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Summary

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Section 1: Recent Developments and Trends

u Global output growth is projected to strengthen to 3 percent in 2014 115.671T/pments1 Tm 003 jETT1 1 Tf10 0 10

4 Composition of capital flows to Sub-Saharan Africa

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- Short-term debt flows
- Bank lending
- Bond flows
- Net portfolio equity flows
- Net FDI flows
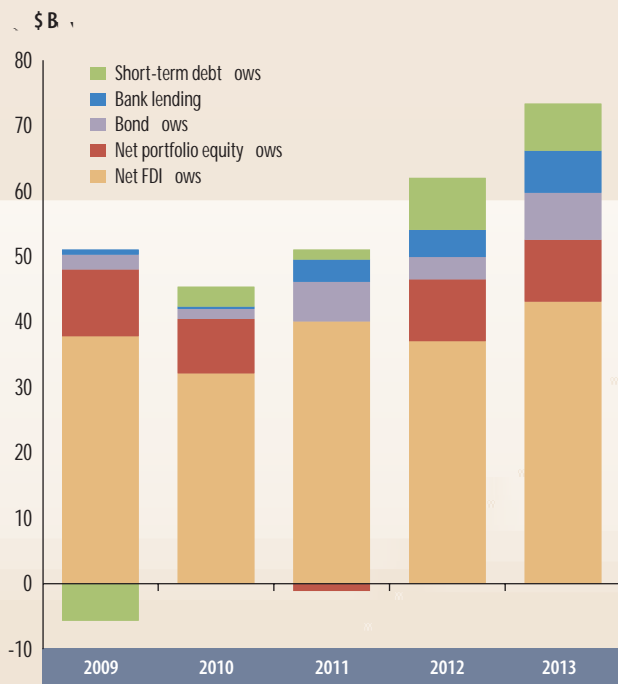
Source: World Bank.
Note: e = estimate.

5 Capital flows to Sub-Saharan Africa's frontier markets

US$ Billion   Percent
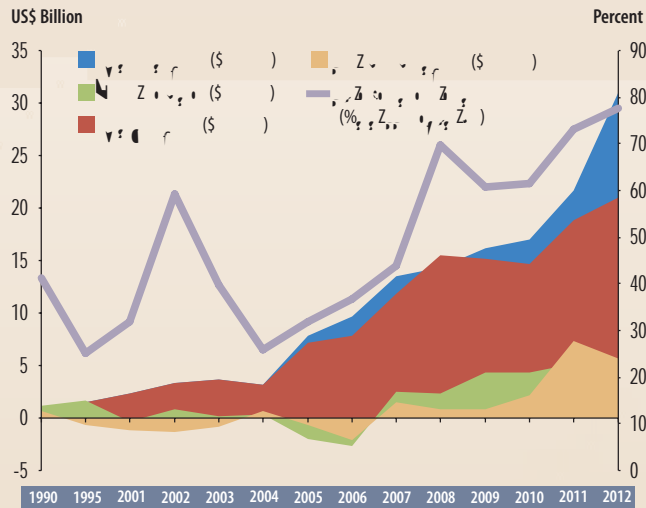
Source: World Bank.
Note: LT = long term; ST = short term.

Foreign direct investment (FDI) to Sub-Saharan Africa expanded more than 30-fold in the last 20 years, 7.5 times faster than in high-income countries and nearly 10 times faster than global GDP. Two investment trends emerge as central to driving this rapid FDI growth in Africa: (i) the extended commodities boom brought about by the unprecedented scale of development in Asia, and (ii) the massive expansion offshoring in global value chains (GVCs). For host countries in Africa, the new wave of FDI not only delivers investment and employment, but opens up new opportunities through deeper global trade integration. However, the extent to which African countries benefit from FDI depends on whether they are able to capture the productivity-enhancing "spillovers" of knowledge and technology.

Recent research (Farole and Winkler 2014) suggests the experience in Sub-Saharan Africa on achieving FDI spillovers has been largely disappointing. At the heart of the problem is that linkages between foreign investors and local economies—especially through supply chains—have remained limited in Africa. But there are some important differences hidden in the aggregate story.

First, some sectors may have greater potential for integration than others. Survey results indicate that while foreign investors purchase virtually no inputs from domestic suppliers in the apparel sector, local supply relationships are more extensive in mining and (not surprisingly) much more in agribusiness (figure 6). One of the main reasons for differences across sectors (especially between mining and apparel) relates to the sourcing strategies of foreign investors in the context of their global supply and production networks. In the apparel sector, local management in African host countries has very limited power over sourcing decisions, most of which are made by parent companies or by global buyers like Walmart and The Gap, which specify what and from whom to source fabric, buttons, and zippers. In mining, by contrast, most of the decision-making power rests with local management, although here, too, global procurement is increasingly encroaching (figure 7).

One positive feature of these findings is that, even in the apparel sector, foreign investors source the large majority of inputs locally (rather than importing them); it is just that often these are sourced from other foreign investors. This means that while local ownership does not increase, local jobs are still created. It also means there may be scope for local firms to take over these supply relationships in time.

Second, some countries appear to be doing better than others. While the survey sample may be too limited to generalize, the degree of local sourcing (and the use of local skilled labor) is likely to be linked closely to the capacity of local firms (and skilled workers), which is in turn partly a function of the depth of local markets. This suggests a "catch-22" situation, whereby generating productivity-enhancing spillovers is dependent on having

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Is Africa getting the most out of FDI? The challenge of generating productivity spillovers in a world of global value chains

a base of relatively productive firms and workers in the first place. Indeed, this is precisely what the study finds. Results from a large cross-country regression[a] show absorptive capacity is the most important factor mediating productivity spillovers from FDI. More specifically, firms that are relatively large, spatially clustered, export oriented, and technologically sophisticated are most likely to be affected by the presence of foreign investors.

Thus, generating spillovers from FDI is not easy, particularly for small economies with limited existing capacity. And in the context of GVC-oriented FDI, the scope for shaping and managing spillovers is increasingly limited. The research suggests, however, that governments have a role to play in facilitating spillovers. Much of this is long term and involves getting the "basics" of policies and institutions right, in particular investing heavily in education and skills development and supporting trade and financial market openness. Beyond this, however, the research suggests there are a number of things governments can do to deepen linkages and support the potential for spillovers in the short to medium term. It is important to note that local context should determine appropriate policies.

First, actions to expand supply chain and labor market linkages may be considered. One possibility is to promote (although not compel) joint ventures; an important finding from the cross-country regressions is that partly foreign-owned firms (joint ventures) are significantly more integrated into domestic markets than fully foreign-owned firms.
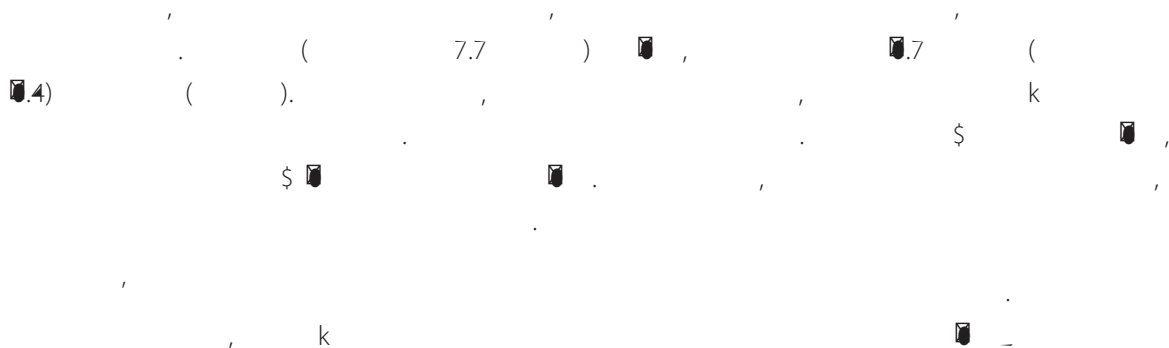
Second, governments can help overcome information gaps around local supply capabilities and align fiscal incentives used to attract foreign investors with the goals of building local supply capacity and local technical skills (including some level of conditionality). Governments can also improve the environment for domestic contract enforcement and other barriers to formal contracting with local suppliers. One interesting finding from the survey was that local suppliers that had formal contracts with foreign investors were 56 percent more likely to receive critical technical assistance from investors than those in more ad-hoc supply relationships.

Third, government can create an environment conducive to facilitating translating linkages into spillovers. An example might be incentivizing foreign investors to employ "appropriate technology"—the study productivity spillovers were greater when the technology gap between foreign investors and local firms was not too large. Another example might be promoting the provision of technical assistance, particularly around building quality capabilities of local firms, which was shown clearly to influence the capacity and performance of local suppliers.

Finally, the study suggests that programs to support linkages and spillovers need to take into account the heterogeneity of local firms, and therefore concentrate limited resources (at least initially) on relatively higher capacity, high-potential firms.

Source: Farole and Winkler 2014.
a. Covering 25,000 domestic manufacturing firms in 78 low- and middle-income countries from the World Bank's Enterprise Surveys over 2006–10.

Inflation

Inflation
decelerated in
Sub-Saharan
Africa in 2013
but inflationary
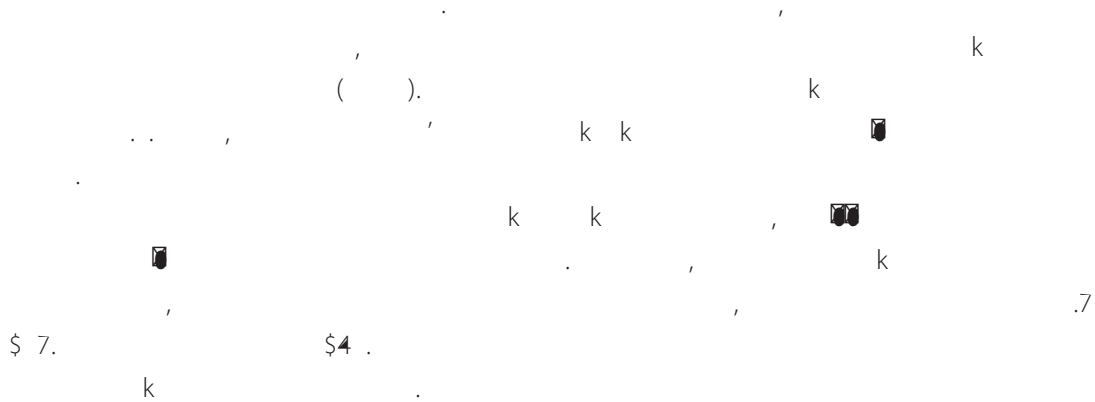pressures have
begun to
pick up

Source: W... k.
Note: Y/Y = year-over-year.

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The summer of 2013 was a turbulent period for many emerging markets, as "tapering talk" roiled these countries, leading to a sharp selloff in their equity and bond markets, and resulting in depreciation of their exchange rates. The impact across emerging markets was not felt uniformly though; some countries were affected more than others. The worst-affected countries, Brazil, India, Indonesia, Turkey and South Africa, since branded the "fragile 5," saw their exchange rates plunge by an average 12.2 percent, reserves decline by 6.4 percent, and stock prices decline by 5.9 percent.

A recent paper (Eichengreen and Gupta 2014) documented the effect of "tapering talk" on a large set of emerging markets and asked who was hit by the U.S. Federal Reserve's tapering talk and why.[a] Two key points emerged from this study. First, there is little evidence that the countries with stronger macroeconomic fundamentals (smaller budget deficits, lower debts, more reserves, and stronger growth rates in the immediately prior period) were rewarded with smaller falls in exchange rates, foreign reserves, and stock prices. Second, what mattered for the emerging markets was the size of their financial markets.[b] Investors seeking to rebalance their portfolios concentrated on emerging markets with relatively large and liquid financial systems. These were perhaps the markets where they could most easily sell without incurring losses, and where there was the most scope for portfolio rebalancing. Their analysis provided an obvious contrast with so-called frontier markets, with smaller and less liquid financial systems. The findings were a reminder that success at growing the financial sector can be a mixed blessing—while easing the financing constraints on developing countries, it can accentuate the impact of financial shocks emanating from outside.

A review of the changes in the nominal exchange rate during April–August 2013 for 40 African countries[c] shows considerable heterogeneity in outcomes, with the largest exchange rate depreciation experienced by countries with floating exchange rates (figure 10): South Africa (10.6 percent), Ghana (8.5 percent), Botswana (5.4 percent), Tanzania (5.2 percent) and Kenya (3.9 percent). Overall, the exchange rate changes in African countries were less marked than in the sample of emerging market countries from other regions

2
Tapering talk: The Impact on African Economies

in Eichengreen and Gupta (2014). Exchange rates depreciated in 55 percent of the emerging markets in other regions, and the proportion of such African countries was much smaller at 37 percent. The extent of depreciation in African countries was smaller, as well, with average depreciation at 2.9 percent compared to nearly 6 percent in emerging markets in other regions.
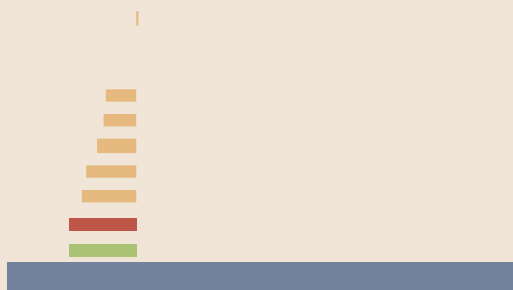
Note: CEMAC = Central African Economic and Monetary Community; WAEMU = West African Economic and Monetary Union.

RISKS TO THE ECONOMIC OUTLOOK
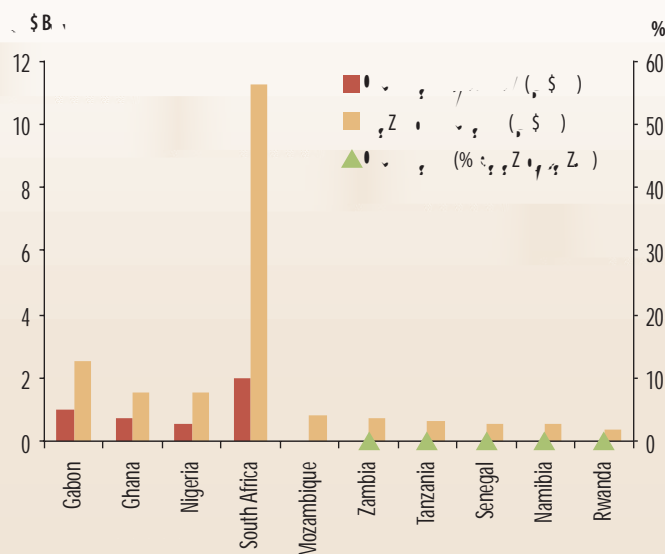
Lower commodity prices

Tighter lea… c…di…

3
Global interest rate shocks and debt vulnerability

Rising global interest rates can have an impact on both public and private debt in a country through a number of channels: (i) direct and indirect impact on interest rates on external debt, (iii) indirect impact on interest rates on domestic debt, and (iii) indirectly through valuation effects from exchange rate shocks. Which of these channels are important for African countries depends on the structure of their debt portfolio, their reliance on external or domestic financing, and their resilience to these shocks.

Many African countries borrow primarily on concessional terms from the main multilateral organizations. These loans typically carry fixed interest rates (or predetermined charges), which means that interest rate risk on these instruments is limited.[a] Similarly, most loans from bilateral lenders, whether from the Paris Club or not, are typically but not exclusively at fixed interest rates.

Some countries, however, have variable-rate external public and private debt, typically on a fixed spread over a market rate such as the LIBOR.[b] This means that any global interest rate shock is immediately transmitted through these loans. Apart from Zimbabwe, which is in a special situation, Angola, Botswana, Côte d'Ivoire, and South Africa have the highest levels of variable-rate external debt (figure 13).

Short-term external loans may have fixed interest rates, but since they need to be repaid fully within one

$B   **%**

12   60

10   50

8   40

6   30

4   20

2   10

0   0

Gabon Ghana Nigeria South Africa Mozambique Zambia Tanzania Senegal Namibia Rwanda

Attracted by relatively high interest rates compared to global rates, nonresident investors have increasingly entered a number of Sub-Saharan local government bond markets. Not all of these markets can be considered subject to global interest rate shocks though. Here the transmission channel of global interest rates is indirect. If nonresident investors do not reinvest in government securities upon maturity, the government may need to sell its bonds to domestic investors, and may need to offer higher interest rates to attract domestic and new nonresident investors. The speed of adjustment of domestic interest rates depends on the share of domestic debt maturing in the short term (or inversely on average time to maturity of the domestic debt portfolio). That is, the higher the share of debt maturing, the faster interest rates will adjust upward.

Data on nonresident participation in domestic markets in Sub-Saharan Africa are difficult to find, but available data suggest that South Africa has the highest participation (37 percent of outstanding domestic debt as of 2013Q2),[c] while in Uganda about 10 percent of domestic debt is held by nonresidents.[d] Furthermore, Ghana, Kenya, Nigeria, and Zambia may have significant nonresident participation.[e] In these countries, between 30 and 50 percent of domestic debt is rolled over every year.[f]

Once a nonresident investor decides not to refinance Eurobonds or domestic bonds due to better alternatives elsewhere, this will amount to a capital outflow, and may lead to pressure on the exchange rate. Any subsequent exchange rate depreciation will increase the domestic currency value of the all public or private loans in foreign currency, and increase the effective interest paid on these loans. The main risk is therefore the total size of external private and public debt relative to GDP.

A country's resilience to absorb interest rate shocks will depend on the extent of policy buffers, such as having relatively low public debt, sufficient fiscal resources, sufficient foreign exchange reserves to repay all external debt maturing in one year, and a well-aligned exchange rate. In addition, it is also important to have structural resilience, such as access to multiple sources of external and domestic financing on favorable terms; good currency match between assets and liabilities on the government, private sector, and household balance sheets; and sound debt management.

Prepared by Ralph Van Doorn:

a. The interest rate risk is not zero. These loans typically have a long amortization (repayment) profile, and in principle each time an amortization takes place, the government must choose whether to repay from the budget or refinance it. At that stage, there is both a risk that these funds are not available (refinancing risk) and a risk that the interest rate may be less favorable than before (interest rate risk). However, since individual amortizations are small relative to the size of the loan, interest rate and refinancing risks are small.

b. London Interbank Offered Rate.

c. Even when compared to other emerging markets. Only Hungary, Latvia, and Peru have higher participation (Arslanalp and Tsuda 2014).

d. World Bank Quarterly Public Sector Debt (QPSD) statistics; http://go.worldbank.org/9PIAZORON0.

e. It is known that nonresident investors can legally enter these markets, and there is anecdotal evidence that this is the case, but firm data are not available. The blog http://www.brookings.edu/blogs/africa-in-focus/posts/2014/02/07-africa-market-turmoil-sy quotes numbers obtained from Fitch and national authorities, roughly in line with the numbers for South Africa (IMF data) and Uganda (World Bank data), but they cannot be verified.

f. Data from recent Debt Sustainability Analyses (DSAs).

Following the 2007–08 global food crisis, food price volatility has been high on the international policy agenda. Volatility implies uncertainty and reduces a supply response. But not all volatility in food prices is uncertain. Some of it follows the annual production cycle. It is seasonal (and largely deterministic), with prices dropping after the harvest to gradually rise and peak just before the next harvest arrives.

Some seasonality in food prices is unavoidable given storage costs and the opportunity cost of capital. But imperfect capital markets (inducing sell-low, buy-high behavior among liquidity-constrained households), uncompetitive market structures, credit constraints for traders, and high transaction costs (e.g., due to poor infrastructure) may further push up the seasonal price gaps. As domestic food markets became more integrated, the topic of food price seasonality in Sub-Saharan Africa has garnered less attention by researchers and policy makers.

Some emerging evidence, however, points to continuing high seasonality in domestic food prices in the region. Using econometric time series techniques, Kaminski et al. (2014) study the domestic food price evolutions over the last 7 to 12 years (2000–12) across 100 marketplaces in three eastern and southern African countries (Malawi,ew0TmeDC BTAor tries tood priduction (.)ꢀJETEMC /Span ꢀMCID 964 ꢁDC BT/T1ꢂ 1 Tf9.5 09.5 5.53

evidence suggestive of a connection between food price seasonality and seasonality in food (and nonfood) consumption. Figure 16 shows the pattern for Tanzania (see Kaminski et al. 2014, for details). Both food and nonfood expenditures are in real terms (expressing quantities), and they track the share-weighted staple

Ghae i Sb-Sahaa Afica: De ic-dead die a dieed?

22 Expansion in aggregate demand in Sub-Saharan Africa by country groups, 1995–2012
(Cumulative variation since 1995, median growth)

Panel A: Fast-growing SSA countries　　　　　　　Panel B: Slow-growing SSA countries
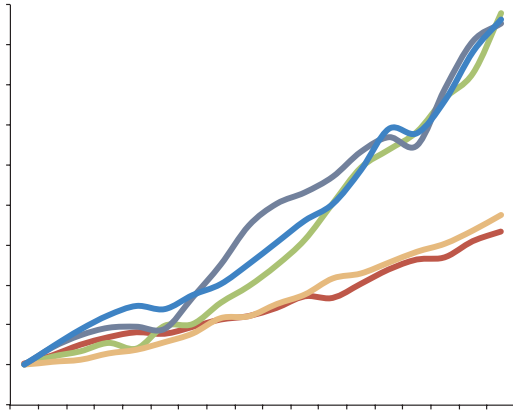
Panel C: Fast-growing resource-rich SSA countries　　　Panel D: Fast-growing non-resource-rich SSA countries

Source: World Bank.

Note: The data on the components of aggregate demand (household consumption, investment, government consumption expenditure, exports and imports) are expressed in U.S. dollars at 2005 prices.

Africa's growth has been fueled in part by its abundant extractive resources. Promoting sustainable

2 Fast-growing countries in Sub-Saharan Africa (Ongoing and new growth spurts during 1995–2012)

	Featu es f Ex ansi na y Phases		
C unt y Res u ces	Sta t	End	

2 Incidence of growth spurts in Sub-Saharan Africa and the developing countries, 1990–2012 (Number of episodes and percentages)

Panel A: Developing countries   Panel B: Sub-Saharan Africa
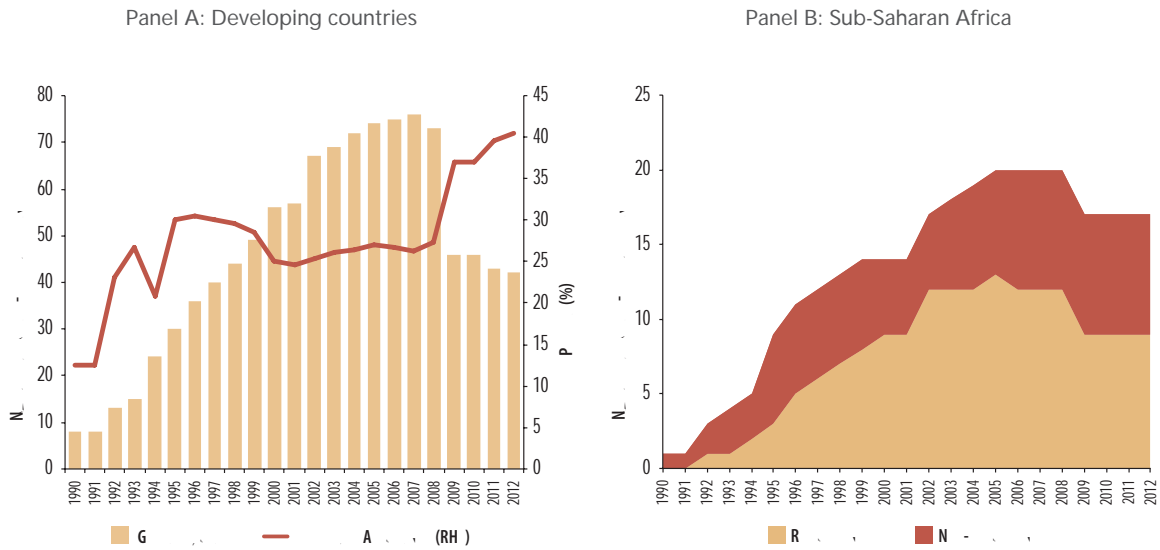
Source: World Bank.

Note: The figure depicts the number of countries experiencing growth spurt episodes each year from 1990 to 2012. The data on real GDP per capita used to compute these spurts are expressed in U.S. dollars at 2005 prices.

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**3** Mean features of growth spurts in Sub-Saharan Africa (In years and percent per year)

	Fast-gwing Develing Cunties	Fast-gwing SSA Cunties		
		All Cunties	Resuce Rich	Nn-Resuce Rich
Duration of the growth spurt (in years)				
Average	13.3	13.4	12.3	15.2
Std. Dev.	7.1	5.7	3.6	7.9
Median	12	11	11	18
25th percentile	9.0	9.0	9.8	8.0
75th percentile	15.0	18.0	15.5	20.5
Average annual growth in GDP per capita during spurt (%)				
Average	5.15	5.99	6.79	4.76
Std. Dev.	1.62	4.57	5.69	1.46
Median	4.76	4.64	4.92	4.39
25th percentile	3.83	3.47	3.47	3.46
75th percentile	5.96	6.54	6.69	6.26
Average annual growth in real GDP during spurt (%)				
Average	5.86	8.58	9.60	6.99
Std. Dev.	1.57	5.35	6.58	1.91
Median	5.67	6.80	7.65	6.61
25th percentile	0.05	0.06	0.06	0.06
75th percentile	0.06	0.10	0.10	0.09
No. Spurts	60	23		

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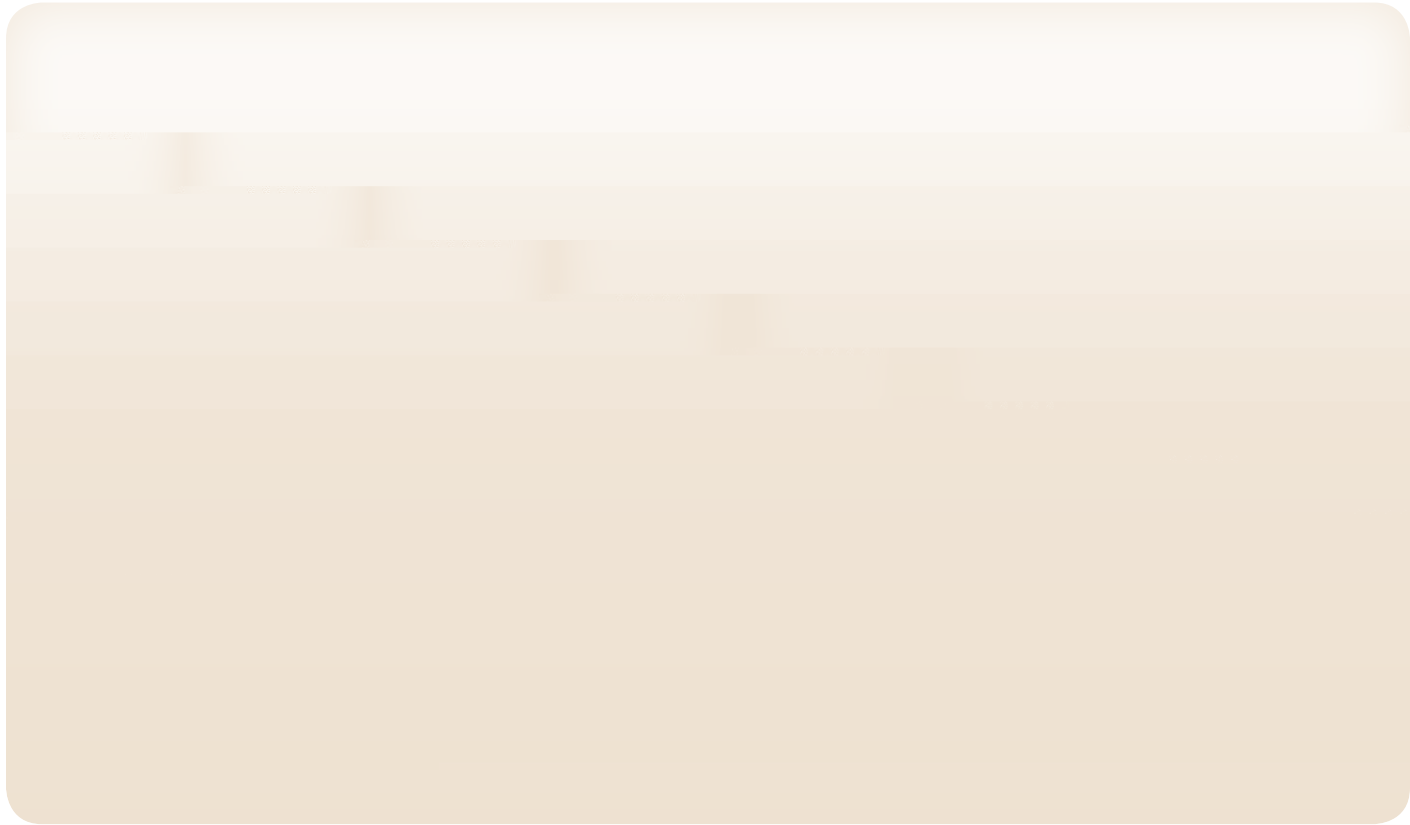
2 Shares of sector activity along growth spurts in fast-growing countries, 1995–2012

Period T (=1.0) is the peak in real GDP per capita previous to the start of the expansion

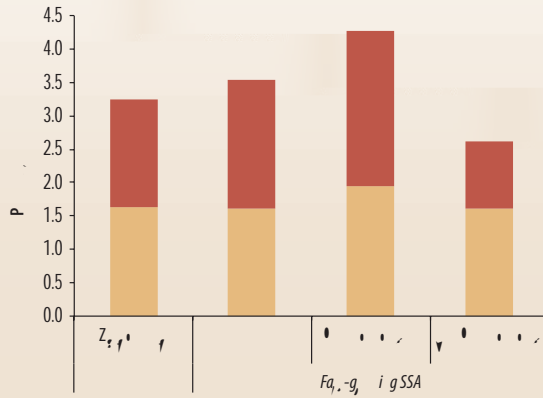Panel A: Fast-growing Non-SSA developing countries   Panel B: Fast-growing Sub-Saharan Africa

Source: World Bank.

Note: T is the trough in real GDP per capita identified using the Bry-Boschan algorithm to detect turning points applied to annual data. The figure reports the growth rate of the ratio.
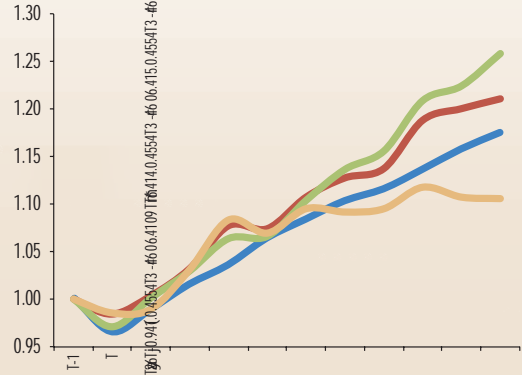
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31 Capital deepening and total factor productivity growth along growth spurts, 1995–2012

Period T (=1.0) is the peak in real GDP per capita previous to the start of the expansion

Panel A: Contribution to output per worker growth
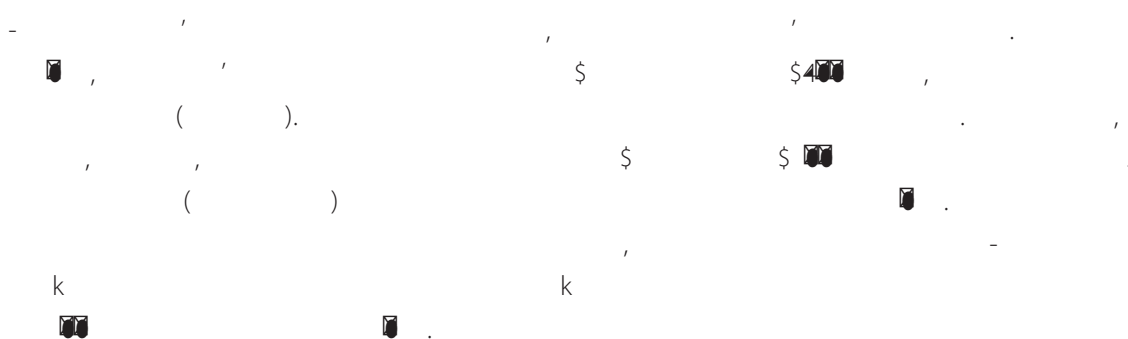
Panel B: TFP dynamics along the spurt

Source: World Bank.

Note: T is the trough in real GDP per capita identified using the Bry-Boschan algorithm to detect turning points applied to annual data. The data of output per worker, capital stocks, and the number of workers were taken from Penn World Tables 8.0 (Feenstra, Inklaar, and Timmer 2013). DEVC = Developing countries.
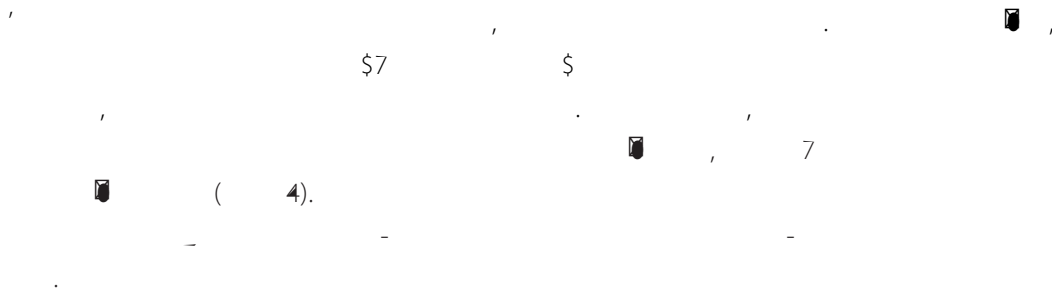
GROWTH AND TRADE PATTERNS IN SUB-SAHARAN AFRICA

32 Evolution of merchandise exports in Sub-Saharan Africa, 1995–2012

Source: WITS 2014.

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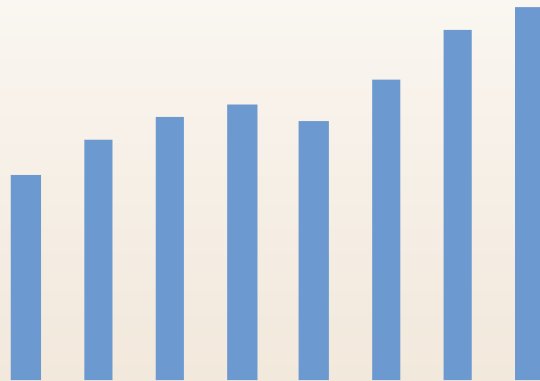
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(4).

4 Share of manufacturing exports in total merchandise exports

Manufactu ing ex ts (% f Me chandise Ex ts)	1995 (%)	2005 (%)	2012 (%)
East Asia & Pacific (developing only)	72	80	76
Europe & Central Asia (developing only)	22	23	21
Latin America & Caribbean (developing only)	39		

35 Size of the service sector in Africa, 2005–12

Source: World Bank.
Note: BOP = balance of payments.

Annex I. Detecting Turning Points with Annual Data

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Peak	t ‗
Trough	t ‗.

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u   *amplitude*   k ( )

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