WORKING PAPERS

Africa Task Force Meeting

JICA and The Initiative
For Policy Dialogue

Yokohama, Japan

June 2-3, 2013

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CONTENTS

Introduction:

HOW INDUSTRIAL POLICY CAN HELP AFRICA MEET THE CHALLENGES OF THE 21ST CENTURY

April 2013

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It is a great pleasure for me to share with you my thoughts about strategies and challenges confronting African development at the fifth Tokyo International Conference on African Development (TICAD). I have had a long-standing engagement with TICAD, having attended the second conference in 1998 as World Bank's Chief Economist and having addressed the last two TICAD summits in 2003 and 2008. I have been impressed by the substantive and serious discussion of policy issues facing African policymakers at the level of heads of government.

This reflects the care that the organizers of TICAD take in developing a considered agenda and background work for the summit meeting.[1] The themes chosen for the conference, on boosting economic growth, ensuring human security—including the achievement of the MDGs and Consolidation of Peace—and addressing environmental

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[1] This year included organizing a meeting with the Initiative for Policy Dialogue at Columbia University, New York in November 2012. Special thanks is extended to JICA for financial support, including support for the IPD task force that led to *Good Growth and Global Governance in Africa*, A. Noman, K. Botchwey, H. Stein, J.E. Stiglitz, eds., New York: Oxford University Press 2012, which discusses issues of industrial development in greater detail.

issues and climate change are, and should be, at the center of concern for African policymakers. This is true both in light of where Africa is today, and the situation of the world economy that Africa is confronting in the wake of the crisis.

I believe that the lessons of East Asia, the remarkable success of this region of the world, have not been fully taken on board within the development agenda. A first step in doing so was of course the project that was sponsored by Japan at the beginning of the 1990s in which I participated. The results, published as a series of background papers for the report, *The East Asian Miracle,*[2] and the literature it spawned, have had enormous influence in rethinking development strategies, including the eventual abandonment of the flawed structural adjustment policies that predominated in the 1980s.

The 21st century has witnessed an impressive revival of growth in Africa—over 5 percent per annum—in sharp contrast to the lost quarter century under the Washington Consensus reforms. Now is the time to address concerns about the quality of this growth to put Africa on a path of sustained, inclusive rapid growth—growth that is sustainable, not only economically, but politically, socially, and environmentally.

These concerns stem from the fact that in much of Africa, a large part of the accelerated growth has been based on booming commodity prices and extraction of minerals. The decline in the share of manufacturing sector in GDP within Africa that occurred during the lost quarter-century—a share that it is no higher now that it was at the end of the 1970s—is yet to be reversed. The same is true for the share of formal sector employment, which is where decent work (to use the terminology of the International Labor Organization) is to be found. Whilst foreign investment has risen substantially, it has been concentrated in non-renewable natural resources. This has been particularly disappointing, given the substantial improvements in "fundamentals" in so many African countries: they have demonstrated better macro-economic performance and better governance, but they

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[2] *The East Asian Miracle: A World Bank Policy Research Report,* Washington, D.C.: The World Bank, 1993.

have not been rewarded by foreign investors in the ways that one might have hoped.

I should emphasize, however, that while natural resources have been important in Africa's growth in recent years, growth has gone well beyond that. One of the best performing countries in the sub-continent, Ethiopia, had been growing at 11 percent a year in the 5 years prior to the death of Prime Minister Meles Zenawi, and around 9 percent over 2000-2010. Other examples of non-oil-rich African countries with good growth—around 6 percent or more during the decade—include Rwanda, Tanzania, Ghana and Uganda. By some estimates, only around a quarter to a third of the sub-continent's recent growth is directly attributable to natural resources

There is a second concern that the growth has not been as inclusive as one might have hoped. It is true that there has been a rise in the number of middle-income households (where "middle income" is given a loose interpretation), and the fraction of the population in poverty has declined. The proportion of Africans south of the Sahara who live on US$1.25 a day or less declined from 58 percent in 1990 to 51 percent in 2005, the last year for which the UN published comprehensive data. But the rate of poverty reduction, despite robust GDP growth in some countries, generally lags behind other developing regions: Across developing countries globally, the proportion of people living on less than $1.25 a day fell from 42 percent of the population in 1990 to 25 percent in 2005. But the absolute numbers in poverty have increased. The number of Africans south of the Sahara living on $1.25 a day or less increased from less than 300 million in 1990 to more nearly 400 million in 2005. And the number of working people living on $2 a day or less increased from 190 million in 1999 to 243 million in 2009.[3]

Again, against these disappointing results, we need to note the successes: "Many Africans are joining the ranks of the world's consumers. In 2000, roughly 59 million households on the continent had $5,000 or more in income—above which they start spending roughly half of it on nonfood items. By 2014, the number of such households could reach 106 million. Africa already has more middle-class households (defined as those with incomes of $20,000 or above) than

[3] All figures from UNDP MDG report.

India. Africa's rising consumption will create more demand for local products, sparking a cycle of increasing domestic growth."[4]

With so many of the poor still living in the rural sector and dependent on agriculture (a situation that is likely to continue for several decades to come), inclusive growth will require increases in agriculture productivity. But results have been disappointing. While countries like India, China, and the United States increased their productivity by a factor of two, four, or more since the 1960s, African yields per hectare have hardly nudged upwards. This is not a surprise given the low levels of investment. The level of irrigation remains far below that of Asia: only 4 percent of arable and permanent cropland, compared with 39 percent in South Asia and 29 percent in East Asia. Fertilizer use of 13 kilograms per hectare in Africa contrasts with 90 kilograms in South Asia and 190 kilograms in East Asia.[5] Africa is still to benefit from a "green revolution."

But underinvestment in agriculture is not the only reason for the poor performance of the sector. Another reason is that the policy framework has been flawed: fertilizer subsidies, it is now recognized, may be an effective way of raising living standards. A third is that the agriculture subsidies of the North have a particularly adverse effect on Africa. A fourth is global warming, which again is having a particularly adverse effect on the region. A fifth is the population explosion. The combination of increasing population and declining land fertility has meant that Africa has gone from a land-abundant region to one in which substantial parts are becoming land-scarce. Systems of agriculture production and land tenure which may have worked well in the past, in a time of land abundance, won't work well in an era of land scarcity. But these systems have unfortunately not changed, or at least not changed as much as they should. Africa will have to learn to manage its land better. However, changing institutional arrangements is not easy. And

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[4] McKinsey Global Institute, *Lions on the Move: The Progress and Potential of African Economies*, 2010; see also footnote 4 for household income data.

[5] See J.E. Stiglitz and A. Noman, 2012, "Strategies for African Development," in *Good Growth and Governance in Africa: Rethinking Development Strategies,* A. Noman, K. Botchwey, H. Stein, and J.E. Stiglitz (eds.), p. 8.

such changes often take time. But there can be large costs associated with such delays.

There are a number of other challenges facing Africa today, which I briefly note. Some of these are two-sided. In the case of others, there are significant down-side risks.

a) *Demography:* The rapid growth of the population in the region, though slowing, still stands in sharp contrast to the low growth, or decline in other areas. Countries with a young population often exhibit more dynamism, more energy, than those marked by an aging population. But Africa will have to find jobs for these young people. This will require heavy investments. It will have to educate these young people. This too will place large demands on government budgets. If Africa fails in these tasks, there may be discontent and political, social, and economic turmoil. In some countries, the unemployment rate is unacceptably high. Markets have not been working in the way they should to ensure that everyone who would like work can get it. Young people who have done everything that they should—studied hard and succeeded—cannot get jobs, or at least jobs for which their education trained them. They feel the system has failed them.

b) There are similarly large challenges in ensuring that this burgeoning population receives adequate, or in many cases, just minimal health care. In some countries, the scourge of AIDS remains a threat.

c) Climate change/global warming is likely to have a more adverse effect on the countries of Africa than elsewhere in the world.

d) Africa, like everywhere else in the world, will suffer from the poor performance in so many of the advanced industrial countries: exports will be less than they otherwise would have been.

e) The global financial system has not worked well in recent years. Flows of funds have been erratic, and even if risk premia now seem to have declined, there is always the worry of a sudden reversal, a sudden increase in risk premia or a decline in the flow of funds.

f) Little has come of the *development round* of trade negotiations, initiated in Doha in November 2001. At the time negotiations were stalled, the agreement on the table arguably would have been of little benefit to Africa; many thought that it would make many African countries worse off. Meanwhile, bilateral ("partnership") agreements have proliferated, and many of these are even more unbalanced, and in particular, reduce access to life-saving medicines.

g) Inequality is a problem in most countries around the world, but the problem in some countries and regions is worse than in others.[6] Some of the African countries have among the highest levels of inequality in the world.

h) Throughout the region, there is a significant infrastructure deficit, and the absence of infrastructure is an impediment to trade and to regional integration.

i) Africa will be urbanizing rapidly in coming years—it has already been happening. But that too will require large investments in infrastructure. There needs, for instance, to be good public transportation systems, water and sewage systems, housing, and public parks. It will be important that these investments be made early, and that there be more planning to the design and expansion of these cities. Without this, there is a risk that cities will evolve in ways that will lower standards of living and endanger the environment. We need to be sure to create livable cities.

[6] For a more extensive discussion of the causes and consequences of inequality, see J. E. Stiglitz, *The Price of Inequality*, New York: WW Norton, 2012.

THE GLOBAL ECONOMIC CRISIS AND THE RETHINKING OF POLICY FRAMEWORKS

The global financial crisis has led to a broad re-examination of the policy frameworks that had become conventional wisdom before the crisis. Indeed, it has even led to a re-examination of the role of the state. The state had, of course, to intervene intensively to moderate the impact of the financial crisis that broke out in 2008 and prevent a disaster on the scale of the Great Depression of the 1930s or worse.

That crisis reflected the poor "quality" of the growth experienced by rich countries in the financial and related booms. Growth was based on debt, and the growth was not inclusive. Those at the top took most of the gains. Those at the bottom, and even middle, saw their incomes stagnate or decline.

The immediate cause of the crisis was the breaking of the bubble.[7] The creation of the bubble (in the US, and in several European countries) was associated with uncontrolled financial liberalization. This is a familiar story—the East Asia crisis too was associated with capital and financial market liberalization. Yet, the world was slow to learn the lessons from these and other experiences.

Thus improving the quality and inclusiveness of growth is as much an imperative for the US and other rich countries as it is for Africa, though what that entails differs in important respects. But there are some lessons for all to learn: unbridled and under-regulated markets, especially in finance, are to be avoided.

There is a more general lesson: There are many different forms of capitalism and different forms of a market economy. The version sold to Africa under the Washington Consensus reforms—a version that retains a lingering influence in some quarters—is based on a particular interpretation of a particular form: the Anglo-Saxon one, particularly as purportedly practiced in the US. A closer look shows, however, that even in the United States, government plays a major role in the economy. This role has been pivotal in the creation of some of its most dynamic sectors, including the internet (hi-tech) and bio-tech.

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[7] For a fuller discussion of the crisis and what gave rise to it, see J. E. Stiglitz, *Freefall*, New York: WW Norton, 2010.

The East Asia miracle showed that development was possible—growth, widely shared, that was beyond the level that had ever occurred before. And behind that development was the *development state,* a government committed to the development of its countries.

An important set of instruments for promoting development are those that fall under the rubric of industrial policies—a term that was not deemed worthy of mention in polite company when I arrived at the World Bank. Now the notion of industrial policy is much more widely accepted—even in developed countries as they try to deal with the great recession, dramatically and effectively practiced, for example in the rescue of the US automobile industry. Showing how industrial policies could facilitate the structural transformation of economies was one of the main concerns of the previous chief economist of the World Bank, Justin Lin. There is also growing concern with such transformation in Africa both amongst governments, such as those of Ethiopia and Rwanda, and civil society as reflected in the think-tank African Center for Economic Transformation (ACET) established some five years ago by K.Y. Amoako.

The increases in living standards that have marked the more advanced countries center around "learning," the increases in productivity associated with technological progress and a more educated labor force. My colleague Bruce Greenwald and I have just completed a book on *Creating a Learning Society: A New Paradigm for Development and Social Progress.*[8] It emphasizes the importance of learning, and the role of government in creating a learning society, and explains why Washington Consensus policies were counterproductive in creating a learning society—and thus in creating an economy with high quality sustained growth.

For Africa, industrial policies will need to have a broader focus than such policies have sometimes had in the past. They will have to focus, for instance, in ensuring the adoption of technologies that are environmentally sensitive. They need to address the other challenges facing the continent—promoting inclusive growth with high levels of employment, creating a learning society, creating livable cities, improving agricultural productivity, including reforming, and land

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[8] To be published by Columbia University Press.

tenure systems, where appropriate. In the West, innovations and investment have focused on saving labor. The growing problems of unemployment around the world, and the evident shortage of jobs, combined with the risks to our environment, imply that innovation and investment needs to be focused on protecting the environment and creating jobs.

Of course, unwittingly, every country—even those that have seemingly been critical of industrial policies—have practiced them. Every law, every public investment decision, indeed, almost every public decision, has some effect on the economy and its structure, some more than others. Building ports enables exports; not doing so "structures" the economy against trade. America's bankruptcy laws gave first priority to derivatives, thus encouraging this risky part of the financial sector.

Critics of the relevance of the development state and industrial policies for Africa sometimes argue that many of the countries in the region don't have the institutional capacity. But this misses two key points. When many of the Asian countries began their development trajectories, their states too were underdeveloped. They developed these capacities. The full-fledged development state does not arrive like manna from heaven overnight; it has to be constructed and along the way there is a continuum of “developmentalist” states with varying capacities.

Indeed, in most of these countries, market institutions too are underdeveloped. The two need to be developed together, in tandem. Each can help the other—and each can serve as a check against the abuses of the other.

To the extent that there are limits in market and state institutions, these limitations should affect the *manner* in which the developmentist state pursues its objectives. The policy framework that works well at one level of development might not work well at another. But it should be clear that the state has an important role to play in promoting growth at *every* level of development. And how to strengthen state capabilities should receive no less attention than how to make markets work better.

CONCLUDING COMMENTS

I want to conclude with six general remarks about changing perspectives on growth and on-going changes in the world. The first is perhaps obvious: instability is bad for sustained inclusive growth. But if that is so, it means that we need to focus on policies that lead to stability. Here, the IMF's recent decision to re-examine the role of capital controls is on target. Unfettered capital flows, especially of the short-term variety, can be, and often are destabilizing

The second is the link between instability and inequality. It is not only that instability leads to more inequality, but inequality leads to instability. This is one of the important points raised in my book the *Price of Inequality*. Our society, our economy, our democracies pay a high price for inequality. And one of the prices we pay is high instability. This is a result that has been again confirmed and emphasized by the IMF.

Thirdly, for more than a decade[9], we have been aware that what separates developed and less developed countries is not just a gap in resources, but a gap in knowledge. There are knowledge gaps not only between developed and less developed countries but amongst the developing countries. Conferences like this can do a great deal to close these knowledge gaps.

Fourthly, while knowledge gaps are important, so too are resource gaps. The developed countries as a whole have not lived up to the commitments on aid that they have repeatedly made. That is why I have been so enthusiastic about the recent announcement of the BRICS Development Bank, a South-South collaboration to enhance the funding available, especially for critically needed investment in the developing countries.

While the developed countries have not lived up to the commitments they made concerning aid, neither have they lived up to the commitments that they have made on trade: They have largely reneged on their agreements to restructure the global trade regime to make it more pro-development. On the contrary, much of what has

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[9] Especially since the World Bank's World Development Report of 1998, *Knowledge for Development.*

happened subsequently has moved in the opposite direction, with bilateral and so-called partnership agreements reflecting the imbalances of economic and political power fragmenting the global trade regime. With further agreements currently being discussed, I hope that any such agreements will be pro-development, will focus on trade creation rather than trade diversion. The latter could mean that the poorest region of the world could become even poorer. There is a need for Western governments to move ahead with the Aid for Trade agenda, and to recognize the *right to development* within the global trade regime.[10]

Fifthly, the BRICS bank to which I alluded to earlier is but one reflection of fundamental changes that are occurring in the geo-political and geo-economic balance of power, especially after the global financial crisis. The income of the BRICS is now larger than that of the developed countries not long ago, at the time of the founding of the Bretton Woods Institutions. Rising incomes in Asia have helped fuel Africa's growth. But rising wages there will also mean marked changes in comparative advantages. This represents a unique opportunity for this continent. Much of manufacturing will be moving out of the countries in which it has been located. There is an open question about where it will move. This is where the industrial policies—focusing on learning—to which I referred earlier become critical.

Finally, we need to be aware of the deficiencies in GDP as a measure of success. As I emphasized in the beginning of these remarks, we want sustainable, equitable growth. I chaired an international Commission on the Measurement of Economic Performance and Social Progress.[11] The Commission was unanimous in its view that GDP was *not* a good measure of success, and relying on it could be highly misleading. This is especially true for countries with high levels of

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[10] See Andrew Charlton and J. E. Stiglitz, 2006, "Aid for Trade," with Andrew Charlton, *International Journal of Development Issues*, 5(2), pp. 1-41 (reprint of paper prepared for Commonwealth Secretariat); and 2013, "The Right to Trade," with Andrew Charlton, a report for the Commonwealth Secretariat on Aid for Trade.

[11] The commission's report was released in 2009 and published as *Mismeasuring Our Lives: Why GDP Doesn't Add Up*, J.E. Stiglitz, A. Sen, and J.P Fitoussi (eds.), New York: The New Press, 2010.

inequality, where there are high levels of foreign investment (so GNP, the income of the citizens of the country, could different markedly from GDP, the output produced within the country), and/or whether there are problems of resource depletion and environmental degradation. But one or more of these problems arise in most African countries.

The challenges facing Africa are daunting. But so are the opportunities. The successes of recent years cannot but make us optimistic. TICAD provides a wonderful opportunity for countries to learn from each other on how best to tackle these challenges, in ways which ensures sustainable and inclusive growth.

The African Transformation Report

Briefing Note

April 2013

African Center for Economic Transformation

The African Center for Economic Transformation (ACET) believes that the two mutually reinforcing goals of economic growth and transformation should be at the center of development policy in Africa.

In 2011 more than 30 African ministers, central bankers, business leaders and international development experts met at the Rockefeller Foundation's Bellagio conference facility to discuss the prospects and requirements for Africa's economic transformation. Given the region's untapped human and physical resources, those prospects were assessed as tremendous—as were the requirements. Convened by the African Center for Economic Transformation, much of the discussion centered on how the drive for transformation should be the focus for African governments, working with and supporting a revitalized private sector. Also covered was ACET's proposed *African Transformation Report* to review country transformation performance and to provide analysis and emerging practices as countries pursue their transformation agendas.

In January this year, the heads of the African Union Commission, African Development Bank, and Economic Commission for Africa met to see how their organizations could best pursue Africa Vision 2063—with a more comprehensive and coordinated approach to tackling Africa's transformative development goals for the next 50 years. They agreed that for the continent to be vibrant and modern, it would have to peacefully resolve conflict, strengthen governance, and make national institutions more effective and the private sector more efficient.

In March, African finance and economic development ministers met in Abidjan to make a unanimous call for commodity based-industrialization as an impetus to Africa's structural transformation, moving from primary products to manufacturing and services. Supporting this call, the ECA's 2013 Economic Report on Africa, *Making the most of Africa's commodities,* highlighted Africa's imperative to use commodity-based industrialization as an engine of growth and structural transformation.

In April, the Board of the African Development Bank approved its strategy for the next 10 years, *At the center of Africa's transformation.* Sound policies and better infrastructure would drive that transformation by improving the conditions for private sector development—and by boosting investment and entrepreneurship. And transformation would diversity the sources of economic opportunity in ways that promote high productivity and sustain inclusive growth. At the heart of this, according the Bank president Donald Kaberuka, is reducing the risk and cost of doing business.

And in May the AU summit of African leaders is marking its 50th anniversary by unveiling an agenda for Africa's socioeconomic transformation. Indeed, several African countries, such as Ethiopia, Kenya, Nigeria, and Rwanda, are already formulating long-term visions emphasizing economic transformation.

It is not only African institutions pushing for transformation. The Japanese government's Tokyo International Conference on African Development in June 2013 (TICAD V), with dozens of African leaders expected to take part, will have transformation as its main theme. The theme for last year's World Economic Forum on Africa was "Shaping Africa's Transformation," and participants, including policymakers and business leaders, discussed how to transform Africa's growth story into shared opportunities for present and future generations.

Transformation is thus the new buzzword in development circles, but it means different things to different people. For those of us at ACET, economic transformation is growth through making the structural shifts from farming to manufacturing and services. But it is more than merely structural. It is growth through expanding the technical capabilities of people and institutions. It is growth through upgrading the technologies that people use on farms, in firms, and in government offices. It is growth through becoming internationally competitive and latching onto global chains. All these channels are mutually reinforcing.

To be kept in mind is that economic transformation is just a means. The end must be to create productive jobs and satisfying lives for all Africans. With good policies for the poor and vulnerable, those jobs can end extreme poverty on the continent, something unimaginable a decade ago but now within reach. And those jobs can narrow considerably the inevitable income gaps that open between rich and poor in rapidly developing economies.

Thus it is that a transforming economy—more than just a growing economy—can create good jobs and share the fruits of prosperity. Thus it is that a Ghana or Kenya can become a Korea.

THE AFRICAN TRANSFORMATION REPORT

ACET's comprehensive research program of country, sector, and thematic studies identifies some of key lessons for transforming Africa's economies and sets benchmarks against Asian and Latin American economies. Drawing on all these studies, ACET's flagship publication, the *African Transformation Report*, provides data and analysis for policymakers, private businesses, and civil society to spur economic transformation. To be launched in October 2013, the report introduces the African Transformation Index, an innovative tool to track how countries are performing over time and against each other (see annex 1 for the report's outline). A short preview of the full report will be released in May.

The report reviews how African countries are diversifying their economies, boosting productivity, upgrading technology, and increasing competitiveness. That country focus and detail distinguish the report in providing guidance and direction for its primary audience: national policymakers and business leaders. Moving beyond generalizations for the continent, it provides action plans to show how countries can transform their economies.

The report and the many research studies (see annex 2) will form the basis for national transformation dialogues and for ACET's advisory services to governments. Indeed, ACET's work will support the AU, AfDB, and ECA as they pursue Africa Vision 2063 and as individual countries formulate and tackle their transformation agendas.

PUSHING FOR TRANSFORMATION IN AFRICA

On all measures of economic transformation, Africa has been lagging behind East Asia—in large part because of state-led industrial policies in the first decades after independence and the market-led adjustment policies of the 1980s and 1990s. Since then, some African countries have been moving toward a middle course between the two policy extremes. Six of the 10 fastest growing economies in the 2000s were in Africa, and others were above or near the 7 percent threshold for economic takeoff, set to double their economies in 10 years. According IMF projections for the top 10 growers through 2015, 7 are again in Africa. All this, in a sluggish global economy.

Much of this growth has come from better macroeconomic policies and booming commodity markets. Needed now is to move to well-managed and robustly growing economies that are competitive in the global marketplace in a widening array of technologically sophisticated goods and services.

Here we describe the main elements of the *ATR* to engage broader audiences in forging a clear understanding of what transformation means, where African countries stand, what are their most promising pathways to transformation, and what they need to do to seize the opportunities.

ASSESSING COUNTRY PERFORMANCE

Country case studies are in-depth analyses of the economic environment in selected countries and their prospects for transformation. In collaboration with domestic think tanks, ACET analyzes country economic transformation performance, based on the key attributes and drivers of transformation. For the 2013 *ATR*, we examine an initial group of 15 countries. Together, these countries represent 85 percent of Sub-Saharan Africa's GDP. By using a shared methodology and in-country expertise the studies provide a unique balance of analytical rigor and local application. The headlines:

- **Botswana –** Growth without transformation
- **Burkina Faso –** Need for faster growth and structural change
- **Cameroon –** Manufacturing development but income stagnant
- **Ethiopia –** Diversifying commodity exports but still very poor
- **Ghana –** Regaining lost potential
- **Kenya –** Silicon Savannah?
- **Mauritius –** Rapid economic growth and structural transformation, but new challenges
- **Mozambique –** Good potential; will it be tapped effectively?
- **Nigeria –** Is the giant waking up?
- **Rwanda –** Remarkable recovery, strong transformation efforts, but still a way to go
- **Senegal –** Good structure, slow growth
- **South Africa –** Advanced economic structure but slow growth
- **Tanzania –** Quiet, steady performer
- **Uganda** – Good performance, but still far from transforming
- **Zambia** – Great potential yet to be tapped

MEASURING TRANSFORMATION

The African Transformation Index provides a common quantitative tool to measure the progress of countries on economic transformation. It comprises five main indicators:

1. Economic diversification
2. Technology
3. Productivity
4. Export competitiveness
5. Human dimension of transformation.

By ranking 50 African countries on this index, the *ATR* shows how countries are transforming over time and in relation to others.

DRIVING TRANSFORMATION

ACET research and country studies point to 10 policy and institutional drivers of economic transformation.

- State capacity for economic management
- Business environment
- Domestic saving and investment
- Public infrastructure
- Education and skills
- Technology upgrading
- Export promotion
- Foreign direct investment
- Labor-industry relations
- Targeted sectoral strategies.

The inaugural *ATR* highlights three of these drivers, so that government officials and business leaders can tailor policy measures and institutional mechanisms to suit their circumstances and transformation objectives.

- *Building state capacity*. Working with the private sector, African states have to formulate a national vision for transformation. They need to develop a planning and budgeting framework that translates that long-term vision into medium-term plans. Through effective macroeconomic management, they need to ensure prudent public expenditure management and monitoring. And to know how they are performing and where they have to change course, they need to strengthen the statistical capacity to provide timely economic statistics. The report also analyzes what states can do to actively support the private sector, going beyond providing a general good business environment to facilitate its access to new technologies and markets and to help raise its competitiveness in international markets. Importantly, the state should not try to do everything—it should build the minimum institutional capabilities to sustain strategic partnerships that support firms and farms.

- *Promoting exports.* The East Asian countries used a number of instruments to proactively promote exports. Some of these instruments are either no longer available or are restricted in today's global environment. But there still is enough scope for a determined government to skillfully use various instruments to promote exports—by lifting the most important constraints on private enterprise. The *ATR* provides insights on key elements of a viable export promotion strategy for Africa today. Offering perhaps the greatest potential is light manufacturing in agroprocessing, in adding value to extractives, and in assembling appliances and other consumer durables—first to meet domestic demand and then to supply regional and global markets. Streamlined regulations and better infrastructure will help reduce costs generally. But more focused efforts will include macroeconomic, exchange rate, and other horizontal measures, as well as vertical efforts to promote targeted exports—such as performance-based subsidies and other support to help exporters acquire and master technology, develop new products, and expand into new markets. The *ATR* argues that more must be done to increase access to developed and emerging world markets. Trade preferences can help, but too often they exclude precisely the products in which an African country would have a comparative advantage. Easing the rules of origin, which define how much processing must take place in the exporting country, could be a major boost.

- *Developing skills for economic transformation.* The East Asians also used their education and training systems to stimulate their economic and social transformations. Building on their success, the *ATR* shows how critical it is for countries to develop and implement comprehensive policies for skills and educational development within the frame of a broader transformation strategy. With guidance from private firms about what they really need, skills development should cut across several ministries and agencies of government, not be the sole preserve of education ministries, and high-level political support should ensure effective coordination. The *ATR* also proposes approaches to meet the financing challenges of skills development.

In each of these areas the state and the private sector have to work together to come up with smart solutions to reach their county-specific objectives—with parliaments, civil society, and the media ensuring that actions are transparent and in the interest of all. The *ATR* provides concrete examples of good practices for all countries to emulate and adapt to their special circumstances. Future *Africa Transformation Reports*, informed by ACET's ongoing research, will explore the remaining drivers.

IDENTIFYING PATHWAYS TO TRANSFORMATION

Each country has different endowments, different constraints, and different opportunities for transformation. The *ATR* explores potential pathways for countries to produce new exports or increase their competitiveness in existing exports and import substitutes. Based on the endowments and comparative advantages of African countries, this year's *ATR* focuses on agroprocessing, extractives, garments, component assembly, and tourism.

- *Agroprocessing.* Drawing on studies of cocoa, coffee, cotton, soya, fruits, palm oil, sugar cane, and rice, the *ATR* presents a market and value chain analysis for each commodity to highlight global trends, identify the key policy constraints to be lifted, and specify the opportunities for adding value to exports. Much is under way in this sector. For example, Zambeef products, one of Zambia's biggest agribusinesses, covers the full value chain in producing, processing, distributing, and retailing beef, pork, fish, chickens, eggs, milk, flour, bread, and edible oils. Annual sales: more than $160 million.

- *Oil, gas, and minerals.* The *ATR* shows how the continent can best leverage its enormous extractive resources to support economic transformation, with emphasis on fiscal policies, value addition, and local content. Because resources, once extracted, are gone forever, they should be seen as part of a portfolio of national assets that also includes human capital, physical capital, financial capital, and institutional capital. Countries can enjoy fast growth and fat revenues from extraction for a time, but they can end up worse off than before a boom if they don't use their share of the revenues to build those other assets—for this and future generations. Consider how Botswana is moving beyond extraction. This year, DeBeers is moving its sorting and trading operations to Gaborone, making the country the world's largest diamond trader.

- *Garments.* The *ATR* explores what it would take for Africa to capitalize on its abundant labor and cotton to produce garments, a traditional launching pad for light manufacturing. It draws on lessons from Mauritius's success, as well as the experiences of Korea, Taiwan, Bangladesh, Pakistan, India, and China, to show what governments can do to support foreign and domestic investors. With so much apparel trade now organized and controlled in global value chains, the *ATR* shows how African firms can insert their activities in wider networks—doing contract work for branded manufacturers in export processing zones, full-package production for global retailers, and generally moving from simple to sophisticated and from fiber to fashion based on price, quality, and punctuality.

- *Component assembly.* With wages rising in China and with the African consumer growing in number, component assembly offers an opportunity for African business to supply national and regional markets for bicycles, motorcycles, appliances, and other consumer durables. Assembly and packaging, the first links in the value chain, are very competitive and very demanding and thus difficult to break into. Firms have to rapidly deepen their skills and capabilities. Countries have to develop world class logistics: for customs, trade infrastructure, port infrastructure, and information and communications systems. On the World Bank's Logistics Performance Index, a measure of competitiveness, South Africa ranks 23, followed by Benin (67), Mauritius (72), and Malawi (73)—and the rest of Africa farther down the list of 155, pulled down by poor tracking, tracing, and timeliness. Getting into components assembly manufacturing will thus require governments and businesses to work with global freight forwarders and express carriers to move goods across long distances in what's been characterized as the "physical internet."

- *Tourism.* Africa had 33 million international visitors in 2011, up from 31 million the year before, with receipts of $33 billion. Half were leisure tourists, a quarter were visiting family and friends, and about a sixth were business and professional visitors. On current trends the arrivals are set to rise to 55 million over the 2010s, contributing US$66 billion to the region's GDP by 2020, and 6.5 million jobs, up from 5.2 billion at decade's start. Adding indirect and induced spending, tourism's total contribution would almost triple to US$172 billion and almost 16 million jobs. Given the continent's dynamism evident almost everywhere, those projections are likely to be low, even very low. The *ATR* shows what countries can do to move to next levels in leisure tourism and especially in business travel, so important for foreign investors and for foreign buyers of African products.

As with the chapters on drivers, those on pathways give examples of good practices to inform country efforts, spelling out in detail the actions they can take to advance on their own economic transformations.

ANNEX 1: OUTLINE FOR THE FIRST AFRICAN TRANSFORMATION REPORT

Overview: Opportunities and prospects for economic transformation in Africa

Part 1: Transforming Africa

1. The case for economic transformation
2. The state of transformation in Africa

Part 2: Policy and institutional drivers of transformation

3. Getting the state and the private sector to work together
4. Promoting exports
5. Developing skills

Part 3: Pathways to transformation

6. Agroprocessing
7. Oil, gas, and minerals
8. Textiles and apparel
9. Component assembly
10. Tourism

Annex 1: Methodology for the African Transformation Index

Annex 2: Summary of the 15 country transformation studies

Annex 3: African Transformation Indicators

ANNEX 2: SELECTED ACET STUDIES

COUNTRY STUDIES

- Botswana
- Burkina Faso
- Cameroon
- Ghana
- Ethiopia
- Kenya
- Mauritius
- Mozambique
- Nigeria
- Rwanda
- Senegal
- South Africa
- Tanzania
- Uganda
- Zambia

STUDIES OF TRANSFORMATION DRIVERS

- Promoting exports: what worked and its current relevance
- FDI inflows in Africa: trends, sources, and sector distribution
- Innovative financing for infrastructure in low income countries: how the G20 might help
- Lessons from the East Asian and European experience for skills development in African
- Skills development for economic transformation in Africa

SECTOR STUDIES

- Building a competitive textiles industry: what can African economies learn from Mauritius?
- Opportunities in the textile industry for transforming African economies
- Agricultural supply chains: market structure, farm constraints, and grassroot institutions
- Promoting sustainable development and transformation in rural Africa
- Value for money in financing agriculture
- Market competition in export cash crops and farm income in Africa
- Tourism in Africa

AGROPROCESSING

- Palm oil production and manufacturing opportunities in Africa: a policy discussion
- The cocoa agroprocessing opportunity in Africa
- The cotton agroprocessing opportunity in Africa
- The soybean agroprocessing opportunity in Africa
- The value capture opportunity in fruit
- Dairy production and processing opportunities in Africa
- Sugar as a driver for transformation: unlocking the potential for African countries

EXTRACTIVE INDUSTRIES

- Case study of Debswana's HR development policy: a De Beers and Botswana partnership
- Case study of Trinidad & Tobago's value-addition using gas resources
- Diagnostic study of Ghana's mineral sector
- Diagnostic study of Ghana's petroleum sector
- Diagnostic study of Uganda's petroleum sector
- The exceptionality of Botswana: economics, politics, and challenges
- The global economic crises, funding public services in Africa, and concessions in the mining sector: the case of Zambia
- Policy, legal, and institutional challenges of local content in Nigeria and South Africa

SPECIAL STUDIES

- Comparison of the Malaysian and South African domestic market
- Looking East: China's engagements with Africa—benefits and key challenges
- Looking East: Ghana–China case study
- Looking East: Rwanda–China case study
- Strategic lessons for Africa's economic transformation: an overview

- Toward economic transformation in Ghana: strategic learning from high-growth nations
- Turning inward? Or fighting the crises with further opening? Evidence from the Nigerian banking system

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MEASURING POLICY PERFORMANCE:

Can we do better than the World Bank?

April 2013

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Abstract

This article questions the relevance of the different measures of policy performance that are currently used by international organizations. It evaluates more especially the pertinence of the World Bank's CPIA and of the various alternatives that have been proposed. Using a cross-country panel dataset over 146 "developing" countries between 1977 and 2008, I show that the CPIA is a blunt and biased tool that can and should be improved upon. In particular, I show that while the CPIA is correlated with current growth, it is not a good predictor for future growth. I thus argue in favor of other measures of policy performance. First, I underline the need of introducing new criteria when measuring policy performance, in particular proxies for the development of fiscal capacity (e.g. domestic tax revenues) and the quality of industrial policy

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[1] I am particularly thankful to Ravi Kanbur, Akbar Noman, Thomas Piketty and Joseph Stiglitz for helpful comments and suggestions. Participants at the Initiative for Policy Dialogue Task Forces also provided valuable advice. A first draft of this paper was prepared for the Tokyo International Conference on African Development (TICAD). The usual disclaimer applies.

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(e.g. export promotion strategies). This is of particular importance to bring sustained growth to sub-Saharan countries. Second, focusing more specifically on the allocation of development aid, I show that performance-based measures—as opposed to measures implying *ex ante* conditionality like the CPIA—are more accurate instruments for aid allocation. Finally, I make concrete proposals for the development of new performance indicators: the idea is to use "aid effectiveness" to allocate aid selectively.

1. INTRODUCTION

This article questions the relevance of the different measures of policy performance that are currently used. It especially evaluates the pertinence of the World Bank's Country Policy and Institutional Assessment (CPIA) and of the various alternatives that have been proposed in the literature. It argues in favor of new measures of policy performance.

Measuring policy performance is of particular importance today. First, the current global economic crisis has been very harmful for developing countries, in particular sub-Saharan countries, with a slowdown of capital flows, trade flows, flows of remittances and development aid flows. Development aid is both a limited and needed resources for developing countries. Finding criteria to allocate it selectively is thus of great concern for donors.

Second, finding an accurate measure of policy performance is of particular importance in the context of sub-Saharan countries which, despite the revival of growth in the past decade, have made little progress on the path to "sustained" growth. No important structural changes have taken place in the majority of sub-Saharan countries. Striking is the fact that the share of manufacturing and formal sector employment are still declining in these countries. A good measure of policy performance has thus to be concerned, with policies that would bring about economic transformations, structural changes and sustained growth. I discuss the relevance of existing indicators and propose a new approach in light of these concerns.

Using a yearly panel dataset over 146 developing and emerging countries between 1977 and 2008, I first show that the CPIA is correlated with current growth rates. This contemporaneous correlation can by explained in part by the fact that the assessments of the World Bank staff are colored by perceptions of countries current performances. Next I show that the CPIA is not a good predictor for future economic growth. I also find a positive and statistically significant correlation between developing countries' votes in the United Nations General Assembly (UNGA) with those of the United States and their CPIA scores. This is obviously subject to a variety of interpretations about causality, but it can be seen as an indication of the influence of a pro-United States disposition in foreign policy on the CPIA. At the very least, this shows that whatever matters, it is more strongly correlated to UN votes that to future growth prospects, which seems odd.

I thus argue in favor of other measures of policy performance. First, I underline the need for introducing new criteria when measuring policy performance. In particular, I show that more weight has to be given to the development of state capacities, which supposes to take into account its fiscal capacity. Fiscal capacity is indeed of crucial importance for raising domestic tax revenues. One has to go further that just underlying the need for "good institutions" when emphasizing the role of the state. Moreover, I underline the importance of the quality of industrial policy and especially of export promotion strategies on the path towards sustained growth.

I then focus more specifically on the allocation of development aid, which is of great importance given both the scarcity and need for aid. I show that performance-based measures, as opposed to measures implying *ex ante* conditionality, are more accurate instruments for aid allocation. In particular, I discuss the relevance of the Kanbur's proposal (Kanbur, 2005) of introducing some "outcome criteria" in the CPIA. I show that introducing straightforward outcome variables will be a significant improvement on the CPIA but will leave some difficulties unsolved.

Finally, I make concrete proposals for the development of new performance indicators. The basic idea beyond these indicators would be to use "aid effectiveness" to allocate aid selectively. Such indicators were supposed to compute one "aid effectiveness" coefficient per country and year. I show how this can be done using the "local Gaussian-weighted ordinary least squares" econometric method.

1.1. RELATED LITERATURE

This paper is first related to the literature which evaluates the relevance of the existing indicators measuring policy performance. The main focus of this literature is the World Bank.[3] Kurtz and Schrank (2007) evaluate the World Bank's coding of "good governance" by exploiting the time-dimension of the data. Using Granger-style causality tests, they found weak support for the notion that "better governance" was connected with successive improvements in growth. Other studies focus more specifically on the CPIA. Since the CPIA data was not disclosed until recently, they mainly emanate from the World Bank. For example, Gelb Ngo and Ye (2004) show that CPIA ratings have been quite strongly associated with medium-run growth performance. On the contrary, in a review of the performance-based allocation system, the World Bank (World Bank, 2001) underlines that, on average, CPIA ratings may be considerably affected by contemporaneous growth, with only modest predictive power with respect to future growth or poverty reduction. This is consistent with the empirical findings I obtain in this paper. Kraay and Nehru (2004) use CPIA ratings and find a significant inverse correlation between the quality of a country's policies and institutions on the one hand and its probability of debt distress on the other hand. Outside of the World Bank, however, other articles are much more critical toward the CPIA. For example, Herman (2004) calls for appreciating the weaknesses of this indicator, especially its low ability to discriminate among countries or over time. This paper contributes to this debate by analyzing both conceptually and empirically the relevance of the CPIA.

This paper is also related to the literature which proposes alternatives to the CPIA or other performance indicators.

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[3] An exception is Stuckler et. al (2009) who show, using the EBRD's own data, that the EBRD's indices of progress in market reforms are biased in the direction of positive growth.

Kanbur (2005) argues in favor of introducing some outcome variables in the CPIA. His proposal is in the spirit of Collier *et. al.* (1997)'s outcomes-based allocation. They indeed propose a basis for aid allocation in terms of retrospective assessment of a few major outcomes such as growth. Similarly, Barder and Birdsall (2006) defend the idea of *payments for progress*. I contribute to this literature by opening the way for a new indicator that improves upon the previous proposals that have been done.

Finally, this paper is related to a growing literature on optimal aid allocation, which emphasizes the necessity to take into account the level of policies as a selectivity criterion. This necessity was first highlighted by Burnside and Dollar (2000) and further examined in the World Bank report *Assessing Aid* (World Bank, 1998). Using these findings, Collier and Dollar (1999) derive an effective allocation of aid in terms of poverty reduction and compare it to the current allocation. They find out that the current allocation is radically different from the allocation which would be effective on poverty reduction. They stress the fact that an optimal allocation of aid not only depends on levels of poverty but also on the political environment. Moreover, they further develop this idea by applying their approach to the dynamic question of poverty reduction Collier and Dollar (2001). Cogneau and Naudet (2007) propose an alternative allocation based on the principle of equality of opportunity: they take into account structural growth handicaps rather than the quality of past policies (see also Llavador and Roemer, 2001). In the same spirit, Wood (2007) presents a more general model of optimal allocation of aid, in which donors take into account future poverty as well as current poverty. Finally, Amprou *et. al.* (2006) argue in favor of considering vulnerability to exogenous shocks and low level of human capital as selectivity criteria. All this literature takes the level of policy or of performance in the effective use of development assistance as given. On the contrary in this article, I try to determine the optimal performance indicator one can use in the selectivity formula for aid allocation.

The rest of the article is organized as follows. Section 2 presents descriptive evidence about the CPIA and assesses its relevance. Section 3 provides new ways to improving upon the CPIA. Section 4 concludes.

2. THE CPIA, A GOOD MEASURE OF POLICY PERFORMANCE?

One of the most influential tools for measuring policy performance as of today is the Country Policy and Institutional Assessment (CPIA), which is the World Bank's tool. In this section, I analyze the relevance of this tool as a measure of policy performance.

2.1. SOME HISTORY OF THE CPIA

Since 1977, the World Bank has carried out an annual performance assessment of its client countries' capacity to effectively absorb development assistance. This assessment, the CPIA, is one of the main criteria used to allocate International Development Assistance (IDA) resources between low-income developing countries. The CPIA is an assessment tool for the Bank, to gauge the likely return to development assistance in specific countries and to guide IDA allocations to countries below the income threshold. CPIA assessments do not directly reflect specific "outcome" criteria as set out in the Millennium Development Goals (MDGs)—e.g. poverty reduction, school enrollment, maternal health, etc.—neither do they directly rest on proxy outcome variables such as GDP, export or investment growth rates. The emphasis is on policy actions and institutional effectiveness. They rely on the judgments of technical analysts to assess how well a country's policy and institutional framework fosters poverty reduction, sustainable growth and the effective use of development assistance (Gelb, Ngo and Ye, 2004).[4] Ratings are against specific criteria but are subjective. Indeed, the CPIAs are produced by the Bank's own staff, i.e. its country teams.

In the past, CPIA results were not made available to the public. Only recently have governments themselves, whose policies are assessed in a particular CPIA, come to be informed of the numerical

[4] Indeed, according to the World Bank, the aim of the CPIA is to assess «how conducive [a country's policy and institutional] framework is to fostering poverty reduction, sustainable growth and the effective use of development assistance» (World Bank, 2007).

ratings on a confidential basis. Since 2000, there has been a public quintile-based disclosure.[5] The exact numerical values of the CPIA have been disclosed starting with the results of the 2005 CPIA exercise. They are fully available to the public today.

The criteria used in the CPIAs have evolved over the years, in response to new analytical insights and lessons the Bank feels it has learned from experience. Originally called Country Performance Ratings (CPR), the assessment exercise acquired the name CPIA with the 1998 redesign to emphasize that it was the policy and institutional environment that was being assessed, not economic outcomes. The definition of the criteria, their relative importance, the rating and disclosure procedures have undergone important changes over the years (van Waeyenberge, 2006).

(A) THE 1980'S

Significantly, during the 1980's, the emphasis moved from an initial concern with both policy inputs and economic performance indicators (growth and savings rates), to a predominant concern with policy inputs. By the early 1990s, an exclusive emphasis on policy inputs prevailed.

In the early 1980s, four criteria were cited in the following order of priority as affecting IDA's resource allocation:

1. National poverty as measured through income per capita;
2. Creditworthiness;
3. Economic performance to be assessed in terms of macro indicators including growth and saving rates, but also in terms of the quality of "administration and economic management" together with "the speed and direction of change;"
4. Project readiness.

[5] With the quintile-based results for the CPIA, its four clusters, the country portfolio, and the IDA Country Performance (ICP) rating posted on the Bank's extemal website, as well as the criteria and the methodology of the performance-based allocation system.

Guidelines on the allocation of lending among IDA-eligible countries issued in 1989 were characterized by a shift in emphasis towards greater consideration of policy performance.

According to Kapur *et. al.* (1997), Bank staff was instructed to rate a country's performance in each of three policy categories: (i) short-run economic management (mainly of demand); (ii) long-run economic management (mainly supply side restructuring); and (iii) the country's poverty-alleviation record as characterized by its delivery of social services, together with reforms removing "distortions" from labor markets and from rural-urban terms of trade. As a result, the 1991 CPIA exercise had three component clusters: (i) short-term economic management; (ii) long-term economic management; and (iii) poverty alleviation policies.

(B) THE 1990'S AND 2000'S

In 1997, criteria covering governance-related issues were added, and in 1998 the CPIA process was revised to add a benchmarking phase.[6]

In 2001, several changes were introduced that included establishing a written record, providing detailed guidance for criteria with several subcomponents, broadening the set of benchmark countries, revising the content of the criteria and defining the different rating levels (previously only the 2 and 5 rating levels were fully defined). A review took place in 2004, when the Bank commissioned an

[6] "The benchmarking phase helps ensure that, given the criteria, the ratings are set at the right level and are consistent across countries and Regions. The Bank's six Regions, the Networks, and Central Departments assist in selecting a representative sample of countries that covers all six Regions, includes IBRD and IDA-eligible borrowers, good as well as poor performers, and has a ratings distribution similar to the overall distribution of the CPIA country scores. The set of benchmark countries is reviewed every year, taking into account the need to both maintain some continuity in the sample and to refresh it. At the onset of each year's exercise, the set of benchmark countries is communicated to the Regions and Networks, along with the timetable for the exercise. " (World Bank, 2007)

external panel to review the CPIA ratings and methodology. The panel made a number of recommendations: (i) simplify CPIA criteria from 20 to 16; (ii) undertake analytic work to better inform the weighting of the various criteria; (iii) reconsider the weight given to the "governance factor"; (iv) provide country authorities with an opportunity for comment on the assessments; (v) establish an independent committee to review the CPIA methodology every three years; and (vi) fully disclose the numerical ratings of the 2005 CPIA exercise for IDA borrowers. The criteria were revised in 2004 to take the recommendations made by the panel into account.

As shown in Table 4 in the Data Appendix, the CPIA currently comprises 16 criteria divided into four clusters. It is split into two groups, the CPIA Cluster A-C (Economic Management; Structural Policies; Policies for Social Inclusion/Equity), and the CPIA Cluster D (Governance Rating: Public Sector Management and Institutions). The CPIA Cluster A-C includes 11 items and the CPIA Cluster D includes 5 items.

The economic management cluster comprises three specific criteria: (i) macroeconomic management; (ii) fiscal policy; and (iii) debt policy.

The structural policies cluster contains three criteria: (i) policies and institutions for economic cooperation, regional integration and trade; (ii) financial sector; (iii) business regulatory environment.

The policies for social inclusion/equity cluster have five criteria: (i) gender equality; (ii) equity of public resource use; (iii) building human resources; (iv)social protection and labor; and (v) environmental policies and regulations.

Finally, the governance rating cluster comprises five criteria: (i) property rights and rule-based governance; (ii) quality of budgetary and financial management; (iii) efficiency of revenue mobilization; (iv) quality of public administration; and (v) transparency, accountability, and corruption in the public sector (World Bank, 2008).

Moreover, each criterion includes a series of sub-indicators through the guidelines that I will not detail here but that are available online. For example, the macroeconomic management criterion can be divided into three sub-indicators: (i) monetary/exchange rate policy with clearly defined price stability objectives; (ii) aggregate demand policies focus on maintaining short and medium-term external balance; (iii) avoiding crowding out private investment.

Using the guidelines, the Bank's country team gives a score to every country comprised between 1 and 6 for each of the 16 criteria and gives each cluster the same weight in producing the overall country assessment.[7]

(C) THE 2010'S

What is striking is that despite the economic crisis and the evaluation of the CPIA released by the Independent Evaluation Group (IEG) in 2009 (IEG, 2009), the criteria used in the CPIA as of today (2012) are exactly the same than those of 2008. The only difference is that *"macroeconomic management"* is now called *"monetary and exchange rate policies."*

The main recommendation of the IEG was to *"strengthen the use of financial indicators in the CPIA write-ups"* (IEG, 2009) as if finance was but the only important thing to bring about sustained growth. This is especially striking given the fact that we know from the literature that there is a key trade-off between safe and sound finance on the one hand and the risk-taking in financial sectors' intermediation between savers and investors on the other hand. Moreover the pattern of the financial sector maturation varies considerably among countries. It has been widely showed that financial instability can lead to poor economic growth. For example, Williamson and Mahar (1998) and Kaminsky and Reinhart (2001) have shown that financial opening preceded most crises. Griffith-Jones (2000) similarly underlines that international markets are inherently unstable due to information asymmetries. Hence it seems that the World Bank, at least from the CPIA point of view, has learned little from the crisis.

As I emphasize below, there is nothing in the CPIA that is related to what could bring sustained growth to developing countries.

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[7] More precisely, for each criterion, countries are rated on a scale of 2 (weak) to 5 (strong), and a country is rated a 1 if it is very weak for two years or more and a 6 if it is very strong for three years or more.

2.2 DESCRIPTIVE EVIDENCE

In this paper, I use the annual series of the CPIA for 146 countries between 1977 and 2008.

Interestingly enough, despite the fundamental changes in the CPIA design described above and despite a general understanding that developing country policies have improved on average since 1977, average CPIA results across countries have remained remarkably steady between 1977 and 2008. This appears clearly in Figure 1(a).[8]

Moreover, CPIA results have been concentrating increasingly around the median (Figure 1(b)). One can argue that this steadiness comes from the fact that some developing countries have improved substantially while others have declined. However, in this case, the standard deviation of the CPIA ratings should have risen, whereas it appears that it has decreased since 1985 (Figure 1(c)). According to Gelb, Ngo and Ye (2004), some inertia is to be expected in the ratings because they assess institutions and capacity to implement policies rather than just "stroke-of-the-pen" policy changes. This can cause CPIA scores to lag reform efforts, as better policies can require time to become properly reflected in the ratings. However, the concentration of the results around the same median for thirty years cannot be explained by such a lag, which leads us to question the current relevance of the CPIA. Indeed, if the CPIA criteria have changed while at the same time the scores have remained the same, one can argue that there is some "hidden conditionality" in the CPIA. I come back to this point below. However, one can also propose alternative explanations to this empirical fact, especially the fact that the CPIA is a way to grade countries in a "relative" rather than an "absolute" way, the goal being to sort countries for aid allocation purposes. But this does not explained the decrease in standard deviations, or the higher concentration around the median.

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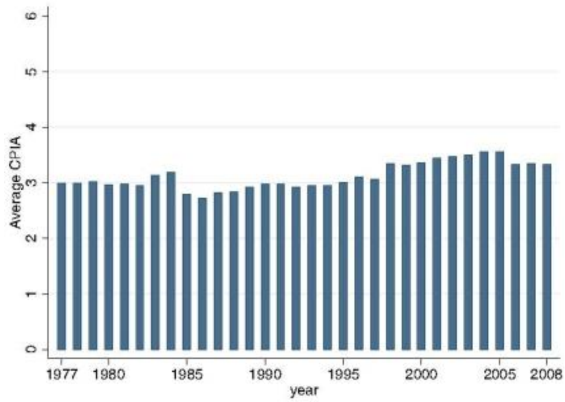
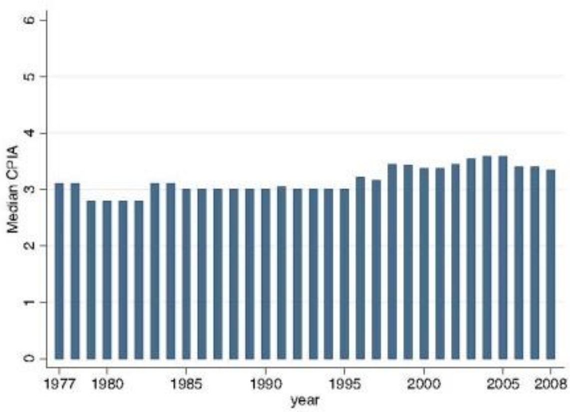
[8] Similarly, Herman (2004) emphasizes *that "although the index was substantially revised in 1998 (and again in 2001) and smaller revisions are made each year, neither the changes in the structure of the CPIA nor in the definitions of individual items seemed to cause significant changes in the rating scores, at least through 2000*." See also World Bank, 2010.

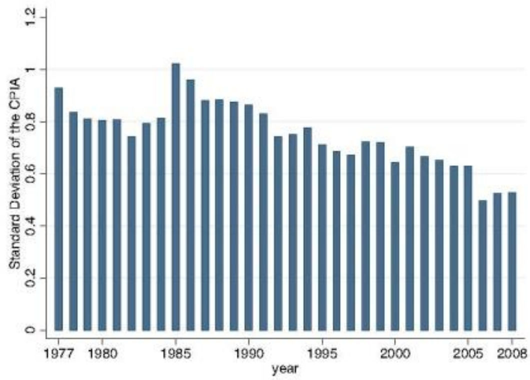
Figure 1: Descriptive Evidence on CPIA, 1977-2008



(a) Average CPIA



(b) Median CPIA



(c) Standard Deviation of CPIA

Note: These figures present some annual descriptive statistics of the CPIA between 1977 and 2008. Figure 1(a) plots the average annual value of the CPIA. Figure 1(b) plots the annual median value of the CPIA. Figure 1(c) plots the annual standard deviation of the CPIA.
Source: CPIA data, World Bank.

If we now look at the average CPIA score by regions, some differences across regions appear (Figure 2). At the end of the 1970s, South Asia had the lowest score with an average score below 3 (Figure 2(e)), followed by Sub-Saharan Africa (Figure 2(a)). However, Asia improved its rating since the end of the 1980s much more than Sub-Saharan Africa. Latin America and the Caribbean also improve their rating during the 1990s (Figure 2(b)). The region which has the best average CPIA score today is Eastern Europe and Central Asia which, despite a slight decrease during the 1990s, is back to its end of the 1970s average score (Figure 2(d)).

However, despite these small changes, it is important to underscore that the average CPIA score for each region has been incredibly stable during the 1977-2008 period. This again goes in the direction of those arguing that there may be today some hidden conditionality that comes with the CPIA.

2.3. THE RELEVANCE OF THE CPIA: REVIEW OF THE EXISTING EVALUATIONS

(A) *EX ANTE* CONDITIONALITY

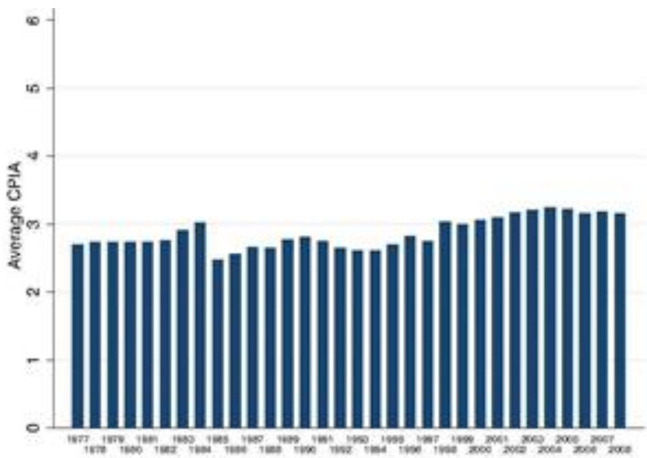
The first caveat of the CPIA is that it relies on policies rather than on outcomes. From this point of view, it corresponds to a model of "*ex ante* conditionality." The main problem of *ex ante* conditionality is that until now it has never worked. As underlined by Stiglitz (1999), "*good policies cannot be bought*."

What is often heard in the public opinion, the criteria on which the CPIA relies are for a very large majority considered as important determinants of growth, poverty reduction and effective use of aid in the literature and are not object of current controversies. A possible interpretation of this finding is that the CPIA may have experienced remarkable changes during the last years with the disappearance of the explicit mention of a set of policy imperatives. For example, it appears that certain lessons of the post-Washington Consensus, such as the hazards of capital account liberalization and the fragility of the financial sector in developing Stiglitz (1998(b)) have filtered through into Bank practice. From this point of view, the CPIA seems to have acquired more relevance.

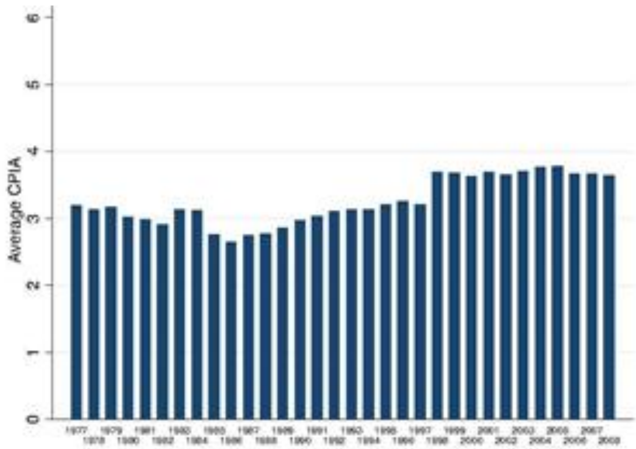
However, as van Waeyenberge (2006) suggests, the meaning of these changes is open to a second possible interpretation. The question could be raised as to whether those imperatives that have disappeared from the narrative guidelines of the CPIAs may have somehow become "embedded" and now steer the CPIA exercise in less visible ways. Van Waeyenberge (2006) illustrates this point with the assessment of trade policy in the 2004 CPIA questionnaire (World Bank, 2004). This questionnaire focuses exclusively on the policy framework regarding trade in goods, without reference to the rules and regulations affecting capital flows. The narrative guidelines on the assessment of the financial sector, in turn, do not make explicit reference to issues regarding foreign investors, state ownership or directed credit. However, van Waeyenberge (2006) argues that closer scrutiny of the guideposts that accompany the narrative guidelines for these respective policy/institutional categories reveals how these specific policy imperatives have in fact been subsumed in the "diagnostic reports" that now serve as guideposts to staff's assessment: "*these typically embody a bias in favor of foreign investment and trade, and are anchored in a framework of traditional welfare economics where government intervention is tolerated only in the context of static market failure.*"

This point follows the lines of those arguing that there is hidden conditionality in the CPIA. This could help explain at least in part the surprising steadiness of the CPIA scores despite the important changes in the criteria.

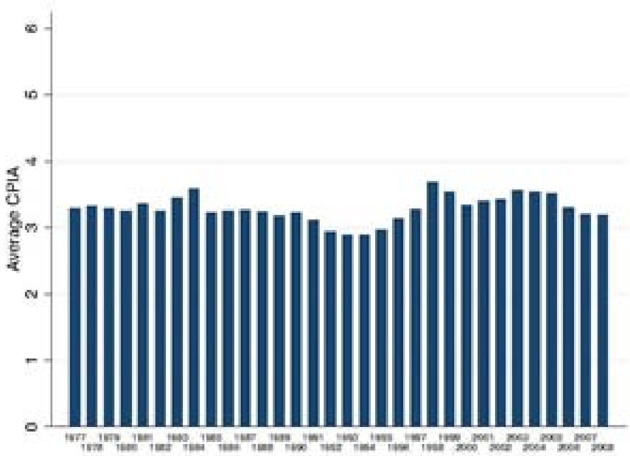
Figure 2: Descriptive Evidence (Average) on CPIA by Region, 1977-2008



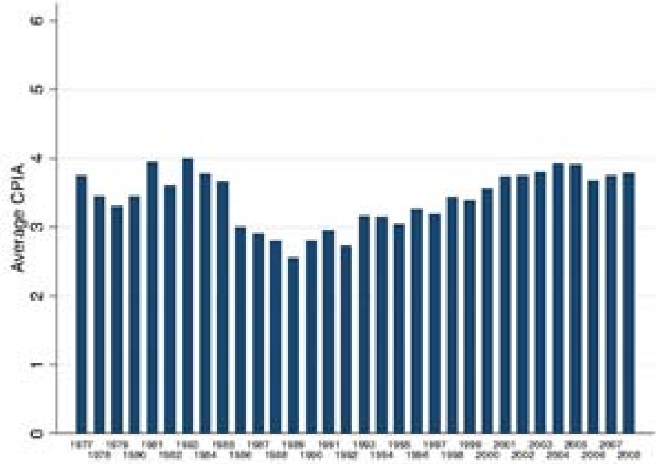
(a) Sub-Saharan Africa



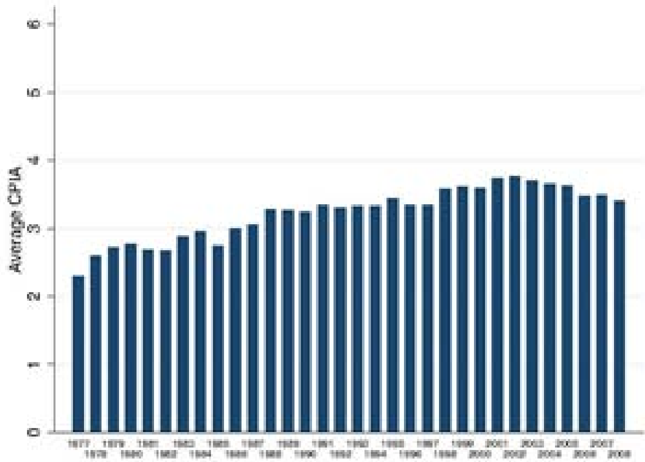
(b) Latin America and the Caribbean



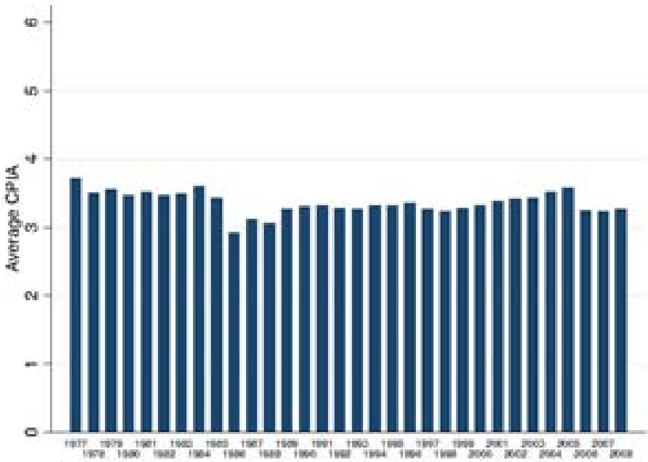
(c) Middle East and North Africa



(d) Eastern Europe and Central Asia



(e) South Asia



(f) East Asia and the Pacific

Note: These Figures present the average annual value of the CPIA by region. Figure 2(a) plots the average annual value of the CPIA for Sub-Saharan Africa; Figure 2(b) for Latin America and the Caribbean; Figure 2(c) for the Middle East and North Africa; Figure 2(d) for Eastern Europe and Central Asia; Figure 2(e) for South Asia and Figure 2(f) for East Asia and the Pacific.
Source: CPIA data, World Bank.

(B) A ONE-SIZE-FITS-ALL APPROACH TO DEVELOPMENT

Another caveat of the CPIA is that it relies too much on a "one-size-fits-all" approach to development while it has been shown in the literature that "*there is no universal recipe*" (Barder and Birdsall, 2006).[9] This point is made in Kanbur (2005) as well as in Cage (2009 (b)). For example as to growth, Cage (2009 (b)) underlines that growth-promoting policies tend to be context-specific: one has to take into account individual country experiences when analyzing the determinants of sustained growth. Even the World Bank seems to have accepted this new emphasis on country specificities. For example, drawing the lessons of the 1990s, the World Bank underlines that "*there*

[9] Similarly, Hoff and Stiglitz (2011) emphasize that *"there are clearly no surefire formulas for success; if there were, there would be more successes."*

is no one right way to achieve development" and that *"which options should be chosen depends on initial conditions, the quality of existing institutions, the history of policies, political economy factors, the external environment, and last but not least, the art of economic policymaking*" (World Bank, 2005).

The CPIA does not correspond to the empirical reality of development. Being the same for every country, it relies too heavily on a uniform model of what works in development policy (Kanbur, 2005). Even if this model were valid "on average," the variations around the average make it an unreliable sole guide to the country-specific productivity of aid in achieving the final objectives of development.

Moreover, the CPIA does not only rely on a uniform model of what works in development policy, but it does so by underlying very specific policies. This clearly appears if one considers the "Policies and Institutions for Economic Cooperation, Regional Integration & Trade" criterion and the "Quality of Budgetary and Financial Management" criterion. They are much more detailed than whatever can be found in the literature, relying on too specific quantitative policies. Moreover, whereas the literature insists on the necessity to set priorities, the CPIA seems to put everything on the same plan.

Relying too heavily on a uniform model, the CPIA thus does not appear to be a good tool for allocating aid, at least conceptually. We show that it is even more the case empirically, since it is not a good predictor for economic growth.

2.4. IS THE CPIA A GOOD PREDICTOR FOR ECONOMIC GROWTH? AN EMPIRICAL ANALYSIS

In this section, I test empirically whether the CPIA is a good predictor for economic, using an annual panel dataset over 146 countries between 1977 and 2008.

(A) DATA DESCRIPTION AND DESCRIPTIVE STATISTICS

In order to determine whether the CPIA is a good predictor for economic growth, I run growth regressions with the CPIA score and the annual change in the CPIA as control variables in a panel of 146 developing countries over the 1977-2008 period.[10] As a dependent variable, I use the growth rate of per capita GDP. Usual controls in cross-country growth equations, used for example in Levine and Renelt (1992), Ramey and Ramey (1995) and Aizenman and Marion (1999), are the initial log level of real GDP per capita; the initial fraction of the relevant population in secondary schools; the initial growth rate of the population; and the average share of trade in GDP over the period. However, since all these controls are fixed at the country level, I choose to introduce directly country fixed effects in all the specifications for robustness reasons. I also control for M2 as a share of GDP lagged one period and aid flows. Panel data on aid flows are taken from the OECD Development Assistance Committee (DAC) annual series. Following Roodman (2006), I use the Net Aid Transfers (NAT) variable for measuring aid flows.[11] Table 1 provides summary statistics for a few key statistics.

Table 1: Summary Statistics[12]

	Mean / sd
CPIA Score	3.16
	(0.77)
CPIA Change	2.10
	(8.13)
Per Capita Growth Rate	1.74
	(5.15)

[10] For the description and the sources of the data in more details see the Data Appendix.

[11] NAT is a net transfer concept, net of both principle payments received on ODA loans and of interests received on such loans. Moreover, NAT excludes cancellation of old non-ODA loans since such cancellation generates little or no additional net transfers.

[12] Numbers in parentheses are standard deviations and the others are averages. Variables are described in the Data Appendix.

Aid/GDP	7.95 (10.93)
Observations	1095

(B) EMPIRICAL SPECIFICATION

Equations are estimated using a panel of eight four-year periods from 1977-1980 through 2005-2008. Thus, an observation is a country's performance average over a four-year period. The averaging over four-year, which is usual in the literature, allows me to avoid the non-stationarity problem for the growth rate.

The baseline empirical specification is:

$$(1) \quad g_{it} = \alpha + \beta \text{CPIA Score}_{it} + \theta \text{CPIA Change}_{it} + \lambda \mathrm{X}_{it} + \vartheta_i + \gamma_t + \ {}_{it}$$

Where i index the countries and t stands for the eight four-year periods (from 1977-1980 to 2005-2008). g is the growth rate of per capita GDP; "CPIA Score" is the average CPIA score over the period; and "CPIA Change" is the average of the annual change in CPIA rating over the period. X_{it} is a vector of control variables that vary with the specification considered. ϑ_i are country fixed effects; γ_t period fixed effects; and ${}_{it}$ is a country-period shock.

I estimate equation (1) using both OLS with robust standard errors and two-step Arellano-Bond GMM (Tables 2 and 3). The use of two-step Arellano-Bond GMM is driven by possible endogeneity concerns. The advantage of the system GMM method is that it helps to overcome endogeneity concerns in the absence of any strictly exogenous explanatory variables or instrument.[13] The results are robust to both methodologies.

[13] When I estimate my regressions using two-step system GMM, I thus use the forward orthogonal deviations transform instead of first differencing because it maximizes the sample size in panel with gaps (Roodman (2006)). The forward orthogonal deviations transform is an alternative to differencing proposed by Arellando and Bover (1995) that preserves sample size in panel with gaps. Indeed, instead of subtracting the previous observation from the contemporaneous—what does the first-difference transform which thus magnifies gaps in unbalanced panels—it subtracts the average of all future

(C) RESULTS

Tables 2 and 3 presents the results of the impact of performance as measured by the CPIA score and the annual changes in this score on the growth rate of per capita GDP (estimation of equation (1)). I find a positive and statistically significant coefficient for the CPIA score using both OLS and two-step Arellano-Bond GMM (columns 1 and 2). I also find a positive impact of the annual change in the CPIA rating but it is not statistically robust to the use of two-step Arellano-Bond GMM. However, these estimates do not prove causality. As acknowledged by Gelb Ngo and Ye (2004) despite the use of clear benchmarks to derive CPIA ratings, it is possible that assessments are colored by perceptions of "how well the country is doing" which are influenced by recent growth trends. In this case, the positive coefficient I obtain for the CPIA score would simply reflect the fact that CPIA scores themselves respond to observed growth rates and so is not indicative of the fact that this score can be interpreted as a good predictor for growth rates.[14]

In the "Staff Guidance Notes" used by the World Bank staff in order to measure policy performance, it is strongly emphasized that the only thing that has to be taken into account is the short term: "*The write-up should focus on the developments of the past one calendar year (...). Unless absolutely necessary, staff are not expected to report developments of more than two years ago in the write-up.*"; "*Policy performance should be rated against the CPIA criteria, rather than the degree of improvements from the previous year, and in relation to the ratings of the benchmark countries*." This emphasis on the short term can explained while the assessments are colored by the current growth rates.

In order to test whether or not the CPIA score can be interpreted as a good growth predictor, I introduce as a control variable the CPIA score lagged one period. Obviously, this cannot be determined by the

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available observations of a variable. No matter how many gaps, it is computable for all observations except the last for each individual, so it minimizes data loss. And since lagged observations do not enter the formula, they are valid instruments.

[14] Similarly, Glaeser *et al* (2004) underline that indicators measuring the quality of institutions, supposed to explain economic growth, are in fact the result and not the cause of economic growth.

current growth rate. But if I were to find a strong positive correlation between the CPIA score lagged one period and the following period growth rate, then the CPIA score could be interpreted as a good predictor of future growth.

When I estimate equation (1) with this new control, I find a negative and statistically significant coefficient for the CPIA score lagged one period, using both OLS and two-step Arellano-Bond GMM (column 3). This means that the contemporaneous correlation between the CPIA score and the growth rate comes from the fact that assessments are colored by current perceptions of country performances. More importantly, this means that the CPIA score is a very bad predictor for future growth rates since the countries with the lowest CPIA scores one period ago are those that do better in terms of growth during the following period. Moreover, the coefficient for the CPIA score lagged one period is negative (and statistically significant for Arellano-Bond GMM) whether or not I include in the regression the current CPIA score (column 4).

One can argue that these estimates do not distinguish between the effect of performance as measured by the CPIA and other influences on growth that may themselves reflect the CPIA rating. For example, growth in high-performing countries may be partly driven by increased AID flows in response to higher CPIA scores. In order to control for these other influences, I include aid flows normalized by GDP as a control variable (column 5) as well as the square of these flows to control for decreasing returns of aid (column 6). The introduction of these controls, whether I use OLS and Arellano-Bond GMM estimations, or 2SLS and 2-step feasible IV/GMM in order to control for aid endogeneity, does not change the results (columns 5, 6 and 7).[15]

Finally one can claim that the negative and statistically significant coefficient I obtain for the CPIA score lagged one period comes from the presence of some outliers in the sample. In order to check whether this is the case, I identify influential observations using the method of Hadi (1992), which classifies nine observations as outliers

[15] In columns 6 and 7 aid flows are instrumented by the correlation of the country votes with those of the US in the UNGA lagged one period.

at the 5 percent level.[16] Removing these observations does not change the results (column 8).

The negative coefficient I obtain for the CPIA score lagged one period thus seems to be robust. It appears that the CPIA is not a good predictor of economic growth.

Table 2 : OLS and 2SLS Estimation[17]

	1 OLS b/se	2 OLS b/se	3 OLS b/se	4 OLS b/se	5 OLS b/se
CPIA Score	1.819***	1.561***	1.954***		1.957***
	-0.352	-0.408	-0.406		-0.41
CPIA Change		0.060*	0.015		0.015
		-0.032	-0.036		-0.035
(One-Period) Lag of CPIA Score			-0.923**	-0.348	-0.981**
			-0.423	-0.419	-0.435
Period and Country FE	Yes	Yes	Yes	Yes	Yes
Aid	No	No	No	No	Yes
Aid Square	No	No	No	No	No
Outliers Included	Yes	Yes	Yes	Yes	Yes

[16] Angola in the 2005-2008 period; Azerbaijan in the 1993-1996 and 2005-2008 periods; Equatorial Guinea in the 1997-2000 and 2001-2004 periods; Liberia in the 1989-1992 and 1997-2000 periods; Tajikistan in the 1993-1996 period; and Ukraine in the 1993-1996 period.

[17] * p<0.10, ** p<0.05, *** p<0.01. Table 2 reports OLS and 2SLS estimates. Table 3 reports Arellano-Bond GMM estimates The unit of observation is a country/period. Standard errors in parentheses are robust. The dependent variable is the growth rate of per capita GDP. The endogenous variable for the 2SLS estimations are the aid ows. The excluded exogenous variable for the 2SLS estimations is the correlation of the country votes with those of the US in the UNGA lagged one period. All the regressions include M2 as a share of GDP as a control. The controls are described in more details in the text.

R-sq	0.48	0.53	0.54	0.51	0.54
Observations	766	748	734	734	722

	6	7	8
	OLS	2SLS	2SLS
	b/se	b/se	b/se
CPIA Score	1.889***	1.958***	2.297***
	-0.425	-0.568	-0.426
CPIA Change	0.014	0.005	-0.032
	-0.035	-0.038	-0.032
(One-Period) Lag of CPIA Score	-0.993**	-0.954**	-0.855**
	-0.436	-0.468	-0.361
Period and Country FE	Yes	Yes	Yes
Aid	Yes	Yes	Yes
Aid Square	Yes	No	No
Outliers Included	Yes	Yes	No
R-sq	0.54	0.49	0.56
Observations	722	658	653

Table 3: GMM Estimation[18]

	1	2	3	4	5
	GMM	GMM	GMM	GMM	GMM
	b/se	b/se	b/se	b/se	b/se
CPIA Score	1.766***	1.516***	1.446***		1.491***
	-0.365	-0.343	-0.338		-0.339
CPIA Change		0.042	0.006		0.008
		-0.031	-0.036		-0.037
(One-Period) Lag of CPIA Score			-1.205***	-1.433***	-1.271***
			-0.42	-0.362	-0.427
Period and Country FE	Yes	Yes	Yes	Yes	Yes
Aid	No	No	No	No	Yes
Aid Square	No	No	No	No	No
Outliers Included	Yes	Yes	Yes	Yes	Yes
Observations	591	571	559	563	547

[18] 18 * $p<0.10$, ** $p<0.05$, *** $p<0.01$. Table 2 reports OLS and 2SLS estimates. Table 3 reports Arellano-Bond GMM estimates The unit of observation is a country/period. Standard errors in parentheses are robust. The dependent variable is the growth rate of per capita GDP. The endogenous variable for the 2SLS estimations are the aid ows. The excluded exogenous variable for the 2SLS estimations is the correlation of the country votes with those of the US in the UNGA lagged one period. All the regressions include M2 as a share of GDP as a control. The controls are described in more details in the text.

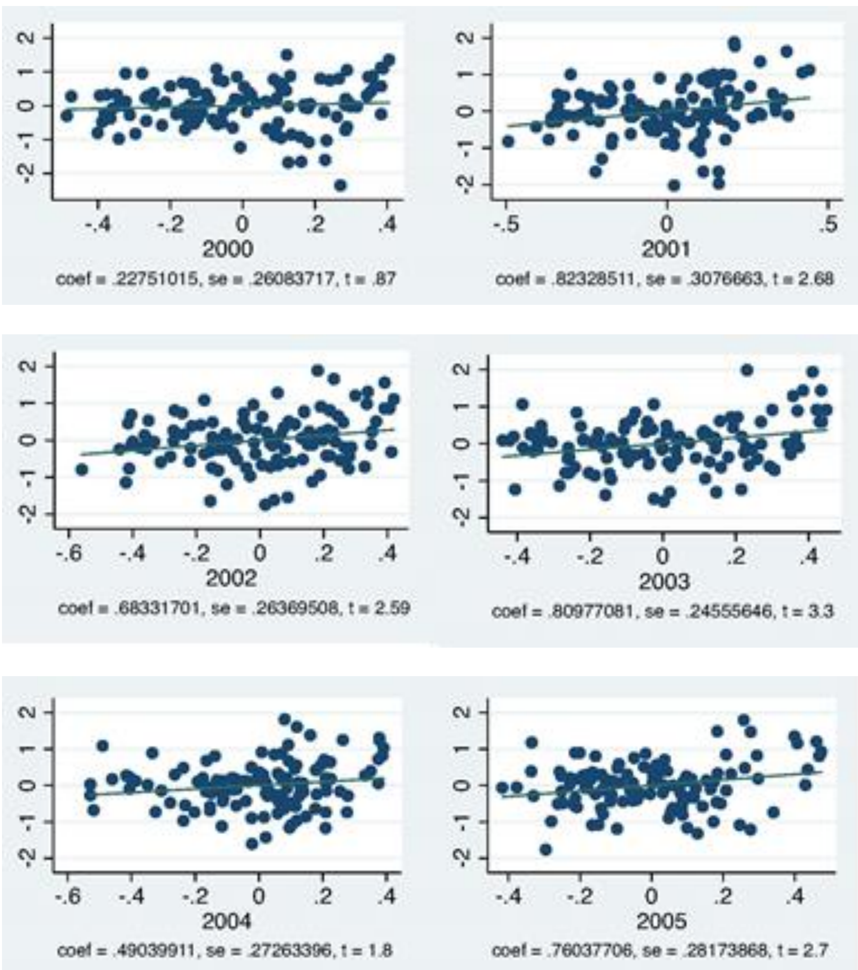
	6	7	8
	GMM	IV GMM	IV GMM
	b/se	b/se	b/se
CPIA Score	1.487***	1.958***	2.297***
	-0.345	-0.561	-0.42
CPIA Change	0.008	0.005	-0.032
	-0.037	-0.038	-0.032
(One-Period) Lag of CPIA Score	-1.280***	-0.954**	-0.855**
	-0.427	-0.463	-0.357
Period and Country FE	Yes	Yes	Yes
Aid	Yes	Yes	Yes
Aid Square	Yes	No	No
Outliers Included	Yes	Yes	No
Observations	547	656	651

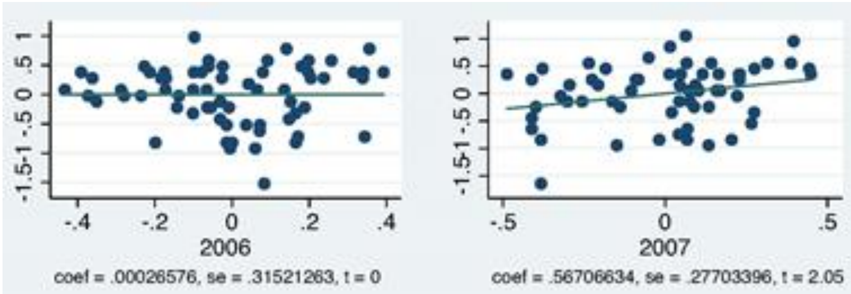
(a) VOTES IN THE UNGA

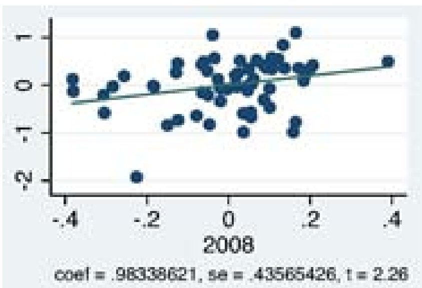
I finally find that there is a strong and statistically significant positive correlation between the CPIA scores of developing countries and the correlation of their votes with those of the US in the UNGA. This appears clearly in Figure 3. For each year between 2000 and 2008, I plot the relationship between the correlation of the votes with those of the US in the UNGA and the CPIA score of the countries. It appears clearly that this relationship is positive and statistically significant: the higher the correlation of the votes, the higher the CPIA score.

Obviously, correlation is not causality, but it seems hard to find an intuitive causal link going from the CPIA score to the correlation of the vote in the UNGA. On the contrary, one can argue that CPIA scores are biased in favor of countries having political links with the US. Moreover, if one remembers that the literature on aid allocation has shown that aid may be used to buy political support from the recipients of aid (Alesina and Dollar, 2000; Alesina and Weder, 2002; Schraeder *et. al.*, 1998; Kuziemko and Werker, 2006), another interpretation could be that countries to which the World Bank is willing to give more aid received a higher CPIA score in order for these countries to effectively receive more aid through the Bank allocation formula. Whatever the precise sense in which that might or might not be the case, this questions the relevance of the CPIA.

Figure 3: CPIA Score and the Correlation of the Votes with those of the US in the UNGA, 2000-2008







These Figures present for each year between 2000 and 2008 correlation between the CPIA scores of developing countries and the correlation of their votes with those of the US in the UNGA.
Source: CPIA data are from the World Bank; Correlation of the Votes with those of the US in the UNGA data has been constructed by the author using UNGA Votes data from Erik Voeten.

The CPIA, despite all the recent modifications and improvements that have been made and need to be acknowledged, thus still appears as a blunt and biased tool that can and should be improved upon.

3. HOW CAN WE IMPROVE UPON THE CPIA?

In this section I first underline the fact that other criteria, and in particular the role of the state and the quality of industrial policy need to be taken into account into the CPIA. Focusing more specifically on the allocation of development aid, I then consider the alternative proposals to the CPIA that have been formulated in the literature and in particular the one of Kanbur (2005). I finally make concrete proposals for the development of new possible allocations based on the idea of using "aid effectiveness" as an allocation tool.

3.1. INTRODUCING NEW CRITERIA INTO THE CPIA

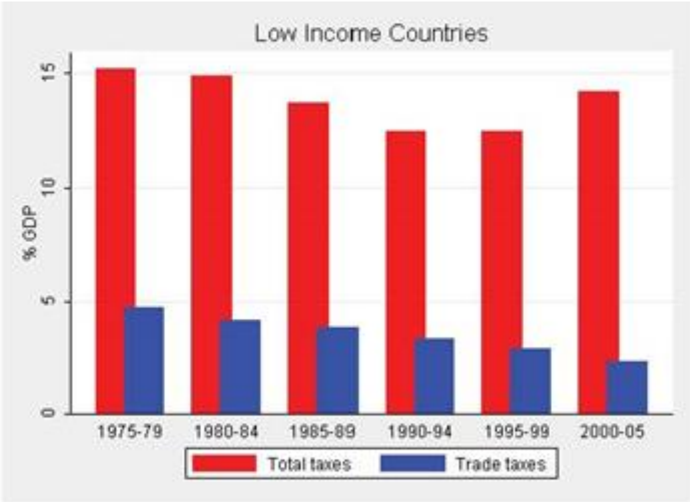
There is still nothing in these criteria related to what could bring sustained growth to developing countries, for example fiscal capacity or industrial policy. The words "fiscal capacity" or "industrial policy" do not even appear in the 103 pages of the "Staff Guidance Notes" for the 2012 CPIA. As I will underline it below, there is similarly nothing on export promotion strategies despite the fact that it is widely acknowledged that all successful liberalizations either explicitly or implicitly promoted export growth. The CPIA only emphasizes the necessity to remove trade restrictions.

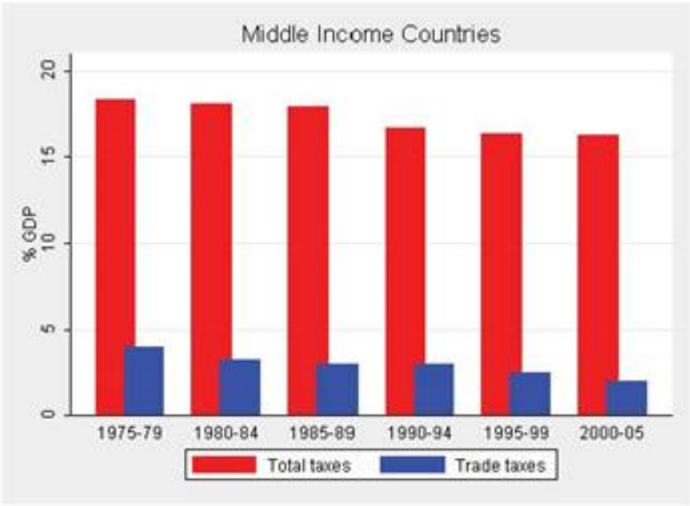
(A) THE ROLE OF STATE BUILDING AND FISCAL CAPACITY

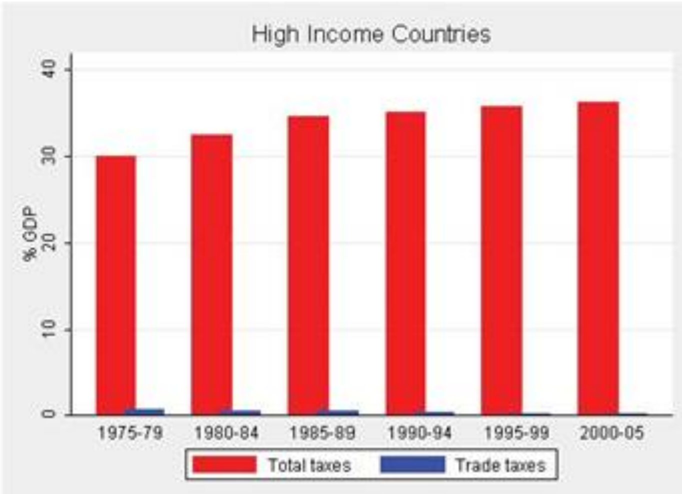
The CPIA clearly underestimates the role that a well-functioning government can and must play in the development process. This is striking when one considers the "trade criteria" in which it is underlined that "*MFN tariffs have been streamlined into a limited number of tariff bands in many countries, so CPIA ratings should reflect how distortionary is the overall structure of trade taxes, including not just tariffs but also other border taxes*."

From this point of view, the CPIA totally ignores the fiscal consequences of trade liberalization, while trade liberalization can have a very negative impact for developing countries in terms of tax revenues as shown by Cage and Gadenne (2012). Trade taxes are indeed an important source of revenue for developing countries. These revenues have fallen over the past decades as these countries liberalized trade. Many developing countries simultaneously experienced a decrease in their total tax revenues. These appears clearly in Figure 4 from Cage and Gadenne (2012). Using a novel panel dataset of tax revenues and government expenditures in developing countries between 1945 and 2006, Cage and Gadenne (2012) identify 110 episodes of decreases in tariff revenues. They show that less than half of the countries recover the lost tax revenues 5 years after the start of the episode. Moreover they find a similar picture when they consider government expenditures.

Figure 4: Evolution of tax revenues as a share of GDP, 1975-2005 (Cage and Gadenne, 2012)







Note: All values are median values for the country group and time period considered. The sample includes in each time period 26 low income countries, 40 middle income countries and 32 high income countries.
Source: Cage and Gadenne (2012).

The questions are thus the following: how to deliver a proper education, health and infrastructure system with tax revenues representing less than 15 percent of GDP, creating a clear competitive disadvantage for developing countries? And how to bring sustained growth without a proper education, health and infrastructure system? In order to levy domestic taxes—and so to be able to open itself to international trade—a country needs pre-existing tax capacity. These tax capacities are not taking into account in the CPIA. I argue in favor of their inclusion as one of the main criterion rather than only emphasizing the necessity to remove trade restrictions.

(B) EXPORT PROMOTION POLICIES

Similarly, while the CPIA only emphasizes the necessity to remove trade restrictions, efficient export promotion policies may have an important role to play and should be taken into account. Cage and Rouzet (2012) show for example that export subsidies may have a positive welfare effect on exporting developing countries by improving both the average quality of their exports and their terms of trade. They study the effect of firm and country reputations (the famous "made in" label) on exports when buyers cannot observe quality prior to purchase. Measuring national reputations by analyzing the content of US newspaper articles about foreign countries over the period 1988-2006, they find that more positive news coverage of foreign countries and companies is associated with higher unit values of the exports to the United States, particularly in sectors with larger scope for vertical differentiation. They rationalize this finding in a model in which firm-level demand is determined by expected quality which depends on both past experience with good and country of origin's reputation. Asymmetric information acts as barrier to entry for high-quality firms but facilitates sales by "fly-by-night" low-quality firms. Countries with a bad quality reputation can thus be locked into exporting low-quality, low-cost goods. In this case, export subsidies have a positive welfare effect on exporting countries.

The findings of this paper are consistent with the success of some export-led growth strategies for developing countries. East Asian economies in particular pursued a few decades ago strategies consisting on exporting low-quality, low-cost goods and gradually moving up to higher quality, higher unit value goods.[19] China is currently attempting to follow the same path. This is for example the strategy of Lenovo, the only Chinese company to get a worldwide sponsorship for the Beijing Olympics. With a Western sounding name, the legacy of IBM brand name and technology and the chief executive from Dell and NCR, Lenovo Group is not a company that most Americans would assume is Chinese. This is exactly what the company aims for, although Lenovo's

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[19] At the end of the Second World War, "Made in Japan" goods had the reputation of being cheap low-quality goods. Japanese companies were suffering from an inferior "national brand." Currently, Japanese cars and electronics ranked among the most reliable in all consumer surveys. Japan's pattern of specialization in manufactures has evolved dramatically. Japanese companies achieved such a dramatic change by privately imposing strict quality norms. They formed export cartels which provided product quality guarantees. In particular, they set product design and quality standards; established industry brand names; guaranteed delivery schedules; and mediated the disputes between exporters and foreign buyers.

largest shareholder is the Chinese government, because it is aware of fact that the American consumer associates Chinese products with cheap and unreliable.

Without policy intervention, moving up to higher quality exportations may not be feasible if the economy is trapped in a self-fulfilling low equilibrium, in which country's reputation for low quality prevents high-quality firms from entering the export markets. In this case, a successful export promotion policy would consist in subsidizing exporters' initial losses or investing public resources into raising country's perception abroad. This is why the quality of the industrial policy—and for example the fact of having an efficient export promotion strategy—has to be taken into account in the CPIA.

3.2. CRITERIA FOR AID ALLOCATION

One of the main uses of the CPIA is as a criterion in the development aid allocation formula. Indeed, when a country is eligible to the International Development Association (IDA)—the development aid agency of the World Bank—the IDA formula to allocate aid is made of four different terms: (i) the CPIA; (ii) the portfolio performance which is used to determine a rating for each country's implementation performance; (iii) population; and (iv) per capita income.[20] The combination of the CPIA and of the portfolio performance forms the Country Performance Rating (CPR):

$$\text{CPR} = 0.24 \times \text{CPIA}_{A-C} + 0.68 \times \text{CPIA}_{D} + 0.08 \times \text{Portfolio}$$

CPIA_{A-C} stands for the clusters A through C of the CPIA; CPIA_{D} for the cluster D; and Portfolio for the portfolio performance rating.

The IDA allocation formula is then computed as follows:

[20] In order to be eligible to the IDA resources, a country has to meet two criteria. First, its relative poverty defined as GNI per capita as to be below an established threshold which is updated annually (in fiscal year 2010: $1,135). Second, it has to lack creditworthiness to borrow on market terms and therefore to need concessional resources to finance its development program.

$$\text{IDA Country Allocation} = F\left[\text{CPR}^{0.5}, \text{Population}^{1.0}, \left(\frac{\text{Gini}}{\text{Population}}\right)^{-0.125}\right]$$

In the last part of this article, I study alternative tools to the CPIA to allocate aid in the most effective way.

(A) EXISTING ALTERNATIVE PROPOSALS TO THE CPIA

(a) KANBUR'S PROPOSAL

Underlying that the CPIA implicitly relies too heavily on a uniform model of what works in development policy, Kanbur (2005) proposes to introduce outcome variables in the development aid allocation formula.

Indeed, as it clearly appears from the formula, the IDA essentially captures needs through the income criterion, and does not go directly to indicators such as infant mortality, maternal mortality, girls' education and other components of the Millennium Development Goals. Moreover, the CPIA itself does not contain any final outcomes variables like poverty, extreme poverty, girls' enrollment, etc. What it has instead is a series of intermediate variables like trade policy, regulatory policy, property rights, corruption, etc.

On the contrary, Kanbur (2005) argues in favor of an outcomes-based aid allocation, or at least in favor of introducing some outcome variables in the CPIA itself. [21] His main idea is to measure the needs side by side with the levels of the outcomes one is interested in, while measuring the performance side by side with the rate of improvement of these outcome variables over a given period of time up to the point of assessment, suitably normalized by the total aid flow over this period. He gives the following example: a country that has very low levels of girls' enrollment in primary schools should get more aid on grounds of need. But a country that is showing rapid improvements of girls' enrollment from this low level, relative to the aid it is receiving, should

[21] *"While leaving the current IDA allocation methodology essentially intact, IDA should introduce one new category of scoring in the CPIA. This category should evaluate the evolution of an actual development outcome variable up to the present. The choice of variable is open."*

get even more. A country that is showing relatively slow rates of improvement should get relatively less on account of this measure of performance. The main advantage of this focus on outcomes is that it prevents the easy temptation of a "one-size-fits-all" approach to development.

As he acknowledges himself, this proposal is in the spirit of Collier's outcomes-based allocation (Collier *et. al.*, 1997). They propose a basis for aid allocation in terms of retrospective assessment of a few major outcomes such as growth. They show how outcome measures can control for influences on growth over which the government has no control and argue that donors should switch from attempting to "purchase" a pre-specified menu of policy changes to the allocation of aid on the basis of periodic overall assessments of government achievements.

Similarly, Barder and Birdsall (2006) defend the idea of "*payments for progress*," the main objective being to link additional aid to clear evidence on progress already achieved on the ground. In order to do so, payments would be determined as a function of the outcomes and not linked to the implementation of any particular policies, any other intermediate outputs, or tied to purchases from particular suppliers or companies.

(b) ADVANTAGES OF KANBUR'S PROPOSAL

One of the main advantages of the Kanbur's proposal is that it relies on performance-based measures—on actual performance—and so does not imply *ex ante* conditionality. Indeed, rating countries according to their rates of improvement of certain outcomes rather than according to their policies corresponds to an "*ex post*" approach of conditionality. From the point of view of this approach, one has to reward countries that used past aid well (*ex post* conditionality) without conditions (*ex ante* conditionality). This is in the spirit of the Paris Declaration (2005) and of the following Accra Agenda for Action (AAA) (2008):

> *Developing countries and donors will work together at the international level to review, document and disseminate good practices on conditionality with a view to reinforcing country ownership and*

other Paris Declaration Principles by increasing emphasis on harmonized, results-based conditionality"

This is an important improvement on the CPIA since, as I underline above, using *ex ante* conditionality is a very inefficient way to allocate aid.

Moreover, the Kanbur's proposal is a useful improvement since it underlines that the CPIA relies excessively on a "one-size-fits-all" approach to development and proposes a way to overcome this difficulty with the use of outcome variables. Finally, his proposal is very well argued and he anticipates various criticisms.

(c) LIMITS OF KANBUR'S PROPOSAL

Given all the advantages of the Kanbur's proposal, the only criticism made by Buiter (2007) to this proposal that seems acceptable is the one according to which realized past outcome changes as a measure of future aid productivity: *"the aid could have been looted, diverted or wasted, that is, not even spent on any activity likely to boost the indicator, and the improvement in the indicator could have been produced by domestic or foreign factors that have nothing to do with the aid dispensed during the benchmark period, but never mind...."*[22] In other words, the Kanbur's proposal relies on the implicit assumption that past output indicators are a good guide to future aid productivity. And this is still to be shown.

Similarly, McGillivray (2004) underlines that Kanbur (2005)'s proposal does not really provide an understanding of what makes aid works. This is why he argues in favor of more radical changes to the IDA formula than outlined in the Kanbur's proposal. According to him, what is required is a better knowledge of what makes aid work and the revisions to aid allocation formula should be considered in this light.

(B) THE NEED FOR AN AID PRODUCTIVITY MEASURE

What emerges clearly from the criticisms of both the CPIA and the Kanbur proposal—and more generally of any outcomes-based

[22] Similarly, Collier *et. al.* (1997) acknowledge that "one disadvantage with switching from policies to outcomes is that it can reward good luck."

allocation—is that what is needed is an aid productivity measure. The CPIA is not an aid productivity measure, being excessively focused on a "one-size-fits-all" approach of development. An outcomes-based allocation would not overcome this difficulty. In order to overcome it, one needs to establish a clear statistical link between past outcomes and future aid productivity. This has never been done and seems hardly feasible. Indeed, this supposes first to evaluate the elasticity of this outcome variable with respect to aid (which can be interpreted as aid productivity). Second, this supposes to evaluate the elasticity of aid productivity with respect to past changes in this outcome variable. In both steps of the estimation, one would be faced with endogeneity and omitted variables concerns. Moreover, in case one would like to introduce not one but various measures of outcomes, the estimation would be even more complicated by the fact that these outcomes may be interdependent. And then it remains to determine the optimal weight to give to each of these outcomes.

Well aware of all these difficulties but at the same time of the real need for an aid productivity measure, I discuss below a new way to approaching this issue. The idea is to use directly aid effectiveness as such a measure.

(a) A NEW APPROACH: USING AID EFFECTIVENESS TO ALLOCATE AID EFFECTIVELY

Aid effectiveness has to be defined with respect to a given outcome, which has to be chosen by donors when they establish their selectivity criteria. This can be the growth rate of the economy; the reduction in the poverty rate; the rate of girls' enrollment or other goals depending both on donors' priorities and recipient countries specificities. Aid is said to be very effective if aid elasticity with respect to the outcome is very high. For example, if the outcome is the growth rate, the higher aid elasticity with respect to growth—i.e. the more the growth rate increases for each increase in the aid flows received—the more aid is effective.

Generally, in order to compute aid effectiveness, one would like to estimate the following equation for each country i and year t:

$$(2)\quad \text{Outcome}_{it} = \alpha + \beta_{it}\frac{\text{Aid}}{\text{GDP}_{it}} + \gamma X_{it} + \epsilon_{it}$$

Where $\epsilon_{it} \sim \mathrm{N}(0, \sigma_\epsilon^2)$

β_{it} measures aid effectiveness. Outcome_{it} is the outcome of interest (for example the growth rate of per capita GDP) and $\frac{\text{Aid}}{\text{GDP}_{it}}$ are the aid flows normalized by GDP. X_{it} is a vector of control variables. ϵ_{it} is a year-country shock. All the coefficients in equation (2) are time-varying, which is why I write β_{it} to denote the coefficient on aid in country \$i\$ at year \$t\$.

The difficulty comes from the fact that with the econometric methods that are usually used the equation one estimates is not (2) but:

$$(3)\quad \text{Outcome}_{it} = \alpha + \beta_i \frac{\text{Aid}}{\text{GDP}_{it}} + \gamma X_{it} + \epsilon_{it}$$

Where $\epsilon_{it} \sim \mathrm{N}(0, \sigma_\epsilon^2)$

That is, one only computes one coefficient for each country i and the entire time period (β_i) and not one coefficient country i and year t (β_{it}). In other words, one cannot estimate aid effectiveness annually.

One way to estimate aid effectiveness annually—to implement the estimation of equation (2)—is to use the "local Gaussian-weighted ordinary least squares" method (used for example by Aghion and Marinescu (2007)). The basic idea of this method—which is also called kernel-based nonparametric regression or local smoothing—is to put more weight on the most recent years. For each year, points that are closer in time are given more weight than points that are further away. More precisely, all the observations are weighted by a Gaussian centered at date t but, since to estimate aid effectiveness in t one only wants to use the information available for the years preceding t, I put a zero weight on the years following t.

Under this method, jumps in the coefficient β are mainly due to changes in the immediate neighborhood of date t, as those observations in the immediate neighborhood of date t are given highest weight. Hence, if there is a change in the aid effectiveness coefficient in t—say an increase—this comes from the fact that the country has improved its effective use of aid in t. And so in terms of aid allocation, it has to be rewarded for this improvement.

Using the local Gaussian-weighted ordinary least squares method, one could thus estimate an aid effectiveness coefficient for each country and each year. However, aid can be endogenous which can lead to biased results.[23] In order to deal with these endogeneity problems, one can use Gaussian-weighted two-stage least squares instrumenting for aid. It is however important to underline that the relevance of the method is totally independent of the instrument choice.

Using Gaussian-weighted two-stage least squares, one could thus obtain a time-varying measure of aid effectiveness, with one coefficient per year and per country. These coefficients can be interpreted as an estimate of aid elasticity with respect to the outcome of interest, i.e. a measure of the country performance with respect to aid effectiveness. This tool could thus be used to reward good "aid performer." Doing so, it helps overcome one of the main weaknesses of the outcomes-based allocations that have been proposed until now in the literature: it does not reward good luck. Indeed, a country can have one given year for example a very high growth rate and at the same time obtain a very low coefficient for aid effectiveness if it did not use aid in an effective way. In this case, its aid allocation decreases despite its good growth performance. The tool I propose only relies on the implicit assumption that past aid effectiveness is a good guide to future aid effectiveness. This is a weaker and more relevant assumption than the one according to which past output indicators are a good guide to future aid effectiveness.

One can also choose to normalize the coefficients obtained using local Gaussian-weighted ordinary least squares by the "global" aid effectiveness coefficient obtained by performing equation (3) for all the countries of the sample taken together (cross-countries regression with country fixed effects). Another possibility could be, rather than to normalize by the cross-countries coefficient, to take into account for each country the performance of its neighbors, for example using the geographical distance. Indeed, there may be some externalities created

[23] This endogenity can come from (i) reverse causation: growth causes aid (e.g. the higher its growth rate, the less aid a country receives because it does not need it); or (ii) simultaneous causation: an omitted variable causes both aid and growth.

by an increase or a decrease in aid effectiveness in a country for its neighbors.

A possible caveat of such a measure is that it does not take into account how donors can have an impact on aid effectiveness. Implicit here is indeed the assumption that aid performance is only the consequence of decisions of the recipient country itself and not of somebody else. But aid effectiveness does not depend only on the behavior of the recipient countries but also on the donor's behavior and one does not want recipients to suffer from bad behavior of donors. One possibility would be to control for an index of donor performance.

Similarly, aid effectiveness can be affected by events not depending only on the recipient's economic policy, for example exogenous shocks like natural disasters. One would have to be very careful in controlling for these exogenous shocks.

Despite these caveats, I think that using and aid effectiveness coefficient—together with other indicators—to allocate aid would be a relevant tool. Indeed, with such a tool, one does not give aid to countries that are the best performers for example in the sense of having a higher rate of girls' enrollment and so perhaps are not the one which need it the most, but to the countries where aid will be used in the most efficient way. That is to say, to the countries that have a sufficient absorptive capacity for receiving higher aid flows. It could help allocating a scarce resource in the most efficient way.

4. CONCLUSION

In this article I question the relevance of the different measures of policy performance that are currently used. I evaluate more especially the pertinence of the CPIA and of the various alternatives that have been proposed in the literature.

Using a yearly panel dataset over 146 countries between 1977 and 2008, I show that the CPIA is correlated with current growth rates but that it is not a good predictor for future economic growth. I thus argue in favor of other measures of policy performance. I underline the need of introducing new criteria when measuring policy performance. In particular, I show that more weight has to be given to the role of the government in the development process, which supposes to take into account its fiscal capacity. Fiscal capacity is indeed of crucial importance for raising domestic tax revenues. I also underline the importance of the quality of industrial policy and especially of export promotion strategies on the path towards sustained growth.

I then focus more specifically on the allocation of development aid which is of great importance given both the scarcity and need for aid. I show that performance-based measures, as opposed to measures implying *ex ante* conditionality, are more accurate instruments for aid allocation. However, performance-based measures proposed in the literature do not help overcome the difficulty of estimating the elasticity of aid effectiveness with respect to outcome-based performance indicators. They let unsolved the question of whether when a donor rewards a recipient for its good performance with respect to a given outcome variable it is not rewarding "luck" rather than an effective use of aid.

Since in order to allocate aid effectively it appears essential to evaluate the elasticity of aid effectiveness with respect to performance indicators, I discuss a new tool based on this elasticity. Using new econometric methods, I show that one could use a time-varying measure of aid effectiveness as an indicator of the performance of a country with respect to aid efficiency. This tool shares with an outcome-based allocation the advantage of not relying on *ex ante* conditionality. Moreover, it is an improvement upon this outcome-based approach since it is a way to reward good "aid performer" rather than good "luck."

Needless to say, more research on aid effectiveness indicators is necessary before they can be applied. The tool could indeed be used by different donors with different goals (growth, poverty, education and so on.). This is an important characteristic because different criteria can be used given the complexity of the relationship between aid, growth and poverty reduction, depending on the recipient country specificities and on the donor preferences. The downside is that aid effectiveness coefficients might be too volatile to be used as single indicators. In my view, the most promising avenue is to use them together with other key development indicators such as investment in fiscal capacities.

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APPENDIX

DATA SOURCES AND DESCRIPTION

Aid: Net Aid Transfers (NAT). Source: DAC.

CPIA: Country Policy and Institutional Assessment. Annual performance assessment of its client countries' capacity to effectively absorb development assistance carried out by the World Bank since 1977. Source: World Bank.

Per capita GDP growth rate: Annual percentage growth rate of per capita GDP at market prices based on constant local currency. Source: WDI.

M2 (percent GDP): Money and quasi money comprise the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government. Source: WDI.

UNus: Annual correlation of voting records in UNGA between recipient and the US (-1 to 1). Source: Erik Voeten.

Table 4: CPIA Criteria 2008

A. Economic Management
1. Macroeconomic Management
2. Fiscal Policy
3. Debt Policy
B. Structural Policies
4. Policies and Institutions for Economic Cooperation, Regional Integration & Trade
5. Financial Sector
6. Business Regulatory Environment
C. Policies for Social Inclusion/Equity
7. Gender Equality
8. Equity of Public Resource Use
9. Building Human Resources
10. Social Protection and Labor

11. Environmental Policies and Regulations

D. Governance Rating: Public Sector Management and Institutions

1. Property Rights and Rule-based Governance
2. Quality of Budgetary and Financial Management
3. Efficiency of Revenue Mobilization
4. Quality of Public Administration
5. Transparency, Accountability, and Corruption in the Public Sector

Source: World Bank, 2008

IS INDUSTRIAL POLICY NECESSARY AND FEASIBLE IN AFRICA?

Theoretical considerations and historical lessons

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Abstract

Even as the general attitude towards industrial policy becomes more positive, its applicability to Africa continues to be treated with scepticism. The article asks whether Africa is uniquely incapable of implementing successful industrial policy. Various arguments of general 'Afro-pessimism'—based on climate, geography, history, and culture—are first criticised. Then four types of constraints on the success of industrial policy in Africa—natural resource abundance, political

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economy, bureaucratic capabilities, and the changes in global economic rules—are critically reviewed.

1. INTRODUCTION: RISING INTEREST IN INDUSTRIAL POLICY SIDESTEPS AFRICA

Industrial policy has been one of the most controversial issues in economics, especially in development economics (for a review of the industrial policy debate since the 1980s, see Chang, 2011). Especially surrounding its role in the development success of East Asia, there was a fierce debate, which came to head in the late 1980s and the early 1990s (Amsden, 1989; Wade, 1990; World Bank, 1987, 1991, and 1993; Stiglitz, 1996).

Fortunately, during the last decade or so, there have been a number of developments in academia and in the real world that have made industrial policy more acceptable and thus the debate surrounding it less ideologically charged and more pragmatic and nuanced.

At the theoretical level, the market fundamentalist view that there are very few theoretical justifications for industrial policy has lost its dominance. On top of that, the infant industry argument has been refined in a number of ways (Chang, 2002; Shaffaedin, 2005; Greenwald & Stiglitz, 2006; Dosi *et al.* (eds.), 2009). An increasing number of more orthodox economists accept that there are many types of market failures that need to be addressed through industrial policy—not just the more conventional 'externalities' problem, but also economies of agglomeration and coordination failures (Lin's interventions in Lin & Chang, 2009; Lin & Monga, 2012).

The interpretation of the evidence on industrial policy has also evolved. It is increasingly recognized that industrial policy is not some highly idiosyncratic practice found only in East Asian 'miracle' economies (Japan, South Korea, Taiwan, and Singapore) but what most of today's rich countries used when they were catch-up economies themselves (Bairoch, 1993; Chang, 2002 and 2007; Reinert, 2007). Some econometric studies have even identified a positive correlation between protectionism and economic growth in the late 19th and the early 20th century (O'Rourke 2000; Vamvakidis 2002; Clemens & Williamson, 2001; Irwin, 2002, provides a criticism of these studies, which is then countered by Lehmann & O'Rourke 2008). In particular, the increasing recognition that Britain and the US—the supposed homes of free-market and free-trade policies—as the pioneers of infant-industry promotion through protectionism and other forms of industrial policy has added a whole new complexion to the history of capitalist development. Recent studies, especially Chang (2002) and Reinert (2007), have revealed that the practice of infant industry promotion was first systematically applied by Robert Walpole, the British Prime Minister of 1721-42, and the theory of it was first invented by Alexander Hamilton, the first US Treasury Secretary, in his report to the US Congress in 1791 (see Chang, 2002, for further details; Hamilton's original report is Hamilton, 1791).

The ISI (Import Substitution Industrialization) experience in the developing world before the 1980s has also been subject to a more nuanced interpretation. The role of industrial policy in the significant economic development achieved by many Latin American countries between the 1930s and the 1980s is increasingly accepted, as well as the success of earlier protectionism in the continent in the late 19th and the early 20th century (on the latter, see Clemens and Williams 2004). Even the typical depiction of industrial policy in Africa, especially Sub-Saharan Africa, in the 1960s and the 1970s as an unmitigated disaster has been questioned (Jerven, 2011).

More recently, the 2008 global financial crisis has enhanced the legitimacy of industrial policy. First, the crisis prompted some major industrial policy actions—both defensive and proactive—by the rich countries that used to preach against industrial policy (e.g., bail-out of the US automakers and in increase in 'green' subsidies in many developed countries, including the US). Second, the crisis has prompted countries like the US, and especially Britain, to accept that their financial sector had been 'over-developed' and therefore that there is a need to 'rebalance' their economies by reviving the manufacturing sector, if necessary through industrial policy. Third, the continued rise of China (and to a lesser extent Brazil) and the solid performance of Germany, all of which have actively used industrial policy, since the crisis have also made people re-assess the importance of industrial policy.

This general shift in the mood in favor of industrial has not, however, extended to the African countries. However effective the policy may have been in Japan, Korea, or China (or even the US in the 19th century), it is argued, it simply cannot work in those countries. A wider range of reasons is given—ranging from excessive natural resource endowments (the so-called 'resource curse' thesis), pathological politics, the lack of bureaucratic capabilities, and the changes in the global economic rules—but the implication is that the African countries would be better off sticking to their natural resource advantages, rather than trying to develop manufacturing industries through industrial policy.

2. ARE AFRICA'S DEVELOPMENT FAILURES STRUCTURAL?—CLIMATE, GEOGRAPHY, CULTURE, AND HISTORY

In the next section of this paper, we will discuss those factors that are supposed to make industrial policy inapplicable to Africa, but we first need to critically review the arguments that Africa is doomed to development failure because of its climate, geography, culture, and history—a group of arguments known as 'Afro-pessimism' (the most prominent examples include Easterly & Levine, 1997; Bloom & Sachs, 1998; Collier & Gunning, 1999; Sachs & Warner, 2001; Acemoglu *et al.*, 2001).

Now, in discussing these arguments, we should bear in mind that there is a huge problem in talking of Africa as if it is homogeneous. After all, it is a continent of nearly 60 countries (the exact number depending on your attitude towards entities like Western Sahara) with very varied natural and human conditions. If most African economies look rather similar to each other economically, it is not because they are in the same continent, but because all economies—in whichever continent they are—at low levels of development look rather similar to each other, due to the lack of specialization and diversification in the production structure, which then leads to high degrees of homogeneity in occupational structures, social organizations, and lifestyles. Bearing this important point in mind, let us see how those arguments that emphasize structural factors, like climate, geography, culture, and history in explaining African development experiences.

2.1. THE ARGUMENTS

According to the argument emphasizing the climate factors, being close to the equator, the African countries suffer from tropical diseases, such as malaria. These diseases become burdens on economic development, as they reduce worker productivity and raise healthcare costs. Some also point out that tropical soil is of poor quality, reducing agricultural productivity.

The geography argument points out that many African countries are landlocked and thus are disadvantaged in integrating into the global economy through international trade. Many of them are also in 'bad neighborhoods', in the sense that they are surrounded by other poor countries that have small markets (which restrict their trading opportunities) and, frequently, violent conflicts (which often spill over into neighboring countries).

Two aspects are highlighted by those arguments emphasizing the historical factors—ethnic diversity and colonialism. High ethnic diversity of many African nations makes their people distrust each other, raising transaction costs. Ethnic diversity, it is pointed out, is likely to encourage violent conflicts, especially if there are a few groups of similar strengths (rather than many small groups, which are more difficult to organize). Africa's colonial history is argued to have produced low-quality institutions in most African countries, as the colonizers did not want to settle in countries with too many tropical diseases (so there is an interaction between climate and institutions) and thus only installed low-quality institutions that were needed for resource extraction ('extractive institutions' of Acemoglu *et al.,* 2001).

The cultural argument is usually presented in rather convoluted ways to avoid the accusation of racism, but it is essentially that African culture is bad for economic development—Africans do not work hard, do not plan for the future, and cannot cooperate with each other. In explaining the economic divergence between South Korea and Ghana, two countries that were at similar levels of economic development in the 1960s, Samuel Huntington, of *The Clash of Civilizations* fame, argues: "Undoubtedly, many factors played a role, but … culture had to be a large part of the explanation. South Koreans valued thrift, investment, hard work, education, organization, and discipline. Ghanaians had different values. In short, cultures count" (Huntington, 2000, p. xi). Daniel Etounga-Manguelle (2000), a Cameroonian engineer and writer writes: "The African, anchored in his ancestral culture, is so convinced that the past can only repeat itself that he worries only superficially about the future. However, without a dynamic perception of the future, there is no planning, no foresight, no scenario building; in other words, no policy to affect the course of events"(p. 69). And then he goes on to say that "African societies are like a football team in which, as a result of personal rivalries and a lack of team spirit, one player will not pass the ball to another out of fear that the latter might score a goal" (p. 75).

2.2. THE CRITICISMS

All the factors highlighted by the 'structural' arguments discussed above are relevant, to one degree or another. However, the fact that a factor is given by nature or history does not mean that the outcome is pre-determined. Indeed, the fact that most of today's rich countries have also suffered from similar 'structural' handicaps suggests that all those structural factors are not insurmountable (Chang, 2009a, 2009b, 2010).

(A) CLIMATE

In relation to the climate argument, we should first note that many of today's rich countries used to have malaria and other tropical diseases, at least during the summer—not just Singapore, which is bang in the middle of the tropics, but also Southern Italy, Southern US, South Korea, and Japan. These diseases have largely (although not entirely) disappeared in those countries not because their climates have somehow changed, but because they have better sanitation (which has vastly reduced their incidences) and better medical facilities (which allow them to effectively deal with the few cases that still occur), thanks to economic development.

Moreover, it should be pointed out that not just tropical climate but also frigid and arctic climates (affecting a number of rich countries, such as Finland, Sweden, Norway, Canada, and parts of the US) impose economic burdens—machines seize up, fuel costs skyrocket, and transportation is blocked by snow and ice. The Scandinavian countries used to be effectively landlocked for half of the year, until the advent of the ice-breaking ship in the late-19th century. Once again, cold climate does not appear to hold those rich countries back because they have acquired the money and the technologies to deal with it (the same as in the case of Singapore's tropical climate).

When you think about it, there is no *a priori* reason to believe that cold climate is better than hot climate for economic development. Indeed, in *Politics* (Book VII, chapter 7), Aristotle argued that the European societies are not very developed because their climate is too cold, which makes their people, well, stupid. He said: "Those who live in a cold climate and in Europe are full of spirit, but wanting in intelligence and skill; and therefore they retain comparative freedom, but have no political organization, and are incapable of ruling over others. Whereas the natives of Asia are intelligent and inventive, but they are wanting in spirit, and therefore they are always in a state of subjugation and slavery. But the Hellenic race, which is situated between them, is likewise intermediate in character, being high-spirited and also intelligent. Hence it continues free, and is the best governed of any nation, and if it could be formed into one state, would be able to rule the world." (Aristotle, 2001, p. 1286)

Therefore, to blame Africa's under-development on climate is to confuse the cause of underdevelopment with its symptoms. Poor climate does not cause under-development; a country's inability to overcome the constraints imposed by its poor climate is a symptom of under-development.

(B) GEOGRAPHY

Much has been made out of the landlocked status of many African countries. Landlockedness does impose economic burdens, but then how do we explain the economic successes of Switzerland and Austria? These are two of the richest economies in the world, but they are both landlocked. Some people would respond to this point by saying that those countries could develop because they had good river transport, but many landlocked African countries are *potentially* in the same position; e.g., Burkina Faso (the Volta), Mali and Niger (the Niger), Zimbabwe (the Limpopo), and Zambia (the Zambezi). So, once again, the argument is based on confusion between the cause and the symptom—it is the lack of investment in the river transport system, rather than the geography itself, that is the problem.

Being in a 'bad neighborhood' may not be as disadvantageous as it may seem. India has grown very fast in the last couple of decades, despite being in the poorest region in the world (poorer than Sub-Saharan Africa), with its share of conflicts (the long history of military conflicts between India and Pakistan, the Maoist Naxalite guerillas in India, Hindu-Muslim violence in India, the Tamil-Sinhalese ethnic war in Sri Lanka, and so on).

(C) HISTORY

It would be silly to deny that ethnic divisions can hamper growth. However, their effects should not be exaggerated. Ethnic diversity is the norm elsewhere too. Even ignoring ethnic diversities in immigration-based societies like the US, Canada, and Australia, many of today's rich countries in Europe have suffered from linguistic, religious, and ideological divides—especially of the 'medium-degree' (i.e. a few, rather than numerous, groups) that is supposed to be most conducive to violent conflicts. Belgium has two (and a bit, if you count the tiny German-speaking minority) ethnic groups. Switzerland has four languages and two religions, and has experienced a number of mainly-religion-based civil wars. Spain has serious minority problems with the Catalans and the Basques, which have even involved terrorism. Due to its 560-year rule over Finland (1249 to 1809, when it was ceded to Russia), Sweden has a significant Finnish minority (around 5 percent of the population) and Finland, a Swedish one of similar proportion. The examples can go on.

The East Asian countries, often believed to have exceptionally benefited from their ethnic homogeneities, also have serious internal divisions. You may think Taiwan is ethnically homogeneous, as its citizens are all 'Chinese'. However, to begin with, there is actually a tiny native population of Polynesian origin (the so-called Kaoshan people). Moreover, even the 'Chinese' population consists of two (or four, if you divide them up more finely) linguistic groups (the 'mainlanders' vs. the Taiwanese) that are hostile to each other. Japan has serious minority problems with the Koreans, the Okinawans, the Ainus, and the Burakumins. South Korea may be one of the most ethno-linguistically homogeneous countries in the world, but that has not prevented my fellow countrymen from hating each other. For example, there are two regions in South Korea that particularly hate each other (Southeast and Southwest), so much so that some people from those regions would not allow their children to get married to anyone from 'the other place'. In this regard, it is very telling that Rwanda is nearly as homogeneous in ethno-linguistic terms as Korea but that the homogeneity did not prevent the ethnic cleansing of the formerly dominant minority Tutsis by the majority Hutus—this is an example that proves that 'ethnicity' is a political, rather than a natural, construction.

The above examples show that rich countries do not suffer from ethnic heterogeneity not because they do not have it, but because they have succeeded in nation-building (which, we should note, was often an unpleasant and even violent process). Indeed, despite being genetically the most heterogeneous country in the world, Tanzania has been so successful in nation-building that it has not had any serious ethnicity-based conflicts.

Finally, the argument that bad institutions are holding back Africa (and often they are) should be tempered by the fact that, when they were at similar levels of material development to those we find in Africa currently, the institutions of today's rich countries were in a far worse state than what we find in Africa today (Chang, 2002, ch. 3). They built the good institutions largely after, or at least in tandem with, their economic development. In other words, high-quality institutions are as much outcomes as they are the causes of economic development.

(D) CULTURE

Many people who believe that 'bad' cultures are holding back Africa do not usually realize that all of the descriptions of those 'negative' cultural traits of Africa heard today used to be hurled at many rich countries when they were poor (Chang, 2007, ch. 9).

Before the start of German economic development in the mid-19th century, the British would frequently say that the Germans are too stupid, too individualistic, and too emotional for economic development—the exact opposite of the stereotypical image that they have of the Germans today and exactly the sort of things that people now say about the Africans. For example, John Russell, an early-19th century British traveller in Germany remarked: "The Germans are a plodding, easily contented people … endowed neither with great acuteness of perception nor quickness of feeling … It is long before [a German] can be brought to comprehend the bearings of what is new to him, and it is difficult to rouse him to ardor in its pursuit" (Russell, 1828, p. 394). When travelling in Germany, Mary Shelley, the author of *Frankenstein*, complained that "the Germans never hurry" (Shelley, 1843, p. 276).

Until the early 20th century, Australians and Americans would go to Japan and say the Japanese are lazy. Having toured lots of factories in Japan, an Australian engineer remarked in 1915: "My impression as to your cheap labor was soon disillusioned when I saw your people at work. No doubt they are lowly paid, but the return is equally so; to see your men at work made me feel that you are a very satisfied, easy-going race who reckon time is no object. When I spoke to some managers they informed me that it was impossible to change the habits of national heritage" (*Japan Times*, 18 August, 1915). Even Sidney Gulick, an American missionary who lived in Japan for 25 years and later became a champion of Asian-American human rights back in the US, had to admit that many Japanese "give an impression … of being lazy and utterly indifferent to the passage of time" (Gulick, 1903, p. 117).

The Koreans were held in even lower esteem. In 1912, they were condemned as "12 millions of dirty, degraded, sullen, lazy and religionless savages who slouch about in dirty white garments of the most inept kind and who live in filthy mudhuts." That comment came from a leading female socialist intellectual at the time, that is, Beatrice Webb of the Fabian movement (Webb & Webb, 1978, p. 375), so one can imagine what a regular European male conservative would have said about the Koreans, had he visited the country.

Of course, the cultures of Germany, Japan, and Korea today are completely different from what are described above. Those transformations happened mainly because of economic development, which created societies in which people have to behave in more disciplined, calculating, and cooperative ways than in agrarian societies. These historical examples show that culture is more of an outcome, rather than a cause, of economic development. Given this, it is wrong to blame Africa's (or any region's or any country's) underdevelopment on its culture.

3. NATURAL RESOURCE ABUNDANCE AND INDUSTRIAL POLICY

In relation to industrial policy more specifically, the natural resource abundance of Africa is often cited as the reason why industrial policy is unwise and/or unworkable. First, it is argued that the African countries have relative abundance (and therefore comparative advantage) in natural resources. Given this, trying to industrialize, especially 'artificially' through industrial policy, would be bad for their economies. Second, countries with natural resource abundance, it is argued, suffer from perverse politics in the forms of corruption and violent conflicts (a form of 'resource curse'). Trying to graft industrial policy onto that political economy, it is pointed out, will mean that it will only be abused, even if it worked elsewhere.

3.1. NATURAL RESOURCE ABUNDANCE AND COMPARATIVE ADVANTAGE

Many people take it for granted that the African countries are well endowed with natural resources, but in fact few of them are (see Chang, 2006, for further details). Fewer than a dozen African countries have any significant mineral deposits. Only South Africa and the Democratic Republic of Congo are exceptionally well endowed with more than one mineral resource. Most African countries may have low population density and thus a lot of land, but only a handful of them are exceptionally well-endowed with arable land (Niger, Liberia, DRC, Chad, Senegal, Sierra Leone, and the Central African Republic). Most African countries look abundantly endowed with natural resources only because they have so few man-made resources, such as machines, infrastructure, and skilled labor.

Moreover, even in the case of countries that have exceptionally abundant natural resource endowments, exploiting them without any clear long-term industrial policy is unlikely to lead to long-term economic development.

Except for a few small oil-rich countries like Brunei, Kuwait, and Qatar, no country—not even the US, Australia, or Canada, the three countries that are best endowed in the world with natural resources—has been blessed by nature to such an extent that it could become rich only by doing things that came 'naturally'. Australia has the smallest manufacturing sector (in per capita terms) by far among the rich countries (it is 1/3 smaller than the next smallest ones) owing to its abundant natural resource endowments, but even it produces manufacturing value added (MVA) per capita of $2,422, which is 35 times greater than relatively more industrialized Senegal ($69) and 220 times greater than the least industrialized Niger ($11) (all figures are as of 2005, in 2000 dollars; UNIDO, 2009, p. 129, Table 1). Given that Senegal's and Niger's natural resource endowments are not even remotely as abundant as that of Australia, there will have to industrialize much more than Australia has done, if one day they are to have living standards that are comparable to that of Australia's today.

We should also note that few countries actually do 'natural' things. Even many 'primary' commodities are not natural, but are products of colonialism. For example, many African countries export cocoa and tea, which were brought from, respectively, Central America and China to Africa by the imperialists. When it comes to high-productivity activities whose existence determines whether a country is economically developed or not, countries become good at something only because they deliberately decide to become so—there is really no 'natural' reason for the Japanese to be good at building cars, the Finns at making mobile phones, and the Korean at making steel.

If we left things to the market, high-productivity industries simply will not get established in developing countries, as there are already superior producers from the more advanced countries. If they want to develop those industries, they have to protect and nurture those industries through tariffs, subsidies and other means of industrial policy—this is, of course, the logic of infant industry promotion, which I discussed above. If the African countries are to develop their economies, they will have to deploy an industrial policy that will eventually make their 'natural advantage' industries unimportant by developing higher-productivity activities.

By saying this, I am not trying to argue that the African countries should ignore their natural-resource-based industries, for at least two reasons. First, it takes a lot of time to develop new industries. For example, it took 40 years for the Japanese car-makers (established in the early 1930s) to break into the world market, while it took 17 years for Nokia electronics (founded in 1960) to make any profit. Therefore, before the new industries fully develop, the natural-resource-based sectors need to provide the output, jobs, and, above all, export earnings that will finance the imports of machinery and technologies for the new industries. Second, natural-resource-based industries can be, and should be, upgraded (on how to upgrade out of the natural resources sectors, see discussions in Chang, 2008, Section III). Despite having very little land (the 5th highest population density in the world, excluding island- and city-states), the Netherlands is the third largest agricultural exporter in the world, as it has upgraded its agriculture.

In the long run, however, successful upgrading of natural-resource-based industries requires successful industrialization. The Netherlands has a high-productivity agricultural sector only because it has 'industrialized' the sector, using its strengths in industries like electronics (e.g., computer-controlled feeding) and chemicals (e.g., fertilizers, pesticides). In the end, the African countries will have to get into many industries that today no one—I repeat, no one—would think they can succeed in, if they are going to become economically developed. And, as I argued above, that requires systematic industrial policy.

3.2. NATURAL RESOURCE ABUNDANCE AND PERVERSE POLITICS

In relation to the argument that natural resource abundance in Africa is bound to create perverse pattern of politics (corruption and violent conflicts), which leads to abuse of industrial policy, even if it were true, it would apply to only a handful of African countries, as most of African countries are not that particularly well endowed with natural resources in the first place, as I have pointed out above.

Moreover, there is no inevitable relationship between a country's natural resource endowment and its politics. If natural resource abundance inevitably led to perverse politics, we cannot explain how many countries—not just super-well-endowed US, Canada, and Australia, but also the Scandinavian countries—have not developed perverse forms of politics despite (or in many cases rather because of) their abundant natural resource endowments (see Wright & Czelusta, 2004 and 2007, on the role of natural resources in the economic development of the US). In addition, in the late 19th and early 20th century, the fastest growing regions of the world were resource-rich areas like North America, Latin America, and Scandinavia, which shows that the 'resource curse' is not something that is inescapable.

4. POLITICAL ECONOMY CONSIDERATIONS: LEADERSHIP, STATE COHERENCE, AND STATE-SOCIETY RELATIONSHIP

Even ignoring perverse politics due to natural resource abundance, there is a general concern that the political economy of most African countries makes effective implementation of industrial policy impossible. Many people characterize politics in most African countries as 'neopatrimonial', which undermines economic rationality in favor of 'Big Man' politics (for a comprehensive critique of this literature, see Mkandawire, 2012). Given this political economy, it is believed, any policy that suspends market discipline will be hijacked and abused, unlike in East Asia or Europe.

This argument is partly in line with one key conclusion of the industrial policy debate, which is that a key difference between success stories and failure stories of industrial policy is in the differences in their political economy (Toye, 1987; Amsden, 1989; Chang, 1994; Evans, 1995). There are three aspects to this.

First, political leadership is considered important in determining the nature of industrial policy. Even if we ignore some extreme cases in which the leaders are interested only in personal aggrandizement, the leaders may have a "wrong" vision. They may be looking backward, rather than forward, as Thomas Jefferson did when he opposed Hamilton's infant industry protection. Or they may be hostile to private sector development, as many African country leaders were in the 1960s and the 1970s. Or, as many 19th century liberal politicians did, they may think that doing nothing, other than protecting private property, is really the best industrial policy.

Second, even if the political leaders have the 'right' vision, they should be able to impose that vision on the rest of the state apparatus. While in theory the state is a hierarchical organization, in practice the wish at the top does not always percolate through the hierarchy. There will be some degree of self-seeking by government bureaucrats, although not as much as it is assumed in the public choice theory. There will also be problems arising from clashing visions (e.g., the bureaucrats may be more conservative than the political leaders), turf wars within the bureaucracy, "tunnel vision" that specialized organizations are wont to develop, internal coordination failures (coming from poor organizational design inside the government or the emergence of new issues that cut across the existing organizational structure), and many other reasons.

Third, even if the leadership has the right vision and even if the state apparatus is coherent, the state still should be able to impose its will on other agents in the society. In some extreme cases, the state may not even have full control of its claimed territories. In some countries, the state cannot implement policies effectively due to manpower and resource shortages. Even when the state has enough enforcement capabilities, there will be attempts by some private sector agents to neutralize or even pervert policies through lobbying and bribing.

The tendency is to assume that these types of political economy problems are uniquely serious in the African countries, but this assumption lacks empirical foundations (Mkandawire, 2012). In addition, the advanced economies all suffered from these problems in the past (and some of them still do to an extent). In fact, when they were at levels of economic development comparable to today's African countries, the developed countries were actually much worse in terms of suppression of democracy, corruption, state capture, incoherence of the state machinery, nepotism, and other 'pathological' forms of politics (Chang, 2002, ch. 3).

Whatever we think of African countries' political economy problems, we should not let the best be the enemy of the good. The existence of those problems should not make us believe that African countries have to wait for a perfect state to emerge before doing anything. In the real world, successful countries are the ones that have managed to find "good enough" solutions to their political economy problems and gone on to implement industrial (and other) policies, rather than sitting around bemoaning the imperfect nature of their political systems.

In fact, quite a few of the successful "industrial policy states" themselves overcame political obstacles to effective statecraft in situations that did not instill much hope. For example, between the fall of Napoleon and the end of the Second World War, the French state was notoriously *laissez-faire*, ineffectual, and conservative. However, this was completely changed after the War, with the rise of *Gaullisme*, the establishment of the planning commission, and the foundation of the ENA (École Nationale d'Administration), the famous school for elite bureaucrats (Cohen, 1977; Kuisel, 1981). For another example, the Kuomintang (Nationalist Party) bureaucracy was arguably one of the most corrupt and inefficient in modern history when it ruled mainland

China. However, after being forced to migrate to Taiwan, following the defeat by the Communists in 1949, it was transformed into a highly efficient and relatively clean one. This was done through a gradual but deliberate process of building "islands of competence" and then giving them greater responsibilities as they succeeded and increased their legitimacy and status within the bureaucracy, finally replacing much of the old bureaucracy with the new one (Wade, 1990).

5. 'DO NOT TRY THIS AT HOME': THE QUESTION OF BUREAUCRATIC CAPABILITIES

Whatever the political intention and power of the top leadership may be, policies are likely to fail if the government officials implementing them are not capable. They have to make difficult decisions, with limited information and fundamental uncertainty, often under political pressure from inside and outside the country. Dealing with all this requires competent decision-makers. On this ground, it has been argued that "difficult" policies like (selective) industrial policy should not be tried by countries with limited bureaucratic capabilities, especially the African countries (World Bank, 1993, is the best example).

In other words, this is the policy-world equivalent of "do not try this at home" (DNTTAH) warning that accompanies the demonstration of difficult and dangerous stunt acts in TV shows. However, there are numerous problems with this argument.

First, the assumption is that industrial policy is exceptionally difficult. However, this assumption is made without any theoretical reasoning or empirical evidence. For example, World Bank (1993) assumes that policies getting the "fundamentals"—such as human capital, agriculture, and macroeconomic stability—right are easier than industrial policy, but there can be no such presumption. First, different governments have competences in different areas—the Japanese government was good at industrial policy but messed up macroeconomic policies in the 1990s. Second, the ease of a policy will also partly depend on its scale. For example, promoting a few industries through industrial policy may be a lot easier than organizing a mass education program. Third, it will also depend on the number of agents involved in the policy. Trying to coordinate investments among a few large firms may be easier than organizing a country-wide distribution of subsidized fertilizer that involve millions of small farmers who are not organized into co-operatives and scattered all over the country.

Second, another (implicit) assumption behind the DNTTAH argument is that industrial policy requires sophisticated knowledge of economics—as exemplified by the comment by Alan Winters, the former head of Research Department at the Bank and the former chief economist of the UK government's DfID (Department for International Development) that "the application of second-best economics needs first-best economists, not its usual complement of third- and fourth-raters" (Winters 2003, p. 66). But is this true? An important fact in this regard is that the East Asian economic bureaucrats were *not* "first best economists". While they were smart people, most of them were not even economists. The majority of the Japanese economic officials that engineered the country's "miracle" were mostly graduates from the Law Department of Tokyo University. Until the 1980s, what little economics they knew were mostly of the "wrong" kind—the economics of Karl Marx and Friedrich List, rather than neoclassical economics. In Taiwan, most key economic bureaucrats were engineers and scientists, as is the case in China today. Korea also had a high proportion of lawyers in its economic bureaucracy until the 1970s, while the brains behind the famous HCI (Heavy and Chemical Industrialization) programmer in the 1970s, Oh Won-Chul, was an engineer by training. Both Taiwan and Korea had rather strong, albeit officially unacknowledged, communist influence in its economic thinking until the 1970s.[2]

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[2] The Nationalist Party's constitution was a copy of the Soviet Communist Party constitution. Taiwan's second president, Chiang Ching-Kuo, who succeeded his father Chiang Kai-Shek, was a communist as a young man and studied in the Soviet Communist Party school in Moscow with future leaders of the Chinese Communist Party, including Deng Xiao-ping. Korea also had its share of

Third, many advocates of the DNTTAH argument believe that high-quality bureaucracies are very difficult to build and that the East Asian countries were exceptionally lucky to have inherited them from history. However, a high-quality bureaucracy can be built pretty quickly, as shown by the examples of Korea and Taiwan themselves. Contrary to the popular myth, Korea and Taiwan did *not* start their economic "miracles" with high-quality bureaucracies. For example, until the late 1960s, Korea used to send its bureaucrats for extra training to—of all places—Pakistan and the Philippines. Taiwan also had a similar problem of generally low bureaucratic capabilities in the 1950s and most of the 1960s (see above). These countries could construct a high-quality bureaucracy only because they invested in training, organizational reform, and improvement in incentive systems. In addition, there was also a lot of "learning-by-doing". By trying out relatively easy industrial policy from early on, the East Asian bureaucrats could build up the capabilities they needed in effectively running more sophisticated industrial policy later. In other words, there has to be *some* "trying at home", if you aspire to become good enough to appear on TV with your own stunt act.

Last but not least, the fact that something is "difficult" cannot be a reason not to try it. When it comes to personal advancement, we actually go to the other extreme and encourage our youngsters to aspire to become the best of the best, when most of them are going to end up as production-line workers or shop assistants, rather than prime ministers or business tycoons. Even when it comes to countries, developing countries are routinely told to adopt "best practice" or "global standard" institutions used by the richest countries, when many of them

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communist influence. General Park Chung-Hee, who masterminded the Korean economic miracle, was a communist in his younger days. He was sentenced to death in 1949 for his involvement in a communist mutiny in the South Korean army but earned an amnesty by publicly denouncing communism. Many of his lieutenants were also communist in their younger days.

clearly do not have the capabilities to effectively run the American patent law or the Scandinavian welfare system. However, when it comes to industrial policy, countries are told to aim low and not to try at all, or at best try to learn from the Southeast Asian countries, which used more market-conforming (and therefore presumably easier) industrial policy than did the East Asian countries (this is the position taken by World Bank, 1993). I am all for people warning against the risks involved in "aiming too high", but why should countries aim low only when it comes to industrial policy?

The problems of low bureaucratic capabilities are real in most African countries. However, they should not be exaggerated. They are not unique to industrial policy, nor are they unique to Africa. And there can be no presumption that industrial policy is necessarily more demanding in terms of bureaucratic capabilities than other policies are. More importantly, in the longer run, bureaucratic capabilities may be enhanced (and relatively quickly at that) with appropriate investments and learning-by-doing, so their poverty at the present moment cannot be an excuse for never using industrial policy in the future.

6. CHANGING RULES OF THE GLOBAL ECONOMY

The changes in global rules of trade and investment since the 1990s—through the WTO (World Trade Organization), bilateral and regional FTAs (Free Trade Agreements), and BITs (Bilateral Investment Treaties)—have made the use of many of the classic tools of industrial policy either banned or significantly circumscribed by). Given this, it is argued, developing countries, including the ones in Africa, the recommendation goes, should not waste their time thinking about policies that cannot be used anyway.

The most important changes have been brought about by the launch of the WTO in 1995. Quantitative restrictions (e.g., quotas) have been banned altogether. Tariffs have been reduced and "bound" (that is, tariff ceilings have been set). Export subsidies are banned. Most other subsidies (except those frequently used by the rich countries, such as those for agriculture, R&D, and regional equalization) have become open to countervailing duties and other retaliatory measures. New issues, like regulations on FDI (Foreign Direct Investment) and IPRs (intellectual property rights), have been brought under the jurisdiction of the WTO, making it difficult for countries to "borrow" foreign technologies for free by violating IPRs or put performance requirements (regarding things like local contents) on the TNCs (Transnational Corporations) that make FDI.

While the WTO has certainly made industrial policy more difficult to implement, the constraints imposed by it should not be exaggerated.

To begin with, even on paper, the WTO by no means obliges countries to abolish all tariffs—only to bind them. Although the middle-income developing countries were forced to bind most of their tariffs, the LDCs (Least Developed Countries), including most countries in Africa, were exempt from tariff-binding. Even though some low-income countries chose to bind some tariffs, the extent of such binding is small and the ceilings quite high. So, the 'policy space' for using tariffs is still considerable for the LDCs.[3]

Second, the use of emergency tariff increases ("import surcharges") is allowed on two grounds. The first is a sudden surge in sectoral imports, which a number of countries have already used. The second is the overall BOP (balance of payments) problem, for which almost all developing countries, including the African ones, would qualify and which quite a few countries have also used. Since countries have discretion over the coverage and the levels of emergency tariffs

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[3] Of course, if the rich countries have their ways in the current NAMA (non-agricultural market access) negotiations of the Doha Round in the WTO, industrial tariffs in the developing countries are, at 5-10%, likely to fall to the lowest level since the days of colonialism and unequal treaties (Chang 2005, p. 4). However, this is yet to happen.

that are meant to lessen the BOP problem, they can target particular industries through this provision.

Third, not all subsidies are "illegal" for everyone. For example, the LDCs are allowed to use export subsidies. Given the enormous benefits that exports generate for developing countries—by enabling them to import better technologies, by exposing them to international quality standards, by making it easier for them to measure performance of the recipients of industrial policy supports—this is a very valuable policy tool that many African countries can utilize. Also, subsidies for agriculture, regional development, basic R&D, and environment-related technology upgrading are at least *de facto* allowed.[4] Even though some of these subsidies are not relevant for most African economies (e.g., R&D subsidies), others (e.g., agricultural subsidies) are, so they should use them proactively. Moreover, the subsidy restrictions only cover "trade-related" ones, which means that "domestic" subsidies can be used (e.g., subsidies on equipment investments, subsidies for investment in particular skills).

Fourth, the TRIPS (trade-related intellectual property rights) agreement has certainly made technology absorption more expensive for developing countries (Chang, 2001). However, this mainly affects the middle-income countries. The technologies that most African countries need are often the ones that are too old to be protected by patents.

Fifth, the TRIMS (trade-related investment measures) agreement has banned certain policy measures which had been successfully used by both the developed and the developing countries in the past (Kumar, 2005) (e.g., local contents requirements, trade balancing requirements), but other measures are still allowed. These include conditions regarding the hiring of local labor (a good way to create technological spill-over

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[4] These subsidies were explicitly allowed ("non-actionable" in WTO parlance) until 1999. Even though the first three have become "actionable" since 2000, not a single case has been brought to the dispute settlement mechanism since then, suggesting that there is an implicit agreement that they are still acceptable.

effects), technology transfer, and the conduct of R&D in the host country. They can also provide targeted subsidies, directed credits, and tailor-made infrastructure (measures that Singapore and Ireland have used, to attract FDI into "targeted" industries; Chang, 2004), insofar as these do not violate the MFN (most-favored nation) provision (Thrasher and Gallagher, 2008). Many of these measures are relevant for the African countries.

Even though the WTO rules allow quite a lot of industrial policy measures, especially for the LDCs and other poor economies, this policy space is in practice highly constrained by other international factors. First, the conditions attached to bilateral and multilateral aids and loans, on which they are quite dependent, significantly constrain their industrial policy space. Second, many developing countries are also parties to bilateral and regional trade and investment agreements, which tend to be even more restrictive than the WTO agreements (Thrasher and Gallagher 2008).

So, all in all, the range of industrial policy measures that developing countries can use has become considerably smaller, compared to the 1960s and the 1970s. However, there is still room for maneuver for countries that are clever and determined enough, especially for the poorest economies, many of which are African, that are subject to less systemic restrictions (especially in relation to tariffs and subsidies).

Moreover, the new global rules of trade and investment are not some unalterable laws of nature. They can be, and should be, changed, if they are found wanting. The modification of the TRIPS agreement in relation to the HIV/AIDS drugs is a good, if a relatively small, example.

7. CONCLUDING REMARKS

In this paper, I have critically examined a number of arguments suggesting that the African countries cannot learn from other experiences, as they possess uniquely disadvantageous conditions against any attempt to develop their economies through deliberate measures.

I first criticized the more general arguments espousing 'Afro-pessimism' on the bases of 'structural' factors, like climate, geography, history, and culture. And then I critically examined four types of arguments skeptical of the applicability of industrial policy to the African context—natural resource abundance, political economy, bureaucratic capabilities, and the changes in global economic rules. I argued that, while all these arguments contain some germs of truths (some more than others), they are all highly biased and partial.

The African countries—even the exceptionally well-endowed and the most industrialized South Africa—still need huge amounts of industrial development. And such developments require substantial degrees of industrial policy. Given this, getting industrial policy right and getting the conditions for its successful implementation right are not matters of choice but imperatives for the African countries. In this paper, I tried to show how the existing possibilities may be exploited and the constraints overcome in all sorts of areas—ranging from landlockedness to bureaucratic capabilities—through an appropriate mix of vision, realism, institutional reform, and investments.

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DEFINING DEVELOPMENT IN THE 21ST CENTURY

Implications for Sub-Saharan Africa

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1. INTRODUCTION

As the international community debates the elaboration of the International Development Agenda post-2015 and the Sustainable Development Goals, the future of development of cooperation is at stake. These debates mark shifts in consensus thinking about development as an international project, how the important objectives are defined, what key constraints are identified, and what strategies are considered as necessary to overcome constraints and achieve objectives. The Millennium Declaration and the Millennium Development Goals (MDGs) marked a departure in how development is defined by achieving a consensus on poverty as its primary, over-arching objective. This is an important achievement in advancing global commitment to human dignity. But as Charles Gore (2010) remarks, this new idea about development replaces an old idea about development. He warned that this could be a 'Faustian Bargain' where developing countries give up the idea of development as transforming the productive capacity of their national economies.

Thus the MDGs mark a major departure from the idea of development as economic transformation that underpinned the post-war framework for international cooperation as support to developing countries to become economically self-sustaining, and around which arrangements for resource transfers and other types of support were developed, including specific arrangements for development aid, trade agreements, debt relief, and capacity building. The focus on poverty is not only new but reframes the architecture of these global economic arrangements. Such shifts in thinking can have fundamental implications for economic and political relations between the rich and poor countries of the world.

This paper explores the implications of these shifts in thinking. It first examines how consensus ideas about development—the MDGs in this case—can exert influence on national and international policy priorities and identifies two mechanisms, through setting standards for performance and resource allocation, and through creating a narrative. The paper then contrasts the MDG consensus framing of development with earlier conceptions of development in the way that it articulates a motivation as a political priority, identifies key problems, objectives, and unit of analysis. Finally, the paper then examines how priorities of national governments and donors have shifted since 2000.

2. HOW GLOBAL GOALS SHAPE IDEAS AND EXERT INFLUENCE ON DEVELOPMENT PRIORITIES

What consequences do global goals have on policies and action? The influences are indirect, for the agenda is not an implementation plan comprised of policy reforms and investment projects, and those who elaborated the MDGs do not have control over resources and policies. But as the recent work on the sociology of numbers show (Merry, 2009), indicators can exert influence in two ways: first, by influencing resource allocation by being used as planning targets or indirectly by setting standards for performance or introducing planning targets; and secondly by communicating a narrative of development and a framework for action.

The MDGs have come to be effectively used in these two ways. First, they have become the standard reference framework for international development. They are used as a proxy to judge progress in tackling global poverty. The UN, the World Bank and numerous other international bodies monitor MDG implementation and issue annual reports with detailed data. IMF country reports systematically include data on MDG progress, along with key macroeconomic performance indicators. UN meetings to review progress in achieving MDGs have become both frequent and high-profile political events that are significant for a country's prestige and international standing. MDGs have come to be used by some governments and donors as planning targets that shape priority spending and effort. National development frameworks, notably the Poverty Reduction Strategy Papers prepared by low-income countries as a requirement for benefitting from debt relief, have adopted the MDGs. Moreover, the monitoring of government performance is predicated on the assumption that the goals are hard planning targets for which government must be held accountable[1].

Second, the MDGs have been most frequently used for communicating global poverty as an urgent challenge and a priority for global action. But in the process, they have also come to redefine development. Political leaders make speeches defending policy initiatives with the warning: 'without such and such action the MDGs will not be achieved'. Economists write research papers on macroeconomic policy choices and evaluate them against contributions to achieving MDGs. Local NGOs advocate national budget reforms 'to achieve the MDGs', however critical they may be of these goals, because they are the accepted standard to evaluate policy. Media reports on poverty refer to failure to achieve MDGs as a demonstration of pervasive abject poverty. In other words, MDGs have become a convenient short hand for what they mean by the purpose of development and ending poverty.

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[1] However, as I have explained in another article (Fukuda-Parr, Greenstein, & Stewart, 2013), this makes little sense as the methodology of national planning requires consideration of many factors other than globally agreed-upon social objectives.

This redefinition of development is not based on a theoretical reformulation of the concept. Yet it presents a narrative that can reframe development policy agendas.

3. LOCATING THE MDGs IN THE HISTORY OF DEVELOPMENT THINKING AND PARADIGMS

The MDG narrative—referred to in this paper as 'Development as Ending Poverty'—contrasts with earlier conceptualizations of development in the way that the key objectives are defined. It also contrasts in its analytical framing in terms of the way that the problem is defined, and the unit of analysis, the priority concern with inequality and poverty within or between countries, and whether development is understood as a set of outcomes or as a process. While there have been multiple and competing conceptions of development that have been advanced, for the purposes of this paper, they can be grouped into three strands of thought that have dominated development thinking: 'development as transforming national productive capacity'; 'development as globalization'; and 'development as improving human well-being'.

3.1. CORE ELEMENTS OF DEVELOPMENT AS ENDING POVERTY

The MDGs are not a theory of development but a list of targets. Moreover, the MDGs were developed as reporting tools to monitor the implementation of the Millennium Declaration's commitments, in which world leaders pledged to do their utmost to lift their fellow men, women and children from the dehumanizing conditions of poverty. Yet they have come to be used as a consensus framework creating a narrative of development. The MDGs identify ending absolute poverty as the core purpose. As explained by the UN (United Nations, 2008), while each of the eight goals is important, they are intended to be seen as a package. "The goals and targets are interrelated and should be seen as a whole. They represent a partnership between the developed countries and the developing countries to create an environment—at the national and global levels alike—which is conducive to development and the elimination of poverty" (United Nations, 2008 p.2).

Thus the MDG framing of development is motivated by concern with absolute poverty as an urgent social priority, and international action appeals to humanitarianism. The goals focus on human outcomes, and the disregard for the means was an important strength in achieving consensus (Fukuda-Parr & Hulme). In fact, the MDGs grew out of the context of the 1990s when the development community was divided in bitter controversies over structural adjustment lending programs and neoliberal policies. The success of the MDGs was to be able to form a consensus on points of agreement—improving human outcomes—without raising the divisive issues of policy strategies (Fukuda-Parr & Hulme). The analytical framework of this narrative identifies the problem as the existence of pervasive absolute poverty in the world, with the unit of analysis focused on the individual, and the situation within the context of inequality within countries. However the specificity of country conditions is ignored, as goals do not take account of initial conditions but set the same time-bound targets for all countries.

3.2. DEVELOPMENT AS TRANSFORMING PRODUCTIVE CAPACITY

The concept of development that dominated the field for much of the 20th century can be characterized as 'transforming productive capacity of national economies' (Gore, 2010). Development as an international project emerged in the aftermath of the Second World War, when the world community adopted it as one of its key objectives along with peace and security. It emerged in the context of the decolonization process, motivated by the need for newly independent countries to be economically, not just politically, viable. The motivation focuses on inequality between countries rather than within. In contrast to the MDG narrative, the analytical framework identifies the problem as the weak capacity of newly independent and other non-industrialized countries. The unit of analysis is the country in the context of an unequal world.

Informed by modernization theories[2] and economic growth models[3], the policy strategy over the 1950s up to early 1980s focused on industrialization and diversification including technological transformation, and built on investment in physical and, later, human capital. In the absence of a significant private sector, public sector investments were considered necessary, requiring capital transfers from rich to poor countries. The purpose of development aid was therefore to provide concessional financing. While mainstream policy strategies focused on national investments, heterodox economists including Structuralists and Dependency theorists identified the workings of the international economic system as key constraints and advocated policy reforms and arrangements in areas of trade, investment, access to capital and commodity markets that would create a more enabling condition for development. Both mainstream and heterodox economists understood development as a long-term process. The main point of concern was as much about the process of transformation in economic and social structures necessary for sustained improvement in living standards as the higher levels of living standards achieved.

Though there sharp divides between the North and the South on the agenda of the South, much of it was reflected in the UN consensus development agendas (Stokke, 2009).[4] The First UN Development Decade set a goal of 5 percent annual growth and emphasized the need for financing development. Industrialized countries were urged to cooperate by helping ensure high commodity prices, providing markets for developing country exports, and providing a target of 1 percent of GDP in concessional finance. The Second UN Development Decade (1970s) set an agenda to promote sustained economic growth with a goal of at least 6 percent per annum. The strategy emphasized the important role of the developed countries

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[2] Such as Rostow's model of takeoff.

[3] Such as Harrod-Domar model, the Solow model, and the New Growth Theories.

[4] For a well-researched history of the four development decades, see Un Intellectual History Project series, notably Olav Stokke, 2009.

in helping transfer capital that was beyond the capacity of the countries themselves and maintained the target of 1 percent of GDP to be transferred in the form of development aid. National governments prepared five-year development plans the core of which was long-term investment projects. External donors supported these plans by financing these projects.

3.3. DEVELOPMENT AS GLOBALIZATION

The onset of globalization starting in the 1980s not only involved shifts in national policies but had major implications for reconceptualizing economic and political relations between the North and the South. The idea of global market integration is underpinned by the principle that all countries compete equally in global markets, an idea that contradicts the principle behind the development project that starts from the recognition of differentiated levels of development, or inequality between countries. In contrast, the basic problem identified in the premise of the earlier development project was the unequal levels of development amongst countries.

The key problem of developing countries is identified as the weak ability to benefit from global markets—trade and private investments—that would be the engine of economic growth. Poverty reduction is assumed to be a consequence of growth and global integration. Policy agendas from the 1980s pursued liberalization, with the core policies described as 'Washington Consensus'. While the application of the core macroeconomic policies—fiscal discipline, monetary policy, trade openness, privatization and deregulations—can vary and has become more flexible and adapted to national conditions, the basic principle of maintaining stability as a central objective remains.

The focus on growth contrasts with the MDG focus on poverty and the individual, yet the two paradigms are perfectly complementary in the way that the earlier framing is not. The MDG narrative neatly skirts around the issue of unequal initial conditions, and of defining development by outcome rather than by a process of transformation.

3.4. DEVELOPMENT AS IMPROVING HUMAN WELL-BEING

Through the decades, critics challenged mainstream strategies for neglecting attention to what should be the ethical motivation for development, namely to improve human lives. Alternative approaches that incorporated well-being into conceptualizing development and in formulating policy strategies came into prominence from the 1970's, as international agencies began to launch initiatives such as the ILO's employment program and the World Bank's poverty initiatives under President McNamara. The introduction of Basic Needs in the late 1970s was a major step in bringing human well-being into conceptualizing development.

The 1980s and 1990s were also decades with important evolution in conceptualizing human well-being as central development objectives. While Basic Needs focused on key outcomes and on social investments as a policy strategy, other approaches emerged which emphasized human agency and development as societal change. The work of Amartya Sen (Sen, 1999) on capabilities was a major advance and provided a rich conceptual framework for reconceptualizing development as expansion of human capabilities, or the freedom that people can have to do and be what they would value. Other approaches, including feminism, human rights, and participation also emerged following distinctive theoretical frameworks. These perspectives that emerged in the 1990s were complementary, especially in forging the mutually supportive policy agendas critical of globalization that were influential in shaping the debates and agendas adopted at the UN Conferences of the 1990s. Each focuses on distinct concerns but shares common elements as development frameworks. They describe the central problem or objective as improvement in human well-being—defined in diverse ways—but challenge the notion of economic growth as a central objective by pointing out that the negative consequences of growth on people. But in addition, they emphasize three other elements—equality, participation and transformation—that were not part of earlier conceptions of development as well-being, including Basic Needs. First, they are motivated by a common commitment to equality of individuals. Second, they emphasize participation as an important element of a development strategy, seeing people as agents of change, not just as beneficiaries. For this reason, empowerment of people and groups is an essential means to progress, and power structures are an important obstacle. Just as the earlier conception saw development as a transformation of productive capacities, these approaches understand development to be transformative of social and political arrangements.

While at first glance, capabilities and rights approaches would appear similar to the MDG narrative, the overlap is very limited. The unit of analysis is the individual, but is broader. Capabilities and rights approaches include groups and inequality between countries as inter-group discrimination, and therefore incorporate attention on groups within countries, and focus on disaggregated analysis. Concerned with what people are able to do and not just outcomes or possession of material resources, development is understood as a process of social and political transformation. Feminist approaches exemplify this way of conceptualizing development; while feminist economics opened up the definition of the economy as market activity to incorporate all activities that lead to provisioning of human needs (Power, 2004), policy frameworks go far beyond advocating for equal education and health to women having a voice in decision making in all spheres of life.

Human well-being began to be reflected in consensus agendas. The UN's International Strategy for the Third Development Decade, adopted in 1981, also included objectives to reduce poverty and inequality, and the human dimensions of development—hunger, childhood survival, health, water and sanitation—were prominent among objectives (Stokke, 2009). For the first time, this UN Development Decade set goals for primary education (universal primary education by 2000), infant survival (120 deaths per 1000 live births in the poorest countries), and employment (full employment by 2000). These themes continued into the Fourth Development Decade of the 1990s. But it was in the 1990s that the development as capability expansion and human rights fulfillment became dominant on UN conference agendas. These agendas were agreed in the context of the controversies over the social impact of structural agenda and the economic liberalization reforms that were being implemented in the 1980s and 1990s throughout the world. An important motivation was to pursue inclusive globalization and that the benefits of globalization were shared broadly by all countries and people within countries (United Nations Department of Economic and Social Development, 2007). The conference agendas reflected the broad human development approach, emphasizing: recognition of human rights from the right to food to women's rights; inequality within and between countries; participation; and inter-connections amongst different dimensions of development.

Table 1 summarizes the contrasts between the MDG narrative and other concepts of development. The MDG narrative reflects important shifts in the conception of development and the way that motivations and objectives are defined, problems are identified and policy priorities and agendas are framed. The MDG narrative redefines the motivation of international development from an economic and political to a humanitarian project; from weak capacity of national economies to individuals living in abject poverty as the inequality issue; and an understanding of development as a process to a set of outcomes. Focusing on outcomes rather than process, and on individuals rather than countries, excludes issues of unequal economic and political relations between countries that development cooperation was originally intended to redress.

Table 1: Development Paradigms Compared

	Development as transforming productive capacities of countries	**Development as globalization**	**Development as improving human well-being**	**Development as ending poverty**
Problem described as	Weak capacity in the economy	Weak ability to benefit from global markets	Constrained human lives conditioned by diverse national and	Extensive absolute poverty in the world
Unit of analysis	National aggregate	National aggregate	Individuals, groups, national aggregates	Individual
Approach to inequality and poverty as a	Between countries	Within countries	Within and between countries	Within countries
Development as outcome or process	Outcome and process	Outcome	Outcome and process	Outcome
Key motivation	Decolonization and catch up	Free markets, global integration	Humanitarian, human dignity and freedom	Humanitarian

4. IMPLICATIONS FOR NORTH-SOUTH ECONOMIC RELATIONS

How did the new definition of development change economic relations between the North and the South? Recalling Gore's Faustian bargain referred to earlier in this paper, has the consensus on poverty lead to a neglect of support for national economic development, as Gore predicted?

4.1. DEVELOPMENT STRATEGY: A BASIC NEEDS AGENDA

The MDGs influence resource allocation by setting standards and creating a narrative. They create incentives to prioritize public investment in meeting basic needs, with little attention to building productive capacities, or to transforming social structures. One major gap is that the MDGs leave out the economy altogether, even though without economic growth, most MDGs cannot be achieved. Employment was only added as an afterthought in 2005 and is embedded in the broader poverty goal. Agricultural production is indirectly reflected in the hunger target, which in itself is buried in the poverty goal. Indeed, Ha-Joon Chang remarked in his recent paper, "Laudable these goals and targets may be, their sum total does not amount to development in the sense we are talking about, as they pay no serious attention to the transformation of productive structure and capabilities" (Chang, 2010).

The priority issues advocated by the developing countries since the 1950s are poorly represented in this agenda. The issues of aid, trade, debt, technology transfer that are central to the economic prospects for countries to compete and succeed in global markets are included in goal 8, under the heading of strengthening global partnerships. These wording of these issues was notoriously weak, with no quantitative targets. These issues were nonetheless included by the architects of the MDGs, because without them, the developing countries would not have endorsed the goals[5]. Development aid is justified on humanitarian grounds for the sake of charity rather than on developmental grounds for the sake of justice. These trends are manifest for example in the negotiations on climate change in which developing countries have had little success in obtaining concessions based on their greater developmental needs for energy in the future and limited contribution to the problem in the past. These ideational shifts thus have important implications for the political economy of international development.

The Development as Ending Poverty agenda is also deceptive with regard to human development. While the MDGs incorporate and thus highlight many human development priorities as well as Economic and Social Rights—schooling, health, hunger, gender equality—it is also bereft of the transformative process of development as empowering people, challenging power structures within and between countries. While inequality within and between countries and participation was the hallmark of the agendas adopted at the 1990s UN conference agendas, these are elements that are outside of this framework.

4.2. PRIORITIES IN NATIONAL AND DONOR PROGRAMMES

National and international development policies continue to give priority to objectives of macroeconomic stability and economic growth, justified by the theory that growth is not only a necessary but also a sufficient condition for reducing poverty. While national and international policies appear to set higher priorities for social sector investments to meet basic needs, other important elements of the human development strategy are neglected such as equality, pro-poor economic growth, empowerment and democratic governance. A study by the author (Fukuda-Parr S. 2010) of 22 Poverty Reduction Strategy Papers (PRSPs) found that these national strategy documents almost all identify poverty reduction as the over-riding goal and action plans focus on

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[5] Interview September 12, 2008, with Michael Doyle, former Assistant Secretary General for Strategic Planning and chair of the technical committee who elaborated the MDGs.

economic liberalization and social investments. They emphasized commitment to the MDGs but were selective in which ones they emphasized among the multitude of targets and indicators. Almost all of them included among core objective and action plans, specific strategies in areas of primary education, health and economic governance. For these areas except governance, the strategies set quantitative targets in line with the MDGs. What is striking is the absence of the strategic elements of a socially transformative agenda—empowerment, distribution, employment generating growth, and democratic governance. Of the 60 MDG indicators, those that received virtually no mention were those most important for ensuring that growth is inclusive and pro-poor, and that development empowers those who are marginalized; less than 4 out of 22 documents mentioned employment, natural resource conservation, protecting orphans from the HIV/AIDS pandemic, women's political representation, violence against women, and social integration of migrants. And while the objective of PRSPs are to generate growth and reduce poverty, there is little by way of proactive government support for these objectives such as infrastructure development, expansion of credit financing or technological upgrading. The growth is expected to come through the private sector by creating a stable macroeconomic environment to foster investments.

With respect to donors, the same study (Fukuda-Parr S. 2010) also analyzed policy statements of the 21 largest bilateral donors. As in the PRSPs, these donor policy documents emphasized poverty but not empowerment, social integration, equality, and pro-poor growth, the themes that are central to human development. There has been a perceptible increase in funding for social sectors and within these sectors to primary basic services ODA for other MDG priorities, notably food production and agriculture—which are important for reducing hunger and malnutrition and for reducing rural poverty—also increased but much less markedly. The proportion of aid allocated by DAC donors to basic social services increased from 10.1 percent in 1999 to 21.0 percent in 2009 while the proportion of ODA for building trade capacity declined from 38.5 percent in 2001 to 28.9 percent in 2009 (Tables 2-3, figures 1-4). There was a corresponding decline in aid allocations to economic infrastructure and services from 24 percent to 15 percent, and production sectors from 12 percent to 7 percent and in budget support from 8 percent to 5 percent.

From the late 1990s, global diseases and health in general received high priority attention from both official donors and new foundations such as the Gates Foundation. This has led to new initiatives and new financing such as the establishment of the Global Fund to fight AIDS, Tuberculosis and Malaria. Manning (Manning, 2009) argues that some of this increase was encouraged by the institutionalization of MDGs that drew attention to neglected priorities in child and maternal health.

Table 2. ODA commitments by DAC donors 1990-2010 (US$millions, constant 2010)

	1990	1995	2000	2005	2010
Social Infrastructure and Services	19,844	20,231	20,919	34,174	44,333
Production Sectors	10,322	6,755	4,405	5,997	8,977
Agriculture		2,142	2,219	3,042	5,372
General Budget Support	1,155	1,291	561	1,826	2,365
Education Total	8,631	7,307	5,522	6,656	9,470
Basic Education	..	775	1,166	1,910	2,510
Health Total	2,441	2,845	2,385	4,076	5,116
Basic Health	..	1,266	1,329	2,532	2,945
Food crop production		83	66	102	239

Source: UN 2011 http://mdgs.un.org/unsd/mdg/Resources/Static/Data/2011 percent20Stat percent20Annex.pdf accessed April 14, 2012.

Table 3. ODA allocations of DAC donors to MDG priorities (percent of sector allocable ODA)

	1999	2001	2003	2005	2007	2008	2009
Basic social services (MDG indicator 8.2)	10.1	14	15.7	15.9	19.9		21
Aid for trade (MDG indicator 8.9)		38.5	29	30.7	27.7	34.4	28.9

Source: UN 2011 http://mdgs.un.org/unsd/mdg/Resources/Static/Data/2011 percent20Stat percent20Annex.pdf accessed April 14, 2012.

Figure 1. Sectoral allocation of ODA commitments by OECD/DAC bilateral donors 1990-2012 ($2010 million)

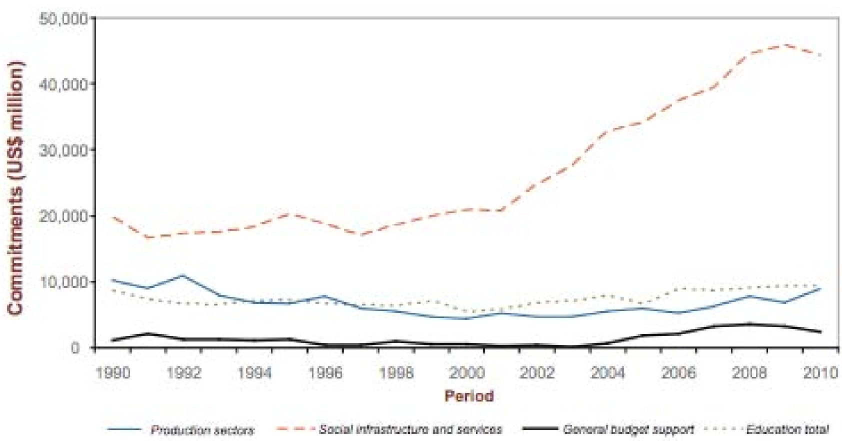


Figure 2. Allocation of ODA commitments by OECD/DAC bilateral donors selected sectors, 1990-2010 ($2010 million)

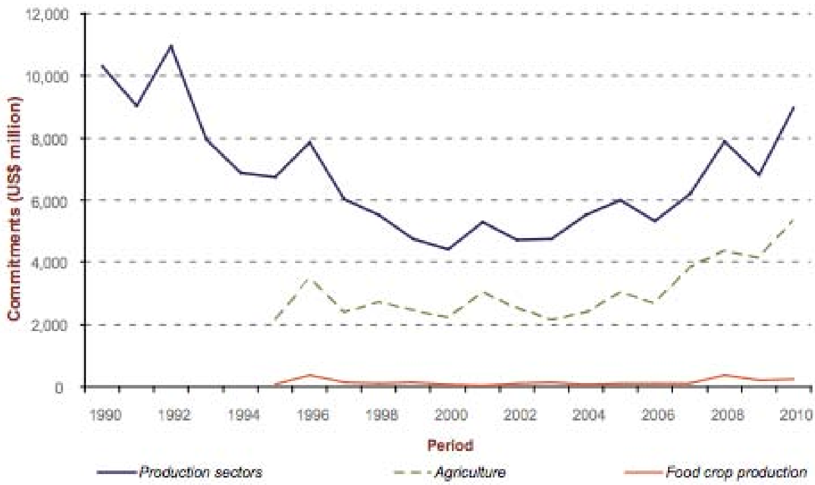


Figure 3. Allocation of ODA commitments by OECD/DAC bilateral donors to the health sector, 1990-2010 ($2010 million)

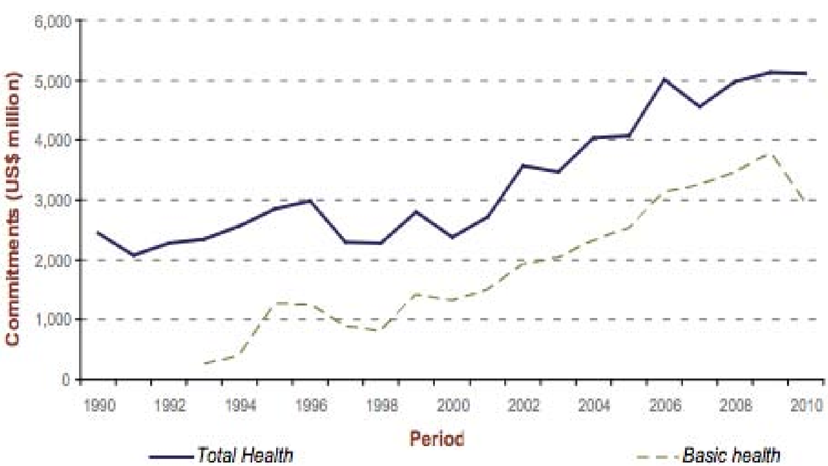
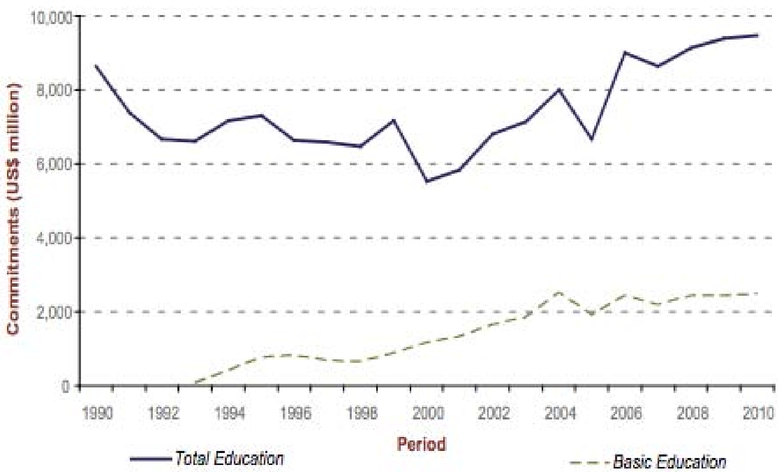


Figure 4. Allocation of ODA commitments by OECD/DAC bilateral donors to education, 1990-2010 ($2010 million)



Source, Figures 1-4: OECD.org, http://www.oecd.org/dac/stats/international-development-statistics.htm

While the MDGs and the consensus on poverty drew from the UN conference agendas for inclusive globalization, the policy content of most PRSPs and donor policy statements contain little attention to issues that were at the core of the inclusive globalization agenda of the UN conference plans of action. And while it was the criticism of the distributional consequences of the Washington Consensus policies and the broader liberalization agendas that drove the demise of the structural adjustment programs of the 1980s and 1990s, and the rise of poverty and human concerns to the fore of international agendas, maintaining a stable macroeconomic environment, economic growth, and liberalization remain key objectives. Stringent macroeconomic policies aimed at maintaining low inflation, minimum balance of payments and budgetary deficits still remain at the core of the economic management and development strategy, coupled with strengthening institutions of economic governance such as property rights. While they are no longer conditions in structural adjustment loans, they are core provisions for access to debt relief from the HIPC initiative and from the IMF under the Poverty Reduction and Growth Facility (PRGF).

Though the Washington Consensus may be 'dead', the basic macroeconomic policy prescriptions for macroeconomic stability and privatization of economic activity remain at the core of both World Bank and IMF lending operations and conditions. Structural adjustment loans have been discontinued, but the macroeconomic policy prescriptions continue under IMF lending programs and conditions for accessing debt relief. It should be noted that much of the criticism of the Washington Consensus was only partly about what the core policy prescription that were included (measures to ensure macroeconomic stability) but also about what they left out (human well-being, poverty and inequality), the rigidity with which the policy prescriptions were applied (ignoring trade-offs involved such as cutting social expenditures), and the aid architecture (conditionality) with which they were implemented.

The post-2000 architecture of international development has changed in terms of instruments and narratives but not in content. The structural adjustment loans have been replaced by HIPC and IMF PRGF. The policy frameworks on which the funding was based is now the national government's PRSPs with a focus on poverty and has replaced the Policy Framework Papers, which required IMF and World Bank approval. These new instruments conform to the narrative of the partnership paradigm emphasizing national ownership, but they retain the same policy content that condition access to financing. Most importantly, the narrative of development and development aid has been reformulated around the moral imperative of eliminating dehumanizing poverty, an unacceptable condition for a world of immense financial and technological means.

While the years following the introduction of the MDGs were striking for the ambitious and high-profile political commitments made by the G8 countries, such as the pledge to double development aid to Africa (or 0.51 percent of their GNIs) made at the Gleneagles Summit in 2005, they have largely not been implemented (United Nations, 2011) though a few countries have made significant increases in their support to Africa.[6] Moreover, no significant international poverty initiatives were launched, and the rich countries have not shifted their positions on critical international economic policies including trade, finance, investment and technology transfer. As the title of the UN MDG Gap Task Force 2011 report, "The Global Partnership for Development: Time to Deliver", makes clear, donor countries have fallen far short of implementing their Goal 8 targets for aid, trade, debt and technology (United Nations MDG Gap Task Force, 2011). So far, the only tangible progress in these areas has been reduction of the debt burden of the poorest countries. Multilateral trade talks—the Doha Round, labeled the 'development round'—have become deadlocked, largely over differences between developing and developed country positions on agricultural subsidies in the developed countries. Aid commitments have increased in volume, but these trends started before 2000 and have slowed since 2006. Moreover ODA still remain at 0.31 percent of donor GNI in 2010, far short of the UN target of 0.7 percent GNI. There has been substantial reallocation to the Least Developed Countries (LDCs)—from $21 billion in 2000 to $29 billion by 2009 (2009 prices and exchange rates). But this is still only 0.10 percent of donor GNIs compared with the UN target of 0.15-0.2 percent GNI (UN 2011 p.10, table 1).

Surprisingly, the consensus on poverty as a policy priority has not led to fundamental debates or new thinking about policy alternatives for faster poverty reduction. While poverty reduction was identified as the 'overarching' objective, development strategies continued to follow the approach of the 1990s that emphasized macroeconomic stabilization as the priority objective through the application of Washington Consensus policies to promote aggregate economic growth through private investments. Greater focus has been placed on social sector investments to meet basic needs and on social protection, including conditional cash transfers.

For sure, important studies have been published, and there have been many departures from the structural adjustment programs of the

[6]The US doubled aid to Sub-Saharan Africa between 2004 and 2009, one year ahead of the pledge; Canada doubled funding from 2001 levels; Norway surpassed the pledge to maintain ODA at 1 percent of GNI, and Switzerland increased its ODA to 0.41 percent of GNI.

1980s. Social investments and protection, including initiatives such as conditional cash transfers, have emerged as important priorities. But the core macroeconomic strategies have remained unchallenged. The MDGs did not propel new thinking about challenging the macroeconomic policy approaches of the Washington Consensus framework, since their implications for poverty reduction have not emerged into mainstream international policy debates. In other words, the core Washington Consensus policies aimed at macroeconomic stabilization and liberalization have continued to dominate development strategies, only supplemented by emphasis on social investments. New development strategies and approaches have emerged not from mainstream thinking and advice from the international community, but from innovation within developing countries such as Brazil and China that have not been in IMF policy-based lending programs. These approaches have included not only alternative growth strategies, but also poverty reduction strategies, particularly in Brazil and several other Latin American countries which have achieved not only stable economic growth and weathered the global financial crisis, but have also reduced inequality. These policy approaches have been more interventionist in promoting expansionary macroeconomic policies, expanding employment, and raising incomes of the poorest, such as through minimum wage legislation.

4.3. OUTCOMES

Whether the MDGs have had an impact on the pace of poverty reduction and development outcomes is difficult to assess, since it is impossible attribute any recent trends to the MDGs as opposed to the myriad of other factors that have driven national poverty outcomes. But the problem remains that poverty reduction has continued globally, but too slowly and unevenly. Overall, the pace of progress has not accelerated, while the trends have been uneven across regions with Sub-Saharan Africa showing faster progress than other regions.

The UN and other international agencies assess progress made against the 2015 targets, focusing on the level of achievement. According to the 2011 UN MDG Progress Report (UN 2011), globally, the 2015 targets for income poverty (goal 1) and water (goal 7) are on track to be met, while steady progress continues in reducing child mortality (goal 4), malaria and other global diseases (goal 6). Primary schooling has been advancing, but the pace has begun to slow down and the goal of universal enrollment may not be achieved. More alarmingly, there has been either stagnation or regress for some goals and targets. The proportion of people who are hungry (goal 1) has plateaued at 16 percent since 2000/2002 and the number of undernourished people has grown from 817 million in 1990/92 to 830 million in 2005/2007. Employment and decent work (goal 1) has shown a setback in many countries, while progress has been slow in gender equality and empowerment, other than in primary education (goal 3) and in reducing maternal mortality (goal 5).

The impact of the MDGs on changing policy behavior and outcomes would be reflected, if the pace of progress were improved rather than whether the goals were likely to be achieved. Countries have different starting points and for many, achieving the MDGs may not be feasible even if they were to adopt improved efforts resulting in better performance (Clemens, Kenny, & Moss, 2007). In another paper (Fukuda-Parr, Greenstein, & Stewart, 2013) my co-authors and I argue that the criterion for success should be improvement in performance, as measured by the pace of progress. We proposed a methodology for this criterion and made estimates for 24 indicators.

Our findings were disappointing for the country level, but more encouraging for Sub-Saharan Africa and South Asia as regions. We found improved performance by a majority of countries for just five of the 24 indicators studied. On the other hand, the majority of Sub-Saharan African countries showed improved progress for 16 indicators. At the global level, the pace of progress improved for under-5 mortality rate, measles immunization and gender parity in primary schooling, but not for attended births or improved water source. For income poverty, the pace improved in all developing regions. Disaggregated to regions, South Asia and Sub-Saharan Africa, the two regions with the highest concentrations of poverty showed consistent improvement and performed better than the other regions. In Sub-Saharan Africa, progress has been made at a faster progress since the MDGs were introduced across all but one indicator for which data are available. In South Asia, improvements are faster for all indicators except child mortality and child malnutrition. While it is not possible to attribute the improved progress to the MDGs, the record of improvement is encouraging.

In brief, the impact of MDGs on outcomes and policy is ambiguous, uneven and limited at best, but has been a significant factor in shaping international debates. The MDGs did not introduce a new concept or policy strategy, but created a narrative that has raised global awareness of poverty as a compelling moral challenge requiring urgent action. The narrative has become a consensus framework for debate on international development. MDGs are widely accepted among the key stakeholders including national governments, donor agencies, NGOs, and local civil society groups, regardless of views that any of these actors might hold individually about their relevance as a development strategy. The importance of this new awareness and consensus should not be underestimated considering that the pursuit of development priorities in the globalized and democratically-governed world requires the public at large to share commitments to these priorities as a matter of ethical imperatives of a common humanity. The MDGs are associated with an increase in social sector investments, notably in aid allocations, but this is continuation of a trend that started prior to the introduction of the MDGs. If there is causation, we might ask if donor policy drove the MDGs rather than the other way round.

5. CONCLUDING REMARKS: 'DEVELOPMENT' IN TRANSITION

As the international community proceeds to define a new international development agenda, what is at stake is as much about a list of priority objectives as what it implies in defining the meaning of development. The experience of the MDGs highlights some key issues to be considered for the new agenda.

First, inequality and poverty within countries should not be a priority at the expense of inequality between countries. The MDGs have been instrumental in institutionalizing ending poverty as a global priority, and equitable and sustainable development as a universal challenge. This has been a great advance. At the same time, countries face widely divergent conditions and constraints and opportunities. Second, the focus on essential Basic Needs should not be at the expense of a broader range of development objectives including economic transformation and social change. As a framework for promoting development and ending poverty, the MDGs were not instrumental in mobilizing greater support for social investments in Sub-Saharan Africa. However, their major weakness is the extremely narrow scope as a Basic Needs agenda, which marginalized productive sectors and the challenge of development as a transformative process that builds productive capacity of economies and that empowers people.

Third, the new agenda should go beyond setting outcome goals to making commitments for policy agendas. While the simplicity of quantitative targets on human outcomes has been the core strength of the MDGs, does not comprise a strategy. As noted, progress over the last decade has been important but uneven and inadequate for the poorest countries. The corollary to these trends has been the failure to address the systemic problems of protecting developing countries from the consequences of global market integration. A leading example of these trends is the inadequate response of international cooperation to protect the poor against the consequences of climate change, and the crises of global financial, fuel and food markets. Seen in this light, the MDGs could arguably have provided a convenient 'cover' behind which the economic model of the 1990s—augmented by the Washington Consensus—could be continued without controversy. The MDGs perhaps co-opted the language of human development, and the inclusive globalization while 'defanging' critical debates about the impact of the liberalization agendas on poverty and inequality.

But the new consensus will require a more effective strategy for equitable and sustainable development that is more than a list of goals. Simple, quantitative, and concrete goals make effective communications device and targets set benchmarks essential for monitoring progress. But that does not make an adequate agenda.

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FINANCE AND GROWTH IN SUB-SAHARAN AFRICA:

Policy and research challenges

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Abstract

This article looks at lessons from the 2007/2008 global financial crises for African low-income countries' financial sectors and suggests research questions which need to be investigated. It examines lessons from recent empirical literature both for the scale and structure of the financial sector as well as its regulation. Excessive—and too rapid growth—of the financial sector is warned against as it can cause very costly financial crises and does not necessarily contribute to financing the real economy. The paper recommends that where market failures exist, government interventions through public institutions or indirect mechanisms may be desirable.

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1. INTRODUCTION

Finance provides a particularly challenging and important field for policy design and policy-relevant research, especially if placed in the context of those countries' needs for development. The policy challenges and research needs are very large, due partly to a major rethinking of the role, scale and structure of a desirable financial sector, as well as its regulation, in light of the major financial crisis that started in 2007/8. There is an urgent need to understand the implications of this policy and analytical rethinking for Sub-Saharan African (SSA), especially low income countries' (LICs) financial sectors, especially regarding its impact on their economic growth.

The financial sectors of African LICs are still at an early stage of development, so lessons from the crisis could inform their financial sector development strategies. Moreover, their financial sectors, while generally still shallow, are experiencing fairly rapid growth. Combined with African countries' existing vulnerabilities, such as limited regulatory capacity, this might pose risks to financial system stability. Despite the infrequent appearance of systemic banking crisis on the African continent over the past decade (see below), fast credit growth in many economies—even if at comparatively low levels—calls for caution, signaling the need for strong, as well as countercyclical, regulation of African financial systems. For policymakers and researchers this poses the challenge of applying the lessons from the crisis in developed and previously in emerging countries to African LICs, while paying careful attention to the specific features of African financial systems.

There are also more traditional policy challenges and research gaps on financial sectors in LICs, and their links to inclusive growth. To support growth, there are a range of functions that the financial sector must meet in African LICs, such as helping to mobilize sufficient savings; intermediating savings at low cost and long maturities to investors and consumers; ensuring that savings are channeled to the most efficient investment opportunities; and helping companies and individuals manage risk. There are also large deficiencies in these areas originating from specific market failures and/or gaps. For example, there is a lack of sustainable lending at relatively low spreads, including with long maturities to small and medium enterprises (SMEs), which is particularly constraining for growth in LICs.

This paper presents two key areas for a policy, as well as corresponding research agenda on finance and growth in Sub Saharan Africa building partly on lessons from the Global Financial Crisis: 1) the desirable size and structure of the financial sector and 2) new challenges for financial regulation. The discussions in these two areas is important to advance understanding on the links between the financial sector and inclusive as well as sustainable growth.

2. FINANCIAL SECTOR DEVELOPMENT AND GROWTH

Central bankers and financial regulators in African LICs have always faced major conceptual and institutional challenges in striking the right balance in their policy design to achieve the triple aims of financial stability, growth and equity.

These challenges acquired a new dimension in the light of numerous financial crises, initially in the developing world, but recently in developed countries. The latter led to a major re-evaluation of the role of the financial sector, its interactions with the real economy and the need for major reform of its regulation, especially in developed and emerging economies (see for example, Griffith-Jones, Ocampo and Stiglitz, 2010, as well as IMF, 2011 and 2012, as well as Haldane and Madouros, 2012 on the need to simplify regulation); the latter resonates very well with LICs. Before examining the implications of this analysis for SSA countries, we will look first at how the Global Financial crisis affected SSA countries.

Interestingly, although the Global Financial Crisis originated in and strongly hit developed economies, its cost to developing SSA (in contrast to all LICs on average) in terms of foregone growth and investment as well as falling tax revenue with increasing budget deficits is quite substantial. Developing SSA[3] suffered a GDP growth slowdown to 4.0 percent in the aftermath of the crisis (2008-2010) in comparison to average growth rates of 4.7 percent between 2000 and 2007. This equals a loss in GDP growth of 0.7 percentage points (see table 1). SSA growth was much more affected by the recent slowdown in economic activity around the world—mainly driven by recession and stagnation in developed economies—than that of all low income countries on average, which have managed to grow by 0.4 percent more in the same period (2008-2010, compared to 2000-2007). Similarly, the crisis impact on tax revenue is potentially larger in SSA than in low income economies on average. While low income countries did not see a reduction in tax revenue in the aftermath of the crisis, taxes collected in SSA fell by 1.7 percent of GDP in comparison to pre-crisis levels. Concurrently, budget positions in SSA countries worsened by 1 percent of GDP on average.

Table 1: The Impact of the global financial crisis on high, middle and low income countries

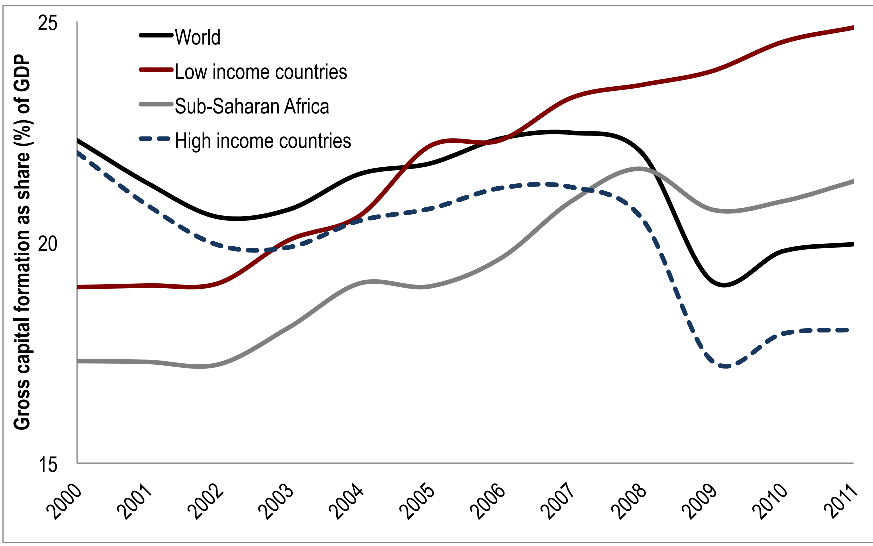
Region/Country	Decline in GDP growth	Decline in investment (% of GDP)	Decline in tax revenue (% of GDP)	Rise in budget deficit (% of GDP)
High income countries	-2.7	-2.2	-1.2	-4.2
Middle income countries	-.08	3.2	0.8	n/a
Low income countries	0.4	3.3	0.8	n/a
Sub-Saharan Africa (developing)	-0.7	2.5	-1.7	-1.0

Note: All decline figures are calculated a difference between the 2000-07 average and the 2008-10 average. Developing Sub-Saharan Africa refers to all Sub-Saharan countries with the exception of Equatorial Guinea, which is classified as high income
Source: World DataBank, World Bank, 2013.

[3] Developing SSA refers to all SAA countries with the exception of Equatorial Guinea, which is classified as high income country by the World Bank. All SSA figures in the document exclude Equatorial Guinea since the focus is on developing economies.

Furthermore, the question can be raised whether SSA growth in investment rates would not have been faster in the absence of the Global Financial Crisis. Figure 1 illustrates this point. Gross capital formation (investment), as share of GDP, peaked at 22 percent in 2008 falling by almost 1.5 percentage points in the following year. The 2008 level has not been recovered as of 2011, the latest year for which data are available.

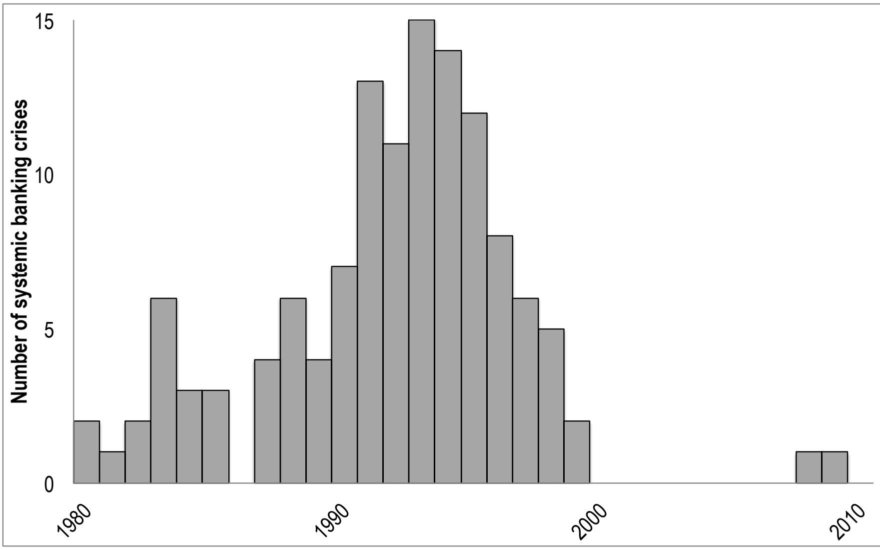
Figure 1. Impact of the global financial crisis on gross capital formation.



Source: World DataBank, World Bank, 2013.

It is interesting that the number of banking crises on the African continent has overall been remarkably low over the past decade (2000-2009), potentially indicating increased resilience of African financial systems particularly in comparison to the 1990s (see figure 2).

Figure 2. Systemic banking crises in Africa, 1980-2009



Source: Laeven and Valencia, 2008.

This argument is in line with the observation that the dissemination of the financial crisis from strongly affected advanced economies to African low income countries has mainly happened through the trade channel, falling commodity prices as well as shrinking remittances and official development assistance budgets.

In this context the Nigerian banking crisis—discussed below—is seen by some as a 'sporadic outlier' (Beck *et al*. 2011, p. 3). There is nevertheless the danger that lack of recent crises can lead to policymakers' and regulators' complacency (as well as that by the financial actors), which precisely could increase the risk of future crises. This phenomenon, known in the literature as "disaster myopia", has in the past contributed to increased risk of crises in other regions.

There has been far relatively little research and policy analysis on the implications of the Global Financial Crisis for African countries and LICs more generally, with some valuable exceptions (see for example, Kasekende *et al* 2011, and Murinde *et al*, 2012 for good analysis of regulatory issues in LICs). As African financial sectors are growing quite quickly, they may be more vulnerable to threats to their financial stability. The value added of policy analysis and research on finance and development that explores the right lessons to learn from the Global Crisis—and previous ones in emerging economies—for African LICs, is thus likely to be high. This research might help answer the question of how the need to ensure financial stability interacts with the need of a financial system in LICs that assures enough access to sustainable finance for the different sectors of the economy, including long-term finance to fund structural change, as well as different segments, such as small and medium-sized enterprises (SMEs) and infrastructure.

3. AREAS OF ANALYSIS

There are two areas of enquiry for understanding the links between the financial sector and inclusive, as well as sustainable, growth: 1) what is the desirable size and structure of the financial sector in LICs? and 2) what are the regulatory challenges to maximize the likelihood of achieving financial stability, whilst safeguarding inclusive and more sustainable growth? Political economy might be a fruitful lens through which to perform such analysis because it sheds light on the political determinants of financial policy.

3.1 SIZE AND STRUCTURE OF THE FINANCIAL SECTOR

At a broad level, what is the desirable ("optimal") size and structure of the financial sector in African countries, to maximize its ability to support the real economy? What are the desirable paths of development of the financial sector in Africa to help it maximize its contribution to growth, considering features of African countries and lessons from recent crises?

The traditional positive link between deeper as well as larger financial sector and long-term growth, that started in the literature with Bagehot and Schumpeter, but then was reflected in quite a large part of the empirical literature, such as Levine (2005), is being increasingly challenged. Authors like Easterly, Islam and Stiglitz (2000) had already early on suggested that financial depth (measured by private credit to GDP ratio) reduces volatility of output up to a point, but beyond that, actually increases output volatility. More recently, a number of papers are showing inverse relation between size of financial sector and growth, especially beyond a certain level of financial development, which is estimated at around 80-100 percent of private credit to GDP. Thus, Bank for International Settlements (BIS) economists (Cecchetti and K. Kharroubi, 2012) based on empirical work reach the following conclusions, which challenges much of earlier writing:

> "First, with finance you can have too much of a good thing. That is, at low levels, a larger financial system goes hand in hand with higher productivity growth. But there comes a point, where more banking and more credit lower growth. Secondly, looking at the impact of growth in the financial system—measured in employment or value added—on real growth, they find clear evidence that faster growth in finance is bad for aggregate real growth. This implies financial booms are bad for trend growth. Hence, macro prudential or counter-cyclical regulation, discussed below, is important."

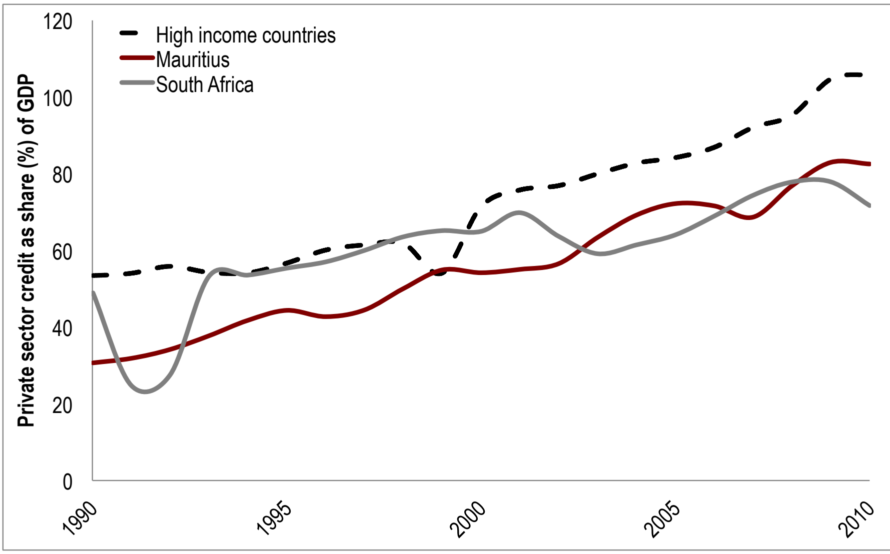
Finally, in their examination of industry-level data, they find that industries competing for resources with finance are particularly damaged by financial booms. Specifically, manufacturing sectors that are R&D-intensive suffer disproportionate reductions in productivity growth when finance increases.

Similarly, an IMF Discussion Paper (IMF, 2012a) suggests empirical explanations for the fact that large financial sectors may have negative effects on economic growth. It gives two possible reasons. The first has to do with increased probability of large economic crashes (Minsky, 1974, Kindleberger, 1978 and Rajan, 2005) and the second relates to potential misallocation of resources, even in good times (Tobin, 1984). De la Torre *et al*, 2011, point out that "Too much finance" may be consistent with positive but decreasing returns of financial depth which, at some point, become smaller than the cost of instability. It is interesting that the IMF Discussion paper, (*op cit*.) results are robust to restricting the analysis to tranquil periods. This suggests that volatility and banking crises are only part of the story. The explanation for the "Too Much Finance" result is not only due to financial crises and volatility, but also misallocation of resources.

It is also plausible that the relationship between financial depth and economic growth depends, at least in part, on whether lending is used to finance investment in productive assets or to feed speculative bubbles. Not only where credit serves to feed speculative bubbles—where excessive increases can actually be negative for growth—but also where it is used for consumption purposes as opposed to productive investment, the effect of financial depth on economic growth seems limited. Using data for 45 countries for the period 1994-2005, Beck *et al*. (2012), and Beck *et al*., (2011) show that enterprise credit is positively associated with economic growth but that there is no correlation between growth and household credit. Given that the share of bank lending to households increases with economic and financial development and household credit is often used for consumption purposes whereas enterprise credit is used for productive investment, the allocation of resources goes some way towards explaining the non-linear finance-growth relationship. In African countries, only a small share of bank lending goes to households. However, as financial sectors and economies grow, this will change, as has been the case in South Africa.

Rapidly growing credit to households—even though desirable when strengthening reasonable levels of domestic demand and financial inclusion, in a sustainable way—might, however, cause financial instability if not regulated prudently. This is especially the case if lending is excessively channeled into the construction sector, creating a housing bubble. The two most advanced African economies, South Africa and Mauritius—both upper middle income countries—have recently experienced or are currently experiencing a construction boom. Both economies possess relatively deep financial markets with strong private domestic lending including significant consumption credit extension. Figure 3 shows that private credit in high income economies was around 100 percent of GDP on average in 2010 while it accounted for 70-80 percent of GDP in Mauritius and South Africa.

Figure 3. Private credit extension in African middle income countries compared to high income countries, 1990-2000

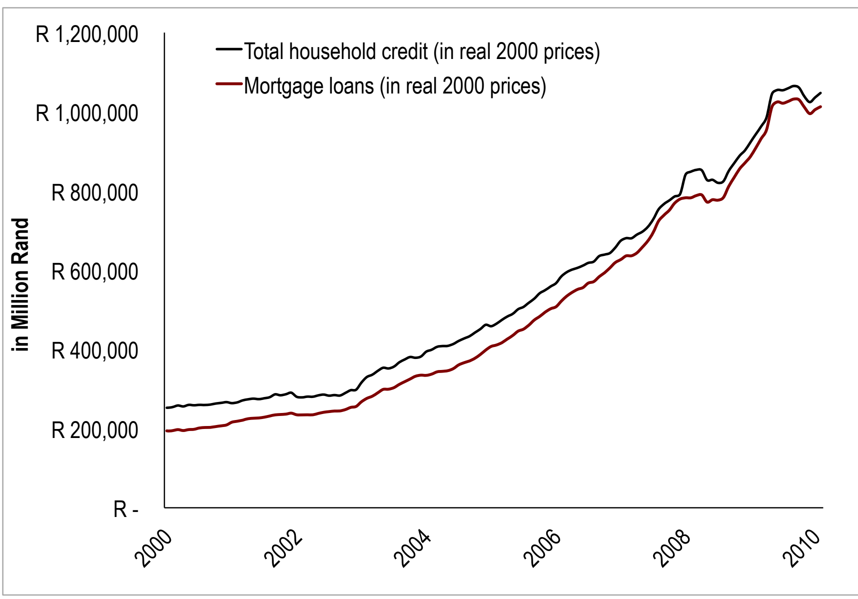


Source: World Development Indicators, World DataBank, World Bank, 2013.

In international comparison, South Africa was the country in Africa which experiences the strongest house real price gains between 2004 and 2007, by far exceeding even the price growth in the booming residential property markets of the US and the UK (see figure 4). In South Africa the ratio of household to business credit is approximately 1:1. The large majority of household borrowing takes on the form of mortgage finance. During the early 2000s this led to an unprecedented housing boom in South Africa fed by growth in housing loans of over 500 percent in real terms between 2000 and 2010 (see figure 5). This was largely absorbed by upper income South African households accounting for three quarters of total household credit created (DTI, 2010). In an attempt to reduce inflation, asset price increases and potential macro-economic over-heating, the South African Reserve Bank gradually initiated monetary tightening in June 2006, accelerating the rise in interest rates the following year.

The subsequent economic slowdown in South Africa was to a large extent based on domestically accumulating economic and financial imbalances while the Global Financial Crisis merely intensified the recession of 2008/09. The fact that credit and consumption-led growth was unsustainable in South Africa was illustrated in over 1 million jobs shed in 2008/09, largely in low-skilled consumption-driven sectors. A positive aspect was that there was no financial crisis, perhaps because of the positive policy response from the economic authorities; however, as mortgage credit picks up, and especially if it does at a very fast pace, care has to be taken to regulate this. The South African experience reiterates that private sector credit expansion at very high levels might lead to output volatility and adverse growth effects (see Easterly, Islam and Stiglitz, *op cit*, and Cecchetti and K. Kharroubi, *op cit*). In order to prevent future crisis and foster economic development a re-orientation towards more business credit, particularly for productive investment, might be needed.

Figure 5. South African private sector credit extension by purpose, 1990-2012

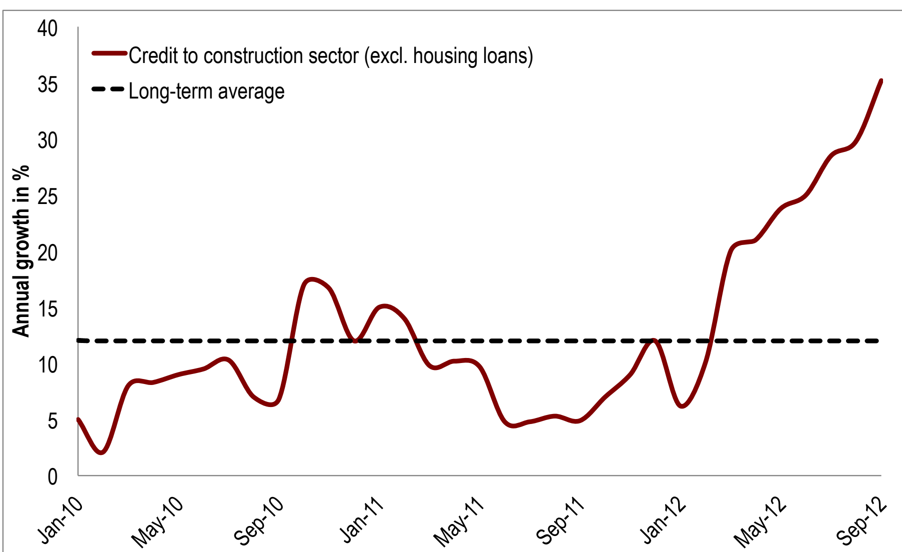


Source: SARB, 2013.

In Mauritius almost one third of private sector credit flows to households, equaling 20 percent of GDP by late 2012. The majority of household borrowing is mortgage finance (60 percent of total household credit) with the rest used to fund consumption (40 percent). Given sustained demand for residential property housing credit has been growing close to 20 percent annually on average over the past 5 years

(Bank of Mauritius, 2012). Simultaneously, foreign direct investment (FDI) flows into the country concentrate on real estate activities with the bulk in tourist resorts, real estate and invest hotels schemes. The construction industry accounted for approximately half of FDI inflows in recent years (2008-2012). Mauritius's construction boom should be monitored with caution, which has also been pointed out by the IMF Article IV Mission Consultation. Financial vulnerabilities appear to be accumulating in the industry with potential adverse impact on balance sheets of domestic commercial banks. Even though non-performing loans as share of total credit are at reasonably low levels, they have increased from 2.1 percent to 3.1 percent between 2010 and 2012. Furthermore, non-performing loans in the construction industry (excluding housing loans) as share of sectorial credit are more than twice as high, rising from around 5 percent in 2010 to 8 percent last year. This development is worrying and calls for counter-cyclical regulation especially since year-on-year growth in construction credit has shot up sharply during 2012, exceeding 35 percent by September. This is almost three times above the long-term average (see figure 6).

Figure 6. Construction sector credit in Mauritius

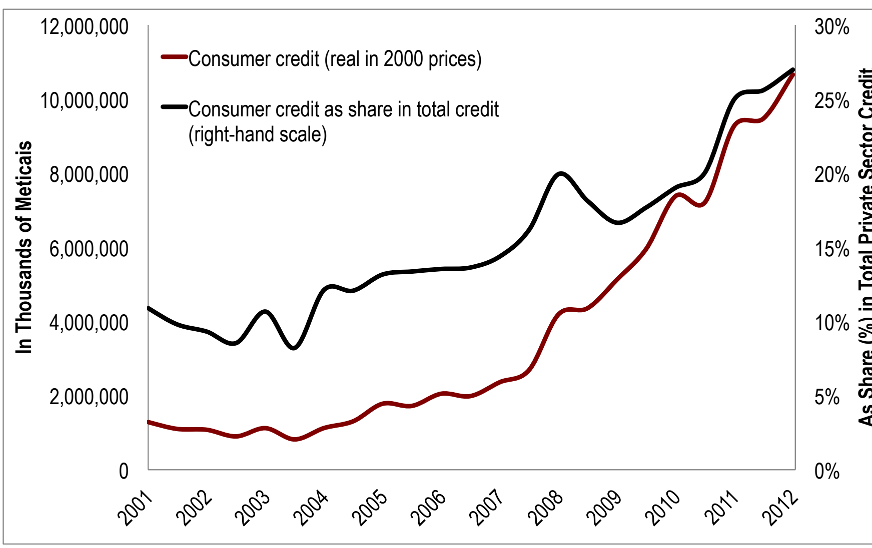


Source: Bank of Mauritius, 2012.

Limited data availability makes it difficult to measure to what extent consumption credit is on the rise in other African economies. This would seem to make the case for more disaggregated credit data, as well as monitoring by regulators as well as policymakers, more urgent.

One of the few low income SSA countries providing disaggregated domestic lending data is Mozambique (Banco de Moçambique, 2013). Private sector credit has increased significantly between 2000 and 2010 in the Southern African country from 15 percent to 23 percent of GDP (see table 2 below). During this period consumer borrowing almost tripled as share of total credit while it grew almost eightfold between 2001 and 2012 in real terms (see figure 7). Mozambique has had a strong growth performance implying a robust medium-term economic outlook despite stagnant poverty reduction and the need for more inclusive growth (IMF, 2012).

Figure 7. Mozambican consumer credit in real terms and as share of total private sector credit, 2001-2012



Source: Banco de Moçambique, 2013

Nevertheless, falling consumer price inflation has been accompanied by potential price pressures present in urban housing markets, which are difficult to assess due to lack of house price data for Mozambique. Significant housing rent increases (20-25 percent per year) have been reported for upmarket and expatriate areas of Maputo (Emerging Markets Consultants, 2012) while central areas in Mozambican towns and cities (so-called 'cement cities') have been observed to experience property price growth of 100 percent annually (CAHF, 2012).

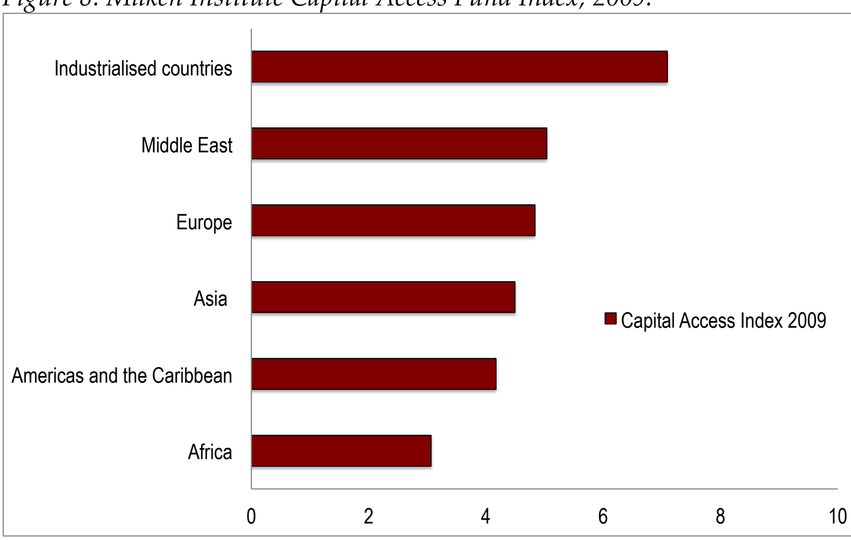
More broadly, as we began to discuss above, of relevance for growth is thus the link between the structure of the financial sector and growth. The IMF in its Global Financial Stability Report (IMF, 2012b) has interesting further empirical analysis of the relationship between the structure of the financial sector and economic growth, as well as the volatility of this growth and financial stress. This is a fairly under-studied area, and one which has hardly been applied to LICs. The preliminary empirical results of the IMF report suggest that cross-border connections through foreign banks may during crises be associated with instability, though their role may be more beneficial in normal times. The empirical evidence also seems to show that "a domestic financial system that is dominated by some types of non-traditional bank intermediation has in some cases been associated with adverse economic outcomes, especially during financial crises."

Crucial in the context of policymaking and research on finance in Africa is the extent to which the findings on the relationship between the structure and size of the financial sector and growth in more developed economies are relevant for and apply to African LICs because their financial systems are markedly different. In particular, these countries' banking systems are small in absolute and relative size, many of them reaching the size of mid-sized banks in high-income countries. Beck *et al*. (2011), *op cit* report for instance, that if measured in relative size based on the claims on the private domestic nonfinancial sector to GDP (private credit), the median for African countries as a whole (i.e. including North African countries) was 19 percent in 2009, while it was 49 percent for non-African developing countries. African financial sectors also show levels of financial intermediation and access to financial services has remained limited for large segments like SMEs, the agricultural sector or poor households. Many of those use informal financial services. In addition, African financial systems are mainly bank-based with non-bank segments showing an even lower level of development.

Given the importance of SMEs in creating employment, the lack of financial infrastructure supporting their activity in African financial systems is a major drawback for development. International financial indicators show that African businesses in general are disadvantaged through less access to finance than competitors in other regions. Concurrently, SMEs enjoy a particularly poor access to sources of finance, leaving them with internal cash flow as main source for investment finance. As consequence, enabling African SMEs to better access financing sources has the potential to strengthen and accelerate growth if done on sustainable grounds under adequate regulation.

The obstacles African SMEs experience in their domestic financial systems are mainly concentrated around the insufficient support by financial and banking institutions, lacking development of equity and bond markets and alternative sources of finance. Therefore, recent developments of deepening African financial markets might help SME growth if successfully and sustainably channeled into this segment. International indicators such as the capital access index and domestic analysis via enterprise surveys, by company size, support this view as argued below.

Figure 8. Milken Institute Capital Access Fund Index, 2009.



Source: Milken Institute, 2010.

A measure that can be used to understand the overall ability of businesses and entrepreneurs to access domestic and foreign capital is the Milken Institute's capital access index, CAI (Barth *et al.*, 2010) which is a ranking tool of the relative strength and performance of capital markets around the world[4]. African economies perform most poorly, with a score of 3.07 on a scale of 0 to 10, on business access to capital (see figure 8). Furthermore, of the 61 countries that form the bottom half of the ranking, 30 are African countries, while 17 of the 20 countries with the lowest scores are African low income economies (see table 2).

Table 2: Bottom 20 CAI scores and country rankings

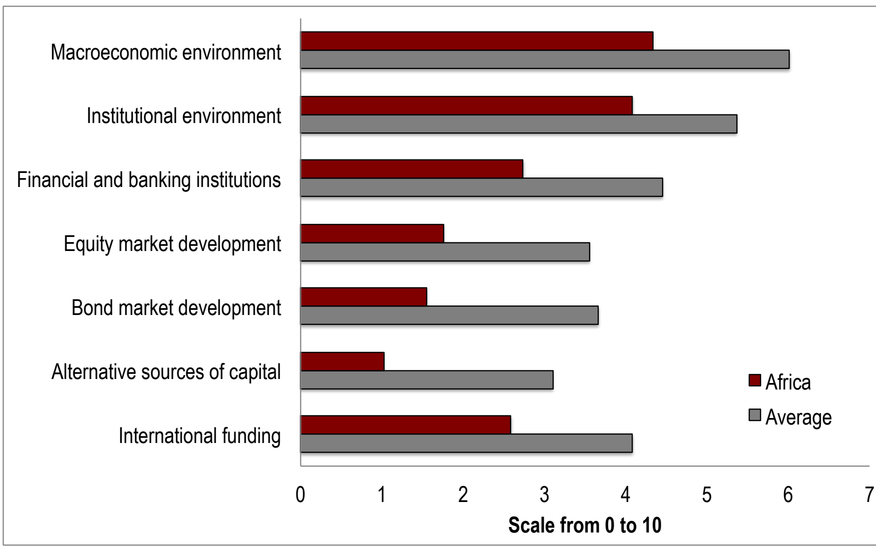
Country	**Score**
Mozambique	2.74
Cameroon	2.67
Rwanda	2.64
Burkina Faso	2.63
Syria	2.59
Benin	2.58
Sierra Leone	2.56
Ethiopia	2.44
Laos	2.37
Mali	2.37
Central Africa Republic	2.32
Togo	2.31
Guinea	2.19
Mauritania	2.18
Republic of Congo	2.17
Madagascar	2.13
Chad	2.06
Niger	2.03
Haiti	1.95
Burundi	1.87

Source: Milken Institute, 2010.

[4] This is achieved by assessing the macroeconomic environment, institutional environment, financial and banking institutions, equity market development, bond market development, alternative sources of capital, international funding in the relevant countries. The CAI is compiled by the Milken Institute and ranks 122 nations on six continents. The latest CAI, referred to in this document, has been provided by the Milken Institute for 2009.

The graphs below illustrates the difficulties that African businesses and entrepreneurs have in accessing finance (see figure 10), in comparison to the average for all countries in more detail (see figure 9). African economies struggle to establish internationally competitive financial and banking institutions, to support equity and bond market development as well as to develop alternative sources of finance. All these, and particularly alternative sources of finance, could serve as crucial sources of finance for SMEs.

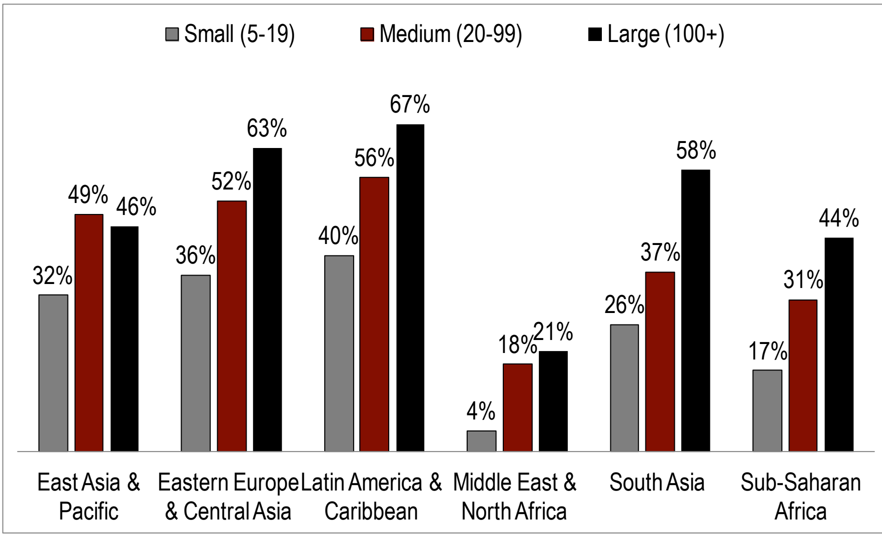
Figure 9. CAI components for Africa compared to the average.



Source: World Bank, 2013.

There is a gap of 4.28 (ranked out of 10) in the score between the top (South Africa) and the worst performing African country (Burundi) in the CAI ranking. This could indicate large discrepancy in financial sector development on the African continent.

Figure 10: Regional percent of firms by firm size with a bank loan/line of credit



Source: World Bank, 2013.
Note: Years vary for different regions, ranging from between 2006—2012.

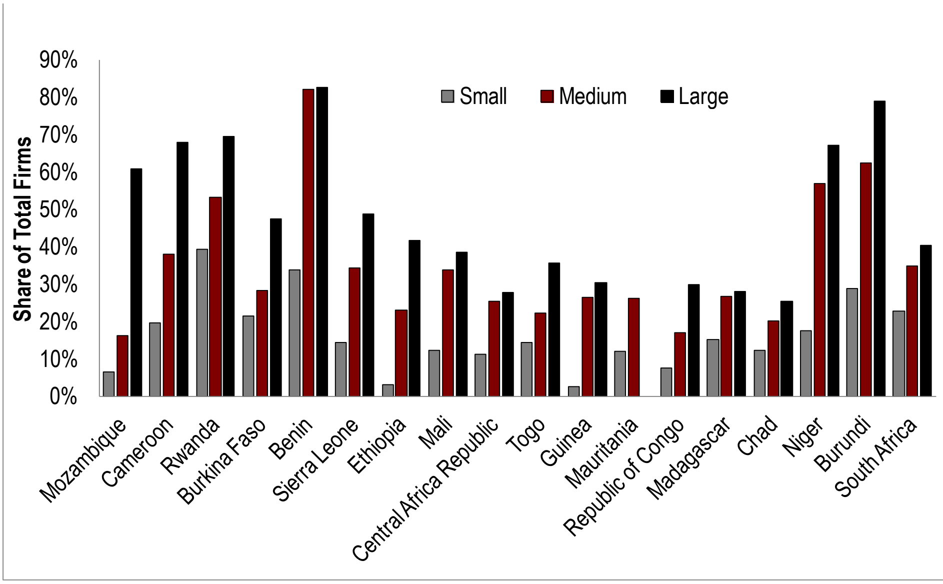
Assessing the ability of firms to access finance more deeply, the percentage of small, medium and large firms that have a bank loan or a credit line can serve as a measure (see figures 10 and 11). Sub-Saharan African small and medium sized firms have poor access to finance (only 17 percent of them, as opposed to 40 percent in Latin America, and 32 percent in East Asia) when compared to other developing regions, performing only better than Middle East and North Africa region. This analysis of access to credit by firm size is taken further below for some Sub-Saharan African countries on two levels:

1) By looking at the firms of different sizes and the implications on the ability of the firm to have a bank loan or a credit line;

2) By assessing whether the performance based on the size of the firm is different if the CAI score for the African country was in the bottom half or the top half.

In some cases where the CAI score is high small businesses have nevertheless poorer access to finance (measured as share of total firms with access to bank loan/line of credit) than countries that scored in the bottom of the CAI rankings. This is true, for example, for South Africa as compared to Rwanda, Burundi and Benin (see figure 11).

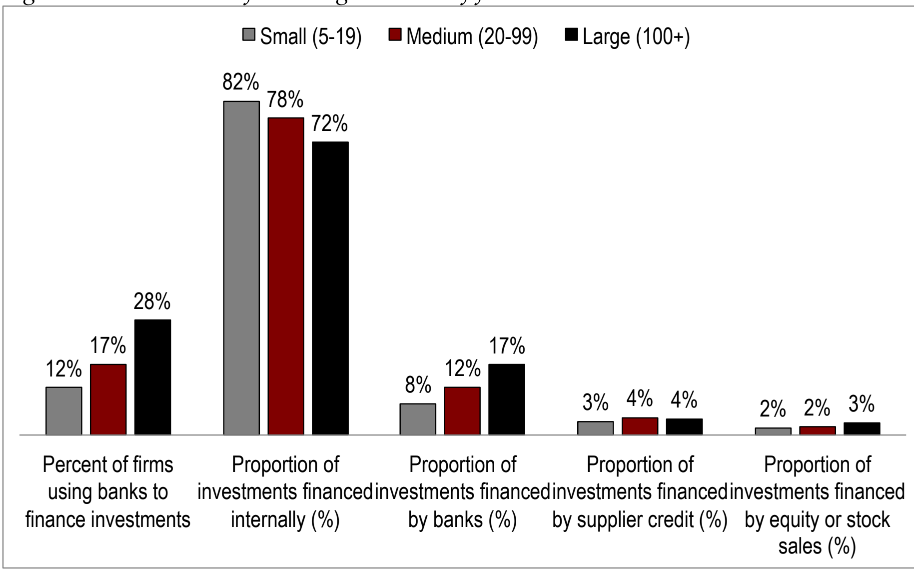
Figure 11. Access to bank loans and/or lines of credit by some SSA countries' firms.



Source: World Bank, 2013.
Note: Years vary for different countries, ranging from between 2006—2011.

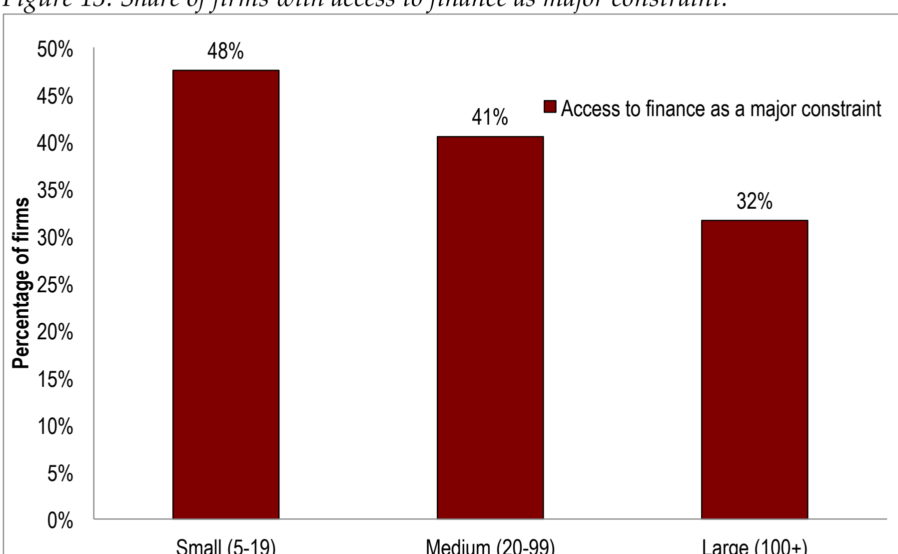
In general, between 60 percent and 70 percent of SMEs in Sub-Saharan Africa need loans, however only 17 percent of small and 31 percent of medium-sized firms actually have access to finance. As a consequence, firms in Sub-Saharan Africa have to finance a high proportion of investment through internally generated cash flows (82 percent among small Sub-Saharan African firms, see figure 12). This reflects the CAI finding that African countries lack developed equity and bond markets, alternative sources of capital and that there are low levels of lending by banking institutions. Not surprisingly, approximately 50 percent of small enterprises in Sub-Saharan Africa have identified access to finance as a major obstacle to their business activities (see figure 13).

Figure 12. Investment financing methods of firms in SSA.



Source: World Bank, 2013.

Figure 13. Share of firms with access to finance as major constraint.



Source: World Bank, 2013.

In an effort to increase the level of participation of financial institutions to finance small medium enterprises public banks, such as the African Development Bank (AfDB), are driving a number of initiatives designed to encourage the participation of financial institutions. One notable initiative is the African Guarantee Fund (AGF), which is a for-profit social investment fund. The AGF is owned by AfDB, AECID and DANIDA with contributions of US$10 million, US$20 million and US$20 million, respectively (African Development Bank, 2012). Over the next 3 to 5 years, this share capital is expected to increase to US$500 million, giving the institution capacity to guarantee up to US$2 billion worth of SME loans. The additional capital will be coming from bilateral donors, private investors as well as from DFIs (African Development Bank, 2012). The AGF will select certain financial institutions to be partner institutions by assessing their commitment to grow their SME portfolio and improving financial product offerings to SMEs. For these partner institutions AGF will have two lines of activity:

1) Partial credit guarantees: the provision of partial guarantees for financial institutions on the African continent to incentivize them to increase debt and equity investments into SMEs. These guarantees, with different fee structures (see table 3), will support:

    a) Loans made by client financial institutions to SMEs through a hybrid approach (portfolio and individual loan basis);

    b) Funds mobilization (i.e. issuance of bonds) by financial institutions in support of their SME financing activities; and

    c) Equity capital financing for SMEs.

2) Capacity development: supporting AGFs partner institutions enhance their SME financing capabilities through assisting to improve the capacity to appraise and manage SME portfolios (African Development Bank, 2013).

Table 3. Mechanisms of the AGF

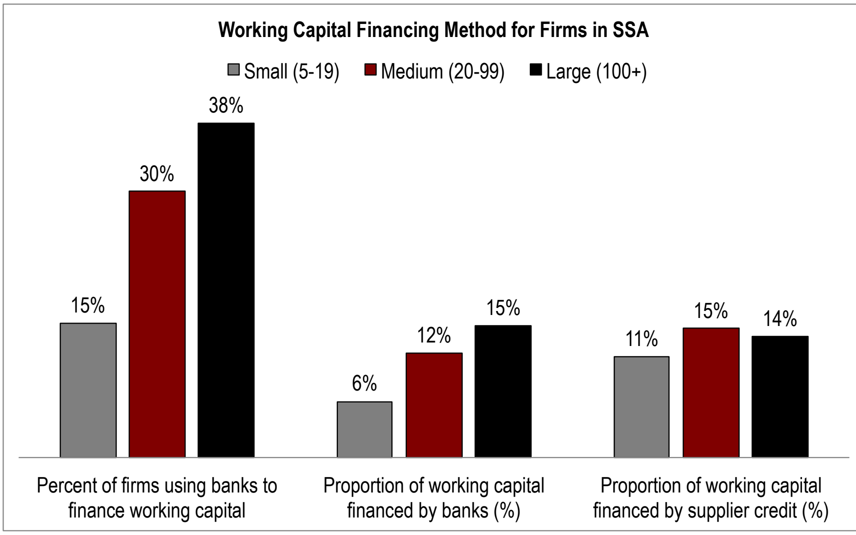
Guarantee type	Guarantee Limit	Pricing	
		Originating Fee (flat)	Guarantee Commissions (p.a.)
Portfolio (Loan) guarantee	US$2,500,000	0.75%	2.00%
Individual (Loan) Guarantee	US$500,000	0.75%	1.75%
Equity Capital Guarantee	US$500,000	1.00%	5.00%
Resource Mobilization Guarantee	US$1,000,000	1.00%	2.50%

Source: African Guarantee Fund, 2013.

Operationally, the AGF will work on a risk-sharing basis with financial institutions and the maximum risk coverage ratio will be 50 percent. The balance of risk will be borne by the financial institutions (African Development Bank, 2013). AGF is designed to achieve a triple-A rating in order to attract a zero percent risk-weight on SME loans provided by partner institutions. This will allow these institutions to lend money with limited need to set aside regulatory capital because of the guarantee from the highly-rated AGF. The tenor of the guarantee will be for 80 percent of the life of the underlying transaction. The first of the AGF guarantee agreements are expected to be signed imminently and thus an assessment of the guarantee is not possible at this point, however, it is reported that there is high interest from financial institutions on the African continent (African Development Bank, 2012).

It is worth noting for the purposes of future research that over and above the general consensus that SMEs lack long-term finance at reasonable lending rates, working capital facilities are also starting to be emphasized. The AfDB notes that (African Development Bank, 2012, p. 3): "SMEs … complain … how banks are hesitant to provide long-term lending and working capital facilities, both of which they need for growth." Currently, 15 percent of small enterprises in Sub-Saharan Africa use banks to finance working capital, however, only a small proportion (6 percent) of their working capital needs are covered by this type of finance (see figure 14).

Figure 14. Financing of working capital by SSA firms.



Source: World Bank, 2013.

The need for working capital finance from financial institutions is echoed by Standard Bank, which found that there is a need for working capital facilities for SMEs in Sub-Saharan Africa (Botha, 2011). To this end, Standard Bank has launched a product called Quick Loans, which provides unsecured loans of between US$300 to US$30000 for 3 to 12 months, as well as other forms of finance to traders (Standard Bank, 2013). Standard Bank (2013) has established SME banking in 13 African Countries (excluding South Africa) and during 2011 provided financial services to more than 150,000 SMEs across these countries.

In general data on the asset composition of banks across different regions shows that unlike banks in other regions of the world, African banks hold a much smaller share of their assets in private sector loans and a much larger share in government securities, foreign assets, and liquid assets (Beck *et al*., 2011, op cit). Household credit constitutes only a small share in bank credit, except in countries where financial sectors are more developed like South Africa.

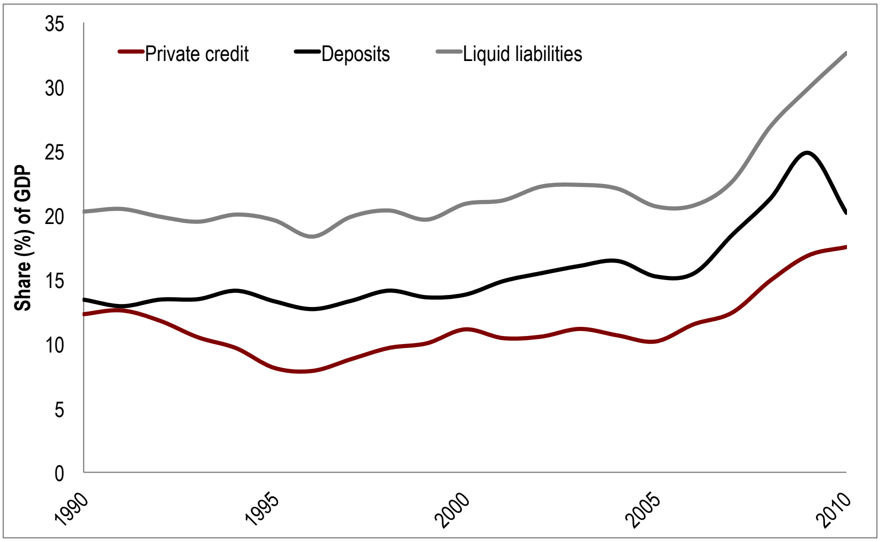
Banking sectors in most African countries are highly concentrated. In many countries, banks are predominantly foreign-owned, many of them being regional banks from other African countries. Banks also operate very profitably, with subsidiaries of foreign banks in sub-Saharan Africa having higher returns on assets than subsidiaries of the same banks in other regions (Honohan and

Beck, 2007).

It is not clear the extent to which the findings on the reverse link between financial depth and growth found in the context of developed and emerging economies is as relevant for low income countries, with a much lower level of financial development, and with large parts of the population and companies, lacking any access to financial services, as to countries with far deeper financial sectors. However, these findings will certainly be relevant for designing policies that will influence their future evolution. Furthermore, it may well be that in the near-term, the issue is more related to avoiding excessive speed of growth of finance, that we have started to illustrate above, which may be more the threat to financial stability in the case of Sub-Saharan Africa, (SSA). Indeed, as shown in figure 15, financial deepening in SSA has accelerated in recent years. The amount of private credit as share of GDP almost doubled from an average of 10 percent during the 1990s to 18 percent by 2010. Bank deposits as share of GDP grew from 13 percent (in 1990-1999) to more than 20 percent (in 2010), while liquid liabilities (also known as broad money or M3)[5] to GDP rose by more than 10 percentage points over the same period from 20 percent to exceed 30 percent.

Figure 15. Financial deepening in Sub-Saharan Africa, 1990-2010.

[5] They are the sum of currency and deposits in the central bank (M0), plus transferable deposits and electronic currency (M1), plus time and savings deposits, foreign currency transferable deposits, certificates of deposit, and securities repurchase agreements (M2), plus travellers checks, foreign currency time deposits, commercial paper, and shares of mutual funds or market funds held by residents. This definition of broad money is used by the IMF and the World Bank.



Source: Global Financial Development Database, the World Bank, 2012.
Note: Sub-Saharan Africa regional aggregate. This Figure was prepared by Florence Dafe.

The above aggregate figures do not do justice to the fast pace of credit expansion in certain SSA economies. Table 4 provides country data about credit extension as share of GDP for all SSA economies individually. It highlights countries which have experienced a doubling of private credit to GDP within the past decade (2000-2010) in light gray. Economies where private credit tripled or increased up to tenfold over the same period are given in dark gray whereas SSA states that saw a rise in lending to the private sector of ten times or more are highlighted in black.

Table 4. Credit Extension in Sub-Saharan Africa by Country, 1990, 2000, 2010.

Country	1990	20000	2010	Credit growth 2000-2010 (%)
Sub-Saharan Africa (developing)	9.2%	11.0%	17.5%	59.1%
Angola	n/a	1.1%	18.1%	1545.5%
Benin	n/a	11.1%	22.1%	99.1%
Botswana	7.8%	13.9%	22.3%	60.4%
Burkina Faso	16.2%	10.8%	16.5%	52.8%
Burundi	7.4%	17.3%	20.0%	15.6%
Cameroon	27.1%	7.7%	11.1%	44.2%
Cape Verde	4.0%	37.5%	59.2%	57.9%
Central African Republic	7.4%	4.4%	7.4%	68.2%
Chad*	6.5%	3.4%	5.0%	47.1%
Comoros*	n/a	8.3%	12.2%	47.0%
Congo, Dem. Rep.	n/a	n/a	n/a	n/a
Congo, Rep.	n/a	5.7%	4.1%	-28.1%
Côte d'Ivoire	36.4%	15.2%	17.3%	13.8%
Eritrea	n/a	n/a	n/a	n/a
Ethiopia*	1.6%	18.2%	17.2%	-5.5%
Gabon	n/a	8.3%	8.1%	-2.4%
Gambia, The	10.0%	11.6%	17.7%	52.6%
Ghana	5.0%	11.7%	13.7%	17.1%
Guinea	n/a	n/a	n/a	n/a
Guinea-Bissau*	13.0%	7.6%	5.8%	-23.7%
Kenya	17.7%	25.6%	30.6%	19.5%
Lesotho	13.8%	14.0%	12.6%	-10.0%
Liberia*	n/a	n/a	13.8%	n/a
Madagascar	14.5%	8.0%	11.1%	38.8%
Malawi	9.2%	4.5%	14.2%	215.6%
Mali	9.2%	4.5%	17.4%	286.7%
Mauritania	31.1%	n/a	n/a	n/a
Mauritius	30.1%	54.2%	82.3%	51.8%
Mozambique	n/a	15.4%	23.2%	50.6%
Namibia	n/a	39.1%	43.7%	11.8%
Niger	12.8%	4.3%	11.8%	174.4%
Nigeria	8.8%	11.1%	30.3%	173.0%

Country	1990	20000	2010	Credit growth 2000-2010 (%)
Rwanda	7.4%	9.5%	n/a	n/a
Sao Tome and Principe*	n/a	4.1%	33.2%	709.8%
Senegal	27.5%	16.5%	24.5%	48.5%
Seychelles	7.0%	15.2%	22.9%	50.7%
Sierra Leone	3.3%	1.9%	9.2%	384.2%
Somalia	n/a	n/a	n/a	n/a
South Africa	49.1%	65.0%	71.7%	10.3%
South Sudan	n/a	n/a	n/a	n/a
Sudan	4.3%	1.8%	10.9%	505.6%
Swaziland	14.2%	12.6%	23.1%	83.3%
Tanzania	12.4%	3.9%	14.6%	274.4%
Togo	22.7%	15.7%	20.7%	31.8%
Uganda	2.5%	5.3%	13.4%	152.8%
Zambia	6.8%	6.7%	10.7%	59.7%
Zimbabwe	0.0%	0.8%	n/a	n/a

Source: Global Financial Development Database and World Development Indicators, World DataBank, World Bank.

* Where 1990 or 2010 data were unavailable 1991 or 2009 data were used if possible .

Countries where private credit extension has (almost) doubled between 2000 and 2010 are highlighted in yellow.

Countries where private credit extension has increased threefold or more (but less than tenfold) are highlighted in orange.

Countries where private credit extension has increased tenfold or more are highlighted in red.

This analysis shows that in the recent decade there has been a considerable number of SSA countries with very rapid credit growth, namely:

- Benin and Swaziland where credit to GDP (almost) doubled;

- Malawi, Mali, Niger, Nigeria, São Tomé and Príncipe, Sierra Leone, Sudan, Tanzania and Uganda where credit to GDP increased threefold and more (but less than tenfold);

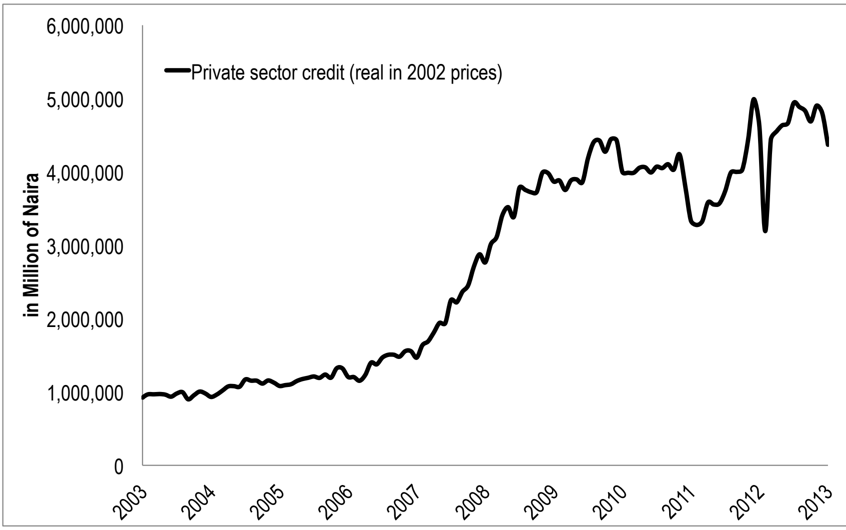
- Angola with private credit growing by a factor of more than 15-fold, or 1500 percent.

Though this is a rough indicator, countries in the last two categories would seem more vulnerable to potential crises, so they may need to examine whether they need to introduce tighter regulations, in general, or in particular sectors.

Financial systems in many African countries share features which seem to increase their vulnerability to shocks in the economic and financial system, including limited financial regulatory capacity, macroeconomic volatility linked to the economic structure of the countries (e.g. natural resource dependence, which implies volatility of their terms of trade) and political pressure for financial deepening with a view to develop the real economy.

Fast credit growth might exacerbate vulnerabilities and enhance the risk of financial crises, as it has done in all other regions of the world. In the African context, the case of Nigeria provides a recent illustration that banking crises might cause a negative link between financial deepening and growth, even at relatively low levels of financial development. In 2004/2005 the Central Bank of Nigeria (CBN) mandated a steep increase of minimum bank capitalization with a view to create large internationally competitive banks and increase financial depth (Soludo, 2004). Banks achieved this capitalization, which was high even by international standards, by means of equity investment, mergers and acquisitions, resulting in the consolidation of the banking sector from 89 to 25 banks. The consolidation in the domestic banking sector, along with abundant capital in the wake of rising oil prices increased the speed of credit creation with significant flows to sectors with little growth impact. Between 2006 and 2009 private credit tripled from 12 percent to 36 percent of GDP. In real terms (2002 prices) this meant that domestic borrowing by the private sector grew almost fivefold (see figure 16).

Figure 16. Nigerian private sector credit extension, 2003-2013.



Source: Central Bank of Nigeria, 2013

This included loans used to finance share purchases, an undesirable practice clearly, setting the stage for a financial asset bubble particularly in bank stocks (Sanusi, 2010). The financial sector boom ended in a bust with a systemic banking crisis in 2009 as financial sector growth was excessive, partly because it had not been accompanied by the corresponding regulatory and supervisory upgrade. Consequently, non-performing loans as percentage of gross loans rose sharply from 9.5 percent in 2007 to almost 30 percent in 2009. Finally, nine financial institutions that were close to collapse had to be rescued at the cost of US$4 billion. The cost of cleaning up the balance sheets and recapitalizing the banks concerned is estimated at about 2.4 trillion Naira, equivalent to almost 8 percent of GDP (IMF, 2011). The Nigerian crisis shows there is no reason for complacency about the need for rigorous financial regulation in African economies especially in the face of rapid credit expansion in many SSA markets.

With respect to the effect of foreign bank presence on financial stability and growth in Africa, the existing evidence is somewhat ambiguous and requires further research. There are indications that foreign banks can bring in experience from other regional economies and can help exploit scale economies in small host countries. Yet the benefits for financial access remain ambiguous, partly because of the greater reliance of foreign banks on "hard" information about borrowers as opposed to soft information which often implies a focus on prime borrowers (Detragiache *et al*., 2008, Sengupta, 2007). Furthermore, it seems that foreign banks are fundamentally different from domestic banks. As argued by Rashid (2011) foreign banks seem less inclined to lending and their loans are likely to be more volatile than those offered by domestic banks. Despite strong foreign bank presence, the effects of the global financial crisis on African banks have been limited. In part, this is due to the relatively limited presence of banks from developed economies in Africa (with a high proportion of foreign banks being regional ones) and the fact that existing subsidiaries mostly fund themselves locally and not via their parents; this, however, limits the contribution these foreign banks make to national savings (Fuchs *et al*, 2011). In addition, reportedly large capital buffers—often above levels required by Basel III—have served to increase the resilience of African banks during the global financial crisis although this may have involved some costs for intermediation (Fuchs *et al*., 2012b).

The fact that financial sectors in LICs tend to be relatively smaller and simpler provides an advantage in that governments have more policy space to influence the future nature and scale of their financial system. Furthermore, the fact the financial sector is smaller may imply it is less powerful politically; thus, potentially this gives more autonomy to regulators and—more broadly governments—to shape the financial sector.

LICs thus have the advantage of being latecomers to financial development and can benefit from positive and negative lessons from experiences and research on other countries. On the other hand, the incompleteness of LIC financial systems means that important challenges remain on extending access (to all types of financial services) to those excluded, such as a high proportion of poor households, microenterprises and SMEs. More generally, it is difficult to fund working capital and investment in sectors such as agriculture and industry, especially for SMEs (and particularly at low spreads and longer maturities) crucial for growth and employment generation. The financing of infrastructure is a well-known problem in LICs, and the mobilization of sufficient long-term finance, as well as the most effective way to channel it to investment in that sector, is a key area of policy, where research, including clear understanding of market gaps—as well as effectiveness of policy interventions—could be very valuable.

Research on the desirable structure of the financial sector could include the following research themes and questions:

a) What functions are particularly important to meet in African LICs? What are the deficiencies and needs in these areas in LICs? For example, how can sustainable lending at relatively low spreads and sufficient maturities to SME be best encouraged? What are the main challenges for delivering that type of finance in LICs? What are the specific needs of particular sectors, e.g. agriculture, for innovation? These and related issues could be researched using a number of methods, including consultation with policymakers and practitioners, theoretical analysis, empirical analysis, such as cross country and time studies, as well as in-depth case studies. Surveys of private companies to determine unmet demand for financial services, and especially credit at reasonable cost, and maturity would be valuable.

b) What combination of public/private institutions/mechanisms may be desirable to best achieve the three objectives of growth, financial stability and equity? This would look—in general and in country settings—at the existence of market gaps and market failures in specific areas (e.g. long-term finance) in LICs, as well as potential government failures. Careful review of theoretical and empirical work needs to be combined with analysis of experiences to offer a balanced menu of policy options for most effective institutional arrangements in particular country contexts. What mechanisms (public guarantees, first losses assumed, for example by IFC) are desirable to encourage private financing? How can they be best structured to avoid excessive contingent public liabilities and for them to be effective? What experiences exist, which have worked well? How can they best be applied to LICs?

c) Since the 2007/2008 crisis, increased interest has emerged in expanding the role of national and regional development banks to provide counter-cyclical lending when private credit falls. Also, public banks can be valuable for incorporating environmental externalities, to give LICs the opportunity to "leap frog" by adopting low-carbon technologies. More broadly, public development banks can be a valuable mechanism for financing particular strategies of development. What are the incentives and institutional arrangements that are required to make such development banks effective and efficient in LICs? What lessons can be learned from successful banks in developed countries (e.g. the European Investment Bank, German KfW) and emerging economies (e.g. BNDES in Brazil, as well as Asian development banks)? Most research on the experiences with development banks in Africa dates from the 1980s and 1990s and evaluations report fairly negative experiences (Brownbridge *et al.*, 1998). However, many development banks have been reformed over the past decade so that research implying re-evaluations of their effectiveness are necessary. Returning to the theoretical issues, what are the specific market gaps and failures which need addressing in specific LIC contexts, and how best can government failures be minimized? A hypothesis to be explored is that the effectiveness of development banks depends substantially on governance arrangements and political economy factors. Pressures on African governments to facilitate access to finance for the real economy may for example be particularly strong. What are pre-conditions, including political economy ones for such banks to be effective in LICs, in ways similar to how they have been in emerging and developed economies?

d) In the case of private banks, should a particular model, for example with respect to size, be encouraged? Many African countries banking systems have an oligopolistic structure where a small number of banks dominate the market and competition is limited. Is there a case that smaller more decentralized banks are better for reducing asymmetries of information? Are there more benefits from increased competition? Or are economies of scale an important factor for determining bank efficiency? Are potential costs of increased systemic risk of large banks so high that smaller, narrower banks may be preferable (Demigurc-Kunt and Huizinga, 2010)? What are the lessons, if any, for African LICs from the debate in developed countries on the structure of banking, for example as reflected in the recent UK Vickers report? What should be the preferred model for international banks in African LICs? Should LIC regulators encourage/require international banks to act as subsidiaries, rather than branches, as the UN Stiglitz Report proposes, to facilitate the task of national regulation? In India and some other developing countries, branching regulations are in place. What have been the experiences with such regulations? Should international (and possibly all large banks) be required to have not just branches in large cities, but also in smaller cities?

e) To what extent is it best to concentrate in LICs on the development of banking, or should non-banking institutions (like stock markets and insurance markets) play also an increasingly important role? Both financial and human resources for developing and regulating non-bank institutions tend to be limited in African countries, so that efforts to develop such markets which are resource-demanding should be based on evidence-based policy advice. Should specialized lending institutions, like leasing or factoring companies, as well as low-end financial institutions, such as cooperatives, credit unions and microfinance be promoted, as suggested in Beck, Demigurc-Kunt and Singer (2011)? If the insights of imperfect and asymmetric information are central, such information tends to be local and specialized (Stiglitz, 2012); this may provide an important theoretical and practical justification for greater use of more low-end and more decentralized institutions. Would the latter, for example be particularly effective for the financing of SMEs, and more broadly for the so-called missing middle? What is the empirical evidence on this, especially in LICs? For many African households such low-end financial institutions constitute the only form of financial access. In Uganda, for instance only 21 percent of adults above the age of 15 have an account at a formal financial institution (Demirguc-Kunt and

Klapper, 2012). Governments have hence promoted cooperatives, credit unions and microfinance. However, there is little systematic research comparing costs and benefits of promoting such low-end institutions as opposed to access to banking services. How can a more desirable mix be encouraged? What is the empirical evidence on which to base such decisions?

f) How can development of primary public debt markets be encouraged, to establish risk-free benchmark curves? Based on deepening of public bond market, how can the local corporate bond market best be developed, including for long-term institutional investors to buy? What are relevant lessons from the analysis of experiences in other parts of the world and of recent empirical work on growth impact of structures of different financial sectors?

g) What kind of institutional developments and financial innovations are valuable for promoting inclusive and more sustainable growth, without increasing systemic risk excessively? More specifically, what systems can improve access by the poor and by SMEs to sustained credit, without creating systemic risk for the financial system? Mobile banking, which should be regulated proportionate to its risk, is an example for such an innovation. How can the poor not only have access to sufficient and sustainable credit, but be protected in times of crises, so that the poor are "not too small to be counted" during crises, whilst banks are rescued as considered too big to fail (BIS paper, 2012)? What are the complementarities between financial and other policies, e.g. for increasing productivity of SMEs?

3.2 THE CHALLENGES OF FINANCIAL REGULATION

A key lesson from recent crises has been the need for regulation to be both counter-cyclical and comprehensive to avoid the build-up of systemic risk (Griffith-Jones and Ocampo, 2009; Saurina and Repullo, 2011). Though there is agreement on these principles, there is far less consensus on how these should be implemented. A great deal of research and policy analysis is being carried out in the BIS, the IMF and the Financial Stability Board on these issues.

One of the key problems is that LICs are not represented at all or are heavily underrepresented in these bodies. Therefore, there is insufficient focus in their work on how relevant these issues are for LICs and how they should be implemented in them.

It may be useful to carry out research that would synthesize on-going discussions on these issues of counter-cyclicality and comprehensiveness, as well as other key issues that LIC regulators and policymakers define as a priority for them. Over the past decade, there has been rapid credit growth in a number of African countries including Angola, Democratic Republic of Congo, Equatorial Guinea, Ghana, Guinea-Bissau, Liberia, Malawi, Nigeria, São Tomé and Príncipe, Sierra Leone, Swaziland, Tanzania, and Zambia (Iossifov and Khamis, 2009). Whether a manifestation of a credit boom or driven by fundamentals, rapid credit growth can give rise to systemic financial and macroeconomic risks, making the design and implementation of appropriate macro-prudential regulation and supervision a policy priority in Africa. For example, the Final Report of *Making Finance Work for Africa*, in collaboration with the Association of African Central banks (AACB) and Bank of Uganda (2011) defined as most relevant and urgent for African LICs—within Basel III—the incorporation of macro prudential supervision. Relevant research in this field would be therefore seen to be a priority. Similarly, the concept of proportionality in regulation implies that regulatory standards should be set in a way proportional to the importance of the risks. (GPFI/CGAP, 2011) and Basle Committee, 2010). This requires further research for LICs.

In the case of macro-prudential regulation, an important research issue is how can it be complementary to monetary policy in LICs? Macroeconomic volatility, for instance, remains a problem, partly because many African countries exports are concentrated in a few commodities, which makes their economies vulnerable to the large price shocks characteristic of commodities.

Furthermore, practical issues on how best to implement macro-prudential policy would require research. These could include:

a) What, in the LIC context, is the best choice of regulatory instruments through which counter-cyclical regulation can best be implemented both for solvency and liquidity? What are the best indicators to determine in LICs when capital requirements or provisions need to be increased in boom times, or allowed to be drawn down in bad times? How should the variables and methodologies suggested internationally for counter-cyclical regulation be adapted to realities in LICs, as regards data limitations, as well as broader context of the smaller financial sector and existing financial regulation (Bank of Uganda, 2012)?

b) Should counter-cyclical regulation of banks be done in LICs mainly at an aggregate level and/or in specific sectors, for example where lending is increasing fastest? How relevant is the emerging international experience in this field (Ren, 2011) for LICs? Should such measures be implemented through *ex ante* rules or have some flexibility?

c) Focusing on the issue of comprehensiveness, how relevant are the international analyses of comprehensive regulation for African LICs and how any international conclusions should be modified for the LIC context? This requires taking into account the different nature of the financial system in LICs, where for example many financial transactions go through informal channels, or financial services are provided by non-banking institutions like retail shops or mobile service providers. The mobile payment service M-Pesa, developed in Kenya, is a case in point. M-Pesa was launched to target mobile subscribers who were un-banked and now has over 7 million customers, both banked and un-banked. Light regulation in the testing phase of the financial product, on the principle of proportionate supervision, contributed to M-Pesa's rapid growth. However, at a later stage of product development and at a higher level of outreach, regulation may need to become significantly more stringent for M-Pesa's success to be sustainable. Yet comprehensive regulation of M-Pesa and other financial innovations may call for closer coordination between regulators of such institutions (e.g. telecommunications regulators in mobile banking) and banking regulators. Therefore, the challenge of comprehensive regulation has a very different institutional character in LICs. Does this mean that underlying principles should also be different, or is the criteria of avoiding systemic risk and concentration of risk common to any financial system?

d) Also in relation to aims of financial regulation, in LICs these include more explicitly the purpose of inclusive growth. Can regulations go beyond stability and be designed more explicitly for growth? How can moral hazard best be avoided? Could lending support industrial policies, regional mandates, to ensure poor regions have more access to credit? What is the experience on establishing minimums and maximums of lending in certain categories, e.g. SMEs? Are experiences like the US Community Reinvestment Act or the Small Business Administration successful and relevant to LICs? Are their similar successful experiences in LICs?

Another issue highlighted by the *Making Finance Work for Africa* report, *op cit* as high priority are regional/cross-border issues. This refers not only to regulation of traditional international banks, but also to the rapidly emerging pan-African banks. As Fuchs, *et al* (2012b) point out, recent reforms of the international supervisory architecture concentrated on creating colleges of supervisors for all internationally operating banks. Representation of African supervisors (especially LICs) is very limited; this is a source of concern as an international bank may have a small part of its portfolio in an African country, but implies a very large share of their market for a particular LIC country. The role of the LIC supervisor in these colleges becomes too small, if any at all, with potentially serious consequences for financial stability and growth impact in the LIC country. Research could be valuable, both on the institutional and technical aspects, but also on the political economy of how practically to enhance the "voice" of LIC supervisors in cross-border supervisory processes that have strong impacts on their economy, to overcome asymmetries of power that can lead to economically inefficient outcomes for LICs.

A key source of macro-economic volatility, as well as of financial systemic risk, is generated by certain types of capital flows. As a result, there has been growing recognition, in IMF and BIS, as well as in the academic literature (for example Stiglitz and Ocampo, 2008; Korinek, 2011; Gallagher, Griffith-Jones and Ocampo, 2012) on the need for management of the capital account. One of the newest research and policy challenges is how to most effectively combine regulation of capital flows and national counter-cyclical regulation. Again discussion in LICs has been more limited. Are capital account management measures needed also in LICs and under what circumstances? In best practice, when are capital account regulations more effective, and when are domestic prudential regulations, which focus on currency mismatches? How best can they complement each other?

The type of issues to be examined on capital account management for LICs would relate to issues of: a) timing, relating to how soon after a surge of capital flows starts occurring should measures to discourage more short- term flows be used? b) should they be temporary or part of a permanent system that can be suspended? c) if and when should these regulations be price or quantity based? d) How can avoidance be prevented?

Our analysis above has focused more on discouraging excessive short-term capital flows when they threaten to cause macro-economic over-heating, overvalued exchange rates and increase financial sector systemic risk. However, there is also the important issue of attracting long-term capital flows, especially where it can provide technology transfer and access to new markets. This is a topic that now has new dimensions, such as the increased role of Chinese and other Southern investors. Research and research synthesis is needed on the positive impact and potential risks to the financial sector of these new country sources and modalities of investment.

4. CONCLUSION

While the 2007/8 crisis originated in, and strongly hit, developed economies, there is no reason for complacency in regulating African financial sectors. Fairly rapid credit growth in the late 2000s in the context of limited regulatory and supervisory capacity, especially in some countries, suggests that the time is now to draw appropriate lessons from the North Atlantic crises for African countries. There is also no reason to believe that if major private financial crises have hit all other continents, Africa would be an exception, unless it proceeds very cautiously with financial liberalization and financial development, as well as accompanies it with strong and effective regulation. Furthermore, the fact that African LIC systems are still relatively small in relation to the size of their economies allows more space for African policymakers and regulators to try to shape their financial systems so they serve well the needs of the real economy, by helping support inclusive and sustainable growth (for example by supporting much needed lending to SMEs), as well as desirable structural change.

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