July 2016

JAPAN INTERNATIONAL COOPERATION AGENCY

JICA TICAD VI
Policy Papers

Economic diversification of African economies

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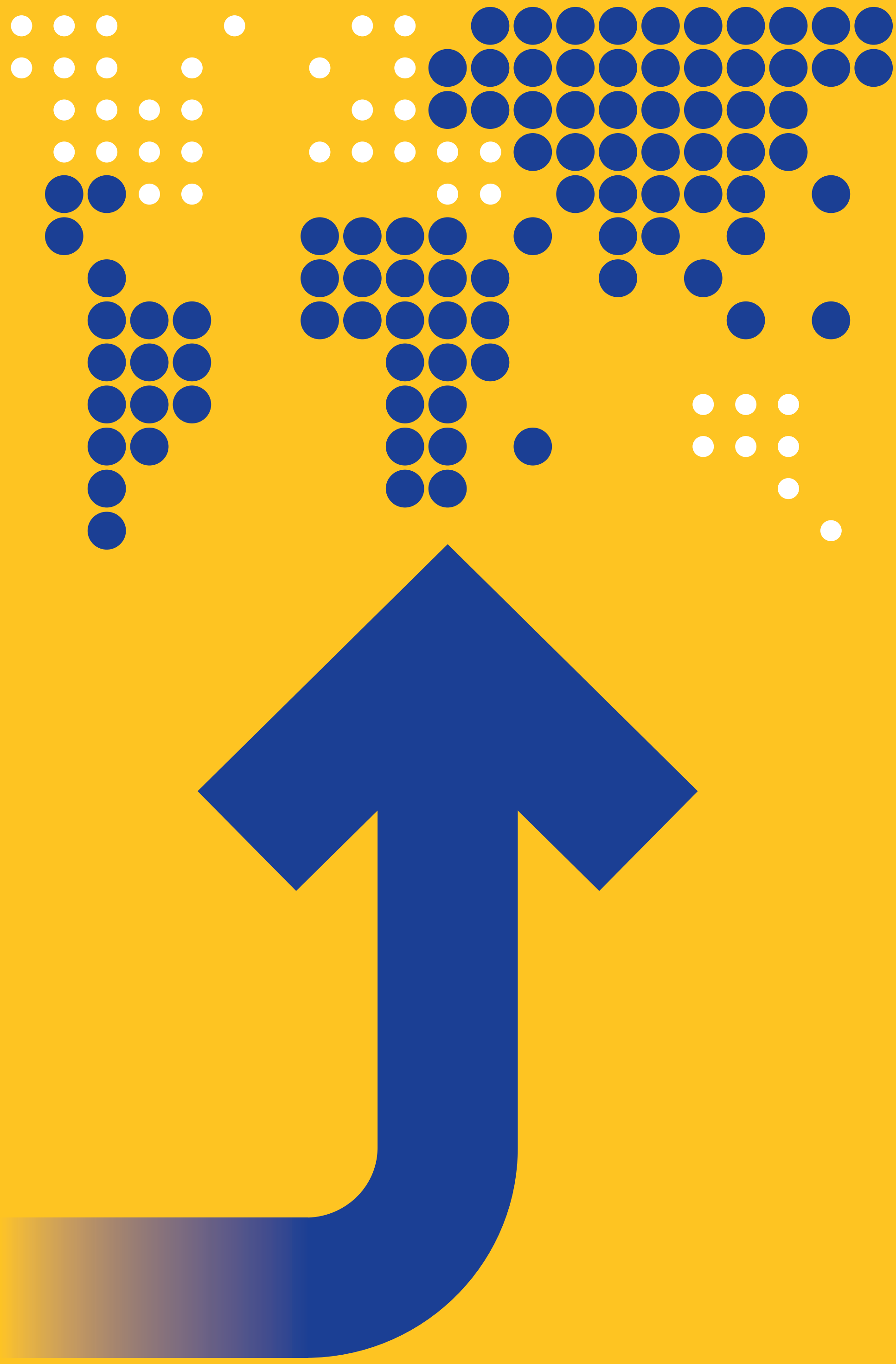

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Preface

The global economic environment at the time of TICAD VI (2016) is much less favorable than that prevailing at TICAD V (2013) when JICA presented a long-term vision—*Africa 2050: Realizing the Continent's Full Potential*—based on Africa's increasing convergence with the rest of the world. These changed circumstances have major implications for African policy makers.

This paper is one of six commissioned by JICA for TICAD VI to draw out these implications and suggest ways to move forward. The other five are:

- *Africa 2050 update*
- *The impact of commodity terms of trade in Africa: Curse, blessing, or manageable reality*
- *Africa's inclusive growth challenge: Reducing deprivation and creating jobs*
- *Infrastructure in Africa*
- *Regional economic integration in Africa*

We are confident that the papers will contribute to a fruitful dialogue among the Heads of State at TICAD VI. In addition, we hope that they will foster the concerted action by African policy makers needed to assure that Africa continues to converge with the rest of the world and, in doing so, meets the aspirations of its people.

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This paper was prepared by James Bond with research assistance from Alden LeClair.

Executive summary

African economies have not diversified. Despite two decades of solid growth, African countries have not developed a modern export-oriented industrial sector. Compared with other developing regions, Africa remains weak in terms of industrialization, which can be seen its very small share of world trade (less than three percent) and its export structure, where natural resources account for three-quarters of exports.

Instead, Africa's recent economic growth was driven by rising commodity prices and the move of low-skilled labor from subsistence farming into the local service sector. Africa's pattern of growth without structural change goes against the trend in other countries, where the share of manufacturing in GDP has increased as per capita income increased. In Africa the share of manufacturing is lower than the per capita GDP would lead one to expect.

Most African workers are engaged in informal self-employment in jobs that do not provide high wages, good working conditions or skills enhancement. African countries need urgently to diversify their economies into export sectors other than natural resources to provide for faster and more inclusive growth for their youth.

Industrialization as part of Africa's development history. At independence few African countries had strong industrial sectors; trade patterns focused on exports of raw materials and agricultural products and imports of manufactured goods. Since then, Africa has undergone three phases of industrialization policy. First, countries adopted state-led industrialization by developing large-scale manufacturing industries, mostly owned and managed by the state and protected behind trade barriers. After an initial boom, this policy proved to be financially and fiscally unsustainable and manufacturing growth slumped. Next came a period of structural adjustment, including trade and exchange rate liberalization, privatization of state-owned enterprises and greater fiscal discipline. Although this led to improved economic management and renewed growth, industrialization still did not take place. More recently, as growth returned, countries have introduced policies to improve their investment climate and streamline business practices and regulation. To date, this has not led to the development of stand-alone industries nor integration into global value chains.

Africa is back where it started in industrial development. Compared with half a century ago macroeconomic management is very significantly improved and regulations are somewhat more business friendly, but infrastructure has deteriorated and worker skills remain inadequate. A different approach to industrial development is needed in Africa.

Policy directions for Africa's economic diversification

To diversify their economies, African policy makers need now to focus on two things. First, they must continue to work on creating the right economic environment, through pursuit of sound macroeconomic management and light-handed regulation combined with elimination of corruption. Second, government entities at all levels must work hand in hand with the private sector to proactively promote new sources of economic growth. Promotion of and support to entrepreneurs should be the new mantra.

Promotion of new sources of growth should focus on integrating into global value chains, which are increasingly important in global production processes. Africa remains behind other regions in the world in this respect. A growing middle class and rapidly growing urban population also offer new opportunities for agro-businesses. Africa also has unexploited advantages in tradable services, a subset of services enabled by modern information and communications technologies and carried out at a distance. Finally, policy makers should seek to develop industrial clusters, which have significant benefits for the acquisition of knowledge and know-how but remain embryonic in the continent.

To diversify out of basic agriculture and low-value services, African governments need to operate in partnership with the private sector and adjust their policies constantly to take account of changing circumstances.

African countries display wide diversity and no set of policy recommendations would fit the entire continent. Depending on their country circumstances African policy makers need policies to address the following obstacles.

- Limited regional integration. Africa has a large number of small economies – which results in high fixed costs for public administration, difficulty for firms to achieve economies of scale, and little development of clusters. Despite, or perhaps because of, a multiplicity of initiatives, Africa's regional integration is weak and has focused more on political aspirations than on improving the competitiveness of African firms. Regional markets are non-existent or in an embryonic stage. African policy makers need to focus on smaller, development-corridor integration initiatives that directly benefit firms.
- Poor infrastructure. Africa has a huge infrastructure gap and the quality of its infrastructure services is poor. This increases costs, particularly for its many landlocked countries. Unlike other regions of the world, African countries do not call on significant private financing for infrastructure (other than mobile telecoms) because of inadequate user fees and uncreditworthy utilities. African policy makers need to rethink their approach to infrastructure development and management, focusing on how the private sector can play a much greater role.
- Weak skills base. Despite very significant progress in school enrollment, Africa remains the continent with the greatest number of low-skilled and unskilled workers. Often, national education systems do not provide the right kind of skills. Current efforts are not enough. African policy makers need to collaborate with the private sector on skills enhancement (basic literacy and numeracy, plus technical skills) through initiatives such as matching grants and shared financing.
- Poor business environment. Despite significant reforms, regulatory and business frameworks still remain unattractive, and African governments still penalize their firms. Regulatory systems need to be completely re-engineered, with African entrepreneurs in mind, rather than adjusted at the margin.

Economic diversification is not a stable economic state. It requires constant policy adjustment by policymakers for countries to remain globally competitive. To diversify out of basic agriculture and low-value services, African governments need to operate in partnership with the private sector and adjust their policies constantly to take account of changing circumstances. The fundamental solution to diversifying African economies lies in the promotion of African entrepreneurs through the creation of a much better business environment throughout the continent.

Economic diversification of African economies

James Bond

The issue: Most countries in Africa have not developed a modern export-oriented industrial sector

With a few exceptions (Tunisia and Mauritius, in particular), two decades of economic growth in Africa has not led to significant structural change of the economy. Notably, compared with other developing regions of the world, Africa remains weak in terms of industrialization. Industrialization is here taken to mean more than just the "smokestack industries" comprising mining, manufacturing, utilities and construction. Modern industry comprises that part of an outward export-oriented economy based on manufacturing, as well as agro-industrial value chains and the tradable services sector (e.g. call centers, financial services, tourism). These all share the same firm-level characteristics and react to business environment parameters in similar ways.[1]

Africa's lack of industrialization is reflected in its trade patterns. From a trade perspective, Africa is the continent least integrated into the world economy. In 2014 the African continent (population: 1.111 billion people, or 15 percent of the world's population) represented around 2.8 percent of world trade (goods and services), less than France (population: 65 million people).[2] Intra-African trade is around 12.8 percent of the continent's GDP, compared with 68.6 percent in the EU or 53.4 percent in Asia.[3] African countries are thus not connected among themselves via trade links, and most have stronger trading relationships with their former colonial masters in Europe or with China than with each other.

A further indicator of the lack of industrialization can be seen in export patterns. Africa's exports currently focus to a large extent on natural resources (minerals and agricultural raw materials) and not on the modern definition of industrial goods and tradable services. In 2014 commodities represented about 80.6 percent of African exports, a proportion that peaked in 2011 at 82 percent, as prices and output went up sharply over the last decade. With a few exceptions Africa does not export processed or semi-processed natural resources either. Although processing of natural resources (bauxite into aluminum, oil into petroleum products, iron ore into pig-iron) does not create much value added, it does enable the development of associated industries around such installations ("clusters") and provides on-the-job training and skills enhancement for workers. Africa does not benefit from this.

Africa's recent economic growth has thus for the most part resulted from the combination of the effect of rising worldwide commodity prices over the past two decades (based to a large extent on China's export-led growth), which has since moderated, and from the move of low-skilled labor in many African countries from extremely low-productivity subsistence agriculture in rural areas, into low- or moderate- productivity services for domestic consumers. Such domestic services are generally delivered through the informal economy in urban areas and do not deliver skills enhancement, employment security or access to the modern economy, notably access to the financial sector or to healthcare[4]. Africa's economic growth has not led to the creation of "good jobs". Paid employment, irrespective of its nature, has positive effects on poverty reduction; but "good jobs" refers to employment in structured firms in the formal economy rather than day labor in the informal economy. In addition to wages, the former confers additional benefits on workers from the firm, such as on-the-job training, and labor market benefits, such as unemployment insurance. Such jobs are rare in Africa largely

1. Definition taken from: Newman, C. et al. (2016). *Made in Africa – Learning to Compete in Industry*. Washington: Brookings Institute.
2. WTO. (2015). WTO statistics.
3. WTO (2013), quoted in the Infrastructure Consortium for Africa, 2015

4. Such activities do not for the most part entail payment of taxes either.

African economies need urgently therefore to diversify their economies in order to create jobs to absorb the cohorts of young people leaving the land.

Table 1: Africa's manufacturing deficit, 2014

Share of GDP (%)	Agriculture	Manufacturing	Construction	Mining and utilities	Services
Middle-income developing economies	16.8	16.5	7.1	8.7	50.9
Africa low income	30.3	8.3	7.8	10.2	43.4
Africa middle income	5.4	8.5	6.8	26.1	53.3

Note: Total value added
Source: UNCTAD (2016)

because the continent has not yet embarked on an export-led growth pattern involving industrialization.[5]

Africa's pattern of growth without structural change goes against a widely observed trend of industrialization around the world – the movement of labor from low value-added agriculture into export-oriented industrial sectors – which has long been the model for development, most recently in Asia. In almost all developing countries the share of manufacturing in GDP increases as per capita income increases. In almost all African countries, the share of manufacturing is below what the per capita GDP would lead one to expect (Table 1, above). For two decades, African labor has moved out of subsistence agriculture into more productive employment but not into industry, and not into sectors that export.

This means that while African countries do differ from one another in terms of economic structure – for example, in resource-rich countries the primary sector dominates – they are almost all characterized by an underdeveloped manufacturing sector and a large unsophisticated service sector providing mostly low value-added services to the domestic economy. (Tunisia, Mauritius, and more recently, Morocco, are striking counter-examples of this, as shall be demonstrated throughout this paper.) The overwhelming majority of young African workers are engaged in informal self-employment, often as day laborers, or in micro-enterprises, in jobs that do not provide them with high wages, good working conditions or skills enhancement. Industrial sectors, on the other hand, deliver employment that provides secure income and enhances skills, and is the best route to sustained poverty reduction because of its distributive effect in the economy.

Africa is the fastest growing continent, and the one where rural-urban migration is most pronounced. African economies need urgently therefore to diversify their economies in order to create jobs to absorb the cohorts of young people leaving the land. Diversification into export sectors, including in particular intra-Africa exports, will create jobs and reduce poverty, as well as lay the foundations of a long term growth platform less dependent on natural resources and less vulnerable to terms of trade shocks.

Industrialization as part of Africa's development history

Six decades ago few African countries had strong industrial sectors. Exceptions were Egypt and, to a lesser extent, Algeria and South Africa. Other countries found themselves with trade patterns almost exclusively focused on exports of raw materials and agricultural produce, and imports of manufactured goods. There was a sense among the emerging leaders of the soon-to-be independent countries that they needed to transform the economies by reducing dependence on imports of manufactures and creating an indigenous

5. Some countries of course buck this trend: notably Mauritius, Morocco, South Africa and Tunisia. But the above summary is broadly in line with the vast majority of African countries.

At independence (in the late 1950s and early 1960s), countries undertook a strategy of state-led industrialization and import substitution.

manufacturing sector at home. Since independence, Africa has undergone three broad phases of industrialization policy to try to diversify the economy.

First phase: State-led industrialization (1960-1985)

Central role of the state

At independence (in the late 1950s and early 1960s), countries undertook a strategy of state-led industrialization and import substitution. The leaders of the newly independent countries had for the most part similar views on the importance played by industrialization in the development process and shared the desire to move away from subsistence agriculture to a modern industrial state. The central element of this strategy was the development of large-scale manufacturing industries, in most cases owned and managed by the state. Such industries are capital intensive and require quite specific labor and management skills, which were often not available in the domestic labor market. This industrial policy was designed around substituting for existing imports of manufactures in the domestic market rather than providing exports to international markets. Governments instituted protective measures on the local market such as import tariffs, non-tariff barriers (e.g. quantitative restrictions), and currency controls, as a way of achieving economic independence.

The state thus became the central actor in the industrialization strategy, both by ownership and operation of assets through newly created state-owned enterprises (SOEs), and by protective policies put in place around the new industries. It should be noted that in adopting these policies, the new African leaders were emulating the prevailing conventional wisdom concerning industrialization and economic development followed in Europe and elsewhere, where there had been a significant move toward a more central role for the state during and following post-World War II reconstruction. [6]

Country examples

Examples of such state-led development were Ghana, where the state under President Nkrumah invested heavily in infrastructure and manufacturing, including producer goods (electrical and machinery industries). Other countries such as Tanzania, Uganda and Nigeria followed similar patterns. Apartheid South Africa also followed this path to some extent despite its already strong private sector, with the creation of strategic industries, including for example the manufacture of petroleum products from the country's abundant coal resources through a state-owned entity, SASOL. With the exception of South Africa, these economic policies generally received both support and financing from the international donor community.

Some countries did not follow this model to the same degree. Examples are Kenya and Cote d'Ivoire, where the state had a smaller role and the private sector was allowed to flourish outside so-called strategic industries. Both built strong domestic private sectors based on exports of agricultural commodities: for Kenya, tea and later, cut flowers and vegetables; for Cote d'Ivoire, cacao and coffee. These sectors have remained strong today and still form the backbone of the economy of these countries.

Other countries followed an even stiffer centralized economy approach. Examples are Madagascar after the revolution of 1972 and institution of the Ratsiraka government of 1975, which nationalized most of the economy and instituted a North Korea-type centralized economy; Ethiopia, which after the 1974 Dergue revolution nationalized most

6. Daniel Yergin and Joseph Stanislaw. T*he Commanding Heights: The Battle for the World Economy*. Free Press (April 2, 2002)

This state-led industrialization policy was not financially or fiscally sustainable in the long term and, by 1975, economic growth in Africa had fallen back and production capacity became underutilized.

privately owned manufacturing enterprises; and Mozambique, which after the Frelimo takeover from the Portuguese in 1975 nationalized many enterprises (which had until then been Portuguese-owned) and instituted import controls. In all three cases, long-lasting damage to the economic fabric ensued, and per capita GDP plummeted. This was associated with increases in poverty and child malnutrition, and reduced life expectancy.

Success stories

Finally, a small number of countries did not follow this model at all. Mauritius became independent only in 1968, by which time the weaknesses of state-led industrial policies implemented in other African countries were becoming apparent. The government therefore sought local and foreign private investment into sectors geared toward exports. An export processing zone (EPZ) was created, which offered duty-free entry of inputs and free repatriation of capital, and the government provided essential infrastructure and plant locations to increase competitiveness. It targeted first the sugar industry (Mauritius has the right climate for cultivating sugar cane), benefiting from the EU sugar protections and its Africa-Caribbean-Pacific (ACP) import preferences; then, as these advantages began to decline, it moved into textiles and tourism; and finally into IT and back-office financial services. This strategy has been outstandingly effective and has conferred on Mauritius the highest 50-year growth rate of any of the countries in Africa, pulling Mauritius into the realm of upper middle income countries.

For its part, Tunisia instituted a dual economy that combined import substitution and export promotion, with an offshore sector dominated by private investors (often foreign) geared toward exports, and an onshore sector shielded from competition and regulated by the state. The offshore sector focused on the nearby European markets (notably France) while the onshore sector, with significantly lower productivity, consisted of many small factories producing simple consumer goods for the local market. Heavy industry and the infrastructure sectors (transport, electricity, water, telecoms) were state-owned.

Although, in hindsight, policies of state-led industrialization and protection from import competition were unlikely to succeed, in many cases newly independent African countries initially experienced a boom. Between 1965 and 1970 manufacturing output grew by more than 7 percent per year, and in some countries, close to 10 percent per year (Tanzania, Uganda). This state-led industrialization policy was not financially or fiscally sustainable in the long term and, by 1975, economic growth in Africa had fallen back and production capacity became underutilized. By the end of the period (1985) manufacturing growth slumped and in some countries turned negative (Ghana, Nigeria and Tanzania). In some cases, the manufacturing sector was actually producing goods with negative value-added, i.e. the cost of intermediate inputs (and thus the domestic sales price) exceeded the border price for the same product. Countries were faced with foreign exchange shortages and loss of fiscal and monetary control. Only Tunisia and Mauritius, with their outward private sector orientation, were able to sustain the pace of industrial growth.

Second phase: Structural adjustment (1985 – 2000)

By the 1970s it was becoming clear across the world that excessive protection of domestic markets and the central role of the state in the economy imposed important costs on the economy in terms of reduced welfare and economic growth. Moreover, Africa's prevailing industrialization policy, which was very capital intensive, could no longer be financed. Over the following decade a set of economic policies known as "structural adjustment" were elaborated by the IMF, the

However, structural adjustment did not lead to significant structural change.

World Bank and the donor community[7]. The specific policies proposed depended on country circumstances, but they included in particular:

- Trade liberalization
- Introduction of a competitive exchange rate
- Privatization of state-owned enterprises
- Greater fiscal discipline, with public expenditures to be focused on basic education and essential infrastructure[8]
- Promotion of foreign direct investment
- Deregulation

Very quickly these policies spread to Africa. By 1979, Senegal turned to the donor community for a stabilization and structural adjustment program, followed by Ghana in 1983. By 1988 eighteen countries had initiated macro-economic stabilization and structural adjustment programs with the IMF and World Bank and a further fourteen obtained support from the donor community for sector-specific adjustment programs. Over the course of the period (1985-2000) over thirty African countries adopted externally financed adjustment programs focusing on exchange rate and trade policy reforms, and others undertook internal adjustment without external support. State-led industrialization based on import protection was essentially at an end.

Privatization of state-owned enterprises became a key part of the adjustment program. It had a dual objective: first, to reduce pressures on the budget and create fiscal space for the government to invest in human capital and essential infrastructure; and second, to improve economic efficiency in the production process by introducing skills, techniques and financing from the private sector. In cases where there was no private investor interest, state-owned enterprises were shut down.

Structural adjustment dramatically improved economic management in the countries concerned, with major improvements in fiscal deficits and freeing up of currencies. Trade was liberalized and the balance sheets of most governments were slimmed down to more manageable proportions through privatization. Quantitative restrictions were replaced by tariffs and budgetary processes became much more transparent and rational. However, structural adjustment did not lead to significant structural change. Most countries experienced a short burst of economic growth, but increased competitive pressures from abroad, the absence of appropriate skills and the scarcity of debt financing soon impacted the former state-owned enterprises. These, now often privatized, in some cases, were operating at around 10 percent of capacity; industrial output plummeted further. By the late 1990s many state-owned enterprises in, for example, Ghana, Guinea, Nigeria and Tanzania, were shut down awaiting privatization or liquidation. Mauritius and Tunisia, with their existing competitive manufacturing sectors, avoided this trend, and Kenya and Uganda were less affected, in part because of their strong private sectors.

An unfortunate outcome of the structural adjustment process was the reduction in funding going to quality public education and infrastructure, despite the stated purpose of many adjustment programs, as a consequence of stricter fiscal management. The long-term effect was to reduce investment in human capital and in infrastructure over the period and beyond, which has resulted in a weak skills base – particularly among cohorts who normally would be at their most productive in today's economy – and inadequate infrastructure. Two decades of lack of maintenance have degraded road systems, allowed rail networks to fall into disrepair and led to widespread shortages of electricity. Poor skills and infrastructure add to the cost structure of Africa's firms and reduce their competitiveness on international markets.

7. This set of policies has since been termed the "Washington Consensus."
8. Although both education and infrastructure deteriorated over the structural adjustment period.

With respect to industrial development, African countries have broadly ended up in 2016 where they found themselves at independence half a century ago.

In hindsight, structural adjustment – by which we mean putting in place a set of rational economic policies – was perhaps necessary, but it was certainly not sufficient to achieve structural change in the economy.

Current phase: Investment climate reform (2000-Present)

By the year 2000 almost all African countries had instituted a set of more open economic policies that included trade liberalization and exchange rate reform. Fiscal deficits were beginning to improve and continent-wide, inflation had come down. Africa started to see positive per capita economic growth. But other than in a small number of countries the continent had not seen the development of an indigenous private sector-led industrial sector, and exports remained focused on natural resources.

In an effort to attract foreign investors for the creation of manufacturing and service sector firms, countries began to take a closer look at their investment climate[9]. A number of very specific micro-economic policies were set in place to streamline business practices and regulation. Most African countries have instituted such investment climate reforms over the past decade and a half. In Kenya, for example, an investment climate program is in place to improve electric power supply, liberalize and streamline regulations of private firms, and introduce fiscal reforms. Ethiopia's Industrial Development Strategy, which dates from 2003, seeks to provide macroeconomic stability, improve access to finance, provide improved infrastructure and upgrade the country's skills base. In Senegal, the government instituted its Accelerated Growth Strategy in 2005 with similar policies; Mozambique followed suit in 2007 and Uganda in 2008. Even Mauritius and Tunisia implemented investment climate reforms to further improve their business environments.

Investment climate reform is still underway across Africa, and it is difficult at this stage to provide a definitive view of its efficacy. For certain, there have been improvements in the business environment across the continent, and economic growth has been sustained. However, it does not seem to have dramatically changed the structure of African economies, nor to have provided for the development of industrial sectors such as manufactures and tradable services. Most of the reform measures have been incremental, enabling countries to improve by one or two positions in the Doing Business rankings at most.[10] African investment climates are for the most part so unattractive that to really have an effect on potential investors, policy-makers cannot simply streamline the current system. The entire regulatory framework needs to be redesigned from the ground up.

Unlike other regions of the world like East Asia, there has therefore not been a major push of foreign investors into creating stand-alone industries or integration into global value chains on the continent. Moreover, growth in African manufacturing output has remained below overall GDP growth over the past decade, indicating that, if anything, Africa continues to undergo de-industrialization as it has grown.

Thus, Africa is back where it started. With respect to industrial development, African countries have broadly ended up in 2016 where they found themselves at independence half a century ago. But economic circumstances across the globe have changed. Notable differences in African economies compared to half century ago are, first, much improved macroeconomic management; second, business regulations that are significantly more rational and business-friendly (although more could be done on this front); and third, a severely deteriorated infrastructure due to lack of maintenance and replacement. Finally, skills of African workers still remain woefully below what an industrial sector would

9. Defined in this document as macro stability and openness, good governance and strong institutions, quality of the skills base, and quality and cost of infrastructure services.

10. World Bank/IFC. *Doing Business surveys* (Annual). World Bank, Washington DC.

Increasingly, the view is emerging that the current trend in business climate policy in African countries – improving the business climate to improve the attractiveness of the country for private investors – is a necessary but not sufficient condition for industrialization.

require, a result both of underperforming education systems and the lack of incentives for workers to acquire useful skills.

Increasingly, the view is emerging that the current trend in business climate policy in African countries – improving the business climate to improve the attractiveness of the country for private investors – is a necessary but not sufficient condition for industrialization. These orthodox economic laissez-faire policies implemented over the past two decades have not delivered on significant private investment in manufacturing nor development of the industrial sectors. Policy makers must take a leaf out of the book of successful East Asian economies, as well as from the experience of successful African industrializers like Mauritius, and recognize the need for a more aggressive set of policies in Africa. But given Africa's unsuccessful experience of public sector-led industrialization of the 1960s, the question remains, what should this policy package look like?

Reasons for lack of industrialization in Africa

There are numerous factors underlying Africa's unusual pattern of growth over the last two decades, which have prevented the development of strongly outward-focused industrial sectors. Some of these obstacles have been or are being addressed in ongoing investment climate reforms. Others have not received the attention they deserve.

- Country size. Africa has a large number of small countries – this results in high fixed costs for the administration, difficulty for firms and sectors in achieving economies of scale, little development of clusters.
- Infrastructure. Africa has a low overall infrastructure endowment and the quality of its infrastructure services is poor. This increases costs, particularly for its many landlocked countries.
- Regional integration. Inter-country linkages are weak and focused more on political union than on improving competitiveness of African firms. Regional markets are non-existent or in an embryonic stage.
- Business environment. Despite significant reforms, regulatory and business frameworks still remain unattractive, and African governments still penalize their firms.
- Weak skills base. Despite very significant progress in terms of school attendance, Africa remains the continent with the greatest number of low- or unskilled workers. Often, national education systems do not provide the right kind of skills.
- Resource-rich countries. These remain a special challenge because of the difficulty in managing fiscal flows and the terms of trade shocks that result from price swings.

Large number of small countries

Africa encompasses 54 countries, of which 48 are south of the Sahara and 15 are landlocked. The most populous country, Nigeria, has 180 million people and the second most populous, Egypt, 90 million, as compared with Brazil with 200 million people and Indonesia with 250 million. In general, countries in Africa are far less populous. As a continent Africa has a lower population than India or China. Average country size in Africa is 21 million, less than or on a par with each of the world's five largest cities (Tokyo, Delhi, Mexico City, Mumbai, Sao Paulo). On average, Africa's countries are small, and no other region has such an agglomeration of small countries; most African cities are also small. No other continent has so many landlocked countries.

Smallness introduces three obstacles for development.

High fixed costs of running the national administration and essential government functions

Small countries have specific economic challenges relating to the overhead cost of being an independent state.

Most African countries have not been proactive in creating an aggressively outward-facing economy the way Mauritius and Tunisia have.

Irrespective of size, countries have certain central government functions that need to be performed (fiscal policy and management legislative functions, central banking and monetary policy, among others). In smaller countries the tax base to finance such functions, and the skills pool to call upon to implement them, are more limited, and the quality of economic policy and administration can suffer.

Lack of economies of scale

Countries with small populations have difficulty in achieving economies of scale because their small internal markets do not provide significant opportunities for local providers of goods and services. The only way to overcome these obstacles is to reach larger markets; this requires an economic policy that is strongly outward looking with a major focus on exports and a very significant effort toward regional integration. It is notable that the two African success stories have undertaken this path:

- Mauritius adopted from the start a strong focus first on sugar exports, benefiting from EU market access provided to ACP countries under the 1975 Lomé Agreement, as well as from the EU Common Agricultural Policy, which pitched European sugar prices significantly above international market prices, offsetting Mauritius's geographic disadvantage compared to other sugar producers. When this opportunity began to decline with Europe's removal of its agricultural price controls, the government actively promoted the development of a textile industry within an EPZ located on the island. Mauritius's textiles exports benefited specifically from the 2000 US Africa Growth and Opportunity Act (AGOA), particularly once clauses relating to origin of inputs were liberalized. At the same time the government actively promoted investment in the incipient tourism sector, including support through the creation of specialized training schools for tourism professionals and a modern international airport (now rated the best in Africa). More recently, as Mauritian labor has moved up the skills and pay curve and become less competitive in textiles, the government has promoted the development of an information technology and financial sector service industry, which is experiencing significant growth (see Box 1).
- Tunisia, after an unfruitful period of state-led development until the early 1970s, adopted a policy focused more on export promotion combined with some import substitution (in a policy known as infitâh). The offshore sector focused on attracting foreign firms to invest in the country and on exports of manufactures to Europe. Tunisian manufacturing grew at 15 percent per year during the 1970s and close to 100,000 jobs were created. By the late 1980s manufacturing growth had slowed and the government started negotiations on a free trade agreement (FTA) with the European Union, concluded in 1998. This effort was supported by the government's proactive industrial modernization plan, including skills enhancement, with financial support from the EU. Exports to the EU grew at more than 10 percent per year. More recently the political turmoil that followed the ouster of President Ben Ali and the subsequent governments have put a severe damper on growth in manufacturing and on exports.

Generally, however, most African countries have not been proactive in creating an aggressively outward-facing economy the way Mauritius and Tunisia have. It is informative to see that in both cases the governments followed heterodox economic policies, with active promotion of specific sectors

Mauritius has followed a pragmatic development strategy in which the liberalization process was sequenced and tailored to its competitive advantages and weaknesses.

Box 1: Mauritius—How a small African country overcame its natural obstacles

Since independence in 1968, Mauritius has developed from a low-income, agriculturally based economy to a middle-income diversified economy with growing industrial, financial, and tourist sectors. For most of the period, annual growth has been in the order of 5 percent to 6 percent. It has also achieved an equitable income distribution with low inequality on a par with European countries (Gini coefficient of 38.9). This has been reflected in increased life expectancy, lowered infant mortality, and a much-improved infrastructure.

Mauritius's development strategy has been articulated along four axes:

Heterodox liberalization and diversification policies: Mauritius has followed a pragmatic development strategy in which the liberalization process was sequenced and tailored to its competitive advantages and weaknesses. The export-orientated approach has encouraged liberalization supported by strong state involvement as a facilitator (of the enabling environment for the private sector); as operator (to encourage competition); and as regulator (to protect the economy as well as vulnerable groups and sectors from shocks). Strategies were evidence-based and adapted according to results, and the country has consistency and stability, regardless of which political party is in power.

Concerted of nation building: Since independence Mauritius has focused on creating the foundations for sustained growth through nation building. Partnerships across ethnic groups allowed economic redistribution to be negotiated and the resulting better balance of economic and political power allowed strong and independent institutions. The political system encouraged a consultative approach to policy formation that allowed strategies for growth to be continued regardless of changes in the parties in power.

Strong and inclusive institutions: Strong institutions are critical in ensuring the country's competitiveness, economic resilience and stability. They have supported development strategies and ensured that export earnings are reinvested in strategic and productive sectors. In the financial sector they have built a regulated and well-capitalized banking and financial system. Perhaps most important, the administration is staffed along apolitical lines, with civil servants who are well educated, competent, effective, well remunerated and non-corrupt.

High levels of equitable public investment: Mauritius has a strong human capital foundation developed through consistent and equitable investment in human development, and among the most effective infrastructure services on the continent. This has enabled Mauritius to exploit advantages, learn from expertise brought in through FDI and maintain competitiveness in a fast evolving international market. Education and health services are free and have been expanded in recent years, in order to create further employment opportunities and ensuring inclusive growth.

Source: Overseas Development Institute

determined to be of greatest potential and benefiting from trade agreements with the EU and the US.

Lack of aggregation economies and difficulties in developing industrial clusters

Across the world, firms tend to agglomerate in clusters drawn by the markets they serve, by the products and services they produce, and by the skills they require. In France, the United Kingdom and the US, 75 to 95 percent of industry is clustered or concentrated relative to the overall economy. In Tunisia, more than half the large scale industrial firms are located in just two geographical areas.[11]

Africa has examples of such clusters:

- Morocco: Tangier (automobiles and automotive parts)

11. Newman et al (2016); World Bank. (2009). *World Development Report 2009*.

Overall, the African continent is by all measures the least endowed region of the developing world in terms of infrastructure, even compared with low and middle income countries in other regions.

- Morocco: Casablanca/Fez (decoration, furniture, leather processing)
- Ghana: Suame Magazine (the largest artisanal engineering cluster in sub-Saharan Africa – metal working: casting, lathe operators, foundries)
- Tanzania: Arusha cluster (furniture)
- Nigeria: Nnewe cluster (auto parts)
- South Africa: Durban auto cluster (auto assembly and auto parts)
- Egypt: Domiatt cluster (furniture)
- Uganda: Lake Victoria cluster (fish processing)
- Kenya: Nairobi cut flower cluster (horticultural products)

However, compared with emerging Asia, notably China, Africa has relatively few clusters, and compared with their peers in other regions African clusters have a relatively low level of sophistication in terms of access to financing, research and development, skills enhancement through specialized education institutions and market intelligence. Also, they do not benefit from the same degree of government support. Indeed, the Nigeria Nnewe cluster for auto parts, one of the more successful examples in Sub-Saharan Africa, developed through a collaborative effort between Nigerian importers of equipment from Taiwan and their Taiwanese suppliers, who provided on the job training and other support. The Nigerian Federal and State governments provided little tangible support. The Nnewi cluster overcame lack of infrastructure and absence of government support by providing its own electric power and water and setting up its own business organizations such as the Nnewi Chamber of Commerce Industry, Mines and Agriculture.

Low infrastructure endowment and poor quality infrastructure services

Infrastructure endowment

Adequacy of infrastructure helps determine one country's success and another's failure in diversifying production, expanding trade, coping with population growth, reducing poverty or improving environmental conditions. Good infrastructure, through the services it provides to the economy, raises productivity and lowers production costs, but it has to expand fast enough to accommodate growth. The kind of infrastructure put in place also determines whether growth does all that it can to reduce poverty.[12] Rural roads, for example, linking rural and urban markets, or rural water supply, will do more for inclusive growth than other infrastructure services targeting higher income populations.

Africa does not have good infrastructure and is not well connected.[13] Overall, the African continent is by all measures the least endowed region of the developing world in terms of infrastructure, even compared with low and middle income countries in other regions. Moreover, performance of infrastructure in Africa is generally poor: high cost, erratic, and undependable. Transport costs are the highest in the world, twice the level of other developing countries (and four times for landlocked countries), and significantly limit Africa's ability to trade regionally and globally.[14] Other infrastructure essential to competitive economies, such as electricity networks and fixed line telephone and broadband connectivity, are also relatively underdeveloped. Sub-Saharan Africa has by far the lowest percentage of the population with access to electricity (35 percent for the total population, but only 17 percent in

12. World Bank, ibid.
13. There are various global indices of connectivity: see of instance McKinsey Global Institute's Global Connectivity Index.
14. Aspen Institute, "Trade Facilitation to Promote Intra-African Trade, Committee on Regional Cooperation and Integration", Addis Ababa, Ethiopia, March 24-25, 2005.

Three constraints – poor initial conditions, low infrastructure endowment, and ineffective regional integration – taken together, have kept African economies relatively fragmented and high cost.

rural areas) and the lowest per capita electricity consumption for those who have access – average residential electricity consumption per capita is equivalent to around half the level of China or one-fifth of Europe.

Africa's combination of low infrastructure endowment and poor quality infrastructure services relative to other developing regions means that the continent has significant cost hurdles to be able to compete internationally in the exports of goods and services.

Unfinished regional integration

Since independence, African countries have supported regional integration through the creation of a large number of overlapping initiatives and organizations (see Figure 1, below.). These have however focused more successfully on political coordination than on creating regional markets or production corridors. In particular, integration has lagged in the critical areas of regional infrastructure, mobility of skills and trade in services and "behind the border" non-tariff barriers.

Africa's experience with regional integration

As indicated in the companion paper on Regional Integration, the integration model followed by the African continent, with leadership from the African Union (formerly the OAU) and support from the United Nations Economic Commission for Africa (UNECA), was to promote the creation of geographic integration blocs or "Regional Economic Communities" (RECs). The goal of the RECs was to advance in a sequential, linear progression from free trade areas (FTAs), to customs unions and to a single market, finally converging toward a continent-wide economic and monetary union.[15]

If such a development plan had been successful, one would expect regional markets for goods, services, capital and labor to develop within (and perhaps between) the different RECs. For example, if regional integration had gone according to plan one would expect that consumer products produced in Benin would access the large consumer markets in and around Lagos in Nigeria, and that the Ivorian telecommunications company Citelcom could be able to operate freely in Mali. These countries all belong to ECOWAS. Similarly, we would expect that an accountant or nurse trained in Uganda would be accredited to work in Kenya or Uganda, and a Kenyan bank would be able to provide a line of credit directly to a company in Tanzania, as these countries all belong to the East African Community, part of COMESA. However, none of these are possible, perhaps indicating that promoting development of regional markets and enabling African firms to improve their competitiveness was not the primary objective of the integration initiatives. The diagram on the next page shows country groupings for the different regional integration initiatives across the African continent (Figure 1).

Three constraints – poor initial conditions, low infrastructure endowment, and ineffective regional integration – taken together, have kept African economies relatively fragmented and high cost. They have hindered firms' ability to operate in the lean, just-in-time production mode needed to effectively participate in global value chains.

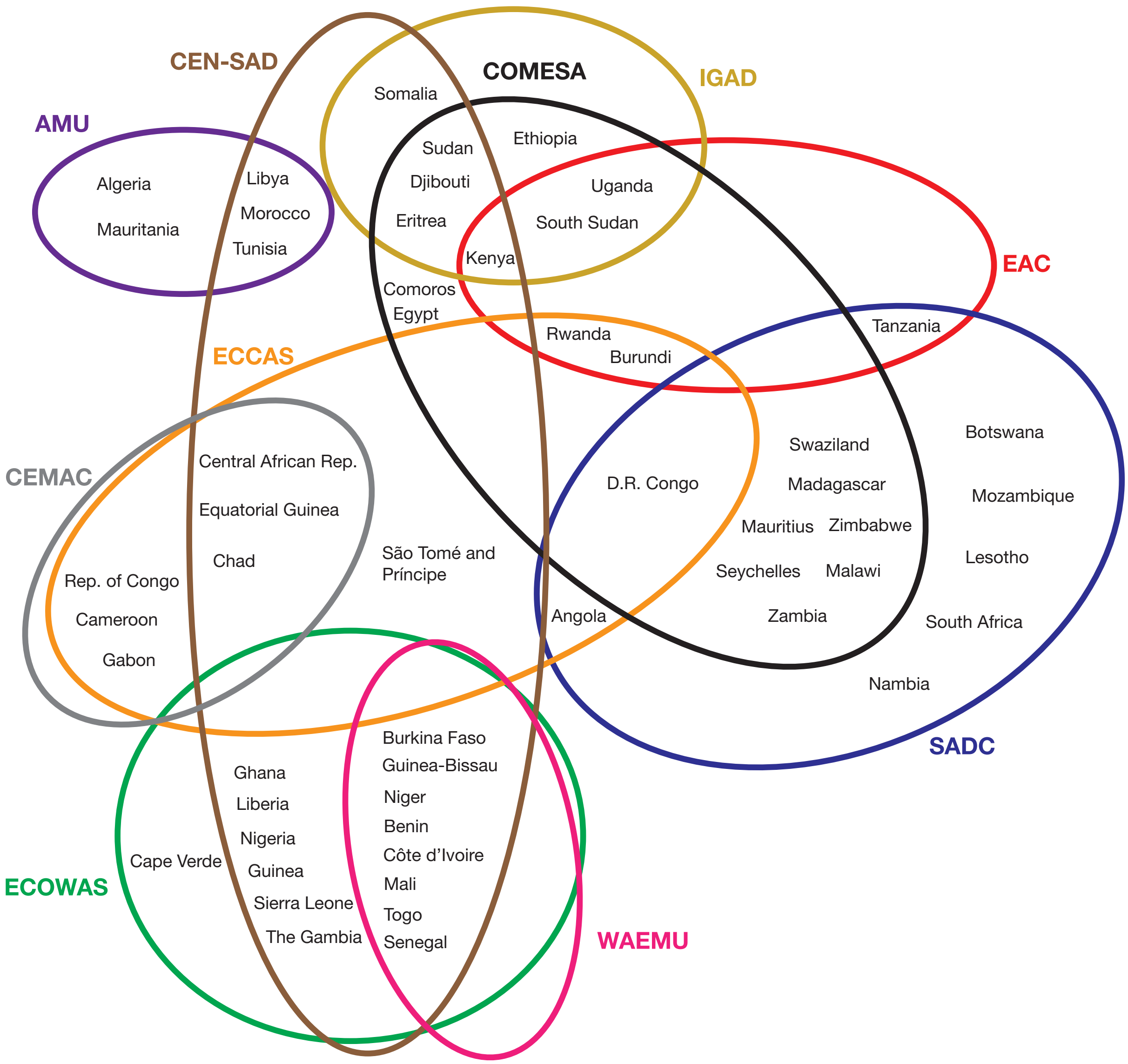
Regulatory frameworks, a key part of the business environment, are still unattractive

The business environment may be defined as the nexus of policies, institutions, physical infrastructure, human

15. Early RECs were: ECOWAS (for West Africa), ECCAS (for Central Africa), COMESA (for South and Eastern Africa), and AMU (for North Africa). In addition, other overlapping regional integration arrangements were set in place. For instance, in West and Central Africa WAEMU and CEMAC became active alongside ECOWAS, while EAC, partly overlapping membership with COMESA, was revived. Also IGAD (Intergovernmental Authority on Development) organizes countries of the Horn of Africa, Nile Valley and the Great Lakes into a REC, while the inter-governmental Indian Ocean Commission (IOC) of 1984 regroups the five island communities of Mauritius, Seychelles, Comoros, Madagascar and La Reunion.

Broadly speaking, a review of the Doing Business report shows that firms in African countries are burdened with inefficient, time-consuming and costly regulations that increase overall cost and reduce their international competitiveness.

Figure 1: Africa's regional integration intiatives



Outdated cadaster systems make registering real estate very difficult in many African countries, and these assets therefore cannot be used by firms as collateral when borrowing from banks.

resources and geographic features that influence the efficiency with which different firms and industries operate. At the firm level, it directly influences costs of production; at the industry level, it often relates to market structure and competition. Its impact is felt more heavily in traded sectors that are not particularly intensive in natural resources (that is, manufacturing, high-value services) than in primary production and extractive resource sectors. Even efficient firms able to transform inputs into outputs with high efficiency and low "factory-floor" costs can be driven out of business by a poor business environment.[16]

The business environment is made up of several different components. Some of these components (infrastructure, geographic features, human capital) are considered elsewhere in this paper. The regulatory framework is, however, a key feature of the business environment that warrants particular examination because, unlike certain other features (e.g. geography or regional integration), it is almost entirely at the discretion of the government where the firm is located. There is, therefore, far more freedom to undertake systemic change to improve competitiveness than with the other components.

It is thus surprising that despite progress over the last decade, African countries figure almost universally at the bottom of the league tables concerning the attractiveness of their regulatory frameworks. The attractiveness of regulatory frameworks is generally measured through the World Bank/IFC Doing Business surveys. Doing Business measures certain business regulations in 189 countries and ranks countries on nine dimensions: starting a business; dealing with construction permits; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and closing a business. The Doing Business approach has been criticized as excessively mechanistic, and the system itself is open to gaming by countries to manage their outcomes in order to improve their rankings. However, flawed as it is, this indicator is the best and most widely disseminated measure of the attractiveness of the regulatory framework.[17]

In 2016, the average rank of African countries on the Doing Business indicators (from 1 as the best to 189 as the worst) was 142, i.e. the African continent as a whole was less competitive than Tajikistan or Lao PDR. In 2016 the country ranked most competitive in Africa was Mauritius at 32nd place, ahead of Spain (33rd) and Japan (34th). The worst country listed was Eritrea (189th), and eight of the bottom ten were African (the exceptions being Venezuela and Haiti).

Broadly speaking, a review of the Doing Business report shows that firms in African countries are burdened with inefficient, time-consuming and costly regulations that increase overall cost and reduce their international competitiveness. For example:

- Outdated cadaster systems make registering real estate very difficult in many African countries, and these assets therefore cannot be used by firms as collateral when borrowing from banks.
- In cases where banks do take land as collateral, poor judicial systems mean they often cannot obtain recourse before the courts in cases of non-payment of loans. This reduces or eliminates incentives for further collateral-based lending.
- The financial sectors of many African countries do not provide term lending at reasonable interest rates for firms (maximum tenors rarely exceed 8 years, and generally less). In some cases, bank lending is simply not available. Domestic debt securities – where they exist – are almost uniquely used by the governments

16. Eifert, B., Gelb, A., & Ramachandran, V. (2005). "Business Environment and Comparative Advantage in Africa: Evidence from the Investment Climate Data." *Center for Global Development: Working Paper,* 56.

17. Newman et al. (2016).

Companies operating in African countries repeatedly cite insufficiently skilled labor as a bottleneck to growth.

Table 2: Doing business in Africa

Region/Category	Average Rank/Ranking
Africa	142
Sub-Saharan Africa	143
North Africa	139
East Asia & Pacific	96
Latin America & Caribbean	104
OECD High Income	25
Best in Africa	32 (Mauritius)
Worst in Africa = worst in the world	189 (Eritrea)

Source: World Bank (2016)

to raise their own short term financing, and there is little appetite in the markets for corporate issuances.[18]

- In countries as diverse as South Africa and Niger, labor legislation in the formal labor market has been modelled on that of European countries, although labor productivity is far below the levels of these countries. These labor protections drive up the marginal cost of labor beyond its marginal productivity; workers cannot enter the formal labor market and are driven into the informal market where jobs are less good.

Among the specific constraints outlined in this section, action on improving the regulatory environment is "low-hanging fruit" that warrants close attention by African policy makers. Incremental change will not be enough; countries must re-engineer their regulatory environment toward supporting firms in a competitive environment.

Weak skills base

Companies operating in African countries repeatedly cite insufficiently skilled labor as a bottleneck to growth.[19] Education is key to improving skills. Significant strides have been made in recent decades in Africa in primary and secondary school enrollment:

- Primary education. Africa has experienced an impressive increase in the number of students enrolled in primary school. Between 1990 and 2012, the number of children enrolled in primary schools more than doubled, from 62 million to 149 million children. In Sub-Saharan Africa, 15 countries have abolished school fees since 2000, enabling more children to attend primary school. However, despite tremendous gains in primary school enrollment, no African country has achieved universal primary education.[20] Globally, of the 58 million children of primary school age were out of school worldwide in 2012, 38 million

18. Morocco and South Africa are notable exceptions to this observation.

19. Interviews with Africa manufacturing firms; World Bank. (2016). Africa Enterprise Surveys.

20. For a country to achieve universal primary education, all children must have completed a full course of primary schooling.

Moreover, other skills, both "hard" technical and scientific skills and "soft" skills like drive, initiative, honesty, and grit, are lacking; management skills are also weak.

were in Africa. About half of all out-of-school African children will never set foot in a school in their lifetime.

- Secondary education. Between 1999 and 2012, Sub-Saharan Africa achieved the greatest gains in secondary education enrollment compared with all other regions of the world. Worldwide, there were 552 million youth enrolled in secondary schools in 2012. Some 49 million secondary students resided in Africa. However, after graduating from primary school many students find it difficult or impossible to attend secondary schools close to home. Across Africa, secondary schools can accommodate only 36 percent of qualifying secondary students. Young people living in rural communities are more likely to have limited access to secondary education compared to youth in urban areas. Seven out of ten rural youth have never attended school, making them for all intents and purposes unemployable in the modern economy.
- Tertiary and technical education. Beyond primary and secondary education, tertiary education (universities) and technical and vocational education and training (TVET) help to strengthen the local workforce, which creates an attractive economic environment for investors. African universities are perceived as less attractive than universities in Europe or the US, and technical and vocational education and training has not been a top priority for many African countries, particularly during and after the structural adjustment policy phase. In 2012, technical and vocational programs accounted for only 6 percent of total secondary enrollment in the region, a decline from 7 percent in 1999. TVET programs markedly declined in the 1980s due to budgetary shortfalls in the education sector of many African countries and they have never fully recovered. On average, only about 2 to 6 percent of educational budgets are devoted to technical and vocation skills development.

Thus, despite significant progress in education over the past decades, African youth have levels of literacy and numeracy below their peers in other regions. Moreover, other skills, both "hard" technical and scientific skills and "soft" skills like drive, initiative, honesty, and grit, are lacking; management skills are also weak. It is very difficult to compete in the international economy without the right skills. The African continent has to make a significant effort to confer useful skills on its youth, not forgetting the more than 60 percent who do not attend high school, and the seven out of ten rural youth who do not attend school at all.

There is no general agreement in the development community on whether vocational training is a better investment than primary and secondary education. However, given current skills levels, we believe that firm-level and sector-level specialized training (e.g. in textiles, garment confection, etc.), delivered by the private sector and tailored to the specific needs of emerging industry, holds the most promise to improve firm competitiveness in the short term. But more broadly African decision makers have to continue their focus on education, particularly as concerns skills for the modern economy.

The challenge for resource-rich countries

Africa's exports mostly consist of natural resources. Experience in Africa and in other parts of the world shows that mining and oil and gas make little direct contribution to the local economy other than generating fiscal revenues. Extractive industries are highly capital-intensive and neither create many jobs nor contribute significantly to development of skills and human capital. Mining and oil and gas operations have few forward or backward linkages to the rest of the economy, and have often been managed as virtual enclaves

In addition to the challenges that other African countries face (small size, low infrastructure endowment, weak regional integration, unattractive regulatory and business frameworks and weak skills base), Africa's resource-rich countries also have to manage the fiscal flows resulting from their exports to offset their deleterious effects.

Table 3: Share of Africa's exports, natural resources (2014)

Export category	Trade Value (billion dollars)	Percent of Total Exports
Primary commodities, precious stones and non-monetary gold	447.136	80.6
Labor-intensive and resource-intensive manufactures	24.267	4.4
Combined	471.403	85

Source: UNCTAD (2016)

without much impact on the economies of host countries other than payment of taxes and royalties.[21]

As seen in Table 3, Africa is predominately an exporter of natural resources. Resource-rich countries have particular challenges to develop sectors not associated with their natural wealth. Resource rents can lead to Dutch Disease[22] and loss of competitiveness and, in some cases, to widespread corruption, the hollowing out of local traditions and institutions and creation of a culture of rent seeking and extraction or, at worst, to armed conflict and war.

Africa developed its trade links with the rest of the world on the basis of its commodity exports. The increase in commodity prices, well in excess of these regions' average import prices (even though these also include commodities), resulted in a marked improvement in terms of trade, which increased by more than 90 percent from 2000 to a peak in 2012. Since then, commodity exporters' terms of trade have declined, even after a very moderate recovery in mid-2016, although relative prices remain higher than at the turn of the century.[23]

Africa's major exporters of natural resources such as Algeria, Angola, Nigeria (oil); Guinea (bauxite and iron ore); Zambia (copper); DR Congo (copper and diamonds) and Zimbabwe (gold and diamonds) have all undergone deindustrialization as their natural resource sectors have crowded out other emerging industrial sectors. The decade-long commodities super-cycle that ended in 2015 accelerated this trend. In addition to the challenges that other African countries face (small size, low infrastructure endowment, weak regional integration, unattractive regulatory and business frameworks and weak skills base), Africa's resource-rich countries also have to manage the fiscal flows resulting from their exports to offset their deleterious effects.

Policy directions for Africa's economic diversification

Given the dominance of East Asian economies (e.g. China, Thailand, Viet Nam, Indonesia) in global manufacturing and the emergence of new players geographically close to these players (Lao PDR, Cambodia, Philippines), it is unlikely that African countries can emulate East Asian industrial policies without adapting them to the continent's specific conditions. Also, economic circumstances have changed since these

21. Ahlers, T., Kato, H., Kohli, H., Madavo, C., and Sood, A. (eds.) (2014). *Africa 2050: Realizing the Continent's Full Potential*, Oxford University Press.
22. Dutch disease is the negative impact on an economy of an event that gives rise to a sharp inflow of foreign currency, such as exports of large amounts of natural resources. The currency inflows that result lead to currency appreciation, which makes the country's other products less price competitive on export markets. It also leads to higher levels of cheap imports and can lead to deindustrialization as industries apart from resource exploitation are moved to cheaper locations. The origin of the phrase lies in the Netherlands economic crisis of the 1960s and 1970s following the discovery of North Sea natural gas.

23. Loser, C. et al., (2016) "The impact of commodity terms of trade in Africa: Curse, blessing, or manageable reality?" *TICAD IV Policy Papers*, Centennial Group International.

Africa, made up as it is by a large number of small countries, would benefit from more effective regional integration.

countries first elaborated their policies: trade and investment patterns have shifted from the historic north-south pattern to include increasing south-south flows (i.e. flows of investment and debt from developing countries such as China, Brazil or India, to other developing countries). This trend reflects increasing domestic savings in middle-income developing countries as their economies have matured as well as a reduction in the appetite of industrialized countries for emerging market investments following the 2008 financial crisis. Economic circumstances are different, and Africa has to design and implement its own economic diversification program based on its own specific features and geography. This section outlines four specific policy directions that Africa might consider.

Creating regional markets and production centers: market-based regional integration

Africa, made up as it is by a large number of small countries, would benefit from more effective regional integration in two manners: first, by creating larger markets for the continent's producers, allowing them to lower their production costs; and second, by achieving aggregation economies through developing industrial production centers on a regional rather than national basis.

Creating regional markets

There are several reasons for the inefficacy of African regional development efforts.

- First, there are too many regional integration initiatives. There are multiple conflicting regional arrangements with significant overlapping membership, in addition to bilateral trade arrangements. Countries pursue different objectives and hold differing views about relinquishing sovereign rights and regulatory authority.
- Second, groupings are too big and don't make economic sense. Excepting a handful of larger, diverse economies (like Morocco, Nigeria, South Africa, Tunisia and, because of its diversity, Mauritius), countries in Africa have relatively similar economic and cost structures, requiring compensation for losers from regional economic integration. The larger the number of members, and the more similar they are to each other the economic structure, the harder it is to reach consensus on decisions and take effective action.
- Third, the private sector has been left out in designing integration policies. To date, private sector actors have not participated in the design and implementation of the regional economic integration agendas, which deprives the process of strong domestic champions. However, private sector views on competition will likely diverge from those of government; incumbents will recommend policies that limit competition while policy makers should seek policies that widen markets and increase competitive pressures on firms.

Developing regional centres of production

There are lessons for Africa in the Asian experience. As outlined in the Regional Integration companion paper,[24] Asian models of creating regional sectors of production, such as clusters, relied on the state playing a supportive and active role. This is also the experience of the two most successful industrial developers, Tunisia and Mauritius. States implemented policies that provided macro-financial stability and maintained competitiveness of economies and of the exchange rate. Public policy in Asia delivered high quality, efficiently managed physical infrastructure (electricity, road, rail, port, airports and communications networks) and developed a reliable, predictable policy and investment environment that

24. Tuluy, H. (2016). "Regional integration in Africa," *TICAD VI Policy Papers*, Centennial Group International.

One approach could be to focus on development corridors centered around a regional port and associated transport infrastructure.

allowed for significant domestic and foreign investment in manufacturing and industry.

Where comprehensive changes were not possible, Asian countries often created enclaves (such as Special Economic Zones, Export Promotion Zones) with special fiscal and labor regimes, high quality infrastructure investment and management that reduced cost and time to trade, and with appropriate legal investor protections. This trend has been most notable in China but is also present elsewhere across Asia.

African countries have also created special zones. However, a study of six African Zone programs (Ghana, Kenya, Lesotho, Nigeria, Senegal and Tanzania) in comparison with four non-African countries (the Dominican Republic, Honduras, Vietnam and Bangladesh) shows that the former have not been as successful in terms of investments, exports and employment generation. A few countries have had better performance, such as Mauritius, Kenya, Madagascar and possibly Ghana. Lower overall success is due perhaps to inadequate attention to infrastructure, skills and the predictability of the business environment. [25]

Asian countries also invested in human capital through both formal education systems and vocational and technical training, which supported the development over time of a skilled, technically qualified labor force. The corporate sector in Asian economies acted as a partner to the active state and substantially benefited from the above features. In turn, the private sector acted as an important lobby for continued openness, competitiveness and deepening of regional economic integration. In addition, states often pursued selective, targeted industrial policies – providing investment incentives, credit facilities, import restrictions and public promotion and support of exports – in partnership with their private corporate sector.

The Asian approach contrasts with the African experience. Although macroeconomic management has markedly improved in Africa over the last two decades, African infrastructure is still lacking both in absolute amount of assets and in the quality of infrastructure services. Africa also lags the rest of the world in skills development, the private sector has had little or no say in regional development initiatives, and African firms are weighed down with excessive business regulation and red tape. Where African states have pursued selective industrial policies, the result has often been crony capitalism (e.g. Egypt) rather than to a competitive outward-oriented export sector.

Perhaps the comprehensive, sequential and top-down approach to regional integration undertaken by the continent needs to be reconsidered. What is required instead is an entirely new focus driven by and with the private sector, based on an economically and geographically coherent spatial entity. One approach could be to focus on development corridors centered around a regional port and associated transport infrastructure. The corridor would increase accessibility of hinterlands and provide them with access to urban markets. It would need to be associated with borderless regulatory environments to allow free flow of capital and labor, and with industry-specific regional skills enhancement initiatives such as matching grants for the private sector to undertake technical and vocational training, and industry schools. This approach is outlined below.

Focused integration

To achieve economic diversification, focused efforts will need to be made to better integrate markets (generally situated around one or several large urban agglomerations as anchor) along transport corridors with access to

25. Farole, Thomas. (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience.* Washington, DC: World Bank.

Trade policies and regulations need to be reformed or eliminated to substantially reduce time and cost of importing and exporting through these corridors.

ocean-going ports. These focused packages need to include the following elements:

- First, variable geometry in which a subset of like-minded countries around certain natural access corridors or with similar sector focus take specific actions to accelerate integration. Other countries operating at different speeds could join at a later time.
- Second, involve private sector actors to generate demand for greater integration – for example, involving councils made up jointly of private and public sector players. But the focus on competition needs to be maintained.
- Third, focus on few key integrated development corridors and sectors or sub-sectors. Critical infrastructure investments (ports, roads, rail, electric power) need to be provided, to the extent possible through private participation.
- Fourth, trade policies and regulations need to be reformed or eliminated to substantially reduce time and cost of importing and exporting through these corridors. Regulatory impediments such as registration, credit and contract enforcement need to be addressed, and state distorting investment, such as privileges accorded to state-owned enterprises, need to be eliminated. This cannot be achieved simply by improving a country's standing by one or two positions in the Doing Business ranking table; systems and processes need to be entirely re-engineered. Essentially, an intermediate input imported, for example, into the Vridi port in Cote d'Ivoire for

Table 4: Existing integrated development corridors

Corridor	Countries/Cities	Location of Industrial Hub	Port(s)
West African coastal	Lagos-Cotonou-Lomé-Accra/ Tema-Takoradi	Lagos Takoradi	Lomé
West African Sahel	Cotonou-Niamey Lomé-Niamey Cotonou-Ouagadougou-Bamako Lomé-Ouagadougou-Bamako	Lomé Cotonou	Lomé Cotonou
Dakar Sahel	Dakar-Bamako	Dakar	Dakar
Abidjan Sahel	Abidjan/Vridi-Ougadougou Abidjan/Vridi-Bamako	Abidjan	Vridi
Douala Corridor	Douala-Yaoundé Douala-CAR-Chad	Douala	Douala
Central Corridor	Mombasa (Dar es Salaam)–Nairobi-Rwanda–Burundi–Uganda	Mombasa Nairobi	Mombasa
Trans Caprivi	Walvis Bay-Zambia-DRC Walvis Bay-Botswana-South Africa	Walvis Bay	Walvis Bay
North-South Corridor	Durban – Zimbabwe – Zambia	Durban	Durban
Maputo-South Africa	Mozambique-South Africa	Maputo Gauteng	Maputo

Value chain investors are very mobile, which is both a blessing because they can be attracted quite easily by creating attractive business conditions and a curse because when international competitive rankings change they quickly relocate their centers of production to new localities.

further processing in Mali, must be able to move in a frictionless way to the factory, with little or no regulation between the two countries.

- Fifth, illegal rent seeking behaviors need to be eliminated, by perhaps the creation of public-private enclave entities with quasi-autonomous authority, removing the discretionary powers of mid-level civil servants. (An example would be the Dubai International Financial Center.) Elimination of inter-country regulation, and the reduced discretionary powers that result, would significantly help in this regard.
- Finally, strengthen sub-regional institutions by establishing high-level monitoring and dispute resolution mechanisms and establishing a transitional compensation mechanism for less well-endowed and landlocked countries.

Value chains and tradable services

Over the last quarter century, worldwide changes in the nature of international trade have increased the complexity of production processes. Whereas traditionally, an export good was produced more or less in its entirety in one country and exported to another, increasingly there is vertical disintegration of the manufacturing production process on a geographic basis with different stages of production carried out in different countries depending on their specific advantages and wage characteristics. For example, Mauritius might export to Europe garments made from cloth woven in India from yarn spun in China using raw cotton from Burkina Faso. There has also been a far greater degree of "imbedded services" (design, after-sales service and the like) in the exported good. These two phenomena are introducing "trade in tasks",[26] which manifests itself in two manners: through value chains and through tradable services. These two are similar to the extent that both have been enabled by the dramatic decline in the cost of international communications, transport and logistics over the past quarter century.

Value chains

A value chain is a set of activities that a firm operating in a specific industry performs in order to deliver a valuable service for the market.[27] Some of these activities can usefully be carried out in different geographic locations, and the very significant decline in costs now enable some of these tasks to be carried out in different countries. Worldwide, imported intermediates today represent nearly half total intermediate inputs,[28] for the most part imported for processing by multinational corporations operating in several sites. Value chain investors are very mobile, which is both a blessing because they can be attracted quite easily by creating attractive business conditions and a curse because when international competitive rankings change they quickly relocate their centers of production to new localities.

Some African countries are beginning to achieve success in value chain development. Morocco has over the past decade developed a thriving automobile assembly business and auto part manufacturing industry in and around Tangier, with investment by the French auto companies Renault, PSA and others. Tunisia has for some time had value chains operated by foreign firms (mostly European) in textile production and electrical/mechanical equipment manufacturing. South Africa has for many years had an auto assembly value chain centered around Port Elizabeth, with exports of finished autos to other countries on the continent. However, compared to other regions of the world the African continent does not participate significantly in global value chains.

26. See Newman et al. (2016).

27. The concept of value chain comes from business management and was first described by Michael Porter in *Competitive Advantage: Creating and Sustaining Superior Performance* (1985).

28. UNIDO (2016)

In many sectors there is a clear case for opening markets to tradable services between and among neighboring countries across the continent.

For instance, Kenya is one of the most developed countries on the continent and has a small manufacturing sector which is the most sophisticated in East Africa. It has a good but rather small port (Mombasa), and transport infrastructure between the port and the industrial areas around the capital is improving. However, despite a relatively diverse base of manufacturing companies, its main industries remain the transformation of agricultural raw materials (particularly of coffee and tea, but also meat and fruit canning, milling and sugar refining). There is some activity in electronics and vehicle assembly, publishing and soda ash processing., Kenya manufactures some goods (e.g. ceramics, shoes, beer and soft drinks, soap, furniture, and leather goods) for its own market, but it does not participate in any meaningful way in international value chains.

Policy prescriptions: Development of value chains seems to require two essential prior conditions: trade agreements with major markets (historically, the US or European Union) and a proactive heterodox government policy of actively attracting foreign investors. African decision makers should consider such measures in the elaboration of their policies.

Tradable services

Tradable services are a subset of services that modern information and communications technologies make possible to be carried out at a distance. Examples of tradable services are: call centers, computer and information technology services, back-office operations for financial firms, remote diagnostics of computer networks and engineering plants (refineries, power plants), tourism and a range of services linked to design and fashion. Services represent worldwide a significantly larger share of GDP than manufactures, and over the last decade global trade in services has risen faster than merchandise trade, with annual growth at 5.4 percent versus 4.3 percent, respectively. Exports of services by developing countries have nearly doubled in the past decade, growing at 11 percent per year.[29]

Regional trade in services: In many sectors there is a clear case for opening markets to tradable services between and among neighboring countries across the continent. Professional services (accounting, legal, banking, insurance), communications (fixed, mobile, broadband) and transport services (road, air, rail, maritime) are critical determinants of manufacturing productivity and competitiveness. Important intermediary professions for trade such as brokers and trade and customs agents tend to be protected by nationality requirements and are therefore fragmented and costly. Countries along integrated development corridors must agree on mutual accreditation of key skills. For example, there is no reason that an accountant registered in Benin cannot exercise her profession in Togo, Niger or Burkina Faso as these countries' accounting systems and education systems are practically identical, and all belong to ECOWAS. Today this is not the case.

International trade in services: Regional trade in services through increased economic integration has potential to diversify African economies, but international trade in services would provide a much larger opportunity for African countries. The African continent lies on almost the same time zone as Europe and shares two of its most important languages (English and French). Investments needed for international trade in services are significantly less than those needed for manufacturing – for the most part, dependable, cheap fixed broadband Internet connections are sufficient. Africa has the potential to become the provider of services such as call centers and remote diagnostics for many European countries.

Policy prescriptions: Developing a trade in services sector is less capital intensive than a more conventional manufacturing sector, but it requires the combination of world-class

29. World Bank. (2016). World development indicators.

African policy makers should proactively promote the development of clusters by including them into the design of special economic zones and EPZs.

cost-effective fixed broadband Internet connectivity, air transport services and the right skills base. In those countries where Internet connectivity is not up to par, African policy makers need to focus on dramatically improving the quality and cost-effectiveness of service. This will require removing statutory monopolies on provision of Internet services where they still exist and requiring open access to fiber-optic cables for Internet service providers. Policy makers also need to consider technical and vocational training institutions in conjunction with the private sector to ensure that the labor force has the requisite skills.

Developing industrial clusters

Firms tend to agglomerate in clusters drawn by the markets they serve, by the products and services they produce and by the skills they require. Clusters play an essential role in promoting local entrepreneurs, by enabling them to find financing, skills and partners for the development of their businesses. Africa has some examples of such clusters, but they are relatively less developed than in other parts of the world.

Africa's lower cluster development likely stems in part from the continent's lower degree of urbanization. A review of clusters in other parts of the world highlight the importance of cities for the development of clusters, and studies have shown that doubling the size of cities is associated with productivity gains.[30] Geographical agglomeration of firms in urban areas allows them to obtain access to skills, financing and markets, although some studies have underlined that such advantages can be achieved through industrial clustering, e.g. in EPZs, rather than in urban centers.

Africa's lower development of clusters might also be due to the continent's industrialization history. At a time when other developing regions were beginning to see cluster development oriented toward export industries (in the late 1980s and 1990s), Africa was dismantling its state-led industries and embarking on macroeconomic reform. There were few opportunities for firms, either domestic or international, to invest in manufacturing capacity. Subsequently the development of trade in tasks (value chains and trade in services) has not been as pronounced in Africa as in other regions, and for this reason the continent has not been able to develop strong clusters of industrial firms.

Policy prescriptions: African policy makers should proactively promote the development of clusters by including them into the design of special economic zones and EPZs. Perhaps as important will be to include consideration of industrial clusters in urban development plans and to promote skills-building through industry-focused technical and vocational training programs developed in partnership with the private sector.

Africa's economic transformation – Conclusion

Africa's 54 countries display wide diversity, from upper middle income economies (Mauritius) to extremely low income (Niger), from landlocked (Central African Republic) to well-placed for exports (Tunisia). It is unlikely that any one set of policy recommendations would fit the entire continent, hence the need to adapt economic diversification policies to country specifics. A complete set of measures would include both those that create the right economic environment, and those that proactively promote development of new sources of economic growth. The fundamental solution to diversifying African economies lies in the promotion of African entrepreneurs through the creation of a much better business environment throughout the continent and the provision of support for these emerging businesses.

Indeed, the central lesson from this review of economic diversification of African economies is that while stable macroeconomic policies and streamlined business regulations

30. Newman et al. (2016)

Unless African governments become more business-friendly and operate in partnership with the private sector they will not be able to attract the new private sector players who will help them diversify out of basic agriculture and low-value services.

are essential, they may not of themselves be sufficient to enable African countries to diversify their economies through development of manufacturing sectors and trade in services. Policies implemented by African policy makers over the past two decades have for the most part focused on orthodox macro management and investment climate reform. These have created the platform for the next stage, which is the focus of the policy recommendation below.

The second key lesson from this review comes from governments of the most successful countries, which in addition to ensuring macroeconomic stability and streamlined regulations, implemented heterodox economic policies. In particular, the governments undertook proactive steps to support their entrepreneurs and to attract new investors, both through direct outreach and by working with the private sector to tailor business regulations, education and infrastructure to their needs. This approach needs to be flexible and to be adapted through time, to adjust to conditions as they change (e.g. Mauritius moving from sugar to textiles, then services).

Creating the right environment

Getting the economic environment right to enable diversification will involve policies that are for the most part widely understood among African policymakers:

- Ensure a coherent and predictable macroeconomic management
- Streamline business regulations and red-tape for businesses
- Invest in infrastructure and improve its operation and maintenance
- Develop a skilled labor force through continued focus on basic education, coupled with vocational training programs designed in collaboration with the private sector
- Pursue targeted regional integration along development corridors to enlarge regional markets

Proactive action on diversification

In addition to the above, policymakers must:

- Invest in regional infrastructure to support the creation of industrial centers along development corridors
- Actively seek investment by international operators of value chains, including outreach to potential investors
- Promote the development of a tradable services sector by outreach to potential investors
- Support the development of agro-businesses to respond to the needs of Africa's growing middle class and rapidly growing urban population

The third and final lesson from the above review is that economic diversification is not a stable economic state. It requires constant policy adjustment by policy makers for countries to remain globally competitive. Policy makers must have their "ear to the ground" to understand international business trends and to be able to adjust policies accordingly. Unless African governments become more business-friendly and operate in partnership with the private sector they will not be able to attract the new private sector players who will help them diversify out of basic agriculture and low-value services.

Annex

Table A1: Country typology and diversification priorities

Country Type	Characteristics	Countries	Key challenges
Industrialized	Have penetrated international markets with goods and services in a significant way	Botswana, Gabon, Mauritius, Namibia, South Africa, Tunisia	Maintain global competitive position through productivity gains, notably continued skills enhancement (TVET) Seek to diversify sectors
Emerging coastal	Emerging Africa with access to the coast	Benin, Cameroon, Cape Verde, Côte d'Ivoire, Djibouti, Egypt, Gambia, Ghana, Guinea, Kenya, Mauritania, Morocco, Mozambique, São Tomé and Príncipe, Senegal, Tanzania	Expand existing export sectors Promote regional markets Strengthen infrastructure Develop skills (basic education and TVET) Promote investment by foreign investors in value chains
Emerging landlocked	Landlocked emerging Africa	Burkina Faso, Ethiopia, Lesotho, Malawi, Swaziland, Uganda, Zambia	Reduce connectivity and other infrastructure costs (transport and Internet) Develop skills (basic education and TVET) Develop trade in services Promote regional integration along transport corridors Reduce connectivity and other infrastructure costs (transport and Internet) Develop skills (basic education and TVET) Develop trade in services Promote regional integration along transport corridors
Resource-rich	Significant portion of their export revenues, and budgetary resources, stem from the export of natural resources	Algeria, Angola, Rep. of Congo, Equatorial Guinea, Nigeria	Implement strong fiscal management to avoid Dutch disease Seek to diversify the economy into areas related to natural resource (cluster development)
Fragile	In, or coming out of, a period of major civil or military unrest and the economy has not returned to normal	Burundi, Central African Republic, Chad, Comoros, D.R. Congo, Eritrea, Guinea-Bissau, Liberia, Libya, Madagascar, Mali, Niger, Rwanda, Sierra Leone, Somalia, South Sudan, Togo, Zimbabwe	Rebuild the economic and institutional fabric Ensure sound macro-economic management Reduce business regulations Strong focus on basic education (primary and secondary) Rebuild infrastructure

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Infrastructure in Africa

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