



The Way Forward: Policies for Achieving Diversification

Two key reasons emerge from the evidence and discussions in the previous two chapters of this report, as to why diversification should become a central pillar in Africa's development efforts. First, diversification is important to strengthen growth in Africa because from the second half of the 1980s, Africa's growth has been mostly accounted for by factor accumulation. Beyond a certain point, factor accumulation becomes binding under certain demographic and physical conditions, making other sources of growth critical. Consequently, the positive contribution of diversification to TFP is central to any efforts to achieve higher and sustainable growth in Africa.

The second reason is that Africa has failed to reap benefits optimally from preferential trade arrangements and from globalization. There is, therefore, a need for a new paradigm on diversification, to enable African countries to benefit from preferences and trade liberalization. As cited earlier, Africa has been unable to benefit fully from preferences at the international and regional level. It is also evident that while other developing regions have increased their share in global trade, Africa has seen its share decline even as global trade liberalization has progressed. The failure to maximize gains from preference utilization and trade liberalization assumes special significance given the likelihood that the future gains that may accrue to African countries from current trade liberalization efforts will be marginal.

Essentially, with the current economic structures, African countries will not be able to maximize gains from trade liberalization, and risk perpetuating the historical failure to secure benefits from global trade reforms. Apart from the suboptimal nature of the expected gains from trade liberalization, it is also possible that Africa will be marginalized further and any such gains will be unevenly distributed among developing countries. Therefore, there is a strong case for a new diversification paradigm in order to help African countries secure benefits from preferential schemes such as AGOA, EBA, DFQF market access promised to LDCs in the Doha Round, and the subsequent trade liberalization in agriculture, NAMA and services under the WTO and EPA agenda.

Several key policies and recommendations are presented in this chapter. These policies constitute the elements of a new diversification paradigm that will enable African countries to benefit from preferences and from ongoing liberalization efforts at bilateral, regional, and multilateral levels. The recommended diversification policies include macroeconomic, trade, sectoral, industrial, and financial development policies, in addition to strategies that will strengthen institutions.

“ *With the current economic structures, African countries will not be able to maximize gains from trade liberalization* ”

6.1 Macroeconomic policies for diversification – the need for pragmatism over orthodoxy

A conservative fiscal policy may end up limiting the necessary fiscal space needed to boost investment

One key recommendation has to do with the need for pragmatic macroeconomic policies if African economies are to be able to diversify. While macroeconomic stability is important for the diversification of an economy to take root, not all components of the macroeconomic framework need to be rigid. Stability alone through conservative fiscal and monetary policies is not enough to ensure the deepening of diversification. While contributing to stability, a conservative fiscal policy may end up limiting the necessary fiscal space needed to boost investment. Such constrained fiscal space, as the empirical results suggest, undermines diversification efforts. Therefore, given that diversification of African economies is necessary for high and sustained growth, pragmatism in designing macroeconomic policies becomes imperative.

For optimal results, African countries should realize that while macroeconomic stability is important, some of the elements of the macroeconomic framework underpinning the diversification and growth strategy need to be sufficiently flexible. This requires a departure from typical macroeconomic frameworks, which are narrowly focused on macroeconomic stability. Flexible fiscal space can be integrated within the framework, and this in turn enables a country to boost investments, which has been shown to be a key determinant of diversification.

6.2 Trade and sectoral policies for diversification – returning to the basics

Another key recommendation relates to the role of economic policies aimed at diversification. In the 1980s, there was significant marginalization of economic policies as the focus in economic management shifted towards macroeconomic policies. This led to the neglect of sector-oriented policies, placing needed microeconomic sectoral reforms at the periphery. This marginalization played a part in extinguishing the gains that African countries were starting to make in deepening diversification in the late 1970s. Nonetheless, it is important to note that the shift in favour of macroeconomic policies was founded on legitimate concerns, namely the need to address the economic crises of the early 1980s. A dose of pragmatism would have recognized the existence of valid justifications for the objectives underpinning the economic policies at the time and prevented the radical shift that curtailed the progress that many African countries were making in diversifying and transforming their economies.

Suffice it to add that, in most cases, economic management concentrated on macroeconomic issues at the expense of sectoral issues and this led to stagnation in or the

weakening of diversification efforts. In a few cases, dependence on oil led to reversal of diversification gains. Yet, the number of countries where reversal in diversification gains occurred due to the discovery and subsequent reliance on oil are few, compared to the number of countries that witnessed poor diversification as a result of the marginalization of economic policies. More proactive macroeconomic policies are needed. Given the determinants of diversification as established in this study, proactive economic policies on trade, finance, industry and research are crucial.

In designing such proactive trade policies, African experiences accumulated to date are important. Special care should be taken to avoid the two extremes that have both failed to enable trade policies to achieve their expected outcomes. On the one hand, trade policies in support of diversification should not focus on protecting domestic markets. Such policies have been tried in the past and caused considerable distortions in African economies, leading to misallocation of resources and to weak growth and productivity. On the other hand, trade policies for diversification should not be the orthodox liberal trade policies that aim at uncontrolled opening up of African economies to external markets. African countries should use trade policies in a strategic way aimed at specific diversification and, by extension, at specific growth and development outcomes (box 6.1). Such strategic trade policies should be proactive, dynamic, adaptable and differentiated between sectors and between the various segments of a given sector in order to enable diversification to contribute effectively to development efforts. Furthermore, gradualism is a hallmark of such strategic trade policies.

Although openness has not necessarily led to diversification, openness can have an indirect influence on the impact of other diversification determinants, such as per capita income, through interaction effects. Results show that, in a direct way, openness can lead to specialization rather than diversification. It is also proven that openness has indirect effects on diversification through interaction effects. Strategic trade policy making should discourage those policies that have mutually exclusive options in terms of liberalization and protection. The Asian experience is an example of how a strategic trade policy cannot be limited to a choice between liberalization and protection. Rather, a strategic trade policy is one that can be used in a dynamic and adaptable way to support specific development choices. Therefore, in order to realize the benefits of diversification, countries in Africa should use trade policies as dynamic instruments towards chosen diversification ends.

For proactive and dynamic trade policies to help countries achieve their diversification choices, some features are essential. First, it is important that trade policies are dynamic and, as a result, develop over time. Second, such policies are likely to vary from sector to sector and even require differentiation not only among sectors but also within the same sector. Therefore, achieving vertical diversification in one sector calls for trade policies that differ from those for achieving the same vertical diversification objective in another sector.

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Box 6.1

Promoting vertical diversification in Ethiopia: the case of the leather industry

“ African countries should use trade policies in a strategic way aimed at specific diversification ”

Ethiopia, like other commodity-dependent economies, is extremely vulnerable to abrupt variations in export earnings due to volatile terms of trade for its major export products. Recognizing this, the Government is making considerable efforts to diversify the economy, through introducing new products (horizontal diversification) and/or diversifying out of traditional products by moving towards the high end of the production chain (vertical diversification). The latter strategy has been used successfully in the leather industry. Given its large livestock population, Ethiopia has been traditionally one of the major exporters of hides and skins in Africa.

The leather industry developed in the early 1970s on the basis of import-substituting industrialization. However, the industry was marred by inefficiencies and lack of competitiveness. By early 1990s, only 45 per cent of total leather exports was in processed form with the remaining 55 per cent in raw form. In recent years, considerable efforts have been expended to make the industry more competitive and increase value addition. This is bearing fruits. Twenty new tanneries and leather-processing industries have been setup in recent years and, as a result, the value-added of leather-exports has increased to 95 per cent. More importantly, these firms combined have generated more than 6,000 jobs. After temporary set-backs due to cheap Chinese shoe imports, more than 30 new shoe-manufacturing industries are operational currently, employing more than 9000 workers. The Government envisages that by 2010 all leather exports will be in processed form, contributing between 8 to 10 per cent of total foreign exchange earnings.

A good macroeconomic environment, favourable investment climate, development of the domestic financial sector, trade policy and appropriate exchange rate policies are considered critical in the promotion of economic diversification, both horizontal and vertical.

Source: Federal Democratic Republic of Ethiopia: Ministry of Industry and Trade.

6.3 Financial sector links between investment and diversification

With regard to financial sector policies, the starting point is the clear link between investment and diversification. The contribution of private investment to desirable diversification outcomes cannot be gainsaid. In that respect, the financial sector and its role in financing private sector contribution to diversification is very critical. Hitherto, the African experience with financial sector reforms has been almost similar to the trade liberalization results. However, the failure of financial sector liberalization to achieve the results expected can be explained from two angles. On the one hand is the failure of liberalization in achieving an efficient financial sector able to play its expected intermediation role for both short-and long-term credit, in an optimal way. On the other hand, comes the failure to achieve reductions in interest rates as was expected, given that interest costs are a major cost of doing business for many private sector firms. These two points are elaborated here in order to point to the need for a rethink of the financial sector architecture, in terms of both policy and institutional frameworks so that proactive financial sector policies can contribute to the deepening of diversification efforts.

With regard to the institutional structure of the sector, financial liberalization in Africa failed to achieve the desired outcomes as a catalyst for financial sector deepening. The key reason noted is that in the same way that trade policies were never seen as part of an integrated financial sector, financial sector liberalization tended to treat the sector in a compartmentalized manner. This was done to the extent that there was unbalanced focus on some components such as commercial banking, neglecting the significance of other dimensions such as development finance institutions and/or other components that are key to capital markets deepening. The results were that the financial sectors were not integrated, and focused on short-term credit issues rather than on development finance and capital markets development, which would be more relevant to diversification efforts. In this respect, given the importance of the financial sector in diversification, it is important that African countries seek a proactive financial sector policy that aims at integrated development of the whole sector that can effectively and efficiently mobilize the sustainable, long-term capital necessary for financing diversification programmes, and by extension, long-term development.

“ *Proactive financial sector policies can contribute to the deepening of diversification efforts* ”

The significance of proactive financial sector policies compared to what has been the practice can be found in the results that were achieved in the past with interest rate regimes. In many African countries, financial sector liberalization became characterized by wide interest rate spreads. Thus, instead of liberalization resulting in more efficient financial sectors, the results were interest rate regimes where the lending rates rose and remained high over long periods of time, while the deposit rates fell, and, in many cases, were negative in real terms. This discouraged the private sector from undertaking productive investments, such as those required for deepening diversification.

Additionally, the inability of the private sector in Africa to access cheap credit meant that it was not possible to undertake initiatives that would lead to both horizontal and vertical diversification. The high interest rates after liberalization also had the negative effect of raising the interest costs of servicing existing debt. This resulted in reduced profitability for most firms. Given that retained earnings also form a significant component of financing diversification efforts in the private sector in most African economies, financial sector liberalization had the indirect effect of limiting these diversification efforts.

6.4 Industrialization policies key to deepened diversification

With regard to industrial policies, it helps to recall that economic transformation is both a necessary and sufficient condition for industrialization. However, economic transformation cannot occur in the absence of diversification. Given the correlation

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between diversification and economic transformation, industrial policies are part and parcel of the new economic policies for diversification that Africa needs. This is particularly the case given that it has also been established in this report that industrial policy is critical to the ability of a country to deepen diversification. Therefore, as in the case of trade policies, there is need for more proactive industrial policies. This calls for strategic use of industrial policies to target diversification efforts in those sectors that are aligned to the overall industrialization strategy.

There is much to be said about the way forward in designing proactive industrial policies. One can recall that import substitution strategies enabled Africa to achieve high levels of economic development in the late 1960s and in the early 1970s, the same period when diversification gains were evident across many African countries. However, these industrial strategies failed as early as the 1980s, due to reasons such as lack of internal structuring of the industries concerned, weaknesses in internal markets and their inability to provide significant markets for new industries, reduced availability of financing to developing countries, and low productivity of new enterprises. The response to the failure of this domestic-market orientation in the development model via reorientation towards external markets did not yield the expected results in Africa. In a similar fashion akin to the role of strategic trade policies, it is also necessary for African countries to have more strategic and dynamic industrial policies that are based on well thought out choices for diversification and, by extension, economic transformation paths.

Such policies should include adoption of sector-by-sector, bottom-up strategies, from downstream to upstream, in order to deepen horizontal diversification in sectors ranging from intermediate goods up to capital goods. Applying this strategy to diversification might make it possible for countries to develop vertical diversification paths by building connections between internal markets and exports. Downstream industrial segments would be export oriented while the intermediate sectors would be oriented towards internal markets. Eventually, the multiple optima of comparative advantages would evolve and export competitiveness would gradually reach intermediate and capital goods sectors.

6.5 Financing research to increase TFP

The other major area in which new economic policies for diversification are required is in research. The majority of African countries, since the demise of diversification gain resorted to relying on factor accumulation as the main source of economic growth. Yet, historical and empirical evidence has shown that the industrialized and NIEs were able to achieve development leaps when dramatic changes in TFP took place. As this report has shown, a link exists between economic growth and diversification through TFP. However, improvements in TFP are almost always a manifestation of innovation in a given economy. Financing research and development stands

out as a clear way in which African countries could improve the level of innovation and hence raise the level of TFP contribution to economic growth. This would then enable these countries to reap maximum benefits from their diversification efforts.

6.6 Strengthening of institutions - a prerequisite for positive diversification outcomes

For new macroeconomic and economic policies to achieve optimal diversification results, it is important for countries to strengthen their institutions. As this report has shown, conflict and governance have very substantial implications for diversification. Conflict always undermines diversification, while good governance (broadly defined) is empirically shown to lead to desirable diversification results. The policy recommendation that flows from these results is that it is important that countries invest in peace-building and peace-promoting institutions that can proactively deal with threats of conflict flare-up or resurgence.

Where conflict exists, be it at the national level or across borders between countries in a given subregion, it is important to have effective institutions to address prevention or resolution. Having conflict prevention and resolution as a key feature of institutions within the RECs is one way in which diversification efforts could be deepened. Countries that aim to deepen diversification also need to invest in good governance structures and institutions. Governance institutions that have to be strengthened should cut across the rule of law and public order – including a judiciary that effectively deals with commercial disputes, as well as tax administration institutions that establish a predictable investment climate.

“ *Industrial policies should include adoption of sector-by-sector, bottom-up strategies, from downstream to upstream, in order to deepen horizontal diversification* ”

