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SUMMARY AND CONCLUSIONS

The 2007 Annual Economic Report on Partner Countries prepared by the Development Economics Advisory Service (DEAS) presents an overview of economic developments in countries covered by three of the EIB's mandates outside the EU: Mediterranean Partner Countries (MPC), Africa, Caribbean and Pacific (ACP) plus South Africa, and Asia and Latin America (ALA), which encompass a total of 123 countries accounting for about three quarters of the world's population and about 40 percent of the world's Gross Domestic Product.

The report consists of two parts, the first of which presents a review of global and regional economic developments in 2006. Driven by strong growth in emerging market and developing economies, the world economy grew by an estimated 5.4 percent, one of its best performances of the last 20 years and the fourth consecutive year of above trend growth. Another welcoming development was Sub-Saharan Africa's growth performance. Benefiting from strong demand for its commodities, the region's economies expanded by 5.7 percent, confirming the growth momentum of the last few years. Economic activity was particularly strong in China and India. China's vigorous export growth contributed to a further expansion of its current account surplus and to the continued accumulation of external reserves, which crossed the one trillion dollar mark. The past year was also marked by oil price volatility, which around mid-year fed inflationary expectations and turbulence in financial markets. However, in the second year half of the year the oil price pressure lowered, reassuring markets that economic growth was not likely to be derailed. Housing market developments have also provided some reasons for concern, notably due to the increased number of defaults in the sub-prime segment of US mortgage markets towards the end of 2006. This notwithstanding, the outlook for 2007 and 2008 remains broadly positive, despite some uncertainty regarding the strength of economic growth in the United States, the possibility of over-heating in China and India, and the potential threats to global financial stability stemming from the large liquidity levels that have accumulated over the last few years due to rather favourable financial conditions. Furthermore, geo-strategic risks stemming from the Middle East region and concerns about terrorism continue to weigh on the stability of the global economy.

Part II of the report discusses options for aid in Africa. The poor performance of sub-Saharan Africa in the 1980s and 1990s has led to a wide ranging debate about aid and reform. The policy reform agenda of major aid agencies has been criticised as being unfocused because of its universal approach of targeting all constraints to growth at the same time and not differentiating at all among countries. In response, new analytical approaches are being developed that seek to tailor reforms to the country-specific needs of the recipients and more directly address the constraints to growth. As an example of this approach, African countries can be divided into three categories: landlocked, resource rich and coastal resource-scarce. Constraints to growth in each country category differ, requiring different reform policies and aid strategies. For example, in landlocked countries the binding constraint is probably the lack of investment opportunities which justifies focusing on the provision of physical infrastructure and human capital. On the other hand, in resource rich countries the crucial constraints to growth are likely to be the inadequacy of institutions which suggests that support for institution building might be the most relevant aid strategy when there is significant commitment on the part of recipients. The section reviews in detail these different options. It also discusses some options that are more speculative at this stage, such as step increases in aid to countries where it might contribute most to economic growth and/or widening preferential access of African Countries to OECD markets that would offset the accumulated economies of agglomeration of Asian countries.

This report was prepared by a team of DEAS economists – Simona Bovha-Padilla, Pedro de Lima, Geoffrey Frewer and Sabina Pogorolec – under the direction of Daniel Ottolenghi, Chief Development Economist and Bernard Ziller, Senior Economic Advisor. Bruno Marzin was responsible for database management and Sanja Steffgen for editorial treatment. The report was written on the basis of information available up to 31st May 2007.

PART I

OVERVIEW OF RECENT TRENDS AND STRUCTURAL ISSUES IN PARTNER COUNTRIES

1 Introduction

This section looks at recent trends in partner countries viewed against the backdrop of trends in the world economy. It also identifies some issues that have been critical to developments in the various regions, notably commodity – oil and non-oil – prices, and it discusses growth prospects over the near and medium terms.

2 Global Overview

Driven by strong growth in emerging market and developing economies, in 2006 the world economy grew by an estimated 5.4 percent, one of its best performances of the last 20 years and the fourth consecutive year of above trend growth. While China and India were once again the star performers – each with GDP growth rates in the neighbourhood of 10 percent and jointly accounting for 14 percent of the world's GDP growth – the pace of economic activity in many of the other partner countries was almost as impressive. This is particularly true in the case of sub-Saharan African countries that expanded by 5.7 percent, confirming that the growth momentum of the last few years has been maintained. In fact, despite some remaining trouble spots in the region, growth has been broadly based and the region as a whole has consistently outperformed the world economy since the beginning of the decade, a welcome reversal of the poor track record of the 1980's and 1990's (Chart 1).

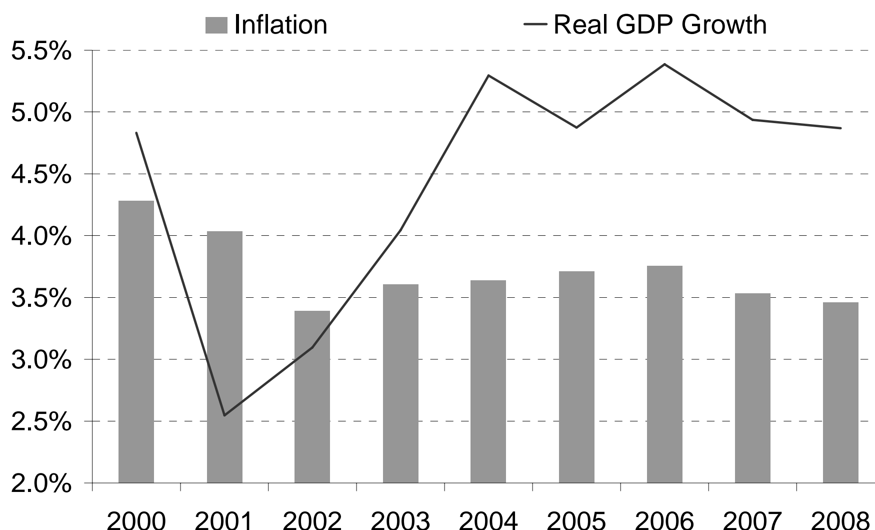
Economic developments in 2006 were marked by oil price volatility. Prices increased rapidly during the first half of the year, reaching a peak in early August – at which point some futures contracts were traded at more than USD 80 per barrel (Chart 2). This raised fears that inflationary pressures could escalate and complicate monetary policy decisions, particularly in advanced economies. In the Euro area, the acceleration in economic activity – growth in 2006 almost doubled, reaching 2.6 percent, on the back of a resurgence of activity in Germany – reinforced the case for tightening of monetary policy. The ECB raised its reference rate 5 times in 2006 by a total of 125 basis points to end the year at 3.5 percent. In the United States, as the economic expansion that started in 2002 progressively lost steam and conditions in the housing market deteriorated significantly, the announced end of the tightening cycle was questioned by oil price developments. On the other hand, oil markets eased considerably after the summer recess, thereby contributing to more benign inflationary expectations. Therefore, after three interest rate hikes of 25 basis points each during the first semester of 2006, the Federal Reserve has since held the federal funds target rate steady at 5.25 percent. This contributed to sustain consumption expenditure in the US economy, which despite an overall slowdown in residential and business investment grew by a respectable 3.3 percent in 2006.

With inflationary expectations fading in most advanced economies as well as in major emerging markets in the fourth quarter of 2006, financial markets around the world recovered rapidly from the volatility bout experienced in mid-year. In particular, in recent months equity prices have reached record values in a number of stock exchanges both in advanced and emerging market economies. This is due to economic fundamentals such as corporate profits as well as monetary conditions that are still relatively accommodating, despite the tightening of monetary policy. Market indicators such as long-term interest rates across the major economies or spreads of emerging market bonds over US treasuries are still close to all-time record lows. As a result, credit growth remained strong, notably in India where it reached almost 30 percent.

The buoyancy of economic activity at a global level was accompanied by a large expansion in world trade and in global flows of foreign direct investment. World merchandise exports increased by 15 percent in real terms, while commercial services grew by an estimated 15 percent. Commodity exporters – notably oil producers – were the main beneficiaries of the merchandise trade expansion. At a country level, however, the most spectacular gains were those boasted by China, whose merchandise exports grew by about 27 percent in 2006. This contributed to the increased share of world merchandise exports by developing countries, which reached the all time record of 36 percent in 2006. The increase in trade flows was paralleled by that of capital flows. With regard to foreign direct investment (FDI), UNCTAD estimates that it reached USD 1.2 trillion in 2006, its second highest level ever and a 34 percent gain over 2005. Developed economies displayed the largest gains, and the US economy was the largest single destination for FDI flows – USD 177.3billion. Among developing countries, oil producing countries – notably in Africa – have been a preferred target for direct investment. On the other end, low-income countries with scarce natural resources continue to receive little FDI.

The rapid expansion of world trade did not however lead to a significant reduction of the persisting imbalances in current accounts across the globe. This is particularly true for China, who now boasts a current account surplus of 9.1 percent of GDP, up from 7.2 percent in 2005. At the other end of the spectrum, the current account deficit of the United States inched up slightly to 6.6 percent of GDP, despite the growth slowdown of the north-American economy. On the other hand, the on-going depreciation of the US dollar – which lost 4 percent of its value in real effective terms, partly driven by expectations of narrowing interest rate differentials vis-à-vis the Euro area – has so far supported a smooth correction of the current account balance. In real effective terms the Euro gained 4 percent in 2006. Despite this the area's economy put forward a strong export performance – most notably Germany.

Chart 1: The world economy



Source: IMF World Economic Outlook, April 2007

One of the most marked trends among developing and emerging market economies over the last few years has been the large accumulation of foreign reserves held by central banks. In 2006 alone, the stock of reserves is estimated to have grown by more than USD 700 billion, 70 percent of which in dollar denominated assets. Reflecting its position as the "factory of the world" and its capacity to attract foreign capital, the Chinese stock of official foreign reserves surpassed the one trillion US dollar mark in 2006 – more than tripling in less than four years. Less flagged in the media, but no less remarkable, has been a similar progression of reserves in many other countries – notably those benefiting from commodity price developments and/or from an enhanced debt position resulting from debt relief initiatives. In sub-Saharan African countries, reserves more than doubled up over the last four years, reaching an estimated USD 47 billion. Similarly, reserves held by fuel exporting countries grew by 42 and 36 percent in 2005 and 2006, respectively, to reach USD 890 billion at the end of 2006.

As for the short- and medium-term prospects, professional forecasters broadly expect that in 2007 and 2008 the global economy will expand at a slower pace than in 2006. The focal point forecast – slightly less than 5 percent – is nonetheless clearly above the 3.6 percent average rate of the last twenty five years. China and India should remain the main drivers of global growth, although at a more moderate pace than in previous years. This partly reflects the expectation that the domestic policy stance in those two countries will tighten up in response to overheating economic conditions, but also to a softening of demand in the three largest economic areas in the world. In the United States, the economy should be growing below potential for at least most of 2007 as conditions in the housing market normalise, and some other sectors of the economy – notably the automobile industry – undergo some structural adjustments. Similarly, growth in the Euro area countries should be easing in 2007 and 2008 in line with the still on-going monetary policy tightening. Of the three areas, the Japanese economy is the only one in which growth is forecast to be similar to 2006. For emerging market and developing countries other than China and India the outlook is also broadly positive, with commodity exporters providing momentum once again, as they should benefit from strong demand and high relative prices – a development to which (Asian) emerging markets themselves contribute heavily.

A combination of political and economic factors suggests that the distribution of risks to this relatively benign economic outlook is broadly perceived to be skewed on the negative side. Geo-strategic risks stemming from

the Middle East region and concerns about terrorism continue to weigh on the stability of the global economy. This could feed through into economic developments via oil price responses and might rekindle inflationary pressures. In fact, even in the absence of major external shocks, oil markets remain under some stress due low spare capacity. Nevertheless, oil futures appear to discount heavily the possibility of the price of the oil barrel breaching the “one hundred dollars” psychological barrier in the near future.

Chart 2: Oil prices*

*Average spot price of Brent, Dubai and WTI crude blends in US dollars. Source: IMF

On the economic side, a number of professional forecasters attribute a non-negligible probability to the ongoing housing market correction in the United States being more pronounced than currently anticipated. This would correspond to a replication of the events that took place in the sub-prime sector of the market earlier this year in other market segments – i.e. sharp increases in delinquency and default rates. Presumably, this would have an economy-wide impact, leading to a recession in the United States and an overall weakening in economic growth at a global level – notably in China and other Asian economies which depend strongly on US demand for their exports. Another risk factor closely associated with the economy of the United States is its large current account deficit – or its mirror image, the large accumulation of reserves by its major creditors. As discussed above, the smooth depreciation of the US dollar in real effective terms has been providing support for a soft correction of those imbalances, notably by the acceleration in north-American exports. That said, most of the currency adjustment has so far taken place against European currencies whereas the currencies of some of the main beneficiaries of the recent economic developments have actually depreciated slightly in real effective terms – notably China’s and Middle Eastern oil producers’ – which tends to perpetuate the imbalances. In fact, the deficit of the US current account remains largely untouched. As mentioned in the recent IMF World Economic Outlook, the US economy has had no problems to attract capital inflows to finance the deficit. However, those flows have first progressively moved from equity to debt – lowering economic risk – but more recently from US Treasuries to corporates and other debt forms – increasing risk exposures.

Another set of risk factors stems directly from emerging market economies. Overheating in the Chinese and Indian economies is a commonly mentioned possibility, as recently recognized by one of three leading credit rating agencies which referred to the Indian economy as having “the classic signs of an overheating economy.” Among emerging market economies, another source of concern is the brisk expansion of private sector credit in the largest Latin American countries over the last few years. In 2006, credit expansion reached 32 percent – Venezuela set the record with a 68 percent growth – mostly driven by credit to households. On the other hand, while figures point towards increased vulnerabilities, financial sectors across the region seem to have enough margin to withstand possible forthcoming corrections.

A final set of risk factors is related to the large liquidity levels that have built up in financial sectors across the world in response to the accommodative monetary policies adopted since 2001.[1] Such liquidity levels have helped created a worldwide “search for yield,” and have thus contributed for well-performing asset markets, low long-term risk-free interest rates, and low credit spreads (both corporate and sovereign). However, they have also triggered some tensions in financial markets, the most evident of which were perhaps the already

[1] A simple indicator is provided by the fact that during the last five years money supply (as measured by narrow money, M1) has outgrown nominal GDP by 17.6, 32.0 and 42.6 percentage points in the United States, the Euro area and Japan, respectively.

mentioned housing prices bubbles registered in a number of developing countries. In addition, abundant liquidity has also nurtured heavy carry trade flows – defined as the practice of borrowing in currencies with low interest rates, such as the yen and the Swiss franc, to invest in those that pay higher rates, such as the Australian and New Zealand dollars – and the increased leverage buyout activity – in which loans are used in equity investments by hedge funds. While the remarkable expansion of derivative instruments over the last two decades provides some assurance that a significant share of those flows might not go unprotected, the sheer size of the transactions involved opens the door for some disruptions, should liquidity levels dry up quickly in response to a rapid switch in investors' sentiment. That said, it is worth stressing that global economic fundamentals appear quite robust, and thus potentially justifying the vitality exhibited by financial markets in the recent past.

3 The FEMIP countries

After several years of extremely good expansion, largely as a result of the exceptionally strong international oil markets, economic growth prospects for the region are robust. The region grew by an average of 5 percent in 2005 and 2006 and is expected to grow by 4.8 percent in 2007 (Table 1). Oil exporters will continue to benefit from record oil prices, but strong oil receipts will continue to tempt governments to raise public spending and investment. Private investment in the non-oil sector will also strengthen, as commercial banks continue to seek outlets for rising oil-induced liquidity levels.

The oil-related surge in liquidity over the past two years has underpinned rising price pressures across the region, although 2006 consumer price increases tended to be in one-digit levels, with the exception of Syria. Higher government spending has stimulated domestic consumption and reinforced domestic demand. The decline of the US dollar against the euro and the yen also contributed to the inflationary pressure, particularly among countries whose currencies are pegged to the dollar. In 2007, such pressures will be partially offset by an expected decline in non-commodity prices. On the other hand, extensive oil subsidies, including non-oil exporting countries, will help to contain inflationary pressures. Thus, average inflation in the region is expected to remain around 6 percent in 2007, as it was in 2006.

The external current account position in MPC countries is strong, especially for oil-exporting countries. However, continued strong increases in merchandise imports (as public spending and private consumption strengthens) will have a negative impact on the current account balance in 2007. The outlook for resource-poor countries in the region is less robust, but nonetheless comfortable, with some serious exceptions such as Jordan and Lebanon.

Table 1: Macroeconomic Indicators for FEMIP countries

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Maghreb [a]	5.1	4.1	4.4	4.4	2.9	1.5	3.0	4.1	7.1	11.9	14.4	8.6	1.8	4.7	5.8	3.8
Mashrek[b] & Turkey	7.6	6.4	5.4	5.1	7.8	7.8	8.4	8.6	-3.4	-4.7	-6.1	-5.7	-6.5	-4.8	-3.8	-5.1

a Algeria, Morocco, Tunisia

b Egypt, Jordan, Lebanon, Syria

Source: IMF

Fiscal balances across the region remained at a sustainable level, especially in the oil-exporting countries. Government revenues, which have reached unprecedented levels in 2006, are expected to decline only marginally in 2007 as oil prices are not expected to decrease. Despite expected strong spending, fiscal accounts of the region's oil producers are not going to experience a major downward pressure. The fiscal positions of the regional non-oil economies will be challenging, partly because of continued high recurrent expenditure.

A critical focus of MPCs' economic transition relates to creating a competitive pro-business environment, free of excessive regulation. In 2006, continued progress has been made by several of the economies to improve aspects of the business environment. Morocco was the top performer in the region on the ease of doing business. It cut the cost of starting a business, complying with tax regulations and doing property transfers, eased tax burdens, increased access to credit, and reduced the cost of exporting and importing, which supported job creation – an urgent challenge across the whole region. Egypt continued its reforms, but at a slower pace. The main reforms were improvements to new company start-up and tax administration. In 2006, MPC countries, with the exception of Lebanon and West Bank and Gaza, each implemented at least one

reform. Besides Morocco, there were other notable reformers in the region. Israel permitted a private credit bureau to start operations and now it is among the top 10 in credit information coverage globally, easing access to credit. Algeria instructed banks and financial institutions to report unpaid credits and loans to the public credit registry, increasing available information about potential borrowers. Syria modernized its trade administration and decreased the cost to register a new company by 40 percent. Tunisia increased investor protection by opening the books of companies to shareholders, strengthening auditor responsibility, and prohibiting company loans to company insiders.

Despite the progress made by MPC economies, there remain large impediments to conducting business in the region, evidenced mainly in high licensing requirements and inefficient courts. Thus, further improvement of MPCs' policies and practices regulating business will have an impact on the development of a productive, competitive private sector that can drive economic development and job growth.

Longer-term growth prospects throughout the region depend upon the implementation of broad-based structural reforms. Much of the region's recent progress has occurred in the area of trade policy, especially in connection with a recent proliferation of bilateral and regional trade agreements. Since 2000, the MPC region has made significant progress in reducing obstacles to trade. In all MPCs, tariffs have been reduced and non-tariff barriers dismantled with the region's largest trading partner, the European Union, as part of the EU Association Agreements. Turkey officially started membership negotiations with the EU in October 2005. Other bilateral and regional agreements – including free trade agreements with the United States in Jordan and Morocco as well as the Agadir Agreement between Egypt, Jordan, Morocco, and Tunisia – have also helped the process of trade liberalization in the MPC region. However, over the short- and medium-term these agreements should have only limited impact on existing trade channels. Furthermore, although the region has made a strong progress with tariff reform over the past five years, trade liberalization remains far from complete. The region continues to be one of the most trade-restrictive in the world, ranking in the bottom 45th percentile of countries worldwide with regards to trade regime openness, higher than only Sub-Saharan Africa and South Asia.

Despite favourable recent macroeconomic developments in FEMIP countries, key challenges facing the region are high unemployment and low productivity. The job creation challenge rests in the ability to conduct far reaching structural reforms to improve the investment climate and integrate into global trade. In practice, countries that have created more open, investment-friendly markets, while relaxing constraints that increase the cost of doing business, have been able to stimulate domestic investment and attract significant flows of foreign direct investments along with their integration into broader economic areas. In order to enhance the investment climate, MPC governments aim to strengthen countries' capacity for designing, implementing and monitoring investment policy reforms and improve intra-governmental policy coordination and cooperation

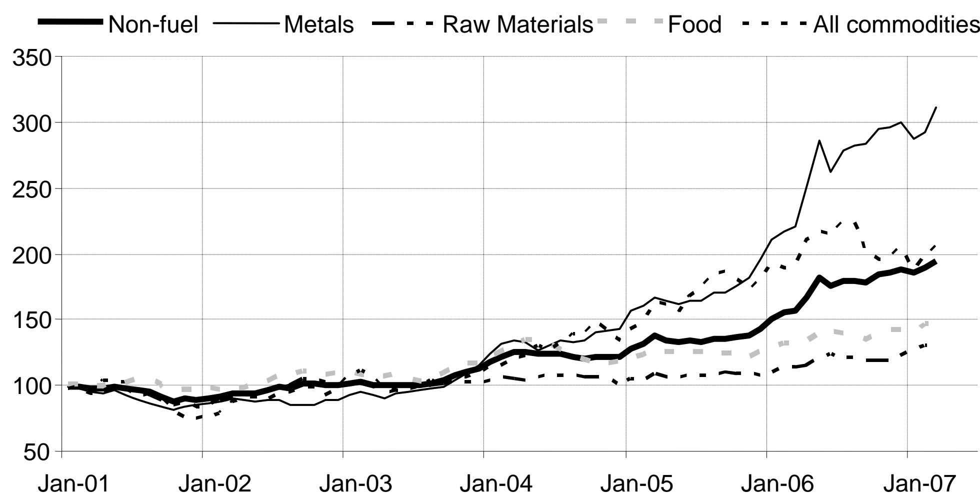
4 Sub-Saharan Africa

In 2006, the economic news coming from the sub-Saharan Africa sub-continent was mostly positive. While only slightly above the world's average – and not nearly as spectacular as the pace of growth in other developing countries – the 5.7 percent growth performance seems nonetheless to shore up the trend initiated in the last few years. The last three years are the only ones on record since 1980 in which income per capita grew by more than 3 percent. Growth was particularly strong in oil-producing countries – notably Angola, which at 15.3 percent recorded the highest growth rate among all Partner Countries in 2006 – but non-oil producing countries also put forward some good performances due to the favourable non-oil commodity price developments, a much improved external debt situation, and a supportive weak US dollar. While inflation remains high compared with other regions, it appears to be decelerating somewhat (Table 2).

The overall pick-up in oil and other commodity prices in the context of the sustained growth of the world economy have had a positive impact on resource-rich sub-Saharan African countries, notably through an improvement to their terms of trade. On the other hand, the excellent overall performance of oil exporters is mostly due to Angola and Nigeria, the two largest economies of the group. With the exception of Cameroon, all other oil exporters – Chad, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, and Gabon – actually registered a decline in their income per capita in 2006, a fact that can be partially explained by the capacity constraints that hit oil production in most of these countries. In Chad and Côte d'Ivoire the poor economic performance is also closely linked to political strife. All this partly explain why GDP growth among all oil exporters in 2006 – Cameroon excluded – stood below that of 2005. This development has however reinforced the investment push of the last few years, an effort that is broadly replicated in most countries across the region and ended being one of the growth drivers in 2006. This investment surge is broadly expected to be providing a boost to productivity levels and is also expected to contribute to some strengthening of GDP growth over the medium-term.

Macroeconomic conditions improved broadly across oil exporters. Inflation has remained relatively restrained and even the 13.3 percent annual price increase registered in Angola needs to be placed against the background of a rapid process of disinflation that has been taking place in the country since the end of civil war in 2002. Furthermore, despite increased government spending on the account of oil revenues, domestic savings have grown rapidly and oil exporters have currently a savings to GDP ratio of about 40 percent. In the same vein, reserve levels have been growing steadily, reaching 7.6 months of import coverage in 2006.

Chart 3: Non-fuel commodity price indices



Source: IMF

Among oil net importers, economic performance benefited from strong economic growth at a global level, particularly during the second half of 2006 when oil import bills receded in line with oil prices. Economic growth was only marginally below the level reached by oil exporters, with noteworthy performances by Ethiopia – driven mainly by strong coffee prices and strong agricultural growth along with expansion in industry and services, in the context of ongoing policy reforms – and Malawi, which reached HIPC's completion point in August and is also benefiting from further debt relief in the context of the Multilateral Debt Relief Initiative (MDRI). Strong demand for some non-fuel commodities – notably minerals – have led to increases in world prices (Chart 3) and sustained activity in countries such as Mozambique, Namibia, South Africa and Zambia. For exporters of agricultural exports strong demand – and good overall harvests – compensated for mostly flat or falling prices.

External and fiscal balances throughout the region are in relatively good shape (Table 2). Again, this is mostly due to the impact of oil and other commodities, but most countries have adopted prudent macroeconomic frameworks in recent years, partly to satisfy the prerequisites of HIPC. More broadly, HIPC and MDRI have contributed to significantly reduce the region's debt overhang, leading to an overall amelioration in financial conditions. This is reflected in the progressive improvement of sovereign ratings and concomitantly in the reduction of the risk perceived by investors to the region. Accordingly, foreign investment inflows to the region have progressed quite rapidly.

As analysed further in the second section of this Annual Report, the last few years have witnessed the increasing importance of Asia – notably China – as a strategic partner for the region. Symptomatic of this development are China's current trade links with the region. In 2005 it absorbed USD 19 billion worth of sub-Saharan Africa exports and originated USD 13 billion of the region's imports – IMF (2007). While these figures are relatively small – China accounted for about 12.8 percent of the region's exports – as the European Union and the United States remain sub-Saharan Africa's main trading partners, they represent a rapid acceleration from an almost non-existing position less then 20 years ago. Between 2000 and 2005 sub-Saharan Africa exports to China grew at 30 percent per year. Currently, China positions itself as a large buyer of fuel and raw materials from sub-Saharan countries, accounting for 16.3 and 25.5 percent of the region's total exports in those two categories.

Table 2: Macroeconomic Indicators for ACP countries

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Sub-Saharan Africa [i]	6.0	6.0	5.7	6.8	9.5	10.5	11.5	12.7	-0.5	0.7	3.2	-0.2	-2.1	-1.1	-1.3	-2.2
Oil producing countries [a]	8.2	8.0	7.2	11.2	11.6	12.2	7.5	7.2	3.7	5.6	8.0	2.3	1.0	4.7	6.0	3.5
East Africa [b]	7.3	8.0	9.0	7.9	8.2	7.9	9.4	9.6	-1.3	-2.7	-3.7	-4.2	-3.8	-6.5	-9.6	-8.8
Central Africa [c]	11.6	5.1	3.5	4.8	2.5	9.3	7.6	7.5	1.9	7.0	17.9	7.3	-3.5	-0.1	2.3	0.0
West Africa [d]	4.7	5.8	4.9	6.3	9.7	13.6	7.9	7.6	2.6	3.6	8.8	1.8	0.6	2.8	5.3	3.7
Southern Africa [e]	4.9	5.6	5.4	6.9	11.4	10.2	15.0	17.8	-1.8	0.0	1.7	-0.5	-2.6	-1.9	-3.1	-3.7

[a] Angola, Cameroon, Chad, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, Mauritania, Nigeria, Sudan.
[b] Djibouti, Eritrea, Ethiopia, Kenya, Sudan, Tanzania, Uganda
[c] Burundi, Cameroon, Central African Republic, Chad, Republic of Congo, Democratic Republic of Congo, Equatorial Guinea, Gabon, Rwanda, São Tomé & Príncipe.
[d] Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo.
[e] Angola, Botswana, Comoros, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Seychelles, Swaziland, Zambia.
i = b +c + d + e

Source: IMF

While the last few years have brought economic growth back to the region, the progress registered so far is limited and the challenges ahead remain enormous. Poverty remains widespread and in fact only a small minority of countries appears to be on track to meet the Millennium Development Goals. Although the number of open military conflicts appears to be waning and political stability on the rise, the region still occupies the majority of top positions in indicators such as the 2006 Failed States Index published by the Washington-based Fund for Peace – 6 of the top ten countries in the index are in sub-Saharan Africa (Sudan, Democratic Republic of Congo, Côte d'Ivoire, Zimbabwe, Chad and Somalia, in decreasing order of violent internal conflicts). Furthermore, even some of the more stable countries face significant institutional challenges and governance problems – as highlighted by the World Bank's governance indicators. In this context, it is not surprising that the reforms taken to address economic and social bottlenecks remain tentative, leading to difficult investment climates. One commonly cited measure that attempts to characterize the prevailing business environments is the set of Doing Business Indicators compiled by the World Bank. The overwhelming majority of countries in the region continues to rank at the bottom of the 175 world economies currently surveyed and 9 out of the 10 worse business environments in the world are in sub-Saharan Africa. This notwithstanding, there are some promising signs – the 2007 edition of the report highlights the wave of reforms that is taking root in the region, and places Ghana and Tanzania among the top ten reformers.

The short to medium term outlook remains constrained by this difficult environment. On the other hand, with most projections pointing for sustained growth at a global level, the region should benefit once again from favourable commodity prices, further supported by a relatively weak US dollar. The lack of economic diversification, however, exposes sub-Saharan countries to the vagaries of oil prices as well as those of other commodities.

5 Caribbean economies

In 2006, regional growth was supported by the strong performance of construction and tourism and reached the regional average of 8.3 percent (Table 3). In Trinidad and Tobago, the fastest growing economy in the region, activity expanded at 12 percent in 2006, benefiting from high energy prices, increased capacity in the gas processing industry, and a construction boom led by public expenditure. Growth was also strong in the Dominican Republic at almost 11 percent, driven by strong consumption and investment. In addition, the Cricket World Cup (CWC) has boosted private and public construction, aided by tax concessions, external grants and public borrowing.

In terms of the fiscal environment, high recurrent expenditures on disaster relief, support for infrastructure development, as well as the accelerated preparations for the CWC have increased pressure on many of the regional countries' government balances. In an effort to counter this, the authorities have implemented

reforms to improve the efficiency and effectiveness of public finance management. However, these efforts as well as the rise in government revenue collections have not significantly decreased overall public indebtedness, which continues to be relatively high, with public debt levels reaching over 90 percent in 2006. External account positions of many of the countries have recently suffered from the high oil prices (although natural gas and oil-producers, such as Trinidad and Tobago, have benefited from the recent highs) and waning in some of the traditional export industries. Due to strong performance of Trinidad and Tobago, last year's regional current account surplus of 2.7 percent of GDP was the highest in several decades.

Table 3: Macroeconomic Indicators for Caribbean economies

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Caribbean[1]	3.5	6.4	8.3	5.5	21.3	6.9	7.7	5.9	1.7	0.4	2.7	2.2	-3.4	-1.6	-2.2	-1.9

[1] Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Lucia, Suriname, Trinidad and Tobago.
Source: IMF

The recently initiated Caribbean Community Single Market and Economy (CSME) agreement is not only perceived as key to the development of the region, but also as an effective way to strengthen the region's bargaining position in trade negotiations with the EU and give the states a stronger voice in the Free Trade Area of the Americas (FTAA) negotiations.[2] Inaugurated on 1 January 2006, the single market component of the CSME has been adopted by 12 states (Jamaica, Barbados, Belize, Guyana, Suriname, Trinidad and Tobago, Antigua and Barbuda, Dominica, Grenada, St. Lucia, St. Kitts and Nevis, and St. Vincent and the Grenadines). The establishment of the single economy component of CSME is scheduled for the end of 2008. The common market would currently encompass a population of about 6 million persons and have a combined GDP of approximately USD 40 billion (for comparison, the FTAA currently under negotiations is expected to have a combined population of 800 million and an estimated GDP of USD 11 Trillion).

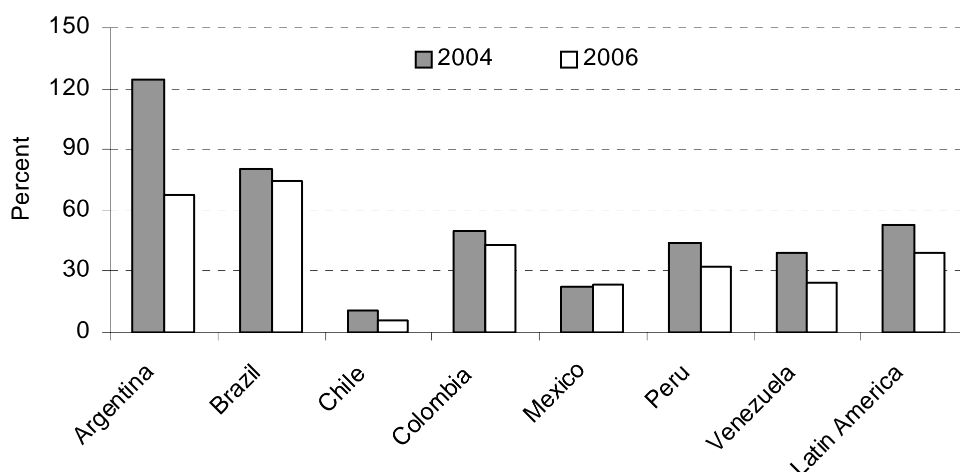
Prospects for the Caribbean in 2007 are fairly positive, although the overall regional growth is expected to slow down to 5.5 percent in 2007, reflecting the slowdown in the US economy and some declines in commodity prices. Most countries enjoy macroeconomic and political stability. The recent efforts to improve the legislative and regulatory environment to reduce money laundering and related criminal activity have bolstered the region's external attractiveness. In spite of CSME relatively small size and other predominant commercial ties of its members, the effort is likely to have a positive if limited impact on growth. Continued structural reforms aimed primarily at diversification, as well as strengthening efficiencies, and improving socio-economic conditions remain necessary.

6 Latin America

Supported by sustained growth of the global economy, strengthening domestic demand, and further increases in commodity prices, Latin America experienced a robust growth of 5.2 percent in 2006 (Table 4). Growth was mainly driven by favourable developments in Argentina, Mexico and Brazil and strengthening of domestic demand has increasingly served as a principal source of growth. Strong economic performance and still ample global liquidity made the region's stock and bond instruments attractive investment options based on risk-adjusted returns. Stock market returns in dollar terms in 2006 ranged from 11.1 percent in Argentina to 94.1 percent in Peru.

[2] An initiative of the Caribbean Community and Common Market (CARICOM) organization, the CSME is made up of two components, of which the single market component allows goods, services and skilled workers to move more easily throughout the region, while the planned single economy component provides for common currency, single stock market, and removal of other restrictions so as to create a single economic space and unify the countries' economic and trade policies.

Chart 4: Public debt to GDP ratios in Latin America



Source: IMF, World Bank

Reflecting the sharp strengthening of the terms of trade – due to higher prices of the region's key commodity exports, including cocoa, coffee, copper, crude oil, silver, soybeans, sugar, and wheat-, the region registered a current account surplus of 1.6 percent of GDP in 2006. Along with strong private capital inflows, the region's international reserves increased to a USD 47.7 billion. Although imports have increase as a result of faster growth of domestic demand, international reserves at the end of 2006 covered 4.8 months of imports. Rapid growth and favourable external conditions helped a number of countries to strengthen their fiscal position and reduce public sector debt to more manageable levels. The region's public debt averaged 39 percent of its GDP in 2006 compared with 53.2 percent of GDP in 2004 (Chart 4). The public debt in Argentina and Brazil remains significant, amounting to 68 and 75 percent of GDP, respectively.

Table 4: Macroeconomic Indicators for Latin America

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Latin America[i]	6.1	4.3	5.2	4.6	6.2	6.2	5.1	5.5	1.0	1.4	1.6	0.4	-1.7	-1.4	-1.6	-1.8
Central America[k]	4.0	4.4	5.8	5.1	7.0	8.1	6.6	5.6	-5.5	-4.8	-4.8	-5.0	-2.9	-2.4	-1.2	-2.0
Andean[l]	9.1	7.0	7.2	5.6	8.5	6.9	6.5	9.0	3.9	5.2	5.7	2.5	0.8	1.9	1.4	-1.2
Argentina	9.0	9.2	8.5	7.5	4.4	9.6	10.9	10.3	2.1	1.9	2.4	1.2	-3.3	-2.4	-2.1	-2.5
Brazil	5.7	2.9	3.7	4.4	6.6	6.9	4.2	3.5	1.8	1.6	1.3	0.8	-2.4	-3.0	-3.0	-2.0
Mexico	4.2	2.8	4.8	3.4	4.7	4.0	3.6	3.9	-1.0	-0.6	-0.2	-1.0	-1.9	-1.5	-1.9	-1.9

[i] Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela
[k] Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama
[l] Chile, Colombia, Ecuador, Peru, Venezuela
Source: IMF

Fiscal discipline and strengthening of domestic currencies helped central banks in most countries in the region to lower inflation by relying on inflation targeting. Annual inflation averaged 5.1 percent in 2006 and only Argentina experienced double-digit inflation, due to rising domestic demand.

The outcomes of seven presidential elections in 2006 have not lead to any major changes in macroeconomic policy for the region as a whole as political leaders recognize that growth and social improvements depend on macroeconomic stability and access to domestic and external capital. However, by electing left-centre candidates, Ecuador and Nicaragua have joined Argentina, Venezuela and Bolivia in favouring an increased role of the state in the economy. Brazil, on the other hand, despite some presidential ambivalence on politically sensitive issues, has generally pursued market-oriented policies. The region should not miss the opportunity provided by favourable global conditions to advance reforms needed for a sustainable long-term growth. Little progress has been done so far in strengthening institutions and improving property rights,

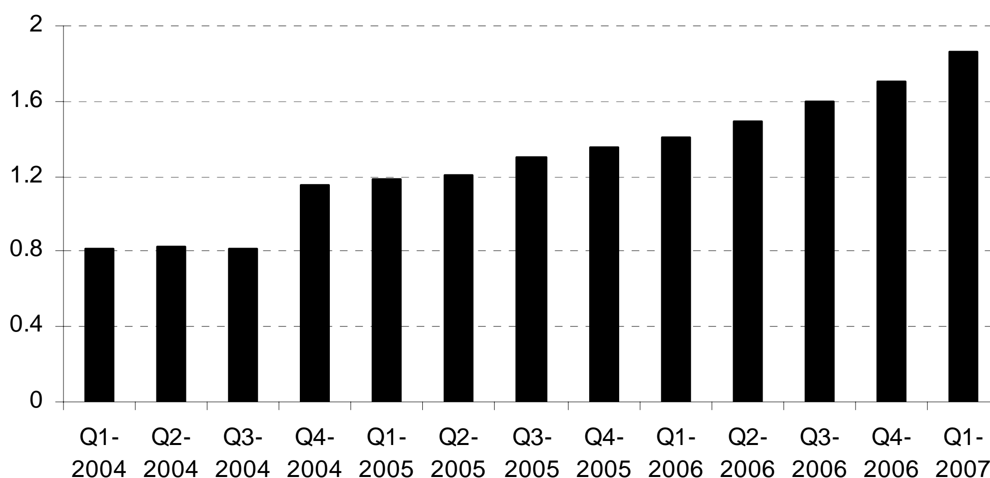
through the introduction of governance reforms. The region's macroeconomic prospects for 2007 are not as favourable as last year, reflecting external developments and a loss of momentum (in Argentina), or even reversal (Venezuela), in some countries. Growth in Latin America is projected to moderate to 4.6 percent as US growth declines and world commodity prices are on a decreasing trend.

7 Asia

Vibrant export growth and a surge in private capital inflows have sustained growth and bolstered the balance of payments in Asia. Another year of strong growth was recorded in 2006, peaking at 8.5 percent, led by Chinese 10.7 percent and Indian 9.2 percent growth rates (Table 5). China's rapid growth continues to be investment led, while in India domestic demand contributed to economic growth. Strong growth, financial liberalization and favourable prospects in the leading emerging markets in Asia attracted USD 225 billion in net private capital inflows in 2006, four times the level in 2002.

Strong export growth and increases in private capital flows boosted official foreign exchange reserves of the leading emerging markets in Asia to USD 1.9 trillion in March 2007 (Chart 5). Although China dominates with USD 1.2 trillion of reserves, other countries also achieved record holdings. Very fast export growth rates (27 percent in China in 2006) and thus current account surpluses of 5.3 percent of GDP in 2006 for the region (9.1 percent of GDP in China) as well as the fact that emerging markets in Asia have increasingly attracted global financial flows are at the root of this build-up of foreign reserves. Moreover, favourable fundamentals, rising incomes of residents and strong foreign investments had a positive impact on the stock markets across Asia in 2006. The Morgan Stanley Capital International Index (MSCI) for Emerging Markets in Asia reached a record level in April 2007, 17 percent higher than a year earlier, and exceeded the 14 percent gain for the MSCI G-7 countries. On the other hand, Asian stock markets experienced two short periods of instability that hit global equity markets in mid-2006 and early 2007.

Chart 5: Official Foreign Exchange reserves in Developing Asia*



* in USD trillions
Source: IMF

Ongoing appreciation pressures have led central banks across the region to try to limit competitiveness losses while controlling the impact of large and rising balance of payments surpluses on domestic liquidity. China has limited the appreciation of the exchange rate since it dropped the peg against the dollar and adopted a managed floating regime. It has been suggested that a 10 percent appreciation of the renminbi could lead to the loss of 3.5 million jobs in China, which would further depress a labour market with significant excess supply. The central bank of Malaysia followed the Chinese example and allowed the national currency to appreciate. The central bank of Thailand enacted a series of measures designed to curb private capital flows after official concern about the steady appreciation in the exchange rate towards the end of 2006. A strengthening exchange rate is a relatively new phenomenon in the Philippines. Fiscal correction and a large current account surplus helped restore investor confidence. Moreover, stronger exchange rate serves as a tool to combat inflation.

Table 5: Macroeconomic Indicators for Developing Asia

	Real GDP growth (%)				Inflation (%)				Current Account Balance (% of GDP)				Fiscal Balance (% of GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
Asia [m]	8.0	8.2	8.5	8.0	3.9	3.4	3.6	3.4	3.4	4.4	5.3	5.6	-1.7	-1.5	-1.0	-1.2
Asean4 [n]	5.9	5.2	5.4	5.5	4.3	7.1	8.3	4.4	3.3	2.1	4.8	4.2	-1.5	-0.6	-0.3	-0.7
NIA [o]	5.9	4.8	5.4	4.6	2.4	2.2	1.7	2.1	6.6	5.6	5.6	5.3	1.2	1.7	1.9	1.6
China	10.1	10.4	10.7	10.0	3.9	1.8	1.5	2.2	3.6	7.2	9.1	10.0	-1.5	-1.3	-0.7	-1.0
India	7.8	9.2	9.2	8.4	3.8	4.2	6.1	6.2	0.1	-0.9	-2.2	-2.4	-7.7	-7.3	-6.4	-5.8

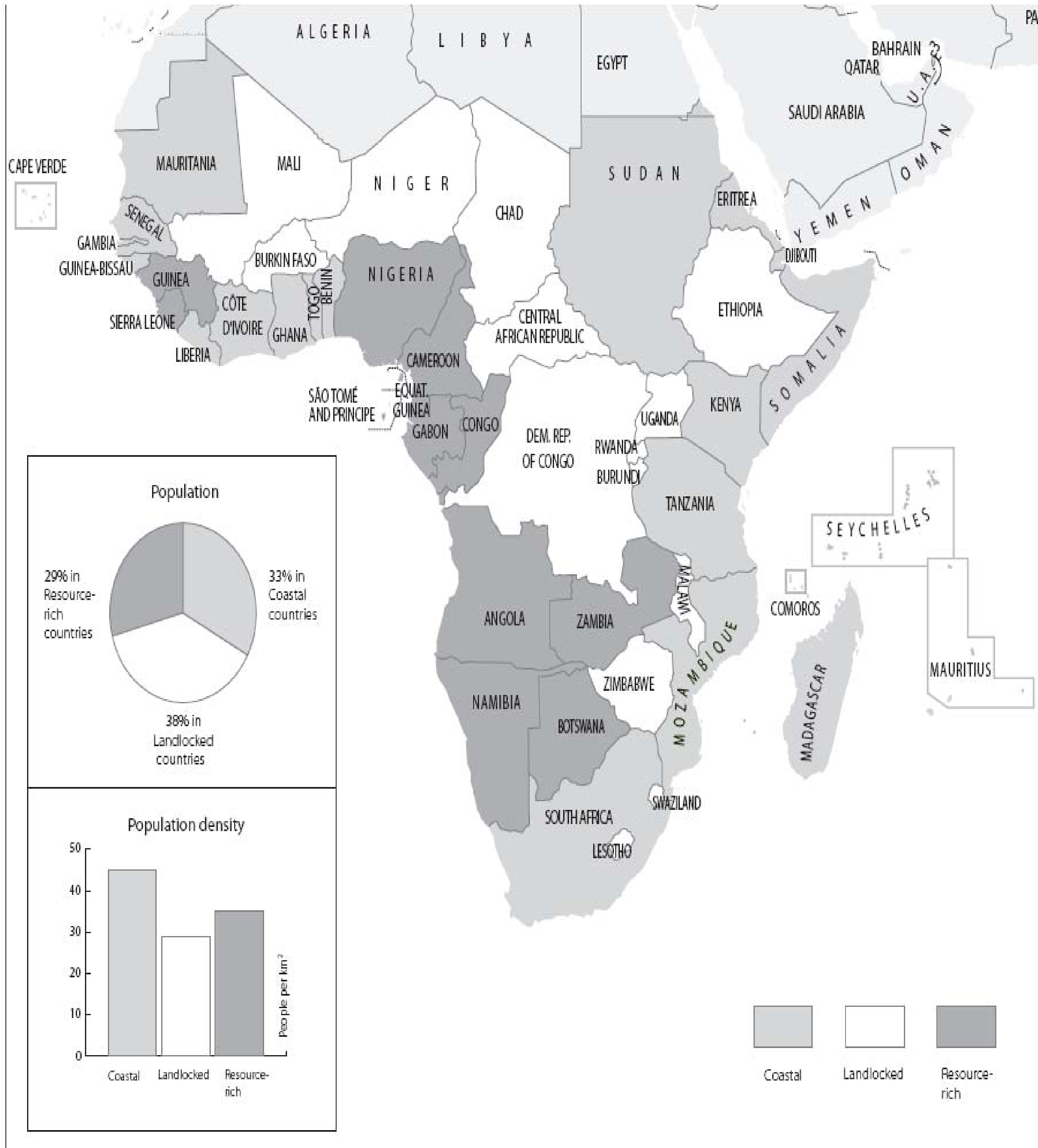
[m] Bangladesh, Brunei Darussalam, China, India, Indonesia, Korea, Lao People's Dem.Rep, Malaysia, Mongolia, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Thailand, Vietnam, Yemen
[n] Indonesia, Malaysia, Philippines, Thailand
[o] Newly Industrialised Asia: Hong Kong, Korea, Singapore, Taiwan
Source: IMF

Robust growth and official concern about inflationary pressures prompted the central banks of India and China to further tighten monetary policy in 2007. On the other hand, falling inflation, moderate growth, and a strong external position in Indonesia led to a continued easing of monetary policy since May 2006. Although the central bank of Thailand ended its tightening cycle in June 2006, it relaxed monetary policy only in the beginning of 2007 to allow for demand adjustment.

Growth in 2007 is forecast to moderate to 2004-05 levels. This is due to a successful tightening of policies in China and India, a firming of domestic demand elsewhere in emerging Asia and a modest reduction in foreign demand. The forecast is based on slower growth in the US, offset partly by a steady growth in Europe and a continuation of recent momentum in Japan. Sustaining economic growth requires governments to advance reforms and make their economies more responsive and flexible to changing conditions. Accelerating financial reform and liberalization needed to develop lagging domestic capital markets should be one a key objective.

PART II

The Human Geography of Sub-Saharan Africa



1 Introduction

During the 1990s sub-Saharan Africa experienced its second consecutive decade of stagnation. For the majority of countries, per capita incomes declined and poverty increased. For some, economic output declined in absolute terms, and no country in Africa achieved a sufficient take-off in growth to provide a significant stimulus to the development of its neighbours. The duration of the decline was unexpectedly long, and took place in spite of unprecedented debt relief, continued high flows of aid, and relatively favourable developments in the external trade environment. Although some countries have achieved growth over the last few years, for many others the decline continues.

The poor growth performance led many to question the modalities of aid and indeed whether aid has had any beneficial impact. The issues have been widely debated, and a large number of studies have addressed the key questions relating to aid, reform and growth – Why did sub-Saharan Africa fall behind? Was there a problem with aid? What are the options to improve aid delivery and support economic development in the future? This policy debate has taken place against a backdrop of new empirical research which has sought to explain Africa's record of growth on the basis of the human geography, the impact of aid, the interactions between poverty, inequality and growth, and the role of institutions.

In particular, the "Washington Consensus" that dominated the agenda of the Bretton Woods institutions for two decades has come under increasing criticism for its "laundry-list" approach, comprising of a comprehensive package of reforms, which resulted in a lack of focus and a failure to target aid according to the specific needs of the recipients. In this section, aid is critically examined within the framework known as "growth diagnostics" that focuses on the key constraints to growth. In practice, there is no substitute for detailed case-by-case analysis. However the geographical distinctions between countries and the broad macroeconomic data give a first indication of the constraints. The section is structured as follows. Africa's long term growth performance is described under heading 2 and some of the recent empirical studies are summarized. Heading 3 covers the constraints on growth focusing on geographical and institutional factors. The debate on aid policy in Africa over the 1990s is reviewed under heading 4, and 5 discusses the policy options going forward. The implications for EIB are covered under heading 6, and 7 summarizes the main conclusions.

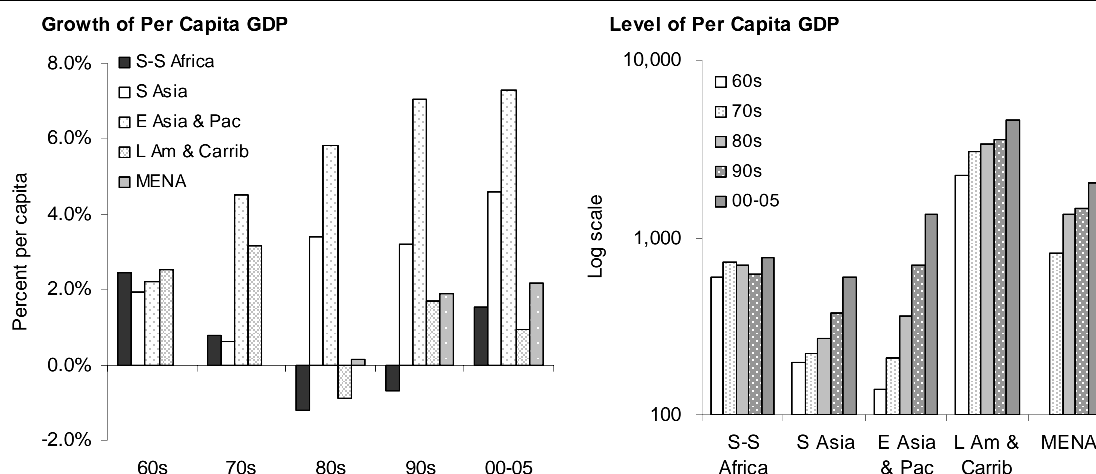
2 Africa has fallen behind

The decline in per capita GDP during the 1980s and 1990s was longer and deeper in sub-Saharan Africa than anywhere else in the world. On the basis of the 10-year aggregates, Latin America is the only other region to have experience a comparable decline (see Chart 6). However, for Africa the decline lasted longer and led to a widening income gap with other developing countries, particularly the rapidly growing Asian economies. The recovery in Africa over the last few years has been driven in part by a favourable external environment with high commodity prices and trade growth. These developments represent an opportunity for some countries, but in absolute terms the gap remains wide. Whereas per capita GDP since the 1960s has increased by factors of three times in South Asia and nine times in East Asia and the Pacific, in Africa it has changed very little. In the league table of per capita growth from 1960 to 2001 Africa has 15 out of the 20 worst performers, and only two out of the 20 best performers.[3]

The period of declining per capita GDP in Africa was associated with increasing poverty. While globally the proportion of people living on less than one dollar per day declined over the 1990s from 28 percent to 21 percent, in sub-Saharan Africa it increased to 45 percent. This increase is a cause for concern not only because of its direct implications for human welfare, but also because poverty and inequality inhibit economic growth. Inequality may increase savings (the rich have a lower propensity to spend), but it leads to resentment and social pressures that create obstacles for reform. It leads to sub-optimal investment by the poor, and tends to encourage the maintenance of poor policies and the protection of rents. Aid agencies and governments have therefore embraced the concept of *pro-poor growth*, acknowledging that sustained economic growth is a necessary condition for poverty reduction.

[3] World Bank, "World Development Indicators" 2005.

Chart 6: Regional per capita GDP growth



Source: World Bank (GDP constant 2000 USD)

Empirical models of economic growth have had mixed success in explaining the poor performance of sub-Saharan Africa. Models that use inputs of capital and labour as determinants of aggregate production show strong correlations between growth and capital accumulation and succeed in explaining approximately half of GDP growth.[4] However, the other half of GDP growth remains unexplained and is attributed to growth of total factor productivity.[5] The models show that the growth of total factor productivity is nearly always lower than in the OECD, and in many instances it is negative.[6] This is in spite of the large potential for catch-up in view of the low absolute levels of productivity in African countries. In many instances total factor productivity has declined as capital has increased. This raises doubts about the efficiency of the investments. Regression models have sought a more detailed explanation of economic growth by including aid, geography and institutions as explanatory variables, and these are discussed further below.

3 Geography and Human Geography

In comparison with other regions, sub-Saharan Africa has a relatively sparse population with an abundance of natural resources. Populations are extremely diverse in ethnic and linguistic terms. Although the region is divided into many countries with relatively small populations, the human geography is such that these populations are themselves made up of many ethnic and linguistic groups. Given the land mass and the number of countries, many are inevitably landlocked. In addition, the small population sizes constrain the development and maintenance of institutions. Small countries typically do not have specialized financial media, or other information channels that would help to provide checks and balances on government, which are important in view of ethnic diversity. Nor are they able to maintain standing armies that provide internal security.

Given the diversity within the region it is useful to consider the countries in categories according to their endowment of natural resources and their access to the coast (see map).[7] This logically gives rise to four categories, coastal resource rich, landlocked resource rich, coastal resource poor, and landlocked resource poor. However, for the resource-rich countries (defined as those countries where primary commodity rents account for more than 10 percent of GDP) access to markets is seldom an important issue. Transportation of commodities is an intrinsic part of resource development, and therefore access to the coast is not a major concern and in the following discussion the resource rich countries are considered as one group.

Landlocked countries lacking in natural resources account for approximately one third of the population of sub-Saharan Africa. In other regions of the world these isolated areas tend to be the hinterlands of larger countries, but in Africa they are independent states. These countries have high transportation costs and poor access to markets which constrain their ability to trade. The problems arising from this economic isolation do

[4] Easterly and Levine 2003, “Tropics Germs and Crops”, Journal of Monetary Economics 50 (1), 3-39.
[5] In a regression model where GDP is a function of capital and labour inputs, total factor productivity is defined as the residual, i.e. the movement in GDP that is not explained by changes in inputs of capital and labour. This is the most commonly used proxy for productivity growth of the economy.
[6] Bosworth and Collins 1996, “Economic growth, Accumulation vs. Assimilation”, Brookings Papers, 2.
[7] Collier 2006, “Africa: Geography and Growth”, Centre for the Study of African Economics, Oxford.

not apply only to landlocked countries, but also affect the inland regions of coastal economies which have inadequate transport systems.

Resource-rich countries face a specific set of problems. The abundance of natural resources has not enabled them to overcome the obstacles to growth. On the contrary, natural resources have turned out to be more a curse than a blessing everywhere in Africa except for Botswana.[8] With few exceptions, the accumulation of evidence worldwide since the 1960s shows that countries with natural resources grow more slowly than those without.[9] Moreover, they also have more unequal income distributions, a larger share of their population in poverty, more corruption, more authoritarian regimes, spend more on the military and face a greater risk of armed conflict. This is not simply a result of the volatility of natural resource booms, or the Dutch disease – the tendency for exchange rate appreciation to redirect resources into less dynamic sectors producing non-traded goods. More important is the damage that natural resource exploitation causes to economic institutions. The size and concentration of economic rents diverts attention from entrepreneurial and productive activities into rent-seeking behaviour. This leads to waste and distortion of investment decisions.

Coastal countries lacking natural resources have been the most successful group in Asia and Latin America. The success of coastal countries in Asia was due to the international relocation of manufacturing industries during the 1980s, such as textiles, seeking low wage costs. Once these industries were established in a given location there was a process of agglomeration in which the availability of labour, the export infrastructure, and the business environment acted as a magnet for related industries and firms. However, with the exception of Mauritius, this process never took off in Africa.

The economic growth of these three groups of countries is shown in Chart 7. The landlocked countries had the worst overall economic performance of the three groups. GDP per capita declined in every period except the 1960s and the level of per capita income in 2005 was some 35 percent lower than it was in 1960. Coastal countries on average have the highest level of per capita income, but are the most dependent on trade and experienced a rapid decline in the 1980s. The resource-rich countries grew the fastest and the level of per capita income in 2005 was 48 percent above the 1960 level. They benefited from the rise in oil and commodity prices in the 1970s, and again post 2000. However, by 2005 the resource-rich countries have only reached a level of per capita GDP which is less than half that of the coastal economies.

This difference in performance of resource-rich, landlocked and coastal economies plays an important part in explaining Africa's poor growth performance relative to other regions. In Africa, the population is evenly distributed between the three categories whereas in the rest of the developing world 1 percent of population live in landlocked countries, 88 percent in coastal and 11 percent in resource–rich countries. Landlocked and resource-rich countries in Africa performed on average no worse than the corresponding groups in Asia.[10] However, they weighed more heavily on Africa simply because they account for a disproportionate share of the population.

In addition to the impact of human geography, Africa has also had a relatively high frequency of episodes of dysfunctional government, such as the loss of control over internal security leading to violent conflict. The combined impact of human geography and episodes of dysfunctional government explain most of the differences in growth between Africa and other regions from 1960 to 1990. However, it does not explain the relatively poor performance of sub-Saharan Africa since 1990. This suggests that a new factor has emerged post 1990 that has put Africa's coastal resource-scarce economies at a disadvantage. One possible explanation is the increasing competition in export markets from the successful Asian economies. However, growth in Asia has also increased the demand for natural resources and made available new sources of investment flows to Africa (see text box).

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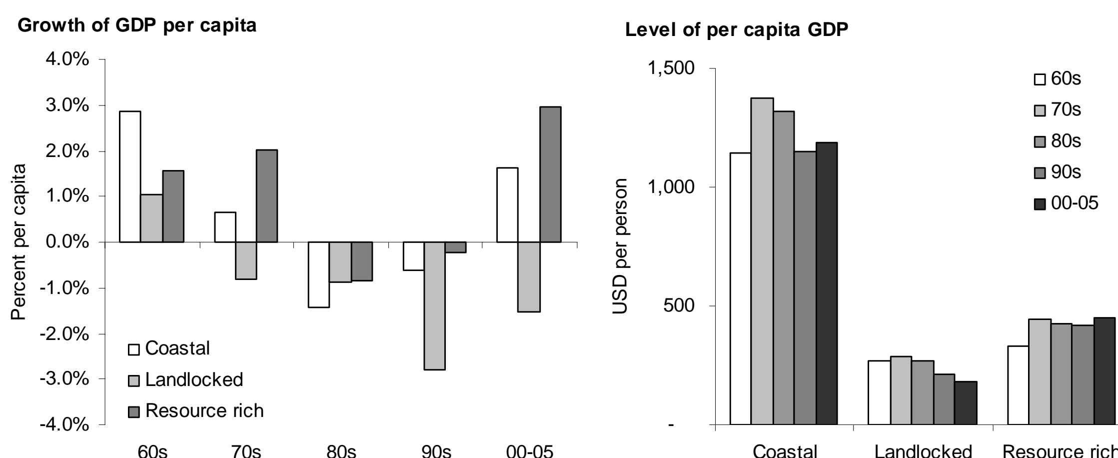
[8] Botswana was not considered to be a resource-rich country during the colonial era. Its pastoral traditions remained intact. These included broad-based political participation by chiefs and cattle-owners. These traditions provided checks and balance on politicians and provided a sound basis for the management of diamond rents.
[9] World Bank 2005, "Economic Growth in the 1990s, Natural Resources – When Blessings become Curses".
[10] Collier 2004, "Growth in Africa: Opportunities, Syndromes and Episodes", African Policy Institutes Forum.

Chart 7: Growth in coastal, landlocked and resource-rich countries



Source: World Bank, World Development Indicators (GDP constant 2000 USD)

Box: China's Role in Africa

In January 2006 the Chinese government issued "China's Africa Policy" with the objective to promote the steady growth of Chinese-African relations. This box summarizes the recent developments in Chinese-African trade and capital flows and highlights the key issues from the policy debate.

China's engagement in SSA has intensified over the past few years thanks to bilateral trade and financial agreements, aid, training, political and cultural exchanges. Chinese-African trade has reached an estimated USD 50 bn in 2006, more than double of that in 2004 (Table A). African exports to China are concentrated in fuels and metal ores and account for around 10 percent of SSA merchandise exports. China is the biggest import supplier to SSA with a wide range of manufactured goods, including machinery, light industrial products and clothing and footwear. Countries like South Africa, Nigeria or Benin have experienced a considerable increase in Chinese textile imports. In some cases local textile companies are struggling with increased competition from China. Trade in services is smaller than in goods, but African services exports have also been rising sharply, notably tourism. China's strong growth and demand has offered windfall gains, especially to many resource-rich economies in SSA.

Table A: 2004 Trade statistics China-SSA*

	SSA Imports from China	*SSA Exports to China*
USD billion	*13*	*20*
Share of total	*8.4%*	*10%*
Av. annual growth %	*28% (2003-2004)*	*48% (1999-2004)*
Biggest trade partner	*South Africa 3.8 bn*	*Angola 6.6 bn*
Top products, % of total	*Cotton and fabrics 8.5%*	*Oil and gas 62%*

**Sources: H. Broadman, "Africa's Silk Road: China and India's new economic frontier"*

In 2004, Chinese FDI in sub-Saharan Africa grew at over 300 percent to reach USD 275 m (Table B). While FDI and bank lending is concentrated in a few resource intensive countries (such as Angola and Nigeria), China's involvement goes well beyond resource-extraction. The main development bank, Export-Import Bank of China (ExIm), finances mostly infrastructure projects. There is also evidence that Chinese entrepreneurs are expanding local trade networks and investing in labour-intensive manufacturing on the basis of technologies that are well-suited to the local conditions and business skills that are better than their western counterparts in difficult business environments. At the same time, faced with acute skills shortages, Chinese firms often resort to compatriots to implement projects, perhaps holding back the development of local labour markets and preventing the transfer of skills.

Table B: Financial relations China-SSA*

	USD billion
Total Chinese Aid In Africa (2002)	*1.8*
Chinese FDI flows to SSA (2004)	*0.3*
Top FDI destination in SSA(2004): Sudan	*0.2*
Exim Bank Loans in SSA (mid 2006)	*12.5*

**Sources: Ibid; AFD (2007) "La Chine Moteur de Développement"; Center for Global Development "China ExIm Bank and Africa: new lending and challenges" (2006)*

There are no consistent and reliable data available to assess the scale of various forms of Chinese overseas assistance, or their effectiveness and impact. Nevertheless, Chinese aid policies have been criticized for supporting African governments with poor human rights and policy records – Zimbabwe or Sudan - and for not being sufficiently concessional and conditional, notably on governance. ExIm Bank has for example not signed the Equator principles and the government has not subscribed to the Extractive Industry Transparency Initiative. Due to its involvement in the natural resource sector, Chinese aid may bring some of the problems associated with resource rents. There have also been criticisms for blending commercial and developmental objectives by for example tying aid to Chinese contracts. For proponents of China's engagement on the other hand, these factors are counterbalanced by greater efficiency, commercial orientation and Chinese willingness to bear risks. The use of Africa as a stepping stone to reach OECD markets may offer opportunities for growth of manufacturing. Moreover, the Chinese government provided significant debt relief (since 2000, around USD 2 billion of loans have been forgiven) though the impact of this on incentives for better policies in beneficiary countries is uncertain. In addition, China also provides training and advice, notably in health/medical issues and agriculture – the latter being an area which has been somewhat overlooked by western donors.

The implications of China's interest in Africa are difficult to predict, given that the country itself is undergoing a period of economic and political transition – and so its approach to Africa, trade, development and finance may also be expected to change. Whether Africa will reap the benefits of China's opportunistic willingness to invest depends on how Chinese intervention interacts with the growth constraints outlined in this paper, and in particular the impact on the policy frameworks in African countries.

4 Doubts about Aid and Criticism of the Reform Agenda

The decline of per capita GDP and the increase in poverty in sub-Saharan Africa at a time when aid flows were increasing prompted a wide debate about the impact of aid, and the effectiveness of the reform agenda that went along with it. A large number of empirical studies have addressed the question of the impact of aid on economic growth.[11] The relationship is controversial and hard to quantify because the term aid covers many different kinds of interventions that are applied in diverse and complex situations. Aid is to some extent fungible and potentially frees up resources which may then be used at the government's discretion. As a result, there is a tendency for aid to be associated with increased consumption rather than investment.[12] Debt relief is potentially the closest to oil in this regard, but it comes with conditions requiring the achievement of policy goals, and constraints on the raising of new debt on non-concessional terms. In addition, the impact of aid on growth might be expected to depend on the policy environment of the recipient country. However, the proposition that "aid promotes growth in a good policy environment"[13], has not been robust to statistical tests[14]. Some kinds of aid, such as education and health care operate on a much longer time horizon than macroeconomic stabilisation or financing of projects. Evidence appeared to support the view that short-impact aid has discernible benefits for growth.[15] However, aid policy has also changed and more aid has been allocated by donors to countries that have policies that are judged to be more conducive to growth. This reverse causality has raised doubts about whether it is aid itself or the situation of the recipient that has led to improved growth.[16]

[11] Dalgaard et al, "On the Empirics of Foreign Aid and Growth", Economic Journal June 2004.
[12] Boone 1996, "Politics and the Effectiveness of Foreign Aid", European Economic Review, 40(2), 298-329.
[13] Burnside and Dollar, "Aid Policies and Growth", American Economic Review, Sept 2000.
[14] Easterly, Levine and Roodman, 2003 "New Data, New Doubts: Revisiting "Aid, Policies, and Growth"" - Working Paper 26, Centre for Global Development.
[15] Clements, Radelet, and Bhavnani (2004). "Counting Chickens when they Hatch: The Short-Term Effect of Aid on Growth," Center for Global Development Working Paper No. 44.
[16] Rajan and Subramanian, "Aid and Growth: What Does the Cross-Country Evidence Really Show?", IMF Working Paper 05/127, June 1, 2005

In summary, the empirical literature has failed to provide decisive evidence that taken in aggregate, aid has improved economic growth. Easterly maintains that Africa would have been no worse off without it.[17] However, the literature has provided some guidance as to situations where aid has been effective which have played a part in re-focusing aid policy. For example, conditionality has evolved and new links have been made between aid and policy actions, or aid and policy outcomes. Moreover, the ability to use aid to target specific constraints on economic growth provides a set of instruments with significant advantages over the simple financial transfers such as natural resource revenues. Collier argues that "aid is not oil", meaning that there is an important difference between aid and natural resource revenues.[18] Whereas resource revenues are sovereign rents entirely in the control of government, aid flows are earmarked for specific purposes - technical assistance, projects, budgetary support linked to conditions, and debt relief. Natural resource rents raised growth in the short term, but almost everywhere failed to promote sustainable development. However, the purposive aspect of aid allows it to focus on growth-related targets.

The recommendations for policy reforms, which were seen as a vital part of the administration of aid under the leadership of the Bretton Woods institutions, have also been subject to critical scrutiny. The package of reforms known as the Washington Consensus had the overall objective to improve efficiency in the allocation of resources.[19] This required macroeconomic stabilisation, liberalization of trade and the financial sector, privatization, deregulation and institution-building. The reduced role of the state, through withdrawal from public enterprises and deregulation, was seen as essential to reduce opportunities for rent-seeking and to allow more transparent and efficient operation of markets. The agenda for public sector institutions was to make decision-making more democratic by decentralisation and improved accountability.

This programme for reform was not restricted to a particular group of countries but was regarded as having relevance to economic development across the world. For example, the same basic principles were applied to the transition economies of Eastern Europe as to sub-Saharan Africa. The programme's track record was disappointing in both cases.[20] These apparent failures led to a wide-ranging criticism of the "laundry list" approach to the reform process. The reform agenda had been too broad and needed to be appropriately tailored to country-specific conditions. Within the reform agenda, the criteria for prioritization had not been clear, and there was a tendency to focus on what was politically doable. The result was neither a balanced programme of reforms nor necessarily an attempt to address the key constraints on growth.

5 New Policy Options

The new policy options discussed below respond to the doubts about aid and the criticisms of the reform agenda. They are views and ideas at the frontier of academic debate and though discussed and widely considered valid within the aid community, they are not yet generally accepted as a basis for policy. The new options seek to improve the focus of aid policy according to the growth diagnostics of specific countries or groups of countries. The diagnostic methodology was proposed by Rodrik and others and is structured around a hierarchy of questions illustrated in the model in Chart 8.[21] At the first level of the decision tree, the objective is to decide whether the prime constraint on growth is scarcity of savings or low returns to investment. If the problem is low returns, then the next level of the tree asks whether this is due to lack of socially profitable investment opportunities or low appropriability.[22] Each subsequent branch goes into further detail to identify the underlying cause of the constraint. Then the policy measures are formulated accordingly: measures to promote savings where the economy is constrained by finance, policies to improve productivity where there is a lack of socially profitable investment opportunities, and to target institutional failure where there are viable projects but investors are deterred by corruption, instability, and so on. The following analysis applies the framework of growth diagnostics to the Collier's grouping of sub-Saharan Africa into landlocked, resource-rich and coastal economies.

In *landlocked economies* the fundamental problem is lack of investment opportunities, and social returns to investment tend to be low. The underlying causes vary between countries and may include one or more of the following: bad physical infrastructure, low human capital, and poor access to appropriate technology. This suggests a focus for aid on a combination of: roads and other communications infrastructure, liberalisation of air transport, telecommunications, education, health care, and technology transfer. Emphasis should be on the proper functioning of such investments, with a focus on maintenance of existing

[17] Easterly, "The White Man's Burden", Oxford University Press 2006.
[18] Collier 2006, "Is Aid Oil? An Analysis of Whether Africa can Absorb more Aid", World Development vol 34, no 9.
[19] Rodik, "Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform" Journal if Economic Literature Dec. 2006.
[20] The World bank, "Economic Growth in the 1990s, Learning from a Decade of Reform", Ch. 2.
[21] Hausmann, Rodrik, and Velasco, 2004, "Growth Diagnostics", JFK School of Government, Harvard University.
[22] Appropriability refers to the ability of the investor to take legal ownership of the returns to the investment.

infrastructure, support for associated institutions, incentives for the private sector and avoidance of the errors of the past. The orientation of the economy to benefit from growth in neighbouring coastal countries is a strategy that has worked in other regions. However, this is problematic in the African context due to the lack of dynamic neighbours. The ultimate objective of improved infrastructure and communications in landlocked countries is to acquire the characteristics that make coastal economies more attractive locations for investment.

Chart 8: Growth Diagnostics

In resource-rich economies the prime issue is reversing the negative impact of resource rents. These countries typically have good access to finance, and many socially beneficial investment opportunities. However, good social rates of return do not translate into viable projects because of market failures and failures on the part of governments to uphold property rights, and provide a stable macroeconomic environment. Many of these problems are the result of poor institutions and a restricted flow of information that result in inadequate checks and balances on government in ethnically diverse environments. In this context, experience shows that democratic systems with decentralized decision-making tend to be the most successful. The importance of democracy here is more in establishing checks and balances than electoral competition per se. The key role of donors is in the support of anti-corruption measures and institutional reforms.

The coastal economies have the biggest opportunities for growth and present arguably the biggest challenges for aid policy. They failed to benefit from the growth in world trade as export businesses chose Asia and not Africa as their preferred location. The African wage differential was insufficient to offset perceived disadvantages in the business environment, and finance attracted high risk premiums. In the absence of any policy measures, Africa might eventually be priced into the market as wages rise in Asia, but this is highly uncertain and might take a long time. These economies are a diverse group requiring potentially quite different growth strategies. A sample of seven of the largest coastal economies is appraised in Part II of the Report.[23]

[23] South Africa, Kenya, Tanzania, Ghana, Mozambique, Senegal, and Madagascar (Mauritius has achieved high growth and is excluded from the sample).

Madagascar and Mozambique would appear to be constrained primarily by savings, with a combination of high external debt, high current account deficits, and high interest rates relative to the other countries in the sample. Scarcity of savings implies a strategy addressing the fiscal deficit. This would increase domestic savings directly, and at the same time would potentially contribute to the relaxation of the external savings constraint by increasing confidence. Ideally, cuts in expenditure would reduce waste. However, it would also be possible to envisage apparently anti-growth measures such as increases in taxes since, if the diagnosis is correct, these are not the binding constraint.

Among the coastal countries with low investment returns, Ghana and South Africa have relatively good indices of corruption and ease-of-doing-business. This is an indication that they are constrained primarily by low social returns to investment, and not poor appropriablity. This would imply a growth strategy emphasising productivity improvements, by targeting key weaknesses in physical infrastructure or human capital.

For Kenya, Tanzania, and Senegal, macroeconomic indicators show relatively high and volatile inflation and high fiscal deficits. These macroeconomic risks reduce expected investment returns to foreign investors by increasing exchange rate volatility and raising the risk of non-convertibility. These are diagnostics of poor appropriability and suggest one of a number of strategies to address macro risks and market failures associated with corruption and poor enforcement of property rights.

Focusing the strategy country-by-country in this way on an enhanced diagnosis of the constraints would certainly do no harm and would probably improve the chance of increasing growth. However, this approach is fundamentally one of incremental improvement, and it is possible that even if the strategy were successful, the resulting increase in growth might not be sufficient to make major inroads into poverty. Moreover, when a country is faced by a number of mutually reinforcing constraints, a broader package of measures might be necessary. The two options considered below are still highly speculative and are presented on that basis as input for debate.

One option is a big push, consisting of a step up in aid flows combined with a package of policy measures that would allow a country to exploit economies of scale. A strategy of simply scaling up the existing effort is unlikely to succeed due to diminishing returns. The capacity to absorb aid is limited, and it would be difficult to envisage a major increase in the volume of projects without compromising quality. The big push would instead focus economic aid on the handful of countries that are most likely to achieve a breakthrough in growth (this geographical focus would clearly not apply to humanitarian or food aid that would still be allocated according to need). It would target the multiple constraints on growth in these countries and exploit the economies of scope and scale. Investments in one sector would provide positive externalities for others (for example, improved road infrastructure would increase the benefits to trade reform), and as a consequence the capacity to absorb a greater volume of aid would increase. If it were successful, growth in these countries might subsequently spill over to neighbouring countries and raise activity in the region as a whole. This idea has some clear drawbacks. It would require coordination between donors with differing views of aid. The concentration of effort into a small number of countries raises the risks. Moreover, politically difficult decisions would have to be made about which countries would be suitable candidates, and which would have to wait for the spill-over benefits.

An alternative option, proposed by Collier, is for temporary protection against Asian competition for African exports in OECD markets. Some of the obstacles that prevented relocation of export industries to Africa in the 1980s have been overcome – apartheid in South Africa, war in Lusophone Africa, socialist experiments in Ghana and Madagascar, and so on - though the recent outbreaks of conflict emphasise how improvement is still fragile. But now that the industries are established in Asia, it is hard for Africa to break into the highly competitive markets. What is needed, according to this argument, is an integrated approach, giving African exporters preferential access to OECD markets. In order to implement this option, it would be necessary to overcome some serious difficulties - it would require political agreement among a fairly large number of countries concerned, and could have implications in terms of WTO regulations. However, preferential market access would complement and encourage reform agendas within Africa, and would stand a good chance of creating some African export transformations following the Asian example.

6 Summary and Conclusions

The poor performance of sub-Saharan Africa, at a time when aid flows were increasing, led to a wide ranging debate about aid and reform. The empirical evidence on the impact of aid on growth is inconclusive, and some maintain that Africa would have been no worse off without it. In addition, the policy reform agenda of major aid agencies has been criticised as a “laundry list” approach that lacked appropriate prioritization criteria and failed to address the key constraints to growth. In response, new policy options have been put

forward that seek to tailor reforms to the country-specific needs of the recipients and more directly address the constraints to growth.

The focus on addressing the binding constraint to growth is a much less ambitious strategy than the laundry list of comprehensive reform. The strategy aims to achieve incremental improvements to growth which would accumulate over time, moving the economy in the right direction with a sequence of what may be relatively small steps. This is a low-risk strategy that would avoid some of the potential pitfalls of more fundamental reform measures. Its implications are as follows:
In the landlocked countries, the binding constraint on growth is the lack of investment opportunities. The focus of aid is then on provision of infrastructure, such as roads, power generation and telecommunications, and improvements in human capital, with the intention to raise productivity. Ultimately, the objective is for landlocked countries to become more like coastal countries.

For the resource-rich countries, the key issue is the inadequacy of institutions. This implies a strategy centred on technical assistance to support institutional building for policy turnarounds, but only where there is a significant commitment on the part of the recipients. The goal for these economies is to benefit more from resource revenues – to make oil more like aid.

However, a disadvantage of this incremental approach is that it might take a long time before it achieves a significant reduction in poverty, and it is unlikely to do enough to close the gap that has opened up between Africa and the rest of the world.

The problem is particularly acute for the coastal resource-scarce countries. These economies have arguably the highest growth potential, and may also be in a position to act as a catalyst for neighbouring countries. They face a diverse set of constraints and failed to attract manufacturing industries that chose Asia instead. A scaling up of existing aid flows is likely to be met by diminishing returns, and therefore two more controversial policy options have been put forward for discussion. The first option is to use aid to support a big push in those countries most likely to succeed in breaking into the world markets. A big push consisting of a step increase in aid is an ambitious strategy that has not been tried before, and would face many difficulties in implementation. But the potential returns are high, and the experiment may be worth considering. The second option is preferential access to OECD markets. This alternative builds on existing preferential trade arrangements to give Africa temporary protection that would offset the Asian economies of agglomeration.