Financial Flows

Comparing the impact of different inflows

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Last updated 17 April 2024 using IFs v7.84

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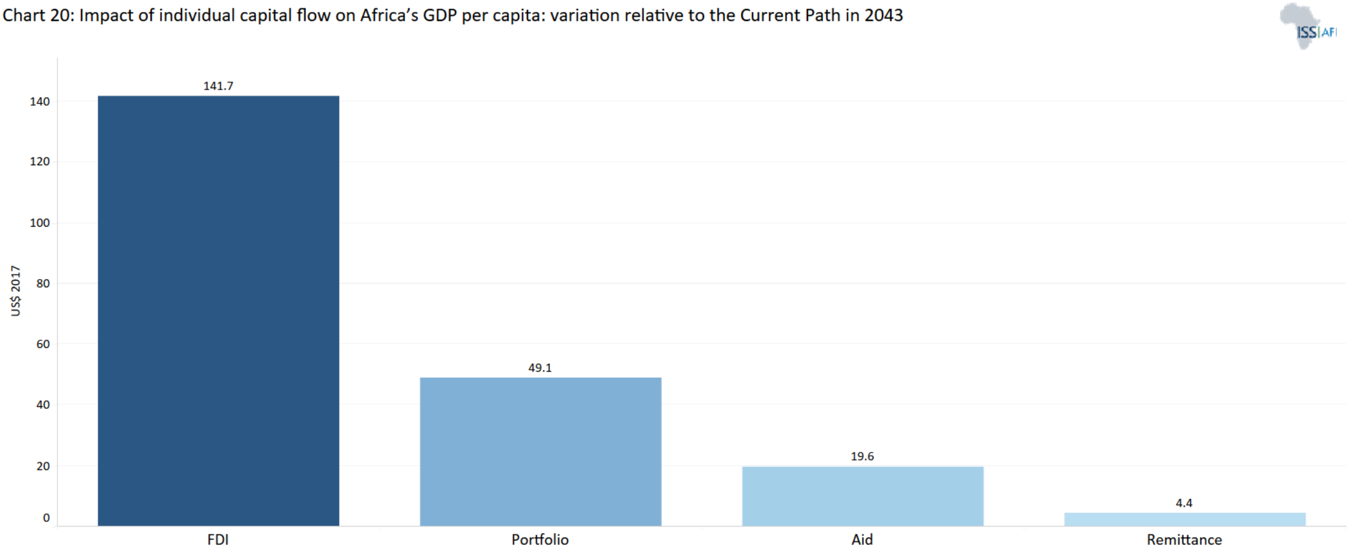
Thus far we have presented the combined effects of capital flows consisting of various components such as aid. However, different types of inward financial flows such as aid versus FDI are bound to affect economic growth and poverty differently. We extend our analysis by investigating the effects of each type of capital flow on Africa's socio-economic development prospects.

Chart 20: Impact of individual capital flow on Africa's GDP per capita: variation relative to the Current Path in 2043



Source: IFs 7.84 initialising from IMF data

Chart 20 shows that an increase in each type of financial flow (aid, remittances, portfolio investment and FDI) could improve Africa's GDP per capita above the Current Path forecast in 2043. The most significant improvement in GDP per capita would come from FDI, followed by portfolio investment flows, aid and remittance. The effect of aid, remittance and portfolio investment flows on growth and GDP per capita is much weaker than that of FDI.

By 2043, the increase in aid flows (to about US$100 in 2043) would improve Africa's GDP per capita by only US$20. The majority of the empirical studies provide no robust evidence of the aid–growth effect. Some studies have found that aid fosters growth in countries with good domestic policies but that it has no impact or a weaker impact in countries suffering from poor governance.[1] Poor governance in most African countries may explain the marginal impact of aid on growth and GDP per capita. In the presence of strong institutions that limit diversion and appropriation, aid can contribute to human capabilities and infrastructure development with a positive effect on growth. In their absence, aid may ameliorate their impact, essentially alleviating suffering, hunger and other effects of slow growth and poor governance.

An increase in remittance would improve Africa's GDP per capita by only about US$4 compared to the Current Path forecast in 2043. Several factors may explain this marginal effect. Remittances can boost growth by providing alternative resources to release financial constraints on domestic investments and consumption. However, the growth gain from remittances can be partially offset if it is spent on imported consumer goods rather than stimulating domestic investment or if they lead to an appreciation of the real exchange rate. Moreover, the 'brain drain' associated with a loss of productive capacity due to the migration of skilled workers can partially offset the positive effect of remittances on economic growth. Some argue that remittances may harm growth by reducing incentives for labour market participation.[2] Remittances may equally hurt growth in developing countries that are net remittance senders, such as South Africa, Côte d'Ivoire and Equatorial Guinea, among others, as they reduce the already low domestic resources available for investment. In this vein, a study by Konan and N'Zué[3] reveals that there is a certain minimum threshold beyond which each dollar remitted will harm economic performance in Côte d'Ivoire.

Increased international portfolio investment (debt and equity) would improve Africa's GDP per capita by US$49 above the

Current Path forecast in 2043. Foreign portfolio investments (FPI) are limited in Africa, especially in low-income African countries. Debt portfolio investments via corporate bonds, for instance, are typically invested productively in the real economy to increase productive capacities, which increase economic growth. However, the same benefits cannot necessarily be expected in the case of pure financial investment, such as equity portfolio investment. In contrast to FDI, FPIs are short-term financial flows and are more liquid, thereby offering investors a chance for quicker returns on their money—or a quicker exit. As such, they can have a destabilising effect on the host economy as they quickly depart the country of investment whenever there is uncertainty or negative news.

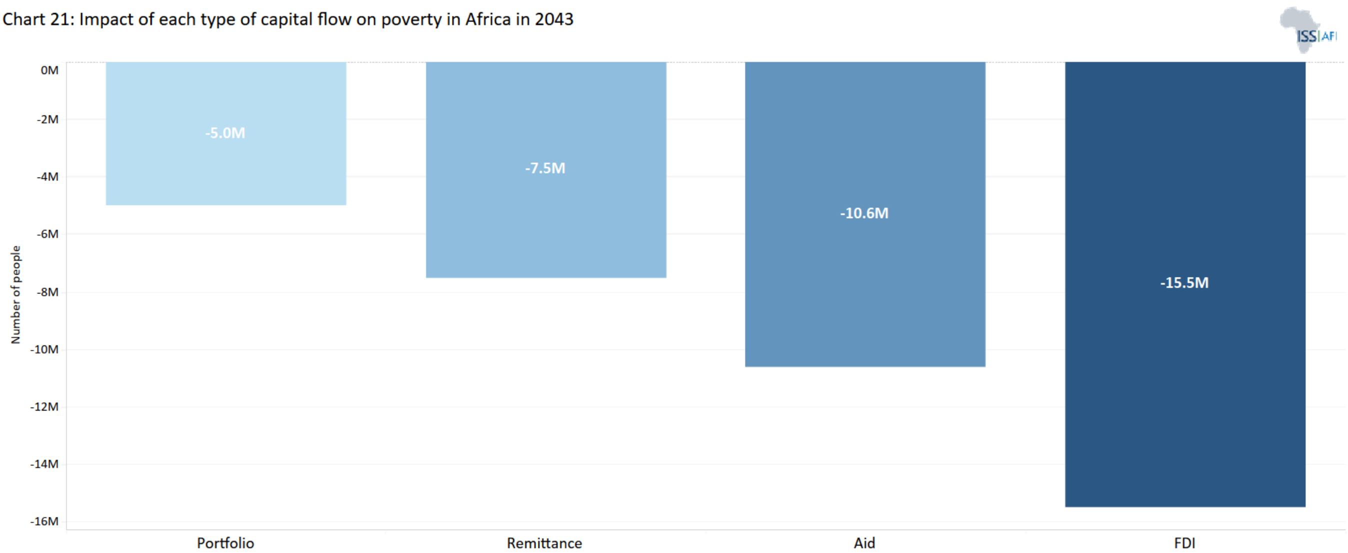
Compared to other types of capital flows, policies to attract more FDI will have the biggest impact on Africa's development prospects by far. An increase in FDI flows to Africa would increase the continent's GDP per capita by US$142 above the Current Path forecast. Transnational corporations, through their FDI activities, fuel economic growth and development because they contribute to capital accumulation, the transfer of superior technology and management skills in the host country.

The impact of each type of capital flow on GDP per capita also varies according to the income groups in Africa. For the upper-middle- an d lower-middle-income groups, FDI has the most significant impact on GDP per capita, followed by portfolio investment flows, while aid and remittance have the lowest impact compared to the Current Path forecast in 2043.

As for the low-income group, FDI has the most significant impact on GDP per capita, followed by aid, while remittance has the lowest impact in 2043, compared to the Current Path forecast in 2043.

As shown in Chart 21, an increase in all types of capital flows could reduce poverty in Africa, and FDI would probably have the most significant impact on the long-term well-being of African populations.

Chart 21: Impact of each type of capital flow on poverty in Africa in 2043



Source: IFs 7.84 initialising from PovcalNet and World Bank data

An increase in FDI flows to Africa could reduce the number of poor people on the continent to 383 million in 2043 instead of 398 million in the Current Path forecast—in other words, 15.5 million fewer poor people than on the Current Path in 2043. FDI reduces poverty through the direct channel by creating jobs in the private sector. Jobs created by FDI in host countries can be particularly good jobs and help in knowledge and technology transfer. These jobs directly reduce poverty, and the knowledge transferred can also enable indigenes to further create more jobs. However, for FDI to directly reduce poverty through job creation, labour-intensive manufacturing FDI is required. The effects of FDI on poverty reduction thus depend on the type of inflow. More labour-intensive manufacturing FDI, such as in the case of Asian countries, could significantly reduce poverty in Africa.

More recent studies suggest that for aid to reduce poverty, it should be targeted at the right programmes and objectives, including social expenditure on health and education.[4] Remittances directly augment the income of those households that receive them, and they are a crucial lifeline for many people, especially in low-income countries.

The impact of each type of capital flow on poverty varies according to the income groups in Africa:

- For the upper-middle-income group, FDI has the most significant impact on poverty, followed by portfolio investment flows, while aid and remittance have the lowest impact compared to the Current Path forecast in 2043.
- For the lower-middle-income group, FDI has the most significant impact on poverty reduction, followed by remittances, while aid has the lowest impact in 2043 compared to the Current Path.
- As for the low-income group, aid has the most significant impact on poverty reduction, followed closely by FDI, while portfolio flow has the lowest impact in 2043, compared to the Current Path forecast in 2043.

Overall, the Financial Flows scenario shows that increased external financial inflows into Africa could promote growth and reduce poverty with aid being particularly important to reduce poverty in low-income countries and FDI for others.

Endnotes

1. C Burnside and D Dollar, Aid, policies, and growth, *American Economic Review,* 90:4, 2000, 847–68.
2. R Chami et al, Macroeconomic consequences of remittances, IMF Occasional Paper No. 259, 2008.
3. SY Konan and FF N'Zué, Should countries' restrict remittances outflow? Evidence from Côte d'Ivoire, *Migration and Development*, 11:2, 2022, 233–51.
4. J Page and A Shimeles, Aid, employment and poverty reduction in Africa, *African Development Review*, 27:S1, 2015, 17–30.

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Kouassi Yeboua and Jakkie Cilliers (2024) Financial Flows . Published online at futures.issafrica.org. Retrieved from https://futures.issafrica.org/thematic/10-financial-flows/ [Online Resource] Updated 17 April 2024.

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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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