Economic Report on Africa 2003

ACCELERATING THE PACE OF DEVELOPMENT

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Addis Ababa
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Manufactured in the United States of America
First printing July 2003

ISBN 92-1-125087-0
Sales number E.03.II.K.1

Material in this publication may be freely quoted or reprinted. Acknowledgement is requested, together with a copy of the publication.

Designed, edited, and produced by Bruce Ross-Larson, Meta de Coquereaumont, Joseph Costello, Elizabeth McCrocklin, Michael Molanphy, Christopher Trott, and Elaine Wilson of Communications Development Incorporated, Washington, D.C.
Cover photographs provided by the World Bank Photo Archives and Photodisc.

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Data notes

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

Two years separated by a dash (2001–02) indicate a range of calendar years, while two years separated by a slash (2001/02) indicate a fiscal year or, in the context of agriculture, an agricultural year.

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

Foreword

The *Economic Report on Africa 2003* is the fourth in an annual series that reviews the continent's economic performance and near-term prospects. Targeted to African and global policymakers, the reports are meant to stimulate discussion and change.

This year's report builds on the work of the three previous reports in laying out an agenda for Africa based on systematic benchmarking of economic performance. It finds that growth slowed in Africa, to an average of 3.2% in 2002, from 4.3% a year before. That modest performance reflects the slower than expected recovery in world trade, the drought and AIDS in southern and eastern Africa, and the political and armed conflicts in several countries. Even so, well-managed countries, with solid reform agendas and good governance, performed well. Mozambique grew at 12%, among the fastest in Africa. And other well-managed reformers—Ethiopia, Rwanda, and Uganda—grew at 6% or more.

This mixed performance underscores the point that stop-go growth in Africa is not conducive to poverty reduction or sustainable improvements in living standards, and that one of the biggest challenges facing African countries is to sustain growth over a long period.

The report also identifies policies that are the best catalysts for sustained growth and development. The main message is that success in accelerating the pace of development will come to countries that maintain fiscal discipline, address deep pockets of poverty, provide opportunities for private entrepreneurs to flourish, and modernize their bureaucracies.

The report continues the innovation of last year's by supplementing the traditional regionwide analysis with seven in-depth country studies. Those studies show the strong relationship between poverty and agroclimatic conditions—that poverty is more severe in rural Africa than in urban Africa. For example, Uganda's solid economic growth has been accompanied by substantial poverty reduction, but within-country disparities are vast and the incidence of poverty is much higher in the north. And in Egypt, one of Africa's emerging modern economies, poverty has declined overall, but it rose in southern Egypt between 1996 and 2000.

Drawing insights from the in-depth country studies, the report sharpens the policy prescriptions, making them much more relevant and practical for policymakers. First, sound economic governance creates an environment that encourages private groups and individuals to take risks, invest capital, and export. Second, governance is the result of strong public institutions—including the bureaucracies essential for policy formulation and implementation. Another major message: only sound governance can

stop poverty from becoming entrenched, investment from dwindling, chronic fiscal deficits from draining and then driving away international resources, and precious human resources from fleeing a country.

Strengthening the rules and institutions to sustain growth is thus central to Africa's quest for sustained long-term development. The issues highlighted in this year's report are central to that quest, but confronting them will require vision and courage—from African leaders, from the African people, and from all others with a stake in Africa's future.

K.Y. Amoako
Executive Secretary
July 2003
Addis Ababa

Acknowledgements

A team under the overall guidance of Patrick Asea, Director of the Economic and Social Policy Division, Economic Commission for Africa (ECA), prepared this report. The team, led by Shamika Sirimanne, comprised Bethelhem Belayneh, Kwabia Boateng, Derrese Degefa, Niall Kishtainy, Geoffrey Mwau, Patrick Osakwe, Oliver Paddison, and Alemayehu Seyoum, with first-rate research assistance from Desta Asgedom and Mamadou Bal. The team appreciates the excellent contribution from Elvira Ezekwe, who managed the financial accounts, and from Wengelawit Tsigie, who provided secretarial support. Others in the division and in the ECA who contributed to the report include Teshome Abebe, Andrew Allimadi, Fabrizio Carmignani, Sam Cho, Chukwudozie Ezigbalike, Nino Fluck, Adrian Gauci, Vittorio Gerosa, Aissatou Gueye, Abdalla Hamdok, Cornelius Mwalwanda, Kasirim Nwuke, Wilfred Ongaro, Antonio Pedro, Sumit Roy, Jean Thisen, and Elizabeth Wolde-Mariam. Special thanks go to Yetinayet Mengistu and Shewaye Woldeyes for the superb desktop publishing work. The work was carried out under the general direction of the Executive Secretary, K.Y. Amoako.

The report benefited from the comments and suggestions of two major peer review meetings. The report was enriched by comments from a group of eminent African scholars at a peer review meeting held in Addis Ababa. Participating were Kwesi Botchwey, Augustin Fosu, Yansane Kerfalla, Mwangi Kimenyi, Simba Makoni, Charles Okeahalam, and Terry Ryan. The team appreciates reviews received from the external peer review meeting held in Washington D.C. that further enriched the report. Participating in the meeting were Fernando Goenha and Armando Pangueme of the Embassy of Mozambique; Sonal Shah of the Center for Global Development; Willene Johnson of Cornell University; Raj Bardouille, Carl Gray, and Adam Smith of the United Nations Department of Economic and Social Affairs; Ousmane Doré, David Dunn, Alvaro Manoel, Gamal El-Masry, Alphecca Muttardy, William Scott Rogers, and Ludvig Soderling of the International Monetary Fund; and Patience Bongiwe Kunene, Abraham Mwenda, Haruna Mohammed, John Randa, and Samuel Wangwe of the World Bank.

The comments and contributions from colleagues in ECA offices, particularly Emile Ahohe, Hakim Ben Hammouda, Sylvain Maliko, Guillermo Mangue, Andre Nikwigize, Halidou Ouedraogo, and Abdelilah Ouaqouaq, are noted with appreciation. Government and nongovernmental institutions as well as international organizations, including the United Nations Development Programme, United Nations Industrial Development Organization, United Nations Children's Fund, International Monetary Fund, and the World Bank, contributed greatly in facilitating the conduct of country studies.

Preparation of the country reports was aided by background research undertaken by Gouda Abdel-Khalek, Michael Atingi-Ego, Shyam Nath, Manasseh Ntaganda, Albert Ondo-Ossa, and Nii Sowa. Quarterly country reports prepared by Michael Atingi-Ego, Abla El Khawaga, Alhassan Iddrisu, Nicholas Mvou, Manassah Ntaganda, and Reshma Peerun provided additional information. In addition, experts in 39 African countries undertook surveys to develop the Economic Policy Stance Index.

The final report was edited, designed, and produced by Communications Development Incorporated's Bruce Ross-Larson, Meta de Coquereaumont, Joseph Costello, Elizabeth McCrocklin, Michael Molanphy, Christopher Trott, and Elaine Wilson.

Special thanks to Peter da Costa, Max Jarrett, Teshome Yohannes, Kibruyisfa Achamyeleh, and other members of ECA Communication Team, who provided input to the copyediting, production, and design of the report.

Overview—Accelerating the Pace of Development

The economic performance of African economies fell short of expectations in 2002, with growth slowing from an average of 4.3% in 2001 to 3.2% in 2002. In 2002, of the 53 countries in Africa, only 5 achieved the 7% growth rate required to meet the Millennium Development Goals. Of the others, 43 registered growth rates below 7%, and 5 registered negative growth.

The modest overall performance in 2002 reflects the weaker global economy and a slower than expected rebound in world trade. Africa's economic performance was weakened by drought and HIV/AIDS in various parts of southern and eastern Africa, and political and armed conflicts in the Central African Republic, Côte d'Ivoire, Madagascar, and Zimbabwe.

> ***"Africa's growth slowed from an average of 4.3% in 2001 to 3.2% in 2003"***

But well-managed countries, with solid reform agendas and a record of stability and good governance, performed well. Mozambique had growth of 12%—among the fastest in Africa. Other well-managed reformers—Ethiopia, Rwanda, and Uganda—grew at 6% or more.

Highlights for 2002

World trade beginning to recover. World trade began to recover from a decline in 2001, with the seasonally adjusted value of U.S. merchandise exports in the first half of 2002 growing at an annualized 7.2% over the first half of 2001. Other regions have not shown such strong improvements.

Commodity prices on an upward trend. Commodity prices recovered strongly as global economic activity picked up. The rise in crude oil prices will slow growth in Africa but will loosen the financing constraints for oil-exporting countries. Rising cocoa prices could benefit producers such as Côte d'Ivoire and Ghana. Despite the upward trend, some commodities have had stagnant or declining prices, notably coffee, tea, and cotton. That will reduce the foreign exchange earnings of such countries as Ethiopia, Kenya, and Uganda.

Foreign direct investment down. Foreign direct investment inflows to Africa declined by $6 billion, in line with the downward trend worldwide, a result of the faltering global economic recovery. Foreign direct investment in Africa continued to be hampered by

weak governance, poor infrastructure and institutions, and ongoing conflicts in a large number of countries.

Privatization still slow and reluctant. An important source of foreign direct investment is privatization, yet progress on privatization has been slow, with activity concentrated in a handful of countries: South Africa, Ghana, Nigeria, Zambia, and Côte d'Ivoire. Of the 2,300 privatizations in Sub-Saharan Africa over 1991–2000 only 66 were of higher value and economically significant enterprises. The vast majority were sell-offs of ailing or small firms. So far, privatization has not boosted investment in Africa.

> "*Capital flight over the past 27 years amounted to about $187 billion*"

Pledges made to increase official development assistance. The UN Conference on Financing for Development in Monterrey in March 2002 elicited pledges to increase official development assistance (ODA) over the medium term from its current level of $50 billion for all aid recipients. Promises from the European Union (EU) and United States alone would generate an extra $12 billion a year from 2006 onwards for all developing countries, with much for Africa. That is a welcome improvement, though well short of the extra $50 billion a year required globally to reach the Millennium Development Goals.

But there are worrying trends. ODA flows to Africa are usually analyzed in the aggregate, with little attention to particular sectors, masking worrying trends. For the "production sectors"—agriculture, manufacturing, trade, banking, and tourism—ODA declined from 17% in 1975–80 to 11% in 1995–2000. In absolute terms, bilateral ODA flows to African economies have dropped in the last decade, with the exception of flows to education.

Capital flight, equivalent to Sub-Saharan Africa's GDP . . . New data for 30 countries shows that capital flight over the past 27 years amounted to about $187 billion. Including imputed interest earnings, the accumulated stock of capital flight was about $274 billion at the end of 1996. Angola, Cameroon, Côte d'Ivoire, the Democratic Republic of Congo, and Nigeria have the highest stocks of capital flight. Five of the 30 countries—Benin, Mali, Niger, Senegal, and Togo—exhibited "negative" stocks of flight capital, indicating that their recorded capital inflows exceed recorded uses of foreign exchange.

. . . is apparently debt-driven. The data show that roughly 80 cents on every dollar that flowed into Africa from foreign loans flowed back out as capital flight in the same year, suggesting widespread capital flight fuelled by debt. And every dollar added to the stock of external debt added roughly three cents to the annual capital flight in all subsequent years. So, debt relief strategies will bring long-term benefits to African countries only if accompanied by measures to prevent a new cycle of external borrowing and capital flight.

Saving and investment still low. A key constraint to growth in Africa remains its low rates of saving and investment. And even countries that achieved high rates failed to reap the benefits in growth, suggesting low efficiency of resource use.

Trade and current accounts in deficit. Eleven countries had unsustainable current account deficits of more than 5% of GDP in 2002, while eight had surpluses, the result of higher export revenues. (The rest ran deficits of less than 5%). Several initiatives, notably the U.S. African Growth and Opportunity Act (AGOA), should help to increase African exports. Improving access for agricultural products to developed countries remains a key challenge.

> *African countries continued to strengthen macroeconomic fundamentals and intensify their focus on reducing poverty*

Fiscal policy continuing to improve. Overall fiscal discipline improved. But fiscal profligacy remains a problem, with a number of countries having deficits of more than 3% of GDP. In some countries, notably Nigeria, this was driven by increased spending in the run-up to elections. In others, such as Angola, spending pressure came from post-conflict reconstruction needs. True, there are some strong performers, but much more needs to be done to improve fiscal management across the continent.

Monetary and exchange rate policies sound. Monetary and exchange rate policies were fairly sound in 2002, with 11 countries holding inflation under 3% as a result of prudent policies. But some countries had massive price increases because of conflict and political crises. The CFA franc appreciated against the dollar, which could hurt the competitiveness of countries with high trade exposures, such as Mali and Senegal. North African exchange rates were generally stable.

Agriculture and food security in crisis. Agriculture in many countries suffered from the adverse climatic conditions in 2002. Flooding hit food production in Algeria, Kenya, and Senegal. Countries in Eastern and Southern Africa faced a food crisis because of drought. In Ethiopia a quarter of the population needs food aid; in Zimbabwe close to half.

Country efforts to reduce poverty intensified. Despite the weaker than expected overall performance in 2002, countries in the region continued to strengthen macroeconomic fundamentals and intensify their focus on reducing poverty. The number of African countries preparing interim or final Poverty Reduction Strategies increased significantly, with nine countries finalizing them in 2002, up from four in 2001.

Second-generation reforms firmly in place for top performers. The Economic Policy Stance Index now pays particular attention to the efforts of countries to deepen their second-generation reforms. In the top-ranked countries—Botswana, South Africa, Mauritius, Namibia, and Tunisia, in that order—market liberalization is more advanced, and policy reversals are minimal. Institutions of policy analysis and coordination are better. Efforts to promote women's access to education and health and gender equality in employment are highly rated. Propoor policies and targeting are effective. The legal system is effective at enforcing contracts. Laws and regulations are more predictable and transparent—and applied more uniformly. The quality of the civil service is better. And the access to and reliability of telecommunications, transport, and electricity are greater. Moreover, poverty rates are relatively low in the top performers, and fixed and mobile telephone networks, which are closely correlated with road networks, are more extensive in all these countries by a considerable margin.

Important strides towards implementing the African Peer Review Mechanism. The New Partnership for Africa's Development (NEPAD) made important strides in operationalizing the African Peer Review Mechanism (APRM) in 2002, critical for African prospects because it represents a bold approach for building capable states with good governance for sustainable development. Through peer pressure and peer learning, the APRM can act as a commitment mechanism to help monitor and assess the progress of African countries in implementing the NEPAD.

> *Growth in the region is expected to rebound moderately in 2003, to 4.2%*

Medium-term outlook mixed. The outlook for 2003 is mixed, with heightened uncertainty about the robustness of the world economic expansion tempering any budding enthusiasm. In addition to deteriorating business sentiment in industrial economies, rising oil prices and financial sector turbulence are amplifying the risk of a return to a global slowdown. This is likely to be further exacerbated by the impact of the U.S.-led war against Iraq on the global economy (box 1). All in all, growth in the region is expected to rebound moderately in 2003—to 4.2%.

Distilling lessons from the seven countries

The countries profiled in this year's Report reveal the range of African policy challenges. Summarized here are four key challenges in accelerating the pace of development:

- Escaping poverty—going beyond averages.
- Achieving fiscal sustainability—exiting aid dependence.
- Energizing African bureaucracies—enhancing the capacity to deliver.
- Moving to mutual accountability and coherence—taking the best route to development effectiveness.

The purpose is to highlight best and worst practices, draw lessons from the experiences of the seven countries, and provide overall policy guidance to African countries. The

Box 1

Economic impact of the Iraq war—small

The impact of the Iraq war on Africa's economies depends on several factors: how the conflict affects the U.S. and global economy, how it influences trade and financial flows to the continent, and whether a country is a net oil importer.

Overall, the short war will have little net impact on African economies. The temporary increase in oil and gold prices will benefit the large exporters of oil and gold—Nigeria, Algeria, Angola, and South Africa—countries that account for much of Africa's GDP. Landlocked and net oil-importing countries will face short spikes in inflation and balance of payments disequilibria. The way these countries manage this external shock will determine the net effect on their economies.

countries profiled this year are Egypt, Gabon, Ghana, Mauritius, Mozambique, Rwanda, and Uganda.

Escaping poverty—going beyond averages

> *Deep pockets of poverty remain within countries: governments should focus on spatial and temporal dimensions of poverty*

The remarkable consensus and commitment for poverty reduction from governments around the world led to the Millennium Development Goals, to reduce the proportion of people in poverty by 50% by 2015 and to reduce other forms of human deprivation.

Even if the absolute poverty goal is achieved—and prospects for doing this are good for several African countries—deep pockets of poverty will remain within countries.[1] People chronically poor suffer poverty for many years, often for a lifetime, and are likely to transfer their poverty to their children. These are the people who benefit least from economic reforms. They experience social exclusion, because of gender, ethnicity, disability, caste, or social position. They often live in remote areas under harsh agroclimatic conditions.

Recent evidence suggests a strong relationship between poverty and agroclimatic conditions in various African countries (ECA 2002). Large differences in living standards between regions in the same country are correlated with unequal distributions of natural assets, differences in agroclimatic conditions, or differences in geographic conditions, such as remoteness from markets and transport routes (Bigman and Fofack 2000). This is intuitive. Households in remote areas, living on fragile lands, would be expected to have fewer opportunities and face greater risks and vulnerability than households in better-endowed areas. It is also consistent with the fact that poverty is more severe in rural Africa than in urban.

Several country profiles underscore this important point—the need to focus on spatial and temporal dimensions of poverty.[2] Uganda's solid economic growth—averaging 6% a year over the past decade—has been accompanied by substantial poverty reduction, but there remain vast regional disparities in the incidence of poverty, with a clear spatial pattern. The more affluent central crescent area around Lake Victoria has made great strides in economic development, while the drier, more disadvantaged northern part of the country has fallen even farther behind. Uganda's case is of concern because the spatial divide in poverty has been accentuated by almost two decades of civil conflict.

The spatial dimensions of poverty are also evident in Egypt, Ghana, and Mozambique. In Egypt—one of Africa's emerging modern economies—the absolute level of poverty has declined, but in upper Egypt it increased between 1996 and 2000. In Ghana, national statistics show a decline in poverty from 52% to 40% over the past decade—lifting 2 million people out of poverty. But those statistics mask an increase in poverty in 3 of 10 regions—central, northern, and upper east. In Mozambique—one of the

fastest growing economies in Africa—poverty remains stubbornly high at 62% of the population, but it is clearly worse in the north.

The countries covered in this report suggest several ways of tackling spatial-temporal poverty. This overview highlights three particularly innovative strategies: poverty-sensitive distribution formulas for fiscal transfers, public expenditure tracking systems, and private provision of social services.

"Uganda has had impressive results with its Public Expenditure Tracking System"

Government spending should be poverty sensitive

Uganda has found that government expenditures (through various fiscal transfer mechanisms) do not adequately redress regional inequalities. The current transfer payment formula allocates 85% of transfers according to the size of the district population and 15% according to the geographical location, with no consideration to poverty.

The regional distribution of transfers to local governments indicates that the western region has received the largest share (27%), followed closely by the eastern (26%), the central (25%), and the northern (22%), where poverty is highest. But if the transfer payment formula considered poverty across districts, in addition to population and size of the districts, more transfers would go to the northern districts. Such a poverty-sensitive distribution would allocate 29% to the northern region, 26% to the western, 23% to the central, and 22% to the eastern.

Public expenditure tracking systems

Addressing spatial poverty also depends on how resources are translated into basic services for the poor—in such areas as health, education, water and sanitation, and energy. Public spending on these services is often biased against the poor and against rural dwellers. Ghana shows significant inequality in the distribution of educational facilities among the 10 regions and between rural and urban areas. Literacy and enrolment rates are lower in the poorer northern regions, with poor school conditions, low quality, irrelevant curriculums, and a lack of teachers. Accentuating the problems: the higher cost of schooling, with poor parents having to bear any additional costs.

Even when public spending is reallocated towards the poor, the delivery of services too often fails the poor. This may be due to corruption, imperfect monitoring of local government expenditures, and weak capacity of local governments. Rwanda and Uganda have tried to improve services by involving poor people in services through the Poverty Reduction Strategy process and by improving local expenditure monitoring systems. Uganda has had impressive results with its Public Expenditure Tracking System, introduced in 1996. The flow of intended capitation grants reaching schools shot up from 13% (on average) in 1991–95 to about 80–90% in 1999–2000.

Private participation in service delivery

Most public delivery systems are highly centralized, with almost all human development programmes designed and controlled by central authorities. Given the weak

national institutions, this centralization reduces the effectiveness of human development efforts. These overly centralized systems focus on inputs rather than outcomes, are associated with low transparency and accountability, and ultimately produce inferior service delivery (Jimenez 1995; World Bank 2000).

To improve service delivery, governments are relying more on private provision and financing, as for health and education in Egypt and Ghana. Private participation in the provision of health services in Ghana is quite intensive, with about 42% of health facilities owned by the private sector. But private facilities are concentrated in the urban areas. Only mission hospitals are predominant in the poor regions. The best way to improve private participation in poor rural regions? Encouraging community-based, NGO-run health and education facilities.

"Aid in large quantities is a double-edged sword—initially helping but eventually weakening a country's economic performance"

Achieving fiscal sustainability—exiting aid dependence

Many countries profiled in this report depend on foreign aid to fund large amounts of government spending, consumption, and investment. For instance, aid accounts for more than 50% of Uganda's budget, 60% of Rwanda's, and 70% of Mozambique's. Yet there is mounting evidence that aid in large quantities is a double-edged sword—initially helping but eventually weakening a country's economic performance (Lancaster and Wangwe 2001). Recent research shows that foreign aid crowds out private investment—a damning indictment, because the early rationale for foreign aid (the two-gap model) was to narrow the gap between savings and investment in poor countries (Clemens 2002).[3] Private investment is the most robust variable in explaining cross-country growth. And if foreign aid crowds out private investment, the prospects for greater prosperity in aid-dependent countries are slim.

Nowhere is this more evident than in Ghana, which has undertaken significant reforms over the past 20 years but has little to show in tangible benefits for the majority of its people. The high aid dependence reflected in poor fiscal sustainability[4] has hurt the Ghanaian economy, with fiscal woes providing an important explanation for the lacklustre economic performance. A chronically weak fiscal position resulting in huge budget deficits and associated spikes in inflation—often associated with political economy issues—heightened uncertainty over the credibility of government policies. This increased the risk premium associated with investing in Ghana, leading domestic and foreign investors to adopt a wait-and-see attitude.

The huge fiscal deficits led to explosions in domestic debt. Financing the domestic debt has crowded out credit to the private sector, further constraining financing options for firms. Financing deficits by issuing high-yielding treasury bills inverted the yield curve for government securities, giving higher rewards to investors in short-dated securities than in long-dated securities. With many investors preferring short-term government

treasury bills, private firms have had trouble raising long-term capital. This has also shifted resources from the securities market to the government bill market, leaving the securities market thin and illiquid.

Fiscal sustainability requires going beyond the country's external debt to the sustainability of aggregate public sector debt

Egypt's fiscal deficit has also been on the rise. Like Ghana, it has seen rapidly rising domestic debt, with interest payments on this debt, along with the wage bill, taking up around half of public expenditure. Because these areas of expenditure cannot be cut back easily, they seriously reduce the authorities' room for maneuver in fiscal policy. With sluggish economic growth and high domestic interest rates the ratio of domestic debt to GDP is likely to continue to rise, posing difficulties in macroeconomic management.

Heavily Indebted Poor Country status confers benefits and risks

Foreign aid provided through concessional loans to many African countries over the past several decades has created large debt overhangs and significant debt servicing obligations. The poor fiscal state of several African countries and their high levels of external debt led the World Bank and the International Monetary Fund (IMF) to develop the Heavily Indebted Poor Countries (HIPC) Initiative. The programme contemplates forgiving a fraction of these countries' bilateral and multilateral debt. The funds freed by debt relief are to be devoted to effective social programmes, which in the eyes of the multilateral institutions will reduce poverty. In addition, the country is expected to impel broad economic reforms to strengthen the productive sector and increase the potential for growth.

An important principle guiding the programme is that in the post-HIPC era the country will achieve "external sector sustainability", and thus not require new rounds of debt forgiveness.[5] The Bank and the IMF (2001, p. 4) have stated this principle in the following way:

> [B]y bringing the net present value (NPV) of external debt down to about 150 percent of a country's exports or 250 percent of a country's revenues at the decision point, [the programme] aims to eliminate this critical barrier to longer term debt sustainability for these countries.

An important question tackled here is what type of fiscal policy will be consistent with maintaining debt sustainability in the post-HIPC era. As the excerpt above suggests, the multilaterals have focused on policies required to stabilize the ratio of external debt to exports. The Ghana profile shows that a comprehensive answer to the fiscal sustainability question requires going beyond the country's external debt to the sustainability of aggregate public sector debt, including both foreign and domestic debt. Ghana has accumulated a significant stock of domestic debt, purchased by the local banking sector, pension funds, and individuals. Indeed, by ignoring domestic debt, sustainability analyses may underestimate the fiscal effort that poor countries will have to make in the post-HIPC era.

Such large fiscal adjustments could have important political economy consequences (Edwards 2002). First, the adjustments may reduce the funds available to implement the antipoverty programmes. And second, very large reductions in primary expenditures may lead to political instability and backtracking on reform.

Slipping back into the debt trap

Unless HIPC countries, such as Ghana, Uganda, and Rwanda, receive substantial concessional aid in the future, their public sector debt is likely to become unsustainable once again. Uganda, the first country to graduate from the enhanced HIPC programme in 2000, is in a difficult situation. The debt and debt service indicators in net present value terms show that its debt sustainability has not improved since it received HIPC debt relief. The net present value of debt to exports ratio increased from 170% in 2001 to 200% in 2002 and is projected by the IMF to increase to 208% in 2003, well above the threshold of 150% under the enhanced HIPC framework. Similarly the net present value of the debt-GDP ratio is projected to increase from 20% in 2001 to 22% in 2003.

> *Adherence to HIPC debt ratios has hidden costs that may easily outweigh the benefits*

The reason for sliding back into the debt trap: without large volumes of concessional assistance, these countries would be forced to undertake major fiscal adjustments to achieve sustainability (Edwards 2002). Adjustments of this magnitude usually crowd out social expenditures, including poverty alleviation programmes, and tend to create political economy difficulties.

The optimal size of a fiscal deficit

The fiscal sustainability question in Rwanda is slightly different. Tensions are emerging between the requirements for macroeconomic stability and for poverty reduction and post conflict construction. The fiscal deficit, on the rise in recent years, is projected to remain high over the medium term. The reason is the increase in public expenditures to address poverty reduction goals set out in the Poverty Reduction Strategy and the need for post-conflict reconstruction—for demobilization and for establishing peoples courts, the genocide survivors fund, and governance commissions. Some development partners recommend that a country like Rwanda, with large fiscal deficits financed by grants and international borrowing, should reduce the deficit in the medium term rather than mobilize additional resources.

Further contradictions have emerged with Rwanda's HIPC status. The use of exports in the HIPC debt ratios implies that absolute levels of debt per capita will be particularly low for a closed economy, such as Rwanda. This has increased the debt relief but it will also reduce the possibilities for new borrowing. So, over the medium term, rising spending needs for poverty reduction and post-conflict reconstruction mean that Rwanda is unlikely to adhere to low debt to GDP ratios as required by HIPC. The reason? Doing so would reduce the government's ability to contract new loans. It is clear that adherence to HIPC debt ratios has hidden costs that may easily outweigh the benefits.

Several lessons from Rwanda question the relevance of current modalities in the HIPC programme. First, as illustrated in the profile, Rwanda's underlying debt sustainability indicators appear to be flawed. Much of the sustainability analysis by the World Bank and IMF is based on rather optimistic assumptions for future economic performance, the external environment, and projected financing needs.

"Macroeconomic sustainability cannot be divorced from political sustainability"

Second, macroeconomic sustainability cannot be divorced from political sustainability. The legacy of violence must be considered, especially with past civil violence a strong predictor of future violence. The needs of social and political reconciliation are therefore critical. And a macroeconomic programme that does not address these issues could be dangerous.

An alternative to the HIPC criteria would be to link debt relief to a proportion of revenues needed for essential spending, possibly with different limits set for different groups of countries. One proposal is to add a criterion for countries emerging from conflict—putting an upper limit to the fiscal revenues used for debt servicing. HIPC needs must also take greater account of external shocks and the critical role of declining terms of trade in the buildup of debt, an issue so far neglected (Birdsall and Williamson 2002; Nissanke and Farrarini 2002).

Even strong performers are concerned about fiscal imbalances

The Mauritius profile highlights another angle in fiscal sustainability. With stellar macroeconomic performance, the economy grew 5–6% a year over the last 20 years. Inflation remained in single digits. And the fiscal deficit averaged about 4% a year between 1985 and 1999. But in 2001 it jumped to about 6.7% of GDP, and for 2002 it is expected to remain around 6%–6.5%, narrowing to previous levels from then onward.

These higher deficits are the result of a massive investment programme by the government to prepare the Mauritius workforce and infrastructure for economic diversification—away from the traditional sectors of sugar, textiles, and apparels, now losing their potential as engines of growth, and towards a knowledge-based economy. There is concern among some development partners that higher deficits will threaten fiscal sustainability. The analysis here shows that this may not be the case. The main issue is to resolve the tension between higher deficits in the short term and investment that may yield higher returns in the medium to long terms.

A smooth exit requires a strong private sector

Exiting aid dependence and improving the fiscal position of African countries will require governments to implement policies and use resources to promote growth that will expand public revenues and obviate the need for future aid.

A strong private sector is critical to achieving this goal. Only through a strong private sector that contributes to the state's coffers will the abysmally poor fiscal position of

African countries be improved. The point is not that countries should not improve tax administration and reduce leakages due to inefficient spending—it is that they should also take actions to broaden the tax base, so that they can get more tax revenues for the same marginal tax rate.[6]

Managing the transition to less development assistance and more private capital flows will require a combination of measures—to increase domestic resource mobilization, provide greater debt relief, reform the current aid regime, improve market access, and enhance the policy environment. This will include improving the business climate—strengthening corporate governance, commercial justice systems, and the regulatory environment. It will also include improving pricing and access in electricity, transportation, and telecommunications, igniting the private sector's supply response.

> *Only through a stronger private sector that contributes to the state's coffers will the abysmally poor fiscal position of African countries be improved*

Energizing African bureaucracies—with more capacity to deliver

The public service bureaucracies will play a critical role in accelerating the pace of development (figure 1). Yet they play a contradictory role, at once part of the problem and part of the cure (Kayiizi-Mugerwa 2003). Economic reforms are matters of public policy. But policies are no more effective than the bureaucracies trying to implement them.

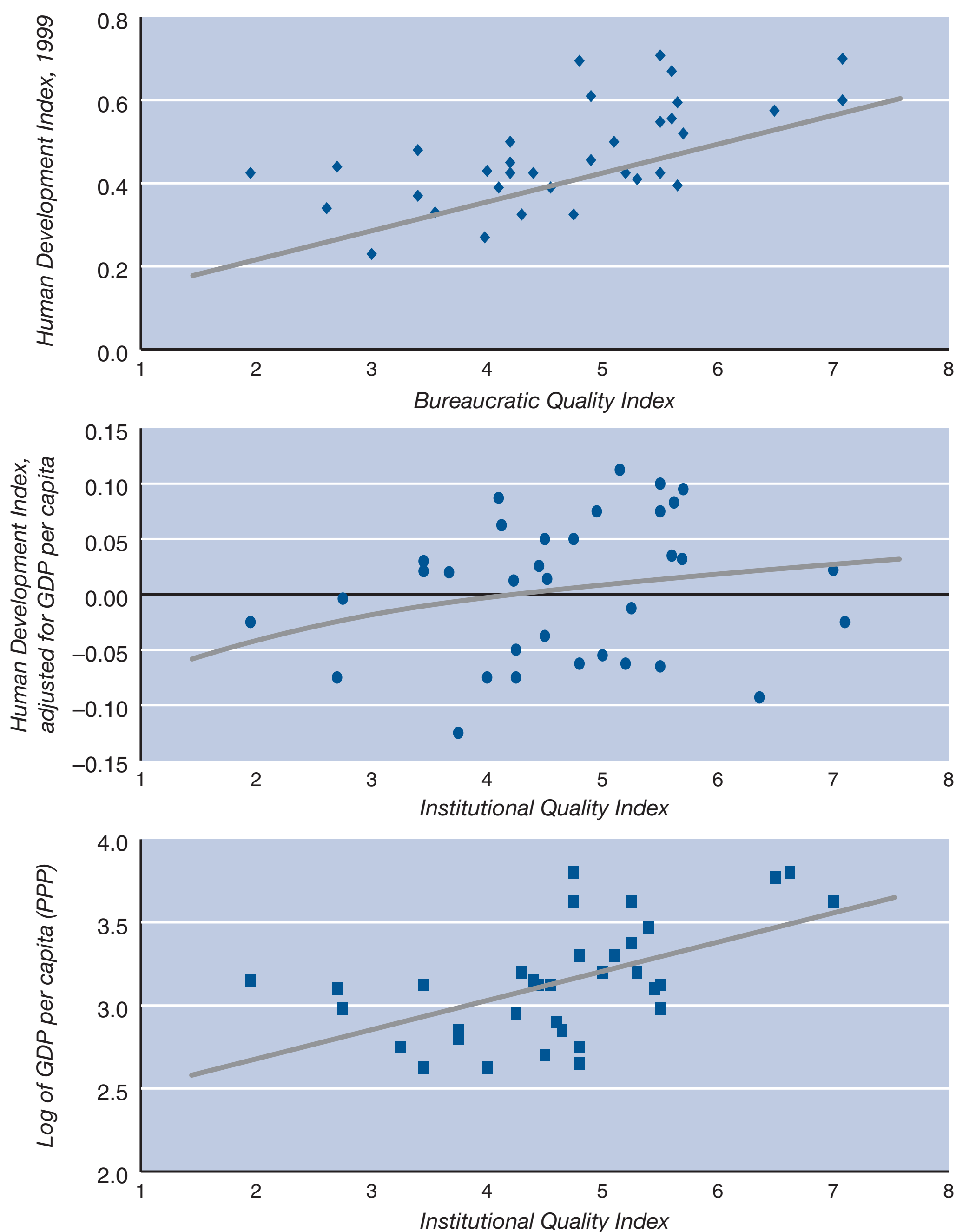
Egypt and Ghana demonstrate the predicament. Despite 20 years of institutional reforms in the public sector, there is little to show for it. These reforms, like those in many African countries, focused on quantitative issues—wage and hiring freezes, downsizings, and retrenchments. They paid little attention to more subtle and challenging issues of bureaucratic quality. In Egypt, state capacity needs badly to be reinvigorated to improve export competitiveness and propel the economy to a higher stage of development. But the reform of institutions faces political and administrative constraints. In Ghana the situation has deteriorated so much that the current government now faces a crisis in the public service.

Two statements from the Ghana Poverty Reduction Strategy reinforce this assessment (Ghana 2003, p. 109):

> It would appear that the totality of the public sector reform programme might be beyond the capacity of the available human and financial resources to plan and implement.
>
> However the reform process cannot proceed effectively without sustained and palpable political commitment, the enforcement of agreed proposals for reform from a political and official level and provision of adequate resources.

The key reform in Ghana—the Public Financial Management Reform Programme, initiated in 1995—introduced an integrated payroll and personnel database, a medium-term

Figure 1
Bureaucratic quality is positively related to development



Note: *The Bureaucratic Quality Index combines factor loadings of government stability, democratic accountability, law and order, and corruption. The sample consists of 39 African countries.*
Source: *Economic Commission for Africa and IMF 2002.*

expenditure framework, and a budget and public expenditure management system. But at the end of 2002 the government was still grappling with the same issues as in 1995.

Several factors are responsible. But compensation and ineffectual management of the public service—including the absence of an overall human resource development, use, and retention strategy—are the prime causes.

> *Public policies have supported high rates of private investment in Mauritius*

Participatory policymaking can be highly effective

In stark contrast, the policy formulation process in Mauritius "contains a very strong dose of consultation, dialogue, consensus building, and democratic principles, ensuring that all concerned stakeholders are actively involved" (Bonaglia and Fukusaku 2002, pp. 171–73). Public-private partnership is pervasive in Mauritian policymaking, and nongovernmental organizations have always been an important part of Mauritian society. As a direct result, public policies have supported high rates of private investment.

The Joint Economic Council is the private sector's apex organization. When a private sector position needs to be voiced, the council expresses it after consulting with members. At least twice a year the government holds meetings with the council, chaired by the prime minister and attended by senior ministers. Structured consultations are also held with private sector organizations, trade unions, and the minister of finance to prepare the national budget. Between budget preparations sessions, there is constant dialogue between the private sector and government through meetings on specific policy matters. Business, labour unions, and government are involved in tripartite wage negotiations.

Private sector and union representatives sit on the National Negotiating Committee on Post-Lomé discussions, the World Trade Organization standing coordination committee, and the Regional Cooperation Council. They also take part regularly in World Trade Organization ministerial conferences.

The participatory policymaking in Mauritius enables all stakeholders to shape the national economic strategy, with private needs reflected in government policy, in line with the country's development objectives.

Moving to mutual accountability and coherence—the best route to development effectiveness

There is much dissatisfaction with the state of development partnerships in Africa (ECA 2001). It stems from a vicious circle of high expectations, grand promises, and only partial accomplishment of goals. There is also the frustration of Africans (that expected benefits were not fully realized) and of development partners (that imple-

mentation was not as expected and the funds provided were not used effectively). The African side blames unrealistic project design, excessive conditions (some of which were just plain wrong), and slow and unpredictable access to promised funds. The donors blame corruption, inadequate political will, and poor implementation by the Africans. There is considerable evidence to support both points of view (Lancaster and Wangwe 2001).

> *There is much dissatisfaction with the state of development partnerships in Africa: it stems from a vicious circle of high expectations, grand promises, and only partial accomplishment of goals*

If the pace of Africa's development is to be accelerated it is imperative that the relationship between Africa and its partners be within the context of interdependence, cooperation, and mutual accountability (ECA and OECD 2002). That is the emerging consensus. Predictability and accountability should be mutual. National leaders should carry out their programmes and inform supporting partners of any changes. Partners should provide the promised resources in a timely manner or consult on the proposed changes. Each should be accountable for fulfilling commitments. Agreements should be clear, stating events and timing, with all to be monitored.

This consensus is reflected in the pledge by world leaders at the UN Conference on Financing for Development in Monterrey:

> A substantial increase in ODA and other resources will be required if developing countries are to achieve the internationally agreed development goals and objectives, including those contained in the Millennium Declaration. To build support for ODA, we will cooperate to further improve policies and development strategies, both nationally and internationally, to enhance aid effectiveness (para 22).

The international community is also committed to intensifying efforts to lower external debt burdens, improve market access, and reduce constraints that prevent poor countries from fully realizing the benefits of globalization. In turn, developing countries acknowledged that they must take responsibility for good governance and sound policies, as African leaders are doing under the New Partnership for Africa's Development (NEPAD). These leaders have committed to implementing sound economic policies, tackling corruption, putting in place good governance, investing in people, and establishing an investment climate to attract private capital. Mutual accountability requires that pledges by both sides be monitored. Box 2 describes an indicative "first set" of performance indicators that could be used to jointly monitor progress by African countries and external development partners on specific commitments and related reform efforts.

Increase the predictability of aid flows

Several country profiles underscore the importance of mutual accountability for development effectiveness. For instance, an important feature of mutual accountability is that partnership arrangements should be clear and predictable. It is accepted that major changes in a recipient country may legitimately require a revaluation of partnership agreements (for instance, if serious conflict breaks out in the country that had been

Box 2

Possible indicators for joint reviews of development effectiveness

For external development partners

Medium-term aid flows and support within local medium-term budgeting and planning frameworks

- Proportion of donors working within medium-term development frameworks derived from national Poverty Reduction Strategies.
- Proportion of aid resources included or reported within medium-term expenditure frameworks.

Donor practices

- Progress in reducing the number of donor missions and increasing the number of joint missions.
- Progress in sharing country analytical work programmes and products of donor agencies, and more systematic preparation of such products in ways that strengthen partner capacity.
- Extent to which donors are working jointly (joint sector support, joint budget support, joint evaluations, delegated cooperation).
- Extent to which donors use common reporting formats.

Capacity building

- Support for national capacity development strategies.
- Donor policies and practices on use and remuneration of local professionals in donor field offices and in public service (use of project implementation units and salary and other incentives in relation to local salary structures).

For African countries

Peace, security, and political governance

- Free and fair elections of all branches of the state, independence of the judiciary, and existence of a free press.
- Clear separation of powers of the judiciary, legislative, and executive branches.
- Freedom of association of political parties, trade unions, peasant organizations, and other private organizations.
- Absence of involvement in nonsanctioned military conflict in other sovereign states.

Economic and corporate governance

- Comprehensive and transparent public accounts covering both expenditures and revenues (including royalties).
- Existence of an independent public accounts committee in the legislature with an oversight function. Implementation of recommendations of the committee and independent government auditors.
- Legislation requiring parliamentary approval of external debt.
- An independent commercial justice system.
- Three-year moving average for inflation and the average weighted tariff rate.
- Barriers to capital imports not excessive.

(continued on next page)

Box 2 (continued)

Possible indicators for joint reviews of development effectiveness

- Regulation of business not overly burdensome.
- Independence of the central bank.
- A nationally owned development plan (or poverty reduction strategy) produced in a participatory fashion and covering trade and private sector development.
- A medium-term expenditure framework (or other medium-term budgetary and planning mechanism) and prioritized sector programmes to ensure effective use of resources.

Human development

- Childhood immunization coverage (DTP3) of at least 50 percent.
- Nonsalary recurrent spending on basic education per school-age child of at least 10 percent of government revenue.
- An HIV/AIDS treatment and mitigation policy.
- Gender equity in access to primary education.

Capacity building

- Existence of an operational government strategy for national capacity building, including civil service reform, encompassing salary top-ups.

peaceful and secure). This was the case in Uganda, where an unplanned increase in defense spending of about 0.5% of GDP in 2002/03 budget led to a reevaluation of multilateral and bilateral relationships. Defense expenditures are projected to be around 5.6% of GDP in 2002/03 compared with 4.6% in the pervious three years. The rise in the defense budget, especially the spending over budget, has raised concerns among several donors, with the government arguing that the increase in spending is necessary to decisively address the security situation in the north.

However, the foreign partner too frequently makes unilateral changes in agreements without consultation. The result: serious disruption of important national programmes and uncertainty about how to plan for the future. In Ghana development assistance that was expected in January 1, 2002 was belatedly received on December 31, 2002. The budget deficit rose to 6.9% of GDP in 2002 (from 4.4% the year before) partly because only 18% of promised grants had been received by the third quarter.

Mutual accountability requires clear understanding by both parties about the timing of release of promised aid funds, and donors should be held accountable for delivering on their promises. Consultation should be the rule if changes are thought to be needed.

To address the unpredictability of aid flows, donors need to programme their aid over a multiyear timeframe consistent with the financial planning horizon of recipient governments.

For this to happen:

- Medium-term commitments should be aligned with medium-term expenditure frameworks, so that the country can plan Poverty Reduction Strategy activities well in advance.
- Yearly disbursements should be aligned with the fiscal budget so that countries can deliver services planned in the medium-term expenditure framework.
- Development partners should provide recipient governments with full information on aid flows, on a regular and a timely basis.
- Development partners should let the recipient government know in advance what information should be included in the annual reviews, streamlining the requests and reducing the number of additional ad hoc requests for information.

"Many African countries receive assistance from several partners in the same economic sectors, with each partner insisting on detailed conditions for their assistance"

Consider Rwanda, where the British government in 1998 entered a 10-year relationship to improve the predictability of resource flows and set up an independent body to review donor practices. The United Kingdom has also led the way in shifting funding towards budget support, with a new programme of budget support of £76 million for 2000–03 agreed in 2000.

Reduce donor "frenzy"

Partnership based on mutual accountability should reduce the high transaction costs for recipient countries. Many African countries receive assistance from several partners in the same economic sectors, with each partner insisting on detailed conditions for its assistance. The conditions exacted by the partners often are not consistent. And the timeframe for the partner agreements tends to be short, creating uncertainty for ongoing programmes and requiring the time of national leaders to negotiate follow-on agreements.

Reducing the high transactions cost requires improving donor coordination and harmonizing development assistance programmes. For this the partners need to align their policies and programmes with the Poverty Reduction Strategy or other nationally owned development plans.

The Uganda profile shows that donors are aligning their programmes around the PRS. But this is not happening across a wide range of countries. For example, in Mozambique, where some progress has been made in this regard, the government is concerned about the burden presented by project aid that bypasses national systems and priorities. Aid there is fragmenting ministries, weakening national and ministerial identity, and undermining authority.

Rwanda has new Guidelines for Productive Aid Coordination, with the Poverty Reduction Strategy now providing the framework for aid coordination. It is also considering a lead agency arrangement, with the largest donor to a sector taking the lead in that sector. A lot more needs to be done in this area (box 3).

Reducing transaction costs may require that development partners move away from project aid towards budget support, which for countries with transparent budget procedures and sound public expenditure management systems is another critical feature of mutual accountability, as in Ghana.

Box 3

Despite the rhetoric, donors not yet fully behind Poverty Reduction Strategies

The Strategic Partnership with Africa carried out pilot action learning missions to three African countries in 2002. The purpose was to investigate specific measures for aligning donor practices with national Poverty Reduction Strategy (PRS) processes and cycles. The missions were to explore, with governments and in-country donors, the possibilities for developing a coordinated government-led, annual PRS cycle, with aid financing, procedures, and practices lined up behind a national review process and budget cycle. The missions also sought to elicit an agenda of the changes needed for donor policies, procedures, and practices to line up behind a nationally led PRS cycle.

Findings

- The number of donor conditions has shown no tendency to decrease.
- The process for agreeing to specific policy actions required by donors remains nontransparent, and is not based on the country's own policymaking process.
- Reporting requirements have not been aligned, either with each other or with the countries' own information systems.

Actions by African governments

- Translate medium-term indicators, targets, and policy commitments into annual goals against which progress can be measured.
- Clarify the link between the PRS annual review and national budget and planning cycles.
- Clarify the links between PRSs and sector programs.
- Ensure consistency between the PRS and medium-term budget allocations.

Actions by donors

- Agree to use the annual PRS review to assess and review country performance and conditions.
- Align disbursements with the government's budget cycle.
- Notify governments, in advance, of the specific information they would like to see included in the annual reviews, and streamline their requests.
- Avoid making additional ad hoc requests for information.
- Support governments through capacity building and appropriate technical assistance.
- Align conditionality with the PRS, and simplify it where possible. A common set of conditions would include all the requirements of all donors providing budget support, but each donor would link its support to its own subset of conditions and render its own judgement about whether these conditions have been met.

Source: *Strategic Partnership for Africa 2002.*

The government of Ghana has a multidonor budgetary programme to support the Poverty Reduction Strategy, requiring donors to provide resources through the government budget and in line with the budget cycles. Participating development partners follow common rules for disbursement and commit themselves to firm financing over the coming year, with indicative commitments for the following two years. Funds are not earmarked for specific activities. Instead, the government and the development partners participating in the programme have agreed to focus on some key reform areas viewed as critical for the successful and efficient implementation of the strategy: public finance accountability reforms, budget processes, decentralization, civil service reform, and governance. For each area of priority actions, a policy matrix will provide benchmarks for monitoring progress.

"In Uganda donors are aligning their programmes around the Poverty Redution Strategy. But this is not happening across a wide range of countries"

The process is facilitated through regular quarterly mini-consultative group meetings. Regular monitoring reports from the government will be in a standard format, including quarterly reports on macroeconomic indicators, the policy matrix, expenditures against the budget and releases, and implementation of the strategy. In turn, development partners are to provide quarterly reports on disbursements and projections of disbursements for the next two quarters.

Making development policies coherent

The success of development policy depends on the effects of other policies, which intentionally or unintentionally may impair development cooperation. The coherence of development policies has to do with ensuring that all policies affecting African development prospects are synergistic—and do not conflict or nullify each other. A lack of coherence has been shown to lead to ineffectiveness (failure to achieve objectives), inefficiency (waste of resources), and loss of policy credibility.

Chapter 1 of the report documents several examples of incoherence in the development policies of Africa's major partners. For example, the EU advocates African countries' integration into the world economy, but its trade policy has numerous protectionist elements, especially in agriculture. An open trade policy and dismantling of the Common Agricultural Policy would complement EU development efforts rather than frustrate them.

To improve food security in West Africa, German development cooperation has promoted beef production in that region, but the success of these projects has been threatened by subsidized EU beef exports to the same countries. The 2002 U.S. Farm Bill, scaling up subsidies, is another example of a policy that conflicts with the government's pledge to reduce poverty in Africa.

In general, Africa's international partners have not implemented their commitments, particularly for enhancing market access and eliminating trade-distorting agricultural subsidies. Abolishing OECD agricultural subsidies would provide developing countries with three times their current ODA receipts. The elimination of all tariff and non-tariff

barriers could result in static gains for developing countries of around $182 billion in services, $162 billion in manufactured goods, and $32 billion in agriculture.

Tariff escalation in the international trade regime makes it difficult for African countries to diversify their economies towards high-value-added processed goods. Tariff peaks—rates above 15%—are often concentrated in products of export interest to developing countries. Two sectors that matter most for developing country exporters are textiles and agriculture. Tariff barriers in textiles remain high, while high tariffs for agricultural commodities and the continued subsidization of agriculture in many OECD countries repel agricultural exports.

"Africa's international partners have not implemented their commitments, particularly for enhancing market access and eliminating trade-distorting agricultural subsidies"

The success of the Doha Development round of multilateral trade negotiations is crucial for improving market access for Africa's exports. But given the apparent breakdown in these crucial talks, there is a strong case for OECD countries to frontload the benefits of trade liberalization for the poorest countries by providing immediate duty-free and quota-free market access.[7]

Because Africa depends more on external trade than do other developing regions, expanding market access for its exports is a clear priority. Of developing country GDP in 2001, 34% came from the exports of goods and services, but for Sub-Saharan Africa, the figure was 40%.

Mutual accountability—Africa's role

Mutual accountability is a two-way process. Partners have to fulfill their part of the bargain, and Africans have to fulfill theirs. For Africans, the commitment to self-monitoring and to peer learning is the linchpin to accountability. (This is distinct from the accountability of having recipients report their compliance with donor requirements, including conditionality.) NEPAD is implementing an African Peer Review Mechanism (APRM) to encourage self-monitoring and peer learning (box 4). This systematic assessment tool will track progress of outcomes, identify and reinforce best practices, assess capacity gaps, and implement the required corrective actions.

Several African countries have already agreed to undergo peer reviews. What is left now is to move forward with implementing APRM and show that African countries are fulfilling their side of mutual accountability.

Good governance is the key to mutual accountability

Several country profiles demonstrate the progress African countries have made in improving governance. In Mozambique the current president has announced that he will step down in 2004 and refrain from anointing a successor. This is a potent signal of the political leadership's commitment to democracy and the rule of law.

Rwanda is also taking positive steps towards deepening democracy and good governance, announcing that multiparty presidential and parliamentary elections will be held

in mid-2003. Crucial to the success of this gradual political normalization are attempts to foster social reconciliation through local tribunals, aimed at paving the way for the eventual reintegration of genocide suspects into their communities. Connected to these efforts is a bold decentralization programme to increase community participation, but serious capacity constraints are apparent in most localities.

Ghana's smooth political transition in January 2001 brings hope that the new government will create an atmosphere of transparency and participation. This has led to more open debates on major policy reforms, such as the recent increase in fuel prices, the adoption of the Heavily Indebted Poor Countries Initiative, and privatization of water.

"Mutual accountability is a two-way process: for Africans, the commitment to self-monitoring and to peer learning is the linchpin to accountability"

Mauritius, with a long period of political stability, remains a sterling example of democracy. The rule of law prevails. Property rights are respected. And public sector activities have been transparent and conducive to private sector activities. The result: the transformation of a poor country with a per capita income of $260 at the beginning of the 1960s to a middle-income country with a per capita income of $3,800 in 2003.

Box 4

NEPAD and the African Peer Review Mechanism

A critical plank of the New Partnership for Africa's Development (NEPAD) is the African Peer Review Mechanism (APRM). The APRM will be used to assess the performance of African countries in terms of their compliance with a number of agreed codes, standards, and commitments that underpin good governance and sustainable development. It represents a sea change in the thinking of African leaders as they seek to reverse political authoritarianism, state failure, and corruption to embrace and consolidate democracy and ensure sound and transparent economic management.

The Economic Commission for Africa has been deeply involved in developing the economic and corporate governance codes and standards for the APRM. Good economic and corporate governance can help countries attract more investment and achieve higher rates of per capita growth. A state that applies rules and policies predictably and fairly, ensures order and the rule of law, and protects property rights will generate confidence and attract more domestic and foreign investment. That, in turn, will generate trade and faster economic growth, providing the wherewithal for sustainable development.

The weakness of the institutions of economic and corporate governance, as a constraint on sustainable development in Africa, is clear and convincing, limiting the public sector in the fulfillment of its economic functions. Strong institutions are needed to maintain fiscal and monetary discipline, mobilize resources, and set priorities among the competing demands for those resources. Similarly, institutional arrangements are required for the efficient delivery of pro-poor public services. In addition, there must be institutional mechanisms to ensure accountability through the capacity to monitor and enforce rules and to regulate economic activities in the public interest. The APRM has the potential to make these desires a reality.

Notes

1. For instance, Uganda has reduced poverty by 22 percentage points over 10 years.
2. The temporal aspect of poverty refers to transitions into and out of poverty, which are often correlated with seasonal fluctuations in food availability.
3. This contradicts the now classic study that finds that where the policy environment is supportive of economic investment, an extra dollar of aid increases investment by nearly twice that amount (Dollar and Burnside 1998).
4. *Fiscal sustainability* refers to a situation in which the ratio of a country's public sector debt to GDP is stationary and consistent with overall demand—both domestic and foreign—of government securities.
5. The World Bank and the IMF (2001) recognize that there is no assurance that these countries will not face future debt problems. According to their document, achieving sustainability will require a rapid and stable rate of economic growth.
6. Higher marginal tax rates are likely to have a greater disincentive effect on trade and private investment.
7. Canada announced duty-free, quota-free access to the least developed countries at the Kananaskis G-8 Summit in June 2002. The African Growth and Opportunity Act gives African countries access to the U.S. market.

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Recent Economic Trends in Africa and Prospects for 2003

The performance of African economies fell short of expectations in 2002—with growth slowing from an average of 4.3% in 2001 to 3.2% in 2002, reflecting the weaker global economy and the slower-than-expected rebound in world trade. In early 2002 it seemed that a global economic recovery, led by the United States, was under way. But by mid-2002 weaknesses in emerging markets and in mature equity markets increased the risk aversion of investors. Africa's growth prospects were further weakened by the lagged effects of low commodity prices in 2001, the droughts in various parts of southern and eastern Africa, and the political and armed conflicts in some parts of the region—notably, the Central African Republic, Côte d'Ivoire, Madagascar, and Zimbabwe.

Despite the weaker performance, countries continued to strengthen their macroeconomic fundamentals and intensify their focus on reducing poverty. Nine countries were preparing either interim or final Poverty Reduction Strategies, up from four in 2001.

For 2003 the outlook is mixed, with growth expected to rebound modestly to 4.2%. In addition to deteriorating business sentiment in industrial economies, rising oil prices and financial turbulence amplify the risk of returning to a global slowdown.

Downside risks in Africa stem from the deteriorating political and economic situations in Zimbabwe and Côte d'Ivoire, with possible contagion effects in the western and southern subregions. In Zimbabwe the crisis brought high and growing inflation, lowered food production, and increased the number of people facing starvation and famine. So far, the conflict in Côte d'Ivoire has not had any major adverse effect in the subregion. But if it persists, there would be disruptions in cocoa supplies to world markets and in the economic activities of neighbouring states.

Renewed flooding and drought in various parts of the continent, especially in the Horn of Africa and the southern region, may affect agricultural production in 2003. In Ethiopia 15 million people face starvation because of failed rains and harvests, with dire consequences for health, labour force participation, and near-term growth.

The U.S. decision in May 2002 to introduce a six-year $51.7 billion farm bill boosting crop and dairy subsidies by 67% doesn't help Africa's prospects. The subsidy will reduce agricultural prices, making it difficult for small African countries to compete.

The global recovery—a mirage?

Since the end of 2001 there has been a turnaround in global economic activity, driven largely by economic developments in the United States. The turnaround gathered momentum in the first quarter of 2002 and led to optimistic forecasts about the prospects for future growth (figure 1.1 and table 1.1). Events of the last quarter of 2002 suggest that the global recovery continued, if slower than earlier expected. The reasons? The diminished pace of economic recovery in the United States in the second quarter of 2002. The declines in equity prices in major financial markets. The rising risk premiums associated with the volatile situation in the Middle East and their impact on oil prices. And the deteriorating economic conditions in several Latin American countries.

> *The global recovery continued in the last quarter of 2002, though slower than earlier expected*

Figure 1.1

Developed country growth—rebounding

Annual GDP growth, OECD, EU and G-7 countries, 2000/Q3–2002/Q3 (percentage change over the same quarter of the previous year)

Source: *OECD 2002.*

Is the U.S. economy headed for a double-dip recession?

The recent declines in equity prices in all major financial markets, the decline in business and consumer sentiments in the third quarter of 2002, and the signs of slow and fragile growth in the U.S. economy in the second half of the year have raised concerns about the timing of the recovery, prompting speculation that the United States may be headed for a double-dip recession, sliding back into another recession after a short-lived recovery. Although most economists recognize this possibility, the general feeling is that it is unlikely because:

- Current U.S. inflation is low—1.1% in 2002—so there is room for monetary policy to stabilize the economy, if needed. In addition, because of the long lags in the monetary transmission mechanism, it is likely that the full positive effects of the interest rate cuts witnessed between the last quarter of 2001 and the second half of 2002 have not been completely realized in the economy. It is therefore likely that this will add some strength to the recovery in the near term.
- Recent gains in labour productivity imply further increases in real wages and disposable income, increasing consumer spending and thus growth.
- Given the U.S. government's steps to strengthen corporate governance and auditing, it is likely that the equity market will stabilize, increasing consumer confidence and thus spending.
- There are indications that the Bush administration will increase government spending if the economy is falling into a tailspin.

"The U.S. government's steps to strengthen corporate governance and auditing are likely to stabilize the equity markets"

Table 1.1

Quarterly changes in real GDP, industrial countries, 2000/Q1–2002/Q3 (percentage change over previous quarter)

	2000				2001				2002		
Region	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**
OECD	1	1.1	0.5	0.4	0.2	–0.3	–0.1	0.3	0.7	0.5	0.8
EU15	0.8	0.9	0.4	0.6	0.5	0.1	0.2	–0.2	0.4	0.4	0.4
Euro Area	0.9	0.8	0.4	0.6	0.5	0.0	0.2	–0.3	0.4	0.3	0.3
G7	0.9	1.0	0.4	0.6	0.2	–0.4	–0.2	0.2	0.8	0.5	0.8
Canada	1.5	0.7	1.3	0.5	0.2	0.1	–0.1	0.7	1.4	1.1	0.8
Germany	1.0	1.1	0.0	0.1	0.6	0.0	–0.2	–0.3	0.3	0.2	0.3
France	0.8	0.8	0.5	1.3	0.4	–0.1	0.4	–0.4	0.6	0.4	0.2
Italy	0.8	0.3	0.6	1.0	0.7	0.1	0.0	–0.2	0.1	0.2	0.3
Japan	2.0	0.4	0.7	1.4	0.5	–1.4	–1.3	–0.5	0.0	0.9	0.8
United Kingdom	0.5	0.8	0.6	0.4	0.6	0.3	0.3	0.2	0.1	0.6	0.8
United States	0.6	1.2	0.1	0.3	–0.2	–0.4	–0.1	0.7	1.2	0.3	1.0

Note: *Data are seasonally adjusted.*

Source: *OECD 2002 (March, September, and December).*

Japan and the euro area—caught in a deflationary trap?

In tandem with evidence of moderating U.S. economic growth, there are increasing concerns that the momentum of growth will ease in Japan, despite strong export performance in the first half of 2002. The Japanese economy is plagued by weak private domestic demand, ongoing price deflation, and severe structural problems, particularly in banking. Real GDP fell 0.7% in 2002, with an increase of 0.8% expected in 2003. For the world's second largest economy, the slow pace of economic growth has adverse effects on global demand and the outlook for prices of Africa's export commodities.

> *Since the beginning of 2002 commodity prices have recovered remarkably, reflecting a rebound in global economic activity*

Economic performance in the euro area, Africa's most important market for nonoil exports, remains weak. Real GDP growth in the euro area was 0.8% in 2002, with an increase to 1.8% expected in 2003.

Outside the euro area, growth in the United Kingdom was weak in the last quarter of 2001 and the first quarter of 2002 but picked up in the second half to bring it to 1.5% for the year, with an increase to 2.2% expected in 2003. About 7% of Africa's exports of goods and services go to the United Kingdom, so any improvements in the economic outlook for this economy would have positive effects on the region.

Commodity prices—surging

Since the beginning of 2002 commodity prices have recovered remarkably, reflecting a rebound in global economic activity. The World Bank price index for petroleum increased from 84.4 in the fourth quarter of 2001 to 117.7 in the third quarter of 2002, while the index for nonenergy commodities rose from 75 to 84.9. There was also an increase in the index for metals and minerals, from 69.4 to 71.5.

Crude oil prices have been rising since the beginning of 2002 despite weak world oil demand and ample supplies. Cocoa prices, which have generally increased since 2000, surged in 2002 because of declining supply and the fact that in July Armajaro—a U.K. trading company—bought vast quantities of cocoa at the London International Financial Futures Exchange in an apparent bid to push up prices. In addition, the recent outbreak of political and armed conflict in Côte d'Ivoire—the world's largest producer of cocoa, with approximately 40% of global output—generated concerns about the stability of the global cocoa supply and resulted in cocoa prices hitting a 17-year high in October. The average annual price of cocoa increased from 90.6 cents per kilogram in 2000 to 169.9 cents per kilogram in 2002.

The prices of tea and coffee have generally been on the decline since 2000, due to oversupply and high stocks. But the price of tea picked up slightly in the beginning of 2002. Gold prices increased from $278 per troy ounce in the fourth quarter of 2001 to $314 in the third quarter of 2002.

Foreign direct investment—still on the decline

African countries have the highest rate of return on investment in the world—four times more than in the G-7 countries, twice more than in Asia, and two-thirds more than in

Latin America. Despite this fact, and the improvements in the macroeconomic policy environment since the mid-1990s, the region has difficulty attracting foreign investment.

In 2002 world foreign direct investment (FDI) dropped 27% because of the lower than expected recovery in the global economy and the adverse effects of the corporate auditing and accounting scandals in some advanced countries. In Africa FDI inflows declined by $6 billion, from a peak of $17 billion in 2001. The decline is attributable to the unusual increase in inflows to South Africa and Morocco in 2001 as well as the intensification of political and social conflicts in some African countries, affecting investor sentiments.

“Foreign direct investment flows to Africa declined by $6 billion, from a peak of $17 billion in 2001”

Official development assistance—new promises

Prospects for official development assistance (ODA) flows to Africa are likely to improve in the short to medium term because of fresh commitments to increase development assistance to the region.

- The European Union (EU) announced that all its member states should seek to meet or exceed the current EU average of 0.33% of gross national income by 2006, as an intermediate step towards the target of 0.7%. The United States announced that it would provide, through its Millennium Challenge Account, an extra $5 billion of aid a year from 2006 onward and an extra $10 billion in total between 2002 and 2006. Together, these increases would amount to an extra $12 billion a year from 2006 onward, a step in the right direction but far short of the $50 billion a year needed from 2001 for all developing countries to meet the Millennium Development Goals.
- Canada has also announced increases in aid. At the Group of Eight (G-8) summit in Kananaskis, Canada, in June 2002, Canada committed an additional CAN$6 billion to Africa over five years—including the CAN$500 million Canada Fund for Africa announced earlier. This commitment is especially welcome because it is in the December 2001 budget and therefore built into existing fiscal frameworks.

Leaders of the G-8 countries—in their Africa Action Plan unveiled at Kananaskis—indicated that half the new development assistance announced at the March 2002 Monterrey meeting would be directed to Africa. The challenge is to ensure that these commitments actually become available and are deployed more effectively than in the past.

An analysis of the sectoral composition of ODA for 1975–80 and 1995–2000 shows some worrying trends (figure 1.2).

- ODA for economic infrastructure and services covers assistance for networks, utilities, and services, including energy, transportation, and communications. It declined from 23% in 1975–80 to 15% in 1995–2000.
- ODA for production sectors covers agriculture, manufacturing, trade, banking, and tourism. It declined from 17% in 1975–80 to 11% in 1995–2000.

- ODA for programme assistance covers balance of payments and budget support—and funds made available for capital projects at the recipient's choice. It dropped from 38% from 1975–80 to 12% in 1995–2000.
- ODA for social infrastructure and services covers efforts to develop human resources and improve living conditions, including education, health, and water supply. It increased from 11% to 37%.

> *Of the 53 countries in Africa, only 5 achieved the 7% growth rate in 2002 required to meet the Millennium Development Goals, 43 had growth below 7%, and 5 registered negative growth*

Between 1990 and 2000 ODA was down by more than half for agriculture, transportation and communications, energy, and trade and tourism (figure 1.3). Flows to education rose from $0.3 billion in 1990 to $1.4 billion in 2002, reflecting donor interest in social sector programs aligned with Poverty Reduction Strategies.

Recent economic developments in Africa

Of the 53 countries in Africa, only 5 achieved the 7% growth rate in 2002 required to meet the Millennium Development Goals, 43 had growth below 7%, and 5 registered negative growth (table 1.2 and figure 1.4). For the region as a whole, real GDP grew 3.2% in 2002, compared with 4.3% in 2001.

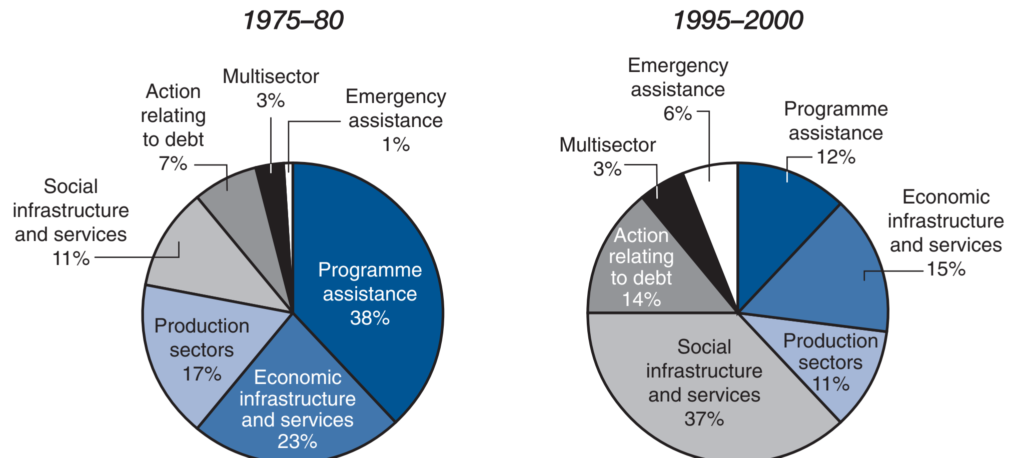
Growth slows in regional powerhouses

The slowdown in regional growth is due to slower growth in four of the five largest economies in the region: Algeria, Egypt, Morocco, and Nigeria.

Figure 1.2

ODA down for economic infrastructure—up for social

Sectoral distribution of ODA to Africa, 1975–80 and 1995–2000



Source: *OECD 2002.*

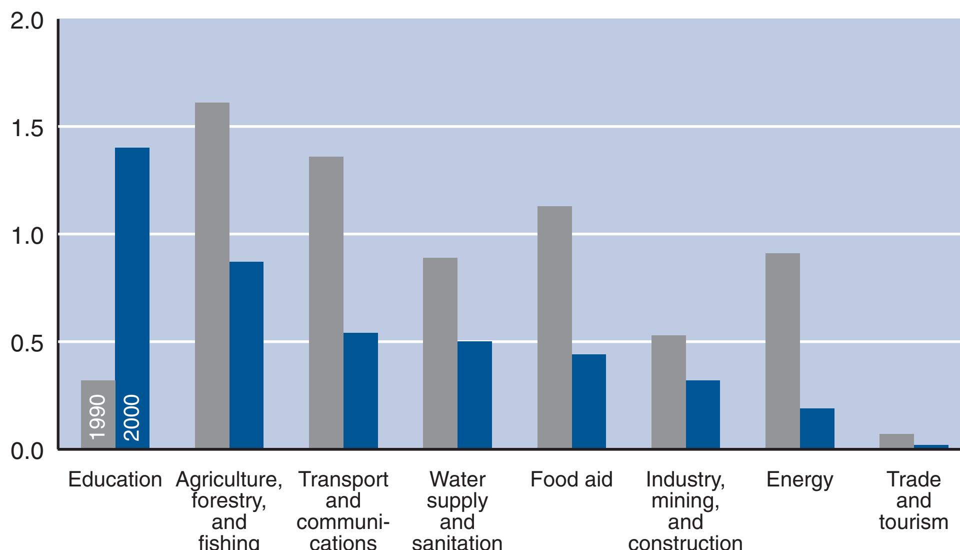
- In Algeria the decline from 5% in 2001 to 2.7% in 2002, despite an increase in oil prices, reflects political and religious tensions, flooding in the east, and weak competitiveness in the industrial sector.
- In Egypt the decline from 3.5% to 3% is due primarily to higher domestic interest rates, sluggish private sector growth, regional insecurity, and lack of political will by the government to implement far-reaching economic and social reforms, such as privatization and trade liberalization.
- In Morocco the decline from 6.5% to 4.3% was due to weak domestic demand and reduced tourism.
- In Nigeria growth declined from 4% to 2.6%, reflecting the combined effect of political risk and deteriorating economic fundamentals emanating from weak fiscal behaviour.

"The slowdown in regional growth is due to slower growth in four of the five largest economies in the region"

Figure 1.3

Education now receives the most bilateral assistance

Aid flows to Africa from Development Assistance Committee donors, 1990 and 2000 (US$ billions)



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

Table 1.2

Distribution of GDP growth rates in Africa, 1998–2002 (number of countries)

Range	1998	1999	2000	2001	2002
Negative growth	2	0	1	5	5
Zero or positive growth	51	53	52	48	48
Low (0–3.9%)	23	26	37	19	27
Medium (4.0%–7.0%)	26	23	14	24	16
High (>7.0%)	2	4	1	5	5

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

South Africa, which accounts for about 35% of the GDP of the five largest economies in Africa, grew 3% in 2002, up from 2.5% in 2001. This weak performance despite recent increases in the prices of its export commodities, particularly gold, is due in part to sluggish growth in the euro area. In addition, the appreciation of the rand against the dollar in the second and third quarters reduced the competitiveness of South African exports. And the South African Reserve Bank tightened monetary policy on a number of occasions to reduce inflationary pressures.

"With the exception of Southern Africa, growth slipped in all subregions—by 3 percentage points in the north, 0.4 in the west, 0.5 in the east, and 1.5 in the centre"

Southern Africa grew faster than the other subregions

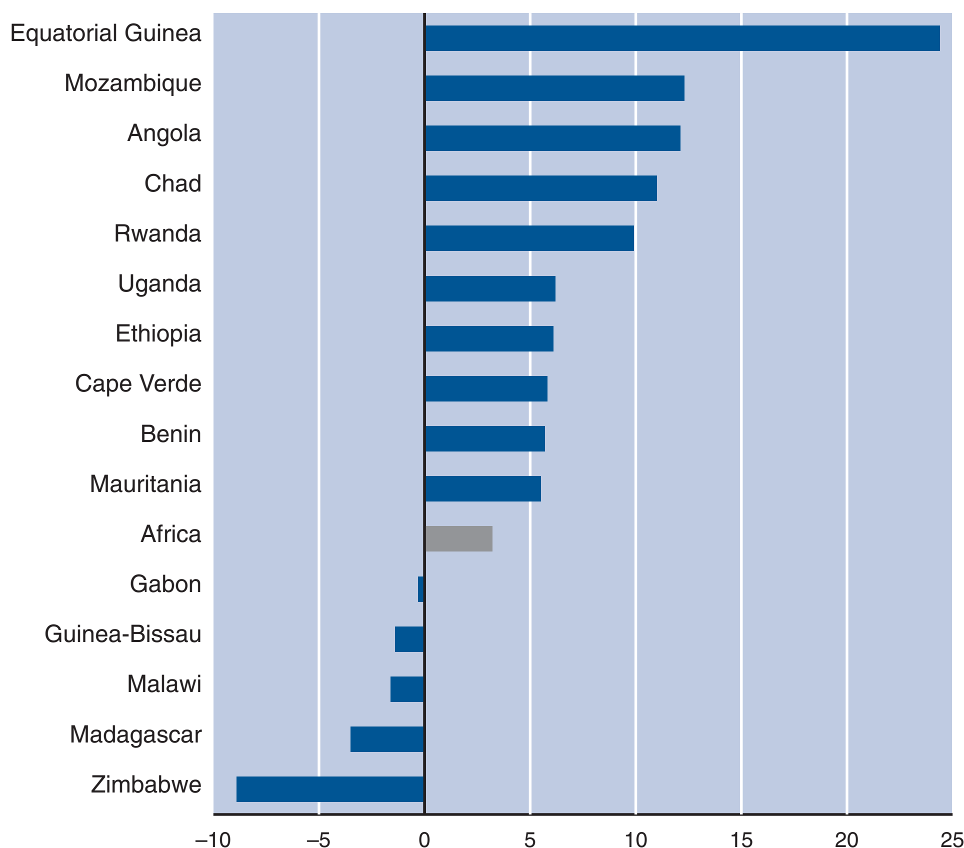
With the exception of Southern Africa, growth slipped in all subregions—by 3 percentage points in the north, 0.4 in the west, 0.5 in the east, and 1.5 in the centre (figure 1.5).

- In North Africa the decline reflects heightened political tension in the Middle East and the subdued growth in the euro area, a major trading partner.

Figure 1.4

The best performers and the worst

Real GDP growth rates for the top 10 and the bottom 5 African countries, 2002 (%)



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

- In West Africa the decline is due in part to slower growth in Nigeria—the largest economy in the subregion—from 4% in 2001 to 2.6% in 2002. Reductions in the pace of economic activity in Burkina Faso, Guinea-Bissau, Niger, Senegal, and Sierra Leone also contributed.
- In East Africa a 3.5% decline in Madagascar, coupled with modest declines in Djibouti, Ethiopia, Kenya, Somalia, and Tanzania, contributed to the slowdown.
- In Central Africa the slowdown is due largely to declines in Equatorial Guinea (from 66.1% to 24.4%), Congo (from 2.9% to 1.7%), and Cameroon (from 5.2% to 4.9%). For the second year in a row, Equatorial Guinea is the fastest growing economy in Africa, thanks to oil and gas.
- In Southern Africa growth increased from 2.4% in 2001 to 3.3% in 2002, largely reflecting improvements in South Africa, Angola, Lesotho, and Namibia.

"For the second year in a row, Equatorial Guinea is the fastest growing economy in Africa, thanks to oil and gas"

Agriculture and food security

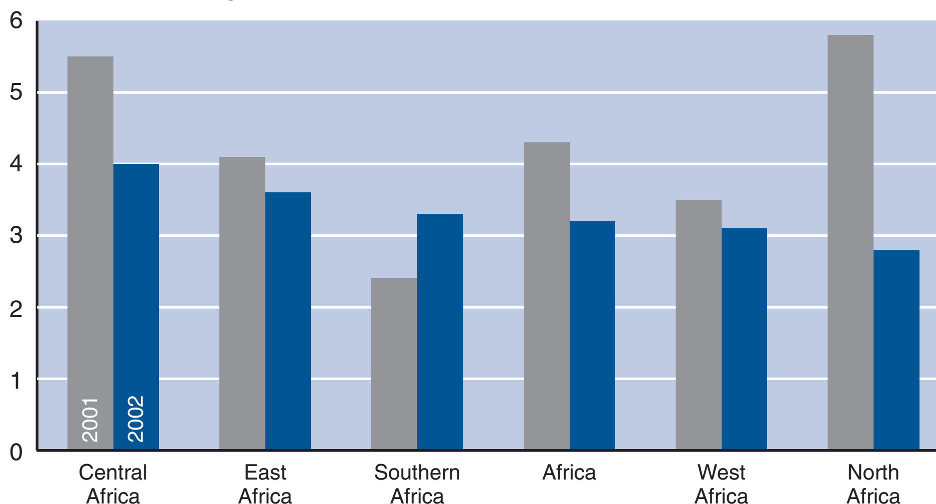
Since 2000 there has been a general deterioration in agriculture, reflecting the slowdown in global economic activity and poor weather. Estimates for 2001 suggest that agricultural production grew by a meager 0.8% in Sub-Saharan Africa (excluding South Africa). Although this is better than the 0.3% decline in 2000, it is far below the sector's average growth of 3.9% in 1992–96.

In 2002 unfavourable weather created severe problems. In Kenya flooding due to heavy rains affected about 30,000 people. In Senegal flooding in February killed 500,000 livestock, destroyed 20,000 homes, and damaged 2,500 hectares of crops. In Algeria agricultural output fell 3.2% in 2002, partly because of flooding in the east in July and August. In Botswana, Ethiopia, Lesotho, Malawi, Mauritania, Namibia,

Figure 1.5

Growth slipping, except in Southern Africa

Annual economic growth, 2001 and 2002 (%)



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

Niger, Swaziland, Tunisia, Zambia, and Zimbabwe drought and generally dry conditions reduced agricultural production (box 1.1). Tunisia's agricultural output declined 14% in 2002.

Despite the poor weather in some parts of the region, agricultural production was expected to grow in 2002 by 11% in Morocco, 5.1% in Uganda, 4.1% in Ghana, 4.0% in Nigeria, 3.4% in Egypt, 3.5% in Cameroon, 3.2% in South Africa, and 2.5% in Côte d'Ivoire.

> *An investment to GDP ratio of 25% or more is needed to accelerate growth in Africa*

Food insecurity—the lack of access by an individual or a group of individuals to enough food for an active, healthy life—is becoming a serious development challenge in the Sahel as well as in parts of eastern and southern Africa. In Ethiopia close to a quarter of the population faces the risk of famine and urgently needs food aid. In Zimbabwe 49% of the population requires emergency food aid, in Lesotho 30%, in Malawi 29%, in Zambia 26%, and in Swaziland 24%.

Declining productivity in agriculture and severe drought have reduced food security in Zimbabwe. After independence and several land reform attempts, most of the large commercial farms were still held by whites, then 1% of the population. In 2001–02 much of the commercial farmland was forcibly resettled, but having inexperienced farmers on commercial land hurt agricultural production (figure 1.6).

Savings and investment—still low

An investment to GDP ratio of 25% or more is needed to accelerate growth in Africa. Historically, savings and investment ratios have been very low on the continent, an important constraint on development.

Box 1.1

Ethiopia—famine in a growing economy

Ethiopia's growth in the last few years has been quite remarkable, reflecting partly the positive effects of the cessation of hostilities with Eritrea and the benefits of debt relief under the HIPC Initiative. With real GDP growth of 8.7% in 2001 and 6.1% in 2002, it is one of the few African countries close to reaching the growth target of 7% required to meet the Millennium Development Goals.

But the recent gains in growth performance in Ethiopia may be wiped out by famine, from failed rains and harvests in the countryside, exposing a quarter of the population to the risk of starvation. Famine is not new in Ethiopia. The first recorded cases of famine in Ethiopia occurred between 1540 and 1742, and there were about 10 famine incidents within this period. This was followed by the "great Ethiopian famine" of 1888–92, killing roughly a third of the population. There was also famine in the Wollo province during 1972–74. The most recent famine was in 1984.

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

In 2000 the average savings ratio for the region was 21.0%, and the average investment ratio 21.8%. Equatorial Guinea, the Republic of Congo, Algeria, Gabon, Mauritius, and Angola had savings and investment ratios above 25% in 1998–2000. Equatorial Guinea, Lesotho, São Tomé and Principe, Eritrea, Seychelles, Gabon, Angola, the Republic of Congo, Mozambique, Burkina Faso, and Mauritius had investment ratios above 25%. Of 42 countries considered, only Mauritius, Equatorial Guinea, and the Republic of Congo had high savings and investment ratios as well as high growth over the period (figure 1.7). The other countries had either low savings and investment ratios or low growth.

> *The region has privatized only about 40% of its state-owned enterprises*

Privatization—still slow and reluctant

As part of efforts to deepen economic reforms and increase private sector involvement in economic activities in Africa, many countries have developed privatization schemes to increase private investment in key public enterprises. Government-run telecommunications companies have been privatized or are being privatized in Tunisia, Ethiopia, Mauritius, and the Central African Republic. State-run agricultural firms have been privatized in Ethiopia and Morocco.

In 2003 privatization efforts are intensifying in Algeria, Ghana, South Africa, and Uganda. But Cameroon, Egypt, Gabon, and Niger are finding it difficult to accelerate the pace of privatization due to concerns about possible outbreaks of violence and resistance by trade unions and other interest groups. Although privatization of public enterprises would eventually increase the overall efficiency of domestic resource use, it has not yet led to more total investment on the continent.

Indeed, the region has privatized only about 40% of its state-owned enterprises. And much of the divestiture has been for smaller, less valuable, often moribund manufacturing, industrial, and service concerns. Of the roughly 2,300 privatizations in 1991–2000, only about 66 involved higher value, economically important firms (table 1.3). An additional 92 transactions were in transport, some of which might have been classified as infrastructure. But even if these are included, less than 7% of the sales have touched upper-end infrastructure firms.

Activity has been concentrated in a few countries. Of the $9 billion raised from 1991 to 2001, a third was generated by a handful of privatizations in South Africa (figure 1.8). Another third came from sales in Ghana, Nigeria, Zambia, and Côte d'Ivoire. Some 26 African countries, together, have privatized a scant $0.7 billion in assets.

African states have retained significant minority equity stakes in the few infrastructure privatizations they have concluded, holding back from the market an average of one-third of the shares. Continuing government involvement and share retention reduce the number of bidders and therefore the price per share sold. The slow pace of sales, the reluctance to place assets with the highest potential value on the market, the failure to sell all shares, poor business and legal environments, and the deficiencies of

government regulation and administration—all combine to leave Africa at the back of the pack in privatizing infrastructure.

Communication networks—improving

International bandwidth in bits per capita, a new measure of Internet use, shows how a country is progressing towards an information-based economy. Bandwidth availability in Africa varies tremendously but is generally very low. Although there are few intra-African links, the marine fibre cables are operational and should provide faster and cheaper routes in and out of Africa.

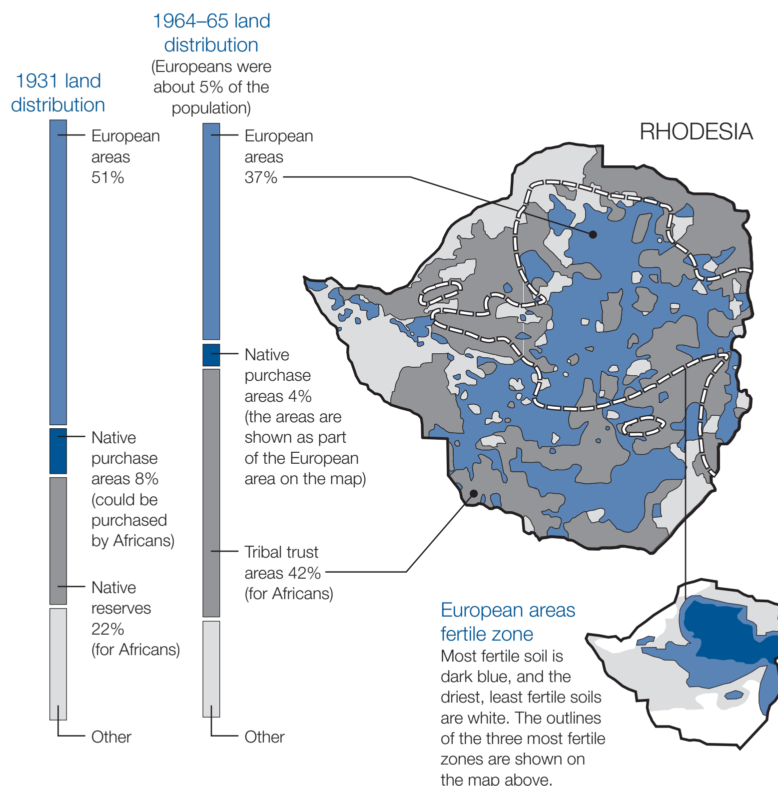
Trade and the current account—deteriorating

In 2002 the region had a 0.5% deterioration in its terms of trade, 3.2 percentage points better than that in 2001. The smaller deterioration reflects largely the improvement in commodity prices in 2002. For Sub-Saharan Africa the terms of trade improved by 0.6%.

Figure 1.6

Zimbabwe: drought and inexperienced farming hurt agricultural production

Land distribution in Rhodesia changed slightly over time. But a majority of the best farmland was held by whites, who were a tiny minority . . .



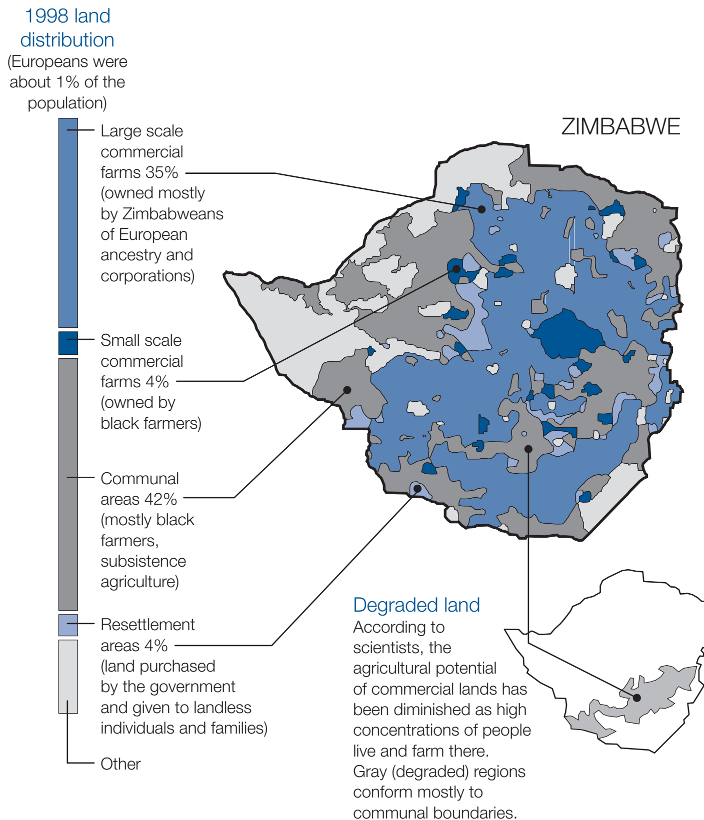
Source: New York Times*, January 12, 2003. Reprinted with permission.*

Access to markets. One of the challenges to trade in Africa is increasing access to developed country markets. At the Fourth 2001 World Trade Organization (WTO) Ministerial Conference held in Doha, WTO member states agreed to undertake negotiations to improve market access for agricultural products exported by developing nations (box 1.2). Since African countries export mostly agricultural commodities, they are likely to benefit.

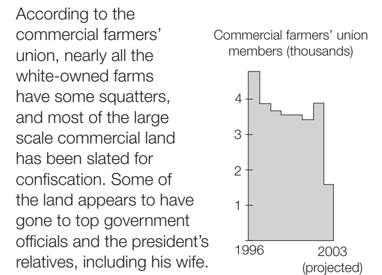
Other measures to improve market access for Africa include:

- The U.S. African Growth and Opportunity Act (AGOA), introduced in 2000, gives most African countries preferential access to the U.S. market for petroleum products, agricultural goods, and such manufactures as textiles. Exports from Gabon, Lesotho, Madagascar, Nigeria, South Africa, and Swaziland have already increased as a result of this scheme. Malawi and Zambia are expected to benefit

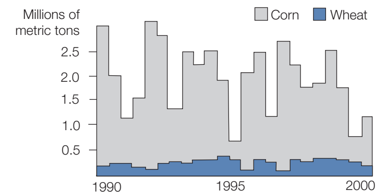
. . . And after independence, the Mugabe government made promises about land reform, none of which altered the distribution significantly. Continued conflicts have caused numbers of white farmers to drop.



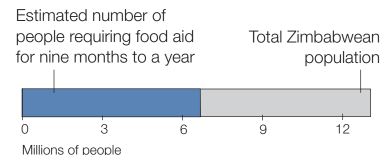
According to the commercial farmers' union, nearly all the white-owned farms have some squatters, and most of the large scale commercial land has been slated for confiscation. Some of the land appears to have gone to top government officials and the president's relatives, including his wife.



Drought and the turmoil over land have hurt agricultural production



Consequently, many Zimbabweans are facing famine



this year through an increase in textile exports. Although the act gives African nations an advantage over other regions, it does not cover all exports from Africa and so its potential benefits to the region will be limited.

- The Everything-But-Arms initiative was approved by the European Union in February 2001 with the objective of eliminating quotas and duties on all goods, except arms, from 49 least developed countries, most in Africa.

> *"The region had a 0.5% deterioration in its terms of trade, 3.2 percentage points better than in 2001, reflecting the improvement in commodity prices"*

Current account. For the 28 African countries that have data, 8 had current account surpluses in 2002, supported largely by higher export revenues—Algeria, Botswana, Côte d'Ivoire, Equatorial Guinea, Libya, Mauritius, Namibia, and South Africa.

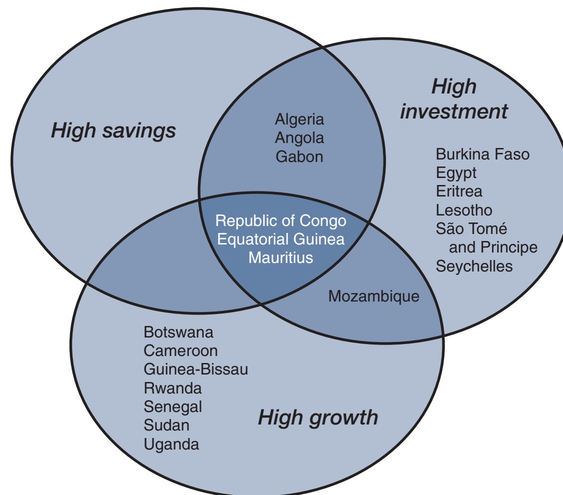
Eleven countries had unsustainable current account deficits of more than 5% of GDP in 2002—Burkina Faso, Chad, Gabon, Lesotho, Malawi, Niger, Senegal, Tanzania, Uganda, Zambia, and Zimbabwe. With a walloping deficit of 48% of GDP, Chad is the worst performer. Its revenues from cotton and cattle exports are declining, and its imports increasing, owing to food shortages and the need for intermediate capital goods for the Doba oil project.

Intra-African trade—still low

Trade among Sub-Saharan African countries (Africa-to-Africa trade) accounts for only 12% of Sub-Saharan exports, up 8% from 1989. The eight major established regional arrangements did not contribute to the increase: their shares of Africa-to-Africa trade were either stagnant or declining between 1989 and 1993.

Figure 1.7

Getting the trinity right—more savings, investment, and growth



Note: *High growth means a growth rate greater than 5%. High savings means a savings ratio greater than 25%. High investment means an investment ratio greater than 25%.*

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

Table 1.3

Privatization in Africa, 1991–2001

Country	Number of transactions	Sale value (US$ millions)	Share of total divested (%)
Angola	57	6.0	—
Benin	28	49.0	38
Burkina Faso	23	9.0	32
Burundi	38	4.0	—
Cameroon	48	244.0	28
Cape Verde	42	53.0	—
Central African Republic	18	—	50
Chad	35	12.0	—
Congo, Rep. of	65	50.0	—
Congo, Dem. Rep. of	5	—	4
Côte d'Ivoire	82	622.0	55
Ethiopia	10	410.0	6
Gabon	1	—	6
Gambia	17	2.4	85
Ghana	181	936.5	69
Guinea	31	45.0	27
Guinea-Bissau	25	0.5	64
Kenya	189	381.0	79
Lesotho	10	6.5	20
Madagascar	61	16.9	33
Malawi	11	53.2	44
Mali	59	67.4	92
Mauritania	19	1.2	20
Mozambique	474	135.0	39
Niger	10	1.8	18
Nigeria	30	893.5	6
Rwanda	1	—	3
São Tomé & Principe	4	0.4	—
Senegal	39	415.0	23
Sierra Leone	8	1.6	31
South Africa	8	3,151.0	—
Sudan	32	—	—
Tanzania	199	287.0	53
Togo	49	38.0	89
Uganda	102	174.0	79
Zambia	253	828.0	90
Zimbabwe	6	217.0	10
Total	2,270	9,111.9	40

— not available.

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

Five countries dominate Africa-to-Africa trade—Côte d'Ivoire, Nigeria, Kenya, Zimbabwe, and Ghana. Côte d'Ivoire accounts for 25% of the exports, Nigeria 20%, Kenya 9%, Zimbabwe 9%, and Ghana 9%. On the import side Côte d'Ivoire is again the leader, but there is much less concentration. While only five countries account for 75% of exports, 16 countries account for a similar share of imports.

> *Trade among Sub-Saharan African countries accounts for only 12% of Sub-Saharan exports, up 8% from 1989*

The importance of Africa-to-Africa trade varies widely across countries—it accounts for less than 2% of Kenya's imports but more than 50% of the Seychelles' imports. Such wide differences indicate that tariff revenue losses associated with regional trading arrangements could fall very unevenly on participating countries. Very little or no trade occurs between countries that are geographically distant, such as Nigeria and Tanzania.

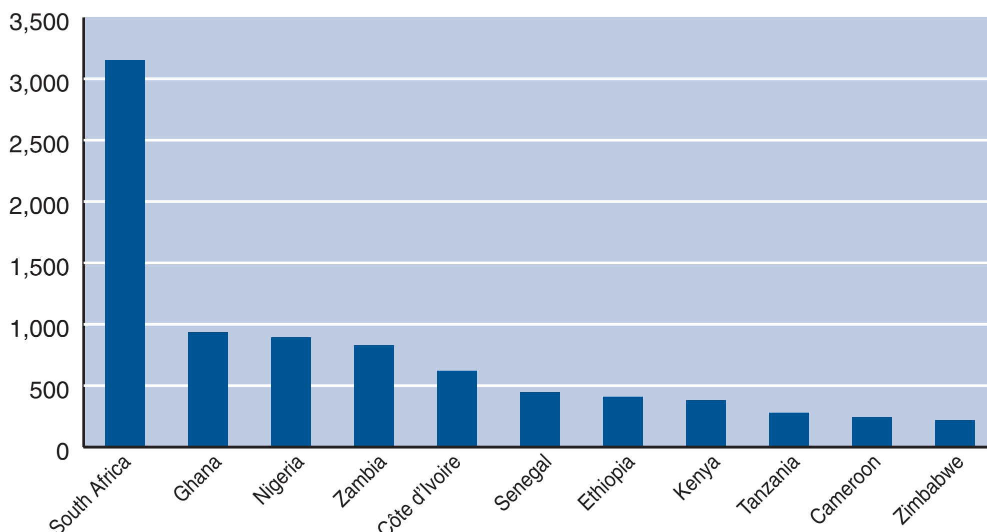
What are the prospects for increased regional trade in Sub-Saharan Africa? Good, for several reasons. First, significant unrecorded cross-border trade occurs in the region. The share of unrecorded trade in total trade of the Economic Community of West African States (ECOWAS) region is between 20% and 25%. The unrecorded trade between Togo and Ghana is several times the official trade. About 30% of Uganda's exports are outside official channels.

Second, foodstuffs and feeds dominate the fastest growing products in Africa-to-Africa trade. Zimbabwe alone accounts for almost 99% of the exports of unmilled maize, the fastest growing product and also the largest product, with current exports approaching $500 million. Regional trade arrangements can enable Uganda to benefit from expanded trade opportunities in foods and feeds.

Figure 1.8

South Africa leads in privatization

Privatization transaction values, cumulative for 1991–2001 (US$ millions)



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

Electricity is the tenth fastest-growing product in Africa-to-Africa trade, with Ghana alone accounting for 90%, at $220 million. Uganda has the potential to tap into this trade with its abundance of hydroelectric power, so it should press for greater access to markets where it has export potential.

Tourism—Africa's silent success

Between 1990 and 2000 tourism in Africa grew at an annual rate of 6.2%, well above the world average of 4.3%. In 2001 tourism receipts totaled $11.7 billion, a mere 2.5% of global tourism receipts, with arrivals at 4% of global inbound tourism (table 1.4).

Box 1.2
Doha development round falters

World Trade Organization (WTO) talks on farm trade reform appear to have faltered. Ministers from nearly two dozen countries meeting in Tokyo in February 2003 seem farther apart than ever on how to lower agricultural tariffs. For the vast majority of WTO members, the agriculture talks are by far the most important issue in the Doha development trade round, due to end in December 2004.

The centrepiece of the talks are proposals by Stuart Harbinson, chairman of the WTO agriculture negotiations, to expand market access for imports and to slash the $1 billion a day that industrial countries spend supporting farmers.

The United States and other exporting nations want agricultural tariffs cut for all categories and limits on access dropped. Developing nations with large farming populations want barriers kept in place. The European Union, Japan, and other developed countries want nontrade issues like food safety and the environment considered. The United States and the Cairns Group of agricultural exporting countries are urging radical and rapid cuts in farm protection. The European Union, backed by Japan, the Republic of Korea, Switzerland, and some other European nations, insists on smaller and slower reforms.

Japan, determined to protect its rice farmers, calls the Harbison draft too ambitious. Japan's agriculture minister said the proposed import tariff reductions, which would slash the 490% rice tariff by at least 45 percentage points, were not acceptable.

The EU, backed by Japan and Korea, offered a 36% average cut in tariffs (allowing flexibility for "sensitive" products, such as rice), a 45% reduction in export subsides, and a 55% cut in trade-distorting domestic farm supports. These would be implemented over six years from 2006.

But the real pain for the EU comes in Harbison's proposals on subsidies—the elimination of export subsidies within 10 years and the halving of trade-distorting farm supports and of subsidies in the blue box (payments to farmers to limit production).

The United States and the 16-strong Cairns Group led by Australia called for a 25% ceiling on all farm tariffs, rapid elimination of export subsidies, and deeper cuts in domestic supports. The United States has opposed efforts to treat agriculture separately from discussions on products and services. Japan and the European Union, Harbison said, benefit with the United States when tariffs on manufactured goods are lowered, yet insist that their farm goods should be exempt.

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

Largely due to the after effects of the September 11 terrorist attack in New York, 2001 was a difficult year for tourism, although less difficult than expected, with a decrease in receipts at a world level of 2.6% and arrivals of 0.6%. Even so, Africa performed strongly, with 8.1% growth in arrivals in the first eight months of 2001, partly offset by a 3.5% decline in the last four. Overall for 2001 arrivals grew 4.3% and receipts 8.8%.

"Since the 1990s, more countries are showing fiscal restraint and adopting sound macroeconomic policies"

About 95% of arrivals in Africa are in 20 of the 53 African countries. In 2001, 40% of international tourist arrivals on the continent were from Africa, followed by Europe (36%), the Middle East (4%), the Americas (4%), and Asia and the Pacific (3%) (WTO 2002). Adding domestic tourism, 75% of all arrivals are within Africa, making the scale of domestic tourism an important (and often overlooked) feature.

Zimbabwe has 67% of its arrivals coming from Africa and 33% from outside, earning an average of $67 per person. But Mauritius has only 25% of its tourists from Africa, while 67% are Europeans, who spend an average of $947.

Fiscal policy—stronger fundamentals

Before the late 1990s African governments had a tendency towards excessive fiscal spending. Since then, more countries are showing fiscal restraint and adopting sound macroeconomic policies.

But fiscal profligacy remained a problem in some parts of the region, as evidenced by the countries with fiscal deficits of more than 3% of GDP in 2002: Algeria, Angola, Ghana, Kenya, Malawi, Mauritius, Morocco, Namibia, and Nigeria.

In some countries—such as Algeria and Nigeria—the higher deficits were due to government attempts to influence voters and get re-elected. The amended Nigerian budget for 2002 brought a 20% increase in government spending. This boost, in the runup to elections in March 2003, increased the already high inflationary pressure in

Table 1.4

Tourism in Africa, selected years (US$ billions)

Region	International tourism receipts			Share of global tourism receipts (%)		Annual growth in receipts (%)		
	1995	2000	2001	1995	2001	1995–2000	1999–2000	2000–2001
Africa	8.1	10.8	11.7	2.0	2.5	5.9	2.7	8.8
North Africa	2.7	3.7	4.2	0.7	0.9	5.9	3.6	15.6
West Africa	0.7	1.1	1.2	0.2	—	8.4	1.8	12.7
Central Africa	0.1	0.1	—	0.0	—	6.6	0.0	—
Eastern Africa	1.9	2.6	2.7	0.5	0.6	5.9	–0.3	6.1
Southern Africa	2.6	3.4	—	0.6	—	5.0	4.6	—

— not available.

Source: *WTO 2002.*

the economy and is likely to force authorities to tighten their monetary stance in the second half of 2003, with adverse consequences for growth in the short term. In Angola the higher deficits were needed to finance reconstruction after the devastating armed conflict between the government and the UNITA rebels.

Countries in North Africa had lower ratios of fiscal deficit to GDP in 2002 than those in Sub-Saharan Africa. Countries in the CFA zone had lower ratios than non-CFA countries, thanks to the fiscal restraints of a single currency and monetary policy in the CFA zone. West African countries outside the CFA zone are expected to show more fiscal restraint if they follow through with their decision to form a second monetary zone in the subregion.

The number of countries with double-digit inflation came down from 30 in 1995 to 11 in 2002, and 26 countries had inflation of less than 5% in 2002

Fiscal policy was tight in some countries—including Botswana, Senegal, Sudan, Cameroon, and Gabon—with the last two registering fiscal surpluses in 2002. Despite the improvements, more needs to be done to tighten fiscal policy and check excessive government spending.

Monetary and exchange rate policy—relatively sound

Inflation. Monetary policy has been relatively tight, bringing inflation down to single digits in several countries. The number with double-digit inflation came down from 30 in 1995 to 11 in 2002, and 26 countries had inflation of less than 5% in 2002 (table 1.5).

The worst performers in 2002 were the Democratic Republic of Congo with an inflation rate of 27.7%, Angola with 108.5%, and Zimbabwe with 137.2%. The high inflation in Angola is due to the effect of armed conflicts between the government and UNITA rebels as well as poor fiscal management. In Zimbabwe it is due largely to inappropriate economic policies and the effect of the political crisis on prices for domestic imported food, which account for a large share of the consumer price index.

Eleven countries in the region—Burkina Faso, Cape Verde, Central African Republic, Djibouti, Egypt, Gabon, Kenya, Mali, Morocco, Niger, and Rwanda—had less than 3% inflation in 2002. And Ethiopia and Uganda had negative inflation rates in 2002.

Table 1.5

Inflation rates in Africa, 2000–02 (%)

Rate	2000	2001	2002
Negative	7	4	2
0–4.9	19	21	26
5–9.9	13	15	12
10–19.9	5	5	7
20–50.0	4	3	2
More than 50	3	3	2
Total number of countries	51	51	51

Source: *IMF 2002.*

In Ethiopia food prices were lower because of weaknesses in agricultural demand and the resulting decline in rural incomes. The recent drought in the country and failed harvest put upward pressure on grain prices and eliminated the deflationary pressures stifling growth. In Uganda bountiful harvests caused food prices to decline.

Real capital flight over 1970–96 amounted to about $187 billion for 30 countries

Of the five largest economies in the region, inflation will continue to pose a problem in South Africa due in part to the lagged effect of the depreciation of the rand in 2001 and the upward pressure on food prices caused by the recent incidents of drought in parts of the country. In 2002 inflation was about 8%, above the target of 3–6% set by the South African Reserve Bank. In Nigeria inflation remains high, but it came down to 16% in 2002, from 19% in 2001. The modest decline reflects the central bank's tight monetary policy stance in the first half of the year, along with an expansionary fiscal policy, blunting the decline in inflation despite a reduction in the growth of broad money supply (M2) from 27% in 2001 to 16% in 2002. In Algeria, Egypt, and Morocco inflationary pressures remain largely subdued—with less than 5% inflation, driven largely by the tightening of monetary policy.

Exchange rates. The CFA franc appreciated against the dollar for much of the year because of the depreciation of the dollar against the euro in the first and second quarters. By the end of the year the CFA franc had appreciated 6% against the dollar. In Burkina Faso, the Central African Republic, and Côte d'Ivoire the impact on competitiveness will be minimal because of their low trade exposure to the United States. But in Gabon, Mali, and Senegal the appreciation will limit the ability to take advantage of opportunities for increased exports to the United States under the African Growth Opportunity Act.

In Egypt, Morocco, and Tunisia nominal exchange rates were fairly stable due to direct government intervention or an exchange rate peg. A large number of currencies in the non-CFA Sub-Saharan African countries depreciated against the dollar in 2002. And six countries had extremely high exchange rate volatility.

Capital flight—fueled by foreign debt

Real capital flight over 1970–96 amounted to about $187 billion for 30 countries (table 1.6). Including imputed interest earnings, the accumulated stock of capital flight was about $247 billion. This group of countries is a net creditor to the rest of the world in the sense that their private assets held abroad, as measured by capital flight including interest earnings, exceed their total liabilities as measured by the stock of external debt. Their net external assets (accumulated flight capital minus accumulated external debt) amounted to about $85 billion.

The ratio of capital flight stock to GDP exceeds 200% for eight countries, with a weighted average of 172% for the group. Angola, Cameroon, Côte d'Ivoire, the Democratic Republic of Congo, and Nigeria have the highest stocks of capital flight. Five of the 30 countries (Benin, Mali, Niger, Senegal, and Togo) exhibit a negative stock of flight capital, indicating that their recorded capital inflows exceed recorded uses of foreign exchange.

External borrowing appears to be the single most important determinant of capital flight (Ndikumana and Boyce 2002). In 1970–96 roughly 80 cents of every dollar that flowed into the region from foreign loans flowed back out as capital flight in the same

Table 1.6

Capital flight from 30 African countries, 1970–96 (1996 US$ millions)

Country	Period covered	Real capital flight	Cumulative stock of capital flight, including imputed interest		Net external assets
			Value	% of GDP	
Angola	1985–96	17,032.5	20,405.0	267.8	9,179.9
Benin	1974–96	–3,457.4	–6,003.8	–271.9	–7,598.1
Burkina Faso	1970–94	1,265.5	1,896.6	96.5	700.4
Burundi	1985–96	818.9	980.9	108.9	–146.0
Cameroon	1970–96	13,099.4	16906	185.6	7,364.4
Central African Republic	1970–94	250.2	459.0	50.8	–482.1
Congo, Dem. Rep.	1970–96	10,035.4	19,199.9	327.1	6,373.5
Congo, Rep.	1971–96	459.2	1,254.0	49.6	–3,986.6
Côte d’Ivoire	1970–96	23,371	34,745.5	324.7	15,221.9
Ethiopia	1970–96	5,522.8	8,017.9	133.4	–2,060.7
Gabon	1978–96	2,988.7	5,028.1	87.0	717.7
Ghana	1970–96	407.3	289.3	4.2	–6,152.9
Guinea	1986–96	342.8	434.2	11.0	–2,806.1
Kenya	1970–96	815.1	2,472.6	26.8	–4,458.4
Madagascar	1970–96	1,649.0	1,577.5	39.5	–2,568.3
Malawi	1970–94	705.1	1,174.8	93.8	–971.3
Mali	1970–96	–1,203.6	–1,527.2	–57.5	–4,533.2
Mauritania	1973–95	1,130.8	1,830.0	167.4	–572.2
Mauritius	1975–96	–267.8	465.9	10.8	–1,351.7
Mozambique	1982–96	5,311.3	6,206.9	218.4	–1,359.4
Niger	1970–95	–3,153.1	–4,768.9	–247.7	–6,392.1
Nigeria	1970–96	86,761.9	129,661.0	367.3	98,254.4
Rwanda	1970–96	2,115.9	3,513.9	249.9	2,470.8
Senegal	1974–96	–7,278.1	–9,998.2	–214.9	–13,661.1
Sierra Leone	1970–95	1,472.8	2,277.8	257.1	1,072.7
Sudan	1970–96	6,982.7	11,613.7	161.1	–5,358.3
Togo	1974–94	–1,382.1	–1,618.3	–155.4	–3,149
Uganda	1970–96	2,154.9	3,316.1	54.8	–358.3
Zambia	1970–91	10,623.5	13,131.2	354.9	5,491.8
Zimbabwe	1977–94	8,222.3	10,882.9	149.0	6,074.8
Total		186,796.9	273,824.3	171.0	84,956.5

Source: *Ndikumana and Boyce 2002.*

year, suggesting widespread debt-fueled capital flight. (Debt-fueled capital flight occurs when funds borrowed abroad are reexported as private assets.) In addition, every dollar added to the stock of external debt added roughly 3 cents to annual capital flight in subsequent years, suggesting that outflows were exacerbated by the debt-driven capital flight. (Debt-driven capital flight occurs when capital flees a country in response to economic circumstances attributable to the external debt itself.) The findings imply that debt-relief strategies will bring long-term benefits to African countries only if measures prevent a new cycle of external borrowing and capital flight. This will require substantial reforms by creditors and debtors to promote responsible lending and accountable debt management.

"Several African countries, with more than half the Sub-Saharan population, recorded successes in reducing poverty"

The results also indicate that past capital flight tends to persist, providing fairly robust support for the propositions that capital flight is negatively related to the growth rate gap between the African country and its OECD trade partners, to the volume of domestic credit to the private sector, and to a political-governance index of voice and accountability. This suggests that Sub-Saharan Africa can reduce capital flight by improving these broader dimensions of economic performance and institutional reform—and by having greater transparency and accountability in capital account transactions.

Poverty reduction—encouraging trends

With close to half the population in Africa living below $1 a day, poverty remains a daunting social and economic challenge. Yet several African countries, with more than half the Sub-Saharan population, recorded successes in reducing poverty (figure 1.9).

Poor households are larger, tend to be in the poorest regions, are less literate, and have lower nutrition levels and life expectancy than the average. But additional evidence shows that fewer than a quarter of the people in a range of African countries are always poor, with up to 60% of the population moving in and out of poverty. This pattern confirms data from other developing countries—that transitory poverty is common—pointing to the importance of reducing vulnerability and securing livelihoods as an antipoverty strategy (table 1.7).

Countries intensified their efforts to reduce poverty, as summarized in Poverty Reduction Strategies (PRSs) and other national development strategies. The number of African countries preparing either the interim or final PRSs during the period increased significantly. Nine countries finalized their PRSs in 2002, up from four in 2001.

Combating HIV/AIDS, malaria, and tuberculosis

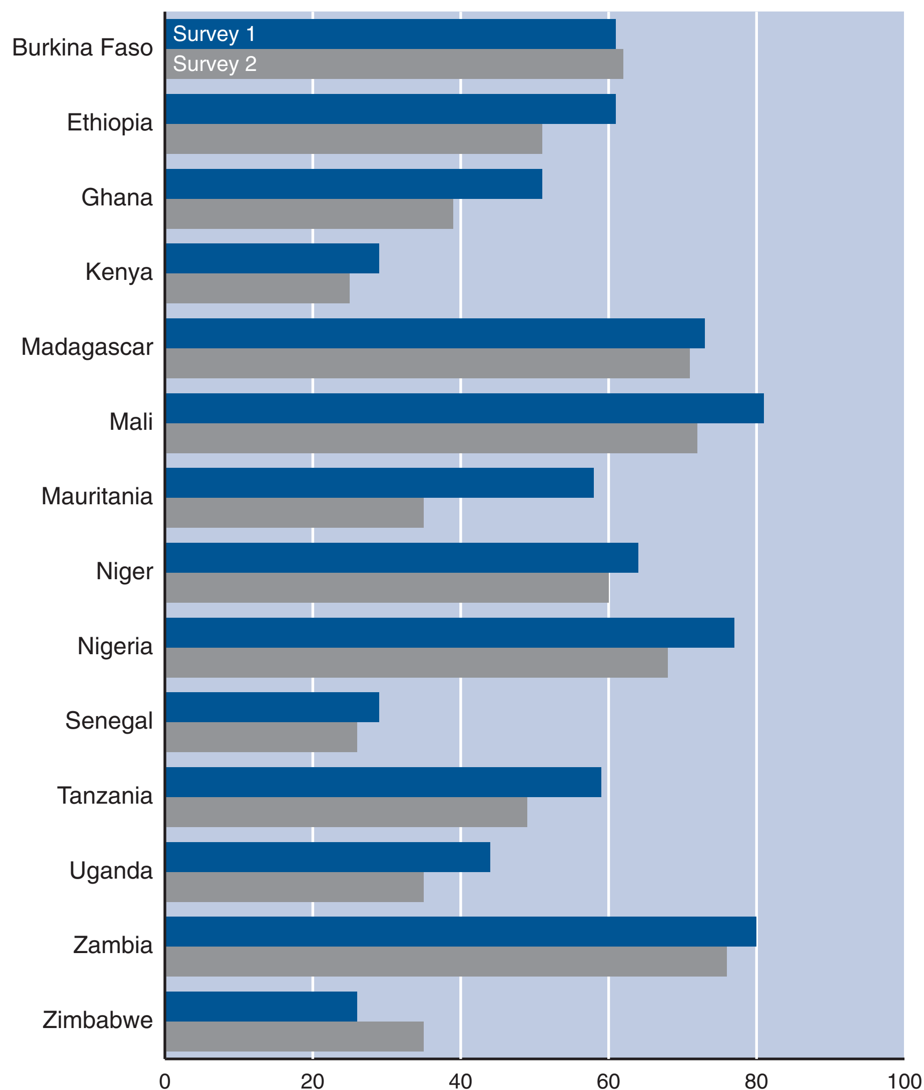
The spread of HIV/AIDS and the resurgence of malaria and tuberculosis are major causes of death and devastation in Africa.[1] An estimated 81% of the world's AIDS–related deaths, 90% of the malaria deaths, and 23% of the tuberculosis deaths occur in Africa.

AIDS, malaria, and tuberculosis undermine productive capacity, overload health services, increase social distress, and perpetuate poverty (box 1.3). At the macroeconomic level, it is estimated that HIV/AIDS reduces GDP growth in Africa by 0.5–2.6% a year on average. Other estimates suggest that Africa's GDP would be as much as $100 billion greater if malaria had been eliminated years ago. And in countries with a high burden of tuberculosis, the loss of productivity is estimated at 4–7% of GDP.

Figure 1.9

Some progress in reducing poverty in the 1990s

Proportion of population in poverty (%)



Note: *The two survey years for each country: Burkina Faso (1992, 1999), Ethiopia (1989, 1995), Ghana (1992, 1998), Kenya (1988, 1998), Madagascar (1993, 1997), Mali (1987, 1995), Mauritania (1987, 1995), Niger (1992, 1997), Nigeria (1990, 1999), Senegal (1986, 1997), Tanzania (1991, 1999), Uganda (1997, 2000), Zambia (1996, 1998) and Zimbabwe (1991, 1996).*

Source: *Christiaensen, Demery, and Paternostro 2002.*

HIV/AIDS has reached epidemic proportions in Africa. At the end of 2001 Africa remained the region most severely affected by HIV/AIDS, with an estimated 28.5 million people living with the disease, including an estimated 2.6 million children under 15 (UNAIDS 2002). Africa is the only continent with HIV prevalence higher for women than for men. Of 28.5 million Africans living with HIV/AIDS, 15 million are women. More telling, 83% of the world's women with HIV/AIDS are African. The disease orphaned more than 10 million children in Sub-Saharan Africa by the end of 2001.

"An estimated 81% of the world's AIDS–related deaths, 90% of the malaria deaths, and 23% of the tuberculosis deaths occur in Africa"

Worst affected are Botswana, Zimbabwe, Swaziland, Lesotho, Namibia, South Africa, Zambia, Kenya, Malawi, Mozambique, and Central African Repubic (figure 1.10), and the epidemic is also escalating in Cameroon and Côte d'Ivoire. But some African countries have combated HIV/AIDS with interventions aimed at behavioural changes. Adult prevalence rates continue to decline in Senegal and Uganda (UNAIDS 2002).

Tuberculosis and malaria—a high toll

Sub-Saharan Africa has the highest tuberculosis incidence in the world, contributing to 20% of the global caseload, with an estimated 200 million of about 600 million Africans carrying the tuberculosis bacillus (Nyarko 2001). People who are HIV-positive are more likely to develop active tuberculosis than those who are HIV-negative (Anderson and Maher 2001). The number of tuberculosis cases in the region is projected to rise to about 4 million new cases per year by 2005.

Malaria is still epidemic in most parts of Sub-Saharan Africa. Accounting for 90% of all fevers in Africa, it imposes severe consequences on populations living in malaria

Table 1.7

Proportion of households always poor, sometimes poor, never poor

Country	Period	Always poor	Sometimes poor	Never poor
Africa				
Côte d'Ivoire	1985–86	14.5	20.2	65.3
Côte d'Ivoire	1986–87	13.0	22.9	64.1
Côte d'Ivoire	1987–88	25.0	22.0	53.0
Ethiopia	1994–95	24.8	30.1	45.1
South Africa	1993–98	22.7	31.5	45.8
Zimbabwe	1992–95	10.6	59.6	29.8
Other				
Chile	1967–85	54.1	31.5	29.8
China	1985–90	6.2	47.8	46.0
India	1968–70	33.3	36.7	30.0
India	1975–83	21.8	65.8	12.4
Pakistan	1986–91	3.0	55.3	57.2
Russia	1992–93	12.6	30.2	14.4

Source: *World Bank 2001.*

endemic and epidemic-prone regions. There are at least 300 million acute cases of malaria each year globally, resulting in more than a million deaths, about 90% in Africa, mostly young children. Africa's leading cause of under-five mortality (20%), malaria accounts for 10% of the continent's disease burden and 40% of public health spending.

Overwhelming evidence suggests that children under-five and pregnant women have the highest risk of malaria-related sickness and death. With a median under-five child mortality risk of 8.0 per thousand, 70% of the malaria deaths are recorded among children in Sub-Saharan Africa (WHO/UNAIDS 2002; Snow and others 1998).

> *"Africa remained the region most severely affected by HIV/AIDS, with an estimated 28.5 million people living with the disease"*

HIV/AIDS—high human and economic costs

HIV/AIDS also raises the risks and costs of doing business in Africa, destroying the twin rationale for globalization: cheap labor and fast-growing markets. The epidemic

Box 1.3
Socioeconomic impact of HIV/AIDS, malaria, and tuberculosis

Estimates suggest that Africa's GDP would be as much as $100 billion greater if malaria had been eliminated years ago. And in countries with a high burden of tuberculosis, the loss of productivity due to the disease is estimated at 4–7% of GDP annually.

Apart from the effects on growth, the socioeconomic impacts are enormous. Some findings:

- The International Labour Organization predicts that, as a result of HIV/AIDS, the labour force in high-prevalence countries will fall by 20–30% by 2020. The average productive labour time lost to tuberculosis is 20–30% of household income, about three to four months of lost work time. The average person-days lost to HIV/AIDS and related illness in Ethiopia's enterprise workplace ranged from 30 to 60 days a year.
- These diseases add an intolerable burden on already overstretched and inefficient health systems. For example, in 2001 HIV/AIDS patients occupied 39% of the beds in Kenyatta Hospital in Nairobi, Kenya, and 70% of those at the Prince Regents Hospital in Bujumbura, Burundi. The annual direct medical costs of AIDS (excluding antiretroviral therapy) have been estimated at about $30 per capita, at a time when per capita public health spending among Africa countries is less than $10.
- The impact on education is already felt. Some 85 percent of teachers with HIV/AIDS die 10 years before they are due to retire. The average percentage of expected teacher deaths in southern Africa ranges from 0.5% to 2.1% a year between 2000 and 2010. The World Bank estimates that an infected teacher or education officer is likely to lose six months of professional time before developing AIDS and a further 12 months after developing it.
- The impact on agriculture and food security is considerable. Most people in rural Africa are engaged in subsistence farming, and illnesses reduce workload and output. HIV/AIDS is seen as one of the contributing factors to the current food shortage in southern Africa. Studies in Côte d'Ivoire and Namibia confirm the negative impact of illness on crop production in rural households.

Sources: *ECA 2002; FAO 1997.*

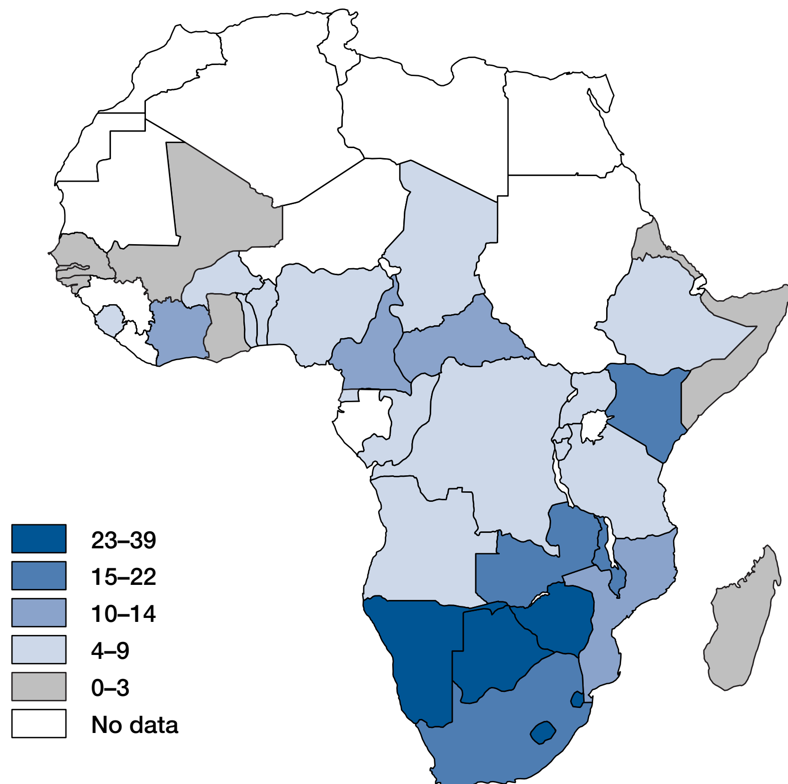
thus forces both transnational and domestic corporations to think twice before investing in countries with high HIV prevalence rates.

HIV/AIDS raises costs through several channels (box 1.4). It kills young and middle-aged adults in their most productive years as employees and customers, adding to labor costs and slowing growth rates. It erodes the competitive advantage that many corporations derive from low-cost labor in developing counties, driving up health care costs and reducing productivity for years.

> *HIV/AIDS raises the risks and costs of doing business in Africa, destroying the twin rationale for globalization: cheap labor and fast-growing markets*

Due to the long latency between infection and the onset of symptoms, a company is not likely to see the costs of HIV/AIDS until 5 to 10 years after an employee is infected. During most of that period, the employee will be fully productive at work. But the company acquires the liability for a stream of future costs from the time of infection. Those costs cannot be avoided because in an increasing number of countries it is illegal to dismiss a worker on the grounds of being infected with HIV.

Figure 1.10
HIV infection rates vary greatly
HIV prevalence in adults ages 15–49, 2001 (%)



Source: *Adapted from UNAIDS 2002.*

A recent study analyzed the impact of AIDS on six corporations, four of them subsidiaries of transitional corporations, based in South Africa and Botswana (Rosen and others 2003). The companies were large by developing country standards, reporting sales of between $35 million and $3.4 billion. They operated six industries—mining, metals, processing, utilities, agribusiness, retail, and media—and employed between 500 and 35,000 workers (table 1.8).

The prevalence of HIV ranges from 7.9% (or 1 in every 12 employees) in company A to 29% (nearly 1 in 3) in Company C. Companies in mining, metals processing, and agribusiness were affected the most, with more than 23% of their employees suffering from HIV/AIDS, slightly less than South Africa's prevalence of 25%. Unskilled and skilled workers were two to three times more likely to be infected than supervisors and managers.

The cost of one HIV infection ranged from less than half the affected employee's annual salary at company E to more than 3.5 times the employees yearly salary at company C.

Box 1.4

The costs of HIV/AIDS to an employer

From one employee with HIV/AIDS

Individual costs

- Medical care
- Benefits payments
- Recruitment and training of replacement worker

Organizational costs

- Reduced on-the-job productivity
- Reduced productivity due to employee's absences
- Supervisor's time in dealing with productivity losses
- Vacancy rate until replacement is hired
- Reduced productivity while replacement worker learns the job

From many employees with HIV/AIDS

Individual costs

- Insurance premiums
- Accidents due to ill workers and inexperienced replacement workers
- Costs of litigation over benefits and other issues

Organizational costs

- Senior management time
- Production disruptions
- Depressed morale
- Loss of experienced workers
- Deterioration of labor relations

Source: *Rosen and others 2003.*

The annual AIDS "tax" on business ranged from 0.4% of the wage bill at company E to 5.9% of the wage bill at company C in 2001. In absolute terms it was $11.9 million a year at company A.

Unskilled workers at companies B, D, and E were not eligible for many of the benefits that other employees received, and lower level workers received only minimal health care benefits. The companies also capped their annual contributions to employee benefit funds, holding costs constant as claims rose, leaving workers to bear more of the financial burden on their own.

"Botswana, South Africa, Mauritius, Namibia, and Tunisia fill the top five spots in the ranking in this year's Expanded Policy Index"

More progress needed to deepen second-generation reforms

The Expanded Policy Stance Index tries to assess the state of economic policy and identify key areas for improvement. This year's index pays particular attention to second-generation reforms in contract enforcement, policy ownership, and regulatory structures because of their importance in accelerating the pace of Africa's development (box 1.5).

Sound macroeconomic management—a hallmark of best performers

Botswana, South Africa, Mauritius, Namibia, and Tunisia fill the top five spots in the ranking in this year's Expanded Policy Stance Index (figure 1.11). All of them, except perhaps Namibia, are known as good performers in a number of policy areas, and a closer look at Namibia reveals comparable achievements, particularly in macroeconomic management.

Table 1.8

Financial impact of HIV/AIDS on six corporations in Southern Africa

Category	A 1999 Utility	B 1999 Agri-business	C 2000 Mining	D 2001 Metals processing	E 2001 Retail	F 2001 Media
Workforce size	>25,000	5,000–10,000	500–1,000	500–1,000	<500	1,000–15,000
Estimated share of labor force HIV-positive (%)	7.9	23.7	29.0	23.6	10.5	10.2
Average cost per HIV infection as a multiple of median salary	3.23	0.82	3.63	0.76	0.46	2.90
Total annual cost of AIDS	$11.9 million	$594,000	$206,000	$93,400	$13,300	$1 million
Total annual cost of AIDS as a share of salaries and wages (AIDS tax; %)	3.7	1.8	5.9	1.9	0.4	2.4
Potential net returns on treatment programmes	$4.88 million	$49,100	$34,400	$12,200	$184	$580,000
Potential reduction in AIDS tax due to treatment programmes (%)	32.5	5.5	15.7	8.9	0.8	40.4

Source: *Rosen and others 2003.*

The top five countries have, on average, lower foreign debt, lower budget deficits, and lower discount rates. They accumulated a relatively small amount of external debt, averaging 30% of GDP but ranging from about 4% of GDP in Namibia to 55% of GDP in Tunisia. Equally important, their debt stocks did not rise substantially during that year. Similarly, the deficit in the government budget (excluding all grants) remained below 4% of GDP (except in Mauritius, at 6.5% of GDP), changing very little from the previous year. Lower discount rates are also a feature of the top five countries, averaging 10.4%. At 14.3% Botswana recorded the highest rate, while at 5.8% Tunisia had the lowest.

"The good performers have lower foreign debt, lower budget deficits, and lower discount rates"

Second-generation reforms firmly in place in top performers

The top five also score high on the qualitative indicators. Market liberalization is more advanced, with few policy reversals. Institutions for policy analysis and coordination are better. Government efforts in promoting women's access to education and health and gender equality in employment are highly rated. Pro-poor targeting is more sharply focused and the effectiveness of pro-poor policies is greater, especially those for microfinance, rural development, urban housing, and adult literacy. The legal system is more effective at enforcing contracts. Laws and regulations are more predictable and transparent—and are

Box 1.5

Expanded Policy Stance Index

The Expanded Policy Stance Index covers three broad areas of policy performance: macroeconomic policies, poverty reduction policies, and institution-building policies.

- The macroeconomic policies cluster covers monetary, fiscal, exchange rate, and macroeconomic policy coordination, as well as trade, financial sector, product market, factor market, and sectoral policies.
- Poverty reduction policies include pro-poor targeting, gender development, and Poverty Reduction Strategies.
- The institution-building cluster covers legal structure and regulation (property rights, contract enforcement), transaction costs (transport, telecommunications, water and electricity supply), central bank independence, private and public sector coordination, and public enterprises and the civil service.

Two types of data are used in constructing the index. The first are quantitative data on national aggregates, and the second, qualitative information collected from individual respondents through surveys in 29 countries in 2002. The surveys are a useful source of information because the success of policy interventions depends on the actions that economic agents take in response to them. Such actions are conditioned by the perceptions of economic agents about the various characteristics of policies. For instance, if people believe that a policy package will be reversed, they will act accordingly and refrain from making the choices that would lead to the realization of the objective associated with the policy package. Given the paucity of quantitative information on the quality of government policies, information on perceptions can fill part of the gap.

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

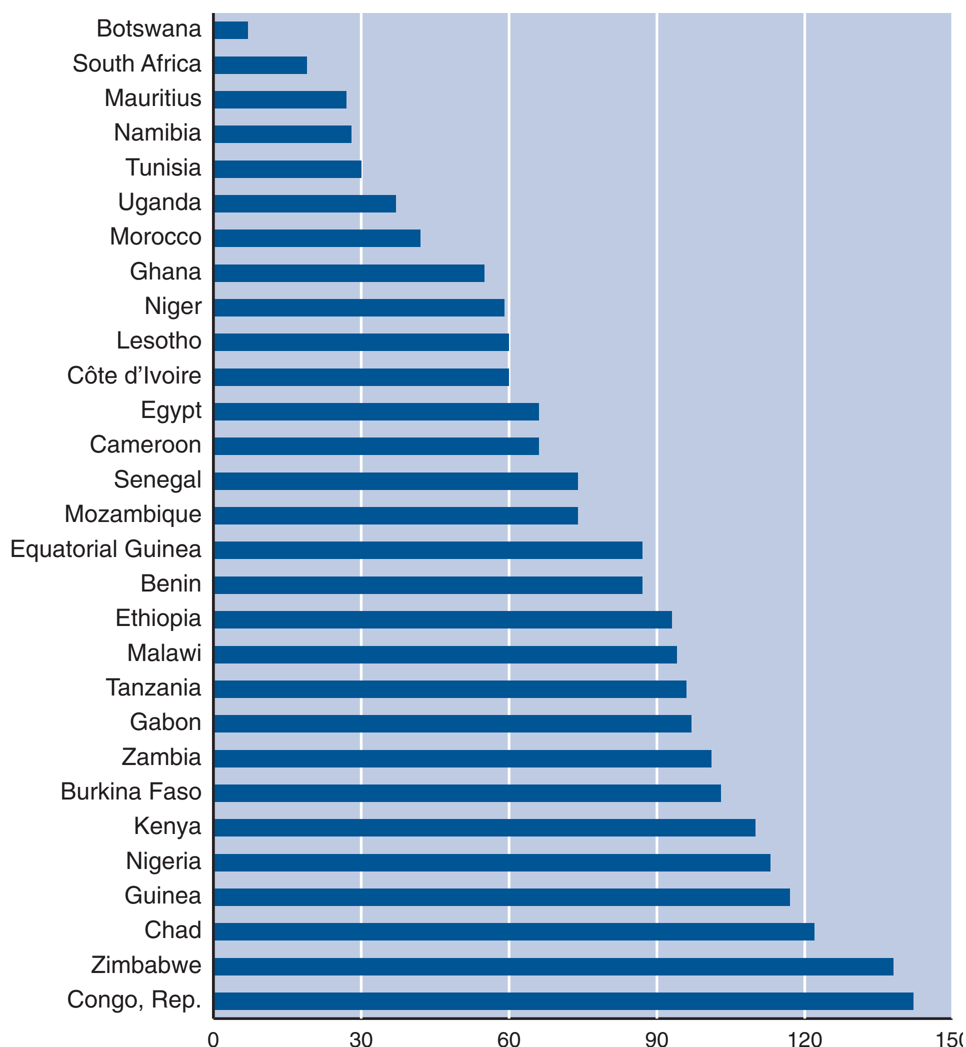
applied more uniformly. The quality of the civil service is better. And the access to and reliability of telecommunications, transport, and electricity are greater. Fixed and mobile telephone networks, closely correlated with other infrastructural determinants of transactions costs, are more extensive—by a considerable margin. Moreover, poverty rates are low in South Africa, Mauritius, and Tunisia.

In contrast, Nigeria, Guinea, Chad, Zimbabwe, and Republic of Congo are at the other end of the ranking. They have accumulated considerable external debt, averaging 113%

Figure 1.11

Bostwana, South Africa, Mauritius, Namibia, and Tunisia—the top 5

Expanded Policy Stance Index, 2002



Note: *Lower scores on the index indicate better performance.*

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

of GDP and ranging from about 73% of GDP in Nigeria to 163% of GDP in Zimbabwe. Budget deficits are high in Chad (12% of GDP) and Zimbabwe (35% of GDP), and discount rates are high in Guinea (16%), Nigeria (17%), and Zimbabwe (57%).

Their qualitative indicators depict a similar (or worse) picture. The liberalization achieved is rather limited, and policy reversals are more frequent. Government capacity for policy analysis and coordination, including the relevant institutions, is weak (except in Zimbabwe). Efforts to target the poor are ineffective. Government promotion of equal job opportunities for women is not robust. The effectiveness of the legal system in enforcing contracts is weak. The predictability and transparency of laws and regulations are low. Uniformity is lacking in the application of laws and regulations. The quality of the civil service is very low. And the access to—and reliability of—telecommunications, transport, and electricity is unsatisfactory. Political tensions make the situations in these countries even more difficult.

> *Macroeconomic policies received the highest approval rating by stakeholders on government policy*

High marks to macro reforms and poverty reducing policies

The qualitative surveys reveal some interesting results on the state of economic policy in Africa (table 1.9). Macroeconomic policies, as a group, received the highest approval rating by stakeholders on government policy. Around 75% of respondents believe that their governments are doing a good job in macro management. The worst raw scores and ranks are for the quality of public sector management, while poverty reduction, sectoral policies and policies for market and institutional development are ranked second, third, and fourth.

But weak institutions are holding back progress

The survey questions attempt to elicit the perceptions of stakeholders on the pace and effectiveness of second-generation reforms, which are essentially institutional and structural, involving five interrelated dimensions:

- *Poverty reduction*—to alleviate poverty and promote equity.
- *Contract enforcement*—to secure property rights, strengthen the legal and justice system, and build effective conflict resolution mechanisms.
- *Ownership*—to enhance ownership through effective participation of stakeholders and consensus-building.
- *Regulation*—to improve the quality of regulation including independence, integrity, transparency, consistency, and predictability for the shift away from direct government management of the economic sphere.
- *Sectoral transformation*—to promote the appropriate pattern of sectoral development.

Some reforms of this type are being initiated in the continent—good examples are gender equality and central bank independence. But the higher raw scores and lower approval ratings of the corresponding policy clusters highlight the still unsatisfactory pace of second-generation reforms in many parts of the continent.

Poverty reduction top on agenda

The results show that poverty reduction has become the central plank of policy in survey countries. The poverty reduction policy cluster ranks second, with an approval rating of 66% from stakeholders on government policy. Corroborating this is the fact that of 29 African countries that adopted an interim or full Poverty Reduction Strategy by the end of 2002, 24 are in the sample here, many of them in the implementation phase.

The promotion of gender equality in access to education, health, and employment is rated particularly high, with an approval rating of 79%. The correctness of the Poverty

Table 1.9

Quality of economic policies survey, 2002

Policy dimension	Average raw score	Rank by raw score	Approval rating (%)
Macroeconomic policies	2.705	1	75.48
Monetary policy	2.705	3	74.49
Exchange rate policy	2.711	4	74.05
Macroeconomic policy coordination	2.699	2	77.89
Sectoral policies	3.222	3	61.96
Trade policy	3.213	8	2.15
Financial sector policy	3.149	7	63.93
Product market policy	3.336	12	58.20
Factor market policy	3.346	13	57.63
Sectoral development strategies	3.064	6	67.92
Poverty reduction	3.070	2	65.73
Pro-poor targeting	3.257	10	64.15
Policies for gender development	2.698	1	78.81
Poverty Reduction Strategy	3.257	9	59.98
Market and institutional development	3.310	4	61.06
Legal structure and regulation	3.562	15	53.86
Transactions costs	3.611	16	51.36
Central bank independence	2.794	5	74.51
Private and public sector coordination	3.273	11	64.52
Public sector management	3.769	5	46.56
Administration of public enterprises	3.369	14	56.25
Civil service	4.170	17	36.87

Note: *The table reports the average raw scores accorded to the major areas of policy and the corresponding approval rating calculated as the average percentage of respondents who expressed their agreement (as 'strongly agree', 'agree', or 'weakly agree') with the positive statement regarding the relevant policy attribute or outcome. The ranking determined by the raw scores is also included. The semantic scale spans strongly agree (coded 1), agree (2), weakly agree (3), weakly disagree (4), disagree (5), and strongly disagree (6). So, low scores indicate better performance.*

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

Reduction Strategy in being broadly pro-poor and reflecting the key development problems of these countries got a 68% approval rating. A similar rating goes to the record of governments in enhancing pro-poor targeting.

Disagreement enters for the credibility and effectiveness of those policies. A low approval rating (47%) is given for the extent that implementation of the Poverty Reduction Strategy accords well with what was planned. Considerable reservation is also registered on how much the poor will actually benefit from these policies (45% approval).

"Performance on the continent is weak in market and institutional development"

A qualitative Poverty Reduction Policy Stance Index was developed to rank countries on their performance in poverty policy, spanning pro-poor targeting, policies for gender development, and the Poverty Reduction Strategy. Botswana, Tunisia, South Africa, Namibia, and Mauritius emerge as the top five performers (figure 1.12). Their efforts in promoting women's access to education and health and gender equality in employment are rated highly. Comparable achievements are also recorded in pro-poor targeting and effectiveness of pro-poor policies.

The bottom-five countries—Zimbabwe, the Republic of Congo, Kenya, Comoros, and the Democratic Republic of Congo—have unsatisfactory efforts to target the poor, with weak benefits to the poor from pro-poor policies. Similarly, government promotion of equal job opportunities for women is not robust.

Market and institutional development is weak

The average performance on the continent is weak in market and institutional development. More specifically, key determinants of transactions costs and contract enforcement are deemed still inadequate. Corruption adds significantly to the cost of economic activity (75% of survey participants agree), and the costs of electricity and transport are restrictively high (67% and 64% agree). And while appreciable improvements in the access to—and quality of—telecommunication services are recorded (with approval ratings of 78% and 84%), cost and waiting times for telephone installation and repair remain a concern (with only around 40% agreeing that services are adequate).

Contract enforcement is another area for improvement. The effectiveness and impartiality of the legal and regulatory system have an approval rating of 54%. Specific areas of concern are the effectiveness and impartiality of courts in cases against the government (37% approval rating), extent of crime (41%), effectiveness of the legal system in enforcing contracts (49%), police effectiveness in protecting people and property (50%), the predictability of laws and regulations (51%), transparency of laws and regulations (53%), and protection of land rights (57%).

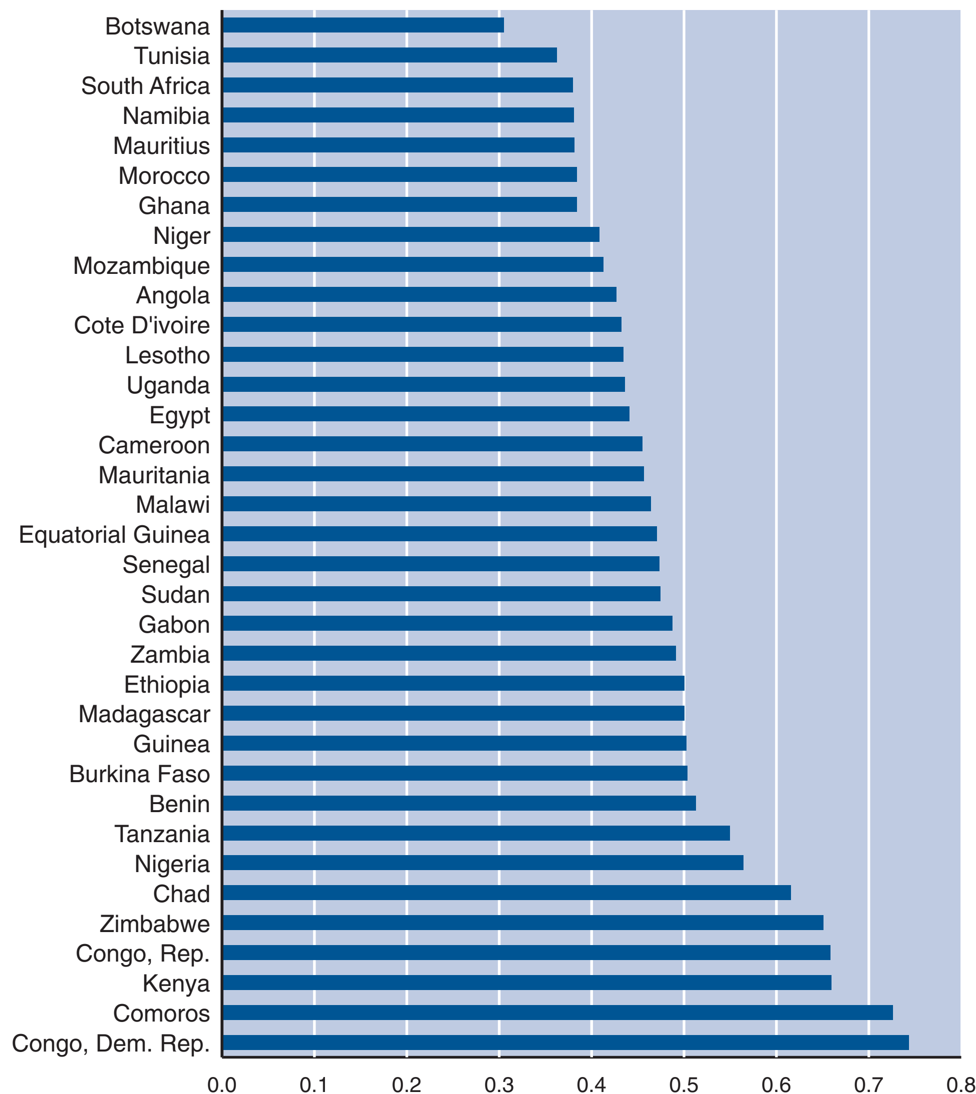
The speed of reform is deemed comparably slow in the areas of private and public sector coordination (an indicator of consensus-building and ownership) and public sector

management (which combines efficiency in the administration of state-owned enterprises, privatization, and quality of the civil service). The weaknesses of the civil service are particularly highlighted. The attractiveness of incentives in the civil service received an approval rating of only 20%. Also scoring low were meritocratic recruitment (approval rating of 39%), promotion (40%), and the regularity of skill upgrades (45%).

Figure 1.12

Botswana, Tunisia, South Africa, Namibia, and Mauritius—the top 5

Qualitative Poverty Reduction Policy Stance Index, 2002



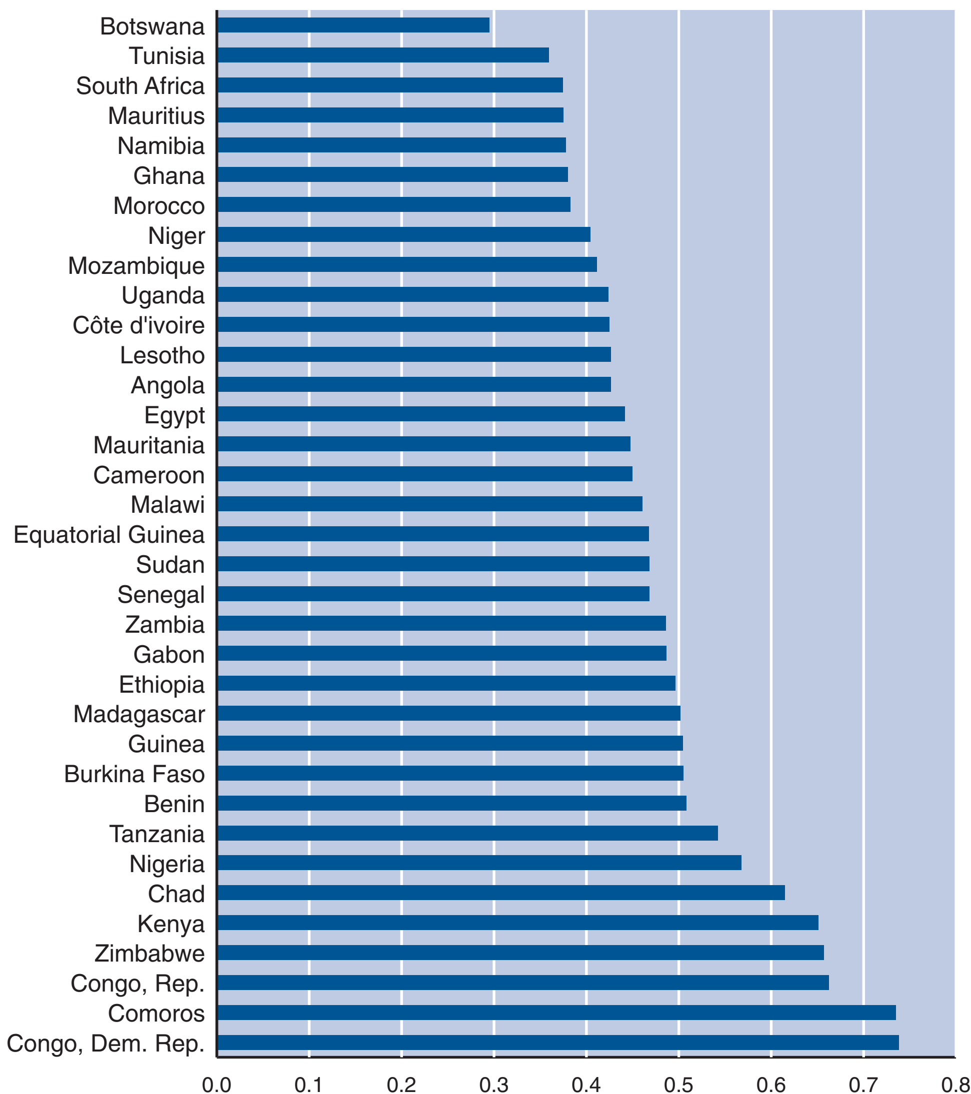
Note: *The scores are standardized from 0 to 1. Lower scores on the index indicate better performance.*
Source: *Economic Commission for Africa, from official sources.*

A qualitative Institution-Building Policy Stance Index was developed to rank countries according to the performance of policies (figure 1.13). It produces the same top five and bottom five countries as the qualitative Poverty Reduction Policy Stance Index. Indeed, the correlation between these two indices is 0.99, indicating a close link between building the right institutions and reducing poverty.

Figure 1.13

Botswana, Tunisia, South Africa, Mauritius, and Namibia—the top 5

Qualitative Institution-Building Policy Stance Index, 2002



Note: *The scores are standardized from 0 to 1. Lower scores in the index indicate better performance.*
Source: *Economic Commission for Africa, from official sources.*

In the top five the legal system is more effective at enforcing contracts, laws and regulations are more predictable and transparent and are applied more uniformly, the quality of the civil service is better, and the access to and reliability of telecommunications, transport, and electricity are greater. But many shortcomings remain. First, the quality of the civil service in these countries still has to improve considerably. Recruitment and promotion on the basis of merit need to become the norm, and incentives to civil servants should improve to attract and retain competent, motivated, and honest people. Second, corruption is still widespread (with the exception of Botswana and Tunisia) and adds significantly to the cost of economic activity. Third, the costs of telecommunications and electricity are still high.

> *"The close movements of the three qualitative policy stance indices underscore the importance of macroeconomic stability, pro-poor targeting, and credible institutions for sustained economic growth and poverty reduction"*

The close movements of the three qualitative policy stance indices underscore the importance of macroeconomic stability, pro-poor targeting, and credible institutions for sustained economic growth and poverty reduction. They reveal that civil service reform, legal and regulatory reform, and further liberalization and effective regulation of the transport, telecommunications, and power sectors are a priority.

Medium-term prospects—mixed

In the near term, growth prospects for African countries will depend mainly on the strength of the recovery in global economic activity, the outlook for commodity prices, the progress in reducing political and armed conflicts, and the commitment of African leaders to macroeconomic stability and the principles of good governance.

Modest improvement in growth in 2003

Economic growth is expected to increase from 3.2% in 2002 to 4.2% in 2003, driven mainly by recent economic and political events in and outside Africa:

- An increase in peace agreements and a reduction in armed conflicts: consider the ceasefire in Angola following the death of the UNITA rebel leader, Jonas Savimbi; the tentative peace in West Africa between Liberia and Sierra Leone; the cessation of hostilities in the Horn of Africa between Eritrea and Ethiopia; the July 2002 peace agreement between the Democratic Republic of Congo and Rwanda in Pretoria; and the recent resumption of peace talks between the Sudanese government and the rebel Sudan People's Liberation Army (SPLA). The cessation of hostilities in these countries is expected to result in a redirection of military spending towards economic and social projects that will reinvigorate growth.
- An increase in the number of African countries eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. This is expected to free up resources—for social expenditures directed at vulnerable groups—and boost economic activity.
- The bottoming out of the global slowdown. An improvement in economic activity should be expected in most of the world's regions in the third quarter of 2003,

spurring economic activity in Africa through increased aid, trade, and foreign investment. In the OECD area growth is expected to increase from 1.5% in 2002 to 2.2% in 2003, in the United States from 2.3% to 2.6%, and in the European Union from 0.9% to 1.9%. Japan is expected to move from a negative growth rate of −0.7% in 2002 to a positive growth rate of 0.8% in 2003.
- The decision by six West African countries to form a monetary union in 2005. The attempts by governments to meet the convergence criteria are likely to improve the macroeconomic policy environment in the subregion, boosting future growth.
- The events of September 11, 2001, and the resulting international war against terrorism. Economic effects for Africa will be positive to the extent that the activities of militant groups are checked in unstable African countries and that western nations become more involved in the economic and political development of African nations to discourage them from providing safe-havens to terrorists. There are already indications that this is happening. Africa featured prominently on the agenda of the last G-8 Summit in Kananaskis, Canada. And several advanced countries have promised to support development efforts in Africa.

"The pace of economic activity is expected to improve next year in all the five subregions"

The pace of economic activity is expected to improve next year in all five subregions. In 2003 growth is projected to be 4.9% in North Africa, 4.4% in East and Central Africa, 3.6% in Southern Africa, and 3.3% in West Africa. North Africa is projected to have the highest growth rate in the region, driven by strong growth in Algeria (5.9%), Sudan (5.7%), Tunisia (5.5%), and Egypt (4.6%). East Africa is projected to have the second highest growth rate in the region, driven by strong growth in Rwanda (6.5%), Uganda (6%), Madagascar (5.5%), Tanzania (5.2%), and the Democratic Republic of Congo (3.8%).

All West African countries—except Côte d'Ivoire, Liberia, Guinea-Bissau, and Sierra Leone—are projected to have growth of 3.0% or more in 2003, underpinned in part by an expected improvement in the prices of key commodities exported by the subregion—notably gold, oil, and cocoa. Guinea Bissau will grow by a meager 1.5%, and Liberia by 1.6%. Economic activity is expected to pick up in Nigeria, with growth projected at 3.0%. Underpinning the improvement would be an increase in oil revenue if OPEC increases its oil quota. Nigeria has already indicated that it would ask for an increase in its quota, likely to be approved if political tensions between the United States and Iraq continue unabated.

In Southern Africa growth is expected to increase from 3.3% in 2002 to 3.6% in 2003 reflecting improvements in the prices of key export commodities—gold, oil, diamonds, and copper. Zimbabwe is expected to have a negative growth rate (−4.6%), explained in part by the political and economic crisis in the country. With an expected growth rate of 10.2% Mozambique will be the fastest growing economy in the subregion, thanks to sound macroeconomic policies and funds from debt relief under the HIPC Initiative. Because of the likelihood that gold and diamond prices will increase, growth is expected to rise in South Africa from 3.0% in 2002 to 3.3% in 2003.

With Equatorial Guinea continuing to have very impressive growth of 21.7% and with strong growth in Cameroon and São Tomé and Principe, the Central African subregion is expected to have a slight boost in growth from 4.0% in 2002 to 4.4% in 2003.

Risks and uncertainties

As usual, there are some downside risks to the realization of the projected growth rate for Africa:

> *"Prospects for Africa in the medium term will be influenced largely by the strength of the recovery in global economic activity, developments in commodity markets, and adoption of sound macroeconomic policies and good governance"*

- The deteriorating political and economic situation in Zimbabwe and Côte d'Ivoire.
- Renewed incidents of flooding and drought in various parts of the continent, especially in the Horn of Africa and the Southern African region.
- The decision by U.S. President Bush in May 2002 to introduce a six-year $51.7 billion farm law, boosting crop and dairy subsidies by 67%. There is the concern that the subsidy will lead to lower prices for agricultural products, making it difficult for small African countries to compete on the world market.
- Inflationary pressures in two of the five big economies in Africa—South Africa and Nigeria—as well as in countries such as Angola, Zimbabwe, the Democratic Republic of Congo, and Malawi would reduce the ability of the monetary authorities to stimulate the economy.
- The high probability of an El Niño phenomenon in 2003—as suggested by the International Research Institute for Climate Prediction—and the associated deterioration of global weather conditions.

In sum, the mixed prospects for Africa in the medium term will be influenced largely by the strength of the recovery in global economic activity, developments in commodity markets, progress in reducing regional insecurity, adoption of sound macroeconomic policies and the principles of good governance, and the ability and willingness of African leaders to intensify much-needed economic and social reforms.

Note

1. This section draws on the forthcoming Economic Commission for Africa report, *Leadership for Better Health: The Challenge of HIV/AIDS, Tuberculosis and Malaria*.

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Chapter 2

Uganda—A Tale of Two Economies?

The Ugandan economy grew 6.2% in 2001/02 (July–June), slightly above the 5.9% growth a year before. The solid growth has been accompanied by substantial poverty reduction—lifting more than 4 million people from poverty (22% of the population) in a decade. But there is no room for complacency. One Ugandan in three still lives below the poverty line. More disturbing: the national poverty numbers mask vast regional disparities. The central and western areas of the country have grown more rapidly than the northern and the eastern, with the high levels of poverty in the northern region of grave concern. Uganda's economic performance may thus be a tale of two economies, with excellent national growth and poverty numbers masking huge swaths of the economy that have not enjoyed the benefits.

"Growth has been accompanied by substantial poverty reduction—lifting more than 4 million people from poverty in a decade"

Inequalities between the more affluent central crescent area around Lake Victoria and the drier, more disadvantaged northern part of the country have been exacerbated by the pattern of development in the last 10 years. The north has lagged largely due to a civil war that has dragged on for two decades. Having one region lag far behind can engender bitterness and ultimately foster rebellion. Thus fear of civil conflict along regional or ethnic lines is reason for genuine concern over Uganda's spatial pattern of development.

Despite higher spending on social services, most social indicators are still below the average for such comparators as Ghana, Kenya, and Zambia. This reflects systemic problems in public service delivery at the district level and specific problems associated with HIV/AIDS. Improving the quality of social services, especially in education and health, remains crucial for further gains.

Prudent macroeconomic management coupled with good weather kept inflation at single digit levels in 2001/02. Financial sector reforms have helped deliver financial stability. Savings and domestic investment rates remain lower than in other Sub-Saharan countries but are trending upward.

The fiscal programme, while exercising restraint, has delivered priority expenditures as outlined in the Poverty Reduction Strategy. But the government still relies on donor funding for close to 60% of the development budget, showing the high aid dependency of the economy. The fiscal deficit, excluding grants, rose slightly from 11.2% of GDP in 2000/01 to 12.6% in 2001/02.

During 2001/02 monetary policy achieved stable and low inflation rates. And sterilization actions by the Bank of Uganda diverted pressure on the Ugandan shilling to appreciate. Overall, the movement in monetary aggregates has been in line with the monetary policy stance. Net foreign assets of the banking system grew by 28.2% in 2001/02 to a comfortable $992 million, around six months of imports.

> *Given agriculture's importance, the country's economic growth depends on its modernization and diversification*

The export sector remains highly concentrated in commodity exports. But the share of coffee, 59% of export earnings in 1997/98, declined to 19% in 2001/02. The current account balance has been persistently in deficit, rising over the years to $476 million in 2001/02. Even so, the external position showed some strengthening in 2001/02, with an overall deficit of $2.8 million, far less than the $55.6 million in 2000/01.

Despite strategies to reduce the debt burden, the total debt stock continues to rise. In 2001/02 the debt stock stood at $3.8 billion, with a debt stock to GDP ratio of 68.2%.

Most of the potential for economic growth and poverty reduction through macroeconomic reforms has been exploited. Further impetus to growth requires deeper reform to create an enabling environment for the private sector. It also requires reducing regional disparities to unleash the full potential of the population. It is farmers, traders, and the rest of the private sector that can lift Uganda's growth one notch up from an average of 6% a year to the 7% required to achieve the government's goal of reducing income poverty to 10% by 2017.

But the private sector has many concerns, ranging from corruption to inadequate infrastructure, poor public service provision, and low access to financial services. Reforms thus have to deal with difficult governance issues and fundamental structural changes to the economy.

Recent economic performance

Even in the midst of a difficult international environment and with deteriorating terms of trade, Uganda's economic performance has been solid. In 2001/02 the economy grew 6.2%, slightly above the 5.9% in 2000/01 (figure 2.1). The resilience of the economy to external shocks is a product of prudent macroeconomic policies leading to macroeconomic stability. GDP per capita grew 3.9% in 2001/02.

Developments in the real sector

The fastest growing sector in 2001/02: transport and communications, up 10.2%, compared with growth of 8.1% the previous year. This was followed by mining and quarrying, manufacturing, construction, wholesale and retail trade, and electricity and water services. The agricultural sector grew 5.1% in 2001/02, up from 4.6% the previous year. Overall, monetary GDP grew 6.7%, up from 6.1% in 2000/01, and nonmonetary GDP grew 4.3%, up from 5.4%.

Agriculture dominates the Ugandan economy, at 41% of GDP in 2001/02 (down from 72% in the late 1970s). It provides employment to about 80% of the labour force and generates almost all the country's exports. Given agriculture's importance, the country's economic growth depends on its modernization and diversification. Broader access to rural credit and better public service delivery, particularly good infrastructure, need attention.

> *A recent survey found tremendous foreign investor interest in agro-processing*

The Plan for Modernization of Agriculture envisions eradicating poverty through a dynamic agricultural and agro-industrial sector—profitable, competitive, and sustainable. The plan identifies six core areas for government action: research and technology, advisory services, access to rural finance, education in the sector, access to markets, and sustainable natural resource management.

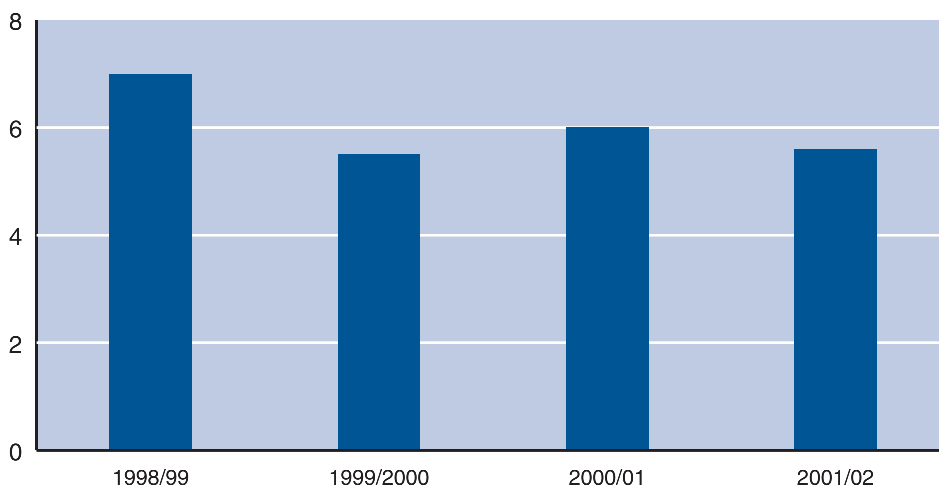
Mining, representing only 1% of GDP, remains largely untapped. Recent efforts to attract foreign investment have resulted in some exploration activities in gold, phosphates, and petroleum.

Manufacturing, accounting for about 10% of GDP, is based largely on processing sugar, cotton, and food crops. A recent survey financed by the World Bank found tremendous foreign investor interest in agro-processing (EIU 2002). Government strategy for manufacturing emphasizes agro-based and small and medium-size industries. Building managerial and technical skills and increasing private participation through privatization are a big part of the strategy. The Uganda Investment Authority has been aggressively promoting horticulture and food processing and packaging.

Figure 2.1

Growth is robust

GDP growth, 1998/99–2001/02 (annual percentage change)



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

Savings still low

Savings remain low, but on an upward trend. Gross domestic savings rose from 4.6% of GDP in 1997/98 to 7.3% in 2001/02. Gross national savings, which includes private transfers and grant financing of the government budget, rose from 10.4% of GDP to 13.6%. Private savings have been on an upward trend, while public savings have been declining (figure 2.2).

"The financial sector's recovery shows up in the higher private shilling deposits at banks, up by 30%"

The upward trend in private savings is in line with the financial sector's recovery from the bank failures in 1998. Its recovery shows up in the higher private shilling deposits at banks, up by 30% from $461.5 million in June 1999 to $601 million in June 2002. Even so, other unproductive savings—such as real estate and foreign currencies held for wealth and speculative motives—still impede the growth of urban household financial savings. Because of the limited access to financial services, the assets of rural households are in commodity stocks, livestock, and land—the nonmonetary economy, an efficiency loss to the economy.

The recent decline in public savings comes from higher spending on poverty reduction programmes. The government's medium-term fiscal programme aims to reconcile this spending with fiscal sustainability, with the deficit targeted to fall gradually as a result of better revenue performance, increasing public savings.

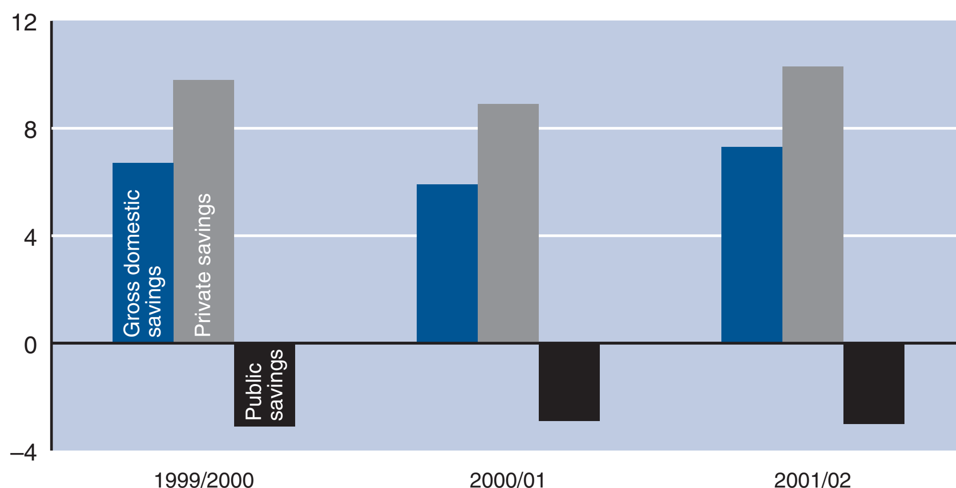
Private investment sluggish

Despite major improvements in the policy environment, private investment remains low (10%) and close to the Sub-Saharan average (figure 2.3). Why the sluggish investment

Figure 2.2

Private savings up in 2001/02—public down

Gross domestic savings, private savings, and public savings, 1999/2000–2001/02 (% of GDP)



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

response to the improved policy environment? Greater competition, due to economic liberalization, has put pressure on firms to cut costs. But many of these costs (related to utility services, transport, and corruption) are not under a firm's control. Erratic infrastructure services, arbitrary tax administration, and crime also affect perceptions of the risks of investing in partly irreversible capital (Reinikka and Svensson 2000). Firms, particularly small ones, are also liquidity constrained, able to invest only when internal funds are available.

> *The monetary policy stance adopted during 2001/02 was cautious*

Gross domestic savings fell short of gross domestic investment by about 13% of GDP from 1997/98 to 2001/02. The gap has been financed by highly concessional loans from the African Development Bank and the International Development Association.

Monetary policy—targets achieved

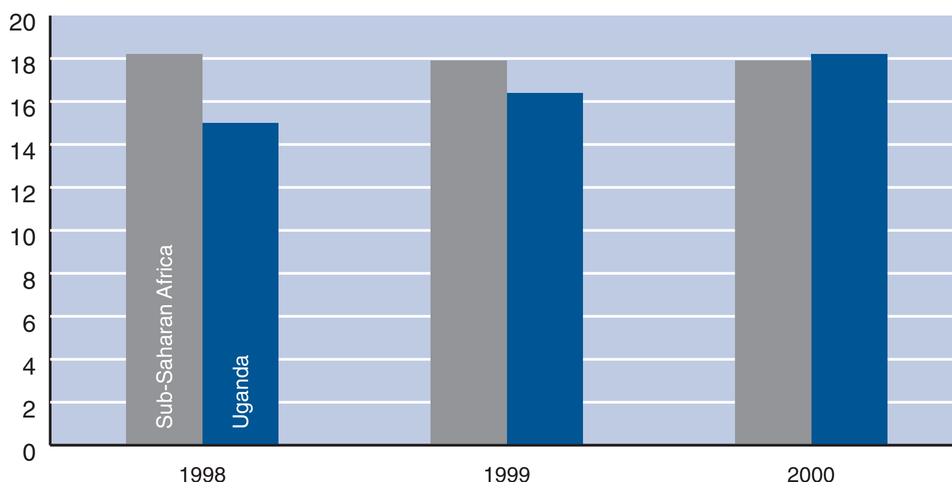
The major objective of monetary policy is to achieve price stability conducive to growth. In response to the negative headline inflation rates registered in 2001/02 (for the prices of all goods and services), the monetary policy stance was eased.[1] Overall, the monetary policy stance adopted during the year was cautious, creating few disturbances on the domestic and foreign exchange markets.

Monetary policy has moved gradually from reliance on direct to indirect instruments. Initially, largely on account of the rudimentary financial system and the limited array of instruments, coordination with fiscal policy was an important part of monetary policy,

Figure 2.3

Investment close to Sub-Saharan average

Gross domestic investment, Uganda and Sub-Saharan Africa, 1998–2000 (% of GDP)



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

evident in the surrendering of treasury bill issuance by the Ministry of Finance, Planning, and Economic Development to the Bank of Uganda. But by June 2002 the array of instruments for managing liquidity and enhancing monetary policy had been widened.

The Bank of Uganda's external assets rose nearly 22%, while its liabilities declined 3.4%

Developments in monetary aggregates

The annual growth rate of M3 for the period ending June 2002 was almost 22%, up from 18% for the period ending June 2001 and 16% for the period ending June 2000.[2] Developments in M3 have been largely a result of the accelerated growth in all components of M3. M2 grew 25%, 10 percentage points above the rate in June 2001.[3] On the supply side, net foreign assets of the banking system grew 28% in 2001/02, compared with 34% in 2000/01. Net domestic assets remained unchanged, after declining 15.5% in 2000/01 (table 2.1).

The Bank of Uganda's external assets rose nearly 22%, while its liabilities declined 3.4%. Foreign liabilities declined largely because of repurchases with the International Monetary Fund (IMF). Assets increased because of higher budgetary support by donors.

Noteworthy in net domestic assets is the slow growth in private sector credit. Private sector credit grew only 1.8% in 2001/02, down from 9.4% in 2000/01. The decline is partly a result of increased recoveries, as reflected in the decline in nonperforming assets to about 5% of private sector credit.

Table 2.1

Determinants and components of broad money, June 2001 and 2002 (US$ millions)

Aggregate	End-June 2001	End-June 2002	Absolute change	Percentage change
Net foreign assets	773.3	991.5	218.2	28.2
Bank of Uganda	505.9	696.4	190.5	37.6
Commercial banks	267.3	295.1	27.8	10.4
Net domestic assets	238.0	238.0	0.0	0.0
Claims on government	294.1	317.5	23.4	7.9
Claims on private sector	405.4	412.8	7.3	1.8
Claims on other public entities[a]	7.2	4.9	(2.3)	(31.9)
Other items net	–468.8	–497.2	(28.4)	(6.1)
Broad money (M3)	1,011.3	1,229.5	218.2	21.6
Foreign exchange deposits	249.2	277.7	28.5	11.4
Currency in circulation	223.6	260.0	36.4	16.3
Demand deposits	308.4	394.3	86.0	27.9
Savings and time deposits	230.1	297.5	67.4	29.3

***Note:** U.S. dollars using end-period exchange rate for June 2000.*

a. Includes state-owned enterprises and local governments.

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

Domestic price developments—good weather turns inflation negative

The inflation outturn in the 1990s was impressive, maintained on average in single digits—a big change from the volatile consumer prices in the 1980s, with headline inflation of 250% in 1987. The success in managing inflation is due to the simultaneous strengthening of liquidity and budget management, especially since 1992.

From September 2001 to June 2002 the economy's headline inflation rate was negative (figure 2.4), largely because of the sharp drop in food prices, the result of good weather. Annual food crop inflation declined from –3.7% in July 2001 to –28.5% in December 2001 before rising to –13.0% in June 2002. Since October 2001 annual underlying inflation (for all goods and services minus food crops) has been positive, but well below 5%.

> *Private sector credit grew only 1.8% in 2001/02, down from 9.4% in 2000/01*

Interest rates—heading downward

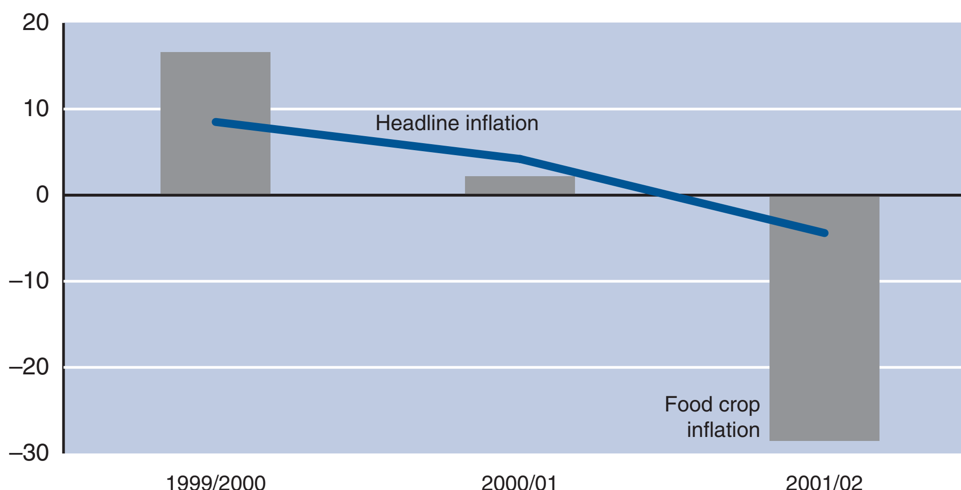
The annualized 91-day treasury bill rate declined from 12% in September 2001 to a low of 3% in March 2002, with the rediscount rate and the bank rate following a similar pattern (figure 2.5). This decline is due mainly to a reduction in the volume of treasury bills, as the Bank of Uganda curtailed their use for sterilization of inflows. Since March 2002, however, the treasury bill rate has been on the rise.

Commercial bank deposit and lending rates registered only a marginal decline. For shilling-denominated deposits, the weighted time deposit rate was 3.6% in June 2002, down from 6.6% in June 2001. The weighted lending rate also declined, to 17.6% from 21.7%. Despite monetary easing, private credit did not respond. Nor has

Figure 2.4

Inflation plummets

Inflation in December 1999/2000–2001/02 (%)



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

the large spread between the lending and deposit rate changed, despite the impressive drop in nonperforming loans. Contributing to the wide spreads are the cost to banks of meeting prudential requirements and the high cost of doing business, particularly for communication, electricity, rents, and security services (Kasekende and Atingi-Ego 1996, 1999). Stringent collateral requirements add to these costs. With legal property titles not clear-cut, the banks have to investigate property deeds offered as collateral by the borrowers and several guarantors, costly in staff time and effort. Yet another reason for the wide spread is the inability of the Bank of Uganda to signal its intentions to the market, given the high volatility in treasury bill volumes.

> *The financial sector has undergone considerable reforms—to strengthen, broaden, and deepen the financial system*

Banking sector—considerably stronger

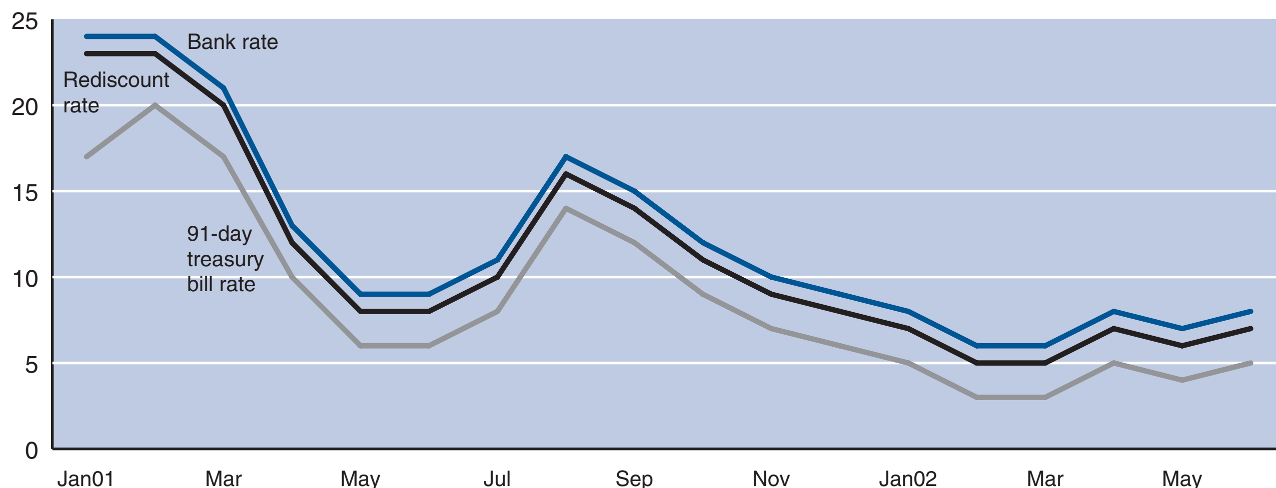
Uganda's financial sector has undergone considerable reforms—to strengthen, broaden, and deepen the financial system and to encourage competition within it. Full liberalization of interest rates and relaxation of entry requirements brought in new banks and other financial institutions. The Bank of Uganda has also instituted a framework for more effective supervision and enforcement of prudential regulations, including the recent increase in minimum capital requirements for financial institutions. As evidence of its strict surveillance of the financial sector since 1998/99 and its intolerance of unethical practices, the Bank of Uganda has closed four insolvent banks due to fraud and mismanagement.

A new Financial Institutions Bill, presented to parliament, strengthens licensing, specifies corporate governance requirements, tightens restrictions on insider lending and large loan exposures, and requires prompt corrective action for distressed banks.

Figure 2.5

Interest rates declining

Indicative policy rates, January 2001–May 2002 (%)



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

The financial sector is trying to reduce the cost of doing business. An electronic clearing system, inaugurated in May 2002, is expected to reduce the time to clear a cheque from three working days to two. To attract savers, most commercial banks have also introduced debit cards, cash cards, automatic teller machines, and specially packaged accounts. And to deepen the financial sector, enhance competition, and ensure a wider financial product range, the Bank of Uganda has allowed the entry of foreign banks.

> *The government has finally divested itself of banking business*

The government has finally divested itself of banking business through the Bank of Uganda's sale of the state-owned Uganda Commercial Bank (box 2.1). To continue to improve confidence in the banking sector it would help to create credit rating bureaus, strengthen bankruptcy laws, and quickly resolve nonperforming assets.

The reforms have improved Uganda's financial indicators (table 2.2). But it is too early to gauge how much confidence these reforms have generated among investors, domestic and foreign. But weaknesses remain in access to credit by smaller enterprises.

Fiscal policies and developments—pursuing prudent policies

Prudent fiscal management has had a big role in keeping inflation in single digits. With the limited potency of monetary policy, cash-budget management allowed fiscal

Box 2.1

Successful resolution of the Uganda Commercial Bank

An initial attempt to privatize the Uganda Commercial Bank to a Malaysian firm, Westmont, failed because of the poor handling of the divestiture and serious concerns raised by parliament on the process, prompting the Bank of Uganda's intervention.

Four banks were subsequently invited to conduct due diligence checks on the bank, two submitting bids to purchase it. The Bank of Uganda decided that selling the Uganda Commercial Bank to the international Stanbic would best meet its objectives. Stanbic bought 80% of the shares while the government retained 20%, available to the general public through the Uganda Securities Exchange.

There were various allegations of irregularities in the deal with Stanbic, particularly that the sale price was lower than the value of assets (*New Vision* 2003). But the U.K. auditors that investigated the allegations gave the all-clear sign to the deal.

The sale of Uganda Commercial Bank achieved the government's long-standing goal of getting out of the ownership and management of commercial banks. More important, the Bank of Uganda attracted a major international bank—with operations in 17 African countries, assets of $38 billion, and capital of $2.3 billion—to purchase the Uganda Commercial Bank and assume responsibility for its branch network and countrywide retail banking operations.

Source: *Bank of Uganda press releases: February 20, 2001; May 30, 2001; August 8, 2001; October 15, 2001; July 12, 2002.*

policy to respond to volatile movements in the foreign exchange market, unrealized revenue performance, and shortfalls in external budgetary support. Notable examples of the built-in flexibility: surrendering treasury bills to the monetary authorities, imposing a coffee stabilization tax during the 1994/95 coffee price boom, and cutting spending whenever there were shortfalls in programmed revenues, as in 1998/99. The negative impact of these actions on fiscal programmes was offset by the macroeconomic stability.

"The medium-term expenditure framework is the main mechanism for linking the poverty strategy to the budget"

Fiscal policy geared to poverty reduction

The government's medium-term fiscal programme has the dual aim of sustaining financial stability and supporting poverty reduction programmes. The medium-term expenditure framework is the main mechanism for linking the Poverty Reduction Strategy to the budget (box 2.2).

The fiscal deficit has been on the rise because of higher government spending on poverty reduction programmes. The fiscal deficit, on a cash basis, rose from 1.4% of GDP in 1997/98 to 5.5% in 2001/02, while the deficit, excluding grants, rose from 6.5% to 12.6%. The 2001/02 deficit was financed largely by donor assistance, which amounted to 11.7% of GDP, mainly reflecting budgetary support from the World Bank for a Poverty Reduction Support Credit (IMF 2002b).

Recurrent spending remained fairly constant throughout 1997/98 to 2000/01, rising significantly only in 2001/02. The rise was mainly due to higher spending under the Poverty Action Fund (channeling part of the debt relief under the Heavily Indebted Poor Countries Initiative), remuneration to members of parliament, and allocations for the state house, missions abroad, local government elections, and defense (Uganda, *Background to the Budget 2001/02*).

Defense spending is estimated to have risen to 5.3% of GDP in 2001/02, from 4.2% in the previous three years. The growth in the defense budget—especially the spending over and above the budget—is raising concerns for some donors. The government deems it necessary to address security in northern regions, where the poor identify insecurity as their main concern.

Table 2.2

Financial sector indicators, 2001 and 2002 (%)

Indicator	End-June 2001	End-June 2002
Financial depth (M2/GDP)	8.2	15
Private sector deposits (share of GDP)	5.0	11.0
Assets of the banking system (share of GDP)	12.1	26.7
Nonperforming assets (share of outstanding loans)	50.0	5.0

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

Meanwhile, development spending has been rising, financed mainly from external sources, which accounted for 71% during 1997/98 to 2000/02. Bolstering the domestic financing of development spending will be important for reducing this aid dependency.

Revenue performance—sluggish

Despite efforts by government to enhance collection, revenues have been sluggish, hampered by deficiencies in tax administration, a narrow tax base, noncompliance, and corruption. This weak revenue performance also puts the medium-term expenditure framework process in disarray.

"The fiscal deficit has been on the rise because of the higher government spending on poverty reduction programmes"

Several measures have been taken to improve the efficiency of tax administration and reform tax policy. In 1997 and 1998 the Income Tax Act streamlined exemptions and introduced accelerated depreciation allowances for investments in plant, machinery, and equipment.

Box 2.2

Linking the Poverty Reduction Strategy to the budget

Before 1992 Uganda produced yearly budgets. Fiscal policy was not linked to development planning, and changes in expenditure allocations were based on incremental adjustments to the previous year's budget.

Since 1997/98 the government has used the medium-term expenditure framework to allocate resources in a framework that ensures consistency with overall resource constraints and to align expenditure priorities with Poverty Reduction Strategies. The medium-term expenditure framework sets sector and district spending ceilings within a rolling three-year framework, considering macroeconomic developments and the prospects for resource mobilization, both domestic and external. District and sectoral working groups, comprising the Ministry of Finance and line ministries, then help develop sectoral priorities within the expenditure limits, ensuring that these are in line with Poverty Eradication Action Plan/Poverty Reduction Strategy priorities. The process culminates in working groups preparing sectoral and district Budget Framework Papers that get incorporated into the medium-term expenditure framework.

Within the medium-term expenditure framework the government initially created a Poverty Action Plan to earmark savings from debt relief under the HIPC Initiative for basic social services. Since then, the plan has attracted additional donor funds.

The medium-term expenditure framework has significantly improved the budget and planning process. It has also increased the harmonization of donor financing plans with Poverty Eradication Action Plan/Poverty Reduction Strategy objectives. But its success depends on the government's realizing the financing assumptions. For external funding, the timeliness and predictability of aid flows are crucial. Equally important is realizing domestic revenues as projected. More progress is needed on both fronts.

Source: *ECA 2001.*

In 2001/02, for the first time in three years, fiscal revenues increased, to 12% of GDP, mainly due to higher revenues from income and value-added taxes. But Uganda's revenue performance is still lower than the 20% for other Sub-Saharan African countries. Efforts are under way to expand the tax base, enhance tax compliance, and improve tax administration by stamping out corruption in the Uganda Revenue Authority. Only a thorough anticorruption programme will improve revenue collection in the medium term. The government recently granted ad hoc investment incentives to some entrepreneurs, a practice that could lower the already-low revenue performance.

> *"Poverty reduction efforts require that a large share of government expenditures be at the local government level"*

Weak capacity hinders fiscal transparency and service delivery

Measures to monitor and control spending have been introduced at central and local government levels. Domestic development outlays have been brought under the Commitment Control System to monitor, report, and enforce government spending commitments. Under the extensive decentralization that began in 1993, the government has also transferred a large volume of budgetary resources to districts, consistent with shifting the delivery of most public services to the districts.

There has been good progress in monitoring spending in education and health. But overall enforcement has been weak, because of low capacity in line ministries and local governments. It appears that local governments are not fully capable of coping with the decentralization of fiscal responsibilities, even less so now that poverty reduction efforts require that a large share of government expenditures be at the local government level. Tracking local government activities and expenditures has been problematic, with accounts not timely. Weak capacity thus hinders the main objective of decentralization—efficient service delivery.

External sector policies and developments

Exports are mostly agricultural products, with coffee the main export crop, and imports are mostly manufactured goods. The share of coffee in total export revenues fell from 59% in 1997/98 to about 19% in 2001/02, reflecting fluctuations in international prices. Revenues from nontraditional exports (fish, cut flowers, and gold) have grown steadily in recent years, showing progress in export diversification.

The persistent fall in international commodity prices has led to a downward trend in the terms of trade. Import prices were generally stable, while realized export unit values declined almost across the board (figure 2.6). The trade and current account balances have been in persistent deficit, widening over the years, a symptom of how much Uganda relies on donor assistance to finance its import bill.

Even so, the external position strengthened somewhat in 2001/02. The overall deficit was $2.8 million, down from $55.6 million in 2000/01. This was financed largely through

exceptional financing consisting mainly of debt cancellations under the HIPC Initiative and deferred debt payments to countries that have not accepted HIPC terms. Exceptional financing in 2001/02 stood at $105.1 million, with $72.2 million for debt cancellation under the HIPC Initiative and $32.9 million for repurchases made to the IMF.

Merchandise exports rose marginally

Merchandise exports rose slightly from $441.8 million in 2000/01 to $444.2 million in 2001/02, largely because of noncoffee exports. Coffee export receipts were down from $109.7 million in 2000/01 to $85.3 million in 2001/02 because of the drop in world market prices from $0.64 per kilogram to $0.45 (figure 2.7).

"Coffee export receipts were down from $109.7 million in 2000/01 to $85.3 million in 2001/02 because of the drop in world market prices"

Noncoffee export receipts were up 8% in 2001/02, rising to $358.9 million from $332.1 million. Fish exports rose to $80.9 million, up from $50.1 million (table 2.3). The increase was due to higher volumes and prices. Uganda's export destinations are now more balanced, with the European Union absorbing 29%, the Common Market for Eastern and Southern Africa (COMESA)[4] 20%, and Asia 19%. If sustained, this shift would reflect some success in market diversification, reducing overreliance on a few markets.

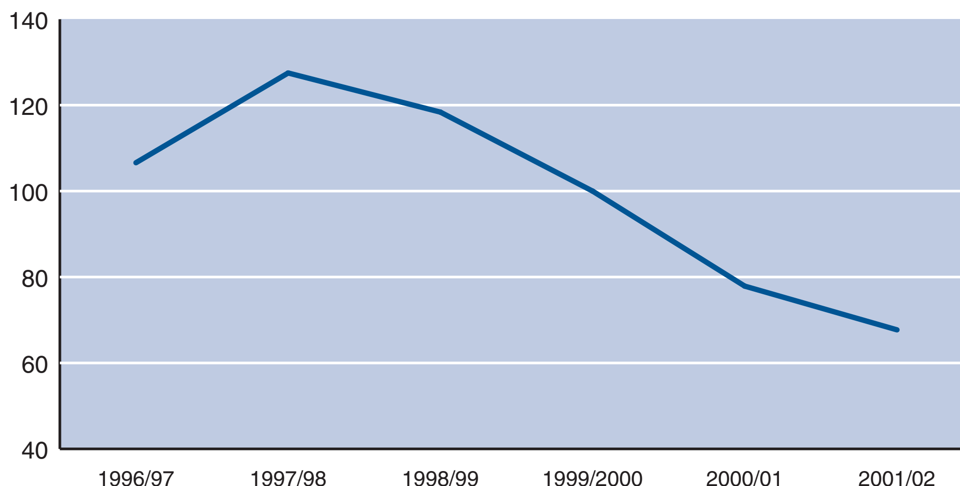
Merchandise imports on the rise

Total merchandise imports rose from $973.3 million in 2000/01 to $1,221.1 million in 2001/02, partly because of the increase in private nonoil imports, which were up 11% (table 2.4). Government imports also rose—from $121.9 million in 2000/01 to $136 million in 2001/02. With world oil prices lower, oil imports dropped from $136.1 million in 2000/01 to $124.7 million in 2001/02.

Figure 2.6

Terms of trade trending downward

Terms of trade, 1996/97–2001/02 (Index 1999/2000 = 100)

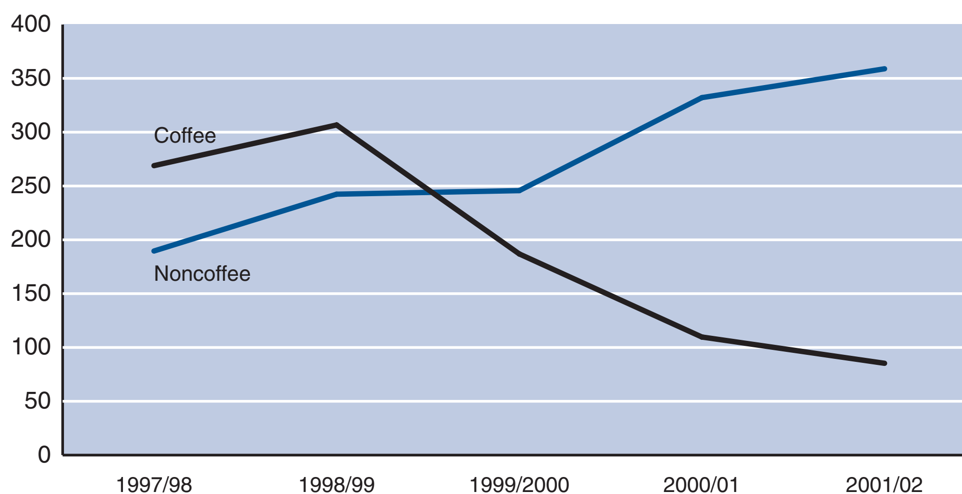


Source: *Economic Commission for Africa, from official sources.*

Figure 2.7

Exports diversifying away from coffee

Coffee and noncoffee export earnings, 1997/98–2001/02 (US$ millions)



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

Table 2.3

Trend and composition of exports, 1997/98–2001/02 (US$ millions)

Exports	1997/98	2000/01	2001/02[a]
Coffee	268.9	109.7	85.3
Total noncoffee	189.6	332.1	358.9
Cotton	11.4	14.1	13.3
Tea	35.0	35.9	26.9
Fish	28.0	50.1	80.9
Beans	2.2	2.0	1.5
Maize	8.1	6.1	13.1
Flowers	6.8	13.2	15.9
Gold	25.5	58.5	56.7
Tobacco	10.8	27.7	32.3
Simsim (sesame)	0.0	0.7	0.5
Electricity	12.0	16.7	13.9
Hides/skins	7.8	22.7	19.7
Cobalt	0.0	12.8	11.0
Others	42.0	71.6	74.0
Grand total	458.5	441.8	444.2

a. Estimated.

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

About 29% of imports come from COMESA, with Kenya, still the main source, accounting for 18%. Asia accounted for 27%, the European Union 24%, and the Middle East 10%.

Service exports and transfers—up marginally

Service exports rose from $187.7 million in 2000/01 to $193.4 million in 2001/02. Tourism, showing some recovery after the Bwindi National Park murders in 1999, accounted for 82% of nonfactor service exports. Payments for services abroad also increased, leaving Uganda a net importer of nonfactor services.

About 29% of imports come from the Common Market for Eastern and Southern Africa, with Kenya, still the main source, accounting for 18%

Private transfers continued to be a significant part of foreign exchange inflows, with net private transfers rising from $166.4 million in 2000/01 to $474.6 million in 2001/02, close to half from nongovernmental organizations. Official transfers to Uganda declined to $375.2 million in 2001/02, from $420.8 million the previous year.

The capital and financial account improves

Uganda removed all restrictions on international capital transactions in 1997 (box 2.3), and the capital and financial account recorded surpluses for the last five years, mainly because of donor funding. In 2001/02 the surplus was $473.2 million, up from $309.5 million the year before. Donor and private loan disbursements more than offset debt repayments. Foreign direct investment also grew, if marginally, from $143.8 million in 2000/01 to $145.7 million in 2001/02 (table 2.5).

Exchange rate policy—shilling remains stable

Uganda now operates a flexible exchange rate regime, allowing the value of the shilling to change against all other currencies in line with market conditions and the underlying economic fundamentals. Bank of Uganda intervention aims to reduce wide fluctuations, without targeting any predetermined level or trend. Its exchange rate policy is geared at creating a viable and sustainable external sector.

Table 2.4

Trend and composition of imports, 1997/98–2001/02 (US$ millions)

Imports	1997/98	2000/01	2001/02[a]
Total	966.2	973.3	1,221.1
Government imports	193.4	121.9	136.0
Project	170.8	89.6	108.8
Nonproject	22.6	32.3	27.1
Private sector imports	572.3	737.7	791.3
Oil	70.3	136.1	124.7
Nonoil	502.0	601.6	666.6
Other imports	200.4	113.7	293.8

a. Estimated.

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

The Ugandan shilling remained relatively stable against the dollar during most of 2001/02. The interbank weighted-period average mid-rate appreciated by 0.5%, compared with a depreciation of 16.5% in 2000/01, largely because of donor inflows and stronger noncoffee exports. On a few occasions during the year the Bank of Uganda increased net sales of dollars in the foreign exchange market to mop up excess liquidity. It was feared early on that lumpy and significant donor resources would appreciate the nominal and real exchange rates, hurting exports. But sterilization by the Bank of Uganda ensured that the exchange rate remained competitive.

The average nominal effective exchange rate appreciated by 2.3%, while the real effective exchange rate depreciated by 0.4% during 2001/02. But on an end-period basis, both rates depreciated, by 6.9% and 9.8% (figure 2.8).

Table 2.5

Balance of payments, 1997/98–2001/02 (US$ millions)

Balance of payments	1997/98	2000/01	2001/02[a]
Current account balance	–251.7	–365.1	–476.0
Exports (fob)	458.4	441.8	444.2
Imports (fob)	–966.2	–973.3	–1,221.1
Service (net)	–202.0	–293.0	–447.2
Income (net)	–83.9	–127.9	–101.7
Current transfers (net)	542.0	587.3	849.8
General government	507.0	420.8	375.2
Private transfers (net)	35.0	166.5	474.6
Capital and financial account	351.9	309.5	473.2
Capital transfers	40.6	0.0	0.0
Financial account	311.4	309.5	478.4
Foreign direct investment	120.0	143.8	145.7
Other liabilities	191.4	165.8	332.7
Medium and long–term loans	212.0	181.7	362.4
Debt amortization	–68.5	–81.9	–80.9
Short–term loans (net)	–20.6	–15.9	–29.7
Errors and omissions	18.1	–14.0	62.4
Overall balance	100.2	–55.6	–2.8
Financing items	–100.2	55.6	2.8
Use of IMF credit (net)	–4.6	–20.9	–37.0
Change in gross reserves	–128.6	–19.3	–127.7
Exceptional financing	14.9	109.7	105.1

a. Estimated.

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

Box 2.3

Liberalizing the capital account: a lesson for other countries?

Liberalization of the capital account in 1997 was preceded by successful macro reforms. These reforms reduced the fiscal deficit significantly and ensured financing of the remaining deficit in a noninflationary manner. They strengthened the prudential supervision and regulation of financial institutions, especially in foreign exchange risk exposure. They liberalized the domestic financial sector. And they restructured debt.

Uganda's experience with a liberal capital account cannot be compared with those of southeast Asian countries because Uganda's financial markets are not well developed and its markets are not liquid enough to facilitate the development of financial instruments that could attract portfolio investment.

Results so far are positive

The inflow of foreign capital—largely in trade flows, transfers, and investment flows—has been fairly large. Uganda has:

- Elicited participation in the domestic capital market, with some interest from foreign fund managers in shilling-denominated assets. The recent issue of East African Development Bank (EADB) bonds attracted foreign participation. And the promissory notes issued by the government have attracted foreign interest.
- Increased private sector investments.
- Shifted from shilling-denominated to dollar-denominated accounts, opening avenues for diversification of savings and borrowing for domestic agents.
- Ensured continuing fiscal discipline and prudent conduct of monetary policy.

But there may be challenges in the future

Foreign exchange inflows under a liberal capital account challenge the stability of the foreign exchange market and the management of liquidity.

- On many occasions, the authorities are constrained in their efforts to deal with inflows known to be temporary because of programme requirements to achieve a floor on net international reserves.
- The capital account was liberalized before a system was put in place to collect data on capital account transactions. The system for holding regular surveys and reporting requirements has just been developed. Laws revoking the Exchange Control Act of 1969 and liberalizing foreign exchange transactions have yet to be passed.
- Liberalization of the capital account created new forms of risk for domestic banks, which they have little experience managing.
- The vulnerability to speculative attacks and the possibility of contagion effects could cause massive outflows of capital.
- Instruments need to be developed to deal with the exposure risks and the uncertainty the private sector faces in a situation where markets and hedging instruments are lacking.

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

External debt management strategies and trends

Uganda's pursuit of sound macroeconomic policies and commitment to structural reforms enabled it to become the first country to qualify for debt relief under the HIPC Initiative. The usual three-year interval between the decision and completion points was reduced to one year, with a decision point set in April 1997 and the completion point reached in April 1998, when Uganda received $347 million in debt relief. Uganda also became the first country to benefit from the enhanced HIPC initiative in April 2000, when it secured $656 million in debt relief.

> *Even with debt relief under the HIPC Initiative, Uganda's debt sustainability has not improved much*

Even with debt relief, Uganda's debt sustainability has not improved much. Its stock of outstanding and disbursed external debt at the end of June 2002 was estimated at $3.8 billion, an increase of 11.5% over June 2001. The total debt stock as a ratio of GDP also rose to 68% in June 2002, from 65% a year before. In line with Uganda's debt strategy, which requires new borrowing on highly concessional terms, about 82% of external debt is owed to multilateral institutions (figure 2.9).

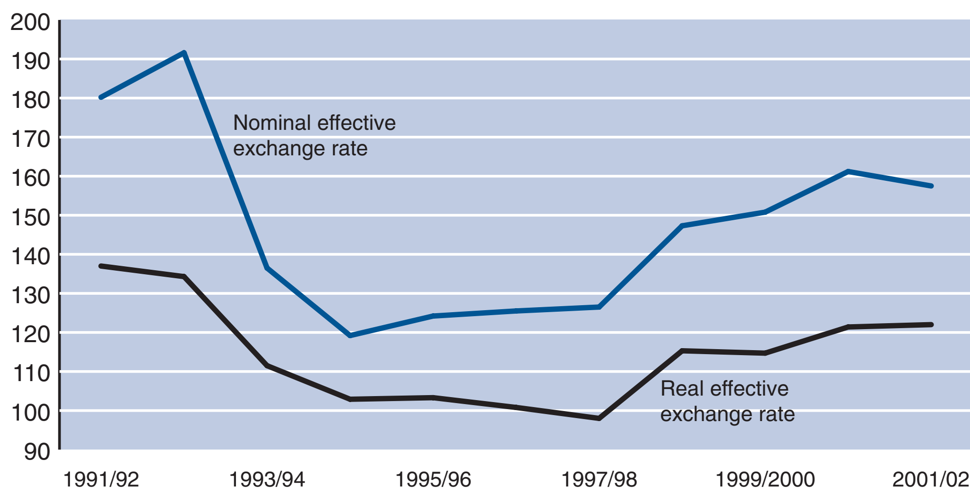
The ratio of debt service (including IMF maturities) to total exports of goods and nonfactor services was 24% in June 2002, down from 27% in June 2001. This was largely a result of increasing exports and a decline in debt service from $167.2 million to $153.8 million (table 2.6).

The debt and debt service indicators in net present value terms also show that Uganda's debt sustainability has not improved since it received HIPC debt relief. The net present

Figure 2.8

Shilling fairly stable against the dollar in 2002

Nominal effective and real effective exchange rates, period average, 1991/92–2001/02 (1990=100)



Note: *Downward movement is appreciation. An upward movement is depreciation.*

Source: *Bank of Uganda.*

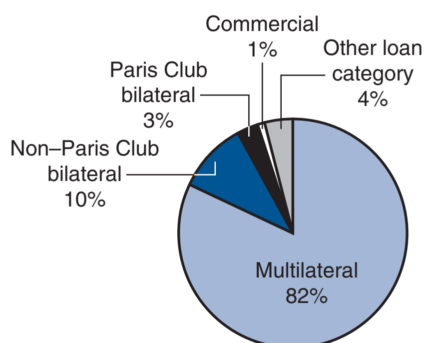
value of the debt to exports ratio increased from 171% in 2000/01 to 199% in 2001/02—and it is projected by the IMF to increase to 208% in 2002/03. Compare that with the threshold of 150% established under the enhanced HIPC framework. Similarly the net present value of the debt to GDP ratio is projected to increase from 20% in 2000/01 to 22% in 2000/03 (table 2.7). Improving debt sustainability is a priority for the medium term, but any external shocks to real GDP and exports or a severe depreciation of the shilling could easily derail Uganda's efforts.

> *Improving debt sustainability is a priority, but any external shocks to real GDP and exports or a severe depreciation of the shilling could easily derail efforts*

Figure 2.9

Most debt is multilateral

Share of outstanding public debt, by creditor, 2002



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

Table 2.6

Outstanding public debt, by creditor, June 1998–June 2002 (US$ millions)

Creditor category	End-June 1998	End-June 2001	End-June 2002[a]
Total debt stock	3,631.0	3,395.2	3,782.9
Multilateral	2,826.8	2,892.9	3,102.7
Non–Paris Club bilateral	423.6	341.3	371.7
Paris Club bilateral	324.4	122.9	115.0
Commercial	33.4	18.0	34.6
Other loan category	22.6	20.1	158.9
Debt service	173.7	167.2	153.8
Debt service to export of goods and nonfactor services (%)	27.4	26.6	24.1
Debt service to GDP (%)	1.4	0.7	0.6
Debt stock to GDP (%)	58.8	64.7	68.2

a. Estimates.

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

Social sector developments

Sound macroeconomic management that generated higher growth in the last decade enabled Uganda to improve the living standards of the population (table 2.8). The proportion of people living in poverty declined from 56% in 1992 to 35% in 2000. And thanks to higher public spending on basic services, most key education and health indicators improved. The government made tremendous progress in improving the efficiency of public spending on social services through the public expenditure tracking system (box 2.4).

The proportion of people living in poverty declined from 56% in 1992 to 35% in 2000—but one in three Ugandans still lives below the poverty line

These impressive gains aside, one in three Ugandans still lives below the poverty line. The overall poverty numbers also hide vast regional and urban-rural disparities. And despite the substantial increases in public spending on basic services, most social indicators are below the average of such comparator countries as Ghana, Kenya, and Zimbabwe. The HIV/AIDS epidemic, though now under control, has also taken a toll on social indicators.

Table 2.7

Debt sustainability indicators, 2000/01–2002/03 (%)

Indicator	2000/01	2001/02	2002/03
Net present value of debt to exports ratio[a]	170.9	199.0	208.7
Net present value of debt to revenue ratio	186.9	180.1	181.8
Net present value of debt to GDP ratio	20.3	21.2	22.4

a. In relation to the average of three consecutive years of exports of goods and services ending in the recent year.

Source: *IMF 2002b.*

Table 2.8

Social indicators, latest years

Region/country	Infant mortality rate (per 1,000 live births) 2000	Under-five mortality rate (per 1,000) 2000	Life expectancy at birth (years) 2000	Combined gross enrolment rate, primary, secondary, and tertiary (%) 1999[a]	Adult literacy rate, ages 15 and older (%) 2000
Sub-Saharan Africa	107	174	48.7	42	61.5
Uganda	81	127	44.0	45	67.1
Ghana	58	102	56.8	42	71.5
Kenya	77	120	50.8	51	82.4
Nigeria	110	184	51.7	45	63.9
Tanzania	104	165	51.1	32	75.1
Zambia	112	202	41.4	49	78.1
Zimbabwe	73	117	42.9	65	88.7

a. Preliminary UNESCO estimates subject to revision.

Source: *UNDP 2002.*

Poverty reduction is at the heart of the country's development strategy. The Poverty Eradication Action Plan/Poverty Reduction Strategy sets out to reduce income poverty to 10% of the population by 2017 by creating a better enabling environment for economic activities and by directly increasing living standards.

Spatial dimensions of poverty

Mean consumption per adult equivalent rose by 4.6% a year between 1992 and 2000, but the growth was much higher in urban areas (6.2%) than in rural (3.9%). Within rural areas, regions with higher initial incomes grew faster—in rural central by 5.2% a year, in rural western by 4.5%, in rural eastern by 3.9%, and in rural northern by only 0.5%.

> *The largest reduction in poverty was reported in the central region*

A similar disparity can be observed in the dynamics of poverty. Of urban households that were poor in 1992, 61% moved out of poverty by 1996, but of rural households only 39% did (Okidi and Mugambe 2002).

The north is significantly poorer. The largest reduction in the proportion of people in poverty was reported in the central region (from 46% in 1992 to 20% in 1999), where the initial incidence of poverty was the lowest in 1992 (figure 2.10). Both the eastern and western regions also saw poverty decline, though to a lesser extent. But in the northern region the incidence of poverty increased to 65% in 1999 from 59% two years earlier. A similar picture emeres when comparing poverty dynamics across regions. In the northern regions only 27% of the households that were poor in 1992 moved out of

Box 2.4
Public funds finally reach schools

In 1996 Uganda became the first country to apply a public expenditure tracking system. Its use was prompted by the observation that despite a substantial increase in public spending on education since the late 1980s, officially reported primary enrollment remained stagnant.

The survey quantified the adverse effects of asymmetric information on the flow of funds. It found that 87% of nonwage funds allocated to districts either disappeared for private gain or were used by district officials for purposes unrelated to education. Following publications of the survey findings, the central government began publishing the monthly intergovernmental transfers of public funds in major newspapers and broadcasting the information on radio, and required primary schools to post information on inflows of funds for all to see. This not only made information available to parent and teacher groups, but also signaled to local governments that the center had resumed its oversight function, creating incentives for increased accountability among local agencies.

Initial assessments of these reforms a few years later, through two locally implemented follow-up surveys, show that the flow of intended capitation grants improved dramatically, from 13% (on average) reaching schools in 1991/95 to about 80–90% reaching schools in 1999 and 2000.

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

poverty by 1996, far less than in eastern (37%), western (60%), and central (63%) regions (Okidi and Mugambe 2002). The north has disadvantages of remoteness, continuing civil conflict, unfavourable agroclimatic conditions, low population density, and many internally displaced people (box 2.5).

> *In the northern region the incidence of poverty increased to 65% in 1999 from 59% two years earlier*

Several factors may explain these spatial variations in growth and poverty reduction. First, Uganda's growth in the 1990s reflects its recovery from disaster. By 2000 the economy was just returning to the income per capita of the early 1970s. Disastrous economic policies, invasions, and civil war had undermined the formal economy and caused "a retreat to subsistence". This hit urban areas more than rural areas. So when security and a stable economic policy framework were restored, there was more scope for the formal economy to bounce back, and economic opportunities improved more in urban areas. This may also explain the better performance of central rural areas, likely to have benefited from proximity to major urban centres.

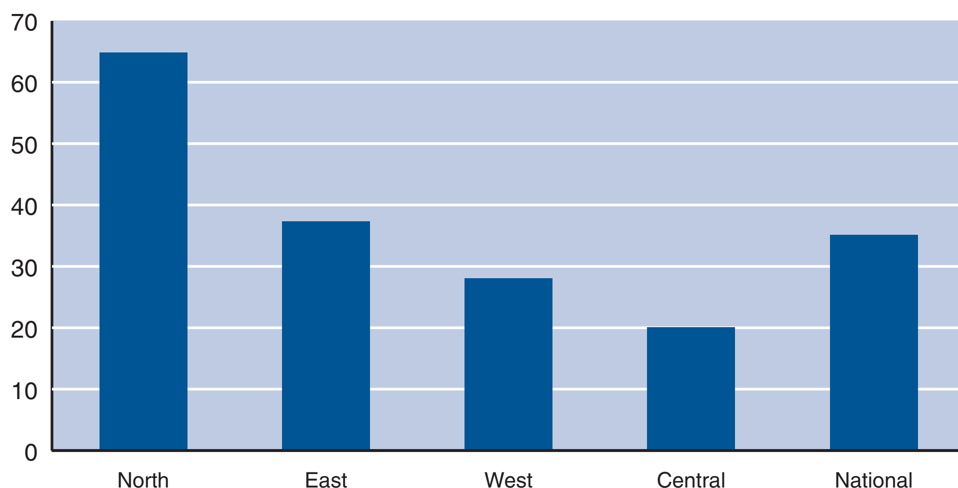
Second, the restoration of security has been uneven. The slow growth of northern rural areas—and to some extent eastern—reflects not only distance from the cities but also poor security. Indeed, it is possible that security did not improve in some parts of the country—four districts were excluded from the 1999/2000 poverty survey due to insecurity, up from two in 1992/93 and none in 1993/94.

Third is the local impact of the coffee boom in 1994/95, when unit values for Ugandan coffee exports rose to $2.55 a kilogram from $0.82 in 1992/93. Coffee accounts for a sizable share of income only in the western and central regions—it is not grown in the

Figure 2.10

Poverty incidence highest in the north

Proportion of population in poverty, by region, 1999/2000 (%)



Source: *Appleton and others 1999; Appleton 2001.*

north. It is likely that much of the windfall was saved, resulting in a permanent rise in income (Collier and Gunning 1999).

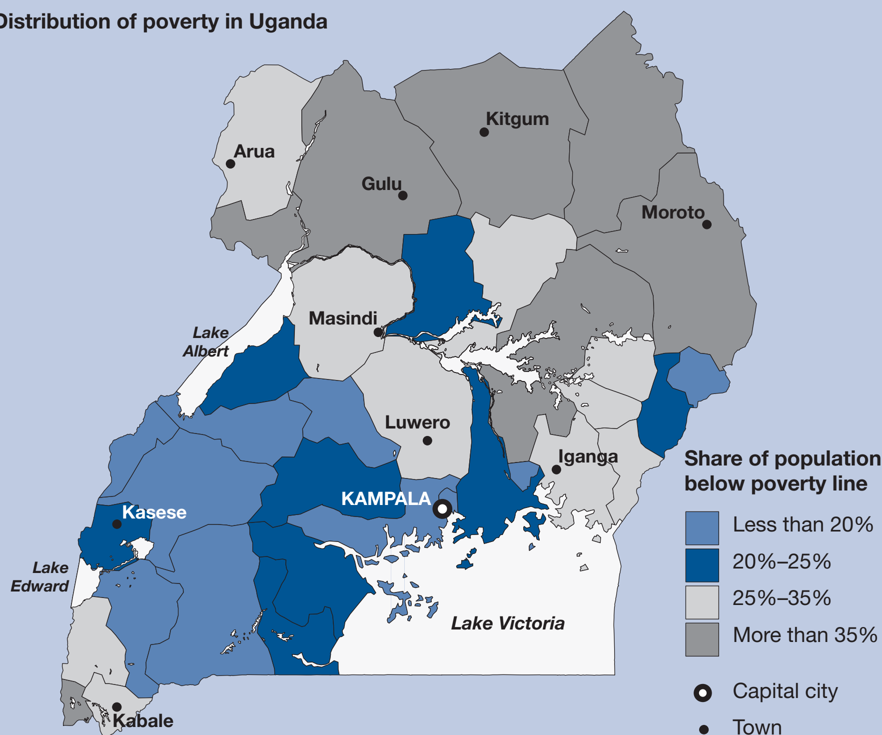
Poverty in food crops sector. There are wide disparities in the ability of various socio-economic groups to benefit from economic opportunities created by the stable macro-economic environment. The food crop sector, mainly subsistence farming, was the poorest in 1992, with poverty declining from 64% in 1992 to 58% in 1996 (Okidi and

Box 2.5

The untold side of the success story

The benefits of Uganda's high growth have not been evenly distributed across the country. There are still great inequalities between the more affluent central crescent around Lake Victoria and the drier, more disadvantaged northern region. The north lags far behind the rest of the country in food security, health, and education.

The northern districts have suffered deaths, torture, abduction of children, disruption of livelihoods, and displacement. More than 800,000 people have been displaced by civil war and live in squalid camps. Another 150,000 refugees in 66 settlements in eight districts are also in need of food. According to the World Food Programme 108,000 tons of food were needed for the first six months of 2003 to avoid famine in the war-torn north.



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

Mugambe 2002). Compare that with cash-crop farming, the second poorest in 1992, with 60% in poverty, but that then dropped to 41% in 1996. The removal of market controls on coffee benefited smallholder coffee farmers, enabling them to get better farmgate prices, especially with international coffee prices high in the mid-1990s.

"The downward trend in poverty emanated from faster economic growth, not from a redistribution of wealth"

National welfare inequality has not changed much over the years. So the downward trend in poverty emanated from faster economic growth, not from a redistribution of wealth. Those who remained poor have not had access to the economic opportunities created by high growth. They may be subsistence farmers, who do not operate in the formal economy. They may lack human and technical skills to benefit from new opportunities. They may belong to vulnerable groups—women, children, refugees. And they may be subject to disruptions from war and natural disaster.

The government is working to improve fiscal decentralization, equalization grants, social spending, targeted intervention programmes, and agricultural development programmes. But more commitment is necessary to address the deep pockets of poverty by concentrating on the priorities identified by the poor themselves: improving security, curbing corruption, and increasing access to basic social services, infrastructure, and markets (Uganda, Ministry of Finance, Planning, and Economic Development 2000). Establishing political stability and ending the economic alienation of the north region should be a key priority for the government.

Poverty-sensitive distribution of resources

The pattern of government expenditures through various fiscal transfer mechanisms may not adequately redress regional inequalities. (The analysis here draws on Uganda 2002.) The transfer formula allocates 85% of transfers according to district population and 15% according to geographical area. This formula applies to the Local Government Development Programme, the Unconditional Grant, the Plan for Modernization of Agriculture Grant, the National Agricultural Advisory Services Grant, and the Agriculture Extension Grant.

The regional distribution of transfers to local governments indicates that of 501.9 billion Ugandan shillings (around a quarter of the budget for 2001/02), the western region received the largest share (27%), followed closely by the eastern (26%), the central (25%), and the northern (22%).

On the basis of recent trends in economic growth and regional inequality, the Ministry of Finance, Planning, and Economic Development has analyzed the geographical pattern of government expenditure under the medium-term expenditure framework and come up with a weight that would be poverty-sensitive, using three factors to determine transfers:

- *Population size:* Districts with a higher population should receive more resources because they carry a higher burden of service delivery.

- *Geographical area:* Larger districts should receive more resources, because it is more costly to provide services to a geographically disbursed and isolated population.
- *Poverty level:* Poor districts should receive more transfer payments, because with their limited economic activity, they have a lower tax base than rich districts.

For illustrative purposes, the ministry gives the following weights—population (60%), area (20%), and poverty (20%)—and using these weights it develops a poverty sensitive distribution.

The central and western regions have bigger populations (28%) than the eastern (25%) and northern (19%). The northern region is the largest in area (42%), followed by the western, central, and eastern. The central region has the biggest share of total household expenditure (39%), followed by the western (27%), eastern (23%), and northern (11%).

Given the weights in this example, a poverty-sensitive distribution would allocate 29% to the northern region (up from 23%), 26% to the western, 23% to the central, and 22% to the eastern. Increasing the allocation to the north could be done only after displaced people are resettled in their home villages and provided decent homes.

> *Primary education now receives about 70% of the education budget*

Education—primary education for all

Government policy on education is to increase the access to primary education. In 1997 the government launched the Universal Primary Education (UPE) programme, entitling up to four children per family to free primary education (the president recently announced its extension to every child). Primary education now receives about 70% of the education budget. The public expenditure tracking system, introduced in 1996, made sure that 80–90% of funds actually reached schools in 1999/2000 (see box 2.4).

The programme has the potential to be one of the most important poverty reduction strategies in Uganda. Estimates of the direct impact of education show that universal primary education would increase agricultural production by about 15%, more than the agricultural productivity gains from access to roads and extension services (Deininger and Okidi 2001). The improvement in primary education indicators has been substantial (table 2.9).

Table 2.9

Primary education indicators, 1994/95 and 2001/02

Indicator	1994/95	2001/02
Public expenditure on education (% of government expenditure)	15.0	24.4
Enrolment rate in primary schools (%)	55	98
Ratio of girls to boys	45:55	45:55
Primary school dropout rate (%)	70	6.6

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

With tremendous achievements in quantity, greater efforts are now needed in improving quality indicators, such as the number of qualified teachers and the pupil-teacher and pupil-classroom ratios. The government is also reforming higher education, with enrolment already rising.

Uganda became one of the first countries in Africa to reverse the HIV prevalence rate in the adult population—from 15% in 1993 to about 7% in 2002

Health—fighting illness on all fronts

The Uganda (2002) Participatory Poverty Assessment identified ill health as the most frequently cited cause and consequence of poverty by the poor. The government has responded by allocating more resources, increasing the number of health facilities across the country, and re-orienting health services from curative to preventive, with particular attention to health education and information and to public health programmes.

Uganda's aggressive response to HIV/AIDS shows the government's commitment to fighting ill health on all fronts. The government's first policy actions were to open a public debate on HIV/AIDS, taboo at the time, and to call for international assistance. The government then increased civil society participation in HIV/AIDS programme planning and design, to build awareness across the country. Most important, the government took a multisectoral approach to AIDS, involving 12 line ministries.

The strategy paid off. Once number one in the world for HIV infections, Uganda became one of the first countries in Africa to reverse the HIV prevalence rate in the adult population—from 15% in 1993 to about 7% in 2002. The largest decline was observed among adolescents (ages 15–19)—from 32% in 1992 to 10% by 1998. But tackling the issue of AIDS orphans—8% of Africa's children orphaned by AIDS live in Uganda—remains a priority.

Other performance indicators have improved as well (table 2.10). Infant mortality has declined from 88 per 1,000 births in 1995 to 81 in 2000. The percentage of one-year-olds fully immunized rose from 66% in 1995 to 83% in 2000 and more than 90% in

Table 2.10

Health indicators, 1995 and 2000

Indicator	1995	2000
Public expenditure on health (% of GDP)	1.6	7.0
Infant mortality rate (per 1,000 live births)	88	81
Under-five mortality rate (per 1,000)	141	127
Maternal mortality ratio (per 1,000 live births)	12	5
Life expectancy at birth (years)	40.5	44.0
Share of people with access to safe water (%)	46	50
Share of people with access to sanitation (%)	57	80
Share of one-year-olds fully immunized (%)	66	83

Source: *UNDP 2002; Economic Commission for Africa, from official sources.*

2002. Accessibility to health care improved from 49% in 1995 to 70% in 1999 and about 80% in 2001. The challenge now is to ensure improvements in the quality of medical care.

Unleashing the private sector—many challenges to surmount

Infant mortality has declined from 88 per 1,000 births in 1995 to 81 in 2000

The potential of macroeconomic reforms to increase growth and reduce poverty has now been largely exploited. Providing further impetus to growth requires a deeper reform agenda to create an enabling environment for the private sector—reforms to make difficult governance and structural changes.

The average real GDP growth rate of 6% over the last decade, though impressive, is still below the target 7% a year required to achieve the government's goal of reducing income poverty to 10% by 2017. Lifting growth by one notch thus falls squarely on the private sector. For a predominantly rural agrarian economy, private sector–led growth hinges on modernizing and diversifying agriculture. Since the majority of the poor make a living out of agriculture, such policies would also reduce poverty.

Throughout the last decade the government has undertaken a series of reforms to address private sector development and create an investor-friendly environment: removing controls on agricultural products, particularly for coffee, liberalizing trade and international capital flows, and privatizing state-owned enterprises.

So far the domestic sector has not responded strongly. Even though inflows of foreign direct investment increased steadily from about $54 million in 1993 to about $145 million in 2002, they are not an adequate response to Uganda's impressive economic management.

The private sector identifies the high price and low quality of utility services and high taxes and interest rates as major constraints to investment (figure 2.11). Corruption, access to finance, tax administration, and the cost of raw materials are next in line as leading constraints.

The government is trying to tackle some of these constraints. The Uganda Electricity Board—a 100% government-owned monopoly since 1964—was unbundled into separate generation, transmission, and distribution entities and privatized. Generation capacity increased from 260 MW in 2000 to 300 MW in 2002 with the addition of two turbines at Kiira Power/Owen Falls extension.

In December 2001 the World Bank Group agreed to support the Bujagali Hydropower Project in Uganda, describing it as a key investment in poverty reduction for a country in which less than 3% of the population has access to grid-supplied electricity. The

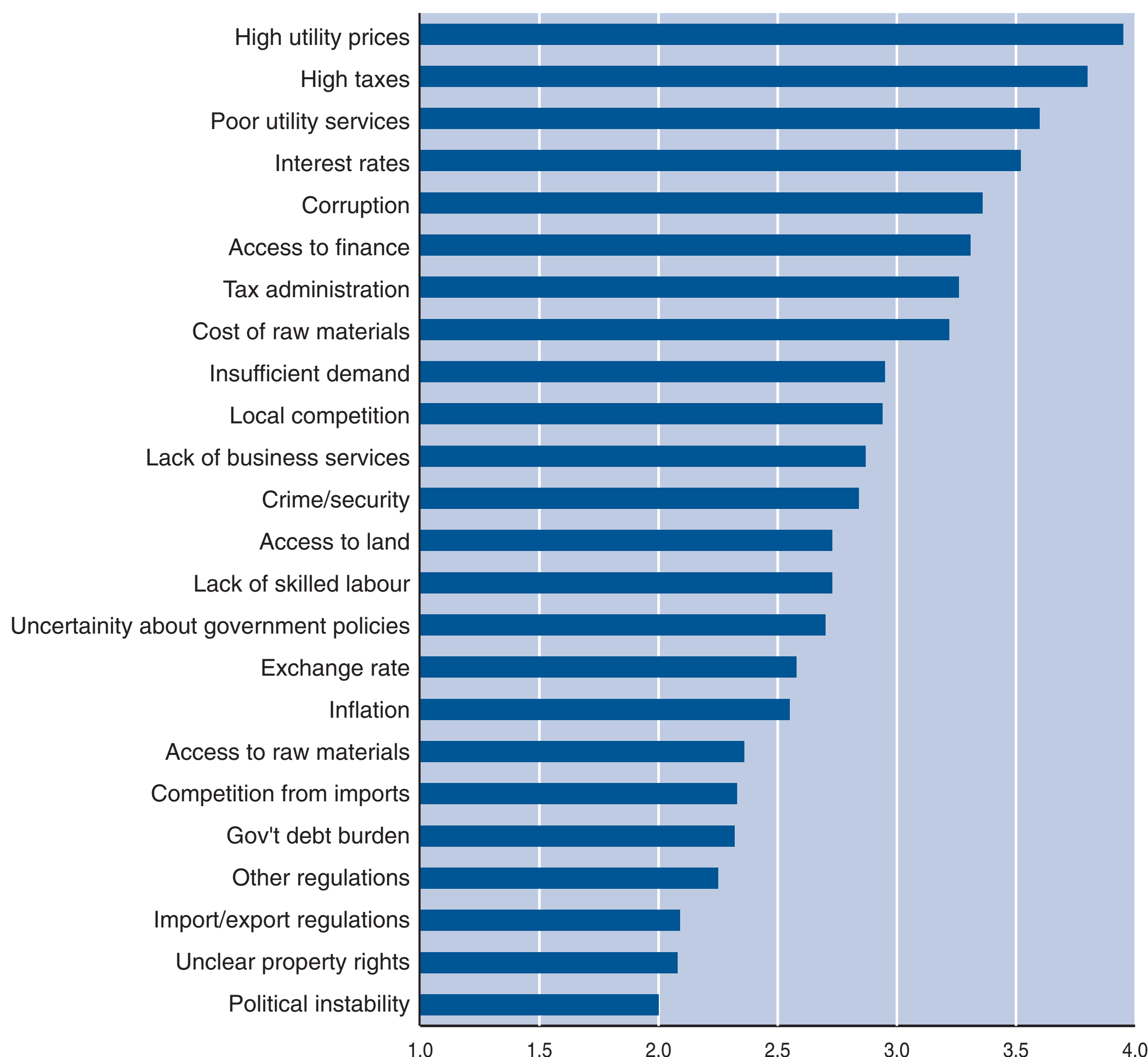
hydropower station will be built, owned, and operated by AES Nile Power Limited, a private firm. The sponsor is the AES Corporation, a public corporation headquartered in Arlington, Virginia.

Telecommunications prices have declined and access has greatly improved with the entry of two additional mobile telephone providers—MTN of South Africa and Telecel of Switzerland. Attempts have been made to strengthen tax administration by changing the senior management of the Uganda Revenue Authority. Security concerns have also been

Figure 2.11

High utility prices, taxes, and interest rates top constraints to investment

Private sector–identified constraints to investment



Note: *1=no obstacle, 2=minor, 3=moderate, 4=major, 5=severe*

Source: *Reinikka and Svensson 1999.*

addressed with Operation Wembley—a zero-tolerance crackdown on armed robbers in June 2002. While the government has tried to improve the business environment, more needs to be done, particularly in the financial sector, infrastructure, and governance.

Improving access to the financial sector

Uganda's financial sector, after many reforms, has emerged much stronger in recent years. But weaknesses still exist in access to credit. Commercial bank lending rates are still prohibitively high. Limiting the ability of small enterprises to borrow are high collateral requirements by banks and the fact that land is not accepted as collateral. Most small firms have access to credit only through microfinance institutions, which operate in a regulatory vacuum.

"Uganda's financial sector, after many reforms, has emerged much stronger in recent years—but weaknesses still exist in access to credit"

With the majority of poor people in rural areas and engaged in agriculture, strengthening microfinance should be a priority. Reform will address the problem of outreach. It will minimize the risk of exposure for clients. It could offer a reliable institutional setup to mobilize savings in rural areas (Kasekende 2002). And it could improve the health of the financial sector.

Improving infrastructure

The government is developing and maintaining infrastructure facilities to reduce the cost of services and improve quality and accessibility. Limiting itself to a regulatory role, the government aims to increase private participation in the operation, financing, and ownership of infrastructure services. Already, there are signs of greater competition and efficiency.

The government is also overhauling postal, telecommunications, energy, water, and transport services, long a major constraint. The benefits of liberalizing the telecom sector are already being felt, but the benefits from other utility privatizations have yet to be seen. Regulatory structures need to be improved along with privatization to realize the benefits.

With significant budget increases over the last four years, the main road programme is funded at 90% of the Poverty Reduction Strategy requirement. But the rural road programme, also crucial, is still underfunded (UN 2002).

Transport and other import-related costs add about 50% on average to the cost of imported inputs (Reinikka and Svensson 1999). Being landlocked makes transportation more expensive. Processing time and unexpected delays create additional burdens. It takes 30 days on average for imported inputs to reach the nearest port (typically Mombasa), another 30 days to reach Ugandan customs, and another 9 days to reach the firm.

Addressing governance—some way to go

Concerns about governance, particularly corruption and insecurity, are high on the list of constraints to private participation in economic activities. These are also highlighted by the poor as impediments to their livelihoods.

Corruption—strong commitment needed. Corruption in Uganda, prevalent in the highest levels on down, significantly increases the cost of doing business. Firms and households identify police and the judiciary as the most corrupt. The Uganda National Integrity Survey of 1998 reveals that 63% of respondents paid bribes to police officers and 50% had bribed court officials. Corruption in the police forces is well documented in the Sebutinde report that investigated police corruption in 2001 (box 2.6).

The government has taken several steps to enhance the integrity and accountability of its institutions

On the positive side, corruption is now discussed openly, particularly in the media, and government inquiries are launched on several cases. The population is becoming less tolerant of corruption in high places. The government, partly pressed by donors over the misuse of their funds, has taken several steps to enhance the integrity and accountability of its institutions. Recent measures:

- Strengthening anticorruption institutions—the Inspector General, the Auditor General, and the Department of Public Prosecution—through capacity building and additional budgetary resources.
- Establishing a Ministry of Ethics and Integrity to set standards and inquire into matters related to corruption.

Box 2.6

Poor governance widespread in the public sector

According to the Transparency International corruption perception index of 102 countries for 2002, Uganda ranks 92. A national survey on corruption in the public sector, conducted in 1998, partly explains why Uganda still has such a bad ranking. About 70% of households interviewed reported corruption in public services to be very high, especially among the police and judiciary.

Based on the percentage of service users who paid a bribe, Mbale District was found most corrupt, with an amazing 73%, and Kisoro District the least corrupt, with only 11%. Users who pay bribes reported that they do not even get better services.

The factors leading to the spread of corruption are deep-seated, dating to independence and Idi Amin's years in power.

By the time President Museveni came to power, Uganda had experienced virtually every kind of corrupt practice imaginable. The new administration made clear that it viewed corruption as one of the evils inherited from the past and a key obstacle to progress. But the fight against corruption is still difficult. For instance, the Sebutinde report on corruption in the Uganda Revenue Authority shows how staff acquired wealth by helping importers evade taxes. The corruption indicator of the *International Country Risk Guide* also shows that perceived corruption has become worse in the past five years.

The press has been of great importance in curbing corruption and providing the public with information about reforms. The government recognizes the value of a free press, with the state-controlled media fairly free to report on abuses of public office.

Source: *Transparency International 2002; Uganda 1998.*

- Initiating inquiries into corruption in public services, including investigations of police forces and employees of the Uganda Revenue Authority.
- Introducing a leadership code for declaring assets and incomes of government officials and parliamentarians.

As voiced by the Minister of Ethics and Integrity, the government has so far failed to address corruption effectively (EIU 2002). The challenge is to muster political will at the highest levels to implement the anticorruption strategy. That would stamp out corruption and reassure investors, both domestic and foreign, about the prevailing business climate in the country.

> *The challenge is to muster political will at the highest levels to stamp out corruption and reassure investors about the prevailing business climate in the country*

Insecurity persists in many parts of the country. The poor security situation in many parts of the country remains a serious constraint to private activities and overall development. Armed conflicts have severely impaired livelihoods in the north and some parts of the west and east. The north, where a bush war has been waged for the last 10 years, has suffered the most. In the west, Uganda's involvement in the Democratic Republic of Congo was a major concern. A UN panel recently reported alleged looting of Congolese wealth by members of the Ugandan armed forces (UN 2001).

Persistent conflicts do not bode well for maintaining political and fiscal stability or attracting external funding from donors and foreign investors. Poor people living in conflict-ridden regions, the biggest losers, identify ongoing wars, rebel activity, cattle raiding, and theft as their biggest concerns (Uganda, Ministry of Finance, Planning, and Economic Development 2000). This is telling indeed.

Medium-term outlook—promising

The medium-term outlook is promising. GDP is projected to grow at an average of 5% in 2002/03 and 6% over the next two years, and the annual underlying and headline inflation rates are expected to remain below 5%. Gross domestic investment is expected to rise to more than 22% of GDP, while domestic and national savings will remain within the current range. Revenue is also projected to rise to about 13% of GDP, and gross reserves to remain at about six months of future imports. With stronger revenues the fiscal deficit is projected to decline to about 11% of GDP (excluding grants) in 2002/03 and 10% in 2003/04. Export receipts are projected to increase by about 10% a year, with the terms of trade improving as the diversification drive gains momentum.

But significant risks lie ahead. The aid dependence of the budget and development programmes and the high military expenditures are concerns. Moreover, negative shocks to GDP growth or exports could severely affect the external debt profile. So sustaining macroeconomic stability and high economic growth rates should be the key objectives of economic policy in the medium term. Any policy slippage would compromise the national development objective of reducing poverty.

Despite commendable gains in poverty reduction, one in three Ugandans still lives below the poverty line, and most social indicators are still below the average for comparator countries. Improving poverty and social indicators requires faster growth, from 6% a year to 7% to achieve the country's goal of reducing poverty to 10% by 2017. Having now largely exploited the potential for economic growth through sound macroeconomic policies, the medium-term challenge would be to find a new source of growth: the private sector.

Creating an enabling environment for the private sector requires deeper structural and governance reforms. The government has to deepen financial reforms, improve the provision of public services, and address widespread corruption and insecurity in many parts of the country. Uganda has a challenging task ahead before taking off.

Notes

1. Headline inflation is based on relative changes in prices of all goods and services. All conversions from Ugandan shillings to U.S. dollars are based on the end period exchange rate for June 2000.

2. M3 includes currency in circulation and private sector deposits, including foreign currency deposits.

3. M2 includes currency in circulation and private sector deposits, excluding foreign currency deposits.

4. COMESA member countries include: Angola, Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, and Zimbabwe.

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Chapter 3

Rwanda—HIPC Contradictions Restrain Development

Amid war, genocide, and conflict in neighbouring Burundi and the Democratic Republic of Congo, the Rwandan economy grew by 9.9% in 2002. This impressive performance was driven partly by favourable weather that boosted agricultural output. Inflation stayed under 4% in 2001 and 2002. But the large spending requirements of social reconstruction raise problems for macroeconomic policy, particularly fiscal management.

> *"The large spending requirements of social reconstruction raise problems for macroeconomic policy"*

In the years after the civil war, security had to be reestablished in the face of threats by armed groups. A grave humanitarian emergency followed the killing of 800,000–1,000,000 people in a population of 7.5 million in the spring of 1994. The violence also displaced some 2 million civilians and destroyed infrastructure and assets. Rural areas suffered particularly from the loss of labour and livestock. The proportion of people in poverty rose from 48% in 1985 to 68% in 2000. In addition, female-headed and child-headed households had little access to land or labour markets.

Despite these challenges the fiscal deficit fell from 13.2% of GDP in 1996 to 8.3% in 1998. But it bounced back to 11% of GDP in 2002 and will remain high over the medium term. The Poverty Reduction Growth Facility, agreed in late 2002 with the International Monetary Fund (IMF), made some allowance for "exceptional" expenditures for people's courts (*gacaca*), demobilization, the genocide survivors fund, and three governance commissions. But some development partners recommend that Rwanda, with large fiscal deficits financed by grants and international borrowing, should reduce the deficit in the medium term rather than mobilize additional resources.

Further contradictions have emerged with Rwanda's heavily indebted poor country (HIPC) status. The use of exports in the HIPC debt sustainability ratios means that the level of debt to exports will be high for countries with low exports, such as Rwanda. This has increased the debt relief, but it also means reductions in new borrowings to maintain the sustainability of debt. So, over the medium term, rising spending needs for poverty reduction and post-genocide reconstruction make it unlikely that Rwanda can adhere to low debt to GDP ratios as required by the HIPC Initiative—because that would reduce the government's ability to contract new loans. Clearly, adherence to HIPC debt ratios has hidden costs that may easily outweigh the benefits.

A longer term development policy and reform agenda is articulated in the government's *Vision 2020,* with the objective of becoming a middle income country. Poverty reduction objectives have been crystalized in the Poverty Reduction Strategy and institutionalized through more transparent budgetary procedures (box 3.1).

Box 3.1
Rwanda's Vision 2020

Eight years on from the 1994 genocide, Rwanda is entering a new phase of reconstruction, set out in the *Vision 2020*. The key parts of *Vision 2020*:

Good governance. Grassroots democratization is essential for increasing popular participation. Given recent history, security is also a priority, along with the promotion of human rights. Sound economic management and macroeconomic stability are also an integral part of good governance.

Rural economic transformation. Recapitalization and transformation of the rural economy are essential to increase agricultural incomes and off-farm employment.

Development of services and manufacturing. Development of industrial and service sectors and the reestablishment of Rwanda as a regional trade center are other important sources of growth.

Human resource development. Rwanda has a scarcity of human capital. Increases in educational attainment are required to close the skills gap. Better health care services are also a priority, to reverse the decline in health indicators and deal with malaria and HIV/AIDS.

Development of the private sector. The business environment needs to be reformed to reduce the risks of doing business in Rwanda. Liberalization, privatization, and increased public-private partnership are also needed, as well as formalization of the informal sector.

Regional and international economic integration. Rwanda, a member of the Common Market for Eastern and Southern Africa (COMESA), is committed to exploiting the opportunities offered by similar frameworks, including the U.S. Africa Growth and Opportunity Act (AGOA).

Poverty reduction. This is the ultimate aim of all other objectives. Reduction of inequality is also essential, including that arising from gender and age.

Selected targets for *Vision 2020*

Indicator	2000	2020 target
Literacy (%)	48	100
Life expectancy (years)	49	55
Infant mortality rate (per 1,000 live births)	110	30
Poverty (% under $1 a day)	64	30
Erosion-protected land (%)	20	100
Secondary teachers, qualified (%)	20	100

Source: *Rwanda Ministry of Finance 2002b, 2002c.*

Recent economic developments

Growth over the last 10 years was strongly affected by the genocide of 1994 (box 3.2), when GDP collapsed by around 50%, and then by the postwar reconstruction, when it boomed to 18% on average between 1995 and 1998. After that, growth stabilized, falling to 6% in 2000 and 6.5% in 2001. Despite strong growth in recent years, per capita GDP has not returned to prewar levels (figure 3.1). Sustained per capita income growth, rising living standards, and poverty reduction have remained limited by structural and environmental constraints. Productivity growth in agriculture, by far the largest sector

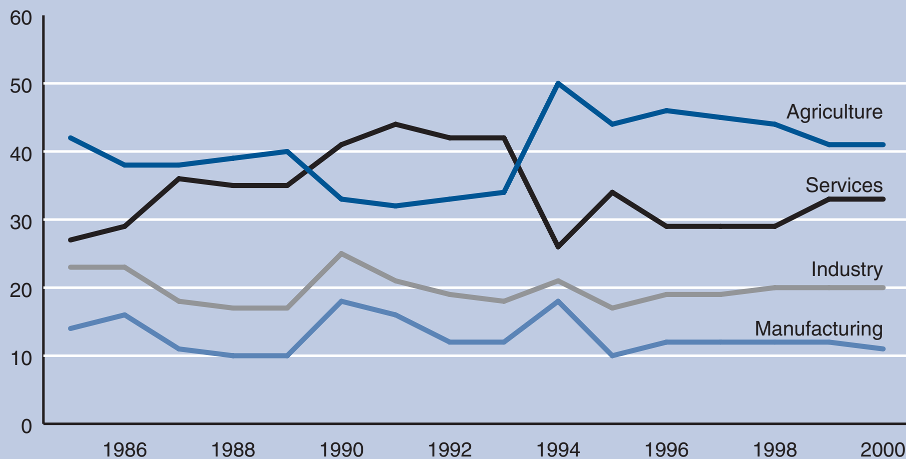
Box 3.2

How conflict affects development

Social disintegration during war pushes up transaction costs as informational access deteriorates and contract enforcement becomes a problem. Machinery and tools are especially vulnerable to looting and destruction. The economy therefore shifts from transaction-intensive and asset-vulnerable sectors towards those less transaction-intensive and asset-vulnerable.

The structural change in the figure seems to suggest these factors at work in Rwanda. The agricultural sector is likely to be the least transaction-intensive sector. The share of agriculture in GDP rose sharply over 1994, interrupting a previous decline. There was also a sharp decline in the share of the service sector, with many transaction-dependent firms, such as banks and trading companies. The economy has not yet reverted to its pre-conflict structure, but the slight decline in the share of agriculture in GDP and the increase in the service sector's share may indicate a gradual return to the market. It is essential to revive the credibility of the exchange mechanism and to provide supporting infrastructure, such as roads. Rebuilding trust through policies fostering social reconciliation is also essential.

Trends in sectoral shares, 1985–2000 (% of GDP)



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

of the economy, has remained sluggish. With high population growth rates, this has put a brake on sustained improvements in living standards.

The real sector—rapid but fragile growth

The economy remains vulnerable to adverse climatic conditions, as in 2000 when El Niño phenomena hurt agriculture. In contrast, in 2002 despite the global downturn and sluggish commodity prices, real GDP growth was high at an estimated 9.9% (figure 3.2), with agriculture growing at 14.4%. The high output was driven by favourable weather conditions rather than underlying sustained productivity growth, highlighting the low technology base of this key sector and the economy's vulnerability to future climatic shocks.

> *In 2002 real GDP growth was high, at 9.9%*

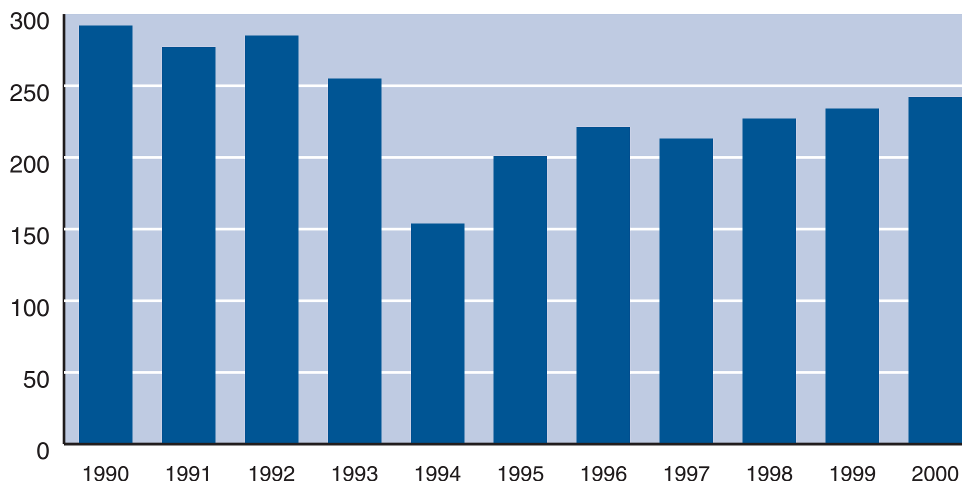
With robust agricultural growth, GDP in 2002 was supported by rapid expansion in construction, growing at 15%, partly the result of house-building by returnees. This growth may understate the true growth when informal activities are considered.

Structural diversification of the economy through the development of nonagricultural sectors has remained limited, and growth from this source is of minor significance. Agriculture, the main driver of growth (figure 3.3), is subsistence activity and has few links with other economic sectors. In 2002 manufacturing growth was 5%, down from 7.2% the previous year. Manufacturing remains beset by technological and skill constraints. Services grew by 4.5% in 2002, virtually unchanged from the previous year. The sector's growth has slowed since 1997, partly because of the gradual phasing out of emergency relief.

Figure 3.1

Genocide cuts incomes

GDP per capita, 1990–2000 (1995 US$)



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

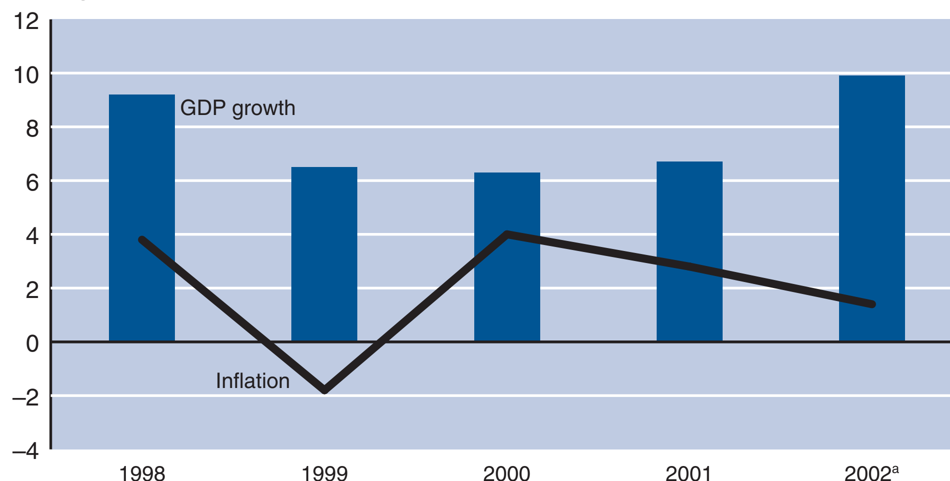
Fiscal policy—tensions between poverty reduction and macroeconomic stability

Rwanda's historical experience of civil conflict and genocide has generated structural biases in fiscal policy. In particular, spending patterns during the 1990s have tilted towards military and security expenditures to the detriment of outlays on infrastructure and social sectors (table 3.1). Following the genocide, the fiscal deficit fell as revenue levels recovered after productive sectors recommenced operations. But with limited domestic resources, Rwanda's fiscal position has remained in deficit, reaching 8.9% of GDP in 2000 and 9.5% in 2001 (figure 3.4) and is likely to reach 11% of GDP in 2002.

Figure 3.2

Strong growth with low inflation

GDP growth and inflation, 1998–2002 (%)



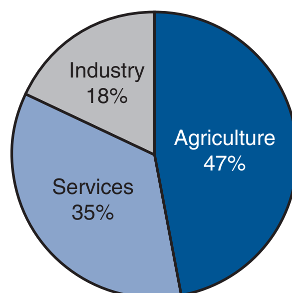
a. Estimated.

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

Figure 3.3

Agriculture—nearly half the economy

Sectoral shares in GDP, 2002



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

As Rwanda pushes forward with its Poverty Reduction Strategy, spending must be reoriented towards reconstruction and poverty alleviation. These include requirements arising directly from the post-conflict situation for spending on infrastructure and the rehabilitation of farming systems. Politically, reconciliation calls for spending on genocide

Table 3.1

Fiscal position, 1996–2001 (US$ millions)

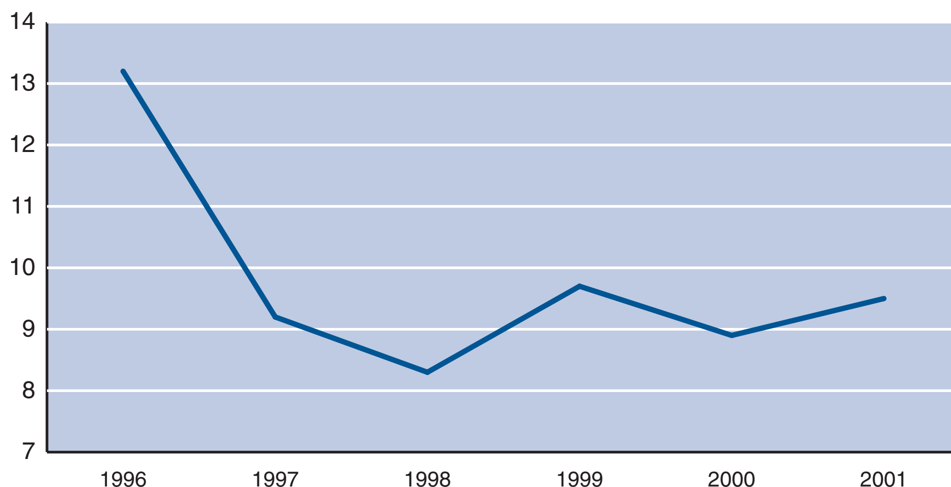
	1996	1997	1998	1999	2000	2001
Total revenue	128.4	192.1	208.2	190.5	176.3	194.6
% of GDP	9.3	10.4	10.6	9.9	9.7	11.4
Tax revenue	118.0	181.5	197.5	180.9	167.6	179.5
Nontax revenue	10.4	10.3	10.7	9.6	8.5	15.1
Total expenditure and net lending	310.6	362.4	370.3	378.6	338.0	356.9
% of GDP	22.5	19.6	18.9	19.6	18.7	21.0
Current expenditure	182.2	211.6	237.5	257.6	228.9	242.4
Education	21.5	32.4	35.0	51.5	61.6	67.3
Health	4.6	5.0	8.2	9.9	9.8	11.5
Agriculture	2.3	2.0	3.2	3.6	2.8	3.8
Defence	73.7	77.1	85.8	80.9	66.2	64.6
Capital expenditure	128.4	152.4	133.4	122.2	107.8	112.9
Budget deficit	–182.2	–170.6	–162.1	–188.1	–161.9	–162.3
% of GDP	13.2	9.2	8.3	9.7	8.9	9.5

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

Figure 3.4

Fiscal deficit down—but now on the rise

Budget deficit, 1996–2001 (% of GDP)



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

trials and on demobilization and reintegration. These special circumstances come on top of the needs in health, education, and agricultural modernization and the broader requirements of economic diversification, putting pressure on the fiscal deficit.

Rwanda's creditors have argued for any unavoidable extra expenditure to be financed by grants rather than concessionary finance because of Rwanda's HIPC status. But the savings from the HIPC Initiative have so far been limited. So, in the medium term Rwanda is unlikely to meet its HIPC targets. And its fiscal constraints will require further external inflows, some likely in loans rather than grants. This tension illustrates the problems with the HIPC Initiative's underlying design, especially its impact in Rwanda's special circumstances (box 3.3).

“Savings from the HIPC Initiative have so far been limited”

Resource constraints. Rwanda's growing expenditure needs exceed its domestic resources and aid flows, which fell from $110 per capita in 1995 to $45 by the end of the 1990s. Cash crops and (undeveloped) manufacturing are the main sources of domestic revenue, reduced by war and genocide. Agricultural revenues remain vulnerable to poor weather. In addition, population displacement has greatly disrupted agriculture and thus economic activity and revenue. Other post-conflict countries—with revenue more dependent on capital-intensive sectors, such as oil and mining—are less affected by population movements (Ndikumana 2001). In addition, political and social unrest led to a slump of 78% in tax volumes in 1994 (World Bank 2002). Revenues have since recovered to prewar levels.

A further structural problem is tax leniency, with loopholes and poor enforcement, thanks to political patronage and clientelism. Progress on this front will require building a more transparent bureaucracy and a strong state. Tariff-cutting commitments as part of the Common Market for Eastern and Southern Africa (COMESA) are also likely to put pressure on revenues.

Given these problems, the government is trying to improve revenues. A value-added tax (VAT) has been introduced, and tax enforcement strengthened. And strong growth in 2001, driven by agriculture and mining, also supported revenue. But even moderate success in these revenue-raising initiatives is unlikely to close the gap with expenditures. In the long term higher revenues can come only from sustained growth and economic diversification.

Fiscal deficit sustainability. The likely deficit of 11% of GDP in 2002 was higher than the 9.9% target because of demobilization costs incurred with the Rwandan army's withdrawal from the Democratic Republic of Congo. This expansionary fiscal stance sparked robust debate with the IMF about the sustainable deficit level, a key issue during the recent talks for renewing Rwanda's Poverty Reduction and Growth Facility. With the holdup in negotiations, several donors delayed their disbursements. An eventual compromise was reached between the Rwandan government and the IMF, with a projected deficit of 9.4% of GDP agreed for 2003. After the negotiations, extra expenditures for the forthcoming election, the health sector, and roads were included in the 2003 budget, now likely to take the deficit beyond that agreed with the IMF.

The Poverty Reduction Strategy sets out three scenarios for future spending: high, medium, and low. The spending plans agreed under the negotiations with the IMF appear to correspond broadly to the low scenario, and the extra expenditure introduced in the 2003 budget will push the fiscal deficit beyond the level set out in this scenario—to around 11% of GDP.

“Concerns about extra spending relate to macroeconomic stability and financing”

Concerns about the extra spending relate to macroeconomic stability and financing. Possible macro effects include inflationary pressure and the blunting of export incentives by external revenue inflows. But such risks must be considered in Rwanda's context (box 3.4). Too great an emphasis on fiscal targets can be misleading: the composition and quality of expenditure and the likely effects on long-term growth and poverty reduction can

Box 3.3

HIPC Initiative's flaws and the post-conflict context

For many African countries, including Rwanda, the HIPC Initiative is not providing the “exit” from unsustainable debt needed to meet the Millennium Development Goals. Rwanda has the added complication of its post-conflict context, starkly illustrating some of the HIPC Initiative's defects.

A key criticism of the HIPC Initiative is that its indicators of underlying debt sustainability are flawed. Much of the sustainability analysis by the World Bank and IMF is based on rather optimistic assumptions about future economic performance, the external environment, and the extent of projected financing needs. Rwanda illustrates each of these problems. There are huge risks to optimistic GDP growth projections of at least 6% over 2000–10. The external environment is likely to remain unfavorable, with declining coffee prices. And financing needs will continue to be great because of the post-conflict context.

An alternative to the HIPC criteria would be to link debt relief to a proportion of revenues needed for essential spending, possibly with different limits for different groups of countries. African leaders under the New Economic Partnership for Africa's Development have advocated this approach. In a similar vein, new proposals put forward in the U.S. Congress would add criteria to the HIPC framework. For example, countries suffering an HIV/AIDS crisis would put aside no more than 5% of their revenues for debt servicing. A similar approach could also be adopted for post-conflict countries. It has also been suggested that HIPC needs to take greater account of external shocks. This reflects the critical role of declining terms of trade in the buildup of debt, an issue previously neglected.

Rwanda's expenditure requirements in its post-conflict context raise issues about the HIPC process. First, the spending needs of post-conflict reconstruction and reconciliation will be essential to future social stability and so are particularly critical. A larger resource envelope may reduce the likelihood of future conflict by allowing more broad-based spending, helping to calm social grievances. Second, much of Rwanda's debt was accumulated under a regime that presided over the genocide. This suggests an application of the “doctrine of odious debt”. The current regime should not be held accountable for debts resulting from earlier external inflows propping up an administration intent on widespread killing.

Source: *Birdsall and Deese 2002; Nissanke and Farrarini 2001; Addison and Murshed 2001; Ndikumana and Boyce 1998; Browne 2001.*

differ markedly across countries. For Rwanda much of the proposed extra spending is to meet the needs of a society emerging from conflict. Implementing such a program will pose enormous challenges, but if the program is sound, implementation would be justified on political, economic, and social grounds.

The effects on inflation will depend on patterns of spending and on how the extra spending is financed. And the biggest constraints to exports are not price distortions—they are the technical backwardness of export sectors and the history of poorly executed investments.

"Monetary policy has been geared towards price stability"

Monetary policy and the financial sector

Monetary policy, fairly successful in recent years, has been geared towards price stability. The government has also focused on the banking sector, especially on establishing a sound regulatory framework for credit delivery.

Prices and monetary policy. Prices have remained relatively stable, with inflation estimated to have stayed under 3% in 2001 and 2002 (see figure 3.2). Because the economy is largely nonmonetized and based on subsistence agriculture, inflation is heavily influenced by output in the agricultural sector. With a favourable climate, strong growth in agricultural output helped to stabilize prices. In addition, the National Bank of Rwanda has intervened to stem fast liquidity growth. So, despite a depreciating exchange rate in 2002, inflation remained tamed, with prices actually declining in the 12 months ending April 2002 (figure 3.5).

But prices have since assumed an upward trend, partly the result of increasing the VAT from 15% to 18%. Higher international oil prices, downward movements in the exchange rate, and the VAT increase have also pushed up the retail price of gasoline between January and September 2002, so transport costs could put pressure on food prices. Also contributing was 10% growth in broad money between December 2001 and July 2002, driven partly by private sector credit, with commerce accounting for the largest share of the increase and agriculture the least (figure 3.6). This higher liquidity was paralleled by declines in interest rates, with commercial bank lending rates falling

Box 3.4

Fiscal policy after conflict

The resources required for the expenditures under the higher Poverty Reduction Strategy scenarios are unlikely to be available. But there are clear economic reasons for the moderate increases in spending. Nor can macroeconomic sustainability be divorced from political sustainability, particularly given Rwanda's recent history. The legacy of violence must be considered, especially in the light of evidence suggesting that a strong predictor of civil violence is the previous occurrence of such violence. The needs of social and political reconciliation are therefore critical. A macroeconomic program that does not address these issues could be extremely dangerous.

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

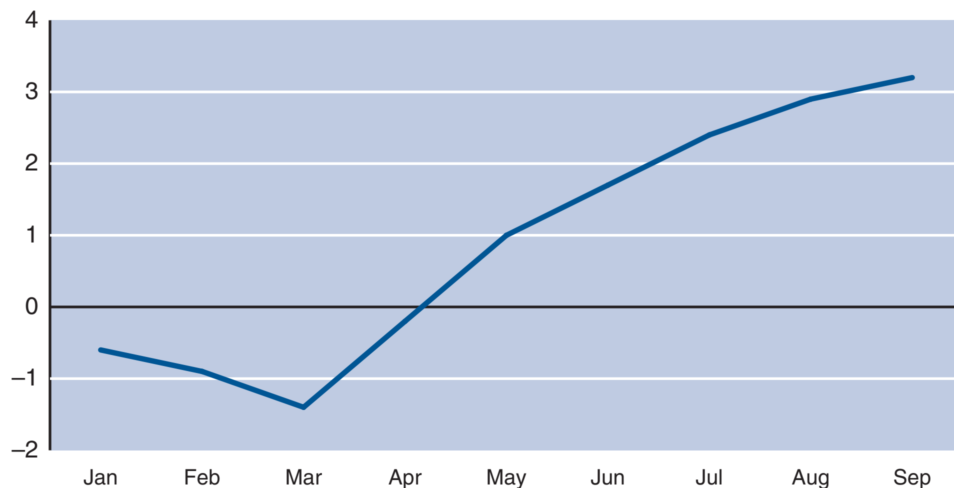
from 17.3% in December 2001 to 15.0% by August 2002, reflecting more liquidity in the banking system and greater competition among banks.

The loosening of the monetary stance was also the result of central bank financing of government operations, increased by the delay in donor disbursements. After May 2002

Figure 3.5

Inflation spikes in 2002

Consumer prices, 2002 (year-on-year percentage change)

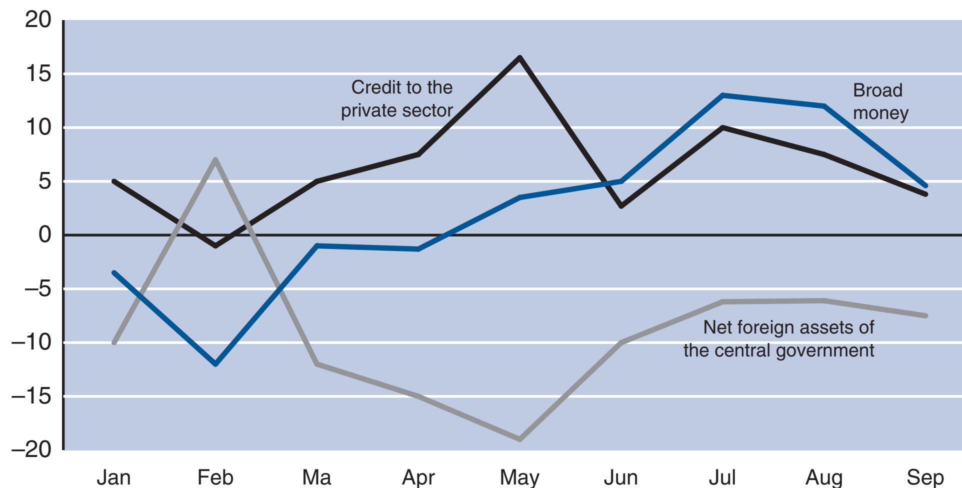


Source: *Economic Commission for Africa, from official sources.*

Figure 3.6

Credit to the private sector leads monetary growth

Contributions to monetary growth, 2002 (percentage change)



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

the National Bank of Rwanda acted to stem this liquidity increase with money market interventions and new government securities, leading to a 6.1% decline in broad money between July and September 2002, part of a continuing trend away from direct to indirect instruments of monetary policy.

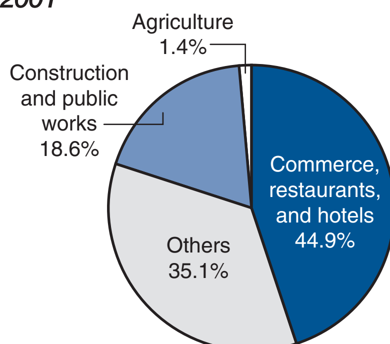
The banking sector—weighed down by bad loans. Of nine commercial banks in Rwanda, five were established after 1994. All remain conservative in their range of services and cautious in lending activities. The sector's performance is hobbled by the huge portfolio of nonperforming loans, some 40% of the total portfolio at the end of 2001 (IMF 2002a). These accumulated because of lax supervisory controls, economic instability, and road tonnage limits imposed on Rwandan trucks by the Kenyan government, hurting trade and transport. An important barrier to restoring the banks' financial soundness is the lack of legal provisions for claiming the collateral assets of defaulting firms. Bank lending to the private sector remains heavily constrained, with lending rates staying high to counter the risk of loan default.

"Bank lending to the private sector remains heavily constrained"

To deal with these problems, the government is establishing a sound legal and regulatory framework for credit delivery. The National Bank of Rwanda is working with the Ministries of Finance and Justice and the bankers association to find ways of improving loan recovery. An action plan detailing specific steps was completed in December 2002. The National Bank of Rwanda is also strengthening its supervisory role over commercial banks and improving its regulatory framework. It is also strengthening its risks and unpaid debts unit to improve the quality of credit information. Several commercial banks are being restructured, with some sell-offs planned.

Credit issues—access skewed and generally limited. Bank lending is concentrated in commerce and construction (figure 3.7), with agriculture getting less than 2%, despite its importance. There are institutional constraints to lending to this sector, as the rural economy is largely noncommercialized. Difficult to acquire, credit remains largely short

Figure 3.7
Agriculture—not being financed
Sectoral shares in credit, 2001



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

term. Retail banking is limited to richer households, and poor households are unlikely to have access to the formal financial sector. The Poverty Reduction Strategy thus includes provisions for expanding microcredit facilities and devising a legal and regulatory framework for microfinance. In addition, the *banques populaires* are being recapitalized to facilitate the expansion of credit to farmers.

Rwanda's trade and current account balances have remained in deficit

External sector

Rwanda's trade and current account balances have remained in deficit over the last two years (table 3.2). The main reason is the narrow export base of cash crops along with colombite-tantalite (coltan), leaving total values vulnerable to the vagaries of international commodity prices (figure 3.8). In addition, the country's landlocked position generates high transport costs, pushing the services account into deficit. The country has depended on aid flows to fund its external imbalances, building up external debt.

The recent global slowdown drove down prices of nonoil commodities, including coffee and tea, which provide more than 80% of Rwanda's export earnings. After rising 14% in 2001, exports of crops slipped 0.4% in 2002. Coltan prices also slumped in 2002, further depressing export values. For January–September 2002, exports were $49.4 million, down 39% from the same period in 2001, when there was a short boom in coltan exports. The sharper reductions in value than in volume show the effect of declining international prices (table 3.3). Imports have fallen slightly over 2002 as a result of reduced food imports, but the decline in value terms is far less than that of exports. Rwanda's trade balance is likely to have remained in deficit over 2002, with the deficit to September totaling $131.6 million, a slight decrease from the same period the previous year.

Exchange rate trends. Floated in 1995 the Rwandan franc has depreciated gradually, moderated by exchange market interventions by the National Bank of Rwanda. Through September 2002 the lower exports and the delays in foreign aid disbursements led to a

Table 3.2

Balance of payments, 1999–2001 (US$ millions)

Item	1999	2000	2001
Exports	62.0	89.8	93.3
Imports	248.8	239.8	255.2
Trade balance	–186.7	–150.1	–161.8
Services balance	–154.4	–156.8	–139.0
Transfer balance	198.3	216.6	190.7
Current account balance			
Including official transfers	–142.9	–90.2	–110.2
Excluding official transfers	–323.0	–295.8	–279.2
Excluding official transfers (% of GDP)	–16.7	–16.3	–16.4

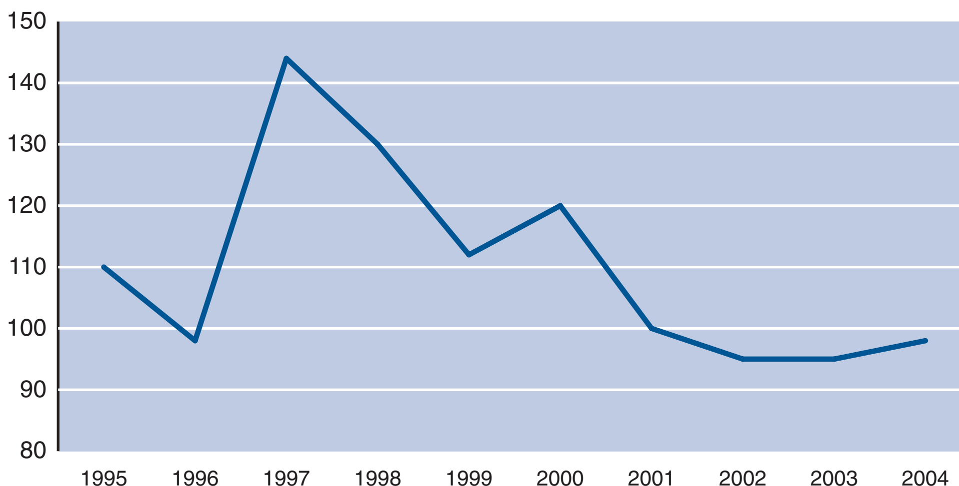
Source: *Economic Commission for Africa, from official sources.*

foreign exchange shortage of $51 million, eroding reserves, still equivalent to more than five months of imports. Against the dollar, the franc depreciated by 2.6% from the end of 2001 to the end of June 2002, continuing recent trends. So far this has not led to serious inflationary pressures, thanks to good harvests and prudent monetary policies. And the introduction of foreign exchange auctions has increased the transparency of the National Bank of Rwanda's open market operations.

Figure 3.8

Collapsing terms of trade

Terms of trade, 1995–2004 (2001 = 100)



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

Table 3.3

Export values and volumes

Export	Jan–Sept 2001	Jan–Sept 2002	Change (%)
Total export value (US$ millions)	80.7	49.4	–38.8
Coffee			
Value (US$ millions)	17.2	12.1	–29.8
Volume (tons)	15,517.2	15,742.3	1.5
Tea			
Value (US$ millions)	19.1	17.2	–10.2
Volume (tons)	12,584.0	11,886.3	–5.5
Coltan			
Value (US$ millions)	38.1	12.8	–66.4
Volume (tons)	1,240.0	961.4	–22.5

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

External flows and the debt stock. Given the long-standing deficit on the current account and the limited potential for private financing as a HIPC, Rwanda depends on official flows to close its financing gap. In 2001 official transfers constituted around 58% of foreign exchange receipts, equivalent to around 60% of the current account deficit. Over time these inflows have built up the stock of external debt, to $1.3 billion at the end of 2001, most of it concessionary (table 3.4).

“Rwanda is unlikely to meet its HIPC targets in the medium term”

Under the HIPC Initiative the net present value of the debt stock in 2001 was reduced to 180% of the value of exports, for a $25 million saving (table 3.5). Previously Rwanda's debt had been paid from an international trust fund, discontinued under the terms of the HIPC Initiative. So in 2001 the actual savings to the Rwandan government was only $4.5 million (this is expected to increase in the medium term). The HIPC Initiative has thus made a negligible contribution to progress on poverty reduction targets. With an ongoing need for external financing because of pressing expenditure requirements, Rwanda is unlikely to meet its HIPC targets in the medium term (see box 3.3).

Table 3.4

External debt, selected years (US$ millions)

External debt	1997	2000	2001[a]
Total external debt outstanding	1,138.0	1,305.0	1,316.0
Multilateral	927.4	1,137.1	1,169.4
International Development Association	557.5	723.5	714.8
International Monetary Fund	40.4	85.8	84.3
Bilateral	201.4	167.4	145.9
Paris Club	93.7	73.1	74.2
Non–Paris Club	107.7	94.3	71.7
Commercial	9.1	0.6	0.6
Total debt stock (% GDP)	61.6	72.1	77.3

a. Estimated.

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

Table 3.5

Debt service savings from the HIPC Initiative, 2001–04 (US$ millions)

Item	2001	2002	2003	2004
Debt service due before HIPC	46.72	46.19	50.66	61.49
Debt service due after HIPC	22.06	11.25	9.23	15.5
Total HIPC saving	24.67	34.94	41.43	45.99
Accruing to Rwanda	4.45	12.05	16.76	19.36
Accruing to donors through multilateral fund	20.22	22.88	24.67	26.63

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

Institutional reforms

Key institutional changes include reform of the centralized bureaucracy, with fiscal decentralization, and privatization focused on development objectives.

Decentralization

A key plank of institutional reform is the decentralization program aimed at reforming the centralized and hierarchical state bureaucracy. A decentralization law was passed in 2001, setting up various tiers of government, including 11 provinces along with the city of Kigali, 106 districts, and many subdistrict *cellules*. The Common Development Fund, established to allocate funds to district programs, will eventually take 10% of central government revenue. And with decentralization of revenue accompanying decentralization of expenditure functions, regional governments will be able to raise some of their income from local sources. The reform program is also harnessing *ubedehe*, promoting community cooperation and the collective articulation of needs. It is envisaged that cellule-level planning will eventually be integrated into broader medium-term expenditure framework processes.

"*Decentralization does not automatically enhance pro-poor service delivery*"

Two motives drive the initiatives. First, decentralized systems of government are believed to promote efficient service delivery. Second, decentralization is seen as a tonic to the predatory centralized regime that presided over the genocide. In the runup to the 2003 presidential and parliamentary elections, the current regime needs to be seen as building the beginnings of more participatory institutions. Decentralization is also linked to processes of reconciliation, as embodied in *gacaca* (box 3.5). Institutional reform is thus essential for future stability (boxes 3.6 and 3.7). The reforms are therefore being driven more by political than economic or administrative necessity. The enabling legislation has moved forward faster than the growth in local administrative capacity to implement the program.

With resources susceptible to capture by local elites, decentralization does not automatically enhance pro-poor service delivery (Crook and Sverrisson 2001). The direct economic benefits of decentralization need to be justified by local politics and local administrative capacities. Attempts are being made to integrate lower tiers of government into the broader planning frameworks now being created. But the lack of local capacity could make it difficult to establish more strategic and comprehensive approaches to expenditure and budgeting, such as sectorwide approaches and medium-term expenditure framework initiatives.

Private sector development and privatization

Many privatizations under the 1996 privatization law were essentially liquidations of nonfunctioning state-owned enterprises, mainly from the agro-industrial sectors, whose physical and human assets had been damaged or destroyed in the civil war. Only now is the privatization initiative bringing developmental objectives to the fore. A privatization secretariat has been set up to support the program, and a regulatory agency established to set tariffs, grant licenses, and prevent companies from acting as private monopolies.

Box 3.5

Gacaca mechanisms for social reconciliation

In 1996 the government passed a law to prosecute people suspected of genocide-related crimes committed during 1991–94. Resolution of the large number of cases was slow, and full settlement was predicted to take a century. Around 107,000 people remain in prison, most of these held in connection with the genocide.

To expedite prosecution, the government has set up *gacaca* courts based on traditional community institutions of dispute resolution. Suspects will be tried in front of the communities in which crimes were committed. The tribunals will not deal with the most senior organizers of the genocide, who are to be tried by the UN's International Criminal Tribunal for Rwanda, based in Arusha, Tanzania.

For gacaca suspects who admit their crimes, sentences will be reduced. Because many have already been in custody for a number of years, this will lead to their release and return to their communities. The process is premised on collective forgiveness as a first step to rebuilding communities and achieving social stability through the rehabilitation of trust (figure 1).

Recent social research has shown the ongoing social and psychological legacy of the genocide in terms of lack of trust. The success of the initiative depends on widespread awareness of the process across all social groups (figure 2).

Figure 1

People who perceive trust as a major social problem, by genocide experience

(% of population)

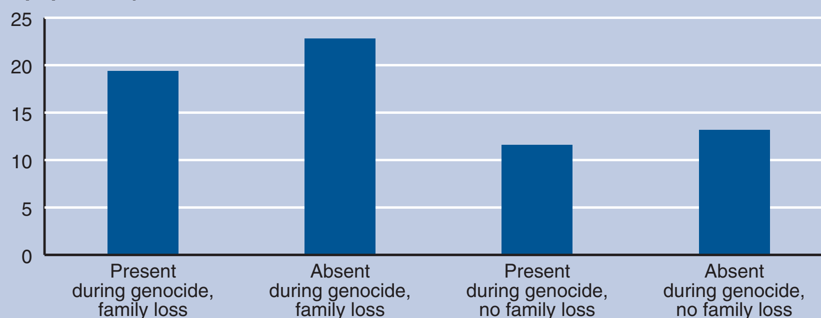
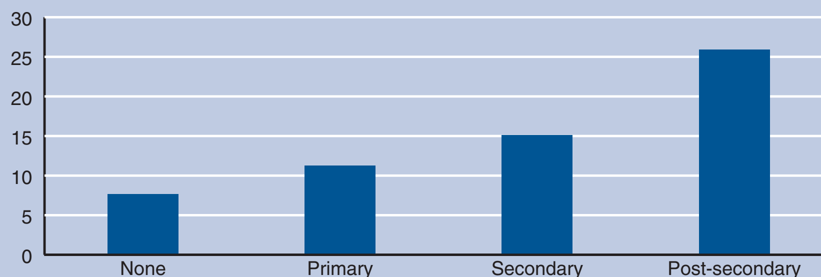


Figure 2

People with good knowledge of *gacaca*, by education

(% of population)



Source: *Economic Commission for Africa, from official sources; Gabisirege and Babalola 2001.*

The sale of the telephone operator, Rwandatel, should be concluded by the end of 2003, with 55% to a strategic investor, 5% to employees, 1% to the government, and the rest to other investors. Electrogaz, the water and electricity provider, will remain in state ownership, with its management privatized through a long-term management contract. The other main sector for privatization is tea. Two of the nine factories are slated for sale as part of a pilot.

Box 3.6
Strengthening institutional quality—the key to stability

The ethnic and linguistic fragmentation of societies has been used by several economists to explain Africa's poor growth, the outbreak of civil war, and the occurrence of genocide. Recent research finds that the probability of genocide increases when countries are more ethnically fragmented. But this effect is found only for countries with low-quality institutions, nontransparent bureaucracies, and poor contract enforcement. Ethnically fragmented countries with poor institutions, such as Angola, Nigeria, and Sudan, are thus at a markedly higher risk of genocide.

In ethnically fragmented countries with high-quality institutions, such as Canada, Malaysia, and Thailand, the negative effects of ethnic fragmentation disappear. Certain ingredients of a good institutional structure—such as efficient bureaucratic procedures, freedom from government expropriation, and the rule of law—may provide avenues for the peaceful settlement of distributive conflicts between ethnic groupings.

But other models suggest very different effects from ethnic fragmentation. The data used to generate these sorts of statistical results are extremely unreliable in conflict-affected countries. The use of econometric techniques has also been criticized for oversimplifying the complex social, political, and economic dynamics surrounding conflict. Even so, the results suggest the importance of institutional strengthening in conflict-affected countries such as Rwanda. The building of an inclusive and nonpartisan state bureaucracy is likely to be essential to future stability.

Fragmentation, institutions, and genocide
Probability of genocide

Institutional quality	Low	Medium	High
Low	0.17	0.1	0.49
Medium	0.12	0	0.07
High	0	0	0

Ethnolinguistic fragmentation

Source: *Easterly 2001; Collier and Hoeffler 1998; Cramer 2002.*

Privatization appears to have political support because of the limited capacity of the state to revitalize firms. But buyer interest has been slight, partly the result of the poor shape of assets and human resources in many of the firms being sold. And in the runup to sell-offs, the government has had little incentive to invest in ailing enterprises. A key challenge is putting in place the institutional mechanisms for the effective regulation of privatized firms.

"Government spending on the social sectors lags behind that of Sub-Saharan African countries"

Social sectors

Government spending on the social sectors in Rwanda lags behind that in other Sub-Saharan countries, crowded out by military spending of 24.4% of GDP in 1992–97, more than twice the Sub-Saharan average of 11.5%. Strengthening education and health is a key priority in the Poverty Reduction Strategy.

Education—improving outcomes and equity

In 1992–97 Rwanda's education spending amounted to 3.3% of GDP compared with 4.9% for Sub-Saharan Africa (Ndikumana 2001). Recent improvements in key indicators reflect a gradual increase in the share of education in total expenditure from 12% in 1996 to 24% in 2001 (IMF 2002a).

- The gross primary enrolment rate improved from 88% in 1999 to 97% in 2000, and is now estimated at 100%. But the quality of primary and secondary education is

Box 3.7

Institutions, ethnicity, and reform

Rebuilding the capacity of the civil service is critical for putting in place the technical and administrative prerequisites for achieving the targets in *Vision 2020* and the Poverty Reduction Strategy. Previous regimes have used civil service appointments as tools of political patronage to bolster support from some ethnic groups. In the post-colonial period discriminatory practices in state employment fostered Hutu domination of the public sector. Such biases can heighten feelings of exclusion among some groups. In the early 1990s structural adjustment and privatization policies inadvertently implied a reversal of these long-standing biases. By rolling back the state and promoting the private sector, these reforms appeared as a threat to Hutu elites in favor of the Tutsis, traditionally perceived to dominate the private sector. The genocide has been interpreted by some as a last ditch attempt by these threatened groups to maintain their hold on power and privilege.

True, the causes of the genocide are complex and multiple. But the application of one size fits all policy prescriptions to this volatile situation may have been unwise. At an international level, future donor policies in institutional reform must be sensitive to underlying social realities. And as the Rwandan state seeks to build its legitimacy, it must be seen to be impartial towards the different social groups, especially in the current drive towards a meritocratic and transparent civil service.

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

low, evident in literacy rates of 48% for women and 58% for men (Rwanda, Ministry of Finance and Economic Planning 2002a).
- Transition rates from primary to secondary levels are low, and dropout and repetition rates at the primary level remain high. Only 7% of the population over 15 years old has a secondary education, and only 0.4% a tertiary education.
- Educational attainment also has a clear income dimension, with only 15% of the poorest fifth of the population completing primary education, compared with 53% for the richest fifth (Rwanda, Ministry of Finance and Economic Planning 2002a).
- Fewer than half of teachers are adequately trained.
- The education system does not equip students with the skills needed for the labour market.

"The quality of primary and secondary education is low"

To begin addressing these needs, skills-oriented colleges have been set up, such as the Kigali Institute of Science and Technology. Vocational courses are to be promoted in secondary schools, and the school curriculum is to be reviewed (box 3.8).

Health—improving access

In 1992–98 Rwanda's per capita expenditure on health averaged just over $9, less than a quarter of the $38 average for Sub-Saharan Africa. The country fares slightly better in health expenditure as a percentage of GDP, with an average of 4.2%, compared with 3.9% for Sub-Saharan Africa (World Bank 2002). And share of health in total expenditure increased from 1.4% in 1996 to 5.1% in 2001. But on several health indicators, Rwanda lags behind the Sub-Saharan average.

- Child mortality rose sharply during the genocide, and although falling later, it remains significantly above the pre-genocide rate and high by African standards (figure 3.9).
- Life expectancy, at 40 years, is still significantly worse than the Sub-Saharan average of 49 years.

Box 3.8
The sectorwide approach in education

In planning and policy management, education is a key area where the shift from an emergency response to a development focus has begun to be institutionalized. The sector is the first to put in place a sectorwide approach aimed at strategically integrating all projects relating to education and orienting them towards the goals of the Poverty Reduction Strategy and *Vision 2020*. This process has resulted in a strategic plan for 2003–08, devised by the Ministries of Education and Gender, local governments, donors, NGOs, and other bodies. The sectorwide approach should guide the education sector's input into the medium-term expenditure framework and provide an early indication of the challenges likely to be faced as the approach is applied in other sectors.

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

- HIV/AIDS prevalence of 8.9% in 2001, though well below those in southern Africa and below the African average of 10.3%, is on the rise. So, HIV/AIDS could hurt long-term growth and development prospects.

> *Use of health services has fallen in recent years*

Causes of ill health include limited access to health services, a result of low income, poor information, and little education, as well as limited access to clean water. Malaria and malnutrition have also been major contributing factors. There is also a critical shortage of key health workers, with only 1.8 doctors per 100,000 inhabitants, particularly in rural provinces (EIU 2002).

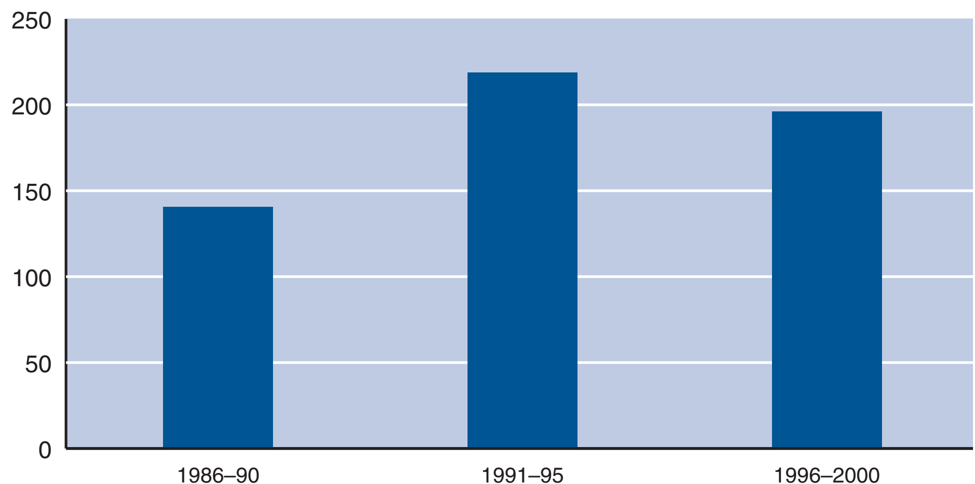
Use of health services, already low, has fallen in recent years, with the number of new cases per inhabitant entering the health system annually falling from 0.34 in 1998 to 0.26 in 2000. Cost appears to be a major constraint. In the Core Welfare Indicators Survey 15% of respondents had been unwell in the month preceding the survey but had not used health services because of the cost (Rwanda, Ministry of Finance and Economic Planning 2001a). More than 20% of rural residents cite cost barriers, compared with 9% for the urban poor and 6% for the urban population overall. Only 8.8% of hospital patients were from the poorest fifth of the population, while 43% were from the richest fifth.

The Poverty Reduction Strategy aims to improve access to health care by reducing costs to the poor, enhancing information provision to communities, improving the quality of health services, and dealing with malaria and HIV/AIDS. Institutional mechanisms

Figure 3.9

Higher child mortality after genocide

Child mortality, 1986–90 to 1996–2000 (deaths per 1,000 children under five years old)



Note: *The data are derived from interviews with surviving mothers and do not include the deaths of children of mothers who died in the genocide. The figures are therefore likely to understate child mortality during the early 1990s.*

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

are being put in place to achieve these aims. For example, *mutuelle* health insurance schemes address cost, while in the *ubedehe* initiative community health workers at the cellule level improve information flows.

Poverty patterns and poverty reduction—violence intensifies the drivers of poverty

The number of households under the poverty line reached 53% in 1993 and jumped to 78% in 1994, with a clear rural-urban divide (figure 3.10). Although rapid postwar growth supported fast reductions in poverty, the levels remain well above those before 1994. Traditionally driving poverty were poor agricultural performance, limited non-farm employment opportunities, and low levels of skills, leaving households vulnerable to weather and terms of trade shocks.

Poverty levels remain well above those before 1994

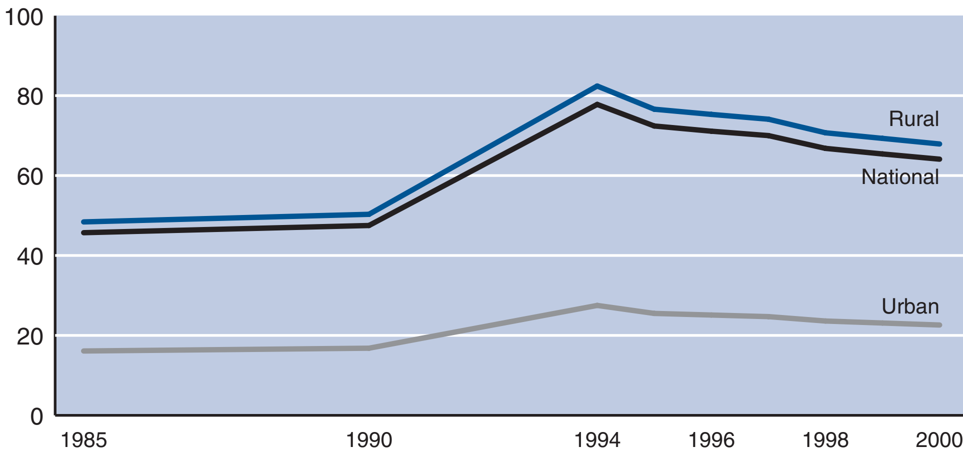
These factors were compounded by the genocide. Many households lost wage-earners and key assets, such as livestock. The number of female-headed and female-dominated households rose dramatically. By 1996 women headed 34% of households, and widows headed 21%. There are also some 85,000 child-headed households (Rwanda, Ministry of Finance and Economic Planning 2002a). Such households are economically vulnerable because of limited wage-earning opportunities and lack of access to land. And with the loss of adult male family members, household members are at greater risk of violence.

The transition to stability has generated waves of population movement, adding to social insecurity. Returning populations lack access to land and shelter (some 192,000 families remain without proper shelter). A villagization program has been initiated to resettle these groups. But the settlements lack basic infrastructure and access to

Figure 3.10

Poverty up sharply in 1994

Households under the poverty line, by urban and rural location, 1985–2000 (%)



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

healthcare and education. All these factors disrupt income streams and survival strategies, exposing households to considerable vulnerability.

Urban Kigali has much lower levels of poverty than rural areas (figure 3.11). A range of problems face outlying regions. In the southern province of Butare, population pressure and low agricultural investment have contributed to declining soil quality—and the region has the highest proportion of widow-headed households, at 28% (Rwanda, Ministry of Finance and Economic Planning 2002a). In Gisenyi in the northwest—an area traditionally advanced in agriculture, with comparatively high fertilizer use—insecurity and the destruction of infrastructure have severely reduced access to markets. Coping strategies there are leading to further environmental and soil degradation. The province with the widest and deepest poverty, Gikongoro in the south, is densely populated, and households have depended on migration to other areas. But heightened insecurity has disrupted this traditional source of income, pushing 77% of households into poverty and 57% into extreme deprivation by 2001.

Urban Kigali has much lower levels of poverty than rural areas

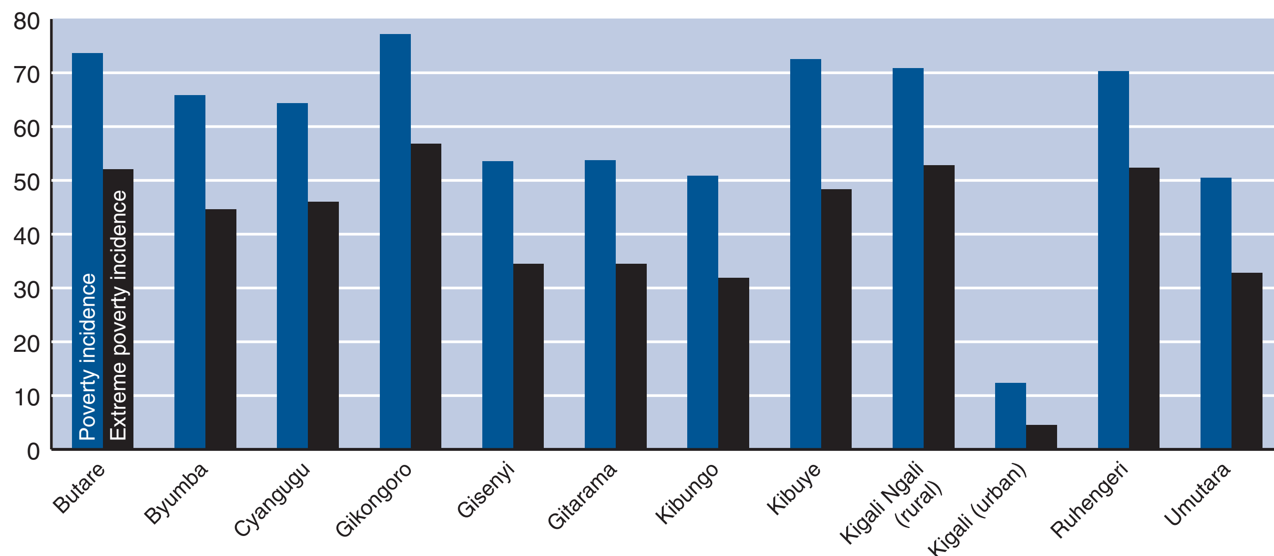
The framework for poverty reduction

Poverty in Rwanda stems from underlying structural problems and the debilitating effects of extreme violence. Efforts to reduce poverty must address purely economic problems but will have to do so within the context of dealing with the political and historical legacies. The spending requirements of social reconciliation and related processes of decentralization and demobilization have a central place in the Poverty Reduction Strategy. In addition, the strategy sets out a number of key priority areas

Figure 3.11

High rural poverty rates

Poverty by region, 2001 (% of households)



Note: *Extreme poverty refers to households falling below the food poverty line.*

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

aimed at cutting poverty to less than half the 2001 level by 2015, including rural modernization and human development (box 3.9).

The objectives in the Poverty Reduction Strategy are extremely demanding, particularly on institutional and financial capacities, but there has been little significant progress towards their realization. The Poverty Reduction Strategy framework has not had enough coordination and harmonization between donors. Nevertheless, the first stages of institutionalizing these goals in a medium-term expenditure framework have begun. Ministries have defined their priority areas through the Poverty Reduction Strategy to allow their integration into the more transparent budgetary framework (box 3.10).

> *Commercial agriculture faces low prices*

One problem with Rwanda's Poverty Reduction Strategy is inadequate coordination and streamlining by donors. Recent proposals to improve the Poverty Reduction Strategy framework are based on a more robust common framework for conditionalities between donors (see box 3.9).

Policy challenges in key sectors

The Poverty Reduction Strategy calls for modernization of the agricultural sector, where productivity is low. In industrial sectors, the effects of the genocide compound problems of low human capital and technology, high costs, and limited access to finance.

The agricultural sector—boosting productivity

Poor living standards and declining incomes are rooted in agriculture, which employs 90% of the workforce and is thus critical for living standards and poverty rates.

High rainfall and steep slopes encourage soil erosion, while management of this problem through terracing and planting hedgerows has not been completely effective (Clay and Lewis 1996). In addition, land scarcity and population pressure have changed the structure of landholdings, which in turn has affected land management (Clay 1996). Population pressure on scarce land has led to more farming on marginal areas and more renting of separated plots of land. This fragmentation has intensified cropping, without accompanying soil conservation investments, degrading soil and reducing yields.

With land now scarce, rising output will have to come from higher productivity through technological improvements in fertilizers and soil conservation. Chemical fertilizer usage is low, only 3% of cultivated land in 2000 (Kelly and others 2001). One of the most serious constraints is farmers' lack of knowledge about fertilizer.

Commercial agriculture faces low prices and high costs. Output of Rwanda's main cash crop, coffee, fell by nearly 80% between 1990 and 2001, with prices approaching the point where farmers abandon their coffee trees or even uproot them (Loveridge, Nyarwaya, and Shingiro 2002). Such disinvestment does not bode well for the capacity of producers to take advantage of possible upturns in international prices. One proposal

Box 3.9
Rwanda's Poverty Reduction Strategy

Rwanda's Poverty Reduction Strategy, approved by the boards of the IMF and World Bank in August 2002, sets out the key requirements for reducing poverty within the country's broader development framework in *Vision 2020*. The main objectives:

Rural development and agricultural transformation. Measures to modernize farming techniques, improve farmers' knowledge, support off-farm employment, provide credit, improve rural infrastructure, and use labor-intensive rural public works.

Human development. Actions to improve health provision (including measures on malaria, HIV/AIDS, and family planning), skills and educational development, and water supply and resettlement.

Economic infrastructure. Measures to develop roads, energy, and communications, including energy provision to poor households and rural enterprises.

Governance. Measures on a host of related issues, including security and demobilization, reconciliation, decentralization, constitutional change, and civil service reform with the introduction of sectoral strategies and the use of more transparent and accountable procedures.

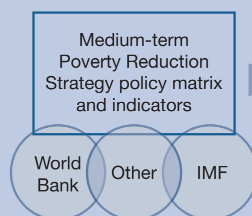
Private sector development. Measures to promote investment and export promotion, reform of the financial sector, privatization, and greater private sector representation.

Institutional capacity building and other cross-cutting issues. Given the loss of skills as a result of the genocide, measures to rehabilitate the capacity of institutions and put in place incentives to retain skilled personnel. Other cross-cutting areas are technology, gender, environment, villagization, HIV/AIDS, and employment.

Progress has been made in monitoring poverty, orienting expenditure to social sectors, and implementing the medium-term expenditure framework. But the government has also said that donor coordination and accountability need to be improved as the Poverty Reduction Strategy process progresses (see figure). In addition, donors and multilateral institutions remain prescriptive on policy approaches, despite the Poverty Reduction Strategy framework's gloss of "country ownership".

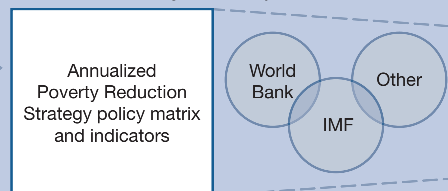
Moving to a common Poverty Reduction Strategy framework

Links between Poverty Reduction Strategy policy matrix and donor conditionality



Current Poverty Reduction Strategy matrix not sufficiently operational for donors to set direct benchmarks and conditions in their programmes for the Poverty Reduction Strategy

Poverty Reduction Strategy–based common conditionality framework for budget and project support



Donor benchmarks and conditions streamlined with the Poverty Reduction Strategy matrix. Additional requirements to meet donor needs (fiduciary safeguards, political governance) should be shared and kept to a minimum

Source: *SPA 2002; Economic Commission for Africa, from official sources.*

for reviving the sector is to upgrade quality and tap into premium and "fair trade" western markets (Loveridge, Mpyisi, and Weber 2002). But this would require considerable investments to improve washing and processing facilities.

Production of the other main cash crop, bananas, declined by some 70% over the last decade, partly because of reduced manure usage, lower government investment, and political instability (Donovan and others 2002). Because households engaged in cash cropping tend to have a lower incidence of poverty than those dependent on subsistence activities, the declines in cash crop outputs may have negative implications for household livelihoods.

> *The industrial sector employs less than 2% of the population*

Solutions require integrated packages. The use of inorganic fertilizer must be combined with organic inputs along with land conservation, particularly in Rwanda's hilly terrain. Fertilizer use must be increased by enhancing farmers' knowledge and offsetting the risk of initial investments in inputs, especially when cultivators are at the bottom

Box 3.10

Institutional mechanisms to put poverty-oriented expenditures in place

Putting in place a medium-term expenditure framework and institutionalizing poverty-reduction objectives, the budgetary reforms have achieved certain objectives. But they still face constraints in the four principles underlying the approach:

Transparency. All ministries are now employing a strategic planning model linking activities with defined objectives. Provinces have been part of this model since 2002. This has aided transparency in the preparation of the budget and provided mechanisms for linking the budget with objectives in the Poverty Reduction Strategy. But in the execution of budgetary plans transparency has not yet been achieved in the linkage between funds requested under subprograms and the objectives used to define the budgetary allocations at the preparation stage.

Coordination. Important achievements have been made in linking the priority areas of the Poverty Reduction Strategy with the detailed spending allocations in the medium-term expenditure framework. Ministries have identified priority programs on the basis of the Poverty Reduction Strategy and integrated them into the process. But projects in individual sectors have not yet been generally integrated into sectorwide strategies. Such an approach would help to bring greater clarity of aims to the medium-term expenditure framework. Efforts in this direction have begun in education.

Comprehensiveness. Though improved, challenges remain in achieving a comprehensive and integrated budget. In particular, management of the development and recurrent budgets by separate parts of the bureaucracy causes problems. Preparation of the development budget has not been well integrated into the medium-term expenditure framework process.

Predictability. Fluctuations in external funding have implications for the predictability of revenues, especially in Rwanda's shaky macroeconomic environment. Because of the delay in donor disbursements as a result of the problems surrounding the Poverty Reduction Growth Facility negotiations, 2002 was a particularly bad year.

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

of their learning curves. And improvements in marketing infrastructures are sorely required in the form of better roads and information. The Poverty Reduction Strategy contains important provisions in these areas aimed at modernizing the sector, but attempts to push the necessary investments remain limited.

"Industrial enterprises were badly hurt by the civil war"

Nonagricultural sectors—underdeveloped and lacking skills

The industrial sector remains weak and of marginal significance, employing less than 2% of the population and contributing only an estimated 18% to GDP in 2002 (Rwanda, Ministry of Finance and Economic Planning 2001b). Firms are small, with only 12 companies having more than 500 employees. Larger manufacturing enterprises are active mainly in beverages, tobacco, cement, textiles, and tea and coffee processing.

Industrial enterprises were badly hurt by the civil war. Many went out of business, and those that survived had to deal with the destruction of physical capital and the loss of workers and skills. Growth in the industrial sectors will be critical for increasing employment opportunities and living standards, particularly with scarce land and low productivity growth in agriculture. The sector shares weaknesses with the industrial sectors of many other African countries: low human capital and technology, high production and transportation costs, inefficient bureaucratic procedures, and limited financial services. In Rwanda the effects of genocide compound these problems, hampering the development of a strong entrepreneurial class.

Some efforts have been made to deal with these shortcomings, with a new private sector federation, an investment promotion agency to streamline investment procedures, and promotion of vocational education. The Poverty Reduction Strategy sets out a financial sector reform plan and an overhaul of the commercial legal environment to support the private sector. But initiatives to develop the nonagricultural sectors remain limited relative to the enormous and diverse challenges in strengthening the economy.

Medium-term outlook—some slowdown in growth

GDP growth will continue to be driven by agriculture and by high public expenditures, supported with donor funding. The rapid growth in 2002 was the result of very favourable weather. Some slowdown is expected, to around 6.5% in 2003 and 2004, with outcomes sensitive to weather. With Rwanda's high aid dependence, greater volatility of external inflows would be damaging. Monetary policy will remain centred on price stability, though inflation is likely to drift slightly upwards to around 4% in 2003—a result of VAT increases and exchange rate depreciation. The main influence on the external balances will be the international prices of Rwanda's main exports: tea and coffee. With inventories at record highs, the downward trend in coffee prices is expected to continue over the coming years, keeping the trade and current account balances in deficit. The requirements of poverty reduction and reconstruction will continue to put upwards pressure on the fiscal deficit, likely to be above 10% of GDP in 2003.

Failures in governance reforms could hurt the broader process of reconciliation in which they are embedded. If the institutions through which reconciliation is being managed lose credibility, this will affect the integrity of the 2003 elections, which in turn could affect prospects for future political stability and economic growth. Other problems stem from the demobilization of troops and the likely release of thousands of genocide suspects (see box 3.5). Judicious political management of these connected processes will therefore be critical, and the emerging institutional framework must be seen to include all ethnic groups.

"Donors need to be forgiving of reasonable deviations from orthodox stabilization policy"

Unexpected costs arising from reconciliation, elections, and demobilization could upset attempts to build a well-functioning and accountable economic bureaucracy if initiatives such as the medium-term expenditure framework are derailed. Here, the fast pace of decentralization poses risks for more efficient budgetary processes, particularly with the limited institutional capacities at the local levels. This key element of reform must thus be carried forward with an eye to these critical constraints: too rapid an implementation could disrupt moves towards better economic management.

To the extent that the events of 1994 were conditioned by poverty and resource scarcity, diagnosis and possible solutions in the economic sphere will have to occur in tandem with social reconstruction and reconciliation. Given the dominance of agriculture in GDP and total employment, solutions to its problems will be vital. Essential prerequisites for its strengthening are technical progress and higher levels of commercialization. Given the land scarcity and soil degradation, economic diversification and the development of nonagricultural wage-labour opportunities will have to be propelled. Progress on this demanding set of tasks will increase living standards.

Rwanda's post-conflict situation must be taken into account, particularly in the conduct of fiscal policy. The crucial requirements of reconciliation, political normalization, and economic development may keep the fiscal deficit fairly high over the medium term. If sound expenditure implementation can be achieved, this will be justifiable. Given Rwanda's special context, donors need to be forgiving of reasonable deviations from the precepts of orthodox macroeconomic stabilization policy.

Moderate progress in the areas identified is likely to bring clear economic and social benefits. But the Poverty Reduction Strategy's aim of cutting poverty to half the 1990 level by 2015 will require average annual GDP growth of 7–8%. Given the structural weaknesses and the interlocking political and economic risks, poverty reduction of such magnitude is unlikely.

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Chapter 4

Mozambique—The Elusive Quest for Pro-poor Growth

Mozambique's economy grew at a phenomenal 12% in 2002, with strong performance forecast for 2003. Despite several natural disasters over the past decade, Mozambique was one of the fastest growing economies in Africa. Per capita incomes almost doubled—from $139 in 1990 to about $220 in 2001, laying the foundation for achieving several of the Millennium Development Goal targets (table 4.1). This remarkable performance is attributable largely to the end of civil conflict and a comprehensive economic reform that abandoned central planning and embraced a market approach to growth and development.

> *Mozambique's economy grew at a phenomenal 12% in 2002—one of the fastest growing economies in Africa*

The better policy environment brought in more official development assistance—averaging 60% of the government budget for 1996–2001. Those aid inflows have also catalyzed a surge in foreign direct investment to $300 million a year, well above the African average. Mozambique receives more than $40 per capita in aid flows, and gross investment stands at 30% of GDP—much higher than the African average of $19 per capita in aid, and investment of 18% of GDP for 1995–2001.

Yet an estimated 64% of the population was below the poverty line in 2001, down from 69% in 1996 (Mozambique 2001). The reasons for the slow response of poverty to Mozambique's high rate of growth hark back to the aftermath of the colonial period, when the country was plunged into war. The conflict raged from 1975 until the 1992 Rome Agreement between the ruling Front for the Liberation of Mozambique (Frelimo) and the Mozambique National Resistance (Renamo).[1] The war polarized the population, devastated agriculture, and destroyed social and economic infrastructure, including much of the transport system. Despite attempts to target the poorest in society, many benefits of the recent economic growth have been channelled into social and physical infrastructure that benefits both the poor and the nonpoor.

If Mozambique sustains the current average GDP growth rate, spurred by manufacturing, and implements effective pro-poor action programmes, poverty could be reduced from 64% to between 32% and 36% by 2006.

Given the massive inflow of external funds, a major objective of macroeconomic policy has been to keep the economy from overheating, without diminishing government spending on poverty reduction and other social sector activities. The Bank of Mozambique's strategy has been to keep the bank rate high to minimize growth in demand for money. Rising oil prices could push inflation up in 2003, but it is expected

to be in single digits, given the growth in the money supply and the improvement in the food supply. Annual inflation for 2002 was 9%, down from 22% in 2001, thanks to tight monetary policy and a 5% increase in cereal production. With the expansion in aluminium exports and the completion of the Pande Gasfield project, the country's balance of trade is expected to improve.

A major challenge is to implement second-generation reforms, such as privatization, decentralization of development programmes, and reform of public services

A major challenge is to implement second-generation reforms, such as privatization, decentralization of development programmes, and reform of public services, including the judiciary and tax administration. Earlier economic reforms eliminated subsidies and quantitative restrictions on imports, simplified import tariffs, and liberalized crop marketing. Foreign exchange and interest rates have also been liberalized, with macroeconomic policy adjusted accordingly.

Mozambique faces three big challenges:

- Reducing income and spatial inequalities.
- Reducing the vulnerability of the population to floods, cyclones, and drought, which in 2000 reduced GDP growth to a mere 1.6% from the previous average of 9%.
- Producing the human resources for effective fiscal decentralization and better public service delivery.

To meet these challenges pro-poor growth strategies need to be coordinated in a comprehensive framework, targeting agriculture, with the majority of the population engaged in subsistence activities. Of particular concern is the lack of credit for small businesses. A micro and rural finance system should be developed to help allocate resources efficiently. Capacity weaknesses in the public services have to be overcome through retraining and institutional reforms, and social infrastructure has to be expanded in rural areas. The domestic transport network, especially linking north and

Table 4.1

Mozambique's progress towards the Millennium Development Goals

Target	Will target be met?
Reduce extreme poverty by half	Possibly
Reverse the spread of HIV	Possibly
Reduce food poverty	Unlikely
Increase access to safe water	Unlikely
Achieve universal access to primary education	Unlikely
Eliminate gender disparity in primary and secondary education	Unlikely
Reduce under-five mortality rate	Unlikely
Reduce maternal mortality ratio	Possibly
Halt and begin to reverse the incidence of malaria	Unlikely
Integrate principles of sustainable development in policy	Possibly

Source: *UNDP and Mozambique 2002.*

south, needs attention. Transparency and accountability in public finance management has to increase significantly (box 4.1). Reform of the judiciary has to speed the effort towards good governance.

To promote democracy and good governance, President Chissano has announced that he will step down in 2004, and a new candidate has been nominated by the ruling party to contest the 2004 elections. But more needs to be done to promote faster national reconciliation and integration.

> *Real GDP growth is accelerating, from an average of 6.5% for 1987–96 to 13% in 2001–02, though it dropped slightly in 2002*

Macroeconomic developments

Economic growth is accelerating, export revenues are rising, and the structure of the economy is changing, with agriculture's share falling and industry's rising. Inflation is on the decline, and while financial sector recovery has been slow, social spending is up and military spending is down.

Economic growth—strong and accelerating

Real GDP growth is accelerating, from an average of 6.5% for 1987–96 to 11% in 1997–99 and 13% in 2001–02, though it dropped slightly to 12% in 2002 (figure 4.1 and table 4.2). The major sources of growth since 2000 have been post-flood reconstruction, the large investment in aluminium production, and recovery in agricultural output (Mozambique and EU 2002).

Export revenues in dollars increased, but the trade and current account deficits remained high due to the high import requirements of large projects, notably the Mozal aluminium plant and the gas pipeline (figures 4.2 and figure 4.3).

Sectoral performance—signs of structural transformation

The structure of the Mozambican economy, dominated by agriculture and services in the 1980s and 1990s, is changing as the aluminium and gas projects reach full capacity. The share of agriculture in GDP dropped from 34% in 1991 to 22% in 2001, while that of industry, buoyed by aluminium, gas, and electricity production, rose from 9.2% to 26% (figure 4.4 and table 4.3). The industrial sector is thus poised to become the country's largest sector, with growth of 34% in 2001 and an estimated 12% in 2002, with 6% growth in manufacturing and 108% growth in construction works related to the gas pipeline and other big projects.

Agriculture—imperative for modernization. Mozambique has great potential for faster agricultural growth, especially for export. Agriculture is the main source of livelihood for rural households, 80% of the country's population. The principal cash crops are cotton, cashews, maize, tobacco, sugar, coconut, tea, and fruit. The largest export earners are prawns, cotton, and cashews. Prawn exports in 2001 amounted to $86 million, and cashew exports to about $13 million. Cotton has a workforce of about 250,000 farm households, and annual exports of more than $20 million.

Box 4.1

What do residents want the government to know and do?

Area	Issues, concerns, and suggestions
Governance	• Commitment to public sector reform is evident from the top of the political hierarchy but not middle-level personnel. • Reorientation and retraining of middle-level personnel is required. • Decentralization is a key factor in improving public service delivery and reducing corruption. • Progress on decentralization is too slow. • Human and material capacity at the local government level are weak. • An independent judiciary must be ensured. • Progress on judicial reforms is too slow. • Pace towards national reconciliation and integration is slow.
Trade and investment	• The Investment Promotion Centre should be strengthened and made independent of the Ministry of Planning and Finance. • Incentives created for foreign direct investment should be extended to local investors, particularly in agriculture and industry. • Small and medium-size enterprises face management and financial problems, due to weakness in human resource capacity and in the banking system. • Customs and tax regulations are cumbersome and uncertain, with a lack of coordination among revenue agencies. • Business wants a logical, rational tax system—not necessarily lower tax rates—to reduce uncertainty in financial planning. • The high value-added tax (VAT) rate is encouraging underground cross-border trade, undermining local legal business. Prompt refunds of VATs must be ensured. • Opportunities for trade—under the South African Development Community, World Trade Organization, U.S. African Growth and Opportunity Act—are growing but the capacity of local firms to meet international standards is low. Need a national trade strategy incorporating training, research, information-sharing, technology, and finance and a supportive regulatory environment.
Business and regulation	• Many rules and regulations—particularly for registration, licensing, and corporate taxation—are outmoded, cumbersome, and ambiguous. • Due to underfinancing from central government, municipalities harass local businesses for revenue.
The rural poor	• Measures may be needed to reduce the impact of trade liberalization on the rural poor in agriculture and agro-processing.

(continued on next page)

Box 4.1 *(continued)*

What do residents want the government to know and do?

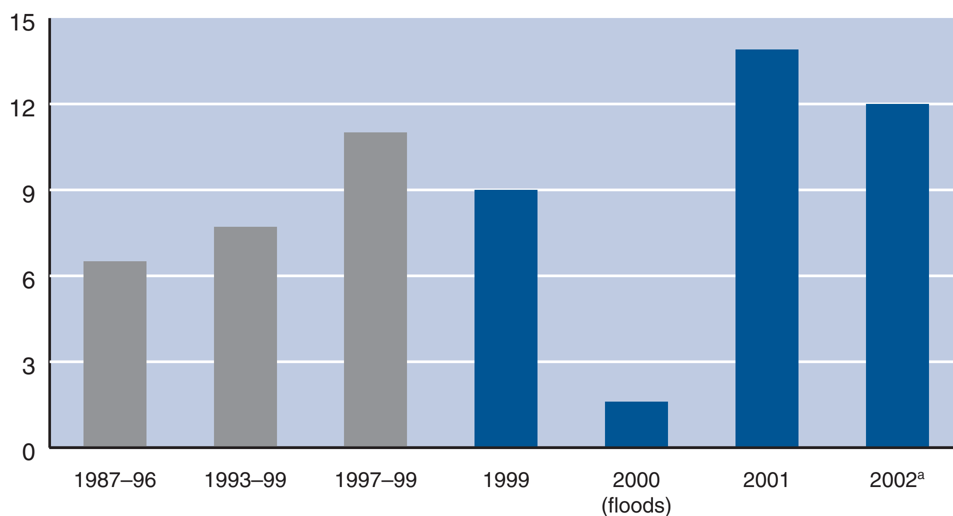
The rural poor (continued)	• Access to primary, secondary, and tertiary education is key to rural poverty reduction. Teachers and private investors need incentives to move to rural areas. • The agro-processing business for cashews, sugar, and fish needs to be revived. • Food security should be strengthened by installing rural food storage facilities, improving transportation networks, and providing small irrigation facilities.
Financial sector	• Interest rates are too high. • The central bank needs to develop an effective microfinance system, linking informal and rural business to modern banking and finance with a supportive policy and regulatory environment.
Education and training	• Lack of an educated and skilled workforce could hinder long-term growth. • Access to education is a key to reducing poverty and inequality. • Private participation in the provision of higher education and professional training must be facilitated.
Infrastructure and utilities	• The infrastructure linkages between regions and provinces need to be strengthened. • Effective competition in the sector should be ensured.
Labour laws	• Regulations for hiring foreign workers are too cumbersome. Obtaining a work permit is time-consuming. • The bureaucracy intervenes too much in industrial relations. • Modern, flexible, and user-friendly labour laws are needed. • The industrial labour force needs training and re-orientation from its socialist mindset.
Land acquisition	• Land is not easily marketed. It is vested in the government but changing hands on the black market at exorbitant prices.
Medium-term economic prospects	• Weak, because of the high failure rate of local enterprises. There is a need for national corporate empowerment. • Good, because improved governance is generating inflows of foreign direct investment and donor funds and new opportunities for trade in agro-industry and tourism. Implementation of reforms, especially in governance and business regulations, and commitment to the rule of law must be adhered to.

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

Figure 4.1

GDP rising, with one bad year and down a bit in 2002

Real GDP growth, 1999–2002 (%)



a. Estimated.

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

Table 4.2

Macroeconomic trends, 1999–2002

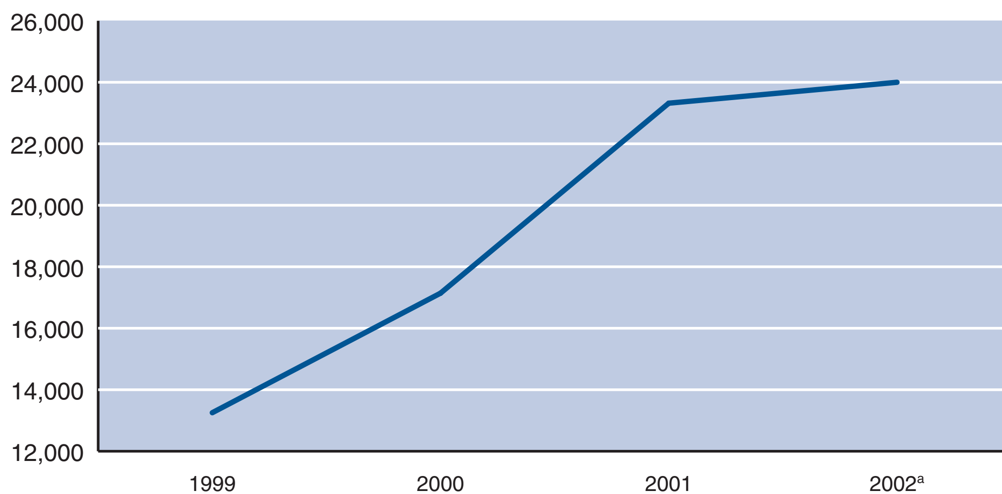
Indicator	1999	2000	2001	2002[a]
Real GDP (US$ billions)	4.1	3.9	3.8	4.4
Real GDP growth (%)	7.5	1.6	13.9	12.0
Inflation, end of period (% year on year)	4.8	11.4	21.9	9.1
Exchange rate (meticais per dollar, end of period)	13,253	17,141	23,320	24,000
Exports (fob, US$ millions)	284	364	704	850
Imports (fob, US$ millions)	1,090	1,162	1,300	1,400
Trade balance (fob, US$ millions)	–806	–798	–596	–550
Current account balance (US$ millions)	–912	–880	–736[a]	–700
Reserves (excluding gold, US$ millions)	652	725	716	790
Import cover (months)	5.2	5.4	4.9	5.0
Total external debt (US$ billions)[b]	5.65	5.37	5.0[a]	6.0
External debt to GDP ratio (%)[b]	138	146	153[a]	189
Net foreign direct investment (US$ millions)	382	139	255	805
Net official development assistance (US$ millions)	804	876	540[a]	565

a. Estimated.

b. Before debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.

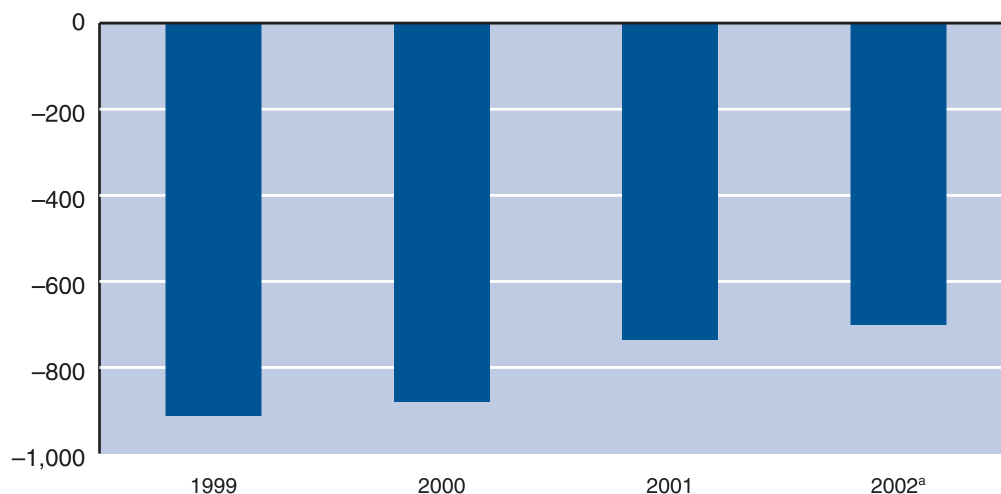
Source: *Economic Commission for Africa, from official sources.*

Figure 4.2
Metical slipping against the dollar
Nominal exchange rate, 1999–2002 (metical per dollar)



a. Estimated.
Source: *Economic Commission for Africa, from official sources.*

Figure 4.3
Trade balance gradually improving
Current account balance, 1999–2002 (US$ millions)



a. Estimated.
Source: *Economic Commission for Africa, from official sources.*

About 46% of the country's land area is suitable for agricultural production, but the supportive environment—the production, storage, and distribution infrastructure, credit and extension services—necessary for take-off is lacking. Largely rainfed, agriculture is dominated by smallholders, with an average farm size of 2.4 hectares and low yields.[2] Of the arable land area of 36 million hectares, only 5.4 million hectares (about 15%) are under cultivation and only 120,000 hectares are irrigated.

"Small irrigation schemes could provide some protection for poor farmers against both floods and drought, helping to stabilize production and boost incomes"

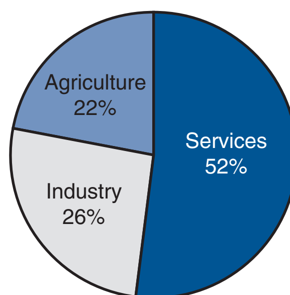
But the country's agriculture is subject to severe droughts and flood in the south and devastating cyclones in the north. In 2001/02 drought in the south cut the region's cereal production by a third, leaving half a million people at risk of famine (table 4.4). Small irrigation schemes could provide some protection for poor farmers against both floods and drought, helping to stabilize production and boost incomes.

Cashew production, once the most important source of livelihood and export earnings, virtually collapsed with the closing of processing plants (box 4.2). In May 2002 a new plant was opened in Namige, Nambula Province. Research findings show that labour-intensive techniques, not the highly mechanized factories of the past, could add value to processed nuts at a competitive cost, making local processing internationally com-

Figure 4.4

Industry poised to become largest sector

Sectoral distribution of GDP, 2001



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

Table 4.3

Average annual sectoral growth rates, 2000–01 (%)

Sector	2000	2001
Agriculture	–10.3	14.0
Mining	–29.4	12.6
Industry (manufacturing and construction)	4.3	34.1
Services (trade, transport, and communications)	11.3	–8.3
All sectors	1.6	13.9

Source: *Economic Commission of Africa, from official sources.*

petitive (McMillan, Rodrik, and Welch 2002; Mozambique, Ministry of Agriculture 2001). A World Bank (1995) study had shown that the value added by the mechanized processing industry was marginal or negative in 1988–92.

Fisheries accounted for almost 40% of Mozambique's exports in 2001. Direct employment in the sector is estimated to be between 75,000 and 80,000, 90% of them artisanal fishers or people associated with handling and distributing an artisanal catch (Nathan Associates 2002). Almost no growth is expected from fisheries in 2002, because of measures to conserve prawn stocks.

"Sugar is now receiving government support to improve the regulatory environment and access to credit—and to attract more investment, particularly from Mauritius and South Africa"

Sugar is now receiving government support to improve the regulatory environment and access to credit—and to attract more investment, particularly from Mauritius and South Africa. Showing the sector's export, employment, and poverty reduction potential, several

Table 4.4

Cereal production, 2001/02

Region	Volume of output (thousand tons)	Change from previous year (%)
North	619	22
South	163	–34
Centre	992	6
National	1,773	5

Note: *Cereal comprises maize, sorghum, rice, and millet, in order of volume.*

Source: *EIU 2002.*

Box 4.2

When economic reform goes wrong: cashews

In the 1960s Mozambique produced half the world's cashews, with production at 156,000 tons in 1964. In 1975 the government banned the export of raw cashews, and the country became the first in Africa to process cashews on a large scale, with 14 processing factories by 1980. In 1992 the export ban on raw cashews was lifted as part of a policy reform agenda proposed by the World Bank. An export tax of 20–40% of the fob price was imposed in 1994, gradually reduced to 14% by 1997. It was hoped that resources would be allocated more efficiently and the incomes of cashew farmers would be boosted. Competition among buyers increased the farmgate prices of raw cashews, though only about 40–50% of this rise went to farmers (around $2.1–2.6 million). The rest went to traders.

Liberalization effectively killed cashew processing because plants were not efficient enough to withstand the competition. Of the sector's labour force of 11,000, 90% lost their jobs. It is estimated that poor households and workers lost $3.5–4.0 million as a result of the liberalization policy—simply because the dynamic consequences of the policy on an imperfect market situation were not adequately addressed.

Source: *Adapted from McMillan, Rodrik, and Welch 2002.*

scientific studies justify continuing government support (box 4.3). Three processing plants have been rehabilitated to ensure a steady market for higher farm production, generating an estimated 20,000 new jobs.

> *Industry, mining, and construction have been the fastest growing sectors over the last 10 years, and aluminium has been a major source of growth of manufacturing output*

Industry, mining, and construction. Industry, mining, and construction have been the fastest growing sectors over the last 10 years, with growth rates of 10%, 12%, and 54% in 2001. Metallurgical products, beverages, and food processing lead manufacturing. Aluminium has been a major source of growth of manufacturing output. BHP Billiton Aluminium SA is expanding its plants in the country, at Mozal 2, to double its aluminium production to 500,000 tons. Sugar processing is receiving more attention, with investments expected to reach $312 million in 2005.

Mining—mainly marble, granite, gold, and bauxite—contributes 2% of GDP and 7% of exports. The unlicensed production of gold and gemstones, not included in official statistics, is said to be on the increase, with an estimated 50,000 artisanal workers in alluvial gold and gemstone work. The titanium project by Southern Mining Company, on its completion in 2006, will be the country's largest mining enterprise. Construction is due to start in 2004, involving an investment of about $1.5 billion, $495 million in the first phase alone. In addition, Kenmore Resources of Ireland has entered into the development and construction stage of its titanium project in the northern province of Nambula.

A major constraint facing these growing sectors: human resources. Professional and other high-skill workers are not readily available, and recruitment of expatriates faces cumbersome administrative procedures.

Services. Services are dominated by internal trade, transport, and communication—and government services. Tourism's contribution is small, even though the country boasts exceptional flora and fauna. The Investment Promotion Centre has identified tourism as one of the most viable investment opportunities in the country. Most tourism investments

Box 4.3

Sugar production has great potential for poverty reduction

Sugar production can do much to reduce poverty—through direct and indirect employment creation and income generation. Employment is projected to reach 21,000 full-time and seasonal jobs, at an average capital expenditure of $20,000 per job, and domestic consumption is increasing. Market access to the South African Development Community and EU amounts to 160,000–280,000 tons a year. Currently a net importer of sugar, Mozambique has the potential to produce 428,000 tons a year. With an average field and factory cost of $180 a ton, it has the potential to be one of the lowest cost global producers of sugar. Investment in sugar is projected to reach more than $300 million by 2005, but it needs supportive trade and investment policies to realize its full potential.

Source: *FAO 2000.*

are for beach destinations, such as the Sodetur-Balanchard project, estimated at $800 million. Other attractions include the Bazaratu Archipelago and the Ibo Islands. The new Ministry of Tourism has identified several community-based ecotourism projects (around the Gorongosa National Park and the Ponta do Ouro zone), good for poverty reduction and conservation. But the lack of air and road transport and telecommunications poses a major constraint to tourism development.

Inflation slowed in 2002, a result of tight monetary policy and higher cereal production

Mozambique has focused on developing transportation corridors to capitalize on its natural resources and trading location. The demand for transport and shipping facilities is high among the three neighbouring landlocked countries—Malawi, Zambia, and Zimbabwe—as well as South Africa. In 2000 the three main ports of Maputo, Beira, and Nacala and the two secondary ports of Quelimane and Pemba handled about 6 million tons of cargo for Mozambique's neighbours, 48% of it for Zimbabwe and 34% for South Africa (Mozambique and EU 2002). Development of the Maputo Corridor between Maputo Port and Witbank, South Africa, could reduce travel distances and facilitate exports and foreign investment. But north-south road links are still poor and vulnerable to natural disasters.

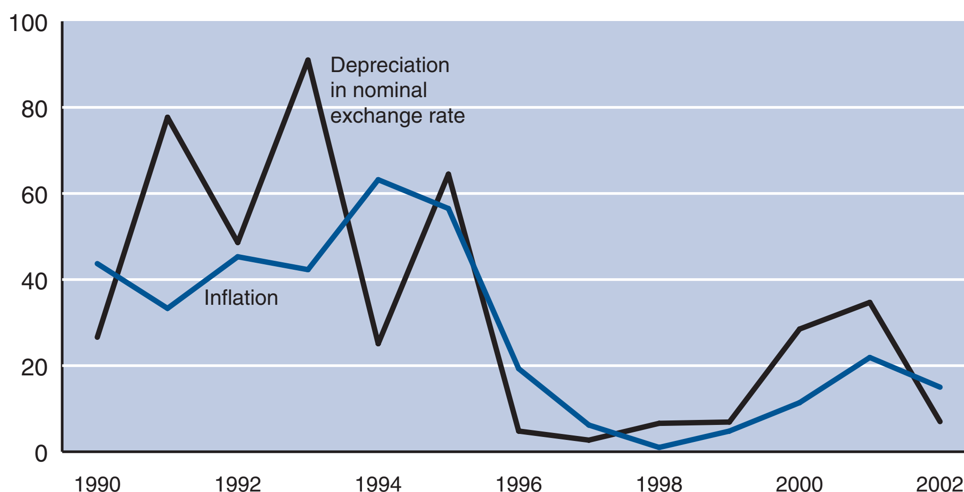
Monetary policy—inflation on the decline

Inflation slowed in 2002, to 9.1% from 21.9% in 2001 (figure 4.5), a result of tight monetary policy and higher cereal production. Holding the increase in the minimum wage to 22%, the rate of inflation in 2001, helped contain cost inflation. (Before 2002

Figure 4.5

Exchange rate down—inflation stabilizing

Inflation and exchange rate movement, 1990–2002 (%)



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

the minimum-wage increments had exceeded the previous year's inflation rate, stoking inflation.) Higher reserve requirements (from 7.9% in 2000 to 11.5% in April 2002) and treasury bill rates (from 21.4% to 31.7%) also helped slow inflation. Reinforcing the measures: strict monitoring of prudential norms by the central bank.

> *Credit to the economy increased 23% between December 2001 and June 2002, with about 82% to the private economy*

To sterilize the increased liquidity caused by foreign aid inflows and the impact of treasury operations, annual expansion of the money stock (M2, currency in circulation plus current and time deposits) has been set at 19%. In 2001 and 2002 the growth in M2 was 25%, better than the 42% in 2000 (Bank of Mozambique 2001, 2002). The main sources of monetary expansion in 2002 were the increase in credit to the economy, the exchange rate depreciation (which resulted in a revaluation of deposits denominated in dollars and other foreign exchange), and deterioration in the net position of government accounts with the banking sector—together accounting for more than 80% of the growth in M2. Credit to the economy increased 23% between December 2001 and June 2002, with about 82% to the private economy. The largest beneficiaries were industry (18%) and agriculture (16%), where 55% of net credit went to capital investments.

Exchange rate depreciation slowed with restrictive monetary policy, higher aluminium exports, and rising donor and foreign direct investment inflows. The local currency slipped by less than 4% in 2002. Nominal exchange rate depreciation has generally been above annual inflation, implying a depreciation in the real exchange rate, improving the competitiveness of Mozambique's exports (Bank of Mozambique 2001).

Financial sector—recovering slowly

The financial sector's health has been closely linked to that of the two largest banks, Banco Austral and Banco Commercial de Moçambique (box 4.4). Nonperforming loans, poor loan recovery, and links to the country's elite call for comprehensive reforms—and for strengthening the regulatory oversight of the banking sector, to maintain investor confidence.

Given the high cost of recapitalizing the failing banks, costs that compete with pro-poor expenditures, strengthening banking supervision should be a government priority. The supervision department of the central bank should receive full authority to implement prudential regulations. Banks should be monitored for compliance with the recently introduced monthly reporting on capital adequacy ratios—and penalized for incomplete or erroneous data. To send a strong signal that the government will not bail out ailing banks, it needs to divest its holdings in the banking sector.

Fiscal policy—military expenditures down, social spending up

The structure of public expenditures has changed significantly since the 1992 peace accord. Reported military expenditures dropped from 10% of GDP in 1990 to 2.4% in 1999. Social expenditures have increased—to rebuild the economy, reduce poverty, and improve literacy (table 4.5).

The aim of fiscal policy is to rebuild the country's economic and social infrastructure and stimulate growth while keeping inflation low. That requires elimination of monetary financing of the budget deficit and the adoption of overall parameters for both external and domestic debt policy and sustainability (World Bank 2001b).

Net domestic financing of the budget deficit declined from 1.8% of GDP in 1992 to –1.2% in 1994 and remained negative until 2001, consistent with the central bank policy of not monetizing fiscal deficits. In contrast, net external borrowing has averaged

Box 4.4

Privatizing major banks to avert a financial meltdown

Banco Austral and Banco Comercial de Moçambique, two of the four major commercial banks in Mozambique, had 47% of the credit market, 48% of deposits, and 62% of bank branches in 2000.

After Banco Austral was privatized in 1996, it started recording heavy financial losses, which led to the withdrawal of the successful bidder. Several of the bank's nonperforming loans were linked to powerful political figures. An attempt to investigate these loans led to the death of a central bank official, Antonio Siba-Siba, in August 2001. In advance of its sale the bank was restructured by the central bank to protect banking sector integrity. Banco Austral was successfully re-privatized in December 2001 and sold to the Amalgamated Banks of South Africa in 2002, for $10 million.

Before Banco Comercial de Moçambique, a former state-owned bank, was privatized in 1996, $14 million was stolen from the bank's vaults. Carlos Cardoso, a newspaper editor investigating the fraud, was murdered. In 2001 the government merged Banco Comercial de Moçambique with Banco Internationale de Moçambique, which increased its share of the credit market to 56%, up from 16% in 2000. The merger is a major step in cleaning up the banking sector and establishing confidence.

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

Table 4.5

Fiscal performance, 2000–02

Indicator	2000	2001	2002[a]
Government expenditure (trillions of meticais)	16.6	22.7	27.4
As % of GDP	28.1	28.9	32.3
Social expenditures (% of government expenditure)[b]	28.6	30.4	35.8
Total domestic revenue (trillions of meticais)	7.5	9.6	11.2
As % of GDP	12.6	12.3	13.2
Fiscal deficit, excluding grants (trillions of meticais)	11.1	13.1	16.2
As % of GDP	15.5	17.6	19.1
Grants as % of GDP	10.9	12.3	10.8

a. Estimated.

b. Includes only education and health expenditures.

Source: *Economic Commission on Africa, from official sources.*

3% of GDP since 1992, peaking at 7.3% of GDP in 1994. Excluding grants, deficits fell from 21% of GDP in 1992 to 10% in 1996, but then rose to 20% in 1998. Including grants, deficits declined from about 5% of GDP in 1992 to less than 2% in 1999, but are also rising, reflecting the underlying fiscal expansion and domestic funding of poverty-related activities.

With tax revenue at 13% of GDP, Mozambique needs to mobilize domestic revenue and adjust expenditures to ensure sustainability

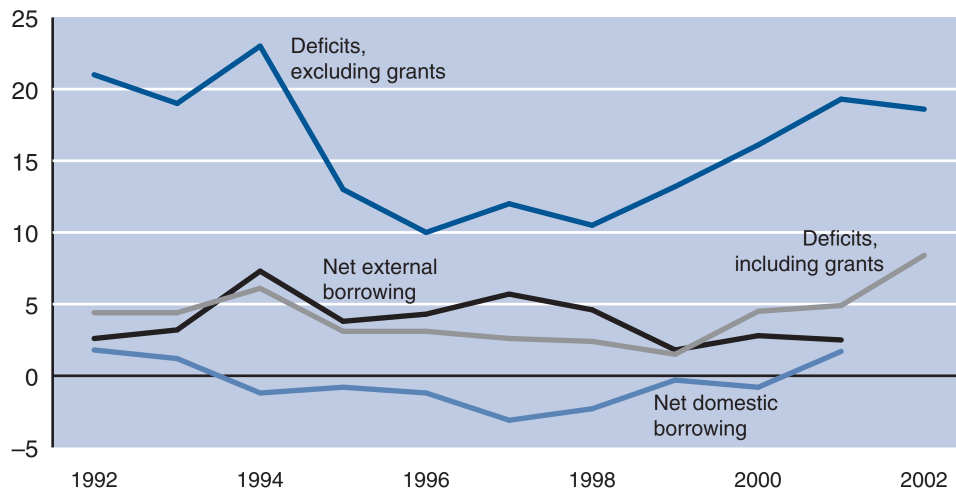
Overall, the fiscal situation continues to suffer from high deficits and heavy aid dependence (figures 4.6 and 4.7). Grants, external borrowing, and debt relief through the Heavily Indebted Poor Countries (HIPC) Initiative provided 49% of the funding for public expenditures in 2000, 51% in 2001, and 49% in 2002. With a large amount of additional external assistance not passing through the treasury account at the central bank, fiscal sustainability is a serious challenge.[3]

With tax revenue at 13% of GDP, well below the Sub-Saharan average of 18–20%, Mozambique needs to mobilize domestic revenue and adjust expenditures to ensure sustainability in the medium term. A 17% value-added tax was introduced, but given the regressive nature of indirect taxation, revenue growth has to be supported by increasing the scope and efficiency of income tax administration. New tax regulations meant to broaden coverage, particularly to corporate and personal incomes, were approved by parliament in April 2002. Under the new regulations, the personal income tax bracket has been extended from 10–20% to 10–35%, and the tax break enjoyed by civil servants to compensate for their low pay has been removed. In addition, the new tax regulations seek to ensure greater coordination and sharing of information between the tax administration and customs, through a computerized management information

Figure 4.6

High deficits and aid dependence

Fiscal performance and borrowing, 1992–2002 (% of GDP)



Source: *Mozambique, Ministry of Planning and Finance 2002b.*

system. The authorities are also planning to improve public financial management through more effective auditing and budget execution.

Coordination between the government and donors has improved, but project aid that bypasses national priorities is fragmenting ministries, weakening national identity, and undermining authority (OECD 2002). That makes it crucial to develop and implement an accounting and disbursement mechanism that coincides with the government's financial management system.

The EU share of Mozambique's exports dropped from 35% in 1990 to less than 30% in 1999, while South Africa's import share increased to 44%

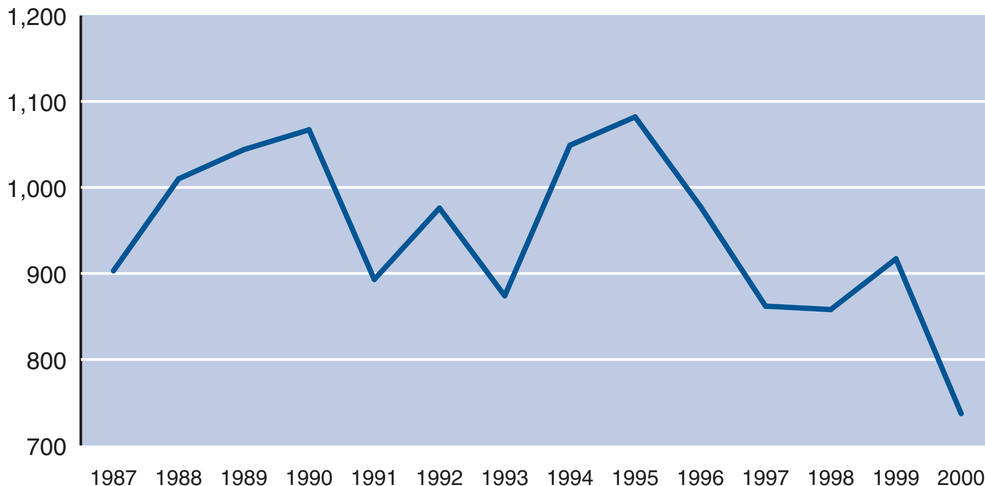
External trade—new trading partners

The EU share of Mozambique's exports dropped from 35% in 1990 to less than 30% in 1999. The import share fell from 33% to less than 16%, while South Africa's share increased to 44%. Mozambique overtook Zimbabwe as South Africa's largest African trading partner in 2001.

The composition of exports is changing from largely agriculture and fisheries to merchandise. Total merchandise exports rose from $364 million in 2000 to $704 million in 2001, an increase of 93%. Aluminium exports from the Mozal smelter accounted for $384 million, about 55% of merchandise exports, up from $60.2 million a year before.

Imports of roughly $1.2 billion a year comprise mainly raw materials, industrial equipment, and consumer goods. In 2001 imports for the Mozal plant and raw materials accounted for nearly half the total, and consumer goods for about a quarter.

Figure 4.7
Heavy aid dependence
Aid flows to Mozambique, 1987–2000 (US$ millions)



Source: *UNDP and Mozambique 2002.*

Exports covered only a third of imports in 2000 (table 4.6). But with the Mozal aluminium plant, that improved to 54% in 2001 and 61% in 2002, for a current account deficit of 18% of GDP in 2002. External debt service in 2002 was about 5% of exports, compared with 9% in 2000 and 3.6% in 2001, the decline in 2001 resulting from HIPC debt relief and increased aluminium exports.

Under the new Southern African Customs Union, Mozambique will benefit from the elimination of the common external tariff

Mozambique is implementing a formal trade strategy to modernize the economy and take advantage of opportunities from the World Trade Organization (WTO) and the Southern Africa Development Community (SADC). The SADC Trade Protocol, which establishes a free trade agreement among the 14 member states, became effective in September 2000. Mozambique's southern provinces are rapidly converging with their South African neighbours, with travel and trade on the increase.

The benefits of closer regional integration have already appeared in the trade with South Africa and in higher revenues from the transport corridors to Mozambique's ports. Mozambique has several new export opportunities within the region, which already accounts for 46% of its exports. But the crisis in Zimbabwe, though it has led to some movement of farm investment towards Mozambique, has poisoned the regional investment environment.

Under the new Southern African Customs Union (with Botswana, Lesotho, Namibia, South Africa, and Swaziland), Mozambique will benefit from the elimination of the common external tariff. In 2002 the base tariff on clothing exports from Mozambique was reduced from 72% to 25%, and that on fishery products, fruits, and vegetables to zero. Mozambique is a crucial transit country in the Zambia–Malawi–Mozambique Growth Triangle. In addition, certain Mozambican products are no longer subject to quotas under a bilateral trade agreement with South Africa.

In December 2001 Mozambique was declared eligible for duty-free trade privileges under the U.S. African Growth and Opportunities Act after fulfilling the conditions of progress

Table 4.6

External trade, balance of payments, and debt, 2000–02

Indicator	2000	2001	2002[a]
Exports (% of imports)	31.3	54.1	60.7
Trade balance (% of GDP)	–20.8	–18.4	–13.7
Current account balance (% of GDP)	–27.7	–23.6	–17.6
Nominal depreciation of the metical against the dollar (annual %)	28.5	34.7	10.0
Debt service (% of exports, after HIPC Initiative debt relief)	9.1	3.6	5.2
Debt outstanding (% of GDP)	58.0	59.4	58.8
Present value of debt (% of GDP)	24.6	25.3	25.4
Reserves, including gold (millions of dollars)	746	680	695

a. Estimated.

Source: *Economic Commission on Africa, from official sources.*

towards market-based economic policies, improvement in the rule of law, implementation of poverty reduction programmes, and the protection of workers' rights. Because of this new status, Mozambique is likely to attract investors into its textile industry from Mauritius and South Africa.

Human development

With social conditions weakened by exposure to floods and droughts and by the long war in the 1980s, indicators of human development are generally lower in Mozambique than among its neighbours (table 4.7).

Between 1965 and 1999 there were 12 major floods, 9 major droughts, and 4 major cyclones (almost one major disaster a year). The floods in February and March 2000 left 491,000 people displaced, 140,000 hectares of farmland inundated, and 52 rural health facilities and 500 primary schools damaged. There was also extensive damage to housing, roads, railways, and key utilities. The direct cost was estimated at $273 million, and the cost of reconstruction at $430 million (World Bank 2002a).

> *"The adult literacy rate of 44% in 2000 is a big improvement, but it is still well below the Sub-Saharan average of 61.5%"*

Education and employment

The adult literacy rate of 44.0% in 2000 is a big improvement over the 28.9% rate in 1985 and 40% in 1997, but it is still well below the Sub-Saharan average of 61.5% and the Least Developed Countries average of 52.8% (UNDP 2002). And the gender gap is wide, with female literacy at 28% and male literacy at 60%. About 87% of the population in rural areas and 50% in urban areas live in households where at least one adult female is illiterate.

Table 4.7

Human development indicators in Mozambique and neighboring countries, 2000

Indicator	Mozambique	Malawi	Tanzania	Zambia
Adult literacy (%)	44	60	75	78
Combined enrolment rate (%)	23	73	32	49
Life expectancy (years)	44	40	51	41
Undernourished (%)	54	35	46	47
GDP per capita (PPP $)	854	943	523	780
Population below $1/day (%)	38	na	20	64
Population using improved water (%)	60	57	54	64
Population with access to essential drugs (%)	50–79	>50	50–79	50–79
Per capita health expenditure				
PPP $, 1998	8	11	8	23
Share of public expenditures (%)	80	43	40	51
Adults with HIV/AIDS, 2001 (%)	13	15	8	22

Note: *PPP is purchasing power parity.*

Source: *UNDP and Mozambique 2002.*

The combined primary, secondary, and tertiary enrolment rate of 23% is significantly lower than the Sub-Saharan average of 42%. The main reason for the low enrolment: only 65% of the population live in villages with a primary school, and only 2% live close to a secondary school.

The main issues in higher education are gender and regional inequality, low graduation rates, and poor management of financial resources

Little surprise, then, that there is an acute shortage of highly educated workers. In 1999 only 483 students graduated from higher education, far shy of the 1,200 professionals needed each year to fill vacancies in the public sector alone. Of the labour force of about 7 million, only 12% is in paid employment, 60% of them in the private sector. About 84% of the labour force can be classified as unskilled. Unemployment is estimated at about 21% (Harber 1999).

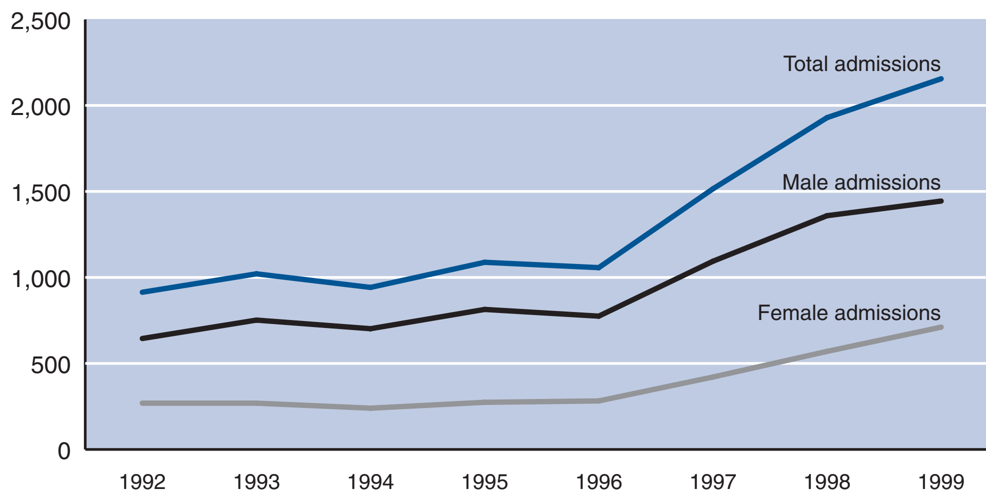
The government is improving public education administration, with funding under a fast-track provision of the World Bank's Education for All Initiative. It is also working on increasing quality and efficiency and reducing cost. The Education Sector Strategic Plan of 1998—with the motto "Fight Exclusion: Renew the School"—targets all levels of education, but with little detail for secondary and tertiary education.

The main issues in higher education are gender and regional inequality, low graduation rates, and poor management of financial resources (World Bank 2002c). Female enrolment in higher education remains at about one-third of new admissions, though there has been some improvement since 1995 (figure 4.8). This is attributable largely to the opening of private institutions, where women make up about 43% of students, compared with about 25% in the public sector (Mozambique, Ministry of Higher

Figure 4.8

Female enrolments—low but rising

New admissions into higher education institutions, 1992–99



Source: *Mozambique, Ministry of Higher Education, Science, and Technology 2000.*

Education, Science, and Technology 2000). Private institutions are fee-paying while public ones are highly subsidized and have better facilities—another issue of gender inequality.

Regionally, the distribution of higher education enrolments is skewed in favour of Maputo Province, where most of the public higher education institutions are located. About 60% of newly admitted students in 1999 were from southern provinces, two-thirds of them from Maputo City alone.

The average life expectancy is about 44 years, with significant regional disparities

Current government strategies for higher education are driven by three needs: to meet social demand for higher education through expansion in access and enhanced equity, to respond to labour market and national skill requirements, and to increase efficiency in resource use. Strategies include building the capacity of the Ministry for Higher Education, reforming curricula, expanding remedial programmes, introducing shorter duration programmes based on need, and improving learning environments, in particular, library and information technology facilities.

Despite these efforts the demand for places far outstrips the capacity of the government to fund them. New admissions in both public and private institutions of higher education are still under 2,500 a year, compared with the secondary education output of 4,000 students. With more investment in the country, the shortfall in the supply of professionals and educated labour could increase, calling for a new strategy (box 4.5).

Health—improving but still below Sub-Saharan averages

The average life expectancy is about 44 years, with significant regional disparities. The average is 62 years for women and 55 for men in Maputo Province, but 38 years for women and 36 for men in Zambezia Province.

Box 4.5

Could fees increase enrolments?

Public universities are constrained by low budgets. Only 100 of the more than 2,000 applicants to the economics department at the University of Eduardo Mondlane (UEM) are admitted each year. And the rate of graduation has been low because of ineffective faculty supervision.

Recently a partial fee-paying scheme has been introduced in some teaching departments of UEM, including the economics department. Students pay only one-third of the tuition charged at private universities, attending classes in the afternoon, after regular classes for government-sponsored students. The proceeds have been used to supplement faculty pay, paint the offices in the department, and buy new equipment, including computers, photocopying machines, and air conditioners. The faculty is spending more time with the students—enhancing supervision and the rate of graduation.

Source: *Economic Commission on Africa interviews with UEM staff.*

The infant mortality rate declined to 127 per 1,000 live births in 2000, compared with 162 in 1970, but remains higher than the Sub-Saharan average of 107. Maternal mortality is very high at 1,100 deaths per 100,000 live births, compared with 530 in Tanzania and 650 in Zambia. Less than 20% of the populace lives in a village with a nurse, midwife, or health post, only 2% near a doctor, and the average distance to a health post is 20–30 kilometres.

About 13% (710,000) of the adult population 15 to 49 years old was living with HIV/AIDS in 2001, and malaria and tuberculosis are rising at alarming rates

About 13% (710,000) of the adult population 15 to 49 years old was living with HIV/AIDS in 2001. And malaria and tuberculosis are rising at alarming rates.

The government has taken a robust stance in addressing the HIV/AIDS epidemic. It has established the National AIDS Council and adopted a multisectoral action plan to coordinate all AIDS-related activities in the provinces and regions. The main strategy is to improve access to voluntary testing and counselling, with assistance focusing on primary and secondary care. Public expenditure on health is projected to rise by about 25%, to $150 million by 2005, from $120 million today, because of the HIV/AIDS epidemic, which threatens to reduce GDP growth by 4 percentage points by 2010.

The Health Sector Strategic Plan (2001–2005–2010) attributes the poor health situation to low education, lack of safe drinking water, and the consequences of war. It seeks to promote quality health care for all by:

- Developing appropriate systems and programmes for the delivery of health care.
- Having communities participate in health care provision and administration.
- Collaborating with local and external partners in the delivery and financing of health care.

Poverty reduction—slow progress

The incidence of poverty—as measured by the head count index based on the basic consumption poverty line of 160,780 meticais (about $14) a month in 1996–97—was 69%, or roughly 12 million of the country's 17 million people.[4] In 2001 the estimated poverty incidence was 64%.

As in other developing countries, poverty in Mozambique is largely rural, highest in Sofala, Tete, and Inhambane provinces, with 80% of the people poor, and lowest in Maputo City, with 48% poor (table 4.8).[5] Why the disparities? Unbalanced growth and differences in access to health and education.

Other demographic factors that influence the incidence of poverty are gender, education, and type and sector of employment. Male-headed households have lower incidences of poverty than female-headed households. Real consumption per capita is 15–18% higher in male-headed households than in female-headed households in urban areas, and 4–9% higher in the rural areas. The effects of literacy and education of the household head on per capita real consumption are stronger in the southern provinces than in the northern because of the greater opportunities for paid employment.

Poverty in Mozambique can also be attributed to low productivity in agriculture, lack of employment opportunities, weak physical infrastructure, and poor access to potable water, communications, and markets (Datt and others 2000). Poor integration of regional and local markets, because of weak transport infrastructure, also contributes to wide variations in welfare across regions. Disparities may deepen with the concentration of infrastructure investments in the Maputo area (table 4.9). Some parts of the country receive almost no direct investment.

Table 4.8

Poverty indices, 1996–97

	Food poverty Headcount index		Basic consumption poverty Poverty gap index	
Regions/provinces	**1996**	**1997**	**1996**	**1997**
Rural	55.7	20.3	71.2	29.9
Urban	44.5	16.0	62.0	26.7
Northern provinces	50.0	17.4	66.3	26.6
Central	59.4	22.6	73.8	32.7
South, with Maputo	47.7	16.5	65.8	26.8
South, without Maputo	54.1	19.3	71.7	30.2
National	53.4	19.4	69.4	29.3

Note: *Disaggregated poverty data are not available for later years.*

Source: *Datt and others 2000.*

Table 4.9

Distribution of foreign and local direct investment, by province, 2001

	Foreign direct investment		National direct investment	
Province	**US$ thousands**	**% of total**	**US$ thousands**	**% of total**
Maputo (city and province)	479,630	92.7	23,844	71.4
Sofala (centre)	17,370	3.4	137	0.4
Cabo Delgado (north)	8,859	1.7	3,694	11.0
Nampula (north)	5,818	1.1	455	1.4
Inhambane (south)	3,006	0.6	2,842	8.5
Manica (centre)	740	0.1	220	0.7
Zambezi Valley	706	0.1	805	2.4
Zambezia (centre)	706	0.1	916	2.7
Gaza (south)	445	0.1	478	1.4
Tete (south)	280	0.1	5	0.0
Niassa (north)	0	0.0	0	0.0
Total	517,561	100.0	33,396	100.0

Source: *Mozambique, Investment Promotion Centre 2002.*

The country's new investment law calls the disadvantaged regions Rapid Development Zones, allowing special tax benefits for investors who establish operations in Niassa Province, Nacala District, Mozambique Island, Ibo Island, and Zambezi Valley (all the districts in Tete Province, and certain specified districts in Zambezia, Sofala, and Manica provinces). To ensure effective local participation in the new businesses, the activities eligible for fiscal benefits must promote development based on local comparative advantage: agriculture, forestry, aquaculture, livestock raising, lumbering, telecommunication, game animal exploitation, water supply, and electric energy generation, transmission, and distribution.

> *"Mozambique reached the enhanced HIPC completion point in September 2001, reducing its foreign debt stock from about $6.1 billion to $1.6 billion"*

The government hopes to develop the Zambezi River Valley along the lines of the Tennessee Valley Authority (TVA) in the United States, and in February 2002 it opened discussions for possible assistance with TVA, the U.S. Agency for International Development, and the U.S. Army Corps of Engineers. When completed, the project would improve navigability, flood control, and reforestation and assist in industrial and agricultural development for a third of the country's people.

The government also aims for high rates of sustainable, poverty-reducing growth by consolidating macroeconomic stability and increasing the provision of social services, based on:

- Pro-poor and pro-rural growth and development.
- Higher and more effective public expenditure, especially in education, health, and infrastructure.
- Conducive macroeconomic and business conditions.
- Private sector development.
- Good governance and justice.
- Strong central and local governent institutional capacity to define, implement, and monitor public policies.

The medium-term expenditure framework seeks more effective use of public resources in education, health, agriculture, and rural development, for greater impact on poverty (table 4.10). The country reached the enhanced HIPC completion point in September 2001, reducing its foreign debt stock from about $6.1 billion to $1.6 billion. Debt relief will reduce annual debt repayment to $56 million between 2001 and 2012, half the $112 million due before June 1999. Though reduced, remaining debt is still close to half the budget for health.

Private sector—poised to benefit from regional markets

The private sector in Mozambique, weak after 15 years of socialism and state intervention, is moving away from a closed, centrally planned regime toward a market system underpinned by private ownership.

The quality and efficiency of business applications and queries has improved considerably in the last five years, with one-stop shops to deal with business registration and related issues (UNIDO 2002). The government has entered an agreement with the African Development Bank to set up a $4.7 million credit fund for small and medium-size enterprises, to complement UNIDO's Integrated Programme for Small and Medium-Size Enterprises.

But bottlenecks remain: red tape, undercapitalization, a lack of skilled labour, investor-unfriendly labour laws, and weak infrastructure. The high cost of doing business in Mozambique is also attributed to outmoded and unclear rules and regulations and ineffective private-public consultative mechanisms (UNDP, UNIDO, and Mozambique Ministry of Industry and Commerce 2001; Nathan Associates 2002).[7]

> *The quality and efficiency of business applications and queries has improved considerably in the last five years, but bottlenecks remain*

Foreign direct investment—from regional powerhouses

In 1999 net flows of foreign direct investment hit 9.7% of GDP, 20 times the 0.4% in 1990. Flows are projected to reach $800 million, more than 20% of GDP, in 2002. Between January and August 2002 the Investment Promotion Centre approved about $1.7 billion in new projects, many of them large. The average investment rose from $21 million a year in 1989–94 to $800 million in 2002.

One of the main features of foreign direct investment flowing to Mozambique is this dominance of large projects. Another is the diversity of sources, from about 45 economies, ranging from Hong Kong to the United States (Mozambique, Ministry of Planning and Finance 2002b). South Africa has become the largest source of foreign direct investment in recent years, accounting for 70%, followed by Portugal (10%) and the United Kingdom (4%).

Table 4.10

Medium-term expenditures under the Action Plan for the Reduction of Absolute Poverty, 2001–05 (% in 2001 prices)

Sector	2001	2002	2003	2004	2005
Priority areas	69.1	72.4	74.0	75.3	74.9
Education	24.1	20.7	21.3	21.4	21.5
Health	11.7	13.6	14.4	14.7	14.9
Infrastructure	20.2	22.4	21.5	21.8	20.7
Agriculture and rural development	3.9	4.7	5.0	5.1	5.1
Governance	8.1	9.1	9.7	10.1	10.4
Other	1.1	1.7	2.1	2.2	2.3
Other sectors	30.9	27.6	26.0	24.7	25.1
Total	100.0	100.0	100.0	100.0	100.0
Total (billions of meticais)	17,704	17,081	18,008	19,936	20,967

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

A major concern is that foreign investment projects provide limited employment opportunities for local labour because of the high skill requirements—and are insulated from the domestic economy through fiscal incentives and exemptions from administrative red tape. BHP-Billiton, owners of the Mozal aluminium smelter, have responded with a small and medium-size enterprise empowerment and linkages programme to provide technical support to local businesses, to train them in tendering procedures, and to improve their cost and financial management.

More than 840 companies were privatized between 1989 and 1997, 90% of them acquired by Mozambican companies and individuals

Privatization—mixed results

Second-generation reforms have focused on the public sector, privatization, the judiciary, tax administration and public financial management, and the legal and institutional environment for private sector development, all to reduce the cost of doing business and enhance the competitiveness of local production.

More than 840 companies were privatized between 1989 and 1997, of the 1,248 companies slated for privatization, 90% of them acquired by Mozambican companies and individuals. Privatization has been most successful in services, notably utilities and transport, probably thanks to the ease of valuing assets and the high interest of foreign investors. The energy sector has been liberalized, and the transport sector, including railways, has been partially liberalized. In May 2002 the domestic airline market was fully liberalized, to allow other airlines to operate on domestic routes previously monopolized by the state-owned airline, as specified under the Yamossoukro Declaration on the Liberalization of Air Spaces in Africa. This is expected to result in lower domestic airfares as foreign companies enter the industry. In the telecommunication sector, Vodacom Mozambique, which has Vodacom South Africa as its majority owner, was awarded a license to set up the country's second mobile telephone network in 2002.

Information and communication infrastructure—closing the digital divide

Telecommunication infrastructure is improving in Maputo and other urban centres, but remains weak in the rural areas. There are 4 telephone mainlines per 1,000 people (the average for Sub-Saharan Africa is 15), 2 cellular phone subscribers per 1,000 people (19 for Sub-Saharan Africa), and less than 0.1 internet host per 1,000 people (0.4 for Sub-Saharan Africa).

The government's strategy is to develop information and communication technology policies to promote competition by liberalizing the telecommunications market and awarding new mobile telephony licenses, to provide universal access to communications services, and to coordinate public-private action to foster information and communication technology in education, health, human resources, information infrastructure, and government.

Public-private partnerships

Alone, neither the public sector nor the private sector can ensure sustained economic growth. But together they can promote Mozambique's economic development, especially

in the provision of social services and public decisionmaking. Public-private consultations could help overcome the shortcomings in public resource management and enhance the delivery of public services. But the dialogue between the private sector and the central government is constrained by red tape, heavy bureaucracy, and a lack of incentives (Mozambique and EU 2002).

The government, the private sector, the donor community, and the universities agree that a sustained national consultative platform is critical to competitiveness and the inflow of foreign investment (UNDP, UNIDO, and Mozambique Ministry of Industry and Commerce 2001). So a secretariat for private-public dialogue has been set up to carry forward Mozambique's development agenda.

Current policy is to involve the private sector in the construction and rehabilitation of transport infrastructure, in the management by contract or concession of ports, railways, airports, and air services and shipping.

"The medium-term outlook is favourable because of improving agricultural production, new investments in aluminium and natural gas, and favourable international prices"

Medium-term outlook—fairly favourable

The medium-term outlook is favourable because of improving agricultural production, new investments in aluminium and natural gas, and favourable international prices for aluminium, cotton, and shrimp. The economy is expected to grow 9–10% a year in 2003–05 (table 4.11). And aluminium production from the Mozal plant should generate about $3 billion in exports by 2006.

Higher oil prices would put pressure on local prices, as would growing social expenditures, especially on HIPC-related programmes. The government should thus continue its tight monetary stance and expand revenue collection efforts.

With poverty a major concern, implementation strategies for the Action Plan for the Reduction of Absolute Poverty should focus on labour-intensive export-oriented activities and on linkages between agriculture and agro-processing. The country also needs

Table 4.11

Medium-term economic prospects, 2003–05

Indicator	2003[a]	2004[b]	2005
GDP growth (%)	9.5	9.0	9.0
Inflation (%)	8.0	5.0	5.0
Fiscal balance excluding grants (% of GDP)	–14.7	–13.2	–12.0
Trade balance (% of GDP)	–6.7	–2.4	4.1
Current account balance (% of GDP)	–10.0	–3.5	–3.5

a. Forecast.

b. Targeted.

***Source:** Economic Commission on Africa, from official sources.*

to develop stronger links between the large foreign investment projects and the rest of the economy—to ensure faster growth, employment generation, and poverty reduction (box 4.6). In addition, the transfer mechanisms for getting public funds to provinces with development difficulties should be made more efficient.

Mozambique has to meet the standards of its neighbours in improving competitiveness —innovating with policies, deepening reform of the public services, and streamlining banking procedures. President Chissano's decision to step down in 2004 augurs well for national governance and the solidification of democratic institutions. But the challenges of good governance, national reconciliation, and political stability remain considerable, with accountability and transparency at the top of the agenda.

Box 4.6

Threats to poverty reduction in Mozambique

Mozambique's economy has been growing at an average of 8% a year over the past decade, but the population living below $0.40 a day (the national poverty line) remains above 60%. The government has put in place a major effort under the Action Plan for the Reduction of Absolute Poverty to meet the challenges. But some serious questions remain.

- What is the capacity for the economy to continue to grow by at least 7% a year in the absence of generous development assistance?
- What would be the impact of natural disasters, notably floods in agricultural areas, for which there are no contingency plans?
- How can the mega projects, vulnerable to unforeseen international market developments, increase employment opportunities for the poor and unskilled?
- How can human resources be developed to support programme implementation?
- What will be the impact of HIV/AIDs?
- What needs to be done to increase the capacity of public and private institutions, particularly with decentralization?

Source: *UNDP and Mozambique 2002.*

Notes

1. In Portuguese Frelimo stands for Frente de Libertação de Moçambique, and Renamo for Resistência Nacional de Moçambique.

2. Maize yields vary between 0.7 and 0.9 tons a hectare, against an average yield in Southern Africa of 1.2 tons a hectare (Mozambique and EU 2002).

3. Fiscal sustainability is achieved when the levels of domestic and external borrowing necessary to finance the budget deficit are not likely to lead to a debt crisis over time and rising interest rates do not crowd out domestic private investment.

4. There are two poverty lines, the food poverty line and the basic consumption poverty line, which includes nonfood consumption. For each poverty line there are different poverty lines for each province and for rural and urban areas. The national poverty line is a weighted average of the different regional poverty lines.

5. The national basic consumption poverty line of 160,780 meticais per month per person (about $170 per person per year, at the average exchange rate prevailing during the survey period), obtained from the 1996-97 National Household Survey of Living Conditions data, was based on estimates of mean per capita daily calorie requirements (food consumption) and nonfood components (see Datt and others 2000). The national food poverty line is 130,377 meticais (about $0.40) a day per person.

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