Part 4

Conclusions and Recommendations

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

Chapter 8 Conclusions and Policy Lessons

Jonathan Leape and Matthew Martin

This book has shown that private capital flows to Sub-Saharan Africa have increased dramatically in the 1990s and are highly significant economically. They are also tending towards what are regarded as "less stable" components — portfolio flows and short-term bank loans. In 1997-99, developing countries in all continents have suffered from the volatility of these flows — with frequently catastrophic effects on their growth and development. So what needs to be done to raise the stability and development impact of private capital flows to Africa? And how can African governments protect their economies from the volatility of these flows?

8.1 Monitoring the Flows

A fundamental step for many African countries and international institutions is to improve their monitoring of private capital flows. In most African countries, liberalisation of flows has been unnecessarily accompanied by elimination of monitoring, in contrast to the more prudent practice of other developed and developing economies.

Reversing liberalisation of monitoring is not easy. It will be impossible without sustained efforts to create a "culture of reporting" in the vast majority of countries where this does not exist. Governments have found that they need to educate the public on why it is in their interest to report on flows (so that they can better understand their competitors and create a more open and stable market, and so that government can formulate policies to encourage flows) and on why they should trust government agencies (because they supply reliable information on markets, do not share information with exchange control, investment approval or revenue collection agencies, and implement credible policies to stabilise flows).

Institution-building in government agencies will be essential to effective monitoring. One important aspect is transparent legisation empowering single or multiple agencies to collect data — while restricting their use and dissemination of such data where appropriate. Consultation with the private sector at all stages of collection is equally vital. Any reporting

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

methods must be supported by incentives and penalties to encourage compliance, designed to avoid unnecessary distortions which scare private investors into the parallel market. Investors also want their identities protected, by avoiding asking for details such as customer names or passport numbers, and aggregating flows on a weekly or monthly basis.

However, consultation and surveys need to be selective and targeted, partly to allow greater interaction with respondents, but above all to reduce costs. Countries have found it most effective to reduce data collected to those sources and types of transaction which are essential to policy formulation — or to analysis by market players of the state of the market. They have also been wisest to focus on major transactions, and review and simplify reporting requirements regularly.

Many governments may initially require donor support to cover high recurrent costs of surveys (for postage, stationery, telephone, fax; fuel and transportation to deliver and collect surveys; PC hardware and software; and extra staff time). Agencies normally begin by shortlisting and costing such requirements, and identifying potential internal and donor resources.

Coordination is also vital. African countries can ill afford the inefficiencies associated with duplication of work and poor information flows among different agencies, or with agencies trying to collect information from respondents with whom they have no regular contact. Successful experiences have been where all agencies play a full role in collecting information from their direct "client base" (central banks from banks and bureaux, investment authorities from direct investors, and stock and bond exchanges or capital markets authorities from portfolio investors). Then they need to cooperate to centralise information for balance of payments data aggregation and coordinated policy analysis: to this end, many countries have created inter-departmental balance of payments statistics committees which report policy conclusions to finance ministries, central banks and statistical offices.

Government institutions have also found it necessary to coordinate other bodies. In their absence, academics, international institutions, donors and private sector bodies have been deluging suppliers of capital flows with surveys, resulting in "survey fatigue" and low compliance. Governments may want to sub-contract surveys to such organisations if mutual relations are good and NGOs have comparative advantage, but their data collection for balance of payments and policy formulation is the top priority. Donors and international organisations have a key role in coordination, because they usually fund the surveys by non-government and government agencies: they need to consider developing country national interest and encourage comparative advantage, coordination and information exchange.

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

Once data are recorded, they are best aggregated in user-friendly computer systems. Many countries need to upgrade recording systems, harmonise those used by different agencies, and create electronic links between primary data sources (stock exchanges, financial institutions and investment authorities) and the central bank and/or finance ministry. This will involve pushing international organisations (Commonwealth Secretariat and UNCTAD) to accelerate their efforts to improve their recording systems to include private sector debt, and to advocate donor funding to upgrade the systems.

Regionally, African countries have much scope for providing bilateral technical assistance to one another — this project has demonstrated that almost every country has an area of expertise which would be useful to others, if donors can be more prepared to fund intra-regional assistance. Coordinated regional targets to reach international data standards might provide an external anchor for individual government policies, but would be ineffectual unless such regional bodies as (in alphabetical order) BCEAO, BEAC, CMA, COMESA, EAC, MEFMI, SACU and SADC (FISCU) give higher priority to recording private capital, and sponsoring training and intra-regional assistance. MEFMI's initiatives to record private debt are most welcome.

African governments are already seeking to match international and regional best practices in monitoring. These involve comprehensive surveys, perhaps beginning with pilot surveys and censuses of stocks and flows. Countries with more advanced monitoring are reassessing the design of their survey forms, frequency, size, and dissemination and processing techniques. On each type of flow, less advanced countries can benefit from their neighbours' advice (for example, on portfolio equity investment, from Kenya, Mauritius, South Africa or Zimbabwe).

Ultimately, countries may want to attain the IMF's internationally recognised standards of data coverage, frequency and timeliness, as a signal to investors of government commitment to improve data and to transparent policy decisions — either the General Data Dissemination System (GDDS) or the more advanced Special Data Dissemination Standard (SDDS). But there is no point in publicly committing to these standards if resource constraints will lead to delay, reversal or lack of government credibility.

*From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org*

8.2 Attracting FDI

The findings of this study indicate that lack of information is one of the most powerful discouragements to investors. Yet when African governments are disseminating information, the increasing diversification of investors by sector and source country highlights the necessity to conduct constant analysis of investor motivations, and to target their investment promotion efforts on sectors and source countries which are the most responsive and motivated. As of 1997, such a targeted policy would have focussed particularly on Asian countries (notably Malaysia, Indonesia and Taiwan), on South African investors elsewhere in the region, and on the activities of the many diverse sub-communities within the "Asian community" in Eastern and Southern Africa (for example targeting Asians living overseas, and those who have already returned and might wish to diversify their businesses when reinvesting earnings). Uganda's example shows that legal and transparent processes for returning seized assets, and targeted publicity campaigns, can achieve far more than blanket investment promotion drives. As for sectors, countries can draw up cost-benefit analyses (from an investor and host nation point of view) of different sectors, similar to those advocated by UNCTAD and, through surveys, target the most dynamic potential sectors.

Similarly, given the rapid changes in their political and economic systems, countries seeking stable FDI flows need to tailor their investment promotion efforts to solving the problems perceived as crucial by investors — which may change dramatically over time.

The *structural barriers* facing investors in Africa are well known. Governments can follow the example of the most dynamic investors in seeking to overcome them, by targeting investment in low cost goods for local markets, or in goods for export to regional neighbours. They can also encourage closer regional cooperation on infrastructure and labour skills so as to ensure that regional trade liberalisation benefits all countries more equitably. Even more interesting is our finding that potential investors still look to governments (rather than the private sector or donors) to supply and regulate the necessary physical and communications infrastructure, to help create and regulate a stable financial infrastructure, and to invest in training and education to improve skills and productivity so that companies can promote Africans to senior managerial or engineering posts. Above all on the training front, governments need to seek ways of encouraging smaller investors to provide their own training programmes, following the example of many successful multinationals, and to set time-bound plans for transferring skilled responsibilities to nationals.

Investors also highly value stable and positive *economic performance*.

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

Governments need to consult the private sector in a transparent and comprehensive manner wherever possible, and to avoid major policy reversals which undermine policy credibility and commitment. In general, particularly given the risks of exogenous shocks, this also implies gradual reforms, particularly in lifting foreign exchange restrictions, to ensure that policies are sustainable; and adjustment programmes which are sufficiently flexible to guard against shocks.

They are also aware that one of their biggest risks is still foreign exchange shortage — another reason why most suggest that the international community should emphasise the stability of aid flows and commodity prices, and provide maximum early debt relief to reduce the liquidity burden of debt service, to underpin a gradual process of external liberalisation. However, many are now equally concerned about the risk of overtaxation or underspending on infrastructure, due to the fiscal burden of debt and the instability of aid flows to the budget, and see greater fiscal debt relief or more stable aid as a means to ensure greater transparency and equity in taxation, in turn encouraging greater tax compliance.

Investors are also realistic about privatisation. It is an important spur to FDI, especially if it can begin with highly profitable industries such as tobacco or breweries rather than with large and politically controversial utilities. They stress measures to accelerate the process between deciding to sell and actual sale, and to make the sales more transparent. But its benefits will be short-lived unless it is reinforced by many other measures to encourage investors.

Another important conclusion is the potential to enhance the role of *investment promotion centres*. Most countries in our study have already made them into proactive one-stop centres, so that they not only travel to sell countries to potential investors, but hand-hold investors through bureaucratic requirements. They have also eliminated duplication of bureaucracy or mandates with sectoral ministries. Yet most centres still lack the resources to track investors after their investment has been approved, so as to continue to assist them in ensuring their investment is pursued successfully. Without a mandate and capacity-building support for such functions, and for the research analysis to support them, both of which are normal in developed country investment promotion centres, a large number of investments will continue not to materialise after they have been approved.

The final set of important factors are political and social. Political stability and strong leadership, and well-publicised measures against crime, corruption and fraud (notably to combat unemployment, to improve the work incentives for civil servants, and increase auditing and fraud inspections) are essential areas for action.

From: Private Capital Flows to Africa: Perception and Reality, FONDAD, November 1999, www.fondad.org

8.3 Stabilising Portfolio Flows

8.3.1 Portfolio Equity Flows

This study has demonstrated once again that portfolio flows are generally the most volatile private capital flows. Stabilising those already present is therefore as important as attracting additional flows. Many elements of such policy are the same as those for FDI (political and economic stability, privatisation, clarification of property rights, and reducing corruption). Even within these broad areas, however, portfolio investors have different concerns such as the "fundamental balance" (current account deficit minus net FDI flows); the tightness of monetary policy which can reduce market liquidity; and a sound banking system.

In seeking to attract portfolio flows, most governments have focussed on promoting the basic structures — notably stock exchanges. National or regional exchanges are important, but not every African country needs its own exchange. If companies in countries without exchanges can list on larger regional exchanges which appear in IFC or Financial Times indexes, they are more likely to attract international investors.

For smaller and national stock exchanges, it is vital to improve procedures, especially on regulation, settlement and custody; to reduce transaction costs; to increase the number of (especially local) companies listed, by creating secondary or over-the-counter markets and selling a small percentage of shares in state-owned companies not targeted for privatisation; to improve information on company performance by tightening accounting and auditing standards, and promoting local brokers, if necessary with capacity-building programmes.

As African governments take such measures, it is to be hoped that IFC and commercial analysts will include more countries in their indices, which can also be a powerful positive influence on investment.

One area of underexploited potential lies in investment funds, particularly those which are already targeting Sub-Saharan Africa, those which are supported by donor institutions with a longer-term perspective and a capacity-building element, and those which are closed-end or attract non-Anglo-Saxon or institutional investors whose flows will be more stable. The managers of these funds have a greater interest than retail investors in maintaining their investment in Africa in times of crisis. However, they have had trouble reaching all but the largest companies.

Nevertheless, even if they are taking all these measures, African governments cannot be assured of stable flows. Global cyclical factors, contagion from other emerging markets and negative perceptions of Africa will continue to make portfolio investors fickle.

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

8.3.2 Portfolio Non-Equity Flows

Another important finding of this study has been the sharply increasing role of non-equity portfolio flows. Most African countries still have few prospects of launching bonds, because they are not perceived as creditworthy and do not have a credit rating, and therefore the cost of any bond would be prohibitive.

For those countries that can issue bonds, their success will depend, above all, on continued macroeconomic stability and credibility of their economic policy framework. This will feed into positive foreign investor perceptions of country credit risk (influenced partly in turn by credit ratings as discussed in Chapter 5). But their success will also be influenced by foreign investors' changing appetites for emerging market risks — a factor almost wholly outside the control of individual governments.

Institutional questions of market structure must also be addressed. Success in attracting foreign investment in domestic securities will rest, in part, on continued efforts to establish a clear legal framework for securities trading, to update information and trading systems and to strengthen administrative procedures for settlement.

The priority for other governments is to monitor and analyse more closely the large and fascinating market in investment in *short-term* Treasury Bills from foreign exchange sources, to identify those which are "foreign" and those which come from resident foreign currency accounts, their relative motivations and impact on monetary policy, and the prospects for issuing longer-term Treasury Bills or domestic bonds in order to reduce liquidity risk, or for discouraging such short-term purchases via taxation or quantitative limits.

8.4 Reviving and Stabilising Bank Lending

Another trend noticed earlier in Africa than in the international data has been the revival of short-term bank lending to the private sector. However, it remains highly volatile and pro-cyclical, so the key challenge is to stabilise such flows.

Meanwhile, long-term lending is still awaiting revival, which will not come until not just commercial debt but overall external debt has been reduced much more dramatically than even under the current HIPC Initiative, freeing countries from both the overhang and liquidity burdens. In contrast, the scope for and benefits of debt-equity conversions are likely to be very limited in highly indebted countries — though they may play a larger role in middle-income or less-indebted countries.

From: Private Capital Flows to Africa: Perception and Reality, FONDAD, November 1999, www.fondad.org

Our most interesting finding on bank lending has been the crucial role of the structure of the banking sector. Multinational banks are essential to the financing of larger multinational companies and major projects, and bring vital access to international correspondent banks. Fortunately, they appear to be reversing somewhat their earlier withdrawal from Africa, but they still need convincing to broaden their client base to local and smaller companies.

The other strong conclusion is the central role of financial sector liberalisation and reform. There are many ways in which the current design of reform (or the partial stage reached) is discouraging bank lending. Liberalisation of foreign exchange regulations is providing a pool of foreign currency funds to replace externally sourced bank lending for small businesses. High yield government domestic debt is allowing banks to avoid needing to lend to make profits, while government arrears reduce assessments of private sector creditworthiness for lending. Oligopolistic banking systems lead to huge profits from local currency lending (or huge losses which prevent any lending) and poor information flows and support services for investors. There are no easy answers in a long struggle to create a healthy banking system and above all to diversify types of institutions.

But governments and donors can take some more immediate steps: by reducing risk through cofinancing and guarantees of private bank loans; by organising regular direct information flows to OECD central banks and encouraging them to be more flexible in provisioning guidelines; and by encouraging OECD export credit agencies to expand their cover for medium-term lending to the private sector, where this is compatible with debt sustainablility.

8.5 Improving Credit Ratings

Insofar as credit ratings influence international capital market perceptions of Africa, our research makes a powerful case for improving their country coverage, methodology and treatment of Sub-Saharan Africa.

As only South Africa in our sample is rated by formal agencies — and the other countries should not want to be until they are more creditworthy — the focus needs to be on the informal agencies.

Country coverage needs extending to all SSA countries with reliable economic data. The methodology of credit agencies could be improved by providing more accurate data, giving priority to (i) providing a clear explanation of their methodology; (ii) moving away from subjective surveys — or at least improving the quality of information supplied to and the diversity of the survey sample; (iii) reducing scope for subjective interpretations

From: Private Capital Flows to Africa: Perception and Reality, FONDAD, November 1999, www.fondad.org

and projections by analysts based on out-of-date or short-term economic data trends; and (iv) concentrating on objective measurement of risk disaggregated by different types of capital flows, and backed by detailed well-informed analysis. One example of good practice in this area is the recent methodological improvements undertaken by the Economist Intelligence Unit in their country surveys.

8.6 Macroeconomic Impact

Private capital flows have had pervasive effects on African economies in the 1990s. While all the countries examined in this study benefited from the surge in private capital flows to developing countries in this period, internal developments — notably, the acceleration of financial sector reform and the liberalisation of exchange controls — have been the most important determinants of the timing of flows and of their macroeconomic impact.

By freeing key prices — most importantly the exchange rate and interest rates — the reforms have created a set of transmission mechanisms via which changes in cross-border capital flows have important real and monetary effects on the economies. The magnitude of the swings in key macroeconomic variables reveals the importance of the continuing rigidities in these economies — arising from factors such as incomplete markets, underdeveloped sectors, and high information and transaction costs. This, in turn, highlights the costs of inappropriate sequencing of reforms — and, in particular, of allowing financial liberalisation to proceed rapidly while structural reforms to the real economy lag behind.

The macroeconomic effects of swings in private capital flows are evident in the balance of payments; in savings, investment and growth; and in the level of real interest rates, monetary conditions and financial market volatility.

Balance of payments. Throughout Africa, the balance of payments has long been driven by swings in commodity prices, and other developments affecting the current account. Exports are dominated by primary goods, and all too often by a single crop or metal (coffee in Tanzania and Uganda or copper in Zambia). In the 1990s, however, the sharp rise in private capital flows has become an important determinant of the balance of payments.

Through the 1980s, dependence on primary exports combined, in most cases, with a large external debt, contributed to persistent overvaluation of the (official) exchange rate — a problem that was exacerbated by fixed exchange rate policies. The result was the emergence of parallel foreign

From: Private Capital Flows to Africa: Perception and Reality, FONDAD, November 1999, www.fondad.org

exchange markets and, typically, a multiplicity of exchange rates. In this environment, it was difficult if not impossible to identify exchange rate effects of changes in the balance of payments.

The liberalisation of foreign exchange markets led to the elimination of parallel markets in the first half of the 1990s. While unification of the foreign exchange market has resulted in exchange rates that are significantly more volatile than the previous "official" exchange rates, part of the increase has simply reflected the volatility that was earlier confined to the parallel markets. Part of the increase in volatility, however, stems from the sharply higher volumes and volatility of private capital flows being experienced in all countries in this study.

Private capital inflows have, in all countries, been associated with an appreciation of the real exchange rate — and capital outflows have quickly led to falls in the exchange rate. In many countries, such as Tanzania, Uganda and Zambia, underdeveloped financial markets have severely circumscribed the scope for sterilisation of capital flows and the overriding importance of maintaining macroeconomic stability has led to heavy reliance on the exchange rate as an adjustment mechanism. Even in countries with more developed money and capital markets, such as South Africa and Zimbabwe, the broader set of monetary policy instruments has proved insufficient to prevent appreciation in periods of heavy inflows (and depreciation in the face of outflows).

Savings, investment and growth. An important aspect of the overall macroeconomic impact of capital flows in these countries is the effect of such flows on the level of investment and savings. While the evidence available from the project countries suggests some tentative findings with respect to investment and growth, relatively little can be said about the effects on savings. This is, in part, the result of weaknesses in the economic analysis of savings, but it is also a product of the weakness of available data where savings statistics in national accounts data are typically residuals.

Perhaps the most important difficulty in identifying the impact of capital flows on domestic savings is that any possible effects are almost certainly swamped by the effects of inflation (where extremely high levels in some countries have depressed savings); of weaknesses in financial systems (which have also depressed savings); and, more recently, of changes in public sector savings (which have increased substantially in some countries in recent years).

By contrast, evidence from project countries suggests that the impact of capital flows on investment has been consistently positive, although varying considerably in degree. Although it is difficult to disentangle the effects of capital flows from those of other factors affecting the investment climate

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

— such as political stability, privatisation programmes, export retention schemes and the exchange rate regime — evidence from a variety of sources suggests that private flows, especially in the form of foreign direct investment, are highly correlated with gross domestic investment.

One issue that emerges is the nature of causality in this relationship. It is possible that increased inflows stimulate higher domestic investment. But, it is also possible that rises in domestic investment attract higher levels of FDI. Finally, changes in other factors — such as interest rates and rates of return more generally as well as other aspects of the economic and policy environment — may cause both domestic and foreign investment to change. There is evidence supportive of each of these three possibilities for at least some of the countries as well as evidence, particularly from South Africa, that the nature of causality in the relationship has been different in different periods.

Evidence of a positive relationship between capital inflows and growth is also found in many countries. The role of external savings in financing investment is identified as important as are the transfers of technology and technical and managerial skills associated with FDI. There are also specific factors such as access to coffee prefinance from foreign sources, which was critical in Uganda.

Monetary policy and real interest rates. The rise in capital flows in the 1990s has had a profound impact on monetary conditions, monetary policy and financial markets in all the project countries. The rise in capital flows has been associated with concerted programmes of financial liberalisation and macroeconomic stabilisation, the result of which has been a profound structural change in the macroeconomic environment. Moreover, as a result of the increase in international capital flows, changes in net foreign assets have become a more important — and, in many cases, dominant — determinant of changes in the money supply. Capital flows influence inflation and the macroeconomy through their effects not only on interest rates, but also on exchange rates. Finally, the increasing volatility of capital flows that has accompanied the rising levels has had implications for monetary conditions and for financial markets more generally.

The combination of financial liberalisation, a broad commitment to maintaining macroeconomic stability and an increase in private capital flows has led to a sea change in the level of real interest rates throughout the region. Virtually without exception, financial liberalisation and macroeconomic stabilisation led to a sharp upwards jump in real interest rates, which had been negative through much of the 1980s and now became significantly positive. The unexpected persistence of high real interest rates, in most countries, has raised questions throughout the

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

region concerning the potential costs associated with the new openness to private capital flows. In countries where capital markets are deepest, such as South Africa, the importance of capital flows and changes in foreign (especially US) interest rates in determining domestic interest rates is readily apparent.

The effects of capital flows on interest rates depend importantly on the policy stance adopted by the authorities, as discussed further below. In countries such as Tanzania and Uganda, where concerns about macroeconomic stability have led the authorities to allow an appreciation of the real exchange rate, capital flows have had more limited effects on domestic interest rates. In Zimbabwe, there is evidence of a strong causal link between capital inflows and interest rates. In South Africa, the discount rate system of monetary policy that was followed until early 1998 meant that short term interest rates were unresponsive to capital flows, but long-term interest rates moved sharply, largely as a result of the actions of foreign investors in the bond market. Since March 1998, when the authorities shifted to a repo tender system for monetary policy, short-term interest rates have become much more responsive to changing capital flows.

A second important channel by which capital flows have had an impact on monetary conditions, and hence inflationary pressures, is via effects on the exchange rate. Rising exchange rates have acted to slow the economy during periods of capital inflows, although the divergent inflationary experiences of Uganda and Tanzania in 1994-5 underscore the continued importance of the fiscal stance.

Financial market volatility. Assessing the impact of capital flows on financial market volatility in Africa is difficult, as virtually every country has been engaged in liberalisation programmes which have focussed, in part, on shifting from administered prices to more market-determined prices. As a result, the increased volatility which can be observed in both exchange rates and interest rates in the recent period is, in part, a product of these reforms. Nevertheless, the analysis in the country studies suggests that capital flows have increased volatility. Although Africa has, to date, escaped the acute financial instability experienced in Mexico in 1994-5 and in Asia in 1997-8, the narrow, illiquid markets found in most countries are ill-suited to the task of absorbing the large swings in capital flows that have occurred in recent years. The non-existence or narrowness of capital markets, in particular, may make these countries more vulnerable to asset price bubbles and the associated risk of crashes. Even in South Africa, with the deepest and most liquid capital markets in the region, the swings in capital flows experienced since 1994 have led to heightened volatility in both interest rates and the exchange rate.

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

8.7 Policy Responses

A key determinant of the ultimate balance between the positive and negative macroeconomic effects identified in Chapter 6 is the set of strategies adopted by governments in response to private capital flows. Where capital flows are large — as they have been, at least in some recent years, for all of the countries studied here — such strategies are likely to prove crucial to limiting the destabilising effects of capital inflows, while at the same time not eroding the higher growth rates and investment that can result.

While achieving certain macroeconomic or other objectives may represent the primary justification for government intervention, governments increasingly recognise that they may have an implicit (or even explicit) liability for servicing private capital flows. The Asian crisis of 1997-8 makes it clear that this liability constitutes a powerful argument for governments to adopt an active and broad-ranging approach in responding to cross-border private capital flows. All of these factors feed into the policy choices in the project countries, where authorities tend to focus on containing vulnerability to possible flow reversals, and minimising risks of overheating, excessive real exchange rate appreciation, and unsustainable consumption growth.

Appropriate policy responses depend on the availability and flexibility of various policy instruments, the nature of domestic financial markets, the scale and composition of inflows, the prevailing policy environment and the extent of policymakers' credibility. While, in theory, policy responses should also be guided by the causes of flows, evidence from our project countries shows that the causes of capital flows are difficult to identify in practice.

Policy options have embraced foreign exchange market intervention, capital account liberalisation, monetary policy and sterilisation, fiscal policy, and financial sector reform and development.

Foreign exchange market intervention and exchange rate policy. Faced by surges in capital inflows and outflows, the most immediate challenge posed to the authorities in these countries is how best to manage the exchange rate and foreign reserves. In particular, the authorities have to decide whether, or to what extent, to allow an appreciation of the exchange rate. The alternative is to allow an accumulation of foreign exchange reserves so as to limit appreciation.

In the 1980s, many African countries were effectively operating some form of fixed exchange rate regime — although typically in a situation of multiple exchange rates as a result of the emergence of parallel foreign exchange markets. By the mid-1990s, most — including all five countries

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

studied here — had succeeded in unifying the foreign exchange market and, in the process, had shifted to some kind of floating regime. While an important motivation for this shift was volatility of the balance of payments — due, in part, to volatile private capital flows — the expected benefits in the form of greater independence in setting domestic interest rates have failed to materialise. Indeed, the recent experience in Africa seems to mirror that in Latin America, where Hausmann *et al* (1999) find that flexible exchange rates have, in fact, resulted in higher real interest rates and increased sensitivity of domestic rates to changes in international interest rates. These tentative findings are far from conclusive, but suggest that the question of the appropriate exchange rate regime for developing countries in Africa remains very much open.

African countries have opted not for "pure" floating exchange rate regimes, but instead for the common intermediate case of a "managed" float — in which the authorities must decide on the appropriate trade-off between an appreciation of the currency and an accumulation of foreign reserves. While allowing the exchange rate to appreciate may facilitate foreign debt service and help contain inflationary pressures, allowing an increase in foreign reserves (to limit the exchange rate rise) may be important to mitigate the deterioration in competitiveness, which can undermine export promotion efforts. The strategies adopted in making these trade-offs have, inevitably, differed across countries and over time. Moreover, the volatility of capital flows has led governments also to intervene with the objective of smoothing inflows and outflows.

Concerns about potentially destabilising inflationary pressures, combined with limited capacity for sterilisation, has meant that capital inflows have, in most cases, been associated with significant appreciation of the exchange rate — leading to widespread concerns about the implications for competitiveness.

South Africa's approach has differed from others primarily in the greater scope for intervention afforded by its more developed financial markets. Two features of South Africa's intervention strategy are particularly noteworthy. First, the Reserve Bank has made heavy use of forward transactions both to alter the supply of dollars to the foreign exchange market (without affecting gross or net foreign reserves) and to alter its own (spot) foreign exchange reserves. While forward market intervention has dramatically enhanced the Bank's ability to dampen volatility in foreign exchange markets, the availability of such a "deep pocket" for intervention has created an incentive to intervene excessively. Second, the Reserve Bank has complemented its intervention in the spot and forward foreign exchange markets with what might be called "potential" intervention in the form of signals of its ability and willingness to intervene. In particular, it has used

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

international credit lines — that is, potential borrowed reserves — as an instrument for influencing the foreign exchange markets via the expectations of market participants.

Capital account liberalisation. While foreign exchange intervention and sterilisation measures (discussed below) focus on mitigating the adverse effects of capital flows, countries have used capital account liberalisation, and related measures, to alter the level or composition of the flows themselves. Liberalisation of controls on non-residents has contributed to increased inflows — although sometimes, as in Zambia, a pent-up demand for foreign exchange has initially led to outflows. Liberalisation of controls on residents has been used, especially in South Africa, to help offset excessive foreign capital inflows by increasing outflows by residents. Lifting controls on residents can also, however, stimulate inflows by facilitating the return of flight capital, as shown by the experiences of Uganda and Tanzania.

While the focus throughout Africa has, to date, been on the liberalisation of capital controls used historically to protect the balance of payments, authorities are increasingly considering the potential role of measures such as the taxation of inflows and special reserve requirements on foreign credits as possibly valuable instruments for managing more effectively the composition and level of foreign inflows — and their macroeconomic impact. The Asian crisis clearly illustrated how capital controls have provided a regulatory function that goes far beyond the protection of the balance of payments. The challenge now facing countries throughout Africa is how best to ensure that mechanisms are in place, once exchange controls are lifted, to limit the systemic risk associated with foreign exchange transactions by resident banks and companies.

The sequencing, timing, speed, consistency and credibility of reforms are also critical issues. The regulatory roles that have implicitly been performed by capital controls indicate that early liberalisation of the capital account may have a devastating impact on the financial sector.

One of the most striking findings to emerge from the country studies is the extent to which current account liberalisation led to a *de facto* liberalisation of the capital account. This is most evident in the experience of Uganda and Tanzania, and evidence on capital flight from South Africa suggests a similar pattern.

The project countries have differed markedly in the timing and sequencing of liberalisation of the capital account — with some, including Zambia and Uganda, opting for a "big bang" approach, while others, notably South Africa and Zimbabwe, have opted for a gradual, phased approach. While the reforms adopted by those following the "big bang" approach have been

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

sustained, the experiences of the project countries following the gradual approach have been mixed. The reforms in South Africa have been sustained and further developed — despite several periods of acute balance of payments pressure. In Zimbabwe, by contrast, balance of payments pressures led, in 1998, to a reversal of reforms. These divergent experiences suggest that gradual approaches, to be successful, require a higher degree of credibility on the part of the authorities. Where such credibility is lacking, the "big bang" approach has the advantage that it makes the reforms themselves more credible (by making them significantly more difficult and costly to reverse) — a factor that was explicitly recognised by the Zambian authorities.

It is, however, the phased approach to liberalisation as followed by South Africa that has been most successful in minimising the associated market and macroeconomic disruption. One of the lessons to emerge from the South African experience is the need for authorities to be attentive not only to the pace of liberalisation — taking care, for example, to spread the impact on the balance of payments wherever possible — but also to the sequencing of reforms (especially as regards the fiscal and regulatory framework) and to the need to manage private sector expectations in the lead up to reforms.

There has been some discussion within the project countries of the possible role of selective capital controls — such as special reserve requirements for foreign borrowing — to assist the authorities in managing the impact of capital flow surges. While it is clear from international experience that such controls are no substitute for sound monetary, fiscal and regulatory policy, they may be useful in helping to dampen volatile short-term capital movements and to reduce the costs of sterilisation. While, in theory, the case for such controls is strong, considerable practical difficulties currently impede their implementation in Africa. First, since special reserve requirements may be seen as a form of capital control, there is a risk that investors may perceive essentially prudent controls as policy reversals. This suggests that such controls are best introduced from a position of strength, when inflows are strong and government credibility is high. Second, the data on capital flows available to the authorities are weak, with serious problems of non-recorded flows and of misclassification. This second problem reinforces the arguments advanced above for governments to give high priority to increasing their ability to measure and monitor private capital movements.

Monetary policy. While fiscal adjustment and other policies form an important part of the medium-term policy response to capital flows, the macroeconomic policy response to capital flows has rested heavily on monetary policy. In particular, monetary policy has been the primary instru-

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

ment, alongside exchange rate policy, for the short-term management of the macroeconomic impact of such flows.

Attempts to limit the upward pressure on the exchange rate in situations of large capital inflows have inevitably resulted in an increase in the central bank's net holdings of foreign assets. The challenge then facing the authorities has been how to sterilise these flows by managing the central bank's balance sheet so as to avoid an excessive monetary expansion (or contraction, in the case of large outflows).

The scope for sterilisation in most African countries is, however, severely circumscribed by the relatively undeveloped state of securities markets. This means, in turn, that the scope for managing the macroeconomic impact of capital flow surges is also severely limited. Either authorities allow the exchange rate to appreciate or they engage in unsterilised foreign exchange intervention — leading to reserves accumulation, increases in the money supply and inflationary pressures. In both cases, the net effect is an increase in the real exchange rate (the first involving a rise in the nominal exchange rate, the second a rise in inflation).

Uganda, for example, has had minimal success in containing monetary growth through monetary policy in a liberalised financial system, and the problem of thin and underdeveloped financial markets has been aggravated by distressed banking systems and other factors. Problems such as these have placed increasing pressure on fiscal policy, as discussed below, but they also highlight the need for continued emphasis on financial market development.

An important exception to this widespread pattern is South Africa, where market (and non-market) oriented monetary measures have been employed with considerable success to manage the macroeconomic impact of capital inflows and outflows. While the authorities have made use of open market operations in government securities, the dominant market-oriented instrument has been foreign exchange swaps.

The quasi-fiscal costs of open market operations (including swaps) can be high — as the interest differential between the high yield domestic bonds that authorities are, in effect, substituting for low-yield foreign exchange is substantial for every African country — and their effectiveness is set to diminish as financial liberalisation and technological change increasingly link domestic and international financial markets. Nevertheless, the South African experience highlights the important role that such operations can play in limiting the adverse macroeconomic effects of swings in capital flows.

Non-market operations have also played an important role in liquidity management in response to swings in international capital flows. Transfers of public sector deposits have been considered in several countries, but

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

only used to any extent in South Africa. Even there, the use has now all but ended as government efforts to improve cash management have eliminated the “idle” balances previously used for such transfers.

The most widely used non-market instrument throughout Africa has been changes in reserve requirements. In many countries, such changes have been used heavily as an instrument of sterilisation. During the 1994-95 coffee boom, for example, Tanzania raised the cash reserve requirement eight times to drain excess liquidity from the banking sector. Zimbabwe, too, has used changes in reserve requirements to manage the impact of destabilising capital flows.

It is, however, increasingly recognised that heavy use of such requirements can work against financial development. By acting as a tax on bank intermediation, reserve requirements can induce savers and borrowers to shift to non-bank financial institutions with adverse implications for monetary control, regulation and supervision and efficiency. That said, it is also recognised that the more effective targeting of such requirements — for example, on off-shore borrowing by banks or on new borrowing after a certain date — may make such requirements substantially more effective in achieving policy objectives while creating significantly less distortion to intermediation generally.

Finally, it is important to note that the sharp increases in the level and volatility of capital flows have had implications for monetary policy frameworks throughout the region. Money supply targets have been downgraded, while the range of intermediate targets used has been broadened, with the exchange rate playing a more important role.

Fiscal policy. After exchange rate policy, fiscal policy has arguably been the most important policy instrument used by African countries in response to changing capital flows. Faced by severe constraints on the scope for using monetary policy, the authorities have attempted to mitigate the adverse macroeconomic impact of capital inflows by decreasing the government’s own contribution to the expansion of domestic liquidity. The principal difficulty with this approach has been that raising additional revenue is not easy, especially where the formal sector is already heavily taxed, and cutting expenditure can have adverse social consequences.

At least as important as its impact on domestic liquidity has been the role of fiscal policy as a signal of governments’ commitment to macroeconomic stability. In this regard, success in reducing large fiscal deficits has, throughout Africa, often proved important in attracting capital inflows — and in stemming capital outflows.

A salient feature of the role of fiscal policy in macroeconomic stabilisation in the project countries has been the importance of institutional reforms. One example has been the high profile and successful crackdown on tax evasion

From: Private Capital Flows to Africa: Perception and Reality,
FONDAD, November 1999, www.fondad.org

which has boosted revenues in Zimbabwe since 1997. Another has been the enhancement of expenditure control in South Africa through adoption of a medium-term expenditure framework A third example has been the adoption of cash budgets in Tanzania and Zambia, with dramatic effects on deficits and inflation. Finally, a number of countries, including South Africa, Tanzania, Uganda and Zambia, have increased revenues as a result of granting the revenue authorities a substantial degree of autonomy — although the mixed subsequent experiences in the latter three countries indicate that institutional reform alone is no panacea. One of the important characteristics of institutional reforms such as these is that by making policy reversals more visible and costly, they work to enhance the credibility of governments' commitment to reform.

Financial sector development. One of the lessons to emerge from the crises in Latin America and in Asia is the crucial importance of effective banking regulation and supervision in making financial systems — and economies — more robust to swings in private capital flows. Surges in capital inflows increase the level of non-performing assets, thereby increasing the vulnerability to flow reversals.

Raising the quality of financial regulation and, on the part of the private sector, of risk management is today a daunting task for even the most developed economies, and one that can easily outstrip the skills and expertise available in the developing countries of Africa. A promising development in many of the project countries has been the increasing role of "imported" risk management skills — and even regulation. Where the licensing of new, international banks has been well-handled, the result has been an influx of managerial and technical expertise in risk management with benefits for the financial system as a whole. In addition, domestic regulators have often, in such cases, benefited from closer relationships with the international banks' "lead regulators". But these benefits may be hard to realise. The collapse of foreign banks — as with BCCI and Meridien — can undermine domestic banking systems as can the wholesale capture of profitable niche markets by foreign banks.

Apart from regulatory issues, capital flows have also, for all the project countries, accelerated the agenda for financial sector development in other dimensions, notably the pressure to develop capital markets (especially stock exchanges) as a vehicle for the efficient allocation of inflowing capital. Many of the countries in the region have given high priority to establishing the legal and institutional framework for capital markets. In Zambia, a stock exchange was established in 1992 and in Tanzania, as discussed above, the framework for capital markets was set out in 1994 and the Dar-es-Salaam Stock Exchange was established.

From: Private Capital Flows to Africa: Perception and Reality, FONDAD, November 1999, www.fondad.org