Economic Commission for Africa

African Union

Economic Report on Africa 2007

Accelerating Africa's Development through Diversification

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Acronyms

ABC	**A**bstain from sex before marriage, **B**e faithful within the marriage and use **C**ondoms - approach
ACGD	African Centre for Gender and Development
ACP	African, Caribbean and Pacific Countries
ADF	African Development Fund
AEC	African Economic Community
AERC	African Economic Research Consortium
AfDB	African Development Bank
AGDI	African Gender and Development Index
AGOA	African Growth and Opportunity Act
AIDS	Acquired Immunodeficiency Syndrome
AMU	Arab Maghreb Union
AMS	Aggregate Measures of Support
APRM	African Peer Review Mechanism
AsDB	Asian Development Bank
ATPC	African Trade Policy Centre
AU	African Union
AUC	African Union Commission
CEMAC	Central African Economic and Monetary Community
CHGA	Commission on HIV/AIDS and Governance in Africa
CIS	Commonwealth of Independent States
CODESRIA	Council for the Development of Social Science Research in Africa
CMA	Common Monetary Area
COMESA	Common Market for Eastern and Southern Africa
CSO	Civil Society Organization
DAC	Development Assistance Committee/OECD
DRC	Democratic Republic of Congo
DfID	Department for International Development/UK
DFQF	Duty Free, Quota Free
EAC	East African Community
EBA	Everything but Arms Initiative
EBRD	European Bank for Reconstruction and Development
ECOWAS	Economic Community of West African States
EIU	Economist Intelligence Unit
EPA	Economic Partnership Agreement

EPZ	Export Processing Zone
ESA	Eastern and Southern African group/COMESA
ESMAP	Energy Sector Management Assistance Program
EU	European Union
FAO	United Nations Food and Agriculture Organization
FAOSTAT	FAO Corporate database for substantive statistical data
FDI	Foreign Direct Investment
FONDAD	Forum on Debt and Development
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Trade and Tariffs
GCF	Gross Capital Formation
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GIPC	Ghana Investment Promotion Centre
GNI	Gross National Income
GSP	General System of Preferences
GSTP	General System of Trade Preferences
HDI	Human Development Index
HIV	Human Immunodeficiency Virus
HDI	Human Development Index
HIPC	Heavily Indebted Poor Country
IADB	Inter-American Development Bank
ICT	Information and Communication Technology
IDA	International Development Association/WB
ILEAP	International Lawyers and Economists against Poverty
ILO	International Labour Organization/UN
IMF	International Monetary Fund
ITC	International Trade Centre
LDC	Least Developed Country
MDG	Millennium Development Goal
MDRI	Multilateral Debt Reduction Initiative
MENA	Middle East and North Africa
MFA	Multi-Fibre Agreement (textiles)
MNC	Multinational Corporation
MSE	Medium and Small Enterprise
MDRI	Multilateral Debt Relief Initiative
NAMA	Non-Agriculture Market Access
NEPAD	New Partnership for Africa's Development
NER	Net Enrolment Rate
NIE	Newly Industrialized Economy
NGO	Non-governmental Organization

ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing Power Parity
PTA	Preferential Trade Area
REC	Regional Economic Community
R&D	Research and Development
REER	Real Effective Exchange Rate
RTA	Regional Trade Agreement
S & D	Special and Differential Treatment
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAP	Structural Adjustment Programme
SME	Small and medium enterprise
SPS	Sanitary and Phytosanitary Measures
SSA	Sub-Saharan Africa
TA/CB	Technical Assistance and Capacity Building
TDCA	SA-EU Free Trade Agreement
TFP	Total Factor Productivity
TPA	Trade Promotion Authority
TWN	Third World Network
UK	United Kingdom
UNAIDS	United Nation Joint Programme on HIV/AIDS
UN-DESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Programme
UNEP	United Nations Environmental Programme
UNHCR	United Nations High Commissioner for Refugees
UNICEF	United Nations Children's Fund
UNCTAD	United Nations Conference on Trade and Development
UNSD	United Nations Statistical Division
UNU	United Nations University
USA	United States of America
WAEMU	West African Economic and Monetary Union
WCO	World Customs Union
WFP	United Nations World Food Programme
WIDER	World Institute for Development Economics Research
WTO/Tourism	World Tourism Organization
WTO/Trade	World Trade Organization

Foreword

Nowadays, profound changes are increasingly occurring in all areas of the world economy. While the industrialized and emerging economies are able to contain the multiple external and internal shocks generated by these changes, Africa on its part is still struggling to cope with them. Such a situation, often of indescribable impact, keeps our continent in poverty at this beginning of the twenty-first century.

Faced with the challenges of globalization and ever-deepening poverty, African Heads of State and Government have decided in recent Summits of the African Union to do their utmost to secure peace and stability on the continent, strengthen capacities for governance and the rule of law, fight corruption, accelerate economic and political integration, make the required investments, pursue sustained growth and speedy development of the African common market.

The oft-expressed policy commitment of African Heads of State and Government to reverse Africa's current marginalization in the world economy and to enable our countries to harness and efficiently exploit their resources also means that we must pool our efforts in order to attain the agreed objectives.

In response to this urgent call to harness the continent's resources, cooperation must be strengthened among the major development practitioners who find, in this rich Economic Report on Africa 2007, jointly produced by the African Union Commission and the United Nations Economic Commission for Africa, the expression of the common will to join our forces in contributing to the common efforts for development.

This first report of its kind, comes as a sequel to the work conducted jointly in 2005 and 2006 on Assessing Regional Integration in Africa (ARIA). It must gain in coming years from the collaboration and involvement of Africa's other business partners, so that the lofty ideals of moving our countries out of under-development and poverty and of guaranteeing peace, stability and sustainable development, can be attained.

The analyses reported in ERA 2007 review the world economy and map out prospects for development in Africa through the institution of structural reforms to diversify and modernize the economy, enhance competitiveness, promote trade, accelerate growth and reduce poverty.

Far from the ready-made policies that have had a disappointing track record in Africa, this report looks pragmatically at innovative strategies and best practices that have proven their value within and outside Africa, the know-how and skills acquired, at how regional resources can be mobilized to address the challenges of globalization and emerging communication technologies and constitutes a rich frame of reference for research into development policies in Africa.

This high-quality work done by African experts is required reading for all decision-makers in our States, relaunching the policy debate and enabling the deepening of reflexion on economic integration, sustainable development, and adaptation of the strategies and measures proposed for addressing the specific conditions in each country.

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Overview

Moderate world growth and the threat of macroeconomic imbalances

Growth in the world economy improved slightly in 2006 relative to 2005, from 3.5 per cent to 3.8 per cent. It is driven by the strong performance by Asian economies, which continue to post growth rates above 8 per cent. In contrast, growth in advanced economies remains modest and is yet to reach the pre-2001 level. Key constraints to growth include the massive global macroeconomic imbalances along with tight macroeconomic stances in advanced economies, which prevent demand-led recovery. High oil prices undermine growth in both advanced and developing countries through high production costs.

Developed countries, especially the United States, face the challenge of rising current account, government, and private sector deficits which threaten domestic economic recovery as well as global financial stability. The US current account deficit has risen systematically since the 1990s, reaching 6.6 per cent of GDP in 2006. Meanwhile, its budget balance has moved from a surplus in 2000 (1.9 per cent of GDP) to a deepening deficit that stood at 2.5 per cent of GDP in 2006. Moreover, the US private sector position continues to deteriorate due to insufficient savings partly driven by the easy credit that fuels consumption.

Thus far, the widening deficits in the US have been financed by savings in the developing world, especially Asia and the oil-exporting emerging economies in the Middle East. Asia, the Middle East, and Latin America increased their current account surpluses since 2000. In particular, China's surplus increased from 1.7 per cent of GDP in 2000 to 7.2 per cent in 2006, making it the largest single financier of the US deficit. Central banks in developing countries have accumulated massive US dollar-denominated reserves partly as a means of preventing national currency appreciation. Given the low world interest rates, these reserves have earned low returns to the asset holders. Low world interest rates have also allowed the US to accumulate debt at low cost.

However, the willingness of central banks to continue to accumulate low-return reserves may be limited. Markets will need to be convinced that policymakers will not let the imbalances go out of hand. This will require concerted and coordinated efforts in industrialized economies and the developing world to achieve a smooth

correction of the imbalances. The adjustment mechanism will involve a decrease in the US deficit, an increase in investment in other countries (a decline in savings in high-surplus countries), as well as a weak value of the dollar, which will allow adjustment of the US trade deficit and reduce incentives for reserves accumulation. Most importantly, it is critical to accelerate growth in advanced economies as well as developing countries, which will require loosening of the policy stance to foster demand-led recovery.

Growth in Africa has increased but it is still not enough

African economies continue to sustain the growth momentum of previous years, recording an overall real GDP growth rate of 5.7 per cent in 2006 compared to 5.3 per cent in 2005 and 5.2 per cent in 2004. As many as 28 countries recorded improvements in growth in 2006, relative to 2005. Only Zimbabwe recorded a negative growth rate in 2006. Africa's growth performance in 2006, as in previous years, was underpinned by improvement in macroeconomic management in many countries, and strong global demand for key African export commodities, sustaining high export prices, especially for crude oil, metals and minerals.

However, for most African countries, real growth rates have remained low relative to their development goals. With only five countries recording an average real GDP growth rate of 7 per cent or more during 1998-2006, few African countries are positioned to achieve the Millennium Development Goals (MDGs) by 2015. Meanwhile, growth performance exhibits substantial disparities across the five subregions. North Africa recorded the highest acceleration in GDP growth, followed by Southern Africa. There was a deceleration in growth in West Africa and East Africa, whereas Central Africa maintained the same growth rate as in 2005. Heavy dependence on primary commodities remains a common feature of production, exports and growth in all the subregions. This exposes the continent to external shocks and makes economic diversification a top priority for growth policies on the continent.

Oil-exporting African countries as a group contributed 57.5 per cent of the continent's 5.7 per cent growth rate in 2006, compared to 53.4 per cent in 2005. Efficient management of oil revenues and economic diversification are essential for oil-exporting African economies to reduce vulnerability to oil price shocks, ensure that gains from oil revenue are broadly shared, and achieve sustainable growth.

Improved economic management and increases in non-oil commodity prices have more than offset the negative impact of high oil prices on the real GDP of African oil importers. The growth impact of higher oil prices was particularly moderate for non-oil and non-mineral-rich economies, where growth performance improved from 4.1 per cent in 2005 to 5.8 per cent in 2006, thanks to debt relief and increased aid

flows as well as improved agricultural production and high agricultural commodity prices. The growth rate in non-oil, mineral-rich African countries was unchanged in 2006 relative to 2005, as gains from the higher prices of minerals were dampened by the effects of rising oil prices.

To minimize the effects of high oil prices on inflation and macroeconomic stability in general, African governments need to pursue prudent policies, especially by avoiding monetization of deficits. In the meantime, the international donor community and international financial institutions should provide special support to oil-importing, low-income African countries to mitigate the impact of higher oil prices. In particular, debt relief and additional non-debt-generating external financing of fiscal deficits are critically needed to assisting African oil-importing countries to sustain economic growth and achieve the MDGs.

Current account balances are driven by developments in the resource sector

For the third consecutive year, Africa achieved a positive and increasing current account surplus (from 2.3 per cent of GDP in 2005 to 3.6 per cent in 2006). Africa's average balance of payments position reflects largely developments in oil-rich countries, which have recorded increasing trade surpluses, while their oil-importing counterparts experienced deepening trade deficits. The deterioration of the trade deficit is more pronounced for landlocked countries.

While exchange rates have been stable for most African countries, high commodity dependence exposes African economies to terms-of-trade fluctuations and extreme exchange rate volatility. The majority of African counties are dependent on oil and minerals or a limited range of agricultural commodities such as tea, coffee, cotton and cocoa. Thus, fluctuations in commodity prices have a significant impact on export revenue and the exchange rate in these countries. This forces many African countries to accumulate excessive foreign exchange reserves at high economic cost. A better approach is to adopt a comprehensive (country-specific) strategy for prudential regulation and capital controls that can minimize exchange rate risk while allowing the countries to benefit from increased export revenue and foreign direct investment (FDI) inflows.

African countries need a new approach to growth policy

More than any time before, it is now understood that the general, one-size-fits-all growth policies embedded in macroeconomic stabilization and second-generation reform programmes will not help African countries. Besides sustaining macroeconomic stability, African countries need to tailor their fiscal and monetary policies to promoting domestic investment, employment generation, and growth. Moreover, it is necessary to identify binding constraints to growth as well as the sources

of growth potential at a disaggregated level, and design incentive mechanisms to channel resources to sectors with the highest potential for growth and employment generation.

Social development: progress towards the MDGs remains below expectations

Compared to other regions, Africa continues to lag behind in all indicators of social development. Measures of poverty have remained virtually unchanged over the past decades. The average share of population below the poverty line was 44 per cent in 2002 compared to 44.6 per cent in 1990; thus, one can hardly talk of any progress in poverty reduction. Sub-Saharan Africa (SSA) also lags behind in progress towards universal primary education. This is despite notable progress in net enrolment rates, which increased from 53.0 per cent to 64.2 per cent in SSA from 1990 and 2004, and from 80.6 per cent to 94.0 per cent in Northern Africa during the same period. It is critical to increase investment in education to match the expansion in demand so that gains in enrolments are not achieved at the expense of quality of education. More efforts are also needed to accelerate progress in gender equity in access to education.

Progress is also modest in the health sector, with SSA visibly trailing behind North Africa. A major threat to the health sector is the spread of the HIV/AIDS. Currently, more than 25 million Africans live with HIV, and 2 million of the 2.8 million AIDS deaths worldwide in 2005 were in Africa. In the 38 hardest hit African countries, it is projected that there will be 19 million additional deaths due to AIDS between 2010 and 2015. Thus, more budgetary allocations are needed to increase both prevention – including through education – as well as treatment to curb the spread of the pandemic.

African countries also continue to face the challenge of other deadly diseases, especially malaria, which remains the number one killer on the continent. Investment in insecticide-treated nets has proved to be a successful approach to preventing malaria, but more is still needed to win the war against this and other preventable and curable diseases such as tuberculosis.

Growth prospects for 2007 and the medium-term outlook

Africa is expected to grow at a rate of 5.8 per cent in 2007, slightly higher than the rate recorded in 2006 (5.7 per cent). Global demand for African products – especially oil, minerals and agricultural – is expected to remain upbeat, but this is contingent on successful economic recovery in major industrial countries and continued strong growth in emerging Asian economies, especially China. Moreover, delivery of the promised aid and debt relief will allow African countries to boost expenditures in key sectors including public infrastructure and social services. Furthermore, consoli-

dation of macroeconomic management will not only reduce inflation in the short run, but also encourage private investment and strengthen growth.

Factors that are likely to hinder growth in 2007 and subsequent years include lack of diversification of production and exports and subsequent instability and vulnerability to shocks, and the increasing spread of the HIV/AIDS pandemic, which undermines labour supply and labour productivity. In addition, inefficient public infrastructure and unreliable energy supply at the national level as well as poor integration of transportation and energy network at the regional level will continue to undermine productivity and international competitiveness. Moreover, higher oil prices are a major concern for African countries, which need to continue to control inflation, promote fiscal stability, improve current account position, and increase growth.

Challenges and opportunities in development financing

The past few years have witnessed encouraging developments in development financing for Africa, which should have positive impact on the continent's growth prospects in the coming years. However, much more needs to be done in both the volume of external finance and the effectiveness in the use of these resources.

External debt remains high and private capital flows insufficient

The hope that Africa's external debt will be significantly reduced under the Highly Indebted Poor Countries Initiative (HIPC) and that economic reforms will stimulate private capital inflows has been very slow to materialize. Although Africa's debt stock declined considerably relative to GDP, total debt service obligations remained unchanged in 2006 due to rising interest rates. The debt burden seriously constrains spending on public investment and ultimately retards growth and employment generation.

The continent has benefited from substantial inflows of external financing in the form of official development assistance (ODA) (including debt relief), which should boost economic growth in the coming years. The Multilateral Debt Relief Initiative (MDRI) announced at the G-8 summit in Gleneagles in 2005 provided much needed relief for 13 SSA countries. However, this debt relief package is not enough and more external funding is needed to help African countries increase growth rates and achieve a meaningful reduction in poverty. Gross domestic investment remains far below the level considered necessary for Africa to half poverty by 2015. Higher external inflows will be needed to fill the chronic investment-saving gap in order to boost economic growth.

There are encouraging developments in external development financing but disbursements fall short of commitments.

Recognizing the impact of their policies and practices on aid effectiveness, donors have committed themselves to better harmonize their policies and practices on aid to enhance the development impact of aid in recipient countries. This has been reflected in a number of international declarations, including the Monterrey Consensus, Rome Declaration, Paris Declaration and, recently, the G-8 summit in Gleneagles. All these declarations call for scaling-up more financial resources to developing countries and improving the delivery and management of aid to enhance its development impact in recipient countries.

Aid disbursements remain much below the 0.7 per cent ODA to GNI target donors have set themselves to achieve. The average ratio for DAC members was 0.26 per cent in 2004. However, a handful of countries have met the target.

With respect to aid effectiveness, donors have made considerable progress in untying aid to African countries. The percentage of aid from Development Assistance Committee (DAC) member countries to Least Developed Countries (LDCs) that was untied rose from 55 per cent in the period 1999-2001 to 68 per cent in 2004. However, there are considerable variations in performance across DAC countries. Some countries including Finland, Ireland, Luxembourg, Norway and the United Kingdom have successfully moved away from tied to untied aid, while others still have very high ratios of tied aid to total aid. Similarly, DAC countries have made substantial progress in increasing the proportion of grants in total ODA with the share of grants in aid rising from 49 per cent over the period 1980-1984 to 90 per cent in the 2002-2004 period.

Donor countries have also made considerable progress in meeting their commitments in the area of debt relief. African countries benefited from the MDRI announced at the G-8 Summit in Gleneagles. While this debt relief is a welcome development, it is, however, not sufficient to finance Africa's myriad development priorities.

Domestic development financing

As witnessed in other developing regions, particularly in East Asia, the mobilization of domestic resources plays a key role in financing investments in economic and social infrastructure, and hence, in tackling poverty.

However, the level of savings in SSA has been historically less than 20 per cent of GDP, which is considerably below the average of East Asia and the Pacific (35 per cent), Latin America and the Caribbean (21 per cent) and the Middle East and North Africa (26 per cent). At the same time, it is promising that there are a number of SSA countries, which have mobilized domestic savings. In fact, five countries, Algeria, Botswana, Republic of Congo, Gabon and Nigeria, have reached a savings

ratio of more than 30 per cent. A key challenge facing these countries is how to translate these high savings into productive investment, especially in non-oil and non-mineral activities, to achieve sustained economic growth. Other African governments need to focus efforts on mobilizing both public and private savings.

As a consequence of low levels of savings in addition to limited private capital flows, investment ratios in SSA countries are lower than in other developing regions. For example, over the period 2000-2004, domestic investment as a proportion of GDP was 18 per cent in SSA compared to 31 per cent in East Asia and the Pacific.

In response to this challenge, African governments need to develop domestic capital markets, including bond markets and stock exchanges, which can play an important role in increasing both the quantity and productivity of investment. There are currently 21 stock exchanges in Africa, though these markets are still characterized by low levels of liquidity, lack of integration with regional and global markets, and a range of capacity and technology constraints. The regional integration of capital markets in Africa offers a solution to this situation, especially for the smaller economies. Overall, to accelerate capital market development, governments need to improve the capacity of all stakeholders, invest in infrastructure, and promote good governance.

Developments in trade negotiations

Trade negotiations are recognized as an important tool for increasing trade prospects and facilitating Africa's integration in the world economy. However, negotiations are still far from realizing the continent's expectations. Much was expected of a successful Doha Round. Likewise, it is often suggested that Economic Partnership Agreements (EPAs) with the European Union (EU) would result in an improved business environment in African countries, allowing for more investments and enhancing the prospects for diversification of their economies.

Unfortunately, on the World Trade Organization (WTO) negotiations front, progress has been limited and below the expectations of African countries. One main reason for the deadlock in WTO negotiations appears to be the disagreement with the levels of demand and offers on agriculture, a critical area for Africa's development prospects. This lack of progress has clearly been a setback for the multilateral process, prohibiting the international community, and especially poorer countries, from significant improvements in the multilateral trading system.

The limited progress in the WTO negotiations is impacting negatively on the cotton initiative, which was sponsored by some African countries for the elimination of cotton subsidies by the developed countries. While the cotton-textile sector in Africa holds a tremendous opportunity for diversification, delays in finalizing the Doha Round is hindering the exploitation of these opportunities. As it were, the Hong Kong Ministerial Conference of December 2005 reached agreement on the elimina-

tion of cotton export subsidies, but agreement has yet to be reached on the elimination of domestic cotton subsidies. There was expectation that progress in the WTO negotiations would allow for an expeditious agreement on cotton.

Probably one of the most significant developments has been the evolution of the participation of African countries in the actual negotiations. African countries were not only engaged actively in the definition of the mandate for the negotiators, but have been active at every stage, as the negotiations have progressed. This active participation has not translated to concrete results whereby African priorities are holistically addressed.

There has been growing concern in Africa that EPAs, while representing significant potential for growth and development, also pose great challenges in terms of adjustment costs. The standstill in WTO negotiations also complicates the EPA process. In the absence of evolutions on rules for preferential trade arrangements, important uncertainties remain on the degree of flexibility African countries would have on the length of transition periods and on the coverage of liberalization. EPA negotiations are probably the major task ahead of African trade policy makers, especially given the slow pace of the Doha Round. They pose great challenges but also real opportunities in terms of development for the continent.

In light of the slow progress in the WTO negotiations and the ongoing EPA process, African countries have an ever greater interest in diversifying their export markets. They are involved in a number of regional and free trade agreements negotiations. Fostering regional integration has been a long-standing objective, but African regional integration remains hampered by several obstacles including political and security factors, and also by poor transport and communication infrastructure, a low degree of complementarity in the structures of production and the overly complex web of memberships across different Regional Economic Communities (RECs).

Preferential trade arrangements are considered promising complementary platforms for diversification. Thirty-seven African countries are eligible to the African Growth and Opportunity Act (AGOA), which grants African countries quasi duty-free, quota-free access to the US market. Thirty-four African countries are LDCs and therefore are eligible to the EU's Everything-but-Arms (EBA) scheme. Other non-LDC African countries are either beneficiaries of the EU's General System of Preferences (GSP) or are party to a bilateral free trade agreement with EU.

Several African countries or groupings are also involved in bilateral or trade negotiations in order to diversify their export markets and enhance their integration in the global economic system. For example, West African Economic and Monetary Union (WAEMU) countries are currently negotiating free trade agreements with several North-African countries. The US and the South Africa Customs Union (SACU) are also engaged in free trade talks. South Africa is also discussing with India and MERCOSUR countries on a potential free trade agreement. With the recent explosion of

trade flows between Africa and China and India, several countries also envisage talks with these two Asian nations.

Diversification as a key pillar in Africa's development efforts

Two distinct periods stand out in Africa's development strategy. The period spanning the 1960s and the 1970s was characterized by policies aimed at strengthening economic autonomy. It is during this period that diversification oriented policies were aggressively pursued in most countries. A major shift in economic policies in Africa was occasioned by the economic crises of the early 1980s. Most of the post-independence economic policies geared to long-term development were replaced by macroeconomic stabilization policies focusing on short-term goals. This reorientation of economic policies has failed to yield the expected results, and it is clear that a shift in policy orientation is needed to accelerate progress towards the MDGs.

In recent decades, sparks of economic growth have often vanished as quickly as they have been ignited. The current growth momentum also rests on a very fragile foundation. The continent continues to rely on primary commodities whose prices have been major sources of trade shocks. While efforts towards diversification had some positive results in the 1970s and early 1980s, these gains were reversed in the mid-1980s due to the economic crises of the period. Therefore, it is critical for African countries to embrace diversification as the central development paradigm.

Diversification experiences in Africa fall into five main categories: countries with little economic diversification such as Burkina Faso and Senegal; countries that made some early progress and then stagnated in the process such as Kenya; those that managed to deepen their diversification process as exemplified by Tunisia and Mauritius; backsliders in the diversification efforts consisting mainly of oil-rich countries such as Nigeria; and non-starters comprising largely of the conflict and post-conflict countries such as Liberia and the Democratic Republic of Congo. This diversity of experiences raises the questions of what factors drive diversification and what policies can foster diversification in the medium-term and in the long-term.

Evidence on the determinants and stages of diversification

The diversification process in Africa is highly influenced by investment, per capita income, degree of openness of trade, macroeconomic policy stance and institutional framework. To begin with, investment is vital for an economy to diversify. Two stages of diversification with respect to investment can be observed for Africa, with a U-shaped relationship between investment and diversification. Unfortunately,

the turning point for Africa was found to be at 12.5 per cent of GDP, indicating that if the continent is to deepen its diversification process, much higher levels of investment to GDP ratios are required.

A second important finding in this report relates to income effects on diversification. Like in the case of investment, the two stages of diversification as established in the literature were confirmed in the case of African countries. The report also argues that trade openness does not necessarily lead to deepening of diversification, based on existing literature and the experience in openness for Africa. It is evident that a strategic trade policy is needed to strengthen this process in Africa.

Rapid liberalization in Africa has put a break on the diversification process

Rapid liberalization could have acted as a constraint to diversification on the continent. The results suggest that the debate on optimal trade policy is highly relevant. Specifically, the evidence for African countries suggests that there is merit in the argument for policy space with respect to trade liberalization. African countries may wish to adopt a gradual approach to liberalization. Indeed, historical evidence indicates that countries that promote diversification first before specializing enjoy much higher and more sustainable levels of welfare.

Macroeconomic stability is necessary for diversification

Industrialization helps to deepen diversification, which fits well with the established development theory that a country evolves from specialization to diversification through industrial deepening before starting to specialize again. Some elements of macroeconomic stability are critical to diversification. In particular, fiscal conservatism appears to be an important constraint to diversification.

The institutional environment is critical for diversification

Good institutions provide an enabling environment for diversification. In particular, good governance enables economies to diversify while conflict stifles diversification. Therefore, consolidation of institutional reforms both at the aggregate (e.g., the legal system) level and at the microlevel (e.g., business and banking regulation) constitutes an important part of the national agenda to promote diversification.

Diversification contributes to growth through productivity

It is well established that economies grow faster when there is an increasing share in the contribution of productivity to growth. Indeed, the rates of economic growth among developed economies are differentiated mainly by the rate of growth of productivity rather than the rate of factor accumulation. Growth in African economies

can, therefore, be scaled up by enhancing diversification, which in turn leads to an improvement in productivity. Deepening diversification is as important as eliminating conflict and investing in human capital, in terms of improving productivity and by extension, economic growth.

Policies to increase diversification

Diversification policies for Africa can operate at three levels: macroeconomic policies to support diversification; trade and sectoral policies to deepen diversification; and strengthen institutions to enhance diversification efforts.

Macroeconomic policies for diversification – pragmatism rather than orthodoxy

African countries need pragmatic macroeconomic policies to foster diversification. While macroeconomic stability is important for the diversification, it is also clear that a rigid macroeconomic framework will hinder diversification. Macroeconomic stability achieved through conservative fiscal and monetary policies may, in fact, delay the diversification process. Flexible macroeconomic policies that especially allow countries to achieve high levels of public investment are key to a successful diversification agenda.

Trade and sectoral policies for diversification – back to the basics

In the 1980s, the focus in economic management shifted towards macroeconomic stabilization policies. This led to the neglect of sectoral policies and microeconomic reforms, which are critical for industrialization and diversification. Therefore, there is need for more proactive micro-level economic policies that are evenly balanced with the macroeconomic policies. African countries should use trade policies in a strategic way aimed specifically at diversification and by extension growth and development outcomes.

The evidence in this report demonstrates that the financial sector plays a critical role in financing private investment, which is vital for diversification. There is, therefore, a need to consolidate financial sector reforms to increase efficiency of resource allocation, which will help to deepen diversification.

With regard to industrial policies, it helps to recall that economic transformation is both a necessary and sufficient condition for industrialization. But economic transformation cannot take place unless diversification takes root. Given the correlation between diversification and economic transformation, industrial policies are, as a consequence, part and parcel of the new economic policies that African countries need to increase economic diversification

The other major area where new economic policies for diversification are required is in research and development. The majority of African countries have resorted to

relying on factor accumulation as the main source of economic growth. Yet, evidence has shown that the industrialized and newly industrialized economies (NIEs) were able to achieve development leaps when dramatic changes in productivity took place. Financing research and development stands out as a clear way by which African countries could improve the level of innovation and increase the contribution of productivity in economic growth. This would then enable these countries to reap maximum benefits from their diversification efforts.

Strengthening of institutions is a prerequisite to diversification

For the macroeconomic and new sectoral and industrialization policies to achieve optimal diversification results, it is important for African countries to strengthen their institutions. Conflict and governance have substantial implications on diversification. It is important that countries invest in peace-building and peace- promoting institutions that can proactively deal with threats of conflict flare-up or resurgence. Countries that aim to deepen diversification will also need to invest in establishing and consolidating institutions that enhance good governance.

Part

1

Recent Economic Trends and Prospects for 2007

Developments in the World Economy and Implications for Africa

Developments in the world economy have important implications for African economies through various channels, including demand for African export commodities, the impact on the trade balance and the cost of external borrowing (via world interest rates). These developments are influenced by monetary, fiscal and trade policies adopted by major industrialized countries as well as by exogenous events such as oil price shocks.

Growth in the world economy remains dominated by the Asian economies, which continue to grow at more than 8 per cent per annum. In contrast, growth in advanced economies remains modest and is yet to reach the pre-2001 level. Key constraints to growth include the massive global macroeconomic imbalances along with tight macroeconomic stances in advanced economies, which prevent demand-led recovery. High oil prices also undermine growth in both advanced and developing countries through high production costs.

Some positive developments in the world economy are likely to sustain growth in African countries. These include high export prices for export commodities due to high demand especially from Asia, delivery of promised aid and debt relief, and rising inflows of foreign direct investment (FDI) with an increasing share coming from China and India, and higher inflows of workers' remittances. However, these developments need to be supported by adequate domestic pro-growth policies to maximize the gains from increased external resources.

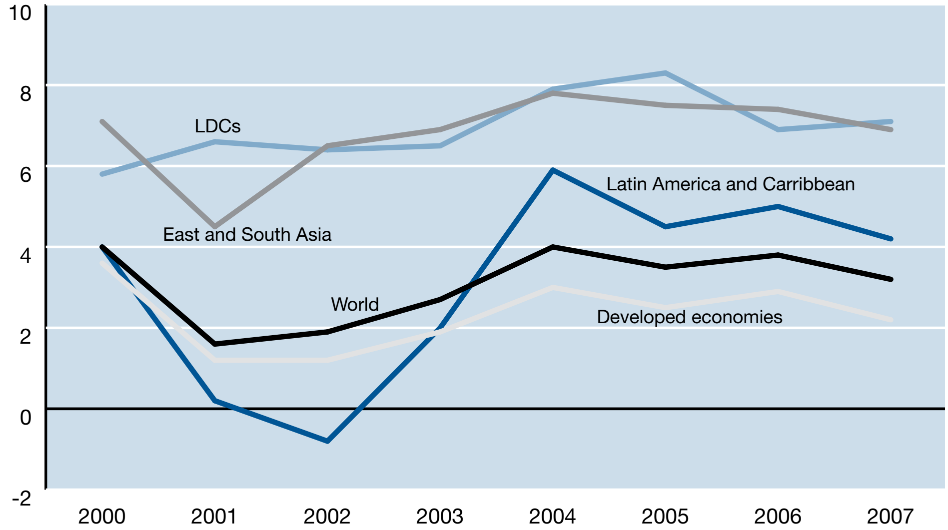
1.1 Global economic performance

World growth is moderate and likely to slow down in 2007

In 2006, world economic growth improved slightly to 3.8 per cent from 3.5 per cent in 2005 (figures 1.1 and 1.2). Globally, growth rates were highest in South-east Europe and Commonwealth of Independent States (CIS) countries as well as in East and South Asia. Growth in the least developed countries remained above 6 per cent since 2001 (United Nations 2007 and UNCTAD 2006a). High prices for oil and

other inputs and a tendency towards more restrictive monetary policies in industrial countries combined with some turbulence in financial markets are likely to contribute to a slowdown in 2007 (UNCTAD 2006a; UN-DESA 2006).

Figure 1.1
GDP growth rates of major regions, 2000-2007 (per cent)



***Source**: United Nations 2007.*
***Note**: The reported estimates of growth rates for world gross product are obtained using country gross domestic product at market prices in dollars as weights. For comparison, growth rates estimated using purchasing power parity-based weights would be 5.1 per cent for 2006 and 4.5 per cent for 2007.*

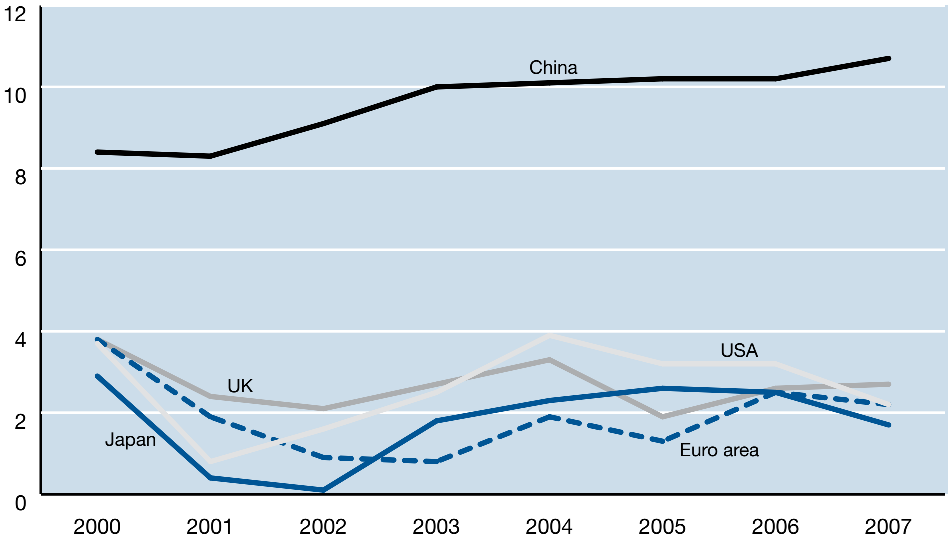
"Rising oil prices and increasing imbalances constitute important downside risks for growth"

Growth in the USA slowed slightly during the second half of 2006 and might slacken further in 2007 but is not likely to go into recession. The decline in house prices is expected to weaken consumer spending as well as import demand (UN-DESA 2006; United Nations 2007). Rising oil prices and increasing imbalances also constitute important downside risks for growth.

The Euro area grew by a modest 2.5 per cent in 2006, though it was the highest growth rate since 2000. This was driven by higher domestic demand, particularly investment expenditure, as well as strong export performance. In 2007, it is expected that external demand will decline, and that stronger currencies will hamper exporters. Monetary and fiscal policies are also expected to tighten, which will reduce growth. Growth in Japan is attributable to buoyant domestic demand and employment growth, but it is expected to slow down in 2007 (UN-DESA 2006; United Nations 2007).

Figure 1.2

GDP growth rates of major economies, 2000-2007 (per cent)



***Source**: United Nations 2007.*

China and India are engines of trade in developing Asia

Growth in developing Asia was high in 2006, driven by China (10.2 per cent) and India (7.7 per cent), which are the engines of trade in manufacturing within the region. In addition, domestic demand has also recovered in most Asian countries. Growth in the region is expected to decline to a more sustainable yet still strong pace due to a slowdown in external demand for Asian products. Additional downside risks include protectionist trade policies in major export destination countries, further increase in the level and volatility of oil prices, the avian influenza, as well as political and geopolitical uncertainties, especially in the Islamic Republic of Iran, Nepal and Sri Lanka (United Nations 2007; UN-DESA 2006; UNCTAD 2006a).

"China is not only experiencing rapid growth but also rapid structural change"

China is not only experiencing rapid growth but also rapid structural change driven by FDI and a rise in competitiveness. Despite strong growth in manufacturing wages (between 12 and 16 per cent in recent years), unit labour costs in manufacturing are falling due to growth of labour productivity by around 20 per cent per annum (UNCTAD 2006a).

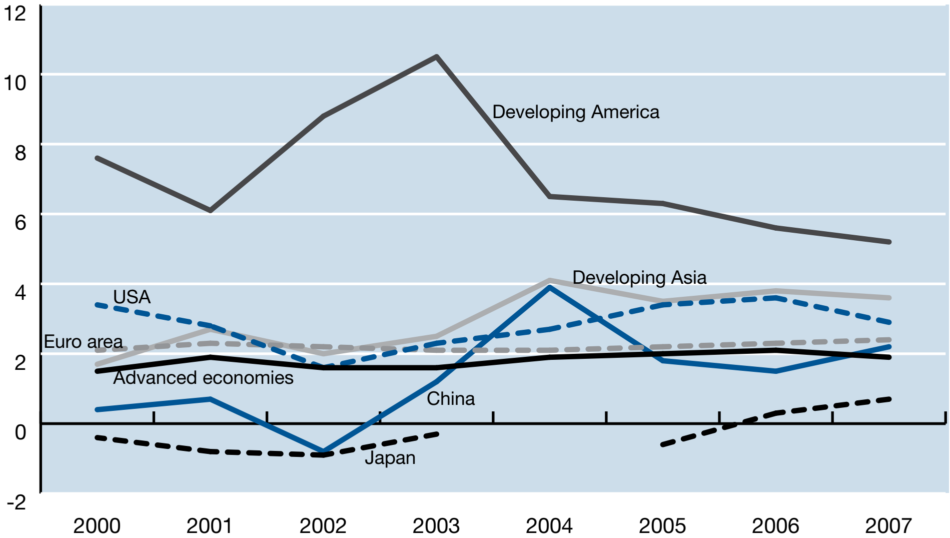
Growth in Latin America has remained above 4 per cent for the past three years due to strong external and domestic demand. At the same time, growth in the region has become more broad-based. However, the external sector remains vulnerable and the region might suffer from higher interest rates in global capital markets as many countries have relatively high debts, which will slow down growth in 2007 and in subsequent years (UN-DESA 2006; United Nations 2007).

1.2 Macroeconomic policies in developed countries

Despite the recent oil price hikes, global inflation has remained low and stable (figure 1.3), partly due to restrictions to wage increases, a tight macroeconomic policy stance in both advanced and developing countries, and the supply of cheap manufactures from China. In general, there is little concern about overheating in most economies.[1]

Figure 1.3

Inflation rates in major regions and economies, 2000-2007 (per cent)

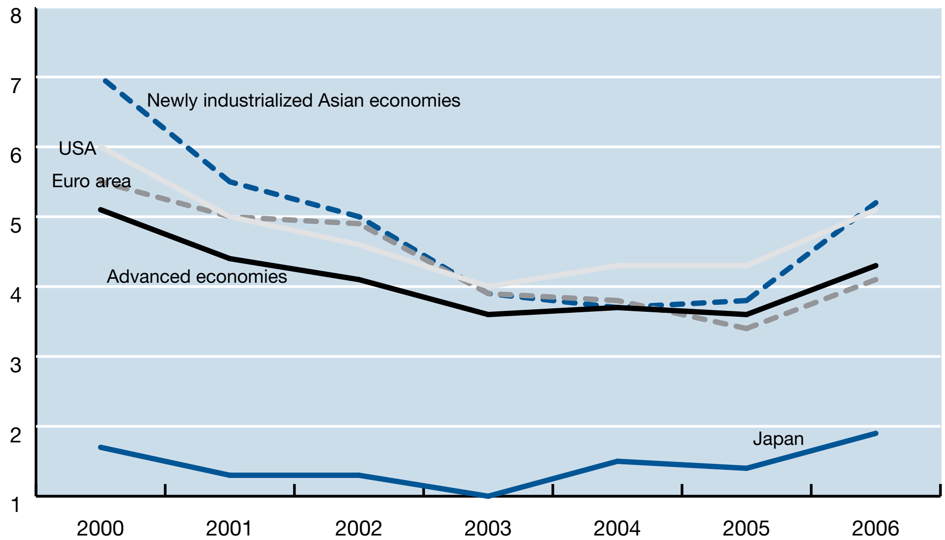


Source: *IMF 2006.*
Note: *Data for Japan is missing for 2004.*

Since 2003, long-term interest rates in the advanced countries have increased from an average of 3.6 per cent to 4.3 per cent in mid-2006; the newly industrialized economies (NIEs) experienced the same trend (figure 1.4). Concerns about expected higher inflation rates led monetary authorities in the USA and in the European Union (EU) to raise short-term rates as a pre-emptive measure, resulting in higher long-term interest rates. Most developing countries have also been tightening monetary policy through higher interest rates and reserve requirements (UN-DESA 2006; IMF 2006). Rising interest rates might contribute to retarding economic recovery by depressing domestic demand, especially private investment.

1 Overheating means that an economy is growing too fast and that its productive capacity cannot keep up with demand, implying rising inflation.

Figure 1.4
Interest rates in major regions and economies, 2000-2006 (per cent)



***Source**: IMF 2006.*

Fiscal balance improving in most regions

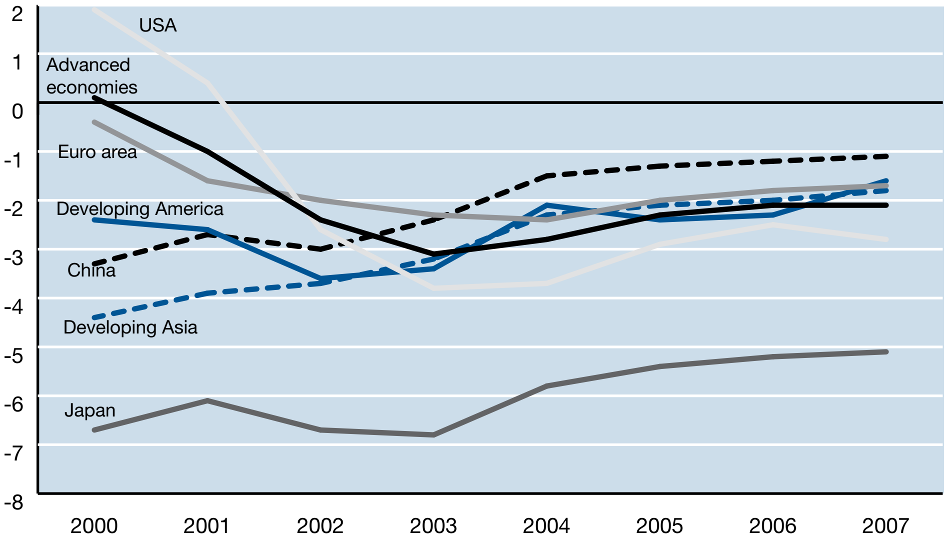
The fiscal balance has improved in most regions since 2003 (figure 1.5). In the advanced economies, the fiscal deficit declined from 3.1 per cent of GDP in 2003 to 2.1 per cent in 2006. Fiscal deficits have also declined in Asia and Latin America. The reduction in the budget deficit was particularly strong in China: from 3 per cent in 2002 to just over 1 per cent in 2006. This development was mainly driven by relatively high growth rates, which contributed to increased government revenues. It was also the result of continued adherence to a tight fiscal policy stance in both developed and developing countries. Oil and commodity exporters in developing countries have witnessed a significant improvement in their fiscal balance position due to high oil prices. In some Asian countries, fiscal policy continues to be expansionary due to increased social and development spending. To ensure fiscal sustainability, governments need to broaden the tax base so as to increase revenue (UN-DESA 2006; IMF 2006).

> *To ensure fiscal sustainability, governments need to broaden the tax base so as to increase revenue*

Generally, the currencies of many developing countries have appreciated against the dollar. Energy and commodity exporters experienced a 10-20 per cent exchange rate depreciation during the second quarter of 2006, but the trend towards appreciation has resumed since then. It is expected that the depreciation of the dollar will continue and the risk of a sudden depreciation due to worsening global macroeconomic imbalances persists (UN-DESA 2006).

Figure 1.5

Central government fiscal balance for selected regions and economies, 2000-2007 (% of GDP)



***Source**: IMF 2006.*

1.3 World macroeconomic imbalances

Macroeconomic imbalances still a major concern

Widening macroeconomic imbalances constitute a major concern for future growth prospects and economic stability. These imbalances cause uncertainty and increase the risk of financial instability, which have negative impacts on economic growth. Recently, equity markets and commodity and currency markets have become more volatile while short-term capital outflows from some emerging markets have increased. This development has raised fears of a new global financial crisis. However, the turbulence is limited to a number of countries with high current account deficits. Losses in stock markets occurred in Eastern European countries, but also in South Africa, which experienced a drop in the value of the rand (UNCTAD 2006a).

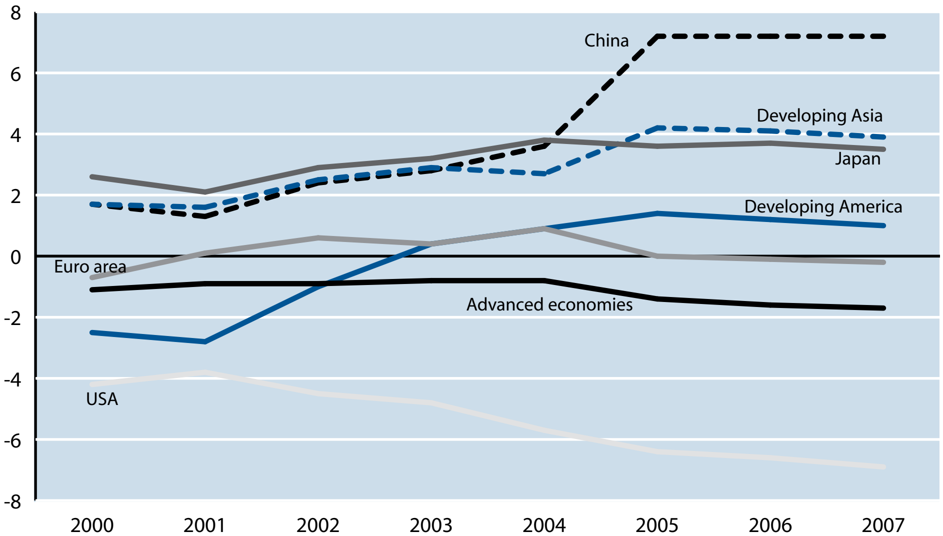
Imbalances in the current accounts widened between 2002 and 2005 but stabilized in 2006 (figure 6). In the advanced countries the deficit widened from 0.9 per cent of Gross Domestic Product (GDP) in 2002 to 1.4 per cent in 2005 and 1.6 per cent in 2006. This was mainly driven by the USA, whose deficit increased from 4.5 per cent of GDP in 2002 to 6.4 in 2005 and stabilized at 6.6 per cent in 2006. The deficits of other developed countries such as Australia, Spain and the UK have also increased.

In Japan, the current account surplus remained relatively constant around 3.5 per cent of GDP between 2003 and 2006. Both Asia and Latin America increased their current account surpluses between 2002 and 2005, which then slightly declined in 2006. China's surplus increased from 2.4 per cent of GDP in 2002 to 7.2 per cent in 2005 and 2006, making it the largest financier of the US deficit (UN-DESA 2006; IMF 2006).

The recent stabilization in global imbalances is mainly driven by weaker domestic demand in the USA, acceleration of economic activity in Europe, continued recovery in Japan and growing domestic demand in developing countries. The reduction of growth in the USA together with the depreciation of the US dollar over recent years has contributed to a 13 per cent increase in exports in the first half of 2006, while imports grew much slower. The decline in oil prices in the second half of 2006 further improved the trade balance (World Bank 2006b).

Figure 1.6

Current account balance for selected regions and countries, 2000-2007 (% of GDP)



***Source**: IMF 2006.*

The widening of global macroeconomic imbalances was partly due to the increases in the price of oil and other commodities. In the USA, the growing current account deficit was associated with deterioration of the private savings rate, further threatening the sustainability of global imbalances. In 2007, global imbalances are expected to stabilize further as cooling of the US housing market and slower growth are expected to reduce imports, while depreciation of the dollar is expected to boost exports and reduce imports (UN-DESA 2006).

Accumulation of reserves comes at a cost

Over recent years, developing countries have pursued strategies to stabilize their exchange rates and accumulate large foreign exchange reserves to shield themselves from financial crises. However, accumulation of reserves comes at a cost as it freezes resources that would otherwise be invested in productive activities to boost growth. As a result, developing countries need to strike a balance between the goals of financial stability through reserves build up and growth through stimulation of private and public investment (UNCTAD 2006a).

"Accumulation of reserves freezes resources that would otherwise be invested in productive activities"

1.4 World prices for African commodities

Commodity prices on the increase

Global demand for oil and minerals has grown fast due to global growth, especially driven by China's high performance. Between 2002 and 2005, the UNCTAD price index for non-fuel commodities rose by 45 per cent, with minerals, ores and metals prices increasing by almost 100 per cent and crude oil by 114 per cent (table 1.1). As a result, commodity prices have remained above their long-term trend. Prices of metals, minerals and oil are expected to stabilize in 2007 but remain elevated (UNCTAD 2006a; World Bank 2006b).

These price hikes were also partly driven by slow supply reactions, especially bottlenecks in refining and storage of crude petroleum, and political instability in the Middle East. In general, investments in mineral extractions have relatively long gestation periods and producers have become more conservative in their investment plans. In 2005, the depreciation of the dollar also contributed to the rise in commodity prices. Other supply-side factors have been disruptions in supply caused by labour disputes and rising production costs due to higher energy costs and the need to undertake exploration in areas that are less accessible (UNCTAD 2006a).

To some extent, exporters of minerals were able to improve their external accounts and offset the negative effects of high oil prices on terms of trade. For example, in Zamibia total exports increased from $US919 million to $US2,095 million between 2002 and 2005. The country depends heavily on copper, which accounted for 57 per cent of total exports in 2005. The surge in copper prices has significantly contributed to Zambia's growth rate of more than 5 per cent in the past three years (UNCTAD 2006a; EIU 2006b; IMF 2006).

Table 1.1
World primary commodity prices, 2000-2005 (percentage change)

	2000	2001	2002	2003	2004	2005	2002-2005
All commodities (excluding crude petroleum)	1.7	-3.6	0.8	8.1	19.4	12.1	44.8
Crude petroleum	55.6	-13.3	2.0	15.8	30.7	41.3	113.9
Food and tropical beverages	**-0.1**	**0.4**	**0.4**	**2.3**	**13.2**	**8.8**	**26.0**
Coffee	-25.1	-29.0	4.7	8.7	19.8	43.8	87.2
Cocoa	-22.1	22.7	63.3	-1.3	-11.8	-0.7	-13.5
Tea	6.8	-20.2	-9.5	8.4	2.1	9.1	20.8
Sugar	30.4	5.6	-20.3	2.9	1.1	37.9	43.6
Rice	-18.2	-15.3	11.0	4.1	23.1	17.1	50.1
Agricultural raw materials	**3.1**	**-3.9**	**-2.4**	**19.8**	**9.9**	**7.1**	**41.0**
Hides and skins	11.2	5.5	-2.9	-16.8	-1.7	-2.1	-19.9
Cotton	11.5	-19.0	-3.6	37.2	-3.3	-11.6	17.2
Rubber	7.9	-14.1	33.1	41.7	20.3	15.2	96.3
Tropical logs	3.7	6.4	-10.5	20.1	19.2	0.3	43.6
Mineral ores and metals	**12.4**	**-10.8**	**-2.7**	**12.4**	**40.7**	**26.2**	**99.6**
Aluminium	13.8	-6.8	-6.5	6.0	19.8	10.6	40.6
Copper	15.3	-13.0	-1.2	14.1	61.0	28.4	135.9
Gold	0.1	-2.9	14.4	17.3	12.6	8.7	43.5

***Source**: UNCTAD 2006a.*

On average, prices for food and tropical beverages rose by 26 per cent between 2002 and 2005 and those for agricultural raw materials increased by 41 per cent. The highest increases were registered for rubber (96 per cent), coffee (87 per cent), rice (50 per cent), sugar and logs (44 per cent). This was partly driven by supply-side problems due to adverse weather conditions, plant diseases and pests in Asia and Latin America. There is also a long-term trend as some agricultural commodities are increasingly used as substitutes for oil, namely rubber, sugar and grain. The latter can also be converted into bio-fuel. In 2006, tea prices further increased by 14 per cent due to a drought in Kenya and coffee prices also were 18 per cent higher than in 2005. The increase in timber prices by 14 per cent is mainly driven by high demand from China.

"Some agricultural commodities are increasingly used as substitutes for oil"

Thus, the trend in commodity prices will depend on future growth of the world economy, specifically in China, which has absorbed more than half of global growth in the consumption of such commodities as cotton and soybeans. It has to be noted that not all commodity producers benefited from higher export earnings. The prices of some agricultural commodities declined between 2002 and 2005. For example,

cocoa prices declined by 14 per cent while those for hides and skins declined by 20 per cent (UNCTAD 2006a; World Bank 2006b).

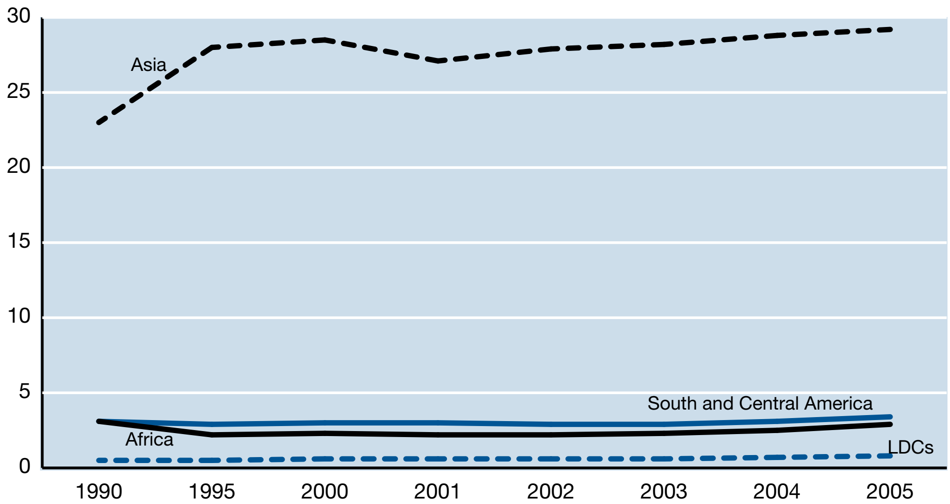
1.5 Globalization trends and implications for Africa

Trade remains uneven

Globally, exports of goods and services are growing faster than GDP. However, not all regions benefit equally from this trend (figures 1.7 and 1.8). The EU share in world exports remained around 40 per cent between 2001 and 2004, and declined to 38.4 per cent in 2005. Over the 1990s, it had declined significantly. In comparison, the shares of Japan and the USA declined between 2001 and 2005.

Figure 1.7

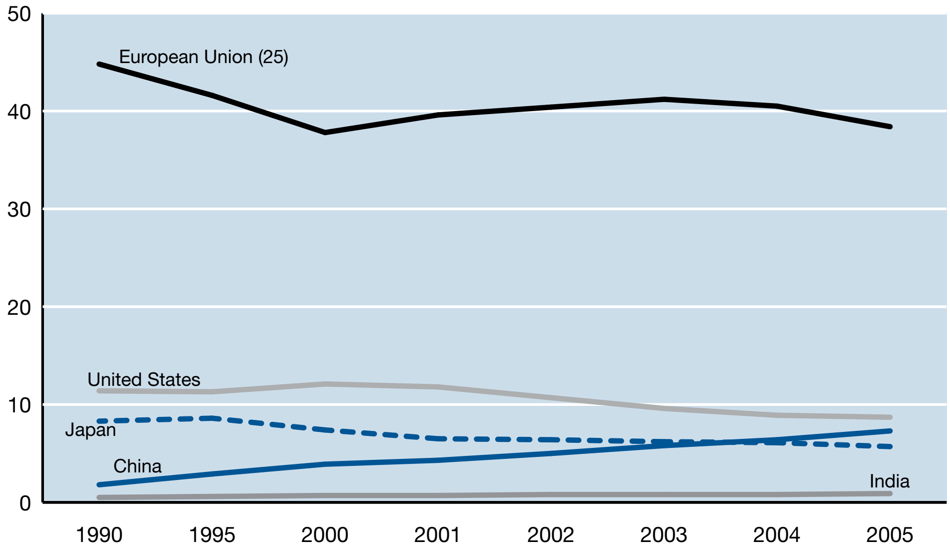
Share in world trade by region, 1990-2004 (% of total)



***Source**: WTO 2006.*

The share of Latin America in world exports remained constant at 3 per cent, whereas that of Asia increased from 27 per cent in 2001 to 29 per cent in 2005. China's share in world trade increased from 4.3 to 7.3 per cent in only 4 years. The share of Africa declined from 3.1 per cent in 1990 to 2.2 per cent in 2002 and increased again to 2.9 per cent in 2005 due to increasing commodity prices.

Figure 1.8
Share in world trade for selected countries, 1990-2004 (% of total)



***Source**: WTO 2006.*

Capital flows are rising

Global FDI flows have again increased substantially, by 29 per cent in 2005, after an increase of 27 per cent in 2004. Trends for different regions are less clear for FDI than for trade (figure 1.9). The EU's share in world FDI inflows increased to 46 per cent in 2005, the same level as in 2003. In contrast, the USA lost a significant share, while Japan's share remained low. The share of Latin America has fluctuated around 10 per cent over the past 5 years, while that of Asia has more than doubled, from 10 per cent in 2000 to 22 per cent in 2005. China alone now accounts for 8 per cent of world FDI inflows, which is half of its share in world GDP. The share of Africa in world investment has also increased, from 0.6 per cent in 2000 to 3.4 per cent in 2005. For both trade and FDI, China and India are becoming more important partners for Africa, a sign of the geographic diversification of trade and source of finance for the continent (see box 1.1).

"The share of Africa in world investment has also increased, from 0.6 per cent in 2000 to 3.4 per cent in 2005"

The rapid growth in both trade and FDI is mainly driven by the distribution of value chains over several countries according to their comparative advantage in particular stages of production. For example, some textiles are designed in Europe, while the fabric is produced in Asia, the cutting and sewing done in Madagascar, and the final product exported to the USA. This process is driven by lower transport and communication costs that enable the spread of different production stages all over the world. However, remoteness is becoming a bigger obstacle as the advantage of being close to major markets increases the chances of being included in these value chains.

Box 1.1

China and India becoming drivers of Africa's growth through trade and FDI

Trade and FDI from Asia to Africa have increased substantially over the past 10 years. The China-Africa summit in November 2006 raised the profile of China-Africa relations. China now offers debt reduction and preferential trade treatment and finances large infrastructure investments in a number of African countries. It is mainly interested in natural resources, especially oil. Angola is expected to become China's most important source of oil in 2006. As in other countries, such as Kenya, Nigeria and Zimbabwe, Chinese state-owned companies invest large amounts in infrastructure to secure licenses for minerals.

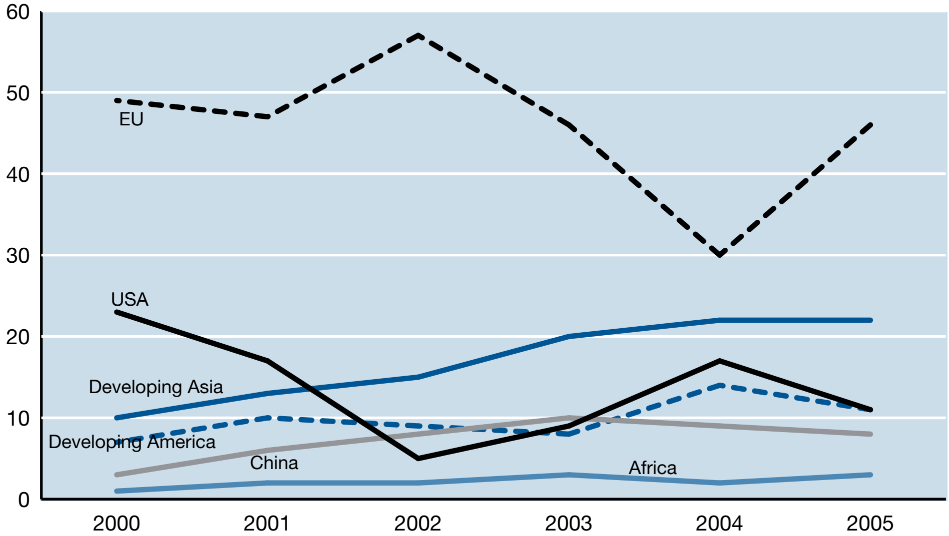
As a result, African exports to China of mainly raw materials have increased tenfold since 1995 and by more than 50 per cent in the first half of 2006 alone. Imports from China also increased by 30 per cent in the same period. As these are mainly cheap labour-intensive manufactures, they have caused problems for local manufactures, especially textiles. Over the past few years Africa has run a significant trade surplus with China, although some countries such as Egypt and South Africa have run deficits. By contrast, Africa runs a trade deficit with India although Indian exports to Africa account for less than one third of the exports from China.

China and India are also becoming major sources of FDI to Africa. Altogether, Asian countries accounted for 10 per cent of all greenfield investment in Africa in 2005. Chinese investors are planning an aluminium production plant in Egypt, upgrading of a highway in Nigeria and a copper project in Zambia. The two Asian countries are also providing aid to Africa through funding of infrastructure projects and provision of training. China has promised to double its aid to Africa by 2009.

However, there are some concerns with the growing influence of India and China in Africa. For example, one complaint is that Chinese firms are not observing workers' rights and do not protect the environment, as they face less pressure from civil society. In addition, they bring a lot of Chinese personnel, which undermines capacity building. Another is that the high demand for African commodities reduces the incentives to diversify. Sudden increases in export revenues cause exchange rate appreciation and increase the risk of currency instability due to fluctuations in commodity prices. There is also a risk for countries that have just reduced their debt burden through HIPC and the Multilateral Debt Relief Initiative (MDRI) to accumulate more debt through Chinese infrastructure and export credit loans.

Sources*: EIU 2006a; OECD 2006b; UNCTAD 2006b.*

Figure 1.9
Share in world FDI flows by region and for selected countries, 2000-2005 (per cent)



***Source**: UNCTAD 2006b.*

1.6 International migration and remittances

Migration reduces human capital and labour productivity in developing countries

As population in advanced countries continue to age, shortage of labour in sectors such as health care continue to attract relatively cheap but qualified labour from developing countries. At the same time, push factors such as poverty, conflict, human rights violations, political instability, lack of employment opportunities and reductions in migration costs continue to induce more migration from the South. The United Nations predicts that the net number of migrants from developing to developed countries will increase by 2.2 million annually, from 191 million or 3 per cent of the world population in 2005 (United Nations 2004).

The discrimination by Organisation for Economic Co-operation and Development (OECD) countries in favour of educated workers contributes to brain drain from developing countries, which subsequently increases the shortage of skilled labour in these countries. The emigration of people with scarce skills, such as entrepreneurs, scientists, technicians and health professionals reduces both the stock of human capital and the overall labour productivity. However, if these highly skilled migrants return, they bring with them experience, knowledge, contacts, and capital, which

have a positive impact on development. Thus, gains and losses from migration depend on whether it is temporary or permanent. There is also growing evidence that remittances reduce poverty (UNECA 2006a; UNU-WIDER 2006; Niimi and Özden 2006).

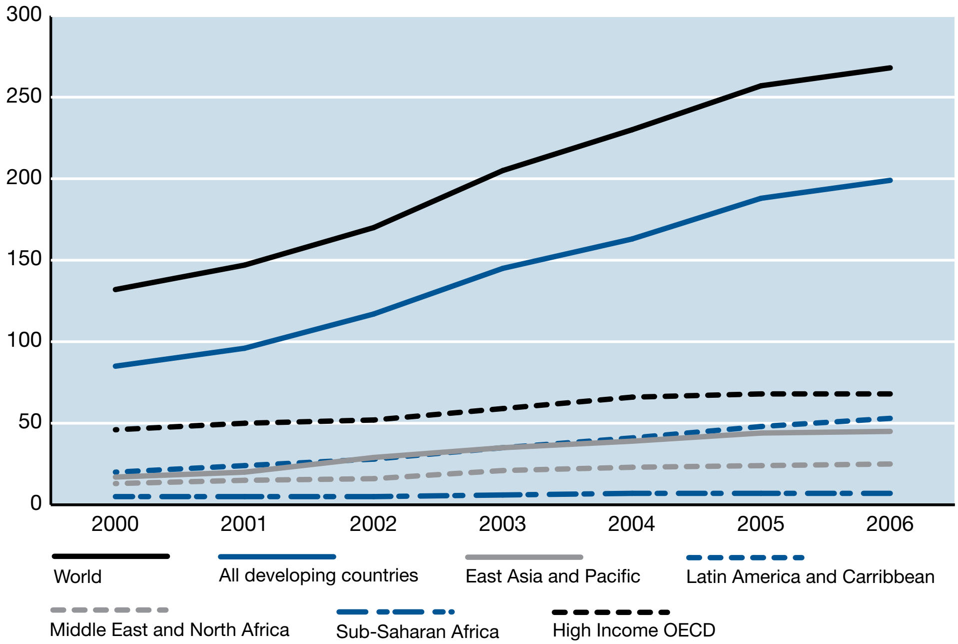
Gains and losses from migration depend on whether it is temporary or permanent

Specific measures are needed to increase the development impact of remittances

At the High-Level Dialogue on International Migration and Development in New York in September 2006, it was reaffirmed that international migration could be a positive force for development provided that it is supported by the right set of policies (United Nations General Assembly 2006, para.7). The development potential of remittances could be increased by facilitating the transfer of funds and improving access to banking services for migrants (United Nations General Assembly 2006, para 12). Although most of the remittances originate from industrial countries (83 per cent), a significant share of remittances is also transferred among developing countries. Remittances worldwide more than doubled between 2000 and 2006, with the highest increases observed in East Asia and Latin America (165 per cent each), while sub-Saharan Africa (SSA) experienced a much lower increase – 40 per cent (figure 1.10) (World Bank 2006c).

Figure 1.10

Workers' remittances received by region, 1990-2004 ($US billion)



***Source**: World Bank 2006c.*

To increase the contribution of migrants to development of their countries of origin, several countries have taken measures to strengthen their ties with their nationals abroad and to encourage highly skilled workers in the direction of return and circular migration. Migrant entrepreneurs could transfer know-how, skills, technology, expertise and linkages to markets (United Nations General Assembly 2006, para.13). To minimize the negative consequences of highly skilled emigration from developing countries, particularly in the fields of health and education, codes of conduct governing recruitment in health and education as well as mechanisms for compensation need to be discussed between the advanced and developing countries (United Nations General Assembly 2006, para.14). These codes will need to be accompanied by appropriate enforcement mechanisms to ensure their effectiveness.

> *"Migrant entrepreneurs could transfer know-how, skills, technology, expertise and linkages to markets"*

1.7 Conclusion

Overall, the medium-term outlook for the world economy remains modest. In addition, global imbalances remain large and weigh heavily on growth prospects. However, there remain some risks for African countries arising from competition from Asia and the weakening of housing markets in advanced economies which could reduce demand and weaken commodity prices. Thus, African countries need to observe these international developments carefully. Measures to reduce vulnerability to external shocks, to increase diversification and to strengthen domestic demand are crucial to sustaining the recent growth recovery in Africa.

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Recent Economic Performance in Africa and Prospects for 2007

African countries still face the critical challenge of raising the rate of GDP growth and sustaining high growth rates over an extended period in order to accelerate progress towards meeting the Millennium Development Goals (MDGs). While growth has recovered over the past few years, very few countries have achieved and maintained the growth rates necessary to reduce poverty. Africa still tails behind other regions in most measures of human development. The continent is plagued by shocks from the vagaries of international markets and climatic changes as well as the expansion of the HIV/AIDS pandemic. To improve the situation, it is clear that African countries need to become more innovative in terms of resource mobilization and in the design of pro-growth and pro-poor policies to tackle the problems of mass unemployment, persistent poverty, and pervasive inequality. Such innovative policies are critical for sustaining the current growth momentum on the continent.

This chapter provides a survey of recent growth performance both at the continental and subregional level. It discusses developments at the sectoral level and progress and challenges in human development, closing with a brief exposition of the prospects for 2007.

2.1 Growth performance

This section examines recent economic performance at the continental and subregional levels. It discusses disparities in growth performance and the factors behind the observed disparities across countries and subregions. The analysis pays particular attention to structural factors such as endowment in natural resources, the role of policies and institutions as well as non-policy drivers of growth, including exogenous factors such as natural calamities, geography, and civil conflicts. The discussion highlights key constraints to growth in Africa and strategies to address these constraints.

African economies continue to sustain the growth momentum

African economies continued to sustain the growth momentum of previous years, recording an overall real GDP growth rate of 5.7 per cent in 2006 compared to 5.3

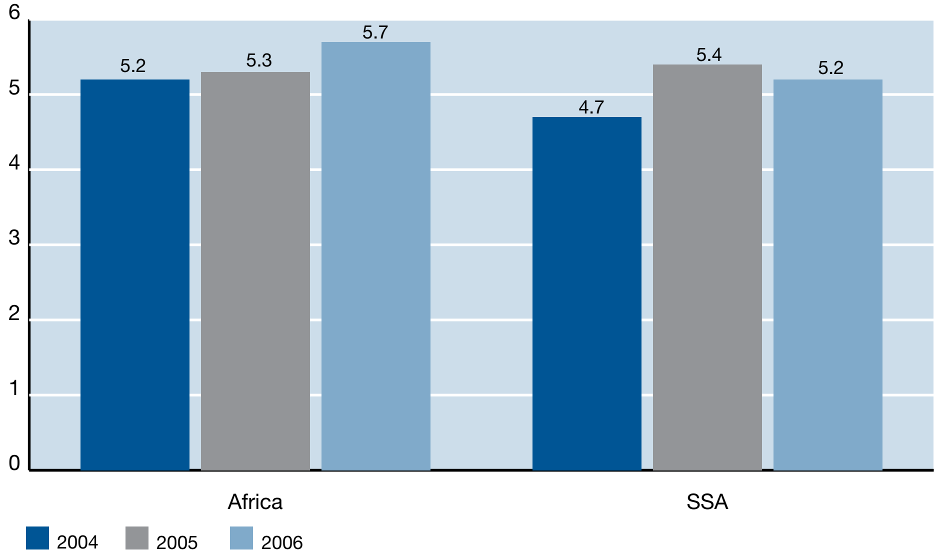
per cent in 2005 and 5.2 per cent in 2004 (figure 2.1). For the second consecutive year, Africa's growth rate remains higher than that of Latin America (4.8 per cent) but lower than that of developing Asia (8.7 per cent). As many as 28 countries recorded improvements in growth in 2006 relative to 2005. Only one country – Zimbabwe - recorded a negative growth rate in 2006.

28 countries recorded improvements in growth in 2006 relative to 2005

Africa's growth performance in 2006, as in previous years, was underpinned by improvement in macroeconomic management in many countries, and by strong global demand for key African export commodities, resulting in high export prices, especially for crude oil, metals and minerals (see chapter 1). This explains the very high growth rates recorded by oil-rich countries (see figure 2.3).

Figure 2.1

Real GDP growth rate in Africa, 2004-2006 (per cent)



***Source**: EIU, January 2007.*

However, for most African countries, real growth rates remain low relative to their development goals. From 1998 to 2006, 25 per cent of African countries achieved a real GDP growth rate of less than 3 per cent per annum. Only five countries achieved an average real GDP growth rate of 7 per cent or more during this period (table 2.1). At this pace, few countries are positioned to achieve the MDGs by 2015. Hence, the continent faces the challenge of increasing growth rates and sustaining these high growth rates over an extended period. Besides sustaining reforms to maintain macroeconomic stability and further improve the domestic investment climate to promote private sector activity, a more strategic approach to growth policy is needed, to effectively address the binding constraints to growth.

Table 2.1
Summary of growth performance 1998-2006

GDP growth rate	Number of countries	Share of total (%)
Less than 3%	13	25.0
Between 3% and 5%	25	48.1
Greater than 5% and less than 7%	9	17.3
7% or more	5	9.6
Total*	52	100.0

***Source**: EIU, January 2007.*
**** Note**: Excluding Somalia due to lack of data.*

Subregional growth performance varies substantially

Growth performance exhibits substantial disparities across the five subregions (see figure 2.2).[1] North Africa recorded the highest acceleration in GDP growth, from 5.2 per cent in 2005 to 6.4 per cent in 2006, followed by Southern Africa, from 5.6 to 5.9. There was a notable deceleration in growth momentum in West Africa, from 5.4 per cent in 2005 to 4.2 per cent in 2006. Heavy dependence on primary commodities remains a common feature of production, exports and growth in all subregions. This exposes the continent to external shocks and makes economic diversification a top priority for growth policies on the continent.

"The continent faces the challenge of increasing growth rates and sustaining these high growth rates over an extended period"

Stronger growth performance in North Africa was mainly the result of higher oil prices, especially for Algeria, Libya, Sudan, and Mauritania. Mauritania achieved the highest increase in GDP growth rate (from 5.4 per cent in 2005 to 14.1 per cent in 2006) owing to the start of commercial exploitation of crude oil in 2006. Also steady growth in secondary and tertiary sectors (especially tourism) continued to help economic performance in North Africa. Adequate management of oil revenue is needed for the subregion to sustain the growth momentum.

Growth in Southern Africa improved in 2006 largely because of economic recovery in Malawi and Lesotho and sustained good performance in most other countries of the subregion. With increased public spending and high FDI flows, South Africa maintained the same growth rate of 2005 through 2006 although private consumption declined due to higher oil prices. Notwithstanding the slowdown in oil production, Angola remains the fastest growing economy in Southern Africa (17.6 per cent) followed by Mozambique (7.9 per cent), Malawi (6.9 per cent) and Zambia (6 per cent). Zimbabwe, though still on the negative side (-4.4 per cent in 2006 from –7.1 per cent in 2005), and Malawi recorded the largest improvements in growth, thanks to favourable weather conditions and commodity markets, although recovery from the 2005 drought is still incomplete. Growth in Mauritius also improved considerably despite stiff competition from Asia in the textile market, thanks to increased investment and notable growth in the service sector. Growth in Lesotho picked up in 2006 as a result of increased investment in manufacturing and mining, resulting

1 Subregional growth rates are calculated using the GDP of individual countries as weights.

in higher textile and diamond exports. Swaziland continued to record a low growth rate (1.2 per cent), owing to drought and a decline in the textile industry.

Heavy dependence on primary commodities remains a common feature of production, exports and growth in all subregions

Growth in Central Africa was underpinned by higher oil prices – Republic of Congo (7.5 per cent), Equatorial Guinea (5.4 per cent), Cameroon (3.8 per cent) and Chad (1.0 per cent). In spite of sustained increases in oil prices, Chad and Equatorial Guinea experienced the greatest decline in GDP growth in 2006, followed by the Republic of Congo, because of slowdown in crude oil production. Oil production declined in Chad in 2006 because of technical problems. Cameroon, Central African Republic, and São Tomé and Príncipe were the only three countries in the subregion with higher growth rates in 2006 than in 2005, thanks to the improved prices for such agricultural commodities as coffee and cocoa (up to 2nd Quarter of 2006).

In East Africa, weather conditions as well as export commodity prices remained largely favourable despite sporadic drought in the Horn of Africa. East Africa was the best performing subregion in 2004 and 2005 but experienced a slight decline in growth rate in 2006. Higher oil prices were the main factor that prevented the subregion from achieving a higher growth rate as all the countries of East Africa are oil importers. Economic performance remained robust in Ethiopia (8.5 per cent), Kenya (5.5 per cent), Tanzania (5.8 per cent), and Uganda (5.0 per cent) owing to higher commodity prices, especially tea and coffee. The Democratic Republic of Congo (DRC), Burundi and Rwanda achieved higher growth rates in 2006 (6.4, 3.8, and 4.2 per cent, respectively), thanks to growth in construction, trade and manufacturing, as economic activity is benefiting from the gradual restoration of peace in the region. The mining sector also contributed significantly to growth in DRC.

Although improving, economic performance remains low in Comoros (1.2 per cent), due to low revenue from vanilla exports and a decline in the tourism sector. Eritrea also recorded low growth (2 per cent), owing to low investment and other adverse effects of border conflicts. Seychelles recorded a notable improvement in economic performance (from –1.5 per cent in 2005 to 1.0 per cent in 2006) owing to a gradual recovery from the adverse effects of the tsunami of 2005 and the decline in tourism and tuna exports in the previous two years.

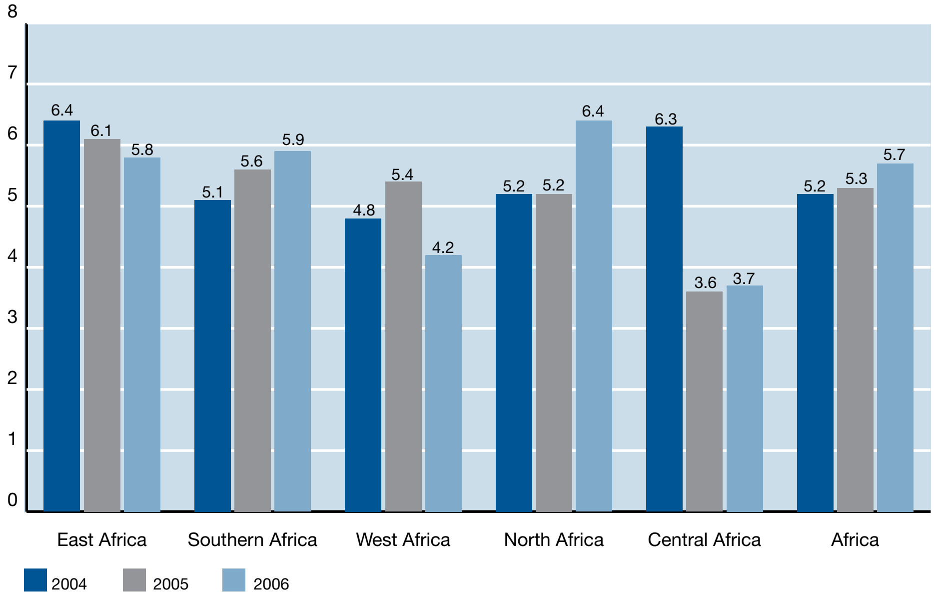
West Africa experienced the greatest decline in GDP growth in 2006 due to a decline in growth in Nigeria from (6.0 per cent in 2005 to 4.2 per cent in 2006) as a result of social unrest in the Niger delta. Growth remained low in Côte d'Ivoire (1.2 per cent) due to political instability, which disrupted agriculture and industry. Among non-oil economies, growth in Senegal (4.0 per cent), though still strong, slowed down because of weaker industrial performance as a consequence of high oil prices and failure to renew the country's fishing accord with the EU.[2] Liberia sustained its strong post-conflict growth recovery. Gambia achieved 5.3 per cent growth rate in 2006 compared to

2 Failure to renew Senegal's accord with the EU on fish exports, which ran from July 2002 to June 2006, restricts Senegalese fish exports to EU and results in $US20.2 million loss in annual financial payments to Senegal (EIU 2006).

5 per cent in 2005 thanks to good rainfall and increased tourism activity. Growth in other countries in the subregion in 2006 was similar to that of 2005.

Figure 2.2

Subregional growth performance in 2004-2006 (per cent)



***Source**: EIU, January 2007.*

Higher oil prices were the main factor that prevented East Africa from achieving a higher growth rate as all the countries are oil importers

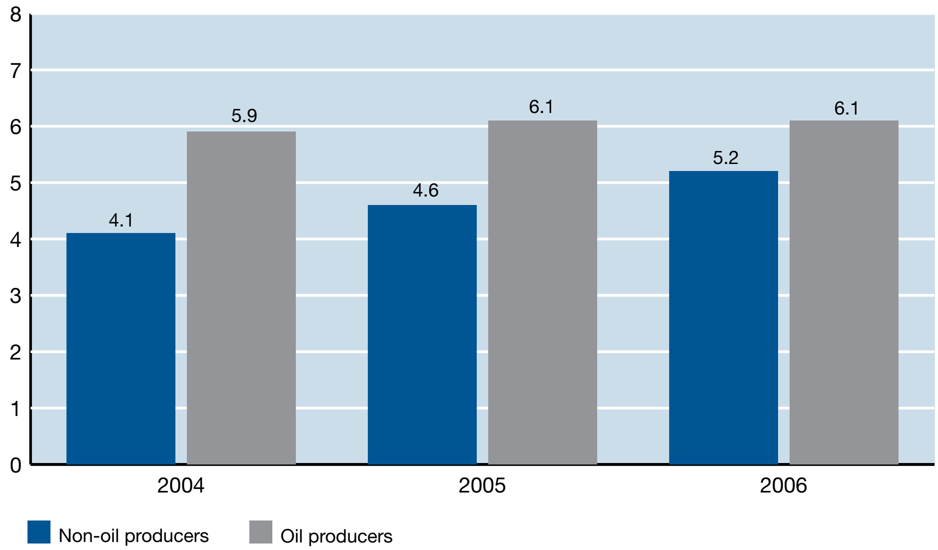
Higher but more volatile growth in oil-rich African countries

The recent oil boom has attracted new foreign investments in oil exploration and production and more African countries (Chad and Mauritania) have joined the club of net oil exporters. Oil-exporting African countries as a group contributed 57.5 per cent of the continent's 5.7 per cent growth rate in 2006, compared to 53.4 per cent in 2005 (figure 2.3). Thus, the recent increase in oil prices has increased the dominance of oil producers in the continent's overall growth, overshadowing the improvements observed among non-oil countries (from 4.6 per cent in 2005 to 5.2 per cent in 2006).

> *Efficient management of oil revenues for economic diversification is essential for oil-exporting African economies*

Figure 2.3

Real GDP growth in African oil vs. non-oil economies, 2004-2006 (per cent)



***Source**: EIU, January 2007.*

Non-oil GDP in the eight oil-exporting SSA countries increased at a higher rate in 2006 (6.5 per cent) relative to oil GDP (5.6 per cent), but its contribution to overall GDP growth is still small (IMF 2006a). This, together with the fact that many oil-exporting African countries (e.g. Angola and Equatorial Guinea) are accumulating large, idle foreign currency reserves, is a manifestation of the need for these countries to use oil revenues more rapidly to enhance domestic investment and economic diversification. Efficient management of oil revenues for economic diversification is essential for oil-exporting African economies to reduce their vulnerability to oil price shocks, ensure that gains from oil revenue are broadly shared, and achieve sustainable growth.

In addition to increased aid flows and debt reduction, improved economic management and increases in non-oil commodity prices have more than offset the negative impact of high oil prices on the real GDP of African oil importers. On average, these countries maintained a positive and rising real GDP growth rate during 2004-2006. The growth impact of higher oil prices was particularly moderate for non-oil and non-mineral-rich economies, where growth performance improved from 4.1 per cent in 2005 to 5.8 per cent in 2006 (figure 2.4), thanks to debt relief and increased aid flows, improved agricultural performance and high agricultural commodity prices. The growth rate in non-oil, mineral-rich African countries was virtually unchanged in 2006 relative to 2005, as the gains from the higher prices of minerals were dampened by the effects of rising oil prices.

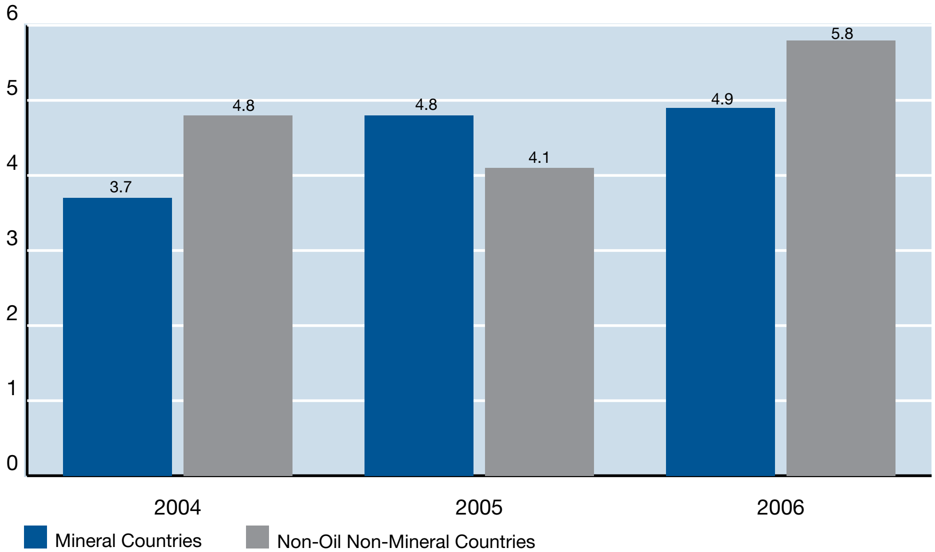
Given that energy and oil intensity of GDP are expected to increase with per capita income over time (ESMAP 2005), oil-importing African countries are likely to face

large increases in energy and oil demand in the future as their incomes rise. Consequently, these countries need to reduce their dependence on oil by making use of alternative sources of energy, especially hydropower, and by utilizing cost-effective technologies. However, alternative energy sources are unlikely to have a major role in energy supply in the short run since they require relatively large initial capital outlays and have a long gestation period. Thus, in the short run, these countries need to adopt strategies to rationalize the use of oil and improve the efficiency of their energy systems.

"Oil importing countries need to adopt strategies to rationalize the use of oil and improve the efficiency of their energy systems"

Figure 2.4

Growth in mineral-rich countries vs. non-oil, non-mineral-rich countries (per cent)



***Source**: EIU, January 2007.*

Oil-importing countries will suffer severe adverse effects if higher oil prices persist in the medium term (see box 2.1). To minimize the effects of high oil prices on inflation and macroeconomic stability in general, governments should adopt consistent and prudent policies, and resist the temptation to increase domestic borrowing to finance oil-price-induced increases in budget deficits. Sustained prudential macroeconomic and financial policies consolidate macroeconomic policy credibility, which is critical for oil importers to attract more external capital flows to ease financial constraints. In the meantime, the international donor community and international financial institutions should provide special support to oil-importing, low-income African countries to mitigate the impact of higher oil prices. In particular, debt relief and additional non-debt-generating external financing of fiscal deficits are critically needed for assisting the oil-importing countries to sustain economic growth and achieve the MDGs. In the absence of such support, the efforts of macroeconomic reforms over the last two decades and the opportunities created by the HIPC Initiative will be wasted.

Box 2.1

Impact of sustained higher oil prices on growth and progress towards the MDGs in low-income, oil-importing African countries

Sustained prudential macroeconomic and financial policies consolidate macroeconomic policy credibility

Sustained higher oil prices will slow down growth and progress towards the MDGs in low-income, oil-importing African countries. Oil-importing African countries are characterized by high oil-intensity of primary energy sources as well as inelastic oil demand. Higher oil prices raise production costs leading to lower output as well as tighter financial constraints. Governments are forced to decrease expenditure on infrastructure and social services in order to finance the higher oil bill. Moreover, higher oil prices fuel domestic inflation, increase fiscal deficits, and worsen the balance-of-payments position as well as the terms of trade. This can undermine economic performance directly as well as indirectly through increased uncertainty.

Although oil-importing African countries have recorded positive overall GDP growth in the past few years, they are experiencing mounting internal and external imbalances. Strong commodity demand, good macroeconomic management, better agricultural performance, improved political governance in many countries and increased aid flows and debt relief are the key factors that helped them to maintain overall growth momentum. However, as a result of the recent hike in oil prices, the share of fuel imports in the merchandise imports of oil-importing African countries rose significantly, leading to notable increases in the current account deficits. Moreover, oil-importing countries faced sustained, large terms-of-trade losses.

Mounting budget deficits and inflationary pressure in oil-importing African countries disproportionately affect the poor because of lower employment prospects and lack of safety nets. Budget constraints may also force governments to introduce user fees for social services and to raise the prices of public utilities such as electricity and water.

The critical challenge for oil-importing African countries is to reduce their dependence on oil by promoting alternative sources of energy. It is particularly critical for these governments to strengthen growth policies, including industrial strategies that promote diversification of production and exports. The international donor community and international financial institutions should provide special support to oil-importing African countries to mitigate the impact of higher oil prices. In particular, debt relief and additional non-debt-generating external financing are critical to allow these countries to sustain economic growth and accelerate progress towards the MDGs.

Source*: UNECA 2006a.*

High growers vs. least performers: growth at the top and stagnation at the bottom

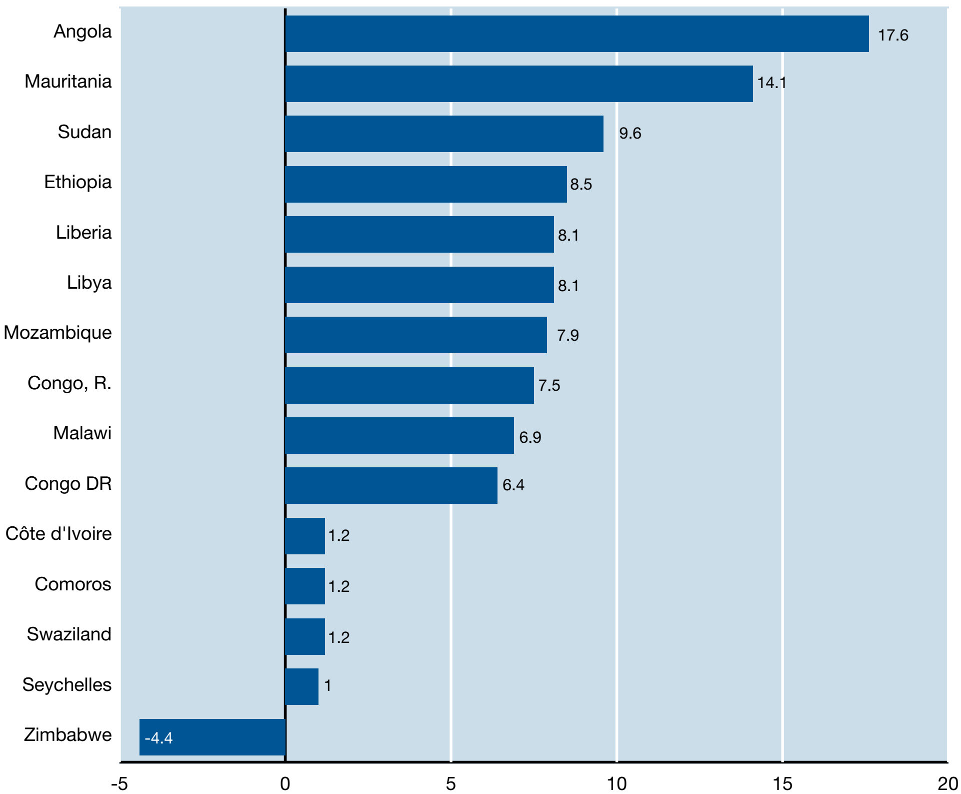
Comparing performance in 2006 with that of the previous eight years shows stagnation at the bottom of the scale (figure 2.5). Only three countries (Angola, Mozambique and Sudan) in the top ten performers in 2006 were among the top ten performers on the basis of average annual growth rates during 1998-2005 (UNECA 2006b). Half of the top ten performers are oil producers (Angola, Libya, Mauritania, Republic of Congo and Sudan). Of the remaining five top performers, two are mineral-rich countries (DRC and Mozambique) and one (Liberia) is a post-conflict country. High oil and mineral prices were the main growth drivers for the best performing oil-and mineral-rich countries. Ethiopia continues to feature on the list of top performers in Africa because of generally good rainfall and high export prices for

tea and coffee, the country's main export commodities. Strong economic performance in Malawi (from 1.9 in 2005 to 6.9 per cent in 2006) was the result of recovery in agriculture from the drought of 2005.

Five countries (Comoros, Côte d'Ivoire, Seychelles, Swaziland and Zimbabwe) have the lowest growth rates over 1998-2006. Swaziland's growth performance has been low and continuously weakening over the last five years due to increasing competition and falling prices in the textile export market and the reduced sugar price in the EU market. Heavily dependent on agriculture, Comoros continued to experience low growth due to low revenue from vanilla exports and a decline in the tourism sector, while political conflict and insecurity continue to deter investment and plague economic performance in Côte d'Ivoire. Economic performance in Zimbabwe remained negative in the last eight years owing mainly to political difficulties exacerbated by recurrent droughts. Foreign exchange constraints and the recent rises in oil prices adversely affected investment and capacity utilization in Seychelles, leading to nearly complete economic stagnation in the last eight years.

Figure 2.5

Top 10 and bottom 5 performers in Africa in 2006 (% annual growth)



***Source**: EIU, January 2007.*

Sustainability of macroeconomic balances remains a concern over the medium term

Overall, Africa has continued to maintain a positive fiscal position, with the average budget balance (excluding grants) of 0.1 per cent of GDP in 2006 compared to 0.4 per cent in 2005. For the 40 countries for which comparable data were available, there was a slight decrease in the number of countries having budget deficits in 2006 relative to 2005 (from 33 to 30) despite higher government expenditures in oil-importing countries due to higher oil prices (table 2.2). Significant increases in public sector investment resulted in sizeable budget deficits in some oil-exporting countries – Angola (-5.0 per cent), Chad (-4.4 per cent) and Egypt (-7.9 per cent).

"The dependence of government budgets on oil revenue and external aid constitutes a source of vulnerability"

Oil as a key factor in fiscal balance improvement

Seven of the ten countries that had budget surpluses in 2006 were oil exporters (Algeria, Cameroon, Republic of Congo, Equatorial Guinea, Gabon, Libya and Sudan). Therefore, oil continues to be the key factor behind the positive fiscal position for Africa as a whole, which raises concern over the sustainability of fiscal balance over the medium term. Official development assistance (ODA) is a major source of budget support for many non-oil economies. The dependence of government budgets on oil revenue and external aid constitutes a source of vulnerability for fiscal balance and GDP growth. For oil producers, fiscal sustainability will require effective strategies for prudent management of oil revenues and strategies to utilize these revenues for enhancing economic diversification. Non-oil countries need to design mechanisms for increased mobilization of revenue from domestic sources.

Table 2.2

Distribution of fiscal deficits in Africa, 2004 -2006 (number of countries)

	2004		2005		2006	
	Oil producers	Non-oil producers	Oil producers	Non-oil producers	Oil producers	Non-oil producers
Countries with surpluses	6	3	7	6	7	3
Less than 5 %	2	2	1	4	2	3
5 per cent to 10 %	2	1	3	1	0	0
More than 10 %	2	0	3	1	5	0
Countries with deficits	7	24	6	27	6	24
Less than 5 %	5	18	5	15	5	13
5 per cent to 10 %	2	5	1	6	0	9
More than 10 %	0	1	0	0	1	2
Total number of countries	13	27	13	33	13	27

***Source**: EIU, October 2006.*

Pressure from oil prices threatens price stability

For the second year, average consumer price inflation increased in Africa (from 8.5 per cent in 2005 to 9.9 per cent in 2006). Inflationary pressure results mainly from higher oil prices, and subsequent increase in production costs and lower output. In most countries, food prices rose significantly due to higher transportation costs. While inflation remained contained and low in most of the 52 African countries with available data, the risk of higher inflation remains a concern should higher prices persist in the near future.

Despite the increase in the average rate of inflation, the situation has improved

Despite the increase in the average rate of inflation, the situation has improved. In 2006, 25 countries recorded inflation rates of less than 5 per cent, compared to 21 countries in 2005 (table 2.3). The number of countries with a two-digit inflation rate dropped from 17 in 2005 to 12 in 2006. The number of countries experiencing increased inflation fell from 33 in 2005 to 24 in 2006. However, a few countries experienced drastic increases in inflation. In Zimbabwe, inflation increased to 1216 per cent in 2006 compared to 237.8 per cent in 2005, owing to inflationary financing of the budget deficit and shortage of food, especially maize. In Guinea, the country with the second highest inflation rate in Africa, inflation remained high (27 per cent in 2006 compared to 31.4 per cent in 2005), due to the effects of high oil prices and imported inflation arising from high imports of consumer goods.

Table 2.3
Distribution of inflation rates in Africa, 2004-2006 (number of countries)

Range	2004	2005	2006
Less than 5 %	30	21	25
Between 5 and 10 % (10% excluded)	6	14	15
Between 10 and 20 % (20% excluded)	13	13	10
20 % and higher	3	4	2
Total number of countries	52	52	52

***Source**: IMF 2006b.*

External balances also driven by developments in the resource sector

For the third consecutive year, Africa achieved a positive and increasing current account surplus (from 2.3 per cent of GDP in 2005 to 3.6 per cent in 2006 – from $18.4 billion to $33.1 billion), thanks to higher commodity export revenue, especially from oil. Africa's average balance of payments position largely reflects developments in resource-rich countries. With the exception of Sudan, all oil-exporting countries had current account surpluses, while only two non-oil economies (Morocco and Namibia) had current account surpluses. Namibia is a mineral-rich country and Morocco has a more diversified export sector as well as significant mineral wealth.

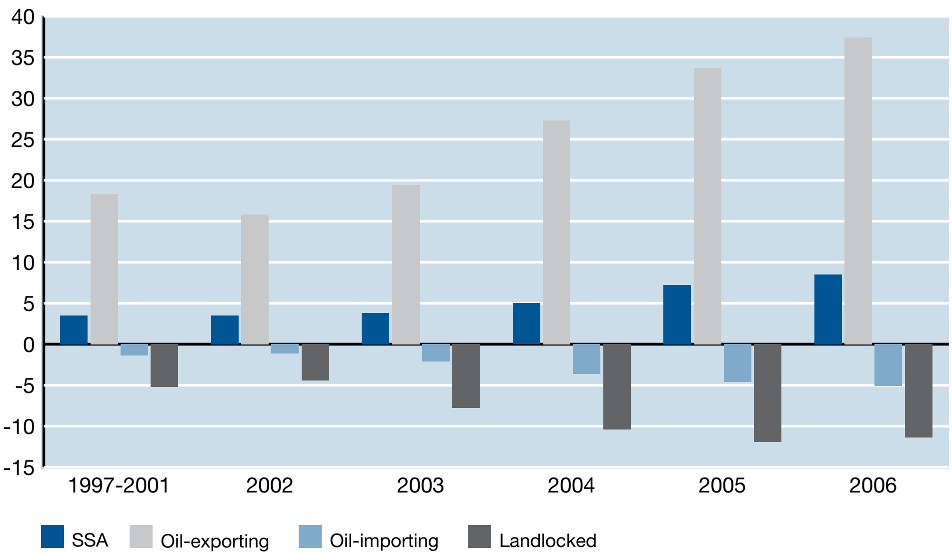
Also, workers' remittances and tourism receipts are important in explaining current account surpluses in Morocco in recent years (Bank Al-Maghrib 2005). Eighteen of the 39 non-oil economies with adequate data experienced deterioration in the current account position in 2006, up from 11 economies in 2005.

The continuing rise in oil prices raises serious concerns about current account sustainability among oil importers

Oil-exporting countries have recorded increasing trade surpluses, while their oil-importing counterparts experienced deepening trade deficits (figure 2.6). The trade surplus for oil exporters as a group more than doubled from 2002 to 2006 (from 16 per cent of GDP to 37 per cent) while oil importers as a group saw their trade deficit deteriorate from -4 per cent of GDP to -11 per cent of GDP. Deterioration of the trade deficit was even more pronounced for land-locked countries. The continuing rise in oil prices raises serious concerns about current account sustainability among oil importers and the associated effects on overall economic performance and macroeconomic stability.

Figure 2.6

Trade balance in Africa by category (% of GDP), 1997-2006



***Source**: IMF 2006a.*

Exchange rates and the impact of commodity booms

In 2006, 35 African currencies appreciated against the US dollar, although the rates of appreciation remained moderate (less than 5 per cent). The Zambian kwacha continued to record the highest rate of appreciation (23 per cent) for the second year in a row because of the high copper price, and growing investor confidence, especially after the country's qualification for debt relief (UNECA 2006b). Large volumes of

speculative capital inflows targeting government securities have also played a significant role in the appreciation of the Zambian kwacha.

Exchange rate appreciation was also notable for the Sudanese dinar (12.5 per cent) and the Angolan kwanza (8.5 per cent) owing to higher oil revenue and FDI flows. On the other side, the Zimbabwean dollar had the largest depreciation (87 per cent) followed by the Malawian kwacha (13 per cent). Zimbabwe and Malawi experienced a decline in exports and increased food imports because of slow recovery from the drought of 2005.

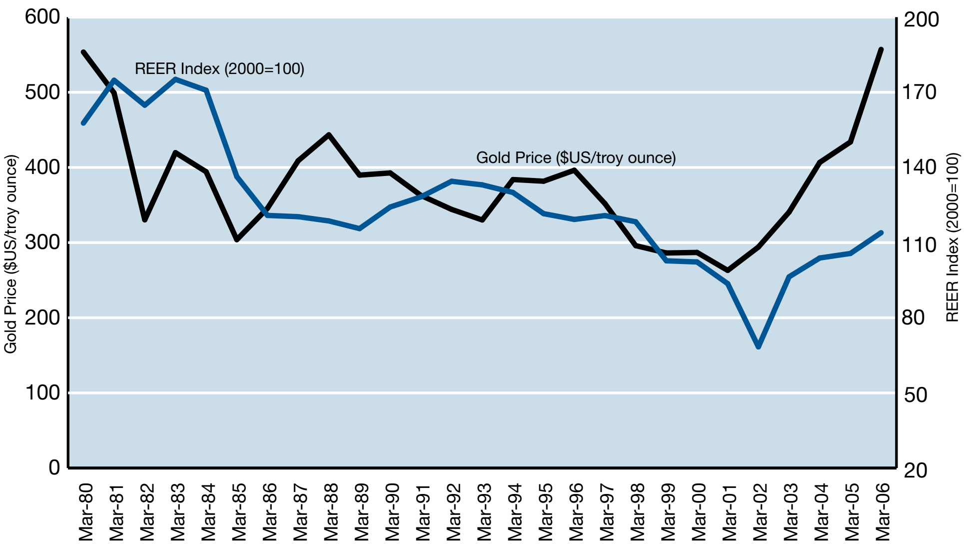
While exchange rates have been stable for most countries, high commodity dependence exposes African economies to terms-of-trade fluctuations and to extreme exchange rate volatility. The majority of African counties are dependent on oil and minerals and on a limited range of agricultural commodities such as tea, coffee and cocoa. Thus, fluctuations in commodity markets have a significant impact on the exchange rates in these countries.

> *High commodity dependence exposes African economies to terms-of-trade fluctuations and to extreme exchange rate volatility*

The case of South Africa provides a clear illustration of the close relationship between commodity (gold) price and the real effective exchange rate (REER) (figure 2.7). Indeed, evidence confirms that variations in the gold price are a major determinant of changes in the REER of the rand (Stokke 2006). The effects of gold price fluctuation have compounded the effects of other factors, namely trade policy, short-and long-term capital flows, and productivity growth (Aron et al. 2000).

Figure 2.7

South Africa's REER and the gold price, 1980-2006



***Source**: IMF 2006b.*

Many African countries have accumulated substantial foreign currency reserves in recent years, mostly from higher oil revenues and aid inflows.[3] For example, Algeria had total reserves, excluding gold, of $66.1 billion (the equivalent of 32 months of imports) in 2006 compared to $56.3 billion (34.5 months of imports) in 2005, while Morocco had $17.7 billion (10.1 months of imports) in 2006 and $16.2 billion (10.3 months of imports) in 2005.

Many African countries have accumulated substantial foreign currency reserves in recent years, mostly from higher oil revenues and aid inflows

Accumulation of reserves is motivated by the desire to hedge against external shocks. However, excessive foreign exchange reserve hoarding takes away resources that would otherwise be used to boost domestic economic activity. A better approach is to adopt a comprehensive strategy for prudential regulation and capital controls that can minimize exchange risks while allowing the country to benefit from increased export revenue and FDI inflows. The types of controls to implement should be country-specific (Pollin et al. 2006). Interventions will have to rely on a set of indicators for early warning signals that monitor movements in foreign exchange, the exchange rate, the structure of external debt, and other financial risk indicators. The ultimate goal is to allow African countries to utilize these resources to increase private and public investment so as to accelerate growth.

External debt remains high and private capital flows insufficient

The hope that Africa's external debt would be significantly reduced under the HIPC Initiative and that economic reforms would stimulate private capital inflows has been very slow to materialize. Africa's total external debt stock stood at $244 billion in 2006 compared with $289 billion in 2005 (IMF 2006b). Although the debt stock declined considerably relative to GDP (from 35.9 per cent in 2005 to 26.2 per cent in 2006), total debt service obligations remained almost unchanged (4.2 per cent of GDP in 2005 and 4.1 per cent in 2006) because of higher interest rates. The debt burden seriously constrains spending on public investment and ultimately retards growth and employment generation.[4]

The continent has benefited from substantial inflows of external financing in the form of ODA (including debt relief), which should boost economic growth in the coming years. The MDRI announced at the G-8 summit in Gleneagles in 2005 provided much needed relief for 13 SSA countries. However, it is clear that this debt-relief package is not enough and that more external funding will be needed to help African countries increase growth rates and achieve meaningful reduction in poverty.

3 For the 49 countries for which data were available, total reserves, excluding gold, amounted to $247.7 billion in 2006, up from $219.7 billion in 2005 and 21 countries (10 oil exporters and 11 oil importers) had $ one billion or more of reserves in 2005. The 13 oil-exporting countries accounted for 73 per cent of Africa's reserves in 2005 and 2006.

4 See section 3.2 in chapter 3 for the discussion on how to address the debt problem and how to mobilize more resources for development. Also see UNECA (2006b).

Increased external flows are particularly important in view of the fact that both gross domestic savings (GDS) and gross domestic investment (GDI) rates in Africa are still low (table 2.4). In fact they were lower in 1998-2006 (19.7 and 20.2 per cent of GDP, respectively) than in the 1974-1985 pre-reform era, (24.5 and 25.4 per cent of GDP, respectively). Most importantly, actual GDI remains far below the level (34.2 per cent of GDP) considered necessary for Africa to half poverty by 2015 (UNECA 1999). The low level and poor quality of investment contribute to the inability of most African countries to achieve and sustain high growth rates over the medium term (Berthelemy and Soderling 2001).

"Low level and poor quality of investment contribute to the inability of most African countries to achieve and sustain high growth rates"

Table 2.4

External flows, domestic savings and investment, 1998-2006

Indicator	Oil economies	Non-oil economies	Africa	Source
ODA ($US billion, average annual)	4.5	14.4	18.9	WDI 2006
FDI ($US billion)	7.3	5.9	14.0	UNCTAD World Investment Report 2006
Remittances ($US billion)	7.6	5.2	12.8	WDI 2006
Other private flows			-6.1	IMF World Economic Out-look database
Gross domestic investment (% of GDP)	22.1 a	18.4 b	20.2 c	WDI 2006
Gross domestic savings (% of GDP)	24.2 d	15.1 e	19.7 f	WDI 2006

***Notes**: FDI is for 1998-2005; other private flows are for 1998-2006; for the remaining indicators, the data are for 1998-2004. Owing to data unavailability, the following countries have been excluded: (a) Equatorial Guinea and Libya; (b) Djibouti, Lesotho, Liberia and Somalia; (c) Djibouti, Equatorial Guinea, Lesotho, Liberia, Libya and Somalia; (d) Equatorial Guinea, and Libya; (e) Djibouti, Liberia, and Somalia; (f) Djibouti, Equatorial Guinea, Liberia, Libya and Somalia.*

Africa needs a new approach to growth policies

More than any time before, it is now understood that the general and one-size-fits-all growth policies embedded in macroeconomic stabilization and second-generation reform programmes are among the key reasons for Africa's slow pace in achieving and sustaining high growth (Rodrik 2004; Gottschalk 2005).[5] These reforms are founded on the premise that macroeconomic stability, if achieved, will stimulate growth. After decades of the stabilization experiment, it is clear that this premise is naive at best.

Moreover, this reform framework is too ambitious and cannot help developing countries to design growth policies that are specific and feasible given the scarcity of resources and the capacity constraints (McCord et al. 2005 and Zagha et al. 2006). According to these programmes, to achieve macroeconomic stability and sus-

5 Poverty Reduction Strategy Papers (PRSPs) are for the most part based on a general reform agenda with no specific and targeted growth strategies. For a review of PRSPs, see Gottschalk (2005).

> *Growth policies in high-growing developing countries are characterized by specificity and pragmatism*

tainable growth, developing countries need, among other things, to promote faster human and institutional development, accelerate privatization, develop the private sector, promote exports to enhance economic diversification, lower transaction costs, increase competitiveness, manage natural resource revenues for growth and increase mobilization of domestic and external resources for development financing (UNECA 1999).

A successful growth policy needs to have specific objectives and has to be based on analyses that identify key country-specific constraints and priorities, and can therefore vary across countries (Hausmann et al. 2006). In addition to general objectives, as those embodied in the reform agenda, growth policies in high-growing developing countries and newly industrialized countries, for example China, India and Vietnam, are characterized by specificity and pragmatism.[6]

Moreover, successful growth strategies require bold policy experimentation in both the fiscal and monetary areas within a dynamic policy framework that is sensitive to country-specific growth potentials, structural constraints, and development goals (Hausmann et al. 2006). Failure to identify the sources of growth potential and the binding constraints to growth result in ineffective growth strategies and inability to achieve high growth even in the presence of abundant resources, including oil revenues and aid flows.

While sustaining commitment to preserve macroeconomic stability, African countries need to tailor their fiscal and monetary policies to promote investment, employment generation, and growth (Pollin et al. 2006; Gottschalk 2005). For example, in their efforts to ensure macroeconomic stability, governments need to define a more flexible range for the budget deficit that can be adjusted to stimulate growth without creating unsustainable deficits (box 2.2). Although this range may vary across countries, evidence suggests that a deficit of 2-3 per cent of GDP is sustainable, and gives the government enough room to expand public investment as a means of boosting growth (Pollin et al. 2006). Moreover, while fostering price stability, monetary policy needs to be broadened (i.e. beyond inflation targeting) to contribute to the national agenda of achieving and sustaining higher growth. This agenda will be undermined by tight and rigid targets for monetary and fiscal policy, as observed in many countries and regions, and as is the case of countries in the West African Economic and Monetary Union (WAEMU) (Gottschalk 2005).

6 Hausmann et al. (2004), cited by Rodrik (2004).

Box 2.2

Accelerating growth through policy experimentation

While committed to maintaining long-term fiscal deficit within a certain limit, a government can increase spending on public investment/infrastructure, income transfers and social support, and employment subsidies to businesses to promote accelerated employment growth without exceeding the deficit limit. For example, a recent study suggests that South Africa can increase spending in these areas by up to R30 billion per annum without exceeding the deficit limit of 3 per cent of GDP (Pollin et al. 2006). A one per cent increase in the deficit-GDP ratio (from 2 per cent to 3 per cent, will finance about 47 per cent (R14 billion) of the increase in government expenditure. The rest can be financed through increases in personal, corporate, and the value-added taxes (R6 billion) and new revenue sources: (a) extending the Uncertified Securities Tax to cover bond trading, in addition to secondary trading of stocks; (b) enacting a mineral and petroleum royalty bill; and (c) the increase in incomes and decline in poverty that will result through the employment-targeted growth programme itself.

Meanwhile, persistent high real interest rates despite falling inflation rates have constituted a constraint to private economic activity. It has been estimated that a one percentage point decline in the prime lending rate, other things remaining the same, would lead to a 0.15 per cent rise in real GDP growth, a modest increase in inflation of 0.2 per cent and also a modest exchange rate depreciation of 0.6 per cent. Thus, easing monetary policy would boost growth with minimal and easily manageable costs in terms of inflation and exchange rate changes.

***Source**: Pollin et al. 2006.*

2.2 Sectoral performance

African economies are experiencing a structural shift whereby the service sector is becoming an important driver of growth. In 2004, the service sector contributed 49 per cent of GDP growth compared to 36 per cent for industry (including mining and quarrying) and 15 per cent for agriculture. In 2004, all three sectors continued to grow, albeit at relatively low rates. The industrial sector had the highest growth rate at 9.05 per cent, although growth in the manufacturing sector fell by almost 3.8 per cent compared to 2003. Developments within each sector and for each subregion are discussed in more detail below.

"African countries need to tailor their fiscal and monetary policies to promote investment, employment generation, and growth"

The agriculture sector

The contribution of agriculture to GDP ranges from a high of more than 33 per cent in East Africa to less than 8 per cent for Southern Africa. It employs some 70 per cent of the work force and generates on average 30 per cent of Africa's GDP. The overall contribution of agriculture to GDP declined in 2004 due to the low performance of this sector in the North and West African subregions (table 2.5).

Table 2.5
Agricultural sector performance by subregion

	Share in GDP				
	2000	2001	2002	2003	2004
North Africa	15.3	16.0	15.8	16.3	15.1
West Africa	28.4	29.6	29.7	27.1	21.0
Central Africa	25.7	26.4	26.7	27.2	27.3
East Africa	35.9	35.0	32.6	32.4	33.0
Southern Africa	7.6	7.8	8.3	8.0	7.8

***Source**: World Bank 2006.*

"Africa is a net food-importing region"

Africa is considered a net food-importing region, except for some countries such as South Africa. The largest share of imported products consists of food products (cereals, livestock, dairy products, and to a lesser extent, fruits and vegetables). However, exports of agricultural products represent an important source of foreign exchange earnings for several African countries. The share of agricultural products in total merchandise exports ranges from a high of more than 80 per cent for Sudan and Burundi to a low of less than 1 per cent for Gabon and Equatorial Guinea. Their leading export destination is the EU and the most important commodities exported are fish and crustaceans, fruits and nuts, cotton, and vegetables.

Table 2.6 shows that commodity production in Africa registered a 1.7 per cent increase in 2004 and a growth rate of 3.0 per cent over 1990-2004. Performance for the main agricultural products exhibits high variation across subregions (table 2.6). The year 2004 was a particularly good one for many important exportable commodities such as cocoa beans, coffee and cottonseeds. In some countries, production continues to be influenced by drought conditions. In North Africa, droughts have adversely affected the production of strategic crops such as wheat, olive and citrus. Southern African countries also continue to suffer from periodic droughts, especially Swaziland and Zambia.

Table 2.6
Commodities production growth rate, 1990-2004 (per cent)

	Total Africa		North Africa		Central Africa		East Africa		West Africa		Southern Africa	
	1990-2004 average	2004	1990-2004 average	2004	1990-2004 average	2004	1990-2004 average	2004	1990-2004 average	2004	1990-2004 average	2004
Commodities	3.0	1.7	3.8	1.6	2.2	-0.5	2.4	0.9	4.0	1.8	2.0	3.0
Crops	2.8	0.0	4.2	0.2	2.8	9.4	4.7	1.8	2.7	-1.7	2.1	-0.7
Oil seeds	2.8	-0.4	5.9	-12.4	2.2	3.5	1.8	3.8	2.9	0.7	3.5	6.6
Fruits and Vegetables	3.5	4.0	3.9	7.0	2.1	-5.3	1.4	0.8	5.2	3.7	3.0	9.1
Animals products	2.6	-3.0	3.8	-3.5	1.4	1.4	3.8	-2.6	2.0	-4.1	0.9	-0.6
Others	2.8	13.3	1.9	38.4	2.0	18.6	3.2	7.3	3.8	9.3	3.4	31.0

***Source**: FAOSTAT 2006.*

The industrial sector

The industrial sector represented 35.9 per cent of the African GDP in 2005, a slight improvement over the period 2000-2004 (World Bank 2006). This relatively high contribution of the industrial sector to GDP is explained by the importance of the non-manufacturing industries (mining and quarrying). The manufacturing sector accounted for only 12.1 per cent of GDP, down from an average of 14 per cent over 2000-2004. The underdevelopment of the manufacturing sector largely explains the limited contribution of industry to GDP growth.

"The underdevelopment of the manufacturing sector largely explains the limited contribution of industry to GDP growth"

The African labour force was estimated at 380 million in 2005, with about 20 per cent in the industrial sector. Labour statistics indicate that the industrial work force did not increase significantly during the past few years despite a steady growth in industrial production. This is attributed to the growing dominance of capital-intensive industries as most of new investments in industrial sector in African countries are absorbed by the mining and energy sector. Furthermore, labour-intensive industries in Africa, such as textiles and clothing, are no longer competitive on both foreign and domestic markets after the adhesion of China to WTO.

Countries with the most diversified economies on the continent (Egypt, Morocco, South Africa and Tunisia) continue to focus on traditional industries, such as food processing and textiles, except for South Africa, which is more industrialized than any other African country. There has been recently a gradual shift towards more capital-intensive industries in Tunisia, such as electrical and electronics industries, while the textiles and clothing sector is experiencing continued decline in its importance in all African economies. In the oil-producing countries, there has also been gradual production development in intermediate and oil-based industries, particularly chemicals, petrochemicals, fertilizers, plastics, and energy-intensive industries.

Overall, African exports of industrial goods are still dominated by mining and crude oil. To promote and diversify the export of industrial goods, African countries have to seek participation in regional and international trade agreements. However, compliance with the commitments and obligations of these agreements has been slow.

The energy sector

In 2005, Africa's production of crude oil averaged 8856 million barrels per day, which was 6.1 per cent higher than the 2004 average. Algeria, Angola, Libya, and Nigeria are the main oil producers, with a share averaging 75 per cent in 2005. Other oil producers are Cameroon, Chad, Congo, Côte d'Ivoire, Egypt, Equatorial Guinea, Gabon, Mauritania, Sudan, and Tunisia.

"Africa continues to be a net exporter of crude and refined oil products"

As far as natural gas is concerned, Africa's production in 2005 averaged 171,735 million standard cubic metres, which represented an increase of 13.1 per cent from 2004. This raised Africa's share in world gas production from 5.5 per cent in 2004 to 6.1 per cent in 2005 (table A2.1 in Appendix). Algeria accounted for 50 per cent of Africa's total production of gas, followed by Egypt, Libya, and Nigeria, together accounting for about 44 per cent in 2005. The increase in African production of natural gas is explained by two main factors. The first is related to the acceleration of the level of substitution of crude oil by natural gas in the generation of electricity around the world, which increases the level of global demand for natural gas. The second reason is the high level of international prices for both oil and gas, which increased the level of extraction of gas on the continent.

At the end of 2005, African proven reserves of crude oil represented 10.2 per cent of the world's total, while reserves of natural gas in Africa accounted for only 7.9 per cent of the world's total (table A2.2 in the Appendix). Algeria, Libya, and Nigeria lead in terms of proven reserves with a share of 76 per cent of total African reserves, followed by Angola, Egypt, Gabon and Sudan with a combined share of 18.4 per cent.

Africa continues to be a net exporter of crude and refined oil products. In 2005, exports of crude oil reached 6477.6 million barrels per day, which represented an increase of 1.8 per cent from 2004. However, Africa's share in the global exports of crude oil declined slightly from 14.9 per cent in 2004 to 14.5 per cent in 2005. For refined products, exports grew slightly by 0.8 per cent compared to 2004. This growth is observed after three successive years of decline in exports of refined products as a result of the higher growth of domestic demand for these products than for refining capacity. In fact, in 2005, African consumption of refined products grew by 2.8 per cent compared to 2004 while the refining capacity grew by only 0.5 per cent during the same period. Five countries dominate the demand for refined products: Algeria, Egypt, Nigeria, Libya, and Tunisia, accounting for almost 65 per cent of the total African consumption of refined products in 2005. Overall, exports of both crude and refined oil products from the region grew by 1.7 per cent relative to 2004,

compared to 4.6 per cent for the world, which shows a continent-wide structural bottleneck in refining capacity.

The services sector

The share of the services sector in Africa's GDP in 2004 amounted to 49.0 per cent, a slight decline on the previous year (table 2.7). The two potential drivers of growth in the service sector are tourism and financial services, and these components are discussed below.

The two drivers of growth in the service sector are tourism and financial services

Table 2.7
Service sector performance in main African subregions

	Share in GDP				
	2000	2001	2002	2003	2004
North Africa	46.5	47.5	47.2	46.4	45.7
West Africa	36.8	33.1	35.3	34.3	35.5
Central Africa	34.7	36.3	39.3	35.6	37.1
East Africa	47.8	48.7	50.4	50.8	50.2
South Africa	59.4	59.2	58.0	59.5	59.5

***Source**: World Bank 2006.*

The financial sector

While the financial sector is generally considered an important factor for growth, its performance in the case of African countries has been less than satisfactory. Financial systems remain largely underdeveloped both in terms of the size and range of financial instruments and services offered. Most countries still do not have a functioning capital market. Even where capital markets exist, they are very shallow and illiquid (Ndikumana 2003). Except for South Africa, African capital markets are mainly limited to equity markets with an underdeveloped bond market and virtually no futures markets.

Despite the series of financial sector reforms that the countries have undertaken since the 1980s, financial systems still exhibit substantial degrees of inefficiencies in their functions of savings mobilization and allocations of resources into productive activities (Senbet and Otchere 2006). It is worth noting that financial sector reforms have resulted in a gradual move towards market-based interest rate determination and curtailment of the government's presence in the financial sector through privatization of government-owned banks. While these are welcome developments, there are many important challenges that African countries need to address to make the financial sector a real engine of growth and employment creation.

One of the key manifestations of the inefficiency of financial systems in African countries is the high interest rate spread, which is a symptom of lack of competition and of inefficient management (resulting in high operating costs) in the banking sector. In fact, contrary to expectations, interest rate spreads have increased in the post-reform era (UNECA 2006b). Another important weakness of financial systems in Africa is that credit allocation tends to be concentrated into short-term and speculative activities. This is partly due to the lack of stable long-term finance but also to the high risk aversion exhibited by banks. The shortage of long-term lending constitutes an important constraint to private investment expansion.

“One of the key manifestations of the inefficiency of financial systems in African countries is the high interest rate spread”

It is clear that African countries need to find ways of increasing access to finance especially for the purpose of long-term investment for accelerated growth. This will require achievement of higher levels of domestic savings mobilization and better pooling of resources into long-term instruments. The development of a vibrant bond market and creation and consolidation of long-term finance mechanisms such as pension funds constitute key elements of a national strategy to deepen financial systems in order to boost domestic investment and accelerate growth.

The tourism sector

Many developing countries now regard tourism as an important and integral part of their economic development strategies. It is estimated that 808 million tourists traveled world-wide in 2004 and generated about $682 billion. Africa received 41.3 million tourist arrivals, which represent only 5.1 per cent of global tourist trips. In terms of receipts, Africa received 3.6 per cent (or $25.2 billion) of the $682 billion world tourist receipts. Within Africa, the North Africa subregion registered the highest market share of tourism activity on the continent in 2004 (38.2 per cent), followed in descending order by Southern Africa (27.5 per cent), East Africa (22.7 per cent), West Africa (9.4 per cent) and Central Africa (2.2 per cent) (see tables A2.3, A2.4 and A2.5).

In 2006, the top four countries in terms of tourism receipts are South Africa ($6.3 billion), Egypt ($6.1 billion), Morocco ($3.9 billion), and Tunisia ($1.9 billion). The seven major destination countries with over a million arrivals in 2004 were Egypt (7.7 million), South Africa (6.8 million), Tunisia (5.9 million), Morocco (5.4 million), Zimbabwe (1.8 million), Algeria (1.2 million) and Kenya (1.1 million).

Despite tourism’s growing importance as a source of foreign exchange earnings for African countries, the industry remains underdeveloped mostly because of poor tourism infrastructure (or weak capacity for accommodation), inadequate information and marketing (measured by internet use) and high health risks (such as malaria). Political and social instability also constitute major deterrents to tourism in some African countries. In addition, the insufficiency of air transport between Africa and the rest of the world and between African countries themselves continues

to be a crucial constraint to tourism. Another key challenge faced is the negative image of Africa portrayed by the media, often on the basis of exaggerated facts and plain ignorance.

2.3 Social development

While growth has recovered on the continent, the gains in terms of social development and poverty reduction are still limited. This sub-section reviews the evidence on social development through the lenses of the MDGs. Following a discussion of progress and challenges for the various goals, the sub-section provides a more detailed discussion of the challenges posed by HIV/AIDS. More details on progress towards the MDGs in Africa is provided in various ECA documents, including a forthcoming report (UNECA 2007), as well as reports by other United Nations publications (e.g. UNDP and UNICEF 2002).

"Recent economic growth has not been accompanied by meaningful job creation"

Overall assessment of the MDGs

As can be seen in table 2.8, progress towards the MDGs is slow; thus, serious challenges remain in all major areas of social development. Nevertheless, on a disaggregated level, some countries have made significant progress.

Goal 1: Eradicate extreme hunger and poverty

The share of the population living on less than one dollar (PPP) per day remains virtually unchanged over the 12-year period, 1990-2002 (table 2.8). The lack of progress in poverty reduction can be attributed to two factors. First, poverty rates tend to follow growth with a lag. Secondly, recent economic growth has not been accompanied by meaningful job creation (UNECA 2006b). This is because in many countries, growth rates have not been high enough to generate sufficient demand for labour. Moreover, growth remains highly volatile, which hampers job creation in the private sector.

Furthermore, the shift of economic activity away from agriculture into capital-intensive sectors such as mining and oil, has also undermined job creation. The fact that employment creation is not integrated into macroeconomic policy frameworks as an explicit goal of macroeconomic policy is an additional reason for the weak gains from recent growth recovery in terms of job creation (Pollin et al. 2006). Therefore, African countries need to adopt more flexible pro-growth macroeconomic frameworks and better targeted sectoral policies in order to increase employment as a means of accelerating poverty reduction.

Table 2.8

Status of MDG achievements in Africa

	Region	1990	2004	2015 target
MDG1: Eradicate extreme poverty and hunger Indicator: People living on less than 1$ (PPP) a day (% of population)	SSA	44.6	44*	22
	NA	2.2	2.4*	1.1
MDG2: Achieve primary education Indicator: Net primary enrolment rate	SSA	53.0	64.2	100
	NA	80.6	94.0	
Indicator : Literacy rates 15-24 year olds (% of relevant age group)	SSA	67.4	73.1	100
	NA	66.3	84.3	100
MDG3: Promote gender equality and empower women Indicator: Ratio of literate women to men of 15-24 age group	SSA	0.80	0.88	1
	NA	0.73	0.91	1
MDG4: Reduce child mortality Indicator: Under 5 mortality (per 1,000 births)	SSA	185	168	62
	NA	88	37	29
MDG5: Improve maternal health Indicator: Proportion of deliveries attended by skilled health workers	SSA	42	46	100
	NA	40	71	100
MDG6: Combat malaria, tuberculosis, HIV/AIDS and other diseases Indicator: Adult HIV/AIDS prevalence	SSA	2.7	5.8**	Stop increase
	NA	<0.1	0.1 **	Stop increase
Indicator: Tuberculosis prevalence (cases per 100,000 population (excluding HIV infected)	SSA	337	492	Stop increase
	NA	64	52	Stop increase
MDG7: Ensure environmental sustainability Indicator: Proportion of land area covered by forest	SSA	29.2	26.5	
	NA	1.3	1.5	
Indicator: Access to an improved water source (% of population)	SSA	49	56	75
	NA	89	91	94
Indicator: Access to improved sanitation (% of population)	SSA	32	37	66
	NA	65	77	83
MDG8: Develop a global partnership for development Indicator: Share of ODA flows (% of donor GNI)	OECD	0.33	0.2	0.7

Source: *UNECA 2006e, based on United Nations Database at www.mdgs.un.org/unsd.*
Notes: ** Data for 2002, ** Data for 2005.*

Goal 2: Achieve universal primary education

Compared to other regions, SSA lags behind in progress towards universal primary education (UPE) (United Nations 2006a). Between 1990 and 2004, net enrolment rates increased in SSA from 53.0 per cent to 64.2 per cent, and in North Africa from 80.6 per cent to 94.0 per cent. Even though progress has been made, efforts need to be scaled up in most African countries to reach UPE by 2015.

Some countries have made significant progress in primary education as in the case of Ethiopia, where enrolment more than doubled from 22 per cent in 1990 to 47 per cent in 2004 (United Nations 2006b) due to large-scale investments in government schools, which now serve nearly 90 per cent of students in primary and secondary schools (World Bank 2005). However, the increase in enrolment needs to be matched by proportional increases in teaching staff and materials to guarantee adequate quality of education. This is true in Ethiopia as in other SSA countries. It is estimated that to reach UPE in SSA the current stock of teachers has to increase by almost 20 per cent each year (World Bank and IMF 2005).

> *"Some countries have made significant progress towards gender parity through school feeding programmes"*

Goal 3: Promote gender equality and empower women

The ratio of girls to boys in gross primary school enrolment increased over the 1991-2004 period from 0.84 to 0.89 in SSA and from 0.82 to 0.94 in North Africa. However, the ratio for secondary enrolment in SSA dropped between 1999 and 2004 from 0.82 to 0.79 and that for tertiary enrolment from 0.69 to 0.63 (United Nations 2006a).

Some countries such as Burkina Faso and Mali, have made significant progress towards gender parity through school feeding programmes. Rwanda also made substantial progress in gender parity as a result of its post-conflict reconstruction programme, which benefited from generous donor support. Close monitoring of the gender gap and a better targeting of policy interventions are needed to accelerate progress towards gender equity. To fill this need for monitoring of gender equity, ECA has developed a new tool, the African Gender and Development Index (AGDI), an integrated index that measures integration of women in all aspects of a country's economic and political life (UNECA 2006b).

Goal 4: Reduce child mortality

Substantive progress has also been made, especially in North African countries, in reducing child mortality over the past decades. Between 1990 and 2004, under-five mortality in this subregion was reduced from 88 to 37 deaths per 1,000 live births and infant mortality from 66 to 20 deaths per 1,000 live births. In contrast, progress in SSA countries has been very modest (United Nations 2006a).

SSA needs to triple its health workforce, adding more than one million workers to reach the health-related MDGs

Goal 5: Improve maternal health

The proportion of births attended by skilled health personnel shows a massive improvement in North Africa from 40 per cent to 71 per cent over the 1990-2004 period. For SSA, the progress has been very modest, from 42 to 46 per cent over the same period (United Nations 2006a). It is estimated that SSA needs to triple its health workforce, adding more than one million workers to reach the health-related MDGs (World Bank and IMF 2005).

Goal 6: Combat HIV/AIDS, malaria and other diseases

Currently, it is estimated that more than 25 million Africans live with HIV, and 2 million out of the 2.8 million AIDS-related deaths in 2005 were in Africa. In the 38 hardest hit African countries, it is projected that there will be 19 million additional deaths due to AIDS between 2010 and 2015. The second part of this sub-section discusses the challenges caused by HIV/AIDS in more detail.

In the fight against malaria, African countries committed themselves in 2000 to dramatically increase the provision of insecticide-treated nets. Remarkable success in the provision of nets to children under five has been recorded in such countries as Eritrea and Malawi, reaching a coverage of 60 per cent and 36 per cent, respectively (WHO and UNICEF 2006). With respect to tuberculosis, the situation worsened in SSA, with an increase in prevalence from 337 per 100,000 of the population in 1990 to 492 in 2004. In North Africa, tuberculosis is less of a problem with only 52 cases out of 100,000 of the population in 2004.

Goal 7: Ensure environmental sustainability

While total carbon dioxide emission increased between 1990 and 2003 from 228 to 413 millions of metric tons in North Africa and from 416 to 530 millions of metric tons in SSA, other indicators of environmental quality have improved. For example, the proportion of the population with access to an improved water source increased from 49 per cent in 1990 to 56 per cent in 2004 in SSA and from 89 per cent to 91 per cent in North Africa. Likewise, access to improved sanitation rose from 65 per cent to 77 per cent in North Africa and from 32 per cent to 37 per cent in SSA over the 1990-2004 period (United Nations 2006a).

The rural sector remains especially marginalized relative to urban areas in access to drinking water, with only 42 per cent of the rural population having access to an improved water source in 2004 as compared to 80 per cent for the urban population. There are also large disparities between countries. In 2004, Ethiopia had the lowest coverage in the world of rural population with safe drinking water - only 11 per cent. In contrast, Burundi and Gambia had a coverage of 77 per cent in the same year. The rapid increase in the urban population, low investment in new water supply systems,

and poor maintenance of existing water networks in Africa constitute major challenges to adequate provision of drinking water in most African countries (United Nations 2006a; WHO and UNICEF 2006).

Goal 8: Develop a global partnership for development

Over the past few years, African countries have developed partnerships that should improve the continent's access to external development finance and export markets. These developments are discussed in chapter 3 of this report (also see UNECA 2006b).

Special focus on HIV/AIDS

The patterns of spread and levels of prevalence of HIV/AIDS exhibit marked subregional variations, with the Southern and Eastern subregions being the hardest hit. The epidemic seems to be slowly gaining ground in Central Africa, while most of West and North Africa has sustained fairly low levels of prevalence (UNAIDS 2006).

HIV/AIDS does not affect men and women equally. In SSA, close to 60 per cent of those living with HIV/AIDS are women (box 2.3). In some areas, up to six times more women than men are infected in the 15-24 age group (WHO-AFRO 2003). Life expectancy, for biological reasons, is generally higher for women than for men. However, in four countries – Kenya, Malawi, Zambia and Zimbabwe – the higher prevalence of HIV/AIDS among women has led to life expectancy for women dropping below that of men (UN-DESA 2005b).

Given the delayed impact of HIV/AIDS and the continued increase in prevalence, the worst is yet to come. The pandemic is not only an immediate crisis, but is also a long-term systemic challenge, with profound consequences for Africa (CHGA 2004a).

“Given the delayed impact of HIV/AIDS and the continued increase in prevalence, the worst is yet to come”

One area of particular concern is the impact of HIV/AIDS on food security. In a recent study of two local communities in rural Ethiopia, UNECA, UNDP and WFP found that even though the progression of the pandemic in rural Ethiopia was at an early stage, the impact could already be felt (UNECA/UNDP/WFP 2004). Households affected by HIV/AIDS have changed their spending patterns, spending more on health and funerals, financed primarily by borrowing. In addition, the resource base of these households has been reduced, as they gave up land to sharecropping and sold livestock. It was also shown that the reliance on social networks is insufficient to cope with HIV/AIDS. Since most households have continued to rely on farming as their most important source of income and food, HIV/AIDS has increased the food insecurity of affected households.

As a result of decades of austerity measures and compression of public expenditure, the capacity of African health care systems has been cut back while the demand for services keeps increasing. Health systems are so strained that a large proportion of Africans do not even have access to the most basic health care. At the same time, the demand for health care services is rapidly increasing, and the increasing morbidity as a result of HIV/AIDS adds to the existing burden on overstretched health care systems (Sandkjaer 2006).

"A more comprehensive approach to fighting HIV/AIDS is required"

Policy responses to HIV/AIDS - prevention and mitigation

Most African countries have established mechanisms for coordination of the response to HIV/AIDS, usually through a National AIDS Commission. With assistance from national and international partners, governments are focusing on how to prevent new infections, while simultaneously keeping those infected healthy for as long as possible.

Until very recently, the country-level response to HIV/AIDS was limited to prevention interventions and minimal care and support for those infected. Today, scaled-up resources, coupled with the decreasing costs of treatment and the emergence of simpler treatment regimes, provide an opportunity to expand national HIV/AIDS treatment and care responses. As a result, treatment coverage increased from 100,000 people on antiretroviral treatment in December 2003, to 810,000 in December 2005, or an estimated 17 per cent of those in need (WHO 2006a).

In a study exploring the consequences of a prevention-centred response to HIV, a treatment-centred response, and a combined response, Salomon et al. (2005) show that an integrated response works best. In the long term, such a response also reduces both direct and indirect HIV/AIDS-associated costs as fewer people will be infected.

A number of lessons have been learnt and are being applied in the scaling-up of treatment in Africa. With regard to prevention, traditional individual-focused approaches are hotly debated. Proponents of an approach that mainly centers on individual behaviour change argue that, given that HIV/AIDS is mainly transmitted through unprotected sex between men and women, effective interventions must focus on severing this transmission route by encouraging individuals to change their behaviour, and ultimately **a**bstain from sex before marriage, **b**e faithful within marriage, and use **c**ondoms – the so-called ABC approach.

Others argue that a more comprehensive approach is required, as individual behaviour is conditioned by many contextual factors which, unless addressed, make individuals unable to change their behaviour even if they so wish. For example, 10-55 per cent of African women surveyed stated that they believe that a wife cannot ask her husband to use a condom and cannot refuse sex, even if she knows that he has

Box 2.3
The Commission on HIV/AIDS and Governance in Africa (CHGA)

The lack of human and financial resources is a key constraint to providing treatment and care. The report by the Commission on HIV/AIDS and Governance in Africa (CHGA), which was launched in 2003 by United Nations Secretary-General, Kofi Annan, contains important findings on HIV/AIDS as well as key recommendations on the way forward in the fight against the pandemic.

- AIDS has many dimensions, which vary at the local, national, and regional level. The challenge of dealing with the many varied causes and consequences of the pandemic is therefore different for each government. The factors driving HIV/AIDS need to be well understood to effectively fight the disease and these factors differ from place to place;

- The vulnerability of women is an underlying factor everywhere. Several cultural norms have to be addressed in order to reduce HIV/AIDS transmission rates. The relationship between gender equality and the extreme vulnerability of women is not fully taken into account yet;

- The growing number of AIDS orphans will continue to present a challenge: Recent estimates show that of the 50 million orphans in Africa in 2010, 37 per cent will be AIDS orphans. The special needs of these orphans have to be addressed through targeted measures and programmes;

- The first priority must be to reinvigorate prevention strategies. Even after 20 years of policy responses to the pandemic, most programmes and services in Africa remain centralized in urban areas, are not gender-sensitive, lack adequate staffing and funding and are poorly targeted. A sense of urgency has to be brought back to HIV prevention, especially by increasing resources from donor nations, as well as strong commitment from national governments;

- The challenge in effectively scaling up HIV treatment and strengthening African health care systems is the lack of human and financial resources; and

- AIDS financing needs to be sustainable, coordinated and better managed. Even though funding for the global response to the pandemic is expected to rise substantially in the near future, some areas deserve further attention, especially measures to build local capacity in the health sector, which is crucial for expanding service delivery and interventions in other sectors, such as education. This calls for budgetary support on the one hand and improved performance in public sector management on the other.

***Source**: CHGA 2007.*

a sexually transmitted infection.[7] For these women, HIV/AIDS can still meet them in the conjugal bedroom, regardless of their willingness to protect themselves. Thus, there is a pressing need for an effective, comprehensive response to the disease in Africa.

The Commission on HIV/AIDS and Governance in Africa (CHGA), which was launched in 2003 by United Nations Secretary-General, Kofi Annan, aimed at

7 This question was asked through comprehensive Demographic and Health Surveys. The percentages quoted relate to surveys carried out in Benin, Botswana, Burkina Faso, Malawi, Mali, Namibia, Tanzania, Uganda, and Zambia between 2000 and 2004 (www.measuredhs.com).

bringing back a sense of urgency to HIV prevention. Its final report contains important findings on this pandemic and gives useful recommendations (box 2.3).

Delivery of the promised aid and debt relief will allow African countries to boost expenditure in key sectors including infrastructure and social services

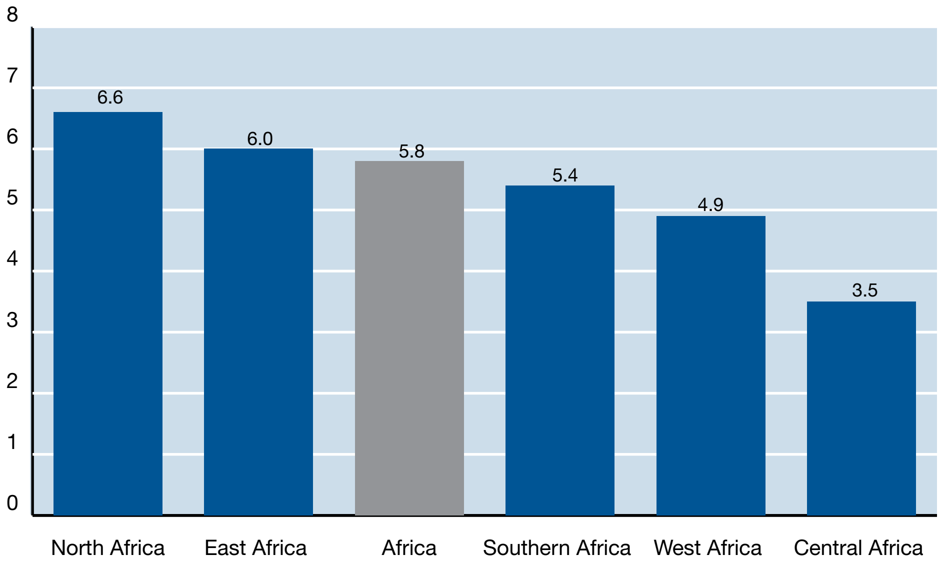
2.4 Growth prospects for 2007 and the medium-term outlook

Africa is expected to grow at a rate of 5.8 per cent in 2007, slightly higher than the rate recorded in 2006 (5.7 per cent) (figure 2.8). Positive growth rates are projected for all subregions led by North Africa (6.6 per cent), East Africa (6.0 per cent), Southern Africa (5.4 per cent), West Africa (4.9 per cent) and Central Africa (3.5 per cent). Despite deceleration of growth in major industrial economies, global demand for African products, especially oil, minerals and agricultural commodities, is expected to remain steady due to strong growth in emerging Asian economies, especially China. Moreover, delivery of the promised aid and debt relief will allow African countries to boost expenditure in key sectors including infrastructure and social services. In addition, consolidation of macroeconomic management will not only reduce inflation in the short run, but also contain long-term inflation expectations, which will encourage private investment.

A number of factors are likely to hinder growth in 2007 and subsequent years. Economic growth in many countries will be compromised by the increasing spread of the HIV/AIDS pandemic, which undermines labour supply and labour productivity. Lack of diversification of production and exports constitutes an important source of potential instability and vulnerability to shocks emanating from changes in commodity demand and prices as well as from unpredictable weather changes. Inefficient public infrastructure and unreliable energy supply at the national level as well as poor integration of transportation and energy networks at the regional level will continue to undermine productivity and international competitiveness, ultimately slowing economic growth (UNECA 2006b). Moreover, higher oil prices are a major concern for oil-importing African countries in terms of controlling inflation, promoting fiscal stability, improving the current account position, and increasing growth.

Achieving and sustaining high growth rates in Africa require a new approach to growth policy. Despite efforts in macroeconomic and financial sector reforms over the past decades, the majority of African countries have been unable to achieve and sustain the growth rates required for achieving the MDGs. Domestic financing constraints are compounded by the high external debt burden, which undermines any gains from macroeconomic reforms, especially in terms of trade liberalization. In addition to pursuing macroeconomic stability, it is critical for African countries to adopt a more strategic approach to growth policy, identifying the binding growth constraints and the activities and sectors that are potential sources of job creation

Figure 2.8
Projected real GDP growth by region for 2007 (per cent)



***Source**: EIU, January 2007.*

and growth. This strategy should also establish incentive mechanisms to channel resources to these activities and sectors.

> *Growth remains volatile and too low for achieving the MDGs, while pressure from oil prices threatens price stability in oil-importing countries*

2.5 Conclusion

Despite notable economic recovery in Africa since the turn of the 21st century, the continent still faces important challenges in attaining its development goals. Being highly commodity dependent, growth remains volatile and too low for achieving the MDGs, while pressure from oil prices threatens price stability in oil-importing countries. Macroeconomic balances are driven by developments in the resource sector and continue to worsen for oil-importing African countries. Moreover, external debt remains high and private capital flows insufficient to bridge the gap between domestic savings and necessary investment for Africa to meet the MDGs.

In order to accelerate and sustain growth over a long period of time, Africa needs to create a policy space and embark on innovative growth strategies. In particular, it should address the factors contributing to low and volatile growth through: improved macroeconomic management; increased domestic investment, which requires mobilization of internal and external resources; improved infrastructure (especially transport and energy supply), and diversification away from resource sectors.

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Appendix

Table A2.1

Trends in basic indicators for the natural gas sector in Africa

	1990	2000	2001	2002	2003	2004	2005
Proven natural gas reserves (%)							
Africa percentage (Share in total world)	6.5	7.7	7.5	7.9	7.8	8.0	7.9
Growth rate of African reserves	3.8	3.9	6.2	4.9	0.8	2.5	-0.4
Growth rate of the world reserves	4.7	2.1	8.3	0.5	1.4	0.3	0.3
Marketed production of natural gas (%)							
Africa percentage	3.4	5.0	5.1	5.2	5.4	5.5	6.1
Growth rate of African production	13.4	5.9	3.7	3.1	8.0	4.6	13.1
Growth rate of world production	3.8	1.8	2.3	1.9	3.5	2.9	2.4
Exports of natural gas (%)							
Africa percentage	10.7	12.9	12.0	11.5	11.5	10.8	12.4
Growth rate of African exports	14.4	7.7	-2.6	1.0	8.4	2.5	20.3
Growth rate of world exports	4.8	5.7	4.3	5.8	7.8	8.9	4.8
Imports of natural gas (%)							
Africa percentage			0.3	0.4	0.3	0.2	0.2
Growth rate of African imports				44.9	-8.7	-37.8	0.0
Growth rate of world imports				4.1	11.2	4.7	6.4

***Source**: OPEC 2006.*

Table A2.2

Trends in basic indicators for the oil sector in Africa

	1990	2000	2001	2002	2003	2004	2005
Proven crude oil reserves (%)							
Africa percentage (share in total world)	6.0	8.7	8.9	9.1	9.9	9.9	10.2
Growth rate of African reserves		4.6	3.8	5.3	10.2	1.0	3.7
Growth rate of world reserves		1.5	1.2	3.3	1.5	0.6	0.8
Production of crude oil (%)							
Africa percentage	10.1	10.3	10.1	10.1	10.8	11.8	12.3
Growth rate of African production		1.3	-2.2	-2.6	12.8	14.7	6.1
Growth rate of world production		1.1	-0.7	-2.1	5.1	4.9	1.7
Refinery capacity (%)							
Africa percentage	3.9	4.0	3.9	3.9	4.0	3.9	3.8
Growth rate of African capacity		1.4	-0.3	1.0	0.8	-1.2	0.5
Growth rate of world capacity		1.2	0.6	0.4	0.0	1.7	1.0
Output of refined products (%)							
Africa percentage	3.5	3.3	3.5	3.7	3.6	3.7	3.8
Growth rate of African output		0.9	7.4	6.0	-2.2	5.3	5.4
Growth rate of world output		1.4	0.9	1.6	1.3	2.1	3.1
Consumption of refined products (%)							
Africa percentage	2.8	2.4	2.6	2.7	2.7	2.7	2.8
Growth rate of African consumption		-0.2	7.7	2.9	2.5	5.1	4.0
Growth rate of world consumption		1.2	1.1	0.6	1.8	3.8	0.9
Exports of crude oil (%)							
Africa percentage	16.1	13.3	13.6	13.7	14.7	14.9	14.5
Growth rate of African exports		1.7	0.2	-0.5	13.1	9.1	1.8
Growth rate of world exports		3.7	-1.7	-1.6	5.7	7.5	4.7
Exports of refined products (%)							
Africa percentage	6.6	7.4	7.5	7.4	6.6	6.0	5.8
Growth rate of African exports		3.5	3.5	-1.6	-6.7	-5.5	0.8
Growth rate of world exports		2.5	1.7	-0.7	5.4	4.0	4.2
Exports of crude and refined products (%)							
Africa percentage	13.1	11.6	11.8	11.8	12.3	12.3	11.9
Growth rate of African exports		2.0	0.8	-0.7	9.4	6.8	1.7
Growth rate of world exports		3.3	-0.7	-1.3	5.6	6.5	4.6
Imports of refined products (%)							
Africa percentage			3.6	3.7	3.6	3.7	3.7
Growth rate of African imports				0.9	7.9	9.9	4.1
Growth rate of world imports				-2.5	10.1	6.3	6.6

***Source**: OPEC 2006.*

Table A2.3

International tourist arrivals

	International tourist arrivals ('000s)			Market share in region (%)			Average annual growth (%)	
	1990	2000	2004	1990	2000	2004	1990-2000	2001-2004
AFRICA	**17,667**	**33,474**	**41,381**	**100**	**100**	**100**	**6.4**	**4.4**
North Africa	**10,905**	**15,530**	**20,714**	**55.4**	**36.3**	**38.2**	**2**	**5.7**
Algeria	1,137	866	1234	7.5	3.1	3.7	-2.7	9.3
Egypt	2,411	5,116	7,795	22.1	32.9	37.6	7.8	11.1
Libya	96	174	149	0.8	1.1	0.71	6.1	-3.8
Morocco	4,024	4,278	5,477	26.5	15.2	16.4	0.6	6.4
Sudan	33	38	61	0.2	0.1	0.2	1.4	12.6
Tunisia	3,204	5,058	5,998	21.1	17.9	17.9	4.7	4.4
West Africa	**1,352**	**2,444**	**3,142**	**8.9**	**8.7**	**9.4**	**6.1**	**6.5**
Benin	110	96	174	0.7	0.3	0.5	-1.4	16
Burkina Faso	74	126	222	0.5	0.4	0.7	5.5	15.2
Cape Verde	24	115	157	0.2	0.4	0.5	17	8.1
Côte d'Ivoire	196			1.3				
Gambia	100	79	90	0.7	0.3	0.3	-2.3	3.3
Ghana	146	399	584	1	1.4	1.7	10.6	10
Guinea		33	45		0.1	0.1		8.1
Mali	44	86	113	0.3	0.3	0.3	7.0	6.8
Mauritania		30			0.1			
Niger	21	50		0.1	0.2		9.1	
Nigeria	190	813	962	1.3	2.9	2.9	15.6	4.3
Senegal	246	389	363	1.6	1.4	1.1	4.7	-1.7
Sierra Leone	98	16	44	0.6	0.1	0.1	-16.6	28.8
Togo	103	60	83	0.7	0.2	0.2	-5.3	8.5
Central Africa	**365**	**666**	**729**	**2.4**	**2.4**	**2.2**	**6.2**	**2.3**
Angola	67	51	194	0.4	0.2	0.6	-2.7	39.7
Cameroon	89	277	190	0.6	1.1	0.6	12	-9
Central Afr.Rep		11	8		0	0		-7.5
Chad	9	43		0.1	0.2		16.9	
Congo, Rep. of	33	19		0.2	0.1		-5.4	
DRC	55	103	30	0.4	0.4	0.1	6.5	-26.5
Gabon	109	155		0.7	0.5		3.6	
Sao Tome & Principe	3	7		0	0		9	

	International tourist arrivals ('000s)			Market share in region (%)			Average annual growth (%)	
	1990	2000	2004	1990	2000	2004	1990-2000	2001-2004
East Africa	**2,842**	**6,600**	**7,597**	**18.7**	**23.4**	**22.7**	**8.8**	**3.6**
Burundi	109	29		0.7	0.1		-12.4	
Comoros	8	24	18	0.1	0.1	0.1	11.6	-6.9
Djibouti	33	20	26	0.2	0.1	0.1	-4.8	7
Eritrea		70	87		0.2	0.3		5.7
Ethiopia	79	136	210	0.5	0.5	0.6	5.6	11.5
Kenya	814	899	1199	5.4	3.2	3.6	1	7.5
Madagascar	53	160	229	0.3	0.6	0.7	11.7	9.4
Malawi	130	228	471	0.9	0.8	1.4	5.8	19.9
Mauritius	292	656	719	1.9	2.3	2.1	8.4	2.3
Mozambique			470			1.4		
Réunion	200	430	430	1.3	1.5	1.3	8	0
Rwanda		104			0.4			
Seychelles	104	130	121	0.7	0.5	0.4	2.3	-1.8
Tanzania		459	566		1.6	1.7		5.4
Uganda	69	193	512	0.5	0.7	1.5	10.8	27.6
Southern Africa	**2,203**	**8,234**	**9,199**	**14.5**	**29.2**	**27.5**	**14.1**	**2.8**
Botswana	543	1104		3.6	3.9		7.4	
Lesotho	171			1.1				
Namibia		656		2.3		-8.2		
South Africa	1,029	6,001	6,815	6.8	21.3	20.4	19.3	3.2
Zambia	141	457	515	0.9	1.6	1.5	12.5	3
Zimbabwe	636	1,967	1,854	4.2	7	5.5	12	-1.5

Source*: World Tourism Organization 2006.*

Table A2.4

Top 20 tourism destinations in Africa ('000s of tourists)

RANKING	2000		RANKING	2002		RANKING	2003		RANKING	2004	
1	South Africa	6,001	1	South Africa	6,550	1	South Africa	6,640	1	Egypt	7,795
2	Egypt	5,116	2	Tunisia	5,064	2	Egypt	5,746	2	South Africa	6,815
3	Tunisia	5,058	3	Egypt	4,906	3	Tunisia	5,114	3	Tunisia	5,998
4	Morocco	4,278	4	Morocco	4,453	4	Morocco	4,761	4	Morocco	5,477
5	Zimbabwe	1,967	5	Zimbabwe	2,041	5	Zimbabwe	2,256	5	Zimbabwe	1,854
6	Botswana	1,104	6	Botswana	1,037	6	Algeria	1,166	6	Algeria	1,234
7	Kenya	899	7	Algeria	988	7	Botswana	975	7	Kenya	1,199
8	Algeria	866	8	Nigeria	887	8	Kenya	927	8	Nigeria	962
9	Nigeria	813	9	Kenya	838	9	Nigeria	924	9	Mauritius	719
10	Mauritius	656	10	Namibia	757	10	Mauritius	702	10	Ghana	584
11	Namibia	656	11	Mauritius	682	11	Namibia	695	11	Tanzania	566
12	Tanzania	459	12	Zambia	565	12	Tanzania	552	12	Zambia	515
13	Zambia	457	13	Tanzania	550	13	Ghana	531	13	Uganda	512
14	Réunion	430	14	Mozam-bique	541	14	Swaziland	461	14	Malawi	471
15	Ghana	399	15	Ghana	483	15	Mozam-bique	441	15	Mozambique	470
16	Senegal	389	16	Senegal	427	16	Réunion	432	16	Swaziland	456
17	Swaziland	281	17	Réunion	426	17	Malawi	424	17	Réunion	430
18	Cameroon	277	18	Malawi	383	18	Zambia	413	18	Senegal	363
19	Malawi	228	19	Swaziland	256	19	Senegal	354	19	Madagascar	229
20	Uganda	193	20	Uganda	254	20	Uganda	305	20	Burkina Faso	222

***Source**: World Tourism Organization 2006.*

Table A2.5

Top 20 tourism earners in Africa ($US million)

RANKING	2004		RANKING	2003		RANKING	2002		RANKING	2000	
1	South Africa	6,282	1	South Africa	5,523	1	Egypt	3,764	1	Egypt	4,345
2	Egypt	6,125	2	Egypt	4,584	2	South Africa	2,909	2	South Africa	2,675
3	Morocco	3,924	3	Morocco	3,225	3	Morocco	2,646	3	Morocco	2,039
4	Tunisia	1,970	4	Tunisia	1,582	4	Tunisia	1,523	4	Tunisia	1,683
5	Mauritius	853	5	Mauritius	696	5	Mauritius	612	5	Mauritius	542
6	Tanzania	621	6	Botswana	457	6	Tanzania	439	6	Tanzania	377
7	Botswana	549	7	Tanzania	450	7	Ghana	358	7	Ghana	335
8	Kenya	495	8	Ghana	414	8	Reunion	329	8	Reunion	296
9	Ghana	466	9	Reunion	413	9	Botswana	319	9	Kenya	283
10	Reunion	448	10	Kenya	339	10	Kenya	276	10	Botswana	222
11	Namibia	403	11	Namibia	330	11	Namibia	218	11	Uganda	165
12	Uganda	266	12	Senegal	209	12	Senegal	190	12	Namibia	160
13	Libya	218	13	Libya	205	13	Libya	181	13	Senegal	144
14	Zimbabwe	194	14	Uganda	184	14	Uganda	172	14	Seychelles	139
15	Algeria	178	15	Seychelles	171	15	Seychelles	164	15	Zimbabwe	125
16	Ethiopia	173	16	Zambia	149	16	Zambia	134	16	Madagascar	121
17	Seychelles	172	17	Mali	128	17	Algeria	110	17	Zambia	111
18	Zambia	161	18	Ethiopia	114	18	Mali	104	18	Nigeria	101
19	Mali	130	19	Algeria	112	19	Benin	93	19	Algeria	96
20	Cape Verde	109	20	Benin	106	20	Zimbabwe	76	20	Benin	77

***Source**: World Tourism Organization 2006.*

Global Development Challenges for Africa in 2006

This chapter deals with Africa's global development challenges in 2006. These challenges particularly relate to trade negotiations at the multilateral and bilateral level and to financing development. It is clear from analysis at the continental level that results are mixed when trade negotiations and the financing development issues are considered together. Thus, this chapter shows that although there is good news at the level of financing development with progress in debt relief initiatives, commitment to scale up aid in order to achieve the MDGs and agreement to improve aid effectiveness, trade negotiations are far from realizing Africa's priorities. In particular, at the level of multilateral trade negotiations, there has been limited progress towards addressing the priorities of Africa in a way that would enable trade to realize its potential as a key pillar for economic development of the continent. In the same vein, bilateral trade negotiations especially between African countries and developed country economies such as is the case with the EU are raising major challenges given the centrality of reciprocity in these negotiations.

"The average export performance of non-oil exporting SSA countries is very much in line with the world average"

3.1 Developments in trade negotiations

World trade expanded significantly between 2000 and 2005. Total world exports increased from $US6,451 billion in 2000 to $10,393 billion in 2005, an increase of 61 per cent.[1] Table 3.1 allows for a comparison of this evolution with African exports over the same period.

Table 3.1 shows that over the past 6 years, world merchandise exports experienced an average growth rate of 10.4 per cent. Over the same period, Africa performed better, increasing its exports by 16 per cent on average annually. However, breaking down the export performance by subregion reveals that the rapid increase in exports is particularly concentrated in oil-exporting SSA countries.[2] These countries achieved an average export growth of 22.4 per cent over the period. On the other hand, the average export performance of non-oil exporting SSA countries is very much in line with the world average (11.2 per cent).

This seems to be further proof that the recent gains in Africa's exports is not based on diversification of the export base but is based rather on increased oil exports.

1 WTO online world trade statistics, in dollars at current prices

2 Angola, Chad, Congo, Equatorial Guinea, Gabon, Nigeria and Sudan.

Moreover, table 3.1 shows that the variability of exports by oil producers is higher than for other countries, probably owing to the volatility of oil prices. The recent improvement in Africa's export performance therefore appears to be vulnerable to shifts in international commodity prices, particularly in changes in oil prices.

"Africa's share of global exports of merchandise remains low"

Table 3.1
Comparative merchandise export performance, World and Africa, 2000-2005 ($US billion)

Region	Exports	2000	2001	2002	2003	2004	2005	Yearly average 2000-2005
World	Exports in current prices	6451.0	6184.0	6484.0	7752.0	9191.0	10393.0	7712.5
	Growth rate (%)		-4.1	4.8	16.8	21.4	13.1	10.4
Total Africa	Exports in current prices	147.1	137.4	140.6	176.5	230.0	295.8	187.9
	Growth rate (%)		-6.6	2.3	25.5	30.3	28.6	16.0
Republic of South Africa	Exports in current prices	30.0	29.3	29.7	36.5	46.0	51.9	37.2
	Growth rate (%)		-2.4	1.6	22.7	26.2	12.7	12.2
North Africa	Exports in current prices	52.7	48.0	48.1	60.8	79.4	106.1	65.8
	Growth rate (%)		-8.9	0.1	26.4	30.7	33.5	16.4
Sub-Saharan Africa oil- exporting countries	Exports in current prices	37.1	32.1	32.4	43.6	62.4	91.6	49.8
	Growth rate (%)		-8.9	0.1	26.4	30.7	33.5	22.4
Sub-Saharan Africa non-oil-exporting countries	Exports in current prices	27.2	27.7	30.1	35.5	41.9	45.9	34.7
	Growth rate (%)		2.2	8.4	18.1	17.9	9.6	11.2

***Sources**: WTO online data, November 2006; UNECA 2006b.*

What is more, despite a recent slight recovery, Africa's share of global exports of merchandise remains low. Figure 3.1 shows the evolution of its share in global exports from 1965 to 2005. Its share in 2005 was 2.85 per cent only, roughly the equivalent of its 1991 value and less than half its peak value in 1980 (5.97 per cent). For comparative purposes, Africa accounted for 14 per cent of world population in 2005.[3] At the current rate of growth of African exports and according to the United Nations population growth estimates, the continent would have to wait until 2045 for its share in world exports to match its share of world population.[4] Non-oil-exporting

3 United Nations Population Division, UN-DESA, online statistics, November 2006.

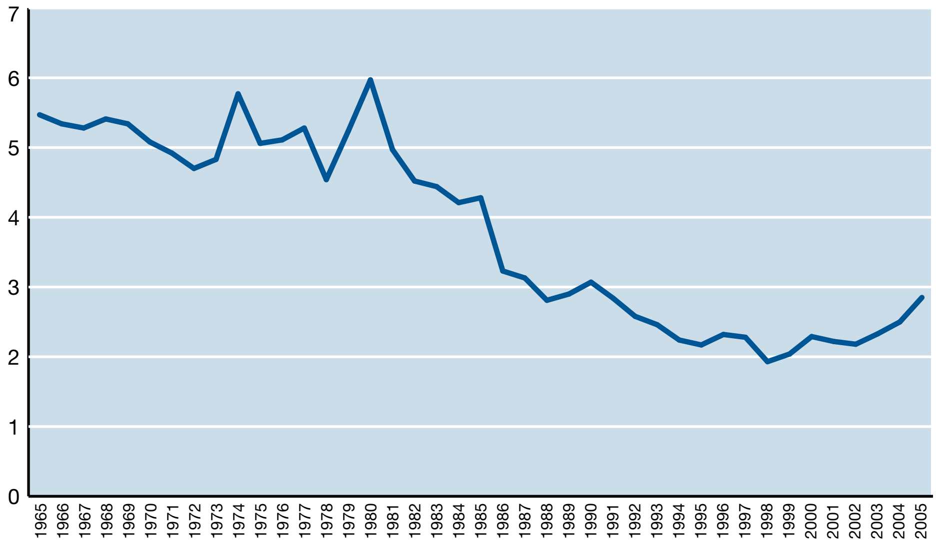
4 Projections for all African countries (including oil-producing and North African countries), estimate a continuation of the average export growth rates over the past five years and of United Nations projections for population growth.

SSA countries currently account for 8.5 per cent of world population. At the current rate of growth of their exports and even without taking account of their increasing weight in total world population, these countries would have to wait until 2387 (382 years!) to see their export share match their share of world population.[5]

In light of the situation of low export performance and dependency on the prices of just a few commodities, diversification should remain a priority objective for all African countries, particularly but not only for SSA countries.

Investment and diversification depend on a number of internal factors such as governance, regulatory environment, productivity and comparative advantages

Figure 3.1
Africa's share in total world merchandise exports, 1965-2005 (per cent)



***Source**: WTO online data, November 2006; UNECA 2006.*

Investment and diversification depend on a number of internal factors such as governance, regulatory environment, productivity and comparative advantages, etc. However, external factors also help to set the conditions for diversification. These include effective market access, regional integration and the multilateral and other international trade agreements that are currently being negotiated.

Much was expected of a successful Doha Development Round of WTO negotiations launched in 2001 at the Fourth WTO Ministerial Conference from 9 to 14 November 2001, in Qatar. Numerous studies suggested that there would be significant gains for developing countries. Likewise, it was often expected that Economic Partnership Agreements (EPAs) with the EU would result in improved business environments in African countries, allowing for more investments and enhancing the prospects for economic diversification. This section takes stock of the developments in the trade negotiations in which African countries are involved.

5 Evaluation for non-oil-exporting SSA countries, without taking account of their projected population growth.

WTO trade negotiations evolving since 2001

The 2001 Doha Development Round of WTO trade negotiations saw ups and downs in the deliberations up to July 2006 when progress stalled. Talks have resumed since then informally and on a low-key basis but the prospects for a breakthrough still appear dim.

> *A fundamental expectation with the Doha Round, therefore, was that it would correct the remaining imbalances in trade rules in favour of developing countries*

The Doha Development Round

The Declaration of the Fourth Ministerial Conference in Doha provided the negotiation mandate for the Round. Developing countries, among them African countries, considered development dimensions to be crucial in fulfilling the Doha mandate which was to reform the multilateral trading system and improve their prospects in global trade. The pro-development agenda was expected to address the skewed nature of the division of global trade benefits, with most gains going to the developed countries. The Doha mandate was supposed to put development at the centre of the discussions with achievement of this mandate to the satisfaction of developing countries the yardstick with which success would be measured.

A fundamental expectation with the Round, therefore, was that it would correct the remaining imbalances in trade rules in favour of developing countries and improve rules to provide developing countries with genuine market opportunities. Negotiations on services and agriculture were programmed by the "in-built agenda" clauses of the Marrakesh Agreement.[6] Importantly for African countries and the African, Caribbean and Pacific (ACP) countries, the Doha meeting also secured a waiver for the transitional arrangements of the Cotonou provisions for EU-ACP countries. The waiver permitted the legal application of the Cotonou preferential trade regime, until its expiry on 31 December 2007. The Doha mandate evolved and was fine-tuned with the subsequent Ministerial Conferences in Geneva, Cancún, and Hong Kong, in 1998, 2003 and 2005, respectively.

The Cancún Ministerial Conference of 2003

In Cancún, in September 2003, the Fifth WTO Ministerial Conference that was intended for stock taking of positions again ended in a deadlock. The main contentions crystallized around the unresolved "Singapore issues": investment, competition, government procurement and trade facilitation. There was also deep

6 The Marrakesh Agreement establishing the World Trade Organization (WTO) was signed on 5 April 1994 and entered into force on 1 January 1995. It developed out of the general Agreement on Tariffs and Trade (GATT) and was a culmination of issues and arrangements tackled at the Uruguay Round of 1986.

disagreement over the treatment of cotton and other agricultural commodity and subsidy issues.[7]

The July Framework Agreement of the WTO General Council

It took member States until July 2004 to achieve any substantial progress on the issues that had stalled the negotiations in Cancún in 2003. After several weeks of intense deliberations, the member States agreed on a text that represented significant progress in clarifying the modalities.

The July Framework Agreement showed progress on agriculture, the Singapore issues and, to some extent, on Non-Agriculture Market Access (NAMA).[8] The text of the July Framework Agreement dropped the Singapore issues with the exception of trade facilitation. With regard to agriculture, advances were achieved on the three pillars identified, with special and differentiated treatment (S&D) featuring in all aspects. Domestic support measures were to be reduced using a tiered formula, implying steeper reductions for the highest level of subsidies. On export competition, the Framework Agreement stipulated reduction of export subsidies, with a view to phasing them out, even though no date was proposed for their concrete elimination. The choice of a tiered formula was also retained for market access. Least Developed Countries (LDCs) were exempted from all tariff cuts. It was further decided that treatment of cotton, one of the causes of contention in Cancún, would be treated under the agriculture negotiations; a sub-committee was created to address this issue "ambitiously, expeditiously and specifically".

The text of the July package was less clear concerning the choice of a particular formula for NAMA reductions. Negotiations had been delayed by the late progress achieved on agriculture, with many members refusing to invest too much effort in NAMA while the outcome of the negotiations in agriculture was still unknown. The July Framework also defined new deadlines for further advancing the negotiations.

However, most of the interim deadlines were missed and not much happened in 2005. The little progress achieved up to the Sixth WTO Ministerial Conference in Hong Kong in December 2005 included a system to assess the ad-valorem equivalent of non-ad-valorem tariffs. Other important issues remained unresolved.

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7 The Singapore issues emerged from the first WTO Ministerial Conference in 1996 and centred on investment protection, competition, policy transparency in government procurement, and trade facilitation.

8 The 2004 July Framework agreed by WTO members came under the overall Doha Development Agenda timeline. Members were asked to clarify and improve GATT Article V on Freedom of Transit, Article VIII on Fees and Formalities of Importation and Exportation and Article X on Publication and Administration of Trade Regulations. The package also agreed on technical and capacity-building assistance to developing countries, cooperation between customs and other trade facilitation authorities and customs compliance issues.

Sixth WTO Ministerial Conference in Hong Kong

Another major highlight of the Hong Kong Declaration was the decision to grant duty-free and quota-free market access to LDCs

This Sixth WTO Ministerial Conference resulted in the Hong Kong Declaration in December 2005 that outlined further progress in the negotiations, although it failed to bridge significant gaps. The main developments brought about by the Declaration included an end date of 2013 for agricultural export subsidies, and end of 2006 for cotton subsidies. Precision was also added to the modalities on agriculture, notably the number of bands for the tiered formulae. Progress was also made on the definitions of sensitive products, special products and special safeguard mechanisms. The Declaration chose a Swiss formula for tariff reduction under NAMA.

With regard to agriculture and NAMA, the Hong Kong Declaration set out a deadline for establishing modalities, particularly on the depth of tariff cuts and domestic subsidies reduction by 30 April 2006, with a view to establishing detailed schedules of commitments by 31 July 2006. On services, the Declaration called for improved offers and included a timeline to do so.

Another major highlight of the Declaration of particular importance for many African countries was the decision to grant duty-free and quota-free (DFQF) market access to LDCs. This extended to 97 per cent of products but notably excluded some textile and garment products. Such market access was to be granted to LDCs by developed countries and also by developing countries in a position to do so.

The Sixth Ministerial Conference in Hong Kong also resulted in an agreement for transparency on rules for regional integration. Finally, the Hong Kong Declaration also called for the creation of a task force on Aid for Trade. Discussions on Aid for Trade had developed during the course of 2005 in parallel with the WTO process.

The pause in the negotiations: July-November 2006

The Hong Kong Declaration had set several deadlines for reaching agreement on modalities. These deadlines were all missed during the first trimester of 2006 and, by the end of June 2006, a meeting of Ministers and Heads of Delegations was called in Geneva. Despite intense discussions on agriculture and NAMA, no agreement on modalities was reached. The issue was discussed at several levels including during the G-8 meeting in July 2006. Finally, after another unfruitful attempt to break the deadlock during a G-6 meeting, Pascal Lamy, the Director-General of WTO, on 27 July 2006, called for the talks to be suspended as, in his view, there was need for reflection and "quiet diplomacy."

The deadlock in WTO negotiations appeared to be primarily associated with disagreement over the levels of demand and offers on agriculture. In particular, it seemed that EU and USA would not agree on the levels of necessary concessions with regard to market access against reductions in domestic support.

The suspension of the talks was clearly a setback for the multilateral process, prohibiting the international community and especially poorer countries from gaining significant improvements in the multilateral trading system. This freeze in negotiations was all the more worrying in light of the expiration of the Trade Promotion Authority (TPA) or "fast-track" at the end of 2007. [9] This constitutes a de-facto deadline for the current Round.[10]

From July to November 2006, there were no official negotiations. On 16 November 2006, however, the WTO Director-General called for an informal trade committee meeting to re-launch the consultation process, as there appeared to be a consensus that WTO members were keen to revive the negotiations. The section below explores the achievements so far in the Doha Round from an African perspective.

> "The main achievements of negotiations under agriculture included first and foremost the decision to abolish all export subsidies by 2013"

Positions and prospects in WTO negotiations issue by issue

WTO negotiations have featured prominently in the headlines during the past couple of years. However, the main protagonists, particularly EU and USA, have not managed to bridge major differences on agriculture. This led to the deadlock in the negotiations in July 2006, with resumptions of talks under discussion at the moment of writing. Despite the lingering and significant disagreement among the various parties, the negotiations have achieved some clear advances. This section details those advances that are of special interest to African countries. It is hoped that they will not be lost if the negotiations stall again.

Agriculture

Agriculture is a sector of key interest for African countries, as it could be a main contributor to poverty reduction and diversification policies (UNECA 2005). Agricultural issues have been the most contentious in the negotiations. Nevertheless, some advances were seen in the African common positions, either in the form of agreed principles or in bracketed text.

The main achievements of negotiations under agriculture included first and foremost the decision to abolish all export subsidies by 2013 and by the end of 2006 for cotton exporters. As negotiations are still blocked, the opportunity of the elimination of cotton export subsidies by end 2006 has already been missed.

In terms of market access, the negotiations established a tiered formula with four bands resulting in steeper cuts for higher tariffs. There were also talks of tariff cap-

9 The TPA allows the American Administration to negotiate international trade agreements and present the outcome to the US Congress for an acceptance vote without the possibility of amendments.

10 Resuming negotiations after 2007 would probably mean waiting for the next US administration to extend a renewed TPA, the timing of which is unknown.

pings. UNECA research has shown that African countries overall would reap larger benefits from a significant reduction in tariffs (UNECA 2005a). The formula applies different sets of cuts to developed and developing countries, in line with the proportionality principle sought by African countries (African Union 2005). Moreover, LDCs were also exempted from reducing tariffs. This would have allowed most African countries to preserve substantial policy space in agriculture, another major objective of the Africa group.

"Developing countries were permitted to proceed to smaller tariff cuts than developed countries"

The principles of sensitive products, alongside special products and special safeguard mechanisms were also agreed despite wide disagreement on actual figures. Developing countries, including those from Africa, had strongly argued in favour of special products and special safeguard mechanisms that would be reserved for developing countries and allow special treatment for goods that have a role in rural development and the livelihoods of rural communities.

Advances were also achieved on domestic subsidies. The choice of a tiered formula had been retained for cutting domestic subsidies, both for the blue box and the Aggregate Measures of Support (AMS). This should translate into higher reduction of the subsidies in countries where they are higher. Further disciplines were proposed on de-minimis subsidies. A substantial reduction of domestic support measures including subsidies in the North were supposed to match the long-term interests of most African countries (UNECA 2005; Osakwe 2006).

Non-Agriculture Market Access (NAMA)

Although they had been somewhat delayed due to lack of progress on agriculture, talks on NAMA had also made some significant advances. For example, LDCs would be exempted from tariff cuts, an important objective for many African countries. The talks also allowed the choice of a Swiss formula for tariff reductions, entailing larger cuts on higher tariffs and a harmonizing effect (UNECA 2004).

The principle of proportionality in tariff cuts for NAMA products was also emphasized in the Hong Kong Declaration. Developing countries were permitted to proceed to smaller tariff cuts than developed countries. However, the precise level of coefficients for the formula remained undecided. The level of these coefficients is crucial as it determines the depth of the tariff cuts and whether or not the cut goes beyond simply reducing "water in the tariff" and results in actual reductions in applied rates. S&D is therefore available through the NAMA differentiated formula.

S&D treatment for developing countries was also reflected in NAMA negotiations through another provision of the Hong Kong Declaration: paragraph 8, which enabled developing countries to either shield a proportion of their tariffs from the effect of the formula, or alternatively to opt for a less-than formula reduction of tariffs for a larger number of their tariffs. Under NAMA, only those developing countries with more than 35 per cent of bound tariff lines had to apply the formula, which means

that eight African developing countries have to apply the formula.[11] Other countries had to increase their binding.

UNECA studies show that while an overly ambitious liberalization scenario in NAMA could lead to gains in welfare for Africa, there is also a risk of de-industrialization of the continent in favour of specialization in agricultural production (UNECA 2006b). Apart from a few important products that are still protected by high tariffs in developed countries, the potential gains in terms of depth of tariff reductions appear to be greater in other developing markets (South-South trade).

> "African countries in particular advocated for S&D treatment to be mainstreamed in all aspects of the negotiations"

Special and differential treatment (S&D)

The pro-development agenda of the Doha Round had different dimensions. These included S&D treatment, enhanced market access, balanced rules, policy space and flexibilities. The ability of the Round to ensure that the multilateral system strengthened the development dimensions for the benefit of developing countries is of major interest to African countries in the negotiations. African countries in particular advocated for S&D treatment to be mainstreamed in all aspects of the negotiations in order to enable them to achieve their legitimate development goals.

Such treatment relates to the preferential provisions in the final agreement in favour of developing countries and LDCs, the two categories in which African countries feature. For instance, through S&D treatment in agriculture negotiations, African countries were looking for modalities that would allow them to pursue agricultural policies in support of development, poverty reduction strategies, food security and rural livelihood concerns.

S&D treatment underpins the quest in the Doha Round for full operationalization of the principle of proportionality in the modalities. By taking into account the existing tariff structure of the African countries the treatment would help to strengthen the development dimensions of the Doha Round. With respect to the industrial tariffs, the modalities aimed at reducing or eliminating tariff peaks, high tariffs, and tariff escalation and would allow autonomy to African countries to pursue industrial policy in line with their development strategies. It would also allow them to initiate and deepen diversification of their economies.

Other issues

In services, negotiations had been initiated prior to the Doha Round by the so-called "in-built agenda" as stipulated by paragraph 1 of Article XIX of the General Agreement on Trade and Services (GATS). Negotiations on services resumed in January 2000, before the Doha Ministerial Conference. Noteworthy for African and other

11 These eight countries are Botswana, Egypt, Gabon, Morocco, Namibia, South Africa, Swaziland and Tunisia (UNECA 2006b).

developing countries, Article XIX-2 of GATS made S&D treatment an explicit element of the GATS negotiations. Therefore, developing countries were only expected to undertake commitments in trade-in-services liberalization compatible with their development levels.[12]

There is no "one size fits all" in international trade in services

Negotiations have been following a "request and offer" approach. Deadlines for submissions have been missed but since March 2003, 69 offers have been made and 30 of them subsequently revisited.[13] These offers cover both sectoral and horizontal/multisectoral proposals. As with the negotiations on agriculture and NAMA, and of importance to many African countries, LDCs are not expected to undertake new commitments in services in the current Round. For other African countries, negotiations in services represent both opportunities and challenges (UNECA 2005a, UNCTAD 2005).

Trade in services has increased significantly worldwide and African countries do have some potential comparative advantages in service sectors such as tourism and in labour-intensive sectors covered by Mode 4. Moreover, the international provision of business support and infrastructure services in sectors such as insurance, banking, and consulting can greatly reduce the cost of doing business and increase competitiveness in developing countries (UNCTAD 2002). On the other hand, liberalization must be planned and sequenced carefully and requires development of an appropriate regulatory framework (UNCTAD 2005a).

There is no "one size fits all" in international trade in services and the negotiations in services liberalization cover a very large number and variety of industries. For developing countries, and in particular African ones, the progress in the negotiations – as highlighted by the small number of offers - is hindered by the lack of experience in negotiating their interests in services. African countries need development support both for their supply capacity in services and for their capacity to participate effectively in negotiations on trade in services. It is suggested by several observers (for example Sauvé, 2006) that Aid for Trade programmes should be targeted at enhancing the capacities of African countries to respond to such challenges.

Talks on trade facilitation progressing significantly

A consensus has also been reached on application of certain trade facilitation provisions by developing countries in exchange for systematic provision of technical assistance to meet them. WTO has always dealt with issues related to trade facilitation and WTO rules include a variety of provisions that aim to enhance transparency and set minimum procedural standards. Among them are GATT Articles

12 GATS Art XIX-2: "*The process of liberalisation shall take place with due respect for national policy objectives and the level of development of individual Members, both overall and in individual sectors. There shall be appropriate flexibility for individual developing country Members for opening fewer sectors, liberalising fewer types of transactions, progressively extending market access in line with their development situation* […]".

13 Seven African countries have made proposals: Egypt, Gabon, Kenya, Mauritius, Morocco, South Africa and Tunisia.

V, VIII and X, which deal with freedom of transit for goods, fees and formalities connected with importation and exportation, and publication and administration of trade regulations. As part of the Doha Work Programme, the General Council decided by explicit consensus to commence trade facilitation negotiations on the basis of clearly defined modalities.

The Trade Facilitation Negotiating Group made considerable progress before WTO negotiations were suspended in July 2006. Several proposals had been tabled. However, addressing the issues of technical assistance and capacity building (TA/CB) as well as S&D proved to be a major challenge. It was unanimously acknowledged that TA/CB for trade facilitation should respond to the specific needs of WTO member States. However, the specific TA/CB issues to be addressed within the WTO framework were unclear. In this regard, it was generally agreed that self-assessments on trade facilitation needs at national level were critically important for African countries because they could facilitate engagement with the donor community among other benefits. A number of tools, including those developed by WTO and the World Customs Organization (WCO) were proposed for conducting such national assessments. The National Trade Facilitation Committees in some African countries would provide appropriate forums to work on these assessments.

“Considerable efforts should be made in other areas such as transit transport management”

It also emerged during the negotiations that access to available resources for capacity building from the donor community remained a challenge to African countries because existing procedures were complex. To address this problem, they continuously stressed the need for a simplified template for requesting technical assistance and capacity building from donors. In terms of the scope of negotiations, they have reiterated the broad scope of trade facilitation, and argue that, in addition to activities aimed at improving customs efficiency, considerable efforts should be made in other areas such as transit transport management. This was especially important for the continent’s 15 land-locked countries.

Regarding the possible structure for a Trade Facilitation Agreement (TFA), the notion of a “trade facilitation ladder” has been emerging that would define the levels of facilitation to which countries would commit themselves. The philosophy behind this notion has been that all WTO members should be required to sign up to the lowest level of standards, with those countries that are most able, implementing a far higher level of facilitation. It was envisaged that the negotiators would define the number of steps in the ladder and their content. Finally, there was convergence on the view that there should be an additional facilitative procedure to resolve disputes arising from trade facilitation commitments, as taking recourse to the Dispute Settlement Procedures should be the last resort

On rules for regional integration, a decision of the Negotiating Group on Rules established a transparency mechanism for regional trade agreements (RTAs). This decision applies to all RTAs provisionally and will be replaced by a permanent mechanism upon the completion of the Doha Round. The discussions on establishing

criteria for assessing WTO compatibility with RTAs have not, however, progressed significantly.

One of the most noteworthy achievements for Africa at the Round so far has been the proposition to grant LDCs DFQF, market access to developed countries and to developing countries in a position to do so.[14] This proposition had been championed by EU. Unfortunately, other developed countries, particularly the USA, insisted on watering it down to apply DFQF to only 97 per cent of all products, which allowed for the exclusion of key products such as some textiles and apparel. This decision could still benefit African LDCs as one of the criticisms of preferential schemes such as the Everything but Arms (EBA) initiative is that they lack the legal security conferred by a WTO commitment.

"The introduction of Aid for Trade under WTO auspices could allow for more transparency and coherence"

Aid for Trade talks represent significant advance

The recent inclusion of Aid for Trade talks on the agenda of the Round is another significant advance. Aid for Trade is not part of the mainstream undertaking, so progress on this issue could be independent from the rest of the Round. The introduction of Aid for Trade under WTO auspices could allow for more transparency and coherence on this issue. It is also hoped that this will increase availability of resources for Aid for Trade programmes, for which there seems to be great scope. Such programmes could facilitate trade negotiations through the reinforcing of African negotiating capacities. They also contribute to developing capacity for applying meaningful S&D treatments in a range of negotiation areas.

Improvements in Africa's negotiating capacities

African negotiating capacities, which have proved inadequate in past negotiations, have evolved over time. One of the most significant developments has been the increased participation of African countries in the actual negotiations. In the past negotiations, including the 1986 Uruguay Round, African countries played a peripheral role. In the current Doha Round, African countries are not only engaged actively in the definition of the mandate for the negotiators, but have been active at every stage as the negotiations have progressed. This active participation and engagement have highlighted the priorities and concerns of Africa and its desire to ensure that multilateralism benefits all, especially through operationalization of S&D treatment in every aspect.

The visible engagement of African countries in the negotiations has been driven mainly by more effective organization of their participation. The African Union Commission (AUC) has led the political efforts and the coordination of the negotiations. This coordination has been able to maintain a strong solidarity among African

14 Brazil recently announced its intention of granting duty-free, quota-free (DF QF) market access to LDCs.

countries despite their diversity. The African Group in Geneva is able to participate in the negotiations from a common framework on all the key issues of interest. Thus, the current common negotiating framework that they are using to inform their positions has been developed under AU coordination and was endorsed by the AU Summit in Banjul, Gambia in July 2006. The AU Summit Decision was based on the outcome of the Conference of African Trade Ministers held in Nairobi in April 2006.[15]

The coordinated technical support provided to African negotiators has been another important development. Many institutions have provided inputs to the political process spearheaded by AU. ECA has been playing a major role through its African Trade Policy Centre (ATPC) with the support of the Canada Fund for Africa. Other institutions playing key roles in providing technical support to the political process include WTO, UNDP, UNCTAD, International Trade Centre (ITC) and research networks such as African Economic Research Consortium (AERC), Council for the Development of Social Science Research in Africa (CODESRIA) and International Lawyers and Economists Against Poverty (ILEAP). Civil society organizations (CSOs) have also been active in advocating for African priorities in the trade negotiations. These include non-governmental organizations (NGOs) operating regionally and internationally. The Third World Network (TWN), South Centre, and OXFAM, among others, have played a major role in advocating issues of concern to African countries.

"The visible engagement of African countries in the negotiations has been driven mainly by a more effective organization of their participation"

The EPA negotiations

The long-standing Lomé preference system between APC countries and EU was reformed in 2000 with the signature of the Cotonou Treaty. Cotonou rolled over the existing unilateral trade preferences up to the end of 2007 when they should be replaced by a WTO-compatible trade arrangement. The Cotonou trade arrangements are currently not compatible with the WTO rules on preferential trade arrangements (Lang 2006). Indeed, they fit neither the criteria of Article XXIV which call for reciprocity and liberalization of substantially all the trade, nor that of the Enabling Clause which entails that preferences are extended to all developing countries or all LDCs. ACP countries and EU had to seek a waiver from other WTO members for the Cotonou Agreement, and this was granted in Doha in November 2001. The waiver expires at the end of 2007. It is expected that the negotiations on the regime to succeed the Cotonou arrangements will have been concluded by this date.

15 The Nairobi Ministerial Declaration on Doha Work Programme was issued by the 4th Ordinary Session of the AU Conference of Ministers of Trade, held 12-14 April 2006, in Kenya. It was on update of previous Declarations including: the Cairo Declaration and Road Map on the Doha Work Programme, from the 3rd Ordinary Session of the AU Conference of Ministers of Trade, 5-9 June 2005, in Egypt, the Kigali Consensus and Declaration on the Doha Work Programme at the 2nd Ordinary Session of the AU Conference of Ministers of Trade, 27-28 May 2005, in Rwanda, and the July Framework Agreement of the WTO General Council of 1 August 2004.

> *The EU has also shown signs of readiness to allocate additional resources to improv the interregional trade infrastructure*

ACP countries and EU have opted to negotiate Economic Partnership Agreements (EPAs), which will be FTAs between ACP Regional Economic Communities (RECs) and EU. In Africa, EPAs are being negotiated with the Economic and Monetary Community of Central Africa (CEMAC), the Economic Community of West African States (ECOWAS), Common Market of Eastern and Southern Africa (COMESA) and the Southern African Development Community (SADC).

The negotiations on EPAs were launched in 2002. They revolve around market access, fisheries, sanitary and phytosanitary (SPS) measures, agriculture, services, investment and competition. Negotiations have evolved differently across the regions. Each region has so far established a roadmap with the EU outlining the way forward for the negotiations. Generally, there has been growing concern in Africa that EPAs, while representing significant potential for growth and development, also carry challenging adjustment costs. Evidence shows that EPAs could also translate into tariff revenue losses, de-industrialization and reductions in intra-African trade (UNECA 2004; 2005). African countries have called for enhanced support to capacity building and financing. EU argues that such tools already exist and that the discussions concerning their improvement are independent of EPA negotiations. The focus of the negotiations for Africa has therefore shifted to the development dimension of EPAs.

The negotiation process is further complicated by the overlapping memberships of African countries in various RECs (UNECA 2006b). African countries and EU appear to be in agreement that EPAs should be an opportunity to enhance regional integration in Africa. Impact studies on EPAs (UNECA 2004) show that the sequencing of liberalization is key to the development of the continent. This would probably translate into a back-loaded tariff reduction on imports from EU, while liberalization within RECs would be a priority. EU has also shown signs of readiness to allocate additional resources to improvement of interregional trade infrastructure, which would benefit African regional integration.

Article 37.4 of the Cotonou Agreement in 2001 stated that the Parties would conduct a formal and comprehensive review of the process, structure and substance of the negotiations, in 2006.[16] This review is under way at the time of writing. Preliminary results seem to indicate that, in several regions, the process of negotiations is evolving more slowly than expected, partly due to disagreements with EU on the development dimension of the EPAs but also because of the difficulties some countries and regions face in forming internal consensus and informed positions on technical and sectoral issues. The formal review will identify the necessary means to allow timely completion of the negotiations by 1 January 2008. Should the negotiations fail to reach conclusion by end of 2007, the question of a WTO waiver will have to be reconsidered.

16 The Cotonou Agreement guides EU's development cooperation with ACP countries. The treaty was signed in Benin in June 2000 and entered into force in 2002. It aimed at eradicating poverty and fostering sustainable development and at integrating ACP countries into the world economy.

One of the questions that recently gained importance in talks regarding EPAs is the potential alternative to the FTAs currently envisaged. The Cotonou Agreement called for all alternatives to be explored. So far, the main alternatives appear to be enhanced preferential schemes such as the Generalized System of Preferences (GSP) and the Everything but Arms (EBA) initiative (Bilal and Rampa 2006). Further analytical work on this issue is crucial.

The standstill in WTO negotiations also complicates the EPA process. In the absence of evolution on rules for preferential trade arrangements, major uncertainties remain on the degree of flexibility African countries have on the length of transition periods and on the coverage of liberalization (Lang 2006). In this context, there is a risk that negotiators will feel constrained and opt for conservative EPA provisions, retaining few sensitive products and short transition periods.[17] This could translate into more acute adjustment costs for African countries in terms of both de-industrialization and regional integration. UNECA research shows that the impact of EPA on African economies could be positive only under a scenario of substantial asymmetry in the degree of liberalization. In particular, the African Party would have to be able to retain a significant share (up to 40 per cent) of trade out of the coverage of liberalization, while EU would have to be willing to open its markets entirely to African exports (Perez and Karingi, forthcoming).

> *The standstill in WTO negotiations also complicates the EPA process*

The breakdown in WTO negotiations also affects other issues in the EPA negotiations. For example, African countries are concerned that gains in access to the EU market for agricultural products may not translate into increased exports as long as international prices remain distorted by subsidies to farmers in the North. Likewise, there may be a potential risk that opening service markets to EU producers may only result in situations of unhealthy monopolies or oligopolies in the service markets of African countries. As a consequence, African countries may feel bound to extend liberalization of their service markets to other WTO members, without obtaining the benefits of reciprocal concessions from these third parties.

EPA negotiations are the major task ahead of African trade policymakers, especially since the freeze of the Doha Round. These pose great challenges but also real opportunities in terms of development for the continent. In view of the short time remaining for completion of the negotiations, it is important that all the parties involved step up their political commitment to successful EPAs. The ongoing comprehensive review process should be seized as an important opportunity to propose solutions to resolve pending issues within Africa and between African groupings and the EU.

Generally, there are some positive developments in the negotiations so far, even if these may still be too limited to make Doha a true development agenda. With the suspension of the talks, there is a risk that these advances may be lost or delayed for

17 The traditional interpretation of Article XXIV is that EPAs should cover at least 90 per cent of trade between the Parties, and should cover all sectors. Moreover, the Understanding on Article XXIV stipulates that transition periods should exceed ten years only in exceptional circumstances.

a long time. In this respect, some have started to call, albeit reluctantly, for an agreement *a-minima*, which would probably mean few commitments in agriculture and NAMA in terms of market access and subsidies reduction, but some progress on trade facilitation and some advances on Services and Aid for Trade.[18]

African countries are involved in a number of regional and free trade agreements and negotiations

Other developments in international trade negotiations

In light of the recent suspension of the WTO negotiations and the ongoing EPA process, African countries have an ever greater interest in diversifying their export markets. They are involved in a number of regional and free trade agreements and negotiations. They are also benefiting from several major preferential schemes such as the USA's African Growth Opportunity Act (AGOA). Some African countries are also engaged in bilateral trade talks with other regions of the world. This section highlights the major recent developments related to these processes.

African regional integration

Fostering African regional integration has been a long-standing objective of the continent. The Treaty of Abuja Establishing the African Economic Community in 1991, (chapter 1) calls for a gradual continental integration process centred on the integration of the five subregions (North, West, East, Central and Southern). EPA processes are also aimed at supporting regional integration in Africa. Unfortunately, integration remains hampered by several obstacles including political and security factors, poor transport and communication infrastructure, a low degree of complementarity in the structures of production and the overly complex web of memberships across different RECs.

This latter problem, also known as the "spaghetti-bowl" situation is particularly acute in some subregions. In West Africa, the most advanced integration is by far that of the WAEMU while EPA negotiations are ongoing between EU and ECOWAS to which is associated Mauritania, a member of the Arab Maghreb Union (AMU). Cape Verde, a member of ECOWAS, has recently shown interest in negotiating a separate EPA with EU (www.acp-eu-trade.org). Most but not all of the COMESA members are negotiating EPAs under ESA. Egypt and Libya are COMESA members but are not part of the EPA negotiation process. However, there are long-term plans for a customs union among COMESA countries so this means that the ESA external tariff may have to be reviewed at a later stage.

Meanwhile, Kenya, the largest economy in Eastern Africa, is associated with Uganda and Tanzania in the East African Community (EAC) customs union. However, while the former two are negotiating EPAs with ESA, Tanzania is negotiating its EPA with SADC. SADC is planning to create a customs union by 2008, implying that Tan-

18 This is for example the case of Peter Sutherland, a former WTO Director-General, in his speech at Chatham House, Tuesday, 14 November, 2006.

zania would, in theory, be part of two customs unions. Moreover, within SADC, Southern African Customs Union (SACU) countries are associated in a customs union with South Africa, which has its own trade agreement with EU. South Africa has, however, been recently associated with SADC in the EPA negotiations, which should contribute to harmonization of positions. In the longer term, it seems that the obvious solution to the question of overlapping membership is the creation of a pan-African free trade area and then customs union, which is the stated objective of the Abuja Declaration.

> *"Several African countries or groupings are also involved in bilateral trade negotiations in order to diversify their export markets"*

Preferential trading schemes

Thirty-seven African countries are eligible under AGOA, which grants African countries quasi DFQF access to the US market. In 2005, US imports from SSA under AGOA totalled $38.1 billion, up 44 per cent from the previous year, primarily due to an increase in imports of oil. US non-oil imports from Africa actually declined by 16 per cent to $2.9 billion, mainly due to increased competition in the textile and apparel sector in the wake of the termination of the Multifibre Agreement. There were also some minor advances in traditional and non-traditional sectors such as chemical products, fruits, nuts, cut flowers and footwear.

Thirty-four African countries are LDCs and are therefore eligible for the EU's "Everything but Arms" scheme. Other non-LDC African countries are either beneficiaries of EU's GSP or are party to a bilateral free trade agreement with the EU (TDCA and Euro-Med process).

Other recent developments with regard to preferential schemes include the participation for the first time of a customs union – Mercosur - in the General System of Trade Preferences (GSTP). GSTP is a South-South initiative under which developing countries grant each other preferential market access.

Bilateral talks

Several African countries or groupings are also involved in bilateral trade negotiations in order to diversify their export markets and enhance their integration in the global economic system. For example, WAEMU countries are currently negotiating FTAs with several North African countries. USA and SACU are also engaged in free trade talks. South Africa is discussing a potential FTA with India and Mercosur countries. With the recent explosion of trade flows between Africa and China and India, several countries are carrying out bilateral trade negotiations with these two Asian nations.

With the suspension of WTO negotiations, several countries and regions have expressed an increased interest in enhancing their trade arrangements networks. EU has recently issued a declaration that it intends to negotiate agreements with coun-

tries in South and South East Asia, and revive its negotiations with Mercosur. The USA is also currently negotiating several agreements within the Western hemisphere and Asia. In this context, there is a risk that Africa will remain isolated from the wave of bilateral trade agreements, due to its low negotiating and manufacturing capacities.

"African countries must continue to reinforce their trade capacities"

Africa could in effect remain in a "spoke" situation while richer countries with more negotiating and production capacities are able to place themselves at the centre – or hub – of a network of trade agreements, thereby attracting more investments. In order to avoid such a situation, African countries must -with the support of the international community - continue to reinforce their trade capacities, both in terms of policy formulation and of negotiations and marketable products. They must also reinforce these capacities at the regional level in order to reap economies of scale.

3.2 Financing development: emerging issues and challenges for Africa

Trends in financing development[19]

The availability of finance as well as access to finance are important in accelerating economic development in Africa and in increasing the likelihood of the region meeting the MDGs. Since the 2000 United Nations Millennium Declaration, several studies have shown that Africa faces a serious financing gap and that if this gap is not filled, it will be unable to meet any of the goals (UNECA 2006a). Sachs et al. (2004) provide evidence suggesting that SSA would need approximately $25 billion in additional ODA per year in order to meet the MDGs. In their view, the region is in a poverty trap and so needs a big push in financial aid in order to achieve sustained growth and poverty reduction. The March 2005 Report of the Commission for Africa also provides evidence for similar conclusions.

In recent years, efforts have been directed at finding ways and means to mobilize the additional funds needed to fill this financing gap through mobilization of both domestic and external resources.. In this section, trends in the various sources of development finance in the region are highlighted.

Enhancing domestic savings mobilization can increase investment

The mobilization of domestic savings will provide the much needed resources to finance investment in economic and social infrastructure in Africa. At the moment, investment ratios are very low in several countries. Relative to developing countries

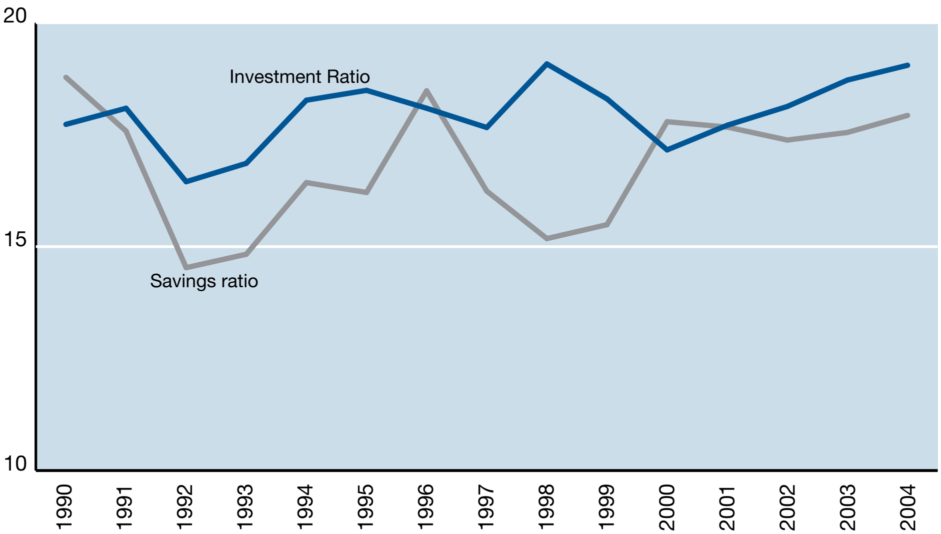
19 UNECA (2006a) provides a detailed discussion on the volume and distribution of capital flows in Africa, as well as on their impact on development, including employment.

in Asia and Latin America, SSA has the lowest investment ratios. For example, over the period 2000-2004, domestic investment as a proportion of GDP was 18 per cent in SSA and 31 per cent in East Asia and the Pacific. As can be seen from figure 3.2, the domestic investment ratio in SSA is low because the domestic savings ratio is also low and the region has difficulties attracting sustained private capital flows. Overcoming this investment and savings constraint is a major challenge for African policymakers and the way in which it is resolved will to a large extent determine the region's ability to achieve sustained economic growth in the medium to long term.

> *The mobilization of domestic savings will provide the much needed resources to finance investment in economic and social infrastructure in Africa*

Figure 3.2

Investment and savings ratios for sub-Saharan Africa, 1990-2004



***Source**: World Bank 2006.*

Historically, SSA saves less than 20 per cent of its GDP. Over the period 1990-1994, the average ratio of domestic savings to GDP was 16 per cent. There was a slight improvement in this ratio to 17 per cent over the period 2000-2004. However, this number is considerably below the average for East Asia and the Pacific (35 per cent), Latin America and the Caribbean (21 per cent), and Middle East and North Africa (26 per cent). Concerted efforts must be made by African leaders to increase domestic savings if the region is to experience sustained growth and increased likelihood of catching up with other developing regions.

The low aggregate savings ratio observed in SSA masks the wide differences in savings patterns across the countries. There are several countries with savings ratio comparable to those in East Asia. For example, over the period 2000-2004, five countries, Algeria, Botswana, Republic of Congo, Gabon and Nigeria, had savings ratios greater than 30 per cent. The ratios range from 32 per cent in Nigeria to 51 per cent in the Republic of Congo. These countries are oil-and or diamond-exporting nations that saw an increase in export revenue due to rises in the prices of these commodities.

As a consequence, they may not be able to sustain the current increase in domestic savings, especially if there is a decline in the world prices of their exports.

Despite this uncertainty and vulnerability, it is worth noting that the increase in savings has enabled the five countries to increase their investment ratios, although the increase in the latter is not as large as in the former. Thus, a key challenge is how to translate these increases in domestic savings into productive investment, especially in non-oil and non-mineral activities, to ensure and increase prospects for sustained economic growth.

> "A key challenge is how to translate these increases in domestic savings into productive investment"

Eleven countries had negative savings ratios over the period 2000-2004. Since several of these are either in political crises or are post-conflict economies, it is not surprising that they had difficulties mobilizing domestic savings. For example, Liberia and Sierra Leone are just emerging from very disruptive political conflicts. However, countries such as Lesotho and Malawi had negative savings ratios although they did not have any equivalent political crises during the review period. Twenty-eight countries in the region had positive but low savings ratios, including South Africa, which has a developed financial system and is thus expected to be more able to mobilize sustainable domestic savings.

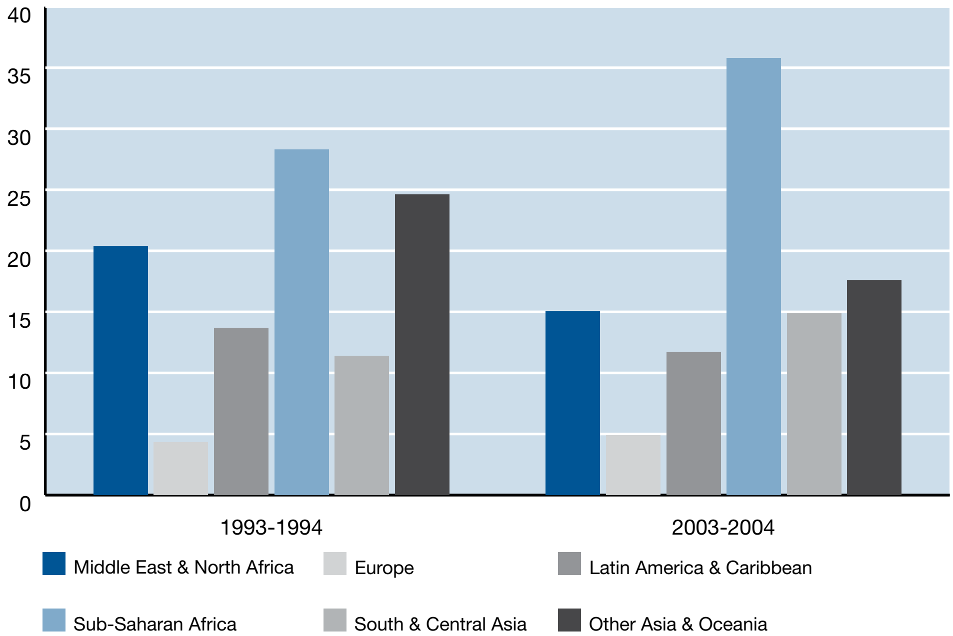
Official flows increasing

Over the past three decades, there has been a shift in the geographic distribution of official flows. In the 1970s, countries in Asia accounted for a large share of ODA. However, since the 1979 oil price shock, SSA accounts for a larger share of ODA. During 1993-1994, about 27 per cent of ODA went to SSA, while the other regions of the world got less than 25 per cent each. During 2003-2004, SSA received about 36 per cent of ODA (figure 3.3). This increase reflects recent efforts by OECD countries to scale up the volume of aid to Africa to enhance the prospects for meeting the MDGs.

Historically, official flows have played an important role in the economic development of countries. As is obvious from figure 3.4, total ODA to SSA has been on the increase since the 1970s. It reached a peak of $19 billion in 1992 and declined for most of the 1990s. The trend in per capita ODA also follows a similar pattern. Since the 2000 Millennium Declaration, however, ODA to SSA has been on the increase again, reaching a peak of $26 billion in 2004. That said, it should be noted that when expressed as a percentage of GDP, ODA to the SSA in 2004 was 5 per cent of GDP, which is still below the 6 per cent figure recorded in 1990.

Within the African region, the distribution of aid flows is uneven with a few countries accounting for a significant percentage of the aid flows. In 1990, the big recipients of the aid flows were: Egypt ($US5.4 billion); Kenya ($1.2 billion); Tanzania ($1.2 billion); Morocco ($1.1 billion); Ethiopia ($1 billion); and Mozambique ($1 billion). The other African countries received less than 1 billion dollars each. As a result of

Figure 3.3
Regional distribution of ODA (% of total disbursements)



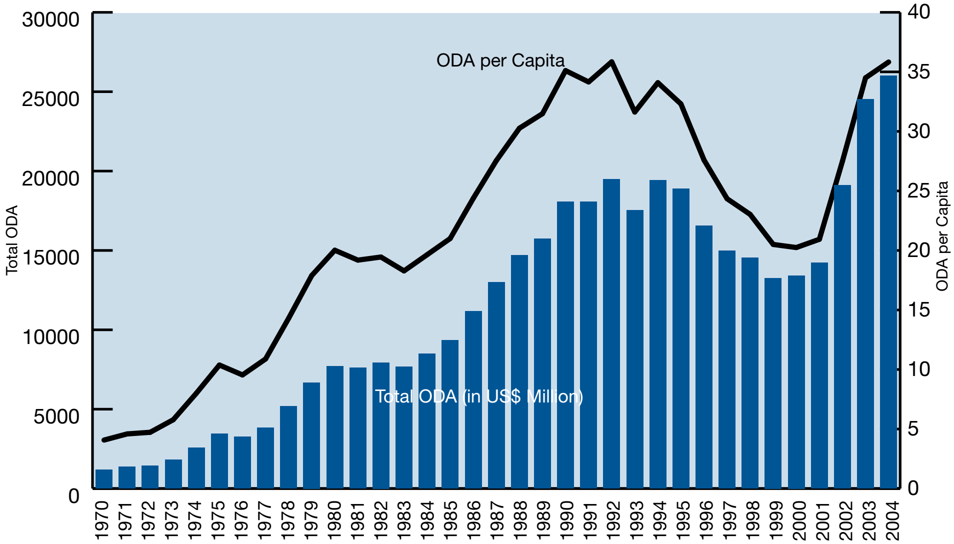
***Source**: World Bank 2006.*

> *Within the African region, the distribution of aid flows is uneven*

the new focus and priorities given to the region by G-8 countries, aid flows to several countries have increased. In 2004, the following ten countries received at least $1 billion dollars of ODA: Angola, Ethiopia, Democratic Republic of Congo, Egypt, Ghana, Tanzania, Madagascar, Mozambique, Uganda, and Zambia. In per capita terms, the main recipients of ODA in the region in 2004 were: Cape Verde ($282); Sao Tome and Principe ($218); Seychelles ($124); Swaziland ($104); Zambia ($94); and Senegal ($92).

Since the launch of the Enhanced HIPC initiative in 1999, there has been a change in the composition of SSA aid commitments. The share of project aid in total aid to the region has decreased while that of debt forgiveness has increased from under 10 per cent in 1990-1994 to about 18 per cent over the period 2000-2003. Nonetheless, project aid still accounts for more than 60 per cent of SSA aid commitments (Gupta et al. 2006). Given the relatively low domestic savings ratios of SSA countries, the region will continue to rely on access to ODA as a major source of financing development, unless drastic steps are taken to boost private capital flows and mobilize domestic savings.

Figure 3.4
ODA to sub-Saharan Africa ($US million)



***Source**: World Bank 2006.*

A large part of recent private capital flows to SSA is in the form of equity as opposed to debt

Private capital flows

Private capital flows is another key source of external finance in SSA (UNECA 2006a). In the late 1990s, it was a more important source of external finance to the region. In 1998 and 1999, net private flows to SSA were 13.7 and 16.7 billion dollars respectively. Over the same period, net official flows to the region were 10.6 and 10.3 billion dollars respectively. Net private capital flows to SSA were low over the years 2000-2002 due in part to the impact of the Asian financial crises on investor attitudes towards foreign investment. Private capital flows to the region has increased fast since 2003 and they exceeded net official flows in 2005 (table 3.2).

A large part of recent private capital flows to SSA is in the form of equity as opposed to debt. In 2005, net equity flows accounted for 86 per cent of net private capital flows to the region. Furthermore, between 1998 and 2002, the net debt flows were negative, reflecting the fact that, during this period several countries in the region were more interested in servicing existing debt than in accumulating further debt. The decline in the debt-equity ratio of private capital flows to SSA is a welcome development as it should limit the incidence of debt overhang in several countries. It should also be noted that there has been a shift in emphasis from short- to medium- and long-term debt, which will help to avoid the maturity mismatches that have been a feature of debt in the region.

Recent equity flows to SSA have also been in the form of FDI inflows (table 3.2), as opposed to portfolio equity inflows that are highly volatile and often leave countries

Table 3.2

Sources of external finance in sub-Saharan Africa 1998-2005 ($US billion)

	1998	1999	2000	2001	2002	2003	2004	2005
Net Private Flows	13.7	16.7	9.9	12.1	6.3	15.8	20.7	28.5
Net equity flows	15.5	18	10.7	14	9.1	14.3	18	24.7
FDI inflows	6.9	9.0	6.5	15.0	9.5	13.6	11.3	17.6
Portfolio equity inflows	8.7	9.0	4.2	-1.0	-0.4	0.7	6.7	7.2
Net debt flows	-1.8	-1.3	-0.7	-2	-2.8	1.5	2.8	3.8
Medium/long term	-1.3	-0.7	0.4	0.1	-1.0	2.5	1.7	2.3
Short term	-0.5	-0.6	-1.1	-2.1	-1.8	-1.0	1.1	1.5
Net Official Flows	10.6	10.3	10.7	10.7	16.6	23.3	25.1	25.2
Bilateral aid grants (excludes technical cooperation grants)	10.1	9.9	10	10	14	22	24.2	28.4
Net debt flows	0.5	0.4	0.7	0.6	2.6	1.2	0.8	-3.2

***Source**: World Bank 2006.*

vulnerable to sudden reversals and investor sentiments. The increasing reliance of African countries on FDI rather than debt should be encouraged because it will help to avoid debt accumulation with the associated debt service burden. FDI is also a good source of financing development because it has a potentially important role to play in stimulating growth and development. African countries should put more effective policies in place to attract FDI and increase their share of development finance from this source. Table 3.3 shows that the region currently attracts less FDI than most developing countries. In 2005, FDI to SSA represented about 7 per cent of FDI to all developing countries.

Table 3.3

Net inward foreign direct investment across regions ($US billion)

Group	1997	1998	1999	2000	2001	2002	2003	2004	2005
All developing countries	168.7	172.4	183.3	168.8	176.9	160.3	161.6	211.5	237.5
East Asia and Pacific	62.1	57.8	50.8	44.3	48.5	57.2	59.8	64.6	65.3
Europe and Central Asia	24.6	27.4	29.8	30.2	32.7	34.9	35.9	62.4	75.6
Latin America and the Carribean	66.7	74.1	88.3	79.3	71.1	48.2	41.1	60.8	61.4
Middle East and North Africa	2.1	2.7	2.4	4.1	3.4	3.7	5.6	5.3	9.1
South Asia	4.9	3.5	3.1	4.4	6.1	6.7	5.6	7.2	8.4
Sub-Saharan Africa	8.3	6.9	9	6.5	15	9.5	13.6	11.3	17.6
(as % of FDI to develop-ing countries)	4.9	4.0	4.9	3.9	8.5	5.9	8.4	5.3	7.4
Angola	0.4	1.1	2.5	0.9	2.1	1.7	3.5	1.4	1.5
South Africa	3.8	0.6	1.5	1	7.3	0.7	0.8	0.6	6.3

***Source**: World Bank 2006.*

The problem of capital flight

The analysis of capital flows to and from Africa reveals a curious paradox. On the one hand, African countries have accumulated large volumes of debt, presumably to fill their resource gap and finance their development needs. On the other hand, as discussed in-depth in UNECA (2006a), the continent continues to experience heavy financial haemorrhage in the form of capital flight, some of which is financed by borrowed funds. This loss of capital deprives Africa of a sizable portion of the very resources it needs for development financing.

In SSA, remittances are becoming increasingly important

Remittances

In economies with very low domestic savings and poor access to international capital markets, migrant workers' remittances can play a vital role in development finance. In several regions of the world, this is indeed growing at an unprecedented rate. In 2004, it accounted for 1.5 per cent of GDP in SSA, 1.7 per cent in East Asia and Pacific, 2 per cent in Latin America and the Caribbean, 4.1 per cent in Middle East and North Africa, and 3.6 per cent in South Asia. In 2005, the total value of remittances from all regions was $232 billion which is marginally below the total value of net inward FDI to all developing countries ($237 billion) for the same year. The true value of remittances may be larger given the fact that some remittances are transmitted through informal channels and so are not reflected in official statistics.

In SSA, remittances are becoming increasingly important, with remittances in 2004 at about 1.5 per cent of GDP. Although this is lower than the 5 per cent figure recorded for ODA in the same year, it is clearly not an insignificant source of financing. UNECA (2006) discusses the advantages and disadvantages of remittances relative to other flows. In terms of monetary value, the magnitude of remittances to SSA is still relatively small compared to receipts by other developing regions. Estimates available for 2005, suggest that SSA received $8.1 billion in remittances compared to $43 billion and $42 billion for East Asia and the Pacific and Latin America and the Caribbean respectively. The region also received less from this source than countries in South Asia and Middle East and North Africa.

That said, it should be noted that the low figure reported for SSA may be due to the fact that relative to other regions, it transfers more remittances through informal channels. It is also due to the fact that financial institutions in the region are less developed than in the other regions and so it is more difficult and costly to transfers remittances.

Migration is also a source of concern because of the negative impact of brain drain, a phenomenon that reflects the failure of African economies to absorb human capital.

In response, governments need to design strategies not only to build human capital but also to retain it.[20]

From Monterrey to Gleneagles

> *Governments need to design strategies not only to build human capital but also to retain it*

African countries and their development partners have recognized the crucial role of finance in development and are making serious efforts to mobilize both international and domestic resources. However, they face serious challenges in their efforts to use development finance as an effective instrument for development. These challenges include:

- Finding an effective and sustainable solution to the external debt crises facing several African countries so as to release resources for development finance;
- Attracting sustained private capital flows, including remittances, and ensuring that they are in sectors with high value-added and employment impact;
- Improving domestic resource mobilization through increased savings, higher tax revenue, and reduction of capital flight;
- Improving the effectiveness and absorptive capacity of foreign aid; and
- Using international trade as a vehicle for resource mobilization.

The Monterrey Consensus, adopted by Heads of State and Government at the International Conference on Financing Development in March 2002, was the first comprehensive and global attempt to address these challenges. It was also the first time that development finance and related issues became the main focus in international financial discussions. In the Monterrey Consensus, world leaders noted with concern the financial gap to be filled in order to attain the MDGs. They called for a new partnership between developed and developing countries and committed themselves to mobilizing domestic financial resources, attracting international capital flows, promoting international trade as an engine for development, increasing international financial and technical cooperation for development, sustainable debt financing and external debt relief, and enhancing the coherence and consistency of international monetary, financial and trading systems for development.

Although the Monterrey Consensus highlighted the importance of aid harmonization for effective development outcomes in recipient countries, there were no clear guidelines and commitments from donors to ensure that the objectives would be achieved, until the High-Level Forum on Harmonization held in Rome in February 2003. In the ensuing Rome Declaration on Harmonization, donors acknowledged the need to reduce transactions costs of aid delivery in recipient countries. They also stressed the need for country ownership of aid programmes and for good practices,

20 See *Journal of African Economies*, December 2006, Volume 15, Supplement 2, for a detailed discussion of this topic.

standards and principles in implementing development cooperation. Against this background, donors committed to providing development assistance in accordance with partner country priorities, implementing good practices, standards and principles in development assistance delivery and management, adapting harmonization efforts to the country context, and harmonizing donor policies and procedures.

“Donors are committed to making their actions more harmonized, transparent and collectively effective”

As a follow-up to the Rome Declaration on Harmonization, an international roundtable on Managing for Development Results was held in Marrakech in February 2004. The outcome of this meeting was the Joint Marrakech Memorandum on Managing for Development Results endorsed by the the African Development Bank (AfDB), Asian Development Bank (AsDB), Inter-American Development Bank (IADB), European Bank for Reconstruction and Development (EBRD), the World Bank, and the Chairman of the Development Assistance Committee of the Organization for Economic Cooperation and Development (DAC/OECD). In the Memorandum, they committed to fostering a global partnership and approach on managing for development results and aid effectiveness.

While the Monterrey Consensus, the Rome Declaration and the Marrakech Memorandum defined the main objectives of the aid-effectiveness agenda and led to an expansion in activities aimed at improving the effectiveness of aid delivery, the Paris Declaration on Aid Effectiveness of 2005 represents the first bold attempt by donors and developing countries to take monitorable actions to reform the way aid is delivered and managed. The latter declaration was the outcome of the High-Level Forum on Aid Effectiveness held in Paris, 28 February – 2 March 2005.

The 2005 Paris Declaration on Aid Effectiveness focused on five key areas, namely, ownership, harmonization, alignment, managing for results, and mutual accountability. Regarding ownership, the Declaration stressed the need for partner countries to exercise effective leadership over their development policies and coordinate development actions. On alignment, donors made commitments to base their overall support on partner countries’ national development strategies, institutions and procedures. They also made commitments to provide reliable indicative commitments of aid over a multi-year framework and to disburse aid in a timely and predictable fashion according to agreed schedules. Reducing the proportion of aid that is tied is also a key aspect of this area of the Declaration.

In the area of harmonization, donors committed to making their actions more harmonized, transparent and collectively effective. On managing for results, they made commitments to manage and implement aid in a way that focuses on the desired results and uses information to improve decision-making. Finally, regarding mutual accountability, donors and developing countries made commitments to enhance mutual accountability and transparency in the use of development resources, as both parties are accountable for development outcomes. An important feature of the Paris Declaration was that indicators of progress and targets were set for each of the five areas to increase transparency in monitoring the implementation of agreed commitments.

The G-8 Summit in Gleneagles in July 2005 added momentum to the commitments made by world leaders in Monterrey to increase aid flows and reduce the burden of external debt on developing countries, to enhance their prospects for meeting the MDGs. The Declaration issued also recognized the need for substantial increase in ODA to consolidate and build on recent advances in Africa and to stimulate growth to reduce aid dependency. On aid, the Declaration indicated that the commitments of G-8 countries and other donors would increase ODA to all developing countries by $50 billion a year by 2010 compared to 2004. Half of this increase would go to Africa, representing more than a doubling of aid to Africa compared to 2004. On debt, the G-8 agreed to a proposal to cancel 100 per cent of the outstanding debts of eligible HIPC countries to the IMF, International Development Association (IDA) and African Development Fund, and to provide additional resources to ensure that the capacity of the international financial institutions was not reduced. They also re-affirmed their commitments to the Paris Declaration on Aid Effectiveness and stressed the need for developing countries and their governments to take the lead on development and to be accountable for their actions.

> *"Efforts have been made by both developed and developing countries to hold donors accountable for the pledges and commitments made to developing countries"*

Monitoring implementation of commitments

Since the Monterrey Consensus was adopted, efforts have been made by both developed and developing countries to hold donors accountable for the pledges and commitments made to developing countries. In this section, we examine the extent to which donors have lived up to their promises and pledges to Africa in three key areas: scaling-up of aid; improving aid effectiveness; and debt relief or debt cancellation. Due to data limitations, some parts of our analysis will focus on commitments made by the G-8 countries.

Compliance with regard to aid quantity

The key target that donors have set for themselves on aid is to attain an ODA to GNI ratio of 0.7 per cent. Since this target was set in 1969, only a few countries have met it. In 2004, the average ratio for DAC members was 0.26 per cent. That said, Denmark, Luxembourg, the Netherlands, Norway, and Sweden have met the target. Countries such as Belgium, France, Portugal, and Switzerland have also made significant progress although they are yet to meet the target. Among DAC members, Japan, the USA, and Italy have the lowest ODA/GNI ratios - below 0.20 per cent in 2004.

The G-8 Research Group at the University of Toronto, Canada, has developed a very useful methodology for assessing the extent to which G-8 countries comply with the commitments made at their annual summits. The assessment uses a three-category scoring method: Full or near full compliance with commitment results in a score of +1; Complete or nearly complete failure to implement a commitment results in a

score of -1; and an "inability to commit" or "work-in-progress" leads to a score of 0. An inability to commit refers to factors outside the executive branch that impedes the implementation of a commitment while "work-in-progress" refers to an initiative that has been launched by a government but is not yet near completion.

> The overall effectiveness of any form of aid depends to a large extent on its quality

Using this scoring methodology, the performance of the G-8 countries in terms of meeting the commitments made to Africa and the developing world on scaling-up aid falls into the category "work-in-progress." This is because the G-8 countries have only met part of the commitments made on scaling-up aid to developing countries and to Africa in particular. One of the reasons why these G-8 countries as a group have not fully complied with their commitments to scale-up aid to Africa is that some of them have not made much progress in following through on their commitments to double ODA to Africa. The USA, one of the big donors, has made some progress in complying with its commitments although it is not enough to double aid to Africa by 2010. In contrast, Canada, France, Germany, the United Kingdom and EU have all fully complied with their commitments in this area and so have a score of +1.

Compliance with regard to aid effectiveness

The quantity of aid is important but the overall effectiveness of any form of aid depends to a large extent on its quality. Consequently, in discussions on aid, it is now popular to talk about the quality of aid and aid effectiveness in recipient countries. There are various factors that determine the overall quality of aid and hence its effectiveness. These include the proportion of aid that is tied, the extent to which aid is in the form of grants or concessional loans, the proportion of aid that goes to poor as opposed to relatively rich countries, the state of governance in recipient countries, and the administrative or transactions costs associated with aid.

Table 3.4 presents the percentage of bilateral ODA from DAC member countries to LDCs that is untied. To the extent that more than half of the LDCs are in Africa, the table captures the region's experience with tied aid as well. It is clear from the table that there has been a reduction in the percentage of aid from DAC member countries that is tied. Over the period 1999-2001, 55 per cent of total DAC aid to LDCs was untied. In 2004, the figure rose to 68 per cent.

Looking at individual DAC countries, however, there are wide differences in performance. Countries such as Finland, Ireland, Luxembourg, Norway and the United Kingdom have successfully moved away from tied to untied aid. The USA, New Zealand, and Greece have a very low ratio of untied aid to total aid and so are at the bottom of the list. More progress needs to be made by these countries, especially the USA, if the DAC average is to improve significantly.

Table 3.4
Proportion of bilateral aid to LDCs that is untied

	1999-2001 (average)	2004
Australia	0.42	0.91
Austria	0.34	0.68
Belgium	0.49	0.99
Canada	0.40	0.76
Denmark	0.77	0.80
Finland	0.69	1.00
France	0.54	0.85
Germany	0.43	0.66
Greece	…	0.41
Ireland	1.00	1.00
Italy	0.30	0.80
Japan	0.76	0.81
Luxembourg	…	1.00
Netherlands	0.86	0.96
New Zealand	…	0.36
Norway	0.99	1.00
Portugal	0.42	0.99
Spain	0.25	0.95
Sweden	0.69	0.98
Switzerland	0.84	0.95
United Kingdom	0.62	1.00
United States	0.01	0.03
Total DAC	0.55	0.68

Source*: OECD 2006a.*

Regarding the composition of aid, there has also been progress in this area. The share of grants in total ODA has increased over the years. For DAC countries, the average was roughly 49 per cent over the period 1980-1984 (Gupta, Pattillo, and Wagh 2006). For the 2003-2004 period, the average was 90 per cent. In DAC countries such as Australia, Austria, Canada, Greece, Ireland, Luxembourg, Netherlands, and New Zealand, grants represent 100 per cent of ODA. At 60 per cent, Japan has the lowest ratio of grant to total ODA. An improvement is needed in this area if Japan is to catch up with the other donors. The increasing share of grants in total ODA is a welcome development in African countries. Several countries are already heavily indebted and are looking for ways to reduce their debt burden. Reducing their proportion of loans in total ODA prevents further accumulation of debts.

"The increasing share of grants in total ODA is a welcome development in African countries"

Compliance with regard to debt relief

Debt relief is one area in which G-8 countries and other donors have made significant progress in meeting their commitments. At Gleneagles, donors promised that all debts owed by eligible HIPC to IMF, IDA, and the African Development Fund would be cancelled. The G-8 Research Group has also examined the extent to which member countries have honoured the commitments made in Gleneagles on debt relief and found that they have fully complied with all commitments in this area.

The outstanding performance of the G-8 in the area of debt relief is due in part to their commitment and support to the HIPC initiative and to the MDRI. The HIPC initiative was established in 1996 to reduce the debt burden of eligible countries. As a result of slow progress in attaining the debt reduction objective of the initiative, an enhanced version was launched in 1999 with relatively less restrictive eligibility criteria. As of July 2006, 40 countries had either qualified or were currently under consideration or were potentially eligible for debt relief under the initiative. Of the 40 countries, 19 have reached the completion point, 10 have reached the decision point and 11 are pre-decision point countries. In addition, of the 19 countries that have reached the completion point, 15 are in Africa.

In addition to supporting debt relief under the HIPC initiative, G-8 countries were also behind the launching of MDRI in 2005 to reduce the debt burden of eligible HIPC countries and provide additional resources to help them meet the MDGs. Under the MDRI, the IDA, IMF and AfDB would provide 100 per cent debt relief on eligible debt to countries that had completed the HIPC process. Although these three institutions are responsible for delivery of debt relief under MDRI, each institution has its own guidelines on how it will implement the agreements. For example, while only HIPC countries are eligible for MDRI provided by IDA and AfDB, the IMF also considers non-HIPC countries with per capita income of $380 or less.

Furthermore, for IMF and AfDB, eligible debt is outstanding debt as of end-2004. For IDA, it is outstanding debt as of end-2003. As of mid-July 2006, committed assistance to African countries under the HIPC initiative and assistance delivered or expected to be delivered under MDRI was $50 billion (IDA and IMF 2006). Of this amount, $34 billion was committed under the HIPC initiative and $15.9 billion under MDRI. Within the HIPC allocation, $21.6 billion represented assistance to the 15 African countries that reached the completion point as at mid-July 2006, while $12.5 billion represented assistance to 10 African countries that have reached the decision point.

In summary, while donors have made significant progress in meeting commitments on debt relief, they have made relatively less effort in fulfilling the pledges made on scaling-up aid and improving aid effectiveness. Urgent actions need to be taken in these areas to enable African countries obtain the pledged resources needed to attain the MDGs.

Emerging issues on aid and debt

In recent years, there have been discussions on the impact of new aid and debt initiatives on recipient countries. There is no doubt that African countries need more aid flows to enable them to increase the likelihood of achieving the MDGs. However, more aid flows will also impose serious challenges on African economies, and policy-makers must prepare themselves to deal with these challenges if they are to maximize the benefits of aid and minimize the costs. Several papers have tried to identify the challenges facing African countries as a result of the decision by donors to scale-up aid to the region (Bourguignon and Sundberg 2006; Heller 2005). These challenges include how to increase the absorptive capacity for aid in recipient countries and how to ensure that aid does not lead to loss of competitiveness through real exchange rate overvaluation. In this section, the economic consequences of scaling-up aid and debt relief to African countries are examined.

> *More aid flows will also impose serious challenges on African economies*

Economic impact of aid

The impact of the scaling-up of aid has been a major preoccupation of researchers and policy-makers in recent years as reflected in the growing literature on the subject. Several papers have addressed the main issues including the "Dutch disease" problem, the effect on growth, the impact on fiscal sustainability and the issue of predictability of aid.

Dutch disease

The Dutch disease effect is probably the most widely discussed potential adverse effect of an increase in aid flows. The idea is that in a small open economy where prices of traded goods are determined on the world market, an increase in aid inflows may lead to an increase in the price of non-traded goods resulting in a real exchange rate appreciation. This appreciation of the real exchange rate will have a negative impact on the competitiveness of the economy. The assumption here is that a large part of the inflows is spent on non-traded goods. In addition, the Dutch disease effect and the impact of aid flows on relative prices and exchange rates are not automatic and depend on several factors including the share of aid spent on productive investment relative to that spent on consumption of final goods. If the aid is financing productive investment, it will improve productivity, enhance growth and have less impact on prices and on the real exchange rate.

The evidence from empirical studies on the impact of scaling-up aid on the real exchange rate and relative prices are mixed. In a recent study of 13 African countries by Chowdhury and McKinley (2006), eight countries had a positive correlation between net aid inflows and real exchange rates, suggesting that increased aid flows were accompanied by depreciation, rather than appreciation of the real exchange rate.

In five countries, the correlation was negative. For the link between the aid inflows and the inflation, the study suggested that the correlation for all the countries was positive, indicating that increasing aid is associated with an increase in inflation, and this has consequences for competitiveness of the economy. The potential for Dutch disease is a real concern for African economies. However, the risk could be mitigated by increasing the level of aid directed to productive investment, to improve productivity and to help the economy respond to pressure from the demand side.

> *If the aid is financing productive investment, it will improve productivity, enhance growth and have less impact on prices and on the real exchange rate*

Aid and growth

An important and compelling reason for increasing aid to Africa is to accelerate growth and increase the likelihood of attaining the MDGs in the region. Assessments of the performance of African countries show that it would be difficult for them to achieve the MDGs if current trends continue. High and sustained growth is needed to reduce poverty in African economies. Thus, it is important to know if scaling-up aid will accelerate growth in Africa. This issue has been discussed at length in several papers (Clemens et al. 2004; Burnside and Dollar 2000; Easterly et al. 2003).

There are three main views on the relationship between aid and growth. The first is that aid has a positive effect on growth, but with diminishing returns as the volume of aid increases. The channels through which aid has a positive effect on growth include: augmenting savings and making it possible to finance investments; increasing worker productivity through investments in health or education; and providing a channel for the transfer of technology from rich to poor countries. The second view on the link between aid and growth is that aid has no effect on growth. Arguments put forward to support this view are that aid is often wasted, supports bad governments, reduces domestic savings, and undermines private sector incentives for investment. In addition, it is often argued that recipient countries do not have the capacity to absorb large amounts of aid. The third view on the relationship between the two variables is that aid has a conditional relationship with growth. It works best in countries with good institutions and policies. For example, a recent study on aid to African countries showed that in 11 "good performance countries" high growth is linked to high aid flows (Bourguignon et al. 2005; World Bank 2005).

Aid and fiscal sustainability

The debate on the challenges of increasing aid has raised the issue of fiscal sustainability (Heller 2005). One of the key concerns here is the impact of increased aid on fiscal attitudes as well as on the efforts of the recipient countries to collect tax and increase government revenues. There is a fear that an increase in aid will not encourage countries to increase their fiscal revenues. However, these views are not supported by the findings of recent studies indicating that the relation between aid

and tax collection is very weak (Bourguignon et al. 2005). Another noteable issue is that of public expenditure management. It has been argued that if higher aid inflows are used to finance labour-intensive public services (e.g. schools or clinics) that have large recurrent costs, then if there is an unexpected fall in aid levels, the ability of the government to continue with the provision of these services may be limited. Consequently, effective fiscal planning is crucial for economies dependent on aid flows.

> "Aid volatility contributes to the weak impact of aid on growth and development"

Volatility of aid

Aid recipients have to deal with the uncertainty surrounding both aid commitments and disbursements. This concern is serious because recipient countries have to formulate and implement medium-term development strategies and it is difficult to do this effectively if they are not certain about the timing and amount of aid that would be available to them over the time horizon considered. The uncertainty surrounding aid is also a problem because studies have shown that it can have negative consequences for output (Lensink and Morrisey 2000). Added to the volatility problem is the inefficiency resulting from conditions and procedures associated with aid delivery. In several countries, the multiplicity of donor programmes and their poor alignment with recipient government priorities often lead to inefficiencies. This inefficiency contributes to the weak impact of aid on growth and development.

Provision of social services

Aid is often used to finance the provision of social services, especially health and education. The idea is that these investments have a positive effect on productivity and hence on growth and poverty reduction. The correlations between aid and health and education expenditures for African countries indicate that there is a strong, positive and statistically significant relationship between health expenditure per capita and aid per capita. This relationship holds for both contemporaneous and lagged aid. The correlation coefficients are 0.28 and 0.33 for contemporaneous and lagged aid, respectively. With regard to education, the results indicate that there is no statistically significant relationship between aid per capita and the share of education in total government expenditure. Despite the need to use aid for increasing provision of social services, it is important that this is not done in a way that reduces investments in infrastructure because this is likely to have a long-run negative impact on growth in the region.

Economic impact of debt relief

Debt relief is also one of the major components or sources of the expected increase in resources to African countries to help them finance activities and actions needed to meet the MDGs. As at mid-July 2006, total HIPC initiative assistance commit-

ment and assistance delivered or expected to be delivered to African countries under MDRI was about $50 billion. If donors follow through on their commitments, this will represent a significant inflow of resources to eligible African countries. It will also present challenges to these countries, including:

- How to manage the additional resource flows emanating from debt relief and ensure that they are effectively used for poverty reduction;
- How to increase domestic absorptive capacity to absorb these inflows and ensure that they do not result in real exchange rate appreciation and a reduction in export competitiveness; and
- How to ensure that current debt relief does not encourage excessive new borrowing and the accumulation of further debt.

“One of the main objectives of debt relief is to free up resources for financing social programmes that are expected to have significant impact on poverty reduction”

As indicated earlier, one of the main objectives of debt relief is to free up resources for financing social programmes that are expected to have significant impact on poverty reduction. In this section, the links between debt relief and social expenditure, inflation and growth are examined.

Debt relief and social expenditure

One of the compelling arguments for debt relief is that it will free up resources for financing social programmes that are vital for alleviating poverty. There is a general belief that an increase in expenditure on education and health will have positive effects on productivity and on poverty reduction. Despite the popularity of these views, it is not clear that an increase in debt relief will actually boost social expenditure. Recent empirical studies have tried to examine the extent to which debt relief leads to an increase in social expenditures. Chavin and Kraay (2005) examined the link between debt relief and social expenditure. They found no evidence of a statistical relationship between debt relief granted over 1989-1993 and the share of government expenditure on health and education during 1994-1998.

That said, they also found that debt relief over the period 1994-1998 was associated with an increase in the shares of education and health in total spending during 1999-2003, although the evidence is not robust. In terms of country-specific evidence, Nannyonjo (2001) argues that in Uganda, debt relief had a positive impact on social expenditure in the late 1990s, particularly in the education and health sectors. Dessy and Vencatachellum (2006) have also examined this issue using African data. They found that debt relief had a positive impact on the share of education and health in total spending over the period 1989-2003.

Debt relief and growth

One of the concerns about the high external debt of poor countries is that it stifles growth and so makes it even more difficult for a country to generate enough resources

to repay its existing stock of debt. High debt can reduce growth through its negative impact on investment. It can also reduce growth by reducing the incentives of governments to adopt structural reforms. Several attempts have been made to examine the link between debt and growth. However, until recently, most of the studies use data for both emerging markets and low-income countries without taking into account the fact that the heterogeneity between emerging markets and low-income countries has implications for the relationship between debt and growth. Unlike emerging markets, low-income countries have very limited access to international capital markets. In addition, they have relatively different economic structures and rely on foreign aid. These differences suggest that the relationship between debt and growth will differ across the two groups of countries.

"Debt relief will increase the prospects for growth and development in the region"

In a recent study, Pattillo et al. (2002) found that external debt has a negative effect on growth after a critical threshold for debt is reached. In particular, they found that when the net present value of debt is greater than 160-170 per cent of exports and 35-40 per cent of GDP, external debt stifles growth. With regard to the link between debt relief and growth, Clements et al. (2005) present evidence suggesting that debt relief under the HIPC initiative will add 0.8-1.1 percentage points to the annual per capita GDP growth rates of the countries in their sample. These findings support the widely held view amongst African policymakers that debt relief will increase the prospects for growth and development in the region.

3.3 Conclusion

It is expected that the recent renewed global attention to the problems of developing countries will contribute to redressing the trends towards marginalization of these countries. This renewed attention could have a positive impact on African economies, allowing them to consolidate the positive growth performance recorded over the past years. This interest in the problems of developing countries was exhibited in the Doha Round of negotiations initiated in 2001, which brought development issues to the centre of the debate in the negotiations. The interest in development was also illustrated in the Monterry Consensus with a global commitment to increase aid and cancel debt for developing countries.

This chapter has highlighted these new trends in global attention against the problems of developing countries in general and African countries in particular. The chapter has also underscored the delays and gaps between commitments and their effective implementation.

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Part

2

Accelerating Africa's Development Through Diversification

Diversification trends in Africa

The diversification of African economies is one way through which the recent economic growth achievements could be sustained. Africa's economic transformation can be achieved through both horizontal and vertical diversification. In addition, such diversification will help to build competitive economies that can productively be integrated into the global economy. Diversification is therefore a pre-condition if Africa is to register accelerated development. The scaling-up of current real growth to desired levels and in a broad manner can also be sustained if there is deepening in the diversification of African economies.

The relevance of diversification to economic growth and development is not new. But diversification might have been abandoned at a time when it could have played a major role in strengthening gains from earlier reforms efforts on the continent. The *Economic Report on Africa 2007* presents the theme of diversification as a new paradigm for Africa's development. The report argues that diversification is a prerequisite to achieving positive development in the continent. This chapter and the following two will provide analytical and empirical evidence of the importance of diversification as a key pillar in the continent's development.

This chapter explores Africa's diversification trends to see how Africa has fared in its attempts to diversify its economy and to enable structural transformation to take place. Practical export experiences of some countries are also presented.[1] This then leads to what this Report calls the diversification regimes that characterize the results of the diversification efforts.

4.1 Diversification trends in Africa[2]

Diversification trends at the regional level

Figure 4.1 shows three different measures of diversification for African economies as a whole (see Ben Hammouda et al. (2006a) for detailed definition of the indices of

1 Although this report focuses on diversification of exports, other aspects of diversification are also crucial for economic growth, especially diversification of production and diversification of markets for African products.

2 A more elaborated version of this section has been published in Ben Hammounda et al. (2006b).

diversification). Three concise comments on the general trend of Africa's diversification experience can be made.

First, African economies exhibit very low levels of diversification and by all measures and accounts, limited diversification of exports with very little change over the last 25 years or so. Within this 25-year period, four distinct phases that give the historical picture of Africa's economic diversification efforts can be discerned. The first phase appears to have ended around 1982 and was characterized by progress with diversification.

"African economies exhibit very low levels of diversification with very little change over the last 25 years"

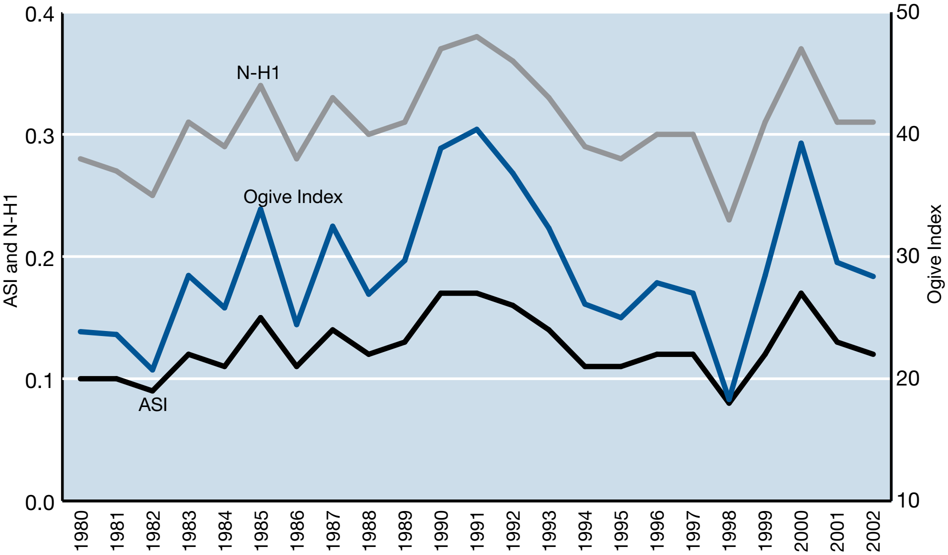
Despite the adverse effects of the economic crises that African economies were experiencing at this time, the diversification efforts during the 1970s were beginning to yield positive results in the early 1980s. However, those positive diversification gains did not last. The escalation of the economic crises in the first half of the 1980s and the structural adjustment measures instituted to deal with them impacted negatively, leading to the second phase of 1982-1991. Over these ten years, the diversification gains that had been achieved earlier were reversed.

The third distinct phase of African efforts toward diversification started in 1992. The macroeconomic stabilization policies of the 1980s may have contributed to this positive development. Unfortunately, the gains registered were fragile as the improvement in the diversification index lasted only up to 1998. Since then, in a fourth phase of the diversification experience, African economies have become more concentrated, considering the upward trend of the diversification index from 1998 to 2002. This trend needs to be reversed for the continent to trade its way out of the challenges it currently faces.

Second, the African diversification experience has been volatile. Considering the evidence from different measures of export diversification, there is no distinct and general trend discernible in the African experience on the whole, as a clear and definite direction is lacking. What is clear though is that at the continental level, there has been volatility in the diversification indicators.

Third, where there have been some improvements in diversification, the gains have been fragile. Against the backdrop of the volatility noted above, African economies have been unable to register any sustainable movements towards deepening diversification. The periods when diversification deepened have turned out to be quite fragile and short-lived, an indication that fundamentals to support such deepening were not in place.

Figure 4.1
Diversification indices for Africa



***Source**: Ben Hammouda et al. 2006a.*

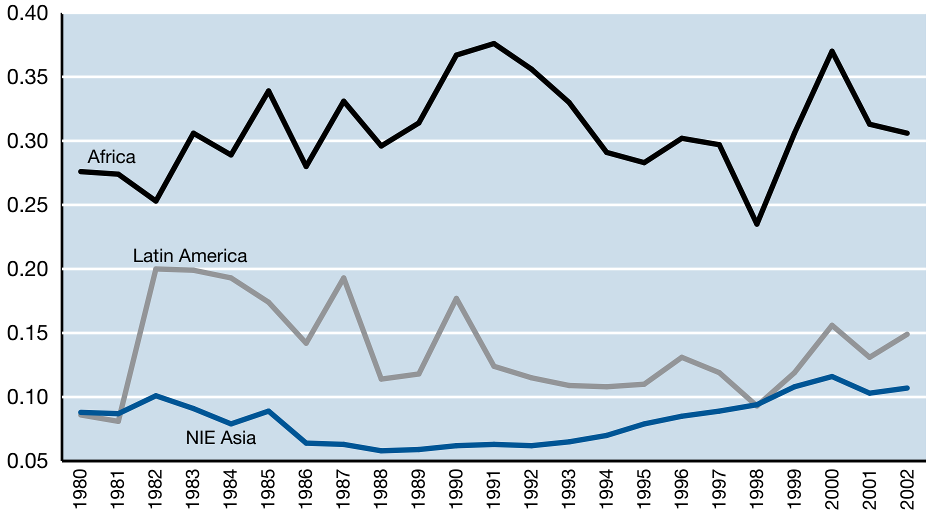
"Growing oil revenues led countries to pursue a more concentrated path, instead of using oil revenues to diversify their exports"

How does Africa's diversification trend compare with those of other regions? Figure 4.2 shows the results of diversification efforts in Latin America and in the Asian NIEs compared with the African situation. The NIEs included are Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand. In the early 1980s, all three regions made concerted efforts towards diversification. However, in the 1980s, the intensity of the economic crises that ravaged mainly the developing world had a very serious impact on diversification results.

The main determining factor of the impact the crises had on the different regions appears to be the nature of their response. The Asian NIEs gave a dynamic response from the early years of the crises by way of accelerated investments and intensified diversification. Clear policies aimed at integrating the Asian NIEs to production value chains have been documented. In Africa, it appears that the response was less dynamic and was more one of concentration on a few commodities. African countries, for the most part, seem to have adopted a defensive reaction instead. The windfalls in some of their commodity sectors underpinned this defensive reaction. This is especially the case with regard to the oil exports of the Central and West African subregions where growing oil revenues dominated and led countries to pursue a more concentrated path, instead of using oil revenues to diversify their exports.

Figure 4.2

Normalized Hirschman Index: Africa, Latin America and NIEs in Asia



***Source**: Ben Hammouda et al. 2006a.*

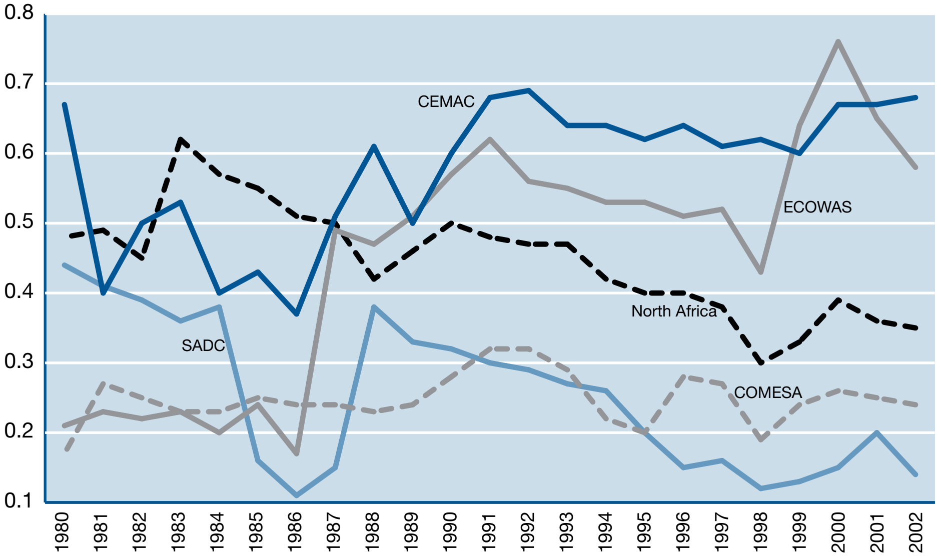
Diversification trends at the subregional level

The general picture of the continental performance that was shown in figure 4.1 masks the gains and losses made at the subregional and country levels. Figure 4.3 gives the situation at the subregional level and it compares five subregions defined around some of the RECs. In 1980, the most diversified subregions were COMESA and ECOWAS. The least diversified was CEMAC with SADC and North Africa in between. By 2002, the diversification gains at the subregional level had changed, with the most significant gains made by SADC, which is now the most diversified subregion on the continent. It is followed by COMESA and North Africa. CEMAC has remained the least diversified subregion.

The improvements in SADC's index of diversification, especially in recent years, are attributed more to South Africa's heavily diversified economy. The diversification results in other SADC countries appear to be easily masked by the dominant nature of the South African economy. Case in point is the Angolan economy which is becoming increasingly concentrated owing to its reliance on oil. However, this concentration is hidden in the overall SADC results due to South Africa's dominance.

In the case of North Africa, there is a clear trend towards diversification. This could be attributed to the efforts of Egypt, Morocco and Tunisia to diversify, given their proximity to the large and lucrative European market (box 4.1). Country-level analyses of the North African experience show that the subregion's diversification results are close to the overall African results (Ben Hammouda et al. 2006a). It is

Figure 4.3
Normalized Hirschmann Index: Africa's subregions



***Source**: Ben Hammouda et al. 2006a.*

noteworthy that although diversification of North African economies was weaker in 1980, the gap between these economies and that of the whole of Africa has been significantly diminished. The Tunisian experience with economic diversification has played a big role in achieving the subregional outcome given the static performance of economies such as Algeria's, after making considerable progress until 1985 or so.

Unlike the experience in North Africa, COMESA lost some of the diversification edge it had at the beginning of the 1980s. Yet, COMESA had a great incentive to diversify. Unlike other subregions such as West, Central and North Africa, the East African subregion has not been favoured with discoveries of new export commodities such as oil. It failed to pursue policies that could have led to a more dynamic response to the challenges that it faced after the main economic crises. While COMESA is one of the most diversified subregions in Africa and even more diversified than Africa on average, performance is driven by only a few economies.

> *"COMESA is one of the most diversified subregions in Africa"*

Kenya and Mauritius have had significant diversification and as such they have outweighed the influence of other economies such as Burundi's, that has had a tendency to become more concentrated. It is important to note that Sudan, which is one of the largest economies in COMESA, had managed to maintain a stable path of diversification until the structural changes following the discovery of oil. For the least diversified, CEMAC, the oil factor dominance through Chad, Republic of Congo, Equatorial Guinea and Gabon is a major determinant of the diversification experience. Notably, the Cameroon economy rates as more diversified than the subregional average.

Box 4.1
A success story of diversification in Egypt: the case of Orascom International

Orascom International Company offers an excellent example of diversification. The company has expanded its range of activities to include mobile telephones, construction, hotels, and information technology, as described below.

Orascom Telecom: Orascom Telecom is a leading international telecommunications company operating GSM networks in seven high-growth markets in the Middle East, Africa and South Asia. As of September 2006, the population under license reached 460 million with an average mobile telephone penetration of approximately 22 per cent.

Orascom Construction Industries (OCI): OCI is a leading cement producer and construction contractor active in emerging markets. As a cement producer, OCI owns and operates cement plants in Egypt and Algeria, which have a combined annual production capacity approaching 13.5 million tons. Its new investments in Pakistan, northern Iraq, Algeria and Nigeria will increase annual production capacity to 24 million tons by 2007. As a contractor, OCI provides engineering, procurement and construction services on industrial, commercial and infrastructure projects for public and private customers primarily in the Middle East, North Africa and Central Asia.

Orascom Hotels and Development (OHD): OHD is the primary designer, developer, contractor and marketing force behind the highly successful El Gouna (Red Sea, Egypt), Taba Heights (Sinai, Egypt), Tala Bay (Aqaba, Jordan) and The Cove (Ras El Khaimah, United Arab Emirates) projects. It is also one of the key private players in the tourism sector and the largest single hotel owner in Egypt.

Orascom Technology Systems (OTS): OTS is one of the leading Information Technology (IT) and communications solutions providers and system integrators in Egypt, with more than 400 major customers involved in a variety of businesses. Casting a wide net over the technology sector, OTS' business activities include sales, support and services for large-scale computer systems, software, telecommunications products, internet security systems, telecommunications software solutions and turnkey project management.

***Source**: Orascom International, Official company records.*

The magnitude of the oil factor in African economies is most pronounced in ECOWAS where the dominance of the Nigerian economy has led to low export diversification in the overall subregional performance. From the late 1970s to the early 1980s, the diversification index for ECOWAS was higher than the aggregate African index.

ECOWAS, at the beginning of the period, was one of the most diversified subregions. However, beginning from 1986 onwards, the economies of the subregion started to become more concentrated, and within 25 years, the diversification gains that had already been made were eroded. In 1986, a clear structural shift occurred in Nigeria that was related to the oil effect and this shift was strong. It is not possible to discount the political factors associated with the conflicts and instabilities that played a part in erosion of the diversification gains. This is particularly the case with the recent history of Côte d'Ivoire, which at one point was a leading economy in the subregion. Political instability undermines diversification and it can be envisaged that instability affects some activities more (or differently) than others. For the

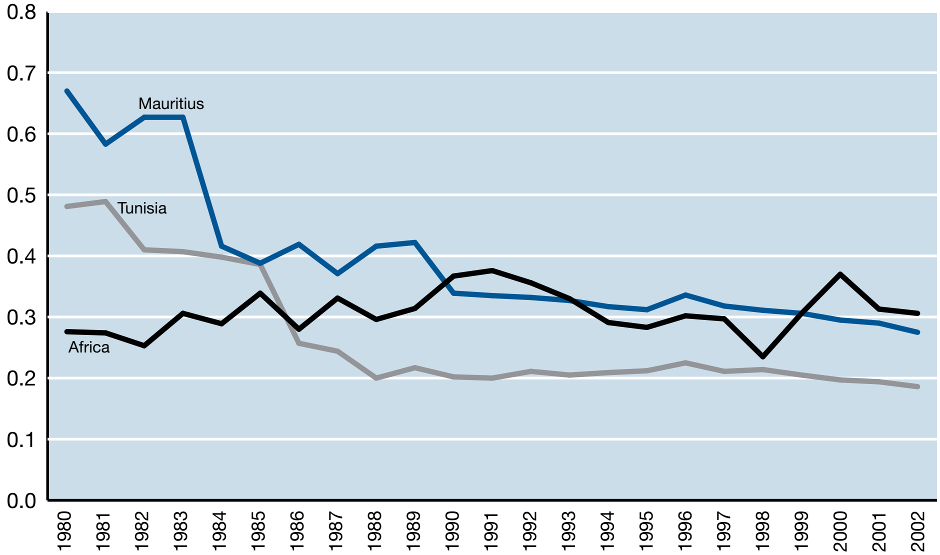
period 1991 to 1998, other economies in the subregion such as Côte d'Ivoire were making substantial progress on diversification. Senegal also managed to safeguard the diversification gains it had achieved. Conflicts and political instability had a negative effect on efforts in other countries to counteract the Nigerian oil effect.

It is apparent that the continental gains are attributed to just a few African countries, whose experience could be replicated elsewhere if the gains had resulted in better economic and social performance. This indicates that country-level performance is important to understanding what is happening at the continental level (figure 4.4). At the start of the period, Africa as a whole was more diversified than both Mauritius and Tunisia.

> *For the period 1982 to 1991, Africa's diversification gains were being reversed with a few exceptions*

Figure 4.4

Normalized Hirschman Index: Africa, Mauritius and Tunisia



***Source**: Ben Hammouda et al. 2006a.*

For the period 1982 to 1991, Africa's diversification gains were being reversed while countries such as Mauritius and Tunisia were becoming more diversified economies. What did Mauritius and Tunisia do to make their economies overcome the constraints posed by the economic crises that so negatively affected the continent as a whole? Both countries had a stable and sustained economic policy aimed at very specific outcomes, in this case, increased diversification. For the most part, subregional analysis of the diversification trends paints a picture of volatility at the country level.

Case studies on export diversification for selected African countries

So far, diversification trends in relation to African economies indicate that different countries have achieved varying results. The overall conclusion is that, in general, African economies have failed to make gains beyond their initial positions in the early 1980s. It has also been pointed out that they reacted defensively to the crises that beset them in the 1980s. Their macroeconomic stabilization policies did not create an environment conducive for dynamic response, as a good number of countries in Asia and Latin America were able to do. Their defensive response as seen in the oil factor, perpetuated the status quo and worsened it in some instances. Earlier gains in such countries as Gabon, Nigeria and Sudan were eroded.

> *African countries have not managed to break out of their traditional exports to more dynamic non-traditional sectors with higher export-earning potential*

In this sub-section, selected results on the different outcomes of various national economic diversification efforts are discussed. The evidence on how some of the countries have responded is based on the cumulative export experience function. The cumulative export experiences of the top ten commodities are employed to make the point that export diversification in Africa has been varied. Most countries have not managed to break out of their traditional exports to more dynamic non-traditional sectors with higher export-earning potential.

The interpretation of the cumulative export experience function is as follows.[3] For two different industries whose cumulative export experience functions are plotted together, the industry whose exports were concentrated earlier would have its functions further to the left. The sectors whose export experiences functions were concentrated earlier are the ones normally referred to as traditional. Those sectors whose export experience function is concentrated later in a given sample period are often referred to as non-traditional industries. Increasing numbers of industries that are concentrated in later years are indicative of a national efforts to break away from over-reliance on more traditional exports. The more the number of sectors with cumulative export experience functions shifted to the right, the more the indication of some dynamism in new export developments.

Case 1 - Mauritius

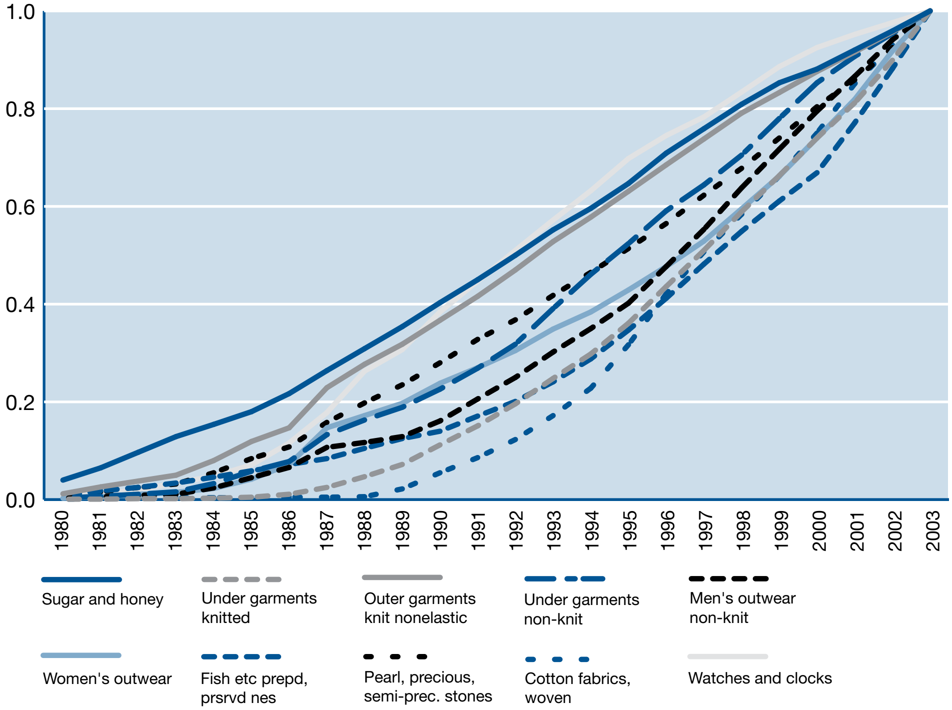
Figure 4.5 presents the cumulative export experience of Mauritius, one of the more diversified African economies. In the Mauritius case, the more traditional sectors are sugar and honey, knitted outer garments; and watches and clocks, with the larger part of the export development occurring early in the 22-year period under con-

3 See Gutierrez de Pineres et al. (1997) on the construction and interpretation of the cumulative export experiences functions.

sideration. On the other hand, Mauritius has managed to develop non-traditional export sectors. These include fish, woven cotton fabrics, knitted undergarments, and non-knitted women's outerwear. These are sectors whose export experience have been developed in more recent years. That the last three of the export categories named above are related to the textiles and apparel sector could also be an indication of some vertical diversification.

Figure 4.5

Cumulative export functions for Mauritius' top 10 export products



Source: *Ben Hammouda et al. 2006a.*

Kenya has managed to attain strong real growth in recent years in export of vegetables

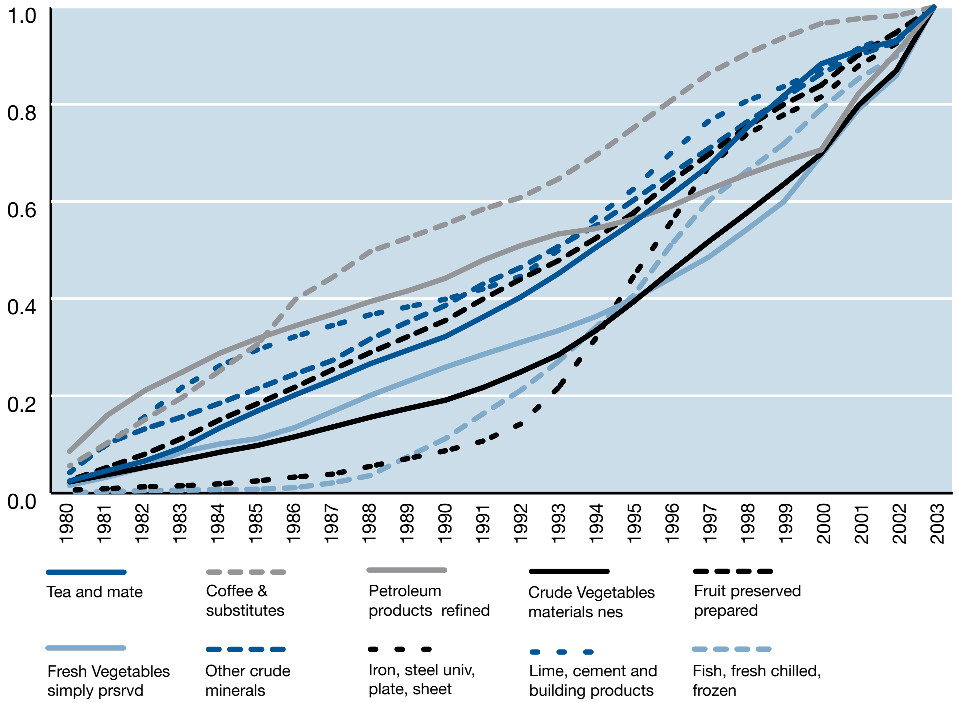
Case 2 – Kenya

The Kenyan experience does not differ much from the experience of Mauritius (figure 4.6). However, the range of experiences in the different sectors are more pronounced. Kenya is also one of the more diversified economies (box 4.2). However, it is evident that the top ten commodities have not broken into the range of manufactured products where there is generally evidence of more dynamism. The most traditional sector is coffee. Iron and steel are also showing strong indications of becoming more traditional exports. As for the non-traditional industries, Kenya has managed to attain strong real growth in

recent years in export of vegetables in particular. Very interestingly, exports of petroleum products indicate that this industry is also becoming more traditional in nature.[4]

Figure 4.6

Cumulative export functions of Kenya's top 10 export products



***Source**: Ben Hammouda et al. 2006a.*

4 Kenya handles a substantial portion of petroleum product re-export to the neighbouring land-locked countries through its oil refinery based in the coastal city of Mombasa.

Box 4.2
Diversification as part of a private sector development strategy in Kenya

Over the past years, Kenya's trade performance has been mixed. On the one hand, the country has increased its share of trade within the East African and COMESA regions. On the other hand, the country's share of trade with the rest of the world is about half what it used to be in the mid-1980s, whereas the ratio of trade to GDP has dropped sharply from 71 per cent in 1995 to the current level of about 56 per cent. This declining share of trade with the rest of the world can be attributed to the country's inability to diversify its exports away from primary products, to manufactured and value-added goods coupled with its inability to access new markets.

In response, Kenya has developed a *National Export Development Strategy* to increase the competitiveness of Kenyan products in external markets, by addressing limitations caused by supply-side constraints. The strategy also addresses the issue of regional preferences, limited range of exports and concentration in traditional markets, foreign exchange risks and uncertainties and labour problems associated with low productivity and high costs.

The export strategy is in the context of the country's *Private Sector Development Strategy* (PSDS) that outlines specific policies and strategies that need to be pursued in order to enhance private sector growth and competitiveness in the country. The overriding objective of the PSDS is to set out a roadmap that would help the country build a strong, thriving private sector over the next five years. It acknowledges the Government's principal role of providing the necessary, enabling environment for the growth and the development of the private sector. Presently, Kenya's private sector accounts for approximately 80 per cent of GDP and provides more than half of the wage employment. As of 2005, agriculture and forestry contributed 24 per cent to the GDP, while manufacturing and trade accounted for 10 per cent and 11 per cent, respectively.

There are five key goals that have been identified by the Kenya Government as having a direct bearing on the overall realisation of the PSDS.

- Goal 1: Improving Kenya's business environment. The expected outcome under this goal is rising confidence, long term planning and investment in the private sector and a globally recognized country-investment grade rating.
- Goal 2: Accelerating institutional transformation within the public sector. The expected outcome is more efficient public institutions with a proven record of accomplishment of service delivery.
- Goal 3: Facilitating growth through greater expansion of trade. This goal's expected outcome is sustained growth of at least 20% annually in exports.
- Goal 4: Improving the productivity of enterprises.
- Goal 5: Supporting entrepreneurship and indigenous enterprise development.

The strategic policy actions and expected outcome under each of these goals mesh almost seamlessly with the policies for diversification that this report outlines, presenting Kenya as positive in responding to the challenge of diversification.

***Source**: Government of Kenya: Ministry of Trade and Industry, 2006, Private Sector Development Strategy: 2006-2010, Nairobi.*

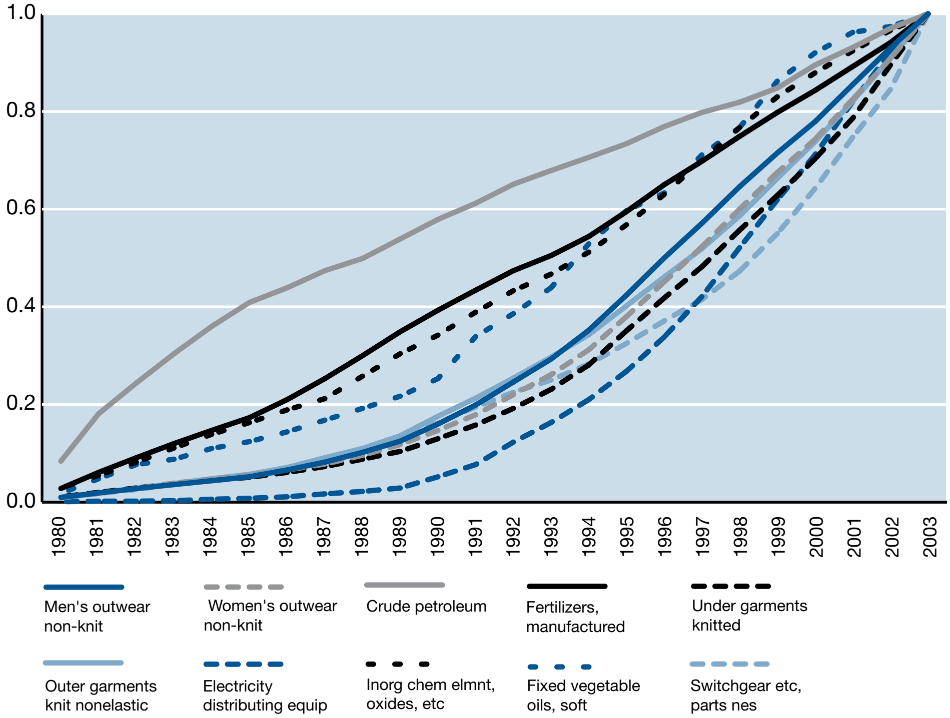
Case 3 – Tunisia

The Tunisian diversification experience indicates significant horizontal diversification in exports (see figure 4.7). Tunisia's top ten products include garments such as knitted non-elastic outer garments, non-knitted men and women's outerwear, and knitted under garments. The others include switchgear and electricity distributing equipment. These products indicate greater export experience in recent years and are the emerging or newer products in the export mix. On the other hand, manufactured fertilizers and inorganic chemical elements, oxides and others have not registered any significant structural changes for 24 years. It is noteworthy that crude petroleum, which is a traditional product, has witnessed a decline in its share of exports from 50 per cent at the beginning of the period to about 7 per cent of total exports in 2002.

> *"The Tunisian diversification experience indicates significant horizontal diversification in exports"*

Figure 4.7

Cumulative export function for Tunisia's top 10 commodities



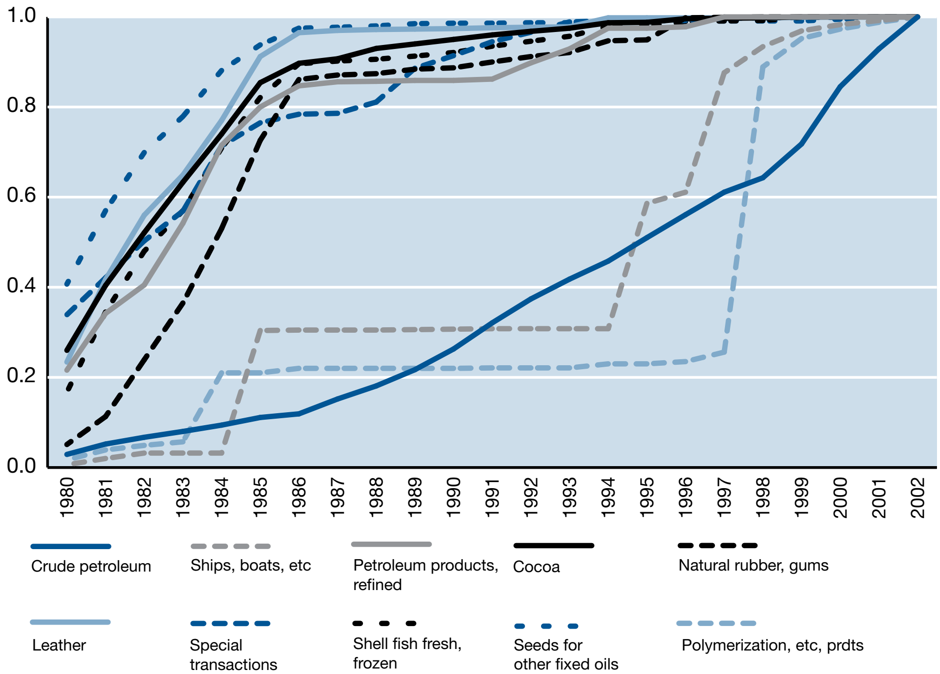
***Source**: Ben Hammouda et al. 2006a.*

Case 4 - Nigeria

The Nigerian experience described in figure 4.8 provides a distinct feature associated with the oil factor. Nigeria's top export products include seed for other fixed oils, leather, cocoa, shellfish fresh and frozen, natural rubber and gums, petroleum products refined and special transactions. These traditional export products decreased their share in the country's total exports around the mid-1980s, as crude petroleum became the dominant export product from Nigeria. Since 1987, the share of crude petroleum export has risen to almost 95 per cent of total exports, maintained this level and then again increased to over 99 per cent in 2000. Other products such as ships and boats, and polymerization products do not have a steady direction. They were not among the traditional exports but there are periods when their exports were very high. Finally, in the late 1990s, these two products were actually dominated by exports of crude petroleum.

Figure 4.8

Cumulative exports function for Nigeria's top 10 commodities



***Source**: Ben Hammouda et al. 2006a.*

4.2 Diversification regimes in Africa

Analysing the various diversification indices and the structure of the top ten export commodities for selected countries over the last two decades and a half provides some useful insights which can be used to define diversification regimes that characterize Africa. Five diversification regimes can be identified from Africa's experience (see Ben Hammouda et al. 2006b). These regimes should not be viewed as steps or as a continuum that a country must follow as it moves from a concentrated to a diversified economy. Rather, the regimes are a result of the policy actions that a country has set in place over a given period of time. The particular regime that a country falls into is likely to be the result of a mix among the various diversification determinants. The five regimes that can be identified in Africa's diversification efforts are summarized below:

- **Little economic diversification:** The countries exhibiting this regime are those that have not achieved much in terms of diversification. These are countries which, without experiencing any conflict, have been unable to achieve any significant diversification gains. Bénin, Burkina Faso, and Malawi exemplify countries that exhibit this regime.
- **Countries that started the process but have not made any significant breakthrough:** The second regime that is evident in the African experience characterizes those countries that have not made major breakthroughs in their diversification efforts over the last 20 years. Even though such countries are among the more diversified on the continent, they have not managed to achieve deep horizontal diversification that encompasses high-value export commodities. Vertical diversification might have occurred leading to new agriculture related exports as is the case in Kenya.[5] However, the vertical diversification is still not based on the higher-valued exports that have been characteristic of the Asian NIEs and Latin American countries.
- **Deepened diversification process:** A strengthened diversification regime is one that has the potential to be sustainable. This is a regime that is characterized by both horizontal and vertical diversification. Examples include Mauritius and Tunisia. Tunisia has managed to achieve horizontal diversification into higher-value exports (box 4.3). Mauritius, on the other hand, has achieved deep vertical diversification, which has led to more textiles-related exports.
- **Backsliders in the diversification process:** The fourth regime characterizes those countries that started well and were registering positive diversification gains but later fell back. It covers countries that, after the economic crises of the early 1980s, concentrated on an internal focus. The Dutch Disease effects might have played a major part in putting the countries under this

5 This is vertical diversification at agriculture-sector level but the new exports are still not of the high-value type.

regime. In the majority of the cases, export booms based on a single commodity played a part in the diversion of factors of production away from other tradables, especially the exportables. Gabon and Nigeria were unable to follow the strategy that Tunisia adopted, whereby the traditionality of petroleum-related exports continued but new sectors were able to emerge and thrive.

- **Conflict and post-conflict countries:** The fifth regime in this characterization of African economies includes conflict and post-conflict countries. The Democratic Republic of Congo, Liberia and countries in similar conditions exhibit diversification efforts but conflict has undermined these efforts.

Box 4.3
Diversification strategies in Tunisia

Tunisian authorities are engaged in a process of restructuring the economy to transform it from an emerging to a developed one. This restructuring policy is summed up in the *Directive Document for the 2007-2017 Decade*. The document presents a package of social, macroeconomic and microeconomic policies that can allow the country to catch up with OECD countries by emphasizing economic transformation. The document makes three recommendations to foster economic transformation:

- The development of the agro-food industries by the diversification of their products and to create complementarities between agriculture and the agro-processing industry to limit exports of unprocessed commodities.
- The exploitation of the potential offered by existing manufacturing activities such as leather, wearing and textile sectors by introducing highly intensive technology products and the development of services related to these industries such as consulting services or information technology services.
- Taking advantage of the new technologies in order to develop financial, social and ecological services.

The government projects that the share of agriculture in the economy will decrease from 12.8 per cent in 2006 to 9.6 per cent in 2016 while that of services will increase from 56.6 per cent to 64.2 per cent over this period. The share of the textile and leather will decrease from 5.2 per cent to 3.8 per cent.

In a second step, the Quantitative Studies Institute was charged to identify sectors in which the Tunisian economy should specialize in order to realize its development objectives. The criterion defined by the Institute was the knowledge intensity. The Institute finds that the share of knowledge-intensive activities in the total production has increased from 10.3 per cent in 1997 to 12.4 per cent in 2004 whereas the share of other industries slightly decreased from 40.9 per cent to 39.7 per cent over the same period. This transformation has been attributed to the increase in the share of investment allocated to knowledge-intensive sectors, from 17.4 per cent in 1997 to 18.5 per cent in 2004, whereas the share of investment allocated to activities with very low intensity in knowledge declined from 28.3 per cent to 26.5 per cent. The Institute recommends increasing the budget allocated to research and development activities as a means of supporting a knowledge-based diversification strategy as a corner stone of the private sector development agenda.

Sources*: Institut d'Etudes Quantitatives, 2006. Rapport Annuel sur l'Economie du Savoir. Tunis; Government of Tunisia, 2006. The Directive Document for the 2007 - 2017 Decade. Tunis.*

4.3 Conclusion

The following conclusions summarize the results of Africa's export diversification efforts and results:

Early diversification results reflected volatility and fragility

- The regional and subregional evidence indicates that the effort towards diversification in the 1970s and early 1980s had positive results in that for most countries, the diversification indices generally trended downwards, showing movements towards some diversification.
- The diversification gains were not sustainable as they could not withstand the pressures of the economic crises and the attendant adjustment policies that needed to be instituted to deal with them. The gains made during this period remained low and the diversification results reflected volatility and fragility. Africa has been unable to sustain a strong foundation of diversified economy. Yet, other regions such as Latin America and Asia which came under similar pressures managed to protect and even deepen their diversification gains.
- Overall, the African economies appear to have responded differently to the challenges posed by the economic crises of the early 1980s as opposed to the kind of response that the Asian economies adopted. However, it is important to point out that there have been clear differences between subregions and between countries in the same subregions. In spite of differences among subregions, it is clear that African economies were, on the whole, less dynamic compared to the Asian countries in their response to the diversification challenges.
- Five regimes characterize Africa's experience with diversification. The policy mix in the various African countries ranging from macroeconomic factors to institutional issues have played a major part in determining the diversification regime into which each African country falls.

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5

Diversification and Growth

The presentation in the previous chapter has painted a varied picture of the results of Africa's efforts to diversify its economies. At the same time, regional differences between Africa, Asia and Latin America were compared. The question then becomes why some countries or regions achieved breakthrough in their diversification efforts while others did not? Identifying the determinants of diversification is one part of solving this puzzle. Linking these policy instruments to growth and development outcomes through growth is the other part of the puzzle. This chapter is about fitting both parts of the puzzle together.

In discussing the empirical evidence on determinants of diversification for Africa, the underlying motivation is to deepen diversification through the use of appropriate policies. The policy options open could be economic or non-economic. In this regard, the presentation emphasizes physical, policy, macroeconomic and institutional factors that influence diversification outcomes. Those that could deepen diversification are separated from the policy options which, rather than deepening diversification, lead to specialization.

The second part of the chapter addresses the second part of the puzzle. It focuses on the evidence that links diversification to economic growth. Through total factor productivity (TFP) growth, countries will be able to deepen international trade capacity, but also significantly reduce poverty by raising their economic growth rates. The chapter concludes by tying national diversification regimes to the established link between diversification and economic growth.

"*Diversification and policy variables constitute a two-way process in that diversification not only influences policy outcomes, but is itself influenced by policy variables*"

5.1 Determinants of diversification in Africa

Diversification and policy variables constitute a two-way process in that diversification not only influences policy outcomes, but is itself influenced by policy variables. This proposition naturally leads to the search for those economic and non-economic policy actions that are likely to affect the level and rate of diversification in a country. What evidence is there that links economic and non-economic variables with national capacity to diversify?

Do more investments and higher income deepen diversification? Does the diversification process in Africa follow the two stages described in Imbs and Wacziarg (2003), suggesting that there is a turning point where diversification deepens as investment

and income rise and economic specialization sets in? Are increases in trade and promotion of industrial products also significant determinants of diversification? Given the centrality of macroeconomic stability in the policy discourse over the last three decades, do macroeconomic variables such as competitive exchange rates deepen diversification? What about the balance on government budget and inflation?

Obviously, the answer to these questions depend to a large extent on whether the deficit is driven by expenditure that has a direct impact on the productive capacity of the economy. On the other hand, where deficits result from recurrent spending such as fiscal policy they could undermine the diversification process. What are the results for African countries with regard to this? In terms of inflation, a key question is whether its level falls within that band where it is not injurious to growth. Moderate but stable inflation might not slow down diversification. Is it also possible that political violence and civil conflicts have proved counter-productive by slowing down economic growth, and therefore impeding diversification? How much does good governance and a good investment climate help in deepening diversification? Table A5.1 shows results obtained from aggregate African data in seeking answers to these questions (see Ben Hammouda et al. 2006a for details). The key findings are discussed below.

Investment is vital for an economy to diversify

The inverse relationship between investment and the diversification index shown in table A5.1 indicates that as the level of investments increases, there is a tendency for economies to become more diversified. The smaller the diversification index gets, the more diversified an economy becomes, and vice-versa for specialization. Unless a country commits a sufficient portion of its national income to building capital stock, it is unlikely to be able to diversify. Investment as measured by gross fixed capital formation turns out to be a key determinant to Africa's diversification results.

In other words, the totality of public and private investments in accumulating capital stock is vital to the process of diversification. Although total investment has a positive impact on diversification, this is only possible if public investment crowds in rather than crowds out private investment.[1] It is important to emphasize this caveat because it may not be the case at the country level that public investment crowds in private investment. Where fiscal policy rather than monetary policy is the major driver of the mix between public and private investment, the expected outcome of investment leading to deepening diversification may not always be guaranteed if public investment is not supportive of the productive sectors.

1 There is abundant empirical evidence that public investments have a crowding-in effect on private investments. The crowding-out factor is a concern usually when there is competition for domestic credit between the public and private sectors.

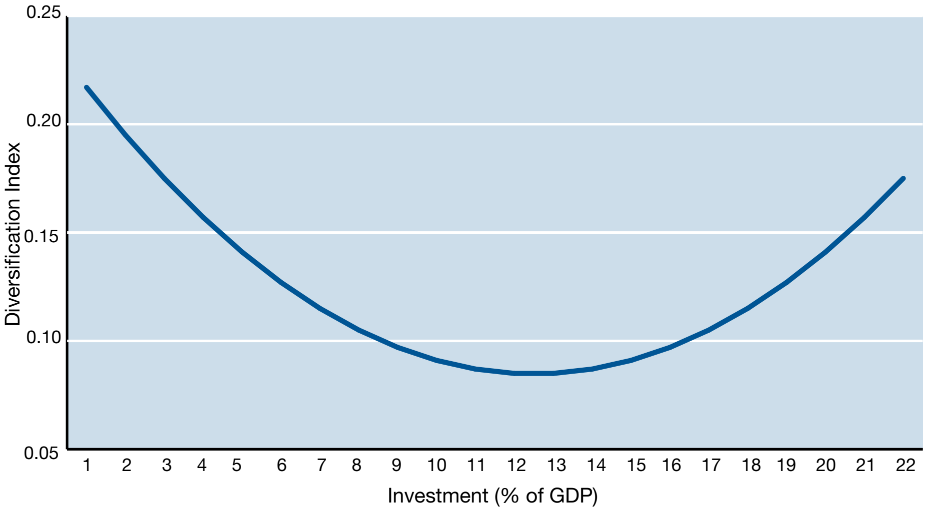
Insufficient investments in Africa have hindered the deepening of diversification

Using the results for Africa shown in table A5.1, it is possible to compute what one could call a turning point in the relationship between investment and diversification. This turning point ought to occur at that point of the diversification measure where the index is lowest. It is important to recall that the lower the index, the deeper the diversification. Therefore, a country ought to undertake investment in such a way that this turning point occurs where deep diversification has been attained. From the results seen, this turning point occurs at an index point that is not sufficient for deep diversification to be achieved and sustained. The low level of investment that African countries have undertaken over the last two decades and a half explain these unsatisfactory results. As figure 5.1 shows, the turning point for an average African economy occurs at an investment point of only 12.5 per cent of GDP. This level of investment has not been sufficient to shift the turning point to a deep enough diversification level.

"Deepening diversification may not always be guaranteed if public investment is not supportive of the productive sectors"

Figure 5.1

Empirical relationship between diversification and investment in African economies



***Source**: Ben Hammouda et al. 2006a.*

Only a very low proportion of income has been invested to lead to an early turning point in the two-stage diversification process for African countries. This early turning point coincides with the failure to attain deep diversification in Africa. The South-East Asian economies on the other hand, have been investing more than twice the average level of investment by African economies. This has not only supported their galloping economic growth rates in the 1980s to the present but explain why

the Asian NIEs are more diversified than those in Africa. The African economies need to invest more on the basis of these results so that the relationship between diversification and investment in figure 5.1 could be shifted both downwards and to the right, allowing the turning point to occur when deeper diversification has been achieved.

Poor countries tend to diversify at first as their incomes rise, before they later begin to become more specialized again

While increasing the level of investment helps promote diversification, the sectoral allocation of investment is also crucial. To boost diversification, governments should therefore design incentive mechanisms to encourage investment in new activities. At the same time, public investment in infrastructure must receive priority, which will in turn crowd in private investment.

Faster economic growth could assist in diversification efforts

The results for Africa, shown in table A5.1, suggest further that as income per capita increases, there is a tendency for African economies to experience improvement in their diversification processes. This is a very significant result and it is in line with other empirical evidence, (see Imbs and Wacziarg 2003), which shows that poor countries tend to diversify at first as their incomes rise, before they later begin to become more specialized. African countries also fit into this theory of the U-shaped stages of diversification.

The results in table A5.1 related to income provide some evidence that African countries have shown consistency with the two stages of diversification. The first stage is one of increased diversification and is explained in the same way portfolio theories in finance are used to explain the character of investors, who diversify their portfolio holdings in order to minimize risk exposure (Acemoglu and Zilibotti 1997). In the same way, economies through the first stage of diversification would be expected to minimize the effects of possible shocks to the economy by avoiding over-reliance on one particular sector. For this first stage to be beneficial to the economy in the long run, it must result in deep diversification. Only after attainment of deep diversification would the second stage that tends towards specialization not lock an economy into a low-income equilibrium.

Unfortunately, the transition point between the two stages for African countries has been at a low per capita income equilibrium. Other studies (e.g. Imbs and Wacziarg 2003) report the turning points of other countries. These points are all higher than the one estimated for Africa. For example, Singapore's occurred at $2,500 per capita income, while for Cyprus it occured at $5,800. Ireland on the other hand experienced this turning point at a per capita income of $7,000. All these countries are now considered developed countries. Indeed, for meaningful results, the benchmark per capita income is approximately $9,000 if the two-stage diversification process is to yield lasting and positive development results.

It is not surprising then that the turning point for Africa at a mere $ 1,667 did not occur at a point when deep diversification had been achieved. [2] If the diversification process in Africa is to lead to sustainable development, sustained high levels of economic growth that shift the U-curve downwards and to the right must be achieved. In making this argument, it is also recognized that the causal relationship between per capita income and diversification goes both ways.

There can be little diversification without an optimal trade policy

"Trade openness has affected diversification in Africa and there is merit in having an optimal trade policy"

The trade policy question and its role in economic growth and development continues to dominate much of the debate in this era of globalization. This debate has intensified since evidence from various authors have queried, for instance, the role of trade liberalization in economic growth in developing countries (see Rodrik and Rodriguez 1999). Such debate is relevant for Africa because the evidence in table A5.1 suggests that trade openness does not necessarily lead to deepening of diversification. Is it possible that trade openness, rather than encouraging Africa to diversify, actually supports a concentration or specialization process? As conventional trade theory postulates, in a world where there are no barriers, countries would specialize in those goods and services for which they have comparative advantage. Thus, countries would have export concentration rather than diversification.

The inconclusive results could be explained by the interaction between per capita income and openness in influencing the turning point in the two stages of diversification.[3] The lesson from these results is that at a certain stage in the diversification process, the portfolio motive for diversification ceases to dominate the comparative advantage considerations.

The key lesson from these results is that trade openness has affected diversification in Africa and there is merit in having an optimal trade policy. The results suggest that rapid liberalization may actually limit an economy's capacity to diversify. This then raises the possibility that for strategic reasons, the speed towards openness could be dictated by whether a country is seeking a more diversified or a more specialized economy. This should not be surprising as the decomposition of the components of openness is made up of two opposing effects. First, there are exports that favour specialization. Second, there is the imports competition component, which would be more supportive of the diversification process. Consequently, the evidence seen for African countries indicates that the export growth effect leading to specialization more than offsets the diversification process that import competition would support.

2 As Imbs and Wacziarg (2003) have empirically shown, the turning point also depends on interaction effects of income and factors such as openness.

3 See Imbs and Wacziarg (2003) for further discussion of this interaction effect.

The development model should determine the optimal trade policy

The two-stage diversification process from economic history has been registered both in open and closed economies. The difference between the two is that the turning point after reasonable and sustainable development has been achieved occurs at a much earlier point for open economies compared to the case for closed economies. In fact, countries that went through a minimum level of specialization relatively early tended to be substantially more open to trade, on average by 15 percentage points (Imbs and Wacziarg 2003). They showed that the turning point occurred at a per capita income level of $5,405 for an average openness of 78 per cent for open economies while it occurs much later in the development process at a per capita income of $9,161 for an average openness of 47.4 per cent for closed economies. Thus, depending on which development model a country pursues, it can remain less open and still diversify with the turning point occurring much later in the development path. Alternatively, a country could consider a much earlier diversification turning point more optimal and as such be comfortable with an aggressive trade-openness policy.

Hence, these results simply add weight to the arguments made by proponents of gradualism in trade liberalization, especially for developing countries. Proponents of a gradual approach to trade liberalization point out that there are inherent constraints in countries that limit their ability to build a competitive advantage to export new products in a short period of time. As such, they argue for policy space that would allow them to pursue policies conducive to diversification through industrialization. This argument is even more relevant for those economies that are commodities-dependent in their export base. These results reinforce to some extent the argument that calling for policy space is a good approach. Calls for such space from multilaterally imposed policies are not misplaced when viewed in the context of strategic trade policy.

Industrialization strategies still have a place in Africa

Industrial production at the continental level was found to lead to deepening of diversification. Taking industrial production as a proxy for industrialization, this fits within the established theoretical development process whereby a country moves from specialization through industrial deepening before starting to specialize again.

Macroeconomic stance is crucial to diversification outcomes

An important aspect of the diversification debate and of Africa's experience has to do with the role that macroeconomic policy plays. This has also been investigated at

the continental level in the results that are presented in table A5.1. Two important indicators of macroeconomic stability, depending on the macroeconomic policy in operation, are inflation and real effective exchange rates and these are found to be among the most critical determinants of diversification outcomes in Africa.

Depreciation does not lead to deepening of diversification

High levels of inflation damage diversification

High levels of inflation damage diversification prospects and the tendency under such circumstances is for increased concentration with little opening-up to new export sectors. This is not surprising, given that diversification in itself requires the emergence and growth of new industries or sectors which are able to meet not just the domestic demand for their products but also the competition on the international market. A high inflation environment is not conducive to the development and maturation of new sectors, nor is it supportive of an environment that fosters other determinants of diversification so that they have significant impact. Ordinarily, it is reasonable to expect that high inflation could lead to diversification as an economy diversifies away from sector-specific income shocks. Due to incomplete markets, economies can be led to diversify for insurance purposes, and to specialize again as financial markets deepen (Saint-Paul 1992).

Effects of the exchange rate depend on existing export potential

The exchange rate affects diversification prospects as there is a significant relationship between the two. The positive relationship between the exchange rate and the diversification index suggests that a depreciating currency is not always supportive of diversification efforts. These results might appear to be counter-productive in the sense that depreciation underpinned by appropriate macroeconomic fundamentals should support increases in existing exports and ease potential exportables into new markets. Such a result supposes two elements. First, it pre-supposes that the country already has this export potential and that the depreciation has the price effect of making the exports cheaper for the foreign markets. It further assumes price-elastic export demand. Second, it also assumes that the depreciation is supported by sound macroeconomic fundamentals with the depreciation being more than a process of building or maintaining competitiveness in the international market of the economy in question. The positive relationship between the two means that the depreciation does not lead to deepening of diversification. This could be interpreted in one of two ways.

In the first instance, it could mean that African countries have a narrow export potential base and the depreciation simply makes the narrow export base more concentrated and specialized. The second explanation could be that the depreciation is symptomatic of macroeconomic instabilities whose consequences create an environment that is not conducive for diversification. The implication of the results for

inflation and the exchange rate is that macroeconomic stability is crucial for the emergence of a diversified economy.

Fiscal space is critical for diversification

> *Macro stability plays a role for the success of diversification efforts*

The positive but insignificant result for the impact of fiscal balance on diversification shows that macro stability plays a role for the success of diversification efforts. At the same time, a proactive fiscal policy, especially in terms of promoting public investment, can support efforts towards diversification. In that respect, the results with regard to fiscal balances and diversification suggest that a conservative economic policy, or fiscal conservatism for that matter, may not be good for a country that is planning to achieve a diversified economy. It should be noted that expansionary fiscal policies are only as good for diversification as the absorptive capacity of the economy and the requisite fiscal discipline that ensures that fiscal spending is directed at building economic production capacities.

The success of an expansionary fiscal policy, assuming an optimal tax regime, depends to a large extent on the way the deficit is financed.[4] Financing options such as domestic borrowing (assuming an illiquid money market) or using credit from the central bank are likely to have the undesirable effect of putting pressure on domestic interest rates. This situation would undermine the investments that are important to diversification. Yet, where domestic money markets are liquid with minimal risk of crowding out private investments, public investment expenditure can be expanded through domestic borrowing that allows for higher fiscal deficits without any detrimental effects on the economy.

It is not just a matter of policy as institutions matter in diversification efforts

Governance is one of the variables that capture the part that institutions play and it emerges as strongly significant. In fact, in absolute terms, looked at from the regional level, governance has stronger marginal effects compared to other variables in our investigations. It is highly probable that good governance enables economies to deepen diversification. As governance structures improve so does the capacity for a country to develop a diversified exports base. The interaction of governance and other variables such as per capita income and investments may drive the diversification process more than individual effects. Just as openness can interact with per capita income to determine the turning point in the two stages of diversification, it is also possible that the interaction of governance and the other variables is critical.

4 It is envisaged in the argument made here that a country pursuing an expansionary fiscal stance has set its taxes at rates that have minimal distortionary effects on the economy. Thus, the extra revenues for the higher expenditures are to be derived from borrowings (domestic and/or foreign).

Governance relies to a large extent on the quality of institutions. In the same way these institutions have been found to be critical to growth, so is their effect in determining the extent of diversification. It is not surprising that conflict, which is associated with deterioration in governance, stifles diversification (box 5.1). The relationship between conflict and diversification, even though weakly significant, indicates a critical influence on diversification. Intuitively, one would expect the impact of conflict on diversification to imply that escalation of conflict leads to reduced capacity to diversify and this is what the continental assessment indicates.

"Good governance enables economies to deepen diversification"

Box 5.1

Conflict and diversification: the cases of Burundi and Rwanda

The cases of Burundi and Rwanda offer a clear illustration of the various channels through which conflict undermines economic diversification. These countries have experienced several episodes of civil wars, the most devastating being the 1994 genocide in Rwanda and the war that erupted after the bloody military coup of October 1993 in Burundi. These two countries illustrate the extent to which conflict not only causes an immediate collapse of the production base but also has severe long-term negative effects on the country's diversification process.

Conflict undermines diversification through various channels. First, conflict destroys economic activity in all sectors, especially trade-oriented activities and those that are heavily dependent on skilled labour and technology, such as manufacturing. Both in Burundi and Rwanda, the manufacturing sector suffered large declines in the conflict years: a staggering 39.7 per cent in Rwanda in 1994 and 18 per cent in Burundi in 1993. The already narrow production base was severely eroded due to the conflicts in both countries.

Second, conflict retards the diversification process by destroying public infrastructure. During conflict, not only existing infrastructure is destroyed or not maintained, but also the capacity of the government to invest in new infrastructure is severely curtailed. Third, conflict creates a fiscal crisis both by causing government revenue to shrink and by displacing public expenditure from productive investment (including infrastructure) to military and security sectors. In Rwanda, government revenue as a share of GDP declined by 56.8 per cent in 1994, most of the decline coming from trade taxes, which dropped by 72 per cent (as a percentage of total trade). In Burundi, government capital expenditures declined by 9.5 per cent in 1993. The fiscal crisis of the State explains the severe shortages in public infrastructure, water, and energy supply that the countries have experienced in the post-conflict eras. These shortages constitute a severe constraint to investment in new activities.

Fourth, by increasing uncertainty, conflict causes investors and lenders to shy away from long-term activities, such as in the industrial sector, and focus on short-term and speculative activities such as commerce. In Burundi, the share of industry in total credit declined from 16 per cent in 1980-94 to 3.8 per cent in 2003-05 while that of commerce increased from 43 per cent to 72 per cent during the same period. At the same time, the share of long-term bank credit has declined systematically from 17 per cent of total credit in 1993 to a meager 2.5 per cent in 2004. The shift of resources away from long-term activities retards economic diversification, undermines post-conflict economic recovery, and makes it harder for the countries to achieve and sustain high rates of economic growth.

***Sources**: Ndikumana 2004; Bank of Burundi (various reports).*

The results vary by diversification regime

At this point, it is worthwhile to recall the five diversification regimes: those countries with little diversification; countries that started but got stuck in the diversification process; those with deepened diversification; backsliders in diversification; and the conflict and post-conflict countries. This report suggests that belonging to a particular regime has more to do with policy and institutional factors at the country level. Consequently, there are different determinants when the discussion is brought to the country level (see table A5.2 for correlation results).

> *In Kenya, per capita income was a strong determinant of diversification*

The results for selected African countries represent the different diversification regimes, namely, for Tunisia, Kenya, Nigeria, Burkina Faso and Sudan. Tunisia, representing a regime with deepened diversification, shows significant results in relation to investment, inflation and exchange rate while it is negatively and significantly related with income per capita, trade and country risk. Tunisia follows the more general African results with respect to the influence of per capita income, inflation, exchange rate and country risk on diversification. Nonetheless, two factors, level of investment and openness, have opposite directions in relationships from the general continental evidence.

Kenya is an example of a country where diversification took off but was not able to go very far. In this case, per capita income was a strong determinant of diversification. The exchange rate was also significant to diversification results in the country. This is also consistent with the continental results. Like Tunisia, Kenya's openness tended to deepen diversification rather than restrain it. Investment, growth in manufacturing value added, inflation and country risk have not played significant roles in the diversification outcomes for Kenya.

Nigeria is an example of an African country where oil dominates exports. Hence, Nigeria is a highly specialized economy in terms of export products. Nigeria's oil exports account for 98 per cent of its total export value. These results are inconsistent with the continental results, especially with regard to the influence of investment, income, trade, exchange rate and country risk. However, the diversification question is dominated by the oil factor in Nigeria's export products.

In the case of Burkina Faso and Sudan, countries representing the regimes of limited diversification and of conflict, respectively, the relationships shown by the correlations do not indicate any plausible economic inferences and the data plots have no clear patterns. In both cases, no clear relationship between the different economic variables and diversification allowed reasonable conclusions to be drawn regarding countries in these regimes.

5.2 Growth, productivity and diversification

There is abundant literature that suggests that there is a two-way relationship between exports and growth. However, an important aspect of this evidence is that it is not just the level of exports that leads to growth but also the level of diversified exports or products. There are two important channels of how diversification may influence growth or income. First, diversification may be considered as an input (a production factor) that increases the productivity of the other factors of production (Romer 1990). The second route is that diversification may increase income by expanding the possibilities to spread investment risks over a wider portfolio of economic sectors (Acemoglu and Zilibotti 1997). This argument suggests that diversification is pivotal to sustaining high economic growth rates and to reducing growth volatility.

> *"Diversification may increase income by expanding the possibilities to spread investment risks over a wider portfolio of economic sectors"*

In the remainder of this chapter, the relationships between economic growth, productivity and diversification in Africa that form the second piece of the puzzle mentioned in the introduction are discussed. First, the sources of growth in Africa are examined. Some growth accounting exercise results are discussed to indicate the relative contribution of capital, labour and TFP in the economic growth of African countries. Then, there is actual discussion of the relationship between the TFP and diversification, on the basis of the first route suggested, that diversification contributes to economic growth.

Is it factor accumulation or total factor productivity that drives growth in Africa?

To investigate the link between growth and diversification, it was important to first quantify the contribution of TFP to economic growth. This section analyses the sources of growth for African countries using the standard growth accounting method, making it possible to disaggregate the shares of growth contributed by TFP, capital and labour. Growth in output is the sum of the growth in capital, labour and TFP. Capital accumulation is an essential element in the growth process, as it enlarges the economy's capacity to produce. Increases in labour or labour force have traditionally been considered a positive factor in stimulating economic growth.

Technical progress through TFP is also important and is the main factor in the growth process. Advances in technology continue to stimulate growth in the rich industrial countries, especially as their population growth rates are close to replacement levels. In Africa on the other hand, there is accumulating evidence that it is factor accumulation that drives economic growth, with below-average contribution by TFP growth. Diversification is expected to have a positive contribution to TFP growth, and by extension, to economic growth. This report has identified the determinants of diversification and suggests that it may be possible to influence the

rate at which TFP contributes to diversification and growth, by influencing these determinants.

Before decomposing the contribution of capital, labour and TFP to growth, it was necessary to find out the historical shares of capital and labour in Africa's output. As in other studies on Africa, the share of capital was found to be 0.39 and that of labour to be 0.61. Estimation of these shares allows us to see the growth that is not accounted for by labour or capital but by TFP.

"Economic growth in Africa is driven by accumulation of the factors of production"

Some results were derived from the growth accounting for individual countries for five-year averages from 1981 to 2000 (see Ben Hammouda et al. 2006a). The results confirmed that economic growth in Africa is driven by accumulation of the factors of production. The average contribution of TFP to growth is negative for the majority of African countries, with the exception of a few countries such as Botswana, Burkina Faso, Cape Verde, Chad, Equatorial Guinea, Ethiopia, Gabon, Guinea-Bissau, Malawi, Mauritius, Mozambique, Senegal, Swaziland, Uganda, Zambia and Zimbabwe.

Another important result is that in the majority of countries, the contribution of TFP growth to growth was positive in the 1980s, especially for the period 1981-1985. By the early 1990s, most of them experienced negative contributions from TFP. Even for a country such as Botswana, the first half of the 1990s saw a negative TFP contribution. There was therefore a reversal in the sources of growth across the continent in that the TFP contribution declined significantly from the second half of the 1980s. In a good proportion of the countries, TFP contributed at least 30 per cent of the growth, and in some cases, more than half of the total growth. This clearly changed especially at the beginning of the 1990s and to a significant extent in the second half of the 1980s. Thus, in Botswana, except for the period 1991-1995, TFP contributed more than one-third of the growth. For Burkina Faso, in 1981-1985 and 1991-1995, TFP contributed half of the growth. Another important observation worth pointing out is that the period 1996-2000 witnessed a return to positive contribution to growth by TFP, although lower than its contribution in the 1981-1985 period.

How can one explain the transition of TFP contribution to economic growth from positive to negative? As indicated, it was in the late 1980s and early 1990s that the transition to negative TFP contribution occurred. To understand the causes of this transition, it is worth recalling that the stylized facts of African economic diversification indicate that the diversification efforts of the 1970s yielded favourable results as Africa entered the 1980s. The favourable though fragile results of the diversification efforts in the early 1980s correlated with the favourable growth results of the same period. Thus, the positive and significant contribution of TFP in the early 1980s explains the better diversification results at the time. However, these gains could not be sustained in the later years of the 1980s. Two explanations come to mind. First is the direct impact of the economic crises of the early 1980s itself

and second is the fact that the adjustment measures addressing these crises had some constraining consequences.

The adjustment measures instituted to deal with the economic crises required stringent macroeconomic policies, which took the form of fiscal and monetary conservativeness. This meant, on the fiscal front, that countries had to make hard choices, such as cutting development expenditure and curtailing the rate of growth of private sector credit. Reduced development spending by the public sector and weak private sector investment might have led to the weakened TFP contribution to growth.

Adjustment measures in the 1980s had some constraining consequences for diversification

The tight macroeconomic policies reduced the flexibility to pursue diversification-enhancing programmes. This may have contributed to the transition from positive to negative TFP contribution to growth. In the next section, the link between diversification and growth through the TFP is explored and discussed further. The significance of this transmission mechanism is that it can validate the proposition that the hard macroeconomic choices that countries had to make to deal with the economic crises invariably affected the role of TFP in Africa's growth, by undermining the diversification efforts at the time.

Economic growth and diversification: exploration of the TFP link in Africa

In this section, the link between TFP and diversification is explored further. The motivation is the proposition that diversification could influence economic growth through one of two links if not both at the same time. These links highlighted earlier are via increasing risk or by risk minimization through spreading of investment portfolios. The focus of this section is on the TFP link, while recognizing that the standard neoclassical growth model and its competing endogenous growth model are one and the same, to some extent, in that the latter attempts to disaggregate the potential components of TFP. Risk minimization and its influence on growth, leading to diversified exports, could reasonably be captured through the influence on TFP.

Whether there is a significant link between diversification and the factors or variables that affect TFP had to be investigated. The variables that were investigated included diversification, human capital, and selected policy and institutional variables such as openness, financial development and conflict. The level of diversification was expected to have a significant influence on the productivity of capital and labour in an economy. As for human capital, in the literature on endogenous growth, it is assumed to be different from other forms of capital. As a result, the level of investment in human capital in a country is expected to have a bearing on the productivity of both labour and capital in the economy. The level of enrolment in secondary schools can be used to measure human capital.

Openness is thought to have an influence on TFP through external effects such as exposure to foreign competition, transfer of technology, economies of scale, and also to some extent, an increased speed of convergence towards richer countries. As has been discussed so far, it is obvious that the level of openness depends on the kind of trade policy a country pursues. Different countries apply different weights to the significance of trade liberalization in promoting growth.

"Financial deepening has a significant influence on TFP in the case of African countries"

Financial development may influence growth positively in two ways. First, a more developed financial structure allows for better mobilization of savings and thus supports more investment. Second, within a more developed financial sector, available information on investment projects is treated more efficiently to boost investments in productive sectors. The lack of access to credit has been identified as one of the impediments to investment and growth in Africa. The arguments in favour of financial markets liberalization are mainly based on the premise that the binding capital constraint to African economies can be undone by liberalizing not just the money markets but also the financial markets, in a broad sense. Thus, the full potential of the banking, insurance, development finance, stock and bond markets need to be unleashed by dismantling the restrictive controls that hamper development and deepening of the financial sector. It was instructive to find out that financial deepening has a significant influence on TFP in the case of African countries.

Economic growth in Africa has been variously linked to the presence or absence of conflict. Significant work has been undertaken on the economics of conflict and post-conflict countries. Indeed, in recent times, most studies have been considered incomplete if they fail to take account of conflict. Weak growth can be attributed to the presence of conflict in a country. Conflict can influence this growth performance either directly or indirectly. In the more direct route, adverse effects on populations (hence on the labour force) and capital destruction undermine the obvious sources of growth through factor accumulation. In the more indirect route, conflict affects TFP, leading to its decline and inability to contribute to growth.

What did the investigation of these factors in determining TFP in Africa reveal? Essentially, that an increasing level of diversification leads to higher TFP. It was also found that as an economy moves from a high level of specialization to becoming more diversified the total productivity of both labour and capital rises. Diversification was found to drive growth significantly in terms of TFP. In other words, a significant link between diversification and growth does indeed exist in African economies via the TFP. Table A5.3 shows the results of the different specifications that were used to examine this link.

Diversification-deepening policies raise growth and TFP

What then do these results imply? They mean that pursuing diversification-deepening policies could help accelerate growth. Important policy implications of this link arise with respect to the determinants of diversification that were discussed earlier in

the chapter. In that discussion, it was noted that key determinants of diversification were per capita income, investment, trade and industrial policies, macroeconomic stability especially the fiscal policy stance, and institutional variables such as governance and conflict. The significance of the results in table A5.3 is that they suggest that even for African economies, if capital and labour are binding, countries can unlock growth potential by pursuing diversification-enhancing policies. Since diversification raises TFP, then African countries can capitalize on the potential of TFP as a source of economic growth.

Since diversification raises TFP, then African countries can capitalize on the potential of TFP as a source of economic growth

While the main objective here is to establish the significance of the empirical link between diversification and growth via TFP, further discussion of the results is required. Building human capital matters. Thus, while economic policies can be oriented to deepening diversification through the determinants already discussed, social policy that dictates higher investments in human capital also has to be defined. Diversification and human capital orientations in economic and social policies would complement each other by enhancing TFP and by extension, economic growth.

Conflict has a negative and significant influence on TFP. It was suggested above that conflict could affect economic growth either directly through destruction of the factors of production, or indirectly through their combined productivity. The results in table A5.3 imply that the indirect link through TFP is also significant. Policies aimed at enhancing growth by deepening diversification that would be transmitted through TFP could easily become neutralized by the presence of conflict.

Openness and financial deepening did not emerge as significant determinants of TFP in the analysis. Does this mean that the trade liberalization that has led to substantial openness in the African economies has failed to catalyse technological spillovers which could have led to increases in the contribution of TFP to growth? These results pointing to the possibility that openness in Africa, especially in terms of imports, have resulted mainly in non-technology-enhancing imports. The imports compression that the liberalization aimed at addressing was undone, leading to the importation of final consumption goods rather than capital and intermediate imports with accompanying technologies that could have led to positive and significant influence on the TFP.

Financial deepening has also failed to catalyse an increase in TFP. The same logic as in the case of openness could be attributed to the results with regard to financial deepening. First, it is important to note that, in some countries, as the money markets are liberalized, the interest rate spread remained significantly high, meaning that the intermediation role of commercial banks in channelling savings to the private sector for investments that would raise TFP failed to materialize. In the same vein, investment opportunities in the majority of African countries are thin and the private sector credit growth witnessed as the financial sector was liberalized has been directed at personal consumption and to short-term activities rather than to investments by private firms in renewing their technologies in research and develop-

ment. Just as personal consumption rather than private investment dominated credit expansion to the private sector, credit expansion to the public sector financed net material consumption by government in the form of salaries for instance, rather than public investments that would have had a positive impact on TFP.

Tunisia has managed to achieve horizontal diversification into higher-value exports

Africa's diversification regimes revisited: A further link to productivity

So, there is a link between growth and diversification via the TFP as the transmission path in Africa. How does this link relate to the diversification regimes that have been seen to characterize African economies? Is there a clear correlation between the diversification regimes and the TFP contribution to growth? To answer these questions, analysis of the sources of growth of a few African countries is related to the different diversification regimes.

The first diversification regime was described as those countries with little economic diversification. The study found that many African countries belong to this regime, including Benin, Burkina Faso, and Malawi. It can be observed from table A5.4 that these countries have positive growth on average for the period 1981-2000. Benin, Burkina Faso and Malawi have average annual growth rates of 3.8 per cent, 3.7 per cent and 3.0 per cent, respectively. The main source of growth is the factor accumulation rather than the TFP. However, it is interesting to note that the contribution of productivity to growth in these countries is positive in almost all but one period, even though they have not diversified much. However, even though growth in these countries was positive over the 20-year period under observation, their growth rates were not on the level at which their economies could take off, as compared to the high growth-performing economies of the NIEs in East Asia.

The second regime comprised those countries that started the process of diversification but did not make any significant breakthroughs. From table A5.4, the examples of these countries are Kenya, Senegal and Zimbabwe. It may be observed that all three countries have shown a slowing-down trend in production during the period 1981-2000, except for Senegal, which recovered during 1996-2000. However, the growth trends are positive despite the setbacks. Kenya grew at an annual average of 2.9 per cent; Senegal at 3.3 per cent while Zimbabwe was growing at 3.1 per cent. Again, the main source of growth was factor accumulation rather than TFP. It is noted, however, that the average TFP contribution to growth in Senegal and Zimbabwe is positive. The main question is, could it be that these countries experienced slackening of growth because they failed to deepen their diversification process and have remained at the same level for a long time?

The third regime is that of countries with a deepened diversification process. Countries such as Mauritius, Morocco, South Africa and Tunisia exemplify this regime. Tunisia has managed to achieve horizontal diversification into higher-value exports. Mauritius, on the other hand, has achieved deep vertical diversification, which has

led to more textiles-related exports. The countries in this regime are characterized by relatively high growth, except South Africa, whose growth has since picked up with the dawn of a new political dispensation. Mauritius and Tunisia in particular have registered growth rates of 5.5 per cent and 4 per cent per annum on average, respectively, for the period 1981-2000. In both these countries, it may be observed that the contribution of capital is much higher than the contribution of labour. Moreover, in Mauritius, the TFP contribution to economic growth is positive with an annual average of 2 per cent, a relatively high figure for an African country.[5]

The fourth regime is composed of countries that registered early positive diversification gains but later tended to specialize in a few products. Countries such as Gabon and Nigeria exemplify this regime. These countries are both rich in oil; hence, this product dominates their exports. As for their growth performance, the GDP growth rates of both countries, although mostly positive, were characterized by fluctuations over the period 1981-2000. On average, Nigeria is growing at 2 per cent per annum while Gabon is growing at 2.3 per cent per annum. As with most of the African economies, their economies are also labour-intensive with a minimal TFP contribution. Nigeria's TFP contribution to growth, on average, is even negative for the period under study. The economic growth of countries in this regime is relatively low compared to such countries in the third regime as Mauritius and Tunisia.

The fifth group comprises those countries within the conflict and post-conflict regime. The countries that belong to this regime are neither diversified nor highly specialized. Examples are DRC and Liberia. Economic growth in these countries was stunted by wars and conflicts and can therefore be expected to be negative. Consequently, the contribution of TFP to their economic growth is also negative. These countries depend a great deal on their labour force for production as the contribution of capital to growth is also deteriorating.

"The diversification process is highly influenced by investment, per capita income, level of openness, macroeconomic policy stances, governance, and conflict"

5.3 Conclusion

This chapter has shown that there are clear and measurable determinants of diversification in Africa at the continental, subregional and country level. Despite the inadequacy of African data, it may be said that, at least at the continental level, the diversification process is highly influenced by investment, per capita income, level of openness, macroeconomic policy stances, governance, and conflict. High levels of investment and rising per capita incomes are necessary for deepening diversification. However, both these determinants have a U-shaped relationship with diversification, indicating that there are two stages to the pattern. Initially, increasing investment and per capita income lead to diversification and after a given level, a turning point is reached where further increases lead to specialization.

5 The highest contribution of TFP to growth in the data set is in Uganda with 3.36 per cent, followed by Botswana with 2.2 per cent and then Mauritius.

Pursuing policies that lead to export diversification can go a long way to overcoming growth constraints

Another important conclusion from our discussion is that trade liberalization in Africa could have led to more specialization rather than to diversification. The specialization forces that led African countries to optimize their comparative advantages as they became more open have, on average, overshadowed the important motivation for diversification, which is to shield the economy from shocks.

Another significant conclusion from the regional results is that macroeconomic stability matters for diversification. High inflation and unstable exchange rates undermine diversification. On the fiscal side, conservative fiscal policy clearly emerged as countering diversification forces. Besides macroeconomic policy stances, conflicts undermine diversification while good governance promotes diversification.

Another issue that has been discussed in this chapter is that related to the link between diversification and economic growth. The analyses have shown that deepening diversification leads to improvements in TFP, among other determinants. The significance of the link between diversification and economic growth in the case of African economies cannot be gainsaid. It means that African countries can scale up economic growth and raise their TFP by pursuing policies that enhance diversification.

Given the clear determinants of diversification, the key conclusion is that pursuing economic and non-economic policies that lead to export diversification can go a long way to overcoming the growth constraints emanating from factor accumulation (box 5.2). African countries should aim at raising their levels of investments, improving governance, eliminating conflicts, adopting non-conservative fiscal policies and ensuring macroeconomic stability in addition to pursuing industrial and trade policies that foster economic diversification. The overall results of such policies are enhanced export diversification and, eventually, increased contribution of TFP to economic growth.

Box 5.2

Diversification in Ethiopia: a story of booming horticulture and textile exports

Ethiopia, like most low-income countries in SSA, has relied on traditional exports such as coffee, oil-seeds, hides and skin, pulses and other export crops to earn foreign exchange. For instance, during the period 1980-1990, the share of traditional exports in total exports was close to 95 per cent. This has begun to change in recent years, however. The share of non-traditional exports, such as flowers, textile and garments, honey, and natural rubbers have begun to play an important role as sources of foreign exchange and employment generation in Ethiopia. In the late 2000, the share of non-traditional exports reached a record level of about 11 per cent, more than double what it was in the 1990s.

This dramatic increase in non-traditional exports is partly explainable by the overall policy stance and stable macroeconomic environment that characterized the Ethiopian economy over the last decade and half. Since 1994, Ethiopia embarked on an Economic Reform Programme designed to achieve macroeconomic stability and long-term growth through its Export-led Industrialization Programme, which emphasized export diversification and import substitution. Greater accord was given to the private sector to lead the country's industrialization effort. This has led to significant changes in the structure of the Ethiopian economy in recent periods. Exports as a percentage of GDP almost doubled from 9 per cent in 1994 to 19 per cent in 2004. In addition, the country's position in attracting FDI improved greatly during the decade, from a paltry 0.3 per cent of GDP in 1994 to 7 per cent in 2004.

An important element of the surge in private investment and non-traditional exports is the incentive package that the Government introduced to foreign as well as national investors in the export sector. From the point of entry up to exit investors receive preferential treatment in accessing suitable sites, basic infrastructure, duty-free privileges for importation of key capital goods and raw-materials, credit facilities and repatriation of profits and a number of other supports necessary for the creation of a secure environment for private businesses. It is expected that these measures will contribute to developing an industrial base that paves the way for substantial economic transformation and sustainable growth.

***Source**: The Ethiopian Customs Authority. Various official documents.*

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Appendix

Table A5.1
Determinants of diversification in Africa

	Variable	Coefficient value
Constant	Constant	0.241 (0.185)
Physical variables	Gross fixed capital formation (% of GDP)	-0.025*** (0.007)
	Gross fixed capital formation (quadratic)	0.001*** (0.005)
	GDP per capita (US$ 1995)	-0.0002*** (0.000)
	GDP per capita (quadratic)	0.00000006*** (0.000)
Policy variables	Trade openness ((X+M) as % of GDP)	0.003*** (0.007)
	Industrial production	-0.001*** (0.0001)
Macro stability	Inflation (%)	0.004*** (0.0001)
	Exchange rate (real effective exchange rate)	0.002*** (0.0001)
	Fiscal balance (% of GDP)	0.006 (0.170)
Institutional variables	Governance	-0.249*** (0.000)
	Conflict	0.120* (0.090)
Model diagnostics	R-squared (weighted) Number of observations	0.88 52

***Source**: Ben Hammouda et al. 2006a.*

***Notes**: The figures in parentheses are p-values. Results are based on a panel of 18 African countries.*

**** Significant at 1%; ** Significant at 5 %; *Significant at 10 %*

Table A5.2

Correlation between diversification and different economic variables for Burkina Faso, Kenya, Nigeria, Sudan and Tunisia

Variables	Tunisia	Kenya	Nigeria	Burkina Faso	Sudan
			Diversification		
Investment	0.433**	0.166	0.702***	0.295	--
Income	-0.468**	-0.586***	0.720***	0.496**	0.644**
Trade	-0.632***	-0.613***	-0.801***	-0.384*	0.399**
Industrialization	0.053	0.212	0.097	-0.173	-0.267
Inflation	0.518**	-0.235	0.114	-0.088	-0.476**
Exchange rate	0.977***	0.482**	-0.929***	--	-0.403**
Country risk	-0.634***	-0.271	0.756***	0.532***	0.773***

***Source**: Ben Hammouda et al. 2006a.*

***Notes**: Numbers are Pearson Correlation Coefficient; ***Significant at 1% level; **Significant at 5% level; *Significant at 10% level.*

Table A5.3

Economic growth and diversification—the TFP link

Endogenous variable: TFP	Model I	Model II	Model III
Constant	23.497*** (0.000)	21.324*** (0.000)	18.887*** (0.000)
Diversification	-3.256* (0.073)	-1.916* (0.080)	-1.119 (0.233)
Human capital	0.071* (0.062)	0.057 (0.278)	0.026 (0.409)
Openness (X/GDP)	-0.012 (0.184)	-0.010 (0.296)	--
Financial deepening (DCP/GDP)	--	0.051 (0.117)	0.076** (0.015)
Financial deepening ((DCP+DCG))/GDP	-0.008 (0.425)	--	--
Conflict	-1.056** (0.049)	-1.041* (0.067)	-1.155** (0.054)
R-squared (adjusted)	0.99	0.99	0.99
Number of cross-sections	26	26	28
Number of observations	98	98	105
Durbin-Watson stat	1.71	1.68	1.47

***Source**: Ben Hammouda et al. 2006a.*

***Notes**: The figures in parentheses are p-values.*

**** Significanct at 1%; ** Significant at 5 %; *Significant at 10 %*

Table A5.4

Diversification regimes and TFP contribution to growth

Countries	Growth in GDP	Contribution of Labour	Contribution of Capital	Contribution of TFP
Regime 1: Little economic diversification				
Benin				
1981-1985	4.66	1.44	2.73	0.50
1986-1990	0.89	1.55	1.86	-2.52
1991-1995	4.25	1.76	2.36	0.13
1996-2000	5.34	1.72	2.81	0.81
Burkina Faso				
1981-1985	4.18	1.19	0.58	2.41
1986-1990	2.64	1.12	0.77	0.75
1991-1995	3.84	1.14	0.73	1.97
1996-2000	4.32	1.21	1.80	1.31
Malawi				
1981-1985	2.17	1.82	0.21	0.14
1986-1990	2.32	1.83	-0.02	0.51
1991-1995	3.52	0.78	-0.07	2.81
1996-2000	3.92	1.28	-0.92	3.56
Regime 2: Early Diversification but no major breakthrough				
Kenya				
1981-1985	2.53	2.31	0.86	-0.64
1986-1990	5.64	2.10	1.07	2.47
1991-1995	1.61	2.14	0.86	-1.39
1996-2000	1.79	1.90	1.01	-1.11
Senegal				
1981-1985	3.23	1.56	-0.01	1.68
1986-1990	3.22	1.56	0.28	1.37
1991-1995	1.53	1.55	0.71	-0.74
1996-2000	5.30	1.50	1.59	2.21
Zimbabwe				
1981-1985	4.36	2.55	-0.07	1.88
1986-1990	4.60	2.34	0.67	1.59
1991-1995	1.39	1.33	1.79	-1.73
1996-2000	2.07	1.18	0.27	0.62
Regime 3: Deepened diversification process				
Mauritius				
1981-1985	4.33	1.51	1.09	1.73
1986-1990	7.39	1.31	2.66	3.42
1991-1995	5.13	1.08	3.05	0.99
1996-2000	5.27	1.01	2.55	1.70
South Africa				
1981-1985	0.91	1.74	1.42	-2.25
1986-1990	1.81	1.62	0.30	-0.11
1991-1995	0.89	1.44	0.18	-0.73
1996-2000	2.65	1.63	0.70	0.32
Tunisia*				
1981-1990	3.72	1.28	2.48	-0.04
1991-1997	4.30	1.36	2.12	0.82

Countries	Growth in GDP	Contribution of Labour	Contribution of Capital	Contribution of TFP
Regime 4:Backsliders in the diversification process				
Gabon				
1981-1985	2.56	1.46	1.33	-0.24
1986-1990	1.73	1.50	0.06	0.16
1991-1995	3.13	1.49	0.09	1.55
1996-2000	1.76	1.10	0.69	-0.02
Nigeria				
1981-1985	-2.75	1.70	2.83	-7.29
1986-1990	5.42	1.55	0.85	3.02
1991-1995	2.50	1.66	1.59	-0.75
1996-2000	2.84	1.64	0.14	1.05
Regime 5: Conflict and post-conflict countries				
Congo, D.R.				
1981-1985	1.86	1.46	1.63	-1.22
1986-1990	0.01	1.57	0.71	-2.27
1991-1995	-7.12	2.05	-1.83	-7.33
1996-2000	-3.93	0.80	-1.89	-2.85
Liberia				
1981-1985	-1.88	1.70	-0.28	-3.30
1986-1990	-1.79	1.59	-1.24	-2.15
1991-1995	-1.51	1.45	-1.72	-1.24
1996-2000	-1.53	1.30	-1.98	-0.85

***Source**: Ben Hammouda et al. 2006a.*

The Way Forward: Policies for Achieving Diversification

Two key reasons emerge from the evidence and discussions in the previous two chapters of this report, as to why diversification should become a central pillar in Africa's development efforts. First, diversification is important to strengthen growth in Africa because from the second half of the 1980s, Africa's growth has been mostly accounted for by factor accumulation. Beyond a certain point, factor accumulation becomes binding under certain demographic and physical conditions, making other sources of growth critical. Consequently, the positive contribution of diversification to TFP is central to any efforts to achieve higher and sustainable growth in Africa.

The second reason is that Africa has failed to reap benefits optimally from preferential trade arrangements and from globalization. There is, therefore, a need for a new paradigm on diversification, to enable African countries to benefit from preferences and trade liberalization. As cited earlier, Africa has been unable to benefit fully from preferences at the international and regional level. It is also evident that while other developing regions have increased their share in global trade, Africa has seen its share decline even as global trade liberalization has progressed. The failure to maximize gains from preference utilization and trade liberalization assumes special significance given the likelihood that the future gains that may accrue to African countries from current trade liberalization efforts will be marginal.

> *With the current economic structures, African countries will not be able to maximize gains from trade liberalization*

Essentially, with the current economic structures, African countries will not be able to maximize gains from trade liberalization, and risk perpetuating the historical failure to secure benefits from global trade reforms. Apart from the suboptimal nature of the expected gains from trade liberalization, it is also possible that Africa will be marginalized further and any such gains will be unevenly distributed among developing countries. Therefore, there is a strong case for a new diversification paradigm in order to help African countries secure benefits from preferential schemes such as AGOA, EBA, DFQF market access promised to LDCs in the Doha Round, and the subsequent trade liberalization in agriculture, NAMA and services under the WTO and EPA agenda.

Several key policies and recommendations are presented in this chapter. These policies constitute the elements of a new diversification paradigm that will enable African countries to benefit from preferences and from ongoing liberalization efforts at bilateral, regional, and multilateral levels. The recommended diversification policies include macroeconomic, trade, sectoral, industrial, and financial development policies, in addition to strategies that will strengthen institutions.

6.1 Macroeconomic policies for diversification – the need for pragmatism over orthodoxy

A conservative fiscal policy may end up limiting the necessary fiscal space needed to boost investment

One key recommendation has to do with the need for pragmatic macroeconomic policies if African economies are to be able to diversify. While macroeconomic stability is important for the diversification of an economy to take root, not all components of the macroeconomic framework need to be rigid. Stability alone through conservative fiscal and monetary policies is not enough to ensure the deepening of diversification. While contributing to stability, a conservative fiscal policy may end up limiting the necessary fiscal space needed to boost investment. Such constrained fiscal space, as the empirical results suggest, undermines diversification efforts. Therefore, given that diversification of African economies is necessary for high and sustained growth, pragmatism in designing macroeconomic policies becomes imperative.

For optimal results, African countries should realize that while macroeconomic stability is important, some of the elements of the macroeconomic framework underpinning the diversification and growth strategy need to be sufficiently flexible. This requires a departure from typical macroeconomic frameworks, which are narrowly focused on macroeconomic stability. Flexible fiscal space can be integrated within the framework, and this in turn enables a country to boost investments, which has been shown to be a key determinant of diversification.

6.2 Trade and sectoral policies for diversification – returning to the basics

Another key recommendation relates to the role of economic policies aimed at diversification. In the 1980s, there was significant marginalization of economic policies as the focus in economic management shifted towards macroeconomic policies. This led to the neglect of sector-oriented policies, placing needed microeconomic sectoral reforms at the periphery. This marginalization played a part in extinguishing the gains that African countries were starting to make in deepening diversification in the late 1970s. Nonetheless, it is important to note that the shift in favour of macroeconomic policies was founded on legitimate concerns, namely the need to address the economic crises of the early 1980s. A dose of pragmatism would have recognized the existence of valid justifications for the objectives underpinning the economic policies at the time and prevented the radical shift that curtailed the progress that many African countries were making in diversifying and transforming their economies.

Suffice it to add that, in most cases, economic management concentrated on macroeconomic issues at the expense of sectoral issues and this led to stagnation in or the

weakening of diversification efforts. In a few cases, dependence on oil led to reversal of diversification gains. Yet, the number of countries where reversal in diversification gains occurred due to the discovery and subsequent reliance on oil are few, compared to the number of countries that witnessed poor diversification as a result of the marginalization of economic policies. More proactive macroeconomic policies are needed. Given the determinants of diversification as established in this study, proactive economic policies on trade, finance, industry and research are crucial.

“Economic management concentrated on macroeconomic issues at the expense of sectoral issues and this led to stagnation in or the weakening of diversification efforts”

In designing such proactive trade policies, African experiences accumulated to date are important. Special care should be taken to avoid the two extremes that have both failed to enable trade policies to achieve their expected outcomes. On the one hand, trade policies in support of diversification should not focus on protecting domestic markets. Such policies have been tried in the past and caused considerable distortions in African economies, leading to misallocation of resources and to weak growth and productivity. On the other hand, trade policies for diversification should not be the orthodox liberal trade policies that aim at uncontrolled opening up of African economies to external markets. African countries should use trade policies in a strategic way aimed at specific diversification and, by extension, at specific growth and development outcomes (box 6.1). Such strategic trade policies should be proactive, dynamic, adaptable and differentiated between sectors and between the various segments of a given sector in order to enable diversification to contribute effectively to development efforts. Furthermore, gradualism is a hallmark of such strategic trade policies.

Although openness has not necessarily led to diversification, openness can have an indirect influence on the impact of other diversification determinants, such as per capita income, through interaction effects. Results show that, in a direct way, openness can lead to specialization rather than diversification. It is also proven that openness has indirect effects on diversification through interaction effects. Strategic trade policy making should discourage those policies that have mutually exclusive options in terms of liberalization and protection. The Asian experience is an example of how a strategic trade policy cannot be limited to a choice between liberalization and protection. Rather, a strategic trade policy is one that can be used in a dynamic and adaptable way to support specific development choices. Therefore, in order to realize the benefits of diversification, countries in Africa should use trade policies as dynamic instruments towards chosen diversification ends.

For proactive and dynamic trade policies to help countries achieve their diversification choices, some features are essential. First, it is important that trade policies are dynamic and, as a result, develop over time. Second, such policies are likely to -vary from sector to sector and even require differentiation not only among sectors but also within the same sector. Therefore, achieving vertical diversification in one sector calls for trade policies that differ from those for achieving the same vertical diversification objective in another sector.

> African countries should use trade policies in a strategic way aimed at specific diversification

Box 6.1

Promoting vertical diversification in Ethiopia: the case of the leather industry

Ethiopia, like other commodity-dependent economies, is extremely vulnerable to abrupt variations in export earnings due to volatile terms of trade for its major export products. Recognizing this, the Government is making considerable efforts to diversify the economy, through introducing new products (horizontal diversification) and/or diversifying out of traditional products by moving towards the high end of the production chain (vertical diversification). The latter strategy has been used successfully in the leather industry. Given its large livestock population, Ethiopia has been traditionally one of the major exporters of hides and skins in Africa.

The leather industry developed in the early 1970s on the basis of import-substituting industrialization. However, the industry was marred by inefficiencies and lack of competitiveness. By early 1990s, only 45 per cent of total leather exports was in processed form with the remaining 55 per cent in raw form. In recent years, considerable efforts have been expended to make the industry more competitive and increase value addition. This is bearing fruits. Twenty new tanneries and leather-processing industries have been setup in recent years and, as a result, the value-added of leather-exports has increased to 95 per cent. More importantly, these firms combined have generated more than 6,000 jobs. After temporary set-backs due to cheap Chinese shoe imports, more than 30 new shoe-manufacturing industries are operational currently, employing more than 9000 workers. The Government envisages that by 2010 all leather exports will be in processed form, contributing between 8 to 10 per cent of total foreign exchange earnings.

A good macroeconomic environment, favourable investment climate, development of the domestic financial sector, trade policy and appropriate exchange rate policies are considered critical in the promotion of economic diversification, both horizontal and vertical.

Source*: Federal Democratic Republic of Ethiopia: Ministry of Industry and Trade.*

6.3 Financial sector links between investment and diversification

With regard to financial sector policies, the starting point is the clear link between investment and diversification. The contribution of private investment to desirable diversification outcomes cannot be gainsaid. In that respect, the financial sector and its role in financing private sector contribution to diversification is very critical. Hitherto, the African experience with financial sector reforms has been almost similar to the trade liberalization results. However, the failure of financial sector liberalization to achieve the results expected can be explained from two angles. On the one hand is the failure of liberalization in achieving an efficient financial sector able to play its expected intermediation role for both short-and long-term credit, in an optimal way. On the other hand, comes the failure to achieve reductions in interest rates as was expected, given that interest costs are a major cost of doing business for many private sector firms. These two points are elaborated here in order to point to the need for a rethink of the financial sector architecture, in terms of both policy and institutional frameworks so that proactive financial sector policies can contribute to the deepening of diversification efforts.

With regard to the institutional structure of the sector, financial liberalization in Africa failed to achieve the desired outcomes as a catalyst for financial sector deepening. The key reason noted is that in the same way that trade policies were never seen as part of an integrated financial sector, financial sector liberalization tended to treat the sector in a compartmentalized manner. This was done to the extent that there was unbalanced focus on some components such as commercial banking, neglecting the significance of other dimensions such as development finance institutions and/or other components that are key to capital markets deepening. The results were that the financial sectors were not integrated, and focused on short-term credit issues rather than on development finance and capital markets development, which would be more relevant to diversification efforts. In this respect, given the importance of the financial sector in diversification, it is important that African countries seek a proactive financial sector policy that aims at integrated development of the whole sector that can effectively and efficiently mobilize the sustainable, long-term capital necessary for financing diversification programmes, and by extension, long-term development.

Proactive financial sector policies can contribute to the deepening of diversification efforts

The significance of proactive financial sector policies compared to what has been the practice can be found in the results that were achieved in the past with interest rate regimes. In many African countries, financial sector liberalization became characterized by wide interest rate spreads. Thus, instead of liberalization resulting in more efficient financial sectors, the results were interest rate regimes where the lending rates rose and remained high over long periods of time, while the deposit rates fell, and, in many cases, were negative in real terms. This discouraged the private sector from undertaking productive investments, such as those required for deepening diversification.

Additionally, the inability of the private sector in Africa to access cheap credit meant that it was not possible to undertake initiatives that would lead to both horizontal and vertical diversification. The high interest rates after liberalization also had the negative effect of raising the interest costs of servicing existing debt. This resulted in reduced profitability for most firms. Given that retained earnings also form a significant component of financing diversification efforts in the private sector in most African economies, financial sector liberalization had the indirect effect of limiting these diversification efforts.

6.4 Industrialization policies key to deepened diversification

With regard to industrial policies, it helps to recall that economic transformation is both a necessary and sufficient condition for industrialization. However, economic transformation cannot occur in the absence of diversification. Given the correlation

between diversification and economic transformation, industrial policies are part and parcel of the new economic policies for diversification that Africa needs. This is particularly the case given that it has also been established in this report that industrial policy is critical to the ability of a country to deepen diversification. Therefore, as in the case of trade policies, there is need for more proactive industrial policies. This calls for strategic use of industrial policies to target diversification efforts in those sectors that are aligned to the overall industrialization strategy.

"Industrial policies are part and parcel of the new economic policies for diversification that Africa needs"

There is much to be said about the way forward in designing proactive industrial policies. One can recall that import substitution strategies enabled Africa to achieve high levels of economic development in the late 1960s and in the early 1970s, the same period when diversification gains were evident across many African countries. However, these industrial strategies failed as early as the 1980s, due to reasons such as lack of internal structuring of the industries concerned, weaknesses in internal markets and their inability to provide significant markets for new industries, reduced availability of financing to developing countries, and -low productivity of new enterprises. The response to the failure of this domestic-market orientation in the development model via reorientation towards external markets did not yield the expected results in Africa. In a similar fashion akin to the role of strategic trade policies, it is also necessary for African countries to have more strategic and dynamic industrial policies that are based on well thought out choices for diversification and, by extension, economic transformation paths.

Such policies should include adoption of sector-by-sector, bottom-up strategies, from downstream to upstream, in order to deepen horizontal diversification in sectors ranging from intermediate goods up to capital goods. Applying this strategy to diversification might make it possible for countries to develop vertical diversification paths by building connections between internal markets and exports. Downstream industrial segments would be export oriented while the intermediate sectors would be oriented towards internal markets. Eventually, the multiple optima of comparative advantages would evolve and export competitiveness would gradually reach intermediate and capital goods sectors.

6.5 Financing research to increase TFP

The other major area in which new economic policies for diversification are required is in research. The majority of African countries, since the demise of diversification gain resorted to relying on factor accumulation as the main source of economic growth. Yet, historical and empirical evidence has shown that the industrialized and NIEs were able to achieve development leaps when dramatic changes in TFP took place. As this report has shown, a link exists between economic growth and diversification through TFP. However, improvements in TFP are almost always a manifestation of innovation in a given economy. Financing research and development stands

out as a clear way in which African countries could improve the level of innovation and hence raise the level of TFP contribution to economic growth. This would then enable these countries to reap maximum benefits from their diversification efforts.

6.6 Strengthening of institutions - a prerequisite for positive diversification outcomes

Industrial policies should include adoption of sector-by-sector, bottom-up strategies, from downstream to upstream, in order to deepen horizontal diversification

For new macroeconomic and economic policies to achieve optimal diversification results, it is important for countries to strengthen their institutions. As this report has shown, conflict and governance have very substantial implications for diversification. Conflict always undermines diversification, while good governance (broadly defined) is empirically shown to lead to desirable diversification results. The policy recommendation that flows from these results is that it is important that countries invest in peace-building and peace-promoting institutions that can proactively deal with threats of conflict flare-up or resurgence.

Where conflict exists, be it at the national level or across borders between countries in a given subregion, it is important to have effective institutions to address prevention or resolution. Having conflict prevention and resolution as a key feature of institutions within the RECs is one way in which diversification efforts could be deepened. Countries that aim to deepen diversification also need to invest in good governance structures and institutions. Governance institutions that have to be strengthened should cut across the rule of law and public order – including a judiciary that effectively deals with commercial disputes, as well as tax administration institutions that establish a predictable investment climate.