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IMF Advice on Capital Flows to Africa and the Middle East

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ABBREVIATIONS

AFR	African Department (IMF)
BAM	Bank Al-Maghrib (Central Bank of Morocco)
BRI	Belt and Road Initiative
CFM	capital flow management measure
DSA	debt sustainability analysis
EBA	external balance assessment
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EM	emerging market
EMDE	emerging markets and developing economies
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FX	foreign exchange
GFC	global financial crisis
IV	Institutional View on the Liberalization and Management of Capital Flows
LIC	low-income country
LIDC	low-income and developing countries
MCD	Middle East and Central Asia Department (IMF)
MCM	Monetary and Capital Markets Department (IMF)
MENA	Middle East and North Africa
MPM	macroprudential measure
PLL	Precautionary and Liquidity Line
REO	*Regional Economic Outlook*
SEZ	special enterprise zone
SSA	Sub-Saharan Africa
UAE	United Arab Emirates
VIX	Volatility Index (Chicago Board Options Exchange)
WEO	*World Economic Outlook*

I. Introduction

1. This paper evaluates IMF advice to countries in the Sub-Saharan Africa (SSA) and Middle East and North Africa (MENA) regions on capital account liberalization and dealing with capital flow volatility. The paper provides a broad assessment of the Fund's overall advice to each region, supplemented by a deeper look at three countries—Ethiopia and Kenya in SSA and Morocco in MENA. The paper focuses on so-called frontier markets, typically low-income economies that have recently gained access to significant private funding. It pays less attention to Fund advice to wealthier oil and gas exporters, which focuses on management of export revenues and diversification of the economy, or to Fund advice to fragile and conflict-affected states, where liberalizing the capital account and managing volatility of capital flows are not at the top of the policy agenda given domestic challenges.

2. The assessment is based on: desk reviews of the IMF's *Regional Economic Outlook (REO)* reports for the two regions and the reports on Macroeconomic Developments and Prospects in Low-Income Developing Countries (LIDC), which the Fund launched in 2014; interviews with current and former staff members in the IMF's African (AFR) and Middle East and Central Asia (MCD) departments; and interactions with outside experts.[1] Case studies of Ethiopia, Kenya, and Morocco draw in addition on interviews with officials in the three countries and the Fund's country reports.[2]

II. IMF Advice to Sub-Saharan Africa[3]

A. Economic Context

3. Sub-Saharan Africa enjoyed strong growth in the decade prior to the global financial crisis (GFC). Growth in the ten years since has been weaker—affected by both the crisis and the collapse in commodity prices since 2014—but still robust, particularly when compared to the region's historical average. Since 2000, GDP per capita has more than doubled in 28 countries and poverty is declining in many. Long strides have been made in essential dimensions of well-being: "Life expectancy is improving rapidly, infant and maternal mortality rates are declining swiftly in most countries, and education levels are improving" (Selassie, 2019).

4. While standard measures of capital account liberalization show that SSA remains more closed on average than other regions, there has been a slow move toward liberalization through the increased availability of private financing for frontier markets and through engagement with new official lenders such as China, particularly through the Belt and Road Initiative (BRI). This is

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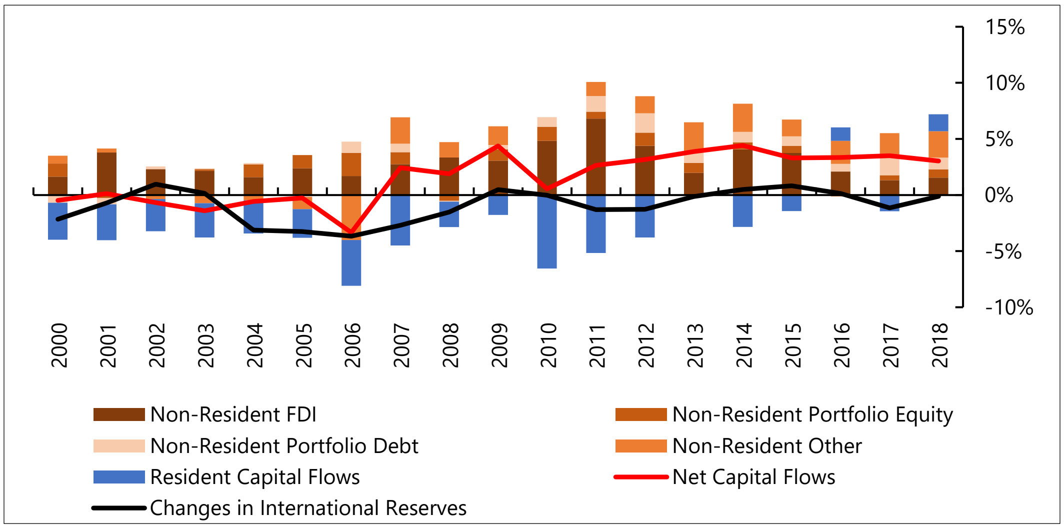
[1] Note that these interviews were completed before the outbreak of the COVID-19 crisis and therefore do not cover this experience.

[2] The assessment also draws upon relevant material from Darius (2019), the background paper on South Africa prepared for the IEO's evaluation of *IMF Advice on Unconventional Monetary Policies*.

[3] This section was prepared by Sriram Balasubramanian, Prakash Loungani, and José Antonio Ocampo.

reflected in the increase over the past two decades in the magnitude of capital flows to the region. Net capital flows to SSA are now 3–4 percent of GDP, up from negligible levels in the 1990s. And while foreign direct investment continues to dominate, the importance of portfolio flows and bank lending has increased over the past decade (Figure 1).

Figure 1. Capital Flows—Sub-Saharan Africa
(In percent of GDP)



Source: IMF, International Financial Statistics.

5. The recourse to substantial external financing, much of it on commercial or near-commercial terms, has contributed to a build-up in public debt levels in many of these economies. Prior to the outbreak of the COVID-19 pandemic, half of low-income economies—concentrated in SSA—were "at high risk of or already in debt distress" (IMF, 2020). The COVID-19 crisis saw a spike in sovereign spreads by 700 basis points and large capital outflows, further exacerbating concerns about sustainability in many economies in the region.

6. Against this background, we address IMF advice to the region on capital account liberalization, specifically on the benefits of sovereign borrowing and the implications of South-South flows relative to the risks. We also discuss the staff's views on the use of capital flow measures to manage volatility in capital flows, although this has been a less active subject of discussion in the region (relative to Latin America or Asia) given the limited degree of integration with international financial markets.

B. Capital Account Issues: IMF Analysis and Advice

7. Analysis of capital account issues has been an important feature of the Fund's *Regional Economic Outlook (REO)* and LIDC reports, often drawing on analytic work conducted by the Fund staff based on extensive data collection. There has been regular analysis of the drivers of capital flows using the standard "push vs. pull" decomposition, with both factors ending up as

about equally important. The Fund's general advice that capital account liberalization should be gradual and preceded by domestic reforms was prominent in these documents but tailored to the two specific developments in the region noted above.

Sovereign borrowing

8. As private capital flows to some SSA economies started to ramp up from 2005, the Fund was generally welcoming, noting the potential benefits of increased access to external financing, while also cautioning against the risks in terms of possible large appreciation of domestic currencies, particularly given the small size of financial markets in these economies (SSA *REO*, September 2006). As countries continued to tap international bond markets during 2006–07, and a rising number of countries secured sovereign credit ratings in anticipation of eventual issuance, the Fund remained supportive, noting the "encouraging signs" of broadening access to international capital markets (SSA *REO*, April 2008).

9. Since the global financial crisis, SSA *REO* and LIDC reports have continued to assess the benefits and costs of sovereign borrowing—particularly the 2013 SSA *REO*, which was the basis for a 2014 AFR departmental paper on the topic. The staff has been open to recognizing the potential contribution that increased access can make to growth and developmental outcomes through a sequential opening up of capital markets.

10. At the same time, since 2011 the staff has also sounded cautionary notes that a prolonged surge of capital inflows "may well induce complacency among country authorities regarding the level of public deficits that can be sustainably financed" (*REO*, April 2011). The staff has warned that international sovereign bonds "may not be the best option for financing infrastructure investment," noting that countries that issued such bonds for infrastructure building had often not experienced a sizable increase in public investment (*REO,* April 2013).

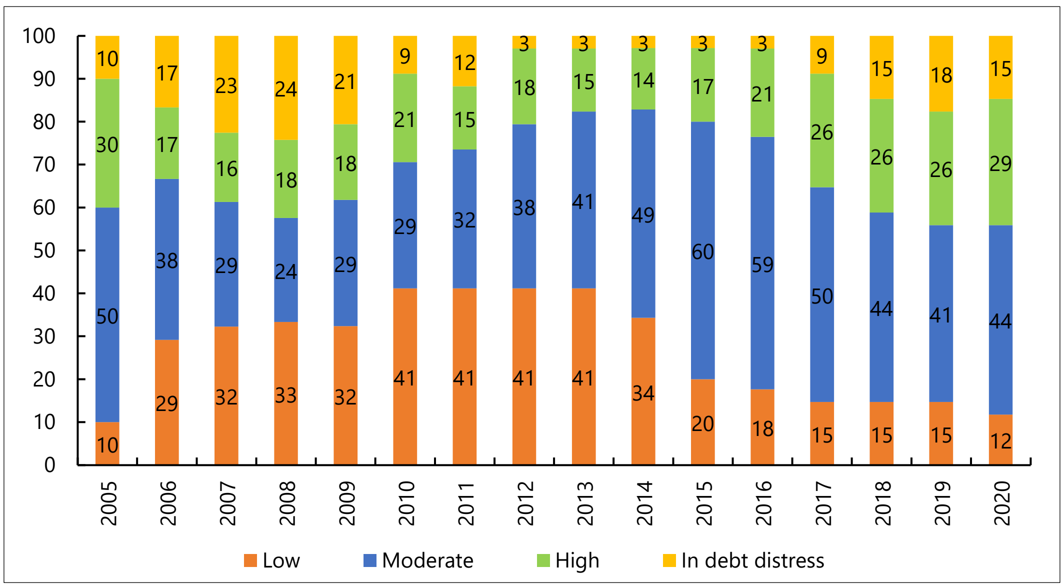
11. The inaugural LIDC report in 2014 stressed the importance of comprehensive medium-term debt-management strategies for countries that were using substantial external borrowing on market terms, notably sovereign bond issues, to finance large infrastructure projects. In addition, that report reiterated the concern about the use of borrowed resources for debt management. Econometric analysis and case studies in the 2015 LIDC report suggested that portfolio inflows were "more strongly correlated" with consumption than investment. For instance, on Zambia, where three Eurobonds totaling US$3 billion were issued over 2012–15, it noted that "the increase in recurrent spending has exceeded the increase in capital spending."

12. In recent years, as external debt has continued to rise, Fund reports have raised increasing concern about the resulting impact on public debt sustainability. The 2018 LIDC report (IMF, 2018a) contained a detailed analysis of how external borrowing from commercial creditors contributed to the build-up in the ratio of external debt to GDP in several countries. A number of factors have contributed, including in some cases growth projections that turned out to be overly

optimistic and, in others, lack of transparency about spending or outright misallocation or misuse of funds.

13. In February 2020, the IMF's policy paper on "The Evolution of Public Debt Vulnerabilities in Lower-Income Economies" assessed that half of low-income economies—concentrated in SSA—were at high risk of or already in external debt distress, as noted above but that "the pace of downgrades had moderated" (Figure 2). These risk ratings are derived from the Debt Sustainability Framework for low-income countries. Ethiopia and Kenya are among the 10 countries that have been downgraded since 2017, as discussed later in this section. The impact of the COVID-19 crisis has worsened the debt situation in SSA with around 34 percent of the countries highly vulnerable to debt distress (*REO*, April 2020).

Figure 2. Evolution of Risk of Debt Distress in Sub-Saharan Africa Countries
(In percent of SSA LICs with DSAs)



Source: LIC DSA database as of May 20, 2020.

Role of South-South investment flows

14. In the absence of bilateral data on international capital flows between countries, South-South investment flows are hard to quantify. Nevertheless, they have clearly risen substantially over the past decade. A major source of South-South flows in the SSA/MENA region has been investments from China, largely into infrastructure and other large projects, particularly since the launch of the BRI. In addition, there have been growing intra-regional flows often intermediated by regional banks—for example, between Moroccan banks and West African countries and between Kenya and other East African countries, as discussed below, and within the Middle East, where the capital has flowed from oil exporters with investible surpluses into oil-importing countries such as Jordan and Lebanon.

15. The Fund staff has generally taken a positive view of the likely growth impact of South-South flows. The Fall 2011 SSA *REO* noted that such investments were not always motivated by "a search for resources" but also included activities such as agricultural or infrastructure development that had "more linkages to recipient economies." The same report also stated that FDI from emerging market economies fosters productivity growth, improves competitiveness in infrastructure-deprived regions such as Sub-Saharan Africa, and promotes regional integration.[4] Subsequent Fund analyses have continued to reach positive assessments of the potential growth impacts of these investment flows, but with increasing concerns—as in the case of sovereign bond issuance—that some of the flows are associated with a build-up in debt and a lack of transparency (as also noted by Reinhart and others, 2020).

16. A detailed assessment of investment flows from China was carried out as part of background work conducted for a 2018 conference that the Fund hosted with the People's Bank of China on the BRI, which has constituted an important source of external funding for some SSA countries. The IMF staff noted that, substantiating the earlier finding in the 2011 *REO*, Chinese FDI was "well diversified across sectors, contrary to the general perception of its concentration in the natural resources sector." Such flows had potential to contribute to growth, particularly by filling infrastructure gaps and identifying a pipeline of such new projects for private sector development. At the same time, the staff also pointed to the fiscal risks and outlined policy options to manage them. Chinese authorities have been responsive to such concerns, including by taking steps to develop a BRI-centric debt sustainability framework for participating BRI countries (see background paper by Patnaik and Prasad, 2020).

Dealing with volatility: use of capital account measures

17. Given the extensive capital account restrictions still in place in many countries in the region and the limited extent of portfolio and short-term debt flows, the use of capital account measures to manage volatility has not been an active subject of engagement. In 2011, as the work leading up to the Institutional View on the Liberalization and Management of Capital Flows (IV) was well underway at the Fund, the staff advocated that countries in SSA follow the "policy response hierarchy" whereby the primary response to inflows would be through macroeconomic policy adjustment and prudential measures to ensure resiliency of the financial system before capital account measures were considered (*REO*, April 2011). The staff noted that only two of the region's 11 frontier markets (Tanzania and Zambia) had opted for capital account measures in response to the volatility of capital flows over the 2008–10 period while the others had continued to rely on macroeconomic policies and macroprudential measures (MPMs). The latter group included South Africa—the African country that is by far the most integrated with

[4] The staff also analyzed the role of special enterprise zones (SEZs) in the region, concluding that "although such zones are second-best solutions compared to economy-wide reforms, they could have benefits for both China and the host countries." Revisiting the issue several years later, the staff noted that "in recent years, some countries have adjusted their approach to developing SEZs, with better results, as in the case of Rwanda" (*REO*, Fall 2018).

international financial markets. As documented in Darius (2019), South Africa essentially relied on exchange rate flexibility to deal with the capital flow volatility engendered by the use of unconventional monetary policies in advanced economies and uncertainty about exit from these policies. The authorities believed that introducing capital account measures would jeopardize the country's reputation for commitment to letting financial markets work freely, and that the exchange rate provided an adequate shock absorber.

18. After the Fund's adoption of the IV in December 2012, the staff urged "only very restricted use of capital flow measures" in Sub-Saharan African frontier markets because of the likely adverse impact on the investment climate; moreover, it was felt that administrative and institutional challenges would come in the way of effective implementation (SSA *REO*, Fall 2013). The skepticism about the effectiveness of capital flow management measures (CFMs) extended to controls on both inflows and on outflows. Regarding inflows, the staff argued that if a restrictive capital account framework is in place, the use of additional CFMs for capital account management may be more damaging than otherwise: "with an already-complex regulatory framework, additional measures may have negative feedback effects on investor confidence." Such adverse effects on future inflows and reputational risks for the country's investment environment would be even larger if SSA economies attempted to limit capital outflows. Hence, any "new CFMs on outflows should be considered only as a last resort in response to a financial crisis" (*REO*, Fall 2013).

19. This view has generally been reiterated in subsequent regional documents that provide policy advice to SSA economies. For instance, the October 2018 *REO* provided an extensive analysis of inflow surges and reversals in capital flows. It acknowledged that, in the face of volatility, foreign exchange intervention to limit currency overvaluation and build adequate reserve buffers may be warranted in some cases; the use of CFMs was not discussed.

20. After the start of the COVID-19 pandemic, portfolio outflows from SSA exceeded US$4 billion in a matter of weeks; "the fastest rate of withdrawal on record" (*REO*, Spring 2020). In advising on the policy response to the market turbulence and large outflows prompted by the COVID-19 pandemic, the staff has advocated exchange rate flexibility and foreign exchange intervention as the primary tools to deploy. CFMs could be considered by countries in the face of an "imminent crisis" but as part of a "wider policy package, and with clear communications to emphasize their temporary nature" (*REO*, Spring 2020). In addition, the Fund quickly provided emergency financing—or augmented existing arrangements—to help countries deal with the budgetary and economic strains. By July 31st, 2020, 33 countries in SSA had received additional access to IMF resources.

C. Engagement with Ethiopia and Kenya

21. Ethiopia and Kenya are among the more successful SSA economies, belonging to what the IMF considers as the group of "diversified" economies that have generally performed well in recent years, relative to the averages for SSA and for low-income economies. Ethiopia has grown

rapidly over the past decade, achieving high rates of public investment and a significant reduction in poverty and improvements in social indicators. In 2019, to enhance sustained growth, it shifted to a more market-oriented approach with financial support from the IMF under a combined Extended Credit Facility/Extended Fund Facility (ECF/EFF). Kenya too has been successful in achieving strong economic growth and has reduced external imbalances over the past decade. However, Kenya's fiscal deficit has remained high, and concerns about the sustainability of public debt have prompted policy corrections in recent years, supported by the Fund through a Stand-By/ECF arrangement between 2015 and 2018. Both countries accessed additional Fund financing to help address the acute needs that were generated by the COVID-19 crisis in early 2020. For Ethiopia, the Fund provided emergency assistance under the Rapid Financing Instrument, and IMF debt service relief under the Catastrophe Containment and Relief Trust. For Kenya, it provided resources under the Rapid Credit Facility.

22. While both countries are growth successes, they have contrasting capital account regimes. Ethiopia still has a largely closed regime in which capital flows are strongly controlled by the government. That said, the country has been open to South-South flows—partially official Chinese financing for infrastructure projects—and it accessed international capital markets through a 2014 bond issue of US$1 billion. In contrast, Kenya has maintained a very open capital account since 1995, permitting both inward and outward flows, facilitating the strong role that Kenyan banks play within the East African region as well as other regional integration links in which non-financial private Kenyan firms participate. The country issued sovereign bonds in global capital markets in 2014 and 2018–19 and has contracted syndicated loans from private international banks.

23. Article IV staff reports and interviews indicate that the IMF staff has not pushed for proceeding with capital account liberalization or external borrowing in either country. The decisions on recourse to international bond issuance and borrowing from China were the result of the authorities' looking for external financing to support growth, rather than influenced by any prior recommendations from the IMF. That said, the staff was generally supportive of these initiatives, while warning of some of the potential risks.

24. Since before the global financial crisis, Ethiopia has relied on a public investment-led development model, influenced by lessons from the early growth experience of China and with that country's active assistance. The Fund staff was broadly supportive of the country's choices, while noting the risks they posed to inflation and debt sustainability. The authorities recognized these risks but their response to Fund advice was of "somewhat tepid intensity" (IMF, 2007). Over 2007–17, Ethiopia's GDP grew by nearly 10 percent a year, twice the regional average. Nevertheless, around 2019, the growth model appeared to have reached its limits amid a build-up in external vulnerabilities, prompting a transition towards a more market-oriented "Homegrown Economic Reform Agenda" supported by the Fund with an Extended Credit Facility and an Extended Fund Facility.

25. Since 2019, there has been broad agreement between the staff and Ethiopia's authorities on the need for capital account liberalization—supported by provision of some technical assistance by the Fund—as part of a package of reforms for gradual capital account liberalization as part of a package of reforms to foster private sector development. The staff has recommended greater openness to foreign direct investment, including in financial services. The government included in its reform agenda the objectives of easing controls on foreign exchange sales to private sector importers and improving the FX management and functioning of the interbank market.

26. In the case of Kenya, whose capital account was already quite open, the dialogue has centered around managing risks associated with the existing degree of liberalization. The staff and authorities have shared an appreciation that the country must be on guard against external shocks that could spur capital outflows—such as a pullback of investors from emerging markets or tightening global monetary conditions. An additional source of risk relates to the international activities of Kenyan banks. The staff has stressed the importance of a strong capital base for these banks and active interactions with bank regulators in the countries where they invest. The authorities have agreed and the Central Bank has continued its efforts to establish strong relationships with regional regulators to enhance surveillance of Kenya's transnational banks.

27. Both Ethiopian and Kenyan authorities have generally appreciated the Fund's debt sustainability analysis (DSA) in the annual Article IV consultation as providing a useful basis for policy analysis with relevant implications for debt management and capital flow policies. They recognize that their debt situations provide reason for concern. While they feel that their countries' vulnerabilities are somewhat overstated, they have taken steps to improve debt structure and reduce risks.

28. In Ethiopia, the DSA went from a low to moderate risk of external debt distress in 2015 to high risk in 2017, where it remains today. In interviews for this evaluation, Ethiopian authorities expressed some disagreement with this assessment, partly because the debt was measured relative to export revenues, and the Fund in their view was underestimating the impact of their ongoing efforts to increase future exports. Nonetheless, the authorities saw the value of relying more on concessional finance, renegotiating some non-concessional project financing, and being cautious about initiating new state-owned enterprise projects that are highly dependent on external financing. Their decisions were consistent with IMF recommendations, as noted by the 2019 Article IV Staff Report.

29. In the case of Kenya, the 2018 DSA suggested an increase from low to medium risk of external debt distress. The IMF's basic diagnosis was that the rise of the country's external debt in recent years has been associated with the government's public investment drive and revenue shortfalls and, in the context of weak export performance, this meant an increase in external debt vulnerabilities. However, the growing share of commercial international creditors has also played a role, and it was the rise in expected debt service that led the Fund to raise Kenya to a case of moderate external debt distress. The staff suggested limiting borrowing to financing for high-

return projects, lengthening the maturity of non-concessional borrowing, and reducing the fiscal deficit to address debt vulnerabilities. Interviews with Central Bank officials suggested that they agreed with the IMF staff, particularly on the need to control the "spending spree" of recent years. However, they were more sanguine than the Fund staff about the risk of debt distress, on the grounds that Kenya would continue to have access to international markets and had a buffer of official foreign reserves.[5] Since then, the COVID-19 crisis has raised external risks to the economy, particularly through the disruption of tourism revenues, leading the Fund to raise Kenya's risk of debt distress from moderate to high.

30. Regarding exchange rate policies and assessments, the Kenyan authorities have been more critical of staff analysis. For both countries, the Fund has strongly recommended a more flexible exchange rate regime. In Ethiopia, the advice is now reflected in an agreed gradual transition to a more market-determined exchange rate under the Fund-supported program. In Kenya, reflecting limited movement of the shilling relative to the US dollar, the Fund reclassified the exchange rate regime from "floating" to "stabilized" in 2018. That year, the Fund staff also assessed the shilling to be overvalued by about 18 percent using a methodology similar to that used in the External Balance Assessment (so-called EBA-lite). The Kenyan authorities strongly disagreed with this analysis, whose findings have implications for Fund support for foreign exchange intervention and other policies to deal with capital flow volatility, and its assessment of reserve adequacy. The Central Bank of Kenya has carried out its own technical analysis, which it regards as more suitable than EBA-lite and which suggests that the shilling is modestly undervalued. The Fund has since reclassified Kenya's de facto exchange rate regime as "other managed," which is considered more flexible than "stabilized," reflecting its assessment that there was greater movement in the exchange rate in late-2018 and 2019.

III. IMF ADVICE TO MIDDLE EAST AND NORTH AFRICA (MENA)[6]

A. Economic Context and IMF Advice

31. The MENA region comprises a diverse group of countries, about evenly split between countries that export oil and gas and those that import them. Changes in world commodity prices, particularly for hydrocarbons, have a direct bearing on growth in the region. While importing countries tend to gain when oil prices are low, there is an offsetting effect from the drying up of intra-regional capital flows from the exporting countries. Many countries have also been subject to periodic bouts of political instability: nearly half of the 21 countries are fragile and conflict-affected states that face ongoing growth and humanitarian challenges.

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[5] Foreign exchange reserves are considered to have reached appropriate levels in Kenya according to the most recent Article IV consultation; previous staff reports had praised the country's decision to accumulate reserves when external financing was abundant. In Ethiopia, in contrast, raising an insufficient buffer of foreign exchange reserves is one of the agreed goals under the Fund-supported program.

[6] This section was prepared by Karim El Aynaoui, Prakash Loungani, and Roxana Pedraglio.

32. Gross capital inflows to the region have tended to be evenly split between oil importers and exporters and relatively concentrated in a few countries: Egypt, Lebanon, and Morocco rank at the top among the former group and Saudi Arabia and United Arab Emirates among the latter. These countries account for half of total flows to MENA.

33. The composition of capital flows to the region has changed over the past decade with FDI supplanted by bank flows in the case of oil-importing countries and by portfolio flows in the case of oil exporters. This was particularly the case during 2016–18, when surging portfolio inflows to the region—nearly three-quarters to Egypt, Oman, Qatar, and Saudi Arabia—accounted for about 20 percent of the total portfolio inflows to emerging markets (compared with 5 percent before the global financial crisis). In contrast, the region attracted only around 5 percent of the total FDI inflows to developing economies in 2015, down from 12 percent in 2008 in response to bouts of economic and political instability as well as limits on foreign participation.

34. Resident capital outflows from MENA have been substantial since the early 1970s as oil and gas exporters invested a sizable share of their surpluses—including sizable amounts within MENA. Since the mid-2000s, however, these flows have declined, driven by oil exporters (e.g., Algeria, Iraq, and Saudi Arabia) which have scaled back their purchases of foreign assets during periods of sharp declines in oil prices, for example in 2014–15. Even periods of oil price increases have led to only modest recoveries in purchases of foreign assets, as countries are increasingly spending their oil revenues on domestic needs.

35. Standard indices of capital account liberalization suggest that on average MENA economies are more open than those in Sub-Saharan Africa. Oil exporters tend to be more open than oil importers, and the wealthier economies in the region are more open than the others, particularly those such as Bahrain and the United Arab Emirates (UAE) that have sought to establish themselves as international financial centers. Still, most MENA economies remain fairly closed relative to the average for emerging markets and advanced economies.

36. IMF advice has overall supported the continued gradual liberalization of the capital account to enable foreign investors to enter and diversify the investor base and improve liquidity as part of bolstering financial stability and development (IMF, 2014). At the same time, as bank and portfolio flows have increased with the region's integration into global financial markets, the staff has raised concerns about associated risks. While not coming out with blanket advice against such flows, the staff has been vocal about the risks they pose, particularly when they flow to sectors such as real estate and foster asset price booms rather than flowing to sectors with more positive spillovers to the rest of the economy. In 2009, for instance, the staff warned about inflated asset price values in the UAE (*WEO*, October 2009), well ahead of a debt crisis in the real estate sector that unfolded later that year, and it has continued to warn about such risks in both the UAE (IMF, 2013) and elsewhere in the region.

37. More recent analytic work by the staff (Saksonovs and Zhu, 2019; Azour and Zhu, 2020) has documented how portfolio flows to MENA countries are more strongly affected by push factors—particularly changes in global uncertainty as proxied by VIX—than are flows to other emerging market and developing countries. These factors make MENA particularly vulnerable to changes in global risk sentiment. Azour and Zhu (2020) suggest that MENA's greater sensitivity reflects a perception that the region is more exposed to geopolitical uncertainties, volatile oil prices, and disruptions from global trade tensions than are other emerging market regions.

38. Given the volatility associated with bank and portfolio flows, IMF staff advice has focused on policies that countries can adopt to attract FDI to foster growth and macroeconomic stability. In making the case for FDI, the staff has relied on existing cross-country evidence on the positive contribution of FDI to economic growth and also carried out new analytic work to show FDI's potential to boost growth in the MENA region (IMF, 2014). The staff has also been active in documenting policy actions and conditions that are conducive to attracting FDI and in recent years it has paid increasing attention to whether the resulting growth would be inclusive (IMF, 2018b).

39. In 2020, the region has been hit by "two large and reinforcing shocks:" the COVID-19 pandemic and the plunge in oil prices (MENA *REO*, 2020). Oil-importing countries are being adversely affected by a large decline in remittances and capital flows from oil-exporting countries. The Fund has responded with active consultations on policies and provided emergency assistance in response to requests from half a dozen countries, including Jordan and Tunisia. In addition, Morocco drew on its Precautionary and Liquidity Line.

B. Engagement with Morocco

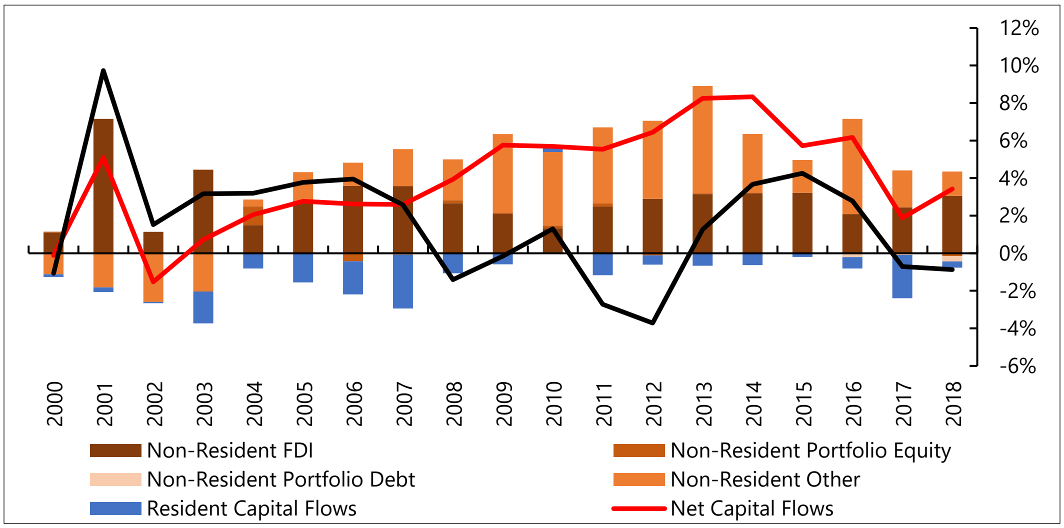
Economic context

40. For the first decades following the country's independence in 1956, capital flows were heavily restricted, fueled by a desire to "Moroccanize" the business environment (Lahlou, 2016). Over the last three decades, however, Morocco has shown an increased appetite for economic openness, reflected in new bilateral free trade agreements and reinforcement of relationships with European and African trade partners. On the capital account front, Morocco has been cautious about liberalizing restrictions on outflows but has aggressively sought to attract foreign direct investment to finance development.

41. FDI and bank flows make up the bulk of Morocco's capital inflows, with portfolio flows playing a negligible role (Figure 3). The government has used tax incentives to boost FDI and channel it to vital industrial sectors to reduce dependence on agriculture and modernize the economy (Azeroual, 2016). While considerable investment has gone into priority industrial sectors, as hoped for by the government, there has also been a strong concentration of FDI flows in real estate. Outflows from Morocco largely reflect the active investment strategy of Moroccan financial companies in Sub-Saharan Africa, in particular the heavy investment by banks and insurance companies in building financial networks in West Africa (e.g., in Côte d'Ivoire).

42. When the GFC hit, the decline in remittances, tourism, exports, and FDI led non-agricultural GDP to decline by 1.6 percent in 2009, though the impact was cushioned somewhat by the still fairly restricted capital account and the limited exposure of Moroccan banks at the time. Moreover, macroeconomic policies shielded the economy: the Central Bank, Bank Al-Maghrib (BAM), reacted promptly by cutting rates between 2008 and 2010 and fiscal policy moved to an expansionary stance as of 2008 to counter the contractionary effect of the crisis on external demand (Agénor and El Aynaoui, 2015). Morocco has had successive Precautionary Liquidity Line (PLL) arrangements with the Fund since 2012 to provide insurance against external shocks and drew on this line in April 2020 to help counter the effects of the COVID-19 shock.

Figure 3. Capital Flows—Morocco
(In percent of GDP)



Source: IMF, International Financial Statistics.

IMF engagement on capital account issues

43. The Fund has had an extensive involvement with Morocco over the past two decades through Article IV consultations, Financial Sector Assessment Program reviews, and provision of a PLL arrangement. On capital account issues, there has been a largely shared view on the strategy for gradual liberalization, with inflow controls relaxed before outflow controls; on the importance of attracting inflows in the form of FDI; and on the need to push ahead with supporting reforms before further liberalizing capital flows.

44. There have been regular discussions on the supporting reforms needed before opening up the capital account: (i) achieving sound public finances; (ii) developing domestic financial markets; (iii) enhancing the monetary policy and regulatory framework to monitor financial stability risks; and (iv) gradually transitioning to a more flexible exchange rate regime. On each of these fronts, there has been engagement with the Fund through surveillance and technical assistance.

- The Fund has been supportive of the efforts of the Moroccan authorities to rein in the public deficit and put public debt on a sustainable path by overhauling the food subsidy system in favor of targeted social programs, reducing the public wage bill, and reducing the tax rates to nudge the informal sector towards formality and other steps to increase the tax base. A fiscal surplus on the eve of the GFC provided room for countercyclical policy to support the economy.

- The Moroccan authorities have worked on deepening the financial markets, including increasing the maturities of treasury bond offerings, and have taken steps to ease foreign investors' access to the Casablanca Stock Exchange.

- In 2006, a new law reinforced BAM's ability to conduct an independent monetary policy. Since then BAM has also been given overall responsibility—acting as part of a systemic risk supervision and coordination committee—for oversight of the risks entailed by greater financial openness. Thus, financial stability has been added to the Central Bank's policy mandate, although not as a main objective. The Fund has monitored and supported these efforts, including through the 2008 Financial Sector Stability Assessment. In 2016, the Fund provided technical assistance to disseminate best practices on supervision of cross-border banking operations, given the expansion of the three main Moroccan banking groups into more than 20 countries in the region.

- BAM, together with the Ministry of Finance, has also moved toward a more flexible exchange rate regime to help the economy better cope with external shocks, with an eye to adopting an inflation-targeting regime in the medium term (Agénor and El Aynaoui, 2015). The IMF has helped BAM to upgrade its monetary policy framework and reinforce its framework for macroprudential policies, providing technical assistance on, for example, stress-testing, the use of countercyclical capital buffers as a policy tool, and addressing data gaps for macroprudential surveillance (e.g., loan-to-value and debt-service-to-income ratios).

45. In interviews, current and former Moroccan officials expressed their general satisfaction with IMF staff advice in recent years. In particular, on issues related to the capital account, officials noted that analysis of the determinants and evolution of capital flows was regularly provided during Article IV consultations and PLL reviews. The Fund staff also regularly presented analyses of the drivers of growth in Morocco in Selected Issues papers (for example in 2005, 2013, and 2016). While the earlier work demonstrated the importance of trade and FDI in promoting growth, the recent work has stressed the importance of complementary reforms in labor and product markets to garner the benefits of increased openness and particularly to ensure that growth is inclusive. Interviewees all expressed appreciation for the MENA Regional Economic Outlook as providing a useful comparative analysis of developments in the MENA region, including for capital flows; many mentioned the *REO* as a key reference that they consulted.

46. Discussions about the exchange rate have also been a central feature of dialogue with IMF staff, particularly since Morocco's partial liberalization of financial outflows in 2007. Officials recognized the usefulness of Fund advice and technical assistance, including on the Moroccan Quarterly Projection Model used by BAM as a macro-modeling tool, that supported the first phase of greater exchange rate flexibility in early 2018. The model proved useful for comparative analysis of adjustment to shocks under the pegged regime vs. the flexible regime and in the transition to a flexible exchange rate regime. But there was some concern whether it would be suitable for analyzing the impact of financial shocks, which could become more prevalent once the capital account had been fully liberalized. Interviewees also expressed some frustration at the inconclusiveness of EBA analyses, which gave different results on exchange rate valuations depending on the approach and hence were not very useful to authorities in guiding decision making (see, for example, 2019 Article IV Staff Report).

47. The Fund's adoption of the IV in 2012 was welcomed as reflecting the institution's "pragmatic view" of capital account liberalization and bringing staff views more in line with the approach long preferred in a number of economies in the region. Officials felt that the IV better allowed tailoring of advice to the particular needs of each country on the path towards full liberalization of the capital account, in terms of business-climate actions as well as the centrality of strengthening financial supervision. For Morocco, the adoption of the IV did not make a material difference in the Fund's advice since there was already broad agreement on the path for gradual liberalization. Still, some interviewees noted that after 2012 the staff seemed to bring up the subject of capital account liberalization less routinely.[7]

48. While agreeing that liberalization of the capital account was a suitable long-term goal for the Moroccan economy, officials stressed that having some restrictions in place had helped to maintain financial stability in the face of adverse shocks by modulating the pace of portfolio investments and the exposure of Moroccan banks through cross-border activities.

49. While appreciative of the Fund's strategic advice on capital account liberalization, some officials pointed to a "narrowness" in the Fund's advice on FDI, with the staff reluctant to engage in forward-looking strategic discussions of Morocco's comparative advantage. It was noted that when asked for specific guidance on whether FDI in particular sectors would be advisable, Fund country teams tended to fall back on generic advice on improving the business climate for all sectors and not trying to pick winners. Some interviewees felt that a greater willingness to appreciate that countries are seeking advice on "industrial policy"—though according to one this term seemed "taboo" at the Fund—would make staff advice more useful. Interviews with staff members suggested that they have been open to highlighting and learning from the experience of industrial policy initiatives when these prove successful. For example, it was noted that the

[7] It was noted that the expression "liberalization of the capital account" appeared 12 times in the 2008 FSAP update and only twice in the 2016 FSAP (though the latter did look at cross-border bank operations). There was also limited explicit reference to capital account policy recommendations in Article IV consultations from 2012 onwards, though the focus remained on putting in place the preconditions for liberalization.

automotive cluster in Morocco was showcased (MENA *REO*, October 2019) as an example of how a targeted intervention by the government had worked.

50. Among private sector participants, it was felt that the Fund could have insisted more boldly on accelerating the pace of the reforms necessary to move to full liberalization. These interviewees felt that a somewhat faster pace of liberalization would have nudged the private sector towards taking somewhat greater risks—balanced by greater use of hedging instruments—and thus deepening financial markets.

51. The authorities have been appreciative of Morocco's four successive PLL arrangements with the IMF since 2012, crediting them with providing helpful resilience against the numerous external shocks the country has experienced, including volatility in growth in Europe and in oil prices, and helping to catalyze access to other sources of finance. In April 2020, Morocco drew on the PLL, which BAM officials noted will allow the country to mount a "proactive response" to mitigating the effects of the COVID-19 crisis while maintaining foreign exchange reserves at a level "capable of consolidating the confidence of foreign investors."

IV. ASSESSMENT

52. The Fund staff deserves considerable credit for detailed and sustained analysis of developments in capital flows to the SSA and MENA regions and the benefits and risks these developments pose. At the same time, the analysis has been largely ex post rather than anticipatory, and policy advice has been two-handed rather than pointed.

53. Policy advice has generally reflected the staff's desire to be open to all possible avenues for fostering growth in regions where developmental challenges still loom large amidst concerns about fiscal and external sustainability. In our view, the staff seems to have struck a balance fairly well, providing advice on capital flows and analyzing the potential benefits of the changes in the composition of capital flows to these regions while also monitoring and drawing attention to emerging risks from the build-up in public debt, particularly external debt. The increasing debt vulnerabilities of many countries, particularly across Sub-Saharan Africa, are certainly a major source of concern, but it is beyond the scope of this evaluation to assess the effectiveness of the Fund's analysis and advice on the full range of factors and policies affecting this broad outcome.

54. The Fund's advice given in the context of Article IV surveillance has been typically been at a fairly general level. Interviews with senior staff members indicate that more pointed and "tactical" advice—including on the desirability of market access and attracting South-South flows—is provided to countries "offline" during or outside the regular consultation cycle. That said, staff members note that authorities often "do not call, particularly when they sense we might not go along" with their plans.

55. IMF staff work in these regions takes place against a backdrop of considerable political and social unrest in many countries, so advice must be tailored to political constraints and

judgment on what is possible. Moreover, severe data gaps and often lack of transparency come in the way of more forward-looking analysis of capital flows. Hence, even an ex post description of what has transpired with capital flows, reported in the *REOs* and departmental policy papers summarized here, has required considerable effort on the part of staff.

56. In both Ethiopia and Kenya, the authorities appreciated the staff's pragmatic guidance on capital account issues and, perceiving a change from past Fund attitudes, they did not feel that the staff was biased toward pushing for capital account liberalization. While there have been some disagreements, as described above, the authorities expressed satisfaction with the overall engagement with staff in both the surveillance and program context. In Morocco, there has been a shared understanding on the pace and sequencing of capital account liberalization that pre-dated the adoption of the Institutional View. The PLL arrangement has been highly valued for boosting the country's resilience to external shocks and has proved useful as the country battles the effects of the pandemic. In all three countries, however, interviewees also offered some more concrete suggestions for areas in which IMF advice could be improved.

ANNEX I. COUNTRIES IN THE SSA AND MENA REGIONS[8]

	Fragile and Conflict-Affected States	Others
Oil and resource producers	Central African Rep., Chad, Congo, Rep. of, Congo, Dem. Rep. of, Guinea, Liberia, Mali, South Sudan, and Zimbabwe	Angola, Botswana, Burkina Faso, Cameroon, Equatorial Guinea, Gabon, Ghana, Namibia, Niger, Nigeria, Sierra Leone, South Africa, Tanzania, and Zambia
	Iraq, Libya, and Yemen	Algeria, Bahrain, Iran, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates
Others	Burundi, Comoros, Côte d'Ivoire, Eritrea, The Gambia, Guinea-Bissau, Malawi, Sao Tomé and Príncipe, Togo, and Uganda	Benin, Cabo Verde, Eswatini, **Ethiopia**, **Kenya**, Lesotho, Madagascar, Mauritius, Mozambique, Rwanda, Senegal, and Seychelles
	Djibouti, Lebanon, Somalia, Sudan, and Syria	Egypt, Jordan, Mauritania, **Morocco**, and Tunisia

[8] Countries in bold are examined in more detail in this Background Paper.

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