Part 2

Perception and the Causes of Flows

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Chapter 2 Foreign Direct Investment

Nils Bhinda, Stephany Griffith-Jones and Matthew Martin

2.1 Introduction

Chapter 1 showed that, contrary to widely held opinion, FDI to many Sub-Saharan African countries has increased rapidly in the 1990s. It remains the most important flow absolutely, and is larger relative to many African countries' GDP than in most other developing countries. Yet flows have risen more slowly than some countries have turned around their economies and established political stability. Why?

Many factors influencing FDI apply to other flows. Most important is lack of information. The information which flows to investors is often inaccurate and out of date. Major investment promotion campaigns fail to overcome distortions and exaggerations in a sensationalist international press. Most international investors cite negative press as powerfully discouraging investment. Even successful countries suffer from negative information about the continent as a whole: "potential investors lump them together with other countries, as part of a continent that is considered not to be attractive" (UNCTAD, 1995b). This is a mirror image of the euphoria about all East Asian markets before the 1997 currency crises. The underlying problem is the short memory and copy-cat behaviour of many Western investors, while regionally-based investors, who are better-informed and less prejudiced, are investing widely and reaping the rewards.

But FDI is different in one major respect: it is difficult to reverse and to a degree irreversible. This generates caution in three ways. First, investors adopt a "wait-and-see" attitude. This creates a vicious circle. If caution reduces investment in a given year, the resulting decline in productive capacity then fulfils their negative expectations, resulting in a low investment equilibrium (ADB, 1993:173). Second, many investors favour a shorter investment time horizon: "the basic rule for black Africa is to get your money back as soon as possible, or don't do it. Who knows what's going to happen next year?". As a result, many foreign investors borrow from local financial institutions, using real assets as security, and repatriate their initial investment immediately. The exceptions are mining companies and plantations, which make such high returns that they are prepared to be involved longer-term.

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The rest of this chapter examines in more detail the national and sectoral causes of FDI. These are closely interlinked: once a country achieves political stability and economic growth, investors focus on sectoral factors.

2.2 Causes Related to Source Countries

As shown in Chapter 1, the source countries of FDI in Africa are changing dramatically in the 1990s. While "traditional" Western investors still account for the bulk of stock and flows, new links are being established with the Far East. The most striking recent development is the growth of a regional market, which is provoking huge intra-regional investments, notably by South African companies and returning South Asian investors.

2.2.1 South Africa

South Africa has become a potent regional influence since its peaceful transition to democracy. Its proximity, sophistication and market size give it strong natural comparative advantages to take a leading role in the region. Since 1995, South African investors have blazed a trail into the region, beginning in high-profit sectors such as breweries, retailing, financial services, mining and tourism, but more recently diversifying into agriculture and manufacturing. They have been encouraged by South Africa's selective liberalisation of capital controls, which has given preference to investment in the region.

2.2.2 Asian Business Groups

Outside South Africa, the most dynamic regional investors have been the Asian community. Much of their returned capital is hidden in "private transfers", concealing the FDI purpose revealed by interviews with Asian business people in the UK and Africa. Their motivations have until now been ill-understood, but they have been strongly influenced by the changed attitudes to their communities of national political leaders. This has been most remarkable in Uganda, which has successfully targeted dispossessed groups to return, using incentives and well planned investment promotion missions led by the President himself. Many of the regional business "empires" have their roots in the Ugandan Asian community.

Of course, there is great diversity within the "Asian community". Tanzania provides a striking example: the Muslims are divided into Shias, Ismailis and Khojas, and non-Muslims include Hindus, Parsees and Sikhs. Not surprisingly, "cultural divisions within the Asian minority are at least as large as those between Asian and African Tanzanians" (Lofchie and Callaghy, 1995:48). But most African officials and donors tend not to differentiate among these groups, showing alarming ignorance. The interactions within and among these communities deserve more study.

2.2.3 The Far East

Until 1997, and especially after 1994-95, interest from Far Eastern companies was growing rapidly, with major increases from China, Malaysia, Hong Kong, Taiwan and South Korea. South Africa was the main initial destination, but during 1995-97 investors increasingly diversified into Botswana, Ghana, the Seychelles, Tanzania, Uganda and Zimbabwe. In contrast, Japan's involvement remains limited. Investors are discouraged by the absence of Japanese trading companies, banks and External Trade Organisation offices, and weak trade relations (only 1.2% of Japanese exports go to Africa). Africa receives 10% of Japan's ODA, but this is largely for humanitarian and social sector projects rather than public-private partnership loans for infrastructure, and so has not stimulated FDI (UNCTAD, 1996:48-50). Nevertheless, most of these obstacles have been overcome or ignored by investors from other Asian countries, which rely less on these types of "developed country" financial patterns and support institutions. Unfortunately for Africa, as the "final frontier" for Asian investment, it has suffered even more than other regions from a cut in Asian overseas investment in 1997-9 due to the economic crisis.

2.2.4 Western Europe and the US

While FDI sources are diversifying, most still comes from the UK and France, reflecting colonial ties. The French are largely in the CFA Zone, and the UK in Anglophone Africa, mainly Kenya, Nigeria, and Zimbabwe. Their flows have increased since the first half of the 1980s when some manufacturers pulled out from politically and economically unstable areas (Bennell, 1995). Nevertheless, these investors are among the least expansionary in the region: their long experience of the region has tended to breed a degree of complacency. Relatively few new Western investors have been coming to Africa outside South Africa — they are the most subject to the perception of black Africa as a basket case area. Yet data for US affiliates in Africa show the return on FDI has been far higher than in Latin America, and above both developed and developing country averages (UNCTAD, 1997a:60-1),

2.2.5 Contrasting Psychological Attitudes

Perhaps the weakest reason for not investing, but one of the most pervasive influences on actual investment, is the diversity of psychological attitudes among different source countries. Japanese tend to feel "cultures do not fit together", but many other Far Eastern, Asian and South African investors have overcome similar distance. In the same way, UK companies suggest that, owing to ties going back over generations, East African Asians are "closer to the ground" in a way the British may once have been, and therefore more attuned to the business culture. It is difficult to escape the conclusion that the potential OECD investor does not want to solve this problem. As a UK Asian investor in East Africa said, "an aloof attitude lets the British investor down".

One additional important factor is the lack of a "strategic" motivation for investing in Africa. Geopolitical factors play a large role in US investment in Latin America, Japanese involvement in Asia and European flows to Central and Eastern Europe and North Africa. In spite of major efforts by the African-American community and the current US government, there is no similar strategic interest in Africa by any developed country.

2.3 Structural Factors

2.3.1 Market Size

Inadequate individual national markets are an important deterrent for many OECD (notably Japanese) firms which intend to service the domestic market. The three main components are low income (GDP per capita) which reduces purchases of high-cost goods, a resulting low domestic savings rate which limits local investment, and a small domestic market (measured in GDP or population) which makes information costs high relative to potential sales, reducing margins and limiting expansion. The exceptions have been South Africa, Nigeria, Zimbabwe and the middle-income Francophone countries.

However, dynamic investors have developed three alternative strategies. Some focus on low-cost goods (as one investor expressed it, "there are some goods everybody has to use"). Others (notably Far Eastern, Asian community and South African firms) aim explicitly for the higher-income South African market: for example, Malaysia is investing in Botswana to produce for South Africa. A third group focuses only on exports outside the region.

The regional market is therefore vital to many firms' "critical mass". Investors have been made more optimistic by regional trade liberalisation through COMESA, the East African Community and the Cross-Border Initiative. But the benefits appear to be concentrated in the economically stronger states (as forecast by Riddell and Cockcroft, 1991:146). Smaller countries are suffering as businesses relocate to South Africa, which provides a better national income base and economies of scale on which to build a strategy for the regional market. Until 1998, similar factors were also encouraging investment in Zimbabwe, although to a lesser degree. The growth of oligopolistic regional business groups of South African, Zimbabwean and Asian companies is being encouraged by their easier access to trade finance and other credit, building on sound corporate financial positions and close links with international or Asian regional banks. Access to South African goods has brought major cost savings to Zambia, Tanzania, Uganda and Mozambique. However, transforming trade liberalisation into sustained development throughout the region will depend on closer cooperation in improving infrastructure and labour skills in the poorer countries — and on continued growth in South Africa to act as a magnet for global FDI.

2.3.2 Infrastructure

Poor infrastructure is cited as a minor disincentive by potential (especially OECD) investors. They use it as a catch-all term to cover almost any practical problem, including unreliable and expensive phone lines, power cuts, water shortages, and congested roads, rail or ports. However, existing investors and those based in the region — those who are having to cope with the problem — seem prepared to "make the best of the situation", and to acknowledge that most countries have made dramatic efficiency-enhancing improvements in the 1990s (in roads, power and notably telephones, due to widespread use of mobile phones and the internet, and the extension of regular phone lines), and that some countries — South Africa, Zambia, Zimbabwe and increasingly Uganda — have relatively few problems.

Financial infrastructure is also vital, and South Africa's developed banking system, akin to many first world countries, enables it to attract significant FDI (Riddell and Cockcroft, 1991). Zimbabwe also has had until recently a relatively strong and well developed financial sector. In contrast, in the country surveys conducted for this project, either actual or perceived potential problems mobilising local banking, leasing or equity finance, or conducting local financial operations through poor payments systems, were near the top of the list of factors discouraging investors in Tanzania, Uganda and Zambia. High domestic interest rates due to inflation, inefficient local financial intermediation (and to the effects of capital inflows themselves!) were also a strong deterrent. To the degree that financial sector problems or underdevelopment deter local investment, they also deter foreign investors by indicating a low local investor confidence.

2.3.3 Labour

Low labour productivity hinders UK and Japanese FDI, with investors finding labour in other regions (especially Asia) to be better value. This concern is legitimate insofar as it focuses on low skills, which outweigh cheap wages, and spring in turn from poor education, and lack of on-the-job training and middle or senior level entrepreneurial experience. Again the picture varies from country to country, with Zimbabwean and South African workers more skilled and experienced than their Tanzanian and Zambian counterparts (see Kufeni *et al*, 1997:46). Yet in-country studies show dramatic recent improvements in productivity.

Another factor perceived by OECD investors as reducing productivity in South Africa is strong trade unionism due to labour legislation. Yet investors in Southern Africa felt that unions throughout the region were becoming more conciliatory, and were not a problem.

In this light, many (particularly UK and South African) companies employ expatriate managers to overcome skills gaps. Expatriates employed by UK companies in Africa actually increased between 1989 and 1993. According to interviewees, this reflected a need for more intensive management in a deteriorating business environment, and the out-migration of local managers. However, there is little evidence that expatriates have been replaced in countries experiencing economic recovery, even though they cost more than local staff. Probably the most powerful factor behind expatriate employment has been the liberalisation of legislative restrictions — though it can take time for legal changes to reach the field (in Zimbabwe, “the amount of time it takes for an investor, local or foreign, to get application papers processed to operate here is still too long” — Kufeni *et al*, 1997:29-30). Many acknowledged that the necessity for expatriates varies by country and sector; they employ local managers in South Africa and Zimbabwe, but expatriates in Tanzania and Zambia. Employing expatriates often causes resentment in the workforce — particularly against managers from other African countries. Yet few companies have a long-term timetabled plan for transferring responsibility to local managers, except if this is mandated under affirmative action programme in South Africa or Zimbabwe. One notable exception is the Mozal project in Mozambique.

Unfortunately, what often underlies investor perception and permanent employment of expatriates is the incorrect view that low productivity reflects immutable "cultural factors", sometimes manifested as primitive racism. A UK-based manufacturer of machetes and hoes with long involvement in Africa was singularly honest: "Africans are perfectly happy falling asleep under a mango tree and leading a subsistence life".

2.4 Economic Performance and Policy Factors

2.4.1 Economic Performance

Actual and perceived performance influence all investors. Among the least informed, notably the Japanese investors (UNCTAD, 1996), it takes the form of an inability to distinguish among countries, and a tendency to attribute negative performance to the whole region. Those closer to the ground easily find countries with strong economic fundamentals to encourage investment.

In view of the differing nature of structural adjustment programmes (SAPs), this study has eschewed simplistic tests of correlation between FDI and adjustment programmes, for which earlier studies have found mixed results. Though investors see the existence of a programme with the IMF or World Bank as a sign of stability and intent to reform, they do not rank this as an important factor in the investment decision. We have therefore preferred to join foreign investors in judging adjustment programmes by the effects of individual policies. However, investors note that some adjustment policies have helped (privatisation, trade reform, new investment codes, decontrol of forex and prices), but SAPs have neglected infrastructure, labour skills, and regional integration. They also stress that programmes need to be more tailored to complexity of local economies and to consult the private sector more directly in their design (see also Bennell, 1995:210). Where major investors perceive SAPs to have a negative effect or to be ignoring their interests, they often try to directly influence government policy in a different direction, in order to encourage inward investment. Many companies have lobbied for tariff or tax structures or labour laws favourable to their activities.

More important, investors are highly sensitive to reform credibility, and consistent and transparent execution. Credibility is fragile: "international experience has demonstrated that credibility may be lost overnight, but is only regained very slowly" (ADB, 1993:173). Investors therefore complain that programmes are too inflexible to cope with sudden economic shocks or regional problems, and that shocks, bad design or overhasty implementation can shatter credibility.

2.4.2 Foreign Exchange Availability

Potential foreign exchange shortages, risking delays or restrictions on remittances, are a major fear — because investors know that Africa remains highly vulnerable to aid shortfalls, terms of trade shocks, and the debt overhang. So are falling exchange rates, which reduce rates of return to parent companies (the main reason for UK disinvestment from SSA in the 1980s and early 1990s) and make imported inputs more expensive, though they favour exporters. One major company said that "impossibly high margins" were needed to survive the slide of the South African rand. This has since pushed his head office to invest elsewhere — although it would have been easy to hedge rand exposure in the deep South African markets.

Perception here is particularly far from reality. Even in days of foreign exchange shortages (in 1985-90) rates of return improved in many sectors, leaving the share of net earnings remitted each year from UK manufacturing investments in Africa well above the global average (Bennell, 1995). Yet even now, when forex restrictions have been lifted in most African countries, and though investors and analysis suggest this encourages higher investment (in Kenya, Tanzania, Uganda, Zambia and Zimbabwe), devaluation and restrictions remain at the back of investors' minds. As a result, while many publicly favour rapid removal of controls, they privately sympathise with a gradual approach (for example in South Africa).

2.4.3 Fiscal Policy

Fiscal policy, specifically tax levels, structure and coverage, are important for all investors. They want a simple, transparent and comprehensive tax system. Until the mid-1990s, many countries had so many taxes and levels that even investors with the best intentions to pay were not aware of them all. Meanwhile tax collection was minimal and evasion easy.

Investors appreciate efforts in the 1990s to streamline the tax structure by introducing VAT, and to improve tax collection through independent revenue authorities in South Africa, Tanzania, Uganda and Zambia (though these have not always been successful — see Chapter 7). Nevertheless, donor pressure on government to raise budget revenue, and the complexity of taxing the rural and informal sectors, have continued to force new taxes on the small formal sector. In Tanzania this is complicated by retroactive imposition of some taxes, and the feeling among investors that they are being taxed at least twice for the same thing with poor compliance and easy evasion. Many investors also feel strongly that government needs to increase spending on infrastructure and education/health to support private sector development. Overall, most therefore feel that fiscal policy is too tight.

Import duties can also work in many ways to influence investment, depending on the relative balance of imports and exports in the investor's potential business. High tariffs are often perceived as an extra cost (to be avoided where possible by getting duty exemptions or lobbying for tariff reductions), particularly where the FDI is import-dependent. They also are blamed for retaliatory tariff measures by other countries which undermine export-oriented investment. As for low tariffs, many investors in Zambia, whether producing for the domestic, regional or international market, felt that its degree of liberalisation (both in reducing tariffs on imports and in reducing subsidies or incentives for exports) put them at a competitive disadvantage compared to larger regional trading partners. Similarly, the degree of import penetration in a given sector in Zimbabwe was a strong disincentive to FDI. Overall, high tariffs can provide an incentive to invest behind a tariff wall — or can discourage investment — depending on import dependence.

2.4.4 Privatisation

Privatisation programmes have often been an entry point for FDI to a country or sector, and are perceived by investors to have had positive effects in Tanzania, Uganda, Zambia, Zimbabwe and South Africa. SSA sales of state owned enterprises (SOEs) were below the developing world average until 1995, with some notable exceptions such as Ghana's Ashanti Goldfields (1994), which brought large net inflows of foreign exchange (Table 2.1). However, 1995 saw a broadening of the countries in which sales were occurring, and 1996 a dramatic increase in gross privatisation revenue (though most of this reflected three large sales in Ghana, Kenya and South Africa).

Privatisation revenue as a source of FDI to SSA is important relative to other developing areas. It comprised 20% of total FDI in 1988-95 (Figure 2.1). This indicates high dependence on privatisation as a source of FDI: one third of Tanzanian and Ugandan recorded FDI since 1992-93 has come from privatisations (though this is well above the SSA average). World Bank data show that FDI was 42% of total gross privatisation revenue for SSA in 1988-95 (Table 2.2), with the bulk going to Ghana, Nigeria and Zimbabwe (Figure 2.2). For our project countries except South Africa this is even higher (Table 2.2).

Nevertheless, privatisation will not be a magic key to FDI. Most programmes have begun with large utilities (telecoms, water, electricity, transport), or smaller guaranteed profit-makers such as cigarettes (Tanzania selling to RJ Reynolds (US)), breweries (Tanzania to South Africa Breweries) or cement (Zambia's sale of Chilanga). They have liquidated or

Table 2.1 Privatisation Revenues in SSA (1990-96)
(millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	Total
SSA Total	**74**	**1,121**	**207**	**640**	**602**	**472**	**745**	**3,861**
Côte d'Ivoire	..	2	10	5	19	74	103	**213**
Ghana	10	3	15	28	476	87	186	**804**
Kenya	12	1	12	10	19	13	137	**203**
Mozambique	3	5	9	6	2	26	38	**89**
Nigeria	16	35	114	541	24	..	..	**730**
South Africa	..	1,073	..	..	..	..	122	**1,195**
Tanzania	..	..	3	27	5	77	13	**125**
Uganda	..	..	12	19	24	47	30	**132**
Zambia	..	..	..	3	14	69	30	**115**
Zimbabwe	..	..	..	..	13	75	..	**88**
Other	33	2	32	2	9	5	86	**168**
Memo: forex generated	***38***	***5***	***66***	***566***	***453***	***275***	***299***	***1,702***

Source:
World Bank, *Global Development Finance 1998*, Vol.1, pp. 108-9, privatisation database and staff estimates.

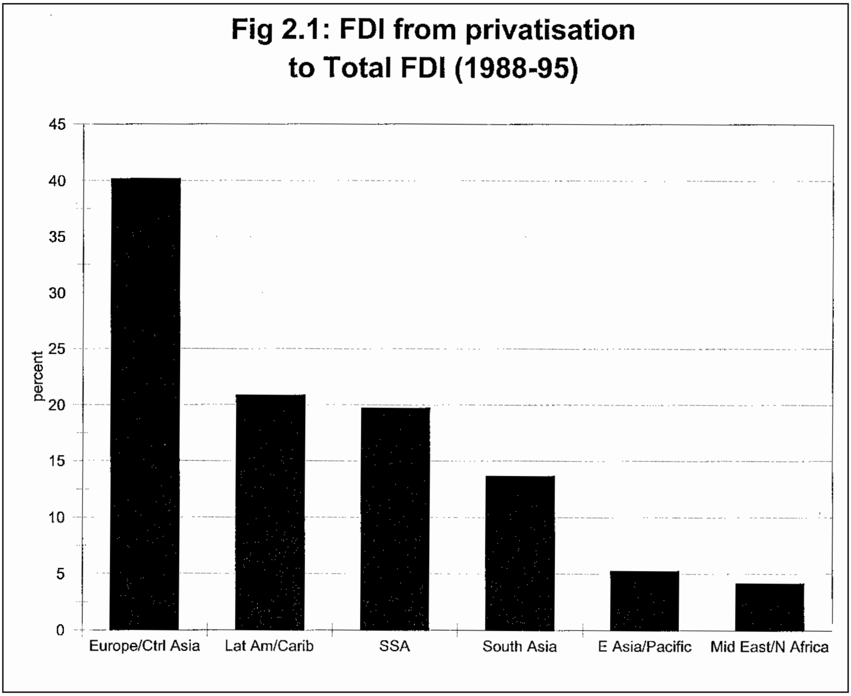


Table 2.2 SSA Privatisation Summary (1988-95)
(millions of dollars, unless stated otherwise)

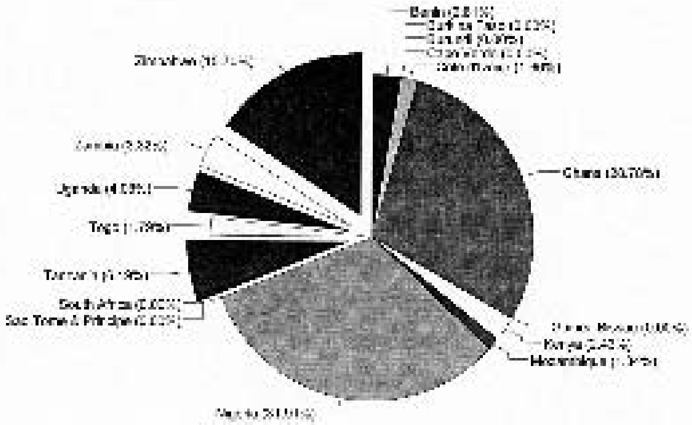
	Revenue	FDI	FDI/Revenue (%)	Number
Benin	54	44	81.5	12
Burkina Faso	0	0	..	1
Burundi	4	0	0.0	8
Cape Verde	0	0	..	1
Côte d'Ivoire	154	26	16.9	24
Ghana	619	451	72.9	52
Guinea Bissau	1	0	0.0	3
Kenya	95	38	40.0	52
Mozambique	52	21	40.4	113
Nigeria	763	500	65.5	58
Sao Tome & Principe	0	0	..	1
South Africa	637	0	0.0	3
Tanzania	111	97	87.4	41
Togo	28	28	100.0	7
Uganda	101	64	63.4	34
Zambia	71	52	73.2	10
Zimbabwe	307	246	80.1	3
Total*	**2,997**	**1,567**	**42.4**	**423**

Notes:
.. figures too small to evaluate.
* numeric average given for FDI/revenue ratio.
Data include all sales of public assets to private entities through public offers, direct sale, contracting out of government services through concessions or licencing agreements, and joint venture arrangements.
Data exclude voucher sales and divestiture and mothballing of SOEs; privatisations under US$50,000; and voucher-based mass privatisations.

Source: World Bank Privatisation Database, in IFC 1997.

sold for virtually nothing a large number of companies, particularly in manufacturing and agriculture. The Zambia study shows graphically how privatisation has been delayed by the absence of functioning stock markets, political opposition to foreign purchasers, technical issues of valuing assets, and complex bidding procedures (which potential foreign investors nevertheless see as non-transparent). After delay has degraded their assets and forced them to be revalued downwards, many companies find few interested buyers, and in final negotiations governments have to take over large amounts of debt, often turning the privatisation into a net foreign exchange loss! Even Zambia Consolidated Copper Mines risks earning less than 30% of its original valuation. While a few prime companies remain to be sold in each country, it is vital to capitalise on these sales with strong positive publicity about wider policies, to mobilise FDI additional to privatisation.

Fig 2.2: Share of FDI Revenue
(1988-95)



2.4.5 Investment Regulations, Promotion and Treaties

Deregulation encourages investors. Restrictive investment codes have been revised in all project countries and across Africa, allowing quicker decision-making, ending commissions or bribes, and creating one-stop investment centres to reduce delay. However, some one-stop centres have become merely an extra level of bureaucracy (UNCTAD, 1995b) with screening for financial viability delayed due to lack of expertise, new inefficient discretionary decisions, or contradictions and disputes between new codes and existing legislation, or their executing agencies. Investors ideally want centres to "hand-hold" them through the bureaucracy of government departments, rather than screening investments. Tanzania's Investment Centre has recently been successfully restructured for a second time with this aim.

Investment promotion centres and their missions to generate funds for particular sectors are widely popular if they are conducted in cooperation with existing investors, who can discuss success stories, focus on examining proposals and detailed preconditions for participation, and help to overcome bureaucratic headaches like work permits or telephone lines. Government also needs to target resources carefully towards probable investors, in preference to blanket large-scale conferences. However, one investor suggested that investment promotion and advice would be better run privately through the local banking system, on the basis that banks might take a longer-term view than government, and would receive funds based only on success.

International treaties and guarantees are rarely cited by investors as important factors. By June 1996 258 bilateral treaties existed between African and capital exporting (mainly developed) countries. All project countries have signed such agreements. They are also all members of multilateral treaties such as the Multilateral Investment Guarantee Authority (MIGA), the International Convention on the Settlement of Investment Disputes (ICSID), and the Convention for the Protection of Industrial Property. Tanzania, Uganda, and Zimbabwe are members of the Convention on Recognition and Enforcement of Foreign Arbitration Awards (UNCTAD, 1997b:xiv; 1996:61, 63; 1995b).

Such agreements indicate commitment to promote and protect FDI, including transfer of payments and profit and capital repatriation, losses from armed conflict or international disorder, nationalisation and expropriation, and dispute settlement. But investors said that they were at most a minor extra safeguard. They cited free trade agreements such as the Lomé Convention as being far more important to their investment decision, especially where they could take advantage of unexploited quotas for exports to the EU. The exception is when source country governments organise investment drives in Africa (for example Malaysia, Brazil, the US) and insist on signature of such agreements as a precondition.

2.5 Political and Social Factors

2.5.1 Political and Social Stability

Political instability is one of the most important criteria affecting investment. Stable government has encouraged investment in Tanzania, Uganda, South Africa, and (until recently) Zimbabwe. Stability need not entail democracy so much as an enabling environment for business. Unfortunately, while investors pay lip service to democracy, they do not care fundamentally who runs the country provided there is strong leadership. One commended Côte d'Ivoire for its death penalty, and another favoured dictatorships for their "rapid decisions", with the view that "democracies in Africa are apparent rather than real". However, antidemocratic moves such as those before the last round of elections in Zambia were acknowledged to generate bad publicity.

But even in stable systems with trusted leaders, foreign investors seem to search desperately for longer-term worries, for example over the "succession" in South Africa and Ghana, or "tribal rivalry" elsewhere. At the back of their minds is the (mis?)perception that stability and effective leadership in black Africa are an aberration. Opinions are also ill-informed and highly subjective. For example one fund manager identified the best prospect in Africa as Kenya, due to strong economic fundamentals and stocks trading at a discount, but another explained this discount was due to political instability.

Investors based in Africa tend to be more realistic and better informed, dismissing most fears as unfounded. They see major advantages to taking a long-term view and maintaining a presence during instability, as this leaves them well placed to resume operations when stability resumes. Those with interests in many countries are best able to spread political risk (Bennell, 1995).

Social instability and crime are equally important. Most potential OECD investors feel they would be unsafe in Africa's cities, in spite of increased policing. Again investors based in Africa are more selective, citing only Johannesburg and Nairobi as more dangerous than London.

2.5.2 Corruption

This is a powerful deterrent to potential OECD investors who, given information constraints and prejudice, see it as endemic across Africa. Those based in Africa tend to be more realistic and better informed, and feel that some types of small-scale and low-level corruption are more efficient than ridiculous taxes or interminable bureaucracy.

Most investors are less forgiving of high-level corruption. "Bleeding the country is Africa's biggest problem", says a British Asian banker with close links to the region. High-profile scandals such as drug smuggling by Zambian ministers or Kenyan politicians buying British firms through Indian firms tarnish the national image and the credibility of economic reform. At middle levels low pay and morale, and high job insecurity for civil servants make corruption more understandable, and many investors suggest urgent salary reviews after removing surplus staff. The most honest investors identify as half the problem a culture within their organisation of paying bribes or petty fraud. Under these circumstances a strong legal framework (as in South Africa) is critical.

Damage through corruption is related to the "credibility" of corruption. As Pfeffermann (1996) argues: "In some fast growing developing economies corruption is commonplace, but is a fairly predictable cost of doing business and bribers can be sure of what they are buying. In contrast, in the majority of developing countries, corruption itself has low credibility — bribers are not sure who to bribe and, most importantly, whether or not they will get what they are seeking to obtain, and this deters all investors, even those who have few scruples about bribery".

This is the crucial issue. The effect on investors depends on their access to information about who to bribe. Smaller investors outside the region face high opportunity costs of obtaining information. Local investors are "more familiar with the way of doing business", and can receive preferential treatment by not paying tariffs or taxes, or tariff protection or monopolies on their goods due to "national or strategic interest". There is a fine line between lobbying and corruption. Trans-national corporations do not hesitate to lobby and offer inducements (political campaign funding, free holidays) where necessary. Some even bribe directly, blaming it on "corrupt bureaucracy and contradictory tax laws". However, they have to watch out for internal auditors or regulations such as the US Foreign Corrupt Practices Act (1978) which fines illicit payments heavily. Though the powers and enforcement of both are often exaggerated, they tend to focus bribery on projects where the transnational corporation can ensure that huge returns will offset any fines.

Western investors have marginally less opportunity to act corruptly. But opinions such as "Western companies are disinvesting from Africa, and are being replaced by smaller Indian outfits with a mind set to endemic corruption" or "British and Europeans are somewhat uptight about corruption which puts them at a competitive disadvantage" bear little resemblance to the truth. A USAID study found only a few dishonest Tanzanian Asians, who give the whole community a bad name (Lofchie and Callaghy, 1995). Instead, these views seem to reflect sour grapes about transnational corporations' slowness in spotting business opportunities and losing out to Asian and South African investors.

2.6 Sector-Specific Factors

Even with favourable economic and political conditions, interest in particular sectors is usually the main driving force determining which countries to invest in. In other words, the success of national efforts to promote FDI depends on natural resources and sector-specific policies.

As shown in Chapter 1, FDI from both traditional and new countries is diversifying into new sectors. Though primary sectors (especially mining and oil) continue to receive most FDI, other sectors such as finance, manufacturing and services are capturing an increasing share (in South Africa, finance, insurance and manufacturing dominate new FDI).

The more dynamic source countries and groups are investing across all sectors. South African investors are putting money into almost every sector. Asian community businesses are also highly diversified across trade, finance and primary and manufactured products. Before the Asian crisis, East Asian companies were investing mainly in non-primary sectors, though post-crisis they have been pulling back because these sectors have suffered. In contrast, OECD investors remain largely wedded to traditional primary sectors.

2.6.1 Primary Sectors

Many SSA countries are endowed with rich natural resource bases, providing huge opportunities in agriculture and mining. Mining is discussed in more detail in Box 2.1. South Asians and Western European investors are heavily involved in agriculture plantations (tea, sugar, cotton). South Africans are strong new competitors, buying farms in neighbouring countries. The biggest growth areas are horticulture and flowers for export. All of our project countries have seen significant expansion in such non-traditional exports during the 1990s. An important negative influence has been commodity price volatility, particularly with the gradual disappearance in the region of marketing board quotas and guaranteed pricing. For example, US FDI in petroleum is vulnerable to oil prices, with companies avoiding new developments or explorations, and paying large dividends to their parents. Location is also important, with investors preferring rich natural resource bases close to manufacturing sites.

Box 2.1 Why Mining and Oil Attract FDI

Mining and petroleum ventures continue to account for the largest proportion of FDI stock and flows in Africa, with dramatic expansion into new countries such as Tanzania and Uganda, Mali, Mauritania and Burkina Faso — as well as new mines in Ghana and Zimbabwe. South African, Australian and Canadian companies feature heavily. Oil also continues to be important for Angola, Cameroon, Congo, Gabon, Nigeria, South Africa and most recently Equatorial Guinea. This sector remains dominated by major OECD oil companies, though Malaysia is investing in South Africa's petroleum sector.

Investment decisions by mining and oil companies are often used as a barometer by businesses in other sectors. One UK mining entrepreneur believes: "we are... the shock troops of investment. If we can invest successfully and harmoniously then we may trigger a move to Africa by international companies which do not need to be in Africa."(World Bank / IMF, *Emerging Markets*, 30/9/96).

However, many factors enable mining companies to overcome problems faced by smaller businesses, through size and diversification. Thus the mining industry views SSA very positively, and is rapidly expanding activity. For example Ashanti has expanded rapidly in the last decade, with mining and prospecting interests in 12 African countries including Ghana, Angola, Ethiopia and Zimbabwe. Anglo-American's restructuring will free resources for mining outside South Africa (which is now one of the most geologically explored parts of the world, and perceived to be in secular decline).

They can invest in their own infrastructure. For example Anglo-American built a water pipeline and employee accommodation at a goldmine in Mali. Needs for extractive industries are so large that self-provision may be more efficient, while other investors expect infrastructure to be provided for them.

They face lower risk. Extractive industries are less exposed to exchange rate risk as they sell almost exclusively on the international market and lodge export proceeds in offshore escrow accounts. They are also experienced in dealing with volatile commodity prices through hedging and forward transactions.

Risk-spreading may be easier. They also reduce their risk by employing small prospecting companies to perform exploration or feasibility studies. These small companies take all initial risk, and are in turn helped by major tax breaks from their home governments.

Financing is more easily available. The primary source is retained earnings, but if a mining company like Anglo-American needs to go to the market, it has a high credit rating and can secure loans against assets abroad, or use its parent company, Minorco's borrowing powers. Mining ventures also find it easier to attract international cofinancing institutions such as CDC and IFC, largely because they have guaranteed streams of hard currency revenues and privileged political status.

Political instability is less worrying for existing investment as mining companies often use their own security forces and infrastructure maintenance. As their projects are strategically vital, they gain access to inside information, and influence political developments. Though they rarely commit new resources under instability, they are rarely obliged to pull out.

2.6.2 Manufacturing

Many relatively new sub-sectors are thriving. **Textiles and footwear** are popular with South Asian and increasingly with South African investors. **Motor and auto-components,** traditionally the preserve of Western European firms, are receiving funds from Korea in South Africa and Botswana, where Hyundai began a vehicle assembly plant in 1996 to service the African market, while South African companies are supplying auto parts and tyres to the region. **Food-processing** is attracting investment from new sources. South Africans are widely involved, and a Chinese firm is planning a cocoa processing plant in Ghana to service the Asian market. **Breweries** are highly lucrative. South Africa Breweries (SAB), the fourth largest in the world, has bought controlling interests in breweries which have been privatised in Tanzania, Zambia, Mozambique, Uganda, Lesotho, Swaziland and Botswana, and set up a virtual regional monopoly, increasing production and introducing new brands. SAB imports effectively reduced Kenya Breweries' production by 20% in 1996, and this is likely to continue with the establishment of a brewery in Thika in late 1998. Huang Gu of China also set up a brewery in Ghana in 1996. **Cigarettes** are another large market, mostly dominated by large TNCs such as RJ Reynolds (which bought Tanzania's privatised company) and BAT. South African and Asian community companies are investing heavily in **soft drink bottling** franchises. **Cement** is proving popular with European and regional investors.

2.6.3 Services

Tourism FDI is growing rapidly, taking advantage of abundant natural resources. Countries with good infrastructure (Zimbabwe) and those without (Zambia) are seeing large new developments. South Africans are involved across the region through chains like Holiday Inn, as are South Asians and Mauritians in Eastern and Southern Africa. The Serena group is a massive investment by the Ismaili Aga Khan. Hong Kong is investing in the Seychelles, and Malaysia in South Africa. This is striking diversification in a sector previously monopolised by Europeans.

In **banking and finance,** South African firms are dominating the region, and providing fierce competition to traditional investors from the West. Standard Bank's purchase of ANZ Grindlay's African section in 1992 under the Stanbic name (in Botswana, Zambia and Zimbabwe, with affiliates in Ghana, Kenya, Nigeria, Uganda and Zaire) means a ready-made presence in many countries, competing effectively with traditional American and British banks. The SA First National Bank also acquired the

Bank of Credit and Commerce in Botswana in 1991. More recently firms have invested in insurance, stockbroking, leasing and merchant banking in Botswana, Namibia and Zimbabwe. South Asians are strong in financial services, most notably banks and foreign exchange bureaux in Kenya, Uganda and Tanzania.

South African **retail** chains are flooding the region, from Zimbabwe through to Kenya, buying up privatised nationwide supermarket networks, though mostly concentrating on the lower end of the market through companies such as Pick 'n'Pay (which for example invested in Zimbabwe's TM Supermarkets in 1995). In East Africa they are even competing successfully with the "regional heavyweight" Uchimi.

South African and Scandinavian companies are leaders in expanding construction activities, with Malaysia and other East Asian and Latin American companies bringing funds into housing and property. Malaysia has also been active in telecommunications in Ghana and South Africa. Private health care and medical supplies are a fast-growing sector for South African and Asian investors, as are radio and television networks and periodicals following the liberalisation of the media in many countries.

2.6.4 Global Sectoral Strategies

One important factor influencing sectoral investment springs from global market trends rather than national endowments: SSA is now competing in a global market on both a country and sector level. Global corporate restructuring has become the trend of the 1990s, particularly among Western and South African TNCs. This involves concentrating on core sectors, shedding diversified projects, in order to maximise comparative advantage and profitability. As examples:

- Unilever's global restructuring in 1994 resulted in selling most of its 40% stake in United Africa Company's Nigerian operations in textiles, timber, air conditioning, and car assembly. In contrast, it increased its holdings in its remaining assets of Lever Brothers Nigeria which were regarded as core business.
- Anglo-American is scaling down non-mining interests in South Africa, built up during the isolation of apartheid, and expanding mining elsewhere in Africa and the world.
- Lonrho has drastically reduced its involvement in non-core sectors, switching from "management by country", which encouraged local knowledge to take advantage of opportunities for diversification, to "management by sector".

2.6.5 Other Factors

Most of the non-sectoral factors which have been discussed earlier in this chapter have varying influences on different sectors, explaining why investors enter some sectors and not others. Four examples will suffice:

- **Economies of scale** in certain sectors enable investors to offset negative national factors. In particular, "strategic" mining and oil activities often continue "even if a country is otherwise falling apart". As discussed in Box 2.1, they continue to be optimistic about Africa. Foreign investors also predominate in certain large-scale sectors (infrastructure, banking etc.) because only they have the start-up capital available from their own funds or international cofinanciers.
- **Treaties** are most useful if they encourage investment in certain sectors, rather than just serve as demonstrations of political goodwill. Agreements between Ghana and Malaysian firms were signed in 1996 covering hotels, banking, real estate, and palm oil development.
- **Risk-sharing** through international cofinancing by banks, international financial institutions or venture capital funds also encourages investment in sectors overlooked by international investors.
- The effects of macro policies on different sectors are also critical. For example, some manufacturing investors argue that **structural adjustment** has hastened disinvestment by manufacturers serving the domestic market, notably through devaluation.

Chapter 3 Portfolio Flows

Nils Bhinda, Stephany Griffith-Jones and Matthew Martin

As shown in Chapter 1, international data assume that portfolio flows come in two main forms: equities and bonds. Within the bond category, this project has identified a key sub-component: foreign purchases of Treasury Bills issued by SSA governments. As equity flows have been by far more important and the fastest growing flow for Sub-Saharan Africa, even exceeding FDI in 1995 (World Bank, 1998), most of the chapter is devoted to their causes, followed by briefer discussions of bonds including Treasury Bills.

3.1 Equity Flows

Portfolio equity flows to SSA have never been systematically analysed: probably because the amounts seem small by global standards and (except for South Africa and Zimbabwe) recent. We conducted comprehensive surveys of specialised African funds, global and emerging market funds, to gauge for the first time the causes of the flows.[1]

3.1.1 Funds and Their Investors

Investment in Africa remains a recent (post-1992) and relatively small field. This reflects low demand from large wholesale investors. Managers of Africa funds have not been reluctant to target large amounts but, with the exception of Morgan Stanley, have not achieved their targets. Nevertheless, their extensive research, sales and marketing work has been bearing fruit during the mid 1990s. Most funds are diversifying across countries and sector, as they gather more knowledge of the region and their perceptions of investment opportunities become more positive.

These efforts to cultivate clients in a “niche market” have protected many against the sharp falls in emerging market portfolio investment in 1997-98.

[1] It excludes purchases of shares directly in international financial markets (e.g. of SSA companies traded or listed in London or Luxembourg), because data are particularly hard to obtain. These are fairly small, but have increased recently.

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

Investors are split roughly evenly between retail and institutions, and the US and UK are the main sources. Evidence from other emerging markets suggests this may bring greater volatility, as Anglo-Saxon (especially US) investors focus more on short-term returns than those from continental Europe. However, some funds (e.g. the Africa Emerging Markets Fund) do attract European and Middle Eastern investors. Framlington and Regent are trying to reduce volatility by targeting local investors and institutions for joint ventures (and for Regent by listings in Kenya and Botswana).

Donor involvement has also been a powerful incentive for diversification and local investment. For example, Framlington targeted the Caisse Française de Développement (CFD) and the IFC. Donors often have the resources to overcome the "information deficit" on Africa, allowing the private sector to receive accurate information without investing resources. But donor involvement raises the question of whether the funds are entirely "private" capital flows.

Another reason for lower volatility of flows to SSA is that 85% have come via closed-end funds (Table 1.4). By their nature, such funds should reduce volatility because they are relatively protected from actual and exempted redemptions by individual investors, as claims are traded on a developed country stock exchange, and are not, like open-ended funds, required to redeem claims on demand. However, the Mexican peso crisis indicates only a marginal effect of closed-end funds on volatility (Griffith-Jones, 1996; IMF, 1995).

3.1.2 Global Factors

Global or "push" factors were extremely important to the rapid rise in portfolio equity in the mid-1990s as part of a broader OECD trend to invest in emerging markets. Among our project countries, these factors have impacted most strongly on South Africa, which is most closely tied to the international economy, and then filtered through to the region.

Globally, the growing asset base of institutional investors, due to huge rises in pension funds, (reflecting a higher ratio of aged to active population in the industrial countries), is dramatically increasing aggregate savings in portfolio flows. In the longer term, this may well be offset by a slowdown in growth of the labour force, and therefore a decline in returns on capital relative to labour. Relaxed regulation is encouraging pension funds to become the "major force in further international diversification and, in particular, in the demand for portfolio equities from developing countries" (World Bank, 1997a:113-123). Declines in international interest rates have triggered huge movements (Calvo *et al*, 1991, 1993, and 1995; Asea and Reinhart, 1995; Chuhan *et al*, 1993; Fernandez-Arias, 1994).

Cyclical downturn in developed countries has also reduced economic activity, and demand for investment funds.

In this context, the most important factor encouraging flows to Africa was risk diversification in search of higher returns, encouraged by low correlation between rates of return in industrial countries (particularly the US and UK) and those in emerging markets. The Morgan Stanley and IFC indices indicated throughout this period tremendous scope for increasing returns through diversification (World Bank, 1997a). SSA markets provided more scope for high returns from diversification, due to low correlation with other emerging markets, in turn reflecting the low levels of flows to SSA. Furthermore, price/earnings ratios in SSA were very low, making shares "undervalued" and overcoming expectations of higher risk and lower growth.

In addition, stock exchanges were much less correlated within SSA than within Latin America (*Emerging Market Investor*, June 1996). For example, Zimbabwe's exchange responds largely to national events, making Zimbabwe more likely to benefit from investors seeking to diversify out of South Africa. At the other extreme, Namibia's exchange is seen as "little more than an adjunct to the Johannesburg exchange, as most stocks have dual listings" (*World Equity*, 2/97:51).

This low correlation has also largely insulated SSA from global financial crises (Mexico 1995; Asia, Russia and Brazil 1997-9), making its stock exchanges less volatile. For example, the Botswana and Zimbabwe exchanges are weakly correlated with the US and Latin America, even though Latin American countries are implementing similar macro and trade reform (Jefferis *et al*, 1997). However, South Africa's short-term links with emerging and developed markets are stronger, due to its weight in fund managers' portfolios, the size of the equity market and its more efficient transmission of signals and shocks (Jefferis *et al*, 1997).

In the mid-1990s, flows to South Africa rose sharply, as did its correlations with world markets and therefore its volatility. Flows, correlations and volatility also rose for other SSA countries as capital markets were liberalised. Many Africa funds invested a disproportionately small amount in South Africa relative to market capitalisation (90% of the region) or GDP (45%) weights (Table 1.5), in order to diversify within the region in search of higher returns from "undervalued and high growth assets" and "frontier" markets (see *Africa Emerging Markets 1998;* Regent, 1998). Increased volatility reflected onward "contagion" from South Africa and increased flows. Countries are therefore faced with policy dilemmas: there is a trade-off between higher flows and increased regional integration, and higher volatility.

As recent crises have shown once again, flows often do not reflect economic fundamentals, so that problems in one country (or group) cause contagion in perfectly healthy economies by leading investors to reappraise exposure to all emerging markets. These unstable cycles of euphoria and pessimism will hit SSA harder as it integrates financially into the world economy.

However, the "herd behaviour" among investors which causes volatility can occasionally be a stabilising influence. For example one fund manager did not pull out of South Africa after the collapse of the rand and the South African stock exchange in mid-1996, because the share of South African stocks in the IFC and Morgan Stanley indices was fairly large. As many of his colleagues invested in line with these indices, he would have performed below average if the South African stock market recovered. An important precondition for attracting and sustaining portfolio flows is the inclusion of SSA markets in key indices, chiefly IFC's.

3.1.3 Perceptions of Sub-Saharan Africa

Perceptions of SSA affect the extent to which increased flows to emerging markets are channelled to the region. These range widely from negative bias, to those who see SSA as "the final frontier" and "the last region of opportunity". Negative perceptions of Africa are a major cause of under-investment. They are based on a mixture of real concerns (discussed below) and a large element of misinterpretation of signals (and in particular, dismissal of new positive trends), and use of irrelevant benchmarks.

Perceptions vary by type of investor. Pan-African fund managers tend to be more "Afro-realistic", and were generally very positive with better informed views of the region. Global fund managers become "Afro-euphoric" when things go well, and "Afro-pessimistic" at other times: they acknowledge their lack of information by urging Africa to "sell itself more", and saying that it receives "a raw deal in the media". Swings in mood are therefore closely tied to quality and quantity of information. The more investors diversify, the less information they have to support their decisions (Calvo and Mendoza, 1995), especially in smaller markets where information collection is more expensive and exposure is small. As one fund manager put it, "there is nobody in the main investment banks or fund managers who has any real experience in Africa: often there is no dedi-cated investment manager for the African continent". This traps many SSA countries in a vicious circle of poor information, low expectation, and low investment.

But even fund managers with better information and optimism about SSA are unwilling to invest due to the way their performance is judged. All managers are assessed on short-term benchmarks (on average three months), even though they are investing long-term assets such as pension funds. Thus individual willingness to take a long-term position may be overridden by pressures not to stray from the herd. This is worsened by perceived volatility of economic policy and performance in SSA, which could (over the short-term horizon) lead a fund with high SSA exposure to underperform, losing money from their clients. It will remain hard for SSA countries to attract huge portfolio flows until a large group of investors changes perceptions fundamentally.

3.1.4 National Factors

Many national influences are shared with foreign direct investors, and have been treated in more detail in Chapter 2. The positive influences most often cited were political stability; low levels of corruption and bureaucracy; commitment to private ownership and attracting foreign flows; strong growth; well coordinated economic policy; regional economic integration to overcome problems of small market size; regional structures for commercial banks as in the CFA Zone with common supervision and regulation (Mistry, 1996); a young and motivated labour force; rich primary resources; and efficient transport and telecom networks. On the basis of these factors, Mauritius, Ivory Coast, Botswana and Zimbabwe were often cited more positively than Latin American or Asian markets during interviews with fund managers in 1996-97.

Portfolio investors also have specific concerns, the most important of which are the development of stock exchanges, perceptions of individual countries, a collection of portfolio-specific macroeconomic indicators, and the presence of donor support for portfolio investment:

Since 1989, many SSA countries have established or expanded stock exchanges, as part of a policy of integration into the international financial market, and of attracting foreign private capital to overcome inefficient local financial intermediation and stimulate savings and investment (Jaspersen *et al*, 1996). Of the 15 SSA exchanges, 10 have been established in the last decade. Another five countries are considering starting their own exchanges. In order to expand the market and increase economies of scale, the stock exchange in Abidjan has been expanded to cover seven countries in the Francophone West African sub-region.

Exchanges are perceived as vastly preferable to trading of large African companies' shares in international markets such as London or Luxembourg. While this widens the investor appeal of African shares, it tends to slow development of local exchanges. For example Ashanti's listing of its stock on the London market caused a substantial rapid transfer of turnover from Ghana to London, to benefit from price differentials.

Exchanges serve an important function because fund managers prefer to (or are legally required to) invest in listed companies. Some invest in unlisted companies if there is the possibility to on-sell, or they are about to be listed, because they offer higher returns. Perceptions vary: the Mauritius Fund invests 20% unlisted, but the Africa Emerging Markets Fund only 5% of a permitted 30%.

Positive performance by stock exchanges has been a powerful attraction for portfolio flows, periodically provoking "Afro-euphoria" among investors (for example for Nigeria, Ivory Coast, Zimbabwe and Namibia in 1995/6). This performance has reflected the expansion of privatisation programmes; the suspension / abolition of capital gains tax in most SSA countries, and reduction of withholding tax on dividends; strong dealing systems; the absence of exchange controls; and especially the presence of strong natural resources, all of which offset the lack of market size. As a result of these factors, investors see opportunities in copper and sugar in Zambia; in minerals in Botswana; and in many sectors in Uganda.

However, several factors hold back the growth of stock exchanges outside South Africa (for more details, see Emenuga, 1997; N'Guessan, 1997):

- lack of indigenous listed companies. This reflects aversion by indigenous entrepreneurs to go public for fear of losing control, and their lack of experience and resources to float their companies (Emenuga, 1997:158; Alile and Anao, 1986). Low domestic levels of savings and investment (due to weak financial infrastructure, and inefficient resource allocations and wealth distribution) also hinder domestic involvement. Low local participation is seen as reflecting lack of confidence, discouraging foreigners. High local participation boosts credibility and moderates the volatility of fickle international flows. The Abidjan exchange has overcome this to some degree by encouraging a "second market" with less strict listing requirements and an over-the-counter unlisted market.
- small average company size. However, this is misleading in some countries, where a few large companies account for most capitalisation, such as Ghana's Ashanti Goldfields.
- low capitalisation — but this doubled in 1993-5, bringing capitalisation/GNP ratios to the same level as many other emerging and developed country exchanges (IFC, 1998:18).
- low liquidity as measured through the turnover ratio (the value of shares traded as a proportion of capitalisation). This has been found by analysts to be the factor linking stock exchanges with economic growth (Levine and Zervos, 1996; Jefferis *et al*, 1997) — though it can also reduce volatility of flows. Low liquidity puts off foreign investors, because it may prevent them from selling their shares, and may cause volatility if trades are dominated by a small number of large privatisations. Even the

Johannesburg Stock Exchange, despite being the largest emerging market in terms of capitalisation, has long been one of the least liquid. Several exchanges have been introducing Treasury Bills, government bonds, CDs and corporate bonds onto markets to increase liquidity.

Low liquidity is due to the dominance of holdings by the original direct investors, the public sector, and local institutional investors, who have a "buy-and-hold" attitude; historical or continuing exchange controls; delays in settlement processes; excessive regulation; high official or "corrupt" transaction costs including taxes; sharp practice or corruption/fraud by brokers; short trading hours (averaging 2 for about 2-5 days per week); official limits on price fluctuations (to discourage speculation); a small number of listings; and the low frequency or absence of external auditing of accounts. Many countries have tackled these problems in 1995-9. In conjunction with privatisations and openness to non-resident investors, this has dramatically increased liquidity (see Emenuga, 1997; and N'Guessan, 1997).

Several macroeconomic issues are crucial to portfolio investors. The fundamental balance (the current account deficit minus FDI, which indicates balance of payments sustainability) is generally negative for SSA. Monetary policy is a crucial indicator of liquidity, suggesting likely future trends in share prices: investors would prefer looser policy to increase liquidity, provided this did not lead to exchange rate falls, higher inflation, collapses in reserves or the ending of an IMF programme. The soundness of the banking system which in most African countries (as discussed in Chapter 4 in more detail) is inefficient, undercapitalised and burdened with overhangs of domestic bad debt is a key deterrent to portfolio investment (see also Mistry, 1996). Exchange rate prospects influence investors both by affecting projected dollar values of investments and by influencing targets (for example encouraging export-oriented industries if devaluation seems likely).

Finally, given the underdevelopment of most African stock exchanges, macroeconomic problems, and volatile investor perceptions, donor support for portfolio funds or technical assistance (for example to help companies list on stock exchanges) has been valuable to increasing portfolio flows. Such assistance is provided through organisations like IFC, CDC, Proparco and the EIB. Though they are small (maximum $25 million), due to their regional knowledge, donor funds are better at identifying opportunities, giving comfort to private investors (both domestic and foreign) and other official investors (for example the CDC's 10-year Commonwealth Africa Investment Fund, COMAFIN, created in 1996, has major participation from institutional investors in Malaysia, Singapore, the Brunei Investment Agency, the Development Bank of Southern Africa, Botswana, Mauritius and Zimbabwe). They also tend to widen the sectors considered by investors (beyond natural resources to services, tourism and private infrastructure); the number of countries receiving investment (even extending to countries such as Mozambique which as yet have no stock exchanges); and the number of companies insofar as they focus mainly on unlisted companies. They often participate actively on company boards, acting more like venture capitalists. As funds are small, success is measured by whether investments will complement rather than crowd out private sector foreign or local investment.

On the downside, investors say donors lack business understanding, and are "reliant on number crunching" with "poor understanding of the rationale for a project". They possess a "lender's mentality, trying to plug the downside at any cost", which "clouds understanding of risk and reward". They are also inefficient due to bureaucracy, options, and shareholder agreements, which are easy to avoid when things go bad, and "encourage poor promoters". Recipient countries complain that they tend to focus mainly on expanding privatised companies, and that the scale of investments ($0.5-10 million) is too large for most indigenous companies.

3.1.5 Sectoral Factors

Investors target strong and undervalued sectors within countries, in order to diversify risk and increase return. Some funds (such as Morgan Stanley) are highly diversified across sectors, but others show clear bias towards particular sectors. Consumer goods and services, considered "less volatile", constitute a third of total portfolio for Mercury and Alliance Capital, and many funds see high potential here. Low-cost, volume-driven primary sectors such as mining and agriculture, and agro-business are targeted as traditionally profitable areas. Regent allocates a third of its portfolio here, Mercury 17% and Alliance 13%. Newly privatised companies such as telecoms, power and infrastructure, breweries and cement are seen as "sure bets". Tourism has immense prospects across the region and particularly for Mauritius, where the Mauritius Fund invests 19%. Banking is very popular in some countries including Mauritius, which is set to become an offshore tax haven for South Africa and other states with high tax regimes. The Mauritius Fund has 27% invested; Morgan Stanley 10%, and Alliance 13% in financial services.

3.2 Non-Equity Flows

Non-equity portfolio instruments (bonds and Treasury Bills) have rapidly become key sources of flows to SSA in the mid-1990s, due to the liberalisation of external and domestic financial transactions. Almost all portfolio funds have considerable exposure in both types of instruments, though exact figures are unavailable due to information constraints. Many funds initiate their investments by focussing on non-equity instruments. In 1995-97 they increased their equity holdings in response to stock market development and global market trends; but in 1998-9, as part of a more global "flight from equity", many reduced the equity holdings and switched to bonds and T-Bills.

3.2.1 Bonds

Fixed income debt instruments (particularly bonds) are often dollar denominated, which implies no currency risk for the dollar-based investor. They comprise new internationally issued bonds, and debt reduction instruments.

New bonds have included a wealth of public and private sector issues from South Africa; Mauritius' first issue in 1995 to finance infrastructure; and Ghana's convertible private sector bond from Ashanti Goldfields. Most have been highly successful (Ashanti's bond was increased from $175m to $250m due to demand, largely from US institutional investors).

The key factors determining the success of bond issues (measured in terms of full or over-subscription and therefore reasonably low spreads over benchmark US bond yields) are positive foreign investor perceptions of country credit risk (influenced partly in turn by credit ratings as discussed in Chapter 5 below); and their changing willingness to take risks in emerging markets — rather than retreating to even more secure developed market bonds.

Fixed income bonds related to debt reduction include Brady bonds in Nigeria and IDA debt reduction bonds in other countries, and promissory notes for other debt. But these are mostly traded on secondary markets, typically in London or New York, and do not generate a net capital inflow into SSA (though if the debt prices in secondary markets rise, this can improve a country's creditworthiness, making it easier to attract other capital flows).

Foreign investment in domestic bonds has been a dominant — and highly volatile — form of capital flow into South Africa in recent years. Table 3.1 shows that bond trading volumes by non-residents have soared since 1995, with gross purchases and sales increasing 40-fold to reach their

Table 3.1 Transactions by Non-Residents on the Bond Exchange of South Africa
(millions of South African Rand)

	1994	1995	1996	1997	1998
Gross Purchases	22,897	35,299	175,138	605,992	1,371,526
Gross Sales	22,479	33,130	171,755	591,214	1,381,291
Net Purchases	1,103	1,871	3,383	14,778	-9,765

Source: South African Reserve Bank.

massive 1998 levels. Net purchases also rose dramatically, more than quadrupling between 1996 and 1997, only to plummet to large net sales in 1998. The causes underlying these trends are discussed below.

Huge increases in non-resident trading resulted from push factors including the normalisation of international financial relations and portfolio diversification by international investors, and critical pull factors including the abolition of the Financial Rand (March 1995) which ended the dual exchange rate system, high domestic interest rates and a series of far reaching reforms to the trading system (Ncube, Leape and Thomas, 1996). Reforms to the bond market began in 1995 with the introduction of a net settlement system, simplification of settlement arrangements, immobilisation of the scrip of major traded stocks at the central depository, adoption of an electronic trading system, and tightening of listing requirements to emphasise full disclosure. In 1996, the Bond Market Association was converted into a formal exchange (the Bond Exchange of South Africa). Subsequent reforms included the shift from a "second Thursday" settlement period to the international standard of three day rolling settlement (T+3). A further pull factor stimulating portfolio investment in recent years is the use of South African bonds as an instrument to hedge liabilities in the growing Eurorand market, in which Rand denominated debt is issued and traded internationally.

The contagion effects of the Asian crisis were, at times, severe. While South Africa continued to experience record inflows during the first phase of the crisis, Figure 3.1 shows there were massive net bond sales by non-residents in October 1997, when the effects of the collapse of the Hong Kong market were felt (Khatri and Leape, 1997). In the wake of the Asian crisis, as the major markets began to recover lost ground, foreign investment in South African bonds resumed, only to experience sharp volatility in mid-1998 with the crises in Russia and Indonesia (see Box 3.1).

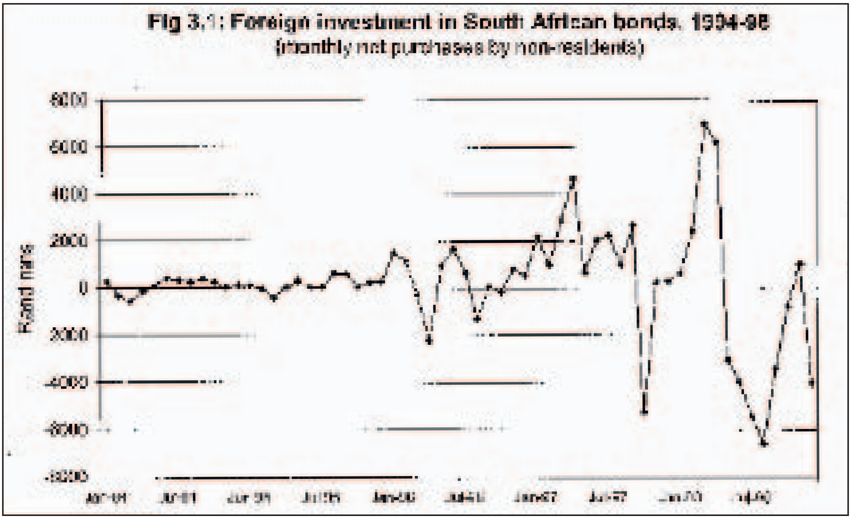


Fig 3.1: Foreign investment in South African bonds, 1994-98 (monthly net purchases by non-residents)

Box 3.1 The Effects of the Asia Crisis on Southern Africa

The "contagion" of the Asia crisis to South Africa and to a lesser extent Zimbabwe shows how the perceptions of international investors can become detached from national reality and be driven instead by developments in other emerging markets. The financial sector crisis in the ASEAN countries was characterised by rapidly depreciating currencies and collapsing asset prices. Its spread to South Africa and also Zimbabwe occurred when the crisis extended beyond the region, to take on global ramifications. The contagion can be analysed in two phases. The first immediately followed the Thai liquidity crisis in mid-1997 and lasted to October 1997. The effects were limited to a handful of neighbouring countries, who were subjected to a reassessment of risks on the grounds both of similarities in relevant characteristics with Thailand, and of vulnerability to direct effects. Figures 3.2a-c show that this phase had no significant effect on either South Africa or Zimbabwe, with their IFC investables indices maintaining their value at a time when the Asian index began its sharp decline. South Africa continued to experience record inflows of foreign investment in bonds and equity. Its resilience at this stage is evidence that international investors judged that in key areas — including exchange rate policy, the soundness of the banking sector and the sustainability of the external position — South Africa did

Fig 3.2a: IFC Investables: Asia

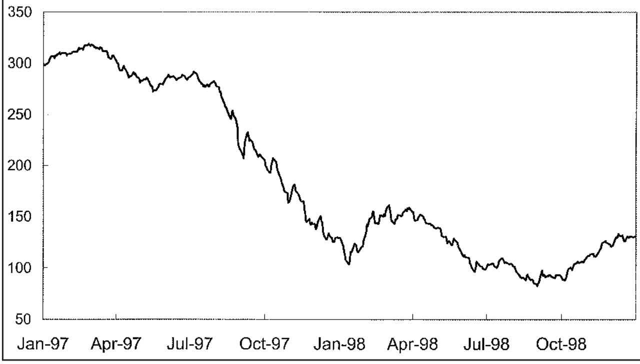


Fig 3.2b: IFC Investables: South Africa

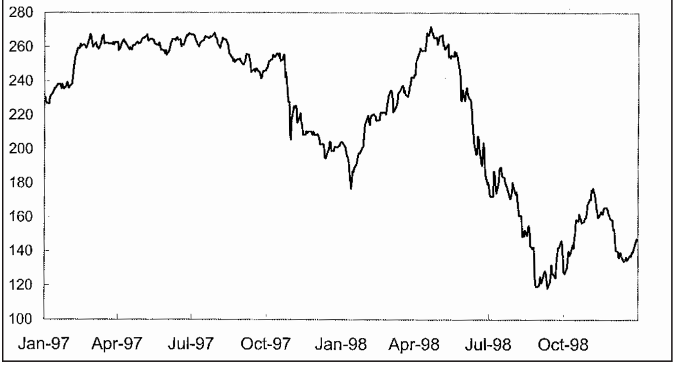
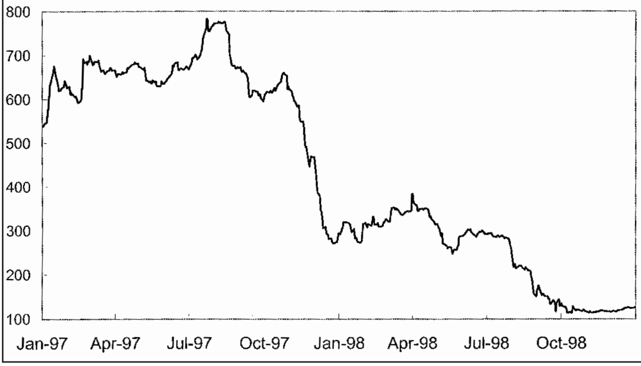


Fig 3.2c: IFC Investables: Zimbabwe



not share the weaknesses identified in the core ASEAN countries.

South Africa and Zimbabwe did, however, feel the effects of the second phase, along with virtually all developed and emerging markets previously insulated from the crisis. Precipitous declines in the stock markets and exchange rates of Thailand, Malaysia, the Philippines and Indonesia led to increasing pressure on the Hong Kong market and the dollar peg. Sustained speculative pressure forced the authorities to raise interest rates sharply, squeezing investors and rendering downward pressure on the Hang Seng irresistible. By October, this triggered crashes in the major equity markets, which fed through to South Africa and Zimbabwe (Figures 3.2b-c). As Asia showed modest signs of recovery before dropping further in April 1998, South Africa made a significant recovery to pre-crisis levels, and Zimbabwe more moderately, before slumping again. That South Africa was affected by the second phase of contagion is explained, in part, by the historically high correlation between returns on the Johannesburg Stock Exchange (JSE) and the stock markets in the US and the UK (contrasting with the low correlations with ASEAN markets). But the effects of the second phase were also driven by two global processes: first, a re-rating by international investors of broad asset classes (including emerging market debt and equity), and second, an increase in investors' risk aversion, reflected on a more global level in a reduced demand for risky assets such as equity.

As shown in Figure 3.1, the large inflows into the South African bond market in the first three quarters of 1997 were sharply reversed in October, with non-resident sales that month of R5.3bn — equivalent to one percent of GDP. In contrast, although prices on the JSE fell dramatically, foreign investors continued to be net purchasers of South African equities. Monthly net non-resident purchases peaked at R3.8bn, as cheaper shares were seen as "bargains". Although the rand depreciated by 6% against the US dollar between July and October, the sharp appreciation of the rand in the first quarter of 1997 meant that the depreciation over the year to the end of October was only 2.8 percent — in contrast to the sharp depreciations in the core ASEAN economies. Offsetting portfolio equity inflows help to explain the limited impact of the October crash on the rand's external value. Figure 3.1 also shows how South Africa was affected by what might be termed a third phase of the crisis in mid-1998. The collapses in Russia and Indonesia in May 1998 triggered a sharp reversal in foreign bond investment, as cumulative inflows in excess of 2% of GDP in March and April were followed by cumulative outflows of 3% of GDP in the next four months.

As South Africa and Zimbabwe compete in different markets to the Asian economies, the effect on trade competitiveness is limited in the short term. In the longer term, Asian exporters might compete directly with South Africa and Zimbabwe in the Africa region, although this will be affected by additional factors including labour costs, and the pace of product and market development in non-traditional exports. The effects on the composition of South Africa's and Zimbabwe's trade partners are also likely to be minimal, as the affected ASEAN economies are not important export markets (e.g., they accounted for only 2% of South Africa's non-gold exports in 1996) while South Africa's and Zimbabwe's main trading partners in Europe and Africa were largely unaffected by the crisis. More generally, falls in gold and coal prices adversely affected South Africa as a major producer, but lower oil prices reduced import costs in both South Africa and Zimbabwe, mitigating potential losses in export receipts on the current account. As Malaysia was a major source of new FDI flows to both countries and South Korea a potential source, the crisis has also had adverse effects on inward investment from these sources.

What can South Africa and Zimbabwe learn from the crisis? Perhaps most obviously, the events of recent months serve as a reminder that crises are costly. Even with bailouts, the adjustments required by financial crises have massive real costs. Moreover, in contrast to Mexico and the ASEAN countries, Africa has no "big brother" to facilitate a bailout in the first place. Looking forward, the Asian crisis highlights the need for attention in four policy areas. The first is *exchange rate policy.* The Asian currency pegs left the current accounts vulnerable to external developments such as the relative strength of the US dollar. Further, the pegs acted as implicit guarantees on the value of domestic assets, encouraging external borrowing, which leads to the second policy area of *debt management.* The Asian crisis highlights the dangers of large unhedged foreign currency debt and an inappropriate maturity structure. The third area is *financial regulation and supervision.* The Asian crisis has again underscored the need to put in place a sound regulatory framework when the implicit regulation contained in exchange controls is removed with liberalisation. The final area relates to the role of *transparency:* the timely and accurate availability of key indicators. Transparency works to pre-empt crises by enhancing the proper functioning of markets, encouraging inward investment and promoting policy discipline.

Source: Khatri and Leape, 1997.

3.2.2 Treasury Bills

Domestically-issued Treasury Bills are another increasingly attractive opportunity for foreigners in SSA. Banks invested heavily in T-Bills for foreign clients in the early 1990s in Tanzania, Uganda and Zambia. This provided "easy money for the banks when no lending was being done", and a "sure bet" for their customers. Newly launched portfolio funds also purchased T-Bills as a "short-term home" for cash while they identified equity projects — but very often these "Africa" funds invested in non-SSA T-Bills (Table 1.5).

The most important factor causing forex inflows to purchase T-Bills has been interest rate differentials with international investments, notably high domestic interest rates in Tanzania (Kimei *et al*, 1997:11), Uganda and Zambia. These high interest rates have been particularly attractive when exchange rates are projected to appreciate or stay constant, but have sometimes even overcome fears of exchange rate depreciation. The interest rates have been doubly attractive because the inverted yield curves of underdeveloped government debt markets, especially when governments are borrowing heavily for 91 days to fund budget deficits, have made rates highest on the short-term instruments which provide less term risk.

In addition, some of the "foreign" purchases have been by returning emigrants (especially Asians) based in the region who can interpret market signals more rapidly and minimise risk. They have inspired large capital flows playing on arbitrage gains from relative trends in exchange rates and T-Bill interest rates in Kenya, Tanzania and Uganda since all three markets were liberalised. As such flows are virtually impossible to track (often entering through foreign exchange bureaux), their scale cannot be reliably estimated, but transactions have often reached several million dollars per week. Many purchases are funded from foreign currency accounts (FCAs) maintained by nationals, implying that these flows may not be genuinely "foreign" and may simply represent "re-use" of forex purchased from other sources.

However, investors have been wary in conditions of "excessive borrowing" leading to perceived default or rollover risk, notably in pre-election periods when governments tend to borrow excessively. Interest rates have also tended to vary sharply with inflation, and real interest rates have fallen over time if inflation stays low for long periods (as in Uganda). Purchases have fallen sharply in most SSA countries as post-liberalisation booms in interest rates subside.

T-Bill purchases have therefore been marked by a high degree of volatility. Fortunately, given the instability in T-Bill markets, most investors in SSA have believed that "T-Bills are no way to build up a business base" and therefore foreign holdings of T-Bills have not risen to levels where their withdrawal has undermined government finance, the exchange rate, the balance of payments and the banking system (as in the Mexican peso crisis — see Griffith-Jones, 1996). However, in some SSA countries (Tanzania, Uganda, Zambia), bank exposure in T-Bills with falling interest rates has exacerbated weak balance sheets and contributed to banking collapses. It is worrying that African governments are often neither monitoring nor analysing these flows.

Chapter 4 Bank Flows

Nils Bhinda, Stephany Griffith-Jones and Matthew Martin

As discussed in Chapter 1, international data show no discernible increase in medium-term bank lending to Sub-Saharan Africa in the 1990s; though short-term debt has had a more positive recent trend. Country data indicate that bank flows have been increasing for almost all project countries — and short-term flows unguaranteed by OECD export credit agencies have risen sharply. If continued, this trend will mean a worrying shortening of the maturity profile, potentially increasing country vulnerability to financial crisis. What explains stagnation of long-term flows except in South Africa, and the rise in short-term flows?

4.1 Structure of the Banking System

One major influence on lending is the continued dominance of foreign banks in our project countries, and their attitudes and client base. The pattern of banking in many countries changed dramatically in the 1980s and early 1990s, with the results shown in Table 4.1.

In some countries — notably Francophone Africa — foreign banks have sharply reduced or rationalised their presence, with British banks closing most of their branches. The French also sold their flagship bank, the BIAO. Nevertheless, banking in many Francophone countries remains dominated by French banks (see Njinkeu, 1997). As of 1997, three French banking groups held 50% of the total bank capital in the BECAO region. At a country level, they also dominate the markets in Burkina Faso (74%); Togo (67%); Senegal (65%) and Côte d'Ivoire (63%); and to a lesser extent in Niger (41%) and Mali (40%). Crédit Lyonnais and Banque Nationale de Paris are also significant shareholders in the banks of Cameroon, Chad and Gabon, though reform of the banking sector has reduced their holdings, and they have no presence in Congo or the Central African Republic.

On the other hand in countries which have privatised and liberalised banking sectors (such as Ghana, Kenya, Mozambique, Tanzania, Uganda and Zambia), many new foreign banks have been established, and existing banks have expanded their branch networks. Citibank has branches in 10 countries; Equator Bank, a subsidiary of HSBC which specialises in SSA, in 8; and Standard Chartered in 11. Once again, South African banks are

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FONDAD, November 1999, www.fondad.org

Table 4.1 International Banking Presence in SSA

	BNP	Barclays	Citibank	Credit Lyonnais	Equator	Société Générale	Stanbic	Standard Chartered
Total Countries	6	11	10	8	8	3	15	11
Total Branches	**	258*	10	**	8	**	**	138
Angola	-	-	-	-	1(r)	-	-	-
Benin	-	-	-	**	-	-	-	-
Botswana	-	34(s)	-	-	-	-	**(s)	15(s)
Burkina Faso	**	-	-	-	-	-	-	-
Cameroon	**	-	1	**	-	**	-	3(s)
Chad	-	-	-	**	-	-	-	-
Congo DR	-	-	1	-	-	-	**(s)	-
Côte d'Ivoire	**	-	1	**	1(r)	**	-	-
Gabon	**	-	1	**	-	-	-	-
The Gambia	-	-	-	-	-	-	-	5(s)
Ghana	-	27(s)	-	-	1(r)	-	**(a)	20(s)
Kenya	-	92(s)	1	-	1(r)	-	**(s)	31(s)
Lesotho	-	-	-	-	-	-	**(s)	-
Madagascar	-	-	-	-	-	-	**(a)	-
Mali	-	-	-	**	-	-	-	-
Mauritius	-	20(b)	-	-	-	-	-	-
Mozambique	-	-	-	-	1(r)	-	**(a)	-
Namibia	-	-	-	-	-	-	**(s)	-
Nigeria	-	1(r)	1	-	-	-	**(s)	-
Senegal	**	-	1	**	-	**	-	-
Seychelles	-	7(b)	-	-	-	-	-	-
Sierra Leone	-	2(s)	-	-	-	-	-	(1(s))
South Africa	-	**	1	-	1(r)	-	771	1(r)
Swaziland	-	-	-	-	-	-	**(s)	-
Tanzania	-	-	1	-	-	-	**(s)	3(s)
Togo	**	-	-	**	-	-	-	-
Uganda	-	2(s)	-	-	1(r)	-	**(s)	1(s)
Zambia	-	15(s)	1	-	1(r)	-	**(s)	14(s)
Zimbabwe	-	49(s)	-	-	-	-	**(s)	44(s)

Notes:

Legal status of country head office (where known):
s - subsidiary of PLC, with HQ shareholding
b - branch of HQ
r - representative office
a - associate bank
* - excludes South Africa
** - number of branches not known.
Number in brackets denotes branch not operational.

Sources:

Information on Anglophone banks supplied by London offices and bank reports.
Information on Francophone banks in Njinkeu, 1997.

also expanding rapidly into the region, notably Standard Bank of South Africa (Stanbic), which purchased the African division of ANZ Grindlays, placing itself in a strong position to compete for corporate and retail banking business with the historically dominant Barclays and Standard Chartered. First National Bank also bought BCCI in Botswana in 1991.

International banks dominate foreign currency deposits and lending in virtually all Sub-Saharan countries. There are three main explanations:

- they tend to manage virtually all of the donor, embassy and NGO funds (whether project-related or administrative accounts), which provide large foreign currency profits;
- they have much better links with international correspondent banks and are therefore able to access credit lines and conduct foreign exchange transactions more easily;
- because of the first two factors, and their international "cachet", they tend to attract foreign currency transactions and deposits from local companies and rich individuals.

However, they are highly cautious lenders, tending to favour blue-chip companies such as the largest multinationals and local corporates, and high net worth foreign and local individuals. Multinationals are most popular because of a "global relationship banking" system where subsidiaries can secure lending, on the basis of a letter of comfort from their HQ and their dealings with the bank elsewhere. While this has worked as a long-run strategy for maximising returns and reducing risk, one or two banks have "taken a beating on this", and now prefer to examine the creditworthiness of local subsidiaries separately. Most multinational banks view national and smaller companies with suspicion, even for short-term finance.

4.2 Term of Lending

The wish of lenders to change exposure in response to economic trends is the most powerful influence on lending trends, as reflected by the term of lending.

It has led to a rapid recent rise in short-term lending, particularly trade financing, which all bankers interviewed in Africa and London consider their "core lending growth area" in SSA. The main cause of this rise has been improving export performance (for example in Zimbabwe, Tanzania and Uganda), because most lending is pre-export finance, secured by the exports themselves via the assigning of export contracts or escrow accounts for the export receipts. It is most common for minerals (copper and cobalt in Zambia, platinum and gold in Zimbabwe), petroleum, and agricultural commodities (coffee in Tanzania and Uganda). A few of the most reputable export companies, with their own stocks of foreign exchange in deposit accounts, are also able to obtain import finance (e.g. Anglo, Lonrho and ZCCM in Zambia). Nevertheless, in order to maintain their ability to change exposure, and because of worries about longer-term risk, banks often use rollovers of such short-term facilities to keep good customers happy while refusing them medium-term loans.

All such credit is short-term, seasonal where appropriate, and lasts 90-180 days. As elsewhere in the developing world, it is highly volatile: even though the loans are largely "self-liquidating", banks monitor commodity production or price changes closely and rollovers are frequently denied. Two collapses in capital flows to South Africa in 15 years were provoked by reduction in trade lines (Leape, 1991; Aron and Elbadawi, forthcoming). Credit is also procyclical, rushing in when commodity prices boom (as with coffee in Uganda) and out when they fall. It therefore exacerbates macroeconomic instability.

On the other other hand, medium-term loans have fallen throughout the last ten years, as maturing loans have not been replaced by new flows. Only a few countries (Botswana, Congo, Ghana, Kenya, Mauritius, Namibia, Tanzania, Uganda, Zambia, Zimbabwe) have attracted funds, and nearly all of these have been related to specific export-oriented mining or oil projects or major privatisations involving foreign investors, where term lending is seen as less risky.

4.3 Local Sources of Foreign Exchange

A third important factor reducing foreign exchange inflows for bank lending has been the rapidly increasing amount of foreign exchange held within the African economy's banking system, removing the need to call on foreign credit lines or correspondent banks. Traditionally, banks had relied on donor, embassy or NGO funds, which were virtually inaccessible for forex lending and highly volatile in response to political or economic instability.

In the 1990s, liberalisation of foreign exchange regulations by SSA governments has led to rapid growth in foreign currency accounts (FCAs) held by resident companies and individuals, which partly represents the return of flight capital. As explained by many banks in interviews, this gives banks a large pool of domestically held foreign exchange to draw upon for lending. Though firm data are not available, bankers estimate that it accounts for tens of millions of dollars in each of the many SSA countries with large foreign currency account holdings. It may explain why the rise in short-term foreign exchange lending is not reflected in the cross-border lending figures published by international institutions. Unfortunately, by replacing lending from bank headquarters, lending from FCAs is hiding creditworthy demand in Africa from the international community. But in the longer term it might translate into further return of flight capital and improved perceptions of creditworthiness.

4.4 Domestic Financial Sector Conditions

Domestic financial sector conditions are among the most fundamental influences on foreign currency lending. The previous chapter provided one reason why banks have little need to undertake foreign exchange lending: they are making large speculative profits from Treasury Bills, many of which are purchased on behalf of clients using foreign currency deposit accounts (though the inflows and outflows of these accounts are ill-recorded in international statistics).

The overhang of government domestic debt is therefore discouraging any other lending (in local or foreign currency) by the banks. Other types of domestic debt — such as arrears on payments to local suppliers — discourage bank lending even more directly by branding as uncreditworthy potential clients who depend on government contracts. In addition, domestic payments arrears are a major factor taken into account by correspondent banks in assessing country creditworthiness. Bankers interviewed therefore suggested that reducing domestic debt would have a much greater effect on lending than cutting external debt.

Partly because of these distortions in the government debt market, but primarily because banking systems have historically been government-controlled or oligopolistic, a third factor which discourages banks from lending in foreign currency is the highly non-competitive nature of the banking system in many African countries, which allows banks to make huge profit margins through differentials between interest rates on local currency loans and those on local currency deposits. These differentials are also often needed by the banks to keep themselves in business, due to a large overhang of non-performing loans from the days of financial repression, and to their own inefficiency and high overheads. Differentials have ranged as high as 20-25% in our project countries, encouraging local rather than foreign currency lending. Instead it has been the clients of the banks who have been demanding foreign currency loans as they perceive the exchange rate to be stabilising and see that interest rates on foreign currency loans are much lower than those on domestic currency.

Poor performance by local banks has two other negative effects on bank lending and FDI from abroad. Local bank branches are often important sources of current and precise information on macroeconomic aspects and company performance. They also provide important services for foreign investors, notably through their lines of credit with correspondent banks. Insofar as they are unable to perform these functions effectively, investors and lenders stay away.

In spite of financial sector reform programmes in recent years, progress to healthy and competitive banking systems, and especially towards diversifying financial institutions by encouraging other organisations which could lend in foreign currency, has been slow in most of low-income Africa. A healthy banking system and a diversified financial sector are universally seen as key prerequisites for attracting new foreign bank flows.

4.5 Risk

The perception of high country risk is the most powerful factor orienting banks towards short-term secured lending. Many of the factors mentioned in Chapters 2 and 3 are influential. But bankers look upon risk in much narrower terms — as pure repayment risk rather than taking into account wider national political, economic or social conditions. As a result, virtually all medium-term lending to SSA has physical guarantees of repayment (e.g. allowing seizure of passenger and cargo aircraft or ships) or guarantees by export credit agencies, making country risk for the lender practically zero. Risk can also be reduced and shared through guarantees or cofinancing by international development finance institutions such as the World Bank, IFC, CDC and EIB. Many banks have been keen to on-lend funds provided by such institutions. These have also been combined with preferred creditor status for individual private sector lenders in various recent offshore projects, and in private sector build, operate, and transfer (BOT) infrastructure schemes such as the Maputo Corridor. Another important risk reduction factor is the involvement of a foreign or multinational investor in a project. Many medium-term loans have been made offshore to the FDI sponsor of a project — including large South African or Zimbabwean corporations. In contrast to their smaller African counterparts, projects supported by large-scale FDI are perceived by bankers to be “viable propositions” and to have “promoters with integrity, commitment, and knowledge of what they are embarking on”.

4.6 Provisioning Guidelines

Another negative factor for most international banks is the guidelines or regulations about the level of risk or loan-loss provisions they need to set aside against loans to an individual country, and the tax allowances they can receive on such provisions. Almost all countries have such guidelines. These tend to be behind the times, reflecting the economic recessions, foreign exchange shortages and restrictions, and debt reschedulings of the 1980s and early 1990s. They therefore recommend very high provisioning for countries like Tanzania, Uganda and Zambia. They also skew lending away from countries whose economies are recovering and which have freed foreign exchange flows. Because they make no allowance for recent positive circumstances, banks would have to provision heavily even against new loans. Finally, they fail to distinguish between government sovereign risk and private sector risk, discouraging lending to thriving private sector enterprises. To avoid penalising countries with strong track records, such guidelines need to be more flexible according to recent favourable economic developments and foreign exchange liberalisation, reducing or even eliminating provisions on new loans; particularly loans to the private sector ought to distinguish between sovereign and private sector risk provisioning levels. Of course, loans secured by foreign exchange proceeds or physical guarantees are exempt from such provisions. The Bank of England for example is replacing its provisioning matrix for country debt introduced in 1987, with a system where banks are responsible for presenting an assessment of their own exposure to country risk. Its matrix had become less compatible with risk-based supervision and hence less useful in assessing appropriate levels of provisions for exposure, notably to South East Asia at end 1997 (Bank of England, 1998:8; Griffith-Jones, 1998).

4.7 Export Credit and Other Guarantees

Another important barrier to new lending is that most OECD government export credit agencies (ECAs), such as the UK's Export Credit Guarantee Department, suspended guarantees against non-repayment of loans for most SSA countries in the 1980s, and have not renewed their cover since. In contrast, export credit agencies in some non-OECD countries (South Africa, India) have more generous policies for cover to SSA countries, and this is in turn an important explanation for the growth in FDI and trade with these countries.

However, the benefits of export credit guarantees for SSA economies are highly questionable. The tying of such credits to exports from the lending country can of course increase the price or reduce the quality of goods. Some OECD ECAs have been notorious for overpricing goods and corruption in their dealings with Africa. It should be remembered that many unguaranteed loans also lack transparency, with banks or exporters relying on single sources of goods (EFA 1996; 1993). The most negative aspect of export credit guarantees is therefore the frequent involvement of SSA governments in having to explicitly or implicitly guarantee payment by the private sector, with potential high costs for the budget if private sector borrowers default. Recent initiatives to provide debt relief (particularly for Heavily Indebted Poor Countries such as Tanzania, Uganda and Zambia) have been accompanied by pledges to expand new export credits — but these should be carefully restricted to private sector loans with no government guarantees, or there will be a strong risk that HIPC country debts will rapidly become unpayable again.

4.8 External Debt Burden

Large external debt stocks owed by SSA countries have deterred new lending. An important question is to what extent reductions in SSA commercial debt, for example via buy back operations, have improved those countries' creditworthiness, and their access to new bank lending. Our interviews and those carried out by London Economics (1996) show that in SSA unlike Latin America, the effect of commercial debt reduction on creditworthiness has been marginal, although it has brought other benefits. This is largely because commercial debt is a relatively small proportion of total. There were strong mixed feelings regarding the Zambia buyback of 1994 for example. Most bankers felt banks and investors had forgotten it so it had no effect on lending. But some felt that it left a bad aftertaste with banks and particularly businesses that had been involved in the country over a long period, and thereby discouraged new flows. Thus reduction of the commercial debt overhang has not led to new flows.

New flows will be more likely if and when SSA finally obtains sufficient relief on its overall debt to make its servicing sustainable and compatible with economic growth, as is explained under the HIPC Initiative. Indeed, a recent study (Bhattacharya, Montiel and Sharma, 1996) provides clear econometric evidence that for 1980-95, SSA countries with a lower external debt burden have attracted significantly more private lending. In addition Uganda's experience shows that where debt ratios are falling due to growth and debt reduction, commercial lending is resuming. This is therefore a crucial step, but it should be remembered that Africa's access to bank credit was relatively limited (though improving) even before the

1980s debt crisis. Though the debt problems made the situation worse, reducing the overall debt overhang might therefore have a less dramatic impact on access to new flows than in Latin America.

It is also worth stressing that even in Latin America commercial debt reduction did not lead to a major return of bank lending. Rather, other flows such as FDI and especially portfolio flows picked up significantly as the debt overhang was reduced, and general economic prospects were seen to improve in the early 1990s. Recent rises in private flows to Uganda show a similar pattern. Further, when bank lending to Latin America resumed in the early and mid-90s, it was led mainly by European banks which had lent relatively little in the 1970s and early 1980s, and had thus suffered far smaller losses from the debt crisis. Given the strong presence of European banks in Africa, this might augur more positively for resumption of bank flows. More importantly, as discussed above, South African and also Asian banks are starting to lend. They do not have a history of debt overhang which makes it easier for them to start.

Some have suggested that one possible way to improve the link between debt reduction and new flows for SSA may be via greater expansion of debt equity swaps, not just for commercial but also for bilateral official debt (Mistry and Griffith-Jones, 1993). In the early 1990s this seemed a particularly attractive vehicle for facilitating privatisation. However, the scale of debt reduction planned under the HIPC Initiative (up to 80%) may sharply reduce the scope for investors to gain subsidies from the margin between the reduction percentage and the secondary market price, reducing the attractiveness of such deals to both investors and governments.

Chapter 5 Credit Ratings

Nils Bhinda, Stephany Griffith-Jones and Matthew Martin

The views of credit ratings agencies are one key input in international capital market perception of Africa. Credit ratings are a crucial determinant of whether — and on what terms — countries are able to issue bonds on international markets. Indeed, the absence of credit ratings for most African countries helps to explain why so few countries have issued international bonds. Rating agencies also claim to have a major influence on multinationals, banks, professional investors, and fund managers, with many "building in ratings as a mandatory part of the decision process".

The ratings agencies fall into two categories. The credit ratings given by formal agencies (IBCA, Standard & Poors, Moody's) have a direct impact on bond prices, the success of a bond launch, and on mutual funds. The ratings given by other agencies (such as the Economist Intelligence Unit, Institutional Investor, Euromoney) provide information investors read occasionally and sometimes, usually informally, factor into their investment decisions.

This chapter examines ratings in four ways, by looking at their country coverage, methodology, results for SSA as a whole, and for our project countries. It shows that most are highly subjective, in spite of seemingly scientific methodologies. Further, while they show that the climate for capital flows to SSA has been improving, they lag far behind actual improvements (or problems), and their country coverage and methodology produce clear biases against Sub-Saharan Africa.

5.1 Country Coverage

The countries covered in the ratings vary dramatically. Of the informal agencies, Euromoney (EM) rates 180, Institutional Investor (II) 135, and Economist Intelligence Unit (EIU) 100 countries. EM covers the most Sub-Saharan countries (44), followed by II (29) and EIU (17). SSA is even more poorly represented by the formal agencies: Standard & Poors and IBCA rate only South Africa; Moody's adds Mauritius.

The formal agencies ascribe this above all to limited staff resources. They suggest that the informal agencies have a less rigorous evaluation process, and other sources (a panel of experts for EM and II, and a full country risk analysis service for EIU). The informal agencies also blame lack of data or interest among the investor community.

Other reasons often given are less plausible. The first is that "few SSA countries have economic performance worthy of a rating": but this view is inconsistent with the views of the informal agencies and other analysts in the international financial community, who rate performance of Botswana, Mauritius and Namibia level with or above South Africa.

The second is that "countries do not approach formal agencies" (normally the first step to a rating) because they are not issuing bonds: but the reality is that most SSA countries do not answer initial approaches from agencies, because they are discouraged by their low existing rating, or have no chance of an investment grade rating which would allow them to issue a bond. Some ratings staff suggest a lower rating is worthwhile, to signal improving policy to the market, and to encourage governments to "maintain good behaviour to keep their rating". But most commercial analysts believe a country should ask for rating only if it will get an investment grade: a lower rating will attract only expensive, short-term capital and diminish prospects for medium-term loans or bonds.

5.2 Methodology

5.2.1 Institutional Investor

II surveys 75-100 of the world's largest commercial banks, and weights them according to their worldwide exposure and the sophistication of their country analysis. But it has no clearly defined methodology, causing large biases and inconsistencies. II has written that its results "must be seen as arithmetical averages and not as evidence of consensus" due to "widespread and interesting differences in the scores each respondent gives to various countries" (September 1993). These wide spreads (which are more pronounced for the lower-ranked countries) make arithmetical averages inaccurate and misleading: presenting the range of scores would be more informative.

These spring from a complex mix of factors, most of which penalise Sub-Saharan Africa. Poor information (which applies particularly to low-income countries) is the most important. II explained the wide spread of views on Malawi by saying: "how much does any lender know, or bother to find out, about Malawi before rating it?". Many other SSA countries are similarly written off. Familiarity with one's neighbours is also central: Western Europeans rate Eastern Europe highly, and Singaporean bankers favour Vietnam. South African bankers support African countries — but there are far fewer South African members in the survey sample. Non-

Western bankers also tend to be more optimistic about developing countries (Asian bankers rated Mexico in 1996 higher than North Americans) but are under-represented. Finally, continuing business ties lead French banks to look favourably on Francophone Africa, and Portuguese banks on Angola and Mozambique. As discussed in the previous chapter, many Western banks have been reducing their operations in Africa.

All four factors lead to a negative subjective bias against Sub-Saharan Africa, making II's survey unresponsive to positive economic and political events. II's results are indicative of long-term perceptions — indeed of unchanging prejudices. They can be overcome only by improving information flows to those surveyed, and diversifying the survey sample by increasing the representation of non-Western bankers and key regional players.

5.2.2 Euromoney

Based on assessments by 45 political risk specialists and economists at major financial institutions, EM's survey appears more scientific and objective than II's, with clearly defined and weighted criteria, and quoted data and information sources. On closer inspection however, there is a high element of subjectivity and judgment in EM's evaluation of economic performance and political risk. Economic performance (which has a 25% weighting) is based on 2-year projections made by EM. These often change sharply over a very short period, indicating that they are based more on perceived than actual recent economic performance. Political risk (25%), based on responses from risk analysts, is highly subjective and difficult to quantify.

The other criteria used also contain large subjective elements, which tend to work against developing countries. An average of formal credit rating scores absorbs 10% (but these have their own biases — and countries score zero if they are not rated); 5% is forfaiting data from banks; and 5% is availability of export credit agency cover for short-term finance. Many apparently objective "economic data" categories also work in biassed ways: for example, OECD countries not reporting to the World Bank are automatically granted full marks for "debt indicators" and "access to bank finance", but non-reporting developing countries score zero. If formal rating agencies, banks, export credit agencies and the World Bank were more open-minded and comprehensive in their coverage, most Sub-Saharan and least developed countries would score much higher. For those who do not read tables, the accompanying textual analysis barely mentions SSA except for South Africa, reinforcing the negative impression that SSA is not worth analysing.

Overall, EM's survey is the most volatile. This reflects not dramatic changes in economic fundamentals, but dramatically changing interpretation by analysts of short-term changes in economic data.

5.2.3 Economist Intelligence Unit

Prior to 1997, EIU's ratings were subject to some of the same criticisms as Institutional Investor. Large proportions of their ratings scores were determined subjectively, and the overall scoring system caused biases because it worked in increments of 5/100. This meant that for 7 criteria which each have a 5% weighting, a country could only score 5 or 0. So a country marginally above average could receive 5 marks, while one marginally below average could receive 0. This exaggerated the gap between rich and poor countries, and ignored improvements in performance from a low level. It also exaggerated peaks and troughs in cycles of political or economic uncertainty. EIU exacerbated this inflexibility in tracking improvements in performance by dividing countries arbitrarily into 5 broad bands of creditworthiness, making changes in category rare.

However, EIU now produces the best informed, most objective results, based on staff assessments and a detailed database and written analysis for each country. As a result of a change in methodology in 1997, there is little to criticise in their methodology. Firstly, it assesses political risk, economic policy risk, economic structure risk and liquidity risk. Virtually all of these different risk categories are measured using objective economic data (the exception being some elements of political risk), implying that over 75% of the assessment is not vulnerable to accusations of subjectivity.

Secondly, and in marked contrast to the other informal agencies, EIU now distinguishes different degrees of risk for the different types of capital flows an investor might be considering (currency risk, sovereign debt risk and banking sector risk). Thirdly, because of its extensive supporting analysis and databases, updated every quarter, EIU's data are more current and their analysis better informed than the other agencies.

5.3 How Does SSA Fare and Why?

Of the 29 SSA countries rated by II, 26 score well below the global average, and 20 are among the 30 lowest countries. EM rates the same three 3 countries above average (South Africa, Botswana and Mauritius), and the rest well behind. Nearly half its bottom 90 are from SSA. EIU also ranks Africa lower than European and Asian countries (see also Haque *et al*, 1996), but in general many SSA countries are ranked higher by EIU than the other two agencies.

What explains these results? First, individual country ratings are lowered by negative perceptions of regional political, economic, and social factors. SSA has a reputation for political instability, which penalises all countries in the more subjective ratings. Thus, while individual ratings and the SSA average have been rising over time in EM and II surveys, SSA lags behind and is expected to stay there. Its "modest gains" are rarely more than a reflection of "a generalised optimism" about emerging markets. "You know banks are feeling better when Africa goes up" said one banker.

Second, econometric analysis of the ratings of EIU and II since 1980 and EM since 1982 by Haque *et al* (1996) has important lessons. This study is based on analysis of economic determinants in these ratings for over 60 developing countries, running regressions to assess the persistence of ratings for countries over time, country-specific factors, and external variables. Regressions results show that:

- ratings are influenced by export composition. "In EM and II ratings regressions, all other country groupings appear to have significantly lower rankings than the exporters of manufactured goods" and "the EIU appears to attach significantly negative ratings to only fuel exporters and producers of primary products" (Haque *et al*, 1996:28). All have lower rankings for countries dependent on a single export. This may be justifiable as commodity export prices are more volatile, and tend to decline relative to manufactured goods, but relegates most SSA countries. Analysis of the study suggests this may be the case, with South Africa and Zimbabwe (with broader manufacturing and export bases) rated more highly than Uganda and Zambia (dependent until recently on coffee and copper).
- all developing countries lose from high international interest rates in all ratings, regardless of domestic economic developments. This is well-known to market analysts — emerging markets always suffer when OECD interests offer higher returns.

Third, countries get stuck in arbitrary groups, which lead agencies to react only very slowly (if at all) to significant changes in policy or outcomes. Agencies vary in the value they give to the stability of their ratings. EM prides itself on tracking the global economic upturn and improved creditworthiness of the late 1980s much more rapidly than its competitors. On the other hand, Standard and Poors prefers to review ratings only once a year, "to come up with a stable rating".

There is little doubt that investors and African countries prefer stable ratings only if they reflect stable country policies and creditworthiness: ratings should reflect country conditions as they change, not inflexible rating systems or outdated information.

5.4 Project Country Observations

To assess the factors influencing African ratings more closely, we looked in more detail at informal ratings of our project countries, for which we had excellent information sources.

II's and EIU's relative rankings for our project countries are the same over time, whereas those for EM change more sharply (Tables 5.1a-c). South Africa has been top in all three, followed by Zimbabwe, with the other three countries well behind (less so according to EM). In general, EM was more positive about our project countries, followed by EIU and II, until 1997, while EIU's ratings have risen sharply since 1997 (Figures 5.1a-e). Referring back to our earlier discussion of methodology, this indicates that the more subjective the ratings, the lower SSA countries are rated, though greater objectivity and more frequent data collection may cause more volatile ratings.

It is also possible to see two notable lags in measurement of changing performance, for Uganda and Zimbabwe. It took 8 years of adjustment and 10 years of political stability before Uganda's rating rose sharply. The eventual rise reflected sharp increases in objective economic performance, partly due to the coffee boom of the mid-1990s, with indicators of political risk (and therefore the agencies depending on them) lagging behind. As late as 1994, II ranked Uganda last in its survey and described it as "destined to remain...(with)...the likes of...Zaire and Haiti". Even after this rise, it ranked until September 1996 below Tanzania and Zambia according to

Table 5.1a Institutional Investor's Sovereign Ratings and Ranking for Project Countries, (1992-98)

	3/92	9/92	3/93	9/93	3/94	9/94	3/95	9/95	3/96	9/96	3/97	9/97	3/98	9/98
South Africa	39.3	39.8	39.8	38.2	38.9	40	42.5	45.2	46.3	46.3	46	46.4	46.5	46.6
	45	*44*	*45*	*50*	*51*	*52*	*50*	*47*	*46*	*48*	*51*	*51*	*50*	*48*
Tanzania	12.5	11.8	12.9	14	13.9	15.2	15.5	16.7	17.7	18.1	18.1	18.7	19.3	19.9
	103	*110*	*110*	*111*	*113*	*111*	*110*	*108*	*104*	*106*	*105*	*110*	*110*	*106*
Uganda	5.5	5.2	7.3	8.4	10.1	11.6	12.9	13.1	14.5	16.1	17.7	20.1	21.2	19.9
	119	*126*	*121*	*123*	*122*	*121*	*119*	*119*	*117*	*113*	*107*	*103*	*104*	*107*
Zambia	9.8	9.5	11.7	12.4	13.1	13.9	14.6	15.1	15.7	16.5	16.1	16	17.5	17.2
	106	*113*	*112*	*116*	*115*	*116*	*115*	*115*	*111*	*112*	*113*	*115*	*113*	*114*
Zimbabwe	28.3	26.1	27.7	26.9	27.9	29	30.7	31	32.2	32.5	32.3	33.8	33.6	29.8
	61	*65*	*66*	*70*	*68*	*70*	*67*	*66*	*65*	*68*	*71*	*68*	*73*	*82*

Notes:
Italicised information denotes global rank.
Institutional Investor grades country risk on a scale of 1-100: 100 being entirely risk free, 0 being the worst.

Table 5.1b Euromoney's Sovereign Ratings and Ranking for Project Countries (1992-98)*

	9/92	3/93	9/93	3/94	9/94	3/95	9/95	3/96	9/96	3/97	9/97	9/98
South Africa	53.90	59.04	60.04	60.25	58.96	62.86	63.56	64.86	62.30	69.88	67.83	61.09
	47	*43*	*49*	*45*	*48*	*45*	*46*	*49*	*48*	*48*	*44*	*50*
Tanzania	19.31	22.68	25.15	27.47	31.89	29.58	27.57	32.34	29.52	28.49	32.59	36.14
	137	*130*	*135*	*133*	*117*	*133*	*140*	*125*	*136*	*139*	*115*	*120*
Uganda	22.34	21.06	24.22	31.14	31.39	28.40	24.74	41.70	37.65	36.70	36.94	43.00
	127	*135*	*140*	*120*	*120*	*139*	*150*	*96*	*99*	*105*	*100*	*91*
Zambia	17.68	20.29	24.91	25.96	26.23	28.56	28.54	34.81	32.76	21.84	24.03	32.84
	147	*141*	*136*	*139*	*133*	*138*	*135*	*113*	*120*	*157*	*148*	*136*
Zimbabwe	42.67	44.78	45.02	42.69	44.95	50.13	49.41	50.49	46.14	42.00	40.88	43.22
	59	*57*	*69*	*77*	*74*	*63*	*66*	*71*	*76*	*95*	*91*	*90*

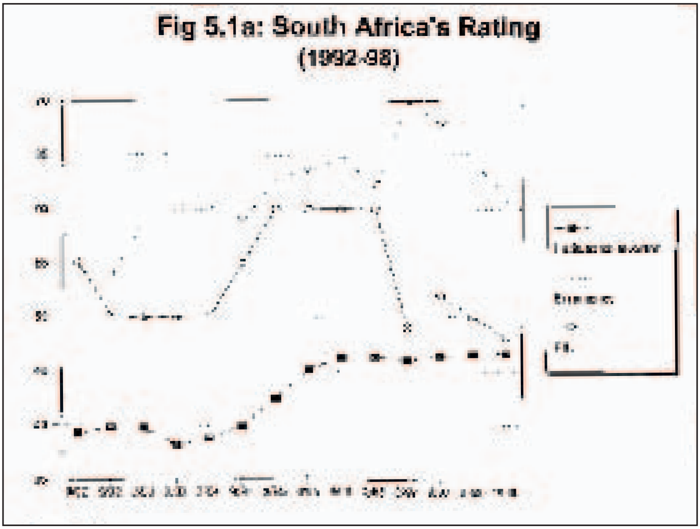
Notes:
* No surveys were conducted in March 1992 or March 1998.
Italicised information denotes global rank.
Euromoney grades country risk on a scale of 1-100: 100 being entirely risk free, 0 being the worst.

Table 5.1c Economist Intelligence Unit's Sovereign Ratings for Project Countries (1992-98)*

	3/92	9/92	3/93	9/93	3/94	9/94	3/95	9/95	3/96	9/96	3/97	9/97	3/98	9/98
South Africa	55	50	50	50	50	55	60	60	60	60	49	52	50	48
	C	*C*	*C*	*C*	*C*	*B*	*B*	*B*	*B*	*B*	*C*	*C*	*C*	*C*
Tanzania	-	-	-	-	-	-	-	-	-	30	37	37	38	39
	-	-	-	-	-	-	-	-	-	*D*	*D*	*D*	*D*	*D*
Uganda	-	-	-	-	-	-	-	-	-	-	-	-	-	43
	-	-	-	-	-	-	-	-	-	-	-	-	-	*C*
Zambia	20	20	20	20	20	20	20	20	25	20	30	28	30	27
	E	*E*	*E*	*E*	*E*	*E*	*E*	*E*	*D*	*E*	*D*	*D*	*D*	*D*
Zimbabwe	40	35	30	35	40	40	50	50	50	50	47	43	37	32
	D	*D*	*D*	*D*	*D*	*D*	*C*	*C*	*C*	*C*	*C*	*C*	*D*	*D*

Notes:
* EIU publishes ratings quarterly, but for ease of comparison with other raters, and as they are highly stable over time, we use only the March and September surveys. Methodology changed in January 1997.
Italicised information denotes global category, as defined in the methodology. No information is as yet available to us on EIU's global rankings.
EIU grades country risk on a scale of 1-100: 0 being entirely risk free, 100 being the worst. For sake of comparison with the other raters, we have reversed this scale, by subtracting EIU's rating from 100.

II, though it has leapfrogged them according to EM a full year earlier (Figures 5.2a-b). On the other hand, no rating agency noticed the gradual economic decline in Zimbabwe until 1997-98.



Methodological problems also explain some sharp changes. For example, Zambia rose 22 places in 1995-98 according to EM, due to favourable economic performance and improved forfaiting terms, but this improvement was not noticed by any other agency.

All of the lower-ranked countries were affected by an upward global trend in emerging market confidence in the early 1990s, which has now been largely reversed.

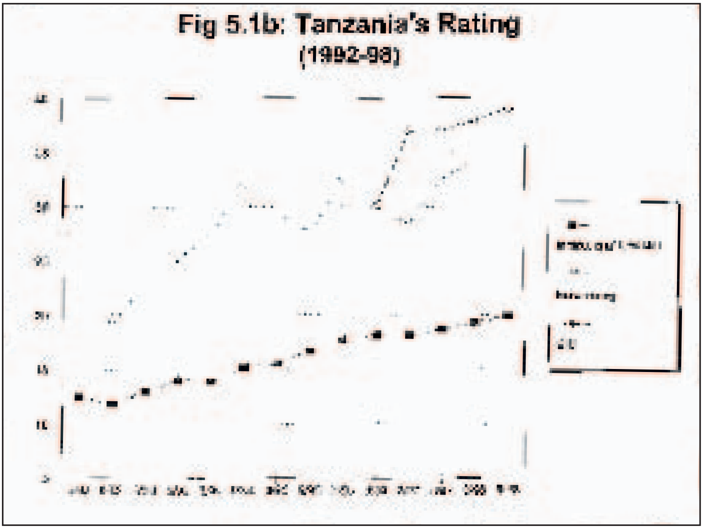


Fig 5.1c: Uganda's Rating

(1992-98)

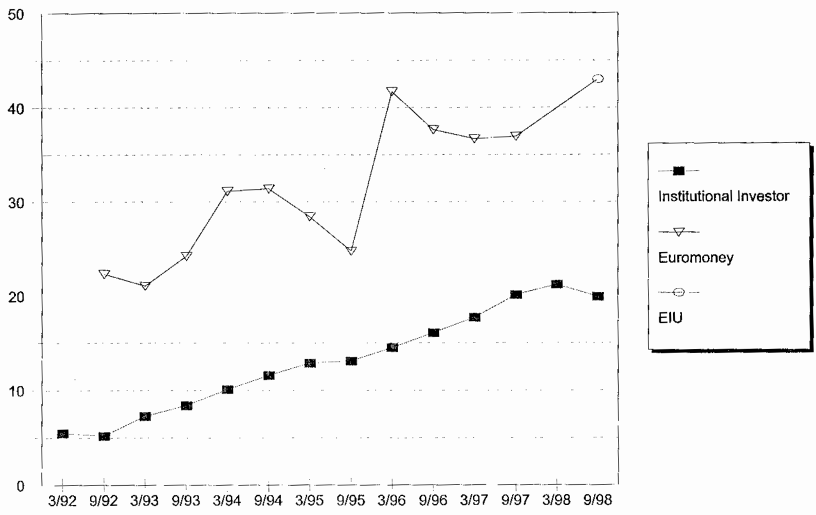


Fig 5.1d: Zambia's Rating

(1992-98)

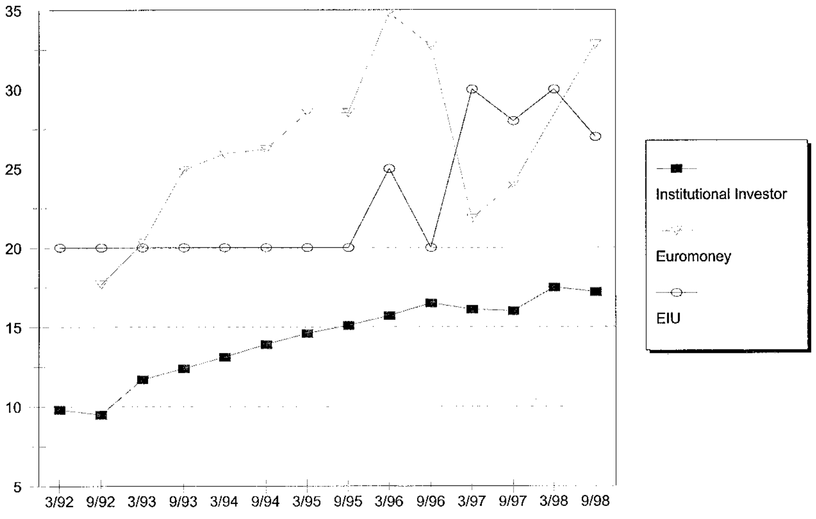


Fig 5.1e: Zimbabwe's Rating
(1992-98)

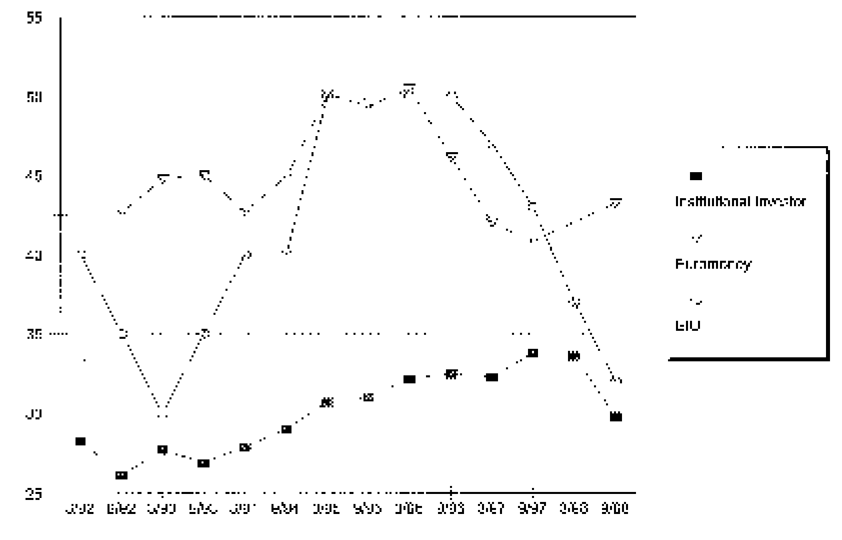
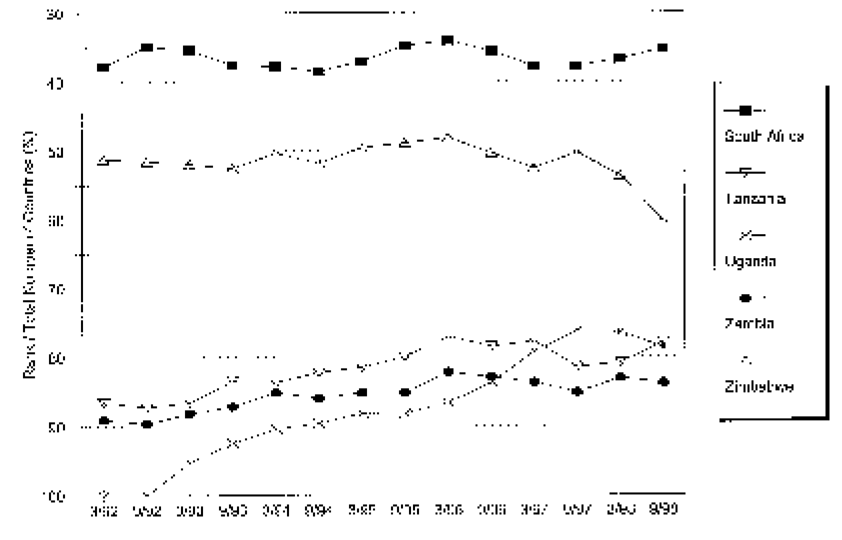
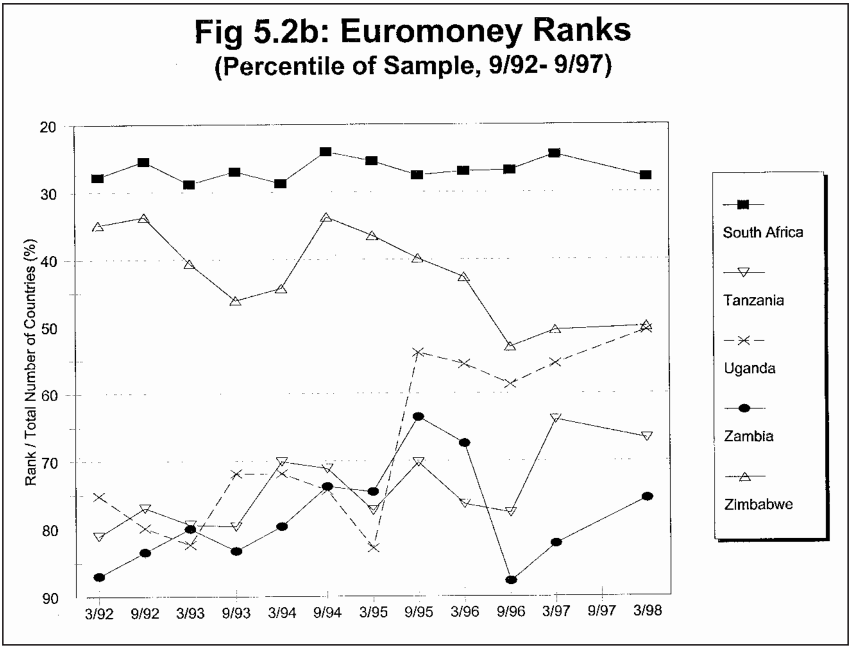


Fig 5.2a: Institutional Investor Ranks
(Percentile of Sample, 3/92- 3/97)





5.5 Conclusions

This chapter has shown that the methodology of ratings depends too much on subjective perception and outdated data. Together with their limited country coverage, these factors automatically bias ratings against most African (and other low-income) countries.

Rating agencies acknowledge that many criteria are subjective, and that others which appear objective contain large subjective components. Some ratings agencies (notably EIU) have made major efforts to improve their methodology. Agencies also argue that the elements of subjective perception match the views of those considering investments, but this in turn reflects a narrow view: they share and therefore reinforce the negative perceptions of those global investors who are less likely to invest, but do not sufficiently reflect the views of analysts or intra-regional investors. As a result, global investors are missing out on important investment opportunities.

Fortunately, it does not appear that ratings are the crucial determinants of most investment decisions. They were not cited by our survey respondents as important for any type of flow except bonds — which means that they are irrelevant to private capital flows for most SSA countries. But, as

Sub-Saharan Africa becomes increasingly integrated into global financial markets, it will be essential that rating agencies expand their country coverage and improve their methodology to reflect the true investment climate of the continent.

Further, a recent study (Merchant International Group, 1999) showed that there are a host of hidden and non-conventional risks, or "grey area dynamics", that can cause assets to underperform. These include crime, fraud, business cronyism, and local customs and attitudes. Investors lose out simply because they pay too little attention to them, and similarly, these tend to be overlooked in the risk assessments of rating agencies and banks.

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