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POLICY BRIEF

BROADENING THE SOURCES OF GROWTH IN AFRICA: THE ROLE OF INVESTMENT

Achieving the African Union's vision of an integrated, prosperous and peaceful Africa that can serve as a pole of global growth in the twenty-first century requires broadening the sources of growth on the continent to lay the foundation for sustained growth and poverty reduction. For this to happen, however, it is necessary to enhance the contribution of investment to the growth process. This can be done by boosting the level and rate of investment, improving its productivity and ensuring that it goes to strategic sectors of the economy. Further, the international community has a key role to play – that of complementing the efforts of national Governments. This policy brief outlines some of the key messages and recommendations of the UNCTAD *Economic Development in Africa Report 2014: Catalysing Investment for Transformative Growth in Africa*.[1]

Key points

- Concerted actions are needed at the national and international levels to stimulate investment in Africa.
- It is necessary to enhance the contribution of investment to the growth process on both the demand and supply sides of the economy.
- Government policy should be geared toward exploiting the complementarities between local and foreign investment.

Understanding Africa's recent growth

From 2000 to 2010, Africa's economies grew at an annual average rate of 5.3 per cent, some 2.5 percentage points above the world average growth rate of 2.8 per cent during the same period. Rapid growth in services, improved macroeconomic management of Africa's economies and a boom in commodity prices were the main contributors to this growth. Beneath this relatively impressive performance, however, lie several anomalies that have yet to be effectively tackled. For instance, recent growth has not had a profound impact on employment creation. Furthermore, it has not been accompanied by the development of productive capacities and structural transformation, two essential building blocks for sustained growth and poverty reduction to which African countries aspire.

Why has Africa's recent growth not had a profound impact on employment creation or fostered economic transformation in the right direction? The answer can be found in structural problems relating to recent growth patterns on both the demand and supply sides of the economy. On the demand side, recent growth has been driven mostly by consumption, and there has not been a substantial change in average investment rates on the continent over the past two decades. The investment rate, measured by the share of gross fixed capital formation in gross domestic product, has hovered around 18 per cent over the past two decades (see table). Although consumption is an important source of domestic demand and has been the dominant driver of growth in Africa over the past decade, a consumption-based growth strategy cannot be sustained in the medium to long term. Such a strategy often results in overdependence on imports of consumer goods, which poses challenges for the survival and growth of local industries, the building of productive capacities, and employment creation. In addition, it causes a deterioration of the current account balance, which would have to be corrected or reversed in the future to maintain external sustainability. Experience has shown that reversals of such current account imbalances often require drastic reductions in consumption, which have a severe negative impact on growth. As stated in the Report, while investment booms can also have a deteriorative effect on the current account, recent evidence suggests that current account deficit reversals caused by investment

1 UNCTAD, 2014, *Economic Development in Africa Report 2014: Catalysing Investment for Transformative Growth in Africa* (New York and Geneva, United Nations publication, Sales No. E.14.II.D.2).

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booms that increase the production capacity for tradable goods are associated with better growth performance than those driven by consumption booms. In this regard, African countries need to rebalance the contributions of consumption and investment to the growth process.

There are also structural problems with Africa's recent growth from a supply or sectoral perspective. For instance, it has not been transformative. Despite the continent's high and steady growth over the past decade, many countries have yet to go through the normal process of structural transformation, characterized by a shift from low- to high-productivity activities as well as a declining share of agriculture in output and employment and an increasing share of manufacturing and modern services in output. Available data indicate that the share of manufacturing in total value added has declined over the past two decades. It fell from an average of 14 per cent between 1990 and 1999 to 11 per cent between 2000 and 2011. Furthermore, the service sector is now the most dominant sector of African economies. Its share of total value added in the period 2000–2011 was about 47 per cent, compared with 37 per cent for industry and 16 per cent for agriculture.

More and better targeted investment needed to diversify the sources of growth in Africa.

In terms of dynamics, the service sector grew at an average rate of 5.2 per cent over the same period, while agriculture grew at 5.1 per cent and industry, at 3.5 per cent. Given that the service sector has the highest growth rate as well as a higher share of total value added, its contribution to growth has been higher than those of other sectors. This pattern of structural change is in stark contrast to what could be expected, given Africa's incipient stage of development. In the early stages of development, the service sector generally plays a leading role in the economy. However, the sector has become increasingly dominant on the continent in the past two decades. This should be of concern because it is driven mostly by low-productivity activities such as informal and non-tradable services. Furthermore, this suggests that Africa's recent growth is fragile and unlikely to be sustained in the medium to long term if current trends continue. Hence the need to diversify the sources of growth to build a foundation for sustained employment growth and poverty reduction.

Shares and growth rates of demand components in Africa, 1990–2011
(Expressed in percentage terms)

	1990–1999		2000–2011	
	Share of gross domestic product	Average growth	Share of gross domestic product	Average growth
Household consumption	65.8	2.6	62.0	5.0
Government expenditure	16.5	2.1	15.1	5.3
Gross fixed capital formation	17.7	3.0	18.7	6.6
Exports	25.8	3.6	34.8	4.9
Imports	26.8	3.8	32.1	7.4

Source: UNCTAD, 2014, *Economic Development in Africa Report 2014.*

Investment and diversification of the sources of growth

Broadening the sources of growth in Africa will require enhancing the contribution of investment to the growth process on both the demand and supply sides of the economy. On the demand side this is necessary to obtain a more balanced role for consumption and investment in the growth process; on the supply side it is needed to foster transformative growth because investment has been identified as one of the main drivers of structural transformation. In this paper, "investment" refers to total investment in the economy, which includes public and private investment. Private investment in turn consists of investment by local and foreign investors. The focus on total investment is important because all components of investment matter for growth and development. Government policy should therefore be geared toward exploiting the complementarities among the various components, rather than promoting one component at the expense of another. Crucially, how can African countries catalyse investment for transformative growth and development?

Policies to catalyse investment for transformative growth in Africa

This policy brief argues that enhancing the contribution of investment to the growth and development process in Africa will require three complementary policy measures: boosting the level and rate of investment, improving the productivity of new and existing investment and ensuring that investment goes to strategic sectors deemed crucial for economic transformation and the realization of national development goals.

Increase the level and rate of investment

It is urgent for African countries to increase the level and rate of investment. This will require the adoption of a more coherent macroeconomic policy framework that, for example, balances the objective of maintaining price stability with that of promoting growth and employment. There is also a need to reverse the policy bias against public investment that has prevailed in Africa since the 1980s because public investment, particularly in infrastructure, is urgently needed to catalyse private investment.

In this regard, African Governments should strengthen efforts to enhance domestic resource mobilization to create fiscal space to boost public investments in infrastructure. Addressing imperfections in credit markets that make it difficult for enterprises to access loans at affordable interest rates is also essential for boosting investment in Africa. In several African countries, access to credit is difficult, and commercial banks tend to hold excess reserves rather than lend to the private sector. Furthermore, bank loan rates are so high that they hinder investment.

One way to reduce the incentives of banks to hold excess reserves in the form of government securities is to ensure that the returns on such securities are not very high. The establishment of partial credit guarantees and the reduction of information asymmetry between lenders and borrowers by strengthening support for the establishment of private credit bureaux and movable collateral registries will also help encourage banks to finance private sector investments. Other measures to raise the level of investment are as follows: to enhance access to long-term finance by establishing and strengthening development banks at the national and regional levels, to reduce risk and uncertainty facing local and foreign investors by maintaining political and macroeconomic stability, and to improve the state of infrastructure.

Improve the productivity of investment

Enhancing the contribution of investment to growth and transformation is not just about increasing the quantity of investment; it is also about improving the productivity or quality of investments – existing as well as new. While there is some evidence that the productivity of investment in Africa at the continental level has improved over the past two decades, it is also true that such productivity either remained stable or declined over the same period in many African countries. Against this backdrop, the Report underscores the need for African Governments to strengthen efforts to enhance the productivity of investment. Developing workforce skills, providing quality infrastructure, improving access to affordable credit and reducing the high costs of factor inputs are ways of raising the productivity of private investment. To enhance the productivity of public investment, particularly in infrastructure, there is a need for better project selection and delivery, maintenance of assets to get more value out of existing infrastructure, and more targeted public investment. This could be achieved by refocusing public investment in areas such as energy, transport, and information and communications technologies.

Ensure that investment goes to strategic and priority sectors of the economy

Certain activities and sectors are critical to building productive capacities and achieving sustained and transformative growth. These include infrastructure and production activities in the agricultural and manufacturing sectors. The national development plans, visions, or frameworks of most African countries identify these as strategic or priority sectors. However, commercial banks and financial institutions in Africa are generally reluctant to finance projects in these sectors, preferring to lend to the non-production sectors.

One of the challenges facing African Governments is how to promote investment in the strategic or priority sectors by redirecting financial resources into these sectors. Industrial policy has an important role to play in achieving this goal. For instance, central banks can encourage lending to strategic sectors by adopting a refinancing (discount) policy that favours lending to these sectors. The policy involves setting a differentiated discount rate that is lower for bank advances devoted to financing investment in strategic sectors or activities. Another way to redirect investment to the strategic sectors, particularly in the case of small and medium-sized enterprises (SMEs), is to encourage financial institutions to use the flow of remittances as collateral for SMEs that seek finance for productive investments. The establishment of partial credit guarantee schemes can increase the flow of funds to strategic sectors and groups such as SMEs. There are also non-financial measures that Governments can take to promote investment in the strategic sectors, one of which is the provision of market information on investment opportunities available in those sectors.

Although the primary responsibility for catalysing investment in Africa lies principally with national Governments, the international community also has a key role to play because the global environment has a bearing on the ability of African countries to effectively boost and use investment for transformative growth. The global environment also affects the kinds of policy instruments that African Governments have at their disposal to promote investment. Concerted actions are needed at the national and international levels to stimulate investment in Africa. The international community can complement the efforts of African countries to boost investment at home in the following ways: by strengthening linkages between local and foreign enterprises, stemming capital flight to release more resources for investment, using aid to catalyse investment and fostering international trade.

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