Njuguna Ndung'u: Implications of capital flight for macroeconomic management and growth in Sub-Saharan Africa

Keynote address by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the Senior Policy Seminar on Implications of Capital Flight and Macroeconomic Management and Growth in Sub-Saharan Africa, South African Reserve Bank, Pretoria, 30 October 2007.

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Honorable Governors and Colleagues,
Honorable Ministers,
Honorable Ambassadors and Excellencies,
Representatives of external partners and institutions,
Ladies and Gentlemen,

I would first like to thank the South African Reserve Bank, and particularly, my colleague Honorable Tito Mboweni, for hosting this important and timely event on the **"Implications of Capital Flight for Macroeconomic Management and Growth in Sub-Saharan Africa"**.

I would also like to thank all my colleagues, and senior officials who have responded positively and are here to participate in the deliberations and contribute to the success of this important event, which has tremendous potential for investment, economic growth and more generally for the development of our continent.

Africa is often labeled as the capital-scarce region of the world; one that has been marginalized in the landscape of global capital flows. The latest statistics published by the World Bank flagship report **"Global Development Finance"** suggest that the region received less than 4 percent of net foreign direct investment (FDI) flows to developing countries in 2006. Interestingly the totality of these FDI inflows went to 5 countries (Angola, Equatorial Guinea, Nigeria, South Africa, and Sudan), all of which are oil and mineral-rich. So these FDIs went to extraction sectors. The region is also lagging on the remittances, receiving just 4 percent of total remittances to developing countries – by far the smallest share. The average in other regions is in excess of 25 percent.

As a result of chronic shortage of capital, investment prospects have been delayed, leaving the majority of countries in the region undiversified, commodity-dependent, and highly vulnerable to terms of trade and exogenous shocks. Over the years, most of these countries have been confronted with chronic balance of payments crises, and relied on external debt to bridge their ever growing financing gap. However, the accumulation of external liabilities over time took Africa's external debt to unsustainable levels, when it reached the critical threshold of US$230 billion, about 45% of GDP in the 1990s. And as external debt continuously increased, so did debt service payments whose high costs undermined investment and growth potential even further.

Paradoxically, the accumulation of external liabilities in the region is mirrored by massive outflows of resources in the form of capital flight – **the voluntary exit of private residents' own capital for safe havens away from the continent**. The latest estimates published by UNCTAD suggest that capital flight from Sub-Saharan Africa is fast approaching half a trillion dollars, more than twice the size of its aggregate external liabilities.

But why capital flight problem, just when the policy directions are clearer now than they were 10 years ago in most SSA countries?

The costs of this financial hemorrhage have been significant for African countries. In the short run, massive capital outflows and drainage of national savings have undermined growth by stifling private capital formation. In the medium to long term, delayed investments in support of capital formation and expansion have caused the tax base to remain narrow. Naturally and to the extent that capital flight may encourage external borrowing, debt service payments also increased and further compromised public investment prospects. Furthermore, capital flight has had adverse welfare and distributional consequences on the overwhelming majority of poor in numerous countries in that it heightened income inequality and jeopardized employment prospects. In the majority of countries in the sub-region, unemployment rates have remained exceedingly high in the absence of investment and industrial expansion.

By way of illustration, at the height of the Latin America debt crisis in the 1980s, Nicolas Brady, then US Treasury Secretary, who advocated policies to stem and reverse capital flight in response to that crisis, especially emphasized its costs for the US economy. In particular, he said, "As many as 400,000 new jobs could be created in the US economy if Latin America could achieve a 50 percent reduction in current debt service." Sure enough, employment prospects would have been even higher in the source region if approximately 50 percent of flight capital was used to fund productive investments there, instead of flying to "safe havens".

For us Central Bankers, massive outflows of resources pose serious challenges for exchange rate management and monetary policy, especially for the majority of undiversified countries in Sub-Saharan Africa, which rely on hard currency for most imports. Most of my colleagues here, and especially the few who have gone through it, know how difficult monetary and exchange rate management becomes when foreign reserves go down to just a handful of months of imports.

Interestingly and in spite of these costs, capital flight has continued to grow unabated in the region, including during the HIPC era, when the severely indebted countries were acceding to debt relief under the Enhanced HIPC Initiative. In particular, capital flight estimates between 1999 and 2004 are about US$80 billion, with more than US$35 billion recorded in 2003 in constant US dollars, the largest single annual outflow over the decades following independence. An annual outflow of this magnitude suggests that capital flight indeed remains a serious problem in the region and may undermine HIPC's effectiveness and its potential impact for domestic resources mobilization in support of investment and economic growth.

However, over the past few years, the costs of this hemorrhage for Africa's development have become more apparent within the international community. This renewed interest at the global level has been partly motivated by the growing welfare and income gap between Sub-Saharan Africa and the rest of the developing world, with the majority of countries slated to miss the MDG targets. In December 2000, the UN General Assembly adopted a resolution 55/188 in which it called upon countries to cooperate through the United Nations system by devising ways and means of preventing and addressing the illegal transfer of assets and repatriating illegally transferred funds. And last month in New York, the United Nations Office of Drugs and Crime and the World Bank jointly launched the Stolen Assets Recovery (STAR) Initiative.

This recent attempt to address the long-standing financial hemorrhage undermining Africa's economic growth and development at the global level, and particularly within the UN platform, is indeed an important starting point, underlying the need for shared responsibilities in the face of persistent lopsided financial flows. Indeed, while massive resources have been fleeing African countries, their final destination has been outside African boundaries. Just last month, over US$30 million owned by one of the Nigerian Governors were frozen in London.

In light of these developments, this Senior Policy Seminar on Capital Flight organized in Africa, is relevant and germane to the growth and development challenges facing the majority of countries in the continent. In this regard, I would like to thank the different organizing institutions which have invested immensely into the planning and organization of this event.

I would also like to congratulate the organizers for putting together a very comprehensive agenda, going beyond the nitty gritty of central bankers' immediate concerns – implications of capital flight for monetary policy and macroeconomic volatility – to address other key issues such as:

- the causes and determinants of capital flight;
- estimation of capital flight and methodology;
- the link between external debt and capital flight;
- implications of capital flight for capital market development;
- implications of capital flight for banks and corporate performance;
- implications of capital flight for investment;
- the theoretical foundation of capital flight;
- mitigation of capital flight through institutional strengthening;
- expected benefits of capital flight repatriation;
- implications of current international financial architecture for capital flight.

I very much welcome the focus of this learning event on the role that the international financial architecture has played in the current asymmetric flows of resources from capital-scarce regions of the developing world, and especially from Sub-Saharan Africa to higher-wage areas in the more advanced economies. In particular, more than just emphasizing the safe haven nature of the destinations to which the scarce resources from Sub-Saharan Africa are flowing to, I would like to urge experts and scholars attending this conference to discuss the role that the bipolar international currency landscape dominated by the dollar and more recently the Euro has played in encouraging capital flight from Africa.

I also welcome the emphasis on capital repatriation and institutional policies and measures to stem capital flight. In the face of the continued marginalization of Africa in the landscape of global capital flows, the success of the region in achieving robust and long-run economic growth very much depends on its ability to generate sufficient resources for long-term investments. In this regard, the massive infusion of resources through a repatriation of a sizable or even part of the half a trillion US dollars that escaped for safe havens via the capital flight channel could play a great deal in supporting investments in critical areas, including infrastructures, telecommunications and education.

Harvard University is often praised for the size of its endowment, which, in excess of US$20 billion dollars, is one of the largest in the world. How many Harvards could be established in this continent to create the critical mass of world-class engineers and scientists, and intellectual leaders needed to advance Africa's development, expand industrial output and enhance employment creation in the era of knowledge from the half a trillion US dollars stored by a handful of Africans in save havens?

Several world-class institutions could be established and thousands if not millions of jobs created from it, especially if repatriated funds were indeed used for productive investments and economic growth and not for consumption, which may further erode the current account. As concerted efforts are underway to recover stolen assets under the STAR initiative, I would like to urge the participants to this Seminar to undertake a comprehensive analysis of the expected benefits of capital flight repatriation, but also the potential risks and risk mitigation strategies associated with such an effort.

Additionally, I welcome the emphasis of the seminar on the possible causes of capital flight. Over the past few years, a number of economists have singled out portfolio diversification motives, political and macroeconomic instability, particularly conflicts and macroeconomic volatility, fiscal deficits and expected devaluation of local currencies as some of the main causes of capital flight. However, recent data which suggest that capital flight has continued to grow unabated even in recent years, where fiscal deficits and macroeconomic volatility have been jugulated, suggesting that there may be other determining factors, particularly, corruption and poor governance.

Let me illustrate this point further by taking you all the way to the America, to Haiti, the first Black Republic in the world. Prior to its independence in 1804, William Pitt, the UK Prime Minister, referred to Haiti as the **"Eden of the Western World"** for its wealth and production. Then, Haiti's production accounted for more than one third of France's foreign trade, and its own foreign trade equaled that of the newly born United States. The Haiti that was so much coveted a couple of centuries ago is certainly not the one we all know today. Why? It has become a country saddled with external debt burden, excess capital flight and recurrence of conflicts.

"The Haitian debt was accumulated not to finance productive investments, but to finance the government's patronage employment and large military and police forces. Corruption has been endemic, so there is a suspicion that some of the proceeds of foreign loans found their way into the pockets of the rulers and foreign bank accounts. This is a description of Haiti's experience in the 90s." However, the 90s to which these facts refer are not the 1990s, but the 1890s.

I do not believe that there is a fatality in the path to underdevelopment or poverty trap for countries located below the tropics as a number of economists have alluded to in the literature on post-conflict and economic geography. Many countries in the developing world, including Africa, have gone through the cycle of external indebtedness, corruption and capital flight, and external debt in a continuing loop. However, in the midst of all this, countries in Asia and Latin America have succeeded in escaping the infinite loop. Remember the East Asian Tigers, and emerging market economies in Latin America, Chile and Argentina. I believe there is a way out of this loop for African countries and hope that the deliberations coming out of this seminar will identify concrete policy options and proposals to support ongoing efforts to stem capital flight and enhance repatriation in support of investment and economic growth across Sub-Saharan Africa; so that Africa in 3007 is not the mirror image of Africa in 2007; the one which has rightly or wrongly been associated with corruption, capital flight, HIPC and poverty.

In wishing successful deliberations to all the delegates, I hereby declare this seminar open.

Thank you all.