The drivers of investment and savings rates: An exploratory note*

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Abstract

This note explores the literature on the determinants of foreign direct investment and domestic savings. With respect to foreign direct investment, it argues that institutional quality is the key driver of the type of investment that is necessary for structural transformation. With respect to domestic savings, focusing on sub-Saharan Africa, which lags behind other regions in savings rates, it suggests that there needs to be a stronger emphasis on long-term capital needs of the region. Policymakers can support the growth of pension and capital markets and the fintech sector through appropriate reforms and through re-orienting sovereign wealth funds towards more developmental purposes.

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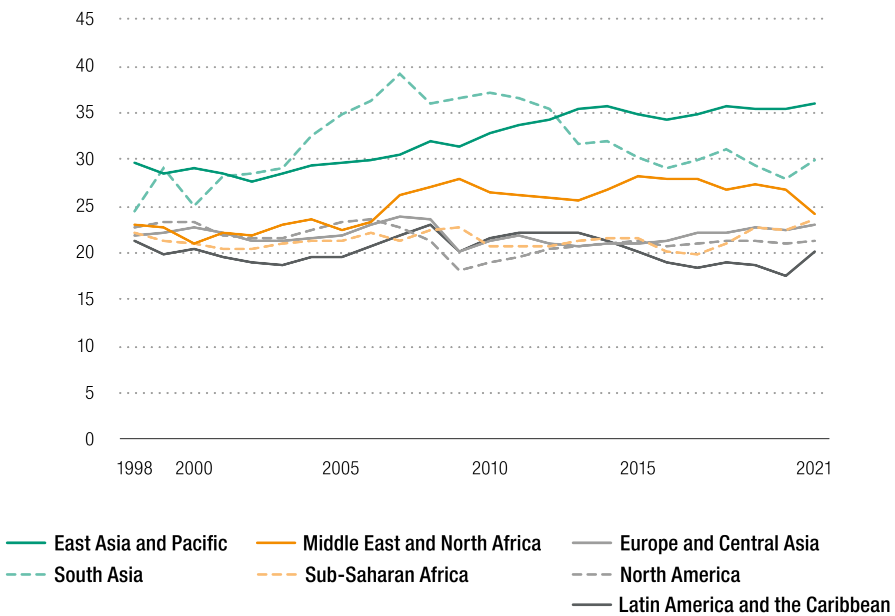
1. Introduction

The vast empirical literature on economic growth has found that investment is a key determinant of growth (Barro, 1991). Investment rates (gross capital formation as a percentage of gross domestic product (GDP) differ greatly across regions (figure 1). For example, the average investment rate in East Asia in 2010–2021, at 35 per cent, was 13 percentage points higher than that of sub-Saharan Africa for the same period. This explains to a large extent why average economic growth rates in East Asia are substantially higher than in sub-Saharan Africa. What explains why some regions have higher investment rates than other developing regions? Investment is composed of foreign direct and domestic investment. The latter is almost completely determined by domestic savings, as noted by Feldstein and Horioka (1980). To understand why investment rates differ greatly across regions, we need to understand the drivers of foreign investment and domestic savings separately, drawing from a recent project by UNU-WIDER, "The Domestic Savings Shortfall in Sub-Saharan Africa: What Can Be Done About It?". The note contributes to the literature on investment and savings, and especially, the determinants of domestic savings.

Figure 1. Investment rates, by region, 1998–2021 (Domestic capital formation as percentage of GDP)



Source: Author's calculations, based on the World Bank's World Development Indicators (accessed 30 November 2023).

A particular challenge that policymakers in Africa face is mobilizing long-term capital for investment needs, given the underdeveloped nature of stock and bond markets in the continent. The interest in developing capital markets was reflected in two sessions that were held as part of the World Investment Forum held in Abu Dhabi in October 2023.[1]

The rest of the note is in three sections. Section 2 briefly discusses the role of institutional quality in determining foreign direct investment (FDI). Section 3 focuses on the determinants of domestic savings. Section 4 concludes.

2. The determinants of foreign direct investment

There is a large literature on the determinants of FDI.[2] Earlier literature has focused on resource endowments, the product cycle and market size of host countries (Dunning, 1970; Vernon, 1966). More recent literature has examined the role of institutional quality in explaining cross-country variations in FDI inflows (e.g. Altomonte, 2000; Bevan and Estrin, 2004). For example, Sen and Sinha (2017) look at the institutional determinants of both within- and across-country variations in United States FDI flows over time. They argue that in countries with high-quality contract enforcement, multinationals are more likely to invest in industries where by their very nature investments are relationship specific. Conversely, in countries with low-quality contract enforcement, multinationals are more likely to invest in industries where investments to a large degree are not relationship specific. Using three-dimensional panel data for United States FDI flows to 50 countries and 6 sectors for the period 1984–2010, they find strong support for their core hypothesis. Their findings suggest that countries that want to attract United States FDI in sectors that are highly intensive in technology and institutions such as transportation and electronics should improve their property rights and contracting environment. This suggests that institutional quality plays a key role in attracting foreign direct investment, especially in sectors such as manufacturing and tradable services which are key to productive structural transformation (Sen, 2023). In contrast, in countries where institutional quality is weak, and where resources such as oil and gas are abundant, FDI is more likely in sectors such as mining, where there are limited possibilities of spillover effects to domestic firms.

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1 See https://worldinvestmentforum.unctad.org/session/sovereign-and-public-investors-dialogue and https://worldinvestmentforum.unctad.org/session/sustainable-finance-and-business-academic-and-practitioner-dialogue.

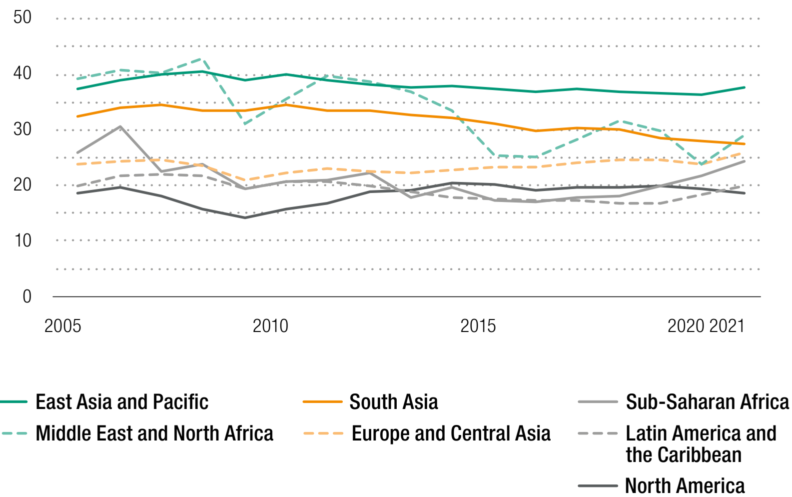
2 See Helpman (2006) and Sinha and Sen (2016).

3. The drivers of domestic savings

Similar to investment rates, savings rates differ widely across regions (figure 2). Among developing regions, sub-Saharan Africa has one of the lowest rates of savings, an average of 19 per cent in 2010–2021. In the same period, in East Asia the savings rate was 37 per cent, which explains to a large extent why East Asia has the highest investment rates among developing regions. In the period 2000–2017, the average savings rate in sub-Saharan Africa was 22 per cent as compared with 34 per cent in East Asia and 27 per cent in South Asia. Of more concern is the fact that the savings rate in sub-Saharan Africa has fallen from a high of 27 per cent in 2006 to 19 per cent in 2017. Clearly, for economic growth to increase in the region, a major policy impetus should be to increase domestic savings rates.

Here, we examine the drivers of savings rates in sub-Saharan Africa, drawing from a recent project by UNU-WIDER, "The Domestic Savings Shortfall in Sub-Saharan Africa: What Can Be Done About It?". The project aims to increase knowledge about (i) the key drivers of domestic saving rates in sub-Saharan Africa; (ii) whether alternative approaches, such as pension funds or fintech, could provide new solutions to increase domestic savings; (iii) lessons learned from the experiences so far in different countries in sub-Saharan Africa and; (iv) what sub-Saharan Africa can learn from the experience of regions that have been more successful in raising savings rates.

Figure 2. Savings rates, by region, 2005–2021 (Gross savings as percentage of GDP)



Source: Author's calculations, based on the World Bank's World Development Indicators (accessed 30 November 2023).

One important development in developing countries in the past two decades has been the way technology and innovation have revolutionized financial markets. Financial technology (fintech) has changed the way banking services are provided, the way banks work, how capital is raised and how payments, including retail payments, are conducted. Ndung'u (2022) traces the development of fintech in sub-Saharan Africa and how it may have led to financial inclusion for underserved and unserved parts of the population in the continent. The author notes that fintech has vast potential to mobilize financial savings in sub-Saharan Africa and suggests options for policymakers to take to increase the rapid uptake of fintech products.

Njenga et al. (2022) review the state of progress in the development of capital markets in sub-Saharan Africa. The authors argue that policymakers need to stabilize capital markets in the continent by building investor confidence through strict enforcement of rules and regulations, having a stable macroeconomic environment and supporting the growth of micro, small and medium enterprises to enhance their attractiveness for being listed in bond and stock markets.

Pension systems are also a potential source of long-term investible funds, as is clear from the East Asian experience. Pensions also provide an important form of social protection for the elderly. Nyang'oro and Njenda (2022) discuss the experience with pension funds in sub-Saharan Africa, noting the low coverage and high costs of joining pension schemes, and that these schemes mostly cover formal sector employees. The authors argue for a targeted universal pension system funded by public resources and that the move to universal coverage needs to be gradual, so as not to lead to fiscal strain.

In many developed (as well as developing) countries, sovereign wealth funds (SWFs) play an increasingly important role in fiscal stabilization, productive investment and intergenerational saving. Addison and Lebdioui (2022) assess the potential role that SWFs can play in Africa in mobilizing savings for investment. African SWFs hold $8 trillion in assets, making them global financial players. Addison and Lebdioui argue that in addition to fiscal stabilization and intergenerational savings roles, African SWFs should act as development funds in financing productive investment in long-term structural transformation.

Many countries in Africa implemented financial sector reforms as part of structural adjustment programmes in the 1980s and 1990s. The debate on whether financial liberalization leads to an increase or decline in savings is unresolved in the African context. Asiedu et al. (2022) assesses the impact of financial liberalization on private savings in sub-Saharan Africa using cross-country panel data and finds no discernible effect of financial reforms on private savings in the continent.

Athukorala and Suanin (2022) examine the experience in Asia, which has done better than other developing regions in having high domestic savings rates.

They argue that there is no evidence that a prior phase of promoting savings through specific policy initiatives was critical to Asia's success in mobilizing savings and that rapid economic growth was a primary factor in initiating the savings transition in the region.

The WIDER project on domestic savings in sub-Saharan Africa provides four implications for policymakers.[3] First, to exploit the vast potential of fintech in mobilizing financial savings in the subregion, there is a need to create a competitive ecosystem and infrastructure that facilitate entry, develop robust consumer protection regulations to provide an enabling and innovative environment, and build capacity to monitor and prevent cybercrime, especially in terms of office-level surveillance.

Second, interventions are needed to accelerate capital market development. They include sustaining efforts to ensure the stability of the capital markets to build investor confidence through strict enforcement of the laws, regulations and rules governing them; having a constantly stable and conducive macroeconomic environment to incentivize investments; developing and implementing focused policies to support the growth of micro, small and medium-sized enterprises so as to enhance their listing attractiveness; implementing prudent and comprehensive policies that support the development of capital markets and their timely review; and growing a vibrant private sector, which is necessary to support the development of capital markets, by designing effective approaches to exploit the benefits anticipated from trade agreements.[4]

Third, to grow and develop pension systems in sub-Saharan Africa, necessary interventions include putting in place a universal non-contributory pension scheme that meets the needs of the unemployed among the working-age population and workers in the informal sector; offering incentives such as a matching contributions or some guaranteed insurance cover if a certain level of contribution is reached by a member in a given period, to motivate members to save more for old age; and instituting a well-structured legal and regulatory framework to streamline the management of pensions funds and minimize costs of administration, especially for private pensions.

Finally, SWFs should act as national development banks to effectively finance productive investments for long-term structural transformation. An enabling

[3] For further details, see Ngugi and Sen (forthcoming).

[4] In addition, as UNCTAD (2023) notes, institutional investors, pension funds and SWFs are ideally placed to help finance clean energy in developing countries. But they often lack access to investment opportunities in developing countries (especially in Africa) because they are prevented from financing non-investment-grade projects. Therefore, enhancing exposure to developing countries and addressing concerns surrounding greenwashing are key priorities for the sustainable finance market.

environment needs to be created for such development funds, which involves full transparency, strong governance and the necessary analytical capacity to ensure that investments contribute to structural transformation.

4. Summary and conclusions

In this note, we discussed the determinants of investment and savings, focusing on domestic savings. In particular, we noted that domestic savings rates in sub-Saharan Africa lag behind those of other comparable regions. This is in large part because of the lack of well-developed capital markets and pension funds. Yet although sub-Saharan Africa has lagged behind other regions in mobilizing domestic resources for investment needs, there is large potential for policymakers in the region to enhance the rate of domestic savings so as to provide the necessary resources needed for financial independence, sustained economic growth, and the attainment of the Sustainable Development Goals.

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