



Economic Commission for Africa

Targeting Employment Expansion, Economic Growth and Development in Sub-Saharan Africa: Outlines of an Alternative Economic Programme for the Region

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Acronyms

CDs	Certificates of Deposits
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
IFI	International Financial Institutions
IMF	International Monetary Fund
MDG	Millennium Development Goals
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
SACCO	Savings and Credit Cooperatives
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
VAR	Vector Auto-Regression
VEC	Vector Error Correction

I. Introduction

Despite recent improvements in economic growth among African countries, progress in meeting poverty reduction and human development targets – such as those enshrined in the Millennium Development Goals (MDGs) – has thus far fallen short of expectations. Economic performance, although better than it had been through much of the 1980s and early 1990s, still lags behind that of most other countries in Asia and Latin America. Moreover, faster growth has not always translated into better employment opportunities, lower rates of poverty, higher educational attainment, reductions in gender inequalities, and healthier populations. The slow rate of progress on the human development front raises concerns about the framework that currently dominates economic management and policy-making. The current framework emphasizes macroeconomic stability – and attempts to sustain adequate growth – but falls short in addressing the development challenges in Africa more broadly.

The priorities reflected in current economic policies have shifted away from development and towards stabilization. As Thandika Mkandawire (1999) writes:

“... economic policy has given overwhelming priority to financial policy instruments and objectives (exchange rates, interest rates) relative to concerns for the ‘real’ side variables and goals that directly affect employment and growth. Such shifts are not only reflective of the exigencies of adjustment to the economic crises that have ravaged Africa since the mid-1970s, but also of the increased presence of international financial institutions (IFIs) in African policy-making.” (pp. 321-2).

This paper discusses an alternative economic framework for Africa, one that would create an environment supportive of improvements in the ‘real’ outcomes, which Mkandawire emphasizes. Instead of targeting inflation or financial variables, we propose a framework that would allow targeting of real outcomes, in particular, employment and living standards. There is need for such ‘development-targeting’ as an alternative to the standard prescriptions of economic stabilization.

The ultimate objective of economic policy should be improvements in well-being and human development, as reflected in the MDGs. Much of this report focuses on employment as an intermediate ‘real’ side outcome of economic policy. The reason for the emphasis on employment is simple: employment is one of the most significant channels through which growth translates into sustainable poverty reduction. Therefore, it represents one of the primary means through which the broader objectives of human development can be pursued. As the UNECA emphasized in its 2005 *Economic Report on Africa*:

“A major route out of poverty in Africa is decent employment, a concept that encompasses the quality of employment – as rooted in productive and secure jobs that provide adequate income and reasonable work conditions—and the quantity of employment. Decent employment strengthens the link between economic growth and aggregate poverty reduction.” (p. 1)

In this report, we outline the elements of a development-targeted economic framework aimed at creating decent employment opportunities as a path to realizing the core human development goals in Africa.

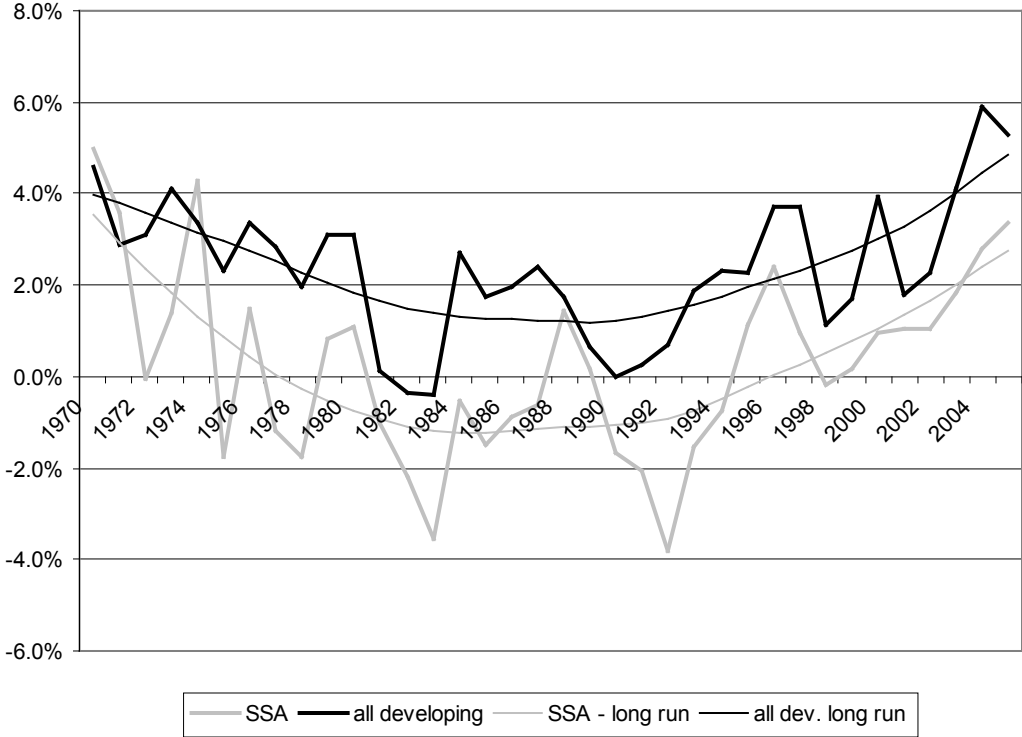
Growth, investment, and trade

Growth is necessary, but not sufficient, for achieving the development goals as reflected in the MDGs and the poverty reduction strategies of African countries. The growth record of African countries since the 1970s does not compare favourably with economic performance among developing countries in general. Figure 1 compares average growth rates of GDP per capita among sub-Saharan African countries with average per capita growth rates among developing countries in general over the period 1970-2005.¹ The graph also shows estimates of the long-run trend in per capita GDP growth for the two groups of countries.² Growth rates in sub-Saharan Africa have fallen below the average growth rate of all developing countries over this time period. More significantly, estimates of the average long-run per capita GDP growth rate among African countries were negative during the 1980s and the early 1990s. That is, average living standards fell over this time. Only in the past ten years have growth rates accelerated, reversing this general decline. Despite this pick-up in the rate of growth, African economies still lag behind the rest of the developing world.

¹ Developing countries are defined as low- and middle-income countries as classified by the World Bank in its World Development Indicators database.

² The long-run trend growth rate was estimated by applying a Hodrick-Prescott filter to the annual growth rate series for the two groups of countries.

Figure 1: Average growth rates of real per capita GDP in sub-Saharan African and among all developing countries, 1970-2005.



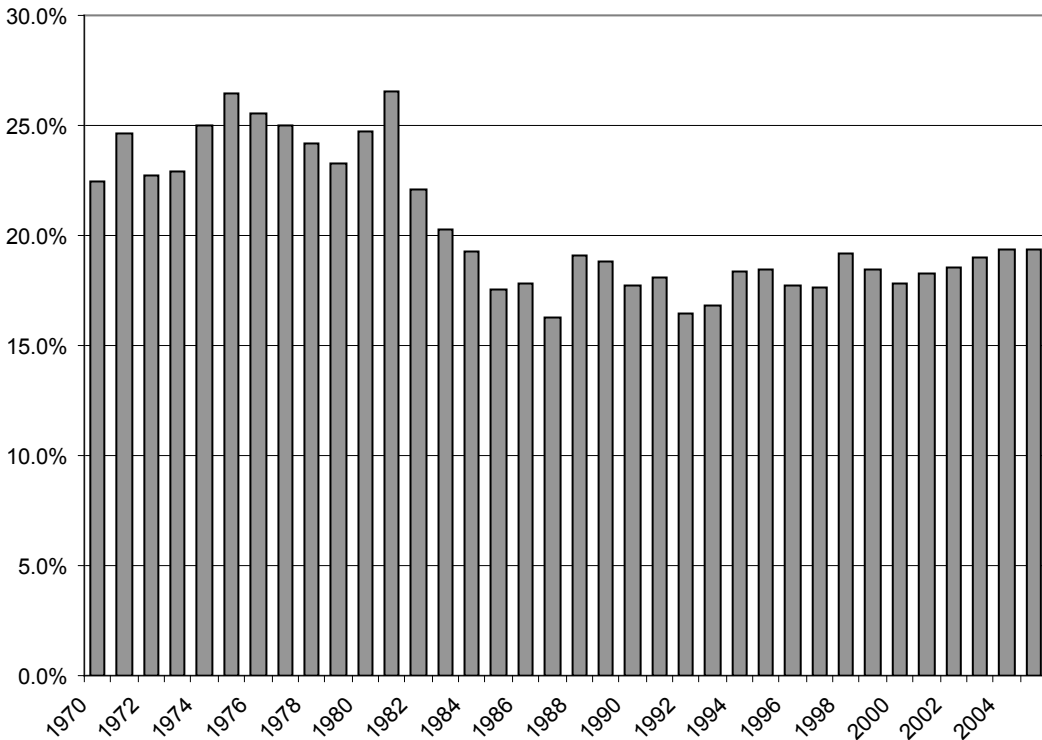
Source: World Development Indicators, 2007.

Slower rates of growth were associated with lower levels of productive investment in Africa. Figure 2 shows the average level of fixed capital investment, expressed as a percentage of GDP, in sub-Saharan Africa from 1970 to 2005. Average rates of investment were relatively strong during the 1970s until the early 1980s.³ However, beginning in the first years of the 1980s, the rate of investment in sub-Saharan African countries fell significantly. The average level of investment has remained below 20 percent of GDP since that time. Although economic growth rates have improved on average in recent years, this has not yet translated into an increase in the level of fixed capital investment as a share of GDP. Of

³ Average gross fixed capital formation in sub-Saharan Africa from 1970 to 1982 was 24.3 percent of GDP, compared to 17.9 percent in South Asia, 23.4 percent in Latin American and the Caribbean, and 29.6 percent in East Asia and the Pacific (World Bank, World Development Indicators, 2007).

course, certain countries have recently managed to raise the level of investment, but the average level of investment remains below the level that prevailed during much of the 1970s.

Figure 2: Gross fixed capital formation as a percent of GDP, sub-Saharan Africa, 1970-2005.

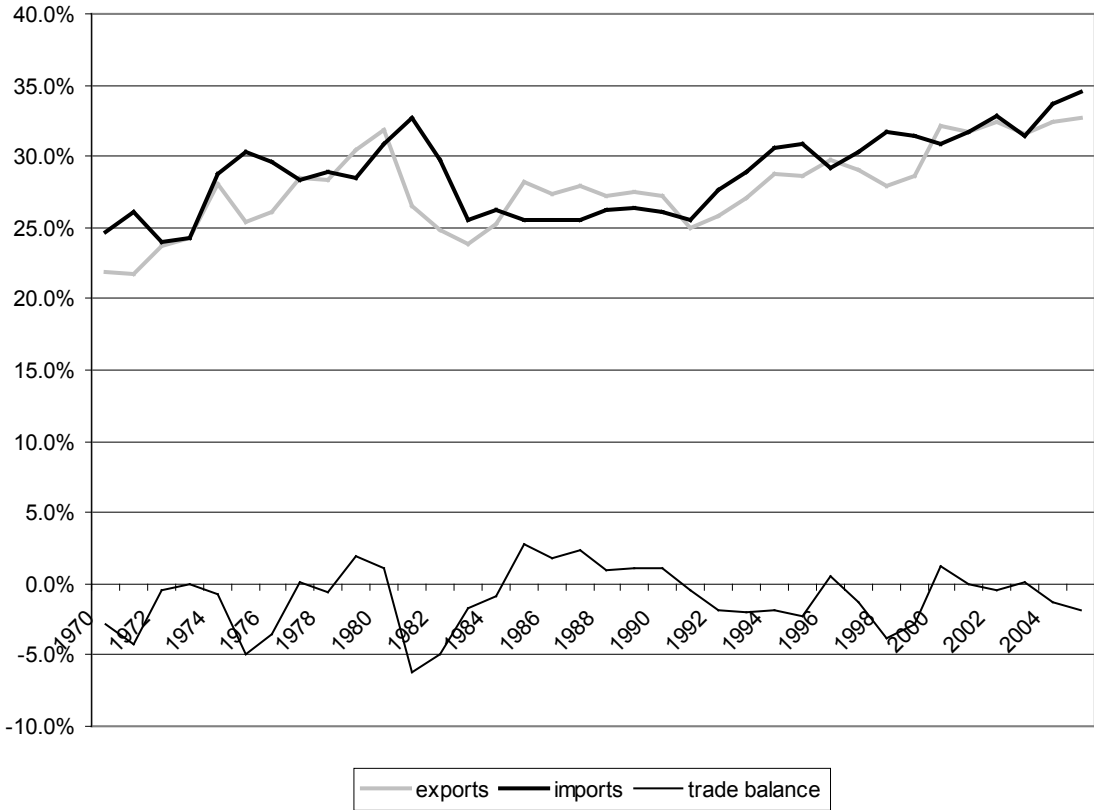


Source: World Development Indicators, 2007.

Patterns of trade among African countries have varied over this period (Figure 3). In the 1970s, the volume of international trade – measured by the value of exports and imports as a share of GDP – increased steadily. However, beginning in the 1980s – during the years of negative average growth – trade in the countries of sub-Saharan Africa relative to the size of their economies remained more or less constant. International trade began to pick up again in the 1990s and trade has expanded faster than GDP over the past decade. Although the growth in trade has resumed, the impact on African economies is mixed. Many countries remain highly dependent on imports – including imported productive inputs and capital goods. Trade balances in much of the region are negative – countries spend more on imported goods and services than they sell in export markets. This creates on-going external imbalances, with deficits financed

by aid flows and external borrowing. Dependencies on external funds can limit the policy space available to African governments to pursue their own, alternative development agendas. In addition, most African countries are highly dependent on commodity exports and have not been able to significantly diversify their export base. Commodity prices, and therefore export earnings, are volatile, raising the level of risk that countries in the region face.

Figure 3: Exports, imports, and the trade balance as a percent of GDP, sub-Saharan Africa, 1970-2005.



Source: World Development Indicators, 2007.

In recent years, there has been evidence of an improvement in economic growth performance in the region, with rates of GDP moving upward and exports expanding steadily. The rise of exports has, in turn, helped to improve the external balance throughout the region. The challenge is to keep this momentum going so as to promote sustainable growth as a foundation for human development and

poverty reduction. The right policy environment is essential to achieve this goal. Much of this paper examines what the components of an appropriate growth policy might look like.

However, it must be noted that growth alone is not sufficient for reducing poverty and meeting primary development objectives, such as those captured in the Millennium Development Goals. Success along these lines depends crucially on how the benefits of growth are distributed. If growth is achieved at the cost of rising inequality, or if the fruits of economic success cannot be mobilized to improve people's lives, then the ultimate objective of human development will remain elusive. The benefits of growth can be widely shared when opportunities to participate in the productive activities of the economy become more inclusive and when the terms of such economic engagement improve. Therefore, the linkages between growth and productive employment represent critical elements of a comprehensive strategy for development.

Organization of the paper

The next section of the paper examines the linkages between growth, employment, and poverty reduction in the context of African economies, providing a foundation for the policy discussion that follows. The policy analysis forms the core of the paper and it is organized into four sections, each with a distinct focus: monetary policy and inflation, exchange rate policy, development finance and financial sector reforms, and public investment and fiscal policy. A short summary concludes the paper.

This paper draws heavily on three large UNDP-sponsored studies of employment-oriented economic policies in Kenya (Pollin, Githinji, and Heintz, 2008), Ghana (Epstein and Heintz, 2006; Heintz, 2004), and South Africa (Pollin et al., 2006).⁴ Therefore, examples from these three countries will be featured throughout the paper. Despite the use of examples from Ghana, Kenya, and South Africa, the policy discussion is not limited to these countries. The paper aims to discuss the elements of an alternative, development-targeted economic framework for African countries in general and, in doing so, the analysis draws on examples, research, and statistics from a wider range of countries.

⁴ The initial research project in Ghana was co-sponsored by the ILO.

II. Employment, growth, and poverty reduction

The vast majority of Africans depend on employment for their primary source of income. Therefore, success in terms of improving employment opportunities can lead to success in reducing poverty, raising living standards, and ultimately meeting human development goals. Simply having access to employment is not enough. Labour force participation rates are generally high across the continent, particularly in sub-Saharan Africa, and yet large numbers of employed people cannot lift their families out of poverty. According to the *Economic Report on Africa 2005*, approximately half of the employed in Africa can be classified as “working poor” – i.e. employed individuals whose living standards fall below a basic needs threshold (UNECA, 2005). Therefore, reducing poverty requires a joint emphasis on the quality and quantity of employment. Research suggests that the greater the employment focus, the more effective economic growth becomes in fighting poverty (Khan, 2006). However, economic growth alone cannot be counted on to generate significant improvements in the quality and quantity of employment opportunities (Osmani, 2006). What is needed is an employment-centered approach to growth and development.

The link between employment and living standards is straight-forward. However, we must be clear on what we mean by “employment” in the African context. Often labour market policy recommendations assume a wage employment relationship as the dominant framework for understanding employment dynamics. Equilibrium earnings are determined by an interaction between the private supply and demand for labour in a formal wage labour market. However, in most African countries, formal private wage employment is the exception, rather than the rule. In these circumstances, the standard labour market models, and the related policy conclusions, only apply to a minority of employed individuals. It is critical to understand the structure of employment in Africa, if appropriate employment policies are to be formulated.

Table 1 gives an overview of the structure of employment in Kenya, Ghana, Mali, and South Africa based on formality status (formal and informal) and employment status (wage employee or self-employed).⁵ Estimates for agricultural workers are also given. In Kenya, Ghana, and Mali, informal self-employment is the dominant form of employment. Agricultural self-employment accounts for a significant share of total employment, but non-agricultural forms of informal employment are also large. Formal wage employment – the assumed relationship in many labour market models – represents a small fraction of total employment. Only in South Africa is wage employment the dominant form of employment.

⁵ For the self-employed, individuals are considered informal workers if the household enterprise in which they work is not registered. For wage employees in Ghana, Mali, and South Africa, informal status is determined by the existence of basic social protections (e.g. social security contributions, paid sick leave, employer contributions to a pension, etc.) or the existence of a written contract. In Kenya, wage employees are considered formal if their employers are members of what is considered the formal private sector.

Table 1: Structure of Employment in Four African Countries.

	Kenya(2005)	Ghana(1998/9)	Mali	South Africa(2004)
Formal Employment				
Formal, private wage employment	6.9%	1.0%	n/a	40.8%
Formal, public wage employment	5.4%	4.1%	n/a	16.5%
Total formal wage employment	12.3%	5.1%	5.8%	57.3%
Formal, self-employment	1.3%	3.6%	5.1%	4.2%
Informal Employment				
Informal wage employment	18.0%	9.3%	11.0%	22.8%
Informal self-employment	64.8%	81.6%	78.1%	14.4%
Other/undeclared	3.6%	0.4%	0.0%	1.3%
TOTAL	100%	100%	100%	100%
... of which ...				
Agricultural wage employment	n/a	1.2%	0.9%	10.6%
Agricultural self-employment	50.0%	52.3%	41.2%	4.7%

Source: Kenya, authors' calculations based on the 2005 Household Integrated Budget Survey; Ghana, authors' calculations based on the 1998/9 Ghana Living Standards Survey; Mali, ILO Bureau of Statistics; and South Africa, Heintz and Posel (2007).

In general, earnings are lowest and poverty rates highest for workers in informal employment and agricultural employment. The concentration of employment in activities with low returns to labour in many African countries helps explain the persistence of poverty in the region. If economic growth is not associated with a movement into better employment opportunities or an improvement in the conditions of employment in informal activities, then the impact of growth on poverty will be minimal.

Economists often identify labour market rigidities – due to excessive regulation or the bargaining activities of trade unions – as one potential constraint on employment growth. The logic of this argument is that such rigidities tend to increase labour costs and higher labour costs reduce the demand for labour relative to the supply. If earnings do not fall, the result will be a reduction in labour demand. Note that this argument only applies to formal wage labour markets – in which regulations are binding and in which the supply of labour (by workers) can be easily distinguished from the demand for labour (from employers). Informal employment lies partially or entirely outside of the regulatory sphere and may not be subject, de facto if not de jure, to legislative rigidities. Moreover, individuals engaged in self-employment are both demanders and suppliers of their own labour. The notion of an equilibrium wage determined by the interaction of an independent labour supply and labour demand does not apply. Therefore, within the

African context, labour market rigidities are simply not relevant for the vast majority of employment.

It could be argued that high labour costs due to labour market rigidities constrain employment growth in the formal economy. If this were true, there are a number of ways in which the problem could be addressed. Labour costs can be lowered by reducing the total compensation, which employees receive. Alternatively, labour costs can be lowered by raising the average productivity of the labour force. In addition, the negative consequences of higher labour costs can be offset by government policies, such as employment subsidies or targeted measures to encourage the growth of productive activities.

Let us consider the first approach: lowering labour costs by reducing the compensation formal employees receive. In evaluating this option, the critical question is: how much additional employment is generated when wages fall? To answer this question, researchers often calculate a wage elasticity of labour demand: the percentage change in employment associated with a 1 percent change in wages, holding all other factors constant. Because of data limitations, credible estimates of wage elasticities in African countries are not always available. The wage elasticity of labour demand has been estimated to be approximately -0.7 in South Africa (Lewis, 2001) and -0.5 in the manufacturing sector of Ghana (Teal, 2000). An elasticity of -0.5 implies that a 10 percent reduction in wages would be associated with a 5 percent increase in employment. The range of elasticity estimates of -0.5 to -0.7 gives a rough guideline of what the wage elasticity of labour demand would be in African formal private labour markets.

How much would wages have to fall to generate substantial numbers of formal sector jobs? In South Africa, to generate an additional 2.1 million jobs – the number that would halve the current rate of unemployment – monthly wages would have to fall by about 40 percent to a level slightly above the estimated poverty line for a family of four (Pollin, et al., 2007). In Kenya, assuming a wage elasticity of -0.6, a 25 percent increase in formal employment would require that wages fall to 10 percent below the poverty line for urban workers and 23 percent below the poverty line for rural workers (Pollin, Githinji, and Heintz, 2008). In both cases, a large number of the currently employed would see their wages fall to a level at or below a basic needs threshold. Of course, some individuals would benefit – in South Africa the unemployed who get new jobs and in Kenya informal workers who would move into formal employment. Nevertheless, the average employment conditions of formal workers would correspond to a poverty-level standard. In addition, the individuals who would see their employment earnings decline outnumber those who would benefit.

Another issue is the amount of formal employment that would actually be generated through efforts to lower wages. For countries like Ghana, Mali, and Kenya – featured in Table 1 – formal private employment is a small fraction of total employment. Therefore, a 30 percent growth in employment (requiring wage reductions of between 40 and 60 percent) would raise the share of total private wage employment to just 1.3 percent of all employment in Ghana and about 9 percent in Kenya. Large changes in the average quality of formal employment – effectively informalizing existing formal employment – would be necessary to achieve very small changes in the structure of employment.

Even if wage reductions are not a viable option for increasing employment, labour market rigidities more generally could potentially discourage the expansion of the formal sector and the hiring of formal wage workers. Are regulations a significant barrier to development in African countries? Table 2 presents the results of a survey of firms for 5 African countries in which employers were asked whether labour regulations posed a significant obstacle to growth and development. It is important to acknowledge that employers are not disinterested parties and would have an incentive to overstate the role of labour market regulations. Nevertheless, there is no case in which a majority of firms reported that labour market regulations were a significant barrier. In Zambia, the largest share of firms reported that retrenchment procedures were a significant obstacle compared to all other categories of regulation and all countries featured in Table 2. Even here, only 26.7 percent of firms saw retrenchment procedures as a problem. Nearly three-quarters of all Zambian firms surveyed did not identify the retrenchment process as particularly onerous.

Table 2: Labour market regulations: firms citing regulatory process as a significant obstacle to development and growth.

	Hiring procedures	Retrenchment procedures	Labour regulation
Ethiopia	0.5%	9.8%	4.6%
Kenya	5.2%	20.9%	22.5%
Nigeria	4.8%	10.6%	12.1%
Uganda	4.1%	8.3%	10.8%
Zambia	1.0%	26.7%	16.9%

Source: Alby, Azam, and Rospabé (2005)

Arguments that high wages and excessive regulation are responsible for a lack of formal employment, high unemployment, or widespread underemployment has limited or no relevance for most African countries. Moreover, efforts to address employment problems by reducing earnings are likely to entrench poverty-level standards in the basic conditions of employment. Despite the above arguments demonstrating the limitation of the ‘labour market flexibility’ approach, the role of labour costs as part of a broader development strategy cannot be entirely ignored. For example, productivity improvements can raise competitiveness in higher value-added industries without cutting living standards. Government programs can be targeted at employment-intensive activities as a way of supporting employment growth without sacrificing quality. These approaches to employment creation will be developed in greater detail later in this paper.

The more significant point is that limited employment opportunities in Africa are not the result of over-regulation of formalized labour markets. The solution to employment problems must therefore be found outside of the labour market. In other words, the challenge of creating decent jobs in African countries is a development challenge, one that requires a comprehensive employment-focused growth strategy.

Poverty and employment outcomes

Not all employment is the same. Simply having access to employment does not provide a guaranteed path out of poverty. The quality of employment must be sufficient to lift employed individuals and their dependents to a decent standard of living. Table 3 illustrates this point for Ghana, using “working poor” poverty rates. Individuals are considered to be “working poor” if they are (1) employed and (2) they are members of households in which the total income falls below the estimated poverty line. Table 3 shows poverty rates for different categories of employment: formal employment and informal employment, agricultural and non-agricultural employment, and wage- and self-employment. Formal employment is distinguished from informal employment by being more highly protected or regulated.⁶ From Table 3 we see that poverty risks are higher for individuals in informal employment relative to formal employment, agricultural workers relative to non-agricultural workers, and the self-employed relative to wage employees.

In addition, women are often disproportionately employed in categories of employment with low returns to labour. This is a fundamental source of gender inequality in many countries. It raises the risk of poverty, particularly for households that depend predominately on women’s paid employment to make ends meet.

The issue of the quality of employment is critically important. Ideally, economic policies should aim at increasing the amount of formal, non-agricultural employment available to the labour force and insuring that all working individuals, men and women alike, have access to these opportunities. Movement into these forms of employment from informal or agricultural employment will reduce average poverty rates. However, it is unlikely that – even with rapid rates of growth – the expansion of formal wage employment will be sufficiently large to improve employment conditions for the majority of the employed, except in the very long-run. Therefore, policies should also raise the returns to labour in other forms of employment: agricultural and informal self-employment. For example, one such policy – discussed in greater depth later – would be to improve access to credit and financial services for small-scale producers by forging linkages between formal and informal institutions.

⁶ The self-employed are considered to be formal if their enterprise is registered with the government. Wage employees are considered to be formal if they have access to basic social protections – paid leave and contributions to a pension fund.

Table 3: Working poor as a percent of employment (15+) in selected employment statuses by sex, 1998/9, Ghana.

	Women	Men	Total
Formal employment, non-agricultural			
Formal private wage employees	---	26.5	25.8
Formal public wage employees	36.5	43.9	42.0
Formal, self-employed	52.0	45.8	49.2
Formal employment, agricultural			
Formal wage employees	---	---	65.6
Informal employment, non agricultural			
Informal, self-employed	57.4	58.8	57.7
... of which: own account workers	57.4	58.5	57.7
Informal wage workers	40.3	43.8	42.8
... of which: informal public wage workers	39.4	46.2	44.4
Unpaid family workers	70.0	60.0	67.0
Informal employment, agricultural			
Self-employed	74.4	72.9	73.5
Informal wage workers	---	56.9	57.7
Unpaid family workers	87.8	80.7	85.8

--- = too few observations for statistically significant estimations.

Households are considered poor if their income from all sources falls below the poverty line calculated on the basis of household composition and adult equivalency scales.

Source: Author's calculations based on the Ghana Living Standards Survey 4, 1998/9.

It is common to note that the primary problem in African countries is not open unemployment per se, but widespread underemployment.⁷ Underemployment is often defined as a situation in which individuals work fewer hours than they would ideally like to work. However, in the African context, this definition of underemployment is not always informative. In many cases, underemployment manifests itself as individuals working very long hours in low-productivity activities, in which earnings are extremely low. These individuals are underemployed in the sense that there is inadequate demand for their labour. This in turn leads to very low pay for these workers' efforts. For example, a recent study of employment,

⁷ This generalization may not strictly hold in all cases. South Africa has a problem of high rates of open employment – according to survey measurements using internationally accepted definitions. Similarly, in other African countries, open unemployment may be a problem in urban areas, but not insignificant in rural areas.

economic policy, and poverty in Kenya found that among Kenyan workers employed 40 hours or more per week, nearly 50 percent of them live in poverty, based on their employment earnings and the official consumption poverty line (Pollin, Githinji, and Heintz, 2008). Poverty rates among Kenyans working fewer hours are higher on average, but simply working longer hours does not, in itself, provide a guaranteed path out of poverty. Higher average earnings are needed.

In short, to have a significant impact on poverty and human development, economic policies must improve employment opportunities in terms of both quality and quantity. The remainder of this paper focuses on alternative approaches to economic policy, which would create an environment conducive to the realization of an employment-oriented development agenda.

III. Policy Analysis

3.1 Monetary policy and inflation management

To generate better employment opportunities in African countries, monetary policy must encourage employment-generating investment, facilitate sustainable economic expansion, and maintain macroeconomic stability. Although monetary policy, by itself, may not directly generate new opportunities, it is a critically important policy instrument for establishing an environment that is conducive to improving employment outcomes. Monetary policy has a direct impact on important economic variables, including the real interest rate, the average price level, and the exchange rate. Inappropriate monetary policy will constrain economic growth and investment, and, as a result, will hinder efforts to create better employment opportunities. Therefore, it is important to consider what monetary policy regime would best serve the developmental objectives of improving employment and reducing poverty in an African context.

A variety of monetary regimes exist in Africa. However, in countries across the continent, the ultimate goal currently is to reduce inflation to the low single digits. For example, Kenya has set a goal of keeping inflation below 5 percent in its national development strategy, the Economic Recovery Strategy. Ghana has set a target of maintaining single-digit inflation in its national Growth and Poverty Reduction Strategy. South Africa has gone a step further and has adopted a formal inflation-targeting monetary regime, in which the performance of the monetary authority is evaluated based on its ability to keep annual inflation rates within a narrow band of 3 to 6 percent.

The monetary strategies for achieving very low rates of inflation differ from country to country. In many African countries, particularly in those countries under the influence of an IMF financial programming framework, monetary policy tends to target the growth rate of the money supply, as measured by a relatively broad monetary aggregate, such as M3. If inflationary pressures are perceived to be increasing, the central bank would intervene to reduce the growth rate of the money supply. Mozambique's Action Plan for the Reduction of Absolute Poverty (2006-09) states this approach succinctly in its discussion of the country's monetary strategy:

“The expansion of the monetary base should be controlled so as to maintain low rates of inflation.”⁸

⁸ “A expansão da base monetária deve ser controlada para manter níveis baixos de Inflação” (p. 39). República de Moçambique (2006). Plano de Acção para a Redução da Pobreza Absoluta 2006-2009, Maputo.

In Mozambique's poverty reduction strategy, monetary growth should be contained to allow inflation to fall to a predicted annual rate of between 5 and 6 percent beginning in 2007.

Although the central banks of many African countries target the growth rate of monetary aggregates as the primary means of conducting monetary policy, other approaches also exist. For example, the South African Reserve Bank primarily influences key short-term interest rates in order to conduct its inflation-targeting monetary policy. When inflation moves outside of the target range, the Reserve Bank intervenes to raise the rate on re-purchase agreements (the repo rate) in an effort to reduce the rate of price increases (SARB, 2007).

Inflation and economic growth

Given the emphasis on conducting monetary policy so as to lower inflation in most African countries, it is important to examine the benefits and trade-offs of low rates of inflation. High inflation is not a desirable end in itself. Given the choice between high inflation and strong economic growth or low inflation and equally robust growth, policymakers should opt for low inflation. However, it is important to examine the premise that low inflation rates are, by themselves, conducive to economic growth. The only reason for relaxing a policy that targets low rates of inflation is that faster economic growth would be possible with a less restrictive monetary stance. Tight monetary policies generally lead to high real interest rates. High interest rates, in turn, dampen economic growth, and thereby, the expansion of decent employment opportunities in the formal sector. Therefore, there are potential trade-offs to maintaining very low rates of inflation.

What is the relationship between inflation and growth? Answers to this question vary widely. Some of the most influential studies were those produced by Michael Bruno and William Easterly. In his 1995 research, Bruno studied the relationship between inflation and economic growth for 127 countries between 1960 and 1992. Bruno found that the average growth rates fell only slightly as inflation rates moved up to 20 to 25 percent. Of particular importance, Bruno found that during 1960 to 1972, economic growth on average increased as inflation rose, from negative or low rates to the 15 to 20 percent range. This is because, as Bruno explained, "in the 1950s and 1960s, low-to-moderate inflation went hand in hand with very rapid growth because of investment demand pressures in an expanding economy," (1995, p. 35). Thus, according to Bruno's findings, inflation that results directly from expansionary economic policies will not create any significant barriers to further growth.

Bruno's findings were challenged by other researchers, who found that high rates of inflation lead to lower economic growth. However, in responding to these critics, Bruno and Easterly (1998) discovered that the clear negative relationship between inflation and growth only operates at very high inflation rates – what they define as in the range of 40 percent or above. When these episodes of very high inflation are considered separately from those of moderate inflation, Bruno and Easterly again found that, for the cases of moderate inflation, no clear relationship existed between inflation and economic growth.

Other researchers have produced findings contradictory to Bruno and Easterly, even after separating out the experiences of high (i.e. 40 percent or more) inflation from moderate inflation. For example, IMF economists Ghosh and Phillips (1998), drawing from a data sample of IMF member countries over 1960-96, found evidence of a negative inflation/growth threshold at 2 ½ percent. But they also acknowledge that thresholds of 5 to 10 percent generate statistical results very similar to their 2 ½ percent threshold.

Their particular conclusions aside, the work of Ghosh and Phillips is within a widely accepted current stream of research that distinguishes the relationship to growth of different levels of inflation – observing how the effects of inflation on growth will vary at, say, 5, 10, 20 and 30 percent inflation rates. These researchers rely on nonlinear econometric models to distinguish the growth/inflation effects at these alternative thresholds. What is also especially relevant for African countries is that this most recent stream of research has found that the growth/inflation relationship is different for industrialized countries and developing countries.

For example, a 2001 study by Khan and Senhadji identified the threshold point for industrial countries at which inflation reduces economic growth at a very low 1 to 3 percent. But their threshold point for developing countries was between 11 to 12 percent. This distinction in threshold points was also found in a 2004 study by Burdekin, Denzau, Keil, Sithiyot, and Willett. They also utilized non-linear estimating techniques. However, they reached conclusions nearly opposite to Khan and Senhadji: that the negative inflation/growth threshold was higher for industrial countries, at 8 percent, than the threshold for developing countries, which was three percent.

Robert Pollin and Andong Zhu (2006) developed another model that estimates the effects of inflation on economic growth. This model includes inflation as one potential factor influencing economic growth, after controlling for a range of other potential influences.⁹ The growth/inflation estimates are based on a data from 80 countries from 1961 to 2000. As with the more recent literature generally, the Pollin/Zhu model includes a non-linear component to capture the differential effects of low versus high rates of inflation. In addition, the models follow Bruno and Easterly in excluding inflation episodes in excess of 40 percent. Finally, this model examines the inflation/growth relationship for the full set of countries in different ways. It provides separate sets of results for OECD countries, middle-income countries, and low-income countries. It also considers the full sample of countries within four separate decades from 1961 to 2000. This study then utilizes four different estimating techniques with each of the various country- and time-period groupings, to test for the robustness of findings using any given technique.

⁹ These other potential influences include 1) the initial level of GDP; 2) the share of investment spending in GDP; 3) the share of government spending in GDP; 4) the fiscal deficit; 5) the level of overall health, as measured by life expectancy; 6) the international economic environment; 7) the effects of natural disasters; and 8) the effects of wars.

The main results of these exercises can be summarized quickly. Considering the full data set, they consistently find that higher inflation is associated with moderate gains in GDP growth up to a roughly 15 to 18 percent inflation threshold. But the results do diverge when they divide the full data set according to income levels. With the OECD countries, no clear pattern emerges in terms of identifying a negative inflation/growth threshold. With the middle-income countries, including South Africa as the one sub-Saharan African country in this grouping, the results again become consistently positive up to a 14 to 16 percent threshold, though these results are not statistically significant. The positive inflation/growth relationship holds more strongly and consistently with low-income countries, with 18 Sub-Saharan African countries included in this group. The results indicate that inflation and growth will be more positively correlated to the degree that macroeconomic policy is focused on stimulating demand; that is, a finding consistent with Bruno's observation that growth and inflation were more positively correlated over the period 1960 to 1972, when active demand management policies were being widely practiced in support of maintaining high employment.

Considering the findings from all these studies, nothing close to a consensus has been reached on this question, even while increasingly sophisticated estimating techniques have been deployed to control for various non-linearities in the inflation/economic growth relationship. At the same time, we can draw a few conclusions from these various studies. First, regardless as to whether researchers observe a negative growth/inflation relationship emerging in the low or high double-digit range for developing countries, only one study found any evidence of a negative relationship between growth and single-digit inflation for developing countries. This suggests that inflation targets in the lower single digits for African countries are unlikely to contribute positively to economic performance and, if accompanied by high real interest rates, may negatively impact growth.

Second, despite the wide range of techniques now being used to estimate the growth/inflation trade-off, no researcher has challenged one important point emphasized by Bruno in his initial 1995 work—namely, that the relationship between inflation and growth will be different depending on what is causing the economy's inflationary pressures. As Bruno found, demand-pull inflation, resulting from a process of economic expansion, will be positively associated with growth as long as the inflation rate remains moderate.

By contrast, following the logic of Bruno's findings, inflation that results from excessive price mark-ups over costs by businesses, supply shocks, or exchange rate volatility will be associated with negative growth effects. But these negative growth effects will not be due to inflation per se, but rather to the monopolistic pricing power of businesses, the economy's attempt at adjusting to supply shocks, or volatile movements of the exchange rate.

Although there is little evidence that maintaining very low rates of inflation – by itself – will positively contribute to economic growth, the interventions required to reduce inflation to the lower single digits may themselves adversely impact economic performance. Specifically, a tight monetary stance often

results in high real interest rates, which can slow economic growth. Macroeconomic studies of Ghana and South Africa – using vector auto-regression (VAR) and vector error correction (VEC) models – show that increases in the real interest rate have a sustained impact on economic growth (Heintz and Epstein, 2006; Pollin, et al., 2007). If slower growth results in the underdevelopment of supply-side productive capacity, a high interest rate policy may reinforce capacity constraints that have long-run implications for inflation in Africa.

Inflation dynamics in the African context

Given the stress placed on inflation, it is helpful to better understand the factors that contribute to inflation in African countries. To do this, we estimate the impact of various economic factors on the rate of inflation in a pooled dataset covering 28 countries in sub-Saharan Africa over the period 1975-2005: Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, the Central African Republic, Chad, Côte d'Ivoire, Gabon, The Gambia, Ghana, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Niger, Nigeria, Rwanda, Senegal, Seychelles, Sierra Leone, South Africa, Sudan, Swaziland, Togo, Uganda, Zimbabwe.¹⁰ Details of the estimation are contained in Appendix 1. Here we only present the results.

Table 4 shows the coefficient estimates for the different factors that influence the annual inflation rate in the countries included in this exercise. The factors considered are: past rates of inflation, the growth rate of GDP, the growth rate of the money supply, the percent change in the nominal exchange rate, and the growth rate of an index of food production. The coefficients show the impact of the change in each variable on the rate of inflation.

Table 4: Coefficient estimates for the determinants of inflation (dependent variable: the annual CPI inflation rate)

Variable	Coefficient
Lagged inflation	0.43**
GDP growth	-0.21**
Money supply (M2) growth	<0.01
% change in the nominal exchange rate	0.12**
% change in index of food production	0.08*

* Statistically significant at the 10% level. ** Statistically significant at the 5% level.

From the estimates in Table 4, we can make a number of interesting observations. First, inflation in these African countries shows a significant degree of inertia in the sense that an inflationary shock in one year

¹⁰ Countries were chosen based on the availability of data. A full set of observations over the entire time period 1975-2005 was not always available for each country.

is likely to persist in future years, although the impact will weaken over time. Second, economic growth tends to be associated with lower rates of inflation. This suggests that growth tends to be characterized by an expansion of productive capacity, which reduces inflationary pressures. If demand-pull inflation were strongly evident in these African countries, we would expect a positive coefficient: higher rates of growth run up against capacity constraints and lead to price increases. Third, the growth rate of the money supply does not have a strong impact on inflation – an issue that we discuss in more detail in the next section. Fourth, a depreciation in the value of the currency (i.e. an increase in the value of the nominal exchange rate) leads to inflationary pressures. That is, there is a significant degree of pass-through between the exchange rate and the price level. Finally, food prices are important components of the general price level in many African countries. Positive shocks to food production reduce inflationary pressures, while negative shocks contribute to higher inflation.

These estimates point towards several important conclusions concerning price dynamics in African countries. First, inflation is often driven by supply-side factors instead of demand-side factors. Therefore, negative supply side shocks will raise the rate of inflation, but, as noted in the previous section, may be associated with lower rates of growth. This does not imply that high inflation slows growth, but rather that inflation and growth respond to the same underlying factors. Second, monetary aggregates have a limited impact on inflation – an observation with important implications for the conduct of monetary policy. And, third, depreciations in the nominal exchange rate contribute to inflation. This suggests that exchange rate volatility may be a source of inflationary pressures – an issue that we will return to in the discussion of exchange rate policy.

Monetary policy instruments and targets

As mentioned earlier, many countries in Africa target the growth rate of monetary aggregates in their conduct of monetary policy. In many cases, the targets and instruments that have been adopted represent the tools recommended in an IMF financial programming framework, a commonly applied macroeconomic framework in countries receiving debt relief or dealing with an economic crisis (Easterly, 2002). In this framework, changes in the domestic money supply are assumed to affect the supply of credit, the inflation rate, and the level of foreign reserves.¹¹ Often, a ceiling on the growth of domestic credit is imposed in a financial programming framework. As discussed above, low-inflation rate targets are frequently included as an objective of the monetary policy regime. The desired growth rate of the money supply is therefore determined by inflation, credit, and/or foreign reserve targets.

¹¹ As Easterly (2002) explains in some detail, the relationship between the money supply, domestic credit, and foreign reserves depends on which variables are considered exogenous, which variables are considered policy variables, and which variables are endogenously determined. Often, changes in the money stock are assumed to be the principal policy variable, with credit or reserves adjusting endogenously.

If credit ceilings and low inflation targets characterize the monetary policy regime within a financial programming context, then there will be little scope for expansionary monetary policy (Epstein and Heintz, 2006). This introduces a contractionary bias into the conduct of monetary policy. Insofar as central banks follow these policy prescriptions, this approach may cause interest rates to be higher and economic growth to be lower than would otherwise be the case. Both of these outcomes would have a negative impact on employment.

Moreover, the supply-side nature of inflation in many African countries, as discussed above, has important implications for the conduct of monetary policy. If monetary policy is tightened in response to supply side-shocks that have inflationary consequences – such as an unexpected increase in food, petrol, or transportation costs – monetary management becomes pro-cyclical. That is, a more restrictive monetary policy is pursued in the face of a negative economic shock. Tightening monetary policy in response to such events in order to maintain low inflation rates runs the risks of worsening the economic impact of these shocks. Therefore, there is a dual risk in the conduct of monetary policy according to a strict inflation-targeting/financial programming framework: (1) monetary policy will exhibit a contractionary bias and (2) anti-inflation monetary policy will be procyclical in the face of supply-side shocks, unless the nature of inflation is taken into account in formulating policy responses.

The economic theory behind the link between money supply and inflation is the quantity theory of money, with its well-known formula:

$$(\text{money supply growth}) + (\text{rate of change of the velocity of circulation}) = (\text{the inflation rate}) + (\text{real GDP growth})^{12}$$

Often, the velocity of circulation of money is assumed to be constant when this relationship is applied. In addition, real GDP growth is often taken as predetermined for the purpose of this formula. This therefore means that the growth rate of the money supply should be closely linked to the country's inflation rate. If these assumptions are taken to be true, the target money supply growth rate should be approximately equal to the country's inflation target plus the expected growth rate of real GDP. In this way, intermediate targets can be set for the conduct of monetary policy. However, the assumptions made in the application of the quantity theory of money do not hold in practice. The velocity of money is not constant and there is often not a one-to-one correspondence between inflation and the growth rate of the money supply (Easterly, 2002).¹³

¹² The quantity theory of money is usually summarized by the following identity: $MV \equiv PQ$, in which M represents the money supply, V the velocity of circulation, P the average price level, and Q real output. The expression given here is simply this standard identity expressed in rates of change (i.e. the derivative with respect to time of the identity expressed in natural logarithms).

¹³ Easterly (2002) demonstrates that changes in velocity typically account for a large portion of changes in the price level and that the elasticity of inflation with respect to the growth of the money supply must be significantly lower than one.

In addition, central banks do not directly control the growth rate of the broad money supply.¹⁴ The central bank can directly influence the growth of a narrower monetary aggregate, which is typically called “high-powered money” or “reserve money.” Reserve money consists of currency in circulation plus reserves in the banking system. It therefore excludes the other components of broader measures of the money supply – e.g. demand deposits, savings deposits, certificates of deposits (CDs), the deposits of non-bank financial institutions, and the foreign currency deposits. In other words, in practice, those central banks which follow this standard approach to monetary policy establish a target growth rate for reserve money that they believe is consistent with low inflation, with the idea that the reserve money target will in turn lead to a growth rate of broader monetary aggregates that keeps inflation low.

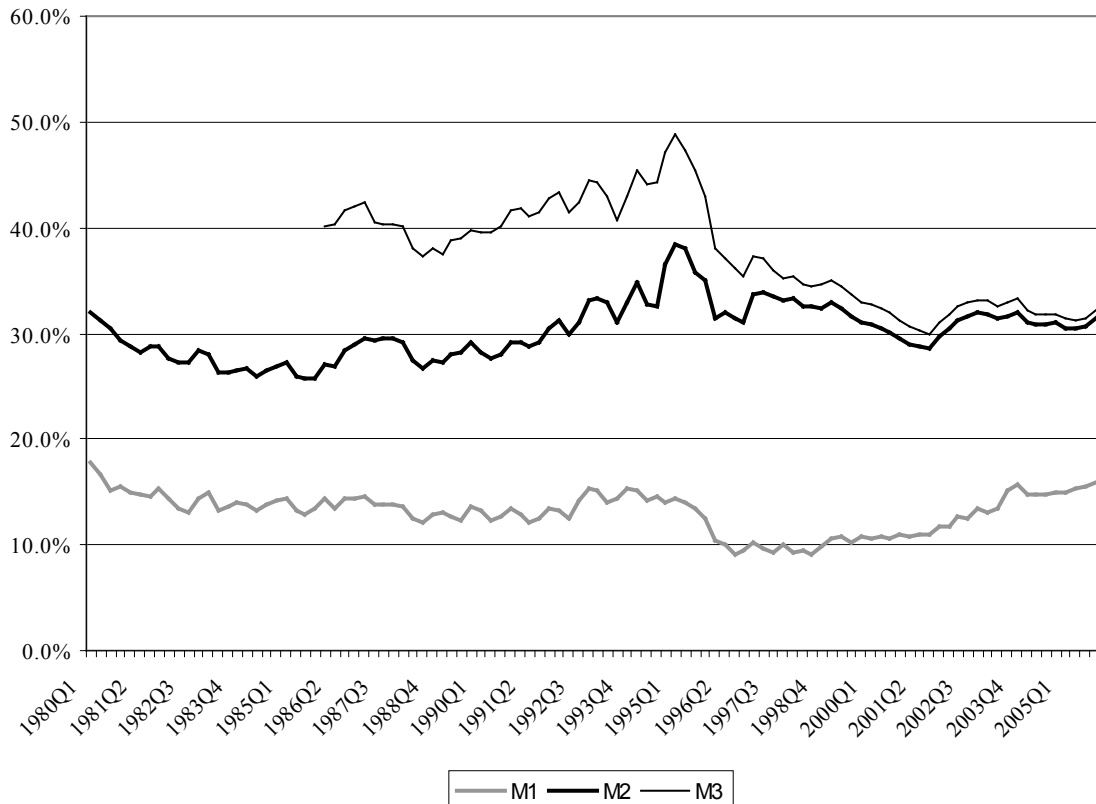
However, the growth of reserve money may not always be strongly linked to the growth of other monetary aggregates – and these broader measurements of the money supply are the economic variables relevant for formulating monetary policy. Here we present an example from Kenya. Figure 4 shows three monetary aggregates as a share of GDP from 1980 to 2005. The three aggregates are M1 (reserve money), M2 (M1 plus savings deposits and CDs), and M3 (M2 plus the deposits of non-bank financial institutions).¹⁵ Measures of broad money (e.g. M2 or M3) increased as a share of GDP on average until the late 1990s at which time broad money, relative to GDP, began to decline modestly.¹⁶ The narrowest definition of the money supply, M1, exhibits a different pattern. M1 as a share of GDP remains relatively constant through much of the period illustrated in Figure 4. However, beginning in the late 1990s, M1 rises as a percent of GDP while M2 and M3 decline.

¹⁴ Nor is there necessarily a clear relationship between the growth of the money supply and the growth of domestic credit (Easterly, 2002).

¹⁵ The Central Bank of Kenya uses new definitions of M2 and M3 which differ slightly from those presented here. Under the new system, M2 is the same as M3 as we define it here. M3 (formerly called M3X) is equal to the new M2 plus foreign currency deposits. We present monetary aggregates using the old definitions to track changes over a longer time period.

¹⁶ Note that the gap between M2 and M3 narrows significantly over this period. The gap represents deposits of non-bank financial institutions. Due to regulatory reforms, many non-bank financial institutions (which were previously able to avoid some of the regulations of the banking sector) were transformed into banks. This, purely regulatory, change would have caused M2 to increase faster than M3, closing the gap between the two series.

Figure 4: Money supply as a percent of GDP, Kenya, 1980-2005.



Source: Central Bank of Kenya.

One possible explanation for the pattern observed since the mid-1990s is that individuals and businesses in Kenya are increasingly moving their financial assets out of the banking system and purchasing non-bank assets – including domestic and foreign stocks, bonds, and derivatives, as well as real estate. Such asset purchases require additional cash. This would mean that the demand for narrow money would rise while the demand for M2 and M3—such as savings deposits and CDs—would fall. However, if this behaviour is prevalent, it means that wealth-holders are moving their assets into- and out of the banking sector on a regular basis.¹⁷ Under such circumstances, the central bank’s control over M3 will diminish.

In addition, large amounts of money and financial assets currently circulate in the Kenyan economy outside of the banking sector. The central bank has virtually no influence over these resources.

¹⁷ See Pollin and Shaberg (1998) for a discussion of this pattern as it affected the U.S. economy

Summary: inflation and monetary policy

From this analysis of monetary policy and inflation dynamics in African countries, a number of observations may be made that have important policy implications.

- The evidence suggests that maintaining inflation in the low single digits will not, by itself, increase the rate of economic growth. If low inflation is achieved through contractionary macroeconomic policies, it may be associated with slower, rather than faster growth. Indeed, the direction of causation may run in the opposite direction: higher rates of growth lead to the expansion of domestic capacity which, in turn, reduces inflationary pressures.
- A policy regime exclusively focused on maintaining low inflation and limiting the expansion of domestic credit has a contractionary bias in the sense that there are no clear circumstances in which an expansionary policy can be pursued.
- Given the nature of employment dynamics in African countries, monetary policy aimed at controlling inflation may be procyclical, when inflationary pressures are the result of supply-side shocks.
- The evidence suggests that targeting the growth rate of monetary aggregates as a means of maintaining low rates of inflation is not effective. This is partly because the conditions needed for a direct link between inflation and money supply growth (i.e. a constant velocity of money) often do not hold. Also, central banks may not be able to directly influence the growth rate of broad monetary aggregates, particularly as African financial systems become increasingly sophisticated.

This is not to suggest that monetary policy can be conducted without any regard for inflationary dynamics. Excessive growth of the money supply – as may be observed during periods of conflict in which the state finances its spending by ‘printing money’ – will lead to monetary and price instability. However, within a prudent range of monetary expansion, an alternative approach to monetary policy could better support an employment-centered development strategy.

What alternatives are available to African countries? Central banks should adopt as their focus a dual mandate of stabilizing inflation at moderate levels while generating more employment and economic growth, a focus that is consistent with the long-run objectives of economic development and poverty reduction. In time we would hope that this could lead to the establishment of decent employment targets alongside inflation targets. Setting employment targets would of course necessitate the collection of information on employment to evaluate the success of the policy. In many countries, the ability to monitor and evaluate employment outcomes would require significant improvements in employment statistics and information systems.

Real economic outcomes – such as growth and employment – represent long-run goals and such indicators may not be useful when making short-run monetary policy decisions. Therefore, intermediate targets for short-term real interest rates would be used to conduct monetary policy. These intermediate targets would be set consistent with longer run development objectives. For example, one goal would be to keep real short-term interest rates at a low, but positive, level. Short-term interest rates would replace the growth of monetary aggregates as the operating targets used to formulate monetary policy. Since the emphasis would be on targeting real interest rates, the intermediate target would embody the balance between inflation management and supporting economic growth necessary for an employment-centered development strategy.

3.2 Exchange rates and capital management

Exchange rate movements affect economic growth, employment, living standards, and the distribution of resources between sectors that trade on global markets (tradables) and those that produce only for domestic consumption (non-tradables). Therefore, appropriate exchange rate policies are critical in designing an economic program that can succeed in promoting economic growth, employment expansion and poverty reduction. If exchange rate policy is not supportive of these broad development objectives, the realization of improved employment outcomes in African countries will be compromised.

Often, when analyzing the impact of exchange rates on real economic outcomes, a distinction is made between the nominal exchange rate and the real exchange rate. The nominal exchange rate is simply the price of the domestic currency relative to one or more foreign currencies. Most commonly, nominal exchange rates are expressed in terms of the amount of the domestic currency one U.S. dollar can buy, although nominal exchange rates can also be measured relative to a basket of foreign currencies (for example, the currencies of the country's largest trading partners). In contrast, the real exchange rate is often defined as the price of traded goods (whose price is determined internationally) to non-traded goods (whose price is determined domestically). In practice, the real exchange rate is often calculated as the nominal exchange rate multiplied by the ratio of foreign prices to domestic prices.

Recent literature suggests that misaligned real exchange rates can harm economic growth. Specifically, an over-valued real exchange rate biases economic activity towards non-traded goods and services and away from traded goods and services (both export-producing and import-competing sectors). Imported goods become cheaper relative to domestic substitutes and exports lose their competitiveness. This creates difficulties for domestic producers to compete against importers within their own domestic markets. An over-appreciation of the real exchange rate occurs when domestic prices rise faster than foreign prices, or when the nominal exchange rate appreciates without a corresponding fall in domestic prices. Allowing a country's currency to rise too high relative to the prices and exchange rates of its trading partners has been shown to negatively impact long-run growth in a number of developing economies, including countries in sub-Saharan Africa (Gala and Lucinda, 2006; Frenkel and Taylor, 2005; Ghura and Grennes, 1993;

Dollar, 1992; Cottani, Cavallo, and Khan, 1990).¹⁸ Therefore, maintaining a competitive real exchange rate is an important policy objective for raising the growth performance and improving employment opportunities in African countries.

Exchange rate regimes

African countries have a variety of exchange rate regimes in place: from pure floats to fixed rates to managed interventions. Table 5 summarizes the IMF’s assessment of the de facto exchange rate regime operating in 51 African countries.¹⁹ Of these 51 nations, 14 countries (or 27 percent of the total) in West and Central Africa belong to the CFA franc zone – a common currency area in which the exchange rate is fixed to the Euro and guaranteed by the French government.²⁰ 15 countries (or 30 percent of the total) have some type of pegged exchange rate regime – either a fixed peg or a crawling peg – in which the value of the domestic currency is adjusted based on the value of one or more foreign currencies. Currently, the most common exchange rate regime in Africa is a floating exchange rate – 22 countries have this system in place. This represents 43 percent of the countries listed in Table 4, but these countries account for 58 percent of the GDP of all African countries, and 60 percent of the continent’s population.

Table 5: Exchange rate regimes, IMF de facto classification.

Exchange rate regime (de facto)	Countries
CFA franc zone (14 countries)	Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Congo (Republic), Côte d’Ivoire, Equatorial Guinea, Gabon, Guinea-Bissau, Mali, Niger, Senegal, Togo
Fixed pegs or crawling pegs (15 countries)	Botswana, Cape Verde, Egypt, Eritrea, Ethiopia, Lesotho, Libya, Mauritania, Morocco, Namibia, Rwanda, Seychelles, Sierra Leone, Swaziland, Zimbabwe
Floating (22 countries)	Algeria, Angola, Burundi, Congo (Dem. Rep.), The Gambia, Ghana, Guinea, Kenya, Liberia, Madagascar, Malawi, Mauritius, Mozambique, Nigeria, São Tomé and Príncipe, Somali, South Africa, Sudan, Tanzania, Tunisia, Uganda, Zambia

Source: IMF, De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework, 2006.

¹⁸ Easterly (2001) questions whether overvalued real exchange rates help to explain the poor growth performance of many developing countries during the so-called “lost decades” of the 1980s and 1990s.

¹⁹ In some cases, the de jure exchange rate policy differs from the de facto regime.

²⁰ Two central banks manage monetary policy in the CFA franc zone – the Banque Centrale des Etats de L’Afrique de L’Ouest (BCEAO) and the Banque des Etats de l’Afrique Centrale (BEAC). The “CFA franc” stands for the “franc de la Communauté Financière d’Afrique” for BCEAO member States, and “franc de la Coopération Financière en Afrique Centrale” for the BEAC area.

There is an on-going debate about which type of exchange rate regime is preferable – a fixed exchange rate or a floating rate (Hoffmann, 2007; Frankel, 1999; Melvin, 1985; Boyer, 1978; Mundell, 1961). Fixed exchange rates often are associated with greater price stability and lower inflation than floating rates. However, countries maintaining a fixed exchange rate may experience more difficult adjustments to external economic shocks. Fixed regimes require the maintenance of sufficient foreign exchange reserves to support the currency at the fixed rate. Because of this, countries with fixed exchange rates may have little or no influence over domestic interest rates, which must be used to secure adequate capital inflows. In effect, maintaining the fixed exchange rate requires sacrificing an independent monetary policy. The effect on interest rates is ambiguous since higher interest rates may be needed to maintain the fixed exchange rate, but a stable exchange rate reduces uncertainty, lowering the risk premium and, as a result, domestic interest rates. Fixed exchange rate regimes can lead to an over-valued real exchange rate, when economic conditions and terms of trade change making the existing rate uncompetitive. Occasionally, the fixed rate is adjusted to deal with problems of misalignment. For example, the CFA franc was devalued in 1994 to address economic imbalances in the region.

Pursing a policy of fixed nominal exchange rates can lead to over-valued real exchange rates, particularly in the context of domestic inflationary pressures (Edwards, 1989). Theoretically, the problems associated with exchange rate misalignment under a fixed nominal exchange rate regime should disappear if the exchange rate is allowed to float. In addition, the potential demands on foreign exchange stocks are fewer under a floating regime. Floating exchange rates allow countries to better adjust to external shocks than fixed rate regimes and countries can enjoy greater autonomy in terms of setting domestic interest rates (Frankel, 1999). However, floating exchange rates are more volatile than managed exchange rates – increasing the level of risk and uncertainty in the macroeconomy.

Moreover, the argument that floating rates are not subject to misalignment does not always hold. For example, high levels of capital inflows can lead to an appreciation of the real exchange – even in the face of a structural trade deficit, in which imports exceed exports. The high real interest rates needed to achieve low inflation targets attract such short-term flows and may lead to an over-valued, yet still market-determined, rate. Global commodity price dynamics can also lead to an overvalued exchange rate due to “Dutch disease” effects. Higher commodity prices in recent years increase export earnings and may raise the value of the exchange rate – eventually leading to a loss of competitiveness and growing import penetration.

Consider again the example of Kenya. Kenya has pursued a variety of exchange rate regimes since gaining independence (Ndung’u, 2000; Ndung’u and Ngugi, 1999). From independence until the early 1980s, the shilling was fixed relative to the dollar or Special Drawing Rights (SDRs), the quasi-currency created by the International Monetary Fund as a tool for promoting its monetary management initiatives.²¹

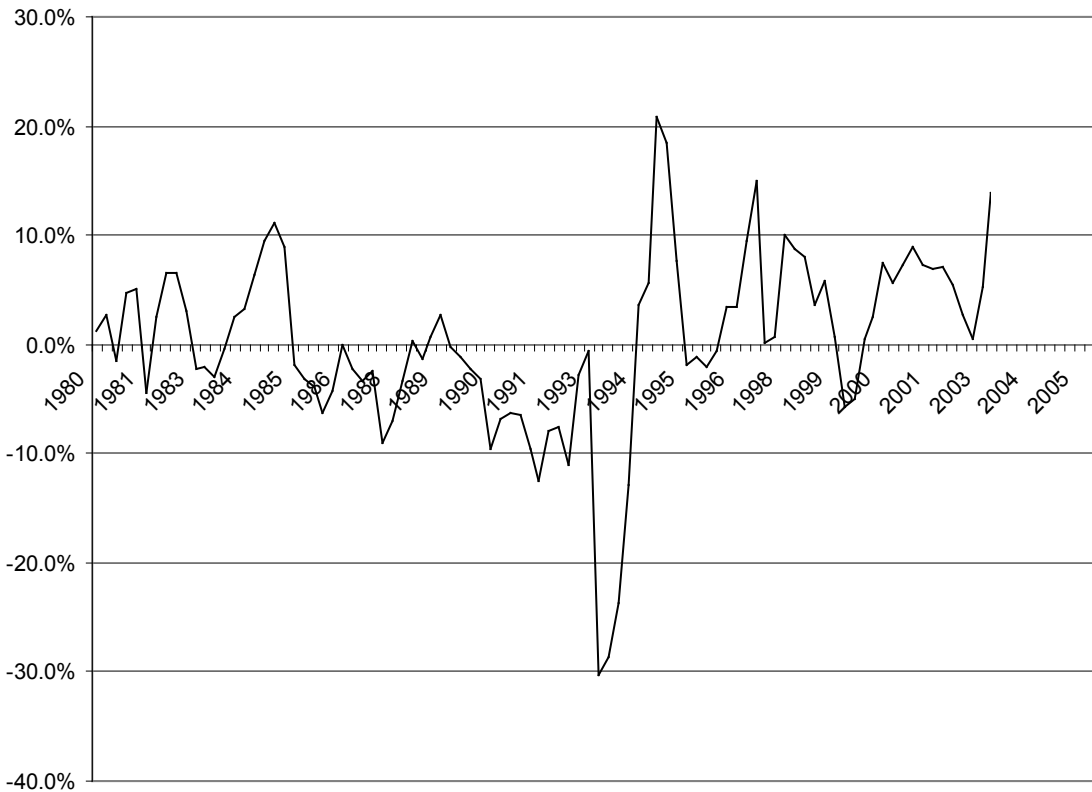
²¹ The shilling was fixed relative to the dollar until 1974. Balance of payments crises in the early 1970s led to devaluations of the shilling, after which the shilling was fixed relative to SDRs.

Beginning in 1982, the exchange rate regime was shifted to a crawling peg in which the exchange rate was adjusted based on price dynamics in Kenya's largest trading partners. The crawling peg was in place until 1990, when a dual exchange rate system was implemented. The dual exchange rate was an interim strategy, aimed at smoothing the transition to a fully floating exchange rate regime. The dual exchange rate regime consisted of an "official" exchange rate and a market exchange rate. In October 1993, the official exchange rate was merged with the market rate and a floating exchange rate was put into place.

Has the switch to a market-determined exchange rate reduced the degree of exchange rate misalignment in Kenya? Pollin, Githinji and Heintz (2008) recently estimated the long-run equilibrium real exchange rate in Kenya. We can compare the estimate of the long-run exchange rate to the actual exchange rate in order to develop a measurement of the extent of misalignment. The main policy concern in Kenya is the possibility of an over-valued exchange rate, which would hurt the country's export performance. Therefore, we measure the misalignment in terms of overvaluation: the difference between the long-run equilibrium exchange rate and the actual exchange rate, expressed as a percentage of the long-run equilibrium. The estimate of the degree of overvaluation is presented in Figure 5.

The estimates show that, on average, the real exchange rate has been moderately overvalued in Kenya since a floating regime was adopted in 1993. Interestingly, during the years of a managed exchange rate regime – after the fixed exchange rate was eliminated – the Kenyan shilling was at a more competitive level, i.e. slightly undervalued. The analysis by Pollin, Githinji and Heintz suggests that, at least in the case of Kenya, a managed exchange rate regime may be an effective tool of maintaining a competitive exchange rate which, in turn, may support more employment-intensive growth. Specifically, statistical estimates show that exports in Kenya appear to respond negatively to a real appreciation of the shilling (Pollin, Githinji, and Heintz, 2008). The positive employment effects would arise from improved performance of labour-intensive export sectors and a better environment for the development of domestic industries that compete with imports. Moreover, the adoption of a floating exchange rate, with a policy of non-intervention into foreign exchange markets, does not guarantee a more "correct" alignment of the real exchange rate – i.e. such automatic adjustments cannot be presumed to operate in all cases.

Figure 5: Measurement of the extent of misalignment (difference between actual real exchange rate and the estimated equilibrium exchange rate expressed as a percent of the equilibrium value), Kenya, 1980-2005.



Source: Pollin, Githinji, and Heintz, 2007.

Note: Positive percentages denote over-valuation.

We can draw a number of conclusions from this analysis. First, the real exchange rate is an important variable in supporting an employment-oriented growth strategy. As African countries diversify their export base away from a reliance on primary commodities, the role of the real exchange rate is likely to become increasingly significant. Second, the exchange rate regime adopted will determine the ability of policymakers to intervene in foreign exchange markets so as to keep the real exchange rate at a level consistent with developmental objectives. Third, there is no guarantee that a purely market-determined exchange rate will be set at a level consistent with long-run growth and development objectives. Some

scope for exchange rate management is warranted. Finally, a properly aligned exchange rate is important for a country to be able to diversify its productive base, since newly emerging industries may not be able to compete with imported goods or on global markets when the exchange rate is overvalued.

It is important to recognize that structural trade imbalances associated with import dependence and limited export diversification will not be solved by exchange rate policies alone. For example, if African countries were to avoid overvalued exchange rates, this will encourage exports and domestic production. However, many of the inputs into these production processes are imported. Therefore, the overall impact on the balance of trade is ambiguous – imports may expand along with exports. Complementary trade, industrial, and agricultural policies are needed. The impact of a competitive exchange rate will be much stronger if barriers to market access are removed. Industrial policies – including targeted infrastructure delivery, investment incentives, and credit programs – could encourage domestic production of inputs that are currently imported. Agricultural policies can support the realization of a diversified export base and entry into niche markets. In all cases, exchange rate and productive sector policies are mutually reinforcing complements, not substitutes for each other.

Capital flows, volatility, and policy options

The liberalization of capital markets associated with modern monetary and exchange rate regimes presents a second set of potential problems that extend beyond the question of how best to manage exchange rates: the increased economic volatility associated with short-term capital flows. Inflows of short-term capital can devastate an economy if the flows suddenly reverse, leading to a rapid depreciation of the currency. The examples of economic and financial crises over the past decade that were triggered by short-term capital flows are numerous, and include Mexico, East Asia, Brazil, Russia, Turkey, and Argentina.

Excessive exchange rate volatility – in either direction – is undesirable. A rapid and uncontrollable depreciation of the currency can lead to a significant economic contraction, inflationary pressures, and failure of the banking and financial system. Excessive appreciations lead to lost output, profits and employment – particularly in industries producing tradable goods. Volatility also increases perceptions of risk among domestic and foreign investors. This can raise interest rates and slow growth as risk premiums increase.

Exchange rate volatility is caused by rapid, and often unexpected, capital flows into and out of an economy. Managing exchange rate volatility therefore is equivalent to managing short-term capital flows. African countries need to take steps to manage the risks associated with volatile capital flows (UNECA, 2006). Capital management techniques represent a set of policies that can be used to reduce excessive volatility. Capital management techniques include explicit capital controls (i.e. restrictions on capital inflows or outflows) and prudential financial sector regulations that limit the risks and uncertainty (Epstein, Grabel, and Jomo, 2005).

In African economies, relatively little attention has been paid to the use of capital management techniques. This is largely because short-term, more speculative, capital flows – driven by international investors – have been relatively small. However, as African equity and bond markets become increasingly sophisticated, the relevance of volatile capital flows and related exchange rate uncertainty will grow. Because of its relatively well-developed financial sector and the growing importance of short-term capital flows in recent years, South Africa provides a useful example of these issues in the African context. A recent study of employment-targeted programs in South Africa has looked at the role of capital controls in some depth (Pollin, et al., 2006). Here we draw on this study to illustrate the relevance of the issues.

Prior to 1979, the South African rand was pegged to either the U.S. dollar or the pound sterling. Exchange controls, a form of capital control, restricted residents' ability to move financial resources out of the country and other regulations limited the ability of non-residents to sell financial assets and convert the proceeds into currencies other than the rand. In 1979, South Africa established a dual-currency exchange rate system, which was intended to break the direct link between domestic and foreign interest rates, as well as to insulate the capital account from certain categories of capital flows. A market exchange rate was used for commercial transactions, while a separate less favourable exchange rate, "the financial rand," was used for capital transactions.

The dual-currency system remained in existence until March 1995, under a managed float. Beginning in 1995, the government decided to progressively liberalize the system of capital controls. The process of liberalization involved: eliminating the financial rand exchange rate; abolishing exchange controls on current account transactions; removing controls on non-residents; reducing limitations on outward FDI; allowing institutional investors to diversify their investment portfolios by buying foreign securities; and gradually removing all other controls on residents (Bruce-Brand, 2002).

What was the impact of exchange controls in South Africa? A 2001 study by Farrell of the South African Reserve Bank examined the evidence. Farrell found that the volatility of the rand was lower during the dual exchange rate period than during the periods in which South Africa had a unified exchange rate (Farrell, 2001). This suggests that dual exchange rate system – a form of capital management – had been effective in reducing volatility (see also, UNECA, 2006). Pollin et al. (2006) also examined how capital controls affected volatility in South Africa. The authors use an index of financial integration for South Africa (i.e. a measure of liberalization) to look at the relationship between policy changes and exchange rate behaviour. They found that when capital controls are tightened, exchange rate fluctuations diminish. When they are relaxed, exchange rate volatility increases.

The evidence from South Africa supports the argument that capital management policies can be effective in reducing exchange rate volatility. These lessons can be applied to other African countries, particularly as the volume of short-term capital flows expands.

Exchange rate and monetary targets

Exchange rate and monetary policies are often seen as operating under a set of constraints (see Frankel, 1999). Specifically, it is argued that only two of the following three conditions may hold simultaneously:

- (1) free movement of capital into and out of the economy;
- (2) a fixed exchange rate; and
- (3) an independent monetary policy.

The idea that only two of the three conditions may hold at any time is often referred to as the “trilemma”. The logic of the argument is straight-forward. Given unrestricted capital mobility, a fixed exchange rate may only be maintained if sufficient foreign exchange reserves are on hand to defend the currency against depreciation. Countries often must maintain high interest rates to attract sufficient capital inflows to maintain the fixed exchange rate. Under these conditions, monetary policy is subordinated to exchange rate targets – i.e. it is not independent. Similarly, if monetary policy is free to set interest rates, the exchange rate must be able to adjust to insure a reasonable external balance with the rest of the world – otherwise, macroeconomic imbalances would eventually prove to be unsustainable. Therefore, an independent monetary policy is often assumed to require a floating exchange rate.

The concept of the trilemma is often invoked to argue for a relatively market-driven monetary policy and exchange rate regime. However, the trade-offs described by the trilemma represent extreme ends of the policy spectrum. That is, the trilemma holds for a fixed exchange rate regime, but there still is substantial policy space to manage the exchange rate without committing to a fixed level. Similarly, inflexible monetary policy targets may require perfectly flexible exchange rates. However, a managed monetary policy – in which short-term real interest rate targets are used as instruments for achieving medium-term developmental goals, such as better employment opportunities – can be adopted without accepting a policy of non-intervention in foreign exchange markets. Policy space for targeting real economic outcomes can be found if the focus shifts away from absolute policy stances – such as a fixed exchange rate or a complete discretionary monetary policy (Bradford, 2004).

Moreover, capital flows into and out of a country do not have to be unrestricted. Instead, they can be managed through the type of capital management techniques described earlier. In addition to controlling volatility, the effective use of capital controls can provide more policy space to target real developmental outcomes. Research suggests that capital controls do have some impact on increasing the amount of discretion policy makers have. A study of capital controls by Dooley (1995) concludes that:

“Capital controls do seem to be effective in insulating domestic interest rates and exchange rates from international factors, but usually only to a moderate degree, especially if the time period

is a long one; and only if the overall set of macroeconomic policies are internally consistent” (p. 29).

The dominant focus of macroeconomic policy – maintaining low inflation and a favourable external balance – is too narrow. Other options are possible. What is needed instead is a policy framework that allows for multiple policy instruments and multiple intermediate targets, all aimed at supporting long-run development objectives, such as explicit targets for employment. Consider the following three macroeconomic objectives:

- maintain a competitive real exchange rate;
- limit macroeconomic volatility due to unstable capital flows; and
- sustain real interest rates in a range consistent with long-run economic growth.

We can imagine three intermediate policy instruments for achieving these objectives:

- interventions in the foreign exchange market to maintain real exchange rates at a competitive, but not fixed, level;
- capital controls and capital management techniques to reduce volatility; and
- short-run real interest rate targets to balance inflation control with the promotion of economic growth.

This policy regime would be significantly more development-friendly than the dominant macroeconomic model. It would address two central concerns of policy-makers: macroeconomic stability and inflation control. And, with multiple instruments available to macroeconomic authorities, the targets could be pursued simultaneously. Long-run objectives, including specific employment targets, could be incorporated into this framework and macroeconomic policies would be coordinated with other policy initiatives to attain these goals.

3.3 Financial sector policies and development finance

The structure of the financial sector has direct implications for improving employment opportunities in African countries. Moreover, the institutional features of the financial system will determine the effectiveness of macroeconomic policies, specifically monetary policy interventions. As has already been discussed, to generate better employment opportunities, central bank policy must encourage employment-generating investment, facilitate sustainable economic expansion, and maintain macroeconomic stability. However, the impact of monetary policy cannot be considered in isolation from the nature of the country’s financial institutions. The financial sector is the primary conduit through which monetary policy affects

real economic outcomes, and monetary policy determines the amount and distribution of resources available to financial institutions. If the financial sector does not channel resource so as to improve real economic outcomes, then the impact of other policy interventions will be weakened.

A developmental financial system channels resources to productive uses and facilitates the management of risks associated with the process of development. However, in most African countries, the developmental role of the financial sector is circumscribed by limited access to the appropriate type of financial services that would encourage an expansion of productive activities. Barriers to credit and financial markets are a particularly severe problem for smaller enterprises, those operating in the informal economy, and agricultural activities. Since these activities account for the vast majority of employment in the country, financial constraints have a negative impact on efforts to improve employment opportunities.

Not only is access to credit limited, the cost of credit is typically high throughout Africa. This represents a significant constraint for many investors, large and small, both in terms of direct costs and cash flow management. Under these conditions, firms are reluctant to take advantage of investment opportunities by borrowing. Those enterprises with existing debt can encounter problems making required payments, adding to the uncertainty of sustaining productive activities and employment. Many factors are frequently identified as contributing to the high cost of credit: large interest rate spreads, poor information systems, the asset portfolio of banks (including reserves), and high transactions costs, in some cases linked to inadequate information.

Banks remain the dominant financial institutions in much of Africa. Therefore, we will focus primarily on the structure of the banking sector in the present analysis. As has been mentioned previously, the financial sectors of several African countries have become more diversified in recent years, particularly with the growth of deeper stock and bond markets. We have already discussed the growing sophistication of African financial institutions in terms of the implications for monetary policy and capital management techniques. Research suggests that the effectiveness of equity markets in mobilizing financial resources and channelling these resources to productive investments is questionable (Mkandawire, 1999; Singh, 1993; Zhu, Ash, and Pollin 2004). Given the ambiguous role of equity markets in promoting the types of developmental outcomes emphasized in this paper, we restrict our attention to the banking system and related institutions.

Institutional factors constraining access to affordable credit

We have already discussed one factor that contributes to the high cost of credit in African countries: restrictive monetary policies, which aim to maintain low rates of inflation. Such policies would also limit the quantity of credit available. However, there are institutional features of the banking sector that raise the cost of credit and restrict access to loans that go beyond issues of monetary policy. Even in those cases in which inflation has been lowered, nominal interest rates have not followed, resulting in high real interest rates throughout much of the region (Table 6a). This is partly due to restrictive monetary policies, which keep interest rates high and partly due to the structure of African financial systems.

Interest rate spreads – that is, the difference between lending and deposit rates – tend to be high throughout much of Africa. The interest rate spread represents a wedge between the banking sector’s cost of acquiring loanable funds and the interest rates charged on loans. The higher the spread, the higher the cost of credit for any given deposit rate. A high spread also may indicate that deposit rates are unusually low. Low deposit rates discourage savings and limit the resources available to finance bank credit, particularly in the absence of a highly developed financial sector.²² Table 6a shows the spread between the prime lending rate and the deposit rate for 26 African countries/ regions. Measured spreads range from a low of 3.4 percentage points in Ethiopia to 21 percentage points in Malawi.

Table 6b contains estimates of spreads in other developing countries, to provide a basis for comparison. Clearly, the problems of large interest rate spreads and high real rates are not confined to African countries alone. There is significant variation in interest rate spreads in countries outside of the region – of the countries included in Table 4b, spreads range from 37 percentage points in Brazil to just 1.5 percentage points in South Korea. However, interest rate spreads in African countries tend to fall in the upper portion of the distribution of spreads in developing countries.

Two factors are particularly important in explaining the relatively large spreads in African banking systems. First, the risk premium that borrowers must pay in formal credit markets is extremely high. This is due to perceptions, often incorrect, that most creditors are high-risk borrowers and not bankable (Atieno, 2001). The reliance on perceptions is important, since many commercial banking sectors never developed the capacity to collect information on the creditworthiness of potential borrowers outside of their traditional clientele (Kimuyu and Omiti, 2000; Nissanke and Aryeetey, 1998; Steele, et al., 1997). Risk premiums are therefore likely to be particularly high for small-scale and rural borrowers. A second contributing factor to the sizeable interest rate spreads observed in Africa is the market structure of the banking system itself. Banking tends to be highly concentrated, with a few large banks dominating the sector. Under these conditions, banks have a degree of market power to raise lending rates and lower deposit rates.

For small-scale and rural borrowers, transactions costs may also raise the cost of credit from commercial banks. A large number of small-scale loans are more costly to deal with than a few large ones. Because many commercial banks in Africa have traditionally extended credit to the public sector or to finance international trade, they may be inefficient in managing loans to small producers (Steele et al., 1997). Therefore, small-scale borrowers require more of the banks’ time and resources in terms of monitoring.

²² When banks themselves have immediate access to liquidity in well-developed financial systems, they can extend credit without necessarily first attracting new deposits. African banks are generally constrained in their access to deep financial markets.

Table 6a: Prime lending rates, deposit rates, and interest rate spreads in African countries, 2006.

	Lending	Deposit	Spread	Real lending
Malawi	32.0%	11.0%	21.0%	18.0%
São Tomé & Príncipe	29.8%	11.5%	18.3%	6.2%
The Gambia	29.8%	12.7%	17.1%	28.4%
Angola	19.3%	4.5%	14.8%	6.0%
Liberia	17.0%	3.4%	13.6%	7.2%
Sierra Leone	24.0%	10.4%	13.6%	14.5%
Zambia	23.2%	10.3%	12.8%	14.1%
Mauritius	21.1%	9.6%	11.5%	12.2%
CFA region*	15.3%	4.3%	11.0%	n/a
Uganda	18.7%	9.1%	9.6%	12.1%
Cape Verde**	12.3%	3.4%	8.9%	11.9%
Tanzania	15.4%	6.6%	8.8%	8.1%
Kenya	13.6%	5.1%	8.5%	-0.9%
Mozambique	18.6%	10.4%	8.2%	5.4%
Morocco***	11.5%	3.6%	7.9%	10.0%
Lesotho	12.2%	4.5%	7.6%	6.1%
Botswana	16.5%	8.9%	7.6%	5.0%
Madagascar	29.5%	22.3%	7.2%	18.7%
Nigeria	16.9%	9.7%	7.2%	8.7%
Egypt	12.6%	6.0%	6.6%	5.0%
Algeria	8.0%	1.8%	6.3%	5.4%
Swaziland	11.2%	4.9%	6.2%	5.9%
Namibia	11.2%	6.3%	4.9%	6.1%
South Africa	11.2%	7.1%	4.0%	6.6%
Libya	6.3%	2.5%	3.8%	3.6%
Ethiopia	7.0%	3.6%	3.4%	-6.5%

* CFA region refers to BEAC countries only. ** 2005. *** 2004.

Source: IMF International Financial Statistics.

Table 6b: Prime lending rates, deposit rates, and interest rate spreads in selected developing countries, 2006.

	Lending	Deposit	Spread	Real lending
Brazil	50.8%	13.9%	36.9%	46.7%
Peru	23.9%	3.2%	20.7%	22.0%
Costa Rica	22.2%	9.8%	12.4%	11.3%
Suriname	15.6%	6.6%	9.0%	n/a
Guatemala	12.8%	4.5%	8.3%	6.5%
Bolivia	11.9%	4.0%	7.9%	7.7%
Nicaragua	11.6%	4.9%	6.7%	2.8%
Russia	10.5%	4.1%	6.4%	1.2%
Bangladesh	15.3%	9.1%	6.2%	8.8%
Ecuador	9.5%	4.1%	5.4%	6.5%
Venezuela	15.5%	10.3%	5.2%	2.7%
Indonesia	16.0%	11.4%	4.6%	3.7%
Lithuania*	5.7%	1.2%	4.5%	4.6%
Philippines	9.8%	5.3%	4.5%	3.7%
Sri Lanka*	9.5%	5.1%	4.4%	2.2%
Mexico	7.5%	3.3%	4.2%	3.9%
Vietnam	11.2%	7.6%	3.6%	3.8%
Malaysia	6.5%	3.2%	3.3%	2.9%
Thailand	7.4%	4.4%	2.9%	2.8%
Argentina	8.6%	6.4%	2.2%	2.3%
Korea	6.0%	4.5%	1.5%	3.8%

* 2004.

Source: IMF International Financial Statistics.

The high cost of bank credit is only one aspect of the credit problem. Often, potential borrowers have no access to credit, even if they were willing to borrow at the prevailing market rate. That is, credit is rationed. Credit to the private sector is very low in most sub-Saharan African countries. Table 7 shows bank credit as a percentage of GDP for selected countries in sub-Saharan Africa, North Africa, and regions outside of Africa. In some African countries, the level of private bank credit is comparable to that in other developing countries – e.g. South Africa, Mauritius, and Namibia. Similarly, in North Africa, the level of bank credit is similar to the level in other countries outside of Africa. However, for much of sub-Saharan Africa, bank credit to private borrowers is noticeably lower.

Table 7: Bank credit to the private sector as a percent of GDP, 2003

Country	Bank credit to pvt. sector (% GDP)
Sub-Saharan Africa	
South Africa	82.7%
Mauritius	56.1%
Namibia	51.6%
Ethiopia	24.3%
Senegal	21.1%
Kenya	20.3%
The Gambia	19.2%
Mali	18.7%
Benin	15.7%
Nigeria	15.7%
Côte d'Ivoire	14.8%
Ghana	14.7%
Mozambique	13.9%
Burkina Faso	13.8%
Cameroon	11.5%
Gabon	11.1%
Madagascar	8.8%
Tanzania	7.6%
Uganda	7.6%
Zambia	6.8%
Chad	6.3%
Malawi	5.9%
North Africa	
Tunisia	60.4%
Morocco	56.0%
Egypt	53.9%
Outside Africa	
Malaysia	97.4%
Thailand	81.8%
Chile	61.7%

Hungary	46.9%
Philippines	34.5%
Estonia	33.3%
Sri Lanka	32.1%
India	31.8%
Costa Rica	31.3%
Poland	29.0%
Brazil	28.1%
Colombia	27.4%
Bulgaria	27.3%
Peru	20.8%
Mexico	16.8%
Romania	11.1%

Source: Sacerdoti (2003), IMF International Financial Statistics

One reason behind the low levels of credit to the private sector is that banks in sub-Saharan Africa tend to hold large amounts of excess liquidity (Sacerdoti, 2005; Mkandawire, 1999; Steele et al., 1997). Banks frequently prefer to hold low-risk assets with strong real returns rather than extending loans to borrowers whom they perceive to be high-risk. Short-term government securities are often the asset of choice because returns are often high and such investments are virtually risk-free. Under these conditions, credit to the private sector is rationed. Credit rationing is likely to be particularly severe for rural and small-scale borrowers for the same reasons that interest rates are extremely high: lack of credit information systems and perceptions of risk.

The banking sector in Ghana provides an example of the problem of excess liquidity. Table 8 shows the required reserve ratio (reserves as a fraction of total deposits) and the actual reserve ratio for four years, 2003-06. In Ghana, there are two categories of reserves: primary reserves (which do not earn interest) and secondary reserves (which are held as liquid interest-earning assets). In 2005, the Bank of Ghana lowered the level of required reserves (primary + secondary) from 44 percent to 24 percent. This represented a dramatic change in the reserve requirement.

Despite the relaxation of the official reserve requirement, banks in Ghana still maintained high levels of excess reserves. Lending to the private sector therefore was kept well below its potential level. In addition, the case of Ghana shows how the behaviour of the banking sector can limit the effectiveness of monetary policy. The relaxation of the reserve requirement could theoretically have led to the large-scale mobilization of excess liquid assets in the banking sector, but the effect was modest, since banks continued to hold excess reserves. The tendency towards excess liquidity is not limited to the largest

commercial banks. The Bank of Ghana notes that rural and community banks also have been shifting investment into holding government bonds and bills, a trend that “can be explained by the apparent high risk associated with lending vis-à-vis the guaranteed return and risk-free nature of Treasury bills.” (Bank of Ghana, 2005, pp. 53-4)

Table 8: Actual and required reserve ratios, commercial banking sector, Ghana.

	Dec. 2003	Dec. 2004	Dec. 2005	Dec. 2006
Actual reserve ratio	82.9	57.0	56.9	47.4
Required reserve ratio	44.0	44.0	24.0	24.0

Source: Bank of Ghana, Statistical Bulletin, various years.

Note: In July 2005, the secondary reserve requirement was reduced from 35 percent to 15 percent.

Mismatch in terms of the maturity structure of loans is also a potential problem (Mkandawire, 1999). In African banking sectors, most of the credit that is extended is short-term credit. However, productive investments often require access to medium- or long-term credit. A number of factors constrain the availability of longer-term credit, one of the most important being the term structure of deposits. As a result of the short-term structure of deposits, banks are reluctant to make long-term loans. The lack of long-term deposit instruments, deposit insurance, and the shallow nature of the financial sector contribute to the bias towards short-term credit (Epstein and Heintz, 2006). Nevertheless, these constraints should not necessarily be binding when excess liquid assets exist. Banks may not extend medium- and long-term credit simply because there is no incentive to do so. The end result is a lack of long-term finance paired with a banking sector characterized by excessive short-term liquidity. Mechanisms for pooling short-term resources to support the extension of long-term credit are absent.

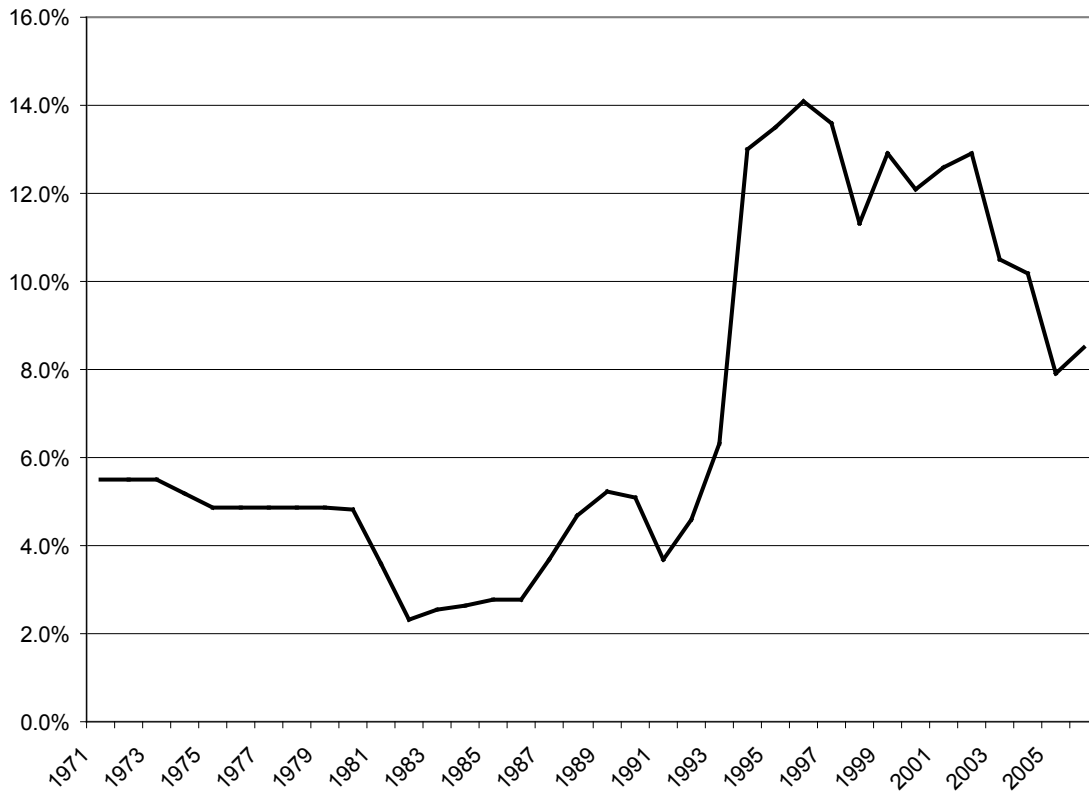
Financial liberalization

As the last section made clear, the institutional structure of the financial sector is critically important in determining the cost of credit, who receives loans, who is excluded from credit markets, and what types of loans are available. The financial structure also directly impacts the effectiveness of macroeconomic policy. In the 1980s and early 1990s, many African countries underwent a process of financial sector liberalization, often as part of a broader set of economic reforms and often in the context of a structural adjustment program (Reinhart and Tokatlidis, 2003). The “financial repression” literature associated with McKinnon (1973) and Shaw (1973) advocated for liberalization of the financial sector. It was argued that financial sector regulations created distortions that reduced the efficient allocation of capital and limited growth and development. Financial liberalization would therefore improve economic performance by increasing credit and improving the allocation of resources (Mkandawire, 1999).

The predicted benefits of financial liberalization in sub-Saharan Africa have not been forthcoming. As a recent paper by Reinhart and Tokatlidis (2003) puts it, “liberalization policies have seemed insufficient in mobilizing savings, deepening intermediation through the financial sector, or raising investment” (p. 54). Steele et al. (1997) show that financial depth (i.e. the money supply relative to GDP) fell following reforms in Ghana, Malawi, Nigeria, and Tanzania and there was little improvement in the share of credit going to the private sector. Financial liberalization in sub-Saharan Africa has frequently meant significant increases in the real interest rate (Reinhart and Tokatlidis, 2003). According to the financial repression hypothesis, higher real interest rates should have mobilized domestic savings in Africa, but any increase in domestic savings as a result of liberalization has been modest at best (Mkandawire, 1999).

Financial liberalization was supposed to lead to a narrower spread between deposit and lending rates. Greater competition and reduced non-market distortions should have raised deposit rates and lowered lending rates. However, in many cases, interest rate spreads increased substantially following liberalization (UNECA, 2006). Take the example of Kenya. A comprehensive financial reform program began in the late 1980s and was completed in the early 1990s. The policy reform included liberalization of interest rates (1990-91) and the elimination of credit guidelines and controls (1993). The financial policy reforms were part of a larger initiative that included trade liberalization and the introduction of the floating exchange rate. Figure 6 shows the interest rate spread in Kenya from 1971 to 2006. The spread was not excessive and relatively stable during the pre-reform years. However, immediately following the reforms, the interest rate spread increased dramatically. More than a decade after liberalization, the spread remains at significantly higher levels compared to the pre-reform years. The financial repression hypothesis argues that the higher interest rates that result from liberalization will encourage domestic savings and raise the level of investment. However, it is unlikely that financial liberalization will have these desired results when the outcome is high lending rates and relatively low deposit rates.

Figure 6: Interest rate spread, lending minus deposit rates, Kenya, 1971-2006.



Source: IMF, International Financial Statistics and Central Bank of Kenya.

Development finance institutions – that is, financial institutions that were designed to purposefully channel funds toward developmental priorities – deteriorated during the era of financial liberalization in Africa. Development finance institutions operate on the principle that markets cannot be relied upon to adequately address the challenges of development. Therefore, they were involved, by their very nature, in the type of “distortions” that the supporters of liberalization defined as problematic. Moreover, in many African countries, state-led financial institutions had become incoherent in terms of their developmental mandate, operating on the basis of favouritism and entrenched political interests (Mkandawire, 1999). This made them particularly easy targets for the critics who supported a privatized and market-driven approach. Particularly significant in terms of the consequences for poverty reduction and human development, agricultural banks collapsed in many African countries during the 1980s and private financial institutions have not filled the gap, except in terms of short-term credit for certain cash crops produced for export (Sacerdoti, 2005).

The process of liberalization may very well have exacerbated many of the constraints outlined in this paper – high domestic real lending rates, the short-term structure of loans, large interest rate spreads, and limited access to financial services for agricultural and informal activities. Researchers have found that the process of financial liberalization pursued under the structural adjustment programs did not adequately deal with the institutional problems of the financial system (Aryeetey 2001, Nissanke and Aryeetey 1998). Liberalization is not sufficient to transform the structure of the financial sector to support growth, employment, and poverty reduction.

Reinvigorating development finance in Africa

Financial sector reform has the potential to contribute to a better economic environment for improving employment, realizing development targets, and, ultimately, enhancing human development. However, reform must be crafted so as to support these objectives, not narrow financial ones. Financial liberalization has largely failed to address the systemic, structural constraints of African financial sectors in supporting ‘real’ economic outcomes, such as growth and employment. What is needed is a reform process that puts development and poverty reduction at the top of the agenda (Mkandawire, 1999). Here we outline some workable strategies that could be pursued as part of a policy of developmental financial reform.

We have discussed, in some detail, the problems of the formal financial sector. However, formal financial institutions – and formal commercial banks – represent only a fraction of the financial institutions operating in African countries. The limitations of the formal financial institutions, and the rationing of financial services, have fuelled innovation in informal financial institutions. In many cases, informal financial institutions have already solved some of the problems associated with the formal sector, although they face constraints of their own. Therefore, when strategizing about financial reform, it is important to recognize the institutional diversity that already exists throughout Africa.

Informal entrepreneurs and small-scale businesses that cannot access formal credit markets may rely on informal sources of credit. Research suggests that, in some circumstances, informal credit institutions have distinct advantages vis-à-vis formal financial institutions. Informal credit institutions frequently have more detailed knowledge of local conditions, their clients, and the communities in which they operate (Aryeetey and Udry, 1997). They often face lower transactions costs when extending credit to underserved communities and regions. Moreover, research suggests that default rates among informal borrowers are often low relative to those of the commercial banking sector (Steele et al., 1997). Informal credit institutions are able to extend credit to such creditworthy borrowers when formal institutions fail to do so. In these respects, informal suppliers of credit have successfully relaxed some of the constraints that inhibit access to formal financial services for people working in small-scale enterprises or informal self-employment.

The historic development of banking in many African countries partially explains the duality between formal and informal financial institutions. As noted previously, lending to government and public

enterprises dominated the extension of credit in the country during the decades following independence. Many banks never had an incentive to develop the institutional capacity to collect information and monitor small-scale private lenders (Kimuyu and Omiti, 2000; Nissanke and Aryeetey 1998). Under these conditions, informal financial institutions helped to fill this gap.

Given the advantages of many informal and small-scale suppliers in advancing finance to individuals excluded from formal financial services, programs that support this tier of financial institutions can improve the quality of employment by increasing access to credit (UNECA, 2005). For example, many countries in the region have savings and credit societies that could play a significantly larger role in realizing an employment-centered development strategy.

However, informal and small-scale suppliers of credit face constraints of their own. Informal suppliers of credit are seldom integrated into the banking system, limiting the resources at their disposal. Formal credit institutions enjoy economies of scale and can mobilize large amounts of deposits for credit extension. Informal credit networks lack the resources and scale economies of formal banks. However, large commercial banks currently cannot serve small-scale borrowers efficiently. By fostering linkages between formal and informal credit institutions, more financial resources could be made available to support the expansion and improvement of informal activities, with potentially large positive impacts on employment outcomes (Aryeetey, 2003, 1998; Amoako-Tuffour, 2002).

Complementary linkages can be forged on a number of fronts. For instance, relationships could be built between formal banks and savings and credit associations in order to facilitate group savings and lending for informal and small enterprise development (Pollin, Githinji, and Heintz, 2008; Amoako-Tuffour, 2002). Such initiatives could be tied to credit guarantees and other credit allocation policies, described below. Developing these new institutional relationships will require a broader regulatory structure for suppliers of credit in Africa that specifically incorporates a role for informal credit institutions.

The lack of prudential regulations for informal financial institutions may hinder the ability to forge links between formal and informal institutions. Formal financial institutions may be reluctant to enter into a relationship with informal institutions, if there are no safeguards in place to ensure stability in the informal financial sector. An appropriate regulatory framework will need to be developed in order to integrate the activities of the two types of institutions. More generally, effective banking regulation and supervision are necessary to minimize credit risk in the banking sector as a whole.

Creating linkages between formal and informal financial institutions represents only one set of strategies for improving the developmental impact of the financial sector. Development finance works by channelling resources to priority areas. In essence, it performs a credit allocation function. Credit allocation policies often have a bad reputation in many African countries. In many cases, credit allocation policies have been inefficient, hindered by favouritism and rent seeking, and biased towards large-scale producers

(Mkandawire, 1999). However, these problems are not inherent to credit allocation policies. They reflect the process whereby credit allocation has taken place in the past. With appropriate governance institutions in place, development finance has enormous promise for contributing to the realization of an employment-oriented growth path.

Credit guarantees represent one such development finance policy. As mentioned above, substantial risk premiums can prove debilitating for investments in employment-improving activities. Extending credit to medium- and long-term productive investments is not attractive to banks in Africa because of the perceived risk and the availability of substitute assets, such as treasury bills, that have high returns and are less risky. One way of reducing the risk associated with these investments is to have the government guarantee a portion of the loan to support approved projects. Government loan guarantees have implications for fiscal policy, since a non-performing loan would place demands on public resources. However, with adequate safeguards to prevent abuse, underwriting loans is a viable strategy to lower risk premiums for investments that support employment-intensive growth.

One potential problem with loan guarantees is that they can create the wrong incentives for borrowers. If borrowers bear no responsibility for the consequences of non-performing loans, then the incentive to insure that employment-oriented investments bear fruit is weakened. Therefore, it is important to design a loan guarantee scheme that reduces risk premiums while simultaneously preserving a system of monitoring and accountability on the part of the borrower.

The interest rate charged on guaranteed loans would be lower than the prevailing market rate. The appropriate level for the concessional interest rate would be a weighted average of the market rate of interest for the type of loan extended and the risk-free rate of return on government securities. At this rate of interest, the program would not place any economic burden on the banks that participated in the guarantee scheme. However, it does suggest that the lowest possible interest rate would be the prevailing rate on government securities (for a 100% secured loan). Therefore, such a credit guarantee program can only lower the cost of borrowing so far. The program would be more effective if paired with strategies to reduce the average cost of borrowing, including the risk-free rate, throughout the economy.

Pollin, Githinji, and Heintz (2008) present a detailed proposal for a credit guarantee scheme for Kenya.²³ The credit guarantee would encourage banks to extend credit to SACCOs (Savings and Credit Cooperatives), which would then on-lend to small producers. The proposal is large in scale, guaranteeing loans totalling one-fifth of Kenya's entire fixed capital investment for a year.²⁴ Loans would be extended at a concessional rate, along the lines outlined above. To help eliminate problems of perverse incentives, a system of escrow accounts is proposed. Both the borrower and lender would contribute to this account

²³ A similar credit guarantee program for South Africa can be found in Pollin et al., 2006.

²⁴ Given the scale of the program, the total costs are estimated to be about 5 percent of the current national budget in Kenya, assuming a high default rate of 30 percent.

and would sacrifice their escrow contributions in the case of fraud or default. Moreover, a “whistleblower” system would be put in place, which would offer substantial rewards for anyone supplying information concerning abuse of the credit guarantee scheme. Although we do not report the details of the credit guarantee policy in their entirety here, the proposal for Kenya provides a concrete example of how such a guarantee program could be designed.

There are other, complementary approaches to development finance, which could be pursued along with a credit guarantee program. For example, asset-based reserve requirements could be used to encourage lending to finance employment-generating investment. The idea behind asset-based reserve requirements is straight-forward: give the banking system an incentive to hold a portfolio of assets that channels resources towards employment-targeted investments. Banks have preferred to hold short-term treasury bills with high yields rather than extending credit to riskier projects. The introduction of asset-based reserve requirements would alter these incentives to favour lending for developmental programs and projects.

For example, if banks extend loans to approved employment-targeted projects, they would enjoy a lower reserve requirement than if they held other types of assets (e.g. other types of loans, t-bills, short-term securities, etc.). Banks that are subject to a lower reserve requirement would enjoy a competitive advantage in the credit market. By introducing such a system, financial resources could be directed to strategic projects, reducing the impediments to employment creation. Note that asset-based reserve requirements differ from other instruments sometimes used for the allocation of financial resources – prescribed assets. A prescribed asset policy represents a type of financial quota. Under such policies, a certain fraction of a bank’s (or other financial institution’s) assets must be held as investments or loans that support a priority area of economic development. Prescribed assets are not new to African economies. For example, in the past banks were frequently required to hold a portion of their assets as loans to the agricultural sector (Mkanadwire, 1999).

Development finance policies need not be limited to efforts to get the formal commercial banking sector to play a more active development role. Development banks – specialized public institutions that have been capitalized by government – have played an instrumental role in the industrial development of many countries. However, as mentioned above, the role of development banks has been deteriorating in African countries in recent decades. There is a real need to revisit the role of development banks in Africa as a means of channelling resources to support employment-creating investments with broad human development impacts.

The role of development banks in successful economic development strategies becomes clear in the discussion of development banking by Alice Amsden in *The Rise of the Rest: Challenges to the West from Late-Industrializing Economies*. Amsden begins her discussion of this topic with the general observation that:

The state's agent for financing investment was the development bank. From the viewpoint of long-term capital supply for public and private investment, development banks throughout "the rest" were of overwhelming importance," (p. 127).

Amsden goes on to document this in the cases of Mexico, Chile, Korea, Brazil, and Indonesia. In many of these countries, development banks helped to finance between a fifth and a half of all fixed capital investment. The public-goods nature of developmental investment – i.e. the idea that such investments generate benefits that extend well beyond private profitability – suggests that development banks will finance activities, which the private financial sector would pass over. If development banks have played such a role in other countries, there is no reason why they cannot play a central role in financing major employment-generating programs throughout the African continent today.

3.4 Public investment and fiscal policy

The type of development-targeted policies discussed in this paper will only be realized if sufficient complementary public investments – in physical infrastructure, basic economic services, and skills and education – are undertaken. Public investments are central for raising productivity and thereby people's incomes. Improving the country's infrastructure and skills base is equally important in terms of promoting trade competitiveness. Similarly, insuring the provision of basic economic services – such as transportation facilities, telecommunications, and energy services – is essential for any growth strategy. Moreover, increased spending on public goods can also serve as a major source of job growth within the country's formal economy, as has been the case with public works programs around the world.

A recent study of sub-Saharan African countries over time has shown that public investment in transportation positively contributes to overall economic performance. Moreover, this research found that public investments are more productive on average than capital investments overall – including private investment (Boopen, 2006). Other analysts have argued that infrastructure investments are essential for sustained growth in Africa – particularly for those countries with geographical limitations, such as being landlocked or far removed from major markets (Ndulu, 2006). There is an enormous literature documenting the returns to education in African countries.

Many of the policies needed to realize an employment-oriented growth path – infrastructure investment, improvement of economic service delivery, reinvigorating development finance, provision of training and education, and support for long-run investment – cannot be pursued through a purely market-based set of strategies policy. Significant market failures are associated with these policy areas and relying on markets alone will not be enough to achieve the core developmental objectives outlined here. The market failures associated with these policy areas are diverse:

Externalities – many of the interventions discussed here have external benefits that are not fully captured by market prices or private profits. For example, investment in education generates benefits for economic actors that extend beyond the private benefits created.

Public goods – investments in infrastructure often involve the provision of goods and services that are “non-excludable” and “non-rival”. Individuals or firms cannot be excluded from the benefits provided and the use of the good by one individual does not reduce the benefits that others receive. Under these conditions, markets will tend to under-supply such goods.

Economies of scale – the generation of electrical power, the expansion of the transportation system, or the creation of an information/telecommunications infrastructure are often characterized by economies of scale, in which marginal costs are often negligible relative to average costs.²⁵ In this situation, markets may not be able to efficiently price such goods in order to insure an adequate supply in the long-run.

Coordination failures – as has already been mentioned, credit may be rationed in financial markets when lenders and borrowers have different objectives, contracts are not costlessly enforceable, and information is not easily accessible. Financial resources for investment in socially desirable activities will be inadequate.

Dynamic inefficiencies – short-run and long-run incentives may contradict each other. Firms may act based on short-run returns – particularly in the face of economic uncertainty – but the decisions they make may be undesirable in the long-run. Markets that respond exclusively to short-run signals will misallocate resources.

State-led interventions and non-state/non-market institutions are instrumental in solving these problems. This does not imply that markets have no role in African development. On the contrary, markets provide information about consumption trends, supply constraints, and production patterns. Such information is important, but not sufficient, to determine the optimal policy mix and allocation of resources to support long-run sustained growth. Therefore, a combination of non-market interventions and the use of market-generated information is necessary to achieve an employment-friendly growth path.

The need for strategic public interventions implies that fiscal policy is an important component of a broader set of economic policies that provides an environment conducive to employment growth while maintaining stability and managing macroeconomic balances. Markets, operating alone, cannot be counted on to adequately fill this gap and, therefore, the public sector needs to be adequately resourced. The budget is the single most important instrument for development, since it plays a fundamental role for achieving the goals of poverty reduction and human development, as reflected in developmental targets such as the Millennium Development Goals.

²⁵ The marginal cost of many types of information may be close to zero – the initial cost of acquiring knowledge for a single firm can be substantial, but the cost of sharing existing knowledge with a multitude of firms may be quite small in comparison.

The role of fiscal policy

The role of the public sector in supporting the type of economic policies we advocate in this paper is clear. However, the resources needed to finance these interventions are seldom readily available. Increasing public investment, creating a large-scale credit guarantee scheme, and re-capitalizing development banks all require the mobilization of additional resources beyond what the public sector is currently spending in trying to meet its social development goals. In African countries, fiscal policies must operate within a particular policy environment. Although the details vary significantly from country to country, the fiscal environment is characterized by:

- High levels of debt – often external and domestic debt;
- Large inflows of donor-directed official development assistance (ODA);
- Limited capacity to mobilize public resources from domestic sources.

These factors limit the discretionary funds available to pursue many of the policy areas outlined here.

Often, the dominant macroeconomic framework places additional constraints on fiscal policy. For example, when monetary policy is focused exclusively on inflation reduction and exchange rates are entirely market-determined, it is often assumed that fiscal policy must address other macroeconomic problems. Within this restrictive macroeconomic management regime, fiscal policy is identified as a way of influencing interest rates. When public spending exceeds revenues, the government must run a deficit, borrowing to make up the difference. The outcome of government borrowing is often assumed to be high interest rates. Therefore, reductions in government spending and domestic borrowing are recommended as a way of keeping real interest rates from rising.

Whether fiscal policy is an effective tool for managing domestic interest rates is debatable. Within the alternative macroeconomic framework outlined in this paper, it is not even an issue. Monetary policy can target short-term real interest rates and exchange rate policy can help maintain international competitiveness. This frees up fiscal policy to deliver on the concrete developmental objectives discussed here, as long as budgets are managed so as to be sustainable in the long-run. Excess borrowing, for example, can lead to high debt servicing costs, which crowd out development spending. Therefore, spending priorities need to be matched with efforts to mobilize public revenues.

Mobilizing public revenues

In the short-run, there are five ways in which additional public revenues could be made available to finance the type of policies that we have put forward here:

- increased collection of taxes from domestic sources;

- increased external borrowing;
- increased domestic borrowing;
- debt relief/forgiveness by foreign creditors; and
- official development assistance providing direct budget support.

Each of these can be examined in turn.

(1) Increased collection of taxes from domestic sources: Mobilizing revenues from domestic sources is perhaps the best way to increase public sector revenues in the long-run. Raising revenues from taxes does not involve taking on additional debt obligations or sacrificing policy discretion to meet the conditions set by donors. Collection of taxes from domestic sources, for a given level of income, can be increased in three ways: (i) increasing the efficiency of tax collection; (ii) expand the tax base; or (iii) raise tax rates or introduce new taxes. In recent years, many countries in sub-Saharan Africa have improved revenue collection through a diverse array of approaches (McKinley, 2007). These include preventing the erosion of traditional sources of revenue (e.g. taxes from international trade), improving the efficiency of tax collection, maintaining a diverse set of tax instruments, and exploring ways of raising domestic non-tax revenues (e.g. licensing fees for access to natural resources). The establishment of autonomous tax authorities represents a concrete institutional reform, which can increase the effectiveness of tax collection and minimize leakages.

The informal sector represents a potential source of additional public revenues for African countries. One strategy for the on-going mobilization of domestic resources is to bring informal activities into the tax base. Of course, individuals working in the informal economy would be more willing to contribute if they received direct benefits from government programs. The type of targeted credit schemes and infrastructure projects outlined in this paper represent two examples of public goods and services which would directly benefit individuals in informal employment if properly designed.

Taxes on immobile assets – such as royalty payments for the right of mining companies to extract minerals or oil companies to extract petroleum – can be used to raise sizeable revenues to fund public investments. The immobile nature of these endowments means that establishing (or raising) taxes will not cause production to relocate. Extraction firms earn profits based on the scarcity of natural resources and these income streams, or ‘scarcity rents,’ should be fully incorporated into the tax base. For example, South Africa’s Mineral and Petroleum Royalty Bill represents tax legislation aimed at raising public revenues associated with the extraction of the country’s rich natural resource base. In general, there are many unexploited opportunities for broadening the tax base in the region (e.g. urban property taxes). The sources of potential revenue will vary from country to country, but identifying untapped sources of public revenue represents a priority area for fiscal policy.

Selectively raising domestic tax rates can be an effective way of increasing revenues. For example, estimated tax revenues in The Gambia more than doubled in the five years 2001-05, because of heightened efficiency of tax collection and increases in the sales tax rate (Heintz, Oya, and Zepeda, 2007). However, increasing VAT or sales tax rates may have an adverse effect on income distribution, since low-income families often pay a larger share of their income in taxes than do wealthier households. Therefore, the distributive consequences of tax changes should be considered when attempting to mobilize revenues from domestic sources.

(2) *Increased external borrowing:* High levels of external indebtedness have emerged as a critical problem throughout much of the African continent. Debt build-ups in the 1970s and 1980s have squeezed public resources and crowded out spending on development. Often the expansion of public debt during this period was not accompanied by a sustainable increase in public expenditures – therefore, the debt burden retarded economic progress without leading to the consequent benefits of public investment. 33 of the 41 Heavily Indebt Poor-Countries (HIPCs) – or over 80 percent of all the countries which qualify for the World Bank and IMF sponsored debt-relief packages – are in Africa. Other African countries have sizeable external debts, although they are not considered HIPCs. For example, Kenya’s external debt is considered to be sustainable, simply because of the country’s export potential.

It is hard to justify significant increases in external borrowing to finance public investment, given the large debt burdens in many countries. Moreover, there are other reasons to avoid reliance on external borrowing to finance a development agenda. Such borrowing exposes fiscal policy to the risk of exchange rate volatility that can dramatically influence debt servicing costs and add an additional element of uncertainty to budget planning processes. Although servicing costs on external debt are frequently lower than the servicing costs on domestic debt, the stock of external debt remains significant and could squeeze fiscal resources excessively in the future, given the potential variability in the costs of such credit.

(3) *Increased domestic credit:* Domestic borrowing is also significant in the region. However, in many cases, the current level of domestic debt among African countries is not high by international standards. We can see this in Table 9, which shows domestic debt as a share of GDP for a group of comparison countries. About half of these countries are African, including Swaziland, Rwanda, Burundi, Kenya, Sierra Leone, Cameroon and Mauritius. We have also included other countries who are now or have recently been at roughly comparable levels of development, including Honduras, Costa Rica, Malaysia, India and Sri Lanka.

Table 9: Domestic Debt as a Percent of GDP and Average Per Capita GDP Growth Rates, Selected Countries, 1994 - 2004

Country	Years	Domestic Debt as a Percent of GDP	Average Annual Growth Rate of Per Capita GDP
Burundi	1997-2004	15.3%	-0.1%
Cameroon	1994-2001	27.3%	1.4%
Kenya	1997-2004	21.8%	0.0%
Mauritius	1997-2004	28.8%	3.8%
Nigeria	1997-2004	7.3%	1.5%
Rwanda	1996-2003	12.1%	2.0%
Sierra Leone	1997-2004	15.5%	-2.5%
Swaziland	1996-2003	1.4%	0.3%
Costa Rica	1995-2002	26.8%	1.7%
El Salvador	1994-2001	8.8%	1.6%
Honduras	1997-2004	5.7%	0.6%
India	1994-2001	48.1%	4.3%
Indonesia	1994-2001	0.5%	1.7%
Malaysia	1994-2001	32.7%	3.0%
Sri Lanka	1997-2004	58.3%	3.6%

Source: Pollin, Githinji, and Heintz (2008).

Note: For each country, figures are reported for the most recent seven-year period for which data are available.

From Table 9 we see that the average level of domestic debt of the African countries, expressed as a percentage of GDP, is not excessive when compared to the average debt of other developing countries. In fact, the average domestic debt of all the African countries falls well below that of Malaysia (32.7 percent of GDP), India (48.1 percent of GDP), and Sri Lanka (58.3 percent of GDP). Table 9 also presents data on average per capita growth rates in recent years. The countries with the highest levels of domestic debt are not penalized with slower growth rates. Indeed, there is a positive correlation between average domestic debt, expressed as a percentage of GDP, and the average per capita growth rates of the countries featured in Table 9. This suggests that it is possible to leverage domestic public borrowing to achieve faster rates of growth.

However, there are limits to domestic borrowing, which must be taken seriously when formulating a development strategy. Debt servicing costs on the domestic debt can be substantial, making domestic borrowing a costly way of raising revenues. These debt servicing costs can squeeze out other priority areas of expenditure (Ouattara, 2006). Moreover, the structure of the debt matters for managing public financial resources. In many African countries, much of the domestic debt is held as short-term treasury bills with high real rates of return. This raises the debt servicing costs in these countries. In addition, high levels of domestic borrowing create a potential constraint on extending credit for other uses, such as the targeted credit policies proposed earlier – as banking assets become tied up in short-term government securities. Banks have an incentive to hold relatively risk-free public securities instead of riskier loans, particularly when the yield on government treasury bills is relatively high. Research has suggested that public borrowing may reduce credit to the private sector, although the size of this effect appears to be relatively small (Sacerdoti, 2005).

As was the case with inflation, high levels of domestic debt are not, in themselves, desirable. Given a choice between two economies with equally strong economic performance, one with high levels of debt and one with low levels of debt, we would select the less indebted country. However, if domestic debt can be leveraged to increase the rate of growth, improve job opportunities, and achieve better developmental outcomes, then domestic borrowing is justified – as long as the debt is sustainable and does not compromise development in the long-run. Much depends on how the additional resources are used. For example, public borrowing that contributes to capital flight in African countries can compromise long-run development (Boyce and Ndikumana, 2001). In contrast, when domestic borrowing is associated with higher government spending on services and investments, the net impact can be positive (Epstein and Heintz, 2006).

Given these caveats, domestic borrowing is a potential source of financing for the type of targeted projects and programs outlined in this paper. Of course, the fiscal sustainability of such sustained borrowing – taking into account prevailing interest rates and economic growth projections – would need to be assessed to avoid escalating domestic debt servicing costs. In addition, incentive schemes could be put in place to counter the possible adverse effects on extension of credit to priority areas in the private sector (e.g. the developmental loans described earlier). In these ways, the problems associated with additional domestic borrowing could be addressed directly.

In addition, the introduction of new public debt instruments – such as longer maturity bonds – would improve the capacity for fiscal and financial management. Specifically, efforts to change the maturity structure of the public debt could lower recurrent servicing costs over time by reducing the need to constantly turn over the public debt.

(4) Debt relief: As mentioned earlier, many countries in Africa qualify for some measure of debt relief under the HIPC program. Other countries, the African non-HIPCs, could also advocate for debt relief

measures, even though they do not fit exactly into the HIPC profile. External debt servicing costs remain substantial. Therefore, complete external debt relief would give governments additional resources to use for developmental spending. Nevertheless, the decision to grant debt relief is not the decision of African governments. Therefore, there is no clear policy recommendation in this regard – except general advocacy for debt forgiveness.

(5) *Official development Assistance*: The impact of ODA on developing countries – whether it is negative, positive, or negligible – is an on-going area of debate. For example, a recent study of ODA in Ethiopia concluded that development assistance helped to increase public capital investment, but it made no difference in terms of recurrent expenditures (including expenditures on social services, such as health and education). Research on Senegal found that increases in aid flows, which were defined to include both grants and loans, were associated with higher debt servicing payments and had little overall impact on domestic public expenditures (Ouattara, 2006). Moreover, a large fraction of the ODA in Senegal was used to finance the existing debt burden. Higher levels of ODA in the form of direct budget support could potentially increase the resources available to implement the strategies discussed in this paper. However, ODA flows can be uncertain and volatile, undermining the budget planning process. Without a commitment to long-term ODA, policy development that assumes a particular level of assistance remains speculative. Like debt relief, increased ODA does not represent a policy decision to be taken by African governments. Therefore, there is no concrete policy recommendation, apart from continued advocacy for direct budget support and the need to focus on domestic sources of revenues to finance the broad development agenda.

Some analysts have warned against increasing ODA flows into low-income countries, because such transfers could upset the macroeconomic balance – leading to inflationary pressures and/or an appreciation of the real exchange rate (McKinley, 2005). Such macroeconomic instability depends on how ODA is spent and absorbed in the receiving country. For example, if the transfer of foreign exchange leads to a rapid expansion of the money supply, the result may be rapid inflation and a real exchange rate appreciation. However, if ODA is channelled so as to affect aggregate supply (e.g. through public investments or improving the quality of human resources), the impact on prices and the real exchange rate is far more nuanced and need not destabilize the macroeconomy (McKinley, 2005). Moreover, an alternative macroeconomic management strategy – integrating the points outlined in this paper – could address any unintended consequences of scaling-up ODA to help finance public investment, employment creation, and a development-targeting approach to economic policy.

IV. Conclusions

We have outlined some of the elements of a development-targeted economic framework for African countries with a specific focus on improving employment opportunities. The emphasis has been on macroeconomic and related policies – monetary policy, exchange rate regimes, financial sector reform, and fiscal policy. Specifically, there is a need to move away from targeting narrow economic variables – such as the inflation rate or financial indicators – and towards targeting the real side of the economy – which has a direct impact on development outcomes. In doing so, other goals, such as maintaining economic stability, do not have to be sacrificed. Indeed, a development-targeted economic framework should help insure long-run stability, not undermine it.

We have not discussed in detail specific projects and programs that could be implemented on the ground – such as strategies to develop a particular sector or to cultivate non-traditional exports. The emphasis in this paper has been placed on “horizontal” strategies – broad-based initiatives that are not targeted at specific sectors, but will generally improve economic performance, employment outcomes, and average living standards. Of course, horizontal strategies would need to be complemented by specific, targeted development projects, aimed at certain sectors (e.g. agriculture) or at certain groups (e.g. women in informal employment). We do not discuss the details of such policies for two reasons. First, the specific projects and programs will vary widely from country to country; such a detailed discussion is beyond the scope of this paper. Second, without proper macroeconomic policies in place, the effectiveness of targeted interventions will be compromised.

We can sum up the policy recommendations that emerge from our analysis:

- There is a general need to move from targeting inflation to targeting ‘real’ development outcomes. The improvement of employment opportunities in Africa represents a critically important ‘real’ policy target.
- Moderate levels of inflation—ranging perhaps as high as 12-15 percent, depending on the sources of inflationary pressures—should not have a negative impact on economic growth. This means that there is more latitude than generally recognized for pursuing a development agenda.
- The current monetary policy practice in many countries of targeting the growth rates of monetary aggregates to achieve very low rates of inflation is ineffective and potentially counter-productive. Targeting real domestic interest rates could be more effective in terms of meeting development targets.

- Floating exchange rate regimes do not protect an economy from exchange rate misalignment. A managed exchange rate – that takes into account development objectives and market forces – is more consistent with development targeting.
- Regulation of capital flows is likely to become an increasingly relevant issue for African economies. Proper capital management techniques are important for containing volatility and maintaining policy space.
- Financial sector reform needs to address the institutional problems that exist in many African countries, which limit access to loans and raise the cost of credit. Targeting credit to promote employment expansion and a wide range of business opportunities can be a focal point for a new policy framework. The role of development finance institutions should be revitalized in the region.
- Public resources are needed to finance an employment-oriented development strategy. Markets will not channel private resources to fill the gap. Therefore, a multi-faceted approach is needed to mobilize public revenues.

These recommendations are far-reaching and would facilitate the realization of a development-targeted approach to economic policy. They would support efforts at improving employment opportunities and thereby reducing poverty. By themselves, these recommendations would not be sufficient for meeting broad human development targets, as captured in the MDGs. However, by moving the focus of economic policy more firmly towards employment and real development, they would create an environment conducive to improving human well-being and ending poverty in Africa.

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