CHAPTER 7

Diversifying Exports, Reorienting Trade Policy, and Pursuing Regional Integration

Africa has huge potential for more diversified production and exports, including in agroprocessing, manufacturing, and services

TO SUCCEED IN THE 21ST CENTURY, AFRICA HAS TO become a full partner in the global economy. The region accounts for barely 1 percent of global GDP and about 2 percent of world trade. Its share of global manufactured exports is almost zero. Over the past 30 years it has lost market shares in global trade—even in traditional primary goods—and failed to diversify on any scale. Africa thus remains almost totally dependent on its traditional export commodities—despite their low income elasticity and declining and volatile terms of trade. Continuing concentration on these traditional exports would have adverse consequences for income and employment, even more so given the speed of rural-urban migration (chapter 1). Had Africa maintained the share of world trade it had in the late 1960s, its exports and income would be some $70 billion higher today.

But Africa has huge potential for more diversified production and exports, including in agroprocessing, manufacturing, and services. The more successful African economies have already begun to diversify and make themselves more attractive business addresses. For some, nontraditional exports—including floriculture, other nontraditional agricultural goods, and nontraditional industrial products—have been growing by 30 percent a year since the mid-1990s, albeit from a low base. Tourism has also grown rapidly. And better-managed economies have been attracting higher foreign direct investment.

The challenge: to sustain the momentum of diversification in some cases and to initiate it in others. Given the region's tiny and fragmented

economies—with a median GDP of barely $2 billion—the issue is not whether Africa should be quickly integrated, both regionally and with the global economy. The question is how, for much still needs to be done to make African economies competitive (see Helleiner forthcoming and Collier 1997, 1998). Trade reforms are important, but much more is needed. The six most pressing policy actions:

Given the region's tiny and fragmented economies, the issue is not whether Africa should be integrated—but how

- *Anchor export orientation on competitive and stable real currencies.* Africa's comparative advantage in exports should be based on sustained real exchange rate competitiveness until economies are sufficiently developed to support a productivity-induced real currency appreciation.
- *Make trade reforms credible and effective.* This would require eliminating the most damaging aspects of the remaining antiexport bias—by administering effective compensating mechanisms to exporters, cutting red tape, and ensuring best practice customs clearance.
- *Integrate further trade policy reforms with national "business plans" for economic diversification.* For many countries that means further moderating tariff peaks, rationalizing exemptions, and taking other steps to ensure effective supply responses. The business plans should cover infrastructure, public service delivery, human capital development, stable and competitive exchange rates, and investment strategies—especially for small and medium-size enterprises. They should also broaden the domestic fiscal base away from trade taxes, so that reform is not destabilizing in macroeconomic terms.
- *Mainstream regionalism in a new way.* Open regionalism would enlarge economic space and lock in trade and other reforms to boost their credibility—and regional convergence criteria would be negotiated for macroeconomic, regulatory, and infrastructure reforms.
- *Create a platform for effective African participation in multilateral forums such as the World Trade Organization.* Such forums are essential for underpinning the credibility of reforms and for enforcing "appropriate" global standards, which are becoming prerequisites for accessing markets in developed countries.[1] But African countries also need to help shape these standards.
- *Base all this on consultative processes.* Underlying many of these actions are the relations between business and government and between labor and government. Too few governments have forged a supportive and consultative relationship with the private sector—one in which the government is accountable for service standards, and business for per-

formance. In the same vein, the cooperation and support of the labor movement have always been critical to successful and sustainable development policy. In many countries closer consultation with labor will be needed in the new era of globalization, democracy, and participatory politics.

Without broad and growing markets, investment will not be attracted to Africa

Why Should Africa Diversify?

The need to diversify Africa's economies, particularly to increase the weight of industry, has preoccupied the region's governments for many years. Diversification is indeed a valid concern. Africa's urban population will triple by 2025. Urban growth and agglomeration create opportunities for new types of economic activity by lowering transactions costs, concentrating consumer power and skilled labor, and facilitating dense producer networks. But providing employment for rapidly growing urban population will be an enormous challenge—as will creating a productive urban economic base to support the infrastructure investment needed to make cities attractive places to live and invest.

Export diversification has received less attention but is equally vital for two reasons. First, export receipts are needed to finance imports of consumer, intermediate, and capital goods. But receipts have been limited by lost trade shares for traditional products and by concentration on a few primary commodities with low demand elasticity. The prices of these staples, though volatile, are expected to continue their long-run decline. Second, given Africa's small economies, it is hard to imagine a successful diversification drive based solely on domestic markets. For the same reason, exports—especially of industrial and nontraditional products—provide the best avenue for attracting high and productive investment. As the experiences of other developing regions suggest, the virtuous circle begins with investment, which triggers higher and sustained growth, increased voluntary savings, and further investment (UNCTAD 1998; Helleiner forthcoming; Rodrik 1996; Agosin 1997). But without broad and growing markets, investment will not be attracted to Africa.

African countries are not just small—they also have a history of high trade restrictions and low domestic competition, and are far behind on

global technology (chapter 5). This suggests that African firms are even more likely to see productivity gains from exporting than firms in other regions:

- In many lines of activity the minimum efficient plant size is large relative to the domestic market. Thus exporting can make plants more productive by raising capacity use.
- Competition has historically been low in African markets. Exporters are likely to be exposed to greater competitive pressures than producers for the domestic market—and so are likely to be more efficient.
- Exporters learn from their buyers. Exporters of basic products gain by learning to process large orders, meet quality standards, and make timely deliveries. Even though this transfer of technology may not be at the upper end of the scale, it allows producers to establish reputations with buyers that lead to transfers of technology, product, and management knowledge.

Exporters in Africa are typically about 20 percent more productive than nonexporters

Firm-level studies provide support for these propositions—exporters in Africa are typically about 20 percent more productive than nonexporters (box 7.1). But most analyses of export diversification assume a sizable manufacturing base, true for only a limited part of Africa. South Africa's strong manufacturing base, created through import-substituting and strategic industrialization, is shifting toward a more competitive, export-oriented focus. Côte d'Ivoire, Ghana, Kenya, and Zimbabwe have

Box 7.1 Gains from Exporting in Africa

Are African exporters more productive than nonexporters? The answer seems to be yes. Bigsten and others (1998) find that among manufacturing firms in Cameroon, Ghana, Kenya, and Zimbabwe, exporters have much higher technical efficiency. Exporting also increases efficiency over time. Small local markets and technological backwardness appear to make the export experience more advantageous; it is not simply the case that exporting firms are the most efficient firms to start with.

Mengistae and Pattillo (1999) find other differences between exporters and nonexporters. The average exporting firm is not much older than the average nonexporter, but it has almost three times as many employees. Thus it seems that exporting allows firms to break the scale barriers imposed by small markets. Capacity use is also higher for exporters. And external links through ownership or trade, though generally low among African manufacturers, are significantly stronger for exporters. At 20 percent, the average share of foreign ownership for exporters is three times higher. An exporting firm is also about twice as likely to hold a foreign license and almost three times as likely to have a foreign technical assistance contract.

manufacturing bases that need consolidation and expansion. Many other countries still need to create the essentials.

Will an open trade regime with an export-oriented strategy increase investment in manufacturing without focused government support? And who will invest in African industry lacking a base of strong small and medium-size enterprises? Such questions concern policymakers as they assess strategies for raising output (Rodrik 1996).

Africa can diversify and be competitive across a broad range of products—if policies are improved and transactions costs lowered

The Debate on Africa's Diversification Potential

CREATING A BASE FOR COMPETITIVE INDUSTRIALIZATION IN AFRICA will not be easy. Efforts to replicate the success of industrializers in Asia and Latin America face some daunting challenges, including landlocked states, high transport costs, low economic density, geographic isolation from high-growth clusters, and limited skills and technology (box 7.2). But there are enough examples to show that Africa can diversify and be competitive across a broad range of products—if policies are improved and transactions costs lowered. This is starting to

Box 7.2 Challenges for Competitive Industrialization in Low-income Africa

- Africa's comparative advantage lies chiefly in low labor costs (and sometimes low raw materials and energy costs). But with global competition, these lower-order comparative advantages have become less important.
- Africa's main competitive strengths are in industries where demand growth is slowest and where international competition—especially from low-cost Asian suppliers—is intense.
- The region's economies are not part of a cluster, so there is no Hong Kong (China), Japan, or Singapore to undertake foreign direct investment on the scale seen in East or Southeast Asia.
- African countries are at a serious disadvantage in infrastructure costs, especially for transport.
- They are at the bottom of the global league in industrial sophistication and technology.
- The private sector is weak, dominated by a few multinational corporations at one extreme and by a mass of small enterprises at the other. The middle layer of medium-size indigenous firms is missing.
- "Technological terms of trade" have shifted against late-starters. The cost of acquiring new technology has risen both in money and, more important, in the skills of operators, technicians, and managers.
- The importance of labor quality in attracting foreign direct investment counts against Africa.
- The region has become excessively and unsustainably dependent on external support, including that for foreign technology and expatriate skills.

Source: UNIDO 1996.

happen in Africa's better-managed economies, and evidence suggests that reforms can have substantial catch-up effects. Still, can Africa expect to have a comparative advantage in labor-intensive products, including manufactures, rather than resource-based primary products?

The Resource-based Thesis

Africa is richer in natural resources—but poorer in human capital—than any other region

Adrian Wood and his research associates (Wood 1997; Wood and Mayer 1998; Wood and Berge 1997) argue that in an era of globalization and integrated capital markets, physical investment is likely to be an outcome rather than a cause of comparative advantage. Instead, natural resources and human capital are likely to be the main determinants of comparative advantage. Africa is richer in natural resources—but poorer in human capital—than any other region, with ratios corresponding to those of Latin America in the 1940s or 1950s.

This analysis predicts that Africa will find it hard to acquire a strong comparative advantage in processed primary exports and harder still to develop manufactured exports. Even with more education, improved infrastructure, and better policies, the share of manufactures in exports will remain far lower in Africa than in Asia, where natural resources per capita are far lower. Thus the way forward for Africa in the medium term is mainly to raise primary exports, both processed and unprocessed. Even so, one-third of African countries have considerable potential for manufactured exports.

But the resource-based thesis has been challenged by several scholars:

- *Resources are poorer than believed.* Bloom and Sachs (1998) argue that Africa's resource base is weaker than supposed. In their view specialization in agriculture is not a viable development strategy. The implication is that labor-intensive manufactures will provide the best poverty-reducing growth strategy if Africa takes steps to reduce the constraints of adverse geography, especially by improving transport infrastructure.
- *High transactions costs shape Africa's economies.* Collier (1997, 1998) observes that the resource-based thesis must operate by making African labor noncompetitive for manufacturing. But Collier argues that evidence does not support this. Africa's extensive natural resources have not translated into higher labor costs. Instead, Africa is poor, undercapitalized, and uncompetitive in transactions-intensive activi-

ties such as manufacturing. Poor policies and weak institutions have led to exorbitant transactions costs, while repeated policy failures and reversals have led to high risk. These, rather than resource wealth, are the key constraints to growth and diversification.

- *Overvalued and unstable real currencies remain a threat.* Williamson (1997) and Elbadawi and Helleiner (forthcoming) argue that a real exchange rate–led export diversification strategy remains relevant for different reasons than in the pre-1980s, when real exchange rates became overvalued due to controls and unsustainable and expansive macroeconomic policies. Because most African countries depend on official development assistance and few are poised to tap global capital markets, the region's economies will be increasingly susceptible to real currency overvaluation and instability. While these flows are essential to support investment and diversification (Collier 1997), their effects on economywide competitiveness can be damaging without an explicit strategy for protecting the real exchange rate. As Chile's recent experience makes clear, such a strategy is essential for successful export orientation (Williamson 1997; Hernandez and Schmidt-Hebbel 1999).

Even while increasing traditional exports, African countries should have considerable scope to diversify

What can be learned from this debate? Even if geography and climate limit African agriculture, the region is still performing well below its potential in this area (chapter 6). And there is no reason Africa should not fully exploit its comparative advantage in agriculture and minerals while also diversifying into (and deepening) other labor-intensive exports. A careful review of the debate suggests a broad consensus that, even while increasing traditional exports, African countries should have considerable scope to diversify. Many are poised, in the medium to long run, to significantly widen their comparative advantage—if they address the policy distortions (including those associated with uncompetitive or unstable real exchange rates), poor infrastructure services, and high risks and high transactions costs (including those due to corruption) that inhibit competitiveness. Indeed, business surveys carried out in 1996–97 for a large number of African countries indicate that in most cases these factors, rather than excessive wages or labor market rigidities, are seen as the prime barriers. (South Africa is a notable exception.) But the above studies also suggest that in many countries Africa's industrialization is likely to be closely linked to natural resource endowments rather than simply composed of "footloose" industries.

Recent Evidence

These conclusions are buttressed by recent trends in export diversification. The performance of nontraditional exports in eight African countries in 1994–98 suggests three encouraging patterns (table 7.1). First, in most cases the range of the new exports is quite wide. It includes diverse processed primary products, a few new agricultural exports, manufactures, and, in Uganda, gold.

Many African countries have seen rapid growth in nontraditional exports

Second, though starting from small bases, growth of nontraditional exports has been quite rapid in most of the eight countries. Even with gold exports excluded, nontraditional exports from Uganda grew by more than 70 percent a year, accounting for 22 percent of exports by 1998. Nontraditional exports from Ghana, Madagascar, and Mozambique have also shown impressive growth. In Ghana and Mozambique nontraditional exports now account for nearly one-fifth of exports. Most important, the growth in Ghana was mainly accounted for by exports of processed and semiprocessed products. In Madagascar the share of nontraditional exports soared to 86 percent. Côte d'Ivoire, Zambia, and to a lesser extent Senegal have also seen considerable export diversification, notably in product lines related to their natural resource bases.

Table 7.1 Nontraditional Exports from Selected African Countries, 1994–98 (percent)

Country	*Share of total exports*		*Average annual growth (in current dollars)*
	1994	*1998*	
Côte d' Ivoire	13.5	17.4	16.4
Excluding processed cocoa, coffee	6.9	8.8	16.2
Ghana	9.7	19.2	35.5
Processed and semiprocessed	6.3	15.2	42.1
Madagascar	64.1	86.1	11.9
Export processing zone	14.3	37.4	32.2
Mauritius[a]			
Export processing zone	67.2	68.9	2.9
Mozambique	5.6	17.8	50.3
Excluding processed cashews	3.5	10.1	47.1
Senegal	11.5	13.3	9.3
Uganda[a]	5.6	34.9	101.5
Excluding gold	5.6	21.6	72.2
Zambia[b]	14.7	33.0	16.5

a. Data are for 1994–97.
b. Nonmetal exports.
Source: World Bank data.

With better policies and an improved economic environment, Africa's comparative advantage in natural resources and diverse cultures has started to pay dividends in terms of new commodity and services exports. For example, horticulture exports from several African countries have jumped to more than $2 billion a year (chapter 6), while tourist arrivals have been increasing at rates well above world averages (box 7.3). The potential of tourism is suggested by its 20 percent annual growth in Tanzania.

African countries can attract labor-intensive manufactures

Third, there is evidence that African countries can attract labor-intensive manufactures. With rising labor costs, Mauritius has probably approached its limit in terms of textile exports (see table 7.1). But there is good news: Mauritian firms are trying to surmount this problem by investing in poorer African countries (box 7.4).

This is significant for Africa because a powerful force in East Asia's development has been the "flying geese" phenomenon—as leading countries have advanced on the technology and wage scale, labor-intensive activities such as garments and toys have moved to poorer countries. Mauritius shows that the geese can fly in Africa too. Confirming business surveys, recent international comparisons suggest that high labor costs are

Box 7.3 Chances and Challenges for Tourism

WITH ITS WIDE SPACES, SPECTACULAR WILDLIFE AND natural resources, and rich and varied cultures, Africa has tremendous potential for tourism. Moreover, indigenous ownership of tourism facilities is quite high. But according to the World Tourism Organization, Africa attracted less than 4 percent of the world's tourists and accounted for just 2 percent of international tourism receipts in 1997. Only South Africa was among the 40 top tourism destinations in 1998.

The region is gaining momentum, however. In 1988–97 world tourism grew 5 percent a year—but Africa's growth was 7.2 percent, second only to East Asia and the Pacific. And in 1997 Africa had the fastest growth in tourist arrivals (8.1 percent). The World Travel and Tourism Council estimates that travel and tourism accounted for more than 11 percent of Africa's GDP in 1999 and projects growth of more than 5 percent a year (in real terms) over the next 10 years, outstripping global tourism growth of 3 percent.

Africa can do even better if governments and the private sector cooperate to eliminate impediments to tourism. Though largely a private activity, tourism needs public support through security, infrastructure development, and efficient visa and immigration procedures. For European and North American tourists, Africa remains the most expensive place to fly, largely because of a highly regulated and inefficient air transport system. In many countries visa processing and immigration formalities are a nightmare. Regional cooperation could help—at some borders, tourists and their luggage are forced to change buses because of protection of the local travel industry. And does it make sense for a tourist wishing to visit West Africa to secure separate visas for each of the region's 16 small countries?

no longer a major problem in most African countries, suggesting that more "flying geese" may be landing in Africa in the future. In Kenya, for example, labor productivity in multinational firms is comparable to that in non-African countries—but nominal wages are lower (Biggs and others 1996). Efforts to develop and upgrade skills are critical, but in many countries labor would be relatively competitive if other obstacles to business were reduced. And after a slow start, developments in Africa's subregions stand to intensify intraregional investment.

After a slow start, developments in Africa's subregions stand to intensify intraregional investment

A Simulation Exercise

The discussion here suggests that the factors inhibiting diversification into exports of nontraditional commodities and services are similar to those explaining Africa's low growth. They include human resources (including healthy and skilled workers), factors that affect transactions costs (including governance and infrastructure services), policies that ensure a stable and competitive macroeconomic environment, and geographic factors. Some of the geographic factors, such as being landlocked or having a low population density, are most damaging when they inter-

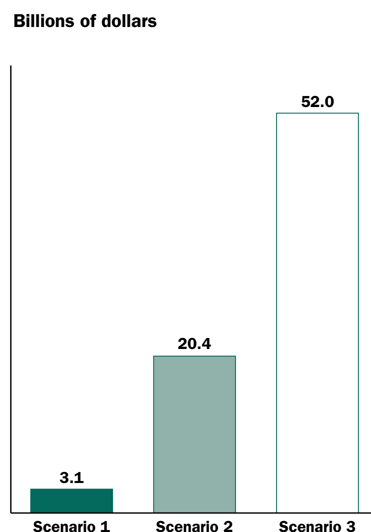
Box 7.4 Are the Geese Flying in Africa?

THE MAURITIAN EXPORT PROCESSING ZONE EXPORTS more than $1 billion a year in textiles and apparel. Its firms are 75 percent owned by local capital. Floreal, the largest textile maker, has gone from a labor-intensive knitting company in 1971 to an integrated spinning, knitting, dyeing, and finishing company with showrooms in Paris, London, New York, and Hong Kong (China). In 1989 Floreal started shifting labor-intensive parts of its business to continental Africa, first manufacturing knitwear in Madagascar—where the export processing zone, dominated by textiles, has created more than 55,000 jobs—then opening plants in Mozambique. With 17,000 workers, Floreal is assessing opportunities for expansion elsewhere in Africa.

With pay levels three times those in poor countries, Mauritius must position itself to become a center for capital- and skill-intensive operations such as design, marketing, and logistics, complementing such "software" with the "hardware" from emerging African exporters. Just as Hong Kong needed China to grow, so Mauritius needs such countries to widen its economic space and keep its industries globally competitive. East Asia's development was spread and accelerated by the "flying geese" pattern, involving similar transfers of labor-intensive stages of production from richer to poorer neighbors. Africa can attract labor-intensive activities and make the geese fly.

But investors still see the usual obstacles. Heightening the urgency of strengthening African competitiveness in textiles is the abolition of the Multi-Fiber Arrangement on 1 January 2005. Guaranteed access to major markets, including through a renewed Lomé Convention and a liberal U.S. Africa Growth and Opportunity Bill, would help Africa compete.

Figure 7.1 Simulated Annual Values of Industrial and Processed Exports by a Median Africa Country



Note: Scenario 1 shows results if the median African country were to achieve East Asian exchange rate policies and transactions costs. Scenario 2 shows results if the median African country were to achieve East Asian exchange rate policies, transactions costs, and investment and education levels. Scenario 3 (directly attainable only by African coastal countries) predicts potential coastal Africa's industrial and processed export values if it achieved scenario 2 as well as East Asian population density along the coast.

Source: Elbadawi and Soludo 1999.

act with other variables—being far from the sea, for example, is a bigger problem if transport services are poor.

Elbadawi and Soludo (1999) estimate the relative effects of these variables across 32 developing countries—22 of them in Africa—to account for country shares of a broad range of industrial and processed exports relative to total exports of the same type of products by the 32 countries (figure 7.1). The export shares are assumed to be explained by four sets of variables:

- Geography and natural endowments, proxied by the percentage of land in the tropics and an interaction term combining the percentage of land on the coast and the population density at the coast. This term measures the potential for facilitating trade through ports.
- Development variables—capital and skilled labor endowments, with investment and primary education used as proxies.
- Two important policy indicators: the misalignment of the real exchange rate and its variability.
- Transactions costs are proxied by three indicators: paved road density as an indicator of infrastructure, the average cost of telephone calls to a global economic center (the United States) to gauge ease of communications, and a corruption index to capture the quality of public services.

The results confirm that geography affects the share of industrial and processed exports. Tropical location reduces the share, while a large, densely populated coast increases it. But other factors matter a lot, and reduce the role of geography. Higher investment and greater primary school enrollment are associated with higher industrial and processed export shares, as are better infrastructure and communications (roads and telephones). Corruption is associated with a smaller share of industrial exports. Consistent with international evidence (Helleiner forthcoming), real exchange rate overvaluation and variability can also lower industrial and processed exports.

Given the constraints of geography, what are the prospects for Africa to increase its market share in industrial and processed exports? To answer this question, Elbadawi and Soludo (1999) generate three illustrative scenarios. First, if the median African country were to adopt East Asian exchange rate policy and attain that region's transactions costs, its annual industrial exports would reach $3 billion (see figure 7.1). This would be a significant jump from the minuscule $28 million in industrial and processed products now being exported by the median African country. Moreover, it should be possible to attain the simulated levels of exports

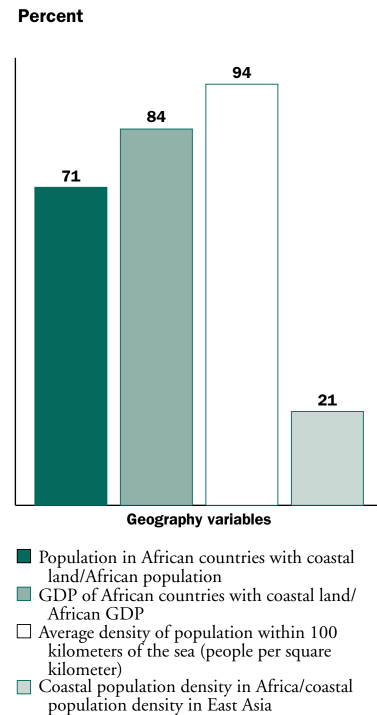
in a relatively short period given that a better macroeconomic environment and lower transactions costs could be achieved fairly quickly.

Second, should the median African country also attain East Asian investment and education levels, its industrial and processed exports would reach $20 billion a year in the medium to long run. Geography does not seem to be an insurmountable obstacle to diversification—the catch-up effects unleashed by sound policies, especially when augmented by strategies to retain and attract investment and invest in people, seem very strong.

Third, the simulations suggest that coastal countries have more options because of their more favorable location. Were it to benchmark policies and development variables on East Asian levels and achieve East Asian coastal densities (an unlikely outcome), the median African country would achieve industrial exports of $52 billion (figure 7.2).

True, any such estimates can only be taken as illustrative. But the central point of the simulations is that despite the constraints of geography, a lot can be done. And with appropriate integration, the dynamic spillover effects from big coastal countries could shorten the catch-up time for the median African country. The results also define the challenges facing policymakers in Africa. With knowledge of what is possible, countries need to design and implement national policies and regional cooperative arrangements to achieve their goals.

Figure 7.2 Aspects of Africa's Geography



- Population in African countries with coastal land/African population
- GDP of African countries with coastal land/African GDP
- Average density of population within 100 kilometers of the sea (people per square kilometer)
- Coastal population density in Africa/coastal population density in East Asia

Source: Elbadawi and Soludo 1999.

A Business Plan for Export Diversification

HAVING POTENTIAL IS ONE THING. REALIZING IT IS ANOTHER. Realizing Africa's export potential requires actions on several fronts—appropriate and stable real exchange rates and other policies to foster openness and economywide competitiveness, complementary measures to strengthen the supply response and raise international competitiveness, and measures to widen economic space through open regionalism and multilateralism. These measures go well beyond trade, but trade policy is the focus here.

Sustaining Competitive and Stable Real Exchange Rates

Real exchange rates are central to the business plan for diversifying exports. International evidence suggests that the real exchange rate is even

more powerful for export growth than trade policy (Rodrik 1997; Helleiner forthcoming; Elbadawi 1998). Successful trade policy reforms have usually been accompanied by liberalized foreign exchange rates, drastically reducing real exchange rate overvaluations or parallel market premiums. Recently, however, some countries have seen a surge of speculative and short-term capital inflows, mainly driven by high real interest rates. The outcome has been increased real exchangerate instability.

Chile's model of real exchange rate–led export promotion offers important lessons for Africa

Africa will have to attract much higher private capital flows in the future. Thus it cannot afford to reimpose sweeping capital account restrictions and so miss out on tapping global capital markets to finance future investment. Maintaining exchange rate stability and competitiveness on the one hand, and creating a hospitable and attractive environment for foreign capital on the other, promises to be one of the key challenges for export diversification and competitiveness.

Malawi and Chile illustrate the challenges and options facing many African countries. Malawi's real exchange rate turbulence is among the highest in Africa. Much of this instability can be attributed to fiscal crises and to pegging the exchange rate at levels that become unsustainable. Two structural elements make matters worse: the seasonality of the country's exports (70 percent are tobacco, mostly exported by three companies) and the difficulty of predicting concessional donor flows (which account for half of foreign exchange receipts). Countries like Malawi could do several things to create more stable incentives for trade: implement a medium-term budget framework to reduce fiscal crises, adjust the nominal exchange rate more often to prevent massive fluctuations, foster competition in the foreign exchange market by easing controls, and work toward diversifying exports, particularly by encouraging manufacturing exports. (World Bank 1999a).

Chile's recent experience suggests that economic competitiveness need not come at the cost of adequate integration with the global capital market. The Chilean model of real exchange rate–led export promotion offers important lessons for Africa, especially for countries with more advanced financial and capital markets. Chile has indirectly influenced both the type and size of private capital inflows in the context of an essentially open capital account. Long-term capital was encouraged while short-term and speculative capital flows were discouraged, holding aggregate capital inflows closer to sustainable levels.

Despite high capital inflows in the 1990s, Chile did not experience major declines in competitiveness. And unlike many emerging markets, it managed to avoid devastating financial and currency crises. In addition to strong macroeconomic fundamentals, genuine central bank independence has been important for Chile's success in managing capital flows. The Central Bank of Chile, which is responsible for exchange rate policy, has an explicit target for the current account: over the medium term it should be in deficit by 3–4 percent of GDP. This approach has allowed Chile to maintain a competitive real exchange rate that supports rapid growth and export diversification. It has also allowed Chile to avoid financial crisis despite the temptation of massive capital inflows (Williamson 1997).

Africa has come a long way on trade reform—but more needs to be done

Making Trade Policy Work for Diversification

> *There is actually a fair bit of consensus on what constitutes a reasonable trade strategy for countries of Africa. The consensus can be crudely expressed in terms of a number of do's and don'ts: de-monopolize trade; streamline the import regime, reduce red tape and implement transparent customs procedures; replace quantitative restrictions with tariffs; avoid extreme variation in tariff rates and excessively high rates of effective protection; allow exporters duty-free access to imported inputs; refrain from large doses of anti-export bias; do not tax exports too highly.*
>
> —Rodrik 1997, p. 2

How far have Africa's trade reforms come? Measured against these criteria, quite a long way. Quantitative restrictions, once widespread, have been replaced by tariffs. These tariffs have been steadily lowered in most countries, and their dispersion reduced. By 1998 trade-weighted tariffs in Uganda averaged 10 percent, with the countries of the West African Economic and Monetary Union not far behind. In most countries foreign exchange regimes have been liberalized for current transactions. And there have been significant moves to rationalize exemptions in most countries. What remains as the unfinished agenda?

Policies still discourage exports. African trade taxes and restrictions are still higher than in other developing regions, and antiexport bias is still considerable in most countries. Especially because of the small size of their economies and the importance of imported inputs, this has considerable impact. But countries typically depend on trade taxes for about one-third of government revenue, with half or more coming from tariffs on inter-

mediate and capital goods. For countries where tariff collection approaches the average statutory rate, reducing tariffs is likely to mean losing fiscal revenue—trade liberalization is unlikely to be self-financing because exports will not expand sufficiently in the short run to permit a large increase in imports. Thus efforts to reduce trade taxes cannot proceed independently of measures to strengthen other sources of fiscal revenues.

Liberalization has been uneven across the region—country–based, and not always compatible with regional coordination

Liberalization is not locked in. Liberalization is not yet anchored in an ideology, such as export promotion. This is because reforms have been spurred by adjustment programs negotiated with international financial institutions rather than by voluntary multilateral negotiations underpinned by strong national ownership. Donor-driven liberalization is subject to reversal—for example, in response to chronic fiscal and foreign exchange shocks. In addition, African tariffs are bound at high levels under the Uruguay Round. These features make private agents less certain of the credibility and sustainability of reforms. An emerging policy issue is therefore how trade reform can be "locked in" for credibility (Gunning 1998).

Reforms have been country-based, not regional. Perhaps for similar reasons, liberalization has been uneven across the region. Even within such subregional groups as the Southern Africa Development Community, wide variations in tariffs and other regulations make it hard to enlarge the economic space for private enterprise. Country-based reforms are therefore not always compatible with regional coordination.

Compensatory mechanisms for exporters often do not work. Africa is rich in export processing zones, duty drawbacks, exemption schemes, and value added tax rebates, to compensate exporters for tariffs on inputs. But except in Mauritius, these have not worked well. In West and East Africa incentives often leak to nonexporters, while rebates to exporters arrive late or not at all. In addition, key services—such as customs—often operate inefficiently, taking weeks to clear consignments and imposing additional costs on business.

The global frontier is moving rapidly in such areas, with normal clearance times down to as little as 15 minutes in some industrial countries. In other regions where trade restrictions are no lower than in Africa, export processing zones are well established and appear to operate more effectively. One example is Central America, where customs clearance is far faster and service standards are higher. An important reason appears to be the strength of powerful exporters and their ability to hold governments accountable for good services. Exporters are not yet a strong pressure group in most African countries. But governments will need to act as though they were if economies are to diversify.

Completing Africa's trade agenda requires embedding second-generation reforms in an overall export promotion strategy that includes widening economic space and working within—and influencing—the evolving rules of the global trading system. Three measures are important:

- Eliminate further antiexport bias. Because of fiscal constraints, this cannot be done by sharply cutting tariffs across the board. Thus there is no alternative but to focus on getting compensatory mechanisms to work efficiently. Aggressive export promotion also requires attention to service standards in key areas, especially for activities requiring imported inputs.
- Sequence further cuts in import tariffs and broaden the fiscal revenue base away from trade taxes.
- Deepen regional integration, not only to enlarge economic space but also to help lock in reforms. For many countries policy reforms will continue to lack credibility without a lock-in mechanism. This is possible through enhanced use of World Trade Organization bindings, by concluding reciprocal free trade agreements with countries outside Africa, and by harmonizing trade and investment policies along subregional lines.

Attracting substantial investment is the fundamental challenge for export promotion

Introducing Complementary Measures beyond Trade Policy

Trade reforms need to be accompanied by measures that lay a stable base for investment and production. These include effective and noncorrupt tax administration, honest customs administration, working commercial courts, reliable infrastructure (including air transport), and a working financial system (chapter 5). Failure to effect these measures has blunted the investment response to first-generation trade reforms in most African countries.

Lowering costs and risks. Attracting substantial investment to the export sector is the fundamental challenge for export promotion. But with Africa ranked among the world's riskiest place to do business, even retaining domestic savings becomes a challenge. So, the first order of business is for African governments to provide a safe and profitable environment to convince their citizens to invest at home. Investment booms everywhere have been led by domestic capital, including capital repatriated from abroad. In 1990 flight capital accounted for almost 40 percent of private wealth in Africa, compared with just 6 percent in East Asia and 10 percent in Latin America (see table 1.3). Capital flight from Africa and other regions has been

caused by factors similar to those that discourage private investment: exchange rate overvaluation, a high-risk environment, and high external debt (Collier, Hoeffler, and Pattillo 1999). Foreign capital follows domestic capital. As noted, high costs for transaction-intensive activities, particularly in manufacturing, and high perceived risks have been among the main constraints to investment and diversification (Collier and Gunning 1999).

Business surveys confirm the high costs of operating in Africa. To some extent this reflects Africa's economic sparseness and the distance of much of its production from the sea. But weak business services, including infrastructure and regulation, are also major impediments to growth in countries that have advanced on macroeconomic and structural reforms (box 7.5).

Box 7.5 Why the Cost of Doing Business Is High in Africa

Local transport. An efficient Nacala rail line and port could save Malawi 3 percent of GDP. A survey in Uganda found that transport and other costs raised the cost of capital goods by 50 percent in 1997; it required 8 or 9 days for intermediate inputs to clear customs after a 30-day journey from Mombasa. Road transport may be twice as costly as in Asia, in some cases reflecting unofficial tolls. Delays at checkpoints in Southern Africa often last as long as a day.

International transport. International transport and insurance charges are higher than necessary for African countries because of restrictive agreements. Air transport is particularly vital given Africa's economic sparseness, the prevalence of landlocked countries, the high costs of road transport, and the promise of new high-value exports such as horticulture. Yet schedules are often inconvenient, and tariffs and handling charges can be twice those for comparable flights in other regions.

Communications. International telephone charges and Internet connections are among the world's most costly. Despite higher investment than in the past, telecommunications reach only a tiny fraction of the population, and waiting times for connections are the longest of any region.

Power outages , bribes, and violence. Ugandan firms lose an average of 91 days a year because of power outages. In addition, the median firm pays bribes equivalent to 3 percent of gross sales or 28 percent of investment in plants and equipment, and bears a similar cost from theft and security charges. Crime and violence raise costs in many countries: a study for South Africa put the effect at 6 percent of GDP in 1996, comparable to estimates for Latin America (Bourguignon 1999).

Trade and tax policies. Despite reforms, tariffs in most African countries are still higher than in more outward-oriented developing countries. And they embody a significant antiexport bias, both for primary products (where the sum of export taxes and import tariffs can exceed 30 percent) and for manufactures (due to high taxes on intermediate inputs and capital goods). Duty drawback mechanisms have proven ineffective except in a few countries, and value added tax rebates are often slow. The effect is a high tax on potential exporters requiring imported inputs.

Slow regional integration. Regional integration has been slow to integrate markets and stimulate internal trade. Some countries belong to more than one regional association and are torn between conflicting obligations.

Restrictions everywhere. In many countries restrictive regulations and practices, often aimed at generating rents for officials and favored groups, constrain business activity, affecting both agriculture and industry.

Even better-managed African countries tend to rank lower on international risk ratings than their policies would warrant. Some countries, such as Mauritius and Uganda, have steadily improved their risk ratings. But others, including Kenya and Zimbabwe, have seen sharp declines in ratings, offsetting gains for the region as a whole. High perceived risks have several causes (box 7.6).

Increasing consultations with business and labor. Any business plan requires developing a supportive, mutually accountable relationship among business, labor, and government. Strong business associations and labor movements can help in this. Some dynamic relationships are starting to evolve in Africa (box 7.7). Much of East Asia's success has been attributed to active interactions between the state and business. The state provided incentives and services, while businesses delivered performance. Close interaction ensures effective feedback and continuing pressure on both parties.

Any business plan requires developing a supportive, mutually accountable relationship among business, labor, and government

A skilled and supportive workforce is also critical to diversification. Labor needs to be well educated about the pains and gains of reforms, and special efforts need to be made to carry labor unions along. Cooperation and higher productivity are more likely when a consultative process ensures the effective participation of labor in policy formulation, or at least its full understanding of the benefits.

Box 7.6 Why Risks Are Perceived As Being High

Perceptions of risk in Africa involve factors beyond political and social stability. On the macroeconomic side, many countries liberalized before containing fiscal deficits, and in some cases this placed greater stress on fiscal management. Many countries have been prone to policy reversals—increasingly associated with elections—and to external shocks. And real exchange rates, real interest rates, growth rates, and fiscal revenues have been unstable through the period of opening to markets (Guillamont and others 1999).

Aid dependence and high indebtedness also increase uncertainty. Large debt service obligations make countries more vulnerable. This is accentuated by "stop-go" patterns of quick-disbursing aid, where big cuts in financing can be triggered by a failure to meet governance standards or structural benchmarks (such as the privatization of a given company by a certain date) rather than by a loss of macroeconomic control.

Surveys of firms also highlight the risks of policy reversals. In contrast to other regions, Africa's trade reforms have been formulated as part of structural adjustment programs negotiated with the World Bank and the International Monetary Fund rather than as part of multilateral negotiations with trading partners. This has meant weaker commitment and higher perceived risk of reversal and incomplete reform.

Box 7.7 Listening to Business

POOR COMMUNICATIONS BETWEEN GOVERNMENT AND business limit growth in many African countries. Laws, rules, and institutions are often inimical to private sector interests. Governments that lack policy credibility have less influence on economic behavior. And a climate of uncertainty and mutual suspicion generates little private investment. There is a bias toward short investment horizons, and economic activity is pushed into the informal sector.

Enterprise networks are growing in West, East, and Southern Africa, providing a voice for emerging African businesses. Several African countries are adopting public-private consultative bodies to facilitate communication, some formal, some informal. These entities enable participants to take joint responsibility for policy choices, and the repetitive nature of the collaboration constrains self-interested behavior. This also helps establish credibility—private participants believe that cheating and reneging are less likely. Politically, these groups serve as proto-democratic institutions, providing direct channels to government for business, labor, and academia. As important, the rules established by the councils cannot be altered arbitrarily. As a result members can concentrate on business and not worry about others trying to curry special favors from the government.

Ghana's consultative group was among the first. Early initiatives led to a private foundation as an umbrella organization for business associations. Hostility and suspicion between government and business have been reduced and communications improved. Madagascar, Senegal, and Uganda have set up similar foundations. Cameroon, Côte d'Ivoire, and Senegal have set up competitiveness commissions, with public and private representation.

Consultative groups work best where there is urgency (a deadline) and a well-focused agenda. The focus should first be on policies and regulations that affect the entire private sector. The initial stages of this type of consultation are fragile and require moral and financial support. Open and public consultations increase public involvement and enhance the accountability of group members. These organizations can also act as "agencies of restraint" on government behavior, forming lobbying organizations to ensure support for pro-export policies.

Widening the Economic Space: Regionalism and Multilateralism

Despite past failures and the lackluster implementation of existing schemes, the case for Africa's economic integration remains compelling. There appears to be a widely held view within Africa that African unity could help stem its political and economic marginalization, create new structures out of its colonial heritage, and protect its interests in international political and economic negotiations. These political motivations, supported by the realization that integrated markets are needed for small African economies to develop, explain the continued support for integration in Africa. The promise of pan-Africanism has kept alive the ideals of the Lagos Plan of Action despite serious lapses in implementation.[2] More recently, continental African integration agendas have reflected the desire for even more ambitious economic and political integration—well beyond the Lagos Plan of Action.[3]

Thus the relevant policy question for the next century should not be whether regional integration will be on Africa's economic and political agenda. Rather, it should be how regionalism can help achieve Africa's development goals in a globalized economy. The starting point would be to identify the reasons for the region's rather disappointing record on regionalism.

Why has regionalism failed? Despite a multitude of subregional schemes and the strong political rhetoric supporting them, the results of integration remain modest. Progress on the 1991 Abuja Treaty—which envisions an African economic community—has been mostly subregional. The main schemes are the Common Market for Eastern and Southern Africa and the Southern Africa Development Community in the east and south, the Economic Community of Central African States in the center, and the West African Economic and Monetary Union and the Economic Community of West African States in the west. These arrangements are sometimes overlapping, with countries subject to conflicting obligations. There have also been wide variations in the nature and speed of integration (box 7.8).

Despite a strong political impetus for integration, integration efforts have had modest results

Regional integration was conceived as an inward-looking instrument of industrial development—a way to increase intraregional trade and aggregate small national economies into regional markets. But this approach was stalled by several shortcomings, including institutional and political constraints (Oyejide, Elbadawi, and Yeo 1999; McCarthy 1999). First, though regional economies are larger than individual economies, the combined market was still not big enough to support industrial transformation through import substitution.

Second, the inward-looking strategy of industrial substitution had two unintended consequences that undermined regional integration. At the macroeconomic level, policies resulted in overvalued currencies and foreign exchange shortages, forcing a preference for trading partners who offered the best credit facilities. Given that most of these partners are from industrial countries, national industrialization strategies continued to support the hub-and-spoke pattern of trade (Kasekende, Ng'eno, and Lipumba 1999). Moreover, the trade protectionism associated with national industrial strategies led to powerful lobbies and "economic nationalism" that also undermined regional development.

Third, the design and objectives of regional integration schemes have been driven by a preference for formal trade and factor market integration rather than by basic policy coordination and collaboration in regional projects. This has resulted in rather ambitious models of regional integration.

But Africa's unfavorable structural features—competitive primary production, small size, low per capita income, limited manufacturing capacity, weak financial sectors, poor transportation and communications infrastructure—make these ambitious models difficult to implement.

Fourth, African integration schemes have suffered from implementation lapses—including those due to weak governance. Some states could not cope with a loss of national sovereignty. Other factors include a lack

Box 7.8 Progress and Challenges for Africa's Subregional Groups

THE COMMON MARKET FOR EASTERN AND SOUTHERN Africa (COMESA) and the Southern African Development Community (SADC) both underwent significant institutional changes in the 1990s, with potential positive effects. South Africa joined the SADC, and agreement was reached on a SADC free trade area following ratification of the SADC Trade Protocol in 1998. Cooperation is under way on harmonizing financial infrastructure (including payments systems and accounting standards), standardizing and improving bank supervision, and improving management of water resources. In addition, South Africa—which accounts for more than 70 percent of Southern Africa's GDP—has signed a free trade agreement with the European Union, with profound implications for regional dynamics. Independent assessments indicate that the agreement will be largely beneficial to other SADC members.

COMESA has recently been focusing on moving toward a free trade area and supporting regional trade through a guarantee facility to help provide political risk cover. The existence of overlapping and competing groups—COMESA and SADC—is a lingering problem in East and Southern Africa, especially given the similarity of their agendas.

In the west, the Economic Community of West African States (ECOWAS) is the umbrella group for 16 countries. Within it are 10 francophone countries that belong to the CFA zone and have another subgroup—the West African Economic and Monetary Union (UEMOA). Despite the sharp division along linguistic lines, ECOWAS has helped keep the community together. Under its leadership, peace has been restored to Liberia and Sierra Leone. The ECOWAS travelers check—a step toward West African monetary union—was launched in July 1999.

The UEMOA has enjoyed significant achievements. Building on a convertible common currency (the CFA franc) and the relatively free movement of capital, a customs union—to be fully implemented in 2000—will help create a subregional economic space to attract investment.

The UEMOA faces challenges, however. The first is how to cope with the pressures unleashed by harmonized markets, including increased population movements, and revenue losses for some members, such as Burkina Faso. A second is not having the central bureaucracy become bloated and ineffective—the UEMOA includes a subregional court, subregional parliament, and other institutions, and the import duty to finance this is to be doubled from 0.5 to 1.0 percent. The third is to ensure sufficient flexibility to prevent the currency from again becoming pegged at an unsustainable level.

The key challenge in ECOWAS is to build bridges across the linguistic divide and fashion a viable subregional group. Ghana is surrounded by the UEMOA. Nigeria has two-thirds of the population and 55 percent of the GDP of ECOWAS countries. A regional integration arrangement in West Africa that leaves out Nigeria would be like leaving South Africa out of the SADC.

of adequate technical and management expertise, concerns about losing trade tax revenues, and concerns about equitable growth and polarized industrial transformation within the subregion.

The way forward. Given the political, institutional, and other problems that have hampered African integration, especially outside the CFA franc zone, alternative approaches are needed. One is to stress an outward orientation—or "open regionalism"—and a flexible design, based on cooperation between countries, to jointly implement specific projects. These can include transportation and communications infrastructure and investment regulation as well as trade policies (Oyejide, Ndulu, and Greenaway 1999; chapter 5).

An outward-oriented integration strategy may be the best approach

Such an approach is not necessarily incompatible with deeper integration. It can provide greater flexibility and serve as a building block for eventual market integration once key constraints to intraregional trade, investment, and labor movements have been eliminated. McCarthy (1999) argues that since the focus is on specific issues, these are depoliticized and present less of a challenge to existing power structures. In time a culture of regional cooperation will develop, laying the foundation for market integration and the acceptance of the loss of sovereignty.

Indeed, since African economies are very small, both individually and as subgroups, the potential welfare gains from freer trade in Africa may be limited, at least in the short to medium term. This raises the issue of whether the principal focus of integration should be on promoting investment rather than intraregional free trade. Creating an economic space where investors can produce for regional as well as global markets may provide small African economies with better growth opportunities than simply removing barriers to trade among themselves.

The Cross-Border Initiative is an attempt to operationalize these principle (box 7.9). As an alternative to "integration by design," where countries are bound by treaty obligations, the Cross-Border Initiative is an example of "integration by emergence." Under the initiative faster reformers set the pace of integration within a framework of harmonized policies that accepts the principle of variable geometry (allowing different groups of countries to proceed at different speeds). Within the framework of a road map for tariff reform—a set of common targets for harmonizing trade policies, but without a treaty—participating countries have made good, if uneven, progress in removing barriers to trade among themselves, while also lowering barriers to trade with third parties.

Box 7.9 The Cross-Border Initiative's "Integration by Emergence"

UNDER THE CROSS-BORDER INITIATIVE (CBI), launched in 1993, 14 countries in East and Southern Africa and the Indian Ocean have made progress on "integration by emergence." For example, the average trade openness rating of CBI countries—based on an International Monetary Fund methodology, with 0 being most open and 10 being least—improved from 8.3 in 1993–95 to 5.9 in 1998. (This compares with an average of 6.2 for all non-CBI African countries undergoing economic reform and 4.4 for the rest of the world excluding Africa.) Moreover, a few countries—Uganda, Zambia—have made considerable progress toward openness levels (rating of 2) in line with those of global good practice economies (Chile, Colombia, Singapore). Nevertheless, since this approach relies exclusively on peer pressure and example, without any formal treaty-based enforcement rules, the mechanism for locking in reforms may not be robust. And there may be complications arising from overlapping bilateral deals and complex rules of origin.

CBI countries have recently moved toward a more balanced approach, paying more attention to facilitating investment. For example, they have agreed to harmonize tariffs, regulations, and investment promotion policies. This approach combines tariff reform to lower the antiexport bias of trade policies with specific measures to remove barriers to cross-border investment. Specific actions on investment facilitation will be taken within a flexible framework of harmonization of policies, but without formal treaty obligations. The potential benefits of this approach would derive from attracting additional foreign investment—currently just 1.2 percent of GDP for participating countries—to produce for the regional market as well as for global markets, which offer still larger welfare gains.

Regional coordination offers African countries many benefits. It could provide a collective agency of restraint, helping to rationalize trade and investment policies and enhance their credibility. Beyond trade, regional cooperation could provide a multilateral lock-in mechanism for orchestrating convergence criteria on policies, regulations, and licensing. Recent proposals for trade areas with the European Union and the United States have been discussed in the context of the renegotiated Lomé Convention[4] and the Africa Growth and Opportunity Act.[5] Both arrangements call for broader, more reciprocal and participatory economic relationships. Africa stands to gain by developing a coordinated approach to the two initiatives, especially since both entail eligibility criteria for participating African countries. There will continue to be debates on how deep and how fast integration should proceed in Africa and in what areas. For example, in the long run it may be desirable for African countries to adopt a common currency or regional currency zones. But it is not clear how quickly these measures should be or could be implemented. And given Africa's marginalization in world trade, there might be a payoff if countries coordinated in subregional groups in multilateral negotiations at the World Trade Organization.

Africa and the world trade system. The World Trade Organization offers a multilateral forum for Africa to take advantage of a rules-based system for trade and development. Most African countries have acceded to the World Trade Organization, and the millennium round negotiations (which started in November 1999) will offer opportunities—and enormous challenges.

New structures of global governance can increase Africa's market access and clarify its rights in the international trading framework. But they also bring obligations, including giving up a degree of sovereignty over trade and investment. As a consequence of continued global liberalization, there will also be a continuing erosion of the preferences enjoyed by African countries. African countries will incur large financial costs as they create the institutions and implement the myriad standards demanded by the multilateral system. For some least developed countries, implementing World Trade Organization obligations would cost as much as an entire year's development budget. Finger and Schuler (1999, p. 1) note that WTO obligations reflect little awareness of development problems and little appreciation of the capacities of the least developed countries. In most cases standards have been developed with little input from the least developed countries, undermining their sense of ownership. More fundamentally, it is not clear that all of these standards are ideal for the least developed countries, and there is the ever-present danger that they will be used to protect markets.

World Trade Organization rule-making should be made compatible with the institutional, human capital, and infrastructure investments required for poor countries to benefit from the global trading system

What does this mean for Africa? African countries will need to pay more attention to multilateral negotiations and try to influence the outcomes. But only Nigeria and South Africa have six or more representatives at the World Trade Organization in Geneva, while about 20 African member countries have no representatives (World Bank 1999b). Multilateral institutions can offer technical assistance, including through the Integrated Framework for Trade and Development in the Least Developed Countries.[6] But a subregional pooling of expertise is essential: small, poor countries cannot go it alone.

Africa can use the multilateral system to achieve clearly defined goals. It can use the opportunity to lock in its reforms and so increase investor confidence. At the same time, it is important that African countries participate in setting the global agenda. They can partner with others to negotiate for the dismantling of restrictive trade practices that inhibit export diversification in poor countries. Three areas are important: agriculture (chapter 6), processed goods, and textiles and clothing. Free trade should work for the poor—as well as for the rich. The next opportunity must not be wasted.

Managing the Business Plan: The Role of the State

The state should manage structural transformation and help overcome market imperfections

Any serious plan for export diversification should include a strategy for structural economic transformation. Managing this must be the responsibility of the state. Still, nearly all development experiences suggest that even if the state delivers—providing stable macroeconomic policy, strong incentives, the rule of law, basic infrastructure, and the like—an adequate and diversified export response may not come quickly. Why? Because of market imperfections due to a variety of factors—such as incomplete or absent information on consumer tastes and producer needs in overseas markets, on the appropriate technology for producing competitive goods, and on the requirements for penetrating these markets.

The presence of market imperfections—and they abound in Africa—suggests an important role for the state in opening up the economy, either by directly subsidizing activities aimed at internalizing these externalities or by supporting creative institutional designs (such as exporter associations) to achieve the same goals.

Most African states lack the capacity to address these complex tasks. But such constraints will not just disappear. States have to develop the capacity to ease them as they pursue economic diversification. For example, a number of countries have offered matching grants to stimulate firms to acquire new technology and overcome critical thresholds, including information needed to comply with the standards of export markets. African firms cannot yet benefit from large agglomerations of skilled employees and the externalities these provide, so there is a case for subsidizing training. Another possible but debated area is whether to offer tax holidays. Many countries do so, competing with each other as well as with countries in other regions. But statutory tax rates in Africa are often high, and countries might benefit more from moving toward uniform and lower tax rates as tax bases are broadened. These and other selective measures should be approached with caution and should be continuously monitored to assess their effectiveness—in particular, that they do not simply subsidize activities that firms would do anyway. In addition, the experiences of other countries offer a useful guide.

Again, Chile provides a compelling case for a limited but important role for the state in export promotion. Chile and other Latin American countries are more relevant than Asia for Africa, because their endowments also include a rich natural resource base. As Chile makes clear, this does not necessarily inhibit development. In particular, abundant natural resources did

not prevent industrialization—but industrialization was built on different foundations than in Asia. Chile's export promotion polices offer three useful lessons for Africa. First, well-managed temporary subsidies could prime the growth of nontraditional exports. Second, foreign direct investment is responsive to activities that open up new export possibilities or introduce new technologies. Finally, a growth strategy spearheaded by a few niche exports can pay handsome dividends (Agosin 1997).

Notes

1. Not all of these global standards—most of which are set by more developed countries—are helpful for Africa. Indeed, achieving these standards can be extremely costly for African countries (Finger and Schuler 1999). Moreover, across-the-board implementation of these global standards could limit trade between developing countries.

2. The Lagos Plan of Action (1980) was a declaration by African heads of states creating four regional groups (including one for North Africa) that would merge into an African Economic Union by 2000.

3. The political will to unite Africa politically and economically was recently put to the test in a September 1999 summit of the Organization of African Unity held in Libya. Some 43 heads of state and government attended the summit to work on a proposal for an African Union, tantamount to the United States, the former Soviet Union, or the European Union. The African Union will have a federal supreme court, a central bank, a monetary fund, an investment bank, and an elected legislature. The union will protect the continent on land, sea, and air and use the congress to help settle disputes between member states.

4. The European Union and ministers of the 71 African, Caribbean, and Pacific countries recently concluded negotiations on a new 20-year partnership agreement that replaces the Lomé IV Convention (which expired on 29 February 2000). The new agreement is based on three pillars—a political dimension, a new trade regime, and development cooperation—and will be signed in Fiji in May 2000. The agreement signaled a radical departure in relations between the European Union and African, Caribbean, and Pacific countries, toward broader and more reciprocal economic relations.

5. In 1999 the U.S. Congress approved the Africa Growth and Opportunity Act. This initiative is aimed at encouraging U.S. trade and investment in Africa by removing quotas and barriers for imports from African countries and establishing a U.S.-Africa free trade area. Political and economic conditions of the arrangement, however, suggest that some African countries may not be eligible to participate.