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**Trade and Current Account Balances  
in Sub-Saharan Africa:  
Stylized Facts and Implications for Poverty**

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# **Trade and Current Account Balances in Sub-Saharan Africa: Stylized Facts and Implications for Poverty**

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## **Abstract**

This paper examines the main components of Sub-Saharan Africa's balance of payments with a view to understanding the role that trade has played in the evolution of current account imbalances in the region. The paper finds that increasing trade openness in SSA has been accompanied by current account deficits in majority of the countries. The paper also finds that while at the aggregate level net income payments were the main source of the current account deficits in SSA, in the majority of countries the trade deficit was the main driver. Furthermore, the paper argues that the composition of the current account matters for employment and poverty and offers suggestions on how to make trade better work for SSA.

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## Note

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## Acronyms

BoP	balance of payments
FDI	foreign direct investment
GDP	gross domestic product
IMF	International Monetary Fund
SSA	Sub-Saharan Africa
TNCs	Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development

## I. Introduction

African countries depend heavily on international trade and this dependence has increased significantly over the past two decades. Trade is an important source of foreign exchange needed to import the intermediate goods required by local industries. It also enlarges consumer choice, provides access to new technology, and has the potential to enhance productivity and to contribute to employment creation and growth. Some of the factors accounting for the increasing dependence of African countries on trade include: reduction in tariff barriers to trade; developments in information and communication technologies which reduced the transactions costs associated with trade; a global paradigm shift from trade protectionism as a development strategy to trade as an engine of economic growth; and the increasing roles of large developing countries in the global economy. The commodity price boom - that started at the beginning of the last decade and began waning at its end - is another driving factor for the increasing trade openness experienced by African countries over the past few decades. It led to an improvement in Africa's terms of trade and enhanced its capacity to export and import.

Interestingly, the increased role of international trade in African economies has been accompanied by significant and growing trade and current account deficits in many countries on the continent. There are concerns that the increasing current account deficits will increase Africa's future debt burden and make the continent vulnerable to financial crises. Experience has shown that growing current account deficits often presage disruptive economic trends such as sudden stops in capital flows, severe decreases in credit and spending, and sharp economic slowdowns, which generate high unemployment and poverty. Africa's growing current account deficits are also of concern because as a rule of thumb, current account deficits that are above 5 percent of GDP are indicative of long-run sustainability problems. Furthermore, growing current account deficits driven by high trade deficits pose challenges for employment and poverty reduction efforts particularly when the deficits are caused by rising imports of consumer goods that can be produced by domestic industries. Another reason why the current account deficits are worrisome is that a deficit is sustainable as long as there is sufficient international credit to finance it. Up until recently, African countries had relatively better access to international finance than was the case in the past. However, with declining commodity prices and slow growth, the continent is vulnerable to declining access to finance which will make financing of the deficits increasingly challenging.

Against this backdrop, this paper examines the main components of Sub-Saharan Africa's (SSA) balance of payments - current account and capital and financial accounts - with a view to answering the following questions: (a) what role has trade played in observed current account deficits in SSA?; (b) How has the current account been financed and what are the implications?; and (c) what can African governments do to reverse recent trends in the current account and use trade, more effectively than in the past, in support of poverty reduction efforts on the continent? Although a clear understanding of the factors that affect the current account balance is essential, balance of payments categories alone are not sufficient to diagnose the general conditions of an economy. The current account balance reflects, broadly speaking, the difference between national income and expenditure. Making the link to national income accounting, in particular to income, consumption and investment, permits an understanding of the source of a deficit or a surplus. A deficit caused by an increase in final consumption is not the same as one fueled by a surge in investment, as investment contributes to future growth and enhances a country's ability to finance and eliminate the deficit.

Hence, the analysis of the evolution of national income variables allows a better understanding of the evolution of the current account and the associated risks.<sup>1</sup>

Equally important are the analyses of the composition of international trade, because what is being imported and exported is linked to the productive capacity and the structure of the domestic economy. The analysis in this paper will also shed some light on the extent of the linkages that both imports and exports have with the rest of the economy. The degree of such linkages has an impact on the proportion of the value added created domestically, which in turn has an impact on employment and revenue generation, which constitutes the basis of the nexus between international trade, profit, investment, and development. International trade can disrupt domestic linkages. Reliance on the market mechanisms for resource allocation can push a poorly diversified economy towards more specialization, which is particularly harmful for employment creation and poverty reduction. Examples abound of resource-rich countries able to achieve chronic current account surpluses despite poorly diversified economy, limited domestic capabilities and high levels of unemployment and poverty, thanks to a capital-intensive export sector based on specific natural resource endowments with poor linkages with the rest of the economy.

## **II. What do we know about Trade and Current Account Balances in SSA?**

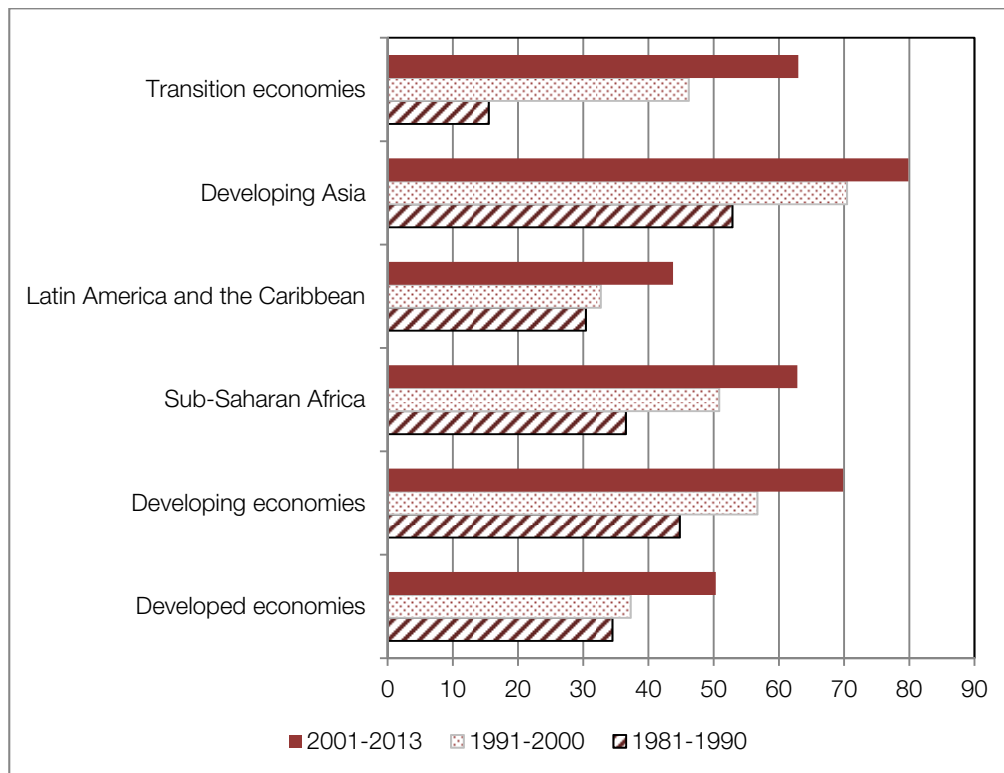
### ***Increasing openness to trade in SSA has been accompanied by current account deficits in many countries***

Openness to trade (as measured by the ratio of exports plus imports over GDP) has significantly increased in all the world's regions at least during the last three decades, and SSA is no exception: its average trade ratio increased from 37 percent in the period 1981-1990 to 51 percent in 1991-2000 and 63 percent in the period 2001-2013. As shown in figure 1, SSA has been more open to trade in the past decade compared to the 1980s. It is also more open to trade than developed economies and Latin America and the Caribbean, but less open to trade than Asia. Within SSA, there is a wide variation in trade ratios across countries, ranging from 35 percent in the Central African Republic to 251 percent in Liberia.

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<sup>1</sup> See Cusolito and Nedeljkovic (2013); Osakwe and Verick (2009); and Suranovic (1999).

**Figure 1: Openness to trade<sup>1</sup> by main world regions, 1981-2013**



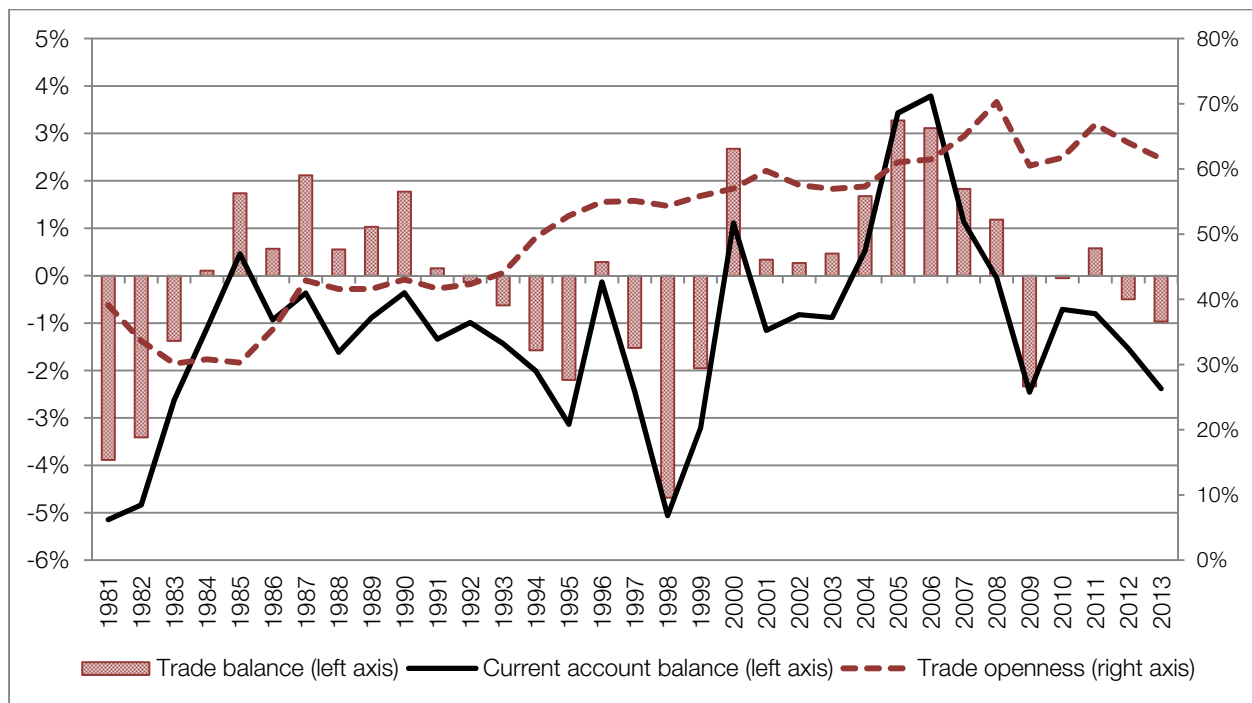
Source: UNCTADstat. Data downloaded on January 2016.

<sup>1</sup> Measured as the ratio of exports plus imports over GDP

The observed increase in trade openness in SSA over the past few decades has gone hand in hand with a deterioration in the current account. Figure 2 shows that SSA had current account deficits beginning in 1986 until 2000 when large shifts in the trade balance contributed to sizeable current account surpluses. Since then the region also experienced current account deficits in the period 2001-2003 and from 2008 to 2013. Figure 2 also shows that SSA had trade surpluses in the periods 1985-1990 and 2000-2008. Nevertheless, the drivers of the trade surpluses of the 1980s and the 2000s are different. In the 1980s, it was the result of the strong fall in imports in the context of structural adjustment policies that was geared towards increasing trade surpluses through decreasing internal demand, in an attempt to manage the debt crisis. In the 2000s, it was the result of a strong surge in exports thanks to the commodity price boom.



**Figure 2: Trade openness, current account balance and trade balance in SSA, 1981-2012 (Percentage of GDP at current prices)**



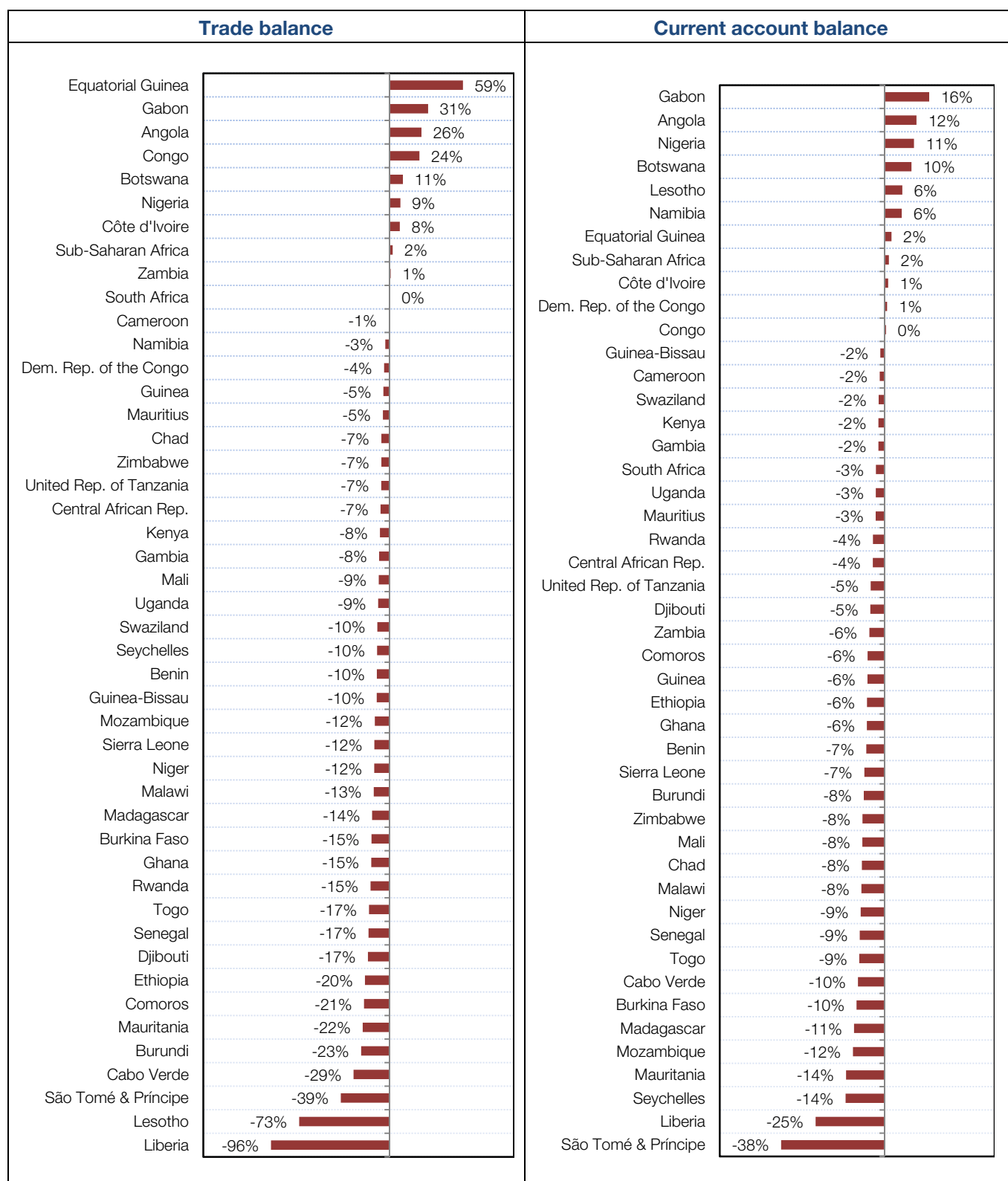
Source: IMF BOP Statistics and UNCTADstat. Data downloaded on January 2016.

Note: Data for Eritrea are only for 1992-2010. For Liberia, data for 1988-2003 and 2009-2012 are missing. Data for Somalia are only until 1989, data for Djibouti are only since 1990.

There are important differences among SSA countries. Between 2000 and 2008, when the region as a whole had a trade surplus, only 8 out of 45 countries - for which data are available - had a trade surplus and only 7 had a current account surplus. In addition, about 33 countries had both trade and current account deficits. The ratio of current account deficit to GDP exceeded 5 percent in the case of 25 countries, of which 7 had a ratio higher than 10 percent (see figure 3). As indicated earlier, the rule of thumb is that current account deficit ratios above 5 percent is an indication that a country is on an unsustainable path and needs to take corrective action to avoid financial and economic crisis. An interesting point to note in figure 3 is that most of the countries that have either a trade or current account surplus are resource-rich countries (Equatorial Guinea, Gabon, Angola, Nigeria etc). Among the deficit countries, it is also interesting to note that there has been a deterioration in the trade and current account deficits over the last three decades (figure 4): the average trade deficit ratio increased from 6 percent in the 1980s to 13 percent in 2001-2013, while the average current account deficit ratio rose from 4 percent to 8 percent over the same period.

Chronic and increasing trade deficits can be interpreted in different ways. Chronic trade deficits can be evidence that domestic firms suffer from low productivity and cannot compete with foreign firms. In this case, and especially in a context of trade liberalization, this does not only limit the capacity of exports but also constrains the development of import-competing industries, which increases import dependence and thus unemployment and poverty. Trade deficit can also result from a country investing in physical capital (through imports of intermediate goods) and building productive capacity, which has the potential of boosting employment and reducing poverty, provided the investments are effective and allocated to job-creating activities.

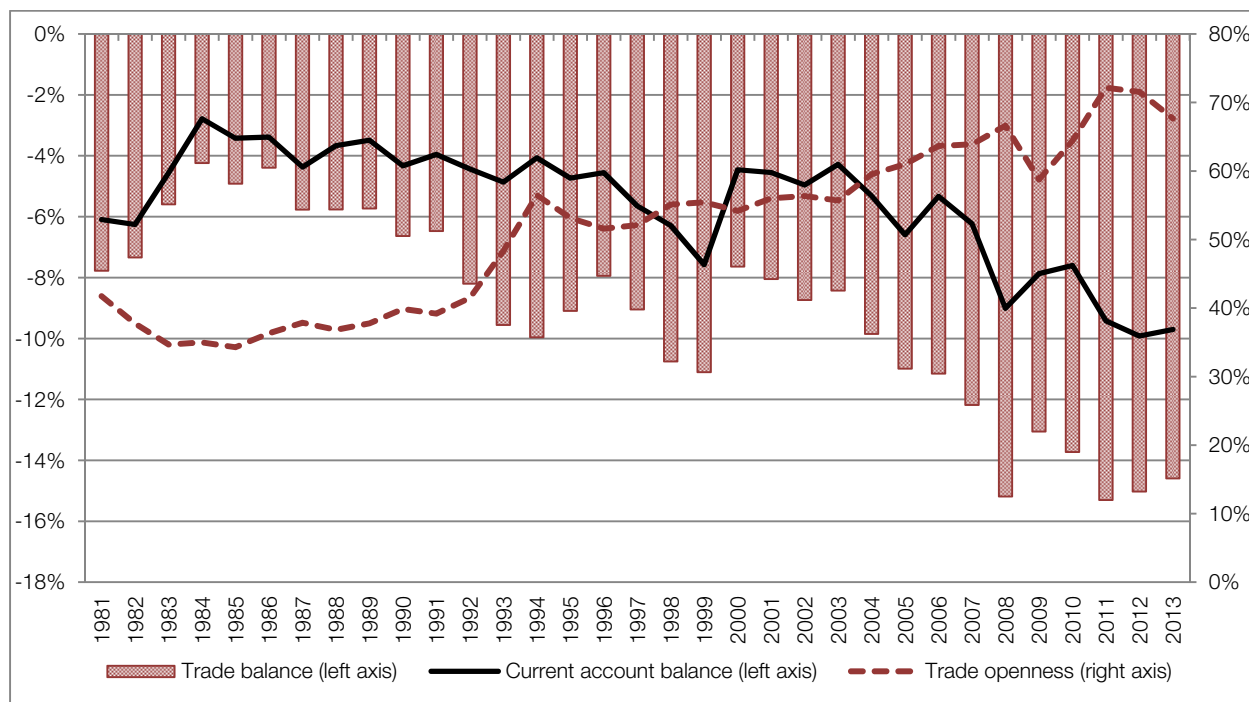
**Figure 3: Current account and trade balance by Sub-Saharan country, 2000-2008 (Annual average, percentage of GDP at current prices)**



Source: IMF BOP Statistics and UNCTAD Globstat. Data downloaded on January 2016.

Note: Data for Liberia are since 2004. Data for Eritrea and Somalia are missing

**Figure 4: Trade openness, current account balance and trade balance in SSA deficit countries<sup>1</sup>, 1981-2013 (Percentage of GDP at current prices)**



Source: IMF Balance of Payments Statistics for trade balance and current account, and UNCTADstat for GDP and trade openness. IMF data until 2004 downloaded on November 2015, all the other data downloaded on January 2016.

Note: Data for Eritrea are only for 1992-2010. For Liberia, data for 1988-2003 and 2009-2012 are missing. Data for Djibouti are only since 1990.

<sup>1</sup>The deficit countries are those that ran both trade and current account deficits in 2000-2008 and for which data are available. These are: Benin, Burkina Faso, Burundi, Cabo Verde, Cameroon, Central African Republic, Chad, Comoros, Djibouti, Eritrea, Ethiopia, Ghana, Guinea, Guinea Bissau, Kenya, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Niger, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Swaziland, Tanzania, Togo, Uganda, Zimbabwe (see figure 3).

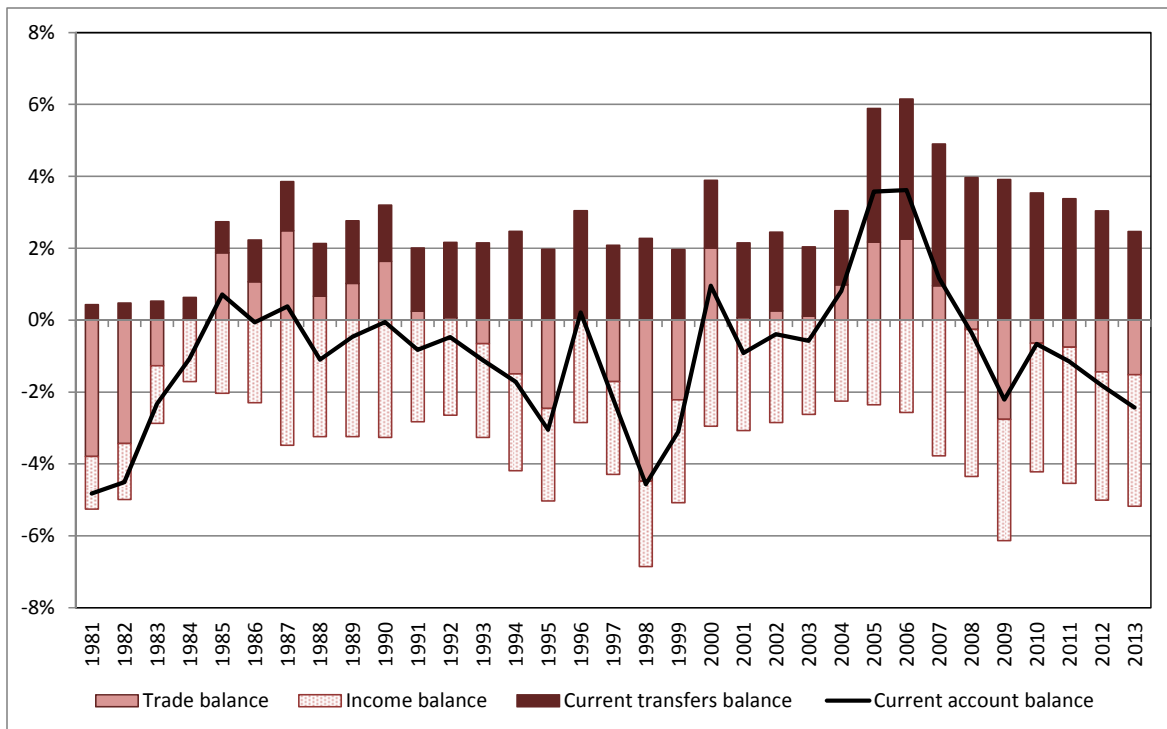
***Income payments have been an important driver of current account deficits in SSA over the past few decades***

The current account is a measure of a country's foreign transactions in a given year. It is expressed as the sum of the balance of trade in goods and services, the balance of income (returns on investment such as interest, dividends, and FDI profits), and the balance of current transfers (such as workers' remittances, donations, aids and official assistance). A current account surplus/deficit means that more money left/entered the country to pay/receive payment for international transactions. It has its counterpart in foreign flows of capital in the form of loans, foreign direct investment, portfolio investment, and capital transfers<sup>2</sup> which make up the capital and financial

<sup>2</sup> The separate identification of current and capital transfers was introduced for the first time in the fifth edition of the IMF's Balance of Payments Manual that started recording capital transfers –previously recorded in the current account - in the capital account component of the balance of payments. Capital transfers include debt forgiveness, investment

account of the Balance of payments. Since 1984, investment income payments have been the main source of the deficit in SSA's current account (see figure 5). The ratio of net investment income payments to GDP more than doubled over the three last decades: from an average of 1.7 percent in the first half of the 1980s, to 3.5 percent in the second half of the 2000s and 3.7 percent in 2011-2013. The trade balance, after a period of surplus that resulted from structural adjustment policies in the 1980s, has oscillated between negative and positive territories according to the movement of commodity prices whose recent decline - that started at the end of the 2000s - seems to be marking the beginning of a new period of trade deficits in the region.

**Figure 5: Current account balance and its components in SSA, 1981-2013 (Percentage of GDP at current prices)**



Source: IMF Balance of Payments Statistics for BOP components, and UNCTADstat for GDP. IMF data until 2004 downloaded on November 2015, all the other data downloaded on January 2016.

Note: The following countries are excluded due to lack of data on current account components: Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Eritrea, Gabon, Liberia, Mauritania, Somalia, and Zimbabwe. Data for Angola are since 1984.

The growing importance of investment income payments in SSA's current account has been due to net payments to FDI investors that became, during the 2000s and by a significant margin, the main contributor to debit in SSA's income accounts. They accounted, on average, for 89 percent of SSA's total investment income balance in 2001-2013. This was the consequence of both the multilateral debt relief initiatives that drastically reduced the amount of external loans and the strong increase of FDI flows since the early 2000s, related to the commodity price boom. The latter had both direct and indirect effects on FDI flows, attracting significant investment from international oil and gas and

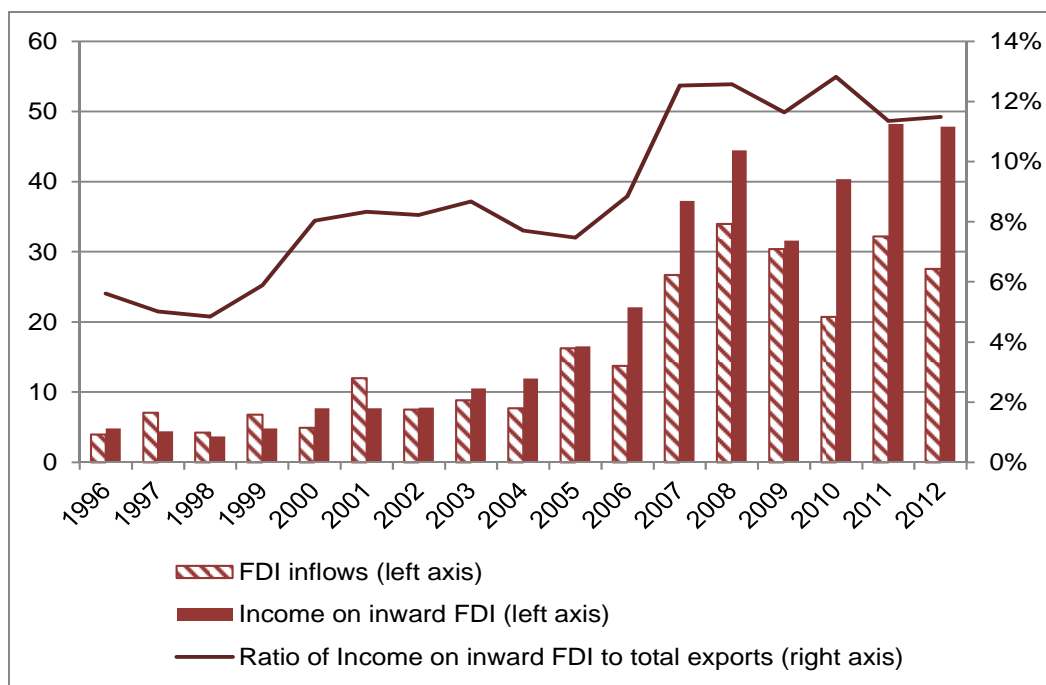
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grants, and other transfers. They are different from current transfers (recorded in the current account as secondary income account) in that they are intended to be for investment rather than for consumption need.

mining enterprises and – by improving terms of trade and domestic consumption – boosting market seeking FDI into the service industry.

Net payments to FDI investors increased from \$7 billion in 2000, to \$48 billion in 2013, totaling \$358 billion in 2000-2013, while trade generated a negative cumulative balance of \$35 billion in this period. Income payments to inward FDI as a percentage of exports increased from an average of 7 percent in 1996-2001, to 9 percent in 2002-2007 and 12 percent in 2008-2013. These facts indicate that the profits of transnational companies have become a major component of the current account in Sub-Saharan Africa, replacing debt interest and portfolio income payments that were prevalent since 1984. Income on Inward FDI was higher than FDI flows, with the difference increasing considerably in 2010-2013 (figure 6), meaning that capital flows to finance TNCs’ activities were not sufficient to compensate for the deficit in the current account that their profits generate.<sup>3</sup>

**Figure 6: Inward FDI flows, Income on inward FDI and its ratio to exports in SSA, 1996-2012 (\$billion and percentage)**



Source: IMF Balance of Payments Statistics. Data downloaded on January 2016

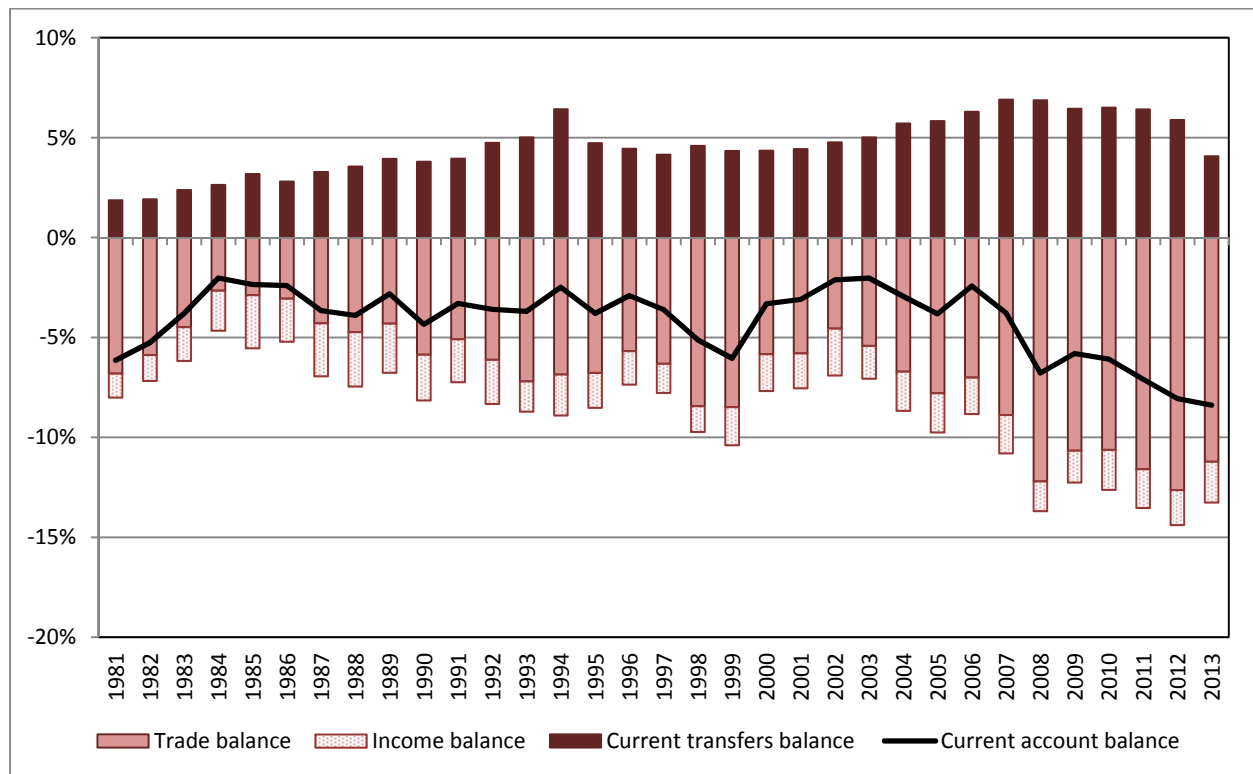
Although at the aggregate level, income payments represent the most important driver of current account deficits in SSA, the trade balance also plays a role and, in many countries, is the dominant driver of the current account deficits. In fact, when Angola, Nigeria and South Africa are excluded from the sample - because of their important weight in SSA trade and GDP<sup>4</sup> - the trade deficit

<sup>3</sup> In fact, FDI flows are, in an important part, financed from retained earnings, which are profits generated in host countries. In balance-of-payments, retained earnings are first recorded as investment income payments in the current account and then as offsetting FDI inflows in the financial account (see Akyüz, 2015). Available data for 34 SSA countries show that in 2005-2013, retained earnings accounted for 51 percent of total FDI inflows and 28 percent of total income on inward FDI (IMF BOP statistics).

<sup>4</sup> Average current account surplus of Angola and Nigeria in 2001-2012 was respectively 128 and 467 times higher than that of the whole of SSA, and their trade surplus was 58 and 75 times higher than the region’s trade deficit in absolute terms. In addition, the GDP of Nigeria and South Africa represented in this period respectively 21% and 36% of SSA’s total GDP.

emerges as the main driver of current account deficits in the region (see figure 7), with the trade deficit ratio increasing significantly since 2007 and averaging 11.5 percent in 2008-2013. By contrast the ratio of net income payments to GDP decreased from 2.1 percent in the 1980s, to 1.8 percent in 2008-2013 as the result of debt relief initiatives that considerably lowered the interest payments of a number of countries.

**Figure 7: Current account balance and its components in selected Sub-Saharan African countries<sup>1</sup>, 1981-2013 (Percentage of GDP at current prices)**



Source: IMF Balance of Payments Statistics for BOP components, and UNCTADstat for GDP. IMF data until 2004 downloaded on November 2015, all the other data downloaded on January 2016.

<sup>1</sup> The countries considered are those, other than Angola, Nigeria and South Africa for which data on current account components are available. These countries are: Benin, Botswana, Burkina Faso, Burundi, Cabo Verde, Cameroon, Comoros, Congo (Dem. Rep.), Côte d'Ivoire, Djibouti, Ethiopia, Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritius, Mozambique, Namibia, Niger, Rwanda, São Tomé & Príncipe, Senegal, Seychelles, Sierra Leone, Swaziland, Tanzania, Togo, Uganda and Zambia.

**Higher trade openness in SSA during the last decade was accompanied by rapid economic growth largely driven by consumption**

After two decades of slow economic growth, SSA's GDP grew at a relatively rapid rate beginning in the early 2000s (table 1). In particular, between 2001 and 2010 the average annual growth rate of real output was about 6 percent, which is 4 percentage points higher than the average growth rate in the 1990s. Interestingly, the strong growth performance experienced in SSA was largely consumption-led (figures 8 and 9) and hence had consequences for the current account.

Actually, the current account balance can also be expressed as the difference between national income and spending. A current account deficit means that a country spent more on goods and

services than it produced during the year, thanks to foreign flows that finance the gap. Current account deficits are not necessarily a sign of weakness. In particular, whether or not deficits are bad depends on the source. For example, a deficit caused by an increase in investment in the trade sector should not be regarded as a bad thing because it increases productive capacity to generate resources required to repay any debt associated with the deficits. On the other hand, a deficit arising from an increase in consumption (or a decline in savings) as observed in SSA should be of concern because it is often an indication that a country is living above its means. Therefore, besides looking at the components of the current account to understand the significance and the drivers of a surplus or a deficit, it is also important to look at the national economic aggregates such as GDP, investment, and consumption.

**Table 1: Trade openness and GDP growth rate in SSA<sup>1</sup>, 1981-201**  
**(Percentage)**

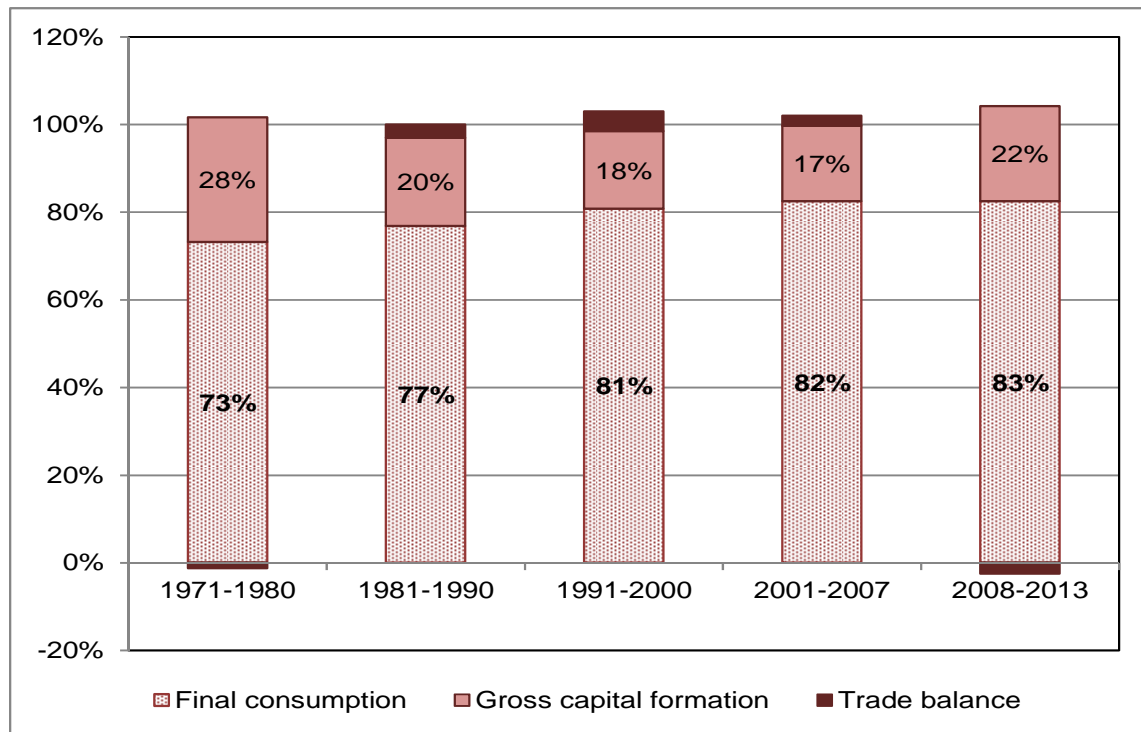
	1981-1990	1991-2000	2001-2010		2001-2007	2008-2013
GDP growth rate	2	2	6		6	4
Trade openness	37	51	62		61	64

Source: UNCTADstat. Data downloaded on January 2016

<sup>1</sup> GDP growth rate is calculated for GDP values in US Dollars at constant prices (2005) and constant exchange rates (2005). For trade openness, see figure 1.

As presented in figure 8, SSA's economic growth has clearly been consumption-led since the 1980s, with the ratio of final consumption expenditure to GDP increasing from an average of 73 percent in the 1970s to 83 percent in 2008-2013. This high share of consumption in GDP coupled with a high consumption growth rate meant that the contribution of consumption to growth was much higher than that of other components of aggregate demand. Figure 9 shows that in the period 2001-2010 real output in SSA grew by 5.5 percent and the contribution of consumption to this growth was 4.7 percentage points while investment contributed 1.7 percentage points and the trade balance contributed to a decline in real output by 0.8 percentage points. While during the 1970s, SSA's economic growth was almost equally driven by consumption and investment, in the 1980s the contribution of investment to growth was negative, which resulted in a decline in the investment to GDP ratio from 28 percent in the 1970s to 20 percent in the 1980s. This ratio continued decreasing until the mid-2000s when it started growing, mainly driven by investments in the extractive industries and infrastructure (see UNCTAD 2014a and 2015a). It should be noted that despite the increase in investment experienced over the past decade, the investment ratio in SSA is still low relative to the 25 percent rate deemed necessary for African countries to make significant progress in the fight against poverty.

**Figure 8: GDP expenditures by main components in SSA, 1970-2013 (Percentage of GDP)**



Source: UNCTADstat, data downloaded on January 2016

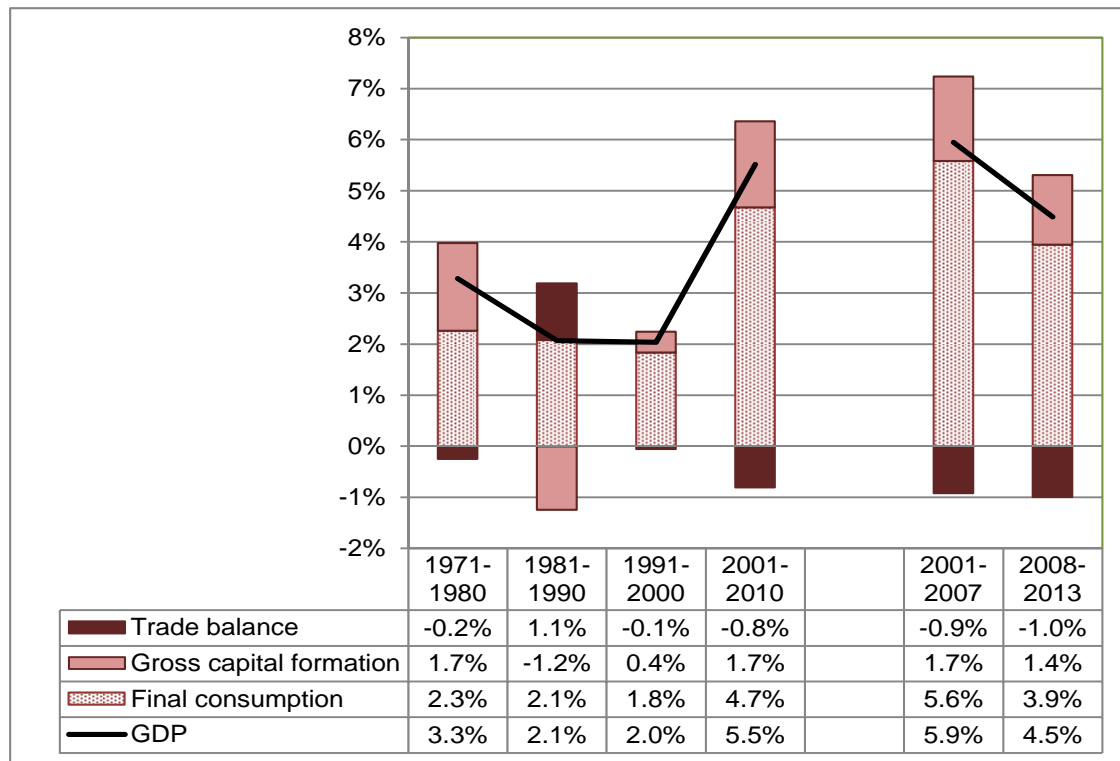
Note: The percentage is calculated for values in US dollars at constant prices (2005) and constant exchange rates (2005).

***Increasing openness to trade in SSA has also been associated with increased specialization in commodity exports***

A key feature of African countries participation in international trade is that they are exporters of primary products and importers of services and manufactured goods. As SSA became more open to trade over the past few decades, the region has also increased its dependence on commodity exports. In fact, the increase in commodity prices since the early 2000s has led to an increase in the share of primary goods in SSA's total exports (from 62% in 1995-1999 to 73% in 2010-2013) and a decline in the share of manufactured goods (from 19% to 13%) and services (from 18% to 14%). Among primary goods, the share of fuel products in total exports surged from 26 percent in 1995-1999 to 47 percent in 2010-2013, that of foods and agriculture products dropped from 20 percent to 11 percent, while the share of ores and metals and precious pearls declined from 17 percent to 15 percent (see figure 10). It should be noted that the message from figure 10 is quite different if Angola, Nigeria, and South Africa are excluded. The difference mainly stems from a more balanced distribution of primary exports between foods and agriculture products, ores and metals and precious stones, and fuels. The latter became since the mid-2000s the main exports item, a place devoted until then to foods and agriculture products that reduced their share in total exports from 35 percent to 22 percent between 1995-1999 and 2010-2013.



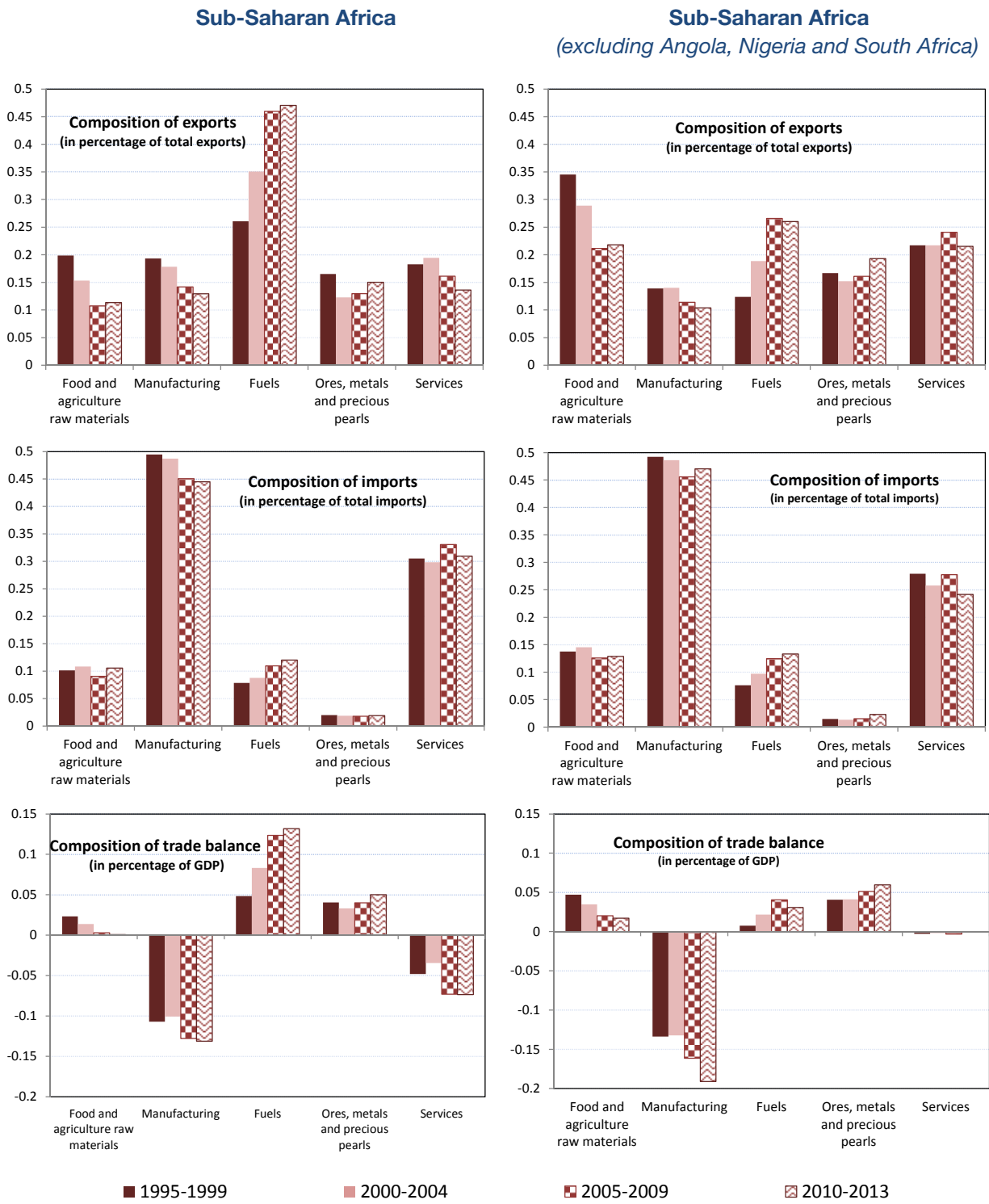
**Figure 9: Contribution to real GDP growth in SSA, 1971-2013  
(Percentage points)**



Source: UNCTADstat, data downloaded on January 2016.

Regarding imports, the structure is characterized by the predominance of manufactured goods that represented 45 percent of total imports in 2010-2013, followed by services, with 31 percent. Due to the strong increases in oil prices in the past decade, fuel products (mainly composed of refined products) have increased their share in total value of imports during the 2000s to reach 12 percent in 2010-2013. SSA imports are largely composed of final consumer goods, and imports of capital equipment and many intermediaries are linked to commodity extraction (see Morris and Fessehaie, 2014). The trade balance suggests there are increasing deficits in manufactured goods and in services equivalent to 20 percent of GDP since the second half of the 2000s. These deficits have been hardly balanced by surpluses in primary products (see figure 10).

**Figure 10: SSA's trade structure: composition of exports, imports and trade balance, 1995-2013 (Percentage)**



Source: UNCTADstat and IMF BOP, data downloaded on December 2015.

***Sub-Saharan Africa exports its natural resources in raw form, and re-imports them transformed into intermediary and finished products***

SSA's exports are highly concentrated in a few primary commodities. For instance, crude oil alone accounted for about 45 percent of total exports in 2008-2014. Furthermore, the top 13 products exported by SSA were commodity products and accounted for 71 percent of total exports. Motor vehicles for the transport of persons – 95 percent of which are exported from South Africa - came at the 14<sup>th</sup> place and accounted for 1.2 percent of total exports. Such export concentration on primary commodities reflects the high dependence of SSA economies on natural resources and the weakness of their industrial sectors. Among primary commodities, exports are concentrated in products with relatively low levels of value-added or processing, which limits further the already low potential for employment creation typical of commodity outputs. The most emblematic case is that of petroleum products that is at the top of SSA's import and export lists, with crude petroleum being the first exported product and refined petroleum the first imported one (see table 2).

**Table 2: Top 15 exports and imports products in SSA<sup>1</sup>, 2008-2014  
(Annual average, in \$billions and in percentage)**

Top 15 export products	in billions	Share in total exports	Accumulated share in total exports	Top 15 import products	in billions	Share in total imports	Accumulated share in total imports
[333] Petroleum oils, oils from bitumin. materials, crude	168	45%	45%	[334] Petroleum oils or bituminous minerals > 70 % oil	31	9%	9%
[334] Petroleum oils or bituminous minerals > 70 % oil	12	3%	48%	[333] Petroleum oils, oils from bitumin. materials, crude	21	6%	16%
[343] Natural gas, whether or not liquefied	11	3%	51%	[781] Motor vehicles for the transport of persons	11	3%	19%
[971] Gold, non-monetary (excluding gold ores and concentrates)	10	3%	54%	[764] Telecommunication equipment, n.e.s.; & parts, n.e.s.	9	3%	22%
[072] Cocoa	9	2%	56%	[723] Civil engineering & contractors' plant & equipment	8	2%	24%
[667] Pearls, precious & semi-precious stones	9	2%	59%	[782] Motor vehic. for transport of goods, special purpo.	7	2%	26%
[681] Silver, platinum, other metals of the platinum group	9	2%	61%	[542] Medicaments (incl. veterinary medicaments)	6	2%	28%
[682] Copper	8	2%	63%	[793] Ships, boats & floating structures	5	2%	30%
[281] Iron ore and concentrates	7	2%	65%	[042] Rice	5	1%	31%
[287] Ores and concentrates of base metals, n.e.s.	6	2%	67%	[041] Wheat (including spelt) and meslin, unmilled	4	1%	32%
[321] Coal, whether or not pulverized, not agglomerated	6	2%	68%	[728] Other machinery for particular industries, n.e.s.	4	1%	34%
[671] Pig iron & spiegeleisen, sponge iron, powder & granu	5	1%	70%	[716] Rotating electric plant & parts thereof, n.e.s.	4	1%	35%
[057] Fruits and nuts (excluding oil nuts), fresh or dried	4	1%	71%	[679] Tubes, pipes & hollow profiles, fittings, iron, steel	4	1%	36%
[781] Motor vehicles for the transport of persons	4	1%	72%	[752] Automatic data processing machines, n.e.s.	3	1%	37%
[684] Aluminium	3	1%	73%	[562] Fertilizers (other than those of group 272)	3	1%	38%

Source: UNCTADstat. Data downloaded on December 2015

<sup>1</sup> This table presents merchandise trade by product based on three digit level SITC Revision 3

Similar examples illustrating SSA's specialization in the segments of commodity products with lower value-added can be found for a number of other products: SSA registers surpluses in the international trade of live animal but deficits in that of processed meats, milk and cream. The same happens with unmanufactured tobacco versus manufactured tobacco, cacao versus chocolate, natural rubber in primary form versus synthetic rubber and materials of rubber, ores and concentrates of base metals versus wire products and manufactures of base metals, and so on. In general, SSA largely exports its natural resources in raw form, and re-imports them transformed into intermediary and finished products. The domestic value added incorporated in the exported commodities is generally only a small portion of the final sales prices of the finished goods made from them, with the bulk of total value added accruing overseas. This mode of integration in international trade is a bad recipe for employment creation because unlike final products, export of primary commodities has limited potential for job creation in the exporting country.

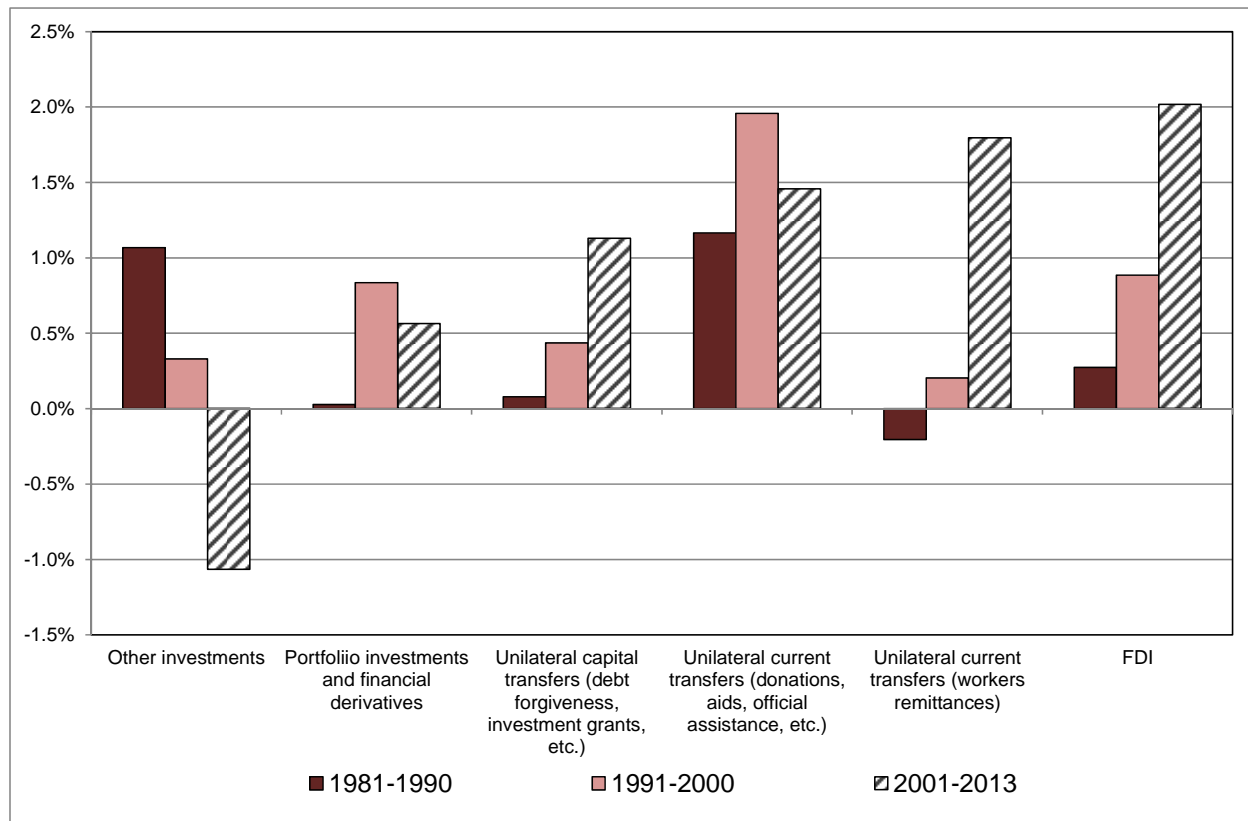
### **III. What are the Key Sources of External Finance in SSA?**

Unilateral transfers – both current and capital - have always been the main source of external finance in SSA. Their importance strongly increased during the 2000s - from 2.6 percent of GDP in the 1990s to 4.4 in 2001-2013 – driven by the strong rise of workers' remittances and capital transfers (mainly in the form of debt forgiveness) that more than compensated for the decline in current transfers in the form of aid, donations and official assistance (see figure 11) .

Although the importance of unilateral current and capital transfers greatly varies among countries, a large majority have a strong reliance on these transfers. Among 37 Sub-Saharan African countries for which data on unilateral transfers are available for 2001-2013, three – Côte d'Ivoire, South Africa and Angola in this order – sent current transfers abroad more than they received, while 32 received a net amount equivalent to more than 5 percent of their GDP (the ratio being higher than 10 per cent for 18 of them).

Since 2000, FDI flows replaced “other investments” (mainly foreign loans) as the main source of external finance other than unilateral transfers. Net FDI flows more than doubled their share to GDP from 0.9 per cent in the 1990s, to 2 per cent 2001-2013, while net flows of foreign loans registered a drastic fall, reaching high negative values in 2001-2013 as a consequence of the debt relief initiatives (see figure 11).

**Figure 11: Sources of foreign finance in SSA, 1981-2013, net values, (Percentage of GDP at current prices)**



Source: IMF Balance of Payments Statistics for BOP components, and UNCTADstat for GDP. IMF data until 2004 downloaded on November 2015, all the other data downloaded on January 2016.

The high reliance of most SSA countries on unilateral transfers reflects their increasing dependence on external sources to finance their investment and development needs. Although these transfers represent a substantial source of external finance that can be an important tool for poverty alleviation, they also entail significant costs. The strong reliance on income generated from external sources increases the economic vulnerability of recipient countries and exposes them to the economic cycle of the source countries. In addition, aid usually comes with a number of conditions imposed by donors not only regarding how the aid should be spent, but also what should be the general orientation of economic policy. The latter often interferes with effective policy-making by forcing the adoption of policies generally inappropriate for the context in which they are applied.<sup>5</sup> Furthermore, aid may make recipient governments more accountable to donors than to their citizens, undermining long-term institutional development.

With regard to remittances, flows appear to benefit households, communities and the macro-economy. But migration also implies sacrifices for the migrants and their families. It also contributes to brain drain and can jeopardize long-term development. The high and increasing reliance on workers' remittances to attenuate external imbalances is a sign of the inadequacy of the existing productive capacity in creating sufficient productive jobs to keep the workforce producing value at home, instead of "exporting" it and receiving back part of its income. More generally, the reliance on

<sup>5</sup> See UNCTAD (2000).

aid and remittances can create perverse incentives, making it easier for governments to delay policy reforms needed to improve the performance of the economy. The persistent influx of easy foreign money foster the emergence of a “rentier state” mentality, weakening the incentives to seek alternative revenue sources through effective policies that encourage diversified and self-maintained investments, which are crucial for the creation of productive employment and poverty alleviation.<sup>6</sup>

Beside unilateral transfers, Foreign Direct Investment (FDI) is also one of the main sources of external finance for Sub-Saharan Africa. FDI is often seen as the preferred and safer alternative source of private foreign capital for developing countries, because of its relative stability and its “non-debt-creating” character. As it generally involves a long-term commitment to a country, it is “less subject to capital reversals and contagion that affect other flows, since the presence of large, fixed, illiquid assets makes rapid disinvestment more difficult than the withdrawal of short-term bank lending or the sale of stock holdings” (World Bank, 1999, p. 54). In addition, as FDI inflows do not involve the direct payment of principal and interest charges, “they are a preferred method of financing external current account deficits, especially in developing countries, where these deficits can be large and sustained” (Demekas et. al., 2005, p. 209).

The non-debt-creating nature of FDI gives the impression that no payments need to be made to foreign direct investors. Although it is true that FDI does not involve the direct repayment of capital and interest, foreign direct investors do not invest without the expectation of profit and the eventual repatriation or relocation of the investment. Actually, the return on FDI is the highest compared to that of other external sources of financing as the rates of profit of foreign firms largely exceed the rate of interest on foreign loans or the rate of profit related to portfolio investments (see figure 12).<sup>7</sup> However, developing countries seek to attract FDI not only as a source of financing, but also because of its potential positive externalities in terms of access to skills, technology, and horizontal and vertical spill-over effects that increase domestic firms’ productivity.<sup>8</sup> The benefits of FDI and the strength of the linkages it can establish with the host economy depend on a number of factors, including the sector where the investment takes place, and the development level of the host economy, especially its level of human capital development, the quality of its infrastructure and institutions. A large proportion of FDI to Africa has gone into the extractive industry whose increasing exports has been a major driver of SSA’s growth recovery since the early 2000s. However this industry has frequently exhibited, in developing countries, low incidence of linkages between foreign affiliates and the local economy<sup>9</sup> due, among others, to the low absorptive capacity of the host economies. Attracting finance into “enclave” sectors such as extractive industries that are high-capital and low-labour intensive does not create significant jobs and sustained poverty reduction.

In general, and most importantly, FDI has potential benefits but does not automatically generate positive externalities for the host economy. A variety of experiences underscore the crucial role of government policy. In a number of developing countries in Asia that have been able to take advantage of positive FDI externalities, the policy to attract FDI was part of a broader industrial

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<sup>6</sup> See, Inter-Parliamentary Union (2015); Action Aid (2011); Abuzeid (2009); and Moss et. al (2006).

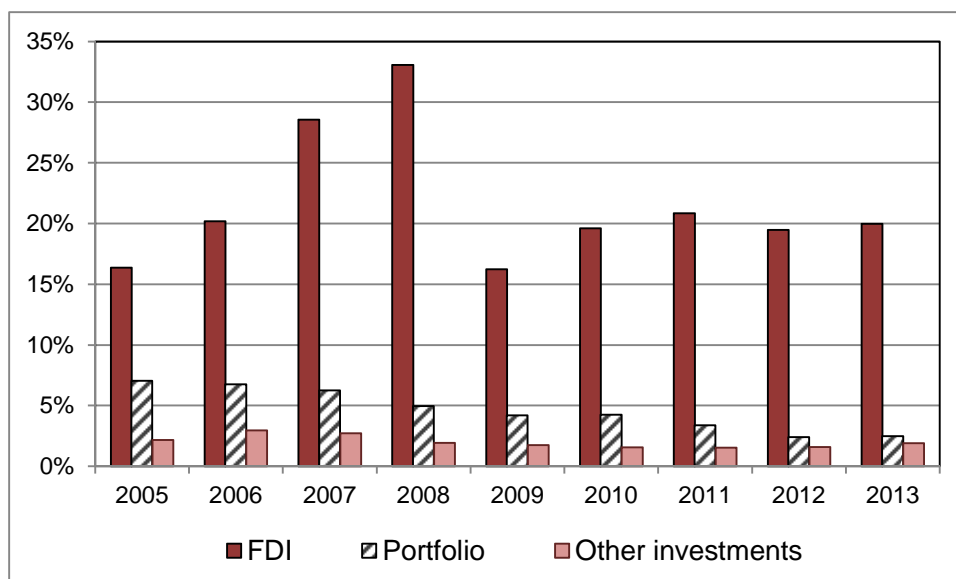
<sup>7</sup> See UNCTAD (1999) and Kregel (1996). See also for South African Case: African Development Bank Group (2015).

<sup>8</sup> Horizontal or intra-industry spill-overs may occur through labor turnover, demonstration and competition effects. Vertical or inter-industry spillovers are related to buyer–supplier linkages and therefore may be from upstream sectors (forward spill-overs) or downstream industries (backward spill-overs). See Ngoc (2015).

<sup>9</sup> See UNCTAD (2007).

development strategy that includes among others, strong education policy, support to local companies (training, preferential loans), the use of local advantages (such as market size or abundant and low cost labour) as assets to bargain effectively with TNCs for government's preferences such as a certain level of local content and national control of the technology transfer. Influencing TNCs performance has been a key ingredient of industrial policies. However, these tools have been progressively limited by a large number of bilateral and multilateral trade and investment agreements signed by SSA countries that impose growing restrictions on policy space and thus on the policy tools available to increase FDI positive externalities.<sup>10</sup>

**Figure 12: Ratio of income payments to liabilities' stock in SSA: FDI, Portfolio and other investments, 2005, 2013 (Percentage)**



Source: IMF BOP, data downloaded on January 2016.

The following countries are included: Angola, Benin, Botswana, Burkina Faso, Burundi, Cabo Verde, Cote d'Ivoire, Djibouti, Ghana, Guinea, Guinea Bissau, Malawi, Mali, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Swaziland, Tanzania, Togo, Uganda, and Zambia.

Data for Burkina Faso are only until 2010, Data for Senegal are only until 2011.

#### IV. Policy Recommendations

This paper examined trends and composition of the trade and current account balances and the external sources of financing in SSA and found that many SSA countries have had chronic trade and current account deficits over the past few decades. The paper also argued that growing trade and current account deficits in SSA should be of concern to African policy makers because it makes the continent vulnerable to external shocks and, more importantly, has negative consequences for employment and poverty reduction efforts. Against this backdrop, the current section of the paper discusses some policy actions that governments can take to reverse the trade and current account deficits and make trade work for Africa. In principle, if employment creation, inclusive growth, and poverty reduction are the ultimate objectives of trade policy, then the strategy of insertion into the

<sup>10</sup> See UNCTAD (2014b), UNCTAD (2012) and UNCTAD (2003).

international economy should focus on how to link international trade with employment creation and the development of productive capacity. An insertion into the global economy based on commodity exports is certainly not the answer, which is to be found rather in the upgrading into differentiated products with a higher content of skilled labor, technology, and innovation.

SSA countries need to address the reasons why stronger growth rates in GDP, trade and financial flows have not stimulated economic diversification and job creation. The market-led development model adopted by most SSA countries has apparently not succeeded in engaging a process of structural transformation, and may have rather contributed to perpetuate commodity dependency by assigning most of the resources to the most profitable sector - i.e. the extractive industry. Specialization in the production of primary commodities is hardly a good recipe for sustainable development. Not only does it present limited opportunities for income growth, but it can potentially prevent the development of other more dynamic economic activities, unless it serves as a basis for economic upgrading through progressively incorporating value-adding processes.

The importance of manufacturing for development is widely recognized, as very few countries have been able to grow, accumulate wealth, and increase their living standard without investing in their manufacturing industries. Manufacturing has historically been the driver of economic growth, structural change, and catch-up. It opens opportunities for economies of scale, technological progress and learning. It acts as a catalyst to transform the economic structure of countries, from primary, slow-growing and low-value activities to more productive activities driven by technology and innovation and with higher growth prospects. Manufacturing sector has “pull effect” on the other sectors by stimulating the demand for more and better services in banking, insurance, communications and transport and encouraging the development of human capital and the use of technological advances in the agricultural sector. It provides – directly and indirectly - job opportunities for the skilled labor force, which boosts revenues and sets the conditions for the reduction of income inequality and poverty. Manufacturing also offers better growth prospects because it generally does not suffer from a secular deterioration of terms of trade that have frustrated the growth prospects of many commodity-dependent countries.<sup>11</sup>

There are no examples of successful industrialization without a pro-active role for industrial policy. But this does not mean that country experiences are identical. The now industrialized countries have followed different paths depending on their initial conditions and endowments, and the timing of their industrialization process. Not all experiences with industrial policies have been successful. Many countries in Sub-Saharan Africa implemented industrial policies in the 1950s and 1960s that were dismantled in the 1980s and 1990s under structural adjustments and trade liberalization policies, which led to significant de-industrialization. Today, the absence of industrial policy in many SSA countries is felt in the low levels of productive capacity – including human capital and infrastructure -, the inability to compete in national and international markets, the high level of unemployment and the large migratory movement of population to developed countries. Faced with that situation, some governments in SSA are paying renewed attention to industrial policies, and reassessing its benefits for structural transformation.

The development of productive capacities is a country-specific process and each country should follow its own route and priorities that normally change over time. However, beyond their differences SSA countries share common obstacles to the development of their manufacturing sector, the most critical being inadequate infrastructure, in particular unreliable water and electricity supply, the lack of access to an effective and efficient labor force, and competition by cheaper imports favored by trade

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<sup>11</sup> See UNCTAD (2015b), KPMG (2014), Naudé and Szirmai (2012); Uzochukwu (2012); Akyuz (2009); and Farfan (2005).



liberalization policy. They all need to put at the center of their development strategy the design of an active industrial policy aimed at promoting growth with employment. It could start building on existing productive resources - which include natural resources, human resources, and physical capital - and setting conditions for the creation of a virtuous circle between investment, growth and employment. Trade policy should be supportive of the overall development strategy that should use international trade as an instrument for the attainment of the objectives of overall employment promotion and poverty reduction rather than considering trade growth as an end in itself.

Building on natural resources could translate into focusing, in a first stage, on adding value to natural resources, instead of producing and exporting raw materials, through progressively strengthening their backward and forward linkages with the economy. This will favor employment creation and import substitution. For example, agriculture activities could provide inputs to tourism, to large retailers, and to manufacturing activities, especially food processing. Manufacturing activities that provide inputs to agriculture (e.g. fertilizers, agriculture equipment) could also be progressively developed. Some upstream and downstream linkages may also be developed with the extractive industry, such as the provision of domestic inputs and the (at least partial) transformation of raw materials.

This requires providing support to micro, small, and medium-sized enterprises which are essential sources of job and important actors in the process of linkage building. Securing them access to affordable loans should be a priority. Policy instruments can include requiring banks to devote a share of their lending to productive capacity building by such excluded categories, public guarantees for certain types of lending, direct provision of credit by public financial institutions, etc..

Building on natural resources could also translate for a number of mineral rich countries into improving the capture of resources rent through tax on land, higher royalties, renegotiation of concessions, participation in the ownership of extractive firms, etc., and using the accrued income in investing in human capital and infrastructure. This is an example of how international trade, by opening external markets to the sale of natural resources, can be an indirect vehicle for industrialization and development.

The State can play a crucial role in capital formation through the structure and orientation of both taxation and public expenditure. Increasing public spending (both investment and consumption) can have an important impact on aggregate supply and demand and on the labour market. Public investment in physical infrastructure (such as transport, communications, irrigation and energy) and in human resources development (such as education, training, skills development, technological and entrepreneurial capabilities) beside tackling serious bottlenecks to development, creates employment, expands productive capacity, improves competitiveness and thus provides more profitable investment opportunities for the private sector. Government procurement policy can be used to induce employment creation and SMEs expansion. Jobs created by both the public and the private sectors can have in turn a positive effect on aggregate demand, which can boost investment.

However, increasing demand for final consumption and investment goods will put a strain on the trade balance due to high import leakages. Governments should invest time, energy and resources to conceive a dynamic process that, taking into account the external constraints, engineers a gradual building of productive capacity and economic linkages with the aim of progressively reducing the mismatch between the structure of domestic production and the pattern of domestic demand. A gradual diversification of production would generate new jobs and income, which increases consumption that could be increasingly met by local production, which would further encourage local producers to invest in more productive capacity, setting a virtuous cycle between investment, local production, employment and income. In this context, macroeconomic policies should be supportive

to growth, job creation and sustainable development, going beyond the pure pursuit of price stability.<sup>12</sup>

Finally governments interested in embarking in industrial policy that “defies” their current comparative advantages may have to resolve the conundrum of being able to defend their own policy space in an international environment upon which they increasingly rely and that pushes towards governance under harmonized rules. SSA countries need to engineer their own solutions to the developmental bottlenecks that they face. However, their obligations under WTO rules, investment treaties, trade agreements, and aid conditions considerably restrict their policy options and the instruments for industrial policy that they can use. In view of their structural development problems, and as latecomers to industrialization, they need to be guaranteed sufficient policy space to find their own solutions to their specific problems. It is therefore important that they press - individually and collectively - for revisions and changes in the international governance architecture that give them greater options to pursue appropriate development strategies.<sup>13</sup>

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<sup>12</sup> See UNCTAD (2013)

<sup>13</sup> See UNCTAD (2014b); Naudé et. al. (2012); and Rodrik (2001)

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