developing regions. Attempts to explain this growth performance uncovered inadequate investment and low returns to investment as key contributory factors. They also suggest that long-term finance remains the key to the region's investment and growth.

The average gross domestic investment as a proportion GDP in SSA countries has been lower than the corresponding average for all developing countries. In addition, the gap in investment rates between SSA and other developing regions has widened from 6-8 percentage points in the 1960s to 10-15 percentage points in the mid-1990s. Low investment rates in SSA countries can be traced to low domestic savings, which are, in turn, explicable in terms of the region's low income, underdeveloped financial institutions and markets that constrain savings, and massive capital flight from the region. Against this background, various estimates suggest that African countries will need substantial, foreign long-term financing if they are to achieve reasonable, poverty-reducing, real GDP growth rates.

This is not new. Domestic resources were inadequate to finance even the limited investment rates that Africa achieved since the 1960s; the difference has typically been sourced externally. But while the share of SSA countries in total private capital flows to developing countries in 1977-82 was almost 9 per cent, the share had fallen to less than 2 per cent by 1990-96. In spite of this fall in relative share, however, as a percentage of gross domestic investment, the stock of FDI in the SSA countries in 1995 was 17 per cent compared to 14 per cent for Asia and 18 per cent for Latin America.

Official development assistance (ODA) flows have played a predominant role in financing development in SSA since the early 1960s. As late as 1996, ODA accounted for as much as 53 per cent of the total net external resource flows to SSA. Although total ODA to developing countries fell by 20 per cent in real terms during 1992-97, ODA flows to SSA have remained largely static in the 1990s. However, some analysts suggest that ODA flows to SSA are likely to suffer a long-term substantial decline beyond the 1990s.

The literature suggests that the heavy reliance of SSA countries on external development finance is not without some inherent disadvantages. In general, the level of ODA and per capita economic growth of recipient countries have shown no systematic relationship. Aid and growth appear to be correlated only in countries where economic management was good. In addition, large private capital flows may, through exchange rate appreciation, threaten macroeconomic stability and impair the export competitiveness of SSA countries.

In general, foreign private capital typically finances only a small fraction of total domestic investment. Hence, external resources inflows are not a substitute for domestic capital formation. The solution to the problem of low growth in SSA must be sought through policies that increase both domestic investment and savings.

I. INTRODUCTION

The economic growth performance of the countries of Sub-Saharan Africa has been poorer than that of any other region of the developing world, particularly since the mid-1970s. Africa's real GDP annual growth rate was 4.7 per cent during 1965-73. While this performance was poorer than that of East Asia (7.4 per cent) over

* Paper prepared for the Fifth Expert Group Meeting on Financial Issues of Agenda 21, Nairobi, Kenya, 1-4 December, 1999. The generous assistance of Abiodun Bankole is gratefully acknowledged.

the same period, it was better than South Asia's 3.7 per cent annual real GDP growth rate. The subsequent trajectories of growth of Africa and the other developing regions diverged quite significantly; while Africa's growth decelerated, that of other regions accelerated. In particular, Africa's average annual real GDP growth fell to 2.8 per cent during 1974-82 (a decline of almost 50 per cent when compared with the growth performance over 1965-73) and declined further to 2.2 per cent in 1983-91. A tentative recovery appears to have been under way from the mid-1990s when Africa's GDP growth rate approached 5 per cent in a couple of years. But the average annual real GDP growth over the 1992-98 period was only 3.0 per cent or a full three percentage point below South Asia's growth rate and six percentage point below that of East Asia over the same period. Translated to growth of real GDP per capita, Africa's growth performance fell from an annual average increase of 2.3 per cent in 1965-73 to -0.3 per cent during 1974-82 and -0.7 per cent in 1983-91. The tentative recovery noted above shows up in the 0.4 per cent growth rate of per capita GDP during 1992-98. The rather chronic and dramatic failure of economic growth which Africa has suffered over the last 2-3 decades has turned it into the world's lowest-income region.

A fairly large and growing literature has developed around attempts to explain this growth performance and to identify the key factors that have influenced it. In providing what is perhaps the best review of this literature, Collier and Gunning (1999) zero in on several important explanatory factors whose impact on African growth performance is mediated primarily through their negative implications for investment, particularly private investment. In their view, "cumulatively, the...variables have contributed to a capital-hostile environment that has lowered the rate of return on investment... This in turn has reduced the rate of return on private investment. Since the 1980s the private capital stock per worker has declined by 20 percent and is now only one third of that in South Asia, the next most "capital-scarce" continent. Hence, the most capital-scarce region has nevertheless had low returns on investment" (Collier and Gunning, 1999, 75).

In spite of the high-risk and other elements of Africa "capital-hostile" environment, finance remains the key to the region's investment and hence growth. As World Bank (1989) argues, savings determines the rate at which productive capacity and income can grow. In particular, long-term finance tends to be associated with higher productivity and growth (Caprio and Demirguc-Kunt, 1998). Since the typical enterprise in developing countries uses significantly less long-term finance than its counterpart in the developed countries, a policy priority for more rapid growth would be to improve the supply of long-term credit to enterprises in the developing countries. In the specific case of Africa, it is important to examine the extent to which domestic saving has financed investment, and whether the realised investment has been adequate for generating the rate of GDP growth that would be required to significantly increase the region's per capita income and alleviate its deep poverty. Both tasks are involved in taking stock of development finance in Africa.

Hence, this paper offers a brief review of broad trends in investment and savings in Africa in section II. This section pays particular attention to the decomposition of both into their public and private components. It examines the investment-savings gap and suggests that since both the historical and current investment levels are lower than what would be required to generate adequate GDP growth rates, the gap probably under-estimates the need for external resource inflows. In section III, the paper takes stock of the key components of external resource inflows. It focuses specifically on the composition and trends, their sources and regional distribution. The next section reviews the literature regarding the impact and effectiveness of some components of these external resource flows, and draws some policy conclusions. Section V concludes the paper.

II. INVESTMENT AND SAVINGS IN AFRICA

The sluggishness of the recovery of African economies, after almost two decades of adjustment, remains a source of deep concern because the low growth rates of these economies significantly and negatively impinge on the welfare of the people in the region. In understanding the factor that will substantially increase the growth rate of African economies and thereby improve welfare in the longer term, the role of investment, both in human and physical capital formation and accumulation, is central.

Recent theoretical research, typified by endogenous growth models, suggests that high investment rates can result in a permanent increase in an economy's overall growth rate (Roemer, 1986; Lucas, 1988). In particular, different variants of these models identify investment as one of the most important determinants of economic growth. In addition, there is now strong empirical evidence that capital accumulation is a fundamental cause of economic growth. In this context, evidence of development experience strongly suggests that the best performing countries in the developing world have achieved this status largely on the basis of their high rates of

investment. More specifically, as a group, the developing countries which have experienced growing per capita incomes over the last two to three decades have had investment to income ratios in the range of 20 per cent to 25 per cent. In the particular case of the East Asian countries, which have grown consistently faster over this period, their investment rates have averaged 25 per cent to 30 per cent. There is some evidence to suggest that the phenomenal economic growth performance of East Asian countries owes much more to their sustained high rates of investment than to productivity growth (Young, 1993). Based broadly on these theoretical and empirical considerations, it is argued that differences in the stocks of accumulated capital across countries are the prime determinant of corresponding differences in national incomes and their growth rates.

The average gross domestic investment (GDI) of SSA countries as a proportion of their GDP has been lower than the corresponding average for all developing countries, and especially for the East Asian countries since the 1960s. In 1965, the investment rate in SSA countries was 16 per cent compared with 22 per cent for the East Asian countries and 20 per cent for all developing countries. The investment rate in SSA countries improved to around 18 per cent in 1970, when the East Asian rate was 26 per cent while the rate for all developing countries was 23 per cent. This upward trend in investment rate was maintained until 1980; thus, the average investment rate in SSA countries moved up marginally to 20 per cent, the average for all developing countries rose to 25 per cent while that of East Asia increased to 30 per cent. Thereafter, the investment growth trajectory in SSA countries diverged as its investment fell back by 1985 to 15 per cent, a rate that was marginally below what was achieved two decades earlier.

By contrast, investment in East Asian countries maintained its upward trend so that by the beginning of the second half of the 1990s, investment rate was 35 per cent compared to an investment rate for SSA countries that was still less than 20 per cent, or below the rate first achieved around 1980. Three points are worth making with regards to the trend of aggregate investment performance in SSA countries: First, since the 1960s, aggregate investment performance has been generally poorer than that of other developing regions. Second, the region has not quite succeeded in recovering from the investment collapse suffered in the late 1970s and early 1980s. Third, since other developing regions have had a virtually uninterrupted growth of investment since the 1960s, the gap in investment rates between SSA countries and other developing regions has widened from 6-8 percentage points in the 1960s to 10-15 percentage points in the mid-1990s.

Buried in Africa's sea of poor investment growth performance are a few islands of impressive achievements. Around 1980, just before the generalised investment collapse in SSA, as many as 14 SSA countries had achieved investment rates of at least 30 per cent. Included among these were Botswana, Cape Verde, Congo, Gabon, Guinea-Bissau, Nigeria, Somalia, Sao Tome and Principe, Somalia, Togo, Kenya, Lesotho, Mauritania, Swaziland, and Seychelles. Another set of four countries — Malawi, Gambia, Liberia, and C[^]te d'Ivoire — had investment rates of between 25 and 29 per cent. By 1993, only a handful of SSA countries had achieved sufficient recovery of their investment capacities to record investment rates of at least 25 per cent. Of these, Guinea-Bissau and Mauritius achieved investment rates in the range of 25 -29 per cent; while Mozambique, Tanzania, and Lesotho recorded investment rates in excess of 35 per cent. It is important to note, however, that the impressive investment performance of four of these countries — Mozambique, Tanzania, Lesotho, and Guinea-Bissau — rests precariously on large external resource transfers. It is only in the case of Mauritius that the investment rate has strong support from a similarly impressive domestic saving rate.

The analysis so far has focused on total investment at the aggregate SSA regional level or at the individual country levels. The split of total investment into its public and private components is also important. It is worth noting to begin with that, overall, public investment rates in developing countries have been declining since early 1980s and by the mid-1990s they were down to about 6 per cent of GDP, rather steep decline from the average level of 10 per cent achieved in the late 1970s. For the 1990s, data on total investment disaggregated into its private and public components are available for only a small number of SSA countries, including Benin, Central African Republic, C[^]te d'Ivoire, Kenya, Malawi, Mauritania, Mauritius, South Africa, and Togo. The weighted-average of public investment rates for these countries declined from 7 per cent in 1990 to 5 per cent in 1995. In comparison, the weighted-average of private investment rates remained stable at around 12 per cent over the same period. This data set, despite its limited coverage, clearly confirms the major contribution of the private sector to investment spending in the SSA context.

There are three notable trends that should, perhaps, be highlighted because they suggest significant implications for future trends in African investment (Iwayemi, 1997). First, private investment increased by just over 50 per cent between 1990 and 1996. Second, private investment has become the dominant source of domestic demand in the 1990s, as the public sector share has declined. Thus, private investment averaged 65 per

cent of total domestic investment in 1996. Third, private investment growth is becoming more widespread. These three trends represent a remarkable departure from the pattern that prevailed during the previous two decades. The rise in private investment, particularly since the mid-1990s, suggests increasing confidence in the region as the macroeconomic environment is becoming more stable and government policies more credible.

One of the critical questions that motivate any serious discussion of the poor economic performance in SSA is: Why are investment rates in Africa so low? Attempts to address this question have invariably turned to an analysis of the key determinants of investment in Africa. There are two closely inter-related but separate elements to this analysis. One may, for instance, focus on the determinants of private domestic investment; but one may also zero in on the determinants of private capital inflows into SSA countries. To the extent that investors, both domestic and foreign, are motivated by broadly similar considerations, the results of both these types of analysis should be quite similar, although there may well be some specific differences that could have important policy implications. In this section, the focus is on the determinants of private domestic investment; analysis of the determinants of private capital inflows is presented in section III.

Both approaches start from the same broad conceptual framework built around four key characteristics of investment (see, for example, Severn, 1996). Both approaches regard these features as relevant for understanding the process of private investment response. First, most investments in fixed assets are, by and large, irreversible. Second, future returns on fixed capital investments are inherently uncertain. Third, economic agents typically have considerable discretion over the timing of the investment in fixed assets that they may wish to undertake. Fourth, and lastly, investors often worry about the potential loss of value of their fixed capital assets on account of several risks, including that of damage to property due to war, civil unrest, weak contractual enforcement, or sheer expropriation. In the context of this conceptual framework, the combination of these four key features in investment generates a powerful and comprehensive principle of investment decision-making. This is, economic agents who are potential investors may, and very often do, exercise their option to delay their decision to commit until the front-loading of investment returns is sufficient to compensate them for risk (perceived or real) of long-term investment. The implication of this is that investment can be expected to be sensitive to the variability (rather than levels) of prices and interest rates and to perceived risks of loss of value (Elbadawi, Ndulu and Udung'u, 1997).

This conceptual framework suggests that the main determinants of private investment can be classified into the following five broad groups: profitability of investment; macroeconomic uncertainty; external shocks and their associated risks; political, social and quality-of-institution risks, and the level and structure of public investment. Projected returns and cost of capital affect the profitability of private investment. Indicators of these include real growth of output, real interest rates and availability of credit, as well as human capital, which influence productivity, and hence return on fixed capital. Macroeconomic uncertainty captures policy-related risks that affect the variability of prices and interest rates and, hence, expected net returns on investment.

In this context, the credibility of macroeconomic policy may be perceived through at least three main indicators: inflation rate and its variability; real exchange rate variability; and sustainability of fiscal balance. These three indicators interact with an economy's degree of openness to trade and the ease of cross-border financial transfers, as moderated by foreign exchange control regulations. Risks associated with external shocks basically take the form of rate of change and volatility of external terms of trade, and/or debt overhang. Risks associated with the political and social environment and quality-of-institutions relate broadly to such concerns as civil strife, instability of governments, violation of civil liberties, the degree to which property rights are protected, corruption and other bureaucratic constraints that may increase the cost of doing business. Finally, the level and structure of public investment may impinge on private investment positively or negatively. For instance, public investment that builds up efficient infrastructure raises the productivity of private investment and hence "crowds-in" such investment. But public investment in commercial activities would compete and probably "crowd-out" private investment.

In one way or another, and in varying degrees, both the actual behaviour of government and the perceived credibility of its policy pronouncements and actions affect all five categories of private investment determinants identified above. Thus, even when specific policy reforms are initiated and implemented to address a particular deficiency in the investment environment, there could be a lag investment response due to two key phenomena. First, is the lingering negative effect of the legacy of previous bad policies; second is the spillover of bad reputation or instability in a regional or sub-regional context.

This conceptual framework offers a powerful tool for exploring what explains the sluggish private investment response in the SSA region after almost two decades of structural and policy reform. An empirical

analysis by Elbadawi, Ndulu and Udung'u (1997), based on this framework, indicates that factors related to risks (especially those emanating from the macroeconomic environment and external shocks to the political, social and institutional conditions) are the main causes behind the sluggish investment response to reforms in Africa.

Since, in general, domestic savings typically largely finance domestic investment, the trend of aggregate investment performance in the SSA region described above is very closely matched by the region's trend of aggregate domestic savings performance. Thus, gross domestic savings as a percentage of the SSA region's GDP was roughly 13 per cent in early 1960s, and rose gradually from about 15 per cent in 1970 to 18 per cent in 1980 before collapsing to about 10 per cent from the mid-1980s and began to rise again in the second half of the 1990s. It remains problematic, however, that the increasing trend of private investment could be frustrated unless a similar upward trend emerges on the side of domestic savings. The average saving rates in the SSA countries of around 16 per cent in the mid-1990s is below the region's current investment rates. It is far below the 23-25 per cent range for developing countries and it is very much below what is needed to boost the investment rates to the level required for more rapid economic recovery and sustained growth in the region.

The low savings rate in the SSA region is attributable to several factors. The region's low income is key among these. But the generally under-developed financial institutions and markets which constrain savings mobilisation are probably more important. In addition, the massive capital flight from the region, propelled by poor macroeconomic policies, as well as the unstable social and political environment, robs the region of much-needed long-term development funds. The fact that African wealth owners have chosen to shift their wealth abroad, rather than to invest in the region, provides an important reason why investment rates in the SSA countries have been so low.

Available evidence suggests that, based on domestic capital flight data between 1970s and 1990, SSA has located 37 per cent of its wealth portfolio abroad compared to 17 per cent for Latin America and 3 per cent for East Asia (Collier, 1997). If the SSA region could reduce its capital flight to the level for Asia, the region's capital stock could increase by as much as 50 per cent.

Africa's investment-savings gap has widened since the general economic collapse that began around the mid-1970s. More significantly, since the investment levels of the 1980s and 1990s are very much lower than that which would be required to generate appreciable growth rates, this "gap" may be viewed as an under-estimate of the required investment resources that cannot be financed by domestic savings. One more such "realistic" estimate of the resource gap is offered by the World Bank (1989). In estimating African financial needs in the 1990s, the World Bank study uses a two-gap model in which the difference between domestic savings and gross investment, plus obligations to repay past loans must equal the difference between imports and exports of goods and services. It is assumed that gross external capital or foreign savings finances this gap. Based on a target real GDP growth rate during the 1990s of 4-5 per cent, annual export growth of 5 per cent and a savings rate of around 20 per cent, the estimated gross foreign financing requirement for Africa was an average of \$28 billion per year during the 1991-2000 period.

III. EXTERNAL RESOURCE INFLOWS

Clearly, the historical and current savings and investment rates in the SSA region are too low to sustain the growth rates that could make a substantial impact on poverty alleviation. This leads to the question: How can such high investment rates be achieved?

In seeking an answer to this question, one might usefully examine the experience of other developing countries in this regard. This experience reveals that although most private investment is financed by domestic savings, increased access to foreign investible resources has played (and continues to play) a significant role in mobilising resources for private sector growth in developing countries. Translated into the context of the SSA region, the need to attract more private investment could reflect two important concerns: One is the wish to increase the equity/debt ratio of foreign capital, given the region's current external debt burden. The other is to acknowledge that growing aid fatigue makes continued heavy reliance on official development finance unrealistic.

The stock of external debt in the SSA region rose from about \$123 billion in 1991 to over \$195 billion in 1995. The debt service associated with this obligation currently claims almost 20 per cent of the region's savings and represents about 4 per cent of its gross domestic product (GDP). Other forms of capital inflow that would enable the SSA region to increase its investment rate without a corresponding rise in the region's debt burden would clearly be preferred. Recourse to large-scale official flows does not appear to be a realistic option however.

Aid fatigue and fiscal pressures in donor countries are making it more difficult for SSA and other developing countries to attract adequate official development finance flows. Hence, SSA countries must strive to tap as much private foreign capital as possible if they are to achieve the investment-induced productivity levels necessary for a sustained increase in living standards.

To the extent that foreign capital inflows bring badly needed foreign exchange to SSA countries and boost their investment rates, they would assist in raising their growth rates. But foreign capital inflows can take various forms, which also determine what specific benefits they bring to the host economy (Cockcroft and Riddell, 1991; Meier, 1995). When these inflows occur in the form of portfolio investment, the foreign investor simply buys a stake in an enterprise without assuming any management responsibility. In this case, the local enterprise benefits from the finance and a sharing of risks with the foreign investors. Foreign direct investment (FDI) involves more than just providing part of the equity of an enterprise; the foreign investor is also involved in the management of the enterprise. FDI provides additional benefits besides finance, particularly in terms of access to better management techniques, market links and marketing expertise as well as technology. Thus, FDI is often associated with several productivity-raising channels while also contributing, as other types of investment, in creating additional economic activity that could, in turn, raise income, employment and tax revenue. Where FDI is implemented through the entry of new firms, it can also increase competition in the host economy, assist in eliminating monopoly profits, and help to stimulate quality upgrades of goods and services produced in the host economy. To the extent that the critical ingredients of rapid economic growth such as technology, created assets, intellectual capital, and organisational competence are increasingly embedded in multinational firms, the access of developing countries to these ingredients is gained largely by attracting such firms to invest and operate in their economies.

Of particular relevance to many debt-distressed SSA countries are the special advantages of FDI over foreign loans. First, equity investment requires payment of dividends only when the enterprise earns a profit, whereas external debt has to be serviced irrespective of the state of the host economy. Second, part of the earnings from FDI is often reinvested; and third, the maturity structure of the earnings from an equity investment and payments on its financing tend to be more closely matched thus avoiding the typical liquidity problems encountered when countries borrow short-term to finance long-term investments.

As indicated above, domestic resources have clearly been inadequate to finance even the limited investment rates that the region has achieved since the 1960s. The difference has typically been sourced externally and, in doing this, the SSA region has had an experience that is, in some respects, similar to those of other developing regions.

A. Private Investment Flows

Fed by a rising trend of closer integration of national economies in a rapidly liberalising global economic environment, foreign investment has been growing in a spectacular way since the 1980s. The developing countries, as a group, have benefited from this increased flow of foreign investment. In fact since the mid-1980s, foreign private investment flows have overtaken official development finance as a source of external financing for economic expansion in the developing world (UNCTAD, 1997).

Long-term foreign capital flows take several different forms. The broad groups include foreign direct investment, portfolio equity investment, and foreign private loans. The last of these groups can be further sub-divided into commercial bank loans, bond finance, and other private loans. Both FDI and foreign portfolio investment were relatively small until the mid-1980s, since when they have grown quite rapidly.

It is easy to demonstrate the growing importance of foreign private resources to developing countries. The proportion of total external development financing accounted for by these private sources increased almost two-fold from 44 per cent in 1990 to over 85 per cent in 1996. FDI has emerged not only as the leading component of all private foreign investments financing sources but also substantially exceeds official development finance. In 1996, FDI averaged roughly 1.7 per cent of the aggregate GDP of developing countries. In the same year, FDI provided 30 per cent of the \$284.6 billion worth of external finance flows to developing countries while private debt flows accounted for 31 per cent, portfolio equity investment took 16 per cent and official development finance contributed 14 per cent (UNCTAD, 1997).

Cockcroft and Riddell (1991) show that foreign investment flows to the SSA region have gone through several phases since the 1960s. During the first phase, most SSA countries pursued “inward-oriented”

development strategies and foreign investment flows were attracted largely to protected import-substitution industries and the exploitation of natural resources. The “tariff jumping” incentive which motivated FDI flows into import-substitution industries was particularly affective in SSA countries with relatively large markets, such as Nigeria. Countries such as Mauritius also benefited from location advantages and natural resources that gave their products preferential access to export markets.

In the context of this account, a second phase of FDI flow into the SSA region is broadly associated with the commodity booms of the 1970s. These had at least three effects on FDI flow. First, escalating commodity prices increased the flows of FDI into the extractive sectors in the SSA region, especially oil and gas, and enabled such countries as Congo and Nigeria to experience sharply increased FDI flows in the 1970s.

Second, the rapidly accumulating balance-of-payments surplus generated by rising commodity prices enabled some commodity-exporters to meet their own investment needs from domestic savings and without recourse to FDI flows. As a result, a number of countries, including Kenya, Nigeria and Zambia imposed new restrictions on FDI which generated sharp declines in the level of such flows in all three countries, in spite of the abundant natural resources in Nigeria and Zambia. In the particular case of Nigeria, a significant effect of the “indigenisation” decrees of 1972 and 1977 was to reduce the proportion of the total production in the manufacturing and service sectors attributable to foreign-owned assets from 40 per cent in the mid-1970s to roughly 20 per cent a decade later. Third, the recycling of part of the accumulated balance-of-payments surplus of the commodity-exporting countries through large-scale sovereign lending by commercial banks enabled private loans to, at least temporarily, push aside FDI as a major source of external finance for development in some SSA countries.

The third phase of FDI flows to the SSA region coincides broadly with the region’s period of structural adjustment and policy reform of the 1980s and 1990s when sustained efforts began to be made to restore macroeconomic stability, to liberalise the business environment including the trade and payments arrangements, to privatise certain economic activities and to deregulate the conditions governing the entry, scope and operations of FDI. This phase has also featured the strengthening of the region’s capital markets including the establishment of several thriving stock exchanges. It seems reasonable to attribute the gradual return of foreign investors to the SSA region and the boost in foreign capital flows to the region in the 1990s to the increasing confidence in African economies associated with these institutional developments and policy reforms.

Aspects of these phases are broadly reflected in the relative position of SSA countries in the league of FDI recipients between 1970 and 1996 (UNCTAD, 1997). For instance, during the 1970-79 period, only two SSA countries ranked among the top 12 developing country recipients of FDI. These countries were Nigeria (ranked 3rd) and South Africa (ranked 7th). During the next decade (1980-89), only Nigeria (ranked 10th) made the list; during 1990-96, no SSA country was among the top 12 recipients of FDI. But, it is important to note, this ranking of FDI recipients in terms of absolute amounts is inherently biased against the low-income economies of Africa which may be too small to attract amounts of FDI that are more likely to be drawn to economies with large markets. Thus, when FDI is expressed as a proportion of each country’s GDP, SSA countries appear to do much better. In 1996 for example, a third of the top 12 FDI recipients, based on this relative ranking, are SSA countries: Angola, Tanzania, Ghana, and Mozambique were ranked first, seventh, eleventh and twelfth respectively.

A narrow focus on the comparison of absolute amounts of private capital flows across regions may also lead to the conclusion that the recent boom in these flows has bypassed the SSA region. Thus, while SSA accounted for as much as 8.9 per cent of total private capital flows to developing countries during the lending boom of 1977-82, the region’s share during 1990-96 has been less than 2 per cent. This assessment should be qualified by the following considerations. First, absolute levels of FDI flows to the SSA region grew five-fold between 1975-80 and 1990-96, compared to 4.7 times for Latin America. Second, FDI stock as a proportion of the SSA region’s aggregate GDP more than doubled over the 1985-95 period. Third, as a percentage of its GDI, FDI stock in the SSA region in 1995 was 17 per cent as compared to 14 per cent for Asia and 18 per cent for Latin America. Finally, in relation to gross fixed capital formation, Africa’s FDI flows during 1990-95 accounted for 5.4 per cent which was roughly the same for Asia, although lower than the 8.4 per cent recorded for Latin America.

This upward trend from the late 1980s has been sustained and FDI flows have grown to dominate aggregate foreign capital flows to the SSA region in the 1990s. But the legacy of the past continues to impact on this upward trend: along with Latin America, the SSA region experienced the sharpest decline in foreign private capital inflows in the wake of the debt crisis of the early 1980s. Hence, for most of the years since 1982, annual long-term foreign private capital flows have been less than half the peak of \$5.5 billion achieved in 1982.

One can classify individual SSA country recipients of FDI in various ways. For instance, according to Cockcroft and Riddell (1991), long-term FDI recipients include Botswana, Mauritius, Seychelles, Swaziland and Zambia whose net FDI flows have probably reached a plateau. Countries that have achieved relatively large increases in the 1990s include Angola, Cameroon, Gabon, Ghana, Guinea, Lesotho, Madagascar, Mozambique, Namibia, Nigeria and Zimbabwe. A large proportion of these increases has been directed to the oil and mining sectors of these economies. The SSA country that has achieved the most drastic turn-around, in terms of FDI flows, in the 1990s is Uganda—its FDI flows reached \$112 million or 2 per cent of GDP in 1996.

The classification of SSA countries in terms of the relative importance of their FDI inflows to the rest of their economies in 1996 reveals the following picture: In the single case of Angola, FDI flows accounted for more than 5 per cent of GDP. In the range of FDI flows greater than 3 per cent but less than 5 per cent of GDP fall three SSA countries, Ghana, Mozambique, and Tanzania. Countries whose FDI flows account for more than 1 per cent, but less than 3 per cent of GDP include Botswana, Cameroon, Gabon, Gambia, Guinea, Lesotho, Namibia, Nigeria, Uganda, and Zambia.

In terms of total dollar amounts, FDI flows to SSA were dominated by the following countries over the 1991-96 period; Nigeria (\$8.5 billion), Angola (\$2.2 billion), South Africa (\$1.1 billion), Ghana (\$0.9 billion), Namibia (\$0.4 billion) and Zambia (\$0.3 billion).

Compared to FDI, portfolio equity flows to SSA countries are still extremely small. The notable exception here is South Africa. Since 1994, more than 40 Africa-oriented funds have been established with a total investment size of more than \$3 billion. Starting from South Africa, the base of these funds has been expanding to cover Botswana, Côte d'Ivoire, Ghana, Kenya, Mauritius, Zambia, and Zimbabwe. Portfolio equity investment (PEI) flows to SSA countries, outside South Africa, rose dramatically from \$17 million in 1993 to \$641 million in 1994 but fell back to \$297 million a year later. The flows to South Africa experienced a more spectacular increase; from \$144 million in 1992 to \$4.6 billion in 1995, the largest such flow to any developing country that year.

PEI flows to Africa is still relatively low in comparison with other emerging markets. Since 1994, interest has been generated in this source of development finance, as African stock markets open to foreign investment. The stock markets in Africa are revitalised and rank among the top two or three best performing markets in the world in the late 1990s. For instance, Côte d'Ivoire, Kenya and Zimbabwe were the top ranking markets, respectively, in 1995 and 1996. This is because more countries in Africa are increasingly embracing and benefiting from privatisation. In 1996, a \$2.5 billion increase in revenue from the level in 1995 was generated, while foreign investors provided about 50 per cent of the privatisation revenue. Africa's stock exchanges still possess a disproportionate representation of listed private firms, though this is being altered with the rising spate of privatisation of public assets.

Loans to SSA have traditionally been bilateral or multilateral in nature. Private loans form an insignificant portion of non-concessional flows. For all countries in the SSA region, commercial bank loans remain negative or at very low levels in the 1990s. Private loans as a percentage of GDP declined from an average of 2.9 per cent in 1980 to 0.6 per cent in 1990 and to -0.2 per cent in 1995 (Bhattacharya, Montiel and Sharma, 1997). The credit worthiness ratings for African countries have also remained low, explaining the trends, while a marginal improvement in the rating in the 1990s has not bolstered lenders' confidence in the region, particularly in the presence of high political risk, weak export performance, low economic growth, and high debts.

Both sectoral and home country distributions of FDI have altered significantly. FDI has traditionally been concentrated in the primary sector, but has changed to accommodate services and manufacturing in the 1990s. Manufacturing accounted for 50 per cent of FDI stock in Nigeria in 1992, while services and the primary sector accounted for about 20 per cent and 30 per cent respectively. Also, FDI from Germany is increasingly targeting manufacturing while those from the United Kingdom and the United States are targeting services (UNCTAD, 1997). Though FDI potential exists in tourism, it is largely unutilised compared to manufacturing and services sectors.

The important sources of FDI for Africa are the European Union, Japan and the United States. These also constitute the traditional sources of FDI. France, Germany, United Kingdom and the United States accounted for 80 per cent of FDI inflows during 1982-1996. In 1992, four countries accounted for three-quarters of FDI stock in Africa (UNCTAD, 1997). Other non-traditional investor countries –Netherlands, Switzerland, Portugal and Spain – have helped to increase FDI flows into Africa by raising their share of outflows to Africa from 2 per cent

in 1982-86 to 22 per cent in 1996. South East Asian countries, for example Malaysia and Korea, are new sources of FDI to SSA.

The extent to which African countries can attract foreign capital inflows to supplement their domestic savings and enhance their investment levels depends on a number of factors. Some of these can be derived indirectly from the analysis presented above. A more systematic method for identifying these factors looks more directly at the determinants of these private flows.

The approach which focuses primarily on the determinants of private capital flows to the SSA region typically starts from the premises that long-term private capital flows from one country to another are influenced by relative rates of return at home and abroad and the relative risks associated with such investments. It also assumes that expected rates of return, risk perceptions and the climate for foreign investment are affected by certain characteristics of the host country as well as the international environment. Host country characteristics are proxied by the economy's growth rate, domestic investment rate, openness of the economy, ratio of external debt to GDP, and volatility of real effective exchange rates. The most important external factor typically recognised is international interest rates which proxies the opportunity cost of investing abroad.

An empirical analysis of private capital flows to the SSA region by Bhattacharya, Montiel and Sharma (1997), based on this framework, reveals that the host economy's output growth, gross fixed capital formation and the economy's degree of openness to trade positively and significantly affect the volume of private capital inflows. By contrast, a large external debt relative to GDP adversely affects private capital inflows. Moreover, different combinations of factors affect the two main components of private capital flows to SSA countries. While FDI is attracted to growing open economies with relatively stable real effective exchange rates, private loans appear to respond more favourably to growing economies with low levels of external debt to GDP and higher rates of domestic investment.

Countries in the SSA region seem to be considered too risky and this appears to be the most plausible factor behind the sluggish response of private domestic and foreign investment to structural and policy reforms by SSA countries. Clearly, these reforms have brought about significant changes in the economic fundamentals that should influence investment. Profitability of private investment has improved over the period 1980-94. Survey results show also that returns to FDI are very high in Africa. In particular, between 1990 and 1994, rates of return on FDI were estimated to be between 24-31 per cent; these are about 60 per cent higher than the rates of return to FDI in other developing regions. Similarly, policy reforms have substantially improved the macroeconomic environment in the SSA region. Inflation rates have declined from an average of over 10 per cent in the early 1980s to less than 8 per cent a decade later. Fiscal deficits were reduced by about 50 per cent over the same period while real exchange rate also improved significantly. However, significant policy reversals in a number of SSA countries continue to feed the uncertainties regarding whether the achievements noted above will be sustained. Developments regarding risks associated with external shocks emanating from terms of trade changes and the external debt burden are much less favourable to investment. In addition, while some progress has, no doubt, been made with respect to risks associated with Africa's political and social environment as well as the region's quality of institutions, they remain paramount in the minds of investors and appear to out-weigh the improving profitability of investment.

B. Official Development Assistance Flows

Official Development Assistance (ODA) flows have played a predominant role in financing development in many African countries since the early 1960s (Lancaster, 1999). There are several indicators of the dominance of ODA in the flow of external resources to Africa. For example, ODA accounted for about 53 per cent of the total net external resource flows to Africa estimated at \$26.1 billion in 1996. During the 1970s and 1980s, ODA flows were as high as 10 per cent of the GNP of African countries. By providing half or more of the total investment in many African countries, ODA flows financed significant proportions of the budgets of many African governments.

Lancaster (1999, 6) traces the rise and subsequent decline of net ODA flows to Africa as follows; the flows were relatively low up to the early 1970s, then grew significantly between the mid-1970s and early 1990s before starting to decline after 1993. Thus, by 1996-97, the share of ODA in the GNP of African countries had fallen to 5 per cent, from around 10 per cent earlier. In spite of these changes, African countries continue to rely on the ODA flows more heavily than other regions of the developing world. For instance, while ODA flows to Africa were as much as \$33 per capita in 1991, this was higher than the average ODA per capita of \$14 per capita

for other low-income countries. By the time that Africa's ODA receipts per capita fell to \$26 in 1996, other low-income countries received on average less than half, at \$12 per capita. Similarly, while ODA flows contributed 6.3 per cent and 5.3 per cent of African GNP in 1991 and 1996 respectively, the corresponding proportions for other low-income countries were lower, at 4.7 per cent and 3.5 per cent respectively in 1991 and 1996.

Although total ODA flows to developing countries fell by 20 per cent in real terms between 1992 and 1997 (GCA, 1999), ODA flows to African countries have remained more or less static in the second half of the 1990s. But there are analysts such as Van de Walle (1998, 22) who suggest that the decline in ODA flows to Africa since 1993 "may constitute the beginning of a long-term more substantial decline" That prediction may well reflect what happens among the key donors to Africa. In fact, there has been a lower concentration of sources of ODA flows to African countries. As Lancaster (1999, 8) reports, the five largest donors (France, the World Bank, Germany, the EU, and the US) accounted for 75 per cent of net ODA flows to Africa in 1981-82. By 1997, Japan had replaced the US in the top five sources of African ODA inflows while the new top five provided just over 50 per cent of these inflows. As ODA flows decline, the African countries that may be most directly affected are also changing. In 1981-82, the top five recipient countries included Sudan, Tanzania, Kenya, Somalia and Congo (Zaire). But by 1997, only Tanzania remains in the top five; the four newcomers include Mozambique, Uganda, Madagascar, and Ethiopia.

IV. IMPACT AND EFFECTIVENESS OF EXTERNAL DEVELOPMENT FINANCE

The primary attraction of external development finance to low-income countries is obviously its "gap-filling" role. It helps such countries to attain level of investments that are sufficiently high to generate a desirable rate of economic growth that they could not otherwise achieve, given their low level of domestic savings. When this external development finance comes in the form of FDI, there may be additional advantages that can be derived from improved managerial and technical expertise, technology transfer and enhanced access to certain marketing networks.

But heavy reliance on external development finance is not without its inherent disadvantages. There is a large and growing literature on the impact and effectiveness of different forms of external development finance. A full articulation of the issues and arguments lies outside the scope of this paper and we limit ourselves to a rather selective summary of the debate and evidence. While affirming that ODA has achieved some notable success in Africa, the literature concludes, generally, that the overall contribution of ODA to African development has been disappointing (Lancaster, 1999). Though no systematic relationship appears to have been found between the level of ODA and per capita economic growth of the recipient countries, it seems that there exists a significant and positive correlation between aid and growth in countries where economic management was good.

However, there is little relationship between changes in aid and policy reform (Burnside and Dollar, 1997). Elbadawi (1998) suggests that heavy "dependence on foreign aid could substantially impair the export competitiveness of" African countries and thus derail their export-oriented development strategies. Finally, Kasekende, Kitabire and Martin (1996) provide evidence showing that private capital inflows have had some negative effect on macroeconomic stability in a number of African countries, especially through exchange rate appreciation.

The enthusiasm with which SSA countries seek to attract capital inflows, of whatever sort, should be tempered, in addition, by several other considerations. Foreign private capital typically finances only a small fraction of total domestic investment. This implies that domestic savings almost wholly finance domestic investment: In 1995, the developing world financed an average of only 7 per cent of its total investment through FDI. Clearly, therefore, foreign investment is not—and should not be treated as—a substitute for domestic capital formation.

Empirical evidence reveals a high correlation between the share of FDI that a country is able to attract and its amount of domestic private investment (UNCTAD, 1997). Experience also suggests that non-enclave type FDI generally flows to countries that already have vibrant private sectors nurtured in a good investment climate (Bouton and Sunlinski, 1996). Taken together, these considerations would indicate that neither foreign capital inflows in general nor FDI in specific can be the solution to the problem of low growth in the SSA region. The problem derives from domestic investment, particularly its private component, which is too low. This is starkly

reflected by the fact that in 1995, only half of total investment in the SSA countries was financed by domestic savings compared to 80-100 per cent in other developing regions (UNCTAD, 1997).

V. CONCLUSIONS

In taking stock of long-term financing for sustainable development in Africa, this paper argues that the SSA region's poor economic growth performance since the mid-1970s is not unrelated to its low investment rates. In addition, it is suggested that since the region's domestic savings have been inadequate for financing even these low investment rates, it has historically relied rather heavily on external resource inflows. It is tempting, in these circumstances, to suggest that the solution to the growth problem in the SSA region is increased investment that is financed even more than in the past by inflow of foreign capital, both official and private.

The paper shows the predominant role of ODA inflows in financing Africa's development and notes the increasing importance of FDI flows as well. But both types of flows are heavily concentrated in a handful of SSA countries and, hence, may not constitute an equitable basis for sustainable development of the entire region. Furthermore, ODA flows may decline and drastically affect the SSA countries that are now heavily dependent on them. In any case, heavy dependence on external resource flows may be associated with other undesirable effects, such as macroeconomic instability and real exchange rate appreciation that could significantly impair the export competitiveness of SSA countries.

These considerations suggest that SSA countries should rely primarily on domestic savings to provide the long-term finance needed for boosting their investment and overall economic growth rates. Policies that discourage capital flight and induce African wealth-holders to invest in Africa, as well as those that stimulate domestic savings by reforming and enhancing the region's financial institutions and markets should assist in the mobilisation of domestic saving for financing the region's development. Key policies, among others, are those that provide for fully funded public and private sector pension arrangements. The experience of other developed and developing regions suggests that long-term financing for sustainable development comes largely from domestic resources. The SSA region cannot for long continue to be an exception to this general rule.

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