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The Long Squeeze: Funding Development in an Age of Austerity

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The Long Squeeze: Funding Development in an Age of Austerity

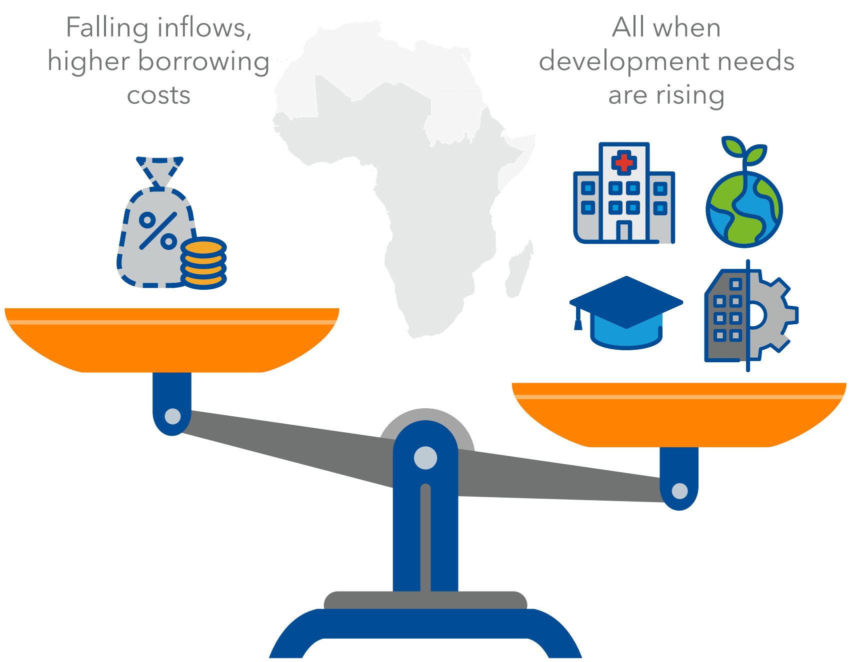
Sub-Saharan Africa is only now emerging from a series of unprecedented global shocks and is still in the grips of an acute funding squeeze. On the positive side, global inflation is receding, and international financial conditions are starting to ease. But the underlying funding challenge may still endure—the crisis has demonstrated the risks of relying on volatile private capital markets for development funding, while other traditional sources such as official development assistance and bilateral lending are shrinking.

Funding for development seems likely to become increasingly scarce and ever more costly, making it more difficult for countries to sustain even current levels of per capita spending on priorities such as health, education, and infrastructure, much less increasing the spending required to meet the Sustainable Development Goals.

But the region is far from powerless. More patient and less pro-cyclical private investment inflows remain a critical and underused resource, and there is significant scope for the region to accelerate investment-climate reforms while carefully considering the role of added public incentives.

Ultimately and most important, domestic resource mobilization is the key to sustainable development. Boosting public revenues is clearly vital. But expanding the pool of private saving is also essential, and to this end, promoting financial market development and financial inclusion should also be a priority.

As development funding becomes increasingly scarce and more expensive, countries must do what they can to even the balance.



Hopes and reality: a crisis in development funding?

Eight years ago, 193 United Nations member states approved the Addis Ababa Action Agenda, a wide-ranging agreement on development funding that was to provide critical support for the 2030 Sustainable Development Goals (SDGs). While recognizing the importance of domestic resources and private finance, the Addis Agenda also stressed the need for the international community to recommit to official development assistance (ODA) targets and called for greater cooperation in financing key investment needs, such as energy, transportation, water, sanitation, and climate.

Much of that agenda remains unfinished. Instead, many developing countries, especially in sub-Saharan Africa, now find themselves in the grip an acute funding squeeze. Many traditional sources of finance have been sharply constrained, and even more recent sources, such as bilateral lending from China, seem to be falling rapidly (see analytical note "At a Crossroads: Sub-Saharan Africa's Economic Relations with China"). In private capital markets, higher interest rates and depreciating currencies have raised debt-service costs and reduced access to new funding—all at a time when development and humanitarian needs have increased (April 2023 *Regional Economic Outlook: Sub-Saharan Africa)*.

Beyond the immediate impact, the squeeze also threatens to undermine longer-term development. Unlike major advanced economies, sub-Saharan Africa entered the recent series of crises with limited fiscal space, hampering policymakers' ability to mount an effective response. With insufficient funding, authorities were less able to protect their most vulnerable during the worst of the crisis and were forced to divert resources from critical development sectors such as health, education, and infrastructure, curtailing the region's growth prospects.

A concern is that this funding challenge might endure. Global inflation is improving, and global financial conditions may follow, but the world is still becoming more volatile, with increasingly larger shocks that seem to arrive more frequently. This has clear implications for risk premiums and borrowing costs and underscores the dangers of relying too heavily on funding from international capital markets, where flows are often sharply procyclical, and development spending is left vulnerable to sudden shifts in global sentiment. Sustainable development requires access to stable, sustainable, and long-term oriented sources of development funding, and these are becoming increasingly rare.

Patterns and trends: a persistent funding squeeze?

Domestic savings in sub-Saharan Africa are structurally low, limiting the region's ability to finance its pressing development needs locally. At 19 percent of GDP on average between 2011 and 2020, savings rates in sub-Saharan Africa slightly outperform those in emerging and developing Latin America and the Caribbean (18 percent of GDP) but are less than half the savings rates in emerging and developing Asia (39 percent of GDP). The young age of the populations in sub-Saharan Africa partly explains why savings rates are low (for each 100 working-age inhabitants, an additional 78 inhabitants are younger than age 15), but other factors contribute to this reality, such as limited access to formal financial services.

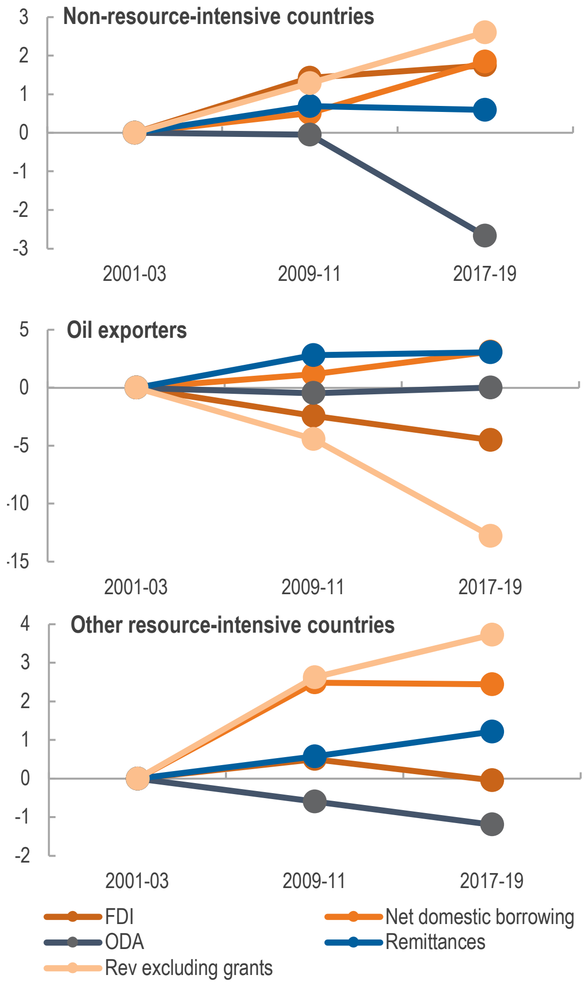
As a result, investment across the region is somewhat constrained, which subsequently shapes the region's ability to meet its SDG targets. The investment ratio in sub-Saharan Africa averaged 21 percent of GDP between 2011 and 2020, well below the ratio of 37 percent seen in emerging and developing Asia.

External Sources

External sources of development funding have declined. ODA flows to the region have dropped significantly, from almost 4 percent of regional GDP in 2001–03 to about 2½ percent in 2017–19. Aid inflows increased sharply in 2020 but dropped back down to precrisis levels in 2021. Moreover, this decline for sub-Saharan Africa may continue. In 2022, although global ODA flows increased by 15 percent compared with 2021, a large portion reflected support for Ukraine and donor spending on hosting refugees. ODA flows to sub-Saharan Africa actually declined by 8 percent in real terms (see OECD 2023). Average inflows of foreign direct investment (FDI) grew in line with GDP before 2015 but have dropped in the period since, largely because of the 2015 commodity price crash (Figure 1).

Remittances have increased over the past 20 years and have become a major source of external development finance. From less than 1 percent of GDP during 2001–03, they have more than doubled in importance. Reflecting the growing dynamism of the African diaspora, these private flows have helped provide beneficiaries with a critical buffer against both domestic and international shocks. But remittances differ from more traditional sources of development finance. They are often directed at households and small businesses, often in the unbanked informal sector, and thus are not readily available for investment in large development projects.

Figure 1. Sub-Saharan Africa: Funding Sources
(Change since 2001–03, percent of GDP)



Sources: Organization for Economic Cooperation and Development; World Development Indicators; and IMF staff calculations.
Note: ODA = Official development assistance; FDI = Foreign direct investment.

Domestic Sources

Domestic sources still represent the largest share of sub-Saharan Africa's development funding mix, largely financing development spending principally through using government revenues and domestic borrowing. In 2021, for example, countries in sub-Saharan Africa raised $257 billion in taxes, more than five times the amount of ODA received. The role of each funding source differs from country to country, but the relative importance of domestic sources is a key feature across the region (Figure 2).

In this context, domestic funding sources are low by global standards and can be volatile for commodity producers. Between 2017 and 2019, government revenues represented 16 percent of GDP, a 2½ percentage point decline compared with 2009–11, partly because of the sharp drop in oil-related collections in 2014. By contrast, revenue in other emerging markets and developing economies stands at about 28 percent of GDP and 40 percent in advanced economies.

Options and policies: funding development in an age of austerity

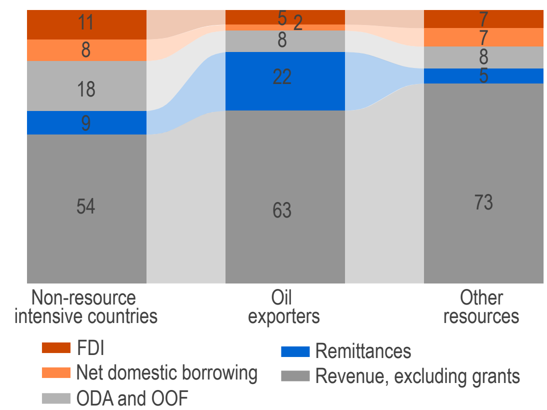
Short-Term Measures

Countercyclical and targeted support. As traditional funding flows have declined over the past decade or so, the only alternative sources have been from international capital markets and new sovereign creditors such as China. In normal times, the cost of servicing this mostly nonconcessional borrowing might be manageable. But the onset of multiple crises has highlighted the need for higher volumes of countercyclical flows—particularly from international financial institutions and ODA—to offset the procyclical nature of private capital flows.

The demand from IMF's members for funding increased dramatically over 2020–22: the IMF provided close to $17 billion to sub-Saharan African countries eligible for the Poverty Reduction and Growth Trust, at zero interest. But the IMF's ability to continue lending at high levels will depend on the availability of concessional resources. The Fund is working very hard to address this challenge, including via pledges from wealthier members. For official donors, in addition to respecting their aid commitment to the region, one option is to ensure more progressivity in the flows that remain, ensuring that scarce resources are channeled to sub-Saharan Africa's poorest and more fragile countries.

Figure 2. Sub-Saharan Africa Funding Sources, 2015–19

(Percent)



Sources: Organisation for Economic Co-operation and Development; World Bank World Development Indicators; and IMF staff calculations.

Note: FDI = Foreign direct investment; ODA = Official develoment asssistance; OOF = other official flows.

Debt relief. A persistent funding squeeze might also have implications for public debt sustainability. If the squeeze endures, liquidity problems now confronting many countries may evolve into a more worrying solvency problem for some. Cases of unsustainable debt need to be restructured, freeing resources for the region's development spending needs. But international debt restructurings have always been difficult, especially when the debt structure is complex, and the creditor base is diverse. The international community should continue to work toward a more rapid, predictable, and efficient resolution framework. (For a discussion of debt restructuring options and constraints, see analytical note, "Debt Dilemmas in Sub-Saharan Africa: Some Principles and Trade-Offs in Debt Restructuring").

Longer-Term Options

Focusing on attracting FDI. Focusing on stable sources of external development finance, evidence suggests that the funding mix typically changes over time as countries become wealthier (Figure 3), with low-income countries relying more on ODA and the share of private finance (FDI) rising for middle- and higher-income countries (see Gates Foundation 2023; Piemonte and others 2019).

The relation between income and the composition of financial flows is complex. Higher growth may simply result in additional investment opportunities and thus attract higher levels of private foreign investment. Or FDI inflows may facilitate a virtuous cycle of investment and growth because these inflows are often associated with increased technology transfers, greater competition, and higher productivity (see Alfaro and others 2004; Dabla Norris and others 2010; Javorcik 2004).

Historically, the expansion of FDI was a key element in East Asia's success story. But rather than repeating that example, many countries in sub-Saharan Africa seem stuck at the earlier stages of this funding transition, reliant on ODA inflows but with the private sector playing a somewhat limited development role. Public entities carry out 95 percent of infrastructure projects in the region, and despite the continent's clear potential, Africa attracts only 2 percent of global FDI. Furthermore, when investment does go to Africa, it is predominantly in natural resources and extractive industries, rather than development sectors such health, roads, or water.

An improved business environment is critical to attract a wider array of private investors and transform the way Africa funds its development. Reform measures to this end are well known and include enhancing the contestability of markets, removing key bottlenecks (such as unreliable electricity or the low average level of education), leveling the playing field between public and private firms, reducing red tape, improving governance and reducing the risk of corruption, and broadening financial inclusion (see IMF 2019).

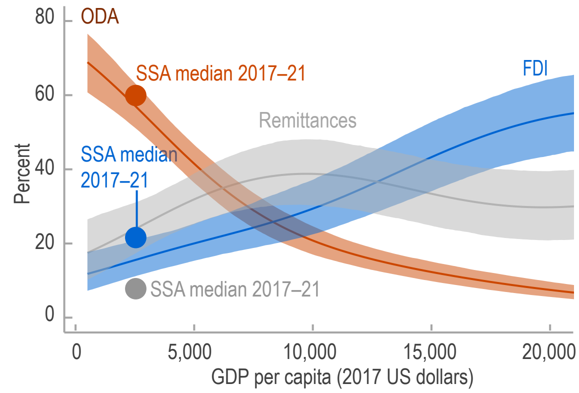
But these reforms may not be enough. Even in the most favorable environments, development sectors are special in a way that often complicates private sector participation. For instance, infrastructure projects often have large up-front costs, but returns accrue only over time, which can be difficult for investors to assess.

When these problems are acute, governments may need to provide extra incentives, which can sometimes be costly. But many projects in development sectors simply won't happen without them. In East Asia, for example, 90 percent of infrastructure projects with private participation receive some government support.

Governments can maximize impact while minimizing risks and costs, for example, with support that is targeted, temporary, and granted based on clear market failures. With this in mind, sub-Saharan African countries and their development partners might consider reallocating some resources toward public incentives for key private projects. Underpinned by sound governance and transparency, a more innovative private sector approach may significantly increase the range and quality of services in the region and promote sub-Saharan Africa's transition to a more dynamic funding mix. (See Eyraud and others 2021, for a discussion of the potential role for public incentives in boosting private investment in sub-Saharan Africa).

Figure 3. Sources of External Funding by Income Level, 2012–21

(Share of total external funding; global sample)



Sources: Organisation for Economic Co-operation and Development; and IMF staff calculations.

Note: FDI = Foreign direct investment; ODA = Official development assistance; SSA = Sub-Saharan Africa.

Expanding Domestic Resources

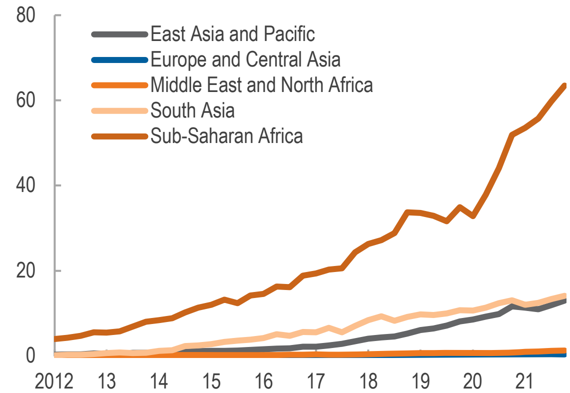
Securing a more stable external funding mix will be helpful, but ultimately, domestic mobilization is the key to sustainable development.

For example, looking only at funds channeled through the public sector, the ratio of tax revenues to external flows in sub-Saharan Africa is typically about 2 to 1, and evidence suggests that this channel only becomes more important as countries develop. The median low-income country collects 13 percent of GDP in tax revenue (excluding social security contributions), compared with 19 percent for emerging market economies and 27 percent for advanced economies. Once again, the relationship between income and tax revenue is likely to be complex—higher incomes imply a larger tax base and greater revenues, but increased income may also shape the nature of the tax base, with a greater proportion of activity in the formal sector (Gaspar and Selassie 2017). Also, higher revenues allow for essential development spending, which ultimately results in increased growth. Either way, domestic revenue mobilization—through broadening the tax base or improved administration—is ultimately a key element in any country's effort to achieve its development goals. (See Benedek and others 2021, for a discussion of the impact of revenue mobilization on development funding. See the May 2018 *Regional Economic Outlook: Sub-Saharan Africa* for a more detailed treatment of revenue mobilization options in sub-Saharan Africa.)

Beyond the public sector, expanding the pool of private savings will also be critical. The need to foster more domestic savings has long been understood as the kernel of economic development, and a large and still unresolved literature investigates why some countries save more than others. Demographics seem to play a role, but many other factors matter, including the health of the domestic financial system.

The development of long-term capital markets has long been recognized as a critical feature of sustainable development (see World Bank 2015). But the challenge in sub-Saharan Africa is particularly complicated by the fact that a large portion of economic activity is in the informal sector, where much of the population remains unbanked, and savings are kept as nonfinancial assets and thus are unavailable for investment. For policymakers in sub-Saharan Africa, financial development entails both improved bank regulation and supervision and the development of local capital markets. But it also requires a focus on financial inclusion, which provides greater opportunities to the region's most vulnerable, taps into underused savings, and allows a more efficient flow of savings to areas of greatest need, thus helping each country to meet more of its development needs locally. In this context, one of the most exciting developments in sub-Saharan Africa is the explosive growth of financial digitalization. The region leads the world in mobile money transfer services (Figure 4), and the accelerating adoption of new products is changing the domestic savings landscape (see Ndung'u, 2022).

Figure 4. Selected Regions: Value of Mobile Money Transactions, 2012–21
(in billions of US dollars)



Source: Global System for Mobile Communication Association (GSMA), Global Mobile Money dataset.

Conclusion

As sub-Saharan Africa emerges from the recent crises, the development funding challenge has shifted. In addition to discussing ways to raise additional funding to meet the SDGs, the immediate concern is how to operate within a reduced financing envelope. Resources have become scarcer and more expensive, and it seems that many policymakers will need to run faster simply to keep pace. But the region's full potential is still untapped, many options remain, and ultimately the region's demographics will ensure sub-Saharan Africa's ever-increasing role in the global economy (see Selassie 2021). Efforts to accelerate the mobilization of funding resources will help ensure that this happens sooner rather than later.

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