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Financial Flows

The Financial Flows scenario

Kouassi Yeboua and Jakkie Cilliers

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The Financial Flows scenario

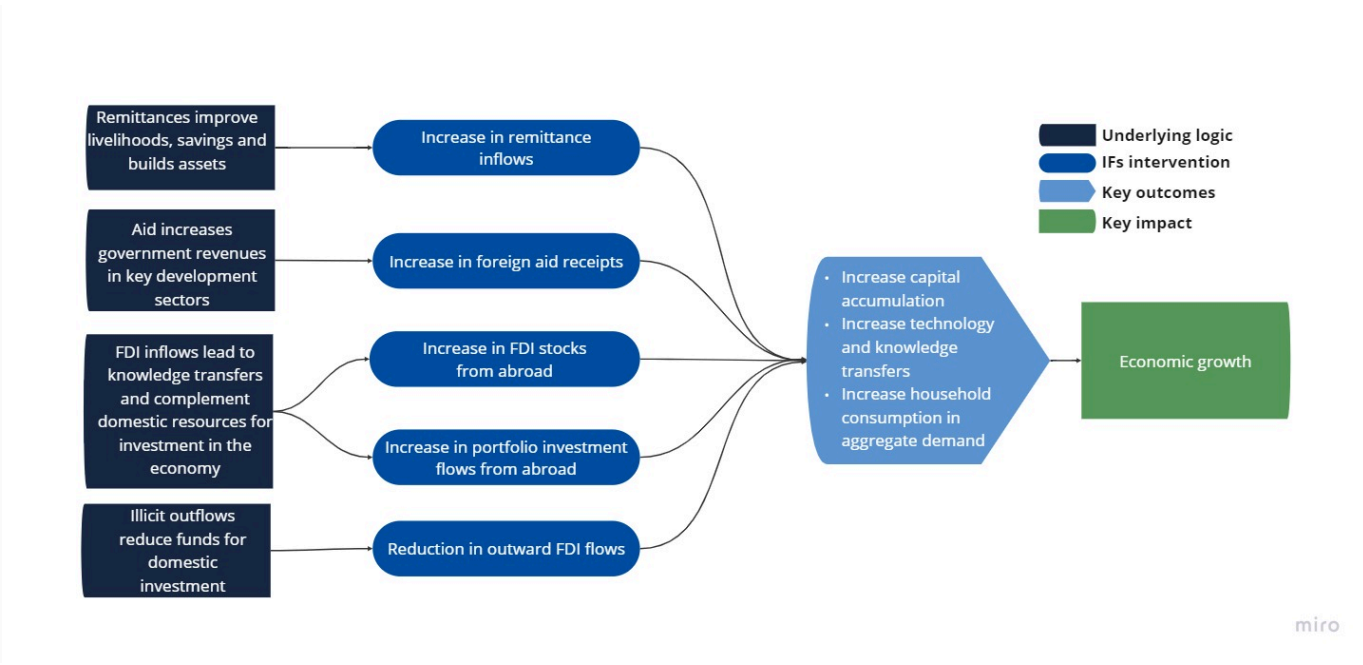
Briefly

The impact of external financial flows on recipient countries has been a subject of extensive debate in the literature. Proponents of capital inflows assert that they promote economic growth, especially in developing countries, because they complement domestic resources, supplement domestic savings, close the foreign exchange gap and guarantee modern technology and the availability of managerial skills. Others argue that foreign capital inflows, aid in particular, are detrimental to economic growth because they often become a substitute rather than a complement to domestic resources and because it is generally consumption oriented rather than investment oriented. Furthermore, foreign inflows support the importation of inappropriate technology, alter domestic income distribution and embolden a bigger, inefficient and corrupt government in developing countries.[1]

In this section, we model the impact of a Financial Flows scenario on Africa's long-term development trajectory using the IFs modelling platform. It includes ambitious but reasonable increases in aid, FDI and remittances, and illicit financial flows from Africa. IFs does not model illicit financial flows as there is no global dataset or substantive methodology to estimate its extent, although UNCTAD and the UN Office on Drugs and Crime (UNODC) recently finalised a conceptual framework to measure illicit financial flows that will eventually contribute to producing global data estimates.[2] For the purpose of this scenario, we reduce outward FDI as a proxy for illicit financial flows. In 2019, outward FDI flows from Africa amounted to US$4.9 billion, with outflows from Libya being the largest (US$1.7 billion).[3]

The logic underpinning our Financial Flows scenario is presented in Chart 15.

Chart 15: Financial Flows scenario



Impact of the Financial Flows scenario

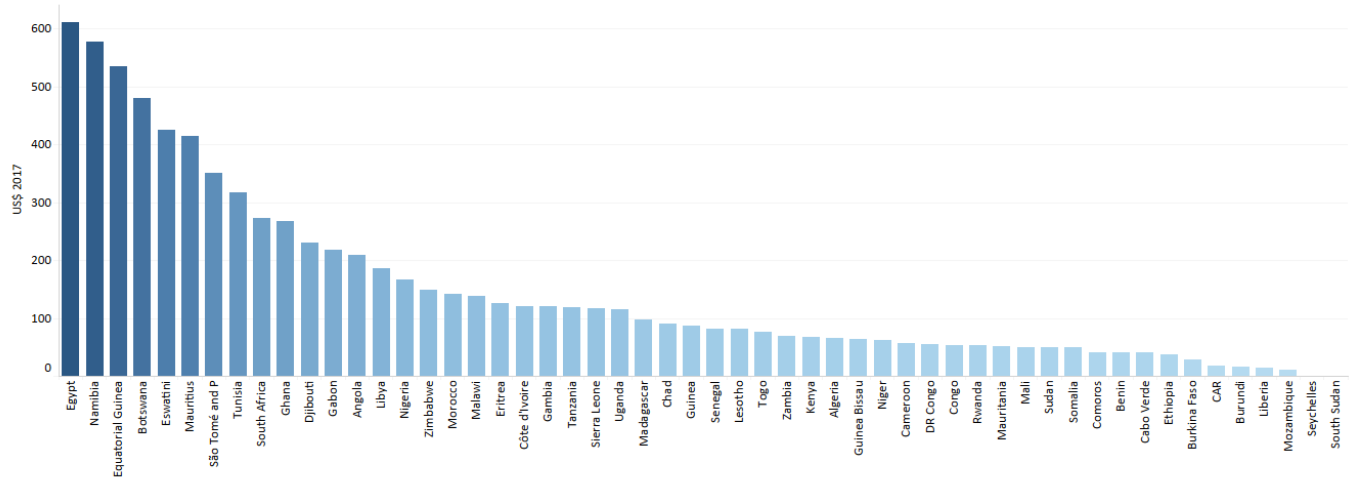
In 2019, FDI inflow in Africa was equivalent to 1.7% of GDP and is set to increase to 3.8% of GDP by 2043 in the Current Path forecast. In the Financial Flows scenario, inward FDI is forecast to increase to 4.9% of GDP—1.2 percentage points larger than the Current Path forecast. The result is that the stock of FDI is projected to be about US$4.3 trillion in 2043 compared to the Current Path forecast of US$3.3 trillion in the same year. The increase is large, yet Africa would still only have 4.9% of the global stock of FDI by 2043. An increase of such magnitude would, however, require more stability in Africa, improvement in the business environment, and likely the full implementation of the AfCFTA.

The Financial Flows scenario sees Africa receiving about US$8.7 billion more aid in 2030 than in the Current Path forecast. Instead of US$85.7 billion aid in 2030 in the Current Path, the final year of the SDGs, Africa is estimated to get US$94.5 billion in the Financial Flows scenario in the same year. Most of the additional funds would go to low-income countries, with Malawi, Ethiopia, Mozambique, the DR Congo and Somalia receiving the largest additional share. Remittances will increase to US$88.9 billion by 2043 in the Financial Flows scenario, compared to US$66.8 billion in the Current Path forecast.

Increased capital inflows into Africa will stimulate economic growth such that the size of the total African economy will be US$110.3 billion larger in 2033 than it would have been otherwise and US$371 billion larger in 2043. Large economies, such as Nigeria, Egypt and South Africa, benefit the most.

The average GDP per capita for Africa increases by approximately US$86 in 2033 and US$215 in 2043 compared to the Current Path forecast. This is a notable increase as the continent's total population will, by 2043, exceed 2.2 billion people. The improvement in GDP per capita for each African country is presented in Chart 16, with many upper-middle- and lower-middle-income countries doing particularly well in the Financial Flows scenario. This might be explained by their relatively better economic and institutional frameworks compared to low-income countries.

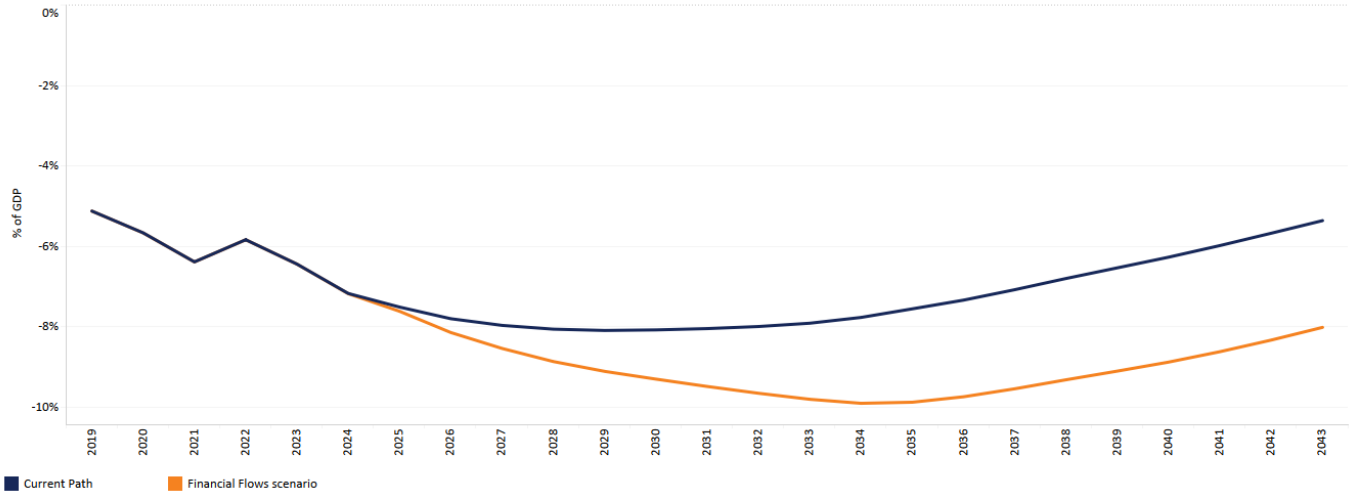
Chart 16: Increase in GDP per capita in the Financial Flows scenario relative to the Current Path in 2043



Source: IFs 7.84 initialising from IMF data

A large inflow of capital may appreciate the real exchange rate, which partially offsets the growth gains by reducing the aggregate demand through its effect on net exports (see Chart 17). A study by Combes et al[4] finds that in developing countries, a 1% increase in total financial flows appreciates the real exchange rate by 0.5%. Chart 17 shows the trends in net export (per cent of GDP) in the Current Path forecast and the Financial Flows scenario. The net export in the scenario remains below the Current Path over the forecast horizon. By 2043, the net export is estimated to be -8% of GDP (trade deficit) in the scenario compared to 5.4% on the Current Path in the same year. In addition to the real exchange rate appreciation, higher economic growth can also deteriorate the trade balance as it increases consumer spending resulting in more purchases of imports.

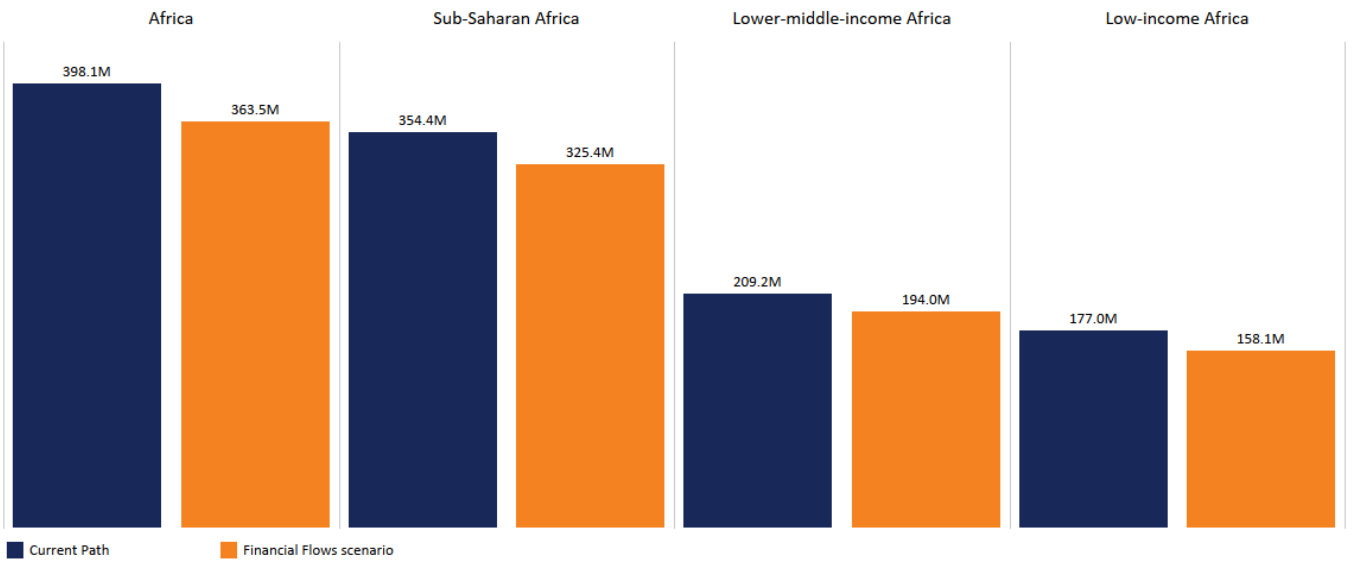
Chart 17: Net exports for Africa: Current Path vs. Financial flows scenario, 2019–2043



Source: IFs 7.84 initialising from IMF and WDI data

Compared to the Current Path forecast, the Financial Flows scenario reduces the number of Africans living in extreme poverty (using the US$1.90 benchmark) by 2033 by 16.6 million people and to 34.4 million in 2043. This translates to a poverty rate of 24.7% in 2033 and 16.2% in 2043 (Chart 18).

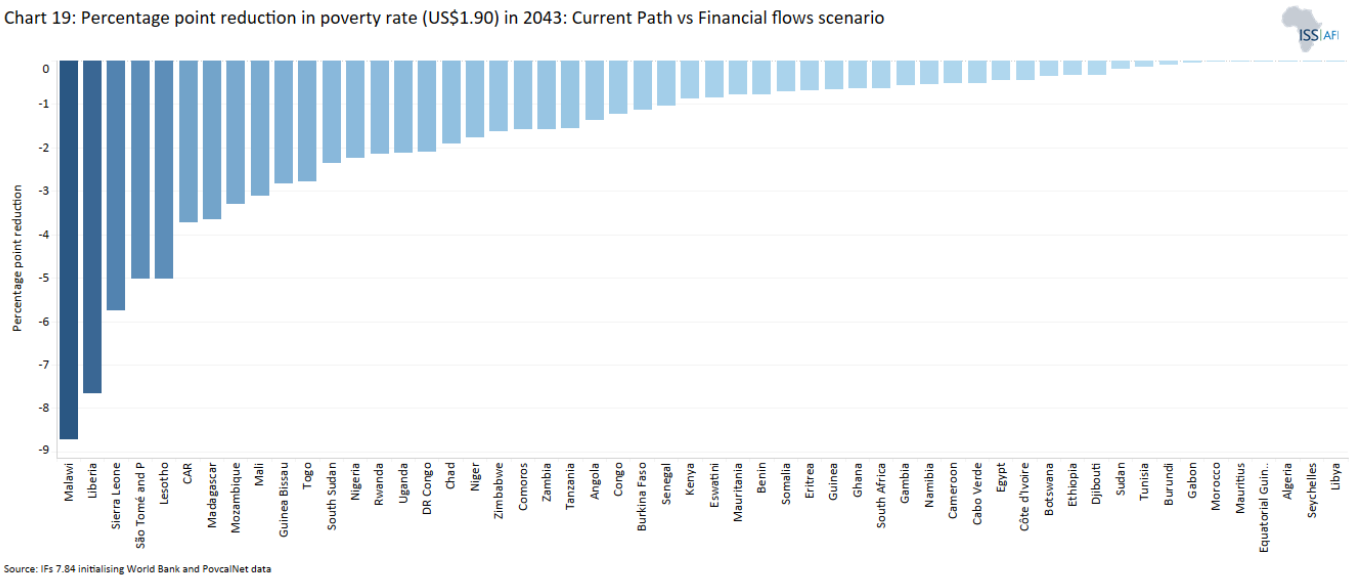
Chart 18: Absolute number of poor people (US$1.90) by 2043: Current Path vs Financial flows scenario



Source: IFs 7.84 initialising World Bank and PovcalNet data

As a percentage of the population, the largest poverty reduction is in Malawi (8.7 percentage points lower than the Current Path forecast in 2043), followed by Liberia and Sierra Leone. However, when considering the absolute number of poor people, Nigeria sees the biggest poverty reduction in the Financial Flows scenario by 2043 (8.7 million fewer poor people compared to the Current Path forecast), followed by DR Congo, Malawi and Mozambique. The extreme poverty rate at US$1.90 is already eliminated in countries such as Seychelles and Mauritius and in North Africa. As a result, the scenario has a marginal impact on extreme poverty reduction in these countries (Chart 19).

Chart 19: Percentage point reduction in poverty rate (US$1.90) in 2043: Current Path vs Financial flows scenario



Source: IFs 7.84 initialising World Bank and PovcalNet data

Compared to the Current Path, the Financial Flows scenario slightly reduces income inequality in Africa. Income inequality, as measured by the Gini coefficient, marginally declines in all the countries relative to the Current Path forecast by 2043 except in Botswana, South Africa, Republic of the Congo, Equatorial Guinea and Seychelles, where inequality slightly increases above the Current Path.

Endnotes

1. S Adams et al. The effects of capital flows on economic growth in Senegal, *The Journal of Applied Economic Research*, 11:2, 2017, 121–42.
2. The framework identifies four main activities that can generate illegal outflows, namely: illicit tax and commercial activities; illegal markets; corruption; and exploitation-type activities and financing of crime and terrorism. Strangely, it does not include a high tax burden, rampant inflation and political instability as drivers, although it does include aggressive tax avoidance (since it is empirically challenging to separate some of these from illicit activities); illegal tax and commercial practices; trade misinvoicing and abusive transfer pricing; criminal activities including the drug trade, human trafficking, illegal arms dealing and smuggling of contraband; and bribery and theft by corrupt government officials and their collaborators. Pilot projects using the new framework are underway in Afghanistan, Colombia, Ecuador, Mexico, Nigeria, Panama and Peru, and will contribute to producing global data estimates. UNCTAD, UN agencies finalise a framework to measure illicit financial flows, 21 December 2020.
3. UNCTAD online data.
4. J-L Combes et al, Financial flows and economic growth in developing countries, *Economic Modelling*, 83, 2019, 195–209.

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About the authors

Dr Kouassi Yeboua is a senior researcher in African Futures and Innovation programme in Pretoria. He recently served as lead author on ISS studies on the long-term development prospects of the DR Congo, the Horn of Africa, Nigeria and Malawi. Kouassi has published on various issues relating to foreign direct investment in Africa and is interested in development economics, macroeconomics, international economics, and economic modelling. He has a PhD in Economics.

Dr Jakkie Cilliers is the ISS's founder and former executive director of the ISS. He currently serves as chair of the ISS Board of Trustees and head of the African Futures and Innovation (AFI) programme at the Pretoria oce of the ISS. His 2017 best-seller Fate of the Nation addresses South Africa's futures from political, economic and social perspectives. His three most recent books, Africa First! Igniting a Growth Revolution (March 2020), The Future of Africa: Challenges and Opportunities (April 2021), and Africa Tomorrow: Pathways to Prosperity (June 2022) take a rigorous look at the continent as a whole.

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