SHIFTS IN FINANCING SUSTAINABLE DEVELOPMENT: HOW SHOULD AFRICA ADAPT IN 2014?

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The Priority

Africa has a large financing gap to not only sustain its current rapid rate of economic growth but also fund its transformation. The continent's infrastructure spending needs alone stand at about $93 billion per year. Over the last decade, the flow of external financing to Africa—an important supplement to fiscal revenues—has increased and the relative importance of its components has changed. Private capital flows to sub-Saharan Africa—driven by investment from the BRICS (Brazil, Russia, India, China and South Africa) countries and portfolio flows—as well as remittances have overtaken aid flows. As a result, it is important to explore policy options to ensure that these external flows are efficiently utilized to achieve economic, social and environmental sustainable development.

Why Is It Important?

A decade after the 2002 Monterrey Consensus, the private sector is leading investments to sub-Saharan Africa as private capital flows overtake official development assistance (ODA). Private capital flows to sub-Saharan Africa—foreign direct investment (FDI), portfolio flows and loan flows—reached $67 billion in 2012, up from $14 billion in 2002. In comparison, ODA increased to only $42.5 billion in 2012 from $18.1 billion in 2002. Since 2002, private capital flows to sub-Saharan Africa have grown at a robust pace of 19.4 percent per year in spite of the global financial crisis. In contrast, ODA grew at 12.1 percent over the period, but was more stable.

South-South investment from the BRICS countries is becoming an engine of growth for private capital flows to sub-Saharan Africa. From 2002-2012, FDI averaged about three-quarters of total private capital flows. While most FDI to sub-Saharan Africa still originates from OECD countries, in particular from France and the United States, BRICS countries have over the years increased their presence in the continent. According to UNCTAD (2013), the BRICS countries' share in the continent's FDI flows reached 25 percent in 2010 and this trend is strengthening.

While negligible in 2002, portfolio flows have become an important component of financial flows to sub-Saharan Africa. Portfolio flows averaged $9.5 billion over the decade and have grown faster since 2006. In contrast to FDI, portfolio flows from BRICS countries remain negligible. In addition to traditional investments in equity markets, especially in South Africa, and domestic bond markets like in Ghana, Nigeria and South Africa, foreign investors have recently purchased euro bonds as a number of sub-Saharan African countries have been able to raise funds in international debt markets for the first time. Indeed, Angola, Côte d'Ivoire, Gabon, Ghana, Namibia, Nigeria, Rwanda, Senegal, Seychelles and Zambia have all issued euro bonds, and Kenya, Tanzania and Uganda are expected to follow their example.

Beyond capital flows, remittances have also become important sources of external financial flows to sub-Saharan African countries. Remittances have averaged about $21.8 billion over the 2002-2012 decade—more than twice the average portfolio flows to the region over that time. During 2005-2011, at least five sub-Saharan African countries received remittance flows accounting for more than 10 percent of their GDP, with Lesotho even receiving 35 percent of its GDP from remittances.

As a result, when remittances are added to private capital flows, the subsequent non-ODA flows have become the main source of external funding to sub-Saharan Africa. Over 2002-2012, non-ODA flows have grown to account for more than two-thirds of total external flows (ODA and non-ODA) from about half of that total in 2002. The relative importance of non-ODA flows is likely to increase, especially as ODA growth is expected to stagnate for the poorest countries with the largest Millennium Development Goals implementation gaps.

What Should Be Done in 2014

The growth in external resources has the potential to complement domestic resources to achieve sub-Saharan Africa's ambitious transformational strategy. Deepening domestic financial sectors and developing local capital markets remain high on the policy agenda. Sub-Saharan African countries need to continue making more efficient use of their existing financial systems and improve their mobilization and allocation of resources to growth-enhancing investments. One benefit of deeper financial sectors and more developed local capital markets is that they should help strengthen the tenuous link between external financial flows and macroeconomic growth. One important starting point will be to continue to build an appropriate financial infrastructure—including the payments systems, and the legal and regulatory framework for financial services—and promote financial literacy. Of course, policy efforts to strengthen *pull* factors are still relevant. Raising the necessary fiscal revenues together with appropriate macroeconomic policies remains a priority. Sequencing the liberalization of the capital account, ensuring debt sustainability, and appropriately managing sovereign debt and external flows should also be a part of the policy toolkit.

Ten years after Monterrey, five priorities emerge for the policy agenda on innovative and sustainable finance:

1. **Getting more transfer of knowledge and skills from FDI:** Over the last decade, about three-quarters of FDI to sub-Saharan Africa went to resource-rich countries and into extractive industries. The prospects for increased investment in this sector look strong given the discovery of new resources on the continent. Yet, in most sub-Saharan African countries, the linkages between extractive industries, local firms and employment markets, and domestic financial systems are tenuous. Instead of creating economic enclaves, FDI flows will benefit more long-term economic growth in sub-Saharan Africa if they are associated with a transfer of knowledge and skills from multinational companies to the domestic private sector. In the medium to long term, sub-Saharan African policymakers can anticipate the type of FDI their countries will attract and build a strategy in advance to develop the future technology and skills that will be needed for the expected investments. In the short term, policymakers can provide incentives for investors to include local businesses in the value chain and invest in education and training. This trend is increasing, for instance, in the information and communications technology sector in sub-Saharan Africa.

2. **Reducing illicit financial flows:** Although it is difficult to estimate, FDI in the resource sector often results in large financial outflows from tax evasion, the underpricing of concessions and trade mispricing. As stressed by the

2013 Africa Progress Report, policymakers will need to ensure that revenues are collected, accounted for, and allocated efficiently and equitably in order to advance public policy goals. International initiatives include the U.S. Dodd-Frank legislation, which requires public disclosure of payments at the project level from listed companies involved in extractive industries. Policymakers need to build national capacity to understand the natural resource sectors better so as to obtain better contract terms. They should work with developed countries and require full public disclosure of the beneficial ownership of companies as well as strengthen multilateral rules on taxation to reduce transfer pricing practices that result in lost fiscal revenues.

3. **Strengthening South-South partnerships:** BRICS countries are playing an important role in sub-Saharan Africa's ongoing integration in the global economy. UNCTAD (2013) data indicate the share of BRICS countries in Africa's total value of greenfield projects—the main mode of investment in Africa—rose to more than 25 percent in 2012 from 19 percent in 2003. Four of the BRICS—South Africa, China, India and Russia—are now among the top investing countries in Africa. One policy priority will be to find ways to attract investment in the primary sector as well as in services and manufacturing sectors, while engaging different types of partners, including state-owned enterprises. Beyond BRICS countries, the regional trade and financial integration agenda offers a platform to come up with creative solutions. By strengthening common institutions, the governments in the West African Economic and Monetary Union (WAEMU) have been increasingly able to mobilize domestic savings from banks and other investors in the eight WAEMU countries and issue Treasury bills and bonds separately from each other. The NEPAD-OECD Africa Investment Initiative aims at raising the profile of Africa as an investment destination while facilitating regional cooperation and has led to a number of investment policy reviews in four South African Development Community countries (Mozambique, Botswana, Tanzania and Mauritius). Going forward, it will be important to garner the political will to accelerate the transition from *de jure* to *de facto* regional integration in sub-Saharan Africa by further reducing non-tariff barriers to trade.

4. **Engaging the diaspora:** Estimates of remittance flows do not capture unrecorded flows and, given their size, policymakers will have to seriously engage the diaspora and find the proper incentives to do so. Since 2008, Africa has been the most costly region in the world to which to send remittances. Two policy questions come to mind. First, how can the cost of sending remittances to the region be lowered? And second, how can remittance flows—which mainly go to education and health expenses, and consumption—be used to finance growth-enhancing investments? Current research points to a number of policy options such as increasing competition among remittance service providers (especially banks), elaborating well-balanced regulation for cheaper alternatives and encouraging technologies such as mobile money transfers. For example, Kenyans can use mobile money transfers to send money from the U.S. and the nationals of some WAEMU countries can now do the same within the Union. Efforts to improve transfer methods to make them cheaper, more efficient and safe should continue. Banks and microfinance institutions could also develop credit products for their customers that benefit from a stable track record of remittance flows. The use of diaspora bonds like those issued by Ethiopia or the placement of infrastructure bonds to the diaspora such as those issued by Kenya are options already being explored by other countries.

5. **Redefining and rethinking the role of aid**: Aggregate numbers mask the disparities in the dependence on ODA by sub-Saharan African countries. While some poorer, post-conflict and/or fragile countries still rely heavily on aid, others have been able to diversify their external resources. The OECD is working to improve the quality and policy relevance of its statistics on resource flows to developing countries beyond ODA. One policy challenge will be to find ways to leverage aid flows so as to attract the private investment necessary to implement the sub-Saharan African policy agenda. African countries will need to have a clear idea of their projects pipeline and associated funding needs. The infrastructure sector offers a number of opportunities in this regard. The large and long-term financing needs of infrastructure projects can require

different types of financiers, including private sector, bilateral and multilateral partners. A recently completed toll road in Senegal used such a model. Islamic financial instruments have been used to finance infrastructure projects in Malaysia, Indonesia and countries in the Middle East, and could attract investors from similar countries. In project finance, solutions to mitigate credit risk could involve multilateral partners. Berne Union data show that medium- and long-term credit guarantees in sub-Saharan Africa reached $9.1 billion in 2012 and were highly concentrated in Angola, Ethiopia, Ghana, Nigeria, Republic of the Congo, South Africa and Zambia.

The evolution of external flows to sub-Saharan Africa indicates that engaging the private sector and the diaspora and at the same time complementing ODA with more diverse and complex sources of funding is becoming more important for African policymakers. They will need to engage and coordinate the different partners and find innovative solutions along the way. While attempting to raise more innovative capital, policymakers should start by asking themselves a simple but important question: What is the money for? For financing to be *sustainable development financing*, it will need to fund the strategies leading to a vision of what Africa should be in the next 10-20 years. Finance should follow, not lead.

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