



Absorption Capacity and Management of Capital Flows

6.1 Introduction

This last chapter of the report examines the capacity of African countries to absorb foreign capital and discusses policies to manage capital flows so as to maximize the benefits while minimizing the risks of financial fragility and other adverse effects. A country's capacity to absorb foreign capital depends on many factors, including the quality of the labour force, the availability and quality of the infrastructure, the depth and efficiency of the financial system, and the overall institutional and policy environment.

The discussion of the role of labour market factors was undertaken in chapter 3 while that of the institutional environment was examined in chapter 5. This chapter examines the role of the depth and efficiency of the financial system in absorbing capital flows and harnessing their direct and indirect effects on the host economy, including technological diffusion and crowding-in effects on domestic investment. It discusses the need for promoting regional financial integration as a means of attracting capital flows, and the mechanisms for monitoring and managing capital flows, including suggestions for warning indicators of financial risks and corresponding policy responses.

6.2 Financial Development and Absorptive Capacity

The depth and efficiency of the financial system influence a country's capacity to absorb capital flows, both private and official. The level of financial development also influences the extent to which a country is able to benefit from capital flows in terms of spillovers from targeted sectors to the rest of the economy, and the overall growth effects.

Efficient financial intermediation enhances absorptive capacity

Foreign direct investment and absorptive capacity

The financial system influences both the volume of foreign capital flows and the impact of foreign capital on economic growth. Long-term foreign capital or FDI is not only

“ A more developed financial system allows foreign investors to borrow domestically to expand their activities ”

the dominant form of private foreign capital in African countries but is also the form of private capital flows that is likely to have a substantial impact on economic growth. Three important relationships are worth emphasizing (Lehman *et al.*, 2004; Feldstein 1994; Di Giovanni 2005).

First, financial development is a determinant of capital inflows because the deeper the financial system, the broader the range of investment opportunities and the higher the incentives for foreign investors to enter the country. Second, financial development is a key component of the host country's absorption capacity. Third, as a corollary to the second relationship, financial development is a key channel for the growth effects of foreign capital. These three relationships are essential in understanding both the relatively poor performance of Africa in attracting foreign private capital and the limited effects of FDI on economic growth on the continent.

Financial development, or more specifically, the depth and efficiency of the financial system, are an important condition for attracting capital inflows. Financial development exerts direct effects on capital flows by offering more opportunities for equity-based investments to foreign investors (Di Giovanni 2005). The deeper the financial system, the broader the range of investment opportunities and the higher the incentives for FDI into the country. A more developed financial system also allows foreign investors to borrow domestically to expand their activities.

Moreover, borrowing from local financial markets allows foreign investors to reduce their exposure to host-country currency risks (Lehman *et al.*, 2004; Feldstein 1994). Furthermore, financial development exerts indirect effects on FDI given that a more efficient financial system is associated with lower transactions costs and better information systems, all of which facilitate investment operations. Through the provision of systematic information on investment opportunities and returns to capital, an efficient financial system alleviates the problems of information imperfections, which are more acute for foreign investors than for domestic investors.

The importance of the financial system for a country's capacity to absorb foreign capital derives from the diverse functions that it plays in the economy. In addition to the traditional savings-mobilization role, the financial system also performs other functions that are vital to the proper functioning of a market economy, namely, information production, price discovery, risk sharing, liquidity provision, promotion of contractual efficiency, promotion of corporate governance, and facilitating global integration (see Senbet and Otchere 2006).

There are two important reasons why financial development is important for the country's absorption capacity. First, the depth of the financial system allows the country to attract intermediate foreign capital with minimal strain on monetary and exchange rate policy (Nkusu and Sayek 2004; Buffie *et al.*, 2004). A large and deep financial system minimizes the exchange rate appreciation effects of capital inflows and gives more degrees of manoeuvre to the central bank in sterilizing the inflows, in order to minimize the inflationary impact. In many African countries, the bond market is

either nonexistent or very thin, which limits the number of tools by which the central bank can control the inflationary and exchange rate appreciation effects of foreign capital inflows. For example, the large increase in domestic interest rates in Uganda between 1998 and 2000 (from 5 per cent to almost 20 per cent) was partly a result of large aid inflows that could not be absorbed, given the relatively thin financial markets (Nkusu and Sayek, 2004). Evidence from other African countries shows similar effects (Buffie *et al.*, 2004).

Second, and most importantly, an efficient financial system allows the country to maximize the spillover effects of foreign capital in the economy. Such effects may occur through demonstration effects, competition effects, and downstream and upstream effects on domestic production. FDI provides incentives for expanding production partly through the creation of FDI-related demand for goods and services and also by pushing domestic producers to invest in innovation and skills acquisition to keep up with the competition.

Production expansion and technology diffusion need to be financed. Plans for expansion and technology acquisition may very well be frustrated by lack of appropriate finance in any country with an underdeveloped financial system. In the absence of adequate finance, FDI sectors may remain economic islands in the country, with minimal effects on overall economic activity. In the majority of African countries, lack of access to finance has been identified as an important constraint to business formation and expansion (see Bigsten *et al.*, 1999; Gunning and Mengistae 2001). Indeed, according to a firm survey of transnational corporations by UNCTAD in 1999/2000, 28 per cent of the firms identified lack finance. It is always one of the most important constraints to FDI in SSA, ranking third after corruption (49 per cent) and access to global markets (38 per cent) (UNCTAD 2000).¹

By facilitating absorption of foreign capital, financial intermediation will enhance the growth effects of foreign private capital. There is growing consensus that FDI affects economic growth less through direct investment effects and more through efficiency or total productivity effects (Mody and Murshid 2005; Durham 2004; Omran and Boldol 2003). The productivity effects of FDI on growth occur through the increase in the marginal productivity of capital in sectors that are directly receiving FDI. These “private productivity” effects are compounded by positive effects on marginal productivity of capital in other sectors in the economy – or “social productivity” effects (Mody and Murshid 2005; Alfaro *et al.*, 2004). FDI therefore creates positive technological spillover effects and managerial externalities in non-FDI sectors that raise total productivity in the economy.

However, these effects will materialize only if the financial system is able to intermediate resources efficiently and meet new demands for investment finance. The overall productivity effects will depend on the efficiency of the financial system in channeling

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¹ Also see Asiedu (2002, 2004), Asiedu and Lien (2004), and Morisset (2000) for further empirical evidence on constraints to FDI in Africa. See chapter 5 for further discussion of constraints to capital flows.

resources to investment activities with the highest returns on capital. The fact that FDI in Africa tends to be concentrated in extractive sectors (see chapter 2) contributes to limiting these productivity effects. In order to maximize the growth effects of FDI, African countries need to establish incentives for diversification of the sectoral allocation of FDI.

The conclusion from this analysis is that a country's absorption capacity, which is influenced by the depth of the financial system, is an important determinant of the growth effects of foreign capital. In countries with underdeveloped financial systems, FDI will have limited effects on growth. This may explain the weak link between FDI and economic growth observed in developing countries (Omran and Boldol 2003). The evidence suggests that African countries must aggressively pursue strategies for improving the efficiency of their financial systems in order to reap the maximum benefits from foreign capital flows.

The foregoing discussion implies that there may be a virtuous circle between FDI and growth arising from the reciprocal relationship between FDI and financial development. Foreign capital creates investment opportunities due to FDI-related spillover effects. This, in turn, induces credit expansion leading to an overall increase in financial intermediation. Therefore, to the extent that countries are able to establish an adequate institutional environment for financial intermediation, exposure to long-term foreign capital may have multiplier effects in both the real sector and the financial sector, eventually boosting the overall economic growth.

“ A country's absorption capacity, which is influenced by the depth of the financial system, is an important determinant of the growth effects of foreign capital ”

Other flows and the role of the financial system: aid and workers' remittances

The depth and efficiency of the financial system also influences the country's ability to absorb and take advantage of other forms of capital flows, namely, ODA, workers' remittances and short-term portfolio flows. Countries with underdeveloped financial systems have difficulty mitigating the negative effects of large inflows of foreign exchange, for several reasons. First, the lack of a developed bond market limits the degrees of manoeuvre for the central banks, in sterilizing the effects of the inflows. This raises the risk for *Dutch Disease* effects whereby the unsterilized inflows cause an appreciation of the local currency, which undermines competitiveness (see Heller and Gupta 2002).

However, attempts to sterilize the inflows by Treasury Bill sales in a shallow domestic money market will lead to higher and more volatile interest rates, which have detrimental effects on private investment. Evidence from Uganda confirms these adverse effects of aid management on interest rates (Nkusu and Sayek 2004). Aid may indirectly crowd-out domestic investment in countries with underdeveloped financial systems. These adverse effects are likely to be more pronounced if aid inflows are spent on domestic non-tradable goods. In contrast, *Dutch Disease* effects are mitigated when the inflows are used to increase production capacity (including investment in public

infrastructure), in which case, positive supply effects offset adverse demand effects, thereby minimizing the impact on inflation and exchange rate appreciation.

Second, the lack of a diversified pool of financial instruments tends to direct private foreign capital into such speculative investments real estate, which causes price distortions and raises the risk for costly asset price crashes. As the volume of workers' remittances continues to rise in African countries, these risks of asset price instability will also continue to increase. The challenge is for African financial intermediaries to develop new instruments to direct these funds away from speculative markets. In this regard, it may be helpful that they initiate discussions with non-resident nationals and the Diaspora about the best options for channeling remittances into productive investments. While financial institutions have the knowledge of the local investment market, non-residents may contribute to the debate by drawing on their experiences of the financial systems in their host countries.

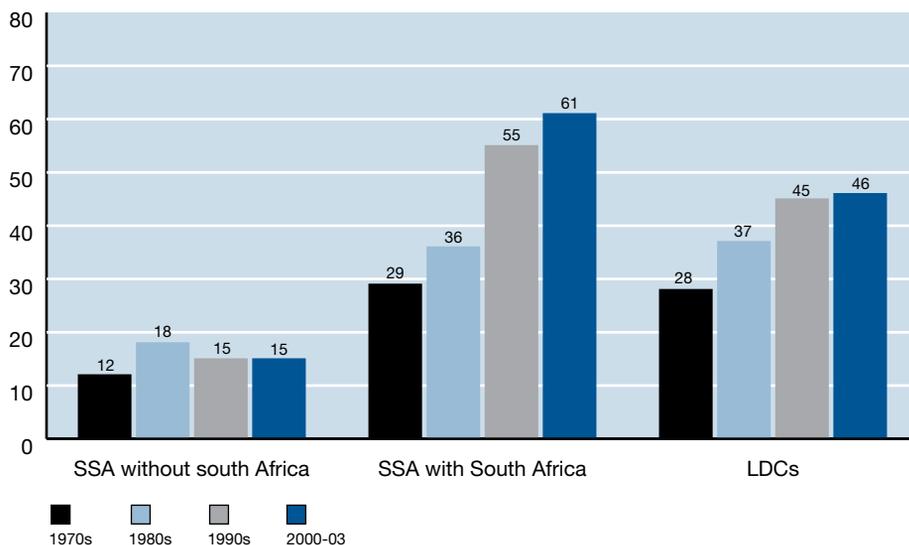
In addition to minimizing the risks of instability associated with official capital inflows, financial deepening also enhances the effectiveness of aid. ODA can contribute to economic growth, although the aid-growth relationship appears to depend on a range of conditioning factors, including the quality of institutions. One strand of the literature that is particularly relevant for the foregoing discussion suggests that the effectiveness of aid is enhanced by the depth of financial markets in aid-recipient countries (see Nkusu and Sayek 2004). In particular, deeper financial markets are able to intermediate external resource flows, thus maximizing positive indirect effects of aid outside the sectors that are directly targeted for aid. These indirect effects will enhance the overall effects of aid on economic growth.

Underdevelopment of African financial systems may explain the weak gains from capital flows

Most measures of financial development show that Africa in general, and SSA in particular, lag behind other regions in development, both in the banking sector and in the capital market. The record indicates that the performance of the financial sector has stagnated and even deteriorated in many countries since the 1990s. As can be seen in figure 6.1, the supply of credit by banks in SSA, excluding South Africa, was lower in the 1990s and early 2000s than in the 1980s. It is clear that the banking sector is not keeping pace with the growth of domestic demand for credit.

“As the volume of workers' remittances continues to rise in African countries, these risks of asset price instability will also continue to increase”

Figure 6.1
Bank credit to the private sector (% of GDP) in sub-Saharan Africa



Source: World Bank, 2005

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 Financial systems in most African countries are dominated by a small number of banks that command heavy market power
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Moreover, despite substantial efforts to reform and liberalize financial systems in Africa, evidence still points to important impediments to efficient mobilization and allocation of both domestic and foreign resources (Senbet and Otchere 2006; Niskanke and Aryeetey 1998; Ndikumana 2003). Financial systems in most African countries are dominated by a small number of banks that command heavy market power, which undermines the efficiency of allocation of resources.

For example, in Burundi three leading banks account for over 70 per cent of deposits, loans, and assets (Nzobonimpa, Nkurunziza, and Ndikumana 2006). The market share of the top 4 banks is as high as 75 per cent in Uganda, 65 per cent in Ghana, and 49 per cent in Tanzania (Senbet and Otchere 2005). The oligopolistic structure of the banking system contributes to high costs of funds, as illustrated by high interest-rate spreads. Contrary to expectations, reforms in the banking system have been accompanied by a rise in the spread between the lending interest rate and the deposit interest rate and an increase in the gap between domestic interest rates and world interest rates. The interest rate spreads in 1996-2003 were twice as high as the 1980s levels in some countries (table 6.1). High spreads discourage savings mobilization due to low remuneration of deposits and depress borrowing due to the high costs of funds. It is clear that financial reforms in many African countries have been accompanied by less and not more efficiency in financial intermediation.

Table 6.1**Average interest rate spread and interest rate differential in African countries**

Period	Deposit rate (%)	Lending rate (%)	Spread (%)	Differential with the USA (%)
1980-84	8.3	13.5	5.2	-19.3
1985-89	10.7	16.1	5.4	-26.5
1990-94	15.4	23.3	7.9	-8.9
1995-99	12.8	23.4	10.6	-0.9
2000-03	10.6	22.4	11.8	4.9

Source: IMF, 2005

Note: The figures are averages for a sample of 22 African countries with consistent quarterly data over the 1980-2003 period. The interest rate differential for an African country is obtained by subtracting the US real interest rate from the African country's real interest rate.

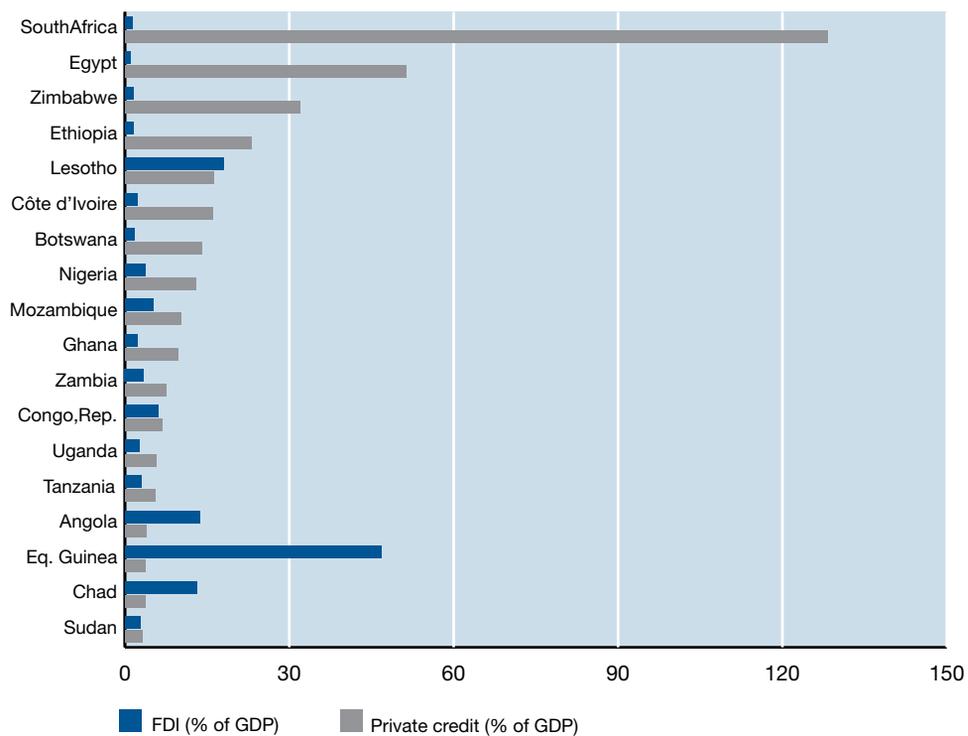
Financial reforms have moved African countries from an interest-repression regime to a high real-interest regime, both of which are detrimental to resource mobilization and investment. Moreover, African banking systems are excessively liquid as a result of risk aversion but also because banks are able to maintain comfortable profit rates by charging usury rates to their traditional borrowers (including the government) while hoarding risk-free government securities. Thus, African banking systems are engaged in *dysfunctional intermediation* (Senbet and Otchere 2006; Senbet 2001) that both wastes resources and keeps countries below their growth potentials.

FDI in Africa has traditionally been concentrated in resource-rich countries. These countries also happen to have the least developed financial systems (figure 6.2), implying very weak absorption capacity.

This partly explains the limited effects of FDI on economic diversification and transformation (see chapter 4) and overall economic performance (chapter 2). FDI has had little effect on the manufacturing sector, which may explain the low gains in terms of growth and employment creation. The data show that there is little relationship between the volume of FDI and manufacturing sector growth (figure 6.3). Leaders in manufacturing growth, such as Egypt, Mozambique, Togo and Uganda rank at the bottom in terms of FDI inflows. The debate on strategies to increase capital inflows in the continent must therefore address the critical question of how to enhance the impact of foreign capital on economic transformation.

“ The critical question of how to enhance the impact of foreign capital on economic transformation must be addressed ”

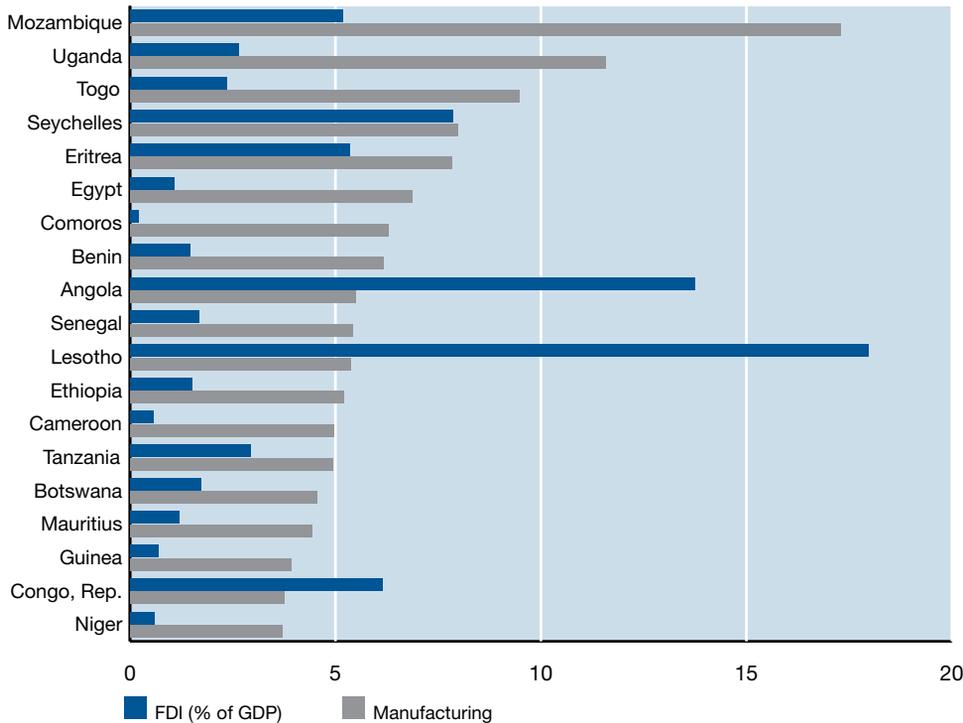
Figure 6.2
FDI and financial development, 1994-2003



Source: UNCTAD, 2005; IMF, 2005.

Figure 6.3

FDI and manufacturing sector growth, 1994-2003



Source: UNCTAD, 2005; World Bank, 2005.

Note: Manufacturing sector growth = growth rate of the ratio of the manufacturing sector value added to GDP.

African countries need to promote regional financial integration

Capital markets constitute a vital complement to the banking sector in the process of developing an efficient financial system. The existing capital markets in Africa are still shallow and highly illiquid, with the exception of the South African stock market (table 6.2). Presently, there are 20 active stock exchanges in Africa and a regional capital market (BRVM) that covers all the eight West African Economic and Monetary Union (WAEMU) member States. Overall, African emerging markets have grown steadily in the last ten years in terms of market capitalization, value traded, and number of listed companies. Moreover, though illiquid, African markets are, nonetheless, quite profitable. In 2005, the average equity return was 34 per cent for Africa, excluding South Africa. However, despite notable progress, African capital markets remain small and isolated and unintegrated in regional and global markets.

Given the small size of national markets and the cost of the infrastructure that is required to run a vibrant capital market, it is clear that national capital markets are

“Despite notable progress, African capital markets remain small and isolated and unintegrated in regional and global markets”

not viable in many African countries. One way to increase the viability of capital markets is to promote regional equity markets by drawing on the experience of existing economic regional integration schemes. However, two points must be made clear from the outset. First, financial regionalism is not a substitute for financial reforms and other efforts at the national level aimed at developing national financial systems. In other words, countries cannot outsource financial development. In particular, the development of efficient national banking systems is indispensable for the success of regional financial integration.

Second, the gains from financial integration are likely to be uneven across countries due to differences in initial conditions. Relatively more advanced countries are likely to reap more benefits due to economies of scale and scope (Venables 1999). However, in the long run, these distributional effects will be outweighed by the gains from integration and may be mitigated through appropriate regional redistributive arrangements.

Table 6.2
African capital markets: key characteristics

Country	Levels 2004 or latest			10-year growth, 1995-2004 (or earliest 9 years)					
	Listed Cos.	Capitalization (m \$)	Turnover	Listed Cos.	Capitalization (m \$)	Turnover	Returns (US \$)		P/E
							2002 Index	2001-02	
Algeria (2002)	3	145							8.8
Botswana	18	2548.3	2.3	4.1	20.4	40.2	41.4	96.1	13.0
Côte d'Ivoire	39	2082.6	2.7	2.3	9.2	2.7	27.4	58	9.9
Egypt	792	38515.9	17.3	0.6	16.9	-2.7	na	na	17.1
Ghana	29	2643.6	3.2	4.3	4.8	6.7	33.3	56.9	5.9
Kenya	47	3891.0	8.2	-1.7	7.5	45.4	7.7	3.9	8.7
Malawi (2002)	8	107.0	13.8	na	na	na	na	na	4.2
Mauritius	41	2378.8	4.5	3.9	6.0	7.7	30.8	22.5	6.0
Morocco	52	25064.3	9.1	1.7	15.5	-14.9	na	na	11.7
Namibia	13	442.3	4.8	2.7	8.9	11.7	-15.8	-44.5	5.4
Nigeria	207	14464.4	13.7	1.4	21.7	32.2	7.6	38	14.3
South Africa	403	455536.2	47.4	-4.5	4.9	22.0	27.9	5.7	11.2
Swaziland (2003)	5	172.0	0.0	2.3	-6.5	na	na	na	51.2
Tanzania (2002)	5	695.0	2.4	na	na	na	na	na	12.4
Tunisia	44	2641.1	9.2	5.4	-3.9	22.7	na	na	8.3
Uganda (2002)	3	52.0	na	na	na	na	na	na	15.2
Zambia (2002)	11	231.0	20.8	na	na	na	9.9	-17.1	5.8
Zimbabwe	79	1941.4	9.2	2.1	-0.5	2.0	-52.2	-59.9	47.1
Memorandum: comparison									
UK		2865200					-14.2	-28.3	
USA		16323500					-22.4	-31.6	
Emerging markets		5143000					-7.5		

Source: World Bank, 2005; UNDP, 2003. IMF, 2006.

There are already some signs of interest in regional capital markets as illustrated by cross-listings in some markets, especially in Southern Africa. This is often a way for companies to raise their visibility in countries where they do business (UNDP 2003). The consolidation of capital markets at the regional level has important advantages for domestic and foreign investors. Financial integration will provide more investment opportunities, thus increasing the scope for portfolio diversification. The benefits from diversification at the regional level arise from the fact that business cycles are not perfectly correlated across member States. As a result, returns on investment will exhibit lower volatility as diversification reduces the effects of country-specific economic shocks on overall returns. By increasing the number of players in the market, regionalization of capital markets will also increase liquidity, which is a critical condition for the growth benefits from financial intermediation.

By expanding the scope of investment opportunities, regional capital markets attract more global investors interested in the higher returns that African markets offer but who are currently discouraged by the illiquidity of national capital markets and the exposure to sovereign risk. Beyond portfolio diversification, the opportunity to maximize returns will be an attractive feature for foreign investors (Senbet 2001). Indeed, the evidence in table 6.2 shows that African stocks are highly profitable and substantially undervalued. The returns on equity are much higher in many African stock markets than in Western markets and the price-earnings ratios are significantly below those observed in mature financial markets (Senbet and Otchere 2006; Senbet 2001). Thus, African markets exhibit substantial unexploited profit opportunities.

The emergence and consolidation of regional markets in Africa allow for the establishment of the crucially needed synergy between capital markets and national banking systems. It is one component of a structural approach to addressing the problem of dysfunctional intermediation in the African banking system described earlier. Despite efforts to liberalize the financial system in African countries, banking systems are still plagued by pervasive inefficiencies. The high interest spreads are only one of the visible signs of lack of competition. Another form of dysfunctional intermediation is the tendency of banks to accumulate government securities, thus crowding out lending to the private sector.

Indeed, the lack of competition in the banking sector creates perverse incentives on the part of banks to maximize profits by investing in risk-free government securities, charging usury rates to the few borrowers that access credit, while discouraging savings. The development of alternative non-bank sources of finance through regional financial markets is a means to increasing both access to capital for firms and a way of promoting efficiency in the banking sector, notably through downward pressure on lending interest rates.

Another benefit from the development of regional capital markets in Africa is that it will increase pressure on countries to accelerate the reforms of the institutional environment that are critical for efficient financial intermediation. Regional integration

“Regionalization of capital markets will also increase liquidity, which is a critical condition for the growth benefits from financial intermediation”



African countries need to attract more external resources and protect their economies from the adverse effects of unregulated capital flows



can serve as a tool to lock in national reforms and enhance the credibility of such reforms in the eyes of investors (Collier and Gunning 2000). In addition, financial regionalism accelerates exposure to and sharing of international and regional best practices and standards in financial intermediation, especially information-disclosure procedures and accounting standards. Thus, less advanced African countries will benefit from spillover effects from more advanced countries in the area of financial infrastructure, payments systems and regulation.

Regional financial integration contributes to overcoming one of the major constraints to capital-market development at the national level. This is the lack of capacity to manage operations and to regulate markets. This capacity constraint must be addressed through joint efforts between governments and their development partners (see box 6.1).

6.3 Managing capital flows

Given the increasing pace of financial globalization and the implied higher risks of financial crisis, African countries need to establish prudential regulation mechanisms for minimizing exposure to such risks. Indeed, while African countries need to attract more external resources, they also need to protect their economies from the adverse effects of unregulated capital flows.

Benefits of capital management for African countries

Box 6.1

ECA's contribution to capacity building for capital market development

To alleviate the capacity constraint in capital market development, ECA launched a capital markets development project in 2002. The main objectives are to:

- Strengthen the capacity of African capital market regulators and operators;
- Strengthen the capacity of African capital markets to achieve regional integration;
- Enhance the capacity of capital market associations to promote regional integration; and
- Increase awareness of African countries of the role of capital markets in national development and poverty reduction.

The main activities are training workshops for market operators and regulators. In addition, the project organizes expert meetings and conferences that bring researchers, capital-market practitioners, and policymakers together to assess progress and draw policy recommendations on the way forward in the area of capital market development at national and regional levels.

A number of reasons can be advanced for activist prudential regulation of capital flows and exchange rates in African countries. First, African countries need to adopt strategies that aim at tilting the structure of capital flows in favour of long-term capital,² as a means of accelerating economic growth and structural transformation through diversification of economic activity. They also need to design capital management strategies that encourage more green-field investments to promote new activities, especially export-oriented investments in the manufacturing and service sectors. In that sense, capital management can serve as a tool for resource allocation, a policy that was successfully used by Asian countries (e.g., South Korea). At the same time, by adopting preferential treatment for long-term capital, African countries can minimize the risk of instability as it has been demonstrated in other countries such as Chile (Epstein, Grabel, and Jomo, 2005; Le Fort and Lehman 2003).

The second reason for adopting active capital management policies in Africa is that African countries need to minimize exchange rate volatility arising from instability of capital inflows and outflows. High volatility of the exchange rate raises uncertainty, which discourages trade and long-term investment. Capital management policies can also prevent excessive appreciation or depreciation of the exchange rate. Excessive appreciation of the national currency has detrimental effects on the economy, including loss of output and export competitiveness. Firm failures or drastic drops in capacity utilization due to loss of export markets carry high costs in terms of employment. In South Africa, for example, episodes of appreciation of the rand have been accompanied by downsizing in the export-oriented sectors such as mining and winery, which have caused substantial losses in employment and firm profits. Any gains from appreciation in terms of cheaper imports are often outweighed by the effects of the loss of export competitiveness.

The third reason for active management of capital flows and exchange rates is to insulate the current account from the effects of financial market volatility. One of the strategies for achieving this objective is to establish a dual exchange rate system consisting of differential treatment for financial and current-account transactions. This strategy has shown some degree of effectiveness, at least in the short run, in the case of South Africa (see box 6.2). One advantage of this technique is that it allows full control for the monetary authority in determining when and how long to implement the measure.

The fourth motivation is that the integration of capital markets carries important constraints on macroeconomic policy choices at the national level. In particular, countries are faced with a classic policy trilemma. In the context of integrated financial markets, it is impossible for a country to pursue the following three major goals of monetary policy independently and at the same time (Obstfeld, Shambaugh, and Taylor 2005):

“By adopting preferential treatment for long-term capital, African countries can minimize the risk of instability”

² Evidence suggests that appropriate capital-control measures can alter the composition of capital flows even when they cannot affect the volume of flows (Montiel and Reinhart 1999; Ahmed et al., 2005).

“ African countries should limit the reliance on short-term debt instruments ”

- An autonomous monetary policy aimed at achieving a domestic goal such as an inflation target, an employment target or any other target;
- Maintaining a fixed exchange rate; and
- Free capital mobility.

Policymakers must choose two of the three goals. If a country is committed to price stability, say by adhering to an inflation target, then a policy of free capital mobility would require allowing unstrained fluctuation in the exchange rate, which would have costly real effects on the economy. Capital management can allow a country to maintain monetary policy autonomy, notably by maintaining a wedge between the domestic interest rates and foreign interest rates. Thus, capital controls enable African countries to preserve their ability to use monetary policy as a tool for promoting a national growth strategy, especially by boosting domestic investment in an era of global financial integration.

The fifth reason for active capital management is to reduce the likelihood of debt crises. In particular, controls of capital-account transactions allow African countries to minimize the risk associated with domestic private actors borrowing in foreign currency. Moreover, by stabilizing the exchange rate, capital management reduces the risk of excessive devaluation of the national currency, which would raise the cost of debt servicing. Furthermore, African countries need to minimize the risk of financial crisis through controls of capital inflows aimed especially at lengthening the debt maturity (Calvo 2001; Fosu and Senbet 2001). Given the high debt burden faced by African countries, it is essential to limit the reliance on short-term debt instruments in order to ensure solvency.

Finally, capital management strategies are needed to retain savings in African countries, especially by preventing capital flight. African countries have experienced heavy financial haemorrhage, which robs the continent of valuable resources that could be

Box 6.2

South African experience with capital and exchange rate management

The South African capital and exchange rate regimes have undergone five major phases since the 1960s (Aron and others 2000). Until 1978, the rand was pegged alternatively to the dollar and the pound, and capital account transactions were strictly controlled. In 1979, the Government adopted a dual exchange rate system, whereby current account transactions were executed at a controlled float exchange rate, the commercial rand, while equity capital was transacted at a freely floating exchange rate, the financial rand. The system was abolished under a controlled float system in 1983 and reintroduced in 1985, lasting until 1995. The exchange rate regime was unified again in 1995 during a systematic move toward a market-based exchange rate system. Foreign exchange and capital controls were motivated by the need to retain domestic savings, prevent the loss of foreign exchange through transfer of assets abroad by residents, and to encourage repatriation of capital. The evidence suggests that the dual exchange rate system, to some extent, insulated current accounts from the volatility of the rand (Farell 2001).

used for domestic investment. Africa as a region has the highest ratio of private assets held abroad, compared to other developing regions (Collier *et al.*, 2001). Sub-Saharan Africa is a net creditor to the rest of the world in the sense that private assets held abroad exceed the region's debt vis-à-vis the rest of the world (Ndikumana and Boyce 2003; Boyce and Ndikumana 2001). Consequently, the agenda for increasing financial resources in African countries must include strategies for curbing and reversing capital flight.

The ability of African countries to take advantage of these benefits of capital management depends critically on their capacity to undertake effective capital flow monitoring and controls. This capacity is currently limited in many countries. Therefore, with the support of development partners, African countries need to invest in capacity building for capital management, including both skills acquisition and improvements of technological capacity.

Strategies for managing capital flows and monitoring and addressing financial risk

It is difficult to determine what types of controls and incentive structures vis-à-vis capital flows should be implemented in a given country at a given time. The appropriate regime must be determined based on a country's particular economic circumstances and the issues faced at the particular moment. For example, emerging market economies are more exposed to financial risks because of their higher openness compared to other developing countries. The implication is that African countries with more open financial systems, especially those with stock markets, have an urgent need for capital controls to prevent financial fragility. However, all African countries need to design strategies for capital management for the purpose of influencing the term structure in favour of long-term capital, to influence sectoral allocation of capital, and to minimize exchange rate instability.

For each type of risk, there should be a particular set of instruments to prevent it and minimize its effects on the economy. The first task is for each African country to establish a monitoring mechanism that identifies the various types of risks associated with financial integration. Then, each country can identify the corresponding warning indicators and possible tools that may be used to address these risks.

There are three main categories of risk: currency risk, flight risk, and fragility risk (table 6.3). For each type of risk, a series of warning indicators (or *trip wires*) and appropriate policy interventions (or *speed bumps*) will be designed to prevent the risk of financial fragility (Grabel 2004). It is important for each country to design these policy tools to be flexible enough to allow adaptation to changes in the country's macroeconomic and financial circumstances.

Capital management strategies need to be complemented with domestic financial regulation in order to minimize the risk of financial distress (Senbet 2001). In particu-

“ Sound domestic banking systems will enhance Africa’s ability to sustain shocks to international capital flows ”

lar, African countries need to develop sound banking regulations to enforce adequate bank capitalization, promote competition, ensure speedy and transparent reporting on the health of individual financial institutions, and prevent contagion of banking distress through timely bank restructuring by capitalization, merger, or liquidation (Kane and Rice 2001). Building sound domestic banking systems will enhance Africa’s ability to sustain shocks to international capital flows.

One important constraint to effective capital management and financial regulation in African countries is the lack of efficient monitoring of capital flows. African countries, with the support of their development partners, need to modernize their statistical frameworks for tracking capital flows. This will allow them to establish specific warning indicators and to design the appropriate policy interventions for minimizing the risks of financial instability.

Table 6.3
Financial risks, and examples of warning signs and policy responses

Financial risks	Warning signs or “trip wires”	Policy responses or “speed bumps”: targeted and gradual changes in policy based on warning signs
Currency risk Investors flee the national currency, inducing sudden and dramatic depreciation.	Ratio of official reserves to short-term external debt; Ratio of official reserves to current account deficit;	- Limit the fluctuations in the value of the domestic currency - Restrict currency convertibility
Flight risk <i>Portfolio investment</i> Portfolio investors sell off a country’s assets, causing reduction in asset prices and increasing the cost of new finance.	Ratio of accumulated foreign-portfolio investment to gross equity-market capitalization or gross domestic-capital formation;	- Controls on inflows - Controls on outflows
Lenders Lenders call loans or stop disbursing new loans.	Ratio of official reserves to foreign-denominated debt;	- Stop new inflows of foreign loans (public and private) - Especially discourage foreign borrowing by private agents
Fragility risk Locational mismatch: Proliferation of debts in foreign currency.	Ratio of foreign currency denominated debt to domestic currency denominated debt;	- Impose ceilings and surcharges on foreign-currency denominated financing
Maturity mismatch: Proliferation of long-term debts financed with short-term credit.	Ratio of short-term debt to long-term debt.	Impose ceilings and surcharges on short-term borrowing and long-term debt rollovers

Source: Grabel, 2004.

6.4 Policy Recommendations

The debates on capital flows and development financing should focus on policies and strategies aimed at increasing the volume of capital flows, enhancing absorption capacity – including policies to improve the efficiency of the financial system –, tilting the balance in favour of long-term capital, increasing the impact of foreign capital on diversification and transformation, raising the employment effects and the overall growth impact of foreign capital. The following policies should figure prominently on the national development policy agenda:

Improving the institutional and regulatory environment to promote financial deepening

The ability of African countries to absorb and take full advantage of capital flows depends on the depth and efficiency of their financial systems. To increase financial deepening, the financial reforms initiated over the past three decades need to be complemented by more vigorous reforms of the regulatory and legal environment, to remove distortions and increase efficiency in the financial system. These reforms must focus on increasing competition in the banking system, the range of savings instruments and the returns on savings, and on encouraging development of alternative tiers of banking institutions that are more equipped to operate at a smaller scale in the rural and informal sectors. The development of a liquid bond market is also essential to deepening of the financial system.

Promoting regional financial integration

Regional financial integration allows African countries to overcome constraints associated with the small size of their domestic markets. Integration allows those that do not have national capital markets to take advantage of regional markets to raise funds for investment. Regional financial integration will also enable the continent as a whole to attract more foreign capital. Therefore, African governments need to support and demonstrate effective commitment to new and existing initiatives for regional integration of trade and finance.

Encouraging investment-oriented remittances

Workers' remittances play an important role in increasing access to basic needs for the recipient households. However, given the observed increasing volume of remittances, it is necessary to design strategies to direct these funds into investment to minimize the inflationary effects of a potential remittance-led consumption boom, but also and most importantly to maximize the effects on economic growth through capital accumulation. Financial institutions need to play an important role in designing investment instruments to attract remittances. This alleviates information asymmetries

faced by non-resident investors, which tend to discourage long-term investment. Discussions between banks and Africans in the Diaspora may generate suggestions for new and creative means of channeling remittances into long-term investment. African governments also need to design schemes that explicitly target remittances, such as facilitating access to land for non-residents, either through purchases or fixed-term leasing arrangements.

Establishing systematic monitoring of capital flows to minimize instability

One of the objectives of financial policy is to prevent financial fragility especially by shielding the financial system and the real sector from the adverse effects of volatility of capital flows. Each African country needs to design mechanisms for monitoring the risk of instability and to establish the appropriate policy responses to impending instability. In other words, each country must identify a number of warning indicators to gauge the risk of instability and establish the appropriate measures to prevent instability. Policies for regulating capital flows must be conceived as an integral part of the national economic policy framework aimed at achieving macroeconomic stability and improving resource allocation throughout the economy.

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African countries continue to face perennial shortages of resources to finance public and private investment. This constrains their ability to accelerate growth, seen as key to reducing poverty. Resource shortages limit the ability of governments to undertake public expenditure in infrastructure and social services needed to boost economic demand, encourage private sector activity, and sustain high levels of economic growth.

To fill the financing gaps and accelerate growth, African countries need to mobilize more domestic and external financial resources. The fact is, official development assistance (ODA) to Africa has grown only in nominal terms, and the resources received over the last decade - excluding emergency aid and debt relief - increased only marginally. But while countries on the continent still depend heavily on aid for development, it is encouraging to note that they are attracting more private capital. Indeed, net flows of private capital have risen, as net official flows have declined and turned negative over the past years.

However, private capital flows remain unequally distributed across the continent, with oil-rich countries taking the lion's share. The concentration of foreign investment in the extractive industries perpetuates Africa's dependence on primary commodities, and exposes the continent to the adverse effects of fluctuations in international commodity prices. For this reason, African must attract more foreign capital, and establish incentive mechanisms to encourage a more diversified allocation of capital across sectors. It is also urgent to monitor and manage capital flows effectively so as to minimize the risks of financial instability.

Economic Report on Africa (ERA 2006) debates capital flows in development financing and examines how they can help African countries to accelerate growth and reduce poverty. The report's objective is to shed light on whether and to what extent more and better-managed capital flows will help Africa achieve its development goals.

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