Strengthening Africa's Participation in the Global Economy

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Executive Summary

This policy brief is intended to assist African governments in efforts to strengthen their participation in the global economy in ways that bring widespread and sustainable benefits to their peoples. It stems from two issues. First, the forces of globalization are perhaps the most important factors that affect the current environment for economic development. Second, there are lessons from Southeast Asian experiences that policy-makers in sub-Saharan Africa could adapt to their own contexts. These lessons stem both from Southeast Asia's era of rapid growth as well as from the current economic crisis. In this report, we highlight three underlying issues and eight key lessons.

Underlying Issues

1. Participating in the global economy provides immense opportunities

This has been shown by the success of countries with an outward-oriented strategy. By contrast, inward-looking development strategies lead to marginalization and condemn countries to slow growth. Pursuing an outward-oriented strategy is even more crucial for most African countries because their domestic markets are particularly small.

2. It also entails significant risks

Participating in the global economy also poses significant challenges for the economic management of fragile economies and can lead to major problems. In particular, a1s shown by the recent Southeast Asian experiences, the risks of liberalization are particularly high for capital accounts due to the massive size and fluctuating nature of financial flows. Although few countries in Africa are facing the scale of inflows relative to the size of their economies that precipitated the Asian crisis, key lessons concern the importance of developing sound financial systems, appropriate sequencing, avoiding overly rigid exchange rate regimes and caution in financial opening.

3. Successful participation requires a strategic approach that is actively pursued

It is vital that African countries actively engage the forces of globalization. But the specific nature and scale of the benefits and costs depend on the forms of integration. A strategic approach is needed.

First, integration is multi-dimensional, involving among others the aspects of trade, investment, capital flows and technology. The optimal level of openness may differ for each aspect, which itself depends critically on the stage of development in each particular market. This leads to questions regarding the best policy mix (towards trade, foreign direct investment and capital flows) to achieve integration.

Second, there seem to be certain prerequisites necessary for countries to manage the risks and to ensure orderly liberalization. This has significant implications regarding the most appropriate pace, sequencing and time-frame for reforms.

Third, international economic interactions are currently characterized by *fractured globalization*. In particular, trade is concentrated in regional blocs. Therefore, African countries should place a high priority on trying to generate economic dynamism with neighbouring countries. Another implication is that countries' strategies towards trade and towards attracting investment should be targeted towards those non-African regional blocs with which the country has the strongest potential complementarities.

Key Lessons for a Successful Outward-Oriented Development Strategy

1. Ensure a stable macroeconomic environment

Macroeconomic stability is an old lesson, but one which remains fundamentally important. Africa's growth "tragedy" is partly attributable to governments' failure to achieve stability on key macro-economic issues such as maintaining low inflation; keeping budget deficits manageable; maintaining an appropriate and stable real exchange rate; and maintaining stable and appropriate real interest rates. Although many African countries have made significant improvements in these areas, there is a need to consolidate and further improve macro-economic fundamentals.

2. Liberalize trade, but with care

In order to participate more in international trade, African countries will need to further liberalize their trade regimes. But liberalization has fiscal and balance of payments implications stemming from the difficulty of finding alternative secure sources of revenue. Also, premature de-industrialization could set in if trade liberalization is carried out without regard to the competitiveness of otherwise successful domestic enterprises. Therefore, in designing credible and sustainable trade reforms, more care will need to be taken regarding the sequencing, pace and phasing of trade liberalization. Countries should start with export liberalization and promotion, while import liberalization should be implemented steadily over a longer period.

3. Realise the opportunities of regional dynamism

Africa's market is equivalent in economic terms to that of Belgium, yet it is fragmented into over forty different countries. Bearing in mind the fact that much international economic interaction is regional rather than global in nature, there would seem to be great potential for African countries to promote regional interaction and markets as a stepping stone towards participating more actively in global markets. The first step is to work towards trade and payments liberalization between neighbouring countries in order to generate regional dynamics. Building regional infrastructure networks in roads and telecommunications would also help.

4. Focus on the primary sector

The performance of the primary sector will be crucial because this sector provides Africa's main source of foreign exchange earnings. A crucial immediate task for most countries in Africa is to rebuild the primary commodity export sector, while also proceeding with strategies to promote export diversification. A vital consideration is that the primary sector should not be penalised.

Governments could also actively intervene in expanding and diversifying primary exports. Creating or supporting institutions for research and development as well as education and training in this sector should be given priority. Infrastructual investments to overcome power failures, water shortages and poor rural road networks are also essential.

5. Some protection and selective promotion policies may be helpful…

Governments could also intervene to promote upgrading of exports and encourage inward investment. Selective promotion measures for consideration include export-processing zones (EPZs), bonded warehouses, and duty exemption and drawback schemes. Also, protection can be justified in order to promote infant industries. Thus, temporary and strictly time-bound protection and promotion for certain industries can be justified if industries are selected in view of countries' evolving comparative advantage.

6. But they can be dangerous if the institutional preconditions are weak

However, in addition to the importance of sound policy foundations, selective measures can only be effective if the necessary institutional foundations exist. In fact, attempting selective measures without the appropriate foundations can actually be harmful. Therefore, African countries should concentrate on building sound policy and institutional foundations. The institutional foundations include government commitment to economic development, communication between the public and private sectors, an effective bureaucracy and low risk of corruption.

7. Reinforce the institutional preconditions for outward orientation and growth

There is increasing acceptance of the value of institutional reform in improving Africa's economic performance in general, and its external performance in particular. By institutions we refer to the formal and informal rules of the game that govern the behaviour of state and market agents as well as their interactions. Institutions are vital, among others, at four levels:

I. *At a political level*, it is important to have institutions that lead to commitment and credibility. There are two key lessons here. *First*, shield top economic agencies from political pressures and follow their advice. *Second*, develop sub-regional free-trade agreements as a means of demonstrating commitment, as well as of realizing other benefits.

II. *At a public level*, it is desirable to have institutions that lead to an efficient and non-corrupt public service. Important measures include:
   - merit-based recruitment and promotion;
   - appropriate wages;
   - limits on political appointments and insulation from political pressures;
   - streamlined structures and bureaucratic practices; and,
   - efforts to combat corruption (most managers identify corruption as the number-one obstacle to doing business).

III. *Regarding the interaction between the public and private levels,* it is important to have a bureaucracy that is responsive to the business community but still independent. Information-sharing through business councils is one useful mechanism to improve this responsiveness.

IV. *At the level of private agents,* the importance of secure property and contract rights cannot be overstated. There is a real need to improve the independence and effectiveness of the judiciary and to establish the rule of law.

Overall, there is substantial evidence that institutional failure in Africa is a critical obstacle to better growth and external performance. In particular, surveys identifying local entrepreneurs' views on the obstacles to business in Africa highlight the unpredictability of changes in laws and policies, the unreliability of law enforcement, the impact of discretionary and corrupt bureaucracies, and the danger of policy reversals due to changes in governments. Unless governments eliminate these kinds of obstacles it is unlikely that business, domestic or international, will flourish in Africa.

8. Developed countries can help by:

- **Radically transforming aid.** Aid will have to be substantially transformed if it is to serve as a useful instrument for mediating Africa's future relationship with the world. The key challenge is how to facilitate the effective transfer of ownership to countries in Africa. Donors could help through substantial reduction in donor procurement restrictions and inappropriate intrusion into domestic affairs as well as in taking longer-term perspectives. They should also be more selective in concentrating their aid towards countries that demonstrate ownership and commitment ñ that have or are actively moving towards the economic policy and institutional foundations for development.
- **Reducing the debt burden.** There is an overwhelming case that significant further reductions in the external debt of debt-distressed countries would improve growth prospects in Africa, particularly if the resources provided are additional.
- **Guaranteeing open markets.** One of the most effective mechanisms to help African countries integrate into the global economy would be for OECD countries to guarantee open markets for African exports and commit themselves to help strengthen Africa's participation in the world economy.

Introduction

The objective of this policy brief is to assist African governments in efforts to strengthen their participation in the global economy in ways that bring widespread and sustainable benefits to their peoples. This document highlights some of the key factors that African countries will need to address if they are going to realise the opportunities and negotiate the challenges posed by globalization. It also outlines some broad practical measures that would help improve the situation with regard to these factors. The brief is not intended to be a comprehensive blueprint, but instead to provide a reference for discussions at the specific country level.

The recommendations in the brief are based on:

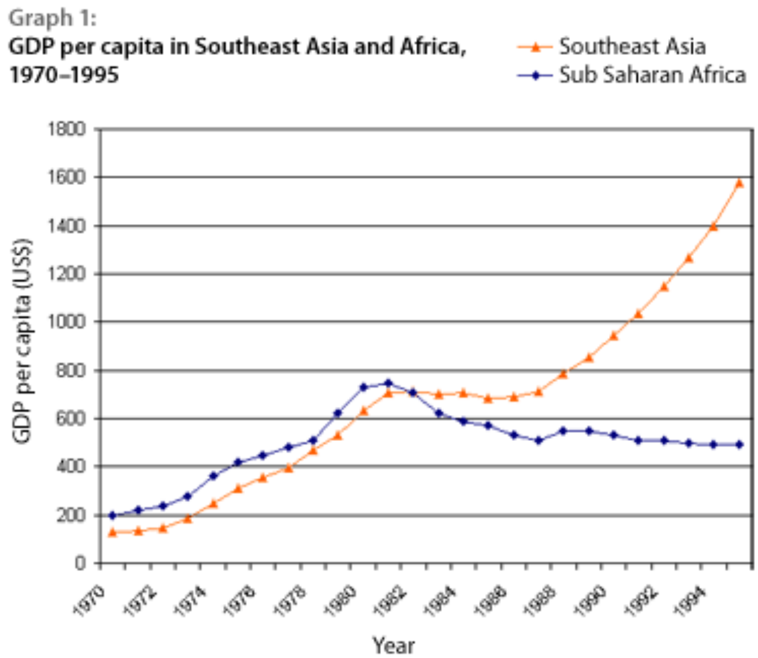
- an assessment of the trends in the globalization process and their specific implications for Africa;
- a review of the latest academic thinking regarding economic performance in general and external performance in particular;
- a review of the causes of Africa's economic marginalization and of its structural adjustment experience;
- a review of the potential lessons contained in the impressive external performance of Southeast Asia over the last thirty years, as well as the lessons for Africa contained in the Asian economic crisis.

The rest of this section provides a brief overview of these issues.

The globalization of the world economy is perhaps the most important trend that affects the current environment for economic development. It offers great opportunities for poor countries to accelerate their economic development. But, it also poses new and substantial challenges for economic management.

Within this context, there has been a tendency to contrast Africa's growth "tragedy" over the last three decades with the economic "miracle" of East Asia. There are certainly likely to be lessons from the East Asian experiences that policy-makers in sub-Saharan Africa could adapt to their own situations. Lessons can be learned both from the era of rapid growth in East Asia as well as from the ongoing economic crisis.

In particular, the Southeast Asian nations Indonesia, Malaysia and Thailand would seem to offer the most relevant lessons for Sub-Saharan Africa. Southeast Asia and Africa had similar levels of income in the 1960s and 1970s. This can be seen in Graph 1, which highlights the changes in GDP per capita in Southeast Asia and Africa since 1970. The two regions also had relatively similar social and political conditions at that time. The graph powerfully illustrates the sustained growth in Southeast Asia for twenty-five years as well as the marked decline in Africa's fortunes since the early 1980s.



Source: Calculated from World Development Indicators (World Bank, 1997)

One of the most obvious differences in the performances and economic structures between the two regions has been the extent of participation in the global economy. The decline in Africa's share of world exports, its continued concentration in primary commodities and its inability to attract inward investment have led to widespread concern over the increasing economic marginalization of many countries in Africa. In contrast, countries in Southeast Asia have not only accelerated the process of integration in the world economy but also upgraded their linkages. This points to the advantages of following an outward-oriented development strategy. But the ongoing Asian crisis highlights the severe challenges for economic management presented by the globalization of the world economy.

Explanations of the increasing marginalization of Africa identify a broad variety of factors. These include: (i) geographical conditions such as weather, climate, natural resource endowment and landlockedness; (ii) policy factors and related variables such as human and physical capital, fiscal and monetary policy, savings and investment, exchange rate competitiveness, and trade regimes; and, (iii) institutional factors, for example political commitment and credibility, bureaucratic quality, law and order. However, as governments cannot change the geographical conditions, we concentrate on the policy and institutional realms.

The brief is divided into three more sections. Section II outlines the forces that are driving the globalization process and identifies some key underlying issues for countries in Africa. Section III highlights measures that might help African countries to enhance their integration into the global economy. Section III(i) focuses on economic policy issues and Section III(ii) focuses on institutional measures. Section IV outlines recommendations for external partners.

Globalization and Africa: The Need for a Strategic Approach

Globalization and the Importance of an Outward-Oriented Strategy

Globalization is perhaps the most important trend shaping the current environment for economic development. The main modes (and therefore indicators) of this global economic integration are international trade, foreign direct investment and capital flows. Globalization is indicated by the fact that the rate of growth of each of these indicators has been faster than the growth of overall world output. In order to make the most of these opportunities and to also manage the risks, the first step is to understand the nature of the forces driving the global economy and the implications for economic management in Africa.

There are a number of factors that appear to be driving the process of globalization. *First*, rapid advances in communication and transportation technology have reduced the costs of moving goods, money, people and information. *Second*, globalization relates to the expanding geographical scope of business activities of private transnational corporations and financial institutions. *Third*, it refers to the increased extent to which markets for goods, services, and factors of production are effectively integrated across national borders. *Fourth*, it is concerned with the higher degree of uniformity in policy and institutional environments that set the rules of the game for economic actions and interactions on the part of private agents based in various countries. The interaction of these factors has undoubtedly led to an accentuated tendency of the world economy towards greater interaction and integration between national economies. It seems realistic to assume that despite current turbulence, this tendency will continue to increase over the medium term.

Globalization can provide immense opportunities for countries to accelerate the development process. These opportunities centre on access to world markets, finance and technology. By pursuing outward-oriented strategies to realise these opportunities, countries such as Korea, Malaysia and Thailand in Asia and Mauritius in Africa have doubled their national incomes in just over twenty years. Pursuing an outward-oriented strategy is even more crucial for most African countries because they are particularly small and poor. As the past experiences of African countries suggest, de-linking from the global economy leads to marginalization and condemns countries to slow growth.

The Vital Need for a Strategic Approach

But, while the benefits from globalization can be significant, they are not necessarily guaranteed. They are dependent on the nature and forms of integration. In this regard, integration has a number of dimensions such as trade, investment, capital flows and technology. The optimal level of openness may differ for each aspect, depending on the stage of development in each particular market. In addition, the risks and costs associated with liberalization can be considerable for small, fragile economies, as they are exposed to external shocks.

Certain prerequisites seem necessary for countries to manage the risks and to ensure liberalization proceeds in an orderly manner. While not downplaying the spheres of international trade and foreign direct investment, recent events indicate that liberalizing capital flows can pose particularly severe risks and costs. Although few countries in Africa are facing the scale of inflows relative to the size of their economies that precipitated the Asian crisis, key lessons for Africa illustrated by the crisis concern the importance of developing sound financial systems, appropriate sequencing, avoiding overly rigid exchange rate regimes and caution in financial opening.

A final issue relates to the observation that the integrated world economy that globalization is popularly assumed to produce has not emerged. What has emerged is a degree of *fractured globalization*. In particular, trade is concentrated in regional blocs instead of being fully global. The implication stemming from this evidence is that African countries should place a high priority on trying to generate dynamism with neighbouring countries.

The Social, Political, and Economic Landscape for Strengthening Africa's Participation in the Global Economy

The explanations for Africa's marginalization over the last two decades have largely concentrated on the inappropriate domestic policy regimes maintained in most African countries. Based on this view, the advice provided has centred on economic policy reforms, namely stabilisation and structural adjustment policies. There was a firm belief that these reforms would remove impediments to markets and thereby boost external performance and growth.

There is little debate that reform was needed, and there is evidence that growth and export performances have been better in countries that have undertaken and sustained a reasonable measure of macroeconomic reform. But the policy regimes and development situation in Africa remain very fragile. The rates of economic growth in most countries are still well below levels that will have a significant impact on reducing poverty. This leads to two questions: How can policy stance be improved further? Is policy reform sufficient; and if not, what other areas need action?

On the first question, analyses indicate that many African countries still do not have economic policy foundations that are likely to lead to significant improvements in external performance. There is still a great need to consolidate economic policy reforms in a few key areas where there is already a consensus. But there is concern that policy advice has had a concentration on short-term targets that may be detrimental to long term growth prospects in Africa. There is also the linked worry that the overriding way these targets are pursued actually jeopardises the credibility and sustainability of reform.

On the second question, there is acknowledgement that "getting the prices right" in Africa is not sufficient. Even in countries that have undertaken significant policy reforms, these have not led to the expected improvements in economic growth and external performance. There remain a number of constraints in Africa that policy reform alone will not rectify.

This assessment has been coupled with research that illustrates the importance of institutions in economic development. By institutions, we mean the rules and arrangements governing the behaviour of economic, bureaucratic and political actors. In particular, research indicates that Africa has very low institutional quality and is the riskiest continent for investment. Therefore, this report highlights a number of important institutional issues and suggests measures that could help Africa improve the institutional foundations for successful external performance.

It is important to note that policies and institutions interact in a number of ways. First of all, policies are outcomes of the institutional system of policy formulation. Second, policies are implemented within the institutional system of policy execution. Thirdly, and conversely, policy decisions and their outcomes set conditions on the operation of institutions, and thus affect their functioning.

This discussion has three broad but important implications. *First*, economic policy choices by African governments towards strategic integration should reflect the existing institutional situation. For many African countries, this entails focusing the state's capability on the most important tasks. *Second*, it means that countries with weak institutional capabilities should not adopt "institution-intensive" approaches to policy — most countries in Africa should start with policy measures that are easier to implement. The economic policy priorities for strategic integration are highlighted below in the next section. *Third*, it is clear that policy reform alone is not enough, and that countries will need to significantly improve institutional quality if they are to integrate with the world economy. These issues are addressed in the next section.

Recommendations for Strengthening Africa's Participation in the Global Economy

Economic Policies

Economic Policy Foundations

There is a significant degree of consensus on the key economic policies that provide a foundation for encouraging development in general and integration with the global economy in particular. Such policies would include:

- investment in human and physical capital (education, transport and communication infrastructure);
- maintaining a stable macroeconomic environment (for example, maintaining low inflation; keeping budget deficits manageable; maintaining an appropriate and stable real exchange rate; and maintaining stable and appropriate real interest rates);
- outward orientation, in particular maintaining a competitive and stable exchange rate.

There is widespread acceptance that the policies highlighted above were a central part of successful outward-oriented development strategies in East Asia. There is also substantial evidence that Africa's growth "tragedy" is partly attributable to governments' failure to achieve stability on key macro-economic issues. Although many African countries have made significant improvements in macro-economic policy, there is a need to consolidate and augment their macro-economic fundamentals. Many countries in Africa still lack a macro-economic policy stance that would enable them to maximise their external performance.

The key issue is how to achieve the policy foundations given the constraints being faced. Large budget and current account deficits and high inflation, for example, are bad for growth, but there are no simple rules for deciding on the optimal level of deficits. One major area of concern is that the over-riding emphasis on short-term stabilisation policies and the zealous pursuit of rigorous macro-economic targets is actually harming long-term growth prospects in Africa. This particularly seems to be the case regarding the impact on Africa's levels of investment in human and physical capital. It is essential that reforms are designed and implemented in a more coherent manner and with realistic targets regarding the pace, sequencing and time frame so that they do not impinge on essential government expenditures and investments that are crucial for the country's long-term development.

Trade and Investment Regimes

The trade policy regimes that prevailed between the time of independence and the adoption of structural adjustment programmes in Africa were truly inward-looking both on the import and export sides. These policies led to Africa's increasing marginalization in the world economy.

Anti-export bias stifled the incentives of exporters causing African countries to fail to participate in and benefit from the growth of international trade. Given these historical experiences, it is not surprising to find that trade liberalization carried great weight in the structural adjustment programmes.

The superiority of an outward-oriented regime over an inward-looking one has been increasingly accepted as a key component of a growth-enhancing development strategy. Openness to the global economy provides nations with the potential to exploit comparative advantages and economies of scale as well as the opportunity for the greater utilisation of capacity. Exports provide a source of foreign exchange with which to improve productivity. Foreign direct investment can be a source of employment and can encourage technological upgrading. Openness also enables global technical change to increase domestic productivity via importing. In addition, competitive pressure can stimulate increased efficiency.

However, despite two decades spent in pursuit of "openness," much of Africa continues to be bypassed by the global trends in trade and foreign direct investment (FDI) flows. The region's share of world trade has declined to about 2 per cent. There has been little export diversification, and Africa's concentration in primary commodity exports continues. The minuscule FDI that flows into the region is concentrated in the extractive oil and mineral sectors.

In the process of implementation, many reforming countries found it difficult to adhere consistently to trade liberalization. Trade reforms' sustainability and credibility are critical issues in Africa as frequent policy reversals have been observed in many countries. Most of these reversals can be traced, by and large, to fiscal and balance-of-payments incompatibility. Therefore, in designing credible and sustainable trade reforms for Africa, a number of pressing issues concerning the sequencing, pace and phasing of trade liberalization need to be addressed.

- *First*, with extremely narrow tax bases and weak tax-collecting capacity, African governments have been overly dependent on taxes on international trade transactions for their fiscal revenue. There is a real difficulty in finding alternative secure sources of tax revenue and instituting efficient tax-collecting systems in the short to medium term, leading to perpetual fiscal imbalance. This indicates a practical need for liberalization to be implemented steadily over a longer period.
- *Second*, balance-of-payments problems may worsen with deep, generalised and sudden import liberalization as has already been witnessed in many African countries. In view of the need to have a sustainable export revenue base in order to avoid recurrent balance-of-payments crises, reforms could be implemented along two tracks. During the first stage, policies could be geared to export liberalization rather than sweeping competitive tariff reductions. Import liberalization could be carried out in a more gradual fashion over a longer period.
- *Third*, in some countries premature deindustrialization could set in if trade liberalization is carried out without regard to the competitiveness of otherwise dynamic successful domestic enterprises.

Realizing the Opportunities for Regional Dynamism

Africa's economic and political geography present challenging circumstances for economic development. Many African countries are too small and balkanised to provide substantial economies of scale to support profitable investment and fifteen countries are landlocked. This situation and the regional rather than global nature of much international interaction suggests that countries place a high priority on trying to generate sub-regional and regional dynamism.

Regional integration can only work in the context of more open national economies. The first step is to work towards trade and payments liberalization between neighbouring countries in order to spur inter-country transactions. Liberalization has already led to increasing intra-regional trade within Africa. Another major step in this direction is to integrate national markets into sub-regional markets through building regional infrastructure networks, in roads and telecommunications, for example. Regional project aid could help here.

Furthermore, while financial market development presents a potential channel for integration into the global economy, most economies in Africa are too small to justify the cost involved in setting up stock markets. One of the most viable ways to overcome this problem is for governments to pool resources in developing regional institutions. These could include: regional securities and exchange commissions; regional self-regulatory organisations; regional committees to promote harmonisation of legal and regulatory schemes; development of regional bond or debt markets; regional institutions for pooling information and research; credible regional credit rating agencies; and coordinated monetary arrangements.

Concentrate on the Primary Sector

The strategy towards globalization for African countries should reflect the structure of their economies and their endowments relative to other parts of the world. While some African countries have the basic infrastructure and human capacity to embark on industrialization drives, the majority are at a pre-industrial stage. In addition, Africa faces the highest transport and telecommunications costs in the world. The performance of the primary sector will be crucial since this sector dominates most economies in Africa and provides the main source of foreign exchange earnings. Given the long gestation period of investments in human capital, the primary sector is likely to remain crucial for many years to come.

A crucial immediate task for most countries in Africa is to rebuild the primary commodity export sector. A vital step is to reduce export taxes so that the primary sector is not penalised. But governments could also actively intervene to expand the level and diversify the range of their primary exports. Priority should be given to creating or supporting institutions for research and development, education and training. Infrastructure investment is also essential to overcome a number of supply constraints, such as power cuts, water shortages and poor rural road networks. Other key transport-related obstacles include the lack of all-weather roads and feeder roads necessary for transportation of agricultural produce to major centres, insufficient rolling stock and lack of refrigerated trucks and cold-storage facilities for perishables.

Government should also look towards longer-term strategies to develop primary-processing capabilities. This can lead to the acquisition of new skills and technologies, productivity growth, externalities and scale economies, and provide an important new source of export revenue. If resources are managed on a sustainable basis, natural resource-based industrialization remains a viable development path for many African countries.

Selective Promotion Measures and Protection ñ and the Pre-requisites for Effectiveness

There are a number of ways in which African governments could intervene to encourage exports, manufactured exports in particular, as well as to attract inward investment. Selective promotion measures such as duty exemption and drawback schemes can be used to create free trade conditions for exporters. Other measures for consideration include bonded warehouses and export-processing zones (EPZs), which allow firms to import on a duty-free basis subject to the requirement that their entire output is exported.

There is also a case for temporary and strictly time-bound protection for certain industries. Protection can be justified during liberalization in order to ensure a soft landing for otherwise successful domestic enterprises and avoid de-industrialization. Protection can also be justified on infant industry grounds if industries are selected in view of countries' dynamically evolving comparative advantage. It is important, however, to emphasise the rigorous pre-requisites if specific measures are to work effectively. *First*, specific measures can only be effective if sound general policy foundations support them. *Second*, the implementation of specific measures requires certain levels of skill, finance and information. *Thirdly*, they need supportive institutional foundations, such as a commitment to economic development, communication between the public and private sectors, an effective bureaucracy and low risk of corruption. Given such rigorous pre-requisites, most countries in Africa should concentrate on building sound economic policy and institutional foundations.

Management of Financial Flows — Lessons from the Asian Crisis

Inflows of capital are usually an indicator of success, reflecting a record of prudent macroeconomic management. They can augment domestic savings to finance higher rates of investment than would otherwise be possible, thereby boosting GDP growth. But the crucial issue is whether they are used productively.

The ongoing financial crisis in Asia highlights the serious risks engendered by capital flows. The massive scale of financial flows and "herd" behaviour can lead to inflows that far exceed a developing market's capacity to invest them productively at reasonable risk. Their rapidly reversible nature makes borrowing countries very vulnerable to shifts in market sentiment, which sometimes bear little relation to the nation's economic fundamentals. In addition, the benefits of free capital movement can be achieved by encouraging foreign direct investment in fixed assets, which is not readily reversible.

It must be noted, however, that few countries in Africa are likely to face the scale of inflows that precipitated the Southeast Asian crisis. Nevertheless, the crisis highlights a number of important financial management issues for Africa. *First* is the problem of an appreciation of real exchange rates and a loss of competitiveness of traded goods. *Second* is the excessive and rapid accumulation of foreign debt, from short-term loans in particular. *Third* is the use of capital for speculation in the property sector and stock markets, resulting in unsustainable rates of asset price inflation.

The current crisis highlights the importance of avoiding overly rigid exchange rate regimes. It also demonstrates again the importance of appropriate timing, speed and sequencing of liberalization of financial systems and capital account transactions. The paramount lesson concerns the importance of developing sound financial systems, and therefore the need to develop effective monitoring, supervisory and regulatory systems. Full-scale liberalization of the capital account and financial sector should be delayed until macroeconomic stability, prudent financial regulations and capable supervision are firmly established.

Management of Aid

As Africa has largely been bypassed by private capital flows, foreign aid has been one of Africa's most significant external links. Aid reached 11 per cent of GDP by 1994, compared with only 1 per cent in other developing countries. Though foreign aid has been critical in filling the resource gap, aid effectiveness remains low and Africa's aid dependence has increased rather than decreased over time.

Aid programmes are more likely to be successful when the recipient government has the capacity to identify and articulate its own priorities and programmes and the ability to implement, monitor, and evaluate the resulting programmes in the context of its own planning and budgeting. The low effectiveness of aid in Africa is partly caused by lack of ownership of the development agenda and deficiencies in resource allocation and budget management in recipient governments.

Furthermore, high levels of aid have engendered apathy on the part of recipients, which in turn encouraged donor agencies to take over project planning and execution tasks. Aid has been donor-driven rather than being a product of discussions, mutual agreement and genuine commitment. This jeopardises the long-term project benefits resulting from ownership. To reverse the current degree of aid control by donors and the passivity of recipient countries, the latter should return to medium-term planning in which broad criteria for projects/programme spending of aid can be defined. These plans, which could accommodate donors' views, should form the basis of future aid allocation.

Rather than expecting donors to coordinate themselves, recipient governments should take the initiative. There would seem to be a strong case for improving governments' capacity to co-ordinate and manage aid. A central coordinating agency would be a useful first step. Such an agency should also have the capacity for policy analysis, enabling governments to identify and articulate priorities and programmes and to monitor and evaluate them. The next aim would be to strengthen aid distribution and allocation mechanisms.

Institutional Foundations

There is an increasing understanding of the importance of institutional factors for development in general. Institutions are defined as the systems of incentives and restraints that govern agents' behaviour and their interactions. These comprise formal rules and laws as well as informal conventions and norms of behaviour. Institutions set the "rules of the game." Institutions affect economic performance because they provide the structure of exchange that determines the cost of transactions. They can improve the levels of investment and growth by processing information, reducing uncertainty and reducing transaction costs.

A useful way of thinking about institutions and their economic effects is to distinguish between different levels where institutions form the basis of interactions between parties:

- *The Political Level:* institutions that regulate government attitudes towards the development process. Desirable outcomes would be commitment and credibility.
- *The Public level:* institutions that align incentives within state agencies, particularly the bureaucracy. The desirable outcome is an efficient and non-corrupt public service.
- *The Public-Private level:* institutions that regulate the interactions between the state agencies and the private sector. The desirable outcome is a bureaucracy that understands the needs of the private sector and that is responsive to the business community but still independent.
- *The Level of Private Agents:* institutions that regulate the interactions between private actors. Desirable outcomes would be secure property and contract rights.

These general areas of institutional analysis can also be used to assess the impact of institutions on external performance. For example, at the political level, the desirable outcome would be political commitment to increasing exports. Research indicates that institutional factors significantly affect external performance. This indicates that enhancing institutional quality is one way of improving external performance. The rest of this section looks at the types of issues that African governments should consider at the four levels indicated.

The Political Level

The key issues are (i) a commitment to developmental policies in general and towards an outward-oriented strategy in particular and (ii) how credible that commitment is. Leaders can indicate their commitment is credible through two mechanisms: *reputation* and *accountability*. First, they could establish a reputation for carrying out their development promises. The desire to retain this reputation then provides an incentive to maintain developmental policies. Leaders can also indicate their commitment by establishing mechanisms that make them accountable for their actions. Accepting a democratic political system is one way to try to ensure governments are held accountable for their actions.

The difference in the level of political commitment to outward oriented strategies between East Asia and Africa is often highlighted. Successful regimes in East Asia have established a good reputation by achieving their development objectives. This was partly done by shielding top economic agencies in the bureaucracy from political pressures and by following these agencies' policy advice. In contrast, many analysts argue that one of the primary causes for Africa's development tragedy is the predatory nature of African states. African governments have tended not to be able to put long-term national development priorities over more immediate political or personal goals.

Two lessons for Africa emerge. *First*, there is an urgent need to shield top economic agencies in the bureaucracy from political pressures and to follow their policy advice. *Second*, entering into sub-regional or regional free-trade agreements is one way of demonstrating political commitment to an outward-oriented strategy; as well as realizing other benefits.

The Public level

Governments' administrative competence is one of the single most important factors for explaining the differences in growth among developing countries. The quality of institutions at the public level determines how efficient and non-corrupt the public service is and the quality of policy intervention. A motivated and well-paid public service is less likely to use its powers to allocate rents to special interests and friends.

Africa has been found to have particularly low levels of bureaucratic efficiency in cross-regional comparisons. The poor economic management capacity and cumbersome administrative and bureaucratic structures of African bureaucracies have limited the successful formulation and implementation of economic policies and posed a central obstacle to market-oriented reforms. African governments often have been more preoccupied with securing public employment than with promoting the quality of the civil service. Positions in public-sector institutions, including many parastatals and monitoring and regulatory agencies, have been made ineffective due to political appointments, politically controlled funding and multiple objectives. Transparency and accountability of these public institutions have been minimal. There is near-universal agreement on the great need to improve the management of African economies.

The key issue is capacity utilisation, indicating a need to align material conditions and incentive structures so that they favour professionalism and quality in the performance of public officials. Some of the key areas that might help build an efficient and non-corrupt bureaucracy include:

- merit-based recruitment and promotion;
- appropriate wages;
- insulation from political pressures;

- limits on political appointments;
- streamlined bureaucratic structures and practices; and,
- internal controls and restraints, such as anti-corruption commissions.

In particular, corruption has been identified as the most significant obstacle to doing business. Some key measures in combating corruption are:

- instituting external mechanisms for accountability;
- organising the government's efforts through co-ordination and a focal point;
- procedural reforms, such as the need to record decisions;
- increasing the pay of civil servants;
- publicity for anti-corruption efforts and involvement of the institutions of civil society; for example a free press plays an important role in reinforcing the rule of law; and,
- punishing high-level offenders ("frying some big fish") indicates that the government is committed to solving the problem of corruption.

The Public-Private Level

The state and the market are two key players in the development process. The importance of a complementary and positive relationship between them is crucial. In this regard, it is important to have a bureaucracy that is responsive to the business community but is still independent.

In Africa, the relationship between the government and the private sector has been much more adversarial than in East Asia, both in general and with specific reference to transnational corporations. There are signs, however, that the relationship between the private and the public sectors is changing in a number of African countries. The proportion of businessmen in Africa who see the state as their opponent has dropped. In certain countries, such as Uganda, Ghana, Mauritius and Mali, there have been dramatic improvements in the proportion of businessmen who found the state helpful. Surveys show that in certain African countries the years of efforts at improving the economy are starting to pay off -- but they also show that much remains to be done.

One way of improving the relationship between governments and business is through business councils. East Asian countries have built forums in which government officials and industry representatives discussed and designed policies for external performance. The councils' main function is to gain information needed to formulate policies that will enhance the performance of the private sector. However, similar experiments in African countries often have not lead to the same results. If they are to be successful, such deliberation councils need to be embedded in a climate of trust and co-operation between governments and the private sector. They also need a substantial technical capability if they are to effectively use the information supplied.

The Level of Private Agents

In order to enhance economic performance, the institutional framework must guarantee property and contract rights between private agents. Markets cannot develop without effective property rights, and property rights are only effective when two conditions are fulfilled. The first is protection from theft, violence and other acts of predation. The second is protection from arbitrary government actions that disrupt business activities.

In terms of rule of law, many countries in Sub-Saharan Africa have certainly lacked the conditions for private sector development. For instance, the survey conducted for the 1997 World Development Report shows that formal enforcement of property and contract rights is indeed a problem. Between 70 and 80 per cent of entrepreneurs answered that they thought that theft and crime were serious problems, that they were not confident that the state authorities would protect their persons and property, and that their nations' judiciaries were very unpredictable. Measures to address these issues should form a significant component in promoting external performance by governments in Sub-Saharan Africa.

Although sound formal institutions are a vital foundation of a long-term development strategy, the fact remains that much private sector interaction is based on informal rules. Informal institutions in the private sector, particularly linkages and networks, can help overcome information scarcities and reduce transaction and search costs. There is a valuable case for policy and institutional measures that would be conducive to the upgrading of informal institutions and arrangements into formal and stable ones.

In summary, there is increasing evidence that institutional failure in Africa is an important obstacle to better growth and external performance. In particular, surveys carried out to identify local entrepreneurs' views on the obstacles to business in Africa highlight the unpredictability of changes in laws and policies, the unreliability of law enforcement, the impact of discretionary and corrupt bureaucracies, and the danger of policy reversals due to changes in governments. These problematic factors are, to a substantial extent, attributable to government behaviour. Unless African governments eliminate these kinds of obstacles it is unlikely that business, domestic or international, will flourish.

Institutional Foundations

Transform Aid

It is increasingly clear that aid will have to be massively transformed if it is to serve as a major instrument for mediating Africa's future relationship with the world. The impact of ODA (official development assistance) is constrained by procurement restrictions and conditions unrelated to development, high transaction costs and poor donor coordination. There is also a need to rethink conditionality, which has not worked well.

There is strong evidence that aid is more effective in countries with sound economic policy and institutional foundations. This implies that donors should be more selective in concentrating their aid towards countries that demonstrate ownership and commitment ñ that have or are actively moving towards the economic policy and institutional foundations for development.

There should be at least two modifications to these recommendations. *First*, disaster relief should be exempted. *Second*, in countries with poor foundations, different types of aid should be prioritised. Aid should concentrate in particular on the longer-term issues of basic health and education, and on technical assistance towards improving the policy and institutional foundations.

Reducing the Debt Burden

Total external debt for Africa increased from US$84 billion in 1980 to US$226 billion in 1995, with a debt service ratio of 14.5 per cent, a debt/GNP ratio of 81 per cent and a debt/exports ratio of 241 per cent. Sixteen African countries were categorised as unsustainable and possibly distressed. While these countries are eligible for debt relief under the HIPC (Heavily Indebted Poor Countries) initiative, the real challenge is to find more substantial and wide-ranging approaches to debt relief.

The implications of the debt burden for development in Africa are far-reaching. Many countries have to allocate considerable amounts of budgetary expenditure to external debt servicing. For example, the Tanzanian government has to allocate 30-35 per cent of its budget for debt servicing, which is equivalent to 9 times that allocated to basic education. The debt burden is obviously enormous in relation to Africa's debt servicing capacity and has become a major inhibiting factor for the recovery of growth and exports.

Easing the burden of unsustainable debt would free government resources for more productive developmental activities, reduce transactions costs (which are a massive burden on policy-makers) and help restore macroeconomic stability and investor confidence. A dollar of reduced debt is therefore likely to be more valuable than an additional dollar of conventional aid. There is an overwhelming case that significant further reductions in the external debt of debt-distressed-low income countries would improve growth prospects in Africa, and particularly if the resources made available are truly additional.

Repeated debt rescheduling has not solved the problems and there is an urgent need to devise new and more effective ways of reducing the African debt burden dramatically. The adoption and implementation of Trinidad Terms, which proposed a reduction of two-thirds in the stock of official bilateral debt, should be the immediate objective of creditor governments. The HIPC initiative should be expanded, its eligibility conditions made more flexible and the completion point of the HIPC criteria advanced.

Guarantee Open Markets

One effective mechanism for integrating African countries into the global economy would be for OECD countries to guarantee open markets for African exports and commit themselves to help reintegrate Africa into the world economy. This is particularly important for key sectors such as agriculture and textiles. This is where Africa's comparative advantage lies, yet these are the most protected markets.

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