

Economic Report on
Africa
2002
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Contents

Foreword ix

Acknowledgements xiii

Overview 1

1 Recent Economic Trends in Africa—and Prospects for 2002 13

The global economy slowed in 2001	13
Is a V-shaped recovery likely?	16
Africa was the only developing region to see faster growth in 2001	17
Changing commodity prices provide mixed blessings for Africa	18
Tourism and remittances experienced steady growth	19
African exports to the United States jumped	21
Africa's emerging markets experienced a sharp increase in private capital flows	23
Africa has seen a shift in foreign direct investment	26
Aid to Africa remains low and volatile	28
African economies grew faster than expected	31
Economic policies have focused on boosting growth and reducing poverty	40
The Expanded Economic Policy Stance Index	43
Annex	48
References	54

2 South Africa—Locomotive for African Growth? 55

Recent economic developments—from currency crises to stabilization programme	56
Agriculture—output sliding, exports up	58
Industry—weak domestic demand	60
Domestic consumption and investment—flat	61
Monetary policy—M3 ahead of targets	66
Exchange rate developments—rand under pressure	68
External debt and foreign borrowing—interest payments remain low	69
Trade policy and global developments—integrating with the world	70
Human development—wide disparities between rich and poor	73
Medium-term outlook and policy challenges—3% growth expected in 2002	77
Note	78
References	79

3 Ethiopia—Good Policies, Decent Outcomes 83

Real sector developments—output, savings, investment, and prices	84
Fiscal policy—budget deficit narrowing	89
Monetary policy—interest rate controls eased	89

	The financial sector—opening	91
	Foreign trade and debt—new policies in place	92
	Poverty—deep in rural areas	99
	Health and education indicators—big improvements needed	101
	Institutional reforms—land tenure and governance	103
	Medium-term outlook—7% growth expected for 2002	106
	References	106
4	Zimbabwe—A Crumbling Economy	109
	Recent economic developments	110
	Agriculture—economic mainstay, but . . .	113
	Mining—foreign dominated	117
	Manufacturing—down to 14% of GDP	119
	Financial sector—captive to government	121
	Monetary policy—M3 up sharply	123
	Fiscal policy—under pressure	123
	External sector—trade liberalized	127
	Human development—deteriorating services	130
	Governance—corruption pervasive	133
	Medium-term outlook—gloomy	134
	Notes	134
	References	135
5	Kenya—Weak Governance Hobbles Economy	137
	Recent macroeconomic performance—real GDP up 1.8% in 2001	137
	Balance of payments and foreign debt—foreign exchange reserves up to 3.5 months of import cover	141
	Monetary policy and the financial sector	142
	Fiscal policy and domestic debt	145
	External policies—regional integration and tariffs	147
	Social sector developments	148
	Institutional reforms and governance	149
	Outlook for 2002—real GDP growth to rise to 2.5%	151
	References	151
6	Nigeria—Untapped Potential	153
	Recent trends and developments—promise and disappointment	154
	Macroeconomic performance 1999–2001—growth nearing 4%	155
	Policy reforms and economic performance	161
	Institutional and structural reforms	167
	Human development	173
	Medium-term outlook—2% growth projected for 2002	177
	Notes	182
	References	182

7	Morocco—Repositioning for Globalization	185
	Recent economic trends—solid improvements	187
	Sectoral performance—not much change	187
	Macroeconomic policies and their impacts	191
	Human development—big improvements	198
	Medium-term outlook and policy challenges—real GDP growth unlikely to exceed 3.5%	201
	References	205
8	Guinea—From a Command to a Market Economy	207
	Recent trends and developments—wide-ranging reforms	208
	Sectoral performance and policies	210
	External sector performance—current account deficit down to 1–2%	216
	Foreign debt—serious management difficulties	219
	Trade policy—rejoining the global economy	219
	Fiscal policy—diversifying the tax base	220
	Financial sector performance and monetary policy—inflation held to single digits	222
	Human development—reviewing the debate	225
	Medium-term outlook—policy coherence needed	227
	Notes	229
	References	229

Boxes

1.1	The economic effects of the September 11 terrorist attacks	15
1.2	Smooth transition to euro bodes well for CFA franc	19
1.3	The African Growth and Opportunity Act—a boost for exports, employment, and investment	23
1.4	Duty-free and quota-free access to U.S. markets for Sub-Saharan textile exporters	24
1.5	The Doha Development Round—key to African prosperity	34
1.6	The New Partnership for Africa's Development—an African framework for faster growth and development	39
1.7	Is West Africa on track for a single currency by 2004?	41
1.8	Ghana—a winning combination of smooth democratic transition and sound economic management	43
1.9	Is South Africa's falling rand a reflection of regional contagion—or irrational pessimism?	44
2.1	Adjusting to slowing world growth	57
2.2	Agricultural reforms—to correct historical injustices	59
2.3	Principles of the new industrial strategy	62
2.4	New inflation targets	67
2.5	The effect of depreciation on the economy	72
3.1	Ethiopia qualifies for debt relief under the enhanced HIPC initiative	98
6.1	Highlights of Nigeria's 2002 budget	165
6.2	The dilemma of national economic management	171
6.3	Investors' perceptions of the cost of doing business in Nigeri	180
6.4	The concerns of Nigerians	181

7.1	A privatization success story—Morocco's telecommunications sector	192
7.2	Rising poverty and inequality in Morocco	202
8.1	Micro-finance in Guinea	224

Figures

1.1	Quarterly changes in real GDP, Group of Seven industrial countries, 1999 Q1–2001 Q2	14
1.2	World commodity prices, January 1998–September 2001	20
1.3	Top four African recipients of worker remittances, 1998 and 2001	21
1.4	Top 10 importers from Africa, 2000	22
1.5	U.S. imports from Africa, January 1999–October 2001	22
1.6	Top 10 exporters under the U.S. African Growth and Opportunity Act, January–September 2000 and 2001	24
1.7	Stock market performance, various African countries	26
1.8	Aid to Africa from all donors, 1960–1999	29
1.9	Average aid flows from members of the Development Assistance Committee, 1991–99	29
1.10	Aid per African from members of the Development Assistance Committee, 1999	30
1.11	Africa's share of world crude oil and natural gas reserves, production, and exports, 1980 and 1999	35
1.12	Gross domestic savings, total investment, private investment, and public investment, Africa, 1990, 1995, and 1999	36
A1.1	Estimated GDP growth, African countries, 2001	48
A1.2	Estimated GDP growth by region, Africa, 2001	49
3.1	Changes in real GDP and agricultural output, Ethiopia, 1991/92–2000/01	85
3.2	Sectoral composition of GDP, Ethiopia, 1991/92–2000/01	85
3.3	Gross private, public, and total savings, Ethiopia, 1991/92–2000/01	86
3.4	Private, public, and total investment, Ethiopia, 1991/92–2000/01	87
3.5	Government revenue, spending, and deficit, Ethiopia, 1986/87–2000/01	90
3.6	Sources of financing for capital spending, Ethiopia, 1987/88–2000/01	90
3.7	Money supply, Ethiopia, 1986/87–2000/01	90
3.8	Real health spending per capita, Ethiopia, 1965/66–1999/2000	102
3.9	Real education spending per capita, Ethiopia, 1965/66–1999/2000	103
4.1	Agricultural land resettled, Zimbabwe, 1979/80–1995/96	115
4.2	Manufacturing production, Zimbabwe, 1990–2000	121
4.3	Monetary aggregates, Zimbabwe, 1995–2000	124
4.4	Inflation rate, Zimbabwe, January 1995–December 2000	124
4.5	Public spending on health and education, Zimbabwe, 1995–2001	127
4.6	Exchange rate of the Zimbabwe dollar against major currencies, 1995–2000	129
4.7	Criminal offences and attempted crimes, Zimbabwe, 1995–2000	131
6.1	Oil, non-oil, and total GDP growth, Nigeria, 1981–2000	158
6.2	Education and health spending as a share of the federal budget, Nigeria, 1990–2001	176
7.1	Change in real effective exchange rate and exports, Morocco, 1991–2000	188

Tables

1.1	Quarterly changes in real GDP, industrial countries, 2000 Q1–2001 Q4	14
1.2	External financing of Africa's emerging markets, 1998–2002	25
1.3	Foreign direct investment outflows, selected African countries, 1990–94 and 1995–99	27

1.4	Cumulative foreign direct investment in Uganda by industry, 1991–98	28
1.5	Distribution of GDP growth rates, Africa, 1999–2002	31
1.6	Macroeconomic indicators, Africa, 1998–2001	32
1.7	GDP growth in Africa by region, 1998–2002	32
1.8	Distribution of inflation rates, Africa, 1999 and 2000	36
1.9	Balance of payments, Africa, 1997–2001	38
1.10	Expanded Economic Policy Stance Index, country scores and clusters, 2001	45
A1.1	GDP growth by economic group, Africa, 2001–02	49
A1.2	Distribution of GDP by sector, Africa, 1980 and 2000	50
A1.3	Annual inflation, Africa, 1995–2000	52
2.1	Components of GDP, South Africa, 1995–2000	63
2.2	Government revenue, South Africa, 1995–2000	65
2.3	Government expenditure, South Africa, 1995–2000	65
2.4	Balance of payments, South Africa, 1995–2000	71
2.5	Government spending on social services, South Africa, 1995/96–2000/01	76
3.1	Changes in real GDP and sectoral output, Ethiopia, 1995/96–2000/01	85
3.2	Domestic and foreign direct investment, Ethiopia, 1995/96–1999/2000	87
3.3	Number and investment capital of projects, Ethiopia, July 1992–July 2001	87
3.4	Inflation and exchange rates, Ethiopia, 1995/96–2000/01	88
3.5	Balance of payments, Ethiopia, 1991/92–2000/01	93
3.6	Share of major exports in export earnings, Ethiopia, 1992/93–1999/2000	93
3.7	Exports and imports relative to GDP and each other, Ethiopia, 1995/96–2001/2002	93
3.8	Annual changes in the volume of total and selected exports, Ethiopia, 1991/92–1999/2000	95
3.9	Exports by destination, Ethiopia, various years	95
3.10	Selected imports by end use, Ethiopia, 1991/92–1998/99	96
3.11	Terms of trade index, Ethiopia, 1970–97	96
3.12	Debt indicators, Ethiopia, 1985–99	97
3.13	Poverty measures, Ethiopia, 1995/96	100
3.14	Poverty, measured by region, Ethiopia, 1995/96	100
3.15	Estimates of poverty, Ethiopia, 1994 and 1997	100
3.16	Gini coefficients, 1994 and 1997, and elasticity of headcount index relative to mean real spending and Gini coefficient, Ethiopia, 1997	101
3.17	Adult and infant mortality rates, life expectancies, and HIV prevalence, Ethiopia, selected years, 1960–2000	102
3.18	Gross enrolment ratios by education level, Ethiopia, selected years, 1980–97	102
4.1	Nominal GDP and real GDP growth, Zimbabwe, 1995–2001	112
4.2	Estimated GDP growth by sector, Zimbabwe, 2000 and 2001	112
4.3	Savings and investment as a share of GDP, Zimbabwe, 1995–2001	112
4.4	Agricultural production, Zimbabwe, 1999/2000 and 2000/01	117
4.5	Budget deficit and revenue as a share of GDP, Zimbabwe, 1995–2001	126
4.6	Estimated government expenditures, Zimbabwe, 2000 and 2001	126
4.7	External and domestic debt, Zimbabwe, 1995–2000	127
4.8	Trade liberalization policies and reversals, Zimbabwe	130
5.1	Changes in real GDP and sectoral output, Kenya, 1996–2001	138
5.2	Major agricultural products, Kenya, 1996–2000	139

5.3	Nonperforming loans and loan loss provisions, Kenya, June 2000 and July 2001	144
5.4	Various measures of poverty in rural and urban areas, Kenya, 1997	149
5.5	School enrolments and life expectancy, Kenya, 1995–2000	149
6.1	Nigeria in a global context, 1999	156
6.2	Selected economic indicators, Nigeria, 1996–2002	157
6.3	Growth rates and contributions to GDP growth by sector, Nigeria, 1997–2000	159
6.4	External debt, Nigeria, selected years, 1980–2002	160
6.5	Monetary, financial, and other targets and outcomes, Nigeria, 1999 and 2000	166
6.6	Maternal mortality ratio in selected Sub-Saharan African countries, 1980–99	176
6.7	Average household income, Nigeria, 1992 and 1997	177
6.8	Major economic and social targets for 2003, Nigeria	178
7.1	Selected macroeconomic indicators, Morocco, 1999–2001	188
7.2	Distribution of GDP by sector, Morocco, 1998–2000	188
7.3	Agricultural production, Morocco, 1996/97–1999/2000	189
7.4	Public finances, Morocco, 1998/99–2001	193
7.5	Monetary trends, Morocco, 1999–2001	195
7.6	External sector performance, Morocco, 1999–2001	198
7.7	Exchange rates, Morocco, 1997–2001	198
7.8	Medium-term outlook, Morocco, 2002–03	203
8.1	Growth in GDP and consumption, Guinea, 1995–2001	210
8.2	Investment and savings, Guinea, 1995–2001	210
8.3	Trade in goods, Guinea, 1999	217
8.4	Balance of payments, Guinea, 1995–2001	218
8.5	Main training partners, Guinea, 2000	218
8.6	External debt, Guinea, 1995–2001	219
8.7	Central government finances, Guinea, 1999	221
8.8	Commercial banks, Guinea, 1998	223

Data notes

Wherever possible, the report shows fiscal data for the calendar year. Where data for the calendar year are not available, however, fiscal year data are used.

Two years separated by a dash (2000–01) indicate a range of calendar years, while two years separated by a slash (2000/01) indicate a fiscal year or, in the context of agriculture, an agricultural year.

Dollar figures are in current U.S. dollars unless otherwise specified. Billion means 1,000 million.

Foreword

Economic Report on Africa 2002 is the third in an annual series that reviews the continent's economic performance and near-term prospects. Targeted to African and global policy-makers, the reports are meant to stimulate a process of discussion and change. It is in this spirit that each report is disseminated and discussed with African leaders at our annual Joint Conference of African Ministers of Finance, Planning, and Economic Development.

This year's report builds on the work of the two previous reports in laying out an agenda for Africa based on systematic benchmarking of economic performance. The main message of the first report was that most African countries, despite significant progress in macroeconomic policy reforms, still lacked the fundamentals for sustained growth and poverty reduction. The chief message of the second report was that structural transformation—the key to sustained growth and poverty reduction—was not happening fast enough to make inroads on poverty. The report argued that many African economies dependent on the primary sectors in production need to graduate to high-value-added products that could compete in the global marketplace.

This year's report begins with a discussion of broad economic trends in 2001 and prospects for 2002. The main finding? Africa weathered the direct effects of the global slowdown in 2001. Some of the reasons were structural: Africa's weak integration into the world economy and the composition of African trade. Others were fortuitous: new access to the U.S. market and buoyant agricultural production due to good weather. Still others were a relief: lower oil prices and the reduction or cessation of conflict in several countries.

The report also reveals general improvements in policy. These are reflected in the Expanded Economic Policy Stance Index, which combines quantitative elements of fiscal, monetary, and exchange rate policies with the results of the Country Sustainability Assessment Survey. Those qualitative assessments take into account judicial independence, respect for property rights, the effectiveness of regulatory institutions, and policies to reduce poverty among women. Of the 23 countries assessed, 10 were rated as having good policies, up from 7 the year before. South Africa had the top score, just ahead of Botswana, followed by Namibia, Swaziland, and Mali.

In a new feature, this year's report supplements the traditional regionwide analysis with seven in-depth country studies. For South Africa, which has the potential to be the locomotive for the continent's growth, moving onto a higher growth path requires narrowing the gap between the modern and peripheral economies through training, broader job opportunities, and better social services. Neighbouring Zimbabwe faces the worst economic crisis of its history: after shrinking by 7% in 2001, the economy is expected to contract by another 5% in 2002. Basic political governance must be restored there to give major economic reforms a chance. Kenya, also suffering from weak governance, expects real GDP growth of 2.5% this year. But it could do even better if it were to patch up its relationships with the International Monetary Fund and the World Bank, sending signals to other

donors and to the private sector. Ethiopia, with its better policies, is reaping much better outcomes, with growth averaging 6% a year over the past few years. The future also looks good—if politics remain stable, the weather stays favourable, and the government exploits the many new opportunities.

For Nigeria the biggest threat is its structural vulnerability—problems of governance, volatile oil prices, and ethnic tensions. But countering this threat is the burgeoning enthusiasm of many Nigerians about rebuilding the economy. Guinea, richly endowed with natural resources, needs to work towards greater policy coherence as it manages the transition from a command to a market economy. Morocco, the fifth largest economy in Africa, did well last year, with good weather boosting growth to 6.5%. And as the government repositions for globalization, it is showing greater commitment to opening the economy—the key to sustaining growth. Future editions of the *Economic Report on Africa* will present in-depth studies of all other African countries—as part of our effort to capture best practices and identify special requirements.

Others of our reports provide indicators for additional aspects of performance, all to aid in monitoring and evaluation and to better inform the policy process. *Harnessing Technologies for Sustainable Development*, to be released in August, presents the Sustainable Development Indicators, which capture country achievements in economic transformation, institutional development, and environmental conservation. On overall sustainability, Mauritius, South Africa, and Botswana rank at the top. But they do less well on environmental sustainability. Of 38 countries, Mauritius is among the bottom three, Botswana is 33rd, and South Africa 17th.

Assessing Regional Integration in Africa, to be released later in the year, presents the Africa Regional Integration Indicators, bringing together different facets of integration to show how well—or poorly—countries are placed to benefit from external markets. The indicators reveal that integration has been slow and uneven. What's needed to progress faster? Political support for integration has to be solidified, with clear strategic priorities established. And the many overlapping regional economic communities need to be rationalized, both in their structure and in their interaction with national governments.

The *Africa Governance Report*, to be released early next year, will present indicators capturing three broad elements of development: political representation, institutional capacity, and economic management and corporate governance. The indicators are intended to help in monitoring efforts to create and sustain capable states—and to promote broader understanding of what constitutes such states. They should also aid in identifying gaps in institutional capacity.

A major focus of our work is thus on tracking performance and progress in Africa. But assessing country performance is clearly not enough. Credible mechanisms are needed to ensure that countries remain on track in implementing policy. That is why, in the context of the New Partnership for African Development, the African Peer Review mechanism is now being developed—to enhance the capability of states, to increase the effectiveness of aid, to stem policy reversals, and thus to accelerate development. The collective action,

mutual learning, and support implicit in such a mechanism can have great benefits, demonstrating to African citizens and the international community that African countries have the political will and commitment to abide by codes and standards that they set for themselves.

To be credible and effective, the peer review mechanism needs to be firmly anchored in rigorous monitoring and evaluation of performance. The Economic Commission for Africa is privileged to have the opportunity to provide support for the New Partnership for African Development and for the African Peer Review mechanism. Indeed, we see each year's *Economic Report on Africa*—with its analysis of trends and prospects and its in-depth country studies—as providing the technical and analytical underpinnings for the African Peer Review mechanism. And we see our other reports, such as those on governance and regional integration, as doing the same.

It is my sincere hope that our work in tracking the performance and progress of Africa's economies will contribute to accelerating the continent's development.

K.Y. Amoako
Executive Secretary
June 2002
Addis Ababa

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Overview—tracking performance and progress



Africa grew faster than any other developing region in 2001, reflecting better macro-economic management, strong agricultural production, and the cessation of conflicts in several countries. But Africa's average GDP growth of more than 4% in 2001 masks wide disparities among countries. Moreover, economic growth remains fragile, and at current rates of progress Africa will not achieve any of the Millennium Development Goals set by the United Nations.

Still, there are many reasons for cautious optimism about Africa's medium-term prospects—including the opportunities created by the U.S. African Growth and Opportunity Act, the European Union's "Everything but Arms" initiative, the New Partnership for African Development, and the launches of the Doha Development Round and the Africa Union. Ultimately, though, Africa's future depends on how it addresses economic and political governance, resolves civil conflicts, and responds to the need for deeper economic and social reforms.

Africa was the only developing region to see faster growth in 2001

Forecasts made soon after the September 11 attacks predicted that economic growth would stagnate in Africa because of lower commodity prices, reduced foreign direct investment, and diminished private capital flows. But the global slowdown has had a much less pronounced impact on Africa than expected. Output has remained relatively strong. Africa's overall GDP growth is estimated to have increased to 4.3% in 2001 from 3.5% in 2000.

Changing commodity prices provide mixed blessings for Africa. Commodity prices are the main channel for transferring external weaknesses to most African economies. Global non-oil commodity prices recovered 2% in 2000 after dropping sharply in 1998 and part of 1999, but prices remained below 1996–97 levels. Moreover, the World Bank's price index for primary commodities from low- and middle-income countries has fallen steadily since 1995.

Terms of trade show no signs of improving in 2001–02. In the first 11 months of 2001 the prices of primary commodities fell in response to the strong downturn in global economic activity. Lowered growth expectations for the world economy after September 11 accentuated weak demand, while supply remained high and the dollar (the currency in which most commodities are priced) stayed strong. In September 2001 average commodity prices were 17% below their cyclical peak of one year earlier.

African exports to the United States jumped. U.S. imports from Africa have grown considerably in recent years, from about \$1.5 billion a month in 1999 to \$2.3 billion a month in 2000. African exports received a further boost with the January 2001 implementation of the U.S. African Growth and Opportunity Act. Although total U.S. imports fell between January and June 2001, imports covered by the act increased sharply—suggesting that these African exports may be insulated from the U.S. economic slowdown.

Africa's emerging markets experienced a sharp increase in private capital flows. Unlike emerging markets in other regions, those in Africa—Algeria, Egypt, Morocco, South Africa, and Tunisia—were not hurt by the September 11 attacks. In fact, between 2000 and 2001 net private flows to these countries nearly doubled, from \$4.9 billion to \$9.5 billion. In addition, net equity investment jumped from \$5.2 billion to \$9.3 billion, mainly reflecting large-scale deals in Morocco and South Africa. Net direct equity grew from \$3.5 billion to \$4.8 billion, driven by privatizations in Algeria and Morocco. And despite weaknesses in global equity markets, net portfolio equity flows shot from \$1.7 billion to \$4.5 billion. Net outflows are likely in 2002, however, as risk-averse investors avoid emerging equity markets. Elsewhere in Africa, stock markets had mixed performance in 2001.

Private credit flows to Africa's emerging markets increased slightly, from a net outflow of \$400 million in 2000 to an inflow of \$200 million in 2001. Still, for a group that includes Africa's largest economy—South Africa—this is an extremely modest amount relative to flows to other regions and to Africa's needs.

Africa has seen a shift in foreign direct investment. Foreign direct investment (FDI) is the most important source of external finance for developing countries—more important than commercial loans, portfolio investment, and official development assistance. Africa's share of FDI in developing countries dropped from 25% in the early 1970s to just 5% in 2000. South Africa is by far the continent's most important source of FDI. Since 1994 South African FDI in other African countries has averaged \$1 billion a year.

Aid to Africa remains low and volatile. Aid to Africa increased from just under \$1 billion in 1960 to \$32 billion in 1991. But by the end of the 1990s aid had fallen to almost half the 1991 level. (Here aid is defined as gross official development assistance—whether grants or concessional loans—from multilateral and bilateral sources.)

Aid from the countries that make up the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD) has been extremely volatile, rising from \$1.3 billion in 1970 to \$23.4 billion in 1991—then falling to \$11.8 billion in 1999. Aid from multilateral organizations has been less volatile, increasing from \$0.4 billion in 1970 to \$9.5 billion in 1994 and then falling to \$6.6 billion in 1999. Aid from Arab countries hardly changed, increasing from \$0.1 billion in 1970 to \$0.3 billion in 1999.

African economies grew faster than expected. In 2001 just 16 African countries experienced GDP growth of less than 3%, down from 27 countries in 2000. The number of countries with growth rates exceeding 3% increased from 26 in 2000 to 37 in 2001, and 3 more countries are expected to join this group in 2002. Thus most African countries appear to

be converging towards growth rates above the “traditional” 3%—with positive implications for poverty reduction.

Africa’s average per capita income grew an estimated 1.9% in 2001—better than the 0.7% increase in 2000 but still not sufficient to achieve the Millennium Development Goal of cutting poverty in half by 2015. In 2001, 30 African countries achieved per capita income growth above 1.5%, and in 2002 this number is expected to increase to 32. Still, raising per capita income remains the biggest challenge for African governments and their development partners.

Economic policies have focused on boosting growth and reducing poverty

Driven by a desire to rapidly reduce poverty, economic policies in Africa in 2000–01 sought to promote macroeconomic stability and higher growth and to improve the delivery of social services. Many governments revived stalled structural reforms such as deregulation and external liberalization. The main themes of economic policy included creating an enabling environment for producers, investors, and employers and improving governance and public finances.

Fiscal policy. In many African countries fiscal policy is now focused on minimizing domestic debt and freeing resources for private sector activity by reducing fiscal deficits and making tax administration and government spending more transparent. But because of higher social spending, among other things, overall fiscal policy was expansionary in 2000.

Monetary policy. To lower inflation, many African governments adopted tight monetary policies in 2000–01. Central banks were compelled to manage broad money supplies by deepening interbank money markets through more regular issues of treasury bills and more effective open market operations.

Exchange rate policy. Exchange rate realignment remained a key challenge, particularly in countries with flexible exchange rates and loose monetary policies. In Africa, where CFA countries have long enjoyed fixed exchange rates through an institutional arrangement with the French government, the 1997–98 East Asian crisis revived a long-standing debate on the merits of flexible and fixed exchange rate systems. CFA countries have preferred fixed exchange rates to promote stable prices, but other countries have relied on managed floating rates.

Prospects for 2002 look favourable

The outlook for African economies in 2002 is shaded by the global slowdown, particularly as it affects South Africa—the continent’s largest economy. But South Africa’s outlook for 2002 is positive, because strong economic fundamentals and a stable macroeconomic environment should allow continued robust expansion over the medium term. Despite increased uncertainty about global economic prospects in the wake of the September 11

attacks, international investors are not writing off emerging markets as an asset class but instead are viewing countries on their own merits.

The three large North African economies—Egypt, Morocco, and Tunisia, which account for 25% of Africa's GDP—provide the greatest potential benefits for Africa in 2002. Macroeconomic conditions are favourable in all three countries: inflation is low, external reserves are adequate, debt has been reduced to more acceptable levels, and substantial progress has been made on structural reforms (particularly privatization and price decontrol).

With oil prices likely to stay below \$20 a barrel this year, African countries are expected to grow by an average of 3.4% in 2002. Thanks to booming oil revenues, real GDP growth in Equatorial Guinea—Africa's fastest-growing economy—continues to be extremely high, at around 65% in 2001. Prospects for continued growth look good with the resolution of a territorial dispute between Equatorial Guinea and Nigeria.

Performance among non-oil exporters is also expected to improve in 2002, reflecting reduced political instability and increased agricultural output. Lower oil prices and a modest recovery in the prices of some key commodities, such as cocoa and cotton, should ease import constraints for several non-oil exporters. In many countries, moderating political instability or the cessation of violence should improve investor and consumer sentiment, and the resumption of official development assistance to some countries will support higher public spending.

African countries present striking contrasts in performance and prospects

The seven countries featured in the report have achieved tremendous progress in some dimensions of well-being and little in others. An important lesson from these seven country studies is how closely related different facets of well-being are. The studies show that lack of progress in some elements—such as those relating to governance—hinders progress in others.

Lessons from Southern Africa—building human capital and promoting good governance are crucial for well-being. Compare South Africa, the continent's largest economy, with Zimbabwe, where impressive progress in reducing poverty and improving health and education in the 1980s has been reversed in recent years.

For South Africa the economic outlook is encouraging. The economy weathered the global slowdown better than most other emerging market economies—from Asia to Latin America. Low external borrowing, depreciation of the rand, and sound financial sector supervision and regulation contributed to the economy's resilience. And thanks to stronger export competitiveness, the country managed to improve its external accounts.

South Africa's macroeconomic fundamentals were robust in 2001. The government met its key fiscal and monetary policy targets. Inflation remained within the target band,

and interest rates fell. But South Africa has been unable to transform its impressive gains on the macroeconomic front into high, sustained economic growth. Real GDP growth has stalled below 3% for the past several years, too slow for robust job creation in a country where unemployment remains around 20%, posing a major development challenge.

Moreover, the South African labour market is highly segregated. Unemployment rates differ sharply between the skilled and the unskilled, groups that are clearly divided along ethnic lines. Further exacerbating the situation, new jobs are created in sectors requiring specialized skills, such as the export and financial sectors, while jobs are disappearing in older sectors depending mainly on low- and semi-skilled intensive labour. Difficulty in finding workers with appropriate skills is becoming a major constraint to growth.

South Africa's integration into the global economy has made science and technology education a growing priority. The move from labour-intensive to knowledge-based production depends on technologically sophisticated production procedures, in agriculture as well as in industry. Thus developing human capabilities is essential to accelerate growth and poverty reduction. The key is education that reflects the demand for skilled labour. The South African government has recognized the importance of improving education standards, and fiscal stability is opening the door to large increases in social spending—particularly in education and health—that should boost the economy's long-term growth potential.

By contrast, the situation in Zimbabwe is dire. An estimated 75% of the population lives in poverty. Unemployment is high and growing. And inflation and the balance of payments are worsening. The economy contracted by an estimated 7.3% in 2001 and is expected to shrink by another 5.0% in 2002. Moreover, the 2002 budget leaves little room for optimism. The budget gives no indication that the authorities will allow market forces to determine interest rates and the value of the local currency. And it provides no timetable for lifting the price controls that are exacerbating shortages of consumer goods and driving large parts of industry and commerce into insolvency. Instead, the government appears to be persisting with the strategies that have contributed to the economic crisis.

Poor weather conditions have contributed to the serious decline in agricultural production in Zimbabwe. But land invasions were the straw breaking the camel's back. They not only contributed to the poorest growth performance by agriculture in several years (−9.5% in 2001). They also sparked distress calls in manufacturing and the financial sector as international confidence in the economy waned, export receipts slumped, and capital inflows tapered off. Growth of manufacturing output decelerated by 5% in 2001, and tourism continued its downward trend as Zimbabwe became the only African country to record a decline in international visitors in 2000.

Economic measures adopted to deal with the crisis in production have proved to be unsatisfactory. As the Reserve Bank of Zimbabwe attempted to control inflation by curbing monetary expansion, the government continued its runaway fiscal spending supported by massive borrowing from the central bank. This policy not only has fuelled inflation but also has crowded out the private sector's access to credit, leading to further

deterioration in employment opportunities for ordinary citizens. Export competitiveness declined as the real exchange rate appreciated with the high inflation rate and fixed nominal exchange rates, while rising production costs stifled manufacturing activity.

Zimbabwe faces a crisis of governance that has effectively put a stop to economic progress. The best opportunity for averting a deepening of the crisis and a worsening of the living conditions of ordinary Zimbabweans lies in improving governance, adopting sound economic policies, and minimizing political alienation and maximizing pluralism. Whether Zimbabwe seizes this opportunity is largely in the hands of the government.

Lessons from East Africa—sound economic management is key to poverty reduction. In East Africa two countries provide an illustrative comparison—Ethiopia, credited with being a well-managed reformer, and Kenya, mired in pre-election uncertainty, locked out of multilateral lending since 2000, and registering only anaemic economic growth over the past five years.

Since 1992 the Ethiopian government has focused on reorienting the economy through market reforms, including structural adjustment. It has cut tariffs, relaxed quota constraints, simplified licensing procedures, eased foreign exchange controls, begun privatization, authorized private banks, decontrolled interest rates, introduced interbank money and foreign exchange markets, and discontinued compulsory cooperative membership and grain delivery. The government has also adopted agriculture-led industrialization as a central plank of its development programme. The strategy focuses on promoting productivity growth on small farms, primarily through an extensive extension programme and labour-intensive industrialization. These reforms, combined with peace and favourable weather conditions for most of the past decade, produced good economic outcomes.

In 1992–2001 real GDP growth averaged 6% a year. Exports grew by about 5% a year, though there was considerable volatility. Inflation averaged about 4% a year. And by 2000/01 investment had risen to 16% of GDP. These outcomes reflect big improvements over 1975–91, suggesting that the policy stance has helped to strengthen economic performance. And the positive trends are expected to continue, with GDP growth of 8.7% in 2000/01 and 7.0% in 2001/02.

Despite the good news on the macroeconomic front, uncertainties remain that may hurt private sector operations and thus economic performance. One issue is contraband trade, which the business community argues has undercut legal operators through cheap imports, limiting their capacity to grow and even endangering their survival. Developments in the financial sector—particularly the anti-corruption campaign, which has affected the country's largest bank, and the withdrawal of some foreign participants—may also have created uncertainty, eroding private sector confidence. These developments appear to have reduced the confidence of bank officials in making business decisions, curtailing credit to the private sector. It is still too early, however, to quantify the effect of these factors on the country's economic outlook.

On the social front, Ethiopia's relatively strong economic growth supported gains in the past decade. The growth reversed the secular decline in per capita income, and the

national poverty rate dropped significantly. Per capita consumption spending rose in both urban and rural areas. Moreover, net school enrolment ratios moved up, and both child mortality and malnutrition rates declined. Still, Ethiopia remains one of the world's poorest countries. The country needs to raise productivity much further and attain significant structural transformation. Effective institutional reform with improved governance and a better civil service will be key in achieving these objectives.

For Kenya the main impediment to development is poor economic governance. Weak infrastructure, widespread corruption, escalating insecurity, poorly managed public resources, and the public sector's inability to deliver services efficiently have undermined development. These governance problems have hurt private sector activities, as shown by the decline in investment. Gross fixed capital formation fell from 21% of GDP in 1995 to 15% in 1999.

Reflecting these circumstances, recent economic trends in Kenya have been disappointing. GDP growth, declining since the mid-1990s, has fallen substantially below the population growth rate, estimated at 2.4%. In 2000 real economic growth turned negative, dropping to -0.3%—its lowest level since independence—from 1.4% in 1999 and 1.8% in 1998. These rates are far below government targets of 2.7% for 2000/01, 3.5% for 2001/02, and 5.0% for 2002/03. Agriculture, which traditionally accounts for the largest share of GDP, shrank by 2.4% in 2000, while real manufacturing output fell by 1.5%. The balance of payments worsened, with current account and trade deficits increasing.

Deteriorating economic and social conditions are also reflected in other key measures. Poverty has increased, and income inequality and social indicators show worrisome trends. In 2001 the number of Kenyans living below the poverty line increased to an estimated 15 million. More than three-quarters of rural and urban poor cannot afford private health care and so depend on public health facilities. Yet nearly three-fifths of the poor do not even seek public health care because drugs are unavailable. Education indicators are also weak for the poor: 13% of the urban poor and 29% of the rural poor have never attended school—and education's high cost is cited as the main reason. Thus the country's most crucial challenge is reviving economic growth and reducing poverty.

To meet this challenge, the government needs to successfully restructure the public sector, reform the management of public spending, strengthen public sector accountability, and combat corruption. It also needs to take steps for the resumption of multilateral lending, which will require passage of a constitutional amendment to re-establish the Kenya Anti-Corruption Authority and an economic crime bill to create a code of conduct for public officials. Since parliament has rejected these bills many times, the prospects for their passage remain slim before the elections that have to be held before January 2003.

Lessons from West Africa—political stability and credible reforms enhance opportunities for integration. In West Africa, compare Guinea with Nigeria. Though both are richly endowed with natural resources, they face different challenges.

Guinea is making tremendous progress in moving from a command to a market economy, though it has been a difficult road. Major reforms undertaken since the political tran-

sition from a socialist regime indicate a political commitment to rehabilitating the economy and fighting poverty. Macroeconomic reforms focus on improving the public sector, liberalizing the exchange rate regime, deregulating prices and interest rates, restructuring the banking sector, monitoring public spending, and strengthening national capacities to manage a market economy—all while emphasizing a participatory approach to development. Though results are not uniform, overall progress has been good.

The Guinean government has also embarked on ambitious reforms in the mining sector, which dominates the country's economic activity and provides much of the employment. The reforms are aimed at improving the sector's legal and regulatory environment and restoring its competitiveness. In addition, the state has initiated a privatization programme to reduce its involvement in mining and encourage private sector prospecting in new regions. These programmes are expected to significantly expand production and create links between mining and other sectors.

To complement these reforms, the government is undertaking massive investments in transport, energy, and telecommunications. It has also introduced a wide-ranging privatization programme, focusing on energy and telecommunications, to encourage private sector participation, especially in building infrastructure. These efforts will help to increase use of the country's largely unexploited mineral resources, bolster its position as an important mineral exporter, and accelerate its economic recovery and integration with the global economy. Moreover, the cessation of cross-border conflicts in the subregion provides an opportunity to increase cross-border trade with Guinea's partners in the Economic Community of West African States (ECOWAS).

Meanwhile, Nigeria is struggling to deliver a "democracy dividend", expected to include faster economic growth and higher standards of living. GDP growth in 2000 and 2001, though higher (at 3.8% and 4.0%) than in 1999, was still too low to bring about an appreciable increase in per capita incomes because of the high population growth (2.9% a year). Economic growth is also insufficient to absorb the 3.5 million secondary school and university graduates joining the labour force every year. So unemployment is increasing, especially among educated youth, and living standards are declining.

The weak growth has made it difficult for Nigeria to meet its external obligations. The country has failed to meet its 2002 debt servicing requirement of \$3.4 billion and has met few of the targets for fiscal consolidation, lower inflation, economic liberalization, and privatization required by the International Monetary Fund. Despite these challenges, the long-term outlook (over the next 5–10 years) remains cautiously positive. Foreign investment is picking up, for example. In February 2002 Shell announced a \$7.5 billion project that will increase oil production in the country by 1.5 million barrels a day.

The optimism in Nigeria's long-term economic outlook stems from two major factors: abundant growth reserves in the form of unexploited natural and human resources, and underused industrial capacity. But Nigeria's recent economic history suggests that the country has rarely committed to the right policy mix to translate its formidable potential into economic performance. Nigeria suffered under the previous military regimes from sub-

stantial leakage of public revenue and dissipation of oil export earnings through mismanagement and political patronage and corruption fuelled by ethnic divisions.

Nigeria's ability to sustain economic growth has also been undermined by its overreliance on oil for both foreign exchange and public revenue. That overreliance has heightened the economy's susceptibility to the vagaries of oil prices.

To ensure sustainable growth and development of the economy, the Nigerian government will need to persevere in maintaining political stability—by improving governance and by providing a durable solution to the rampant ethnic and religious conflicts in the country. It will also need to address the fundamentals underlying its fiscal operations, particularly by building into the federal revenue sharing formula new mechanisms for smoothing out national current spending from oil windfalls. And it will need to commit resources to expanding economic opportunities for Nigerians by opening the economy to international trade and investing in economic diversification and human capital development.

Lessons from North Africa—integration into global markets reduces economic vulnerability and creates new opportunities. The one North African country featured in the report, Morocco, experienced impressive GDP growth in 2001—6.5%, compared with a meagre 0.9% in 2000. But this growth resulted less from the structural adjustments and policy improvements adopted by the government than from the strong agricultural performance, which benefited from particularly favourable weather in 2001. Fully realizing the danger of the country's heavy reliance on agriculture, which has repeatedly proved vulnerable to weather conditions in recent years, the government is taking steps to diversify the economy.

The Moroccan government is also committed to promoting greater integration into global markets, a commitment reflected in policies to attract foreign direct investment from beyond the Middle East and North Africa. These include implementing a transparent privatization programme, removing tariff barriers, reforming financial sector regulations, and strengthening stock exchange operations. The government has also intensified efforts to improve domestic competition, expand rural infrastructure, and reform agriculture—all with the aim of ensuring a more equitable distribution of the gains from trade. Moreover, several improvements have been made in monetary and financial sector policies. The Central Bank has established credibility in maintaining price stability and taken steps to strengthen financial sector supervision and regulation, helping to maintain a healthy banking sector.

Morocco's generally sound macroeconomic environment supports economic diversification and global integration. But the growing budget deficit is emerging as a major threat to reform. Indeed, the deficit remains within an acceptable range only after privatization receipts are taken into account. Once all assets are sold, the government faces a real danger of having to fall back on building up arrears to domestic suppliers and increasing public debt. These are issues that need to be addressed. Success in diversifying the economy away from agriculture and promoting a non-agricultural export sector may also require adopting a flexible exchange rate, a policy advocated by interest groups in tourism and manufacturing. Overall, however, Morocco appears well placed to gain from greater integration into global markets.

The need to track performance across the board

A key part of fostering economic well-being in African countries is having a clear idea of how individual countries are performing. That, indeed, is the main motive for producing the *Economic Report on Africa*.

This year's report shows general improvements in the Expanded Economic Policy Stance Index, which combines quantitative elements of fiscal, monetary, and exchange rate policies with the results of the Country Sustainability Assessment Survey. Those qualitative assessments take into account judicial independence, respect for property rights, the effectiveness of regulatory institutions, and policies to reduce poverty among women. Completed for 23 countries, the index for 2001 shows that 10 have scores rated as good, up from 7 the year before. Nine were rated fair, and 4 poor. South Africa had the top score, inching out Botswana. And Ethiopia moved from fair to good.

In other publications the Economic Commission for Africa will be reporting on country performance in areas important to economic and social development. The Sustainable Development Indicators, improving on previous work for the Economic Sustainability Index, capture country achievements in economic transformation, institutional development, and environmental conservation (see the forthcoming report, *Harnessing Technologies for Sustainable Development*). On overall sustainability, Mauritius, South Africa, and Botswana rank at the top. But they do less well on environmental sustainability. Of 38 countries, Mauritius is among the bottom three, Botswana is 33rd, and South Africa 17th.

The Africa Regional Integration Indicators, just developed by the Economic Commission for Africa, bring together different facets of integration to show how well—or poorly—countries are placed to benefit from external markets. The indicators reveal that Africa's integration has been slow and uneven (see the forthcoming report, *Assessing Regional Integration in Africa*). The average African country conducts only 8% of its trade with other African countries—and 92% with the rest of the world.

The Governance Indicators, also just developed, capture three broad elements: political representation, institutional capacity, and economic management and corporate governance (see the forthcoming *Africa Governance Report*). The indicators are intended to help in monitoring efforts to create and sustain capable states—and to promote broader understanding of what constitutes such states. They should also aid in identifying gaps in institutional capacity.

The way forward—to mutual accountability

Another key part of fostering economic well-being in African countries is having credible commitment mechanisms to reduce the risk of policy reversals and implementation failures. A proposal for an African mechanism was adopted by the Heads of State and Government Implementation Committee of the New Partnership for African Development (NEPAD) in Abuja in March 2002. Following in the spirit of the NEPAD,

the proposed African Peer Review (APR) mechanism will build on the concepts of African ownership and mutual accountability.

The APR mechanism will strengthen African ownership by allowing credible assessments of economic and corporate governance in African countries by Africans. Moreover, it will contribute to accountability, demonstrating to African citizens and the international community that African countries have the political will and commitment to conduct self-monitoring and to take corrective action where needed. And it will promote development by creating systems of good economic and corporate governance—encouraging private investment and enhanced aid flows and thus stimulating growth and poverty reduction. Ideally, the APR process will lead to a convergence of interests for African countries and their development partners.

The APR mechanism also offers the potential to transform African countries' relationships with external partners. By providing a means for assessing progress towards mutually agreed performance targets and standards for both donors and recipients, it will move away from the old model of donor-imposed conditionalities. Mutual accountability is a core element of the new development paradigm endorsed by the NEPAD. And it is a critical part of Africans taking responsibility for the continent's destiny while closing the development gap that has opened over centuries of unequal relations.

The African Peer Review mechanism will not only support mutual accountability. It will also reduce the transaction costs associated with aid recipients' need to negotiate separately with different donors supporting the same project and to account to each of them in turn. It will help eliminate or reduce the tying of aid. And it will help create an environment conducive to greater and more predictable long-term flows of resources.

To be credible and effective, the new peer review mechanism—indeed, the entire set of activities being launched under the New Partnership for African Development—needs to be firmly anchored in rigorous monitoring and evaluation of performance. The *Economic Report on Africa*—with its analysis of trends and prospects and its in-depth country studies—provides some of the technical and analytical underpinnings for those efforts.

Recent Economic Trends in Africa—and Prospects for 2002

Africa grew faster than any other developing region in 2001, reflecting better macro-economic management, strong agricultural production, higher than expected exports under the U.S. African Growth and Opportunity Act (AGOA), currency depreciation in the largest economy (South Africa), and the cessation of conflicts in several countries. These gains were made amid the turbulence created by the global economic slowdown and the September 11 terrorist attacks on the United States. But Africa's average GDP growth of 4.3% in 2001 masks wide disparities, from growth of 65.0% in Equatorial Guinea to -7.5% in Zimbabwe. Moreover, economic growth remains fragile, and at current rates Africa will not achieve any of the Millennium Development Goals set by the United Nations.

Still, there are many reasons for cautious optimism about Africa's medium-term prospects—including the opportunities created by the U.S. African Growth and Opportunity Act, the European Union's "Everything but Arms" initiative, the New Partnership for African Development (NEPAD), and the launches of the Doha Development Round and the African Union. Ultimately, though, Africa's future depends on how it addresses economic and political governance, resolves civil conflicts, and responds to the need for deeper economic and social reforms.

Africa grew faster than any other developing region in 2001

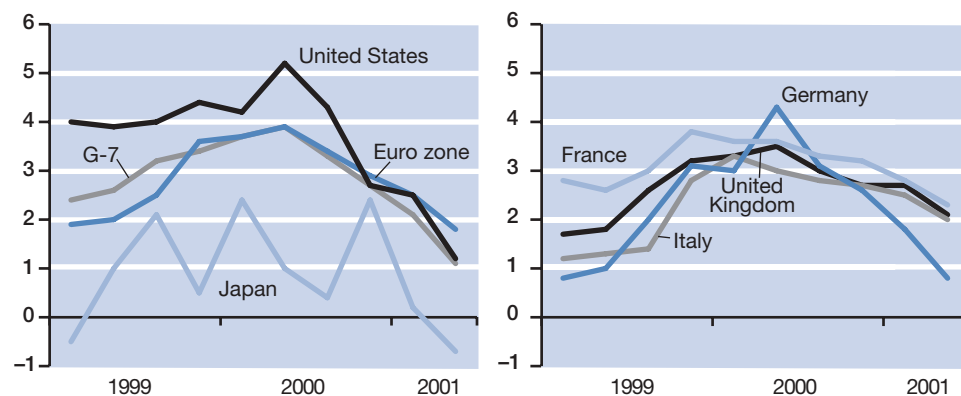
The global economy slowed in 2001

The global economy underwent significant adjustments in 2001. Excess capacity in production of telecommunications equipment and computer hardware—partly reflecting a sharp drop in demand—reduced output and world trade. This reduction was most marked in East Asia, but imports—and hence exports—have been declining in most major economies since at least mid-2001. World trade in goods and services increased by no more than 2% in 2001, down from nearly 13% in 2000. In 2002 global demand for exports from developing countries is projected to drop about 10%.

Economic activity slowed in all of the seven main industrial countries (G-7) in 2001 (figure 1.1). Between the first and second quarters of 2001 real GDP rose just 0.1% in the United States and the euro zone, and in Japan economic activity fell sharply (table 1.1).

Figure 1.1

*Quarterly changes in real GDP, Group of Seven industrial countries, 1999 Q1–2001 Q2
(percentage change over same period of previous year)*



Notes: Based on seasonally adjusted data. The G-7 are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Source: Economic Commission for Africa from official sources.

Table 1.1

*Quarterly changes in real GDP, industrial countries, 2000 Q1–2001 Q4
(percentage change over previous quarter)*

Country/region	2000				2001			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
G-7	1.0	0.9	0.2	0.5	0.4	-0.1	0.1	—
Germany	1.0	1.2	0.1	0.2	0.4	0.0	-0.2	-0.3
Italy	0.8	0.3	0.5	0.8	0.8	0.0	0.1	-0.2
United Kingdom	0.4	1.1	0.7	0.5	0.6	0.5	0.4	0.0
Canada	1.5	0.5	1.1	0.4	0.3	0.2	-0.1	0.5
United States	0.6	1.4	0.3	0.5	0.3	0.1	-0.3	0.4
Japan	2.0	0.8	-0.7	0.3	1.0	-1.2	-0.5	-1.2
Euro zone	0.9	0.8	0.5	0.6	0.5	0.1	-0.1	—
European Union	0.8	0.8	0.5	0.6	0.5	0.1	0.1	—
Western Europe ^a	0.8	0.8	0.5	0.6	0.5	0.2	0.1	—
Western Europe, North America, and Japan	1.0	0.9	0.3	0.5	0.4	0.2	—	—

Note: Data are seasonally adjusted.

^a Western Europe is defined as the European Union plus Norway and Switzerland.

Source: Eurostat 2002; national statistics.

Box 1.1

The economic effects of the September 11 terrorist attacks

The economic effects of the September 11 2001 terrorist attacks on the United States seemed obvious immediately afterwards. The blow to consumer and business confidence, the likely damage to financial markets, the destruction of physical and human capital, and the negative impact on global economic integration looked certain to tip the U.S. into recession. Asset misallocation—invested capital that does not produce expected returns and cannot easily be converted to uses demanded by new economic realities—would further dampen economic activity. But the likely policy response—further aggressive interest rate cuts by the Federal Reserve and a hefty fiscal stimulus—would ensure a swift and steep recovery.

Were these consensus predictions accurate? U.S. GDP growth had already slowed dramatically in the summer of 2001, from an annual rate of 5% to almost zero, and was headed into negative territory. GDP contracted in the third quarter of 2001 as business investment and consumer spending, though still positive, slowed further. And unemployment rose sharply in October as companies increased layoffs and industrial production continued to decline.

But to the surprise of many observers, economic activity bounced back in November. Falling oil prices, aggressive sales campaigns by U.S. automobile manufacturers, and a rebound in the stock market generated a surprisingly strong gain in retail sales in the fourth quarter. The negative effects of the attacks may have been offset by easier financial conditions—driven by aggressive interest rate cuts by the Federal Reserve, which lowered short-term rates to their lowest level in 40 years (2%), and by a hefty fiscal stimulus from the federal government, boosting demand.

In the medium term the U.S. outlook will be determined by total factor productivity—the variable that determines the growth rate an economy can manage without generating inflation. If the “productivity miracle” of the late 1990s continues, there are strong prospects for a quick recovery. And rapid growth in productivity should occur as long as the long-term implications of the September 11 attacks—higher security costs and greater impediments to global economic integration—do not inhibit productivity gains. The durability of the technology-driven changes in U.S. economic performance in recent years will determine how quickly the economy recovers.

The terrorist attacks in New York City and Washington, D.C. on 11 September 2001 and the start of military responses in Afghanistan on 7 October 2001 amplified the already considerable uncertainty about the U.S. economy and the global economy (box 1.1). By the fourth quarter of 2001 it was clear that the United States, the world’s largest economy, was in recession. The U.S.-based National Bureau for Economic Research determined that the recession began in March 2001, bringing to an end the country’s longest economic expansion since World War II. In the third quarter of 2001 the U.S. economy shrank 1.1%, and in the fourth quarter the country saw its heaviest job losses in 20 years—with 415,000 jobs shed in October, on top of 213,000 lost in September. Unemployment jumped from 4.9% in September to a seasonally adjusted 5.4% in November—the highest rate since December 1996. In addition, in September 2001 the value of U.S. factory orders fell 5.8%, the biggest drop since January, to a seasonally adjusted \$313 billion.

“Forecasts for world output growth in 2001 had already been lowered before the September 11 attacks”

In the euro zone—Africa’s largest trading partner—economic growth essentially came to a halt in the second quarter of 2001. Quarter-on-quarter GDP growth was 0.1%, down from 0.5% in the first quarter (see table 1.1). The slowdown mainly reflected much weaker growth in private consumption and falling demand for exports. Between January 2001 and October 2001, 230,000 jobs were cut in the euro area. In Germany more than 4 million people—nearly 10% of the labour force—are unemployed. In addition, fixed investment has fallen, reflecting weaker industrial confidence, increased idle capacity, and a bleaker outlook for sales and profits. The deterioration in economic performance also depressed consumer confidence. In September Germany’s leading business climate index, according to the IFO Institute for Economic Research, suffered its biggest drop since the world oil price shock in 1973.

The economic outlook in the euro area continued to deteriorate after the September 11 attacks in the United States. Manufacturing sank deeper into recession in October as output, employment, and new business orders fell. The data suggest that the euro zone, like the United States and Japan, is headed for a recession. GDP, having contracted 0.1% in the third quarter (on a quarter-on-quarter basis), could fall even more in the fourth quarter.

The United Kingdom, not part of the euro zone but a major African trading partner, had the strongest economic performance among G-7 economies during the second and third quarters of 2001. GDP grew 0.5% in the third quarter, and annual growth is predicted to be 2.2% in 2001 and 2.3% in 2002.

Japan’s economy continued to stagnate in 2001, with falling asset prices and a deeply distressed financial system. Over the past decade Japan experienced three recessions, and many analysts believe that it slipped into another one in 2001. Japan’s GDP fell 0.8% in the second quarter, and industrial production was 4% lower in the third quarter than in the second—and 10% lower than in the third quarter of 2000. Business sentiment also deteriorated sharply between the second and third quarters. External demand has plummeted, particularly for information technology and capital goods. Merchandise exports fell 6% in the second quarter, down 11% from the year before. The drop in exports of goods and services is expected to reduce GDP growth by 0.7 percentage points in 2001, and the balance of trade for goods and services is at its lowest level since 1997.

Is a V-shaped recovery likely?

Forecasts for world output growth in 2001 had already been lowered before the September 11 attacks. In early September the International Monetary Fund (IMF) forecast global growth of 2.6% in 2001, down from the 3.2% expected in May. Forecasts were lowered further after the attacks and now range from 1.5–2.0%—close to the 1.4% in 1991 and 1.1% in 1982, the two preceding years of global recession.

But economic fundamentals are fairly strong in many countries, and policies are being implemented to deal with the economic downturn and the September 11 aftermath. The consensus view in financial markets is that, after another quarter of negative growth, the

U.S. economy will revive in the second quarter of 2002. Almost all U.S. economic indicators have bounced back from post-attack lows and soared above pre-attack levels. U.S. equity rallies traditionally lead economic recoveries by about six months.

Given its enormous size, the U.S. economy will have to lead the world out of the current slowdown. With annual output of more than \$10 trillion in goods and services, the U.S. economy is larger than those of France, Germany, Japan, and the United Kingdom combined—reflecting the explosion in information technology in the late 1990s. In 1995 the U.S. economy was 50% larger than Japan's; today it is more than twice as large. Thus the key questions for 2002 are: How strong will the U.S.-led recovery be? And what form will it take?

The analysis conducted for this report indicates that the U.S. economy will recover gradually, picking up speed in the second half of 2002 and achieving 3% growth for the full year. Such optimism is warranted because the main causes of the recession have abated: real oil prices have fallen 50% from their peak, stock markets have recovered from their post-September lows (though they remain well below the highs reached in 2000), and investment and inventory adjustments have made considerable progress. Although many recent U.S. recessions originated in downturns in consumer spending linked to shocks in consumer confidence—troubles typically rectified with interest rate cuts—the current economic anaemia was spawned by overly optimistic business models and excess capacity.

The absence of inflationary pressures has allowed the Federal Reserve to cut interest rates from 6.5% to 1.75% in less than a year. The yield curve is now sloping strongly upwards. Other central banks have also relaxed monetary policy: the European Central Bank cut rates from 4.75% in early 2001 to 3.25% in November 2001. Reflecting these and other positive signs, growth in the G-7 countries is projected to average 3% in 2002.

The main threat to a global recovery is Japan's economy. Japanese banks have \$600 billion in bad debts, a sum equal to 18% of GDP. In addition, prices are falling 4% a year. This deflation has lowered housing prices, eliminating home equity on nearly half of the mortgages in Japan. Some analysts fear that Japan will try to solve its debt problems by printing money—a move that would depreciate the yen to 160–200 to the U.S. dollar, from about 130 in early 2002. Such a steep devaluation could cause competitive devaluations in China, the Republic of Korea, Singapore, Taiwan (China), and Thailand because they have investment and trade links to Japan. Widespread devaluations in Asia would unleash a flood of low-priced goods onto world markets, hurting emerging African countries and Latin American countries.

Africa was the only developing region to see faster growth in 2001

Forecasts made soon after the September 11 attacks predicted that economic growth would stagnate in Africa because of lower commodity prices, reduced foreign direct investment, and diminished private capital flows. But the global slowdown has had a much less pronounced impact on Africa than expected. Output has remained relatively strong, with

The U.S. economy will have to lead the world out of the current slowdown

***The global slowdown
has had a much less
pronounced impact on
Africa than expected***

growth accelerating in 2001 in countries such as Ethiopia (8.7% growth), Mozambique (9.2%), and Uganda (5.4%). Africa's overall GDP is estimated to have increased to 4.3% in 2001 from 3.5% in 2000.

Africa's resilience to the global slowdown reflects many factors:

- Lower oil prices, which helped 42 oil-importing African countries by easing pressures on foreign exchange, inflation, and public spending.
- Continued improvements in agricultural output across the region—particularly in Morocco, Tunisia, and East Africa.
- Sounder economic management, resulting in stronger economic fundamentals in many countries—with lower inflation, better fiscal positions, and stronger external positions (box 1.2).
- Higher than expected exports under the U.S. African Growth and Opportunity Act (AGOA).
- Reduced conflict and insecurity in Burundi, the Democratic Republic of Congo, Eritrea, Ethiopia, Guinea, and Sierra Leone.
- Currency depreciations in the largest economy—South Africa—and rising domestic demand across the continent, buoyed by strong remittances.

The significance of these factors should not be overstated, however. Many African countries are dependent on international markets, and a sharp and sustained deterioration in global conditions will eventually take a toll on the region's economies.

Changing commodity prices provide mixed blessings for Africa

Commodity prices are the main channel for transferring external weaknesses to most African economies. Global non-oil commodity prices recovered 2% in 2000 after dropping sharply in 1998 and part of 1999 (figure 1.2), but prices remained below 1996–97 levels. Moreover, the World Bank's price index for primary commodities from low- and middle-income countries has fallen steadily since 1995.

Terms of trade show no signs of improving in 2001–02. In the first 11 months of 2001 the prices of primary commodities fell in response to the strong downturn in global economic activity. Lowered growth expectations for the world economy after September 11 accentuated weak demand while supply remained high and the dollar (the currency in which most commodities are priced) was strong. In September 2001 average commodity prices were 17% below their cyclical peak of one year earlier.

Commodity price movements provided mixed blessings for Africa. For most African countries, where oil accounts for up to 30% of merchandise imports, the 56% increase in oil prices in 1999–2000 was a major cause of the inflation and economic slowdown in 2000. Thus the drop in oil prices in 2001 freed resources for other imports and minimized inflationary and other pressures. In Egypt, for example, lower oil prices eased pressures on interest rates,

Box 1.2

Smooth transition to euro bodes well for CFA franc

After three years as a virtual currency, the smooth introduction of the single European currency notes on January 1, 2002, and the currency's initial weakness against the U.S. dollar, boded well for CFA countries. The euro was expected to be a strong currency—but so far its performance has been mixed, declining 22% against the U.S. dollar since 1999 and only marginally strengthening at the beginning of the second quarter of 2002. If the U.S. economy recovers strongly in 2002, as most analysts expect, investors will continue to demand dollars rather than euros—further strengthening the dollar and weakening the euro.

This is good news for CFA countries because one of the main risks of the shift from the CFA franc–French franc peg to the CFA franc–euro peg was that it would lead to devaluation of the CFA franc as the euro appreciated. An overvalued CFA franc would cause a loss of competitiveness. Exports from CFA economies would become more expensive and imports cheaper than competing domestically produced goods. These developments would be especially devastating given the already stiff competition generated by exports from countries outside the region.

The other main fear about the euro's effect on the CFA franc was that France might not support the fixed exchange rate. That seems less likely now. With the launch of the euro, the French Treasury has retained sole responsibility for guaranteeing convertibility of CFA francs into euros without any monetary policy implications for the Bank of France or the European Central Bank. Although the two CFA central banks—Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) and Banque des Etats de l'Afrique Centrale (BEAC)—maintain an overdraft facility with the French Treasury, the amount that can be withdrawn is limited.

Though the launch of the euro was an extraordinary achievement, it has not transformed the euro zone economy or turned it into an autonomous global centre of growth. As a result, CFA countries, with diminished fears of devaluation, will be able to enjoy key long-term benefits of the peg—credible monetary policy and low inflation, leading to a stable and favourable investment climate for both domestic and foreign investors. The benefits to CFA countries that proponents claimed would come from increased exports to the euro zone as it became a major growth centre were always questionable in a region dependent on primary commodity exports.

exchange rates, and domestic investment. Moreover, oil exporters could sustain growth in 2001 using the substantial revenue from the 1999–2000 boom. Thus lower oil prices generally had a positive effect on Africa, where net energy exports constitute only 5% of GDP.

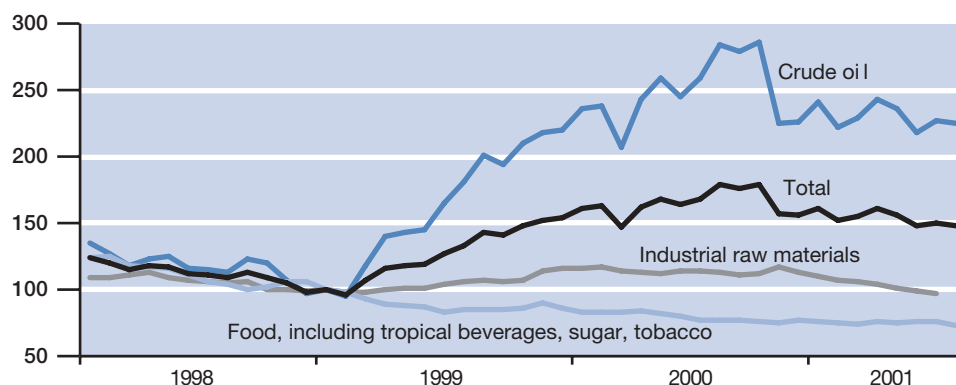
Many African countries, however, depend on commodity exports—and the outlook for commodities is not good. A recovery in commodity prices will require more than a modest recovery in global demand. To draw down inventories, global growth of 4–5% is needed.

Tourism and remittances experienced steady growth

Prospects for tourism in Sub-Saharan Africa remain strong despite the September 11 attacks. Tourism accounts for more than 11% of the region's GDP and is expected to grow

Figure 1.2

World commodity prices, January 1998–September 2001
(Index: January 1999 = 100)



Note: Indexes are based on current U.S. dollar prices.

Source: Economic Commission for Africa from official sources.

“Over the past decade
worker remittances to
Africa have grown
significantly”

by more than 5% a year in real terms through 2010. With Sub-Saharan Africa’s tropical weather, exotic wildlife, pristine coastal areas, proximity to Europe, and low wages, tourism has enormous growth potential.

Kenya’s recent efforts to address problems in the tourism industry seem to have paid off. International arrivals increased 10% between the first eight months of 2000 and the same period in 2001, from 309,000 to about 340,000.

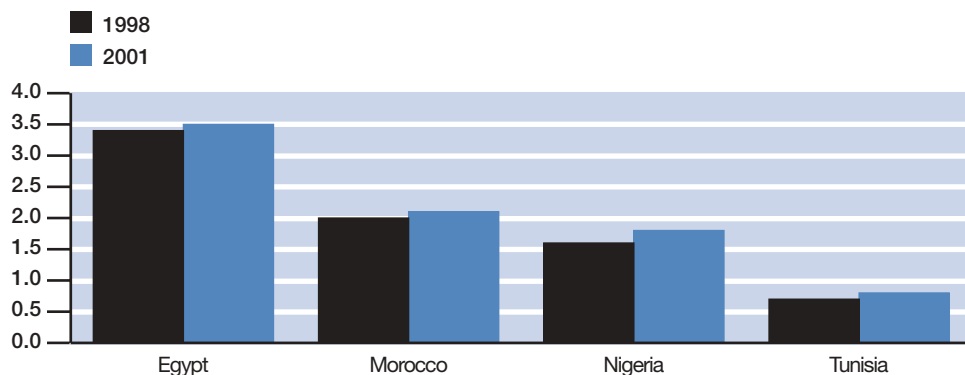
Kenya and other African destinations stand to benefit from the steep fall in U.S. and European air traffic since September 11. For example, South Africa—another major destination for African tourism—has seen an increase in international flights as foreign airlines redirect planes from routes in the United States. South Africa is doing well because it is considered a relatively safe destination.

Western Union—the U.S. financial services giant, with 20,000 outlets in 45 African countries—recently reported that remittances to Africa from Europe, the Middle East, and the United States remained strong through the fourth quarter of 2001. Remittances from Africans working abroad have powerful multiplier effects, with each dollar generating additional dollars for businesses that supply products bought with these resources. Remittances also support consumer demand during economic crises.

Over the past decade worker remittances to Africa have grown significantly (figure 1.3). According to the IMF, remittances exceeded \$100 billion in 1999. But actual remittances are likely much higher. For example, Western Union estimates that \$100 million

Figure 1.3

*Top four African recipients of worker remittances, 1998 and 2001
(billions of U.S. dollars)*



Note: Data for 2001 are estimated.

Source: Economic Commission for Africa from official sources.

in remittances is transferred across southern African borders each year using an informal system of taxi and bus drivers.

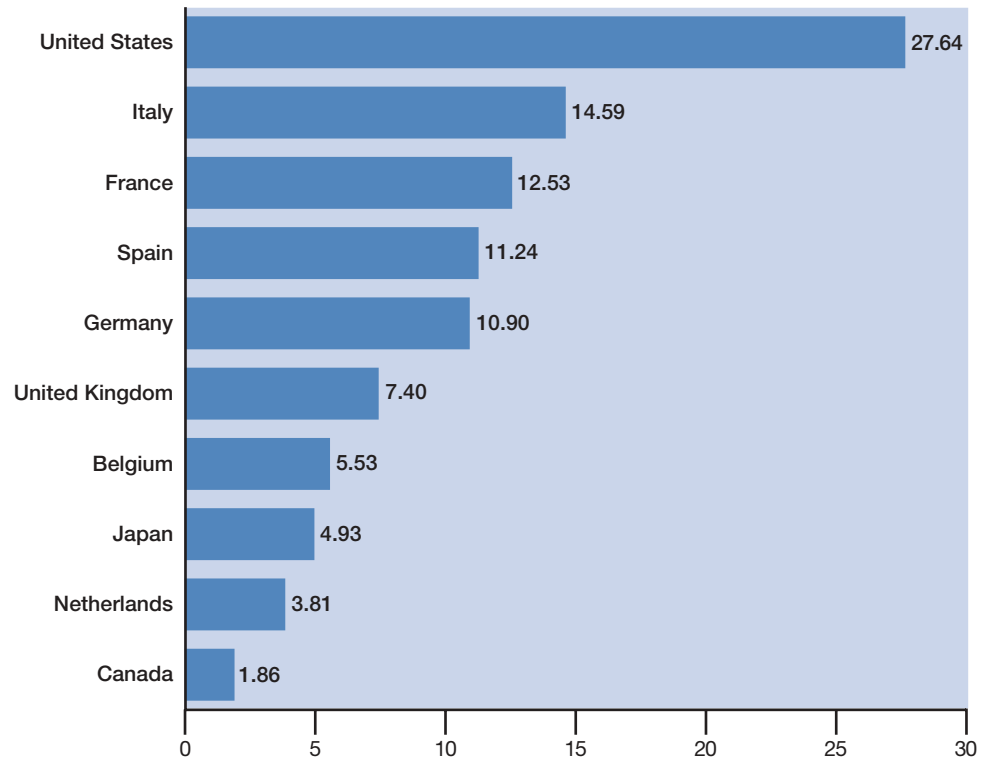
African exports to the United States jumped

U.S. imports from Africa have grown considerably in recent years, from about \$1.5 billion a month in 1999 to \$2.3 billion a month in 2000 (figures 1.4 and 1.5). African exports received a further boost with the January 2001 implementation of the U.S. African Growth and Opportunity Act (boxes 1.3 and 1.4). Although total U.S. imports fell between January and June 2001, imports covered by the act increased sharply—suggesting that these African exports may be insulated from the U.S. economic slowdown.

The composition of these exports explains this pattern. Between January and September 2001 about 91% were energy-related products, reflecting U.S. diversification of sources for such imports. Textiles and apparel, transportation equipment (vehicles), minerals and metals, and agricultural products accounted for the rest. The main exporters under the act were Nigeria (accounting for 56% of the total), South Africa (22%), and Gabon (12%; figure 1.6). Among the 10 top exporters, only South Africa provided a more varied mix of products—with transportation equipment accounting for 57%, followed by minerals and metals (24%), agricultural products (13%), and textiles and apparel (6%).

Figure 1.4

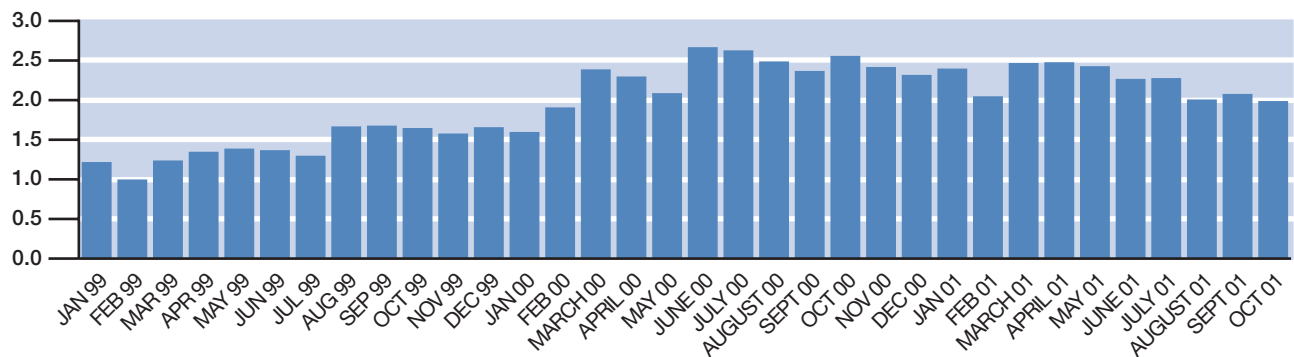
*Top 10 importers from Africa, 2000
(billions of U.S. dollars)*



Source: Economic Commission for Africa from official sources.

Figure 1.5

*U.S. imports from Africa, January 1999–October 2001
(billions of U.S. dollars)*



Source: Economic Commission for Africa from official sources.

Box 1.3

The African Growth and Opportunity Act—a boost for exports, employment, and investment

In June 2000 the U.S. Congress passed the African Growth and Opportunity Act. Among other benefits, the act eliminated U.S. duties on textile imports from eligible Sub-Saharan countries—good news not just for those countries but also for the international textiles industry, which is always seeking new low-wage countries with good access to industrial country markets.

The preferential tariffs provided by the act have provided an enormous boost to the textiles industry in Madagascar, one of the first countries to qualify for benefits. Textile exports surged in 2001, and in the first half of the year U.S. imports from Madagascar totalled \$133 million—a 115% jump from the first half of 2000. Among the most visible beneficiaries of the textiles boom are women who previously earned low, unpredictable incomes selling produce or working in rice fields. Moreover, the boom has spread to other industries such as construction and engineering. Formal employment has more than doubled, boosting tax revenue.

In addition, foreign investment has risen sharply in Madagascar and the 12 other Sub-Saharan countries that have qualified for trade benefits under the U.S. legislation. Lesotho has plans for more than \$120 million in new investments. In Kenya the act will create 50,000 jobs directly and another 150,000 indirectly.

Although the Growth and Opportunity Act has dramatically improved market access for African exporters, the United States retains more than a hint of protectionism. For instance, the act withholds benefits on high-end sweaters—one of the most lucrative textile products—inhibiting about 5,000 potential jobs in Madagascar's textiles industry.

To ensure long-term benefits from better access to U.S. markets, African countries must diversify their economies, investing in the infrastructure and education that attract higher-tech companies. Indonesia and Malaysia achieved this economic transformation in the 1970s, and Mauritius did so recently.

Source: Economic Commission for Africa from official sources.

Africa's emerging markets experienced a sharp increase in private capital flows

Unlike emerging markets in other regions, those in Africa—Algeria, Egypt, Morocco, South Africa, and Tunisia—were not hurt by the September 11 attacks. In fact, between 2000 and 2001 net private flows to these countries nearly doubled, from \$4.9 billion to \$9.5 billion (table 1.2). In addition, net equity investment jumped from \$5.2 billion to \$9.3 billion, mainly reflecting large-scale deals in Morocco and South Africa. Net direct equity grew from \$3.5 billion to \$4.8 billion, driven by privatizations in Algeria and Morocco. And despite weaknesses in global equity markets, net portfolio equity flows shot from \$1.7 billion to \$4.5 billion. Net outflows are likely in 2002, however, as risk-averse investors avoid emerging equity markets. Elsewhere in Africa, stock markets had mixed performance in 2001 (figure 1.7).

“Between 2000 and 2001 net private flows to emerging markets in Africa nearly doubled, from \$4.9 billion to \$9.5 billion”

Box 1.4

Duty-free and quota-free access to U.S. markets for Sub-Saharan textile exporters

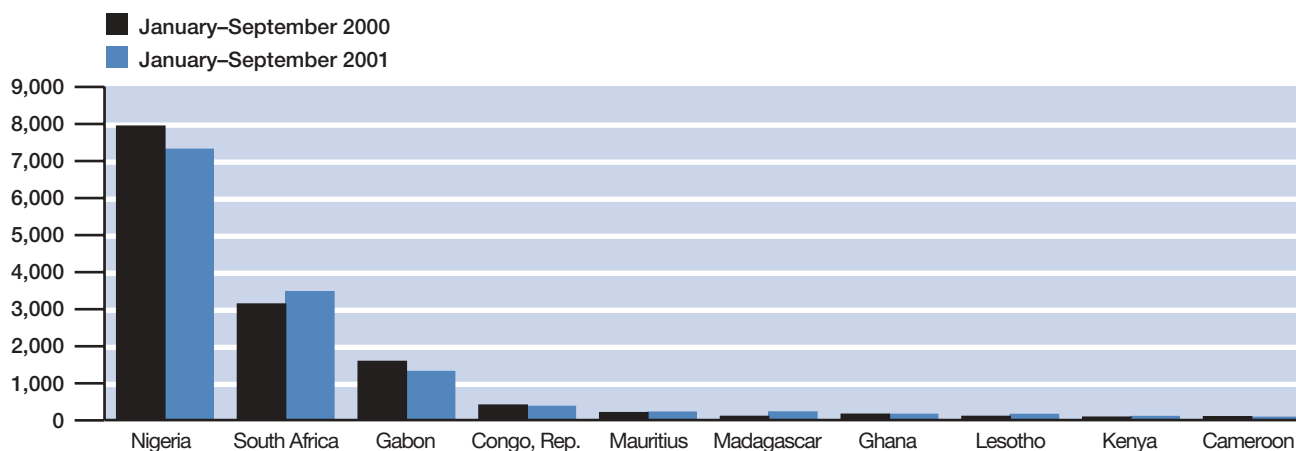
The African Growth and Opportunity Act eliminated U.S. import duties and quotas on all but two types of apparel and textile exports from eligible Sub-Saharan countries. But while 34 countries were deemed eligible for the act's general provisions, a country does not become eligible for the act's apparel provisions until the United States has determined that its customs system prevents the unlawful transshipment of apparel and textile products and the use of counterfeit documents related to the import of such products into the United States.

Through September 2004, however, countries with per capita GNP of less than \$1,500 in 1998 are exempt from U.S. duties on apparel manufactured from fabric produced in third world countries (that is, outside Sub-Saharan Africa and the United States). All Sub-Saharan countries except Botswana, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, and South Africa fall below this per capita threshold.

Source: Economic Commission for Africa from official sources.

Figure 1.6

Top 10 exporters under the U.S. African Growth and Opportunity Act, January–September 2000 and 2001 (millions of U.S. dollars)



Note: Data for 2001 are estimated.

Source: Economic Commission for Africa from official sources.

Table 1.2

External financing of Africa's emerging markets, 1998–2002
(billions of U.S. dollars)

Indicator	1998	1999	2000	2001 ^a	2002 ^b
Current account balance	–6.5	–2.9	7.1	6.0	3.6
External financing	4.3	7.8	4.4	8.8	7.5
Private flows	6.7	10.5	4.9	9.5	8.0
Equity investment	4.7	6.8	5.2	9.3	7.3
Direct equity	1.2	2.1	3.5	4.8	4.9
Portfolio equity	3.5	4.7	1.7	4.5	2.4
Private credit	2.0	3.6	–0.4	0.2	0.7
Commercial banks	0.9	0.2	–0.3	0.4	0.2
Nonbanks	1.1	3.5	–0.1	–0.1	0.5
Official flows	–2.4	–2.7	–0.5	–0.7	–0.5
International financial institutions	0.1	0.5	–0.1	0.0	–0.2
Bilateral creditors	–2.5	–3.2	–0.4	–0.7	–0.3
Resident lending and other financing ^c	0.7	–5.5	–7.9	–7.9	–4.6
Reserves (– indicates increase)	1.6	0.5	–3.5	–6.9	–6.5

Note: Covers Algeria, Egypt, Morocco, South Africa, and Tunisia. All data are calculated in net terms.

a. Estimated.

b. Projected.

c. Includes net lending, monetary gold, and errors and omissions.

Source: Institute of International Finance 2001.

Private credit flows to Africa's emerging markets increased slightly, from a net outflow of \$400 million in 2000 to an inflow of \$200 million in 2001. Still, this is an extremely modest amount for a group that includes Africa's largest economy—South Africa—relative to other regions and to Africa's needs.

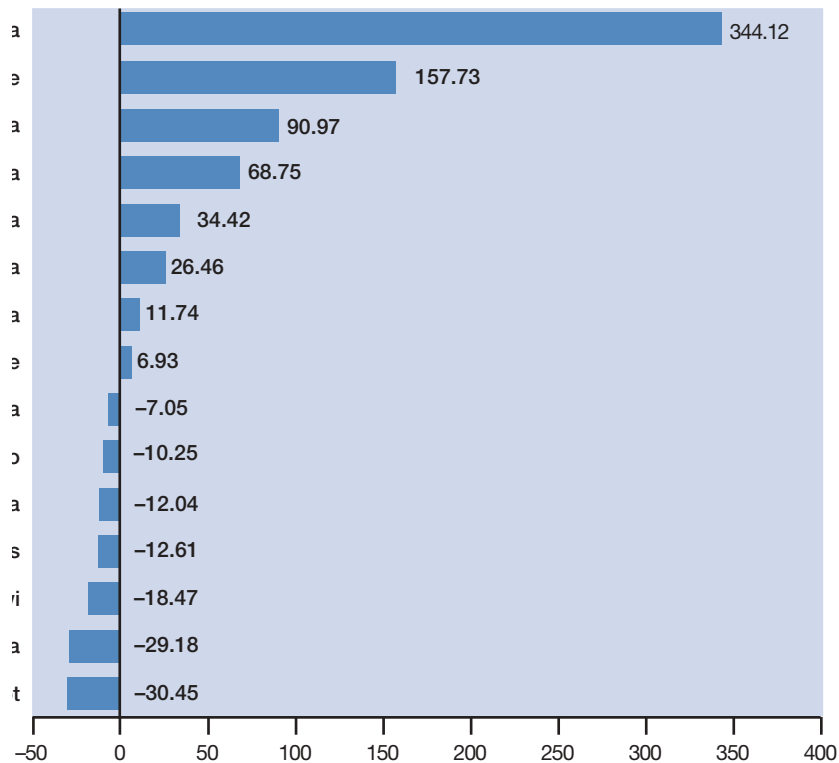
Bond market and other net lending by nonbanks was flat in 2001, reflecting fewer primary bond issues and significant net repayments. Net nonbank lending is expected to grow marginally in 2002, to \$500 million. Immediately after the September 11 attacks the spread between U.S. Treasury bonds and JP Morgan's emerging market index widened by 81 basis points (0.81%). But some African countries were hit even harder—for example, spreads on Nigerian debt had fallen to nearly 1,400 basis points in May 2001 but rose to more than 2,000 basis points in mid-September.

Emerging market equity prices fell particularly hard after the September 11 attacks. By September 18 emerging market equity prices, as measured by the Morgan Stanley Capital International Index, were 23% lower than at the beginning of the year. But prices had started to fall significantly in July, reflecting increased pessimism and uncertainty about the global economic slowdown. Except for South Africa's exchange, which rose 26%, Africa's emerging equity markets lost value in 2001 (see figure 1.7).

“Intra-African foreign direct investment rose during the 1990s”

Figure 1.7

*Stock market performance, various African countries
(percentage change)*



Note: Changes are based on the performance of local stock indexes—except in Uganda and Tunisia, where they are based on market capitalization. In Uganda new listings account for most of the increase in market value.

Source: Wall Street Journal Market Data Group; Birinyi Associates.

“South Africa is by far the continent’s most important source of foreign direct investment”

Africa has seen a shift in foreign direct investment

Foreign direct investment (FDI) is the most important source of external finance for developing countries—more important than commercial loans, portfolio investment, and official development assistance. Africa’s share of FDI in developing countries dropped from 25% in the early 1970s to just 5% in 2000, but this average figure masks a number of interesting trends (Odenthal 2001). First, new sources of FDI have emerged. In the past most FDI in Africa came from a handful of Organization for Economic Co-operation and Development (OECD) countries—mainly France, the United Kingdom, and the United States. During the 1990s, however, FDI from Canada, Italy, the Netherlands, Norway, Portugal, and Spain increased from less than 10% to nearly 25%. Second, FDI from developing Asian economies has also increased, led by the Republic of Korea and followed by China, India, Malaysia, and Taiwan (China). Third, during the 1990s intra-African FDI rose, notably by firms from South Africa and Mauritius.

Table 1.3

Foreign direct investment outflows, selected African countries, 1990–94 and 1995–99
(millions of U.S. dollars)

Country/region	1990–94	1995–99
Côte d'Ivoire	461	186
Ghana	0	297
Kenya	0	87
Mauritius	89	30
Nigeria	2,558	403
Seychelles	18	51
South Africa	3,707	8,738
Zimbabwe	53	110
Africa	7,783	12,037
Sub-Saharan Africa	7,753	10,658
Developing countries	130,037	274,640

Source: UNCTAD 2002.

South Africa leads intra-African flows

South Africa is by far the continent's most important source of FDI. Since 1994 South African FDI in other African countries has averaged \$1 billion a year. South Africa is home to three of the world's largest transnational corporations: Sappi Limited (with \$4.6 billion in foreign assets in 2000), Barlow Limited (\$1.8 billion), and South African Breweries (\$700 million). South African Breweries, the world's fourth largest brewer (by volume), operates in 11 African countries and has extensive holdings in India and Central and Eastern Europe. Similarly, Nedbank, the South African banking giant, has subsidiaries or associated companies in Lesotho, Malawi, Mauritius, Mozambique, Namibia, Swaziland, and Zimbabwe. It also owns 40% of HSBC Equator Bank, which is based in London but has offices in Angola, Côte d'Ivoire, Ghana, Kenya, Mozambique, South Africa, Uganda, and Zambia.

Mauritius is emerging as an important investor in Côte d'Ivoire, Madagascar, Mozambique, Seychelles, and South Africa (table 1.3). Ghana's Ashanti Goldfields—the country's largest company, employer, and foreign exchange earner—has operations in Guinea, Tanzania, and Zimbabwe valued at \$2 billion. It was also the first Sub-Saharan company to be listed on the New York Stock Exchange.

Uganda attracts FDI flows in its nascent manufacturing sector

In 1988–93 FDI in Uganda averaged just \$9 million a year. But in 1994 FDI jumped to \$88 million, and since 1995 it has been more than \$100 million a year. Though small, Uganda's manufacturing activities have attracted the most FDI—particular beverages

“Foreign direct investment in Uganda rose from \$9 million a year in 1988–93 to more than \$100 million a year since 1995”

Table 1.4

*Cumulative foreign direct investment in Uganda by industry, 1991–98
(millions of U.S. dollars)*

Industry	Investment
Manufacturing	422.8
Real estate	56.7
Transport, communication, and storage	70.3
Mining and quarrying	47.7
Tourism (hotels and casinos)	52.0
Agriculture, forestry, and fishing	57.2
Other business services	13.6
Water and energy	0.0
Trade	30.1
Financial services	31.2
Construction	18.1
Social services	12.1
Total	811.8

Source: Economic Commission for Africa from official sources.

but also textiles, sugar, cement, footwear, packaging, plastics, and food processing (table 1.4). Most FDI in agriculture, forestry, and fishing has gone to coffee, tea, and cotton plantations. The liberalization of telecommunications resulted in a major investment by MTN, a South African company that was awarded Uganda's second service license. In addition, the U.S.-owned AES Power Nile is starting a major power project at Bujagali Falls.

Aid to Africa remains low and volatile

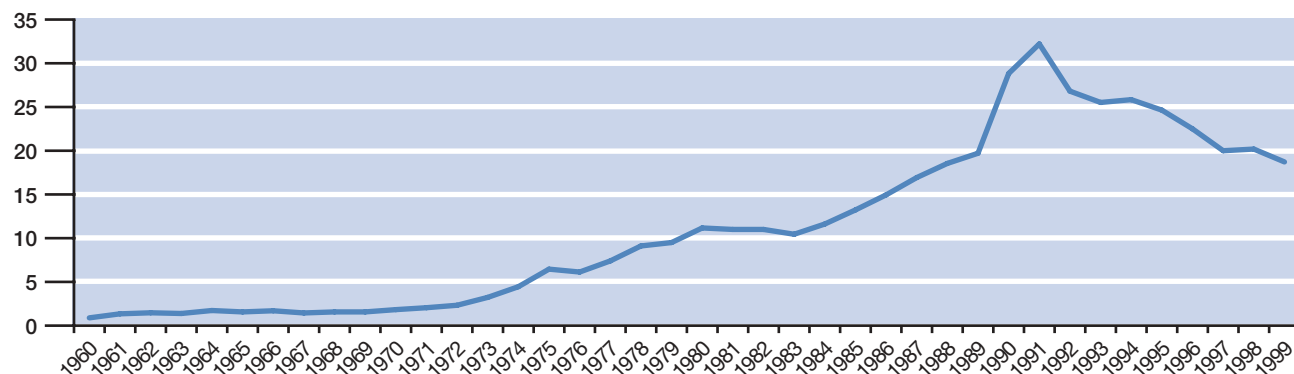
Aid to Africa increased from just under \$1 billion in 1960 to \$32 billion in 1991. But by the end of the 1990s, aid had fallen to almost half the 1991 level (figure 1.8). (Here aid is defined as gross official development assistance—whether grants or concessional loans—from multilateral and bilateral sources.)

The countries that make up the Development Assistance Committee (DAC) of the OECD are the largest source of African aid, though their share of the total fell from 72% in 1970 to 63% in 1999. Multilateral organisations are the second largest source, and their share of the total jumped from 21% in 1970 to 35% in 1999. Africa's remaining aid comes from Arab countries, which accounted for 7% of the total in 1970 and 2% in 1999.

Aid from DAC countries is extremely volatile, rising from \$1.3 billion in 1970 to \$23.4 billion in 1991—then falling to \$11.8 billion in 1999. Aid from multilateral organisations is less volatile, increasing from \$0.4 billion in 1970 to \$9.5 billion in 1994 and then falling

Figure 1.8

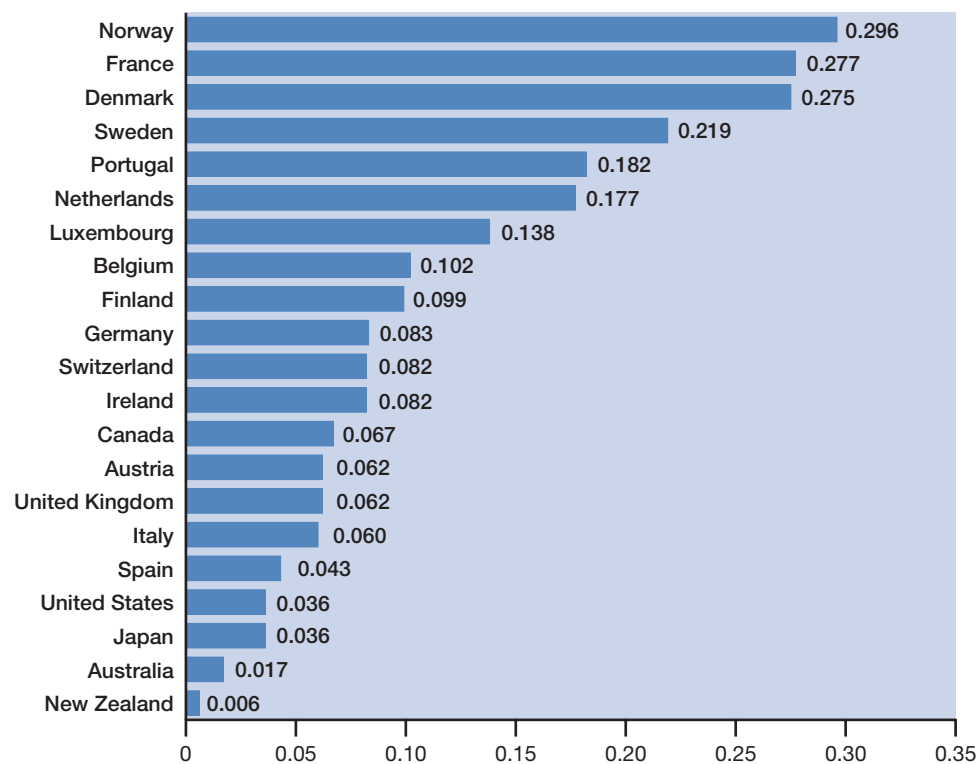
Aid to Africa from all donors, 1960–1999
(billions of U.S. dollars)



Source: DAC 2001.

Figure 1.9

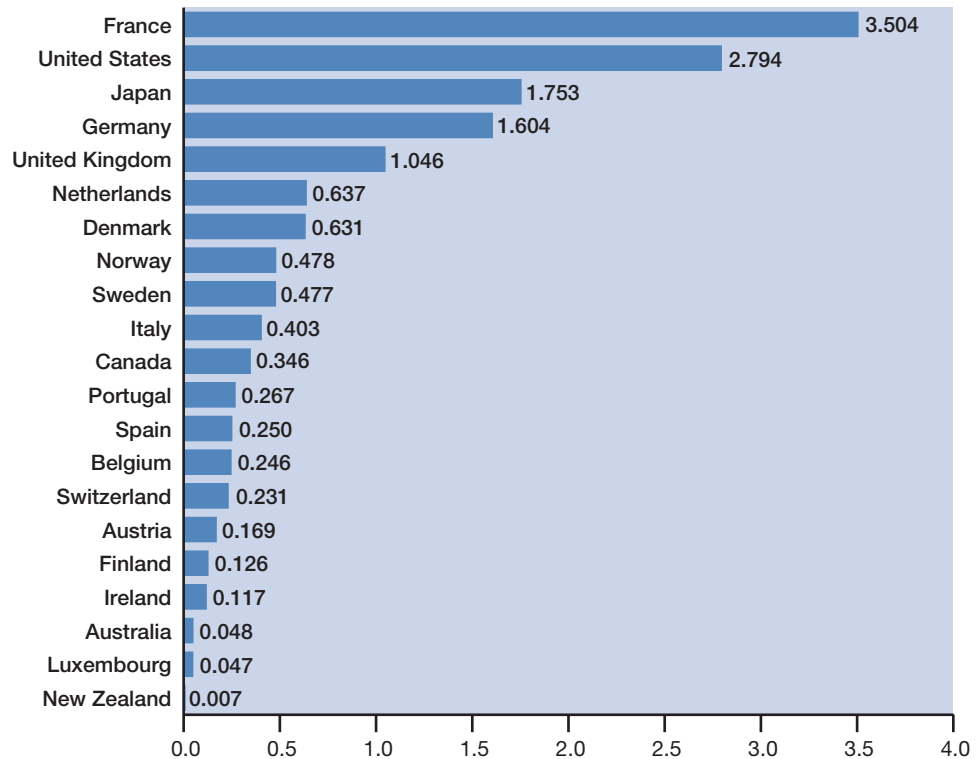
Average aid flows from members of the Development Assistance Committee, 1991–99
(percentage of GDP)



Source: DAC 2001.

Figure 1.10

*Aid per African from members of the Development Assistance Committee, 1999
(U.S. dollars)*



Source: DAC 2001.

*During the 1990s aid to
Africa as a portion of
donors' GNP increased
in just 4 of 21 countries*

to \$6.6 billion in 1999. Aid from Arab countries hardly changed, increasing from \$0.1 billion in 1970 to \$0.3 billion in 1999.

During the 1990s aid to Africa as a portion of donors' GNP increased in just 4 of 21 DAC countries: Denmark, Ireland, Luxembourg, and New Zealand. The OECD target for aid to all developing countries is 0.7% of DAC members' GNP, but few members have achieved that goal. Still, in 1991–99 some rich countries provided significant aid to Africa—Norway provided aid equal to 0.30% of its GNP, Denmark and France provided 0.28%, Sweden provided 0.22%, and Portugal provided 0.18% (figure 1.9). The world's two largest economies, Japan and the United States, provided Africa with aid equal to just 0.04% of their GNP.

African aid per capita varies considerably in terms of DAC country populations, from \$91 a person in Denmark to \$0.06 a person in New Zealand in 1999. The most generous donors in per capita terms are Denmark, Luxembourg, Norway, France, and Sweden. Seen from another perspective, in 1999 France provided \$3.50 in aid per African, the United States provided \$2.79, and Japan provided \$1.75 (figure 1.10). Except for Denmark,

Table 1.5

Distribution of GDP growth rates, Africa, 1999–2002
(number of countries)

Growth rate (percent)	1999	2000	2001 ^a	2002 ^b
Negative	0	1	4	2
0–0.9	1	0	1	2
1.0–2.9	18	26	11	9
3.0–4.9	17	15	12	19
5.0–6.9	12	9	19	14
7.0 and above	5	2	6	7

a. Estimated.

b. Projected.

Source: Economic Commission for Africa from official sources.

Ireland, Luxembourg, New Zealand, and Portugal, DAC countries cut aid per African in the 1990s, with the largest declines occurring in the United States, Finland, Italy, Sweden, Canada, and Germany. Among the 21 DAC countries, 16 provided less than \$1 in aid to the average African in 1999—and 14 donated less than \$0.50.

“Most African countries appear to be converging towards growth rates above the “traditional” 3%”

African economies grew faster than expected

In 2001 just 16 African countries experienced GDP growth of less than 3%, down from 27 countries in 2000 (table 1.5). The number of countries with growth rates exceeding 3% increased from 26 in 2000 to 37 in 2001, and 3 more countries are expected to join this group in 2002. Thus most African countries appear to be converging towards growth rates above the “traditional” 3%—with positive implications for poverty reduction.

In recent years Africa’s slower GDP growth relative to other developing regions has been attributed to its more restrictive conditions on aid, trade, and foreign direct investment. Underlying these factors, however, are the inadequate production and management systems that have resulted from years of poor economic management and social and political instability. To close the performance gap, Africa needs to upgrade its technology and, more important, develop democratic and tolerant political systems, strengthen regional and national security, and foster sound economic management.

During 1999 and 2000 Africa’s terms of trade improved considerably—mainly because of higher oil prices and a partial recovery in gold and metal prices—leading to stronger fiscal and current accounts (table 1.6). In addition, the region’s debt burden declined as a result of higher export earnings and the provision of debt relief to some countries.

Africa’s average per capita income grew an estimated 1.9% in 2001—better than the 0.7% increase in 2000 but still not sufficient to achieve the International Development Goal of cutting poverty in half by 2015. In 2001, 30 African countries achieved per capita income

Table 1.6**Macroeconomic indicators, Africa, 1998–2001**

Indicator	1998	1999	2000	2001 ^a
GDP growth (percent)	3.1	3.2	3.5	4.3
Inflation (percent)	10.8	11.5	13.6	12.6
Terms of trade (percentage change)	–9.4	6.0	18.1	–2.1
Fiscal balance (percent of GDP)	–3.9	–3.3	–1.7	–2.0
Nonfuel commodity prices on world market (percentage change)	–14.6	–8.3	1.2	–4.8
Broad money aggregates (percentage change)	17.0	20.1	19.2	12.3
Current account balance (billions of U.S. dollars)	–20.6	–15.5	2.1	–3.9
External debt				
Billions of U.S. dollars	291.4	290.8	285.1	275.1
Percentage of exports of goods and services	242.0	226.9	183.4	176.6
Debt service payments				
Billions of U.S. dollars	28.1	27.5	28.0	29.4
Percentage of exports of goods and services	23.3	21.4	18.0	18.9

a. Estimated.

Source: Economic Commission for Africa from official sources.

Table 1.7**GDP growth in Africa by region, 1998–2002
(percent)**

Region	1998	1999	2000	2001 ^a	2002 ^b
Africa	3.1	3.2	3.5	4.3	3.4
North Africa	4.4	3.5	4.1	5.8	2.8
Sub-Saharan Africa	2.6	2.9	3.1	3.3	3.7
West Africa	3.6	3.2	2.7	3.3	3.3
Central Africa	4.9	4.4	4.4	4.9	4.4
East Africa	2.5	4.1	3.1	5.0	5.2
Southern Africa	1.7	2.2	3.0	2.4	3.5

Note: Data are weighted by country GDP relative to African GDP.

a. Estimated.

b. Projected.

Source: Economic Commission for Africa from official sources.

growth above 1.5%, and in 2002 this number is expected to increase to 32. Still, raising per capita income remains the biggest challenge for African governments and their development partners.

Slow growth in per capita output reflects the absence of growth in productivity, which in turn is caused by poor resource management and a lack of technological progress. If Africa is to achieve the International Development Goals, these issues must be addressed.

Performance by region

Except for Southern Africa, all African regions achieved decent economic performance in 2001—especially North Africa, where GDP growth averaged nearly 6% (table 1.7). Southern Africa's GDP grew just 2.4%, down from 3.0% in 2000—mainly because of negative growth in Zimbabwe and slower growth in South Africa, reflecting poor harvests. After falling in 2000, average GDP growth rose to 3.3% in West Africa and 5.0% in East Africa, driven by lower prices for oil imports and higher prices for agricultural exports. In 2002 GDP growth is expected to accelerate in East and Southern Africa and slow in North and Central Africa.

The five largest African economies—South Africa, Algeria, Egypt, Nigeria, and Morocco, which account for 59% of African GDP and contain 36% of the continent's population—grew 3.9% in 2001, up from 3.2% in 2000 and 2.7% in 1999. This better performance was due to rapid economic growth in Algeria, Egypt, and Morocco. Although South Africa experienced more stable mineral prices in international commodity markets, it had the slowest growth rate in this group.

Africa's 11 oil-exporting countries account for half of the continent's GDP and just over a third of its population. In 2001 their GDP growth averaged 4.1%, remaining the same as in 2000. Among the 42 non-oil exporters, growth averaged 3.7% in 2001, up from 2.9% in 2000 and 2.7% in 1999. Lower oil prices explain the better performance of the non-oil economies in 2001.

Performance of agriculture and industry

Agriculture

Agriculture significantly influences the performance of most African economies (box 1.5). It accounts for 24% of Africa's GDP, 40% of its foreign exchange earnings, and 70% of its employment. In 2000 about 56% of Africans (431 million people) depended on agriculture for their livelihoods. (In this section and those that follow, 2000 is the most recent year for which complete economic data are available for all Africa countries.) In East Africa agriculture accounted for 39% of GDP, in West Africa 37%, in Central Africa 21%, in North Africa 17%, and in Southern Africa 11%. Although the primary functions of agriculture are realized through the production, exchange, and consumption of agricultural products, the sector has important implications not recognized in the marketplace: natural resource management, environment preservation, social cohesion and stability, and cultural continuity and heritage. Hence agricultural development must promote not only output growth but also improvements in natural resource management and social stability.

“Agriculture significantly influences the performance of most African economies”

Box 1.5

The Doha Development Round—key to African prosperity

A new round of global trade negotiations, dubbed the Doha Development Round, began in January 2002. The negotiations are focused on agriculture and so are crucial to African prosperity. Member countries of the World Trade Organization (WTO) have agreed to negotiate better access to their agricultural markets, reduce trade-distorting support for domestic agriculture, and eventually eliminate subsidies for agricultural exports. A level playing field would enable African farmers to compete more effectively in both domestic and export markets, and could generate an additional \$400 million a year for Africa.

Africa's main goals during the negotiations are for WTO members to:

- Substantially reduce or eliminate all tariffs on agricultural products, including quota duties.
- Substantially reduce or eliminate tariff escalation (that is, when a processed product has a higher tariff than an unprocessed product).
- Simplify complex tariffs—say, by converting all tariffs to an ad valorem or fixed percentage of a product's value.
- Substantially reduce or eliminate market-distorting export subsidies and domestic support.
- Recognize the special needs of the world's least developed countries.

Successful negotiations will require active participation by all of the WTO's 143 members. Africa's concern that it was poorly equipped to participate in the Doha Round was answered by pledges from the international community to help build capacity in complex trade negotiations. This is important, because Africa has committed to negotiating new issues such as investment, competition policy, and environmental concerns.

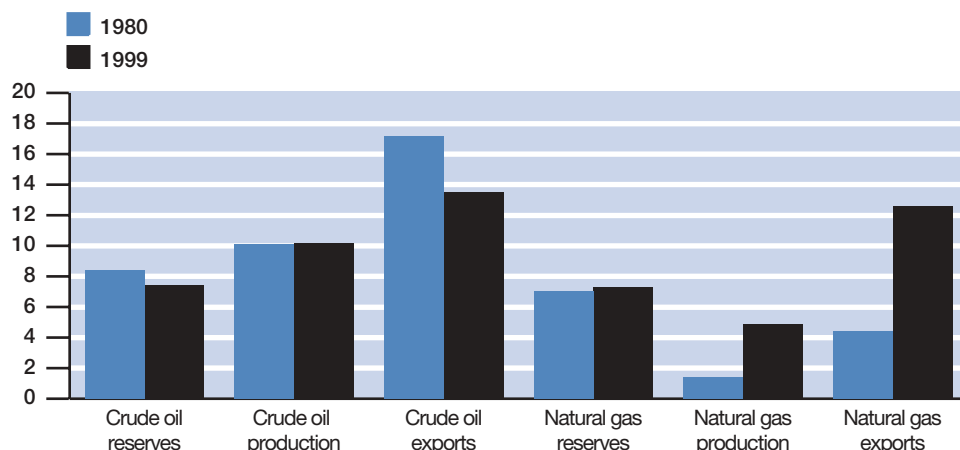
The Doha Round was also a breakthrough for Africa because its ministerial declaration confirms the right of developing countries to provide access to affordable versions of otherwise costly patented drugs during public health emergencies. This is an important breakthrough for African countries, many of which are struggling with the ravages of HIV/AIDS.

During 2000, 42 African countries achieved agricultural growth. The top performers were Malawi (12.7%), Seychelles (9.5%), Zambia (7.4%), Tunisia (6.0%), Senegal and Niger (5.8% each), Mali (5.3%), and Sudan (5.0%). Nine countries experienced negative growth, largely because of delays in seasonal rains: Guinea Bissau (−5.3%), Djibouti (−2.7%), Mauritius (−2.4%), Republic of Congo (−2.1%), Democratic Republic of Congo (−1.8%), Côte d'Ivoire (−1.0%), Somalia (−0.5%), Equatorial Guinea (−0.4%), and Togo (−0.3%). Southern Africa was the best regional performer (5.2%), followed by West Africa (3.5%) and North Africa (3.2%).

Despite massive efforts and investments in agriculture by African governments and their development partners, the sector remains heavily dependent on the weather and largely traditional, dominated by an illiterate and poor workforce and overwhelmed in some countries by civil instability. Recent agricultural policies have placed too much reliance on market forces, neglecting more fundamental structural issues such as technology and extension services, marketing infrastructure, and civil conflicts over land and pasture.

Figure 1.11

Africa's share of world crude oil and natural gas reserves, production, and exports, 1980 and 1999
(Billions of U.S. dollars)



Source: Economic Commission for Africa based on data from OPEC 1999.

Industry

Industry in Africa continued to face challenges from foreign competition, lack of skilled workers, and limited financial resources. In 2000 the industrial sector—comprising manufacturing, mining, construction, and electricity, gas, and water—accounted for 33% of Africa's GDP, with manufacturing and mining accounting for three-quarters of the total.

Many countries secured industrial growth in 2000, notably Uganda (15.2%), Lesotho (11.8%), Angola (7.9%), Mozambique (7.8%), Ethiopia (7.5%), Burkina Faso (7.0%), Benin (6.8%), Algeria (5.9%), Tunisia, Tanzania, Botswana (5.7% each), and Senegal (5.6%).

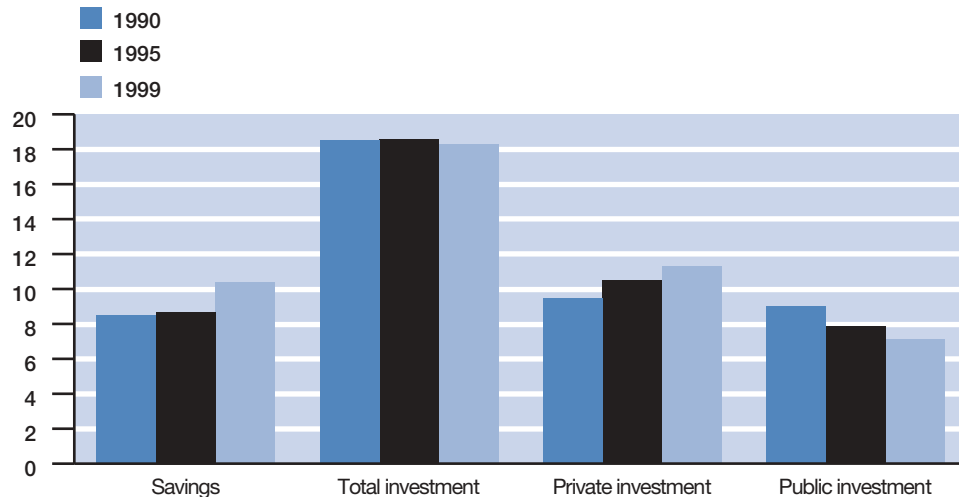
The fastest-expanding industrial subsector was electricity, gas, and water (with a growth rate of 4.9%), followed by construction (3.9%) and mining (3.5%). African manufacturing grew 2.5% in 2000, led by growth in East Africa (4.4%) and Southern Africa (3.5%).

Mining accounted for a substantial share of industrial growth and remains the key to industrial prosperity in many African countries—a potential that has yet to be fully exploited. Africa contains about 30% of Earth's mineral reserves, including 40% of gold, 60% of cobalt, and 90% of platinum. In 2000 the best performers in mining were Ethiopia (13.0% growth), Mozambique (10.3%), Burundi (9.5%), Benin (8.7%), Angola (8.6%), Algeria (7.5%), Botswana (6.2%), Ghana (5.8%), Uganda (5.6%), and Togo and Senegal (5.0% each). The worst performers were Sierra Leone (−10.3%), the Democratic Republic of Congo (−2.8%)—both as a result of civil instability—Côte d'Ivoire (−1.2%), and South Africa (−1.0%).

During 1980–99 Africa's oil reserves grew 1.96% a year and oil productions grew 0.38% a year. Yet because of increased production in other parts of the world, crude oil exports

Figure 1.12

Gross domestic savings, total investment, private investment, and public investment, Africa, 1990, 1995, and 1999
(Percentage of GDP)



Source: Economic Commission for Africa from official sources.

Table 1.8

Distribution of inflation rates, Africa, 1999 and 2000
(number of countries)

Inflation rate (percent)	1999	2000
Negative	9	6
0–4.9	20	20
5.0–9.9	13	14
10.0–19.9	3	4
20.0–50.0	3	4
More than 50.0	3	3

Source: IMF 2001.

dropped from 5.1 million barrels a day in 1980 to 4.7 million in 1999 (figure 1.11). During 1980–99 Africa's natural gas reserves grew 3.6%, production grew 9.8%, and exports grew 10.9%. In 1999 gas production increased 6.2% and gas exports, 6.4%.

Consumption, savings, and investment

African economies remain trapped in a vicious circle of low savings and investment. In 2000 spending on consumption absorbed 88% of Africa's GDP, leaving little for savings and investment. In 32 of 37 countries for which data are available, general government con-

sumption averaged 15% of GDP. In the other 5 countries it was more than 20%: Zimbabwe (23%), Botswana (28%), Namibia (29%), Angola (32%), and Eritrea (65%).

Besides low incomes, the main obstacles to higher savings are inefficient financial intermediation and high macroeconomic volatility. To achieve sufficient growth, Africa requires investment of at least 25% of GDP. But in 2000 gross domestic savings in the region averaged 12% of GDP, indicating a wide gap—13% of GDP—between actual savings and the required investment. Still, 14 African countries have achieved savings rates above 15%: Algeria (32%), Angola (53%), Cameroon (19%), Republic of Congo (48%), Côte d'Ivoire (23%), Equatorial Guinea (58%), Gabon (35%), Guinea (15%), Mauritius (23%), Morocco (15%), Nigeria (18%), Seychelles (20%), South Africa (18%), and Swaziland (21%).

Gross domestic fixed capital formation—spending on fixed assets such as buildings, vehicles, plants, machinery, and the like—was just over 20% of Africa's GDP in 2000, less than the 25% required for industrial takeoff. With many countries privatizing state-owned enterprises, private investment accounts for a growing share of domestic investment and public investment for a shrinking share (figure 1.12).

Inflation

In 2000 Africa's average inflation rate—excluding Angola and the Democratic Republic of Congo—rose to 7.3%, up slightly from 7.0% in 1999. Inflation of more than 50% in Angola (326%), the Democratic Republic of Congo (556%), and Zimbabwe (56%) reflected civil instability (table 1.8). But most countries, notably CFA zone countries, had inflation below 10%—a remarkable achievement given the higher oil prices in 2000. CFA countries pursued tight monetary and fiscal policies consistent with those of the European Central Bank, and some recorded negative or less than 5% inflation. This performance was aided by favourable weather, which supported satisfactory food supplies.

In South Africa high prices were partly caused by high fuel prices and by the depreciation in the rand relative to the U.S. dollar. Higher inflation in East Africa was driven by the 1999/2000 drought, which raised local food prices, and by rising petroleum prices. In North Africa inflation was subdued and is expected to stay that way in 2001–02 due to lower food prices and higher oil prices.

Exchange rates

Several African countries saw their real effective exchange rates appreciate in 2000. Among the causes were worsening terms of trade, government commercial policies that placed a premium on imports, and international movements of capital and incomes.

In addition, between 1999 and 2000, 44 African countries experienced depreciations in nominal exchange rates between their currencies and the U.S. dollar. This change mainly resulted from the adoption of flexible exchange rate regimes. In 23 countries the depreciation was less than 10%. But in 5 countries it exceeded 50%: the Democratic Republic of Congo (1,011%), Angola (201%), Ghana (107%), Malawi (72%), and Zambia (58%). These enormous depreciations were mainly caused by worsening political situations (as in

African economies remain trapped in a vicious circle of low savings and investment

Table 1.9

Balance of payments, Africa, 1997–2001
(billions of U.S. dollars)

Indicator	1997	1998	1999	2000	2001 ^a
Exports of goods	114.4	98.8	105.9	133.1	132.8
Imports of goods	105.2	104.4	104.4	110.4	117.8
Trade balance on goods	9.2	–5.6	1.4	22.7	15.0
Services (net excl. factor incomes)	–10.2	–10.3	–9.9	–11.6	–11.4
Trade balance on goods and services (incl. net factor incomes)	–1.0	–15.9	–8.5	11.1	3.6
Current account balance	–7.8	–20.6	–15.5	2.1	–3.9
Total external financing	27.7	25.6	26.2	13.8	24.1
Non-debt creating flows	24.8	20.7	23.2	13.5	23.1
External borrowing	2.9	4.9	3.0	0.3	1.0
Official creditors	2.2	3.9	2.0	0.1	0.4
Private creditors	0.7	1.0	1.0	0.2	0.5
Change in reserves (– indicates increase)	–10.6	1.9	–3.6	–13.3	–10.5

a. Estimated.

Source: Economic Commission for Africa from official sources.

“Higher unit values for exports and imports caused Africa’s terms of trade to appreciate 18.1% in 2000, the largest increase since the mid-1980s”

Congo and Angola) or declining foreign exchange earnings resulting from poor commodity prices (as in Ghana and Malawi).

Balance of payments

Africa’s export earnings rose nearly 26% in 2000, reflecting a 19% increase in their unit value and 6% increase in their volume (table 1.9). Higher oil prices drove most of the increase in unit value. But a 1.5% increase in volume and 1.7% drop in unit value caused export earnings to fall 0.2% in 2001.

Higher prices and volume were also responsible for a 6.7% increase in import costs in 2001, with a 0.8% increase in their unit value and 4.8% increase in their volume. The higher volume of imports was a welcome break because it enabled higher investment, increased capacity utilization in manufacturing industries, and dampened inflationary pressures—particularly in oil-exporting countries, where demand surged with the higher incomes engendered by oil exports.

Higher unit values for exports and imports caused Africa’s terms of trade to appreciate 18.1% in 2000 (see table 1.6), the largest increase since the mid-1980s. But in 2001 terms of trade fell 2.1% due to falling oil prices.

In 2000 the favourable external environment—particularly for oil exporters—reversed the unfavourable position of Africa’s trade account in 1998–99 (see table 1.9) In 2001 the trade surplus in goods is estimated to have fallen to \$15 billion, driven by movements in oil prices.

Box 1.6***The New Partnership for Africa's Development—an African framework for faster growth and development***

The New Partnership for Africa's Development (NEPAD) is a pledge by all of Africa's leaders to eradicate poverty and move towards sustainable growth and development. The partnership focuses on African ownership of the development process and seeks to reinvigorate the continent in all areas of human activity. Through the partnership, African leaders have agreed to:

- Strengthen mechanisms for conflict prevention, management, and resolution.
- Promote and protect democracy and human rights by developing standards for accountability, transparency, and participatory governance.
- Restore and maintain macroeconomic stability.
- Implement transparent legal and regulatory frameworks for financial markets.
- Revitalize and extend education, technical training, and health care services.
- Promote women's role in social and economic development.
- Promote the development of infrastructure, agriculture, agroprocessing, and manufacturing to meet the needs of export and domestic markets and local employment.

The NEPAD document draws Africans' attention to the seriousness of the continent's economic challenges, the potential for addressing them, and the challenge of mobilizing support for change. The main strategies proposed include:

- Fostering conditions for long-term peace, security, democracy, and good governance by, among other things, building capacity for early warning systems, addressing political and social vulnerabilities, combating the illicit proliferation of small arms and light weapons, and implementing institutional reforms of public services.
- Promoting the provision of regional and subregional public goods such as water, transportation, energy, environmental management, and other infrastructure—notably telecommunications.
- Developing education and human resources at all levels, and in particular increasing the role of information and communication technology in education and training, inducing a “brain gain” for Africa, and eliminating gender disparities in education.
- Increasing domestic resource mobilization and accelerating foreign investment.
- Creating a conducive environment for private sector activities, with an emphasis on domestic entrepreneurs.
- Promoting the inflow and effective use of official development assistance (to support the provision of international public goods in Africa) by reforming systems for delivering and evaluating aid.
- Pursuing gender equality in education, business, and public service.
- Supporting efforts by the Economic Commission for Africa to strengthen Poverty Reduction Strategy Paper Learning Groups.

Source: Economic Commission for Africa from official sources.

Because African countries are overly reliant on foreign freight, insurance, and banking services to support their export-import trade, the continent's service balance remains in deficit. In 2001 this deficit is estimated to have fallen slightly, to −\$11.4 billion. Driven by higher export revenues in oil-exporting countries, the current account recorded a surplus in 2000 (see table 1.6), but this surplus was not maintained in 2001. Still, the current account deficit fell from 4.8% of Africa's GDP in 1998 to 0.9% in 2001.

Driven by a desire to rapidly reduce poverty, economic policies in Africa sought to promote macroeconomic stability and higher growth and to improve the delivery of social services

Economic policies have focused on boosting growth and reducing poverty

Driven by a desire to rapidly reduce poverty, economic policies in Africa in 2000–01 sought to promote macroeconomic stability and higher growth and to improve the delivery of social services (box 1.6). Many governments revived stalled structural reforms such as deregulation and external liberalization. The main themes of economic policy included creating an enabling environment for producers, investors, and employers and improving governance and public finances.

Stabilization and structural adjustment programmes focused on maintaining tight fiscal and monetary policies and on realigning exchange rates. These measures were complemented by efforts to restructure financial markets, deepen customs and tax reforms, strengthen budget procedures and fiscal discipline, and restructure industrial relations and legal and judicial systems. Many African countries adopted the poverty reduction strategy framework introduced by the World Bank and the IMF, which requires developing clear strategies for investing the savings from debt relief in poverty reduction programmes and defining the human, social, and political environment in which poverty reduction is to be achieved.

Some African countries, suffering from political turmoil and in some cases armed conflict, will not reap all the expected short-term benefits of such reforms. In other countries HIV/AIDS has undermined development efforts and placed new demands on government finances. But in the medium and long term, better economic policies should lead to better economic performance.

Fiscal policy

In many African countries fiscal policy is now focused on minimizing domestic debt and freeing resources for private sector activity by reducing fiscal deficits and making tax administration and government spending more transparent. But because of higher social spending, among other things, overall fiscal policy was expansionary in 2000.

Several governments have increased social spending. Cameroon's implementation of the programme defined in its Poverty Reduction Strategy Paper, with the accompanying \$100 million a year in interim debt service relief under the Heavily Indebted Poor Countries (HIPC) initiative, boosted government spending on health care, primary education, HIV/AIDS prevention, basic infrastructure, and rural development. In some countries, however, social spending faces considerable challenges. To reduce its fiscal deficit from 14%

Box 1.7

Is West Africa on track for a single currency by 2004?

Members of the Economic Community of West African States have agreed to launch a common currency area called the West African Monetary Zone. The aim is to create a single currency and then merge the new currency with the 14-country CFA franc zone in 2004. The plan requires five countries currently outside the CFA franc zone—the Gambia, Ghana, Guinea, Nigeria, and Sierra Leone—to adopt a single currency by 2003. CFA countries have had a single currency since 1948.

As with the European single currency, the success of this project depends on macroeconomic convergence among the new member countries. The convergence criteria are:

- Single-digit inflation by the end of 2000 and of no more than 5% by 2003.
- Gross foreign currency reserves covering three months of imports by the end of 2000 and six months by the end of 2003.
- Central bank financing of the budget deficit limited to 10% of the previous year's tax revenue.
- Maximum budget deficits (excluding grants) of 5% by 2000 and 4% by 2002.

Four of the five countries have achieved the inflation goal. Three have limited central bank financing of fiscal deficits, and two have achieved the targets for foreign reserves and budget deficits. Two of the five countries have met all the criteria.

The CFA zone has been largely successful and has achieved far lower inflation—averaging 2–3% among its members—while in Ghana and Nigeria inflation has remained high. In Nigeria an oil-fuelled fiscal expansion has raised inflation to about 20% in recent years. In Ghana the new government is reigning in fiscal and monetary policy, and inflation is falling—though it is still expected to be about 20% in 2002.

of GDP in 1999 to 4% in 2000 while protecting social programmes, Zimbabwe had to slash other public spending. In Angola social spending did not increase because the government failed to complete its Poverty Reduction Strategy Paper.

In 2000–01 ratios of tax revenue to GDP and of direct tax revenue to total tax revenue increased, though they remain low. Grants continued to play a substantial role in Sub-Saharan Africa, accounting for more than 4% of GDP, compared with about 1% in North Africa. To sustain needed public spending, new strategies are required to raise tax revenues—especially through reforms of direct taxation systems. Tax reforms would generate revenue and improve macroeconomic management through automatic stabilization.

Second-generation fiscal reforms emphasize reducing poverty, improving governance, developing basic infrastructure, and delivering social services more efficiently. These reforms will be executed through public spending planning systems such as the Medium Term Expenditure Framework and the Poverty Reduction and Growth Facility.

Monetary policy

To lower inflation, many African governments adopted tight monetary policies in 2000–01. Central banks were compelled to manage broad money supplies by deepening interbank

“Some African countries, suffering from political turmoil will not reap all the expected short-term benefits of reforms; for others, HIV/AIDS has undermined development efforts”

To improve the external competitiveness of their economies, African governments have been paying more attention to movements in exchange rates

money markets through more regular issues of treasury bills and more effective open market operations.

In the West Africa CFA zone the planned second devaluation of the CFA franc did not occur because economic growth remained positive. Thus the CFA franc remained pegged at 656 to the euro. In 2000 inflationary pressures associated with the 1999 decline in the CFA franc led the regional central bank (the Banque Centrale des Etats de l'Afrique Ouest, or BCEAO) to tighten its policy in line with that of the European Central Bank (box 1.7).

To encourage growth, some central banks—taking advantage of lower inflation—cut their discount rates. For example, Algeria cut its discount rate from 7.05% to 6.0%. Local banks followed suit by revising their lending rates, which fluctuated from 8–10% in 2000, down from 8.5–10.5% in 1999. Some countries, such as Nigeria, used a band system that allowed banks to apply different rates to reflect potential investment risks. Central African CFA countries continued to pursue reasonably tight fiscal policy, while their central banks re-established a measure of restraint in monetary policy. In Ghana interest rates dropped to 39% in October 2001, down from 43% in January 2001.

Exchange rate policy

Exchange rate realignment remained a key challenge, particularly in countries with flexible exchange rates and loose monetary policies. In Africa, where CFA countries have long enjoyed fixed exchange rates through an institutional arrangement with the French government, the 1997–98 East Asian crisis revived a long-standing debate on the merits of flexible and fixed exchange rate systems. CFA countries have preferred fixed exchange rates to promote stable prices, but other countries have relied on managed floating rates.

Most African governments are resistant to devaluing or depreciating their currencies. For example, the weakening of the euro in 2000 made the euro zone more competitive against Moroccan exports—leading Morocco's business community to demand a devaluation of the dinar. But the government resisted this move given its potentially adverse effects on the cost of oil imports and on other macroeconomic conditions. In contrast, Zimbabwe abandoned its fixed exchange rate in August 2000 and carried out a series of mini-devaluations, intensifying inflationary pressures. The central bank of the Democratic Republic of Congo devalued in October 2000, narrowing from 395% to 90% the gap between the official and parallel exchange rate. Egypt moved from a managed float to a managed peg. Ghana's currency, the cedi, depreciated relative to the U.S. dollar in the first half of 2001 due to deteriorating terms of trade for cocoa (the country's primary export) and declining gold prices. But since mid-2001 the cedi has stabilized against the dollar, largely as a result of fiscal prudence (box 1.8).

To improve the external competitiveness of their economies, African governments have been paying more attention to movements in exchange rates—particularly real exchange rates—and adopting macroeconomic policies to reduce their volatility. Among the largest African economies, real exchange rates have been relatively stable in Algeria and Morocco. Nigeria has experienced considerable volatility since the late 1990s. Finally,

Box 1.8

Ghana—a winning combination of smooth democratic transition and sound economic management

When Ghanaian President John Kufour came to power in early 2001, his administration faced daunting challenges, including high unemployment, runaway inflation, dependence on aid, and hard-pressed public services.

Sound fiscal management, however, has achieved impressive results. Ghana's inflation rate dropped from 41% in January 2001 to 25% in August. In the first half of 2001 the cedi depreciated by 38% relative to the U.S. dollar, but in the second half of the year depreciation was just 2.5%. The primary fiscal balance recorded a surplus (1.9% of GDP) for the first time since 1997, a 2.6 trillion cedi (\$350 million) gap in foreign exchange requirements was closed by the end of 2001, and debt service was cut by 2.8 trillion cedi (\$375 million) under the HIPC initiative. And GDP growth—which had been expected to slow because of high inflation, severe imbalances in fiscal and external accounts, and the tight monetary policy announced in March 2001—actually improved, rising 3.5% in 2001 compared with 2.0% in 2000.

With low prices for cocoa and gold and high prices for oil in 2001, Ghana's considerable foreign exchange reserves shrank because vital imports had to be purchased. To improve matters, the government made the country attractive to new investors, luring them into new sectors capable of diversifying the export base. Pro-business legislation, privatization, and proximity to a substantial regional market—including Nigeria—will help attract investors.

Source: Ghana, Ministry of Finance 2001.

South Africa's rand has been depreciating since mid-2001, and in 2002 the exchange rate is expected to fall below 11 rand to the dollar, creating fears of higher inflation and lower foreign investment (box 1.9).

The Expanded Economic Policy Stance Index

The Expanded Economic Policy Stance Index, introduced in last year's *Economic Report on Africa: Transforming Africa's Economies*, combines quantitative aspects of fiscal, monetary, and exchange rate policies with the results of the Country Sustainability Assessment Survey, which has been completed in 23 African countries (up from 21 in 2000). The survey's qualitative assessments give the index greater breadth than one based solely on quantitative data. For example, the survey takes into account judicial independence, respect for property rights, the effectiveness of regulatory institutions, and policies targeted at reducing poverty among women. The survey draws on government employees and officials, members of the business community, resident employees of international organizations, resident employees of nongovernmental organizations (NGOs), academics, and independent professionals.

The scores for the Expanded Economic Policy Stance Index and the corresponding country groups—good, fair, and poor—were obtained by cluster analysis. This analysis

Box 1.9

Is South Africa's falling rand a reflection of regional contagion— or irrational pessimism?

South Africa's rand ended 2001 as Africa's worst-performing currency, down 45% against the U.S. dollar. The rand's precipitous fall since October 2001 has shaken business confidence and started to chip away at South Africa's hard-earned macroeconomic stability. South Africa is Sub-Saharan Africa's economic anchor, so any further loss of confidence could prove disastrous for the region.

The extent and speed of the depreciation cannot be easily explained by economic fundamentals and may be a case of "irrational pessimism"—the opposite of the "irrational exuberance" that U.S. Federal Reserve Chairman Alan Greenspan said was behind the meteoric rise of U.S. equity markets in 2000. The main factor in the rand's decline appears to be political fallout from events in Zimbabwe. But even if the rand has become a barometer for regional investor sentiment, that still does not fully explain its decline—because in the fourth quarter of 2001 no new developments emerged in Zimbabwe's political situation.

Technical factors may explain some of the depreciation. First, the slow pace of South Africa's privatization programme has put a damper on FDI. In addition, some of South Africa's top companies now have their primary listings in London. Second, the Reserve Bank's net open foreign exchange position has made the rand an easy target for speculators. Though the bank's position has been reduced considerably in recent years, at \$4.8 billion it is still large compared with the bank's \$7.5 billion in foreign reserves. In addition, the country's large mining houses have been accused of causing the rand's poor performance by withholding foreign exchange earnings and keeping their usual supply of dollars out of the market. Whatever the cause, the government's strong fiscal position and expected tax cuts should lead to a stronger rand in 2002.

shows that the good cluster consists of 10 countries, up from 7 in 2000 (table 1.10). This year South Africa earned the top score, inching out Botswana. This ranking is commensurate with the strong economic fundamentals reflected in the recent upgrade of South African debt by Moody's. Namibia, Swaziland, and Mali round out the top five. Uganda, ranked eighth last year, slipped out of the top 10 due to uncertainties surrounding the 2001 presidential election and cross-border conflicts in the Democratic Republic of Congo and Sudan.

Ethiopia moved from fair to good based on its Interim Poverty Reduction Strategy Paper, good targeting of poverty reduction efforts to the most disadvantaged, commendable HIV/AIDS awareness, low inflation, and cessation of hostilities with Eritrea. The poor performers were joined by Kenya, which is plagued by political uncertainty and weak regulatory institutions. Otherwise there were no changes at the bottom of the league, with Burundi, Liberia, and Sudan receiving the lowest scores—mostly because of civil or political conflict and economic mismanagement. The average score for the entire sample rose to 4.7, from 4.2 in 2000, suggesting general progress in improving economic policies.

Table 1.10*Expanded Economic Policy Stance Index, country scores and clusters, 2001*

Country/region	Index score	Index cluster
South Africa	8.65	Good
Botswana	8.40	Good
Namibia	8.35	Good
Swaziland	7.20	Good
Mali	6.40	Good
Mauritius	6.32	Good
Mozambique	6.00	Good
Uganda	5.60	Good
Lesotho	5.30	Good
Ethiopia	5.20	Good
Malawi	5.00	Fair
Benin	4.00	Fair
Egypt	4.00	Fair
Niger	4.00	Fair
Nigeria	4.00	Fair
Senegal	4.00	Fair
Togo	4.00	Fair
Zambia	4.00	Fair
Central African Republic	3.00	Fair
Kenya	2.40	Poor
Burundi	1.00	Poor
Liberia	0.80	Poor
Sudan	0.50	Poor
Average	4.68	

Source: *Economic Commission for Africa from official sources.*

The outlook for African economies in 2002 is shaded by the global slowdown, particularly as it affects South Africa—the continent's largest economy. But South Africa's outlook for 2002 is positive, because strong economic fundamentals and a stable macroeconomic environment should allow for continued robust expansion over the medium term. Despite increased uncertainty about global economic prospects in the wake of the September 11 attacks, international investors are not writing off emerging markets as an asset class but instead are viewing countries on their own merits.

South Africa's international credit rating, already in the prime investment grade category, was recently upgraded by Moody's Investors Service. The country's foreign debt is stable at about 30% of GDP, and public debt has fallen to 47% of GDP—well below the internationally accepted safe level of 60%. In the medium term it is unclear what effect Moody's upgrade will have on foreign portfolio investment flows, but it will certainly lower

the cost of government borrowing in international loan and bond markets. GDP growth is forecast to be 3.5% in 2002, up from 3.0% in 2001.

The three large North African economies—Egypt, Morocco, and Tunisia, which account for 25% of Africa's GDP—offer the greatest potential benefits for Africa in 2002. Macroeconomic conditions are favourable in all three countries: inflation is low, external reserves are adequate, debt has been reduced to more acceptable levels, and substantial progress has been made on structural reforms (particularly privatization and price decontrol).

The three large North African economies—Egypt, Morocco, and Tunisia—offer the greatest potential benefits for Africa in 2002

Although the global economic slowdown will likely affect these economies because of their deeper integration with the world economy, strong economic fundamentals should provide a comfortable cushion in the medium term. For instance, the latest IMF statement on Tunisia lavished praise on the government's economic and development policies. The real economy grew 4.7% in 2000 and 6.0% in 2001, inflation remained below 3%, and a flexible exchange rate, prudent fiscal and monetary policies, and increased opening of the economy prevented strong growth from putting excess pressure on domestic resources. Prospects for 2002 remain positive, driven by strong manufacturing growth and solid tourism performance.

Morocco and Tunisia have signed cooperation agreements with the European Union, and EU negotiations with Algeria are under way. The agreements require market-oriented reforms—such as harmonizing standards, rules, and regulations—to eliminate practices that distort trade, including monopolies, government subsidies, and privileges for public enterprises. Thus the EU agreements will provide a strong impetus for North African countries to move towards open trade policies, with substantial benefits for growth and investment.

North Africa's status as one of Africa's main recipients of FDI makes it vulnerable to an expected drop in investment flows—a threat already evident before the September 11 attacks. But this effect will likely be felt with a lag, and economic expansion in Egypt, Morocco, and Tunisia should hold up in 2002. Still, North African economies remain hobbled by their narrow export base. Moreover, trade between them is limited, accounting for a small fraction of each country's total trade. Individually, North African markets are small and highly protected. Trade protectionism takes many forms, including high tariffs, valuation problems, nontariff barriers (such as standards and regulations), and physical barriers at borders. As a result FDI (apart from that associated with privatization) remains low given the region's considerable potential.

Despite a continued decline in world cotton prices, production in West Africa is set to soar in 2002, reflecting favourable climatic conditions and government policies to stabilize farmers' incomes. For the 2000/01 season, cotton output is expected to exceed 2.1 million tonnes, compared with the long-term average of 1.5 million tonnes a year. Among francophone countries the top producers are Burkina Faso, Côte d'Ivoire, and Mali, which account for about two-thirds of regional production. In 2002 Mali's government expects to more than double cottonseed production, to 560,000 tonnes.

After two years of increased spending financed by higher oil revenues, Africa's oil exporters face mixed prospects in 2002. Although they are still receiving considerable revenue, large oil exporters will likely see growth somewhat dampened by lower oil prices, smaller OPEC quotas, and less favourable foreign investor sentiment. Smaller oil exporters should fare better because they are not bound by OPEC quotas and foreign investors continue to be attracted to these countries. For instance, increased output and exports are expected to sustain growth in Angola and Sudan, and Sudan will also benefit from increased production of refined petroleum products.

With oil prices likely to stay below \$20 a barrel in 2002, African countries are expected to grow by an average of 3.4% in 2002. Thanks to booming oil revenues, real GDP growth in Equatorial Guinea—Africa's fastest-growing economy—continues to be extremely high, at around 65% in 2001. Prospects for continued growth look good with the resolution of a territorial dispute between Equatorial Guinea and Nigeria. Nigeria agreed to recognize Equatorial Guinea's sovereignty over the ExxonMobil-operated Zafiro and associated oil fields. In return, Equatorial Guinea conceded a large share of France's TotalFina fields. The agreement will likely boost oil exploration and development in deep offshore waters between the Guinean island of Bioko and Nigeria's Niger Delta.

Performance among non-oil exporters is also expected to improve in 2002, reflecting reduced political instability and increased agricultural output. Lower oil prices and a modest recovery in the prices of some key commodities, such as cocoa and cotton, should ease import constraints for several non-oil exporters. In many countries—the Central African Republic, the Democratic Republic of Congo, the Republic of Congo, Côte d'Ivoire, Eritrea, Ethiopia, Guinea—moderating political instability or the cessation of violence should improve investor and consumer sentiment, and the resumption of official financial assistance to some countries will support higher public spending. Conversely, the civil unrest that may result from upcoming presidential and parliamentary elections in Kenya, Zambia, and Zimbabwe, along with the continuing land reform controversy in Zimbabwe, will likely have a destabilizing effect on travel, tourism, and general economic activity in East and Southern Africa in 2002.

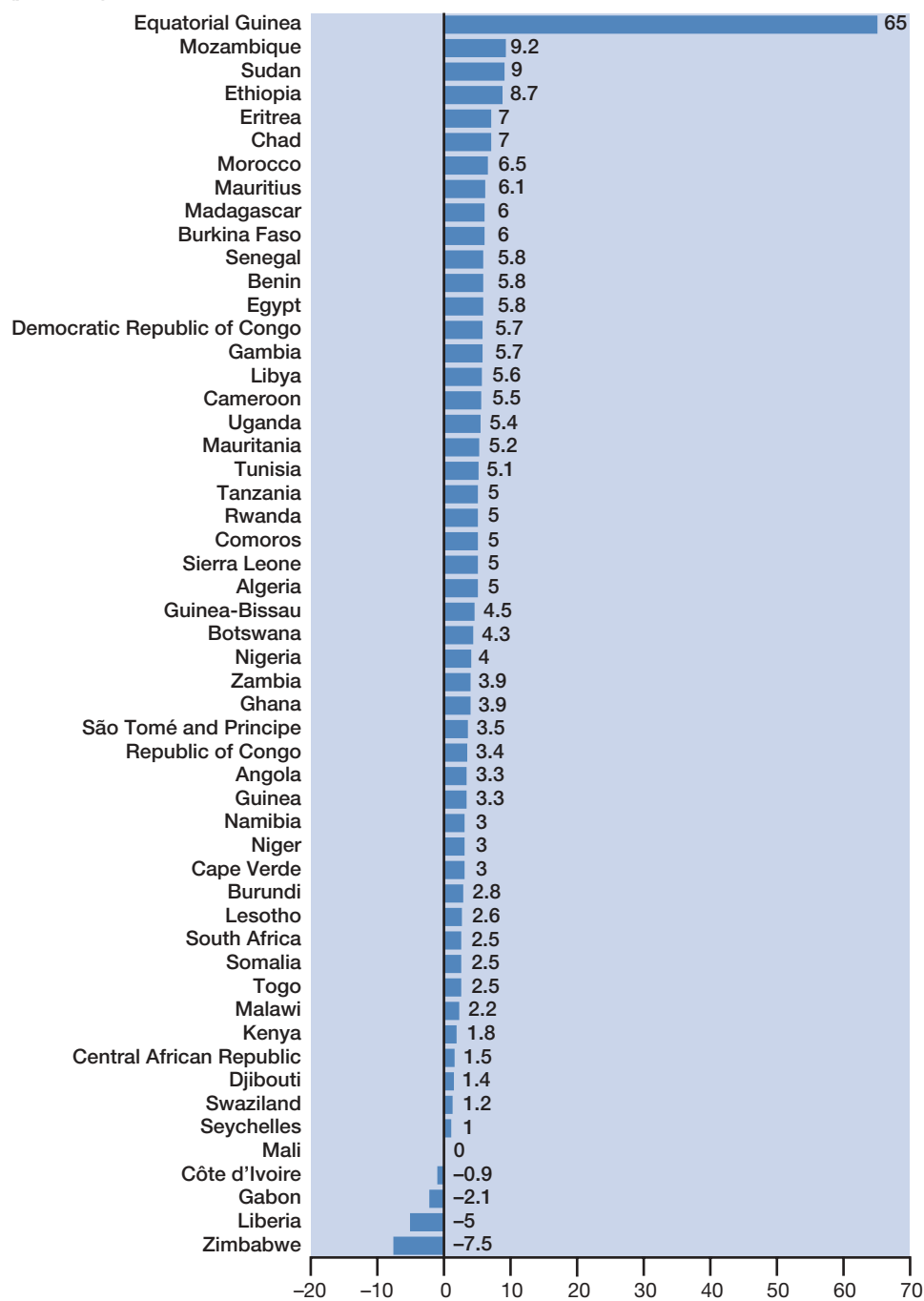
In 2002 some countries—Benin, Ethiopia, Mali, Niger, Senegal, Tanzania—will benefit from debt relief under the enhanced HIPC initiative. Tanzania should see debt repayments slashed from \$193 million in 2000 to \$116 million in 2002, a savings of \$77 million. Mozambique will benefit from an estimated 73% reduction in its external debt stock and a halving of its external debt service obligations.

Africa's oil exporters face mixed prospects in 2002, while performance among non-oil exporters is also expected to improve

Annex

Annex figure A1.1

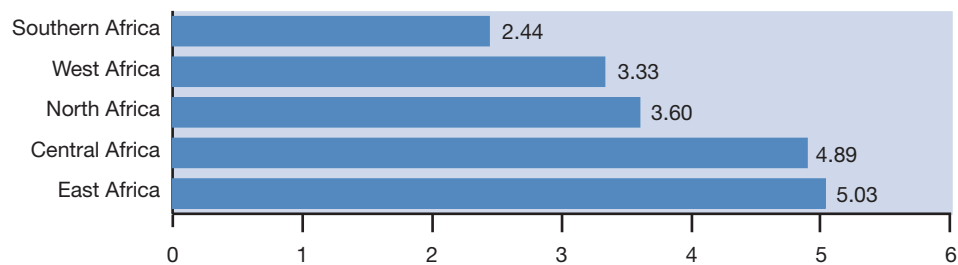
*Estimated GDP growth, African countries, 2001
(percent)*



Source: Economic Commission for Africa from official sources.

Annex figure A1.2

*Estimated GDP growth by region, Africa, 2001
(percent)*



Source: Economic Commission for Africa from official sources.

Annex table A1.1

*GDP growth by economic group, Africa, 2001–02
(percent)*

Group	Number of countries	Share of Africa's GDP, 2000	Share of Africa's population 2000	Mean growth rate	
				2001 ^a	2002 ^b
Top five economies	5	58.8	35.8	3.9	2.8
Oil exporters	11	49.1	35.0	4.1	2.8
Non-oil exporters	42	50.9	65.0	3.7	3.9
Least developed countries	33	16.5	48.1	4.8	6.2
Island economies	6	1.6	2.4	5.3	5.3
Landlocked countries	15	9.8	23.0	3.5	4.0
Sub-Saharan Africa	46	59.5	77.7	3.2	3.7

a. Estimated.

b. Projected.

Source: Economic Commission for Africa from official sources.

Annex table A1.2

*Distribution of GDP by sector, Africa, 1980 and 2000
(percent)*

Region/country	Agriculture		Industry		Manufacturing		Services	
	1980	2000	1980	2000	1980	2000	1980	2000
Africa	22.3	20.0	39.0	26.3	8.7	13.2	38.7	53.7
North Africa	13.5	16.6	48.5	37.6	8.8	11.3	38.0	45.8
Algeria	8.3	5.7	59.0	57.9	7.8	8.9	32.7	36.4
Egypt	19.3	19.3	41.5	27.7	13.6	10.4	39.2	53.0
Libya	2.5	8.3	64.5	51.1	3.0	9.4	33.0	40.6
Mauritania	24.3	27.9	29.2	26.8	6.3	6.5	46.5	45.3
Morocco	18.3	16.6	34.3	28.4	19.3	15.9	47.5	55.0
Sudan	36.9	37.5	15.9	16.2	7.8	9.5	47.1	46.3
Tunisia	15.6	20.2	36.6	35.7	13.6	19.4	47.8	44.1
West Africa	33.7	36.3	18.6	28.6	5.9	7.7	47.7	35.1
Benin	47.9	39.2	13.8	18.6	6.1	6.3	38.2	42.2
Burkina Faso	46.9	37.7	14.7	30.8	11.9	13.6	38.4	31.5
Cape Verde	20.5	20.8	27.3	30.9	5.5	7.8	52.1	48.3
Côte d'Ivoire	35.4	26.2	20.8	20.9	11.2	13.5	43.8	52.9
Gambia, The	25.4	23.2	17.4	12.8	6.7	5.7	57.1	64.0
Ghana	46.8	62.6	12.7	13.4	7.6	8.6	40.5	23.9
Guinea	45.8	45.8	21.5	22.1	3.2	3.3	32.7	32.1
Guinea-Bissau	51.0	56.2	6.0	4.6	1.7	1.3	42.9	39.2
Liberia	15.7	33.9	33.6	26.9	9.1	10.9	50.7	39.2
Mali	61.2	56.8	10.0	12.8	3.7	5.7	28.7	30.4
Niger	44.5	49.6	19.0	15.6	3.7	3.2	36.5	34.8
Nigeria	20.6	31.3	41.7	39.1	5.7	4.6	37.6	29.6
Senegal	21.1	22.7	27.7	33.0	17.2	19.7	51.1	44.3
Sierra Leone	31.9	31.1	19.5	19.8	4.5	11.1	48.6	49.0
Togo	30.5	26.9	23.4	30.5	4.9	7.8	46.1	42.5
Central Africa	28.9	20.9	32.7	38.2	6.8	10.1	38.4	40.9
Cameroon	30.3	21.7	28.0	35.8	8.4	12.8	41.7	42.5
Central African Rep.	39.6	45.4	19.2	16.6	7.5	10.1	41.2	37.9
Chad	41.7	42.8	12.2	9.3	8.8	6.7	46.1	47.8
Congo, Rep.	9.5	10.5	49.3	47.1	6.6	6.7	41.2	42.5
Equatorial Guinea	41.5	37.5	11.9	10.0	5.1	3.7	46.6	52.5
Gabon	6.1	7.8	64.7	59.2	6.4	5.1	29.3	33.0
São Tomé and Príncipe	37.1	22.9	22.0	23.4	8.4	9.4	40.9	53.7
East Africa	32.6	38.3	16.6	18.2	8.3	7.5	50.8	43.5
Burundi	61.1	49.7	13.5	15.0	8.2	8.2	25.3	35.2
Comoros	46.3	43.4	16.5	14.3	5.7	4.8	37.1	42.3
Congo, Dem. Rep.	34.0	30.8	25.3	35.8	2.8	2.4	40.6	33.4

Annex table A1.2 (continued)

*Distribution of GDP by sector, Africa, 1980 and 2000
(percent)*

Region/country	Agriculture		Industry		Manufacturing		Services	
	1980	2000	1980	2000	1980	2000	1980	2000
Djibouti	4.6	2.5	21.1	15.2	10.1	5.0	74.4	82.3
Ethiopia	50.3	45.5	15.5	10.8	10.7	5.6	34.2	43.7
Kenya	32.4	23.8	21.7	18.8	12.7	11.9	45.9	57.5
Madagascar	42.6	41.8	18.0	16.0	11.5	10.1	39.3	42.2
Rwanda	44.8	40.2	19.4	17.1	14.2	8.7	35.8	42.8
Seychelles	7.8	5.5	20.4	26.0	10.5	17.3	71.8	68.5
Somalia	38.7	60.3	19.6	7.1	8.2	2.5	41.7	32.6
Tanzania	46.3	51.8	15.6	14.5	10.2	4.7	38.1	33.8
Uganda	73.8	50.0	5.2	14.5	4.4	8.2	20.9	35.5
Southern Africa	22.9	11.0	28.3	37.4	10.8	20.5	48.8	51.6
Angola	42.4	43.1	30.5	30.1	2.6	2.2	27.1	26.8
Botswana	13.8	4.6	46.6	56.0	6.9	4.1	39.6	39.4
Lesotho	22.6	9.3	22.7	51.7	6.0	13.8	54.7	39.0
Malawi	38.1	34.7	21.8	17.3	13.9	11.5	40.1	48.0
Mauritius	14.3	7.9	24.7	34.3	15.7	24.4	60.9	57.7
Mozambique	42.8	49.3	16.6	25.4	8.8	14.2	40.6	25.3
Namibia	—	11.1	—	31.3	—	7.3	—	57.6
South Africa	—	5.0	—	39.4	—	22.9	—	55.6
Swaziland	24.8	16.1	31.8	33.9	22.0	25.5	43.3	50.0
Zambia	14.3	30.3	34.9	37.9	17.7	27.2	50.8	31.9
Zimbabwe	16.0	19.6	36.5	28.9	25.1	19.8	47.5	51.5

Note: Manufacturing is a subset of industry.

Source: Economic Commission for Africa from official sources.

Annex table A1.3**Annual inflation, Africa, 1995–2000***(percentage change in consumer prices)*

Country	1995	1996	1997	1998	1999	2000
Africa^a	19.7	15.4	10.2	8.1	7.0	7.3
Algeria	29.8	18.7	5.7	5	2.6	0.3
Angola	2,672.2	4146	221.5	107.4	248.2	325
Benin	14.5	4.9	3.8	5.8	0.3	4.2
Botswana	10.5	10.1	8.8	6.5	7.2	8.5
Burkina Faso	7.8	6.1	2.3	5	–1.1	–0.2
Burundi	19.4	26.4	31.1	12.5	3.4	24.3
Cameroon	25.8	6.6	5.1	0	2.9	0.8
Cape Verde	8.4	6	8.6	4.4	4.4	–2.4
Central African Rep.	19.2	3.7	1.6	–1.9	–1.5	3.1
Chad	9.1	11.8	5.9	4.4	–8	3.8
Comoros	7.1	2	3	3.5	3.5	4.5
Congo, Dem. Rep.	541.8	616.8	198.5	106.9	269.6	553.7
Congo, Rep.	8.6	10.2	13.2	1.8	3.1	0.4
Côte d'Ivoire	14.3	2.7	4.2	4.5	0.7	2.5
Djibouti	4.9	3.5	2.5	2.2	2	2.4
Egypt	9.4	7.1	6.2	4.7	3.8	2.8
Equatorial Guinea	11.4	6	3	3	6.5	6
Eritrea	10.7	9.3	1.3	9.5	9	19.9
Ethiopia	13.4	0.9	–6.4	3.6	3.9	4.2
Gabon	10	4.5	4.1	2.3	–0.7	1
Gambia, The	4	4.8	3.1	1.1	3.8	0.9
Ghana	59.5	46.6	27.9	14.6	12.4	25.2
Guinea	5.6	3	1.9	5.1	4.6	6.8
Guinea-Bissau	45.4	50.7	49.1	8	–2.1	8.6
Kenya	4	9	9.2	9.3	6.1	7.1
Lesotho	9.9	9.1	8.5	7.8	8.7	6.1
Libya	8.3	4	3.6	3.7	2.6	–3
Madagascar	49	19.8	4.5	6.2	9.9	11.9
Malawi	83.1	37.7	9.1	29.8	44.8	29.6
Mali	12.4	6.5	–0.7	4.1	–1.1	–0.7
Mauritania	6.5	4.7	4.5	8	4.1	3.3
Mauritius	6	5.9	7.9	5.4	7.9	5.3
Morocco	6.1	3	1	2.7	0.7	1.9
Mozambique	54.4	44.6	6.4	0.6	2.9	12.7
Namibia	10	8	8.8	6.2	8.6	4.5
Niger	11.2	5.3	2.9	4.5	–2.3	2.9

Annex table A1.3 (continued)**Annual inflation, Africa, 1995–2000****(percentage change in consumer prices)**

Country	1995	1996	1997	1998	1999	2000
Nigeria	72.8	29.3	8.5	10	6.6	6.9
Rwanda	22	8.9	11.7	6.8	–2.4	3.9
São Tomé and Príncipe	36.8	42	69	42.1	16.3	11
Senegal	8.1	2.8	1.7	1.1	0.8	0.7
Seychelles	–0.3	–1.1	0.6	2.7	6.3	6.7
Sierra Leone	26	23.1	14.9	35.5	34.1	–0.9
South Africa	8.7	7.3	8.6	6.9	5.2	5.4
Sudan	68.4	132.8	46.7	17.1	16	8
Swaziland	12.3	6.4	7.9	7.5	5.9	9.9
Tanzania	26.5	21	16.1	9.8	9	6.2
Togo	6.4	2.5	5.5	–1.4	4.5	–2.5
Tunisia	6.3	3.8	3.7	3.1	2.7	2.9
Uganda	6.1	7.5	7.8	5.8	–0.2	6.3
Zambia	34.9	43.1	24.4	24.5	26.8	26.1
Zimbabwe	22.6	21.5	18.8	31.7	58.5	55.9

*a. Excludes Angola and Democratic Republic of Congo.***Source:** IMF, *World Economic Outlook*, December 2001.

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South Africa—Locomotive for African Growth?

South Africa fared better than most developing economies in 2001 despite the global slowdown and the economic woes of other emerging market economies (such as Argentina and Turkey). The relative resilience of its economy was due primarily to sound financial regulation, low external borrowing, and depreciation of the rand (ZAR). Indeed, a significant increase in South Africa's competitiveness slowed growth in imports and raised exports, contributing to a current account surplus in the first half of 2001. This was mirrored by a small but positive net inflow of capital through the financial account.

Growth in real GDP picked up from an annualized rate of 2.0% in the first quarter of 2001 to 2.5% in the second quarter. The terrorist attacks on the United States dampened prospects for the second half of the year, however, and economic growth in 2001 is estimated to be 2.5%, down from a pre-September 11 forecast of 3.0%.

Macroeconomic fundamentals remained sound in 2001. Consumer price inflation declined to within the target band of 3–6% in August and September. Prime lending rates and government bond yields fell sharply. And monetary easing has resulted in real interest rates that compare well with those in other emerging market economies. The sound macroeconomic conditions are reflected in lower household debt, a credit upgrade, and higher tax revenues at lower tax rates.

The rand fell sharply against major currencies, ending the year 40% lower than its initial level. The slump in the currency will push up the price of imported basic necessities, particularly oil, which in turn could raise the cost of commuting for the poor. On the positive side, the depreciation of the rand contributed to a substantial boost in exports, with the trade surplus for 2001 at ZAR 29.1 billion, up from ZAR 14.4 billion in 2000.

Private and government investment increased, with investment rising by 5.6% in the first half of 2001. Household spending continued to rise, but at a more moderate pace than in 2000. Total employment, however, continued its declining trend.

The budget deficit is expected to be 2.3% of GDP for 2002/03, with real increases in non-interest spending averaging 3.7% over the period 2002–05. Declining bond yields have reduced government borrowing costs to their lowest levels in four decades.

In the medium term fiscal adjustment and monetary easing in the face of a weaker global environment, and the more competitive cost structure of the South African econ-

Fiscal adjustment and monetary easing should accelerate economic activity

“Sustaining poverty reduction will require appropriate microeconomic and institutional reforms”

omy, should accelerate economic activity and raise the cyclical and potential growth rates of the economy. Raising growth rates and sustaining poverty reduction will also require appropriate microeconomic and institutional reforms to complement macroeconomic adjustment. As the largest economy in Africa—accounting for a fifth of regional GDP—South Africa has the potential to be the locomotive for African growth.

Recent economic developments—from currency crises to stabilization programme

Two issues have dominated macroeconomic policy and performance in South Africa since 1995. First, the rand went through three currency crises—in the first half of 1996, in mid-1998, and in the second half of 2001. Second, and partly in response to the first of these crises, in June 1996 the government announced a stabilization programme—the Growth, Employment, and Redistribution (GEAR) programme—which defined policy instruments and objectives for the five years until 2001. In announcing the programme government officials stressed both its “home grown” nature and its close parallels with the standard approach of the international financial institutions.

Despite the frequent currency crises, South Africa’s macroeconomic policy performance has been solid. The government has met its key fiscal and monetary policy targets, bringing the fiscal deficit under control and keeping inflation stable throughout the period. In addition to macroeconomic policy interventions, the government has undertaken structural reforms, including liberalizing tariffs and strengthening tax collection, that have supported the strong macroeconomic performance.

Nonetheless, economic growth has been disappointing. GDP growth averaged 2.6% a year from 1995 to the third quarter of 2001. With population growth estimated at just over 2.1% a year, annual GDP per capita growth averaged a mere 0.5%.

This persistently poor performance in growth is due in large part to poor performance in investment, especially private investment. The country has been unable to sustain the post-apartheid “honeymoon,” which led to greater investor confidence in the early years. Moreover, the government appears not to fully appreciate the links between its positions on socio-economic and geo-political issues and the trends in markets. There seems little doubt that its failure to take strong positions on such issues as HIV/AIDS and regional political and economic instability, particularly in the period since 1998, have had an adverse effect on capital flows and contributed to the currency instability over the past three years.

Some factors in the collapse of investor confidence have been unrelated to domestic policy, however. In particular, volatile capital flows resulting from the collapse of confidence among portfolio investors worldwide have affected the exchange rate and the money market and reduced the confidence of domestic producers and foreign direct investors.

Box 2.1

Adjusting to slowing world growth

The U.S. and world economies are expected to rebound in the second half of 2002. But the effects of the deflation on economic growth may be felt longer in many parts of the world. Falling prices and household spending, combined with declining investment and output, send signals to policy-makers everywhere that greater fiscal and monetary easing is in order. The poor global economic environment is expected to affect South Africa primarily through slower growth in exports and weaker confidence and consumption.

Some precautionary easing has occurred in South Africa's monetary stance in 2001, and the exchange rate has weakened. Government spending has strengthened, and a steady recovery in public capital spending is under way. Fiscal and monetary policy adjustments are helping to sustain the economic growth momentum despite the unfavourable international environment.

The inflation target for 2003 will remain 3–6% (for consumer prices minus mortgage interest costs, or CPIX inflation). With a declining trend in inflation, bond yields and interest rates will have room to continue falling, lowering the cost of doing business.

The budget deficit for 2002/03, which was expected to be 2.3% of GDP, is now expected to reach 2.6% of GDP as social spending increases and tax cuts take effect. Deficits for 2003–05 will similarly be adjusted, by around 0.3% of GDP. A declining trend in the deficit will be maintained, however, to ensure that borrowing costs continue to fall, freeing up additional fiscal resources.

The proposed adjustments are aimed at ensuring that South Africa is well placed to take advantage of growing economic activity in the rest of the world in 2002.

Source: Economic Commission for Africa.

Indeed, economic performance in 2001 was shadowed by global developments (box 2.1). The weakening of the international economy contributed to a slowdown in output growth in South Africa in the first quarter of 2001. But unlike in the global economy, in the domestic economy growth picked up, from an annualized rate of 2.0% in the first quarter of 2001 to 2.5% in the second quarter.

The resilience of the South African economy in the first half of 2001 can be attributed in part to the fact that the potential benefits of the rand's depreciation were not eroded by higher inflation, as has happened so often in the past. Investment and output growth in manufacturing, construction, trade, and services have also contributed to the economic resilience. Investment and growth in these sectors are expected to strengthen in the next few years as lower production costs raise profitability in export-oriented sectors.

The service sector has become increasingly important for the broader economy and a large contributor to employment. In the first two quarters of 2001 wholesale and retail trade grew by an average 3.3%, and financial services by 4.1% (seasonally adjusted and annualized growth). The transport, storage, and communications sector grew by an average 4.5%.

Agriculture—output sliding, exports up

Agricultural output continued to decline in the first half of 2001, at a seasonally adjusted and annualized rate of 3.1%. Agriculture's share of total value added is expected to be 4.2% in 2001, largely unchanged over the past five years.

**Agriculture's share
of total value added
is expected to be
4.2% in 2001**

The country is self-sufficient in most agricultural commodities and not dependent on imports for its domestic food supply. Imports of agricultural products have fallen both as a share of GDP (from 1.3% in 1995 to 1.1% in 2000) and as a share of merchandise imports (from 7.7% in 1995 to 5.4% in 2000).

Agricultural exports have increased slightly as a share of GDP, rising from 1.7% in 1995 to 2.1% in 2000, but declined slightly as a share of merchandise exports, from 9.5% in 1999 to 7.9% in 2000. Sugar, wine, and fruits were the most important export products by value in 2000. The largest market for South Africa's agricultural exports is the European Union, which accounted for 27.9% of total exports by value in 2000.

Despite South Africa's abundant labour, agriculture is largely capital intensive, accounting for only 11% of formal employment. In the former homelands an estimated 2.2 million people are employed in agriculture, 37% as subsistence farmers. The rest are small-scale farmers who sell at least some of their produce, or farm workers employed on commercial farms.

Poverty is significant in the sector. Of those employed in agriculture, 69% are among the lowest income earners—those with monthly incomes of ZAR 500 or less—compared with 22% among all other employed people.

At the end of the apartheid period the agricultural sector was marred by inequity and inefficiency, which constrained production to below optimal levels. The sector was effectively split in two—one white-owned, capital-intensive, and large-scale segment and one black-owned, labour-intensive, and subsistence segment. The second, concentrated in the former homelands, produced output at levels below subsistence for the total homeland population, while white, large-scale farmers produced 90% of the total value added of the sector. Policy distortions, such as subsidized credit for white farmers, resulted in capital-intensive production and farms that were larger than the efficient size.

Once elected in 1994, the African National Congress (ANC) government embarked on an ambitious programme of land reform, rural financing, and deregulation of agricultural marketing (box 2.2). Policy reforms introduced since 1995 are perhaps too recent to show significant results, however. Low productivity growth, stagnant export revenues, and limited absorption of labour remain serious policy challenges in the sector. Moreover, reforms have not been smooth. Land redistribution and restitution tend to take time. And some controls were not abolished immediately.

On the positive side, the number of enterprises operating in agriculture increased significantly between 1990 and 1998, with new registrations growing by an average 16% a

Box 2.2

Agricultural reforms—to correct historical injustices

After taking office in 1994, the ANC government embarked on an ambitious programme of agricultural reforms aimed at undoing the effect of 80 years of inequality and discriminatory practices. The programme focuses on land reform, deregulation of agricultural marketing, and rural financing.

Land reform

The land reform programme, initiated in 1995, aims to transfer 30% of all agricultural land in 15 years. A redistribution programme provides grants and technical assistance to the landless poor. A restitution programme returns land that was lost or otherwise compensates victims of the 1913 Land Act, which awarded white settlers rights to 87% of South Africa's arable land and relegated blacks to so-called homelands. And a tenure reform programme is creating a validated system of landholding, including recently approved legislation (the Extension of Security of Tenure Act) aimed at protecting vulnerable farmers who do not own their land. Other goals include improving the incomes and nutrition of the rural poor, reducing congestion in overcrowded former homeland areas, and expanding opportunities for women and young people who stay in rural areas.

Deregulation of agricultural marketing

Since 1995 the government has deregulated previously strictly controlled markets. It removed price controls, and by early 1998 it abolished all agricultural control boards (transferring their assets to industry trusts to support marketing and export services). These policies led to the disappearance of official "single channel" markets. The deregulation efforts have reduced government-induced distortions in South Africa to much lower levels than ever before.

Restructuring of rural finance

During the apartheid regime disadvantaged people had poor access to rural finance. To rectify this situation, the government abolished the Agricultural Credit Board, which had provided subsidized credit to large farmers, and gave a new mandate to the government-owned Land Bank, which had served a similar purpose. Now the Land Bank provides credit to historically disadvantaged farmers, a capacity in which it has already done much to redress the imbalances of the past. In addition, the government has removed many other subsidies, such as funding options for fencing, irrigation facilities, and on-farm infrastructure. And it has amended the tax regime, eradicating implicit subsidies for capital equipment provided through rapid depreciation schemes.

Source: ANC 1994; statistics South Africa and South Africa, National Department of Agriculture 2000.

year. Capital productivity is improving, suggesting that the capital-intensive bias of the sector is being addressed. Prices for agricultural products have largely stabilized, thanks in part to the establishment of a futures and options market for agricultural commodities in 1995. The abolishment of the control boards and reduction in the anti-export bias in agriculture have led to a marked increase in the production of export crops, especially fruit and vegetables and, to a lesser extent, in livestock production.

Industry—weak domestic demand

Manufacturing output edged upward in the first half of 2001

Industry (mining, manufacturing, and construction) contributed around 29.0% of GDP (in gross value added terms) in 2000. This share has fallen steadily from 31.1% in 1995. Manufacturing output fell by 0.7% in real terms between 1995 and 2000. Since export growth was strong, the decline probably reflects weak domestic demand. Manufacturing output edged upward in the first half of 2001, however, growing by 1.2% on a seasonally adjusted and annualized basis. Mining production fell by 1.9% from June 2000 to June 2001, largely as a result of a sharp decline (around 9.1%) in gold production. Platinum production continued to rise in 2001, achieving an annual growth rate of 6.2%. Platinum output is likely to continue to expand as investments come on stream.

In 1995 industry accounted for 32% of formal employment in South Africa. Between 1995 and 2001, however, employment in the sector fell by around 14%, compared with a drop in total non-agricultural employment of around 10%. Employment fell by as much as 37% in construction and 30% in mining over the same period. In construction the drop in formal employment may reflect a shift towards casual labour.

Industrial exports grew at an average annual rate of 16.8% between 1995 and 2000, responding rapidly to new opportunities emerging after international sanctions were lifted. The composition of industrial exports has changed slightly in favour of basic processed goods and machinery and equipment. That shift, combined with a decline in mineral exports as a share of merchandise exports (from 27.0% in 1995 to 21.9% in 2000), suggests that downstream manufacturers are becoming more successful exporters.

The manufacturing subsectors of basic metals and “rubber, glass, plastic, non-metals, and minerals” show a particularly strong export orientation, with the ratio of exports to output in these sectors at 57.0% and 24.2% in 2000. The export orientation in mining, historically extremely strong in South Africa, was as high as 77.2% in 2000.

Imports of industrial merchandise goods also increased between 1995 and 2000, rising from 17.4% of GDP to 21.0%. The composition of merchandise imports has shifted away from machinery and equipment and towards mineral imports. The relative decline in machinery imports may be due to the depreciation of the rand along with weak domestic demand. At the aggregate level the textile and apparel industries do not appear to have suffered from the huge inflow of inexpensive imports that critics of the trade liberalization expected, although it is possible that the exchange rate depreciation has temporarily postponed the effects on these sensitive industries.

Accelerated trade liberalization aimed at introducing competitive pressures from imports was central to the industrial policy developed by the ANC government. The government also introduced a powerful competition policy, including a revamped Competition Act (1998) and independent enforcement authorities. In addition, the government embarked on an ambitious programme of privatizing state-owned enterprises and introduced spatial development initiatives aimed at overcoming the spatial legacy of apartheid and refocusing economic activity away from import substitution and towards production for global markets.

The competitive pressures resulting from import liberalization, competition policy, foreign investment, and privatization—combined with supply-side incentives and export opportunities—were expected to kick-start a deep restructuring of domestic manufacturing and lead to internationally competitive and outward-oriented industries.

In the past two years the industrial policy has shifted towards a greater focus on knowledge-intensive sectors and human resource development, placing less emphasis on comparative advantage based on natural endowments. The industrial policy now being developed will include sectoral strategies based on creating competitive advantages in knowledge-intensive manufacturing (box 2.3).

“The public sector has not taken up the ‘slack’ in investment demand”

Domestic consumption and investment—flat

Household consumption has remained stable as a share of GDP since 1995 (table 2.1). The private investment rate peaked in 1997, then fell with the onset of recession in 1998 and has remained well below the peak even with a small rise in 2001. Thus while the 1994 elections were associated with an improvement in investor confidence, the effect was quite modest and also fragile. The small growth in private investment was halted by the first foreign exchange crisis in 1996, and punctured by the second two years later. Even though the GEAR policy was intended precisely to improve policy credibility among investors, it did not lead to any noticeable improvement in the investment rate, even before the 1998 collapse of the rand.

The public sector has not taken up the “slack” in investment demand. The only substantial increase in public investment was that linked to the one-time rise in telecommunications investment in 1998 required as a condition of the purchase by a U.S.-Malaysian consortium of a 30% strategic partnership stake in the government-owned fixed line operator in 1997. Infrastructure investment by the government (beyond that by public corporations) has remained almost flat in real terms through most of the post-apartheid period, with the government focusing most of its fiscal policy attention on bringing the deficit under control. The government signalled an intention to increase investment spending in its (March) 2001 budget, however, and restated this commitment in the November 2001 medium-term budget policy statement looking ahead to the 2002 budget.

More recent developments in aggregate demand are positive, with consumption and investment patterns pointing to a potential for the economy to pick up in 2002. Real household consumption spending rose by around 2.3% in the first two quarters of 2001. Real government consumption spending rose by 1.5% in the first half of 2001 and is expected to grow by an annual average of 2.5% in 2002–03.

Investment performance improved in almost all sectors in the first half of 2001. Gross domestic fixed investment increased to 15.3% of GDP. Private corporations and the public sector contributed to a 5.6% average rise in investment, while the government’s contribution to gross capital formation grew by 1.8%.

Box 2.3

Principles of the new industrial strategy

Don't rely on the old ways

A large share of South Africa's manufactured products—particularly exports—rely heavily on inputs of raw materials and energy. But access to cheap raw materials has become increasingly less important and it no longer provides a firm foundation for a competitive position—for producers that are now competitive or for the manufacturing sector as a whole.

Don't bank on cheap labour

Many have argued that policy should aim at reducing the cost to employers of unskilled labour and increasing flexibility in the market for unskilled and semi-skilled labour. This is a complex issue with clear political and economic considerations. But the trajectory of industrial development does not support these goals as the basis for a sustainable industrial policy.

As globalization proceeds, a combination of factors appears to be raising the demand for skilled labour and reducing the demand for unskilled and semi-skilled labour. That phenomenon is evident in South Africa. Thus lowering the cost and increasing the flexibility of unskilled and semi-skilled labour will not provide a sustainable basis for most manufacturing in South Africa.

Forget protection

Privileged market position similarly is no basis for a sustainable industrial strategy. The South African government is committed to continued trade liberalization. This entails more bilateral trade agreements and possibly additional offers within a new round of negotiations in the World Trade Organization. Consequently, manufacturers will face ever more competitive markets, both domestically and internationally.

Pay attention to innovation

Manufacturing firms in South Africa generally spend little on innovation. While increasing innovation activities will be an important policy effort, new technology will continue to come mainly through transfers from abroad—technology similarly available to producers elsewhere.

Enhance knowledge capacities

As the structure of world trade shifts away from commodity production and simple, raw material-intensive manufactured goods and towards increasingly knowledge-intensive goods and services, the traditional sources of competitive advantage for South African manufacturers will decline. Their ability to compete will increasingly turn on their capacity to master information technology, to innovate, and to meet the precise needs of their customers. These activities are all highly knowledge intensive. The industrial strategy will need to reflect this important shift.

Source: South Africa, Department of Trade and Industry 2001a.

The rise in investment growth since the first half of 2000 has been unusually widespread across sectors. Economy-wide and sector-specific factors—such as declining relative costs and platinum prices—have contributed to the improvement. Investment in mining, manufacturing, and financial services accelerated somewhat in 2001. Investment also grew in the construction industry in 2000 and 2001, possibly signalling an end to the

Table 2.1

Components of GDP, South Africa, 1995–2000
(percentage of GDP)

Component	1995	1996	1997	1998	1999	2000
Household consumption	62.6	62.3	63.0	63.4	63.3	63.6
Private investment	11.6	11.7	11.8	11.3	10.5	10.7
Public investment ^a	4.3	4.4	4.5	5.5	4.7	4.2
Government consumption	18.3	19.4	19.8	20.0	19.4	18.4
Exports	23.0	24.5	24.6	25.9	25.9	29.1
Imports	22.1	23.2	23.5	24.7	23.1	26.1
Change in inventories plus residual	2.3	0.8	–0.3	–1.2	–0.6	0.1
GDP (millions of 1995 dollars)	151,117	157,390	161,318	162,426	165,471	170,572

a. Public investment data include both general government and public corporations.

Source: South Africa Reserve Bank.

long shakeout in that industry. The broader shift in the economy towards greater export production is expected to feed through into non-tradable and import-competing sectors. Even so, deeper problems related to investor confidence remain serious constraints to economic growth.

Employment and remuneration

The long-term decline in employment in the non-agricultural formal sector continued in the first quarter of 2001, while private sector wages continued to rise modestly. The moderate wage increases, combined with strong productivity growth (related in part to the drop in employment), led to a further slowdown in the growth of nominal unit labour costs. In the medium to longer term this trend may lead to stronger international competitiveness for domestic producers—and thus to stronger growth in exports, employment, and the economy.

Data from the 2001 Labour Force Survey suggest that employment losses in older sectors of the economy have been partly offset by employment gains in newer sectors, the informal sector, and outsourcing. These shifts reflect changes in the composition of demand for South African products, with little net change in effective demand. Currency depreciation and heightened competitiveness have also played a part in the shifts in employment, by contributing to employment creation in export industries. Nonetheless, at around 20%, the unemployment rate remains a major problem in South Africa.

Productivity growth remained strong in 2000 and the first quarter of 2001, resulting in moderate increases in real unit labour costs, lower domestic price inflation, and healthy corporate earnings. Over the past two years productivity has risen faster than real wages, reducing labour market disequilibria and setting the stage for employment growth in the medium term. Growth in real disposable household income remained healthy in 2001, averaging around 2.5% in the first half of the year.

“Over the past two years
productivity has risen
faster than real wages”

“South Africa has managed to bring its fiscal deficit under control”

Fiscal policy and the budget framework

South Africa has managed to bring its fiscal deficit under control. After escalating to 10.1% of GDP in 1993, the deficit fell to well below 3.0% by 1998, surpassing the target set by the ANC government in 1994. As part of its fiscal reform programme, the government had established a series of annual targets to lower the fiscal deficit to 3.0% of GDP by 1999. The deficit remained well below the GEAR target of 3.0% of GDP in 1999 and 2000, was projected at 2.0% of GDP for 2000/01, and is expected to increase to 2.3% of GDP in 2001/02 and 2.6% in 2002/03 before falling to 2.2% by 2003/04.¹

Fiscal reforms have also been aimed at improving the revenue collection performance of the South African Revenue Services by increasing its autonomy from the Department of Finance. The resulting growth in direct (income) taxes has increased total government revenue as a share of GDP by nearly 2 percentage points since 1995 (table 2.2). The improved revenue collection has enabled the government to meet its deficit targets with relative ease, at least since 1998. The government has used its extra fiscal “room” to move towards higher public investment spending. Despite the moderate increase in the budget deficit expected in 2001/02, debt will continue to fall as a share of GDP and debt service costs will continue to decline as a share of government spending, releasing resources for productive uses.

Despite the improved fiscal control, the government has been unable to reduce its total current spending as a share of GDP (table 2.3). Part of the reason is the rise in interest rates in 1996 and again in 1998, related to the foreign exchange crises of those two years. But current consumption spending also has risen, largely because of the growth in social spending as a share of the budget and of GDP (all three components of social spending—education, health, and welfare—increased as a share of GDP). To help offset these increases, the government has reduced spending on subsidies and transfers.

The government has thus met the promise made in its GEAR policy to increase the redistributive focus of its expenditure programmes. But the higher spending has not been fully reflected in government *output*—that is, improved service delivery to the public. And significant improvements in the *outcomes* of government social programmes—such as in basic skill levels or the population’s health status—remain some way off.

Against this background the minister of finance, Trevor Manuel, presented the 2002 medium-term budget policy statement to Parliament on 20 October 2001. The proposed budget reflects a fiscal policy stance that takes into account the slowdown in the international economy and the sluggish growth in South Africa. Designed to support a projected recovery in growth and building on a sound fiscal foundation since 1994, the medium-term budget policy statement outlines a programme of further tax relief and strong real growth in non-interest spending, averaging 3.7% over the next three years. The proposed 2002 budget framework signals:

- Priority for reducing poverty and vulnerability.
- Increased spending on health services and social grants, municipal infrastructure and housing, improved police and justice services, and critical administrative services for citizens.

Table 2.2

Government revenue, South Africa, 1995–2000
(percentage of GDP)

Item	1995	1996	1997	1998	1999	2000
Direct taxes on income and wealth	12.4	13.4	13.8	14.9	14.9	14.4
Indirect taxes on production and imports	11.7	11.3	11.1	11.5	11.5	11.5
Total other revenue ^a	1.3	1.5	1.4	1.3	1.3	1.3
Current income ^b	25.4	26.2	26.3	27.6	27.7	27.1
Budget deficit	–4.2	–5.0	–4.7	–3.5	–2.6	–1.8

a. Transfers receivable and income from property.

b. Government revenue less interest on public debt, subsidies, and transfers.

Source: South African Reserve Bank.

Table 2.3

Government expenditure, South Africa, 1995–2000
(percentage of GDP)

Item	1995	1996	1997	1998	1999	2000
Interest on public debt	5.9	6.3	6.1	6.3	6.2	5.9
Subsidies	1.5	1.4	1.2	1.2	0.9	0.8
Current transfers to households	3.4	3.5	3.4	3.1	3.1	3.1
Transfers to the rest of the world	0.5	0.5	0.6	0.6	0.7	0.8
Final government consumption expenditure	18.3	19.4	19.8	20.0	19.4	18.4

Source: South African Reserve Bank.

- Strengthening of programmes that address the impact of the HIV/AIDS epidemic.
- A step-up in the electrification programme and support for the restructuring of the post office and the unemployment insurance fund.
- Strong growth in transfers to municipalities, recognizing their critical role in extending basic services to underserved communities and households.

In addition, a range of new infrastructure projects are envisaged that will contribute to social and economic development in the years ahead, such as telecommunications investments, water supply schemes, a toll road concession, industrial development zones, and a gas pipeline from Mozambique to South Africa. These projects will be largely self-funding and thus are outside the main budget. In some of these projects private investors will provide funding through direct equity participation or public-private partnerships. In others, funds will be raised against the balance sheets of public corporations. Even with these investment plans, the consolidated public sector borrowing requirement is expected to remain modest, rising from an estimated 1.6% of GDP in 2002 to around 2.4% by 2004.

Against the background of the substantial tax reforms over the previous two years, the 2002 budget will herald a period of consolidation in tax policy. The personal income tax

“The consolidated public sector borrowing requirement is expected to remain modest”

“Bank credit to the private sector has continued to grow briskly”

structure will again be lightened, with relief particularly for low- and middle-income wage earners, and the tax treatment of retirement savings will receive a thorough review. Investment incentives amounting to ZAR 3 billion will take effect over the next four years. In addition, shortcomings in the income tax treatment of the banking sector will be addressed, and effective tax rates in other sectors reviewed. And work will continue with other southern African countries on customs administration, tax incentives, tax reform lessons, and effective revenue administration. All this work notwithstanding, the broad parameters of the tax law are now in place.

Monetary policy—M3 ahead of targets

The rapidly changing international environment and relatively favourable domestic economic conditions have made decisions on an appropriate monetary policy stance challenging. Until 1999 the Reserve Bank set growth targets for broad money supply (M3), adopting what it termed an “eclectic” monetary policy approach in which the nominal exchange rate was sometimes also implicitly targeted. But the M3 growth rate greatly exceeded the targets as a result of the large gross inflows of foreign portfolio capital associated with the liberalization of the capital account. These large inflows were a central factor in the Reserve Bank’s decision to abandon its approach to targeting money supply growth.

In February 2000 the government established an inflation targeting regime in which the minister of finance sets a formal target for consumer prices minus mortgage interest costs (CPIX) and the Reserve Bank is responsible for meeting it. The initial target is a range of 3–6%, to be reached by 2002 (box 2.4).

Monetary aggregates

Since 1994 growth in the money supply has fluctuated with a series of innovations and structural changes in the financial sector, contributing to a breakdown in the relationship between M3 and inflation. Since inflation targeting began, growth in M3 is no longer used as an intermediate target for monetary policy. Nevertheless, money supply and credit continue to provide useful information about spending plans and inflationary pressures. Recent trends have been encouraging. M3 growth has accelerated noticeably, but largely as a result of strong growth in long-term deposits (which may reflect fears of losses on equity investments more than intentions to spend in the future).

Bank credit to the private sector has continued to grow briskly, with much of the expansion in credit going to the corporate sector. Over the past year fixed capital formation has been growing at a solid pace in that sector, laying the foundation for future economic growth. The credit expansion also reflected reasonably buoyant consumer demand. The net claims of the banking sector on the government sector declined quite sharply in the first half of 2001, slowing the growth in total bank credit extension to a low rate.

Box 2.4

New inflation targets

The government announced an inflation targeting framework to guide monetary policy in the 2000 budget, with an initial target band of 3–6% for CPIX inflation in 2002. Since monetary authorities need lead time to adjust policy—because of the time lag between a policy change and its impact on CPIX—the cabinet decided that the target will remain at 3–6% for 2003.

A critical factor in lowering inflation is how the targeting framework affects the expectations of producers, financial markets, and labour market agents about future inflation. To influence these expectations, the Reserve Bank has opened the monetary policy-making process to public scrutiny and explained the benefits of lower inflation to the public.

To further enhance the transparency and credibility of the framework, the cabinet has announced the inflation target for 2004 and 2005—an average of 3–5%. This target band represents an intention by South Africa to achieve inflation rates similar to those of its major trading partners and thus will help to maintain the economy's competitiveness.

In addition, the framework has been adjusted to make the “escape clause” more concrete. This clause provides for flexibility in the event of exogenous and supply-side shocks to the economy, such as drought, a sharp rise in international oil prices, or international financial contagion that causes major changes in the exchange rate unrelated to domestic economic fundamentals and monetary policy. When it is expected that the CPIX inflation target will not be met, the Monetary Policy Committee will set out the path and time horizon for bringing inflation back in line with the target. This flexibility will be critical in avoiding costly losses in jobs and output.

Source: *South African Reserve Bank 2000.*

Inflation

The slower growth in nominal unit labour costs and the lower international oil prices were reflected in lower year-on-year price inflation in the first half of 2001. Price pressures at the production level have started to ease in recent months, and consumer price inflation has also started to decline.

Domestic producer prices rose by 7.8% in the year to September but are expected to decline as the prices of imported goods stabilize in the years ahead. Consumer price inflation as measured by CPIX peaked in 2000 and has declined since, reaching 6.0% in August 2001 and 5.8% in the year to September 2001. Slower growth in food and oil prices was the primary factor in the easing of consumer price increases.

Although administered prices continue to grow more rapidly than CPIX, the rate of growth is slowing. Medical and transport costs, for example, grew by 11.9% and –3.6% in the year to August 2001, down from 16.1% and 10.1% in March and January. Rates of increase in administered prices will moderate as these sectors, particularly health and transport, adjust more fully to changes in market conditions, regulatory and industry structures, and legislation.

“South Africa’s real interest rate compares well with those in other emerging market economies”

Between the first and second quarters of 2001, however, there were signs of acceleration in endogenously generated inflation. For example, prices of domestically produced goods and non-food consumer goods rose more rapidly in the second quarter than in the first. Moreover, although growth in overall inflation was curbed by smaller increases in the prices of imported goods and a decisive slowdown in the prices of consumer services during the first half of the year, the drastic slide in the rand since September 11—which again put pressure on import prices—heightens inflationary pressures and may call for increases in domestic interest rates.

Interest rates

Confident that an upturn in the growth of aggregate demand in the second half of 2001 would not jeopardize inflation prospects, the Reserve Bank cut the repurchase rate in June 2001 from 12% to 11%, resulting in a decline in the prime rate from 14.5% to 13.5%. A subsequent rate cut in September, in addition to a technical change in how the repurchase market functions, led to a further decline in the repurchase rate to 9.5%. The prime rate fell to 13%. Lower short-term interest rates were accompanied by a large decline in long-term interest rates. All these rate adjustments were consistent with the policy objective of lowering inflation to within the upper region of the 3–6% target range in 2002.

Real interest rates declined from an average of around 12% in 1995–98 to around 6% in 2001. South Africa’s real interest rate compares well with those in other emerging market economies.

Exchange rate developments—rand under pressure

The external value of the rand is and has been under considerable pressure, mainly from developments outside South Africa that affect not only the rand but also many other currencies. Despite these pressures, the Reserve Bank did not sell dollars in the foreign exchange market to strengthen the exchange rate of the rand. The bank regards such intervention as undesirable because it is effective only if it signals a change in underlying policies, if it is strongly supported by participants in the foreign exchange market, and if the central bank is prepared to intervene repeatedly and decisively.

In fact, the Reserve Bank continued to buy small amounts of dollars in the market to gradually reduce the net oversold open position in foreign exchange. Its objective is to gradually close down the net open position, amounting to \$4.8 billion in 2001, to eliminate the risk involved in carrying such a position and the negative influence it has on the perceptions of potential market participants. The net open position is expected to reach zero sometime in 2002.

Reducing the net open position in foreign exchange may also lead to depreciation of the rand or prevent the rand from appreciating when an overall surplus is recorded on the balance of payments. Consequently, transactions aimed at reducing the position that are based on portfolio and short-term capital flows could provide speculators with a one-way

bet. To counter such speculation, the Reserve Bank buys dollars in the foreign exchange market only under exceptional circumstances, such as when large direct investments or more permanent capital flows are received.

The Reserve Bank's oversold forward book has an important influence on the management of the country's foreign reserves. No less than 85% of the Reserve Bank's foreign exchange holdings were in U.S. dollar-denominated assets on 31 July 2001 because the oversold forward book is denominated largely in U.S. dollars. Although liquidity is still an important focus of reserve management, risk returns are also taken into account. The Reserve Bank's risk management strategy also aims at prudence, risk aversion, capital preservation, and reciprocity with counterparts that extend credit to the bank.

The Reserve Bank continued to follow a conservative approach to borrowing funds that would support the level of reserve holdings. On 31 July 2001 the bank's outstanding foreign loans amounted to \$2.5 billion and the available facilities to \$1.1 billion.

External debt and foreign borrowing—interest payments remain low

South Africa's foreign currency debt is around \$25 billion, equal to 19.7% of GDP and 64.1% of exports. Interest payments remain low, falling from 8.6% of export earnings in 1999 to 6.2% in 2000.

In 1985, after facing a serious foreign exchange crisis, South Africa declared itself unable to repay its foreign creditors. Debt standstill agreements entered into with creditors allowed South Africa to freeze its debt repayments. On 15 August 2001 the government issued final authorization for repaying all outstanding capital on loans in the standstill net, bringing to an end an unfortunate chapter in South African history. Throughout that period, however, South Africa meticulously honoured all the capital redemption schedules and interest payments on this debt in accordance with the standstill agreements.

South African bonds remain well priced on international markets, despite an increase in the average cost of issuing new debt in most emerging markets. South Africa's favourable status among emerging market economies allows the country to borrow abroad at relatively low interest rates. Moreover, Moody's upgraded South Africa's credit ratings in November 2001. It raised the country ceiling for foreign currency bonds from Baa3/Not Prime to Baa2/Prime-2, and the rating for foreign currency-denominated bank deposits from Ba1/Not Prime to Baa2/Prime-2. In addition, it raised the rating for local currency bonds from Baa1 to A2.

Sales of government bonds by non-residents in 2001 did little to slow a rally in the bond market predicated on lower government borrowing and declining inflation. The public sector borrowing requirement fell from 4.8% of GDP in 1997 to an expected 1.1% of GDP in 2001, contributing to a sharp drop in long-term government bond yields. Domestic and foreign borrowing will remain moderate in 2002–03.



*South Africa
meticulously honoured
all the capital
redemption schedules
and interest payments
in accordance with
standstill agreements*



Gross official reserves improved marginally in 2001, rising from \$7.51 billion in January to \$7.53 billion in September. Net reserves, however, declined from \$4.92 billion to \$3.54 billion as dollar proceeds from a syndicated loan were used to reduce the forward book.

“Trade reforms led to considerable real growth in trade in 1995–2000”

Trade policy and global developments—integrating with the world

South African trade policy has been characterized by accelerated trade liberalization and an outward orientation since 1994. The lifting of international sanctions beginning in the early 1990s provided new opportunities for South African exports and reintegration with the world economy.

Trade liberalization

In response to the new opportunities, the ANC government adopted several major trade policy changes. First, South Africa joined the Southern African Development Community (SADC) in 1994, a step towards regional re-integration. Second, the country acceded to the World Trade Organization (WTO) and became a signatory to the Uruguay Round agreement so as to reap the benefits of the lifting of sanctions. Third, it negotiated a free trade agreement with the European Union in 1999, to increase access to strategic markets.

South Africa has also made tremendous progress in rationalizing its once very complex tariff regime and reducing nominal and effective protection. It reduced the number of tariff bands by almost half by 1997, lowered average tariffs in all categories to below the bound levels under the General Agreement on Tariffs and Trade (GATT), and eliminated import surcharges. These changes reduced the average nominal tariff from 27.5% in 1990 to 7.0% by 1997. By July 2000 nearly 60% of South Africa's imports faced a zero tariff. Despite the tariff rationalization, as many as 1,941 non-ad valorem tariffs still existed in 2001. But almost all remaining quantitative restrictions on imports have been abolished. And on at least four occasions the government has accelerated the WTO programme of trade liberalization.

The South African government further reduced industrial protection by phasing out its demand-side export subsidy scheme in 1997. To cushion the effect of reduced tariff protection and to stimulate exports, the government introduced supply-side measures such as import duty rebates, export credit guarantees, and an export marketing assistance scheme. Improved access to markets, including the SADC and the European Union, further stimulated exports. The continuing depreciation of the rand has helped to sustain the trade liberalization, and to accelerate it in 1996, by providing protection from import competition and stimulating exports.

The trade reforms led to considerable real growth in trade in 1995–2000. Imports grew on average by 8.2% a year, up from an average 2.1% over the previous four years. And exports grew by 7.9% a year, up from an average 0.5% (table 2.4).

Table 2.4

Balance of payments, South Africa, 1995–2000
(percentage of GDP)

	1995	1996	1997	1998	1999	2000
Exports						
Merchandise exports	15.8	16.8	17.3	18.4	18.9	21.9
Net gold exports	4.1	4.3	3.8	3.5	3.1	3.1
Service receipts	3.1	3.5	3.6	4.0	3.9	4.0
Factor income receipts	0.8	0.8	0.9	1.0	1.2	1.7
Total exports of goods and services	24.0	25.0	26.0	27.0	27.0	31.0
Imports						
Merchandise imports	18.1	19.2	19.5	20.5	18.8	21.6
Payments for services	4.0	4.0	4.0	4.2	4.3	4.5
Factor income payments	2.7	2.9	3.0	3.3	3.6	4.3
Total imports of goods and services	24.7	26.1	26.5	28.0	26.8	30.4
Current transfers ^a	–0.4	–0.5	–0.5	–0.6	–0.7	–0.7
Balance on current account	–1.5	–1.3	–1.5	–1.8	–0.4	–0.3

Note: Export and import values are f.o.b. (free on board).

a. Net receipts.

Source: South African Reserve Bank.

Global events

Despite all the trade reform efforts, the recent performance in South Africa's external sector has been determined largely by exogenous events. In the United States in 2001 investment spending on information technology declined sharply, which spilled over into other areas of the economy. Equity prices on the New York Stock Exchange declined sharply. For small open economies worldwide, the investment collapse unwinding in the United States and in Europe has depressed growth and trade. Industrial production in the Republic of Korea, Malaysia, Singapore, and Taiwan (China) declined by around 10% in August 2001 from a year earlier. The terrorist attacks on the United States led to further turbulence in financial markets and capital flows.

For South Africa, the impact of these global developments is reflected in the current and financial accounts of its balance of payments. South Africa has fared better than most other developing economies, primarily because of its sound financial regulation and low external borrowing and export competitiveness.

Current account

The current account of the balance of payments moved into a surplus in the fourth quarter of 2000 and fared reasonably well in the second quarter of 2001—with a slightly smaller ZAR 6.3 billion surplus—despite the slowdown in the international economy. This positive trend was due primarily to the much-improved competitive position of South African exports. Despite weaker global demand, South African manufacturing

“South Africa has fared better than most other developing economies”

Box 2.5

The effect of depreciation on the economy

Exchange rate depreciation can affect an economy in different ways, depending on the size of the depreciation and the price-setting response by firms, unions, importers, and exporters. Depreciation of the rand has benefited the South African economy, mainly by encouraging greater exports and offsetting the adverse effect of declining commodity prices on exports.

In addition, depreciation shifts domestic demand towards domestically produced rather than imported goods. Together with rising demand for South African exports, this raises effective demand and leads to greater profitability and more rapid growth. And rising demand for South African products in foreign countries leads to increasing demand for the rand and thus to exchange rate appreciation.

Most emerging market currencies depreciated against the U.S. dollar in 2001. The rand is estimated to be undervalued by around 30% against the dollar.

Source: *Economic Commission for Africa.*

“Strong exports and moderate imports resulted in a cumulative trade surplus of 25.1 billion rand”

and services exports have responded well to the increased competitiveness of the rand (box 2.5).

Merchandise export volumes recovered somewhat from the slight weakness in the first quarter of 2001. Nominal export earnings showed impressive growth, bolstered by the increase in domestic prices caused by the depreciation of the rand.

The increase in import prices that followed the depreciation of the rand in 1999–2000, helped by a decline in inventory investment, discouraged imports of goods and reinforced the trade surplus in the second quarter of 2001. This healthier trade balance was offset by a considerably higher deficit on the services and income account, reflecting the steady increase over the past eight years in non-residents’ ownership of shares in domestic companies. As a consequence, the current account surplus fell back slightly in the second quarter of 2001.

Strong exports and moderate imports resulted in a cumulative trade surplus of ZAR 25.1 billion for the first half of 2001. Imports are likely to grow with the expected acceleration in economic activity in 2002. Meanwhile, exports are expected to benefit from the U.S. African Growth and Opportunity Act that came into effect in 2001. Exports are likely to strengthen further if the current gap between returns to exports priced in dollars and rand-denominated production costs is maintained. This fundamental improvement in competitiveness may accelerate the relocation of export industries to South Africa from developed economies.

Changes in the services and income account of the balance of payments in 2001 came primarily from dividend outflows by foreign-listed companies with domestic operations. Between the first and second quarters of 2001 dividend outflows on foreign direct investments increased by a seasonally adjusted and annualized ZAR 22.8 billion, and those on

portfolio investments by ZAR 8.7 billion. The change in dividends on inward non-direct investment was also large, rising by a seasonally adjusted and annualized ZAR 12.5 billion from the first to second quarter of 2001.

Concerns about emerging markets and the uncertainties about the recession in Europe, Japan, and the United States in 2001 led to sharp reversals in capital flows and considerable currency volatility in many emerging market economies. In South Africa, by contrast, non-residents continued to make substantial purchases of listed shares in the first half of the year, although they were net sellers of bonds.

Capital flows were dominated by a restructuring of the shareholding in the De Beers mining company. In part as a result of this transaction, FDI into South Africa rose from a net outflow of ZAR 6.4 billion in the first quarter of 2001 to a net inflow of ZAR 93.8 billion in the second quarter. The matching component of the De Beers transaction resulted in a large net portfolio investment outflow as shareholders received shares in a non-resident company (Anglo American Corporation) in return for the delisting of their De Beers shares. The net outflow of portfolio investment amounted to ZAR 60.8 billion in the first half of 2001, compared with an outflow of ZAR 13.8 billion in 2000.

On a net basis other investment flows declined by ZAR 5.7 billion in the first quarter of 2001 and by ZAR 19.3 billion in the second quarter as South African firms repaid cross-border loans and extended trade finance. South Africa's financial account recorded a small cumulative net surplus of ZAR 1.6 billion in the first half of 2001.

“South Africa's financial account recorded a small cumulative net surplus in the first half of 2001”

Human development—wide disparities between rich and poor

Many of the human development challenges in South Africa reflect its history of apartheid, which left a legacy of disparities in access to good quality education and health care. Poverty rates remain high, in part because of such disparities.

Population and employment

The South African population was estimated at 44 million in 2000, with an average annual growth rate of 2.1% between 1995 and 2000. Average life expectancy is 58 years, although this composite figure conceals differences in life expectancy across population groups (black and white South Africans have different life expectancies).

Both the population growth rate and life expectancy are expected to fall dramatically as a result of the HIV/AIDS pandemic. Population growth may fall to zero by 2010, and some estimates suggest that life expectancy could be as low as 40 years by 2008, compared with a potential 65 years without the epidemic (Lewis 2001).

The labour force accounts for 25.7% of the population, reflecting the large share of South Africans who are below the age of 15 (women account for 35.6% of the labour force).

The gap between rich and poor in South Africa is among the largest in the world

Still, only 19.6% of the population was employed in 1995. The high unemployment means a dependency ratio of more than five people for every employed person.

As a result of apartheid policies, the South African labour market is highly segmented, with large differences in unemployment rates among unskilled, semi-skilled, and skilled workers. And employment does not necessarily ward off poverty: around a third of South Africans who are employed earn incomes below the poverty level (Indicator South Africa 2000).

Poverty

South Africa is not among the world's poorest nations in GDP terms. Yet because of the extreme inequalities, half the population is poor. In fact, the gap between rich and poor in South Africa is among the largest in the world, with the Gini coefficient of inequality estimated at 59.3 in 1993–94 (Indicator South Africa 2000; UNDP 2001).

Whether people are poor in South Africa is determined by the province in which they live (the population of the industrial heartland, Gauteng, is best off; that of the rural Northern Province worst off), by their racial group (60% of black South Africans are poor, compared with 30% of those of mixed race, 5% of Indians, and 1% of whites), and by their gender (nearly twice as many female-headed households as male-headed households are poor). Women are more likely to be unemployed, and the average wage in female-headed households is a third that in male-headed households. Children are particularly affected by poverty, with 60% living in poor households (Indicator South Africa 2000).

Education

Before 1994 South Africa's education sector was marked by apartheid policies. The country had two distinct education systems with different levels of funding and quality. The "Bantustan" system, underdeveloped and with insufficient resources, provided education for more than 70% of all children. The other, highly developed and with rich resources, served exclusively white South Africans.

These disparities have left a legacy of challenges in education. The country's literacy rate was 84.9% in 1999 (UNDP 2001), though illiteracy continues to decline. Gross primary enrolment is around 88%. Some sources estimate net primary enrolment in 1995–97 at 96% (with female primary enrolment at 89%), and net secondary enrolment at 56% (UNDP 2000). A large gap in quality remains between historically disadvantaged institutions and historically white and private schools.

Between 1994 and 2000 a major shift took place in education policy, reflected in a constitutional amendment making education (in all 11 of the country's official languages) a basic human right. The new education policy aims at providing 10 years of compulsory, free education, revising the curriculum, reducing class sizes, and instituting adult basic education and training programmes. But despite the change in policy and the subsequent real increases in education spending, government spending on education has not grown dramatically as a share of GDP or as a share of the budget.

Health

The South African health sector was characterized by a similar dichotomy in funding and quality before 1994. One health system, underdeveloped and underfunded, stretched to provide even primary health care. The other, a state-of-the-art, highly developed, well-funded system, provided secondary and tertiary health care to the privileged.

Nevertheless, in recent years health indicators have shown progress on some fronts. The fertility rate in 1999 was 4.2 births per woman, down from 4.6 in 1997. The infant mortality rate has been falling—declining from 66.6 per 1,000 live births in 1997 to 63.0 in 1999—although it is expected to rise again with the increase in HIV/AIDS in pregnant mothers. Children in poor households continue to die from curable diseases such as measles, typhoid, diarrhoea, and tuberculosis. Nonetheless, the infant mortality rate for South Africa compares well with those for East Asia and Latin America—though the average for the country hides considerable disparities among provinces and racial groups (UNDP 2000).

The greatest health and socio-economic challenge in South Africa is AIDS. Recent estimates indicate that the AIDS epidemic has cost the lives of more than 500,000 South Africans. And projections suggest that by 2015 this figure will increase to more than 10 million (ING Barings 1999, 2000). Because the disease typically affects those of prime working age (25–45 years old), the epidemic will put great pressure on the health care system and social services as many heads of household become unable to work, require care, and eventually die.

The AIDS epidemic has had a disproportionate effect on children. As early as 1994, 2.3% of babies in South Africa were HIV-positive and as many as 10.7% of reported AIDS cases were children. And the number of AIDS orphans is growing steadily.

The government's health policy objective is to shift the emphasis of the health system from curative services to primary health care, providing free medical services at state facilities for children under six and for pregnant women. Despite the policy change and the subsequent real increase in health spending, government spending on health has not increased as a share of GDP and has risen only slightly as a share of the budget (from 10.0% in 1995 to 11.1% in 2000).

Public spending on social services

Over the past five years the government has devoted roughly the same share of its spending to social services, with a one-time increase in 1997. Social spending amounted to 14.3% of GDP and 47.5% of the main budget in 2000/01 (table 2.5).

The share of spending on social services is large by international standards. Japan directs 37.5% of its central government spending to social services, and the United States only 28.5% (Indicator South Africa 2000). South Africa's comparatively high level of spending can be explained by several factors. First, the country is working to redress the inequalities of apartheid. Second, poverty rates are much higher in South Africa than in

“
Government spending
on health has
not increased as a
share of GDP
”

Table 2.5**Government spending on social services, South Africa, 1995/96–2000/01**

Type of social service	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01
Education						
As share of GDP	6.7	7.0	7.1	6.5	6.4	6.5
As share of main budget	21.3	22.1	22.0	21.6	21.4	21.5
Health						
As share of GDP	3.1	3.3	3.6	3.4	3.3	3.3
As share of main budget	10.0	10.4	11.3	11.1	11.2	11.1
Social security and welfare						
As share of GDP	3.0	2.9	3.7	3.6	3.6	3.7
As share of main budget	9.7	9.3	11.6	11.9	12.2	12.4
Housing and community development						
As share of GDP	0.6	0.3	1.1	0.8	0.7	0.6
As share of main budget	1.9	0.9	3.4	2.6	2.2	2.1
Total social services						
As share of GDP	14.5	14.5	15.6	14.4	14.1	14.3
As share of main budget	46.0	45.9	48.6	47.6	47.5	47.5

Note: All data refer to the fiscal year ending 31 March.

Source: South Africa, National Treasury.

many other countries. Third, social spending has limited impact in a situation of high and growing unemployment. And fourth, as a share of GDP, South Africa's national budget is smaller than that of developed countries.

Spending on social security increased from 9.7% of the main budget to 12.4% between 1995/96 and 2000/01, while spending on health rose from 10.0% to 11.1%. Spending on housing increased sharply in 1997/98 and 1998/99, reflecting the changing priorities of the new administration. Surprisingly, education spending has retained largely the same share of the total budget (rising only from 21.3% in 1995/96 to 21.5% in 2000/01), although the distribution of the funds has changed as the post-apartheid government has sought to rectify the past imbalances in spending. As a share of GDP, education spending has dropped and health spending has increased slightly.

Even without sizeable increases in the share of the budget devoted to social spending, South Africa achieved a number of social objectives between 1994 and 1999 (UNDP 2000):

- It extended access to water supply from 70% of the population to 80%.
- It expanded the electricity infrastructure grid from 40% of the population to 63%.
- It extended the landline telephony infrastructure from 24% of the population to 33%.
- It launched a primary school nutrition programme serving 5 million children.
- It built and repaired 10,000 classrooms.
- It extended free medical care to children under six and pregnant women.

- It built 638 health clinics.
- It constructed 1 million low-cost houses (by 2000).

The 2002 budget signals the government's continuing commitment to addressing the poverty and social vulnerability that affect most South Africans. Spending on social services will account for around 50% of consolidated non-interest expenditures.

Medium-term outlook and policy challenges— 3% growth expected in 2002

Despite relatively sound macroeconomic fundamentals, the South African economy has performed well below its potential. Economic growth has been slow since the 1970s, averaging 3.2% in that decade, 2.2% in the 1980s, and 1.3% in the 1990s. The effects of the slow growth have been intensified by the sharply declining labour absorption capacity in the economy. A relatively low savings ratio and high net outflow of capital have typified the stagnating growth performance over the decades. Perhaps the only factor defying the slow growth has been the steady growth in exports, due primarily to the constantly depreciating rand.

The slow economic growth has exacerbated the country's huge socio-economic disparities, which have developed over time as a result of many economic, socio-economic, political, and institutional factors. Another policy challenge has been the HIV/AIDS pandemic. Many economists have predicted a significant downward trend in total and per capita GDP as the epidemic leads to reductions in labour supply and total factor productivity and shifts in household and public spending. By 2010 GDP could decline by 19%, or 8% per capita, compared with a "no AIDS" counterfactual (Lewis 2001).

One obstacle to improved economic performance lies in the lack of investor confidence, which appears to be related largely to political and socio-political issues rather than purely macroeconomic concerns. Among the reasons for the lack of confidence:

- Delays in formulating a telecommunications policy contributed to a delay in the initial public offering of South Africa's national telecommunications company, Telkom, and few now believe that the listing can proceed before the middle of 2002. Despite signs that further postponement is likely, the government insists that the offering is on track for the current fiscal year (2001/02). Adverse market conditions are part of the problem. But there are also indications that the privatization and liberalization process in South Africa has lost its way because of competing economic and social demands. Indeed, the country's telecommunications policy had to be redrafted no less than four times after a series of interventions by vested interests. Less government interference in the drafting of the policy would probably have allowed an earlier listing of Telkom, despite less than ideal market conditions.
- The South African labour market remains severely overregulated, a disincentive to foreign direct investment.
- The investment environment in South Africa is unattractive. Investors must contend with massive red tape and high start-up costs. Corporate taxes are high, and firms face

*“Slow economic growth
has exacerbated the
country's huge
socio-economic
disparities”*

“*The economy is expected to achieve growth of around 3% in 2002*”

hidden taxes in the form of levies. And human resource departments need dedicated teams to monitor all the relevant laws and regulations.

- Attempts to rectify the social imbalances created by apartheid constrain liberalization, and in the privatization process policy implementation often appears to sabotage policy directives. Both these problems undermine the macroeconomic environment.

What is the immediate outlook for South Africa? The economy is expected to achieve growth of around 3% in 2002. The currency will continue to be vulnerable to external shocks, which could stem from further troubles in other emerging market economies and from deteriorating political and economic conditions in neighbouring Zimbabwe. But the rapid depreciation of the currency during the second half of 2001 and the improved global economic conditions in 2002 will give a major impetus to exports. The trade agreement with the European Union may provide another significant boost.

Inflation is expected to continue to be low in 2002 (averaging 5.5%), thanks mainly to the Reserve Bank's resolve to pursue a tight monetary policy. New targets set for 2003 and 2004 are designed to ensure a declining path for inflation as well as stability in real household income in coming years. The budget deficit is expected to rise slightly to 2.6% of GDP in 2002/03—with real increases in non-interest spending averaging 3.7% over the period 2002–05—and to fall to 2.2% of GDP in 2003/04. As a result, the consolidated public sector borrowing requirement is expected to remain modest in the years ahead, rising from an estimated 1.6% of GDP in 2002 to around 2.4% by 2004.

South Africa faces important choices relating to its future growth and development performance. Most critical will be putting in place the necessary conditions for achieving 5–6% growth. That effort must include narrowing the large and growing gap between the modern core economy and the peripheral economy. While greater integration with the global economy is often correlated with a reduction in unemployment, this correlation does not seem to hold in South Africa. One possible reason for this is that the benefits of globalization are largely confined to South Africa's sophisticated and industrially developed core economy, while the peripheral economy surrounding it has no real functional links to that core nor any link to global markets.

Narrowing the gap between the modern and peripheral economies will require economically empowering those in the periphery through training, job opportunities, and better social services. Only then will the economy allocate scarce resources more efficiently and thus move onto a higher growth path. Until then, South Africa may not fulfil its potential as the locomotive for regional growth.

Note

1. South Africa's fiscal year ends on 31 March. However, to be consistent with the rest of the report, fiscal data are reported for the calendar year whenever possible. When data for the calendar year are not available, fiscal year data are used.

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Ethiopia—Good Policies, Decent Outcomes

Ethiopia's recent economic performance has been quite encouraging. During 1992–2001 real GDP growth averaged 6% a year. Exports grew by about 5% a year, though there was considerable volatility across years. Annual inflation averaged about 4%. And by 2000/01 investment had risen to 16% of GDP.

These outcomes are much better than those in 1975–91. And the positive trends are expected to continue, with GDP growth of 8.7% in 2000/01 and 7.0% in 2001/02. Still, poverty remains deep and severe, with nearly half of Ethiopians living below the poverty line.

Since the mid-1970s the Ethiopian economy has undergone two major shifts in policies. The first occurred in 1975, when the Imperial government was violently overthrown by a group of military officers known as the Derg. The Derg replaced mainly liberal policies of the Imperial era with a centralized regime that discouraged a market economy and private property. Land and medium-size and large enterprises were nationalized. Prohibitive tariffs, extensive quotas, and complicated licensing procedures restricted foreign trade. Manufactured goods were rationed. Small farmers were forced to join cooperatives and to deliver grain to a government marketing agency. These policies generated disastrous economic outcomes that, combined with brutal political repression, led to civil conflict. The conflict ended with the downfall of the Derg and the assumption of power by the Ethiopian People's Revolutionary Democratic Front (EPRDF) in 1991.

Since 1992 the EPRDF government has focused on reorienting the economy through market reforms, including a structural adjustment program. As a result the state's direct role in economic activity has declined. Tariffs have been cut, quota constraints relaxed, licensing procedures simplified, foreign exchange controls eased, compulsory cooperative membership and grain delivery discontinued, and privatization begun. The government has also adopted agriculture-led industrialization as a central plank of its development programme, with a focus on productivity growth on small farms and labour-intensive industrialization. Increased agricultural productivity will be achieved primarily through an extensive extension program.

These reforms, combined with peace and favourable weather conditions for most of the past decade, produced the good economic outcomes noted above. Still, Ethiopia remains one of the world's poorest countries, with a per capita income of just \$110 in 2001. The structure of the economy remains largely unchanged, with rainfed agriculture gener-

The positive trends are expected to continue



*Ethiopia has good
medium-term
prospects*

ating nearly half of GDP, more than 85% of employment, and almost all exports. The country remains dependent on a few primary exports that suffer from deteriorating terms of trade, resulting in volatile export earnings. Growth is also constrained by heavy external debt. And the recent war with Eritrea did not help matters.

Moreover, in the past decade income inequality appears to have increased in both rural and urban Ethiopia. Urban unemployment has grown and, perhaps due to that, urban poverty has not fallen much. In addition, HIV/AIDS will likely be a major constraint on sustained growth. More than 3 million Ethiopians live with HIV/AIDS, and each year about 300,000 die from the disease. The pandemic has increased illness and mortality rates, lowering productivity and raising health care costs. Poor people will be hit especially hard as the disease spreads.

Ethiopia's government is preparing a Full Poverty Reduction Strategy Paper (Full PRSP). This process provides a good opportunity to focus on alleviating poverty and fostering medium- to long-term development. Among many other issues, the process is expected to map out a strategy for combating HIV/AIDS. Similarly, reducing debt through the enhanced Heavily Indebted Poor Countries (HIPC) initiative and using the resulting savings in areas such as education and health could contribute significantly to human development and economic growth.

In brief, Ethiopia has good medium-term prospects—prospects that will be realized if it remains politically stable and the weather continues to be favourable, and if the government fully exploits opportunities from, among other things, the HIPC initiative and the Africa Growth Opportunity Act (AGOA).

Real sector developments—output, savings, investment, and prices

Between 1998/99 and 2000/01 real GDP growth averaged 6.6% a year, up from 4.8% over the previous three years (table 3.1). Estimated GDP growth of 8.7% in 2000/01 was the highest since 1995/96.

With agriculture employing more than 85% of the population and accounting for nearly half of GDP, Ethiopia's economic performance is largely determined by what happens in the agricultural sector. Over the past decade changes in GDP and agricultural output have been closely linked—and erratic (figure 3.1). This volatility is a direct result of the economy's extreme dependence on rainfed agriculture. GDP growth is highest in years with good rains (1995/96, 2000/01) and lowest in years without (1997/98).

The structure of the Ethiopian economy has hardly changed since 1991/92 (figure 3.2)—or indeed, over the past four decades. Agriculture accounted for 53% of GDP in 1973/74 and for 45% in 2000/01. Over the past decade the share of industry hovered around 11% of GDP; services accounted for the remainder. Promoting structural change remains a key policy challenge.

Table 3.1

Changes in real GDP and sectoral output, Ethiopia, 1995/96–2000/01
(percent)

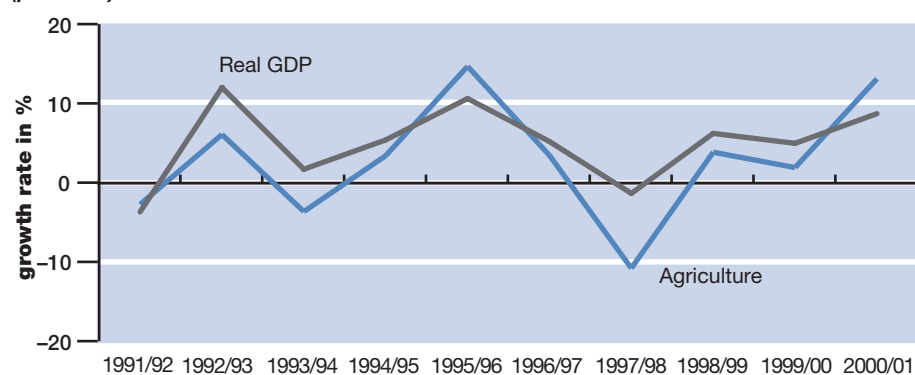
							Average 1995/96– 1997/98	Average 1998/99– 2000/01
Indicator/sector	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	1997/98	2000/01
Real GDP	10.6	5.2	−1.4	6.2	5.0	8.7	4.8	6.6
Agriculture	14.7	3.4	−0.8	3.8	1.9	13.1	2.4	6.3
Industry	5.3	7.0	0.9	6.9	5.1	10.6	4.4	7.5
Services	7.0	7.1	10.4	8.5	8.0	5.3	8.1	7.3

Note: As of 1997/98 the fiscal year covers July 8–July 7. Before that, fiscal and monetary data cover July 8–July 7 and all other data cover July 1–June 30.

Source: Economic Commission for Africa from official sources.

Figure 3.1

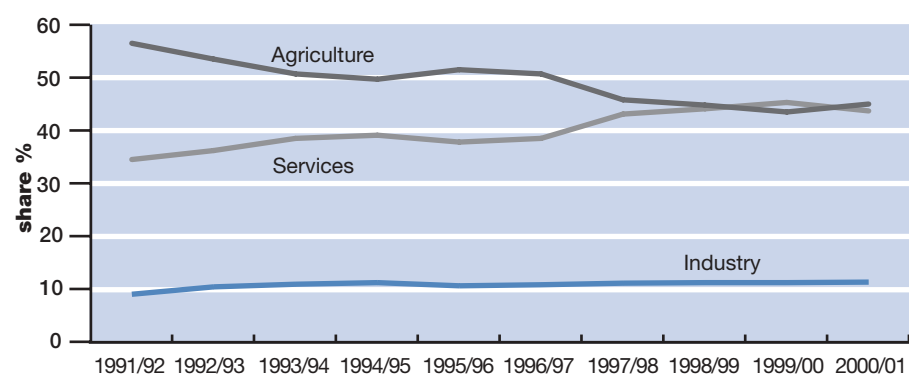
Changes in real GDP and agricultural output, Ethiopia, 1991/92–2000/01
(percent)



Source: Economic Commission for Africa from official sources.

Figure 3.2

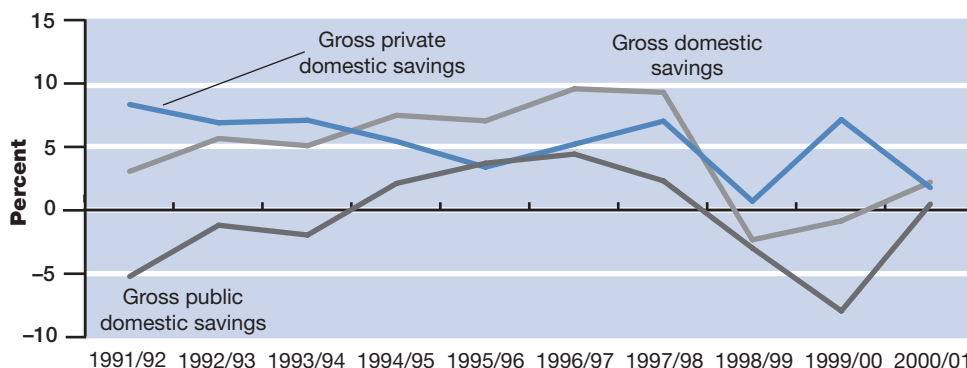
Sectoral composition of GDP, Ethiopia, 1991/92–2000/01
(percentage of GDP)



Source: Economic Commission for Africa from official sources.

Figure 3.3

*Gross private, public, and total savings, Ethiopia, 1991/92–2000/01
(percentage of GDP)*



Source: Economic Commission for Africa from official sources.

Savings—tripling, then flat

As in many African economies, savings are very low in Ethiopia. Gross domestic savings increased significantly after market reforms were introduced, tripling from a paltry 3% of GDP in 1991/92 to 9% in 1997/98 (figure 3.3). But the onset of the Ethio-Eritrea war in 1998 put a stop to that growth. In the subsequent two years public savings continued to decline and has recovered marginally in 2000/01 period. Private savings experienced a sharp drop in 1989/99 and recovered in the subsequent year, yet again to decline in 2000/01. The combined effect shows that the gross savings ratio, which declined in the aftermath of the Ethio-Eritrea war, is finally on a path to recovery by 2000/01.

Investment—modest increases, but still low

Except during the two years of conflict with Eritrea, investment has been rising since reforms began in 1992 (figure 3.4). But the increases have been modest, and investment remains low. In 2000/01 total investment equalled 16% of GDP, 2 percentage points higher than in the two preceding years of conflict. Both private and public investment have recovered, with private investment exceeding prewar levels.

Foreign direct investment—up substantially

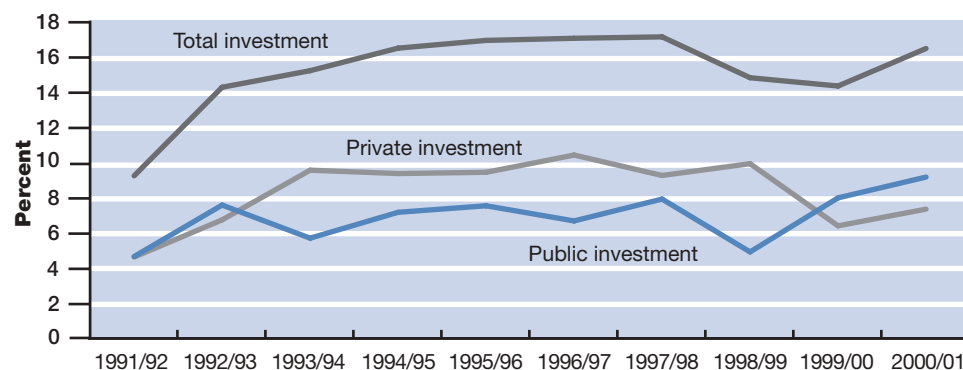
Foreign direct investment (FDI) has been increasing since the 1992 reforms, rising from 2% of total investment in 1995/96 to 59% in 1997/98 (table 3.2). Although this share fell during the Ethio-Eritrea war, FDI accounted for 20% of investment capital for projects commencing in 1992–2001 (table 3.3). Mining, hydrocarbons, agro-industry, and tourism are the most promising sectors for FDI.

Saudi Arabia has been the source of 60% of the FDI approved so far, with MIDROC Ethiopia, a private limited company, accounting for much of that. The European Union has been the second largest source of FDI, providing about 30%. Ethiopians living abroad have also provided substantial FDI.

“*Saudi Arabia has been the source of 60% of the FDI approved so far*”

Figure 3.4

Private, public, and total investment, Ethiopia, 1991/92–2000/01
(percentage of GDP)



Source: Economic Commission for Africa from official sources.

Table 3.2

Domestic and foreign direct investment, Ethiopia, 1995/96–1999/2000

Indicator	1995/96	1996/97	1997/98	1998/99	1999/2000
Domestic investment (percentage of total)	97.8	50.2	40.8	68.2	90.1
Foreign direct investment (percentage of total)	2.2	49.8	59.2	31.8	9.9
Total investment (millions of birr)	841.7	2,400.6	2,871.4	1,120.0	3,216.4

Source: Economic Commission for Africa from official sources.

Table 3.3

Number and investment capital of projects, Ethiopia, July 1992–July 2001

Indicator	Number of projects	Investment capital (millions of birr)	Percentage of total investment
Private domestic investment	6,195	46,167	64.3
Public domestic investment	33	11,072	15.4
Foreign direct investment	282	14,610	20.3
Total investment	6,510	71,850	100.0

Note: Include only projects that have commenced operation.

Source: Economic Commission for Africa from official sources.

FDI has increased in response to market reforms and the introduction of investment guarantees and incentives. Investment guarantees include no expropriation or full market value compensation when public interest requires expropriation as well as full repatriation of profits and capital, interest payments on foreign loans, proceeds from asset sales, and technology transfer payments. Investment incentives include considerable tax exemptions and investor choice of depreciation methods.

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Ethiopia had the lowest
stock of capital per
worker in Africa
”

Although regulations on FDI are much more relaxed than during the Derg period, some restrictions remain. FDI is excluded from large sections of the economy, including banking, insurance, broadcasting, and printing. These exclusions, together with infrastructure weaknesses, partly explain why Ethiopia receives less FDI than other developing countries.

FDI in Ethiopia is expected to recover now that the conflict with Eritrea has ended. Further relaxation of regulations on FDI would also encourage investors. Moreover, recent agreements with the World Bank and the International Monetary Fund (IMF) and the resulting resumption in external assistance will likely help because they send positive signals to foreign investors.

In 2000 Ethiopia had the lowest stock of capital per worker (\$441) in Africa. In addition, the country's road and telephone networks had some of the lowest densities in the continent. Output per worker, at \$268, was the second lowest in the continent. This undercapitalization helps explain Ethiopia's low productivity. Thus the country's physical and infrastructure capital stock should be boosted through increased investment, combined with the introduction of appropriate technologies. Achieving those goals will require a considerable increase in domestic savings. Although low incomes are a major constraint, limited saving instruments have also discouraged private savings. The government, working with the private sector, should develop credit and investment policies that encourage domestic savings and investment as well as FDI.

Unemployment and inflation—urban jobseekers rise, prices remain stable

According to Ethiopia's Central Statistical Authority, unemployment in rural areas increased from 0.4% in 1984 to 0.7% in 1994, and in urban areas from 8% to 22%. Household surveys indicate that in 1997 urban unemployment was about 30%—showing the seriousness of unemployment in urban areas. Further evidence to that effect is provided

Table 3.4
Inflation and exchange rates, Ethiopia, 1995/96–2000/01

Indicator	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01
Inflation (percent) ^a	–2.6	–1.5	3.5	1.2	4.0	–7.2 ^b
Exchange rate (birr to the U.S. dollar)						
Official rate	6.32	6.50	6.88	7.51	8.14	8.33
Parallel market rate	7.64	7.16	7.08	7.69	8.60	8.70

a. Based on the new country-level consumer price index (base year 1995/96).

b. Through June 2001.

Source: Economic Commission for Africa from official sources.

by the ratio of registered job seekers to announced vacancies. This ratio was 3.2 in 1984/85 and 3.9 in 1989/90—then rose sharply to 6.3 in 1996/97. Policy reforms have had little effect on urban unemployment. Labour market policies should focus on the informal sector, which employs 51% of economically active Ethiopians.

Since the mid-1990s prices have been quite stable in Ethiopia (table 3.4). Inflation was modest in 1998/99 and 1999/2000, and in 2000/01 prices actually fell—as they have in three of the past six years. Price stability is mainly due to conservative monetary and fiscal policies and strong agricultural performance. Agriculture has a significant effect on inflation because food items account for nearly half of the basket of goods that determine the consumer price index. Thus significant expansions (contractions) in cereal output lead to lower (higher) inflation. Indeed, the decline in prices in 2000/01 mainly reflects a bumper cereal harvest.

“
External assistance and
external borrowing
continue to be
important
”

Fiscal policy—budget deficit narrowing

Fiscal policy improved modestly in 2000/01. Government revenue rose from 17.5% of GDP in 1999/2000 to 20% in 2000/01, while spending fell from 32% of GDP to 30% (figure 3.5). As a result the budget deficit narrowed to 10% of GDP—a decline of nearly 5 percentage points.

The government was able to use its revenue to finance most budgeted current spending. Over the past decade external assistance has covered only about 3% of recurrent spending. In the past three years the government has also managed to finance about half of its capital spending from its revenue. Still, external assistance and external borrowing continue to be important, particularly as sources of capital finance. External assistance financed 13% of capital spending in 2000/01, and external borrowing financed 35%—slightly higher shares than in 1999/2000 (figure 3.6).

Monetary policy—interest rate controls eased

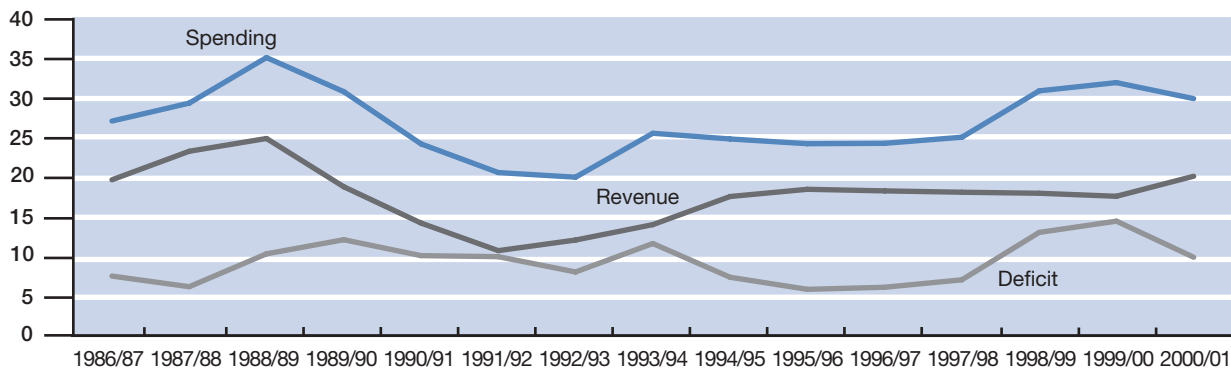
The government has been pursuing prudent monetary policy. After contracting in 1998/99, narrow money (M1) and broad money (M2) expanded in 1999/2000 and 2000/01 (figure 3.7). The ratio of M2 to GDP increased in 2000/01, reflecting the gradual monetization of the economy.

Interest rate controls have been eased as part of the reforms that began in 1992. The National Bank of Ethiopia—the central bank—now sets a floor only for the deposit rate, allowing market forces to determine all other rates. In line with the gradualist strategy, the bank implemented this policy in steps.

Until 1992 all foreign exchange earnings were surrendered to the National Bank of Ethiopia, which rationed foreign exchange to sectors accorded priority in the national plan. The greatest priority was given to public enterprises and cooperatives, and the least to the private sector. For nearly two decades until 1992, Ethiopia had a fixed exchange rate of 2.07

Figure 3.5

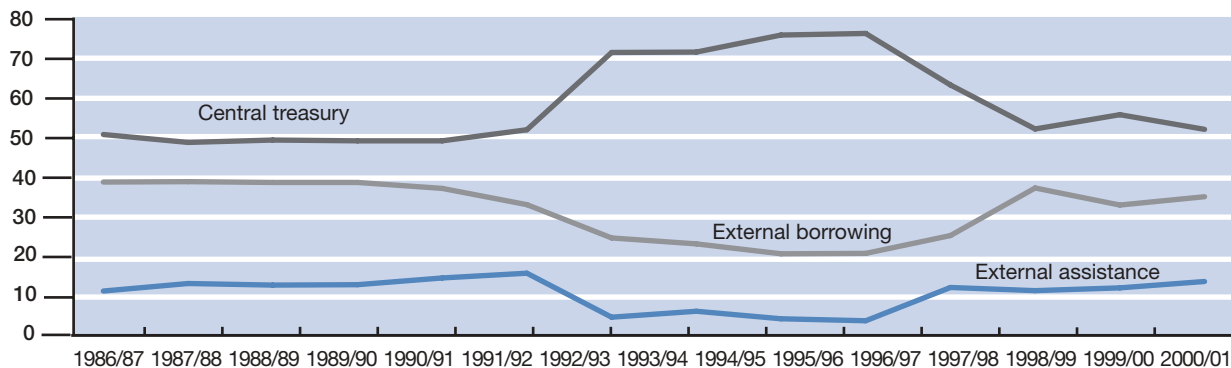
Government revenue, spending, and deficit, Ethiopia, 1986/87–2000/01
(percentage of GDP)



Source: Economic Commission for Africa from official sources.

Figure 3.6

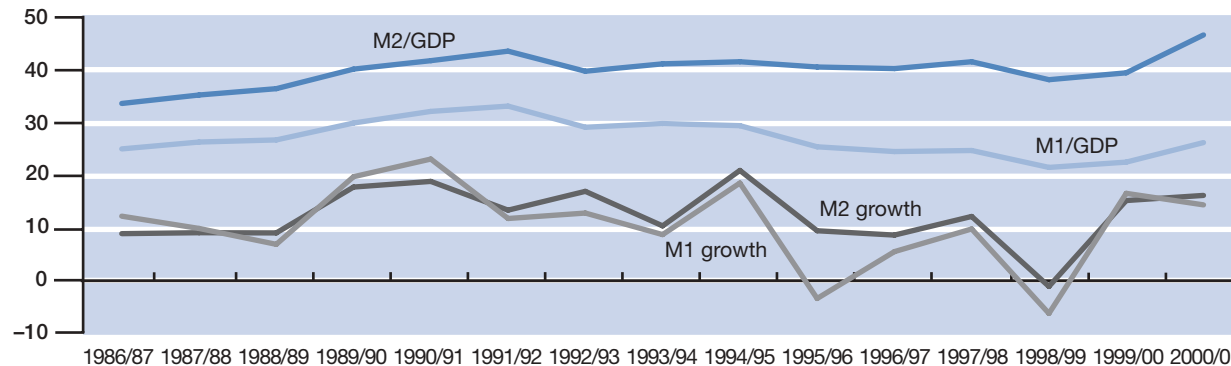
Sources of financing for capital spending, Ethiopia, 1987/88–2000/01
(percentage of total financing)



Source: Economic Commission for Africa from official sources.

Figure 3.7

Money supply, Ethiopia, 1986/87–2000/01
(percent)



Source: Economic Commission for Africa from official sources.

birr to the U.S. dollar. Early in the reform period the birr was devalued to 5 to the dollar, and subsequently an auction-based system was introduced to determine the exchange rate. After several modifications, the auction-based system was replaced in 2001 by an interbank foreign exchange market. The exchange rate is now determined daily through transactions in this market.

The exchange rate has shown remarkable stability since the auction-based system was introduced. Since the mid-1990s the difference between the official (auction-based) exchange rate and the parallel (unofficial or illegal but tolerated) rate has narrowed. Thus the government's exchange rate policy has been quite effective.

A related liberalization measure taken by the government was the establishment of an interbank money market. This market facilitates borrowing and lending among banks, microfinance institutions, and nonbank financial institutions at interest rates freely determined by the borrowers and lenders.

The financial sector—opening

Many financial sector reforms have been introduced since 1992. The state plays a less direct role in the financial sector. New private financial institutions have been allowed to operate. And the role of the National Bank of Ethiopia has been reformulated.

The government achieved these goals by gradually opening the financial sector to new participants. As a result six private banks and eight insurance companies now operate alongside public ones. In addition, the government increased domestic capacity before full liberalization by initially restricting the financial sector to domestic investors, strengthening regulation and supervision by the National Bank of Ethiopia, providing autonomy to banks, and opening the interbank money market.

The private banks and insurance companies are relatively small. Indeed, the government-owned Commercial Bank of Ethiopia remains the country's largest commercial bank. But its dominance is declining as private banks grow. The Commercial Bank of Ethiopia's share of total deposits fell from 92% in 1996/97 to 84% in 1998/99, and its share of disbursed credit fell from 75% to 58%. During this period private banks' share of deposits rose from 4% to 8%, and their share of disbursed credit rose from 6% to 22%. Thus private banks could see their shares of both deposits and lending increase significantly over the next few years.

In the future the Commercial Bank of Ethiopia is also likely to face competition from international banks—which is one reason the government decided to allow an international bank to run the Commercial Bank under a management contract. The State Bank of India, the only bidder, won the three-year contract in August 2001 and was supposed to take over management later that year. But the year ended without the takeover, and the Indian bank has withdrawn the management contract with the Commercial Bank. More recently, almost all the top officials of the Commercial Bank were arrested as part of the government's anticorruption campaign.

“Many financial sector reforms have been introduced”

Foreign trade and debt—new policies in place

In 1992 the government began adopting significant reforms for foreign trade. In a radical departure from the previous administration's statist approach, new foreign trade policies aim to:

- Promote private sector development.
- Provide adequate incentives for exporters.
- Replace quantitative restrictions with tariffs.
- Encourage export diversification and minimize illicit trade.
- Restructure state-owned trading enterprises.

Many steps have been taken to achieve these objectives. The exchange rate has been liberalized using the auction system. Licensing procedures, tariff structures, and foreign exchange retention procedures have been simplified. And private exporters have been given support services, including transport assistance, overseas market research, and training in marketing and packaging.

For customs purposes, imported goods are classified into 21 sections and 99 chapters. These chapters contain 5,291 goods—5,119 with ad valorem rates of 5–50%, 169 that are duty free, and 3 with specific rates. The weighted average tariff is about 25%, down from as high as 230% before the reform. In addition to customs duties, imported goods are subject to a sales tax (5–12% of the good's value) and an excise tax (10–100%).

In addition to streamlining export licensing, two duty incentives have been introduced. Duty drawbacks are provided to part- and full-time exporters, while duty-free imports are provided to firms devoted to supplying products to foreign markets. Exporters also have the right to retain half of their export earnings and foreign currency remittances in a retention account. Within three weeks of the entry date, the account holder must offer to sell 80% of these funds to commercial banks (at negotiated rates) or to the auction market. The account holder should use the remaining 20% to import goods and services, promote exports, or any other payment approved by the National Bank.

Balance of payments—ballooning deficits

Ethiopia's balance of payments has run a deficit for most of the past decade (table 3.5). The only exceptions were 1993/94 and 1994/95, when smaller trade deficits, substantial transfers, and positive capital account balances produced surpluses. The trade deficit ballooned in 1998–2000—that is, during and just after the Ethio-Eritrea war.

Exports. Ethiopia's exports are dominated by a few commodities such as coffee—which accounted for about two-thirds of export earnings for most of the 1990s—*chat* (a mild stimulant), and hides and skins (table 3.6). Since the early 1990s six items have accounted for nearly all exports. Chat recently became quite important and is now the second largest export after coffee, accounting for about 15% of exports in 1999/2000.

Exports accounted for an average of 15% of GDP in 1995/96–1997/98 and 1998/99–2000/01 (table 3.7). In contrast, imports jumped from about 24% of GDP in

“*The trade deficit ballooned in 1998–2000*”

Table 3.5

Balance of payments, Ethiopia, 1991/92–2000/01
(millions of U.S. dollars)

Indicator	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01
Balance of payments	-205.7	-178.1	277.6	166.1	-43.6	-213.2	-22.5	-46.9	-312.8	-70.5
Current account	-391.6	-587.7	-296.8	-229.3	-611.1	-180.3	-194.9	-701.8	-615.2	-644.7
Trade balance	-720.6	-952.3	-575.1	-593.8	-990.15	-548.0	-614.2	-1,073.8	-1,125.1	-1,101.7
Net services	13.2	-12.9	30.0	53.3	65.7	110.6	101.6	82.9	99.3	77.8
Private transfers (net)	315.8	377.5	248.3	311.2	313.4	257.1	317.7	289.2	410.4	379.2
Capital account	316.6	593.6	464.3	439.5	386.8	102.7	369.7	444.5	430.5	653.6
Public transfers (net)	431.6	609.7	250.7	409.6	391.6	223.5	260.6	212.9	290.9	395.0
Nonmonetary capital ^a	-115.0	-16.1	213.6	29.9	-4.8	-120.8	109.1	231.6	139.6	258.6
Net errors and omissions	-130.7	-184.0	110.1	-44.0	180.6	-135.6	-197.3	210.4	-128.2	-79.4

a. Sum of long-term and short-term capital flows and foreign direct investment.

Source: Economic Commission for Africa from official sources.

Table 3.6

Share of major exports in export earnings, Ethiopia, 1992/93–1999/2000
(percentage of total)

Type of export	1992/93	1993/94	1993/94	1995/96	1996/97	1997/98	1998/99	1999/2000
Live animals	0.17	0.87	0.28	0.03	0.32	0.26	0.16	0.38
Coffee	67.05	57.96	65.85	67.90	66.20	69.77	60.16	57.47
Hides and skins	16.80	16.44	13.67	12.20	10.68	8.40	5.16	7.99
Petroleum and petrol	3.78	5.85	3.48	2.44	2.38	0.25	0.00	0.00
Oil seeds and pulses	0.65	5.80	5.62	4.69	4.65	10.08	10.63	8.74
Chat	8.21	8.71	6.31	6.87	5.72	6.58	12.67	14.63
Combined share	96.66	95.64	95.21	94.13	89.95	95.32	88.78	89.21

Source: Economic Commission for Africa from official sources.

Table 3.7

Exports and imports relative to GDP and each other, Ethiopia, 1995/96–2001/2002
(percentage of GDP)

Item	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02 ^a	1995/96–1998/99–	1999/98–2000/01
Exports	13.1	16.2	15.8	14.2	15.0	15.1	14.8	15.0	14.8
Imports	23.0	23.7	23.7	31.3	30.2	29.3	28.5	23.5	30.3
Exports/imports (percent)	57.0	68.5	66.9	45.2	49.6	51.4	52.1	64.1	48.7

a. Projected.

Source: Geda 1999; Ethiopia, Ministry of Economic Development and Cooperation 1998, 1999b.

“ **Ethiopia’s debt
increased steadily
through the late 1990s** ”

1995/96–1997/98 to 30% in 1998/99–2000/01. As a result the import coverage generated by exports deteriorated from 64% in the first period to just 49% in the second period—indicating an increase in financing requirements and hence debt.

Exports exhibited enormous volatility over the past decade, largely due to their concentration in a few primary commodities (table 3.8). Bad weather conditions, production or marketing problems, and international price shocks affecting one or two of these commodities can cause a huge swing in export volumes, values, or both.

Most of Ethiopia’s exports are destined for a few countries (Germany, Italy, United States, France, United Kingdom, Japan, Saudi Arabia; table 3.9). This pattern has held fairly steady over the past 10 years aside from the increasing importance of importers in Asia (particularly Japan), the Middle East (particularly Saudi Arabia), and Africa. Thus there is a clear need to diversify the destinations of exports.

Imports. Over the past decade, capital goods, fuel, semifinished goods, and consumer nondurable goods accounted for at least 80% of Ethiopia’s imports (table 3.10). This pattern reflects the country’s inability to produce capital goods and its heavy reliance on imported consumer goods, which account for a third of imports.

Terms of trade. Ethiopia’s terms of trade deteriorated in the 1990s, continuing a trend that started in the 1970s (table 3.11). Except in 1976–77, when coffee prices soared, the terms of trade have been deteriorating—especially since 1987, and with a historic low in 1993. This trend is due to rising import prices and declining export prices.

The deterioration in the terms of trade and the instability in export volumes have been the main causes of Ethiopia’s persistent current account deficit. Thus these two factors are important constraints on economic performance.

Foreign debt—too heavy a burden

Ethiopia’s debt increased steadily through the late 1990s, reaching \$10.4 billion in 1998 (table 3.12). At the same time, interest and principal arrears accumulated, reaching 84% of GNP and 506% of exports by 1997. Both developments indicate that by the end of the 1990s, debt had become too heavy a burden for Ethiopia.

Two recent developments have addressed this burden. First, in 1999 Russia agreed to cancel about 80% (\$4.8 billion) of the debt Ethiopia owed to the former Soviet Union. This agreement cut Ethiopia’s debt stock by almost half, sharply reducing total repayments (principal and interest) due. Combined with traditional debt relief from members of the Paris Club and other creditors, this cancellation lowered Ethiopia’s debt to \$5.3 billion and reduced debt service to \$189 million in 2000/01.

The second development was the 2001 decision by the World Bank and the IMF qualifying Ethiopia for debt relief under the enhanced HIPC initiative (box 3.1). This decision followed Ethiopia’s submission of its Interim Poverty Reduction Strategy Paper (I-PRSP) and the paper’s acceptance by the World Bank and the IMF. As a result Ethiopia is eligible

Table 3.8*Annual changes in the volume of total and selected exports, Ethiopia, 1991/92–1999/2000*

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	Average	Standard deviation
Total exports	-52.2	55.2	69.4	-2.2	-11.9	15.7	-15.7	-19.3	4.2	4.8	37.8
Coffee	-58.8	108.9	2.6	18.9	18.7	26.2	-2.5	-15.7	16.1	12.7	44.4
Hides and skins	-35.1	51.6	40.1	26.3	-23.5	14.6	-9.2	-25.8	47.7	9.6	33.8
Live animals	-94.3	150.9	670.8	-69.4	-75.3	616.6	1.5	-30.6	82.8	139.2	297.0
Chat	-82.9	671.5	45.0	44.2	-8.6	36.0	18.9	62.2	61.5	94.2	221.2

*Source: Economic Commission for Africa from official sources.***Table 3.9***Exports by destination, Ethiopia, various years
(percentage of total)*

Destination	1988/89	1989-96	1996	1999
France	4.90	4.37	3.39	4.73
Germany	23.20	26.87	29.72	18.15
Italy	6.50	7.73	7.43	6.86
United Kingdom	1.90	3.93	3.11	2.40
United States	12.40	7.35	6.11	4.87
Other Europe	—	8.32	7.15	8.78
Asia and the Middle East	15.10 ^a	29.59	29.74	35.21
Africa	—	10.71	12.43	17.99
Rest of the world	—	1.13	0.92	1.02

*a. Includes only Japan and Saudi Arabia**Source: Economic Commission for Africa from official sources.*

Table 3.10

Selected imports by end use, Ethiopia, 1991/92–1998/99
(percentage of total)

Type of import	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99
1. Raw materials	1.95	1.96	1.82	2.00	2.38	2.04	2.05	1.74
2. Semifinished goods	12.89	9.02	16.29	17.00	16.71	19.16	16.35	16.80
3. Fuel	13.77	22.68	15.31	15.17	12.37	18.44	24.45	11.36
4. Capital goods (transportation)	23.30	23.27	13.43	13.39	16.46	16.22	7.18	9.91
5. Capital goods (agricultural)	0.24	0.26	0.71	1.94	1.02	1.00	0.71	0.95
6. Capital goods (industrial)	12.99	11.44	15.09	16.53	16.87	21.61	21.88	22.85
7. Development or investment good (total, 1 to 6)	65.14	68.63	62.65	66.03	65.81	78.48	72.63	63.62
8. Consumer goods (durables)	9.71	7.25	9.76	8.68	9.52	9.74	8.40	9.83
9. Consumer goods (nondurables)	24.84	24.06	25.36	23.78	22.76	10.89	11.30	18.27
10. Consumer goods (8 + 9)	34.56	31.31	35.12	32.47	32.28	20.63	19.70	28.10

Source: Economic Commission for Africa from official sources.

Table 3.11

Terms of trade index, Ethiopia, 1970–97
(1987 = 100, based on U.S. dollars)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Index	166	141	148	164	104	96	167	232	154	155	118	98	105	107
	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Index	119	117	131	100	98	92	79	85	79	63	69	94	77	97

Source: World Bank 2000a; World Bank, World Tables (Electronic-STARs) 2000.

Table 3.12
Debt indicators, Ethiopia, 1985–99
(percent, except where otherwise specified)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Debt stock															
(billions of U.S. dollars)	5.21	6.13	7.36	7.70	7.84	8.63	9.12	9.34	9.70	10.07	10.31	10.08	10.08	10.35	5.55
Debt/GNP	78.1	88.0	99.0	100.5	98.6	126.6	171.6	169.2	157.6	208.5	180.3	168.9	159.0	152.1	86.9
Debt/exports	932.1	891.0	1,150.4	1,189	1,034.8	1,276.3	1,666.7	2,036.9	1,889.2	1,788.0	1,276.5	1,224.4	968.1	932.2	—
Interest/exports	8.8	8.8	10.8	14.8	11.2	8.7	8.3	10.3	5.7	7.8	7.8	6.7	4.5	4.2	—
Debt service/exports	28.4	32.6	38.9	47.7	40.1	34.9	25.2	23.9	18.5	19.8	19.1	42.2	9.5	11.3	16.8
Arrears/GNP	0.0	0.0	0.7	0.2	0.9	4.1	20.5	32.2	39.7	66.3	71.1	80.2	83.6	80.6	—
Arrears/exports	0.3	0.2	8.5	2.4	9.1	41.2	198.8	388.1	475.6	569.1	503.6	581.1	506.2	503.0	—
Interest arrears/total arrears	21.4	27.3	6.7	10.2	23.0	15.3	15.2	14.5	13.8	12.3	10.7	10.0	10.2	10.6	—
Principal arrears/total arrears	78.6	72.7	93.3	89.8	77.0	84.7	84.8	85.5	86.2	87.7	89.3	90.0	89.8	89.4	—

Source: World Bank 1998, 2000a.

Box 3.1

Ethiopia qualifies for debt relief under the enhanced HIPC initiative

The IMF and the World Bank's International Development Association (IDA) have agreed that Ethiopia has taken the steps necessary to reach its decision point under the HIPC initiative, making it the 24th country to qualify for debt relief under the initiative's enhanced framework.

HIPC debt relief from Ethiopia's creditors will total about \$1.3 billion in net present value terms, or 47% of Ethiopia's official external debt after traditional debt relief (corresponding to \$1.9 billion in debt service relief over time). As a result the net present value of the debt-exports ratio will be cut from 350% to 150% at the decision point, and will fall even further over the next decade.

HIPC assistance will generate substantial savings in debt service, averaging about \$96 million a year through 2021. Debt service as a percentage of exports will be cut by more than half, from 16% to 7% by 2003 and falling below 4% by 2021. Debt service as a share of fiscal revenue will also drop significantly, to an average of 7.8% over the next 10 years, and debt service as a share of GDP will fall to 1.6% over the same period. Both measures will decline further thereafter. The resources freed by HIPC debt relief will be used for key antipoverty programmes outlined in Ethiopia's I-PRSP. Poverty-targeted spending is projected to increase from 10.9% of GDP in 2000/01 to 14.7% in 2001/02 and 15.5% in 2002/03.

The full debt relief from the IMF, IDA, and other creditors will be delivered to Ethiopia after it completes a number of measures recommended by the boards of the World Bank and IMF in February 2001. In defining the completion point triggers, the Ethiopian authorities—in consultation with IMF and IDA staff—have focused on ensuring that measures will be monitorable, ambitious but achievable within a relatively short period, and streamlined and complemented by reforms pursued as part of the PRSP and other Bank- and IDA-supported programmes, and that they will lead to tangible and measurable outcomes.

Measures include:

- Completing a Full PRSP—Ethiopia is to complete, and implement satisfactorily for one year, a fully participatory PRSP, for which the boards of the IMF and World Bank will have concurred with their staffs' assessment that it provides a sound basis for reaching the completion point and for securing future concessional assistance.
- Maintaining macroeconomic stability—macroeconomic stability should be maintained, as evidenced by satisfactory implementation of the IMF's Poverty Reduction and Growth Facility program.
- Strengthening governance and public expenditure management—public expenditure management should be improved, with an emphasis on reconciling monetary and fiscal accounts starting in 2001/02 and consolidating on a comprehensive basis federal and regional budgets starting in 2002/03.
- Enhancing structural reforms—required reforms include introducing a value added tax by January 2003, completing the financial restructuring of the Commercial Bank of Ethiopia and making the financial sector more competitive, and increasing the competitiveness and efficiency of fertilizer input markets.

Box 3.1 (continued)

Ethiopia qualifies for debt relief under the enhanced HIPC initiative

- Pursuing social sector objectives—required reforms include increasing gross primary school enrolment for girls from 40% to 50%, reducing repetition at the primary level, increasing DPT3 vaccination coverage to 50%, increasing the use of health outreach facilities, and fighting HIV/AIDS by complementing the government's overall strategy with increased distribution of condoms throughout the country.

Source: IMF, press release 01/45, 12 November 2001.

for interim debt relief while it develops its Full PRSP. Interim relief is expected to reduce debt service obligations by about \$60 million in 2001/02. Moreover, a good track record in implementing structural reforms and a poverty reduction strategy entitles the country to further savings in debt service, averaging an estimated \$96 million a year through 2021. In conjunction with HIPC debt relief, in March 2001 the IMF approved a programme under its Poverty Reduction and Growth Facility that will provide Ethiopia with \$110 million over three years.

“Poverty indicators for the second half of the 1990s show some encouraging trends”

Poverty—deep in rural areas

Recent measures show that poverty is pervasive in Ethiopia. Nearly half of the country's people live below the poverty line. Moreover, rural poverty accounts for about 90% of national poverty (table 3.13). In four regions (Tigray, Afar, Amhara, Southern Region) more than half of the population lives in poverty (table 3.14). Only three largely urban regions (Harrari, Dire Dawa, Addis Ababa) have headcount indexes of 30% or less.

Poverty indicators for the second half of the 1990s show some encouraging trends, however. Household surveys indicate that between 1994 and 1997 the share of poor Ethiopians fell in rural areas and in the country as a whole (table 3.15). Economic reforms and appropriate policies were partly responsible for the improvements. But urban poverty hardly changed, and so is a major concern for government policy.

Poverty would have fallen even more if the distribution of income had not worsened. Between 1994 and 1997 the Gini coefficient rose 4 percentage points in rural and urban areas as well as nationally (table 3.16). In fact, the elasticity of the headcount index relative to the Gini coefficient implies that changes in income inequality affected poverty almost as much as changes in income. Thus new reforms and government policies should address growing income inequality and its effects on poverty.

Several factors may explain the increase in income inequality. During 1994–97 Ethiopia underwent a transition from civil war to peace and a more liberal economic system. Economies that undergo such a transition are likely to see an increase in income

Table 3.13

Poverty measures, Ethiopia, 1995/96
(percent)

Area	Share of population	Headcount index (P_0)	Poverty gap (P_1)	Poverty severity (P_2)	Contribution to national poverty
Rural	86.0	47.5	0.13	0.05	89.8
Urban	14.0	33.2	0.10	0.04	10.2
National	100.0	45.5	0.13	0.05	100.0

Source: Economic Commission for Africa from official sources.

Table 3.14

Poverty, measured by region, Ethiopia, 1995/96
(percent)

Region	Headcount index (P_0)	Poverty gap (P_1)	Poverty severity (P_2)
Addis Ababa	30.0	11.0	4.0
Afar	51.8	16.0	6.0
Amhara	56.7	17.0	7.0
Benshangul-Gumuz	47.6	14.0	5.0
Dire Dawa	24.6	9.0	2.0
Gambella	41.8	12.0	5.0
Harrari	29.1	2.0	3.0
Oromiya	34.7	8.0	3.0
Somali	34.6	8.0	3.0
Southern Region	56.5	18.0	7.0
Tigray	59.7	18.0	7.0
National	45.5	13.0	5.0

Source: Economic Commission for Africa from official sources.

Table 3.15

Estimates of poverty, Ethiopia, 1994 and 1997
(percent, adjusted for differences in local prices)

Area	1994			1997		
	Headcount index	Poverty gap	Poverty severity	Headcount index	Poverty gap	Poverty severity
Rural	41.9* (0.01)	16.8* (0.01)	8.8 (0.18)	35.5* (0.01)	12.7* (0.01)	6.2 (0.15)
Urban	37.5* (0.03)	13.8* (0.01)	6.9 (0.16)	35.5* (0.03)	12.6* (0.01)	6.1 (0.15)
National	41.2* (0.01)	16.3* (0.01)	8.5 (0.18)	35.5* (0.02)	12.7* (0.01)	6.2 (0.43)
t-statistics for differences in P_0 between 1994 and 1997						
Rural areas	-3.49*					
Urban areas	-0.46					
National	-3.39*					

Note: These data were generated using a sample of villages in different parts of Ethiopia. Numbers in parentheses are standard errors of the poverty measures.

* Statistically significant at the 5% level.

Source: Tadesse, Kebede, and Shimeles 1999.

Table 3.16

Gini coefficients, 1994 and 1997, and elasticity of headcount index relative to mean real spending and Gini coefficient, Ethiopia, 1997

Area	Gini coefficient (percent)		Elasticity of headcount index relative to	
	1994	1997	Mean real spending	Gini coefficient
Rural	39	43	-1.2	1.1
Urban	44	48	-1.3	1.2
National	40	44	-1.2	1.1

Note: These data were generated using a sample of villages from various parts of Ethiopia.

Source: Tadesse, Kebede, and Shimeles 1999.

inequality because during the initial stages of economic liberalization the returns to scarce resources—such as capital—rise faster than the returns to other factors of production. In addition, the liberalization of trade and rationalization of the government budget can provide greater rewards to skilled workers and those engaged in trade-related activities. (For a more complete discussion of income inequality in transition see Milanovic 1995; Ferreira 1997; Kanbur 1998; and Collier and Gunning 1999.) What is important is whether Ethiopia's increase in income inequality is persistent or transitory. Given government efforts to rapidly reduce poverty and foster pro-poor growth, the rise in income inequality may soon be reversed.

“
Infant and child
mortality fell
considerably
”

Health and education indicators— big improvements needed

Infant and child mortality fell considerably through 1998 but remain high (table 3.17). Adult mortality, by contrast, rose sharply in the 1990s. Civil conflict and HIV/AIDS are the main reasons for the increase. With 3 million Ethiopians living with the disease and an estimated 300,000 dying from it every year, HIV/AIDS is rapidly becoming the main cause of illness and adult mortality. As a result life expectancy fell during the 1990s for both men and women. The government appears, rather late, to recognize the danger. It has begun implementing measures to combat the pandemic, including setting up a National AIDS Council and initiating a public awareness campaign.

Over the past 30 years recurrent spending on health has been less than 4% of government spending, and capital spending on health has been less than 2%. Indeed, real health spending per capita has been falling, reaching its lowest value in 1999/2000 (figure 3.8).

Education outcomes in Ethiopia also need to improve. Adult literacy was estimated to be just 38% in 2000. Gross enrolment ratios at all levels of schooling are among the world's lowest. More than half of children of primary school age are not in school (table 3.18).

Table 3.17

Adult and infant mortality rates, life expectancies, and HIV prevalence, Ethiopia, selected years, 1960–2000 (per 1,000 unless otherwise indicated)

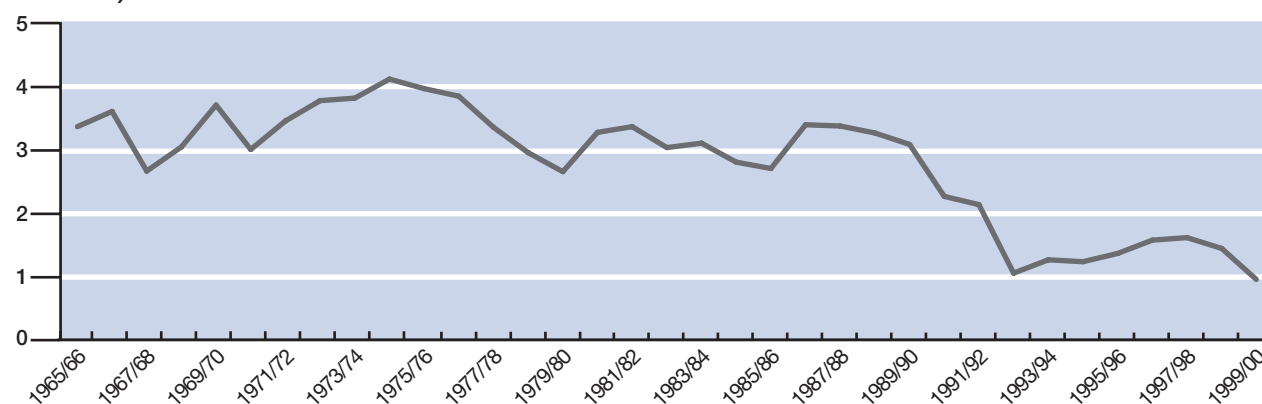
Indicator	1960	1970	1980	1990	1997	1998	1999	2000
Adult mortality rate, females	391	411	401	358	510	529	545	555
Adult mortality rate, males	475	483	491	448	550	562	596	594
Child mortality rate	280	239	213	190	175	173	183	179
Infant mortality rate	174	158	155	124	107	107		
Life expectancy at birth, females (years)		42	44	47	44	44	43	45
Life expectancy at birth, males (years)		39	40	44	42	42	41	43
HIV prevalence (millions infected)					2.6		3.0	

Note: Adult mortality rates measure the probability of a 15-year-old dying before age 60, if subject to current age-specific mortality rates between ages 15 and 60.

Source: World Bank 2001; Economic Commission for Africa from official sources.

Figure 3.8

Real health spending per capita, Ethiopia, 1965/66–1999/2000 (U.S. dollars)



Source: World Bank 2001; Economic Commission for Africa from official sources.

Table 3.18

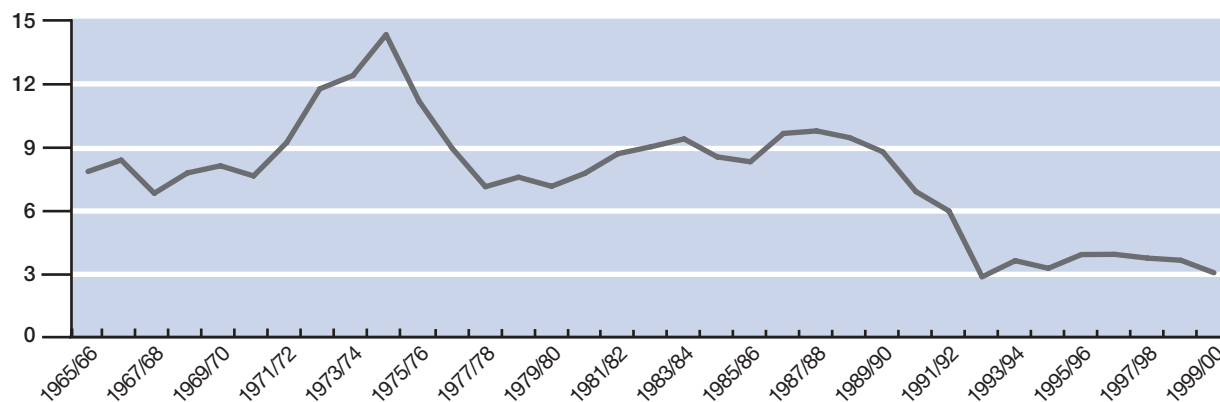
Gross enrolment ratios by education level, Ethiopia, selected years, 1980–97 (percent)

Level	1980	1985	1990	1995	1997
Primary	37.4	37.7	32.7	37.5	42.9
Secondary	9.4	12.6	14.2	11.6	12.3
Tertiary	0.4	0.7	0.8	0.7	0.8

Source: World Bank 2000b.

Figure 3.9

Real education spending per capita, Ethiopia, 1965/66–1999/2000
(U.S. dollars)



Source: Economic Commission for Africa from official sources.

Moreover, gender parity in primary education—measured as the ratio of gross primary enrolment of girls to that of boys—is among the lowest in Africa.

Gross enrolments improved in the 1990s, however, particularly at the primary level. In addition, the shares of recurrent and capital education spending in total public spending rose in the 1990s (except during the war with Eritrea). But because spending has not grown faster than the population, per capita spending on education has steadily declined (figure 3.9).

“Ethiopia’s land tenure system is a major constraint to agricultural development”

Institutional reforms—land tenure and governance

Land tenure and governance are among the most pressing areas requiring institutional reforms in Ethiopia.

Land tenure—still a constraint

Ethiopia’s land tenure system has evolved from feudal ownership (until the fall of the Imperial government in 1975) to nationalized ownership (until the fall of the Derg regime in 1991) to the current setup, which reflects some reforms but has not made significant progress towards a market-based system. After the fall of the Derg regime the new government promised a national referendum on land tenure, but it has never occurred. Moreover, in 1994 the new Constitution reestablished state ownership of land.

Regional governments are responsible for administering and redistributing land, following their own laws and regulations. Rural farmers have a guaranteed right to use land indefinitely, free of charge, and to temporarily lease it to other farmers and transfer it to

“Land has been
reallocated in many
rural areas, with
mixed results”

their children. But farmers cannot sell or mortgage their land. Urban land is leased by regional governments at rates determined by the market or by public auctions.

Rural areas. Land has been reallocated in many rural areas, with mixed results. Land policy is vague on redistribution, leaving such decisions to regional governments—and so resulting in a lack of coherence in land policy. Furthermore, uneven distributions of land in terms of holdings and quality, along with the threat of future redistribution, have resulted in tenure insecurity. This situation has discouraged land investment, especially in inputs that would increase productivity and conserve soil. Current land policy has also reduced family holdings and pasture, exacerbated food shortages, and contributed to environmental degradation.

Urban areas. Urban land is leased for various purposes, including housing, industry, education, health, culture, and sports. But numerous constraints impede the use of land. Among the most common:

- High lease rates, especially in Addis Ababa.
- Bureaucratic procedures and lack of qualified personnel.
- Limited access to bank loans using lease deeds as collateral, limiting access to credit.
- Poor basic infrastructure (water, electricity, telecommunications).
- Breach of contracts by the government, particularly in the provision of infrastructure.
- Uneven distribution of land due to hindrances in administrative practices.

Land policy and foreign direct investment. The government is increasing efforts to promote investment, particularly foreign investment. To attract foreign investors, steps should be taken to ensure the availability of land, infrastructure, and labour.

Foreign investors can acquire real estate if they have the standard investment certificate and necessary legal status. They can also lease land from regional governments under the same procedures as for local investors—except that half the lease must be paid for upfront. Still, several constraints deter FDI, including the high cost of land leases (particularly in big cities such as Addis Ababa), the required 50% down payment, delays in obtaining land and work permits, and a lack of proper infrastructure.

Required reforms. Land policy has not yielded the expected results. Moreover, it has been heavily criticized for not being participatory. The policy was the result of a centralized, top-down approach rather than being developed through consultations with all concerned parties (farmers, civil society, businesses). Unclear lease rules revealed the limits of the law. As a result economic development—including construction, foreign investment, and infrastructure—have been hampered.

Land policy must be amended to resolve these inefficiencies. The government recently began reviewing the policy, assessing urban land law at a December 2001 conference. The weaknesses of the implementing agency and the legal framework were identified as the main reasons for the policy's failures in resolving real estate issues, particularly in Addis Ababa.

Among the policy recommendations made to resolve land tenure issues were:

- Promoting private investment to broaden the government's revenue base and diversify revenue sources.
- Clarifying land law provisions and reducing administrative procedures.
- Increasing access to bank loans and credit through government incentives.
- Focusing on the availability and cost of urban land, which are deterring local and foreign investment.
- Creating alternative employment to encourage rural farmers to move into other productive sectors, which could ease the pressure on land and so make the land tenure system more flexible.

Although the land issue is politically difficult, it needs to be resolved quickly since it impedes the development of several key sectors. In particular, the success of the government's main development strategy, agriculture-led industrialization, may largely depend on addressing rural land tenure insecurity.

Governance—decentralization's shortcomings

In a country like Ethiopia good governance should be seen as an end in itself and, perhaps more important, as a means for creating a dynamic economy. In the 1990s the main institutional change in this regard was the adoption of a new Constitution and the consequent change in the structure of the state from unitary to federal. As a result regional governments were established, organized along ethno-linguistic lines. But decentralization has had five main shortcomings:

- It is occurring without devolution of decision-making power to lower levels of government.
- In several cases it has not been accompanied by the establishment of pertinent institutions.
- It suffers from Ethiopia's shortage of skilled workers, with the appointment of politically loyal officials compounding the problem.
- Regional governments have very limited capacity to raise local resources.
- Discrepancies develop between official policy and actual practice, as manifested in the central government's considerable interference in matters pertaining to local jurisdictions (Kassahun 2001).

These shortcomings partly reflect the fact that the federal structure is a new form of government.

Moreover, good governance remains in short supply—notwithstanding efforts to develop policies and laws that promote legitimacy, accountability, transparency, the rule of law, and popular participation. The government is attempting to improve governance through judicial and civil service reform, public sector capacity building, and an anticorruption campaign.

The anticorruption campaign, in particular, is in full swing. Court cases have been brought against some former high-ranking government and party officials, bankers, and businesspeople. Although there is consensus that corruption has become a major problem, the timing, pace, and coverage of the campaign have created concerns. The start of the campaign coincided with the split in the ruling party, and the legislation associated with it was rushed through parliament in a few days. Some observers also argue that the campaign is not even-

“Regional governments were established along ethno-linguistic lines”

handed, concentrating on a select group of officials and businesses. These concerns should be addressed, because the approach to combating corruption is the key to a lasting solution.

Medium-term outlook—7% growth expected for 2002

“Real GDP is forecast to grow 7% in 2001/02”

A number of developments in 2000/01 indicate positive prospects for 2001/02. Peace with Eritrea continued to hold, allowing further cuts in defence spending. The cessation of hostilities also paved the way for the resumption of external assistance. The IMF's Poverty Reduction and Growth Facility for Ethiopia, totalling \$110 million over three years, was approved in March 2001. That facility, combined with the debt relief provided under the enhanced HIPC initiative, will generate additional resources in 2002. In addition, the cereal harvest at the end of 2001 was quite good.

Reflecting these developments, real GDP is forecast to grow 7% in 2001/02. It is also expected that, with further recovery in nonagricultural economic activity and relatively high oil prices, the decline in consumer prices in 2000/01 will be reversed. Inflation is projected to rise to 5%. Lower defence spending, higher revenue, and fiscal prudence are anticipated to lower the budget deficit to 8.2% of GDP. In contrast, falling international coffee prices and growing imports will push the current account deficit up slightly, from 5.5% of GDP in 2000/01 to 6.2% in 2001/02. On the policy front, the government's key strategy is the completion of the Full PRSP in 2002.

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Zimbabwe—A Crumbling Economy

Zimbabwe faces the worst economic crisis of its history. Its economic performance, weak since 1997, deteriorated over the past two years, with real GDP contracting by 5.5% in 2000 and an estimated 7.5% in 2001. The outlook for 2002 remains dismal, with GDP forecast to contract by another 5.0%.

The nature, causes, and effects of this crisis are as varied as they are controversial. The economy confronts a dangerous mix of ballooning domestic and external debt, crippling foreign exchange shortages, poor weather conditions, negative real interest rates, and escalating inflation. Growing crime, the deleterious fast-track land reform, and rising wages, fuel prices, and raw material costs have all exacerbated the crisis.

Output in the real sector (agriculture, mining, and manufacturing) declined in 2001, leading to company closures and job losses. At least 25,000 jobs were lost in manufacturing in the first quarter of 2001. And recently imposed administrative measures to slash the prices of basic goods have raised fears of more company closures in manufacturing.

The government's strategy for reversing the economic decline centres on the Millennium Economic Recovery Programme (MERP). This programme, introduced in 2000, is aimed at stabilizing the economy by speeding land resettlement, reducing duties on all imported inputs, lowering production and capital costs, accelerating privatization to attract both local and foreign investment, rebuilding confidence in the economy, and providing effective and efficient infrastructure services.

The MERP has so far failed to turn the tide, however. This failure stems in large part from weak policy implementation and from policy inconsistencies between the Reserve Bank of Zimbabwe, which is in charge of monetary and inflation control, and the government, which is responsible for enhancing policy credibility and bringing spending under control. Monetary policy has been largely ineffective because of continued funding of the fiscal deficit and continued support for financially distressed banks. The broad money supply increased from around 60% of GDP to more than 68% between December 2000 and March 2001 alone, fuelling the already high inflation, estimated at 112% in the month of December 2001 (EIU 2001). As a result, real interest rates turned negative, undermining the incentive to save.

In response to the turmoil in the financial sector, which culminated in the collapse of the United Merchant Bank, the government introduced reforms to strengthen bank supervision and prudential regulation and ensure commercial banks' adherence to monetary pol-

Zimbabwe faces the worst economic crisis of its history

*The stage may be set
for a major economic
meltdown in 2002–03*

icy objectives. To arrest the runaway fiscal spending and enhance policy credibility, the government also attempted to restructure its fiscal operations in 2001/01. None of these objectives has been achieved, however. Fiscal policy has remained highly expansionary and inconsistent with monetary policy. And failure to stimulate efficiency in the public sector—through the restructuring or privatization of public enterprises and a reduction in the size of the civil service—has made a sustainable fiscal position even more elusive.

Poor export performance, a thin interbank foreign exchange market, low foreign exchange reserves, and excessive import demand characterized the external sector in 2001. Rather than further opening the economy, however, the government has reversed some of its steps towards liberalization—for example, by introducing exchange rate controls and reintroducing import controls. Thus at the end of 2001 the country continued to confront isolationist policies, poor export performance, foreign exchange shortages, and real exchange rate appreciation.

The government's social sector reforms centre on improving the living standards of the poor. But poverty has become both deeper and more extensive. An estimated 76% of the population lives below the poverty line today, compared with 61% in 1998 (Poverty Reduction Forum 2000). This high poverty rate stems mainly from the general deterioration in the economy, which has led to high unemployment and escalating prices for basic commodities. Moreover, social sector programmes, particularly in health and education, have suffered because of the weak fiscal position and the emphasis on funding Zimbabwe's participation in the war in the Democratic Republic of Congo.

Growing corruption and weak governance have undermined confidence in the economy. The looting scandals at the National Oil Company of Zimbabwe (the country's main procurer of fuel)—now associated with the national fuel crisis—epitomize the large-scale corruption. Politically motivated intimidation and violence have led to mutual suspicion between the independent media and the public media and between the media and civil society.

This dismal situation suggests a gloomy outlook for Zimbabwe's economy in the medium term. The economic decline is expected to continue, with the real sector contracting further in 2002 and the inflation rate expected to rise further above 100%. Domestic and external debt are also expected to rise, and external accounts to deteriorate.

The stage may be set for a major economic meltdown in 2002–03 if present trends continue, amid the reactions of the Zimbabwean political opposition and the international community to the outcomes of the March 2002 elections. Or perhaps the severity of the crisis may become a catalyst for long-awaited political and economic reform in Zimbabwe.

Recent economic developments

The crisis in Zimbabwe needs to be viewed in the context of political governance, economic management, and policy reforms during and after the Economic Structural Adjustment Programme (ESAP), implemented in 1991–95 with support from the International Monetary Fund (IMF) and the World Bank. These reforms, referred to as the “first-era

market reforms”, were aimed at speeding the replacement of state economic management with a market system, and improving the living standards of Zimbabweans. The market reforms included introducing fiscal and monetary consolidation, liberalizing trade and exchange rates, deregulating agricultural pricing and marketing, deregulating investment, reforming parastatals, and lifting price controls. The first-era reforms were reinforced and succeeded by the Zimbabwe Programme for Economic and Social Transformation (ZIMPREST), implemented in 1996–2000.

Poor macroeconomic performance under the ESAP and inadequate implementation of ZIMPREST led the government to launch the Millennium Economic Recovery Programme in 2000. The MERP is home-grown, with a broad group of stakeholders (government, business, and labour) involved in its formulation. The programme emphasized consolidating the gains from the first-era reforms, improving the institutional capacity of implementing agencies, further liberalizing external trade, deregulating public transport, and pursuing fiscal consolidation. This chapter examines the performance of Zimbabwe’s economy against the objectives of the second-era reforms under the MERP.

GDP growth—down, and down further

Output growth in Zimbabwe has decelerated since 1997 (table 4.1). Real GDP fell by 5.5% in 2000 and was expected to fall by another 7.5% in 2001, mainly because of poor agricultural performance. The agricultural sector was deeply affected by the economic and political crisis, particularly the “farm invasions” by war veterans. The main source of GDP growth in the past, agriculture was expected to be the main source of economic decline in 2001 (table 4.2).

Tourism too has been hit hard by the political turmoil. Until recently Zimbabwe was a major destination for tourists. The country has a well-developed tourism industry, with world-class hotels, good transport infrastructure, and well-endowed national parks. In 1999 it attracted more than 2 million visitors—36% of the total to East Africa. But in 2000 Zimbabwe earned a mere 8% of the tourism revenue in the subregion. The image of political instability being projected outside the country seriously threatens the potential of its tourism industry. In 1999/2000 the sector experienced negative growth (–11.2%), while tourism in East Africa as a whole had positive growth of 3.8%.

The economy’s total output has been greatly affected by rising production costs and foreign exchange shortages. Official projections for 2002 point to low savings, deepening debt, escalating inflation, a critical foreign exchange situation, and a continuing decline in agricultural, mining, and manufacturing output (Zimbabwe, Ministry of Finance, *Budget Statement* 2002).

Savings and investment—declining severely

Savings in Zimbabwe have been declining as a share of GDP since 1996 and were projected to be 6% in 2001 (table 4.3). This marked decline in savings can be attributed to the high inflation, shrinking real incomes, and high government consumption.

Capital formation has been declining since 1995. The decline was initially attributed to the drought in the 1994/95 agricultural year, which led to more funds being channelled

“*The economy’s total output has been greatly affected by rising production costs and foreign exchange shortages*”

Table 4.1**Nominal GDP and real GDP growth, Zimbabwe, 1995–2001**

Indicator	1995	1996	1997	1998	1999	2000	2001
Nominal GDP							
(billions of dollars)	7.1	8.5	8.4	6.3	5.6	7.2	—
Real GDP growth (percent)	–0.6	8.7	3.7	2.5	–0.2	–5.5	–7.5 ^a

— Not available.

a. Estimate from EIU 2001.

Source: IMF 2001; Standard & Chartered Bank 2000a, b.

Table 4.2**Estimated GDP growth by sector, Zimbabwe, 2000 and 2001 (percent)**

Sector	2000	2001
Agriculture	3.0	–9.5
Manufacturing	–10.5	–5.0
Mining	–14.0	–3.0
Distribution and hotels	–4.5	1.0
Finance	1.5	3.0
Construction	–4.5	–2.0
Electricity and water	–2.0	2.0
Transport	–13.0	2.0

Source: Standard & Chartered Bank 2000a, b.

Table 4.3**Savings and investment as a share of GDP, Zimbabwe, 1995–2001 (percent)**

Indicator	1995	1996	1997	1998	1999	2000	2001
Gross national savings	21	18	10	8	12	14	6
Gross fixed capital formation	25	19	16	11	10	2	4 ^a

a. Official target.

Source: Zimbabwe, Ministry of Finance, Budget Statement 2002; EIU 2001; World Bank 2001b; IMF 2001.

to consumption spending rather than investment. In addition, the gloomy economic environment has made the country unattractive to investors. The good rainy season between 1996 and 1997 brought prospects of stronger growth in capital formation. But these hopes were quickly dissipated by the collapse of the Zimbabwe dollar against major currencies in 1997. In 1998 gross capital formation declined again, dropping from 16% of GDP in 1997 to 11%. Continuing economic instability, the low savings rate, and the growing violence in the country—along with the increasing isolation from international partners and the 2002

presidential elections—are likely to further inhibit capital formation, with many companies closing down and many others streamlining their operations. The investment rate was projected to fall to less than 4% of GDP by the end of 2001 (Zimbabwe, Ministry of Finance, *Budget Statement*, 2002).

Agriculture—economic mainstay, but . . .

Agriculture has historically been the mainstay of Zimbabwe's economy, contributing more than 60% of the country's foreign exchange earnings and between 15% and 19% of GDP, depending on the rainfall pattern. More than 75% of Zimbabwe's largely rural population derives its livelihood from agriculture. In addition, the sector has strong forward and backward links, particularly with manufacturing and services. At least 60% of local agricultural output finds its way into local manufacturing, while 20% of manufacturing output is absorbed by agriculture. Zimbabwe's highly diversified agricultural sector produces tobacco, dairy products, beef, horticultural products, wheat, coffee, and grain.

But the contribution of agriculture to the economy is under threat. The socio-political issues surrounding the government's land resettlement programme have resulted in a notable decline in agricultural production. Production was disrupted in 2000 by the invasions of mainly white-owned farms provoked by war veterans. At the heart of the problem is the racial disparity in landownership: just 4,500 white farmers own 11 million hectares of prime agricultural land, while 12 million blacks own 16 million hectares of mostly marginal land, often barely scratching out a living in drought-affected regions.

The land issue—compromised

Organized as “pioneers” by Cecil Rhodes, the white community arrived in Zimbabwe in 1890, initially to search for mineral wealth. When that endeavour failed, the white settlers took over large tracts of land that had been occupied for more than a thousand years by the local Ndebele and Shona communities.

The landownership structure was, and largely still is, skewed in favour of the white community. The Land Tenure Act of 1969 reserved 50% of the land for white farmers, setting aside the most arable land, with rich soil, high plateaux, and good rains, in the north and east of the country. The act declared the rest of the country to be communal land, and the black majority was driven to this land to cultivate poor soil on smallholdings. This gave rise to a typical African agricultural sector—a two-tier system, with subsistence farming on communal land and extensive, modern commercial farms producing for the market. In Zimbabwe historical circumstances have therefore resulted in an agricultural sector divided by colour and an apartheid political system.

The struggle for independence in Zimbabwe was thus about “land and liberty”. Not only the right to vote was at stake, but also the right to participate fully in the economy as landowners. In 1978 the embattled white government accepted an “internal settlement”, mainly with the United African National Council of Bishop Muzorewa, but the political arrangement was never recognized by the international community.

“Agriculture has strong forward and backward links, particularly with manufacturing and services”

“
*Productivity and welfare
were substantially
higher among the
resettled farmers*
”

In 1979 the government of the United Kingdom convened a conference of all concerned parties at Lancaster House in London. The parties arrived at a political compromise, set out in the Lancaster House Agreement:

- An interim U.K. administration would supervise “free and fair” elections in 1980. The elections were won by ZANU-PF, which garnered 57 of the 80 parliamentary seats reserved for Africans and has ruled ever since. The white community was allotted 20 seats.
- There would be a 10-year, constitutionally mandated “willing buyer–willing seller” arrangement for prime agricultural land.
- The constitution emerging from the Lancaster House Agreement called for a British-style parliament with an executive prime minister and a president as titular head.
- Britain would finance a resettlement scheme (£44 million), which involved buying farms and handing them over to landless peasants or to militants.

This political compromise perpetuated the landownership system favouring the white minority and gave political power to the black majority, creating political problems in delivering the land for which most Zimbabweans fought.

Post-independence era—limits of resettlement

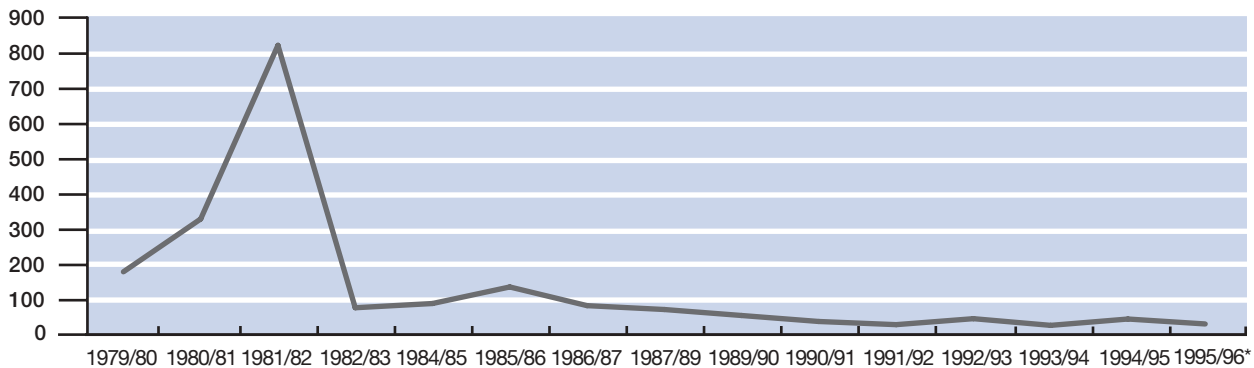
After Zimbabwe became independent in 1980, plans called for resettling 162,000 families within three years. But by 1995 only 62,000 families (38%) had been resettled (figure 4.1). The limited resettlement meant the loss of potential production gains on prime agricultural land and fed a sense of political grievance among the rural population still expecting land. The Lancaster House Agreement had provided for the purchase by the government (from willing sellers) of little productive land. Meanwhile, the population was growing by 3% a year in the 1980s, leading to overcrowding and environmental degradation of communal lands.

The limits of the resettlement scheme stemmed largely from governance problems and the cost of the scheme. Although no known data exist showing that landownership was linked in some cases to political patronage, this likelihood cannot be excluded. In addition, the “cultural” change experienced by households in shifting from subsistence farming to cash crop production was not fully appreciated, and the scheme was not consistently effective in delivering training (including in entrepreneurial skills) and agricultural extension services to the resettled farmers. This failure might also have to do with governance issues, since an administrative budget and decentralized services were not in place in the 1980s.

Even though the resettlement scheme was only partly implemented, productivity and welfare were substantially higher among the resettled farmers than among the communal farmers. Moreover, the resettlement scheme, which involved 3.2 million hectares, had no adverse effect on the large-scale commercial farm sector (Kinsey, Burger, and Gunning 1998). Indeed, during the first 10 years of independence the government bought the resettlement land at market prices, encouraging the commercial farming sector to remain in business.

Figure 4.1

Agricultural land resettled, Zimbabwe, 1979/80–1995/96
(thousands of hectares)



Note: The years refer to agricultural years.

* Data for 1995/96 refer to the target for that year.

Source: Moyo 2000.

The 1980s ended with nearly the same landownership structure as at the beginning of the decade, and with the same political pressure from rural communities for more productive land.

Political problems in the 1990s—land tenure largely unchanged

In 1992 the Zimbabwean Parliament adopted the Land Acquisition Act, which provided for buying nearly 50% of white-owned land. But opposition from the farmers put a halt to the scheme in 1995. In January 1998 a coalition of civil rights groups formed the National Constitutional Assembly to press for a new constitution curtailing the government's powers and restoring individual rights. The government countered by appointing the 400-member Constitutional Commission in March 1999, which eventually produced a draft constitution that mainly reflected ZANU-PF positions. But in a popular referendum in 2000 the draft constitution was rejected by 54.7% of voters. Despite this defeat, the government pushed another constitutional amendment, providing for the expropriation of land without compensation or, better still, with compensation paid by the former colonial power. The fact that the constitution has been amended 15 times since independence denotes the perception of the Lancaster House Agreement as a "political straitjacket" by both the government and the opposition.

After 20-odd years of independence the land tenure system remains largely unchanged. The future of Zimbabwe will depend on how the government deals with land resettlement. Expectations created by the post-independence plans remain unfulfilled, and land reform is back on the political agenda. Invasions of farms have accelerated and have now extended to factories and mines, with grave political and economic implications for the country.

“After 20-odd years of independence the land tenure system remains largely unchanged”

“
Although the reforms
encouraged private
sector participation,
they overlooked the
institutional constraints
”

Sector reforms and their impact—farm earnings slide

Before 1990 the agricultural sector was dominated by wide-ranging controls on procuring inputs and disposing of output. The government gave marketing boards a mandate, through the Agricultural Marketing Authority, to purchase most agricultural products and to regulate the transport and distribution of agricultural inputs. The aim was to ensure fair prices for farmers, cheap food for urban consumers, and adequate tax revenue from agricultural products. But this system of controls proved to be inefficient. It encouraged corruption and patronage, created policy distortions, and cost a great deal to operate, as evidenced by the marketing boards' large losses.

The first-era reforms sought to do away with these crippling controls. But they failed to achieve their objective because they were based on the erroneous assumption that agricultural production is homogeneous and that farmers have equal opportunities to enter and benefit from the liberal market system (SAPRI 2001). Although the reforms encouraged private sector participation, they overlooked the institutional constraints. And while liberalization benefited tradables more than non-tradables, productivity in the sector, particularly in smallholder activities, fell significantly during the reform period.

The second-era reforms under the MERP are aimed at strengthening the agricultural sector by:

- Speeding the land resettlement programme, to improve access to land for the poor majority.
- Reducing duties on all imported inputs, including fertilizer and other agro-chemicals.
- Recapitalizing the Agriculture Development Assistance Fund to boost input credit schemes.
- Improving access to low-cost inputs in the sector—for example, by increasing the participation of smallholder farmers in the programme for seed multiplication.

Despite these intentions, farm earnings fell in the face of high production costs and low international prices. The prices of agricultural inputs (fuel, fertilizer, and other agro-chemicals) rose significantly as a result of currency depreciation, which also led to shortages of fuel and electricity. Moreover, the government's increasing reliance on bank borrowing against the background of dwindling revenue has meant inadequate concessional finance for agriculture. The conflict between the government and commercial farmers has exacerbated the situation.

Hardest hit was tobacco, Zimbabwe's major foreign exchange earner; its production fell by 25% in the year ending October 2000. Maize production also fell significantly in 2000. Still, total agricultural output rose marginally in 2000, by 3%. But output was projected to decline by 10% in 2001 as a result of drought, escalating input costs, and the chaotic fast-track land reform programme (Dhliwayo and Makamure 2001). The Ministry of Finance predicted a 31% decline in maize output in 2001, a 20% decline in tobacco production, and a 19% decline in cotton output (table 4.4). The Commercial Farmers' Union forecast a 30–40% fall in commercial agricultural production in 2002.

Table 4.4**Agricultural production, Zimbabwe, 1999/2000 and 2000/01**

Crop	1999/2000 (actual; thousands of tonnes)	2000/01 (forecast; thousands of tonnes)	Percentage change
Tobacco	2,452	1,959	-20.1
Flue cured	2,369	1,902	-19.7
Maize	2,148	1,476	-31.4
Sorghum	103	61	-40.8
Wheat	281	200	-99.3
Mhunga	29	20	-31.0
Rapoko	14	23	64.3
Groundnuts	191	195	2.1
Soybeans	144	175	21.5
Cotton	353	286	-19.0
Paprika	14	13	-7.1
Sunflower	16	32	100.0

Source: Zimbabwe, Central Statistical Office and Ministry of Finance.

Five problems lie at the centre of the poor agricultural performance:

- *Land redistribution and farm invasions.* Current farm owners, unsure about future policy directions, have planted less land. New farm owners, uncertain about their occupancy and about policy continuity, have not cleared enough land for planting. And politically motivated violence on farms is turning away serious farmers and undermining farming activity.
- *Reduced access to working capital for farming.* Given the uncertainty in the sector, it is becoming increasingly difficult to use farm land and machinery as collateral, and many farmers have been unable to secure loans from banks.
- *The collapse of manufacturing and the foreign exchange shortages.* Because of the strong links between agriculture and the manufacturing sector, the collapse of manufacturing translates into a collapse of agriculture.
- *The downward trend in international prices of agricultural commodities.*
- *The hostile macroeconomic policy environment.*

“The mining sector is heavily dominated by foreign companies”

Mining—foreign dominated

The mining sector is oligopolistic, heavily dominated by foreign companies such as Rio Tinto, Ashanti Goldfields, Falcon, and Delta. The sector accounts for around 4% of GDP, 5% of formal sector employment (with around 62,000 workers), and 30% of foreign exchange earnings. Its major products, most of which are destined for the export market, include asbestos, gold, nickel, ferro-alloys, copper slimes, coal and coke, and various non-ferrous ores and concentrates.

“Mining output declined
by 14% in 2000”

Besides the major foreign companies that dominate mining, there is a growing informal sector, particularly in gold panning. The large number of panners, estimated at between 50,000 and 500,000, coupled with the enormous geographic expanse of the activity, makes gold panning virtually impossible to regulate.

Sector reforms and their impact—regulation unsuccessful

Under the ESAP the government sought to regulate the industry and eradicate production inefficiencies. These objectives were to be achieved by increasing technical support, training workers, providing financial support, and privatizing the parastatals in the sector. Contrary to expectations, the policy reforms failed to bring a new face to the sector. The government is therefore seeking to resuscitate the sector through the MERP by:

- Attracting external investment in mining and greater investment in mineral-based manufacturing.
- Recapitalizing the Mining Industry Loan Fund to meet the increasing demand for credit from small and medium-size mines.
- Speeding the privatization of two mining parastatals, the Zimbabwe Mining Development Corporation and the Roasting Plant Corporation.
- Giving greater financial support to research and development institutions and other services supporting investment in the mining sector.
- Enforcing environmental laws and encouraging environmental best practices.

None of the government's attempts to regulate the industry has been successful so far. Most of the panned gold is believed to leave Zimbabwe illegally, resulting in large losses in tax revenue and foreign exchange. Meanwhile, production costs have been soaring. Mining output declined by 14% in 2000 as 10 gold mines, 1 copper mine, and 1 coal mine closed amid the economic turbulence and promises by government officials to nationalize mines and take over foreign-owned companies. As a result of these developments, along with the depressed international prices of minerals and the low volume of nickel, asbestos, and copper exports, export earnings were 37% lower in 2000 than in 1996.

To cushion gold producers from the low international prices, the government announced a \$55 million gold subsidy package in April 2001. The subsidy guarantees gold producers an effective price of \$326 an ounce, \$63 more than the world market price (although the lack of a budget allocation for the subsidy raises concerns about how it is to be financed). World prices for gold changed little in 2001. But production costs rose further as fuel prices increased in the second half of the year. While gold producers may escape the full consequences of the rising costs, total mineral production is likely to fall further.

Future prospects—bleak

Economic reforms have improved access to new technology in Zimbabwe's mining sector. But the threats of mine invasions, the depressed world mineral prices, the high borrowing costs, and the foreign exchange shortages point to a bleak future for the sector.

Platinum, set to be the leading mineral export, has suffered a serious setback with the suspension of production at the Hartley platinum mine. The mine faced viability problems

due to mine design conditions and a drop in the world prices of platinum caused by the Russian Federation's offloading of huge stockpiles onto the market. The closure of the mine has led to employment and income losses for communities in the Chegutu area.

The performance of gold, another major mineral export for Zimbabwe, has also suffered from depressed world prices, although gold production has increased marginally. Bullion prices have fallen because of decisions by the IMF, the Bank of England, and the Swiss Central Bank to reduce gold reserves in 1999–2000. Other countries are also planning to offload bullion stocks, in a process that probably will eventually decouple major currencies from gold.

Zimbabwe is the fourth largest producer and exporter of asbestos, after the Russian Federation, Canada, and Brazil. But the looming international ban on trade in asbestos, because of its association with environmental health problems, has put the future of this subsector at risk. Production of asbestos is nevertheless expanding in Zimbabwe. In an effort to forestall a ban on the use of asbestos in some countries, Zimbabwe has become a signatory to the International Labour Organization's code of conduct on the safe use of chrysotile asbestos, alleged to be the source of the environmental health problems associated with asbestos.

“Manufacturing is diversified and well integrated with the rest of the economy”

Manufacturing—down to 14% of GDP

Manufacturing contributes a significant share of GDP, export earnings, and employment in Zimbabwe. Its share of GDP averaged 25% in the 1970s and 1980s, though it has fallen to less than 14% since then. The sector is diversified and well integrated with the rest of the economy, with particularly strong links with agriculture, mining, construction, and commerce. Zimbabwe's manufacturing base owes its diversity to the import substitution strategy of industrialization adopted in the mid-1960s when the United Nations imposed sanctions against the government of what was then Rhodesia. Manufacturing expanded rapidly during this period, under heavy protective barriers.

Sector reforms and their impact—several companies close

In response to the sector's weak performance under the ESAP and ZIMPREST, the government launched various policies under the MERP intended to reverse the decline and stabilize the sector's performance. These policies are aimed at:

- Removing duties on imports of industrial raw materials.
- Lowering production and capital costs.
- Attracting local and foreign investment.
- Building confidence in the economy.
- Providing effective and efficient infrastructure services.

The reforms have not been carried out in their entirety, however. Rather than attracting investment, lowering production costs, and building confidence in the economy, government policies (including covertly sanctioning factory invasions and settlement of “labour disputes” by the war veterans) have led several companies to close down. Acute foreign

“Manufacturing value added has been declining slowly over the years”

exchange shortages, the shrinking domestic market, high interest rates, and erratic fuel supplies also took their toll on the performance of manufacturing. Moreover, any prospects of immediate recovery in manufacturing, and of the sector's reform in line with the precepts of the MERP, are being undermined by the threats of international isolation of Zimbabwe.

The volume of output in manufacturing fell by 10% in 2000, with the largest losses in paper and printing (34.8%), clothing and footwear (27.6%), and transport equipment (25.8%). The average cost of production increased by 35% in the year ending March 2000. The largest increases in production costs occurred in paper and printing (90.7%), beverages and tobacco (81.1%), and non-metal mineral products (48.3%).

In May 2000 capacity utilization in manufacturing averaged around 54%, reflecting a 31% fall from the 1999 level. In Bulawayo, Zimbabwe's second largest city, unused factory and office space increased by 30% between May and July 2000. In Harare, the capital city, it increased by 86% over the same period.

Manufacturing value added has been declining slowly over the years, with negative growth in 1995 (–7%), 1997 (–1%), and 1999 (–2%). The strong links between the manufacturing and agricultural sectors have meant low value added in agriculture as well. The perpetual foreign exchange shortages in 2001 probably resulted in another year of negative growth of value added in manufacturing.

Problems faced by manufacturers—lack of competitiveness

Some of the problems in manufacturing predate the MERP, however. An index of manufacturing production indicates a decline in output of more than 20% since trade liberalization began in 1991 (figure 4.2). Several factors in the internal and external economic environment have contributed to this adverse situation.

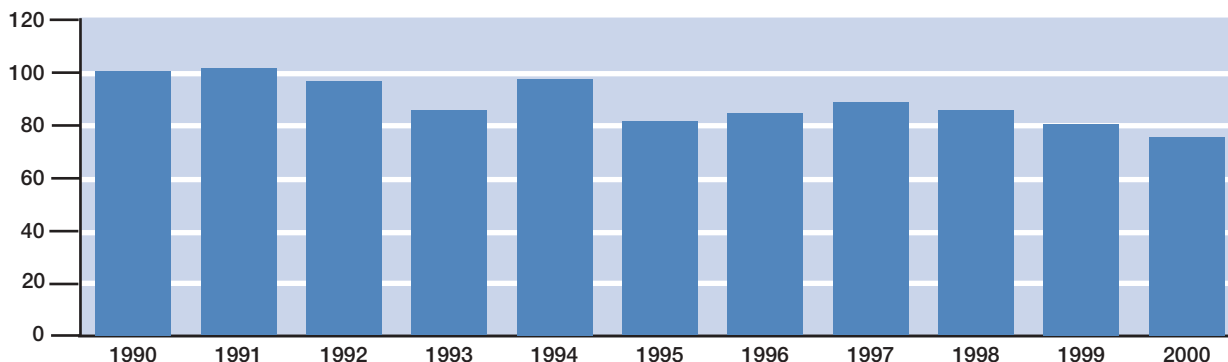
First, manufacturing has been an “infant” industry in Zimbabwe, and uncompetitive as a result of the protection it received before 1990 (including in pre-independence days, under international sanctions). Firms had a guaranteed domestic market, and in foreign markets they concentrated on those resulting from past colonial arrangements, such as the Rhodesia–South Africa trade agreement and the Lomé Convention. Because of this background, firms could not compete effectively once the trade regime was liberalized.

Second, other market reforms brought new challenges for manufacturing, such as deregulation of the domestic market, currency depreciation, and higher borrowing costs. After the domestic market was deregulated, flea markets mushroomed across the country, flooding the market with second-hand clothing and the like. This dealt a major blow to the textile and apparel industry, and several firms went under. The Zimbabwe Congress of Trade Unions estimates that more than 30,000 people in the industry have lost their jobs since 1992. Continuous depreciation of the local currency and shortages of foreign exchange also affected the sector, particularly firms relying on imported inputs.

Third, recent weather-related problems, such as drought and the El Niño effect, added to the industry's problems because of the dependence of some subsectors on good agricul-

Figure 4.2

Manufacturing production, Zimbabwe, 1990–2000
(index: 1990 = 100)



Source: Zimbabwe, Central Statistical Office.

tural performance. Among those most affected have been grain processing, sugar refining, meat and dairy products, tobacco processing, and the textile and clothing industry.

Finally, the extension of farm invasions to industry, under the guise of labour disputes, has seriously affected manufacturing performance. Many firms have received huge claims for past-due wages accompanied by threats of violence from war veterans if the claims are not settled.

“Stringent administrative controls depressed capital market activity”

Financial sector—captive to government

Before the first-era reforms beginning in 1991, the financial sector was tightly controlled and highly oligopolistic, dominated by Barclays and Standard Banks. Market entry was restricted, and competition therefore limited. The sector’s operations were distorted by ceilings imposed on lending and deposit rates, portfolio restrictions on financial institutions, and the government’s directed lending programmes and selective credit policies. The government prescribed the investments of many pension and insurance funds, making them captive to the government debt market. Stringent administrative controls depressed capital market activity. Small firms and poor and marginalized groups had little access to credit, and rural areas were neglected.

Initial reforms—produce 3% growth

The first-era financial reforms sought to deregulate lending and deposit rates, remove credit controls, relax foreign exchange controls, open the capital market to foreigners, reduce restrictions on pension and insurance funds, allow new entrants into the sector, and permit domestic borrowing by non-resident firms. The reforms led to growth in the financial sector averaging 3% a year at a time that other sectors were contracting. Commercial banks still dominate the market, but new merchant banks and several finance houses have emerged. Other financial institutions have also been established, including unit trusts, leas-

“The reforms have deepened and widened the financial sector’s operations”

ing firms, exchange bureaux, agricultural banks, venture capital companies, and formal and informal micro-finance institutions. The many new entrants have created competition and mobilized massive savings.

But these advances did not improve access to credit for poor and marginalized groups (UNDP and University of Zimbabwe 1999). Nor did they bolster development finance. Moreover, the economic uncertainty and instability in the ensuing period made purely speculative investments more attractive than productive ones. Adding to the risk, the financial liberalization was not matched by measures to enhance the capacity of the Reserve Bank to supervise the financial system.

Recent reforms and their impact—unprecedented product diversification

To reduce the potential risk and turmoil in the financial sector, the government announced broad financial reforms as part of the MERP:

- Strengthening bank supervision and prudential regulations.
- Introducing a deposit insurance scheme (not yet fully operational).
- Improving commercial banks’ adherence to monetary policy objectives.
- Developing a secondary market for government debt.

Two important pieces of legislation relating to bank operations and supervision have been introduced since 1999. The Reserve Bank Act and the Commercial Bank Act, which became effective in August 2000, are intended to enhance the supervisory role of the Reserve Bank of Zimbabwe and its power to deal with problem banks. The Reserve Bank is to carry out its supervisory role (including on-site inspection) by reviewing bank operations, asset quality, capital adequacy, and compliance with applicable rules and regulations. But the Reserve Bank Act does not grant it the independence to carry out monetary policy, nor does the act establish monetary policy goals.

The reforms have deepened and widened the financial sector’s operations, with liberalization leading to a surge in the number of competitors.¹ The increased competition has led to unprecedented product diversification, especially by the merchant banks, which have ventured into commercial banking to boost their portfolios. The new entrants are targeting niche markets, such as in-store banking, which is less costly than setting up branch networks.² The high interest rates seen before 2001 increased savings mobilization and helped expand the asset base of many institutions. And competition has led banks to adopt state-of-the-art technology, such as automated teller machines and electronic banking.

At the same time, several factors have exacerbated the short-term risk in the industry, such as deteriorating asset quality, the low capital adequacy of many banks, and rapid growth in the non-performing loans of some commercial banks. The previously high interest rates had claimed victims in the productive sector, with serious adverse effects on the banks. Land invasions and disruptions of farming activities have also exposed the vulnerability of the banking sector. Many big banks, particularly the state-owned agricultural bank, have a large share of their loan portfolio tied up in farms designated for land resettlement.

The owners of these farms are not repaying their loans, and although the banks hold the titles to the land as collateral, they cannot take over the farms because they now belong to the government.³

Today, with low interest rates in the money market and poor performance in industry, investment is shifting towards the stock market. Thus while the country faces a serious economic crisis, its stock market is experiencing robust growth. The liberalization of the financial sector had revived the sense of optimism about the Zimbabwe Stock Exchange. The adoption of an indirect monetary policy approach and the liberalization of the foreign exchange system supported the relaxation of capital market controls and led to greater participation in the stock exchange by foreigners.

“Investment is shifting towards the stock market”

Monetary policy—M3 up sharply

In 2001 interest rates dropped sharply as a result of government manipulation of the Treasury bill market. The government had been attempting to bring a rising fiscal deficit under control by pushing down interest rates (and thus reducing debt service payments). The rate on 90-day Treasury bills, around 48% in early January 2001, dropped to around 10% by the end of April. With inflation running at around 70% in 2001, real interest rates have therefore turned sharply negative.

Inconsistency in fiscal and monetary policy, especially the continued bank financing of the budget deficit, has undermined the effort by the Reserve Bank of Zimbabwe to pursue a tight monetary policy. The money supply has grown continually since 1998 (figure 4.3). The broad money supply (M3) increased from 59.9% of GDP in December 2000 to 68.3% in March 2001. Underpinning this growth has been credit expansion, driven largely by the government's increased reliance on bank credit.

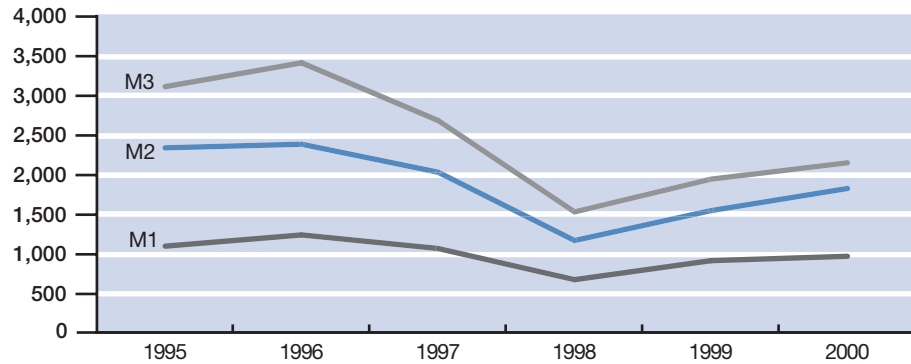
The rapid growth in the money supply in Zimbabwe has been the main cause of inflation since 1998. The inflation rate followed a generally increasing trend in 1995–2000 (figure 4.4). And in 2001 inflation averaged an estimated 70.0%, up from 55.1% in 2000 and 55.6% in 1999. The high inflation has eroded consumer purchasing power, depressing the demand for goods and services. Moreover, the costs of production have continued to rise. And the inflationary pressures have led to high nominal effective interest rates, making it difficult for firms in the productive sectors to service their debt.

Fiscal policy—under pressure

Zimbabwe has been unable to maintain a sound fiscal policy as a result of both internal and external political pressures: the demand for higher social spending for war veterans and the military involvement in the Democratic Republic of Congo. The growth in government spending has outstripped growth in revenue, leading to increasing reliance on the Reserve Bank to fund the deficit and thus to harmful growth in the money supply. Given the negative growth in real GDP and thus in potential fiscal revenue, the government will need to curtail its spending to contain both the fiscal deficit and the external current account deficit.

Figure 4.3

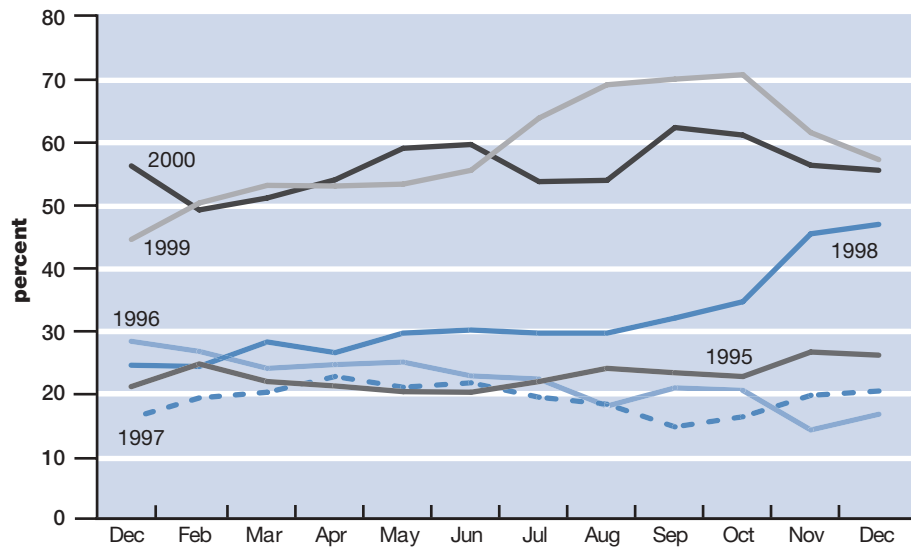
Monetary aggregates, Zimbabwe, 1995–2000



Source: Reserve Bank of Zimbabwe 2001a.

Figure 4.4

*Inflation rate, Zimbabwe, January 1995–December 2000
(year on year)*



Source: Zimbabwe, Central Statistical Office, Stats-Flash, February 2001.

“The high inflation has eroded consumer purchasing power”

Many attempts have been made to improve fiscal management. But the real issue is the need for reasonable discipline by the authorities. Public finances improved in 1998 following the adoption of IMF-supported programmes but deteriorated again in 1999. In 2000 new fiscal reforms were introduced under the MERP.

Fiscal reforms and their impact—deficit deepening

The first-era reforms sought to reduce government deficits and increase revenue through the following measures:

- Improving the credibility and ownership of the budget.
- Accelerating the disposal of public assets through privatization.
- Improving the management of the budget.
- Taking steps to enhance revenue.
- Improving the operational efficiency of public enterprises.
- Reducing salaries and wages in real terms.
- Restructuring the government's short-term debt by converting it into long-term debt.

Some positive developments have occurred, particularly in procedural and institutional aspects of budget management. More recently, the government introduced a cash budget system in some departments, with the goal of bringing all departments on board by the end of 2001 (this attempt was not completed, however, because of the government's preparations for the 2002 elections). In addition, the government established the National Revenue Authority in 2000 to improve the effectiveness of tax collection. It also sought to convert 30% of its short-term debt into long-term debt to reduce interest payments.

But despite the government's initial intention to consolidate the budget, fiscal policies have been highly expansionary. More often than not, they have been inconsistent with monetary policies. The recent expansionary fiscal policy stance can be traced directly to the government's attempts to raise social spending for war veterans and the poor, the involvement of Zimbabwe's army in the conflict in the Democratic Republic of Congo, and the financing of parliamentary and presidential election campaigns. These spending increases have occurred even as tax revenues have dwindled. Mismanagement of government expenditures has become responsible for many other problems in Zimbabwe's economy (Dhlodhlo and Mabugu 2000).

The fiscal deficit has been rising to unsustainable levels since 1999. It increased from 10% of GDP in 1999 to 23% in 2000, and was targeted at 12% for 2001 (table 4.5). The large budget deficit in 2000 has its roots in the dominance of non-discretionary spending (wages, interest payments, constitutional and statutory obligations) and in the military involvement in the war in the Democratic Republic of Congo (table 4.6).

The revenue side of the budget has exacerbated the situation. Revenue collection in the first nine months of 2000 fell 11% short of the target of \$68.5 billion. The 2001 budget projected revenues of \$140 billion, counting on a boost from an accelerated privatization programme. But that projection may be too optimistic given the current economic downturn (Dhliwayo and Makamure 2001).

The deepening deficit has hit capital spending the hardest. And while social spending, such as on health and education, has risen in absolute terms, its share in total spending has been declining steadily since 1999 (figure 4.5). Government spending on education declined from 24% of total spending in 1999 to 16% in 2000, when a new policy of recovering costs

*Fiscal policies have
been highly
expansionary*

Table 4.5

Budget deficit and revenue as a share of GDP, Zimbabwe, 1995–2001
(percent)

Indicator	1995/96	1996/97	1998	1999	2000	2001
Budget deficit	10.0	6.5	4.0	10.1	23.0	12.0 ^a
Revenue	—	29.4	30.5	27.3	27.5 ^a	28.0 ^a

a. Official target.

Source: Zimbabwe, Ministry of Finance, Budget Statement 2001; IMF 2001.

Table 4.6

Estimated government expenditures, Zimbabwe, 2000 and 2001

Item	Estimated expenditures in 2000 (billions of Zimbabwe dollars)	Budgeted expenditures in 2001 (billions of Zimbabwe dollars)	Percentage change in nominal terms	Percentage change in real terms
Total expenditure	164.6	223.5	35.8	–20.0
Wages	54.8	61.3	11.9	–34.0
Interest	55.4	106.2	91.7	2.8
Capital	12.3	9.0	–27.0	–55.3
Non-interest recurrent expenditure	96.9	108.4	11.8	–36.3
Education	32.3	33.2	2.8	–39.6
Defence	15.4	13.3	–13.6	–49.4
Health	9.3	10.9	17.2	–31.4
Home affairs	7.1	6.7	–5.6	–45.0

Source: Standard & Chartered Bank 2000b.

from tertiary students was introduced. Health spending, which has generally been low, has declined further as a share of total spending.

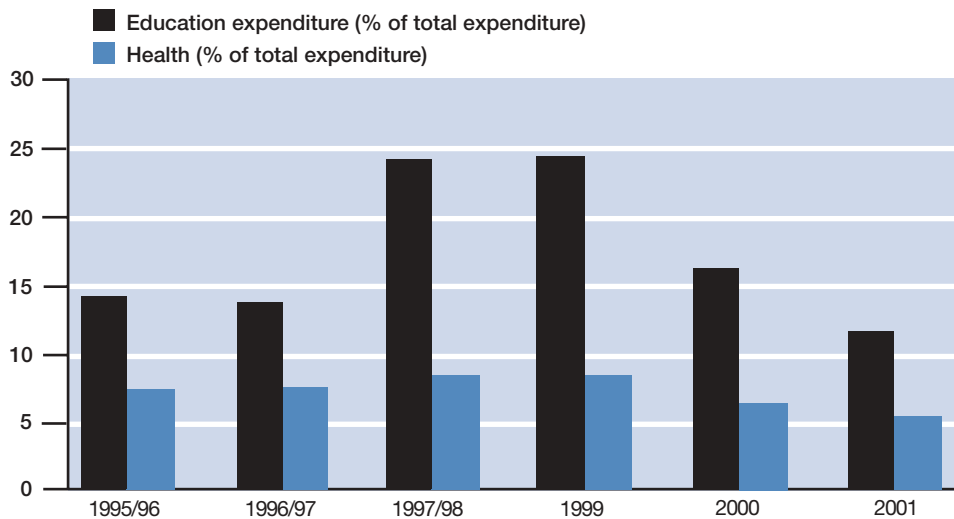
Domestic and external debt—situation worsening

Zimbabwe inherited enormous debt from the colonial regime in 1980. Heavy spending on social and infrastructure programmes soon after independence led to a steady rise in external debt. The debt continued to grow in the 1990s as the persistently large budget deficits compelled the government to borrow excessively (table 4.7).

In 1999–2000 several factors worsened the external debt situation—currency depreciation, greater commercial borrowing by the government, and less reliance on concessional loans for funding public sector projects. The country had to suspend its debt service payments, and as a result external arrears reached nearly \$0.7 billion at the end of 2001 (World Bank 2001b). Parastatal companies defaulted on a significant amount of debt, although this is not included in the reported arrears, and have accumulated substantial arrears with both counterparts and external suppliers, particularly for fuel and electricity purchases (EIU 2001).

Figure 4.5

Public spending on health and education, Zimbabwe, 1995–2001
(percentage of total spending)



Source: Zimbabwe, Ministry of Finance, Budget Statement 2001.

Table 4.7

External and domestic debt, Zimbabwe, 1995–2000
(millions of dollars, except where otherwise specified)

Item	1995	1996	1997	1998	1999	2000
Long-term external debt	4,002	4,141	4,117	3,841	3,958	3,957
Short-term external debt	417	554	849	669	532	416
Total external debt	4,419	4,694	4,966	4,510	4,490	4,373
External debt as a percentage of GDP	62	55	59	79	80	60
Domestic debt	1,933	2,768	1,827	1,044	1,573	1,725

Source: Reserve Bank of Zimbabwe 2001a; Zimbabwe, Ministry of Finance, Budget Statement, various years.

Although external debt is larger, domestic debt has been growing faster. Because of the country's loss of access to international sources of credit in recent years, the government has resorted to borrowing from domestic sources, predominantly through short-term Treasury bills. This domestic borrowing is in many ways becoming a greater concern than the government's external debt obligations.

External sector—trade liberalized

Independent Zimbabwe pursued a development strategy based on import substitution, imposing severe controls on trade, foreign exchange flows, and exchange rates. Initially viable, the

“On the export side
manufactures have
been the hardest hit”

policy later produced serious problems—industrial inefficiency, low productivity, rent seeking, market distortions, public sector decay, and, more important, the drying up of foreign exchange resources. By 1991 import cover had fallen to only a couple of days. A general economic crisis loomed. With no alternative, the government agreed to reforms that would ensure inflows of foreign exchange and other support from the IMF and the World Bank.

These reforms, part of the ESAP, were aimed primarily at:

- Removing fiscal incentives for exporters.
- Phasing out the import licensing regime.
- Eliminating foreign exchange controls.
- Reducing tariffs and creating a tariff band ranging from 0% to 30%.
- Achieving export growth of 9% a year over the five years from 1991.

While the government did not fully implement the fiscal aspects of the ESAP and other macroeconomic programmes, it did carry out the trade liberalization component of the programme. Moreover, it introduced export processing zones to promote non-traditional exports. These zones have failed to take off, however, hampered by policy reversals, the government's lack of commitment, the lack of coordination between government departments, the economic hardships faced by firms, and their difficulties in obtaining the incentives offered.

The ESAP was succeeded by the second-era reforms under ZIMPREST and then the MERP, which sought to deepen trade liberalization. Through the MERP, the government has sought to:

- Adopt an appropriate exchange rate.
- Strengthen international reserves.
- Stimulate exports and expand export capacity.
- Attract foreign direct investment.
- Renegotiate the terms of maturing external debt obligations.
- Reprioritize large-scale development projects requiring foreign currency outlays.
- Control and monitor leakage of foreign currency abroad.

Exchange rates—seven devaluations

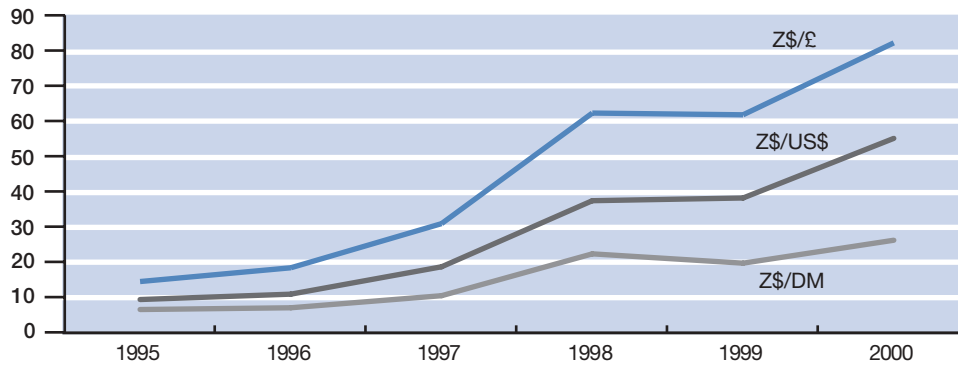
Exchange rate policy has been characterized by inconsistency and reversals. While the stated policy is to move towards a market-based exchange rate system, in practice the government fixes the exchange rate. The government has devalued the Zimbabwe dollar seven times since 1991. But the devaluations have failed to close the gap between the official and parallel market rates. That has led to speculative pressures, with most exporters holding onto their foreign currency in anticipation of continued devaluation. The Zimbabwe dollar depreciated steadily against the currencies of major trading partners between 1995 and 2000 (figure 4.6).

Balance of payments and foreign reserves— 1.5 months of import cover

Poor export performance, strong import demand, and reduced capital inflows have put the country's balance of payments position under immense pressure in the past two years in 1999

Figure 4.6

Exchange rate of the Zimbabwe dollar against major currencies, 1995–2000



Source: Reserve Bank of Zimbabwe 2001a.

and 2000. The balance of payments account recorded a deficit of \$449 million in 2000, following a surplus of \$178 million in 1999. Merchandise exports fell by 6.9% in 2000, while imports increased by around 25%. The capital account also deteriorated, going from a surplus of \$189 million in 1999 to an estimated deficit of \$298 million in 2000, mainly because the World Bank, the African Development Bank, and other multilateral agencies discontinued their support.

As a result of these developments, Zimbabwe's foreign exchange reserves fell from around \$450 million to \$340 million (one and a half months of import cover) between January and June 2000 (Reserve Bank of Zimbabwe 2001a). The foreign exchange reserves fell further to an estimated \$167 million by the end of April 2001, but the IMF believes that a significant share is in illiquid assets and therefore cannot be used on short notice (EIU 2001).

On the export side manufactures have been the hardest hit, mainly because of increased competition, difficulties in accessing new markets, high inflation, firm invasions, and a hostile macroeconomic and political environment. Traditional exports have not fared any better. Zimbabwe has been losing more through the deterioration in its terms of trade than it could ever make up for by improving market access for its traditional exports. The world prices of Zimbabwe's commodity exports have been on a downward trend, and most have fallen below 1990 levels. In response to the declining export performance, the government provided tax-based export incentives in the 1999 budget (readjusted in the 2000 budget). But this policy has failed to stimulate exports. Exports were projected to fall further in 2001, to \$1.60 billion, down from \$1.63 billion in 2000.

Policy reversals—so little support

The mixed results of trade reforms have played into the hands of those who initially opposed liberalization as having been imposed from outside, and many liberalizing policies have been reversed (table 4.8). These policy reversals have been associated with poor macroeconomic policies, shortages of foreign exchange, deficiencies in trade policies, fiscal indisci-

“Policy reversals have been associated with poor macroeconomic policies”

Table 4.8*Trade liberalization policies and reversals, Zimbabwe*

Scope	Policy implemented under the ESAP	Policy reversal under ZIMPREST	Rationale for reversal
International and domestic trade policies	<ul style="list-style-type: none"> • Removing import licences and reducing tariffs 	<ul style="list-style-type: none"> • Introducing import licences on some goods and raising tariffs 	<ul style="list-style-type: none"> • Strategic reasons and falling government revenue
Regional trade policies	<ul style="list-style-type: none"> • Deregulating domestic prices and controls • Signing a trade protocol in the Southern African Development Community (SADC) and committing to a zero duty in the Common Market for Eastern and Southern Africa (Comesa) 	<ul style="list-style-type: none"> • Introducing selective price • Raising tariffs on regional imports • Mid-loading reductions in intra-SADC and residual tariffs • Falling behind schedule in meeting Comesa's October 2000 deadline for adopting a zero duty 	<ul style="list-style-type: none"> • Riots against price increase in food • Delay by other countries • Result of tariff rationalization • Divided allegiance between SADC and Comesa
International policies	<ul style="list-style-type: none"> • Complying with commitments on tariff binding and reductions under the World Trade Organization (WTO) agreement 	<ul style="list-style-type: none"> • Binding tariffs at higher levels than applied rates • Increasing applied tariffs 	<ul style="list-style-type: none"> • Need to generate revenue • Permitted under the WTO agreement
Foreign exchange policy	<ul style="list-style-type: none"> • Removing controls on foreign exchange and remittances abroad 	<ul style="list-style-type: none"> • Pegging the exchange rate • Suspending foreign currency accounts 	<ul style="list-style-type: none"> • Excessive depreciation of the Zimbabwe dollar • Shortage of foreign exchange
Export incentives	<ul style="list-style-type: none"> • Removing the export retention scheme and other incentives 	<ul style="list-style-type: none"> • Imposing a levy on tobacco exports • Introducing export incentives in the budget 	<ul style="list-style-type: none"> • Need to generate revenue • Shortage of foreign exchange

Source: Economic Commission for Africa.

pline, exchange rate mismanagement, and a general inability of economic managers to fathom the substance and process of trade liberalization.

Human development—deteriorating services

Under the MERP the government has set several objectives for strengthening the social sectors:

- Increasing public spending targeted to the poor.
- Improving the access of vulnerable social groups to land and capital.
- Developing social safety nets.
- Ensuring access to decent housing for vulnerable groups.
- Allocating more funds to the Employment and Training Programme to train laid-off workers for self-employment.

But the social, economic, and political turmoil that has rocked the country in the past two years has led to greater poverty and crime, deteriorating social services, soaring unemployment, and many other social ills.

Poverty and inequality—deeper

In 1996 an estimated 62% of Zimbabweans lived below the poverty line. Most of the poor lived in rural areas, where 75% of the population is poor (Economic Commission for Africa 1997). Poverty in Zimbabwe is closely linked to landlessness. Around 70% of the population depends on small-scale agriculture, where productivity is low because of the limited access to land and other agricultural resources. Efforts to reduce poverty have been hampered by the persistent adverse effects of structural adjustment policies, the recurrence of droughts, and the ineffective attempts to redistribute land.

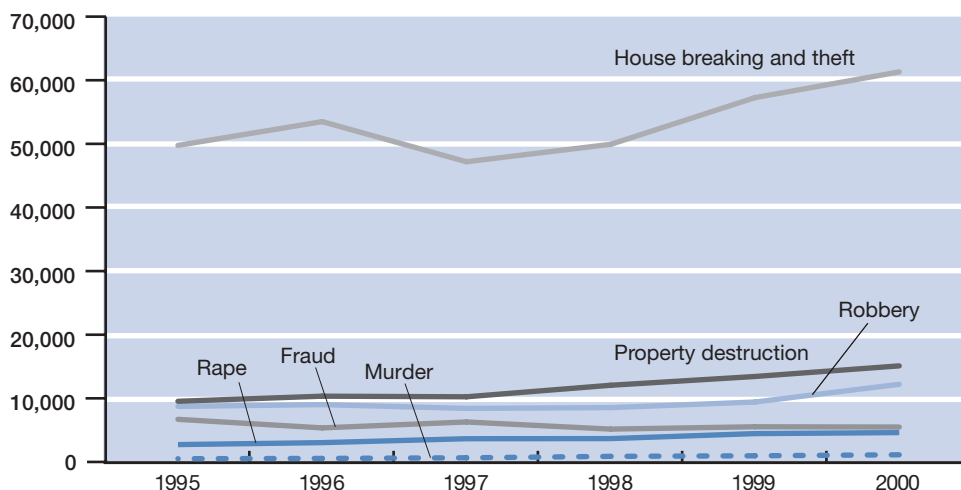
Poverty has recently become both deeper and more extensive, in part as a result of the AIDS epidemic. New data suggest that the number of households whose incomes are below the poverty line has risen from 61% in 1998 to 76. Moreover, income in Zimbabwe is very unevenly distributed, as reflected in the country's high Gini coefficient of 0.568 (UNDP 2001). This high inequality has given rise to a series of empowerment efforts culminating in the current "land redistribution exercise". The extent of the social crisis is evident from the decline in the human development index for Zimbabwe since its independence, from 0.570 in 1980 to 0.554 in 1999 (UNDP 2001).

The high poverty rates have exacerbated other social ills. For example, crime rates are rising as many people resort to illegal means of livelihood (figure 4.7).

“Zimbabwe had to rely on massive food imports to offset its domestic supply shortfall”

Figure 4.7

Criminal offences and attempted crimes, Zimbabwe, 1995–2000



Source: Zimbabwe, Central Statistical Office, Quarterly Digest of Statistics, December 2000.

“The government has failed to act decisively and effectively in combating HIV/AIDS”

Food insecurity—rising in urban areas

The inequitable distribution of land and the chaotic land reform process have been the main constraints to improving food security in Zimbabwe. Most smallholder farmers can meet their subsistence needs but often have little surplus to generate income for other uses. Thus in today's economic climate, with the rising costs of agricultural inputs, smallholder farmers have found it increasingly difficult to obtain hybrid seeds and fertilizer. As a result, food insecurity in rural areas has worsened (Christian Aid 2001).

Food insecurity is growing in urban areas as well, as food prices rise, real wages fall, and unemployment soars. The urban poor, especially those without strong family links in rural areas, could soon become the most food-insecure.

Zimbabwe had to rely on massive food imports to offset its domestic supply shortfall in 2001. According to the World Food Programme, around 2.5 million Zimbabweans would have faced starvation if they had not received food handouts (*Zimtoday*, 29 November 2000). Given the country's deteriorating economic conditions and severe foreign exchange shortages, there is reason for concern about even more widespread food insecurity in the future.

Health—system deteriorating, challenges growing

Zimbabwe's health system consists of a profitable private sector that caters to a minority in urban areas, a deteriorating public system that serves the urban poor, and the Zimbabwe National Traditional Healers' Association (Zinatha), which dominates in rural areas. The health sector has not been spared the economic hardships facing the country. It has suffered serious staff shortages as doctors and nurses flee the country. In 2001 alone around 41 doctors and 341 nurses left the health system. Moreover, in June 2000 the minister of health reported that all major hospitals had less than a month's supply of essential medicines. The shortages of drugs and other essential hospital supplies have resulted mainly from fiscal problems and poor management in public hospitals. In addition, insufficient capacity in the hospital system means that patients must put up with overcrowding.

At the same time that the country's health system is deteriorating, the challenges from AIDS are growing. The most recent statistics show that Zimbabwe has the third highest prevalence of HIV in the world, with a national adult infection rate of 25% (Christian Aid 2001). This high rate of infection has translated into around 3,000 deaths a week, most of them among the economically productive population (UNAIDS 2000). Zimbabwe has some 600,000 AIDS orphans, overwhelming extended family networks, and an alarming number of child-headed households. Yet it is still rare for people to openly admit that they or someone close to them has been infected with HIV (Christian Aid 2001).

The government has failed to act decisively and effectively in combating HIV/AIDS, even though other African countries, such as Senegal and Uganda, have shown that with full government commitment the spread of HIV/AIDS can be slowed. Besides HIV/AIDS, other diseases prevalent in the country include malaria, tuberculosis, skin diseases, and other sexually transmitted diseases.

Unemployment—up

Between May 1999 and April 2000 at least 135,000 Zimbabweans were laid off from jobs in the formal sector—10% of all formal sector employees. Although these job losses are a result of the crisis, they also feed the crisis through loss of tax revenue and more unemployment in other sectors. By May 2000 unemployment in manufacturing, mining, tourism, and agriculture had risen to 800,000 people, with agriculture accounting for around half. Around 15% of the labour force in Zimbabwe's private sector had been laid off because of the economic and political crisis, bringing the unemployment rate to 55%. Even so, the government has failed to keep its promise to provide funds for retraining laid-off workers.

Governance—corruption pervasive

Many of the problems across sectors in Zimbabwe can be linked to one central difficulty: the “crisis of governance”. To address the governance problem, the government has sought under the MERP to:

- Demonstrate commitment to whatever reform programme that it chooses to implement.
- Ensure the consistency, predictability, and certainty of policies.
- Improve transparency and stakeholder participation in the formulation of major policies.
- Improve transparency in the government tender system.
- Establish an institutional structure to fight corruption, based on international best practice.

Despite good intentions, these policies have not been implemented. More worrying is that existing legislation, such as the Prevention of Corruption Act, appears to be selectively applied and feebly enforced.

Corruption is pervasive in Zimbabwe. Transparency International, in its annual survey of corruption in 2000, ranked Zimbabwe 65th on its Corruption Perceptions Index, with a score of 3.0. The index ranges from 0, indicating highly corrupt, to 10, indicating highly clean (UNDP and University of Zimbabwe 2000). Numerous cases of large-scale official corruption have been reported in recent years. The fraud department of the Zimbabwe Republic Police reported that 91% of the cases it investigated in 1998 had occurred in the government, and three-quarters of them had involved the award of tenders and contracts. Misuse of resources in the government and in state-run companies cost the country close to \$800 million in 1999–2001.

Good governance entails not only a lack of official corruption but also the assurance of basic political rights—the right to vote and to join the political party of one's choice, freedom of expression, supremacy of the rule of law, an independent judiciary, and free and fair elections. These rights have eluded Zimbabweans, and the human rights situation in the country is generally perceived as grave.

Violence and intimidation have characterized all by-elections and local government elections since June 2000. Relations between the independent media and the public media have been marked by mutual suspicion and accusations. And the independence of the judiciary—a

The lack of a proper framework of governance has made Zimbabwe an unattractive destination for investment

“
The economic decline
is expected to continue
”

crucial element of democracy—has been heavily undermined. Judges are often labelled “antigovernment”, and the government is seen as making political appointments at the highest levels of the judiciary.

The lack of a proper framework of governance has made Zimbabwe an unattractive destination for both domestic and foreign investment. Internationally, the country has become a pariah state. The increased isolation has led to the abandonment of several donor-funded projects, including the Zambezi Water Project and the \$18.1 million solar energy programme sponsored by Italy.

Medium-term outlook—gloomy

The medium-term outlook for Zimbabwe’s economy is gloomy. The economy faces four main problems: the disruption of economic activity by the farm and factory invasions carried out in the name of restoring equity in resource distribution, the economic isolation of the country, the hostile macroeconomic environment, and the global economic slowdown.

The economic decline is expected to continue. Projections for the real sector indicate a further decline in agricultural and manufacturing output in 2002, with GDP shrinking by 5%. The fiscal deficit is forecast to increase to 17.6% of GDP in 2002 before dropping back to 9.9% in 2003, while domestic debt continues its rapid growth (World Bank 2001b). The pressure on interest rates will increase, perhaps requiring the Reserve Bank to take measures to reduce the interest cost of domestic debt. The inflation rate is expected to rise further above 100% in 2002. Meanwhile, the current account deficit is expected to widen to 4% of GDP in 2002.

A major economic meltdown is possible unless immediate steps are taken to reverse the deterioration in governance and the economy. If basic political governance is not restored, economic reforms may simply not work. But perhaps the sheer magnitude of the impending economic crisis in 2002–03 will force through the reforms needed in Zimbabwe.

Notes

1. In 1999 Interfin Merchant Bank and Agricultural Bank of Zimbabwe (Agribank) entered the market, and National Merchant Bank converted into a commercial bank. In 2000 First Merchant Bank merged with two other discount houses to form the African Banking Corporation, and Discount Company of Zimbabwe (DCZ) Holdings Limited merged with Kingdom Bank to form Kingdom Financial Holdings Limited.

2. The new entrants are Century Bank, Kingdom Financial Holdings, and Trust Bank.

3. In December 2000 the financial sector had \$81–109 million in outstanding loans to the 804 farms that the government had earmarked for confiscation.

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Kenya—Weak Governance Hobbles Economy

Recent economic trends in Kenya have been disappointing, with GDP growth declining since the mid-1990s and falling substantially below the population growth rate, estimated at 2.4%. In 2000 real economic growth turned negative, dropping to -0.3%—its lowest level since independence—from 1.4% in 1999 and 1.8% in 1998. These rates are far below government targets of 2.7% for fiscal 2001, 3.5% for fiscal 2002, and 5.0% for fiscal 2003. Agriculture, which traditionally accounts for the largest share of GDP, shrank 2.4% in 2000, while real manufacturing output fell 1.5%. The balance of payments worsened, with current account and trade deficits increasing. Deteriorating economic and social conditions are also reflected in other key measures. Poverty has increased, and income inequality and social indicators show worrisome trends.

Kenya's macroeconomic management has been relatively strong in recent years, with inflation rates and fiscal deficits within their targets (except in 2000). The challenge is translating these achievements into growth. The main problem is weak governance—as indicated by extensive corruption, weak rule of law, escalating insecurity, and poor infrastructure. Governance problems have undermined private sector activities, as reflected in falling investment. Gross fixed capital formation fell from 21% of GDP in 1995 to 15% in 1999.

Crucial prerequisites for the success of the macroeconomic strategy, identified in Kenya's 2001 Poverty Reduction Strategy Paper (PRSP), include:

- Making clear progress on governance problems to improve the environment for private sector activities.
- Allocating more public resources to improve infrastructure and security.
- Maintaining macroeconomic stability by, among other efforts, reducing domestic debt and real interest rates.

Recent macroeconomic performance— real GDP up 1.8% in 2001

In 1997 Kenya's economic growth began slowing considerably, culminating in a 0.3% contraction in real GDP in 2000 (table 5.1). In 1999–2001 real GDP growth averaged just 1% a year—less than half the already low average growth of 2.7% in 1996–98. A moderate recovery emerged in 2001, however, with real GDP expected to increase 1.8%.

“Macroeconomic management has been relatively strong in recent years”

Table 5.1

Changes in real GDP and sectoral output, Kenya, 1996–2001
(percent)

Indicator	1996	1997	1998	1999	2000	2001 ^a	1996–98	1999–2001
Real GDP	4.1	2.4	1.8	1.4	–0.3	1.8	2.7	1.0
Real GDP per capita	–0.3	–0.6	–1.1	–1.5	–2.6	–0.6	–0.7	–1.6
Real agricultural output		1.0	1.5	1.2	–2.4	2.0	1.2 ^b	0.3
Real manufacturing output		1.9	1.4	1.0	–1.5	1.2	1.7 ^b	0.2

a. Estimated.

b. Average for 1997–98.

Source: Kenya, Central Bureau of Statistics, 1998–2001; EIU 2001.

Agriculture accounted for about 25% of GDP in 1996–2001, and manufacturing for about 13%

The slowdown in GDP growth meant that real GDP per capita continued to suffer, falling by 1.6% a year in 1999–2001—faster than the 0.7% annual drop in 1996–98. In 2000 real GDP per capita fell 2.6%, the largest decline in recent years, but in 2001 the rate of decline slowed to 0.6%.

The sectoral composition of GDP has not changed in recent years. Agriculture accounted for about 25% of GDP in 1996–2001, and manufacturing for about 13%. These shares, along with the share of the services sector, varied by less than 1 percentage point during this period.

Performance by sector—composition unchanged

The persistent decline in real GDP growth since 1997 was caused by weak performance in key economic sectors. Of the four main contributors to GDP, only two—financial services and trade, restaurants, and hotels—recorded positive growth in 2000. Meanwhile, output in the other two—agriculture and manufacturing—contracted 2.4% and 1.5%.

Agriculture. Agriculture is crucial to Kenya's economy, making large contributions to output, employment, and exports. Thus its recent weak performance had major repercussions. Production of maize, a staple, dropped from 296,000 tonnes in 1996 to 201,000 tonnes in 2000 (table 5.2). Wheat production was even more volatile, rising from 130,000 tonnes in 1996 to 177,000 tonnes in 1998—then plummeting to 53,000 tonnes in 1999 and recovering slightly to 71,000 tonnes in 2000. Dairy production displayed the same pattern.

Such fluctuations have enormous financial implications. Because most Kenyans consume maize and wheat, large supply shortfalls lead to huge import bills for the government. In 2000, for example, the decline in maize production led to the import of 409,000 tonnes of maize valued at 4.7 billion Kenyan shillings (about \$62 million at the 2000 exchange rate). Similarly, that year 635,000 tonnes of wheat were imported at a cost of 7 billion Kenyan shillings (about \$92 million at the 2000 exchange rate).

Table 5.2**Major agricultural products, Kenya, 1996–2000**

Product	1996	1997		1998		1999		2000	
	Production (thousands of tonnes)	Production (thousands of tonnes)	Annual change (percent)	Production (thousands of tonnes)	Annual change (percent)	Production (thousands of tonnes)	Annual change (percent)	Production (thousands of tonnes)	Annual change (percent)
Maize	295.5	204.6	–30.8	218.0	6.5	223.5	2.5	201.2	–10.0
Wheat	130.0	124.2	–4.5	176.7	42.3	52.9	–70.1	70.5	33.3
Coffee	103.2	68.0	–34.1	51.3	–24.6	64.3	25.3	98.0	52.4
Tea	257.2	220.7	–14.2	294.2	33.3	248.8	–15.4	236.3	–5.0
Cattle ^a	1,219	1,320	8.3	1,800	36.4	1,805	0.3	1,908	5.7
Dairy ^b	257	197	–23.3	126	–36.0	180	42.9	137	–23.9

a. Production measured in thousands of heads of cattle and calves.

b. Production measured in millions of litres.

Source: Kenya, Central Bureau of Statistics.

Output of export crops also fluctuated. Production of tea—the largest foreign exchange earner among all of Kenya’s exports—fell 14% in 1997, rose 33% in 1998, and declined 15% in 1999 and 5% in 2000. Coffee production also fluctuated considerably. In the first seven months of 2001 tea production is estimated to have increased, while coffee production declined.

Because Kenya’s agriculture is largely rainfed, it is extremely vulnerable to weather conditions—which is one reason output is so volatile. Agricultural production suffered from the drought that began in 1998 and continued through the first half of 2000. Better weather in 2001 led to increased production of most domestically consumed and export crops.

But factors other than weather also contribute to agriculture’s poor performance. Poor infrastructure, especially roads, makes it difficult to market produce and expensive to distribute farm inputs. In addition, in 2000 higher power tariffs and fuel prices raised production costs considerably—yet the prices of many crops fell. All these factors likely dampened farmers’ incentives for production.

Kenya’s PRSP, issued in 2001, indicates that agriculture needs to grow by 4–6% a year to make a meaningful contribution to poverty reduction. The paper argues that the sector could expand by more than 5% a year if the constraints facing it are addressed. Besides those noted above, the paper points to inadequate supplies of quality seeds, inappropriate production techniques, lack of access to credit for most small farmers, expensive farm inputs, poor rural infrastructure (especially feeder roads, power supplies, and market facilities), inconsistent policies, weak institutions and laws governing the sector, and an inability to control pests and diseases that affect crops and livestock. Thus the government needs to implement policies that target these constraints.

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Inflation fell from 6.6%
in 1998 to 3.5% in 1999,
but rose to 6.2%
in 2000
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Manufacturing. Real manufacturing output has stagnated, growing by an average of just 0.2% a year in 1999–2001 (see table 5.1). Output actually fell 1.5% in 2000, then recovered slightly in 2001. Such growth rates are especially disappointing given the targets set in Kenya’s industrialization programme. This programme recognized that manufacturing needs to grow faster than agriculture and eventually become the economy’s engine of growth.

Some of the factors contributing to manufacturing’s weak performance have been external to the sector. These include the drought and its attendant power shortages, which led to higher power tariffs and rationed power supplies—especially in 2000, when prolonged power rationing slowed down the entire economy. As a result the demand for manufactured goods dropped considerably. Manufacturing also suffered from the high costs of domestic investment resulting from poor infrastructure, water shortages, heavy dependence on imported inputs and machinery, and reduced supplies of raw materials.

Services. Services account for more than half of Kenya’s GDP and two-thirds of formal employment. Key subsectors are tourism and travel, financial services, communication services, and transport services. In recent years tourism alone has been the third largest contributor to GDP after agriculture and manufacturing. Tourism has also become the largest earner of foreign exchange after tea.

The government’s most recent development plan projected that tourism would grow 8.4% a year, with tourist arrivals increasing from 764,000 in 1997 to 1,160,000 in 2001. In 1999 Kenya received 969,300 international visitors—equivalent to 0.15% of the world market and 3.5% of the African market. Still, for several reasons tourism has been weaker than in the first half of the 1990s. Although no tourists were hurt in the tribal clashes that preceded the 1997 general election, tourism is extremely sensitive to events that affect the actual or perceived security of visitors. Poor weather, deteriorating roads, and increased competition from other African countries also harm tourism. The industry has been recovering, however, with a 10% increase in international arrivals in the first eight months of 2001. But the September 11 terrorist bombings in the United States may have dampened this recovery over the rest of 2001.

Performance has been mixed in other service subsectors. The recovery in tourism helped trade and restaurant services, which grew 1.9% in fiscal 2001 compared with 1% in fiscal 2000. Transport and communication services also improved marginally, mainly due to the licensing of a second mobile telephone provider and an increase in mobile telephone subscribers. But building and construction services have continued to perform poorly, reflecting a slump in the real estate market and limited public sector construction projects.

Price movements—inflation back down, shilling stabilizing

Inflation. Inflation fell from 6.6% in 1998 to 3.5% in 1999. But with rising prices for food, fuel, and power, inflation rose to 6.2% in 2000. To contain inflation, in 2001 the Central Bank of Kenya restrained the expansion of the money supply. Indeed, in the second half of 2001 M3 fell about 2%. (The Central Bank defines M3, broad or reserve money, as currency held by the nonbank public and Kenyan shilling deposits held by banks and

nonbank financial institutions.) This move, combined with prudent fiscal policy, eased the pressure on prices—and in 2001 inflation fell to an estimated 3.3%.

Exchange rates. Kenya has maintained a floating exchange rate since 1993. The Central Bank allows the shilling's value to be determined by the interbank market but intervenes in the event of extreme volatility. Since its flotation the shilling's value has varied considerably, reflecting external and internal pressures. The real effective exchange rate has been depreciating since 1997, when the International Monetary Fund (IMF) suspended its Enhanced Structural Adjustment Facility. Within three months of the suspension, foreign investors repatriated more than \$250 million and the shilling depreciated 20% against the U.S. dollar. But in recent years pressure on the shilling has eased as a result of larger foreign exchange receipts from tea, horticulture, and tourism, as well as weaker corporate demand for foreign exchange. In 2000 the shilling's depreciation against the U.S. dollar slowed to 8.4%, and in 2001 to 4.1%.

To achieve stable prices, the government needs to strengthen export promotion efforts and attract long-term capital flows into the economy. Many analysts believe that the shilling exchange rate is artificially high because of speculative short-term flows attracted by high interest rates. Exporters in particular complain about the drop in export receipts caused by an overvalued shilling. The Central Bank's response is that its job is not to influence the direction of the exchange rate, but to maintain stable conditions in the market.

“The current account deficit is expected to widen from 2.4% of GDP in 2000 to 2.6% in 2001”

Balance of payments and foreign debt—foreign exchange reserves up to 3.5 months of import cover

In 2000 Kenya's imports grew 11.4%, but in 2001 import growth slowed to an estimated 4.7%. In contrast, exports grew just 1.4% in 2000 and contracted by an estimated 4.1% in 2001. As a result the current account deficit is expected to widen from 2.4% of GDP in 2000 to 2.6% in 2001.

Kenya's external imbalance is partly caused by a narrow range of merchandise exports and by international price shocks. In 2000 coffee, tea, horticulture, and petroleum products accounted for nearly two-thirds of merchandise exports. Between the first quarter of 1999 and the fourth quarter of 2001 international coffee prices slumped from \$0.80 to \$0.25 a pound for robusta and from \$1.10 to \$0.55 a pound for arabica. In addition, tea prices fell in 1999 (by 12.8%) and 2001 (by 15.1%), though they rose slightly in 2000 (by 5.8%). Lower coffee and tea prices offset higher revenue from horticultural exports—which have become the most important agricultural export after tea—and from increased tourism earnings and net transfers. In addition, short-term outflows increased by about \$280 million between June 2000 and June 2001, partly because of lower interest rates on government paper. Portfolio investments through the Nairobi Stock Exchange also registered net outflows in 1999 and 2000.

Foreign exchange reserves, targeted to cover 4.0 months of imports, stood at \$955 million in June 2001—equivalent to 3.5 months of coverage. This was an improvement over June 2000 reserves of \$808 million, equivalent to 3.3 months of import coverage.

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Fluctuating world
market prices continue
to affect traditional
exports”

Kenya's balance of payments is volatile and heavily influenced by exogenous factors. Fluctuating world market prices continue to affect traditional exports such as coffee and tea. World prices of crude oil, a major import, also exert a strong influence. And tourism earnings have not been as high as expected because of an influx of low-budget tourists. Prospects would improve with the revival of the IMF's structural adjustment programme, which would increase confidence in the economy and encourage foreign direct investment and long-term capital flows.

Since 1996 Kenya's external debt has fluctuated around \$6.0 billion, ranging from \$5.7 billion in 2001 to \$6.9 billion in 1998. Decent export earnings in 1996–98 and continued concessional flows from donors have kept debt close to sustainable levels. Although Kenya has been able to service its debt in a fairly timely manner, tightening liquidity and high debt service have forced it to reschedule debt twice through the Paris Club (representing official creditors). The most recent rescheduling occurred in fiscal 2001, when the government was granted a 10-year grace period on bilateral debt secured before 1991. The government is still negotiating its \$5 billion in debt with the London Club (representing commercial creditors).

Monetary policy and the financial sector

Monetary and financial policies have focused on two objectives. The first is achieving and maintaining stable prices; the second is fostering the liquidity, solvency, proper functioning, and stability of the financial system. Other goals of monetary policy include efficiently managing foreign exchange reserves and promoting a well-functioning system of payments, clearing, and settlement.

Monetary policy—tighter

The Central Bank uses several instruments in conducting monetary policy, with quantitative credit guidelines being the most common. Interventions in the money market include close monitoring of minimum statutory cash ratios and of net sales of government securities to regulate domestic liquidity. Given that the main goal of monetary policy is to achieve stable prices, money supply targets are based on the real GDP growth rate. Thus, given the persistent slowdown in economic growth in recent years, the Central Bank has maintained a tight monetary policy.

The Central Bank's monetary policy focuses on M3. In fiscal 2000 the money supply was targeted to expand by 8% or less. This target was to be achieved through cash ratios, open market operations, and discount and overnight lending by the Central Bank as the lender of last resort. This target, predicated on GDP growth of 2.5%, was intended to increase bank lending to support economic recovery. But with the continued economic slowdown, private sector demand for bank credit slackened. In response the Central Bank adopted a tighter monetary policy to absorb excess liquidity. In 1999 M3 increased by 2.6%, and in 2000 by just 0.8%.

Financial sector—struggling

At the end of 2001, 48 commercial banks were operating in Kenya. But 8 major banks—2 foreign-owned and 6 state-owned—dominate the banking sector, accounting for 71% of the market at the end of 2000. The other banks are small and rather unstable.

Banks continue to struggle with nonperforming loans, which in July 2001 accounted for 42 percent of the loan portfolio (table 5.3). As a result banks have continued provisioning for bad and doubtful debts, lowering profits. In June 2000 the Central Bank began requiring that all banks work with it to agree on the size of such provisions, which subsequently dropped from 67.7 billion shillings in September 2000 to 66.0 billion in September 2001.

The number of banks liquidated or placed under statutory management reflects the poor performance of the banking sector. Since 2000 five banks have been placed under statutory management and one building society has been placed under an investigator. Depositor committees were formed to help restructure the banks under statutory management. Three were reopened, but one was liquidated after a year. Similarly, Delphis Bank, a small bank, was placed under statutory management in April 2001, and debt recovery is ongoing.

Poor bank performance has mainly been caused by mismanagement, insider lending, and slow loan recovery. These problems, in turn, are the result of an inefficient court system, inadequate regulatory powers for the Central Bank, and the slowdown in economic activity. Several steps have been taken to address some of these problems. In 1999 the Banking Act was amended to give the Central Bank more power to enforce bank laws and regulations. The act now restricts insider lending, places strict requirements on lending and provisioning for nonperforming assets, and strengthens the Central Bank's supervision department. The Central Bank has also been empowered with cease and desist provisions and can impose financial penalties for failure to comply with the law. In addition, the minimum capital of banks and nonbank financial institutions has been raised. Capital requirements were initially raised to 200 million shillings for banks and 150 million shillings for nonbank financial institutions, then to 500 million and 375 million shillings.

In July 2000 prudential regulation was strengthened further, requiring that:

- Boards of directors eliminate all executive chairs to improve corporate governance.
- Banks maintain core capital of no less than 8% of the sum of their risk-adjusted assets and risk-adjusted off-balance-sheet items.
- Banks maintain core capital of no less than 8% of their deposit liabilities.
- Banks maintain total capital (core and supplementary) of no less than 12% of their risk-adjusted off-balance-sheet items.

Moreover, all banks must now publish their audited accounts in newspapers by 31 March of each year. Published audited accounts for 2000 show that the measures applied by the Central Bank are yielding results: banks' financial performance seems to be improving. Still, bank runs remain a significant risk. This risk is compounded by economic stagnation. Thus regulatory authorities need to maintain regulatory vigilance.

“The Banking Act was amended to give the Central Bank more power to enforce bank laws and regulations”

Table 5.3

*Nonperforming loans and loan loss provisions, Kenya, June 2000 and July 2001
(billions of Kenyan shillings unless otherwise indicated)*

Indicator	June 2000	July 2001
Total loans (gross)	289.8	301.9
Nonperforming loans	113.5	126.2
Provisions made for nonperforming loans	63.6	77.5
Net nonperforming loans (2–3)	49.9	48.7
Value of securities (estimated)	36.2	39.7
Net exposure (4–5)	13.7	9.0
Nonperforming loans/total loans (percent)	39.2	41.8
Net nonperforming loans/total loans (percent)	17.2	16.1
Net exposure/total loans (percent)	4.7	3.0
Provisions/nonperforming loans (percent)	56.0	61.4

Source: Kenya, Central Bank, Monthly Economic Review, various issues.

“**High interest rates have strongly discouraged long-term investment and constrained Kenya’s ability to grow**”

Interest rates—high

In recent years excessively high interest rates have strongly discouraged long-term investment and constrained Kenya’s ability to grow. With nominal rates ranging from 20–30%, the private sector has been unable to borrow. In addition, the 11–18 percentage point spread between lending and deposit rates is much higher than the 5 point spread common in other developing countries.

High interest rates can be traced to 1993, when the Central Bank raised the discount rate on Treasury bills to more than 70%. After a lag other interest rates also increased, including interbank rates and the lending and deposit rates of commercial banks. In response to increased demand, the rate on Treasury bills has since declined, reaching 13.5% in 2000 and about 12% in 2001. Correspondingly, interest rates on commercial bank loans fell from 25.2% in 1999 to 19.6% in 2000, and rates on deposits fell from 6.2% to 4.5%.

Growing pressure from key economic players led Parliament to adopt the Central Bank of Kenya (Amendment) Act (commonly known as the Donde Act), which entered into force in August 2001. The act allows the Central Bank to regulate interest rates. More specifically, it:

- Sets the maximum lending rate that commercial banks and other financial institutions can charge at 4 percentage points above the 91-day Treasury Bill rate, as long as the interest charged does not exceed the principal amount loaned.
- Sets the minimum interest rate that commercial banks and other financial institutions pay on deposits in interest-earning accounts to 70% of the 91-day Treasury Bill rate.
- Prohibits banks and financial institutions from levying charges other than statutory charges and interest on loans.

The act's provisions on interest rates apply retrospectively to 1 January 2001.

The act also established a Monetary Policy Advisory Committee. This committee is composed of four Central Bank employees, two ex officio members of the Treasury, and five other members—at least two of whom must be women—appointed by the minister of finance. The committee's main function is to advise the Central Bank on monetary policy, including the volume of 91-day Treasury bills. The committee is also expected to perform other functions as prescribed by the minister.

The government and commercial banks have aggressively contested the Donde Act, arguing that it does not address the root causes of the interest rate problem. Donors have also expressed concern about the legislation. Banks have gone to court to stop the implementation of the act, claiming that it is unconstitutional and that its retroactive application to secured loans will deny them legitimate returns. The government, meanwhile, has argued that interest rate controls will only lead to costly distortions in the financial sector. In fact, one such distortion has already occurred: commercial banks have sharply reduced lending to the private sector and increased their demand for Treasury bills. As a result economic operators have found it increasingly difficult to borrow despite relatively low interest rates. If not corrected soon, this lending behaviour could have serious economic repercussions.

“The budget system experienced some major problems that threatened fiscal balance in the short run”

Fiscal policy and domestic debt

During 1997–2001 the Kenyan government pursued prudent fiscal policy. The budget system, however, experienced some major problems that threatened fiscal balance in the short run. These problems included considerable arbitrariness in the budget process, a bloated public sector with a correspondingly high wage bill, and large budget deficits financed by short-term domestic borrowing. In recent years debt service and wage obligations ate up more than half the budget, squeezing out other recurrent spending and capital investment. Thus it is extremely difficult for public spending to foster growth. Indeed, although the government collected nearly a quarter of GDP in revenue, the budget was unable to ensure sufficient provision of basic economic and social infrastructure to support productive activities.

Fiscal policy—making public spending more effective

To make public spending more effective, in 2000 the government adopted the Medium Term Expenditure Framework. The framework seeks to:

- Allocate spending to agreed priorities, identified as those with the greatest potential effect on economic growth and poverty reduction.
- Link the three-year budget programme to longer-term objectives.
- Make funding for priority projects and programmes more predictable over a three-year period.
- Formulate the budget through a more consultative process, involving all ministries, departments, and other economic stakeholders in identifying priorities to be funded to achieve national objectives.

“*The government has sought to define a realistic three-year macroeconomic and fiscal framework*”

The priorities relevant to the framework are outlined in the Full Poverty Reduction Strategy Paper (Full PRSP) prepared by the Kenyan government in consultation with donors. That paper, which has formed the basis for negotiations with the World Bank and the IMF on a new programme under the Poverty Reduction and Growth Facility, is a product of broadly based, in-depth consultations among key players in the economy. (The IMF approved Kenya's initial Poverty Reduction and Growth Facility programme in August 2000 but suspended it at the end of that year for noncompliance with agreed implementation measures.) The priorities identified in the poverty paper are to be implemented through the Medium Term Expenditure Framework over the next three years.

Accordingly, the government has sought to define a realistic three-year macroeconomic and fiscal framework as the basis for forecasting tax revenues and grants as well as for setting spending ceilings for each sector. In line with these resource ceilings, which have received approval at the highest level of government, detailed budgets are prepared for ministries and departments.

Unlike previous government budgets, which spread resources thinly over a large number of projects, the Medium Term Expenditure Framework aims to focus resources on high-priority programmes and provide adequate resources for operations and maintenance. Thus the framework has become the main instrument for increasing the effectiveness and efficiency of public resource use. In addition, as part of efforts to address poor management of public spending and service delivery, the government is publishing a quarterly budget review that monitors implementation of the budget plan.

Domestic debt—nearly \$3 billion

Kenya's domestic public debt is nearly \$3 billion, and each year interest payments consume about 12% of government revenue. Moreover, most of this debt is in 91-day Treasury bills—forcing the government to take continuous recourse to the market to roll over the debt. High debt is one of the main reasons the government cannot afford sufficient public services.

In fiscal 2001 the budget deficit totalled 20 billion shillings (about \$250 million). The government desperately needs budget support to avoid financing the deficit through more domestic borrowing. Accordingly, the government urgently needs to expedite the trigger actions for the resumption of an IMF–World Bank programme. If this support is not secured soon, attempts to lower public debt to sustainable levels may be futile. The government also faces the daunting challenge of supporting sustained economic growth without increasing overall public spending. The government must consider accelerating its privatization programme, especially in telecommunications, and using the proceeds to retire part of the domestic debt.

External policies—regional integration and tariffs

In October 2000 Kenya joined the free trade area formed by the Common Market for Eastern and Southern Africa (COMESA). Membership creates opportunities for increased exports in several sectors. Kenya's exports to COMESA members increased from 51 billion shillings in 1997 to 57 billion shillings in 2000. Indeed, the COMESA region has overtaken the European Union as the main destination of Kenya's exports, with its share increasing from 43% of the total in 1997 to 45% in 2000.

Although there is enormous potential for increasing exports to the East African Community (EAC), there is a growing feeling among the EAC's two other members—Tanzania and Uganda—that Kenya needs to buy more from them to ease the huge trade imbalance favouring Kenya. Unless this situation is addressed, Kenya's exports to Tanzania and Uganda may be undermined by nontariff barriers and other tariff-like charges—a development that is raising concern among exporters. Exports to the two countries account for 61% of Kenya's exports to other African countries. Whereas most exports to the European Union are primary products, manufactured goods dominate exports to the EAC and COMESA. Given Kenya's goal of diversifying exports away from traditional products, the COMESA and EAC markets should be safeguarded.

Membership in the COMESA free trade area exposes Kenya to potentially stiff competition from stronger economies such as Egypt and Mauritius. Vulnerable goods include sugar, wheat, and rice, imports of which have already increased from the COMESA region. But it is suspected that some of these imports may be originating in other areas and entering fraudulently as COMESA imports. Customs authorities need to tighten verification procedures, allowing only items that qualify to enter Kenya.

Other markets offering opportunities for increased Kenyan exports include the United States—especially with the passing of the African Growth and Opportunity Act (AGOA) by the U.S. Congress—and the European Union. Kenya has secured investment commitments worth an estimated 500 million shillings since being designated as a beneficiary of the AGOA. Over the next few years the act is expected to almost double Kenya's export earnings, from 2.7 billion to 5.2 billion shillings.

Kenya's trade outlook will also be influenced by its tariff structure. In 1999 Kenya had only five non-zero tariff bands. But suspended duties were levied on 30 items considered sensitive. The suspended duties were applied in addition to normal duties and so were equivalent to customs duties. The suspended duties nullified the benefits of reduced COMESA tariffs because the reductions were based only on normal duties. Under pressure from the IMF, World Bank, World Trade Organization, and its trading partners in the region, Kenya was forced to eliminate suspended duties. In fiscal 2001 suspended duties were merged with normal duties to form nine non-zero tariff bands ranging from 2.5% to 100%.

In line with agreements with COMESA and EAC members, and as part of the IMF's Poverty Reduction and Growth Facility programme (currently suspended), Kenya will rationalize its tariff structure over the next four years. Already, imports from COMESA members

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Kenya's trade outlook
will be influenced by its
tariff structure
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that meet the rules on origin are duty free on a reciprocal basis. In addition, imports from Tanzania and Uganda receive a 90% tariff reduction on a nonreciprocal basis—an arrangement intended to narrow the huge trade imbalance favouring Kenya. Ultimately, Kenya's maximum tariff will be lowered to 25% and the number of non-zero tariff bands reduced to three.

“Imports from COMESA members that meet the rules on origin are duty free on a reciprocal basis”

Social sector developments

The main challenges for Kenya's social sector policies include reducing poverty, increasing enrolments, and expanding access to health care.

Poverty—15 million poor

In 1997 just over half of Kenyans lived below the poverty line (table 5.4). At the same time, more than three-quarters of rural and urban poor people could not afford private health care and so depended on public health facilities. Yet nearly three-fifths of poor people did not seek public health care because drugs were not available. Education indicators are also weak for poor people: 13% of the urban poor and 29% of the rural poor have never attended school—and education's high cost is cited as the main reason.

In short, Kenya's poor are malnourished, have little education, and do not have access to proper medical care. As a result they suffer from high unemployment and mortality rates. In 2001 the number of poor Kenyans increased to an estimated 15 million. Thus the country's most crucial challenge is reviving economic growth and reducing poverty.

Education—enrolment rates below norm

During 1998–2001 Kenya spent more than 7% of its GNP and 18% of its government budget on education. Yet gross enrolment rates at the primary and secondary levels are below the norm for such high spending. More worrisome, gross primary enrolment fell about 4 percentage points in 2000 (table 5.5). The introduction of school fees, combined with stagnant and falling incomes, was the main cause of the decline.

Moreover, the quality of education has fallen due to insufficient resources. In fiscal 2001 recurrent spending accounted for 98% of spending by the Ministry of Education. Administrative costs consumed 82% of recurrent spending, with most used for teacher wages. The remaining funds are inadequate to provide sufficient educational equipment, supplies, and services.

Health—life expectancy gains reversed

In fiscal 2001 health accounted for 15% of recurrent government spending on social services, second only to education. In addition, the private sector and nongovernmental organizations increased their investments in health care facilities. As a result the number of hospitals rose 7.1%, health centres 1.3%, and dispensaries 2.5%. As noted, however, many Kenyans do not seek health care. Poor people's access to health care has worsened because of falling incomes, the introduction of user charges in government facilities, and the unavailability and high cost of drugs.

Table 5.4

Various measures of poverty in rural and urban areas, Kenya, 1997
(percent)

Area/poverty measure	Headcount ratio	
	Households	Individuals
Rural areas		
Food poverty	43	50
Absolute poverty	46	53
Hardcore poverty	30	35
Urban areas		
Food poverty	32	38
Absolute poverty	43	50
Hardcore poverty	6	8

Source: Kenya, Central Bureau of Statistics 1997.

Table 5.5

School enrolments and life expectancy, Kenya, 1995–2000

Indicator	1995	1996	1997	1998	1999	2000
Enrolment (percent)						
Primary school	84.9	85.9	87.0	88.0	89.0	85.0
Secondary school	24.4	25.1	25.8	26.4	27.1	29.1
Tertiary school	1.9	2.0	2.0	2.1	2.1	2.2
Life expectancy (years)		55.0	54.0	52.1	47.7	48.9

Source: World Health Organization 2001; World Bank 2001.

Making matters worse, HIV/AIDS has reversed gains in life expectancy. The disease is the main reason for the drop in life expectancy from 55 years in 1996 to 49 years in 2000 (see table 5.5). In 2000 the national HIV prevalence rate reached 13.5%. With more than 1 in 10 adults infected with HIV, the cost of the epidemic is expected to total more than \$2 billion over the next five years. The government responded by establishing a National AIDS Control Council to strengthen capacity and coordination. AIDS committees have also been established in all political constituencies, including provinces and districts.

“The quality of education
has fallen due to
insufficient resources”

Institutional reforms and governance

Poor economic governance is the main impediment to Kenya's development. Poorly managed public resources, widespread corruption, and the public sector's inability to deliver services efficiently have undermined development over the years. Citing these reasons, in 1997 the IMF suspended its Enhanced Structural Adjustment Facility. As noted, this move crippled Kenya's balance of payments position because external investors repatriated about \$250 million—leading to a 20% depreciation in the shilling and a 9 percentage point increase in the Treasury bill rate, from 18% to 27%.



In 2000 the government began implementing a major public sector reform programme



Similarly, in 1998 the World Bank suspended a structural adjustment credit of \$87 million to Kenya, arguing that the government was not committed to agreed actions. The Bank subsequently placed Kenya in its low-case lending group, limiting available support to nonlending programmes aimed at improving economic governance and financial management and accountability. The Bank also indicated that unless the public sector improved its spending management and project implementation capacity, conventional lending was unlikely to be effective.

In 2000 the World Bank agreed to resume lending, providing a total of \$150 million as an Economic and Public Sector Reform Credit. The funds were to be released in three instalments of \$50 million, with the first made in September 2000. But with the IMF's suspension of its Poverty Reduction and Growth Facility at the end of 2000, the Bank did not disburse the second and third instalments.

Kenya is in the midst of consultations with the IMF on the Poverty Reduction and Growth Facility. IMF approval would lead to SDR 20 million (about \$16 million) in budget support as part of the facility approved in July 2000. To obtain this approval, Kenya basically needs to establish a constitutional Anti-Corruption and Economic Crimes Authority. The previous Anti-Corruption Authority was declared unconstitutional because the establishment of an independent corruption authority was considered to usurp the powers of the attorney general. The revised law was introduced in Parliament but defeated, and six months must pass before it can be reintroduced. To demonstrate Kenya's commitment to containing corruption, however, Kenya's president has established a corruption-fighting unit in the police force.

In addition, to address governance challenges, the government has embarked on an ambitious programme that involves restructuring the public sector, reforming the management of public spending, and strengthening public sector accountability. The programme's main elements are public sector reform, local government reform, and privatization.

Public sector reform—performance-oriented management

In 2000 the government began implementing a major public sector reform programme focused on establishing performance-oriented public sector management. The main elements of the reform are a public service management programme, legal and judicial reform, efforts to enhance integrity and accountability, and efforts to increase interaction with civil society. The first task was to restructure the government around a limited number of core functions. Thus the number of ministries was cut from 28 to 15 and some permanent secretaries were eliminated. These steps were followed in fiscal 2001 by a fairly successful staff retrenchment programme, combined with improved pay and benefits for remaining staff.

Local government reform—autonomous authorities

Kenya's central government has developed a decentralization strategy aimed at assigning responsibility for local services to autonomous local authorities. Two mechanisms have been implemented to achieve this goal: the Local Authority Transfer Fund and

Financial Control Management Boards. The fund transfers 5% of income tax revenue to local authorities. A local authority service charge has been phased out, but local authorities must meet strict requirements to obtain financing from the transfer fund.

Privatization—divesting large enterprises

Kenya's public enterprise reform programme is focused on divesting large infrastructure and service enterprises, especially Telkom Kenya, Kenya Railways, Kenya Ports Authority, and Kenya Pipeline Corporation. The government has committed to a number of measures in reforming and privatizing state-owned enterprises.

Public enterprise reform and privatization are key conditions for World Bank and IMF loans. But privatization has fallen short of expectations in terms of speed and achievement, as with the telecommunications company. The World Bank and other development partners consider this a reflection of the government's weak commitment to privatization, but the government argues that the long, complex privatization process is responsible for the delays.

“Economic outcomes will be even better if the IMF and the World Bank resume assistance to Kenya”

Outlook for 2002—real GDP growth to rise to 2.5%

Kenya's economy should continue to recover in 2002. Growth will be stronger in agriculture, while manufacturing is expected to grow twice as fast as in 2001—partly as a result of better power supplies, the elimination of some tariffs, and reductions in others. Reflecting these developments, real GDP is projected to grow 2.5%. With the domestic economy recovering, exports and imports will expand, causing the current account deficit to increase slightly from 2.6% of GDP in 2001 to 2.8% in 2002. Inflation will also edge upward, reaching 3.8%.

Economic outcomes will be even better if the IMF and the World Bank resume assistance to Kenya. Such assistance would not only provide additional resources, it would also send a positive signal to other donors and private investors. Thus in the coming year the government should make a concerted effort to improve its relationship with both institutions.

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Nigeria—Untapped Potential

Thanks to a wealth of oil and human resources, Nigeria has the potential to become one of Africa's leading economies. But years of mismanagement and social division have paralysed the giant of Africa. Real GDP growth was projected to rise slightly in 2001 to 4.0%, up from 3.8% in 2000, largely as a result of improvements in the non-oil sector. The oil sector was hurt by a slump in oil prices and by oil production constraints imposed by the Organization for Petroleum Exporting Countries (OPEC).

The current growth projection of 4% falls far short of the 6–10% promised at the start of President Olusegun Obasanjo's administration—and of the 7–10% growth required to make a significant dent in poverty and to achieve the international development goals for 2015. As a result, Nigeria's position in global poverty rankings has improved little over the years, and the government faces mounting pressure to make good on its promise of “democracy dividends”.

Driven largely by an oil windfall, external accounts improved significantly in 2000. Exports maintained the strong growth started in 1999 (58% in 1999 and 64% in 2000), providing the foreign exchange needed to finance the massive (181%) growth in imports in 2000. The strong growth in export revenue—and thus in import demand—is unlikely to be sustained in the short to medium term, since oil prices are not expected to recover to their 2000 level. As a result of the downward trend in oil prices and further production restrictions by OPEC, export earnings are expected to fall significantly in 2002.

Tax revenue from the oil sector helped to support a sharp rise in public investment spending in 2000. In addition, inspection of imports rose to 100%, significantly increasing revenue from import duties and offsetting what could have been a significant budget deficit for 2000. The government budget for 2001 had envisaged even greater capital outlays (around 50% more than in 2000 and 250% more than in 1999). But the introduction of procurement rules and value-for-money audits of capital projects helped to slow capital spending and prevent waste.

The medium-term outlook for the economy is unfavourable. Real GDP growth is projected to slow to around 2% in 2002, as a result of a reduction in OPEC quotas at the beginning of the year and an expected slump in oil prices. Declining investor interest—especially in privatized companies—and increasing social and political tensions may exacerbate the slowdown. Still, increased investor activity in offshore oil and gas projects and expected improvements in agricultural output might help keep the economy from registering negative growth. The biggest threat to the economy is the country's structural vulnerability—governance problems, volatile oil prices, ethnic and religious tensions, and unpredictable relations with the donor community.

Nigeria's position in global poverty rankings has improved little over the years

“The challenges are not made easier by the immense pressure to deliver democracy dividends”

According to the 2002 budget statement, Nigeria's policy reforms are expected to continue to focus on four main themes: pursuing sound economic management, improving the condition of public infrastructure, diversifying the economy while emphasizing poverty reduction, and increasing integration with the regional and global economies. The successful rescheduling of external debt with the Paris Club of bilateral creditors and the extension of the Stand-By Arrangement with the International Monetary Fund (IMF) will also be key to ensuring better growth performance in 2002. And as oil prices fall, fiscal prudence will be required. But the constitutional right of local governments to a share of federally collected revenue and the inability of the federal government to constrain spending by lower levels of government make it difficult for the federal government to manage oil windfalls or to devise a fiscal rule to smooth national consumption after a windfall. Thus in the next few years Nigeria's economic performance will be tied to the efficiency and effectiveness with which the government tackles the country's public sector resource management issues.

The task of turning around the Nigerian economy is daunting. But the prospects are good, and Nigerians are upbeat about rebuilding their country—as is their head of state.

Recent trends and developments— promise and disappointment

The new administration of President Olusegun Obasanjo was mindful of the challenges and expectations of Nigerians as it took office in May 1999. In *Obasanjo's Economic Direction 1999–2003*, it therefore promised to establish

one of the leading economies in Africa: an economy that experiences rapid and sustained growth at not less than 6–10% per annum at the end of the present Administration's tenure. The creation of a national economy that is highly competitive, responsive to incentives, private sector-led, broad-based, diversified, market-oriented and open, but based on internal momentum for its growth, is the aim. (Nigeria, Ministry of Finance 2000c, pp. 8–9)

Nigeria's economic performance since 1999 has been a mix of promise and disappointment, however, as President Obasanjo's new civilian government has grappled with the daunting task of turning around a country paralysed by decades of mismanagement and ethnic division. The challenges are not made easier by the immense pressure to deliver democracy dividends and the impending campaign for the 2003 general elections.

An uncomfortable comparison can be made with the last civilian administration, that of President Shehu Shagari (1979–83). Nigeria experienced a major oil price boom during the early years of the Shagari regime. But the oil boom was squandered, economic mismanagement reached unacceptable levels, and the Nigerian state and economy ended up in worse shape than before. The civilian-managed transition through elections in 1983 was rigged and highly divisive and, together with the comatose economy, provided the impetus for military intervention in December 1983. The Obasanjo regime faces the ghost of

that era: history is waiting to be repeated or to be reversed. An oil boom heralded the Obasanjo administration. An election is due in 2003.

Analysts are divided on how to interpret the progress so far. Optimists give the Obasanjo government credit for keeping the economy on an even keel after many years of mismanagement under military rule and are hopeful that if the present trend towards good governance continues, economic growth will rise appreciably. Conversely, the pessimists expect slow growth and poverty, social tension and violence, and continued decay in public infrastructure for the foreseeable future.

“Another huge growth reserve is the stock of flight capital”

Macroeconomic performance 1999–2001— growth nearing 4%

When the new civilian government took over in 1999, Nigeria had abundant growth reserves—idle productive resources that could, with the right strategy, be transformed into huge growth windfalls in the short to medium term. These reserves include arable land, 60% of which lies idle; educated youth, more than 40% of whom are unemployed or underemployed; industrial capacity, whose utilization remains less than 35%; and several natural resources that go unexploited, including solid minerals and natural gas. The rate of capacity utilization in the economy today is comparable to that in most countries just emerging from conflict. Experience in such countries suggests that with serious reforms, it is possible to initiate annual growth of more than 6% a year and to sustain that growth for a time.

Another huge growth reserve—though one that is abroad—is the stock of flight capital, estimated at more than twice the size of GDP. If the stock of flight capital is assumed to be only around \$90 billion, a 10% annual return on that would yield some \$9 billion. In essence, if the Nigerian government introduces policies and incentives encouraging the owners of the wealth to repatriate just the interest earnings, the Nigerian economy could gain \$9 billion a year in additional investment—equivalent to 20% of GDP.

Neither the required (or expected) growth nor massive repatriation of flight capital took place in 1999–2001. On all counts Nigeria is a desperately poor country. In a ranking of the world's countries by income level, Nigeria fell near the bottom, with per capita income around half the average for Sub-Saharan Africa (in purchasing power parity, or PPP, terms; table 6.1). This comparative performance is all the more disappointing given the country's abundant human and natural resources.

The GDP growth rate in 2000 was 3.8%, up from 2.8% in 1999 and higher than the 3.1% targeted in the 2000 budget (table 6.2). With population growth of around 2.9% a year, however, this growth rate translated into GDP per capita growth of less than 1.0%. Growth in 2001 was estimated to have risen slightly, to around 4.0%, despite OPEC production restrictions and the sluggishness of reforms to remove structural constraints on the private sector. The growth performance in 2001 was driven largely by favourable conditions in the non-oil sector. The oil price remained on average above the \$20 a barrel used in the 2001 budget estimates, but OPEC reduced the country's production quota by around 9% in the first quarter of 2001.

Table 6.1
Nigeria in a global context, 1999

Indicator	World	Nigeria	Nigeria's world rank ^a
Population (millions)	5,975	124	10
GNP (billions of dollars)	29,232	37	54
Per capita GNP (dollars)	4,890	319	179
PPP GNP (billions of dollars) ^b	38,804	92	49
PPP GNP per capita (dollars) ^b	6,490	744	193
Human development index	0.716	0.455	136 ^c
Gender-related development index	0.706	0.433	123 ^c

a. Out of around 200 countries, except where otherwise noted.

b. Adjusted for purchasing power parity (PPP).

c. Out of 162 countries.

Source: UNDP 2001.

“Gross fixed capital formation rose from 5.4% of GDP in 1999 to 7.9% in 2000”

Inflation remained moderate in 2000, with the composite consumer price index rising by 6.9%, slightly more than the 6.6% in 1999. According to the Central Bank of Nigeria, two main factors led to the increased pressure on prices towards the second half of 2000: the scarcity of petroleum products and the excess liquidity in the banking system arising from the monetization of the increased oil export receipts. A good agricultural harvest moderated the effects of these factors. But a loosening of monetary policy and an increase in government spending that boosted domestic demand and money supply at a time that the exchange rate was depreciating put the pressure back on the general price level in 2001. As a result, inflation averaged an estimated 15.6% in 2001, with the prices of staple food items increasing by around 40%. Independent estimates suggest aggregate inflation of between 28% and 35%, however, with food prices increasing by around 66% in 2001.

At around 11%, the official estimate of the oil sector's direct contribution to GDP seems small compared with its impact on the economy.¹ The wider effect of the oil price boom can be inferred from the expenditure components of GDP, which are driven largely by oil revenue and foreign exchange. Gross fixed capital formation rose from 5.4% of GDP in 1999 to 7.9% in 2000—reflecting massive public sector investments financed by oil revenue (see table 6.2). Government final consumption also increased sharply in 1999, by 71%, then declined by 1.2% in 2000. In contrast, private consumption experienced a puzzling collapse in 1999, then posted a 5% increase in 2000. The government budget for 2001 had envisaged even greater capital outlays than in 2000 (around 50% more than in 2000 and 250% more than in 1999). But new procurement rules and value-for-money audits of capital projects helped to slow capital spending and prevent waste.

The oil factor—an unexpected boom

In 2000, thanks to the oil windfall, the growth rate of oil GDP improved by 4.8 percentage points compared with the 1999 growth rate. Indeed, the unexpected boom in the international oil market essentially drove the growth performance of the entire economy in 2000. Oil prices rose from \$18.00 a barrel in 1999 to \$28.60 in 2000. Moreover, in 2000 the

Table 6.2**Selected economic indicators, Nigeria, 1996–2002**

Indicator	1996	1997	1998	1999	2000	2001 ^a	2002 ^b
Real GDP growth (percent)	3.4	3.2	2.4	2.8	3.8	4.0	2.0
Oil sector growth (percent)	6.9	1.4	−4.9	−4.2	0.6	6.6	3.7
Oil production (millions of barrels a day)	2.0	2.2	2.1	2.0	2.2	2.3	2.3
Manufacturing capacity utilization (percent)	36.8	34.0	34.9	36.0	34.5	33.8	—
Gross fixed capital formation (percentage of GDP)	5.1	5.4	5.3	5.4	7.9	6.6	6.6
Inflation rate (percent)	29.3	8.5	10.0	6.6	6.9	15.6	13.3
Overall fiscal balance (percentage of GDP)	1.3	−0.2	−4.7	−8.4	−2.9	−4.3	−3.9
Broad money (M2) growth (percent)	16.8	16.9	23.3	31.6	48.1	—	—
Overall balance of payments (percentage of GDP)	−1.9	0.0	−7.8	−3.1	7.0	3.6	−2.5
Current account balance (percentage of GDP)	8.5	1.2	−11.6	0.4	5.8	3.4	−3.3
Capital account balance (percentage of GDP)	−10.2	−1.0	4.1	−3.5	−6.8	−3.8	−6.0
External reserves (billions of dollars)	4.07	7.58	7.10	5.45	9.91	9.60	9.80
Average crude oil price (dollars per barrel)	21.2	19.4	12.9	18.0	28.6	22.0	21.5
Average interbank foreign exchange market rate (naira per dollar) ^c	—	—	—	96.1	101.7	115.6	133.5
Average parallel market exchange rate (naira per dollar)	83.1	85.0	87.9	99.2	111.1	132.5	150.0

— Not available.

a. Estimated.

b. Projected.

c. The average annual official exchange rate for 1996–98 was 21.9 naira per dollar.

Source: Central Bank of Nigeria, Annual Report and Statement of Accounts, 2000, and EIU 2001a, except for data for 2001 and 2002, which are Economic Commission for Africa estimates based on official sources, including Nigeria, Ministry of Finance 2000a.

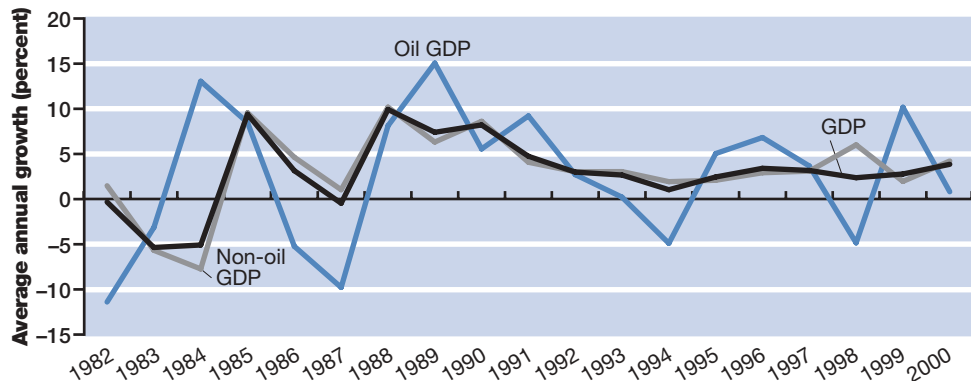
OPEC quota for Nigeria increased from 1.885 million barrels a day in March to 2.033 million in April, 2.091 million in July, 2.157 million in October, and 2.178 million in November. Of the total daily production, around 1.88 million barrels a day were exported, up from 1.66 million in 1999.

Although oil is in many ways an enclave sector in Nigeria, with few forward and backward links with the rest of the economy, it is still decisive for economic performance. The oil sector accounts for around 95% of foreign exchange earnings and more than 80% of government revenue. Its impact is transmitted mostly through the income effect, mediated through public spending and imports. Much of the modern productive sector depends on imported inputs, and the oil sector provides the foreign exchange needed.

Oil GDP is clearly more volatile than non-oil GDP (figure 6.1). Because of the volatility in oil prices, the sector can experience rapid growth in value added one year followed by an equally rapid decline in the next—and the wide swings in the sector's value added have historically been reflected in volatile growth rates for the economy as a whole. While non-oil GDP closely tracks total GDP, there is evidence that oil GDP leads the cyclical trend

Figure 6.1

Oil, non-oil, and total GDP growth, Nigeria, 1981–2000



Source: Economic Commission for Africa.

“Agriculture dominates the Nigerian economy, contributing 41.5% of GDP”

in both non-oil and total GDP. Changes in oil prices could therefore have both contemporaneous and lagged effects on general economic performance.

Sectoral performance—unchanged

Agriculture dominates the Nigerian economy, contributing 41.5% of GDP in 2000 according to official data (table 6.3). Industry (including mining, manufacturing, and building and construction) contributed around 18.8% of GDP. The service sector accounted for the other 39.7%.²

Agriculture also provides employment for much of the population. Nonetheless, the sector has become progressively less profitable, and while Nigeria was a large exporter of agricultural products in the 1960s, it has now become a sizable importer. President Obasanjo, who introduced a national food production programme while ruling the country in the 1970s, has taken steps to refocus attention on agricultural development. But revitalizing the sector will require major investments in rural infrastructure and in productivity-enhancing production systems.

Manufacturing is concentrated in a few products, with textiles, cigarettes, beverages, soaps and detergents, and cement accounting for around 60% of total manufacturing output. These subsectors have benefited from substantial foreign investment in recent years. But they are highly dependent on imports and therefore vulnerable to foreign exchange difficulties. Rising production costs and falling consumer demand are the main factors constraining growth in manufacturing output.

Remarkably, sectoral growth rates did not change from 1999 to 2000 except for industry, which reversed its decline of the previous two years to post a growth of 2%. This trend was led by a reversal of the two-year decline in crude petroleum production, which had negative growth in 1998 (–5%) and 1999 (–7%) but posted positive growth of 1% in 2000.

Table 6.3

Growth rates and contributions to GDP growth by sector, Nigeria, 1997–2000
(percent)

Sector	Average annual growth				Share of GDP of 2000	Contribution to GDP growth, 2000
	1997	1998	1999	2000		
Agriculture	3.0	5.0	5.0	5.0	41.5	2.08
Industry	1.0	–4.0	–4.0	2.0	16.7	0.33
Manufacturing	0.0	–4.0	4.0	4.0	—	—
Building and construction	6.0	6.0	4.0	4.0	2.1	0.08
Wholesale and retail trade	1.0	3.0	2.0	2.0	11.6	0.23
Other services	4.0	4.0	4.0	4.0	28.1	1.12
Total GDP growth						3.84

Source: Calculated on the basis of data from Central Bank of Nigeria, Annual Report and Statement of Accounts, 2000.

Mining and quarrying maintained 3% growth in both 1999 and 2000. Agriculture maintained the strongest growth, at 5% a year. The sectors' weighted contributions to GDP growth give an aggregate growth rate of 3.84% in 2000.

External sector performance— big improvements, thanks to the oil windfall

External accounts improved significantly in 2000, following the positive shift in terms of trade thanks largely to the oil windfall (see table 6.2). The improvement in the external accounts is unlikely to be sustained in the short to medium term, however, as oil export earnings will probably fall in 2002. Imports did not fall proportionately because of a combination of factors—the expected increase in government capital spending, the projected growth in investment in offshore oil production, and the likely effects of further cuts in customs tariffs. Thus the surplus in the trade account declined from 5.8% of GDP in 2000 to 3.4% in 2001 and is expected to decline further in 2002. Moreover, although the inflow of official multilateral and bilateral credit and aid has increased modestly since the return of democracy, foreign assistance is expected to remain at a relatively low level as donors maintain a wait-and-see attitude towards Nigeria.

Nigeria's debt problem persists, but some progress was made in 2000–01 in managing its external debt. The total debt service obligation for 2000 was around \$3.6 billion, but a rescheduling arrangement reached towards the end of that year reduced the burden in 2001. Debt service arrears at the beginning of 2000 were around \$19.5 billion. Even after rescheduling, the debt service owed to just the Paris Club of bilateral creditors amounted to around \$3 billion, but successful negotiations reduced this to \$1 billion. At the beginning of 2001 Nigeria's stock of external debt stood at \$28 billion—\$4 billion less than estimated by the IMF (table 6.4). (The difference can be attributed mainly to the IMF's inclusion of public

“The surplus in the trade account is expected to decline further in 2002”

Table 6.4**External debt, Nigeria, selected years, 1980–2002**

Item	1980	1995	1996	1997	1998	1999	2000	2001 ^a	2002 ^b
Total debt (billions of dollars)	6.5	31.9	31.5	30.9	31.6	32.0	31.9	27.9	26.4
Debt service as a percentage of exports of goods	3.1	16.8	14.5	11.8	12.3	14.9	8.6	7.9	9.8
Interest payments as a percentage of exports of goods	2.4	7.3	4.9	3.5	4.5	7.7	4.4	—	—
Amortization as a percentage of exports of goods	0.7	9.5	9.6	8.3	7.8	7.1	4.2	5.3	5.0
Total debt as a percentage of GDP	10.0	113.6	89.1	86.3	95.9	92.2	78.1	72.6	73.1
Total debt as a percentage of exports	24.0	256.5	185.1	187.5	286.2	250.0	149.2	7.9	9.8
Change in debt stock (percent)	—	—	–23.8	–9.5	–7.1	–4.9	–6.6	–1.4	0.2

*a. Estimated.**b. Projected.***Source:** IMF 2001b except for data for 2001 and 2002, which are from the reconciled data of Nigeria's Debt Management Office and EIU 2001b.

“There is an asymmetry between the size of productive sectors and their shares in the use of foreign exchange”

enterprise debt and government-guaranteed commercial loans to non-government enterprises.) By September 2001 Nigeria's Debt Management Office had completed reconciliation meetings with 13 of the country's 14 bilateral creditors. It had also reviewed the draft bilateral agreements prepared by 12 of the 14 Paris Club creditors to which Nigeria is indebted.

The changing structure of foreign exchange utilization is another interesting development in the external sector. In 1996 imports of goods accounted for 92.5% of foreign exchange allocations, while invisibles (capital transfers and payments for services) accounted for 7.5%. In 1999 invisibles' share increased to 12.1%, and in 2000 it almost doubled to 22.5%, while imports of goods accounted for 77.5%, down from 87.9% in 1999. Some analysts worry that the growing share of invisibles in the use of foreign exchange indicates increasing capital flight. Nigeria was among the African countries suffering enormous capital flight in the 1980s, and the economy is said to be grossly undercapitalized today. The uncertainty about the business environment (due to military coups) and the prolonged military dictatorship were fingered as the main cause of this capital flight. The near doubling in the share of invisibles in the use of foreign exchange within the first year of civilian rule is therefore worrisome.

Also important are the changes in the sectoral use of foreign exchange. Three features are worth highlighting. First, the share of industry in the use of foreign exchange has been falling (dropping from 59.6% in 1996 to 39.3% in 2000). Second, there is an asymmetry between the size of productive sectors and their shares in the use of foreign exchange. In 2000 industry accounted for 18.8% of GDP but used 39.0% of foreign exchange, while agriculture, which accounted for 41.5% of GDP, used only 2.5% of foreign exchange for imported inputs. This may support the claim by some analysts that agriculture is being marginalized in the allocation of foreign exchange. Third, the share of finished goods in the use of foreign exchange—37% in 1998 and 36% in 1999—dropped to 31% in 2000. All these changes in shares might have been a result of the increasing share of invisibles relative to total imports, however.

In the import structure a disturbing development has been the rising share of food imports. In 2000 food accounted for 14.4% of imports, up from 8.0% in 1990. This trend suggests that Nigeria could face a food crisis in the future. Nigeria is now around the 10th most populous country in the world, and its population is projected to grow to 235–250 million by 2025. That growth will make it one of the five most populous countries, but it will be the only one in the group that is nowhere near self-sufficient in food. The rapid population growth has made it increasingly difficult for Nigeria to feed its people, and the volatility of oil exports means that the present level of food imports is not sustainable. Nigeria faces the major policy challenge of transforming its agricultural sector to feed its population.

“Both revenue and spending have been on the increase since 1999”

Policy reforms and economic performance

Four major clusters of policy reforms have underpinned the economic performance of Nigeria, and their further success—or failure—will largely determine economic outcomes in the medium to long term. These reforms include:

- Managing the large fluctuations in oil revenue to ensure efficient, non-inflationary, and sustainable growth.
- Rehabilitating decaying infrastructure and institutions.
- Diversifying the economy so as to help reduce poverty.
- Adopting strategies aimed at integrating the Nigerian economy into the global and regional economies so as to promote economy-wide competitiveness.

The brief review here describes the broad policy thrusts.

Fiscal policy—tough to cap spending

The public sector plays a decisive part in the country’s economic performance—especially through its spending—and the budget is therefore the key annual policy document. A fundamental challenge of fiscal policy since the new civilian administration assumed office in 1999 has been the pressure to deliver democracy dividends through massive increases in public spending. These increases, it is feared, would be difficult to reverse if oil prices collapse. Fiscal restraint is made all the more difficult by constitutional provisions requiring that all federally collected revenue (including oil revenue) be shared among the federal government, the 36 state governments, and the federal capital territory (Abuja) as well as 774 local government districts. This automatic right to revenues and the constitutional inability of the federal government to restrain spending by lower levels of government make it difficult for the federal government to manage oil windfalls or to devise a fiscal rule for smoothing national consumption by sterilizing windfalls.³

Both revenue and spending have been on the increase since 1999. Although a supplementary budget was passed in 1999 after the civilian government was sworn in, the first substantive budget of the current government was that of 2000, passed in the middle of that year. Government revenue increased sharply in 2000, reflecting the substantial rise in the

“Oil receipts rose by 119.7%, accounting for 84% of total revenue.”

price of crude oil over the budget benchmark of \$20 a barrel. Oil receipts rose by 119.7%, accounting for 84% of total revenue.

Consolidated government spending (the sum of federal and state government spending) increased to 43% of GDP in 2000, up from 31% in 1999. Aggregate spending by the federal government increased by 25.3% over the level in 1999. The government financed the resulting deficit, at 2.9% of GDP, entirely from domestic resources by issuing Treasury bills (pushing total domestic debt up to around 25% of GDP in 2000). A breakdown of spending showed that current spending took the lion's share, 66%, primarily because of an increase in civil service pay, while capital spending accounted for 34%.

In January–September 2001 federally collected revenue rose by 52% over the level in the corresponding period in 2000, surpassing the estimate for the period by 6.4%. The increased revenue fuelled higher spending at all levels of government. The federal government's spending increased by 77.6% over the level in the corresponding period in 2000 and exceeded the projected spending by 4.2%.

Pressures to address the endemic poverty led the government to once again experiment with the failed old strategy of public sector-driven employment and income creation programmes. In May 2000 the government more than doubled civil service wages, in part to compensate for the substantial erosion of real wages and probably also to reduce petty corruption. The government also attempted to end the petroleum subsidy and deregulate the downstream petroleum sectors, but these initiatives were stalled by strong protests by labour unions, because of a perceived adverse impact on workers' well-being.

The 2000 budget will have long-lasting consequences, especially since most of the increases in recurrent spending—such as the wage bill—will be difficult to reverse when oil prices fall. Given this ratchet effect of current spending, either the adjustment burden will fall on capital spending or the government will resort to increased borrowing or attempt to raise revenues by removing subsidies on petroleum products and increasing tariffs and income taxes. Some of these measures would be politically difficult. Curtailing capital spending would pose major challenges given the decayed infrastructure and impending elections. Resorting to borrowing (especially from the domestic market) would increase the already huge stock of domestic debt and lead to inflation, appreciation of the real exchange rate, and a rise in the already very high domestic interest rates. There are no easy choices. This situation provides the context for evaluating the 2001 and 2002 budget proposals.

The 2001 budget increased consolidated government spending to 53% of GDP and raised total spending (recurrent and capital) by more than 70% over the level in 1999. Capital spending was increased by 250% over the level in 1999. The goal of the 2001 budget was to consolidate the thrust of the 2000 policies in laying a solid foundation for a private sector-led, market-driven economy, for lower unemployment and poverty, and for single-digit inflation. Specifically, the budget aimed to:

- Provide a legal, fiscal, and monetary environment that would enable the private sector to become an effective engine of growth.
- Upgrade the performance of major infrastructure facilities.

- Improve the operational capabilities of law enforcement agencies in reducing crime.
- Continue the policy of probity, transparency, and accountability, to reduce the cost of doing business in Nigeria.
- Take bold steps to fight illiteracy through the Universal Basic Education Scheme.
- Intensify the efforts to reduce rural poverty and improve food security by providing fiscal incentives (for lenders and borrowers) to increase agricultural production.
- Improve the health of the population through rapid upgrading of the health care system.

The 2001 budget placed overwhelming emphasis on power and steel (reflecting the national concern to improve electricity supply), public works and housing (to rebuild decayed infrastructure, especially roads), and water resources (since less than 40% of the population has access to safe water). But the budget does not reflect priority for the social sectors and poverty reduction, at least as measured by capital spending on health and education.

Historically the Nigerian government has lagged behind other countries (including some Sub-Saharan countries) in spending on health and education. In 1994–98 the federal government spent on average around 2.5% of GDP a year on health, compared with an average of 3.9% for Ghana, 6.9% for South Africa, and 4.0% for Sub-Saharan Africa. Between 1985–87 and 1995–97 the Nigerian government’s spending on education fell from 1.7% of GDP to 0.7%, while education spending rose in most other Sub-Saharan countries, including Côte d’Ivoire, Ghana, and South Africa. An important caveat, however, is that Nigeria has a federal structure, and all three tiers of government are responsible for providing health and education services. Data on the health and education spending of the other two levels of government are poor or non-existent. Thus it is possible that aggregate or consolidated government spending on health and education could exceed spending (as a share of GDP) in many of the comparator countries or even the average for Sub-Saharan Africa.

Evaluating the full impact of the 2001 budget must await the final, economy-wide data. But President Obasanjo was not optimistic about the final outcomes in his 2002 budget speech:

An analysis of the economic outlook for the rest of the year indicated that the performance of the economy might weaken further, as inflation, exchange rate and macroeconomic instability could intensify as a result of the continued expansionary fiscal policy and the concomitant intractable problems of excess liquidity in the banking system. (Nigeria, Ministry of Finance 2001)

The 2002 budget was presented to the National Assembly on 7 November 2001 against a background of declining oil revenue and an unpredictable global economy. Under the assumption that the price of oil would average \$18 a barrel in 2002, the government estimated federally collected revenue to be 1.15 trillion naira. Of this amount the federal government hopes to spend 925 billion naira (around 80% of the total), reserving 193 billion naira (\$1.7 billion) for servicing external debt.

The budget does not reflect priority for the social sectors and poverty reduction

“Enforcing the cap on government spending will be difficult in the run-up to the elections scheduled for early 2003”

An important feature of the budget is the government's proposal to raise non-oil revenue to around 45% of total revenue, with company income taxes accounting for 8%. Since non-oil revenue fell in the previous year and the non-oil sector is not expected to improve significantly in the coming year, many analysts question the basis for the optimistic projections and worry about the potential drag of higher taxes on the economy. These concerns are heightened for the manufacturing sector, already burdened by a plethora of charges and an unfriendly investment climate. Like previous budgets, the 2002 budget addresses privatization, economic liberalization, unemployment, infrastructure, and social sector priorities (box 6.1).

The 2002 budget will present two main challenges. First, the budget is based on the optimistic expectation that non-oil revenue can be raised to 45% of total revenue in one year. Although the increase in the non-oil share will partly reflect the decline in oil revenue, it is still substantial, estimated at around 19% of non-oil GDP. Second, enforcing the cap on government spending will be difficult, especially in the run-up to the elections scheduled for early 2003.

Monetary policy—yawning gaps between targets and outcomes

Monetary policy in Nigeria mostly responds to the government's fiscal behaviour in an attempt to achieve the Central Bank of Nigeria's primary goal of price and exchange rate stability. The yawning gap between the Central Bank's monetary targets and the outcomes, however, raises questions about the role and effectiveness of monetary policy in the context of Nigeria's peculiar fiscal structure (table 6.5).

Throughout 2000 the Central Bank pursued a loose monetary policy to reflate the economy. It cut the minimum rediscount rate in three stages from 18% at the end of 1999 to 14% in December 2000 and reduced the cash reserve requirement in two steps from 12% to 10% over the same period. This loose monetary policy—combined with rapid growth in the money supply (due to the monetization of the increased oil receipts), a large increase in public sector wages, and rising food prices—led to a swift rise in inflation in the last quarter of 2000 and into 2001. In response to the sharp jump in inflation and the volatility of the naira, the Central Bank raised the minimum rediscount rate to 18.5% at the end of June 2001.

Interest rates have varied markedly with trends in the growth of monetary aggregates and in the Treasury bill rate and minimum rediscount rate. In 2000 interest rates declined, reflecting the liquidity overhang. The Treasury bill rate fell from 17% in January 2000 to 13% in December, and the deposit and lending rates of commercial and merchant banks declined accordingly.

The structure of interest rates reveals interesting distortions in the banking system. The gap between the real savings and lending rates has progressively widened. While the real savings rate continues to be negative, the real lending rate is around 20%—with enormous implications for the cost of doing business in Nigeria. The risky investment climate has led banks to take a cautious stance on long-term lending, while the huge returns on short-term activities, such as commerce, provide incentives for concentrating their portfolios on those activities.

Box 6.1

Highlights of Nigeria's 2002 budget

The federal government aims to use the 2002 budget to address a multiplicity of objectives:

- Continuing to privatize government investment and public utilities.
- Striving towards GDP growth of at least 5 percent.
- Minimizing the budget deficit and eliminating extrabudgetary spending.
- Continuing to liberalize the foreign exchange market by sustaining the interbank foreign exchange market.
- Targeting moderate inflation.
- Pursuing low interest rates.
- Reducing unemployment by increasing capacity utilization and encouraging self-employment initiatives.
- Increasing funding for the police, judiciary, and other law enforcement agencies so as to step up the fight against crime.
- Enhancing the performance of infrastructure facilities by properly rehabilitating and maintaining existing infrastructure and providing additional facilities, particularly in water and energy.
- Strengthening the war against corruption in both the private and the public sector.
- Enhancing funding for education at all levels, with a particular emphasis on the Universal Basic Education Scheme.
- Improving health care delivery, with an emphasis on preventive care.
- Increasing food production and the provision of post-harvest storage facilities, including by maintaining a system of buyer of last resort and guaranteed minimum prices.
- Diversifying the economy by providing appropriate fiscal incentives for investing in tourism, natural gas, solid minerals, petrochemical industries, and industries related to agriculture.
- Encouraging foreign direct investment through increased liberalization.
- Pursuing the reduction of debt service and the debt stock through dialogue with the World Bank, the International Monetary Fund, and the Paris Club of creditors.
- Pursuing new investment in information and communications technology and in biotechnology.

The main instruments for achieving these objectives, as announced by the president, will include:

- Striving to maintain a nearly balanced budget.
- Paying attention to the completion of ongoing projects.
- Consolidating the policy consistency and sense of direction gained in the past two budgets.
- Strengthening and deepening macroeconomic stability to ensure that the dividends of democracy flow to the grass roots.
- Institutionalizing the “due process principle”, by linking spending to resources on the basis of identified priorities, economy, efficiency, and effectiveness.

Source: Nigeria, Ministry of Finance 2001.

Table 6.5

*Monetary, financial, and other targets and outcomes, Nigeria, 1999 and 2000
(percent, except where otherwise specified)*

Indicator	1999		2000	
	Target	Actual	Target	Actual
Growth in M2	10.0	31.6	14.6	48.1
Growth in M1	4.1	18.0	9.8	62.2
Change in aggregate bank credit	18.3	30.0	27.8	-23.1
Change in net credit to the federal government	10.2	32.0	37.8	-162.3
Change in net credit to the private sector	19.9	29.2	21.9	30.9
Inflation rate	9.0	6.6	9.0	6.9
Growth in GDP	3.0	2.8	3.0	3.8
Accrued to external reserves (millions of dollars)	500	1,650	500	4,460
Exchange rate (naira per dollar, end of period)		98.20		110.05

Source: Central Bank of Nigeria 2000, p.5.

“Nigeria’s external sector policies have been torn between protectionism and liberalization”

Nigeria’s exchange rate regime is a managed float. In 2000 the exchange rate depreciated in all markets. In the official interbank foreign exchange market the naira depreciated on average by 6.5%, to 101.65 naira per dollar, mainly because of significant growth in import-driven demand for foreign exchange following the increase in government spending. The parallel market rate depreciated by 30% between December 1999 and May 2001.

In April 2001 a foreign exchange crisis emerged when the Central Bank made a small adjustment of the interbank foreign exchange market rate before it had effectively mopped up the excess liquidity triggered by the fiscal expansion. The parallel market rate depreciated to 140 naira per dollar in early April. The government sold large amounts of foreign exchange to deal with the crisis, depleting its foreign reserves. As a result of this measure and others to tighten monetary policy, the parallel market rate appreciated from 140 naira per dollar to an average of 133 throughout the rest of 2001, with the gap between the official and parallel market rates averaging 14% for the year.

External sector policies—average tariffs declining

Nigeria’s external sector policies have been torn between protectionism and liberalization, although they have shown a systematic movement towards liberalization. The current customs and excise schedule (1995–2001) is expected to be replaced by a new tariff regime in 2002 with a simplified structure and lower tariffs. Customs duties have been regularly revised in the annual budgets. The 2000 budget reduced the average import tariff from 24% to 12%. And the 2001 budget introduced many cuts in import duties as well as some increases, especially for final goods. These changes are expected to further reduce the average tariff.

In addition, some non-tariff barriers have been removed. The customs and excise schedule originally included import prohibitions on 16 items and absolute prohibitions on

19 items (mostly on health, safety, and moral grounds). These import prohibitions have been progressively reduced by the annual budgets. After extensive consultations with stakeholders and the general public, the Ministry of Commerce has prepared a new trade policy document, which is awaiting approval by the federal executive council.

Institutional and structural reforms

The Obasanjo administration has initiated several efforts to remove institutional and structural impediments to growth and development. Two of these are particularly important: the privatization programme, critical for supporting fiscal reform and capital market expansion in the country, and the effort to promote good governance and effective public administration.

Privatization—weaknesses to address

In the 1970s and 1980s Nigeria developed a large public enterprise sector encompassing manufacturing, agriculture, public utilities, and other service industries. As in many developing countries, the aim was to accelerate industrialization and support economic self-sufficiency. The huge oil revenues arising from the global oil price hikes of the 1970s and 1980s enabled Nigeria to vigorously pursue the policy of public investment in productive activities, and an estimated 800 billion naira was invested in the sector during those two decades (World Bank 2001b). Today there are around 600 public enterprises at the federal level and 900 at the state and local levels, accounting for 50–60% of the formal labour force. Most of these enterprises have earned negligible, or even negative, returns.

Prompted by several issues—the poor performance of public enterprises, their weak capacity for reform, abuse of monopoly powers, and mismanagement, corruption, and nepotism—the government embarked on a privatization programme under the Privatization and Commercialization Act of 1999. The programme aims to revamp the economy through a private sector-led growth strategy. Its objectives include diffusing enterprise ownership, encouraging private sector control and operation of key enterprises, attracting investment to catalyse economic growth, providing a dynamic link between industry and the capital markets, and thereby closing supply and efficiency gaps in the Nigerian economy.

The programme is divided into three phases for the period 1999–2004:

- *Phase 1*—full divestiture of federal government shares in banks, cement companies, and oil marketing firms listed on the Nigerian Stock Exchange.
- *Phase 2*—full divestiture of federal government shares in hotels, vehicle assembly plants, and other industrial, agricultural, and service sector enterprises operating in competitive markets.
- *Phase 3*—partial divestiture of federal government shares in major enterprises operating in non-competitive but potentially competitive sectors, such as the telecommunications company (NITEL), the National Electric Power Authority (NEPA), Nigerian Airways, and the oil refineries.

“There are around 600 public enterprises at the federal level and 900 at the state and local levels, accounting for 50–60% of the formal labour force”

The programme will transfer around 100 public enterprises in industry, agriculture, services, and infrastructure to private ownership

The government has appointed competitively selected investment advisers to prepare and execute the divestiture transactions under the supervision of the Bureau of Public Enterprises. In each sector an interministerial divestiture committee, comprising top ministry officials and representatives of stakeholders such as labour unions and professional associations, is responsible for overseeing the preparation of related sectoral reforms under the auspices of the National Commission for Privatization. These structures have been set up to enhance the programme's transparency and to build consensus.

The programme will transfer around 100 public enterprises in industry, agriculture, services, and infrastructure to private ownership. The privatization of public enterprises in phases 1 and 2, through the Nigerian Stock Exchange, is expected to generate around 20.2 billion naira in 2002 alone (Okafor 2002).

The reform programme for telecommunications provides for full liberalization of the market and limits the role of the government to policy formulation through the National Communications Commission. The programme's main goals are to expand connectivity to a total of 2 million fixed and mobile phones in 2001–03 and to create a flexible regulatory environment. In January 2001, as part of the market liberalization, the federal government successfully auctioned three digital mobile licences and appointed technical and auditing teams to carry out the necessary due diligence for divesting NITEL by the end of 2001. (NITEL's privatization was still pending in March 2002, however, following the winning bidder's failure to meet payment deadlines in January and the federal authorities' consequent suspension of the sale agreement.)

In the power sector the government will provide the overall direction for sector development while allowing competition in power production and distribution. The National Electricity Regulatory Commission, established under the new power policy, will be responsible for issuing licences to private operators and ensuring access to transmission networks at competitive prices.

The privatization process in Nigeria has benefited from lessons from similar exercises in other countries about ensuring transparency in transactions. Still, several weaknesses need to be addressed. These include the lack of coordination between the sector reform committees and key government agencies and the lack of oversight and control by the National Commission for Privatization over the management boards of key public enterprises in the period before divestiture. In addition, there is a need to design a consistent severance payment framework that is fair and acceptable to the workers affected.

As the World Bank has noted, some Nigerians are opposed to privatization:

While the Obasanjo administration is strongly committed to an accelerated privatization programme, significant stakeholder groups are resisting the reforms. These include PE [public enterprise] managers and employees, senior government officials and civil servants, . . . who perceive that their current power and perquisites will be reduced as the privatization programme is implemented (2001b, p. 22).

The strongest opposition has emerged from labour unions, particularly in the utilities sector. The National Union of Electricity Employees has spoken out against the proposed privatization of NEPA because of the fear of mass layoffs. The union has argued that electricity is a basic need and that privatizing NEPA would negate the government's policy of increasing access to basic utilities and reducing poverty. Today NEPA has a workforce of 33,000 and an installed generation capacity of 6,000 megawatts. Much of this capacity is non-operational, however, which means that a large share of NEPA's workforce is under-utilized. Consequently, its privatization is expected to lead to some retrenchment in the short term.

Privatization also involves a political economy issue—how to ensure an ethnic and regional balance in the acquisition of privatized firms given the uneven distribution of wealth among ethnic groups. The Indigenization Decree of 1971 and 1973 led to a skewed distribution of the ownership of some privatized firms that favoured westerners at a time that the east was recovering from a devastating civil war and the north was fairly poor. Today's liberalization policy is being influenced by the country's "north-south ethnic politics", and a slower pace has been suggested to avoid repeating the errors of the past.

Nigerian economists recently voiced support for the federal privatization programme, noting that public enterprises had become channels for political patronage and that they account for more than 55% of national debt and 5% of federal budget deficits. The economists argued that maintaining the momentum in privatization was critical to modernize technology, strengthen capital markets and attract investors, dismantle monopolies, promote better enterprise management, eliminate parasitic public enterprises, and reduce fiscal deficits.

The privatization programme will further increase stakeholder participation to minimize the social risks to achieving its goals. But in addition it needs to develop carefully designed measures to mitigate the adverse effects of privatization on retrenched workers and other groups. A comprehensive compensation framework is needed, built on the results of a full-scale assessment of the social impact of privatization. If properly communicated to the stakeholders, the resulting compensation framework could go a long way towards minimizing the social tensions surrounding privatization and liberalization.

Governance—bold initiatives

Nigeria faces an enormous task in transforming its economic potential into sustained growth and poverty reduction. The key to meeting this challenge may lie more in military, regional, and religious factors influencing national development than in economic policy instruments. In 1999 President Obasanjo promised democracy dividends, fully aware of the potential of the country but also of the socio-political constraints that have kept the giant economy in continual slumber.

At its inauguration in May 1999 the Obasanjo government also vowed to fight corruption, reduce poverty, eliminate inefficiencies in government, and reform economic management. After years of military rule had gravely weakened public service institutions, the

“The privatization programme will further increase stakeholder participation to minimize the social risks to achieving its goals”

“Public revenue continues to leak away, especially in the oil sector”

expectations were high. To build a sound foundation for economic growth and political stability, the new government was expected to diffuse long-standing ethnic and religious tensions and, by ensuring transparency in government, reduce the mismanagement of public resources (box 6.2). The new government was also expected to renew the government machinery through a highly motivated civil service.

Nigerians fully expected democracy dividends because they saw the democratic, civilian government as the better route to economic development. But efforts on several key fronts in the past two years have yet to make their impact felt. Social conditions continue to deteriorate. The incidence of poverty remains high—at more than 60%—and appears to be increasing. Public revenue continues to leak away, especially in the oil sector. Violent social conflicts have become more frequent. Few states have seen improvements in water and electricity supplies. Federal budgetary allocations to health and education have fallen relative to total fiscal spending, casting doubt on the government’s commitment to reducing poverty. Revenue allocations to the states have also fallen, and unrestricted imports of food continue to undermine the recovery of agriculture. In the midst of these shortfalls in realizing democracy dividends, serious social conflicts have occurred throughout the country, and the government’s options for effectively addressing ethnic violence have been limited to the use of force.

Nevertheless, the Obasanjo government has taken a number of bold initiatives towards good governance and effective administration:

- Establishing the Corrupt Practices Commission to fight corruption.
- Establishing the Budget Monitoring and Price Intelligence Unit under the office of the president to ensure compliance with due process in evaluating, contracting, and monitoring public projects.
- Approving the recommendations of the World Bank’s Country Financial Accountability Assessment in January 2001 as a basis for reforms in financial management.
- Opening up for review oil contracts signed in the last days of the outgoing government.
- Formulating a new civil service code.
- Establishing value-for-money audits to review the effectiveness of capital spending.
- Setting up the Economic Policy Coordinating Committee under the office of the vice president to ensure internal consistency and coordination among government policies.
- Setting up the Debt Management Office with a mandate to consolidate, reconcile, and manage Nigeria’s external and domestic debt.
- Embarking on a pay parade verification exercise—matching pay cheques with attendance registers and duty rosters—in 2001 to address the problem of “ghost workers” and curtail the wage bill.
- Streamlining poverty alleviation institutions by closing nine and merging another six.
- Instituting 100% inspection of imports and modernizing the ports and the customs clearance procedures to increase revenue from import duties.
- Embarking on a review of the new tariff schedule with the aim of substantially reducing protection and eventually harmonizing tariff policy with other West African states, with a common external tariff for the Economic Community of West African States (ECOWAS).
- Producing *Obasanjo’s Economic Direction 1999–2003* (Nigeria, Ministry of Finance 2000c), which involved aggressive revision of the trade policy, industrial policy, competition and antitrust policy, and power and telecommunications policies.

Box 6.2

The dilemma of national economic management

The failure of NEPA and of the energy sector as a whole illustrates the problems faced by the Nigerian government in managing the economy. Shortly after entering office, the Obasanjo government initiated a programme to reform and restructure NEPA, aimed at first improving its service and then preparing it for privatization. Two layers of management were replaced and a professional career structure was established to remove conflicts in the chain of command and improve morale.

But in mid-2001, two years after the exercise had started, NEPA's generation and distribution problems persisted. At a maximum of 2,500 megawatts, NEPA's production still fell well short of the installed capacity of 6,000 megawatts and of the 4,000 megawatts needed to meet national demand. As a result, NEPA was still generating only enough revenue to meet its wage bill.

To push through the privatization of NEPA, electricity tariffs will have to be raised from the present unrealistic rate of \$0.03 a kilowatt-hour. But this increase is certain to raise public concern, especially since no consistent plan exists to offset the effects of the tariff increase on the poor or to compensate the workers likely to be retrenched.

Nor are examples of mismanagement difficult to find in the local fuel supply business. Nigeria is Africa's biggest oil producer and the world's sixth largest oil exporter, yet the state capitals experience constant fuel shortages throughout the year. Private commercial entities have managed to gain control of distribution, and sometimes even production, by tampering with pipelines and hoarding fuel to create artificial shortages. Thus a few powerful, well-connected businesspeople have been able to extract huge profits from the market for petroleum products and chase out legitimate operators.

The government saw deregulating and privatizing the oil sector as a way to open new possibilities for an efficient, profitable refining sector and to end shortages. But opening the way to successful privatization required removing subsidies on fuel. The government has announced the removal of fuel subsidies several times since 1999, each time sparking a confrontation with labour unions and the public and consequently maintaining the subsidies.

Source: Africa Confidential 2002.

As founding director of Transparency International, President Obasanjo had strong antigraft credentials before his election. Yet the Corrupt Practices Commission has yet to prosecute a major corruption case involving any high-profile member of government. There appear to be two main reasons for this failure: the electioneering system and the ethnic factor.

The most conspicuous beneficiaries of the return to civilian rule have been senior politicians and their business allies (*Africa Confidential* 2002). The slow start-up of reforms in 1999 has also been attributed to political patronage, which is most extensive at the state and local levels.

Some, including the Obasanjo government, attribute the spate of violent communal clashes to the work of saboteurs and malevolent forces, since political skirmishes have

The ethnic factor in Nigeria is said to be at the core of political patronage and economic mismanagement

increased as the 2003 elections approach and northern political coalitions come together. Others attribute the unrest to the government's failure to deliver on campaign promises and the population's increasing frustration with the deep-seated public mismanagement.

The ethnic factor in Nigeria is said to be at the core of political patronage and economic mismanagement. Indeed, Easterly and Levine (1997) have hypothesized that 35–45% of Africa's growth shortfall in the 1970s and 1980s can be explained by the high degree of ethno-linguistic fragmentation, and this phenomenon is particularly relevant to Nigeria's economic performance in recent years. Ethnic and religious identification remains strong in Nigeria, and poses a serious social risk to the Obasanjo reform programme. Moreover, the long military rule, dominated by the Hausa-Fulani ethnic group of the north, has "converted multi-ethnicity into constraints on growth" (Nwuke 2001). Recurrent social conflicts, particularly between religious groups, have diverted resources from productive uses to the containment of conflict and post-conflict reconstruction and have also led to inefficient choices in public and private investment management. Ethnicity continues to strongly influence budgetary allocations and plays a significant part in the mismanagement of public revenue.

Nigeria is divided along many lines—between north and south, between Muslims and Christians, between more than 250 ethno-linguistic groups, between civilian and military politicians, and between rich and poor. Successive governments have managed these divisions largely through political concessions and compromises, such as by offering greater local autonomy within the federal framework. But this autonomy has led to a perpetual struggle among groups for federal resources, regardless of the impact on the national economy or that of neighbouring states or communities, and weakened the federal government's ability to curtail spending and tackle fiscal reforms.

Particularly difficult has been finding a federal revenue sharing formula that is fair and that minimizes the economic disparities among states. This issue has been the main factor precipitating the "dissident conflict" in the oil states, a conflict that cost the economy an estimated \$1 billion in revenue in 1999. Moreover, the effort to minimize the tensions stemming from revenue sharing has eroded the potency of fiscal spending instruments in engineering the growth and development of the national economy. And the continued focus on the regional allocation problem has impeded the development of a sound federal fiscal structure.

Meanwhile, state governments are trying to run their local economies autonomously. Many have borrowed funds on the capital markets, and the federal government appears to be losing its control over public debt management and fiscal policy in general. The states have resorted to borrowing largely because of a decline in their federal revenue allocation, which dropped by 11% in 2001 because of the fall in oil revenue.

Regional considerations continue to shape the motivations underlying not only fiscal policy but also other policy interventions, such as economic liberalization and privatization. The reason is that policy changes have different impacts on different factor and product markets, and the populations in the country's regions are distributed in different ways

among these markets. Thus, for example, the north sees trade liberalization and privatization as reinforcing the dominance of the south, where most of the big businesses are located, while the north's agrarian economy continues to decline and its poverty rate to rise.

The success of Nigeria's economic re-engineering therefore depends on the government's ability not only to push through macroeconomic reforms but also to address deep-rooted socio-political issues. These issues have emerged as formidable barriers to the realization of President Obasanjo's vision of Nigeria as one of Africa's leading economies, with sustained growth of not less than 6–10% a year. As part of the effort to deal with the political economy issues, perhaps Nigeria should consider the following:

- Undertaking campaign finance reforms aimed at minimizing post-election political patronage and misuse of public resources.
- Building a national consensus on a federal revenue sharing formula and on a scheme for enhancing state and local capacity to generate revenue.
- Strengthening the Corrupt Practices Commission and facilitating its work to help it gain trust and minimize scepticism about government programmes among the general public.

The success of Nigeria's economic re-engineering depends on the government's ability to address deep-rooted socio-political issues

Human development

Nigeria is among the world's 27 poorest countries, according to the United Nations Development Programme (UNDP 2001). Poverty has been on the rise in the past decade, and today more than 60% of Nigerians live on less than \$1 a day. But despite the enormous problems in the social sectors, they have not received the same priority in policy reforms as other sectors have. For example, education and health spending has declined sharply as a share of the federal budget since the mid-1990s. And the 2001 capital budget appears to leave underfunded key items that would benefit the poorest groups—such as universal basic education, the national immunization programme, and road maintenance and rehabilitation—while proposing considerable resources for such items as an Olympic-size stadium complex. But the federal government perceives all its spending as benefiting the poor—whether it is getting the National Electric Power Authority to work or improving the security of lives and property.

Education and employment—poor human resources, a handicap

Nigeria's poor human resource base is considered to be its biggest handicap in attracting foreign capital, improving productivity and reducing poverty. The country has 35,000 primary schools with an enrolment of 12.9 million pupils, and 6,400 secondary institutions with an enrolment of 5.1 million. At the tertiary level it has 62 colleges of education (with 86,000 students), 47 polytechnic institutes (120,000), and 42 universities and inter-university centres (325,000). But its combined primary, secondary, and tertiary gross enrolment ratio of 45% is only slightly higher than the average for Sub-Saharan Africa of 42% in 1999. The adult literacy rate remains low at 63%, compared with an average of 73% for developing countries; the average for Sub-Saharan Africa is around 60%.

“ *The growing unemployment among recent graduates stems in part from the mismatch between educational output and requirements of the labour market* ”

The country confronts two main problems in human resource development: unemployment among the educated youth and the dwindling federal budgetary allocations to educational institutions. The growing unemployment among recent graduates, particularly at the tertiary level, stems in part from the mismatch between educational output and requirements of the labour market. The quality and relevance of education have declined as academic resources, whether faculty or equipment and facilities, have become in increasingly short supply. In 1997/98, for example, the ratio of students to academic staff exceeded the national norm in the key faculties of administration, agriculture, engineering, law, medicine, health, and pharmacy at all federal universities (Hartnett 2000).

As the national population has grown, enrolments have outpaced budget allocations. Faculty recruitment doubled between 1991 and 1998, but enrolment more than quadrupled. The average enrolment per university in the federal sector rose from 8,300 in 1991/92 to 13,200 in 1998/99 (Dabalen and Oni 2000). But much of the growth has occurred in areas with little labour market demand, while enrolment in such critical areas as medicine and administration has grown relatively slowly. For example, between 1987 and 1997 the share of science students among university graduates dropped from 29.4% to 24.5%. Under the National Rolling Plan for 2001–03 the federal government intends to increase science enrolments to more than 54% of the total by 2003.⁴

Nigeria's education system turns out more than 3 million secondary and tertiary graduates every year, but it is estimated that the economy can absorb only around 10% of these graduates annually (Nigeria, Ministry of Finance 2000a). As a result, the economy is saddled with more than 15 million unemployed or underemployed youth, a situation that is undermining living standards throughout the country. Under the National Rolling Plan for 2001–03 the government envisages growth in employment of 1.8 million jobs—600,000 a year—but that number is still a mere 20% of what is needed just to hold unemployment and underemployment constant among the educated youth.

An increase in the number of university graduates from 15,000 in 1980/81 to 55,000 in 1998/99, in the face of slow economic growth and productivity improvement, has increased the unemployment rate among university graduates to an estimated 17–25% (Dabalen and Oni 2000). In October 2000 hundreds of unemployed graduates mounted a demonstration in front of the presidential offices in Abuja to demand that the government provide them with jobs. Urban registered unemployment increased from 4.9% in 1998 to 5.5% in 1999 as a result of the dwindling public and private sector expansion programmes and the economy's low absorptive capacity (Nigeria, Ministry of Finance 2000a). Attempts by the government to create more employment through public works programmes have had limited impact.

The declining funding for education poses a major obstacle to solving the problems of poor quality in education and thus of the unemployment among the educated youth. Public spending on education in Nigeria has lagged behind that in other Sub-Saharan countries for many years. As a share of the federal budget, education spending fell sharply from its peak of nearly 15% in 1994 to around 7% in 2001 (figure 6.2). As noted, however, states also contribute to social sector funding, and the consolidated spending would be larger than the federal spending.

Health—expenditures declining

Funding has also been declining in the health sector. As a share of the federal budget, health spending fell from 15% in 1994 to 6% in 2001 (here again, however, consolidated spending would be higher). Per capita spending on health stood at \$23 a year in 1999, with around two-thirds of that being private. The country has only 19 physicians for every 100,000 people (UNDP 2001). Only 10% of the population has access to modern medical facilities. And according to the UNDP (2001), only 63% of Nigerians have access to sanitation facilities, 57% to improved water supply, and only 10% to essential drugs.

Malaria is rampant in Nigeria, especially in the urban south, which partly explains the country's higher infant mortality rate (112 per 1,000 live births) compared with that in other Sub-Saharan countries. Infant mortality declined by a mere 7% between 1970–75 and 1995–2000 (UNDP 2001). The malnutrition rate among children under five is 39%, largely because of the high level of food poverty in the country, especially in urban areas. And Nigeria has one of the highest maternal mortality ratios in the world—and the highest in West Africa (table 6.6).

The nation's HIV/AIDS infection rate among adults remains low at around 5%, compared with 8.7% for Sub-Saharan Africa. But almost 3 million Nigerian women are infected, representing nearly 12% of all infected women on the continent. And most of them have no access to medical relief.

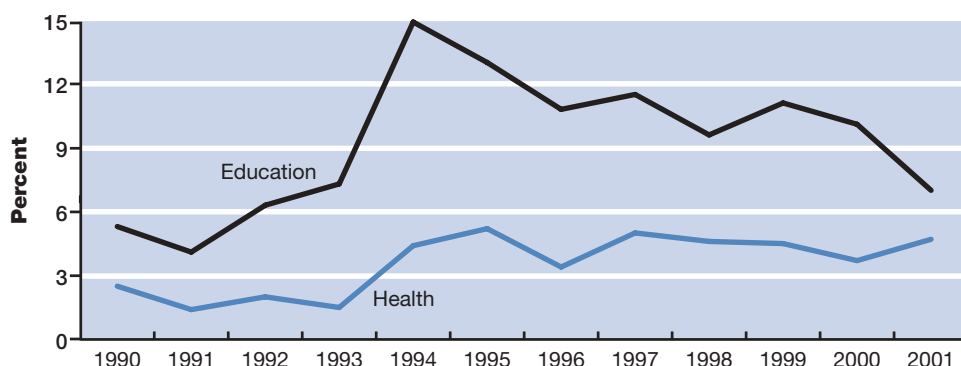
Underfunding of the health sector explains much of the poor health status of Nigerians, especially among women and children. The emerging challenges of HIV/AIDS and Lassa fever and the renewed outbreaks of tuberculosis, cholera, guinea worm, and meningitis have increased the pressure on health facilities, which need massive public investments for rehabilitation. The government is vigorously studying the viability of a national health insurance scheme, for which an enabling act has been promulgated since 1999. To adequately serve children, the poor, the elderly, and other disadvantaged groups, especially in rural areas, the national health insurance scheme would need to be funded in part through the public budget.

Poverty—widespread and growing

Despite Nigeria's massive human and natural resources—far more than enough to provide all the health, education, and infrastructure services the population needs—poverty is widespread and growing in the country. According to official statistics, the number of people living below the national poverty line rose from 18 million in 1980 to 67 million in 1996—from 28% of the population to 66% (Nigeria, Federal Office of Statistics 1999). During the same period the share of the population in core poverty (with per capita consumption spending less than a third of the national average) increased from 6% to 29%, with most in rural areas.

The poverty rate is higher in the northern states (70%) than in the southern states (60%). And as in other developing countries, in Nigeria poverty is a rural phenomenon. The average household income in rural areas is significantly lower than the national average (table

“Malaria is rampant in Nigeria, especially in the urban south”

Figure 6.2*Education and health spending as a share of the federal budget, Nigeria, 1990–2001**Source: Based on data from Nigeria, Ministry of Finance (2000a).***Table 6.6***Maternal mortality ratio in selected Sub-Saharan African countries, 1980–99 (per 100,000 live births)*

Country	Ratio
Nigeria	700
Côte d'Ivoire	600
Niger	590
Benin	500
Togo	480
Ghana	210

*Note: Data refer to the most recent year available during the period specified.**Source: UNDP 2001.*

“ *The emerging challenges of HIV/AIDS and Lassa fever have increased the pressure on health facilities* ”

6.7). The north-western states (Sokoto, Katsina, Kaduna, Kano, Kebi, Zamfra) and the south-eastern states (Bayelsa, Rivers, Akwa Ibom, Cross River, Delta) are the poorest zones in the country, with the highest share of income spent on food (more than 70%). More than 60% of Nigerians spend 70–80% of their income on food. Thus increases in food prices, averaging an estimated 35% in 2001, have severe effects on food poverty in the country.

Among Nigerians with no education, the poverty rate rose from 30% in 1980 to 73% in 1996, higher than the national average. Thus education is generally seen as providing an escape route from poverty, through access to formal sector jobs and public positions. Yet access to education is still poor, as reflected in the high illiteracy rate and low enrolment ratio.

The main source of the worsening poverty has been the slow economic growth (averaging around 3% a year in the 1990s) combined with the rapid population growth (2.9% a year in 1975–99). The high level of income inequality has compounded the problem of

Table 6.7

**Average household income, Nigeria, 1992 and 1997
(current naira)**

Category	1992	1997
Rural households	1,140	3,280
Urban households	1,345	4,260
National	1,243	3,770

Source: Central Bank of Nigeria 1997.

poverty, however, and heightened social conflict. The Gini coefficient for Nigeria is as high as 0.506, while the average for Sub-Saharan Africa is 0.440 (the Gini coefficient ranges from 0 to 1, with 0 representing perfect equality, and 1 perfect inequality). The poorest 10% of the population accounted for a mere 1.6% of national consumption in 1999, while the richest 10% accounted for 41% (World Bank 2001c).

In the short term efforts to reduce poverty must involve a broad-based strategy to minimize leakage from public revenues, improve transparency and accountability in government, and ensure effective monitoring of public spending and effective project implementation. In addition, market (and pricing) structures need to be reviewed within the framework of the country's competition policy. But the main challenge is to transform agriculture so that it is capable of feeding the Nigerian population all year round.

Medium-term outlook— 2% growth projected for 2002

Nigeria's medium-term prospects must be evaluated in the context of the country's enormous needs and its limited capacity to meet them. The needs are evident: Nigeria is one of the world's poorest countries, with more than 60% of its population in deep poverty. To make a significant dent in poverty and achieve the international development goals for 2015, Nigeria would need to achieve annual GDP growth of 7–10% as well as other social and structural transformations.

The Obasanjo administration was once optimistic about its ability to reach the growth and development goals, perhaps because of the country's rich growth reserves. In *Obasanjo's Economic Direction, 1999–2003*, the government targeted growth of at least 6–10% a year by the end of its administration. In the shorter version, Nigerian Economic Policy, 1999–2003, the government clearly spells out other ambitious targets for 2003 (table 6.8). But its 2002 budget, which targets GDP growth of 5%, may be one indication that the reality is sorely different. The performance of the economy so far suggests that outcomes will fall dramatically short of the targets. Indeed, during the next two years the economy is unlikely to achieve even half of each target. Based on present economic trends, all independent assessments conclude that achieving a growth rate of 5% by the end of 2003 would be difficult. Current projections are for GDP growth of a mere 2% in 2002.

“Efforts to reduce poverty must involve a broad-based strategy”

Table 6.8**Major economic and social targets for 2003, Nigeria**

Indicator	Target	Current ^a
GDP growth (percent)	10.0	4.0 ^b
Inflation rate (percent)	Single digit	15.6 ^b
Share of labour force gainfully employed (percent)	70	50
Share of population with access to safe water (percent)	60	40
Share of households with access to electricity (percent)	60	34
Functional telephone lines (per 1,000 people)	30	4 ^b
Share of school-age children in school (percent)	90	50
Adult literacy rate (percent)	80	63
Average daily intake of calories	2,500	2,120
Level of satisfaction of other basic human needs	Medium/high	Low
Child malnutrition rate (percent)	20	39
Infant mortality rate (per 1,000 live births)	50	112
Maternal mortality ratio (per 100,000 births)	400	700 ^c
Women's participation in informal sector and food processing and subsistence agriculture	Recognition and inclusion in the national accounting system of the economy	—

— Not available.

a. Data refer to 1999 unless otherwise specified.

b. Data refer to 2001.

c. Data refer to the most recent year available in the period 1980–99.

Source: Nigeria, Ministry of Finance 2000b, pp. 10–11.

Growth prospects are also closely tied to political stability and improved governance

The low growth projection for 2002 is due mainly to a 6.5% reduction in Nigeria's OPEC quota effective on 1 January 2002. Moreover, because Nigeria's production exceeded its OPEC quota by some 4% during the last few months of 2001, the total downward adjustment required in 2002 will be around 10%. If projects for offshore oil and new gas production get off the ground in 2002, however, this may partly offset the adverse effect on GDP of a possible further cut in oil production quotas and the poor prospects for a recovery in oil prices.

Dominating the medium-term growth projections beyond 2002 are the uncertainties about the future price of oil, the likely response of the government to oil price shocks, and the response of the private sector to the economic environment. Growth prospects are also closely tied to political stability, improved governance, steadfast implementation of structural reforms, prudent fiscal policy and successful stabilization, the rebuilding of public institutions and infrastructure to create an attractive environment for private investment, and a renewed economic partnership with the rest of the world. Without serious structural reform, the non-oil sector may grow more slowly than the population until 2003 and achieve only modest per capita growth through 2005, according to the World Bank (2001a). A positive outcome also depends on successful debt rescheduling with the Paris Club of creditors, which in turn depends on an extension of the Stand-By Arrangement with the IMF.⁵

President Obasanjo, in his 2002 budget speech, was not optimistic about the medium-term outlook. He admitted that the global recession is likely to have severe consequences for Nigeria's monolithic economy and concluded that the economy's performance might further weaken in 2001. Even so, the budget sticks to the growth target of 5% in 2002, as set in the 2001–03 rolling plan. The impetus for maintaining this target is unclear, especially given the allusion to the worsening international environment and projected decline in oil prices. Nevertheless, the government expected that external reserves would stand at \$10.5 billion at the end of 2001, though it estimated that only \$100 million would accrue to reserves in 2002 as a result of the projected decline in the price of oil.

The fiscal situation may pose a major challenge in the medium term

The fiscal situation may pose a major challenge in the medium term, particularly if oil prices continue to fall. Efficient management of the volatile revenue base therefore remains crucial. In 2001 the government piled up huge external reserves—but these can pay for only a few months of imports. In 2002 fiscal prudence will require major cuts in spending at all levels of government, to match the projected fall in oil prices. Drastic cuts in spending would be politically difficult, however, especially in the run-up to general elections in early 2003. The government might be tempted to run down external reserves. But sooner or later a fundamental fiscal adjustment must be undertaken. And that raises the issue of macroeconomic stabilization, especially difficult in the context of Nigeria's fiscal federalism. A key challenge is to create a workable intergovernmental fiscal structure for smoothing or stabilizing revenue and expenditures at all levels of government—to ensure sound macroeconomic management. That will require creative manoeuvring around the constitutional provisions on the revenue sharing formula.

However Nigeria addresses its fiscal policy challenges, the external payments situation will remain difficult in the medium term. The current account deficit is expected to grow from 3.3% of GDP in 2002 to around 7.0% in 2003. The capital account is expected to register a small but increasing surplus over the next few years. Nevertheless, the IMF (2001a) predicts a financing gap averaging \$1.5–2.0 billion a year until 2005, even after taking into account the Paris Club debt rescheduling agreement of 13 December 2000.

Thus the medium-term outlook is one of fragile promise and enduring challenges. Despite Nigeria's abundant resources, current trends suggest that it will be some time before the country can achieve the growth and economic transformation needed to significantly reduce poverty. Now growing at almost 3% a year, the population will double in around 24 years—making Nigeria one of the five largest countries in the world. The economy and social infrastructure continue to stagnate or decline even as urbanization accelerates. The country is increasingly unable to feed itself, staple food prices continue to escalate, joblessness is on the rise, and pervasive poverty and ethnic tensions strain the social fabric. Without urgent and fundamental socio-economic transformation, Nigeria might be a time bomb waiting to explode. The new civilian administration has made some important progress, but it could all unravel.

Perhaps the most fundamental threat to the medium-term outlook and the sustainability of reforms is the country's structural vulnerability—both in its political environment and in its economy. The key political challenges are to forge a stable nation out of the coun-

Box 6.3

Investors' perceptions of the cost of doing business in Nigeria

“*The medium-term outlook is one of fragile promise and enduring challenges*”

In 2000 the Center for International Development at Harvard University, in collaboration with the World Economic Forum, conducted a survey in 24 African countries on the competitiveness of their business environment. How did Nigeria do?

- *Infrastructure*: The business community rated Nigeria's roads, ports, railways, and airports the least satisfactory.
- *Customs*: Firms reported an average customs clearance time of 25 days, ranking Nigeria 22nd out of the 24 countries.
- *Telecommunications*: Nigeria ranked 20th in the quality of telecommunications—22nd in Internet access and 23rd in telephone prices.
- *Hidden import barriers*: Nigeria ranked 23rd in this area, with businesses citing the over-valued exchange rate, lack of export credit, and multiple licensing and regulation requirements.
- *Security*: Nigeria also ranked 23rd on security, with negative perceptions of security and organized crime strongly evident among businesses.
- *Education*: The business community ranked Nigeria among the bottom quarter of countries on the quality of its university education.
- *Policy*: Nigeria was seen as having the third most volatility in policy.

Source: Center for International Development and World Economic Forum 2000.

try's disparate nationalities (ethnic groups)—dealing with the so-called nationality question—and to manage a civilian-administered election and change of government. There have been heightened ethnic and religious crises since the transition to democracy, and unceasing calls for a “sovereign” national conference—a conference of all nationalities to agree on whether and how Nigeria should operate as one country. Moreover, every attempt in Nigeria at a civilian-administered election and change of government has been characterized by violence and rigging, and the military has always found excuses to seize power. Thus 2003 is the year Nigeria has a date with history—to repeat it or to overcome it. A heightened political crisis would have severe consequences for the economy. Investors already have a negative perception of the cost of doing business in Nigeria (box 6.3). A political crisis would make an already bad situation worse.

The most crucial economic challenge is the deep, pervasive poverty combined with the dependence on a highly volatile external sector. Oil prices and donor behaviour are largely beyond the control of the government. But how it responds to shocks can make a fundamental difference. Moreover, the government does have control of such issues as governance, transparency, and accountability for public sector resource management—all of which are critical in addressing the country's socio-economic problems.

Beyond undertaking budgetary, institutional, and structural reforms, the government can improve the medium- and long-term outlook by successfully addressing poverty and

Box 6.4

The concerns of Nigerians

As part of the process of devising a Comprehensive Development Framework with the World Bank, the Nigerian government held consultations with the public throughout the country in March–April 2000 to invite input into a poverty reduction strategy. Held at eight different venues, the consultations involved a wide range of Nigerian leaders and attracted participants who were energetic, enthusiastic, and committed to fighting corruption and ethnic and religious intolerance for a better Nigeria. The discussions, focusing more on what was wrong than on how things could be fixed, revealed a broad spectrum of opinions.

Nigerians still look to the federal government for the solutions to all problems. But they also realize that the government does not work well. They distrust politicians (and the military) and think that most if not all politicians are driven purely by self-interest. They believe that the system provides no accountability for local government authorities. They see corruption as a complex issue—one that stems from poverty and greed—and many see it as a major moral issue. People in the Delta refer to the “legitimate” constitution of Nigeria, which allowed each region to retain 50% of its revenue. They complain that before the discovery of oil, when the sources of revenue were cocoa, oil palm, and groundnuts, there was no push to divide the pot equally.

In almost every discussion Nigerians complained about policy implementation and lack of continuity in policy formulation. They are cynical about the new programmes the government announces because they have seen so many failures. They believe in expanded private participation in key sectors but are wary of full privatization because they think assets will be sold for far less than their true value. They see education as critical, not only for development but also for the preservation of the nation.

Nigerians speak a lot about lack of patriotism and the tendency of their compatriots to identify themselves with ethnic or religious groups rather than with the nation. There is a deep sense of loss of values over the past 30 years. People feel that greed, lack of trust, a high regard for wealth, and an erosion of traditional cultures and values characterize Nigerian society. Consequently, there is a strong belief in the value of “enlightenment campaigns”.

Source: World Bank 2001a.

human capital development, tackling infrastructure, and establishing a conducive environment for private enterprise. Also crucial will be opening the economy and linking it to the world economy by pursuing economy-wide competitiveness, and improving the country’s relations with the donor community. None of these challenges will be easy, especially given the economy’s dependence on the volatile oil sector.

So the task of reforming the economy is daunting—but the prospects are not hopeless. According to a survey of local businesspeople in Sub-Saharan Africa, those in Nigeria were most optimistic about their country’s economic prospects—in the wake of the restoration of democratic rule in May 1999 (Center for International Development and World Economic Forum 2000). Moreover, a national survey of Nigerians conducted as part of the Comprehensive Development Framework process with the World Bank found Nigerians upbeat and enthusiastic about rebuilding the country (box 6.4). Whether these sentiments will be translated into concrete improvements in the economy remains

to be seen, however. Events in the next two years will be critical in propelling Nigeria onto a path of sustained progress—or onto one of continued decline.

Notes

1. The IMF (1998) estimates that the oil sector contributes around 35% of GDP.

2. The sectoral shares of GDP depend on the source of data. Even within the Central Bank of Nigeria's *Annual Report and Statement of Accounts, 2000*, sectoral shares vary widely depending on whether GDP is valued at 1984 factor cost or at current factor cost (compare appendix tables 5a and 5b in that report). For example, at current factor cost the share of industry (mining and manufacturing) is 31.7%, while at 1984 factor cost it is 16.7%. These differences cannot be explained solely by the differences in the deflators. The differences with IMF data are even more dramatic: the IMF (2001b) shows industry contributing the largest share, at 44.0%, compared with the 16.7% estimated by the Central Bank of Nigeria at 1984 factor prices. The data inconsistency is disturbing. The different data sources on the Nigerian economy show such marked variations that sometimes the qualitative direction of the data can change, so that the opposite inference is equally true.

3. In the annual federal budget the federal government assumes a benchmark oil price for revenue estimates. If the actual oil price exceeds the estimated price, the "excess" can be regarded as a windfall and saved against a future drop in prices. In 2000 the oil windfall amounted to \$4 billion, or 10% of GDP. Around 50% of this accrued to states and local governments. A serious political debate is under way to develop a solution to the problem of managing such windfalls.

4. The National Rolling Plan for 2001–03 is the 12th in a series of medium-term, three-year plans since 1990 and the second under President Obasanjo. Used as a national development strategy, the plan covers mainly programmes and projects of the federal and state governments. The 2001–03 plan focuses primarily on poverty alleviation, managed deregulation, fiscal discipline, and privatization.

5. The IMF failed to extend the Stand-By Arrangement in 2001, on the grounds that its major benchmarks were not met. The Stand-By Arrangement was to be reviewed in the first quarter of 2002. On 6 March 2002, however, the IMF announced that it was discontinuing its informal monitoring of macroeconomic developments in Nigeria, following the Nigerian government's insistence on developing its own "home grown" programme.

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“The task of reforming the economy is daunting—but the prospects are not hopeless”

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Morocco—Repositioning for Globalization

Morocco is the fifth largest economy in Africa. It is also one of the most weather dependent on the continent. Changes in the weather have been the main determinant of macroeconomic and social trends in the country. Along with the weather, slow adoption of policies for sustained growth and macroeconomic stability constrained economic performance in the mid-1990s. Recognizing the potential benefits of active integration with the world economy, the Moroccan government has shown increased commitment to opening the economy. This renewed commitment is reflected in policies to attract foreign direct investment from beyond the Middle East and North Africa—implementing a transparent privatization programme, removing tariff barriers, reforming financial sector regulations, and strengthening stock exchange operations. To ensure a more equitable distribution of the gains from trade, the government has intensified efforts to improve domestic competition, expand rural infrastructure, and reform agriculture.

GDP growth rose from a low 0.9% in 2000 to an estimated 6.5% in 2001. This marked improvement was due largely to the recovery from drought, which allowed the agricultural sector to provide a much-needed boost to the economy. Agricultural output increased by an estimated 25% in 2001, contributing to more than half the growth. Non-agricultural output grew by 3.8%. Despite improvement in the supply situation, particularly in the food supply, inflation was expected to drop only marginally, from the 2.0% recorded in 2000 to 1.9% by the end of 2001. The decline was limited because of the devaluation of the currency (the dirham) in 2001 and the lagged effects of the oil price hikes of 2000.

Trade and investment reforms remain a national priority under King Mohammed VI. These reforms, along with the free trade agreement with the European Union, are expected to enable Morocco to reap greater benefits from globalization. For example, net foreign direct investment—which, at less than 0.1% of GDP in 1999, has been low compared with that in other African countries—was boosted by the privatization of the state-owned telecommunications company, Maroc Telecom, in December 2000. That transaction brought in more than \$2.1 billion (6.3% of GDP) in 2001.

The dirham was devalued in April 2001 largely in response to its appreciation against the euro and the strident calls for devaluation from exporters—and despite the improved external position in 2001, strengthened by the successful sale of Maroc Telecom. Exports rose by an estimated 8.1% in 2001, thanks largely to an increase in exports of phosphate and phosphate by-products. The trade deficit was expected to improve from 9.5% of GDP

Trade and investment reforms remain a national priority

Fiscal and monetary policies shifted slightly to an active stance of promoting macroeconomic stability and growth

in 2000 to 8.7% in 2001, and the current account balance from -1.7% of GDP to a small surplus of 0.7%.

Fiscal and monetary policies, which have been pro-cyclical, shifted slightly to an active stance of promoting macroeconomic stability and growth. Interest rates were brought down in 2001 to encourage private investment. This rate reduction was made possible by cuts in interest rates in the international money market, as attempts were made to reverse the global slowdown. Thus Treasury bill rates dropped from 6.3% in 2000 to 5.8% in 2001. Private investment increased only marginally, however, from 21.7% of GDP in 2000 to 21.8% in 2001.

The budget deficit increased to a projected 7.2% of GDP in 2001, up from 6.5% in 2000 (excluding privatization revenues), as a result of large retroactive wage payments, capital transfers to public enterprises, and investment spending under the Hassan II Fund. This extrabudgetary fund, set up in 1999/2000, is designed to protect up to 50% of privatization proceeds to promote infrastructure and social investment in partnership with the private sector.

The fiscal situation is emerging as a serious concern. The deficit has remained within an acceptable range only when privatization receipts have been taken into account. In the meantime, the expenditure side of the budget remains inflexible. In response to the vulnerability of the fiscal position, Standard and Poor's recently downgraded Morocco's country risk outlook from stable to negative. The rating agency maintained Morocco's foreign currency debt rating, however, at double-B/B.

Elections due in September 2002 pose a risk of weak fiscal control but also offer hope for revitalization of the economy. In the medium term fiscal consolidation and acceleration of structural reforms could produce higher and more stable economic growth.

Actions to improve governance and industrial competitiveness represent the main source of hope for further expansion of the Moroccan economy in the coming years. Towards this end, programmes to develop rural infrastructure and increase access to health, education, and other social services are critical and need to be pursued with renewed vigour. To address rural poverty, the government will need to continue its policy focus on reforming the land tenure system, expanding agricultural extension services, and improving rural infrastructure, such as irrigation and health services.

Unless promptly addressed, the growing poverty (particularly in rural areas) and the inequity in access to basic social services may pose a significant threat to the ongoing political transition. The Moroccan authorities have already acknowledged the importance of making significant strides in reducing poverty, particularly by establishing an enabling environment for private sector development. Nonetheless, continued progress in poverty reduction will depend, as in the past, on the government's success in stabilizing the economy, undertaking comprehensive reforms, and maintaining strong economic growth.

Recent economic trends—solid improvements

Trends in macroeconomic aggregates show solid improvement in the Moroccan economy in 2001. Much of the improvement was due to the 25% increase in agricultural output resulting from favourable weather conditions and the decline in oil prices. The estimated GDP growth of 6.5% in 2001 was a significant achievement given the high rural poverty and urban unemployment (table 7.1).

The improvement in terms of trade and export competitiveness following the April 2001 devaluation, along with the proceeds from the privatization of Maroc Telecom, helped shrink the current account deficit and external debt in 2001 (figure 7.1). External debt dropped from 48.3% of GDP to 43.1%, while debt service dropped from 20.8% of exports in 2000 to 19.3% in 2001.

“The improvement in terms of trade and export competitiveness helped shrink the current account deficit and external debt”

Sectoral performance—not much change

The distribution of GDP among sectors remained around the same between 1998 and 2000, although agriculture's share fluctuated between 11% and 16% depending on the weather (table 7.2). The industrial sector's contribution has stagnated at around 30%, and the service sector's at 37–40%. The general government sector provided 17–18%. These figures suggest that the relative performance of different sectors has remained much the same over the years, resulting in no change in the structure of the economy.

Agriculture—output up 25% in 2001

Agriculture plays an important role in the Moroccan economy, contributing 11–16% of GDP and 18% of exports. In 1999 it employed more than 3 million people, accounting for 48% of employment, 80% of rural employment, and 62% of female employment.

Agricultural output grew an estimated 25% in 2001, indicating a recovery from the two-year drought of 1999–2000. The potential of this sector to contribute to growth and employment is constrained by many factors—most notably by frequent droughts, the complexity of real estate structures, the poor quality of human resources in agriculture, the low rate of investment in the sector, the high transport costs, and the limited use of improved technologies.

The production and yield of cereals, the main crop, declined significantly between the 1996/97 season, when there was no drought, and the 1999/2000 season (table 7.3). Dependence on the weather has resulted in large variations in the annual value of agricultural production, which has fluctuated between 10 billion dirhams (1982) and 24 billion dirhams (1992). Between 1996 and 2000 the range was 13 billion to 23 billion dirhams.

This volatility worsens poverty and unemployment in rural communities, where households have few alternative sources of employment and the lack of modern financial institutions severely constrains asset ownership. And it has serious implications for Morocco's economic fortunes, which are tied to the performance of agriculture.

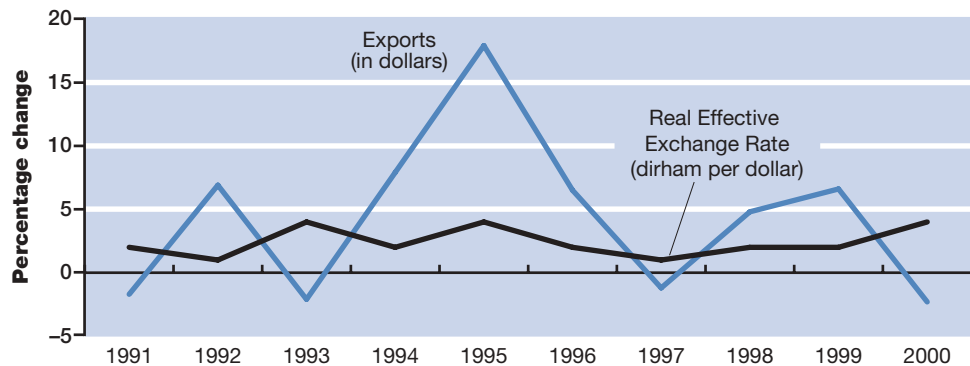
Table 7.1*Selected macroeconomic indicators, Morocco, 1999–2001*

Indicator	1999	2000	2001
GDP growth (percent)	0.0	0.9	6.5 ^a
Unemployment rate (percent)	13.9	13.6	—
Inflation rate (percent)	0.7	2.0	1.9 ^a
Nominal exchange rate (dirhams per dollar)	9.80	10.59	11.28
Current account balance as percentage of GDP	–0.5	–1.7	0.7 ^a
External debt as percentage of GDP	50.1	48.3	43.1 ^a
Terms of trade (percentage change)	–3.4	–10.2	2.5
Gross fixed capital formation as percentage of GDP	24.2	24.7	24.8 ^a

— Not available.

a. Estimated.

Source: Economic Commission for Africa; IMF 2001.

Figure 7.1*Change in real effective exchange rate and exports, Morocco, 1991–2000*

Source: Morocco, Ministry of Economy and Finance.

Table 7.2*Distribution of GDP by sector, Morocco, 1998–2000 (percent)*

Sector	1998	1999	2000
Agriculture, forestry, and fishing	16	13	11
Industry	30	30	31
Services	37	39	40
Market GDP	83	83	82
General government	17	17	18
Total	100	100	100

Source: Morocco, Ministry of Economic Planning 2000.

Table 7.3

Agricultural production, Morocco, 1996/97–1999/2000
(thousands of tonnes)

Type of crop	1996/97	1997/98	1998/99	1999/2000
Principal cereals	4,015	6,549	3,764	1,943
Garden crops	4,538	4,615	4,608	4,266

Source: Economic Commission for Africa from official sources.

Rural areas are home to 45% of Morocco's population and 70% of its poor. Thus developing agriculture is crucial for developing the overall economy. Several efforts have been made to promote agricultural expansion, including subsidizing selected wheat seeds, developing irrigation, improving real estate structures, and undertaking projects for pastoral improvement. The irrigation projects have extended the irrigated area by around 19,000 hectares a year, bringing the total to more than 1.1 million hectares in the past five years. In addition, a drought insurance scheme has been established since 1999.

While promoting the expansion of the sector is important, reducing the economy's overreliance on agriculture is equally important. Measures to promote the sector should be designed carefully. Past policies have encouraged the planting of crops such as cereals in climatically vulnerable areas, which led to more frequent and devastating crop failures. The rapid environmental degradation, deforestation, and overgrazing occurring in rural areas may exacerbate future fluctuations in agricultural output, with serious consequences for the performance of the economy.

Industry—net enterprise creation, falling

Industry's share of GDP has remained constant at around 30%, with manufacturing accounting for 54% of that. In the past five years, however, net enterprise creation has fallen, especially in the textile sector (Cherkaoui 2001). The deceleration in net enterprise creation is generally attributed to the liberalization of trade and the elimination of internal market protection and production subsidies in several sectors. Several factors have hindered industrial development in Morocco—poor managerial capability, inefficiencies in capital and money markets, lack of openness to foreign markets, lack of effective internal competition, poor entrepreneurial attitudes, poor industrial relations, and inefficient public services.

In the wake of increased globalization and trade liberalization, the Moroccan government has taken several measures to improve the capacity and readiness of local industries. The government developed an industrial strategy aimed at creating an economic environment favourable to private investment. To support this strategy, it promulgated an investment charter in 1995 that provides for promoting free trade zones, providing fiscal incentives favouring regional development, and reducing taxes on profits and capital investment. The government introduced one-stop investment shops—*guichets uniques*—to encourage private investment by simplifying bureaucratic procedures. It also created administrative and trade courts and enacted a competition law in June 2000 (effective July 2001) aimed at improving the investment environment and promoting industrial efficiency.

“The government has taken several measures to improve the capacity and readiness of local industries”

“The service sector has made significant gains since the government adopted its policy of economic openness”

Finally, the government put in place a programme to strengthen the competitiveness of local firms, which were exposed to greater external competition by the trade liberalization. The programme supports export promotion activities, measures to improve vocational training, and the creation of centres for disseminating business information. It also includes sector-specific initiatives to strengthen professional associations and efforts to build information and communications technology infrastructure.

The new competition law provides for the establishment of a competition commission, charged with enhancing price competition and transparency in trade relations. The law requires firms to notify the government about any merger that would give the new company a 40% or greater share of sales in a given market. Reports from the Competition Commission suggest that competition has increased since 1999.

Services—big gains

The service sector, which contributes 40% of GDP, has made significant gains since the government adopted its policy of economic openness in 1995. The main source of these gains has been tourism and telecommunications, which have benefited from major policy changes relating to trade liberalization, privatization and private sector development, capital market development, and the application of new technologies. All these policy measures have been aimed at improving the quality of services, increasing the use of modern, efficient management techniques, and developing competitive activities with high value added.

The tourism sector has shown strong potential to supplement the traditional sources of foreign exchange and GDP growth in the Moroccan economy. Between 1995 and 2000 the number of tourists increased by some 4%, allowing the sector to contribute 8% of GDP. This growth has been due in part to policy measures to increase investment in the sector. In 2001 the tourism sector was heading for a record year until the terrorist attacks of 11 September.

In 2001, in consultation with the main business association (the General Confederation of Moroccan Enterprises, or CGEM), the Moroccan government adopted a new tourism policy aimed at increasing tourist arrivals to 10 million a year by 2010. This goal will require building 80,000 new hotel rooms between 2000 and 2010, bringing the total capacity to 115,000 rooms (230,000 beds). To increase coastal tourism, Morocco will build five new seaside resorts, expanding the capacity of such resorts from 30,000 beds in 2000 to 160,000.

To support the achievement of these goals in the tourism sector, the government has granted hotel companies tax holidays during their first five years of operation and reduced the value added tax rate on catering services from 20% to 10%. Other actions have also been taken, such as restructuring the regional interest group for tourism, reviewing the tourism promotion policy of each region, supporting studies aimed at improving the competitiveness of the tourism sector, revising norms for hotel classification, simplifying local taxes, opening the air transport sector to competition, and strengthening training schemes for workers.

In the telecommunications sector, deregulation in 1999 was followed by a significant reduction in tariffs. The sector employs 47,000 people and generates value added of around 2% of GDP. In 2000 Morocco had around 4.35 million fixed line and mobile phone connections. The number of mobile phone connections has increased exponentially, from almost zero in 1995 to 2.9 million today. The number of Internet subscribers remains small, however, at around 200,000.

The state-owned telecommunications company, Maroc Telecom, was privatized in 2000, in a process hailed as a model of openness and transparency (box 7.1). The transaction brought in \$2.1 billion (6.3% of GDP) in 2001, adding substantially to external reserves (IMF 2001). Other development efforts in telecommunications include creating a national industry in information technology and promoting the audiovisual sector. In addition, a contract was signed to launch the Moroccan Academic and Research Wide Area Network (MARWAN) to link universities.

“The reform in the policy-making apparatus and in the policy direction continued in earnest”

Macroeconomic policies and their impacts

The political opening associated with the transition to power of King Mohammed VI after the death of King Hassan II, and the recognition of the challenges of globalization and trade liberalization, have led to several economic policy changes in Morocco. Thus the reform in the policy-making apparatus and in the policy direction, as well as in fiscal and monetary policy in general, continued in earnest in 2001.

Fiscal policy—deficit targets met

Fiscal policy has been aimed at rationalizing and controlling spending and optimizing revenue, to keep the budget deficit below 3% (including privatization receipts). Nonetheless, the fiscal deficit (excluding privatization revenues) has been widening since 1999 (table 7.4). Special factors—such as drought-related spending, large retroactive wage payments, and increased investment funding through the Hassan II Fund—contributed to the widening of the deficit in 2001.

The fiscal policy stance is emerging as a serious threat to the government's medium-term objectives. Radical changes are needed to contain the fiscal deficit and address the inflexibility on the expenditure side. Standard and Poor's recently downgraded Morocco's country risk outlook largely on the basis of the fiscal outlook. A careful review of the revenue and expenditure structure reveals the underlying vulnerability.

Within the framework of trade liberalization and promotion of domestic investment, the government has continued to simplify customs duties, reduce corporate taxes, and lower customs duties on investment goods. The direct fiscal effect of these measures has been a drop in revenue relative to GDP, although this decline also reflects the fact that agricultural output is not taxed. Because of the lack of an agricultural tax, an increase in the share of agricultural output in GDP (arising from improvements in the weather) generally results in a fall in the ratio of revenue to GDP.

Box 7.1

A privatization success story—Morocco's telecommunications sector

Morocco's privatization programme began in late 1989, when Parliament adopted a privatization law. The programme presented an initial list of 112 "privatizable" public enterprises that were to be privatized by 1995 (this deadline was later extended).

Guaranteeing the transparency and accountability of the privatization programme has been a major goal. Towards this end, operating responsibilities have been separated, and careful attention has been paid to oversight. The Ministry of Public Sector and Privatization is responsible for managing the process. An interministerial Transfer Commission, appointed by the king, advises the ministry on privatization strategies for different enterprises and on the selection of bidders for open tenders and private placements. An independent Valuation Authority reviews the valuation of enterprises and sets minimum prices. Although the process has not been perfect, there is a general consensus among local and foreign investors that it has been conducted openly and professionally.

The privatization of telecommunications has been hailed as a success story for its exemplary openness and transparency. The government began to liberalize the sector in 1999 by awarding a mobile telecommunications licence through international tender—challenging the monopoly of the state-owned Maroc Telecom. The winner, Medi Telecom, paid \$1.1 billion, one of the highest prices ever paid for a mobile licence relative to population size. (This transaction was followed by the sale of 35% of Maroc Telecom for \$2.1 billion in December 2000.)

Getting privatization "right" put Morocco on the radar screen of foreign investors and enabled it to reap big rewards. In what ways did Morocco get it right? By establishing a credible regulatory framework, ensuring transparency in the tendering process, and making the terms of the licence attractive.

- The government set up the legal and regulatory framework—including an independent regulatory body, Agence Nationale de Réglementation de Télécommunications (ANRT)—before starting the tendering process. The law clearly defined the principles for licensing and competitive award. And it addressed regulatory risks, dispute resolution, and general principles of interconnection.
- The process for awarding the licence was transparent and conducted fairly by ANRT. The criteria for evaluating bids were clearly set out in the tender documents, and ANRT published a bid evaluation report on its Web site disclosing the scores for each part of the seven bids.
- The licence allowed the winning operator the flexibility to invest in and develop its own network and thus to overcome possible capacity and pricing bottlenecks in Maroc Telecom's network.

The new licence has already led to lower prices and better services. It also promises higher revenues for the government and new job opportunities. The \$1.1 billion licence fee boosted fiscal revenues by 13% in 1999—and according to Wellenius and Rossotto (1999), total fiscal benefits (including future taxes and research and development) could be much larger, between \$2 billion and \$3.5 billion by 2008 in present value terms. Medi Telecom expects to employ around 3,000 people, and its operations may generate an additional 20,000 jobs.

Table 7.4

Public finances, Morocco, 1998/99–2001
(percentage of GDP)

Item	1998/99	1999/2000	2000 ^a	2001 ^b
Revenue	27.4	27.0	26.3	24.3
Tax revenue	24.6	24.7	24.2	22.2
Expenditure	29.9	31.5	32.4	31.5
Non-interest expenditure	24.8	26.1	27.2	26.5
Wages	11.8	12.1	11.9	12.6
Capital expenditure	5.1	5.0	6.0	5.9
Primary balance	2.7	1.2	–1.2	–2.2
Overall budget balance (commitment basis)	–2.5	–4.3	–6.5	–7.2
Privatization and mobile telecommunications licence revenue	0.1	3.2	0.0	6.3
Overall budget balance (including privatization and mobile telecommunications licence revenue)	–2.4	–1.1	–6.4	–0.9

a. Sum of realizations for the first half of fiscal year 1999/2000 and the second half of calendar year 2000. The fiscal year was changed from July–June to January–December in 2000.

b. Estimated.

Source: Morocco, Ministry of Economy and Finance; IMF 2001.

The government achieved its deficit target in 2001 thanks largely to privatization receipts and financial inflows from the World Bank and the International Monetary Fund (IMF). Privatization proceeds reached 6.3% of GDP in 2001, up from almost nothing in 2000. And in May 2001 the World Bank approved a new three-year country assistance strategy that will transfer \$250 million a year to Morocco, to support poverty, unemployment, and human development programmes.

Expenditures amounted to an estimated 31.5% of GDP in 2001. Non-interest expenditure, which accounted for close to 84% of spending, has been increasing both in absolute terms and as a percentage of GDP. By contrast, interest expenditure has remained around the same since 1996/97. Non-interest expenditure increased from 74.0 billion dirhams in 1996/97 to 91.0 billion dirhams in 1999/2000 and was projected to increase to 102.8 billion dirhams in 2001, while interest expenditure will increase from 18.9 billion dirhams in 1999/2000 to 19.4 billion dirhams in 2001. The main source of the spending increase is the wage bill (which rose by 16.1% in 2001) and capital spending (which increased by more than 30%).

The revenue and expenditure structure of the fiscal budget raises serious concerns. Fiscal revenues have been boosted in the past few years largely through the privatization receipts, a fair portion of which has gone to current spending rather than real investment. The public sector wage bill, which has risen steadily over the years, absorbed close to half of fiscal revenues. As a result, cutting spending will be very difficult if fiscal revenues should

“The government achieved its deficit target in 2001”

fall. To keep the fiscal deficit manageable, the government is relying increasingly on selling assets. The danger is that if the expected privatization receipts fail to materialize, as has happened in the past, the government will have no choice but to fall back on building up arrears to domestic suppliers and increasing government debt.

The main monetary policy objectives have been to keep inflation below 3% and to offer sufficient financial support to private sector activity

Monetary and financial policies—inflation kept low

The Moroccan government's main monetary policy objectives have been to keep inflation below 3% and to offer sufficient financial support to private sector activity. It has undertaken monetary policy reforms centred on adopting market instruments for conducting monetary policy (such as interest and discount rates), increasing the independence of the Central Bank (Bank al-Maghrib), and liberalizing the banking system.

These monetary policy reforms, which began in 1995, have involved abolishing the credit support mechanism, eliminating the requirement for banks to hold treasury bonds, and liberalizing lending rates. In this new context the Central Bank has relied essentially on two instruments for monetary intervention since 1995: a weekly seven-day auction rate (a floor rate) and the five-day repurchase rate (a ceiling rate). Partly in response to cuts in interest rates in the international money market, the Central Bank lowered benchmark interest rates in 2001.

Monetary policy was eased in 2001 to support the economic recovery. The effects of this monetary policy action are reflected in an increase in credit to the economy and growth in the money supply (table 7.5). Foreign reserves also strengthened in 2001. Net foreign reserves, around \$5 billion at the end of 2000, rose to around \$7 billion by April 2001 as a result of the sale of Maroc Telecom. By the end of 2001 they were estimated to be at a comfortable \$7.5 billion, equivalent to around 6 months of imports.

The broad money supply grew by a projected 9.5% in 2001. This growth rate, up from 8.4% in 2000, amounts to an overshooting of the Central Bank's target rate by 6 percentage points. But for now the loose monetary stance can support the economic recovery without putting pressure on prices. The Central Bank has established credibility in maintaining price stability. In 2000 consumer price inflation averaged 2.0%. In 2001, despite the marked improvement in the supply situation, inflation was expected to drop to only 1.9%, as a result of the devaluation of the dirham in 2001 and the lagged effects of the oil price hikes of 2000.

In the financial sector the Central Bank has taken steps to strengthen its supervisory and regulatory functions, mainly by imposing sanctions for non-compliance and extending prudential requirements to non-bank financial institutions. The Central Bank also intends to increase its independence as the supervisor of the banking sector and the stock market. As part of its efforts to reform the financial sector, the Central Bank is restructuring and recapitalizing two troubled development banks. It has introduced management changes in Crédit Immobilier et Hôtelier and taken steps to partially recapitalize the bank. The restructuring of Caisse Nationale du Crédit Agricole, which suffered serious repercussions from droughts, may include debt forgiveness and partial rescheduling of debt for small-scale farmers unable to make their loan payments.

Table 7.5**Monetary trends, Morocco, 1999–2001**

Indicator	1999	2000	2001 ^a
Billions of dirhams			
Domestic credit	268.2	297.9	317.4
Net credit to government	82.2	92.4	90.5
Credit to the economy	185.9	205.4	226.9
Percentage change from previous year			
Domestic credit	3.1	11.1	6.6
Net credit to government	–10.1	12.4	–2.1
Credit to the economy	10.3	10.5	10.5
Money and quasi money	10.3	8.4	9.5

*a. Estimated.***Source:** Morocco, Ministry of Economy and Finance; IMF estimates.

Overall, the banking sector remains healthy. Private banks have sound balance sheets, strong branch operations, and the capacity to apply new technologies. Through stricter prudential requirements and prompt measures to address the troubles of banks, the Central Bank hopes to significantly strengthen the performance of the financial sector.

Development of capital markets—plans to increase activity

Efforts to develop capital markets have centred on the Casablanca Stock Exchange, which has been substantially transformed since 1993. Before 1993 the exchange was a state institution under the authority of the Ministry of Economy and Finance. Banks were the only authorized dealers. The exchange was extremely illiquid, with the market limited mainly to a small circle of informed investors. Reforms in 1993 significantly altered the roles of different actors in the stock exchange and the conditions under which they operated.

The reforms consisted of three laws to restructure the management and organization of the exchange. The first made the exchange a joint stock company. The second established a securities commission to protect shareholders, oversee the operation of the market, and help the government regulate the stock exchange. The third law established mutual funds, which have steadily increased in number—from 12 in 1995 to 25 in 1996, 42 in 1997, and 116 in 2000. In addition, in 1997 a second-tier market with lower listing requirements was introduced to improve the supply of stocks. The exchange adopted the French screen-driven trading system.

Stock market transactions grew from 6.4% of GDP in 1996 to 10.9% in 2000, after reaching a record high of 28.2% of GDP in 1999. The stock market index appreciated by 47.2% between 1996 and 2000—11.8% a year on average. The trend since 1998 indicates a continual decline, however, with the index falling from 804 in 1998 to 777 in 1999, 658 in 2000, and 568 in October 2001. The authorities have therefore felt a need to boost investor interest in the stock market.

“ To encourage transactions on the stock exchange, the authorities published a new law to promote initial public offerings ”

“ One important element of the trade liberalization is the trade agreement with the European Union ”

To encourage transactions on the stock exchange, the authorities published a new law in 2000 designed to promote initial public offerings. The law creates a third window open to companies with a capital of 5 million dirhams (rather than the 15 million dirhams required for the first window and the 10 million dirhams required for the second). To help increase the supply of shares, the authorities granted private firms newly quoted on the exchange a 25% income tax break for three years and a 50% tax break if this quotation involves an increase in capital.

Moreover, the exchange has devised a plan of action to increase activity by private and institutional investors. It has promoted information sections, share clubs, on-line services, and advertising to expand the share of stocks held by small private investors. That share is now 3%, compared with a world average of 25% (EIU 2001).

Trade and exchange rate policies—integrating with the world

Morocco's external trade policy is aimed at increasing the country's integration with the world economy and, in particular, promoting exports to the European Union. The country has liberalized the external sector substantially since the mid-1980s. It has reduced tariffs, unified the special import tax and customs tariff, and reduced the number of tariff bands. Despite these changes, the trade regime remains restrictive. For example, Morocco's most favoured nation (MFN) tariffs are higher than those of the other countries in the region (IMF 2001). Efforts are under way to reform the MFN tariffs, mainly by reducing the tariffs and the number of tariff bands.

One important element of the trade liberalization is the trade agreement with the European Union. This agreement includes commitments on good governance, free movement of goods, respect for private property rights, unrestricted capital flows, improved competition policy, and other macroeconomic measures. It also calls for the removal of quantitative restrictions and tariffs.

Morocco is dismantling its quantitative restrictions on imports in line with commitments negotiated in the World Trade Organization (WTO). Its tariff reduction programme is to eliminate tariffs on all industrial goods coming from Europe in three phases between 1 March 2000 and 1 March 2012. The first phase covers a list of essential investment goods for which taxes and tariffs are already very low. The second phase includes industrial raw materials not produced locally and industrial spare parts for which tariffs and equivalent taxes are being progressively eliminated in 2000–02. The third list includes sensitive industrial goods produced locally, for which taxes will be reduced by 10% a year starting in 2003.

Morocco's export promotion policy is aimed at increasing product and market diversification, with a large role for the private sector. A new investment code encourages investment in the export sector by both Moroccan and foreign investors. And the rules and regulations applying to international trade continue to be simplified.

Exporters have been given a number of incentives, including tax rebates, customs facilities, foreign exchange facilities, and free trade zones. Despite these incentives, the export

sector's competitiveness has eroded over time as a result of high taxes, the strong dirham, and the high costs of labour and raw materials. During the reform period in the 1990s movements in the shares of the four major manufactured exports in total exports (the Herfindahl-Hirschman Index) indicated diversification in the products exported (Cherkaoui and Jalali 2001). But exports continue to be concentrated in a few markets in Europe.

After narrowing in 1996 and 1997, the trade deficit widened in 1998–2000, rising from 7% of GDP in 1999 to 9.5% in 2000 (table 7.6). Exports grew by only 1% in 2000, compared with 5% in 1999, mainly because of the poor agricultural harvest and the difficulties faced by the textile sector.

In the first eight months of 2001 imports fell by 0.4%, and exports by 0.7%, compared with the same period in 2000 (EIU 2001). A decline in equipment imports was the main factor in the low level of imports, while a fall in the sales of seafood and vegetables was the main cause of the low level of exports. During the same period, however, exports of leather and textiles grew by 4.1%, and exports of phosphate and phosphate by-products increased by 9%, mainly as a result of a public investment programme to promote the mining sector. On a year-to-year basis, exports rose an estimated 8.1% in 2001, thanks largely to the increase in phosphate exports. The trade balance was expected to improve from –9.5% of GDP in 2000 to –8.7% in 2001, and the current account balance from –1.7% of GDP to 0.7%.

The main objective of exchange rate policy has been to keep the real effective exchange rate of the dirham broadly constant relative to the currencies of Morocco's main trading partners, so as to maintain the country's export competitiveness. Other objectives include reducing the trade deficit and increasing tourism receipts and workers' remittances while taking into account the debt burden and the cost of oil imports.

These objectives are to be achieved, in nominal terms, by fixing the dirham against a basket of currencies and, in real terms, through a budgetary and monetary policy aimed at limiting inflation and dismantling foreign exchange controls. Despite the changing circumstances in both domestic and external markets, the nominal exchange rate was fixed during the past decade. The fixed exchange rate system had several adverse effects, including a 22% real appreciation of the dirham between 1990 and 2000 that led to rising pressures on the competitiveness of the export sector. Moreover, in the past two years the nominal exchange rate appreciated against the euro, which accounts for more than two-thirds of Moroccan export transactions (table 7.7). The textile and apparel sectors have been hit the hardest, since their exports are destined almost exclusively for European markets. Since 1999 the textile sector has reported a loss of 29,600 jobs—12% of its employment (IMF 2001). The sector's problems are not entirely due to the exchange rate appreciation, however.

In response to the deterioration in the export sector, in April 2001 the currency was devalued by 5%. In addition, the basket of currencies was revised to take into account the growing role of the euro in Moroccan trade. The currency devaluation may have contributed to the reversal of the worsening of the trade balance expected in 2001. Nonetheless, exporters have complained that the currency is still overvalued by around 10%. But the government contends

“Objectives include reducing the trade deficit and increasing tourism receipts and workers' remittances”

Table 7.6

External sector performance, Morocco, 1999–2001
(percentage of GDP, except where otherwise specified)

Indicator	1999	2000	2001 ^a
Trade balance	–7.0	–9.5	–8.7
Current account balance	–0.5	–1.7	0.7
Debt service (percentage of exports)	20.8	20.8	19.3
External debt	50.1	48.3	43.1

a. Estimated.

Source: Morocco, Ministry of Economy and Finance; IMF estimates.

Table 7.7

Exchange rates, Morocco, 1997–2001

Exchange rate	1997	1998	1999	2000	2001
Official rate, dirhams per dollar, period average	9.527	9.604	9.804	10.588	11.277
Official rate, dirhams per dollar, end of period	9.714	9.255	10.086	10.641	—
Real effective rate, dirhams per dollar, end of period	114.734	117.478	118.684	122.173	—
Official rate, dirhams per euro, period average	—	—	—	9.82	10.20
Official rate, dirhams per franc, period average	1.63	1.62	1.59	1.49	1.53

— Not available.

Source: Morocco, Ministry of Economy and Finance.

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The high rates
of poverty and
unemployment could
undermine the
political transition
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that if the U.S. dollar continues to fall against the euro, as is expected, the dirham may soften against the euro. Moreover, the government is worried about the possibility of inflationary pressures resulting from further depreciation. The recent devaluations in Egypt may put further pressure on Morocco, however, as the two countries have similar export patterns. Even with further episodes of discrete depreciation of the dirham, the fixed exchange rate policy will remain a major barrier to improving the competitiveness of the export sector.

Human development—big improvements

Morocco has achieved significant improvements in human development in the past two decades. These advances are reflected in the human development index calculated by the United Nations Development Programme (UNDP); Morocco's index rose from 0.539 (out of a possible 1.000) in 1990 to 0.596 in 1999. Despite the progress in several social indicators, two vastly different Moroccos coexist: a prosperous urban society to which all amenities are readily available and a poor rural society whose social conditions are closer to those of Sub-Saharan Africa than to those of other middle-income countries. Poverty and unemployment increased in the 1990s, and today one in five Moroccans lives below the poverty line and around 13.6% of the labour force is unemployed. Unless promptly addressed, the high rates of poverty and unemployment could undermine the political transition that started in the mid-1990s.

Although the government has emphasized the importance of the social sector problems and initiated some actions, there has been no consistent vision for financing or implementing the different policies. Thus policies remain rather ad hoc and poorly integrated. Still, the brighter economic performance in 2001 could significantly bolster the capacity for addressing poverty, unemployment, and weak rural infrastructure.

Population—low dependency ratios

Morocco does not appear to suffer the rapid population growth that continues to obstruct growth in per capita income in other African countries. The fertility rate declined from 6.9 births per woman in 1970–75 to 3.4 in 1995–2000. And the population grew by an average 1.7% a year in 1995–2000, increasing from 26.3 million to 28.7 million. Morocco's population is young, with those under 15 representing 32% of the population and those over 60 around 7%. Thus a large share of the population is productive and the dependency ratio is low, with favourable implications for raising savings and capital per worker.

The population living in urban centres increased from 51.9% in 1995 to 55.0% in 2000. This large share in urban areas—high compared with that in other developing countries—has put significant pressure on urban infrastructure and employment requirements.

Education—attainment up substantially

Educational attainment in Morocco has improved substantially since the mid-1980s. The adult literacy rate rose from 45% to 48% between 1985 and 1999, while the net primary enrolment ratio increased by 31%. Around 30% of tertiary students are enrolled in science, mathematics, and engineering programmes. Despite the progress, these indicators remain lower than those in other middle-income countries and elsewhere in the Middle East and North Africa.

Morocco's education system includes nine years of basic education, consisting of six years of lower basic education for students ages 7–12 and three years of higher basic education for students ages 13–15. After completing basic education, students move on to secondary and technical education, which lasts three years.

Between 1995 and 2000 the number of students in lower basic education grew by an average 4.1% a year, reaching 3.6 million in the 2000/01 school year. The number in higher basic education grew by 2.1% a year in the same period, to 1.04 million. And the number of students in secondary education grew by 6.2% a year on average during that period, reaching 483,720 in 2000. Still, the dropout rate is high in Morocco.

The national enrolment ratio for children ages 6–11 was 80% in 2000, according to the Economic and Development Plan. Disparities were apparent between urban areas (89.7%) and rural areas (69.5%) and between boys (83.8%) and girls (74.1%). There are also large differences in skill attainment between rural and urban schools.

Under the new education reform programme adopted in 1999, all students who pass the baccalaureate examination at the end of high school have the right (in the year in which they pass the exam) to enrol in one of the public universities free of charge. Based on the French

“A large share of the population is productive, with favourable implications for raising savings and capital per worker”

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*Morocco has one of
the highest life
expectancies in Africa*
”

model, the higher education system includes 14 public universities, 1 university with a special status, 33 specialized institutions, many teachers colleges, and 83 small private institutions.

The best students usually go to public institutions, where entrance is highly selective. The private institutions offer training in a small number of fields, such as business and computer science; these institutions charge fees and some have a selection process. The public universities enrol some 250,000 students, of which around half are registered in the faculties of law, economics, and political science. The rest study at private institutions (9,000 students) or teachers colleges (16,000 students).

The inadequacy of the training provided by the higher education system, and its failure to meet the needs of the labour market, led to attempts to adjust the system, then to a conviction that a reform of the entire system was needed. The reform was aimed at matching the output of the education system to the needs of the labour market and economic development—while reducing the cost per student. Public spending on education has declined as a share of GNP in recent years, however, falling from 6.2% in 1985–87 to 5.3% in 1995–97 according to the UNDP (2001). Even so, it has increased as a share of government expenditure during the same period, from 21.5% to 24.9%.

Health—left to the private sector

Morocco has one of the highest life expectancies in Africa, at 67 years (UNDP 2001). But it has one of the lowest levels of public spending on health, at 1.2% of GNP in 2000. As a result, private spending on health care, at 3.2% of GNP, is higher than that in most developing countries. The low level of public spending on health has created serious problems in the access to and quality of health services, especially among vulnerable groups. Public health spending has benefited mostly affluent groups in urban areas, favouring expensive curative services rather than primary and preventive health care for the rural poor. An estimated 66% of the population has access to essential drugs.

The prevalence of HIV/AIDS in Morocco is among the lowest in the world. In 1999, 0.03% of adults in Morocco were infected, compared with an average 8.7% in Sub-Saharan Africa and 0.2% in Arab countries. The country's infant mortality rate dropped from 119 per 1,000 live births in 1970 to 45 in 1999, indicating a significant improvement in the health status of Moroccans over the past two decades.

Unemployment and poverty—urban unemployment, beyond 20%

The slow GDP growth in 1992–2000, combined with an increase in the wage-rental ratio in the formal sector (resulting from an increase in wages and a decline in the cost of capital), has led to growing unemployment. The unemployment rate has been especially high in urban areas, where it rose from 14.4% in 1987 to 21.5% in 2000. Job losses have been particularly large in the textile industry, as a result of trade liberalization and years of real appreciation of the dirham.

Urban unemployment was higher among women (26.7%) than among men (19.9%) in 2000. It was higher among youth than among older workers—37.6% for those ages

15–24. And it was higher for those holding a university degree, at 29.2%. But the rural unemployment rate, at 5%, was much lower than the urban rate, pulling down the overall unemployment rate in 2000 to 13.6%.

Around 19% of Moroccans live below the national poverty line, but less than 2% live on less than \$1 a day. Although the standard of living deteriorated in the initial years of structural reform in the mid-1990s, the decline has been partially reversed as income and consumption have increased, thanks to policies aimed at raising farm productivity and producer prices and better access to productive resources in rural areas. Even so, income poverty and unemployment remain higher than in the early 1990s, and social sector problems are still a major concern (box 7.2).

King Mohammed VI has emphasized giving priority to poverty, unemployment, and illiteracy. The Hassan II Fund, financed by privatization receipts from the telecommunications sector, addresses unemployment. And the government, in cooperation with the World Bank and non-governmental organizations, has increased its efforts in tracking poverty, identifying vulnerable groups, and improving access to health and other social services, especially among women in remote areas.

“ *The Moroccan economy is expected to do better in 2002* ”

Medium-term outlook and policy challenges— real GDP growth unlikely to exceed 3.5%

Two main factors account for the fluctuations in macroeconomic aggregates for Morocco: the weather and oil prices. With good weather in place and oil prices remaining below \$20 a barrel, the Moroccan economy is expected to do better in 2002, with the improvement in GDP growth expected to continue into 2003. Growth is projected at 4.5% in 2002 and 4.4% in 2003 (table 7.8). Nevertheless, since the country's economic fortunes are still tied to weather patterns, these growth predictions need to be interpreted with the underlying uncertainty and variability of the weather in mind.

Inflation is expected to remain significantly below the 3% target as long as fiscal deficits are kept within the target range and oil prices remain stable. Interest rates in the money and capital markets are expected to move up with the accelerated growth and the rise in government borrowing. The dirham is expected to weaken against the euro as a result of realignment in international currencies in 2002. That could improve the competitiveness of Moroccan exports, especially in Europe, helping to narrow the trade deficit incurred in 2000 and 2001. The trade deficit is forecast to be 7.6% of GDP in 2002 and 7.4% in 2003. And the current account deficit is expected to be 0.4% of GDP in 2002 and 0.2% in 2003. These projections may change, however, if the textile and apparel sector undergoes further structural adjustment because of the phasing out of textile and apparel quotas under the WTO agreement.

Under the 2000–04 fiscal plan, the 2002 budget is expected to include measures to simplify the fiscal system, such as modifying the customs code, aligning the fiscal incentives for companies, and strengthening the mandates of local tax commissions. In addition, the gov-

Box 7.2

Rising poverty and inequality in Morocco

Morocco's slow growth over the past decade, accompanied by frequent droughts, has led to a significant worsening in the living standards of its population. According to the Living Standards Measurement Study survey in 1998–99, 19% of Moroccans lived below the national poverty line, up from 13% in 1991.

Poverty is most prevalent in rural areas, where most people depend on agriculture for their livelihood. In the rural population 1 in 4 is poor, compared with 1 in 10 in the urban population. Moreover, poverty is more severe in rural areas and became increasingly so in the 1990s.

Urban poverty is also on the rise, because of rural-urban migration and the poor performance of manufacturing. A third of the poor now live in urban areas. Urban unemployment rose from 15% of the labour force in 1991 to 22% in 1999. Most affected are young university graduates.

Although poverty worsened in the 1990s, access to basic social services has improved. Nonetheless, serious disparities remain in the equity and efficiency of service delivery.

While Morocco has achieved one of the highest life expectancies in the Middle East and North Africa, infant and maternal mortality rates are significantly higher than the regional averages. Its public spending on health is among the lowest in the region. And there is a large gap in health indicators between rural and urban areas. In some rural areas the proportion of the population with access to health services is only a fourth that in urban areas. This gap is exacerbated by the urban bias in government health spending, with urban hospitals absorbing close to 70% of the recurrent budget.

Although the government devotes significant resources to education—amounting to 6% of GDP—the quality and equity of education are serious concerns. Morocco has one of the highest illiteracy rates in the region, at around 52%. But among rural women 83% are illiterate, reflecting stark disparities by gender and between rural and urban areas. Even though enrolment ratios are rising, around 2.5 million children—most of them rural girls—do not go to school.

Inequalities in education spending are partly responsible for the disparities in attainment. For example, around 20% of resources go to secondary education, and 17% to tertiary education, where spending disproportionately benefits urban and better-off segments of the population. The problems in the quality of education are reflected in poor retention and the mismatch between higher education and the needs of the labour market.

Since the mid-1990s the government has sharpened its focus on regional and gender disparities in poverty and in access to basic services. It has expanded public investment in rural infrastructure programmes, introduced social programmes in the poorest regions through such initiatives as the Social Priorities Programme, and taken measures to promote girls' enrolment. While it is still early to measure the full impact of these initiatives, preliminary results are encouraging. Girls' primary enrolment in rural areas is reported to be increasing. And some progress has been made in improving basic rural infrastructure.

Source: World Bank 2001.

Table 7.8

Medium-term outlook, Morocco, 2002–03
(percent)

Indicator	2002	2003
Real GDP growth	4.5	4.4
Export growth	8.2	7.3
Trade balance as percentage of GDP	–7.6	–7.4
Current account balance as percentage of GDP	–0.4	–0.2
Inflation rate	2.8	2.3

Source: Economic Commission for Africa from official sources.

ernment will grant institutional investors a 50% tax break on profits on the sale of shares and exempt individual investors from income taxes on such profits. And it is expected to reduce the value added tax on some products used in the pharmaceutical industry from 20% to 7%.

The government is expected to further widen the tax net and reduce spending on the civil service and on consumption subsidies. Even so, the budget deficit is expected to rise slightly above the 3% target in 2002 given the national elections in September 2002 and the increase in capital spending in rural areas and the coastal tourism sector.

The 2000–04 economic plan sets three main macroeconomic objectives:

- Maintaining GDP growth of at least 5% a year.
- Reducing the external debt burden by lowering the debt-to-GDP ratio to 3.5% and the debt service ratio to 20% of exports by 2004.
- Keeping both the inflation rate and the budget deficit below 3%.

Achieving these objectives will require policy changes in key sectors of the economy. The Moroccan government must address the pressing needs of boosting economic growth and reducing poverty and unemployment to pave the way for a smooth transition into the global economy.

Agriculture

In agriculture the major policy challenges are promoting sustainable agriculture and reducing vulnerability. These challenges call for:

- Improving the control of water resource use.
- Reversing policies that promote cultivation on climatically vulnerable land.
- Pursuing efficient research and dissemination efforts aimed at transferring appropriate technologies to farmers and reducing vulnerability to adverse weather conditions.
- Adopting a regional approach to development, so as to efficiently exploit the diverse potential of different regions.
- Adopting a new approach to agricultural financing, using mechanisms appropriate to farmers' needs and the climatic conditions.

“The government must address the pressing needs of boosting economic growth and reducing poverty and unemployment”

“Morocco’s export performance has been unsatisfactory in recent years”

Industry and services

In industry and the service sector the main challenges include:

- Restructuring local industry to take full advantage of the opportunities emerging from the free trade association with Europe, through improvements in capacity utilization and the adoption of new technologies.
- Developing an appropriate legal and public service delivery system that is sensitive to the needs of the business community, local and foreign.
- Developing new industrial zones and rehabilitating existing ones.
- Improving labour management through effective labour laws.

Fiscal and monetary policy

Achieving a stable, growing, and competitive economy entails several key fiscal and monetary policy challenges in the medium term:

- Addressing the vulnerability of the fiscal position. The steadily rising wage bill and the overreliance on private sector receipts to maintain revenue are concerns that need to be promptly addressed.
- Establishing a stable real exchange rate regime. This might require adopting a flexible exchange rate system that responds effectively to exogenous shocks.
- Achieving price stability.
- Enhancing the credibility of the Central Bank in the management of the economy.

External sector

Morocco’s export performance has been unsatisfactory in recent years, limited by overdependence on the European market, appreciation of the dirham against the currencies of major trading partners, and competition from Asia and Eastern Europe in the market for light manufactures.

The fixed exchange rate regime has been a major constraint on the competitiveness of the export sector. Discrete devaluation may not help. The government needs to think about introducing a floating exchange rate system.

Results of a study by Cherkaoui and Jalali (2001) suggest that real exchange rate depreciation alone cannot achieve sustained export growth. The reason is that once the initial macroeconomic framework is set, including the real exchange rate, the momentum for export growth will slow. Sustained export expansion requires export diversification, product innovation, and quality upgrading. And all these require appropriate industrial and competition policies complemented by strategic alliances, joint ventures, and government-supported research and development programmes.

Human development

Among the main challenges in human development are these:

- Achieving a sustained reduction in poverty and unemployment.

- Reducing disparities in enrolment ratios and achievement levels between rural and urban areas and between males and females.
- Reducing the dropout rate.
- Extending health services to rural areas and to the urban poor.
- Enhancing safety nets for the poor and the unemployed.
- Increasing access to basic infrastructure for the rural poor.

* * *

The pace of economic growth in the past has fallen far short of expectations and of the potential of the country. Both structural and macroeconomic weaknesses are to blame. The overdependence on agriculture, the deteriorating fiscal outlook, and the lack of competitiveness in the export sector may continue to threaten Morocco's ability to achieve the macroeconomic objectives of the 2000–04 economic plan. Unless these constraints are addressed, real GDP growth may not exceed 3.5% a year over the long term.

“The pace of economic growth has fallen far short of expectations and potential”

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Guinea—From a Command to a Market Economy

Guinea is often referred to as a geological oddity because it is so richly endowed with mineral resources. The country is the second largest producer of bauxite and has vast untapped reserves of the mineral that can be easily extracted through open pit mining. Guinea also has huge quantities of gold and iron as well as zinc, copper, nickel, marble, and granite. Perhaps even more notable are the country's supplies of high-quality diamonds. Yet despite this immense wealth, Guinea ranks among the world's least developed countries.

Efficient use of the country's largely unexploited mineral resources would accelerate its economic recovery and its integration with the global economy. But Guinea also faces serious constraints to development stemming from domestic political instability and conflicts in neighbouring countries. And the transition from a socialist regime has not been easy. Even so, major reforms undertaken in the mid-1980s by the government of President Lansana Conté indicate a political commitment to rehabilitating the economy and fighting poverty.

In 1990–2000 Guinea's GDP grew at an average annual rate of 3.4% in real terms. GDP growth began a downward trend in 1997, dropping to its lowest level (1.1%) in 2000. But growth was projected at 3.3% for 2001 and is expected to rise to 4.5% in 2003.

The poor growth performance in 2000 mainly reflected deteriorating security conditions and unfavourable world price trends for the country's two main exports, bauxite and alumina. The economy's heavy reliance on mining means that the fortunes of that sector largely determine macroeconomic and social outcomes.

The current account deficit amounted to 1.2% of GDP in 2001, a slight improvement from the deficit of 2.1% in 2000. Guinea has managed to keep inflation to single digits for the past 10 years, mainly through tight monetary policy.

The current government has taken steps to rehabilitate the economy and to establish democracy and good governance. It has also made debt management and poverty reduction high priorities. With the support of the international community, Guinea has completed several rounds of debt rescheduling. The country also has recently received debt relief under the Heavily Indebted Poor Countries (HIPC) initiative, which is aimed at reducing poverty and boosting economic growth. As a result, its debt to GDP ratio has steadily declined, reaching 33% in 2001.

On the social front Guinea has achieved commendable progress, particularly in education and health. Education reform has resulted in a large increase in gross primary

*A geological oddity
richly endowed with
mineral resources*

“*The medium-term outlook for Guinea is positive, with growth projected to pick up as peace takes hold*”

enrolment—although the rate, at 56% in 2000, is still dismally low. Health sector programmes have led to significant improvements in primary care and access to essential drugs, and infant and maternal mortality rates have fallen remarkably as a result. But with the majority of the population still poor, much remains to be done to lift people out of poverty.

To spur economic development, the government needs to intensify its reform programmes while ensuring a structured and comprehensive approach that can bring about deep institutional and administrative changes. Such changes would support the sound macroeconomic policies needed to promote economic growth and social development. The government will also need to ensure that monetary and fiscal policies are in line with its reform programmes. Finally, sectoral analysis points to a need to diversify the economy so as to reduce the heavy reliance on mining, to direct investment towards the development of industrial and agricultural (mainly fishing) activities, to modernize and develop the energy sector and basic infrastructure (including transport and telecommunications), and to promote tourism.

The medium-term outlook for Guinea is positive, with growth projected to pick up as peace takes hold in the subregion. A durable peace appeared likely towards the end of 2001, as sanctions against Liberia and increased military pressure on the Revolutionary United Front—the organization fighting the government of Sierra Leone and responsible for thousands of civilian deaths—led to new interest among regional players in a general settlement. The president of Guinea agreed to negotiate directly with the head of state of Liberia about that country’s alleged support of incursions into Guinea by the Revolutionary United Front.

Greater efforts towards regional integration in the Economic Community of West African States (ECOWAS) should serve Guinea well as regional initiatives to improve infrastructure come on stream. These initiatives include upgrading transcoastal roads, connecting railroad networks to improve links between Guinea-Bissau and Sierra Leone, launching a West African satellite, and upgrading the Conakry seaport. The single West African currency slated for 2003 will help to consolidate sound macroeconomic policies, a prerequisite of growth and development.

Recent trends and developments— wide-ranging reforms

The political environment in Guinea has been difficult in recent years. Until 1984 the Guinean economy was governed by a centrally planned system put in place by the socialist regime of Sekou Toure. This system was characterized by inefficiency, corruption, and mismanagement.

In the late 1980s a series of economic and financial reforms were implemented to restore budgetary balance, promote economic recovery, and renew international confidence. Although the reform programme received much support from the donor community, policy implementation was inconsistent, with brief periods of progress followed by policy slippage. Political instability was largely to blame for this inconsistency.

In early 1996 a group of military officers made an unsuccessful attempt to seize power from Lansana Conté, who has ruled Guinea since a military takeover in 1984. Conté was elected president in 1993 and re-elected in 1998. The 1998 presidential election led to more political and military instability. One of the main opposition candidates, Alpha Condé, was found guilty of having plotted against the state and given a five-year sentence in late 2000. In May 2001, however, he was granted an amnesty after having served half his term.

Also destabilizing has been the inflow of refugees fleeing a regional conflict that erupted in 2000 along Guinea's western and southern borders with Sierra Leone and Liberia. This conflict led Guinea to postpone its 2000 legislative election. Since the signing of peace agreements between the Revolutionary United Front and the government of Sierra Leone, border skirmishes have waned. Nevertheless, the massive flood of refugees has strained public spending and led to substantial environmental costs.

Although the domestic instability has made reform difficult, Guinea carried out major economic, social, and institutional reforms in 1995–2000. During this five-year period GDP grew at an average annual rate of 3.4% in real terms. The projected growth for 2001 was 3.3%, the outcome of a downward trend that began in 1997, with GDP growth reaching its lowest level in 2000 at 1.1% (table 8.1).¹

Investment was subject to the same downward trend, dropping from 17.9% of GDP in 1996 to 12.1% in 1998 before stabilizing (table 8.2). This trend stemmed mainly from fluctuations in private investment, with public investment remaining stable over the period at around 5% of GDP. After initially rising, the savings rate fell from 10% of GDP in 1997 to 4.8% in 1999. The savings rate subsequently rose, though unsteadily. Final consumption also followed the same downward trend from 1997.

The reforms that the government has undertaken in recent years have been wide ranging, focusing on budgetary, monetary, financial, external, social, and governance policies. Indeed, in 1996–98 the government formulated a holistic development policy, laid out in “Guinée Vision 2010” (Guinea, National Government 1998a). The policy became operational in December 1998 through the National Human Development Programme, developed after broad consultations with civil society (UNDP 1997). Within this framework the government initiated a variety of programmes in the priority sectors of health, water, education, agriculture, and transport. But implementation was constrained by the lack of a government strategy coherent enough to attract the participation of domestic actors and the support of development partners. In 1999 the International Monetary Fund (IMF) suspended support to Guinea because the agreed reform programme was seriously off track.

In early 2001, however, the IMF granted Guinea a loan through its poverty reduction and growth facility, based on a programme targeting economic growth of 5.5% between 2001 and 2004. The loan is also linked to the preparation of a poverty reduction strategy paper, a draft of which was completed in October 2000 (a final version was to be presented in late 2001, but has not yet been).

The results achieved in 1995–2000 sum up the liberal approach that the Guinean government embarked on in 1985, breaking away from the planned economy in place

“*Reforms in recent years have been wide ranging*”

Table 8.1

*Growth in GDP and consumption, Guinea, 1995–2001
(average annual percentage growth)*

	1995	1996	1997	1998	1999	2000	2001 ^a
GDP	4.1	5.6	2.8	3.9	3.0	1.1	3.3
GDP per capita	1.3	2.7	–0.1	1.0	0.0	–1.7	0.4
Per capita consumption	–3.8	0.1	–2.3	3.6	–5.0	–3.0	0.1

a. Projected.

Source: Economic Commission for Africa from official sources.

Table 8.2

*Investment and savings, Guinea, 1995–2001
(percentage of GDP)*

	1995	1996	1997	1998	1999	2000	2001 ^a
Total gross fixed capital formation	17.4	17.9	14.0	12.1	13.7	14.1	13.4
Public gross fixed capital formation	5.9	5.1	5.8	4.0	4.9	5.2	5.5
Private gross fixed capital formation	11.5	12.8	8.3	8.1	8.7	8.9	7.8
National savings	10.0	12.5	10.0	4.8	7.9	7.7	7.2

a. Projected.

Source: Economic Commission for Africa from official sources.

“Given the country’s enormous potential the macroeconomic results proved disappointing”

for a quarter century. The 1995–2000 economic reform programme, which had gained the support of all development partners, focused on reforming the public sector, liberalizing the exchange rate regime, deregulating prices and interest rates, restructuring the banking sector, monitoring public spending, and strengthening national capacities to manage a market economy—all while emphasizing a participatory approach to development.

Given the country’s enormous potential in agriculture, fisheries, minerals, and energy, the macroeconomic results proved disappointing, however. This outcome can be explained in part by the long transition from one regime to another, as Guinea sought to eliminate the remnants of the socialist regime while also dealing with the demands of a market economy. The country had to contend with all the institutional and behavioural problems common in a transition economy.

Sectoral performance and policies

Agriculture and mining are the two largest sectors of the Guinean economy, with manufacturing a distant third.

Agriculture—reviving exports

Agriculture accounts for around 21% of GDP, provides employment for some 65% of the population, and produces around 10% of exports. Rice is the most significant crop, cultivated on 50% of irrigated land (although the country still imports up to 40% of its requirements).

The sector grew at an average rate of 4.9% (in volume terms) between 1995 and 2000, outpacing GDP. Most dynamic were foodstuffs and livestock production: between 1991 and 1997 rice production increased by 26%, meat production by 48%, maize production by 74%, and cassava production by 170%.

Efforts to revive agricultural exports—targeting mainly coffee, cotton, fruit (particularly mangoes and pineapples), and rubber—were partly successful. Positive results seemed to indicate better prospects for cotton (with exports rising from 12,547 tonnes in 1995 to 30,000 in 1998) and rubber, although the performance of coffee and fruit remained disappointing.

This progress notwithstanding, the challenges in developing and modernizing agriculture remained significant. The increase in the production of foodstuffs came essentially through an expansion of cultivated area. Growth in productivity remained modest: between 1991 and 1995 the average output of rice rose from 1.38 tonnes per hectare to 1.43, and that of maize from 0.96 tonne per hectare to 1.03.

Agriculture has been a policy priority for the government for the past 15 years, reflecting its importance both in diversifying the economy—long dependent on mining—and in reducing poverty in rural areas, where most of the population lives. Implementing agricultural policy is the responsibility of the Ministry of Agriculture and Livestock.

Despite the country's enormous water resources (the country used to be called “West Africa's Water Tower”), the sector has performed well below policy expectations. Serious constraints have limited its development. The productive capacity (based on soil, water, and forest resources) has declined sharply, in large part because of the traditional farming methods, which have changed little for decades. Rural infrastructure (roads, irrigation facilities) is inadequate. And lack of access to land, insecure land tenure, poor access to credit and the high cost of financial services, and the weak institutional support system have all constrained private sector participation.

The main policy guidelines for the sector were laid out in 1991 by the first agricultural development policy paper and updated in 1997. This policy was aimed mainly at ensuring food security, diversifying agricultural production, increasing the volume of exports, promoting private investment in the rural sector, developing basic rural infrastructure, and protecting the environment. The policy has led to significant progress in a few areas.

But broader progress has been undermined by the low level of investment and the persistence of traditional practices. These problems stem from the lack of financial services tailored to agricultural development, insufficient training and education, and limited use of

“*Broader progress has been undermined by the low level of investment and the persistence of traditional practices*”



The lack of growth in agriculture impedes the development of the entire economy

technology. And all these constraints seriously limit the growth opportunities of the sector, particularly in food processing.

In the coffee subsector, for example, there were eight packaging enterprises and four processing enterprises with a total capacity of 11,000 tonnes in 2000. But only 57% of the capacity was being utilized. Despite the high quality of Guinean coffee, local producers are unable to develop effective marketing strategies at the local level to position the product for export. As a result of such problems, agricultural output is exported in its raw state, to the detriment of the local processing industry.

Consider another example, in the fruit and vegetable subsector. On-the-spot processing has strong potential and could provide local employment. But because of the subsector's inability to comply with international standards, Guinea has progressively lost the world market share it had acquired 30 years ago.

The fruit and vegetable subsector has recently received tax concessions on imported inputs for use in producing exports, which could promote its development. But financing the purchase of inputs continues to be difficult because of the land tenure system. Because that system reserves land ownership for the state, it is impossible for producers to use land as collateral for bank loans.

The lack of growth in agriculture impedes the development of the entire economy and holds back progress in reducing poverty. And the country's overreliance on exports of a single product—bauxite—increases the potential cost of external shocks. Thus it is critical for the government to carry out reforms addressing the constraints in agriculture and making good use of the country's agricultural resources. These reforms should focus on:

- Expanding and improving basic infrastructure, particularly transport and irrigation.
- Developing community financial institutions (micro-finance) that meet the needs of rural activities.
- Strengthening agricultural productivity through policies to encourage the most efficient use of inputs.
- Promoting the development of livestock production.
- Supporting the creation of professional associations of livestock breeders, farmers, and fishers, with a view to promoting learning and participation.
- Supporting the activities of rural women to help develop their economic and social potential.
- Assessing the impact of macroeconomic, fiscal, and customs policies on rural development.
- Rehabilitating and expanding export potential.

Fishing—undeveloped

Guinea has done little to develop its fishing sector, despite the country's 300-kilometer coastline and huge fisheries. A lack of infrastructure, particularly a modern fishing port, constrains the development of the fishing sector and undermines quality.

Fishing contributes just over 1% of GDP, although it accounts for around 6% of exports. Domestic consumption of fish has doubled since the mid-1980s. To meet the growing domestic demand, Guinea imports almost 30,000 tonnes of fish a year, including 17,000 tonnes of processed fish products and 12,000 tonnes of frozen fish products.

Industrial fishing accounted for less than 40% of the estimated 118,000-tonne catch in 2001, with foreign companies landing 65% of the industrial catch. The Guinean fleet is still in its infancy, apparent from the fact that small-scale fishing accounted for around 60% of the catch and 90% of the volume reaching markets.

Mining—provides bulk of industrial employment

Mining dominates the industrial sector and represents a large part of the country's economic activity, accounting for around 20% of GDP, 85% of export income, and 30% of fiscal revenue. In fact, until 1990 mining generally accounted for more than 20% of GDP, well over 90% of recorded exports, and 70% of government tax revenue. But its contribution to GDP dropped from 22.38% in 1989 to 20.51% in 1991 to 19.52% in 1994 before becoming relatively stable.² The important bauxite-alumina sector has been troubled by financial problems and deteriorating terms of trade since the late 1980s, although several new projects are emerging to add value to the ore.

Mining production relies on reserves that have generally proved capable of open cast mining: bauxite (20 million tonnes), limestone (40 million tonnes), nickel (73 million tonnes), iron (1 billion tonnes), diamonds (20 million karats), graphite (11,300 tonnes), titanium (100 million tonnes), and gold (5,000–10,000 tonnes). Recent research shows that the northeast of Guinea has immense gold resources, on the order of 500 tonnes.

Carried out mainly by major joint or foreign mining enterprises, mining provides the bulk of industrial employment (10,000 direct permanent jobs). It is the second largest employer after the civil service, even excluding the jobs created through subcontracting and the 100,000 jobs in the cottage industry. Through its tax contribution, the mining sector provides the equivalent of 51% of government spending on health, education, water supply, and infrastructure development. In addition, it contributes to grass-roots development through the construction of roads and the creation of education and health facilities.

The government has embarked on an ambitious reform programme in the mining sector. In 1995 it promulgated a new mining code aimed at improving the sector's institutional, legal, and regulatory environment and restoring its competitiveness. The code takes significant steps towards liberalizing mining activity. In another measure to liberalize the sector, the government established an independent mining cadastre (official property registry) under the Ministry of Mines, Geology, and the Environment. Efforts in coming years will be geared towards modernizing the information systems of the cadastre. Updating the geological map of the country would also be desirable, to help reduce investment risks in mining.

The state is also reducing its involvement in the sector. It has cut its participation in one mining company to 15% and aims to reduce its participation in several other mining

“Mining provides the equivalent of 51% of government spending on health, education, water supply, and infrastructure development”

“
*The state is reducing its
involvement in mining*
”

companies through a privatization programme. In addition, it will pursue strategies to encourage private investment in bauxite mining and processing in the Boke region.

To intensify mineral exploitation and accelerate the country's economic growth, several major projects have been identified, particularly in bauxite processing (alumina and aluminium). These include the Sangaredi project (an aluminium smelter with a projected capacity of around 250,000 tonnes a year) and the Dian-Dian project (a bauxite mine and aluminium smelter). These projects will significantly expand the volume of activity in the sector, help to diversify mining activities, and increase the vertical integration of the sector. Moreover, the investment in the sector in the next five years is expected to contribute to the country's overall growth by generating links to other sectors.

Development efforts in the mining sector need to be geared to two goals: intensifying mining activities and promoting the further development of minerals. To support these goals, the main policy priorities should be improving the technical and legal protection of mining assets, developing basic infrastructure for mining activities, and promoting new projects for private investors.

Energy—strategy to increase supply

In Guinea all industrial sectors except mining are still at an embryonic stage. In the energy sector conditions have improved, however, with a sharp increase in the supply of electricity and in the efficiency of the distribution network. But the sector continues to suffer from poor management and from conflicts between the state and its foreign private partners. These conflicts culminated in the departure of the Canadian associates from the electricity company (Sogel) in 2001, much like the departure of the French associates of the water management company (SEEG) in 2000.

This event notwithstanding, the government's strategy is aimed at increasing the energy supply to meet the needs of the national economy. Today, with no proven fossil fuel resources, the country relies on fuel wood for more than 80% of domestic energy needs. In fact, only 16% of the population is connected to the electricity grid. The long-term objective is to make Guinea an electricity exporter, taking advantage of its enormous water resources.

To help meet the investment needs in the energy sector and turn Guinea into a power exporter, the government has developed institutional mechanisms and procedures to enable private partners to invest in infrastructure. Through these mechanisms, major projects have been identified, technical studies carried out, and discussions started with the private partners. Designed to correspond with the development of the mining industry, these projects include the Soapiti dam project, with annual production estimated at 3,496 kilowatt-hours a year.

Manufacturing—growth hits 7%

Manufacturing expanded from 3.5% of GDP in 1986 to 7.75% in 2000, and its annual growth rate rose from 3.2% in 1995 to 7.0% in 2000. This recovery deserves to be consol-

idated by appropriate policies.³ To support growth in manufacturing, the government has adopted a new investment code intended to promote the emergence of a relatively dense network of small- and medium-size enterprises. The most significant investments have been in the production of beverages (beer and soft drinks), building materials (cement), and tobacco and in the small processing and import substitution sector (soap, paint, plastic, sheet metal). These are the main manufacturing activities in Guinea, and they remain concentrated in the capital, Conakry.

Like all other sectors, manufacturing faces several obstacles that hinder its development and performance: The domestic market is weak. Inputs such as water, electricity, and telecommunications are costly, and the supply is irregular and inadequate both in volume and in quality. Deficiencies in administrative services result in long and costly procedures and in the entry of fraudulent imports that compete unfairly with locally manufactured products. And manufacturing firms bear an excessive tax burden because of the widespread tax evasion in the country.

Tourism—needs marketing

Guinea has strong potential for tourism in four distinct regions endowed with a rich variety of animal and plant life and a great diversity of arts and culture. So far, however, the tourism sector has contributed little to the national economy. Attempts to promote tourism have met with less international response than expected. The country attracted only around 17,000 foreign tourists in 1998. According to the Ministry for Tourism and the Hotel Industry, around 98% of hotel clients are business customers.

The weak demand for tourism no doubt reflects the absence of a marketing policy for the sector, the lack of investment, the outdated tourism infrastructure, and the country's post-independence heritage of a policy of self-exclusion. The poor skills of staff in the tourism sector and the inadequacy of basic infrastructure—such as water, electricity, transport, and communications—also discourage tourists.

Transport—hurt by the downturn

In the transport sector the state pursued a policy of disengagement during the 1980s. As a result, rail transport is now limited to the lines serving the mining companies, and shipping and river transport are limited to the main ports of Conakry, Kamar, Kankan, and Siguiri. Air transport is being fully restructured with the establishment of several private airlines.

Land transport, the main mode of transport in the hinterland (representing 95% of traffic), is developing gradually, with steady growth in the fleet of vehicles. But the general economic downturn has greatly hindered the performance of this subsector. Inadequate and in poor condition, road networks cannot cope with the explosion in the number of vehicles in Guinea—a number that grew from 25,000 in 1985 to 91,000 in 1996. Vehicles are 10 years old on average. Road regulations (such as the highway code and rules dealing with technical inspection and transport documents) contain gaps in coverage and are badly implemented. And the transport service sector remains poorly organized.

To support growth in manufacturing, the government adopted a new investment code

“The export sector is poorly diversified and lacks competitiveness”

The contribution of the transport sector to GDP increased between 1995 and 1998. But since then it has been in decline, falling to 1.5% of GDP in 2000 and an estimated 1.0% in 2001.

The government thus faces several challenges in this sector:

- To meet the needs of people for low-cost transport while ensuring acceptable quality.
- To improve road safety and construct and rehabilitate roads.
- To rehabilitate the air transport infrastructure.
- To establish a centre for collecting and recycling wastes from ships at the port of Conakry.
- To privatize the Conakry-Kankan railway line through a concession, as part of an effort to improve links with the hinterland and with neighbouring countries such as Côte d'Ivoire and Mali.
- To improve air transport services by privatizing Air Guinea, which has been losing market share.
- To re-regulate urban transport so as to reduce congestion and pollution.

Telecommunications—progress towards privatization

Inadequate telecommunications services continue to hinder economic development in Guinea. But the country has made progress towards improved services by privatizing the Guinean telecommunications company (Sotelgui) and granting operating licences to three private operators (Interce, Spacetel, and Wireless).

External sector performance—current account deficit down to 1–2%

The Guinean export sector is fragile. It is concentrated in minerals that are particularly sensitive to fluctuations in world markets (especially the two main exports, bauxite and alumina). It is poorly diversified, particularly in agriculture and fisheries. And it lacks competitiveness, particularly in agriculture, relative to the rest of the subregion. The lack of competitiveness stems from the prohibitive costs of inputs (particularly packaging and transport), supply-side constraints on the ability to adapt to changing international demand, and the absence of an entrepreneurial export culture. And all these bottlenecks are linked to the weak business environment, the lack of productive investment, and the inadequate and high-cost infrastructure services.

The trade balance has remained in deficit since 1991. This can be explained in part by the decline in earnings from mineral exports due to the drop in prices and production levels for bauxite and alumina. These two minerals account for more than half the goods exported by Guinea. Exports grew in 1998, mainly because of an increase in gold exports resulting from recent investments in the gold sector.

Imports are equivalent to roughly a quarter of GDP, with food and agricultural products (mostly rice, sugar, and flour) accounting for around 30% of the total (table 8.3). The changing fortunes of mining are reflected in the fluctuating value of machinery and equip-

Table 8.3**Trade in goods, Guinea, 1999**

Product category	Share of total
Exports	
Bauxite	43.9
Alumina	14.5
Gold ^a	14.1
Diamonds	7.6
Fish	6.5
Coffee	5.4
Others ^b	8.0
Total	100.0
Imports	
Food and agricultural products	29.1
Chemicals and plastics	19.4
Machinery and equipment	15.0
Textiles and footwear	8.7
Vehicles	8.3
Metal articles	7.1
Mineral products and fuels	5.7
Others	6.6
Total	100.0

a. Including physical gold exports by the Central Bank.

b. Mainly food products.

Source: IMF 1999; Guinean customs data.

ment imports in recent years and in the recent rise in imports of semi-finished goods destined primarily for the construction industry. The growth in total imports reflects an increase in the volume of intermediary goods and capital, closely linked to investments by the public sector, investments in the mining sector, and growing purchases of petroleum products.

Estimates of the current account deficit vary from one source to another, but both the IMF and Guinean institutions have observed a declining trend over the years. The IMF put the current account deficit at 6.3–7.2% of GDP between 1997 and 1999 and estimated it at 2.9% (including official transfers) in 2000. Official statistics put the current account deficit at 2.1% of GDP in 2000 and an estimated 1.2% in 2001 (table 8.4).

The European Union is the country's main trading partner, accounting for more than 50% of total trade. The United States has been an important client of Guinea since 1995 (mainly for bauxite). Trade with Asia is almost unidirectional, consisting mainly of imports from China and Japan (table 8.5).

“Estimates of the current account deficit vary but show a declining trend”

Table 8.4**Balance of payments, Guinea, 1995–2001**

Item	1995	1996	1997	1998	1999	2000	2001 ^a
Growth in exports of goods, f.o.b. in dollars (percent)	16.9	–6.1	4.0	3.7	–1.7	6.2	11.5
Growth in imports of goods, c.i.f. in dollars (percent)	–7.2	–13.0	–5.5	14.1	–6.5	–11.4	12.4
Ratio of exports to imports (percent)	85.2	96.1	110.4	102.8	116.5	149.9	155.8
Balance on trade account (millions of dollars)	–255.90	–219.66	–96.70	–194.26	–173.36	–67.88	–46.59
Current account, including official transfers (millions of dollars)	–159.17	–218.71	–88.37	–228.62	–182.87	–105.08	–65.17
Current account as a percentage of GDP	–4.3	–5.6	–2.1	–5.2	–3.8	–2.1	–1.2
Total balance (millions of dollars)	–66.64	–81.41	–127.83	–138.72	–69.65	–78.70	34.37
Total balance as a percentage of GDP	–1.8	–2.1	–3.1	–3.1	–1.5	–1.5	0.6
Funding needs (millions of dollars)	0.00	0.00	0.00	0.00	0.00	0.00	1.64

Note: f.o.b. is free on board; c.i.f. is cost, insurance, and freight.

a. Projected.

Source: Economic Commission for Africa from official sources.

Table 8.5**Main trading partners, Guinea, 2000
(percent)**

Source of exports	Share of total	Source of imports	Share of total
Belgium-Luxembourg	16.9	France	17.5
United States	13.0	China (including Hong Kong)	10.3
Russian Federation	9.3	United States	10.2
Spain	9.1	Côte d'Ivoire	7.9

Source: IMF 2000.

Although some trade is developing with countries in the subregion, particularly Côte d'Ivoire, Nigeria, and Senegal, it remains insignificant. Further growth in trade will depend on the development of lower-cost transport through the establishment of road, rail, sea-port, and airport networks.

Foreign debt—serious management difficulties

The Guinean government has undertaken sizable investments in support of its socio-economic objectives, financed largely by concessionary credits from external partners. The development of basic infrastructure (roads, water, electricity, communications) and agriculture was accompanied by a substantial increase in debt. In 1995 the country's external debt amounted to \$2.9 billion, and in 1999 to \$3.4 billion (table 8.6). Despite the concessionary nature of the loans and the debt rescheduling negotiated with the Paris Club of bilateral creditors, the country faced serious difficulties in managing its debt.

In recognition of the government's reform efforts, Guinea was declared eligible for the HIPC initiative in 1999 by the executive boards of the IMF and the World Bank. A debt rescheduling agreement reached in 1997 with the Paris Club had already cancelled 50% of Guinea's debt and authorized the country to convert up to 20% of outstanding arrears into local currency equity for investment in development projects. A similar agreement followed in 2001. The debt relief under the HIPC initiative has helped to finance the country's poverty reduction strategy.

“The development of basic infrastructure and agriculture was accompanied by a substantial increase in debt”

Trade policy—rejoining the global economy

The government's new liberalization policy, laid out in the Economic and Financial Reforms Programme, aims to help reintegrate the country with the global trading system after a quarter century of socialism. In the long run the policy is expected to make the Guinean economy internationally competitive and to enable the country to accumulate external reserves to cope with the difficulties typical for countries relying on exports of one or two primary commodities.

Table 8.6
External debt, Guinea, 1995–2001

Category	1995	1996	1997	1998	1999	2000	2001 ^a
Debt service							
(millions of dollars)	139.89	128.31	118.47	95.73	106.45	105.24	111.50
Debt service as a							
percentage of exports of							
goods and services	18.5	17.7	16.1	12.6	14.2	13.5	13.1
Total debt							
(millions of dollars)	2,875.88	3,195.80	3,120.10	3,261.20	3,376.00	3,442.50	3,564.33
Total debt as a							
percentage of GDP	79.2	81.6	68.5	59.6	51.1	37.7	33.0

a. Projected.

Source: Economic Commission for Africa from official sources.

“One important step has been to enhance the flexibility and transparency of exchange operations”

One important step towards these goals has been to enhance the flexibility and transparency of exchange operations. The government has done so by limiting the involvement of the Central Bank in the exchange market (by eliminating short-term fluctuations) and by encouraging transactions on the foreign currency auction market.

Guinea still lacks a coherent policy on international trade, however. Responsibility for international trade policy lies with the Ministry of Private Sector Development, Industry, and Trade. Although the ministry has a Directorate of Trade and Competition, which is responsible for evaluating and planning trade policy, there is confusion about the relative priority of domestic trade and international trade. In fact, formulating trade policy seems to be the de facto responsibility of other ministries dealing with export sectors, particularly minerals, agriculture, and fisheries.

To increase the coherence of international trade policy, a ministry with exclusive responsibility for trade ought to be created. Within this ministry could be established a directorate of domestic trade, a directorate of international trade, and a competition and monopoly commission.

International trade policies have been limited to developing knowledge on World Trade Organization agreements and follow-up capacity, developing entrepreneurial skills in exports, and improving the conditions for moving goods across borders. But only the last policy issue has received much attention from the government, which has focused on eliminating or harmonizing tariffs on trade with neighbouring countries and streamlining customs procedures at ports and airports.

Fiscal policy—diversifying the tax base

The government's fiscal policy goals are to increase revenue collection and ensure optimal allocation of public revenue, with the aim of reducing poverty and dependence on foreign aid. In 1997 the government adopted a medium-term expenditure framework aimed at enhancing efficiency and ensuring that resource allocation is consistent with strategic priorities.

Developing the medium-term expenditure framework involves several stages. These include identifying medium-term strategic objectives, translating these objectives into sectoral programmes, estimating programme costs, and establishing a binding medium-term budget ceiling for each sector that reflects the priorities established. Based on the priority programmes, the annual fiscal budget is then prepared by the National Budget Planning Division and presented to the National Assembly for approval.

In the past fiscal revenue has come primarily from mining. To diversify the tax base, the government decided to increase non-mining revenue from around 7.8% of GDP in 1999 to 9.2% in 2001 and around 10.0% in 2002. To do so, it eliminated all value added tax exemptions and introduced a quota system for tax-exempt imports, among other measures.

On the expenditure side, all spending categories have been declining as a percentage of GDP. Moreover, public consumption of goods and services has fallen in absolute terms. This trend largely reflects the shrinking role of the state in economic activities and is

expected to continue. The exception is spending on social programmes, which is expected to increase as HIPC debt relief is channelled to poverty reduction programmes.

The government intends to maintain a primary surplus sufficient to service public debt without further borrowing. The hope is that this policy will shift private investment away from government debt and towards productive activities, and increase liquidity in the domestic banking system to support private sector initiatives. The authorities planned to raise the primary surplus to 3.0% of GDP by 2001, up slightly from around 2.4% in 1999 and 2.7% in 2000. However, the surplus forecast for 2001 was only around 1.5%.

The budget deficit has remained relatively stable at around 3.0% since 1995 (except for a 0.7% deficit in 1998). The government relies on foreign sources to finance much of this deficit (around two-thirds). Table 8.7 gives an overview of central government finances in 1999.

The government has undertaken a number of reforms to improve expenditure management. These reforms have led to regular production of a consolidated balance of the Treasury and regular auditing of the budget to ensure strict enforcement of budgetary procedures. In addition, coordination among ministries is to be improved to ensure the collection of coherent budgetary data; this should also increase transparency and expand the flow of information for administrative purposes. If fully implemented, these reforms should ensure better expenditure management.

Beyond these measures, the government should also continue to consolidate public finances and ensure that medium-term expenditures benefit the poor. This means giving priority not only to improving revenue mobilization and expenditure management but also to significantly increasing budgetary allocations to the sectors most critical to most of the people, such as health, education, and rural development.

“The government intends to maintain a surplus sufficient to service public debt without further borrowing”

Table 8.7

Central government finances, Guinea, 1999
(billions of Guinean francs)

Item	Amount
Total revenue and grants	628.3
Tax revenue	484.4
Non-tax revenue	32.8
Grants	111.1
Total expenditure	773.3
Current expenditure	429.5
Capital expenditure	343.9
Balance on a commitment basis (including grants)	-145.0
Change in external arrears	-3.8
Change in domestic arrears	0.04
Balance on a cash basis	-148.4

Source: Economic Commission for Africa from official sources.

Financial sector performance and monetary policy—inflation held to single digits

“ **Reforms have increased public confidence in the banking sector** ”

Guinea's financial system remains rudimentary. It consists of the Central Bank, seven deposit taking banks, four insurance companies, a social security institution, two small co-operative banks, and some 50 exchange bureaux (table 8.8). Banking activity is concentrated in Conakry.

Recent banking reforms have been aimed at restructuring the sector and strengthening regulatory and supervisory capacity. Several insolvent banks have been liquidated, and some have undergone reorganization of their management, followed by recapitalization with government support. The government has also established micro-finance institutions to broaden access to savings and credit (box 8.1).

These reforms have increased public confidence in the banking sector, as clearly indicated by the steady growth in demand deposits. Moreover, banks are moving into new activities; while banks earlier provided loans mainly for short-term operations and for trade (rather than investment), they are now granting medium-term loans for activities other than trade (EIU 2001). Banks still suffer from institutional and structural problems, however, as evidenced by the high level of non-performing loans and low levels of loan recovery.

The Central Bank formulates and implements monetary and financial policies. But it cannot claim autonomy, as it is effectively under the control of the government and, even more so, the party in power.

Monetary policy has been aimed primarily at controlling inflation and maintaining exchange rate stability. Nonetheless, the Central Bank's monetary and financial policies are also used as a means of achieving the government's broad macroeconomic policy objectives. These include:

- Achieving GDP growth of more than 4% (5.5% is one target).
- Keeping the budget deficit (excluding official transfers) to 6% of GDP.
- Maintaining inflation at an average of 4%.
- Increasing the money supply (M2) to 10% of GDP.
- Maintaining a stable exchange rate between the Guinean franc and the major currencies used in foreign currency transactions (the U.S. dollar and the French franc).
- Eliminating the divergence between the official and unofficial exchange rates.

For the past 10 years the Central Bank has managed to keep inflation to single digits by pursuing a tight monetary policy. In 1996–2000 the inflation rate averaged 4.3% a year, largely reflecting the small price increases for basic essentials, particularly rice. Some analysts doubt the validity of the government's inflation figures, however (EIU 2001).

Guinea has maintained a floating exchange rate regime since 1994, though the official rate has been controlled from time to time. As a result, there is a thriving parallel foreign exchange market, where the difference between the official rate and that offered by the

Table 8.8
Commercial banks, Guinea, 1998

Bank	Capital (billions of Guinean francs)	Main foreign shareholders	Market share (percentage of deposits)	Number of branches (regional + Conakry)
Banque Internationale pour le Commerce et L'Industrie de la Guinée (BiciGui)	11.2	Banque Nationale de Paris, Caisse Française de Développement ^a , International Finance Corporation, and Deutsche Investitions und Entwicklungsgesellschaft	40	3 + 9
Société Générale de Banques en Guinée (SGBG)	3.9	Société Générale (France), Crédit Suisse (Switzerland)	25	1 + 1
Union Internationale de Banque en Guinée (UIBG)	2.0	Crédit Lyonnais (France)	15	1
Banque Internationale pour L'Afrique en Guinée (BIAG)	1.6	Belgolaise (Belgium)	11	1
Banque Islamique de Guinée (BIG)	4.5	Dar Al-Maal Al-Islami Trust (Bahrain) and Islamic Development Bank	3	1
Banque Populaire Maroc-Guinéenne (BPMG)	2.7	Banque Centrale Populaire (Morocco)	6	1

a. Now Agence Française de Développement.

Source: EIU 2001.

exchange bureaux ranges from 5% to 10%. In 1999 the Central Bank introduced a foreign exchange auction system in an attempt to unify the rates.

Beyond the main monetary policy objectives of maintaining price and exchange rate stability, the government should also focus on managing public debt, particularly foreign debt. The priorities should be avoiding excessive accumulation of debt after the debt relief through the HIPC initiative and attracting foreign direct investment. Guinea has lagged behind the rest of Africa in foreign direct investment. While it received investment equivalent to 1.14% of GDP in 1997, 0.78% in 1998, and 1.05% in 1999, the averages for Sub-Saharan Africa (excluding Nigeria and South Africa) in those years were 2.10%, 2.76%, and 3.47%.

Box 8.1**Micro-finance in Guinea**

To extend financial services to the many poor Guineans who lack access to formal credit, the government decided to establish micro-finance institutions with the support of donors. By 2001 Guinea had four micro-finance institutions. These decentralized institutions collect savings and distribute loans from internal and external resources (savings deposits, gifts, and subsidies). Their activities grew steadily throughout the 1990s (see table).

Micro-finance activity, Guinea, 1991–99

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bank	65	77	99	114	122	122	117	125	139
Non-bank corporations	30,180	43,218	63,857	84,810	108,546	117,304	119,190	130,048	117,795
Savings (millions of dollars)	1,160	3,227	7,493	7,748	14,175	9,263	9,546	10,302	11,359
Loans (millions of dollars)	1,169	1,951	3,114	4,974	7,774	6,329	6,728	7,057	6,887

Source: Calculations based on data from the Guinean Central Bank.

Crédit Rural de Guinée

Established in 1988 as a three-year experimental rural credit project, Crédit Rural de Guinée relies on group guarantees and social pressure from villagers to ensure repayment of loans. For medium-term loans, it also demands individual collateral and guarantees. The institution has received financial support from Caisse Française de Coopération (which later became Agence Française de Développement, the French development agency), and management and technical assistance from the Institute for Research and Application of Development Methods.

Crédit Mutuelle de Guinea

Crédit Mutuelle de Guinea (CMG) was also established in 1988 as an experimental project, with support from the French International Centre for Mutual Credit. CMG began by building up funds—30% from the agricultural sector and 50% from other sectors—and then moved on to granting loans.

CMG succeeded in establishing a network of banks. But the rapid development of the network led to serious management difficulties, caused mainly by a lack of skilled staff, unreliable procedures, and poor loan recovery. To address these problems, the Ministry of Agriculture, the Central Bank, and CMG's funding agencies drew up a plan for restructuring the network. But the rescue mission failed, and CMG became bankrupt in 2001.

Integrated Enterprise Development Programme

The Integrated Enterprise Development Programme (PRIDE) was set up in 1991 as a non-governmental organization funded by the U.S. Agency for International Development. Its operations are carried out by two U.S. non-governmental organizations: the Council for International Development and Volunteers in Technical Assistance.

PRIDE provides business training, grants loans to small informal sector businesses (retail trading, handicrafts, restaurants), and supports private sector development through information, education, and communication. Its lending approach, modelled on the practices of the Grameen Bank of Bangladesh, relies on group guarantees.

People's Savings and Credit Bank of Conakry

The Guinean government started developing the People's Savings and Credit Bank of Conakry in 1997 in cooperation with the Canadian International Development Agency (CIDA). This network of 15 savings banks in Conakry and its environs receives technical assistance from CIDA.

Human development—reviewing the debate

In 1992, 1993, and 1994 Guinea ranked last in the human development index published by the United Nations Development Programme (UNDP). In the most recent ranking it placed 150th out of 162 countries (UNDP, *Human Development Report* 2001). This poor performance prompted a renewed human development debate in the country. With the help of external partners, mainly the UNDP and the Canadian International Development Agency, the government held a series of discussions and consultations with civil society that resulted in the National Human Development Programme. This programme aims to put people at the centre of the development process by making improvement of their welfare and quality of life the ultimate objective.

“Guinea faces significant human development challenges”

Guinea faces significant human development challenges. Population projections suggest that growth will follow a rising trend from 1983 to around 2008, with the population expected to double from 4.7 million to 9–11 million. Thus the demand for social services will increase tremendously in an already difficult social and economic environment.

Today the social environment is marked by high unemployment, inadequate health and education systems, and issues relating to youth, gender, and vulnerability. Around 53% of the population is of working age (15–64 years old). The employment rate for the economy as a whole is 80%, according to 1991 estimates, with employment concentrated in the rural sector (73%), followed by the informal sector (15%) and the modern sector (12%). Unemployment continues to increase among graduates of universities and professional schools. This high unemployment rate reflects the slow creation of jobs in the modern sector and the mismatch between training and the needs of the labour market.

Population—youthful

Estimates based on data from the most recent general census put the population of Guinea at around 7.2 million in 1999. The annual population growth rate is estimated at 2.3%. The population is unevenly distributed. While the average population density is 29.4 inhabitants per square kilometre for the country as a whole, it ranges from 14.2 in Upper Guinée to 2,429 in Conakry, home to more than half the urban population. Around 68% of the population lives in rural areas.

The Guinean population is extremely young, with around 45% under age 15. This young age structure reflects the fertility rate, which has remained high despite family planning and reproductive health programmes. The fertility rate is 5.41 births per woman, slightly lower than the average of 5.68 for Sub-Saharan Africa (excluding Nigeria and South Africa). The mortality rate is also high, estimated at 18.4%, but has been on a downward trend from the 22.4% in 1990. Average life expectancy at birth was recently estimated at 44 years (compared with 47 for Sub-Saharan Africa) and has been steadily increasing.

There are large internal migratory movements in Guinea, but international migration remains limited despite the opening of the country in 1984. However, Guinea received an inflow of around half a million refugees from neighbouring Guinea-Bissau, Liberia, and Sierra Leone following the outbreak of armed conflicts in these countries. In addition,

“
The net primary
enrolment rate was
68% in 1999, yet only
40% for girls
”

Guinean nationals who fled the country during the socialist regime began to return as a result of the political and military conflicts in those countries as well as Côte d'Ivoire.

Guinea pursued a pro-birth population policy during the first 20 years of independence, consistent with its socialist orientation. Since 1980, however, the government has changed its stance, having realized that it could not continue to ignore the population aspects of development. In 1992 it set up an interministerial group of population experts to work towards the adoption of a national population policy. The result was a policy aimed at controlling fertility and migration and reducing infant and maternal mortality. Its implementation was entrusted to the National Commission on Population and Human Resources, as well as to donors and non-governmental organizations, through a policy framework prepared in 1996.

Education—more resources for primary schooling

While education reform has achieved appreciable results in Guinea, enrolment rates are still among the lowest in the region. Gross primary enrolment rose from 31.9% in 1991 to 56.0% in 2000. But while the enrolment rate for boys increased from 49.0% in 1991 to 69.7% in 2000, the rate for girls rose only from 23.2% to 44.3%. The net primary enrolment rate was 68% in 1999, yet only 40% for girls.

These trends need to be viewed against the steady decline in public spending on education in Guinea. Education spending fell from 2.14% of GNP in 1991 to 1.90% in 1997 (UNESCO 1999), and in real terms it declined from \$70.0 million in 1995 to around \$55.9 million in 2000. In that year 64% of the budget went to pre-university education, 26% to higher education and scientific research, and 10% to technical and professional education.

How does the quality of education measure up? Judged by the pupil-teacher ratio in primary schools, it is not satisfactory: at around 46 pupils per teacher, the ratio is markedly higher than the average for Sub-Saharan Africa (excluding South Africa), which is around 38. Moreover, the adult literacy rate is estimated at only 36% (UNESCO 1995).

Thus much remains to be done to improve the education of the Guinean population. Despite the government's efforts, the education sector still faces many constraints, including inadequate infrastructure, shortages of teaching and supervisory staff, a lack of teaching materials, and financial barriers preventing the poor from obtaining an education. In addition, the country's second chance education programme needs to be extended to illiterate adults.

The government plans to speed the development of the education sector by providing adequate resources for improving primary education through a 10-year universal primary education programme. It also seeks to improve the quality of education by providing school materials, aiming for speedy recruitment and continuous training of teachers, and taking measures to improve the health and nutrition of students.

In technical education and professional training, the policy focus should be on adapting the educational content to the needs of the job market. Public authorities have identified three main efforts for developing the country's human resources and promoting

sustained economic growth: improving the practical and professional skills of skilled and unskilled workers who have completed primary education, training senior professional staff in the use of advanced technologies, and providing for apprenticeships, continuous training, and retraining of workers, including those in the informal sector.

Health—expanding basic programmes

The Guinean government has made health a primary concern, implementing extensive programmes to improve vaccination rates, primary health care, and access to essential drugs since 1996. These programmes have achieved encouraging results. But the health sector still faces many challenges. Health services are insufficient and of low quality, and geographic coverage is poor. Medical staff (doctors and midwives) are concentrated in Lower Guinea, especially Conakry, leaving the rest of the country underserved. The pervasive poverty means that a large share of the population has difficulty obtaining health services. Major health problems remain, such as malaria, HIV/AIDS, and water-borne diseases. Food shortages are also a serious problem. A 1991 survey by the *Projet d'Appui au Développement Socio-Economique* (PADSE, a project supporting social and economic development) found that 30.5% of children under five suffered from chronic malnutrition, and an estimated 11.3% from acute malnutrition.

Even so, population and health surveys in 1992 and 1999 showed favourable trends in health, particularly maternal and child health. According to these surveys, the infant mortality rate fell from 138 per 1,000 live births in 1991 to 118 in 1998—though this is still markedly higher than the average of 91 for Sub-Saharan Africa. The child mortality rate (ages 1–4) fell from 229 per 1,000 in 1990 to 184 in 1998; this rate too is markedly higher than the Sub-Saharan average, by a full 3 percentage points. The estimated maternal mortality ratio for 1992–99 was 528 per 100,000 live births. Although this ratio is lower than those in several other African countries, it is higher than the estimated rates in such countries as Morocco, Namibia, and Zimbabwe. The HIV/AIDS infection rate, while high compared with rates in some Sub-Saharan countries, is still relatively low at around 1.5% of the adult population (WHO 2000).

To ensure all Guineans access to quality health care, the government will need to act in earnest. The national health policy should emphasize strengthening the fight against the major diseases, increasing the access of poor people to basic health services, and improving the supply and distribution of essential drugs. To achieve these goals, the government will need to increase its allocation of resources to health and expand its participation in financing primary health care. Important steps to increase efficiency would include decentralizing the health care system and budget allocations and improving the management of financial and human resources. Also crucial is to develop new sources of funding for the sector, such as by strengthening public-private cooperation and improving the complementarity of the public and private sectors.

Medium-term outlook—policy coherence needed

Despite the major social, economic, and institutional reforms in Guinea in 1995–2000, the living standards of most people did not improve significantly. The country's failure to trans-

“*Extensive programmes to improve vaccination rates, primary health care, and access to essential drugs have achieved encouraging results*”

“Failure to transform its human and natural resources into opportunities has kept its people in extreme poverty”

form its human and natural resources into opportunities has kept its people in extreme poverty. To strengthen its efforts against poverty, the government prepared a poverty reduction strategy paper in June 2001 to serve as a general framework for coordinating its economic policies and the efforts of its external partners. The policy focuses on three main areas: increasing economic growth and creating employment and income earning opportunities for poor people, providing equal access to basic services and improving governance, and strengthening institutional and human capacities.

For the medium term the government is concentrating on promoting macroeconomic stability and speeding broad-based growth for the benefit of poor people. The main sources of this growth will be agriculture, fishing, mining, and livestock production. Policies will also aim at diversifying production and exports and creating a favourable environment for private sector development.

The government's medium-term goals include achieving average GDP growth of 5.5% in 2001–04, reducing inflation to 2.8% in 2004, and raising international reserves to the equivalent of 3.5 months of imports. The fiscal deficit based on commitments made (including grants) is expected to decline from 2.9% of GDP in 2000 to 1.3% in 2004. This projection includes the additional spending on poverty reduction initiatives, financed in part through the debt relief under the HIPC initiative.

The Guinean government appears to be committed to development. It has taken the political steps towards reform and laid out ambitious economic reform programmes. But no clear thread runs through all the reform attempts, resulting in confusion and a lack of coherence.

In several areas the roles that ministries are to play in the reform process have been poorly defined. Ministries end up having competing policy mandates and no clear picture of where they should focus their attention. In addition, the political environment may well have led foreign investors to look elsewhere for investment opportunities. Frequent reshuffling of the cabinet, the 1996 mutiny of the armed forces, and attempts to amend the constitution to allow indefinite re-election of the president have created an environment that is deemed untrustworthy. Border skirmishes between Guinea and its neighbours have done little to increase the confidence of foreign investors. This political setting has taken its toll on the country's economic performance.

The government has realized that the economy is too dependent on the mining sector and should be diversified, but doing so has proved more difficult than expected. At the same time, many sectors are underutilized and lack the necessary infrastructure. Although Guinea could well be a net exporter of fish, for example, it is now a net importer—no doubt owing to the lack of investment and infrastructure in the fisheries sector.

The education and health sectors are still lagging. The government is cutting spending on education at a time that indicators suggest that Guinea should take measures to increase access to education. While evidence suggests that investing in education fosters growth, Guinea's primary enrolment rate is dismally low.

But policy-makers are not entirely to blame for the weak economic performance. Some factors are clearly beyond their control. The low growth rate in 2000—a mere 1.1% when the target rate was around 5%—may be due in part to the deteriorating security situation and the overreliance on mining, a sector vulnerable to volatile world prices. Nevertheless, to deliver the fundamentals required to achieve growth and thus advance on the path towards prosperity for the Guinean people, the government needs to tackle the problems of unclear priorities and lack of coherence in its reform agenda.

“The government needs to tackle the problems of unclear priorities and lack of coherence in its reform agenda”

Notes

1. The growth rate reported for 2000 varies from one source to another. Official Guinean statistics put the rate at 1.1%. The Economist Intelligence Unit estimates it at around 1.8% (EUI 2001). The figures in this chapter are based largely on World Bank (2001), EUI (2001), and official government publications.

2. The declining trend in the contribution of mining to GDP largely reflects the diversification of the economy rather than the fall in bauxite production and in the world price of aluminium, whose production is already very low in Guinea.

3. An investment forum organized in 1998 with support from the United Nations Industrial Development Organization (UNIDO) attested to the resumption of industrial activities and prepared the way for possible foreign partners.

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