

Unlocking Growth in Africa

Aid for humanitarian purposes is desperately needed, but it cannot be the engine of growth

Kenneth S. Rogoff



Kenneth S. Rogoff is IMF Economic Counsellor and Director of the IMF's Research Department.

IF THE world's rich countries really honor recent aid pledges to sharply increase aid for Africa, the results could be dramatic.

We may see aid flows increasing three-fold, with many countries receiving transfers equivalent to 20 percent of their GDP and more, *every year*. If sustained for 10 to 15 years, such flows might go a long way toward helping Africans achieve basic living standards, as set out in the UN's Millennium Development Goals (MDGs). The MDGs, widely accepted benchmarks for core human welfare, span issues ranging from health and education to the welfare of women.

We all fundamentally applaud the strategy, but I would like to voice a couple of concerns. First, it is vital that massive aid increases come mainly in the form of grants, not loans. Burdening countries with massive debts won't help and will likely hurt. If we have learned nothing else from the last 40 years, we should have learned that donors have tended to be too sanguine about the growth-inducing power of aid flows. Growth will come mainly from improving institutions and governance and from reducing corruption and conflict—not from aid. Second, achieving the MDGs shouldn't be viewed as a final goal for Africa. Most Africans want to know that future generations are moving toward achieving the living standards enjoyed by their industrial country counterparts. Growth and macroeconomic strategies need to help people move beyond just achieving the MDGs. The "M" in MDGs should stand for "minimum."

Grants or loans?

Why is it so important that the bulk of aid flows to Africa come in the form of outright

grants, not loans? Here, both theory and practice have led to a sea change in thinking. In the 1970s and 1980s, it was argued that Africa was teeming with investments offering ultra-high returns, so that loans could easily be serviced out of the growth the investments would generate. But, over the past decade, economists have realized that accelerating growth is a much more complex process than simply accumulating physical capital (plant, equipment, roads, and bridges). Nowadays, it is recognized that "soft factors"—such as institutions and governance—matter just as much and probably a lot more. No matter how much capital is poured into an economy, strong growth is impossible if individuals and companies don't enjoy meaningful property rights, reliable courts, and other basic market institutions. The IMF's April 2003 *World Economic Outlook* estimates that if sub-Saharan Africa's institutions were to be raised to OECD quality, per capita GDP would rise by 150 percent and annual growth by almost 2 percentage points—and these estimates might even be conservative (see "Testing the Links," page 35).

While it goes too far to argue that loan-financed aid projects are always ill advised, the recent shift toward viewing aid to Africa as principally humanitarian—as opposed to growth-enhancing—makes more sense. Too many African countries today carry massive debt burdens that are the scars of failed development strategies and Cold War-driven geopolitical loans. All too often, even if the loans weren't squandered through government consumption and corruption, the anticipated growth never materialized because of war, disease, and famine, as well

as factors more under the governments' control. IMF research shows that the debt burdens of many poor countries substantially weigh down their growth. This includes many countries that, as beneficiaries of the IMF–World Bank program for the heavily indebted poor countries—most of which are in Africa—have had their debts somewhat reduced.

The use of rosy growth projections to justify loans instead of grants was also used for the former Soviet Union countries known as the “CIS-7.” They received massive loans after achieving independence in the early 1990s, and these loans were supposed to be manageable, given projected fast growth. But, for many reasons, not least the transitional costs of changing institutions—and lingering weak governance and corruption—the envisioned fast growth never materialized. Now these countries are saddled with debts amounting to 60–100 percent of their GDP and problems that might never have occurred, according to a recent IMF study, if the first several years of aid had come in the form of grants.

Are the MDGs enough?

There are some who argue that achieving the MDGs, if that is possible, should be enough to put many African economies onto desired growth trajectories. Therefore, it is a mistake to look too far beyond relieving immediate poverty. Perhaps. Sick, undernourished workers can't be productive, and ensuring universal basic nutrition will surely enhance growth. MDG-oriented policies intended to enhance the rights of women, who potentially constitute half of a country's workforce, must enhance growth as well. And the provision of retrovirals to combat AIDS will allow more teachers to be in the schools. This, too, should help growth.

Yes, the MDGs have to be a piece of the puzzle. Africa cannot grow if its population collapses into a Malthusian cycle. But it's hard to see the MDGs providing a framework for long-term growth. To begin with, consider the awkward fact that MDGs are stated as absolute goals and don't embody any notion of trade-offs or priorities. Moreover, progress toward some of the MDGs is extremely hard to measure. There is now a heated debate among researchers about the reliability of official poverty estimates. Some academic researchers (notably Surjit Bhalla and Xavier Sala-i-Martin) argue that global poverty has been falling much faster than official estimates suggest—so much so that some countries, such as India, have already met their MDGs for poverty reduction (see “Bhalla Versus the World Bank: An Outsiders' Perspective,” page 50).

A recipe for growth

If achieving the MDGs is only part of the answer, then what is the rest? First, **African countries must become more open to trade and foreign direct investment, and their efforts must be reciprocated.** Far too often, poor African countries

have been frustrated in their efforts to integrate with the world economy, because rich countries use artificial obstacles to block African exports of products like textiles, agricultural goods, and footwear, in which Africa has a natural comparative advantage. It is preposterous that the industrial countries spend \$300 billion a year on agricultural subsidies, five times what they spend on foreign aid. Blocking Africa's exports hinders not only current growth but also future growth. Research shows that exporting boosts the productivity of African manufacturing firms because of the technological information they gain, and the same opportunities should be open to producers in other sectors.

Second, **governments must be careful not to fall into debt traps.** I have already spoken about external debt, but domestically financed deficits can be equally problematic. Because domestic debt markets are ill developed throughout most of Africa, governments tend to finance large deficits by ramming debt into banks, which have no option but to accept it because of financial repression. As a consequence, even banks with large deposit bases often have little capacity to intermediate funds for private sector projects.

Third, **African countries need more flexible exchange rate and price systems.** Many African countries have succeeded in bringing down inflation, with annual average inflation on the continent dropping from 17 percent in 1990 to 10 percent in 2003 (in sub-Saharan Africa, from 20 percent to 12 percent). But the future of exchange rate systems in Africa is uncertain. In the short term, many countries have very little option but to float. With commodity exports subject to wild price gyrations, failure to allow the exchange rate to adjust would inevitably force large adjustments elsewhere in the economy. Yet many African countries today don't seem to allow their exchange rates to float nearly enough, given the large terms of trade shocks they face. Perhaps in the long run, many African countries will choose to merge their currencies with larger ones.

Finally, given the enormous volatility that African countries face—not least because of erratic and uncertain aid flows—**it's important for them to improve the flexibility of their product and labor markets.** The IMF's April 2003 *World Economic Outlook* estimates that labor and product market rigidities reduce output in Europe by 10 percent, and the cost of such rigidities in Africa's highly volatile macroeconomic climate is probably much larger.

It will be a very good thing if aid flows to Africa pick up sharply in the coming years, and the IMF will certainly try to help these countries negotiate any ensuing macroeconomic problems, such as aid-induced real exchange rate appreciation. And the macroeconomic problems will be far less if aid comes in the form of grants. But, in the long run, growth is needed to raise standards of living in Africa, growth that takes the region far beyond the minimum standard of the Millennium Development Goals. ■