Increasing Capital Flows to Africa

Cornell University
Emerging Markets Program Annual Symposium

Susan E. Rice
October 23, 2003

Good afternoon, Ladies and Gentlemen. Thank you, Dr. Ralph Christy, for inviting me to speak at this year's Emerging Markets Symposium. Although, I have spent very little time here, Cornell has a special place in my heart. I grew up listening to my father regale us with fond memories of his time at the University as a young Assistant Professor in the Department of Economics. Our family still owns a place here in Ithaca, and so in an odd way, this is something of a home-coming. Thank you again for having me.

I am pleased to share with you some thinking that several colleagues and I have done recently on Increasing Capital Flows to Africa. I was proud to serve on a distinguished Commission led by Former Export-Import Bank Chairman and Wall Street financier, Jim Harmon. The Commission's membership included twenty-eight leaders from North America, Asia, Europe and Africa with exceptional experience in business, finance, government, academia, nongovernmental organizations and international institutions.

We deliberated intensively and issued our final report in June, entitled a *Ten Year Strategy for Increasing Capital Flows to Africa*. It can be found on the web at: www.iie.com.

What I'd like to do now is review in some detail its main premises and conclusions. With your indulgence and the permission of our Chairman, I will borrow liberally from the text of the report. Then, I will briefly give you a sense of some other thinking going on in Washington on this topic and, finally, touch on some possible next steps for advocates and U.S. policy-makers.

The Context

Let me begin with the context. Despite its 800 million people and vast natural resources, Africa's potential is frequently overshadowed by crises, conflicts and chronic poverty. As a result, it is not a primary destination for global and, especially, American, capital. But without significant amounts of new capital, Africa's development objectives will not be achieved.

Africa is a continent with great challenges, tremendous opportunities and unappreciated accomplishments. Since 1990, for example, 42 of 48 countries in Sub-Saharan Africa have held multi-party elections, and most Africans today have the right to choose their leaders at the ballot box. On the other hand, Africa has fallen behind the rest of the developing world in many dimensions of development. Life expectancy has decreased and the average

African is poorer today than he or she was two decades ago. The number of people living in poverty has also increased steadily during the past twenty years. Though it represents more than 10 percent of the world's population, Africa attracts less than one percent of all international private investment.

Africa's challenge is underscored by compelling but contradictory facts. HIV/AIDS is ravaging the continent, accounting for the bulk of the world's 6,000 new infections each day. Yet, Senegal and Uganda, have made major strides in reducing their HIV incidence rates.

On the one hand, according to recent World Bank findings, investors reaped higher returns in Sub-Saharan Africa last year than in any other part of the world. On the other, the World Economic Forum recently reported that the international investment attracted by all of Africa's 53 states is slightly less than the amount attracted by Singapore.

These broad trends, nevertheless, mask significant differences across the continent. While some countries remain mired in conflict and economic stagnation, nearly a dozen have achieved economic growth rates of 5 percent or more for the last five years, including Mozambique, Tunisia, Senegal, Uganda, and others. This past year Ethiopia and Rwanda also grew at more than six percent. Overall, Africa's growth in 2002 averaged 3.2%, down from 4.3% in 2001.

In an increasing number of countries, there are successful, profitable and export-oriented private investments. These include Senegal's mango exports, cut flower exports from Uganda and Kenya, Ghana's electronic data entry, Mozambique's aluminum smelter and Mauritius' backoffice services. Due to the African Growth and Opportunity Act, there are more people today working in Lesotho's private sector than its public sector.

These successes suggest new opportunities for external capital to generate attractive returns and for some African countries to emerge as examples – both political and economic – that can provide leadership for the rest of the continent to follow. Nevertheless, despite important progress in some parts of Africa, the continent still suffers from a perception of risk that in many cases is greater than warranted. As a result, even those African countries that have made significant strides in improving their investment climates experience difficulty attracting substantial new investment.

U.S. Interests

Why does this matter to the U.S.? The U.S. has significant economic and national security interests in Africa. Our interests extend well beyond historical and cultural ties or the important humanitarian and moral imperative to help lift the world's most under-developed region out of poverty and despair. While the U.S. shares many of these interests with its G-8 and OECD partners, U.S. leadership is essential for ensuring that these interests are secured. Two broad areas of interest are worth highlighting: economic and security.

Economic Interests: Four out of every five new consumers now come from the developing world. Soon one billion of them will live in Sub-Saharan Africa. In 2002, U.S. exports to Sub- Saharan Africa were 46 percent greater than those to all the former Soviet republics (Russia included), 47 percent greater than to India, and nearly twice those to Eastern Europe. U.S. exports to South Africa alone were larger than U.S. sales to Russia, whose population is more than 3.5 times as large. These numbers grow even larger after adding the countries of North Africa.

Over one hundred thousand U.S. jobs are tied to exports to Africa, which already buys at least $6 billion of American products annually. Yet, the U.S. share of the African market is small - 3 - only 7.9 percent, suggesting significant growth *potential* for the U.S. in the years to come. For this market to reach its potential, the U.S. share must not only grow but so must the market itself. Such growth can be enhanced through increasing capital flows to Africa.

In addition to Africa's potential as a consumer market, U.S. economic interests include access to Africa's valuable resources. Africa supplies over 16 percent of our imported crude oil, and it is estimated that within the next decade an estimated 20 percent will come from Africa, rivaling the Persian Gulf region. Africa accounts for nearly half of the world's production of bauxite, chrome, diamonds, more than half of its cocoa and platinum, and nearly three-quarters of its cobalt.

Security Interests: Even more important and immediate are U.S. national security interests in Africa. Africa is the world's soft under-belly for global terrorism. Porous borders, weak law enforcement and security institutions, plentiful and portable natural resources, disaffected populations, conflict zones, and fragile and failed states have made some African countries into increasingly attractive safe-havens and breeding grounds for Al-Qaeda and other global terrorist organizations. The 1998 embassy bombings in Kenya and Tanzania, last year's attacks in Mombasa, Kenya, and, most recently, in Morocco are vivid reminders of such groups' penetration of the continent.

Africa's fragile and impoverished states are among the weakest links in the U.S. war on terrorism. Without increased stability, economic opportunity and democratic progress, these states will grow increasingly vulnerable to exploitation by terrorist and criminal organizations and will remain substantial security liabilities for the U.S. The American people, therefore, have a compelling national security interest in strengthening African economies and democratic institutions in part to increase African countries' will and capacity to be strong partners in the war on terrorism.

The Challenge

Africa needs dramatically increased volumes of capital, especially investment capital, if it is going to achieve the sustained economic growth necessary to alleviate poverty and establish stable, democratic institutions. A substantial body of research suggests that there is a

correlation between foreign direct investment (FDI) flows and economic growth, especially when there is an educated work force and hospitable conditions for investment.

Africa has not done well in attracting FDI. In 2000, global flows of FDI soared to a record $1.3 trillion but dropped by 43 percent to $735 billion in 2001.

In Sub-Saharan Africa, the volume of capital inflows fell from $8 billion in 1999 to $6.5 billion in 2000 and remained relatively stagnant in 2001. The region's portion of global FDI flows is about 0.7 percent. The largest portion of this investment went to Africa's extractive sectors (mainly oil and minerals), which tend to have a less pronounced impact on productivity and income growth than investments in other sectors such as manufacturing and services.

So, how to improve Africa's performance? Let me clarify that, despite our multinational composition, the Commission focused on steps the U.S. can take to spur increased capital flows to Africa. The Commissioners, however, are well aware that this approach, at best, tackles only one 4 side of the equation. On the other side are the crucial reforms that African governments need to take to attract capital to their countries. These include privatization, tax reform, enactment and enforcement of effective anti-corruption and anti-money laundering laws, protection of property rights and creditors' rights, effective private sector regulation, and bureaucratic streamlining. African states must also improve the domestic environment more generally to make it easier for Africa's own entrepreneurs to succeed.

Many African leaders, in government, business, media and other sectors have taken up this challenge and begun to take the necessary steps to create these conditions. NEPAD, the New Partnership for African Development, reflects the recognition by African governments that they must improve governance, transparency and stability in order to induce donors, international businesses and others to bridge the tremendous gap that exists between Africa and the rest of the world.

It is too soon to know how and in what ways NEPAD will succeed. Nevertheless, our Commission strongly endorsed NEPAD's vision of a compact predicated on the idea that as Africa undertakes critical political and economic reforms the West must respond with substantial new public and private resources.

However, official development assistance (ODA), including World Bank lending, will not be sufficient to facilitate Africa's integration into the global economy. Africa needs more private capital, more investment and more linkages to global markets to achieve its development goals and to free up development assistance for other pressing needs.

A Ten Year Strategy

The Commission's proposed strategy incorporates over 30 recommendations in the areas of trade liberalization, tax and investment policies, export credit, development

assistance, privatization, debt relief, NEPAD and its focus on peer review, small and medium enterprises, and building Africa's human capital.

We are steadfast in the view that this strategy must be implemented over a period of at least ten years to give Africa the temporary advantage that has at times been afforded to other regions and which we believe will allow Africa the opportunity to begin to catch up. We are also well aware that Africa's circumstances are not homogenous, and one approach will not work everywhere. Nevertheless, we believe that our recommendations provide the basis for encouraging new capital flows and investment to many countries in Africa, and can thus contribute to fighting poverty and encouraging economic growth across the continent.

The Commission's Key Recommendations

Allow me to highlight the Commission's key recommendations:

1. *African Growth and Opportunity Act (AGOA)*

The African Growth and Opportunity Act (AGOA), the landmark piece of legislation signed into law by President Clinton in 2000, is only an initial step in liberalizing trade between the United States and Africa. AGOA was designed to stimulate light manufacturing in Africa, and has achieved early success. Between 2001 and 2002, all AGOA imports to the U.S. increased 10 percent, while apparel imports more than doubled. Transportation equipment exports from AGOA 5 countries increased 81 percent over 2001, and agricultural products grew 38 percent. Unfortunately, the benefits have not been evenly distributed, with Nigeria, South Africa, Gabon and Lesotho accounting for more than 90 percent of AGOA duty-free benefits.

There is also concern that AGOA's benefits will be diluted as the U.S. government seeks to negotiate free trade agreements with other regions such as the Middle East and Central America. The time has come both to rectify AGOA's shortcomings and to build on its early success to help stimulate additional investment and economic growth in Africa.

Several limitations inhibit qualifying countries from benefiting fully from AGOA. First, each country's eligibility must be reviewed annually, and second, the regime expires in 2008. Third, apparel imports remain subject to tariff rate quotas, or duty-free caps, as well as restrictions on the source of fabric. Finally, textiles and many other goods are excluded from AGOA benefits.

So, the Commission recommended several steps with respect to AGOA:

-- First, the U.S. should immediately extend AGOA benefits until at least 2018, so that the current 2008 termination date does not act as a disincentive to investment.
-- Second, all products coming from Africa should enter the U.S duty-free and quota-free. The rules of origin permitting apparel exports from AGOA-eligible

African countries made from textiles manufactured outside Africa or the U.S. should also be extended for ten years.
-- Third, as is the case for Canada and Mexico under the provisions of NAFTA, African countries should be exempted from U.S. safeguard actions that restrain imports in sensitive sectors.
-- Fourth, country qualifications for AGOA should be presumed to last for ten years rather than being subjected to the current annual review process, which discourages investors. The President should retain authority to revoke a country's AGOA benefits under extraordinary circumstances.

2. *Agricultural Subsidies*

Africa's ability to attract capital and increase trade is adversely affected by the domestic agricultural subsidies provided by the United States and the European Union. U.S. agricultural subsidies are a major impediment to African agricultural exports, which would otherwise be a significant source of economic growth on the continent. These subsidies also run counter to U.S. claims that it favors a more open and fair global trading system. The 2002 Farm Bill significantly increased U.S. farm subsidies, creating even greater non-market advantages to U.S. farmers and leading to significant declines in commodity prices, especially cotton, much to the detriment of African farmers. European farm subsidies do even more damage. If the U.S. is serious about creating opportunities for Africans to connect to global markets, then we must address this issue.

The Commission recommends that the U.S. accelerate the reduction or elimination of industrialized countries' agricultural subsidies, particularly those contained in the U.S. Farm Bill and the EU's Common Agricultural Program, in advance of the conclusion of the WTO's Doha Development Round. This action is especially urgent, however politically difficult, in the wake of the bust-up in Cancun. Cancun's failure underscores the need for the U.S. to speed the successful conclusion of the Doha Round.

3. *Free Trade Agreement*

The original AGOA legislation envisioned an eventual free trade agreement (FTA) with Africa. The Bush Administration, to its credit, has begun negotiations for a FTA with the five nations that comprise the Southern Africa Customs Union (SACU). This is a good step but doesn't go far enough. The U.S. vision should be bolder and extend beyond the SACU countries. Other regional organizations such as COMESA, SADC and ECOWAS have also begun to create free trade areas to expand regional markets and facilitate the movement of goods, capital and services.

Our view is that the Administration should set the goal of creating within ten years a U.S.- Africa Free Trade Area, building on ongoing African efforts to create regional markets. We should also increase technical assistance to regional organizations to strengthen their capacity to negotiate and implement free trade agreements.

4. *Tax Policy*

To provide additional incentives to spur new U.S. investment in Africa, we recommend bold but affordable changes to the U.S. tax code. Specifically, Congress should

change to zero the tax on repatriated earnings on *new* investments by U.S. companies in Africa for a period of ten years. This time-limited exemption would apply to bona fide FDI income earned by a registered subsidiary or branch of a U.S. company doing manufacturing or service business in Africa.

This is not a new idea. Congress established a precedent with the Puerto Rico Tax Incentives Act of 1998. A similar incentive would increase the return on U.S. investments in Africa and lower the risk that many potential investors now perceive. Because many OECD countries do not tax their companies on foreign earnings, a zero tax on repatriated earnings would also make U.S. companies more competitive in Africa.

We can afford to do this at a modest cost. Total repatriated income derived by all U.S. firms in Africa in 2000 was $3 billion. As an outside estimate, U.S. tax revenue on the repatriated income would not exceed 10 percent of the $3 billion, or about $300 million annually.

For this measure to have its maximum impact, it would have to be taken in conjunction with tax reform in the recipient countries. By cutting corporate and withholding taxes and otherwise simplifying the tax system, African countries can attract more FDI and boost economic activity in a variety of manufacturing and service activities.

5. *Investment Policy*

There is much to be gained from making our official trade agencies more effective. Although Africa suffers from a lack of sufficient equity financing, the Overseas Private Investment Corporation (OPIC) – the principal U.S. government instrument that supports non-extractive foreign direct investment in Africa - is prevented by statute from providing much of this financing.

Originally established to promote development by insuring foreign direct investment against political risk, OPIC’s authorizing legislation has become so restrictive that it does not – and currently can not – insure foreign direct investment in labor-intensive manufacturing and assembly projects of the kind that would be most beneficial to Africa. OPIC is also forbidden from supporting “runaway investments” that result in the loss of a single job within the U.S. and is restrained from providing insurance or financial guarantees to investments in “sensitive sectors” such as textiles, apparel or agribusiness.

Research shows that outward investment from the United States can significantly increase the flow of U.S. exports to the economy where the investment is located – and thus leads to a greater number of higher-paying, export-related jobs at home. Enabling OPIC to fulfill its role more effectively could therefore benefit both Africans and Americans.

We recommend that OPIC be permitted to support investment in all sectors in Africa for ten years, including sectors currently categorized as “sensitive,” such as textiles and apparel, electronics, agribusiness and industrial products. OPIC should also be allowed to support investments that promise to provide net benefits for the U.S. economy, even if some U.S. jobs are lost.

6. ***Export Credit Agencies***

Parallel steps should be taken to enhance the role our Export-Import Bank can play in tandem with other export credit agencies (ECAs). The availability of long-term debt capital is essential to the growth of the private sector. In recent years, the export credit agencies of OECD countries have collectively provided approximately $70 *billion* per year in long-term credit for developing countries to purchase goods and services from OECD members. However, less than 5 percent of this amount has gone to Africa. Under the current OECD arrangement, ECAs can finance local costs for African projects only up to 15% of the export value – a limit that constrains financing for many important projects, especially in infrastructure and other sectors where local costs are high.

There are straightforward changes that can and should be made in order to increase the involvement of export agencies in Africa by expanding the availability of long-term debt capital. Specifically, we recommend that the OECD enable Export Credit Agencies to allow 20-year repayment terms (instead of the current ten years) for African projects and to raise the ceiling for local costs from 15 percent to 50 percent of the export value.

7. ***Development Assistance***

More U.S. assistance should be invested in developing Africa's human capital (especially health and education). A significant portion should be devoted to the establishment of long term, low-rate financing vehicles dedicated to small business in Africa as well as to the provision of technical assistance to these small enterprises.

D.A. funds should also be deployed creatively to help remove constraints on private investment and to strengthen national legislative, administrative and legal processes.

8. ***African Financial Fellowship Exchange Program***

At the same time, it is in the interests of our private sector to help build Africa's capacity to attract and sustain investment. Many African countries lack sufficient exposure to and experience in managing the instruments of international finance, capital markets and corporate transactions. The State Department recently launched a campaign to encourage African countries to obtain sovereign credit ratings, which are important to Africa's longer term economic future. Yet, there must also be a targeted and immediate effort to build Africa's knowledge of and linkage to global finance.

Thus, our commission recommends that, the U.S., in conjunction with other OECD governments and private sector entities, create an African Financial Fellowship Exchange Program. Such a program would second professionals with finance, capital markets, corporate finance or economic policy experience to African countries to work in public and private institutions for a certain period of time. In exchange, each participating African country would commit two individuals for training for up to two years at qualified investment or commercial banks in the U.S. or other OECD countries.

9. *Debt Relief*

On the matter of how to address Africa's debt burden, the Commission was divided. Members agree that the U.S. government should support an appropriate process to review the Heavily Indebted Poor Countries (HIPC) debt initiative and consider whether it is desirable to pursue proposals that go beyond it. However, pointing to the fact that HIPC and the Enhanced HIPC program have not enabled African countries to achieve debt sustainability, some Commissioners, I among them, argued for more specific measures. These include: capping debt service from all Sub-Saharan nations at 1 percent of GDP; providing accelerated debt relief for countries emerging from conflict or autocracy, and; the creation, by the U.S. and other G-8 members, of a contingency facility that would make supplementary relief available when a HIPC country encounters a severe debt deterioration due to exogenous events like a terrorist attack or commodity shock.

Ladies and Gentlemen, these are the broad contours of the Commission's most salient recommendations. In making them, we are well aware that increased private capital flows are but one of the many challenges that Africa faces. HIV/AIDS, conflict, poor governance pose even greater challenges. Yet, we remain confident that increased capital flows can contribute significantly to Africa's development, and that the U.S. government, together with the G-8 and OECD nations, could do much to stimulate and facilitate these flows. The budgetary costs to the U.S. of what we recommend would be modest, and more than offset as Africa becomes a stronger trading and investment partner. Moreover, these proposals would pay important dividends in terms of advancing U.S. humanitarian, foreign policy and national security interests.

Another Initiative

Separate from the work of the Commission but related in substance and intent are the efforts of a Washington-based group called the AGOA 3 Action Committee. Led by my former colleague, Rosa Whitaker, the first Assistant U.S. Trade Representative for Africa, and by former Congressman Jack Kemp, this bipartisan group of business, NGO and faith-based groups is proposing specific legislation to expand and extend AGOA. In many respects, it is less ambitious than the Commission's recommendations. In other ways, however, it is more so.

Because of the caliber of the people pushing this initiative and its substantive merits, this effort bears watching and supporting at least as a starting point, even if, in some respects, it may not go far enough. The AGOA 3 Action Committee is focused on simplifying as well as extending AGOA through at least 2020. They also propose renewing the crucially important third country fabric provision to enable poorer African countries to continue receiving AGOA benefits for apparel made with non-African and non-American fabrics after the expiration of this provision next September. They are not, however, calling for the duty-free, quota-free import of all African goods, including textiles, as the Commission has.

With respect to tax incentives for U.S. investment in Africa, the AGOA 3 Committee would exclude investments in the energy and mineral sector (a concept I am

personally sympathetic to) but also limit the tax break to investments in products that have a minimum 35% value-added to basic raw materials or to investment in infrastructure development and the service sector.

In three areas, the AGOA 3 Committee goes beyond the Commission's recommendations. Most notable is their call for the EXIM Bank, TDA and OPIC to be exempt from restrictions on lending, risk coverage, feasibility studies and related trade promotion activities in certain sectors (agribusiness, electronics and textiles) in AGOA eligible countries. This is a bold and important recommendation that bears support.

In addition, the AGOA 3 Committee calls for a number of valuable and specific steps to increase substantially U.S. assistance to remove phyto-sanitary and other barriers to expanded U.S.-Africa trade in the agricultural sector. They also usefully propose further technical assistance to build African capacity to take advantage of AGOA benefits as well as public-private partnerships to spur enhanced communication and transportation linkages between the U.S. and Africa. Taken together, these proposals have merit and complement, in many respects, the recommendations of the Commission on Capital Flows.

The Way Ahead

Finally, where do we go from here?

First, as you can discern, there is a need better coordination of substance and strategy among those in Washington working towards a common end: devising the optimal U.S. tools to increase capital flows to Africa, primarily through trade and investment. With some effort and patience, I am hopeful this can be achieved. The differences that exist are more tactical than strategic. The Commission opted to be bold and attempt to get a full loaf. In some respects, the AGOA 3 Action Committee, in deference to the political complexity of some of these issues, such as textile imports and agricultural subsidies, opted to aim for what they judge to be a more feasible outcome. Most of these differences, I believe, can be bridged sufficiently to allow friends of AGOA to craft the next generation of legislation in unison and with efficacy.

Next is the question of legislative strategy and timing. We are into an election season – the worst possible time to raise trade issues – especially in a sluggish economy. But, without Congressional action soonest to extend key AGOA provisions (e.g. third country fabric), they will expire next year. As a result of this uncertainty, potential investors will hedge and take their dollars elsewhere, thus undercutting much of the progress achieved to date under AGOA.

Therefore, the most effective strategy, I believe, is to press for quiet and minimalist Congressional action early next year to extend AGOA for at least ten years as well as the third country fabric provision. When Congress reconvenes after the 2004 elections, circumstances should be more conducive for serious consideration of the bolder and long-term recommendations set forth by the Harmon Commission and the AGOA 3 Action Committee. Taking a phased approach will also enable AGOA supporters to resolve their differences, rebuild and expand the constituency and educate Members of Congress.

If we succeed, then I am confident we all, Americans and Africans stand to benefit. I hope you will consider joining us in this effort. Thank you.