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DIIS Brief

From bear to bull?
Sub-Saharan Africa and Global Capital Markets

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Summary:

The current boom in global commodity prices and the expansion of Chinese interests in sub-Saharan Africa are part of a general warming of external investors to the region. This policy brief examines trends in commercial financial instruments such as equities, bonds and commercial bank lending and their impact on economic development. It reviews the nature and behaviour of these instruments in developing countries compared with more traditional development finance, such as foreign aid. This provides a foundation for analysing past and present trends in sub-Saharan Africa. It is argued that, like many other low income countries in the past, sub-Saharan Africa has received negligible inflows of external commercial financing. If anything, the region has been additionally excluded from these flows due to very weak levels of financial sector development even compared to other low income countries. At the same time, recent changes in global and domestic conditions mean that the situation is evolving rapidly. There is mounting evidence to show that many economies in sub-Saharan Africa are enjoying significantly expanded access to commercial external capital flows. Given good prospects that this trend will continue, the playing field for traditional donors is likely to alter significantly. The brief concludes by reflecting on how donors might respond to these emerging policy challenges.

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Introduction

If current headlines are anything to go by, sub-Saharan Africa is the new bull of international financial markets. A recent OECD report tells its readers that Africa is becoming "an important asset class for investors from the OECD area" (Blommestein and Horman, 2007, p.1). The Financial Times also asserts that Africa is "at the heart of the latest surge of enthusiasm to hit emerging markets" (19 November 2007, p.17). Despite these upbeat messages it is evident that the distribution of global capital flows continues to be heavily skewed towards high and middle income countries. Textbook economic theory predicts that lower income countries should be net beneficiaries of external capital inflows. In contrast, however, scholars note that over recent years these countries have become net creditors to higher income economies on average (Prasad et al., 2006).

What are we to make of these trends? And what implications do they hold for foreign aid and prospects for development in sub-Saharan Africa? This *DIIS Policy Brief* provides some guidance to this controversial and rapidly evolving field.[1]

From the outset it is useful to stress that the relationship between economic development and external financing in developing countries is controversial. This is highlighted by continued debates over the effects of foreign aid.[2] At the same time, although overseas development aid (ODA) and foreign direct investment (FDI) have been the main instruments through which most sub-Saharan African countries have gained access to external capital, they are not the only games in town. Global capital markets represent an important and growing phenomenon throughout the developing world.

The argument of this briefing is that market-based private capital flows, such as equities, bonds and lending from commercial banks, present important opportunities and risks for sub-Saharan Africa. The region's exclusion from global capital markets in the past, although more extreme than other developing countries', is not indicative of special treatment by international investors. Recent changes in global and domestic conditions indicate that access to new forms of commercial financing in sub-Saharan Africa is expanding rapidly and will significantly alter the playing field for traditional donors.

The past and present role of global capital markets in sub-Saharan Africa is the main focus of this briefing. The next section gives a highly condensed overview of trends in global capital flows. This is followed by a summary of previous research into the characteristics and

[1] This brief is based on the *DIIS Working Paper*, "Sub-Saharan Africa and Global Capital Markets – past and present" by Sam Jones, December 2007. Hereafter denoted as Jones (2007).

[2] The debate between Jeffrey Sachs and William Easterly in the Washington Post (2005) is a case in point.

expected developmental impacts of different external financing instruments. This sets the context for analysis of past and present trends in access to global capital markets by sub-Saharan African countries. The brief finishes with suggestions for how donors might engage constructively with this emerging agenda.

Trends in global capital flows

Recent trends in global capital flows to developing countries are dominated by movements in private capital, not foreign aid. As shown in Figure 1, aggregate net inflows to developing countries have risen from around US$ 50 billion in 1986 to over US$ 300 billion in 2005. This growth has been driven almost entirely by increases in foreign direct investment (FDI) and commercial private financing (labelled 'non-FDI' in the figure). The total volume of overseas development aid has remained broadly stable and now represents less than 20% of total net external capital flows to developing countries.

Even so, the data clearly show that there are systematic differences between countries in terms of their access to external financing instruments. Low income countries have been consistently marginalized from commercial private capital flows – see Figures 2 and 3. On average they also have received lower volumes of foreign direct investment, making overseas aid the predominant form of external capital inflow on average. In contrast, middle income countries and, specifically, a small group of major emerging market economies have been the main beneficiaries of global capital market instruments. The latter are Brazil, India, China, Thailand and South Africa (referred to here as the "BICTS") which received average annual net inflows of non-FDI private capital equal to US$ 50 per capita during the most recent decade. If anything, and as Figure 3 suggests, access to global capital markets may have become more restricted for low income countries over the period 1996-2005 compared to a decade earlier.

Figure 1: Aggregate net external capital flows to developing countries (annual)[3]

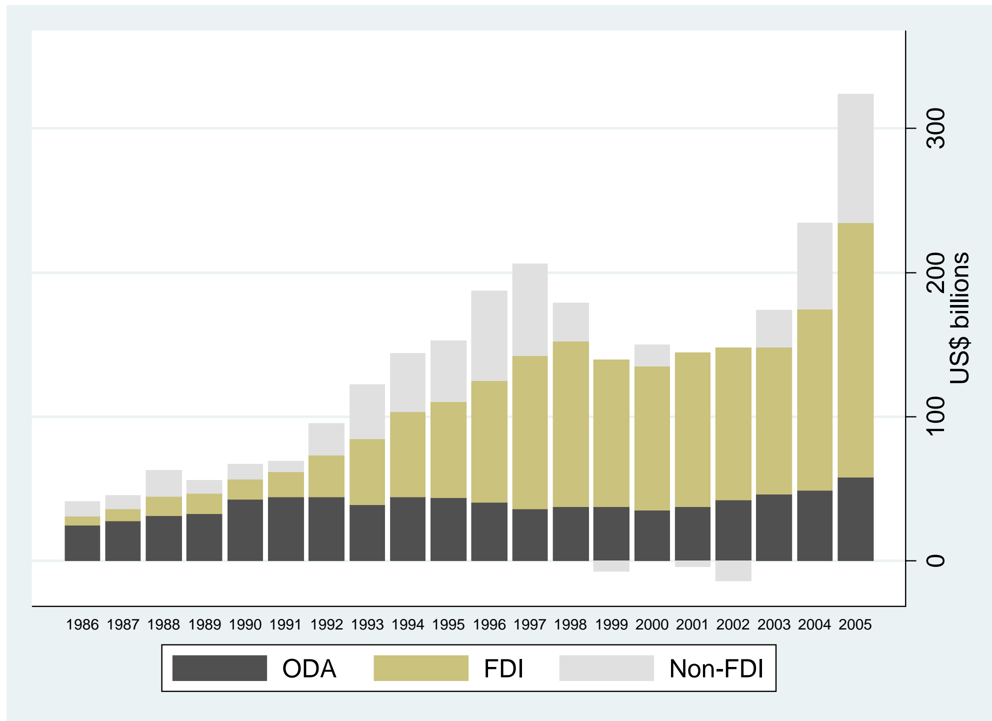
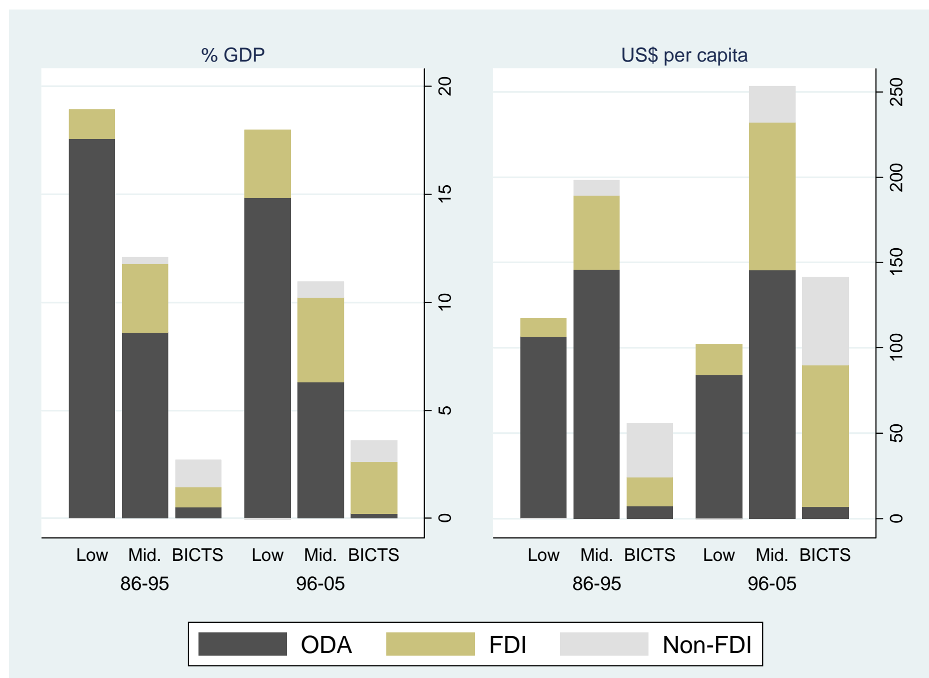
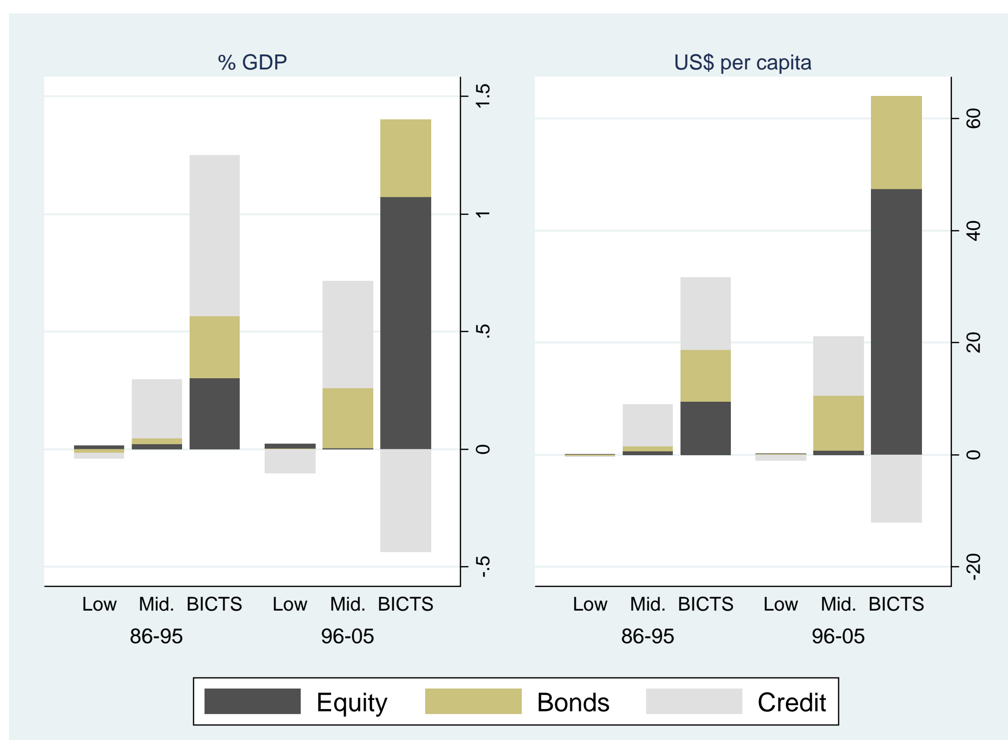


Figure 2: Relative economic size of net capital flows (by period)



[3] All graphs are the author's, based on data from the World Bank (2006), *World Development Indicators*. No weighting scheme is applied (i.e., each country has an equal weight).

Figure 3: Relative economic size of net non-FDI capital flows (by period)



Understanding financing instruments

How do we make sense of systematic patterns in global capital flows? The first point to make is that the global distribution of capital flows contradicts textbook economic theory. This predicts that lower income countries will receive the largest (net) inflows of private external capital because returns to investment in these countries should be higher than in more advanced economies. Indeed, this perspective provides no clear rationale for overseas public agencies to channel investment to other countries precisely because the incentives are aligned for this to be undertaken by private agents.[4]

As a result, a framework of market failures operating at both global and domestic levels is needed to get to grips with the reality of cross-border financial flows.[5] Much of the literature operating within this framework takes a broadly cynical view of the effects of global capital markets on lower income countries. Perhaps reflecting the experience of the Asian crisis of 1998, which sparked large outflows of commercial bank lending from developing economies (see Figure 3), the speculative and volatile nature of these instruments is presented as a major

[4] While there may be a rationale to support the provision of public goods, one can argue that with adequate provision of private external capital, a domestic tax regime can be devised to ensure sufficient sources of internal financing for the public sector.

[5] 'Market failure' is used as a general term here to indicate deviations from the (textbook) conditions deemed necessary to achieve a general equilibrium in all markets.

risk to economic growth. It is then argued that preference should be given to more stable flows of external capital such as FDI and ODA.

These concerns are not unjustified. There are good reasons to be wary of the risks posed by large inflows of market-based private capital. In particular, these instruments are most likely to be used by speculative investors and are particularly sensitive to small changes in (observable) risk factors such as exchange rates and interest rates. For these reasons they are most commonly associated with contagion and herd-like behaviour in financial markets.

This should not amount to a blanket rejection of the role that global capital markets can play in lower income counties. Three points support this argument. First, the extent to which the above risks generate real economic costs is determined by the existence of market failures. In other words, the negative aspects of market-based private capital flows are not inherent to these instruments themselves; rather, these instruments can simply aggravate pre-existing weaknesses. In economic terms, therefore, the 'first best' solution is to resolve (manage) the underlying market failures.

Secondly, it is important to recognise that global capital market instruments substantially widen the financing space for institutions in developing countries. That is, they sit between the relative extremes of overseas aid and foreign direct investment. For example, while foreign aid is provided on concessional terms, it often comes with significant conditions attached and tends to be directed to the provision of public (social) goods rather than private investment. The high risks taken by foreign direct investors in terms of both foreign exchange exposure and their ability to liquidate the investment are compensated by managerial control and ownership of the profit stream.

In contrast, capital market instruments present a more diverse set of risk-reward combinations. Typically these instruments simultaneously place a larger share of risks on the investor and limit his rewards in comparison with, say, foreign direct investment. The flexibility, diversity and enhanced liquidity of these instruments can be preferable for both investors and beneficiaries. Of course, if external investors are risk-averse, the supply of funds may be extremely low. Alternatively, investors may require much larger rewards for taking on additional risks, thus rationing effective demand for such financing towards zero.

Thirdly, capital market instruments *can* offer significant advantages compared with the 'traditional' alternatives. Following from the previous point, institutions may gain access to funds which would neither be forthcoming nor demanded by institutions themselves if external aid or foreign direct investment were the only options. Bond financing, for example, can involve much lower overall financing costs than foreign direct investment, as it does not

cede management control or ownership of profits to external parties. The result can be an increase in the aggregate supply of funds and a more efficient matching of investors to projects.

In addition to these direct benefits, capital market instruments are associated with a wide range of efficiency spillovers for the financial system. The increase in supply of credit at market rates, as well as enhanced competition in the financial services industry, can contribute to lower financing costs throughout the economy. Also, as emphasised by recent research on domestic bond markets (e.g., Burger and Warnock, 2004), the activity of foreign investors on local equity and debt markets can significantly strengthen the development of the financial system in general, holding positive implications for domestic savings and the efficiency of capital markets in particular. Where finance is raised in public markets, the increased exposure of public and/or private agents to wider scrutiny can provide a useful disciplinary function, support the correct pricing of risk throughout the economy and provide signals on macroeconomic developments to non-market participants. Importantly, these benefits do not accrue to traditional financing instruments, especially where their engagement with local financial markets is limited.

Empirical evidence confirms the complex reality of trends in external financing to developing countries. If anything, previous research has not been able to identify a stable, robust relationship between external financing and economic growth. We do know that market imperfections are prevalent at all levels of the financial system. However, we do not have a rigorous understanding of how these multiple imperfections interact over time and space to influence the developmental trajectory of a given country. Recent literature generally supports the notion that access to capital inflows, especially those in focus here, and their capacity to contribute to economic growth are positively associated with the extent of market imperfections, particularly those of the recipient's financial system (e.g., IMF, 2007a). The general expectation, therefore, is that lower income countries may face the greatest restrictions in access to non-traditional finance capital and may be poorly equipped to ensure they yield positive investment and/or efficiency spillovers. More specific findings, particularly at the policy level, however, are in short supply.

Sub-Saharan Africa in the past

Focussing on sub-Saharan Africa, it hardly needs emphasising that a large number of the world's poorest countries are located in the region. Indeed, of the sample of developing countries analysed in Jones (2007), 70% of the low income group are from the region.

Following from the findings of the above sections it is no surprise that external capital market instruments have not played a prominent role in sub-Saharan Africa over the past two decades. In contrast, both foreign aid and foreign direct investment have been predominant (see Figure 2).[6]

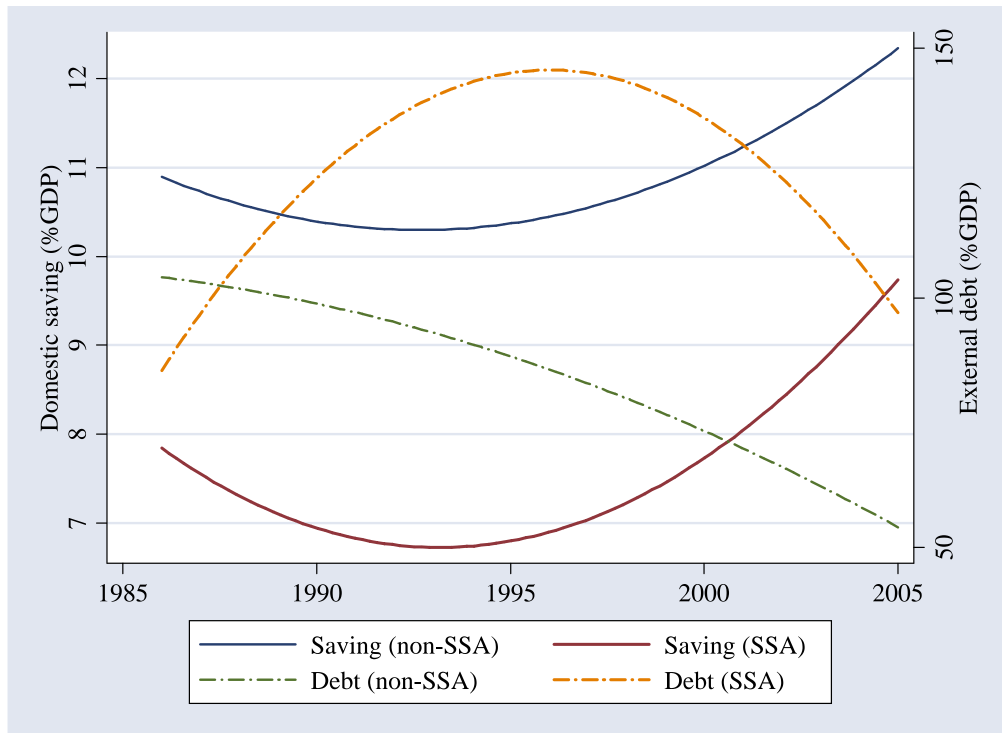
The question remains whether there are differences in the way international investors have treated sub-Saharan African countries. If not, then changes in variables that historically have been associated with greater access to global capital markets can be expected to be relevant for the region. Preliminary evidence from Jones (2007) suggests that sub-Saharan African countries (on average) have faced additional restrictions in access to external bonds and commercial bank lending relative to other lower income economies, controlling for income differences and regime shifts in global capital flows. However, plausible explanations for these trends refer to exactly those variables that are deemed relevant for all developing markets.

Compared to lower income countries in other regions, sub-Saharan Africa shows more extreme levels of financial underdevelopment on a number of indicators. Despite substantial financial sector reforms across the sub-continent over recent decades, savings rates remain at extremely low levels. As indicated in Figure 4, the average sub-Saharan African country achieved domestic savings equal to less than 8% of GDP over the period 1986 to 2005, versus 11% in other lower income countries, and 28% in the BICTS group. External debt levels have been higher on average in sub-Saharan Africa than in other regions – see Figure 4. Scholars also point to higher levels of capital flight from sub-Saharan Africa compared to other developing regions (Boyce and Ndikumana, 2001). The need for improved domestic financial development throughout the region is a consistent theme of recent policy research coming out of both the World Bank and the IMF (e.g., Honohan and Beck, 2007).

Thus, despite more severe exclusion from global capital markets in the past, there is no compelling evidence that international investors have treated sub-Saharan Africa as an entirely separate or special case. This is confirmed by levels of access to foreign direct investment and external equity financing in the region that are highly comparable to other low income developing economies (see Jones, 2007).

[6] Note that the Republic of South Africa is not in focus and is excluded from the analytical definition of sub-Saharan Africa used here.

Figure 4: Fitted quadratic trends in selected financial indicators for sub-Saharan African countries (SSA) and selected lower income countries from other regions (non-SSA)



Sub-Saharan Africa in the present

In financial markets the past is not always a good guide to the future. Very recent changes in global and local conditions across sub-Saharan Africa have led to a significant escalation of interest from global investors. Relevant global "push" factors include the upward trend in commodity prices, excess liquidity and low interest rates in advanced countries. Investment in commodities and other assets linked to commodity prices has increased substantially due to their low correlation with alternative asset classes. This dynamic is fundamental for sub-Saharan Africa, where economic diversification is relatively low and exports are dominated by (raw) primary products. As a result, sub-Saharan African assets are gaining increased prominence as important contributors to portfolio diversity, particularly in the midst of financial volatility in advanced markets. In addition, South-South globalization and enhanced competition for access to developing country markets have raised the profile of previously neglected lower income markets. The expansion of Chinese interests in Africa is highly relevant in this regard.

Changes in domestic conditions are also important. Strong progress in macroeconomic fundamentals appears to reflect a more permanent improvement in economic conditions for many countries in sub-Saharan Africa. Not only is the region "enjoying its best period of

sustained growth since independence.” (IMF, 2007a: 95), but also consumer price inflation has fallen to single digit levels (7.3% in 2006) and current account balances appear to be contained at manageable levels on average. Substantial debt relief, boosted in some cases by debt repayments, also has led to considerable improvements in overall debt sustainability across the region. The latest estimates are that Africa’s external debt as a percentage of GDP has fallen nearly threefold over a short period from 183.8% in 2002 to 68.7% in 2006 (IMF, 2007b).

The long-term trends suggested by these changes are hard to judge and only limited evidence can be presented at this stage. Even so, there are good indications that many sub-Saharan countries are witnessing an expansion of financing opportunities and interest from external financial investors. For example:

Domestic stock markets: appear to have entered a new phase of increased activity since around 2005, particularly among the financially more developed sub-Saharan African countries. In Kenya, for example, the volume of shares traded in 2006 was equal to over 5% of GDP, up from less than 1% annual volume from 1995-2003. See Jones (2007, Table 4). Similar trends have been evident in Zambia, Nigeria and Ghana (to name a few).

Debt securities: sub-Saharan African countries with more stable macroeconomic conditions are also showing substantial interest in undertaking long-term sovereign bond issues on both local and international markets. The lead has been taken by Ghana, which issued sub-Saharan Africa’s first international bond in September 2007 (excluding those issued by South Africa). This raised US$ 750 million with a 10 year maturity at a competitive yield of 8.5%. Various other countries, such as Nigeria, appear set to follow suit.

Commercial lending: non-concessional loans to sub-Saharan Africa appear to be on the rise, particularly from other developing countries. The World Bank (2006) estimates that from 2004 to 2006 the region received around 20% of all new loan commitments (by value) made by developing country banks to other developing countries. Much of this refers to lending by Chinese banks to specific (resource-rich) countries including Angola, Congo and Sudan. While the exact figures and terms of these loans are not known exactly, reports suggest they may total in excess of US$ 5 billion in the last two years alone (e.g., Moss and Rose, 2006).

Foreign bank ownership: finally, there has been a trend increase in foreign bank penetration into sub-Saharan Africa. The share of banking assets owned by foreign banks in the region is among the highest of all developing regions – at 55% versus under 15% in the Middle East, South Asia, East Asia and the Pacific (Van Horen, 2007). The importance of foreign players in the banking sector was underlined very recently by China’s Industrial and Commercial

Bank who made a US$5.6 billion purchase of a 20% stake in Standard Bank, one of the sub-region's largest banks with operations region-wide. The point is that foreign banks can serve as a conduit for increased cross-border lending operations with the local subsidiary operating as the intermediary.

Policy challenges

The implications of enhanced financial integration and access to international capital markets are not trivial for sub-Saharan Africa. There is no doubt that the broadening of financing opportunities may be positive in a number of ways. It may facilitate higher levels of investment directed to the productive sectors, provide financing for long-term infrastructure projects and generate a range of efficiency spillovers in domestic markets. Where these contribute to robust growth in the context of stable economic fundamentals, they could mark a turning point away from chronic aid dependence.

At the same time, exposure to new opportunities brings new risks. Overseas lenders may seek to take advantage of countries' improved debt positions in the context of continued support from bilateral and multilateral donors. In the extreme this may lead to the (re)emergence of unsustainable levels of external debt. The combination of external capital inflows with domestic market imperfections may also exacerbate a range of problems, particularly as regards macroeconomic management (e.g., Dutch Disease) or speculative bubbles. A final risk is what may be described 'financial extraversion', whereby access to external sources of finance means that the domestic financial system remains underdeveloped or is weakened when strong domestic firms transfer their financial relationships to overseas markets. In sum, the danger is that international capital flows have significant distortionary effects and that investment benefits are isolated to specific (export) sectors, whilst potential efficiency spillovers are non-existent.

How might donors to sub-Saharan Africa confront this emerging agenda? Evidently, overseas development aid remains a dominant source of external capital for low income countries and, given the scale of the development challenge they face, will remain a core source of funds over at least the medium-term. Even so, there is a vital role for policies which reduce the downside risks from access to alternative sources of external finance and promote their upside investment and efficiency effects. Constructive engagement with expanding access to alternative sources of financing could be an important component of reduced aid dependency. This demands that donors pro-actively seek to understand the evolving financial landscape in

sub-Saharan Africa and take a more comprehensive view of the entire financing space, rather than focusing narrowly on overseas aid.

More specific policy priorities for donors include:

1) *Focus on domestic financial markets*: a principal message of this policy brief is that deeper and more efficient domestic financial markets are essential for low income countries to attract and benefit from private capital inflows. Actions to support domestic financial sector development, therefore, should be given a high priority by donors. This might concentrate on widening financial services and deepening the liquidity and efficiency of domestic capital markets. The importance of such measures is reinforced by persistent financial sector weaknesses across much of sub-Saharan Africa.

2) *Promote comprehensive financing strategies in low income countries:* comprehensive long-term public financing strategies can establish targets for the volume and nature of inflows of different forms of capital. They can also identify domestic policy priorities needed to complement expected changes in financing sources (e.g., capital controls). As such, they enable the risk-reward profiles of different financing mixes to be considered and help to avoid *ad hoc* financing choices that may hold nefarious welfare implications. At present, however, few countries in sub-Saharan Africa have developed such strategies.

3) *Make progress on global market failures*: these failures can undermine the potential benefits from enhanced access to private capital flows. A principal challenge is to promote capital flows with longer-term investment objectives rather than short-term speculation. A relevant focus for donors in this vein may be on the role of official development finance institutions, such as the IFC (International Finance Corporation) and regional development banks, as well as sovereign wealth funds.

4) *Support enhanced data collection and transparency*: data on the size and characteristics of private capital flows to emerging markets is far from complete. An essential aspect of improved data collection is enhanced transparency of the terms and total value of external financial commitments, both on- and off-balance sheet. Evidently, moves towards greater transparency needs to be comprehensive and should embrace new providers of finance to developing countries, particularly those located in the South. This will be critical in order to monitor the emergence of excessive borrowing and to comprehensively evaluate the opportunity costs of different financing choices.

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