Trade and Development Board
Seventy-second executive session
Geneva, 17–21 October 2022
Item 5 of the provisional agenda

Economic development in Africa: Rethinking the foundations of export diversification in Africa – The catalytic role of business and financial services

Overview*

Summary

Africa is among the least diversified regions in the world with regard to exports. Commodities account for more than 60 per cent of total merchandise exports in 45 of the 54 countries of Africa, leaving them highly vulnerable to global commodity price shocks and undermining the continent’s inclusive growth and development prospects. Economic Development in Africa Report 2022: Rethinking the Foundations of Export Diversification in Africa: The Catalytic Role of Business and Financial Services shows that neglecting the potentially transformative role of high-intensity services such as information and communications technology and financial services, is among the key reasons why export diversification remains a challenge in the region. Accordingly, in the report, it is shown that addressing barriers to trade in services under the African Continental Free Trade Area will be key to unleashing the transformative role of services in enhancing the diversity and complexity of products from Africa. For export diversification strategies to be impactful, furthermore, the adoption of policies that enhances inclusive access to innovative financing technologies, including for small and medium-sized enterprises, is recommended. Effectively leveraging high knowledge-intensive services to enhance productivity and improve competitiveness in the private sector will be key in achieving higher value added diversification and growth under the African Continental Free Trade Area.

Introduction

1. Despite efforts to achieve export diversification, African countries remain predominantly dependent on exports of primary products in the agricultural, mining and extractive industries. This has adverse impacts on inclusive growth in the long term, as, among other things, it dims the prospects of industrialization and human capital development. Forty-five African economies are commodity dependent, with highly volatile revenues due to the nature of the market, characterized by periods of price boom and bust. While many parts of Africa have enjoyed positive economic growth in recent years, such growth was in part due to a commodity supercycle. The high concentration of exports in a small number of commodity products can create macroeconomic instability, especially during times of commodity price volatility and global shocks, such as those affecting supply and demand. The disruptive effect of these shocks on the trade balance, export revenues and financial flows can in turn generate a negative impact on productivity, economic growth, (both government and income) revenues and investment. Commodity price shocks are also associated with lower levels of financial sector development in commodity dependent countries.

2. The diversification of African exports and economies is the most viable means by which these countries can prosper in the global economy and survive vulnerabilities and economic uncertainties exacerbated by commodity price volatility. There is currently great potential for African economies to transform and achieve a higher level of diversification and competitiveness. The successful implementation of the African Continental Free Trade Area, a growing middle class, an emerging consumer market, the increased use of financial services and technology, and dynamic private entrepreneurs will drive export diversification and sustainable economic growth in Africa.

3. When examining the various strategies put in place by African countries to diversify exports and foster competitiveness at the regional and global levels, what becomes apparent, however, is the underestimated potential of the services sector as a cornerstone of productive activities for industry, manufacturing and agriculture. Moreover, many export diversification programmes overlook the potential of the private sector and financial services to reach their objectives. The private sector, which includes small and medium-sized enterprises, can provide innovative and efficient ways of diversifying and transforming African economies; financial services can serve as a sustainable channel through which small and medium-sized enterprises can mobilize financing to enter new markets, diversify exports, upgrade productive activities and improve competitiveness.

4. In this regard, in Economic Development in Africa Report 2022: Rethinking the Foundations of Export Diversification in Africa: The Catalytic Role of Business and Financial Services, the great potential is highlighted of African countries to transform and achieve higher levels of diversification and competitiveness through increased internalization of high-intensity services, in particular information and communications technology and financial services. The report identifies and analyses new avenues for enhanced growth in the services sector that can strengthen both backward and forward participation of African countries in high-end global value chains. Emphasis to drive this process is placed on:

(a) A vibrant private sector, inclusive of microenterprises and small and medium-sized enterprises to provide innovative and efficient ways of diversifying and transforming African economies;

(b) Catalytic financial services as the sustainable channel through which the private sector, inclusive of small and medium-sized enterprises can mobilize financing to enter new markets, diversify exports, upgrade productive activities and improve competitiveness.
I. Main findings

5. The analysis in the report sheds light on how the services sector could be a forceful impetus for economic diversification, growth and structural transformation in Africa. This requires, however, that policies be aligned to build complementarities between the services sector and other sectors of the economy, particularly manufacturing. The implementation of the African Continental Free Trade Area may help catalyse national efforts to link these services and industries and prioritize services sectors that are relevant to a value chain that is strategically important for a given country.

6. For decades, export diversification has been a policy priority for Africa. However, fewer than half of all African countries have succeeded. While some countries have added new product lines to their export basket, insufficient progress has been made in steering the industrial sector into high value added manufactured goods that are key to successful sector growth and effective integration into the high-value segments of regional and global value chains.

7. Although much of the literature converges on the pivotal role of services in regional and global value chains, in the report, it is shown that trade in services in Africa is low, accounting for only about 17 per cent of its total exports between 2005 and 2019. In addition, traditional services such as travel and transport dominate trade in services covering more than two thirds of the total trade in services, suggesting limited access to a variety of fundamental competitive services inputs from within the continent.

8. Knowledge-intensive services, which include 8 of the 12 services categories, have the potential to add higher value to the export of services, enable innovation in business operations and production systems and drive sector growth. Such services, however, are underrepresented in African services exports, accounting for only 20 per cent of the continent’s total exports of services. Despite the importance of traditional services (travel, transport, and maintenance and repair services) in facilitating production and supply linkages, with significant implications for the overall competitiveness of firms through net trade costs, they do not have a direct impact on the complexity and diversity of the export basket, which is seen to increase with high knowledge-intensive services such as information and communications technology services.

9. Services are essential to enhance export diversification through the provision of business, financial and information and communications technology services to make it easier to tap into new markets and make new products. However, the performance of trade in services, both in terms of diversity of players and products within the domestic market, remains imperative in ensuring the availability of relevant services to ensure the enhanced complexity and diversity of manufactured goods. For instance, the utilization of inputs of business and communication services is low in most African countries, with an average of about 10 per cent in production and exported output. While services account for more than 50 per cent of the inputs in production, the largest part comes from distribution services.

10. There are fair intramanufacturing linkages in most countries. Inputs from within the manufacturing sector account for about 48 per cent on average of the manufacturing inputs in production and about 46 per cent on average of the sector’s exported value added. This highlights the potential for regional value chains provided that services linkages are strengthened to enhance quality and diversity. A stronger services sector with increased value added across sectors is seen to be key in enhancing the productivity and competitiveness of exports and facilitating viable integration of countries into productive value chains. However, services are weakly internalized in other economic sectors in most African countries.

11. The services sector could be a forceful impetus for economic diversification, growth and structural transformation in Africa. However, this requires that policies be aligned to build complementarities between the services sector and other sectors of the economy, especially manufacturing. The implementation of the African Continental Free Trade Area may help catalyse national efforts to link these services and industries and prioritize those services that are relevant to a value chain that is strategically important for a given country.
12. If Africa is to better harness its trade in services potential, services policies and their regulation need to better target areas of market failure – accessibility, quality, affordability, competition, the high costs of trade in services, protectionist policies, low levels of digitalization and technology, difficult access to financial services and poor infrastructure. Addressing the limited productive capacities and strengthening regional integration will be key to enhancing the internalization of key services.

13. Businesses can play an essential role in efforts to achieve export diversification, including by facilitating the intensive and extensive margins of exports and by leveraging high intensity services to facilitate entry into new markets with new or existing products.

14. African small and medium-sized enterprises stand to gain from many opportunities in the services sector. However, they need to be innovative and make good use of networks in the sector to improve access to relevant information on markets and other developments therein. Overcoming credit constraints and facilitating access by small and medium-sized enterprises to affordable finance will be important for their growth, competitiveness and position as potential engines of growth and diversification.

15. Furthermore, small and medium-sized enterprises are the backbone of African economies. They make up about 90 per cent of firms in the region and employ about 60 per cent of its workforce. Trade in services offers many opportunities for the increased engagement of small and medium-sized enterprises in Africa. However, restricted access to finance, poor integration in regional and global markets, and a limited skills base make it virtually impossible for them to compete with large public and private firms that dominate the sector. Establishing viable value-based networks within sectors or across clusters of industries and forging stronger partnerships that can foster deeper integration into regional and global value chains are the most effective way to productively leverage their contribution in the different services subsectors.

16. Leveraging the potential of small and medium-sized enterprises in diversifying African exports and integrating trade in services linkages may present significant challenges. These include informality, finance gaps and a lack of skills essential to outsourcing their services. In many countries in Africa, the informal economy remains pervasive and constitutes a significant share of the total economy. From 2010–2018, the informal economy accounted for 36 per cent of gross domestic product in Africa. There are about 50 million formal microenterprises and small and medium-sized enterprises with an unmet financing need of $416 billion every year. Exporting firms, particularly new entrants and small-scale exporting firms, need to secure external financing to cover large costs to enter export markets. Those costs include information costs (to better understand the required regulations and standards of a potential foreign market), compliance costs (to redesign exporting products that meet demand standards for a specific market and establish new processes to comply with foreign market regulations and standards) and other costs related to trade barriers (customs, logistics, lead time and tariffs).

17. Overcoming credit constraints and facilitating access by small and medium-sized enterprises to affordable finance will be important for their growth, the competitiveness of small and medium-sized enterprises and to position them as potential engines of growth and diversification. In many African countries, the existing financial structure does not offer greater flexibility and resources to support small firms’ growth and export performance, which require tailored financing mechanisms, such as venture capital and business angels, and financial technologies that can improve traditional credit channels and offer other promising channels for bridging the financing gap of microenterprises and small and medium-sized enterprises.

18. Although the development and deepening of financial products and services markets have not yet reached the level of maturity required to influence a paradigm shift in export expansion and diversification in Africa, the potential for alternative finance to expand and upgrade the portfolio of financial products and services and to offer more innovative firm-centric products that can sharpen the operational efficiency and competitiveness of small and medium-sized enterprises could be a game changer for export diversification. Effective implementation of export diversification initiatives will require rules-based
governance frameworks and coherent financial sector policies, including those related to financial technology.

19. As current investment models are failing African small and medium-sized enterprises, it is time to explore fresh options. Financial technology and alternative financing could be transformative, provided that the appropriate legal and institutional frameworks are in place, not only by facilitating the financing and growth of small and medium-sized enterprises, but also by leveraging the potential of these firms to drive export diversification. The recent growth of financial technologies and innovations in alternative financing has begun to have significant positive impacts on small and medium-sized enterprises and the unbanked (mainly youths and rural dwellers) of around 42 per cent of the adult population, by easing and expanding their access to financing opportunities that are better tailored to their specific characteristics and needs. Notwithstanding the great potential of financial technology and other alternative small and medium-sized enterprise financing models (equity funding, venture capital, credit insurance and peer-to-peer lending), many legal, regulatory, operational and transparency obstacles could hinder their use by trade customs and African firms, including export-oriented ones.

II. Policy recommendations

20. Much of the debate over strategies or drivers of export diversification has focused on the role of the public sector, with a limited push towards more dynamic and game-changing agents, for example, the private sector. High knowledge-intensive services sectors and systems, such as financial technology, are essential to transforming African exports and overall economies.

21. Enhancing the complexity and diversity of African exports requires a two-pronged approach that looks at the incentives for increasing services utilization in the manufacturing sector and scaling up entrepreneurship activities towards potential new products, with benefits for structural change, while optimizing opportunities for deeper integration in regional and global value chains and catalysing conducive business and financial services. This entails confronting the barriers that undermine the performance of trade in services. This also requires enhanced access to competitive services, while reorienting national and regional investment and trade policies to strategically enhance the productive capacities of firms in developing new products and services with a potential to transform and sophisticate productive structures and market activities, without necessarily crowding out the diversification potential of existing products and businesses.

Improve the capacity of people and firms to emulate and innovate

22. Several channels can improve the capacity of people and firms to emulate existing products and innovate new products. Intellectual property rights play a key role in emulating and innovating new products to promote export diversification. Stronger national intellectual property rights can benefit export diversification, as they are an important motivation for innovative activities. Firms face a risk in innovating new products, but if they are successful, others will follow in their steps and increase competition, driving profits down. As a result, the social benefits of innovation and firm-level product diversification are greater than the private benefits. However, restrictive international architecture for the protection of intellectual property rights can undermine export diversification strategies, as it limits the opportunity for firms to reverse-engineer and copy the products they try to emulate. Therefore, African policymakers should ensure the establishment and/or legal enforcement of intellectual property rights at the national level to protect entrepreneurial creativity. Moreover, African policymakers should advocate support for more flexibilities, such as voluntary licences, under the Agreement on Trade-Related Aspects of Intellectual Property Rights of the World Trade Organization, which can help achieve development goals. Developing coherent regional frameworks can help spread the use and application of policies relating to intellectual property rights and other measures that can foster the growth and competitiveness of African firms.
Support firms to innovate

23. Most small and medium-sized enterprises, which do not generally have extra resources for innovation, risk failure in their attempts to achieve diversification. Access to financing instruments designed to promote economic diversification, such as funding provided by development banks, can facilitate emulation. In addition, providing research and development subsidies to incentivize firms to innovate has been an important tool to expand diversification. Governments should act in all these channels to boost the capacity of firms to emulate and, therefore, increase the rate of emulation. Strengthening market information tools can also reduce market uncertainties and raise the chances of success. Therefore, African Governments should design and use policy instruments that teach firms how to innovate and emulate. Some of these policy instruments are public–private research and development, innovation hubs, extension services and industrial institutes. Investing in creating national innovation systems and leveraging technical and technological expertise in universities, research institutes, financial institutions, certification and metrology institutes, and regulators are conducive measures for the growth of innovating firms. Furthermore, African Governments should provide training to give people the necessary entrepreneurial skills to leverage the system so as to create new businesses that produce and provide “new-to-the-country” goods and services. This would include specific skills that go beyond the establishment of a business and have at the core the capabilities required to identify opportunities for emulation based on work that people already perform.

Expand the set of technologies and infrastructure

24. Another way to promote emulation is by expanding the set of technologies and improving the quality of infrastructure. This includes skills and technologies in areas that are important for firms entering new sectors, among others, electricity and digital infrastructure. The facilitation of technology transfer is a common mechanism used to raise the level of technology in an economy and to increase export diversification. The report describes several ways through which technology transfer can be facilitated, including exports or imports of final goods (trade), licences, purchase of foreign firms (mergers and acquisitions), strategic alliances or joint ventures, migration of people for work or education, open-knowledge sources, contracts with research entities, collaborative research and development, a collaboration between universities on technology transfer, and bilateral or multilateral technology agreements. For instance, the Technology Bank for the Least Developed Countries was set up to facilitate technology transfer to those countries. The online platform of the Technology Facilitation Mechanism also contributes to this work by providing information on available technologies that can be used to attain the Sustainable Development Goals. On-the-job training is essential for the transfer of non-tradable technologies (know-how, tacit knowledge and methods and procedures that are learned by doing). Transfer of technology, in which new technology is licensed to a firm in a developing country, does not fully complete the technology transfer. Therefore, African Governments should set up central open-source technology databases to facilitate information-sharing, skills gap needs assessments and the design of more effective technology transfer initiatives for local firms and people. African policymakers should put in place policies and investment agreements that ensure skills transfer and technological know-how and innovation and that can contribute to the specific skills upgrading needs of the local firms and workforce, and hence promote local competitiveness and job creation.

25. It is important to increase the number of people trained in areas related to the new sectors that a country is promoting. As such, Governments in Africa should invest more in people and firms that offer a comparative advantage in the new sectors. This includes training engineers who can work with new machines, training technicians who can engage in the new processes and learning new technologies by observing and doing the work. Moreover, closer partnership between African Governments and the private sector should be geared towards mobilizing additional domestic resources to provide targeted infrastructure and technology that encourage industrialization. They should also adopt strategies that encompass a regionally oriented holistic approach towards tackling inadequate economic infrastructure (electricity, information and communications technology, and transport). Such an approach will help promote viable integration into regional and global value chains effectively. It is equally important that industrial policies
target local small and medium-sized enterprises with, for instance, public procurement clauses and foreign investment requirements to create linkages to domestic private sectors or with incentives to promote joint ventures.

**Reinforce linkages between industries and encourage the use of local content and suppliers by domestic firms**

26. Some progress has been made in the sectoral and modal aspects of trade in services in Africa, particularly through the African Continental Free Trade Area, and prior to its adoption by member States. This relates mainly to transport, tourism and modal services, which are conduits for the movement of persons. For example, key sectoral milestones in the transport sector were achieved under the Africa Transport Policy Programme, which aimed at improving connectivity in the region by establishing comprehensive road and transport corridors and networks to transport goods and people across Africa more efficiently. Nonetheless, services provision remains suboptimal and is delivered at a high cost. Various regulatory and policy shortcomings prevail and impede Africa from fully capitalizing on its services sector potential. Therefore, African Governments should regularly assess and review the process of removing key barriers to the efficient participation of small and medium-sized enterprises in the diversification of trade in services. This includes encouraging those small and medium-sized enterprises operating in the informal sector to register with the formal system. A formal system of registration would provide many advantages, such as government support programmes for building and enhancing skills and technologies, as well as increased access to innovative financing instruments and institutions.

27. African Governments should also adopt industrial policies targeted at small and medium-sized enterprises that minimize the impact of their size in terms of both technical and financial capacity. This could be achieved by promoting the use of local firms as suppliers of factories set up in a specific country with foreign direct investment (for example, through public procurement clauses and foreign investment requirements to create linkages to domestic enterprises or promotion of joint ventures). To strengthen the linkages between domestic suppliers and large firms to substitute for imports, African Governments and relevant partners could develop supplier development programmes through, for instance, investment promotion agencies or other related institutional or regulatory arrangements. Firms of the same or related industry could benefit from a network of specialized suppliers, services and skills spillovers. With regard to the African Continental Free Trade Area, a regional approach based on the inclusion of regional firms should be promoted. For instance, regional cooperation and harmonization through the African Continental Free Trade Area Protocol on Competition Policy should aim at addressing cross-border anticompetitive behaviour more effectively, with special provisions or special treatment provided to countries with limited administrative capacity, such as the least developed countries.

**Enhance the access of small and medium-sized enterprises to alternative finance**

28. Relevant policies that encourage a diversity of players and products in the financial sector will be key in ensuring financial inclusion across businesses and sectors. For instance, while fostering growth in the banking sector is essential, the report highlights the importance of insurance services in diversifying exports. Venturing into new product lines for export in Africa is generally viewed as risky, suggesting that it is only likely to be undertaken when such risks are hedged with insurance products and services. With regard to funding for start-ups and small and medium-sized enterprises, banks will generally finance existing product lines rather than new ones. Stronger protection of property rights and rules-based governance, in addition to guaranteeing a level playing field for enterprises (particularly small and medium-sized enterprises) to compete, are prerequisites to promoting export diversification. For example, African policymakers could collaborate with financial institutions and market participants to put in place novel policies and programmes that provide small and medium-sized enterprises with specialized financial and non-financial products and services, such as government loan guarantees and risk pooling that can better help meet the long-term financial needs of small and medium-sized enterprises. Means of alternative finance, including financial technology, should be
developed, accompanied by appropriate regulatory frameworks that could address the information asymmetry inherent in financing decisions for small and medium-sized enterprises so that funds can also flow more easily into this traditionally neglected but promising sector.

29. Furthermore, African regulators and financial services providers, should be encouraged to facilitate the interoperability of technology, rules and standards between digital services and products across different national and regional jurisdictions. African regulators, supervisors, standard-setters and financial technology companies should be encouraged to collaborate more closely, develop coherent testing frameworks for the use of technology in financial services and adopt appropriate rules and standards that can safeguard the broad use of financial technologies and other innovations. These collaborative mechanisms should be accompanied by legislation and rules that reduce the risks or uncertainties of financial technologies that can discourage their use by market participants. This includes, among others, legislation aimed at preventing money laundering, client asset protection rules, prudential treatment of exposure of regulated financial institutions to digital threats and other systemic risks and know-your-customer processes and requirements. Moreover, it is important to set up training facilities and other information-sharing mechanisms that aim at supporting regulators and supervisors in developing appropriate internal understanding and expertise in the use of technology in financial services, as well as mechanisms that can build their capacity to monitor and mitigate the concentration and operational and systemic risks associated with the application of such technologies. African Governments, financial institutions and regulatory bodies at the national and regional levels should promote the regional integration and convergence of the different systems, regulations and platforms required to catalyse financial technologies and increase cross-border access to alternative finance. This includes establishing regional clearing and settlement and payment systems, legislating regional policies and devising strategies aimed at convergence in the regulation and supervision of the use of innovative financial technologies.

Maximize the potential benefits of the African Continental Free Trade Area for export diversification by streamlining with inclusive growth and financial inclusion goals and practices

30. A potential means of overcoming some of the structural constraints identified in the report is the facilitation of trade with close trading partners through regional integration and the promotion of business services through marketing and consulting on how to position products in the market. The finding that importer demand and gross domestic product matter more than an African exporter’s market size emphasizes the potential role of regional integration in overcoming small country constraints, increasing scaling opportunities for businesses and fostering export diversification. Lengthy processes to establish a business, burdensome trade regulations and entry barriers created by specific requirements or preferences in the value chain pose significant challenges for local firms and marginalized groups to do business and enter the market, even at low levels of the value chain. Breaking down regulatory barriers to market entry and ensuring equal access to productive resources to all population groups should be understood as a prerequisite to diversification. Therefore, the recommendations that follow are put forward for consideration.

31. Regulatory innovation in financial technology and a regional approach to competition policy, investment facilitation, promotion and protection are necessary to protect consumers and small and medium-sized enterprises across borders from the anticompetitive behaviour of large firms while maintaining efficiency and supply of affordable products. African countries and regional institutions should pay particular attention to the needs of vulnerable groups and reinforce efforts towards removing formal legal barriers that have prevented women entrepreneurs from owning and operating businesses or have lowered their effective and impactful participation in formal cross-border trade. Moreover, African Governments and regional institutions should commit and invest more into initiatives that encourage equal access to finance, business services and market opportunities, as well as equal rights to access education, health and productive resources. National and regional competition policies that reduce anticompetitive behaviour
of dominant firms should be designed with a more focused gender lens and thus be supportive of women’s economic and financial empowerment. The design, implementation and impact of such policies and initiatives will not be effective without the close cooperation of women entrepreneurs and related associations or their increased participation in the process.

**Strengthen efforts to improve trade and financial data**

32. The report highlights that having good quality data remains key in assessing and identifying conducive trade and financial policies in Africa. Equipping national statistical offices with human and financial resources, and technical support is essential to promote data collection efforts and ensure, for instance, the availability of disaggregated data on trade in services and key indicators, such as global value chains, and services trade-restrictive indices, as well as the innovative use of technology in financial services. Therefore, African Governments and partners should design and implement tailored capacity-building and technical assistance programmes aimed at developing specific skills in high knowledge-intensive services. These could include public–private research and development, innovation hubs, extension services and industrial institutes. African Governments, regional organizations and relevant institutions should also legislate access to the processing and sharing of financial and financial services data at the individual and firm levels. This could include an enforcement mechanism giving the African Union or the African Continental Free Trade Area [secretariat] supervisory roles that will ensure consistency of trade and financial services data provision and processes across all jurisdictions.

**III. Conclusions**

33. Over the last two decades, less than half of African countries managed to diversify their exports despite efforts to do so. Due to structural challenges, Governments must strategically create targeted incentives to promote diversification that benefits structural change. The services sector could be a significant driver of economic diversification, growth and structural transformation in Africa. This, however, requires policies to be aligned to build complementarities between the services sector and other sectors of the economy, particularly manufacturing. The implementation of the African Continental Free Trade Area may help to catalyse national efforts to link these services and industries, to prioritize those services that are relevant for a value chain that is strategically important to a given country. Untapped opportunities exist in the services sector for African small and medium-sized enterprises. However, they need to be very innovative and make good use of the networks in the sector to enhance access to relevant information on markets and other developments in the sector. Addressing the credit constraints of small and medium-sized enterprises and facilitating their access to affordable finance will be critical for their growth, competitiveness and position as potential engines of growth and diversification. Notwithstanding the great potential of financial technologies and other alternative financing models (including equity funding, venture capital, credit insurance and peer-to-peer lending) to help bridge the financing gap of small and medium-sized enterprises in Africa, many legal, regulatory, operational and transparency challenges could hinder their use by African firms (including export-oriented ones) and trade customs. Moreover, effective implementation of export diversification initiatives will require that coherent financial sector (including financial technologies) policies and rules-based governance frameworks are in place. Consequently, enhancing the complexity and diversity of African exports requires a two-pronged approach that looks at both the incentives for increasing services utilization in the manufacturing sector and scaling up entrepreneurship activities towards potential new products with benefits for structural change, while optimizing opportunities for deeper integration in regional and global value chains and catalysing conducive business and financial services.