Part 2: Industrialization–Trade Nexus

CHAPTER 6

TOWARDS A SELECTIVE TRADE POLICY FRAMEWORK FOR INDUSTRIALIZING AFRICA

KEY THEMES

Africa's growth continued to increase in 2014, though at a lower rate than previously estimated, surpassed only by the East and South Asia regions. Private consumption and gross capital formation continued to underpin growth, supported by improved governance and macroeconomic management, rapid urbanization (and a rising middle class), diversified trade and investment ties with emerging economies, and improved regional integration and trade partnerships.

Africa's medium-term growth prospects remain strong, with some progress in enhancing productivity, associated with its recent high-growth performance. But enhanced intra-African trade and increased export diversification from agricultural commodities, minerals, and oil through value addition, and promotion of industrialization and structural transformation are required to stimulate Africa's growth further.

Medium-term prospects face several downside risks, including sharp slowdown in oil and other commodity prices, slow recovery in developed countries, slowing Chinese growth, and tighter global monetary policies.

TRANSLATING THE GAINS FROM THE RECENT PAST INTO THE FOUNDATIONS FOR A SUSTAINABLE FUTURE

A leading challenge is to translate growth into sustainable and inclusive development. Social development strategies consistent with the needs of the industrial and modern sectors must be honed. The right socio-economic conditions—peace and security, as well as political will—are important.

Both theory and evidence suggest that trade can be a tool to promote industrial development in Africa. Trade policy, through promotion of competition, innovation and efficient utilization of resources, can enhance the dynamic efficiency of mature firms and foster industrialization. But it must not expose infant industries to competition too early, as this can lead to de-industrialization. A critical factor for trade policy to promote industrialization is the appropriate balance between promotion of relatively mature sectors and simultaneous protection of fragile sectors. This is not easy, but it has been performed by most industrialized countries.

Trade-induced industrialization is not automatic, and it demands real effort. For trade policy to foster industrialization, coherent trade, industrial and other complementary policies are a prerequisite, and they must be tailored to the overall goals of a country's national development strategy while internalizing the external environment. Notably, trade policy must respond to developments in the global production architecture, especially production of intermediate goods rather than finished goods, and participation in one or two links along a value chain instead of all links. Thus a coherent trade policy that promotes trade in intermediates, in tasks and in services (services are key to international production processes) is an essential precondition of modern industrial development.

Structural transformation has been unconvincing in Africa as resources have kept moving from agriculture and industry to the services and informal sectors. Although industry has contributed to economic growth, its recent growth has not reached post-independence period levels, nor has it been driven by manufacturing. Low-return, low-productivity and the lack of structural change pose a great challenge for sustainable long-term growth in Africa.

The link between knowledge creation, technical and technological processes, entrepreneurship and innovation underpinned by a healthy and educated workforce is the strategic thrust for positive spillovers from and to successful structural transformation.

In itself, trade openness does not necessarily raise productivity, as it had a negative effect on productivity-enhancing structural transformation over 1980–2010. But it could when combined with policies for adding value to commodity exports and diversifying exports from agricultural commodities, unprocessed minerals and unrefined oil.

The experience of industrialized and emerging countries and of African countries in their previous attempt at industrialization suggests that a gradual approach to upgrading and industrialization is preferable. African economies should start from labour-intensive sectors and upgrade to medium- and high-technology sectors. As African countries are at different levels of industrial development, some will have to start with labour-intensive sectors, while others should be upgrading already.

GETTING TRADE AND OTHER POLICIES TO WORK TOGETHER

Given that African countries depend on international markets for both inputs and outputs, trade policy instruments must be carefully selected to avoid negative policy externalities. They must promote dynamic efficiency of mature firms and at the same time promote efficiency of infant industries through a temporary shield from international competition. For the latter, tariff protection combined with activities to develop competitiveness of firms in the industry must be designed and implemented to address the source of externalities.

For most African countries, industrial development is just one of the objectives of trade policy. In order for trade policy to foster industrialization, industrial development must be its core objective. Thus coherence between trade and national development strategies needs to be ensured. Findings from 10 African country case studies on their trade and other policies, however, show little synergy, with few countries promoting industrialization, even though most of their policy documentation recognized the need to do so, via selectivity.

For trade policy to foster industrialization, it must be highly selective for two reasons: trade-induced industrialization involves huge resource costs and requires implementation, monitoring and evaluation. While recognizing the role and place of horizontal industrial policies, the vertical (i.e., selective) policies are important for developing dynamic comparative advantage. The need to add value and develop or join regional and global value chains also was featured in most documents.

African governments are, however, labouring in an ever-narrowing policy space. But they have yet to identify and deploy alternative instruments under global trading system rules. The point is that the world will not wait for African countries to catch up with industrialization: rather African countries need to be smart, analyse and exploit the system to their advantage, and deploy trade policy instruments, as the newly industrialized economies of East Asia did so well.

JOINING GLOBAL AND REGIONAL VALUE CHAINS

Global value chains (GVCs) are an important feature in today's global economy. The growing importance of information and communications technology (ICT) enables African countries to enter several value chains without having to develop the whole production process. Participation in GVCs and competitiveness are linked to having access to fairly priced and predictably delivered intermediate imports (a theme picked up below).

Regional and global trade and production networks open new potential opportunities for Africa's industrialization. Value chains offer the scope to engage in international trade at a specific stage of the production process, thereby harnessing comparative advantage. Services play a key role in adding value along the supply chain.

African countries show high participation rates in GVCs, though at a very low level. While backward integration has been increasing, Africa still needs to focus on improving it, as the larger share of Africa's GVCs participation is in forward integration, driven by exports of raw materials. Intra-regional trade in processed goods is the first opportunity for African firms to move up the chain. GVCs linkages need to be expanded to other firms and areas of the economy.

At the sectoral level, policy initiatives that improve infrastructure and linkages among firms in the value chain (e.g., the Mozal project in Mozambique) can increase Africa's backward participation, but they must overcome poor linkages between successful sectors and other areas of the economy. Hence, policies need to focus on establishing production networks within African economies: regional value chains (RVCs). Further, trade-integrated regions are more attractive to the leading firms in a value chain, as epitomized by Southern and East Africa, which are more integrated into Africa's RVCs, as they participate more in GVCs than other African subregions. Finally, as the leading firms control and set product standards in their value chains, making it almost impossible for local firms to move up GVCs, regional production networks should receive greater attention.

Participation in GVCs also requires investments in sector-specific skills and human capital, as well as infrastructure, financial services and conducive policy frameworks. Based on the level of development of these parameters in most African countries, intra-African trade and RVCs are a platform for learning and enabling economies of scale, facilitating Africa's industrialization and eventual entry into GVCs.

In intra-African trade, the weight of manufacturing intermediates is far greater than in the continent's exports to the rest of the world, suggesting considerable scope for regional supply chains to support Africa's industrialization. But as RVCs are poorly exploited (only 12 per cent of Africa's imported intermediates is sourced from the region), a strong production network at national and regional levels is needed to achieve economies of scale.

Large countries such as Algeria, Egypt, Nigeria and South Africa have, in relative terms, little participation in continental value chains (they account for the bulk of the continent's imports of intermediates, but source few of their imports from Africa). Conversely, small and landlocked countries such as Botswana, Swaziland and Zimbabwe are far more integrated, but trade the lowest absolute amount of value added. Southern and East Africa have the highest share of trade in value added within Africa and within their regions, and have been aided by their regional trade agreements. When well applied, sectoral policies may also be useful.

Moving up the value chain in agriculture is profitable and needs to be put on the national and regional development agenda. An expansion in these labour-intensive industries generates new jobs that bring a social upgrading. However, given the dominance of leading giant firms in the food value chains, policies need to invest massively in rural industrial clusters development under commodity-based industrialization.

REVERSING THE WRONG-WAY TREND IN TRADE IN INTERMEDIATES

In the new global division of labour, transnational corporations retain the most profitable links of processing along their supply chains, while outsourcing or offshoring others through regional and international production networks. This has helped to spur international trade, particularly among intermediate goods, which account for about half of the world's trade.

Yet Africa is missing out: although intermediate products account for the bulk of Africa's merchandise trade (60 per cent of its imports and over 80 per cent of its exports), and although intermediates are the most dynamic component of Africa's merchandise trade (increasing fourfold over the last decade), Africa still only accounts for 2–3 per cent of the global figure. Imports of manufacturing intermediates have largely failed to reverse Africa's premature de-industrialization or to spawn the emergence of regional supply chains.

Worse, the continent's exports of intermediates are increasingly dominated by mining products and resource-based manufactures (basic metals and fuels), typically embodying limited domestic value addition. This trade pattern suggests that African producers are increasingly linked to GVCs, but mainly as suppliers of raw materials or other low-end products. The minor role played by exports of manufacturing intermediates—in particular light manufacturing inputs—concurs with the evidence of persistently limited weight of intra-industry trade in the region, and points to the low level of integration into international production networks, whether regional or global.

TRADE IN SERVICES: MORE IMPORTANT FOR SOME COUNTRIES THAN OTHERS

Services are becoming more important in international trade, contributing 50 per cent of Africa's total trade in value added. They have an essential role in Africa's economic transformation, as key inputs to most other businesses, making a direct contribution to GDP and job creation, attracting investment into local businesses and pulling in foreign direct investment. Services can themselves be an avenue for economic transformation, particularly for small countries and island states, as not all countries can develop through manufacturing. Establishing services hubs and RVCs can help African countries exploit each other's capabilities and boost competitiveness.

USING TRADE AGREEMENTS TO AFRICA'S ADVANTAGE

Preferential schemes have generally been helpful in supporting Africa's trade with preference-giving countries, but they have failed to broadly enhance Africa's industrialization. One of the key constraints limiting the use of preferences in manufacturing goods has been the inadequacy between productive capacity of African countries and stringent rules of origin under World Trade Organization (WTO) regulations. Although they remain useful for Africa, unilateral trade preferences alone will not help to develop RVCs.

Fast-tracking the implementation process of Africa's integration—specifically, setting up the African Continental Free Trade Area (CFTA)—seems vital for an industrializing Africa. It would help increase both intra-African trade and its industrial content. Adoption of trade facilitation measures on top of CFTA reform would vastly enhance the outcomes further.

Opening Africa's market to foreign partners requires strategic trade policies. Reciprocity between Africa and traditional partners can provide significant trade benefits for both sides, but initial asymmetric protection conditions are likely to lead to unbalanced gains, with benefits for non-LDC African countries only expected in a few agricultural subsectors. Still, such reforms should be used as an opportunity to strategically define external tariff structures (e.g., by allowing for cheaper imported intermediate inputs to be used in the production of industrial goods) to make sure Africa's regional integration and industrialization agendas remain intact. Given the fairly tight policy space in different types of trade agreements, South–South cooperation could be more promising than North–South engagements.

Sequencing of trade policy reforms matters greatly for industrialization. There is powerful evidence that a CFTA should be put in place before other trade agreements are fully implemented by African countries or by the rest of the world (e.g., mega-regional trade agreements), which would not only preserve the anticipated benefits from these agreements but also offset most—if not all—of these other agreements' costs to Africa.

POLICY RECOMMENDATIONS

African countries need to leverage the progress made and continue building robust institutions that improve the business environment, economic governance and macroeconomic management. This will boost investors' and consumers' confidence and strengthen the continent's growth prospects. Growth must be sustainable and inclusive, with its sources diversified to reduce vulnerability of African economies to internal and external shocks. Policies should promote inclusive growth, productivity and structural transformation through industrialization, value addition, export diversification and regional integration.

A social development strategy is necessary, as human capital is central. The strategy must be anchored on long-term planning; anchored on strengthened productive capacities of the labour force through high-quality, equity-based education and health policies; and complemented by investments in research and development focused on driving industrialization and high-end services.

In many African countries, trade policy design has not been effective, and its coherence with other policies has been limited. The observed limited coherence is an important reason why the majority of African nations have failed to diversify their exports from agricultural, mineral and crude oil products. African countries need to mainstream trade policy into development strategies and ensure coherence among all national policies, but especially between trade and industrial strategies. Industrial policy should precede trade policy, and the latter should promote the goals of the former. Subsequently, coherence should be built at various regional economic communities (RECs) level, then continent-wide.

Each country or region should first analyse its best route to structural transformation. If industrialization is justified, the second level entails determining the role of trade and trade policy. This is largely because African countries differ by development and endowment: no single model will work for them all.

A gradual approach to industrialization and upgrading along value chains is recommended. This comes from experience in the industrial development trajectories of East Asian economies and in Africa's own ambitious but failed attempts after independence. A well-sequenced, gradual approach to upgrading and industrialization is more practical than short, sharp shocks. African economies should start from labour-intensive sectors and upgrade to medium- and high-technology sectors. Their trade policies must promote dynamic efficiency of mature firms and promote efficiency of "infant industries" through temporary shields from international competition. Trade policy design should be informed by factor endowments and comparative advantage, and should recognize that African industries are dependent on international markets for both inputs and outputs.

Africa needs strategic continent-wide trade policies. Introducing reciprocity between Africa and traditional partners can provide significant trade benefits for both parties. But initial asymmetric protection conditions lead to unbalanced gains, with Africa's benefits only expected for non-LDCs (least developed countries) in few agricultural sectors. Nonetheless, such reform should be used as an opportunity to strategically define external tariff structures (such as allowing cheaper imported intermediate inputs to be used in the production of industrial goods) to ensure Africa's regional integration agenda and industrialization are not weakened.

A highly selective and carefully designed trade policy (to promote efficiency of mature firms and protect infant industries, avoid negative policy externalities, effectively engage all stakeholders in the process and put industrial development above other objectives) is important. Running and managing it are as important as designing it. It must be time-bound and must progress towards benchmarks that are regularly evaluated. And the process must be carefully managed to avoid political hijacking by well-connected insiders.

African countries need to rethink trade policy, taking deliberate steps resounding through all levels of trade and investment negotiations. Each bilateral, regional and multilateral trade deal has narrowed scope for traditional instruments once used by developed countries. African countries should halt this erosion by insisting on the right to promote industrialization, auditing agreements that they have signed to exploit any flexibilities, develop the capacity to do such auditing and, further, take full advantage of the agreements to which they are party.

African countries should stop negotiating agreements as if industrialization does not matter. They should turn back the trend in policy-space erosion, especially when negotiating trade and investment agreements, by insisting on the need to use such policy instruments to promote industrialization. This is more relevant when negotiating bilateral and regional agreements with developed countries.

African countries would gain from developing capacity (to negotiate, implement, comply with obligations and defend rights) to take advantage of signed trade agreements. Tariffs are the easiest trade policy instrument to implement, and they also generate revenue for governments. However, other trade policy instruments, including para-tariff measures and contingent trade-protection measures, are valid. But using them is more demanding than enforcing tariff measures. Technical capacity and institutions need to be built, and regulations enacted. To promote industrialization, African countries need to move from tariff measures only and develop capacity to fully engage in modern trade policy.

Africa should adopt and implement a continental negotiations template that will help to promote coordination and harmonisation of policies and thus assist in fast-tracking the establishment of the CFTA and deepen continental integration. A promising approach for African countries would be to start developing and strengthening RVCs by developing regional clusters. Intra-African trade, in view of its more diversified composition, represents a promising avenue to support industrialization and foster the emergence of interconnected regional supply chains, notably in manufacturing. Establishing the African Continental Free Trade Area (CFTA) could go a long way in supporting industrialization, a key for Africa's intra-regional integration. CFTA would help increase both intra-African trade and its industrial content. Boosting intra-African trade and its industrial content can be achieved rapidly through CFTA, Africa's own mega-regional trade agreement, by removing all tariff barriers on goods still remaining within Africa and tackling those related to services trade.

The sequencing of trade policy reforms matters greatly. There is powerful evidence that CFTA should be put in place before other trade agreements are fully implemented by African countries or by the rest of the world (such as mega-regional trade agreements).[1] Doing so would not only preserve the anticipated benefits from these agreements but also offset most—if not all—their costs to Africa and to its industrialization. African countries' ambitions for regional integration should be elevated with greater attention on deepening RVCs. And deeper, broader and bolder regional integration should be followed by the gradual opening-up of African economies to the rest of the world, as African countries would then be in better position to compete internationally.

Preferential schemes have been helpful in supporting Africa's trade with preference-giving countries, but they have failed to broadly enhance Africa's industrialization. African countries should be conscious of the need to use these schemes for promoting industrialization. One of the key constraints limiting the use of preferences in manufacturing goods has been the imbalance between the productive capacity of African countries and stringent rules of origin. Policies that relate productive capacities of African countries with rules of origin are required for preferential schemes to promote industrialization. Yet, in order to amplify the benefits of trade and generate better distributed gains from trade across Africa, it is necessary to be bold and ambitious. For example, the reduction of NTBs—in particular the reduction of costs to trade across borders through aggressive trade facilitation reforms—are critical to ensure Africa's industrialization. A more integrated African market can stimulate the productive capacity required to develop solid RVCs and can assist diversification. The harmonization of rules of origin within the continent and possibly beyond will also be essential to reducing obstacles to trade and to those hindering movement up the value chains. So, African member states, individually and through the RECs, should make the necessary policy changes to realize the intra-African trade agenda and harness the domestic resources required.

African countries show high participation rates in GVCs, but at a low level, and the potential to tighten integration owing to the abundance of natural resources and low labour costs remains huge. African countries should design trade policy that promotes and reverses the current participation in GVCs at a low level.

CFTA should not be seen as an ultimate objective but rather a stepping stone to an African customs union aided by harmonized common external tariffs—a union which should open up trade with partners outside the continent. This demands that political commitments be made swiftly.

Trade policy alone cannot deliver industrial development, complementary policies and institutional structures are required. But trade policy alone cannot deliver industrial development.

The following specific policy instruments and institutional arrangements are required to enable trade to effectively promote industrialization:

- The growing importance of **information communication technology (ICT)** enables African countries to enter several value chains without developing the whole production process. Usually, services are poorly captured in traditional trade statistics, but they play a key role in increasing countries' participation in GVCs.
- Successful policies need to include sectoral initiatives that develop **product standards and good product quality, improving physical infrastructure** (telecommunication, roads, ports etc.) to connect with global players, establishing a national production network (business environment) to include more countries and reducing NTBs and/or increasing tariff liberalization to reduce costs of trading.
- Similarly, given the poor linkage between successful sectors and other areas, policies need to focus on **establishing production networks** within an economy.
- The similarity in structures of production across African economies calls for renewed efforts to spur structural transformation and development of Africa's productive capacities, including dynamic industrial policies' broad array of measures that improve the business environment and enhance coordination among firms. Likewise, governments could endeavour to **redress coordination failures and favour the emergence of viable clusters**, especially in manufacturing, although an overarching approach is needed to ensure that fiscal incentives to attract local and foreign investment are justified by the scope for promoting backward and forward linkages.
- On the financial front, African countries have increased their **budget for infrastructure provision,** including through regional frameworks such as the Programme for Infrastructure Development in Africa (PIDA), so that Africa finances nearly half its infrastructure projects. Yet the **financial needs remain daunting**. An annual investment of $7.5 billion is required over 2012–2020 to deliver projects in the PIDA Priority Action Plan, and $360 billion for PIDA's long-term view over 2012–2040. Innovative financial mechanisms should therefore be considered.
- It is imperative for African countries to identify—working with the private sector and other stakeholders—their own strategic priorities, **coordinate with regional partners the sequencing of trade facilitation measures, and assess related financial and technical assistance** needs. In doing this, African countries should make full use of the flexibilities available under Section II of the Trade Facilitation Agreement, to sequence the different measures in such a way that the commitments undertaken at the multilateral level are fully supportive of regional integration.
- The adoption of trade facilitation measures on top of CFTA reform would enhance positive outcomes. The level of ambition for Africa's regional integration should be elevated. Non-tariff barriers (NTBs) should be tackled along with tariffs on both goods and services. Greater attention should also be given to developing RVCs largely untapped within the continent.

ENDNOTES

1 Mega-regional trade agreements (MRTAs) are profound integration partnerships between countries often from different regions. Each MRTA usually accounts for a significant share of world trade and GDP.