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DRAFT

## Chapter 6

## Enhancing Absorption Capacity, Attracting and Managing Capital Flows

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# VI. ENHANCING ABSORPTION CAPACITY, ATTRACTING AND MANGING CAPITAL FLOWS

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## 1. Introduction

This last chapter of the report examines the capacity of African countries to absorb foreign capital and discusses strategies to attract more capital flows and policies to manage them so as to maximize the benefits while minimizing the risks of financial fragility, Dutch disease effects, and the emergence of enclave economies. A country's capacity to absorb foreign capital depends on many factors, including the quantity and quality of the labor force, the availability and quality of the infrastructure, the efficiency of financial intermediation, and the overall institutional and policy environment. The discussion of the role of labor market issues was undertaken in chapter 3 while that of the institutional environment was examined in chapter 5. This chapter examines the role of the depth and efficiency of the financial system in attracting and absorbing capital flows and harnessing their direct and indirect effects on the host economy, including technological diffusion and crowding in of domestic investment. The chapter also discusses the importance of macro and micro-level incentives for attracting and retaining foreign capital, for retaining domestic savings (i.e., prevent capital flight), and for increasing synergy between foreign capital and domestic investment. The last part of the chapter examines motivations for capital management policies and draws lessons from experiences from African

and non-African countries. While the discussion in the chapter focuses on the two dominant forms of flows in African countries, foreign direct investment and official development aid, we also examine the case of worker remittances, which are becoming an important form of external financing.

## 2. Financial Development and Absorptive Capacity

The depth and efficiency of the financial system influence a country's capacity to absorb capital flows, both private and official flows. This chapter focuses on the two dominant forms of flows in African countries, foreign direct investment and official development aid. The chapter also briefly discusses the case of worker remittances, which are also becoming an important form of external financing.

### 2.a. Inefficient financial intermediation undermines absorptive capacity

*Foreign direct investment and absorptive capacity*

The financial system influences both the volume of foreign capital flows and the impact of foreign capital on economic growth. Long-term foreign capital or foreign direct investment is not only the dominant form of private foreign capital in African countries but it is also the form of private capital flows that is likely to have a substantial impact on economic growth. Three important relationships are worth emphasizing. First, financial development is a determinant of capital inflows; second, financial development is a key component of the host country's absorption capacity; third, as a corollary to the second relationship, financial development is a

key channel of the growth effects of foreign capital. These three relationships are essential in understanding both the relatively poor performance of Africa in attracting foreign private capital and the limited effects of foreign direct investment on economic growth in the continent.

Financial development, or more specifically, the depth and efficiency of the financial system is an important condition for attracting capital inflows. Financial development exerts direct effects on capital flows by offering more opportunities for equity-based investments to foreign investors. The deeper the financial system, the broader the range of investment opportunities and therefore the higher the incentives for foreign direct investment into the country. A more developed financial system also allows foreign investors to borrow domestically to expand their activities. Furthermore, financial development exerts indirect effects on foreign direct investment given that a more efficient financial system is associated with lower transactions costs and better information system, which facilitate investment operations. Through the provision of systematic information on investment opportunities and returns to capital, an efficient financial system alleviates the problems of information imperfections, which are more acute for foreign investors than for domestic investors.

The importance of the financial system for a country's capacity to absorb foreign capital derives from the diverse functions that it plays in the economy. In addition to the traditional savings mobilization role, the financial system also performs other functions that are vital to the proper functioning of a market economy: information production, price discovery, risk sharing, liquidity provision, promotion of contractual efficiency, promotion of corporate governance, and facilitating global integration (see Senbet and Otchere 2005).

There are two important reasons why financial development is important for the country's absorption capacity. First, the depth of the financial system allows the country to intermediate foreign capital with minimal strain on monetary and exchange rate policy. A large and deep financial system minimizes the exchange rate appreciation effects of capital inflows and gives more degrees of maneuver to the central bank in sterilizing the inflows in order to minimize the inflationary impact. In many countries, the bond market is either inexistent or very thin, which limits the number of tools by which the central bank can control the inflationary effects of foring capital inflows. Second, and most importantly, an efficient financial system allows the country to maximize the spillover effects of foreign capital in the economy. Such effects may occur through demonstration effects, competition effects, downstream and upstream effects on domestic production. Foreign direct investment provides incentives for expanding production partly through the creation of FDI-related demand for goods and services and also by pushing domestic producers to invest in innovation and skills acquisition to keep up with the competition. However production expansion and technology diffusion need to be financed. Plans for production expansion and technology acquisition may very well be frustrated by lack of appropriate finance in a country with an underdeveloped financial system. In the absence of adequate finance, FDI sectors may remain economic islands in the country, with minimal effects on overall economic activity. In the majority of African countries, lack of access to finance has been identified as an important constraint to business formation and expansion (see Bigsten et al 1999; Gunning and Mengistae 2001).

By facilitating absorption of foreign capital, financial intermediation will enhance the growth effects of foreign private capital. There is growing consensus that FDI affects economic growth less through direct investment effects but more through efficiency or total productivity effects (Durham 2004; Omran and Boldol 2003). The productivity effects of FDI on growth occur through two main channels. The first channel is the increase in the marginal productivity of capital in sectors that are directly receiving foreign direct investment. These "private productivity" effects are compounded by positive effects on marginal productivity of capital in other sectors in the economy – or "social productivity" effects (Alfaro et al 2004). FDI creates positive technological spillover effects and managerial externalities in non-FDI sectors that raise total productivity in the economy. However, these effects will materialize only if the financial system is able to intermediate resources efficiently and meet new demands for investment finance. The overall productivity effects will depend on the efficiency of the financial system in channeling resources to investment activities with the highest returns to capital. The fact that FDI in Africa tends to be concentrated in extractive sectors (see Chapter 2) contributes to limiting these productivity effects. In order to maximize growth effects of FDI, African countries need to to establish incentives for diversification of the destination of FDI.

The conclusion from this analysis is that there may be no independent effects of FDI on economic growth. FDI will have positive effects on economic growth only when the country has the appropriate capacity to absorb the resources. New empirical evidence points to this missing link between FDI and economic growth in developing countries (Omran and Boldol 2003). The evidence suggests that African countries must aggressively pursue strategies for improving the

efficiency of their financial systems in order to reap the maximum benefits from foreign capital flows.

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

*Other flows and the role of the financial system: aid and worker remittances*

The depth and efficiency of the financial system also influences the country's ability to absorb and take advantage of other forms of capital flows, namely official development aid, worker remittances and short-term portfolio flows. Countries with underdeveloped financial systems have difficulty mitigating the negative effects of large inflows of foreign exchange for several reasons. First, the lack of a developed bond market limits the degrees of maneuver for the central banks in sterilizing the effects of the inflows. This raises the risk for *Dutch disease* whereby the unsterilized inflows cause an excessive appreciation of the local currency, which undermines competitiveness (see Heller and Gupta 2002). However, attempts to sterilize the inflows by treasury bill sales in a shallow domestic money market will lead to higher and more volatile interest rates, which has detrimental effects on private investment. Evidence from

Uganda confirms these adverse effects of aid management on interest rates (Nkusu and Sayek 2004). Thus aid may indirectly crowd out domestic investment in countries with underdeveloped financial systems. These adverse effects of aid are likely to be more pronounced if inflows (especially aid and remittances) are spent on domestic non-tradable goods. Note, however, that these *Dutch disease* effects are mitigated when the inflows are used for to increase the production capacity (including investments in public infrastructure), in which case positive supply effects offset the demand effects, thus minimizing the impact on inflation and exchange rate appreciation.

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

In addition to minimizing the risks of instability associated with official capital inflows, financial deepening also enhances the effectiveness of aid. A large empirical literature supports the notion that official development aid can contribute to economic growth, although the aid-growth

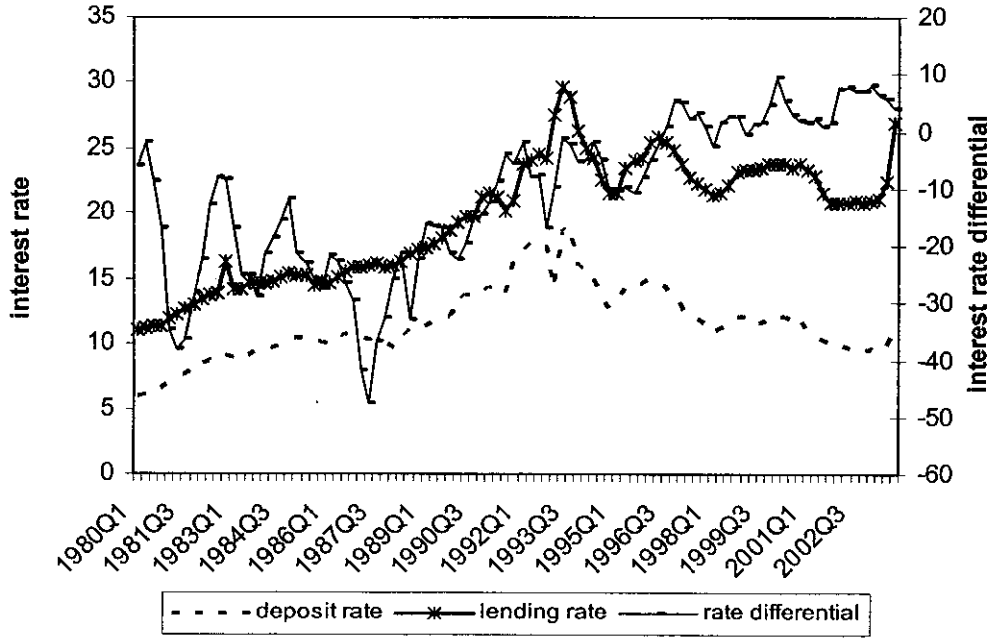
relationship appears to be depend on a range of conditioning factors, including the quality of institutions. One strand of the literature that is particularly relevant for the foregoing discussion suggests that the effectiveness of aid is enhanced by the depth of financial markets in aid-recipient countries (see Nkusu and Sayek 2004). In particular, deeper financial markets are able to intermediate external resource flows, thus maximizing the indirect effects of aid outside the sectors that are directly targeted for aid. These indirect effects will enhance the overall effects of aid on economic growth.

**2.b. Underdevelopment of African financial systems may explain the weak gains from capital flows**

Despite substantial efforts to reform and liberalize financial systems in Africa, the evidence still points to important impediments to efficient mobilization and allocation of both domestic and foreign resources (Senbet and Otchere 2005; Nissanke and Aryeetey 1998; Ndikumana 2003). Financial systems in most African countries are dominated by a small number of banks that command heavy market power, which undermines the efficiency of allocation of resources. Moreover, the oligopolistic structure of the banking system contributes to maintaining high costs of funds, as illustrated in the high interest rate spreads in the continent. Indeed, contrary to expectations, reforms in the banking system have been accompanied by a rise in the spread between the lending interest rate and the deposit interest rate as well as an increase in the gap between domestic interest rates and world interest rates (Figure 6.1). High spreads discourage savings mobilization due to low remuneration of deposits and depresses borrowing due to the high costs of funds. Financial reforms have moved African countries from an interest repression

regime to a high real interest regime, both of which are detrimental to resource mobilization and investment. Moreover, African banking systems are excessively liquid as a result of risk aversion but also because banks are able to maintain comfortable profit rates by charging usury rates to their traditional borrowers (including the government) while hoarding risk-free government securities. Thus, African banking systems are engaged in *dysfunctional intermediation* (Senbet and Otchere 2005) that both wastes resources and keep countries below their growth potentials.

**Figure 6.1: Interest rates in 22 African countries 1980Q1-2003Q4**

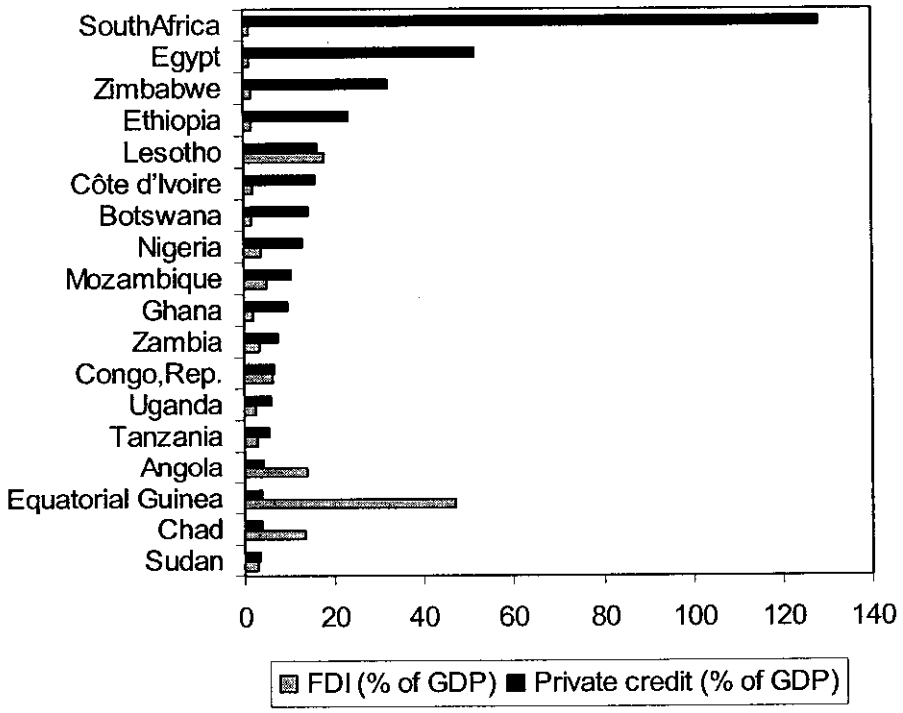



Source: IMF, IFS 2005.
Note: The Figure includes 22 African countries with consistent data over the 1980-2003 period. The interest rate differential is with respect to the United States.

Foreign direct investment in Africa has traditionally been concentrated in resource-rich countries. These countries also happen to have the least developed financial systems (Figure

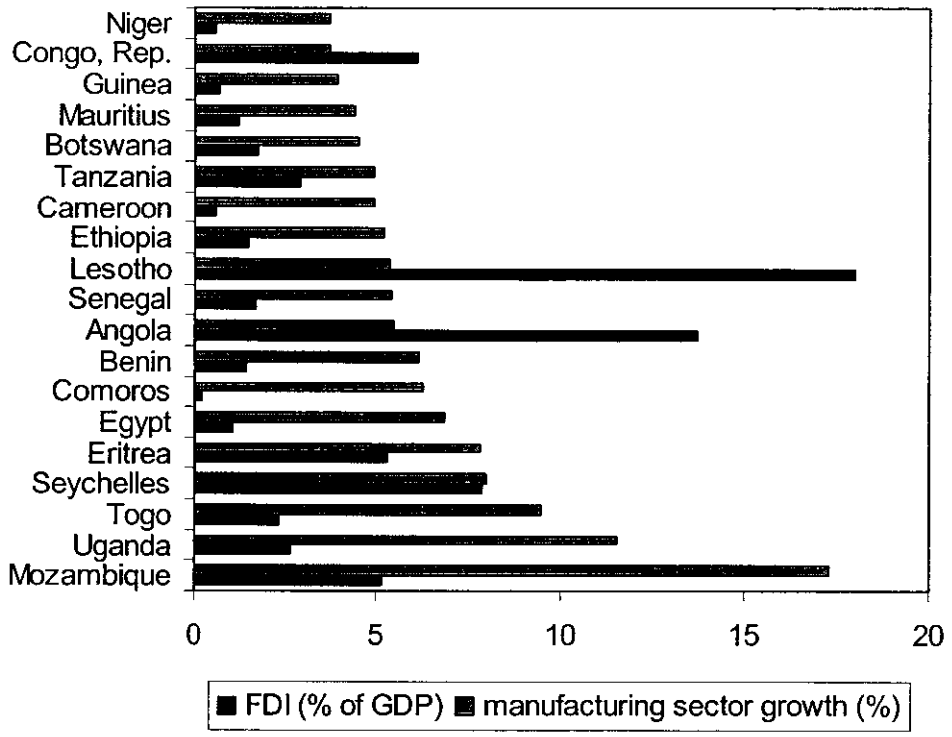
6.2), implying very weak absorption capacity. This partly explains the limited effects of FDI on economic diversification and transformation (see chapter 4) and overall economic performance. FDI has had little effect on the manufacturing sector, which may explain the low gains in terms of growth and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

**Figure 6.2: FDI and financial development, 1994-2003**




Source: UNCTAD (2005); IMF, IFS 2005.

**Figure 6.3: FDI and manufacturing sector growth, 1994-2003**




Source: UNCTAD (2005); World Bank, World Development Indicators 2005.
Note: Manufacturing sector growth = growth rate of the ratio of the manufacturing sector value added to GDP.

### 2.c. The need to promote regional financial integration

The existing capital markets in Africa are still shallow and highly illiquid, with the exception of the South African stock market (Table 6.1). Yet, capital markets constitute a vital complement to the banking sector in the process of developing an efficient financial system. Given the small size of national markets and the cost of the infrastructure that is required to run a vibrant capital market, it is clear that national capital markets are not viable in many countries.

One way to increase the viability of capital markets is to promote regional equity markets by drawing on existing economic regional integration schemes. However, two points must be made clear from the outset. First, financial regionalism is not a substitute for financial reforms and

other efforts at the national level aimed at developing national financial systems. In other words, countries cannot outsource financial development. In particular, the development of efficient national banking systems is indispensable for the success of financial regionalism.

**Table 6.1: African capital markets: key characteristics**

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

Source: World Bank, 2005. *World Development Indicators* 2005; UNDP, 2003. *African Stock Markets Handbook.*

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

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

By expanding the scope of investment opportunities, regional capital markets will attract more global investors who are interested in the higher returns that African markets offer but who currently are discouraged by the illiquidity of national capital markets and the exposure to sovereign risk. Beyond portfolio diversification, the opportunity to maximize returns will be an

attractive feature for foreign investors. Indeed, the evidence in Table 6.1 shows that African stocks are highly profitable and substantially undervalued. The returns to equity are much higher in many African stock markets than in Western markets and the price-earnings ratios are significantly below those observed in mature financial markets (Senbet and Otchere 2005). Thus African markets exhibit substantial unexploited profit opportunities.

The emergence and consolidation of regional markets will allow to establish the crucially needed synergy between capital markets and national banking systems. It is one component of a structural approach to addressing the problem of dysfunctional intermediation in African banking system described earlier. Despite efforts to liberalize the financial system in African countries, banking systems are still plagued by pervasive inefficiencies. The high interest spreads are only one of the visible signs of lack of lack of competition. Another form of dysfunctional intermediation is the tendency of banks to accumulate government securities, thus crowding out lending to the private sector. Lack of competition in the banking sector creates perverse incentives on the part of banks to maximize profits by investing in risk-free government securities, charging usury rates to the few borrowers that access credit, while discouraging savings. The development of alternative non-bank sources of finance through regional financial markets is a means to both increasing access to capital for firms but also a way of promoting efficiency in the banking sector, notably through downward pressure on lending interest rates.

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

reforms and enhance credibility of such reforms with investors (Collier and Gunning 2000). In addition, financial regionalism will accelerate exposure to and sharing of international and regional best practices and standards in financial intermediation, especially information disclosure procedures and accounting standards. Thus, less advanced countries will benefit from spillover effects from more advanced countries in the area of financial infrastructure, payments systems and regulation.

### 3. Attracting capital flows

African countries face the challenge of designing policies and establishing an institutional environment that allow them to attract, retain and maximize the gains from foreign capital. However, African policy makers must not lose sight of the very important fact that foreign capital cannot be a substitute for domestic investment. The former must complement and enhance the productivity of the latter. Indeed, in most cases, an environment that is good for foreign capital will also be good for domestic capital and vice versa.[1] Therefore, policy makers should think in terms of strategies for improving the investment climate, which will induce both foreign and domestic investment.

The starting point in designing strategies for attracting capital inflows is to capitalize on the evidence from the empirical literature which has identified key determinants of foreign investment, which include openness to investment, availability and quality of infrastructure, and the quality of institutions (Asiedu, 2002, 2004; Asiedu and Lien, 2004; Morisset, 200). Some of these factors relate to the macroeconomic environment while others concern micro level aspects

[1] The exception may be the case of FDI to extractive industries, which appears to be less affected by the quality of institutions and the investment climate in general.

of the investment climate. Policy action therefore must encompass both levels of the investment climate.

### 3.a. The macroeconomic environment

Improvements at the macroeconomic and political levels serve to reduce sovereign risk, which is critical to getting foreign investors to make the initial move into the country. In this respect, each African country must work hard to differentiate itself in order to overcome the usual stereotype whereby Africa is regarded as risky by foreign investors, often on the basis of insufficient country-specific information.

In addition to helping in attracting capital flows, a sound macroeconomic environment and political stability contribute to increasing the absorption of capital inflows, notably by raising current and future marginal productivity of capital, thus encouraging long-term investment. This contributes to tilting the balance in favor of long term capital inflows compared to portfolio flows. It also enhances the diffusion of the new technologies and ideas that accompany foreign direct investment. Indeed, higher confidence in the economy encourages foreign investors to not only stay longer but also to invest more in building local capacity as well as synergies with other domestic activities as a means of expanding the scope for future profitability of their investments.

An important constraint to capital flows and investment in general is the concern with regard to credibility and sustainability of macroeconomic reforms. When reforms are perceived as temporary, investor's preferences become biased towards short-term rent-seeking types of

investments that allow them to get the profits and exit in time before the expected reversal of reforms (Islam 2000). Indeed, empirical evidence tends to confirm that lack of credibility and reliability of reforms is an important deterrent to foreign investment in African economies (Asiedu and Lien, 2004).

By reducing overall investment risk, improvements in macroeconomic environment in African countries will increase the incentives for holding domestic assets. This will raise domestic investment while curbing capital outflows, both legal and illegal (capital flight). Note, however, that the gains from reforms at the aggregate level in terms of capital inflows may take time to materialize. This is partly because governments need to gain credibility especially with regard to the risk of policy reversal. Moreover, complementary reforms and improvements at the microeconomic level are necessary to raise the returns to investment.

**3.b. Micro-level incentives and strategies for improving the investment climate**

Reforms at the micro level affect directly or indirectly the cost of doing business, hence the profitability of investment. This sub-section discusses strategies that African countries need to initiate as well as constraints that they need to address in order that improve the investment climate.

*Reducing factor costs: Energy supply and public infrastructure*

Lack of reliable energy supply and poor quality of infrastructure constitute a major deterrent of domestic and foreign investment in African countries. Therefore, investment promotion strategies must focus on ways to reduce production costs, especially by increasing the

availability and reliability of public infrastructure and energy supply. So far, investment promotion strategies have emphasized tax incentives to attract foreign investors. However, governments need to strike a balance between reducing business taxes and raising revenue to finance infrastructure. In fact, a high tax–good infrastructure environment may be preferable for firms to a low tax–poor infrastructure environment, especially for manufacturing sector-oriented investment. The absence of reliable energy supply forces firms to invest in private energy generators, which displaces valuable resources from investment in productive capital (Reinikka and Svensson 2002). In addition to increasing the supply of reliable energy sources, countries need to also improve management and maintenance of existing ones. In particular, digitization of the collection system would improve efficiency through better tracking and faster operations.

Poor infrastructure contributes to steering investors away from some forms of activities that are more sensitive to transportation costs and storage inefficiencies, such as agricultural production and agro-processing. Thus, African countries are unable to exploit fully their endowments in agricultural resources. Other sectors as well remain repressed due to inadequate infrastructure.

*Streamlining the regulatory environment*

African countries also need to streamline the regulatory environment to minimize business costs and increase transparency in administration procedures at the start of a business and for routine operations. Cross country evidence shows that SSA countries as a group have a much higher cost of starting a business than other developing regions (Table 6.2). One of the elements of these high costs is the human and financial resources that firms invest in dealing with licenses,

often due to complexity of the system as well as corruption. As can be seen from Table 6.2, there are substantial variations across African countries.

One element of the regulatory environment that is often pointed out as a deterrent of investment is labor market regulations. While the data in Table 6.2 shows higher labor market rigidities in SSA compared to other regions, the gap is not as large as for other indicators. Moreover, while it is necessary to minimize the costs due to excessive labor market regulations, it is also essential to ensure that labor laws protect adequately the rights of workers, including decent compensation and healthy work place conditions. Given the massive unemployment in African countries, workers' reservation wages are very low, which exposes them to potential abuses by rent-seeking investors. Therefore, governments must protect workers, especially by establishing, updating, and enforcing living wage laws.

**Table 6.2: Cost of doing business in African countries: 5 highest-cost and 5 lowest-cost countries, 2005**

| Starting a Business: Cost (% of income per capita) in 2005 | | Dealing with Licenses: Cost (% of income per capita) in 2005 | | Hiring and Firing Workers: Rigidity of Employment Index in 2005 | | Registering Property: Cost (% of property value) in 2005 | | Total tax payable (% gross profit) in 2005 | | Enforcing Contracts: Cost (% of debt) in 2005 | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Five lowest-cost countries*** | | | | | | | | | | | |
| South Africa | 8.6 | Mauritius | 17 | Zambia | 10 | Malawi | 3 | Nigeria | 27 | Mauritius | 9 |
| Mauritius | 8.8 | South Africa | 38 | Uganda | 13 | Ghana | 4 | ST&P | 27 | Angola | 11 |
| Botswana | 10.9 | Kenya | 40 | Malawi | 21 | Kenya | 4 | Angola | 33 | South Africa | 12 |
| Zambia | 18.1 | Lesotho | 134 | Namibia | 27 | Botswana | 5 | Lesotho | 38 | Ghana | 14 |
| Namibia | 18.8 | Mozambique | 149 | Eritrea | 27 | Uganda | 5 | Mauritius | 38 | Ethiopia | 15 |
| ***Five highest-cost countries*** | | | | | | | | | | | |
| Chad | 360.8 | Tanzania | 4,110 | Congo, Rep. | 80 | Cameroon | 19 | Kenya | 68 | ST&P | 70 |
| Niger | 465.4 | Mali | 4,903 | Sierra Leone | 80 | Mali | 20 | Mauritania | 76 | CAR | 72 |
| DRC | 503.3 | Burkina Faso | 5,002 | Burkina Faso | 84 | Chad | 21 | DRC | 135 | Burkina Faso | 95 |
| Angola | 642.8 | DRC | 6,516 | Niger | 90 | Congo, Rep. | 22 | Sierra Leone | 164 | Malawi | 137 |
| Sierra Leone | 835.4 | Burundi | 10,741 | DRC | 90 | Nigeria | 27 | Burundi | 174 | DRC | 257 |
| Regional averages | | | | | | | | | | | |
| SSA | 215.3 | SSA | 1,597 | SSA | 53 | SSA | 13 | SSA | 58 | SSA | 42 |
| MENA | 64.2 | MENA | 470 | MENA | 40 | MENA | 7 | MENA | 35 | MENA | 18 |
| EAP | 42.9 | EAP | 137 | EAP | 26 | EAP | 5 | EAP | 31 | EAP | 62 |
| SA | 40.50 | SA | 386 | SA | 40 | SA | 6 | SA | 35 | SA | 37 |
| LAC | 56.20 | LAC | 381 | LAC | 40 | LAC | 5 | LAC | 53 | LAC | 23 |

Source: World Bank (online data on "doing business");
SSA = sub-Saharan Africa; MENA = Middle East and North Africa; EAP = East Asia and Pacific; SA = South Asia; LAC = Latin America and Caribbean; CAR = Central African Republic; DRC = Democratic Republic of Congo; ST&P = Sao Tome and Pricipe

Regulations and procedures governing international trade also carry indirect costs for businesses. Reform efforts must aim at simplifying and clarifying customs regulations and procedures to reduce delays in customs clearance. Harmonization of customs and non-trade elements of the tax system, and modernization of the tax system especially through digitization, are essential to increasing efficiency of the entire tax system both for the sake of maximizing tax revenue collection and minimizing indirect costs for businesses.

The design and enforcement of property and creditor rights features prominently among the conditions for creating an enabling environment for both foreign and domestic investment. The quality of investor rights depends critically on the ability of the legal system to independently, objectively, and expeditiously handle claims and arbitrate disputes. It also depends on the ability of public administration in general to minimize the costs and delays associated with the registration and exercise of these rights. Therefore, overall improvement in bureaucratic efficiency and independence of the judiciary are critical for the quality of the investment climate.

**3.c Broadening the scope of FDI**

In addition to resource-seeking FDI, the other dominant form of FDI is the efficiency-seeking and tariff-jumping investment in export oriented manufacturing sector activities. In their drive to attract foreign capital in the manufacturing sector, African countries face an uphill battle against more advanced emerging economies such as China, India and Brazil, which enjoy important comparative advantages, including a large highly skilled and low-cost labor force. Therefore, African countries must run where their competitors can afford to walk.

African countries need to expand the scope of FDI destination to increase their competitiveness vis-à-vis other regions. In particular, they need to explore their comparative advantage in market-seeking FDI in services, tourism, and offshore services. However, efforts to attract foreign capital in these activities may face resistance from incumbent national monopolies. Therefore, reforms aimed at increasing competition in the overall economy constitute an integral part of the strategies for attracting and retaining private capital flows in the continent.

Furthermore, while African countries need to pursue efforts to improve the investment climate at the national level, they also must consolidate efforts to develop regional trade arrangements to increase the scope for intra-Africa trade. This will not only open up trade and investment opportunities for African firms, but it will also attract more foreign capital to the continent.

## 4. Managing capital flows

### 4.a Benefits of capital management for African countries

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

A number of reasons can be advanced for activist prudential regulation of capital flows and exchange rates in African countries. First, African countries need to adopt strategies that aim at

tilting the structure of capital flows in favor of long-term capital[2], as a means of accelerating economic growth and structural transformation through diversification of economic activity. They also need to design capital management strategies that encourage more green-field investments to promote new activities, especially export oriented investments in the manufacturing and service sectors. In that sense, capital management can serve as a tool for resource allocation, a policy that was successfully used by Asian countries (e.g., South Korea). At the same time, preferential treatment for long-term capital can minimize the risk of instability as it has been demonstrated in other countries such as Chile (Epstein et al 2005; Le Fort and Lehman 2003).

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

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

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

The fourth motivation is that the integration of capital markets carries important constraints on macroeconomic policy choices at the national level. In particular, countries are faced with classic policy trilema. In the context of integrated financial markets, it is impossible for a county to pursue independently the three major goals of monetary policy at the same time: (1) an autonomous monetary policy aimed at achieving an inflation target, an employment target or any other target; (2) maintaining a fixed exchange rate; (3) free capital mobility. Policy makers must choose two of the three goals. If a country is committed to price stability, say by adhering to an inflation target, then a policy of free capital mobility would require allowing unstrained fluctuation in the exchange rate, which would have costly real effects on the economy. Capital management can allow a country to maintain monetary policy autonomy, notably by maintaining a wedge between the domestic interest rate and foreign interest rates. Thus monetary policy could serve as a tool for promoting a national growth strategy, especially by boosting domestic investment.

The fifth reason for active capital management is to reduce the likelihood of debt crises. In particular, controls of capital account transactions allow to minimize the risk of excessive borrowing in foreign currency by domestic private actors. Moreover, by stabilizing the exchange rate, capital management reduces the risk of excessive devaluation of the national currency which would raise the cost of debt servicing. Given the high debt burden faced by African countries, it is essential to prevent these risks to ensure solvency.

Finally, capital management strategies are needed to retain savings in African countries, especially by preventing capital flight. African countries have experienced heavy financial hemorrhage, which robes the continent of valuable resources that could be used for domestic investment. Africa as a region has the highest ratio of private assets held abroad compared to other developing regions (Collier et al 2001). Sub-Saharan Africa is a net creditor to the rest of the world in the sense that private assets held abroad exceed the region's debt vis-à-vis the rest of the world (Ndikumana and Boyce 2003; Boyce and Ndikumana 2001). Consequently, the agenda for increasing financial resources in African countries must include strategies for curbing and reversing capital flight.

**4.b The South African experience with capital and foreign exchange management**

South Africa has had a long experience with capital and exchange controls with varying degrees of success. The South African exchange rate regime has undergone five major phases since the 1960s (Aron, Elbadawi, and Kahn 2000). The first phase goes until 1978, where the rand was pegged alternatively to the dollar and the pound. This period was also characterized by strict controls of the capital account. In 1979, following the recommendations by the De Kock

Commission, the government adopted a dual exchange rate system to stabilize the capital account while attracting foreign investment. Under this system, current account transactions (trade, authorized capital transfers and current payments including remittances of dividend and interest payments) were executed at a controlled-float exchange rate, the *commercial rand.* Equity capital, in turn, was transacted at a freely floating exchange rate, the *financial rand.* The reform was intended to eliminate the disincentives associated with the pre-existing *securities rand* system, whereby inflows of investment other than purchases of listed securities were transacted at the official exchange rate whereas investment outflows were transacted at a lower rate. In 1983, the dual system was unified under a controlled float system (third phase), but the dual system was reintroduced in September 1985 and lasted until 1995 (fourth phase). In March 1995 (fifth phase), the regime was unified again, in the context of a systematic move toward a market-based exchange rate system.

The motivations for capital controls in South Africa have been: (1) the preservation of savings through management of capital inflows and outflows; (2) preventing the loss of foreign exchange through transfer of assets abroad by residents; (3) encouragement of repatriation of capital. The overriding objective has been to achieve effective management of capital flows without interfering with the efficient operation of commercial, industrial and banking functions.

The historical evidence tends to indicate that the dual exchange rate system contributed to insulating the current account from volatility of the rand to some extent. Indeed, Farell (2001) finds empirical evidence indicating that the volatility of the exchange rate was lower during the financial rand period than during periods of a unified rate. However, the evidence also indicates

that the effectiveness of capital and exchange controls was weakened by exogenous shocks, such as the decline in gold prices in 1983, which caused the rand to depreciate.

While some people argue for abolition of capital and exchange controls in South Africa, there are also calls for caution. The 2003 IMF report expressed reservations to removing the controls given the weak foreign exchange position relative to short term debt (IMF 2003). The report argued in particular that complete removal of capital controls may result in higher exchange rate volatility. Exchange rate risk may be minimized through – among other means – appropriate interventions to maintain a high ratio of reserves to short term debt.

**4.c. Strategies for monitoring and addressing financial risk**

It is difficult to determine what types of controls and incentive structures vis-à-vis capital flows should be implemented in a given country at a given time. The appropriate regime must be determined based on a country's particular economic circumstances and the issues faced at the particular moment. For example, emerging market economies are more exposed to financial risks because of their higher exposure to global markets compared to less financially integrated developing countries. The implication is that African countries with more open financial systems, especially those with stock markets, would face a more urgent need for capital controls to prevent financial fragility than those without capital markets. However, all African countries need to design strategies for capital management for the purpose of influencing the term structure in favor of long-term capital, to influence sectoral allocation of capital, and to minimize exchange rate instability.

Moreover, each particular risk will require a particular set of instruments to prevent it and minimize its effects on the economy. Table 6.3 presents the various types of risks associated with financial integration and the corresponding warning indicators and possible tools that may be used to address these risks. Ilene Grabel (2004) refers to these indicators as *trip wires* and the tools as *speed bumps*, which serve to monitor and minimize the risk of financial fragility. These tools need to be flexible enough to allow adaptation to changes in the country's macroeconomic and financial circumstances.

**Table 6.3: Examples of warning signs and policy responses to financial risks**

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

Source: Grabel (2004).

## 5. Policy Recommendations

The debates on capital flows and development financing should focus on policies and strategies aimed at increasing the volume of capital flows, tilting the balance in favor of long-term capital,

increasing the impact of foreign capital on diversification and transformation, raising the employment effects and the overall growth impact of foreign capital. The following policies should figure prominently on the national development policy agenda.

- *Improving the institutional and regulatory environment to promote financial deepening*

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

- *Consolidating macroeconomic stability*

African countries need to continue to pursue consolidation of macroeconomic stability so as to reduce sovereign risk, which will attract more capital flows and also make it easier to manage these flows. Moreover, a stable macroeconomic framework is indispensable for the development of the financial system. In particular, the development of bond markets – an important component of the financial system – needs to be supported by prudent fiscal policy, especially to avoid unsustainable deficits. High deficits financed by bonds may lead to high interest rates, which crowd out private investment.

*Creating an investor friendly environment*

Improvements at the macroeconomic level need to be complemented by reforms at the micro level to reduce the cost of doing business and improve the overall investment climate. This involves measures to increase efficiency of the legal system in enforcing property and creditor rights as well as reforms of the investment code to increase clarity and transparency of rules and regulations governing private investment.

- *Microeconomic incentives for diversification of FDI destination*

African countries need to design strategies to encourage investments in new sectors to diversify FDI away from extractive industries. Each country will need to carefully determine the sectors to be targeted for special consideration based on its development and industrialization goals. Once these sectors have been determined, special measures such as tax incentives will be established to encourage domestic and foreign capital to move into those sectors.

- *Incentives for employment creation*

As this report has emphasized, African countries face a challenging task of accelerating employment creation. It appears that growth over the recent years has been accompanied by insufficient employment generation. Therefore strategies for increasing investment must be accompanied by measures to increase job creation in the private sector. These measures include tax incentives as well as preferential credit facilities that are explicitly designed to reward investors for the creation of new jobs.

- *Encouraging investment-oriented remittances*

Worker remittances play an important role in increasing access to basic needs for the recipient households. However, given the observed increasing volume of remittances, it is necessary to design strategies to direct these funds into investment to minimize inflationary effects of a potential remittance-led consumption boom, but also and most importantly to maximize the effects on economic growth through capital accumulation. Financial institutions will need to play an important role in designing investment instruments to attract remittances. This will alleviate information asymmetries faced by non-resident investors, which tends to discourage long-term investment. Governments will also need to design schemes that explicitly target remittances, such as facilitating access to land for non-residents either through purchases or fixed-term leasing arrangements.

- *Establishing systematic monitoring of capital flows to minimize instability*

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

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