

CHAPTER 2: MACROECONOMICS

I. Introduction

The 1960s was a decade when many African countries gained independence. Driven by the desire to raise living standards across the continent, African leaders adopted a development strategy that relied heavily on an extensive system of government interventions and controls for the purposes of economic management. Price controls, import licensing, foreign exchange restrictions, controls on bank credit and interest rates, the taxation of the agricultural sector, and the establishment of public enterprises in strategic sectors were the main instruments of economic management.

In Sub-Saharan Africa (SSA), although in the 1960s there was a modest increase in per capita income and export growth was strong, there was a marked deterioration of economic performance during the 1970s. The growth rates of real GDP and per capita income decelerated, and aggregate export volume trended downward. In the 1960s there was an upswing in the terms of trade followed by a downturn in the 1970s (in the wake of a surge in oil prices). In North Africa, where the average growth rate was lower than in the SSA region in the 1960s, growth performance improved in the 1970s.

Beyond the adverse effects of the oil price shock, most countries began to experience the paralyzing influence of government interventions and controls. Savings and investment rates were woefully inadequate to meet the needs of human resource and infrastructure development, unprofitable public enterprises became an unsustainable burden on the budget, and the private investments needed for agricultural and industrial development were not forthcoming. The state-administered system of controls on domestic prices, crop marketing, credit allocation and bank interest rates, and the allocation of import licenses and foreign exchange made it extremely difficult for the private sector to function.

Following a rethinking of development strategies in SSA, an increasing number of countries began to implement far-reaching reforms to achieve macroeconomic stability and eliminate the government interventions that impeded economic activity, especially in the private sector. Economic performance was disappointing throughout the 1980s with a decline in per capita income. In the first half of the 1990s inflation rates accelerated. The first signs of economic recovery emerged only in the mid-1990s. Throughout this protracted period of 15 years, investment-savings gaps and fiscal imbalances remained large and were financed by substantial inflows of foreign aid and external debt relief. Growth performance also weakened in North Africa during the 1980s and the 1990s.

Notwithstanding the disappointing overall economic performance of African countries during this period (1980-95), there was some evidence that countries that had improved their macroeconomic policies and implemented reforms in a sustained manner performed better than countries that were less successful in implementing structural adjustment programs. In SSA reform efforts implemented over an extended period by an increasing number of countries had led to an increase in the number of successful adjusters or countries with improved growth performance. In addition, the Franc Zone countries of West and Central Africa, where growth performance was chronically weak because of a highly overvalued exchange rate, launched new adjustment programs based on a substantial devaluation of the exchange rate in August 1994. Their economic performance improved with a short lag.

Section II traces the economic performance of Africa since 1960, distinguishing between two sub-periods; 1960-mid-1990s and the strengthened performance from the mid-1990s to date. Section III focuses on investment and savings performance. It starts by reviewing recent trends in investment and saving rates and then presents policy recommendations to raise these rates to the levels that are required in the coming decades to underpin sustained high growth rates. The concluding Section IV outlines the macroeconomic policy framework for sustainable high growth and inclusion, i.e., to achieve the Africa 2050 vision.

II. Broad trends in Africa’s Economic Performance (1960 – 2011)

During the 12-year period from 1957 to 1968 thirty three African countries joined the international community as independent nations. Eight more countries gained independence over the period 1974-80. Only a few countries had gained independence prior to the 1950s: Liberia (1847), Egypt (1922) and Morocco (1927) were the earliest forerunners. A notable exception is Ethiopia, which was never under colonial rule. A. The deterioration in economic performance between the 1960s and the mid-1990s

The deterioration in economic performance between the 1960s and the mid-1990s

In the 1960s Africa’s new leaders relied on highly interventionist economic policies to promote rapid economic development. These policies sought to achieve rapid industrialization by curtailing import dependence, establishing public enterprises to control and manage economic activities in strategic sectors, and putting in place wide-ranging regulations to control prices, restrict imports through strict licensing and other trade barriers, and control the availability and allocation of bank credit and foreign exchange. Governments relied on the taxation of agriculture and often on exports to raise resources for the financing of their economic development plans. Many countries were able to mobilize financial support for their development plans from foreign development partners (including both bilateral and multilateral institutions).

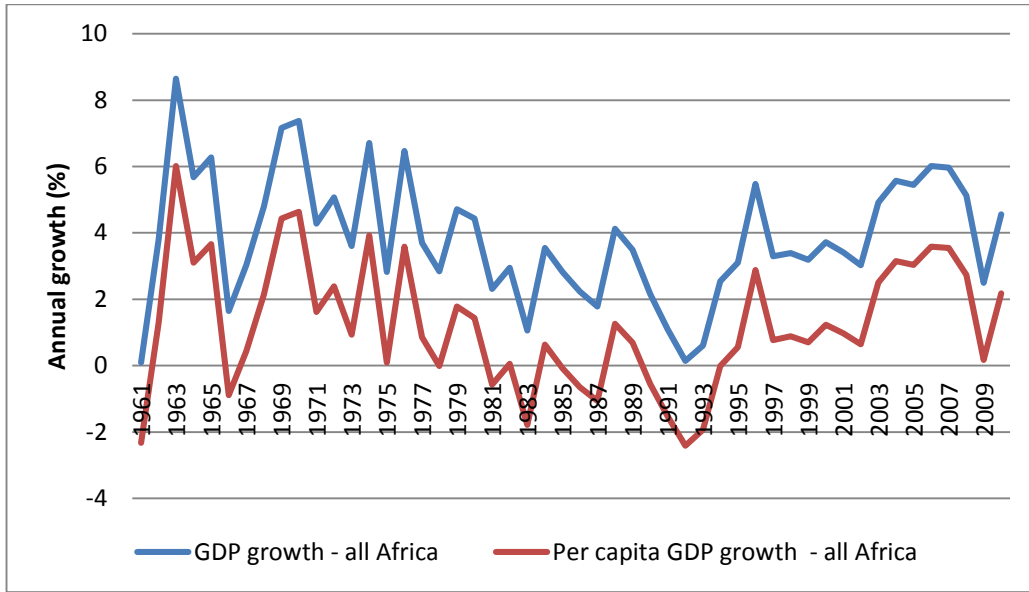
Despite the challenges of transition to new Governments and the extra caution required to work with the basic economic database of the 1960s, it is useful to report briefly on the early assessments that exist of broad economic trends in the post-independence years. The data for this study are drawn mainly from various past issues of the World Bank’s African Development Indicators, the IMF’s World Economic Outlook and the UNCTAD database.

Worsening economic growth performance

Africa’s overall growth performance in the 1960s was encouraging and reflected several positive trends (Figure 2.1). In both Sub-Saharan Africa (SSA) and North Africa real GDP growth was on average somewhat faster than population growth, although reportedly slower than the average for other developing countries.⁴ However, economic growth weakened substantially during the 1970s, especially in the non-oil and non-mineral producing countries of SSA. In North Africa the average growth rate continued to improve in the 1970s.

⁴ The World Bank (1989) – “Sub-Saharan Africa: From Crisis to Sustainable Growth.”

Figure 2.1: Growth rates of Real GDP and Per Capita Real GDP



Source: UNCTAD database

In the 1960s per capita GDP increased in both regions at an average annual rate of somewhat more than 2 percent (Figure 2.1). During this decade the growth in agricultural production (2.7 percent) was roughly the same as population growth in SSA countries and agricultural exports increased at about 2 percent a year.⁵ Moreover, the volume of total exports from SSA reportedly grew on average at 6 percent a year, led mainly by oil exports. A surge in commodity prices in 1967 boosted exports and strengthened growth performance. The available data for North Africa (covering 1965-69) indicate that during this five year period annual growth rates (in real terms) averaged 8 percent in industry (inclusive of oil and other mining) and 4 percent in agriculture (which was noticeably faster than population growth).⁶

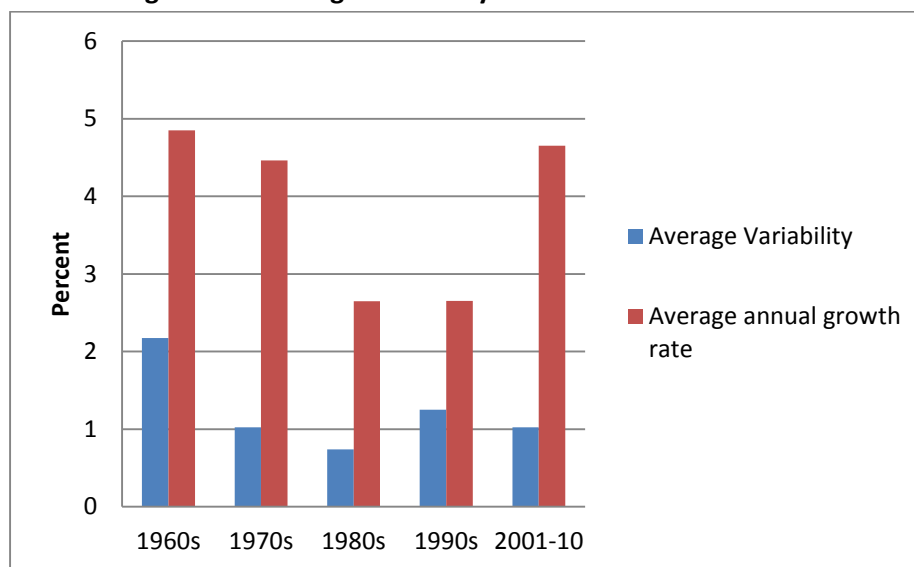
During the 1970s the decline in economic growth rates in SSA reflected a deceleration of growth rates in the non-oil and non-mineral producing countries following a substantial worsening of their terms of trade. In these countries the increase in per capita GDP was barely equal to the population growth rate. Aggregate export volume trended downward following the 1973 oil shock for all SSA countries (including oil exporters). The share of Africa's total exports in world exports declined and its share of world exports of primary commodities fell even more sharply. Agricultural exports from Africa's non-oil primary commodity exporters were on a declining trend. The non-oil primary commodity exporters of Africa had remained narrowly concentrated on a few agricultural commodities and had yet to tap into the growing markets in other developing countries (especially Asia). Mauritius and Kenya are notable exceptions where efforts were made to diversify away from exports of primary commodities.

⁵ Ibid.

⁶ Global Coalition for Africa (2003/04): "The 2003/04 Annual Report – African Social and Economic Trends." This publication cites World Bank data as its data source.

In the 1960s and the 1970s in both sub-regions growth performance was accompanied by a volatility of annual growth rates (Figure 2.2).⁷ The relatively undiversified structure of Africa’s production and exports made it difficult to moderate (or mitigate) the negative impacts of both external and internal shocks.

Figure 2.2: Average Variability in Growth Rate - all Africa



Source: Derived from UNCTAD data used in Figure 2.1

The deterioration of performance during the 1970s was due to serious structural weaknesses. The oil shock of 1973 and the terms of trade losses of subsequent years (especially the early 1980s) were only part of the reason underlying the protracted slowdown in growth performance in the SSA countries. Savings and investment ratios were well below what was needed to address the pressing challenges of economic development and growth. Substantial deficits in the public sector and terms of trade losses had weakened domestic savings.⁸ Moreover, investments were costly due to poor transport services, adverse taxation and other policies; also the returns to investment (as measured by the incremental capital-output ratio) were lower than in other regions.⁹ Even among Africa’s oil exporting countries where substantial resources were derived from higher oil prices there was little success in diversifying production and exports.¹⁰

Higher public investments and savings were necessary to increase expenditures for both human resource and infrastructure development. The efficiency of public investments needed to be improved. Private sector investments in agriculture and industry were not adequate to spur growth. An enabling regulatory environment and more efficient infrastructure services were required to promote private sector development. Stronger efforts were needed to boost private savings through urgently needed

⁷ Variability is measured by the average deviation from the mean.

⁸ Ibid.

⁹ The World Bank (2000) – “Can Africa Claim the 21st Century?”

¹⁰ Ibid.

reforms in the financial sector. Greater priority needed to be given to capacity building in both the public and the private sector.

A rethinking of the interventionist economic development strategy was triggered by the urgent need for economic recovery. From the second half of the 1970s through the 1980s an increasing number of countries began to implement far-reaching economic reforms to achieve macroeconomic stability and remove the structural distortions that resulted from official price controls and state-owned monopolies in agricultural marketing, the taxation of agricultural exports, overvalued exchange rates, the extensive reliance on restrictive import licensing and other trade and foreign exchange restrictions, and the rigid controls on interest rates and credit allocation that inhibited efficient financial intermediation. Reforms also sought to restructure and privatize public enterprises in banking as well as in other sectors to improve economic efficiency, reduce the fiscal burden of unprofitable enterprises and, most importantly, to support private sector development. From only a few countries in the early 1980s the number of SSA countries with IMF-supported programs increased sharply by the early 1990s (to cover 24 countries).

The results of the reform efforts took time to bear fruit across Sub-Saharan Africa as the pace and intensity of reforms varied widely across countries. In Sub-Saharan Africa (SSA) average annual growth rates continued to decline through the 1980s and until the mid-1990s. During this 15-year period the average annual growth rate of per capita GDP was negative as recovery began only in the second half of the 1990s. In the 1980s and the early 1990s economic performance was particularly disappointing in the CFA franc zone countries of West and Central Africa where the problems associated with unsustainable fiscal and external deficits were compounded by a highly overvalued exchange rate. These countries, which had a fixed peg to the French Franc, devalued their exchange rate in August 1994 and adopted structural adjustment programs that laid the basis for their subsequent economic recovery in the latter half of the 1990s. In North Africa, where growth rates declined during the 1980s, the annual improvements in per capita GDP (less than 1.5 percent) were on average much less than the previous two decades.

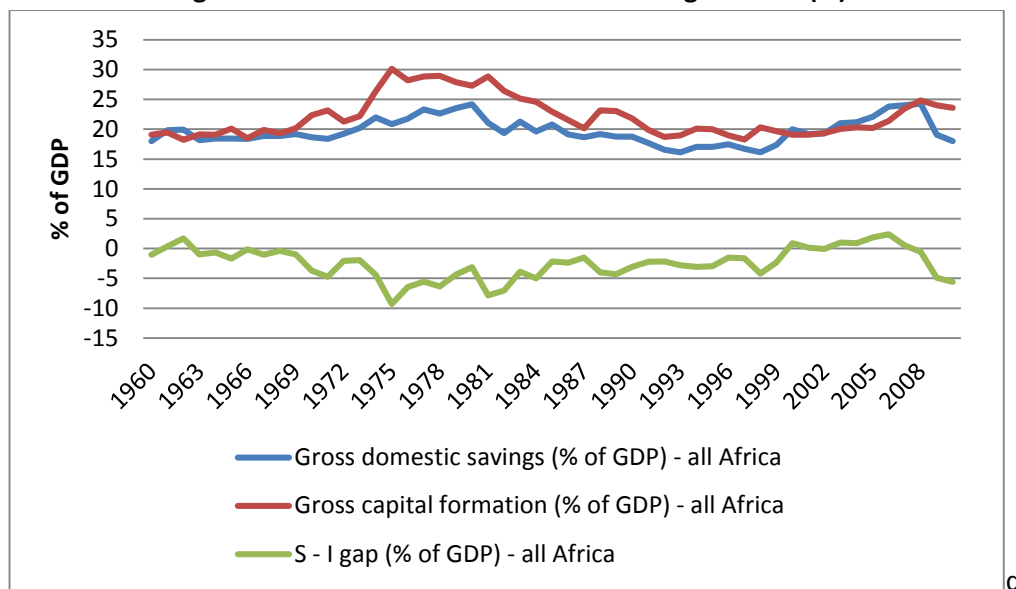
The discussion that follows indicates that throughout the economic reform process Africa faced serious macroeconomic challenges: tackling large fiscal and external current account imbalances, reducing inflationary pressures, increasing domestic savings and investment, and addressing external debt management problems. Once there was adequate progress in establishing macroeconomic stability, economic performance improved over an increasing number of countries.

Weak Savings and Investment Efforts

Africa's savings rate has remained virtually stagnant for almost four decades 1960s-1990s. The investment rate has been higher than the savings rate for most of the period under review. After a decade of stagnation in the 1960s, the investment rate increased sharply in the early 1970s but subsequently trended downward over the subsequent three decades (Figure 2.3). The financing gaps resulting from these trends were covered by aid inflows and foreign borrowing with aid flows mainly

benefitting the SSA countries. Fiscal deficits remained large and were financed by foreign aid and debt relief operations.

Figure 2.3: Ratios of Investment and Savings to GDP (%)



Source: UNCTAD database

In SSA savings ratios remained basically low and stagnant in the 1960s and showed only a modest improvement in the 1970s. The investment rate rose in SSA through the 1960s and at a slower pace in the 1970s. Thereafter, the savings and investment ratios of the SSA region trended downward during the 1980s. There was no visible improvement in the investment rate (18 percent) and the savings rate (15 percent) in the 1990s, which remained well below the levels of the 1970s. The trends in savings and investment in North Africa were similar. Savings ratios remained basically low and stagnant in the 1960s and showed only a modest improvement in the 1970s. In North Africa investment ratios rose markedly in the second half of the 1970s and subsequently trended downwards through the 1980s and early 1990s, but savings ratios remained lower and showed virtually no improvement. Consequently, annual investment-savings gaps (although declining) remained large in these countries.

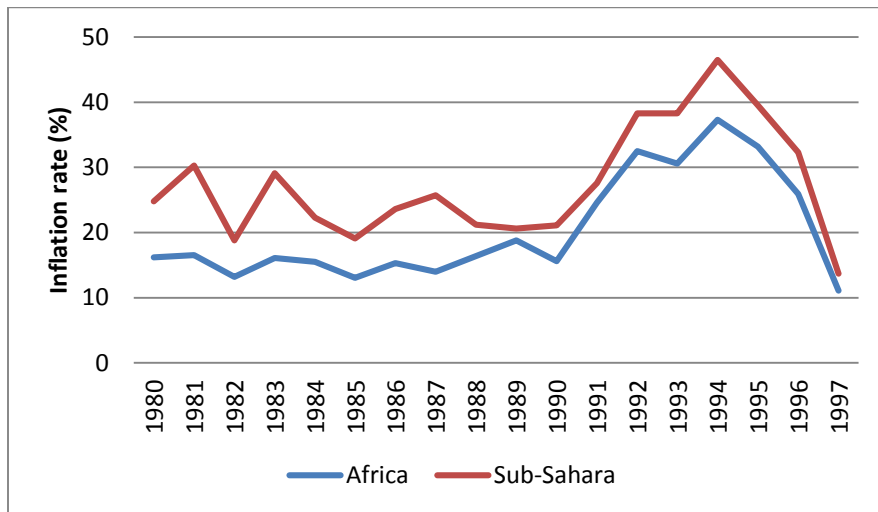
Growing Inflationary Pressures, Monetary Expansion and Exchange Rate Policies

As measured by the GDP deflator, in the 1960s annual inflation rates were relatively low in SSA (about 6 percent) and North Africa (about 2 percent).¹¹ However, inflation rates were markedly higher in the 1970s in both the SSA countries (13 percent) and North Africa (about 9 percent). The inflation rate accelerated further in the 1980s in the SSA region where it ranged between 20 to 30 percent. In North Africa inflation remained around 10 percent. For Africa as a whole the inflation rate was double-digit during the 1980s (in the range of 10 to 20 percent).

¹¹ Ibid

There was a surge in Africa’s inflation rate in the first half of the 1990s followed by a steep reduction during 1995-97, again reflecting a similar trend in the SSA region (Figure 2.4). The average annual inflation rate declined in SSA in the latter half of the 1990s with significant progress in reducing inflationary pressures in an increasing number of countries.¹² In North Africa, inflation rates in Algeria, Egypt and Libya declined below 10 percent in the latter part of the 1990s while Morocco and Tunisia continued to maintain their low-inflation environment.¹³

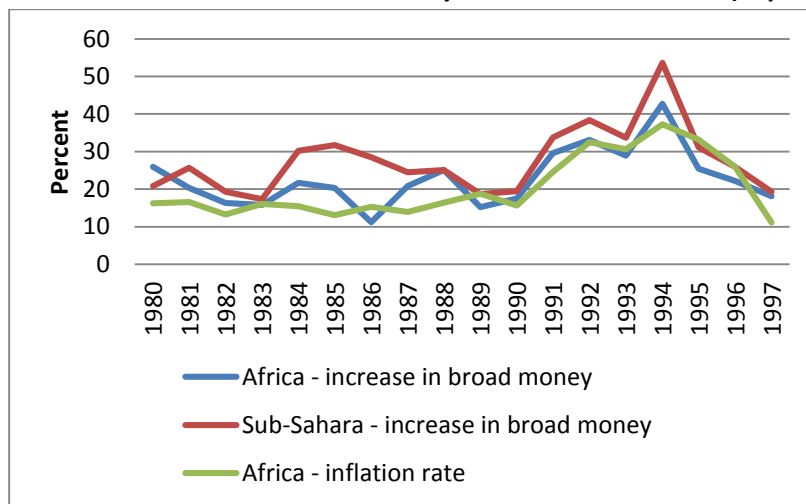
Figure 2.4: Consumer Prices Inflation Rate (%)



Source: IMF WEO database

The movements in the inflation rate reflected closely the rates of monetary expansion in Africa (Figure 2.5). In particular, both indicators moved sharply up in the early 1990s and then declined during 1995-97.

Figure 2.5: Growth rates of Broad Money and the Inflation rate (in percent)



Source: IMF WEO database

¹² International Monetary Fund (October, 2004): “Sub-Saharan Africa Regional economic Outlook.”

¹³ International Monetary Fund (October 1999): “World Economic Outlook.”

The inflation experiences of African countries with fixed exchange rates differed from those that had more flexible exchange rate regimes. For example, inflation rates in the CFA Franc Zone countries averaged well below 10 percent during 1975-89 while double digit inflation rates were not uncommon in this period in the countries with flexible exchange rates (such as in Ghana, Sierra Leone, Uganda and Zambia). Low inflation in the CFA franc countries is the result of their special monetary and financial arrangements, which include not only a fixed exchange rate but also a high degree of openness of the external capital account and an independent common central bank. In this situation, domestic credit expansion does not lead to monetary expansion and inflationary pressures. The impact of large fiscal deficits and investment-savings imbalances is channeled through a build-up of foreign debt and/or drainage of foreign reserves; there is little or no spillover in to inflation. In countries with flexible exchange rate regimes the main cause of inflation was fiscal deficits entailing substantial monetary financing. In these cases, exchange rate devaluations can aggravate inflationary pressures by raising the cost of imports (especially of imported inputs), more so if domestic supply elasticity is low.

The inflationary impact of the 1994 CFA franc devaluation (50 percent in foreign currency terms) implemented by 14 Franc Zone countries was large for a short period following the devaluation. All the 14 countries implemented the devaluation simultaneously and quickly launched macroeconomic programs to maximize the gains from the devaluation. This explains the temporary upturn in Africa's inflation in 1994 and the subsequent drop in inflation during 1995-1997.

In other countries too, exchange rate devaluation *per se* has not always led to inflationary pressures. Where countries had large differentials between the official exchange rate and the rate in the parallel market, devaluations have tended to close this gap without significant inflationary effects when appropriately tight macroeconomic financial policies were in place. This is because domestic prices already reflected the parallel market exchange rate prior to the devaluation. The experiences of countries that moved from fixed to flexible exchange rate regimes such as Ghana, Sierra Leone, Uganda and Zambia indicate that high inflation and thriving parallel markets prevailed before the reform of their exchange rate regimes in the 1980s. Devaluations in these cases tended to align the official rate with the parallel rate and in some cases alleviated fiscal pressures by increasing government revenues. Thus these exchange regime reforms contributed little to inflationary pressures.

Many African countries implemented structural reforms of the financial sector. Central banks were granted more autonomy in conducting monetary policy. Interest rates were liberalized and credit allocation systems were phased out. Strict limits were introduced on government borrowing. The solvency of banks was improved by restructuring measures, and bank supervision and auditing practices were strengthened. Steps were also taken to shift from direct to indirect monetary policy implementation.

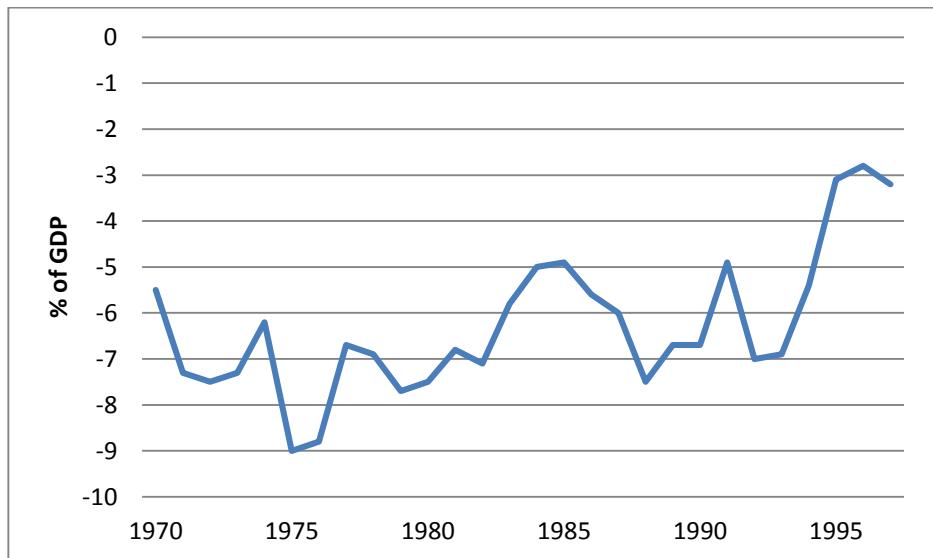
In the aftermath of the August 1994 devaluation the CFA franc countries implemented several financial sector reforms. Crop credit was included under an overall credit ceiling. Credit controls were eliminated and a new rating system for assessing creditworthiness was introduced to guide the refinancing policy of the central bank. A system of indirect monetary management was launched within the framework of a regional interbank and money market. Money market auctions and a central bank discount window

were introduced. To provide liquidity for banks a form of repurchase agreement was created. Interest rates were liberalized. Bank supervision capabilities and regulatory and prudential standards were substantially improved and their enforcement was strengthened.

Persistence of large Fiscal Deficits

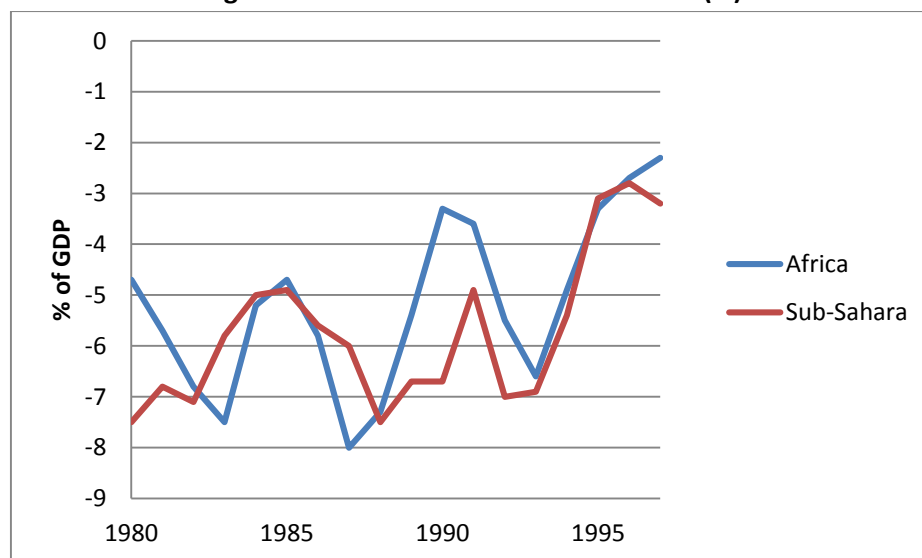
From the beginning of the 1970s to the early 1990s, Sub-Saharan Africa’s fiscal deficits have fluctuated between 5 and 9 percent of GDP without a clear trend towards a narrowing of the deficit (Figure 2.6). A sharp reduction of the deficit was achieved during 1994-1997. For Africa as a whole the time profile of the overall fiscal deficit has been very similar to that of the SSA countries (Figure 2.7).

Figure 2.6: Sub-Saharan Africa: Ratio of Fiscal Deficit to GDP (in percent)



Source: IMF database

Figure 2.7: Ratio of Fiscal Deficits to GDP (%)



Source: IMF database

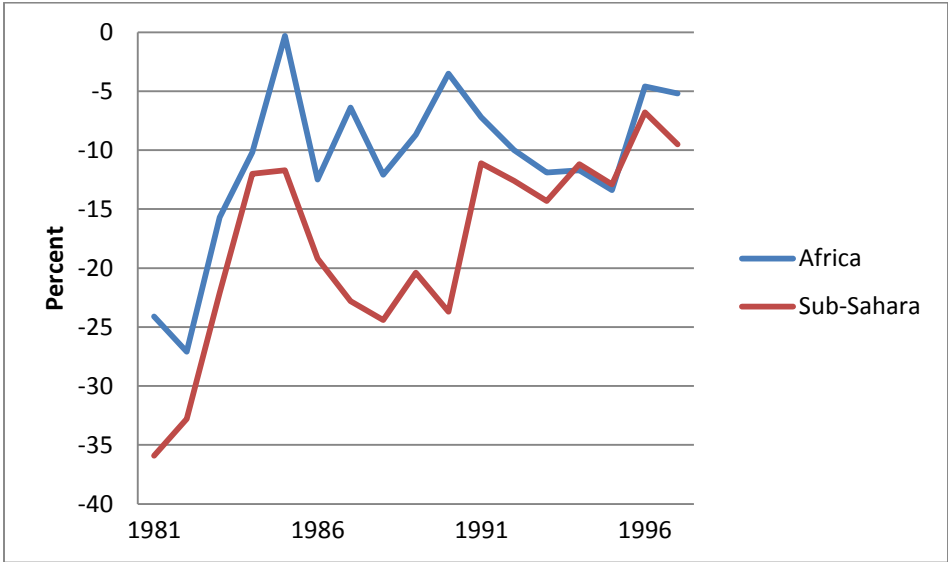
Reform efforts in the 1980s and 1990s included various fiscal measures. Public investment programming was integrated within a coherent budgetary framework and supported by improvements in project selection and public expenditure management systems. In prioritizing government expenditures more attention was given to human resource development (through emphasis on health and education) and poverty reduction objectives. Measures were implemented to restructure the public enterprise sector, privatize some of these enterprises, and reduce this sector’s reliance on budgetary subsidies and domestic bank credit. A number of countries (The Gambia, Ghana, Lesotho and Mali) took steps to reduce the civil service wage bill as a percentage of GDP and improve the wage structure.

On the revenue side, steps were taken to improve tax administration, broaden the tax base and rationalize tax structures. Efforts were made to reduce reliance on taxation of foreign trade and shift towards taxes on domestic transactions and sources of domestic income. In The Gambia, Kenya, Madagascar, Niger, Senegal, Tanzania and Togo, reforms of import tariffs included reducing the number and the highest level of the duty, reduction of exemptions and the conversion of specific to ad valorem taxes. In some cases, broad-based sales taxes replaced a multiplicity of sales tax rates and several countries (Kenya, Malawi, Mali, Niger and Senegal) took steps to introduce value-added taxes. Personal income taxation was simplified in some countries (Kenya, Madagascar, Malawi and Tanzania) by lowering the highest marginal rates, reducing the number of rates, reducing exemptions and deductions, and shifting to improved definitions of income.

Prolonged Deficits in the External Current Account of the Balance of Payments

As a result of the fiscal imbalances, Sub-Saharan Africa’s external current account deficits were substantial as a proportion of exports throughout the 1970s and the 1980s (averaging about 23 percent); these deficits began declining around the mid-1990s (Figure 2.8). For Africa as a whole the external deficits were smaller as a ratio of exports because of the lower ratios in North Africa.

Figure 2.8: Ratio of the External Current Account Deficit to Exports of Goods and Services (in percent)

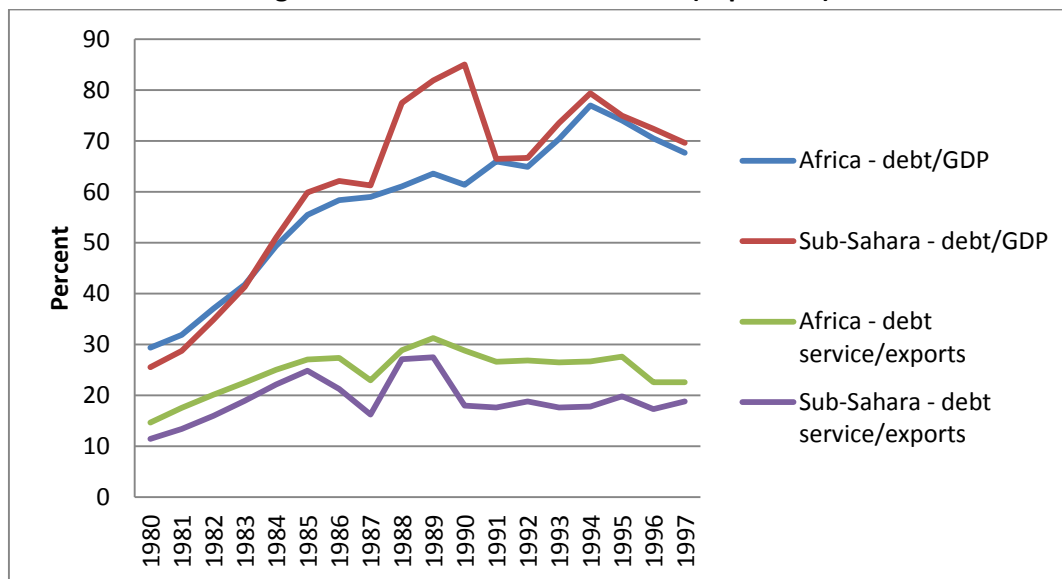


Source: IMF/WEO database

A growing debt problem and repeated recourse to debt relief

The large deficits in the fiscal and external current accounts were financed by substantial foreign borrowing in Sub-Saharan Africa. Consequently, Sub-Saharan Africa's external debt to GDP ratio increased from 24.9 percent in 1973 to about 70 percent of GDP by the mid-1990s (Figure 2.9). The external debt service ratio to exports for the SSA region rose from 8 percent in 1974 to about 20 percent by the mid-1990s. For Africa as a whole these ratios followed similar trends.

Figure 2.9: External Debt Indicators (in percent)

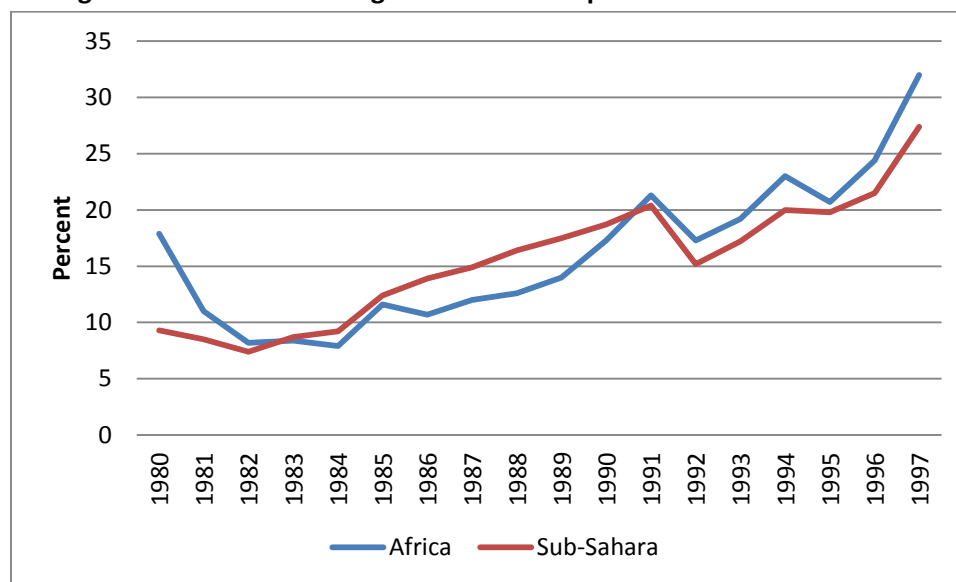


Source: IMF/WEO database

Bilateral official creditors sought to alleviate Africa's debt burden through repeated rescheduling operations on increasingly concessional terms, mainly (but not exclusively) for the low-income countries. In 1990 bilateral official creditors granting debt relief through the Paris Club introduced its Houston terms for the benefit of eligible middle-income countries. Houston terms provided for longer grace and repayment periods than the traditional classic terms which rescheduled debt at appropriate market rates. In December 1994, the Paris Club introduced its Naples terms under which eligible countries could get 50 percent to 67 percent of their eligible debt cancelled. In 1996 the Highly Indebted Poor Countries (HIPC) initiative was launched by the IMF and the World Bank to provide broader debt relief to heavily-indebted poor countries with severe debt burdens and to strengthen the links between debt relief, poverty reduction and social policies. The HIPCs include 30 African Countries. The Paris Club created its Cologne terms in June 1999 for the benefit of countries that are eligible for assistance under the HIPC initiative. Cologne terms allow for higher levels of debt cancellation than Naples terms (90 percent of eligible debts). Finally, the Multilateral Debt Relief Initiative (MDRI) was launched in 2005 to supplement the HIPC initiative and help speed up progress toward the UN's Millennium Development Goals (MDGs). The MDRI provides countries completing the HIPC process with 100 percent debt relief on eligible debts owed to the IMF, the World Bank and the African Development Fund (ADF).

As a result of substantial foreign aid inflows and debt relief from bilateral and official development partners, African countries were able to not only finance their fiscal and external imbalances but also gradually build up a much-needed (albeit modest) cushion of foreign reserves. In SSA reserves increased from less than one month of imports in 1980 to slightly more than 2 months of imports (Figure 2.10).

Figure 2.10: Ratio of Foreign Reserves to Imports of Goods and Services



Source: IMF/WEO database

The contribution of reform efforts to economic recovery

Success in implementing reforms differed widely across countries as well as across the various areas of policy reform. Assessments of Africa’s progress in implementing reforms and achieving the intended economic results were periodically undertaken by both the World Bank and IMF staff as well as by development economists in academic institutions. A World Bank study examined the experience of twenty- nine countries and reported that the six countries with the most improvement in macroeconomic policies between 1981-86 and 1987-91 achieved the strongest improvement in economic performance.¹⁴ These countries achieved a strong recovery in the growth rate of per capita GDP along with substantial increases in their industrial and export growth rates. Agricultural growth rates also accelerated in countries that reduced the tax burden on farmers. While noting that reforms were uneven across countries, the report concluded that the countries studied had in general been more successful in improving their macroeconomic, trade and agricultural policies than reforming their public and financial sectors. A later IMF staff study reviewed the adjustment experiences of two groups of countries during 1986-93, namely countries that had implemented broadly appropriate policies under their programs for at least three years (the sustained adjusters) and those that were less successful in sustaining the implementation of their programs (weak adjusters). It reported that the countries classified as sustained adjusters improved their external competitiveness and implemented structural reforms (to cushion the impact of terms of trade losses) and performed better than the countries

¹⁴ World Bank (1993) – “Adjustment in Africa: Reforms, Results and the Road Ahead.”

classified as weak adjusters. The group of strong adjusters achieved positive and higher rates of per capita real GDP growth, higher rates of government savings and investment growth. By contrast the weak adjusters experienced negative per capita income growth and declines in domestic savings and investment in both the public and private sectors.¹⁵

As a growing number of countries implemented reform programs, often over extended periods, evidence of improved economic performance emerged gradually across an increasing number of countries. An IMF staff study found that the economic performance of SSA countries had improved markedly between the periods 1981-84 and 1995-97.¹⁶ It noted that after recording negative growth rates of per capita GDP through most of the 1980s and the five-year period 1990-94, the growth rate of per capita real GDP rose to 1.2 percent during 1995-97. In the latter period growth rates picked up in 37 of the sample of 46 countries examined in the study. Compared with the number of countries that had achieved increases in per capita GDP during 1990-94 (16 countries), there were more than twice as many countries experiencing positive growth rates during 1995-97. This overall turnaround in the economic performance of SSA countries masks the significantly weaker growth performance in countries affected by past or continuing political turmoil. The growth rates in these conflict affected-countries (including in Burundi, Comoros, the Democratic Republic of the Congo, Rwanda, Sierra Leone, Swaziland, and Zambia) remained negative or declined.

B. Strengthening of macroeconomic performance since the mid-1990s

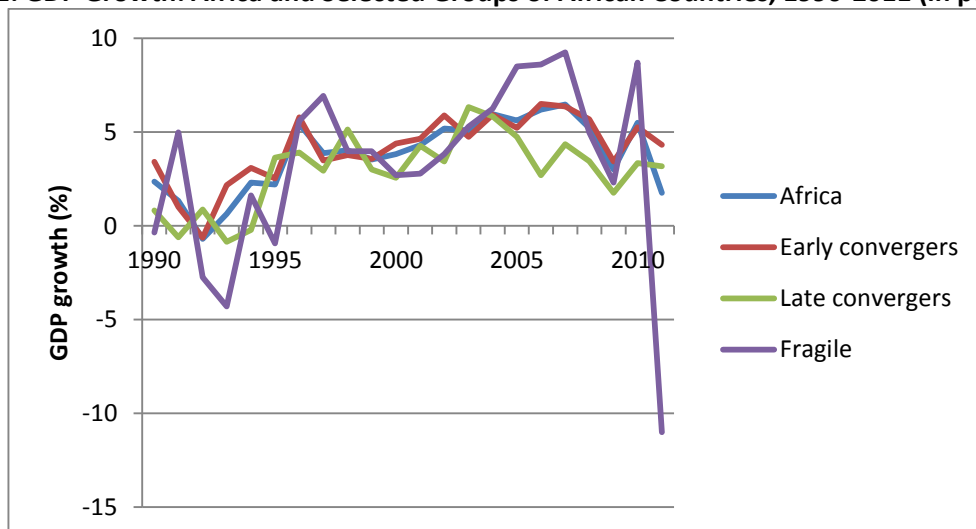
1. *Growth and Inflation*

Africa's macroeconomic performance improved markedly over the last decade and a half, not only in terms of higher growth rates but also in terms of important gains in reducing inflation and thus in macroeconomic stability. Africa's GDP growth increased considerably from the early- to mid-1990s, and has averaged around 4.6 percent a year since then (Figure 2.11). Moreover, despite the weak global economic environment that followed the onset of the global financial crisis of 2008-09, annual growth averaged of 4.8 percent during 2007-11. This performance is remarkable, even it is somewhat lower than in the previous few years. Most countries shared in this solid expansion.

¹⁵ International Monetary Fund (IMF, 1995) Occasional Paper 118: "Sub-Saharan Africa – Growth, Savings and Investment, 1986-93.

¹⁶ IMF Working Paper 99/51 (1999): "Adjustment and Growth in Sub-Saharan Africa."

Figure 2.11: GDP Growth: Africa and Selected Groups of African Countries, 1990-2011 (in percent)



Source: Centennial Group International

Note: The sharp drop in the growth rate of fragile countries mainly reflects the major decline in GDP experienced by Libya.

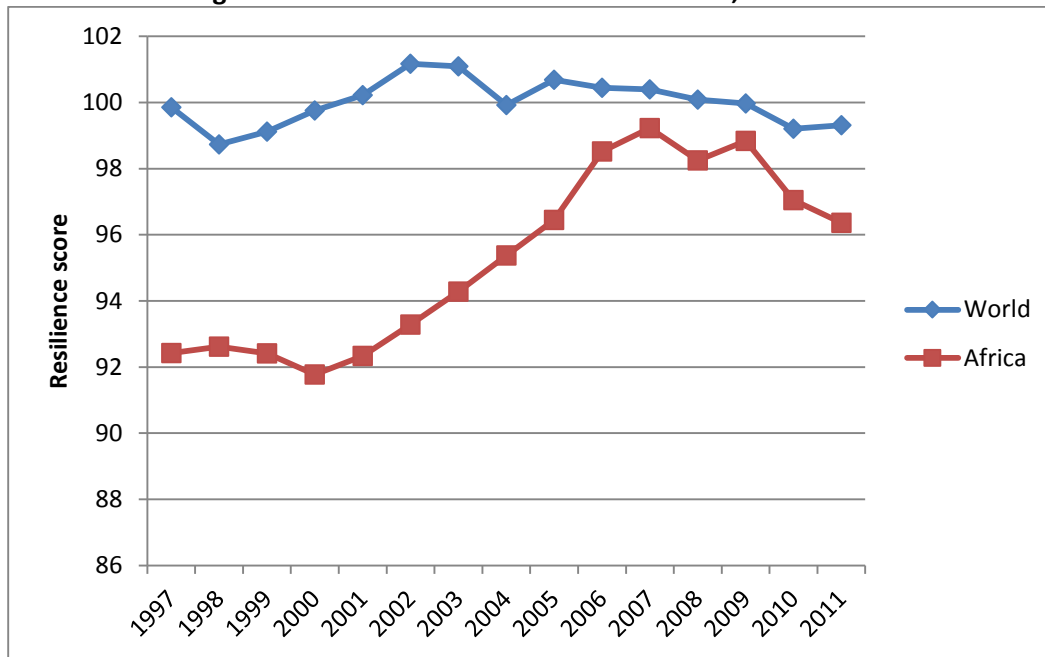
The improvement in economic performance is—to a considerable extent—the result of important policy efforts, including the wide-ranging reforms implemented by many countries prior to and in the context of the HIPC and MDRI Initiatives, which helped lower fiscal deficits and public debt to sustainable levels.¹⁷ These reforms, which were also carried out by a number of non-HIPC eligible countries, were instrumental in introducing dynamism to the economies, as evidenced by higher economic growth and a remarkable strengthening in resiliency (Figure 2.12).^{18 19} Africa’s growth performance also benefited from a considerable improvement in its terms of trade in recent years, and the associated increase in production of natural resources in several countries.

¹⁷ While there were significant concerns about the adverse effects resulting from donors reducing their assistance after having provided debt relief to a country, this problem did not materialize on average. ODA flows to Africa (in 2010 prices and exchange rates) actually increased from an average of US\$30.7 billion a year during 1990-99 to US\$37.4 billion a year during 2000-09 and US\$48.1 billion a year during 2010/11. See OECD, Development Aid at a Glance, Statistics by Region, Africa, 2013.

¹⁸ In the aftermath of the global financial crisis, Sub-Saharan Africa’s GDP growth fell to 1.6 percent in 2009 but it rebounded to 4.6 percent in 2011, reflecting the strengthening in resiliency. The focus here on Sub-Saharan Africa is an attempt to isolate the improvement in the region’s resilience from the adverse economic impact on some Northern African countries associated with the “Arab Spring”.

¹⁹ Boorman, Jack et al, The Centennial Resilience Index: Measuring Countries’ Resilience to Shock, February 2013. The index provides a measure of the capacity of an economy to cope with and bounce back after having been hit by a shock. The key components of the index are Fiscal and Monetary Policy Soundness, Government Effectiveness, Overall Governance, Bank Soundness, Export Diversity and Independence, External Robustness, Private Sector Debt, and International Reserves. In this study, the average index for the 130 countries under review is set to 100.

Figure 2.12: Resilience: Africa and the World, 1997-2011



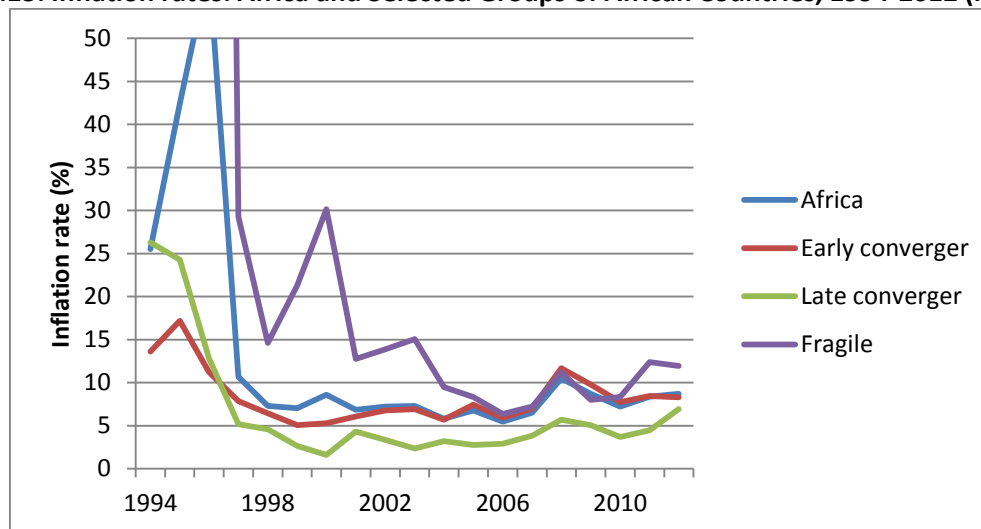
Source: Centennial Group International

Africa’s inflation rate dropped markedly during the last decade and a half, even if it still remains higher than that of the advanced countries and other regions (Figure 2.13).²⁰ The relative increase in inflation since 2007 most likely reflects rising food prices and the considerable incidence that food has in Africa’s consumption basket. What is remarkable is the major improvement among the fragile countries,²¹ as their inflation rate approached the average for the region by the late 1990s. Also noteworthy is the decline in inflation among the late convergers, from about 25 percent in the mid 1990s to low single digits during most of the period under review.

²⁰ The decline in inflation from the mid-1990s in a number of countries reflects the tapering off of the impact of the large devaluation of the CFA Franc in 1994.

²¹ For a list of the fragile African countries, see Appendix 1.

Figure 2.13: Inflation rates: Africa and Selected Groups of African Countries, 1994-2012 (in percent)



Source: Centennial Group International

It should be noted, however, that in 2011, the Sub-Saharan countries with conventional exchange rate pegs recorded an inflation rate of 3.6 percent, whereas those without such a peg recorded an inflation rate of 10.4 percent.²² Moreover, inflation in the Sub-Saharan oil importing countries (excluding South Africa) was 13.2 percent, reflecting the jump in world oil prices.

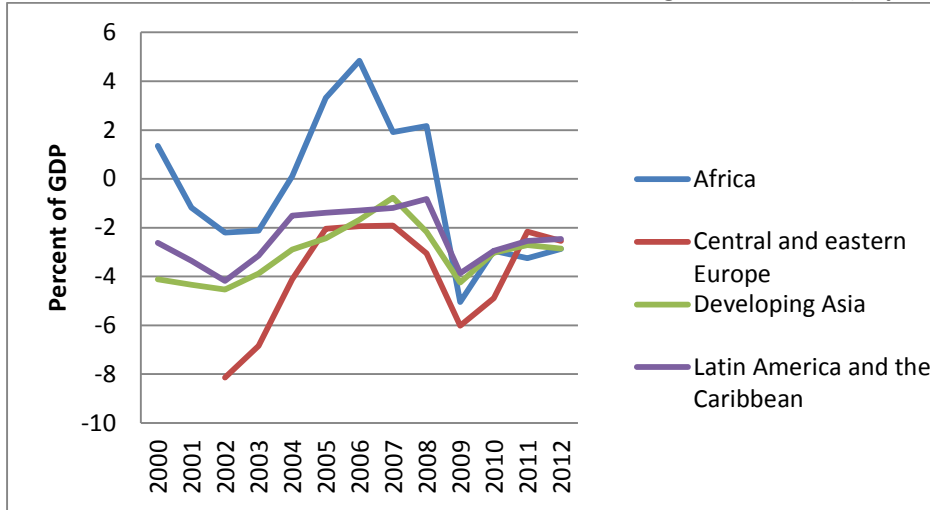
Many African countries have improved considerably their monetary policy management over the last decade and a half. Most of the countries without a conventional exchange rate peg have introduced indirect instruments to control monetary aggregates, and some of these countries have adopted inflation targeting frameworks. Those with exchange rate pegs have kept a prudent credit policy. Many countries have increased the autonomy of their central banks, and thereby enhanced its capacity to control inflation. Nevertheless, after important efforts, progress in containing inflation rates has been limited in recent years. As mentioned above, inflation has been relatively high, suggesting that monetary policies may need to be strengthened, even if part of the recent inflationary developments reflect the impact of higher food and fuel prices. Monetary authorities need to prevent these inflation rates from becoming entrenched.

2. Public finances

Fiscal Policy in Africa, as measured by the government overall balance, has been prudent during the last decade, showing significant surpluses in the period 2004-08 (largely accounted for by the fragile and late converger countries) that turned into small deficits in the aftermath of the global financial crisis of 2008-09. While these deficits have been largely similar to those prevailing in other regions, Figure 2.14 shows that Africa's public finances were more severely affected by the crisis than the other regions. In particular, government revenue fell considerably as government spending remained relatively stable (Figures 2.15 and 2.16).

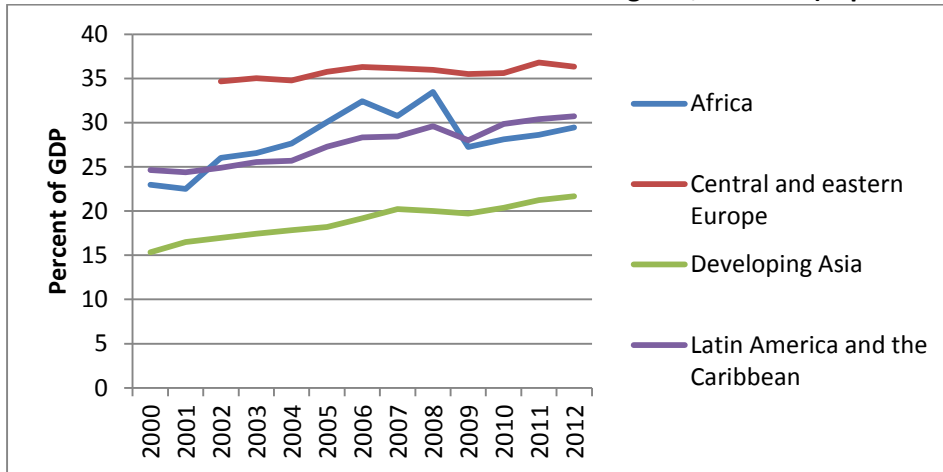
²² IMF, Regional Economic Outlook, Sub-Saharan Africa, October 2012.

Figure 2.14: Government Overall Balance: Africa and Selected Regions, 2000-12 (in percent of GDP)



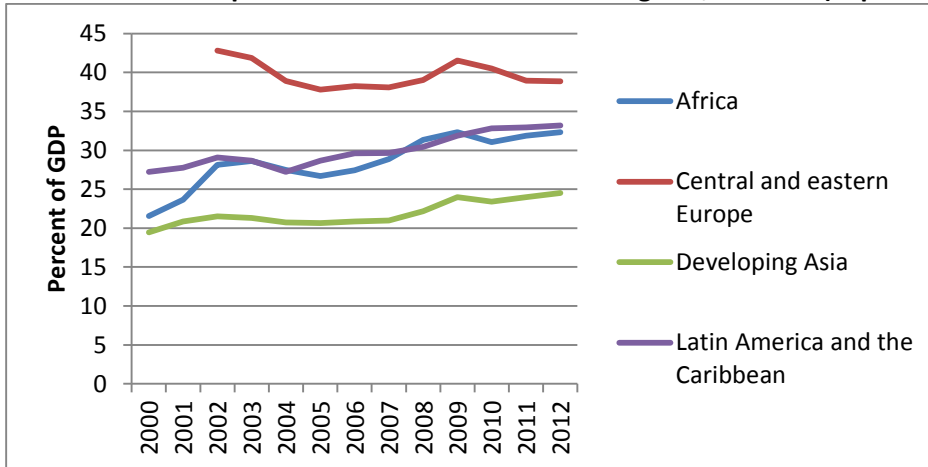
Source: Centennial Group International

Figure 2.15: Government Revenue: Africa and Selected Regions, 2000-12 (in percent of GDP)



Source: Centennial Group International

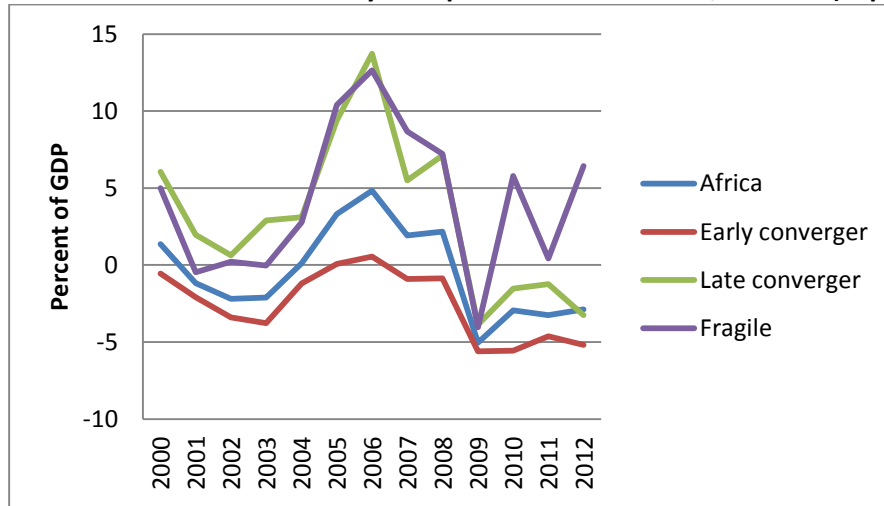
Figure 2.16: Government Expenditure: Africa and Selected Regions, 2000-12 (in percent of GDP)



Source: Centennial Group International

Not surprisingly, the region’s aggregates mask large differences between the various groups of countries. As noted, both the fragile and late convergers showed large overall surpluses during 2004-08 (Figure 2.17). But the surpluses of the latter group turned into small deficit in the aftermath of the global crisis; the overall balances of the fragile countries fluctuated significantly, but remained in surplus. The overall balances of the group of early converger countries showed a similar pattern, but were in deficit virtually the whole period, weakening to around 5 percent of GDP since 2009.

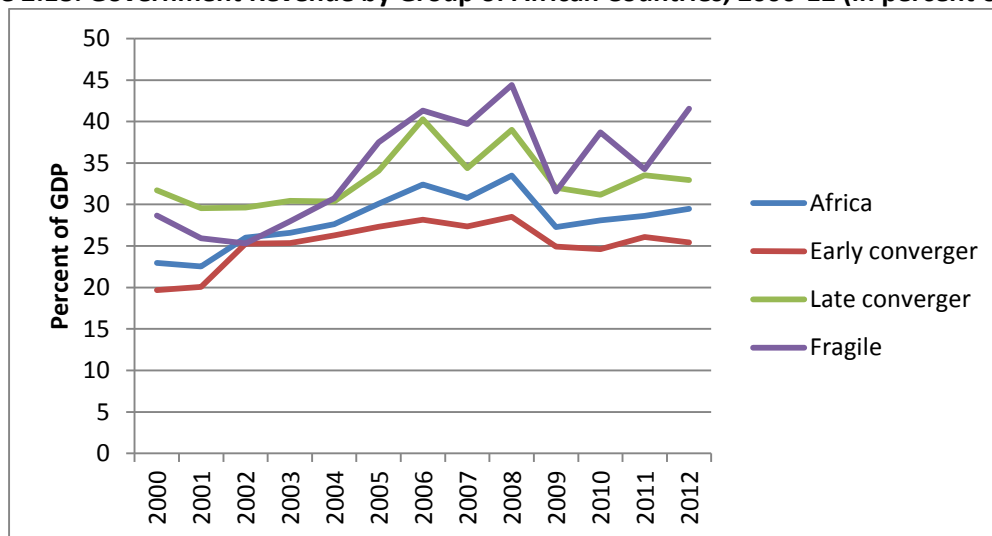
Figure 2.17: Government Overall Balance by Group of African Countries, 2000-12 (in percent of GDP)



Source: Centennial Group International

This performance reflects a considerable increase in government revenue since the early 2000s (Figure 2.18), mainly attributable to the groups of fragile and late converger countries, as revenue of the early converger group remained relatively flat. This increase may be related to the large proportion of resource exporters among these countries.

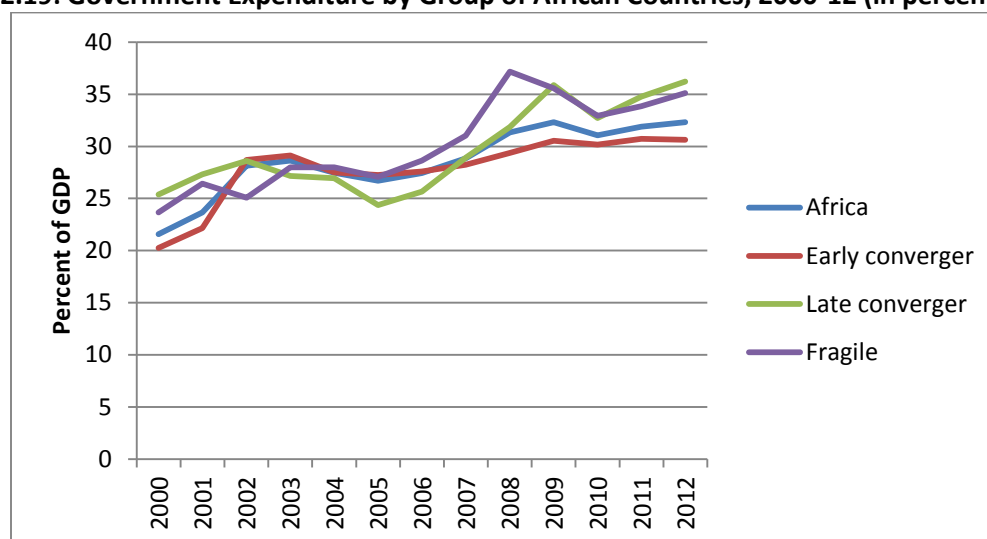
Figure 2.18: Government Revenue by Group of African Countries, 2000-12 (in percent of GDP)



Source: Centennial Group International

Government spending also rose markedly in the early 2000s in all the subgroups (Figure 2.19). Although all groups continued to increase government spending, the increases among the fragile and late converger countries have been significantly larger, indicating a remarkable correlation between increases in government revenue and expenditure. Given the large proportion of resource-rich countries in these groups, such a pro-cyclical behavior raises concern about the sustainability of macroeconomic stability, especially in the event of a weakening in the terms of trade.²³

Figure 2.19: Government Expenditure by Group of African Countries, 2000-12 (in percent of GDP)



Source: Centennial Group International

Moreover, as shown in Figure 2.16, Africa's government expenditure is quite similar to that of Latin America and the Caribbean but considerably higher than that of fast growing Asia. In view of the need to increase expenditures in infrastructure and human capital, African policy makers will need to re-balance the composition of government spending by containing the growth of other current expenditure and avoid rising total government expenditure excessively. Otherwise, the tax burden on the private sector will be too heavy and thus affect adversely economic growth. Indeed, Africa's government revenue ratio to GDP, while similar to that of Latin America and the Caribbean, is considerably higher than that in fast growing Asia.

Despite the overall positive performance, many African countries show enormous infrastructure gaps, weak human development indicators, and poor income distribution. Fiscal policies should play a key role in improving these conditions. To this end, there is a need to address structural weaknesses on the revenue and expenditure sides, and thereby prevent them from constraining growth potential.

3. Public debt

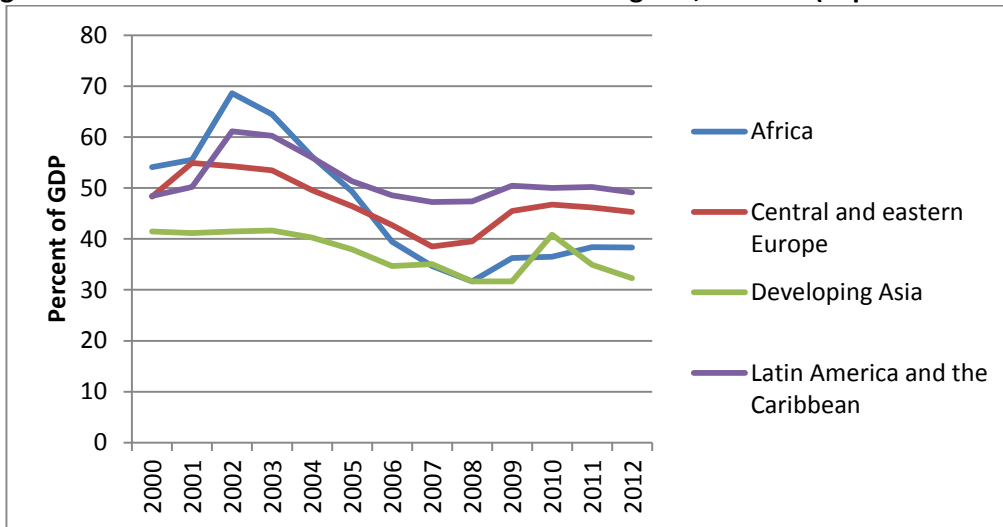
Africa's public debt was reduced considerably as a ratio to GDP in the context of the HIPC and MDRI Initiatives, as shown in Figure 2.20, thereby making the debt burden sustainable. While the public debt ratio bottomed down in 2008, it increased significantly since then, owing to the fiscal stimulus packages

²³ Loser, Claudio, Commodity Terms of Trade in Emerging Markets: A Fragile Blessing (forthcoming in Global Journal of Emerging Market Economies).

adopted following the onset of the global financial crisis. This increase is largely attributable to the group of early converger countries (Figure 2.21). While all other regions also show an increase in 2009 or 2010, for similar reasons, their debt ratios stabilized immediately thereafter and—in Developing Asia—even returned to virtually the previous lower level by 2012.

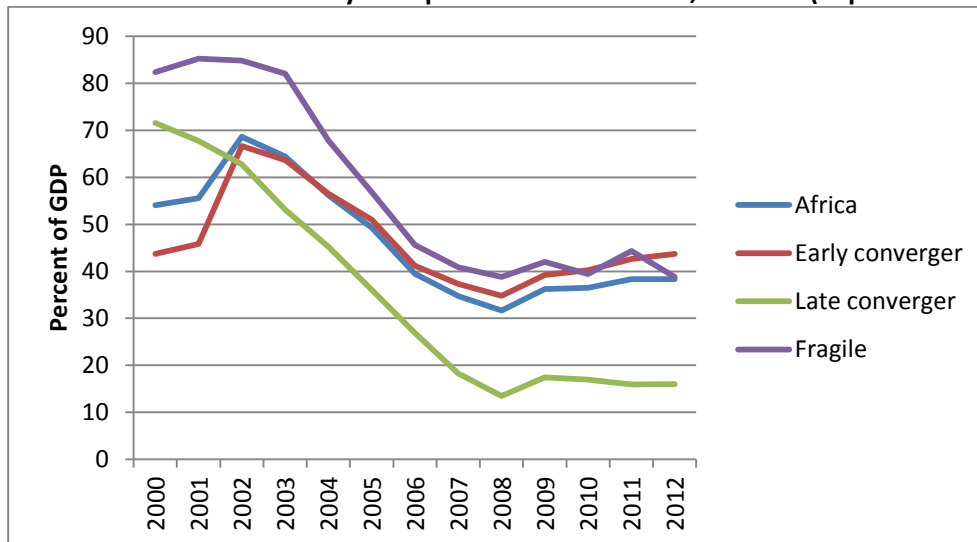
Given the depressed economic situation of Europe—a continent that accounts for a large share of Africa’s exports—it is understandable that the fiscal stimulus measures are difficult to unwind without affecting economic activity, but African countries need carefully to rebuild their fiscal space and resilience and ensure debt sustainability.

Figure 2.20: Gross Public Debt: Africa and Selected Regions, 2000-12 (in percent of GDP)



Source: Centennial Group International

Figure 2.21: Gross Public Debt by Group of African Countries, 2000-12 (in percent of GDP)

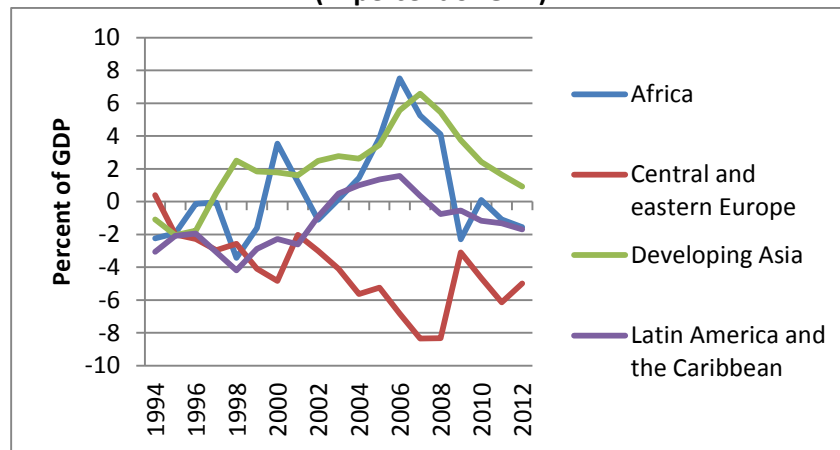


Source: Centennial Group International

4. Balance of Payments

Mirroring the strengthened macroeconomic policies of the last decade and a half, as well as the contribution of the improved terms of trade, Africa's external current account showed large surpluses until 2008, i.e., the onset of the global financial crisis. While the current account balances turned into small, sustainable deficits, they have been more than financed by FDI and portfolio inflows. Developing Asia and Latin America and the Caribbean show similar trends. By contrast Central and Eastern Europe show the reverse trends as easy access to external borrowing led to a boom of consumption that was reversed in the aftermath of the global crisis (Figure 2.22).

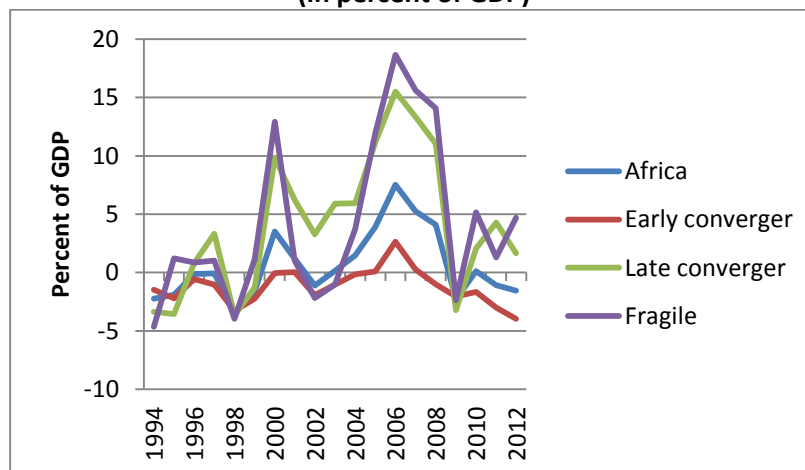
Figure 2.22: External Current Account Balance: Africa and Selected Regions, 1994-2012 (in percent of GDP)



Source: Centennial Group International

The trends for the groups of late converger and fragile countries are considerably more pronounced (most likely reflecting a higher incidence of the gains in terms of trade). The group of early converger countries also shows a strengthening of the current account balance until 2006 and steady decline thereafter; although their deficit does not raise major concern, further declines may be worrisome (Figure 2.23).

Figure 2.23: External Current Account Balance by Group of African Countries, 1994-2012 (in percent of GDP)



Source: Centennial Group International

III. Investment and Savings Needs for Sustained High Growth

A. Growth, Investment and Savings Recent Performance

1. Growth

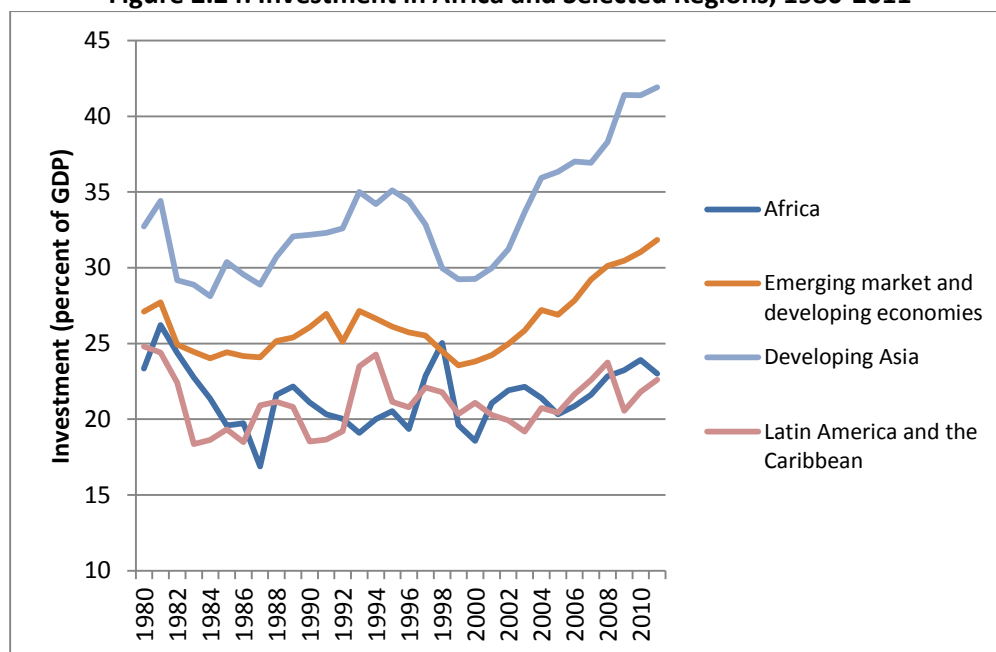
The growth path for the group of early converger countries has been very similar to that of the continent as a whole, although with less volatility in recent years (see Figure 2.11). This volatility is greatly influenced by the high instability of the fragile countries. Growth performance of the group of late converger countries is significantly weaker than the other groups, with somewhat lower volatility than the fragile group. More importantly and of greater concern is that the group of late convergers shows a declining trend in GDP growth since the early 2000s.

While Africa is expected to maintain a moderate rate of growth over the next few years, including as a result of new natural resource production in several countries, the weaker performance of recent years also suggests that the important efforts noted above need to be reinforced for GDP growth to accelerate, especially by creating the conditions for Africa's low investment and savings ratios to rise markedly.

2. Investment ratios

Africa's investment as a ratio to GDP is too low to sustain high rates of real GDP growth for long. Having fluctuated around 20 percent during 1980-2011, it has risen to about 23 percent of GDP since 2007. While these ratios are quite similar to those of Latin America and the Caribbean, they are significantly lower than the average for emerging market and developing countries, and markedly lower than those of the fast growing countries in developing Asia, as shown in Figure 2.24.

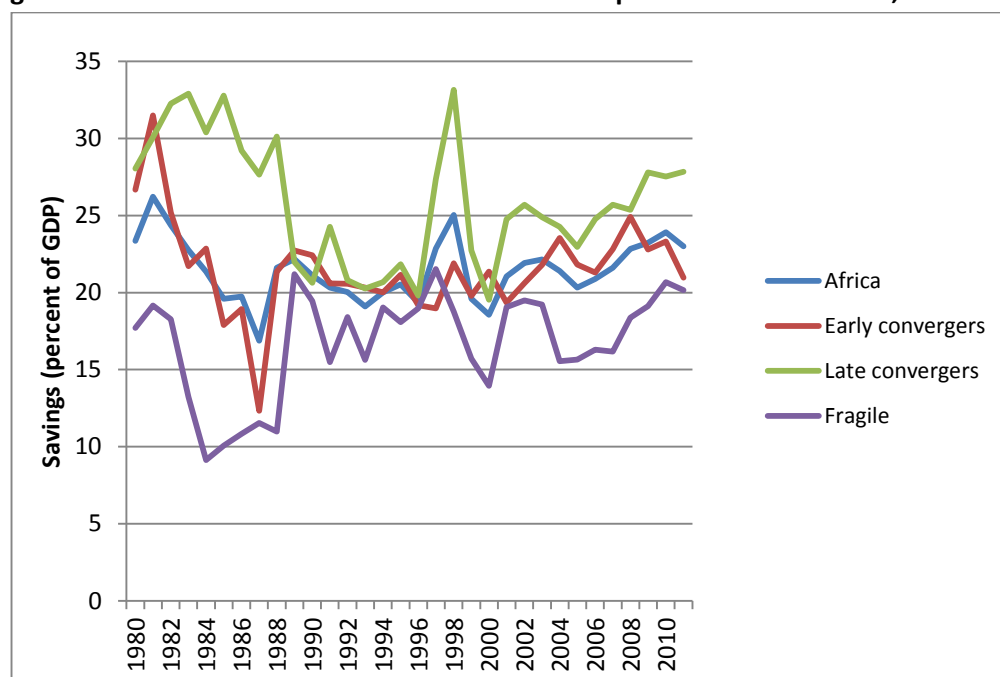
Figure 2.24: Investment in Africa and Selected Regions, 1980-2011



Source: Centennial Group International

While the investment ratios of the group of early converger countries have been quite similar to those of the continent, the decline in the ratio of these countries over the last few years is disturbing, and contrasts with the increases observed in the other two groups. The decline may reflect a drop in FDI associated with the Euro-zone crisis. While the investment ratios for the group of fragile countries have been volatile and lower than the average during the period under review, the considerable increase since the early 2000s is remarkable. By contrast, the investment ratios for the late convergers, while as volatile, have been significantly higher than the average and show a major pick up since 2000. Perhaps the higher ratios reflect the high proportion of resource exporting countries in this group, and the capital-intensive nature of natural-resource production.²⁴

Figure 2.25: Investment in Africa and Selected Groups of African Countries, 1980-2011



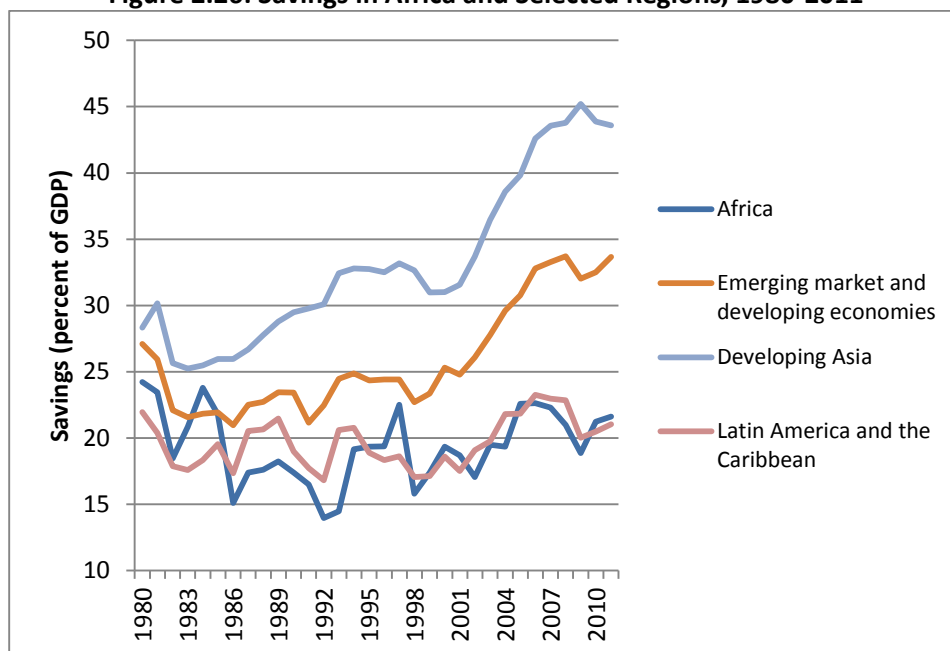
Source: Centennial Group International

3. Savings ratios

Like in the case of investment, Africa's savings ratio to GDP is also too low and compares poorly with those of other regions (except for Latin America and the Caribbean) and particularly the fast growing countries, as shown in Figure 2.26. It averaged well below 20 percent of GDP during 1980-2011; although it rose steadily from 2001 to about 23 percent in 2006-07, it declined to about 20 percent in recent years. This decline is striking given the income gains arising from the significant improvements in terms of trade.

²⁴ It is interesting to note that investment ratios in the North African countries are markedly higher than those in the Sub-Saharan countries, but real GDP growth rates are considerably lower. As this suggests a higher capital-output ratio (i.e., lower productivity of capital) in the North African countries than in the Sub-Saharan countries, the former countries will need to raise their investment ratios well above the average for the continent.

Figure 2.26: Savings in Africa and Selected Regions, 1980-2011

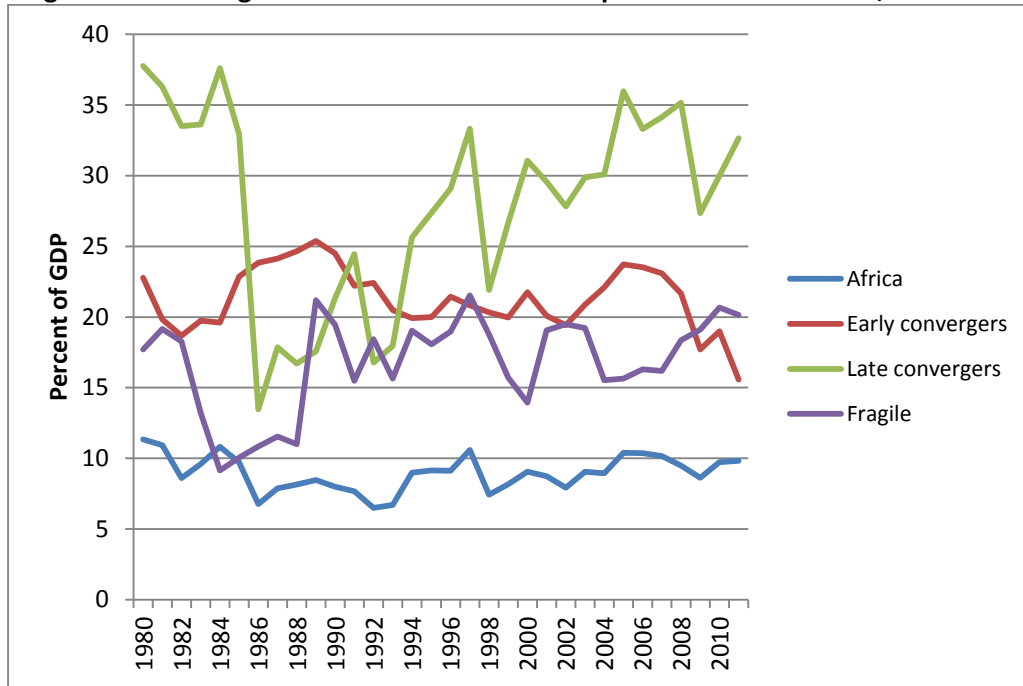


Source: Centennial Group International

The regional averages mask very large disparities between African countries; for instance, about half of the Sub-Saharan countries have currently a savings ratio of less than 15 percent of GDP.²⁵ Moreover, Figure 2.27 shows that the group of early converger countries has had higher savings ratios than the average for the continent as a whole for most of the period under review, but has experienced a sharp deterioration starting in 2005 and surprisingly falling below that average in recent years. The savings ratios of group of late convergers have experienced wide fluctuations, but their levels are considerably higher than the average for the continent. Perhaps this reflects the high proportion of resource exporting countries in this group, and the size and volatility of the rents obtained from such exports. As would be expected, and like in the case of the investment ratios, the group of fragile countries has lower savings ratios than the other groups, but the recent increase to just below the average for the continent is noteworthy. The latter may reflect increased rents from exports of natural resources.

²⁵ IMF, Africa Regional Economic Outlook, October 2012.

Figure 2.27: Savings in Africa and Selected Groups of African Countries, 1980-2011



Source: Centennial Group International

B. Policy Recommendations to Achieve Higher Investment and Savings Ratios

The low investment and savings ratios raise concern about the sustainability of Africa’s growth prospects. Thus, there is a need to create the conditions for Africa’s low investment and savings ratios to rise markedly. The following sections propose a non-exhaustive list of needed steps and policies.

1. Investment

To achieve the goals of the vision for Africa in 2050, particularly sustaining a GDP growth rate of 6.5 percent a year as in the convergence scenario of that study, Africa will need to raise its investment to an average of about 30 percent of GDP.²⁶ Of course, a number of African countries, which already have high investment to GDP ratios--especially the capital-intensive natural resource producing countries--will need to raise their investment ratios well above this figure. The increase in investment will help close the existing wide infrastructure gap and build over time an infrastructure that supports the targeted rate of GDP growth. Moreover, the investment ratio of those countries that also need to invest in closing very large gaps in housing and the associated infrastructure (water, sanitation, etc) will also need to increase above the 30 percent ratio.

It is expected that the new, higher investment would be more productive as it would bring in new technology. This, together with the policies proposed in the Africa 2050 study--especially regarding education and health--will raise Total Factor Productivity (TFP) growth and generate considerable

²⁶ Such a ratio will still be lower than the average for the emerging market and developing countries (see Chart 24). The ratio is based on the average ICOR of 4.8 recorded during 2007-11 and a TFP growth of 1.6 percent a year. The average investment ratio envisaged in the growth model used for the Africa 2050 study is 30.4 percent of GDP.

employment opportunities. As TFP growth is expected to increase over time--as a consequence of those policies--the investment ratio could decline somewhat without impacting adversely on GDP growth.

While an investment ratio of 30 percent of GDP is achievable, important efforts are needed to make it a reality. These efforts are mutually reinforcing and create a virtuous cycle; they aim at developing an environment that establishes the basis for sustainable high economic growth. They include:

1. The implementation, or continued implementation, of a sound and stable macroeconomic policy framework that allows both the government and the private sector to plan ahead and increase investment. Moreover, the framework should generate mutual trust and confidence in economic policies. This would enable the private sector (domestic and foreign) to play a key role as an engine of growth. An important aspect of the policy framework is a stable and efficient tax regime (see below).
2. Higher public investment also to crowd in private investment. Poor infrastructure (especially in power, water, communication, transportation and logistics) is one of the greatest constraints on economic growth, and especially because it leads to high costs and loss of productivity.²⁷ Thus, policy makers need to re-balance government expenditure towards much higher public investment. This will help crowd-in private sector investment (as a consequence of the complementarity between public and private investment) and lead to a more dynamic and growing economies. Moreover, given the limited resources available to governments, the re-balancing effort needs to be supplemented by the adoption of a (or strengthening of the existing) legal framework that encourages (domestic and foreign) private sector participation in enhancing infrastructure, through PPPs and other such arrangements.
3. Development of constructive and collaborative relations between the state and the private sector. This includes a reduction in the cost of doing business through the establishment of a business environment in which economic agents are not constrained by red tape and unnecessary regulations, and by poor public services. Regulatory certainty and institutional reforms that enhance governance and the rule of law are critical to promote a dynamic private sector.²⁸ They also need to improve the state's efficiency, effectiveness and responsiveness, by professionalizing and upgrading the competence of the public service, and strengthening accountability. In such a context, the private sector should respond by building a more competitive economy.
4. The build-up of a well qualified labor force that is able to adopt and adapt, and eventually develop new technologies associated with new investments. This will involve enhancing the quality of and access to education, as well as training. It may need to be supported by encouraging immigration of professionals.

²⁷ Fujita et al (forthcoming), Policy Challenges for Infrastructure Development in Africa – The Way Forward for Japan's Official Development Assistance (ODA). In Chapter: JICA TICAD Report (tentative).

²⁸ In the case of resource-rich countries, policy makers also need to remove, inter alia, uncertainties over ownership, tax treatment and allocation of mineral rights.

5. The development of a seamless Africa and open markets that allow the exploitation of economies of scale. This can be complemented with greater competition in domestic and regional markets.
6. The above aspects would be also critical to attract foreign direct investment, but efforts are necessary to give such investment equal treatment to domestically generated investment. FDI is generally associated with bringing new technologies, as has been the case of the foreign involvement in the exploitation of natural resources, and therefore plays a key role in raising TFP and growth.
7. An advanced and efficient financial system is essential to the development of capital markets that finance investment activities. The rapid spread of pan-African banking systems, as well as the introduction of a framework that facilitates taking advantage of portfolio capital inflows (frontier markets) should help in this regard.
8. Ensure environmental sustainability, within reasonable parameters of costs and benefits. In water constrained countries, enhance water management and infrastructure, as this is an essential step in expanding agriculture and agro processing and thus rural development.

2. Savings

Correspondingly, savings will need to rise to some 26 percent of GDP a year to avoid balance of payments problems while allowing for the imports associated with higher investment.²⁹ As in the case of investment, a number of African countries, which already have high savings to GDP ratios --especially those obtaining high rents from natural resource production--will need to raise their savings ratios well above this figure. The increase in savings needs to be supported by higher foreign direct investment (FDI), especially in non-resource extractive activities. Clearly, as growth rises on a sustainable basis, domestic savings will respond accordingly and become a more important financing source for investment, leading to a virtuous cycle of higher investment, savings and growth, as well as a sustainable balance of payments position.

Like in the case of investment, important efforts are needed to promote savings. These include:

1. A sound and stable macroeconomic policy framework, aimed at fostering sustainable high growth, is critical to increase savings, both domestic and foreign. Such a framework is also critical to help curb capital flight and even encourage the repatriation of the considerable resources Africans are holding abroad. Just deposits held by Africans at the BIS reporting banks amount to US\$345 billion.³⁰
2. The public sector should play an important role in increasing domestic savings. The government would attain it by ensuring fiscal sustainability and re-balancing government spending to make room for higher public investment. The public enterprises should also add to public savings by becoming more efficient and thus improving their profitability. More generally, public savings

²⁹ The implied external current account deficit of 4 percent of GDP is expected to be more than financed by FDI and sustainable external financing, and thus allow for some accumulation of international reserves.

³⁰ This is only a portion of the assets Africans own abroad, as some financial assets are most likely held in, or channeled through, non-BIS reporting financial institutions; assuming that Africans also hold deposits in offshore financial centers in about the same share as those in BIS reporting banks, some US\$55 billion would need to be added to that amount. In addition, one should add the value of real estate properties and other assets Africans own abroad, but that is difficult to quantify.

can be increased considerably by enhancing the public sector's effectiveness and governance. In the case of resource-rich countries, stabilization and wealth funds, as discussed in the Africa 2050 study, need to play an important role in this regard.

3. Similarly, efforts to reduce the cost of doing business, especially those associated with having to deal with red tape, unnecessary regulations, and poor public services and infrastructure should promote a dynamic private sector and thus higher corporate savings.

An efficient, competitive, and well-regulated financial system will help encourage financial savings, which are relatively low in Africa.³¹ Higher financial savings will help deepen financial intermediation and, eventually, develop a dynamic domestic capital market.³² This could be supplemented by a comprehensive social security system that includes affordable compulsory membership for all employees.

IV. A Macroeconomic Policy Framework for Sustainable High Growth and Inclusion

Undoubtedly the policy reforms and associated hard won improvements in macroeconomic performance African countries have attained need to be preserved, but further efforts are needed to ensure and strengthen the sustainability of these improvements and thus achieve high growth. The following sections address the macroeconomic areas where such further efforts may need to be considered.

It is important to acknowledge that it is difficult to propose a single macroeconomic policy framework for all African countries, given the diversity of stages of development, circumstances, institutions and endowments. Nevertheless, it is generally recognized that for economic activity to expand rapidly and equitably on a sustainable basis, macroeconomic policies need to ensure stability and predictability, as these aspects are critical to create an environment that enables economic agents to plan ahead, fostering high private sector investment and thus promoting high economic growth.

Stability and predictability require a clear commitment from policy makers to implement sound fiscal and monetary policies, consistent with debt and balance of payments sustainability. The ideal would be for these policies to be supported by a flexible exchange rate regime, given that such a regime allows for an independent monetary policy and provides countries with a critical policy instrument to help absorb external shocks. However, it is important to note that many African countries have had a fixed exchange rate regime or have belonged to a currency union for years, and that such arrangements may also help support macroeconomic stability, if properly managed.

The following sections broadly discuss the various policies, and, where possible, propose specific approaches appropriate to certain country circumstances.

³¹ For example, in 2011 the average ratio of bank assets to GDP was 48 percent in Sub-Saharan Africa, compared with 60 percent in Latin America and the Caribbean and in the Middle East and North Africa, and 163 in Asia.

³² In the case of the smaller economies, consideration could be given to the development of regional capital markets in order to take advantage of economies of scale.

1. Fiscal policy

From a macroeconomic point of view, sound fiscal policies call for the maintenance of relatively overall fiscal deficits that ensure public debt sustainability and thus preserve macroeconomic stability. From a microeconomic point of view, sound fiscal policies call for an effective and equitable revenue mobilization system, as well as an efficient resource allocation process that is geared at improving human and physical capital and at reducing inequality. From both points of view, governments should provide the certainty that future fiscal policies will remain sound. This certainty should help lower the cost of capital and thus foster higher private investment and savings, promoting faster economic growth and contributing to the development of an inclusive society. Good governance requires that fiscal policies be conducted in a framework of transparency and accountability. In the case of mineral extracting/exporting countries, sound fiscal policies also involve the need to deal with revenue volatility as well as with sustainability and intergenerational equity considerations.

There is no doubt that the current provision of public goods and services does not meet the population's needs in many countries, in terms of both quality and quantity, given the very severe gaps in education, health, and infrastructure gaps. These gaps are mainly a consequence of pressures caused by growing other current expenditures (including very large generalized subsidies in a number of countries). And the concern is that these gaps are likely to widen as current spending continues to rise with the size of bureaucracies and inefficient outlays, and eventually with population aging.

The priorities and goals of fiscal policy need to change. They should help establish an environment for sustainable, high and inclusive economic growth, and thereby achieve three critical objectives: 1) increase employment, 2) reduce inequality, and 3) improve equity:

1. By closing the enormous gap in infrastructure (e.g., transport, logistics, energy, water resource development, schools, hospitals, and sanitation), public investment (including through Public-Private Partnerships) will help create employment directly (in the formulation and construction of projects, the production of inputs for the projects, and the operation and maintenance of the new facilities).³³ Public investment also crowds-in private investment and thus creates employment indirectly by improving the efficiency of the economy and laying the basis for stepped-up growth. This is the multiplier effect. Moreover, given Africa's rich human factor endowment, labor-intensive construction methods—where appropriate—should be given preference over capital-intensive ones.
2. Government spending to enhance human capital needs to increase. As in the case of South Africa and other African countries, the current quality of education denies many the skills needed to access employment, and thereby reduces the dynamism of the economy. Poor health care denies many the future. By improving the quality of education (at all levels)³⁴ and health will endow the population with the necessary tools to take advantage of opportunities and thus reduce inequality. Thus, there is a need for allocating the resources necessary to improve school infrastructure, educational materials and equipment, clinics, hospitals, medical

³³ World Bank. *Africa's Infrastructure: A Time for Development*, 2009.

³⁴ This should also encompass training, including early-stage entrepreneurship and artisan training.

supplies and equipment, it is imperative that budgets provide adequate resources to build the human resources for the education and health sectors of the future. Similarly, assistance to farmers through extension services and improved irrigation infrastructure will help develop a more prosperous rural population. The same applies to supporting financial co-ops or other financial entities that would enable small farmers to enter formal value chains. Of course, employment will be increased through all these efforts.

3. Policies that raise growth can significantly advance social equity goals. However, this needs to be supported by direct policies, such as enhancing social protection, food security and nutrition. In some countries (like South Africa), government may play a role in the development of low income housing, within its budget constraint. In view of the success of the conditional transfers programs implemented in Latin America, African policy makers may also want to consider establishing such programs. Such transfers have not only reduced poverty, but also increased economic activity, creating important centers of development.

To address the infrastructure and human capital gaps and reduce misallocation and waste, there is a need to improve public expenditure allocation and management, including the public procurement process, and to implement a targeted system of subsidies where they are considered essential. But this may not be enough to provide the necessary room to cover the much-needed increase in public infrastructure investment, education and health. While Africa will be potentially benefiting from its demographics in the next decade or two, over time, its population will begin to age and therefore countries will see increases in spending associated with aging, which could be significant. This involves a strong safety net (which should be affordable as countries become richer (some will be prosperous middle-income countries). One approach would be to entrench a social security system that covers all working people, with special protection for the poor using conditional transfers, as mentioned earlier.

Accordingly, to avoid widening the overall fiscal deficit, government revenue will need to rise considerably, even after assuming that gains in efficiency spending and subsidy reduction could be significant.³⁵ Revenue will also need to rise in order to eliminate Africa's aid dependency.³⁶

The tax structure in African countries needs to serve the objective of raising revenue, while promoting economic growth, the following tax structure may be considered. We recognize that it is difficult to propose an ideal tax structure to a continent with such a diversity of countries and with so different endowments as the African one, but it is possible to outline some key features:

- A flat corporate income tax with rates that make the countries competitive and attractive to Foreign Direct Investment (FDI);
- A relatively progressive personal income tax with only a limited number of brackets and low threshold;

³⁵ In addition, the elimination or even important reduction of implicit subsidies, especially those on fuel consumption, should yield considerable revenue gains. Of course, there will be a need for measures to ameliorate the impact of the subsidy elimination or reduction on the most vulnerable segments of the population. Over time, as the population becomes richer, even such measures should be eliminated to make room for other priority spending, including that related to population aging.

³⁶ In 2011, budgetary grants amounted 2.4 percent of GDP for Sub Saharan Africa (excluding Nigeria and South Africa) and 0.75 percent for the continent as a whole.

- A value added tax that applies uniformly to all consumer goods and services; and
- A set of selected excise taxes, especially on fuel consumption and low import duties, an up-to-date system or real estate taxes (administered by local governments).
- A contributory social security system.

The tax system should have virtually no exemptions nor preferential treatments to avoid tax planning (avoidance) and evasion. The pros and cons of any exemptions or preferential treatments will need to be evaluated carefully against their opportunity costs, including a potential proliferation of such exemptions or preferential treatments that would undermine the integrity and efficiency of the tax system. The tax system will need to be supported by an effective and efficient tax administration, using best practices and latest technologies, and avoiding discrimination among taxpayers.³⁷

2. Monetary and exchange rate policies

The long-term nature of this study would suggest that there is no need to address monetary policy, given its relative short-term focus. However, experience has made abundantly clear that price and financial stability are essential to establish and maintain the basis for sustained, strong economic growth.

As noted above, many African countries have improved considerably their monetary policy management over the last decade and a half, especially as a result of increasing the autonomy of their central banks, and thereby enhanced its capacity to control inflation. Those countries with flexible exchange rate regimes have introduced indirect instruments to control monetary aggregates and have implemented successfully; some have adopted inflation targeting frameworks. Those with conventional exchange rate pegs have kept prudent credit policies. Nevertheless, Africa's higher inflation rates than those in other regions suggest that monetary policies may need to be strengthened, especially because the poor are hurt the most by the inflation tax and to prevent these inflation rates from becoming entrenched.

- How monetary policy needs to be conducted and the tools to be used depend very much on the exchange rate regime and the degree of development of the financial system:³⁸ For countries with a flexible exchange rate regime and a more developed financial system, the adoption of an inflation-targeting framework would be advisable. Such a framework has proven to be quite successful in reducing inflation and keeping it low. Adoption of this framework requires a high degree of independence or autonomy of the Central Bank in conducting monetary policy and that government deficits do not condition the growth of money supply (i.e., no fiscal dominance). As mentioned, some African countries have been implementing such a framework quite successfully; South Africa has been a leader in this area among emerging markets.
- For countries with a flexible exchange rate regime, but with an underdeveloped financial system, the Central Bank will need to target directly the monetary aggregates in the initial

³⁷ While many countries have followed the advice of International Financial Institutions and centered their efforts on large taxpayers units, these efforts may have encouraged firms to remain small and thereby forgo the benefits of scale and possible access to credit and new technologies, thus hampering growth potential.

³⁸ We take the view that a flexible exchange rate regime is preferable to a fixed one because it provides the authorities with an important macroeconomic policy instrument and because it allows the exchange rate to act as a shock absorber.

stage and as the financial system develops and an interbank becomes operational, the Central Bank may start to control such aggregates through indirect instruments such as open market operations. As the financial system becomes more developed, the monetary authorities should move towards creating the basis for the adoption of, and subsequently adopt, an inflation-targeting framework.

- For the countries that have a fixed exchange rate regime or are part of a currency union, most notably those in the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Union (CAEMU), the authorities will need to assess if these exchange arrangements are serving well their countries. If these regimes were to continue, it would be important that credit policy remain cautious and consistent with preserving external competitiveness.

As elaborated in the chapter related to natural resources, it is important to note that the conduct of monetary policy in resource-rich exporters, under any exchange rate regime, will be considerably facilitated by the establishment of a stabilization/liquidity fund that removes the pro-cyclicality of fiscal spending associated with fluctuations in export earnings. Similarly, the establishment of a sovereign wealth fund would help reduce the excessive pressure on domestic resources that a natural resource boom typically causes. Moreover, the combination of these two funds will lead to a more stable macroeconomic environment and therefore less significant exchange rate tensions than otherwise. Please note that this combination provides a strong foundation for monetary policy based on an Inflation-targeting framework.

The conduct of monetary policy will also be strengthened by a sound and developed financial system, as a precursor to an advanced capital market. To this end, it would be critical to adopt a regulatory and supervisory framework that is in line with international best practices. Such a financial system will facilitate the external liberalization of capital markets.

As financial integration spreads worldwide, African countries will inevitably have to prepare for eventual integration to that framework. That being said, liberalizing capital markets without adequate preparation in terms of structural reforms and financial soundness would be premature and costly. The costs and benefits as well as the timing of such external liberalization should be carefully weighed. The potential benefits of integration into external trading systems and the associated modern financial technologies ought to be weighed against the likely costs of substantial volatility of capital flows. Countries will have to be prepared with an appropriate strategy for managing capital flows, perhaps with a focus on encouraging stable, long-term inflows rather than potentially volatile short-term inflows.