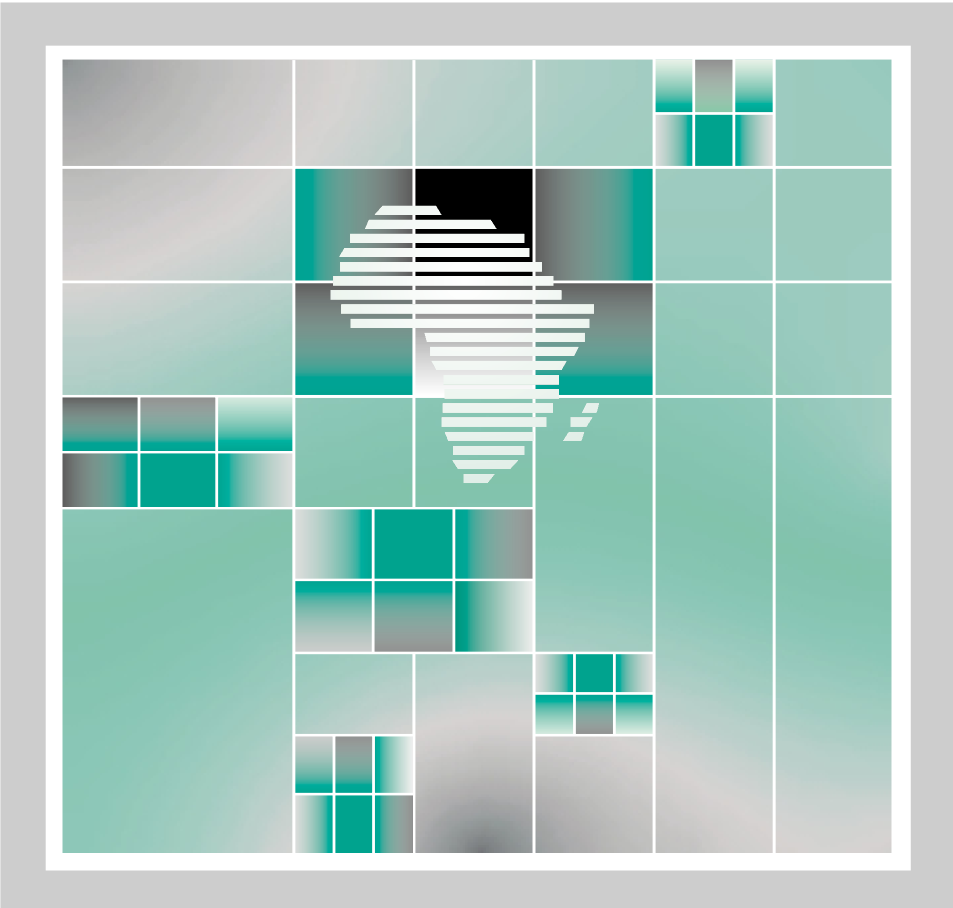
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# CAPITAL FLOWS AND GROWTH IN AFRICA

UNITED NATIONS



UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
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## *Contents*

## *List of tables and charts*

# CAPITAL FLOWS AND GROWTH IN AFRICA

## A. Introduction

The international community has long recognized that developing countries need a substantial inflow of external resources in order to fill the savings and foreign exchange gaps associated with a rapid rate of capital accumulation and growth needed to overcome widespread poverty and to lift living standards to acceptable levels. Among various developing regions, the need for external financing is nowhere more pressing than in Africa, particularly in sub-Saharan Africa,[1] where income levels are too low to generate adequate domestic resources for the attainment of even modest rates of investment and growth. Since private capital inflows, in particular foreign direct investment (FDI), lag behind rather than lead growth, the task of filling the resource gap inevitably falls on official financing. International efforts have indeed been taken over the past three decades in this regard through both multilateral and bilateral financing. However, while the savings and foreign exchange gaps in Africa have tended to widen since the beginning of the 1980s as a result of a combination of a number of factors, including adverse movements in the terms of trade and a sharp increase in the import content of growth brought about by rapid trade liberalization, capital inflows have failed to keep pace.

While official inflows[2] have stagnated or fallen, the region has not participated in the recovery in private capital inflows to emerging markets that began in the early 1990s. Efforts to integrate the region into the global financial system and to attract private flows through a rapid liberalization of the capital account have resulted not in increased inflows of such capital, but in greater volatility, with attendant consequences for exchange rate instability and misalignments. A number of countries in the region have experienced considerable financial instability and payments difficulties, but these have been given little attention by the international community, largely because, unlike the recent bouts of financial crisis in emerging markets of Latin America and East Asia, they did not pose a serious threat to the stability of the international financial system and their damage has been confined to the economies concerned. Moreover, an increased proportion of net capital inflows has been used for purposes other than current account financing, i.e. for offsetting financial transactions (including private capital outflows) and for accumulation of reserves as a safeguard against speculative attacks on currencies and capital flight. Consequently, not only has the volume of net capital inflows continued to fall far short of the resource gap, but also the proportion of such inflows used for real resource transfers from abroad has fallen in the past 10 years.

Given that financial flows are inadequate and volatile and the region is subject to frequent terms-of-trade and natural shocks, it should come as no surprise that growth continues to be too erratic and slow to permit an increase in both living standards and domestic savings. Breaking this vicious circle requires, *inter alia*, a sustained injection of external financing in amounts large enough to give a big push to the region to accelerate and maintain growth at levels higher than in the past. This initial big push could only come from official sources of finance, and it would need to be combined with policies that recognize the need not only for market-based incentives, but also for a greater role for the State and for institution building.

Such a process would help break aid dependence in two ways. First, rapidly rising income would allow domestic savings to be raised faster than output, thereby raising total investible resources without additional external financing. Secondly, sustained growth would attract private capital, as a substitute for official financing. In other words, the only feasible way to end aid dependence is to launch a massive aid programme and to sustain rapid growth for a sufficiently long period so as to allow domestic savings and external private flows to gradually replace official aid. The experience of the East Asian countries that successfully broke out of the vicious circle of poverty and inadequate domestic resources during the 1960s and 1970s suggests that if GDP growth could be raised to some 6 per cent per annum and sustained at that rate for a period of 10–12 years, through a large injection of official aid accompanied by appropriate domestic policies, the need for official financing would gradually diminish as these alternative sources of financing came forward. But if the minimum quantum of resources needed to initiate and sustain such a process is not provided, aid dependence is likely to continue unabated. To use a Keynesian metaphor, aid can thus be like a widow's cruse: it does not get wasted by expending more of it, but attempts to spare it can translate the cruse into a Danaid jar which can never be filled up.

This paper addresses these issues. The next section reviews recent trends in the capital inflows of Africa and is followed by an analysis of the use of such inflows for offsetting financial transactions and real resource transfers. Section D examines the size and stability of short-term capital flows. Section E presents various scenarios to analyse the possible evolution of domestic savings and private capital inflows through a process of rapid and sustained growth made possible by, *inter alia*, a large injection of foreign aid and the implications of this process for aid dependence. The final section briefly discusses the policy approach needed to ensure that aid is effectively translated into investment and growth, keeping in mind the policy mistakes made both during the pre- and post-adjustment periods.