

# MACROECONOMIC POLICY AND STRUCTURAL TRANSFORMATION OF AFRICAN ECONOMIES







United Nations  
Economic Commission for Africa

# **MACROECONOMIC POLICY AND STRUCTURAL TRANSFORMATION OF AFRICAN ECONOMIES**

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## Abbreviations

AfDB	African Development Bank
CDF	Comprehensive Development Framework
COMESA	Common Market for Eastern and Southern Africa
DSGE	Dynamic Stochastic General Equilibrium
EAC	East African Community
ECA	Economic Commission for Africa
ECOWAS	Economic Community of West African States
FDI	Foreign direct investment
GDP	Gross domestic product
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
IFI	International financial institution
IMF	International Monetary Fund
IT	Inflation targeting
NEPAD	New Partnership for Africa's Development
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PRSP	Poverty-reduction strategy paper
SADC	Southern African Development Community
SAP	Structural adjustment programme
SOAS	School of Oriental and African Studies (University of London)
TNC	Transnational corporation

All dollar amounts are US dollars unless otherwise indicated.

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# FOREWORD

The sustainability and inclusiveness of Africa's impressive recent growth hinge on the structural transformation of its economies, through enhanced productivity and greater diversification of production and exports. The 2013 and 2014 editions of the Economic Report on Africa have shown that Africa is transforming. But the pace of transformation has been too slow for the continent to translate its recent growth momentum into commensurate gains in poverty reduction and job creation — or to promote sustainable and inclusive development.

African countries in the years of structural adjustment confirmed that structural transformation cannot be assumed to be automatic. Indeed, government has a critical role in guiding the process, through a development planning framework with coherent strategies to achieve development objectives in both the short term and the long term.

This Report argues that developmental macroeconomic policies are crucial for structural transformation that is both sustainable and inclusive. A coherent set of policies should address the three building blocks of structural transformation: human resources, infrastructure and institutions. Fiscal, monetary and financial policies are key elements of this framework, and should be complemented by policies in such other areas as trade, technology and social services.

Fiscal policy can contribute much in creating a positive relationship between the public and private sectors for structural transformation. Quality public goods and services help create productive assets, particularly for the poor. They also contribute to the national ownership of development strategies and encourage participation in the economy by private individuals.

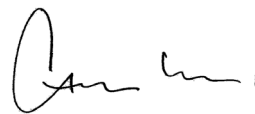
This relationship is essential for broadening the tax base. Currently many African countries rely heavily on

trade and resource taxes. Action is required not only to formalize informal activities, but also to explore underused tax options such as direct and corporate taxation. The relationship with foreign investors in natural resources in particular needs to be reviewed. Rather than race to the bottom, African countries should race to the top, improving the environment for doing business rather than competing on tax concessions and exemptions.

As this Report highlights, monetary policy cannot be restricted to rule-based macroeconomic stability management. Yes, stability is important for the promotion of domestic and foreign investment. But, it has to be twinned with the longer term objective of sustainable development.

Monetary policy also must be complemented with adequate financial regulation to curb excesses. The emergence of innovative sources of financing for Africa, such as private equity, presents not only new opportunities but also new challenges. To benefit fully, countries must reduce the risk and volatility of these new sources of finance.

The recommendations in this Report are based on a thorough evaluation of experiences with macroeconomic regimes and structural transformation from African and emerging economies. Macroeconomic policy can be a powerful tool in promoting transformation and inclusiveness. But its potential can be harnessed only by placing macroeconomic management at the heart of the overall development policy framework.



**Carlos Lopes**  
*Executive Secretary*  
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# CHAPTER 1

## INTRODUCTION

## 1.1 Background

Africa's growth has turned around impressively since the start of the century. Against the backdrop of the commodity boom that began in the early 2000s, Africa as a natural resource-rich continent has achieved higher gross domestic product (GDP) growth than in its own past and than in developing regions such as Latin America and the Caribbean.

African countries grew at close to 6 per cent a year over 2001–2008 and coped with the impact of the global financial crisis of 2008–2009 and the subsequent downturn of the world economy relatively well (IMF, 2013; AfDB et al., 2014). And in a break with historical trends, growth rates in Central, East, Southern and West Africa have surpassed that in North Africa in the immediate aftermath of the crisis, while those in several countries in North Africa have been hit by political unrest and civil conflict since 2010. Robust annual growth of nearly 5 per cent for Africa is forecast to continue, making it one of the fastest-growing regions in the world, after it reached an estimated growth of 3.9 per cent in 2014 (ECA, 2015).<sup>1</sup>

This apparently secular turnaround has led to a marked sea-change in investors' attitudes to African prospects, raising hopes that it will finally emerge as a new growth pole. In the media worldwide, the narrative has become the African renaissance or Africa rising. Not only is Africa blessed with rich natural resources, but it has a demographic dividend (a young working-age population), which investors' increasingly factor into their decisions. Many emerging economies — Brazil, China, India, the Republic of Korea, Turkey and capital-rich Gulf States — have boosted their economic ties to Africa and increasingly engaged with it as a key development partner as part of invigorated South–South cooperation. The high growth has not been confined to a handful or two of resource-rich economies, but

has started spreading across other middle- and low-income countries such as Ethiopia and Rwanda.

Yet it is by no means universal. The majority of African countries have scarcely diversified their narrow-based, commodity-dependent economies or significantly changed their socioeconomic structures. Foreign and domestic investment may have stepped up sharply and domestic demand risen as the middle classes have driven demand over the last decade, but Africa's growth still depends on external factors. The commodity boom that shifted investors' perceptions has yet to generate economy-wide spillover effects at country, regional and continental scales.

Despite early signs that growth is broadening across sectors, beyond oil and mining, manufacturing still accounts for a meagre share of GDP. Africa's economic enablers still pale in comparison with those in East Asia a few decades ago, where the foundations for dynamic growth were laid by the formation of dense production networks and marked consumption spillovers. The inability of African economies to accelerate diversification and structural transformation, and hence to benefit from the technology-driven dynamism of globalization, has kept them vulnerable to external shocks.

It is also one reason for Africa's tardiness in eradicating poverty; another is inconsistency in development policies and patterns of economic growth since independence, when most African countries had endemic poverty and high inequality. This inconsistency stemmed from the combined effects of low and volatile growth and the absence of conduits for translating growth into broad-based and inclusive development (Thorbecke, 2011). Crucially missing were deep integration into the global economy, structural transformation and modernization of agriculture — all key elements in East Asia's ability to propel itself into a virtuous circle of growth and poverty reduction under globalization.

<sup>1</sup> The outbreak of the Ebola epidemic affected the economic growth of several Western African countries in 2014, but had virtually no impact on continental growth.

Central, East, Southern and West Africa has fallen far behind other regions in attacking poverty.<sup>2</sup> Its growth elasticity of poverty (how much poverty can be reduced for a given rate of economic growth) is estimated at -0.7, or much lower than the -2.0 for other developing regions, excluding China (World Bank, 2013). This low conversion rate points to the urgency of making the growth pattern more inclusive<sup>3</sup> — even if the reduction in poverty seen since the mid-2000s is an early sign of hope — because of the prevalence of extreme poverty and high inequality in income and asset distribution.

In 2010 about half the population of Central, East, Southern and West Africa still lived in extreme income poverty, meaning they had to get by on \$1.25 or less a day. Just over two thirds lived below the poverty line of \$2 a day.

The average Gini coefficient in Central, East, Southern and West Africa — a measure of inequality — based on household consumption data is 45.1, while 26 African countries have a Gini of more than 40. This makes the region the world's second most inequitable after Latin America and the Caribbean, which has an average Gini coefficient of 50.1 based on income distribution.<sup>4</sup> In 2010, six out of the 10 most unequal countries worldwide were in Central, East, Southern and West Africa (AfDB, 2012). Polarization at the extreme ends of distribution is likely to be more striking, because the richest capture the largest share of income, while the poorest, particularly in rural areas, get only a minute share. Such polarization may threaten social cohesion.

Africa's past growth pattern can be enhanced through effective utilization of funds obtained by

exploiting natural resources and expanding broad-based and inclusive development (chapter 2). While Africa's imperative for structural transformation is now widely acknowledged, an appropriate set of macroeconomic and other policies need to be put in place and effectively implemented.<sup>5</sup> Orthodox policy prescriptions, as featured in the Washington consensus and the post-Washington consensus, have failed to engender structural change fast enough to address Africa's pressing development needs. In particular, a key point of this document is that conventional policies with a sole focus on maintaining macro stability is inadequate to accelerate the pace of structural change.

We therefore propose macroeconomic policy for structural transformation bounded by a long-term development strategy to facilitate transformation of economic and social structures, with a view to ensuring a positive feedback loop in the investment-growth nexus and to engendering inclusive growth. These policies should be projected as one of the critical mechanisms for laying an institutional foundation for fostering a productive public-private partnership, which is vital for advancing Africa's developmental agenda.

## 1.2 Outline

The document outlines a set of macroeconomic policies and is structured as follows. In chapter 2, we examine the critical question for policymakers in Africa: how to proceed with structural transformation in the coming decades in light of Africa's experiences and current conditions. In section 2.1, we discuss Africa's experiences with structural change from a comparative perspective of different integration patterns under globalization in developing regions.

2 See Nissanke and Thorbecke (2010) for comparative analyses of the globalization-inequality-poverty nexus in Asia, Africa and Latin America. Nissanke (2014a) extends the earlier analysis, incorporating the effects of the recent growth on poverty reduction in Africa (excluding North Africa).  
3 See Nissanke and Thorbecke (2006a, 2006b and 2010) for further discussion on the pattern of growth in relation to its "inclusiveness" arising out of the distribution effects.  
4 Since income distribution is generally more unequal than consumption, World Bank (2013) suggests that Central, East, Southern and West Africa may be as unequal as Latin America.

5 For example, one of the most recent IMF (2014b) policy papers presents empirical evidence based on cross-country regressions and country case studies to show the role of structural transformation and diversification in sustaining long-run growth and macroeconomic stability in low-income countries. However, it fails to provide a coherent policy framework that would facilitate transformation and diversification. Instead, it confines its discussion to disparate policy measures on its own merit for each.

In section 2.2, we examine what sort of structural transformation Africa should strive for in the 21st century, to move the continent and transform its rural and informal sectors.

In section 2.3, the creation of an articulated economy is discussed in relation to efforts aimed at deepening regional integration. As many African economies are too small as viable markets on their own and fragmented geographically, an articulated economic structure becomes feasible through intensified regional integration that creates vibrant regional markets based on dynamic externalities and agglomeration-clustering effects.

In section 2.4, we discuss how to proceed with structural transformation from the challenging conditions found in Africa, in particular, with reference to the deficits in the three areas of human development, infrastructure and institutions (including governance). Reductions in these deficits act as building blocks for shifting Africa's revealed comparative advantage, respectively producing important primary productive assets, enhancing secondary productive assets and linking economic activities, and producing a productive public-private partnership for socioeconomic development.

With this understanding of the process of structural transformation, in chapter 3 we examine how macroeconomic and development policy frameworks have evolved in Africa. We first present a review of the evolution of the inter-relationship between the policy framework, institutional configuration and macroeconomic outcomes over the last four decades of the 20th century, when the policy frameworks abruptly changed with the shift in development paradigms (section 3.1 and section 3.2). We show how both regimes failed in encouraging Africa to make the public investment needed to attract private investment, or to provide high-quality public goods to domestic stakeholders. In section 3.3 we discuss the new emerging landscape influencing macroeconomic policies in the first decade of this century, and the key opportunities and challenges arising from changing internal and external conditions.

Drawing on lessons from Africa's earlier experiences with policy frameworks, chapter 4 presents proposed macroeconomic policies for structural transformation. We emphasize the need to resolve the short-run trade-off between the twin objectives of stability and development by placing individual macroeconomic policies in a development-centred planning framework with a coherent set of wide-ranging economic policies and a system of endogenously evolved institutions as a country's institutional configuration to navigate the process of structural transformation. The chapter outlines five main components of the proposed macroeconomic policy — scaling up public investment and public goods provision; maintaining macro stability to attract and sustain private investment; coordinating investment and other development policies; mobilizing resources and reducing aid dependence over time; and securing fiscal sustainability by establishing fiscal legitimacy — which are taken up in more detail in chapters 5 and 6, largely following a fiscal/monetary split.

In chapter 5, we discuss how fiscal policies should be configured. Section 5.1 underlines the importance of a consolidated approach to fiscal configurations. Beyond conventional discussions on maintaining fiscal discipline for macro stability, we take an institutional perspective on the question of fiscal sustainability and legitimacy, and call for an integrated approach towards revenue mobilization and inclusive public expenditures as a prerequisite for building a developmental nation-state in Africa. We discuss how to: establish fiscal legitimacy with high-quality public goods provision (section 5.2); staunch illicit cross-border financial flows and improve public resource management (section 5.3); turn natural-resource wealth into productive assets through inclusive fiscal spending (section 5.4); and manage public finance and sovereign debt sustainably through counter-cyclical macroeconomic management and institutions for public resource management (section 5.5).

In chapter 6, we set out by reviewing the debate on monetary policy regimes with a critical reappraisal of the inflation-targeting regime (section 6.1). We

move on to discuss options for pursuing domestic monetary policy with exchange-rate and capital-flow management for an open economy becoming more integrated in the global financial system (section 6.2). We stress the need for prudential regulations to tame market excess as part of monetary and financial policy configurations. In section 6.3, after casting a wary eye over some new financial instruments, and a hopeful one over potential sources for mobilizing

resources, we discuss the importance of deepening domestic financial markets.

In chapter 7, in concluding remarks, we revisit key elements of the macroeconomic policy for Africa's structural transformation of the 21st century by listing the main policy messages arising from our analyses.



# CHAPTER 2

## STRUCTURAL TRANSFORMATION IN AFRICA

## 2.1 Comparative experiences

In the literature on development economics, structural change is discussed conventionally in terms of sectoral compositional changes in output or employment in relation to primary, secondary and tertiary activities as economic development proceeds.<sup>6</sup> However, a deeper appreciation is required for strategic policymaking on transformational processes beyond the understanding of a linear progression from a primary sector–dominant structure towards a higher-order one, as encapsulated in several recent studies.

For example, noting significant productivity gaps across sectors as well as the heterogeneity and duality of productivity within sectors in developing countries, McMillan and Rodrik (2011) examine the relationship between structural transformation and productivity growth. They suggest that overall productivity growth can be achieved by productivity increases *within* sectors through capital accumulation, technological change, industry rationalization and other means<sup>7</sup> and by movements of resources from lower- to higher-productivity activities *across* sectors.

Their empirical analysis of decomposition of labour productivity growth applied to historical data of 38 countries for 1990–2005 reveals a contrasting picture among countries in different developing regions, especially between countries in East Asia, on the one hand, and those in Africa and Latin America, on the other: while Asian countries have tended to experience productivity-enhancing structural change, both Latin America and Africa have experienced productivity-reducing structural change.

In Asia, average annual labour productivity growth was 3.87 per cent, broken down into 3.31 per cent

through productivity growth within sectors and 0.57 per cent due to inter-sectoral labour migration from low-productive sectors to high-productive sectors. In contrast, in Africa, overall annual labour productivity growth was significantly lower at 0.86 per cent, with positive productivity growth of 2.13 per cent within sectors being somewhat offset by a productivity contraction of 1.27 per cent stemming from inter-sectoral patterns of labour migration in the *wrong* direction.<sup>8</sup>

This negative pattern of structural change is particularly conspicuous in oil- and mineral-dependent countries such as Nigeria and Zambia, where the share of manufacturing and services had shrunk and that of agriculture expanded over this period. In fact, countries with comparative advantage in natural resources in Latin America and Central, East, Southern and West Africa are those that experienced the most negative, productivity-reducing structural change. In those regions, labour moved in the reverse direction from what is expected from growth-enhancing structural change: from more to less productive activities, often to informal activities, with negative effects on productivity and economic growth.

Dividing a database covering 1960–2010 into three sub-periods, de Vries, Timmer and de Vries (2013) further examine African experiences with structural change. Their analysis shows that for the earlier part of the post-independence years (1960–1975), the expansion of manufacturing activities led to an increase in overall productivity resulting from efficiency-increasing inter-sectoral reallocation of labour from agriculture to manufacturing. However, the productivity- and growth-enhancing process of structural change stalled between 1975 and 1990. Since 1990 structural change has been characterized by static gains but accompanied by dynamic losses as labour migrated from agriculture and manufacturing

6 For example, see Kuznets (1966 and 1971) and Chenery (1979) for classical propositions on empirical regularities of structural changes in accompanying the process of economic development.

7 The term “industry rationalization” refers to processes in which the least productive firms exit the industry, while the remaining shed excess labour (McMillan and Rodrik, 2011: 16).

8 Likewise, in Latin America overall labour productivity growth was 1.35 per cent a year, where positive productive growth within sectors of 2.24 per cent was diminished by inter-sectoral productivity contraction of 0.88 per cent.

to services such as retail trade, hospitality, transport and distribution.

De Vries, Timmer and de Vries (2013) explain that the static gains arise because the level of labour productivity in services sector was greater than that in agriculture but that the dynamic losses resulted because the growth of labour productivity in services was slower than in manufacturing.

Africa's relative productivity set against the global technological frontier has also steadily declined across sectors since the 1980s. De Vries, Timmer and de Vries (2013) suggest that the migration of labour into services displaying low marginal productivity does not contribute to aggregate growth in most African economies. This pattern in structural change is also present typically in Latin American countries, but not in Asian countries, where relative productivity compared to the technological frontier has notably improved.

These two studies make three points unequivocally: that structural transformation should be associated with overall labour productivity growth and a move into sectors with dynamic growth possibilities; that it is harder to get productivity-enhancing structural change on the basis of fragile economic activity regardless of the sectors; and that the nature and pace of structural transformation would make a critical difference to economic development. They concur with the increasingly accepted empirical evidence that economies with revealed comparative advantage in natural resources and specialization in primary commodity exports are at a disadvantage to those with a comparative advantage in human resources and specialization in exports of manufactured goods. The former group of countries in Africa and Latin America have failed to get productivity-enhancing structural change underway in the process of integration into the world economy as globalization has gathered pace since the early 1990s.

The increasingly diverging pattern of structural change among developing regions since 1990, as noted by the two studies, further corroborates

the findings in comparative studies such as those by Nissanke and Thorbecke (2010) and Nissanke (forthcoming), particularly on the point that the difference in development outcomes among nation-states under the recent phase of globalization is likely to be explained better by country subgroups' specific nature of integration and specialization rather than by the degree of openness of the trade and investment regimes, as often claimed.

Thus integration into the global economy does not guarantee productivity-enhancing structural change. The effects of globalization on growth and poverty are diverse and context-specific, and the forces of globalization are inherently neither beneficial nor deleterious for development prospects. Rather, the difference in the ability of structural transformation to sustain growth as well as the different speeds of progress in poverty reduction can be explained by countries' internal patterns of economic growth and the forms of integration they follow. A comparative analysis of globalization across the three developing regions of Asia, Central, East, Southern and West Africa and Latin America (Nissanke and Thorbecke, 2010) shows that globalization has worked best for the poor through the growth channel when globalization-induced growth generates more stable employment opportunities at a steady pace for the growing population and labour force.

The employment-creating effect of growth is pronounced in most of East Asia's economies, where globalization has brought about a substantial reduction in poverty owing to vigorous growth despite increasing inequality.<sup>9</sup> Indeed, East Asia is the region widely regarded as having benefited most from the dynamic growth effect of the recent wave of globalization. The region has benefited from powerful growth-enhancing effects of openness through trade and foreign direct investment (FDI), for example. Following aggressively an outward-oriented development strategy, most East Asian economies not only managed the process of integrating into the

<sup>9</sup> See Nissanke and Thorbecke (2008) for a summary of the findings of the impact of globalization on the poor in Asia.

world economy much earlier than other developing countries but also upgraded their linkages to it. Thus their active integration strategy greatly contributed to their productivity-enhancing structural change.

The inclusive pattern of public expenditure in favour of the rural poor at early stages of development in no small measure contributed to sustaining shared growth in East Asia during the 1960s and 1970s.<sup>10</sup> In those early years, governments attempted to help the poor to build productive assets through such measures as equitable distribution of land; extensive public provision of free and universal primary education; promotion of small enterprises; and development of rural infrastructure, such as roads, irrigation, schools, agricultural-support outposts, health stations and irrigation systems. Inclusive growth in East Asia was evidently not just a manifestation of market-driven growth effects.

Building on this early inclusive expenditure to increase productivity in agriculture and rural development, subsequent poverty reduction involved strong demand for unskilled and semi-skilled labour, driven by exporting labour-intensive goods and attracting pro-trade FDI, bringing about transfers to their technology, knowledge and skills base. The production and trade structures in most East Asian economies have featured continuous upgrading of this base via active technology diffusion and learning by doing, allowing a shift in the comparative advantage of each country in a flying-geese pattern to form a dense production network of “factory Asia” within the Asia Pacific region (Baldwin, 2012; Lin, 2011).

Relying on their fast-evolving dynamic comparative advantages and increasing specialization in sectors with large spillovers, East Asian economies have

maximized the benefits collectively. This has engendered a regionalization of supply-chain and production networks, driven by vertically integrated operations of manufacturing firms, based on growing regional and global markets for their products.

Africa and Latin America missed out on all this. These empirical observations from comparative studies point to the importance of policymakers being engaged in strategic integration, in place of the passive integration of simply waiting for private investors and agents to respond to market signals and incentives.

This strategic policy stance should be formed to enhance productivity in each sector, and to help to transform production and trade structures towards sectors with high potential for stable job creation, given their capacity to generate large spillovers and dynamic externalities. Liberalized trade and investment policies on their own have not achieved this, instead feeding through into jobless growth, casualizing employment and informalizing economies.<sup>11</sup>

## 2.2 Structural transformation for Africa in the 21st century

The pattern of productivity-reducing structural change in Central, East, Southern and West Africa over three decades since the mid-1970s is a direct consequence of the extreme paucity of productive investment in both public and private sectors. It has manifested itself in a halt to socioeconomic development, evidenced in extreme adverse conditions in many parts of the continent during those years.

10 On this account, the growth pattern of East Asian countries in the 1960s and 1970s was popularly described as highly inclusive and viewed as a model of “shared growth” in a number of earlier studies (Ahuja et al., 1997; Campos and Root, 1996). This shared growth pattern has, however, been seriously eroded since then, in particular since the 1990s, and economic growth has been accompanied by rising inequality in most Asian countries under the current wave of globalization.

11 Along with African countries, countries in Latin America and the Caribbean experienced weak growth and rising inequality throughout the 1980s and 1990s, when globalization produced an essentially “jobless” pattern of growth with little impact on poverty (Thorbecke and Nissanke, 2008). The recent impressive poverty reduction in Latin America and the Caribbean is attributable to institutional innovations for social protection such as conditional cash transfer programmes in Mexico and Brazil (Thorbecke, 2013a).

### Continuing dominance of the informal economy and little change in comparative advantage

In the normal process of productivity-enhancing structural change, informal activities and enterprises are expected to build up productive assets over time so that they grow and graduate to more robust, formal economic units. However, instead of graduating in this way, in most African economies they have remained the mainstay. Worse, most countries have seen the reverse trend: informalizing economies with fast-depleting stocks of productive assets. The labour migration from manufacturing and agriculture into services since 1990 discussed above reflects this. While move of labour from manufacturing was linked to casualization of jobs and informalization of activities, from agriculture it was the result of migration of the rural poor into an informal economy at the margin of urban centres.

Largely for these reasons the informal economy with its extreme fragility has remained an important source of jobs and income for many urban and rural households. According to estimates from survey results (AfDB et al., 2010), the average share of informal employment in total non-agricultural employment in Central, East, Southern and West Africa was 76 per cent in 1990–1994, and increased notably throughout the 1990s, taking the share in some African countries like Chad and Mali to about 82–95 per cent. In 2000–2007 this metric in North Africa was 47 per cent, the same as in 1995–1999.

The fragility and insecurity of informal employment is reflected in labour market statistics. As most labour forces are absorbed into household-based activities or micro-enterprises, the share of wage earners in the labour force (with or without permanent contracts) was around 2–3 per cent in the mid-2000s, even in some of the continent's relatively more dynamic economies like Ghana, Rwanda and Tanzania (Lin, 2011). The fragility of these activities is also evident in the very high share of vulnerable employment and working poor in total employment for Central, East, Southern and West Africa, along with South Asia, compared with other regions (table 2.1).

Furthermore, without rigorous productivity-enhancing investment and acquisition of skills, technology and knowledge, the revealed comparative advantage of many African economies remained static throughout the period. Based on either mineral resources or agriculture, specializing in primary commodity exports inherited from the colonial era, their relative endowment structures have not undergone fundamental changes since independence. The pattern of their integration into the global economy has therefore been shaped by their static comparative advantages in relative resource endowments.

Remaining heavily dependent on oil and minerals, the continent's resource-rich economies are severely handicapped in advancing an inclusive developmental agenda. The "resource curse" or "Dutch disease" literature extensively discusses the political-economy issues of managing distributional conflicts over resource rents, or the demanding tasks of macroeconomic management across several commodity price cycles.<sup>12</sup> They are also disadvantaged because the resource sectors often form an enclave and fail to create secure jobs economy-wide through spontaneously generated linkages and spillovers on a large scale. Fundamentally, owing to the high capital intensity of the technology employed, resource sectors do not provide many jobs, and so could not contribute much to accumulation and formation of productive human capital.

Most of the resource-poor economies in contrast are based on traditional, smallholder agricultural activities. They entered the new millennium having seen little public investment or technological gains in agriculture, keeping their rural communities isolated and fragmented, and deprived of opportunities for more productive activity. The upshot is that few resource-poor African economies are near the critical take-off stage of economic development.

<sup>12</sup> These issues are discussed in detail in chapters 3 and 5.

**Table 2.1 Vulnerable employment and the working poor, 2010 and 2012**

	Vulnerable employment <sup>a</sup> (% of total employment)		Working poor <sup>b</sup> (% of total employment)	
	2010	2012	2010	2012
World	53,10	49,20	26,6	12,3
Developed economies and European Union	11,20	10,10	..	...
Other Europe <sup>c</sup> and Commonwealth of Independent States	23,80	19,70	5,0	1,7
East Asia	58,40	48,90	31,2	5,6
South East Asia and the Pacific	65,20	61,10	33,7	11,7
South Asia	81,30	76,90	43,9	24,4
Latin America and the Caribbean	35,80	31,50	7,8	3,5
Middle East	33,50	27,00	1,4	1,8
North Africa	42,10	41,40	9,5	6,4
Central, East, Southern and West Africa	81,80	77,20	56,7	40,1

a. Sum of own-account workers and contributing family workers.

b. Employed people living in a household that earns less than \$1.25 a day per person.

c. Refers to non-EU countries in Central and South Eastern Europe.

Source: Adjusted from UNDP's (2014) *Human Development Report 2014*, table 2.4, based on data from the International Labour Organization (ILO).

Structural transformation envisaged in Africa needs to tackle these weak conditions, in a strategic approach supported by purposeful, concerted societal efforts to direct public and private investment into new dynamic activities.

### The evolving characteristics of industrialization processes

The development literature depicts structural change as associated with the acceleration of industrialization and urbanization alongside that of technological innovation and capital accumulation (Lin, 2011). As Murphy et al. (1989) note, "virtually every country that experienced rapid growth of productivity and living standards over the last 200 years has done so by industrializing. Countries that have successfully industrialized — turned to production of manufactures taking advantage of scale economies — are the ones that grew rich, be they eighteenth-century Britain or twentieth-century Korea and Japan" (Murphy et al., 1989: 1003). Similarly, Rodrik (2011)

emphasizes that manufacturing industries have much greater potential to absorb surplus labour presently employed in traditional agricultural or informal activities. He identifies manufacturing as the "convergence sector" capable of placing economies on the "automatic escalator up" through industrialization.

At the same time, with the imperatives of adopting "green and clean" technology, the nature of industrialization should change, and radically. With technological advances, organizational structures of industrial production are also likely to undergo fundamental changes. Baldwin (2012), for example, predicts that the 21st century's global and regional economic activities will be characterized by a high degree of interconnectedness in the trade–investment–services–intellectual property nexus, in which: trade will be dominated by cross-border trade in parts and components rather than in final goods; international investment will be in production facilities, training, technology and long-term business; infrastructure services (telecoms, Internet

services, air cargo, trade-related finance, customs clearance) will be used to coordinate production; and cross-border flows will include intellectual property, as well as managerial and marketing know-how.

African economies need to ensure that they are front-row participants in this emerging order. As noted in the *African Economic Outlook 2014* (AfDB et al., 2014), global supply/value chains may well increasingly dominate Africa's integration into the global economy, which requires strong service sectors providing efficient logistics. This may mean a shift in sectoral composition into services that support activities in other sectors, including manufacturing, mining and agriculture. An increasing share of services in GDP induced by technological and organizational changes may then result, rather than purely a shift into conventional manufacturing. African countries, as latecomers, need not therefore emulate the processes that today's advanced and newly industrialized economies followed.

Similarly, once the economic infrastructure is built to improve connectivity for remote rural communities, transport and communication costs as well as the associated costs of coordination should decline in many areas. This would allow a dispersion of activities into rural areas, or semi-rural areas, and open up an entirely new array of employment opportunities in rural or surrounding locations. Such rural-based development and spatial spreads could reduce the negative externalities linked to overcrowded cities and urban centres (traffic, high land prices, crime or pollution) or in some cases entirely prevent these problems from developing. Reflecting a trend to innovation, green technology and non-urban life styles, Africa's moves to structurally transform itself, industrialize and urbanize could well turn out unique.

### **Moving to a self-sustained, articulated economy**

From this forward-looking angle, we suggest a fresh way to analyse structural change in Africa in the 21st century, taking into account the lessons available to latecomers, as rendered graphically in figure 2.1. We start with an overarching economic goal of an articulated economy, in which economic activities are

closely tied to each other in a coordinated manner, so that the dynamic gains discussed above can come fully into play.<sup>13</sup> The strength of such a structure lies in its ability to generate demand locally on a self-sustained basis, reducing dependence on foreign demand.

Transformation of the economic structure would entail reallocation of resources from low- to high-productivity activities both within and across sectors. With a much more diversified structure encompassing a plethora of activities generating local demand in a self-sustaining loop, an articulated economy is more capable of producing secure jobs and providing a growing population with employment, creative activities and learning opportunities than a narrowly based, mono-economy dominated by an enclave structure or fragmented economic activities.

Structural change must be more than economic. It needs to involve a social transformation towards inclusive development, sharing opportunities among all population groups, regardless of wealth, gender, ethnicity or religion — or any other criteria. One of the best ways to understand this is through the prism of Amartya Sen's "capability approach". He defines development as expanding an individual's freedoms along five instrumental dimensions: political freedom, economic facilities, social opportunities, transparency guarantees and protective security (Sen, 1999). Africa's socioeconomic development needs to encompass these. Building resilient human resources through inclusive expenditure with a focus on sustained universal provision of high-quality public services in health and education has its own rationale as well as an important place in Africa's strategy of structural transformation.

13 The concept of an articulated economy is akin to that of the "big push" originally introduced by Rosenstein-Rodan (1943) and developed by Nurkse (1953) and others subsequently. The development paths embedded the ideas of "big push" or "balanced growth" are examined afresh in Murphy et al. (1989).



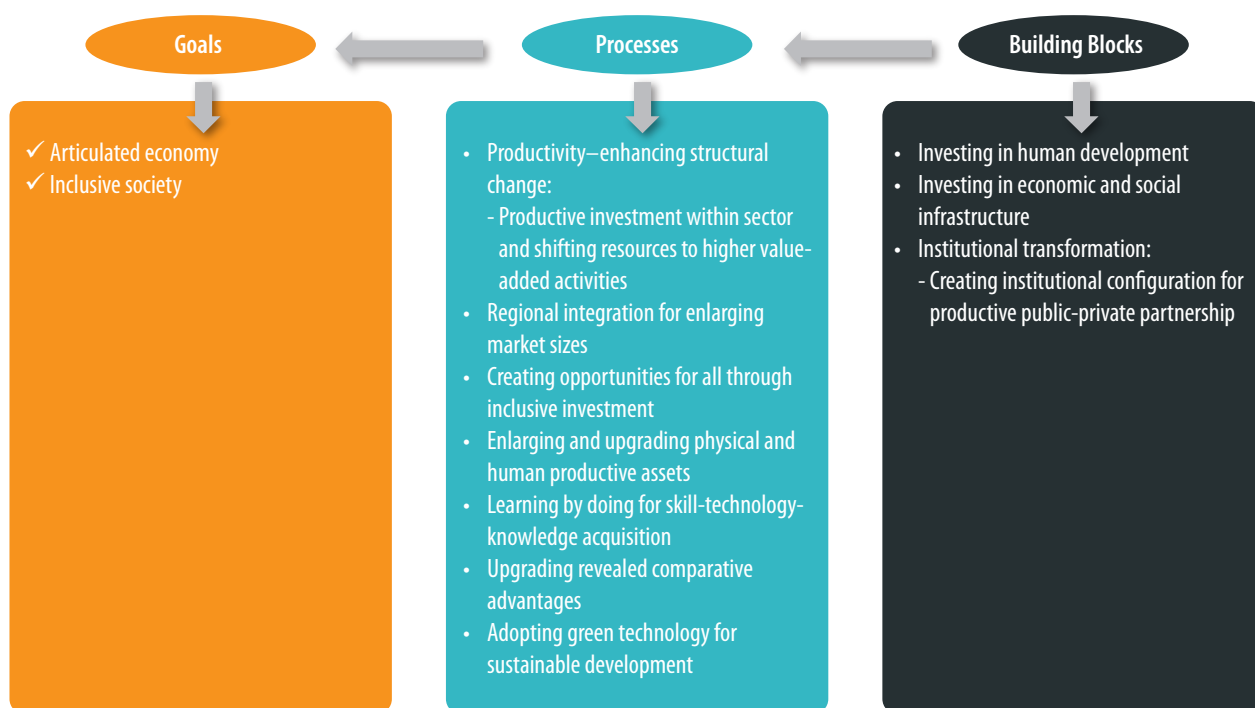
### Building on what Africa already has

Africa’s economic transformation requires not only productive investment into new sectors for *diversification* but also strong commitments to enhance productivity in the traditional primary sectors. In particular agriculture in both resource-poor and resource-rich countries requires significant investment by disseminating new technology and providing institutional support for raising productivity and increasing food security. Further, there is no escape that Africa’s structural transformation should build on current resource endowments to begin with: the mining and oil industries should be seen not only as a vital source of development finance via resource rents but also critical platforms for learning by doing, for instance. Even if the commodity-price super-cycle seems to have faded, Africa can still pursue commodity- and resource-based industrialization, which can “serve as a launching pad for long-term diversification and competitiveness in new and non-commodity sectors” (ECA and AUC, 2013: 9).

Linkages should be strengthened between the commodity sector and domestic industrial and service sectors (ECA and AUC, 2013). While the case for linkage development is traditionally made for promoting downstream, forward linkages through processing raw materials, there are plentiful opportunities for developing upstream, backward linkages, as well as horizontal linkages. This is because most resource companies’ preferred business strategy is to concentrate on their core competences and outsource everything else to other local firms.

Local firms serving the larger foreign and domestic corporations operating in resource sectors have the potential to build productive assets by acquiring knowledge and skills in organization and management, which can be transferred to the rest of the economy through demonstration effects or by their moving and expanding into new sectors and activities (ECA and AUC, 2013).

**Figure 2.1 Africa’s structural transformation in the 21st century**





The question then is how to transfer this newly acquired financial and knowledge-based capital to sectors promising high economic and *social* returns. As market incentives and price signals have proved insufficient, macroeconomic policy to advance Africa's structural transformation agenda is warranted to achieve its high-order societal goals (chapter 4). Before that, we look at why regional integration is so important for structural change in Africa, and how to build a foundation for it by plugging the human, infrastructural and institutional deficits (the rest of this chapter), then evaluate previous macroeconomic frameworks and their impact on Africa (chapter 3).

### 2.3 Accelerating regional integration

For articulated economic structures to emerge in Africa, it is necessary to surpass a critical minimum threshold of market size so that spatial externalities and agglomeration effects take hold, as emphasized in the literature on the new economic geography (sometimes known as the spatial economy).<sup>14,15</sup> A small domestic market poses a real impediment to building an articulated economy with dynamic externalities and spillovers required for high-value added activities. National markets in most of Africa are indeed small, largely due to low per capita income, while 20 countries also have a small population of less than 6 million. For them, specialization through trading is a realistic option for development.

Regional integration is consequently a logical option, especially as Africa has an excellent opportunity to take advantage of the demographic dividend of a growing young labour force. By investing in acquiring

skills and knowledge (section 2.4), Africa could enlarge market sizes collectively.

#### Turning aspiration into attainment

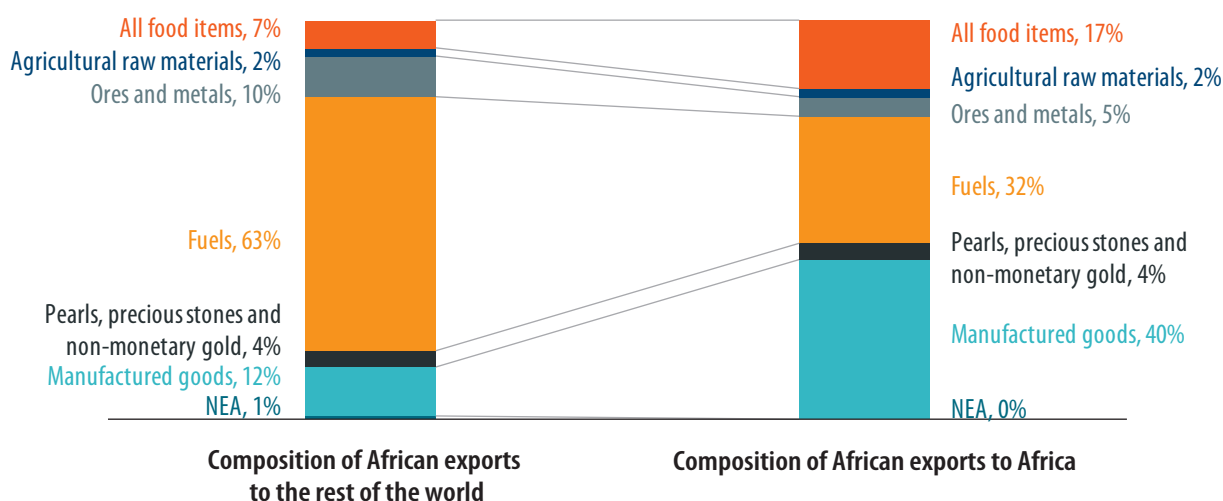
Such integration has been an aspiration for many years — Africa has a long history of committing to pan-African economic integration — though it is still imperfectly realized in eight main trade blocs, many with multiple and overlapping memberships.<sup>16</sup> Official intra-bloc trade has not expanded much until recently, owing to similar and undiversified production structures, and weak cross-border infrastructure. Tariffs between blocs remain high. However, unofficial, or informal, trade has persisted historically across borders in local communities, as national borders were often drawn artificially in the first place without regard to the commercial ties that had existed for centuries.

After several decades of slow growth of official intra-bloc trade, Africa's efforts at regional integration have intensified. Negotiations on regional cooperation among the main regional communities now range wide over areas such as trade, investment promotion, transport and energy infrastructure, free movement of people, macroeconomic convergence, agriculture and food security, peace and security, social affairs, tourism, and industry and planning (ECA and AUC, 2013). Several regional communities have established customs unions or common markets, while COMESA has set up a regional investment promotion agency to coordinate national activities. As cross-border physical infrastructures such as road and rail networks have been built or rehabilitated, intra-African trade has grown, but it remains far below potential.

14 A branch of the new trade theory, this literature was pioneered by Krugman (1991) and further developed by Fujita et al. (1999). As with the imperfect competition trade models, they challenged the assumption of constant returns to scale embedded in the "old" trade theory as in the Heckscher-Ohlin-Samuelson model, and examined the interplay between locational dispersion and agglomeration forces geographically.

15 The criticality of the size of a market for manufacturing firms, which need to match the economies of scale of their competitors, is also highlighted by Murphy et al. (1989).

16 The eight are CEN-SAD (Community of Sahel-Saharan States), COMESA (Common Market for Eastern and Southern Africa), EAC (East African Community), ECCAS (Economic Community of Central Africa States), ECOWAS (Economic Community of West African States), IGAD (Inter-Governmental Authority on Development of six East African states), SADC (Southern African Development Community) and UMA (Arab Maghreb Union). Of those, COMESA, ECOWAS and SADC formed a free trade area.

**Figure 2.2 Composition of official African exports, 2010–2012**

Note: NES = Not elsewhere allocated

Source: Adjusted from Figure 1.13, ECA and AUC (2014), originally taken from UNCTAD (2013).

Intra-African trade is estimated to be around 12 per cent of the continent's total trade, or around 20 per cent if informal cross-border trade is considered.<sup>17</sup> Regional markets have deepened somewhat, recording strong growth in intra-African trade in recent years. After establishing a common market in 2010, intra-bloc trade among five countries belonging to EAC saw rapid growth, with a 22 per cent annual increase in 2012. With a plan to form a continent-wide free trade zone for Africa as a whole by 2017, intra-African trade is expected to grow substantially in years to come. Indeed, the last three issues of the *Economic Report on Africa* (ECA and AUC, 2013, 2014 and ECA, 2015) and also the forthcoming report suggest that intra-bloc and intra-African trade have the potential to contribute more to the process of Africa's diversification and structural transformation than extra-African trade, as the former trade structures are more diversified, with higher shares of manufactured goods (figure 2.2).

<sup>17</sup> This is compared with interregional trade accounting for 60 per cent of total trade in Europe, and 40 per cent in North America (ECA and AUC, 2013).

### Regional integration through negotiations and technology

The politically inspired process of regionalism achieved through negotiations can take place alongside technology-driven regionalization, which achieves integration through forming dense production and supply networks.

In the past, regional integration in Africa was very much politically inspired (as was post-war European integration). Africa's regional integration attempts have closely followed the regionalism model of the European Union, which aimed for deeper economic integration through negotiations among sovereign nation-states, including removal of tariff and non-tariff barriers to trade, no restrictions on FDI, and cross-border free mobility of labour and capital, before moving to a higher degree of economic union harmonizing regulatory frameworks and monetary union. However, as the "old" trade theory of comparative advantage shows, unlike North–North integration, South–South integration is perceived to give rise to income divergence among participating countries by creating a sharp configuration of

winners and losers within a trading bloc (Venables, 2003).

Similarly, through an analysis of one-off trade-creation and trade-diversion effects on formation of a customs union, Viner (1950) argued that as benefits from positive trade-creation effects would not spread evenly among member countries, and negative trade diversion effects could even exceed gains for some members, a thorny issue of redistribution of potential gains could dominate negotiations as interests of sovereign states diverge, unless mechanisms such as fiscal transfers were designed centrally (supranationally) to overcome distributional conflicts.

In contrast to such static analysis of effects of regional integration with a focus on changes in trade flows covered in the old trade models, the literature of the new economic geography points to a gain for all member countries by extending analysis to dynamic positive effects of regional integration on both intra- and extra-regional FDI. The new literature shows that if regional markets are formed and enlarged, the high likelihood of growing into sizeable internal markets would result in a notable shift of investors' perceptions about a region's potential. For Africa, this means that private investors intending to make long-term commitments by building production facilities can greatly increase their engagement with economies on the continent, in the hope of exploiting the internal and external economies of scale arising from larger markets. Dynamic effects originating from positive effects of regional integration on such increased investment could be substantial for structural transformation-cum-development through an all-round leap in productivity. Already over the last decade, intra- and extra-regional investment flows have been rising in all three major regional blocs — COMESA, EAC and SADC (UNCTAD, 2013, 2014).

Growing regional markets would benefit each production unit from economies of scale and competition effects. Internal economies of scale would allow efficiency-enhancing specialization, while reducing, through competition, the incentives for maintaining inefficient operations. At the

same time, large dynamic externalities — external economies of scale — could result not only from labour-pooling effects but also from pecuniary effects, creating dense, region- and continent-wide production/supply networks with deepened backward and forward linkages and internal consumption spillovers. Such networks and linkages are shaped by firms' attempts to slice up production processes into various tasks and functions, and then to disperse them over different locations within a region, as in East Asia. Thus regional integration could provide an opportunity to improve firms' competitiveness as well as to form more efficient supply chains.

Partly reflecting the continent's increasing integration into global supply chains, over recent years FDI projects in Africa have become dominated by investment in service sectors such as technology, media and telecoms, wholesale and retail trade, and financial and business services. Transaction costs could be substantially lowered by improved infrastructure and services, cross-border agglomeration, industrial clustering, closely linked production activities and larger integrated markets. Such cumulative effects could set up a virtuous circle for investment and growth, attracting more FDI.

If realized, this outcome would mean a sharp break from the past as the nature of FDI in Africa could well be qualitatively different, as more market-seeking FDI than the traditional resource-seeking type (aiming to exploit natural resources and cheap labour) comes in. FDI would then become a dynamic force for economic development in Africa, provided that technology and knowledge diffusion followed, in turn allowing Africa to avoid relying on impoverished workers and their underconsumption.

To maximize benefits from regional and pan-African integration, development strategy and investment should be well coordinated within each regional bloc and between them (that is, continent-wide), allowing dense production networks to generate secure jobs as evenly as possible across the region. Negotiations on the best deals for stakeholders with transnational corporations (TNCs) and foreign

investors should be conducted in a coordinated, region-wide manner. Competition for investment should take place in an environment where each state and region adopts a strategy of a “race to the top” — strengthening economic fundamentals and the institutional environment — rather than alluring foreign investors in competitive bids to each other in a “race to the bottom” — like granting excessive tax exemptions, relaxing regulations on workers’ rights or easing prudential norms on capital flows. Regional communities should also institute effective conflict-resolution mechanisms to address diverse interests among member countries for securing ‘win-win’ outcomes.

## 2.4 Bridging the deficits in human resources, infrastructure and institutions

Articulated economic structures can neither emerge spontaneously nor be created over the short term. They require long-term commitment. Challenges faced by African countries as they entered the new

millennium were particularly daunting, after a protracted debt crisis was eventually resolved only with the adoption of the Multilateral Debt Relief Initiative in 2005. Those countries categorized as Heavily Indebted Poor Countries (HIPC) had long been starved of productive investment during the “lost decades” of the 1980s and 1990s (chapter 3).

Since mid-2005 matters have improved (as seen earlier), but there are still massive deficits in three key areas — human resources, infrastructure and institutions, all three of which are building blocks for an articulated economy and inclusive society (see figure 2.1).

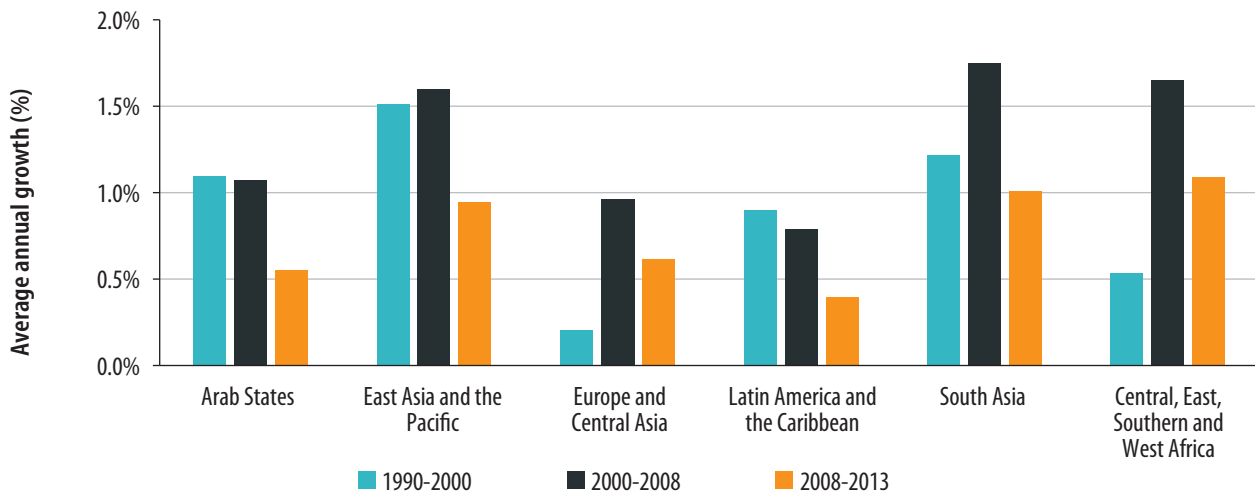
### Human development

Over the past decade Africa has made progress in human development under the Millennium Development Goals. The *Economic Report on Africa 2014* (ECA and AUC, 2014) notes marked improvements in several education and health indicators (table 2.2). Yet in 2013, most African

**Table 2.2 HDI and components, 2010 and 2013**

Human development group or region	Human Development		Life expectancy at birth		Mean years of schooling		Expected years of schooling		Gross national income per capita	
	Index value		(years)		(years)		(years)		(2011 PPP \$)	
	2010	2013	2010	2013	2010	2013	2010	2013	2010	2013
Very high human development	0,885	0,890	79,7	80,2	11,7	11,7	16,2	16,3	38.548	40.046
High human development	0,723	0,735	73,9	74,5	8,1	8,1	13,1	13,4	11.584	13.231
Medium human development	0,601	0,614	67,1	67,9	5,5	5,5	11,3	11,7	5.368	5.960
Low human development	0,479	0,493	58,2	59,4	4,1	4,2	8,7	9,0	2.631	2.904
Arab States	0,675	0,682	69,7	70,2	6,2	6,3	11,7	11,8	15.281	15.817
East Asia and the Pacific	0,688	0,703	73,5	74,0	7,4	7,4	12,3	12,5	8.628	10.499
Europe and Central Asia	0,726	0,738	70,7	71,3	9,6	9,7	13,3	13,6	11.280	12.415
Latin America and the Caribbean	0,734	0,740	74,2	74,9	7,9	7,9	13,8	13,7	12.926	13.767
South Asia	0,573	0,588	66,4	67,2	4,7	4,7	10,6	11,2	4.732	5.195
Central, East, Southern and West Africa	0,468	0,502	55,2	56,8	4,8	4,8	9,4	9,7	2.935	3.152
World	0,693	0,702	70,3	70,8	7,7	7,7	11,9	12,2	12.808	13.723

Source: Adjusted from UNDP’s (2014) *Human Development Report 2014*, table 2.1.

**Figure 2.3 Average annual growth in HDI of developing countries by region**

Note: Population-weighted panel of 99 developing countries.

Source: Based on data from UNDP (2014) *Human Development Report 2014*.

countries lag behind those from other developing regions, which trail at the lower end of the United Nations Development Programme (UNDP) Human Development Index (HDI) (table 2.2 and figure 2.3).

Although Africa has the world's youngest population, increasing faster than anywhere else (ECA, 2014), its demographic dividend can be converted to productive use only if the quality of human resources is continually upgraded, to be a provider of skilled labour and a source of rising internal demand. Skills demanded and those supplied show a wide gap, which at least partly explains the continent's high youth underemployment. Despite progress in universal primary enrolment, completion remains low at 70 per cent, and the quality of education at all levels is unimpressive.

African countries' current revealed comparative advantages that are presupposed by their human-resource and capital scarcity do not point to engagement in skill-intensive, high value-added activities. Therefore, Lin (2011) argues that they should adopt a "comparative-advantage-following" strategy of industrialization by specializing in low-skill, low-technology manufacturing. He argues strongly against their pursuing a

"comparative-advantage-defying" strategy, which he regards as unviable and too costly. He recommends that African countries should take advantage of the new opportunities arising out of China's own imminent graduation from low-skilled, labour-intensive manufacturing owing to rising wages. Estimations indicate that up to 100 million low-skilled jobs will be freed up from China soon. Hence, he urges African countries to "follow the dragon".

However, one of the most useful lessons from East Asia's success is that many of its governments, including China's, have in fact changed its traditional resource endowments and comparative advantages to a more skilled- and knowledge-intensive structure by investing heavily in developing human resources (section 2.1).

Thus it is imperative for African countries to embark now on making long-term commitments to sustained investments in human resource development for all. Otherwise, they will be condemned for a long time to come to a low equilibrium, shaped by the international division of labour inherited from the colonial era. The benefits of low-cost labour would largely accrue to TNCs and global consumers, and low-skilled manufacturing activities are not capable

of generating dynamic externalities and economy-wide spillovers on their own. They should therefore be regarded as a launching pad for learning by doing in a transition phase. African countries need to upgrade their comparative advantages to high value-added activities, which require sizeable public investment in education and skill upgrading, to include the poor.

### Infrastructure

Africa faces an enormous infrastructure deficit.<sup>18</sup> Its low- and middle-income countries are far behind their peer groups in other regions on almost every main measure, except total road density and mobile density (table 2.3). The African Development Bank (AfDB; 2010) summarized the situation as:

*Less than 40 per cent of the continent's population has access to electricity, about a third of the rural population has access to roads and only 5 per cent of agriculture is under irrigation. The situation is no better for social infrastructure, with only 34 per cent of the population having access to improved sanitation and a slightly better situation for clean water at about 65 per cent. ... Furthermore, Africa faces higher access costs compared to other developing countries. The continent's road freight is about 4 times more expensive, power costs 14 US cents per kilowatt-hour against 5–10 US cents, and mobile telephony costs \$12 per month compared to \$8 elsewhere. (AfDB, 2010: 2)*

Foster and Briceño-Garmendia (2010) suggest that Africa's infrastructure services are on average twice as expensive as elsewhere.

While the quality of public services in almost every aspect of infrastructure remains inadequate in all urban and rural areas, coverage and quality are particularly low in rural areas, where 65 per cent

of the population lives, compared with urban areas (AfDB, 2010). Table 2.3 also indicates that the infrastructure gaps are significantly higher in Central, East, Southern and West Africa than these statistics for Africa as suggested in the quote above, as many countries there are in low-income categories. For example, the availability of rural roads ranges from 0.5 kilometres per 1,000 people in Malawi to 35.5 kilometres in Namibia.

The state of Africa's hard infrastructure is largely a direct consequence of the neglected public goods provision of the 1980s and 1990s (chapter 3), and the opportunity cost in producers' productivity and competitiveness is very steep. In power, for example, even though many firms install their own emergency generators, lost working hours are extremely high (figure 2.4). Overall infrastructure deficiencies have depressed African firms' productivity by about 40 per cent (AfDB, 2010).

The critical contribution of infrastructure is well established in the global empirical literature. Foster and Briceño-Garmendia (2010), for example, cite the results of World Bank studies that suggest that improved infrastructure has been responsible for more than half of Africa's growth performance, with a significant contribution to total factor productivity growth (figure 2.5).

As connectivity is critical to creating an articulated economy, the tasks ahead in transport and communication infrastructure are especially onerous, as Africa is a vast continent with difficult terrain and low overall population density. While intraregional and international connectivity in power and transport sectors is very low for many small landlocked states, many cross-border, inter-regional and trans-African links are missing altogether (AfDB, 2010).

The costs of putting this right will be huge. Estimated financing requirement to close the infrastructure gap comes to \$93 billion a year between 2010 and 2020. These financial needs represent about 10 per cent of GDP in Africa's middle-income countries and 15 per cent in its low-income countries (AfDB, 2010).

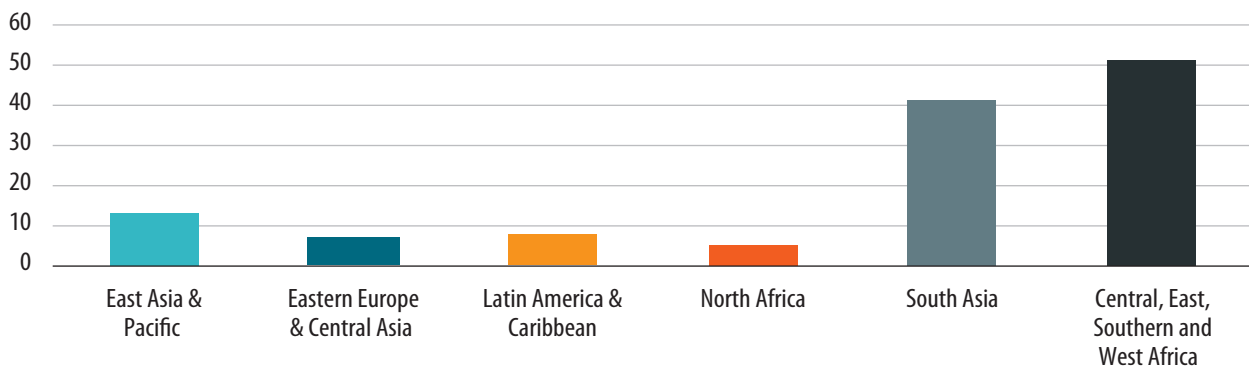
18 The most comprehensive study on this was carried out jointly by the World Bank and the African Development Bank with other donor agencies in 2009. Its results reveal the scale of infrastructure deficit in Africa (Foster and Briceño-Garmendia, 2010; AfDB, 2010).

**Table 2.3 Infrastructure deficit, low- and middle-income countries, Africa and elsewhere**

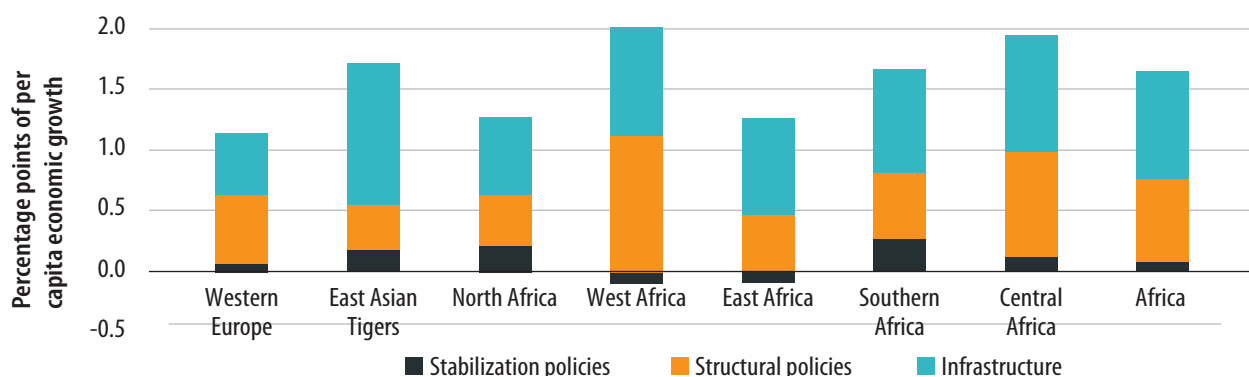
Normalized units	African low-income countries	Other low-income countries	African middle-income countries	Other middle-income countries
Paved-road density	34	134	284	461
Total road density	150	29	381	106
Main-line density	9	38	142	252
Mobile density	48	55	277	557
Internet density	2	29	8.2	235
Generation capacity	39	326	293	648
Electricity coverage	14	41	37	88
Improved water	61	72	82	91
Improved sanitation	34	53	53	82

Note: Road density is measured in kilometers per 100 square kilometers of arable land; telephone density in lines per thousand population; generation capacity in megawatts per million population; electricity, water, and sanitation coverage in percentage of population.

Source: Yepes, Pierce and Foster (2008) from Foster and Briceño-Garmendia (2010), Table 1.

**Figure 2.4 Working hours lost due to power shortages in Africa and other regions**

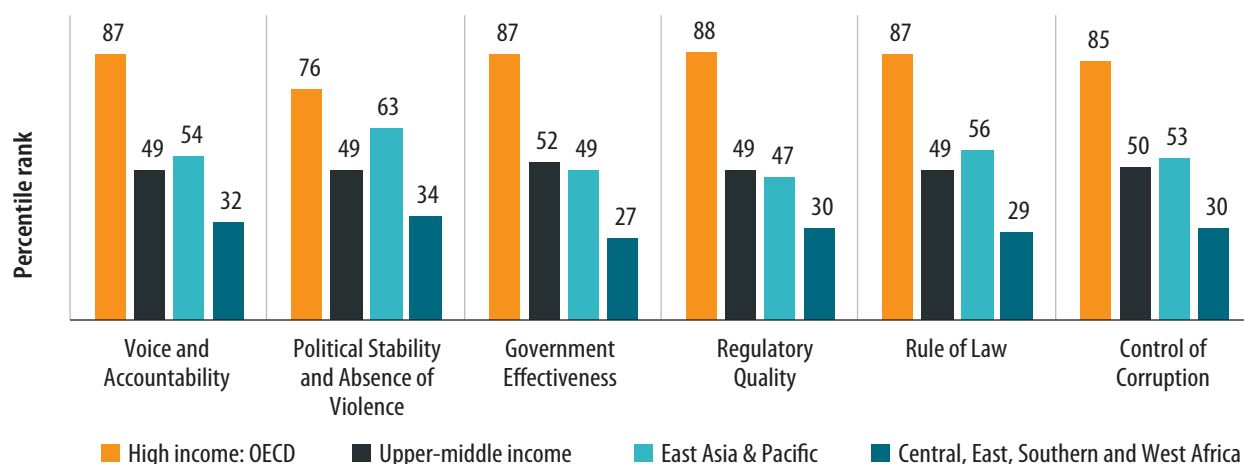
Source: Calculation based on World Bank Enterprise Surveys, available from: <http://www.enterprisesurveys.org/data/exploreTopics/Infrastructure>.

**Figure 2.5 Changes in growth per capita caused changes in growth performance, 1990–2005**

Source: Adjusted from Calderon (2008) from Foster and Briceño-Garmendia (2010), Figure 1.1.

Note: East Asian Tigers = Hong Kong (China), Indonesia, the Republic of Korea, Malaysia, Singapore, Taiwan, and Thailand.



**Figure 2.6 Governance quality indicators, 2013 (percentile rank)**

Source: Data from World Bank Worldwide Governance Indicators Graph is drawn from data at <http://info.worldbank.org/governance/wgi/index.aspx#home>.

There are also substantial inefficiencies in distribution losses, undercollection of revenues and user fees, and overstaffing particularly in power and water utilities, and regulatory oversight is weak. Meeting all shortfalls affecting infrastructure development could generate efficiency gains of an estimated \$17 billion per year (AfDB, 2010).

### Institutions

Africa's poor economic performance is partly attributable to its massive institutional deficit, in particular, poor governance at local, national and regional levels.<sup>19</sup> The World Bank's Worldwide Governance Indicators place Central, East, Southern and West Africa at the bottom of its ranking on all

six indicators, averaging 30 (figure 2.6).<sup>20</sup> East Asia averages 54.

To overcome such institutional deficits, African governments need deeper institutional transformation. This requires them to understand how institutional configurations have been formed in their own particular societies and how changes could unfold (box 2.1)<sup>21</sup>. They must avoid the tendency in some policy debates to assume that there is only one universally applicable set of institutions, a set usually found in advanced economies.<sup>22</sup>

Challenging such a "universalist" prescriptive, we argue four points. First, formal institutions that are simply supplanted from outside without careful adaptation to local environments are not enforceable

19 According to the definition used for measuring governance performance in the World Bank's Worldwide Governance Indicators, governance is understood as consisting "of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them". (<http://info.worldbank.org/governance/wgi/index.aspx#home>)

20 These aggregate indicators combine the views of a large number of enterprise, citizen and expert survey respondents. They are based on 32 individual data sources produced by a variety of survey institutes, think tanks, non-governmental organizations, international organizations and private firms. See Kaufmann et al. (2010) for details of the methodology. These indicators are measured in percentile scores from 0 (the worst) to 100 (the best).

21 See Niskanen (2015b) for more detailed discussion on these questions.

22 Consequently, it is often suggested, at least implicitly, that institutional development would involve convergence towards, or emulation of, best practice in Western societies.



### Box 2.1 Dynamic interplays between institutions and organizations, and possible prototypes of the state

Institutions are defined broadly in the literature, regulating different domains of human interactions — economic, political and social. There are two distinctive schools in approaches to institutional analysis, classified conventionally into old institutionalism and neo-institutionalism (Greif, 2006). Contemporary economic literature is dominated by the latter, which itself is divided into two perspectives: institutions as rules of the game and transaction cost economics.

North (1989, 1990, 1995), representing institutions as rules of the game, defines them as the humanly devised constraints that shape human interaction, structure opportunities and human exchanges. From this perspective, institutions are meant to ensure that individuals comply with collective rules through establishing incentives and sanctions. He further emphasizes that institutions encompass both formal rules (a constitution, property rights and contracts) and informal rules (social norms and customs).

Noting that institutions can be combinations of these elements, Aoki (2001, 2007) draws our attention to institutional configurations as a system of interrelated but distinct components, and so institutional arrangements can be very complex and diverse, involving multiple equilibria. Likewise Greif (2006) defines institutions as a system of rules, beliefs, norms and organizations, which together generate a regularity of social behaviour and social rules. Institutions guide and motivate individuals to follow specific social behaviour.

In a society, individuals act and interact as members of different organizations. North (1990, 1995) defines organizations separately from institutions as ongoing interest groups bound by a common purpose to assure the perpetuation of certain structures: institutional arrangements create the framework, but collective action takes place within organizations. Similarly, contrasting institutions as the rules of the game, Aoki (2007) defines organizations as the players of the game who can act as agents of institutional change. Such change therefore results from the interplay between institutions (as the rules of the game) and organizations (the players).

Transaction cost economics, represented by Coase (1992) and Williamson (1985, 1996), focus on the functional role of organizations, postulating that economic agents — responding

to rules — draw efficient contracts and establish organizations to minimize transaction costs.

Aoki (2007) attempts to reconcile the two perspectives, placing rules in a sharper hierarchical order: rules exogenously predetermined outside the domain of economic transactions, such as legal and social norms; and economic institutions such as contracts, markets, organizations and their hybrids as rational transaction cost–saving responses within them.

Both perspectives in the neo-institutionalism take a largely functional view on the role of institutions, and many commentators argue that institutions are above all created for efficiency gains, identifying the main functions of institutions as to protect property rights and to reduce transaction and information costs, by establishing a stable structure for human exchange and interaction.

Aoki (2007) develops an analytical framework to examine different prototypes of the state in the polity domain, making a distinction between the government as an organization (player) and a state as “a stable order of relationships between the government and private agents”. He thus sees government as a strategic player that may pursue its own objective but is constrained by strategic interactions with private agents.

Second, he links the emergence of the nation-state to an expansion of market exchanges as the latter requires an effective third-party mechanism for protecting property rights and enforcing contracts. He suggests that the extent of market development and demand for third-party mechanisms are interdependent.

Third, presenting three prototypes of the state — democratic, collusive and predatory — he suggests that each is a possible stable equilibrium in the polity domain, and which one of the three prevails is contingent on strategic interplays between a government and private agents through taxation versus public goods provision. Such provision includes security of property rights and contract enforcement — one of the critical requirements for further market enhancement and developments.

and hence unsustainable over time, as well as being functionally ineffective, because they are not upheld by local informal institutions, social norms and beliefs. Second, institutions should be endogenously developed in a specific context, so that they are viable and sustainable, and backed up by expectations and calculations affecting behavioural

patterns of the people.<sup>23</sup> Third, as the dynamics between institutions and organizations are critical

23 See Niskanen (2015b) for an application of the concept of endogenous institutions and institutional changes, advanced by Greif (2006) and Aoki (2007) in a quest for institutional foundation towards inclusive development.

### Box 2.2 Inclusive versus extractive institutional regimes

Institutions exert a heavy influence on the rate and pattern of growth and socioeconomic development. But while their vital role in producing efficiency gains has long been the focus of the growth literature, they also have a powerful influence on distributional outcomes.

These distributional effects are, for example, explicitly taken up by Acemoglu and Robinson (2012) to explain how institutions matter for nations' prosperity and poverty. In accounting for diverse experiences over many centuries globally, they use a typology of two institutional regimes — inclusive and extractive.

Inclusive economic institutions “enforce property rights, create a level playing field, and encourage investment in new technologies and skills.” They are in turn supported by, and support, inclusive political institutions that distribute political power widely in a pluralistic manner and achieve some amount of political centralization so as to establish law and order, the foundations of secure property rights, and an inclusive market economy” (p. 470).

In contrast, extractive economic institutions “. . . are structured to extract resources from the many by the few. These are synergistically linked to extractive political institutions, which concentrate power

in the hands of a few, who will then have incentives to maintain and develop extractive economic institutions for their benefit and use the resources they obtain to cement their hold on political power” (p. 471).

Acemoglu and Robinson emphasize that in the presence of powerful synergies between economic and political institutions, extractive regimes would give rise to a vicious circle of failed development and economic decline, whereas a virtuous circle would be generated under inclusive regimes. They argue that even though extractive institutions can, from time to time, succeed in spurring economic growth, they cannot maintain growth on a sustainable basis. This is partly because extractive institutions are in essence fearful of innovation and creative destruction, which are necessary for sustained economic growth, and partly because the extractive regime eventually engenders political instability.

They also argue that nations with extractive institutions fail under the weight of poverty (and that inclusive institutions are conducive to sustained economic growth and prosperity), and suggest that institutional takes place constantly in a society as the outcome of conflict over income, power and institutions, and this would lead to opening up to differences in institutional set ups across nations.

forces for social change, institutional changes should be initiated and sustained by local organizations and stakeholders. Fourth, socially and politically sustainable development involves institutional innovation to effect coordination, cooperation and conflict resolution among groups of stakeholders in a local setting with defined developmental objectives.<sup>24</sup>

On the theoretical basis outlined in boxes 2.1 and 2.2, we address the question of how to proceed with institutional changes conducive to Africa's economic and social transformation in chapters 4 and 5, where we present macroeconomic policy for structural transformation, covering the issue of creating a developmental nation-state in Africa.

First, however, we need to examine the evolution of development policy since independence, to understand the historical context of Africa's dismal performance in structural transformation. Only by drawing on lessons from the past can we move towards a fresh start. The three critical deficits Africa faces today — in human development, infrastructure and institutions — are the legacy of earlier policy frameworks, whose impact on structural transformation we now assess.

24 Rodrik (2004) places an emphasis on institutional innovation in economic development, too. Similarly, Acemoglu and Robinson (2012) firmly reject the modernization theory that projects a linear, unidirectional convergence of institutions.

# CHAPTER 3

## EVOLUTION OF DEVELOPMENT POLICY FRAMEWORKS

Most African countries have made abrupt changes to their development policy framework since independence, as the dominant development policy paradigm shifted — twice — depriving them of policy continuity.

We review the evolution of the relationships between policy framework, institutional configuration and macroeconomic outcomes over the four decades of the 20th century since independence,<sup>25</sup> divided into two 20-year periods (sections 3.1 and 3.2).<sup>26</sup> We compare the development experiences (schematized in figure 3.1) along the lines of the interactions among the three elements and evaluate the impact of the two sharply contrasting policy paradigms on structural transformation. We then evaluate the emerging new policy environments and discuss Africa's challenges and fresh opportunities in pursuing structural transformation in the coming decades (section 3.3).

### 3.1 Development planning, 1960–1979

At independence, African states were often structured around the top political leaders in the executive branch who could act as benevolent social guardians (Teranishi, 1996). These leaders, who had emerged from long years of struggle in countries such as Côte d'Ivoire, Ghana, Kenya, Tanzania and Zambia, had a vision to build a nation-state and set development goals. They were motivated by high aspirations to improve the livelihoods of their people, and many chose the mechanism of development planning. And despite differences in approach, their development policies were informed by the “high development” theory prevailed at the time.

In those early years, private agents and institutions were often viewed as nascent, fragile, technologically backward and incapable of creating the dynamism needed for autonomous development.<sup>27</sup> The state apparatus was assumed to play a central role in forging the developmental agenda. However, there was a huge gap between the vision and the states' capacity to realize it, as manifested in technical weaknesses of development plans, which were often internally inconsistent or had too little provision to build implementation capacity (Killick, 1983). There was little coordination and coherence among economic policies and instruments applied.

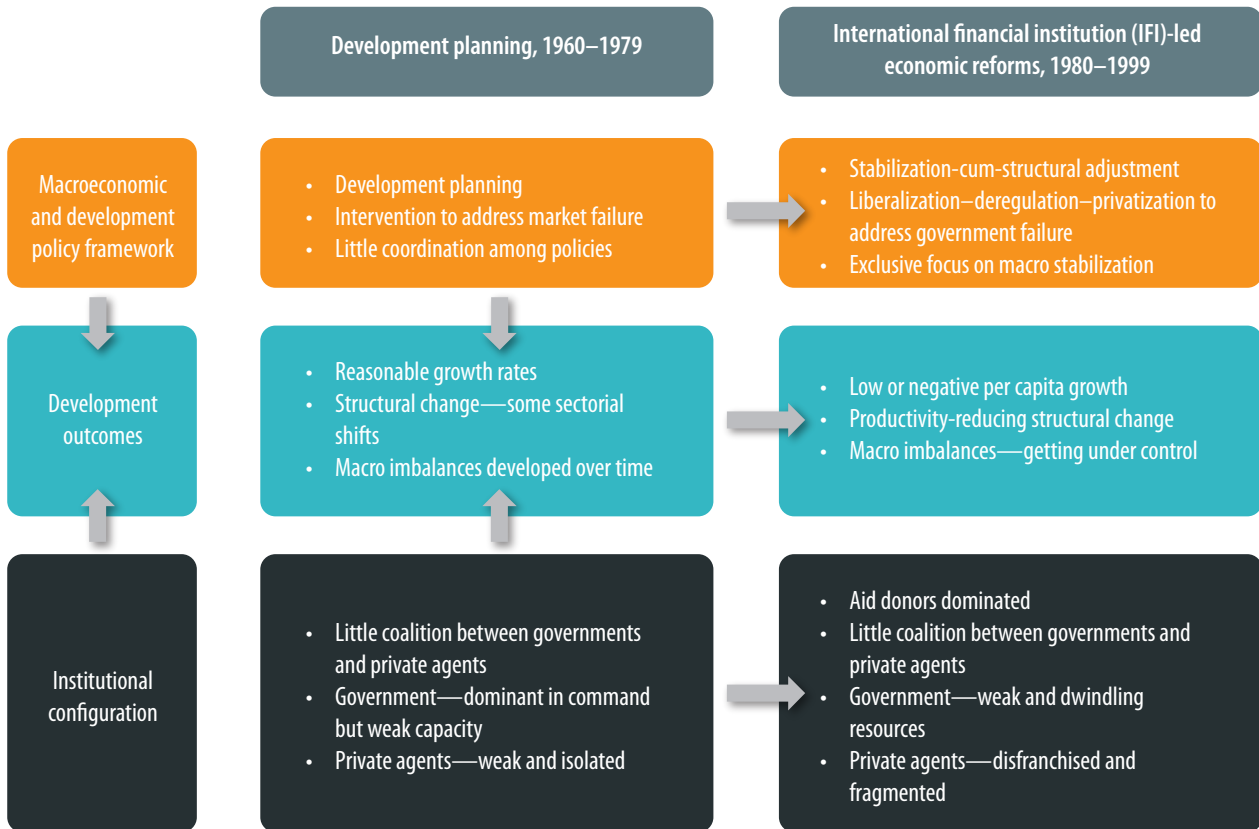
Institutional gaps were also pronounced. In several countries, authoritarian and highly centralized governments, often led by military officers, emerged in place of the leaders at independence. In those countries, governance structures subsequently evolved such that African states were often portrayed as having autocratic governance structures. These were often justified on the basis of the ethno-linguistic complexity within nation-states, whose borders had been imposed by the colonialists. Unstable political regimes, which prevented impersonal state institutions from emerging, often caused rulers to rely on their own narrow circles, generally based on kinship.

With limited administrative capacity made worse by dysfunctional judicial and regulatory systems, these centralized, authoritarian states were quickly overextended. Government offices, including many oversight (regulatory and monitoring) agencies for public sector institutions were rendered ineffective by political appointments, politically controlled funding, multiple and conflicting objectives, and few incentives for keeping staff morale high. These offices' transparency and accountability left much to be desired, resulting in few checks on government policies and actions. Many governments became fiscally profligate, as private actors promoted the interests of politically connected factions, such as

25 Our discussions should be taken as an attempt to summarize key features and extract broad trends. Some countries' experiences differed markedly, of course—the “exceptions”.

26 The dividing line between the two subperiods is of course arbitrary, and others choose different periods. ECA (2011), for example, has four: 1960–1973 (development planning), 1973–1980 (transition), 1980–2000 (structural adjustment programmes) and 2000–2007 (quasi-planning).

27 The economic policies of many countries (with exceptions like Kenya) had a bias against private entrepreneurs and rural farmers in the early decades.

**Figure 3.1 Historical evolution—policy framework, institutional configuration and outcomes**

military cliques and ethnic groups (Aron, 1996). Clientelism became pervasive in many aspects of public institutions, leaving little scope for collectively building a nation-state.

In this environment, private agents were reluctant to make risky, forward-looking productive investments. Most private firms and rural farmers were left disenfranchised from economic development and the collective efforts of nation-state building. Even well-intentioned policies could not be executed because of overstretched public institutions that had no stakeholder participation.

In those early years, sound macroeconomic conditions were not well recognized as critical for sustaining economic growth and maintaining

external and internal balances and investment-saving ratios. Private investment was not appreciated as a driving force in economic development, and a productive public-private partnership was very rare. Nor were macroeconomic balances openly debated or evaluated. Under prevalent long-term development strategies, short-run stabilization issues were not at the forefront of the concerns of policymakers, who paid insufficient attention to maintaining macro balances,<sup>28</sup> and who failed to recognize the critical role of macroeconomic policies in building and consolidating nation-states.

28 Botswana, which gained political independence later than others in 1966, is an exception (box 5.3).

So although the goals were set, the means to achieve them were lacking. Institutional configurations were yet to emerge, and domestic stakeholders had yet to be identified as vital agents. African countries were still at a very early stage of the process of forming nation-states, and many of them were fragile politically and economically.

Within a decade of most countries' independence, those dependent on imported oil faced a balance-of-payments crisis triggered by the oil-price shock of 1973–1974. They were particularly vulnerable because they had not had enough time to build resilience. In addition, many that had kept the colonial-era dependence on primary commodity exports - had to pay very heavy prices for their pro-cyclical spending during the short-lived commodity boom of the 1970s. The boom was followed by a sharp commodity-price collapse in the late 1970s and early 1980s. This ultimately led to protracted sovereign debt crises of the 1980s and 1990s, compelling many countries to undergo the structural adjustment programmes (SAPs) imposed by the international financial institutions (IFIs), and to abandon development planning.<sup>29</sup>

### 3.2 IFI-led economic reforms and their effects, 1980–1999

Diagnosing the development failure evident in the escalating macroeconomic imbalances as resulting from pervasive government failures, the IFIs recommended solutions to the debt crises of the 1980s and 1990s that were adaptations of policies of economic liberalization and deregulation. The reforms aimed to keep government size to a minimum in exchange for aid and debt restructuring under the SAPs.

These deregulatory policies had no place for sectoral policies aimed at fostering selected economic

activities, and regarded government intervention and support in any form as an unnecessary interference in the market mechanism. The only role of governments in economic management they judged legitimate was to maintain macroeconomic balances through short-run stabilization policies designed by the International Monetary Fund (IMF). The idea was that sound macroeconomic conditions alone would allow private investors to advance development, and that a government development strategy was unnecessary.

Yet the IMF's stabilization policies had deep flaws in their design for economies dependent on primary commodities. Primarily, they failed to acknowledge that aggregate demand management of such economies hit by external shocks<sup>30</sup> should be counter-cyclical to commodity price movements — but they were pro-cyclical. They depressed aggregate demand further by imposing severe austerity measures on economies already in recession owing to the sharp decline in revenue from commodity exports. Misdiagnosing these economies' external payment crisis due to overheating domestic demand, the IMF applied standard financial programming, with unfortunate results.

In particular, the repeated doses of large-scale fiscal retrenchment, which were part of the “policy conditionality” of structural adjustment loans in the first decade of the debt crisis, cut spending on public goods provision. Governments were left with little capacity and dwindling resources to run domestic development policies or to undertake sustained public investment. Large infrastructure projects were the first to be axed (common practice worldwide), but the fiscal retrenchment at the height of the debt crisis in the 1980s was so that even essential public goods such as basic education and health were curtailed; it was assumed that these goods could be provided on a fee-paying basis. These measures often led to fragile states with seriously depleted

29 This was the case despite its contribution to generally respectable growth and to some progress in changing the sectoral composition (de Vries, Timmer and de Vries, 2013) in the early post-independence years.

30 The collapse of commodity prices in the 1980s amounted to a loss of real purchasing power of 40–60 per cent for many such economies in Africa—a deeper crisis than that faced by most major economies during the great depression of the 1930s.

### Box 3.1 A rationale for deregulation

During the 1980s, several Western governments heavily liberalized and deregulated their economies, with a profound impact on their aid policy that contributed to a decline in donor-financed infrastructure projects.

The *World Development Report 1994: Infrastructure for Development* (World Bank, 1994) reflected this position, advocating greater private involvement and full-cost recovery in utility provision. Infrastructure lending, which had constituted about half of World Bank lending in 1987 and before fell to an all-time low of 30 per cent in 2003. The predominant view in policy circles was that once these sectors were deregulated and privatized, private investors would take over and turn around their coverage and quality.

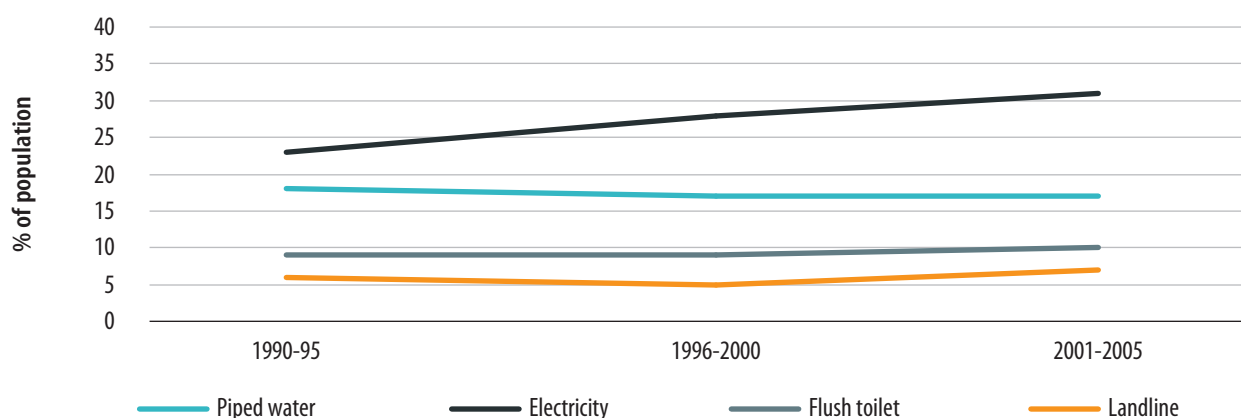
institutional capacity to build physical infrastructure or deliver essential public goods.

Such problems, then and later, were compounded by the aid reallocation of donors. They steadily reduced aid for hard infrastructure projects relative to overall aid and to aid for social spending in Africa in the 1980s and 1990s (Nissanke and Shimomura, 2013). This shift was acutely detrimental to countries whose governments just did not have the resources for infrastructure maintenance and development. It was justified on three grounds.

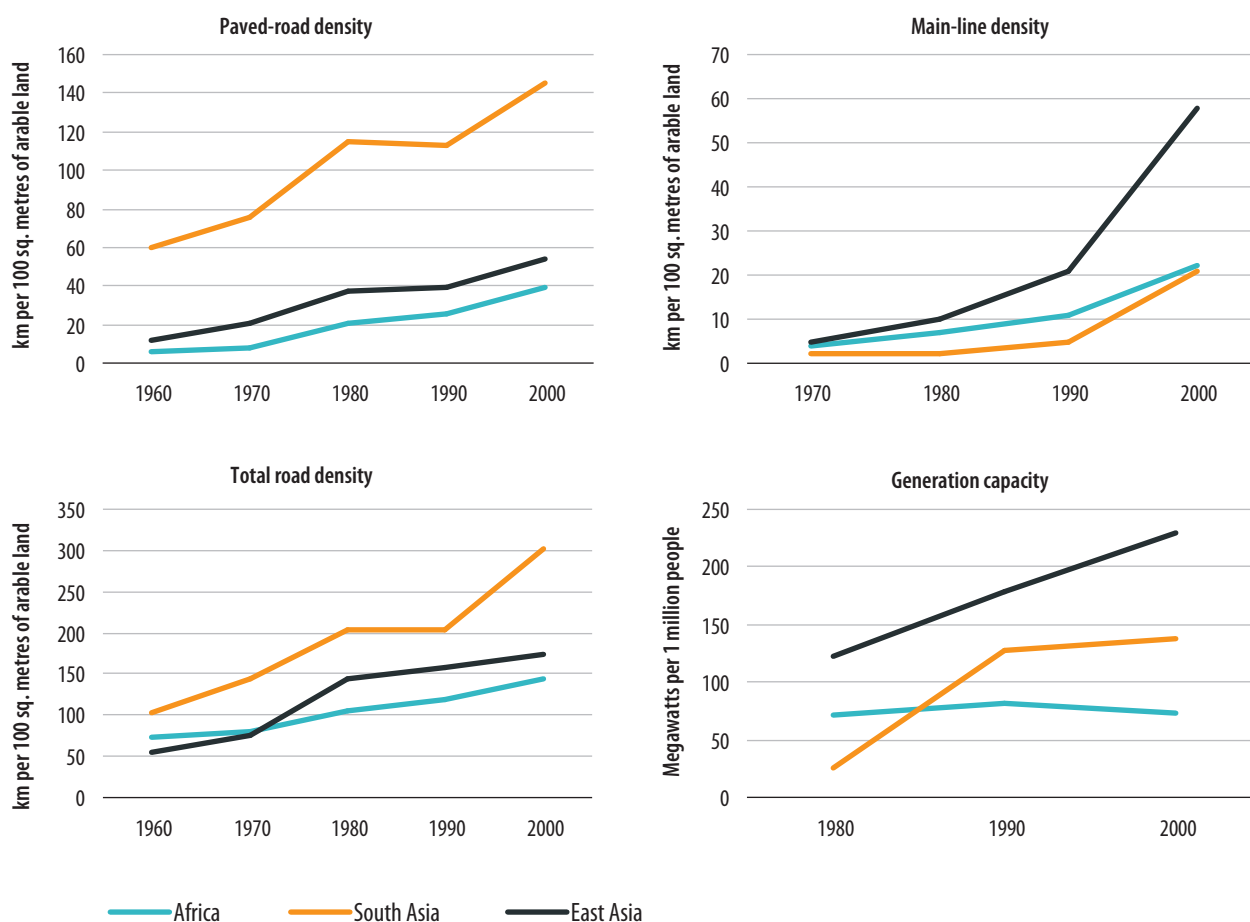
First was the perceived failure of many donor- and government-funded infrastructure projects in the 1960s and 1970s, often dubbed “white elephants”, owing to politically motivated funding, inadequate provision for recurrent and maintenance costs, unrealistic pricing, regulatory forbearance or gross mismanagement. Second was the drive pursued by bilateral Western donors (as their governments had done at home) and by the IFIs for public divesture, privatization and deregulation in infrastructure, including water, telecoms, transport and power in the 1990s (box 3.1). Third was powerful advocacy for shifting public spending towards social sectors such as health and education, partly owing to the Copenhagen Social Summit in 1995.

Yet the optimism proved unfounded. Over 1990–2002, Africa attracted far less private infrastructure investment (\$28.1 billion) than East Asia (\$199.4 billion) or Latin America and the Caribbean (\$397.4 billion). Most of it went to telecoms (66 per cent) and electricity (18 per cent), but very little to transport or water. Even then the distribution was skewed, as only a handful of countries, notably South Africa, dominated the figures (AfDB, 2006a). Africa’s stagnation on infrastructure services is clear, both absolutely (figure 3.2) and against South Asia and East Asia (figure 3.3).

**Figure 3.2 Household access to infrastructure services, Africa**



Source: Adjusted from Foster and Briceño-Garmendia (2010), Figure 0.1.

**Figure 3.3 Growth of infrastructure stocks, Africa and two Asian subregions**

Source: Adjusted from Yepes, Pierce, and Foster (2008) from Foster and Briceño-Garmendia (2010), Figure 1.4.

### The need to boost public investment to attract private investors

The paltry private investment in the continent partly reflects the big wedge between private and social returns in providing utility services to the poor in developing countries. The initial sunk costs of infrastructure investment in poor, inaccessible areas are very high, and cost recovery through pricing and user charges is (now) known to be impossible without commitments of substantial public financial resources. Appropriate pricing of services is one of the most difficult issues in infrastructure reforms in low-income countries.

As infrastructure development and public goods provision have high positive externalities and

spillovers, higher social than private returns, and high risks (in large projects with long gestation periods), the public sector should be expected to shoulder a large share of financing them at the early stages of economic development. Yet during the 1990s the opposite happened: the public sector across developing countries drastically reduced its contribution to infrastructure development.

Unsurprisingly, progress on the HDI was among the slowest in Central, East, Southern and West Africa among global regions in the 1980s and 1990s (table 3.1 and figure 3.4). Several countries individually regressed (UNDP HDI report, 2014). The South Asian region, with exactly the same HDI in 1980, forged ahead. Africa's progress has, though, picked up somewhat since the mid-2000s.



**Table 3.1 HDI, trends and annual growth, 1980–2013**

	Value					Annual change (%)		
	1980	1990	2000	2005	2013	1980-1990	1990-2000	2000-2013
<b>HDI group</b>								
Very high	0.76	0.80	0.85	0.87	0.89	0.52	0.62	0.37
High	0.53	0.59	0.64	0.68	0.74	1.04	0.81	1.04
Medium	0.42	0.47	0.53	0.57	0.61	1.22	1.09	1.17
Low	0.35	0.37	0.40	0.44	0.49	0.64	0.95	1.56
<b>Regions</b>								
Arab States	0.49	0.55	0.61	0.64	0.68	1.14	1.05	0.85
East Asia and the Pacific	0.46	0.52	0.60	0.64	0.70	1.23	1.42	1.29
Europe and Central Asia	—	0.65	0.67	0.70	0.74	—	0.21	0.80
Latin America and the Caribbean	0.58	0.63	0.68	0.71	0.74	0.79	0.87	0.62
South Asia	0.38	0.44	0.49	0.53	0.59	1.37	1.16	1.39
Central, East, Southern and West Africa	0.38	0.40	0.42	0.45	0.50	0.44	0.52	1.37
Least developed countries	0.32	0.35	0.39	0.43	0.49	0.79	1.26	1.70
Small island developing states	0.55	0.59	0.61	0.64	0.67	0.75	0.43	0.62
<b>World</b>	<b>0.56</b>	<b>0.60</b>	<b>0.64</b>	<b>0.67</b>	<b>0.70</b>	<b>0.66</b>	<b>0.67</b>	<b>0.73</b>

Source: Data from Statistical Tables, UNDP (2014) *Human Development Report 2014*.

The dwindling capacity of debt-burdened governments to undertake public investment forestalled, however, any attempts to promote or crowd in private investment, such that the low public and private investment combined severely affected economic growth and development.

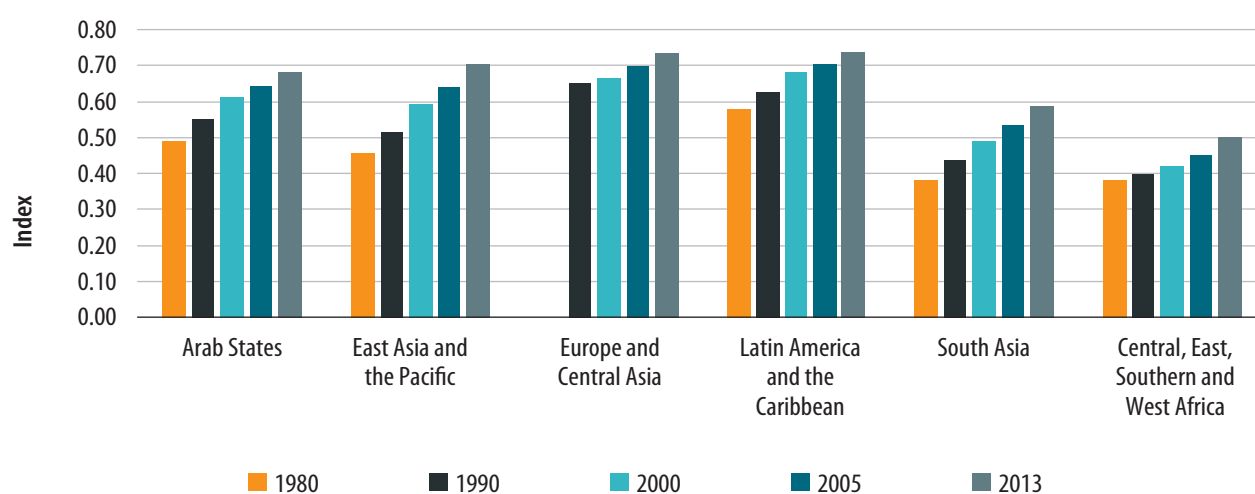
Without reliable public goods provision and a solid regulatory climate, economic transactions were often conducted in a highly uncertain and risky environment, engendering volatile returns on investment and income. Left unattended, such an environment is a powerful deterrent not only for private investment and economic growth but also for the composition of investment, favouring reversible and safe investments that have the character of self-insurance. While the wealthy could invest abroad, resulting in substantial capital flight, other private investors placed their capital in short-term assets in sectors with low sunk costs and short turnover periods, such as trading, rather than in long-term productive investment projects. In these conditions,

productive investment required for structural transformation ground to a halt.

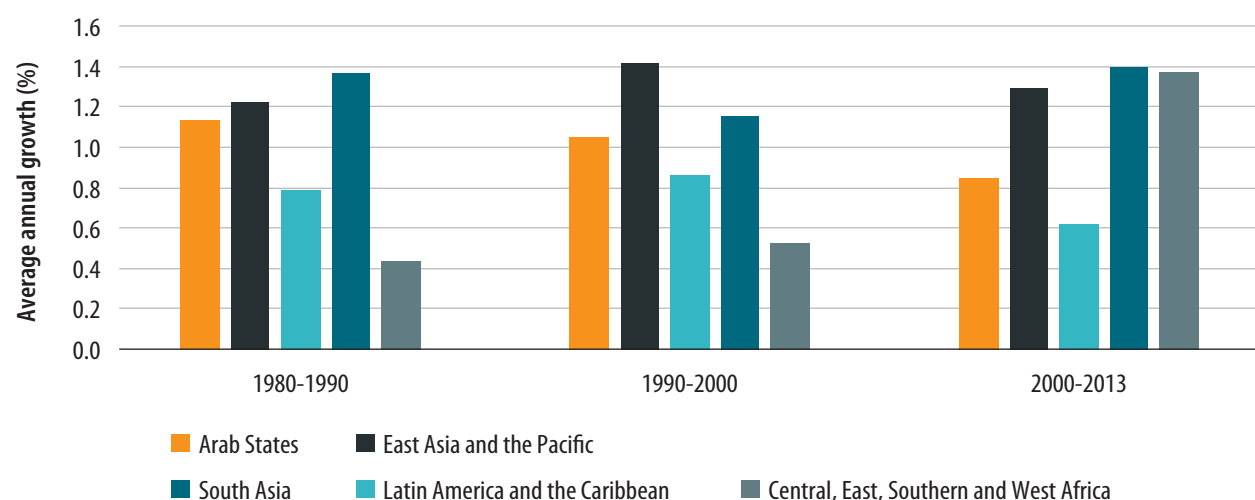
#### **An unhealthy aid relationship at times**

Thus the huge deficits in human development and infrastructure are an inevitable consequence of policy prescriptions embedded in the policy conditionality imposed by the IFIs and traditional donors. The aid relationship with the latter in the SAP era was unhealthy, and not conducive to nurturing developmental domestic institutions for structural transformation. There is nothing inherently wrong about sovereign aid and debt contracts specifying conditions that conform to internationally accepted rules or norms, but SAPs went beyond that in their *policy* conditionality, imposing a particular development model that they regarded as universal.

Better results could often have been achieved if the donors had taken a much less intrusive position, focusing on providing aid for enhancing recipients'

**Figure 3.4 HDI, trends and annual growth, 1980–2013**

Source: Data from Statistical Tables, UNDP Human Development Report 2014.



Source: Data from Statistical Tables, UNDP Human Development Report 2014.

efforts in building an institutional foundation through technical cooperation, and allowing national governments to develop their own home-grown strategies, policies and institutions (Nissanke, 2010a, 2013a; Nissanke and Shimomura, 2013). After all, policies adopted by the government may not yield the intended outcome if they are superimposed from outside without regard to existing institutional conditions, and fail to encourage the emergence of a self-sustaining system of shared beliefs or indigenous institutions (chapter 4).

Governments receiving aid are naturally required to be accountable to the donor community. This by itself does not pose problems, but high pressure from donors on important decisions over development strategy and policies that could have huge effects on recipient countries' development paths may push recipient governments close to conflict with responsibility towards their own citizens. Such situations can easily, and probably unintentionally, undermine the democratic credentials of recipient governments, as key decisions on development

strategy and policies should be made out of intensive dialogue with domestic stakeholders in any democracy.

In fact the way in which IFI-led reforms were executed in the 1980s and 1990s was not conducive to Africa's nation-state building, and the slow progress towards closing the institutional gaps cannot be fully understood without referring to the unproductive aid relationships many African countries experienced with the IFIs and the donor community during the debt crises of the 1980s and 1990s.

Given the poor growth of the first decade of the SAPs, the IFIs themselves acknowledged that simply adopting liberalizing and deregulatory measures was not enough to address Africa's development challenge, which is why they shifted from diagnosing policy failures in the 1980s to diagnosing institutional and governance failures in the 1990s as an underlying condition of Africa's inability to induce economic take-off, adding good governance to the list of reforms required. Still, facing strong criticism in Africa and beyond, the IFIs subsequently moderated their ideologically charged tone for policy prescription, leading to the post-Washington consensus. Yet the core principle of economic management, including the centrality of the imperatives for maintaining macroeconomic balances, remained intact.

### 3.3 A changing aid and economic landscape, 2000 to the present

The IFIs modified their policy frameworks for developing countries. Recognizing the need for moving away from the core principles embodied in the SAPs, the World Bank launched the Comprehensive Development Framework (CDF) to underpin its poverty-reduction strategies in 1999.<sup>31</sup> Several of its features are marked departures: the

CDF stresses the interdependence of all elements of development — social, structural, human, governance, environmental, economic and financial (CDF Secretariat, 2000). The CDF was articulated around four major principles: long-term, holistic development frameworks; country ownership of development programmes and policies; country-led partnership among various stakeholders; and results orientation (ECA, 2011).<sup>32</sup>

Unfortunately, soon after launch, the CDF lost prominence as a framework for poverty-reduction strategies and for enhancing the effectiveness of the development partnership for developing countries.<sup>33</sup> In fact, mention of the CDF has dissipated gradually from the World Bank's official policy documents, no doubt indicating its own deep-rooted apathy to a state-led planning approach.

Still, a less ambitious, more muted, version of poverty-reduction strategies has survived in the IFIs' fresh attempts to provide countries immersed in the protracted sovereign debt crises with an exit route. After launching the HIPC Initiative I in 1996, they re-launched it in the HIPC Initiative II in 1999 to HIPCs, with a country poverty-reduction strategy paper (PRSP), a conditionality for these countries' access to debt relief (box 3.2).

The aid-effectiveness debate evolving since the mid-1990s at the IFIs and traditional donors has chiefly been conducted from a narrow perspective of moral hazard arising from granting debt relief and aid without the recipient country giving a firm commitment to reform, although the protracted debt crisis of the HIPCs was finally ended with debt cancellation under the Multilateral Debt Relief Initiative in 2005. This issue also influenced the move by the IFIs to adopt a new aid allocation approach with redesigned policy conditionality from *ex ante*

31 The CDF was launched by the then president of the World Bank, James Wolfensohn, under the intellectual leadership of the Chief Economist at the time, Joseph Stiglitz.

32 ECA (2011) views the CDF as a sign of the IFIs' readiness to accept "quasi-planning" for developing countries' economic policy.

33 Stiglitz's departure from the post of Chief Economist of the World Bank amid his disagreements with the IMF on the latter's handling of the Asian financial crisis of 1997–98 and its aftermath led to a practical abandonment of the CDF.

### Box 3.2 PRSPs — SAPs with a new cover?

PRSPs were presented as a new framework to strengthen domestic accountability for poverty reduction, involving a broad range of stakeholders and covering macroeconomic, structural and social policies and programmes. Their aim was to promote growth and poverty reduction.

Yet despite such comprehensiveness, PRSPs underplay the considerable contradictions between their different components. This tension reflects, in part, the fact that PRSPs are built on an eclectic macro model, the Revised Minimum Standard Model (the RMSM), which was used to underpin the SAP model and which assumes complementarities between the SAPs' putative growth-enhancing economic policies and poverty-reduction policies. In particular, PRSPs do not explicitly question the approaches to macroeconomic policies in the SAPs. In reality, simply appending the poverty-reduction strategy to the SAP macroeconomic policy stance without attention to the complexities of the growth–poverty nexus can be problematic, throwing into relief the internal inconsistencies of the policy package.

This weakness is often most evident in country PRSPs suggesting that poverty reduction should be achieved almost exclusively through increased social spending. However, as the poor need a range of primary and secondary productive assets to reduce their vulnerability (box 5.2), fiscal expenditure should encompass broader categories

of public goods, including economic infrastructure. Further, the PRSP framework itself is largely silent on other sectoral policies or regulatory issues, generally avoiding deeper discussions of these issues and of how to finance higher fiscal spending for poverty reduction, while ensuring self-sustainable medium-term fiscal balances — that is, without perpetual dependence on foreign aid or a risk of fiscal unsustainability.

While increased social spending is of course important in any poverty-reduction strategy, unfounded expectations that poverty can be reduced only by these measures should not be encouraged. This is because poverty is an outcome of economic, social and political processes and their interactions, mediated through a range of institutions. The multidimensional nature of poverty implies that any strategy to reduce poverty should include long-term measures for changing institutional structures and environments, that is, institutional transformation.

Thus despite involving domestic stakeholders more closely, the PRSP framework is still based on the IFIs' conviction that the design of economic policy reforms under SAPs is appropriate and adequate to effect structural transformation in Africa. Policy conditionality is still seen as a means of tying the hand of recipient governments to policy reforms designed by donors.

conditionality on the promise of policy reform to *ex post* conditionality on a performance-based selectivity basis (Nissanke, 2010a). This debate now seems almost arcane, as if the IFIs and traditional donors of this confined, rather inhibiting and paternalistic discourse were unaware of the huge economic and aid-related changes sweeping over Africa since the start of the new millennium.

#### Commodity prices surge

The prices of commodities — still the economic mainstay for many countries in the region — after 2002 and until recently have seen an unprecedented boom, driven largely by surging demand for natural resources from China and to a lesser extent other emerging economies. This allowed China and other countries such as Brazil and India to increase aid-cum-investment to the continent, offering a new kind of South–South development partnership (Nissanke

and Shimomura, 2013). They heavily concentrated their activities on infrastructure and agriculture technology transfer, offering development cooperation without policy conditionality, often taking either a collaborative state-business approach through aid-trade-investment as a package (China) or private FDI (India and others). New technology such as mobile telephony and the Internet has also changed the growth constraints of access to information in remote locations.

In these favourable conditions, Africa has made some encouraging progress in building its human capital (see table 3.1 and figure 3.4), not to mention its New Partnership for Africa's Development (NEPAD) (box 3.3).

### Box 3.3 An African development paradigm — NEPAD

Throughout the 1980s and 1990s, African states searched for “self-reliant, culturally relevant and state-influenced development strategies”,<sup>34</sup> as credible alternatives to the IFIs’ development policy paradigm. Their efforts culminated in NEPAD in 2001.

It identifies internal and external conditions that have hurt Africa’s economic performance and aggravated political turmoil in the continent (NEPAD Secretariat, 2011). These conditions include inefficient revenue mobilization and aid dependence; weak central banks and inefficient financial sectors; non-transparent budgetary procedures and ineffective oversight by parliamentary and other auditing bodies; and an unfriendly environment for private investment, characterized by pervasive corruption, poor economic infrastructure and unpredictable public administration.

To tackle these impediments, based on African Union member states’ own conviction of the need for economic policy and governance

reforms, NEPAD established the voluntary African Peer Review Mechanism.<sup>35,36</sup> Acting as an agency of restraint on government policies, it promotes and reinforces democracy and good political governance, economic governance and management, corporate governance, and socioeconomic development.

Each of these four areas aims to promote democracy, accountability and transparency. In economic governance and management, for example, wide-ranging objectives have been set up, in order to promote macroeconomic policies that support sustainable development; to implement transparent, predictable and credible government economic policies; to promote sound public-finance management; to fight corruption and money laundering; and to accelerate regional integration by harmonizing monetary, trade and investment policies among participating countries.

### Spending at last on hard infrastructure

Within a few years of NEPAD’s creation, the traditional donor community belatedly recognized the vital role of public investment in infrastructure development. This was tacitly acknowledged in, for example, the Commission for Africa’s Report (2005), which called for an immediate doubling of ODA to Africa to \$50 billion a year and for about half of ODA to be spent on building infrastructure.

Infrastructure development entails not only new greenfield investment but also a huge rehabilitation backlog (figure 3.5), which will cost several times more than preventive maintenance would have

(Foster and Briceño-Garmendia, 2010).<sup>37</sup> Africa is now paying a high price for neglecting infrastructure maintenance in the 1980s and 1990s.

Though there has been a surge in private investment in some subsectors such as mobile telephony and some seaports, most of the infrastructure development still requires heavy public investment to bear the initial sunk costs or to attract private actors via a public-private partnership. For this reason governments, traditional donors, multilateral and regional development banks, and emerging-country partners have made a real push to build infrastructure, visibly changing Africa’s physical landscape at construction sites in urban centres, airports and seaports.

### Is Africa at take-off?

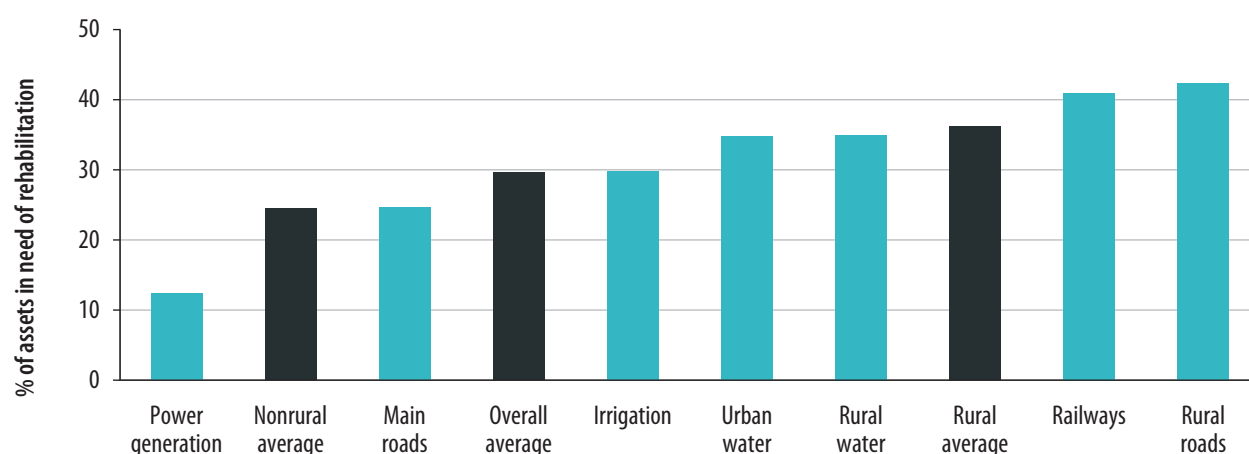
Do the recent increase in economic growth and the visible scale-up of productive investments mean that growth-enhancing structural change has taken off in Africa? There are some encouraging signs. McMillan

34 See <http://www.nepad.org/history> for a series of initiatives taken by the Organization of African Unity during the 1980s and 1990s in its efforts in transforming its focus from political liberation to economic development.

35 NEPAD has 30 African country members ascribing to its core principles and to the African Peer Review Mechanism.

36 Another peer review initiative of note is the African Progress Panel set up by 10 eminent international and African people, chaired by Kofi Annan, to promote equitable and sustainable development in Africa. It publishes annual reports to monitor the progress in economic and political governance of African countries in topical areas relevant to African economic development.

37 Spending \$1 on road maintenance is estimated to save \$4 over the longer term, for example (Foster and Briceño-Garmendia, 2010).

**Figure 3.5 Africa's rehabilitation backlog in infrastructure, c. 2010**

Source: Figure O.5, Foster and Briceño-Garmendia (2010).

et al. (2014) — in a follow-up study to their earlier paper (McMillan and Rodrik, 2011) — find evidence of a “remarkable turnaround” when dividing the data of nine African countries into two subperiods, 1990–1999 and post-2000, seeing differences in sectoral experiences behind structural change among the nine after 2005.

Their post-2000 analysis suggests four pointers hinting at an (incomplete) move to take-off: overall labour productivity growth in Africa has become second only to Asia; structural change has started making a positive contribution to overall productivity growth, accounting for 1.4 percentage points of labour productivity growth in their weighted sample and around 0.4 percentage points in their unweighted sample; in around half the nine, growth after 2000 has been accompanied by small expansions in manufacturing; and, although the size of overall productivity growth and structural change is small, certainly compared with that in Asian economies, structural change has been in the right direction since 2000.

To maintain such momentum, policymakers need to translate expectations for Africa’s rise into sustainable reality. One aspect of this will be to get the macroeconomic framework right, as well as the institutional change. With growing demand

for more accountability and transparency from public institutions and government agencies, the importance of governance reforms are now a part of Africa’s own home-grown agenda, as demonstrated by the African Peer Review Mechanism. However, Africa still needs to change institutions more deeply so as to produce a public-private partnership as the basis of a truly developmental nation-state.

African governments have risen to take on new challenges in managing their own economic affairs with growing confidence. Expressing their desire to reclaim ownership of the developmental agenda, African states have returned to strategic development: countries such as Ethiopia, Kenya and Uganda have adopted long-term development visions with ambitious growth and social development objectives, and detailed strategies and policies (ECA, 2011).

African aspirations for economic policies and governance have become more visible and gained wider outreach, while the need for structural transformation is acknowledged in an increasing number of home-grown strategy documents. Yet many of them lack detail on the key elements of appropriate macroeconomic policy, to which we now turn.

# CHAPTER 4

MACROECONOMIC  
POLICY IN A LONG-TERM  
DEVELOPMENT STRATEGY

Under the aegis of a long-term development strategy directed at the goals of an articulated economy and inclusive society, our proposed macroeconomic policy for developing countries aims to achieve twin objectives of stability and development, under an overarching policy agenda covering investment coordination, resource mobilization and fiscal sustainability, via fiscal, monetary, exchange-rate and other financial policies (figure 4.1). These policies are tied closely to building a developmental nation-state accountable to domestic stakeholders as discussed in more detail in chapter 5.

While the twin objectives can be made complementary in the long run, there is an inherent tension between them in the short run, most acutely felt in the trade-off between stability and development. In the past, stabilization objectives have not been well integrated into long-term development strategies, allowing short-run issues to drive the agenda. Most of Africa's macroeconomic policies have in fact been assessed against their stabilization objectives, and while this may be understandable in a mature economy assumed to operate not far from a full-employment equilibrium in normal circumstances,<sup>38</sup> it is certainly not suited for low-income countries with large reserves of unemployed resources waiting to be used as productive assets. This focus is wholly inadequate for accelerating Africa's structural transformation (see chapter 2).

Stabilization can be achieved through action plans within the long-term development strategy. That is, action plans should be drawn specifically with reference to medium- and long-term development objectives, using forecasting tools and models as measures for both crisis prevention and crisis management (appendix 1). In short, African countries should pursue stabilization while not losing sight of

#### **Box 4.1 Botswana, reconciling the short and long views**

Botswana is one of the few African countries that avoided the debt crisis despite its heavy reliance on diamonds for export and fiscal revenues. Diamonds are different from other primary commodities in many aspects, and so the country did not experience price shocks as deeply as other resource-rich African countries in the 1980s and 1990s. This has enabled Botswana to maintain its development-planning system.

Taking advantage of this, the government, buttressed by robust institutional and governance structures, addressed both stabilization and development objectives simultaneously, with reference to the anchor of its National Development Plans.

*Source:* Elhiraika and Bodart (2012); Robinson and Persons (2006).

development goals, as Botswana has managed to do (box 4.1).

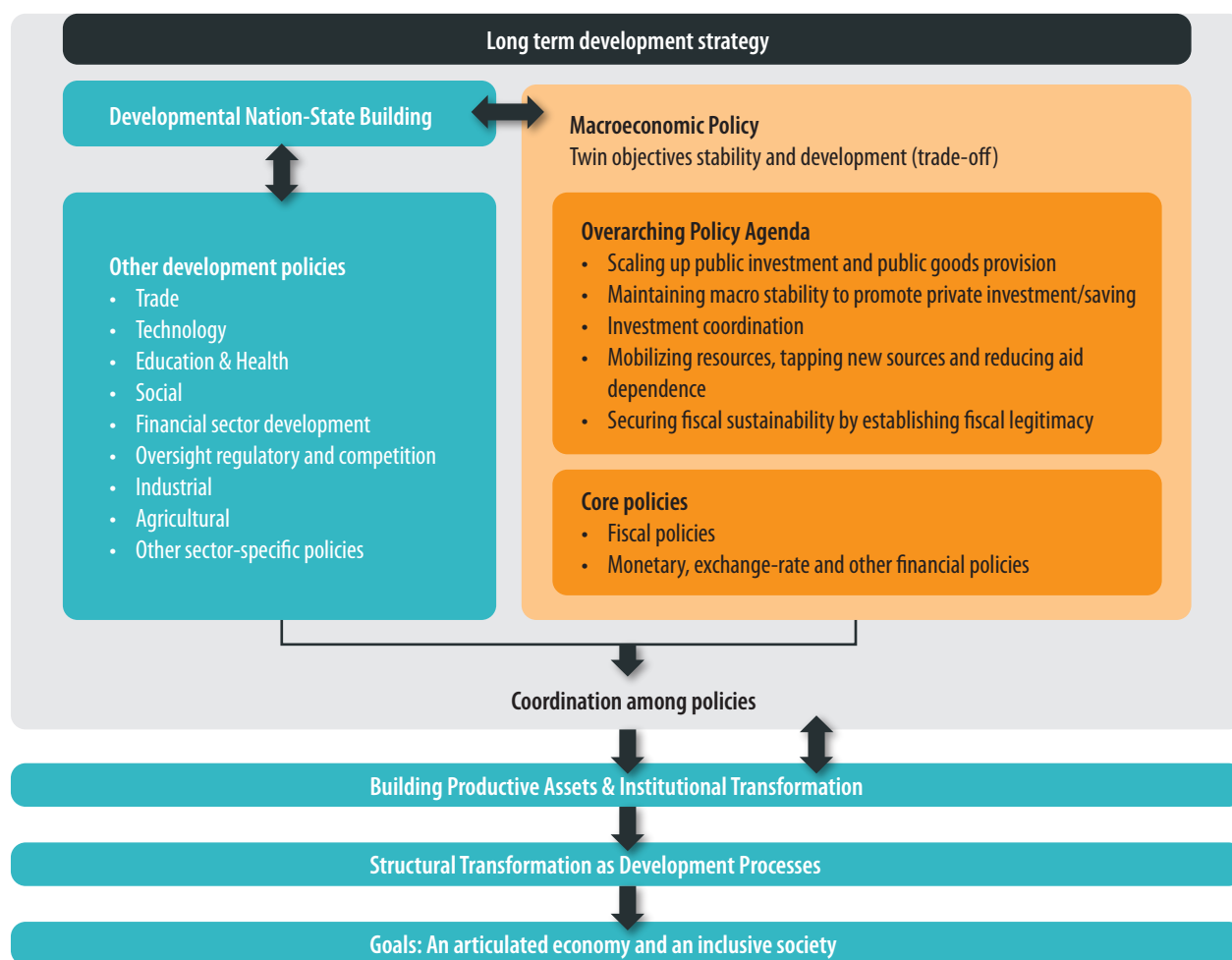
Botswana is, though, an exception. The majority of African countries have experienced difficulties in resolving the trade-off (see chapter 3). In 1960–1979, development processes of many countries were severely disrupted, despite their having planning in place, mainly owing to the absence of institutional capacity and readiness to tackle macroeconomic imbalances. In 1980–1999, incorrect stabilization policies were applied, aggravating the crisis in many countries and depleting national and individual stocks of productive assets.

The continent's macroeconomic policies should therefore be integrated into its development objectives, contained in a long-term development strategy to facilitate transformation of economic and social structures, with a view to ensuring a positive feedback loop in the investment–growth nexus and to engendering inclusive growth.

The concept of development is much broader than that of economic growth, and any long-term development strategy, which should be at the apex of the planning process (see figure 4.1), must encompass this. It is an evolving process, not just a set of targets over a particular time horizon, as in a centrally

<sup>38</sup> As discussed below, amid the fear of descending into a deep depression of the global economy at the outset of the global financial crisis, we have witnessed a revival of the policy debate on how to achieve macroeconomic stability while maintaining economic growth in advanced economies.



**Figure 4.1 Macroeconomic policy in a long-term development strategy**

planned, command economy. A regime guided by development planning requires, above all, coherent wide-ranging economic policies *and* a system of endogenously evolved institutions to navigate the process. There are very close interrelationships between institutional configurations and the quality of policymaking and policy implementation. Multilayer feedback loops interact in the institution–policy–development nexus — it is not a simple cause-effect relationship (see box 2.1). Such institutions and policies should ideally be formulated in a country- and region-specific context.

This nexus implies that a country’s institutional configuration significantly affects the government’s ability to formulate and implement its long-term

development strategy, including macroeconomic policy. At the same time, development plans and macroeconomic policies and the way they are formulated and executed influence institutional configuration and its evolution. Inter-reactive effects of institutions and policies then determine developmental outcomes, which in turn affect subsequent institutional evolution.

Macroeconomic policy lays an institutional foundation by fostering a productive public-private interface that would give rise to an emergence of a developmental nation-state. It also covers individual macroeconomic policies — fiscal, as well as monetary and financial (see figure 4.1; they are discussed in detail in chapters 4 and 5). These are embedded in the long-term

development strategy, the latter providing an anchor for strategic policy decisions for navigating the trade-off between stability and development.

The policy's "overarching agenda" is critical for spanning the three deficits identified in chapter 2. Although the issues are interrelated, we discuss them under five headings.

#### 4.1 Scaling up public investment and public goods provision

Africa at its stage of development requires a big push in public investment — economy-, region- and continent-wide — in the coming decades. Without committed public investment, sustained private investment will not be made, causing overall productive investment to fall below the level needed to keep the growth momentum going. This scale-up has to be conducted in a financially sound manner (section 4.5 and chapter 5), and should be made in light of an economy's absorptive capacity, which itself should increase as it starts reaping the gains from its productive investments.

#### 4.2 Maintaining macro stability to attract and sustain private investment

As public investment is necessary for provision of public goods, it needs to scale up initially to address Africa's pervasive market failures, and then to crowd in larger private investment from private agents. To secure strong private investment, macroeconomic stability is essential, as high uncertainty and risks deter private agents from making forward-looking productive investments. At the same time, harsh fiscal retrenchment and overly restrictive monetary policy aimed at attaining the stabilization objective only cannot take the transformation agenda forward.

In conventional macroeconomic policy debate since the early 1980s, monetary policy has been increasingly given primacy over fiscal instruments in counter-cyclical aggregate demand management, reflecting the growing influence of the monetary school over the

Keynesian school. However, in navigating a dynamic path to achieve macroeconomic balance in the short run, a return to Keynesian policy in the framework suggested by Jan Tinbergen (appendix 1) should be our first reference. He postulates that policymakers are required to have the same number of policy instruments as policy targets.

Reliance on one single policy instrument — monetary, as in the original version of inflation targeting (chapter 6) — has had to be critically reappraised after the global financial crisis of 2008–2009. Policymakers globally were forced to adopt large fiscal stimulus to attenuate its impact (though the austerity/stimulus debate drags on). This episode demonstrates the importance of other policy instruments in navigating imbalances.

#### 4.3 Coordinating investment and other development policies

Public investment using scarce resources should be made selectively, sequenced and directed to achieving the highest development dividends in the long run. This requires public and private investment to be well coordinated across sectors in a big push with aggregate demand spillovers to facilitate "a move from a bad to a good equilibrium" (Murphy et al., 1989), especially given the well-known market failure of coordination (appendix 2).

Other development policies critical for structural transformation include trade, technology, financial development, oversight (regulation and competition), social matters, education and health, and sector-specific policies such as those for industry and agriculture (see figure 4.1). Pro-development, and pro-investment macroeconomic conditions should be set, allowing for inter-temporal and spatial consistency.

#### 4.4 Mobilizing resources and reducing aid dependence over time

The scaling up of productive investments requires a stable supply of financial resources of considerable

size for many decades to come. For mobilizing development finance from private sources, it is critical to develop financial institutions (banking and non-banking) and deepen financial markets. This topic is picked up in more detail in chapter 6.

Several frontier-market economies such as Kenya, Nigeria and South Africa have deepened their financial markets over the last two decades for raising funds in domestic equity and bonds markets. More recently other low- and low-middle-income countries such as Ghana, Rwanda, Tanzania and Zambia have turned to international capital markets for infrastructure finance, taking advantage of international investors' increased appetite for holding African assets in their search for higher returns. Foreign investors have also been increasingly involved in equity financing. However, such portfolio flows are extremely volatile and unpredictable (chapter 6), and high reliance on them risks replaying financial crises in Africa this time.

Development finance should be sought from more stable sources of funding, such as domestic savings or overseas investors committed to Africa's development, including remittances and inflows from the diaspora via, for example, diaspora bonds. Yet Africa's banks, operating in an environment of high transaction costs and poor information, are still reluctant to extend loans to domestic entrepreneurs, especially small and medium-sized enterprises. Instead they hold excess liquidity in low-risk assets with a short maturity, such as treasury paper. Nor are they active in mobilizing savings. These weaknesses need to be tackled.

On public finance, Africa must develop and secure a stable domestic revenue base, as foreign aid flows are volatile and unpredictable — and it is time to address the aid-dependence syndrome that some African countries suffer from. Fragile, post-conflict countries

will remain aid dependent for budgetary support for some time, but others should lay down a concrete path leading to graduation from aid dependence, by firming up their own revenue base, by arresting illicit financial outflows, and by building a robust tax system.

#### 4.5 Securing fiscal sustainability by establishing fiscal legitimacy

The recommended surge in public investment cannot materialize in a fiscally fragile environment. An escalation of fiscal deficits in an unsustainable, even explosive, manner would risk macro instability. There is an urgency to develop the capacity of prudent and efficient public finance management. But this must be the bedrock of a relationship between the government and domestic actors, for fiscal sustainability can only be secured in the medium to long run on such a foundation (see chapter 5). The scaling up of public investment and provision of public goods requires increased and stable tax revenues, which is more likely when private agents are assured that their government is accountable to them and serves their collective interests. For this, the quality of governance at all levels of public institutions should be vastly improved by rooting out corruptive practices that have led to large-scale illicit financial outflows from the continent. In a word, Africa requires institutional transformation to build a developmental nation-state, which keenly recognizes the centrality of taxation in public goods provision.

To resolve the above five issues on the overarching policy agenda, governments need to apply fiscal, monetary, exchange-rate and other financial policies coherently as part of a planned whole, moving away from the all-too-common fire-fighting response to crises of the past. Most of the rest of this document looks at these policies in more detail.

# CHAPTER 5

## MACROECONOMIC POLICY — FISCAL POLICIES

## 5.1 Institutional perspective of fiscal sustainability

Fiscal policy should, above all, be subject to prudent and disciplined management of public resources, and governments should conduct it with utmost transparency and accountability to domestic stakeholders. It is one of the critical conduits for advancing structural transformation in its dual role of providing public goods and mobilizing resources, which explains the importance of firmly anchoring it (including public finance management) in the country's long-term development strategy.<sup>39</sup>

It is also important to deploy an integrated approach to the two sides of the fiscal balance — revenue and expenditure — instead of focusing merely on a net balance or reducing the deficit.<sup>40</sup>

On the revenue side, from an institutional, political-economy perspective, the nexus between taxation and public goods provision should be treated as an implicit social compact between the government and other stakeholders, a fundamental element in a productive public-private relationship. An extension of Aoki's analytical framework (chapter 2) is pertinent to developing a tax policy conducive to such a relationship. Defining government as a strategic agent maximizing its fiscal revenue, Aoki et al. (1996: 17) note “whether government chooses to act as a predator or as a promotor of the private sector depends critically on the quality of its tax apparatus. A revenue-maximizing government with a poor tax apparatus will always choose to act as a predator”. Thus he suggests that, to restrain government from acting as a predator,<sup>41</sup> a nation-state should have a

high-quality tax-collection system and information-processing capability.

With predatory government behaviour (or the possibility of it), private agents refrain from making risky, forward-looking productive investments. With a weak tax base, a predatory state may extract as much income, or rents, from them as possible, without consideration of the future. This has happened in autocratic governments of resource-rich countries in Africa, where politicians lacked any incentive to develop an efficient tax system or engage with domestic private actors, as they could privately access resource rents in non-transparent dealings with foreign oil or mineral companies.

On the expenditure side, Bates (1981, 1983) and Teranishi (1996) suggest that in the early post-independence years, autocratic regimes in Africa used more extensively than did other regions divisive fiscal instruments such as subsidies or preferential credits as favoured mechanisms to buy political support or to appease various interest groups. In these circumstances, some governments became hostage to a narrow political-support base, often in urban areas, while the patronage distributed in this way became an increasing burden on public finance.

Distributive conflicts inherent in any society are more likely to be exacerbated by the proliferation of patron-client relationships and patronage arising from the widespread use of such instruments, and risk turning the state predatory. Governments of many African countries with their urban public-spending bias were criticized for ignoring agriculture and failing to undertake inclusive public investment in rural areas. Politically favouring an urban group or groups, they sometimes disenfranchised the majority, especially in rural areas, from development.

These outcomes were in sharp contrast to East Asia's experience, where the poverty-reducing effects of globalization and integration were not purely manifestations of market-driven growth. In most of East Asia, the inclusive pattern of public expenditure in favour of the rural poor, with reforms aiming at redistributing productive assets such as land at early

39 See Elhiraika and Bodart (2012) for a discussion of how having an anchor in the development-planning framework would enhance public expenditure effectiveness, using two case studies of Botswana and Malaysia.

40 Public offices responsible for fiscal policy should also be guided by three principles—fiscal discipline, allocative efficiency and operational efficiency.

41 Under a predatory regime, private firms and rural households would have little incentive to carry out investments on their own unless such investments were supported by the government or they were assured that they could keep a substantial portion of the returns.

stages of development, produced and sustained the shared growth process for some time (section 2.1).

It is of course naïve to explain the differences in patterns of fiscal expenditures simply along developmental versus predatory state lines to characterize the autocratic regimes of early post-independence East Asia and Africa (Botswana, for example, avoided this institutional trap). But the conditions in Africa in those years may be related to the dilemma facing predatory states as discussed in the literature on comparative institutional analyses (Nissanke, 2015b).

The IFI-sponsored economic reform programmes were of course meant to address these governance problems, with the results seen earlier (chapter 3). The key fiscal point is that without functioning formal institutions, economic activities were restricted to small-scale production and local trade, leading to a weak and narrow tax base. The continued poor provision of public *goods* and the fragile fiscal condition kept many economies condemned to a low equilibrium, leading to a fragile state with a reduced institutional capability. Historical experiences worldwide suggest that fiscal fragility aggravates distributional tensions and conflicts in ethno-linguistically fractured societies, as in Africa, and therefore without attending to this institutional trap governments could make little progress in nation-state building.

The gradual transition from personal or authoritarian rule to democratic regimes since the turn of the 1990s was important in laying the institutional foundations for broad-based development. Democracy cannot, however, work in an institutional vacuum. As Aoki (2001) notes, institutional configurations for supporting the democratic state as a stable self-enforcing equilibrium can emerge only through active interaction between the government and private, domestic stakeholders.

African governments' high dependence on foreign aid has seriously undermined progress towards building a developmental nation-state. Hence it is imperative to secure fiscal sustainability and

legitimacy by building a solid domestic revenue base to provide domestic stakeholders with high-quality public goods. This would bring about a double dividend: escape from the vicious circle of fiscal fragility characteristic of African countries in the past; and an institutional foundation for governments' and public institutions' transparency and accountability to domestic stakeholders in public finance management. With increased credibility of their government's ability to provide public goods and undertake compelling investments in basic infrastructure, domestic stakeholders' readiness to contribute towards tax revenues should rise.

What is required is a solid institutionalized mechanism for productive dialogue between policymakers and domestic stakeholders.

## 5.2 Establishing fiscal legitimacy with high-quality public goods provision

The weighted average tax ratio measured as a ratio of all collected taxes to GDP for African countries had risen sharply since the mid-1990s to a peak of 27 per cent in 2008 just before the global crisis, recording an almost 10 percentage point increase over 15 years. The rise was driven mainly by resource-based taxes in resource-endowed countries, particularly oil-producing countries. Resource-based tax revenues in Africa as a share of GDP on average surged from 3 per cent in 1998 to 15 per cent in the late 2000s.<sup>42</sup>

The tax-to-GDP ratio varies widely, of course, depending on natural-resource endowments and incomes. By country group classified by income, the tax ratio of low-income African countries in 2012 was about 17 per cent, and for lower-middle-income countries just about 20 per cent. Upper-middle-income African countries had a tax ratio of 34.4 per cent that year, converging with the average tax ratio in OECD countries of 35 per cent (AfDB et al., 2014). For Africa as a whole, the average tax-to-GDP

<sup>42</sup> This ratio was strikingly high in some countries at the close of the 2000s: 66 per cent in Libya and 39 per cent in Angola, for example. (AfDB et al, 2010)

ratio was 26 per cent in 2012, higher than in many developing countries in Latin America and the Caribbean or East Asia and the Pacific, where the ratio remained around 10–17 per cent by the close of the 2000s. But this is not in itself good news (box 5.1).

The unbalanced tax mix, including excessive reliance on a narrow set of taxes, reflects the extremely shallow tax base that most African countries rely on, in large part a reflection of high levels of informality in economic activities and huge administrative constraints in collecting taxes. Hence mobilizing more public resources and achieving fiscal sustainability cannot be addressed simply by increasing tax rates from the existing narrow base.

Tax issues are a deeper symptom of the structural issues in domestic public resource management. This suggests that fundamental changes in the political economy of fiscal sustainability are needed. The current low equilibrium of poor public goods provision and fragile tax revenue need to be overcome as a first step towards fiscal consolidation, but this — including broadening the tax base — can be achieved only if governments and public agencies establish the firm legitimacy of fiscal operations by providing high-quality public goods and services, as part of the implicit social compact.

For now, though, those in the informal economy, concentrated in fragile activities offering no basic labour rights or social protection, often suffer from social exclusion, and are not part of that compact. By the nature of their activities they operate outside the tax net. It is often reported that many see little benefit in paying taxes, whether direct or indirect, as they see little tangible payback in public services or goods. For the same reasons many stay informal: AfDB et al. (2010) note that informality often arises where the costs of legal employment outweigh the benefits for producers, employers or employees. If entry costs into a regulated economy are unaffordable, people and businesses are forced to remain outside it.

But if governments start to deliver high-quality public goods at affordable cost, this would serve as

### Box 5.1 An unbalanced tax mix

What makes Africa's tax mix different from such mixes in other developing regions are:

- A very heavy reliance on resource-based taxes, especially in resource-rich countries.
- A very small share of direct taxes (personal income and corporate income taxes combined) in most African countries, often 5–7 per cent.
- Within direct tax, corporate tax revenues are low against potential corporate income tax revenues, at least partly because many countries have granted too many tax concessions and exemptions to corporations.
- The conditions that lower-income countries increased the share of indirect taxation despite its regressive nature, and that land tax and property tax, which are more progressive and could be a key source of tax revenue, are absent in many countries.
- The high share of trade taxes in poorer countries.

an incentive for informal units to register, because an act of formal registration of their business and activities would be viewed as a means of allowing them to secure legal protection as well as access to public services. This shift could start the process of transforming informal fragile activities into more robust ones with their higher propensity to make forward-looking productive investment.

The primary objective of formalizing in the initial period is therefore to trigger this transformation. Once it is substantially under way, the newly formal entities could well form a reliable source of tax revenue. The starting tax rates applied to these fragile activities should, though, be set at an extremely low level, almost a token rate. Encouraging registration as a formal entity should not be motivated by the desire to raise revenue, but by the need to mainstream informal units, so as to attack the root cause of their fragility.

Institutional changes required to crack a historically formed behavioural impasse in public-private relationships may be slow to instil, as institutions are extremely path dependent. However, concerted efforts on all fronts should make a difference, helping to lift institutional constraints and freeing an



economy from the low-equilibrium institutional trap. This means establishing fiscal legitimacy in the eyes of domestic stakeholders.

Mainstreaming informal activities should be a part of the strategy to improve public resource management more widely. The fiscal mechanism should also be used for distributional purposes, so that a genuine public-private partnership can be forged.

### 5.3 Staunching illicit cross-border financial flows and improving public resource management

The unbalanced and shallow tax base in African countries today, in particular their strikingly heavy reliance on resource-based tax revenues, is not only testimony to the continuous susceptibility of fiscal revenues to commodity boom-bust price cycles but also a result of the historically evolved weak incentives for governments to forge a meaningful partnership with domestic stakeholders.

The poor management of public finance and weak governance is a feature of most African countries, as evident in their low scores on the Worldwide Governance Indicators or the Corruption Perceptions Index (chapter 2). Naturally, fiscal legitimacy cannot be established in environments where domestic stakeholders have little trust in public office holders' resource management. Rampant corruption at government offices and public institutions would deprive private agents of incentives to contribute to tax revenue.

The problems are especially acute for resource-rich countries where governments have direct access to natural-resource rents. And the number of such states is growing: over recent years, several countries that until now were regarded as resource poor and agrarian, such as Ghana, Kenya, Mozambique, Tanzania and Uganda, have discovered oil, gas and other natural resources. Africa as a continent therefore has to make yet greater efforts to manage resource rents inter-generationally for broad-based development in the decades to come.

### Capital flight — corporate and individual

The scale of illicit financial flows from Africa is enormous, depriving African economies of a vital source of internally generated development finance. Resource rents and other public resources have often been siphoned off by political leaders and other actors, benefiting in particular from weak governance, lack of transparency and global financial liberalization (ECA, 2013).

Ndikumana and Boyce (2011) suggest that the size of African capital flight is staggering, in both absolute terms and relative to GDP. Constructing data from balance-of-payments statistics of 33 countries in Central, East, Southern and West Africa, they estimate that more than \$700 billion fled the continent over 1970–2008. Including interest earned at market rates on the accumulated personal wealth, that value jumps to \$944 billion — not far from the GDP for Central, East, Southern and West Africa in 2008 of \$997 billion.

Thus instead of being used for development purposes through fiscal mechanisms, resource rents and rents extracted in political processes (political rents) have left the continent en masse through non-transparent transactions or illicit channels used by high-profile politicians or other government officials with access to public funds. These people have accumulated large personal wealth in foreign bank accounts or in real estate assets overseas. Illicit financial outflows are not, however, a thing of the past and seem not to have abated, despite collective efforts like, for example, those of the African Peer Review Mechanism.

Thomson Reuters Foundation reports an estimate by a Washington-based research group, Global Financial Integrity, that Africa lost \$55.6 billion each year in the decade to 2011, with outflows growing at 20 per cent annually.<sup>43</sup> According to the same source \$1.3 trillion was lost to illicit financial flows from Africa over

43 See an article published at the Thomson Reuters Foundation site report on 8 August 2014, <http://www.trust.org/item/20140808080141-h5x8o/?source=jtOtherNews1>.



1990–2008, with about one third from North Africa. ECA (2013) reports various estimates that the annual average of illicit financial flows from Africa could be \$50 billion–\$148 billion a year. This compares with the estimated annual infrastructure funding gap of \$31 billion.

Outright corruption by those holding public office should never be tolerated to start with, but has been allowed because of weak governance in most African countries. The scale of the outflows has been made worse by the involvement of foreign counterparts, who have also benefited from Africa's immature institutional environments in which robust regulatory oversight, functional legal systems and democratic institutions are yet to emerge.

According to the estimate reported in ECA (2013), at least 70–80 per cent of total illicit financial outflows are accounted for by aggressive exploitation of opportunities available to private corporations over commercial transactions. For example, TNCs can mis-invoice trade transactions in goods and services, taking a proportion of profits out of Africa. Other opportunities include transfer pricing, costing Africa huge resource rents that could have been used for development.

Many of these practices have been available to TNCs because of the way negotiations over FDI, resource exploration, extraction and concessions or privatization have been allowed to take place between themselves and governments. Nor has privatization of mining concerns, pursued in the 1990s at the insistence of the IFIs as their solution to massive embezzlement of mineral wealth and rents by politicians, necessarily addressed serious developmental concerns over the use of resource rents.

Negotiations over privatization and direct investment with TNCs in the future should ensure that a fair share of resource rents stays with host countries, so that rents advance their developmental agenda. Africa saw a considerably weakened position of governments after privatization in the 1990s owing to excessive tax preferences, inefficient taxation of

extractive activities or states' inability to fight abuses of transfer pricing.

Under the negotiated arrangements for privatization and the resulting TNC-dominated ownership of mineral concerns, policy space for autonomous fiscal and monetary management has been heavily cut in some African countries. Zambia, for example, found itself in a much less favourable position than Chile in distributing or using its mineral rents (Nissanke, 2010b). Given a public outcry over unfair tax regimes for mineral rents negotiated under earlier secret deals, its government was forced to renegotiate the initial fiscal concessions accorded to TNCs.

In a similar vein, Aarsnes and Pöyry (2010) argue for more transparency and the need for host countries to move away from agreements with individual TNCs made via closed-door negotiations. They emphasize the merit of establishing open, general, transparent non-negotiable fiscal terms enacted directly in the tax law, as in most developed countries. In particular, they suggest that host countries should have tax systems and tax rates neutral relative to the TNC's home country, or clearly benchmarked against comparable countries in the case of capturing resource rent. Their proposal is specifically intended to avoid unnecessary fiscal competition and to reduce TNC's incentives to use transfer pricing to repatriate profits.

Domestic constituents should also be automatically accorded a democratic right and an institutional channel through which they can express their insistence on complete information of negotiated terms as well as total transparency of the process. After all, their country's assets belong to them. Political leaders and government officials should understand that they are entrusted to represent these constituents' interests in negotiations and thus to be fully accountable to stakeholders, including the voiceless poor.

### **Why not a race to the top?**

Most negotiations on FDI between TNCs and host governments have produced outcomes decidedly in

favour of TNCs, because host countries — too fearful of losing TNCs' interest — have offered unnecessarily generous fiscal concessions through granting tax holidays or lower tax and royalty payments. With asymmetric access to information on TNCs' global strategy combined with little transparency of negotiation, these discussions often led to a race to the bottom in granting excessive tax exemptions by competing host governments.

Ironically, such tax incentives are not always among the top criteria for TNCs, which must also consider other aspects such as the size of potential national and regional markets or skills of local labour (with horizontal and vertical integration); the quality or other technical properties of natural-resource deposits (resource-based FDI); transport costs and other transaction costs; and overall political and economic stability. Policymakers should therefore contemplate a race to the top, focusing on improving these fundamental conditions. Beyond attracting investment, such improvements would also lay a solid foundation for socioeconomic development more widely. Over the past decade, many African governments have already made such moves, stressing the enabling environment for doing business, which is crucial for both domestic and foreign investors.

#### 5.4 Turning natural-resource wealth into productive assets through inclusive fiscal spending

Fair fiscal distribution requires effective and robust institutions for collective action to represent the interests of diverse groups, as well as for conflict resolution over distribution matters. Undoubtedly, it takes time for such institutions to emerge and function as endogenous institutions, as this is part of the efforts to build a developmental nation-state with democratic representation. In the absence of effective and fair institutions, rent distribution can be very contentious in a policy domain, and if amicable political settlement cannot be attained, tensions can easily escalate into conflict among contesting groups in an ethno-linguistically fragmented society.

Further, competition for rent distribution can assume an unproductive character in countries where a patrimonial order of blending the public and private sectors is more readily accepted as the norm. Over recent decades, many African states have moved away from such ready acceptance, but many political scientists still suggest that African politics is essentially neo-patrimonial (for example, Kelsall, 2013; Booth and Cammack, 2013).

Establishing the principle and mechanisms for transparent and fair fiscal distribution of resource rents, irrespective of group, can be a critical step towards institutional transition from an older patrimonial order of governance into a developmental nation-state under democracy.

Lacking the institutions for initiating inclusive fiscal expenditure in the past, resource-rich African countries trail at the bottom of international rankings in most indicators of human resource development, with persistent poverty and worsening inequality (African Progress Panel, 2013).

One of the most effective ways to distribute natural rents for development objectives is to make fiscal expenditure decisively inclusive, aiming to turn a country's natural-resource wealth into productive assets of the poor. Box 5.2 gives a perspective of poverty through an institutional lens.

Inclusive fiscal expenditure should aim to sharply raise all aspects of productive assets of the poor. This involves consolidating the size and quality of primary and secondary assets through constant public investment in primary assets and steady provision of high-quality public goods, including the infrastructure to enhance secondary assets, with collective efforts at making institutional parameters and environments inclusive and developmental. In this way, fiscal mechanisms are used for distributional purposes, so that a genuinely functional public-private partnership can be forged. Fiscal expenditure policy can then play a pivotal role in converting natural-resource wealth into productive assets of all domestic stakeholders, including the poor.

### Box 5.2 Assets — vital for the individual's well-being

Individuals have access to assets of different types, and these assets generate returns at different rates. The asset size of each individual, as well as the level and volatility of returns to these assets, usually determine his or her well-being. They can be primary, attached to individuals or households (private goods), or secondary, accessed through local communities or extra-communities (public goods).

Primary assets can take different forms, encompassing the natural (land, pasture, forests, fisheries and water); the human (household composition and size, health and nutrition status, education, and skills and knowledge); the physical (productive and household assets, livestock and food stocks); and the financial (cash, savings, and access to credit and insurance markets). Secondary assets can be social (household social ties and networks, intra-household dynamics), locational, infrastructural, political and institutional.

Poverty at the individual level is usually evaluated on a combination of extremely low levels of primary assets held by the poor; very low returns on these assets; and high volatility in returns to these assets. These attributes of primary assets, which determine the incidence, depth and severity of poverty, are in turn influenced by access to secondary assets and to a range of institutional parameters. That is, secondary assets and institutional parameters together constitute the institutional environment that affects — even determines — the level of and returns to primary assets an individual possesses.

The majority of Africa's population is endowed with a very meagre stock of productive assets in all forms. Governments face a massive challenge in building them, as evident in huge deficits in all three key areas discussed above (human development, infrastructure and institutions). Yet as argued earlier, governments' firm commitment to enhancing productive assets through public investment can generate a virtuous circle of development dividends.

Latin America and Asia have used many successful inclusive interventions and pro-growth poverty-reduction strategies through innovative arrangements. Most are gender-centred, grass-roots interventions, which have been found to best reach all members of poor households, notably the women

and children. They go beyond conventional micro-finance institutions established for widening access of the poor to financial services, now in many parts of Africa. They are forward looking, linking public goods provision to enhancing the primary assets of the poor (Thorbecke, 2013).

## 5.5 Managing public finance and sovereign debt sustainably

For fiscal policy to advance structural transformation in Africa, prudent and sustainable management of public finance in the face of highly volatile resource rents and tax revenues is essential. To avoid replicating past experience with forced fiscal retrenchment in crises, macroeconomic management over commodity cycles has to be improved.

### Aggregate demand management in theory

The case for counter-cyclical aggregate demand management at a time of commodity boom has been well covered since the literature emerged in the 1970s and 1980s. Whilst the political economy of rent creation and distribution associated with a resource boom — in particular unproductive rent-seeking behaviour by economic agents and outright resource looting — is extensively discussed in the resource curse literature<sup>44</sup> the adverse macroeconomic effects of positive commodity price shocks are deliberated in the Dutch disease literature. The latter model examines boom-induced structural changes that affect adversely the long-term development pattern and the potential of resource-dependent economies through spending, resource-transfer and monetary effects.<sup>45</sup> The model predicts that the three effects

44 See, for example, Collier (2007), Auty (2001), Sachs and Warner (2001), among others.

45 For the pioneering works on the three main mechanisms of engendering Dutch Disease syndrome, see Corden and Neary (1982), Corden (1984), Neary and Van Wijnbergen (1986) and Edward (1989). See Bevan et al. (1999) and Collier et al. (1999) for the related "construction boom" literature which makes a sharper distinction between permanent and temporary trade shocks and examines the differential effects of the two types of shocks on the formation of agents' expectations, and hence their saving behaviour.

reinforcing each other can lead to an appreciation of the real exchange rate and to a de-industrialization or de-agriculturalization of the booming economies. In short, the commodity boom can be a curse.<sup>46</sup>

However, as argued by Nissanke (2010c), Dutch disease is not inevitable, and its symptoms are commonly observed because economies tend to run into short-term absorptive capacity bottlenecks at a time of boom-induced euphoria or a sudden influx of foreign exchange. Intelligent execution of macroeconomic adjustment policies through fiscal and monetary policies, coupled with effective management of international financial flows and exchange rates over the commodity price cycle, can mitigate shocks and attenuate market forces, limiting overshooting and Dutch disease effects.

The policy of time-phasing is key to creating a mechanism whereby a sudden increase in foreign income can be absorbed by the domestic economy gradually and then used effectively over an extended period commensurate with its progressively incremented absorptive capacity. In short, a policy of de-synchronization of the path of absorption from that of income should be central to macroeconomic adjustments in response to commodity price fluctuations.

Hence the question of an intertemporally optimal allocation of resources over the commodity price cycle becomes an issue of intelligent portfolio management of a whole range of domestic and foreign assets and debt instruments in the light of the current and expected risk – return structures. A country's net lending position vis-à-vis the rest of the world will evolve, as it essentially accounts for the difference between its income and expenditure (absorption) at the time. An optimal portfolio choice of domestic and foreign assets is thus country specific, depending largely on its initial income and

capital endowments, and its absorptive capacity evolving over time.

Mishandling these policies on boom management entails a heavy cost to advancing the developmental agenda. It could amplify the effects of external shocks and market forces, thereby aggravating Dutch disease effects and resulting in policy-induced overshooting. Moreover, such mismanagement in the upward phase of the cycle would require austere stabilization policies during the downward phase, which could contain much harsher measures than would otherwise have been needed, usually damaging the social fabric because the most vulnerable are hit first.

The cost to the economy of imprudent spending during the boom period could therefore be intolerable if the cost is calculated over the complete price cycle, because the downward adjustment costs could outweigh any benefit derived from the windfall. Many African countries dependent on primary commodities found that the cost of mismanaging their windfalls from the commodity boom of the 1970s was escalated by the very harsh austerity measures imposed by the IFIs in the downturn phase of the cycle (see chapter 3).

### Stabilization funds in practice

An efficient, counter-cyclical intertemporal allocation of resource rents and asset portfolios should be a critical part of intelligent fiscal management for structural transformation. One of the counter-cyclical measures widely discussed in the literature on the Dutch disease is to facilitate absorption-smoothing over commodity price cycles, for example, by accumulating foreign assets in commodity-stabilization funds abroad.<sup>47</sup> Many high- and middle-income countries such as Norway and Chile have abated Dutch disease effects by moderating the

46 See Gelb (1988) and Gelb and Grassman (2008) for detailed empirical examination of the effects of windfalls on oil-exporting developing economies. See Van der Ploeg (2011) for more updated literature on this and related issues for resource-rich economies.

47 See Nissanke (2010d) and Nissanke and Kuleshov (2013) for critical assessments of the proposal of using macro-hedging with derivative instruments as an effective substitute for counter-cyclical macroeconomic management through commodity stabilization funds. For such a proposal see Borensztein et al. (2009)

transmission of commodity price shocks to the rest of the economy through stabilization funds. Chile adopted a formal structural fiscal balance policy in 2001 with a view to developing a cyclically neutral fiscal policy, where current expenditure is stabilized by linking it to the structural level of fiscal income (Ffrench-Davis, 2010).

A counter-cyclical fiscal policy entails the accumulation of revenues from the resource sector during booms, and the use of these revenues when prices fall. This policy not only stabilizes revenues over the commodity price cycle but also reduces the pressure on the exchange rate to appreciate during the boom. Such a policy can effectively be implemented where revenue from natural resources accrues to governments (box 5.3).

Some countries could not conduct such management in the recent boom because they obtained very unfavourable terms when privatizing their mineral concerns, which were often negotiated under the auspices of the IFIs. For example, the Zambia Consolidated Copper Mine — a large state-owned mineral complex — was privatized in the 1990s at a time of historically low copper prices. It was split into several companies owned by TNCs, with the government retaining a small share and with TNCs securing very low royalties, and export and profit taxes. For this reason mining's contribution to the fiscal budget was marginal even when copper prices shot up to historical highs during the commodity boom.

Further, foreign exchange incomes earned from copper exports have gone directly into the currency market under the float-cum-monetary-target regime rather than into the central bank. This has not only generated a pro-cyclical movement in exchange rates (large appreciation during the boom and sharp depreciation in the bust), but also prevented the Zambian government from establishing a stabilization fund. Zambia was left with little room to pursue counter-cyclical interventions.

However, the practicality and efficacy of implementing such macroeconomic policy do not depend solely on how mineral rents are distributed

### Box 5.3 Stabilization funds in Norway, Chile and Botswana

In Norway the state ownership of oil and gas resources has made it possible to save windfalls through its Pension Fund, both to stabilize income and ensure intergenerational income transfer.

The government of Chile retains a 40 per cent share in the huge, privatized copper-mining company, having negotiated reasonable returns from the private companies in royalty payments and taxes when it privatized Codelco.

A new taxation regime for the mines approved in 2005 has contributed handsomely to accumulating fiscal surpluses in absolute terms and as a share of GDP during the copper boom that started in 2002–2003. The invested surpluses were used to attenuate the macro shocks from the global financial crisis, including building safety net measures for the vulnerable poor.

Among African countries, Botswana has followed similar fiscal rules over many years, with the government saving rents from diamond revenues or investing them as part of counter-cyclical demand management. It has refined and updated these rules from one planning period to the next. Many oil-exporting countries have established sovereign wealth funds during the recent commodity boom (AfDB et al., 2014).

between domestic stakeholders and TNCs and how they are managed. Many low-income African countries may find it hard to conduct because it requires high technical knowledge and institutional capacity, and because the opportunity cost of holding savings abroad may be too high in view of immediate pressing needs to accelerate economic development and reduce poverty.

### A slight change in tune from the IMF

A 2011 paper by van der Ploeg and Venables examines different development paths of resource-rich and low-income countries on receiving positive income shocks, challenging the IMF's conventional policy advice on the basis of the permanent income hypothesis. This posits that resource-rich countries should save a temporary windfall from resource booms in foreign assets, for example, in a sovereign wealth fund, to support a sustained increase in



consumption into the future with interest earned on accumulated foreign savings.

Van der Ploeg and Venables (2011) present five reasons for not following such a conventional advice used to be given by the IMF:

- This strategy is not optimal for capital-scarce developing economies given their initial limited stock of productive capital.
- Incremental consumption should be skewed towards present generations in the light of the prevalence of poverty and the huge demand for accelerating development.
- Saving should be directed to accumulating domestic private and public capital rather than foreign assets, so as to bring forward the development path of the economy, particularly to accelerate growth of the non-resource economy.
- Windfall revenues are particularly useful for reducing distortionary taxes and foreign debt.
- Optimal policy depends on the impact of distortionary taxes required to fund public investment as well as consumers' ability to borrow against future revenues without paying a high interest rate, or that of governments to access international capital markets without a high premium.

Acknowledging the immense development challenge facing low-income countries due to their limited productive capital, the IMF has re-examined frameworks for resource-rich developing countries, appreciating some of the recommendations made by van der Ploeg and Venables (2011). IMF (2012a) considers the question not only of how much to save, but where to save (foreign assets or domestic capital) in light of low-income countries' characteristics, such as low per capita incomes, scarcity of domestic capital and limited access to international capital markets. It proposes frameworks and tools for macroeconomic management of resource-rich developing countries to be used for providing policy advice on a range of issues, including weighing expected rates of return to alternative investments, evaluating absorptive capacity constraints, accounting for the possibility of Dutch disease,

assessing the downside risks of commodity-price collapse, and considering possible debt distress.

IMF's proposed frameworks incorporate several innovations in its policy advice, including a fiscal sustainability framework that accounts for the growth- and revenue-enhancing impact of public investment; a sustainable investment tool to analyse the fiscal and macroeconomic implications of saving/investment scaling-up scenarios; fiscal indicators to measure the savings from and use (consumption or investment) of resource flows; a framework that generates current account benchmarks for external sustainability analysis; and new tools for designing fiscal rules that smooth revenue volatility and assess long-term fiscal sustainability.

These policy frameworks and tools are underpinned by two Dynamic Stochastic General Equilibrium (DSGE) models for a small open economy (box 5.4 and appendix 1).

In both models, however, for actual calibration and simulation exercises for the long period spanning over 25 years, compromises had to be made on key parameters such as absorption capacity or public-investment efficiency. And because country-specific values for these parameters are simply not available, they have to be substituted with evidence gathered from other countries or regions, or with a value arrived at by deduction or guesswork.

The results from the debt sustainability analysis are used in IMF's Article IV consultations for all low-income countries to determine their sovereign borrowing options and levels allowed on the basis of the debt sustainability analysis conducted for each country from all available sources, including concessional and non-concessional borrowing. For resource-poor low-income countries, which do not have much possibility of conducting intertemporal allocation of their own savings obtained from windfalls in a boom, sovereign borrowing constitutes a venue to consider for financing a scale-up of productive investments for the foreseeable future. Maintaining debt sustainability is thus still critical for achieving fiscal sustainability.

### Box 5.4 Two DSGE models used in the IMF's fiscal and debt sustainability analyses

DSGE models have recently been developed at the IMF to examine fiscal and debt sustainability under alternative dynamic paths of internal and external macro balances and other key parameters resulting from taking a specific policy decision such as scaling up public investment (Berg et al., 2012; Buffie et al., 2012). The IMF is working on combining the sustainable investment tool with the debt sustainability framework so that a unified model can be applied to countries that wish to scale up investment using natural-resource revenues and external borrowing.

Berg et al. (2012) develop, for example, a dynamic stochastic small open-economy model with three production sectors: natural resources, non-traded goods and non-resource traded goods. The model is used to analyse the macroeconomic effects of a resource revenue-financed scaling up of public investment, taking into account the structural characteristics of these economies such as public-investment inefficiency, absorptive capacity constraints, weak tax systems, Dutch disease effects, revenue volatility and exhaustibility, and financing needs to sustain capital. The model allows analysts to determine the appropriate size of the investment scaling-up for meeting the financing needs to sustain capital on the one hand, and the adequate size of a stabilization fund as a buffer on the other. It demonstrates a sustainable investment approach — via a combination of raising public investment and saving some of the

resources in a resource fund — that helps to meet development needs, preserve resource wealth and maintain economic stability.

A similar two-sector DSGE model was developed by Buffie et al. (2012) to examine the public investment–growth nexus for projecting coherent long-run, forward-looking debt sustainability of low-income countries of Africa. The two-sector model with traded and non-traded sectors was built to allow an analysis of real-exchange-rate and terms-of-trade shocks with three types of public sector debt (external concessional, external commercial and domestic) and three agents (firms, consumers and government).

Their model incorporates several characteristics specific to such African countries, including limited absorptive capacity due to coordination problems or supply bottlenecks during the implementation phase of public-investment projects; low efficiency of public-investment spending, assuming that spending on public investment does not lead to an equivalent increase in the stock of public capital because of the possibility of waste or spending on projects with poor returns; slow response of the private sector; difficulty in adjusting taxes and spending, which is necessary for servicing debt in the face of limited, exogenously given aid and the concessional funds available; dominance of hand-to-mouth consumers; and limited access to international capital markets.

The use of such macroeconomic models could enhance technical aspects of macroeconomic management of African economies and could enrich discussions on policy options and future actions. In particular, an application of calibration and stress tests could inform various simulated scenarios; help to apply empirical information, for example, on project rates of return; and allow more systematic risk assessments. The models provide a useful toolkit for making informed decisions on different policy options, limited by the particular construct and assumptions of the models.

#### Models can be useful — when used intelligently and with caution

We should of course be mindful of mechanically applying calibration/simulation results from macroeconomic models. For example, if productive investment can indeed bring about a major shift in economic structure, spillovers and social returns in

a short period (as in East Asia), predictions made on historical data may not be so useful. Hence an interpretation of calibrated results for fiscal and debt sustainability 20–25 years from now should be made with this in mind. Good judgement backed up by detailed country-specific knowledge is required: models are only guides to the route — they are not the route itself.<sup>48,49</sup>

More generally, the increasing sophistication of models and calibration techniques cannot replace

48 This is particularly so in light of serious problems associated with the use of debt-burden thresholds practised widely to date for the IFIs' Debt Sustainability Framework (Nissanke, 2013).

49 No economic forecasting exercises even in advanced countries with more sophisticated modelling and more reliable data can claim to pass an accuracy test of small margins of error, for a shorter period of up to five years, let alone for 20–25 years as made in the IMF's fiscal and debt sustainability analyses. Any forecasting of macroeconomic balances and debt burden indicators beyond five years or so is very unlikely to have much predictive power.

efforts in engaging with the concepts of fiscal or debt sustainability at a deeper level. There is a need for going beyond discussing macroeconomic variables such as fiscal and current account balances in net terms or aggregate ratios. Deficit financing or indebtedness on its own is not a problem if the selection and management of debt-financed projects is sound, and if sensible debt management and an efficient facility to deal with downside risks and debt-distress management are in place. Debt financing should be viewed as one of the mechanisms for overcoming low-income countries' structural handicaps over time, that is, to address developmental bottlenecks through investment. Debt sustainability should imply that accumulating liabilities today creates productive assets tomorrow.

Debt management as well as all budgetary allocations should be embedded in a well-run system of public finance management with transparency and accountability to all parties. Further, prudent and responsible management of public finance

and sovereign debt should be framed in terms of fundamental development issues, such as how to enhance an economy's absorption capacity and debt-carrying capacity; how to increase efficiency of public investment over time at macro and micro levels; and how to increase growth and development dividends from publicly financed investment projects. The sustainability of debt and development are closely linked.

These questions inevitably involve efforts in enhancing the capacity of public-investment management throughout project cycles via learning by doing. Above all, publicly funded investment projects should be selected with reference to a country's structural transformation agenda upfront. Potential investment projects should be evaluated not just along narrowly specified technical criteria, like self-financing. Projects with large positive externalities and high social returns should be given priority, and closely monitored, to maximize the growth and development dividends.



# CHAPTER 6

MACROECONOMIC  
POLICY — MONETARY,  
EXCHANGE-RATE AND  
OTHER FINANCIAL  
POLICIES

## 6.1 The debate on inflation-targeting shifts

How domestic monetary policy is conducted has important ramifications on macro stability, a critical condition for inducing productive fixed investment. But such stability alone is not enough for accelerating Africa's structural transformation. Although most African countries have brought down inflation over the last two decades, structural change has not been at the scale Africa needs. So what has gone wrong?

As part of our macroeconomic policy, monetary policy is important for creating an environment conducive to scaling up productive investment, by explicitly setting out stability and development in its twin policy objectives (see figure 4.1).

Yet as a reflection of the increasing dominance of the monetary school over the Keynesian school in macroeconomic policymaking since the early 1980s, the debate on appropriate monetary policy has been conducted mainly with the purpose of achieving macro stability, in which monetary policy is assumed to take a primary role (chapter 4). With this shift in emphasis, the scope of conventional monetary policy discussions has narrowed, with a focus firmly and increasingly placed on the choice between the two domestic monetary policy regimes: inflation targeting (IT) and monetary-aggregates targeting.

This narrow debate has reflected the nature of the dominant academic literature in monetary policy for some time, manifesting itself in the “great moderation” thesis in 2004 by Ben Bernanke, in which the efficacy of macroeconomic management is almost exclusively found in the adoption of IT as a universal means to ensure monetary and macroeconomic stability.

A recent IMF policy paper on monetary policy conditionality (IMF, 2014c) epitomizes this angle of the debate, focusing its discussion on the choice between a monetary-aggregates and an IT regime, noting: “Many developing countries have moved away from operating monetary policy frameworks centered solely on periodic quantitative targets for

monetary aggregates to greater reliance on policy rates to signal the monetary policy stance” (p. 5).

### Simplicity beguiles

The supremacy of the IT regime over monetary-aggregates targeting rests on the ease of communicating the central bank's monetary policy stance to the public. With the advent of liberalization of financial systems and policies, financial markets have deepened considerably with emergence of innovative financial instruments globally. This has weakened the association between monetary aggregates (money) and inflation rates (price), and the gradual loss of the power of the monetary policy with enfeebled transmission channels under monetary-aggregates targeting.

IT is in fact the latest attempt to find a robust nominal anchor for monetary stability. It anchors inflationary expectations of private agents in a transparent and coherent manner, certainly compared with previous attempts in seeking an anchor for currency stability under exchange rate-based stabilization or in a stable monetary base under money-based stabilization. Under the IT regime, an anchor is sought in the institutional set-up, in which the credibility of a central bank in pursuing its policy objectives is enshrined in an institutional guarantee of its independence, in which its accountability and transparency are paramount. Hence the IT regime is intended to put much greater weight on credibility and rule-based decision-making.

Although the earlier interpretation of the IT regime with the one-target-one-instrument rule has been increasingly challenged following the global crisis (see just below), the IT regime has gained popularity as a superior regime for its simplicity, in particular in its original interpretation that there is only a single target and a single policy instrument — the interest rate. All a central bank then needs to do for monetary policy is to follow its policy rate rule.

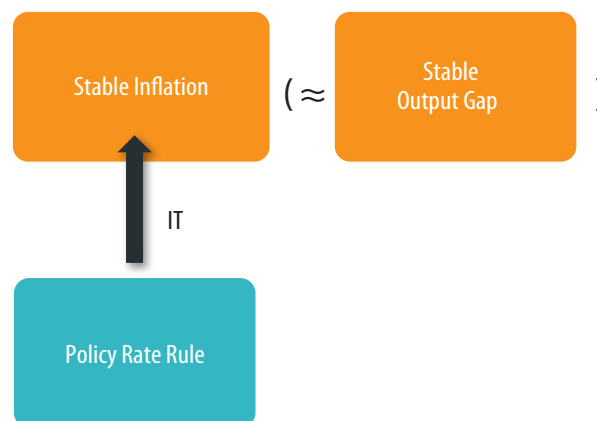
Such rule-based decision-making is thought superior to a discretionary approach as it can overcome time-inconsistency problems arising out of dynamic

interface/feedback loops between policies and private agents' expectations. It is presumed that this property would allow simpler and easier communication to the public, because the IT regime is *seen* to provide a credible, rule-based anchor in forming the inflation expectations of the public.<sup>50</sup>

The beauty of the IT regime's simplicity — one target of low, stable inflation with one policy instrument — was too much for many macroeconomists and policymakers alike to resist concluding that they had found a magic wand in conducting monetary policy for ensuring macro stability by reducing volatility in the two key variables — output and inflation. Central banks globally, in developed and emerging countries alike, enthusiastically embraced the IT regime lured by this premise. Many developed countries' central banks adopted it as a framework, believing that stable inflation would deliver economic stability at large, including a stable output gap (figure 6.1).

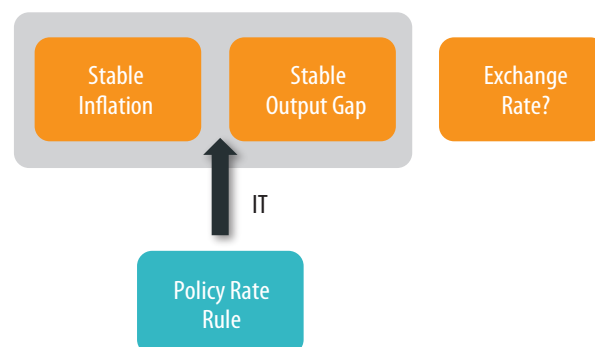
There are some variations in the mandate given to those central banks that were granted formal independence from politicians and the ministry of finance (treasury). In the US, for example, the Federal Reserve Board continued to have growth and inflation targets, and so adopted flexible inflation targeting, an approach in which central banks are allowed to carry out temporary deviations from the inflation target to stabilize what they see as the output gap. Central banks in some emerging market economies such as Brazil have instituted an exit route of some discretionary nature in light of a greater effect of exchange rate movements on monetary stability, without having the exchange rate as a target (figure 6.2). For example, in Brazil under the IT regime adopted with a switch from a managed-band exchange rate regime to a market-based regime in 1999, it is stipulated that exchange rate movements should only affect central banks' functioning if they are at odds with the inflation target. Other central

**Figure 6.1 IT before the crisis in developed countries**



Source: Blanchard (2012), figure 1.

**Figure 6.2 IT in developing and emerging market economies**



Source: Blanchard (2012), figure 4.

banks, such as the Bank of England, in contrast, have a single target — low, stable inflation, often set at 2 per cent.

In Africa the majority of central banks have been for some time on reserve-money programmes, in which central banks' balance-sheet operations are the instrument and base money is the operational target. Most African central banks have continued using broader monetary aggregates as their intermediate

50 For central banks responsible for monetary policy under the IT regime, the public means, above all, financial institutions and market participants, representing holders of shares, other assets and wealth, rather than domestic stakeholders generally.

targets, within a version of the IMF's financial programming model. However, many central bankers in Africa have been attracted to the IT regime and its rule-based simplicity. South Africa was the first to adopt it. With the IMF's technical support, others such as Ghana and Kenya, with relatively deep financial markets — a precondition for a successful IT regime — followed suit. Many other central banks on the continent are considering elements of inflation targeting, including an emphasis on policy coherence, transparency, forecasting and communication with the public (O'Connell, 2013).

IT may not be suitable for most countries on the continent, in particular given the cost-push nature of inflation in African countries, which has disproportionately large effects on the livelihoods of the rural and urban poor (below).

Africa has not witnessed intense, open debate among policymakers or domestic stakeholders on whether the IT regime is alone suitable for achieving the twin objectives of stabilization and development, and whether to choose a rule-based or discretionary regime: the fear is that the cost of achieving credibility in maintaining low inflation may be too high in foregoing other equally important policy objectives. IT may, for example, negatively affect the trajectory of development through the real exchange rate and financial volatility due to highly volatile, pro-cyclical capital inflows (section 6.3). Other technical questions (that other countries have aired in public) have not been raised in the public debate, but simple ones are, for example, whether Africa is ready for the IT regime in light of its shallow financial markets. For its part, with Africa's financial deepening, the IMF recommends that its central banks consider shifting to IT.

### **No longer one target, one instrument**

All the more interesting therefore is that a critical evaluation of IT in its original form came from the IMF's chief economist, Oliver Blanchard, questioning what went wrong with macroeconomic policymaking before the global crisis, pondering the circumstances that made the US and some European economies

centres of that crisis: "The fact is that there are many targets and there are many instruments. How you map the instruments onto the targets, and how you use these instruments best is a very complicated problem" (Blanchard, 2012: 1).

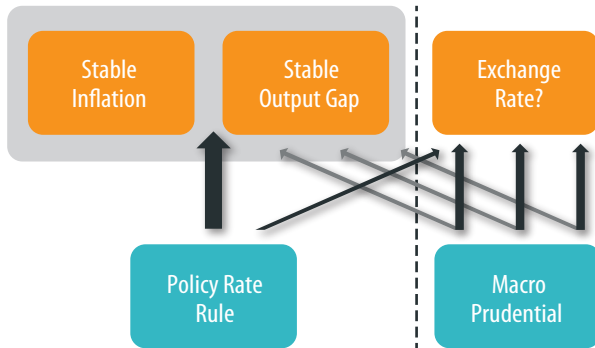
The IT regime of the period before the crisis failed to pay attention to fragility developing in financial systems and markets, leading to a post-crisis consensus among many economists suggesting that the list of targets must include financial as well as macroeconomic stability, and that the single policy rate instrument cannot achieve both financial and monetary stability.<sup>51</sup> Many central banks are thus now pursuing a solution to maintain financial stability via other policies such as macro prudential tools, so as to prevent systemic risks in financial systems from developing uncontrollably.

In his reappraisal of the IT regime, Blanchard (2012) asserts that the link between inflation stability and the output gap is much less tight than previously assumed. Hence the policy rate cannot achieve macro stability, because by itself it cannot reduce volatility in output *and* prices. His overall conclusion is that central banks should move from a one-target-one-instrument world to one with many targets and many instruments, with the following: "We need to think about monetary policy in a broad sense, as having many targets — at least three — inflation, output, and risk — and having many instruments .... We must also realize that most instruments are going to affect all three targets in some way" (Blanchard, 2012).

The IT regime, seen as a neat solution to macro stability before the crisis, has since been evolving into a regime with multiple objectives and targets on the one hand, and more policy tools on the other (figure 6.3). In addition, the central banks of advanced countries have been forced to resort to unconventional monetary policies in the form of quantitative easing. Faced with first recession and

<sup>51</sup> This is an equivalent to an acknowledgement of the need to revert back to a Keynesian approach for macroeconomic policymaking (chapter 4 and appendix 1).

**Figure 6.3 IT after the crisis in developed countries**



Source: Blanchard (2012), figure 3.

then slow recovery since the onset of the global financial crisis, most of the central banks have kept policy rates near zero for over seven years in an effort to revitalize economies. Under such conditions policy rates cannot be actively used as an instrument.

If the IT regime is not a panacea in advanced economies, it cannot be one for the multiple objectives facing developing countries. To begin with, the IT regime could never be a sole solution to

**Box 6.1 How food and fuel prices drive headline inflation in Tanzania**

By decomposing the headline price index into three components — food, energy, and non-food core prices — Adam et al. (2012) conclude that food prices are mainly determined by supply factors such as highly volatile agricultural outputs, caused by lack of irrigation and exacerbated by spatially fragmented domestic markets and inadequate storage. Food prices are a major element in the headline inflation index; the non-food core price index is determined mainly by monetary policy.

Money growth and hence the stance of monetary policy both matter for inflation in the long and short runs, but food is the main item in the consumption basket of the majority of basic wage goods. Hence food price inflation, and so overall inflation, need a policy to tackle supply-side factors, including both domestic agricultural output shocks and the pass-through from world prices for food and fuel.

cost-push inflation, as in many developing countries, including Africa, where the recent rise in inflation is tied to escalating food and fuel prices (box 6.1), large currency depreciation or both. In Africa, increased prices of wage goods such as food are usually caused by shocks on the supply side, such as crop failures or steep rises in prices of agricultural inputs, including fertilizer. Further, many countries in Africa, including agriculture-based economies, are no longer self-sufficient in food, and rely increasingly on food imports. Thus high inflation accompanied by excessive price volatility cannot be addressed effectively by the IT regime as practised in advanced countries. Cost-push inflation of this kind requires policies that address the root causes behind these supply shocks domestically as well as attending to volatile currency movements.

Central banks should not be content with a single focus on keeping inflation stable, but instead should tackle the question of how to make sure inflation targeting is not pursued at a cost of low growth and high unemployment. The empirical evidence suggests that low policy rates lead to excessive risk taking, thus requiring macro prudential tools, which not only affect systemic risk, but also have macroeconomic effects such as higher loan-to-value ratio that affects housing investment and thereby GDP.

Policymakers in Africa should critically evaluate other countries' policy experiences in light of conditions in each country. African economies should have an integrated macroeconomic framework that guides domestic monetary policy alongside exchange rate policy, as their exposure to highly volatile currency movements affects macro stability and monetary conditions greatly.

**6.2 An integrated approach to domestic monetary and exchange-rate policy, and capital-flow management**

Optimal exchange rate management for a small, open economy depends on policymakers' objectives, the source of macroeconomic shocks and the economy's structural characteristics. For

such an economy, exchange rates are universally regarded as the key relative price to determining its macroeconomic configuration. The choice of the exchange rate regime for developing and emerging market economies is complicated because the exchange rate policy affects external and internal balances as a stabilization and expenditure-switching policy instrument. In the latter guise it influences not only net external trade balances (through competitiveness of tradable goods) but also internal resource allocation (between tradables and non-tradables through changes in the real exchange rate).

In earlier debate, this dual role had given rise to two approaches for an appropriate regime among development macroeconomists (Agénor and Montiel, 1996): the real-target approach to keep tradable goods internationally competitive so as to ensure a sustainable current account position; and the nominal-anchor approach to ensure domestic monetary stability. In the face of real shocks to the current account, the first approach aims to provide greater flexibility to the exchange rate, the second greater stability to nominal variables to ensure financial discipline.

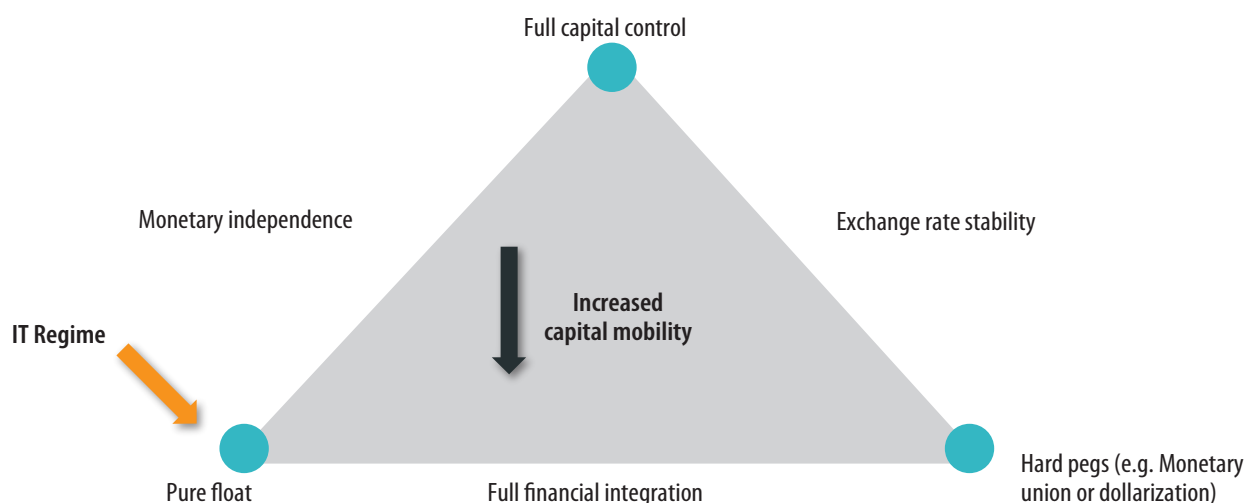
A compromise has to be made if one of the two approaches is chosen without attention to the other's objective, involving necessarily a trade-off between flexibility and stability, which should be assigned relative weights. For example, if policymakers' objective is only to achieve macro stability by attaining a stable inflationary environment, they may opt for a nominal anchor exclusively, in particular for hard peg regimes. Under hard pegs, exchange rates are fixed to a stable hard currency via a currency board as adopted in Argentina in the 1990s; a monetary union whose exchange rate credibility is supported by a particular institutional arrangement as found in the CFA zone backed up by the French authorities; or complete dollarization as in Panama. The hard peg makes it impossible to respond to external shocks through adjusting the currency and so may impose a substantial cost in terms of forgone growth, investment and development more widely, and its rigidity may force policymakers to abandon the arrangement, as happened in Argentina in 2001.

### Staying flexible

A degree of flexibility is critical in exchange rate policy in many developing countries. For example, a developing country whose current account position imposes a constraint on economic growth may need to give attention to its developmental objectives such as increasing competitiveness of tradable goods or diversifying a narrowly specialized economy with the high reliance on primary commodity exports. For this type of economy, including most African countries, it is imperative to have an exchange rate policy that lets them increase the competitiveness of newly emerging tradable goods on domestic and foreign markets, and develop non-traditional exports. Here, Rodrik views an undervalued currency as a developmental policy tool for structural transformation. He suggests, "Of all methods of subsidizing modern tradables, perhaps the most effective is currency undervaluation. Growth promoting structural change is greatly assisted by a highly competitive real exchange rate ... [, and] undervaluation helps offset market and government failures that are endemic to underdevelopment" (Rodrik, 2011: 38–39).

Given these policy considerations, there are grounds to argue that an intermediate regime such as a target-zone or crawling-band system may be the best option for many developing and emerging market economies, as such systems combine elements of both flexibility and stability. In theory, they could provide some scope for an independent monetary policy in a world of free capital mobility as adjustment within the band permitting the exchange rate to bear part of the burden of absorbing unanticipated real and monetary shocks. They could also potentially provide an anchor for monetary stability because monetary discipline is required to keep the exchange rate within the band.

In practice, a central issue that needs to be resolved for sustaining any intermediate regime is, however, how to establish the credibility of policymakers' commitment to such exchange rate regimes. It is on this credibility issue that the prospect for the intermediate regime option was severely tested by

**Figure 6.4 Positioning in macroeconomic trilemma**

Source: Adapted from Frankel (1999), Fig. 1 for illustrating policy options under financial globalisation.

Note: IT = inflation targeting.

the currency and financial crises that plagued many emerging market economies in the 1990s.

### The impossible trinity

As financial globalization has accelerated, discussions on appropriate exchange rate regimes for emerging market economies have increasingly been framed by the “impossible trinity”, or trilemma (figure 6.4). According to this theory, policymakers in open economies face a macroeconomic trilemma: that is, while they typically have three desirable objectives (exchange rate stability; full financial integration, such as free international capital mobility; and monetary policy independence to engage domestic economic goals), they are in practice forced to give up one objective, as only two out of the three can be mutually consistent.

Some argue that the only exchange rate regimes that remain viable in an era of cross-border capital mobility are the two bottom corner positions (a pure float or a hard peg). This position is referred to as the two-corner view, also known as the hollowing-out hypothesis or the bi-polar view. For example,

Eichengreen (1999: 134) concludes that “... a middle ground of pegged but adjustable exchange rates and exchange rate target zones will hollow out, and policy makers will be confronted with a choice between floating and monetary union”. By the early 2000s, the two-corner view held a dominant position in the debate on appropriate exchange rate regimes for emerging market economies.

This position is driven by the imperative of financial globalization, which itself has been severely questioned in the aftermath of the global crisis. The arguments rest on the assumption that financial openness alone should not be challenged in the trinity, either because of the considerable benefits that financial openness has been promised to produce in emerging economies, or because free capital mobility is inevitable due to changes in global technology, market structure or politics. While the impossible trinity applies to any open economy, the policy constraint is particularly severe for emerging market economies, reflecting their disadvantaged position in global finance. As Eichengreen and Hausmann (1999) note, emerging market economies are handicapped by the “original sin” of incomplete



domestic financial markets as an additional source of financial fragility, which makes them more susceptible to financial and currency crises.

This financial fragility is closely tied to their asymmetric position against advanced countries in international finance as well as to their structural characteristics. Few of them, for example, have the ability to issue international securities in domestic currency. The prevalence of the “fear of floating” (Calvo and Reinhart, 2002) or the “case of hard pegs” (Calvo, 2000) in emerging market economies is also closely linked to liability dollarization<sup>52</sup>; fear of inflation due to high pass-through coefficients (i.e. measurements of the speed of transmission of devaluation to inflation); and their nascent capital markets. Despite the strong case made by many influential macroeconomists for the two-corner view (such as Fisher, 2001), Husain et al. (2005) argue that intermediate regimes have proved the most resilient, at least up to the mid-2000s.

The IT-cum-pure-floating-regime was the IMF’s preferred policy regime for emerging and developing economies before the crisis (see figure 6.4). The IT regime is intended to operate under a pure float, as a nominal anchor is assumed to be provided by a credible institutional commitment to the IT regime, thus superseding the argument for a fixed regime as a nominal anchor. The IT regime is popular partly because it allows an economy to opt for a floating regime in a world of free capital mobility, the commitment to IT rendered credible by institutional arrangements for ensuring transparency and accountability for monetary stability.

Yet as Frankel (1999) suggests, the impossible-trinity thesis does not, in principle, preclude countries from having a half-independent monetary policy and a half-fixed exchange rate policy by adopting an intermediate regime such as a target zone; nor does it stop an economy from having an independent monetary policy and a fixed exchange rate, if it imposes capital controls.

52 Financial contracts are expressed in foreign currency.

The optimal combination of an exchange rate and monetary policy regime is of course not set in stone, but instead varies by country characteristics. Yet many developing economies fear a floating currency, not only because of high pass-through rates and their increasing liabilities expressed in foreign currency but also because of frequent supply shocks and vulnerability to external shocks.<sup>53</sup>

### From trilemma to dilemma, and a reappraisal

African policymakers should be forward looking on the choice of exchange rate and monetary policy regime, given increasing integration of their economies into international capital markets, and may wish to take note of a conclusion by Rey (2013), who examined the impact of international capital flows on global financial cycles. She found that in fact the global financial cycle transforms the trilemma into a ‘dilemma’ or an ‘irreconcilable duo’: “independent monetary policies are possible if and only if the capital account is managed, directly or indirectly via macroprudential policies” (p. 287).

In the aftermath of the global crisis, more people have questioned the way financial globalization has been promoted. Given the practical difficulties of reforming the international financial and monetary system at the global level soon, reinstating certain forms of capital control has regained some legitimacy as an option for nation-states. Since 2009, several developing countries — including Brazil, the Republic of Korea, and Indonesia — have reintroduced different forms of capital control to curb speculative flows. The IMF has also departed from its long-standing official position of promoting free capital movements by recognizing that, for emerging economies, capital controls are a legitimate part of macroeconomic management (IMF, 2012b).

53 Among emerging economies in East Asia, many of which staged a quick recovery from the Asian crisis of 1997–1998 and the global financial crisis, many adhere to dollar pegging in flexible forms such as target bands (hard pegs are very rare). Many, though, built up large international reserves for self-insurance, far in excess of any foreseen shortfalls stemming from the needs for current account transactions (Miller and Zhang, 2007).



Drawing on all the above theory, full of uncertainties as it is, we suggest that it is critical for African policymakers to conduct monetary policy while managing an exchange rate trajectory and cross-border capital flows based on their own country's context. They should screen cross-border capital inflows, weighing the benefits and costs of the different types, while keeping prudential norms to help to prevent a crisis from developing in the first place.

### 6.3 Mobilizing resources through financial sector development

With increased cross-border private capital flowing into Africa over recent years, its asset–liability position with the rest of the world and its debt profile have been changing. If these flows are properly deployed in productive investment, the absorptive capacity of capital flows and the debt-carrying capacity of African economies could be raised as well. For mobilizing resources from private sources as a reliable source of development finance, it is vital to develop financial institutions (banking and non-banking) and deepen financial markets. Over the recent boom years, some economies have turned to new approaches.

#### Going abroad ...

Innovative financial instruments have attracted attention as mechanisms for financing Africa's development, in particular for closing its vast infrastructure gap by mobilizing private savings through financial markets. Among them are instruments targeted at international investors who can bear high currency and country risks in their quest for high return in a global low-interest environment, including debt instruments issued in hard currency to raise funds on international capital markets, or private equity funds or vehicles (Beck et al., 2011). Many states, including low-middle-income countries and low-income African countries, have taken advantage of the increased appetite for African assets against a backdrop of Africa's improved growth and macroeconomic management.

For example, Ghana's issuance of a 10-year sovereign bond worth \$750 million in late 2007 for financing energy and infrastructure projects attracted much publicity. It was the second sovereign bond by a country in Africa (excluding North Africa), after South Africa. It was a success, with a B+ rating by Standard & Poor's and Fitch, and four times oversubscribed, with strong demand from foreign asset managers in particular.

Encouraged by Ghana's success, other African countries — including Senegal, Tanzania, Zambia, Rwanda, Kenya and most recently Ethiopia — have issued sovereign bonds on international markets for financing economic infrastructure in energy and transport. Nigeria and South Africa have issued international sovereign bonds, providing a benchmark (given their economic weight) for other governments and the corporate bond markets on the yield spread at which their foreign currency debt is traded.

These bonds carry considerable currency risk, however, and are much dearer than concessional borrowing. The spread on these bonds at the time of initial offering was 372–600 basis points, with tenors of 5–10 years, against, for example, standard credit from the International Development Association to low-income countries, which is payable over 40 years with a 10-year grace period and a calculated grant element of 62 per cent at a 6 per cent discount rate. Blend term credit to low- and middle-income countries is payable over 25 years with a five-year grace period and a calculated grant element of 35 per cent. And as global interest rates rise, such bonds' yields at issue will pick up, possibly causing investors' risk appetites to shift abruptly, as seen when the Chairman of the Board of Governors of the US Federal Reserve in summer of 2013 announced a "tapering" of quantitative easing.<sup>54</sup>

54 <http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20130619.pdf>

**Box 6.2 Private equity funds**

Increasingly interested in providing long-term finance to Africa, managers of private equity funds have access to a variety of resources held by private or institutional investors, such as pension funds and insurance firms, or development financial institutions. Managers employ a mix of financing instruments.<sup>55</sup> Some funds invest in infrastructure projects with national, regional or pan-African scope (Beck et al., 2011).

Private equity managers finance enterprise development that has an excellent growth prospect by offering a combination of debt sourced from a bank and equity sourced from institutional investors, over 5–10 years. At the end of the period, the private equity fund managers “exit” by listing the company on a stock market through an initial public offering.

Though private equity is a relatively new financing mode in Africa, over the boom of 2006–2008, private equity funds were said to have raised about \$6.4 billion in total, and invested about \$7.6 billion in Central, East, Southern and West Africa, targeting upper-medium-sized firms. They raised about \$1.6 billion in North Africa in 2008 alone. After a notable slowdown during the global crisis, they have grown fast again, amounting to \$3 billion in 2011 in Africa (ECA, 2014). Private equity investment has so far been confined to a few African countries, including Egypt, Ghana, Kenya, Morocco, Nigeria and South Africa.

Private equity funds have also become active in Africa’s development financing (box 6.2). Foreign investors can, however, bid up assets prices beyond the level at which they can generate the returns reasonably expected from investment in real activities. Such expectation of steep asset-price gains during booms has historically been one of the key factors in financial crises, including that of 2008–2009.

Despite these shifts in attracting new resources, portfolio flows — equity and debt — are generally characterized by volatile, pro-cyclical patterns. This is largely because they are more for diversification for financial investors to hedge and shed risk (to achieve maximum risk-adjusted returns) than development finance.

55 Equity, senior debt, subordinated debt or mezzanine finance.

Sometimes mediated through high-frequency trading, portfolio flows are viewed rightly as hot money for their global cross-border mobility, reflecting sudden switches in investors’ risk appetite/aversion, making them strongly pro-cyclical. Sudden changes in investors’ often self-fulfilling expectations and market sentiment can induce global synchronized bubble-bust cycles in asset markets and credit conditions. Equity or debt, portfolio flows present serious policy concerns over macroeconomic stability and domestic asset prices.

One of the reasons why cross-border capital flows can spawn unsustainable macro imbalances is that financial globalization has proceeded without a proper global governance structure, one that includes internationally coordinated regulation and supervision of financial institutions. Africa’s reliance on internationally mobile finance risks it replaying (with its own variants) the financial crises of East Asia, Latin America, Russia and elsewhere since the early 1990s, which underlines its need for prudence (box 6.3).

**Box 6.3 Forewarned is forearmed**

Prudential regulatory measures to tame financial excesses are important for market-based economies to function well, heading off the havoc that otherwise hits real economic activities periodically, stemming from the systemic risks of financial institutions.

African countries, as newcomers to international capital markets, should be able to draw their own lessons from previous experiences of other countries that liberalized and deregulated but failed to put prudential measures in place when adopting full capital-account convertibility. Maintaining macroeconomic stability is much harder when an economy is exposed to highly volatile cross-border flows once the capital account is fully liberalized, as recent financial crises show.

### **... sticking with those you know, home and away ...**

Development finance should be sought from more stable sources, such as domestic savings or overseas investors firmly committed to African development. Sovereign wealth funds are increasingly seen as one of these sources, particularly for infrastructure projects. Established by resource-rich countries, unlike private equity funds, they are managed by governments. They have become a net creditor to the rest of the world owing to the rapid increase of commodity prices since 2002 and new discoveries of mineral and oil deposits in Africa. Windfalls from these resource rents often far exceed a country's capacity to deploy them well in development in a short period, and as commodity prices are inherently volatile, policymakers of these countries require attractive savings instruments to smooth their income and outlays over commodity boom-bust cycles (chapter 5).

There have also been attempts to mobilize overseas funds via diaspora bonds. Ethiopia issued Millennium Corporate Bonds targeting Ethiopians (at home and abroad) to raise capital mainly for electricity generation. Kenya has also experimented with a diaspora bond, while Nigeria is reported to be preparing to issue a diaspora bond (World Bank, 2014). Beck et al. (2011) estimate that diaspora bonds could raise potentially \$5 billion–\$10 billion annually by tapping into the wealth of 16 million Africans abroad.<sup>56</sup>

Members of the diaspora are viewed as less risk averse towards bonds issued in domestic currencies because they know more about their country of origin than other foreign investors, often have liabilities in their home countries (allowing for some

matching), and frequently have a strong desire to help their origin country to develop.

As many African countries require a learning period before confidently working the international capital markets, they may consider first issuing debt instruments in local currencies and aiming primarily at domestic investors and financial institutions or those with very specific ties to or expertise in countries in Africa — like the diaspora. Since investors participating in these vehicles are more likely to have firm commitments and interests closely aligned with Africa's economic development, they are more willing to take currency or other country risks associated with these local-currency instruments and to position themselves with a longer perspective.

### **... or just staying at home?**

Ultimately, more effort should be put on deepening domestic financial markets and strengthening the capacity of domestic financial institutions rather than on courting international investors excessively. Besides prudential regulations therefore, developing deep liquid financial markets as well as forward markets for domestic currencies is vital. Several frontier-market economies, such as Egypt, Kenya, Nigeria and South Africa, have deepened their domestic equity and bond markets over the last two decades, using them to domestically finance infrastructure projects (box 6.4).

Bond markets are among the most sophisticated financial markets, requiring market-supporting institutions with the capacity to price risk, and to trade long-dated debt efficiently. They also have to be highly liquid, offering appropriate term structures. Only a handful of countries with frontier markets can realistically issue debt in their own bond markets, for the time being at least. Many smaller countries would have to access subregional market-hub countries for national infrastructure development, and for regional cross-border infrastructure projects, as they cannot fund them alone.

These hindrances can, though, be overcome through regional integration and cooperation,

56 World Bank (2014) provides the following estimates: diaspora saving from Central, East, Southern and West Africa reached about \$37 billion in 2012; officially recorded remittance flows to the continent increased by 3.5 per cent in 2013, reaching \$32 billion (Nigeria alone accounted for \$21 billion); and remittances to the region are expected to increase in 2014–2017 at 9 per cent a year.

### Box 6.4 Domestic financing, Kenya and South Africa

The Kenyan government issued local-currency bonds for roads, energy, water, sewerage and irrigation, for a value of \$1 billion in 2009–2010. This paved the way for private and state companies to issue corporate bonds, including Safaricom (a leading mobile phone company) and KenGen (a power utility).

Incentives were launched to attract interest in the infrastructure bonds: bondholders can use them as collateral for bank loans, and banks can pledge them as collateral for their operations; bondholders are exempted from tax on interest payments; and Islamic banking is practised, so that banking institutions such as the Gulf African Bank could participate.

In August 2010 Standard Bank Group in South Africa offered Rand-denominated commodity-linked exchange-traded notes, which are listed on the Johannesburg Stock Exchange, with redemption date and returns tied to the performance of precious metals.

Source: Brixiova et al. (2011).

including subregional banks, funds, special-purpose investment vehicles and subregional public-private partnership units.

Even with the recent progress in deepening the financial markets and widening financial services, Africa's banks, in environments with high transaction costs and poor information flows, are still reluctant to make loans to small, domestic entrepreneurs. They prefer to maintain excess liquidity, holding assets predominantly in low-risk instruments with a short maturity such as treasuries or central bank paper issued for sterilizing capital inflows. High policy rates (against inflation or for sterilization) have also crowded out loans to small businesses, while steep transaction costs and fragmented financial markets — all keeping loan-deposit interest spreads high — make bank loans prohibitively dear for most of them. Little progress on these environments over the years explains banks' timorous efforts to mobilize domestic savings, despite strong latent demand for credit. The operational constraints should be addressed so that banking and non-banking financial institutions can fulfil their vital role in financial intermediation.

### Box 6.5 Mobile banking improving access in Kenya

Mobile banking and mobile money services have boosted their outreach. The latter is an SMS-based money transfer system that stores and transfers money. Kenya's M-PESA is the biggest mobile money service provider, launched as a joint venture by Safaricom with Vodafone of the United Kingdom in 2007. It has dramatically changed access to financial services in money transfers and payments in Kenya, providing an opportunity for many previously unserved low-income people to bank. M-PESA offers basic banking much more cheaply than bank branches. Africa now accounts for over half the world's global mobile money services.

Source: The results from the 2012 Global Mobile Money Adoption Survey, available <http://www.gsma.com/mobilefordevelopment>.

More widely, the above macro- and microeconomic impediments highlight the need for striking a better balance between the stabilization and development objectives, so that, for example, private domestic firms can access bank loans at reasonable cost. Heintz and Pollin (2008) offer one suggestion.

Noting the relatively high thresholds at which inflation starts exerting a negative effect on growth in developing countries relative to developed countries, Heintz and Pollin (2008) argue that the excessive contractionary bias in monetary policies of the past has stifled growth of domestic firms and their ability to create jobs in Africa. As inflation in many African countries is of the cost-push variety, they argue that if monetary policy is tightened in response to supply-side shocks that have inflationary consequences, aggregate demand management is pro-cyclical, with a more restrictive monetary policy pursued in the face of a negative economic shock nearly always worsening the shock's impact.

Given this, Heintz and Pollin (2008) suggest that strict inflation targeting with an exclusive focus on maintaining low inflation and limiting the expansion of domestic credit is often inappropriate. Instead, they stress the need for low short-term *real* interest rates as the operating targets in monetary policy for job-centred development. Their proposal merits serious consideration.

# CHAPTER 7

CONCLUDING REMARKS  
AND KEY POLICY  
MESSAGES

In our quest for macroeconomic policy for structural transformation — a developmental process encompassing both productivity-enhancing structural change *and* institutional and societal transformation towards an articulated economy and an inclusive society — we reviewed how, under two contrasting development policy paradigms (economic planning and the IFI-led reforms) over the last four decades of the 20th century, Africa failed to undertake the public investment needed to attract private investment, though there are now some signs that productivity-enhancing structural change has just started taking place.

Yet Africa still needs macroeconomic policy for advancing structural transformation, designed as part of a long-term development strategy — a focus of the document schematized in figure 4.1. The anchor on the development strategy allows policymakers to resolve the short-run trade-offs between stabilization and development objectives, while the thrust of the policies allows them to build an *institutional* foundation for fostering a productive public-private partnership.

The macroeconomic policies should accomplish five items on the overarching policy agenda:

- Scaling up public investment and public goods provision.
- Maintaining macro stability to attract and sustain private investment.
- Coordinating investment and other development policies.
- Mobilizing resources and reducing aid dependence over time.
- Securing fiscal sustainability by establishing fiscal legitimacy.

In the light of these objectives, fiscal, monetary, exchange-rate and other financial policies should be carefully calibrated. Summarized, fiscal policies should:

- Establish fiscal legitimacy, including broadening revenue bases, with high-quality public goods provision.

- Staunch illicit cross-border financial flows and improve public resource management.
- Turn natural-resource wealth into productive assets through inclusive fiscal spending, in order to effect a change in Africa's comparative advantages.
- Manage public finance and sovereign debt sustainably, through counter-cyclical macroeconomic management and developing institutions for public resource management that are truly accountable to domestic stakeholders.

In monetary and financial policies, above all, the challenge of resolving the short-run stability–development trade-off should be tackled. Our key policy messages are:

- Conduct monetary policy after a careful evaluation of the sources of inflationary pressures, including those emanating from supply shocks in agriculture.
- Conduct domestic monetary policy in conjunction with an appropriate exchange-rate regime, and manage cross-border capital flows in a country- and region-specific context.
- Adopt prudential regulations, including measures aimed at taming market excess, on international capital flows as well as domestic financial conditions.
- Mobilize resources in parallel with efforts aimed at deepening domestic financial markets as well as strengthening the capacity of financial institutions so that they can play a fuller role in resource mobilization, financial inclusion and financial intermediation.
- Reappraise the contractionary bias in the conventional monetary policy stance in order to strike a better balance between the twin objectives of stability and development.

# APPENDIX 1

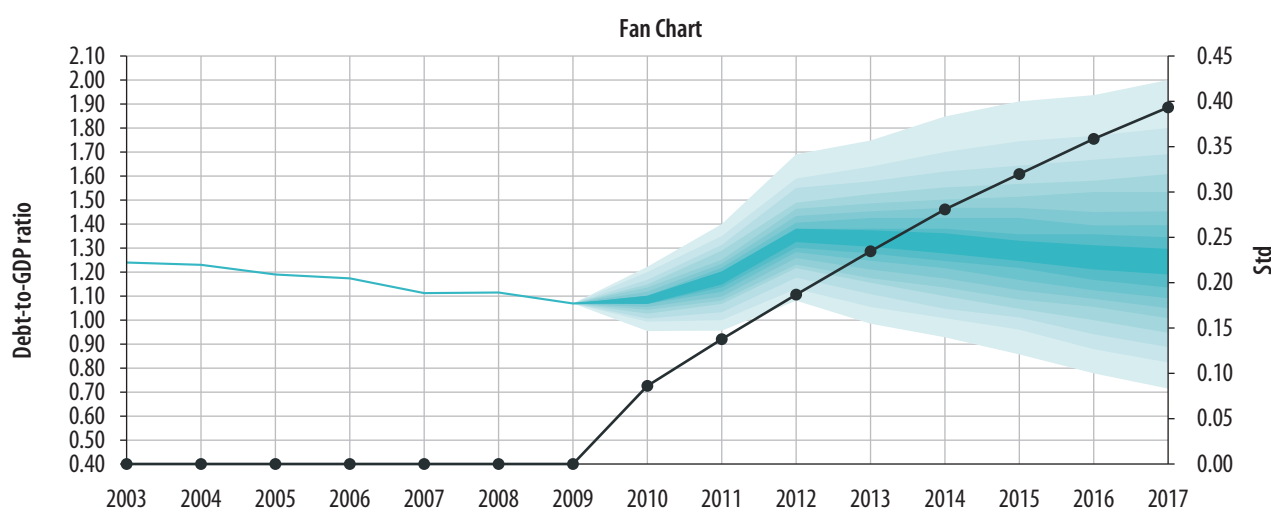
## Managing Macroeconomic Imbalances with Macroeconomic Models and Simulation Tools

Effective management of macroeconomic disequilibria to prevent distress and crisis situations from developing and derailing economic development involves prevention measures *ex ante* as well as distress/crisis management *ex post*.

In both cases, timely use of appropriate macroeconomic models and econometric techniques is of great help. For crisis-prevention, macroeconomic forecasting tools such as dynamic simulation techniques with calibration around alternative scenarios can be used. The value-at-risk model is one of the tools widely used for short-term macroeconomic forecasting at central banks and private financial institutions in many developed

countries. This model can incorporate the structure of random shocks hitting the economy to obtain a complete distribution of probable outcomes. It produces fan charts — a graphic illustration of wide-ranging possible paths of dynamics of macroeconomic variables (figure A1.1). Hence, the fan charts are capable of conveying a ‘message’ of probabilistic nature of forecasting, demonstrating graphically how much and how quickly the predictive power of forecasting diminishes over time. If appropriately used, the fan charts can offer a useful medium for policy dialogue regarding alternative scenarios on a more informed basis. However, its usefulness is limited to exercises over a shorter time horizon, certainly not exceeding five years.

**Figure A1.1 Fan charts (example)**



Source: Figure 14 in Borensztein et al. (2010).

Note: Std = Standard deviation



The Dynamic Stochastic General Equilibrium (DSGE) model for a small open economy — an increasingly favoured analytical tool at the IMF for macro sustainability analyses of African economies — can also be used to examine alternative dynamic paths of internal and external macro balances and other key parameters under different policy scenarios (see box 5.4 in the main text for a short description of the application of DSGE models to African economies). It generates a dynamic trajectory of macroeconomic effects of key policy decisions, such as effects of public-investment surges on growth, or fiscal and current account balances, among other effects. It attempts to capture some of the key features of a typical low-income country or a lower-middle-income country on the basis of historical records of African economies.

Within the confinement dictated by a particular construct of these models with a set of built-in assumptions, the use of these models would enhance technical aspects involved in macroeconomic management of African economies and enrich discussions on policy options and future actions to allow for more informed decisions. These models and forecasting tools are generally helpful for monitoring the dynamics of key variables and for understanding possible effects from alternative policy decisions. However, the accuracy of forecasts and predictions depends on appropriateness of model structures and parameters used, and is based on the premise that historical data would allow evaluating the probability of various future events, or combinations of events, occurring, while real world events are characterized by highly unexpected events full of uncertainty. Constant updating of data on a frequent basis is also necessary for these tools to be of any use. Hence, mechanical, deterministic application of these models and tools may produce more harm than benefits for addressing long-term sustainability issues (as discussed in section 5.5).

The use of these techniques cannot guarantee that distress situations can always be prevented, though the probability of crises happening can be minimized through applying prudence and constant vigilance in macroeconomic management and through

ensuring that other critical regulatory measures are in place over a variety of institutions and markets. Today, African economies find themselves in a highly interdependent globalized economy with its inherent high uncertainties and risks.

For example, large shocks from the global financial crisis transmitted through trade and financial channels, the escalation of food and fuel prices, and difficulties in coping with these problems domestically have adversely affected and disrupted progress in Africa, too.

While the growth record so far and the positive prospects for African countries as a whole keep the story of Africa rising in the global media, private investors' positions may change quickly as soon as any small sign of troubles appears over the time horizon of their expectation formation. Though Africa's economic growth as a developing region as well as that of many individual countries did cope with the immediate impacts of the global crisis relatively well, some marked increases in macroeconomic imbalances and inflation have been recorded in several countries such as Ghana. Concerns over the emerging imbalances have been voiced. The question of whether macroeconomic stability has gone out of policymakers' control and whether sustainability will be at risk soon in some African countries has been raised more frequently over the last year or so.

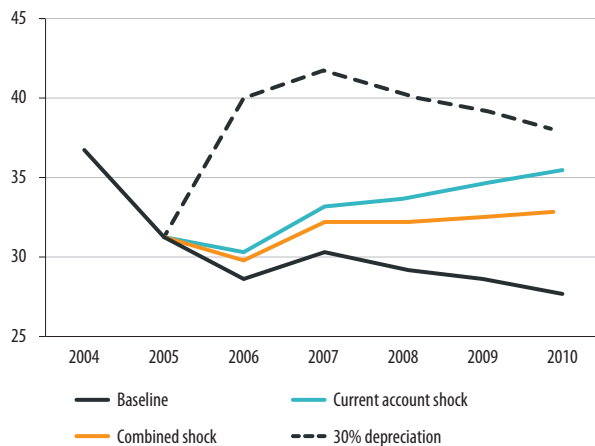
Hence policymakers should be conversant with intelligent approaches to crisis management. Ad hoc adjustments made in a panic would produce havoc by further aggravating crisis conditions and obstructing progress or reversing it altogether in socioeconomic development. An orderly management of distress conditions is possible if policymakers can anticipate shocks more strategically and put necessary policy procedures in place in advance.

Wyplosz (2007) suggests that by using an appropriate combination of a policy target and a chosen instrument, the focus of policy analysis should be on navigating a dynamic path of the target variable with

the policy instrument so that the target variable does not follow an explosive path over time. His analysis shows that shocks to equilibrium could be dealt with by policies that spread adjustment costs over time (figure A1.2). This is a typical example of how a Keynesian macro policy analysis suggested by Jan Tinbergen can be conducted to reduce imbalances towards a desired state of equilibrium in an orderly manner without causing a sharp contraction in aggregate demand. Policymakers should revert back to Keynesian macroeconomic policy analyses, where macro models are used for policy analyses of the disequilibrium adjustment processes. Unlike in textbooks, economies in the real world cannot be assumed to be in equilibrium on a continuing basis.

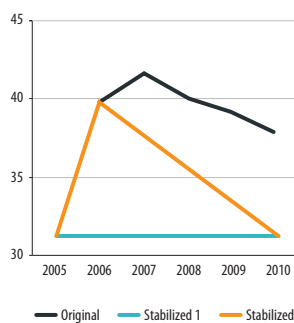
**Figure A1.2 Comparative analysis of policy responses**

(a) Simulated paths of the debt-to-GDP ratio under debt sustainability analysis

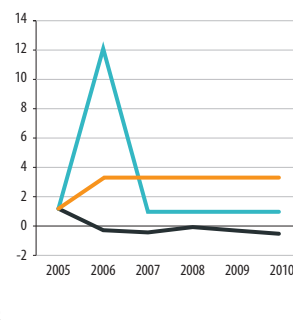


Source: Figure 3 in Wyplosz (2007).

(b) Debt (% of GDP)



(c) Primary balance (% of GDP)



Source: Figure 5 in Wyplosz (2007).

## APPENDIX 2

### Organizational Structures for Implementation: Achieving Coherence and Coordination within a Long-Term Development Strategy

Organizational and institutional structures for coordination and consultation should be decided in a country-specific context and evolved over time. That goes without saying. However, some overarching requirements stand out.

First, to execute policies in an internally consistent manner, organizational structures for decision-making in policies should not be rigid. Rather, depending on the issues confronted at a particular time, decision-making structures should evolve dynamically in a coordinated manner. It is incorrect to assume that government offices responsible for a particular set of policies, such as the ministry of finance or the central bank, should always dominate other government offices and ministries. Instead, all government agencies should collectively take joint decisions on critical strategic issues, for formulating and implementing them.

Once such decisions on overall direction are reached, detailed pathways of implementation should be worked out for the short, medium and long runs. Depending on specific objectives attached to each policy and strategy, one office with competence in a specialized area can be identified and designated as a focal point throughout the stage of detailed policy formulation and implementation, taking a lead in designing an action plan and executing it with support of other offices. For example, executing industrial or technology policies, the lead ministry/agency could be the ministry of industry and technology, with support of all other offices, including the ministries of finance, trade, education and the central bank.

A coordinating central office will probably be needed. It would oversee consultation, coordination and monitoring among government offices, so that individual policies are internally consistent in achieving overall long-run objectives. A key point is mutual transparency and accountability, to the public and society generally. For the latter, stakeholders' participation in consultation is crucial. A credible democratic system of checks and balances should be in place, so that no executive office can unilaterally change the overall rules of the game arbitrarily.

Policies and institutions should also be highly adaptable in responding to changing external and domestic circumstances. Increasingly integrated into the global economy, African economies are more exposed to global shocks through different channels than before, and so must build resilience over time by reducing their vulnerability.

Development planning of the 21st century is not a simple return to old-style economic planning. Responding to changing conditions, more high-frequency operationalized action plans should be in place. Annual operational plans and any medium-term plans should be prepared with reference to a long-term development strategy. Any question on whether a system should be rule based or discretionary should be settled case by case. In short, the structure should be flexible, adaptable and dynamically evolving over time, so that it is capable of making a swift and reasonable decision on how to adjust to changing circumstances.

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