# Opportunities and Challenges for African Development

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# Theme of the lecture

- The long term development of sub-Saharan Africa (SSA)
- Structural transformation of the economy is integral to long term development
- What are the strategic policies to promote structural transformation?
- What must SSA do to emulate the dynamic economies of East Asia which achieved the transition from low to middle income status in one generation?

# Economic Performance in SSA improved in the decade prior to the global crisis

- Real GDP growth in SSA accelerated and averaged 5% per annum during 2000-08
- But this does not warrant too much optimism
- Not yet clear how much of the improvement was attributable to purely cyclical, favourable conditions in the international economy
- With population growth of 2.4% per annum, real per capita growth was only 2.6%, which does not compare well with developing countries which achieved middle income status in one generation
- The dynamic economies of East Asia achieved real per capita growth rates of 8 percent per annum for periods of 10-20 years

# Prospects for the global economic climate facing SSA are uncertain

International economic environment was generally favourable to SSA in the years before the recent global crisis

Whether it will be as favourable in the post crisis future is unclear

Stagnant economies and fiscal crises in the industrialised countries will constrain growth of traditional export markets, workers' remittances and external aid

But emerging economies can provide new export markets and sources of capital

South-South trade and regional integration should become more important for SSA

# Economic development and structural transformation

- All developing countries which raised themselves from low income to middle income status did so by transforming the structure of their economies

- Structural transformation entails the shift of the labour force;

  out of low productivity, low technology activities, (peasant agriculture, petty trading, etc)

  and into modern sector activities (manufacturing, agro-industry, commercial agriculture, etc)

  The modern sector is more capital intensive, uses technology and skilled workers and is run on commercial principles; labour productivity and income per worker is much higher than in the traditional sector

  Modern sector activities are subject to competitive pressures which raise productivity through time, these activities more likely to be found in the tradeables sector

  In SSA, 80% of the labour force still works in the informal sector

  In agriculture, value added per worker in SSA is only one tenth the level in Latin America and the Caribbean (see next slide)

# Agricultural value added per worker (per annum): SSA and Latin America and Caribbean

**Sub-Saharan Africa**

| | |
|---|---|
| 1990-92 | $305 |
| 2005-07 | $318 |

**Latin America and Caribbean**

| | |
|---|---|
| 1990-92 | $2,213 |
| 2005-07 | $3,273 |

# Private investment, in factories, farms, etc is needed to create modern sector businesses

Private investment in the modern sector in SSA is very low, outside of the capital intensive fuel and minerals industries and telecommunications

The private sector has not invested heavily in labour intensive medium scale enterprises: why?

# Obstacles to private investment in the modern sector

Market imperfections: negative externalities arising from technology spillovers, training workers, etc – drives a wedge between social and private returns

Government failures: corruption raises the cost of doing business, inefficient provision of public goods and services needed as inputs

Weak institutions for protecting property rights; unclear land tenure, etc

Other constraints include high cost of capital, shortages of skills, high cost of accessing international markets

These factors combine to reduce the returns to, and raise the risk of, private investment in the modern sector

They are not unique to SSA, but some of the constraints are more acute in SSA

# Strategic policy priorities for structural transformation

- Key to structural transformation is to promote private investment in modern sector activities
- SSA countries are not homogeneous; hence no policy blueprint is applicable to all
- But five broad sets of policy are relevant

  1. Macroeconomic stability
  2. Openness to international trade and foreign investment, and regional integration
  3. Measures to raise the returns to private investors in the modern sectors
  4. Improving the efficiency of public goods provision
  5. Accelerating the demographic transition

# Macroeconomic stability

- Importance of macroeconomic stability for private investment should not be contentious

- Macroeconomic management has improved in SSA since the 1990s, as demonstrated by lower inflation, higher growth, larger holdings of international reserves, and the response to the global economic crisis; most SSA economies avoided recession and BOP crises

- Technical capacities for designing and implementing fiscal and monetary policy have been strengthened

# Openness to Trade and Foreign Investment

- Dynamic exports have often provided the engine of growth
- Foreign investment provides a conduit for technological upgrading
- “Successful economies have imported what the rest of the world knew and exported what it wanted” (Justin Lin and Celestin Monga)
- SSA exporters should seek new markets in emerging economies and through regional trade (e.g. The East African Common Market)
- But liberal trade policies and booming export markets are not sufficient to generate export dynamism, because supply capacities are weak

# Policies to boost private investment

To encourage more private investment in modern sectors, public policies should aim to raise returns and lower the risks to private investment

Two approaches are possible:

1. Targeted, firm specific subsidies

2. More broad based measures which support industries or sectors but not specific firms

# Targeted, firm specific subsidies

In principle, this is the most cost effective way to tackle market imperfections that deter private investment

In practise, firm specific subsidies are vulnerable to “rent seeking” by politically connected firms

The strongest pressure for subsidies will come from firms which are failing (e.g. firms in default); not firms with a viable future who can pioneer the growth of new industries

Hence firm specific subsidies risk propping up failures, not “picking winners”

# Broad based measures to support industries or sectors

<u>Undervaluation of the real exchange rate</u>

boosts returns to investment in tradeable goods production

Used by some emerging economies to drive export growth

drawbacks are that consumption must be held down, hence static welfare losses; sustaining real undervaluation requires tight fiscal stance

# Broad based measures to support industries or sectors

Support for vocational skills training; through subsidies to firms that train workers, vocational colleges, public certification of skills, etc

Trade facilitation measures: improving trade infrastructure, reducing delays at customs posts, strengthening competition in service industries which provide inputs (e.g. transport)

Investment in power generation and distribution, to improve reliability and reduce cost of power

# Strengthen governance and efficiency of public expenditure

- Modern sector activities require public goods and services; an educated workforce, transport infrastructure, etc
- Hence improved provision of these public goods will complement private investment
- But an aggregate expansion of public expenditure and larger fiscal deficits could crowd out private investment in domestic credit markets or appreciate the real exchange rate and so damage export competitiveness
- These trade offs can only be avoided if the efficiency of public expenditure is improved; requires public financial management reforms and stronger governance

# The demographic transition in SSA

The demographic transition is still in its early stages in SSA and has stalled in some countries

Average fertility rate is 5.1 births per woman in SSA, compared with 2.4 in middle income countries

As a consequence of high fertility, the dependency ratio in SSA averages 85 (dependents per 100 workers), compared to 51 in middle income countries and 43 in East Asia

High dependency ratios shackle development

# Benefits of a faster demographic transition

If fertility rates fell, dependency rates would also fall

This would boost private savings rates, because there would be fewer consumers per worker, and thereby lower the cost of capital for private investors

Smaller families would allow resources devoted to the education and health of each child to rise, boosting the quality of human capital

Per capita growth rates would rise because the share of workers in the population would increase, and with smaller families more women would join the workforce

# Policies to encourage a fall in the fertility rate

- better education for girls
- expansion of family planning programmes
- strong lead from government to promote smaller families
- empowerment of women

# Conclusions

- Sub-Saharan Africa is poor because large parts of the labour force work in the informal and traditional sectors where labour productivity is very low
- Structural transformation entails shifting labour into high productivity activities: the key to this is private investment in the modern sector
- Private investment is impeded by a plethora of market failures, government failures and other constraints
- Macroeconomic stability, a liberal international trade regime and openness to foreign direct investment are necessary policy foundations for structural transformation, but are not sufficient
- Public policy should aim to raise the returns to, and reduce the risk of, private investment in the modern sector. Policy options include: undervaluation of real exchange rates, strengthening provision of public goods which complement private investment (vocational training, transport infrastructure, etc) and improving power supplies
- To expand provision of public goods which complement private investment, efficiency in the public sector must increase
- Policies to reduce fertility rates and accelerate the demographic transition will raise domestic savings rates and strengthen human capital formation