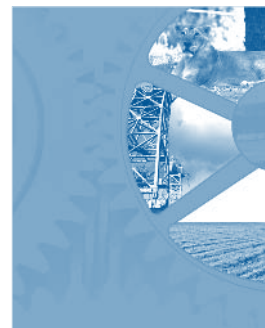


Overview



Moderate world growth and the threat of macroeconomic imbalances

Growth in the world economy improved slightly in 2006 relative to 2005, from 3.5 per cent to 3.8 per cent. It is driven by the strong performance by Asian economies, which continue to post growth rates above 8 per cent. In contrast, growth in advanced economies remains modest and is yet to reach the pre-2001 level. Key constraints to growth include the massive global macroeconomic imbalances along with tight macroeconomic stances in advanced economies, which prevent demand-led recovery. High oil prices undermine growth in both advanced and developing countries through high production costs.

Developed countries, especially the United States, face the challenge of rising current account, government, and private sector deficits which threaten domestic economic recovery as well as global financial stability. The US current account deficit has risen systematically since the 1990s, reaching 6.6 per cent of GDP in 2006. Meanwhile, its budget balance has moved from a surplus in 2000 (1.9 per cent of GDP) to a deepening deficit that stood at 2.5 per cent of GDP in 2006. Moreover, the US private sector position continues to deteriorate due to insufficient savings partly driven by the easy credit that fuels consumption.

Thus far, the widening deficits in the US have been financed by savings in the developing world, especially Asia and the oil-exporting emerging economies in the Middle East. Asia, the Middle East, and Latin America increased their current account surpluses since 2000. In particular, China's surplus increased from 1.7 per cent of GDP in 2000 to 7.2 per cent in 2006, making it the largest single financier of the US deficit. Central banks in developing countries have accumulated massive US dollar-denominated reserves partly as a means of preventing national currency appreciation. Given the low world interest rates, these reserves have earned low returns to the asset holders. Low world interest rates have also allowed the US to accumulate debt at low cost.

However, the willingness of central banks to continue to accumulate low-return reserves may be limited. Markets will need to be convinced that policymakers will not let the imbalances go out of hand. This will require concerted and coordinated efforts in industrialized economies and the developing world to achieve a smooth

correction of the imbalances. The adjustment mechanism will involve a decrease in the US deficit, an increase in investment in other countries (a decline in savings in high-surplus countries), as well as a weak value of the dollar, which will allow adjustment of the US trade deficit and reduce incentives for reserves accumulation. Most importantly, it is critical to accelerate growth in advanced economies as well as developing countries, which will require loosening of the policy stance to foster demand-led recovery.

Growth in Africa has increased but it is still not enough

African economies continue to sustain the growth momentum of previous years, recording an overall real GDP growth rate of 5.7 per cent in 2006 compared to 5.3 per cent in 2005 and 5.2 per cent in 2004. As many as 28 countries recorded improvements in growth in 2006, relative to 2005. Only Zimbabwe recorded a negative growth rate in 2006. Africa's growth performance in 2006, as in previous years, was underpinned by improvement in macroeconomic management in many countries, and strong global demand for key African export commodities, sustaining high export prices, especially for crude oil, metals and minerals.

However, for most African countries, real growth rates have remained low relative to their development goals. With only five countries recording an average real GDP growth rate of 7 per cent or more during 1998-2006, few African countries are positioned to achieve the Millennium Development Goals (MDGs) by 2015. Meanwhile, growth performance exhibits substantial disparities across the five subregions. North Africa recorded the highest acceleration in GDP growth, followed by Southern Africa. There was a deceleration in growth in West Africa and East Africa, whereas Central Africa maintained the same growth rate as in 2005. Heavy dependence on primary commodities remains a common feature of production, exports and growth in all the subregions. This exposes the continent to external shocks and makes economic diversification a top priority for growth policies on the continent.

Oil-exporting African countries as a group contributed 57.5 per cent of the continent's 5.7 per cent growth rate in 2006, compared to 53.4 per cent in 2005. Efficient management of oil revenues and economic diversification are essential for oil-exporting African economies to reduce vulnerability to oil price shocks, ensure that gains from oil revenue are broadly shared, and achieve sustainable growth.

Improved economic management and increases in non-oil commodity prices have more than offset the negative impact of high oil prices on the real GDP of African oil importers. The growth impact of higher oil prices was particularly moderate for non-oil and non-mineral-rich economies, where growth performance improved from 4.1 per cent in 2005 to 5.8 per cent in 2006, thanks to debt relief and increased aid

flows as well as improved agricultural production and high agricultural commodity prices. The growth rate in non-oil, mineral-rich African countries was unchanged in 2006 relative to 2005, as gains from the higher prices of minerals were dampened by the effects of rising oil prices.

To minimize the effects of high oil prices on inflation and macroeconomic stability in general, African governments need to pursue prudent policies, especially by avoiding monetization of deficits. In the meantime, the international donor community and international financial institutions should provide special support to oil-importing, low-income African countries to mitigate the impact of higher oil prices. In particular, debt relief and additional non-debt-generating external financing of fiscal deficits are critically needed to assisting African oil-importing countries to sustain economic growth and achieve the MDGs.

Current account balances are driven by developments in the resource sector

For the third consecutive year, Africa achieved a positive and increasing current account surplus (from 2.3 per cent of GDP in 2005 to 3.6 per cent in 2006). Africa's average balance of payments position reflects largely developments in oil-rich countries, which have recorded increasing trade surpluses, while their oil-importing counterparts experienced deepening trade deficits. The deterioration of the trade deficit is more pronounced for landlocked countries.

While exchange rates have been stable for most African countries, high commodity dependence exposes African economies to terms-of-trade fluctuations and extreme exchange rate volatility. The majority of African countries are dependent on oil and minerals or a limited range of agricultural commodities such as tea, coffee, cotton and cocoa. Thus, fluctuations in commodity prices have a significant impact on export revenue and the exchange rate in these countries. This forces many African countries to accumulate excessive foreign exchange reserves at high economic cost. A better approach is to adopt a comprehensive (country-specific) strategy for prudential regulation and capital controls that can minimize exchange rate risk while allowing the countries to benefit from increased export revenue and foreign direct investment (FDI) inflows.

African countries need a new approach to growth policy

More than any time before, it is now understood that the general, one-size-fits-all growth policies embedded in macroeconomic stabilization and second-generation reform programmes will not help African countries. Besides sustaining macroeconomic stability, African countries need to tailor their fiscal and monetary policies to promoting domestic investment, employment generation, and growth. Moreover, it is necessary to identify binding constraints to growth as well as the sources

of growth potential at a disaggregated level, and design incentive mechanisms to channel resources to sectors with the highest potential for growth and employment generation.

Social development: progress towards the MDGs remains below expectations

Compared to other regions, Africa continues to lag behind in all indicators of social development. Measures of poverty have remained virtually unchanged over the past decades. The average share of population below the poverty line was 44 per cent in 2002 compared to 44.6 per cent in 1990; thus, one can hardly talk of any progress in poverty reduction. Sub-Saharan Africa (SSA) also lags behind in progress towards universal primary education. This is despite notable progress in net enrolment rates, which increased from 53.0 per cent to 64.2 per cent in SSA from 1990 and 2004, and from 80.6 per cent to 94.0 per cent in Northern Africa during the same period. It is critical to increase investment in education to match the expansion in demand so that gains in enrolments are not achieved at the expense of quality of education. More efforts are also needed to accelerate progress in gender equity in access to education.

Progress is also modest in the health sector, with SSA visibly trailing behind North Africa. A major threat to the health sector is the spread of the HIV/AIDS. Currently, more than 25 million Africans live with HIV, and 2 million of the 2.8 million AIDS deaths worldwide in 2005 were in Africa. In the 38 hardest hit African countries, it is projected that there will be 19 million additional deaths due to AIDS between 2010 and 2015. Thus, more budgetary allocations are needed to increase both prevention – including through education – as well as treatment to curb the spread of the pandemic.

African countries also continue to face the challenge of other deadly diseases, especially malaria, which remains the number one killer on the continent. Investment in insecticide-treated nets has proved to be a successful approach to preventing malaria, but more is still needed to win the war against this and other preventable and curable diseases such as tuberculosis.

Growth prospects for 2007 and the medium-term outlook

Africa is expected to grow at a rate of 5.8 per cent in 2007, slightly higher than the rate recorded in 2006 (5.7 per cent). Global demand for African products – especially oil, minerals and agricultural – is expected to remain upbeat, but this is contingent on successful economic recovery in major industrial countries and continued strong growth in emerging Asian economies, especially China. Moreover, delivery of the promised aid and debt relief will allow African countries to boost expenditures in key sectors including public infrastructure and social services. Furthermore, consoli-

ation of macroeconomic management will not only reduce inflation in the short run, but also encourage private investment and strengthen growth.

Factors that are likely to hinder growth in 2007 and subsequent years include lack of diversification of production and exports and subsequent instability and vulnerability to shocks, and the increasing spread of the HIV/AIDS pandemic, which undermines labour supply and labour productivity. In addition, inefficient public infrastructure and unreliable energy supply at the national level as well as poor integration of transportation and energy network at the regional level will continue to undermine productivity and international competitiveness. Moreover, higher oil prices are a major concern for African countries, which need to continue to control inflation, promote fiscal stability, improve current account position, and increase growth.

Challenges and opportunities in development financing

The past few years have witnessed encouraging developments in development financing for Africa, which should have positive impact on the continent's growth prospects in the coming years. However, much more needs to be done in both the volume of external finance and the effectiveness in the use of these resources.

External debt remains high and private capital flows insufficient

The hope that Africa's external debt will be significantly reduced under the Highly Indebted Poor Countries Initiative (HIPC) and that economic reforms will stimulate private capital inflows has been very slow to materialize. Although Africa's debt stock declined considerably relative to GDP, total debt service obligations remained unchanged in 2006 due to rising interest rates. The debt burden seriously constrains spending on public investment and ultimately retards growth and employment generation.

The continent has benefited from substantial inflows of external financing in the form of official development assistance (ODA) (including debt relief), which should boost economic growth in the coming years. The Multilateral Debt Relief Initiative (MDRI) announced at the G-8 summit in Gleneagles in 2005 provided much needed relief for 13 SSA countries. However, this debt relief package is not enough and more external funding is needed to help African countries increase growth rates and achieve a meaningful reduction in poverty. Gross domestic investment remains far below the level considered necessary for Africa to half poverty by 2015. Higher external inflows will be needed to fill the chronic investment-saving gap in order to boost economic growth.

There are encouraging developments in external development financing but disbursements fall short of commitments.

Recognizing the impact of their policies and practices on aid effectiveness, donors have committed themselves to better harmonize their policies and practices on aid to enhance the development impact of aid in recipient countries. This has been reflected in a number of international declarations, including the Monterrey Consensus, Rome Declaration, Paris Declaration and, recently, the G-8 summit in Gleneagles. All these declarations call for scaling-up more financial resources to developing countries and improving the delivery and management of aid to enhance its development impact in recipient countries.

Aid disbursements remain much below the 0.7 per cent ODA to GNI target donors have set themselves to achieve. The average ratio for DAC members was 0.26 per cent in 2004. However, a handful of countries have met the target.

With respect to aid effectiveness, donors have made considerable progress in untying aid to African countries. The percentage of aid from Development Assistance Committee (DAC) member countries to Least Developed Countries (LDCs) that was untied rose from 55 per cent in the period 1999-2001 to 68 per cent in 2004. However, there are considerable variations in performance across DAC countries. Some countries including Finland, Ireland, Luxembourg, Norway and the United Kingdom have successfully moved away from tied to untied aid, while others still have very high ratios of tied aid to total aid. Similarly, DAC countries have made substantial progress in increasing the proportion of grants in total ODA with the share of grants in aid rising from 49 per cent over the period 1980-1984 to 90 per cent in the 2002-2004 period.

Donor countries have also made considerable progress in meeting their commitments in the area of debt relief. African countries benefited from the MDRI announced at the G-8 Summit in Gleneagles. While this debt relief is a welcome development, it is, however, not sufficient to finance Africa's myriad development priorities.

Domestic development financing

As witnessed in other developing regions, particularly in East Asia, the mobilization of domestic resources plays a key role in financing investments in economic and social infrastructure, and hence, in tackling poverty.

However, the level of savings in SSA has been historically less than 20 per cent of GDP, which is considerably below the average of East Asia and the Pacific (35 per cent), Latin America and the Caribbean (21 per cent) and the Middle East and North Africa (26 per cent). At the same time, it is promising that there are a number of SSA countries, which have mobilized domestic savings. In fact, five countries, Algeria, Botswana, Republic of Congo, Gabon and Nigeria, have reached a savings

ratio of more than 30 per cent. A key challenge facing these countries is how to translate these high savings into productive investment, especially in non-oil and non-mineral activities, to achieve sustained economic growth. Other African governments need to focus efforts on mobilizing both public and private savings.

As a consequence of low levels of savings in addition to limited private capital flows, investment ratios in SSA countries are lower than in other developing regions. For example, over the period 2000-2004, domestic investment as a proportion of GDP was 18 per cent in SSA compared to 31 per cent in East Asia and the Pacific.

In response to this challenge, African governments need to develop domestic capital markets, including bond markets and stock exchanges, which can play an important role in increasing both the quantity and productivity of investment. There are currently 21 stock exchanges in Africa, though these markets are still characterized by low levels of liquidity, lack of integration with regional and global markets, and a range of capacity and technology constraints. The regional integration of capital markets in Africa offers a solution to this situation, especially for the smaller economies. Overall, to accelerate capital market development, governments need to improve the capacity of all stakeholders, invest in infrastructure, and promote good governance.

Developments in trade negotiations

Trade negotiations are recognized as an important tool for increasing trade prospects and facilitating Africa's integration in the world economy. However, negotiations are still far from realizing the continent's expectations. Much was expected of a successful Doha Round. Likewise, it is often suggested that Economic Partnership Agreements (EPAs) with the European Union (EU) would result in an improved business environment in African countries, allowing for more investments and enhancing the prospects for diversification of their economies.

Unfortunately, on the World Trade Organization (WTO) negotiations front, progress has been limited and below the expectations of African countries. One main reason for the deadlock in WTO negotiations appears to be the disagreement with the levels of demand and offers on agriculture, a critical area for Africa's development prospects. This lack of progress has clearly been a setback for the multilateral process, prohibiting the international community, and especially poorer countries, from significant improvements in the multilateral trading system.

The limited progress in the WTO negotiations is impacting negatively on the cotton initiative, which was sponsored by some African countries for the elimination of cotton subsidies by the developed countries. While the cotton-textile sector in Africa holds a tremendous opportunity for diversification, delays in finalizing the Doha Round is hindering the exploitation of these opportunities. As it were, the Hong Kong Ministerial Conference of December 2005 reached agreement on the elimina-

tion of cotton export subsidies, but agreement has yet to be reached on the elimination of domestic cotton subsidies. There was expectation that progress in the WTO negotiations would allow for an expeditious agreement on cotton.

Probably one of the most significant developments has been the evolution of the participation of African countries in the actual negotiations. African countries were not only engaged actively in the definition of the mandate for the negotiators, but have been active at every stage, as the negotiations have progressed. This active participation has not translated to concrete results whereby African priorities are holistically addressed.

There has been growing concern in Africa that EPAs, while representing significant potential for growth and development, also pose great challenges in terms of adjustment costs. The standstill in WTO negotiations also complicates the EPA process. In the absence of evolutions on rules for preferential trade arrangements, important uncertainties remain on the degree of flexibility African countries would have on the length of transition periods and on the coverage of liberalization. EPA negotiations are probably the major task ahead of African trade policy makers, especially given the slow pace of the Doha Round. They pose great challenges but also real opportunities in terms of development for the continent.

In light of the slow progress in the WTO negotiations and the ongoing EPA process, African countries have an ever greater interest in diversifying their export markets. They are involved in a number of regional and free trade agreements negotiations. Fostering regional integration has been a long-standing objective, but African regional integration remains hampered by several obstacles including political and security factors, and also by poor transport and communication infrastructure, a low degree of complementarity in the structures of production and the overly complex web of memberships across different Regional Economic Communities (RECs).

Preferential trade arrangements are considered promising complementary platforms for diversification. Thirty-seven African countries are eligible to the African Growth and Opportunity Act (AGOA), which grants African countries quasi duty-free, quota-free access to the US market. Thirty-four African countries are LDCs and therefore are eligible to the EU's Everything-but-Arms (EBA) scheme. Other non-LDC African countries are either beneficiaries of the EU's General System of Preferences (GSP) or are party to a bilateral free trade agreement with EU.

Several African countries or groupings are also involved in bilateral or trade negotiations in order to diversify their export markets and enhance their integration in the global economic system. For example, West African Economic and Monetary Union (WAEMU) countries are currently negotiating free trade agreements with several North-African countries. The US and the South Africa Customs Union (SACU) are also engaged in free trade talks. South Africa is also discussing with India and MERCOSUR countries on a potential free trade agreement. With the recent explosion of

trade flows between Africa and China and India, several countries also envisage talks with these two Asian nations.

Diversification as a key pillar in Africa's development efforts

Two distinct periods stand out in Africa's development strategy. The period spanning the 1960s and the 1970s was characterized by policies aimed at strengthening economic autonomy. It is during this period that diversification oriented policies were aggressively pursued in most countries. A major shift in economic policies in Africa was occasioned by the economic crises of the early 1980s. Most of the post-independence economic policies geared to long-term development were replaced by macroeconomic stabilization policies focusing on short-term goals. This reorientation of economic policies has failed to yield the expected results, and it is clear that a shift in policy orientation is needed to accelerate progress towards the MDGs.

In recent decades, sparks of economic growth have often vanished as quickly as they have been ignited. The current growth momentum also rests on a very fragile foundation. The continent continues to rely on primary commodities whose prices have been major sources of trade shocks. While efforts towards diversification had some positive results in the 1970s and early 1980s, these gains were reversed in the mid-1980s due to the economic crises of the period. Therefore, it is critical for African countries to embrace diversification as the central development paradigm.

Diversification experiences in Africa fall into five main categories: countries with little economic diversification such as Burkina Faso and Senegal; countries that made some early progress and then stagnated in the process such as Kenya; those that managed to deepen their diversification process as exemplified by Tunisia and Mauritius; backsliders in the diversification efforts consisting mainly of oil-rich countries such as Nigeria; and non-starters comprising largely of the conflict and post-conflict countries such as Liberia and the Democratic Republic of Congo. This diversity of experiences raises the questions of what factors drive diversification and what policies can foster diversification in the medium-term and in the long-term.

Evidence on the determinants and stages of diversification

The diversification process in Africa is highly influenced by investment, per capita income, degree of openness of trade, macroeconomic policy stance and institutional framework. To begin with, investment is vital for an economy to diversify. Two stages of diversification with respect to investment can be observed for Africa, with a U-shaped relationship between investment and diversification. Unfortunately,

the turning point for Africa was found to be at 12.5 per cent of GDP, indicating that if the continent is to deepen its diversification process, much higher levels of investment to GDP ratios are required.

A second important finding in this report relates to income effects on diversification. Like in the case of investment, the two stages of diversification as established in the literature were confirmed in the case of African countries. The report also argues that trade openness does not necessarily lead to deepening of diversification, based on existing literature and the experience in openness for Africa. It is evident that a strategic trade policy is needed to strengthen this process in Africa.

Rapid liberalization in Africa has put a break on the diversification process

Rapid liberalization could have acted as a constraint to diversification on the continent. The results suggest that the debate on optimal trade policy is highly relevant. Specifically, the evidence for African countries suggests that there is merit in the argument for policy space with respect to trade liberalization. African countries may wish to adopt a gradual approach to liberalization. Indeed, historical evidence indicates that countries that promote diversification first before specializing enjoy much higher and more sustainable levels of welfare.

Macroeconomic stability is necessary for diversification

Industrialization helps to deepen diversification, which fits well with the established development theory that a country evolves from specialization to diversification through industrial deepening before starting to specialize again. Some elements of macroeconomic stability are critical to diversification. In particular, fiscal conservatism appears to be an important constraint to diversification.

The institutional environment is critical for diversification

Good institutions provide an enabling environment for diversification. In particular, good governance enables economies to diversify while conflict stifles diversification. Therefore, consolidation of institutional reforms both at the aggregate (e.g., the legal system) level and at the microlevel (e.g., business and banking regulation) constitutes an important part of the national agenda to promote diversification.

Diversification contributes to growth through productivity

It is well established that economies grow faster when there is an increasing share in the contribution of productivity to growth. Indeed, the rates of economic growth among developed economies are differentiated mainly by the rate of growth of productivity rather than the rate of factor accumulation. Growth in African economies

can, therefore, be scaled up by enhancing diversification, which in turn leads to an improvement in productivity. Deepening diversification is as important as eliminating conflict and investing in human capital, in terms of improving productivity and by extension, economic growth.

Policies to increase diversification

Diversification policies for Africa can operate at three levels: macroeconomic policies to support diversification; trade and sectoral policies to deepen diversification; and strengthen institutions to enhance diversification efforts.

Macroeconomic policies for diversification – pragmatism rather than orthodoxy

African countries need pragmatic macroeconomic policies to foster diversification. While macroeconomic stability is important for the diversification, it is also clear that a rigid macroeconomic framework will hinder diversification. Macroeconomic stability achieved through conservative fiscal and monetary policies may, in fact, delay the diversification process. Flexible macroeconomic policies that especially allow countries to achieve high levels of public investment are key to a successful diversification agenda.

Trade and sectoral policies for diversification – back to the basics

In the 1980s, the focus in economic management shifted towards macroeconomic stabilization policies. This led to the neglect of sectoral policies and microeconomic reforms, which are critical for industrialization and diversification. Therefore, there is need for more proactive micro-level economic policies that are evenly balanced with the macroeconomic policies. African countries should use trade policies in a strategic way aimed specifically at diversification and by extension growth and development outcomes.

The evidence in this report demonstrates that the financial sector plays a critical role in financing private investment, which is vital for diversification. There is, therefore, a need to consolidate financial sector reforms to increase efficiency of resource allocation, which will help to deepen diversification.

With regard to industrial policies, it helps to recall that economic transformation is both a necessary and sufficient condition for industrialization. But economic transformation cannot take place unless diversification takes root. Given the correlation between diversification and economic transformation, industrial policies are, as a consequence, part and parcel of the new economic policies that African countries need to increase economic diversification

The other major area where new economic policies for diversification are required is in research and development. The majority of African countries have resorted to

relying on factor accumulation as the main source of economic growth. Yet, evidence has shown that the industrialized and newly industrialized economies (NIEs) were able to achieve development leaps when dramatic changes in productivity took place. Financing research and development stands out as a clear way by which African countries could improve the level of innovation and increase the contribution of productivity in economic growth. This would then enable these countries to reap maximum benefits from their diversification efforts.

Strengthening of institutions is a prerequisite to diversification

For the macroeconomic and new sectoral and industrialization policies to achieve optimal diversification results, it is important for African countries to strengthen their institutions. Conflict and governance have substantial implications on diversification. 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. Countries that aim to deepen diversification will also need to invest in establishing and consolidating institutions that enhance good governance.