

ATTRACTING CAPITAL INFLOWS TO AFRICA: ESSENTIAL ELEMENTS OF A POLICY PACKAGE

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EXECUTIVE SUMMARY

While Latin American and Asian economies have been recipients of large inflows of private foreign capital in the 1990s, Africa has been largely left out of this net private flow to developing economies. As a result, Africa continues to rely primarily on ODA flows to close the domestic savings-investment gap.

Negative investor perceptions are part of the problem. Attracting private capital to the Sub-Saharan Africa (SSA) is complicated by negative investor perceptions about the region in general. There is a tendency to lump African countries together as part of a continent that carries high risks to investments and thus is unattractive to potential investors.

This paper analyses those policies that can help to promote inward foreign investment into Africa to take advantage of the surge in cross-border flows into developing countries since the 1990s, while being mindful of some of the dangers this can present. The paper recognises that not all African countries are the same: There are characteristics and historical or colonial linkages that give advantages to some countries with regard to FDI and other capital inflows.

Among the most significant impediments to inward investment is political risk (whether perceived or real) and the fact that reforms in Africa seem to take some considerable time to enhance the credibility of governments. This is often the result of several serious policy reversals in the past. Therefore, policies that promote transparency and allow for checks and balances against executive power will help to build credibility in the institutions and public offices of African countries. Institutional reform should include strengthening the judiciary, and its ability to enforce the rule of law, and providing for an independent central bank for the promotion of monetary stability. Policy credibility can also be enhanced by external mechanisms of restraint through linkages with the EEC and other trading areas. This would be pursued in conjunction with rationalising and strengthening regional trade arrangements intended to increase market size. African countries should also reduce costs of doing business in the region by improving the quality of public infrastructure, investing in people and reducing corruption. But most important is the commitment to ensuring macroeconomic stability and continued reform of the African economies. This is critical for attracting sustainable long-term foreign investment to Africa.

Africa may not currently be a major recipient of inward investment but the future promises enhanced integration into the global capital market as long as Africa can improve its investment climate.

I. INTRODUCTION

While Latin American and Asian economies have been recipients of large inflows of foreign capital in the 1990s, Africa has been largely left out of this net flow of capital to developing economies. For example, African and Middle Eastern countries received less than 10 per cent of FDI flows to developing countries (United Nations, 1999). In the case of portfolio flows, Africa has received an even lower share of net flows to developing nations — in 1996 it was 1.6 per cent. As a result, Africa continues to rely on ODA flows for the lion's share of capital inflows to close the domestic savings-investment gap.

Official flows (including grants and debt-service) to SSA have averaged approximately 5 per cent of GNP over the period 1990-95 while the average is one per cent for all developing countries. According to estimates by the Commonwealth Secretariat, total official development assistance declined for five successive years prior to 1998. In 1998 it increased by \$3.2 billion to \$51.5 billion, equivalent to 0.23 per cent of total donor country GDP. The increase in official development assistance in 1998 is mainly associated with the rescue packages for East Asia and Russia. Otherwise the projections point to a decline in 1999. As budget constraints in donor countries become more severe, these flows are expected to fall further in the medium to long-term, while in the short-term conditionalities on their utilisation become

stricter and therefore restrict the freedom of recipient countries to choose how funds are utilised. Therefore, it is essential that Africa attract a larger share of private capital flows to finance its development. This is by no means a simple task, or one that can be achieved overnight, but as a first step policy measures need to be identified which can achieve this goal. Beyond this, the task of implementing policy measures is potentially even more difficult.

Even when reforms are successfully implemented, the ability of policymakers to attract private capital to SSA countries is complicated by negative investor perceptions about the region in general. UNCTAD has the following comment on the issue: “although several countries in Africa have an investment climate that is good, a number of potential investors lump them together with other countries, and see them as part of a continent that is considered not to be attractive for transnational corporations, especially if compared with competing locations in the worldwide FDI market”. While a considerable body of literature exists for the Latin American experience with capital flows, and some for East Asia, studies focusing on Africa are virtually non-existent — exceptions include Asea and Reinhart (1995) and Kasekende and Hussain (1997). The areas examined in this literature include the scale and composition of capital flows, their implications for macroeconomic management and their causes and sustainability, among others. This paper identifies those factors that can best encourage capital inflows to Africa, with a special focus on the policy measures that should be taken by governments. The paper also highlights efficient and productive ways in which foreign inflows can be utilised in financing development and ensuring sustained improvements in well being as measured (rather crudely) by economic growth. Examples will be presented from Uganda’s recent experience in the utilisation of foreign inflows.

II. MEASURING CAPITAL INFLOWS IN SUB-SAHARAN AFRICA

There are considerable difficulties in interpreting the data on capital flows to Africa. Often there is a lack of resources for the monitoring and recording of capital flows resulting in poor data quality. Some countries have kept a hands-off approach in the new liberalised environment so as to avoid sending the wrong signal to investors because they may believe (wrongly) that the old regime of control still exists. Some capital controls remain, but these have been easily circumvented. For example, in order to avoid capital account restrictions, some transactions are mis-recorded as current transactions.

Table 1. Composition of Private Capital Inflows to Developing Countries, (per cent)

	1978-82			1990-93		
	<i>Latin America</i>	<i>Asia</i>	<i>Sub-Saharan Africa</i>	<i>Latin America</i>	<i>Asia</i>	<i>Sub-Saharan Africa</i>
FDI	15.1	15.0	9.8	33.0	37.5	140.3
Portfolio	4.9	3.6	0.0	68.1	14.2	10.9
Long-term bank loans	63.6	53.9	53.9	-32.1	21.7	-143.5
Short-term loans	16.4	27.5	36.3	30.5	27.0	92.3

Source: IMF, *International Financial Statistics*, various issues; and World Bank, *World Debt Tables*, various issues

The composition of inflows to Africa is skewed towards those types that are most difficult to measure. The outcome has been that inflows to SSA countries have been under-recorded and this has been exacerbated by the absence of recording systems. In some African countries private transfers have reached high levels, such as 9 per cent of GDP in Tanzania and 4 per cent in Uganda (Helleiner, 1998), but it has been difficult to break them down into their constituent parts. Almost certainly some part of these private transfers represents capital account flows. Kasekende and Hussain (1997) find that including private transfers in the measurement of capital flows for Kenya, Uganda, Tanzania, Zambia and Zimbabwe increases them from an average 1.1 per cent of GDP for the period 1986-1993 to 4 per cent. Indeed, the inclusion of private transfers accounts for most of the increase in capital flows to these countries over the period 1990-1993 compared to 1986-1989. It is certainly possible that the increase in recorded private transfers is in fact a recovery, at least partially, in unrecorded foreign direct investment into these Sub-Saharan African economies. In the case of Uganda, the increase in private transfers is partly explained by the return of flight capital and returning Asians (Kasekende and Hussain, 1997).

While there are certainly difficulties in identifying the constituent parts of private transfers, on the whole, Sub-Saharan Africa continues to lag behind other developing regions of the world in attracting foreign capital inflows, especially in absolute terms. World Bank estimates based on capital account and debt/equity inflows indicate that during 1990-94 inflows averaged more than \$180 billion a year. Of these, only \$16 billion a year went to SSA countries.¹

Notwithstanding the above, Africa played host to increased levels of private capital inflows in the period 1994 to 1997. In that period, private capital inflows increased by a factor slightly higher than three from \$4.8 billion to \$16.3 billion. This was mainly on account of increased levels of foreign direct investment and other net investments. In an earlier study on the subject², it was established that inflows to Africa and especially to Sub-Saharan Africa, amounted to levels, measured in relation to GDP, comparable to flows to other developing countries. Indeed, the debate on the possible causes and the challenges to macroeconomic management of increased capital inflows was being considered as part of broader policy measures to sustain growth and promote macroeconomic stability. Apart from the potential adverse impact of these inflows, the recipients of private capital were able to finance higher levels of private sector investment rates. Uganda is a clear case where levels of investments well above its savings rate are largely financed by both private and public foreign savings.

In response to the East Asian crisis, developing countries in general suffered a contraction in private sector inflows. Private inflows to developing countries declined in both 1997 and 1998 from \$212.1 billion in 1996 to \$149.1 billion in 1997 and to \$64.3 billion in 1998. The decline largely affected the Asian countries, which suffered massive reversals of inflows in both 1997 and 1998. With the exception of South Africa, Africa largely survived the negative impact of the East Asian crisis on inflows due to the limited integration of their financial markets into the global capital markets. Indeed, FDI and net portfolio flows in 1998 were recorded at levels comparable to 1996. The issue then is how does Africa prepare itself for higher levels of volatility that may be associated with a deeper integration into the international capital markets.

III. CAUSES OF CAPITAL INFLOWS

Before putting together a policy package designed to attract foreign capital it is first necessary to identify factors that can achieve this goal. The literature groups the factors that attract foreign capital into two groups: external “push factors” and domestic “pull factors”. Among the “pull” factors are:

- (a) economic and political reforms that boost confidence in the economy;
- (b) reforms such as debt restructuring which ease the long-run foreign exchange constraint and therefore enhance the sustainability of foreign exchange inflows;
- (c) liberalisation of foreign exchange flows (both current and capital) in the balance of payments;
- (d) simplification of red-tape requirements for direct and portfolio investment; and

¹ World Bank IECIF database.

² Kasekende and Hussain (1997).

- (e) liberalisation of restrictions on private sector borrowing from abroad.

Among the “push” factors are:

- (a) the relative decline in international interest rates (mostly US dollar rates) when compared to interest rates in developing economies;³
- (b) cyclical downturns in economic activity in developed economies, which reduce the demand for investment funds; and
- (c) a move towards international diversification of asset portfolios by major portfolio investors such as pension funds and insurance companies.

The literature identified both push and pull (for example: Asea and Reinhart, 1995) factors as being behind the increase in capital flows to developing economies in the 1990s. However, it is domestic or “pull” factors over which policy-makers can have a direct impact in attracting inflows of private capital.

IV. THE POLICY PACKAGE

While public investment rates in Africa are comparable to those in other developing countries, private investment rates are much lower (Collier and Gunning, 1999). In a world of mobile capital, capital should flow to those areas where returns are highest. But while returns in Africa are high in nominal terms, in risk-adjusted terms they may not be, suggesting that reducing the risk factors in Africa can help attract more foreign capital. A policy package that reduces risk factors to foreign investment should also be able to deal with many of the risk factors that result in low levels of domestic private investment.

A. Reducing Political Risk

1. Enhancing the credibility of reforms

The international image that Africa has is one of unstable governments, military coups and abrupt policy reversals. Moreover, Sub-Saharan Africa seems to be seen as one homogeneous continent and therefore the bad behaviour of few governments often leads to a negative image for all. Evidence from surveys suggests that policy reversal is regarded by investors (both domestic and foreign) as the main component of overall investment risk (Collier and Gunning, 1999). This is reflected in sovereign credit ratings for Africa. Although there are no formal credit ratings available for SSA outside South Africa, a number of agencies (among them the Economist Intelligence Unit) provide a measure for sovereign credit risk. Political and policy risk are given the largest single weight in the overall rating. However, most of the available measures have a large subjective element in their calculations (Bhinda and Martin, 1994) which bias the ratings downward.

Actions by governments that increase uncertainty (especially policy reversals) are particularly bad for attracting foreign capital. Uncertainty complicates long-term planning and deters investments that require large initial start-up costs or would entail large exit costs in the event of upheaval. Hadjmichael and others (1996, 29) concludes, “the most important impact of policies on private investment behaviour was through their effect on macroeconomic stability and uncertainty”.

Policy reversals in the past have also made it more difficult for present Governments to credibly commit to reforms today. Building credibility is likely to take time while potential investors take a wait and see attitude. For example, in Uganda, even though the law on the return of property to their Asian owners was passed in the early 1980s, it was not until the late 1980s and early 1990s that Asians began to return in numbers.

Credibility also matters for the sustainability of reforms. Reforms that are credible are more likely to be sustainable in the long-run as economic agents react positively to policy measures and result in a virtuous circle of behaviour. For example, a credible programme of reforms can lead to increased domestic and foreign investment creating employment and tax revenues that can be used to cushion some

³ On a risk-adjusted basis, interest rates in developing economies may not be higher than in developed economies.

of the costs of reform. When reforms lack credibility the intended benefits may take much longer to materialise while the costs of reform mount. Those sections of the population that are most burdened with the social costs of reforms may successfully lobby for policy reversal. Therefore, it is essential that reforms undertaken by government have the support of the people from the very beginning and that there is a dialogue between interested parties and government.

There may be mechanisms of restraint, both external and internal, that reduce the ex-ante probability of reversal and thereby increase the credibility of the reform process itself. External restraints might include conditionalities on foreign aid or membership of, and signatory to, international organisations such as World Trade Organisation (WTO) which limit the ability of governments to impose discretionary measures such as increases in import duties, for example. However, on aid conditionality, Burnside and Dollar (1997) find that during a period of generally increasing aid conditionality there was, in fact, a deterioration of country risk ratings in Africa. This may be why the Highly Indebted Poor Countries (HIPC) Initiative is provided for only those countries that have implemented a sustained period of policy reform.

Internal restraints include providing the central bank with legal independence, which would go a long way to ensure that monetary policy is free from political interference. According to Collier and Gunning (1999), internal restraints may be weaker because of autocratic behaviour by African presidents in the past. There should also be measures put in place that enhance judiciary independence so that it can operate without political interference. This will also ensure that politicians operate within the law, and where they do not, the judiciary can act as a check. An example is the recent impeachment of several Ministers in President Yoweri Museveni's Government in Uganda by Parliamentary majority. Such checks and balances are welcome developments, providing for effective monitoring of Government actions.

2. Political reform

Political disorder is very damaging to economic growth (Chege, 1999) and is not a conducive environment for both domestic and foreign investment. Political reform should be aimed at building frameworks that are more inclusive, encourage power-sharing and allow for enhanced public participation in the political process. There should be room for political debate; opposition groups should be given official recognition under the law. Lack of access to television and radio and other forms of communication that unfairly limit the ability of opposition views to campaign for support can lead to alternative, including violent, forms of struggle. In fact, peaceful conflict resolution is a key ingredient to maintaining stability in African economies. This has been demonstrated by recent conflicts in the Great Lakes involving several African countries.

Chege (1999) emphasises the need to reform political institutions in Africa as a basis for consolidating the reforms, mostly economic, which have been undertaken to date. It should also be noted that a high degree of ethnic diversity has not necessarily translated into greater conflict in African countries. As in any society, there will be conflicts over the distribution of power and resources, which, in Africa, most often works along tribal lines. Whether the outcome is peaceful or disorderly will depend upon the ability of the institutions of governance to resolve conflict peacefully. These institutions should be able to operate in an objective environment where decisions are made according to the law.

Inclusiveness in Africa does not have to mean Western style democracy. Institutions and the system of government should aim to be inclusive but in a way that accounts for the particular ethnic and religious characteristics of the individual country. For example, the Movement system since the NRM took power in 1986 has served Uganda well and is expected to be a transitional phase to full multi-party democracy.

Experience from different multi-party elections in Africa in the 1990s shows that the results have not always been beneficial to the country concerned. It seems that tribal loyalty has translated into party loyalty along the same lines (Chege 1999). This means that multi-party democracy has merely transferred the potential for division along tribal lines to political parties. What is needed, in addition to free and fair elections, is a system of government and institutions that is inclusive to minorities. The political process should not be used as a convenient means of marginalising minority parties (tribes) using the cloak of multi-party elections. This will require careful consideration of the unique ethnic and religious

characteristics of each country so that reforms are tailored to ensure a pluralistic and civil society that is able to minimise and peacefully resolve conflict.

3. Insurance against policy risk

Countries can sign bilateral or multilateral investment treaties that have legally binding elements establishing the obligations of the host country toward foreign investors from other signatory countries. These can help to ensure continuity in the environment under which foreign investors operate and also to limit the power of governments to renege on their promises. These mechanisms can also be used to resolve disputes. One example is the International Centre for the Settlement of Investment Disputes, a multilateral institution that is part of the World Bank group, which provides a mechanism for arbitrating investment disputes amongst member countries.

Such mechanisms should enhance the credibility of other complimentary reforms in areas affecting foreign investors. African governments should carefully consider signing multilateral and bilateral arrangements that can promote their own goals of attracting foreign investment, while not subjecting them to undesirable commitments that might otherwise be part of some of these arrangements.

B. Ensuring Macroeconomic Stability

Macroeconomic stability is a prerequisite for attracting sustainable, long-term foreign investment into a country. Hadjmichael and others (1996) conclude “the most important impact of policies on private investment behaviour was through their effect on macroeconomic instability and uncertainty”. This suggests that greater macroeconomic instability can have a considerable adverse impact on domestic and foreign private investment.

A considerable amount has been achieved in the area of establishing a stable macroeconomic environment. In 1997, 33 countries recorded inflation rates less than 10 per cent compared to just 12 in 1994 (African Development Bank, 1998). But, much needs to be done to consolidate these improvements and to ensure that those countries which continue to perform poorly carry out the necessary reforms. Continued improvements in macroeconomic performance — low inflation, low and sustainable budget deficits, stable but competitive exchange rates — will help to enhance the overall environment in which private investment is conducted. For example, low budget deficits ensure that the private sector is not crowded out of the market for credit, and a stable and competitive exchange rate reduces uncertainty and ensures export competitiveness.

C. Macroeconomic Policies

1. Reducing the burden of external debt

In many African countries external debt servicing, most of it official, continues to exact a significant burden on finances. At the end of 1994, the total debt stock was \$164 billion in present value terms of which 17 per cent was owed to private creditors, 64 per cent to official creditors and 19 per cent to multilateral institutions (Claessens and others, 1996).⁴ Resources that might otherwise be used to invest in public infrastructure, education and health have to be used to service external debt, often in circumstances where foreign reserves are low and have to be rationed.

In principle, heavy external debt does not automatically translate into low growth. Growth in export earnings can allow for continued importation of investment goods to maintain growth while servicing external debt at the same time. However, for reasons of solvency, this process cannot go on forever. There are two possible end scenarios; an orderly crisis-free resolution where foreign exchange earnings are generated by investments made using borrowed foreign money in the first place. However, if borrowed money is invested primarily in the non-traded sector, then a situation will arise where the economy is unable to pay for imports required to maintain growth. In these circumstances, the authorities may be forced to apply foreign exchange controls that are designed to limit the availability of foreign

⁴ The data cover International Development Association-only HIPCs, excluding Nigeria.

exchange for “non-priority” areas including the ability of foreign investors to repatriate earnings and dividends. If private investors conclude this end scenario, it can induce a “rush for the exit” that brings forward such a crisis. This type of conclusion is most certainly affecting investor perceptions today about investing in Africa.

A heavy debt burden can also hinder a country’s ability to restore confidence in its domestic economy and credibility to its reform programme. The adjustments required to restore debt to sustainable levels are usually painful, and for this reason, they may not be credible. For instance, those groups worst affected by the adjustment may be politically able to roll back some of the changes.

The HIPC initiative has gone some way in reducing the debt-service burden to sustainable levels for heavily indebted poor countries⁵ that have a track record of implementing sound economic policies. These countries are required to invest the savings made from HIPC relief in priority areas such as health and education. As mentioned previously, improvements in human capital should be part of any process to encourage private capital inflows to Africa. But, in general, reforms should have significant local participation in their design to ensure that local ownership is maximised. This will enhance the long-run sustainability of reforms (Killick, 1994).

2. Capital account convertibility

Although many countries have made progress in eliminating capital account restrictions relating to long-term flows, a number of African countries continue to have restrictions relating to FDI and the repatriation of foreign exchange (IMF, 1999). These clearly do not help investor confidence in these countries.

Freeing-up capital account transactions can send a positive signal to the investment community about government intentions towards foreign investment; why would a government expose itself to a sudden flight of capital when confidence deteriorates, unless it has inside knowledge about its own strong commitment to reform.

Opening up the capital account should be carefully sequenced so that it is sustainable. The experience of East Asia has shown that the financial sector and supervisory authorities have to be effective in managing capital inflows during boom years, to ensure that returns generated by the investments into which they flow are able to service the future external obligations.

D. Investment in Public Infrastructure

“The low capacity of infrastructure, institutions and human capital constitute major underlying development challenges in the continent” (Africa Development Bank, 1997). This was stated as part of four broad sets of issues constraining private sector investment in Africa. This is one rationale for the present policy under the HIPC initiative to direct savings from debt relief to social programmes such as health and education. We use the term public infrastructure in its broadest sense to include institutions, human capital as well as physical infrastructure such as roads.

1. Infrastructure investment

Inadequate public infrastructure reduces the return to private investment since they are complementary. For example, poor roads increase the cost of transporting goods to the marketplace and may even make the supply unpredictable if they cause more frequent breakdown of vehicles. If the demand for these goods is price elastic it becomes more difficult for the producer to pass on the costs to the consumer. In the case of Uganda, recent survey evidence from private sector firms revealed that the power sector was a serious constraint to doing business (Reinikka and Svensson, 1998). Unreliable and costly power supply mean that private businesses are often forced to invest in private generators, which further increases the costs of doing business.

⁵ The Heavily Indebted Poor Countries are comprised of 41 countries, most of which are in Sub-Saharan Africa.

E. Building Sound Institutions

When foreign investors arrive they are likely to meet several government agencies along the path to finally starting up operations, and such agencies can have a considerable impact on the final decision of whether or not to invest. The cost of doing business increases when such institutions are very inefficient, maybe requiring bribes to provide incentives for “fast-track” clearance. Other examples are slow and bureaucratic procedures in applications for investment licenses. Therefore, institutions need to be effective at providing the services they are designed for, and in a manner that is fair. Discretionary application of rules and procedures reduces confidence in public institutions and can lead to attempts to circumvent them or abuse them to gain unfair advantage (such as offering bribes). As part of a plan to encourage FDI, Bhinda and Martin (1994) recommend that tax and duty structures and levels should be made more transparent to encourage greater compliance.

1. Legal and regulatory environment

A fair and efficient legal system is essential in ensuring that all economic agents are treated fairly and there exists an effective mechanism for resolving conflict. Legal rights (property rights for instance) must be upheld, and the rule of law should prevail. Such a system can then act as a restraint against abuse of power by the executive arm of government, and a check against reversal of policies that are enshrined in the law. These mechanisms are designed to reduce the institutional uncertainty that any investor, whether domestic or foreign, faces when planning ahead and deciding whether to invest or not.

Africa’s legal institutions suffer from a lack of credibility. Collier and Gunning (1999) report that African courts generally work less reliably than elsewhere, while only about a quarter of African lawyers consider the judiciary to be fully independent of the executive.⁶ This, in turn, often leads to less reliance on the courts to resolve conflict. This is why legal reforms that provide for an independent judiciary and a fair legal system for conflict resolution are essential in rebuilding credibility. These institutions should be provided with sufficient human and physical resources to carry out their duties.

F. Microeconomic and Sectoral Policies

Macroeconomic policies alone are unlikely to effectively promote foreign investment. Complementary microeconomic policies at the industry and firm level can play a critical role in providing incentives for foreign investors.

1. Tourism

Tourism is potentially a significant source of foreign inflows. Africa’s vast natural resources, such as the game reserves and national parks, are the biggest attraction for foreign visitors that distinguishes Africa from other tourist centres. Tourism should be promoted in a way that safeguards the long-term viability of the continent's natural resources. Some of the income from national parks and game reserves could be used to improve the monitoring and safeguarding of animal populations against threats such as poaching.

2. Investment promotion centres

Investment promotion centres can, at their very simplest, take the form of international trade missions to countries that are potential inward investors, or the setting up of agencies designed specifically to speed up the clearance of procedures for inward investment. At the other end of the spectrum, they may be export promotion zones that provide for concessionary tax rates, tax holidays and other incentives.

Investor missions can have significant benefits if they are well targeted and organised to deliver a consistent and favourable message. Potential investors should be clearly identified and targeted and then missions should introduce opportunities to them that they are currently not aware of. This requires skilled

⁶ Based on analysis by Mauro (1995) using data from Business International.

communication and a well thought out strategy on the part of agencies such as investment authorities. On the other hand, if such missions are seen as lacking focus by foreign investors they may do more harm than good to a country's investment image.

This type of marketing has been seen in trade and investment missions from developed countries. They usually involve a high level politician (such as the minister for trade) and chief executives of top tier companies from the host country.

3. Export promotion zones

These are zones demarcated to provide for various incentives to attract both domestic and foreign investment into export sectors. These incentives include tax exemptions on profits, favourable utility prices and guaranteed service provision and reduced red tape, among others. The essential question is whether such preferential treatment provides for a net benefit to the country over some specified time horizon. The initial costs to government can be high in the form of foregone tax revenue and utility provision. It may also be difficult to judge whether the resulting investment would have taken place anyway in the absence of the export promotion zones (EPZs); governments would not want to provide incentives for those foreign investments that would take place even in the absence of specific incentives such as tax holidays.

But while EPZs may be costly in the short-run, they contribute significant positive externalities in the form of technology and management skill spillovers. Other benefits include increased employment and skill acquisition through training and development. The use of the EPZ in Mauritius has resulted in strong links between the domestic textile industry and textile producers in Hong Kong, China. In the case of countries like Uganda, EPZs could help to strengthen links between domestic investors and Asian investors.

4. Encouraging joint ventures

In a joint venture, the local partner is likely to have a comparative advantage over its foreign partner with regard to information about local market conditions, bureaucratic procedures and contacts with local customers. The foreign partner may bring new and improved managerial skills to the relationship and have access to financing that may not be available to the local partner, as well as new technologies and processes being used in overseas markets. These synergies can help to overcome fears that foreign investors may have when investing in new markets and benefit the local partner in the form of a more rapid transfer of skills and technology.

In Africa, there is a paucity of information about local conditions, and this information gap may be enough to deter potential investment. So long as the legal relationship between partners is properly defined and laid out, joint ventures can be one way to encourage foreign investment, at least in the early stages of entry of foreign investors.

However, a number of safeguards should be put in place, which allow for equal participation for the local and foreign partner. For example, it should not be the case that foreign partners are not allowed to have voting rights on the board of directors of a company simply because they are from a foreign entity. Policies that are designed to simply attract foreign investment without providing for a stake in the decision-making process is very likely to fail to deliver the intended benefits.

G. Strengthening the Financial Sector

The financial sector plays an important role in the management and sustainability of capital inflows. In Africa, the banking sector dominates the financial sector. Inflows of foreign capital can enhance the deposit base of banks and consequently their ability to expand their loan portfolio. If this happens too quickly, and internal monitoring and control systems are unable to manage such an expansion, a large share of these loans may become non-performing, eventually threatening the solvency of the bank.

Foreign inflows also present foreign exchange risks for banks. While the liability is in foreign currency, the corresponding asset will be in domestic currency. If the entity holding the loan has most of its revenues denominated in domestic currency, it will be subject to the risk of a depreciation in the

domestic currency versus the foreign currency, which increases the cost of servicing the foreign currency loan. Such risks need to be effectively managed both internally and by external supervision by the Central Bank or other supervisory authority.

Foreign capital can flow into a country in several ways depending on the nature and purpose of the original inflow itself. For example, portfolio flows are more likely to flow into the country if there is a broad-based and liquid stock exchange where equity can be traded. Indeed, where a fledgling stock market already exists, foreign capital can enhance liquidity and diversify holdings of equity holdings. However, one danger that has been highlighted by recent events in Latin America and East Asia is that short-term portfolio flows can be subject to sudden reversal, causing an exchange rate crisis.

H. Regional Co-operation

The small size of most African markets has often been highlighted as a disincentive for foreign investment that requires a minimum market size before it is profitable. Regional trade agreements that lower barriers to trade by eliminating tariff and non-tariff barriers can potentially solve this problem. Presently, within the Cross-Border Initiative in Eastern and Southern Africa there are five different Regional Trade Arrangements or RTAs (IMF, 1999). Member countries have to deal with conflicting objectives between these RTAs, different strategies for liberalising trade and investment, and conflicting rules and administrative procedures. The goal of facilitating cross-border activity would benefit from a harmonisation of the goals and objectives of the different RTAs, at the very least. A better solution would be to rationalise the structure of the overlapping RTAs, and consolidate them into fewer entities or one single entity. It would then be easier to align objectives and goals, allowing for more co-ordinated implementation of agreements while ensuring objectives are internally consistent.

When regional groupings are not clear, potential investors can find it difficult to identify market opportunities. Complicated structures usually involve larger amounts of red tape requiring more investment in expertise in the areas of taxation and legal procedures, which increases the cost of doing business.

I. Encouraging Links with South African Companies and Investors

Encouraging tie-ups with South African investors may be another promising avenue for attracting foreign capital. South African enterprises have been “moving north” into other African countries in wide ranging areas, from mining to brewing. Within the Sub-Saharan region, South Africa has a better record of attracting foreign investment. This is partly the result of having a better image in the international community and the fact that the transition to the post apartheid period has been relatively smooth and peaceful.

Given its proximity to the rest of SSA, South Africa could potentially be a conduit through which foreign direct investment passes to the rest of Africa. Geographical and historical links give South African entrepreneurs and companies expert regional knowledge about the risks and benefits of investing in various areas and sectors around SSA. This kind of reliable information about African investments can potentially solve the problem of market failure by providing for credible signals to potential foreign investors about the viability of different investment projects or proposals. Funds, which would not otherwise have been invested in various projects, could then take advantage of this superior knowledge.

South Africa also benefits from superior brand name when compared to other countries. This is helped by the fact that within SSA, South Africa is home to the largest number of multinational companies.

V. CLOSING THE SAVINGS-INVESTMENT GAP AND SUSTAINING GROWTH

Capital inflows can help to close a deficit savings-investment gap in a country and is one of the major reasons why they are important for countries in Africa, which are mostly in deficit. Calamitsis and Dhonte (1996, 1) state that “...to achieve gains in real per capita GDP an expansion in private savings and investment is key”. In this respect, to generate and sustain growth in Africa, investment in physical and human capital is crucial, but with the current low levels of domestic savings rate much of this will have to

be financed with foreign surplus capital (see table 2). Over the period recorded in the table and most recently, it is official development assistance that has enabled total investment to be consistently higher than total domestic savings, with private investment and savings mostly in line with each other.

Table 2. Trends in savings and investment in Sub-Saharan Africa, 1986-92
(per cent of GDP)

	1986	1987	1988	1989	1990	1991	1992
Total domestic saving	10.3	11.6	10.9	12.0	14.0	13.3	11.9
Total investment	17.0	18.3	18.7	17.5	18.4	19.4	18.8
Private saving	8.1	10.9	11.6	11.8	12.8	11.8	12.1
Private investment	8.4	9.2	10.2	9.7	10.6	10.8	10.3

Source: IMF, Economic Trends in Africa database, August 1993

As we have discussed previously, there are various preconditions that are necessary before foreign investors (both private and public) are willing to invest. The lack of these conditions in the past has discouraged foreign investment in Africa. Reforms have included liberalisation of the foreign exchange regime. In the 1970's, with a very poor political and economic environment in much of Africa, capital flight was a major constraint to economic activity. Foreign exchange was rationed by central banks. This severely limited the importation of key spare parts that could only be found abroad and generally constrained the level of economic activity to those areas that were deemed to be essential. In these circumstances official development assistance was mainly used for the purposes of importing essential goods and services.

More recently, there have been significant reform efforts in various African countries and this has been associated with a return of flight capital and new inward foreign direct investment. In Uganda, for example, the response from private sector investment underlines this return of confidence, having risen from 7.6 per cent of GDP in 1986 to 11.1 per cent in 1995-96. This has been associated with a considerable pick-up in private transfers—they were only \$1 million in 1986-87 but had increased to an estimated \$510 million in 1996-97 (Kasekende and Kitabire, 1998).⁷ Such private sector inflows have eased the foreign exchange constraint for countries such as Uganda that have undergone a sustained reform effort and stabilised the macroeconomic environment. The trade deficit is now largely financed by private sector receipts of foreign exchange recorded in the current and capital account, while official development assistance has allowed the central bank to build up foreign reserves with the local equivalent amount being spent by government ministries on social sector development projects.⁸ Within the area of development expenditure, health and education projects have been major recipients of external official development assistance. This should, in the long-term, allow for more balanced growth, with private sector inflows financing imports of physical capital while Government expenditure, financed by ODA flows, are channelled to the development of human and social capital.

An easing of the external financing of investment expenditure on inputs of production and investment has enabled the Ugandan economy to enjoy high rates of economic growth in the 1990s (averaging 7 per cent). In the earlier part of this period, economic growth resulted mainly in higher rates of capacity utilisation. The earlier period of conflict and civil unrest resulted, not only in capacity destruction, both human and physical, but also in a large fall in economic activity and therefore an increase in spare

⁷ Due to mis-recording, private transfers capture a substantial FDI component as well as private remittances.

⁸ The ability of the central bank to accumulate foreign reserves will obviously be limited by the extent to which Ministries spend ODA receipts on imports of goods and services.

capacity. As spare capacity falls, additional growth will have to come from capital formation. Arguably, this is more difficult to achieve than the simple utilisation of spare capacity, and will require high rates of investment on a sustained basis. Given Uganda's present low savings rate, this next phase of growth will rely more heavily on foreign investment (private and official). Domestic savings rates should then respond to higher levels of income that are generated by these investments, and structural policies are in place that encourage saving.

Ghana is another example of a country in Africa having recently undergone reforms. In Ghana, too, net private transfers increased substantially during their Economic Recovery Programme. There were small outflows during 1983/86, but by 1987/91 average annual inflows of private transfers had increased to \$200 million, equivalent to approximately 3.5 per cent of GDP (Nowak and others, 1996, 37). Taken together, net external financing (official and private) more than doubled to \$472 million in 1987/91 from \$172 million in 1983/86. This considerably eased the external constraint on the path for growth and investment in Ghana.

If private capital inflows generate a virtuous circle of increased investment that generates income and savings, leading to more investment can have considerable other benefits. For example, expanding economic activity requires larger amounts of labour. This can help to provide employment to previously idle labour, and in turn generate tax revenues that can be spent by government and invested in social sectors such health and education.

V. CONCLUSIONS

The paper has shown that a confluence of factors will help Sub-Saharan Africa attract capital inflows. These factors include both economic and non-economic factors. But this is not necessarily the case that all these factors will come into play for Sub-Saharan Africa to play host to increased capital inflows. This recent experience has shown that a strong commitment to eliminating distortions in the macro-economic environment has caused a reversal of flows to the benefit of the reforming countries. To sustain and increase those inflows requires continuous restructuring of the economies to eliminate residual distortions, as well as investing in institutional reform, including strengthening the judiciary and political institutions. This would help in reducing adverse perceptions about Africa, reduce risk of policy reversal and costs of doing business. The paper has also shown that factors constraining domestic investments such as poor public infrastructure would equally discourage foreign investment. There is a need to address impediments to investments in general for Africa to attract higher levels of inward investment.

Regional integration has been identified as critical in eliminating constraints associated with the limited size of most of African economies. SSA should therefore move quickly to rationalise the structure of overlapping regional integration groups if it is to benefit from forming such trading blocs. Related to this are the increasing investments originating from South Africa in the rest of SSA. This is a very welcome development that should be fully harnessed.

The paper has presented the potential benefits of increased capital inflows to Sub-Saharan Africa. Such inflows would ease the foreign exchange constraint that affected a number of the countries during the 1970s and 1980s. Consequently, countries would be able to finance higher levels of imports while building foreign exchange reserves. In addition, countries would be able to sustain levels of investment higher than what can be sustained by domestic levels of savings. This would enhance growth prospects and economic performance of countries benefiting from higher inward capital inflows. More importantly, such countries would reduce poverty levels as employment of resources increases.

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