Jan Joost Teunissen and Age Akkerman (editors)

Africa in the World Economy

The National, Regional and International Challenges

Charles Abuka, Olu Ajakaiye, Vivek Arora, Roy Culpeper, Zdeněk Drábek, Adam Elhiraika, Stephen Gelb, Brian Kahn, Damoni Kitabire, Kamran Kousari, Lolette Kritzinger-van Niekerk, Matthew Martin, Mothae Maruping, Gordon McCord, Benno Ndulu, Yonghyup Oh, Ritva Reinikka, Jeffrey Sachs, Andrés Solimano and Wing Thye Woo

FONDAD

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FONDAD
The Hague

ISBN-10: 90-74208-27-4
ISBN-13: 978-90-74208-27-7

This publication was made possible thanks to the support of the Department for Development Cooperation of the Dutch Ministry of Foreign Affairs.

Additional copies may be ordered from FONDAD:
Noordeinde 107A, 2514 GE The Hague, the Netherlands
Tel.: 31-70-3653820, Fax: 31-70-3463939, E-mail: a.bulnes@fondad.org
www.fondad.org

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From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

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Acknowledgements

This book is yet another result from the Global Financial Governance Initiative (GFGI), which brings together Northern and Southern perspectives on key international financial issues. In this initiative, FONDAD is responsible for the working group Crisis Prevention and Response, jointly chaired by José Antonio Ocampo, under-secretary-general for Economic and Social Affairs of the United Nations, and Jan Joost Teunissen, director of FONDAD.

FONDAD very much appreciates the continuing support of the Dutch Ministry of Foreign Affairs and the stimulating ongoing cooperation with the Economic Commission for Latin America and the Caribbean (ECLAC) in Santiago de Chile, the North-South Institute (NSI) in Ottawa, the African Economic Research Consortium (AERC) in Nairobi, Debt Relief International (DRI) and Development Finance International (DFI) in London, the Korea Institute for International Economic Policy (KIEP) in Seoul and the many other organisations with which it works together.

We are grateful for the assistance and inspiration from X.P. Guma, Monde Mnyande and Brian Kahn at the South Africa Reserve Bank, who helped in the organising of the conference in Pretoria (13-14 June 2005) from which this book emerges. We are also grateful for kind permission of AERC to partial use of substance from a paper by Benno Ndulu which was presented at the Plenary Session on Commission for Africa Report, AERC, Biannual Workshop, December 4-10, 2004, Nairobi, Kenya.

A special thanks goes to Adriana Bulnes and Julie Raadschelders, who assisted in the publishing of the book.

Jan Joost Teunissen
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December, 2005

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Abbreviations

ACP	Africa, Caribbean and the Pacific
AERC	African Economic Research Consortium
AfDB	African Development Bank
AFRODAD	African Forum and Network on Debt and Development
AGOA	African Growth and Opportunities Act
AU	African Union
BCEAO	Central Bank of West African States
BEAC	Banque des États de l'Afrique Centrale
BIS	Bank for International Settlements
BWIs	Bretton Woods institutions
CEMAC	Central African Economic and Monetary Community
CEPR	Centre for Economic Policy Research
CFA	Communauté Financière Africaine
CMA	Common Monetary Area (Southern Africa)
COMESA	Common Market for Eastern and Southern Africa
CPIA	Country Policy and Institutional Assessment (of the World Bank)
DAC	Development Assistance Committee (of the OECD)
DFID	Department for International Development (UK)
EAC	East African Community
ECA	Economic Commission for Africa (of the UN)
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
ECOWAS	the Economic Community for Western African States
EEFSU	Eastern Europe and the former Soviet Union
EPA	economic partnership agreement
EU	European Union
FDI	foreign direct investment
FTA	free trade area
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
HIPC	heavily indebted poor country

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ICRG	International Country Risk Guide (of the PRS Group)
IDA	International Development Association
IDB	Inter-American Development Bank
IDS	Institute of Development Studies
IFI	international financial institution
IMF	International Monetary Fund
KIEP	Korea Institute for International Economic Policy
LAC	Latin America and the Caribbean
MCA	Millennium Challenge Account
MDGs	Millennium Development Goals
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MOU	memorandum of understanding
NEPAD	New Partnership for Africa's Development
NGO	non-governmental organisation
ODA	official development assistance
OECD	Organization for Economic Cooperation and Development
PECC	Pacific Economic Cooperation Council
PPP	purchasing power parity
PRGF	Poverty Reduction and Growth Facility
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
RIAs	regional integration arrangements
R&D	research and development
RMA	Rand Monetary Agreement
RTAs	regional trade arrangements
SACU	Southern African Customs Union
SADC	Southern African Development Community
SADCC	Southern African Coordinating Conference
SDT	Special and Differential Treatment (within the WTO)
SSA	Sub-Saharan Africa
TNC	transnational corporation
TRIMs	Trade-Related Investment Measures
TRIPs	Trade-Related Aspects of Intellectual Property Rights (WTO Agreement)
UEMOA	West African Economic and Monetary Union
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa

UNRISD	United Nations Research Institute for Social Development
US	United States
VAT	value added tax
WAIFEM	West African Institute for Financial and Economic Management
WTO	World Trade Organization

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Clichés, Realities and Policy Challenges of Africa: By Way of Introduction

Jan Joost Teunissen

After all, the world is full of clichés, and we know that many of them endure even when reality tells us that they are wrong. Well-known clichés about Africa include, "Africans should stop blaming others for their economic problems and first put their own house in order" or "Pumping more money into Africa is useless and will only prolong its addiction to foreign aid." Are these clichés right? Are they wrong? Whatever one thinks about them, they may have one very negative effect: they may prevent Western policymakers from doing what they ought to do in the first place and in all modesty: help African policy-makers more effectively to put an end to the suffering of the African people.

Now I must confess immediately that I myself harbour some clichés about Africa. One of them is that I often think: Let Africa become like us, fully capitalist, otherwise they will never be able to compete with us in world politics and world economics. At the same time, I resist this thought because I am concerned about the shortcomings and negative tendencies in our capitalist societies and would not like to see them copied in African societies. Still, it will be hard to stop this process.

This book examines a number of the economic challenges and constraints that African countries are facing. They range from national and regional challenges such as improving infrastructure and the financial sector to international challenges in the spheres of trade and finance. All of the chapters defy some clichés about Africa's development and deliver valuable insights into how the constraints can be overcome.

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Domestic and External Constraints to Development

In the next chapter, Wing Thye Woo, Gordon McCord and Jeffrey Sachs challenge some of the economic clichés that many of the Western policymakers and mainstream economists hold about Africa. The main cliché Woo *et al.* deal with is the pretence of the so-called Washington Consensus that Africa's poverty and development problems can simply be blamed on "macroeconomic mismanagement" and "poor governance". "Many parts of Africa are well governed," according to Woo *et al.*, "and yet remain trapped in poverty. Governance is a problem, but Africa's development challenges are much deeper."

I find it remarkable that Andrés Solimano (Chapter 3), who has been with the World Bank for ten years, endorses the critical view of Woo, Sachs and McCord about the Washington Consensus. This shows that another cliché, i.e. that the World Bank and IMF are monolithic institutions that do not allow diversity of opinion, is wrong. Solimano not only agrees that in its original formulation, the Washington Consensus ignored the importance of institutions, politics and social conflict, but also endorses a fundamental point of Woo *et al.*: governance is not an exogenous variable that explains economic performance. "On the contrary," says Solimano, "the quality of governance in itself is a result of the development level of a country.[1] In this line, the traditionally assumed causality from governance to development must be changed for a causality that goes from development to governance."

Indeed, one of the central arguments of Woo, Sachs and McCord is that good governance does not depend so much on the idiosyncrasy of a people but on the availability of sufficient government resources to pay reasonable salaries to well-talented professionals. But there is more. Not only is there a need for money to pay the salaries of good professionals, there is also a need for freedom of design and implementation of African development policies. Here we see another constraint to good policymaking in sub-Saharan Africa: the policy conditionality imposed on African policymakers by Western donor countries and international institutions such as the IMF and World Bank. Even though the IMF and World Bank and the donor countries assert that they do not interfere in Africa's policymaking, or only do so with good intentions, the reality is that they do interfere – and not always with good (say, altruistic)

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[1] However, the reverse need not be true. In my view, a high level of development is not a guarantee for a high level of governance.

intentions. Therefore, it is not surprising that well-informed observers like Matthew Martin (Chapter 17) advocate ending this practice of limiting the room and freedom for policymaking in African countries. "In terms of economic policy," says Martin, "the major constraint for most African countries is excessive conditionality. … Another major problem is that restrictive macroeconomic frameworks set by the IMF still provide insufficient 'fiscal space' to absorb aid in sufficient amounts to reach the Millennium Development Goals."

Constraints to achieving development in Africa is a recurrent theme throughout this book. The contributing authors recognise that these constraints are both of a domestic and an international nature. When I invited them to prepare papers for a conference to be held in South Africa, I asked them to emphasise the international constraints. In no way does this mean that I, or the contributing authors, think that domestic constraints are less important. They are just as important, as public and private authorities as well as civil society in African countries recognise. The main reason I invited the authors to focus on the international constraints is that policymakers all over the world have agreed to engage in enhanced support for Africa to try and help Africa overcome its "poverty trap".

The MDGs and Africa's "Poverty Trap"

The concept of the "poverty trap" (being too poor to grow) features prominently in the chapter by Woo *et al.* and is the basis for their appeal to Western policymakers to fully support the Millennium Development Goals (MDGs) as a way out of Africa's poverty trap. "What is needed is a 'big push' in public investments to produce a large 'step' increase in Africa's underlying productivity, both rural and urban. Foreign donors will be critical to achieving this substantial 'step' increase," say Woo, Sachs and McCord.

Some of the authors in this book raise questions about the desirability and adequacy of the MDGs. Yonghyup Oh (Chapter 4) sees two problems. First, he views the MDGs as a combination of enhanced foreign intervention, more external money and a top-down approach, which has the danger of depriving recipients of the spirit of independence. Second, since the focal area of interest in the MDGs is to build up infrastructure to provide more public goods (human development, environmental protection) there is likely to be a funding problem after 2015, the year set to reach the MDGs. How will successful MDG

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outcomes be sustained after that date? "The idea is not for the donor countries to continue providing funds," says Oh. "The fact is that a fall in inward ODA is anticipated for after 2015, and the major MDG goals aim to produce public goods, which does not generate cash flows to re-create these public goods."

Roy Culpeper, who recognises the importance of the MDGs as a political commitment agreed worldwide, observes nonetheless that they "are hardly an adequate basis for cooperation internationally on development". Culpeper argues that fulfilment by the year 2015 of, for example, the first MDG of elevating at least 50 percent of the people living on one-dollar-a-day or less would be very unsatisfactory. "Even if, and it is a big if, not just 50 percent, but 100 percent of that goal were achieved, so that no one was left at a dollar a day by the year 2015, what kind of success would that really indicate? If we still had 40 percent or 50 percent of humanity struggling to subsist at between one and two dollars a day, in my view it would not be much of an achievement. MDG-1 is not just a very modest goal; one could say that it is totally inadequate."

Even more critical about the MDGs is Percy Mistry, an Indian economist and investment banker who contributed to a large number of FONDAD publications. Recently Mistry wrote an article in which he said that the MDGs in themselves are laudable, but portraying them as development goals stretches credulity. "The MDGs are, in fact, poverty reduction goals that have surprisingly little to do with fostering development."[2]

In his article, Mistry argues that the history of Africa since independence has been one of development failure. Aid to Africa has not worked because human, social and institutional capital – not financial capital – poses the binding constraint. Doubling aid to Africa is, therefore, a questionable proposition. The aid community's current obsession with the MDGs may even be harming rather than helping the cause of development in Africa as aid damages the psyches and retards the capabilities of recipients in a variety of subtle and not-so-subtle ways. To develop (like China and India), Africa will need to be connected to the global economy in ways that defy the limits of African and donor imaginations. Africa will need a large influx of foreign investment and

[2] Mistry, Percy S., "Reasons for Sub-Saharan Africa's Development Deficit that the Commission for Africa Did Not Consider", In: *African Affairs*, Vol. 104, No. 417, pp. 665-678, September, 2005.

know-how to connect it to the global economy in productive ways. The human capital that Africa needs will have to come mainly from the developing world, particularly from China, India and other emerging countries of Asia and Latin America. "In short, it will require large-scale immigration of a kind that diversifies, widens, deepens and augments Africa's limited human resource base," says Mistry.

Woo *et al.* disagree with Mistry's vision. They argue that jumpstarting growth through inward immigration worked in Australia, New Zealand, Canada, and the United States, but certainly has not been the mechanism that launched East Asian economic growth in the second half of the 20th Century. "The problem is not that Africans are incapable of learning; the problem is that the typical poor African economy cannot even afford to educate everyone at the primary school level. Capacity building is the operative concept, not mass migration into Africa."

The Challenges of Financial Sector Development

The various authors contributing to this book examine a large number of economic constraints to growth and development in sub-Saharan Africa. These constraints include the underdevelopment of domestic capital markets (Brian Kahn, Olu Ajakaiye and Damon Kitabire, Chapters 6-8), the lack of national and regional infrastructures (Benno Ndulu, Lolette Kritzinger-van Niekerk, Ritva Reinikka and Charles Abuka, Chapters 9-10), the lack of successful regional economic cooperation and integration (Mothae Maruping and Zdeněk Drábek, Chapters 11-12), and the ongoing dependence on the export of commodities whose prices and markets are volatile and largely determined by the big companies of rich countries (Kamran Kousari, Chapter 13). All authors analyse these constraints in light of what African policymakers and others can do to overcome them. In this and the next two sections, I highlight the challenges that contributing authors have identified at the national and regional levels; in the third section, I highlight the challenges that they have identified at the international level.

Brian Kahn starts his chapter by mentioning that there is a positive relationship between economic growth, on the one hand, and financial sector development, on the other. He observes that financial markets generally expand when per capita income increases and analyses the role that financial markets and bond markets in particular can play in reducing sub-Saharan Africa's external vulnerability as well as being an additional source of mobilisation of capital. Since financial crises are often caused or exacerbated by weaknesses in a country's financial system, the development of robust financial systems is important, says Kahn. Moreover, bond markets may also help to finance fiscal deficits and can provide useful market signals for macroeconomic policy. The generally narrow tax bases and growing demands for infrastructure and social services in sub-Saharan African countries have resulted in fiscal deficits which need to be financed either through domestic or foreign borrowing. The lack of depth of the domestic financial systems is a constraining factor, and is to a large extent a result of low savings ratios in sub-Saharan Africa.

A central theme in Kahn's chapter is the question of "original sin", that is the inability of developing countries to borrow abroad in domestic currency. This inability may result in excessive foreign borrowing, which increases vulnerability in the face of a crisis. Kahn recognises, however, that the development of domestic financial markets does not completely insulate countries from foreign exchange crises. Extensive foreign participation in domestic bond markets can make the currency vulnerable when risk perceptions change.

Olu Ajakaiye (Chapter 7) discusses the role of the state in financial sector development in sub-Saharan Africa. He stresses that a major lesson of the past century is that neither the free market nor pervasive state intervention and control, working alone, can lead to sustainable development. The challenge, therefore, is to secure a social order where "the ingenuity, enterprise and initiatives of private individuals and organisations are combined with a purposive state intervention, regulation and guidance". Such social order requires full participation of all stakeholders, stresses Ajakaiye, that is, business community, government officials, politicians and political office holders, labour unions and civil society organisations. "Such cooperative relationships should rest squarely on intensive formal and informal discussions and consultations in an environment of mutual respect, trust and sincerity of purpose."

I cited Ajakaiye's words literally, as they reflect a way of thinking that I consider important for defining Africa's challenges. All too often there is a tendency among both Western and African policymakers, and economists and politicians alike, to analyse development problems and challenges in terms of what government officials and business people think. Ajakaiye clearly departs from this view by emphasising the need for "full participation of all stakeholders".

In his chapter, Ajakaiye provides detailed data showing that the financial sector in sub-Saharan Africa is seriously lagging behind that of the rest of the world. Therefore, it should be clear that the role of the state in financial sector development has to go beyond the usual provision of regulatory frameworks, says Ajakaiye, as this presupposes that the market exists in the first place. Since capital markets in sub-Saharan Africa hardly exist and still are extremely underdeveloped, it is imperative to recognise that the prevailing syndrome of minimalist state should change. Instead, governments should play three inter-related roles: create an enabling environment for all economic agents; shift frontiers by investing in activities which are either too risky or too large for private entrepreneurs; and initiate development activities that are required to get things started in an otherwise fallow field, including by creating needed state companies. For example, states emerging from war or states that have nothing to privatise should not be precluded by the current development paradigm from creating useful public enterprises.

Anyone reading this far who now thinks that Ajakaiye is an old-fashioned state interventionist is wrong. Listen, for example, to what he says about governments intervening in the economy: "The state should intervene to get things started in the capital market. Therefore, the reform of public sector enterprises should be instrumental in establishing and deepening the capital market. To begin with, the lucrative public sector enterprises should be commercialised and given necessary institutional framework (including incorporation as companies) that will enable them to form the foundation stocks of the capital market. The investment programmes of such enterprises should cease to be funded by government treasury once they are listed in the capital market. Instead, they should issue bonds in the nascent capital market as a way of gradually diluting the ownership. Over time, the share of government in the total equity of the companies should be falling and this process can be speeded up by government offering its own stock for sale to the nascent investing public. The next step is for the government to pursue aggressive reform measures to make hitherto unprofitable public sector enterprises quite profitable and hence eligible for commercialisation and subsequent listing on the national stock exchange. This way, the number of enterprises listed on the national stock market will increase and the market capitalisation will also grow."

In his comment on Kahn, Damoni Kitabire (Chapter 8) reports that in the late 1990s, both the central bank and commercial banks in Uganda supported the introduction of long-term government bonds. The Bank of Uganda was keen to develop a benchmark yield curve to promote capital market development and stimulate long-term bond issues by the private sector, while commercial banks hoped to boost profits from higher rates of interest income on longer-maturity low-risk government securities. However, Uganda's Ministry of Finance, for which Kitabire works, has some concerns about issuing long-term government bonds. There are several reasons for concern. First, establishing a yield curve requires a critical number of competitive investors in the market for long-term securities to develop a functioning market – Uganda still lacks that critical number. Second, yields on government bonds are higher than on treasury bills, reflecting the premium required for longer-maturity securities, therefore the introduction of bonds will increase the budgetary cost of liquidity management. Third, issuing a government bond crowds out private sector issuers of securities, damaging long-term productive investment in the economy. Fourth, following the introduction of bonds, one-third of Uganda's total domestic debt is now longer-dated, which poses a considerable rollover risk (especially in the event of a withdrawal of donor aid). Because of all these concerns, Kitabire warns that sub-Saharan African countries should carefully sequence the development of bond markets. He stresses that the issuance of government bonds makes only sense when both the number of financial institutions holding long-term liabilities (such as private sector pension institutions) and the number of competitive investors in the market for long-term securities has increased. Otherwise, there will not be a functioning market and a reliable yield curve.

The Challenges of Infrastructure Development

Benno Ndulu, Lolette Kritzinger-van Niekerk and Ritva Reinikka (Chapter 9) argue that the MDGs are fine but that they somewhat neglect the importance of economic growth, while, above all else, sub-Saharan Africa needs to grow faster. They identify four reasons for Africa's slow growth: (1) low capital accumulation; (2) high price of investment goods for African investors; (3) low productivity of investment; and (4) geographical disadvantages. I will not summarise their discussion of these four problem areas but focus instead on the geographic fragmentation of sub-Saharan Africa to which they pay considerable attention. As they emphasise, this geographic fragmentation reduces substantially the prospects of creating growth by exploiting economies of scale. "Sub-Saharan Africa is fragmented into 48 small economies with a medium size of GDP of 3 billion dollars. A large number of these countries are landlocked, hosting 40 percent of sub-Saharan

Africa's population," say Ndulu, Kritzinger-van Niekerk and Reinikka. The consequences of this fragmentation include higher costs of production and trade (within and with the rest of the world), disadvantages of fragmented markets and negative effects of ethnic fragmentation partly accentuated by the sovereign fragmentation.

Having reviewed geographical disadvantages as constraints to growth in African countries, Ndulu, Kritzinger-van Niekerk and Reinikka see the improvement of infrastructure as a key challenge for sub-Saharan Africa. The authors emphasise that infrastructure is not just about supporting growth and trade, it is also about poverty reduction through lowering the cost of access to quality social services. "In this broader sense, the question is not about choosing between infrastructure and other social sectors, but on investing in infrastructure for better social outcomes."

The authors also discuss the importance of regional cooperation and integration. "Regional integration helps growth and infrastructure and vice versa. It is possible to meet Africa's geographical disadvantages and address the financing needs by focusing on regional solutions," they say.

Charles Abuka (Chapter 10) agrees with Ndulu, Kritzinger-van Niekerk and Reinikka that problems with roads, rail, ports, air transport, energy, telecommunications and other infrastructure are one of the chief constraints to economic growth in Africa. He gives as an example that as much as 50 percent of the harvest is lost in many parts of Africa because farmers lack post-harvest storage and are unable to get their goods to the market. Sufficient and reliable electrical power is another infrastructural facility needed to move rapidly into resource based manufacturing and commodity processing as well as trade in services. Africa has the lowest electrification in the world, observes Abuka. Only 23 percent of Africa's population has access to electricity. Yet another infrastructural facility that is still highly inadequate is information and communications technologies. Apart from encouraging developments in Botswana, Mauritius, Namibia and South Africa, the African region lags seriously behind others in the use of modern information technology. The limited use of information technology is caused by inadequate, inefficient and very expensive telecommunications services.

Abuka observes that trade has been a key driver of economic growth over the last 50 years for the rich western countries and for some developing countries, particularly in Asia. Asian countries have used trade to break into new markets and change the face of their economies. But this has not been the case for African countries. The last three decades they have stagnated, resulting in a collapse of their share of world trade from 6 percent in 1980 to about 2 percent in 2002. Dynamic and competitive regions have made major shifts into manufacturing. Again, Africa has been left behind and the task of catching up is harder.

Abuka stresses that Africa needs urgent, sustained, coherent and large-scale investment in transport and ICT systems, standardisation of cross-border procedures, and establishment and strengthening of institutions to improve the functioning of markets and expedite the flow of goods. Increasing the volume of trade by producing enough goods, with the right quality and at the right price, will enable African countries to penetrate new markets and to grow at 7 percent by the end of the decade and sustaining it thereafter. Africa must overcome obstacles of discouraging the investment environment to release her entrepreneurial energies. Abuka concludes that the development of adequate infrastructure in Africa is a critical issue and that regional integration could play a vital role in tackling problems that are common to a number of African states.

The Challenges of Regional Integration

The challenges of regional integration are the exclusive theme of the chapter by Mothae Maruping (Chapter 11). Maruping focuses on the achievements, lessons, challenges and the way forward for one of the key components of regional integration process, which is macroeconomic convergence. Reviewing the "dreams and realities" of the various regional integration efforts in Africa, he observes that results have not met expectations. "In spite of the existence of the above African blocs, that have secretariats and regular technical and ministerial level meetings and summits of heads of state and government, African integration efforts have had limited impact so far. Perhaps because reality on the ground does not match ideals in treaties, protocols and MOUs. The degree of integration remains highly superficial."

Responding to the lessons learnt, Maruping suggests a number of challenges and opportunities. The first is to eradicate costly duplication of multiple memberships and rationalise some overlapping sub-regional blocs. The second is to secure commitment beyond political rhetoric amongst member countries of the various sub-regional blocs to the implementation of treaties and protocols. The third is to strengthen technical capacity for conducting informative cost-benefit analysis and ensure fair and equitable sharing of the costs and benefits of integration.

The fourth is to provide the necessary financial and technical resources, in part through international, regional and national private sector involvement at all stages of integration. The fifth is the development, harmonisation and integration of national and regional financial markets, including elimination of barriers and reducing risks affecting the free movement of labour and capital, e.g. cross-border and foreign direct investment. The sixth is the effective pooling of resources and expertise to tackle cross-cutting regional challenges, such as infrastructure, governance, gender, HIV/AIDS, peace, security and conflict prevention. The seventh is to strengthen and empower the institutions that implement and monitor regional integration programmes both at the regional and country levels. The eighth is to apply variable geometry and variable speed that accommodates the effects of different circumstances confronting member states and sectors, which is a pragmatic approach that has worked well for the European Union.

Indeed, the list is almost endless, and clearly inspired by Europe's experience with integration efforts.

Maruping concludes that regional integration remains a critical part of Africa's development strategy. In his view, the era of isolated tiny national economies has to give way to strategic alliances that permit to benefit fully from the advantages of regional integration. Such efforts will only be successful, he emphasises, if there is "greater resolve, speed and effectiveness in translating the good intentions into concrete, implementable, monitorable and results-oriented actions on the ground."

Zdeněk Drábek (Chapter 12) wonders whether policymakers in sub-Saharan Africa are enough aware of the factors that inhibit successful macroeconomic convergence. He sees three inhibiting factors. The first is the presence of serious distortions in product and factor markets, or policies that do not allow those markets to operate efficiently. The second is that countries are likely to have different costs of adjustment, and the question will be how these costs will be financed and by whom. The third is that different speeds lead to different costs of adjustment. Drábek also raises the question of whether policymakers in sub-Saharan Africa can start macroeconomic convergence before opening up their markets and what kind of domestic trade regimes they should adopt. "Should convergence target the regional countries even though most of Africa's trade and financial relations are primarily with the rest of the world? Should a country open its capital accounts and what are the implications for the conduct of exchange rate policies since macroeconomic conditions differ among countries in sub-Saharan Africa?"

Drábek thinks that the main objective for African policymakers should not be to achieve macroeconomic convergence, but to ensure that they provide for a macroeconomic environment that is conducive to a stable trade policy and sustainable balance of payments. "This is somewhat different from thinking about macroeconomic convergence, which could be excessively costly under present circumstances."

Here we see a cautious Czech economist, Zdeněk Drábek, who has been involved in getting his country into the EU (see Drábek's bio in the Notes on Contributors), warning an African colleague (Maruping has been governor of a central bank) about the danger of being too ambitious in efforts at regional integration.

International Challenges: Trade and Finance

The five last chapters of the book (chapters 13 to 17) discuss the international constraints and challenges to African development. Four of the five authors deal with the economic constraints and challenges at the global level, while one (Stephen Gelb) deals with the challenges posed by South-South investment. In this section, I will highlight a few of the many insights they present in this last part of the book. In a final section, I will draw conclusions about the development challenges that Africans and the international community are facing. I will do so by returning to the ideas and proposals put forward in the chapters by Culpeper, and Woo, Sachs and McCord.

Kamran Kousari (Chapter 13) extensively analyses the constraints that sub-Saharan Africa faces in the international trade arena. Drawing on a series of UNCTAD studies on African development, Kousari observes that African countries remain dependent on the export of commodities such as coffee and cocoa for their foreign exchange earnings. Commodity exports account for some 80 percent of Africa's total export receipts. The decline in the prices of commodities since the early 1980s has been a major factor in the poor economic performance of African countries between 1980 and 2000, stresses Kousari. Had prices not declined, investment ratios in non-oil exporting countries would have been 6 percentage points higher per annum, and per capita GDP would have been 50 percent higher at the end of the decade.

International commodity policy has not been helpful, says Kousari. In fact, after the slowdown in the world economy in the 1980s, the international community abandoned any attempts at price stabilisation. Instead, reliance on market forces became the order of the day and adjustment programmes called for the dismantling of state institutions responsible for the marketing of commodities and providing extension and other services to farmers. The fruits of liberalisation in Africa have not been reaped by the farmers but by a few firms in rich countries that are now controlling the purchase, processing and distribution of major agricultural export products.

In the case of fuels and minerals exports, African countries have not fared much better. In an effort to revive the extractive sector in Africa, policy advice by the World Bank called for privatisation and liberalisation of the sector and the provision of incentives in order to attract foreign capital. African countries undertook wide-ranging reforms of their mining codes, including the provision of generous tax incentives, which contributed to the recovery of investment to the sector and put the region in third place behind Latin America and Oceania. However, Africa has reaped little benefits of this investment. In Tanzania, for example, where gold exports have risen from less than 1 percent of export revenues in the late 1990s to over 40 percent in 2003, six major mining companies earned about $890 million in five years, out of which the government received less than 10 percent in revenues (taxes) and royalties.

In Kousari's view, international trade policy and policy advice by institutions like the World Bank vis-à-vis Africa need a fundamental overhaul. African countries should be allowed to engage in strategic industrial policies involving selective liberalisation and differentiated tariff structures, duty drawback schemes as well as fiscal, credit and other incentives to exporters. In international trade negotiations, African countries should be granted sufficient flexibility to enlarge their policy space to accommodate those policies that respond to their own domestic development agendas.

Vivek Arora (Chapter 14), who is with the IMF, agrees with Kousari that discretionary tax incentives to foreign mining firms outweigh any benefits that they might have since the foreign firms may have come in anyway. "In addition, these discretionary tax incentives distort the playing field in favour of foreign firms and against domestic firms. … A level playing field would be better." Arora disagrees, however, that trade liberalisation has harmed poor African countries. In his view, it has contributed to higher growth and higher per capita income.

Arora agrees with Kousari's emphasis on the need for doubling aid to Africa in order to give Africa a major boost in financing for development and that such financing should include a reduction of the debt overhang. However, he disagrees with Kousari and other critics of IMF policy conditionality. Conditionality can be improved, says Arora, by streamlining it, giving greater ownership to African countries and so on, but it should not be abandoned. The IMF should try to make conditionality more effective.

Matthew Martin (Chapter 17) retorts that IMF's streamlining (cutting back) of conditionality should be done much more dramatically than usually considered. Moreover, emphasises Martin, "Africans need to design their own systems for a self-monitoring peer review of policy quality and not rely on external assessments of what is good economic policy".

Adam Elhiraika (Chapter 15) stresses that it is essential that Africa diversifies its exports and gets better access to rich countries' markets through reduction of tariffs and other barriers, and through special and differential treatment. But he warns about having too high hopes of African countries becoming global economic players. An integrated continental market would offer better hopes for Africa to build its manufacturing sector and diversify its economy away from primary products, says Elhiraika. This requires removing trade barriers within the continent and a strengthening of regional infrastructure.

Matthew Martin observes that analysts often make simplistic assumptions (hold cliché beliefs, one might also say) that freer trade would benefit Africa along with other countries. But, if all the barriers and subsidies (in Europe and the United States) went away, would Africa be the one to benefit? No, says Martin, because Africa would still produce a narrow range of primary commodities, and have problems with processing, market information, complying with developed country or purchaser standards, and infrastructure. In other words, it would lack capacity to trade. So the international community needs to continue special arrangements for the poorest countries while they develop the capacity to trade.

Another simplifying assumption often made, says Martin, is that the benefits from trade will get to the poorest people in developing countries. This is highly unlikely as long as there are unfair trade arrangements within countries (such as monopolies, monopsonies, and inability of poor producers to access markets).

Martin stresses that the international community should get rid of all the problems it is causing by reducing barriers and protectionism, subsidies and dumping. However, if it cares about African development it should also invest massively in enhancing African capacity to trade, ensure maintenance of special arrangements for the poorest countries, and reform international and national production and marketing structures to ensure that the benefits from trade really reach the poor.

Martin criticises current aid practices arguing that they result in insufficient aid for public investment to grow and reach the MDGs, that they are of poor quality and low effectiveness, and that the global aid architecture is thoroughly inadequate. He emphasises that the international community should double aid to Africa (from 25 billion to 50 billion dollars) immediately, and not gradually over the next five years.

As far as private flows are concerned, Martin stresses that the international community should encourage greater foreign flows, but not treat them as a panacea. "Often people talk as if more FDI could solve Africa's development problems. Yet many other regions, and indeed Africa, have suffered foreign exchange crises as a result of private inflows turning themselves into outflows. So we need to encourage not just quantity but above all higher quality flows, with less debt and more equity, more stability and less volatility, better risk assessment to reduce the very high returns demanded by countries, and investment in underinvested sectors and regions. Africa and its international partners need to tailor and target the types of investment, encourage public infrastructure investment to facilitate private flows (though avoiding high-cost public-private partnerships)."

Martin says that the international community should also enforce anti-corruption conventions, track capital flight and money laundering, repatriate stolen funds, and encourage inward remittances.

Stephen Gelb (Chapter 16) reports that over the last 10 years there has been a very rapid increase in South-South foreign direct investment (FDI). "South-South" flows rose from $4.6 billion in 1994 to an average of $54.4 billion between 1997 and 2000, equivalent to 36 percent of total FDI inflows to developing economies in the latter period. FDI flows into Africa from other developing countries have increased as part of this broader trend, with two major sources: Asia and South Africa.

Since the mid-1990s there has been a massive increase in investment from China, India and Taiwan into sub-Saharan Africa. Companies from these countries invest in a range of sectors, both services (IT, banking) as well as manufacturing, including automotive, steel and pharmaceuticals. The second major source of South-South investment into the rest of Africa is South Africa itself. Since the advent of democracy in 1994, there has been a very rapid movement of South

African firms throughout the continent.

What does this entry of foreign investors from other developing countries mean for Africa's economic development? Do South-South investments differ from North-South investments, and if so, how? In order to answer these questions Gelb makes a distinction between market-seeking and resource-seeking foreign investment. Although research is still lacking to give any definitive answers, Gelb believes that market-seeking FDI is likely to increase the scope and quality of goods and services that are available to domestic firms and households, while resource-seeking investment (especially producers seeking cheap labour) is more likely to have some impact on employment promotion and exports.

Gelb points to an interesting positive effect of FDI that is often overlooked: the immigration of Asian entrepreneurs into Africa. Indeed, this relates to the issue raised by Percy Mistry in his critical article about the MDGs. Gelb reports, "Asian firms tend to use large numbers of expatriate managers and supervisors in their foreign investments, and these individuals often leave their employers to set up their own firms in the economies where they find themselves. The greater prospects offered abroad are an incentive for aspiring entrepreneurs from China, Taiwan or India to move from their home countries, where their opportunities are more limited."

This observation by Gelb reminds me of what Percy Mistry once told me when we were discussing policy-led and market-led regional integration in Europe and South-East Asia respectively: "Don't forget that the overseas Chinese community has been a driving force in the market-led integration of Asia."

Another important advantage of South-South resource-seeking investments that Gelb mentions is that they embody business models that are less corporatised and more informal than western models, and are often more appropriate to the host country context. Also, such investments can provide individual governments in Africa with greater bargaining power in their relations with multinational corporations from industrial countries and foreign investors more generally, precisely because it diversifies the host countries' options, and so gives their governments more bargaining power.

Whether the beneficial effects of Southern FDI are in fact achieved has not been empirically demonstrated, says Gelb. His institute (The EDGE Institute) will collect firm-level data in South Africa, India, Kenya, Tanzania and Uganda to assess the development impact in both host and home economies of FDI flows.

From Poverty to Development

The chapter by Woo, Sachs and McCord (Chapter 2) summarises the fallacies of the Washington Consensus that Woo has identified in his contribution to a previous FONDAD book, *Diversity in Development: Reconsidering the Washington Consensus* (2004). In that same book, I suggest in my introduction that officials of governments and international financial institutions may tend not to consider the arguments and proposals of critical observers (from both within and outside their institutions) seriously enough, because they know it is often not the quality of the ideas that count, but whether they serve certain interests. This is another simple notion or cliché which unfortunately turns out all too often to be true – but not always and not by definition. And, of course, there is no reason to consider good but "unviable" ideas as less important.

Many of the ideas presented in this book run the risk of not being adopted, or much later than suggested. For example, I am afraid that Roy Culpeper's suggestion in Chapter 5 that inequality is an issue that needs to be addressed urgently if one really wishes to reduce poverty in the world has little chance to be adopted widely and soon. Chances are higher that the processes and interests that create and maintain inequality will be prolonged. Nonetheless, Culpeper's arguments sound convincing, at least to me. Commenting on Woo *et al.*'s chapter, Culpeper says that health and education investments in developing countries will certainly improve the current circumstances of the poor and the outlook for their children, but will hardly change existing inequalities. Those will only change if one goes beyond health and education to consider real assets. "In a poor country context," says Culpeper, "one has to consider things such as land reform and land redistribution. This is where the fuse starts to get a little bit short and people start really to get nervous, because these are intensely sensitive political and social issues. And yet, they are issues that we have ignored at our peril if indeed our objective is to have an impact on the poorest quintiles of society."

As far as income distribution is concerned, Culpeper believes that one has to look at strategies that have an impact in the productive sector. Referring to some of the discussion in Woo *et al.*'s chapter on the rural economy, Culpeper observes that the strategy of East Asian countries was one of protection of the agricultural sector, which in many ways persists to this day. The protection of the agricultural sector led to price and income configurations that benefited the rural poor and rural workers directly – and the cost of redistribution was borne by society as a whole. However, the policy advice given to developing countries today is completely at odds with the East Asian experience, says Culpeper. "They are faced with the prospect that, if the North abolishes its agricultural subsidies, then the South also has to open its markets to agricultural imports. Such propositions completely neglect the adverse impact those kinds of liberalisation policies in the South will have on the rural poor and in the agricultural sector."

In Culpeper's view, the MDGs also pay too little attention to poverty in the urban economy. "Again, the MDGs as they are currently articulated, say hardly anything about the need for decent employment. Employment in the productive sector is surely the pathway out of poverty for the poorest urban dwellers, and yet this is understated in the MDGs and in strategies related to the MDGs."

Finally, Culpeper argues that tax policy has an important role to play. He observes that the current tax systems in developing countries are too often regressive, relying as they do on sales and consumption taxes, and not enough on progressive income taxes. "It seems to be the rule rather than the exception that in so many developing countries elites do not pay taxes or very little tax, which indicates a very regressive distributional policy. A more progressive tax policy, on the other hand, is difficult to design and implement. Income taxes are administratively beyond the current reach of many poor countries." Moreover, income taxes will receive fierce opposition by powerful groups in developing countries, says Culpeper.

While Culpeper thinks that the proposals by Woo *et al.* do not go far enough, it is likely that those in power in rich and poor countries and in international financial institutions such as the IMF and World Bank will consider some of the criticism and policy proposals of Woo *et al.* as too radical. For example, they will have difficulty with the blunt statement by Woo *et al.* that the fallacies of the Washington Consensus apply fully to the African case and that the improved second-generation Washington Consensus (which recognises that not only prices but also institutions are important) "is still woefully incomplete in its prescriptions for the African countries".

However, it will be difficult for the policymakers to dismiss the plea by Woo and his colleagues for moving Africa out of the poverty trap. Woo, Sachs and McCord echo the UN Millennium Project's core operational recommendation, which is that each developing country with extreme poverty should adopt and implement a national development strategy that is ambitious enough to achieve the MDGs. The authors stress that the country's international development partners – including bilateral donors, UN agencies, regional development banks, and the Bretton Woods institutions – should give all the technical and financial support needed to implement the country's strategy. It seems to me that policymakers cannot disagree with this recommendation as they themselves lay emphasis on the importance of "country ownership" of policies to be pursued.

In the case of Africa, the adoption of policy proposals by Woo, Sachs and McCord, as well as those made by Culpeper and other contributors in this book, will certainly help to achieve the goal of Africa moving more rapidly and effectively from poverty to development.

At the same time, as deputy governor X.P. Guma of South African Reserve Bank observed prior to the publication of this book, "the issues discussed in this book are of great relevance to the development prospects, not only of the African region, but of poor countries in general."

Part I

The Development Paradigm for Africa

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

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Understanding African Poverty: Beyond the Washington Consensus to the Millennium Development Goals Approach

Gordon McCord, Jeffrey D. Sachs and Wing Thye Woo[1]

1 The Misperceptions About African Poverty

The era of structural adjustment, which can be dated approximately to the last two decades of the twentieth century, was a failure for African economic development. Africa was the only major developing country region with negative per capita growth during 1980 to 2000; its health conditions are by far the worst on the planet; its soaring population is exacerbating ecological stresses; and despite the policy-based development lending of structural adjustment, it remains mired in poverty and debt.

What went wrong? In the extreme interpretation of the Washington Consensus by its proponents, as well as by its critics, its unambiguous promise is that if a developing country were to implement conservative macroeconomic policies while expanding the role of the private market at the expense of the state, then it would achieve sustained high growth rates on its own. By extension, if a developing country is failing to grow, the problem must be either macroeconomic mismanagement or a hindering of the private market expansion in the country, usually attributed to corruption or more broadly "bad governance".

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[1] Paper presented at the conference "Africa in the Global Economy: External Constraints, Regional Integration, and the Role of the State in Development and Finance" organised by FONDAD, held at the South African Reserve Bank, Pretoria, 13-14 June 2005. We are grateful to Yonghyup Oh, Andrés Solimano, and Jan Joost Teunissen for insightful comments that clarified our thinking.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

This first assumption – that Africa is suffering from a governance crisis – is unsatisfactory. Poorer countries systematically have poorer governance measures than richer countries, since good governance itself requires real resources. Regression analysis in Table 1 shows that Africa's governance, on average, is no worse than elsewhere after controlling for income levels. Using four different widely accepted measures of quality of governance, we estimate the effect of being a tropical African country after controlling for income, and find that for all four indicators, poor governance among developing countries is associated with having low income, and not with the Africa dummy.

This finding is not surprising, since – despite much rhetoric to the contrary – it is quite intuitive that good governance requires resources. For example, low-income country governments frequently need to raise civil service pay scales to make them comparable to the salaries offered by the private sector, international agencies, and development partners. Higher pay is needed to attract and retain highly qualified public sector workers and to reduce the incentives for corruption and moonlighting. Yet impoverished countries lack adequate domestic resources to meet such challenges. In addition, governments require resources to make necessary investments in the physical infrastructure of the public administration to improve service delivery and reduce opportunities for corruption. Some examples include:

- Communication and information infrastructure for all levels of government, including computer and telecommunications services for government offices, public hospitals, land registries, schools, and other public institutions.
- Information systems to improve the speed, reliability, and accountability of public sector transactions and systems to share information across branches of government. India, for example, is working to put all land deeds into a national database, which citizens can gain access to from anywhere in the country. This will eliminate the need for citizens to travel in order to request a copy of the deed to use as collateral in a loan.
- Modern technological capabilities for the customs bureau, to speed shipments, reduce smuggling, and control cross-border movements of illegal or dangerous goods.
- Modern technological capabilities for law enforcement, including national criminal databases, information systems to reduce response times, and adequate dissemination of information to local law enforcement.

Table 1 Governance Quality and Income[a]

Independent Variable	*Dependent Variable*			
	Corruption Perceptions Index, 2003[b]	Index of Economic Freedom, 2001[c]	Average Kaufmann *et al.* indicators, 2000[d]	Average ICRG indicators, 1982-1997[e]
Log (GDP pc PPP 2001)	**1.05**	**-0.48**	**0.40**	**0.45**
	(5.31)	***(-4.75)***	***(5.20)***	***(4.00)***
Dummy variable for tropical sub-Saharan Africa[f]	0.58	-0.27	-0.05	0.15
	(1.57)	*(-1.58)*	*(-0.33)*	*(0.71)*
R-squared	0.40	0.27	0.42	0.29
N	67	82	92	73

Notes:
[a] The sample consists of ninety-two countries worldwide, excluding high-income countries and former republics of the Soviet Union. All regressions are ordinary least squares and include a constant term (not reported). Numbers in parentheses are *t*-statistics; coefficients within statistical significance at the 5 percent level are in bold.
[b] From Transparency International, this index relates to the degree of corruption in the country as perceived by business people, academics, and risk analysts and ranges between 10 (highly clean) and 0 (highly corrupt).
[c] The index is published by the Heritage Foundation and the Wall Street Journal and ranges from 1 to 5, where 5 indicates the greatest government interference in the economy and the least economic freedom.
[d] Average of six World Bank governance indicators measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes.
[e] Average of six governance indicators from the PRS International Country Risk Guide, with values ranging from 1 to 6, with higher values reflecting better governance.
[f] Refers to sample of 33 countries defined in Sachs *et al.* (2004).

Source:
Authors' regressions using data from Kaufmann *et al.* (2002); PRS Group (2004), Kaufmann *et al.* (2003), Miles *et al.* (2004), Transparency International (2004).

- Electronic government procurement and logistical systems, for example, to ensure reliable access to essential medicines in government clinics and hospitals.

A second common assumption – that Africa grows slowly because of its poor governance – also rings hollow. Many parts of Africa are well governed, and yet remain trapped in poverty. Governance is a problem, but Africa's development challenges are much deeper. Even after controlling for governance (again using several different measures of governance quality), sub-Saharan African countries grew more slowly

Table 2 Governance and Africa's Economic Growth[a]

Independent Variables	(I)	(II)	(III)	(IV)	(V)
Tropical Sub-Saharan Africa Dummy[b]	-3.28	-3.06	-2.68	-3.43	-3.40
	(-6.56)	(-6.50)	(-6.11)	(-7.05)	(-6.46)
Corruption Perception Index 2003,	0.83				
Transparency International[c]	(5.23)				
2001 Index of Economic Freedom[d]		-0.96			
		(-2.75)			
2000 Average Kaufman, Kraay,			1.89		
Zoido-Lobaton indicators[e]			(5.91)		
1982-1997 Average ICRG Indicators[f]				1.56	
				(5.29)	
1982 Average ICRG Indicators[f]					0.68
					(3.78)
Log (GDP p.c. PPP in 1980)	-2.07	-1.65	-1.75	-2.00	-1.82
	(-7.02)	(-6.06)	(-7.07)	(-7.01)	(-5.84)
R-squared	0.58	0.46	0.59	0.59	0.54
N	60	71	78	65	52

Notes:
[a] The dependent variable is average annual growth of GDP per capita, 1980-2000. The sample consists of 92 countries worldwide, excluding high-income countries and former republics of the Soviet Union. All regressions are ordinary least squares and include a constant term (not reported). Numbers in parentheses are *t*-statistics; all coefficients reach statistical significance at the 1 percent level.
[b] Refers to sample of 33 countries defined in Sachs *et al.* (2004).
[c] From Transparency International; this index relates to the degree of corruption in the country as perceived by business people, academics, and risk analysts and ranges between 10 (highly clean) and 0 (highly corrupt).
[d] The index is published by the Heritage Foundation and the Wall Street Journal and ranges from 1 to 5, where 5 indicates the greatest government interference in the economy and the least economic freedom.
[e] Average of six World Bank governance indicators measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes.
[f] Average of six governance indicators from the PRS International Country Risk Guide, with values ranging from 1 to 6, with higher values reflecting better governance.
Source:
Sachs *et al.* (2004). Regressions use data from Kaufmann *et al.* (2002), Miles *et al.* (2004), PRS Group (2004), Transparency International (2004).

than other developing countries, by around 3 percentage points per year, as shown by the regression analysis in Table 2. Africa's crisis requires a deeper explanation than governance alone.

Our explanation is that tropical Africa, even in well-governed parts, is stuck in a *poverty trap*, too poor to achieve robust, high levels of economic growth (and in many places, simply too poor to grow at all). More policy or governance reform, by itself, is not sufficient to overcome this trap. The fallacies of the Washington Consensus detailed in Woo (2004) certainly apply to the African case:

- While the expansion of the analytical sphere of the Washington Consensus from just merely "get your prices right" to include "get your institutions right" is a quantum improvement in its understanding of the growth process, this second-generation Washington Consensus is still woefully incomplete in its prescriptions for the African countries. For example, the Washington Consensus preaches "free trade regimes" while the successful East Asian growth experience featured extensive import tariffs and export subsidies.
- The Washington Consensus tends to deny the state its role in providing an important range of public goods, and does not acknowledge the importance of these public goods before "self-help" can work in Africa. The Washington Consensus is guilty of linear thinking on the complex growth phenomenon where certain prerequisites must be met before sustained growth is ensured.
- The Washington Consensus does not understand that the ultimate engine of growth in a predominantly private market economy is technological innovation, and that the state can play a role in facilitating this innovation.
- The Washington Consensus does not recognise the constraints that geography and ecology could set on the growth potential of a country. Having malaria and being landlocked seriously hamper foreign investment, regardless of the quality of governance.

A better explanation of Africa's poverty trap would move beyond the limitations of the Washington Consensus to recognise that *before* privatisation and market liberalisation can unleash private sector-led economic growth in Africa, a massive amount of public investment in health, education, and infrastructure is required, which African countries cannot afford. Africa's poverty trap is the outcome of a complex web of many interactive factors, including structural conditions and socio-political history:[2]

- Very high transport costs and small markets;
- Low-productivity agriculture;
- Very high disease burden;
- A legacy of adverse geopolitics;
- Very slow diffusion of technology from abroad.

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[2] See Sachs *et al.* (2004) for a formal model of some mechanisms that can create a poverty trap, i.e. the bad equilibrium in a multiple equilibrium world.

High Transport Costs and Small Markets

To a remarkable extent, Africans live in the interior of the continent and face enormous transport costs in shipping goods from coastal ports to where they live and work. These costs are much higher than in Asia. Moreover, the Sahara effectively cuts off sub-Saharan Africa from high-volume overland trade with Europe, its major high-income trading partner, adding to the high costs of transport. Problems of isolation are compounded by small market size. High-intensity modern trade in Africa can only get started with an extensive road system, which is expensive to build and maintain.

Low-Productivity Agriculture

Most Africans live in the sub-humid or arid tropics, with few rivers to provide irrigation and a lack of the large alluvial plains, typical in much of South and East Asia, which permit cheap irrigation. As a result, Africa has the lowest share of food crops produced on irrigated land of any major region of the developing world. African agriculture also suffers from high transport cost of fertiliser, erratic rainfall, high rates of evapo-transpiration due to high temperatures, and a secular decline in rainfall across the continent during the past 30 years, perhaps linked to long-term climate change. Finally, the new seed varieties that sparked the Green Revolution in Asia and Latin America are poorly suited to African farming conditions.

Very High Disease Burden

Africa carries a disease burden unique in the world. In recent years, the most prominent disease has been HIV/AIDS, wreaking economic and social catastrophe throughout the region. The spread of HIV is fueling an epidemic of TB, which takes its heaviest toll among young productive adults. In some high HIV prevalence African countries, TB infection rates have quadrupled since the mid-1980s, placing overwhelming burdens on existing TB control programmes. Africa is also home to numerous endemic tropical diseases, especially vector-borne diseases. Among these, malaria is by far the most consequential. Of the more than 1 million malaria-related deaths every year, it is estimated that 90 percent occur in sub-Saharan Africa, the great majority of them among young children.

A Legacy of Adverse Geopolitics

On top of the structural challenges, Africa has suffered brutally at the hands of European powers for almost five centuries, and the record with Arab powers has been little better. A massive slave trade helped undermine state formation and may have depopulated Africa's coastal regions. In the nineteenth century, the slave trade was replaced by direct colonial rule and a century of exploitation by European imperial powers, who left very little behind in education, healthcare, and physical infrastructure. Adding to the burden, during the Cold War politics of the late twentieth century, many African countries found themselves to be battlegrounds in a global ideological struggle.

Very Slow Diffusion of Technology from Abroad

Africa has been the great laggard in technological advance, notably in agriculture and health. The uptake of technologies to prevent and treat major diseases, such as malaria, has been extremely slow. In agriculture, most of the developing world had a Green Revolution surge in crop yields in the 1970s–90s as a result of scientific breeding that produced "high-yielding varieties" combined with increased use of fertilisers and irrigation. The absence of a Green Revolution in Africa had a clear impact. Sub-Saharan Africa has the lowest cereal yield per hectare of any major region and the only major region with a (slight) decline in food production per capita during 1980–2000.

Africa's extreme poverty leads to low national saving rates, which in turn lead to low or negative economic growth rates. Low domestic saving is not offset by high inflows of private foreign capital, for example foreign direct investment, since Africa's poor infrastructure and weak human capital discourage private capital inflows. With very low domestic saving and low rates of market-based foreign capital inflows, there is little in Africa's current dynamics that promotes an escape from poverty. Something new is needed.

2 The Way Out of the Poverty Trap in Africa: MDG-Focused Investments

Sachs *et al.* (2004) and the United Nations Millennium Project (2005), an independent advisory project to Secretary-General Kofi Annan, argue that what is needed is a "big push" in public investments to produce a large "step" increase in Africa's underlying productivity, both rural and urban. Foreign donors will be critical to achieving this substantial "step" increase. In particular, well-governed African countries should be offered a big expansion in official development assistance (ODA) to enable them to achieve the Millennium Development Goals (MDGs), the internationally agreed targets for poverty reduction by the year 2015. The MDGs are useful intermediate targets in the process of helping Africa to break out of its poverty trap because they address the key areas in which major productivity improvements are both needed and achievable. We note with regret that the rich countries have repeatedly committed themselves to help Africa achieve these goals, with more funding if necessary, but some of them have yet to deliver fully on that promise.

The UN Millennium Project's reports identify how a big push in key investments in social services, basic infrastructure, and environmental management could enable Africa to meet the MDGs, and how that, in turn, would help to extricate Africa from the current development trap. This will require a comprehensive strategy for public investment in conjunction with improved governance. The Project has laid out an investment strategy focusing on *interventions* – defined broadly as the provision of goods, services and infrastructure – grouped into nine intervention areas:

- Rural Development;
- Urban Development;
- Health;
- Education;
- Human Resources;
- Gender Equality;
- Science, Technology and Innovation;
- Regional Integration Priorities; and
- Public Sector Management Priorities.

Rural Development

The first investment area focuses on raising rural productivity, since three quarters of Africa's poor live in rural areas. In particular, the investments in farm productivity will increase rural incomes and reduce chronic hunger, predominantly caused by insufficient agricultural productivity. A Twenty-First Century African Green Revolution is needed, and feasible, to help launch an environmentally sound doubling or more of agricultural productivity. Additional interventions in roads, transport services, electricity, cooking fuels, water supply, and sanitation all provide a basis for higher productive efficiency.

Urban Development

Throughout sub-Saharan Africa, the large cities do not have internationally competitive manufacturing or service-based industries. To generate such industries, an MDG-based urban strategy needs to focus on urban infrastructure and services (electricity, transport, water, sanitation, waste disposal, and so forth) and slum upgrading to attract foreign investment. Of course, the success of urban development and the establishment of viable export industries across Africa are contingent on improving access to rich countries' markets, particularly for apparel and light manufacturing, and the flexibility to use targeted industrial policies as needed. As populations are growing very rapidly across the continent, African countries must develop mutually reinforcing investment and urban development strategies that maximise job creation and prevent slum formation.

Health

Investments are needed to address Africa's extraordinary disease burden, widespread micronutrient deficiencies, and extremely high fertility rates by focusing on health, nutrition, and family planning. This package includes health-system based interventions to improve child health and maternal health; prevent the transmission of and provide treatment for HIV/AIDS, TB, and malaria; improve nutrition; and provide reproductive health services. Halting the AIDS, malaria, and TB epidemics is of enormous importance.

Education

MDG-based strategies in Africa should aim for universal completion of primary education, and increased access to secondary and tertiary education. In designing this package of interventions, particular attention needs to be paid to increasing girls' completion rates through additional demand-side interventions, such as incentive payments to poor households to encourage them to keep their daughters in school.

Human Resources

To achieve the MDGs in Africa, significant investments in human resource development are needed urgently, since health, education, agricultural extension, and other critical social services cannot function without cadres of properly trained staff. Given the need to reach rural and often remote areas, we put great stress on scaling up the training of vast numbers of community workers in health, agriculture, and infrastructure, with training programmes that are one-year long. This process of scaled-up community-based training should start right away.

Gender Equality

As indicated above, all MDG-based investment programmes for Africa should pay particular attention to promoting gender equality, both as a goal in itself and as a crucial input to achieving all the other Goals. This includes ensuring full access to reproductive health rights and services, as well as guaranteeing equal property rights and access to work, backed by affirmative action to increase political representation. Of particular concern in many parts of sub-Saharan Africa are persistently high levels of violence against women and girls, which need to be confronted with public awareness, legislative and administrative changes, and strong enforcement.

Science, Technology, and Innovation

An essential priority for African economic development is to mobilise science and technology. Tropical sub-Saharan Africa produces roughly a twentieth of the average patents per capita in the rest of the developing world. And it has only 18 scientists and engineers per million population compared with 69 in South Asia, 76 in the Middle East, 273 in Latin America, and 903 in East Asia. We stress the need for increased investments in science, higher education, and research and development targeted at Africa's specific ecological challenges (food, disease, nutrition, construction, energy).

Regional Integration Priorities

Regional integration is essential for Africa. It will raise the interest of potential foreign investors by increasing the scope of the market. It is also important in achieving scale economies in infrastructure networks, such as electricity grids, large-scale electricity generation, road transport, railroads, and telecommunications – and in eliciting increased R&D on problems specific to Africa's ecology but extending beyond any single country (e.g. public health, energy systems, and agriculture). Regional programmes, such as those advanced by the New Partnership for Africa's Development (NEPAD), thus require greatly increased support.

Public Sector Management Priorities

Although governance in Africa is not systematically worse than that in other countries after controlling for income, many of the government systems are still weak on an absolute scale and require significant investments in public administration. Information management systems and investments in the training of public sector managers will undoubtedly be crucial. Addressing this issue should be closely linked to reversing and treating the AIDS pandemic, which is taking the lives of hundreds of thousands of civil servants throughout the continent.

3 Implementing the MDG Strategy: National-Level Processes for Scaling-Up

To be aligned with the MDGs, the full intervention package must be converted into a country-level investment plan, one that works backward from the outcome targets to identify the infrastructure, human and financial resources needed to meet the targets – this methodology is hence dubbed a "needs assessment" approach to the MDGs. The UN Millennium Project estimates the costs of the interventions for three African countries – Ghana, Tanzania, and Uganda – chosen for their high levels of extreme poverty, insufficient progress towards achieving the MDGs, and good governance relative to their level of income; and concludes that the financial costs required to meet the MDGs to be around $110 per capita. Of the $110, around $40 could be financed through increased domestic resources (both public and private), leaving a remainder of $70 that would need to be funded through official development assistance. The overall results suggest that, in order to reach the MDGs, these countries will require average annual official development assistance (ODA) equivalent to at least 20 to 30 percent of GDP through to 2015.

The UN Millennium Project's core operational recommendation is that each developing country with extreme poverty should adopt and implement a national development strategy that is ambitious enough to achieve the MDGs. The country's international development partners – including bilateral donors, UN agencies, regional development banks, and the Bretton Woods institutions – should give all the technical and financial support needed to implement the country's strategy. In particular, official development assistance should be adequate to fill the financing needs, assuming that governance limitations are not the binding constraint, and assuming that the recipient countries are making their own reasonable efforts at domestic resource mobilisation. For many low-income countries, such a policy-design mechanism already exists that allows governments to design of a national strategy in collaboration with their development partners as well as with civil society and the private sector. This strategy is called the Poverty Reduction Strategy Paper (PRSP), which is the main country-level framework used jointly by the international development agencies and the national governments to focus their development efforts.

As the central country strategy document, however, poverty reduction strategies must be aligned with the Millennium Development Goals (in countries where the Goals are already within reach, "MDG-plus" targets can be set). So far, most national strategies have not been ambitious enough to meet the MDGs, and have instead planned around modest incremental expansions of social services and infrastructure, based on existing budgets and levels of donor aid. Instead, MDG-based poverty reduction strategies should present a bold, 10-year framework aimed at achieving the quantitative target set out in the MDGs. They should spell out a financial plan for making the necessary investments, then show what domestic resources can afford and how much will be needed from the donors. Although poverty reduction is primarily the responsibility of developing countries themselves, achieving the MDGs in the poorest countries – those that genuinely aspire to the MDG targets – will require significant increases in official development assistance to break the poverty trap. Importantly, the UN Millennium Project is not advocating new development processes or policy vehicles, only that the current processes be MDG-oriented.

The core challenge of the MDGs lies in financing and implementing the interventions at scale – for two reasons. One is the sheer range of interventions that should be sequenced and integrated to reach the Goals. The second is the need for national scaling up to bring essential

MDG-based investments to large proportions of the population by 2015. Scale-up needs to be carefully planned and overseen to ensure successful and sustainable implementation. The level of planning is much more complex than for any single project, and requires a working partnership between government, the private sector, NGOs and civil society. In the past, scaling up has been immensely successful when governments are committed to doing it, communities are encouraged to participate in the process and implementation, and long-term predictable financing has been available.

4 A New North-South Compact for Economic Development

A new framework for donor-African relations will be required to underpin the big investment push needed to meet the MDGs. The package of public investments proposed by the UN Millennium Project implies a significant increase in ODA transfers to Africa, perhaps a doubling or more. Donor-recipient mechanisms will be needed to translate large-scale aid flows into effective investments and poverty reduction. Where domestic governance is adequate (e.g. at or above the norm for countries at the given income level), aid processes should be guided by four core principles:

1. Policies should be aligned with the 2015 time horizon, with that MDG target date serving as the planning horizon for both recipient countries and donors;
2. The public investment programme needs to be guided by bottom-up assessments of *needs* rather than *ex ante* budget constraints set by the donors;
3. Donor assistance needs to be harmonised and coordinated around budget support, particularly in countries where governance structures are not the limiting factor to accelerate progress towards the MDGs (only approximately 27 percent of net bilateral ODA to sub-Saharan Africa took the form of budget support in 2002); and
4. Donor financing requires new notions of sustainability, including recognition that in some cases grant financing is the only way to pay for the investments and leave the recipient countries with viable public finances at the end of the process.

In practical terms, African governments could implement these guiding principles through a three-stage process. First, each country would convene a planning team comprised of government representative, key stakeholders, and technical advisors – the bilateral and multilateral donors, UN specialised agencies, and civil society leaders – to conduct an MDG needs assessment. In the second step, the needs assessment feeds into a ten-year public investment and human resource strategy. The third step is to construct the medium-term budget framework (e.g. for three to five years, as with the PRSP), which would finance the first three to five years of the 10-year investment strategy. Government-led coordination will be crucial not just for crafting plans but also for implementing them. As their part of the bargain, recipient governments will need to implement a clear and transparent system for monitoring and evaluating the implementation of plans, building in regular milestones to monitor progress, and checkpoints through which plans can be adjusted as necessary.

In developing an explicit MDG-based planning framework, increased ODA inflows will raise a number of structural macroeconomic issues. Countries must maintain their efforts to mobilise domestic revenue and foster domestic savings and investment in order to support long-term economic growth. With significant increases in ODA inflows, issues of Dutch disease will arise and need to be managed carefully. Finally, underlying this discussion of macroeconomic programming is the consideration of what to do if donor funds are not readily forthcoming to meet the needs of the MDG-based Poverty Reduction Strategies (PRSs). In that case, of course, the MDGs are unlikely to be met. The IMF, however, should not simply urge a country to live within its means. The Fund should present the technical case that the country could achieve the MDGs if given additional support, and should urge donor countries to expand the level of available support such that it is sufficient to enable any well-governed African country making the effort to achieve the MDGs.

In countries where governance is weak, the preceding framework will not apply, mainly because development aid allocated to poorly functioning governments can easily be squandered or even used to reinforce bad practices. The key is to understand the nature of the poor governance, and to take actions that make sense in the context. As mentioned previously, in some cases what is called poor governance actually derives from a lack of financial resources to carry out reasonable public functions. In other cases, the problems of governance are deeper. They may involve violent conflict, authoritarian rule, or corrupt and predatory practices by the state. When the problem is violent conflict, the role of aid needs to be focused in the first instance on peace making, peacekeeping, and humanitarian assistance. When the governance problem is entrenched despotic rule of some sort, large-scale aid transfers to the government are ill advised; aid to such governments should be limited and should instead be substantially allocated through non-governmental organisations and international agencies.

Sachs *et al.* (2004) have also compared the aid flows needed to achieve the MDGs (equivalent to 20-30 percent of recipient countries' GDP) with the benefits of increased international trade liberalisation. Although trade reform is welcome and important, the paper outlines how it is certainly not sufficient to achieve the MDGs in tropical Africa. This is for two reasons. First, trade gains do not directly provide the targeted public investments needed in health, education, rural development and other social sectors. Second, gains from trade liberalisation are commodity-specific and therefore country-specific. Non-foodstuff exporters, such as the cotton producers of West Africa, will enjoy significant benefits from trade liberalisation with welfare benefits estimated at perhaps 2 percent of GDP. Meanwhile, net food importing countries will in many instances be adversely affected by trade liberalisation that increases global food prices.

After surveying the range of estimates from a number of studies, Sachs *et al.* (2004) concluded that:

> "Even if the Doha trade negotiations yield African countries the most optimistic outcomes, these countries' benefits will likely not exceed 1 or 2 percent of GDP per year. This level of welfare increase would amount to progress, but the economic benefits are at least an order of magnitude less than the level of resources required to achieve the MDGs in the poorest countries. So while the benefits of trade are real and non-trivial, they are not a substitute for sustained increases in ODA needed to fund the public investments required to attain the MDGs."

In considering the small population size of most African countries and the large number of landlocked countries, there is a critical need for deepening regional integration and investments in cross-country transport, energy, and communication infrastructure, as promoted by the New Partnership for Africa's Development (NEPAD). Not only does sub-Saharan Africa have extremely low per capita densities of rail and road infrastructure, but existing transport systems were largely designed under colonial rule to transport natural resources from the interior to the nearest port. As a result, cross-country transport connections within Africa tend to be extremely poor and are in urgent need of extension to reduce intra-regional transport costs and promote cross-border trade.

In addition, many of Africa's challenges in agriculture, health, environment, or access to energy services require breakthroughs in science and technology. Examples of promising technologies that could help Africa achieve the MDGs include new vaccines or treatments against malaria and HIV/AIDS, improved varieties and cropping systems for predominantly rain-fed and drought-prone agriculture, cost-effective information and communication technologies, and low-cost water treatment and purification systems. While private markets in developed countries are able to engage in development-stage scientific activities and, to a lesser extent, research-stage scientific activities, this is not the case in poor countries. Even though these market failures have been understood for some time, the international system has so far not responded adequately. Appropriate solutions could consist of global coordinating mechanisms based on one of the following models: (i) pre-commitment purchase agreements, (ii) *ex post* prices, (iii) public-private partnerships based on contractual terms that ensure free access to intellectual property rights generated through publicly funded research, and (iv) direct financing of research.

The UN Millennium Project's conservative bottom-up estimates suggest that the current level of ODA is a limiting factor for achieving the MDGs in the well-governed African countries and that those countries need an additional $40 or so per capita per year in development assistance. If we supposed that 620 million Africans were to receive that amount, it would add about $25 billion a year to the roughly $18 billion a year provided in 2002. If the increment were limited only to well-governed countries, the overall increase would be perhaps a bit more than half of the $25 billion a year, depending on where donors draw the line. The UN Millennium Project calculates that the total cost of supporting the MDG financing gap for every low-income country would be $73 billion in 2006, rising to $135 billion in 2015. In addition to these direct costs of investments in the Goals, there are added costs at the national and international level – in capacity-building expenditures of bilateral and multilateral agencies, outlays for science and technology, enhanced debt relief, and other areas. In total, the UN Millennium Project finds that costs of meeting the MDGs in all countries are on the order of $121 billion in 2006, rising to $189 billion in 2015, taking into account co-financed increases at the country level.

The bottom line is how small even these "large" numbers really are. In the Monterrey Consensus, and on many occasions both before and since, the rich world has committed to official development assistance of 0.7 percent of donor GNP. With a combined GNP of around $31 trillion, the donor countries of the OECD have in effect committed to donor flows on the order of $217 billion, compared with actual flows of around 0.25 percent of GNP, roughly $78 billion per year. Even the UN Millennium Project's estimate of $135 billion per year (this includes ODA for non-MDG purposes as well) would put the donor countries at around 0.44 percent of GNP (rising to $195 billion or 0.54 percent of GNP in 2015), far below the long-standing commitment.

Large-scale aid is not sufficient for ending the poverty trap, nor even warranted, when domestic governance is poor. Official development assistance should be scaled up significantly only for countries that can help themselves. ODA numbers should not be picked out of the air, but instead based on true needs assessments on a country-by-country basis. The situation in much of Africa is sufficiently desperate and the potential benefits of increased donor-finance investments is sufficiently high, that the world community should start immediately partnerships with well-governed African countries to help them to end their poverty trap once and for all.

5 One Extreme Implication from the Fixation of the Washington Consensus on "Institutions"

"Bad governance" continues to be the lens through which the Washington Consensus interprets the failure of economic development in Africa. According to the investment banker and ex-World Bank official, Percy Mistry (2005), the annual $50 billion capital flight from Africa is evidence that "Africa is failing to develop not because of a shortage of money. Rather, it suffers from a chronic inadequacy of human, social and institutional capital. Without such human, social and institutional capital (which is not the same as capacity building), development in Africa will not occur, no matter how much aid is thrown at it .... In any event, it is unlikely that the MDGs will be achieved in Africa by 2015 regardless of the amount of aid provided. The absorptive capacity does not exist to handle it." (Mistry, 2005, p. 2, pp. 11-12).

While Mistry (2005) recognises that Africa lacks the technical capacity to use aid most advantageously and to react fully to new economic opportunities (e.g. those created by globalisation), he rejects aid-funded capacity building as the method to solve this "binding constraint on

African development".[3] His answer is to import skill labour and put Africa under receivership: "The human capital that Africa needs will have to be sourced from around the world". Specifically, "the installation and embedding in Africa of human, social and institutional capital on a permanent basis" (Mistry, 2005, p. 5) should occur as follows:

1. "African leaders and governments ... [should] pursue immigration policies as open as Africa's investment policies – something that no aid agency has suggested or required of African governments in the context of economic reform" (p. 6);
2. "To support civil administration donors might consider establishing a permanent civil service for Africa. Such a service could adopt international (e.g. United Nations) standards of compensation and benefits to enable it to employ civil servants from around the world – with qualified Africans being given a clear preference – operating to international standards of probity, competence and efficiency." (p. 8);
3. "The international community could also create an international judicial service for Africa on lines similar to those suggested for civil servants. Such a judicial service could employ retired judges, advocates and attorneys from developed and developing countries or provide opportunities for serving lawyers in other countries to undertake rotational assignments in Africa under arrangements that provided continuity and quality control." (p. 8)
4. "The same could be done with an international law enforcement service for Africa whose remit would include regular policing as well as specialised law enforcement, such as narcotics trafficking, human trafficking, internal revenue, customs and excise." (pp. 8-9)

Mistry suggested that the last three "types of international services could be established and administered over the long term with oversight by agencies such as the Crown Agents who have experience in these particular areas of governance." Mistry, of course, realised that "[this] kind of thinking out of the box … may, at first glance, smack of expatriate patronisation of the worst kind. It is worth asking, however, whether it is any worse than the condescension Africa now suffers from

[3] "Africa and the donor community .... can argue that Africa has the capacity to develop its own human, social and institutional capital organically – to cope with increasingly complex challenges of development in a globalising world. But such a choice will mean Africa and its donors continuing to explain for the next half century – as they have for the past four decades – why development still eludes Africa." (Mistry, 2005, p. 5).

daily with micromanagement of African economic and political affairs from Washington D.C., London, Paris and Brussels – a consequence of its chronic dependence on aid." (p. 9).

Clearly, Mistry's recommendations represent one extreme interpretation of "bad governance" in Africa, and it is most likely a minority view within the Washington Consensus camp. Bluntly put, Mistry is claiming that the "bad governance" is the outcome of Africans being incapable of governing themselves, at least up to this point; and that the moral thing for rich countries to do is to "re-colonise" Africa for its own good. Building upon the fundamental assumption of the Washington Consensus that the engine of modern economic growth are the economic institutions that originated in Europe and North America, and Mistry added the twist that in order for these institutions to work properly in Africa, qualified people from other countries will have to be in charge of these institutions – until the Africans are ready to take over.

The lucky truth for Africa is that Mistry is wrong in many of his claims, and in his prescriptions. To consider but a few examples on each front:

Facts

Mistry claimed that "the neosocialist wave that emerged in the latter half of the 1990s saw international development agencies being led by a new generation whose rhetorical commitment to social justice exceeded their capacity to learn from history" (p. 13). How could the neosocialists have usurped power at the World Bank and the IMF after the collapse of communism in Eastern Europe and the Soviet Union, after the highly successful reign of Margaret Thatcher, Ronald Reagan, and Helmut Kohl, and the turn of China from in-your-face communism to closet capitalism? Furthermore, the latter half of the 1990s were the high point years of the institution-fixation type of Washington Consensus – which is why the IMF saw the Asian Financial Crisis as a Crisis in Crony Capitalism.

Mistry also claimed that the ODA lobby and the neosocialists (naturally) have been using disinformation[4] successfully to secure "larger appropriations for aid budgets" (p. 13). Mistry is correct about

[4] Africa and the donor community are arguing "for more aid when they know (and acknowledge in camera) that it won't work .... [and they] pretend that money (particularly concessional aid) is the binding constraint" (p. 5).

the amount of aid only if we measure foreign aid in absolute numbers rather than as a proportion of donor's income or as aid per citizen in the recipient country – and we think that the absolute numbers measure is the least defensible analytically. The data show that with the end of the Cold War, foreign aid had stagnated or declined as a proportion of GDP in most rich countries until the late 1990s. In the case of the United States, foreign aid rose markedly only after Usama Bin Ladin attacked the United States on September 11, 2001. Should we therefore be surprised that the African countries have generally not improved their performance in the 1990s in the face of reduction in ODA?

Prescriptions

Jumpstarting growth through inward immigration certainly worked for the lands of recent settlement like Australia, New Zealand, Canada, and the United States; but it is certainly not the mechanism that launched East Asian economic growth in the second half of the 20th century. Immigration in short is *not* a precondition for modern economic growth to take place. The fact is that ideas can travel from one country to another without permanent mass migration. The problem is not that Africans are incapable of learning; the problem is that the typical poor African economy cannot even afford to educate everyone at the primary school level. Capacity building, not mass migration, is the operative concept, and poor African countries cannot afford capacity building.

Mistry pointed out that Botswana "has managed to attract immigrants of the required calibre" and he concluded that its "experience provides an example that the rest of Africa would do well to consider" (p. 7). What Mistry neglected to mention is that Botswana has rich diamond deposits and had a small population to begin with. The mining of natural resources afforded Botswana the ability to support a larger population at a new higher standard of living. If a landlocked semi-desert African country like Mali wishes to attract a massive inflow of foreign talents, the only way to do so would be to give high subsidies to the new immigrants. We do not see how Mali would be able to afford this policy – unless it expropriates the land of the existing residents and gives it to the new arriving residents, a common action by many colonial governments in the past. Since Mistry is surely not suggesting that the African governments treat its new citizens better than they treat the existing citizens, his suggestion for immigration into

Africa is a non-starter for the poorest African countries. The usual phenomenon in migration is that many more people move from poor to rich countries than vice versa. Hence, Mistry's idea that there would be a large inward migration of skill labour into a poor landlocked semi-desert country if the country were to permit it (in addition to deregulating the economy into a neoclassical paradise) seems to us to be putting the cart before the horse.

Finally, among the many valid objections to why colonialism cannot, and should not, be the institution to initiate and sustain economic development in Africa, the most telling one is that it has been tried before on a massive scale before World War II, and it did not work most of the time. It is a sad sight indeed to see extreme proponents of the Washington Consensus like Mistry engaging in mental contortions about the causes of "bad governance" in order to avoid recognising the existence of poverty traps.

6 Summing-Up

The Washington Consensus is an economic programme focused myopically on short and medium-term stabilisation of output, prices, and the balance of payments, and not on long-run sustained growth, particularly in the poorest countries. This accountant's approach to economic management means that little attention is given to national specificities because accounting statements are the same everywhere in the world (even though the same outcomes might have been generated by different sets of factors). Why is there this accountant's mentality toward economic management?

The answer lays in the institutional weaknesses of the international financial and development institutions, especially the World Bank and the International Monetary Fund, and the need for root-and-branch reforms there. The recent negative experiences with the EEFSU economic transition and the Asian financial crisis show that bureaucratic inertia, operational convenience, and governance problems within the international financial and development institutions coalesced to produce the "one size-fits-all" type of policy packages. We have to change the incentives within existing international economic organisations, most importantly by making them goal-oriented so that they design their programmes specifically to meet the internationally agreed Millennium Development Goals. They should help countries make financial plans to fund poverty reduction strategies that are ambitious enough to meet the Goals, and in countries where there is insufficient domestic and aid finance to make the necessary investments, the IMF and World Bank should request more funding from the donors. Our suggested role for the World Bank and the IMF are very different from their current role, we want them to transform themselves from being creditor institutions to become genuinely international institutions. These international financial and development institutions, and the international economy, would benefit greatly in the long run if the voting structure were altered to better represent developing countries, if an international bankruptcy court were created, and if the international financial and development institutions built into their programmes policies regarding the tragedy of the global commons brought about by the trend of higher global economic growth.

In conclusion, it needs to be re-emphasised that the causes of under-development are many. The reality is that countries differ in structure and in the international economic constraints they face; many combinations of different shocks produce similar readings on a number of economic indicators; and country characteristics and the international situation could change abruptly. A practice of differential diagnosis is needed to correctly identify what is causing a poverty trap or hindering economic growth in a particular country, and country-level plans need to be made accordingly. The international frameworks exist to do this correctly – the PRSP process brings together the developing country government, private sector, and civil society with the donors to design a strategy. The missing piece, however, has been the financing for strategies that are ambitious enough to break the poverty trap and meet the Millennium Development Goals. The recent commitment of the European Union to reach the 0.7 percent of GNP target in ODA is a welcome step. Now Japan and the United States must pull their weight if the world is to have a hope at ending extreme poverty and achieving true security for us all.

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3

The Challenge of African Development: A View from Latin America

Andrés Solimano

Africa is an urgent development challenge in the world economy today. As documented in the stimulating chapter by McCord, Sachs, and Woo, Africa has experienced, on average, negative GDP per capita growth in the last decades, showing indicators of underdevelopment that are probably the most alarming in the world. Given the very low level of income per head of most African countries, this is really a development disaster for it implies a high level of poverty, deprivation, low living standards and high human vulnerabilities.

In this chapter, I will concentrate on: (a) the recent experience with economic reform and development in Latin America and its relevance for Africa; (b) the role of governance factors in economic development; and (c) the scope and limits of a strategy based on a "big push" financed with foreign aid as a development strategy for African development.

Reform Policies in Latin America: Main Results

Economic growth in Latin America in the last 25 years or so has been modest and volatile (see Solimano, 2005a). The policies of the Washington Consensus (in its original version) comprising macro stabilisation, market liberalisation and privatisation were applied in Latin America since the early 1990s (although some countries, such as Chile, started similar policies in the mid-1970s). Although reform policies contributed to reduce inflation, bring fiscal discipline and open the economies for foreign competition they failed to deliver sustained

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

and stable growth; in fact, the average annual rate of growth of GDP has been below 3 percent in the 1990-2004 period leading to small gains in per capita income growth and in poverty reduction (which has remained persistent at near 45 percent of total population, say over 200 million people). Moreover, inequality of income and wealth has not declined in the last decade. As a result of limited economic growth and slow job creation, emigration outside Latin America (mainly to the US) surged in the 1990s and early 2000s.[1]

In Latin America, an excessive reliance on natural resources as a source of export earnings, fiscal revenues and national income leads to exposure to shocks in commodity prices and to macroeconomic volatility. At the same time, the concentration in the export of natural resources with a low level of elaboration tends to hamper the development of more value-added intensive products. On the positive side, several countries in Latin America in the last 10 years or so have put in place stabilisation funds with built-in savings mechanisms to avoid the traditional boom-and-bust cycles associated with terms of trade bonanzas. Now part of the extra income gains associated with positive terms of trade shock are saved. This is also a relevant development experience for Africa, a continent also reliant on natural resources.

The combination of social inequality with unstable political systems is another characteristic that makes more difficult the adoption of adequate economic and public policies in Latin America. In several countries of the region such as Ecuador, Bolivia and Argentina, there is a chronic record of political instability, a high turnover of political authorities including the president, finance ministers and other key officials. The high turnover of authorities leads to short horizons in policymaking and deters private investment and innovation, critical factors for long-term prosperity. Thus, political fragmentation and the lack of consensus-oriented processes are an unfortunate feature of the political process of the region.[2] The point is simple but important: politics matter for economic development. In turn, the political process is linked to the social structure, the political culture of the country and the working of its formal institutions (see Solimano, 2005c).

[1] In the early 2000s, according to OECD, around 18 million people born in Latin America were living in the United States; see Solimano (2005b).

[2] In the positive side, Latin America has a reduced degree of ethnic and religious fractionalisation avoiding the kind of ethnically driven internal conflict and civil wars seen in other areas of the world, including Africa.

The Role of Governance in Promoting Development: Causality Issues

It is apparent that for policies to yield good economic outcomes some basic conditions are required to be in place: social peace and respect for human life, contracts and property rights, appropriate education and health levels of the workforce, a physical infrastructure that enables trade and investment. It is in Africa where the absence of these elements is more acute.

The Washington Consensus policies in its original formulation often ignored, at least explicitly, the importance of institutions, politics and social conflict in policy formulation and execution. The chapter by McCord, Sachs and Woo makes an interesting additional point: governance is not really an exogenous variable that explains economic performance; on the contrary, the quality of governance in itself is a result of the development level of a country. In this line, the traditionally assumed causality from governance to development must be changed for a causality that goes from development to governance. The authors highlight that good governance requires resources. For example, a government needs to adequately pay well-talented professionals to run sound economic and public policies. Poor countries have under-funded governments that fail to attract the most talented people to policymaking. The social cost of poor policymaking can be enormous. In addition, if talent is under-appreciated it will avoid government and eventually may leave the country. The importance of having adequate human resources for ensuring good governance underscores a related topic: that qualified resources are mobile and prefer to undertake exciting and rewarding endeavours either in their home country or abroad. In poor environments, human capital flight can be as important as financial capital flight in retarding economic development. Although the new literature on the topic has brought to the fore the concept of "brain circulation" rather than "brain drain", for Africa the old notion of a depletion of qualified human resources that aggravates a development trap is still very relevant (see Solimano, 2005d).

A Big Push and Foreign Aid: Scope and Limits

The McCord, Sachs and Woo chapter's main recommendation for Africa to get out of its poverty trap is a national development strategy based on a big push funded by generous foreign aid. The "big push" would be a massive investment effort in human and physical capital

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

oriented to upgrade the infrastructure and human resource base as a condition for the economic take-off of Africa. This reminds us of the famous Paul Rosenstein-Rodan blueprint for industrialisation in southern Europe in the 1940s. The Rosenstein-Rodan notion of a big push was similar to the one proposed in the McCord *et al.* chapter, not in the details, but in its essence: say a coordinated effort of investment in physical and human capital in several fronts to take countries towards a high development path. This provided the analytical underpinnings for the reconstruction of Western Europe after World War II under the financial and political support of the Marshall Plan. Of course, the historical context, the human resource base, the institutions and the geopolitics were very different in post-war Europe to the one currently prevailing in Africa. Latin America also tried a strategy of economic development tied to foreign aid in the 1960s under the Alliance for Progress. This programme was launched by the President Kennedy administration in the United States, chiefly as a reaction to the challenge posed by the Cuban revolution. Clearly, there are historical precedents for the strategy of the big push that can offer useful clues on what can work (or cannot) for the specific case of Africa.

The idea of a broad national development strategy, as different from the rather narrow focus of the Washington Consensus, is an appealing one. However, I would not throw out completely all the elements of the Washington Consensus. Things such as the need of fiscal discipline and macroeconomic stability (albeit narrowly defined) and the importance of incentives for resource allocation are valid and have been emphasised by less ideologically charged formulations of economic policy for development.

Finally, a couple of comments on two key elements of the grand strategy proposed by McCord *et al.*: first, the reliance on foreign aid and, second, the absorptive capacity of the countries targeted to receive that aid. Foreign aid is a complex business that is not guided only by increasing the social welfare of the recipient countries. Geopolitical, bureaucratic and economic interests of the donor countries also influence the amounts and modalities of foreign aid. The different interests of various actors in donor countries may not coincide with the development interests of the recipient countries. Still this is not to deny the importance and the moral obligations of rich nations and the international community with Africa. The Millennium Development Goals signed by a majority of countries also incorporate these concerns.

The other element that is critical for the success (or failure) of the big push strategy is the internal absorption capacity of African countries to receive large amounts of money and use it productively. According to the calculations of McCord, Sachs and Woo, some African countries need to receive between 20 and 30 percent of their GDP in foreign aid to finance their economic take-off. Here it is useful to remind the classical issues of macroeconomic adjustment and governance associated with the receipt of large amounts of foreign aid: a tendency for appreciation of the real exchange rate, the disincentives for non-traditional exports and national savings, and the risk of possible misuse of the money (i.e. corruption).

To sum up, Africa poses an extremely complex challenge to the development community. The development experiences of other countries and regions in the world are certainly useful. At the end, however, the proposed big push will be more effective if it is merged with an appreciation of current economic and political realities of the region and the scope and limits of other strategies of big push to device the appropriate policies needed to pull Africa out of its dramatic condition of underdevelopment.

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4

Are the MDGs Helping Africa to Become Independent?

Yonghyup Oh

There is no shortage of evidence for African poverty. The 2005 Human Development Report published by the United Nations Development Programme shows that as of the end of 2003, most African nations found themselves in the lower group of socio-economic development, and the disparity of income within each country was among the largest in the world. Moreover, it is these nations whose progress in human development was among the slowest during the period of 1975 to 2003.

While it does not take an economist to get a rough picture of their situation, the fact that these nations are in trouble and that there is no visible sign of a breakthrough demonstrates that efforts to create a better life for a majority of African citizens have not been successful. The sub-Saharan area receives the largest official development assistance (ODA). During 1990-2003, ODA to this region increased from 12 percent to 18.6 percent of its GDP, and its share in world ODA was over 32 percent in 2003 (UNDP, 2005). It seems natural to question the potential effectiveness and probability of success of the Millennium Development Goals (MDG) that aim to double aid to 50 billion dollars by 2015, set as an initiative by the United Nations.

Why Are the MDGs Not Convincing Enough?

Aid usually comes with visions of what it hopes to effect. Those who are offered help generally are not in a position to decline it. A situation might occur in which the country offering aid exerts influence on the

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

recipient. The recipients would accept, but they are free to choose the degree of cooperation for the vision to be realised.

Once help is accepted, the key to success is in the hands of the recipients, not the donors. From the beginning, both parties should define a vision together, share it and understand what achieving it will require from each side. The eight MDG goals and their measures of progress do not define a vision. They are goals, seemingly driven by donors. Do Africans feel sure enough about the UN measures to be willing to make sufficient effort?

The MDGs are a declaration of enhanced intervention in the aid programme to Africa. Doubling the aid to 50 billion dollars by 2015 certainly sends a signal to the international community, as well as to African authorities, that things will be done differently from the way they have been done in the past. It is a top-down approach. This combination of enhanced intervention, more money and a top-down approach has the danger of depriving recipients of the spirit of independence.

Knowledge and Commitment Style

If economies in the African continent start to grow, their impact on the world economy will be enormous. While the amount of ODA received is large, the net FDI flows to the sub-Saharan nations are not small relative to GDP. They increased from 0.4 percent to 2.2 percent during 1990-2003. This region is not economically unattractive. If the MDGs are perceived as attainable, more private capital flow will enter.

The MDGs are organised to allow each of the donor countries to operate individually. Although there is some coordination, the differences lie in the choice of receiving countries as well as the style of governance exercised by each donor country. Generally, the donor countries have a long history of established relations with the recipient countries, and tend to have more in-depth knowledge on the recipient countries than other countries. Therefore, it would not be easy for a third party, even the United States, to enforce a consistent aid management style among donor countries. While this tendency can be effective in nation-specific areas like education, it may leave a large grey area for areas of development at a more regional scale, such as developing sustainable trade and financial system.

Information is one of the main determinants in cross-border capital flows – both FDI and financial flows – and it is not bad that private flows move together with ODA. The question is whether the receiving country would be able to internalise these flows into sustainable economic growth. Again, lack of a clear vision for the MDGs casts doubts.

Governance Required by the Recipient

Governance is never complete without the voluntary and active participation of the recipient. Past experience corroborates this. Capital flight, legal or illegal, from Africa is estimated to amount to about 50 billion dollars a year (Mistry, 2005). To and from where this moves is uncertain, but it is an indication of the magnitude of lack of governance. Most of these nations do not have a stable enough economic and financial system to prevent this capital flight. As the spirit of the MDGs is to provide cash flow to the African economy, it is necessary to have tighter financial regulations against illegal capital flight and close surveillance on legal capital flight.

Public Goods and the Creation of Wealth

The focal area of interest in the MDGs is to build up infrastructure to improve quality of life. Therefore, they aim to provide more public goods. Human development and environmental protection are at the centre of this agenda. These are expected to generate an endogenous self-proliferation of more sound systems beyond 2015. There cannot be any dispute over the essentiality of this agenda for Africa.

But there is a missing link. Suppose that progress goes smoothly until 2015. After 2015, any successful MDG outcomes will need to be sustained. The idea is not for the donor countries to continue providing funds. The fact is that a fall in inward ODA is anticipated for after 2015, and the major MDG goals aim to produce public goods, which does not generate cash flows to re-create these public goods. This calls for wealth creation from now to then. Are the African nations preparing for this?

There are increasing signs of rising income inequality around the world, both within nations and between nations. Providing funds in an unconditional manner and giving donations will become more important in trying to fill this gap. The MDGs are a sizeable step forward, but they have some potential flaws and limitations. They will help improve living conditions for many Africans. However, their ability to put African economies on a path of sustainable growth remains in question. The ultimate goal should be to help make Africans self-sufficient.

Comments to Woo *et al.*

I would like to start with some building blocks to look for ways on how African economies can put themselves on the path to growth. There are at least four building blocks:

1. Identification of specificities in socio-economic infrastructure that are at the micro level for African economies: people, natural endowments, religious backgrounds, and social cohesion. Growth is an outcome of concerted effort, whether deliberately designed or naturally borne, based on these micro factors.
2. Identification of development projects: which business opportunities would spur growth?
3. Business and social infrastructure that would allow opportunities to be transformed into results. These include financing means as well as social infrastructure like health and education.
4. Institutions to help coordinate project and means in an efficient and effective manner.

The chapter by Woo *et al.* focuses on blocks 3 and 4. In particular, it looks into financing methods, without overlooking the role and importance of institutions, to help African countries gain momentum for sustainable growth. The message is clear. First, the rest of the world should provide African economies with more aid. The amount of financial aid proposed in the MDG framework is in the same scale of what they have already been receiving. Second, aid should be distributed locally in a bottom-up manner. That is, donors need to first identify the needs of each economy and deliver the aid in a tailor-made way. One size does not fit all.

The chapter by Woo *et al.* is in line with Woo's contribution to a previous FONDAD book (Woo, 2004), where he pointed out why the Washington Consensus is not entirely appropriate for Latin American economies. The chapter in this volume does not deal with the implications of the Washington Consensus to African nations in full. However, it does make a point on the link between the Washington Consensus and the role of governance. It shows that the problem of a lack of governance is not exclusive to the sub-African economies, but is in fact a general problem for lower income nations. While this is sensible, I do not find the comparison very relevant, because governance is probably a critical factor in its own right for many of the African nations.

It would be helpful to explain why the financing side is critical, as it is a central agenda in the MDGs and the Monterrey Consensus. It is surprising to see that the scale of aid proposed by certain countries is below previous amounts. There might have been criticism based on the idea that giving more aid is not the first priority in resolving African poverty. Elaborating this would help to define the scope of the chapter in a more lucid fashion.

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5

Development Beyond the Millennium Development Goals

Roy Culpeper

The Millennium Development Goals are of central concern to the international community. The year 2005 is a year of benchmarks for the Millennium Development Goals – the questions commonly asked are, are we on target? Will the world achieve the Millennium Development Goals (MDGs) by 2015? One can make a distinction between the achievability versus the adequacy of the MDGs. It seems to me that the adequacy question needs to be answered before the achievability question. So I would like to address the issue of adequacy of the MDGs first and then briefly assess the likelihood of achieving the MDGs by 2015.

Let me say by way of preamble that analysis of the MDGs has been a great preoccupation for the North-South Institute. We brought out three publications in 2005 that deal with the MDGs. One is about Canada's international policy, the second is our annual flagship publication: the Canadian Development Report, which emerged in September just before the Millennium Review Summit, and the third publication is entitled, *We the Peoples 2005 - Special Report, The UN Millennium Declaration and Beyond - Mobilizing for Change, Messages from Civil Society*. Some of my comments will be based on the findings of this last report, which is the fourth in a series of surveys we have commissioned or undertaken canvassing some 450 civil society organisations all over the world, 60 percent of whom are from the South. In this report, we try to ascertain their knowledge of and engagement with the Millennium Development Goals and the Millennium Declaration.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

The Adequacy of the MDGs

At the outset, it is important to acknowledge the significance of the Millennium Declaration and the MDGs in the context of North-South relations. It is also important to note that both the declaration and the goals have generated a considerable amount of energy and political commitment to the development enterprise, precisely because the MDGs happen to be quantified and time-bound. Having said that, by themselves, one can argue that the Millennium Development Goals are hardly an adequate basis for cooperation internationally on development. That is the thrust of my remarks. I also want to say that it seems churlish to be critical of the MDGs. However, my remarks should be understood very much in the spirit of supporting the MDGs. I believe that the MDGs constitute a minimum platform for action and mobilisation.

Let me explain. First of all, let us remember where the Millennium Declaration and the MDGs came from. They came from a series of UN conferences that were organised in the 1990s, from the Earth Summit in 1992 through the Beijing summit on gender, the Cairo Conference on Population and Development and so forth. What came out of those conferences was first codified by the Development Assistance Committee at the OECD in 1995. Subsequently they found expression at the world Summit in the year 2000 with its Millennium Declaration and the MDGs. However, the point is that both these syntheses of the earlier UN conferences represented a substantial retreat from what was talked about, discussed, and decided on in the 1990s.

For example, MDG-3, on gender inequality: nowhere does MDG-3 mention issues of sexual and reproductive health rights, which has been an issue of real concern and criticism by not only women but people who take gender equality issues seriously. Similarly, we say in our report that MDG-6, which simply calls for a halt to and reversing the spread of HIV/AIDS, malaria and other major diseases by 2015, represents a goal that is "scandalously modest".

The goal of MDG-1 is, by the year 2015, to elevate at least 50 percent of the people living on one-dollar-a-day or less. Even if, and it is a big if, not just 50 percent, but 100 percent of that goal were achieved, so that no one was left at a dollar a day by the year 2015, what kind of success would that really indicate? If we still had 40 percent or 50 percent of humanity struggling to subsist at between one and two dollars a day, in my view it would not be much of an achievement. MDG-1 is not just a very modest goal; one could say that it is totally inadequate.

Our analysis encompasses the Millennium Declaration as well as the MDGs. The reason is straightforward. The MDGs themselves do not include issues of human rights or issues of peace and security. One has to look at the document that embodies the MDGs, the Millennium Declaration, to get a more holistic, all-embracing statement context for the goals. And finally, I don't need to point out that the MDGs have not attracted universal support. The US, for example, has never embraced the MDGs in their present form. So on a number of grounds the agenda that MDGs represent by themselves is inadequate.

Just a short footnote on all of this: The definition of poverty in such narrow terms, that is, measuring absolute poverty with the dollar-a-day benchmark, leads to a statistical blind alley. You have the spectacle of intellectual debate between Sala-i-Martin and Martin Ravallion with huge discrepancies between them as to the number of people who are at or below one dollar a day. I find this debate rather sterile, but it is a direct consequence of defining poverty in such an arbitrary way. The goal should not be the eradication of "absolute poverty", however that is defined.

Inequality and Distributional Dynamics

So if not the MDGs, if not absolute poverty, then what should be the targets of international development? If one is genuinely interested in poverty eradication, one has to start from the point that the poor are not disembodied from the rest of society and from the economy. They are very much an integral part of the way the rest of society and the economy works. The poor are neither the problem nor are they are – as Hernando De Soto might put it – the solution to the problem. Rather, it is really important to understand poverty in a much more holistic, whole of society, whole of economy context. This line of thought leads into a serious consideration of distributional issues – income distribution and the distribution of both economic and social assets as well. It leads to a focus on *relative* rather than absolute poverty. And it also leads into a more dynamic consideration of poverty, in other words, its creation and its re-creation through time. One cannot understand poverty unless one understands income distributional dynamics and the historical context of inequality.

Moreover, one of the first things to acknowledge is that over the past 25 years inequality has widened all over the world. Interestingly enough, widening inequality began in the North in the 1970s in the US and the

UK and seems to have characterised an increasing number of countries both in the North and the South. This has been a subject of considerable study in a WIDER project conducted by Giovanni Andrea Cornia a couple of years ago. It also was the subject of a paper that I wrote for UNRISD (Culpeper, 2002). One of the interesting things that emerge from the literature of the past 10 years is that inequality is not just an equity issue; it is also an efficiency issue. In contrast, the conventional view in the older economics literature (for example, Kuznets) was that there is a trade-off between equity and efficiency. Greater equality would only impair economic growth; or, put otherwise, widening inequality is the price of development, at least until a relatively affluent level of per capita income is attained.

What the newer literature says is that countries with less inequality perform better economically: that is, they grow faster. There is plenty of historical evidence to support this proposition among the East Asian countries. Of course, there was inequality, but much less inequality than in other parts of the world, either in the North or in the South. The other side of that coin is that the wider is inequality the greater does the threshold of economic growth have to be in order to ameliorate living standards among those at the bottom end of the income distribution spectrum. Where inequalities are narrow, it might be possible to elevate the bottom quintile out of poverty at, say, 5 or 6 percent GDP growth. But if inequalities widen considerably one has to contemplate 7 to 12 percent GDP growth in order to have a significant impact on the poor. Therefore, with high inequality the levels of growth that are required to have that kind of impact may simply not be achievable.

It is noteworthy that having been ignored for many years, in 2005 there are two prominent reports from the international system that are focusing on inequality issues, the UNDP's Human Development Report as well as the World Bank's World Development Report. That, I hope, means that serious attention is now being placed on the issue of inequality.

Implications for Development Strategies

Where does this argument lead us in terms of development strategy? First of all, distributional policies are very sensitive. I think it is important to acknowledge that at least in some aspects a more equitable distribution of human capital, as we have heard from Wing, has been acknowledged as a very important vehicle. Health and education investments improve not only the current circumstances of the poor but also the outlook for their children. So far so good. But I think if one does justice to policies of redistribution, one has to go beyond health and education to consider real assets. In a poor country context, one has to consider things such as land reform and land redistribution. This is where the fuse starts to get a little bit short and people start really to get nervous, because these are intensely sensitive political and social issues. And yet, they are issues that we have ignored at our peril if indeed our objective is to have an impact on the poorest quintiles of society. So much for assets.

As for income distribution, one has to look at strategies that have an impact in the productive sector. And here, to draw on some of the discussion in Chapter 2 by Woo *et al.*, particularly in the rural economy it seems to be so important to devise and maintain policies that have an impact on those working in the agricultural sector. Again, if you look at the experiences of the East Asian countries, what was the strategy? The strategy was one of protection of the agricultural sector, which in many ways persists to this day. The protection of the agricultural sector led to price and income configurations that benefited the rural poor and rural workers directly – and the cost of redistribution was borne by society as a whole.

The policy advice given to developing countries today is completely at odds with the East Asian experience. They are faced with the prospect that, if the North abolishes its agricultural subsidies, then the South also has to open its markets to agricultural imports. Such propositions completely neglect the adverse impact those kinds of liberalisation policies in the South will have on the rural poor and in the agricultural sector.

In the urban economy, this line of argument leads much more directly into the realm of employment creation. Again, the MDGs as they are currently articulated, say hardly anything about the need for decent employment. Employment in the productive sector is surely the pathway out of poverty for the poorest urban dwellers, and yet this is understated in the MDGs and in strategies related to the MDGs.

Finally, tax policy has an important role to play. One has to contemplate the burden and the distributional impact of taxes. We have heard from Brian Kahn and others that the current tax system is too often regressive, relying as it does on sales and consumption taxes, and not enough on progressive income taxes. It seems to be the rule rather than the exception that in so many developing countries elites do not pay taxes or very little tax, which indicates a very regressive distributional policy. A more progressive tax policy, on the other hand, is difficult to design and implement. Income taxes are administratively beyond the current reach of many poor countries. User fees for public health and education are certainly regressive and arguably go counter to the MDGs. Taxes on large landholdings, particularly where landholdings are skewed in favour of the rich, would be progressive. But taxes on land often generate powerful political opposition or are simply not collected. On this issue, therefore, considerable effort must be invested in developing countries toward the design and implementation of tax policies that are both equitable and efficient.

Last but certainly not least, a fundamental dimension of inequality in all countries is rooted in gender disparities. A far-reaching strategy for achieving gender equality in health, education, in the distribution of assets, in the productive sectors, and in the political domain could by itself do more than anything else to reduce inequality significantly.

The Achievability of the MDGs

It may seem paradoxical to argue that the MDGs are inadequate when at the same time experts such as Jeffrey Sachs are predicting that they are not achievable in most of the poorest countries, particularly in sub-Saharan Africa. However, this paradox is easily resolved. If development strategies in the poorest countries were to change in the direction suggested above, the chances of achieving the MDGs would be greatly improved.

In particular, if more emphasis were placed on attacking inequality through a distributional strategy biased toward the poor, there would be a much greater "payoff" in terms of poverty reduction from any given aggregate rate of growth. In other words, with narrower income and asset inequality the poverty reduction impact of a 5 percent growth rate would be similar to the impact of a 7 percent growth rate with wider inequalities. This is particularly important in the case of sub-Saharan Africa where it is widely assumed that the rate of growth needs to be at least 7 percent to achieve significant poverty reduction. Few, if any, countries in sub-Saharan have sustained a growth rate of 7 percent. However, in the past five years some countries have reached growth rates of 5 percent, which itself is quite high compared to averages near zero in the past twenty years.

At the same time, the growth performance of poor countries could be enhanced through a distributional strategy aimed at reducing inequality and favouring agriculture, rural development and urban employment. Policies to enhance gender equality should play a central role in such strategies.

In other words, despite the dismal growth record of poor countries in sub-Saharan Africa, it may indeed be possible to achieve hitherto relatively unknown growth rates of 7 percent or higher via development strategies more explicitly oriented toward income and asset redistribution. With higher growth rates and a greater poverty reduction impact at any growth rate, the MDG targets – in particular, the reduction of poverty levels by at least one-half by 2015 – could be more easily achieved.

Donor countries can help by supporting countries adopting strategies aimed at reducing inequalities. Moreover, donor countries could also stop advocating policies that widen disparities and inequalities in poor countries. For example, policies of rapid liberalisation often widen income disparities by discriminating against the poor.

Donor countries could also help developing country partners to develop their systems of taxation and revenue mobilisation, ensuring that they are as progressive as possible. In the longer term, if the MDGs are to be sustainable, they cannot be maintained by foreign aid alone. Unless developing countries build up their own systems of resource mobilisation, the MDGs could simply induce chronic aid dependence, and there would be little guarantee that even if the MDGs are achieved, they would be sustained. In this sense, it would be better if the MDG targets were missed by 2015 if there is more assurance that they would be supported increasingly by domestic resources and less and less by donors.

Conclusion

To summarise, where does it lead us in terms of policy actions?

At the national level, in developing countries it seems certainly to lead to much more active attention to distributional policies and strategies, to policies of employment, sustainable livelihoods and a more dynamic approach to income distribution policy. At the international level, it seems to me that international financial institutions and others have to incorporate inequality into the millennium development campaign. I would strongly advocate not waiting until the year 2015 to start thinking about and doing something about inequality issues. Let's go beyond restricting ourselves to the notion of absolute poverty and explore what we can do in the broad realm of development.

I realise in saying all of this that there is a number of sensitivities, both in the developing countries and at the international level, among some very powerful countries, about considering income distribution as a priority objective of economic policy. But I believe that if we do not consider income distribution as a fundamental underpinning of and complement to the Millennium Development Goals, we will achieve very little through the MDG campaign and the Millennium Declaration by themselves.

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Part II

The National and Regional Challenges for Africa

6

"Original Sin" and Bond Market Development in Sub-Saharan Africa

Brian Kahn[1]

The relationship between domestic financial market development and economic growth has been extensively covered in the literature. It is generally agreed that there is a positive relationship between economic growth and financial sector development, although there may not always be agreement on the direction of causation. The more modern functional approaches (see Levine, 1996 and Ul Haque, 2002) emphasise the point that the financial sector performs more functions than simply being a conduit for the mobilisation of saving. These approaches highlight that policies should move beyond simply encouraging the growth of commercial banking. It is also established (see for example Montiel, 2003) that financial markets develop as per capita income increases. As the process of development proceeds, financial markets expand, although the nature of these markets may differ from country to country, depending on the policy, regulatory and legal infrastructure. In general, commercial banks dominate the financial markets in developing countries (Ul Haque, 2002).

The focus of this chapter will be on the role that financial markets and bond markets in particular can play in reducing a country's external vulnerability as well as being an additional source of mobilisation of capital. Financial crises are often caused or exacerbated by weaknesses in a country's financial system. It is argued that central to

[1] South African Reserve Bank. The views expressed here are not necessarily those of the South African Reserve Bank.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

this is the question of "original sin",[2] that is the inability of developing countries to borrow abroad in domestic currency. This in turn results in excessive foreign borrowing which increases vulnerability in the face of a crisis. Eichengreen, Hausmann and Panizza (2003) question the ability of developing countries to escape from origin sin without an international solution. This gloomy prognosis has been challenged by Goldstein and Turner (2004) who argue that the problem of currency mismatch is likely to become less severe as countries develop. The argument underlines the need to develop domestic financial markets, particularly domestic bond markets. They argue that a range of domestic policies can be implemented to overcome this problem.

It would appear that both arguments have merit and are not mutually exclusive. However, reforms to the international architecture are unlikely for some time. Under such circumstances, countries should take active steps to develop the domestic financial system and the bond markets in particular and provide adequate incentives for foreign participation. However, it is also recognised that these developments also may take time, and that not all developing countries will be able to attract foreign participation into their bond markets. Under such circumstances, there are still advantages to bond market and financial market development, although not necessarily to help solve the problem of currency mismatch.

Although domestic bond markets have developed quickly in recent years in a number of emerging markets, particularly in Asia,[3] bond markets remain rudimentary in sub-Saharan Africa (SSA), apart from South Africa, where domestic bond market development has more recently included the significant expansion of the corporate bond market. The lack of a developed bond market not only has implications for the issue of currency mismatch, but also for the efficacy of fiscal policy. It is also argued however that the development of domestic financial markets does not completely insulate countries from foreign exchange crises. Although the problem of currency mismatch is reduced, extensive foreign participation in domestic bond markets can make the currency vulnerable when risk perceptions change.

The chapter is organised as follows: Section 1 briefly discusses the concept of original sin and Section 2 considers the causes of original

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[2] See Eichengreen and Hausmann (1999) and Eichengreen, Hausmann and Panizza (2003).

[3] See for example World Bank/IMF (2001) and PECC (2004).

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

sin and why countries find it difficult to overcome the problem. Section 3 looks at the importance of domestic bond market development and the requirements for this development. Section 4 analyses the development and role of bond markets in sub-Saharan Africa, and Section 5 concludes.

1 Original Sin and Domestic Borrowing

The term "original sin" (in the economics context) was originally used by Eichengreen and Hausmann (1999) and refers to the inability of developing countries to borrow abroad in their own currencies. If a country's external debt is denominated in foreign currency, resulting in a currency mismatch, then in the event of a currency crisis, a depreciating domestic currency, (and the difficulty of rolling over short-term debt) leads to balance sheet problems which become a key source of financial instability and possibility of default.

Originally, the term was used to include not only the difficulty of borrowing abroad, but also the difficulty faced by countries in borrowing at home at long maturities, sometimes referred to as domestic original sin. This is the notion that was also used in a number of other studies (e.g. Bordo, Meissner and Redish, 2003). Countries suffering from both aspects of original sin would be particularly at risk in coping with adverse shocks. If the currency depreciates in response to the shock, the country will be hurt by the balance-sheet effects of the aggregate currency mismatch. But attempts to support the currency by raising interest rates will harm the financial position of firms as a result of the rise in the short-term interest rate, given the absence of long-term, fixed-rate debt.

In Eichengreen, Hausmann and Panizza (2003), the definition was narrowed to exclude domestic original sin on the grounds that a growing number of countries are showing an ability to borrow long term in domestic currencies. They note that Chile, Hungary, India and Thailand amongst others are now able to borrow on domestic markets at fixed rates without exchange rate indexing of their bonds. However, their ability to borrow abroad remains limited. They point to the fact that local corporate bond issues in emerging markets grew by a factor of ten between 1997-99 and 2000-1 and that local bond markets have been the dominant source of funding for the public sector in emerging markets. Similarly, in Latin America, local bond issues were almost as large as international issues of bonds, equities and syndicated lending in 1997-2001.

Other studies (e.g. World Bank/IMF 2001) also point to the growth of bond markets in Asia, particularly since the Asian crisis. Different reasons are posited for these developments. Some argue that economic growth and the concomitant growth of contractual savings institutions has been instrumental to this growth. Rousseau and Sylla (2001) point to a less benign interpretation, noting the relationship between the development of bond markets and the need to finance large government deficits (particularly relating to funding of war efforts).

However, despite the expansion of domestic bond markets in emerging markets, it is argued that the fact that many bonds placements are linked to the exchange rate, they are indistinguishable from foreign-currency denominated issues from a currency risk point of view, while a large amount are indexed to the short-term interest rate, thereby providing little protection from interest rate increases. So despite the recent rapid development of domestic bond markets, which would have required compliance with a range of prerequisites for the development of domestic bond markets,[4] Eichengreen *et al.* (2003) argue that they have made little progress in the capacity to borrow abroad in their own currencies, leading them to the conclusion that the problem relates to the structure of foreign demand for claims denominated in the local currency. Although domestic policies and institutions are important for the ability of countries to borrow abroad in their own currencies, so are factors largely beyond the control of the individual country. In other words, in line with Bordo, Meissner and Redish (2003), domestic policies and institutions are a necessary but not a sufficient condition for the elimination of original sin.[5]

It should be noted that original sin and currency mismatch are not the same. Eichengreen, Hausmann and Panizza note that a consequence of original sin is for countries to accumulate international reserves as a way of protecting themselves from potentially destabilising financial consequences. Where reserve accumulation is large, currency mismatch tends to be small, so although aggregate currency mismatch is a possible consequence of original sin, it is not a necessary one. Original sin can

[4] The issue of the appropriate policies for domestic bond market development is discussed later on.

[5] They also stress that the development of a domestic bond market should not be seen as a means to avoid foreign financing completely. They argue that this would minimise the benefits of international borrowing and lending for smoothing consumption, diversifying risk and augmenting investment.

therefore result in currency mismatch, large reserve accumulation or both to some extent. Reserve accumulation, however, comes at a cost, particularly when domestic interest rates are significantly higher than foreign interest rates, which raises the cost of sterilisation.

2 The Causes of Original Sin: Why Countries Find It Difficult to Escape

Eichengreen *et al.* (2003) play down the role of factors such as the level of development, macroeconomic credibility and quality of institutions as the sole explanations for original sin, although they concede that these factors may have some limited role. But they argue that even those emerging markets that have improved their policies and institutions have made relatively little inroads into solving the mismatch problem.

According to them, factors beyond control of countries such as network externalities, transactions cost and imperfections in global capital markets account for original sin. The only variable that is both statistically and economically significant as a determinant of original sin is country size and this leads them to formulate an explanation for original sin based on the costs and returns to portfolio diversification at the global level.

The reason that portfolios are concentrated in currencies of large countries relates to the fact that the optimal portfolio will have a finite number of currencies because of transactions costs, and the marginal benefit of each additional currency declines with each additional currency. So most of the benefits of international portfolio diversification are obtained by building portfolios limited to a handful of currencies and only large countries offer significant diversification possibilities, implying that most investors will choose to invest in a few large currencies. Because of the declining marginal benefits of diversification, it does not follow that the characteristics that allowed a few small countries (including South Africa) to issue external debt in their own currencies, should allow us to conclude that acquiring those characteristics would be sufficient to allow others to achieve the same results.

The solution they propose is the creation of an emerging-market currency basket and for the encouragement of the international financial institutions and G-10 governments to issue debt in that composite currency. They propose an emerging market index composed of an inflation-linked basket of the currencies of about 20 of the largest emerging economies, weighted according to GDP.

The gloomy prognosis of this view has been challenged on a number of grounds. It implies that developing countries would find it hard to reduce financial fragility, and efforts to strengthen macroeconomic policies and institutions would either be ineffective or take too long. Burger and Warnock (2004), Goldstein and Turner (2004) and Ul Haque (2002) stress the importance of national macroeconomic policies and institutions. In order to borrow abroad in domestic currency, domestic bond market development is essential. Low inflation is important for building deeper local bond markets. Goldstein and Turner and Bordo, Meissner and Redish (2003) also argue that fiscal policy and debt management policies are important considerations which is in contrast to Eichengreen et al's inability to find evidence that fiscal policy can explain cross-country differences in original sin.

Burger and Warnock (2004) provide an analysis of foreign participation in domestic bond markets globally. Their analysis of 49 bond markets show that creditor-friendly policies (e.g. policies that promote low and stable inflation) and laws are important determinants of the development and size of domestic bond markets.

They point to the possibility that "responsible" policies promote a virtuous cycle in local bond market development. Broader bond market development also tends to encourage the creation of derivatives markets to enable investors to hedge their currency risk, which in turn increases the attractiveness of these markets. Their results show that large countries and those with better inflation performance have larger local-currency bond markets and rely less on foreign currency bonds. Furthermore, countries with strong institutions have broader local-currency bond markets, and those with stronger creditor rights rely less on foreign currency bonds.

Their data also shows that when looking at the bond market as a whole, the share of the bond market denominated in local currency is not much different between emerging markets and advanced economies (although Latin America is a bit of an outlier in this respect). However, the size of the bond market relative to GDP is much smaller in emerging markets.

Of greater relevance to this discussion is the extent and determinants of foreign participation. The data (for 2001) show that US investors "severely underweight foreign bonds overall, and the bonds of some countries more than others" (Burger and Warnock p. 12). US investors held approximately $150 billion local-currency-denominated foreign bonds issued by developed economies, compared to $3 billion on emerging market bonds. Underweighting is significant even with developed country bonds, but more so in emerging markets. South Africa was an exception, with the relative weight being higher than for many developed countries, and the ratio was the same as the developed country average. Their results suggest that US investors avoid markets that exhibit high historical variance or negative skewness. The importance of currency hedges in emphasised by the fact that the variance of local bond returns is dominated by exchange rate volatility.

Bordo, Meissner and Redish (2003) focus on trying to understand how the exceptions to the original sin rule were able to break free.[6] Their analysis reveals that although sound fiscal institutions, high credibility of the monetary policy regime and good financial development are important factors, they are not sufficient. Conversely, poor performance in these areas is not generally a necessary condition for original sin. They emphasise the role of shocks such as wars, massive economic disruption and the emergence of global markets:

> "The differences in evolution between the US and the Dominions we attribute to differences in size, the traits of a key currency, which the US possessed and others did not, and to membership in the British Empire. The important role of major shocks suggest that the establishment of a bond market involved significant start-up costs, while the role of scale suggests that network externalities and liquidity were pivotal in the existence of overseas markets in domestic currency debt" (Bordo *et al.*, p. 5).

The emphasis in their work on path dependence implies that it could be difficult to extrapolate lessons of their experience to other countries.

Burger and Warnock (2002) also argue that there is a strong positive relationship between the level of economic development and depth of financial markets i.e. the size of a country's local-currency denominated bond market is related to GDP per capita rather than country size.

Whereas Eichengreen *et al.* seem to imply that all emerging markets are in the same boat with respect to original sin, and that the prospects of escaping from this are limited, particularly with respect to domestic solutions, Goldstein and Turner (2004) show that although emerging bond markets are smaller relative to the size of their respective economies, the size, liquidity and ability to hedge risk varies considerably. South Africa features strongly in these comparisons, but is the only

[6] They accept the original sin definition, which includes the inability to borrow long term domestically.

African country to do so. They also argue that over time, most of the countries should develop to where South Africa is today, implying that there is scope for development. One of the factors stressed, for example, is that although hedging facilities remain limited in some of the smaller emerging markets, this could be due to the fact that experience with exchange rate flexibility is limited. As experience is gained, the development of hedging instruments should be expected to expand.

The currency regime is also a consideration. Eichengreen *et al.* argue that hedging is more difficult and more expensive under flexible exchange rate regimes. Furthermore, they contend that most flexible exchange rate regimes have very high levels of original sin. Goldstein and Turner on the other hand contend that most emerging market currency crises in the past few years have been in countries with fixed or announced targets for exchange rates and that behaviour towards currency risk tends to improve as countries move towards greater flexibility.

Institutional factors may also be central to overcoming original sin and currency mismatch. Goldstein and Turner (2004) note three reasons for stressing institutional factors; they govern the working of microeconomic incentives, strong institutions increase the chances of good macroeconomic and exchange rate policies being adopted, and strong institutions nurture confidence. Often emerging markets lack an adequate market infrastructure, including well-developed and liquid money markets.

There is a general acceptance, that emerging markets are beginning to develop bond markets, and that the development of a domestic bond market is an essential requirement for escaping from original sin, and no emerging market has been able to escape without this. The issue of course remains whether these bond markets are attractive to foreigners.

It should be noted however that foreign access to domestic currency denominated bonds is not unproblematic in the event of a decline of foreign investor confidence or other contagion effects. Having a domestic debt market does not shield the exchange rate or the capital account from sudden capital reversals. Even if a country issues domestic denominated debt, if these are widely held by foreigners they can expose the exchange rate to sudden movements. There is the advantage to government of not incurring foreign exchange losses through the higher domestic cost of servicing foreign-owned debt, and also that non-residents will bear the exchange rate risk. Although there is no exchange rate risk to the government in terms of repayment and servicing, to the extent that domestic firms or banks suffer from currency mismatch, they are exposed to potential instability.

3 Why Develop Bond Markets?

To this point, we have considered the issue of the importance of developing domestic bond markets from the point of view of overcoming or alleviating the problems of original sin. However, there are a number of broader reasons for developing domestic bond markets. Herring and Chatusripitak (2001) and PECC (2004/5) for example, argue that bond markets are central to the development of an efficient economic system, and there would be additional significant benefits if bond markets are developed. They provide greater investment opportunities for both retail investors and financial institutions, and help deepen financial markets. This is particularly the case if foreign investors are attracted.

From a macroeconomic policy perspective, the lack of a bond market places constraints on the financing of fiscal deficits, while bond markets provide useful market signals for macroeconomic policy. Domestic debt is also needed for monetary policy purposes, including for sterilising inflows of foreign exchange.

Bond markets also help to provide interest rates across the maturity spectrum and a more efficient pricing of risk. By providing an alternative source of financing, they reduce concentration of intermediation in banks. Because lending can be hedged in the bond market, banks have the ability to lend longer.

The usefulness of domestic debt markets can also be seen in the context of countries that are dependent on aid flows. International aid is often linked to project financing and can therefore not finance capital projects not supported by the donors. Furthermore, the supply of foreign financing is uncertain, and dependent on the aid agencies' budgets and assessment of economic performance in the recipient country. In many instances, domestic debt has increased because of a need to fill the shortfall caused by the decline in the supply of foreign aid. Rwegasira and Mwega (2003) show that, in general, accumulation of domestic debt has reflected the size of the budget deficit and the extent to which SSA countries have been able to borrow externally.

Even if foreign debt is significantly cheaper than domestic debt, the latter is easier to roll over than foreign debt, and there is no foreign exchange requirement. The greater the degree of foreign indebtedness, the more vulnerable a country is to cessation of loans or foreign exchange crises. As Christensen (2004) points out, many IMF-supported programmes include a cap on non-concessional borrowing, in order to limit external vulnerability.

PECC (2004) sets out a number of general requirements for bond market development.[7] The factors stressed include the simultaneous development of market width, market depth and market infrastructure. Other factors include effective coordination among government agencies as well as close public-private sector partnership, regulation focusing on maintaining and enhancing transparency and the treatment of taxation. It is also proposed that special support measures be introduced when market depth is lacking.[8] Finally, from the perspective of attracting non-resident participation, it is argued that "markets will attract investors if there is competition among market participants and if they are open to many players, both domestic and foreign. Such conditions ensure that market prices for risk are properly reflected and provide fair returns" (PECC, 2004 p. 3).

To the extent that the Eichengreen, Hausmann and Panizza argument is correct, that high costs would inhibit the increased participation of non-residents in domestic bond markets, the option of regional bond markets should also be considered. PECC (2004) for example argue that given their small size, most of Asia's bond markets face serious limits to liquidity, efficiency and growth. Therefore, there would be mutual benefits across the region from increased cross-border issuance and investment and eventually the establishment of a regional bond market that would enable companies and public entities to more directly tap the savings within the region. It would also attract international investors, by providing wider market choice, diversification of risks, and higher returns. Requirements for regional bond markets (in addition to those factors relevant to the development of domestic bond markets) include the eventual opening of capital accounts and more flexible exchange rate arrangements; regional policy coordination and cooperation (including harmonisation of market infrastructure and practices); and credit enhancement facilities at domestic and regional levels that could an important role in financing small and medium enterprises.

[7] The discussion focuses on regional bond market development, but it is argued that the emergence of a regional bond market needs to start with reforms to develop and strengthen domestic bond markets.

[8] They quote the example of the use of collateralised bond obligations (CBOs) in Korea, which involved pooling of bonds issued by companies into combined issues at a time when it was difficult for companies to raise funds because of the collapse of the Daewoo Group in 1999 and the problems faced by the Hyundai group in 2000.

4 Fiscal Policy and Domestic Borrowing in Sub-Saharan Africa

There are a number of impediments to long-term bond market development in sub-Saharan Africa. Non-bank financial institutions are generally underdeveloped in sub-Saharan Africa (SSA), except in South Africa. Although the non-bank sector is significant in Kenya, Madagascar, Mauritius and Rwanda, the differences in absolute size between them and South Africa is significant. The lack of institutional investor base reduces the demand for long term paper, and the higher interest rates mean that governments are unwilling to issue long-term bonds. Furthermore, where macroeconomic stability is threatened, long-term debt is unattractive, and there is also the problem of default risk.

As noted above, the efficacy of fiscal policy is reduced because of a lack of domestic bond markets and the lack of depth of the financial sector. This could affect monetary policy as well, through restricting the channels through which monetary policy operates. Despite the general trend towards financial sector liberalisation during the 1980s and 1990s in SSA, financial markets remain relatively small and undeveloped, except in South Africa. The result has been that governments either have to maintain their dependence on foreign capital or aid inflows to finance fiscal deficits, or they have to pay very high interest rates if they finance these deficits locally. This has threatened or has undermined fiscal policy by creating unsustainable fiscal positions as well as vulnerability through currency mismatch.

The generally narrow tax bases and growing demands for infrastructure and social services in SSA countries has resulted in fiscal deficits, which need to be financed either through domestic or foreign borrowing. The lack of depth of the domestic financial systems is therefore a constraining factor, and is to a large extent a result of low savings ratios in SSA. This in turn has resulted in a lack of institutional capacity to mobilise long-term savings.[9]

The low levels of savings can be attributed to low income levels. Sachs *et al.* (2004), for example, quote a survey conducted in Uganda where only 24 percent of rural Ugandan households indicated that they had ever undertaken any saving, and 85 percent of those which do not save gave low income as the reason, although some did mention lack of

[9] Sachs *et al.* (2004) argue that the savings situation is even worse than it looks because the national income accounts data probably significantly overestimate Africa's true savings rate by counting resource depletion as income.

access to financial institutions. Poor people have to use all or more than all of their income simply to stay alive.

The lack of savings in turn acts as a constraint on investment. The lack of long-term markets is not only a problem for the financing of government deficits, but also for the financing of domestic private investment. Even in South Africa, it is only recently that the domestic private bond market has expanded significantly. Hernandez-Cata (2000) argues that the narrow tax base results in high levels of taxation, which in turn explains the low levels of investment.

Access to borrowing by government is essential if fiscal policy, particularly for capital and other infrastructural investment, is constrained by the narrowness of the tax base. The general Poverty Reduction Strategy Paper (PRSP) recommendations with respect to tax policies have been to avoid corporate or personal taxation because of the disincentive effects, and the process of trade liberalisation would also reduce trade taxes. The alternatives therefore are consumption taxes such as VAT, and improved administration. However, consumption taxes are regressive and could reinforce poverty. Tax revenues can be increased by improving the tax administration and tax structure. For example, tax revenues have been increased significantly in South Africa over the past few years through efficiency gains in collection, and this has allowed for a reduction in personal tax rates. According to Rwegasira and Mwega (2003), many African countries have undertaken tax modernisation programmes to broaden the government revenue base including changes in tax rates, tax bands, coverage of taxation and the revamping of the major collection departments. However, there are limits to these efficiency gains.

As an alternative to increased taxation, there has been increasing focus on the introduction of user charges in education and health in particular, to take some pressure off the fiscus. These policies obviously have their limits, depending on distributional patterns in the country and income levels.

A recent study by Christensen (2004) looks at the issue of domestic debt in SSA. Money and domestic debt markets have an impact on the implementation of both monetary and fiscal policies. Table 1 shows that although most SSA countries have some form of domestic debt market, there are wide variations between them. The average ratio of domestic debt increased from 11 percent in the 1980s to 15 percent in the late 1990s, and the number of countries with debt ratios exceeding 20 percent of GDP increasing from three in 1980 to nine in 2000.

Table 1 Domestic Debt/GDP of Selected Sub-Sahara African Countries
(percentages)

	1980-89	1990-94	1995-2000
Angola	0	0	0
Botswana	0	0	0
Burundi	3	2	6
Congo, DR	0	0	0
Ethiopia	16	9	10
Gambia	3	13	23
Ghana	12	8	24
Kenya	21	23	22
Lesotho	8	8	5
Madagascar	3	3	3
Malawi	13	8	9
Mauritius	27	29	33
Mozambique	0	0	0
Namibia	0	8	19
Nigeria	28	29	16
Rwanda	8	9	5
Seychelles	14	45	68
Sierra Leone	13	5	7
South Africa	30	37	45
Swaziland	4	37	1
Tanzania	26	6	12
Uganda	2	1	2
Zambia	25	9	6
Zimbabwe	35	29	37
Average	*11*	*12*	*15*
HIPC	9	66	8
Non-HIPC	14	18	23

Source: Christensen (2004).

Countries that have relied on domestic debt have included Ethiopia, Kenya, Mauritius, Nigeria, South Africa, Tanzania, Zambia and Zimbabwe. Botswana's lack of debt market is a result of the fact that until recently the government always had fiscal surpluses.

Not surprisingly, the table shows that the HIPCs have a much smaller debt burden, given their reliance on external debt. However, what is not clear is whether the lack of a domestic debt market results in excessive reliance on external debt, or if access to cheap external debt

Table 2 Financial Sector Depth and Domestic Debt, 1980-2000

	M2 (percent of GDP)			Domestic Debt (percent of M2)		
	1980-89	1990-94	1995-00	1980-89	1990-94	1995-00
Angola	107	72	18	0	0	0
Botswana	19	20	21	0	0	0
Burundi	18	18	19	19	11	30
Congo, DR	8	14	7	0	0	0
Ethiopia	28	41	41	57	47	25
Gambia	21	22	29	13	57	80
Ghana	15	16	22	83	47	106
Kenya	29	38	50	71	63	44
Lesotho	49	34	31	18	25	16
Madagascar	21	22	21	15	13	12
Malawi	22	22	16	59	38	57
Mauritius	47	67	77	57	44	43
Mozambique	37	22	21	0	0	1
Namibia	12	30	42	0	25	44
Nigeria	27	21	17	106	137	95
Rwanda	13	16	17	62	59	30
Seychelles	32	42	78	43	107	86
Sierra Leone	19	12	14	53	71	81
South Africa	56	53	56	53	71	81
Swaziland	33	32	26	12	3	4
Tanzania	27	17	16	93	38	74
Uganda	9	8	13	24	7	16
Zambia	17	20	19	145	44	30
Zimbabwe	27	22	42	129	130	91
Average	*231*	*30*	*32*	*39*	*39*	*42*

Source: Christensen (2004).

makes domestic debt unattractive and therefore restricts the development of the market. Domestic debt in HIPCs was 8 percent of GDP while in non-HIPCs the domestic debt to GDP ratio increased from 14 percent in the 1980s to 23 percent by the end of the 1990s. As a proportion of total debt, domestic debt remains small.

The scope for expanding domestic debt depends on the depth of the financial sector. The traditional variable to measure this is the M2/GDP ratio shown in Table 2. The table shows that African financial sectors are

Table 3 Average Maturity of Domestic Debt (2000)

	Domestic Debt/GDP (in percentages)	Maturity in days
Burundi	9	77
Uganda	2	93
Gambia	31	112
Ghana	29	122
Malawi	11	177
Sierra Leone	10	190
Lesotho	11	203
Nigeria	21	228
Cape Verde	26	256
Zambia	5	296
Rwanda	6	351
Kenya	22	382
Namibia	19	859
Swaziland	1	1145
South Africa	42	1748
Average	*15*	*231*
Mexico	23	720
Brazil		1085
India		3050

Source: Christensen (2004).

relatively small and smaller in the HIPCs. The countries with the highest ratios are Cape Verde, Kenya, Mauritius, Seychelles and South Africa. The small size of financial sectors limits the scope to expand domestic debt. The table also shows the depth of South Africa's domestic debt market, with most of the government budget deficit being financed through domestic borrowing. The South African government has refrained from accumulating foreign debt because of the exchange rate risk involved.[10]

One of the implications of shallow financial markets for macro-economic policy is the preponderance of short-term debt, resulting in increased risk for governments. Christensen (2004) estimates that the

[10] South Africa is not eligible for highly concessionary loans from the IFIs.

average maturity was about five and half years or seven times longer in six developed and emerging market countries for which data were available, than in Africa.[11] Table 3 shows that, in general, public debt maturities in Africa are less than one year. With short-term debt, the government has to roll over debt more frequently and is therefore exposed to increased vulnerability with respect to interest rates and consequently to the cost of debt servicing. This could lead to a loss of confidence in government bonds and further rises in interest rates on government debt.

Longer-term savings instruments are important to prevent excessive exposure to short-term debt portfolios by government, which could cause a significant burden on, and risk to the budget. However, if Christensen is correct in his observation that the length of maturity is related to per capita GDP rather than the size of the domestic debt market relative to GDP, then as African economies develop, their debt markets can be expected to become more sophisticated and long-term in nature.

An important issue for fiscal policy is the cost of debt servicing. Financial liberalisation in most countries in Africa in the 1980s and 1990s has resulted in higher real interest rates, implying increased costs of servicing domestic government debt, or, as Rwegasira and Mwega (2003) note, a shift from a high inflation regime to a high real interest rates regime. It is generally the case that the cost of servicing domestic debt is higher than that of foreign debt. Many SSA countries have access to foreign financing at very low concessionary rates and at very long maturity from international aid agencies or on grant terms. Domestic borrowing is generally at higher interest rates and shorter maturities.

Another important issue is that of currency risk. Whether or not the effective interest rates paid on domestic debt are in fact higher than foreign interest rates depends on exchange rate changes. A real depreciation, for example, increases the real burden of foreign debt. This is turn may provide an incentive for governments to intervene to prevent a depreciation or delay a necessary devaluation. Beaugrand *et al.* (2002), however, argue that even after adjusting for exchange rate risk, highly concessional loans are still the most attractive way to finance budget deficits.

In cases where domestic interest rates are high, domestic debt service can become a significant proportion of government revenues, implying

[11] The length of maturity appears to be roughly related to levels of per capita income rather than to the size of the debt market relative to GDP.

less expenditure on other items. The interest cost of domestic borrowing can rise quickly along with increases in the outstanding stock of debt, especially in shallow financial markets. Under such circumstances, increases in domestic debt will lead to higher domestic interest rates, which in turn could result in crowding out of private investment. The ratio of interest payments to GDP is over two percent in a number of countries, including Zimbabwe, Ghana, Malawi and Sierra Leone. Of note is the fact that interest payments on domestic debt are similar in size to interest payments on foreign debt despite significantly lower levels of domestic debt. Christensen notes that domestic interest payments exceeded foreign interest payments in almost half of the 22 countries for which data were available.

Similarly, Rwegasira and Mwega (2003) show that in Kenya's 1999/00 budget, the interest payments on domestic debt were more than double those allocated to financing external debt even though the stock of external debt was about three times the stock of domestic debt. Servicing of public debt accounted for 16 percent of total government expenditure. According to the World Bank (2001, p. 82), six heavily indebted countries in Africa spend more than a third of their national budgets on debt service and less than a tenth on basic social services. In this context, the UNCTAD (2002) report argues that the trade-off between capital investment and current social spending is aggravated when interest payments absorb large and even increasing proportions of the budget, while government revenues cannot be raised sufficiently rapidly because of sluggish growth. The higher cost of servicing government domestic debt is at the expense of social and capital expenditure programmes.

UNCTAD (2002) cautions strongly against excessive zeal in developing domestic debt markets. It is argued that the shift from central bank financing to direct financing through issuance of treasury bills and government bonds has injected new elements of instability into African economies. "Rather than securing greater fiscal discipline, they have resulted in increased accumulation of domestic debt, with consequences for income distribution no less serious than inflationary financing. Indeed, the shift to financing public deficits by government debt on market terms under conditions of very thin financial markets has led to very high and volatile real interest rates. Rapid accumulation of domestic debt at high real interest rates has often resulted in excessive debt burdens on the budget, leading to Ponzi financing…" (UNCTAD, 2002, p. 29).

Although it is true that there is an additional level of uncertainty, it is not clear how the process of financial deepening can proceed without the development of a domestic debt market. It would also seem to imply that countries should prefer foreign debt. However if a country is reliant on foreign debt financing with little domestic debt, constraints on macroeconomic policy appear when for example inflows dry up, or if there is a significant depreciation of the exchange rate. A deeper domestic debt market may make it easier to spread this risk, but as noted above, the higher interest rates may constrain public expenditure as a higher proportion of the budget goes to interest payments.

The bottom line however is that any form of debt, whether domestic or external, comes at a cost, and the issue is the sustainability of the debt. Debt sustainability will be a function of real interest rates and real growth. If foreign debt is involved, the foreign real interest rate and the real exchange rate become additional factors in determining sustainability.

With respect to how to deal with the growing domestic debt burdens in a number of African countries, two of the options put forward by Christensen (2004) include: (1) extend the maturity structure of debt, in part through strengthening and expanding the insurance and pension sector. This would require a significant increase in domestic savings, and (2) improve foreign access to holdings of domestic debt. This would result in increased competition, which would reduce financing costs and possibly contribute to a more efficient market through the introduction of financial technology and innovation. This would depend on the extent to which the country is able to attract foreign funds, i.e. to overcome the problem of original sin.

5 Conclusion

As argued above, the state would benefit from the existence of a developed bond market if it results in a more efficient mobilisation of resources and a deeper pool of savings, particularly if non-residents are attracted to it. If bond markets are to be developed in SSA or in other emerging markets, the role of the state becomes critical, as a range of policies would be required. At the domestic level, it requires appropriate macroeconomic policies, including fiscal and monetary discipline to promote a virtuous cycle in bond market development. Default risk and high inflation are important impediments.

Of importance would be the creation of institutions to provide the incentives for foreigners to invest in these new bond markets. Such institutions would include the development of a repo market for government bonds, a system of primary dealers and liquid money markets. Governments could also ensure that borrowing is not fragmented by co-ordinating bond issues between different government departments and agencies and a transparent regulatory framework, including taxation. There are of course dangers that excessive government intervention in these markets could stultify their development.

The question is, to what extent can this be generalised to all countries? Some, (for example Goldstein and Turner), take issue with the argument that it would be too costly for emerging markets to wait for the very slow impact of improved policies to impact on original sin, and that only a few emerging markets have the potential to escape from original sin (given the costs of diversification noted earlier). They also question whether an international solution should merit first priority.

There does not seem to be a strong case for delaying attempts at financial market deepening, including the development of domestic bond markets, as such developments are important in the development process. There is also much evidence that a number of emerging markets have been able to develop viable bond markets, although the ability to attract foreign participation varies. Although domestic solutions may be slow, international solutions may even be slower, given the lack of will regarding any changes to the international financial architecture. It would seem that initiatives on both fronts are important, and that domestic initiatives are a necessary condition for the success of any international initiative.

Given the nature of most financial markets in SSA, it is likely that Africa will continue to lag behind other regions with respect to bond market development. It is also likely that many SSA countries are simply too small to develop viable and deep enough markets to attract foreign interest even with the appropriate macroeconomic policies and institutions. The diversification argument of Eichengreen *et al.* seems compelling in the African context. It would appear that the solution would be to move towards a regional bond market(s), which would help overcome the diversification problem. Moving in this direction would be consistent with the current regional monetary integration proposals, and strengthens the argument for regional capital markets in Africa.

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7

Role of the State in Financial Sector Development in Sub-Saharan Africa

Olu Ajakaiye

A major lesson in development knowledge and practice during the 20th century is the realisation that neither the free market nor pervasive state intervention and control, working alone, can lead to sustainable development (Ajakaiye, 1990, Adelman, 1999). The challenge, therefore, is to secure a social order where welfare of the people is maximised in an environment where the ingenuity, enterprise and initiatives of private individuals and organisations are combined with a purposive state intervention, regulation and guidance. Clearly, this social order requires full participation of all stakeholders in the development process, ranging from problem identification, selection of priority actions, implementation, monitoring implementation and assessing impact or outcomes. In such an environment, enduring cooperative relationship should exist amongst the social partners, viz., business community, government officials, politicians and political office holders, labour unions and the civil society organisations. Such cooperative relationship should rest squarely on intensive formal and informal discussions and consultations in an environment of mutual respect, trust and sincerity of purpose. In such an environment, development in all sectors of the economy and society are well coordinated in a mutually reinforcing manner.

Economic development requires growth with structural and technological change (Ajakaiye, 2003). Therefore, growth is a necessary but insufficient conditions for economic development. In sub-Saharan Africa (SSA), growth increased from an annual average of 1.7 percent between 1980 and 1990 to 2.8 percent between 1990 and 2003 (World Development Indicators, 2005). On the other hand, the structure of output of

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

the region remained largely unchanged between 1990. Again, as shown in the World Development Indicators, 2005, there was no perceptible structural transformation of the African economy. Output remained dominated by crude materials production (in the form of agriculture and mining) and services while the contribution of transformation activities (manufacturing) was small and generally falling. In contrast, the share of agriculture in total output for East Asia fell from 29 percent in 1980 to 14 percent by 2003; the contribution of manufacturing, which was already high by 1980, increased further by 2003.

With respect to technological change, electric power consumption per capita as at 2002 was only 457 kWh compared to 849 kWh for East Asia; telephone lines per 1000 persons was only 11 as at 2003 (the lowest in the world) compared to 161 in East Asia; mobile phone lines per 1000 persons as at 2003 was only 52 compared to 195 for East Asia; and Internet users per 1000 persons was only 20 compared to 68 for East Asia. With respect to the number of researchers in R&D per million persons and number of technicians in R&D per million persons between 1996 and 2002, only Burkina Faso, Central African Republic, Republic of Congo, Guinea, Madagascar, South Africa, Uganda and Zambia had non-zero entries. All other SSA countries had either zero entries or the data was not available. Clearly, while there was considerable improvement in growth, there was no structural change in output, largely as a result of technological backwardness. Evidently, whereas the over 7 percent growth of output in East Asia was accompanied by structural and technological change, the very miniscule growth in output of SSA was characterised by structural retrogression and technological backwardness. Thus, while there are indications of economic development in East Asia, there was none in the case of SSA.

The primary role of the financial sector, especially in a developing, is that of mobilising financial resources from the savers and directing these resources into channels of desired development activities. Thus, the pioneering works of Gurley and Shaw (1967), Shaw (1973) and McKinnon (1973) drew attention to the relationship between real and financial developments in terms of the role of financial intermediation, monetisation and capital formation in determining the path and pace of economic development. The financial sector is made up of the banking sub-sector and the stock or capital market. Again, financial sector development requires growth in the volume of activities as well as changes in the structure of the market. Probably more important is the changing character of the linkages between the financial sector and the rest of the economy. Generally, as the economy develops, the expectation is that the volume of transactions in the financial sector will increase and there will be less reliance on the banking sector, at least, for long-term credit.

Available data suggests that the financial sector in SSA is lagging behind that of the rest of the world. For instance, the M2/GDP ratio, which was 32 percent in 1990, increased marginally to 37 percent by 2003. In the case of East Asia, the corresponding figures are 63.1 and 158.8 percent respectively. The SSA figures are less than 50 percent of the world average. In terms of efficiency, despite the series of unilateral and structural adjustment programmes induced liberalisation of the banking sector in SSA, the interest rates spread increased from 8.2 percent in 1990 to 12.4 percent by 2003. In the two periods, the interest rates spread for SSA was the highest in the world implying that the SSA banking sector remains the least efficient in the world.

Turning to SSA stock market, market capitalisation, which is one of the measures of size, was about $143 billion in 1990. By 2004, it has doubled to reach $294 billion. Impressive as this seems, it is extremely inferior to the growth of East Asian stock market size, which increased from about $87 billion in 1990 to over $1 trillion by 2004. Another measure of size is the number of listed domestic companies. For SSA, there was a decline in the number of listed companies from over 1000 in 1990 to about 900 by 2004 while in the case of East Asia, the number increased from 774 in 1990 to 3,582 by 2004.

In view of the relatively poor performance of the SSA economy and its financial sector, it is clear that the role of the state in the financial sector development has to go beyond the usual provision of regulatory frameworks as this presupposes that the market exists in the first place. To provide a basis for the articulation of the roles of the state in financial sector development of the SSA countries, I will briefly discuss the dominant channels of linkages between the financial sector and the economy in the next section. The concluding section contains suggestions on the roles of the state in creating and expanding the size of the financial sector in SSA.

Channels of Linkages Between the Financial Sector and the Economy

In characterising the role of the state in the financial sector of SSA, it should be instrumental to briefly describe the channels of linkages between the financial sector and the economy. In this connection, it is pertinent to take account of the fact that the functioning of an economy involves the production of goods and services (production); generation of income as factors are compensated for their contributions to production (income-generation); and usage of a part of income generated to purchase final goods and services while saving the other part (expenditure and savings). As economic agents, (household, businesses and government) carry on their consumption and production activities, they need the facilities of credit (short and long-term credit) and equity (financial services) provided by the financial sector. These financial resources can be injected through supply (production) channel or through demand (final consumption) channel. In reality, financial resources are injected into the system through a combination of both channels. However, at any point in time, one of these two channels may be dominant and the role of the state in the financial sector development should be influenced by the imperatives of the predominant channel and the level of development of the economy. It is, therefore, important to briefly sketch the workings of the two channels bearing in mind the above stylised facts about an economy.

Workings of the Demand Channel

When the bulk of the financial resources is used to boost the consumption of final goods, then demand channel is dominant. In that case, empirical specification of the aggregate consumption function may look like the followings:

$$C = f(Y,M);\ f'y,\ f'm > 0 \qquad (1)$$

Where,

C = private and government final consumption expenditure

Y = income

M = financial resources (mainly in the form of credit).

Equation (1) says that increase in income and or financial resources will lead to an increase in private and government final consumption expenditure. Accordingly, when the banking sector makes more financial resources available to consumers, the immediate effect is for the increased effective demand to put upward pressure on prices. Through higher prices, the increased financial resources will be funnelled to the producers. Meanwhile, ceteris paribus, rising prices will lead to increased output as existing producers step up action and/or new producers, attracted by high profits come into the economy to set up. Ultimately, the level of economic activities (consumption and production) will be higher. Needless to say, the possibility and speed of realising these outcomes depend, among other things, on the existence of excess capacity and the degree to which the economy is self reliant in production and consumption. The desirability of the outcomes will also depend critically on the extent to which the structure of production, determined by the expenditure pattern, conforms to the long-term development aspirations of the people.

Nevertheless, whenever the demand channel is predominant, a rise in bank lending rate will make credit more expensive and, hence, reduce effective demand. Reduced demand will force producers to lower prices to clear the market. Under this circumstance, increases in interest rates should be efficacious in fighting inflation as it should help choke off excess demand for goods and services on account of higher cost of funds needed to finance final consumption expenditure.

In such an economy, the capital market will be very deep and active and corporate bodies will normally patronise this market for investment fund while relying more on retained earning and other internal sources such as accounts payables for finance most of their working capital. Also in such an economy, monetary policy takes into account the level of capacity utilisation. In general, when the capacity utilisation is reaching around 75 or 80 percent, the monetary authorities will invariably pursue high interest rates policy to manage demand and this signals to the real sector producers that it is time to seek investment fund from the capital market to expand capacity. As soon as new capacity comes on stream, the level of capacity utilisation will drop to between 60 and 70 percent, at which time the monetary authorities will commence downward review of interest rates. In general, monetary policy is not permanently restrictive, as it tends to oscillate between restrictive and expansionary policy depending on the level of capacity utilisation.

Observers of the US and EU monetary policy postures will find empirical support for this pattern of monetary policy formulation implying that the demand channel is, indeed, the dominant one. In these developed economies, the financial sector is fully developed in the sense that the banking and capital markets are fully established. In essence, an economy where the linkage between the financial sector and the economy is dominated by the demand channel is one where the banking sector meets the financial services required by consumption activities and the capital (bond) market meet the financial services required by production activities. In such economies, the role of the state can be limited to regulation and surveillance.

Workings of the Supply Channel

Supply is predominant when the bulk of financial resources is used to boost the production of goods and services. The relationship can be specified thus:

$Q = f(K,L,M); Q'k\ Q'l\ Q'm > 0$ (2)

where,

Q = Output

K = Physical capital

L = Labour

M = Financial Resources (credit).

Equation (2) says that output will increase if there is an increase in the supply of capital, labour and financial resources which is mainly in the form of short and long-term credit. The transmission mechanism goes thus. When there is an increase in supply of financial resources to producers, part of it will be used to finance variable inputs (working capital) while the remaining part will be used to finance increase in physical capital (investment) thereby increasing production capacity. The increase in credit via the process of transfer of real assets and payments for inputs is transmitted into income which invariably leads to increases in final consumption expenditure and savings. Consequently, increase in demand may lead to increases in prices of certain commodities. This event, however, depends on the length of the production cycle and existing stock of inventory of finished goods. The increase in saving as a result of increase in income, on the other hand, will lead to an increase in the financial resources which can be mobilised by the financial sector. This invariably makes more funds available for investments.

Under this channel, an increase in the cost of credit will lead to a reduction in output as producers reduce their demand for credit. Besides, cost of production will increase as a result of the increased cost of funds. Where feasible, the cost increase will be passed on to prices especially where a large proportion of working capital is financed from borrowed funds. Otherwise, the profit margin and hence, the possibility of relying on internal source of funds to meet financial resource requirement will be reduced thereby further discouraging any expansion in output.

In the supply channel, interest rate and prices are positively related, contrary to the expectations of the proponents of financial repression framework. As succinctly put by Thomas Tooke (1844) and as cited by Humphrey (1986):

"A general reduction in the rate of interest is equivalent to or rather constitute a diminution in the cost of production... in all cases where an outlay of capital is required... The diminished cost of production hence arising would, by the competition of producers, invariably cause a fall of prices of all the articles into the cost of which the interest of money entered as an ingredient." (p. 144)

In the same vein, Patman (1952) asserted that, "The more interest that business must pay for the capital it uses the more it adds to cost of doing business. To that extent, increases in interest rates are inflationary". (p. 735)

It should be noted that when Tooke and Patman were making their assertions, the Western European economies were at the initial stages of modernisation. Their capital markets were quite rudimentary and the producers relied heavily on the banking sector for working capital and investment funds. In other words, the supply channel was dominant and this realisation informed the conduct of financial sector policies during the early 19th century. By the middle of the 20th century, the demand had become dominant. Accordingly, the financial sector policies changed to what it is today. However, largely under the influence of the international financial institutions, many developing countries embarked on financial sector policies similar to those of the present day developed countries ignoring the fact that the supply channel of linkage between the financial sector and the economy is still dominant. Consequently, there is widespread disappointment in outcomes.

Role of the State in SSA Financial Sector Development

Clearly, in an economy where the supply channel of linkage between the financial sector and the economy is dominant, the financial sector itself is dominated by the banking sub-sector with the capital market either non-existent or quite rudimentary. Evidently, this is a better approximation of the situation in virtually all of the SSA countries. The role of the state in financial sector development in SSA should, therefore, go beyond regulation and surveillance of the banking sector to the establishment and deepening of the capital market.

For this purpose, the state should intervene to get things started in the capital market. Therefore, the reform of public sector enterprises should be instrumental in establishing and deepening the capital market. To begin with, the lucrative public sector enterprises should be commercialised and given necessary institutional framework (including incorporation as companies) that will enable them to form the foundation stocks of the capital market. The investment programmes of such enterprises should cease to be funded by government treasury once they are listed in the capital market. Instead, they should issue bonds in the nascent capital market as a way of gradually diluting the ownership. Over time, the share of government in the total equity of the companies should be falling and this process can be speeded up by government offering its own stock for sale to the nascent investing public. The next step is for the government to pursue aggressive reform measures to make hitherto unprofitable public sector enterprises quite profitable and hence eligible for commercialisation and subsequent listing on the national stock exchange. This way, the number of enterprises listed on the national stock market will increase and the market capitalisation will also grow.

It is imperative to recognise that in order to sustain the growth of capital market in SSA, the prevailing syndrome of minimalist state should change. Instead, government should be seen as an agent that plays three inter-related roles in the development process in general and the capital market development in particular. The first role is that of an enabler where government creates enabling environment for all economic agents to maximise their socially acceptable welfare.

The second is that of a frontier shifter where government continues to invest in sectors and activities which are either too risky or too large for private entrepreneurs. A contemporary example is the role of the US government in the space programme between 1960 and now. It should be recalled that it is only recently that private sector involvement in the sector as investors becomes perceptible. This is because the government has shifted the frontier considerably and it is now possible for the private sector to exploit the new field. Outer space programmes are still entirely in the responsibility of governments of the developed countries. It is, therefore, inappropriate for anyone to restrict the roles of governments of SSA countries and, indeed, developing countries to that of an enabler. Instead, what is required is to continuously build capacity and retooling the public sector to be able to play the roles of an enabler and a frontier shifter. In order for government to be able to play the role of frontier shifter without regular recourse to the budget, public sector enterprises should be sold at appropriate prices and the proceeds should be kept in development fund accounts that can only be used for frontier shifting investment programmes.

The third role of the state is that of initiating development activities. In other words, state intervention is required to get things started in an otherwise green field. This is essentially similar to the second role of the state except that the fund for these activities will have to come from the development budget. It is reasonable to presume that with the exception of countries emerging from wars and severe state breakdowns, most SSA countries have passed this stage. However, states emerging from war situations and or those that really have nothing to privatise should not be precluded by the current development paradigm from creating public enterprises. The challenge for development practitioners and policymakers is to design appropriate monitorable framework for progressing towards commercialisation and privatisation at the earliest possible time. The current strategy of preventing the state from initiating development activities in areas where the private sector is either unwilling or unable to venture is tantamount to compromising development prospect of the present day developing countries. The point here is that the role of the state in financial sector development in SSA should be viewed from the prism of a developmental state. Development partners, practitioners and policymakers should be preoccupied with the articulating strategies for ensuring that the state does not deviate from the path of a responsible developmental state. This is imperative if SSA countries are to catch up with East Asian countries, keep pace with them and possibly surpass them.

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8

Capital Market Development in Uganda

Damoni Kitabire

The focus of Brian Kahn's chapter is on the problem of "original sin", which is the inability of developing countries (in particular governments) to borrow abroad in domestic currency (narrow definition) and the difficulty faced by developing countries in borrowing at home at long maturities (broad definition). The chapter argues that bond market development can play a critical role in overcoming this problem (for governments, this means financing fiscal deficits), as well as contributing to financial market deepening and providing information to the market on benchmark long-term interest rates across a maturity spectrum (yield curve).

Uganda's Experience

In the late 1990s, both the Bank of Uganda and commercial banks in Uganda supported the introduction of long-term government bonds. The Bank of Uganda was keen to develop a benchmark yield curve to promote capital market development and stimulate long-term bond issues by the private sector, while commercial banks hoped to boost profits from higher rates of interest income on longer-maturity low-risk government securities, at a time when interest rates on shorter-term securities were low.

Since 2004, the Bank of Uganda has issued 2-year, 3-year, 5-year and 10-year government bonds. For a number of years beforehand, the Ministry of Finance, Planning and Economic Development deferred the issuance of long-term government bonds and still have some

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concerns for the following reasons:

Establishing a yield curve requires a critical number of competitive investors in the market for long-term securities to develop a functioning market – Uganda still lacks that critical number. This means that the proposed benefits are at best marginal and will not materialise until there are a sufficient number of competitive investors (which will require pension sector liberalisation).

The government of Uganda does not have a domestic borrowing requirement and specifically plans its budget to avoid domestic borrowing so as to create more room for private sector borrowing from the financial system. (Uganda's high fiscal deficit is financed by donor aid, not domestic borrowing. The rapid expansion in the issuance of treasury bills has been for purposes of liquidity management, not to finance the deficit). The IMF recommended that the government of Uganda should not issue long-term bonds unless these are needed to finance the fiscal deficit.

In conducting monetary policy, yields on government bonds issued are generally higher than on treasury bills reflecting the premium required for longer-maturity securities, therefore the introduction of bonds will increase the budgetary cost of liquidity management.

The market for long-term bonds in Uganda is very shallow, meaning that the supply curve for long-term funds is inelastic; hence no bond interest rate is independent of the demand for funds from bond issuers. (In other words, bond issuers are not price-takers and a reliable yield curve is difficult to establish; a yield of 15 percent on a 5-year government bond does not mean private issuers can assume a similar yield). Bond market development requires financial institutions that hold long-term liabilities, because only by holding long-term liabilities can a financial institution invest in long-term assets. Uganda has no such institution except for NSSF (pension monopoly), which invests its long-term assets in short-term assets or real estate. The issuance of government bonds should not have preceded the reform of the supply-side of the capital market (including liberalisation of the pension sector and introduction of private sector pension institutions).

Issuing a government bond crowds out private sector issuers of securities (both in volume and cost terms), damaging long-term productive investment in the economy. Due to the absence of long-term saving institutions in Uganda, there is a very limited supply of funds for investment in long-term securities, yet potential high demand for long-term funds from companies such as Stanbic Bank, UTL and

BAT etc. Government issuance of long-term bonds simply exacerbates the imbalance between supply and demand.

Following the introduction of bonds, one-third of total domestic debt is now longer-dated, which poses a considerable rollover risk (especially in the event of a withdrawal of donor aid). Further, the government of Uganda operates a three-year macroeconomic framework, so the timing of maturities is not consistent with the liquidity management time profile.

Summary

Uganda does not face the "original sin" problem as it is able to finance its fiscal deficit through donor grants and concessional loans.

The development of bond markets and issuance of government bonds should be carefully sequenced, not preceding reforms of the supply-side of capital markets, which (i) increase the number of financial institutions holding long-term liabilities (such as private sector pension institutions) and consequently the supply of funds for investment in long-term securities; and (ii) increase the number of competitive investors in the market for long-term securities required to develop a functioning market and a reliable yield curve. Premature bond market development delivers only marginal benefits but significant costs in terms of private sector crowding out and higher budgetary costs of conducting monetary policy.

In terms of priorities for capital market development, bond market development should not be a priority, so long as long-term bonds are not needed to finance the fiscal deficit. In Uganda, priorities for capital market development are pension sector reform and expansion of microfinance provision.

9

Infrastructure, Regional Integration and Growth in Sub-Saharan Africa

Benno Ndulu, Lolette Kritzinger-van Niekerk and Ritva Reinikka

Achieving higher economic growth is one of the major challenges for sub-Saharan Africa. Its long-term growth has been slow relative to other developing countries, experiencing less than half of the average growth and about half of average investment efficiency levels obtained in other developing countries. More recently, about half of the countries in sub-Saharan Africa have been growing at a somewhat higher rate of 4 percent per year or more.[1] Yet, the policy response has not been sufficient to overcome nearly two decades of falling incomes per capita or to reverse other adverse legacies from the long period of economic decline – including deteriorated capacity, weakened institutions, and inadequate infrastructure.

In explaining Africa's slow long-term growth, one can make a distinction between endowment variables and policy variables. Although many of the studies on growth have emphasised the influence of government policy on risk and barriers to competition, governments also have an important role in providing public goods, supporting the provision of infrastructure, and addressing market failures. The under-provision of public goods and services can significantly increase costs to firms and make potential opportunities unprofitable. Inadequate infrastructure is one of the key impediments to faster economic growth.

[1] Sub-Saharan African countries with growth rates above 5 percent during 2001–02 include Botswana, Burkina Faso, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Ghana, Malawi, Mali, Mauritius, Mozambique, Namibia, Rwanda, Senegal, the Seychelles, Swaziland, Tanzania and Uganda.

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In this chapter, we focus on infrastructure and regional integration as two mechanisms that can help foster stronger economic growth in Africa. During the past decade and a half, focus has been more on improving health and education. It has meant that in foreign aid in the 1990s, support to human development for Africa increased from 14 percent to 34 percent. This shift was accompanied by similar shifts in governments' own expenditures. At the same time, private investment in infrastructure did not materialise as initially expected. As a consequence, infrastructure has not received adequate attention in public policy and spending.

This chapter will reflect on the need to reverse this shift, while maintaining the gains made in human development. We will briefly discuss needs for infrastructure investment and finance, inspired by the new focus on Africa, recent promises of doubling of foreign aid, the work of the Commission for Africa, and so forth. We will also discuss regional cooperation, particularly from the perspective of improved infrastructure services and economic growth.

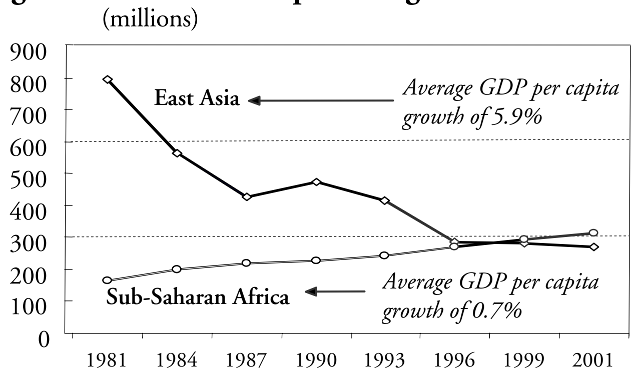
We will argue for a big push to offset or mitigate the disadvantages of Africa's "unfavourable" endowments mainly through improved infrastructure and regional integration. In the case of infrastructure, success will require breaking with the past by applying greater economic scrutiny of projects at the selection stage, integrity in procurement, efficiency in implementation, effective post-completion management to ensure maintenance and efficient operation and, continuing accountability to users.

In the remainder of this chapter we will: (i) analyse the close link between economic growth and poverty reduction; (ii) review the geographical constraints to growth in African countries and argue the case for a big push for improving infrastructure in Africa, as a necessity for scaling up growth and facilitating delivery of services to the poor; (iii) call attention to the large financing gaps for investment and, given the fact that private sector investment is currently a small proportion of total resource outlay, point to the need to scale up public investment; and (iv) emphasise the important role infrastructure plays in fostering successful regional integration in Africa through improved connectivity to enhance market integration, requiring effective regional coordination in infrastructural investments.

1 Poverty and the Challenges of Slow Growth in Africa

The African growth performance of the 1980s and 1990s has been

Figure 1 Number of People Living on Less Than $1 Per Day



Source: Chen and Ravallion, 2004; WDI.

disappointing, in spite of reforms. More than half of sub-Saharan African countries have pursued economic reforms to improve macroeconomic management, liberalise markets and trade, and widen the space for private sector activity. There is evidence more recently on higher growth, but it is still insufficient to eliminate poverty.

Figure 1 covers the 1980s and 1990s and shows the dramatic drop in poverty – people living on less than 1 dollar a day – in East Asia, which has been growing very considerably at almost 6 percent per capita. Towards the end of 1990s, sub-Saharan Africa overtook East Asia as the home of the largest absolute number of poor people, reaching now 300 million.

Figure 1 captures the close link between economic growth and poverty reduction, when poverty is measured by household consumption.

On the challenges of slow African growth, we identify four areas: (1) the low capital accumulation, in absolute terms, or relative to GDP; (2) the high price of investment goods for African investors; (3) the low productivity of investment; and (4) geographical disadvantages. We will discuss each of them briefly.

Low Capital Accumulation

During the four decades since 1960, African countries have achieved significantly lower capital accumulation than other developing regions (see Table 1). The ratio of investment to GDP in sub-Saharan Africa (in 1985 international prices) averaged 9.5 percent of GDP compared to nearly 15.6 percent in other developing countries (Hoeffler, 1999).

Table 1 Low Capital Accumulation, Comparative Investment Rates, Africa versus Other Regions, 1960-1992

Region	Capital stock, growth rate	Investment rate: National prices (2)	International prices (3)	Ratio (2) to (3)
Africa	4.8	19	9.5	2
China	6.7	22.3	20.5	1.1
South Asia	5.2	18.9	11.3	1.7
Latin America	5.4	21.4	16.9	1.3
Industrial countries	4.5	20.8	24.5	0.8

Source: Columns (1)-(3): Collins and Bosworth (1996), Table 2.
Column (1) is derived from estimates of the capital stock, which are in turn derived by applying the perpetual inventory method to annual investment data from column (2).

African countries have also largely under-invested in infrastructure against the wisdom that countries which typically manage to invest more, do so particularly in infrastructure sectors (Esfahani and Ramirez, 2003).

High Price of Investments

The second point is that investments in African countries are more expensive. There are two explanatory facts. First, the average relative price of investment goods for sub-Saharan Africa was 70 percent higher than for OECD countries or East Asia (Sala-i-Martin, Doppelhofer, and Miller (2004)). Thus, a firm has to be much more profitable to afford those investment goods. Using this information, Artadi and Sala-i-Martin (2003) estimate that the average growth rate in African countries would have been 0.44 percentage points higher in every year, if the relative price of investment goods was the same as in OECD or East Asia.[2] The second explanatory fact for high prices of investment goods are higher transport costs for capital goods, which are largely imported. We will give some evidence in Section 2 on how much higher these costs are. The high costs of capital goods in Africa also comes out clearly in the country-specific enterprise surveys, carried out by the World Bank (2004).

[2] This cost differential is reflected in the wide divergence between the average share of investment in GDP for SSA in domestic and international prices. In domestic prices this ratio for the period 1960-1994 (weighted by average GDP at 1985 international prices) was 19% compared to only 9.5% at 1985 international prices (Table 1).

Table 2 Low Returns on Investment, Productivity of Investment – Returns Comparisons

	Africa	East Asia & Pacific	Europe & Central Asia	Latin America & Caribbean	Middle East & North Africa	South Asia
1960-69	0.326	0.301	0.263	0.259	0.54	0.314
1970-79	0.243	0.316	0.215	0.247	0.239	0.225
1980-89	0.151	0.146	0.109	0.085	0.106	0.235
1990-99	0.074	0.191	-0.229	0.143	0.214	0.22
2000-02	0.109	0.237	0.258	0.048	-0.022	0.175

Notes:
Investment productivity is defined as the amount of incremental output that is "derived" out of additional capital stock (investment) – here ratio of growth rate to investment rate.

Source: Author calculation based on data from GDF and WDI online database.

Low Returns on Investment

Table 2 presents some evidence on low returns on investment in Africa, as compared to other developing regions. The table presents a simplified ratio of growth rate to investment rate for more than four decades. If we look at Africa, it is notable that "investment productivity" for the early decade of the sixties was quite high and comparable to the level in other developing regions. However, this average sharply fell during the 1980s and 1990s, and lagged behind East and South Asia by a factor of three and, Latin America by a factor of two during the 1990s. But this is just the ratio of growth rate and investment rate to try to capture the issue that for similar levels of investment African economies have on average achieved only half the growth achieved in other developing regions. There are many possible reasons for this. One of them is poor quality of investment choices. Looking back, there have been too many white elephants. Another explanation is the low utilisation of installed capacity and lack of complementary human skills, which are needed to gainfully use more complex capital. An explanation that we are especially highlighting is under-investment in infrastructure, or complementary capital, necessary to private investment in productive capital.

Aschauer (1989) found that the stock of public infrastructure capital in the US had a significant effect on total factor productivity, a 10 percent increase in the public capital stock raising total factor productivity by almost 4 percent.[3] Devarajan, Easterly and Pack (2003) point to another category of factors, namely, poor incentives created by foreign exchange market distortions and large budget deficits, which they conclude significantly explain why investment is not productive in Africa. The World Development Report (2004) *A Better Investment Climate for Everyone* shows that improvements in the investment climate can raise both investment and productivity. The Report shows that improving policy predictability alone can increase probability of new investment by over 30 percent. Furthermore, firms facing strong competitive pressure are 50 percent more likely to innovate than those that do not.

Geographical Disadvantages

Geographical disadvantages are the fourth set of factors underlying slow African growth. One disadvantage is the burden of disease due to tropical climate, which hampers growth through an adverse impact on life expectancy, human capital formation, and labour force participation. Ninety-two percent of sub-Saharan Africa lie within the tropics compared to 3 percent in the OECD countries and 60 percent in East Asia. Artadi and Sala-i-Martin (2003) estimate the forgone growth in Africa as a result of malaria prevalence to be a high 1.25 percent annually.

The geographical dislocation with respect to input and output markets is another geographical disadvantage. We have evidence from Limão and Venables (2001) on the median transport costs. For instance, for intra-regional trade in sub-Saharan Africa transport costs are $7,600, while the comparable figure for Latin America and the Caribbean is $4,600; in East Asia under $4,000; and in the Middle East region just above $2,000.

Furthermore, the geographic fragmentation of sub-Saharan Africa reduces the prospects of creating growth by exploiting economies of scale. Sub-Saharan Africa is divided into 48 small economies with a medium size of GDP of $3 billion. A large number of these countries is landlocked, hosting 40 percent of sub-Saharan Africa's population. Transport costs in landlocked countries are 50 percent higher than in typical coastal economies, and their trade volume is 60 percent lower.

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[3] Using a Cobb-Douglas production function and annual data for the 1949-1985 period, Aschauer (1989) found a strong positive relationship between productivity and the ratio of the public to the private capital stock in the US.

Table 3 Interregional Comparison of Geographical and Sovereign Fragmentation Indicators

						Natural Resource (NR) rents dominance[c]		
	Ratio of nr. of countries to area (*10^{10})	Average population density (people per km^2)	Average number of borders	% of population in landlocked countries	Average transport costs ($)	Proportion of NR economies[d]	% NR economies in each region[e]	frequency of NR economies[f]
SSA	2	77.7	4	40.2[a]	7,600	64	32	6
EAP[g]	1.44	405.5	2.09	0.42	3,900[b]	52	13	8
ECA[g]	1.17	74.6	4.93	23.06	–	36	11	3
LAC[g]	1.52	119.9	2.34	2.77	4,600	80	26	7
MNA[g]	1.6	136.3	3.94	0	2,100	78	15	5
SAR[g]	1.67	382.9	2.75	3.78	3,900[b]	38	3	3

Notes:

[a] Congo, Dem. Rep., Sudan and Ethiopia are treated as "landlocked" countries.

[b] Data on transportation costs is available for East and South Asia region together (Limão and Venables, 2001).

[c] An economy which generates more than 10 percent of its GDP in primary commodities exports is classified as a "natural resource economy".

[d] As a share of the total # of countries in each region.

[e] As a share of the total # of "Natural Resource" economies 93 (in the world).

[f] Average number of times a "Natural Resource" economy generates greater than 10% rents from exports of primary commodities over the period 1960-2002.

[g] East Africa and Pacific (EAP), Europe and Central Asia (ECA), Latin America and the Caribbean (LAC), Middle East and North Africa (MNA), South Asia Region (SAR).

Population density in sub-Saharan Africa is relatively low, and though urbanisation rates are rising, a large share of population resides in rural areas. All these factors result in a high transport intensity of economic activity.

There is also a tendency that each country prefers to have its own institutions and to do things within its national borders, which exacerbates the problems of geographic dislocation.

The situation is partly a result of colonial legacy and got worse post independence with the break up of federations (e.g. Northern Rhodesia Federation), customs unions, currency zones (only the CFA zone survived), as countries established their own trade regimes, central banks, and immigration administrations. This further multiplied policy frameworks; fragmented transport networks (e.g. disbanding of the

East African Railways); and led to increased trans-shipments, longer transit times, and more limited backhauls.

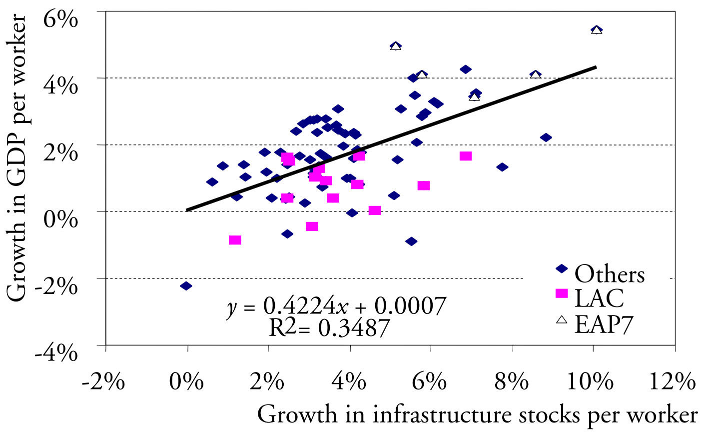
Table 3 provides evidence of geographical and sovereign fragmentation. Sub-Saharan Africa has a relatively high number of countries to area and a low average population density. The average number of borders is high, but it is also high in Eastern Europe and Central Asia. The proportion of population in landlocked countries is by far the highest in Africa, as are transport costs and natural resources rents. The proportion of natural-resource based economies is high in Africa, but it is also high in several other developing regions. While the figures in Table 3 indicate several geographic disadvantages, it does not mean that Africa is suffering from all of them. But in many areas, Africa is fragmented and hence is face with geographical disadvantages.

The consequences of fragmentation include higher costs of production and trade (within the region and with the rest of the world), and the now well-studied effects of ethnic fragmentation, accentuated by the sovereign fragmentation. Easterly and Levine (1997) highlight the role of polarised societies, captured by the measure of ethnic diversity, in encouraging the adoption of growth-retarding policies (that foster rent-seeking behaviour) and making it more difficult to build a consensus for delivering growth-promoting public goods, such as infrastructure and education.

2 Infrastructure and Growth in Africa

Having broadly reviewed the challenges of growth in Africa, in this section we turn our focus to improved infrastructure as an important measure for offsetting or reducing the impacts of some of these factors. There are four broad strands of empirical studies which assess the contribution of infrastructure to growth and poverty reduction. The first focuses on aggregate impacts of infrastructure on long-term growth, using either reduced form cross-country regressions or structural models. The second assesses the impact of infrastructure or complementary capital on firm performance and investment in productive capital at the firm level. The third strand explores infrastructure and important platforms for growth, such as trade. The fourth strand assesses the impact of infrastructure on delivery of services, and hence achievement of the Millennium Development Goals. We will briefly discuss each of these strands below.

Figure 2 Infrastructure Stocks and Growth of GDP
(1960-97 country averages, percent)



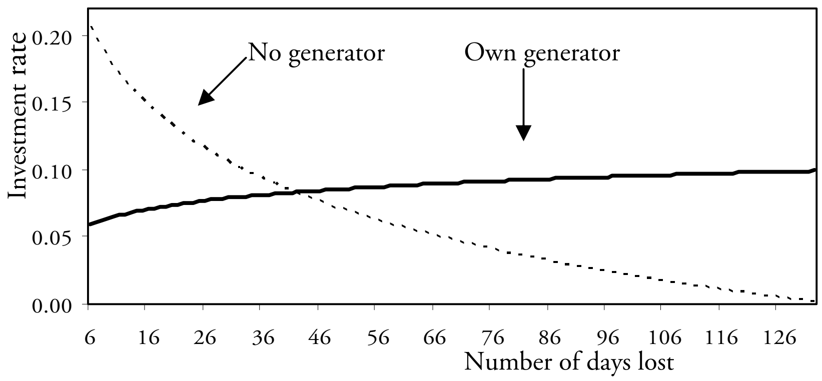
Source: Calderón and Servén (2003).

But before discussing them it is useful to note how infrastructure contributes to growth in Africa. Infrastructure is important for creating wealth, both within households and within enterprises. Infrastructure reduces costs faced by enterprises and enlarges their markets. Enterprises are more willing and able to invest in productive assets, when the complementary capital is in place and services are at low cost. For households, access to utility and infrastructure services dramatically improves living conditions and welfare.

Aggregate Impacts

Easterly and Rebelo (1993) have found that public expenditure on transport and communications has a positive effect on growth. Studies prepared for the 1994 World Development Report estimate that on average a 1 percent increase in infrastructure stock is associated with a 1 percent increase in GDP. More recent studies (e.g. Esfahani and Ramirez, 2003) show that the contribution of infrastructure services to growth is substantial and in general exceeds the cost of provision of those services. For example, if the growth rate of telephones per capita rises from about the current 5 percent per year in Africa to 10 percent per year as in East Asia, the annual growth of GDP would rise by about 0.4 percentage points. In the power sector, an increase of per-capita

Figure 3 Investment Rates of Ugandan Firms as a Function of Poor Electricity Service



Source: Reinikka and Svensson, 2001

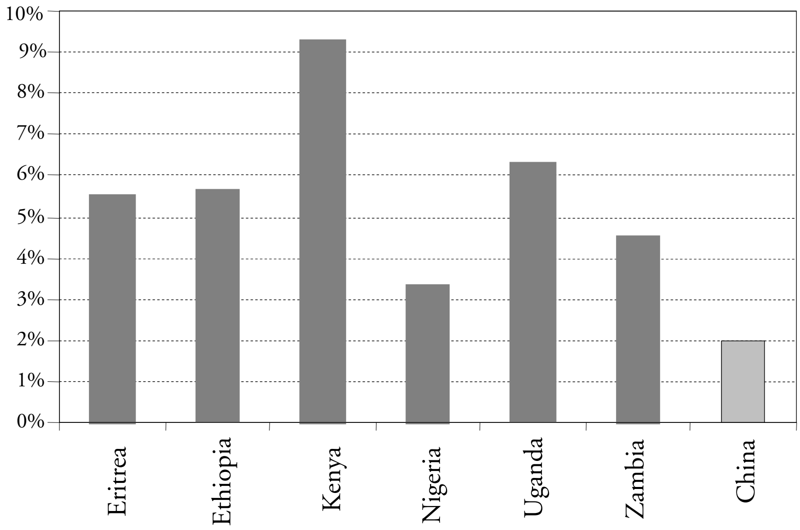
production growth rate from the current 2 percent in Africa to 6 percent as in East Asia, can raise annual GDP growth rate by another 0.5 percentage points.

The cross-country regression in Figure 2 shows a positive cross-country impact of growth in infrastructure stocks on growth of GDP per worker. Another recent study by Calderón and Servén (2004) finds that growth is positively affected by the stock of infrastructure assets, and that income inequality declines with higher infrastructure quantity and quality.

Firm Level Impacts

Moving from aggregate level to micro (firm) level, Figure 3 shows the impact of infrastructure on private investment using enterprise survey data. In this study, Reinikka and Svensson (2002) relate investment rates of Ugandan firms to the number of days without electricity. For firms without their own generator, investment rates are high, over 20 percent, when they do not have many lost days during the production year due to power cuts. When more operation days are lost due to power outages, as shown in figure 4, the investment rate for these firms declines very fast; when over 30 days are lost, the investments rate falls under 10 percent. But the level of productive investment stays low, below 10 percent, for firms that own a generator. This is because firms have to invest, on average, around 25 percent of the total investment funds in generators. Hence, productive investment will be reduced.

Figure 4 Output Loss Due to Power Outages in Various Countries (percentages)



Source: Wormser, 2005.

Figure 4 makes a similar point, showing average output losses due to power outages in six African countries and China (Wormser, 2004). Kenya has the biggest losses at close to 10 percent. That of course, severely hampers the competitiveness of firms.

Impact via Trade

For most African countries distance from their primary markets and high transport costs of their products inhibit their participation in the global economy. Transport costs represent the biggest form of such a disadvantage and they in turn, depend on the level of infrastructure. The burden of poor infrastructure on trade increases with geographic and sovereign fragmentation, and, as discussed before, sub-Saharan Africa is uncharacteristically highly fragmented.

Amjadi and Yeats (1995) demonstrate that relatively high transportation costs especially for processed products often place African exporters at a serious competitive disadvantage. Nominal freight rates on African exports are normally considerably higher than those on similar goods shipped from outside the region. In 1970, for example, net freight payments to foreign nationals absorbed 11 percent of

Table 4 Impact of Infrastructure on Trade

	Shipping data			CIF/FOB		Gravity	
Infrastructure: percentiles	Transport costs $	Sea km, equiv. change	Land km, equiv. change	CIF/FOB ratio	Km, equiv. change	Trade volume % change	Km, equiv. change
25th	4638	-3989	-481	1.11	-2358	68%	-2005
Median	5980			1.28			
75th	6604	3466	419	1.4	2016	-28%	1627

Source: Limão and Venables, 2001.

Africa's export earnings; that ratio had increased to 15 percent by 1990. And for landlocked African countries, the freight cost ratio exceeds 30 percent, as exports must transit neighbouring territories. In a similar vein, a more recent study by the African Development Bank (1999) on exports to the United States found that freight charges as a proportion of CIF value are on average approximately 20 percent higher for African exports than for comparative goods from other low-income countries.

Limão and Venables (2001) present some evidence that infrastructure has a large impact on trade costs and consequently on trade volumes (see Table 4). They find that the median landlocked country has only 30 percent of the trade volume of the median coastal economy. Halving transport costs would increase that trade volume by a factor of five. Improving the standard of infrastructure from that of the bottom quarter of countries to that of the median country would increase trade by 50 percent. So improving infrastructure in sub-Saharan Africa is especially important for increasing African trade.

Limão and Venables (2001) argue that landlocked countries can substantially reduce transport costs by improving the quality of their infrastructure and that of transit countries. They estimate the elasticity of trade flows with regard to transport costs to be high, at about -2.5. Infrastructure problems largely explain the relatively low levels of African trade.

Impact via Service Delivery

Infrastructure is not just about supporting growth and trade, it is equally about poverty reduction through lowering the cost of access to quality social services. In this broader sense, the question is not about choosing between infrastructure and other social sectors, but on investing in infrastructure for better social outcomes. The 2005 World Development Report presents several examples of such outcomes. Building rural roads in Morocco increased primary school enrolment from 28 to 68 percent; access to clean water reduced the probability of child mortality by 55 percent, the presence of a paved road in the community more than doubled girls' school attendance (according to a study on Morocco). In Colombia, 72 percent of children with electricity at home read in the evening, compared to only 43 percent of those without. Calderón and Servén (2004) in a study of over 100 countries from 1960-2000, demonstrate that infrastructure reduces income inequality and benefits the poor more than proportionally.

Wormser (2004) provides another set of examples of such impacts from studies in sub-Saharan Africa. In Central African Republic, 10 percent increase in an index of Water and Sanitation reduced child and infant mortality by 4 to 5 percent and maternal mortality by 8 percent. In South Africa, households without electricity spend 14 to 16 percent of their incomes on energy compared to 3 to 5 percent for those with electricity in their homes. In Kenya, using wood fuels instead of charcoal, increase childhood respiratory infections between 21 percent and 44 percent. In Zambia, access to a passable road was associated with a decrease in the probability of child labour by 5.5 percent; with an increase in probability of school attendance by 7.4 percent and with higher educational achievement.

Much more evidence on the relationships between infrastructure and poverty reduction comes from Latin America. It would be worthwhile to study these relationships more closely, because infrastructure is an important public policy issue. There are a few studies showing that better infrastructure is essential in achieving the Millennium Development Goals, such as better education and health outcomes. In Colombia, of the children with electricity at home, 72 percent read in the evening, while without electricity this is only 43 percent, which is a large difference.

This kind of infrastructure services provision also has an impact on inequality. Calderón and Servén (2004) recently showed that in Peru, for instance, improving infrastructure to the level of Costa Rica, which is the Latin American leader, would increase the income share of the poorest quintile of the population from 5.6 to 7.5 percent.

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Table 5 Access to Infrastructure and Income Distribution
(in percentages)

	Electricity		Piped water		Improved water	
	Early 90s	Early 00s	Early 90s	Early 00s	Early 90s	Early 00s
Poor	0	0	0	0	35	39
Q2	1	4	0	0	41	53
Q3	4	13	0	2	51	57
Q4	22	32	13	10	70	70
Rich	68	75	53	43	88	85

Source: Estache (2005).

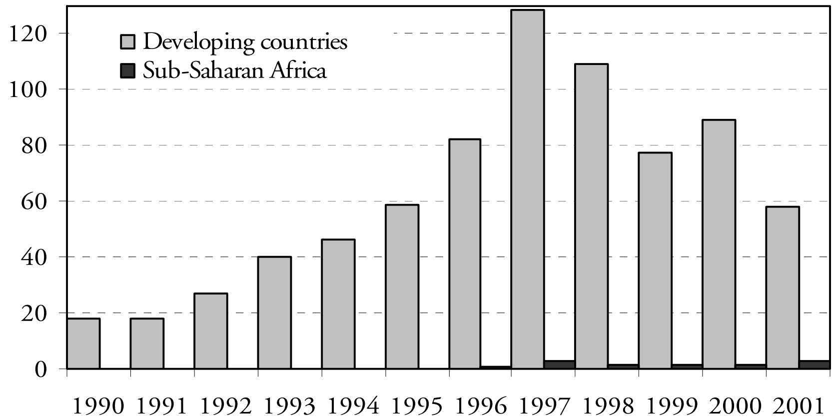
Table 5 presents some results from research on access to infrastructure and income distribution by Estache (2004a,b). It shows early-1990s and early-2000s access figures for electricity, pipe water, and improved water. For instance, in pipe water, where there had been some private participation, access actually declines over the decade and one can see that the lowest 40 percent do not benefit at all. They did not benefit before either, but they did not benefit from these reforms.

Access to electricity in Africa is very low (Table 5). Even in electricity, one can observe that wealthier people are better-off. In the lower income groups, the penetration of electricity is extremely low. Access to improved water – not piped water, but some other kind of improved water source – has however increased also for the poor. So, there has been some progress, some of the policies and interventions that have been included in the PRSPs and put into practice in the 1990s have delivered results to the poor.

3 Financing of Infrastructure

Anticipating increased assistance to Africa by the donor community, World Bank has estimated how much might be needed. Today total expenditure is about 2 to 2.5 percent of GDP on infrastructure, of which private investment is just 0.3 percent. The infrastructure investment needs are estimated at 5 percent of GDP per year and the operation and maintenance 4 percent, totalling 9 percent of GDP, which would mean a massive increase in infrastructure spending.

Figure 5 Financing of Infrastructure – Declining Private Flows
(in billions of 2001 dollars)

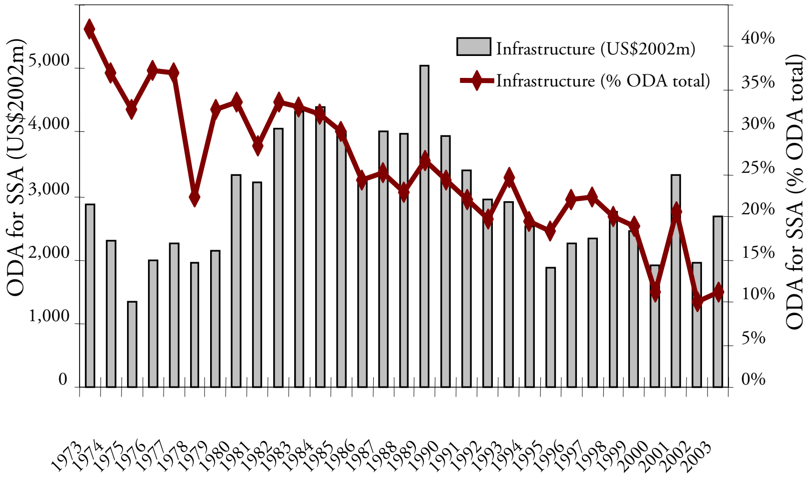


Source: World Bank PPI Projects Database.

Figure 5 shows that there are declining private flows into infrastructure in developing countries. They peak in 1997, after which they are going down. In other words, the private capital investment did not materialise as expected. Foreign direct investments in Africa are not declining, but they are very small. Although the 1990s saw rapid expansion of private sector participation in the developing countries, sub-Saharan Africa has had limited success in attracting private sector investment into infrastructure outside of telecommunications. Between 1990 and 2002 private commitments for infrastructure in sub-Saharan Africa, totaled $27.8 billion compared to $804.9 billion for the developing world as a whole. Nearly two thirds of this amount ($18.5 billion) was for telecommunications. At the same time, official development assistance (ODA) financing of infrastructure has declined since the early 1970s. Figure 6 provides the evidence.

Despite the changes since the 1990s the domestic public sector remains the most dominant source of financing spending on infrastructure in the developing world, accounting for 70 percent of current spending on infrastructure. The private sector and ODA account for 20-25 percent and 5-10 percent respectively, for the developing world as a whole (Briceno *et al.* (2004). The private sector is in fact a much smaller contributor for Africa. Therefore, the importance of the public sector cannot be overemphasised, particularly in financing road and railway services where so far private participation in Africa is minimal.

Figure 6 Financing of Infrastructure – Drop in ODA financing



Source: OECD IDS Online Database, 1973-2003

4 Regional Cooperation for Improved Infrastructural Services and Growth

There is a close relationship between regional integration, growth, and infrastructure. It is possible to face Africa's geographical disadvantages and address the financing needs more effectively by focusing on regional solutions.

One area has to do with regional commons, that is, cooperation in the management of shared natural resources. There are initiatives like the Nile Basin or the Great Lakes, where countries come together to manage water sheds in international rivers to everybody's benefit.

There are public goods with trans-boundary implications, for instance, infectious diseases. One country cannot deal with malaria or air pollution on its own, because these travel across-borders. Hence joint action is needed.

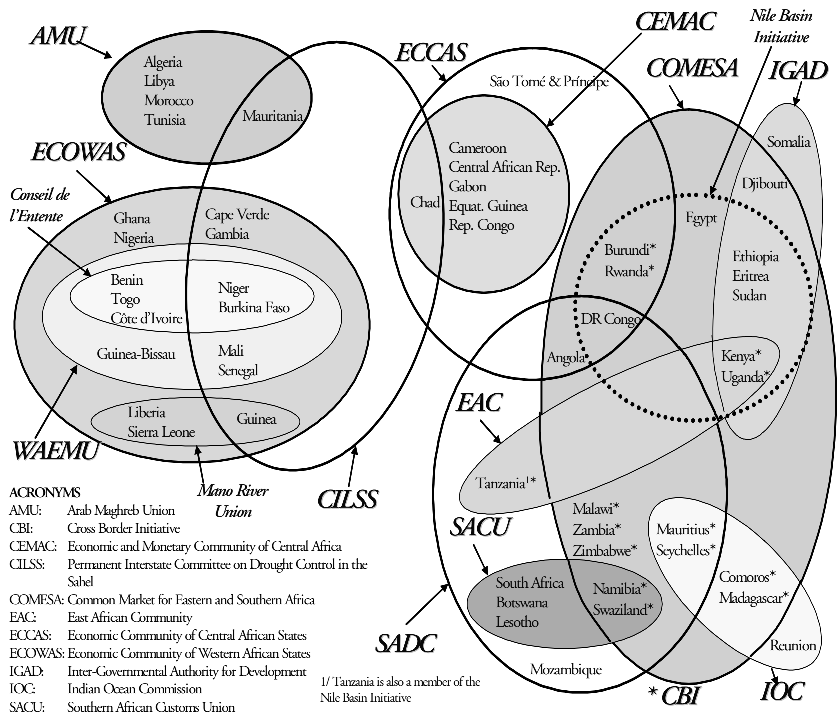
Many policy issues can be best tackled through a regional integration approach, such as, converging macroeconomic policies, as we see in the Southern African Customs Union. Legal and regulatory frameworks are increasingly being harmonised, for instance in Eastern Africa. Scale and competition are improving through integration of infrastructure, markets for goods, finance, labour, and energy.

The renewed regional initiatives are largely built on the principle of open regionalism, involve greater participation of the private sector, and accommodate variable geometry/multi-speed arrangements. There are other notable differences with past initiatives, including up-front resolution of the difficult issues related to sharing benefits from collaborative arrangements; increased attention to investment facilitation and connectivity; collaborative arrangements to deal with peace, security and sustainable development; and harmonisation or coordination of policy and institutional reforms.

Infrastructure is one of the key areas of collective regional interest that NEPAD and a number of sub-regional integration initiatives have recently raised. The objectives are partly to foster integration of African markets through improved connectivity and partly to facilitate cross-country investment within Africa. The high proportion of landlocked countries necessitate cross-border trade facilitation and coordination in trans-boundary infrastructure investment. In other cases, trans-boundary cooperation in the provision of infrastructure services could lead to substantial reduction of their cost among members and enhance reliability of services. A good example of potential here is the West Africa Power Market Development Project, where there is a large potential for significant reduction in power generation costs. Nigeria and Cote d'Ivoire could reduce their power generation costs from 8-10 US cents per kWh to only 3.5 and 4-4.5 cents per kWh. Two approaches are being pursued for regional infrastructure initiatives: regional or multi-country projects and coordination among individual country projects to maximise on cross-country synergetic effects of infrastructure projects. Examples for the former include the gas pipeline project between Mozambique and South Africa, the Nile Basin energy and conservation projects, and the planned West African Gas Pipeline project. Examples of investment coordination includes the Southern Africa power grid sharing and roads programme under the East African Community.

However, successful regional integration depends on countries fulfilling some pre-conditions, subscribing to keep principles and stick to them in practice. We argue that there is a need for rationalisation of regional integration arrangements in Africa and Figure 7 conveys that message. This maze of organisations may work against effective regional integration.

Figure 7 Geographic Scope: Regional Integration Areas in Africa



Pre-conditions for successful regional integration are to a large extent political: domestic peace and security in countries; political and civic commitment and mutual trust among countries. In the economic area, pre-conditions are a minimum amount of macroeconomic stability and financial management, price stability, realistic real exchanges rates, and sufficiently broad national reforms to open markets. Otherwise, regional integration may not fulfil the expectations.

Between the key principles for successful regional integration, openness is crucial. We argue that national and regional markets are too small, making openness to the rest of the world essential.

Further, the subsidiary principle is also important. Regional organisations should only do what national governments cannot do as well, where they have additionality, or subsidiarity. Private sector leadership is important. And integration should be applied with pragmatism and variable geometry, that is, countries join when they are ready.

5 Concluding Remarks

Much of the effort toward creating the conditions for growth in Africa have emphasised the influence of government policy and behaviour on risk and barriers to competition. However, governments also have an important role in providing public goods, supporting the provision of infrastructure, and addressing market failures. Under-provision can significantly increase costs to firms and make potential opportunities unprofitable. The background papers for the Commission for Africa correctly identify three fundamental constraints to Africa's future prosperity: geography, market integration, and institutions. In this chapter, we have argued that geographical disadvantages and natural resource dependence are not a predicament, as their effects can be offset or ameliorated. Botswana, the fastest growing economy in Africa (and among the fastest globally) for the past four decades, presents a striking example. It is landlocked, natural resource dependent and has not had a history of a settler colony. Arguably, the strength of its state capacity, its being part of the Southern Africa's relatively effective infrastructure system, customs union and monetary area (for a long period) helped offset the negative effects of remoteness and geographic and policy regime fragmentation. The wealthy interior of South Africa likewise is a story of fast growth in spite of remoteness and high natural resource dependence.

These two countries tend to be important exceptions from the typical African country that has largely under-provided quality infrastructure services leading to higher transactions costs for business and service delivery. During the 1990s, African governments and development partners sharply reduced the share of resources allocated to infrastructure in favour of scaling up spending in social sectors. Several reasons were behind this shift. One was the spectre of the "white elephants" in public infrastructure projects, which suffered particularly from inadequate provision for recurrent costs, unrealistic pricing, and a wide range of regulatory forbearance. Secondly, the 1990s and early-2000s saw an expansion of divestiture programmes and increased participation of the private sector in infrastructure, particularly in telecoms, water and power raising hopes that the private sector would fill the investment gaps. It has become clear that due to high risks and substantial externalities associated with investment in infrastructure, the balance between public and private sector involvement needed to be revisited.

Apart from good governance, the need for which is getting increasing attention in the region, the other big push area for reducing transactions costs for growth and delivery of services is infrastructure. The estimated resources needed to meet the growth and consumption requirements of infrastructure service at 9 percent of GDP are large. But it is possible to finance those gaps more effectively by increased regional integration and ensuring that in-country investments in infrastructure will lead to sustainable and efficient provision of services.

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10

Infrastructure, Regional Integration and Growth in Africa

Charles Abuka

I agree with Benno Ndulu, Lolette Kritzinger-van Niekerk and Ritva Reinikka that low capital accumulation, high price of investment goods, low productivity of investment and geographical disadvantages are indeed the set of challenges that slow African growth. It is true that investment in African countries is more expensive, 70 percent higher than for OECD or East Asia, and as a result Africa remains prone to losing 0.44 percent in average growth per annum. Geographical disadvantages, which include land-lockedness and poor infrastructure, have led to higher transport costs for capital goods, which are largely imported. These factors have exacerbated the prices of investment goods. It is agreeable, on the one hand, that the competitiveness of African enterprises and trade in global markets, income distribution and welfare depend on infrastructure, while regional integration has the solutions to mitigating Africa's geographical impediments, financing needs and growth on the other.

Infrastructure quality is a dominant explanatory factor of manufacturing performance and competitiveness. Infrastructure serves as a key component of the investment climate. Problems with roads, rail, ports, air transport, energy, telecommunications and other infrastructure are cited by the business community and African Finance Ministers as one of the chief constraints to economic growth in Africa. As much as 50 percent of the harvest is lost in many parts of Africa because farmers lack post harvest storage and are unable to get their goods to the market (Commission for Africa, 2005). To improve the quality of infrastructure, it is necessary to assess current and future priorities for infrastructure

From: Africa in the World Economy - The National, Regional and International Challenges
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development and for establishing investments and policy interventions. The process should start with the analysis of enterprise level priorities for infrastructure followed by sector level cost analysis for providing necessary air, road, water, railway transport and electricity. To compete effectively in international markets African countries need good and efficient electrical power infrastructure. Power is required to move rapidly into resource based manufacturing and commodity processing as well as trade in services. The efficiency of agriculture can also be enhanced by provision of reliable energy supplies. With 3.1 percent of world power generation, Africa has the lowest electrification in the world. Only 23 percent of Africa's population has access to electricity (ECA, 2004). The bulk of the electricity supply is unreliable and subject to power rationing or unscheduled cuts. In a World Bank survey of 55 countries, 67 percent of the firms cited electricity as a business constraint (World Bank/UMACIS, 2004). Indeed as the previous chapter points out the cost of running generators during outages make the overall costs of poor power supply even higher. Africa's export diversification drive is being slowed by poorly functioning energy infrastructure. The promotion of regional and sub-regional integration in energy services will promote the development of Africa's power sector. Regional power development will help reduce power costs and minimise operating costs of existing sub-regional networks.

Indeed Africa contends with high transactions costs. At present the costs and difficulty of moving goods in Africa are far higher than in wealthier countries, leading to higher consumer prices. The burden of high transport costs is greater in land locked African countries than elsewhere in the world, for example in land-locked countries where transport costs work out to be three-quarters of the value of exports. In particular, transport charges represent the equivalent of 80 percent of the cost of cloth exported from Uganda. Moreover in many African countries quantities are not pooled for transport and storage so as to achieve returns to scale. By extension, the continent operates on a rudimentary, costly and risky transport set up (Fafchamps and Gabre-Madhin, 2001). Transport related impediments make it extremely difficult to deliver goods to the market at competitive prices.

The problem of excessive costs extends beyond land transport into clearance at ports. For example, it costs about the same to clear a 20-foot container through the port of Dakar as it does to ship the same container from Dakar to a north European port. Shipping a car from Japan to Abidjan costs $1,500 but shipping the same car from Abidjan to Addis

Ababa would cost $5,000. Delays at ports are another problem. It is estimated that every day spent in customs adds 0.8 percent to the cost of goods. Africa has the longest delays among the regions of the world. Customs delays in the whole of Africa average 11.4 days; while in sub-Saharan Africa the delays average 12.1 days. For individual countries the delays range from 14 days in Uganda to as high as 30 in Ethiopia compared to an average delay of 3.4 days in Western Europe (Dollar *et al.,* 2000; ECA, 2004). On the other hand, excessive bureaucracy, high insurance costs, cumbersome customs procedures and outright corruption by public servants using bribes, official and unofficial checkpoints escalate transport costs in Africa.

Information and communications technologies are important for competitiveness and productivity and need improvement in Africa. Apart from encouraging developments in Botswana, Mauritius, Namibia and South Africa, the African region lags behind in the use of modern information technology in international trade. Limited use of information technology is explained by inadequate, inefficient and very expensive telecommunications services. Since Africa has the lowest Internet diffusion in the world, African countries are not yet making full use of e-commerce systems. Use of e-commerce is affected by deficient electronic infrastructure and the underdeveloped legal and regulatory framework. African entrepreneurs need training in the use of the Internet for business.

Trade Facilitation Initiatives

African countries have, from Seattle to Doha and Cancún, consistently expressed concern regarding the incorporation of issues of trade facilitation under the umbrella of the work programme of the World Trade Organization (WTO). At this stage, it is not productive to indulge on the polemics of the pros and cons of trade facilitation, but rather focus on the current status and future challenges. African countries recognise the importance of trade facilitation and the gains that can be made from a more efficient flow of goods and services as well as improved international competitiveness when transactions costs fall as result of improved trade facilitation processes. The importance African countries attach to trade facilitation has been reflected in numerous agreements at bilateral, sub-regional and regional levels as well as efforts made at the country level to facilitate the flow of goods and services. Such initiatives include trade facilitation measures being spearheaded within sub-regional organisations such as the East African Community (EAC), the Common Market for Eastern and Southern Africa (COMESA), the Southern African Development Community (SADC), the Economic Community for Central African States (ECCAS), the Economic Community for Western African States (ECOWAS), and the continental organisation, the African Union (AU), among many others. Despite these notable efforts to integrate Africa's economic space and improve its international competitiveness, most of the trade facilitation initiatives have yielded limited results. Transactions costs in many African countries remain high, as evidenced by high transport and communications costs; high charges and delays at numerous roadblocks; long customs and administrative delays at ports and border posts; and inefficient international payments systems.

Furthermore, non-compliance by some countries to agreed agreements on trade facilitation, poor programme implementation, lack of coordination among and between African countries, lack of coordination among relevant agencies within countries, inadequate skilled manpower and lack of a multi-sectoral approach to trade facilitation, have also contributed to the less than satisfactory outcomes on trade facilitation initiatives in Africa.

Regional Integration: Differences Between Poor and Rich Countries

The problem of multiple memberships of regional integration groups is discussed in the chapter by Ndulu, Kritzinger-van Niekerk and Reinikka. The nature of regionalism in Africa is that many countries are members of several RIAs. For example, within the five main regional economic communities associated with the African Union, ten countries belong to more than one regional grouping, with the Democratic Republic of the Congo holding three memberships. Multiple membership is only beneficial if the RIAs are compatible, which is not the case. Note that the option to form a trade bloc is exercised only if it increases the voter's utility further (Panagariya, 2000). This is not the case for Africa. Most of the RIAs have conflicting policies in treatment of third countries and sometimes-different regulations and technical standards governing the import of the same commodity from different sources. Indeed, overlapping memberships in the different regional groupings – and hence overlapping commitments – have resulted in duplication of effort and occasionally inconsistent aims in African regional integration initiatives (Masson and Pattillo, 2004). Ultimately, multiple memberships result in increased complexity, cost and uncertainty of trade (Schiff and Winters, 2003).

To solve these problems, African regionalism should move away from FTAs because they undermine members' own tariff structures and involve imposing rules of origin that are protectionist to forming customs unions in order to induce greater degree of integration and to increase trade gains. Indeed it appears to be more paying if small developing countries combine into a single market to reap economies of scale and enhance competition while raising revenue through tariffs on trade with the outside world.

It seems that globalisation took African countries by surprise. Initially, Africa's regional integration seemed to have started out of fear to be left out. It was not economic prospects but the "bandwagon effect" that drove Africa into regionalism. If everyone is doing it, shouldn't we? The rich countries had and still have a clear agenda for regional integration especially with the Africa countries namely to create an expanded and secure market for the goods and services produced in their territories, to enhance the competitiveness of their firms in global markets (Schiff and Winters, 2003).[1] This should be the same agenda for African regionalism and should be pursued vigorously.

Regionalism in Africa is more focused on attracting FDI and forming trade bargaining blocks for increased trade gains in WTO negotiations. On the other hand, many RIAs in Africa are political in origin (Schiff *et al.,* 2000). The benefits of regionalism are likely to depend on finding the best partner. The notion of "natural" trading partner should be dropped and is no longer useful. The obvious tendency is for trade blocs to form around neighbouring countries, including the desire to reduce trade costs by relaxing or abolishing boarder formalities and to facilitate collection of tax revenues. Most likely, this development will result into trade diversion rather than trade creation because of discriminatory or restricted liberalisation (Fafchamps, 2001). It is argued that a developing country does better in pursuing regionalism with a larger country than with a smaller one. This is because in trade terms a large rich country is likely to be a more efficient supplier of most goods and a source of greater competition for local producers. However, in the case of Africa, several conditions need to be met to make this argument a reality.

[1] Schiff and Winters (2003) indicate the relevance of following agreements (a) North American Free Trade Agreement (NAFTA), FTA, Article XXIV; extension of 1989 Canada-United States Free Trade Agreements (CUSF-TA), Article XXIV. 1994, Canada, Mexico, United States, (b) Group of three (G3), FTA, Enabling clause. 1995, Colombia, Mexico, Venezuela (c) European Union (EU), Common Market, Article XXIV; formerly European Community (EC).

Trade: Competitiveness and Diversification

Trade has been a key driver of economic growth over the last 50 years for the rich western countries and for some developing countries, particularly in Asia. Asian countries have used trade to break into new markets and change the face of their economies. This has not been the case for Africa. The last three decades have seen stagnation in African countries and a collapse of their share of world trade from 6 percent in 1980 to about 2 percent in 2002 (Commission for Africa, 2005). Yet the composition of Africa's exports has remained essentially unchanged. Dynamic and competitive regions have made major shifts into manufacturing, Africa has been left behind and the task of catching up is harder. On the other hand, Africa does not produce enough goods to trade, at least not of the right kind or quality, or at the right price. At the same time, Africa faces indefensible trade barriers, which, directly or indirectly, tax its goods as they enter the markets of developed countries. The way forward suggests that Africa needs urgent, sustained, coherent and large-scale investment in transport and ICT systems, standardisation of cross-border procedures, establishing and strengthening of institutions to improve functioning of markets and to expedite the flow of goods. However, the effectiveness of the proposed investment will largely depend on what Africa is doing and willing to, particularly, in the area of trade governance. African governments should address weak management of trade issues, provide facilitation, incentives and motivation for individuals to get things right. Increasing the volume of trade by producing enough goods, with the right quality and at the right price will enable African countries to penetrate new markets and to grow at 7 percent by the end of the decade and sustaining it thereafter. Therefore, Africa must overcome obstacles of discouraging the investment environment to release her entrepreneurial energies.

African countries should increasingly cooperate in handling trade issues so that the volume of trade and trade gains increase. The current level of trade between them (individually) and between African trade blocs is still very low. The challenge to African policymakers is to encourage competitiveness and diversification towards higher value-added goods and services with greater technological content. Competitive countries export a broader range of products; likewise, Africa must save and invest more, enhance its human capital stock and achieve more dynamic export performance. Concentrating on production of low weight/high value produce and service exports is more likely to be cost-competitive,

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and that understanding transport logistics, keeping airports efficient, and reducing transport cots in all sectors, will be important in maintaining external competitiveness.

In conclusion, while the authors do not provide a definitive answer to the direction of causality between infrastructure and growth, they nevertheless bring attention to the critical issue of infrastructure development in Africa and the vital role that regional integration could play in tackling problems that are common to a number of African states.

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11

Challenges for Regional Integration in Sub-Saharan Africa: Macroeconomic Convergence and Monetary Coordination

Mothae Maruping

The majority of sub-Saharan African countries are members of one or more regional or sub-regional arrangements that seek to promote economic coordination, cooperation or integration among the member countries concerned. The various African regional economic blocs, and indeed the individual countries that comprise their membership, are at varying stages of development and implementation of their regional arrangements. The blocs' scope covers various socio-economic, developmental and political considerations, including the promotion of intra-regional trade, socio-economic policy coordination, and management or development of shared physical infrastructure and the environment. Some of the African regional arrangements also cover issues of common interest in the areas of public governance, defense and security, among other socio-economic and political dimensions (see Box 2 below).

Some of the many African sub-regional arrangements have a long history of existence, dating back to the pre-independence era, which has been punctuated by occasional stagnations or reversals in a few cases, and only modest achievements at best in others. Some African countries have only recently rekindled their interest in economic integration, but for different reasons from the initial decolonisation agenda and the desire to overcome the colonially imposed "artificial" boundaries. They have been inspired by the success of integration efforts in Europe and the Americas. They also need post-independence economic integration to

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gain bargaining power and survive economically against the threat of marginalisation in the globalisation process. Countries in the region have also pursued regional integration in the context of South-South cooperation, which was necessitated partly by the declining terms of trade and disappointment with the rejection of the New International Economic Order (NIEO) proposal in the 1970-80s. However, in order to translate the dreams about economic integration into reality, Africa's perceptions, approach and pace in this area will need to shift towards more pragmatism and meticulous implementation of the agreed agenda. It should be tackled in a way that can effectively address the challenges encountered in the process of regional integration.

In this context, this chapter focuses on the achievements, lessons, challenges and the way forward for one of the key components of regional integration process, which is macroeconomic convergence. The chapter looks at the case of Eastern and Southern African countries. The two economic blocs in question are the East African Community (EAC), and Southern African Development Community (SADC). The latter also encompasses the long-established but smaller sub-grouping of the Southern African Customs Union (SACU), along with its Common Monetary Area (CMA) of all but one SACU member state. EAC and SADC intersect with COMESA.

1 The Meaning of Regional Economic Integration

Goals of Economic Integration

The ultimate goal of regional integration is to merge some or all aspects of the economies concerned. This usually evolves from simple cooperation on and coordination of mutually agreed aspects amongst a given number of countries to full integration or merger of the economies in question.

Objectives of Economic Integration

The history of regional integration in Africa shows that the reasons or objectives for integrating have been evolving over time. These have shifted from the initial focus on the political decolonisation of Africa to the current emphasis on socio-economic integration in the post-independence era for stronger bargaining base in global fora and for mutual benefit in the form of accelerated growth and development.

Box 1 The Stages, Pros and Cons of Regional Economic Integration

By definition, regional integration entails the coming together of two or more states, normally through reciprocal preferential agreements, based on one of more of the following successively more integrating cooperation arrangements:

- Preferential Trade Area (PTA) or Agreement, where member states charge lower tariffs to imports produced by fellow member countries than they do for non-members;
- Free Trade Area (FTA), a PTA without any tariffs on fellow members' goods;
- Customs Union, an FTA using the same or common tariffs on imports from non-members;
- Common Market, a customs union with free movement of the factors of production;
- Economic Community, a single-currency common market or monetary union in which fiscal and monetary policies are unified. If political sovereignty is given up, an economic community becomes a federation or political union with common legislation and political structures.

Pros and Cons of Integration

Regional integration can foster competition, subsidiarity, access to wider market (via trade), larger and diversified investment and production, socio-economic and political stability and bargaining power for the countries involved. It can be multi-dimensional to cover the movement of goods and services (i.e. trade), capital and labour, socio-economic policy coordination and harmonisation, infrastructure development, environmental management, and reforms in other public goods such as governance, peace, defense and security.

However, integration can be complicated by perceived or real gains or losses among the members that may lead to disputes and a sense of "loss" of national sovereignty. For success, integration thus requires strong commitment in implementing the agreed arrangements, fair mechanisms to arbitrate disputes and equitable distribution of the gains and costs of integration.

The basic objectives that have underpinned the pursuit of regional integration are to merge economies, i.e. integrate them, and, as a derivative, thus form a monetary union. This requires a harmonisation of economic policies, to pave way for merger, hence convergence.

Other derivatives of integration objectives are the enlargement and diversification of market size, and tapping of related opportunities and the promotion of intra-regional trade and free movement of the factors of production, which also results in stronger member states' bargaining position in relation to other regional and international blocs and the fostering of socio-economic progress, political stability, as well as peace and security.

The varying emphasis placed on the objectives for the different African regional blocs is influenced by the specific stage of development of the integration process, including the expected benefits and costs (see Box 1). Given the fragmented and small sizes of its low-income economies, Africa needs to competitively participate in multilateralism from a regionalised standpoint, to negotiate more effectively for international market access and ward off marginalisation and unfair competition in the global arena.

Conditions for Effective Convergence

Much of African regional integration history shows that they initially arose from political rather than economic or developmental agendas, but more recently they have been re-launched with an economic focus. Some regional economic groupings have been shallow arrangements that have tended to "skip" the necessary sequencing (progression through the development stages). It is essential that the following conditions are fulfilled for successful macroeconomic convergence:

- efficient and non-distortionary markets for products and factors of production, including freer movement of capital notably labour;
- effective compensatory financing arrangements to make the domestic costs of adjustment affordable, and equitably share the costs and benefits of integration, and fully incorporate the effects of exogenous shocks such as adverse weather, terms of trade, disease, and external financing shocks including debt relief;
- proper timing and sequencing as well as consensus-based choice of a convergence anchor (whether rigid or flexible benchmarks and criteria);
- enabling policies that reduce risks;
- development and retention of expertise;
- focus on smaller sub-groupings for greater success, with provision for variable geometry and variable/multi-speed arrangements.

Box 2 Overview of the Developments in African Regional Integration Blocs

Africa is not alone in aspiring for regional integration. With increasing globalisation and the advent of the World Trade Organization (WTO), other parts of the world have embraced the ideal. Among others, these include:

- The European Union, in which some members have opted for a single currency, a central bank and for all members free movement of factors of production;
- North American Free Trade Area (NAFTA) which brings together the US, Canada and Mexico;
- Latin American Integration Association (LAIA) and the Andean Common Market (ANCOM);
- Central American Common Market (CACM);
- Caribbean Community and Common Market (CARICOM); and,
- Council of Arab Economic Unity (CAEU) in the Middle East.

Overview of Review of Progress on African Integration

Apart from the African Union (AU), which, as the umbrella political Africa-wide body, envisages eventually having a common currency and central bank by 2025, the continent has various regional economic communities in all the four cardinal parts of the continent. Following the Lagos Plan of Action (1980) and Abuja Treaty (1991), various regional arrangements on policy coordination, cooperation or integration have been initiated, re-invigorated or re-aligned to continental aspiration on integration in the following sub-regional blocs:

Central Africa:

- Central African Economic and Monetary Community (CEMAC) in Central Africa aims to become an economic union: customs and monetary union and convergence have been achieved.
- Economic Community of Central African States (ECCAS) is considering implementation of free trade area with a view to eventually attaining full economic union status.

East Africa:

- The East African Community, comprising of Kenya, Tanzania and Uganda, has been resuscitated and has progressed on free trade

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

Box 2 (continued)

area status and commenced a move towards a customs union with harmonised fiscal and monetary policies as agreed on 1 January 2005.

Southern Africa:
- Southern African Development Community (SADC) in Southern Africa (plus Tanzania from East Africa): Seychelles withdrew, while Madagascar may be interested in joining. SADC aims for full economic cooperation that includes a free trade area, to move towards monetary union. Mechanisms to cooperate on power, peace and security have been created.
- Southern African Customs Union (SACU), formed in early 1900s, comprises of Botswana, Lesotho, Namibia, South Africa and Swaziland. They also have a Common Monetary Area (CMA), which excludes only Botswana. Customs Union stage has actually been achieved, on the ground.

North Africa:
- Community of Sahel-Saharan States (CEN-SAD): has studied feasibility of free trade and pursues selected sectoral integration.
- Arab Maghreb Union (UMA) in North Africa, which envisages an economic union, has conventions relating to investment, payments and transportation. It is however yet to become a free trade area.

West Africa:
- Economic Community of West African States (ECOWAS) and its Monetary Union (UEMOA) in West Africa aim for an economic union through selected tariff reduction, macro-economic and monetary convergence. It has harmonised business laws, and also pursues peace and security issues.
- The Manor River Union (MRU) of West Africa seeks to integrate various sectors, but has been adversely affected by political factors.

Other Groupings:
- Common Market for Eastern and Southern Africa (COMESA): macroeconomic convergence criteria have been set. Integration has generally been slow. Most COMESA countries have been struggling to attain the 10 percent inflation regional target.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

2 Progress on Integration: Dreams versus Reality

Intra-Regional Trade in Eastern and Southern Africa

African integration includes, as one of its objectives, the promotion of intra-regional trade, including preparing members for greater global competition and bargaining power. However, liberalisation in Africa's regional trade has been limited by, among other factors: costly overlapping memberships, including some bilateral agreements; different time horizons for full liberalisation of trade among member states and sub-regions implying that considerable trade barriers – both tariff and non-tariff barriers – continue to inhibit intra-regional trade and cross-border trade; delays by some member states in signing trade treaties and protocols, followed by additional delays in implementation.

There has been relatively more bias towards participation in international trade negotiations at the expense of efforts at the regional level, resulting in a decline of Africa's share of global trade from 5 percent in the 1980s to only 2 percent by 2002. Although some groupings have launched free trade areas enabled by trade protocols and other instruments and steering and overseeing committees, de facto substantial barriers to intra-regional trade still exist.

Overall, as a share of the continent's global trade, intra-regional trade in Africa is generally low (see Table 1), even where changes[1] in membership are taken into account. Trade is also constrained by lack of diversification, due to the high concentration on similar primary commodities and lack of value adding, as well as the exclusion of informal sector trade. Some countries face a difficult trade-off between public revenue losses from trade liberalisation and the long-term benefits from trade integration. This tends to delay the ratification of trade protocols and postpone their implementation. Also, some countries, e.g. South Africa in SADC, overwhelmingly dominate intra-regional trade.

It should be noted in Table 1 that regional integration in the above economic grouping became more active from the mid-1990s for SADC for which the key objective changed from mainly infrastructural development to reduce dependence on apartheid South Africa under the then Southern African Coordinating Conference (SADCC), to economic

[1] Yang and Gupta (2005) conclude that despite a proliferation in African regional trade arrangements (RTAs), time series data do not confirm a high intra-regional trade impact from the RTAs.

Table 1 Intra-Regional Arrangement Trade as Percentage of Total Trade (1970-2003)

	1970	1980	1990	1998	2003
Exports:					
COMESA	9.7	9.1	8.1	8.9	8.6
SADC	9.4	2.7	6.9	6.0	6.0
Imports:					
COMESA	6.7	2.8	3.4	3.9	5.8
SADC	4.9	3.8	6.0	6.1	6.3

Source: IMF Direction of Trade Statistics, cited in Y. Yang *et al.* (2005).

integration under SADC. The intra-regional trade data in the table thus also includes years that preceded the launch of economic groupings, to aid comparison between pre and post integration periods. It is also noteworthy that the membership was evolving over the period under review.

In EAC, Kenya has attained a 90 percent tariff reduction, while Tanzania and Uganda apply 80 percent. Non-tariff cross-border trade barriers are being removed, while studies are underway or have been completed on cross-border agriculture trade and establishment of an East African Trade Regime. For the SADC region, intra-regional trade has remained more or less the same as a percentage share of total trade.

Why the Quest for Macroeconomic Convergence?

The pursuit of macroeconomic converge, which by definition entails the setting of lower and/or upper limits for selected macroeconomic variables, is usually underpinned by the desire to guide certain key aspects of future economic and financial policy and its management among the member countries concerned. Macroeconomic convergence in this respect therefore serves an eligibility test whereby only those countries that attain the convergence benchmarks would qualify for membership to an economic grouping. Other reasons for seeking macroeconomic convergence are the advantages it confers to members, either individually or collectively. These may include attainment of macroeconomic stability, e.g. through sustainable fiscal deficits and public indebtedness, external current account deficit, as well as low and stable levels of inflation, which are among the key pre-conditions for achieving strong and sustainable economic growth.

The Choice of Given Targets: Examples from Eastern and Southern Africa

Traditionally, macroeconomic convergence has focused on the maximum allowable levels for a few key indicators that have to do with fiscal discipline and monetary and financial stability, namely: rate of inflation, budget deficit and public debt, as well as external current account balance. In some cases, the primary criteria may be backed by a secondary set of indicators that are derivatives of the primary indicators, and are intended to monitor, for instance, the level of recurrent spending in government finances, external and interest rate stability, the level of foreign currency reserves and central bank lending to government.

Achievements of the East African Community in Macroeconomic Convergence

The East African Community (EAC) comprising of Kenya, Tanzania and Uganda has achieved free trade area status. EAC's long history started with the following efforts: building of a common service i.e. the Uganda Railway in 1895; establishment of the Customs Collection Centre in 1900; establishment of the East African currency board in 1905; the Court of Appeal of Eastern Africa was set up in 1909; the Customs Union came into force in 1919; the East African income tax board established in 1940; the Joint Economic Council was set up in 1940; formation of the East African high commission in 1948; establishment of the East African Common Services Organisation in 1961; establishment of the East African community in 1967-1977; collapse of the East African community in 1977; agreement to revive the East African cooperation treaty in 1992, which lasted for the period 1993-2000; establishment of the EAC Secretariat in Arusha in 1996; following the transformation of the Cooperation into a Community in 2000, the Community launched its first development strategy in April 2001; inauguration of the East African Assembly and Court of Appeal in December 2001; signing of the East African customs union protocol in March 2003.

After falling apart in 1977 and getting resuscitated in 2000, member states to the revised EAC treaty have agreed to establish an East African Community, and to start the process with a customs union. The coming into force of the Treaty establishing EAC in July 2000 created an organisation that did not fit any of the then existing regional arrangements listed earlier. Another unique feature of EAC is that even before becoming a customs union, it has already established institutions and is

Table 2 EAC Members' Performance: Macro-Convergence Criteria (2000-2004)

Indicator	EAC Target	Time Frame/ Deadline for Target	2000	2001	2002	2003	2004a
Underlying Inflation							
Kenya	< 5% p.a.	2000	6.8	5.0	2.7	3.5	3.5
Tanzania			6.2	5.2	4.6	4.5	4.6
Uganda			4.5	-2.0	5.7	5.1	5.9
Current Account Deficit (Exc. Grants)/GDP Ratio							
Kenya	Low/ Sustain-able levels (<5%)	–	-3.4	-4.3	-0.1	-1.1	-3.7
Tanzania			-5.3	-5.3	-3.8	-2.4	-5.8
Uganda			-6.5	-5.6	-5.9	-6.2	-1.9
Fiscal Deficit (Excl. Grants)/GDP							
Kenya	<5%	2000	0.4	-4.8	-3.2	-3.9	-0.4
Tanzania			--	--	-8.2	-7.2	-9.2
Uganda			--	--	-10.6	-10.1	-10.3

Notes:
[a] Estimates.

Source: Central Bank of Kenya, EAC website and IMF Statistics (website).

involved in areas of cooperation more advanced than those of a customs union. Examples include: establishment of East African Legislative Assembly; establishment of East African Court of Justice; cooperation in sectoral fields, such as trade, investment and industrial development, infrastructure, tourism and wildlife management, health, education, science and technology, agriculture and standardisation and quality assurance; coordination and harmonisation of macroeconomic, monetary and financial policies including free movement of capital; cooperation in defense and security matters.

The EAC has therefore not followed the traditional progression stages of regional arrangements. In addition, given the stage at which it will be by the time the Customs Union protocol comes into force, the efforts that will be required to establish the Common Market will be minimal. In this context, it would be realistic to suggest that the EAC Common Market is feasible within a period of two to four years counting from June 2004.

With respect to convergence, EAC member states are supposed to go through a process of monetary policy harmonisation with a view to achieving macroeconomic convergence. In order to assess progress towards this objective, a number of convergence criteria have to be formulated. In this way, obstacles can be detected that stand in the way of implementation. Remedial measures will allow member states to achieve macroeconomic convergence and set the stage for moving on to the Monetary Union.

The process of fiscal and monetary harmonisation in East Africa involves the attainment of the following set of macroeconomic convergence criteria targets, grouped into traditional criteria; derivatives; derivatives of derivatives and means to the end. These tend to be more elaborate and to go beyond the traditional minimum considerations. Traditional criteria include: a reduction of current account deficit to GDP to a sustainable level; reduction of budget deficit excluding grants to GDP ratio of less than 5 percent; and maintenance of stable competitively determined exchange rates. Derivative criteria include: maintenance of optimal market determined interest rates; maintenance of low underlying inflation to single digit rates of less than 5 percent; and building gross foreign exchange reserves to a level equivalent to 6 months of imports in the medium term. Derivatives of derivatives include high and sustainable rate of growth in real GDP of 7 percent as minimum target annually. Means to an end criteria include: raising national savings to GDP ratio at least to 20 percent in the medium term; pursuit of debt reduction initiatives both domestic and foreign debt; and maintenance of prudential norms, strict supervision, improved corporate governance and transparency of all financial transactions.

From Table 2 above, it is evident that the three member states of the EAC have been tending towards convergence at low and sustainable levels of the key macroeconomic convergence indicators, namely underlying annual rate of inflation, and the current and fiscal deficits as percentages of GDP. It is also noteworthy that the moving towards sustainable fiscal deficits that exclude external grant financing has been more difficult to achieve, given the relatively high donor dependence especially for Uganda and Tanzania. Kenya, which for many years has not received any substantial budgetary support from external donors, seems to perform better than the other two member states in the EAC.

Apart from achieving most of the above targets, undertaking ministerial pre- and post-budget consultations and presenting national budgets on the same day, the EAC has a working Committee on Fiscal and Monetary Policies that evaluates policy compliance twice a year. Marked progress has been achieved in harmonising fiscal and monetary policies, guided by a common macroeconomic framework, partner currency convertibility, harmonised banking regulations, value-added and double taxation, and pre-shipment requirements. Capital markets development, cross-listing policies and trading practices are also being harmonised through the East African Securities Regulatory Authorities (EASRA) and the Capital Markets Development Committee (CMDC).

Effective from 1 January 2005, the EAC commenced a customs union, with a standard single entry document and harmonised customs classification code. Other areas targeted for integration are industry, investment, transport, communication, energy, agriculture, natural resources, the environment, social sector, and the involvement of the private sector and civil society in the process of regional integration. The ultimate objective is to attain a monetary union under a single currency and central bank by 2010. Thereafter, a political federation would be contemplated.

Achievements of the Southern African Development Community (SADC)

Cooperation amongst SADC member states started in April 1980 as the Southern African Development Coordinating Conference (SADCC) of nine member countries that focused on common regional (mainly infrastructure) projects intended to reduce economic dependence on apartheid South Africa by forging member states links and mobilising resources. The SADCC had a Summit of Heads of State or Government, Council of Ministers, a Standing Committee of Officials and the Secretariat. Different sectors were decentralised to each member state. As Namibia and South Africa gained political independence in the early 1990s, SADCC was transformed into an institution that goes beyond mere cooperation, and began to pursue regional economic integration and development. Membership also grew from nine to fourteen, until Seychelles pulled out more recently.

The key objectives of SADC are to promote equitable, self-sustaining economic growth and socio-economic development with a view to alleviating poverty; cultivate common cultural, social and political values, as well as maintain democracy, peace, security and stability; achieve complementarity, and sustainable environmental and resource utilisation.

A Memorandum of Understanding (MOU) on macroeconomic convergence, which requires signature by at least two thirds of the membership to become effective, has been drawn. It sets out modalities, principles, institutional arrangements, monitoring and surveillance mechanisms, indicators/criteria, data requirements, and monetary and fiscal policy cooperation parameters for the member countries. The MOU is premised on the recognition by member countries of the need for financial and economic stability, soundness of institutional structures and policy frameworks. This is deemed critical in achieving fiscal balances that avoid the monetisation of deficits, unsustainably high or rising ratios of public debt to gross domestic product, wide external current account and financial imbalances and market distortions resulting in high rates of inflation and stifling of growth amongst SADC member countries.

Macroeconomic convergence in the SADC region is guided by the following criteria and benchmarks that have been specified by a Committee of Central Bank Governors and which focus on the key essential requirements for macroeconomic convergence: inflation rate to reach single digit by 2008; 5 percent by 2012; and 3 percent by year 2018; the ratio of budget deficit-to-GDP should not exceed 5 percent by 2008, and 3 percent as an anchor, within a 1 percent bank by 2012 through to 2018; and nominal public debt-to-GDP ratio should be less than 60 percent by 2008 and beyond to 2018.

Apart from various protocols that provide the legal framework for cooperation, SADC has set the following roadmap and milestones for tracking progress in harmonisation and convergence processes among its member States: elimination of exchange rate controls by 2005; establishment of a free trade area by 2006; establishment of a customs union by 2010; establishment of a common market by 2012; and establishment of a monetary union by 2016.

The membership of SADC is not homogenous. Institutional constraints have also limited the extent to which various political level commitments have been implemented and monitored in terms of concrete programmes of action. There are still significant disparities among many member states in terms of income levels and distribution; macroeconomic performance notably fiscal deficits and public debt as percentages of GDP thus leading to high rates of inflation; financial sector development and stability; human resources; infrastructure development; as well as peace, security and governance.

However, the encouraging positive lessons that could be replicated from the longstanding existence of the Southern African Customs Union (SACU) and Common Monetary Area (CMA), whose members are also in SADC, include the attainment of customs union and de facto

Table 3 Macroeconomic Convergence in SADC: Rate of Inflation (1997-2004)

Inflation (target: single digit by 2008)	2001	2002	2003	2004[a]
SACU (incl. CMA)				
Botswana	6.6	8.1	8.7	6.3
Lesotho	6.9	11.2	7.6	5.5
Namibia	9.3	11.3	7.2	5.5
South Africa	5.7	9.2	5.8	1.4
Swaziland	7.5	11.7	7.4	3.5
HIPCs				
Congo, DR	357.3	25.3	12.8	3.9
Malawi	27.2	14.9	9.6	11.6
Mozambique	9.0	16.8	13.4	12.6
Tanzania	5.2	4.6	4.5	4.6
Zambia	21.7	22.2	21.5	18.0
Post-Conflict / in-Crisis				
Angola	152.6	108.9	98.3	43.6
Congo, DR	357.3	25.3	12.8	3.9
Zimbabwe	76.7	140.0	431.7	282.4
Other				
Mauritius	4.8	5.9	5.2	4.4

Notes:
[a] Estimates.
Source: IMF (2004 and 2005).

monetary integration among four of the five members. There have also been recent efforts to reform and centralise the institutional arrangements of SADC both at the regional and national levels, so as to enhance efficiency and effectiveness as well as to improve policy coordination.

Table 3 shows that in the SADC group of countries, the SACU member states and Mauritius have been the most convergent using the annual underlying inflation rate. Post-conflict economies have also demonstrated a rapid move towards lower levels of inflation rates, although the 2004 levels still remained high. Zimbabwe, which is experiencing economic decline or stagnation has the highest level of inflation, and is therefore the least convergent using inflation trends. The SADC HIPCs are a mixed bag with regard to inflation reduction, with the Democratic Republic of Congo and Tanzania having succeeded in reaching the regional inflation targets. Overall, Angola, Malawi, Mozambique, Zambia, Zimbabwe are yet to achieve the single digit inflation rates, but some could do so by 2008 if the current inflation reduction trends are maintained, except for Zimbabwe which would have to halt and reverse the trend and make a much more marked progress in this regard.

SACU member States, Tanzania (influenced mainly by EAC target) and Mauritius have already achieved the targets ahead of the 2008 schedule, and so only need to maintain these inflation rates at current levels.

Other indicators of convergence, shown in the Annex Tables, generally follow a similar pattern as described above for the respective sub-categories of EAC and SADC member states. For instance, HIPCs are generally above the target level for the fiscal deficit-to-GDP ratio, reflecting the fact that these countries are highly donor dependent and so their fiscal deficits excluding grants tend to be high and would be unsustainable if donor support were not available or drastically reduced. This point is much clearer for Malawi, which has an estimated deficit of over 20 percent of GDP, given the fact that the country has experienced delays in receiving HIPC debt relief. Swaziland (among the convergent SACU members) and Zimbabwe also portray high budget deficits, due to expansionary fiscal policy and economic crises, respectively. The impact of these fiscal positions is to influence the current account adversely and also to worsen debt ratios, which are almost equal to or greater than 60 percent for all SADC HIPCs and Zimbabwe.

The EAC and SADC blocs are also working on coordinating, co-operating on or integrating other sectors, such as peace and security, governance, health, agriculture, food security, training and education (human resources development), environment and conservation, transport and communication links, energy and freer movement of people.

3 Lessons and Challenges for African Integration

General Lessons and Challenges for African Integration

Many of the monetary harmonisation programmes in the different African integration sub-regional blocs have been slower or not in line with the African Monetary Cooperation Programme (AMCP) which aspires to have a single continental currency and central bank by the year 2025. The common monetary policy convergence criteria, which are to be implemented in six stages of successively tighter targets over time include: the budget deficit (excluding external grants) as a percentage of GDP of no more than 3 percent, with minimised budget financing from the central bank and sustainable public debt levels, and rate of inflation also not exceeding 3 percent; external reserves of at least 6 months of import cover (although this would be a derivative of other measures).

Other secondary criteria include: non-accumulation of domestic public sector debt service arrears; tax revenue-to-GDP ratio and also internally funded public investment-to-tax revenue ratio of 20 percent; wage bill-to-tax revenue ratio of no more than 35 percent; and maintenance of a stable exchange rate and positive real interest rates.

Given the slow progress among many sub-regional groupings, including COMESA, emphasis is being placed on "fast-tracking" the establishment of regional monetary unions ahead of the AU's 2025 continental target. For COMESA, it is hoped that monetary union status will be achieved by 2018. However, rushing prematurely to monetary union without adequate preparation could pose problems in the end. Some African blocs do not have macroeconomic convergence criteria, while many that do are still grappling to converge, partly due to differences in: socio-economic environment, governance and political will especially regarding the ceding of sovereignty to a supranational entity; policy implementation constraints, including lapses and reversals; perceived or real benefits and costs, which has adversely affected commitment to integration; regional and national financial markets that are generally not harmonised, are undeveloped or only just emerging, and so lack the depth, liquidity and currency convertibility required to fully fund the public and private sectors and cross-border investment in a pro-integration manner.

Overall, there are five African regional economic communities that have set macroeconomic convergence criteria as a precondition for realising monetary unions. These are: UEMOA, CEMAC, ECOWAS, COMESA and EAC. The convergence targets cover fiscal and monetary policies. UEMOA and CEMAC have had longer experiences of monetary integration through the CFA-franc that also involves consultations with the French authorities. Within COMESA, two countries, namely Namibia and Swaziland, also share a common currency under the Common Monetary Area (along with South Africa and Lesotho).

Without a common currency and faced with the risks from various floating exchange rates for currencies that are not convertible, many African regional blocs may require clearing houses, such as exists between

ECOWAS and COMESA (and inside COMESA itself since 1984), to facilitate payments and so promote intra-and inter-regional trade. COMESA aims for full monetary union by year 2018 (if fast-tracking works), based on a convergence framework covering macro-policy, external debt and some adapted EU's Maastricht-type criteria.

Lessons from the experiences in Europe and elsewhere show that for macroeconomic convergence to work there must be key determinants in place, such as: building consensus in developing the convergence criteria and its implementation modalities, as well as commitment to agreed obligations; prioritisation in the design of policy objectives, strategies as well as the setting up of relevant institutions and assigning mandates at the national and regional levels; equitable, objective and transparent mechanisms for determining and allocating the costs, benefits and corrective measures that integration entails; an appropriate, independent supranational authority and requisite regional institutions (e.g. a single central bank), with a clear focus and realistic transition framework towards integration – such a supranational authority should be adequately empowered with rules for enforcing and penalising any errant behaviour by non-compliant members.

European Monetary Union experiences highlight the important role of institutions in influencing the level and distribution of costs and benefits of macroeconomic integration, especially when the region is affected by exogenous shocks. Thus, without proper institutional design and consistent policy objectives (as happens under a federation or political union), heterogeneity of policy preferences among members to a convergence agreement, e.g. choice in the employment-inflation trade-off, can affect the sustainability of monetary integration;

Convergence towards a monetary union can act as a regional agent of beneficial fiscal restraint that instils a culture of discipline among member states. The cost-reduction benefits include the removal of exchange rate risks that sometimes cause uncertainty to investors, and can court speculative attacks through reversals in capital flows and contagion effects.

Other lessons for Africa from the European Union experience include the need for a common central bank to focus on price stability as its primary objective and thus causing national fiscal compliance with this goal by all member states. The central monetary authority should be guided by clear and realistic parameters that are equally enforceable amongst all members.

The EU's Maastricht-approach also shows that transition may need to be gradual if there is vast asymmetry amongst member states at the beginning, while fast-tracking stands a chance of succeeding where stability and prudence has already taken root among the members. Thus, it would be appropriate for flexibility in progression to integration through allowing room for variable speed, variable geometry and variable depth.

Specific Lessons and Challenges for Macroeconomic Convergence

In spite of the existence of the above African blocs, that have secretariats and regular technical and ministerial level meetings and summits of heads of state and government, African integration efforts have had limited impact so far. Perhaps because reality on the ground does not match ideals in treaties, protocols and MOUs the degree of integration remains highly superficial. Thus results have been below expectations. This has been due to a number of constraints, including:

Membership issues. On a continental basis and also within sub-regions, many African countries belong to several groupings or sub-groupings that sometimes compete, conflict or overlap amongst themselves rather than complement each other. This adds to the burden of harmonisation and coordination, and is wasteful duplication in view of constrained resources.

Slow ratification of protocols and reluctant implementation of agreed plans. Due to low political commitment and/or perceived or real losses and sacrifices involved, a number of countries have been reluctant to fully implement integration programmes on a timely basis. This has been partly caused by the lack of prior cost-benefit analysis and broad internal consultations on the part of the member countries concerned. In some cases, changes in the socio-economic and political dynamics within the member states involved have also militated against implementation of regionally agreed programmes, especially where socio-economic sacrifices are concerned.

Socio-economic policy divergence. The inconsistency or incoherence at the macroeconomic level has also been a source of problems for the systematic implementation and "internalisation" of the regional integration agenda into national programmes. It has been impossible to integrate regionally where there has been continuously glaring policy, implementation and information inconsistencies at the national level. There is therefore need for an appropriate policy mix and coordination at the national level that targets low inflation and fiscal discipline.

Limited national and regional capacities. The lack of mechanisms and resources for effective planning, coordination, implementation, monitoring and pragmatic adjustment of programmes on the ground have been another constraint to regional integration.

In the area of trade and mobility of factors of production, African integration has been relatively more outward-looking at the expense of intra-regional trade. Xenophobia has partly hampered labour movement among members, while capital mobility has been constrained by largely undeveloped financial markets.

Domestic, regional and international financial and investment constraints have also hampered regional integration, which requires considerable resources to plan, coordinate, implement, and monitor progress in its implementation. There is low saving as a percentage of GDP, while foreign direct investment (FDI) remains elusive and eschew Africa. Furthermore, official development assistance (ODA) has also been dwindling.

Lack of full private sector involvement at both planning and implementation stage has not elicited maximum deliberate input from this important sector, which usually has the financial resources and owns productive capacity. In most countries the private sector remains weak and is sill not well organised. Civil society involvement has also been wanting.

There is also a high degree of vulnerability to exogenous shocks, including heavy and unsustainable external debt burdens (the majority of HIPCs are in Africa), inadequate and erratic external resource inflows, adverse weather patterns, natural disasters, unfavourable terms of trade (witness the current oil price shocks affecting non-oil exporting countries amidst declining primary commodity prices), while civil strife – itself a result of abject poverty and other forms of socio-economic – and political instability have also had their toll.

From the foregoing, it could be concluded that, on the whole, Africa's monetary and financial integration remains largely elusive, with marked variation among individual sub-regions and their respective member states.

4 The Way Forward: From Ideals to Action

Names given to most African regional groupings have tended to reflect the goal rather than stage of integration that has actually been reached. Some use the name "Community", others "Common Market" to indicate the destination aspired for. Elsewhere in the world the name of he grouping usually reflects the stage of integration which has actually been attained.

African experience so far seems to indicate that groupings with fewer members tend to be more successful and show better progress than large groups. The examples of EAC and SACU/CMA support this view. Initially, regional groupings in Africa came into being for political reasons. Now circumstances have forced that they be resuscitated but this time around for economic reasons. Much has been done already to raise awareness on the indispensability and viability of African sub-regional and regional integration in the face of the risks of marginalisation and the loss of opportunities offered by globalisation. Participation in the globalisation process should be increasingly realised from a regionalised African platform to enhance the bargaining power of countries or their regional groupings.

The benefits of regional economic integration are (i) benefits for all through synergy and symbiosis; (ii) bargaining bloc in international arena; (iii) viable size for foreign direct investment; and (iv) improved scope for diversification and its benefits of lowering risk.

Responding to Lessons Learnt: Challenges and Opportunities

Progress has been rather slow and reality has fallen far short of aspirations. So there is ample room for improvement when it comes to implementation. Practical measures could be geared towards:

Eradicating wasteful or costly duplication of multiple memberships and rationalising some overlapping sub-regional blocs. This should be based on priority needs and efficiency from comparative advantage. To deal with this challenge, the reasons for belonging to various groupings or forming sub-groups within the same groups should be carefully studied. There is need to rationalise the number of blocs and membership to them, based on thorough analysis of comparative advantages and cost and benefit. Inter-regional interaction should also be cultivated to "sell" the logic and benefits of rationalisation.

Securing irrevocable commitment beyond mere political rhetoric amongst member countries of the various sub-regional blocs to the ratification and meticulous and punctual implementation of treaties and protocols, without inefficiencies, lapses or reversals. Prior informed analysis and internal consultations, including bringing civil society and the private sector on board much earlier, should precede integration programmes to enhance ownership that motivates full implementation among all stakeholders. The process should be inclusive and participatory. At the national level, there should be coherent coordination, public awareness, engagement of private sector and civil society, whole-hearted political will, and rules-based implementation and accountability.

Strengthening technical capacity for conducting informative cost-benefit analysis and ensuring fair and equitable sharing of the costs and benefits of integration should be the starting point among member States. They should also plan for dealing with changes in country circumstances that may militate against implementation of integration programmes or diffuse their impact.

Capacity for comprehensive and consistent planning, policy formulation and implementation at the national level should be strengthened in the member countries to reduce the risks of conflicting policy objectives, and enhance synchrony and complementarity. Capacity also needs to be sharpened to effectively tackle all stages of integration: from planning, to coordination, implementation, monitoring and evaluation of impact. This calls for human and institutional capacity building covering planning, policy analysis/formulation, implementation and monitoring of programmes. Data availability and credibility and other information requirements should also be addressed. This is where African sub-regional and regional institutions, complemented by targeted and regionally coordinated international expertise that cross-pollinates regional capacities, can play a meaningful role.

Providing the necessary financial and technical resources, in part through international, regional and national private sector involvement at all stages of integration is important. Foreign direct investment, equity investment, development of financial markets and increased technical and financial support through Africa's international development partnerships should be mobilised for this purpose. African countries and sub-regional blocs, for their part, should create an enabling legal, institutional, socio-economic and political environment that supports and attract financing for integration. Member countries should pay fully the agreed financial contributions punctually. Considering that assessed contributions from member countries and external donor assistance may not be enough to fund integration, other non-traditional sources of funding need to be explored, including imposition of selected taxes or charging levies where feasible. Rationalisation also would have a cost-saving effect.

Development, harmonisation and integrating of national and regional financial markets, including elimination of barriers and reducing risks affecting the free movement of labour and capital, e.g. cross-border and foreign direct investment could be another step. Such markets would also help finance the integration process itself in other pertinent sectors. Harmonisation of financial markets also reduces risks of differences in the impact of monetary policy measures that may be taken by the common central bank under a monetary union.

Effective pooling of resources and expertise to tackle cross-cutting regional challenges, such as infrastructure, governance, gender, HIV/AIDS, peace, security and conflict prevention, can help reduce the average costs of delivery, and also assist to harmonise and raise standards.

Regional integration treaties, protocols, leadership and priorities should be unambiguous in providing binding rules-based frameworks and results-oriented milestones to guide national, sub-regional and regional actions required for envisaged eventual continental integration. Effective monitoring, follow-up and corrective mechanisms should be put in place and enforced. The regional and continental bodies should be adequately staffed and resourced, with authority to act as necessary.

Africa's negotiation capacity, especially in the area of multilateral trade, needs to be strengthened from a regionalised vantage point.

The rules for allocating the seignorage effects of centralised monetary union (via a common central bank) should be underpinned by an equitable compensation mechanism.

There is need to strengthen and empower the institutions that implement and monitor regional integration programmes both at the regional and country levels. Any central authority overseeing convergence and integration should be independent of all national authorities' influences. It should have a mandate that is well anchored on the agreed key objectives, such as ensuring price stability, with sufficient authority to enforce (and possibly supervise) compliance by all members for the attainment of the shared objectives. The roles for national central banks and the common central bank should also be clearly defined beforehand.

The time-frame for transition to macroeconomic and monetary convergence should be agreed to by consensus among all member countries: An amicable decision that is realistic for all members should be reached on whether the transition will be gradual or accelerated, based on analysis of the *pros* and *cons* and costs and benefits of either option as well as on ability of members to comply.

Applying variable geometry and variable speed, that accommodates the effects of different circumstances confronting member states and sectors, respectively, is a more pragmatic approach. This has worked well for EU.

Planning Process

It is critical that planning and implementation of the regional integration agenda becomes highly inclusive and participatory at all stages, including formulation of strategic frameworks, action plans, rolling programmes of action, monitoring, evaluation and reviews. There should be clear milestones, and enhanced coordination and management systems that incorporate results-based management at the regional, country and sectoral levels.

5 Conclusion

The benefits of regional integration, and indeed globalisation, remain a critical part of Africa's workable development strategy. The era of isolated tiny national economies has to give way to strategic alliances that harness knowledge-and-resource-based comparative advantages through integration. This however does not come effortlessly and at no cost: a lot of dedicated planning and hard work must be put in first. Some decent planning has already been going on. The next step should be to expedite implementation through greater resolve, speed and effectiveness in translating the good intentions into concrete, implementable, monitorable and results-oriented actions on the ground. This would hopefully see the African Union realising the continent's dream of a single currency and central bank by 2025 or soon thereafter, including halving poverty as envisaged.

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Annex Table 1 SADC and EAC Fiscal Deficits (excl. Grants) to GDP (1997-2004)

Fiscal Deficit/ GDP (target: <5%)	1997-2001 Average	2002	2003	2004[a]
SACU (incl. CMA)				
Botswana	-4.5	2.5	1.0	1.3
Lesotho[b]	-6.4	-8.1	-1.4	0.1
Namibia	-3.3	-3.1	-3.8	-2.3
South Africa	-2.5	-1.2	-2.1	-3.0
Swaziland	-1.3	-5.5	-8.1	-8.6
HIPCs				
Congo, DR	-5.0	-3.1	-6.7	-10.6
Malawi	-12.3	-14.3	-14.1	-22.8
Mozambique	-14.1	-19.9	-15.1	-13.1
Tanzania	-4.5	-8.2	-7.2	-9.2
Uganda	-8.1	-10.6	-10.1	-10.3
Zambia	-10.7	-13.4	-12.9	-8.6
Post-Conflict / in-Crisis				
Angola	-16.8	-9.3	-7.2	-5.4
Congo, DR	-5.0	-3.1	-6.7	-10.6
Zimbabwe	-10.5	-3.9	-0.3	-9.7
East African Community (EAC)				
Kenya	-2.2	-4.2	-4.3	-6.9
Tanzania	-4.5	-8.2	-7.2	-9.2
Uganda	-8.1	-10.6	-10.1	-10.3
Other:				
Mauritius	-5.0	-6.3	-6.3	-5.9

Notes:
[a] Estimates.
[b] Lesotho ratios are influenced by the difference between use of GDP and GNP, due to impact of workers' remittances.

Source: IMF, *World Economic Outlook*, 2005; IMF, *Sub-Saharan Africa Economic Outlook*, 2004.

Annex Table 2 SADC and EAC External Debt to GDP Ratio (1997-2004)

Debt/GDP (Target: <60%)	1997-2001 Average	2002	2003	2004[a]
SACU (incl. CMA)				
Botswana	21.9	23.6	17.8	16.1
Lesotho	71.2	71.0	47.0	43.2
Namibia	2.2	3.0	2.3	2.3
South Africa	28.2	30.7	23.2	22.6
Swaziland	21.7	31.9	28.2	26.4
HIPCs				
Congo, DR	267.1	192.4	187.4	160.6
Malawi	139.7	149.0	165.8	157.5
Mozambique	129.7	140.2	121.7	101.8
Tanzania	86.9	55.9	59.5	58.6
Uganda	53.2	54.1	60.6	58.8
Zambia	182.0	156.6	128.3	106.3
Post-Conflict / in-Crisis				
Angola	129.0	80.6	65.1	37.2
Congo, DR	267.1	192.4	187.4	160.6
Zimbabwe	58.1	20.0	55.3	90.3
East African Community (EAC)				
Kenya	50.3	42.1	38.7	37.9
Tanzania	86.9	55.9	59.5	58.6
Uganda	53.2	54.1	60.6	58.8
Other:				
Mauritius	26.7	21.8	19.3	17.8

Notes:
[a] Estimates.

Source: IMF, *World Economic Outlook*, 2005; IMF, *Sub-Saharan Africa Economic Outlook*, 2004.

Annex Table 3 SADC and EAC Countries' Current Account (incl. Grants)/GDP (2001-2004)

Current Account Balance/ GDP (target: <5%)	2001	2002	2003	2004[a]
SACU (incl. CMA)				
Botswana	11.5	2.2	6.5	6.3
Lesotho	-13.2	-16.9	-12.3	-1.0
Namibia	1.7	3.8	4.0	5.5
South Africa	–	0.6	-0.9	-2.5
Swaziland	-4.5	6.0	0.6	-0.6
HIPCs				
Congo, DR	-4.9	-2.8	-1.5	-2.5
Malawi	-6.8	-11.2	-10.3	-7.6
Mozambique	-21.4	-22.3	-16.8	-12.4
Tanzania	-5.3	-3.8	-2.4	-5.8
Uganda	-5.6	-5.9	-6.2	-1.9
Zambia	-20.0	-15.4	-15.2	-11.5
Post-Conflict / in-Crisis				
Angola	-14.8	-2.9	-5.2	6.5
Congo, DR	-4.9	-2.8	-1.5	-2.5
Zimbabwe	-3.5	-1.8	-5.0	-5.3
East African Community (EAC)				
Kenya	-3.5	2.4	-0.2	-3.7
Tanzania	-5.3	-3.8	-2.4	-5.8
Uganda	-5.6	-5.9	-6.2	-1.9
Other:				
Mauritius	-2.1	2.2	2.0	0.6

Notes:
[a] Estimates.

Source: IMF, *World Economic Outlook*, 2005; IMF, *Sub-Saharan Africa Economic Outlook*, 2004.

12

Is Sub-Saharan Africa an Optimal Currency Area?

Zdeněk Drábek

Mothae Maruping wrote an interesting and thought-provoking chapter. The objective of his chapter is to analyse the achievements, lessons and challenges facing sub-Saharan African countries in promoting regional integration and to assess the importance of macroeconomic convergence as a key component of regional integration. The latter in itself is an extremely interesting issue on its own and would deserve a separate treatment, but Mothae Maruping goes further. His task is to look at the various regional integration efforts in Africa and to see how they have performed, what were the main problems in the implementation of these initiatives, why the implementation was not always meeting the objectives of governments. He demonstrates that there have been a great deal of regional integration schemes in sub-Saharan Africa (SSA) and reaches as his first main conclusion that these schemes have not been by and large very successful. He makes a powerful and highly convincing point that most of these regional arrangements have been set up primarily by politicians and have been driven by political objectives. The integration has been constrained, for example, by overlapping and costly memberships,[1] different time horizons for trade liberalisation, ratification problems, and the continued presence of intra-regional trade barriers. It also appears that the architects of all

[1] Mothae Maruping provides perhaps the best direct argument against the proliferation of regional trading arrangements, which has been so much criticised by Jagdish Bhagwati who compared these arrangements to what is now known as "spaghetti bowl" of regional deals (see Figure 7 on p. 118).

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

these initiatives have not given much thought to the kind of economic policies and institutions needed to make these arrangements work and make them successful.

The second interesting part of Maruping's chapter is when he looks at the performance of these regional trading arrangements (RTAs). The evidence provided in the chapter is extremely disappointing and, I would almost dare to say, damning to all these initiatives. As we can see from his Table 1, the intra-regional trade within COMESA was 9.7 percent of the members' total trade in 1970 and by 2003 the share had declined. The story is essentially the same for SADC and it applies to both exports and imports with only a small improvement in the case of intra-SADC exports (all assessed in terms of percentages). In other words, the performance is in sharp contrast with ideals, or, as he puts it, the performance reflects "dreams against reality". Needless to say, this conclusion will be shared by most observers who must concur with his disappointment. In brief, the RTAs have not done well in sub-Saharan Africa.

The third message of Maruping, one that may be the most innovative part of the chapter, concerns something that can be called "the new thinking" in Africa, especially in the southern and eastern African region. As a part of this "new thinking", politicians and economists in the region have been apparently calling for deeper forms of integration, moving away from simple free trade area arrangements to something more complex, including not only custom unions but also initiatives calling for coordination of other policies. This corresponds to similar movements in other parts of the world, as the notion of "deeper integration" has been set firmly into the arsenal of alternative policies towards regional integration.[2] Maruping identifies in the chapter a number of such initiatives and practical arrangements that have been adopted in the region over time.

What is intriguing about all these new initiatives and thinking in the region is the fact that these moves come at a time when the more shallow arrangements (RTAs) have not done very well as noted above and by Maruping himself. Moreover, these efforts represent a considerable jump in what I would call a natural sequence of regional integration arrangements. The latter, the "natural" sequence, would involve arrangements that start from free trade areas before members of these areas proceed

[2] For more evidence and discussion of this point, see Drábek (2005), chapters 1 and 2.

to coordinate other policies such as external trade policies, elimination of barriers to movement of labour and capital or coordination of monetary policies. Instead, we seem to be observing an attempt in SSA to move directly to complex arrangements, including the attempts to policies towards macroeconomic convergence. There is perhaps no need to note that such a convergence would require a certain degree of harmonisation of macroeconomic policies.

There has been a great deal of discussion about regional arrangements in sub-Saharan Africa as well as elsewhere in Africa. Some of the debate has been conducted in the past on the platform of FONDAD. It would have been, therefore, also helpful if the chapter were to identify the main concerns arising from that debate and address them explicitly. It would have been also helpful to have from Maruping more empirical evidence about the performance of RTAs in sub-Saharan Africa. Clearly, the problems with RTAs in SSA must differ from country to country and from a RTA to another RTA. Moreover, the problems with performance or constraints on the effectiveness of RTAs may also vary from case to case.

Three "Convergence" Issues

My main comment is about one specific issue that is addressed at some length by Maruping, and it concerns the question of macroeconomic convergence of sub-Saharan African countries.

I hasten to add that my knowledge of macroeconomic policies in sub-Saharan Africa is very much out of date. My comments will, therefore, address the convergence question in more general terms, which are derived from the theoretical literature or from practical experience of other countries. In this respect, it may be interesting to raise three issues that might be useful in looking at the subject of macroeconomic convergence.

There is not much of any dispute or controversy about the convergence criteria that have been proposed in the chapter, even though I do have a small point to make which I will do further below. The limitation of the chapter is that the author does not discuss the conditions under which policies aimed at macroeconomic convergence are likely to be successful – an issue I wish to discuss here. Let me also add that the idea of macroeconomic convergence in sub-Saharan Africa is not new. What is new about Maruping's chapter is that the idea of convergence is extended beyond the Common Monetary Area in Southern Africa by including other countries in the sub-Saharan Africa region.[3]

In general, the starting question about convergence is: What is the mechanism to ensure that the convergence will succeed? Or to put it differently, what is in the present system that is preventing a more successful convergence of macroeconomic indicators? I would suggest that there are probably three broad areas of factors inhibiting macroeconomic convergence that should be taken into account. The first area concerns the role of product and factor markets. The second one concerns what I would call the compensatory mechanism that needs to be normally put in place in attempts of that kind. The third issue is the question concerning speed and sequencing of convergence. I shall now briefly turn to each one of these issues.

Product and factor markets. The first critical condition for a successful macroeconomic harmonisation is the presence of efficient product and factor markets. It is difficult to imagine that efforts to achieve macroeconomic convergence will be successful in the presence of serious distortions in product and factor markets, or policies that do not allow those markets to operate efficiently. While it may be possible to harmonise some elements of macroeconomic performance it would certainly not be possible to harmonise the rest of macroeconomic indicators. Consider, for example, two countries, one of which maintains restrictions on the inflow and outflow of foreign capital and both countries pursue policies targeting a convergence of inflation rates. The inflation rates of both countries may converge even in the presence of the restrictions on capital flows (i.e. distortions in financial markets) provided governments are prepared to change their monetary policies until the rate of inflation in the high-inflation country drops or the one in the low-inflation country increases. However, this is clearly not an optimal pattern of convergence, since it leads to interest rate differentials that are maintained through restrictions on the movement of capital across borders. Differences in interest rates lead, in turn, to different incentives to investment in both countries and, therefore, different growth paths of the countries. In addition, the interest rate

[3] The Common Monetary Area (CMA) in Southern Africa began as the Rand Monetary Agreement (RMA) in 1974 and it included South Africa, Botswana, Lesotho and Swaziland. The RMA was replaced by an agreement on CMA in 1986 and signed by South Africa, Lesotho and Swaziland. Namibia joined CMA in 1992. Botswana has been formally out of the agreements since 1976 but maintained informal but tight links to the monetary arrangements. For more details, see Grandes (2003).

differences may also be accompanied by higher inflation rates in at least some of the countries. In general, judging from the experience elsewhere, the product and factor markets need to function reasonably well in order to ensure sustainability of macroeconomic policies and to meet the convergence targets. Without efficient markets, the convergence policies would be under threat and, most likely, not sustainable.[4]

Now, suppose that product and factor markets work well and are unconstrained by wrong policies. Would there still not be an argument against policies towards macroeconomic convergence? The answer is still potentially the same – countries whose markets are not well integrated economically will probably not succeed in integrating their policies and institutions including policies towards monetary convergence. As shown by Dorrucci *et al.* (2002), institutional integration interacts with economic integration on regional level, and this link constrains the policy space of governments aiming at closer institutional integration.[5] In addition, the process of (macro)economic convergence is greatly dependent on a variety of factors that have been so well identified in the literature on *optimal currency areas* as developed by Mundell (1961).[6] Whether these conditions are present in SSA remains an open question even though there are some indications that some of the SSA countries do meet the criteria.[7]

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[4] The assumption of well functioning markets in the SSA is particularly questionable in the case of financial markets. The latter are generally seen as “special” markets for a variety of reasons such as information asymmetry and fragility but they are particularly vulnerable in emerging markets of developing countries such as those in SSA. The presence of distorted financial markets is, of course, extremely serious for macroeconomic convergence since the link between monetary policy and financial markets is very tight and both are mutually dependent. For a useful summary of these issues see, for example, Baldwin and Wyplosz (2004), chapter 15.

[5] At the same time, economic integration is driven co-driven by forces of gravity and geographic factors. This explains why countries often form RTA within their regions but, for a variety of reasons, these forces are not powerful in SSA. See also Greenaway and Milner (2002).

[6] These conditions relate partly to the operations of factor and product markets (flexibility of domestic prices and costs, high mobility of factors) and partly to structural features of the countries’ economies (highly diversified structure of production, symmetry of shocks between countries).

[7] The model of optimal currency area was tested by Grandes (2003) who analysed the functioning of the Common Monetary Area (CMA) in Southern Africa. He also identified benefits and costs from macroeconomic convergence to member countries. See also footnote 3 above for details on CMA.

Compensatory mechanism. The problem faced by policymakers in the process of macroeconomic convergence is that the latter implies an economic adjustment, and adjustment leads to adjustment costs. This means that when countries are targeting a macroeconomic convergence, they are likely to have different costs of adjustment, and the question will be how these adjustment costs will be financed and who will finance them. In the process of establishing optimal currency areas, such a compensatory mechanism (i.e. fiscal tax transfers) has been recognised in the theoretical literature as one of the fundamental conditions for optimality. Such a mechanism is likely to be important also in the case of other arrangements of monetary cooperation. This leads to the question that is pertinent for the convergence process in SSA: Do African countries that are targeting convergence and maybe even harmonisation of macroeconomic policies, have the capacity and resources to fund such a scheme and put an appropriate mechanism in place?

Now, compare the situation in SSA with that of the European Union which is facing the same questions, and in which the same issue is arising as a part of the accession of new countries and in which the issue was faced in the earlier accessions of Spain, Greece and Ireland. All of these new acceding countries started with fundamentally different macroeconomic conditions when they began their process of convergence. The assumption of policymakers both in the acceding countries as well as in the incumbents was that the adjustment costs would be large, and this resulted in a (negotiated) compensatory mechanism in order to facilitate the adjustment of acceding countries. The mechanism included, for example, the introduction of structural funds, various agricultural supports, technical assistance in legal and justice systems, education, technical support for SPS and TBT[8] mechanisms and so on. The presence of similar compensatory financing instruments is something that will have to be in place in SSA if macroeconomic convergence is to succeed.

Timing and sequencing of macroeconomic convergence. The speed and sequence of convergence are also critical issues. There are two kinds of questions that need to be asked by policymakers with regard to timing and sequencing of macroeconomic convergence. The first question concerns convergence targets. Specifically, why do we want to pursue a macroeconomic convergence? The answer to this question is not

[8] Sanitary and Phytosanitary Measures (SPS) and Agreement on Technical Barriers to Trade (TBT).

straightforward since the need for convergence is not obvious. This can be seen from the data in Maruping's tables and his accompanying comments. One gets the impression that the main objective for policymakers should, in fact, be to ensure that they provide for a macroeconomic environment that is conducive to a conduct of *stable* trade policy and *sustainable* balance of payments. This is somewhat different from thinking about macroeconomic convergence, which could be excessively costly under present circumstances.

But suppose that the decision to converge is taken for whatever reason. Under that scenario, my second question to policymakers would be: How should one "anchor" the convergence? Surely, it must make a difference for a country like Malawi to "converge" to the market conditions prevailing in, say, Botswana, rather than in South Africa or the United States. What should be the criteria that should guide the policy to make such a choice? The answer to this question is extremely important. The "anchor" will affect the country's competitiveness in international markets, the degree to which economic cycles are synchronised, the external sources of economic growth and the exposure to financial instability.[9]

This leads to a related question – what is the optimal speed towards macroeconomic convergence? There can hardly be a scientific answer to this question but the question must be addressed by policymakers because different speeds lead to different costs of adjustment. These concerns are quite evident in the similar debate that has been conducted in the United Kingdom where the British government made it clear that the accession of the United Kingdom to the European Monetary Union can only take place if certain conditions are met. The UK Treasury has, therefore, come up with a set of conditions under which the UK would consider joining. Once again, it appears none of these issues seems to be debated in SSA. What should be the exchange rate mechanism under which the countries concerned should enter the process? What should be the level of exchange rate at which would the countries would wish to converge? At what level of unemployment would policies towards convergence be acceptable on political grounds

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[9] The answer to the question of *which anchor* should be chosen is, of course, partly related to the link between economic and institutional integrations noted already in the text above. Another part to the answer depends on *how rigid* the chosen anchor could or should be. For a broader discussion of these questions with regard to the choice of exchange rate regimes see, for example, Wyplosz (2000).

and at what level they would not? Surely, these and other concerns should be raised in discussing the speed of convergence, and these examples are only raised here as illustrations of the type debate which is likely to accompany these ambitious objectives.

Finally, a comment about targets. It is often assumed that targets are fixed by definition and cannot be changed. The assumption is not only logical but also reasonable. However, what should happen if targets are found "unrealistic" or simply wrong? Should they not be changed or modified? The problem with changes is that they may adversely affect the credibility of policies. On the other hand, the problem about rigidity is that we may stick to wrong targets. In other words, we could be damned if we do have targets or if we could be damned if we do not! Once again, the debate in the European Union about the so-called Maastricht criteria is quite educational. The criteria restricting the governments' room for fiscal flexibility by setting limits on fiscal deficits and public debt have recently been criticised and strongly resisted by critics even in the traditionally fiscally conservative countries such as Germany. So far, the criteria are kept but the countries have already agreed on rules that may allow more flexible interpretation of the original targets.

In summary, the lessons from Europe provide again a guidance for the debate about convergence and its speed and sequencing in SSA. As Maruping clearly shows in his chapter, many countries in SSA continue to have a serious debt problem and its management. The solution to the debt problem is not entirely a matter of domestic adjustment but it will also require an agreement with external donors. This means that until that happens it is probably going to be difficult to pursue the policy towards convergence. Second, convergence requires the presence of strong financial institutions without which the convergence process could jeopardise the process of financial intermediation as well as monetary control. Third, another constraint appears to me to be their poor access to external financial markets since it always helps to have better access to external resources. Without external resources, the burden of adjustment will fall on domestic (macroeconomic) policies, and given the size of macroeconomic imbalances in the region, the costs of adjustment may be too high to be entirely funded by domestic resources.

The fourth constraint on the conduct of policies in SSA is specific to the region. Like most African countries, the region has been subject to a great degree of instability due to highly unstable conditions in markets

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

for primary commodities on which the region continues to be heavily dependent. The region has also be subject to extremely severe and changing climatic conditions and to debilitating diseases severely affecting health standards in the region and the productive potential of labour. All of these factors are exogenous, and this makes it particularly difficult in the management of balance of payments. That, in turn, poses serious problems for creditors in their assessment of creditworthiness of SSA and of the risks of investing in the region. Moreover, the exogeneity of these factors must make it even more difficult for governments to conduct a sensible fiscal policy, one that is sustainable in medium term. Last but not least, SSA has historically suffered from capital flight, which also needs to be considered by policymakers when pursuing the policy of macroeconomic adjustment. In ignoring capital flight in its financial programming, governments would be making serious mistakes since unaccounted movements of capital could reap havoc into the government's ability to control monetary aggregates.

Conditions for Successful Convergence

Let me conclude in a rather different manner than one is accustomed in similar circumstances. Maruping's chapter raises important questions about regional integration in SSA that remain, in my view, open. A particularly interesting questions concern the desirability of macroeconomic convergence in SSA. Perhaps, politicians and economists in the region will soon provide the answers that will be needed if the region is truly serious and will wish to pursue a policy of macroeconomic convergence. Should countries converge in terms of their macroeconomic indicators or not? Is sub-Saharan Africa an optimal currency area? This is the first fundamental but difficult question because convergence implies limitation of the space in which governments will be able to operate and conduct an independent macroeconomic policy. It is my instinctive belief that on this issue there is a room for positive answers. Low rate of inflation is desirable, a level of debt that is sustainable is also desirable, and a sensible fiscal management is surely also something that must be supported. Moreover, a macroeconomic convergence may be sensible on efficiency grounds if the conditions prevailing in the Common Monetary Area in Southern Africa could be extended to other countries in the SSA region. However, whether all of these targets should call for a rigid macroeconomic convergence or whether they should be a part of a prudent macroeconomic policy towards macroeconomic stability remains an open question. For a distant external observer like me, this is an issue of macroeconomic stability, rather than that of macroeconomic convergence.

The second fundamental question applies in situations in which a decision to converge has already been taken. What would be the conditions for a successful and sustainable convergence in SSA? Can or should, for example, policymakers start macroeconomic convergence before opening up their markets to a reasonable extent? What kind of domestic trade regimes should be adopted? Should convergence target the regional countries even though most of Africa's trade and financial relations are primarily with the rest of the world?[10] Should a country open its capital accounts and if so under what circumstances? Similarly, what are the implications for the conduct of exchange rate policies since macroeconomic conditions differ among countries in SSA? Some of these differences are critical in making a sensible judgment about the exchange rate regime to be adopted since they involve differences in external debt positions, the level of foreign exchange reserves, sources of government revenues, the depth of financial markets to name just a few.

Sensible answers to these questions can only be provided if policymakers carry out a thorough assessment of the desirability of macroeconomic convergence and an economic analysis of costs and benefits of such a policy.[11] Until these costs and benefits are recognised and the constraints on convergence identified, the path to macroeconomic convergence will be arduous.

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Part III

The International Challenges: Trade and Finance

13

Africa's Development and External Constraints

Kamran Kousari[1]

While the primary responsibility for achieving the conditions of rapid and sustained growth lies with the African countries themselves, the international community also has responsibility in securing consistency and coherence between international and domestic policy actions. This is because international actions exert a major influence not only on the external conditions facing Africa, but also on domestic policies through aid conditionality and stabilisation and adjustment programmes.

Thus the external and internal constraints of African economies cannot be usefully disentangled. The structural deficiencies from which many African countries suffer, particularly in sub-Saharan Africa, has led to continued heavy reliance on commodity exports as a major source of foreign exchange earnings with the result that these economies are vulnerable to the vicissitudes of markets and weather conditions. With the secular decline in the prices of commodities and the resulting terms of trade losses, levels of savings and investment have not been sufficient to invest in human and physical infrastructure development, thus retarding the economic transformation of these countries. And the continent has had to rely on external financing both

[1] This chapter is principally based on a series of studies undertaken by UNCTAD on African development starting from a section exclusively devoted to Africa in the Trade and Development Report 1998, followed by the annual publications entitled Economic Development in Africa, which were launched in 2000. However, some of the views expressed in the paper are solely those of the author's and should not be attributed to the UNCTAD secretariat.

From: Africa in the World Economy - The National, Regional and International Challenges
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from multilateral and bilateral sources to bridge the financing gap. This has proven to be inadequate for financing adjustment, unevenly distributed and pro-cyclical.

The less than satisfactory outcome of policy advice attached to lending has had its costs in terms of low growth, increased indebtedness, rising poverty, weak institutions, and the inability of countries to diversify their economic base. Furthermore, in the face of inadequate resources to finance long-term development, attracting foreign direct investment has assumed a prominent place in the strategies of economic renewal being advocated with the result that 80 percent of such investment has gone in to the extractive rather than productive sectors without engendering the benefits generally touted for FDI or raising substantially fiscal revenues from the sector.

This chapter will argue that under present conditions Africa needs a major boost in terms of financing for development and an exit solution from the debt overhang. While critical, this is not a sufficient condition. It has to combine with greater policy space adapted to the trade and industrial development requirements of the countries concerned at the domestic level, with much greater flexibility in the application of multilateral disciplines, as well as reduction of subsidies by the North and better market access.

In order to judge how policy advice has played itself out in various aspects of African development, first a look at the export sector of African economies would be in order.

1 Commodity Dependence, Terms of Trade and the Value Chain

African countries remain by and large dependent on the export of commodities for their foreign exchange earnings. According to UNCTAD's calculations, commodity exports (comprising fuel and non-fuel commodities) account for some 80 percent of Africa's total export receipts. With the secular decline in the prices of commodities since the early 1980s, terms of trade declines have been a major factor in the poor economic performance of African countries between 1980 and 2000.

A simulation on "unchanged terms of trade" counterfactual, carried out by UNCTAD based on the World Bank's estimates of cumulative terms of losses, suggests that in non-oil exporting countries, investment ratios would have been 6 percentage points higher per annum. This would imply that per capita GDP would have been 50 percent higher at the end of the decade (UNCTAD, 2001).

The downward trend in the relative prices of commodities has been accompanied by a high degree of volatility. After a downward trend in the 1980s and 1990s, prices picked up between 1996 and 1998 to drop down again (and for some commodities such as coffee to their lowest historical levels) and then increase again towards 2003. The latest rise has been fueled mainly by higher prices for the region's fuel and mineral exports on the back of strong global demand, in particular the continuing growth in demand from emerging economies such as China and India. This, added to better agricultural performance owing to clement weather conditions, and improved political stability as well as increased levels of external resource inflows, has led to a GDP growth of 4.6 percent in 2004, moderately higher than 2003 (UNCTAD, 2005b).

However welcome this latest development may be, boom periods in commodity markets have tended to be much shorter than slumps (UNCTAD, 2003) and therefore the current trend might not be a guide for the future.

The Agro Sector

International commodity policy has not been helpful. In fact, after the slowdown in the world economy in the 1980s, the international community basically abandoned any attempts at price stabilisation and saw a demise of the Integrated Programme for Commodities negotiated at UNCTAD IV in 1976 (with the aim of bringing stability to commodity markets). Instead, reliance on market forces became the order of the day and adjustment programmes called for the dismantling of state institutions responsible for the marketing of commodities and providing extension and other services to farmers. Concomitantly, fewer firms through major mergers and acquisitions are now controlling the purchase, processing and distribution of major agricultural products of export interest to African countries. For example, in the case of coffee, the market share of the five largest processors went up from 21.5 to 58.4 percent between 1995 and 1998, and three multinational trading companies dominate the trading stage. In the case of cocoa, the number of grinders in Europe fell from about 40 in the 1990s to nine in 2000 and the three largest grinders account for over 50 percent of the market, with even higher levels of concentration in chocolate manufacturing (UNCTAD, *Discussion Paper,* forthcoming).

There is also continuing concentration in the vegetable oil industry (UNCTAD, 1999, pp. 243-44).

Paradoxically, the production side has been moving in the opposite direction. The dismantling of marketing boards in Africa has shifted chain governance to major buyers and processors that have moved into operations formerly in the province of these boards. This has created an asymmetry in the chain with enhanced power at the downstream end and diminished power at the upstream.

A similar scenario is being repeated in the non-traditional agricultural export sector. In most Western European countries, the five largest grocery retailers now account for over two-thirds of market share and concentration ratios in food manufacturing can be even higher than this. These trends are also apparent in the US market. While such retailers have been important in expanding Africa's trade in non-traditional commodities such as fresh fruits and vegetables through increased access to these markets, marketing and distribution channels in the hands of major supermarket chains has meant that the value added is captured by them and reliance on one or two buyers and retailers has increased the vulnerability of producers. This combination of forces has often meant that the benefits of liberalisation have not been appropriated at the farm gate but by firms in the high-income consuming countries.

The concentration and vertical integration has thus provided the possibility for major firms to abuse their dominant position in the market by dictating prices and quality in a market where producers have become increasingly atomised, and it is perhaps not surprising that producer prices have been at their historical lows for some of these products (although prices have recently picked up with coffee, for example, thanks to lower stocks in developed markets).

An examination of Africa's leading primary exports still shows only limited capacity in more dynamic products (UNCTAD, 2003) and even in those products where African economies have shown some success, price trends appear to have become less favourable in recent years (Gibbon, 2003), while production costs (particularly those associated with storage and processing) as well as (imported) input costs may be rising (Humphrey, 2003).

Case studies of non-traditional exports tend to confirm restricted progress in the absence of more strategic policy approaches to support domestic investment in both the private and public sectors (Helleiner, 2002; World Bank, 2005) and while participation in production chains may well be unavoidable for a growing number of products, this should not be seen as a substitute for more effective policy action. In fact, certain complementary assets, in addition to a favourable agro climate and relatively inexpensive labour, must be put in place. Because this will involve public investments in such areas as transport infrastructure, farm advisory and support services, land development, and the transfer of technology and skills, policymakers will need a framework to fully evaluate the costs and the benefits of moving into these areas (World Bank, 2005, pp. 252-56; Weatherspoon *et al.*, 2001, p. 10).

The Extractive Sector

In the case of fuels and minerals exports, African countries have not fared much better. In an effort to revive the extractive sector in Africa, policy advice by the World Bank has called for privatisation and liberalisation of the sector and the provisions of major incentives in order to attract high risk capital. As a result, African countries have undertaken wide-ranging reforms of their mining codes, including the provision of generous tax incentives. This has no doubt contributed to the recovery of investment to the sector. The 15 billion dollars invested in mining in Africa in 2004 represented 15 percent of the global total, up considerably (from 5 percent) from the mid-1980s, and putting the region in third place behind Latin America and Oceania. Of the total investment, South Africa accounted for 48 percent (Mining Journal, 2005). With the exception of South Africa, most was FDI.[2]

Certainly from the corporate perspective, the outcome of the recent reforms undertaken in the mining sector in Africa have been positive, as reflected in the significant increases of FDI in the sector. From the host country perspective, in order to assess the outcome of these reforms, governments would need to consider whether the increasing set of incentives provided to foreign investors have been commensurate with the desired outcomes in terms of income, technology transfer, employment, backward and forward linkages with the economy, environmental protection etc. Already some observers have described the incentive competition as a "winners curse" for host countries, whereby investment competition among them can trigger a "a race to the bottom" both in the more static sense of foregone fiscal earnings, but also in terms of giving up policy options which would be needed to organise a

[2] For a full discussion of FDI in Africa, see UNCTAD, 2005a.

more dynamic long-term growth path.[3] A review of incomes derived from the mining sector from two countries is telling: In Tanzania, where gold exports have risen from less than 1 percent of export revenues in the late 1990s to over 40 percent in 2003, six major mining companies earned total export revenues of about $890 million (between 1997 and 2002) out of which the government received $86.9 million (that is, about 10 percent) in revenues (taxes) and royalties. In Ghana, a calculation based on 2003 Government figures of the total value of mineral exports juxtaposed to income (revenue) derived from mineral taxes shows that Ghana earned only about 5 percent of the total value of exports, i.e. about $46.7 million out of total mineral export value of $893.6 million.[4]

Generous tax incentives provided to transnational mining corporations have an opportunity cost in terms of government revenues. As such they are a (hidden) subsidy which developing countries are providing to transnational corporations (TNCs) and ultimately to final consumers, while the provision of subsidies to domestic firms are considered as an anathema to the proper functioning of market forces and are labeled distortionary. Such subsidies are, in general, only likely to be warranted where the TNC uses elastically supplied factors intensively, they do not lower the market share of domestic firms, and there are strong positive productivity spillovers (Hanson, 2001). It seems unlikely that any of these hold for the extractive sector. Consequently, a lot would appear to hinge on significantly augmented government revenues from the sector.

In the energy sector, a large part of the additional revenue immediately leaves the continent, as foreign companies capture much of the rent. For example, Chad's revenue from its oil exports represents roughly

[3] Akabzaa, 2000 and 2004; Lissu, 2001; Charlton, 2003; Campbell, 2004; Hilson and Potter, 2005. The idea of a "race to the bottom" accompanying a globalising world has attracted a good deal of hostile press and carries a number of, not always consistent, meanings. Certainly its initial use to suggest that in a more open trading system, the entry of more low-skill manufacturing exports from developing countries would cause worsening labour market conditions in the North has been widely criticised (see UNCTAD, 1995). However, a rather looser use of the term exists, which is more akin to the idea of "beggar-my-neighbour" trade policies whereby, given increasingly mobile capital, measures to bolster competitiveness are pursued by increasing labour market flexibility, weakening regulations on corporations, reducing social provisions, etc., in the uncertain expectation that this will bolster investment, including FDI, and bring large and positive spillovers in terms of technology and jobs (see ILO, 2003, p. 117).

[4] Data obtained from the Ghana Minerals Commission.

6.7 percent of the value of its oil exports while that of Congo represents 34.4 percent. Oil producing countries such as Kuwait, Iran and Algeria have revenue shares of 98.5 percent, 83.3 percent and 72.7 percent respectively (UNCTAD, 2005b). Related to this, most sub-Saharan African oil-producing countries have not managed to build links between the oil sector and the rest of their economies, losing much of the value added of oil production to foreign service providers, and forgoing the possible positive effects of oil production for industrial development. Energy is being exported in raw form rather than being used for local growth and the export of value-added products.[5]

It is important to weigh the costs and benefits of foreign direct investment in the extractive sectors including environmental and social ones. The devastating effects of gold mining on the environment are well documented with respect to polluted waters and land by the use of arsenic and mercury. Sulphides in the rock, when exposed to the elements for the first time, become sulphuric acid and create a chain reaction of freeing dangerous and toxic heavy metals of lead, mercury and cadmium. Bearing in mind the capital intensity of the sector, evidence has shown while thousands of people have been displaced, only a few jobs, numbering in the hundreds, have been created by the mining companies.

Owing to its enclave nature, it is unlikely that backward and forward linkages can be created with the rest of the economy as capital and intermediate goods are imported or that other spillovers usually associated with foreign direct investment such as the transfer of technology will be realised. Furthermore, a recent calculation shows that among 21 African countries in which there have been relatively higher levels of investment, in a third of them cumulative outflow of profit remittances has been more than the cumulative inflows of investment and in some countries by many-fold (UNCTAD, 2005, Table A2).

2 Trade Liberalisation

Domestic Policies

The fact that trade as a share of GDP for sub-Saharan Africa (excluding

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[5] See statement by the officer-in-charge of UNCTAD to the Ninth African Oil & Gas Trade and Finance Conference, Maputo, Mozambique, 2005.

South Africa and Nigeria) increased from 45 to over 50 percent between 1980-1981 and 2000-2001 demonstrates that Africa is not trade averse (UNCTAD, 2003). However, policy advice has been to liberalise trade and to reduce tariffs and non-tariff barriers even if there were to be no reciprocity, as unilateral trade liberalisation would bring in its benefits. Much of the literature has been drawing on cross-country regressions showing the benefits of trade "openness". The success of emerging markets has been attributed to higher ratios of openness, while disregarding the fact that countries opened up after becoming competitive at the international level, while African countries are being advised to open up in order to become competitive. This is a classic case of confusing correlation with causality. The World Bank has proposed that developing countries will "gain significantly more from their own reforms" than market opening in industrialised countries (World Bank 2005, pp. 50-51). Thus trade liberalisation has been a key ingredient of the policy advice of multilateral financial institutions. A more open domestic trade environment was expected to force efficiency of local enterprises and thereby strengthen the growth prospects of developing countries through the efficient allocation of resources through the market mechanism. Trade policy advice has therefore pushed far beyond requirements arising from the multilateral disciplines that African countries have agreed to in the context of the WTO.

However, experience in Africa and elsewhere has shown that contrary to the promises held out by the neoclassical case for free trade, this has not transpired and in fact has led to balance of payments problems, increased indebtedness and de-industrialisation. However, the neo-classicists have not been put off by this outcome because the underlying institutional assumptions of the orthodoxy include a market structure that is complete and a government that intervenes in the markets only to correct failures (see Akyuz, 2004). Therefore, any negative outcome in this respect is attributed to bad institutions or governance failure. But how the Bretton Woods Institutions can make such institutional assumptions in countries where structural weaknesses are compounded by imperfect markets and the withdrawal of the state (proffered by the BWIs themselves), and the resulting weak institutions, remains a mystery. It would be useful to recall that viable institutions emerge through long and, at times, painful historic processes and many that are now regarded as prerequisites for successful economic development were the outcomes, rather than the causes, of economic development in today's advanced countries.

Certainly, given that the broad body of evidence suggests that export success involves self-selection by strong performing domestic firms, a more strategic approach to trade policy will also be needed, involving selective liberalisation and differentiated tariff structures, duty draw-back schemes as well as fiscal, credit and other incentives to exporters (UNCTAD, 1998).

A developmental state must also be able to mix and sequence policies with the aim of raising investment and diversifying into non-traditional exports. Such policies will aim to raise profits above those provided by market signals as well as improving the coordination of investment decision across complementary activities, including through support for effective corporate governance in local firms. While the term seems to have disappeared from the conventional policy lexicon, *strategic industrial policies* have a key role to play in this regard.

The strategic component does not, as sometimes portrayed, mean favouring universal protection; rather, it prescribes liberalisation, protection and subsidies in various combinations, depending on a country's resource endowments, macroeconomic circumstances and level of industrialisation, as well as disciplining the recipients of the rents generated by such interventions through the enforcement of effecttive time limits and the use of performance requirements. Similarly, industrial policy, a staple feature of the rise of today's advanced countries throughout the last century, is not synonymous with picking winners or public ownership;[6] rather, it is part of the discovery and coordination process facing firms and governments as they learn about underlying costs and profit opportunities associated with new activities and technologies, evaluate possible externalities associated with particular investment projects and push towards a more diversified and higher value added economy (Amsden, 2001; Rodrik, 2004).

International Policies

The external constraints to Africa's trade expansion should therefore be seen both in the light of national policies referred to above, international rules and disciplines, and the external trading environment. Many African countries have yet to draw significant benefits from their

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[6] Ironically, conventional policy thinking has made "attracting winners" through opening up to FDI a measure of policy success even as it decries any efforts to give strategic support to domestic firms.

participation in the international trading system. Phasing out subsidies in agriculture remains an important element in Africa's capacity to enhance its agricultural trade. The case of cotton is well documented and need not be described in detail.[7] But there is also a debate as to whether African countries would stand to gain from the removal of agricultural subsidies as many are net food importing countries and that this would eventually raise their food import bills. A recent study by the World Bank (2005) shows that, on the whole, sub-Saharan Africa stands to gain from global agricultural trade liberalisation.

More fundamentally there is a need for a review of current agreements and practices with a view to assessing their impact on African development, and to translate them into explicit obligations. Some of the areas where such action is needed include a re-evaluation of the concept of transitional periods particularly in the context of TRIPS and TRIMS; a review of the Agreement on Subsidies and Countervailing Measures to take into account the specific circumstances and requirements of African countries; measures for the realisation of the technology transfer objectives envisaged in the TRIPS Agreement; and, effective implementation of Article IV of GATS for building services capacity, access to technology and distribution channels.

It would appear that there is a consensus on the issue of granting more flexibility to developing and least developed countries in the implementation of their commitments in the WTO. For example, paragraph 44 of the Doha Ministerial Declaration, adopted on 14 November 2001, reaffirms "…that provisions for special and differential treatment are an integral part of the WTO Agreements… [and noted] the concerns expressed regarding their operation in addressing the specific constraints faced by developing countries, particularly the least developed countries in that connection…". In paragraph 28 of the same Declaration, WTO members agreed to "negotiations to clarify and improve disciplines under the Agreements on Implementation of Article VI of the GATT 1994[8] and on Subsidies and Countervailing Measures … taking into account the needs of developing and least-developed participants". Earlier on in paragraph 6, members of the WTO reaffirmed their commitment to the objective of sustainable development, and underscored their conviction that an open and non-discriminatory multilateral system and

[7] For a full discussion, see UNCTAD (2003), Annex. See also Drábek (2004).

[8] This Article, among other things, covers issues of "determination of dumping", "determination of injury" and the "definition of domestic industry".

"…the protection of the environment and the promotion of sustainable development can and must be mutually supportive", while emphasising that measures taken to attain these objectives should not constitute a disguised restriction on international trade.

In effect, the effective participation of developing, including African, countries in the on-going negotiations of the Doha Round cannot be gainsaid. This would be to ensure that they are granted sufficient flexibility under the relevant Agreements to enlarge their policy space to accommodate those policies that respond to their own domestic development agendas. In the interim, they should find ways and means of utilising effectively existing flexibilities available under the SDT they already enjoy as members of the WTO. This having been said, policy coherence at the international level is crucial.

As the UK's recent Commission for Africa Report aptly notes in its discussion of the Doha Round, negotiations should proceed with the aim of ensuring "…special and differential treatment works for Africa, prioritising development without resort to legal disputes, with sufficient flexibility to allow trade reform to be achieved at a locally agreed pace – not forced through reciprocity or IFI conditionality – with appropriate sequencing and within the framework of national and regional development and trade strategies" (Commission for Africa, 2005, p. 269). Coherence on these objectives is particularly crucial because other EU bilateral trade agreements with developing countries in recent years have often tended to cover a range of disciplines, including the so-called Singapore issue, in a "WTO-plus" agenda (Karingi *et al.*, 2005). Considering that under the Cotonou Agreement, ACP countries have to cooperate on investment, competition policy (and possibly on government procurement), the issue is whether African countries should allow themselves to be locked into disciplines to which they have not committed themselves in the context of on-going multilateral negotiations within the WTO. Recently, African delegates at an African Union meeting expressed concern about the principle of reciprocity in the EPA negotiations between the AU and African countries and that reducing tariffs to similar levels would mean sharp tariff cuts in African countries in relation to the EU products. Concerns were also expressed with regard to the deindustrialisation impact that it might have. There was also concern that the EU would introduce TRIPs-plus proposals which would oblige African countries to adopt intellectual property disciplines beyond the WTO. Finally, African countries saw problems with respect to the effect of these negotiations on regional integration efforts in Africa.

Liberalisation in African and other developing countries invariably raises adjustment problems (WTO, 2004, p. 20). Although largely ignored or underestimated in the past, it is now widely recognised that short- to medium-term assistance to cope with adjustment to external shocks is indispensable to gaining the full commitment of poor developing countries to freer trade. Otherwise, it is argued, trade liberalisation may be resisted and reversed (WTO, 2004, p. 20). The multilateral trade agreements of GATT/WTO were traditionally silent on the issue of adjustment, leaving it entirely for national policies to address, but currently an international consensus is emerging on this issue that these agreements should include provisions and specific measures to deal with adjustment costs. This is especially important for African countries, most of which lack adjustment assistance instruments to meet increased import competition, for which substantial international support is required.[9] The new challenge for the multilateral trade negotiations would be to properly design such adjustment mechanisms, ensure their funding and find ways to effectively integrate them into the negotiating outcomes.

3 Financial Flows

It is useful to recall that in its study on Capital Flows and Growth in Africa (UNCTAD, 2000), the UNCTAD secretariat demonstrated that the immediate requirement for Africa was a doubling of aid and maintaining it at that level for ten years in order to raise domestic savings and investment which could lead to a virtuous process of growth and development thereby attracting private capital flows and reducing aid dependency in the longer term. This analysis found favour with the Zedillo Report on Financing for Development (United Nations, 2001). More recently both the Report of the Commission for Africa (2005) and the Sachs Report on the MDGs (Sachs, 2005) have arrived at similar conclusions. Combined with a debt write-off, this should provide African countries with the necessary "big boost" in domestic investment,

[9] Some recent initiatives to address this issue include a temporary "Aid for Trade Fund" proposed by the UN Millennium Project's Task Force on Trade in its Report on Trade For Development, 2005, while P. Mandelson, EU Trade Commissioner, proposed on 4 February 2005 to establish a special Trade Adjustment Fund to "help the poor to trade more effectively and ease the social costs of adjustment".

both private and public, in order to break out of the vicious circle of low growth and rising poverty.

Recent announcements by the EU with respect to increasing aid to 0.5 percent of GNP by the year 2010 and to the 0.7 percent target by the year 2015 is a welcome development and should go a long way in dealing with the most pressing financial needs of African countries and give the necessary boost. Other developed countries should be convinced to do so.

Delinking lending and aid from policy conditionality is paramount in this respect. There is now a general recognition that conditionalities imposed by the IFIs have gone beyond their proper areas of competence. The Meltzer Report (IFIAC, 2000, p. 7) argued that: "detailed conditionality (often including dozens of conditions)....has burdened the IMF programmes in recent years and made such programmes unwieldy, highly conflictive, time consuming to negotiate and often ineffectual". Similar views have been expressed in the Council of Foreign Relations Independent Task Force Report (CFRTF, 1999, p. 15): "Both the Fund and the Bank have tried to do too much in recent years, and they have lost sight of their respective strengths. They both need to return to basics." According to Horst Köhler, the previous Managing Director of the Fund who called for a greater focus in the Fund's conditionality: "…I trust that ownership is promoted when the Fund's conditionality focuses on what is crucial for the achievement of macroeconomic stability and growth. Less can be more if it helps to break the ground for sustained process of adjustment and growth."(Köhler, 2000).

The question of the debt overhang of African countries should be equally addressed. Research in UNCTAD (2004) found that the criteria applied in the debt sustainability analysis such as net present value of debt to exports ratios and thresholds for fiscal sustainability were lacking in objectivity and were arbitrary. Sachs has argued, for example, that official creditors (Paris Club, IFIs) "have used arbitrary formulas rather than a serious analysis of country needs to decide on the level of debt relief….[consequently] the so-called debt sustainability analysis of the HIPC Initiative is built on the flimsiest of foundations" (Sachs, 2002, p. 275). The UNCTAD report also found that eligibility ratios were based on neither a comprehensive measure of poverty nor indebtedness; as a result, neither the poorest nor the most indebted countries were HIPC eligible. Furthermore, the scope of country selection is regarded as too narrow since the "IDA-only" criterion disqualifies some otherwise debt strapped countries (Gunter, 2001; G-24 Secretariat, 2003). UNCTAD proposed that debt sustainability should be based on other criteria such as human development indicators and the ability of countries to meet the Millennium Development Goals. On those criteria, it was obvious the external debt of the poor African countries would need to be written off. While calls for a debt write-off have gathered momentum, it should be pointed out that it should not be limited to the HIPCs group only. UNCTAD called for the establishment of an independent panel of experts, selected by debtors and creditors, to assess the debt sustainability of indebted countries, with creditors accepting to write-off debt deemed as unsustainable. It also proposed that in the meantime, no additional interest should accrue on the outstanding debts of the indebted countries concerned. The decision by the G-8 to write-off the debt of the countries that have achieved the completion point under the HIPCs initiative is encouraging although dampened by the proviso that an equivalent amount would be reduced from future flows. Furthermore, there are increasing indications that debt relief would be counted against future ODA flows which goes against the principle of additionality.

4 Conclusions

African countries need adequate resources and debt relief in order to jump-start their economies. But this in itself is not enough to create the conditions for a virtuous circle of growth and poverty reduction. National policies matter and here a major overhaul of conditionality is required, de-linking it from aid flows and lending.

It is argued that the poverty reduction policies being advocated have addressed the weaknesses of the older generation of adjustment policies, with greater ownership of the policies by the countries concerned. However, as the UNCTAD study on adjustment and poverty reduction showed (UNCTAD, 2002), while policymakers have been provided some flexibility in devising social safety nets, the macroeconomic policies contained in the Poverty Reduction Strategy Papers (PRSPs) are not fundamentally different from those under the Structural Adjustment Programmes (SAPs).

Growth-oriented strategies would require much greater policy space in order for African countries to devise strategic trade and industrial policies adapted to their specific economic and social conditions and based on their endowments. This would not only include providing special and differential treatment (and facilitating the utilisation of existing measures) under the current multilateral trade rules combined with a reduction in agricultural subsidies and improved market access for processed products, but also a frank and impartial assessment of the impact of macroeconomic policies applied in the last two decades, and drawing the necessary lessons not only from past mistakes but also from successful experiences.

Policymakers also need to rethink the singular preoccupation with attracting foreign direct investment and pay more attention to the its costs and benefits, including: gauging the impact of FDI on local costs and profitability; the size of spillovers; backward and forward linkages with the economy; level of rents and income generated and profit repatriation; and, the longer-term social and environmental impact, particularly in the extractive industries.

Finally there is need for a balance between too much state control which marked African economies in the post-independence period and too much reliance on the market which has been the hallmark of the adjustment period. This requires a hard and unbiased rethinking of the role of the state and the strengthening governance institutions both in the public and private domains.

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14

Keeping Africa's Policies on the Right Track

Vivek Arora[1]

Kamran Kousari's chapter on "Africa's Development and External Constraints" touches on some of the core development issues in Africa, and in developing countries more generally. The chapter by Matthew Martin is also relevant in this discussion because the chapters are largely complementary.

The first point to recognise in discussions about economic development in Africa is that the key objective for all observers and policymakers is basically the same: how we can help to increase growth and to raise living standards through reducing poverty and unemployment.

Against that background, the criteria that I use for commenting on Kamran Kousari's chapter is not whether it says things in favour or against particular institutions, initiatives, or "consensuses", but whether the policy recommendations are likely to increase growth and living standards. In that context, several of the main points in the chapter are well made. But some specific arguments are less convincing; in particular the call for an easing of macroeconomic policy discipline to stimulate growth is undermined by actual fact and experience.

My remarks concentrate on the sections on international policies and financial flows.

[1] IMF Senior Resident Representative, South Africa and Lesotho. The views expressed in this comment are my own and should not be attributed to the International Monetary Fund.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

Conditionality and Debt Sustainability

First of all, I agree fully with the assertion that the international community has a key responsibility to help in the development process, including the responsibility to increase market access, reduce agricultural subsidies and increase ODA to the 0.7 percent of GNP target.

Second, in that context of aid, the case is well made that that Africa needs a major boost in financing for development and that such financing should include a reduction of the debt overhang. Given the scale of the continent's problems, the simple reduction of the debt overhang is not going to be enough. Something more is needed.

On the next logical step in Kousari's argument, however, a different view is possible. While one can agree that something more is needed, the question is: what exactly? The chapter seems to favour a relaxation of policy discipline, presumably including macroeconomic policy discipline, and the de-linking of assistance from conditionality. However, based on actual experience in a vast number of countries a more convincing argument can instead be made that countries need to reinforce policy discipline in order to ensure that debt overhang and macroeconomic instability do not become problems again.

A key observation to make here is that a debt overhang does not just strike countries like a natural disaster. It is a product of policies and, of course, of other circumstances, but countries do have some responsibility. My conclusion for countries that just have come out from the debt problem would rather be that the countries should try to ensure that the economic mismanagement and excessive borrowing that contributed to these problems in the first place should not be repeated.

Debt relief is clearly good for the countries that get it. Several countries do not get it, however, and that is an issue that needs to be addressed. Furthermore, one can agree with Kousari that debt relief is not going to be sufficient and that additional resources are needed. In that sense, aid and grant financing are very important.

But a key consideration has to be that an ongoing set of actions is needed to prevent external resource constraints from re-emerging and to set the stage for higher growth and poverty reduction. On both of these questions, preventing excessive borrowing and consolidating debt relief, country policies remain a critical consideration.

Policy conditionality could be helpful in that regard. Of course, one can have a debate about the effectiveness of policy conditionality in the past, and indeed a lot of empirical work is being carried out on that question, looking at both the role of conditionality and the role of policy implementation. I do not think that the jury is out yet, but, contrary to the unambiguous criticism in the chapter, my conclusion from the literature is that the experience has been generally positive but that it could have been better in some areas.

Now conditionality can obviously be improved in many ways. That is why the chapter by Matthew Martin is particularly interesting, because some of the points that he makes on areas in which conditionality could be improved, like streamlining, greater ownership and so on, are exactly correct. In fact, those are the areas where the international financial institutions, including the Fund, are looking at trying to make conditionality more effective.

The main point here is that policies matter and policy conditionality can help. If there are areas to improve in policy conditionality, as I have no doubt there are, then I would think that this is an argument for making an effort to improve conditionality, not for abandoning conditionality altogether.

Improving the HIPC Initiative

Still on debt relief, the chapter touches on the HIPC Initiative and it also drew on a previous UNCTAD report that argued that the HIPC is flawed, because many African countries continue to suffer a so-called debt overhang after the HIPC completion points. I will not go into too much detail here, but I would just note that it is important to be clear on what debt relief can realistically achieve. Debt relief can reduce debt burdens at a given point in time towards levels that are seen as sustainable and this indeed has been an objective of the HIPC. But as long as countries continue to take on new debt and are affected by exogenous shocks, debt relief can certainly not guarantee sustainability going forward. Indeed, the fact that debt sustainability itself is a probabilistic concept, by which I mean that it depends on probabilities of future outcomes and events, means that sustainability concerns cannot be addressed by debt relief alone. They need a comprehensive approach to financing (as is acknowledged in the chapter).

Several suggestions have been made to change some technical aspects of the HIPC calculations – this is referred to also by Matthew Martin in his chapter. In fact, many of the suggestions on the debt sustainability framework have been adopted. For example, several additional indicators are now used in addition to the standard HIPC ratios, and public domestic debt is now also analysed in the Debt Sustainability Assessments (DSAs). Stress tests do take into account in the countries individual historical trends as well as their volatility.

Overall, it is clear that debt sustainability should be addressed in conjunction with low-income countries' overall efforts to meet the MDGs. But I would not go on to draw the conclusion that the HIPC Initiative itself needs to be extensively modified or that debt relief alone is the solution. While further debt relief would help to reduce the tensions between sustainability and financing needs, in order for it to be effective countries still need to manage their economies and their external debt well, just as they need to manage aid inflows effectively.

So rather than suggesting that further debt relief or modified rules for the HIPC Initiative can guarantee long-term sustainability, a stronger argument can perhaps be made that durable progress toward the MDGs would best be achieved under a paradigm for development financing that allows low-income countries to receive the financing that they need to meet development objectives on terms that will keep debt and debt service at manageable levels. This proposition will require significantly higher grant resources. Further debt relief can indeed be a useful complement but it clearly will not be sufficient. Moreover, it is worth noting that debt relief allocate resources to countries based on past borrowing decisions rather than current policies.

Structural Reforms

On the other parts of the chapter, I am going to be very brief. First of all, on agriculture. The main point that I took away from the chapter is that countries in which commodities form a significant proportion of output and exports are subject to more vulnerability. That is true. What it suggests is that more diversification in production would be useful. I think that is hard to disagree with.

On the extractive sector a key point was made, which I fully agree with, that discretionary tax incentives in favour of foreign firms do have significant costs for the budget and indeed these costs can, and probably usually do, outweigh any benefits that they might have since the foreign firms may have come in anyway. In addition, these discretionary tax incentives distort the playing field in favour of foreign firms and against domestic firms. The benefits are of course questionable. A level playing field would be better.

On trade liberalisation, there is a very large amount of empirical work that directly contradicts the suggestion in the chapter that trade liberalisation has harmed poor countries. I will just note two key points.

First, there is a lot of empirical evidence that reducing distortions, including trade distortions, is associated with higher growth. In a widely cited study, Jeffrey Frankel and David Romer (1999) present evidence to show that a higher openness ratio, meaning a higher ratio of trade to GDP, is associated with higher levels of per capita income. Their evidence suggests that a 1-percentage-point increase in the ratio of trade to GDP is associated with a 2-percent increase in the level of per capita income. Moreover, they argue that there is a causal relationship from trade to income. David Dollar and Aart Kraay (2004) have provided evidence that countries that are more integrated with the world economy tend to have more success with growth and poverty reduction than those that do not. Jong Wha Lee (1992) has done another cross-country study showing that high tariffs are correlated with lower growth. And so on. There is also much country evidence on the benefits of trade liberalisation, from countries such Chile, India, and Korea in recent decades, where liberalisation was followed by strong increases in growth performance.

Second, increases in growth have benefits on both the macroeconomic and the microeconomic fronts. On the macroeconomic front, for example, higher growth rates make a given level of debt more sustainable, and to that extent, it is relevant in the context of the present session. It also obviously has macroeconomic and social benefits. It has been generally noted that growth is good for the poor, and there is in practical experience a strong connection between increases in growth and poverty reduction. Indeed, we do not have examples of countries that have decisively lowered poverty that have not also grown rapidly.

In terms of helping countries to adjust to trade shocks, there are facilities that international financial institutions are putting in place to help countries deal with such adjustment. The Bank and the Fund recently developed a trade integration mechanism system (TIMS) that helps countries to cope with the effect on their balance of payments of trade liberalisation in third countries. Bangladesh recently became the first country to take advantage of this support as it sought to adjust its textile sector in response to the Multi Fibre Agreement (MFA) shock.

To conclude, I agree with many of the substantive points that are made in the chapter, particularly on the responsibility of the international community and on the benefits of debt relief. But I would just reiterate two key points: first, that debt relief needs to be seen as a *part* of any increase in external financing, but perhaps only as a complement to other parts of a package that may themselves end up being more important. Second, new financing needs to be accompanied by the right policies, otherwise debt problems and economic instability will simply recur. And conditionality can be helpful for keeping policies on the right track.

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15

An Integrated Approach to Africa's Development Constraints

Adam Elhiraika[1]

Over the last two decades, many African countries have undertaken major economic reforms, on their own or with the assistance of multilateral development institutions such as the World Bank and the IMF, to achieve economic stabilisation and improve economic performance. Embracing a market-friendly framework has been at the heart of these reforms, which included liberal trade and exchange rate policies, financial sector deregulation, privatisation, and public sector downsizing. Improved macroeconomic management in the continent coupled with improving governance in many countries have resulted in greater macroeconomic stability manifested in lower inflation rate, declining fiscal and current account deficits as well greater transparency in Africa's monetary systems and public finance. This has enhanced confidence in public policy and reduced uncertainty for private investors in many African countries.

Africa's average growth rate has been steadily increasing recently, reaching 4.3 percent in 2003 and 4.6 percent in 2004, due largely to: global expansion that led to higher demand and prices for commodities; a significant increase in official development aid, driven mainly by debt relief and emergency assistance; and improving macroeconomic stability.[2] Yet it is a long way for the continent to achieve sustainable growth

[1] The chapter is based on work done at UNECA, but the views expressed here are solely mine and do not represent UNECA.

[2] OECD/AfDB, *African Economic Outlook, 2005*, OECD and African Development Bank, Paris/Abidjan, 2005.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

rates commensurate with its development targets, namely the Millennium Development Goals (MDGs).

More importantly "economic performance in the continent remains fragile due to: unpredictable weather conditions; concentration of production and exports in the commodity market; and volatile external capital flows that are also too tiny relative to global capital flows. Meanwhile, though increasing, domestic saving and investment rates in Africa remain low by international standards and in relation to the resources needed for Africa to achieve its development goals".[3]

Kamran's Kousari's chapter clearly highlights many of the above constraints and identifies key overall economic challenges faced by Africa in terms of: (1) the fact that economic growth in Africa is highly dependent on weather conditions and exogenously-determined commodity prices, where most of African countries rely on the agricultural and extractive sectors; (2) the effects of aid conditionality on domestic policy and economic performance; (3) problems of debt overhang and debt servicing commitments that affect the ability of countries to finance development; and (4) liberal trade policies that open up the markets of African countries, while many of their trading partners in the developed world continue to protect their markets. It is worth emphasising that the chapter underscores the fact that "international actions exert a major influence not only on the external conditions facing Africa, but also on domestic conditions".

However, by focusing mainly on external constraints and policy actions, Kamran's chapter leaves out many important domestic factors that can be equally important in influencing Africa's economic performance. We argue that an integrated approach to analysing Africa's internal and external constraints provides a better understanding of these constraints that need to be simultaneously confronted. This is important because research has shown that even if all external, for example debt and aid, constraints are removed Africa will not realise sustainable development in the absence of good domestic policies. Conversely, even if feasible, good domestic policies alone are not enough for achieving desired growth rates in Africa without external support.

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[3] UNECA, "Unleashing Private Sector Development in Africa", Policy Report by the United Nations Economic Commission for Africa, Addis Ababa, 2005 (forthcoming).

Africa's Financing Needs

In addition to the need to simultaneously address external and domestic constraints on Africa' development, an important question arises as to why aid conditionality and external capital flows fail to adequately respond to improving macroeconomic conditions and policies in the continent. The answer to this question seems to lie in the fact that external policy restrictions remain important as far as perceived or real policy and other risks are strong. Donors and foreign investors see many countries in Africa as lacking either capacity or commitment to good policymaking. While more domestic policy measures and reforms need to be implemented for the continent to consolidate improvements in the macroeconomic environment and prove the ability of local initiative to drive growth, improvements in the international environment are also needed for domestic policies to be successful. So, there is a two-way link and interaction between domestic and external factors and policies.

The Monterrey Consensus[4] of the International Conference on Financing for Development (FfD) illustrates how domestic and external constraints can be analysed and provides a useful framework for policies to simultaneously confront them. Whereas the Monterrey framework calls for an integrated approach to resolving internal and external constraints on development in developing countries, "the prospect of rather less than the envisaged inflows, and the likelihood of even more pervasive and intrusive conditionality" has persuaded some African policymakers to shift focus to internal policies and programmes that can be implemented with or without external support.[5] This shift has received strong support from research, which indicates, "Permanent solutions can only come from within African countries themselves, with help from outside being based upon their own resources and initiatives".[6] This implies that more attention should be given to domestic resource mobilisation, at national as regional levels.

In fact, African policymakers have long noted that despite concerted

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[4] See for example, United Nations, "Report of the International Conference on Financing for Development", held in Monterrey, Mexico, 18-22 March 2002, United Nations, New York.

[5] See Kwasi Anyemedu, "Financing Africa's Development: Can Aid Dependence Be Avoided", mimeo, CODESRIA/Third World Network, 2002.

[6] See for example, Louka T. Katseli, "Financing Africa's Development", Summary Recommendations of the Fifth International Forum on African Perspectives 2005: What is New for Africa?, organised by OECD, Bercy, June.

Table 1 The Resource Gap and External Financing for Africa

	1993	1998	2002
Gross domestic investment (% GDP)	18.7	21.6	21.5
Gross domestic savings (% GDP)	16.6	16.8	21.0
Budget deficit (% GDP)	-4.4	-3.0	-2.9
Official development assistance[1]	21.2	17.84	22.16
Debt disbursement[1]	21.0	13.49	16.01
Net transfers on debt[1]	-4.19	-13.46	-10.08
Net Foreign direct investment	2.49	9.87	13.27

Note:
[1] Nominal $ billion
Source: World Bank Africa Database, 2004.

efforts by African countries and their development partners to enhance official assistance, promote debt relief, increase and mainstream trade, and accelerate economic and financial reforms to boost domestic investment and external resource mobilisation, most countries are unable to meet the MDGs, chiefly because of the overriding financing constraint. It is also generally recognised that partial reforms and policy measures are unlikely to be effective in resolving Africa's financing needs.

For example, economic and financial reforms have contributed to a notable recovery in many African countries in terms of macroeconomic stability and growth since the mid 1990s but both internal and external resource flows remain far below the levels required for these countries to finance their development needs (Table 1). Despite notable increases in domestic saving rates and recovery in official and private capital flows, including foreign direct investment, Africa has not yet been able to boost the domestic investment rate. With unsustainable debt levels in many countries, substantial debt relief is needed for Africa to capitalise on domestic saving and foreign capital flows to finance infrastructure and other investment to meet its development targets.

Africa needs a holistic approach to simultaneously address domestic and external development constraints.

Needed Actions Within a Holistic Framework

The above challenges can best be addressed within the framework of the Monterrey Consensus, which notes that in the increasingly globalising interdependent world economy, a comprehensive approach[7] to the interconnected national, international and systemic challenges of development financing in all parts of the globe is essential. In this light, countries or regions might be able to develop an integrated framework to take actions to enhance develop financing and thus confront a key development constraint from both internal and external angles. Leading actions within this holistic framework are:

Mobilising domestic resources for development. This requires good governance, appropriate policy and regulatory frameworks, control of corruption, capacity building, and an effective, efficient, transparent and accountable system for mobilising and allocating public as well as private resources. Domestic resource mobilisation and private domestic capital formation is the largest source of new investment in developing countries. On average, it is five times the level of foreign investment. However, effective resource mobilisation and use in Africa requires further reforms to widen and deepen the domestic financial sector, adopt prudent fiscal and monetary policies, and improve legal systems and economic as well as corporate governance. To strengthen capacity for domestic resource mobilisation, there is a need for, among other things, the development of a continental domestic resource mobilisation strategy, and the creation of an African Monetary Fund, a continental investment bank, and a continental capital market.[8] Africa should also harmonise laws and regulations across countries, develop debt markets, adopt a continental banking charter and create appropriate institutional structures to attract more remittances and direct them to better uses.

Mobilising international resources for development (FDI and other private flows). To attract increased private productive capital flows, countries need to ensure a transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, and sound macroeconomic policies and institutions at national as well as regional levels. Despite notable increases in recent years, FDI flows in Africa remain very low in comparison to Asia and other regions and tend to be concentrated regionally (i.e. North Africa) and

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[7] See UN-DESA, "Implementation of the Monterrey Consensus: A Regional Perspective", Department of Economic and Social Affairs, United Nations, New York, 2005.

[8] UNECA, "Financial Systems and Domestic Resource Mobilisation for Economic Development in Africa", a Regional Workshop organised by ECA, Nairobi, 1-3 November 2004.

sectorally (i.e. in the extractive industries). FDI flows to the service sector in general, and the electricity, wholesale and retail sub-sectors in particular, have been on the rise in recent years, challenging the dominance of the extractive industry. This is due to privatization and liberalization of the sector as well as technological innovations, which have increased the range of tradable services. It is important for Africa to tap-up South-South FDI flows, especially from such countries as South Africa, China, India and Brazil.

International trade as an engine for development. Trade is considered as potentially the single most important source of external financing for developing countries. Therefore, WTO and related institutions, should put the interests of poor countries at the heart of their work programme to encourage trade within less developed countries and between developed and developing countries.

Africa's share in international trade has been declining over the last two decades. To realise Africa's commitment to achieving sustained economic growth and eradicating poverty with trade as a major source of financing, it is essential to: diversify exports; successfully conclude the Doha Development Round; and widen Africa's access, specifically, to developed countries' markets through reduction of tariffs and other barriers and through special and differential treatment. Meanwhile, an integrated continental market offers the best hope for Africa to build its manufacturing sector and diversify its economy away from primary products. This requires intensive efforts targeted at removing trade barriers within the continent, besides strengthening regional infrastructure.

Increasing international financial and technical cooperation for development. Official Development Assistance (ODA) plays an important role in complementing other sources of finance, especially in countries that lack capacity to attract FDI. Effective national leadership and ownership of plans with sound policies and good governance are essential to ensure ODA effectiveness. Developed countries have been repeatedly urged to honour the target of 0.7 percent of GNP as ODA to developing countries, and donors and recipients should work together to make ODA effective.

ODA represents the main source of development financing for many African countries, reaching over $23 billion for sub-Saharan Africa in 2003, and far exceeding debt service payments in that year. However, aid flows to Africa remain volatile and cannot meet the MDGs' financing needs even if the goal of 0.7 percent of rich countries' GNP is achieved. Therefore, Africa should ideally focus on attracting private flows, particularly foreign direct investment. Generally, FDI is less volatile, has less impact on domestic policy choices and has the potential to enhance productivity and growth through technology transfer. However, significant non-extractive FDI would only flow to developing countries that have already managed to build a conducive business environment, and poor countries might only afford to do so when they receive adequate aid. Therefore, effective aid management is critical for countries to reduce aid dependence and enhance their policy choices in the long run.

External debt and debt relief. The Monterrey Consensus state that debtors and creditors must work together to ensure sustainable debt flows to support public and private investment and prevent and resolve unsustainable debt situations. External debt relief can play a role in freeing resources for development financing through the Highly Indebted Poor Countries (HIPC) and other initiatives. In spite of these initiatives Africa's external debt has continued to increase at a high rate. There are huge differences in debt levels across countries, and debt sustainability in heavily indebted poor countries in Africa is a major constraint on development. Therefore, the international community has a responsibility to increase financing for debt relief because: debt reduction is more predictable than bilateral aid; has a longer-term horizon; reduces the transaction costs of managing aid, and acts as direct budget support, thus increasing recipient ownership. However, even if all the external debts of sub-Saharan Africa were relieved, the saving would fall far short of the amount required for meeting the MDGs.

As a matter of fact the HIPC has already helped to reduce the external debt burden of its beneficiary countries, many of which – for example, Uganda and Mozambique – have also been able to increase spending on the social sector. However, debt burden remains unsustainable for some of the HIPC countries, while annual debt service payments are higher or the same as before for others. Therefore, there is a need for improved debt sustainability analysis as well as expansion of the HIPC initiative to cover more heavily indebted African countries and reduce the burden of debt on economic and social spending. Meanwhile, an understanding has to be reached between lenders and borrowing countries for future borrowing to be tailored to country-specific circumstances, taking into account the quality of institutions, as well as vulnerability to shocks. This will assist future generations in developing countries to avoid problems of odious debt. Resource transfers beyond the sustainable debt-serving capacity of a given country should be in the form of grants.

Addressing systemic issues: Enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development forms an integral part of efforts to address internal and external constraints on development within the Monterrey framework. Mutual accountability, harmonisation of aid modalities and policy coherence are among the main tools in addressing systemic issues. Several country-level and regional initiatives – such as African Peer review Mechanism (APRM) and The New partnership for Africa's development (NEPAD) – have created opportunities for African countries to improve governance and enhance policy coordination. To compliment this effort, Africa's development partners are urged to move faster to ensure that all their policies – on ODA, market access, and debt – are consistent with meeting the MDGs.

Conclusion

It follows from the discussion above that external and internal constraints on Africa's development can be more usefully analysed and simultaneously confronted within a holistic framework that underscores their interaction. Individual countries have the primary responsibility for developing long term plans to reduce dependence on foreign assistance and associated policy intervention through increased domestic resource mobilisation, retention and efficient allocation, and through attracting productive foreign flows, especially FDI. Regional integration will help in this direction through expansion of regional markets, facilitation of capital and labour movement and strengthening Africa's negotiating position in international fora such as WTO.

16

South-South Investment: The Case of Africa

Stephen Gelb

This chapter focuses on South-South foreign direct investment (FDI), particularly as it relates to Africa, on which there has been very little analysis to date. The EDGE Institute is starting a research project on this issue, so that this chapter will reflect some of the initial thinking and background work done to get the project underway rather than detailed research.

Over the last 10 years there has been a very rapid increase in South-South FDI. FDI inflows to developing countries increased nearly four-fold, from an annual average of just over $54 billion in the 1985-95 decade to over $200 billion between 1998 and 2003. At the same time, FDI outflows from developing countries rose from $12 billion in 1991 to a peak of $99 billion in 2000, with the average outflow from developing economies being $61 billion between 1998 and 2003. (UNCTAD, 2004) However, South-South flows have grown far faster than North-South flows. One recent estimate suggests that "South-South" flows rose from $4.6 billion in 1994 to an average of $54.4 billion between 1997 and 2000, equivalent to 36 percent of total FDI inflows to developing economies in the latter period (Aykut and Ratha, 2004).

Foreign Investment into Africa

FDI flows into Africa from other developing countries have increased as part of this broader trend, with two major sources. The first has been Asia. A recent World Bank report on Africa's economic links with Asia is one of the few that addresses South-South FDI (World Bank, 2004).

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

It indicates a massive increase in investment from China into sub-Saharan Africa through the latter half of the 1990s: between 1990 and 1997, Chinese investment into Africa amounted to about $20 million, but from 1998 to 2002 that increased six-fold to $120 million. Only about twenty percent of that amount came into South Africa, not as large a share as might have been expected. The report indicates that there are 450 Chinese-owned investment projects in Africa, of which 46 percent are in manufacturing, 40 percent in services and only 9 percent in resource-related industries. In value terms, extractive and resource-related projects comprise a much higher share at 28 percent, but nonetheless 64 percent of the value of Chinese investment in Africa is in the manufacturing sector.

Taiwan has also been a major source of FDI into Africa. There was a substantial wave of Taiwanese investment into South Africa during the 1980s, but more recently, particularly in response to the African Growth and Opportunities Act (AGOA) passed in the US in the late 1990s, Taiwanese investment has entered several other Southern and East African countries. There are now as many as 700 Taiwanese investment projects throughout sub-Saharan Africa.

The third Asian country which is rapidly growing in importance as an investment source in Africa is India. In South Africa there has been a very rapid move by Indian conglomerates into a range of sectors, both services (IT, banking) as well as manufacturing, including automotive, steel and pharmaceuticals. There are now estimated to be 35 Indian companies present in South Africa, but probably double that number in terms of projects.

Much less investment is coming into Africa from Latin America, although Brazilian firms are now starting to move quite actively into the other Lusophone countries in Africa, Angola and Mozambique in particular.

The second major source of South-South investment into the rest of Africa is South Africa itself. Since the advent of democracy in 1994, there has been a very rapid movement of South African firms throughout the continent. A press clipping count of investment projects done at The EDGE Institute in mid-2004, about a year ago, yielded over 600 projects by South African firms in the rest of Africa. The number of projects provides a useful indicator of the very rapid and extensive move into Africa by South African companies. Their sectoral distribution is also interesting: about 15 percent of these projects were in mining, very few in agriculture, and only about 20 percent in manufacturing. The vast majority were in service industries: in utilities, hospitality and tourism, construction, IT and banking.

Market-Seeking and Resource-Seeking Investment

Why is there this rapid increase in South-South FDI? The process can be examined using the basic distinction between market-seeking and resource-seeking investment common in analysis of FDI. In broad terms, the entry of South African and Indian companies into Africa is largely market-seeking, and has been driven by the liberalisation of regulations and lowering of entry barriers in the host countries. This applies also to inward FDI coming into South Africa from industrialised countries during the past 10 years, and to firms which were present in South Africa under apartheid but have expanded their operations in South Africa to use it as a base for exporting to the rest of sub-Saharan Africa (Gelb and Black, 2004).

The second thrust of South-South FDI into Africa is resource-seeking, and this characteristic is much more prominent in Chinese and Taiwanese investment. "Resource-seeking" should be taken to mean not only extractive industries such as mining or agriculture, but also to include the quest for cheap labour as a resource. The latter has become increasingly important as a result of AGOA. In this case, it is not host country liberalisation that is enabling and encouraging foreign investment, but rather trade access – firms are coming to Africa seeking resources, either for export back to their home markets or for processing in Africa for export onto third markets, with the US particularly important in the clothing and textile sectors.

What does this entry of foreign investors from other developing countries mean for Africa economic development? One of the key issues that needs to be addressed for African development in general (taking account of differences amongst countries) is improving governance, defined in broad terms as reducing the risk elements in the investment climate and promoting human capital resources and their accumulation. A related constraint on development is the weakness, and in some cases complete absence, of a domestic business class in many African economies. An important question that we should be posing in relation to the balance of costs and benefits of FDI in Africa is about its contribution to promoting the activities of domestic business, and increase the supply of entrepreneurs. In this regard, one can again make a distinction between market-seeking and resource-seeking foreign investment.

The former offers much more potential in terms of promoting forward and backward linkages and in terms of impacting on competition in the domestic market, though the latter effect might be negative. Market-seeking FDI is likely to increase the scope and quality of goods and services that are available to domestic firms and households as inputs into production and consumption. In contrast, resource-seeking investment (especially producers seeking cheap labour) is more likely to have some impact on employment promotion and exports, with some possible impact on the transfer into the host economy of technology and new business models and on establishing or improving productive infrastructure.

The Advantages of South-South Investments

Do South-South investments differ from North-South investments, and if so, how? Ten years ago, Yeung (1994) argued that "developing country TNCs are a special species of the capitalist beast – they are more beneficial to the host economy than other TNCs from developed countries." We can hypothesise that market-seeking firms in manufacturing, in utilities and services are more likely to provide accessible goods and services to domestic firms and households, if the supplying firm comes from another developing economies than from an industrialised economy. *A priori*, South-South investment is also more likely to make use of distribution and business network models that will not only lead to more successful entry for the foreign firm, but also more effectively promote backward and forward linkages within the domestic economy and therefore support domestic enterprise development. With limited "absorptive capacity" in the host economy to adopt new technologies and innovate, the smaller "technology gap" between domestic firms and foreign investors firms from other developing countries enhances the possibility of technological spillovers via FDI. Resource-seeking investments have different advantages: one that is often understated is that these investments, particularly from Asia, often increase the supply of entrepreneurs through immigration. Asian firms tend to use large numbers of expatriate managers and supervisors in their foreign investments, and these individuals often leave their employers to set up their own firms in the economies where they find themselves. The greater prospects offered abroad are an incentive for aspiring entrepreneurs from China, Taiwan or India to move from their home countries, where their opportunities are more limited.

Another important advantage of South-South resource-seeking investments is that they embody business models which are less corporatised and more informal than western models, and are often more appropriate to the host country context. As a result, learning and spillovers to the domestic economy are possible, though local business culture may limit the latter's absorptive capacity in this regard. More generally, investors from developing countries, including some of the South African corporations moving into Africa, tend to be less risk-averse and more willing to deal with the informal governance arrangements and processes found in many African economies in relation to distribution of goods and services, security issues and so on.

At the same time, they are perhaps more likely to press for improved governance and infrastructure to lower their risk, than investors from industrialised countries, who would more likely choose not to enter in the first place, or to exit if they find themselves in a situation where risks have increased substantially. The experience of Lesotho is interesting in this regard. As a result of AGOA there has been very rapid growth of the textile and clothing industry as a result of Asian firms entering, to the point where the sector now contributes a huge share of overall output. What we are seeing now is a process of growth leading infrastructure as Chinese and Taiwanese investors demand improved infrastructure in transport, energy and water, all necessary for profitable operations in the sector. As a result, the government is beginning to address these issues with the help of the donors.

While one does not want to overstate the potential for foreign direct investment from "the South" to promote development in the host economy, in theory it is possible that both resource- and market-seeking FDI can have a positive impact. Whether these benefits are in fact achieved has not been empirically demonstrated. The EDGE Institute's project will investigate this, by collecting firm-level data in South Africa, India, Kenya, Tanzania and Uganda to assess the development impact in *both* host and home economies of FDI flows between these countries. The quote from Yeung above also refers to specific characteristics of the investing firm, underlining the need to assess the *home* economy impact of South-South FDI flows as well. In this regard, we can hypothesise that the benefits may vary according to the destination of the FDI.

The rise in South-South investment into sub-Saharan Africa will not automatically change the terms of the relationship between Africa and "the North" (industrialised countries) in the short-term. But it can provide individual governments in Africa with greater bargaining power in their relations with multinational corporations from industrial countries and foreign investors more generally, precisely because it diversifies the host countries' options, and so gives their governments more bargaining power. To the extent that it contributes to the creation of a strong and domestic business class and other development processes, over the long run it may contribute to changing the power balance.

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17

Africa's External Constraints: What Developed Countries Should Do

Matthew Martin

This is a time of major initiatives by developed countries to reduce external constraints to African development. That is why I am not going to discuss only what the international community should do for Africa but also what the international community is likely to do for Africa, and what Africa has to do to benefit most from these initiatives.

It is important to ask whether the international community should do anything for Africa. One interesting reaction by many Africans, in civil society in particular, to the UK Commission for Africa report, for which I helped write several background papers, was that the international community should let Africa develop on its own. I disagree profoundly. Africa's relationship with the international community is crucial for its development – and unless those committed to African development speak up loudly, this relationship will be left to those with other much less laudable motives, and its development will be undermined. For this reason, it is also vital to analyse what the international community *should not* do.

It is also important to look beyond developed countries: at what international institutions and other countries should do, because Africa's South-South relations are increasingly important.

My thoughts are based mainly on the ideas of the 35 low-income African governments we work with extensively, and earlier work I have done with organisations such as AERC, ECA, FONDAD, MPH (the Make Poverty History campaign), the North-South Institute, and the Swedish Ministry of Foreign Affairs. It contains informal preliminary thoughts, which are doubtless not comprehensive or unbiased.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

I will look at six issue areas: (i) economic policy and governance; (ii) poverty reduction policy; (iii) shocks and non-shocks; (iv) financing issues (aid, debt relief, and private flows); (v) trade access and capacity; and (vi) enhanced voice for Africa.

1 Economic Policy and Governance

In terms of economic policy, the major constraint for most African countries is excessive conditionality. Almost every low-income African country has a Poverty Reduction Strategy Paper now, and many other countries (such as Nigeria and Swaziland) are trying to construct similar programmes. It is a general consensus that many of these have far too much external input. Most countries also face additional conditions through IMF PRGF loans, PRSCs from the World Bank, multi-donor budget support frameworks, and bilateral conditions from many donors and lenders. There have been laudable efforts in recent years to try to streamline this conditionality, but they are not going far enough and more needs to be done.[1] Everybody is currently reviewing international organisations' conditionality and trying to streamline it further.

There is also growing shadow conditionality, otherwise known as selectivity in aid provision, which is a very negative trend. This is a different type of conditionality in which countries don't get to negotiate with the providers of money what the conditionality should be, because the allocation or the willingness to give anything at all is decided in a non-transparent way by the providers themselves. The most alarming type is the pre-selection in the US Millennium Challenge Account (MCA), but the World Bank's performance-based allocation framework of the CPIA is not much better.[2] They are particularly worrying because they give high importance to governance and institutional change conditions, even though the international community has shown itself to be extraordinary bad at changing these over the years.

Another major problem is that restrictive macroeconomic frameworks set by the IMF still provide insufficient "fiscal space" to absorb aid in sufficient amounts to reach the Millennium Development Goals. There has been some sign of change here, but nowhere near enough.

In terms of what the international community should do, the first step

[1] See e.g. Matthew Martin and Hannah Bargawi (2005a).

[2] For critical comments on MCA and CPIA, see Ocampo (2005).

is to streamline conditions much more dramatically. The recent initiative by the UK DFID, which will dramatically streamline conditionality, should be followed by everyone. They are going to cut conditionality back to: (i) having an economic programme broadly on track, which they will assess independently from the IMF and much more flexibly; (ii) minimal fiduciary conditions relating to public expenditure management; and (iii) minimal human rights and governance standards.

Similarly, we should avoid entirely shadow conditions and selectivity. If this is not possible, all assessments of country performance should be fully transparent and preferably based on the country assessing itself, and with a much lower weight for governance conditions.

Finally, we should provide greater macroeconomic flexibility and fiscal space in programmes, in order to allow countries to absorb additional aid.

What is likely to happen? A rather mixed picture. Some donors are beginning to move in a similar direction to DFID, but others will continue with many bilateral conditions or prior selectivity. It would be interesting to get the views of the IFIs represented here, as to whether IMF, World Bank and multi-donor budget support conditions will be streamlined. Obviously, it will depend on the views of their major shareholders and those donors who are co-financing multi-donor budget support. My impression is that these are relatively split about which direction conditionality should take. The World Bank is taking moves to disseminate the results of the CPIA system, but it would be much better if it could fully adapt the assessment to country's own priorities, and discuss it transparently and openly with civil society in each country. There will be some progress on fiscal space, but only if in particular the IMF can be convinced that providing more fiscal space will be compatible with macroeconomic stability, that the country has the capacity to absorb aid, and that the money will be spent transparently.

So if Africa wants to benefit from what is likely to happen, it needs to continue to develop its own capacity to negotiate down conditions and demonstrate the case for fiscal space. Often the reason why Africans don't get flexibility from the international system, is that they don't have the capacity to convince anyone that they have a case. Second, Africans need to design their own systems for a self-monitoring peer review of policy quality and not rely on external assessments of what is good economic policy. And third, they need to develop the will to be more selective about the donors they use, depending in part on the conditionality those donors insist on.

From: Africa in the World Economy - The National, Regional and International Challenges
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2 Poverty Reduction Policy

Poverty Reduction Strategy Papers (PRSPs) are a huge step forwards because they force Africa and its international partners to focus on poverty reduction as well as growth. But they suffer from several major problems:

- African countries' wish to spend more on poverty reduction has often been overridden by the needs of macroeconomic balance and stability. The IMF Independent Evaluation Office concluded a few months ago that generally PRSP macroeconomic frameworks were aligned to rather unambitious IMF PRGF programmes – rather than the reverse, which had been the original intention.
- The structural policies African countries have been asked to implement are mostly not analysed for their poverty impact in enough detail – but rather are just being assumed to be good for the poor.
- The first generation of PRSPs were mostly too narrowly focused on the Millennium Development Goals, social sectors and safety nets. This is less true in Eastern and Southern Africa, because there was more donor money around, and countries developed their own strategies which went well beyond the social sector. But in Francophone Africa, virtually all of the additional spending which in the first generation of PRSPs was health, education and water. Of course, the Millennium Development Goals concern goals that we all care about deeply, and to which the whole international community has committed itself: but the Commission for Africa, NEPAD and the World Bank have recently stressed how vital infrastructure is as well.[3]
- There was insufficient attention given to the voices of the poor in African countries. They were consulted, but usually did not feel they had participated in designing the strategies.

In that context, what needs to be done?

1. Aligning macroeconomic frameworks with spending needs for poverty reduction and the Millennium Development Goals. Here the UN Millennium Project has made unique progress (whatever the criticisms of their detailed methodology) by starting from the right end of the process by saying: how much do we need to spend to reach the MDGs, and what do we need to do to get there? Similarly, the World Bank has recently done good work in Ethiopia and

[3] See the chapter by Ndulu, Kritzinger-van Niekerk and Reinikka in this volume.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

Nigeria, working out what we need to do to generate the growth rates required to achieve the MDGs, and how we should mobilise the money to support them.

2. Ensuring that all major macroeconomic and structural policies are pro-poor, based on comprehensive and participatory poverty and social impact analysis – PSIA as it is known. This needs to go beyond analysis of single structural policies such as privatisations, to the overall macroeconomic framework and such vital aspects as tax and spending incidence.
3. Allowing more space for non-MDG related needs. Sometimes we forget what a limited sub-set of goals these are. Some time ago I was training some people from Benin and Rwanda in London in analysing the health-related MDGs, and a woman from Benin said: "The MDGs cover the key diseases and maternal and child health, but what happens to the men, are they not allowed to be healthy ?" This slightly naive question showed how the MDGs don't take a wide enough overview of national health systems.

   We also need to broaden the definition of poverty reduction spending, to include infrastructure. But how far should this go? I have over the last 15 years of working with Africa heard many people talk about infrastructure. What this means varies from wells in rural areas to six-lane motorways, or presidential palaces. Almost anything seems to be able to be called infrastructure – and we should step up efforts to reject funding of white elephants, especially by our export credit agencies.
4. Ensuring that the voice of the poor takes precedence permanently. There is a strong danger in many countries that the participatory process that was created for building Poverty Reduction Strategy Papers is dying away. The process of consulting the poor during implementation and revision is not nearly as strong as it was in the design of the first generation of PRSPs. Added to failure in many countries to deliver results, this could discredit the whole PRSP process.

What is likely to happen here? There will be some marginal changes to macroeconomic frameworks, but it is still likely, unless Poverty Reduction Strategy Papers dramatically improve their macroeconomic content, that they will continue to align their macroeconomic frameworks to PRGF negotiations with the IMF, rather than vice versa. Probably, a few structural policies in each country will be examined for their poverty and social impact, but far too few. And the analysis may continue to be done largely by the international community, with far too little African participation. There will probably be a continuing primary focus on the Millennium Development Goals, with some inclusion of infrastructure spending, but also some continued funding of white elephants.

There may also be a reinforcement of participatory frameworks and the capacity of the poor, civil society organisations and parliaments to analyse all of these policies. But while a lot of fine words are spoken about this, and the Dutch government has launched some fine initiatives, there is a great deal more to do here, and little sign that it will be forthcoming.

What does Africa need to do? First, to ensure that second-generation PRSPs contain a full analysis of broad-based and pro-poor growth. Second, that they contain PSIAs of all major structural and macro policies, preferably conducted by the government with independent support. Third, that they contain any growth-promoting infrastructure-related spending needs. And fourth, that participatory structures and transparency of government, above all to Parliament, are dramatically strengthened.

3 Shocks and Non-Shocks

Africa faces huge and frequent, and indeed in many cases growing, shocks: unexpected events which undermine its development, whether they be climatic, commodity prices, aid volatility, political shocks or conflict. However, a lot of these are not shocks.

- For the last 10 years, nobody has been able to claim that HIV/AIDS is a shock, but yet it is only in the last three or four years that BWI research has began to take into account the devastating impact that it might have on national development.
- In many countries of the Sahel, desertification is a longstanding, creeping peril and yet it is never included in economic projections.
- We all can quite easily calculate historical commodity price volatility, aid volatility or shortfalls, and the impact of foreseeable conflict or political problems. Yet in response to all of these, the international community has often sat on its hands and hoped they would go away, rather than intervening and trying to counteract their projected effects.

Equally important, the international community should stop causing shocks itself. If we are serious about reducing Africa's shocks, we should be combating climate change much more strongly; ending agricultural subsidies and protection; improving aid stability and disbursement; being much tougher on poor governance; and especially ending arms sales.

We should also be investing dramatically more in helping to prevent shocks. Many things can be done to prevent desertification, droughts or floods. We can build food stocks, diversify out of primary commodities, reduce aid dependence, and especially fund African institutions to facilitate political dialogue, conflict prevention or peacekeeping. In Darfur and other regions of Africa, international leaders have pronounced wonderful words about wanting African institutions to lead, but took a long time to fund them to do so.

Finally, we all need to forecast and combat the impact of non-shocks. It is very easy to set up contingency mechanisms and funds at an international level to deal with this. We have recently written papers for the Commission for Africa and DFID on this (Martin and Bargawi, 2005b), as has Alan Gelb within the World Bank.

What is likely to happen? We are all likely to act too slowly, on climate change, subsidies and protection. We should see some improvement in aid stability and disbursement, but not enough. Most disappointingly, the international community is likely to continue to give conflicting governance signals, with some members of the G-8, for example, being very tough on governance, and others continuing to fund the same appallingly governed countries they have funded until now. And equally, few are likely to give up chances for arms sales where there is a market. We will probably not invest enough in preventing shocks, and therefore will continue to have to spend fortunes to overcome their effects after the event. We will probably improve our forecasts, but still be too optimistic in our expectations. Above all, I hope we will establish more anti-shock financing mechanisms, preferably with extremely low conditionality, and grant based.

What does Africa need to do? It needs to insist on including anti-shock measures, contingency funds, and realistic projections as a core part of PRSPs; to reinforce and fund African institutions for political dialogue, conflict prevention, and peacekeeping, particularly peer review processes; and to build its own capacity to make forecasts of non-shocks, and establish contingency mechanisms supported by donor funds to deal with them.

From: Africa in the World Economy - The National, Regional and International Challenges
Fondad, The Hague, December 2005, www.fondad.org

4 Financing

Aid to Africa Needs to Be Improved

On aid, I do not want to give the impression of only talking about official development assistance from OECD governments. A lot of this analysis applies equally to NGOs and international civil society organisations. The biggest constraints on aid financing have been:

- Insufficient aid for public investment to grow and reach the MDGs. A conference run by the IMF, DFID and INWENT in Maputo in 2005, asked "will too much aid provoke Dutch Disease (currency appreciation) and undermine Africa's exports?" The overwhelming response from African governments was that their real problem was insufficient and volatile aid.
- Poor aid quality and low effectiveness. Around 50-60 percent of aid is of poor quality. This is a controversial figure – Action Aid recently produced a report suggesting that 75 percent of aid is of poor quality, but most donors would suggest around 30-40 percent. Effectiveness varies across donors, but several give aid which achieves very little in terms of development.
- The global aid architecture is thoroughly inadequate. It has seen massive institutional proliferation, of multilateral, regional and sub-regional organisations, private sector foundations, and NGOs. It has also seen extremely skewed distribution across countries. Most countries in Eastern and Southern Africa get enough high-quality aid to reach the MDGs, but Francophone Africa has far fewer poor-performing donors, and therefore little chance of reaching the MDGs.

The international community should double aid to Africa. Annual flows at the moment are 25 billion and they need to rise to 50 billion immediately (not over the next five years) – an amount that Africa can easily absorb on essential health, education, anti-poverty and infrastructure spending. Above all, the international community should improve the quality of aid – because a rise in poor quality aid will only leave all sides asking in 5 years what bad aid has achieved and why it shouldn't be cut.

When Trevor Manuel was asked in a BBC interview the other day what he thought was the number-one thing the international community should do for Africa, he said, "Provide more budget support for countries which have good budgetary systems, rather than

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fragmenting everything in multiple projects". I agree that this is the number-one priority aid issue.

But there are others which are equally important, for example, transforming technical assistance into capacity building. Almost everybody, these days, calls any technical assistance project that they have a capacity building project. Very few of them are: it is a very long way from those nice words to actually building sustainable capacity in African countries, for them to do things themselves rather than making them dependent on a never-ending series of expatriate advisers.

Similarly, it is necessary for the international community to align all their aid procedures with national systems where these are reliable, and put aid through African budgets rather than executing everything themselves, to make sure that as a result it is disbursed much more rapidly.

And it is necessary, as I earlier said, to streamline conditionality, and improve the quality of the policy dialogue: listen more to what African governments and civil society's priorities are at the national level.

For predictability of aid it is vital to make multi-year pledges so African governments can plan ahead, and then to ensure that the aid comes predictably as it was promised and the aid tap is not turned on and off all the time. Equally, we should all set aside extra contingency funds in case aid does not come as predicted or other exogenous shocks hit the economy.

What is likely to happen? Just about everybody – including the G-7 and EU – seems to be pledging to double their aid to Africa. But we should be cautious here for two reasons: (1) they (especially Canada, Japan and the US) are not pledging their global aid will double and therefore it is not clear we can rely on them to cut their aid to other regions in favour of Africa; and (2) they may well be derailed by budget constraints, as Germany and Italy have been from delivering what they promised a few years ago as an EU target.

The quality of aid is likely to improve, but patchily across donors. There are initiatives under way, sponsored by the OECD DAC, with developing country partners, to try to improve aid quality. But some donors have strange ideas of what constitute quality improvements, different from most of the international community. For example, "privatising aid" – as a result of which in the US, the Millennium Challenge Corporation has taken three years to begin disbursing any funds. This is why it has taken five years since the MDGs for donors to produce targets for themselves on aid quality.

Donors are also more likely to harmonise among themselves, than to align with country priorities. Donors have made a lot of progress in trying to have joint missions, similar reporting formats and procurement systems, notably across the different Multilateral Development Banks, than they have so far with aligning with country systems, as the DAC's own analysis shows.

We will not see much progress on reforming the aid architecture. IDS produced an excellent report for the Swedish government on this.[4] Halfway through a conference in Stockholm to discuss it, a Swedish policymaker asked: "You say institutional proliferation has been negative, but which organisations would you abolish?" There were 40 experts on the international financial system in the room, but nobody could agree on this. In fact, the report itself was proposing the creation of another sub-regional Multilateral Development Banks. This is an issue similar to that of regional integration in Africa – there are many overlapping regional organisations, some of which achieve nothing, but nobody will close them down due to vested interests.

It would be fantastic if Africa would decide to close down some of these institutions or at least reduce their time demands on policymakers through countless meetings. The recent decisions to merge AfDB and UNECA ministerial meetings are a very good first step.

Africa also needs to develop its own aid strategies and scenarios to ensure that countries mobilise the right quantity and quality of aid. It is pleasing to see that the UNECA is going to lead this process through a mutual accountability initiative with the DAC in the next few years. They can best build on our work with BCEAO/BEAC, MEFMI and WAIFEM, to help 35 governments in Africa to develop their own aid strategies and scenarios.

Africa also needs not to be afraid of aid dependency. It is easy to find Africa's aid-to-GNP ratios alarming, but Botswana and Korea, in the period when they had most rapid growth, had much higher per capita aid flows than the poorest African countries today. The high aid-to-GNP ratios really reflect the appallingly low level of GNP of most African countries.

Africa needs, in addition, to prove it can absorb aid without destabilising the economy, on high-quality spending and by improving government procedures and transparency, to ensure that donors do

[4] Francisco Sagasti, Keith Bezanson and Fernando Prada (2005), *The Future of Development Financing - Challenges and Strategic Choices*, Palgrave Macmillan and Ministry for Foreign Affairs, Sweden, Global Development Studies No. 1.

move forward on alignment. What is very clearly coming out of the DAC negotiations on donor commitments is that donors will move only in countries where they feel that African governments' own procedures are adequate.

Africa also needs to become more selective about the donors and aid types it wants. Until now, most African governments have had aid strategies which are limited largely to the cost of the funds. They have not thought about cutting back on donor numbers. Mozambique, for example, has 65 donors, two of which give it much less than $1 million a year, and yet the government spends eight days a year hosting Ministers from these countries. Nor have many done enough to streamline the types of aid they are prepared to accept (notable exceptions are Tanzania and Uganda).

Africa needs to build its own capacity to analyse aid quality and, above all, to hold donors mutually accountable – but not just to implementing the internationally-agreed targets, because they are going to be so vague that it will be impossible to hold any individual donor accountable, and will leave out some vital indicators such as conditionality. So African governments need national targets, and national indicators. They also need to be more accountable to their own parliaments and civil societies for how aid is spent. In this respect, recent initiatives in Zambia to establish a much more tripartite system for consultative group meetings are laudable.

Debt Relief Without Hurdles

On debt relief, we all know two of the main constraints: the debt overhang which deters private and public investments; and the debt service which diverts resources away from the MDGs. But there is a third constraint that has received less attention, which is the domestic and private sector debt that is becoming a major problem in Africa.

The international community should use debt cancellation extensively. It is a very high-quality aid instrument, if well designed. However, it needs to be accounted for properly, and not used to inflate ODA falsely. We are all going to see an apparent increase of $10 billion a year in aid over the next three years – but this is mostly going to be debt relief for Iraq and Nigeria – so this should be stripped out to show what is really happening

We need to extend debt relief beyond the Heavily Indebted Poor Countries (HIPCs), to all modestly indebted low-income countries.

Because debt sustainability is not about "present value", or debt sustainability ratios. Debt is sustainable only when the Millennium Development Goals are financed. I do not want to give the impression that debt relief is universally desirable. Where you are accessing international capital markets it may not be, depending on the terms of that access. But there are a lot more African countries where creditors could introduce unilateral debt relief and actually thereby enhance their access to capital markets.

We should also be including domestic and private sector debt, in both analysis and workouts. Before anybody gets alarmed, I don't mean that we should be diverting donor funds to deal with private sector debt. But we should all be aware that domestic and private sector debt have wrecked developing country budgets and reserves many times in the last 25 years. And that if we don't monitor, analyse, and do something about them in workouts, we won't protect countries from debt problems.

We also need to remove the hurdles, delays and suspensions with which HIPC and other debt relief schemes have been riven. There are many other ways to ensure that debt relief money is well spent: if we are really worried we can place it in a trust until it can be better spent. We don't need the various conditionality hurdles for debt relief: we can easily get rid of them.

What is likely to happen?

- HIPCs will get their multilateral debt to the IMF, IDA, and the African Development Bank cancelled. The G-8 deal represents a major step forward by saying, "We do not care about debt sustainability in determining how much debt relief we have to provide; we consider the lack of money for the MDGs, and the need to get money there quickly and in a high-quality form, to be the most important issue".
- Nigeria may get a debt relief deal, but there will not be a lot of progress for other countries.
- There is little prospect that people will drop the hurdles and suspensions that result in the delays and suspensions in debt relief.
- There is a prospect that there will be an improvement in transparency of accounting for debt relief.
- There is a lot more prospect that the multilateral organisations and donors will conduct more analysis of domestic and private sector debt, although this may not be sufficiently tied to action to reduce the burdens.

What does Africa need to do? First, enhance the capacity, particularly for non-HIPCs, to argue their case for debt relief where it is desirable. Second, develop its own future borrowing strategies and scenarios to fund the Millennium Development Goals. Third, insist on more analysis and action on domestic and private sector debt. And fourth, continue showing transparency on how it spends debt relief proceeds.

Private Flows: The Need for Higher Quality

Typically, at an international level, the main constraint for Africa is often seen as insufficient foreign private capital. But a lot of work that we are doing, with BCEAO/BEAC, MEFMI and WAIFEM, is demonstrating that there are massive private capital flows in many African countries, which we just have not been tracking until now.[5]

So perhaps the constraint lies in their often low quality. What do I mean by that? They are not necessarily going to the sectors that would be regarded as key for African growth (although that too is changing as investors diversify rapidly beyond resource-based investments), they are not going to poorer regions in countries, they are quite volatile, they have very high repatriation and return levels, they contain a large amount of private sector debt, which is quite worrying for long-term debt sustainability, and they pay no taxes. While the international community has paid some attention to quality of flows with things like corporate social responsibility and some targeted investment promotion and incentive strategies, this is not enough.

Another issue is the huge amount of outward remittances and capital flight, estimated in excess of $2 billion. Yet people often forget that these flows are largely confined to the richest 2 percent of the population, and they happen because most OECD governments and their economies welcome such flows with no accountability. It is striking that many major OECD countries still have not signed international anti-corruption conventions, and are putting restrictive conditions on repatriating stolen funds to countries.

In quite a few countries remittances are reversing into huge capital

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[5] See Martin, Matthew and Rose-Innes, Cleo (2004), *Private Capital Flows to Low-Income Countries: Perception and Reality*, In: Canadian Development Report 2004, North-South Institute, Ottawa; and Martin; Matthew; Rose-Innes, Cleo; and Rogers, Gill (2006 forthcoming), *Private Capital Flows to Low-Income Countries: Perception and Reality*, Development Finance International, London.

inflows, although again this is not tracked well. Some have suggested that many African countries could tap investment from these remittances, and it is true that in some countries (e.g. Uganda) remittances have been a major channel for investment. But in many others, remittances are primarily for safety nets and helping out families, and hold little investment potential.

What can the international community do? Encourage greater foreign flows, but not treat them as a panacea. Often people talk as if more FDI could solve Africa's development problems. Yet many other regions, and indeed Africa, have suffered foreign exchange crises, as a result of private inflows turning themselves into outflows. So we need to encourage not just quantity but above all higher quality flows, with less debt and more equity, more stability and less volatility, better risk assessment to reduce the very high returns demanded by countries, and investment in underinvested sectors and regions. Africa and its international partners need to tailor and target the types of investment, encourage public infrastructure investment to facilitate private flows (though avoiding high-cost public-private partnerships). Enforce anti-corruption conventions, track capital flight and money laundering much better and repatriate stolen funds. And we need to encourage inward remittances, but also improve their quality if we can.

What is likely to happen? There will be encouragement to greater foreign flows and liberalisation of capital accounts and inward and outward flows, but there may be much less attention to quality or volatility of the flows until there is some major foreign exchange crisis which appears on the international radar screen. There will certainly be more focus on public infrastructure investment, and some on dealing with capital flight and stolen assets. Another current vogue is for reducing the cost of inward remittances by reducing transaction costs in money transfer companies.

What does Africa need to do? Enhance government institutions' capacity to analyse the quantity, quality and impact of foreign private capital. Interestingly, most in the donor community seem to see this area as one in which high-cost commercial international consultants should lead, rather than building sustainable public sector capacity. Second, revise investment promotion strategies to target high quality flows. Third, stress public infrastructure investments in the PRSPs. Fourth, track capital flight more effectively, and enforcing anticorruption strategies and pursuing repatriation more actively. Fifth, design measures to try to tap inward remittances.

5 Trade Access and Capacity

The major constraints here are often seen as trade barriers, protectionism, agricultural subsidies and dumping. As with private flows, analysts often make simplistic assumptions that freer trade would benefit Africa along with other countries. But, if all the barriers and subsidies went away, would Africa be the one to benefit? No, because it would still be focused on a narrow range of primary commodities, and have problems with processing, market information, complying with developed country or purchaser standards, and infrastructure. In other words, it would lack capacity to trade. So the international community needs to continue special arrangements for the poorest countries while they develop the capacity to trade. Another simplifying assumption often made is that the benefits from trade will get to the poorest people in developing countries. This is highly unlikely as long as there are unfair trade arrangements within countries (such as monopolies, monopsonies, and inability of poor producers to access markets).

The international community must get rid of all the problems it is causing by reducing barriers and protectionism, subsidies and dumping. But if it cares about African development it also needs to invest massively in enhancing African capacity to trade, ensure maintenance or enhancement of special arrangements for the poorest countries, and examine and reform international and national production and marketing structures to ensure that the benefits from trade really reach the poor.

What is likely to happen? This is probably the area of least optimism. Major steps forward in Hong Kong at the end of 2005, on protectionism, subsidies and dumping, would frankly be a miracle. We will probably retain special arrangements for the poorest countries, but with only marginal benefits. There will be substantial investment in building countries' capacity to trade, but let us hope they are of better quality than existing programmes. Most important, people are unlikely to pay enough attention to distribution of benefits. The World Bank and others have done good analytical work on this in the last few years, but then not implemented findings on the ground.

Africa needs to invest heavily in designing its own trade strategies, ensure that its capacity needs are included in second-generation PRSPs, enhance its negotiation capacity to attain special arrangements, analyse for itself the antipoverty benefits of trade increases, and reform when necessary internal production and marketing structures to make trade more equitable.

6 Enhanced Voice and Listening

Everybody talks about the fact that there is insufficient African voice in the international system. That is often seen to spring from three factors.

- There is an inadequate technical capacity to express that voice, although there are now very many well qualified articulate experts in Africa, and some excellent initiatives such as the technical support to the Bretton Woods Institutions' African executive directors offices, managed by the AERC and funded by the Netherlands and the UK.
- Inadequate voting rights and structures in international organisations.
- Inadequate groups to express African voices collectively, notably because a lot of groups are dominated by large middle-income countries.

On the other hand, the main reason for insufficient African voice is that the international community did not listen enough. That has changed much over the last few years with the whole of G-8 beginning to focus on Africa and especially in 2005 with the Commission for Africa.

The international community should, if it is serious about continuing that trend, assist Africa to build technical capacity to negotiate international systemic issues, reform voting structures and rights in international financial institutions and the UN Security Council. Support groups through which smaller and low-income countries can be heard. Listen to African preoccupations via the UNECA Big Table, NEPAD, a revitalised African Development Bank and the mutual accountability process.

What is likely to happen? People will assist African capacity but somewhat patchily. Probably there will be very little progress on the voting structures and rights, partly due to division within Africa. People are likely to support smaller country and low-income country groups intermittently, particularly where they focus on key issue areas. And people will obviously vary in their degree of listening, and will to be held genuinely mutually accountable.

Africa needs to fund its own training of technical capacity, which is happening through AERC, MEFMI, and some other regional and subregional organisations. It needs to campaign on voting issues in a more united way, for example agreeing on a rotating seat in the Security Council rather than continuing to fight over which one or two countries should have a seat. Larger African countries could give smaller low-income countries more say. Analyse donor policies for themselves and hold them mutual accountable on all the above issues.

7 Overreaching Issues and Priorities

Finally, a few overreaching issues and priorities.

- Africa does not have homogeneous needs or capacities, so the international community needs to tailor all the international actions to varying needs. But this does not mean putting countries in pigeon holes and then having rather indiscriminate selectivity. For example, people talk about fragile states, as if they were a permanent separate group of countries. They are not: many countries fall in and out of fragility, and almost every country has some degree of fragility. There is a tendency, for example, to say one cannot build capacity in fragile states, because their government structures are so weak that they need technical assistance. That is rubbish; because if you pour technical assistance into weak institutional structures with no attention to building capacity, local staff get even more demotivated and you end up stuck with no capacity.
- I have talked about mainly what the G-8 and major OECD countries will do, but obviously there are tremendous benefits from South-South cooperation. To enhance its voice, Africa needs southern alliances: the G-20 and the cooperation between India, Brazil and South Africa have been very positive in recent years. Other southern countries are also often much more flexible and open on the other issues I have talked about, notably trade and FDI, and they are becoming increasingly important aid sources. In many African countries, China is becoming one of the biggest sources of aid and investment. But we also need to be realistic about South-South motivations. Fundamentally, donors, businessmen, investors and NGOs from those southern countries have the same sort of motivations as those from OECD countries. They may have more understanding of the local context and be more flexible, but one needs not to treat them like automatic friends.
- There will be a huge variation in the responsiveness of the international community to Africa's needs across different issues. So Africa needs to define clear priorities for what to do for itself. Top of the list must be designing its own second-generation growth and poverty reduction strategies with a strong focus on infrastructure, trade, anti-shock measures, and poverty impact analysis. Next comes designing its own strategies for development financing, especially looking at the quality of the money and not just assuming that everything that comes in is good, whether FDI, aid, or debt relief. Next, demonstrating its

capacity to monitor, analyse and absorb all of this funding productively – especially to its own people, so that they realise Africa can gain from working with the outside world.

We are now five years after the Millennium Development Goals were agreed, and we have only 10 more years to meet them. Most African countries have designed plans to meet the MDGs; yet, at a meeting in Paris in March 2005 (the Paris High-Level Forum on Aid Effectiveness, see www.aidharmonization.org), a couple of very unlike-minded donors suggested that donor targets to support them should refer only to 2015. Fortunately, African countries, NGOs, and like-minded donors said, if donors don't do anything until 2015, how can we possibly expect Africa to reach its MDGs by then? They won the day but only marginally. In that light, the most important next step for Africa is to be able to hold the international community mutually accountable across the whole range of issues discussed in this chapter. Without this, the international community will certainly not do many of the things I have suggested as likely to happen, let alone what it should do – and Africa's development will not accelerate significantly in the 21st century.

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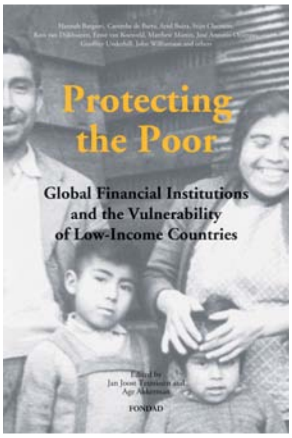

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ISBN-13: 978-90-74208-26-0
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"Developing countries, and particularly low-income countries, are subject to important shocks emanating from exogenous variations in their balance of payments." (**John Williamson, Institute for International Economics**)

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"Rather than accepting the current rules of the game, developing countries will have to play the game by identifying their collective interests." **José Antonio Ocampo, Department of Economic and Social Affairs, UN.**

"The IMF should adopt a genuinely multilateral attitude and recast itself in the role of partner rather than macroeconomic master." (**Caoimhe de Barra, Trócaire**)

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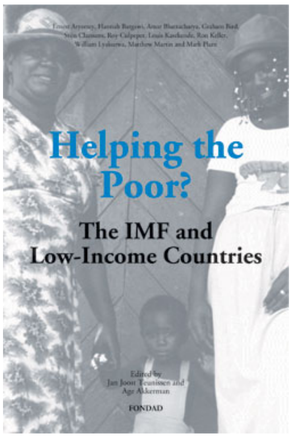

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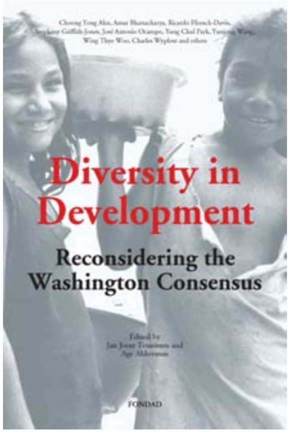

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The contributors to this book examine the economic constraints to growth and development faced by sub-Saharan African countries. These constraints include the underdevelopment of domestic capital markets, the lack of national and regional infrastructures, and the ongoing dependence on the export of commodities whose prices and markets are volatile and remain largely determined by the large companies of western countries.

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