Opportunities for African Development after the Economic and Financial Crisis: What Must Africa and the International Community Do?

by Professor Emmanuel Tumusiime-Mutebile
Governor, Bank of Uganda

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Abstract

The theme of the lecture is the structural transformation of sub-Saharan African economies and the domestic policies needed to drive this transformation. Structural transformation is integral to long term development and entails the transfer of labour from low productivity, traditional activities into modern sector activities where labour productivity is much higher and where competitive pressures drive continuous increases in productivity. Creating modern sector activities requires private investment, which is impeded by a plethora of market imperfections, government failures and other constraints. Sound macroeconomic management and open trade and investment regimes are necessary, but may not be sufficient, to stimulate the required levels of private investment in modern sector activities. Public policy should also seek to raise returns and lower risks to this investment, through broad based measures of support at the industry or sector level. Policies to lower fertility rates and thereby accelerate the demographic transition can also make a major contribution to structural transformation, by boosting savings and enhancing human capital formation.

Introduction

I would like to begin by expressing my gratitude to the organizers of this conference – the Volkswagen Foundation, Deutsche Messe and Stiftung Mercator - for according me the honour of presenting a key note lecture before such a distinguished audience of scholars and policymakers from all over the globe.

The theme of my lecture today is the long term development of the economies of sub-Saharan Africa and the strategic policies which are required to drive this development. At its core, development entails structural transformation of the economy. I will explore the reasons why structural transformation has proved so challenging in sub-Saharan Africa and discuss long term solutions which I believe are feasible. As I will elucidate in my lecture, the strategic policies needed to unlock the long term structural transformation of African economies are primarily domestic policies. The international community can support Africa’s development, especially by ensuring that markets for

Africa's exports remain open, and reducing those trade barriers that remain in place. Africa will also continue to need external finance, both concessional and commercial, to supplement its own domestic savings. However, the impetus for development must be found from within the continent.

African economic performance improved in the decade preceding the global economic and financial crisis. Real GDP growth per annum averaged 5 percent in sub-Saharan Africa during the period 2000-2008. Nevertheless that does not warrant taking an overly optimistic view of long term African economic prospects. It is not yet clear whether the improved growth performance of the 2000s will prove to be a purely cyclical phenomenon, driven by booming commodity prices and inflows of external finance, or the start of a more permanent secular trend. Part of the improvement can be attributed to better macroeconomic policies, which augurs well for the sustainability of higher growth rates. Nevertheless, the real growth rates achieved in sub-Saharan Africa in the 2000s look less impressive when viewed in per capita terms. With population growth in sub-Saharan Africa averaging 2.4 percent per annum in this period, real GDP growth per capita was only 2.6 percent per annum. At that rate of growth it will take 45 years for the average sub-Saharan African economy to become a middle income economy.

The per capita growth rates recorded in sub-Saharan Africa in the 2000s are still a long way short of what was achieved by the East Asian countries which made the transition to middle income status within one generation. East Asian countries such as Korea and China have achieved per capita income growth of 8 percent per annum over periods of 10-20 years.

In the years immediately preceding the global economic and financial crisis, the international economic environment was generally favourable to African economies, and this undoubtedly contributed to the higher growth rates recorded on the continent. Whether the international economic environment in the decade ahead will be equally propitious is not easy to predict. The stagnation of the industrial economies will have adverse effects on the traditional markets for African exports in those countries and on transfers of workers' remittances to Africa. Aid from traditional donors is likely to stagnate or fall because of the severe long term fiscal crises facing these countries. On the other hand, the rapid growth of the emerging economies will provide alternative export markets for Africa and new sources of finance for investment.

In this lecture I want to discuss what has to change in sub-Saharan Africa, in terms of domestic policies, if the region is to emulate the economic dynamism which has characterized the Asian tigers and some of the other emerging markets. The starting point for this analysis is to understand the integral link between economic dynamism and structural transformation.

1. Economic development and structural transformation

All of the developing countries which have raised themselves from low income to middle income status have done so by radically transforming the structure of their economies. In essence, structural transformation entails the shift of the labour force out of low productivity, low technology activities, sometimes referred to as traditional sector activities, into modern sector activities, where labour productivity, and hence income per worker, is much higher. This has been understood ever since the seminal work of Sir Arthur Lewis in the 1950s on the dual economy nature of developing countries.

In most sub-Saharan African countries, a large majority of the labour force, estimated at about 80 percent, earns its living in informal sector activities such as peasant food crop agriculture, petty trading and artisanal activities. Labour productivity, and hence incomes, in these activities is very low because technology is rudimentary, capital investment is minimal, the scale of operations is very small and labour is often under-employed.

One statistic can starkly illustrate the depth of this problem. During the mid 2000s, value added per worker in agriculture in sub-Saharan Africa was just $318 per annum, and this had grown by only 4 percent over the previous decade and a half. In contrast, agricultural value added per worker in Latin America and the Caribbean, a region with a somewhat similar resource endowment to that of sub-Saharan Africa, was $3,273 in the mid 2000s, ten times more than in sub-Saharan Africa, and it had grown by nearly 50 percent in the previous decade and a half.[1]

The key to the structural transformation of economies in Africa is to transfer labour out of the low productivity sectors and into the modern sectors of the economy. The modern sectors are defined by their commercial orientation, their use of capital equipment, technology and modern business management practices and the larger scale of their operations, which raises the productivity of labour. Not only is labour productivity much higher in the modern sector than in the traditional sector, it also tends to increase over time in the former whereas it is largely stagnant in the traditional sector. The modern sector in Africa potentially comprises a range of activities; manufacturing, commercial farming, agro-industry and modern services. Modern sector activities are more likely to be found in the tradeables sector, because this sector is more exposed to continuous competitive pressures in the international markets to improve efficiency.

[1] Data from the World Development Indicators, 2010, table 3.3

2. Obstacles to investment in modern sector activities

The building of modern sector activities requires private investment in factories, farms etc; investment which has been generally lacking in sub-Saharan Africa. While it is true that private investment has increased in sub-Saharan Africa in the last decade, this has been mainly focused on the minerals and fuel sectors, together with banking and telecommunications; all of which are capital intensive and hence have not brought about a major shift of the labour force into the modern sector. There has been much less private investment in labour intensive small and medium scale industries which is imperative to provide modern sector jobs on a mass scale and hence raise the average productivity of the labour force. This begs the question of why this is the case?

There is probably no single answer to this question. Instead many different factors contribute to impede the growth of modern industries in sub-Saharan Africa. Private investors in new modern sector industries face negative externalities which drive a wedge between private and social rates of return. Those who make the first moves into a new activity incur very large risks, because they do not know whether their investment will be viable, but their experience provides valuable information for those who follow. Investment in technological learning involves spillovers which cannot be fully captured by the investor. Firms which train workers in the skills needed by modern industries cannot be sure of reaping the rewards, because these workers can take their skills to other firms. Because of these market imperfections, the market will under-invest in modern sector activities.

Such market imperfections are not unique to Africa, but are to be found in all economies. However, investors in African economies also face additional constraints. The cost of domestic capital is very high in Africa. Technical and managerial skills are scarce. Land tenure systems often do not provide clarity about land ownership rights. In general, sub-Saharan Africa has weak institutions for protecting private property rights and ensuring that legal disputes can be settled impartially, which increases the risks facing investors and the cost of capital. Poor governance also raises the cost and risks of doing business. Finally, the high costs of accessing international markets, especially for the landlocked countries, discourages investment in the tradeables sector. The combined impact of these market failures and other constraints is to reduce the returns to investment in modern sector activities and to raise the risk of this investment. Private investment is thus deterred from investing in modern sector activities, outside of a few sectors such as oil and minerals where the rents which can accrue to private investors are sufficiently large to outweigh the constraints and risks.

How can Africa stimulate private investment in modern industries?

To promote long term development in sub-Saharan Africa, public policy must tackle the constraints which lower the returns and increase the risks to private investment in the modern sectors of the economy. Sub-Saharan African economies are not homogeneous and hence no policy blueprint can be applicable to all countries on the continent. Country specific circumstances will dictate the detailed design of policies. Nevertheless, I believe that it is possible to identify five broad areas of policy reform which are relevant across the region. These are:

1. Macroeconomic stability
2. Openness to international trade and foreign investment, and the deepening of 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

The importance of maintaining macroeconomic stability should not be contentious. Moreover, this is an aspect of economic management where substantial improvements have been made since the 1990s in many countries in sub-Saharan Africa. Average inflation has been reduced to single digits, public sector debt has been cut to sustainable levels and international reserves have been accumulated to relatively comfortable levels. The fact that most SSA economies were able to ride out the global economic crisis without suffering recession or a balance of payments crisis is testament to the extent to which macroeconomic management has been strengthened. It is imperative to maintain this progress, which should not be an insurmountable challenge, given what has been achieved so far and the technical capacities which have been built up in central banks and finance ministries.

As I noted above, modern sector activities tend to be disproportionately concentrated in the tradeables sector, hence dynamic export growth has often provided the engine of growth for economies which have achieved structural transformation. In addition, for many of these economies, foreign investment provided an important conduit for technological upgrading. This is succinctly summed up in a quote from two of the pioneers of "new Structural Economics" – Justin Lin and Celestin Monga of the World Bank: "Successful economies have imported what the rest of the world knew and exported what it wanted".[2] Hence it is imperative for sub-Saharan African economies to maintain open markets for international trade and foreign direct investment.

[2] Lin and Monga (2010), p12

The traditional export markets for sub-Saharan Africa in the industrialised countries may not experience much growth over the medium to long term, because of the problems facing many of these economies. Despite this, lack of demand should not be an obstacle to African export growth, because global demand for exports will shift to the rapidly growing emerging markets. Regional integration within Africa, as with the East African Community Common Market, can also make an important contribution to promoting markets for African exports.

However, buoyant export demand and an open trade regime are not sufficient, by themselves, to stimulate dynamic export growth in sub-Saharan Africa because export supply capacities are weak. Exports are constrained by low productivity, a lack of economies of scale and the high costs of accessing markets. These constraints reflect the lack of private investment in modern production facilities, which can add value to traditional commodity exports, as well as the high logistical costs of exporting goods. Therefore, strengthening export supply capacities, especially in non traditional exports, requires private investment in the modern sectors of the economy and in the public infrastructure which is needed to support exports.

I have already discussed why the private sector is deterred from investing in the export sectors and other modern sector industries, because of market imperfections, government failures and other constraints. Boosting private investment requires public policy measures which can raise the rate of return to private investment or reduce the risk, thereby offsetting the negative impact of these constraints. What are the feasible policy options available to governments? Two broad approaches are possible.

The first approach is to provide selective assistance, such as subsidies, to those firms which could pioneer the drive into new modern industries and export activities and which, by doing so, would generate positive externalities. In principle, this would be a cost effective approach, because scarce public resources could be targeted to where they could generate the highest social benefits. But in practice, policy measures which target public resources on selected private investors would be very vulnerable to rent seeking from politically well connected investors as well as placing exacting technical demands on the public officials responsible for implementing the measures. The experience of several countries in sub-Saharan Africa which have provided public subsidies on a selective basis to private investors does not give grounds for optimism that this approach would work. Few of the beneficiaries of public subsidy have grown into dynamic firms able to survive without subsidy in the long term and which can lead the drive to modernize the economy. Instead, the strongest pressure for public subsidy has emanated from companies facing severe financial difficulties, which require a bail out from public funds to avoid liquidation at the hands of their creditors. Instead of "picking winners" selective subsidies have more often involved propping up losers.

The second approach is to implement more broad based measures which are not targeted at specific firms but which seek to raise returns and reduce risk at the industry or sector level. Such measures are less vulnerable to rent seeking than selective subsidies but because they are not targeted at the specific firms which might make best use of them, they may not be very efficient in terms of stimulating private investment. There are several options in terms of broad based measures to stimulate modern sector investment which can be considered; including the undervaluation of the real exchange rate, public investment in the training of workers in vocational skills and trade facilitation measures.

Real exchange rate undervaluation boosts the returns to investors in tradeable goods production and can, therefore, encourage the growth of modern sector tradeable goods industries. The drawback is that it imposes static welfare costs on society, because the undervaluation of the real exchange rate reduces domestic expenditure: public and/or private consumption must be constrained so that savings rise. Sustaining real undervaluation almost certainly requires a very tight fiscal stance. Such costs are not self evidently justified in a very poor society. Nevertheless, some of the most dynamic economies in the developing world have used real exchange rate undervaluation to propel the growth of their manufactured exports which in turn has driven their rapid economic growth: hence it should be considered seriously as a strategic policy option in sub-Saharan Africa.

Modern sector industries require skilled workers, often workers with very specific vocational skills, but vocational skills are scarce in sub-Saharan Africa, which lacks the institutions to train workers to proper standards. Firms which require skilled workers may under-invest in training their workers because they cannot guarantee to retain their staff and so reap the benefits. Consequently public support for vocational training can help to lower the costs of firms in the modern sector; this support could take the form of setting up publicly funded vocational training colleges or subsidies for firms which train workers, subject to safeguards to ensure that minimum standards of training are met. Public certification of vocational skills would also be useful, as this would lower informational costs which impede the operation of labour markets.

Trade facilitation measures are intended to enhance the competitiveness of exports by reducing the costs of transport and other services. These include reducing the delays faced by exports at customs posts and port facilities, improving the transport and telecommunication infrastructure and to promote competition in service industries which provide inputs to exporters.

The huge deficit between supply and demand for energy in sub-Saharan Africa will also need to be tackled if modern sector businesses are to be competitive on world markets. The magnitude of capital investment required to bridge the energy gap is very large.

Attracting private investment into the energy sector is critical both to generate the finance required and to ensure efficient operation of power infrastructure.

Many of the measures which I have discussed involve the provision of public goods and hence require public expenditure. This creates potential trade-offs, however. While some public goods complement, and so raise the returns to, private investment, an expansion of aggregate public expenditure is likely to damage private investment, either through an appreciation of the real exchange rate if financed externally or by crowding out private investors from domestic credit markets if financed domestically. The former is why more external aid to fund public expenditure is not an unmitigated benefit for economies which aim to promote growth in their tradeable goods sectors. For a development strategy which focuses on stimulating private investment and export led growth to succeed, fiscal deficits must be kept to relatively modest levels. Consequently, improving the supply of public goods which modern industries require has to be accompanied by improved efficiency of public expenditure, through institutional reforms to strengthen capacity and improve incentives for performance in the public service. These reforms should be part of a broader drive to strengthen governance.

Finally I want to address an issue which is not always considered germane to economic policy but which is crucial to long term development in sub-Saharan Africa: population policy. Sub-Saharan Africa has only just begun its demographic transition and in some countries the transition has stalled. The average fertility rate in sub-Saharan Africa is 5.1 births per woman. As a result of high fertility, Sub-Saharan Africa has a dependency ratio of 85 dependents to every 100 workers, the highest of any region of the world. The average dependency ratio of middle income countries is 51, while that of the most economically dynamic region of the world – East Asia and the Pacific – is only 43, half that of sub-Saharan Africa. The high dependency ratios of sub-Saharan Africa are a shackle on development.

If fertility rates in sub-Saharan Africa can be brought down to the levels which prevail in middle income countries – approximately 2.5 births per woman – dependency ratios will fall sharply and generate a major stimulus for development and structural transformation. In particular, private savings rates will rise because the ratio of consumers to workers will fall. Higher savings rates will reduce the real cost of domestic capital for private investors. Smaller families will allow each child to have better education and health care, thereby boosting the quality of human capital which is essential for a modern economy. More capital investment and better educated and skilled workers are the key ingredients for the structural transformation of the economy.

Accelerating the demographic transition should be a strategic policy priority in sub-Saharan Africa. This requires specific measures to encourage the fertility rate to fall, including better education for girls, an expansion in family planning programmes to improve access to contraceptives, a strong lead from government to promote smaller families and the greater empowerment of women in society.

3. Conclusion

Structural transformation is the key to long term sustainable development in sub-Saharan Africa. This will not happen automatically. It requires a large expansion of private investment in modern sector activities, many of which are in the tradeables sector. Private investment in the modern sector 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 they may not be sufficient: they need to be complemented by policies which can raise the returns and reduce the risk of private investment in the modern sector. These policies could include the sustained undervaluation of the exchange rate and the strengthening of public provision of key inputs into modern sector activities, such as the vocational training of skilled workers and trade facilitation measures. Priority should also be accorded to policy measures which can reduce the very high fertility rates in sub-Saharan Africa and thereby accelerate the demographic transition.

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