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The Constraints to Structural Transformation in Africa; Suggestions for the Research Agenda

1. Introduction

I would like to begin by thanking the African Finance and Economics Association and especially its President, Dr. Elizabeth Asiedu, for according me the honour of giving this keynote address. I am delighted to be among such a distinguished group of economists, which includes both academics and policymakers. The agenda for the conference includes a truly impressive range of research papers on a wide variety of important topics and is testimony to the progress being made by African academics, in universities and research institutions all over the world, to extend the boundaries of our knowledge about the economics of Africa.

The theme of my address this lunchtime is the knowledge gaps in our understanding of the forces driving or impeding the structural transformation of African economies; knowledge gaps which I hope academic research can help to close. Africa's economic performance has improved markedly since the 1990s. During the 1990s, average per capita real GDP growth in sub-Saharan Africa (SSA) was -0.7 percent per annum, but this has risen to 2.7 percent since the turn of the millennium. The acceleration of real growth has not, however, been accompanied by major structural transformation of the economies of SSA. For the most part, these economies still export primary commodities, the majority of the workforce (almost 60 percent) still earns its living in agriculture, where labour productivity has been virtually stagnant for two decades,

manufacturing contributes only about 10 percent of GDP, and a large scale shift of labour from low productivity informal sector activities into high productivity modern industries has not yet begun. The share of SSA in global exports of manufactures and agribusiness products is negligible, at less than 1 percent and less than 2 percent respectively.[1]

The lack of structural transformation in SSA, which stands in stark contrast to that achieved in many countries in developing Asia and Latin America, reflects failures along several key axis of development; the failure to realise a green revolution in SSA, the failure to mobilise private investment in modern labour intensive industries, the failure to generate large scale formal sector employment and the failure to establish more competitive domestic financial markets. The underlying reasons why SSA has been much less successful than other regions of the developing world are not self evident - I do not think that they can be attributed entirely to a lack of policy reform in SSA - and to some extent these failures represent development conundrums for the region. Improving our understanding of the causes of these failures is essential if we are to design more effective policies to promote structural transformation on the continent, and this is clearly an area where academic research can make an important contribution.

In the rest of this address I will briefly elaborate on what I think are some of the most important questions which must be answered if we are to design more effective development strategies in Africa, although I want to acknowledge that my focus is necessarily selective and based mainly on my own area of expertise, which is macroeconomics and finance. I will not cover many other issues which are probably equally important for structural transformation, such as human capital formation, the modernisation of agriculture, the role of institutions and the demographic transition, all of which are the subject of valuable ongoing research, including research which will be presented at this conference.

2. Why is there so little formal sector employment in Africa?

[1] The Africa Competitiveness Report 2011.

Probably the most disappointing facet of sub-Saharan Africa's improved economic performance since the 1990s is the failure to translate higher real economic growth into large scale formal sector employment. Across SSA, the share of the labour force with a formal sector job is very low. Data on formal sector employment are not available for all SSA countries, but the IMF's 2011 Regional Economic Outlook for SSA provided data for six countries, in which the median formal sector employment as a share of the working age population was only 13.6 percent (see table below).

Country	Formal sector employment as percent of working age population
Cameroon	9.5
Ghana	13.3
Mozambique	16.7
Tanzania	9.5
Uganda	13.9
Zambia	13.8
Median	13.6

Source: IMF, 2011, table 2.3.

Although mass unemployment is not the norm in most SSA countries (with the exception of South Africa), the vast majority of the labour force have to earn their living in the informal sector, where labour productivity and wages are low and livelihoods insecure. About 80 percent of the labour force in Africa is self-employed, mainly in household enterprises, which absorb most of the new entrants onto the labour market as well as labour which migrates from rural to urban areas (Fox and Gaal, 2010; African Development Bank, 2012). Although formal sector employment is growing slightly faster than the workforce, the difference is not large enough to bring about a significant shift of the workforce into formal sector employment. There is no reason to believe that workers voluntarily remain in the informal sector; most would like a formal sector job. The lack of formal sector jobs matters profoundly for structural transformation, because it is mainly through formal sector employment that labour productivity is raised and workers acquire more advanced vocational skills and expertise.

Understanding why there is so little formal sector employment in Africa, despite the buoyant economies, has potentially profound implications for economic policy. Does the explanation lie in policy induced labour market rigidities, which could be alleviated through policy reform; in other types of market imperfection; on the supply side of labour markets (for example a lack of appropriate skills in the workforce) or do the constraints lie outside of the labour market, in the goods or capital markets?

Outside of South Africa, empirical research into SSA labour markets is not extensive. Nevertheless, the research which has been conducted provides important insights. These insights include the finding that wage rigidities do not, in general, characterise the formal sector labour market in SSA. Real wages in the formal sector are quite flexible, varying in response to unemployment and economic conditions. However there are large wage differentials across different segments of the labour market, which cannot be explained entirely by differences in human capital.. There is also a substantial wage premium related to firm size; larger firms pay much higher wages than small firms (Kindon, Sandefur and Teal, 2005).

The evidence that excessive labour market regulations are a major constraint to job creation is weak. Furthermore, SSA economies are very heterogeneous in terms of labour market rigidities and the strength of trade unions (Fox and Gaal, 2008). Marcel Fafchamps and Mans Soderborn have argued that the positive relationship between wages and firm size in manufacturing firms in SSA is consistent with an efficiency wage model of the labour market which implies that weaknesses in labour management might be a constraint to stronger formal sector job creation (Fafchamps and Soderbom, 2006).

It is also possible that important constraints to formal sector job creation lie outside of the labour market, in the product or capital markets. The informal sector of the labour market is dominated by the service sector. Formal sector jobs are more likely to be found in the non agricultural traded goods sector (e.g. manufacturing), where a minimum degree of size and formal status is often a precondition for being able to compete on global markets. Hence the lack of formal sector job creation might reflect constraints to the expansion of the traded goods sectors.

3. Private sector investment

A second disappointing feature of SSA's improved economic performance is the relatively low level of private investment, outside of the capital intensive mining and oil sectors and residential construction. The average level of private investment in SSA to GDP was 18 percent in 2008,[2] which is about half the level in developing Asia. There was very little investment in large scale labour intensive manufacturing, which is one of the most important sectors for driving structural change.

The poor response of private investment in developing countries to structural adjustment in the 1980s and 1990s prompted an active research agenda into the determinants of private investment. One of the conclusions reached at that time, which drew on new theoretical insights which stressed the option value of deferring irreversible investment in the face of uncertainty, was that private investment was held back by high levels of uncertainty, emanating from macroeconomic volatility, debt overhangs, lack of reform credibility, etc (e.g. Oshikoya, 1994; Serven, 1997). But this explanation is no longer as convincing as it might have been in the 1990s. Macroeconomic volatility has been reduced substantially in many SSA countries as a result of better macroeconomic management and public debt ratios are quite low as a result of external debt relief initiatives. However, exchange rate variability, which is a characteristic of many SSA economies, has been found to be negatively and significantly correlated with private investment (e.g. Bayraktar and Fofack, 2007; Serven, 2003), and hence this may be one of the reasons why private investment in SSA has not been robust even though economic performance has improved. In addition, other microeconomic and institutional factors which create uncertainty for investors might still be important.

The empirical analysis of private investment in manufacturing industries in SSA has been greatly enhanced by the availability of firm level panel data from enterprise surveys, which have been

[2] The data are from the African Economic Outlook, 2010.

carried out in several SSA countries. These data indicate that the lack of private investment is not because ex post returns to capital are low. On the contrary, there is robust evidence of high returns to capital, but there is no significant relationship between past profits and investment by these firms (Gunning and Mengistae, 2002; Warnholtz, 2008). The evidence that private investment in manufacturing in SSA is constrained by a lack of access to external finance is also weak. Asiedu (2002), who examined foreign direct investment (FDI) flows to SSA, also found that higher returns to capital had little impact on FDI flows to SSA in contrast to other developing regions. She suggested that the risks associated with potential policy reversals negated the impact of higher returns to capital in attracting FDI to SSA.

It seems likely that the investment climate has an important impact on fixed investment by the private sector, because of its impact both in the costs of doing business and the risks involved. Potentially important factors which affect the cost and risks of doing business are the adequacy of infrastructure, especially power and transport links, non tariff barriers to the movement of goods across borders and restrictions on trade in services, which are often an impediment to intra-regional trade within Africa, and the transparency and predictability of business regulations. Unfortunately the specific aspects of the investment climate which are the binding constraints in each country have not been easy to identify as yet through empirical research. The conclusion I want to draw from this brief summary is that if we are to design effective policies to raise private investment rates in SSA, we need more research into the constraints which are holding it back.

4. Financial intermediation and interest rate spreads

The third area where more research is needed to guide policymakers pertains to the financial sector, which research has shown to play an important role in development (e.g. Murinde, 2010). Financial sector reform programs have been implemented in many SSA countries over the last two decades, which have aimed to liberalise financial markets, promote competition and diversification, and strengthen bank regulation and supervision. Nevertheless, the financial

systems of SSA are still small compared to developing countries in other regions of the world and their levels of intermediation (the ratio of loans to deposits) are among the lowest in the world; which implies that a shortage of domestic resources is not the only constraint to lending. The median bank lending to the private sector as a percentage of GDP in Africa was 19 percent in 2009, which is only 40 percent of the average for developing countries in other regions.

African banks also have interest rate spreads which are much higher than in other developing regions, with the exception of Latin America and the Caribbean; a feature which is most likely linked to the shallowness of financial systems and low rates of intermediation in Africa (Beck, Maimbo, Faye and Triki, 2010). Interest rate spreads have remained persistently high even though the quality of bank assets, as measured by non performing loans to total loans, has improved markedly in the 2000s in several countries; hence the high spreads are unlikely simply to reflect higher credit risks faced by banks. Real lending rates in many SSA are in the region of 10-20 percent.

A research project commissioned by the African Development Bank investigated the impact of financial sector reforms on bank intermediation efficiency and competitiveness in eight African countries. The findings were mixed. There is some evidence of stronger competition in banking markets but, especially in the smaller economies, there was only limited progress towards greater efficiency (Mlambo and Murinde, 2011 and the case study papers in the March 2011 African Development Review).

The shallow and inefficient banking systems in Africa are a constraint on structural transformation because banks are the main source of external finance for most firms. If the financial system works well, it should channel scarce savings to firms which can use financial resources most productively. A key driver of structural transformation is the expansion of firms which can use resources most productively, thereby spurring faster growth in total factor productivity. Whether a lack of finance is currently the most binding constraint to private investment is unclear, as I have already discussed, but it would appear unlikely that a large and

sustained increase in private investment in SSA could be achieved without an accompanying expansion of financial intermediation.

For policymakers in SSA, key questions are what are the most important causes of high interest rate spreads and what are the most important constraints to a more rapid growth of financial intermediation? Of particular relevance for bank regulators is the role of competition and barriers to entry; do more liberal entry regulations promote more competitive banking systems and does more competition lead to lower interest rate spreads and greater intermediation of funds, and if so, is this at the expense of bank fragility? These are important issues for the research agenda on the financial sector in Africa.

5. Conclusion

Economic development is a complex process; a process which despite all of the advances made in economics over the last few decades, we do not fully understand. Indeed it is fair to argue that the causal processes of structural change – which are the essence of development - are some of the least understood features of economics. As a consequence, policy makers in Africa, and other developing regions, are often forced to make decisions without adequate analytical understanding of the issues involved. Should we offer private investors fiscal incentives? Should we impose a minimum wage? Should government subsidise vocational training by firms? These are just a few of the many decisions policymakers are confronted with to which an authoritative answer, backed by economic theory and empirical evidence, is illusive. The point on which I want to end is that we need the contribution of academic research if we are to craft successful development strategies for Africa.

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