

Using ODA to Accumulate Foreign Reserves in Sub-Saharan Africa

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Donors of foreign aid expect it to boost investment and aggregate demand by transferring real resources to recipient countries. Such transfers are essential to sub-Saharan Africa (SSA). Furthermore, attaining the Millennium Development Goals (MDGs) calls for substantial increases in aid in order to strengthen domestic investment and welfare expenditures.

Yet, the IMF has been encouraging some of the poorest countries in SSA to adopt restrictive policies that prevent the transfer of real resources from abroad, including capital imports. A recent report by the Independent Evaluation Office of the IMF, *The IMF and Aid to Sub-Saharan Africa, 2007*, found that SSA countries with an IMF Poverty Reduction and Growth Facility (PRGF) spent an average of only 28 per cent of aid flows during 1999-2005.

This 'low spending' policy has aimed at avoiding increases in inflation above five per cent, the low threshold set by the IMF. However, this target is excessively restrictive, as has been argued in the One Pager *'Why is Africa Constrained from Spending ODA'*.

This One Pager on foreign reserves focuses, instead, on the lack of 'absorption' of ODA. According to the same IMF report, only 63 per cent of aid flows to sub-Saharan Africa were 'absorbed' during 1999-2005. The remaining 37 per cent were used to stockpile reserves. Countries with international reserves equivalent to less than 2.5 months of imports used aid almost exclusively to boost reserve levels, 'absorbing' next to none. Those above this threshold allowed much fuller 'absorption'. This practice is linked to the adoption of capital account liberalisation, which allows capital to flow freely out a country.

'Absorption' is a technical term referring to a widening of the current account deficit that corresponds to the transfer of real resources to an aid-recipient country. Absorption is controlled by the central bank since it can make aid-related foreign currency available to importers or keep it in reserves.

Using aid to build reserves can be a reasonable policy for a short period of time if aid is volatile and reserves are very low. But the policy of building reserves in SSA has continued for several years, and built up levels well beyond the 2.5 months threshold.

The table shows that aggregate reserve levels in SSA rose from 3.7 months of imports in 1997-2001 to 5.2 months in 2006, and are expected to reach 5.6 months in 2007. The increase has been driven by oil exporters, such as Nigeria, which are currently accumulating oil rents. But reserves have also risen well beyond 2.5 months of imports for many of the poorest countries, such as Guinea-Bissau, Mali and Sierra Leone.

Rising reserves in Africa are part of a general trend (encouraged by the IMF) of reserve accumulation among developing countries since the financial crises of the late 1990s. Developing-country reserves as a proportion of imports are now roughly three times

Reserves, Sub-Saharan Africa, (Months of imports)

	1997-2001	2002	2003	2004	2005	2006	2007e
Ghana	1.4	2.0	4.1	3.7	3.2	3.2	3.1
Guinea-Bissau	5.5	11.8	3.8	6.9	6.3	8.1	7.5
Kenya	2.8	3.8	4.2	3.3	3.1	3.6	3.7
Madagascar	2.6	4.2	2.8	2.9	2.9	4.0	4.1
Mali	4.1	6.7	7.8	6.4	5.6	5.6	6.1
Niger	1.7	3.1	4.6	3.6	2.8	4.3	3.5
Senegal	2.8	3.7	5.0	5.2	4.0	3.9	3.7
Sierra Leone	3.0	3.0	2.0	4.1	4.2	7.8	7.1
Zambia	1.3	4.1	1.7	1.7	2.5	3.0	3.2
SSA Total	3.7	3.8	3.4	4.2	4.6	5.2	5.6

Source: IMF, *Regional Economic Outlook: Sub-Saharan Africa, 2007*. 'e' means estimated.

those of developed countries. On average, they are estimated to be about 25 per cent of developing-country GDP. Most countries regard them as protection against sudden reversals in capital flows and ensuing financial panics, or continuous capital flight.

The policy of the excessive build-up of reserves is a response, in large measure, to capital account liberalisation and the free movement of capital that have made access of countries to liquidity essential. Since the late 1990s, moreover, developing countries have accumulated substantial short-term debt, for which rising reserves have functioned as liquid cover.

The costs and risks of such a policy are significant, however. A large proportion of reserves are held by central banks as low-yielding U.S. Treasury securities while the return on investment in productive assets would be much higher. There is also considerable risk because a fall in the value of the U.S. dollar could lead to losses in terms of the corresponding value of domestic currency.

It is misleading to call reserve accumulation 'self-insurance'. The policy was forced on developing countries by liberalised international capital flows and financial deregulation. There is thus a good case for actively managing the capital account, and thereby lessening the need for a large low-yield stock of reserves.

In sub-Saharan Africa reserve accumulation also represents a defence against aid volatility. Building up such a buffer would be unnecessary, however, if donors could provide more predictable flows. This problem is only compounded by the IMF's encouragement of 'low absorption' of ODA. Instead of financing real resource transfers into the economy, a sizeable proportion of aid money has been committed needlessly to securing greater liquidity.

Fiscal and monetary policies have become correspondingly conservative, choking off the prospects for greater public and private investment and more rapid growth. Hence, for many reasons, the current practice of excessive reserve accumulation acts as a substantial barrier to attaining the MDGs, especially the priority goal of halving extreme poverty in the low-income countries of sub-Saharan Africa.