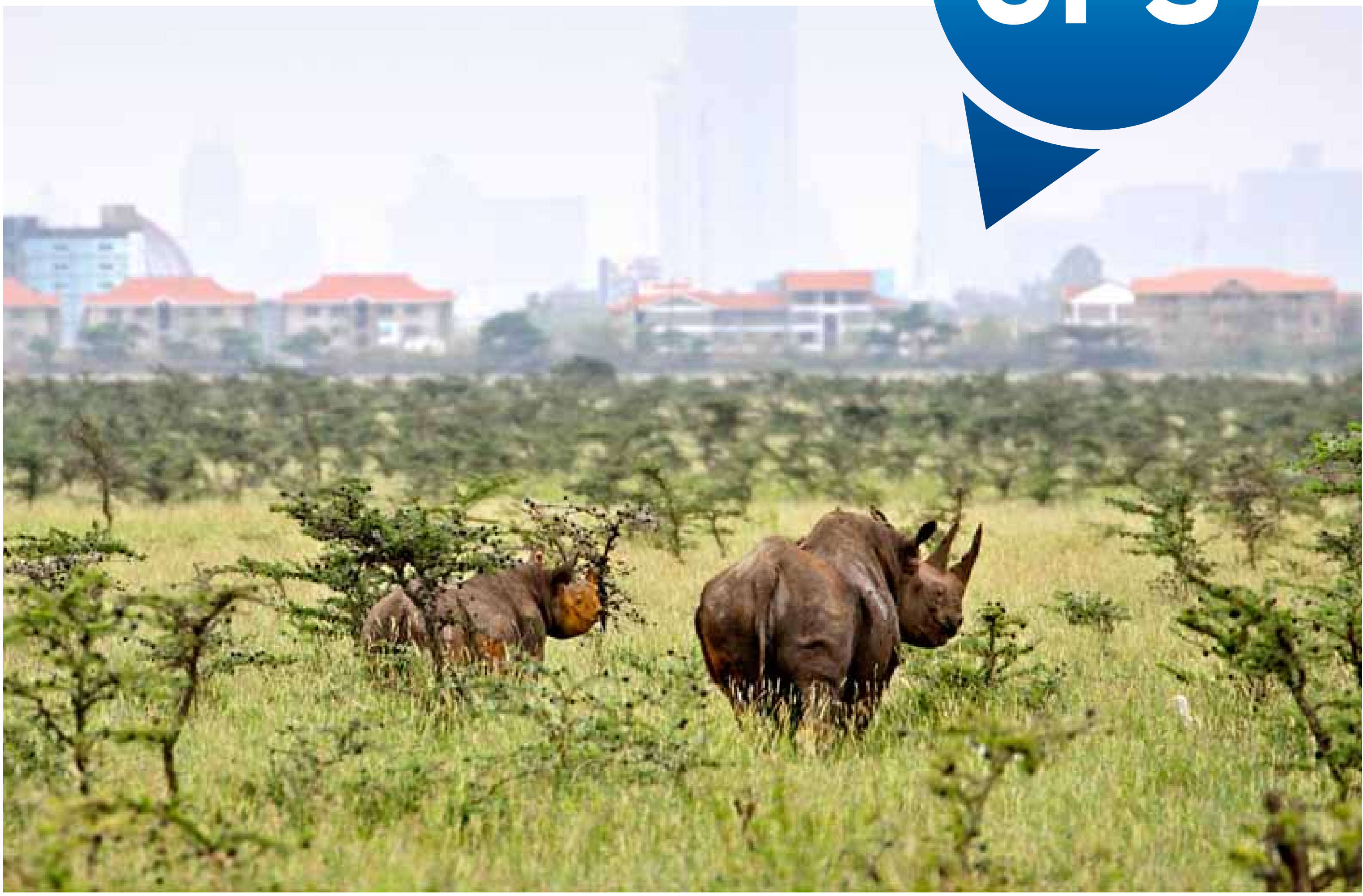


SUB-SAHARAN AFRICA

The Route to Transformative Growth

Citi GPS: Global Perspectives & Solutions

6 September 2012

David Cowan

David Cowan
+44-20-7986-3285
david.cowan@citi.com

David Cowan is currently a Managing Director at Citi and the economist responsible for the bank's economic research on Africa.

Prior to joining Citi in 2007, Mr Cowan held two posts at the Economist Intelligence Unit in London for a total of eight years. As Senior Economist for Africa he was responsible for their coverage of Ghana, Nigeria, Tanzania, Zambia and Zimbabwe and also the overall forecast for Sub-Saharan Africa. He then moved on to serve as Director of the Middle East and North Africa team, leading the coverage of Egypt and Morocco.

Prior to joining the Economist Intelligence Unit Mr Cowan worked for six years as Principal Research Officer at the Bank of Botswana, the country's central bank. During his time at the bank he co-edited a book, *Aspects of the Economy of Botswana: Selected Papers* (published by James Currey and Lentswe la Lesedi with J.S. Salkin, D. Mpabanga, J. Selwe and M. Wright). He also worked for three years for the Economic Research Unit of the Saudi Arabian Ministry of Foreign Affairs.

During his working career Mr Cowan has built up a wide ranging knowledge of financial and foreign exchange markets in Africa, global oil markets and the problems of maximising the benefits of natural resources in African countries.

Much of Mr Cowan's primary education was in various African countries, including Swaziland and Sierra Leone, but he completed his secondary education in Hong Kong. He has a first degree in economics from the University of Bath and a PhD from the University of London. This examined the impact of Tanzania's structural adjustment programmes from the mid-1980s to the early 1990s.

SUB-SAHARAN AFRICA

The Route to Transformative Growth

The potential for economic growth in Sub-Saharan Africa (SSA) is enormous given the continent's positive demographics and the abundance of natural resources, but historically, infrastructure, political and policy challenges have stood in the way. Without question, there has been a sharp pick up in real GDP growth in the region in the 2000s compared to the previous two decades, when SSA was often seen as a development disaster. This pick-up has led to a marked change in how many investors think about SSA, and has facilitated a switch from decades of Afro-pessimism to the new wave of Afro-optimism.

To give an idea of the potential impact of growth, Citi's February 2011 long-term growth projection paper, *Global Growth Generators: Moving Beyond 'Emerging Markets' and 'BRIC'*[1], argued that Africa could move from accounting for only 4% of world GDP in 2010 to 7% by 2040 and 12% by 2050. In this new report we examine in much greater depth the prospects for growth in SSA and ask what steps need to be taken to generate truly transformational development that can unlock the potential of the continent's demographic and resources dividend. Critically, to unlock the full potential policymakers must find a path from the current growth model to one which achieves greater global economic integration.

Clearly the rise in global commodity prices has played an important role in the growth pick-up throughout the 2000s in SSA, but we show that commodities have only made up about a third of the overall increase. In order to continue the growth trajectory of the past, a focus on the other two thirds of the growth story — improved political stability, better economic policy and a new wave of investment into SSA by corporates — is required.

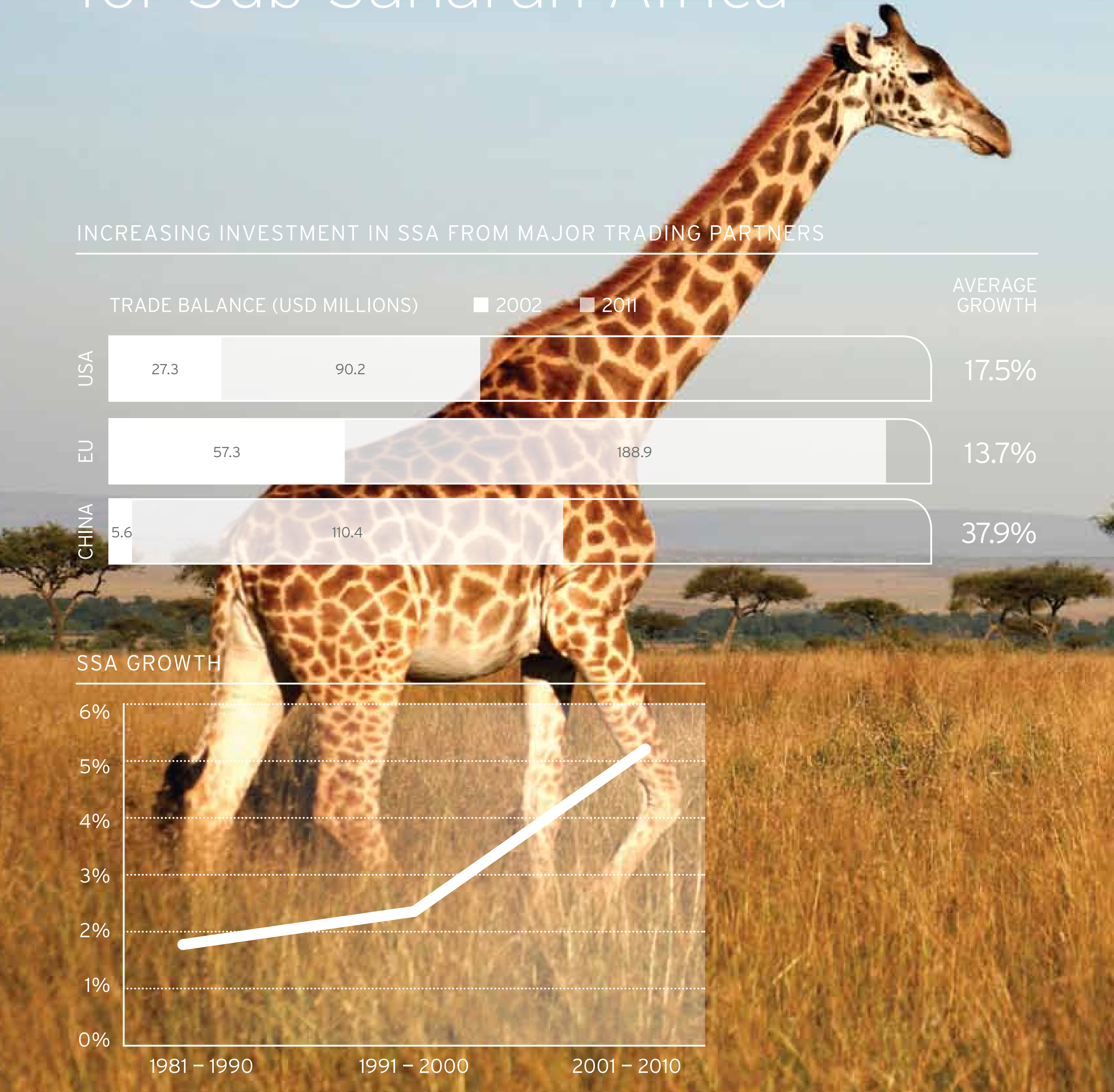
There is unlikely to be any one standard "off the shelf" model of growth that a typical SSA country can follow in the coming decades. Looking at a combination of a country's demographics, political and economic heritage, plus its resource endowment, provides a base of a framework for development models. Increased economic integration could be obtained through the expansion of the service sector, revisiting manufacturing or agriculture potential, or encouraging an effective development state which supports economic growth, provides public services and reduces poverty.

Inward-looking economies with large populations and domestic markets could provide us with a "new big five" in SSA — Democratic Republic of Congo (DRC), Ethiopia, Nigeria, Sudan and Tanzania. Countries that are "coastal outward lookers" have smaller domestic markets but better education levels and infrastructure which gives them the potential to develop a significant manufacturing export business. For countries that have the infrastructure constraint of being landlocked then regional market trade could provide the best means for economic growth.

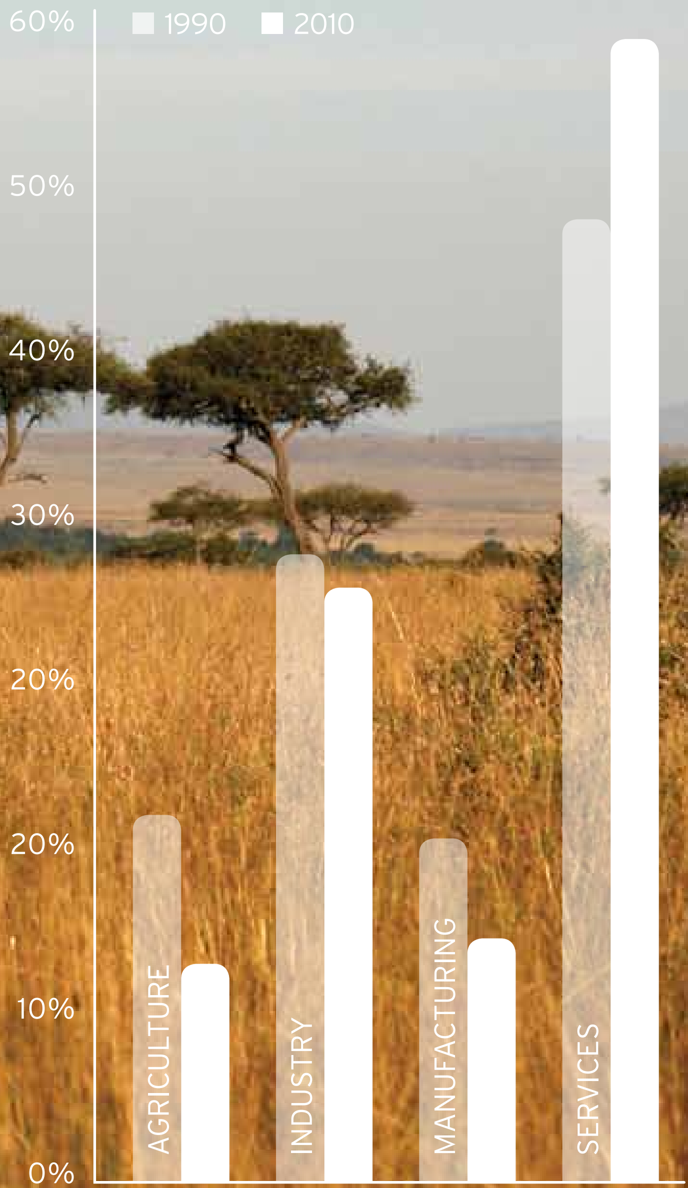
In the end the real challenge for SSA policymakers is to make more fundamental decisions around infrastructure investment and improve the business operating environment, as well as to develop a much clearer and more coherent picture about where their particular country fits into the global economy in the future. We think this will be necessary to encourage truly transformative growth that will drive the integration of SSA into the global economy.

[1] For a more detailed look at this, see Citi Economics, Global Growth Generators; Moving Beyond "Emerging Markets" and "BRIC" by Willem Buiter and Ebrahim Rahbari.

Looking at the Growth Picture for Sub-Saharan Africa



STRUCTURE OF THE SSA ECONOMY



AFRICA AS A % OF WORLD GDP

2010

AFRICA	4%
W. EUROPE	19%
N. AMERICA	22%
ROW	21%
DEV. ASIA	27%
JAPAN/AUS/NZ	7%

2030 est.

AFRICA	7%
W. EUROPE	11%
N. AMERICA	15%
ROW	19%
DEV. ASIA	44%
JAPAN/AUS/NZ	4%

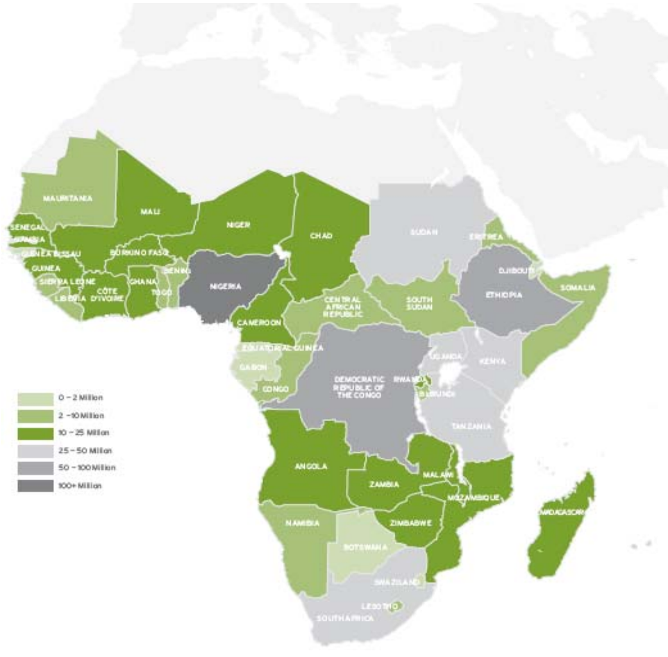
2050 est.

AFRICA	12%
W. EUROPE	7%
N. AMERICA	11%
ROW	18%
DEV. ASIA	49%
JAPAN/AUS/NZ	3%

Contents

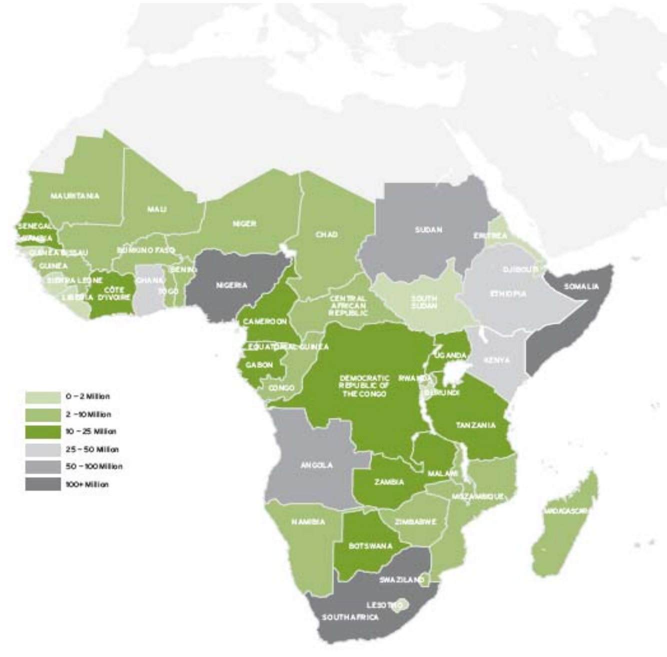
SSA at a glance

Figure 1. Sub-Saharan Africa population



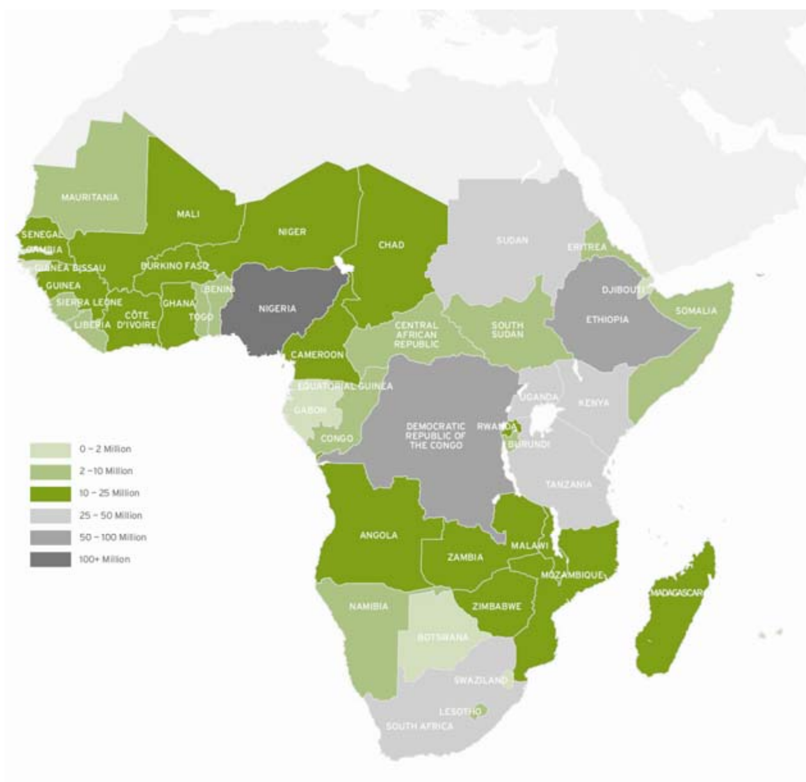
Source: World Bank, Citi Research

Figure 2. Sub-Saharan Africa GDP



Source: World Bank, Citi Research

Figure 3. Distribution of FDI flows, by range, 2011



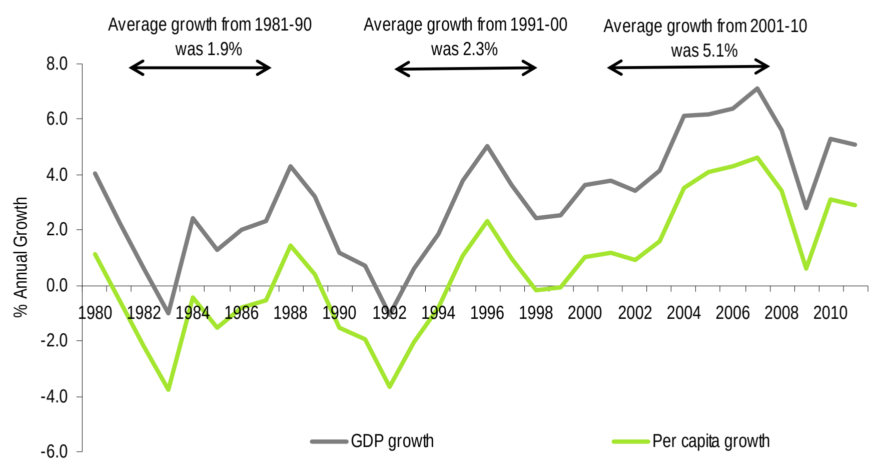
Source: World Bank, Citi Research

The basic drivers of the growth story of the last decade

Sub-Saharan Africa is geographically the area in Africa south of the Sahara Desert and generally excludes the Arab states of North Africa (Algeria, Egypt, Libya, Morocco, Tunisia and West Sahara)

There has been much hype about the pick up in growth in SSA in the last decade, with a majority of this driven by promotion of the subcontinent as the newest frontier market. For many reasons this is obvious. In an increasingly globalised world where investing in many of the large emerging markets throughout Asia and Latin America is now considered mainstream, SSA represents the final investing frontier. The problem, however, is that much of the analysis provided, and many an investor, has viewed the pick up in growth in an over-simplistic way — one in which growth has been solely driven by rising commodity prices. Viewed in this light, investment in the sub-region is largely seen as a commodity play by most of the investment community.

Figure 4. There has been a clear pick up in growth since the mid-1990s



Source: Haver Analytics from the World Bank and IMF

Commodity story has played in important role…

The reality, we think, is much more complicated. It cannot be denied that the commodity story has played an important role in the growth pick up in SSA in the 2000s. High global commodity prices have created a significant terms of trade gain for some countries, in particular for SSA's eight major oil exporters. This is evidenced by the fact that the growth rate for oil exporters in the SSA has been higher than that for SSA as a whole. The reality, however, is that this aggregate hides as many issues as it highlights.

…but improved political stability & economic policy plus new investment and a catch-up in growth are also drivers

Although commodities are, and will be for the foreseeable future, a major driver of growth in the region, we have identified four additional factors that also stand out as important drivers: improved political stability; improved economic policy; a new wave of investment into SSA by corporates; and catch-up growth from a low base.

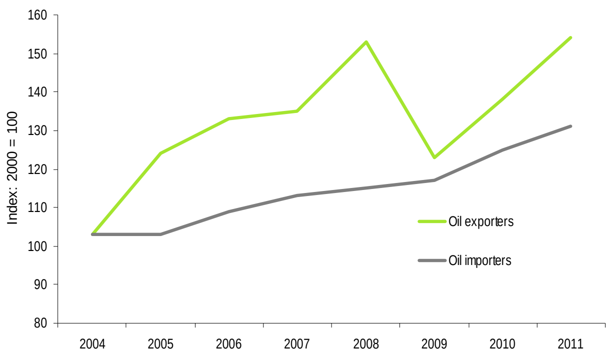
The commodity conundrum

High oil prices not always the key to pushing GDP growth

Understanding the link between the commodity story and growth is not easy. Generally, the key to pushing up GDP growth is growth in commodity production, not higher prices. Instead, higher commodity prices generally feed into growth indirectly, either by increasing government revenue[2], or crucially in some cases, by increasing export earnings and limiting the balance of payments constraint on growth. In effect, rising commodity prices are a positive terms of trade shock for an exporting country.

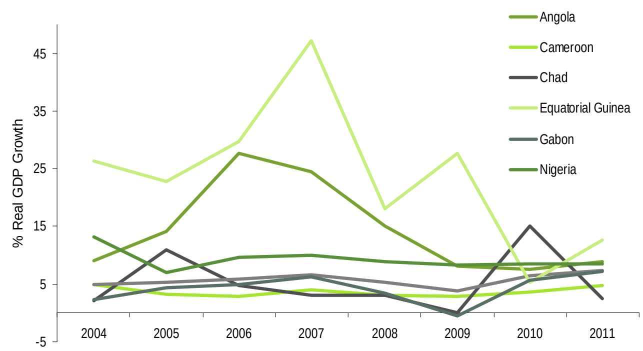
These broad trends are clear for SSA's oil exporting countries where the aggregate GDP growth rate has been pushed up sharply by exceptionally strong growth in a limited number of countries on the back of sharp increases in production, led by Angola and Equatorial Guinea. For many others, notably within the Franc zone, and best exemplified by Gabon, the impact of high oil prices on growth has been much more limited.

Figure 5. The terms of trade gain has been significant for some countries in SSA



Source: IMF

Figure 6. High oil prices can produce very different growth performances for oil producers



Source: IMF

Commodities can help growth if you avoid the resource curse

But even this pattern is not always clear. In the case of SSA's largest oil exporting country, Nigeria, growth has risen to among one of the highest in the sub-group of oil exporters, but this has been alongside virtually stagnant oil production. It is worth emphasizing how much Nigerian growth in the 2000s represents a market break when compared to its long-term average. For the 20 years from 1981-1999, growth in Nigeria averaged only 3% per annum and in many ways it was the "poster child" used to highlight the problems of the resource curse. However, in the 2000s Nigerian growth has averaged 6.6% per annum. Moreover, and crucially, for much of this period, oil production effectively stagnated.

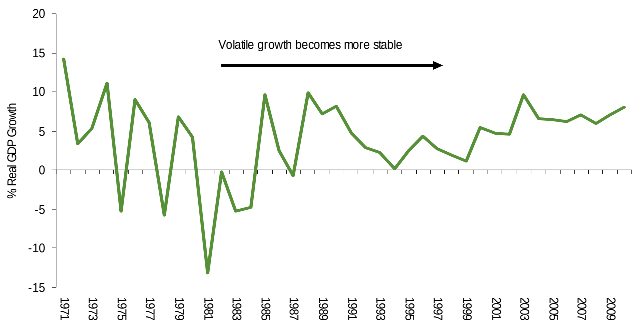
[2] The increase in government revenue is largely in oil producing states. In other cases, gold in Ghana and Tanzania for example, or copper in Zambia, the rise in prices is not closely linked to rising government revenue, although recent changes to tax regimes mean this may change going forward.

Oil and mining accounts for a declining share of GDP

There are a number of reasons for this change in the growth performance. The most obvious is that although historically Nigerian growth has picked up on the back of rising production and high oil prices, it also seemed to collapse just as quickly. As a result, the poor historical average GDP growth rate has been a reflection of the volatile oil sector growth. However, over time Nigerian growth has become less volatile, as the oil sector has shrunk as a percentage of GDP.

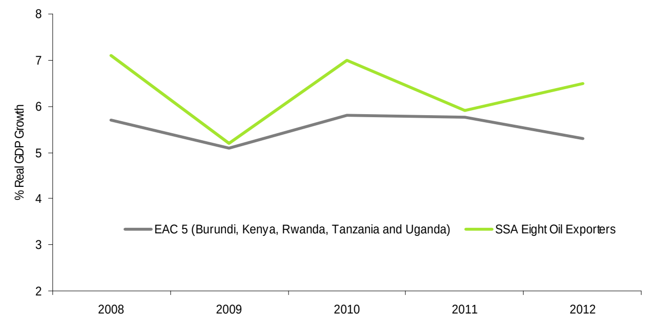
In fact, for most SSA countries, the commodity sector (i.e. mining and oil) of the economy is one of the smaller ones and therefore the impact on growth is much more limited than people presume. As we highlight in the next section, non-oil growth has been the main driver of GDP growth in Nigeria throughout the 2000s, reflecting a wider trend in growth across the whole of SSA.

Figure 7. Nigeria: Growth becomes less volatile and higher



Source: World Bank and IMF

Figure 8. Oil producer and EAC 5 growth: the difference is not as pronounced as may be expected



Source: IMF

The second point to remember about commodity prices in SSA are that they are very much a twin-edged sword, given the rapid growth in oil imports in many countries on the back of rising economic growth[3]. There are a substantial number of important economies, notably but not exclusively in East Africa (e.g., Ethiopia, Malawi, Kenya and Uganda) that are not really significant commodity exporters, but have still grown strongly. In West Africa, Senegal would also very much fit this classification.

But even for those countries that do export significant commodities, such as Ghana and Tanzania, which have both benefitted from high world gold and beverage prices, the improvement in their terms of trade has been quite limited, as these benefits have been significantly offset by the high price of oil imports.

The commodity story probably accounts for around a third of the SSA growth story

What this highlights is that while commodities are, and will be for the foreseeable future, a major part of the SSA growth story, their impact should not be overstated and instead should be examined within a country-specific context. And, while it is hard to put an exact number on the nature of the impact, various studies indicate that about a third of the pick up in growth in SSA in the last decade – either directly or through the indirect link of export earnings and government revenue, which higher commodity prices have driven in some countries – is attributable to the positive impact of high commodity prices. However, if commodity prices only account for around one-third of the SSA growth story of the 2000s, then two-thirds are being explained by a variety of other factors.

[3] Anyone visiting a major city in SSA in the last decade could not avoid noticing the significant increase in car use and the rise of major traffic congestion. According to a London-based consultancy, Citac, demand for oil in SSA is set to grow at an annual rate of 4.2% in the coming decade and reach 2.5m b/d by 2020.

A political mishmash

Helpless to much better

The reality is that SSA has historically had a poor image given political instability, wars and corruption. For many investors this was most starkly summed up in The Economist cover in May 2000, *Africa: The Hopeless Continent*[4] with its black cover and an image of an AK47-toting rebel fighter. But, by the middle of the 1990s, the political picture in SSA had begun to change, although we are cautious to go as far as suggesting political revolution on the sub-continent.

Instead, we think a good starting point when thinking about African political development in the last decade is acknowledging that it is hard to identify any one political trend that covers the majority of its countries. With hindsight, this is surprising. In the mid-1990s it seemed the end of the Cold War and apartheid in South Africa would be the driving forces behind a new wave of democratization. Arguably, this sense of optimism was best captured in the 1997 Financial Times article, *Ripples of a Revolution*, by the paper's then Africa editor, Michael Holman.

There are a wide variety of political regimes in Africa

One the best ways to highlight the extent of this political diversity across Africa is to take a short trip along the West African coastline from Senegal in the north to Gabon in the south. Facing the thundering surf of the Atlantic Ocean there are emerging democracies such as Ghana, Benin and Senegal, side by side with countries that have recently passed through political crises and are now rebuilding themselves, such as Cote d'Ivoire and Sierra Leone. Then there are countries with longstanding autocratic regimes, such as Equatorial Guinea. And finally, there are some countries, such as Cameroon, Gabon and Nigeria that are probably best viewed as political hybrids, with aspects of democracy and autocracy.

Holding elections only has a loose link to democracy

Despite this plurality, we think it is possible to draw some conclusions about the development of political systems in SSA over the last decade or so. Of these, perhaps the most important general conclusion is that, outside of a limited number of countries, the subcontinent has not embraced democracy in a meaningful sense. It may have been bitten by the election bug – as reflected in the large number of elections held in any given year compared with other parts of the world – but the process of holding elections itself should not be equated with a nation embracing democratic ideology. Instead, to understand the politics of a country it is important to look beyond the electoral process. In fact, there is an argument that in many cases, elections are a non-event in SSA when trying to understand a country's political dynamics.

> "…what seems to have emerged over time are a range of political systems which have shown the capacity to evolve and survive crises…."

[4] What has always been somewhat sad about this issue of the Economist is that despite the very negative cover page and headline, which attracted all the interest, the survey was actually relatively optimistic about the outlook for SSA. In fact, it could be argued that this was the first major press feature to highlight the changes underway in SSA which led to the subsequent hype.

Instead, what seems to have emerged over this time are a range of political systems which have shown the capacity to evolve and crucially, to survive crises, rather than to slip back into conflict and chaos. Revisiting the trip down the West Africa coast, we note that although it has taken time for Cote d'Ivoire to emerge from its civil war, it has done so largely intact and has not been dragged down into a failing state. More pertinently, Nigeria overcame the death of the incumbent president, Umara Yar'Adua, without the military re-involving itself in politics even if the transfer of power did not follow the exact procedures outlined in the constitution. A similar tale occurred in Gabon on the death of Omar Bongo. Although at the other end of the scale, facing a crucial election to define its democratic credentials, Senegal passed with flying colours in 2012 when it went through a peaceful and democratic presidential transition.

Improved politics feeds into improved policy

What is also clear is that while it is possible to argue about the nature of the political evolution underway in SSA, the bottom line is that increased political stability, and the decline in conflict, has been a major benefit in terms of encouraging investment, notably by the private sector, even if the overall political situation in SSA is hard to categorise and varies from country to country. Moreover, and perhaps crucial to understanding the overall growth story, this greater political stability has allowed an improvement in the overall economic policy environment.

Wars do end, but insurgencies can rumble on

Despite the improved political situation in SSA generally in the 2000s, political risk has not disappeared. In fact, as a major reminder of this, an insurgency combined with a coup d'état in Mali in early 2012 once again showed that even an apparently politically stable country can suddenly find itself running up a political *cul du sac*. But what is changing is not only the nature of political systems in SSA, but also the nature of conflict itself.

This change is more clearly highlighted in one of the more comprehensive recent studies of conflict in SSA by Scott Straus, *Wars do End: Changing Patterns of Political Violence in SSA*. As he shows, in terms of headlines, there has been a major fall in the number of conflicts in SSA in the last decade. In fact, by the mid-2000s there were about half as many conflicts as in the 1990s. But as he also points out, it is just as important to remember that there has been a change in the nature of conflicts in SSA. Rather than large-scale conflicts — good historical examples range from the Biafra secession in Nigeria to the SPLM conflict in Sudan or the NRA in Uganda — the predominant form of conflict is now usually a rebel insurgency on the peripheries of states. In addition, although far from exclusive to SSA, other forms of political conflict will continue to occur. This will range from election violence, to conflicts over resources, both mineral and crucially land.

In the case of insurgencies in SSA, although they often grab headlines, largely because the fighting has a major toll on civilians living in the affected regions, the reality is that the majority are either too weak in military terms, or involve a rebel movement that is too factionalised, to be able to challenge the authority of the central government. Recently, the political risk consultancy, Eurasia Group, estimated that 95% of global insurgencies wither and die. Good examples of this in SSA in recent years are in the Casamance region of Senegal or the Lord's Resistance Army in Uganda where both insurgencies now seem very much on the wane. The key, however, is to work out which are potentially in the 5%, or to understand whether the rise of Boko Haram in Nigeria, or the recent conflict in Mali, for example will follow and also drop out of the headlines, or pose a more significant long-term political threat.

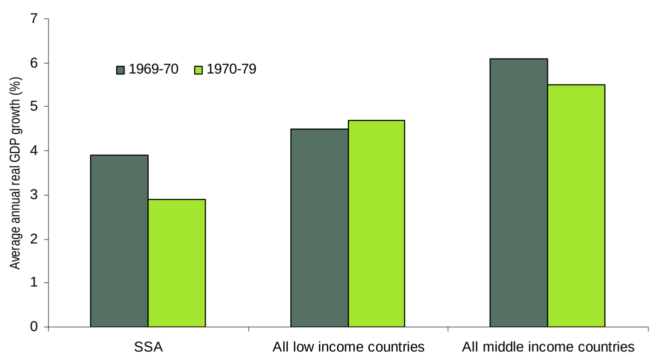
The policy turning point

The return of economic orthodoxy

Writing about SSA in the 21st century, it is easy to forget the economic low point that SSA reached in the early to mid-1980s. After a period of strong economic growth in the post-independence era, growth in SSA started to fall back from the mid-1970s and the economic crisis on the subcontinent intensified. In response to this, African ministers of finance eventually approached the IMF and World Bank seeking a way out of the growing crisis. The Bank's response was the publication of an arguably seminal report in 1981, called *Accelerated Development in Sub-Saharan Africa: An Agenda for Action*, more widely know as the Berg Report, after its lead author.

The Berg Report was in many ways a shock for academics and African politicians, in that it switched the focus of the debate about the economic malaise facing SSA around. While it did highlight the problems of colonial inheritance and exogenous economic shocks, in-line with common consensus, it also argued that a major cause of the growing economic crisis lay in poor economic policies and that these could only be remedied by deliberate policy changes by governments in SSA. This also tied into a wider debate about whether aid could be effective if the economic policy environment was not supportive.

Figure 9. Average annual real GDP growth



Source: World Bank, Accelerated Development in SSA: An Agenda for Action

Figure 10. SSA fared poorly vs. other low income countries

Source: World Bank, Accelerated Development in SSA: An Agenda for Action

From the Berg Report to the Washington Consensus

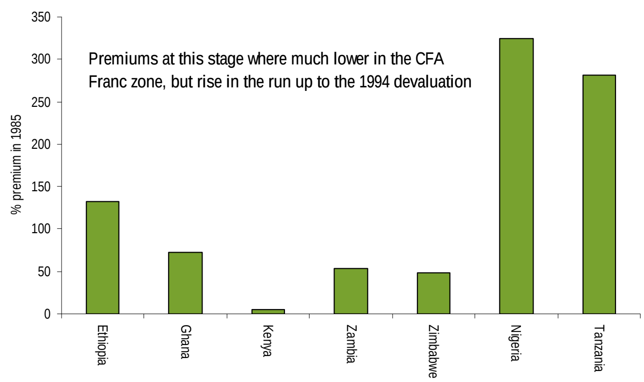
The policies initially proposed in the Berg Report eventually saw the light of day in various structural adjustment programmes, usually led by the IMF, which introduced its first Structural Adjustment Facility (SAF) for low income countries in 1986, but were eventually adopted by many countries in SSA. Over the years the alphabet soup of letters attached to these programmes have transmogrified from SAF, to EASF, to PSI, to PRGF and currently the ECF, but all have a common underlying theme in promoting fiscal and monetary policy discipline to help support growth[5].

[5] Despite his opposition to the phrase, in a 1989 paper, the US economist John Williamson of the International Institute of Economics identified ten broad, yet relatively specific policy recommendations that formed the basis of most structural adjustment programmes implemented not just in SSA, but other developing countries, on the advice of the IMF and World Bank.

From a distance, it is sometimes difficult to fully remember the passions that the structural adjustment debate raised, and even arguably still lingers on for some academics. But the positive outcome in SSA, after a huge and deeply emotional debate over the future direction of economic policy, was arguably a return to economic orthodoxy. Moreover, the two clearest indicators of this positive outcome in terms of economic policy were a steady reduction in fiscal deficits against the background of improved agricultural sector growth. Combined, these led to a major reduction in inflation across the continent from the mid-1990s, with the impact arguably most visible from the early 2000s.

In particular, efforts to control fiscal deficits were important in SSA given the level of development in most countries, and the still weak monetary transmission mechanism. In fact, the most visible example of where fiscal discipline has collapsed in SSA in recent years is Zimbabwe, whose economic performance in the 2000s stands in such strong contrast to the majority of countries in the sub-region. For the decade from 2002-11, average GDP growth in Zimbabwe was -2.8% a year, and only this high because of the recovery since 2009, compared to 5.8% for SSA as a whole. However, it highlights that the link between fiscal deficits, high inflation and weak exchange rates remains at the heart of the economic policy debate to this day and will remain arguably more important in the coming decade.

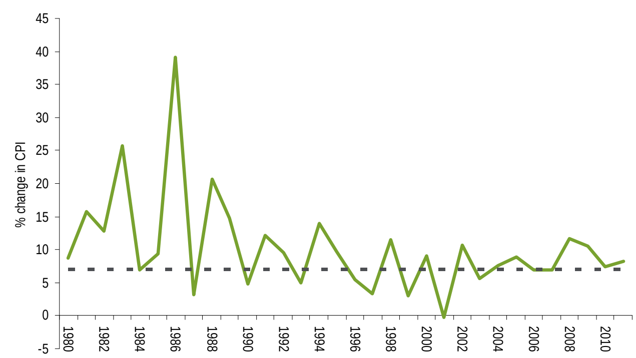
Figure 11. Large parallel market premiums existed in the mid-1980s



Source: Citi Research

Note: Angola, Mozambique & Uganda not included as premium in thousands

Figure 12. Inflation has been on a steady downward trend until recently



Source: Citi Research

Currency liberalization was arguably a crucial step

But while much of the policy focus has been on improved fiscal discipline, there is also one reform that is often overlooked when thinking about policy reform in SSA: currency liberalization. Anyone travelling around SSA from the late 1970s to the early 1990s could not have avoided noticing the wide divergences between the official exchange rate and those prevailing on the parallel, or black markets. In fact the magnitude was often in the hundreds of percent. We think that the difficulty of sourcing foreign exchange, and the subsequent barrier to investment that this created, was a key factor historically holding back growth in SSA (and a major driving factor, along with political uncertainty, of capital flight from the sub-region).

We think that the single most important policy reform made in SSA was the widespread liberalization of foreign exchange controls and liberalization of foreign exchange markets. In some ways, this has a similar parallel with India, when it liberalized its currency regime in 1994 attracting a wave of new investment and unleashing a prolonged period of robust economic growth.

A new wave of investment into SSA

Emerging opportunities through an improved political and economic policy environment

In hindsight it is perhaps not surprising that high commodity prices, against the background of an improved political and economic policy environment led to a new wave of investment into SSA. A key driver to SSA investment was politics, but not necessarily in the recipient country for the investment. The end of the apartheid regime in South Africa in 1994 meant that its companies where no longer political pariahs on the subcontinent. While a very few large companies, such as South African Breweries, Anglo American and Investec[6], chose to leave South Africa and carve out an international role, medium-sized companies found that a more logical route was to seek to leverage off emerging opportunities on their doorstep.

However, what is potentially more interesting is that this new wave of investment was not just into commodity projects, but has also been into other sectors, notably the consumer goods and service sectors. To some extent, the charge into SSA was led by mining companies, but it was soon followed by mobile phone operators, retailers and other service providers.

Mobile phones were a game changer

In fact, of these new investments, the impact of mobile phones in boosting growth and providing a demonstrative effect about the existence of a large consumer market in SSA is arguably the single most important factor behind the pick up in growth in the 2000s. As argued in one of the original pieces of research on the potential impact of mobile phones on growth in developing countries by Leonard Waverman at the London Business School, adding 10 mobile phones per 100 people in a typical developing country leads to an additional 0.59 percentage points in GDP growth per person.

> “Arguably, nowhere else has the mobile revolution been more high profile than in SSA due to the poor state of the fixed-line networks in many countries….”

Arguably, nowhere else has the mobile revolution been more high profile than in SSA due to the poor state of the fixed-line networks in many countries prior to the introduction of the mobile phone networks. This in turn not only reflected the lack of investment, but also that the distances and population densities involved meant that fixed-line networks are expensive to install and maintain in SSA.

Financial inclusion a positive outcome of the mobile phone revolution

Another important part of the mobile phone revolution on SSA was its role in financial inclusion. With the lack of land-line phones and the number of bank branches limited across the region, the mobile network moved ahead more rapidly than in other parts of the world from being a major source of communication to a financial tool, or a major way to pay and transfer money around countries. In some ways, Kenya and its M-Pesa system shows the impact of this most vividly, where now over 14 million people are estimated to deposit money through their phone to either save for future use, or to send to other parts of the country.

[6] Although many of these have not forgotten their African roots, notably SAB-Miller which has a major presence through Africa which it is continuing to strongly grow.

The mobile phone revolution is still evolving

How this mobile revolution will ultimately play out in SSA remains far from clear, even at this point. Already mobile technology is seen as a force for political change having been used as a way of recruiting new members to political parties, talking to voters and monitoring election results. It is also a driver of social change, and a major source of information on issues ranging from politics, health and even farming advice. The impact of mobile phones will only advance as network capacities are upgraded and local entrepreneurs take advantage of the new technology.

Continued penetration of mobile phone usage will continue to have a positive impact on growth although, interestingly, no new studies exist to show whether the marginal impact of these new uses of mobile technology are greater, or lesser, than the initial benefits provided by the provision of a mobile network, especially given that, for most countries, the mobile penetration rate is now set to slow significantly after an initial extremely rapid first decade or so. It may also prove that for governments, the mobile phone becomes an irresistible way of raising new tax revenue.

Airlines are another good indicator of the changes underway

But it is not just using mobile phones for communication that has made business in SSA much easier. There has also been a range of less high profile developments such as the rise of the airline industry. For decades, the industry was dominated by bankrupt and inefficient national airlines with monopolies over domestic and international routes. However, the rise of new airlines in SSA in the 2000s has transformed travel around the continent as the former national airlines have been allowed to collapse by governments.

This, of course, has taken different forms. Arguably, in East Africa, it is a battle between three more commercially oriented and reformed national airlines: Ethiopian, Kenya Airways and South African Airways are all key players, with smaller companies such as Precision Air and Uganda Airways sniping at the edges. In contrast, in West Africa it is newer private airlines, often based in Nigeria with its larger domestic market, which are the main players. Between them Aero, Nigerian Eagle Air and Arik Air can fly a businessman to most countries in West Africa. While still not always easy, and the schedules are still subject to sudden late changes, the overall transformation is hugely noticeably and welcome.

A numbers game from a low base

Catch up growth from a low base is important

Added to these drivers of growth in SSA is the simple fact that the pick up in growth is also, at least in part, a numbers game. In the end, there is a simple catch up effect which comes into play. If you get some of the basics right, notably on the politics and policy front, which seems to have been the case in SSA, then it is arguably relatively easy to grow rapidly from a low base[7]. With this in mind, much of the focus of the SSA growth story has been on countries with a “reformist reputation” such as Ghana, Senegal, Zambia and the five members of the East African community (Kenya, Uganda, Tanzania, Rwanda & Burundi).

But there is an additional, and often overlooked, part of the numbers game that has been crucial in helping to drive up the overall headline GDP growth rate in SSA: the larger economies have simply been growing more rapidly. One way to think about this is to remember that Botswana and Mauritius attracted considerable attention as both had high rates of growth over prolonged periods in the 1980s and 1990s. But the reality is that, given their small size, their high rates of growth have had little impact on the overall growth rate for the SSA region.

[7] For a more detailed look at this, see Citi Economics, Global Growth Generators; Moving Beyond “Emerging Markets” and “BRIC” by Willem Buiter and Ebrahim Rahbari.

> "The importance of the growth of Nigeria and South Africa cannot be understated….together they accounted for just under 50% of SSA GDP in 2010."

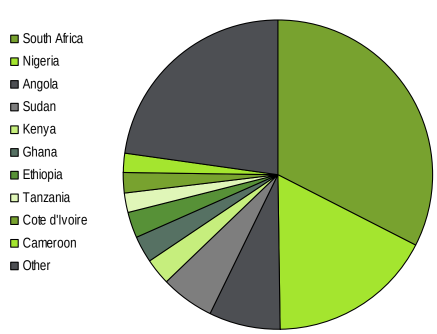
Instead, what is also unique about the pick up in SSA growth in the 2000s is that there has also been a sharp pick up in growth in the two biggest economies on the continent: Nigeria and South Africa. South Africa's annual average growth rate for the 20 years from 1981-1999 was only 1.8% per annum, but in the next 12 years, from 2000-11, it nearly doubled to 3.5%; whereas for Nigeria the rise was even more noticeable, from an average of 2% per annum to 6.5% per annum.

The importance of this one trend simply cannot be understated, given that World Bank data shows that these two economies alone accounted for just under 50% of SSA GDP in 2010. Quite simply, the math alone dictates that the combined rate of growth for the two countries is extremely important in understanding the overall growth rate for SSA.

Nigeria is likely to become the largest economy in SSA in the not too distant future

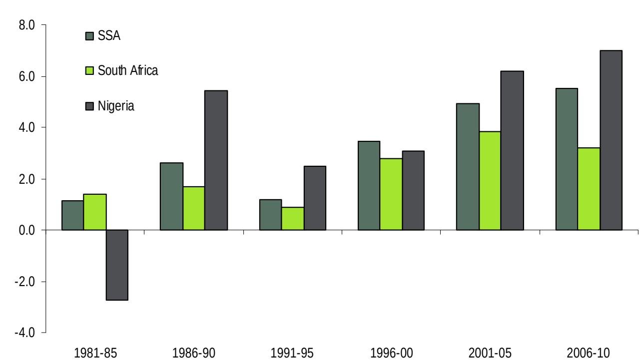
There are some important points to bear in mind about the big economy story in SSA. The first is that, although growth picked up in South Africa in the 2000s, the country still grew more slowly than the rest of SSA. This is unlikely to change significantly going forward. Second, the importance of Nigeria may become more pronounced if, as we expect, its GDP data is revised along the lines of that completed in December 2010 in Ghana. At that time, Ghana revised its GDP figures higher by 60.3% to GhC44.8bn to reflect, among other things, an improvement in the compilation methodology and an improvement in data sources. A revision along the same lines for Nigeria could potentially increase its GDP by around 40%, moving it much closer to potentially becoming the largest economy in SSA.

Figure 13. Africa's biggest economies in 2010 (% of total GDP)



Source: Haver Analytics from World Bank

Figure 14. SSA, South Africa and Nigeria growth (% pa over period)



Source: Haver Analytics from World Bank and IMF

The informal sector is a part of the economy that is not taxed, monitored by any form of government or included in any economic statistics.

The informal sector – A "Red Herring" in the Growth Story

One reason widely cited for the underestimation of the size of the consumer market in SSA in recent decades was that investors did not really understand the size of the informal sector. There is, of course, some truth to this, but it should not be overstated. The informal sector exists not only in SSA, but in most emerging markets and is usually well understood. Some better national statistical agencies already make efforts to estimate the size of informal sectors in their formal calculations of national accounts. In SSA, one of the most obvious examples of this are estimates on the size of informal construction activities, which in turn can be linked to cement sales.

The substantial December 2010 Ghana GDP revision does highlight the weakness of the data, even on the formal sector GDP data, in SSA in recent years. It also shows that the data may not have been fully capturing the growth story, notably the structural changes to the economy and the increasing service sector which had occurred. GDP data is generally less robust in capturing service sector growth, as both its inputs and outputs are much less tangible than in other sectors of the economy. It will be interesting to see the extent of the proposed Nigerian revision, although other SSA governments have not really announced that they will follow the West African lead.

More importantly, when thinking about growth, whether its size is being estimated appropriately or not, it is unlikely that the rate of growth in the informal sector is higher, or significantly higher, than in the formal sector. Therefore, the current data is most likely not significantly underestimating the growth rate. We still think of the informal sector as a following, rather than a leading sector in this respect.

The rise of the BRICS in SSA

The rise of Chinese trade with SSA

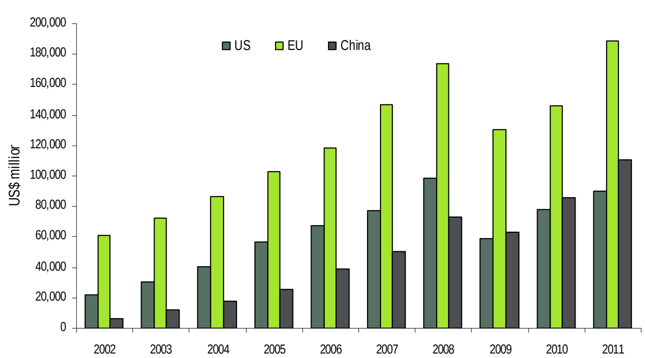
China's move into SSA is most visible in the rise in trade

While, as we have argued, South African companies were some of the earlier investors in SSA, one of the most interesting economic stories in SSA over the last decade has been the rise of "China" as an increasingly important economic force and engine of growth in the sub-continent[8]. In broad terms, there have been two major factors driving greater Chinese interest in SSA:

- Pull factors such as rising growth in SSA in the 2000s and rising demand for commodities within China have naturally attracted Chinese investors; while
- The introduction of China's "going out" policy incorporated in 2002, aimed at encouraging Chinese entrepreneurs to venture abroad has been an important push factor.

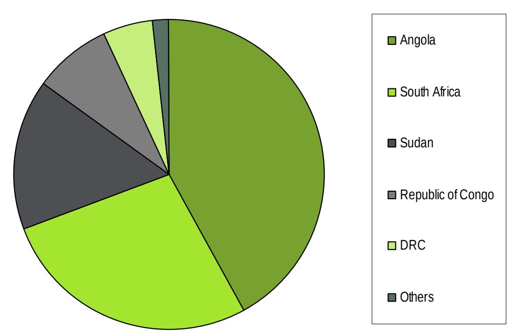
The growing economic importance of China is most visible in the trade data, which show that in 2011 China had become the largest single country trade partner with SSA[9]. In fact, trade between SSA and China over the 2002-11 decade has grown by 38% a year, compared to 13.7% a year for EU trade and 17.5% for US trade. This has meant that, while in 2002 total Chinese trade with SSA was worth only US$6.2bn, by 2011 it had risen to US$110.4bn. This latter number compares to SSA trade with the EU worth a total of US$188.9bn and with the US worth a total of US$90.2bn.

Figure 15. Rising China trade with SSA



Source: IMF, Direction of Trade Yearbook

Figure 16. China trade with selected SSA countries



Source: IMF, Direction of Trade Yearbook

[8] In some ways, to imply that there is some "collective idea" called "China" that is involved in SSA is, we think, inaccurate. Instead, the reality is that there are a lot of different Chinese agents involved. For just over the last decade the government has set a broad policy agenda through the Forum on China-Africa Cooperation (FOCAC), which held its first ministerial conference in Beijing in October 2000. But the reality on the ground is much more complicated with a myriad of interested agents sometimes cooperating, but also competing against each other. These include not only the Chinese government, but state governments and state-owned companies as well as the private sector and individuals.

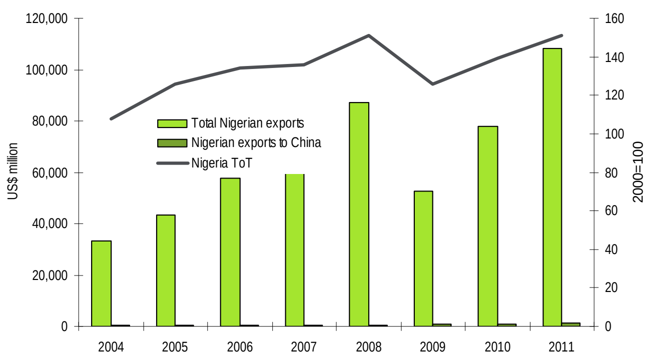
[9] The data used here is IMF Direction of Trade data. This provides a consistent series, but the accuracy of the trade data from the SSA perspective is an issue. The best way to think about the data is through the broad trends it outlines.

This rise in trade, and in particular the speed of growth, now means that Chinese growth is probably a more important factor impacting on growth in SSA, than traditional G7 growth. Recent academic research seems to show that, whereas historically G7 growth has had an impact on SSA growth, in the 2000-09 period the impact has been minimal. In contrast, Chinese GDP growth is now a more important determinant on SSA growth than G7 GDP growth, with a 1 percentage point change in Chinese growth having a 0.34 percentage point impact on SSA growth[10].

The commodity price link is strong, but should not be overplayed

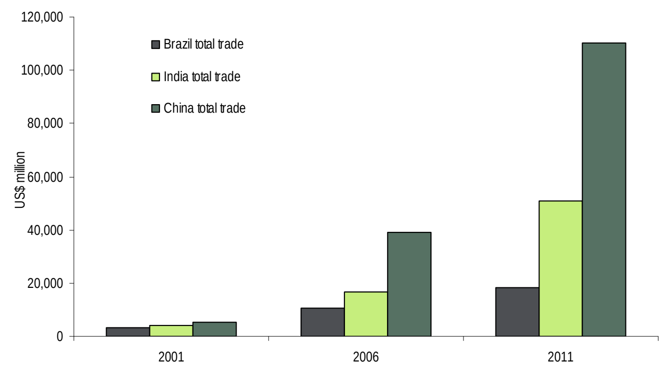
Arguably, the relationship between China and SSA is also deeper than indicated by the actual trade flows, as it also runs via the indirect influence of commodity prices and cheap manufactured imports. A favourable external environment – or rising global commodity prices and falling import prices – has created a positive terms of trade gain for some countries in SSA, notably for the sub-region's' eight significant oil exporters. This indirect impact is clearest in Nigeria where, although oil exports to China are small in relation to its overall exports, Nigeria has benefited strongly from the high global oil price of recent years via a substantial rise in its terms of trade.

Figure 17. Nigerian terms of trade and China trade



Source: IMF

Figure 18. Growing BIC trade with SSA



Source: IMF Direction of Trade

China's involvement in SSA is often seen as a negative

But returning to the trade story, in simplistic terms, the rapid growth in trade with China over the last decade has often been characterised as a somewhat exploitative relationship, with the word "neo-colonial" often being bandied around in the press. In these stories, China buys raw materials/commodities to feed its economic boom from SSA, while exporting cheap, often seen as "shoddy" manufactured goods. The other simplistic view of the relationship is that, because of the Chinese government's often stated policy that it will not intervene in the internal politics of a country, its companies have much greater leeway to strike investment deals in difficult political circumstances and with opaque clauses which companies from other countries would be very wary of taking.

As with many caricatures, there is an element of truth in this description of China's involvement in SSA. For example, some of China's highest levels of trade are with a limited number of countries: Angola, The Democratic Republic of Congo (DRC), The Republic of Congo and Sudan, of which, for three of the four, the main export is an obvious natural resource – oil – coupled with extremely difficult operating environments. Moreover, one does not have to dig deep to find words in many local languages that imply that imported Chinese consumer goods are of poor quality.

[10] See Levy Yeyati, On Emerging Markets Decoupling and Growth Convergence', Centre for Economic Policy Research.(2009) and Garroway et al, The Renminbi and Poor-country Growth, The World Economy (2011).

China imports very large amounts from a very limited number of countries

In fact, the depth of this involvement with a limited number of countries cannot be understated. Using the IMF Direction of Trade Statistics (DoTs) figures, the most important exporter from SSA to China is Angola, accounting for 42% of SSA's total exports to China. The two other oil exporters, the Republic of Congo and Sudan are also crucial in this equation. Between them, these three countries account for around two-thirds of SSA exports to China. Add in exports from the DRC and South Africa, which are commodity dominated but outside of oil and, if the DoTs data is to be taken at face value, in a typical year 95% of SSA exports to China coming are from just five countries.

But the relationship is complicated and the trade data is opaque. Sometimes this is deliberately the case. For example, investment in Angola's oil sector by Chinese oil companies is relatively limited. Instead, much of the Sino-Angolan oil trade is conducted by the Queensway Syndicate and the exact terms of trade deals will not see the light of day but are based on long-term oil supply contracts, the payment for which includes the building of infrastructure. Similar concerns were raised by the IMF over the exact terms of the Sino-Congolese Cooperation Agreement.

In other cases, it just reflects the weakness of the authorities collecting the data. For example, Zambia's exports are dominated by copper and in recent years it has exported as much to Switzerland as to China. But the reality is that the copper which is being sold to Swiss commodity trading companies, is destined for use elsewhere and probably never physically crosses a Swiss border.

Griping about China and SSA may reflect disguised protectionism

Discussions on Chinese trade with SSA tends to become emotive as they can often include an element of disguised protectionism, where established investors in SSA, or existing local entrepreneurs, feel their previously privileged position is coming under a new competitive threat and naturally have a strong vested interested in playing up the story. Of these two groups, it is arguably local entrepreneurs who feel they have come under most pressure from Chinese companies, most notably when Chinese workers first come to SSA working on a formal project, but stay on to set up a small scale business once the initial contract has ended.

> "…while Chinese involvement in SSA is often seen as a negative one, the depth of this involvement with a limited number of countries cannot be understated…"

China is changing it's involvement in SSA through project development and corporate stakes

Finally, it is clear that the Chinese government and companies are re-thinking how to be involved in the SSA resource story. For example, Chinese companies led the development of the Sudanese oil sector, led by the China National Petroleum Company (CNPC). Not only was CNPC the main developer of the fields, but also in the construction of the pipeline to Port Sudan. Given this close level of involvement, up to 80% of Sudanese oil exports are sold to China. However, this approach to development of resources in SSA by Chinese companies is unlikely to be repeated in most countries.

The most obvious change is, rather than being the sole player in large scale projects, Chinese companies are increasingly buying into companies that operate in SSA, although this is also a global trend. The most high profile example of this was outside the resource sector, in the financial sector in fact, when the Industrial and Commercial Bank of China (ICBC) bought a 20% stake in Standard Bank of South Africa in late 2007. But the more active current deals are probably in the resource sector and take two forms. First, Chinese companies are increasingly becoming

junior partners in joint ventures, such as becoming a member of the Tullow consortium developing the Lake Albert oil find in Uganda. Second, they are buying into small resource companies such as Kalahari Minerals or independent oil companies.

Moving beyond direct trade links with China

This simplistic view of the relationship between China and SSA focuses largely on the rapid rise of trade flows and the impact of commodity prices, and the fallout if either of these falls. However, it fails to capture a whole range of other issues surrounding the emerging linkages between the two regions, which will remain central to the relationship, whether Chinese growth slows in the coming decade or maintains its current trajectory.

The Chinese construction drive

China: helping to build a continent

The need to build infrastructure is arguably one of the most pressing issues facing SSA. In fact, while there has been much talk about the issue, and detailed analysis of the problem such as that provided by the World Bank in its major 2009 study – *Africa's Infrastructure: A Time for Transformation* – progress on building infrastructure has been quite limited. However, where infrastructure projects have moved ahead it is typically Chinese construction companies that have been at the forefront of helping to build a new SSA.

Although the Chinese construction effort in SSA comes in many forms, there are two that overwhelmingly dominate:

- First, projects built through the direct provision of aid to various governments or organisations to fund construction. This has largely been used to build official buildings, of which the most high profile in recent years has been the new African Union headquarters in Ethiopia. But, while very visible and high profile, understanding and analysing this trend is difficult given the lack of data provided by the China Exim Bank and the China Development Bank, the main providers of this type of funding. Moreover, as much of this funding is in the form of tied aid, its real value is much harder to determine.

- Second, having established a presence in many countries, Chinese construction companies are now major bidders for most official contracts to build projects in SSA, whatever their source of finance.

But, when all is said and done, according to the Chinese Ministry of Commerce, Chinese companies are now signing infrastructure deals worth around US$50bn a year in SSA.

Investment in SSA as a surplus labour export model

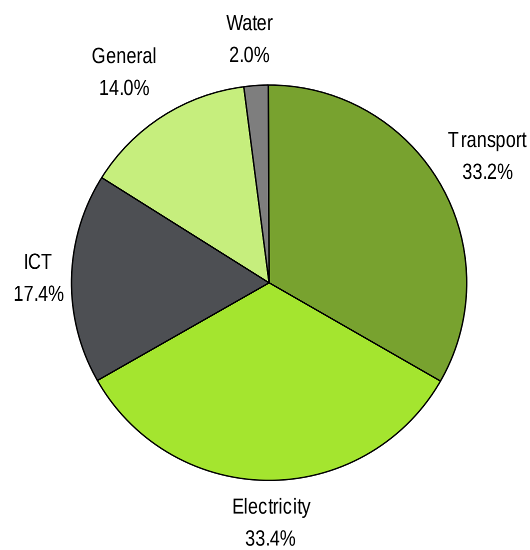
Another way to think about Chinese involvement in the construction industry in SSA in the last decade is as a surplus labour export model. Effectively, many of the Chinese companies active in the construction sector in SSA are state owned companies which have won contracts at aggressively cheap prices. It seems their goal is not necessarily to ensure high rates of profitability, but instead to be representatives of Chinese diplomacy, and to broadly break even and continue to employ a large number of Chinese workers. Another clear trend, however, is that the Chinese workers who came along to work on construction projects often move on to work in other sectors, often retail and agriculture (such as chicken or vegetable farming), either in breach of their initial visa conditions or with new, but irregularly issued, visas.

Despite concerns and issues over projects, they are getting completed

The discussion on the impact of Chinese construction activities in SSA, however, is not all positive and there are real issues with many of the construction projects underway in SSA by Chinese companies. Critics highlight the lack of transparency of the terms being struck for new infrastructure projects, notably when they are paid for through Chinese lending. A continual issue that crops up is the heavy use of expatriate labour and the lack of training of local staff. There are also questions over the lack of environmental assessment studies and questions about the quality of the completed projects. And finally, perhaps the biggest concern is that building new infrastructure is only one part of the equation. In fact, there is an argument that, while much has been built in SSA over the last decades, far less has been properly maintained and this is where the real problems lie.

The bottom line remains that Chinese companies do get projects completed which have often being stalled for years and, in a region with a huge infrastructure deficit, this is arguably of overwhelming importance.

Figure 19. Confirmed Chinese infrastructure finance commitments in SSA (2001-07)



Source: World Bank-PPIAF (2008)

Potentially building a manufacturing base

Chinese imports and manufacturing not necessarily driving the SSA manufacturing base decline

The impact of Chinese imports on the manufacturing base in SSA is an issue often highlighted as a major concern for governments in the sub-region. Perhaps the negative impact is best illustrated through the decline in textile manufacturing companies in SSA over the last decade and there can be little doubt that rising Chinese imports have been a contributory factor in the collapse of the industry. Most of those that have survived have only done so by moving upmarket.

But the reality may be that there is no conclusive answer at this stage as to whether growing Chinese trade with SSA is a help or hindrance to the development of a wider manufacturing base. Even in the SSA textile industry, a simple lack of investment over the last decade by the existing owners may potentially explain the sector's problems as much as rising import competition from China.

Winners and losers from Chinese involvement

Despite the general concern that China imports will create only losers in SSA, there may well be winners going forward from the relationship with China. The other key area where Chinese involvement in SSA is also showing signs of evolving is the efforts of the Chinese government since 2006 to set up manufacturing, or Export Processing Zones (EPZ) in SSA at least in part to try and overcome perceptions that its relationship is purely negative[11].

Non-interference already shows signs of strain

Credibility and pragmatism, plus non interference are positive for politicians

In some ways, the Chinese government and Chinese companies have played two key political cards in their evolving relationship with SSA over the last decade:

- The first is that they have a natural credibility with governments of other poor countries in the light of China's own development performance since the late 1970s; and
- Second is that they are known to act pragmatically, which allows them to get on with things even in difficult circumstances.

These two advantages have also been supported by the broad government policy goal of trying to maintain political neutrality in other countries, and not taking positions on what the Chinese government argues are purely domestic issues.

An increasing problem for the Chinese government and Chinese companies in SSA is that non-interference was much easier when they were growing but marginal players. Maintaining this stance now that they have become larger and more important players is much harder. This has become most notable in Sudan over the last few years, where the Chinese initial involvement in developing the country's oil industry was with the Sudanese government of the north. The creation of a new country, South Sudan, where most of the oil fields are now located, has meant it has had to redefine its political involvement.

Non involvement is getting more difficult

While the creation of a new country is obviously quite a drastic political factor to build into any investment equation, a simple change of government, which is increasingly occurring throughout SSA, is not. Therefore, the traditional assumption of many Chinese actors that a stable political status quo will continue may prove increasingly unlikely. This will, in turn, make the doctrine of non-involvement in domestic politics harder for both the Chinese government and its companies to maintain going forward.

[11] For a more detailed analysis of the potential and pitfalls of this route, see Deborah Brautigam and Tang Xiaoyang, *Africa Shenzhen; China Special Economic Zones in Africa*, Journal of Modern African Studies (2011). The World Bank report, *Light Manufacturing in Africa, Targeted Policies to Enhance Private Investment and Create Jobs* (2012) is also a useful resource to help think about this potential process and why the manufacturing sector has stagnated in SSA and how it can recover.

How a changing growth story in China may affect its evolving relationship with SSA

In the short term the pattern seems set

If one accepts that the relationship between China and SSA is in a state of evolution, perhaps the next logical question to ask is how are these developments likely to develop going forward. Of course in the very near term, the Chinese government would like all the current initiatives to deepen and develop going forward.

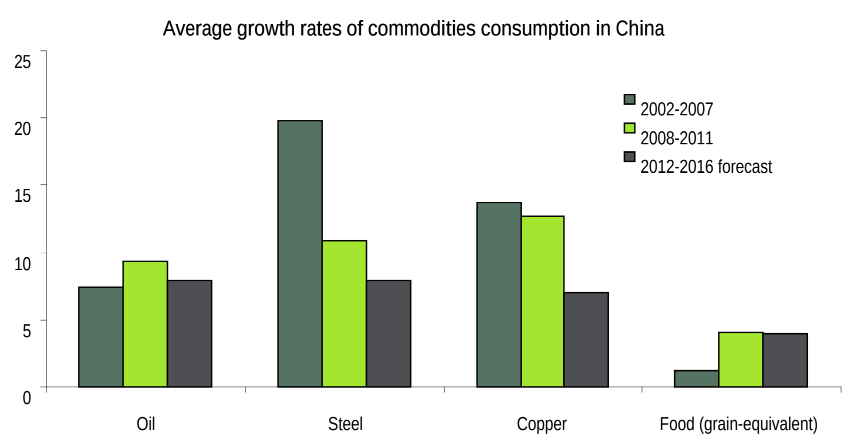
To this end, at the July 2012 Forum on China-Africa Cooperation (FOCAC) in Beijing, the Chinese government announced a doubling of credit to be directed towards Africa, to US$20bn over the next three years compared to the US$10bn pledged in Egypt in 2009. The Chinese leadership were also at pains to stress their desire to continue to "rule out external interference" while also building "mutual understanding and trust" between themselves and Africa. Another clear theme of the Chinese leadership was the need for China to "expand its imports" of goods from Africa in a clear effort to promote more balanced trade.

But perhaps of more fundamental importance when thinking about how this relationship may evolve over the medium to long term is the need to understand how China will change in the coming decade, especially if we expect Chinese growth to undergo a major rebalancing and slowing. In other words, if the Chinese growth story shifts from an export dominated model of growth driven from the coastal regions to one in which internal demand plays a higher role.

Mixed signals from commodities

In this respect, the next question is how will a change in the growth model of China impact commodity demand? Clearly some commodity prices will ease, but the impact on commodities overall should perhaps not be overstated. As the trade data shows, by far the main commodity being bought by China from SSA is in fact oil. Assuming rising consumption translates into rising auto ownership and usage, then the need for rising oil imports in China will remain undiminished for some considerable time. Only for countries such as the DRC and Zambia, both of which are major copper exporters, where the demand for their export is tied more intimately to China's construction boom, would the potential impact be more significant.

Figure 20. The changing composition of China's commodities demand



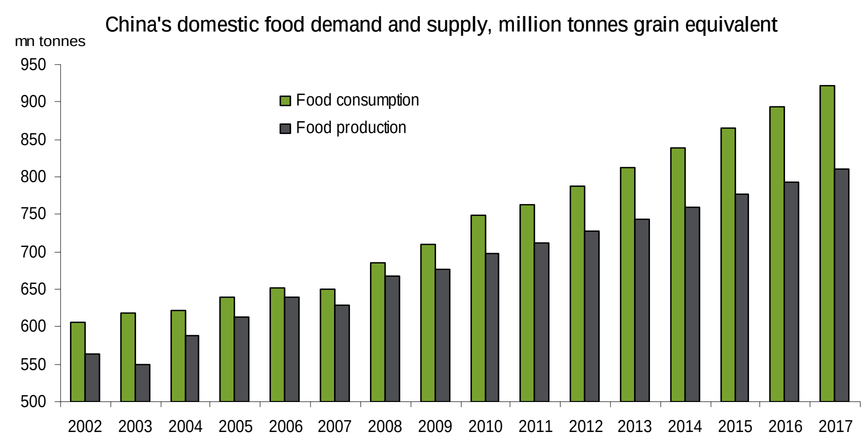
Source: Citi Research

Meanwhile, the impact of soft commodities and foodstuffs may well prove more complex and difficult to tease out. More balanced Chinese growth and rising consumption is likely to raise demand for soft commodities and food, which can clearly be met by SSA producers. While not exhaustive, there is potential for rising demand for tea, coffee, cocoa, cotton and palm oil and even tropical fruit and spices in China going forward. Moreover, the economic reality is that booms in soft commodities tend to have a more widespread economic impact in SSA than booms in minerals which are often mined in an enclave fashion with little direct employment creation[12].

China's food trade deficit could mean higher agriculture investment

The equation is more complicated when thinking about food production more specifically. China's own recent growth story started with an agricultural revolution in the late 1970s and early 1980s fashioned by the reforms of Deng Xiaoping. But China has around 22% of the world's population, yet only around 7% of the world's arable land and going forward it seems that a richer Chinese population will need new sources of food as demand patterns continue to change. Already the most visible sign of this is in meat: in 1985, the average Chinese consumed only 25kg of meat per person per year, but by 2005 this had risen to 52kg.

Figure 21. China's food trade deficit could double in five years



Source: UNFAO, Citi Research

In fact, the Chinese government prioritised large scale agricultural investment in SSA at the FCOAC Summit in 2006, promising to establish 10 agricultural demonstration centres. This was followed by the announcement of several major agricultural projects and investments, some in dams for irrigation, notably in Angola, Mozambique, Tanzania and Zambia.

But, despite the initial high profile attached to agricultural investment, to date it is unclear what level of investment has materialised. Instead, it seems that this high-profile approach to agricultural investment has waned in recent years, perhaps with the Chinese government realising the potential pitfalls of agricultural sector investment in SSA (largely the political sensitivity of acquiring large tracts of land) and instead a much more "stop-go" mentality has come to the fore in terms of large investments, although many small scale Chinese farmers are now very active in a number of countries.

[12] For a more detailed discussion of this, a good starting point are the papers presented at the African Economic Research Consortium (AERC) Senior Policy Seminar in Cameroon in 2007 on Commodity Booms in SSA.

> Changing patterns of demand for commodities from a changing Chinese economy will generate both winners and losers in SSA.

Commodities, China and SSA going forward

The bottom line therefore is that perhaps the best way to think of China and the commodity story in SSA going forward is one where changing patterns of demand for commodities from a changing Chinese economy will generate both winners and losers. In simple broad brush terms, demand for industrial and construction related materials is likely to fall back, but demand for oil and other soft commodities is likely to continue to grow. This would create not only winners and losers across countries, but even within a country there would be winners and losers across sectors. In the case of Zambia, falling demand for copper can potentially be offset by the fact that Zambia has some of the best potential in SSA for agricultural production.

Rising Chinese labour costs and manufacturing

In addition to changing demand for commodities, the other obvious implication of more balanced Chinese growth is that that rising labour costs in China, driven by the country's own demographic profile, mean that some Chinese companies will see the more aggressive development of EPZs in SSA as a potentially important destination for them to invest in new lower cost manufacturing operations (although we think that much of the relocation initially will be to other countries in Asia given the current wage, productivity, exchange rate ratios in SSA). Moreover, as part of this economic and demographic change, the surplus labour export model used by many Chinese construction companies may become less important, with some starting to set down longer-term roots in SSA and changing their current labour recruitment practices.

From China focus, to the BIS[13] and beyond

As the Chinese surge into SSA runs out of steam other countries will take up the mantle

After such spectacular growth, China's current trade and investment surge into SSA is bound to run out of steam although at a new "much, much" higher level of involvement than historically. At this point, the challenge for governments in SSA will be to seek new alternative sources of investment. We expect that the final outcome to this story may not be so much about China, as it increasingly starts to looks more inward on itself.

India, like China, also has a long history of involvement in SSA, with large Indian populations in Eastern and Southern Africa for almost a century. There is also a strong argument that the Indian growth model, characterised by high domestic consumption and services and comparative strategic advantage in the value chain, is much more closely aligned to the current economic trends in SSA than the Chinese growth model. But, despite this shared history, Indian companies to date have been more cautious in their moves into SSA.

[13] Although Russia has attempted at various times to increase its profile in SSA to date these efforts are insignificant compared to the other four members of the BRICS grouping. While this may change, it still seems unlikely that Russia will be a major player in the evolving SSA political and economic landscape moving forward.

The Tata Group's involvement in SSA is arguably a template for Indian involvement

Having said that, we think the pace of Indian development is likely to continue to pick up. Total trade between India and SSA has already risen from US$5bn in 2002 to US$50.7bn in 2011. Perhaps one of the best ways to think about the rising Indian involvement in SSA compared to China's is through the prism provided by the Tata Group. Tata which primarily sells vehicles, already has ventures in a range of diverse sectors across SSA, from agricultural investments in Mozambique to hotel ownership in Zambia, all run by Tata African Holdings from its headquarters in South Africa.

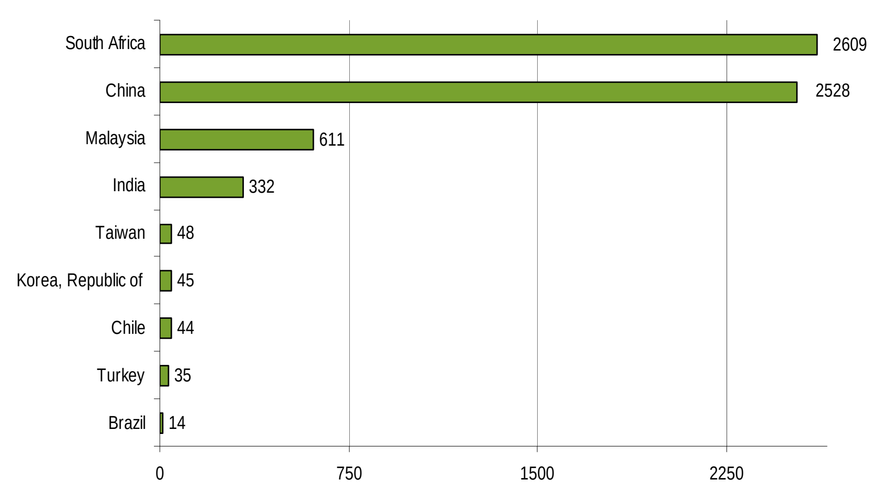
But while the involvement of the Indian private sector in SSA is much greater than in the case of China, a crucial similarity is that the rise in trade is also set against a background of bilateral government agreements. The first India-Africa summit was held in New Delhi in April 2008 and the second in Ethiopia in May 2011. These have set the framework for government cooperation via the India-Africa Framework for Cooperation Forum and the Delhi Declaration. Although the financial aid package promised at these meetings has been significantly lower than the amounts pledged by China – at the 2008 conference the Indian government offered US$5.4bn of concessionary credit over the following five years and greater access to the Indian market – they are still substantial.

Moreover, where China and India tread, others are already rapidly following. Of the BRIC nations, Brazilian companies are increasingly becoming involved in SSA. Some of this has been in the high profile commodity sector, led by Vale and Petrobas, but it is also clear that Brazilian companies potentially have a huge role to play in the agricultural sector which may become a very important engine of growth.

And the net could easily spread more widely

All of this points to a new rebalancing in SSA, in which the growth driving engine of Chinese economic growth is replaced by more balanced external drivers of growth at some point in the next decade, driven by all three of the BIC nations. In fact, this story could be widened out even further, to include investment, which is already happening from Turkey, the Gulf States, and from other Asian countries, as each of these rise in importance. Coupled with the possibility that the EU and the US economies could start to recover shortly, SSA should be able to benefit from a positive story all round, which makes the current high profile role of China in SSA seem much less of a potential concern than it seems at present.

Figure 22. Major developing economy investors in Africa (avg FDI flows pa 2006-08, US$m)



Source: United Nations World Investment Report 2010

The rise of African investors within SSA

While part of the future growth story is likely to involve an increasingly wide range of external actors increasing their involvement in SSA, it is also clear that looking at investment in SSA as something driven externally is no longer true. The obvious leading internal investors in the sub-continent have been South African companies which also has important implications in thinking about the development of some markets.

In retail and brewing for example, South African companies have seen their immediate neighbouring countries, even before 1994, as a logical extension of their home market (for Zimbabwe this has clearly been a very long term trend). Moreover, given the small scale of the markets in Botswana, Namibia, Lesotho and Swaziland, goods have even been joint-marketed. But this area is now expanding to include not only Zambia, but increasingly Mozambique. The relatively close geographical proximity of these markets, the lack of large scale domestic retailers and the relatively high incomes in many by SSA standards, along with a similar structural nature, not only means that the level of competition in these markets is already higher, but that the nature of any future expansion is likely to be different.

In contrast, any move into retail investment in the rest of SSA is happening in a less competitive environment and faces a range of potentially more complicated issues. Not only are the logistics of setting up and running retail operations much harder, but the competition is potentially much more interesting. This is clearest in East Africa, where key Kenyan supermarket chains have built their own local brand loyalty which they are now rolling out to their neighbours. In West Africa the competition is less clearly developed, but the rise of domestic retailers such as Goodies and Pick n Pay, will also affect the nature of competition on the way forward. In addition, shopping patterns are still dominated for many consumers by open air markets and perceptions of freshness. In fact, in some ways, the development of the East Africa retail market in the coming years may well prove how successful the South African retailers are in pushing out into other markets in SSA.

Another interesting example has been the push by Nigerian banks into the rest of SSA. While this was held up due to Nigeria's own domestic banking crisis in 2008-09, with this now coming to an end Nigerian banks are now well set to pick up competition to existing banks throughout the sub-continent. Similarly, some of the Kenyan banks see East Africa as a logical extension of their home market as do many Kenyan companies (with some even eyeing potential opportunities in South Africa).

Developments in inter Africa trade and investment are less on the radar. Some Egyptian companies have identified investment opportunities in Ethiopia and Sudan, while Moroccan companies have become increasingly involved in investments in Senegal and look towards some of the Sahelian West African countries as potential investment destinations.

Markets, such as petrol retailing are even more diverse. The withdrawal of all of the oil majors from petrol retailing in SSA, bar France's Total which remains very active, has created a host of smaller companies running regional operations. In Southern Africa, Sasol is a major player, while Mauritius-based Gulf Africa Petroleum Corporation (GAPCO) has operations in East Africa. Smaller players with perhaps 20 operations in one or two countries may well find themselves ripe for consolidation, depending on how petrol price reform plays out in SSA over the coming years.

The hotel industry also offers interesting examples of the changing dynamics of investment. Historically, there has not been a major hotel chain operating across SSA, although all the major players have a presence in some markets. While South African groups such as Southern Sun and Protea have pushed into SSA, other local competitors are emerging, again driven by East African based chains such as Serena, part owned by the Aga Khan. Against this is the aggressive push by Denmark's Raddison Blu into SSA which has seen it enter into a number of new markets where it previously had no presence.

Finally, markets in SSA have opened up in ways that are not always easy to follow such as in the entertainment sector. In many ways, the rise of South African satellite television, arguably on the back of its broadcasting of the UK's Premier League football, has been the key driver of a pan-African identity, especially with programmes designed to bring in people from other countries such as Big

Brother Africa. But, at the opposite end of the spectrum, the ongoing march of Nollywood films and soap operas is also a very large and growing market amongst lower income consumers, while the industry in Nigeria is a large and growing employer.

Two final points are perhaps worth stressing. In some ways, for African companies to diversify out of their home markets is very logical. One way to think about investing in still a potentially risky area such as SSA is for companies to move into a range of different activities in one country, or to diversify into a more limited range of activities across countries. Whichever option is pursued, the same logic applies: it is unwise to place all your eggs in one basket.

The other point is that that has only been “very, very” limited investment by African companies in the resource sector, other than by South African mining companies. This may change, with the emergence of Nigerian independent oil companies such Afren and Oando.

The changing structure of economies in SSA

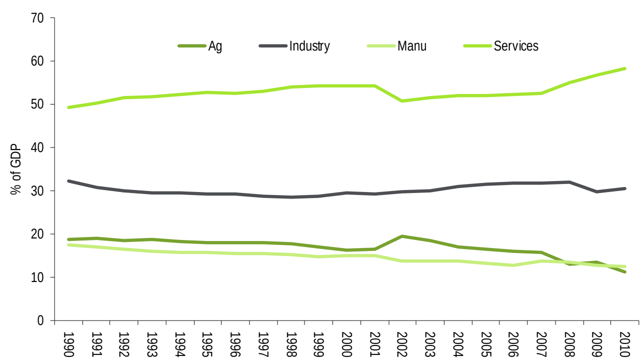
The rise of the service sector

The surprising service sector

While much analysis of the SSA growth story has tended to focus on commodities and the pick-up in the headline growth rate, arguably what is most interesting about the story, and arguably more surprising, is that services have invariably been the most important engine of growth for the last decade. In fact, as shown in Figure 23, even with the substantial rise in commodity prices in the 2000s, the industrial sector has only just about been able to hold its own as a percentage of GDP, whereas the service sector has risen as a percentage of GDP and now accounts for over 50% of GDP for SSA as a whole and in most countries.

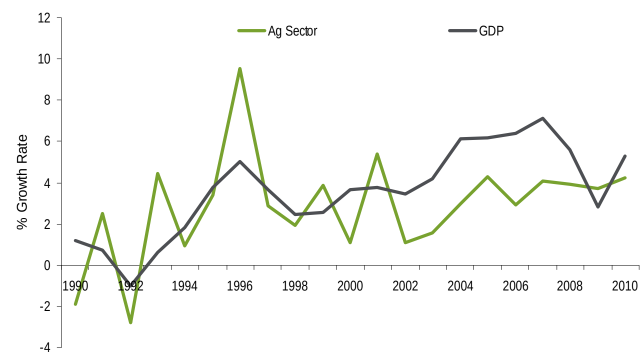
While this does have some variation from country to country, we still think that it is the dominant trend in most economies in SSA over the last decade. Moreover, in many ways this trend is not all that surprising. Despite all the talk about commodities and growth in SSA, simply looking through the GDP data for most SSA countries in the last decade, it quickly becomes clear that the fastest growing sectors are broadly similar: telecommunications and transport, retail and wholesale trade, business and financial services and construction. All of these fall into the services sector.

Figure 23. The changing structure of economies in SSA



Source: Haver Analytics and World Bank

Figure 24. Lagging agricultural sector growth in the 2000s



Source: Haver Analytics and World Bank

Manufacturing in decline due to removal of trade barriers

Meanwhile, the manufacturing and agricultural sectors have been in absolute and relative decline, respectively, as a share of GDP. In the case of the manufacturing sector, this is not surprising. Having opened up their economies, and removed many barriers to trade in the mid-1990s as part of their policy reform efforts, notably against imports, most African manufacturers have faced a competitive onslaught in the last decade from Asian manufactured products. In aggregate, World Bank data shows that manufacturing as percent of GDP rose from 24.8% in the 1960s to 31.1% in the 2000s in East Asia, but fell from 9.4% in Sub-Saharan Africa to only 8.5% in the same time period.

In fact, even in countries which have kept a wider range of import barriers, such as Nigeria, illegal imports have undermined the local manufacturing industry. This is most visible in the textile industry in SSA, which is now extremely limited in terms of the scale and scope of domestic production despite many countries in SSA being large cotton exporters.

Naturally, there will always be exceptions to the rule. Some companies have managed to move up market and distinguish their products from cheaper Asian imports. There has also been some growth in those sectors of manufacturing industry that tend to produce low value, but relatively bulky products, aimed at SSA's low income consumers. Cement is part of this story, although the cement industry in SSA is also arguably better protected by import barriers than other cheaper and less visible consumer goods.

Agriculture sector growing slowly with horticulture the main bright spot

The decline as a share of GDP is more surprising in the case of the agricultural sector. Of course, the reality is that some parts of the agricultural sector have grown strongly. Recent rises in cocoa production in Ghana have been a part of its growth story. Growth in the horticulture sector has been strong, led by the Kenyan horticulture industry, and other strength can be found from Ghanaian fruit exports to Senegalese cherry tomato exports. But the reality is that, overall, the agricultural sector in SSA has grown more slowly than the overall headline growth rate, leading to its decline as a total percentage of GDP.

The demographic dividend, an emerging middle class and rising urbanisation

A rising population

A delayed demographic dividend will drive rapid population growth

The rise of mobile phone penetration and the service sector in SSA, against a background of improved politics and robust economic growth has also opened up a wider debate about the potential rise of a middle class. In fact, the rise of a middle class is also tied into a wider debate over growing evidence that SSA has been subject to a delayed demographic transition. In this case, the argument is that the surge in SSA's population growth rate in the coming decade and beyond will help drive a sustained pick up in the GDP growth rate and create a much larger consumer market.

The potential importance of the demographic dividend on growth is not always clear. But some studies argue that as much as two-thirds of the growth differential between SSA and other parts of the emerging world in the 1990s and 2000s can be explained by the delay. Moreover, this may be particularly important in the case of SSA, where there is also a sensible body of research that argues its historically low population levels, and in particular its low population density, have been major factors holding back growth historically.

Doubling from 1 to 2 billion people

In terms of the basic numbers, according to the UN, the population of SSA is set to double towards 2 billion people in the coming 50 years, reflecting the fact that the median age is now just under 20 years old, compared to 30 in Asia and 40 in Europe. For Afro-optimists, the biggest positive in this data is that this rapid growth of the labour force creates a large and dynamic consumer market. But the key question is how much income will these new consumers have?

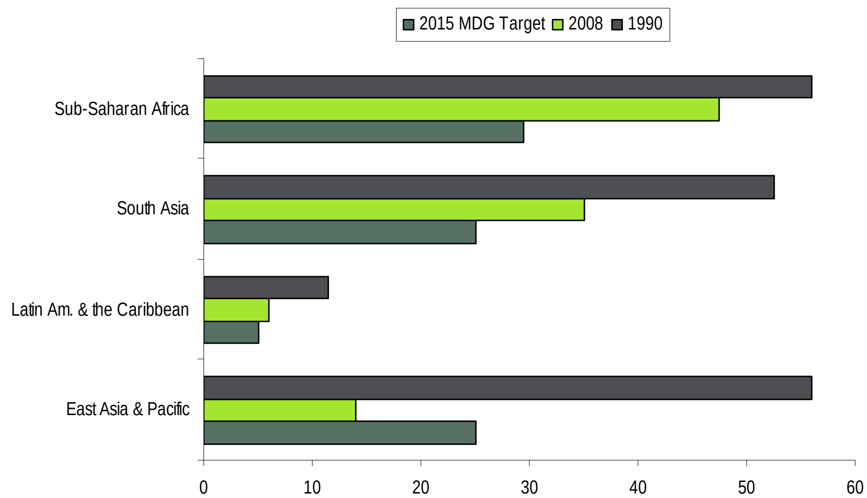
New consumers abound, but are they really a middle classes?

Strong growth, falling poverty

In early 2011, the African Development Bank produced an extremely interesting and well-reasoned report on SSA – *The Middle of the Pyramid; Dynamics of the Middle Class in Africa*. It argued that strong growth in the 2000s had reduced poverty, from 50% of the total population (using the PPP US$1.25 a day poverty line) to 44% by 2010. Moreover, and the headline grabber, was that growth had also increased the size of the middle class.

Defining the middle class as those with a daily consumption of US$2-$20 per day in 2005 PPP US dollars, the AfDB argued that by 2010 the middle class accounted for around 34% of the population or a market of over 300 million people. The study has been leapt upon and expanded, with articles adopting a straight line approach to thinking about the issue, arguing that the middle classes in SSA will grow from 355 million people in 2010 to 1.1 billion by 2060.

Figure 25. Headcount poverty index using $1.25 a day poverty line



Source: World Bank, World Development Indicators

But the AfDB also made some important, and often overlooked, distinctions within this group. The most important of these is arguably what it calls the "floating group" with spending of between US$2-$4 per day. In fact, as the AfDB notes, this means that 60% of this new middle class, or around 180m people, are "barely out of the poor category" and could easily fall out of their definition of being in the middle class if growth was to slow or inflation was to rise sharply.

There is only a small middle class by the traditional EM definition

This much larger group compares to the upper middle class, with consumption spending of US$10-$20 a day, or just under 45 million people, and the lower middle class with a population of around 89 million. But even these numbers must be put into their proper context: probably the more widely accepted definition of a middle class consumer in an emerging market is one with a per capital annual income of US$5,000 (or US$13.70/day), PPP adjusted. It is at this level and above that people really increase their purchasing of large consumer durables, notably autos and houses.

Does this mean that the SSA middle class consumer story has no legs? We think not, but it does have to be more clearly understood. While doubts can be thrown around about the quality of the data, the overall pattern of rising consumption spending does seem to fit, with caveats, into the trends identified in household income and expenditure surveys in many SSA countries. For example, many of these surveys show that households now eat one hot meal a day and that a rising number of households now own a radio, a television, DVD player or a bike.

> …we think it is more logical to talk about the emergence of a new consumer market in SSA, not an emerging middle class…

A new consumer market will continue to emerge

But what is crucial to understand is that these levels of income are still very low. Therefore, while there can be talk of an emerging middle class, we think it is much more logical to talk about the emergence of new consumer market in SSA. This new consumer will, for all extents and purposes, largely consume basic goods and services for the next decade or so assuming that the overall SSA growth trend remains robust. The question is how can this be exploited?

Changing face of retail to accommodate the new consumer class

We think that at least in the coming decade or so, the key consumer markets in SSA will largely be low-end, with a splash of high-end colour. What does this mean in practice?

Primarily, this means that demand for all sorts of basic consumer goods, sold and priced appropriately to low-end consumers, will continue to grow robustly. This includes foodstuffs, from pasta to tinned products (processed meat, tuna, pilchards, tomatoes), to healthcare products such as toothpaste and shampoo. It will also include shoes and clothes.

Consumers "trading up" will be an important commercial idea

While a large proportion of these will still be sold in traditional open air markets, the rise of more formal shops, shopping malls and supermarkets is set to continue unabated. By stacking basic products "high and cheap" retailers will establish a steady low income market. But the retail format will also allow consumers to" trade up" when they have additional income, as well as serve the more traditional market of the upper middle classes. To some extent this is already the model pioneered in SSA by the new supermarkets.

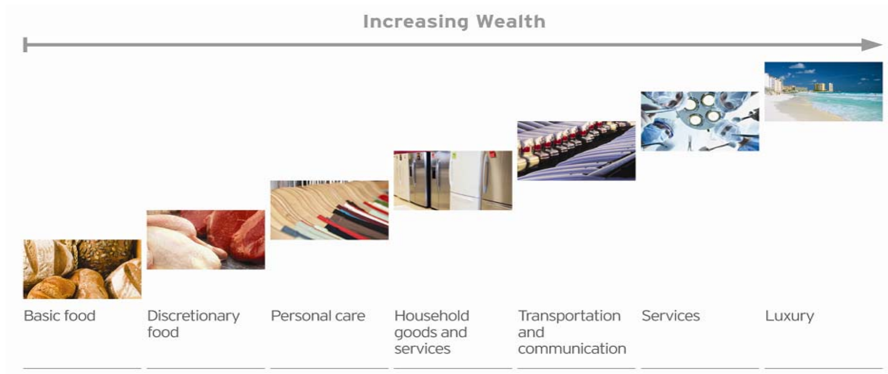
In fact, the idea of trading up will be crucial for many companies selling into the SSA consumer market. Companies that have a steady base sales line, but can benefit when consumers have additional income to spend are likely to be winners. In the beverage industry this is already clear. If a consumer has an extra US$5 in his pocket at the end of the week, they can trade up to buy a clear bottled beer as opposed to a traditional brew. The next logical step is that a beer drinker can be encouraged to "trade up" to drinking wine or spirits. This argument can be applied widely to supermarkets, fast food outlets, tobacco and beyond.

Moving beyond basic consumer goods

Supporting the consumer goods industry will be a growing durable goods market. The main markets will be housing-related products: metal roofs, door and window frames, paving slabs and paint. But this will be supported by cheaper-end white goods such as stoves, fridges and radios/televisions (and the accompanying CDs and DVDs).

Furniture sales will also fall into this category and again, all these markets have a trading up aspect. A person with additional income can move from sleeping on flattened cardboard boxes on the floor, to sleeping on a foam mattress to sleeping on a bed (of varying quality). A person can buy a second-hand fridge imported from Europe, or a new one from a more formal retailer. In this respect, another way to think about the "trading up" argument is that within SSA in the coming decade there will likely be strong, but erratic, "aspirational" demand.

Figure 26. Evolving consumer taste



Source: Citi Research

The formal-informal sector interface

There are potentially two important aspects of economics to think about if this pattern of growth does materialize:

- The first is that increasingly informal and formal sectors will collide in SSA. Someone builds a house by employing a local bricklayer and paying them in cash over time. Even if the bricks are made by a local employer, at some point the construction of the house will start to increasingly link to the formal sector as roofing materials, doors, windows and paint are purchased. This moves a further stage forward if the house is ultimately connected to the electricity grid and so the linkages develop.
- The second point is that the rise in incomes driving the rise in consumer demand will also potentially create a virtuous cycle of growth as a whole range of service and support industries will be added to the economy. Rising housing development should boost demand for professions from plumbers to electricians and bricklayers and so the argument can be taken forward. The linkages for some additions are less clear, for example the rise of the Nigerian "Nollywood" entertainment industry. Growth in this niche sector is likely to continue unabated, although the key to generating profits will be to reduce pirating. Many of these new industries will be small-scale players, but at some point, these will have the potential to become more formal businesses.

The upper end market exists but spread around large cities

While markets and consumption should rise, the idea of some form of "mythical middle class consumer" in most countries is probably not on the cards for some time to come, certainly not in the next decade. Instead, perhaps a better way of thinking about the new middle class in SSA is as an "elite" middle class. It will probably number around 50 million, but although this is potentially a large market, the problem is that it will be spread around a limited number of larger cities. Crucially, it will also be supported by an additional market that is provided by corporates and government spending. This means that there is a viable top end of the market to provide a range of goods to higher income consumers.

African gateway cities should emerge and thrive

One way to potentially think about this market is to understand how higher income earners and businesses will interact going forward to create a potentially important market for some businesses. We think that businesses, both multinationals and local companies with operations across SSA, will increasingly seek to run their SSA operations from a limited number of base cities, chosen for qualities such as their stronger transport links (crucially an airport) skilled labour base and existing range of services (i.e., restaurants, schools and hospitals). Within SSA these cities are likely to be Johannesburg in South Africa, Lagos in Nigeria and Nairobi in Kenya (and maybe Accra, Ghana or Abidjan, Côte d'Ivoire). But we could also potentially

include cities outside SSA, possibly Cairo and increasingly Dubai. These in a way could add to the existing gateway centres in London, Paris and New York.

These cities are likely to emerge, or remain, as business bases, or gateways into SSA, where there is a significantly larger high income consumer base and a wider range of facilities and amenities available. Obviously, the high-end retail opportunities in these cities will also be significantly above those elsewhere in the sub-region.

SSA retailers facing increased competition

Greater competition in retailing will be important…

The reality within SSA at the moment is that many companies providing existing goods and services work in an oligopolistic market structure, at best, and at worse in a monopoly or duopoly. In turn, this results in the high cost structure in many cities in SSA, as reflected in cost of living surveys by Mercer or the EIU. But as new competitors are starting to emerge it may be that sectors, such as the retail industry, and potentially, others are on the brink of an important change that will only be apparent towards the end of the decade.

To gain an insight into how this could potentially play out it is constructive to look at the retail sector in East Africa and the supermarket industry in particular. For example, Shoprite Holdings opened its first store in Pugu Road in Dar-es-Salaam, Tanzania in December 2001. For some time, this was a successful monopoly attracting high income consumers from Tanzania’s commercial capital and also lower income consumers trading up, or buying a limited number of items at guaranteed prices in bulk. On the back of this Shoprite opened another store in Dar-es-Salaam in Mlimani City in 2006, while another was opened in Arusha, Northern Tanzania in 2003.

But the real key is to look at how retailers move beyond their relatively limited base in the face of rising competition. Kenyan supermarket chain Uchumi has opened in Quality Mall in Dar-es-Salaam for example (Uchumi already has a significant presence in Kenya and three stores in Uganda), while Nakumatt has opened a store in Moshi, Tanzania following on from its successful expansion into Rwanda. Meanwhile, to wake up Kenyan retailers on their own turf, it was also recently announced that South Africa’s Massmart is to invest in operations in Kenya.

…as will the move into secondary urban sectors

In some ways this model of steady expansion has already occurred in Southern Africa where South African supermarkets moved into major cities, but have now have also moved out substantially into smaller urban centres in Botswana, Lesotho, Namibia and Swaziland as well as in Zambia and Zimbabwe. But here incomes are higher and the competition from local retailers less intense. In the case of Kenya and Nigeria, the reaction from local companies will be strong and competition much greater.

> “Similar but different battles across all retail and business sectors are likely throughout SSA in the coming decade – retail, banking, mobile phones, airlines, hotels, cement and other building materials – could, and should, all see greater competition.”

Hopefully the consumer is the main winner

Hopefully, the main winner from this increased competition will be the SSA consumer, who will see greater competition (allied to superior logistics?) driving down prices, while rising formal sector competitors raise quality standards and provide governments with an important and growing source of revenue. The other hope is that the rise of new retailers will create greater backward linkages into their host economies, as at least some of the goods on sale will be provided by emerging

local suppliers either based on taste preferences, or perhaps more importantly because of their cost advantage (local production is cheaper than imports).

There are derivative implications of increased competitive

Increased competition in SSA could have many potential derivative implications for investors. For example, many companies in SSA can fund their investment programmes simply through reinvested earnings: the classic example of this has been the mobile phone industry. This limits their need to borrow from banks, apart from short-term overdrafts, or even issue equity. But greater competition may start to change this in the coming years as companies operating in SSA have to raise capital to fund investment by more conventional means.

Africapolis: An Aside on Urbanization and Growth in SSA

One factor that is commonly stated about SSA is that the region is rapidly urbanizing, a key structural economic change, which ties in with the idea that the main consumer market is the new emerging urban middle classes. The reality, however, may well prove to be much more complicated.

According to UN and Habitat data, which is by far the most widely cited, SSA is rapidly urbanizing and on course to become a predominantly urban continent at some point in the not too distant future. But recent research, focused initially in West Africa, but now also in East Africa, casts some doubt on these conclusions. Using a detailed analysis of population censuses and comparing it to satellite pictures and observations on the ground of urban growth, the Africapolis project argues that the rate of urbanization is being heavily overstated in this official data[14]. This does not mean that urban growth is not happening in SSA — cities are still growing. But overall, and crucially, the percentage of population living in urban areas – the definition of urbanization – is not rising significantly and the percentage of the population living in urban areas in SSA may currently be significantly overstated.

While perhaps initially surprising, on reflection this is perhaps not all that out of kilter with the overall SSA growth story. Although rural-urban migration is a complicated phenomenon and in SSA is often circular, it still tends to be a highly economically logical action. Potential migrants identify jobs in cities, often through relatives and other contacts from their own village or tribe. These contacts also provide temporary accommodation and support, helping facilitate the move. As a result, migrants also generally move to secure a higher income than they could earn in a rural occupation. But, if large numbers of jobs are not being created, notably manufacturing jobs which are the traditional entry point for most migrants, then the move to an urban area is simply less attractive.

The growth and urbanization story may also help explain the nature of urban growth in SSA. Urban centres are growing, but mainly through urban sprawl and often resulting in the hollowing out of traditional city centres. Moreover, much of this growth is low-rise urbanization rather than an increase in urban population density. In some ways, this may reflect the lack of real land pressures in SSA, but may just as much reflect a pattern of growth where existing residents identify new areas to settle and move on to them, rather than growth being driven by large inflows of migrants into existing urban areas. The lack of formal manufacturing jobs also drives informal urban economic activity. While much of this is petty trading, there is also a considerable component that is peri-urban agriculture. In effect, these can also be seen as urban survival strategies, rather than a strong motor of growth, although the pattern does still support the overall growth story.

What are the economic implications of stagnating urbanization? First, the demographic dividend assumes that female fertility rates fall quite sharply as the population urbanizes. This may be less of a plausible assumption if a larger percentage of the population is still rural. Second, corporate strategies focused on meeting strongly rising urban demand may well miss a hugely important growth market in the African context — rural consumers. In fact, the similarities between rural and urban markets may be far less pronounced than automatically assumed.

---

[14] The Africapolis research, while very comprehensive, seems to have been very much under the radar, but was highlighted by a paper by Deborah Potts for the African Research Institute, *Whatever happened to Africa's Rapid Urbanisation?*, which uses the Africapolis research plus some of her own.

Consumption growth from remittances

Remittances are a transfer of money by a foreign worker to his or her home country.

One question that could be asked about the trend in rising consumption in SSA in the last decade is the extent to which it has been driven by rising growth and incomes, or simply sustained by rising remittances. Using World Bank data, the value of official remittances into SSA has risen sharply in the 2000s: up from an estimated US$4.6bn in 2000 to just over US$20bn a year in the in 2008-11 period (with unrecorded flows this could, in fact it is highly likely, be much higher). The World Bank estimates that this will rise to closer to US$30bn by 2015. These are significant numbers, but there are a number of questions about the data:

- First, it is not always clear whether remittances are being used to fund consumption, or are, in fact, investments back into rapidly growing home economies. Having said that, the difference may not be important to the overall growth story. Whether recipients use the funds to start small businesses, make home improvements, or spend the money on other investments, such as to pay school fees, or for more immediate consumption needs, the economic impact remains strong and positive.
- Second, although remittances have grown strongly, it is still not clear how many people receive them. In fact, a 2011 Gallup survey in 11 SSA countries showed that only 4% of households surveyed received an international remittance. In contrast, over 30% received a domestic remittance, most often an urban to rural household transfer. Although the number for international remittances seems low, it will vary from country to country. In particular, in some countries, such as Senegal or Sierra Leone, many economists would argue that the importance of remittances is much greater in driving consumption than the rise in domestic incomes.

Does the end of golden era for remittances loom?

The growth in remittances in SSA in recent years could potentially reflect two trends. The first is simply better data capture, and arguably, even with this substantial flows are probably still not being captured in the data. Second, it may well prove that remittances are rising due to the demographic profile of those sending them. Many of the current diaspora fled SSA in the 1970s and 1980s when the political situation was unstable and the economic one arguably worse. Those who emigrated were usually well educated, and many by now have established careers for themselves and are at the peak of their earning potential.

This however, raises the very real prospect that remittance growth will start to slow in the not too distant future. As this group of the disapora retire their remittances will slow, and it is far from clear whether their children will remain as committed to sending money to SSA. In addition, it is not clear whether current migrants into Europe and the US, where barriers to immigration have risen, will follow the same income pattern as this earlier group. In fact, many may end up working in low income, menial jobs with limited employment security.

Retirement and a returning diaspora could offset a decline in remittances

In the short to medium term however, the prospect of declining remittances could be obscured by other factors. First, many of the earlier generation of migrants are now coming up to retirement and are thinking about spending at least part of the year, back in SSA. This may result in an increase in remittances, at least temporarily. This trend is probably most noticeable in West Africa where emigration was highest in the 1970s and 1980s. Second, there could be a returning diaspora as some of the first generation emigrants and the later migrants from the 1990s are now seeking to return to the new SSA to set up their own businesses and take advantage of the growing economic opportunities.

In the end, remittances are likely to remain buoyant in the short term and act as a support to rising consumption, if not the driving force. But it would be unwise to assume that the strong growth of recent years can be maintained indefinitely unless a new wave of migrants from SSA were to seek employment outside the continent. With low growth set to continue in the traditional destinations for SSA migrants — the EU and US — this would probably require a major change in migration patterns. And while a trickle of new migrants may have gone to Asia and China in recent years, at present, this does not seem to be a wave.

The potential complications of the demographic transition

Will a shift in demographics lead to new consumers or new mouths to feed?

While much is written about the positive aspects of the demographic transition in development terms, there is, of course, an alternative side to it. The other side of new consumers is that agricultural production also needs to increase to feed the rapidly rising population; while jobs need to be created to drive the consumption boom. Without this, a potentially common political theme, already highlighted by the Arab spring in the north and the rise of Julius Malema as a political force in South Africa[15], is that those without jobs can quickly become a political force demanding change.

There is an important technical factor to bear in mind with respect to the demographic transition. For it to work smoothly and to boost growth there needs to be a sharp fall in the fertility rate. In this respect, there is already one part of Africa that is similar to the rest of the world — its urban population lives longer and have fewer children. But there is also another part, the rural population, where the fertility rate may not be falling as fast as projections indicate, but where the infant mortality rate is falling quickly. In fact, if SSA is not urbanising as fast as projected, then the future projected slowdown in the population growth rate will take longer to materialise and put even greater pressure on the need to provide food and jobs for a growing population.

> "…if SSA is not urbanizing as fast as projected...the future projected slowdown in population growth will take longer to materialise…"

Population growth creates winners and losers…

The other point to remember about rising populations in SSA is that the impact is likely to vary largely from country to country. When looking at East Africa for example, many parts of Kenya and Tanzania are under-populated, but by the time one moves into the interior countries of Burundi, Rwanda and Uganda, population densities have risen sharply. The population density in Tanzania in 2010 is estimated by the World Bank at 50.6 persons per square kilometre compared to 430 in Rwanda.

In fact, if one took the UNPOP population projections for Uganda at face value, its population is projected to triple from 33.4m in 2010, with a current population density of 167.3 people per square kilometre, to 94.3m in 2050. This would have potentially disruptive effects unless the rate of urbanization, and urban job creation was to rise substantially, or productivity in the agricultural sector for very small scale

[15] Julius Malema rose to political prominence in South Africa on an overtly populist policy platform within the ruling ANC, notably in his calls for mine nationalisation. While he has since been expelled from the ANC following a conviction for hate speech, his relevance may well lie in the fact that he becomes emblemic of a new generation of politicians in SSA who want to adopt more populist policy measures to try and boost employment and reduce poverty.

farmers was to rise even faster. One response to rising population density is to allow greater migration within SSA from higher density countries to lower ones, but this in turn carries significant political dimensions.

…and create second tier large economies will emerge

Finally, it is worth noting that while the overall growth performance of SSA in the 2000s was dominated by the two largest economies, Nigeria and South Africa, this will change going forward as a number of countries emerge with large populations. In the medium term, the three main new players are likely to be Sudan, Ethiopia and Tanzania which are all likely to impact more significantly on SSA growth as they emerge as the second tier of large economies. In the longer term, a country such as the Democratic Republic of Congo (DRC) could also potentially join this group. In this picture of the future SSA, although Nairobi will remain a gateway into East Africa in the medium term, Kenya will likely fall behind its regional neighbours as the largest economy in the East Africa region, although arguably it will still have the highest income per capita.

Short-term growth prospects

A changing policy environment and global head winds

Moving beyond politics and policy

The exercise of trying to understand what has happened in SSA in the last decade or so, is not just one of theoretical economic interest, but also an attempt to understand how the past will drive future economic developments. In fact, what is interesting is that some of the drivers of growth in the last decade, notably the improved political and economic policy environment may now be less important for the future. We increasingly think the challenge for policymakers is to switch from the old thinking about growth to developing new drivers of growth. In effect, to run with some new structural drivers of growth and understand how these will propel long-term growth.

The idea that the economic policy element of growth has changed in a substantive way is evidenced clearest in the economic developments in SSA in the 2009-11 period when growth did not slow as significantly as many economists forecast in response to the 2008 financial crisis and the subsequent Euro Area crisis. In the April 2009 edition of the *IMF Regional Economic Outlook for SSA,* the Fund expected SSA real GDP growth to fall from 5.4% in 2008 to only 1.5% in 2009, with warnings that the downturn could be even more severe[16]. In the end growth did slow, but not as severely as feared, and the downturn was also short. IMF data now shows that real GDP grew by 2.7% in SSA in 2009, rebounded to 5.4% in 2010 and has remained at this level, at 5.5%, in 2011.

Understanding the "shallow v" recession

However, we think that when you analyze the drivers of growth in SSA, they do help to explain the relatively short and more moderate slowdown: a lower case "v" rather than even a "u" shaped slow down. First, as our reading of the growth story highlights, with services a crucial driver of growth, and largely unconnected with the wider global economy, the domestic motor of growth is simply much more robust than it had been historically. Even where there was a possible link to the broader global economy, e.g., via the financial services sector, this proved relatively weak. In fact the main links seemed to be the drying up of trade credit and a sharp, but short-lived, drop off in FDI inflows, with both factors having a significant, but short, impact on growth[17].

> "With services a crucial driver of growth…the domestic motor of growth in SSA is simply much more robust than historically."

[16] The extent of the concern about the growth outlook for example, was clearly highlighted at the African Economic Research Consortium (AERC), Senior Policy Seminar in Lusaka on 6-8 April 2009, when most papers presented were extremely pessimistic about the economic outlook.

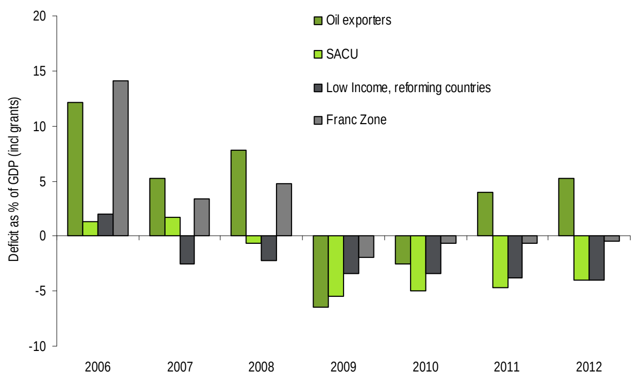
[17] The concern about the possible impact, coupled with the withdrawal of portfolio investment and a strengthening US dollar, did however, lead to a sharp collapse in many currencies in SSA in late 2008. See Figure 8.

Finally, the holding up of growth in SSA was also helped by a relatively swift government policy response, in the form of a significant loosening of fiscal and monetary policy. There were two important aspects to this:

- First, although the loosening of fiscal policy was initially embarked upon following the advice of donors (led by the IMF) who advocated an appropriate counter-cyclical policy response to the global economic slowdown, the reality was that this advice coincided with an election cycle which saw many of the bigger SSA economies approaching election years. In some ways, this meant the domestic political support for the policy of fiscal easing was strong.

- Second, the easing of monetary policy also seemed to coincide, fortuitously, with two years of good agricultural production in SSA in 2009-10, following a sharp rise in prices in 2008. This meant that the easing of policy did not lead to a surge in consumer price inflation (CPI) over the period. In fact, inflation continued to maintain a downward trend, although in the SSA context it remained volatile as shown with the sharp rise again, notably in East Africa, in 2011.

Figure 27. Rising fiscal deficits in 2009-10



Source: IMF

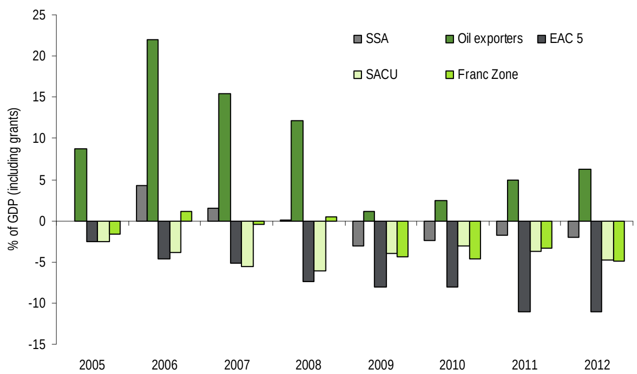
Figure 28. The long decline in inflation seems to be bottoming out

Source: IMF

There were two interesting side effects to the loosening of fiscal and monetary policy and the relative rebound in growth. Probably the most important of these was that, as a whole, SSA moved into a considerable current account deficit over the 2008-10 period, as shown in Figure 29. In some ways, rising government spending and strong growth has continued to suck in imports more quickly than export growth could offset.

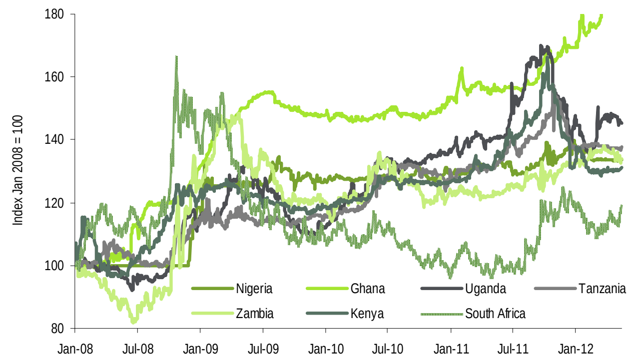
The second trend is that the move into twin fiscal and current account deficits, along with loose monetary policy, meant that by and large, SSA currencies, notably those allowed to float, remained remarkably weak during this time. This was certainly true in comparison to other emerging market currencies where the need to raise interest rates attracted significant portfolio inflows. Using the South African rand as a proxy for emerging market currencies more broadly, this weakness is clear when plotted against the main investible SSA currencies over the period as in Figure 30.

Figure 29. Rising current account deficits



Source: IMF

Figure 30. Weaker currencies in SSA since 2010



Source: Thomson Reuters and Citi Research

Reconciling development and investor interests

Note that weak currencies and large current account deficits are not a logical part of a growth story when thought about in development terms. In fact, one would expect relatively poor counties, with large unmet investment needs to run significant current account deficits if they need to grow fast. But from an investor perspective, if these deficits are not fully financed and currencies do weaken, they make it much harder to calculate what a suitable rate of return is for investments.

Current headwinds to a rapid pick up in growth

Short term growth facing headwinds

While growth in SSA has picked up relatively robustly in 2010-11 after the short-lived slump in 2009, we remain wary about forecasting that growth will continue to pick up further in the short term, or get back up to the peak of 7.2% recorded in 2007. This, in part, reflects our view that at least some of the factors which have helped create a mild and short-term growth slowdown in SSA in 2009 may now be on the wane, which will limit any quick recovery.

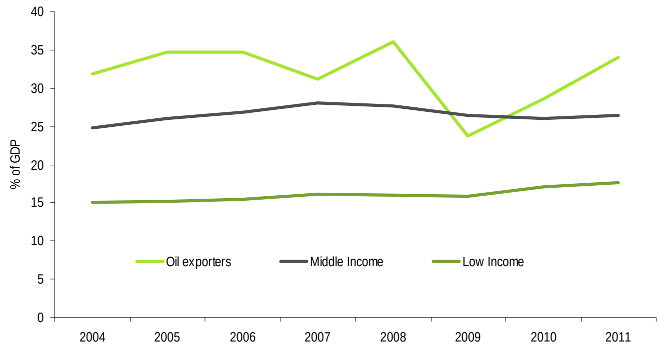
- The most obvious brake on any strong pick up in growth is likely to be slowing growth in Asia. While we do not expect any sort of imminent hard landing in China, the reality is that very high growth rates seen in the last decade may not be sustainable in the next few years. We expect Chinese GDP growth will slow from 9.2% in 2011, to 7.9% in 2012, and remain around the 8% level in 2013.
- The slowdown in Asia is also happening at the same time as there is a need to unwind the fiscal stimulus in many SSA countries. In fact, in parts of East Africa and Nigeria this policy brake on growth is more evident because monetary policy has already had to be tightened sharply in 2H 2011 to offset rising inflation and currency weakness.
- Moreover, and crucially, the need to unwind the fiscal stimulus is arguably most apparent in the Southern Africa Customs Union (SACU) countries, including South Africa. In fact, returning to our earlier big country theme, our forecasts that the South African economy is only set to grow at 2.7% in 2012 and 3.6% in 2013, a considerably slower rate compared to 2001-10, looks set to place a distinct brake on any pick up in growth for SSA as a whole in the next few years.
- Finally, the infrastructure deficit and constraints to doing business in SSA remain very real and were not fundamentally tackled during the growth slow down in 2009. Both have quickly re-emerged as constraints to the growth pick up in 2010-11, most notably in the power sector where examples of prolonged power shortages have becoming increasingly common throughout the region.

The need to raise domestic taxes to close fiscal deficits

Development spending needed

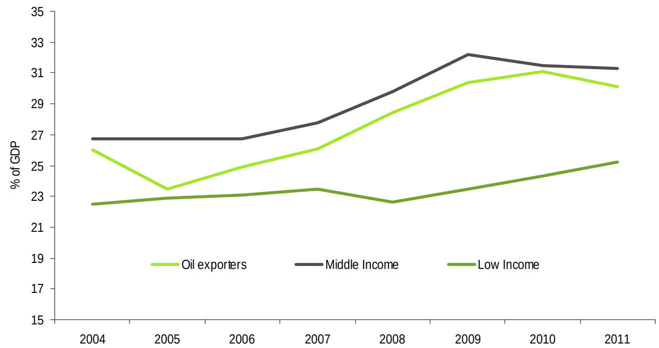
The need to close the fiscal deficits in SSA in the coming years comes at a time when, as we have argued, there are still huge and unmet infrastructure needs. This is turn, will make the policy choices particularly tricky. One of the most obvious issues is that spending will have to increasingly be directed away from recurrent spending and towards development/capital spending. In fact, there is an argument that because the rise in spending in recent years coincided with a series of elections, much of the increase was recurrent spending.

Figure 31. Slow-growing government revenue (excluding grants)



Source: IMF

Figure 32. Fast-rising government spending



Source: IMF

With pressure to increase development spending, we think the reality is that for most governments the only way to keep fiscal deficits under control will be to increase domestic revenue — i.e. increase tax revenue. Available data indicates that domestic revenue in SSA has risen in the 2000s on the back of rising growth. But, this growth has been relatively slow, and crucially, there is also an argument that the ability to continue generating revenue growth of the back of economic growth is close to its limit. This reflects the narrow tax base in most countries in SSA.

> "The challenge for governments will be to widen the tax net in the coming years."

Widening the tax net

We think that the formal sector in SSA is now relatively heavily taxed, while the opportunities to implement more trade taxes, an important source of revenue in SSA, are limited. If this does prove the case, then the challenge for governments will be to widen the tax net in the coming years. There are several ways that this could potentially be achieved.

- The first, which is to a point happening already, is to increase taxes on mineral production. The recent reforms to the Zambian mining tax regime highlight this general trend, along with increases in royalty taxes on gold miners in Ghana and Tanzania in 2011[18].

[18] There is some evidence that mining activities are under taxed in SSA. This probably reflects the sector's recent history, with governments offering relatively generous concessions to mining companies in the late 1990s and early 2000s to invest in their countries given the then recent history of SSA and lower global mineral prices. A decade later this situation has changed significantly, with many countries in SSA having

- The second is to widen the tax base by first bringing more of the informal sector into the tax net; and second, taxing property in SSA countries, notably urban properties. We also think that going forward governments within the sub-region will find it increasingly hard not to increases taxes on mobile phones in some way or form given their rising role in trade and financial transactions.

Raising taxes effectively also requires "fiscal legitimacy"

For tax reform to work effectively, the bottom line is that governments in SSA will have to improve what the OECD calls their "fiscal legitimacy". Only by showing people that the tax they pay is spent wisely and will help drive overall development, will people really be encouraged to pay more tax in a less grudging fashion. This may well prove much more complicated than simply introducing new tax legislation.

Infrastructure spending as short- to medium-term driver of growth

The need to push up spending on infrastructure

Whatever happens in the short run in SSA, the need to build infrastructure is arguably one of the most pressing issues facing SSA if it is to achieve sustained growth in the medium to long term. In fact, there is a strong argument that in the face of a difficult external environment in the coming years, an important source of potential growth is spending on infrastructure development. This, in part, reflects the fact that while there has been much discussion and detailed analysis about the need to build infrastructure, such as that provided by the World Bank, in its major 2009 study – *Africa's Infrastructure: A Time for Transformation* - the reality on the ground is that infrastructure development is still significantly lagging the overall growth rate[19].

Figure 33. Indicators of infrastructure development in SSA & other developing regions

Indicator	Sub-Saharan Africa	South Asia	East Asia and Pacific	Europe and Central Asia	Latin America and Caribbean	Middle East and North Africa
Transport						
Paved road density	49	149	59	335	418	482
Total road density	152	306	237	576	740	599
ICT						
Mainline teledensity	33	39	90	261	197	100
Mobile teledensity	101	86	208	489	350	224
Internet density	3	2	7	16	14	10
Power						
Generation capacity	70	154	231	970	464	496
Electricity Access	18	44	57	-	79	88
Water and sanitation						
Improved water	63	72	75	87	90	85

Source: World Bank and PPIAF

By this we mean that projects are often talked about and while some do materialize, especially those driven by Chinese companies, they remain a minority of the total, not the majority. This trend is arguably discernible in two ways:

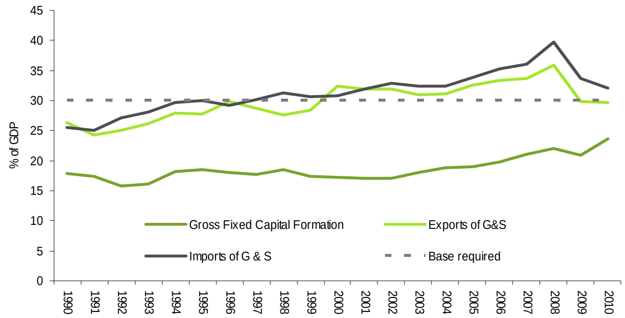
- On the aggregate level, total gross fixed capital formation in SSA for the last decade is still fundamentally too low, despite picking up gradually. In fact, we think that a benchmark of around 30% of GDP is required to sustain higher, transformative rates of growth in the coming decades, well above the 20% average of the last decade.

undergone a decade of political and economic policy improvements against the background of higher commodity prices. The trend is perhaps better understood as a scaling back of incentives aimed at attracting investors which are no longer necessary.

[19] Although in defence of governments in SSA, the problem may not just apply to them. As Ian Bremmer of Eurasia Group argues, "it's perhaps the biggest lesson from the last four years – the world is moving much faster; governments aren't".

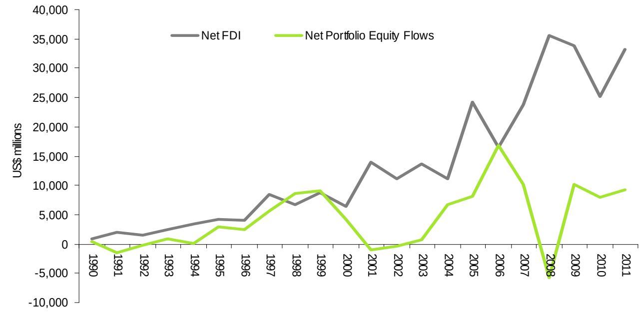
- But it is also clear in more specific sector statistics. For example, the World Bank's road statistics show that in 1999 16.5% of SSA roads were paved, while despite reportedly huge spending on roads in the following decade, this figure had only risen to 18.3%.

Figure 34. A low level of gross fixed capital formation



Source: Haver Analytics and World Bank

Figure 35. Surging FDI inflows



Source: World Bank and UNCTAD, *World Investment Report*

China instrumental in infrastructure projects

As already alluded to, for Afro-optimists the biggest push for infrastructure development in SSA in the coming decade looks set to be China's ongoing efforts to build a new Africa, and the figures often thrown around are substantial. At the Fifth Ministerial Conference of the Forum on China-Africa Cooperation (FOCAC) in Beijing in July 2012, China's president, Hu Jintao announced that China would lend US$20bn to African governments for infrastructure and agriculture projects over the next three years; double the amount offered at the last FOCAC in 2009. Moreover, while there are valid discussions about the quality of the projects that Chinese companies are building, and even the potential hidden costs, the sharp reality is that Chinese construction companies are embarking on, and completing, projects all around SSA, which are likely to have a positive impact on growth.

But even if the Chinese are now investing more in SSA infrastructure than the World Bank, this will still be insufficient. In the end, we think governments in SSA are going to have to overcome a number of internal constraints that are holding back projects from moving ahead quickly and raise funding from a variety of sources if they are going to push up the level of gross fixed capital formation to 30% of GDP and above.

Electricity pricing highlights the barriers to quick progress

Of the sectors that need prioritizing, perhaps the most pressing in need of investment is electricity — a sector in which growth can be driven by the private sector if the government gets its pricing policy correct. According to the 2012 World Bank "Doing Business Indicators", while SSA is only the third most difficult region to obtain electricity – average rank 122 compared to 128 for South Asia and 129 for Eastern Europe and Central Asia – the cost is easily the highest at 5,430% of income per capita. The reality is that while there has been some progress in increasing electricity provisions in SSA in recent years, it has been far too slow. We think this reflects the struggle by governments to balance what they consider the needs of the public with the higher tariff rates demanded by potential investors.

What governments in SSA need to fundamentally accept is that in many countries, the private sector, as well as many individuals, are acutely aware of the full cost of providing electricity, as most run generators on a daily basis. In Nigeria, the reality is that many run two generators. In most cases, the tariffs charged by parastatals are well below the cost of this privately generated electricity. Therefore, while increases in tariffs are unpopular, there is still considerable upward scope for price rises given the super high costs already being paid. More crucially, government should perhaps not fret too much about establishing fully optimal tariff structures but concentrate on boosting supply.

Taking the converse of the argument presented about mining taxes in Footnote 18, there is an argument that to attract investment into the electricity sector at the early stages of development may involve investors making above normal rates of return for a certain period of time, as the risks associated with the large investments required are still relatively unclear. This should help ensure that a stable supply framework is put in place relatively quickly. Then, when the system is established and more stable, the goal is to regulate away these abnormal profits over time.

Figure 36. Cost of infrastructure services in Africa

	Sub-Saharan Africa	Other developing regions
Power Tariffs ($ per kilowatt-hour)	0.02-0.46	0.05-0.1.0
Water Tariffs ($ per cubic meter)	0.86-6.56	0.03-0.60
Road freight tariffs ($ per ton-kilometre)	0.04-0.14	0.01-0.04
Mobile telephony ($ per basket per month)	2.60-21.0	9.9
International telephony (% per 3-minute call to the US)	0.44-12.5	2.0
Internet dial-up service ($ per month)	6.7-148.0	11.0

Source: Foster and Briceno-Garmendia (2010), World Bank

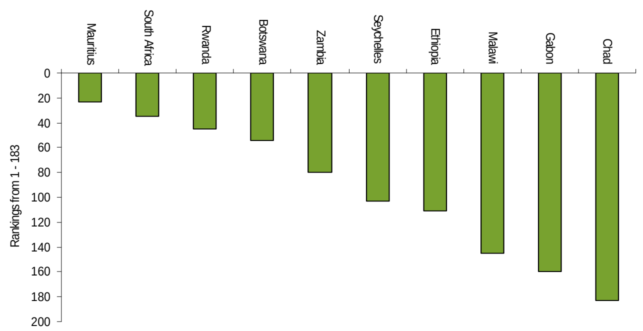
The profitability-investment conundrum

Resolving the infrastructure constraint in SSA, may also help resolve one of potential conundrums at the heart of the SSA growth experience of the last decade. Although there has been a sharp rise in FDI into SSA, as shown in Figure 35, and there is considerable evidence, notably produced by UNCTAD in its *World Investment Report,* that FDI into SSA is highly profitable and there is some tentative evidence that the impact of FDI on growth in SSA is less pronounced than in other parts of the world. We think this represents two factors:

- First the infrastructure deficit; and
- Second, for simplicity, the higher cost of doing business in SSA which captures a range of factors including low capacity utilization to the higher costs of capital goods[20]. The high cost of business is reflected in the World Bank's "Doing Business In" reports over the years. While some countries, notably Mauritius, South Africa, Rwanda and Botswana are in the top third of ranked countries, or the top 61; the harsh reality is that of the bottom third ranked countries, or those ranked from 123 to 183 in the 2012 index, 33 are from SSA.

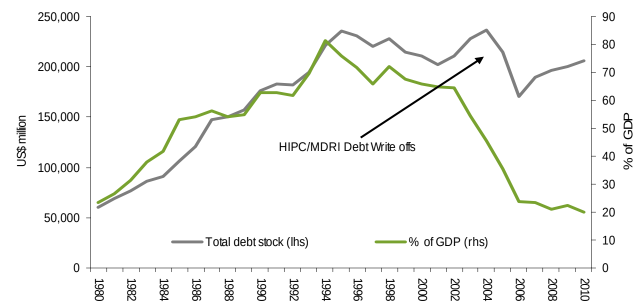
[20] The initial look at this was by Bosworth and Collins, The Empirics of Growth, An Update (2003), Brookings Papers on Economic Activities.

Figure 37. Doing Business Index: Selected SSA countries by 2012 ranking



Source: World Bank, *Doing Business In*

Figure 38. A rising external debt stock once again



Source: World Bank, Global Development Finance

Development and debt: financing the infrastructure push

Debt write offs changed debt profiles in SSA

The push to build infrastructure around the sub-continent has the potential to be an important supportive engine of growth. However, the downside of this is likely to be a rising debt stock to fund this much-needed investment at a time when taking on new debt can be an emotive issue. In many ways this conundrum reflects SSA's recent history with debt. After decades of borrowing, much of it unwisely, the debt profiles of many countries in SSA have been through a fundamental change with the implementation of a series of major debt write-offs staring in 1995.

A relatively modest write off came under the 1996 Highly Indebted Poor Countries (HIPC) Initiative, which was then followed by a more significant write-off in 1999. Then, an even more dramatic write-off for many countries was driven by the 2006 Multilateral Debt Relief (MDRI) Initiative. Even countries which did not qualify for HIPC or MDRI, such as Nigeria, were able to hitch a ride on the momentum for granting debt write-offs, with its government reaching a bi-lateral deal with creditors – where creditors wrote-off and the Nigerian government bought back at a discount – a major part of the country's external debt stock in 2005-06.

The number of potential lenders has increased

Since the debt write-off, many countries have started to borrow quite heavily again. One way of viewing what has happened in the post HIPC/MDRI debt write-off environment is that governments in SSA have somewhat reluctantly borrowed money, as lenders have been very keen to provide funds. This has resulted in the total external debt stock for SSA now being almost identical to its level prior to the mid-2000s debt write-offs. On a more positive note, the other trend that is clear in recent years is that although the nominal debt stock in most countries has risen, because both nominal and US dollar GDP growth has been relatively strong, external debt stocks as a percentage of GDP have remained more constant.

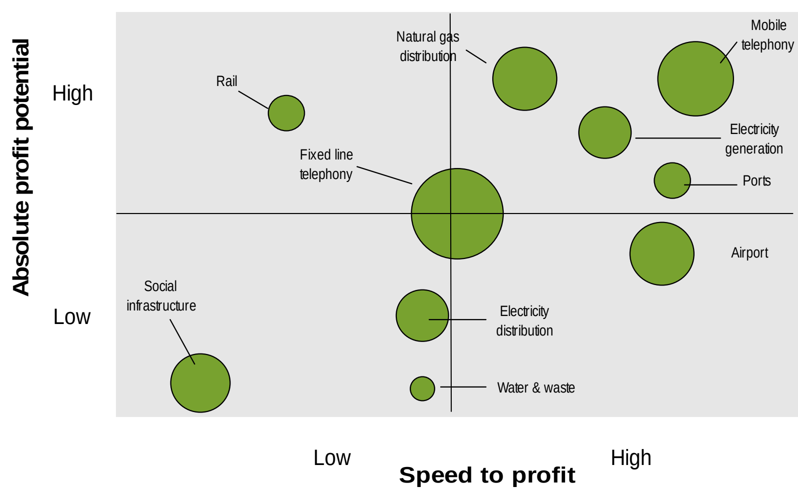
With lenders knowing that governments in the sub-region want to borrow money to spend on projects to close the infrastructure deficit, governments in SSA have faced an influx of potential lenders wanting to fund these projects: investment bankers extolling the virtues of issuing Eurobonds; Chinese quasi-government officials offering apparently "free" money and South-South solidarity but with long-term catches or payment implications; and the multilateral institutions seeking to reinvent themselves in SSA.

At broadly the same time given the ongoing economic problems in the G10, certainly since 2008, cheap loans from traditional bilateral donors have reduced somewhat. The combination of these trends can be seen in the rising debt stock, which now has a higher non-concessional component than historically, although it is not always clear what qualifies as concessional (i.e. reduced interest rate loans typically directed by a government agency) and non-concessional lending if terms are somewhat opaque. But the bottom line is also that this trend looks set to continue in the coming decade.

Borrowing needs to be more logical versus an ad-hoc process

The problem with this somewhat ad-hoc approach to borrowing is that the new debt being taken on still needs to be paid back unless another debt write-off is on the cards in a couple of decades time. Meanwhile, what governments in SSA arguably have not done, is to sit down and rationalise the borrowing process. In other words, think carefully, probably within a specific cost-benefit framework, about what money they need and who they should borrow it from. This is crucial if SSA governments are not to head back into the debt trap of the 1990s from which they have just escaped.

Figure 39. Thinking about borrowing



Source: *McKinsey Quarterly Review*

Key is choosing the correct source of finance for the different projects

One way analyse how a government in SSA should think about borrowing is with the help of a diagram recently produced by the consultancy group, McKinsey (Figure 39). Essentially within the McKinsey framework, countries should be borrowing at concessional rates from official donors to fund projects which are low in terms of absolute profit and low in terms of speed to profit. Conversely, they should borrow entirely from the market for projects in the top right hand corner (high absolute profit and high speed to profit). For other projects, the options are much more varied. Moreover, within the McKinsey framework there is significant scope for SSA governments to increase borrowing from the private sector.

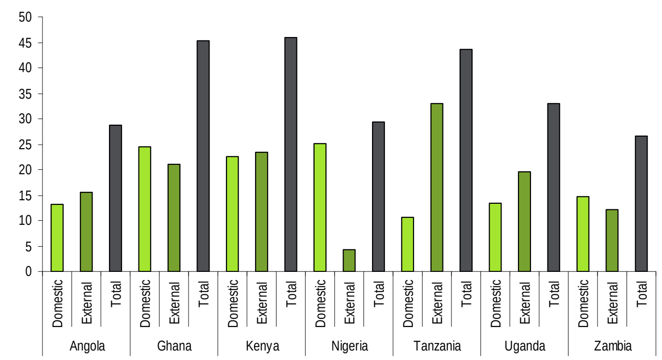
With a pressing need to build infrastructure, and potentially a period for at least several years of very low interest rates in the EU and the US, against a strong background interest in SSA, this is potentially a good time to raise debt on international capital markets. In fact, there is a strong argument that despite the economic problems in the G8, there is a still a structural over-demand for assets from most large-scale investors seeking to get access to the SSA growth story and to diversify their asset holdings.

But the interest rate is not the only part of the equation that needs to be examined. Foreign currency loans may attract lower interest rates, but in an era when currencies are under pressure due to large current account deficits, then there is also a cost if the earnings to pay off the loan are in local currency (which is usually the case for infrastructure projects). This would highlight the need for governments to think hard about greater domestic debt issuance in addition to external borrowing.

Lengthening maturity, but not really borrowing more

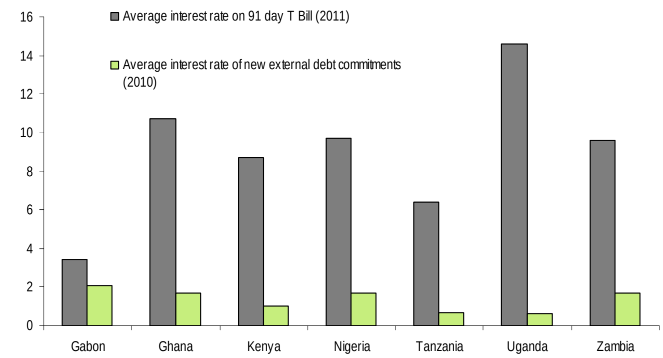
Many governments in SSA have spent the last decade slowly pushing out the length of the yield curve for domestic debt and some governments can now issue bonds with maturities of 10-25 years, something that would have seemed very difficult even as recently as the late 1990s. But while they have concentrated on lengthening the maturity profile of their domestic debt, at least in part to reduce the roll over risk and to deepen local capital markets, many have seemed less interested in really considering domestic debt as a more specific financing option for infrastructure development. In most cases, the domestic debt stock in SSA is still much lower as a percentage of total GDP than the external debt stock.

Figure 40. Domestic debt, external debt and total debt stock in selected SSA countries (% of GDP, end 2011)



Source: Various IMF Country Reports

Figure 41. A snapshot of domestic and external interest rates on government debt (%)



Source: World Bank, IMF and Citi Research

Kenyan infrastructure bonds: not quite what they say they are…

One of the main exceptions to this in recent years is arguably Kenya. Traditionally less dependent on donor support than other reformist countries, it has issued both longer-dated domestic debt, but since 2009 included within this some bonds which it has specifically labeled as “infrastructure bonds”. These have a 9- or 12-year maturity with a partial redemption every 3 or 4 years. In fact, the growth of domestic debt issuance in Kenya in recent years has meant that for the first time, the domestic debt stock surpassed the external one, a relatively unique feature for a country in SSA, although since 2011 the trend has been partially reversed. But the reality remains that although called “infrastructure bonds” there is no real link with Kenyan long-term debt and the infrastructure they finance. In effect, it is little more than longer maturity domestic debt.

...but true infrastructure bonds could be a good tool

We do think that governments in SSA should be more actively thinking about the development of local currency infrastructure bonds and the key to this is not just issuing longer maturity debt instruments, but more explicitly linking the coupon on the bond to the sources of revenue associated with the infrastructure. There are two relatively simple options to support this:

- First, to clearly hypothecate the revenue from an infrastructure project to repay the loan. This is most obvious in the case of a bridge, toll road or power project, but this could work in wider contexts such as a tax on airline tickets, or linking a portion of port fees to the building of a new quay.

- Second, to develop local currency bonds with government guarantees to specific state-owned agencies or perhaps more widely "project operators". They in turn will have to identify the revenue stream being used to pay back the bond.

The perceived higher cost of domestic debt

There are several possible reasons for the unwillingness to issue more domestic debt for long-term funding of projects in SSA, but the most likely is that compared to concessional lending rates, governments in the sub-region still tend to see non-subsidized domestic debt as an expensive option for long-term financing. Although inflation in SSA has fallen in the last 20 years, as we have argued, with strong growth, structural bottlenecks and relatively wide fiscal deficits we would expect that inflation will remain in the current range in many countries for some time to come. In this case, to obtain a real long-term rate of return on a longer-term bond the interest rate will have to be in the range of 10-15%.

In contrast, according to the World Bank's *Global Development Finance*, the average interest rate on all new commitments of external debt from 2006-10 was only 2.9% (with an average grace period of over 6 years and a maturity of over 20 years). In fact, looking at the rates on current SSA Eurobonds, even issuing debt via 10-year Eurobonds is likely to be cheaper purely in terms of the interest rate compared to long-term domestic currency bonds.

But, as we argued earlier, these US dollar driven rates do not take into account the impact of a depreciating currency to finance the repayments. This is especially the case as most infrastructure projects will earn any returns only in local currency and repayments need to be made in foreign currency. In addition, there are also the potential benefits to a country of developing deeper and more liquid capital markets by increasing domestic borrowing levels and extending the maturity profile of the domestic debt stock.

Balanced and well thought out debt issuance is the goal

Bearing all this in mind, we think the challenge for governments in the sub-region in the coming few years is two-fold. First, to start actively thinking about how much they need to borrow. Then, second, to think about how to get their debt issuance programme right: in effect balancing off interest rate differentials, currency risk, non-financial terms attached to loans; and the need to develop local debt markets. None of this will prove easy, but will be essential if the push to build much needed infrastructure in SSA is really to gather momentum.

The longer-term growth story

Where does SSA fit into the global economy?

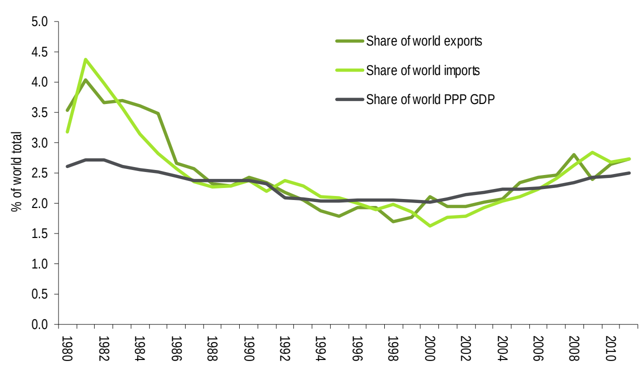
The need for more transformative growth

For economists, there is an argument that the quest for economic growth never ends – it merely changes its form. From an economic low base the main goal is to lift people out of poverty, whereas for higher income countries the goals morph to arguably more esoteric concerns such as happiness and the quality of life. But while the nature of the growth quest may change, the reality is that it can still be dislocating for various sections of society. In fact, growth, in the early stages of development, is in many ways most visibly captured in the phase coined by Joseph Schumpeter, "creative destruction".

In some ways, this is now the goal for SSA. On the one hand, we are confident that the model of growth of the last decade will continue for some time to come, even if global and domestic policy headwinds mean that growth rates are stuck in the 5-6% range. Arguably the real question that policymakers should now be asking themselves is whether this model can drive higher rates of growth, up to double digits for a period of a decade or more, which ultimately will be more fundamentally transformative growth. Arriving in a country growing at double digits for a prolonged period is like walking into a permanent building site, and in this respect, most countries in SSA will need to see major new construction efforts.

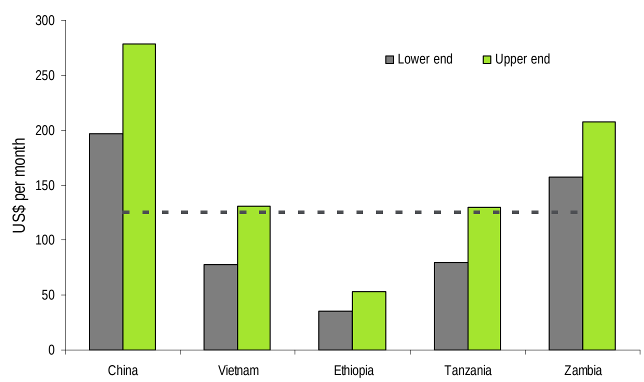
Although the model of growth in the last decade – commodity export and service sector growth – has been relatively successful, it is not clear whether this has led to SSA becoming more closely integrated into the global economy. In fact there are signs, such as looking at the share of exports and imports as a percentage of global trade flows for example, that it is just holding its own. In fact, if there is one question that should keep Afro-optimists up at night worrying, it is a simple one: where does SSA fit into the global economy going forward?

Figure 42. SSA global share of exports, imports and GDP



Source: World Bank and IMF

Figure 43. Range of wages for average unskilled labour in various countries



Source: World Bank and Global Development Solutions 2011

One way to think about this is to try and answer the question: can I trace a potential path which sees SSA moving from its current model of growth to one which achieves this goal of greater integration? To make this easier, it is perhaps possible to identify potential generic drivers of growth: demographics; expanding service sector growth; revisiting the manufacturing question and agriculture. Then, assuming that governments are in a position to benefit from these, the second question that follows is: what can we see the potential growth pattern in individual economies in SSA looking like in the future?

The potential and limits of the service sector elevator

The traditional view of growth holds less hope for early service sector growth

Historically, economists have tended to argue that the service sector is a trailing sector in growth terms and that economic modernisation follows a typical pattern whereby economies move in a roughly linear fashion from agricultural-based economies, to manufacturing economies and then to service sector economies. At present, in most countries in SSA, despite the low productivity of the agricultural sector, it still employs over half of the labour force in most countries.

In this idealised pattern of development, the basic argument is that as countries grow richer they buy more services. In effect, incomes are raised as workers move from low productivity activities, such as subsistence farming, into higher productivity sectors, notably manufacturing and services. Moreover, the development of manufacturing is crucial as it lends itself to specialisation and economies of scale which can absorb high levels of labour as they move out of the agricultural sector. By and large, it is also based in urban centres and is the main source of employment in countries undergoing rapid urbanisation.

But this view is now changing, at least at the margins. The example of India has, at least in part, driven this adjustment in thinking. Rather than services being a trailing sector, the development of technology and outsourcing now means that services can be exported and act more as an engine of growth[21]. Examples include software development, outsourcing, call centres and business centre processing. There are examples of these types of service businesses in SSA, notably in South Africa and Kenya. As such, services can be seen more as an engine of growth rather than a trailing sector. Some economists have gone as far as to argue that there may be additional advantages to service sector growth, such as its higher employment of women and lower environmental impact.

The problem is that many service jobs require education and skills

There are, however, issues that need to be addressed when thinking about these types of service exports. While basic manufacturing production is capable of absorbing workers with only minimal skill levels and basic education levels, this is not always the case with service sector jobs, which by and large require more skilled workers. Moreover, higher levels of productivity in the sector mean that it employs fewer people. There are of course, exceptions to this, with the tourism sector for example potentially able to generate a higher level of low-income service jobs. But this is not the case when thinking about outsourcing and call centres, which usually are staffed by university graduates.

> “If services are to drive growth in the medium term and create jobs, then perhaps the most obvious engine in the short term is tourism.”

Having said that, if services are to drive growth in the medium term and create jobs, then perhaps the most obvious engine in the short term is tourism. There are plenty of tourism models to follow even within SSA, from Botswana's low-volume, high-value approach, to the cheap package holiday model in The Gambia. But the reality is that few countries in SSA earn even close to their potential from tourism, apart from South Africa and some of the islands such as Cape Verde, Mauritius and Seychelles,

[21] See for example, Service with a Smile: A New Growth Engine for Poor Countries, E Ghani, A Grover and H Kharas (2011) at http://www.voxeu.org/.

despite beautiful coastlines, abundant fauna and flora and interesting cultural histories.

Tourism offers immediate short-term gains from services

Some countries which had started to make really good progress in developing a tourism industry, have seen set backs in recent years. Tourism in Kenya, for example, has suffered from the violence that followed its December 2007 elections and then from the subsequent fallout after the political collapse of Somalia. But this does highlight one important issue: for all the progress made on the political front in the past decades, political issues are still a major concern that must be resolved when developing a tourism market. Developments in Zimbabwe since 2000 are as clear an indication of this, as are events in Kenya. Personal safety, or arguably more accurately, perceptions of personal safety, are crucial in developing a tourism industry and many SSA countries are still struggling with this.

Negative perceptions and institutional constraints need to be overcome

Overcoming negative perceptions such as political risk and personal safety will be crucial in developing a tourism industry. While brand building can take time, there are still short-term steps that can be taken to help boost the development of the tourism sector. For example, despite the improvement in the airline industry in SSA in the last decade, it is largely used by business travellers and flying into most countries is still relatively expensive. SSA governments will have to be more open in allowing lower-cost airlines to fly to their countries and dealing with security concerns from EU countries and the US at their airports.

This relatively simple move can then be followed by a series of steps ranging from the relatively straightforward – such as proactive and forward-thinking land use plans for areas in which they aim to develop tourism allowing them to prioritise these developments – to the more complicated – such as how to encourage the greater integration of the industry into the local economy through hotel purchasing and employment policies.

The bottom line is that if governments want to encourage tourism, they will have to actively promote it. The Gambia, for example, actively promoted its tourism industry, and while you can debate the costs and benefits of it, the country attracts large numbers of visitors relative to its size. In contrast, countries such as Ghana and Senegal, neither which have been significantly affected by any real political instability, have both failed to capitalise on their significant tourism potential seemingly due to a lack of real government commitment.

A manufacturing renaissance: the missing middle step

Can other African countries follow Mauritius and South Africa?

Even if one accepts the argument that the service sector has considerable potential to drive economic growth in SSA, in many ways this is still unproven especially in terms of providing large numbers of jobs for low-skilled and semi-skilled labour. Therefore, in the short to medium term, one is drawn back to addressing the issue of whether a manufacturing future is possible in SSA, when there are few examples of manufacturing-led growth to date.

Perhaps more fundamentally, the issue is that even if the prospects for the development of the manufacturing sector do not seem all that positive in the short term, is there good reason to also be pessimistic about the medium- and long-term outlook. We think there are two simple, yet important questions to be answered in this respect:

- First, can labour in SSA, in terms of wages and productivity, compete in the global manufacturing stakes and in what sectors; and

- Second, are investors able to take practical advantage of this new labour source to ramp up production and exports of manufactured goods.

The wage and productivity equation

There is a considerable body of work about the question of competitiveness of SSA manufacturing, some more positive and some less so. But one of the more comprehensive, a recent World Bank study[22] does yield some extremely interesting insights. First, splitting manufacturing production into a low technology group, compared to medium or high technology, helps identify a range of sectors where SSA countries could potentially compete. Examples identified in the study include not only the most widely talked about sector, clothing and textiles, but a wider range that also includes food and beverages, leather and wood processing and the production of simple metal products.

Second, the World Bank also shows that for a range of countries from Ethiopia to Zambia, wage costs are low enough compared to China and Vietnam to potentially make manufacturing in these low-technology sectors potentially attractive, although at present this wage advantage seems to be offset by lower levels of productivity, although the data in this respect is much more ambiguous.

IDZs and EPZs help overcome critical constraints

The question is therefore, how to ensure that this manufacturing potential can be turned into a reality. In broad terms, the question is to what extent governments can resolve the most critical constraints to production in the most promising sectors and this should then be the thrust of any broad industrial policy. In practical terms, the key is likely to be the development of Industrial Development Zones (IDZ) or Export Processing Zones (EPZ). In simple terms, the former provide a location for industry seeking to primarily sell into the local market, while the latter a location for making products mainly for export.

The most obvious example of where the manufacturing sector has worked as an engine of growth in SSA was the development of the Mauritian economy. Mauritius was traditionally a monoculture sugar-based agricultural economy, but the government added an EPZ-based textile industry in the 1980s (based on textiles, but specifically gloves and sweaters) and is now moving into a higher value services economy, of which tourism is the centrepiece.

There are other examples as well. South Africa also provides some insights and is in the process of developing IDZs. However, much of its industry sells into the rest of SSA, although some segments are globally competitive. Kenya has also made some progress, although like South Africa it sells largely into the regional East African market. Countries like Botswana have also tried to develop EPZs although these have been hindered by its landlocked location. Arguably, Madagascar has been the other most successful country in moving down the Mauritian path, although this has recently been undermined by political instability.

We think some countries can move down the IDZ / EPZ route, but need to get to critical mass

The above examples of manufacturing-led growth would indicate that with government commitment, some countries in SSA will be able to follow the Mauritian route. But they will probably need to be coastal, given the high transport costs associated with landlocked countries in SSA. In other words, we expect to see the growth of some globally competitive manufacturing industry in EPZs, which can take advantage of SSA preferential access to the EU and US markets, but which can

[22] *Light Manufacturing in Africa, Targeted Policies to Enhance Private Investment and Create Jobs* (2012) by HT Dinh, V Palmade, V Chandra and F Cossar, is not only a useful source of data and comparisons with Asia and Latin America, but is also a good guide to help think about this potential process and why the manufacturing sector has stagnated in SSA and how it can recover

draw on some local inputs. We still expect it to take some time for the exchange rate/productivity equation to move fully in their favour and for Asian labour costs to rise to the point where SSA is seen as a second choice manufacturing base.

The development of EPZs is likely to be supplemented by some investment into IDZs producing goods for the domestic market. Potential industries in the IDZs will range from cement to fertilisers to basic metal and construction products. Essentially, heavy goods which are bulky and expensive to transport, but have a large and growing demand in economies moving from a low base in SSA.

The Chinese kick start

Whether the investment in these sectors can gather enough momentum to start to really pick up, is a story that will be told over the coming decade. But arguably a key driver of this process could be China, given its government's efforts since 2006 to see its engagement with SSA as mutually beneficial to both parties[23]. In effect, Chinese companies will not only build the infrastructure for IDZs and EPZs, but provide the core investors, at least initially. Perhaps one of the most interesting examples of these, to give an idea of how they could potentially work, is the nascent Ethio-China Light Manufacturing Special Economic Zone in Ethiopia, which aims to manufacture clothing, but arguably more importantly leather and agricultural products for export. In addition to this EPZ, the Chinese have targeted zones in Zambia, Nigeria, Egypt and Mauritius.

Can Africa help to feed the world? The challenges of agricultural sector growth[24]

Agriculture is important in a world of rising food prices

Agricultural sector growth in SSA in the last decade has generally lagged overall growth rates, outside of some smaller sectors, led by horticulture. Agriculture is arguably SSA's most neglected, but potentially most important and competitive sector in the global economy, going forward, especially in a world where food prices could remain at significantly higher levels than historically has been the norm.

At the core of the global food price surge of the last decade is that food demand is continuing to rise (due to population growth, changing consumption patterns, a notable increase in meat consumption, and rising incomes) while supply is still constrained by the available land area on which it is possible to grow food (especially in a world where growing demand for biofuel crops is competing for this land).

For a region with an apparent surplus of land, it is no real surprise that the rise in demand for food supplies has already washed up on the shores of SSA, but we think talk about agricultural sector growth needs to quickly move beyond the headlines of land grabs by foreigners and food security concerns. In fact, on a continent which is perhaps not urbanising as fast as some of the data would indicate, we think there is a pressing need to think about models of agricultural development which reflect the needs of the existing rural populations along with the need to raise investment and output and the reality of geography/climate in SSA.

[23] For a more detailed analysis of the potential and pitfalls of this route, see Deborah Brautigam and Tang Xiaoyang, *Africa Shenzhen; China Special Economic Zones in Africa*, Journal of Modern African Studies (2011).

[24] This sector draws on a number of diverse sources. But in particular, the Africa Research Institute Counterpoints pamphlet, *Why Africa Can Make it Big in Agriculture* (2010); McKinsey Quarterly, *Four Lessons for Transforming African Agriculture* (April 2011); Chatham House Briefing Paper, Diana Hunt and Michael Lipton, *Green Revolutions for SSA* (2011); The Economist, *The Miracle of the Cerrado* (August 28 2011) and Lorenzo Cotula and Sonja Vermeulen, *Deal of No Deal: the Outlook for Agricultural Land Investment in Africa,* International Affairs (2009).

The water question

In this respect, a key issue to think about is that although in total SSA has a low population density at about 36 people per square kilometre, it is not clear how productive much land is for agricultural development. One particular problem is rainfall. Although in general terms, Africa has a relative abundance of water, many areas experience high hydrological variability, or there are major variations in the level of rainfall, not only throughout the year, but also from year to year.

> "…the real challenge in developing the agriculture sector in SSA is to try and ensure there is investment in water infrastructure…."

The real challenge in developing the agricultural sector in SSA is to try and ensure that there is investment in water infrastructure to boost storage, and allow a significant increase in irrigation. Quite simply, SSA is an "under-dammed" region by global standards. Building dams is not without controversy, notably on rivers which run through many countries and is a major political hot potato with respect to the Nile.

The reality is that large-scale irrigated agriculture is only practised in a handful of countries in SSA: the World Bank estimates that only a total of 7mn hectares, or less than 5% of the current cultivated area, is irrigated. Yet, this limited area produces 20% of the value-add in agriculture. Some estimates looked at by the World Bank indicate that this area could relatively easily be increased by a further 10-15mn hectares.

Picking agricultural winners is not always obvious

Water, or access to it, will also help dictate the pattern of agricultural-driven growth in SSA. For example, it is harder to make a strong case that there is major agricultural potential in countries on the borders of deserts, notably the Kalahari (Botswana and Namibia) and those on the southern border of the Sahara (Mauritania, Mali, Niger and northern Chad). But estimating which other countries emerge as strong agricultural economies is more difficult to ascertain. Some countries, like Zambia, are more obvious, given their potential water resources. But there are groups of countries where the potential is less obvious. For example, Ethiopia, Sudan (north and south) and the Central African Republic, countries most closely linked in the popular imagination with famine and food shortages, could emerge as major new agricultural producers if the water issue is resolved.

Private sector involvement provides the key link to the global economy

Finally, while it would be almost impossible to provide a proscriptive model of agricultural growth for all countries in SSA, we do think that private sector involvement is the key. Government interventions in agriculture in SSA have generally proved disappointing, whereas private sector companies seem to produce more positive outcomes, especially when supplying inputs to farmers and providing guaranteed markets for the end crops.

The Kenyan horticulture sector is a good example of this and serves as a crucial reminder that while farm plot size is a poor indicator of competitiveness, smaller scale farmers need support to allow them to integrate into the global economy. Whether this would provide sufficient levels of employment for a rapidly growing population is questionable, but we think unlikely. While the agricultural sector will

generate some jobs and potentially export earnings, in the end this will be insufficient to resolve the employment issue.

Food processing could be a huge boom

Without wanting to repeat some of the ideas in the section on manufacturing, the bottom line is that in an era of potentially elevated global food prices, food processing and manufacturing could prove a key growth area in SSA. Horticulture is at one end of this, when the processing and packaging is limited, but still adds value. But it is easy to extend this to fruit juice and canning, to producing tomato-based products and then into meat and fish exports to markets with strong rising demand in Asia. These arguments would then be extended to greater processing of more basic soft commodities in SSA from cocoa, tea and coffee, to palm oil and spices and nuts.

A Green Revolution in SSA

In a field in which views can vary considerably, one area in which there seems to be considerable agreement with respect to agricultural development in SSA is the need for a green revolution. Moreover, there seems to be an acceptance that this has to be holistic; or range from the demand side of the equation with efforts to develop the buying and marketing structures to bring crops to market; to supply-side issues, such as the need to develop crop types that will be higher yielding and able to survive the various climatic and soil conditions prevalent in SSA.

Two themes seem to appear consistently in various literatures. First, what lessons can SSA learn from Asia's Green Revolution, or its ability to raise the productivity of small-scale farmers? Second, almost, but not quite at the other end of the size spectrum, what lessons can Africa learn from Brazil and its transformation of the cerrado? This is particularly pertinent because like SSA, the soil and climatic comparisons between this area of Brazil and SSA seem a closer fit.

While Asia and Brazil both offer a potential model, it is not clear how they could be exported to SSA. On a positive note, we do see the emergence of some potential examples which may combine features of the two. One of the most interesting may be in Tanzania. As part of the 'kilimo kwanza' policy, the aim is to create a large agricultural corridor which includes a combination of large-, medium- and small-scale farmers in an integrated agricultural whole. The Southern Agricultural Growth Corridor of Tanzania (SAGCOT) initiative with the government is helping build the central infrastructure down the corridor roads and the private sector is providing the additional supports of new seeds, fertilisers and irrigation facilities, as well as processing and selling the crops harvested. This has the potential to create the innovative agricultural development that occurred in Brazil with the productivity gains that were seen in Asia.

The development state and SSA

State involvement in SSA often led to "state capture"

There is an argument that the economic policy debate in SSA in the last 20 years or so has been a relatively sterile one. This reflects the post independence history of SSA where greater state involvement in the economies of many countries in the 1960s and the 1970s, was at least one of the causes to the economic collapse of the 1980s. In fact, perhaps more than anywhere else, many of the problems with the state-led development model in SSA in the 1960s and 1970s was that it led to "state capture", or where influential interest groups used the state to foster their own interests and extract rents, while losing sight of the overall goal of seeking to promote wider economic development.

This last theme can be taken a stage further, highlighted in literature on the development state. This argues that a particular problem within SSA, the ability of the state to capture rents, is not solely about corruption. In fact, the key issue is not whether the development state leads to increased corruption, but whether the underlying thrust of the overall economic policy somehow loses sight of its goal – the need to drive economic development – but rather is driven by a more

destructive logic – the need to yield benefits for limited groups. In some ways in the context of SSA, this is the case of killing the goose that lays the golden egg.

Zambia is good case study of state involvement, withdrawal and now potential re-involvement

As such, the economic policy thrust of much of the last 20 years has been trying to reduce the involvement of the state and therefore it is not surprising that there was a strong consensus among policymakers in many countries in SSA to follow policies with a stronger market and liberalization bias from the mid-1990s. Perhaps one of the most vivid illustrations of this loss of faith in the state was in Zambia, where the copper sector was nationalised with the creation of Zambia Consolidated Copper Mines (ZCCM) in 1969. While at the time the copper belt was a dynamic and vibrant part of the economy, the following 30 years from 1970-2000 were one of decline in the sector as the inefficiencies in such a massive parastatal (state-owned enterprise) such as ZCCM, lack of investment and falling world prices all combined to drive a drastic drop in copper production. Zambia's copper production peaked in 1969 at 748,000 tonnes, when the sector accounted for around half of GDP and virtually all of its export earnings, but fell to only 234,000 tons in 2000. Since then, the industry's wholesale privatization has led to a new copper boom. However, the challenge for the government is now how to earn a greater level of income from this boom, and how to use the state to ensure that the benefits of this boom are more widely distributed. Similar tales could be told around SSA in different industries.

> "Despite the history, we still think the state has an important role to play in driving development in SSA."

Re-involving the state in SSA

Therefore, despite the history, we still think that the state has an important role to play in driving development in SSA. One crucial area of thinking we believe still needs to be resolved in the overall development story in SSA in the coming decade and beyond is that of how much governments want the state to be involved in the development drive. Moreover, the idea of involving the state has a clear resonance in SSA, not only given its history, but also in a region where the rise of China, which has used the state as an important although much misunderstood agent of development, has been important. Moving closer to home, there is also a strong argument within SSA, that the two most successful states in terms of economic development – Botswana and Mauritius – have actively used the state as a key engine of growth.

A developmental state must have two key features

For this to be achieved, broader academic research seems to argue that a "developmental state" must have two defining features:

- First, the state must have political control over the majority of its territory and possess a set of core capacities that will enable it to design and deliver policies; and
- Second, the policies that it seeks to implement must involve some degree of reach and inclusion, and have an institutional, long-term perspective that transcends any specific political figure or leader and reduces the scope of the policies being captured by vested interests.

What does all this mean in practice? Well the bottom line is that to be an effective developmental state, the government probably not only has to be able to articulate a clear commitment to a national development agenda, but it must also have the capacity and reach to implement it so that overall, economic growth meets the additional goals of poverty reduction and the provision of public services.

SSA states are arguably being overwhelmed with demands on them

For most people looking at SSA, the current situation is one where the first criterion is now in place. In fact, a cursory glance around the continent shows there are no shortages of donor-inspired poverty reduction strategies outlining the prospects for inclusive growth, five-year plans and crucially development visions outlining the route to becoming a medium income country. In fact, SSA as a whole even has its own vision for the continent, via the New Partnership of African Development (Nepad).

But, it is arguable whether the second criterion is also in place. If it is not, then it will be much harder for the state in SSA to become a more active player in the development process. In particular, the main problem is that state capacity remains limited. Moreover, there is a concern that rather than creating a state capable of driving development, in current circumstances the actual outcome of efforts to promote more active state intervention in the economy will simply result in a larger-sized state which still doesn't necessarily have the capacity to achieve its stated goal.

This in turn reflects the fact that at the current stage of political development in SSA, more actors are demanding to be included in the decision-making process and they also expect better services and enhanced state accountability. In fact, in many SSA countries the state may be overwhelmed by the new demands brought about by both democratic and growth pressures and is unable to respond adequately because it lacks the necessary institutional and administrative capacity.

Government size does not equate to effectiveness

Running towards some sort of logical conclusion to this section, we think the challenge in creating a development state in SSA is to move beyond the idea that increased active government intervention in the economy requires the creation of a bigger government. Instead, the challenge is to increase the capacity of the existing government institutions, to, in effect, do their job or implement agreed policies.

In this respect, there is no reason to assume this cannot happen. Progress in some of these areas would increase government credibility in SSA, and that in turn would reinforce confidence that governments can work effectively. The outcome is likely to be a process of evolution, but the concern will always be that government becomes larger, but no more effective. This policy debate is set to rage in SSA for many years to come.

Looking in versus looking out

No one model, but some broad patterns are discernible

A *“mix and match”* approach

If we put together all this understanding we have about the SSA growth story and its past and potential future drivers, is it possible to gain a greater understanding of where SSA will be in 20-30 years. What we think is clear is that there is unlikely to be any one standard, “off the shelf” model of growth which a typical SSA country can follow in the coming decade.

Instead, the best way to think about growth is more as a *“mix and match”* approach, with countries fitting into various possible models. What is perhaps clearer is that at least in the short to medium term, the East Asian model of manufacturing industry driven growth will only have limited relevance. Instead, we believe elements from the Australian, Canadian and Brazilian growth models, along with those Asian countries with a strong resource base, such as Malaysia and Indonesia, should all provide clues as to how to kick start the food manufacturing sector and the processing of soft commodities.

We still expect there to be a number of generic growth themes over a wide range of countries. The first is that in the short to medium term, construction, driven by the need to close the infrastructure deficit, will be a major driver of growth. Fortunately, this is also likely to be an important source of job creation. The question beyond this is to try and understand how the nexus of service sector, agricultural and industrial sector growth (whether manufacturing for export or the domestic market) and natural resource processing, will mix across the various countries to potentially create sustained and prolonged double-digit growth.

The mix of politics, economics demographics and location

In this respect, perhaps one of the best ways to think about the future growth story in SSA is through those economies that will look in, rather than those that will look out. This in turn, reflects a combination of their demographics, political and economic heritage and their resource endowment, but of these factors, perhaps the main driver may well prove to be demographics. In particular, one of the key demographic trends that we think will emerge in SSA in the coming decade will be the emergence of a group of second-tier countries with large populations – behind the behemoth Nigeria. Alongside these will exist a larger number of medium- and smaller-sized countries, which will have more need to understand where they fit into a changing world.

Four main types of development model

Using this framework, it is possible to provide some broad classifications of development models into which countries can be placed, although any classification of this nature should be used with caution:

- **Inward lookers**: The main link between these economies, is that they have large populations, which mean that that they have a significant domestic market. But they may also have a significant resource endowment. In many ways this could be the "new big five" in SSA: DRC, Ethiopia, Nigeria, Sudan and Tanzania.
- **Coastal outward lookers**: Again, although some of the countries in this grouping have a significant resource endowment, others do not. But the smaller size of their domestic markets, and arguably their better education and infrastructure heritage, makes them more outward orientated, either within SSA or globally, and gives them the potential to develop a significant manufacturing export business. Angola, Cameroon, Côte d'Ivoire, Ghana, Kenya, Mozambique Senegal and South Africa all fit into this broad grouping.
- **Landlocked outward lookers**: While countries near the coast may be able to export manufacturing goods, the infrastructure constraints of being landlocked mean for a number of countries this is unlikely. Instead, countries like Uganda, Rwanda, Zambia, and Zimbabwe will all need to build regional markets for their goods and services and supplement exports to international markets.
- **Small economies**. Finally, there are the specific problems of small economies in the SSA context, but these are far from insurmountable.

Inward lookers: leveraging a large, dominant, natural resource, to drive growth

Population and resources

If, as we expect, a smaller number of SSA countries emerge with large populations but substantial natural resources, these will prove crucial in driving the overall growth story. The problem is that managing these often politically diverse countries can be challenging and complex. The best approach to promoting growth in this context is largely a governance and economic management route, with the wise

investment of rent derived from mineral resources into health and education helping drive growth.

This model is best epitomised by Nigeria and its dependence on oil. While, on the one hand, politics and economic policy can be problematic, in some ways, driving growth in a large country with one resource is both harder, and easier, than for a small country. In large states, government and economic management issues are often more challenging. But if you have a large population it is much easier to attract manufacturing and services investment selling into the local market (even if initially behind domestic tariffs) than for a small country.

The law of comparative advantage is complex for mineral producers

One of the key policy issues for these inward lookers is how to deal with the development of the natural resources sector. In this case the key policy issue to think carefully about is comparative advantage. One of the most basic rules of economics is that just because you pump oil or gas, or mine a solid mineral in a country, or even grow a crop there, it does not automatically follow that it makes sense to process it there. In some instances the economics will favour this move, in others it will not. In most cases, the main incentive to process a mineral or crop locally is to reduce bulk and reducing shipping costs, while adding value.

The other economic policy concern about going down this route is the extent of the full economic benefits to a country if government policy provides a subsidised input to make the cost of processing the mineral or crop more attractive. This is a complex policy decision, but if the need for a subsidy is accepted, along the infant industry argument lines, then the second best policy decision should be that it is only be provided for a limited period, after which it is phased out according to a clear timetable or simply ended.

Taking a cautious, yet firm approach can yield dividends. At the opposite end of the extreme in size terms, but still providing an important lesson, Botswana has for decades sought to develop a local diamond polishing industry and has struggled to do so. However, its policy does now seem to be moving towards a critical junction with the decision by De Beers to move most of its sorting operations to the country along with the emergence of a domestic cutting industry. Nigeria is also perhaps at the start of this process and needs to ensure that it gets the balance right in its Petroleum Industry Bill designed to encourage the establishment of much greater local content in the country's oil industry, while continuing to attract high levels of investment into the sector.

Coastal outward lookers: export diversification

Diversifying within the natural resources envelope

For some countries with a wider range of natural resources, as opposed to a dominant one, the option is to diversify within the primary sector as well as adding value to these primary exports. In these cases, the natural resources envelope would include agriculture as well as minerals. This model applies to a large number of African countries, from Côte d'Ivoire and Ghana in the west, to Kenya in the east to Angola and Mozambique in the south.

While this is a governance and economic management story, it is also one in which there are arguably far more options. In particular, a range of natural resources provides policymakers with more policy options, and potentially to get things both right and wrong in different sectors, rather than being held as a "policy hostage" by one particular sector.

The gas kicker

An interesting side fact, and one that seems purely a matter of chance, is that many of the countries in SSA with a range of natural resources, also seem to have substantial gas resources (of the countries listed above, all have gas). For some, these reserves may eventually prove sufficient to export. But perhaps more importantly, this provides many of them an additional option within the resource

envelope: the ability to use a gas resource to produce power, but also to link into the production of a range of basic industrial products from fertiliser to cement to processing agricultural and mineral commodities.

Landlocked outward lookers: finding regional markets

Small and landlocked: turning a curse into a benefit

Being a small and landlocked country in the context of SSA has for the last 20 to 30 years been a major problem when thinking about development options. In fact, it is arguably a development curse. In emerging SSA, the goal is to turn this into a development advantage, or to ride on the coat tails of wider growth. If you think down the chain, there is an argument that if the larger economies, either with an inward- or outward-looking orientation, are riding the coat tails of strong Asian growth, or the rise of the Pacific century over the passing Atlantic century, then this group of countries are seeking to exploit the trickle down.

In recent years, one of the best examples of this has been the Uganda growth story, where the government has used its geographic location and political stability within central Africa to its advantage and turned the country into a trade, financial and even manufacturing centre for the region. Moreover, there is no reason why this cannot be emulated. Countries like Burkina Faso could take advantage of strong growth in Côte d'Ivoire, Ghana and Nigeria could fill a similar role to Uganda. Similarly, Zambia and Zimbabwe grow as the critical lynchpin between the East Africa and Southern Africa growth nodes.

Of course, as in the rest of SSA, this may also have a natural resources element attached to it from copper to gold to oil, but the crucial point may well prove agricultural. Countries as diverse as Chad, Rwanda, Uganda, Zambia and Zimbabwe may all find themselves as significant food exporters either within SSA, or outside the sub-continent.

The specific problem of small countries

SSA has many small countries

One particular development problem facing SSA is the preponderance of small countries, some of which have few, or no, major natural resources. Using 2010 population data we calculate that 19 countries have a population of less than 5 million and a further five less than 10 million. This small size, especially in a remote location, provides a number of specific development issues, although none of these problems are insurmountable. Instead, we think the key to growth for these economies will be to find niches both within the global economy, and within a growing SSA economy.

- **Resources with a small population**. For a number of SSA countries with a small population and a large resource, the best option to follow is to seek to add value and tax appropriately. The model to date is Botswana and diamonds. If you are a small state – for example with a population of less than 5mn – with a substantial mineral endowment this is probably the best route to follow.
- **Labour export, some agricultural and high value service sector**. The bottom line is that within SSA in the coming decades, many of these smaller countries will depend on the prosperity of their neighbours. But they can add to that a dynamic export service sector, potentially tourism, and a small value added agricultural/ horticultural sector. Remittances will also remain crucial for many of these economies as they export labour to more developed economies, or within SSA.
- **Transit and re-location economies**. For some countries, it will either be trade flows through them, or the desire to relocate headquarters to smaller, more liberally regulated environments. Interestingly, this is already favouring two of the more developed economies in SSA with Botswana and Mauritius developing as "offshore" tax and back office locations.

- **Small tourist island economies**. The Seychelles and Cape Verde, in different ways, show the potential of largely tourism-driven growth in small island economies and provide a possible growth model for many of the islands around SSA, but also mainland countries.

From here to there, but how?

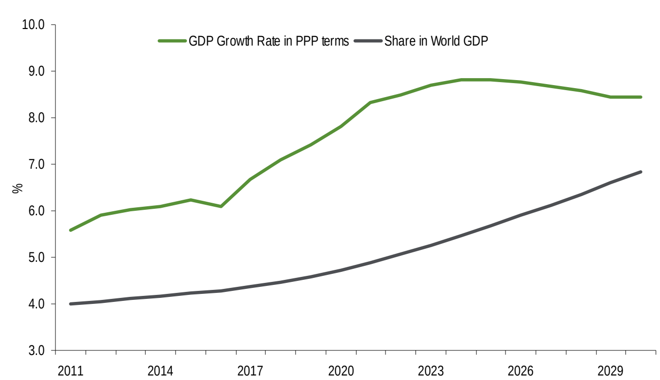
Growth and development are rarely straight line stories

We think that the growth story in SSA is at an interesting phase. In many ways it is now quickly moving beyond a story about gains from high commodity prices against the backdrop of improved economic policy environment and improved political stability. Yes, these have improved and have played an important part in the pick-up in growth in the 2000s. Moreover, they will remain important in future. Instead, it is other factors that will increasingly drive growth in SSA in the coming decade and beyond.

To give an idea of the potential impact of this growth, we return to Citi's February 2011 long-term global growth projection paper, *Global Growth Generators: Moving Beyond 'Emerging Markets' and 'BRIC'*. One of the most interesting global trends that was highlighted in this study is the rise in Africa from accounting for only 4% of world GDP 2010 to 7% by 2030 and 12% by 2050. In this case Africa includes North Africa, notably Egypt.

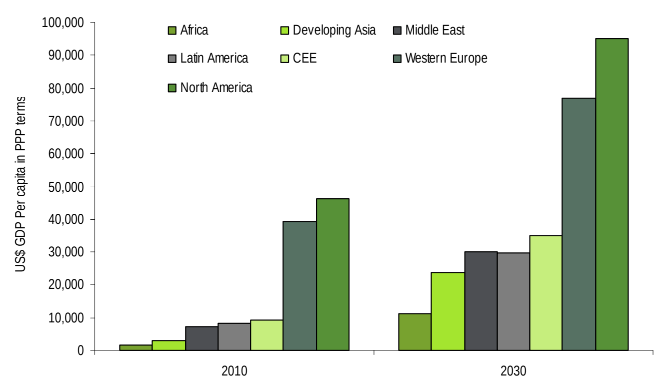
Having set a base case, as we have argued in this Citi GPS paper, growth stories are very rarely straight line stories. Setbacks should, and in fact must, be expected. The reality is that while SSA as a whole may continue to grow robustly in the coming decade, it is a large and complicated region, and within it some countries and sub-regions may experience temporary, or even prolonged, crises. These could be economic, or political, or a combination of both, and will often prove difficult to spot coming. More optimistically, as we have argued, many countries in SSA now seem to have developed a political robustness which means that these crises are now setbacks, rather than becoming more fundamental problems.

Figure 44. Africa becomes a larger part of the world economy



Source: Citi Research

Figure 45. But income levels per capita are still relatively low



Source: Citi Research

Growth will rise, but on the back of integration into the global economy

As such, there are periods when growth will be above trend, and then, as we expect in the next few years, periods when it be below trend. The key to achieving the long-term goal and getting investment right is to understand these fluctuations. The other point to make is that our projections assume the effort to integrate Africa into the global economy makes progress in the coming years, which in turn allows acceleration in the growth rate that we are projecting between 2015 and 2025. Without this, the rise of Africa in the global economy will be much slower.

Another crucial point to bear in mind is that rapid development provokes dislocation as well as progress, and in the coming decade, the need to maintain investment diversity across such a diverse sub-continent – in terms of countries and asset classes – is likely to remain the most important investment theme. This is a two-way story: initially the lack of easily investible assets means that the most successful investors are those that can buy into a range of assets.

The need to change the growth story and seek global integration

But whatever the setbacks, the real challenge for policymakers in SSA in the coming years is to make more fundamental policy decisions. These will revolve around infrastructure investment and substantively improving the business operating environment. Moreover, and crucially, governments in SSA will have to develop a much clearer and more coherent picture about where their particular country fits into the global economy going forward and how potentially the state can help achieve this goal.

We think this is likely to revolve around the development of the agricultural and mineral sectors and whether these can grow quickly and add more value locally, in addition to providing tax revenue. It will also involve decisions about how to make it more attractive for manufacturing firms to relocate to SSA and how to develop the tourism sector going forward. The reality remains that to encourage truly transformative growth, SSA will have to become more closely integrated into the global economy. The rise of SSA is not pre-ordained, or inevitable. But we remain optimists that this can be achieved, even if we are optimists with the brake firmly on.

IMPORTANT DISCLOSURES

This communication has been prepared by Citigroup Global Markets Inc. and is distributed by or through its locally authorised affiliates (collectively, the "Firm"). This communication is not intended to constitute "research" as that term is defined by applicable regulations. Unless otherwise indicated, any reference to a research report or research recommendation is not intended to represent the whole report and is not in itself considered a recommendation or research report. The views expressed herein may change without notice and may differ from those views expressed by other Firm personnel.

You should assume the following: The Firm may be the issuer of, or may trade as principal in, the financial instruments referred to in this communication or other related financial instruments. The author of this communication may have discussed the information contained herein with others within the Firm and the author and such other Firm personnel may have already acted on the basis of this information (including by trading for the Firm's proprietary accounts or communicating the information contained herein to other customers of the Firm). The Firm performs or seeks to perform investment banking and other services for the issuer of any such financial instruments. The Firm, the Firm's personnel (including those with whom the author may have consulted in the preparation of this communication), and other customers of the Firm may be long or short the financial instruments referred to herein, may have acquired such positions at prices and market conditions that are no longer available, and may have interests different or adverse to your interests.

This communication is provided for information and discussion purposes only. It does not constitute an offer or solicitation to purchase or sell any financial instruments. The information contained in this communication is based on generally available information and, although obtained from sources believed by the Firm to be reliable, its accuracy and completeness is not guaranteed. Certain personnel or business areas of the Firm may have access to or have acquired material non-public information that may have an impact (positive or negative) on the information contained herein, but that is not available to or known by the author of this communication.

The Firm shall have no liability to the user or to third parties, for the quality, accuracy, timeliness, continued availability or completeness of the data nor for any special, direct, indirect, incidental or consequential loss or damage which may be sustained because of the use of the information in this communication or otherwise arising in connection with this communication, provided that this exclusion of liability shall not exclude or limit any liability under any law or regulation applicable to the Firm that may not be excluded or restricted.

The provision of information is not based on your individual circumstances and should not be relied upon as an assessment of suitability for you of a particular product or transaction. Even if we possess information as to your objectives in relation to any transaction, series of transactions or trading strategy, this will not be deemed sufficient for any assessment of suitability for you of any transaction, series of transactions or trading strategy.

The Firm is not acting as your advisor, fiduciary or agent and is not managing your account. The information herein does not constitute investment advice and the Firm makes no recommendation as to the suitability of any of the products or transactions mentioned. Any trading or investment decisions you take are in reliance on your own analysis and judgment and/or that of your advisors and not in reliance on us. Therefore, prior to entering into any transaction, you should determine, without reliance on the Firm, the economic risks or merits, as well as the legal, tax and accounting characteristics and consequences of the transaction and that you are able to assume these risks.

Financial instruments denominated in a foreign currency are subject to exchange rate fluctuations, which may have an adverse effect on the price or value of an investment in such products. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. Investors should obtain advice from their own tax, financial, legal and other advisors, and only make investment decisions on the basis of the investor's own objectives, experience and resources.

This communication is not intended to forecast or predict future events. Past performance is not a guarantee or indication of future results. Any prices provided herein (other than those that are identified as being historical) are indicative only and do not represent firm quotes as to either price or size. You should contact your local representative directly if you are interested in buying or selling any financial instrument, or pursuing any trading strategy, mentioned herein. No liability is accepted by the Firm for any loss (whether direct, indirect or consequential) that may arise from any use of the information contained herein or derived herefrom.

Although the Firm is affiliated with Citibank, N.A. (together with its subsidiaries and branches worldwide, "Citibank"), you should be aware that none of the other financial instruments mentioned in this communication (unless expressly stated otherwise) are (i) insured by the Federal Deposit Insurance Corporation or any other governmental authority, or (ii) deposits or other obligations of, or guaranteed by, Citibank or any other insured depository institution. This communication contains data compilations, writings and information that are proprietary to the Firm and protected under copyright and other intellectual property laws, and may not be redistributed or otherwise transmitted by you to any other person for any purpose.

IRS Circular 230 Disclosure: Citi and its employees are not in the business of providing, and do not provide, tax or legal advice to any taxpayer outside of Citi. Any statements in this Communication to tax matters were not intended or written to be used, and cannot be used or relied upon, by any taxpayer for the purpose of avoiding tax penalties. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Notes

Notes

Notes

NOW / NEXT

Key Insights on Africa's Growth Prospects

INFRASTRUCTURE

Total gross fixed capital formation in SSA of 20% over the last decade has been fundamentally too low – only 18.3% of SSA roads are paved. / The push to build infrastructure has the potential to be an important supportive engine of growth in SSA. Governments will need to overcome a number of their own constraints to projects and raise funding from a variety of sources.

LABOR MARKET

SSA has been subject to a delayed demographic transition which has held back growth. / Africa's population is set to double towards 2 billion people in the coming 50 years and this rapid growth of the labour force will create a large and dynamic consumer market.

SHIFTING WEALTH

Poverty levels have been reduced and expectations for an emerging middle class are high. / The majority of the new consumer class are not true middle class and instead are barely out of the poor category leading to an increase in consumption of very basic goods and services for the next decade.