Can Intra-African Trade Unlock Africa's Industrial Potential?

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Introduction

This is an opportune time to be discussing the question of regional integration in Africa and its potential—and the role of trade and trade finance in promoting it

- 1st Ending of commodity boom, lingering effects of Great Recession and continued sluggishness of OECD economies, slowdown in China are all dampening Africa's growth
- 2nd Enhanced momentum to the regional integration objectives of Africa 2063 Agenda—2 significant steps in 2015:
  - 1) Signing of Tripartite Free Trade Area Agreement between COMESA, EAC, and SADC marked a significant step towards rationalizing Africa's regional trade arrangements
  - 2) The launching of negotiations on the Continental Free Trade Area

Seizing the Moment

- Momentum for regional integration
  - Also earlier in 2016, AU, ECA and AfDB jointly published a report on regional integration in Africa, including launching a regional integration index to track progress
  - Growing recognition of the failure in Africa in economic transformation and diversification
  - The strategic emphasis on intra-African trade adopted by the Bank and the African Union provides the opportunity to foster the process of Africa's industrialization and eventually set the region on an export diversification path
- Regional integration and efforts at industrialization and transformation can be mutually reinforcing
  - There is increasing attention to the "Blue Economy" with its potential to promote intra-regional trade
  - Rising production costs in China provide unique opportunity for African industrialization

Outline

I shall address the question posed in three steps:

1. An economic agenda for Africa
2. Africa’s lost quarter century
   - Sketch the reasons for and lessons from Africa’s de-industrialization
3. Policies for unlocking Africa’s growth potential
   - Examine the policies needed to reverse the lost quarter century—including the potential contribution of intra-African trade

1. An Economic Agenda for Africa

A Broad Perspective

Africa's lost quarter century

- Per capita income in 2000 was barely at the level of the mid-1970s
  - Economic decline particularly sharp during 1980-95, partially as a result of plethora of conditionalities imposed on SSA
- Africa's manufacturing value added accounted for only 1.6 per cent of the global total in 2014
- Africa's manufacturing value added in GDP has fallen from nearly 12 per cent in the 1970s to just over 9 per cent in the 2010s

Growth without Change

- The revival of growth in this century welcome and impressive: 6 of the 10 fastest growing economies in 2000s in SSA -- annual growth averaged more than 7.5 percent for a decade or more in Angola, Chad, Ethiopia, Mozambique, Nigeria, and Rwanda
- But except for Ethiopia and Rwanda, which eschewed Washington Consensus (WC), the growth was based on booming commodity prices and hydrocarbon discoveries
  - Even countries that succeeded in achieving reasonable macro-stability and good governance did not get the promised flow of FDI
  - Hence concern about nature and sustainability of growth reflected e.g. in recent reports of ACET and ECA on economic transformation
- Excessive reliance on commodities subjected region to natural resource curse
  - Low growth, high inequality and instability
    - Increased exposure to recurrent adverse shocks and global volatility
    - Deterioration of terms of trade
    - Persistence of poverty in the absence of expanding labor-intensive industries

Lack of Transformation

- **Lack of transformation** → woeful inadequacy of generating "decent" jobs, forcing most of the rapidly expanding labor force into very low productivity agriculture and the informal sector—often a form of disguised unemployment
  - Much of Africa marked by high level of inequality
    - Benefits of what growth has occurred have not be widely shared

Structural Transformation

- **All countries are in need of structural transformation**
  - In advanced countries, in response to technology and globalization
    - From manufacturing to service sector
  - In China, from export-led growth to domestic demand-driven growth
    - From quantity to quality
  - In all countries—in response to need to address problems of climate change (both mitigation and adaptation)
  - In natural resource economies—to diversify away from dependence on natural resources

Structural Transformation

- **Markets on their own don’t manage these transformations well**
  - Impediments imposed by capital market imperfections
  - Important externalities and coordination failures
- Government needs to assume an important role
  - How best to do this is central theme of this talk
  - Multiple objectives

Some Key Challenges Facing Africa

- Diversifying economy
- Achieving inclusion
- Addressing climate change
- Increasing employment
- Promoting growth
- Regional integration

Some Key Challenges Facing Africa

- Some of these are complementary, in other cases there may be trade-offs; some are key means to broader ends—achieving increases in standards of living
- Will require *multiple* strategies
  - Some focusing on employment creation, some on inclusion, some on achieving a modern, diversified economy
  - Industrialization by itself unlikely to create enough jobs
  - Large fraction of population likely to continue working in agriculture—need to increase productivity
  - Service sector dominant in almost all advanced countries

2. Africa's Lost Quarter Century

- Largely a result of Washington Consensus (WC) policies, in part the result of plethora of conditionalities imposed on SSA
  - Reflected neo-liberal ideology
  - Became prevalent just as economic science had shown the limitations of markets (market failures)—e.g. associated with asymmetric information, imperfect risk markets and limited competition, etc.
  - Too rapid and often excessive liberalization, privatization and deregulation
  - Failed spectacularly not just in SSA but also in Latin America and transition economies

Washington Consensus (WC)

- Consequences in SSA included **stunted economic transformation** with little, **no or even negative changes in** economic and export **diversification**, foreign investment in non-extractive activities, access to finance on reasonable terms for domestic investors
- And relatedly **deindustrialization**: share of manufacturing in GDP still below the peak of the late 1970s

SSA large and diverse and varied experiences but above generalizations widely applicable

Explaining Africa's Slow Growth

- Failures of WC policies led to search for explanations with its proponents turning to implementation, governance, geography and conflict
  - But poor results of WC even in non-conflict countries, countries with "good" geography, good governance
  - Explanations confuse cause and effect; ends and means
    - Low incomes tend to lead to poor governance

Good Governance

- “Good governance” (GG) agenda that emerged focused on *restraining* government—in accordance with neoliberal agenda-- rather than *developing capacities* for transformative development
- Most successful countries were those where government took on role of **developmental state**
  - Following successful examples in East Asia
- Recognizing the importance of **dynamic comparative advantage**
  - Based on learning and dynamic efficiency
- We have argued for a different approach emphasizing other capabilities and institutions—for a more prioritized, context—specific and feasible agenda emphasizing the capacity to design and implement policies for dynamic transformation

Geography

- "Geography" is important but it is not destiny nor an explanation for poor economic performance in SSA.
  - Landlocked economies have tended to grow faster than coastal ones for an extended period
  - The two most impressive performers in the region, Ethiopia and Rwanda, are both landlocked

Implementation

- Implementation failures often blamed by WC advocates for disappointing results.
  - Poor implementation reflects that “programs” were not designed taking into account the strengths and limitations of those who were supposed to implement them
  - WC paid insufficient attention to the pacing and sequencing of reforms.
    - Sequencing is especially important because economic reforms confront the problem of the second-best: eliminating some of many distortions may make matters worse
    - Reforms need to be mindful of the absorptive capacity of the country
      - Not only governmental capacity but also of the ability of agents to digest and respond to a myriad of changes.

Political "Buy-in" and Sustainability of Reforms

- Sustainable reforms have to have political "buy-in"
  - They can't be seen to be imposed by outsiders, especially when those outsiders lack legitimacy, when there is an appearance of a conflict of economic interests or a colonial heritage
  - Helps to explain failure of structural adjustment programs

Learning and the Reform Process

- Moreover, no set of reforms is ever perfect.
  - Implying that any successful implementation process must entail learning, both about what is working and what is not.
  - Successful reforms programs thus must create institutional frameworks for learning and adaptation.
  - An approach that allows for experimentation and flexibility with successes scaled-up and failures abandoned quickly is an important ingredient of success

Learning and the Reform Process

- This does not constitute a general argument for always going slow: there may be threshold effects that require decisive, critical minimum efforts.
  - When Ethiopia launched its reform program in the early 1990s, it moved rapidly on selected fronts: establishing macroeconomic stability, dismantling collectivized agriculture and establishing a system of famine prevention.
  - But Ethiopia's reforms have been much more measured and gradual in other areas, such as financial liberalization
  - This mixture of speediness and gradualism worked: its economy grew at 10% per annum during nearly a decade until global crisis of 2008; around 8% a year during 2004-14
    - Shared growth: the proportion of the population living below the poverty line of $1.25 per day—in PPP terms—fell from 56 percent in 2000 to 31 percent in 2011
- Such a mixture of speed and gradualism characterized other successes, most notably China and Vietnam

Further Comments on WC Mistakes

- Too often, “one-size-fits-all” policies, insufficient learning about particular circumstances of each countries, insufficient attention to pacing and sequencing
  - WC financial sector reforms focused on liberalization of interest rates in very thin and imperfect markets.
    - Often resulting in exceptionally high real interest rates and limited access to credit

Further Comments on WC Mistakes

- Too often, “one-size-fits-all” policies, insufficient learning about particular circumstances of each countries, insufficient attention to pacing and sequencing
  - The structure, pacing, and sequencing of privatization and trade policy reforms led to the deindustrialization of Africa.
    - Domestic firms faced strong competition from foreign competitors who had better access to finance at attractive rates.
      - Not surprisingly, many did not survive
    - The advanced countries did not simultaneously liberalize their markets.
      - Escalating tariffs kept poor African countries supplying raw materials, and prevented them from entering higher value-added activities

Further Comments on WC Mistakes

- Little investment in infrastructure meant that even were firms able to produce something that might be desired in developed countries, the “internal barriers” to trade remained significant

3. Policies for Unlocking Africa's Growth Potential

- Industrial policies
- Intra-regional trade
- Finance

3A. Industrial Policies

- Central to economic/structural transformation
  - Key failure of many resource based economies was not to diversify during commodity price boom
- Justified in terms of standard theories of **market failures—** instances in which markets on their own do not produce efficient outcomes
  - Affecting the structure of production and the choice of technology
- Broad objectives (not just GDP: environment, equality, employment, economic diversification)

Industrial/LIT Policy

- Industrial policy: actions that aim to alter the allocation of resources (or the choice of technology) from what the market would bring about.
  - Not confined to industry but also to policies aimed at other sectors, e.g. finance or IT and agriculture.
  - More accurate to call it Learning, Industrial and Technology (LIT) policy
- LIT policies take many different forms
  - African examples of LIT for IT provided by Rwanda and for agriculture by Ethiopia (earlier Kenyan tea)
  - Green revolution in South Asia
    - Facilitated by policies of price support setting a floor on output prices as well as input subsidies, including notably for electricity, that enhanced the profitability of tube-well irrigation
  - The most famous examples are East Asian “developmental states”
- Industrial policies were central to almost all countries that “caught-up” with the technological frontier and became developed

LIT Policies

- LIT policies target the dynamic capacities of the economy.
  - Allocating a given amount of resources in a way that is consistent with *static* efficiency, as desirable as it may seem, may actually impede development and growth
  - These and associated societal transformation depend on ***learning,*** in all its forms—including *closing the knowledge gap that separates developing and developed countries and learning to learn*
- Possible conflict between policies that enhance static efficiency and those that contribute to learning
  - Striking the right balance is at the core of success.
  - Neoliberal WC policies paid no attention to learning, seemingly unaware of the potential conflict, and thus failed to strike the right balance

3B. Intra-Regional Trade

- As a share of GDP intra-African imports rose from 2.7% in 1995 to 4.5% in 2013 but this compares with 6.7% in the Americas, 17.9% in Asia and 21% in Europe
  - Moreover, very little of that small trade is in manufacture goods
- Geographical proximity is not the same as economic proximity
  - Part of the explanation why trade within Africa lags behind other regions
  - Highlighting need for infrastructure investment
    - Complementarity of various parts of development agenda

High Costs from Failure to Develop Intra-regional Trade

- Intra-regional trade has emerged as absorber of global shocks
- Intra-regional trade can help countries achieve the necessary economies of scale
- The development of regional value chains can pave the way for ease of entry into global value chains
    - and enhance the integration of the region into the global economy

Approach to Regional Integration (RI)

- There are many dimensions to RI
  - Trade, labor and capital markets
  - The considerations of priorities and sequencing that we have emphasized are also relevant to this agenda
  - Given the complex issues and risks that factor markets liberalization, especially capital markets pose, the priority should be on trade
- And measures for promotion of intra-regional trade themselves face issues of prioritization and sequencing
- Including trade policy, easing or removal of tariff and non-tariff barriers
- But equally important issues of infrastructure

Beyond Relaxing Trade Restrictions

Simply relaxing barriers to trade is not enough, especially for poor countries, where there are many other constraints to expanding trade

- Relaxing formal barriers to trade has had little impact on developing countries
- **Production constraints**: Producing goods that can be exported
    - Important role for industrial policies
    - Important role for *finance*
        - In many countries, there are constraints in obtaining finance for investment and even working capital
            - Especially for sme's—especially important in developing countries
- **Trade constraints**
    - Infrastructure
    - Trade facilitation (customs and port costs and procedures)
    - Trade finance

Trade Finance

- AFREXIM bank has a particularly important role in trade financing.
- Given the importance of industrial policies for promoting intra-African trade, and the important of trade for promoting industrialization, AFREXIM bank could consider
  - longer-term financing, possibly in partnership with AfDB or some other development bank to foster production of exportables.
  - Possibly strengthening a window for special financing of intra-regional trade in non-traditional, learning intensive goods and services
  - Explore other ways of encouraging development finance
- Reflecting the growing recognition of the role of finance for development and the role of public institutions (development banks) in providing finance for development and trade

Manufacturing in Africa

- LIT policies and intra-regional trade can reverse Africa's deindustrialization
  - And go beyond that to raise the share of manufacturing above its previous peak given how small the manufacturing sector was even at its peak
  - There is considerable scope for import substitution, especially at the regional level which trade integration will help

Limitations of Manufacturing

- While there is considerable scope for industrialization in Africa, the world is changing and the heavy *reliance* on manufacturing is an unrealistic option for most African countries
  - This is partly because of the rapid increase in productivity in manufacturing means that global employment in manufacturing will be in decline
  - There is intensified competition in a more globalized world
- So it is all the more important for Africa to take advantage of the opportunities available.

Limitations of Manufacturing

- Africa should be wary of the risks of excessive financial and capital market liberalization which will impose risks which small African producers will not be able to bear
  - Some regional integrations schemes in Africa propose Capital market liberalization.
  - The priority rather should be trade and the sort of industrial and trade promotion policies we have advocated

A Narrow Window of Opportunity

- This is a particularly opportune time for shifting Africa's development strategy.
  - There are major changes occurring in the global economic landscape.
  - China provides a very large and rapidly growing market for African exports, and not just for its natural resources.
  - And wages in China are rising, creating "space" in world markets for labor-intensive, simple manufactures that Africa could easily occupy, and eventually, for less labor-intensive and more complex manufacturers.
    - One example of Africa exploiting that opportunity is the huge shoe manufacturing plant in Ethiopia established by a Chinese firm, but facilitated by Ethiopia's industrial policies

A Narrow Window of Opportunity

- To the extent such a window opens, it might not be for long: other low-income economies could fill the void rapidly.

- All of this enhances the urgency of the sort of policy reforms discussed here and highlights the importance of the finance provided by the African Export-Import Bank