

**Economic Alternatives for Sub-Saharan Africa:  
'Poverty Traps', MDG-Based Strategies  
And Accelerated Capital Accumulation**

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**Terry McKinley, UNDP<sup>1</sup>**

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<sup>1</sup> Policy Adviser on Economic Policies and Poverty Reduction, Bureau for Development Policy, UNDP, New York.

## Abstract

This paper addresses the problem, which is posed by the U.N. Millennium Project, that many countries in sub-Saharan Africa are caught in a 'poverty trap', the main cause of which is a lack of national savings. The paper briefly examines the possible causes for low savings in sub-Saharan Africa and shows that even for the countries growing the fastest since 1990s, savings performance is often inadequate. Much of their investment is financed by external capital flows, especially ODA. More troubling is that they are not making progress on basing their investment on domestic resource mobilization.

The paper also highlights the dynamics of global savings, showing that the United States absorbs almost 72 per cent of all global excess savings (which is seven times the level of total ODA). Other rich countries (such as Japan and Germany), developing countries (such as China), and oil exporters (such as Russia and Saudi Arabia) are the big exporters of capital. The problem is that their excess savings is not being recycled to poor countries, where it is most needed. Changes in the economic policies of savings-surplus countries and rich savings-deficit countries, such as the U.S., are necessary, and will play a larger role in redistributing global income than ODA.

In response to these problems, the paper suggests economic policies that, it believes, are growth-oriented and conducive to domestic capital accumulation. It recommends fiscal policies focused on public investment, which, it argues, can 'crowd-in' private investment and stimulate more rapid growth. In order to create the 'fiscal space' for such investment, the paper argues strongly for dramatic debt reduction.

The paper also maintains that the domestic revenue base of governments should be boosted to 20-25 per cent of GDP in order to provide essential public services and infrastructure. Part of the problem has been the loss of tariff revenue as a result of trade liberalization and the inability of the value added tax to compensate for this. The implication is more caution in liberalizing trade and more attention to making the VAT efficient. In addition, in order to keep tax systems moderately progressive, the paper counsels against dramatically lower tax rates on corporate profits and personal income.

For monetary policy, the paper argues against strict 'inflation-targeting', especially when cost-push factors cause a significant proportion of inflation in sub-Saharan Africa. It recommends that central banks use a more flexible definition of price stability and gear monetary policy to growth and employment generation as well as the containment of inflation. The impact of inflation on the exchange rate can be moderated, the paper maintains, by a managed float of the exchange rate.

The paper maintains that commercial banks are hampering development by restricting access to credit for long-term private investment. Banks also have problems in attracting savings deposits. The paper focuses its recommendations on providing incentives to banks to lend long term. Such incentives could include loan guarantee schemes or differential asset-based reserve requirements. Where appropriate, reviving the role of development banks might also make sense. For increasing deposits, the paper recommends consideration of measures such as deposit insurance schemes.

## Introduction

The starting point of this paper is the report of the U.N. Millennium Project team, “Ending Africa’s Poverty Trap”, published by the Brookings Institution (Sachs et al. 2004; see also U.N. Millennium Project 2005). The basic premise of this report is that the main problem in Africa is not slow growth *per se* but a ‘structural trap’ that prevents countries from achieving rapid and sustained growth. Thus, this ‘structural trap’ (what the report calls a ‘poverty trap’) needs to be directly addressed; otherwise, Africa will be blocked from growing and developing.

For the Millennium Project, the main solution is a rapid and large infusion of external development finance. In other words, a ‘big push’ in Official Development Assistance is needed in order to extricate Africa from its ‘poverty trap’. ODA can be either concessional loans or grants. For Africa, the Millennium Project favors grants since they do not increase external debt.

ODA is not, of course, the only source of development finance. Other external sources of finance include commercial loans, portfolio investment and foreign direct investment. Current transfers, such as remittances (which are a significant inflow in many developing countries), can also be converted, in part, into domestic investment. Debt relief, on past commercial or concessional loans, can also free up public resources for financing development.

Domestic sources of finance include public revenue (such as taxes) and private savings (such as household savings and corporate retained earnings). The former is the basis for financing increased public investment. The later is the basis primarily for financing increased private investment.

For the Millennium Project, the primary constraint in Africa is low national savings. Domestic finance is not sufficient to raise capital per worker (‘capital deepening’). A rise in this ratio is considered the driving force of economic growth.<sup>2</sup> The lack of capital per worker is a serious problem in Africa because the rapid growth of the labour force in many countries has been spreading the available capital over a larger number of workers (‘capital widening’).

Before proceeding, we note three issues related to ‘capital deepening’ and ‘capital widening’. The first is that the concept of ‘capital deepening’ should be interpreted in a broad sense. Increased human ‘capital’ could be considered part of ‘capital deepening’, for example. Environmental assets should also be included in such accounting.<sup>3</sup>

A second point is that capital per worker could be increased by slowing the growth of the labour force, i.e., hastening the demographic transition. But if the proportion of workers in the population declined, the corresponding rise in the dependency ratio (the number of dependants per worker in each household) would likely lower domestic savings. Such demographic factors are often powerful determinants of domestic savings rates. In sub-Saharan Africa, the dependency ratio is high, namely, 0.9 dependants for every worker, but 88 per cent of dependants are younger than 15. Such a

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<sup>2</sup> Technological progress, which improves the efficiency of capital, is often considered the main long-term determinant of economic growth but the Millennium Project does not consider this to be the chief constraint for development in Africa. In this paper, we do not explore this important issue further.

<sup>3</sup> This point opens up a much broader discussion, which goes beyond the focus of this paper. The World Bank has developed a measure of ‘adjusted net savings’, which takes into account not only education expenditures but also depletion of environmental assets.

high degree of dependency can dampen domestic savings. This ratio will decline since the population growth rate is projected to decline from 2.5 to 2.0 per cent per year over the next ten years. We will return to the issue of determinants of savings later.

A third point, which is not possible to ignore in much of Africa, is that the HIV/AIDs epidemic is slowing the growth of the labour force, as well as reducing human ‘capital’ (the number of skilled workers). The epidemic is disproportionately affecting people of working age.

For the Millennium Project, the main manifestation of the ‘structural trap’ confronting Africa is the ‘savings trap’. When national savings are too low, capital per worker remains too low (as the labour force continues to grow). Moreover, capital per worker not only remains low, but it also begins to decline because of both the growth of the labour force and the depreciation of capital. As capital per worker declines, output per person declines. Africans become poorer in income terms.

Domestic savings are indeed low in sub-Saharan Africa. Gross national savings as a ratio to gross national income was only about 17 per cent in 2003 (Table 1). Gross national savings is gross national income minus private and public consumption plus net current transfers. This compared to 23.1 per cent for all low-income countries in 2003. Another measure of savings, which takes account of the impact of the depreciation of fixed capital, is net national savings. When investment remains low, the capital stock is not being replaced, and thus begins to age and deteriorate.

**Table 1. Gross and Net National Savings  
(Percentage of Gross National Income in 2003)**

	Middle- Income Countries	Low- Income Countries	East Asia and the Pacific	South Asia	Sub- Saharan Africa
Gross National Savings	27.9	23.1	41.8	24.9	16.9
Net National Savings	17.8	14.2	32.6	15.9	6.3

Source: World Bank, World Development Indicators 2005, Table 3.15

Note: See Appendix Table 1.

In all low-income countries, net national savings was about 14 per cent in 2003 (Table 1). In East Asia and the Pacific, however, it was over 32 per cent. In sub-Saharan Africa, by contrast, it was about six per cent. In effect, this is a very small pool of national savings to finance net increases in capital stock. See Appendix Table A1 for the net national savings rates of 34 countries in sub-Saharan Africa.

### **What Are the Causes of Low Savings?**

Why are Africa’s savings so low? There are various explanations. We have mentioned demographic factors already. Another common explanation is that when incomes are low, a very large proportion of the total has to be devoted to ‘survival consumption’. In other words, Africans are ‘too poor’ to save. Yet poor countries in other regions of the world—particularly in East Asia—have succeeded in saving, accumulating capital and developing. What is holding Africa back from doing so?

Another explanation is that Africa lacks financial institutions—namely, institutions that can mobilize and ‘monetize’ domestic savings. This could indeed be an important factor. As a ratio to GDP, banking-sector credit was about 75 per cent in 2003 in sub-Saharan Africa, compared to about 45 per cent for all low-income countries (Table 2). Of course, the ratio for South Africa was about 158 per cent, which weighs heavily in the aggregate for Africa. If the impact of South Africa is netted out, then the ratio for the rest of Africa is only 27.7 per cent. Lack of credit is not the only problem, however. Very little credit seems to be financing productive private investment.

**Table 2. Domestic Credit as a % of GDP, 2003**

	Low- Income Countries	Sub- Saharan Africa	South Asia	East Asia and the Pacific	Middle- Income Countries
Domestic Credit from the Banking Sector	45.3	74.6	53.2	150.9	85.3

Source: World Bank, World Development Indicators 2005, Table 5.5

Another explanation for low savings is that there is a lack of investment opportunities in Africa. For some forms of investment, such as in land, for example, the act of investment is simultaneously an act of savings. There is also the general Keynesian explanation that investment creates its own savings, through the ‘multiplier-accelerator’ model (Pollin 2002). This approach emerged in opposition to the Pre-Keynesian view that the saving rate is the main determinant of investment. However, the Keynesian model does not explain how the first burst of autonomous investment, which initiates the ‘multiplier-accelerator’ process, can be financed (Ibid., p. 4 based on Kaldor 1960).

When savings are low, it might be difficult to jumpstart the initial phase of self-sustaining capital accumulation. The state might have to intervene not only to generate an initial pool of national savings but also to direct it to long-term productive investment. This factor appears to be one of the explanations of the rapid economic progress of some East Asian economies. So, neither the Neo-liberal position on savings (namely, that financial liberalization will surely amplify savings and savings, in turn, will be channeled to finance private-sector investment) nor the Keynesian position on savings (namely, that investment will generate its own savings) is totally satisfactory for underdeveloped economies. Neither position presents an adequate theory of capital accumulation.

Part of the explanation for low savings in Africa might be relatively high inequality. The argument would be that a highly skewed income and wealth distribution leads to wasteful elite consumption, instead of high savings (the latter being what conventional wisdom assumes).

An extension of this argument would that the rich in Africa are involved in causing substantial capital flight. Some analysts have argued, for instance, that far from being heavily indebted, many sub-Saharan African countries are net creditors to the rest of the world (Boyce and Ndikumana 2000). While the governments of these countries might be net debtors, the countries themselves are net creditors because well-to-do Africans spirit much of their wealth out of the continent. Boyce and Ndikumana estimate, for example, that cumulative capital flight totaled about US\$ 285 billion (including imputed interest earnings) for 25 sub-Saharan countries during 1970-1996. This was

about 1.6 times their total stock of external debt. Capital flight is undoubtedly a significant factor in explaining the relatively low domestic savings rates in Africa.

### **The Sources of Slow Growth in Africa**

Given the conditions in sub-Saharan Africa, what can be done to initiate a more rapid process of domestic capital accumulation? What growth strategies are most appropriate for these countries? The U.N. Millennium Project advocates a ‘Big Push’ in public investment, financed, at least initially, by a substantial increase in Official Development Assistance. If such a growth strategy is followed, how can public investment be designed to stimulate increased private investment? And if the initial push is “ODA-led”, how can this approach be converted into a sustainable process of domestic resource mobilization?

In order to accelerate capital accumulation, Africa needs a post-stabilization, MDG-oriented policy agenda. This implies that the ‘second generation’ of Poverty Reduction Strategies, which are currently being formulated in many countries, should be MDG-based—e.g., more ambitious, more growth-oriented and more geared to long-term capital accumulation and development. In other words, Poverty Reduction Strategies should be transformed into more long-term development strategies. The ‘first generation’ of Poverty Reduction Strategies (mainly PRSPs) was fixated on stabilization and social safety nets.

One of the major obstacles to making such changes is a continuing ideological mindset wedded to restrictive fiscal and monetary policies. But such policies are becoming increasingly inconsistent with MDG-based Poverty Reduction Strategies. To begin with, they contradict the need for more rapid economic growth in Africa. In fact, it is becoming increasingly clear that “Washington Consensus’ economics has not produced viable growth strategies for developing countries, and certainly not for Africa. The underlying problem is that there is no real theory on how to foster a self-sustaining process of rapid capital accumulation.<sup>4</sup> Many East Asian economies have solved this problem by adopting an aggressive export-led development strategy. Corresponding strategies that would be appropriate for Africa have yet to be devised.

The rate of economic growth in sub-Saharan Africa has certainly accelerated in the last 10-15 years. The rate of growth of GDP was 2.8 per cent during 1990-2003, for example. However, this compares favorably only to its very low rate of growth during the 1980s, namely, 1.7 per cent. Also, since the rate of population growth was 2.5 per cent during 1990-2003, the rate of growth of income per person was barely above zero.

An additional problem has been the instability of growth. For example, in only six of the 39 years from 1961 to 1999 was the standard deviation of growth rates for sub-Saharan African countries lower than the average growth rate of all countries.<sup>5</sup> Much of this instability is due to terms of trade shocks and to variable weather that affects agriculture. Although not conclusive, the available evidence suggests that this degree of instability has served to lower average growth rates. What is incontestable, however, is that such instability means that a significant proportion of the population in Africa is frequently plunged into poverty.

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<sup>4</sup> World Bank. 2005b. *Economic Growth in the 1990s: Learning from a Decade of Reform*. Washington D.C.: World Bank. p. 11.

<sup>5</sup> Weeks 2005. p. 28.

**Table 3. Poverty-Reducing Growth of Some African Economies**

Country	GDP Growth (% per year) 1990-2003	Gross Domestic Savings (% of GDP) 2003	Gross Capital Formation (% of GDP) 2003	Aid as a % of Gross National Income 2003	Gross FDI as a % of GDP 2003
<b>Benin</b>	5.0 (2.3) <sup>a</sup>	5	18 (14) <sup>b</sup>	8.5	3.9
<b>Botswana</b>	5.2 (2.9)	38	27 (37)	0.4	8.3
<b>Burkina Faso</b>	4.2 (1.8)	4	19 (18)	10.8	0.4
<b>Ethiopia</b>	4.3 (2.0)	1	20 (12)	22.8	--
<b>Ghana</b>	4.3 (2.0)	11	23 (14)	12.2	1.8
<b>Guinea</b>	4.2 (1.8)	7	10 (18)	6.6	2.2
<b>Mali</b>	4.9 (2.4)	19	23 (23)	12.7	12.4
<b>Mauritania</b>	4.4 (1.8)	3	45 (20)	20.9	--
<b>Mauritius</b>	4.1 (4.1)	25	23 (31)	-0.3	1.3
<b>Mozambique</b>	4.8 (4.8)	11	28 (22)	25.1	7.8
<b>Senegal</b>	4.0 (1.4)	8	20 (14)	7.0	2.7
<b>Sudan</b>	5.7 (3.4)	25	21 (--)	3.8	7.6
<b>Tanzania</b>	3.7 (1.1)	10	19 (26)	16.3	2.5
<b>Uganda</b>	6.8 (3.9)	7	21 (13)	15.6	3.1
<b>Sub-Saharan Africa</b>	2.8 (0.3)	18	19	6.0	1.9
<b>-- Nigeria</b>	2.7 (0.0)	32	23 (15)	0.6	--
<b>--South Africa</b>	2.3 (0.3)	19	17 (17)	0.4	1.0

Source: World Bank, *World Development Indicators 2005*, Tables 4.1, 4.9, 6.1, 6.10

Notes: 'a' is per capita growth rates; 'b' is capital formation for 1990.

Jumping to gloomy conclusions about Africa's growth prospects would be misplaced, however. There are 14 countries that achieved rates of economic growth during 1990-2003 that would be rapid enough to halve extreme income poverty by 2015 should they be sustained (Table 3).<sup>6</sup> Although most of these rates are not spectacular, they have been maintained over 14 years. While Botswana and Mauritius are middle-income countries, the rest are low-income. Since the absolute size of each of these 14 economies is not large, the growth rates of these countries do not impart a more positive picture to the whole region.

South Africa and Nigeria are included at the bottom of the table because they are such large, important economies. South Africa, which accounts for over 36 per cent of sub-Saharan Africa's GDP, had a growth rate of GDP of only 2.3 per cent per year during 1990-2003 (0.3 per cent per capita); Nigeria, which accounts for another 12 per cent of the region's output, grew by 2.7 per cent (0.0 per cent per capita) (Table X). These two potential growth poles need to achieve significantly higher rates in order to have a

<sup>6</sup> The per capita growth rate for Tanzania is low, i.e., 1.1 per cent, but it is included in the table because its more recent growth rate has been higher. Countries with recent high growth rates, such as Chad, could eventually join the group of 14 countries. Also, other much smaller economies, such as Cape Verde and Equatorial Guinea, could have been included now in the table. But lack of comparable data for these countries posed a problem in examining their experiences.

positive impact on other countries in the region. While Nigeria's economy has prospered recently (achieving a 10.7 per cent yearly growth rate of GDP in 2002-2003), mainly because of rising oil revenues, South Africa's has sputtered (limping along at a 1.9 per cent rate).

An examination of the other columns of Table 3 provides some hints about the general factors behind the performance of the 14 countries. Gross domestic savings does not correlate well with these countries' above-average growth rates. As a ratio to GDP, savings varies from 38 per cent for Botswana and 25 per cent for both Mauritius and Sudan to four per cent for Burkina Faso, three per cent for Mauritania and one per cent for Ethiopia.

There is much a closer correlation between growth rates and investment rates (expressed as gross capital formation). As a ratio to GDP, gross capital formation is above-average among these countries. With one exception (Guinea), investment rates are about 20 per cent or higher. However, many of these countries do not have the domestic savings rates to back up these investment rates. A few countries do: Botswana, Mauritius and Sudan. But this can be explained partly by export of rich natural resources (or an aggressive export-led strategy in the case of Mauritius). However, other countries, such as Ethiopia, Mauritania, Mozambique, Tanzania and Uganda, which have low domestic savings rates, rely heavily on ODA to finance their investment. Some of the countries with low domestic savings, such as Mali and Mozambique, are also able to draw on significant foreign direct investment.

In general, the pool of external savings provided by ODA and FDI has filled in for the lack of domestic savings in many of these growing economies. This could be a cause for distress or hope, depending on how one views the relationship between aid and development. Botswana and Mauritius can be excluded from consideration because aid has not played a major role in their economies. For the remaining eleven countries with data, six countries experienced increasing domestic savings rates over 13 years while five countries experienced decreasing rates. For some of the countries with increases, the results were marginal: Benin increased its rate from two to five per cent and Uganda from one to seven per cent. For some other countries, such as Ghana, Mozambique and Tanzania, the increases were more substantial but their 2003 savings rates remained only 10-11 per cent.

What is even more worrisome is that savings decreased for some countries that already had very low rates in 1990: Burkina Faso's rate declined from five to four per cent, Ethiopia's from seven to one per cent and Mauritania's from five to three per cent. For almost all the countries that performed poorly with regard to mobilizing domestic savings, ODA accounted for about 10-20 per cent of their GDP. This simple analysis is revealing. The implication is that unless the development strategies of these countries are transformed, continuing high levels of ODA—if not increasing levels—will be necessary to underwrite their growth. Clearly, ODA is not being converted into enhanced capacities to mobilize domestic resources. This is not, however, an argument for reducing ODA, but for redirecting it.

### **The Dynamics of Global Savings**

While many development specialists, such as those in the U.N. Millennium Project team, are calling for a dramatic scaling up of Official Development Assistance, the dynamics of



global savings and investment are working against poor developing countries, particularly in sub-Saharan Africa.<sup>7</sup> The biggest importers of capital are a few rich industrial countries. The United States alone imports an incredibly high percentage of all capital flows, namely, about 72 per cent. The United Kingdom and Australia together import roughly another eight per cent of the total. Spain and Italy together import roughly another six per cent (Table 4).

Some of the biggest exporters of capital are other rich industrial countries. Japan exports over one fifth of all capital exports, Germany exports almost eight per cent and Switzerland over six per cent. But China ranks third, exporting almost seven per cent. If Hong Kong SAR and Taiwan Province were included, this bloc would account for 14 per cent of the total. After Switzerland, Russia exports over five per cent of all capital and Saudi Arabia exports 4.4 per cent.

**Table 4. Major Exporters and Importers of Capital**

<b>Capital Exporting Countries</b>	<b>Percentage of Total Capital Exports</b>	<b>Capital Importing Countries</b>	<b>Percentage of Total Capital Imports</b>
Japan	20.5	United States	71.5
Germany	7.8	United Kingdom	4.1
China (Mainland)	6.9	Australia	4.1
-- <i>Taiwan Province</i>	4.5	Spain	3.2
-- <i>Hong Kong SAR</i>	2.6	Italy	3.0
Switzerland	6.4	Greece	1.4
Russia	5.3	Mexico	1.2
Saudi Arabia	4.4		
Norway	4.3		
Singapore	4.2		
Canada	2.6		
Netherlands	2.3		

Source: IMF, *Global Financial Stability Report*, 2005, p. 147.

The net capital inflow into the United States in 2003 was about US\$ 550 billion (Table 5). This was about seven times higher than the total Official Development Assistance given by donor countries in that year, namely, about US\$77.4 billion.

For emerging economies and developing countries as a whole (IMF designation), the net outflow of capital was close to US\$ 290 billion, or about 53 per cent of the U.S. net capital inflow. In other words, these countries were exporting their savings instead of channeling it into domestic investment. Most of the countries in this grouping that exported capital are middle-income countries, many of them in Asia. Some of capital exporters are transition economies, such as Russia; others are oil exporters, such as Saudi Arab. Newly industrialized countries—a separate category for countries such as the Republic of Korea and Singapore—have also been capital exporters.

<sup>7</sup> This section draws heavily on the paper by Alex Izurieta, 2005, “Can the Growth Patterns of the U.S. Economy Be Sustained by the Rest of the World?”, Draft Paper for the Poverty Reduction Group of UNDP, June 2005 and Terry McKinley 2005b, “Global Savings Is Flowing Uphill (to One Country): Redistributing Capital Through Fiscal Expansion in Developing Countries.” Draft, August.

**Table 5. Total Capital Inflows and Outflows  
(billions of US Dollars)**

Country/Region	Capital Inflow 1993	Capital Outflow 1993	Capital Inflow 2003	Capital Outflow 2003	New Inflow 2003 <sup>b</sup>
United States	262.1	-220.5	829.2	-283.4	549.8
Japan	-38.7	-90.0	121.5	-242.3	-120.8
United Kingdom	251.6	-230.5	591.0	-557.3	33.7
Euro Area	--	--	645.9 (700.8) <sup>a</sup>	-686.4 (-688.1) <sup>a</sup>	-40.5
Emerging/ Developing Countries	206.8	-103.0	347.4	-636.8	-289.4

Source: IMF, *Global Financial Stability Report*, 2005, Table 1, p. 160-161.

Note: 'a' stands for 1999, the first year available for the Euro Area. 'b': the table does not include other industrial countries such as Australia, Canada, Norway and Switzerland nor newly industrialized economies such as Republic of Korea of Singapore.

For emerging economies and developing countries, savings now exceeds investment by 2.3 percentage points of GDP (Table 6). But this condition is not characteristic of all regions or of all individual countries. For example, in Africa (which includes the oil-exporting countries of North Africa), domestic investment exceeds domestic savings. This imbalance is even more pronounced for sub-Saharan Africa.

For most of the IMF regional groupings of developing and transition economies, domestic savings exceeds domestic investment. The disparity is largest among countries in the Commonwealth of Independent States but this result is driven mainly by the surplus savings of Russia (an oil exporter). There is also a marked disparity between savings and investment among countries in the Middle East, chiefly because of rising oil prices. For example, the differential in Saudi Arabia between savings and investment is astounding—namely, about 20 percentage points of GDP. The disparity is also large for Developing Asia but China's surplus savings looms large in this aggregate statistic. Nevertheless, surpluses in other Asian countries, such as Malaysia and Indonesia, also figure prominently.

**Table 6. Trends in Gross Domestic Savings and Investment  
(Per cent of GDP)<sup>8</sup>**

Category	Investment 1991-1998	Savings 1991-1998	Investment 2004	Savings 2004
<b>World</b>	24.0	22.9	24.6	24.9
<b>Industrial Countries</b>	21.6	21.1	20.7	19.4
--United States	18.5	16.1	19.6	13.6
--Euro Area	21.1	21.4	20.2	20.9
-- Germany	22.7	21.8	17.7	21.3

<sup>8</sup> World output is the denominator for the world.

-- France	19.4	20.4	20.0	19.8
--Japan	29.2	31.6	23.9	27.6
--United Kingdom	16.8	15.6	17.0	14.8
--Newly Industrialized Asia	31.8	33.8	24.9	31.3
<b>Developing and Transition Economies<sup>a</sup></b>	27.5	25.4	29.2	31.5
--Africa	20.1	16.6	21.0	20.6
--Developing Asia	32.8	31.3	35.5	38.2
--Middle East	25.6	22.9	25.4	32.0
--Latin America	21.2	18.3	19.8	21.0
--CIS <sup>b</sup>	16.2 <sup>c</sup>	24.2 <sup>c</sup>	21.4	29.4

Source: IMF, World Economic Outlook, 2005, Table 43, pp. 271-273. Notes:

'a' includes Central and Eastern Europe and Russia; 'b' includes Russia; 'c' denotes 1999 (data not available earlier).

When developing countries are grouped by income levels, savings exceeds investment in lower middle income and upper middle income countries, but not in low income countries.<sup>9</sup> Excess savings has grown in both upper and lower middle countries since 1990. For upper middle income countries, for example, savings now exceeds investment by five percentage points of GDP. In lower middle income countries, savings exceeds investment by two percentage points. By contrast, in low income countries, where savings is most needed, it falls short of investment by three percentage points.

The real issue is that these excess savings are not being recycled to poorer developing countries, such as in South Asia and sub-Saharan Africa, but to richer countries, such as the United States and the United Kingdom. Both South Asia and Sub-Saharan Africa have 'deficient' savings: their domestic savings rates are not high enough to finance their current domestic investment rates. In other words, capital is flowing 'uphill' (from middle income and newly rich countries to the richest), not 'downhill' to poorer developing countries.

The Millennium Development Goals campaign has been building public support for a doubling of Official Development Assistance. But compared to the absolute sums of financing involved in the transfer of resources from middle income countries to rich countries, ODA can play, at most, only a limited redistributive role. Its main role will be in financing more extensive public-investment programmes in poor countries. An injection of public savings will help to re-establish a balance between domestic savings and investment in these countries, but at a higher level for both.

However, within the context of the larger imbalances in resource flows afflicting the world economy, ODA can function only as a targeting mechanism. These imbalances require significant changes in macroeconomic policies and development strategy in both middle income countries with large current-account surpluses and rich countries with large current-account deficits. For surplus countries, this will involve a shift in development strategy more towards augmenting domestic demand and boosting domestic

<sup>9</sup> The statistics are based on the World Bank designation and rely on 2003 data from the World Development Indicators 2005, Table 4.9.

incomes. For rich deficit countries, this will necessitate gradual—but substantial—fiscal contraction. This shift in the locus of both fiscal expansion and fiscal contraction will play a much larger role than ODA in redistributing global income.

As middle-income countries focus more on stimulating domestic demand, countries in sub-Saharan Africa might well benefit from the derived demand for their exports. They might also benefit, to some degree, from foreign direct investment by middle-income countries. South-South economic cooperation could play a role in facilitating the transfer of capital and stimulating demand for Africa's exports. But sub-Saharan Africa is unlikely to be able to replicate the export-led model that many Asian countries have been strenuously pursuing. For countries such as China, such a development model hinges precariously on the fortunes of the U.S. economy.<sup>10</sup> Clearly, the current U.S. consumption levels are unsustainable. The U.S. economy cannot function indefinitely as the 'consumer of last resort' for the world economy, and for export-oriented developing countries in particular.

Sub-Saharan Africa will have to rely on a diverse set of trading partners, including Europe, transition economies and middle-income developing countries (and within the continent as well). But many of these higher-income countries will have to decrease their current-account surpluses in order to accommodate more exports from Africa. Such a re-orientation is likely to be of far greater benefit—particularly over the long term—than a doubling of current ODA levels to the continent. The valuable role that ODA can fulfill is to finance the extensive public investment programmes that will help Africa strengthen its supply response to—and broaden the benefits from—these new export opportunities.

### **Growth-Oriented Economic Policies for Sub-Saharan Africa**

We turn now to some of the rudimentary elements of development strategies, and their associated economic policies, which, we believe, could boost economic growth in sub-Saharan Africa, based on enhanced domestic resource mobilization and accelerated capital accumulation.

These policies could also assist in accomplishing two other strategically important objectives: 1) making growth more stable and 2) making it more equitable. In Africa, the instability of growth is of major concern. Not only has it increased poverty but also it has undoubtedly lowered average growth rates.<sup>11</sup> Also, if economic growth were not only more rapid and sustained but also more equitable in its impact, the resources that need to be mobilized for financing investment could be reduced.<sup>12</sup>

Conventional policies advocating 'private sector led' development assume that investment is a 'free good'.<sup>13</sup> In other words, private investment will automatically respond as long as the government de-regulates, withdraws from the economy and creates a pro-business climate. However, most states in rapidly growing economies have intervened actively in the private economy in order to help mobilize domestic savings,

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<sup>10</sup> See Palley 2004 and Dooley, Folkerts-Landau and Garber 2004 for contrasting views on China's development model.

<sup>11</sup> Instability leads to a reluctance to invest. Sharp and prolonged recessions can lead to long-term deterioration of capital, including human capital.

<sup>12</sup> Kakwani and Son 2005.

<sup>13</sup> Weeks 2005, p. 5.

stimulate private investment and deploy public investment. Capital has to be amassed if growth rates are to be accelerated.

If the pattern of growth were equitable, then the direct impact on poverty would be magnified. This implies that the resource cost of the aggregate investment would be reduced because the investment would be more efficient in reducing poverty. In other words, the same impact on reducing poverty could be achieved with a lower capital-output ratio.

In addressing these issues, this paper covers mainly four components: public investment-led fiscal policies, more flexible monetary policies, tax policies that can boost revenue and financial policies that can augment domestic savings and investment.<sup>14</sup> In general, countries in sub-Saharan Africa have been demand constrained for the last 20-25 years. They have maintained high real rates of interest in order to contain inflation and endured fiscal austerity in order to service their debt burden. More expansionary fiscal and monetary policies are needed.

### ***Fiscal Policies***

Countries need more ‘fiscal space’, namely, increased public revenue and loanable funds, in order to deploy more expansionary fiscal policies. Central to expansionary fiscal policies is public investment. The reason: it can perform three important functions: 1) stimulate aggregate demand (the ‘Keynesian’ function) 2) expand the productive capacity of the economy (the ‘Development’ function) and 3) focus resources on poor households (the “Anti-Poverty” function). It is important to clarify and expand on the “Development” function of public investment since this is the most neglected, and probably the most important.

Few developing countries, particularly those in sub-Saharan Africa, have viable strategies for rapid capital accumulation. Part of the problem is that prevalent growth strategies rely on ‘private sector led’ development. But, by definition, the private sector cannot ‘lead’ development: that is not its inherent objective. Although the private sector can be the main generator of growth and employment, in underdeveloped economies the public sector clearly has to lead the development process.

Once this confusion is dispelled, then clarity is still needed on how the public sector should lead. The usual response is that the public sector has to create a more ‘pro-business’ environment—e.g., boost ‘business confidence’. But changing the ‘climactic’ conditions for the private sector seems to have had little effect in many countries. Businesses are not investing, and for good reason: growth is too slow or uncertain and profit expectations are not promising.

In order to help break this logjam, states have to deploy public investment, not only to stimulate aggregate demand but also to lay the groundwork for long-term economic growth. This makes eminent sense in many low-income developing countries, where the public capital stock has remained low or has deteriorated as a result of fiscal retrenchment. The state has to ensure that the private economy is supported by an adequate economic and social infrastructure. Achieving such an objective will require, for most countries, a dramatic scaling up of public investment. If well designed, this investment will raise the productivity of labour and private capital.

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<sup>14</sup> This section draws extensively on Terry, McKinley 2005a, “MDG-Based PRSPs Need More Ambitious Economic Policies.” UNDP Discussion Paper, January.

By increasing productivity and stimulating economic growth, public investment will ‘crowd-in’ private investment, not ‘crowd it out’, as is often feared. A recent UNDP-supported paper (Levine 2005) has regressed private investment on public investment (lagged by one year) for 511 observations from 41 developing countries covering the period 1980-1999. Domestic savings and growth rates, both of which were suitably lagged, were also regressors in the estimation. Domestic savings provided an indication of resources available for both public and private investment. Private investment is known to respond to growth rates so a variable lagged two periods was included in order to control for this effect.

Results showed that the parameter for public investment was 0.18, and was statistically significant (as were savings and growth). This implies that a one point increase in the percentage of GDP represented by central government capital expenditure was associated, the following year, with a 0.18 point increase in the percentage of GDP represented by private fixed investment. This result supports the hypothesis of ‘crowding-in’. The results are strongest, in fact, for low-income developing countries, as one would expect.

**Table 7. Public Investment Trends by Region  
(Per cent of GDP)**

<b>Region</b>	<b>1970s</b>	<b>1980s</b>	<b>1990s</b>
<b>East Asia &amp; Pacific</b>	3.4	3.9	4.1
<b>Latin America &amp; Caribbean</b>	4.0	2.7	2.8
<b>Middle East &amp; North Africa</b>	11.7	9.2	6.8
<b>South Asia</b>	2.4	2.5	2.6
<b>Sub-Saharan Africa</b>	4.7	3.6	3.3

Source: Levine 2005. Note: The table captures central government capital expenditure

One of the major contradictions in current development strategies is that although public investment has to play a central role in stimulating growth and capital accumulation, it has been allowed to decline since the 1970s in most developing countries. Such investment has often been the first victim of fiscal retrenchment and austerity. In sub-Saharan Africa, available evidence indicates that as a ratio to GDP, public investment fell from 4.7 per cent during the 1970s to only 3.3 per cent during the 1990s (Table 7). In Kenya, for example, it fell from 4.8 to 3.8 per cent; and in South Africa from 3.4 to 2.3 per cent. If rates of depreciation of public capital were included, net public investment would likely approach zero in many countries.

As in sub-Saharan Africa, there were notable general declines in public investment in Latin America and the Caribbean and in the Middle East and North Africa. In South Asia, public investment remained low and stagnant. Only in East Asia and the Pacific was there a clear upward trend.

Often, it is argued that when governments run large fiscal deficits, their borrowing to finance such deficits will ‘crowd-out’ private investment, by driving up the lending rate of interest. But the primary fiscal deficit in most African economies is not big

enough to cause concern about ‘crowding-out’.<sup>15</sup> This deficit has been dropping since the 1980s. While the primary fiscal deficit was a negative 3.58 per cent of GDP during the period 1979-1989, it was only a negative 1.63 per cent during 1990-2002 (Table 8). The scale of such deficits could be accommodated in a healthy growing economy. However, the overall deficit (which includes interest payments on debt) was almost a negative five per cent of GDP during 1990-2002.

So it is the large external debt of African countries that still represents the most difficult fiscal problem that they face. In 2004, their aggregate external debt was about US\$ 228 billion. In absolute terms, this amount is not large, especially compared to the external debt of Developing Asia (US\$ 772 billion) or Latin America and the Caribbean (US\$ 780 billion). However, if the primary government budgets (current revenue minus current expenditures) of countries in sub-Saharan Africa remain in deficit every year, then the debt burden could increase if it is financed by external loans. If deficits are used to finance productive public investment, however, debt should not expand in the future.

**Table 8. Fiscal Deficits in Africa  
(As a Percentage of GDP)**

<b>Primary Deficit 1979-1989</b>	<b>Primary Deficit 1990-2002</b>
<b>-3.58</b>	<b>-1.63</b>
<b>Overall Deficit 1979-1989</b>	<b>Overall Deficit 1990-2002</b>
<b>-6.45</b>	<b>-4.99</b>

Source: Rogoff 2003.

In order to open up some ‘fiscal space’ for African governments to be able to finance growth-inducing public investment, dramatic debt reduction—if not outright debt cancellation—is a priority. Thereafter, grant assistance should be used to help finance necessary budget support. This does not minimize the need, however, for governments to eventually be able to raise the domestic public revenue necessary to provide essential public services, e.g., education, health, energy, roads, water and sanitation. Grant assistance should be targeted, in part, to help governments build viable tax systems that can fulfill this function.

### ***Tax Policies and ‘Fiscal Space’***

Public revenue is low in many developing countries. This is a particular problem in sub-Saharan Africa. Low incomes or poor growth performance are often given as reasons for low revenue. Nevertheless, many countries will have great difficulty in halving extreme income poverty by 2015 or reaching other MDG targets without mobilizing more domestic revenue. A larger influx of Official Development Assistance could help scale up public investment programmes to attain the MDGs, but such assistance cannot supplant domestic resource mobilization over the long term.

Despite conventional assumptions to the contrary, the domestic revenue base of most developing countries is too small, not too big. A widespread ‘small government

<sup>15</sup> Crowding out takes place only under fairly restrictive assumptions, namely, that the economy is at full employment and private capital is more productive than public. See Weeks 2005, p. 25.

ideology' has masked the reality that many governments do not command the resources necessary to finance many essential public services. To put matters in perspective, for all developing countries, tax revenue as a ratio to GDP is only 18 per cent, compared to 38 per cent for industrial countries (Tanzi and Zee 2001). The revenue of many poor countries is well below this average. It is imperative for many developing countries to find ways to boost their revenue base towards 20 per cent—if not towards 25 per cent of GDP over the longer term. This process will not be easy, of course.

The case for boosting public revenue is particularly compelling in sub-Saharan Africa. Table 9 contains data on government revenue for 20 low-income developing countries in this region.<sup>16</sup> It shows statistics on revenue for the latest year available in IMF Statistical Appendices. What is noteworthy about the table is that only three countries (Burundi, Cameroon and Kenya) have total revenue that is equal to 20 per cent of GDP or higher. The unweighted mean for the 20 countries is 15.5 per cent of GDP.

Fourteen of the 20 countries have total revenue that is less than 15 per cent of GDP. Among the countries with the lowest revenue base are Burkina Faso, Chad, Guinea, Madagascar, Sudan, Tanzania and Uganda. What is worth noting is that several of the countries with above-average rates of growth since 1990, listed earlier in Table 3, still have very low public revenue: Burkina Faso (11.1 per cent of GDP), Guinea (11.5 per cent), Tanzania (12.1 per cent) and Uganda (12.6 per cent). Other countries listed, such as Benin and Mozambique, also have relatively low public revenue. Not surprisingly, these six countries also have low domestic savings rates.<sup>17</sup> This is another indication that even some of the countries that have been successful in maintaining decent rates of economic growth have not been able to translate this success into a self-sustaining process of development. However, it would be mistaken to conclude that mobilizing more domestic revenue is an insurmountable task for many countries.

**Table 9. Government Revenue (% of GDP)**

Country	Total Revenue	Tax Revenue	Nontax Revenue
Benin (2001)	16.2	14.2	2.0
Burkina Faso (2001)	11.1	10.5	0.6
Burundi (2002)	20.3	18.0	2.3
Cameroon (2000/1)	20.6	12.6	7.8 <sup>a</sup>
Chad (2002)	7.9	7.1	0.8
Ethiopia (1999/2000)	18.3	12.5	5.8
Gambia, The (2001)	15.1	13.0	2.1
Ghana (2000)	17.7	16.2	1.5
Guinea (2001)	11.5	7.5	4.0 <sup>b</sup>
Kenya (2001/2)	21.6	17.6	4.0

<sup>16</sup> Some low-income countries, such as Angola and Mauritania, are not included because of the substantial resource rents that enlarge their central budgets. Generally, oil exporters have a large revenue base as well as sizeable domestic savings. Angola's revenue benefits greatly from oil (as do Cameroon and Sudan in the table) while Mauritania's revenue benefits from selling fishing rights.

<sup>17</sup> Budget surpluses add to gross domestic savings, deficits to dissavings.



Madagascar (2001)	10.0	9.6	0.4
Malawi (2001/2)	17.2	15.3	1.9
Mali (2002)	16.6	13.8	2.8
Mozambique (2002)	14.2	12.5	1.7
Senegal (2000)	18.0	17.3	0.7
Sierra Leone (2002)	14.2	14.0	0.2
Sudan (2003)	16.8	6.1	10.7 <sup>a</sup>
Tanzania (2001/2)	12.1	10.9	1.2
Uganda (2003/4)	12.6	11.7	0.9
Zambia (2003)	18.1	17.4	0.5

Source: IMF, Statistical Appendices, various years. Notes: ‘a’ is mainly oil revenue; ‘b’ is mainly Mining

A big part of such mobilization effort should concentrate on making tax systems more efficient—starting with better administration of consumption taxes and eliminating exemptions and loopholes on income taxes. But making tax systems more equitable would also help augment revenue. Direct taxes on income or wealth tend to be more progressive than indirect taxes, such as the Value Added Tax (VAT), but tax reforms often emphasize indirect over direct taxes. This weakens ‘vertical equity—namely, obliging those with greater ability to pay taxes to contribute a larger share of their income or wealth.

Even when tax systems are nominally progressive, the rich often benefit from a myriad of loopholes, exemptions and deductions. In addition, they benefit from poor enforcement of tax laws. The IMF Independent Evaluation Office has recently recognized these problems: “stronger and parallel efforts [to the VAT] should be made at improving collections, curtailing discretionary exemptions, and reducing tax evasion—particularly [for] direct taxes (personal and corporate)...” In the same context, it also noted that “efforts by the IMF in this area have not been forceful enough..., particularly if they affect powerful vested interests” (IMF 2003, p. 10).

Tax systems often allow ‘powerful vested interests’ to escape progressive taxes because conventional wisdom regards such taxes as an inefficient means to redistribute income. This has led to widespread efforts to lower the top marginal tax rates on personal and corporate incomes. As a result, for example, taxes on corporate income have been in marked decline in many parts of the developing world, despite the fact that in the past they have contributed, on average, more revenue than personal income taxes. According to an IMF-supported study in Latin America, for example, corporate income taxes as a share of total tax revenue dropped from 15.1 per cent in 1990-1994 to 12.2 per cent in 1995-1999 (Stotsky and Wolde Mariam 2002).

The justification for lowering top marginal rates is that doing so would augment total revenue. But another IMF-supported study of taxation in transition economies (Stepanyan 2003) finds that lowering the top marginal tax rates on personal income and corporate profits has had no discernible impact on increasing tax revenue. Savings has not increased because of lower rates, nor has the supply of labour and work effort. The study also finds no evidence that business investment has increased because of lowered rates on corporate profits.

Another indication of the trend towards less vertical equity is the negligible taxation of wealth. Taxes on property are rarely a significant component of tax systems

even though they have a substantial untapped potential to contribute to total revenue. Residential and commercial real estate are often largely left untaxed, for instance. In addition, little effort is undertaken to register and properly value such property. As market values of real estate rise, revenue could rise correspondingly.

The Value Added Tax, the modern version of a consumption tax, is usually regarded as the main workhorse of the typical tax system of a developing-country. One reason is that such a tax is assumed to be more efficient than direct forms of taxation. The standard recommendation to tax reformers in developing countries is to replace trade taxes—which are a big source of revenue for many poor countries—with the VAT. However, although trade liberalization has significantly reduced trade taxes in many countries, the VAT has failed in many cases to recoup the losses (Weeks and Roy 2004). Part of the reason is the demands that such a tax places on administrative capacity. Also, such a tax can often be regressive because the poor consume more of their income than the rich. Hence, even if the tax rate were the same for all, it would deal a heavier blow, relatively, on the consumption of the poor.

Another recent IMF-supported study, this one on VAT taxation and trade liberalization (Baunsgaard and Keen 2004), finds that the Value Added Tax has been successful in compensating for the loss of trade taxes only in high income countries. Middle-income countries have been able to compensate for only about 45-60 percent of the revenue lost from trade liberalization. The most troubling finding, however, is that the VAT in low income countries has recovered, at most, only about 30 per cent of the revenue lost from trade liberalization. So, the perverse result is that poorer countries are the most likely to suffer absolute losses of revenue from modern tax reforms.

Thus, more care should be taken in carrying out trade liberalization and more effort devoted to making the VAT more efficient. A smooth transition from trade taxes to domestic consumption taxes cannot be taken for granted. Also, a big priority for progressive tax reform is to re-assert vertical equity as a basic principle of taxation. This would involve tilting the composition of taxes away from heavy reliance on regressive consumption taxes and towards progressive income and wealth taxes. In industrial countries, the ratio of income to consumption taxes is more than double that of developing countries (Tanzi and Zee 2001). Approximating the ratio of industrial countries should be used as a long-term benchmark for reforming tax systems in developing countries.

In sub-Saharan Africa, the difficulties in strengthening tax systems are, of course, daunting. Income taxes usually have only limited coverage since the formal-sector workforce is small, particularly in low-income countries. Even consumption taxes, such as the VAT, have a limited impact since most poor countries have a sizeable and largely unrecorded informal sector. Improving tax administrations, which are customarily weak, can increase tax collection for both income taxes and the VAT. Also, the VAT should be supplemented by other indirect taxes, such as excise taxes, especially on non-essential, luxury items. Exclusive reliance on the VAT could be a mistake.

Given their shortage of revenue, governments in sub-Saharan Africa can ill afford to indulge in the recent mania to drastically lower top marginal tax rates for personal and corporate income. There is little evidence to suggest that lowering rates would significantly boost total revenue. Moderately high rates should be maintained, particularly on corporate profits. If rates on corporate profits were significantly lowered,

such reductions should apply mainly to small enterprises. Although it might be difficult to substantially increase income taxes, property taxes remain a largely untapped source of revenue. Income taxes will grow as the formal sector expands.

Trade taxes remain the main source of revenue for most governments in sub-Saharan Africa. In 2003, such taxes accounted for 27 per cent of all revenue in the region.<sup>18</sup> Taxes on personal and corporate income accounted for 19 per cent and taxes on goods and services for 22 per cent. Given the importance of trade taxes, governments should not assume that the VAT will make up for any loss of revenue from lowering tariffs. As suggested above, the evidence from countries that have implemented trade liberalization confirms that the VAT cannot compensate for the resultant loss of revenue.

Governments in sub-Saharan Africa should be allowed to run moderate budget deficits (e.g., 2-3 per cent of GDP) if the financing for such deficits is used for public investment. One option is to resort to domestic financing of the deficit. This could involve selling T-bills or bonds but the interest paid on such securities usually accrues to richer households. If the securities are short term, such as T-bills, then their repayment can put continuous pressure on the budget. Another option, for which some analysts have argued,<sup>19</sup> is monetization (i.e., selling securities to the Central Bank, which would thereby increase the money supply). As long as inflation remains moderate and the trade balance manageable, such an inflation tax could also enhance 'fiscal space', particularly when other methods for mobilizing revenue are limited.

In sub-Saharan Africa, grants accounted for 19 per cent of government revenue in 2003. This is, of course, mainly Official Development Assistance. Aid represented six per cent of gross national income in sub-Saharan Africa in 2003.<sup>20</sup> Thus, doubling ODA could well open up more 'fiscal space' for governments but the danger is that such an infusion might supplant the concerted efforts needed to raise domestic revenue.

Debt relief should also be used to enhance the 'fiscal space' of African governments. In 2003, debt service accounted for 2.2 per cent of gross national income.<sup>21</sup> Dramatic debt relief, if not outright debt cancellation, could make a marked difference in immediately freeing up resources to finance public investment that is critical to accelerating progress towards the MDGs.

Debt relief is a logical starting point for opening up fiscal space for many sub-Saharan African countries. Additional ODA could also provide a reliable stream of external finance over a longer period. Domestic borrowing, even through monetization of the budget deficit, could also play a role, although this would be limited. Longer term, the most viable option is to mobilize more public revenue through strengthening domestic tax systems.

### ***Monetary Policies***

In recent years, global inflation has declined to its lowest level since the 1960s. From 1990-1994 to 2000-2003, global inflation dropped from about 30 per cent to almost four per cent (Rogoff 2003). Inflation in developing countries declined from a high point of

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<sup>18</sup> World Bank, 2005a. *World Development Indicators*, 2005, Table 4.13.

<sup>19</sup> Weeks 2005, p.38.

<sup>20</sup> *Ibid.*, Table 6.10.

<sup>21</sup> *Ibid.*, Table 4.17

about 53 per cent in 1990-1994 to a historically low level of under six per cent in 2000-2003 (Table 10).

Inflation in Africa was under 12 per cent in 2000-2003, and is projected to decline to about eight per cent during 2004-2006. By contrast, during 1990-1994, inflation was almost 40 per cent and during 1995-1999 still over 20 per cent. These trends suggest that price instability in Africa, though not to be ignored, is no longer the principal problem for policymakers. In Appendix Table A2, which lists CPI inflation rates for sub-Saharan countries, 21 out of the 43 countries had inflation rates lower than five per cent during 2000-2003. Moreover, only nine countries had inflation rates above 10 per cent.

**Table 10. CPI Inflation Rates (% per year)**

	<b>1980-84</b>	<b>1985-89</b>	<b>1990-94</b>	<b>1995-99</b>	<b>2000-03</b>
<b>Africa</b>	<b>16.8</b>	<b>17.9</b>	<b>39.8</b>	<b>20.6</b>	<b>11.8</b>
<b>Developing Countries</b>	<b>31.4</b>	<b>48.0</b>	<b>53.2</b>	<b>13.1</b>	<b>5.7</b>

Source: Rogoff 2003

The usual justification for containing inflation is that low rates are a necessary condition for economic growth. There is the added justification that high inflation is ‘anti-poor’—namely, that it disproportionately harms the interests of poor households. Arguing that high inflation is ‘anti-poor’ misses the point of the debate, however. What should be regarded as high inflation? Very high inflation that destabilizes an economy (namely, above 40 per cent) certainly hurts the poor. At the same time, very low inflation (below five per cent) can also hurt the poor by slowing growth and employment.

Moderate rates of inflation (conservatively estimated to be 5-15 per cent) correlate well with growth (Chowdhury 2004; Bruno and Easterly 1998). Some studies have found, in fact, no evidence for a negative effect of inflation on growth until inflation reaches 20-25 per cent (Bruno and Easterly 1998).

When growth is accelerated—as it needs to be in many poor countries—the ensuing increase in investment demand might well expose supply bottlenecks in the economy that drive up prices. This is the kind of demand-pull inflation that can often accompany economic expansion. Cost-push factors are also important in explaining inflation in sub-Saharan Africa. Adverse weather conditions can drive up food prices, for example. Or rising oil prices can rapidly drive up a country’s import bill. Other negative trade shocks can have a similar inflationary effect.

Even the in-house researchers of the IMF find that there is a clear negative impact of inflation on growth in developing countries only above the threshold of 11-12 per cent (Khan and Sendhadji 2001). Part of their explanation for this threshold, which is higher than for industrial countries, is that because governments in developing countries suffer from low tax revenue, they have to compensate by resorting to an inflation tax. So raising revenue in this way does not negatively affect growth as long as inflation remains below the threshold. But their research does not consider the effect of demand-pull inflation or the possibility that growth might cause higher inflation. If the reverse effect of growth on inflation were confirmed, this could bias their econometric results.

In practice, the problem is that many countries have now adopted ‘inflation targeting’ as their chief macroeconomic policy instrument. Many others practice implicit

‘inflation targeting’. Often, the stated ‘target’ is inflation rates in the range of 3-5 per cent per year. In this approach, raising real interest rates is the preferred tool to maintain such low inflation rates. In addition, Central Banks are judged on whether they achieve low inflation, not on whether they help promote growth, employment or poverty reduction. The theory behind such practices is that inflation is caused by excessive aggregate demand (fueled by excessive growth of the money supply) and this is reinforced by expectations of continued high inflation in the future. So, in order to dampen such expectations, Central Banks publicly announce their intention to maintain low inflation rates for the foreseeable future.

One of the main drawbacks of the inflation-targeting approach is that it subordinates fiscal policy to monetary policy. The main objective of fiscal policy is a limited one: constrain government deficits. Such an approach leaves little room for policymakers to achieve output stability, much less more rapid growth led by public investment.

When inflation in sub-Saharan Africa is exacerbated by cost factors, such as the rising price of imported oil, inflation ‘targeters’ have only one policy response to such a problem: drive up the real interest rate. This causes either a recession or economic stagnation. Similarly, when accelerated growth is accompanied by demand-pull inflation, the response is to raise interest rates in order to maintain price stability. Inevitably, growth slows; in the process, inflation targeters can claim victory by squeezing ‘excess’ aggregate demand out of the economy. However, deprived of employment and rising incomes, low-income households can take little solace from such price stability.

Real rates of interest remain relatively high in many countries in sub-Saharan Africa. For the twenty countries in sub-Saharan Africa listed in Appendix Table A3, 14 have real rates of interest that are higher than 10 per cent and nine have rates higher than 15 per cent. Such rates make productive private investment difficult. And if government seeks to borrow funds to finance public investment, such an action also becomes very expensive. The interest rate should be disassociated from its role as an instrument to contain short-run macroeconomic instability and geared to the long-term purpose of stimulating economic growth. Hence, as a general rule of thumb, the real rate of interest should remain consistent with the sustainable rate of growth of income per person. In this context, real rates of interest of 10 per cent or higher in many countries in sub-Saharan Africa are wildly misaligned.<sup>22</sup>

The general solution to such dead-end policies as inflation targeting is to broaden the objectives of monetary policies. National policymakers should be gearing their policies to growth as well as inflation. In assessing their success, Central Banks should be monitoring progress in accelerating growth, employment and poverty reduction, not just in containing inflation. In other words, they should be concerned about a range of real variables as well as monetary variables. Even when they prioritize macroeconomic stability, they should be evaluating their success in maintaining output stability as well as price stability.

Even price stability should be given a more flexible definition. Depending on the specific country context and the causes of rising prices, inflation rates of 5-15 per cent per year can be considered acceptable if they enable the economy to grow at a significantly higher rate. Allowing the money supply to grow at a faster rate than the real

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<sup>22</sup> Weeks 2005, p. 32.

economy, which will tend to raise the inflation rate, can also contribute to financial deepening. The ratio of money supply to national output tends to be low in sub-Saharan Africa and financial markets remain relatively shallow.<sup>23</sup>

Such moderate rates of inflation would no doubt exert a downward pressure on the exchange rate of countries in sub-Saharan Africa. If such rates were fixed, this would represent a potentially serious problem. But flexible exchange-rate regimes do not seem to be a viable option in Africa either. One reason is that the exchange rate is not likely to be ‘market-determined’ in many countries because most of their flows of foreign exchange, such as ODA and debt payments, are not market related.<sup>24</sup>

Under such circumstances, a managed-float system should be the optimal choice. Gradual, controlled depreciations of the exchange rate would help maintain the competitiveness of Africa’s exports. If the exchange rate is properly managed, policymakers should be able to maintain a wedge between the export price in domestic currency and the world price. An exchange rate that tends to be under-valued could be the desirable result of such interventions.<sup>25</sup>

This should help loosen up the balance of payments constraint that many African countries face. In fact, a valuable role that ODA might play in Africa is to provide the basis for foreign exchange reserves that could help national policymakers manage the exchange rate. Exchange rate volatility has been a major problem in sub-Saharan Africa. By helping control deficits in the balance of payments, a major constraint on government action, ODA would open up the space for more autonomous domestic fiscal policy. However, regulation of the capital account is likely to be a necessary complement to such exchange rate management. Otherwise speculative attacks on exchange rates and the ensuing increases in real interest rates will erode macroeconomic stability.

### ***Financial Policies***

Financial policies are inextricably linked, of course, to monetary policies. When tight monetary policies raise the real rate of interest, for example, the financial sector is directly affected. But financial policies, including those influencing the mobilization of savings and the disbursement of credit, have a scope far beyond monetary policies.

Financial policies are crucial to mobilizing domestic savings. They are also crucial to channeling these savings, plus external private financing, into productive long-term investment. While raising tax revenue can expand the ‘fiscal space’ of governments to pursue more concerted public investment programmes, mobilizing and deploying private domestic savings are essential to stimulating private investment. Economic prosperity results from running along both these tracks. In most countries that have sustained rapid rates of growth, the state has invariably played a central role not only in providing essential public investment but also in ensuring that necessary and sufficient conditions are laid for self-sustaining capital accumulation—i.e., mobilizing domestic savings and capturing it for deployment in productive private (and public) investment.

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<sup>23</sup> This is one reason that interest rate policies are generally ineffective in controlling inflation or stimulating the real economy.

<sup>24</sup> *Ibid.*, p. 35.

<sup>25</sup> The downside of this policy approach is that it could heighten competition among African countries themselves for the same export markets.

The record of financial liberalization in this regard has not been stellar. Its impact has likely been neither pro-growth nor pro-poor. Responding to liberalization, commercial banks have concentrated their activities in major urban areas of developing countries. As a result, although aggregate statistics of ‘financial deepening’ might have improved, access to credit has become, if anything, more unequal. The rural population remains deprived of credit in most countries, and is likely worse off compared to the access to credit that state-owned agricultural banks had previously provided.

One reason that growth is faltering in many developing countries, especially in sub-Saharan Africa, is that access to long-term investment is severely limited. Understandably risk averse, particularly in conditions of economic stagnation, commercial banks focus more on short-term lending, such as for consumer durables for high-income households, working capital for enterprises or purchase of short-term government securities. The risks are too high for banks to commit loans for long-term investment purposes. When they do so, they provide loans to the few large corporations in urban areas that they consider creditworthy.

**Table 11. Performance Indicators of Financial Institutions, 2003**

	Low- Income Countries	Sub- Saharan Africa	South Asia	East Asia and the Pacific	Middle- Income Countries
Domestic Credit to the Private Sector (% of GDP)	27.0	63.7	31.0	123.6	64.2
Interest Rate Spread <sup>a</sup> (percentage points)	12.4	12.4	7.3	5.2	6.3

Source: World Bank, World Development Indicators 2005, Table 5.5 Note: ‘a’ lending minus deposit rate.

In aggregate, banks in sub-Saharan Africa provide decent levels of credit to the private sector. In 2003, domestic credit for this purpose, as a ratio to GDP, was almost 64 per cent, much higher than the average of 27 per cent for all low-income countries (Table 11). But this aggregate statistic incorporates the large impact of the domestic credit provided by banks in South Africa, where the corresponding ratio for 2003 was 142 per cent (which is close to the world average).

When the effect of S. Africa is removed, the ratio of credit provided to the private sector in sub-Saharan Africa is a little under 20 per cent. Ratios in other sub-Saharan Africa range from highs of 59.3 per cent for Mauritius and 52.8 per cent for Namibia (both atypical, middle-income countries); to mid-range ratios of 26.1 per cent for Ethiopia and 21.3 per cent for Kenya; to more prevalent low ratios, such as 7.6 per cent for Tanzania and 6.7 per cent for Zambia.

Because aggregate statistics can be misleading, Table 12 provides statistics on domestic credit to the private sector for both 1990 and 2003 for a cross-section of individual low-income countries in sub-Saharan Africa. Some of the countries that provided credit comparable to, or higher than, the average for all low-income countries in 1990 slipped well below average in 2003. These include Benin, Cameroon, Kenya and Senegal. Several other countries—such as Burkina Faso, Chad, Madagascar, Malawi, Mozambique, Tanzania and Zambia—which provided below-average credit in 1990

provided even less in 2003. A third group, which increased their level of credit to the private sector during 1990-2003, still provided relatively low levels. Ghana, Guinea and Uganda illustrate this trend.

**Table 12. Domestic Credit Provided to the Private Sector  
Percentage of GDP, 1990 and 2003**

<b>Country</b>	<b>Domestic Credit to the Private Sector 1990</b>	<b>Domestic Credit to the Private Sector 2003</b>
Benin	20.3	14.5
Burkina Faso	16.8	14.0
Cameroon	26.7	10.2
Chad	7.2	5.9
Ghana	4.9	11.8
Guinea	3.5	4.0
Kenya	32.8	21.3
Madagascar	16.9	8.8
Malawi	10.9	7.7
Mali	12.8	19.2
Mozambique	17.6	2.2
Senegal	26.5	20.8
Tanzania	13.9	7.6
Uganda	4.0	6.9
Zambia	8.9	6.7
<b>All Low Income Countries</b>	<b>22.3</b>	<b>27.0</b>

Source: World Bank, World Development Indicators 2005, Table 5.1

Integrally connected to the lack of credit in many of the poor countries in sub-Saharan Africa is the higher interest-rate spread between deposit and lending rates of interest, i.e., over 12 percentage points. In South Asia, in contrast, the spread is about seven percentage points, and in East Asia even lower, i.e., about five percentage points. Moreover, the interest-rate spread has widened in Africa since 1990, when it was about eight percentage points.

The high spread for most countries in Africa indicates that loans are relatively expensive, particularly for long-term private investment. Appendix Table A3 presents both deposit and lending rates of interest for 20 countries in sub-Saharan Africa. For some countries, such as Ethiopia, Namibia and South Africa, the spreads are not unreasonable. However, for 14 of the countries, the spread is over 10 percentage points. The highest spreads are found in Zambia (almost 19 percentage points) and Malawi (almost 24 percentage points). Such spreads imply that commercial banks can make hefty profit rates on the loans that they disburse but their volumes are too low to make large profits in absolute terms.

These few simple tables underscore why the performance of private investment in Africa is so lackluster. Among other problems that it faces, the private sector is starved of credit. In many instances, it has even less access to credit after financial liberalization than before. The condition of the financial system in many sub-Saharan African countries



is short-circuiting a more rapid accumulation of capital. Not only are banks having difficulty in mobilizing savings but also when they do have savings at their disposal, they are reluctant to lend for long-term investment.

This implies that if African countries are to accelerate economic growth, or even sustain the growth rates that they have already attained, major financial sector reforms focused on the mobilization of domestic savings and the financing of private investment are necessary. Such reforms are central to any effort to speed up capital accumulation.

A recent UNDP-supported study in South Africa on “An Employment-Targeted Economic Program” tried to identify viable alternatives for monetary and financial policies that could generate more employment-intensive public and private investment.<sup>26</sup> Unemployment remains a major problem in South Africa. Part of the problem is that the employment intensity of the country’s output has been steadily declining. Under current projections, unemployment could well rise to affect about one third of the workforce.

In order counteract this trend, the study recommends that the Reserve Bank of South Africa lower its prime lending rate about two percentage points. This reduction, the study argues, should give some boost to growth and employment. It also endorses the government’s intention to moderately increase its fiscal deficit as a stimulus to aggregate demand.

Supplementary to these policies, the study recommends that credit at concessionary terms should be provided to sectors of the economy with above-average employment multipliers. It provides three options for doing so: 1) expanding the lending activity of the country’s eight development banks 2) obliging banks to hold 20 per cent of their assets in loans to employment-intensive sectors and 3) expanding the country’s loan guarantee scheme. The study estimates that its proposals for the loan guarantee scheme (including assumptions about the expected default rate) should obligate no more than 1-2 per cent of the government’s fiscal budget.

The report acknowledges that such expansionary measures are likely to raise South Africa’s inflation rate. However, the increase is not expected to be more than moderate. If inflation threatens to accelerate beyond a moderate level, the report advises the government to institute an incomes policy and weaken the monopolistic pricing power that exists in some sectors of the economy. As a means to ensure stability of the exchange rate, the report also recommends the use of capital management techniques. Such measures will guard against volatility in capital flows as a result of any precipitous change in the perceptions of portfolio investors.

UNDP has supported a similar recent report on employment targeting in Ghana.<sup>27</sup> It notes that Ghana’s financial sector has problems similar to those in many other countries of sub-Saharan Africa. Its main manifestation is the provision of high-cost, short-term credit. The high real rates of interest that banks charge for loans are caused, in part, by concentration in the banking system. But they are also due to tight, ‘inflation-targeting’ monetary policies.

Moreover, banks have difficulty in mobilizing deposits and most that they acquire are short-term. One of the explanations for this problem is the lack of a deposit insurance programme, which could help overcome the lack of confidence in the banking system. Also, the reason that banks refrain from providing long-term loans (bank assets) is that

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<sup>26</sup> Pollin et al., 2005.

<sup>27</sup> Epstein and Heintz 2005.

their deposits (bank liabilities) are short-term. As a result, banks hold large amounts of excess reserves even though reserve requirements are already high. This means that a significant proportion of national savings are lying idle. Banks also use about one fifth of their assets to buy risk-free short-term government securities. As a consequence, only about 30 per cent of bank assets are being used for loans to the private sector.

According to the report, financial institutions in Ghana are excessively risk averse. One of the report's recommendations is therefore designed to motivate banks to provide more loans to long-term investments, especially in employment-intensive sectors. The motivation for banks would be lower reserve requirements for such loans. Another option advocated by the report is a loan guarantee scheme, which would help lower risk premiums on certain forms of investment, but would have adequate safeguards established to prevent abuse.

The report also advocates that the Government of Ghana expand its efforts to develop longer-term public debt instruments. The Government incurs high interest rate costs when it issues short-term treasury bills. Longer-term instruments would facilitate the financing of public investment and help the government improve management of its public debt.

## **Concluding Remarks**

This paper tries to tackle the issue of how countries in sub-Saharan Africa can accelerate domestic capital accumulation for long-term development. Initially, it focuses on the work of the U.N. Millennium Project, which calls for dramatic scaling up of ODA for African countries in order to inject enough additional capital into their economies so that they can extricate themselves from a 'poverty trap' of low incomes, rapidly growing populations and low savings.

The paper then examines the performance of a set of African countries that have achieved poverty-reducing rates of growth since 1990. It pays particular attention to how they have been able to mobilize domestic savings and public revenue and translate these development resources into increased public and private investment. The conclusion is that although these countries have been successful in raising their investment rates, they have not done so by raising a corresponding proportion of domestic resources. Thus, their ODA-driven growth might not be sustainable unless they are able to convert their increasing incomes into the mobilization of additional domestic savings.

The paper places the development challenges facing sub-Saharan Africa within the context of the current dynamics of global savings and investment. Over half of the 'excess savings' in the world economy are being generated by middle-income developing countries, transition economies and newly industrialized countries. But almost three quarters of these excess savings are being absorbed by the U.S. economy. The amount going to the U.S. alone is about seven times higher than global ODA flows.

The paper maintains that these savings flows are traveling in the wrong direction, namely, to rich countries, instead of poor countries, such as in sub-Saharan Africa. ODA can play a role in redistributing global savings, but only a limited one. Economic policies in current-account surplus countries (such as China), rich current-account deficit countries (such as the United States) and poor current-account deficit countries (such as in Africa) will have to be significantly re-adjusted in order to direct savings to poorer countries instead of rich.

The paper then examines four sets of economic policies in sub-Saharan Africa. It concludes that fiscal policies should become more expansionary and centered on public investment. In addition to recommending reforms in expenditures, the paper suggests that greater efforts should be concentrated on mobilizing domestic tax revenue and making tax systems more equitable. This effort is intended to boost both savings and investment and bring them into balance at a higher absolute level.

The paper also recommends, as complements to expansionary fiscal policies, more flexible monetary policies (disengaged from inflation targeting), management of the exchange rate in order to keep it competitive (if not undervalued) and regulation of the capital account in order to contain capital flight.

Lastly, the paper stresses the priority of building up domestic financial institutions in sub-Saharan Africa. Without viable financial institutions, countries in the continent will not be able to mobilize substantial domestic savings and, once having mobilized such resources, be able to effectively channel them to long-term, productive private investment. These two inter-connected functions are essential to a self-sustaining process of domestic capital accumulation and development in countries in sub-Saharan Africa.

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**Appendix Table A2. CPI Inflation Rates in Africa:  
1990-1999 and 2000-2003**

<b>Country</b>	<b>Inflation Rate per annum 1990-1999</b>	<b>Inflation Rate per annum 2000-2003</b>
Angola	1011.0	165.5
Benin	7.7	3.2
Botswana	10.9	6.3
Burkina Faso	4.5	2.6
Burundi	13.8	9.8
Cameroon	5.2	2.9
Cape Verde	7.3	1.4
Central African Rep.	3.9	3.6
Comoros	3.9	1.6
Congo, Dem. Rep.	3369.0	236.4
Congo, Rep.	8.2	1.6
Cote d'Ivoire	5.9	3.6
Equatorial Guinea	7.5	8.6
Eritrea	--	19.3
Ethiopia	7.4	-1.4
Gabon	5.5	1.2
Gambia, The	5.8	4.6
Ghana	27.6	21.1
Guinea	8.7	4.6
Guinea-Bissau	37.5	4.5
Kenya	16.9	5.6
Lesotho	11.1	8.5
Madagascar	17.3	6.2
Malawi	30.5	19.0
Mali	4.2	3.6
Mauritania	6.2	4.0
Mauritius	7.8	5.4
Mozambique	33.6	11.8
Namibia	10.3	9.8
Niger	5.0	2.5
Nigeria	31.8	13.5
Rwanda	17.3	3.1
Senegal	4.2	2.0
Seychelles	2.1	6.1
Sierra Leone	45.9	0.6
South Africa	9.9	7.4
Sudan	80.4	6.0
Swaziland	9.5	9.8
Tanzania	22.4	5.1
Togo	7.3	3.4
Uganda	17.2	2.4
Zambia	76.5	22.1
Zimbabwe	28.5	180.6
<b>Sub-Saharan Africa</b>		<b>11.8</b>
<b>Developing Countries</b>		<b>5.7</b>
<b>World</b>		<b>4.1</b>

Source: Kenneth Rogoff, "Globalization and Global Disinflation," 2003.

**Appendix Table A1. Net National Savings in Africa**

<b>Country</b>	<b>Net National Savings % of GNI 2003</b>	<b>Country</b>	<b>Net National Savings % of GNI 2003</b>
Angola	11.2	Malawi	-13.2
Benin	-3.4	Mali	7.6
Botswana	23.8	Mauritania	1.3
Burkina Faso	-1.0	Mauritius	15.4
Burundi	16.5	Mozambique	5.2
Cameroon	2.7	Namibia	19.3
Chad	3.7	Nigeria	11.1
Congo, Rep.	17.9	Rwanda	5.0
Cote d'Ivoire	5.6	Senegal	5.4
Eritrea	-2.5	South Africa	3.0
Ethiopia	12.5	Sudan	13.5
Gabon	23.5	Swaziland	4.8
Guinea	2.3	Tanzania	2.0
Kenya	5.1	Togo	-5.9
Lesotho	-9.3	Uganda	10.3
Madagascar	4.4	Zambia	7.8
<b>Sub-Saharan Africa</b>	<b>6.3</b>		
<b>Low Income Countries</b>	<b>14.2</b>		
<b>Middle Income Countries</b>	<b>17.8</b>		
<b>East Asia &amp; Pacific</b>	<b>32.6</b>		
<b>South Asia</b>	<b>15.9</b>		

Source: World Bank, *World Development Indicators 2005*, Table 3.15

Note: Net National Savings = gross national income + net current transfers – public and private consumption – consumption of fixed capital.

**Appendix Table A3. Interest Rates in Sub-Saharan Africa**

<b>Country</b>	<b>Deposit Rate 2003</b>	<b>Lending Rate 2003</b>	<b>Real Interest Rate 2003</b>
Botswana	10.0	16.3	12.3
Cameroon	5.0	18.0	16.9
CAR	5.0	18.0	14.5
Chad	5.0	18.0	18.5
Congo, Rep.	5.0	18.0	23.0
Ethiopia	3.4	8.0	-5.7
Gabon	5.0	18.0	19.4
Kenya	4.1	16.6	4.7
Madagascar	11.5	24.3	20.9
Malawi	25.1	48.9	33.9
Mauritania	8.0	21.0	18.9
Mauritius	9.5	21.0	14.6
Mozambique	12.1	24.7	10.7
Namibia	8.8	14.7	16.2
Nigeria	14.2	20.7	-0.3
Sierra Leone	8.4	20.0	12.8
South Africa	9.8	15.0	8.5
Tanzania	3.0	14.5	8.3
Uganda	9.8	18.9	8.0
Zambia	22.0	40.6	17.1

Source: World Bank, *World Development Indicators 2005*, Table 5.7