



VI

Growth in Sub-Saharan Africa: Performance, Impediments, and Policy Requirements

When recent turmoil in financial markets disrupted economies across the globe, the countries of sub-Saharan Africa (SSA) were adversely affected through trade and the decline in commodity prices induced by the crises. But there was little impact on their financial markets or on the financing conditions facing them, with the exception of South Africa (see Box 2.1). These countries were in effect largely immune to financial contagion because of the low degree of international integration and underdevelopment of their financial markets. These same factors, however, from a longer-term perspective, have also hampered economic growth in the region. Although growth performance has improved in the second half of the 1990s, it remains fragile and, in most countries, insufficiently strong to significantly reduce the dire levels of poverty that are prevalent. This chapter explores some of the main sources of the disappointing growth performance of the SSA countries, discusses areas where reforms are needed to increase growth, and considers the potential contribution of the Heavily Indebted Poor Countries (HIPC) debt relief initiative.

Past Growth in SSA Countries and Its Relationship to Policies¹

The growth performance of SSA in recent decades has been weak by most standards. The region's aver-

age real per capita income in 1998 was roughly unchanged from its level in 1970 (Figure 6.1). This average performance masks significant differences across countries, however, and is strongly affected by developments in the two largest economies, South Africa and Nigeria, which in 1998 together accounted for almost 30 percent of the region's total output (in terms of purchasing power parities). Out of the 47 SSA countries,² the nine fastest growing economies achieved average annual growth of 3.1 percent in real per capital incomes over the past 30 years. In the nine slowest growing economies, real per capita income contracted by 2 percent a year on average, owing in some cases to armed conflicts and political instability.³ In fact, SSA had by far the worst performance among developing country regions: the Middle East and Europe regions as well as Latin America experienced real per capita income growth of 1–2 percent a year on average during 1970–98, while in Asia, at 4.7 percent a year, growth was well above the world average of 2.4 percent.

In the second half of the 1990s, average real per capita income growth in SSA rose to 1.5 percent, partly reflecting policy improvements, including in the context of programs supported by the IMF and the World Bank.⁴ In several countries average annual growth exceeded 3 percent,⁵ sometimes reflecting special circumstances such as recovery from armed conflict (Angola, Ethiopia, Mozambique, Rwanda) or the exploitation of recently discovered oil reserves (Equatorial Guinea). Some other countries, however,

¹For recent analyses of SSA growth performance, see Paul Collier and Jan Willem Gunning, "Explaining African Economic Performance," *Journal of Economic Literature*, Vol. 37 (March 1999), pp. 62–111; Ernesto Hernández-Catá, "Raising Growth and Investment in Sub-Saharan Africa: What Can Be Done?" Working Paper (Washington: IMF, 1999, forthcoming); William Easterly and Ross Levine, "Africa's Growth Tragedy: Policies and Ethnic Divisions," *The Quarterly Journal of Economics* (November 1997), pp. 1203–50; Jeffrey D. Sachs and Andrew Warner, "Sources of Slow Growth in African Economies," *Journal of African Economy*, Vol. 6 (1997), pp. 335–76; Dhaneshwar Ghura and Michael T. Hadjimichael, "Growth in Sub-Saharan Africa," *IMF Staff Papers*, Vol. 43, No. 3 (1996), pp. 605–34. For the policy implications in particular, see Stanley Fischer, Ernesto Hernández-Catá, and Moshin Khan, "Africa: Is This the Turning Point?" Working Paper 98/6 (Washington: IMF, May 1998). For an analysis of growth performance in relation to adjustment programs, see *The ESAF at Ten Years: Economic Adjustment and Reform in Low-Income Countries*, Occasional Paper 156 (Washington: IMF, 1997), pp. 1–50, and the May 1995 *World Economic Outlook* (Annex II).

²Eritrea has been omitted from the sample for lack of data availability.

³Throughout the chapter, high- and low-growth countries are defined by the top and bottom quintile of the distribution, respectively, when SSA countries are ranked by their 1970–98 average rate of increase in real income per capita. The first group comprises Botswana, Congo, Equatorial Guinea (even excluding the spectacular oil-induced growth since 1996), Guinea, Mauritania, Mauritius, Mozambique, Seychelles, and Swaziland, while the second group consists of Angola, Democratic Republic of Congo, Djibouti, Liberia, Madagascar, Sierra Leone, Somalia, Togo, and Zambia. The remaining countries constitute the medium-growth group. The average growth rates dividing the three groups are –0.75 and +0.93 percent per annum.

⁴For the role of ESAF programs in enhancing growth by promoting macroeconomic stability, external viability, and structural reforms, see *The ESAF at Ten Years*.

⁵Angola, Botswana, Equatorial Guinea, Ethiopia, Gabon, Malawi, Mauritius, Mozambique, Rwanda, Sudan, Uganda.

experienced an average yearly contraction of per capita income during this period of more than 1 percent, in most cases as a result of civil war.⁶

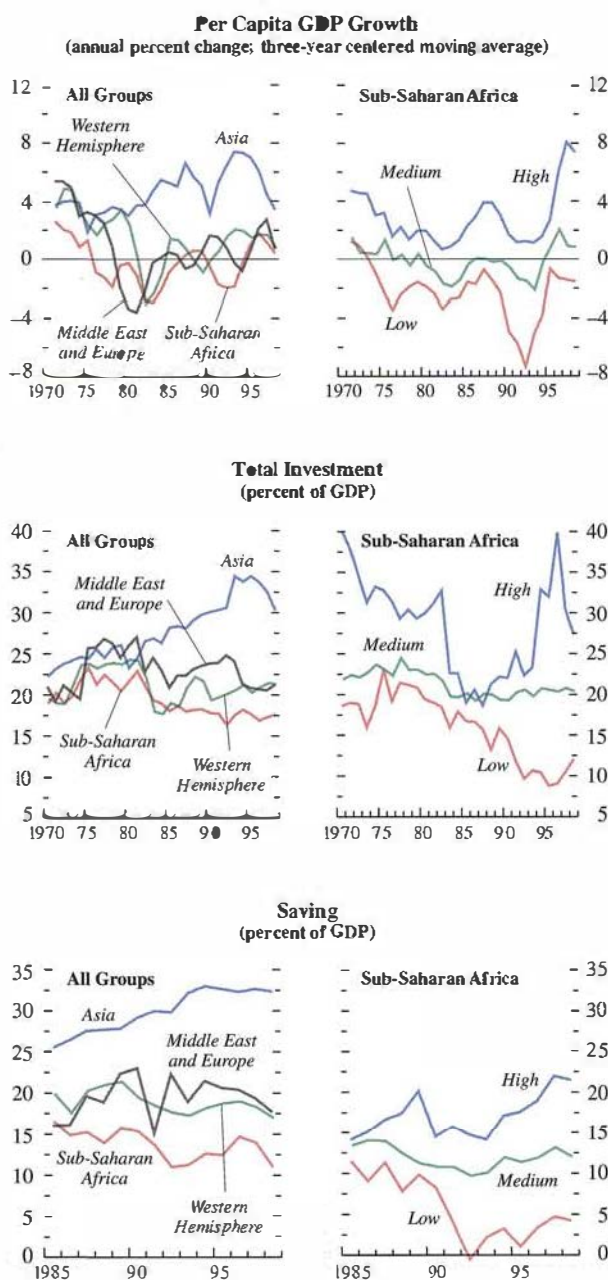
Causes of Inadequate Growth

In the past two decades there has been a revival of research on the sources of economic growth. One of the hypotheses tested has been that of conditional convergence of per capita incomes, based on the observation that poorer countries tend to grow faster, other things being equal.⁷ The standard cross-section growth regressions (based on initial per capita income and such explanatory variables as investment rates, the level of education, and macroeconomic policy characteristics) were unable to explain the poor SSA growth performance. Recent analysis has therefore emphasized the importance of various institutional, social, and political factors, which constitute a focus of this chapter. Obviously, most of these factors are also strongly influenced by output growth and the level of economic development, making it difficult to establish the causal relationship either way. It has also been suggested that economic growth in SSA countries has been adversely affected by several factors beyond their immediate control, such as rapid population growth, unfavorable climatic conditions, location (landlocked positions in some cases and distance from large markets), terms-of-trade changes, and virulence of diseases.⁸

Sustainable growth of per capita income usually results from investment in physical and human capital and growth in total factor productivity (TFP). Growth accounting exercises for SSA countries over 1973–94 show a modest contribution to per capita income growth from accumulation of physical and human capital, and a large negative contribution from TFP growth (of the order of a negative 1.3 percent per annum), which indicates major impediments to growth.⁹ A rise in TFP may in fact result not only from advances in technology and economies of scale, but also from amelioration of the economic environ-

Figure 6.1. Sub-Saharan Africa and Other Developing Country Groups: Growth, Investment, and Saving

Among developing country groups, higher investment and saving tend to be correlated with higher growth.



⁶Burundi, Comoros, Democratic Republic of Congo, Djibouti, Guinea-Bissau, Sierra Leone, Zambia.

⁷The conditional convergence hypothesis implies that countries grow faster the further their per capita real income is below its potential path, which in turn depends on a number of factors, including technology, cultural, demographic, social, institutional, and political characteristics. See Robert Barro and Xavier Sala-i-Martin, *Economic Growth* (New York: McGraw Hill, 1995) and October 1994 *World Economic Outlook* (Box 11).

⁸For geographic and climatic factors in particular, see Sachs and Warner, "Sources of Slow Growth in African Economies," and David E. Bloom and Jeffrey D. Sachs, "Geography, Demography, and Economic Growth in Africa," *Brookings Papers on Economic Activity* (1998), pp. 707–95.

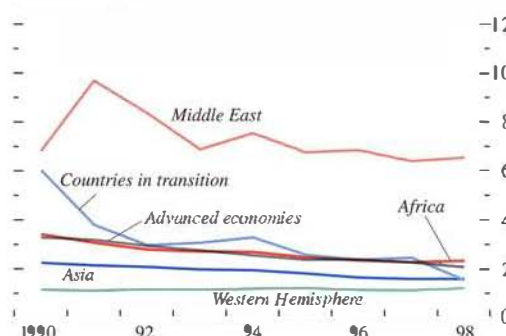
⁹Susan M. Collins and Barry Bosworth, "Economic Growth in East Asia: Accumulation Versus Assimilation," *Brookings Papers on Economic Activity* (1996), pp. 135–203.

Box 6.1. Africa and World Trends in Military Spending

Since the mid-1980s, there has been a persistent fall in military spending throughout the world, including Africa.^{1,2} *World Economic Outlook* data for 132 countries show that the share of military expenditures in GDP fell gradually from 5.1 percent in 1985, to 3.4 percent in 1990, and to 2.1 percent in 1998. As a share of total government spending, military outlays fell from 13.9 percent in 1990 to 9.4 percent in 1998. This downward trend in worldwide military spending is confirmed by the other three widely known sources of data on military expenditures:³ the Stockholm International Peace Research Institute (SIPRI), the International Institute for Strategic Studies (IISS), and the U.S. Arms Control and Disarmament Agency (ACDA).⁴

Regional differences in military spending patterns have narrowed down in the 1990s (see first figure). These differences are due primarily to regional tensions and the concentration of armed conflicts and military engagements in different parts of the world. A country's military spending is also likely to be affected by spending in neighboring countries.⁵ According to SIPRI, the number of major armed conflicts in the world fell from 31 in 1990 to 24 in 1997, before rising to 26 in 1998. In Africa, the number of conflicts halved between 1990 (10 conflicts) and 1996 (5 conflicts) but has risen since (8 conflicts in 1997 and 11 conflicts in 1998). The increase in overall major conflicts in the world in 1998

Military Expenditures, 1990–98
(Percent of GDP)



has been accounted for by conflicts on the continent of Africa.⁶

In Africa, despite the recent increase in the number of armed conflicts, the downward trend in military spending throughout most of the 1990s is confirmed by different data sources (see second figure). However, military outlays remain relatively high among African countries, at 2.3 percent of GDP in 1998, against 1.6 percent of GDP in Asia, and 1.3 percent of GDP in the Western Hemisphere. Military spending has been higher in Africa than in these two regions as a share of GDP throughout the 1990s, even if conflict countries are excluded from the analysis. Among developing and transition countries, Africa spends more as a share of GDP on the military than all other regions except the Middle East. As a share of government spending, military outlays fell to 8.5 percent in Africa in 1998 from 12.5 percent in 1990. This ratio is lower in Africa than all regions in the developing world and transition economies, except the Western Hemisphere and the transition economies of Central Europe. As in many countries in other regions, budgetary data may not capture, in full, all military outlays. The recent increase in armed conflicts is likely to have put further pressures on governments in Africa to increase military outlays and these expenditures may rise as a share of total government spending.

Size of the Armed Forces

A large army relative to population can exert significant pressure on a government's wage bill, thus crowding out spending on more productive programs. In line with the fall in military spending in the 1990s, ACDA data show a reduction in the size of the armed forces per 1,000 population between 1990 and 1995. Data for 134 countries show that the size of the armed forces has fallen since

¹Africa includes Sub-Saharan Africa. Algeria, Morocco, and Tunisia.

²See Sanjeev Gupta, Calvin McDonald, Luiz de Mello, and Randa Sab, "Military Spending Continues to Stabilize: Some Countries Increase Social Spending," *IMF Survey*, Vol. 28, No. 11 (June 7, 1999, pp. 186–88); and also Sanjeev Gupta, Jerald Schiff, and Benedict Clements, "Worldwide Military Spending, 1990–95," IMF Working Paper 96/64 (June 1996).

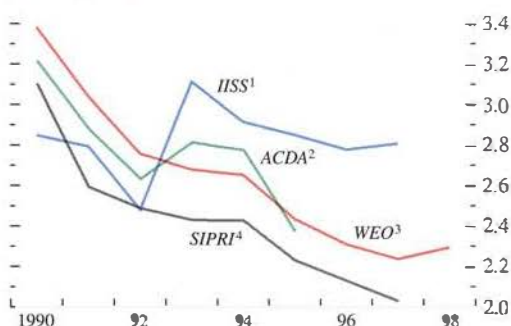
³In a sample of 71 countries, SIPRI reported a fall in worldwide military expenditures to 2.3 percent of GDP in 1997 from 3.2 percent of GDP in 1990. For a sample of 89 countries, IISS data show that worldwide military expenditures fell by 0.6 percent of GDP since 1990 to 2.5 percent of GDP in 1997. The data produced by ACDA are available only up to 1995 and show a decline in military spending for 102 countries of 1.0 percent of GDP since 1990 to 2.7 percent of GDP in 1995.

⁴These data sources differ primarily in country coverage and the definition of expenditures. The WEO data set contains defense budget outturns reported by IMF country desk officers and has the widest coverage of countries. SIPRI uses the NATO definition and includes military pensions, military interest payments, and paramilitary expenditures in total outlays, but excludes police expenditures. IISS uses the NATO definition only for NATO countries, and defense budget outturns for non-NATO countries. These sources also differ in the treatment of calendar and fiscal year data. For instance, WEO and SIPRI data are calculated on a calendar year basis, while IISS uses a mix of fiscal and calendar year data. The timeliness with which data are reported also varies among these data sources.

⁵See Hamid Davoodi, Benedict Clements, Jerald Schiff, and Peter Debaere, "Military Spending, the Peace Dividend, and Fiscal Adjustment," IMF Working Paper 99/87.

⁶The UN Secretary-General has recently called for a reduction in military spending in Africa; see "Secretary-General tells assembly debate on durable peace in Africa, immediate and dramatic action needed to ease Africa's debt burden," Press Release GA/9475, October 1998.

Military Expenditures in Africa, 1990–98 (Percent of GDP)



¹*The Military Balance*. The International Institute for Strategic Studies (IISS), includes 16 countries.

²*World Military Expenditures and Arms Transfers*, U.S. Arms Control and Disarmament Agency (ACDA), includes 26 countries.

³*World Economic Outlook (WEO)* includes 43 countries.

⁴*SIPRI Yearbook, Armaments, Disarmament and International Security*, Stockholm International Peace Research Institute, Stockholm (SIPRI), includes 23 countries.

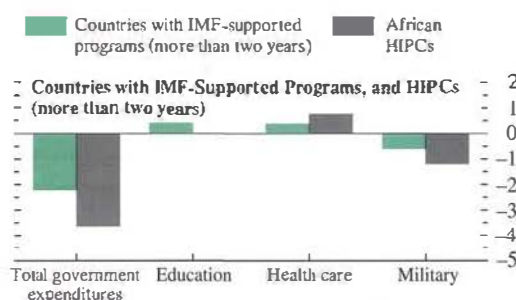
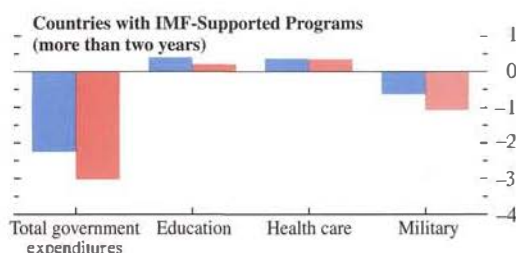
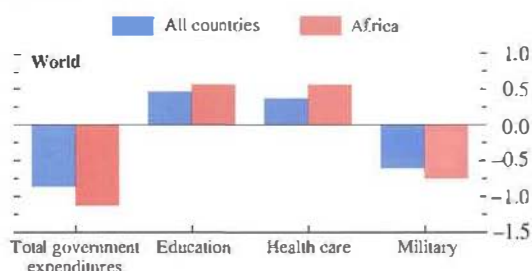
1990 for all regions from 6.7 per 1,000 population to 5.7 per 1,000 population, except in the newly industrialized Asian countries. Countries in Africa and the Western Hemisphere have the smallest armed forces as a share of population. In the 45 African countries in our sample, the size of the armed forces fell from 3.9 per 1,000 population in 1990 to 3.3 per 1,000 population in 1995.

Military Spending Versus More Productive Expenditure: The Case of Education and Health Care

Military spending appears to have become, on average, a lower priority in government budgets compared to spending on education and health care. Because poor social indicators are often associated with low levels of spending on education and health care, a decline in military outlays in relation to both GDP and total government spending frees resources in the budget that can be used to finance more productive expenditures for human development. In a sample of 56 countries for which data are available for 1990–97, the fall in military spending is associated with increases in spending on education and health care as a proportion of GDP (third figure, top panel). The 25 African countries in the sample fare particularly well, with greater increases in health care and education spending.

In IMF-supported programs, particular attention is devoted to improving the composition of government expenditures in favor of programs with higher productivity, including supporting human development. Among the countries that have had an IMF-supported program for more than two years, military spending has fallen faster

Changes in Military, Education, and Health Care Expenditures, 1990–97¹ (Percent of GDP)



Source: IMF staff estimates.

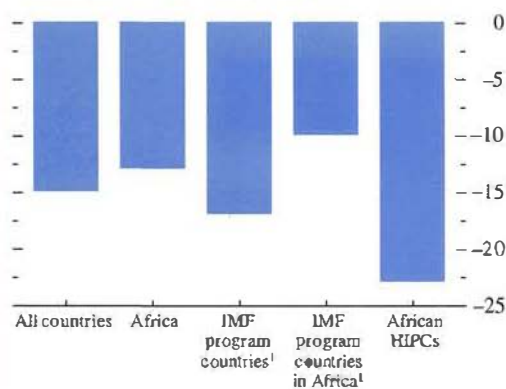
¹Unweighted averages. Excludes industrial countries.

as a share of GDP in Africa than elsewhere (third figure, middle panel).^{7,8} These African countries have increased expenditures in education and health care despite the reduction in total government spending.

(continued on next page)

⁷Data are available for 14 African countries in a sample of 31 countries that have had IMF-supported programs for more than two years, over 1990–97.

⁸Evidence that military expenditure was more likely to be reduced in African countries with IMF programs for the period of 1978–87 can also be found in Geoff Harri's and Newman Kusi, "The Impact of the IMF on Government Expenditures: A Study of African LDCs," *Journal of International Development*, Vol. 4, No. 1 (1992), pp. 73–85.

Box 6.1 (concluded)**Changes in Size of Armed Forces, 1990–95***(Per 1,000 population; percentage change)*

Source: *World Military Expenditures and Arms Transfers*, U.S. Arms Control and Disarmament Agency (ACDA), Washington, D.C.

¹Countries with IMF-supported programs for more than two years.

An increase in education and health care spending has also taken place in the African countries that are eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.⁹ Through debt relief, the Initiative focuses on ensuring additional financing for social sector programs—primarily basic health care and education. African HIPCs (by far the majority of all HIPCs) have increased health care spending faster than other countries that have had IMF-supported programs for more than two years. This increase was achieved despite the reduction in total government expenditures (third figure, bottom panel).¹⁰ However, African HIPCs have failed to match the increase in education spending of other IMF-supported program countries. With regard to army size, the fall in the size of the armed forces between 1990 and 1995 was twice as large in the African HIPCs as in the African countries that have had an IMF-supported program for more than two years (see fourth figure).

⁹The HIPC Initiative entails a coordinated action by the international financial community, including multilateral institutions, to reduce the external debt burden of heavily indebted poor countries to sustainable levels following the implementation of sound economic policies in the context of IMF- and World Bank-supported programs. The Summit of G-7 Finance Ministers held in Köln in 1999 has recently called for broadening the scope of the HIPC framework to provide deeper and faster debt relief.

¹⁰Data are available for 14 African HIPCs in a sample of 31 countries with IMF-supported programs for more than two years.

ment for private sector activity, which may stem from improvements in macroeconomic, trade, and structural policies, or in the quality of the public sector infrastructure, institutions, and governance. These factors tend to be complementary to investment in physical and human capital, making it more productive.

Shortage of Human and Physical Capital

*Education and Health*¹⁰

Improvements in health and education are primary sources of human and economic development. Although SSA countries have made significant progress in enhancing education (Table 6.1), they are still lagging behind other regions in terms of literacy rates and especially with regard to secondary school enrollment. High-growth SSA countries had much higher levels, as well as faster accumulation, of human capital throughout the observation period than slow-growth countries. After some improvement during the 1970s, secondary school enrollment in low-growth countries has not increased any further over the past 20 years. Gains from efforts to provide better education have also been limited by the deleterious effects of the “brain drain,” which has been particularly prevalent in countries that have suffered long periods of economic stagnation and political instability. Such emigration is likely to continue to be a significant impediment to economic development as long as SSA countries fail to offer an attractive economic and political environment to their better educated citizens.

A similar pattern applies to the main health indicators—infant mortality and life expectancy—with SSA countries, despite significant improvements, still lagging behind other regional groups, and high-growth SSA countries scoring better than low-growth countries over the past 30 years. Life expectancy has not increased in the past 15 years in either group of SSA countries, partly owing to the devastating effects of AIDS.¹¹ Infectious diseases in general, and AIDS in particular, are estimated to be a significant constraint on growth in many SSA countries.¹²

¹⁰Health and education are both sources and outcomes of economic growth. Clearly they affect the productivity of the labor force and thus per capita income. On the other hand, the higher the per capita income, the easier it will be to provide the population with health and education services, and the higher the demand for such services.

¹¹It is estimated that in 1997 21 million SSA inhabitants were infected with HIV/AIDS, i.e., about 3.4 percent of the total SSA population and 7.8 percent of the regional labor force. UNAIDS and WHO, “Report on the Global HIV/AIDS Epidemic” (New York: United Nations, 1998).

¹²See Bloom and Sachs, “Geography, Demography, and Economic Growth in Africa.”

Table 6.1. Sub-Saharan Africa and Other Developing Country Groups: Education and Health

	Illiteracy Rate			Secondary School Enrollment ¹			Primary School Enrollment ²		
	1970	1997	1970-97	1970	1995	1970-95	1970	1995	1970-95
Asia	51	24	36	24	61	45	82	112	107
Advanced economies	...	...	...	80	106	94	102	103	103
Western Hemisphere	26	13	18	28	52	44	100	112	106
Middle East and Europe	69	38	52	24	64	49	68	97	91
Sub-Saharan Africa	71	42	56	7	27	19	50	77	74
World	46	26	34	31	67	51	83	104	100
SSA countries: unweighted group by yearly per capita GDP growth rate in 1970-98									
High growth (top quintile)	59	33	45	13	38	29	59	90	88
Medium growth	71	45	57	6	25	17	49	72	72
Low growth (bottom quintile)	70	41	55	9	18	17	64	84	72
<i>Memorandum</i>									
CFA: unweighted average ³	81	54	67	6	20	17	50	67	70

	Life Expectancy at Birth			Infant Mortality Rate		
	1970	1997	1970-97	1970	1997	1970-97
Asia	56	67	63	95	48	69
Advanced economies	71	77	74	22	6	13
Western Hemisphere	61	70	65	84	32	56
Middle East and Europe	53	67	60	134	49	87
Sub-Saharan Africa	44	51	48	137	91	112
World	59	67	63	98	56	76
SSA countries: unweighted group by yearly per capita GDP growth rate in 1970-98						
High growth (top quintile)	46	55	52	132	78	96
Medium growth	44	52	49	138	87	110
Low growth (bottom quintile)	42	48	46	155	114	134
<i>Memorandum</i>						
CFA: unweighted average ³	42	50	47	146	92	117

Source: World Bank, World Development Indicators (regional groupings may differ from WEO classifications).

¹1995=1994 for sub-Saharan Africa and for Western Hemisphere; 1970=1975 for advanced economies.

²1995=1994 for sub-Saharan Africa; 1970=1975 for advanced economies and for Western Hemisphere.

³Communauté Financière Africaine and Coopération Financière en Afrique.

Investment and Saving

Physical investment, in particular private fixed capital formation, remains low in SSA. The ratio of total fixed investment to GDP has actually declined gradually over the past 30 years, to 17.5 percent of GDP in the second half of the 1990s from 20 percent in 1970-74 (see Figure 6.1), while private fixed investment has averaged 11-12 percent of GDP since 1970 with only a modest upward trend. These aggregate figures conceal large differences among countries within the region. High-growth countries have relatively high investment ratios that have been rising, with total and private investment reaching 32 and 25 percent of GDP, respectively, in the second half of the 1990s, while in the same period total and private investment ratios in the low-growth countries averaged 10 and 5 percent, respectively. Investment in SSA also appears to have

been relatively unproductive, as indicated by the negative estimates of TFP growth.

This evidence suggests that the poor growth performance of SSA countries may be attributed partly to factors that either discourage investment or make it less productive. Inadequate infrastructure, poor quality of public services, and distortions in investment incentives have been factors limiting the productivity of capital.¹³ Moreover, the high risks attached to the return on investment in Africa, particularly those associated with macroeconomic and political instability, inefficient institutions, and weak legal systems, have

¹³This may explain why some studies (Shantayanan Devarajan, William Easterly, and Howard Pack, "Is Investment in Africa Too Low or Too High?" (Washington: World Bank, May 1999)) find that investment, even by the private sector, has contributed little to growth in SSA.

played a major role in reducing the incentive to invest (see below).¹⁴

Investment has also been constrained by the limited availability of financing.¹⁵ National saving rates have been low compared with other regions, partly due to widespread poverty and partly due to the same reasons that discourage investment (see Figure 6.1).¹⁶ Over the past 15 years, national saving rates averaged 14 percent of GDP, well below those in other developing country regions, especially Asia. National saving rates have dropped in the 1990s and have shown only modest signs of recovery recently, except in the high-growth countries, where they have risen to 20 percent in the second half of the 1990s, while in low-growth countries they have dropped to 4 percent.

Low domestic saving is not the only obstacle to investment financing in SSA. Financial intermediation is still very limited, typically provided by a few financial institutions that often do not perform in a competitive environment. Private capital flows into the region are low, although they have been rising during the 1990s: foreign investors in search of high risk-adjusted returns have tended to prefer other developing countries where risks are smaller and capital markets are better developed and less subject to government control. Reliance on official development assistance (ODA) has been predominant and its use often inefficient. ODA flows have declined in recent years, and it cannot be taken for granted that they will recover to levels reached in the past, given budgetary constraints in the advanced economies, and the concentration of assistance on countries with superior track records in translating aid into growth.¹⁷

Roles of Macroeconomic, External, and Structural Policies

Macroeconomic Stabilization Policies

Over the past 30 years, high-growth SSA countries had much lower inflation and fiscal deficit-to-GDP ra-

tios than low-growth countries (Figure 6.2). It is now generally accepted that the direction of causality, even though difficult to establish, runs primarily from macroeconomic stability to growth.¹⁸ During the past decade, policy efforts in the SSA region have aimed increasingly at macroeconomic stabilization and the implementation of essential structural reforms, often under ESAF-supported programs. Much of the recent improvement in SSA growth performance has indeed been attributed to relatively successful macroeconomic stabilization efforts: the average fiscal deficit (including grants) fell from 5 percent of GDP in the first half of the 1990s to 3 percent in 1995–98, while average inflation fell from 29 to 21 percent, with median inflation declining from 11 percent to 8 percent. Fiscal measures have included reducing tax exemptions and unproductive expenditures (such as transfers and subsidies to state enterprises), as well as enhancing revenues through the introduction of VAT. Monetary policy reforms have ranged from targeted reductions in domestic credit expansion to the elimination of selective credit controls, directed credit, and interest rate controls.

As in other developing countries, there has also been a shift toward increased exchange rate flexibility in SSA. Even so, approximately half of the SSA countries have continued to peg their domestic currency to one or more foreign currencies:¹⁹ 15 countries peg to the French franc (the 14 CFA countries and Comoros), 2 to the U.S. dollar (Djibouti, with a currency board, and Angola, with a crawling peg), 4 to a currency basket (Botswana, Burundi, Cape Verde, Seychelles), and 3 to the South African rand (Lesotho, Namibia, and Swaziland). Despite the shift toward greater exchange rate flexibility, the variability of real exchange rates in the SSA region has diminished as inflation has fallen.

In the countries with pegged rates, adjustments of the pegs have been used to correct currency misalignments that have arisen. In particular, in the CFA countries, the devaluation of the CFA franc in 1994 corrected a fundamental misalignment, and in combination with stronger reform and stabilization efforts led to a significant improvement in growth performance. Thus annual growth in CFA countries increased strongly from –2 percent in the first half of the 1990s to 5 percent in the second half, with a large increase in private investment (from 12 to 18 percent of GDP, on average, between the same periods) and to a major reduction in the fiscal deficit (from 6 to 2 percent of GDP). This improved performance increased the confidence of international investors and attracted private

¹⁴For a detailed analysis of the impact of risk factors on investment, see Paul Collier and Catherine Pattillo, *Investment and Risk in Africa* (London: Macmillan, 1999) Chapter 1, pp. 3–30.

¹⁵However, contrary to widely held belief, Collier and Gunning, “Explaining African Economic Performance,” find financial factors to be less important than other factors in explaining low-growth performance.

¹⁶In particular, the underdevelopment of the financial sector, poor monetary policies (e.g., administrative credit allocation and interest rate controls), and lack of adequate accounting practices and property titles.

¹⁷For recent studies showing that aid helped growth only when coupled with significant reforms in the recipient countries and associated with an increase in private investment, see Craig Burnside and David Dollar, “Aid, Policies and Growth,” Policy Research Working Paper 1777 (Washington: World Bank, 1997), and David Dollar and William Easterly, “The Search for the Key: Aid, Investment, and Policies in Africa,” Policy Research Working Paper No. 2070 (Washington: World Bank, 1999).

¹⁸The argument that macroeconomic stabilization is important for growth is supported, for example, by the econometric analysis of Evangelos A. Calamitis, Anupam Basu, and Dhaneshwar Ghura, “Adjustment and Growth in Sub-Saharan Africa,” Working Paper 99/51 (Washington: IMF, April 1999).

¹⁹See October 1997 *World Economic Outlook* (Chapter IV).

capital flows and foreign direct investment, which rose in relation to GDP from 0.6 to 3.0 percent and from 0.8 to 1.9 percent, respectively, between the first and second halves of the 1990s.

Trade and Exchange Liberalization

Empirical studies have provided substantial evidence of a positive causal relationship running from trade and exchange rate liberalization to growth and of a two-way causal relationship between trade and growth.²⁰ During the past decade, many SSA countries have made substantial progress in eliminating multiple exchange rates and in reducing exchange restrictions on current account transactions: in 1990, 43 SSA countries (out of 47) had not accepted the obligations of Article VIII of the IMF's Articles of Agreement; this number had dropped to 33 by 1995 and to 13 by 1998.²¹

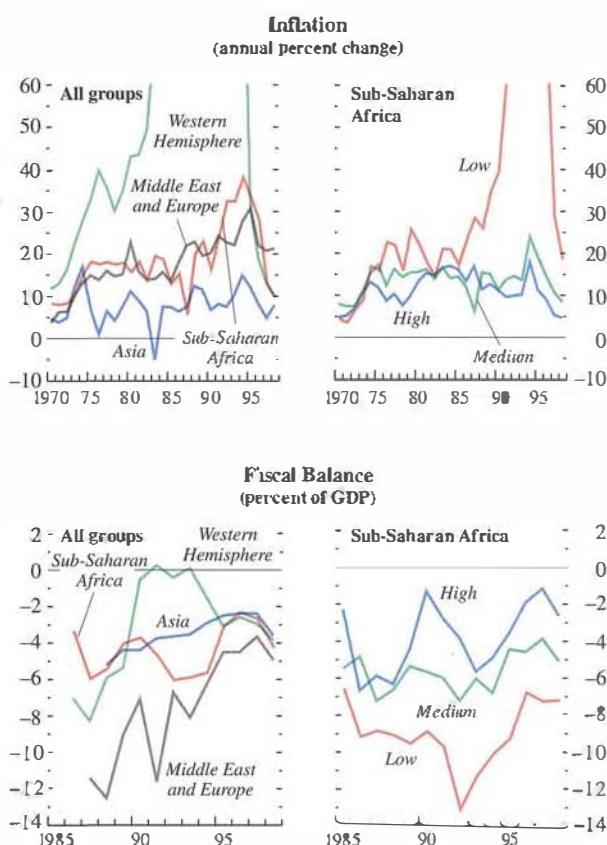
Although lagging behind other developing country regions in terms of trade liberalization, SSA countries have recently adopted widespread trade reforms: non-tariff barriers and licensing requirements have been greatly reduced and replaced with ad valorem tariffs, which have subsequently been progressively reduced as well. Such efforts have often been made in the context of regional trade arrangements (see Chapter V).

In their quest to attract a larger share of global FDI, many African countries have introduced changes in policy. These include increasing the number of sectors open to FDI; lowering government participation in equity holding and moving away from mandatory joint ventures; expediting the approval process for FDI by opening one-stop investment centers; removing restrictions on the repatriation of profits, the provision of tax incentives, and the creation of export processing zones; allowing foreign participation in the privatization of state-owned enterprises; enhancing measures to protect intellectual property rights; and signing various multilateral trade and investment agreements.

SSA authorities have proceeded with prudence in the liberalization of capital account transactions. Particularly in the light of the financial difficulties experienced by several countries in the second half of the 1990s, such liberalization should follow the develop-

Figure 6.2. Sub-Saharan Africa and Other Developing Country Groups: Inflation and Fiscal Balance

Among sub-Saharan African countries, greater macroeconomic stability is associated with higher growth.



²⁰In particular for SSA countries, see Easterly and Levine, "Africa's Growth Tragedy," for the role of black market premium, and Dani Rodrik, "Trade Policy and Economic Performance in Sub-Saharan Africa," NBER Working Paper 6562 (May 1998), for the effects of trade liberalization.

²¹Article VIII prohibits members from imposing restrictions on payments and transfers for current international transactions, engaging in multiple currency practices, or implementing discriminatory currency arrangements. The following countries had not accepted the obligations of Article VIII at the end of July 1999: Angola, Burundi, Cape Verde, Democratic Republic of Congo, Ethiopia, Liberia, Mauritania, Mozambique, Nigeria, São Tomé and Príncipe, Somalia, Sudan, Zambia.

Table 6.2. Sub-Saharan Africa and Other Developing Country Groups: External Performance

	Openness ¹			Foreign Exchange Black Market Premium ²		
	1990–94	1995–98	1970–98	1990–94	1995–98	1970–98
Asian NIEs ³	60.1	68.4	60.3	...	...	...
Asia	21.3	24.4	15.3	...	...	...
Advanced economies	19.3	21.9	18.8	...	...	...
Western Hemisphere	14.2	15.7	13.6	...	...	...
Middle East and Europe	31.4	32.2	32.8	...	...	...
Sub-Saharan Africa	27.8	31.6	28.2	...	...	...
World	19.4	22.4	19.7	...	...	...
SSA countries: unweighted grouping by yearly per capita GDP growth rate in 1970–98						
High growth (top quintile)	52.8	59.0	53.7	1.2	1.1	2.3
Medium growth	30.6	32.8	29.5	1.4	1.1	3.1
Low growth (bottom quintile)	34.7	34.0	35.2	17.5	6.7	19.5
<i>Memorandum</i>						
SSA: unweighted average ⁴	35.6	38.1	35.4	4.3	2.1	6.1
CFA: unweighted average	30.8	37.8	34.1	1.0	1.0	1.0
	Ratio of Private Capital Inflows to GDP			Ratio of FDI to GDP		
	1990–94	1995–98	1970–98	1990–94	1995–98	1975–98
Asian NIEs ³	...	–1.3	1.4	...	...	...
Asia	2.8	2.3	1.5	1.8	2.8	0.9
Advanced economies	...	...	...	...	...	...
Western Hemisphere	3.0	3.6	2.3	1.1	2.4	0.8
Middle East and Europe	5.3	1.5	–0.3	0.5	0.8	0.3
Sub-Saharan Africa	0.6	3.0	1.7	0.8	1.9	0.8
World	...	...	...	...	...	...
SSA countries: unweighted grouping by yearly per capita GDP growth rate in 1970–98						
High growth (top quintile)	3.0	9.3	4.7	4.4	7.8	2.5
Medium growth	2.5	4.1	2.3	1.5	1.9	0.7
Low growth (bottom quintile)	2.1	0.3	1.6	1.2	3.3	0.9
<i>Memorandum</i>						
SSA: unweighted average ⁴	2.5	4.4	2.6	2.0	3.3	1.1
CFA: unweighted average	1.4	7.7	3.8	2.2	4.7	1.2

Source: IMF WEO database; and World Bank, World Development Indicators for Foreign Exchange Black Market Premium (regional groupings differ slightly from WEO classifications).

¹Average ratio of exports and imports of goods and services to GDP.

²The maximum ratio of market to official exchange rate has been set to 100.

³Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.

⁴Sub-Saharan Africa.

ment of mature domestic financial markets, in order to limit the vulnerability of the economic and financial system to the volatility of capital flows and the risk that capital inflows may be directed toward inefficient investment projects.

The dismantling of official distortions in exchange markets has drastically reduced black market premia during the 1990s (Table 6.2). Trade liberalization has helped to spur trade flows, which have risen progressively during the 1990s, both contributing to, and being reinforced by, the increase in output growth during the second half of the decade. Interestingly, recent evidence (based on gravity models) suggests that the relatively low (absolute) levels of SSA trade are not

unusual, as they reflect primarily the small size of SSA economies.²² Private capital inflows and ratios of FDI to GDP increased by more than 50 percent between the first and second halves of the 1990s, mostly reflecting the financing of specific projects, the liberalization of FDI regulations, the implementation of privatization

²²Foroutan and Pritchett, "Intra-Sub-Saharan African Trade: Is It Too Little?" *Journal of African Economies* (1993), pp. 74–105; Rodrik, "Trade Policy and Economic Performance in Sub-Saharan Africa"; and David T. Coe and Alexander W. Hoffmaister, "North-South Trade: Is Africa Unusual?" Working Paper 98/84 (Washington: IMF, June 1998; forthcoming in *Journal of African Economies*).

programs, and the increasing confidence of international investors that SSA countries would pursue pertinent reforms, but also as a result of the recent strengthening of growth prospects.

Structural Policies and Sectoral Composition of Output

Following independence from colonial rule, leadership in many SSA countries questioned the efficiency and fairness of market economies and the importance of comparative advantage, and introduced extensive controls on prices, exchange rates, distribution systems and, more generally, on the sectoral allocation of resources. The agricultural sector was often effectively discriminated against by the imposition of price and exchange rate controls, the creation of public monopolies for the marketing of agricultural goods, and the inadequate provision of rural infrastructure. The industrial sector, in most countries dominated by inefficient public enterprises, was often implicitly subsidized by import-substitution policies, by the rents derived from public monopolies, and by the artificial suppression of agricultural prices, but nevertheless failed to flourish, as the resulting distortions entailed inefficient investment and chronic mismanagement.

In the 1990s many of these policies have been reversed and many distortions eliminated, as price controls have been reduced, agricultural marketing liberalized, large public monopolies eliminated, and many public enterprises privatized. The full effects of this greater reliance on market mechanisms will not be felt for several years, while further efforts are still needed to provide the right incentives for an efficient allocation of resources.

Improving SSA's Growth Performance Further

Recent policy efforts have brought SSA countries closer to macroeconomic stability and reduced distortions in incentive structures, resulting in some improvements in growth performance. In most cases, however, these efforts have not been sufficient to eliminate the obstacles and disincentives to increased capital accumulation: only in the high-growth countries has private investment risen in the second half of the 1990s. There is certainly more to be done in the areas of macroeconomic stabilization and structural reforms: in 1998, average inflation in SSA was 10 percent, while the average fiscal deficit including grants stood at 4.3 percent of GDP. More than a quarter of SSA countries do not yet accept the obligations under Article VIII, while average tariff and nontariff barriers—although lower than in the past—are still relatively high. Many state monopolies remain, along with extensive price and quantity controls. FDI flows are still overregulated,

via cumbersome industrial and trade licensing procedures as well as restrictions on the issuance of work permits for expatriates. Further progress in these, as well as the following, areas is essential.

Reforms Aimed at the Public Sector, Financial Markets, and Infrastructure

There are several aspects of public policy, services, and institutions that constitute major obstacles to enhancing productivity and add to the riskiness of investment: they include inefficiency of the state bureaucracy, corruption, limited respect for the legal system and property rights, political risks associated with political instability and domestic conflicts, underdevelopment of the financial system, and lack of an adequate physical infrastructure.

Quality of Public Sector Institutions and Governance

In many cases the lack of broad representation and the political instability that followed independence from colonial rule, coupled with conflicts related to historical and ethnic factors, have hindered the development of an efficient political and institutional environment, and clearly constrained growth. Reforms aimed at improving the quality of the public sector, institutions, and governance remain urgent in many of these countries.

Inefficiency in the provision of public services results from underqualified public employees as well as remuneration systems unrelated to performance, and absorbs budgetary resources that could be better devoted to the development of human resources or physical infrastructure.²³

Extensive corruption within the political system and inefficient government bureaucracy tend to increase transaction costs and constrain the efficiency of resource allocation.²⁴ The lack of an impartial legal system, the generally inadequate observance and enforcement of law, the risk of expropriation, and the lack of effective sanctions for contract repudiation are important factors increasing the riskiness of investments.

²³For a detailed analysis of employment and remuneration policies in SSA countries, see Ian Lienert and Jitendra Modi, "A Decade of Civil Service Reform in Sub-Saharan Africa," Working Paper 97/179 (Washington: IMF, December 1997). Regarding the importance of remuneration policies in avoiding and reversing the brain-drain phenomenon, see Nadeem Ul Haque and Jahangir Aziz, "The Quality of Governance: 'Second Generation' Civil Service Reform in Africa," Working Paper 98/164 (Washington: IMF, November 1998).

²⁴Note, however, that recent evidence on the determinants of corruption and growth indicates that the corruption process in SSA is little different from elsewhere, once the structure of the economy and institutional characteristics are taken into account. See Sergio P. Leite and Jens Weidmann, "Does Mother Nature Corrupt? Natural Resources, Corruption, and Economic Growth," Working Paper 99/85 (Washington: IMF, July 1999).

Table 6.3. Sub-Saharan Africa and Other Developing Country Groups: Quality of Governance, Institutions, and Public Services(0–10, higher=better quality)¹

	Quality of Bureaucracy 1984–98	Extent of Corruption 1984–98	Government Stability 1984–98	Ethnic Tensions 1984–98	Political Violence 1984–98	Law and Order 1984–98	Risk of Expropriation 1984–97	Risk of Contract Repudiation 1984–97
Asian NIEs ²	7.3	6.9	6.5	7.5	9.0	7.4	8.3	9.1
Asia	4.6	4.3	5.0	4.5	6.0	5.0	6.3	6.0
Advanced economies	8.7	8.3	6.5	8.2	8.7	8.7	7.9	9.2
Western Hemisphere	4.2	4.6	4.9	7.1	5.8	4.8	5.7	6.0
Middle East and Europe	4.8	4.7	5.7	5.9	5.7	5.4	6.2	5.9
Sub-Saharan Africa	4.1	4.6	4.8	4.9	5.5	4.4	5.3	4.8
World	5.4	5.5	5.4	6.4	6.6	5.8	6.3	6.4
SSA countries: unweighted grouping by yearly per capita GDP growth rate in 1970–98								
High growth (top quintile)	4.3	5.9	5.5	5.7	6.4	5.1	5.6	5.3
Medium growth	4.6	4.7	5.0	5.1	5.7	4.6	5.7	5.2
Low growth (bottom quintile)	3.0	3.5	3.8	3.9	4.5	3.6	4.3	3.4
Memorandum								
CFA: unweighted average ³	4.5	4.3	4.9	5.4	6.0	4.4	5.7	5.3

Source: International Country Risk Guide (published by Political Risk Services).

¹For regional groupings: unweighted averages of countries in the dataset.²Hong Kong SAR, Korea, Singapore, and Taiwan Province of China.³Communauté Financière Africaine and Coopération Financière en Afrique.

Armed conflicts, political instability, and civil wars reduce the expected profitability of investments, by increasing the risk that capital assets will be destroyed and economic activities interrupted. Government instability introduces uncertainty about economic and other policies. The persistence of nonelected governments in some countries tends to increase government intervention and corruption.

All these factors tend to reduce the overall efficiency of the economy and discourage domestic and foreign investment. According to surveys, high-growth SSA countries have tended to score somewhat better on most of these factors, both in the past 15 years and more recently (Table 6.3).²⁵ But SSA countries as a whole have ranked substantially worse than other regional groups in recent years, especially relative to the advanced economies and fast-growing developing and newly industrialized economies of Asia. While these findings may partly reflect an interdependence between economic performance on the one

hand and the quality of public sector institution and governance on the other, SSA countries clearly need to create an institutional and political environment which increases efficiency and reduces the riskiness of economic activity.

Financial Development

The development of the financial system has been shown to be an important factor in determining growth performance.²⁶ A well-functioning financial system facilitates economic transactions, stimulates saving, and channels savings to productive investment activities, thus helping to mobilize resources and improve their allocation. SSA countries need to develop financial markets that allow portfolio diversification, facilitate consumption-smoothing, and provide insurance, given the high exposure to risks associated with such uncontrollable factors as weather changes and terms of trade shocks.

Recent studies document the substantial efforts by SSA countries to improve the functioning of their financial systems since the late 1980s.²⁷ Liberalization

²⁵The relevance of these political and economic indicators for growth has been documented by Hélène Poirson, "Economic Security, Private Investment, and Growth in Developing Countries," Working Paper 98/4 (Washington: IMF, January 1998), pp. 1–31. A pioneering analysis on the role of corruption is Paolo Mauro, "Corruption and Growth," *Quarterly Journal of Economics*, Vol. 110 (1995), pp. 681–712; Easterly and Levine, "Africa's Growth Strategy," argue that ethnolinguistic diversity is harmful for growth, while Paul Collier and Jan W. Gunning, "Explaining African Economic Performance," find that this is true particularly when combined with low levels of democracy and political rights.

²⁶See, for example, Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature*, Vol. 35 (1997), pp. 688–726.

²⁷Enrique Gelbard and Sergio Pereira Leite, "Measuring Financial Development in Sub-Saharan Africa," Working Paper 99/105 (Washington: IMF, September 1999), and Hassanali Mehran et al., *Financial Sector Development in Sub-Saharan African Countries*, Occasional Paper, 169 (Washington: IMF, 1998).

of the domestic financial market has been one of the most successful areas of reform, and only a few countries still impose quantitative credit controls or maintain negative real lending rates. However, further progress is needed. On the basis of various measures of financial development, the average SSA country attained only about one-third of the level of the overall financial development of South Africa in 1987, and still just above one-half in 1997:²⁸

- In most SSA countries the financial sector is uncompetitive, and credit allocation is often subject to government intervention. In 1997, banking systems were highly concentrated: the average spread between lending and deposit rates was between 6 and 10 percentage points (reflecting higher credit risk as well as lack of competition), the average share of nonperforming loans in the portfolio of the banking system was above 20 percent (partly due to the weak legal system), and less than half of the countries had risk-adjusted capital adequacy ratios that matched the recommendation of the Basel Committee.
- The range of available financial products is unduly limited in SSA, with the notable exception of South Africa: in most countries no interest is paid on demand deposits, while the maturity structures of both deposits and government securities are very short (also because of the pronounced economic and political uncertainty), and both stock markets and interbank markets are largely underdeveloped.
- The use of monetary policy instruments in SSA countries still needs to be improved. Political interference in monetary policy decisions is still common. Central banks often rely on advances to commercial banks as a major instrument of monetary policy, and less on the use of open market operations. In addition, few countries have payment systems that can ensure rapid settlement of transactions, and interbank markets are often very thin.
- Banking supervision and regulation are often inefficient and seldom independent from political pressure. Financial and commercial legislation, and the associated institutional environment, are inadequate in many countries. The low level of computerization and the generally limited use of technologies also hamper the development of the financial system.

All these factors require attention, as they reduce the efficiency of financial intermediation, raise borrowing

costs, reduce saving incentives, increase the risk of bank failure, and also increase the likelihood that private sector borrowers may be unable to obtain finance even for viable projects.

Progress in financial sector reform often does not provide immediate benefits, not only with respect to output growth, but also with regard to the development of financial intermediation. After years of financial distortion, repression, and underdevelopment, businesses and households, and also the public sector, have to learn and adapt to the different environment, where decisions on bank lending and the corresponding interest rates are no longer made by the government, but by market forces in a competitive environment, with financial institutions basing decisions on new kinds of information to assess the creditworthiness of borrowers. The benefits of financial development may therefore take time to accrue.

Infrastructure

SSA countries need to redirect public spending partly toward increasing the quantity and improving the quality of infrastructure, not only to stimulate investment and growth, but also to reduce poverty and income inequality, and to minimize environmental damage.²⁹

Many of the high-growth SSA countries have benefited from having a larger initial stock of infrastructure than slow-growth countries, and from faster growth rates of infrastructure over the past 20 years (Table 6.4). The quality of infrastructure is, of course, also important. In many countries few roads are paved, raising transportation costs, and the public supply of electricity is unreliable, causing firms to install their own private generators, with associated increases in production costs.³⁰ For landlocked countries, improvements in transport infrastructure would enhance economic integration with other countries, thus stimulating trade and growth.³¹

Despite recent improvements, further investment in infrastructure is essential. By one indicator, in 1995–97, the average number of telephones per employee in SSA countries was about two-thirds of that in the Middle East and North African region, and one-third of that in the Western Hemisphere, with the differences widening in the first half of the 1990s.

After decades of exclusive central government provision of infrastructure, the 1990s have witnessed the emergence of a new strategy: the promotion of local community involvement and the stimulation of private

²⁸Gelbard and Leite, "Measuring Financial Development in Sub-Saharan Africa." The index of overall financial development encompasses measures of the competitiveness of financial markets, the degree of financial liberalization, the quality of financial institutions' services, the extent of financial integration with foreign markets, and the availability of monetary policy instruments.

²⁹See African Development Bank, *African Development Report* (Oxford: Oxford University Press, 1999).

³⁰For small firms, generators can account for as much as a quarter of the value of their capital equipment.

³¹See Sachs and Warner, "Sources of Slow Growth in African Economies," on the importance of geographic factors for growth.

Table 6.4. Sub-Saharan Africa and Other Developing Country Groups: Infrastructure Indicators

	Telephone Lines per Employee			Growth Rate of Telephone Lines per Employee		Paved Road/Total Road		
	1980–84	1995–97	1970–97	1995–97	1970–97	1980–84	1995–97	1970–97
Asia	11	81	24	29	12	...	...	...
Advanced economies	111	216	143	3	4	...	...	...
Western Hemisphere	63	182	89	15	7	...	...	...
Middle East and Europe	32	92	52	14	8	...	...	...
Sub-Saharan Africa	21	62	36	10	7	...	...	...
World	103	180	127	2	4	...	...	...
SSA countries: unweighted grouping by yearly per capita GDP growth rate in 1970–98								
High growth (top quintile)	20	39	23	20	12	21	33	29
Medium growth	12	32	20	10	7	9	15	14
Low growth (bottom quintile)	11	19	14	4	1	8	14	12
Memorandum								
SSA: unweighted average ¹	13	31	20	11	7	10	18	16
CFA: unweighted average ²	11	28	17	17	13	7	15	11

Source: World Bank, World Development Indicators (regional groupings may differ from the WEO classifications).

¹Sub-Saharan Africa.

²Communauté Financière Africaine and Coopération Financière en Afrique.

sector participation, including through the privatization of state-owned enterprises. This strategy has succeeded in improving the development, management, and efficiency of infrastructure services and seems likely to be an important ingredient of future infrastructure policies.

The Debt Problem and the HIPC Debt Relief Initiative

In the past 30 years, the foreign indebtedness of most SSA countries has risen alarmingly. The total external debt of the region rose from almost \$9 billion in 1971 (or 14 percent of area GNP) to \$107 billion in 1985 (56 percent of GNP) and to \$220 billion in 1997 (68 percent of GNP).³² By the mid-1980s, external debt had already risen to high levels for many countries. In 1985, 24 SSA countries (out of 47) had nominal debt-to-export ratios above 250 percent, and 22 countries had debt service-to-export ratios above 20 percent (Table 6.5).³³ The creditors were mostly official: excluding South Africa, only one-quarter of external debt was owed to private creditors and most of that was guaranteed by the public sector of the borrowing country.

³²The overall debt-to-GDP ratios mask large differences among countries. Small countries tend to be more indebted, relative to GDP, than large ones, as shown by the unweighted average debt-to-GDP ratio of SSA countries, which was 124 percent in 1997.

³³Debt service due, which includes amortization payments but for which broad data are unavailable, would be an even larger percentage of GDP.

Official donors have provided large amounts of concessional financial assistance through official development assistance (ODA) and debt relief, aimed at reducing the burden of the debt and debt service. Debt relief provided to SSA countries, in the form of reductions or rescheduling of principal (often at reduced interest rates) and of interest falling due, averaged more than 3 percent of recipient countries' GNP annually over the past 15 years. Official aid, in the form of grants or concessional lending, rose from slightly above 2 percent of the GNP of SSA countries on average in 1970–84 to almost 6 percent in 1985–1994, and subsequently declined to 4.5 percent of GNP in 1995–98. The share of concessional debt rose from 28 percent in the first half of the 1980s to 37 percent in the second half of the 1990s. Despite official financial assistance, external debt burdens remained unsustainable in many countries, some of which became more and more dependent on the continuation of such assistance. As of 1997, the ratio of the net present value (NPV) of debt to GNP averaged 92 percent, while the ratio to exports reached 347 percent (Table 6.5). There were 19 countries with ratios of the NPV of debt to exports above 250 percent, and 12 countries with debt service-to-export ratios above 20 percent.³⁴

³⁴The net present value of the debt is a more meaningful measure of the existing effective liability than nominal debt, whenever loans have been contracted or rescheduled at concessional rates: the lower the concessional rate, the lower the net present value of all future debt-service obligations (interest and principal) discounted at the market rate.

Table 6.5. Sub-Saharan Africa: Selected Debt Sustainability Indicators

	Debt to GNP 1985	Debt to Exports 1985	Debt-Service to Exports 1985	Debt to GNP 1997	Debt to Exports 1997	Debt-Service to Exports 1997	NPV of Debt to GNP ¹ 1997	NPV of Debt to Exports ¹ 1997
Sub-Saharan Africa	56	171	18	68	202	13	...	...
High growth (top quintile)	106	356	20	113	325	11	92	217
Medium growth	79	437	23	120	506	16	83	389
Low growth (bottom quintile)	121	479	19	151	517	14	126	349
<i>Memorandum</i>								
SSA: unweighted average ²	92	432	22	124	474	15	92	347
CFA: unweighted average ³	91	241	21	106	294	12	79	214
SSA HIPC: unweighted average ⁴	108	572	27	162	635	18	114	469

Source: World Bank, Global Development Finance.

¹NPV refers to net present value.

²Sub-Saharan Africa.

³Communauté Financière Africaine and Coopération Financière en Afrique.

⁴Sub-Saharan Africa, Heavily Indebted Poor Countries.

Reasons Behind Debt Accumulation to Unsustainable Levels

There are several reasons for the accumulation of the huge debt of SSA countries and its unsustainability, ranging from external factors to inappropriate policies in both borrowing and lending countries. Large loans and sizable official financial assistance were often requested and granted without significant conditionality attached, partly in view of overly optimistic expectations of output and export growth, and without regard to the high economic and political uncertainty characterizing the region. SSA countries were generally unsuccessful in channeling these financial inflows into productive investment, which would have enhanced growth and export-earning capacity and allowed the loans to be repaid. Economic stabilization and reform efforts were often not sufficient to create an economic and institutional environment conducive to growth, and in some cases were undermined by political instability.

External factors, such as terms of trade shocks and, to a lesser extent, adverse weather conditions, reduced the market value or the volume of exports.³⁵ The inflow of financial assistance was often poorly managed, thus reducing the economic return on aid programs: corrupt practices sometimes took their toll on available resources, while the fungibility of aid allowed governments to deflect financial assistance towards implicitly financing alternative projects politically more appealing but economically less productive than those originally targeted by the donors.³⁶

³⁵For evidence on policy and exogenous factors contributing to the accumulation of large and unsustainable debt, see Ray Brooks et al., "External Debt Histories of Ten Low-Income Developing Countries: Lessons from Their Experience," Working Paper 98/72 (Washington: IMF, May 1998).

³⁶When foreign aid is provided to finance essential projects that would be pursued by the authorities even in the absence of such aid,

High indebtedness aggravated the situation, as debt-service costs claimed a rising share of export earnings and limited the fiscal resources available for productive expenditure. It also discouraged investment (especially foreign), both because of the resulting lack of infrastructure, and because of the effects of the actual and expected burden of taxation.³⁷ Moreover, it reduced the amount of financial assistance available to finance new projects, as almost a third of financial aid provided to SSA countries is estimated to have been devoted to the servicing of past loans.³⁸

Official aid was not always based on economic criteria relating either to need, such as low levels of income per capita and inability to find alternative foreign resources, or to policy performance. In fact, official aid was often driven by political and strategic consideration,³⁹ especially during the cold war, and including the support of former colonies. Much official aid has been tied to the purchase of goods and services produced by the donor country and sold at uncompetitive prices.⁴⁰ Empirical evidence suggests that coun-

it actually frees fiscal resources that become available for alternative use ("fungibility"). In this case, foreign aid "effectively" finances such alternative use, or public expenditure at the margin. For a discussion and estimates of the fungibility of aid, see Shantayanan Devarajan, Andrew S. Rajkumar, and Vinaya Swaroop, "What Does Aid to Africa Finance?" Policy Research Working Paper 2092 (Washington: World Bank, 1998).

³⁷For evidence on the impact of the debt overhang on investment and growth in SSA countries, see Ibrahim A. Elbadawi, Benno J. Ndulu, and Njuguna Ndung'u, "Debt Overhang and Economic Growth in Sub-Saharan Africa," in Zubair Iqbal and Ravi Kanbur, eds., *External Finance for Low-Income Countries* (Washington: IMF, IMF Institute, 1997).

³⁸Devarajan, Rajkumar, and Swaroop, "What Does Aid to Africa Finance?"

³⁹Alberto Alesina and David Dollar, "Who Gives Foreign Aid to Whom and Why?" NBER Working Paper No. 6612 (1998).

⁴⁰Barfour Osei, "The Cost of Aid Tying to Ghana," University of Ghana, mimeo, presented at the African Economic Research Consortium Research Workshop, Nairobi, Kenya, December 5–10, 1998.

tries' economic performance has benefited lastingly from official assistance only when the aid has been accompanied by appropriate stabilization and reform policies.⁴¹

The HIPC Initiative

Under the HIPC Initiative, developed jointly by the IMF and World Bank in 1996, eligible heavily indebted poor countries can receive from the international community sufficient financial assistance, in addition to traditional relief mechanisms, to reduce their debt to a sustainable level. To qualify for such assistance, countries have to meet certain requirements; in particular, (1) they have to be ESAF-eligible and IDA-only eligible countries, (2) they must have established and sustained a record of strong policy adjustment and reform in the context of programs supported by the IMF and the World Bank, and (3) their external debt situation at the "completion" point must remain unsustainable after the full adoption of traditional debt-relief measures.⁴²

There are three reasons why the HIPC Initiative is expected to have a stronger impact on growth than the debt-relief mechanisms of the past 15 years.

- First, the financial assistance under the initiative has to be preceded by significant macroeconomic and structural reforms, which have been shown to provide benefits in terms of growth (as previously discussed).
- Second, insofar as the HIPC Initiative will reduce debt to a sustainable level, it should greatly reduce the drag that debt servicing imposes on investment and economic growth.
- Third, the commitments both of the donor countries to write off part of the debt, and of the borrowing countries to reform, in order to permanently eliminate the need of regular rescheduling, should appear more credible under the HIPC Initiative than under previous assistance programs. This credibility effect should boost domes-

tic and foreign investment, by reducing political and economic uncertainty.

Twenty-six SSA countries have been classified as HIPC countries—a majority of the 41 HIPC countries worldwide. Uganda and Mozambique are the only SSA countries that have already received HIPC assistance; Burkina Faso, Côte d'Ivoire, and Mali have received commitments of assistance subject to the successful implementation of programs supported by ESAF arrangements; while for Benin and Senegal their debt has been judged sustainable without HIPC assistance (although these two countries may qualify for assistance under the proposed strengthening of the HIPC Initiative). These seven countries improved their performance between the first and second halves of the 1990s more than other SSA countries, but given their less advantageous starting positions there is at present no significant difference in saving-investment ratios, the degree of openness, the ability to attract foreign private capital, the level of infrastructure, or the overall quality of the institutional and political environment between these countries and the SSA average. Thus further efforts will be needed to spur investment and generate satisfactory, sustainable growth, including in areas such as reforming the public sector, improving legal and political institutions, stabilizing the political situation, developing the financial system, and improving the quality and quantity of infrastructure. In the absence of such further steps, growth performance and prospects may not improve, irrespective of the help provided by the HIPC Initiative.

The Path to Sustained Growth

Economic growth in sub-Saharan Africa has long been woefully inadequate to the needs of the region, although recent improvements are encouraging. This chapter has discussed the main reasons for the poor performance and the main areas where further reforms are needed to improve growth prospects.

The poor growth performance of the SSA region may be attributed largely to the interaction of economic, political, social, institutional, and geographic factors that have prevented the development of the right conditions for productive investment to flourish. However, Africa is not doomed to remain poor. Most of these factors can be changed, provided that governments have the determination and perseverance to pursue consistently the long agenda of needed reforms.

- In many countries, an essential condition is to establish peace and a stable political situation, reversing the recent trend of a rising number of conflicts (see Box 6.1, page 138).
- SSA countries should continue to press ahead with macroeconomic stabilization programs that control inflation and curtail excessive budget deficits, improve the use of public resources, and

⁴¹Burnside and Dollar, "Aid, Policies, and Growth," and Dollar and Easterly, "The Search for the Key."

⁴²For technical and historical information regarding the HIPC Initiative, see October 1998 *World Economic Outlook* (Box 1.1) and Anthony R. Boote and K. Thugge, "Debt Relief for Low-Income Countries: The HIPC Initiative," Pamphlet Series No. 51 (Washington: IMF, 1999). Debt sustainability is defined, on the basis of past experience, by generic thresholds: NPV of debt-to-export ratio below 200–250 percent and debt service-to-exports ratio below 20–25 percent; these thresholds are adjusted for other fiscal, financial, and external factors that may affect country-specific vulnerability. A good evaluation of the effects of the HIPC Initiative is provided by Stijn Claessen and others, "HIPC Debt: A Review of the Issues," *Journal of African Economies*, Vol. 2 (1997). Enhancement of the HIPC Initiative, with less restrictive criteria, more favorable assistance schemes, faster procedures, and an explicit link to poverty reduction has recently been endorsed by the G-8 at the Cologne Meeting (June 18–20, 1999) and is currently under preparation.

further reduce trade and exchange restrictions. These are important elements of programs supported by the IMF and World Bank.

Equally important, governments should intensify their efforts in the following areas:

- Intensify programs aiming at the improvement of health and education.
- Improve the efficiency and quality of public services, fight corruption, enhance the protection of property rights, and increase the respect for law and the impartiality of the legal system.
- Stimulate the development and improve the efficiency of financial markets and institutions, which constitutes a necessary precondition for pursuing the liberalization of the capital account.
- Devote sufficient resources increasing the stock of infrastructure as well as enhancing its quality.
- Highly indebted SSA countries should take full advantage of the opportunity offered by the HIPC Initiative to intensify and press ahead with reforms while benefiting from the debt reduction.

Only if combined with domestic efforts can international support reduce the external debt burden, allow countries to gain the confidence of world financial markets, and restore their ability to borrow under normal conditions to finance sustainable growth.

Such policies will improve the economic environment for private sector activity, by improving political and economic stability, enhancing social capital, and providing the right incentives for stimulating the accumulation of productive physical and human capital. At the same time, the implementation of such measures may well increase the amount of official development assistance, as donor countries become more convinced of its beneficial effects.

At the turn of the millennium, the HIPC Initiative could provide the right incentive for a concerted regional implementation of the long but essential agenda necessary to bring Africa on to a path of sustainable growth in the context of globalized trade and financial markets.