How Can Sub-Saharan Africa Attract More Private Capital Inflows?

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International private capital has largely bypassed sub-Saharan Africa. But this fact masks significant differences among countries. What accounts for these differences, and what actions can sub-Saharan countries take to attract more private capital?

OFFICIAL FINANCE accounts for a higher proportion of external financial flows to sub-Saharan Africa than to any other developing region (Chart 1). Despite the sharp increase in official finance to Europe and Central Asia in the 1990s, sub-Saharan Africa continues to account for the largest—and, indeed, a growing—share of official development finance; during 1990–95, the latter region received 26 percent of total official development finance provided to all developing countries. Almost 95 percent of this was made available on either highly concessional or grant terms.

In contrast, the share of long-term private capital—defined as the sum of private loans (bank loans *plus* bond finance), portfolio equity flows, and foreign direct investment—flowing to sub-Saharan Africa is lower, as a percentage of GNP, than that of all other developing regions except South Asia. Private transfers and other private flows (including returning flight capital) play a relatively important role in sub-Saharan Africa, as they do in such other regions as South Asia and the Middle East and North Africa. Nonetheless, adding in these flows does not change the picture; in fact, total private flows (including unrequited transfers) to sub-Saharan Africa are lower, as a percentage of GNP, than for all other developing regions.

Along with Latin America, sub-Saharan Africa saw the sharpest decline in private flows in the aftermath of the debt crisis (Chart 2). Private flows to sub-Saharan Africa began to recover in the second half of the 1980s, but, in contrast to the experience of most other developing regions, they declined again in the early 1990s before recovering modestly during 1993–95. For most years during 1982–95, annual long-term private capital flows have been less than half the peak of $5.5 billion reached in 1982.

Why has sub-Saharan Africa been left out? A survey of commercial banks, investment banks, and mutual fund managers conducted by the authors reveals that investors perceive the risks to be higher there than in other regions and face greater impediments to identifying and exploiting profitable opportunities in sub-Saharan Africa than elsewhere. Despite these handicaps, some countries in the region are attracting private capital flows. Their efforts to adopt outward-looking policies

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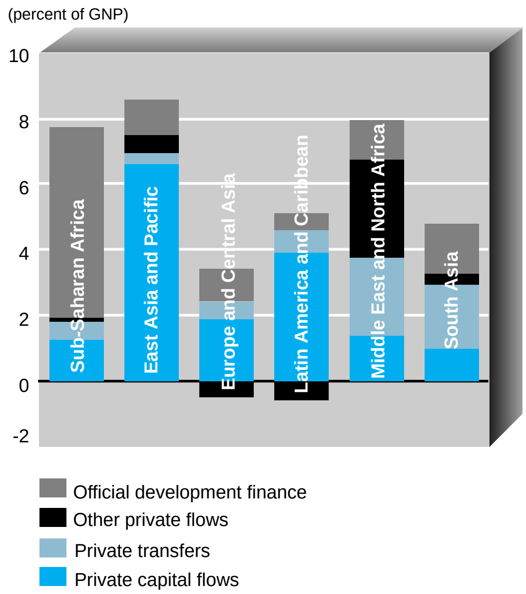
Chart 1

Structure of external finance

Annual averages during 1990–95

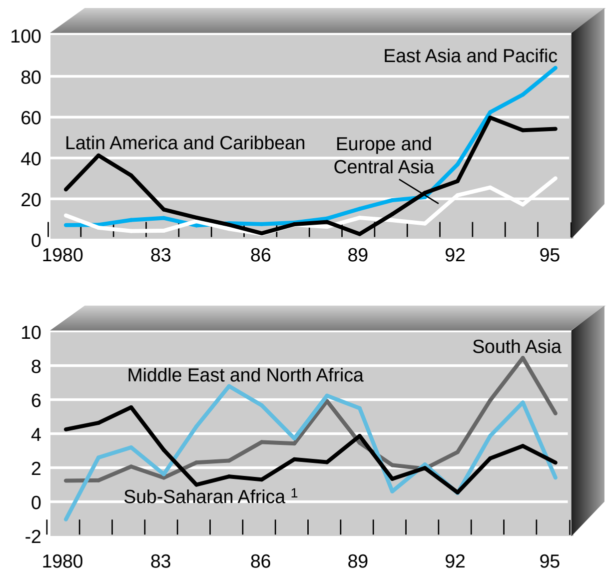


Source: World Bank, Debtor Reporting System.

Chart 2

Private flows by region

(billion dollars)



Source: World Bank, Debtor Reporting System.

[1] Excluding South Africa.

and establish stable macroeconomic environments are beginning to pay off.

Where the money goes

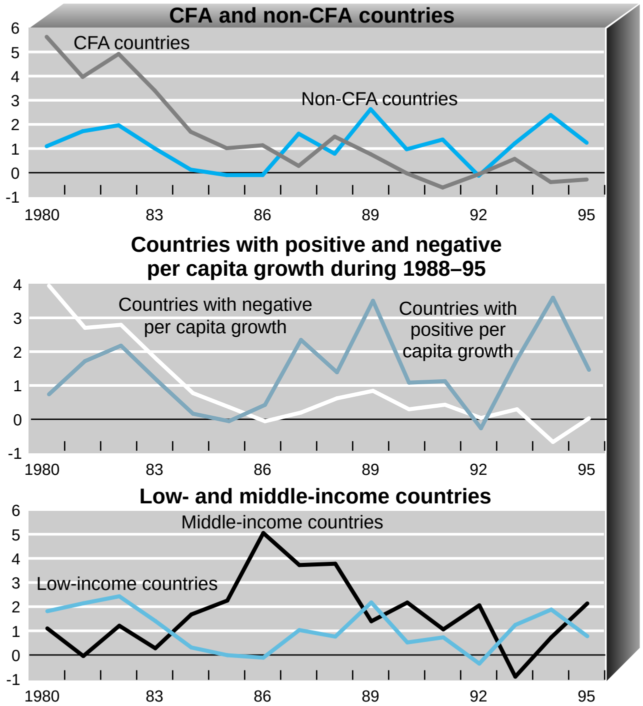
Within sub-Saharan Africa, the CFA countries (the members of the African franc zone) suffered larger and more sustained declines in private capital flows than did non-CFA countries (Chart 3). When private transfers are included, the difference is even more striking. In contrast, private flows to the non-CFA countries recovered significantly in the second half of the 1980s and increased further during 1993–95. In fact, such flows to non-CFA countries are not much lower, as a percentage of GDP, than those to developing regions outside Africa. Similarly, countries with positive per capita growth during 1988–95 received larger private flows than countries with negative per capita growth over the same period. Growing economies also showed an improving trend, especially when private transfers were taken into account. Private flows to the middle-income countries (excluding Angola and South Africa) displayed a very erratic but long-term declining trend, which appears to have been arrested during 1994–95. Private flows to the low-income countries recovered in the second half of the 1980s and increased further during 1993–95.

Underlying the aggregate trend in private flows are quite marked differences in trends between different types of flows (Chart 4). Private loans, which were the dominant component of private flows during the commercial bank lending boom of 1977–82, declined sharply following the debt crisis, recovered briefly in the second half of the 1980s, and subsequently declined again. For sub-Saharan Africa as a whole, they have been either negative or close to zero during most of the 1990s. In contrast, foreign direct investment (FDI) in the region has been on an upward trend throughout the 1980s and 1990s, and now dominates aggregate private flows. Finally, recorded portfolio equity flows to sub-Saharan Africa (excluding South Africa) were nonexistent until 1992, amounted to $17 million in 1993, jumped to $641 million in 1994, and then fell back to $297 million in 1995. Portfolio equity flows to South Africa have seen a more spectacular increase, skyrocketing from $144 million in 1992 to $4.6 billion in 1995, the largest such flow to any developing country in that year.

Foreign direct investment. FDI has shown a significant increase since the late 1980s for the non-CFA countries and countries with positive per capita growth. For some of these, FDI as a percentage of GDP in 1994–95 compares favorably with recipient countries in Asia and Latin America. For instance, Ghana, Mozambique, and Nigeria all received more FDI as a percentage of GNP than Brazil, India, Mexico, or the Philippines. By contrast, FDI flows have been stagnant or shown only modest increases for the CFA countries and countries with negative per capita growth.

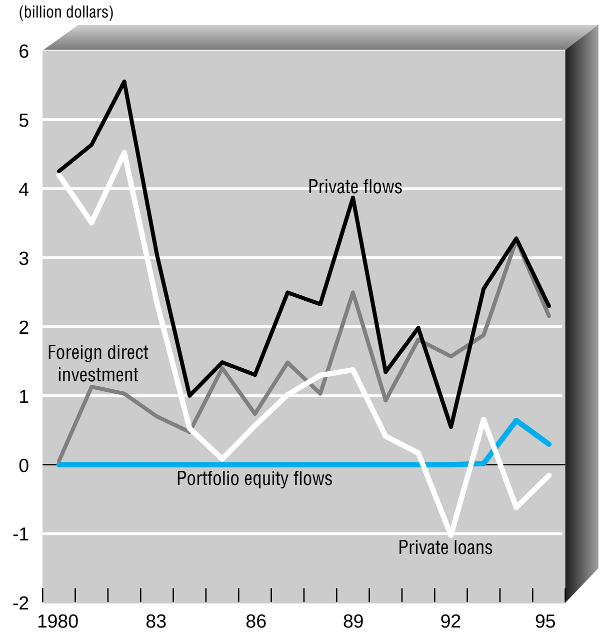
The major recipients of FDI flows to Africa can be placed in three broad groups. The first consists of the longer-term recipients, including Botswana, Mauritius, Seychelles, Swaziland, and Zambia. Since these countries were early recipients, their net FDI flows have tended to plateau or even decline (Botswana and Zambia). The second group, which consists of countries that recorded large increases in FDI flows during the 1990s, includes Angola, Cameroon, Gabon, Ghana, Guinea, Lesotho, Madagascar, Mozambique, Namibia, Nigeria, and Zimbabwe. A large proportion, although not always a majority, of FDI flows to these countries has been directed to the oil and mining sectors. The third group consists of countries where FDI flows have been low and declining during much of the 1980s and early 1990s but have begun to turn around in the last year or two. In some cases, the turnaround has been spectacular: for instance, FDI flows

Chart 3
Private flows to sub-Saharan Africa [1]
(percent of GDP)



Source: Amar Bhattacharya, Peter J. Montiel, and Sunil Sharma, 1996, "Private Capital Flows to Sub-Saharan Africa: An Overview of Trends and Determinants," unpublished, World Bank and International Monetary Fund (Washington).
[1] Excluding Angola and South Africa.

Chart 4
Composition of private flows to sub-Saharan Africa [1]



Source: World Bank, Debtor Reporting System.
[1] Excluding South Africa.

into Uganda are estimated to have reached $112 million in the 1995/96 fiscal year (partly, it should be noted, as the result of a reclassification of private transfers), which amounted to 23 percent of total net official inflows and 2 percent of GNP.

Most countries in sub-Saharan Africa have received very modest amounts of FDI, however, despite the fact that rates of return on FDI have generally been much higher in sub-Saharan Africa than in other developing regions. During 1990–94, rates of return on FDI in the region averaged 24–30 percent, compared with 16–18 percent for all developing countries. This suggests that risks are perceived to be higher in sub-Saharan Africa than in other regions.

Experience in other regions has shown that investors choose countries with stable political and economic environments. Open markets, minimal regulation, good infrastructure facilities, and low production costs are also key factors in attracting and holding foreign investment. Bringing these factors together has proven difficult for many countries in sub-Saharan Africa. Specifically, they suffer from

• *Civil strife.* On the one hand, during the past 15 years, a relatively large number of countries in the region have been affected by civil strife, which, in the most extreme cases (Liberia, Rwanda, Somalia, Sudan, and Zaïre), brought FDI inflows to a standstill. On the other hand, several countries that have seen an end to civil conflicts (such as Angola, Mozambique, Namibia, South Africa, and Uganda) have benefited from significant increases in FDI inflows during the 1990s.

• *Macroeconomic instability.* Large structural fiscal deficits, erratic monetary and exchange rate policies, and weaknesses in financial systems in many sub-Saharan countries have contributed to high and variable inflation and interest rates and a high degree of volatility in real exchange rates. These factors have all worsened the general investment climate. Countries that have made progress in reducing macroeconomic instability have, however, enjoyed some success in attracting FDI inflows.

• *Slow economic growth and small domestic markets.* Although FDI investments in the primary sectors (notably, agriculture and mining) in Africa have, on average, earned high rates of return, the poor growth performance of sub-Saharan Africa and the limited size of its domestic markets have deterred broader-based FDI. Annual GNP growth in sub-Saharan Africa (excluding South Africa) averaged 2.3 percent during 1983–89 and 1.4 percent during 1990–95, compared with 3.8 percent and 5.1 percent for all other developing countries (excluding the former Soviet Union), during these periods.

• *Inward orientation and burdensome regulations.* Compared with other developing regions, which have seen dramatic shifts to more outward-oriented and market-based investment regimes since the mid-1980s, sub-Saharan Africa has remained relatively inward-oriented, with foreign investment often subject to excessive and discriminatory regulation.

• *Slow progress on privatization.* In contrast to many Latin American and Eastern European countries, which have used aggressive privatization programs to boost FDI, progress in privatizing state-owned enterprises has been slow in sub-Saharan Africa. During 1988–94, the proceeds from privatization amounted to $2.4 billion in sub-Saharan Africa, compared with $63.4 billion in Latin America and $16.3 billion in Europe and Central Asia (World Bank, 1996).

• *Poor infrastructure.* Sub-Saharan Africa's physical, financial, human, and institutional infrastructure are all generally less developed than in other regions and, in many cases, have actually deteriorated since the early 1980s. This has reflected sub-Saharan countries' low and declining investments in all areas of infrastructure, heavy state intervention coupled with poor implementation capacity, and limited success thus far in expanding private provision of basic infrastructure.

• *High wage and production costs.* As a result of the macroeconomic and microeconomic factors listed above and, in some cases, countries' labor market policies, wage costs in the region tend to be high relative to productivity levels. Overall costs of production are also generally higher than elsewhere—for example, almost double those prevailing in low-income Asian countries.

Private loans. Private loans have been on a declining trend for all country groups in sub-Saharan Africa. Unlike other developing regions where commercial bank loans have shown a sharp turnaround in the 1990s, such lending to most sub-Saharan countries has remained negative or at very low levels. In part, this has occurred because most African countries have not yet restored their access to financial markets. In contrast to other regions, where creditworthiness ratings have shown a marked improvement in the 1990s, creditworthiness ratings for sub-Saharan African countries have remained much lower, on average, and are only just beginning to improve. The main factors believed to have contributed to sub-Saharan countries' generally low levels of creditworthiness are high political risk, weak growth and export performance, macroeconomic instability, and high levels of indebtedness. Low levels of commercial bank borrowing also reflect decisions made by many countries to restrict such borrowing, especially for general budgetary support.

Portfolio equity flows. Although portfolio investment into sub-Saharan Africa (with the notable exception of South Africa) is still extremely small compared with flows into other emerging markets, there are encouraging signs of growing investor interest. Since 1994, more than 12 Africa-oriented funds have been set up with a total size of more than $1 billion. Initially, the focus of these funds was primarily the South African market, but the base has been broadening to encompass a growing (though still limited) number of other African countries, including Botswana, Côte d'Ivoire, Ghana, Kenya, Mauritius, Zambia, and Zimbabwe. This growing pool of portfolio investment is already perceived to bring important benefits including liquidity, incentives for privatization, and pressure for policy reforms and improvement of the financial infrastructure.

Investors, looking ahead, express guarded optimism about making portfolio investments in Africa. In sharp contrast to the situation only a few years ago, virtually all stock markets on the continent have now been opened up to foreign investment, and in many countries there has been a shift away from state-centered ideologies. A number of factors are, however, still seen as constraining portfolio investment: investors view political instability and weak macroeconomic fundamentals as the most important impediments.

Many structural weaknesses are also viewed as inhibiting investment. A reduction in the transaction costs of doing business will be critical. The setting up of an efficient securities trading and settlement system and the presence of international custodians are important elements of the financial infrastructure that is needed to attract foreign investors. Corruption in the public sector, including the judiciary, is cited by many investors as not only increasing transaction costs but also acting as a deterrent in its own right.

The supply of assets is still very limited, and, in addition to the public companies already listed on stock exchanges, the number of private firms listed needs to be increased. In some cases, privatization of public assets offers the best avenue for increasing the supply of assets in the economy and attracting foreign investors. While foreign investment can play a valuable role in stimulating capital markets in Africa, the growth and stability of these markets will require the development of a healthy base of domestic investors. Pension reform and the promotion of mutual funds could encourage domestic investment in fledgling stock markets. Over the longer term, deficiencies in human capital, infrastructure, and institutions need to be addressed if more African countries are to attract the growing pool of portfolio investment.

The future

Aid fatigue and fiscal pressures in the industrial countries have made it more difficult for developing countries to attract official capital flows. In such an environment, sub-Saharan Africa has no recourse but to tap private foreign capital to raise productivity levels necessary for sustained increases in living standards. With many Asian and Latin American countries growing rapidly and far ahead of most African countries in terms of putting in place the financial infrastructure needed to efficiently absorb foreign capital, most African countries will have to undertake speedy policy and structural reform to attract private flows. Market discipline is likely to be severe in the initial stages, and countries that backtrack on reform will find their access to international capital limited and what is available to them will be provided on costlier terms.

At the micro level, sub-Saharan countries will need to take concerted action on many fronts:

• improve infrastructure;

• strengthen banking systems;

• develop capital markets by accelerating the pace of privatization and broadening the domestic investor base;

• formulate an appropriate regulatory framework and a more liberal investment regime;

• introduce competitive labor market policies while creating and maintaining institutions for upgrading human capital; and

• reform the judiciary system and contain corruption.

It needs emphasizing that a piecemeal approach, even one including tax holidays and other investment incentives, is unlikely to sway investor decisions and attract international resources on a sustainable basis.

While microeconomic factors are difficult to quantify, the macroeconomic factors used in the empirical analysis we have carried out (Bhattacharya, Montiel, and Sharma, 1996) yielded clear-cut conclusions. In sub-Saharan Africa, economic characteristics like output growth, openness, relative stability of real effective exchange rates, low external debt, and high investment rates have encouraged private capital flows. The first three of these have been crucial for drawing in FDI and the last two factors, coupled with output growth, have been particularly important for obtaining foreign private loans. F&D

Suggestions for further reading:

Amar Bhattacharya, Peter J. Montiel, and Sunil Sharma, 1996, "Private Capital Flows to Sub-Saharan Africa: An Overview of Trends and Determinants," unpublished, World Bank and International Monetary Fund (Washington).

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World Bank, 1996, World Debt Tables *(Washington).*