THE CHALLENGES OF FINANCING
DEVELOPMENT IN AFRICA
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Heads of Delegation Meeting: 29 delegates
I. Executive Summary

1. The overall aim of this paper is to provide a selective review of critical issues facing African policy makers in mobilizing resources to finance development. To set the stage, the paper discusses in Section II the recent performance of African economies and evaluates it against specific, time-bound, poverty-reduction objectives and targets (adapted from the Copenhagen Summit). The indicative scenario (assumptions spelled out in the text) is to reduce poverty by half by the year 2015—a rate of reduction of the poverty level at an annual rate of 4 per cent per annum. The objective is to highlight the growth rates and broad orders of magnitude of the resource needs and the policy challenges implied by the poverty reduction targets. The key conclusion is that macroeconomic performance of the past four years—4.5 average annual GDP growth, resulting in positive per capita income rise—has laid a good foundation for growth. But while commendable, if the growth rates are not raised substantially—to an average of 7 percent per annum for Africa [8 per cent for Sub-Saharan Africa]—the poverty reduction targets are not likely to be attained. At the projected levels of domestic savings and efficiency of capital, the average annual magnitudes of external resources (measured as a proportion of GDP) needed to realize the set poverty reduction targets are 47 per cent during 1999-20000; 32 per cent during 2001-2005; and 10 per cent for the period 2006-2010 for Sub-Saharan Africa. North Africa needs about 5 per cent of GDP in external resources, which, in light of the present ODA flows—averaging about 3 per cent of GDP—leaves a financing gap of 2 per cent of GDP.

2. Considering the strong effort, which led to the good recent performance, the paper notes that attaining and sustaining the GDP growth rates indicated above in terms of resources and policy reforms, is a monumental task. The paper then focuses on reviewing developments and the mix of actions necessary to enhance development financing—focusing on measures to increase the impact of ODA, attract private capital, stem capital flight, raise domestic savings and switch resources from debt service to development. Trade surpluses, if attained, could also be an important source of resource inflows. The impact of the East Asian financial crisis on trade and financial flows to Africa is discussed to raise policymakers' awareness of important lessons to be learnt from the experience and the issues central to the debate on the possible reform of the protocols and institutions regulating international financial flows. The whole discussion is cast in the context of Africa's transition from public sector-led development to a private sector-driven partnership, where the public sector enables and supports an environment conducive to non-speculative private investment.

3. The discussion is intended to guide and inform the dialogue at the Joint Conference of the Ministers of Finance and the Ministers of Economic and Social Development and Planning, without necessarily attempting to be comprehensive or exhaustive. But it is expected to contribute to clarifying options in key areas of country policy, and to lead to collective regional and subregional follow-up plans towards agreed objectives in a sub-set of the issues discussed. In particular, a common regional approach is needed for fostering African ownership of the development agenda and the process for building consensus towards that agenda—so as to better focus ODA, and for engaging actively in the process of resolving the debt problem. Similarly, common steps are needed in sensitizing the proposals for reform of the international financial system to the special needs of development financing, and in supporting a subregional approach to capital markets development, in view of its importance for development financing. A similar approach is needed to build the capacity in Africa to participate in the new data and financial reporting and information dissemination systems, which have been designed by the IMF in the
wake of the Asian crisis. They are important disclosure processes that are likely to influence investor location decisions. Currently, only South Africa participates in these reporting processes.

4. The rest of this Section I of the paper summarizes the main conclusions and key policy issues for debate and for information and experience sharing. It is organized in seven sections, which relate to the sub-themes of the Conference and the structure of Sections III through VIII of the paper.

5. **Prospects and outlook for official development assistance to Africa:** The ODA component of development finance is discussed in Section III. The conclusion is reached that large increases in ODA are unlikely, even as the prospects for aid effectiveness in Africa are improving. Yet the contribution from official development assistance is important in terms of strengthening governments' ability to make long-term investments that are vital for private sector-led economic growth. Effective aid enables key public investment programmes in infrastructure and human resources to be carried out in a non-inflationary manner, which lowers operational costs and improves the efficiency of private investment. Studies have shown that in reforming countries, one dollar of aid attracts $1.80 of private investment. Aid is playing a critical and, for now perhaps, irreplaceable role in closing the gaps in financial markets that inhibit investment through its coverage of marginal risks and stretching out maturities. This helps attract billions of dollars of private investment in infrastructure and other forms of direct foreign investment, particularly large-scale, that otherwise would not take place. Aid is most effective in a good macroeconomic policy environment, and is ineffective or even harmful in poor policy environments.

6. Studies have shown that on average, aid has not been as effective as is desirable, and may have nurtured a culture of aid dependency. Reasons given for poor aid effectiveness in the continent suggest that corrective measures would need to include the maintenance of a stable macroeconomic environment; more recipient ownership and less donor-driven programmes and public expenditure decisions; and the implementation by donors of more effective aid modalities. If implemented, such measures are likely to improve the quality of management of aid resources by donors and recipients and to enhance the coordination, cohesion, focus and impact of specific donor-supported programmes and of development assistance in general.

7. Aid would be even more effective if its allocation by donors between countries was "efficient"; i.e. if it were based on poverty levels and programmes. With sound economic management, financial assistance leads to faster growth, poverty reduction, and improvements in social indicators. New studies show that in the right macroeconomic environment, ODA equivalent to 1 per cent GDP translates into a 1 per cent decline in poverty, and a 1 per cent decline in infant mortality. Additionally, among low-income countries with good economic policies, per capita GDP growth of those receiving large amounts of aid was higher than those receiving small amounts (3.5 per cent versus 2.0 per cent growth per year). It has been found that the impact on poverty reduction of reallocating aid more efficiently can only be matched by a four-fold increase in aid budgets. With a poverty-efficient allocation, aid could sustainably lift roughly 80 million people out of absolute poverty. Thus, the case for reviewing aid modalities to increase aid effectiveness is compelling, particularly in view of the poor prospects for large increases in aid budgets.
8. The Conference may wish to focus on issues of improving the efficiency and impact of public expenditures financed with foreign aid resources and "optimizing" aid's share in development expenditures, so as to reduce aid dependency in the long run. The Conference may also wish to deliberate on the substance and prospects for new aid modalities, which emphasize a holistic and comprehensive approach, as elaborated particularly in the OECD-DAC, World Bank and SPA proposals. Ministers may wish to share views on how best to foster a new donor-beneficiary relationship in which multi-donor programmes focus on supporting an Africa-driven agenda. With the support of the African Development Bank (ADB) and the Organization of African Unity (OAU), ECA has launched the African Development Forum (ADF) with that objective in mind. Its first meeting will take place in October 1999 on the theme: "The Challenge to Africa of Globalization and the Information Age. How can the ADF process best reinforce the objectives of the proposed new aid modalities?"

9. **Other sources of external finance:** Non-official sources of external finance (private capital inflows) are discussed in Section IV. Noting that Africa has not benefited from the phenomenal growth in foreign investment, compared say to East Asia, the paper lays out some key conditions and policy challenges to attract foreign investment. Among them are supportive macroeconomic policy and legal and regulatory frameworks; the rule of law and the enforcement of contracts; functioning social and economic infrastructure, financial sector reforms, support for capital markets development; deliberate and explicit attention to the concerns of investor risk rating agencies, etc. Privatization as an instrument for attracting foreign capital is discussed, along with its possible downside — the political risk associated with the declining share of national assets in the total domestic investment portfolio. The policy of promoting capital markets is highlighted as key to attracting long-term investment, including venture capital, and footloose portfolio investment, but the risks associated with globally mobile capital are pointed out, as well as possible mitigating policies, particularly in light of recent evidence from the Asian crisis.

10. The Conference may wish to reflect on the fact that notwithstanding the notable efforts made by many African countries to implement economic and financial reforms, FDI flows to most of them remain marginal. The Conference may further wish to discuss and share experiences of implementing FDI-friendly policies and the different outcomes in various countries. The Conference may also wish to reflect on the role of the International Finance Corporation (IFC) in catalyzing private sector investment and the effectiveness of the Multilateral Investment Guarantee Agency (MIGA) in offsetting the non-commercial risks perceived by potential investors in Africa. How can these agencies' work be made more effective in the task of financing Africa's development?

11. **Capital flight and its impact on development:** While striving to attract foreign savings for development, Africa has a larger proportion of wealth held overseas by residents than any other continent (39 per cent compared with 6 per cent for East Asia before the crisis). Stemming and reversing capital flight could go a long way to solving Africa's development finance problem. Section V discusses the negative financial outflows due to capital flight from Africa; the policy lapses likely to trigger or contribute to capital flight; and the measures required for stemming and reversing this phenomenon. The paper notes that adverse investor risk ratings, unsustainably high external debts and macroeconomic policy errors — or fear of their possible occurrence — are root causes of flight capital. Policy errors that cause inflation, exchange rate misalignment and high fiscal deficits choke off opportunities for profitable investments. Inconsistent and unsustainable sets of policies can also trigger capital flight even when, in the very short run, everything looks
just fine. The absence or weakness of capital markets contributes to the problem. Capital markets spread risks among investors and can create investment opportunities for the non-professional and typically small investor. Additionally, large amounts of corruptly obtained funds, particularly by public officials, are more likely to be stashed away overseas than invested in their country of origin. Corruption raises transaction costs and its unpredictability makes returns on investment uncertain, which discourages private investment. Corruption must be fought using political, administrative and economic policy instruments.

12. The Conference may wish to consider and discuss measures and policies that can improve the investment climate in African countries in order to stem the flow of resources out of the continent, focussing on policies for creating and sustaining a consistent and stable macroeconomic environment and promoting capital markets. It may further wish to discuss experiences with respect to the impact of simpler classification and administrative procedures in key areas — such as taxation, export and import licensing — on corruption by officials, and the impact of eliminating market distortions on discretionary powers of government officials and corruption. Some changes in the banking regulations of developed countries, where corruptly obtained flight funds are invested, could also facilitate repatriation of capital and forestall capital flight. The Conference may also wish to consider modalities for engaging developed countries on reforming aspects of their banking regulations that create a “safe heaven” for corruptly obtained and exported funds.

13. The challenges of mobilizing domestic resources: In the medium-to-long run, sustainable development will require higher levels of domestic resource mobilization. Section VI considers key issues in raising the savings effort — from its present level of about 18 per cent to about 24 per cent of GDP (the average for all developing countries as a group), which was assumed in the scenario that generates the resource gap in Section II. Policies to raise the savings rate need to focus on macroeconomic stability, financial and capital market reforms, financial deepening through institutional reforms and innovative savings instruments, and interest rate policy management. For public savings, the potential for further implementation of tax reforms, cost-sharing in the provision of public goods and services, the management of the terms of trade-related booms and the enhancement of public expenditure productivity are important policy areas on which to focus.

14. The Conference may wish to discuss ways of raising private savings, including strengthening and improving reliability of thrift institutions and incentives to save, as well as the need for broadening the range of flexible financial savings instruments. Ministers at the Conference may also wish to review and share experiences with tax reforms in their countries and associated problems, and discuss burden-sharing arrangements in the provision of public goods and services, as well as measures they have implemented to raise the effectiveness of government expenditure.

15. The development of capital markets has emerged as important in raising the level of domestic savings, and as critical to attracting foreign private investment, stemming and reversing capital flight. In 1996, ECA organized in Accra, Ghana, a major conference on "Reviving Private Sector Partnerships for Growth and Investment," out of which the African Capital Markets Forum was born. Its functions are to serve as a clearing-house for the exchange of views and to provide training and other services needed to build and strengthen the capacity of capital markets in Africa. Because of the limitations of small nation-states — from economic and financial points of
view – and the advantages to be gained from operations in the context of larger financial markets, a subregional approach to capital market development, including the provision of support services, is very appealing. Ministers may wish to discuss practical steps for a subregional approach to capital market development. How can the African Capital Markets Forum be further supported and rendered more effective in its functions?

16. **Africa's external debt problems:** Excluding a few less impacted countries, at over 100 per cent of GDP for the better part of this decade (leaving out South Africa and Nigeria data), Africa’s debt is essentially non-payable and certainly unsustainable under any sensible growth-oriented macroeconomic scenario. Section VII analyses issues of external debt and their resource implications. It concludes that what African countries need is the release of more resources from debt servicing for financing development and for creating conditions that encourage inflows of private foreign investment. The current HIPC Initiative, while an important instrument for delivering debt relief, is rather restrictive in its eligibility criteria and its technical basis for determining such eligibility — including the length of the “track record”.

17. Any credible solution to Africa’s debt problem must entail substantial debt cancellation — besides better debt management by Africa in the future, of course. But many creditors, particularly multilateral institutions, are extremely sensitive about the idea of debt cancellation, which is a political, rather than a technical, issue. That said, one has to note that the political will to cancel debts does exist — the UK, for example, has already unilaterally cancelled portions of debts owed it by the poorest countries, mostly African countries. New initiatives by key Group of Seven (G-7) creditors now underway could entail substantial debt cancellation, particularly if Africa’s voice could be heard. Research shows that relieving the debt overhang could be the most effective way to stem and reverse capital flight and to attract private foreign investment, as the sustainability of a stable macroeconomic framework would look more credible in the eyes of investors.

18. Five variants of enhanced debt relief proposals have been put forward for consideration at the forthcoming G-7 meeting in June 1999, in Cologne, Germany. The proposals are aimed first and foremost at strengthening and accelerating the implementation of the HIPC Initiative with a view to enabling as many countries as possible to make the necessary adjustments and receive debt relief quickly and comprehensively, but with certain important *quid pro quo* caveats. In a way, the proposals represent a shift in the official position of the industrialized creditor countries, which hitherto rallied behind the existing mechanisms and terms of the HIPC, without entertaining pleas for their revision. There is a lot of common ground between the proposals—the significant exception being the proposed additional sale of IMF gold. If adopted, the proposals could significantly reduce the waiting period before effective debt relief is granted (the German proposal would reduce it from six to three years) and result in significantly more countries becoming eligible for debt relief, in contrast with the current HIPC process.

19. The Conference may wish to revisit the ministerial statement issued at the conclusion of the 1997 Sixth Session of the Conference of Ministers of Finance, which addressed these issues. The Conference may then wish to deliberate on the various proposals laid before the forthcoming Cologne G-7 summit meeting, as well as those of other stakeholders that are geared to finding a “lasting solution to the problem”. These include the UNCTAD proposal of applying established

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1 According to the information available to us at the time this paper was written
national insolvency procedures, with independent assessment to determine a country’s debt sustainability, and calling for immediate write-off of all non-collectable debts. The Conference may further wish to discuss and share experiences of the application of non-HIPC debt relief instruments, such as debt conversion, intended to benefit middle-income countries, mainly in North Africa. In light of recent developments, the Conference may also wish to adopt a plan for Africa’s active participation in the unfolding new debt initiatives (including putting up credible alternative proposals) — a plan where Africa speaks with one voice that is coherent, loud and clear.

20. Impact, lessons and policy implications of the East Asian crisis: Section VIII discusses the impact, lessons and policy implications for Africa of the East Asian crisis and issues related to the possible reform of the international financial system. It concludes that the crisis has had a differing impact on different national economies. While oil-exporting countries are bearing the brunt of the crisis, others have experienced offsetting effects from lower oil prices and lower commodity prices. Because most African economies are relatively unintegrated in the world economy, the impact has been minimal from the point of view of financial flows. This is testimony to the fact that despite the recent good economic performance, the diversification of sub-Saharan Africa’s economies remains an elusive objective. Nevertheless the banking and currency crisis in Asia is a wake-up call for Africa and has profound policy lessons. Transparency in financial transactions must be enforced and bank supervision and regulation by central monetary authorities in Africa must be strengthened and they must remain vigilant at all times. One can also expect a second-round impact from the point of view of demand for Africa’s commodity exports due to currency realignment. The devaluation of currencies of some Asian countries that produce commodities in competition with Africa — e.g. oil palm — could result in lower demand for African exports because of higher costs in foreign currency terms of buying from Africa. So, Africa must take the necessary steps to remain competitive.

21. The Conference may wish to discuss and share experiences of the direct and indirect impact of the recent East Asian crisis on the economies of Africa, and more specifically, on trade and investment flows. The Conference may further wish to consider strategies for forestalling an East Asian-type crisis in Africa’s financial markets in light of the likely increase in private capital flows to the continent in future. Additionally, the Conference may wish to discuss measures to prevent possible loss of markets due to more competitive agricultural products from East Asia, following recent currency devaluation.

22. At the international level, proposals are being debated on how to strengthen or reform the present international financial system to prevent a re-occurrence of further crises; to respond and resolve them quickly — should they occur, and to strengthen institutional mechanisms to best support stable global financial markets. Central to the crisis prevention debate is the question of fostering better policies and more effective institutions at the national level, including sound macroeconomic policies, robust financial systems and sound infrastructure — economic, social, governance, judicial, accounting, auditing and reporting. The issue here is how to develop and agree on international standards, principles and practices on all aspects of national policy and institutions that are judged to be of central importance for successful integration in the international financial system. A key element in the crisis response and resolution debate is the contentious issue of how to strengthen the international lender-of-last-resort function, while addressing moral hazard and ensuring that the private sector is sharing appropriately in the risks. Coping and transition issues for countries in crisis are also under active debate — provision of
emergency financing, financial restructuring and mitigation of the social and human costs of financial crises. Institutional strengthening or reform has elicited hot and sometimes emotional debates, including calls — mostly by non-G-7 countries — to scrap the IMF and possibly start regional financial institutions to parallel the IMF. However no proposals have been comprehensively and openly debated; nor have alternative architectural forms of a possible new system been unveiled to the public by G-7 countries, which hold the trump card. The G-7 meeting in Cologne is expected to look at these issues.

23. An additional concern for Africa, in the debate on the possible new international financial architecture, is how to accommodate the legitimate need of poor developing countries for development financing in a situation of volatile trade, finance and capital markets. In this connection, the timing of the liberalization of the capital account is an issue of interest to Africa, as premature liberalization could prove disastrous to the development effort. Another concern should be the new stringent and streamlined reporting requirements under consideration by the IMF. The General Data Dissemination System (GDDS) and the Special Data Dissemination System (SDDS) are intended to foster transparency in financial flows under globalization. Currently, only South Africa is a participant in the systems, which are likely to become important disclosure mechanisms that private investors are likely to follow keenly in their decisions on where to invest. There is a clear need to widen Africa’s participation in the GDDS and SDDS. Already thin in statistical capacity, Africa will be hard pressed to comply with these requirements.

24. The Conference may wish to share views on the options — currently being debated in the international community — on how best to reform or strengthen the international financial architecture. Ministers may further wish to discuss and adopt a follow-up plan to make the voice of Africa heard in the deliberations. They may also wish to adopt a pro-active strategy for accessing bilateral or multilateral technical cooperation facilities to strengthen national and regional capacities for reporting international trade and financial flows in compliance with the new requirements to be applied by the IMF.

II. Recent Economic Performance and Prospects for Poverty Reduction

25. This section reviews the recent performance of African economies in relation to the objective of poverty reduction. It also derives macroeconomic policy targets for the medium-to-long term with respect to growth and investment requirements that are consistent with specific poverty-reduction goals. The objective is to set the stage for the discussion of the resource and policy challenges African policy makers face in moving forward with the poverty reduction agenda, through enhanced growth.

26. After about four decades of independence and numerous development assistance programmes, poverty in Africa continues to be widespread, deep and severe. It is estimated to affect the lives of 60 per cent of the population in sub-Saharan Africa, and 27 per cent in the North African subregion. While there are many important factors in the African poverty profile, poor economic performance is at the root of the problem. For two decades before the mid-1990s, Africa’s economies stagnated. Since the mid-1990s however, the continent has experienced a rise in many economic indicators. Real GDP growth accelerated to 4.5 per cent between 1995 and 1997 (compared to an average annual rate of 1.5 per cent between 1990 and 1994). Real average per capita GDP growth became positive, at 1.1 per cent annually over the same period (compared to about negative 1.9 per cent during 1990-94). Export growth doubled, from an annual average
of 3.9 per cent between 1990 and 1994 to 7.8 per cent between 1995 and 1997. For changes in other key economic indicators see Appendix Table 1. The improvement in Africa’s economic performance is attributable mainly to the positive effects of the macroeconomic adjustment measures undertaken in many countries since the mid-1980s and better weather conditions, which have led to strong growth in export earnings. But this performance is fragile and research has shown that key sustainability conditions are missing in most African countries — a fact partly shown by the inability to sustain the 1995 growth rate in 1997, and even less so in 1998 in the majority of countries.

27. Besides good policies, resources are needed to build on the recent good news to sustain and accelerate development for the purpose of poverty eradication. But what levels of additional resources are needed for this purpose? A number of studies and initiatives have attempted to provide alternative estimates of the total amount of resources required by Africa to achieve the objective of sustainable growth in the medium term. Some of the estimates include: World Bank (1989), ADB (1985), and ECA (1993) and most recently, van Holst Pellekaan (World Bank, 1996) and Amoako and Ali (1998), whose estimates set the stage for the resource needs and policy response discussion throughout the rest of this paper.

28. The objectives of Amoako and Ali’s estimates are to highlight the growth rates and broad orders of magnitude of the resource needs and the policy challenges implied in the poverty reduction targets. Their estimates are based on the specific objective of reducing poverty by half by the year 2015 — a 4 per cent per annum rate of reduction of poverty levels — which is an objective adapted from the Copenhagen Summit. Two critical assumptions are made, which the authors acknowledge to be optimistic — the savings rate and the efficiency of use of capital (see footnote). They point out, however, that the economic reform programmes implemented in the region will eventually lead to improvements in these parameters.

29. Based on recent work on the dynamic behaviour of poverty, a growth elasticity of poverty of 0.76 is assumed, implying that per capita income growth of 5.2 per cent is required for poverty reduction. Assuming an average population growth rate of 2.8 per cent for the sub-Saharan African region, a GDP growth rate of 8 per cent is required to achieve the poverty-reduction objective. The comparable figure for the whole of Africa is 7 per cent, mainly because the incidence of poverty is less in North Africa. The estimates show that the average annual magnitudes of external resources (measured as a proportion of GDP) required to reduce poverty by half by the year 2015 in sub-Saharan Africa are 47 per cent during 1999-2000; 32 per cent during 2001-2005; and 10 per cent for the period 2006-2010. These magnitudes of external resources are so massive that they are not likely to be attainable, particularly if the bulk of them were expected to come from official development assistance. North Africa only needs 5 per cent of GDP in external resources, which in light of the present ODA flows averaging about 3 per cent of GDP, leaves a financing gap of about 2 per cent of GDP.

30. The key conclusion is that while macroeconomic performance of the past four years — 4.5 average annual real GDP growth, resulting in a positive per capita income rise — has laid a good

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2. First, the current levels of savings in the region, which average about 16% of GDP, are assumed to increase to the historical best performance—23.5% of GDP—by the end of the planning horizon. Second, the current average incremental capital output ratio of about 9 (implying a rate of return on capital of 11 per cent) is assumed to reach the best attained in the past— 2.4 (implying a rate of return on capital of 42 per cent) achieved by Uganda in 1998.
foundation for growth, the job ahead is monumental. Considering the strong effort which led to
the good recent performance, attaining and sustaining 8 per cent GDP growth rate in terms of
resources and policy reforms is a Herculean task. The optimistic assumptions about the savings
and capital output ratios as well as the estimated massive resource requirements serve to highlight
the nature of the challenges facing African decision makers in an environment where resource and
policy options leave little room for trade-offs.

31. In order to move forward, a comprehensive framework for concerted action and strategic
interventions is needed on the part of African governments, civil society, foreign bilateral donors,
multilateral institutions and private sector actors. The aim should be to implement a mix of
macroeconomic and structural policies and programmes for enhancing investment, growth,
poverty reduction and social development. The focus should be on the simultaneous need to
increase the impact of ODA, attract more private capital, stem capital flight, raise the domestic
savings effort, and to release resources from debt service for application to development and
social programmes. The comprehensive approach to Africa’s development has already been
advocated by major development actors, most notable among them the OECD-DAC in 1996, the
UN in 1998, and more recently by the World Bank President. It is a step in the right direction.

III. Official Development Assistance (ODA)

32. African countries have always striven to complement their national development efforts by
mobilizing support from overseas “donors” — the United Nations, bilateral governments and
multilateral organizations. In response, various donor agencies have provided official development
assistance (ODA) in the form of diverse programmes with varying degrees of recipient
participation, and with different results relative to expectations. In addition, the UN General
Assembly has, from time to time, adopted a number of initiatives targeted at Africa, often in
response to Africa’s request, and sponsored several international conferences on specific
development issues of relevance to Africa. These fora are meant to be rallying points for the
several stakeholders in Africa’s development to focus, mobilize resources and pull in the same
direction for the same cause. Notable among the UN regional initiatives are the UN Programme
of Action for African Economic Recovery and Development (UN-PAAERD) 1986-1990, the UN
New Agenda for the Development of Africa in the 1990s (UN-NADAF) 1991, and the UN
System-wide Special Initiative on Africa (UNSIA), launched in March 1996. The latter was in
response to the Cairo Agenda for Action adopted by the OAU Summit in June 1995.

33. The first two initiatives envisaged additional resource flows to the continent — which
largely were not forthcoming — while UNSIA’s value-added (as the implementation vehicle of
UN-NADAF) is expected to be derived from better coordination of development assistance,
synergies between agency programmes and avoidance of waste and duplication. No additional
resources are expected to drive the programme. There are also global platforms of action — the
products of several UN-sponsored international conferences — in areas of interest to Africa.

3 Shaping the 21st Century, OECD-DAC, 1996; The Causes of Conflict and the Promotion of Durable Peace and Sustainable
Development in Africa — Report of the UN Secretary-General to the Security Council, 16 April 1998; A Proposal for a
Comprehensive Development Framework (A Discussion Draft) — Report by World Bank President James D. Wolfensohn to The

4 E.g. the Copenhagen World Summit for Social Development (1995), the Beijing World Conference on Women (1995) and the
While the jury is still out on UNSIA, there is evidence of its success in a number of programme sectors, e.g. education and information technology. However, the expected benefits from the earlier UN-PAAERD, and from UN-NADAF generally have not materialized. As well intentioned as they are, these initiatives have not reached the desired goals, causing considerable anxiety and frustration among African leaders, who have high expectations.

34. The global platforms embody quantitative and time-bound programme goals and objectives of direct relevance to Africa's socioeconomic development. At the Copenhagen Social Summit, the 1995-2000 period was chosen as the time frame within which to achieve important developmental goals, including raising life expectancy, reducing under-five mortality rates by a third and reducing poverty by half. But the global platforms are silent on the resources needed to realize the set targets. Lack of clear sources of additional resources could further add to the frustration of African leaders. Section II of this paper indicated the massive resources needed to reduce poverty by half by the year 2015 in sub-Saharan Africa — even though this would represent a slippage of the Copenhagen targets by 15 years. Can ODA flows to Africa rise sufficiently to partly bridge the resource gap within the relevant time frame? If not, how can we make the most of what is likely to be available? And what reforms of the present development assistance environment and dynamics does this entail?

35. A clear understanding of the aid environment and dynamics is necessary before postulating any reforms. From the outset, aid has had two potentially conflicting objectives. The first was the promotion of long-term growth and the reduction of poverty in developing countries. The second was the promotion of the short-term political and strategic interests of donors. It was not unusual, for example, that aid from OECD countries went to regimes that were political allies of the major Western powers, irrespective of their macroeconomic policy frameworks. And it is no wonder that ODA is declining in the wake of the end of the Cold War. In this context, it is also not surprising that the US, which is running fiscal surpluses, is not raising its ODA/GNP ratio. Hopefully, a combination of altruism and self-interest on the part of donors, i.e. the premise that in the long term, the economic and political security of donors would be enhanced if poor countries were growing, will carry the day (World Bank, 1998).

36. From a developmental point of view, aid was originally conceived in the post-World War II environment in the context of a particular "development paradigm", where poor countries were perceived to be caught in a low-income equilibrium trap, unable to generate adequate savings to promote capital formation and rapid growth. At the low level of development which is characteristic of most sub-Saharan African countries, low domestic savings rates had to be supplemented by foreign savings — in the form of ODA and FDI. The general belief was that capital from developed countries was needed to provide the spurt of growth that would make economic take-off possible. More recent research has shown that the domestic savings rate is positively correlated with the per capita level and growth rate of real GDP (Hadjimichael ET al, 1995), which further strengthens the case for aid to countries with low per capita GDP. In recent times, other aid objectives have been articulated by donors, including poverty reduction, bridging "the gender gap" and the promotion of environmental sustainability and good governance — non-controversial goals. But not all donors emphasize the same aspects in their development assistance programmes. This is a sign that donors can have different priorities in their assistance programmes, which is a source of potential non-complementarity of multi-donor, technical cooperation programmes and one of the elements in the controversy about aid.
37. Until recently there was little controversy, if any, about the role of development assistance in recipient countries. While the evidence on aid effectiveness is mixed, it is clear from recent research that when the right policy conditions prevail, aid can be effective in the promotion of growth and the alleviation and reduction of poverty. But aid can be ineffective or harmful in a poor policy environment. Effective aid complements private investment. It enables key public investment programmes in infrastructure and human resources to be carried out in a non-inflationary manner, which lowers operational costs and improves the efficiency of private investment. Studies have shown that in reforming countries, foreign aid acts as a magnet that "crowds in" private investment by a ratio of almost $2 to every $1 of aid. This is due to the fact that aid increases the confidence of the private sector and helps to provide public services that investors need, such as education and infrastructure. The recent positive trend in private capital inflows to Africa makes the contribution from official development assistance more important in terms of strengthening governments' ability to make long-term investments that are vital for private sector-led economic growth.

38. Official financial assistance leads to faster growth, reduction of poverty and improvements in social indicators in countries with sound economic policies, per capita management. "The effect is large: with sound country management, 1 per cent of GDP in assistance translates into a 1 per cent decline in poverty and a similar decline in infant mortality" (World Bank, 1998b, p. 14). GDP growth of those receiving large amounts of aid was higher than that of those receiving small amounts (3.5 per cent versus 2.0 per cent growth per year). With the present aid allocation and sound macroeconomic policy environment, aid is effective in sustainably lifting some 30 million people per annum out of absolute poverty.

39. More efficient allocation between countries on the basis of their relative poverty levels and quality of their policy programmes could dramatically enhance the impact of aid. Recent studies have shown that the impact on poverty reduction of reallocating aid more efficiently can only be matched by a four-fold increase in aid budgets. With a poverty-efficient allocation, aid could lift roughly 80 million people per annum out of absolute poverty.

40. On average, aid has not been as effective in Africa as would be desired. While aid has generally appeared to be important to Africa, the outcomes have been different from country to country. Questions began to be asked about the effectiveness of aid in the promotion of growth and poverty reduction, as aid has appeared in different cases to be highly effective, totally ineffective and everything in between. The poor performance is attributed to a host of factors, including the lack of recipient ownership; ineffective management of aid resources by donors and recipients; prevalence of donor-driven programmes and poor aid coordination. With the budgets of aid beneficiary countries strained, inadequate project counterpart funds and a shortage of resources for operations and recurrent maintenance have plagued donor-financed projects (Burnside and Dollar, 1997, p.5).

41. Policy implications for Africa of the above findings are very clear. With a good macroeconomic environment, aid can indeed be a powerful tool for the promotion of growth and

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5 Burnside and Dollar (1997) use a broad definition of sound policies and institutions that closely correlates with both economic growth and poverty reduction. They include open trade, secure private property rights, absence of corruption, respect for the rule of law, social safety nets, and sound macroeconomic and financial policies.

6 See the Dollar definition in footnote 1 above.
the reduction of poverty. Without continued improvement in the macroeconomic policy environment, the perception and reality that aid has not been effective would persist. Fortunately, an increasing number of African countries have improved, or are in the process of improving, their macroeconomic policy environment. Thus, it is ironic and tragic that the volume of aid to Africa may decline just as the environment for effective aid utilization is improving (World Bank, 1998b). African countries would best be further advised that as overall aid flows continue to decline, the continent could begin to lose out on aid allocations both in absolute and relative terms, compared to other regions with relatively better economic performance and aid effectiveness records. Therefore, it is incumbent on African countries to deepen their policy and institutional reforms in order to attract additional aid and use it more effectively.

42. Aid dependency is also an issue of concern for Africa — although in the short run, it is quite inevitable. While there is considerable country variability, aid dependency measured by the ODA/GDP ratio has already risen from an average of 2.7 per cent in 1974-84 to 5.0 per cent in 1990-96. For other indices of aid dependency, see Appendix Table 3. The high aid dependency is a reflection of the low savings prevalent in African countries. It has serious implications for the sustainability of the development momentum in Africa and adds to the number of questions being asked about optimum levels of aid and aid effectiveness. Without the reforms outlined above, aid effectiveness is likely to remain low and aid dependency perpetuated. Policy makers need to keep at the top of the agenda the issues of improving the efficiency and impact of public expenditures financed with foreign aid resources and "optimizing" aid's share in development expenditures, so as to aim at reducing aid dependency in the long run. They also need to foster a new donor-beneficiary relationship in which multi-donor aid programmes are focused on an Africa-driven agenda, in order to strengthen the impact of aid.

43. Past experience with aid on the part of donors and beneficiary countries suggests an urgent need to reexamine current aid modalities with the aim of increasing aid effectiveness. Both donors and developing countries seem to agree on this issue. A key objective of the reforms should be to break the spiral of the weakness in (recipient) country capacity (for programming, monitoring and evaluation), which has led to escalating donor intrusiveness in public expenditure decisions (motivated by the urge to disburse funds) — which in turn has further weakened recipient country capacity. The key to breaking this spiral is to put in place a mechanism for consensus building among key African development stakeholders (including donors) around an Africa-led agenda and to return spending authority, control and accountability to the beneficiary countries.

44. Towards this goal, the framework advocated by the OECD DAC and the recent call by the UN Secretary-General, as well as the World Bank President for a holistic and comprehensive approach to Africa's development are welcome steps. The Special Programme of Assistance to Africa (SPA) partnership has also come on board in terms of advocating a more prominent and systematic incorporation of perspectives from SPA countries; strengthening the focus on aid effectiveness through the development of new aid instruments; performance monitoring; selectivity and more effective follow-through within agencies and on the ground. The emphasis of the new thinking is the integration at national level and among global players of macroeconomic aspects of development with fundamental long-term issues of the structure, scope and substance of

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8 See Section II footnote 2.
societal development. They imply open sharing of information among all players and clear leadership by developing country governments in the programming and implementation of development programmes. Moving a step towards operationalizing the holistic and comprehensive framework, the World Bank's proposal articulates a matrix that juxtaposes the structural prerequisites for sustainable growth and poverty alleviation with the activities of donors and partners who can assist in the process of attaining those structural objectives. The matrix is a tool for identifying unmet needs and for strengthening cooperation, transparency, partnership and accountability for results.

45. In such a comprehensive framework for aid, for example, aid, debt and other factors impinging on the development process would not be considered in isolation. Creditor governments and their ODA agencies would act in concert: the ODA arm to ensure that aid composition is consistent not only with the long-term need for fiscal and external balance in the debtor country, but also with long-term structural transformation needs. Creditor governments would ensure that the terms of debt relief support rather than subvert ODA objectives and, debt relief arrangements do not have the effect of diverting ODA intended to promote economic development. The OECD DAC report emphasizes, among other things, that well-targeted debt relief could make a real difference to the achievement of social and poverty reduction goals by the 21st century. At the same time, it would help to reduce dependence on aid. When operational, the comprehensive approach would be a major step towards enhancing the effectiveness of ODA in the African development process.

46. Aiming to facilitate Africa's lead in driving the continent's development agenda — on which aid would selectively focus — and with the support of the OAU and ADB, ECA has launched the African Development Forum (ADF) as a regional and country-level process to rally Africa's development stakeholders, among them donors, around key issues and programmes. The overall objective of the ADF is to facilitate a process of consensus building among the key stakeholders of Africa's development on a shared vision of the continent and a strategy and instruments for realizing that vision. We expect some 200 to 300 invited participants from African governments, civil society, researchers and academics, intergovernmental organizations and donors at each forum, which will focus on a specific theme each year and will set goals and priorities for the continent. The forum will result in sharply defined, time-bound actionable programmes that can be implemented within the capacity of African countries. Because selected partners will be invited to participate in proceedings of the Forum, or its other activities, the Forum will facilitate donor contributions to consensus building. It will also enhance the donor community's familiarity with African development aspirations and priorities, which will enable donor programmes to be more responsive to locally determined needs.

47. The ADF process is designed to strengthen cohesion in multi-donor assistance programmes and to tap synergies of various agencies in support of Africa's development. It will bridge, and hopefully make unnecessary, the continued proliferation of new external agency-led initiatives towards a future vision of Africa — initiatives which, in any event, have proved difficult to translate into cohesive programmes. It will also answer the call of the UN Secretary-General to Africa's regional institutions to take the lead in facilitating a well thought out and articulated development agenda for the continent, which is Africa-led and appropriately supported by the international community. The first forum will be held in Addis Ababa in October 1999 on the theme: "The Challenge of Globalization and the Information Age", which will further promote the objectives of the African Information Society Initiative.
IV. Other Sources of External Finance

48. The net rate of return on investment in African countries is higher than in other developing countries. It was estimated at between 20-30 per cent during 1990-1994, on average, as opposed to 16-18 per cent for all developing countries. Yet Africa has not been one of the significant beneficiaries of the dramatic increase in global foreign direct investment flows. FDI flows to Africa amounted to only $4.76 billion in 1997, the same level as in 1996, representing a minuscule 3 per cent of global FDI flows. Moreover, the flows are concentrated on a few countries and activities. Only about 20 countries are beneficiaries, with Nigeria, Egypt, Morocco, Tunisia and Angola together accounting for two-thirds of FDI flows to Africa in 1997 (UNCTAD, 1998b). More than 50 per cent of all FDI went to support the oil and petroleum industry, and most of the rest went to extractive, mainly mining, activities. And one needs to recognize that the decline in commodity prices, especially those of petroleum, gold, and diamonds could reduce the attractiveness to foreign investors of some of the countries — such as South Africa, Nigeria and Angola — that have been major recipients of FDI in the recent past. Little FDI went to industry or services, where there are the greatest opportunities for technology transfer to sustain the development process. The foreign-funded manufacturing sector, which was dominated by import-substituting industries, remains weak, largely because import liberalization has adversely affected their shares of the domestic market, in addition to large currency devaluations which have undermined their rates of return in foreign currency terms.

49. Africa’s difficulty in attracting foreign investment is attributed to the perception that investing in the continent is a high-risk activity. This perception is rooted in a number of interrelated factors, which have given the continent a negative image, including poor human, social and economic infrastructure, fear of policy reversal, civil conflicts and an inadequate legal framework for the enforcement of contracts. Low levels of income and small market size, poor international competitiveness, weak domestic private sectors, undeveloped domestic financial sectors and rudimentary capital markets are other key constraints to attracting private capital flows. Surveys of foreign investors show that, FDI goes to countries with a stable political and economic environment, transparent and minimal regulations, good infrastructure facilities, a skilled labour force and low production and transactions costs — much the same set of factors that encourage domestic investors. These features have been largely absent in a number of African countries (Fisher et al, 1997) and account for the poor performance. For selected FDI stock indicators for 1987 and 1996, see appendix Table 4.

50. In spite of the constraints to accelerated flows of FDI, there are encouraging signs that this could change. Major steps are being taken by several countries to eliminate those factors that inhibit FDI flows, including maintenance of a supportive macroeconomic policy environment; increased liberalization of markets and trade regimes, business facilitation and improvements in the regulatory framework for private investment. As a result, economic fundamentals in the region are improving, which is an essential inducement for private sector investment (UNCTAD, 1998b, p. 177). Initiatives outside Africa to promote private investment in the continent are also likely to reinforce this trend. Notable among them is the US initiative elaborated in the African Growth and Opportunity Act, which was approved by the United States House of Representatives in March 1998. While there is some lingering debate within the Africa constituency in the US, and some alternative proposals are being put forward, the initiative is a major step in US-Africa trade and investment relations. The proposals in the present initiative include the removal of all quotas and tariffs for apparel and textile imports from Africa; establishment of a $150 million
fund for equity investment in Africa; and setting up a $500 million private equity fund for investment in particular infrastructure projects. These funds, to be set up by the Overseas Private Investment Corporation (OPIC) are expected to induce private investors to participate (UNCTAD, 1998b).

51. Domestic and foreign programme and policy initiatives, however, will by themselves not produce durable private investment and development in Africa without key sustainability conditions being met, including raising the productivity and competitiveness of African economies. African countries will need to invest in human capital, physical infrastructure as well as technology. As UNCTAD argues, strong productivity growth in the economies of Bangladesh, India and Indonesia was the key ingredient of their export success. It is, therefore, also imperative that African countries concentrate on improving the competitiveness of their economies in order to gain a foothold in the world economy.

52. In the absence of selective export promotion policies, competitiveness depends on the behaviour of real wages, on productivity growth and on the real exchange rate. A comparison of unit labour costs in African countries and some potential competitors in a number of manufacturing sectors in 1995 shows that in most cases, costs in Africa were much higher than in competing countries. Moreover, in general, unit labour costs in Africa actually increased after 1980 relative to those in competing countries, even though in many cases real wages stagnated or even declined (UNCTAD: 1998a, pp. 198-201). African countries, therefore, will need also to focus on how to improve the productivity and competitiveness of their economies as an integral part of the strategy to attract foreign direct investment and strengthen private sector activities in general.

53. Privatization in Africa is becoming an increasingly important (although far from fully explored) avenue for foreign investment (UNCTAD, 1998b). Expanding privatization programmes in a number of African countries has broadened opportunities for FDI. In the privatization process, foreign investors bring along with them proven managerial capabilities, new technology and market access. Although privatization is attracting foreign direct investment (FDI) in Africa, the amount is small relative to total FDI and compared to privatization-related FDI flows to the rest of the world. Such flows represent less than 5 per cent of all foreign investment in the Africa region, compared to 43 per cent in the transition economies of Eastern Europe, and 15 per cent in Latin America and the Caribbean (White and Bhatia, 1998). The low level of participation by foreigners in privatization in Africa can be directly attributed to the small size of privatized enterprises, weak promotional efforts, lack of transparency of transactions, weak legal systems and the preference for local investors in areas of interests to foreigners.

54. There are a number of policy issues with which African countries have to grapple in the process of privatization. The most urgent one is the issue of broadening the ownership base of privatized enterprises to be more inclusive of major national constituencies. If ownership is broadened, national aspirations are satisfied and political acceptance of the process is garnered. Concrete issues relate to the avoidance of concentration in one particular ethnic group as opposed

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9 UNCTAD: 1998(a), pp. 198-201
10 These include Angola, Cape Verde, Côte d'Ivoire, Egypt, Ghana, Kenya, Morocco, Mozambique, Nigeria, Senegal, South Africa, Tunisia, Uganda and Zambia. Programmes have been recently introduced in Burkina Faso, Botswana, Ethiopia, Madagascar, Namibia and Zimbabwe.
to another; the rich as opposed to the middle class; one political class as opposed to another, and a
minority as opposed to the majority. Another important issue is the extent to which foreigners
should have control over the “commanding heights of the economy” in the process of
privatization. Should foreigners be allowed to own a larger share of most industries or sectors of
the economy? In many African countries, there is reluctance to allow foreigners to own majority
shares in sensitive areas of the economy such as the banking and power sectors. Some African
countries have not yet opened up their economies to foreigners. Opening up is often seen as
economic neocolonialism. Nationalists argue that while privatization can be an important source
of financial resources for development, African countries have to reconcile financial needs with
the delicate issue of complete foreign ownership of important sectors of the economies. It has
been noted, however, that selling to foreigners is often the only way to avoid accusations of either
tribalism or nepotism (White and Bhatia, 1998).

55. The role of capital markets in the provision of risk capital has come to the promotion of
capital markets in an effort to increase domestic resource mobilization, centre stage in many
African countries. African countries have in recent times been giving greater attention improve
the supply of long-term capital, and encourage the efficient allocation of existing resources. In
many countries, there has been renewed activity in old markets while new ones have either
emerged or are being planned as a result of the key roles which capital markets are beginning to
play. They include lowering the cost of equity capital, thereby stimulating investment and growth.
By spreading the risks associated with long-term investment projects and by imposing a degree of
control over the investment behaviour of companies, capital markets contribute to more efficient
investment. They also enhance the supply of investible funds by attracting foreign portfolio
capital. They contribute to the mobilization of domestic resources and the provision of fresh
equity capital to the corporate sector (Dailami and Michael, 1990).

56. Capital markets are especially important in attracting portfolio equity funds, which
currently are of relatively minor importance in many countries. The exception is South Africa,
which attracted the lion’s share — $1.8 billion or 90 per cent — of portfolio flows to Africa in
1996. However, these flows are likely to assume more importance in more countries as capital
markets develop. Such investments are usually made by financial institutions, institutional
investors (such as pension funds, insurance companies or investment trusts) or individuals.
Foreign equity investment is made through direct purchases by individual investors of shares in
companies listed on the stock exchange of the countries concerned.

57. Capital markets are also critical to attracting venture capital funds, which in general seek to
invest in new and high-risk undertakings (UNCTAD 1998a). Venture capital funds are more
likely to consider favourably small-scale investments and, on the face of it, would appear to be
more appropriate for African and other developing countries. Unfortunately, because of the small-
scale nature of the projects attractive to it, venture capital is unlikely to satisfy the need for
private finance in Africa. As the development of capital markets is very important for venture
capital funds, African countries should make concerted efforts to expand and to deepen capital
markets as an instrument for resource mobilization. There is also a need to develop the regulatory
and supervisory framework for the effective functioning of capital markets. 11

11 See UNCTAD (1998a) for more details.
58. Because of their potential for mobilizing foreign and domestic resources, many African countries are now trying to promote and should deliberately support the development of domestic securities markets. But there are challenges to be faced in the process. First, there is the need to put in place supportive infrastructure for the market. Such infrastructure includes efficient, non-banking financial intermediaries (trust companies, brokerage firms, etc.) and reliable communications networks. Second, there is a need for legal and institutional framework for the efficient functioning of such markets. Third, there is a need for an appropriate enabling macroeconomic environment — including political and economic stability, fiscal discipline, and appropriate interest and exchange rate policies. A viable market cannot be developed in an environment where monetary expansion is excessive, and inflation and budget deficits are high. Similarly, financial repression is a major obstacle to the evolution of capital markets. Furthermore, building a strong banking system has to be part and parcel of the process of deepening and broadening financial intermediation in Africa. It will require improvement of the institutional framework and management for effective intermediation, prudential regulation and supervision of banks and non-bank financial institutions; broadening financial instruments available to both savers and investors; and enhancing the contribution of indigenous banking and financial institutions in the mobilization of savings.  

59. In a world of global financial flows, the development of capital markets places a lot of responsibility on economic and financial policy managers, as the funds in the market are mobile. At any time, the country hosting the funds is in competition with others that can attract those funds away. The East Asian banking and currency crisis and the massive migration of capital out of the region is testimony to the fact that economic and financial management must be meticulous if foreign capital is going to play a greater and sustained role in the development of African countries. While it is clear that efficient capital markets can play an important part in mobilizing domestic and external resources to support development, the challenges facing many African countries in developing, operating and regulating such markets are enormous. Policy makers should reflect on the fact that notwithstanding the notable efforts made by many African countries to implement economic and financial reforms, FDI flows to most of them remain marginal. Sharing experiences of implementing FDI-friendly policies and the different outcomes in various countries would also be useful. What additional steps need to be taken to enhance Africa’s competitiveness in global capital markets? It would also be appropriate to explore opportunities for enhancing the role of the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA) in catalyzing private sector investment in Africa.

V. Capital Flight Issues

60. Africa has a larger proportion of wealth held overseas by residents than any other continent (39 per cent vis-à-vis 6 per cent for East Asia before the crisis). Another possible non-conventional source of financing development which has not been adequately explored is, therefore, the possible stemming and reversal of capital flight, which has devastated Africa’s development over the years. Notwithstanding definitional problems, there is ample evidence that the amount of capital flight is significant. Between 1982-91, capital flight from the severely indebted, low-income countries in sub-Saharan Africa was about $22 billion (Ajayi, 1997).
equivalent to about half the external resources required for development as estimated by Amoako and Ali (1998) — see Section II. It is also noteworthy that as Africa struggles to cope with debt, for about 18 countries, the average capital flight/debt ratio was over 40 per cent — and much higher for some countries (94.5 per cent for Nigeria, 94.3 per cent, Rwanda, 74.4 per cent for Kenya and 60.5 per cent for Sudan). In relation to GDP, capital flight was estimated as high as 133 per cent for Nigeria, 102 per cent for Sudan and 58 per cent for Kenya, respectively. (Ajayi, 1997). Capital flight constitutes a menace to, and a diversion of resources from Africa’s development.

61. There are serious negative consequences of capital flight. First, any amount of money sent away to foreign lands cannot contribute to domestic investment. Thus, capital flight is a diversion of domestic savings from domestic real investment. Second, income and wealth generated and held abroad are outside the purview of domestic authorities, and therefore cannot be taxed. Thus, potential government revenue is reduced, thereby constraining project execution and debt-servicing capacity (Ajayi, 1992). Third, income distribution is negatively affected by capital flight. The poor citizens of African countries are subjected to austerity measures in order to pay for external debt obligations to international creditors.

62. Given the magnitude of capital flight and its macroeconomic significance, the policy challenge is how to stem capital flight and cause its reversal. In order to achieve this objective, there is need for an understanding of the causes and means of effecting capital flight from Africa. The causes of capital flight are many — economic and otherwise. The economic causes stem largely from relative risk, exchange rate misalignment, financial sector constraints and/or repression, fiscal deficits and external incentives. Other causes include corruption of political leaders and extraordinary access to government funds (Ajayi, 1992). Trade faking is a key instrument for illegally effecting capital transfer. Four categories of international trade faking have been identified in Africa (Ajayi, 1997): under-invoicing of exports and over-invoicing of imports, over-invoicing of both exports and imports, under-invoicing of both exports and imports and under-invoicing of exports and over-invoicing of imports. Over-invoicing/under-invoicing in Africa can arise from the maintenance by countries of overvalued currencies and foreign currency restrictions (Ajayi, 1992). Second, the existence of high import duties can provide the incentives among importers to under-invoice imports in contrast to the usual case of over-invoicing imports when a premium exists on foreign exchange in the black market. Third, if there is a subsidy on imports it will likely cause over-invoicing of imports. Fourth, if a subsidy exists on exports, it will lead to over-invoicing of exports.

63. Econometric analysis clearly shows that domestic macroeconomic policy errors are the culprit in capital flight. Of particular significance are policy errors that cause inflation, exchange rate misalignment (generally, currency overvaluation) high fiscal deficits and the lack of opportunities for profitable investment within the domestic economy. The policy challenge lies in establishing a stable macroeconomic environment, avoiding an overvalued exchange rate, maintaining free access to foreign exchange through the market system, and maintaining a trade liberalization policy, where high tariffs and subsidies are eliminated. In many African countries, surveillance and monitoring are also necessary. Indeed, where policies to meet these objectives have been sustained, there is evidence of reversal of capital flight. In a number of countries, including Côte d’Ivoire, Uganda, Ghana and Kenya, this began to happen in the late 1980s and early 1990s as a result of a favourable macroeconomic environment — reinforced by political stability and the availability of more investment instruments. But the significant edge foreign
countries have over Africa in terms of investment safety and flexible investment instruments cannot be ignored. It stems from the financial repression which was characteristic of most African countries until recently. The financial liberalization embarked upon by a number of African countries is helpful, and will be even more so as capital markets develop, in the process of stopping or reducing capital flight, and encouraging capital inflows.

64. Capital flight from Africa has political dimensions that must be addressed. First, there is anecdotal evidence that some African leaders and government officials — through the perquisites of their offices — operate huge, foreign currency-denominated accounts outside their countries, which is tantamount to abuse of office. Those who illegally acquire such assets should not be allowed to circumvent the due process of law. The time has come for transparency and accountability in governance. The second political dimension is the responsibility of countries that play host to such accounts to discourage the placement of such money by refusing to accept it. This can be very helpful to African countries in retaining within their borders funds which they badly need for development. It would also be very helpful to Africa if the whole of the international community enforced a system of account disclosure, whereby the accounts of foreigners (with owner’s name) after a given account balance threshold are periodically (say quarterly) published in papers that circulate internationally. In the case of large accounts where the owners have died, it would be helpful if access to such illegally acquired wealth could be given to the treasury of the country of origin of the depositor.

65. Much of capital flight from Africa appears to have originated from illicit diversion of public funds rather than to have been constituted by business incomes seeking economic stability or high yields abroad. To that extent, market confidence and policy credibility considerations probably play a minor role in the decisions about where the funds are invested. A change in the banking regulations of those developed countries where these funds tend to be invested would probably be a more effective measure towards their repatriation, as indicated above, and also by UNCTAD (UNCTAD: 1998(a), pp. 215-216). It should, however, also be recognized that considerations of risk and return are not completely irrelevant in explaining capital flight out of Africa. Greater political stability, effective property rights, investment incentives and stable exchange rates have often helped to stem and/or reverse capital flight.

VI. Domestic Resource Mobilization

66. The need for African countries to mobilize domestic resources as a medium- to long-term goal is now widely accepted. In the past, savings rates in Africa have been low, as have investment rates. While savings performance varies between countries, African countries have lower savings and investment rates than other less developed countries. In 1997, domestic savings as a percentage of GDP was 17.6 per cent (compared to 24 per cent for all developing countries), while investment was 18.3 per cent of GDP in contrast to the over 32 per cent required for the poverty reduction targets set in Section II. A sustained increase in growth rates requires higher levels of savings and investment, as well as increased investment productivity. Thus, policies to promote savings have a central role to play in driving growth via investment and reducing aid dependency in SSA, particularly in the face of the anticipated global reduction in aid. Identifying policies that promote savings (and the policy distortions that inhibit it) should be an essential element in any strategy for the long-term development of the continent (Elbadawi and Mwega, 1998). This is a basic policy challenge for decision makers in Africa.
67. Given that savings come from households, the business sector and from the government, what can be done to promote savings? There is abundant theoretical and empirical literature on private saving behaviour even though different studies focus on one or two aspects of the issue. Surveys suggest that the literature is somewhat fragmented, with no single model able to deal with every dimension of the savings issue (Edwards, 1994). Among the determinants of private savings are economic growth, terms of trade, fiscal and financial policies, macroeconomic stability and demographic factors. However, for most low-income African countries, it is generally recognized that a significant autonomous increase in the domestic savings rate is not feasible as a way of accelerating growth. Rather, efforts would need to be directed at increasing output, income and aggregate savings by greater utilization of existing resources, increased inflows of ODA and by improving the allocation, quality and efficiency of investment.  

68. **Macroeconomic Stability:** Empirical results suggest that macroeconomic stability is critical to stimulating savings. Mason et al (1995) find that saving is negatively correlated with inflation. The rate of savings is, therefore, enhanced in an environment where the rate of inflation and level of budget deficits are low. Uncertainty about the real returns on savings, and about the direction of macroeconomic policies, has deleterious effects on savings (Hadjimichael et al 1995). This conclusion calls for increased transparency and debate in the culture of economic decision making. At the technical level, it calls for the determination of a sustainable growth path for national income consistent with non-expansionary monetary policies and sustainable balance of payments and budgetary positions. Continued strengthening of macroeconomic policy modeling capacity in the government’s key economic and financial policy management agencies should be an element of the reforms necessary to foster higher domestic savings.  

69. **Financial and Capital Market Reforms:** The effects of financial and capital market reforms on private savings work through various channels, and the effects can be negative or positive. First, capital market reforms may reverse capital flight, thereby raising the portfolio share of domestic assets and increasing measured income, measured net exports and measured domestic savings. Second, financial liberalization and capital market deepening may raise the efficiency of intermediation, thereby increasing growth and thus private savings. Third, financial liberalization and the consequent increase in geographical density of financial institutions, the range of financial institutions, and the quality of regulation and supervision in the financial sector, typically lead to financial deepening that will be reflected in more financial savings (Schmidt-Hebel, 1996). The flexibility that investing in capital markets gives to all types of savers and the spreading of risks among them, makes a powerful case for pursuing capital market development strategies. Additionally, as noted earlier, development of capital markets is critical to attracting foreign savings to Africa in the form of foreign direct and portfolio investment. But its role is limited in part due to the dominance of small, nation-state markets in Africa. Policymakers should adopt a subregional approach to the support and development of capital markets, so as to strengthen their catalytic role in mobilizing savings.  

70. **Financial Deepening:** The monetization of a broader range of economic activities and transactions would facilitate financial savings, as would the broadening of the range of flexible savings instruments — all key elements in the process of financial deepening, which is often measured by the ratio of broad money to GDP. There is empirical evidence of the positive and significant effect on savings of the increase in the ratio of broad money to GDP. Thus the process

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13 For an elaboration of this argument, see UNCTAD: 1998 (a), pp. 166-171, 189-191, and 212-217.
of financial deepening, which is spreading throughout the whole of Africa, has a large pay-off in terms of domestic resource mobilization. With the policy and regulatory framework for financial sector operations established under past and on-going reform programmes, policy makers need to add to their menu of concerns the promotion and development of institutional architecture that will facilitate the process of financial deepening. Innovative, flexible and targeted savings instruments, savings schemes and savings mechanisms appropriate to different segments of the population should be promoted. For example, since research shows (the life cycle model) that the age composition of the population does have an influence on household savings behaviour — with the youth and the elderly saving least — middle-aged working people should be targeted. Instruments such as well-structured, professionally managed retirement funds could be important savings vehicles for this category of the population. Experiences of countries with relatively new savings instruments, such as those of Malawi with Unit Trusts, could be shared among conference participants.

71. **Interest Rate Policy:** According to available research evidence, the impact of interest rates on household savings is ambiguous because there are both income and substitution effects which work in opposite directions. Higher interest rates increase the opportunity cost of consumption, hence households increase savings (the substitution effect), while the rising wealth of positive savers (as a result of the increase in interest rates) increases consumption (the income effect). Empirical studies usually find a non-significant or small interest rate elasticity of domestic savings. However, it has also been argued that in a situation of financial repression, typical of many African countries before financial sector liberalization, the liberalization of interest rates would increase savings and the supply of investible resources in the economy (McKinnon, 1973; Shaw, 1973; Elbadawi and Mwega, 1998). In any event interest rate policy should be designed to allow a margin appropriate to the risk an investor/saver faces over the term of the savings/investment instrument.

72. **Terms of Trade:** The management of trade booms and contractions can be critical to private as well as public savings. To the extent that terms of trade shocks contribute to macroeconomic volatility, undermine fixed exchange rate regimes and destabilize the domestic banking system, booms and contractions can have far-reaching consequences for private and public savings. Depending on how the boom is managed and whether more of the adjustment falls on the public or private sector, the outcome will depend on the combination of fiscal, monetary and banking regulation instruments applied, the availability of hedge instruments, as well as the political environment for fiscal decisions. Generally, an improvement in the terms of trade increases incomes, and hence potential private and public saving, especially if the improvement is considered transitory (Mwega, 1997). This effect is important in Africa where exports which are sold in volatile markets are limited to a few primary commodities. During periods of commodity price booms, savings mobilization campaigns and innovative, flexible, publicly and privately issued hedge and insurance instruments should be developed, as well as improved incentives to hedge and self-insure against the risk of a possible contraction. Critical to the success of any hedge strategy is the quality of regulation of financial institutions. The experience of countries with various instruments to manage booms and raise savings, such as that of Uganda with a temporary export tax on coffee in 1996 can be shared among conference participants.

73. **Fiscal Reforms, Public Expenditures and Public Savings:** Besides fiscal action in the commodity boom situation discussed above, other areas hold prospects for increased public savings: further implementation of tax reforms, cost sharing in the provision of public goods and
services and enhancing public expenditure productivity. Taxes are a principal means of public domestic resource mobilization, but the need for revenue must be balanced against the possible adverse effects of particular taxes and the whole tax structure on relative prices and incentives, which may give inappropriate price signals. Broadly, tax reforms should aim at broadening the tax base, raising tax elasticity with respect to economic growth, reducing exemptions, and simplifying tax administration. The sharing of experience by policy makers in implementing public resource enhancement measures in the above areas will be most useful.

VII. Africa's External Debt

74. In addition to ODA and private foreign and domestic flows, which are conventional sources of development finance, the resolution of Africa's debt has great potential as a non-conventional source of resources. Most of sub-Saharan, low-income countries' debt is owed to official creditors. In contrast, 40 per cent of the debt of African middle-income countries, mainly North African, are commercial. Of the five ECA operational subregions, North Africa has the largest share of Africa's total debt — over one-third of the total in 1996. The subregion is the most current on debt service, accounting for over 40 per cent of the total debt service payments by Africa to creditors in 1996. While debt severity is usually associated with sub-Saharan Africa, at 30 per cent (1994-96) Morocco's ratio of total debt-service to export revenue is one of the highest in Africa. Even though the severity of debt differs between countries and subregions, Africa's debts are too high to afford and debt relief on a more inclusive and more effective basis than hitherto remains essential to the continent's ability to meet minimum development needs. As a proportion of GDP and of export earnings, Africa's debt of $350 billion in 1998 is the highest of any developing region (see Appendix Table 5).

75. Judged by the debt burden indicators and debt servicing capacity, it is clear that many African countries are still in debt difficulty in spite of previous debt relief extended by creditors. The discrepancy between debt service paid and debt service due has continued to grow. Additionally, the ratio of scheduled external debt service relative to government current expenditure exceeded 50 per cent in a large number of African countries. The extent of the inability to pay is indicated by accumulated arrears which, by 1996, had reached over $64 billion, amounting to more than a quarter of the total debt—and accounting for about two-thirds of the increase in debt in 1998 (UNCTAD, 1998 p. XII).

76. What African countries need is the release of more resources from debt servicing. The large debt implies that vast amounts of resources are allocated to debt service, thereby reducing what is available for financing development. For most countries, it means that inadequate resources are left for national development after debt service. The implication is that the debt has become so large, relative to export earnings and economic size of the countries, that it would be impossible to repay it without imposing an unbearable burden on debtor countries. There is already abundant empirical evidence that Africa's external debt burden is having a severe adverse impact on investment and renewed growth. It impedes public investment in physical and human infrastructure and deters private and foreign investment thereby creating a situation that discourages inflows of new external resources (ECA, 1997 p.27).

77. Given the negative effects of the debt burden on African economies and the need to release resources, the issue of debt should be discussed more fundamentally from a political dimension and the perspectives of Africa's economic development. While the need to do something about
debt appears to be universally accepted, what to do is still being debated, as past initiatives clearly have not been comprehensive enough. The most recent one—the Heavily Indebted Poor Countries (HIPC) Initiative—was born out of the recognition in the 1990s that a significant number of low-income countries had debt burdens that remained above sustainable levels over the medium term. Even strong policy performers that made full use of current debt relief mechanisms were in trouble. The primary objective of the HIPC Initiative is to ensure—for countries with a good track record of adjustment and reform—a robust exit from debt rescheduling and the achievement of debt sustainability.

78. During the first two years of implementation of the HIPC Initiative, 10 countries were reviewed for eligibility. Debt relief in the amount of $6.1 billion was eventually committed to seven countries, five of which are in Africa: Burkina Faso, Côte d'Ivoire, Mali, Mozambique and Uganda. A number of African countries in the pipeline include Ethiopia, Guinea-Bissau and Mauritania. No doubt the HIPC Initiative, spearheaded by the World Bank and the IMF, is the boldest step in the direction of debt relief so far. While some have argued that it is too early to pass judgement on HIPC, doubts have been expressed about its ability to solve once and for all Africa's seemingly intractable debt problem. Basic concerns have been expressed with regard to eligibility for and the adequacy of debt reduction, the speed at which relief should be granted—the length of the completion period—(UNCTAD, 1998), the performance criteria and the technical basis of the debt sustainability analysis. Also at issue is the role of the Fund and the Bank, both of which are creditors. As creditors to the HIPC Initiative, the Bank and Fund may not be free from possible conflict of interest (UNCTAD, 1998).

79. African Finance Ministers at the Sixth Session of their Conference, held in Addis Ababa in 1997, shared the above concerns. The Ministers were of the opinion that the debt sustainability analysis used to determine eligibility for the various stages of the Initiative and the basic assumptions underpinning this analysis were unrealistic. They pointed out that a lot of countries are struggling over the seemingly tough performance criteria under the programme—a situation that could result in assistance for too few countries, too late. It has also been argued that during the interim period of three years, greater cash flow relief should be provided. The Ministers agreed that for the Initiative to be effective in re-establishing conditions for sustained growth, significant adjustments need to be made regarding the eligibility criteria, the adequacy of the debt reduction granted and the speeding up of the implementation of the Initiative. It has been argued that if the international community is genuinely interested in enhancing the impact of the HIPC, it should seriously consider relaxation of the eligibility criteria—including the length of the workout to the completion point—so that more African countries can benefit from it. Of great importance is the need to increase substantially the amount of relief granted under the Initiative so as to restart Africa on the path of sustained growth.

80. Additional measures to reduce the debt burden over the short run have been advocated. Some of the options suggested include debt reduction and, more radically, debt cancellation. Some analysts have argued that there are two realistic options for the African debt situation: debt cancellation and conversion into grants of any remaining official bilateral and multilateral debt (UNCTAD, 1998a). Church organizations and NGOs have championed the case for debt cancellation—not the African countries. Debt cancellation for African countries can be based on a number of grounds. The first is that, given the magnitude of the debt and the continent's growth prospects, particularly in the export sector, African countries cannot realistically pay the debt in the foreseeable future. Second, releasing resources in the form of debt cancellation, or the
conversion of debt into grants, will afford the affected countries the opportunity to return to a
growth path. No matter what approach is taken, the resolution of external debt problems is a
touchy subject because of the underlying and interwoven economic and political issues. Critical to
the evolution of the debt debate is the position of the Bretton Woods institutions.

81. The position of the IMF is that the debts are obligations that must be honoured and that
calls for their cancellation are therefore unrealistic and raise false expectations. Unconditional
cancellation raises the risk that debt relief could be squandered on official corruption, increased
military expenditure, or grandiose projects, with little benefit, if any, in terms of sustainable
growth or poverty reduction (IMF Survey, 1998). That position is, of course, understandable
from the perspective of development institutions to which debts must be paid in order for them to
maintain some degree of viability and integrity. The reality of the situation, however, is that a
number of African countries are too far gone and payment seems impossible under any plausible,
human development-centered economic growth scenario.

82. Other reasons given against debt cancellation include the “moral hazard” argument. In its
crude version, the argument is that any scheme of forgiveness will lead debtor countries to pursue
irresponsible policies and lead eventually to a new round of over-borrowing. A variant of the
argument goes further to assert that if debts were reduced through any form of relief or
forgiveness, debtor countries would be less concerned with pursuing the objective of domestic
stability and the promotion of growth. Some have also argued that the African debt crisis in
particular cannot be divorced from recent developments in Africa with respect to governance
issues, particularly corruption and lack of accountability and transparency, factors that have led to
the mismanagement and derailment of progress in Africa. They could similarly undermine the
expected benefits of debt cancellation for most ordinary Africans.

83. Many potential benefits of debt reduction can be identified. First, we have seen in Section
V that stemming and reversing capital flight would be the single most effective way of financing
Africa’s development. Studies have shown that the debt to GNP ratio explains upwards of 40 per
cent of capital flight. For Guyana, for example, debt forgiveness under HIPC, which is estimated
to reduce indebtedness by 25 per cent, would reduce the proportion of Guyanese private wealth
held abroad by 10.1 per cent. Guyanese private wealth holders would repatriate $610 million as a
result. Each dollar of public funds benefiting the country from debt reduction is augmented by
$2.41 of repatriated funds. Second, debt reduction will go a long way towards reducing the
high degree of uncertainty for both domestic and foreign investors. Third, many of the policy
makers will be released from protracted and uncertain debt negotiations. Fourth, much-needed
resources will be released for Africa’s development by the debt reduction or cancellation. Fifth,
the removal of the elements of uncertainty inherent in the huge debt will stimulate private
investment. Sixth, as a result of the release of new resources there will be growth in the affected
African countries, which will have spill-over effects that will benefit developed countries in terms
of the demand for their goods and services. Moreover, as some analysts have pointed out, all the
arguments against debt cancellation beg the issue. It is clear that substantial debt reduction must
constitute a major element in any serious, internationally supported effort to restart African
development. What is needed for the way forward is strong political will. The prospects for a

14 Paul Collier, Anke Hoeffler and Catherine Pattillo, Flight Capital as a Portfolio Choice, Draft Discussion Paper. The World Bank,
political solution should be brighter, given the fact that a significant proportion of Africa’s debt is owed to governments and official institutions, rather than to private creditors.

84. The debate on the African debt problem has to be conducted within the context of African development. Thus, the impact of debt on the performance of African economies has to be linked to their capacity to alleviate, reduce or totally eliminate poverty. The World Bank’s Board, while acknowledging the role of the HIPC Initiative in providing debt relief to poor countries, has called for a fundamental review of the Initiative. Supporting the review, creditors have called for a reconsideration of debt sustainability analysis as well as the impact of the Initiative on poverty reduction. They also acknowledge the political dimensions of the African debt problem and its impact on economic and social development. According to the IMF (1998), the Boards discussed the link between debt relief and social development and concluded that this link should be viewed from the perspective of overall poverty alleviation. Although the HIPC framework has always emphasized the need to link debt reduction with effective long-term policies for economic and social development and poverty alleviation, its debt relief is primarily aimed at lowering external debt to sustainable levels with benefits accruing over time, and not in the short run. The HIPC Initiative was not intended for the total elimination of debt.

85. What is needed for a solution to the African debt crisis is political will on the part of creditors, as was called for at the Sixth Conference of African Ministers of Finance in 1997. It is encouraging to point out that a number of creditor governments, e.g. the U.K., have already unilaterally cancelled portions of debts owed them by the poorest countries, most of which are African. New initiatives by key G-7 creditors — Germany, UK, USA, France and Canada15 — have now been put forward for consideration at the G-7 meeting in Cologne, Germany, in June 1999. The proposals aim at enabling as many countries as possible to make the necessary adjustments and receive debt relief quickly and comprehensively. Included in the proposals are certain quid pro quo provisions on governance and other issues related to the use of resources released from cancelled debt obligations, as a response to the concerns raised against total debt cancellation. While the current HIPC framework is the point of departure for these proposals, they in a way represent a shift in the official position of the industrialized creditor countries, which hitherto rallied behind the existing mechanisms and terms of the HIPC Initiative, without entertaining pleas for their revision.

86. The key elements of the German initiative are: shortening the “work out” period up to debt relief from six years to three years so that the countries qualifying for inclusion can benefit from debt cancellation as early as possible. The proposal stipulates that all countries entitled to participate in the debt relief process will be able to ascertain the extent and date of their debt relief by the year 2000. Tackled to the eligibility criteria is the clause that such countries should observe the principles of the welfare state (a proviso targeted at poverty and inequality reduction) and the rule of law. As in the HIPC Initiative, eligible countries should also be carrying out reform programmes in collaboration with the IMF and World Bank. For some countries confronted with particularly difficult problems (as determined in the Bank/Fund macroeconomic framework), the initiative proposes that the Paris Club consider total cancellation of commercial credits and loans. Applying multilaterally coordinated procedures, the initiative further proposes binding and complete cancellation of development assistance-related debts by the Paris Club for countries that qualify for HIPC treatment. However, it qualifies this with the provision that debtor countries use

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15 According to information available to us at the time of writing. It may need to be updated later.
funds released by this action for projects that foster sustainable development and reduction of poverty and inequality, and that fulfill basic legal and economic principles of good governance. Recognizing that no improvement in the living standards of the poor can be sustained by any amount of debt relief in a situation of a poor political environment and conflict, the initiative stipulates that every debt relief initiative be embedded in a comprehensive strategy for conflict prevention. Unlike some other proposals, the German initiative does not call for a commitment now to sell additional stocks of IMF gold. Germany has committed itself to meeting its share of the financing of the HIPC Trust Fund and replenishment of the IMF's ESAF.

87. The US initiative proposes coordinated action, which could result in forgiving $70 billion in global debt relief by making significant improvements to the HIPC Initiative. It proposes a shorter "work out" period, the complete forgiveness of all bilateral concessional loans to the poorest countries and deeper and broader reduction of other bilateral debts raising the percentage from 80 to 90. It also proposes to provide at least 90 per cent of future development assistance to HIPC-eligible countries on a grant basis, the sale of additional IMF gold and further contributions by G-7 countries to HIPC Trust Fund resources.

88. The British Chancellor of the Exchequer proposes that by the end of the year 2000, all highly indebted poor countries be on a systematic programme of debt reduction — and wipe out $50 billion of debt over the subsequent years. He also calls for a reduction in the length of the debt "work-out period" before countries qualify for debt relief, in line with the German and US proposals. He further proposes the sale of more IMF gold (in addition to the 5 million ounces currently proposed) to fund the HIPC Trust Fund, in line with the US proposal. The French and Canadian governments too have put forward a proposal for the Cologne Summit, essentially along similar principles. In sum, these proposals seem to resonate together, except on the matter of additional sale of IMF gold, where Germany would like to keep the matter open. These proposals could significantly reduce the waiting period before effective debt relief is granted. They could also result in significantly more countries becoming eligible for debt relief, in contrast with the current HIPC process.

89. A related proposal is by UNCTAD. Drawing on established national insolvency procedures, UNCTAD has emphasized the need for "independent assessment" and "immediate write-off of all unpayable debt" as possible elements of a strategy for a lasting solution to the problem. UNCTAD, however, recognizes that there may be serious difficulties in applying the insolvency procedures to sovereign or private international debt through an international bankruptcy court. Nevertheless, it maintains that it is possible to establish key insolvency principles which, when applied within the existing international framework, would dictate an immediate write-off of all sub-Saharan Africa's debt as unpayable. UNCTAD advocates an independent assessment of debt sustainability in the future, arguing that experience has demonstrated that the approaches to debt reduction have fallen short of addressing the problem. This has perpetuated aid dependency and undermined the application of "sound policies" and commitment to and ownership of reform programmes, among other problems (UNCTAD, 1998-a, pp.127-130).

90. For middle-income countries, mainly in North Africa, the standard Houston Terms of rescheduling official Paris Club debt at market rates apply. The arrangements also allow debt swaps and conversions. All ODA and 20 per cent of non-ODA debt may be converted. Commercial debt, which is relevant for middle-income countries, is restructured under the
London Club and its Coordination Committee constituted of the main creditor banks. Since 1980, restructuring for middle-income countries has been in the context of the Brady Plan, whereby commercial debt can be restructured in the form of debt conversion, using the reduction facilities offered by the secondary debt market through partial discounting. The facilities can be a vehicle for attracting additional investment towards priority sectors and for privatizing public assets. Creditors can choose between securitization with old-debt swaps against fresh guaranteed loans at discounted rates; debt repurchasing at substantial discounts; debt swaps against new par value securities at lower interest rates; or debt swaps against equity investment in private and privatized public companies. A number of middle-income African countries have benefited from debt and debt service reduction by the Paris Club and through the Brady Plan. Egypt's debt stock declined from $44.2 billion in 1988 to $31.4 billion in 1996 after debt reductions by the Paris Club. Nevertheless, for most middle-income African countries, the reductions obtained on the debt stock and debt service are generally low. The impact of debt-service reduction on the balance of payments has been estimated at a maximum 5 per cent of exports. Moreover, the decline in external debt has usually been accompanied by a rise in domestic debt, negating most of the expected tax-reduction benefits.

91. While debt conversions — debt/equity swaps and debt/development bonds swaps — between 1985 and 1995 amounted to $141 billion for all developing countries, Africa accounted for less than 5 per cent of this amount. The question is whether the potential exists for Africa to take further advantage of debt conversion; i.e. swaps of external debt against local currency, financial instruments or shares. Comprehensive use of this option is constrained by the low ceiling of eligible non-ODA debt, weakness of the secondary market, the poor interest shown by creditors and the likelihood of the rise in domestic debt, which can unravel the macroeconomic framework under adjustment.

92. The above initiatives present opportunities that Africa must be fully aware of and issues on which to speak with one voice before decisions are taken by creditors. This is even more critical in view of the fact that the impact of the HIPC Initiative has been insignificant, and not all middle-income African countries seem to have benefited from debt conversion and other debt-reduction instruments to reduce their debt to manageable levels. The critical importance of African countries speaking with one voice on these issues was recently emphasized by the President of Mozambique on 20 September 1998, when he urged developing countries to fight together to seek not reduction but the total scrapping of the debt. Similarly, UNCTAD has emphasized that the "absence of a consistent debtors' strategy" for effectively dealing with the debt problem is a significant factor contributing to the slow progress towards a lasting solution. A follow-up strategy on this issue is an important expected outcome of the Joint Conference of African Ministers of Finance and those responsible for Social and Economic Planning.

VIII. The Impact, Lessons and Policy Implications for Africa of the Asian Crisis

93. Asia has been the world's economic miracle for the last 30 years, experiencing dramatic economic growth and poverty reduction: stable growth in per capita income of 5 per cent and above with few downturns, and a fall in poverty from 64 per cent in 1975 to 11 per cent in 1995. But significant gains from decades of progress were wiped out remarkably quickly by turmoil in the region's financial and currency markets. Combined GDP growth in Korea, Indonesia, Malaysia, Thailand and Philippines declined from a pre-crisis level of 7 per cent to negative 7 per
cent in 1998, and unemployment has reached 18 million, up from 5.3 million in 1996. Africa has as much to learn from the development strategy that created the miracle as from the errors that undermined it.

94. The East Asian crisis, which began in 1997, had ripple effects throughout the world economy. It occurred despite a benign international economic environment, with low international interest rates and solid global growth of output and trade (World Bank, 1998a). As is usual with most financial sector crises, the East Asian crisis was generated by multiple factors, which were rooted mainly in private sector financial decisions against the backdrop of financial sector weaknesses, easy global liquidity, external sector and foreign currency problems and contagion from Thailand to other countries. Public sector borrowing was not a factor in generating the crisis (Goldstein, 1998). A synopsis of what went wrong is essential for a discussion of issues and lessons of relevance to Africa.

95. The growth of bank and non-bank credit to the private sector exceeded by a wide margin the already rapid growth of the real economy. The credit boom, which was fueled in part by large net private capital inflows, was directed to real estate (and largely to other non-tradable) and equities. This over-extension and concentration of credit in non-exportable goods and services sectors left the economies vulnerable to a shift in credit conditions or to a reversal of capital flows. When the shift came, it brought down property prices and increased the share of non-performing bank loans in bank asset portfolios. In addition, the 1990s were a time of bountiful global liquidity conditions with over $420 billion in net private capital flows to Asian developing countries alone, which reduced spreads, lengthened maturities, and weakened loan covenants (Goldstein, 1998). This was in addition to the fact that most of the affected countries already had run moderate-to-large current account deficits in the 1990s. Furthermore, competitiveness of the affected countries was waning as a result of the appreciated real effective exchange rate, sharp slowdown in merchandise export receipts and a perceived shift in regional comparative advantage vis-à-vis China. Thailand was hit first. Then the contagion of financial disturbance quickly engulfed the economies of South Korea, Indonesia, Malaysia and the Philippines.

96. Africa is impacted by the East Asian crisis through the contagion effects, which are transmitted through three major channels: trade, financial flows and the international environment in which African countries operate. The Asian countries most directly affected account for a relatively modest share of global economic activity — 3.6 per cent of world GDP, about 7 per cent of world trade, 6 per cent of global foreign direct investment (FDI) inflows, 4 per cent of FDI stock and less than 4 per cent of gross international bank lending. What is also known is that no country outside Asia relied on the markets of the five most affected countries for as much as 10 per cent of their total exports, or received as much as 10 per cent of its total merchandise imports from these countries. South Africa and Mozambique, which have the most extensive trade relations with Asian countries, contributed only 4.8 per cent, and 1.5 per cent, respectively, to imports of the Asian five in 1996. In the same year, the share of the Asian five in South Africa's imports was 4.1 per cent.

97. The crisis has had variable impact on different countries. Oil producers in Africa have carried the major burden. By the first quarter of 1998, oil prices had fallen by 21 per cent, as Asia was the largest net fuel-importing region since the early 1990s. Consequently, slower Asian

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16 The Asian five are Indonesia, Korea, Malaysia, Philippines and Thailand.
growth has kept the price of oil under pressure, which has had a dramatic effect on Nigeria, Angola and Gabon, reducing their terms of trade by 23 per cent and their incomes by 8 per cent. Other commodity prices, which collapsed in 1996 and had not recovered at the onset of the Asian crisis, plummeted further due to falling demand in Asia. The fall in the price of minerals, agricultural products, and livestock prices—due to declining Asian demand — have negatively affected non-oil producing countries (Stiglitz, 1998). On the other hand, the same group of countries benefited from offsetting cheap oil imports. Primary product exports, which are linked to most of the FDI flows to Africa, have suffered.

98. On the whole, Africa has escaped the worst of the financial contagion effects. There are a number of reasons for this. First, as a result of the steadily improving policy environment, Africa is now less susceptible to external financial crisis. In contrast to Asian and Latin American countries, foreign capital inflows are mostly long term and government guaranteed, while private firms have relatively little exposure in foreign currency. Second, African countries are less integrated in the world economy than many other countries. Africa's escape from the financial contagion can be attributed in part to the fact that it has lagged behind other regions in opening up to world trade and private capital flows. Third, Africa's financial systems are still relatively underdeveloped — notwithstanding the financial liberalization in many countries. Banking systems in many countries are just emerging from long periods of weakness; and asset markets are rudimentary in many countries. While escaping the crisis is good news, the main reason for escaping is not such good news. It shows that despite the positive growth performance of African economies since the mid-1990s, little structural transformation and integration in the global economy has taken place.

99. Besides being bypassed by the crisis, the other good news is the lessons Africa can learn from it. As Calvo (1998) put it, for Africa, which has not yet suffered from capital flow volatility, the recent crisis has considerably improved the understanding of the issues and, thus, the continent's capacity to cushion their effects. Moreover, while the immediate overall impact of the crisis appears minor there are likely to be second-round impacts in the medium-to-long run that could be far-reaching for Africa, as are some of the issues and lessons to be learned from the crisis by Africa. The crisis is a wake-up call to Africa as financial liberalization proceeds ahead of proper globalization.

100. How to cope with surges of capital inflows as Africa gears up for foreign direct investment and capital flight reversal for growth is critical to attaining macroeconomic and social stability. Even when the overall macroeconomic conditions look good, financial markets can create two kinds of illusion that channel money into wrong investments. One kind is produced by capital inflows themselves. Economic reforms and financial liberalization produce a spurt of capital inflows, which chase high rates of return. The inflows in turn lead to currency appreciation while the spending boom financed by the foreign flows leads to higher prices of non-traded goods, services and real estate — mainly non-traded goods and services that do not provide the wherewithal for future servicing of external debt. The short-run currency appreciation offers an incorrect reading of future relative prices. Given the fact that capital inflows must in the long run be paid for through increased net exports, the exchange rate is most likely to depreciate in real terms in order to service the capital inflows. Another kind of illusion can be created by financial market liberalization, which typically stimulates large-scale capital inflows. The deregulation and

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privatization of banks may give greater latitude to borrow from abroad. Such banks may operate under distorted incentives, borrow abroad and invest in the domestic economy with reckless abandon.

101. For Africa to avoid the above pitfalls, besides appropriate counter-cyclical macroeconomic policies, financial institutions must be strengthened and strict transparency standards in financial transactions and decisions must be enforced, including with respect to credit policies, disclosure rules, loan documentation and bank portfolio management. The supervisory and regulatory functions of central banks must be strengthened in order to enforce the rules and norms of prudent financial management among financial institutions and to ensure consistency of monetary aggregates with sustainable balance of payments and other macroeconomic account profiles.

102. The potentially destabilizing effect of short-term debt has been demonstrated by the Asian crisis. Virtually every country with short-term debt greater than reserves had serious financial trouble in 1997 (Stiglitz, 1998). The composition of foreign borrowing is as important and deserves as much attention as the overall debt burden. In particular, a high and rapidly rising share of short-term debt to net international reserves has become a red flag for financial operators (Goldstein, 1998). This is a situation African countries should avoid. Debt management must be vigilant in order to avoid an unsustainable term structure of private and public debt obligations.

103. A second-round impact on Africa’s exports and output in the real sectors is a real possibility. The demand for Africa’s commodity exports could be more severely affected than the evidence hitherto shows. The devaluation of currencies of some Asian countries that produce commodities in competition with Africa — e.g., oil palm — could result in lower demand for African exports because of higher costs in foreign currency terms of buying from Africa. So, Africa must take the necessary steps to remain competitive in light of currency realignments in the wake of the Asian crisis. What are the most appropriate steps to take in preparation for this possible eventuality?

104. The Asian crisis and its spillover effects have also revealed weaknesses in the international financial system of which Africa needs to be aware, including the folly of leaving development finance purely to "international financial markets". Experience has shown that these markets are not always able to perform this function properly, not only for the majority of poor countries, which are typically bypassed by international capital flows, but also for the so-called emerging markets. In these markets, benefits of surges in capital inflows can be more than wiped out by outflows that follow. This makes the process of managing and financing development extremely difficult. Any discussion of the reform of the "international financial architecture" would need to focus on its role in the provision of "development finance" rather than just managing financial instability per se.

105. Related to the special development funding requirements of the poor countries is the need to take a critical look at the applicability to developing countries of the liberalization of the capital account — a policy goal of recent years. The current financial crisis has demonstrated the inappropriateness of abrupt or premature liberalization of the capital account. It has proved too difficult for developing countries that liberalize the capital account to adapt to the conditions generated by volatile international capital flows. As pointed out by Stiglitz (1998a), capital account liberalization without the development of policies to protect, or insulate the domestic economy from the instabilities engendered by huge, external, and particularly short-term resource
flows is a direct prelude to disaster. Capital account liberalization in developing countries has to be adopted in a gradual fashion. It should follow full liberalization of the domestic financial market, the development of a system of risk management and adoption of an appropriate exchange rate policy, and in all cases should not be undertaken before or simultaneously with action to float the exchange rate.

106. The above discussion indicates, as is now widely acknowledged, that the present system is badly equipped to prevent financial crises, and only partly equipped to manage them. (UN, 1999). There is a need to modernize the system to catch up with the rapid expansion of private capital flows, and to lessen its vulnerability to financial shocks. Reform must encompass a number of interrelated aspects of crisis prevention, management and resolution. Reforms should entail measures to strengthen global consistency of macroeconomic policies—in order to avoid at the global level inflationary and deflationary biases — financial regulations, private sector involvement in forestalling and resolving crisis situations (Quattara, 1998), and the international institutional architecture. Institutional strengthening would aim at provision of key services more effectively: the coordination and surveillance of global macropolicy; enhanced transparency in financial transactions; a strengthened interface between financial institutions; provision and better management of adequate international liquidity, as well as development funds to the poor countries.

107. At the practical level, different proposals and issues associated with them are being actively debated, and will be a major item on the agenda of the forthcoming G-7 meeting in Cologne, Germany in June 1999. Africa should take a keen interest in the debate. Related to the essential elements of reforms outlined above, the debate focuses on how to strengthen or reform the present international financial system to prevent a recurrence of crises; to respond and resolve them quickly — should they occur, and to strengthen institutional mechanisms to best support stable global financial markets. Central to the crisis prevention debate is the question of fostering better policies and more effective institutions at the national level, including sound macroeconomic policies, robust financial system and sound infrastructure — economic, social, governance, judicial, accounting, auditing and reporting. The issue here is how to develop and agree on international standards, principles and practices on all aspects of national policy and institutions that are judged to be of central importance for successful integration in the international financial system. A key element in the crisis response and resolution debate is the contentious issue of how to strengthen the international-lender-of-last-resort function, while addressing moral hazard and ensuring that the private sector is sharing appropriately in the risks. Coping and transition issues for countries in crisis are also under active debate — provision of emergency financing, financial restructuring and mitigation of the social and human costs of financial crises. Institutional strengthening or reform has elicited hot and sometimes emotional debates, including calls — mostly by non-G-7 countries — to scrap the IMF and possibly start regional financial institutions to parallel the IMF. However, no proposals have been comprehensively and openly debated; nor have alternative architectural forms of a possible new system been unveiled to the public by G-7 countries, which hold the trump card. The G-7 meeting in Cologne is expected to look at these issues.

108. An important aspect of the package of reforms to the international financial system currently under debate is greater transparency on the part of all private, public and multilateral participants in the world economy. Towards this objective, new, stringent and streamlined reporting requirements are under consideration by the IMF. The General Data Dissemination
System (GDDS) and the Special Data Dissemination System (SDDS) are intended to foster transparency of economic information and financial flows under globalization. From Africa, only South Africa is currently a participant in the systems, which are likely to become important disclosure mechanisms that private investors are likely to follow keenly in their decisions on where to invest. There is a clear need to widen Africa’s participation in the GDDS and SDDS. Already thin in statistical capacity, Africa will be hard pressed to comply with these requirements. A regional strategy is needed to build national capacities to enable active participation in these reporting and disclosure processes.

109. The Conference may wish to share views on the issues and options currently being debated in the international community with regard to how best to reform or strengthen the international financial architecture. Ministers may further wish to discuss and adopt a follow-up plan to make the voice of Africa heard in the deliberations and to strengthen regional capacity to participate in the new economic and financial information disclosure processes.
References


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The Causes of Conflict and the Promotion of Durable Peace and Sustainable Development in Africa — Report of the UN Secretary-General to the Security Council, 16 April 1998;


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(1998) World Development Indicators

Appendix Table 1: Africa: Macroeconomic Performance, 1990–1997

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Source: IMF data, 1998

Appendix Table 2: Summary Indicators of ODA Flows to SSA, 1975-1996

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## Appendix Table 3: Aid Dependency Measures

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**Note:**  
* Aid as percent of GNP  
** Aid as percent of Gross domestic investment  
*** Aid as percent of Imports

**Source:** World Bank World Development Report, 1998
Appendix Table 4: African countries: A selected FDI stock indicators, 1987 and 1996

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*Source:* UNCTAD, FDI/TNC database.

A Ranked according to 1996 values of the indicators; countries shown are those with values of at least one indicator exceeding the African average.