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**Economic development in Africa:**

**trade liberalization and export performance in Africa**

### Economic Development in Africa

## Export Performance following Trade Liberalization: Some Patterns and Policy Perspectives<sup>\*†</sup>

### Overview

#### *Executive summary*

This year's *Economic Development in Africa* report examines Africa's export performance following trade liberalization, with a view to proposing policies to improve export performance. The report shows that the extensive trade liberalization undertaken by African countries has not been followed by a substantial improvement in their export performance. This suggests that there are serious obstacles hampering a supply response to the new incentive structure created by the removal of barriers to trade. The obstacles mainly consist of structural problems related to weak capacity in the production and marketing of exports in both the agricultural and manufacturing sectors. Strong State capacity is required to increase access to factors of production and improve the business environment. In the manufacturing sector, efforts to improve all aspects of productivity and to create efficient export promotion agencies that help firms to identify and seize opportunities in export markets should be at the heart of industrial policy. The agricultural sector would benefit from better research and development, irrigation facilities and extension services. Greater liberalization of agricultural trade in the markets of developed countries is also key to improving Africa's agricultural export performance.

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\* This document was submitted on the above-mentioned date as a result of processing delays.

† The information in this document should not be quoted by the press before 15 September 2008. This overview should be read in conjunction with the full report (UNCTAD/ALDC/AFRICA/2008).

## **I. Trade liberalization in Africa: timeline**

1. In the twentieth century, Africa's trade relations with the rest of the world went through three principal phases. During the colonial period, African countries' trade policies were defined according to the interests of the colonizing countries. In the decades following independence, many African countries chose protective trade policies aimed at import-substitution industrialization. Following the economic crisis of the late 1970s and early 1980s, most African countries took measures to liberalize their trade regimes. Trade liberalization was often part of an extensive package of market-oriented reforms promoted by the international financial institutions at a time when African countries were in acute need of their assistance. These institutions argued that more liberalized trade regimes would improve the efficiency of the economy by promoting greater production of tradables and would expand output by increasing the level of exports.

2. Trade liberalization consists of a number of policy measures that aim to reduce the misalignment between domestic and international prices. These include reductions in tariffs, the conversion of non-tariff measures into tariffs, and a reduction in the overvaluation of currencies. The speed and sequencing of reforms varied among African countries, so it is difficult to pinpoint when precisely liberalization occurred in a given country. Generally speaking, however, the most comprehensive studies of liberalization suggest that the process started in the mid-to late-1980s and was completed in most African countries in the late 1990s.

3. Tariffs on imports were one of the main instruments used to protect domestic industries in Africa. Trade liberalization sought to simplify tariff structures, reduce the number of tariff bands and reduce tariff levels. Overall, tariff levels in Africa were nearly halved between 1995 and 2006, from 22 per cent to 13 per cent. However, there are considerable differences between country experiences in terms of tariff reduction, and tariff levels remain higher than in most other developing regions.

4. Non-tariff measures such as quantitative import restrictions and administrative barriers were also prominently used as trade protection measures in Africa. The conversion of these measures into tariff equivalents, known as "tariffication", was therefore a crucial part of trade liberalization in African countries. Nowadays, Africa is one of the regions where non-tariff measures are least used.

5. Many African countries suffered from a severe overvaluation of their currencies prior to trade liberalization. This constituted an important disincentive for exports as it rendered domestic products less competitive in foreign markets and created important pressures for trade protection. Exchange rate liberalization has been largely successful in Africa. From an average unweighted average of over 200 per cent in the period 1981–1985, the parallel exchange rate premium fell to under 50 per cent in the late 1990s. In recent years, there has been a convergence between official and parallel exchange rates in African countries.

6. Other barriers to exports such as export taxes and agricultural marketing boards have been completely removed in most African countries.

## **II. Export performance trends following trade liberalization in Africa**

7. Improvements in export performance following trade liberalization have been limited in most African countries. Indeed, as a proportion of gross domestic product (GDP), exports in Africa increased by only 10 per cent following liberalization. In

comparison, non-African developing countries saw their exports as a share of GDP increase by 62 per cent. The increase in exports was also smaller than the increase in imports, leaving the trade balance in Africa in a worse situation after liberalization.

8. Econometric analysis undertaken to estimate the specific effect of liberalization on exports suggests that, other things being equal, liberalized African countries have export-to-GDP ratios that are 9.5 per cent higher than those of non-liberalized ones. The effect of trade liberalization on the ratio of exports to GDP in Africa appears to be higher than in other developing countries, where trade liberalization led to a 5 per cent increase in the ratio of exports to GDP. The difference between this result and the descriptive statistics discussed earlier is due to the fact that the econometric model attempts to attribute causality to different factors determining trade performance. Indeed, weak export momentum and inappropriate domestic policies appear to be the main factors explaining this difference. Africa seems less able to maintain its export market share than its competitors from other developing regions. Out of one percentage point of GDP in exports in a given year, African countries are able to keep 0.78 of a percentage point of GDP the following year, as a result of the lower momentum effect. This is lower than in other developing countries where the ratio is 0.87, other things being equal. Moreover, domestic policies, proxied by the changes in the real effective exchange rate (which incorporate currency overvaluations), have the highest negative effect on exports in Africa relative to other developing regions.

9. In absolute value terms, exports increased by 12 per cent per annum on average over the period 1995–2006 in Africa. This increase is slightly larger than that observed for all developing countries over the same period. When the increase in value is disaggregated between volume and price effects, however, it appears that this is mainly due to rising world prices for African exports over the last few years. Indeed, export volumes grew by a yearly average of only 6 per cent over the period, which is lower than the comparable figures for world and developing-country exports (6.5 per cent and 9 per cent, respectively). If export unit prices are considered, however, it appears that African exports have benefited from rising prices to a much higher degree than other regions. This suggests that African exports continue to grow at a lower rate than other regions in volume terms and that it is only the rising prices of fuels, minerals and other primary commodities since 2002 that have maintained African export value growth at a level comparable with other developing regions.

10. The trade structure of African countries did not undergo significant changes in the years following trade liberalization. Most countries in the region remain essentially primary commodity exporters, with only a handful of countries drawing a significant part of their export revenue from manufactured products. In comparative terms, sub-Saharan Africa remains the region with the highest dependence on primary commodity exports. It also appears that export concentration has increased in the years following trade liberalization, strengthening Africa's standing as the region with the highest concentration of exports.

11. There are several trends in the destination of African exports. However, these appear to have been generally unaffected by the process of trade liberalization. European countries continue to represent the largest market for African exports, although their share has been decreasing steadily over time as the influence of historical ties on African trade patterns diminishes. North America's share in Africa's export markets has increased in recent years, mainly as a result of increased oil exports and new preferential market access initiatives such as the African Growth and Opportunity Act. The importance of Asia to African exporters has increased considerably since the 1990s. This is mainly due to sustained high rates of

economic growth in Asia and the associated need for primary products produced in Africa. Finally, the share of intra-African exports has seen an increase. This increase largely predates trade liberalization, however, and intraregional trade remains low when compared to other regions, offering a remarkable potential for growth.

### **III. Trade liberalization and agricultural exports**

12. Agriculture remains the bedrock of African economies. It contributes around a fifth of total GDP and employs nearly two thirds of the population in sub-Saharan Africa. Agricultural exports also represent the bulk of total merchandise exports in most African countries.

13. Though the value of African agricultural exports has increased by 74 per cent since 2001, this rise has mainly been proportionate to the increase in GDP and has been considerably lower than the rise in agricultural export values seen in East and South-East Asia or Latin America. As a result, the contribution of agricultural exports to GDP has not increased noticeably since trade liberalization and the African share in global agricultural exports has actually decreased. Moreover, the proportion of agricultural production that is traded fell steadily in sub-Saharan Africa between 1995 and 2006.

14. Looking at individual country experiences, it appears that the countries that have been most successful in exporting agricultural products are those in which a deliberate export orientation of agriculture and product diversification was pursued by Governments. Overall, however, most sub-Saharan African countries continue to export traditional bulk agricultural commodities. Only a few countries have started to export new market-dynamic horticultural products.

15. Much of the explanation for the lack of agricultural export response to the new incentives created by trade liberalization is rooted in the constraints that limit agricultural production in general in African countries.

16. First, African agricultural producers tend to face severe credit constraints. This situation is partly due to the insecurity of land titles in many African countries and the poor performance of the financial sector in rural areas. In addition, market-oriented reforms, of which trade liberalization measures were a part, dismantled many of the institutions designed to provide credit and other inputs, including extension services, to small agricultural producers. As a result, agricultural producers lack access to capital and other inputs which would allow them to intensify or extend their production for exports.

17. Second, public investment in the agricultural sector and the rural economy in general has diminished over time. This has aggravated the difficulties facing agricultural producers, mainly owing to poor infrastructure provision and agricultural research services that do not address the main priorities of African countries. Indeed, the poor quality and lack of maintenance of infrastructure in rural areas impose high costs on production and commercialization. It appears that the fall in public investment in the agricultural sector is related to the decline in official development assistance targeted at this sector. Indeed, public investment in agriculture was previously strongly supported by external funding in many African countries.

18. The result of these constraints on the agricultural sector is that cereal yields in Africa have not significantly improved since the 1960s and are now several times lower than those of other developing regions.

19. In terms of market access, African countries benefit from trade preferences in many of their export markets. Overall, then, Africa enjoys good market access for its products when compared with other regions of the world, but this is largely due to the low barriers imposed on products such as fuels, ores and metals. Countries exporting mainly agricultural commodities that compete with developed-country production – such as wheat, meat or cotton – face very high tariffs and non-tariff measures as well as competition from highly subsidized production.

20. Furthermore, agricultural commodities are increasingly traded within global marketing and distribution channels in which only a small share of the final sale price goes to the producer. Africa's share in global agricultural exports has been reduced by a combination of the way in which African producers are integrated in global value chains and increased competition from other developing regions that have improved their agricultural productivity.

21. Overall then, it appears that the expectations of the advocates of trade liberalization policies have not been met in most African countries. It was expected that by removing the barriers to trade, production for exports would automatically increase in response to new incentives. It is now clear that barriers to trade were only one of the many factors constraining African agricultural exports, and that the issues plaguing the production side and the global market structure will need to be addressed before there can be any large increase in agricultural exports from Africa.

#### **IV. Trade liberalization and manufactured exports**

22. Manufacturing exports represent a negligible proportion of GDP in most African countries. Indeed, in the period 2000–2006, only eight African countries had manufacturing exports worth 10 per cent of GDP or more. As a result, Africa is the region in which manufacturing represents the lowest share of total merchandise exports. Furthermore, a handful of middle-income African countries account for the quasi-totality of African manufacturing exports. In global terms, Africa plays a minor role in manufactured exports.

23. Above all, the low level of manufacturing exports reflects the small size of the manufacturing sector in most African economies. The level of manufacturing in the economy has not increased noticeably in Africa since trade liberalization. If anything, there has been a slightly downward trend in the ratio of manufacturing value-added to GDP in the years following liberalization.

24. To explain the poor response of the manufacturing sector to the opportunities created by trade liberalization, it is important to examine the constraints that manufacturing firms in Africa face and that prevent them from expanding and branching into production for exports.

25. One of the key elements preventing African manufacturing firms from becoming successful exporters is their low level of competitiveness as compared with firms in other regions. Indeed, the costs of production in African countries tend to be considerably higher than those in other regions. Studies suggest that the main determinant of the difference in productivity is the high cost of labour in Africa, although allocative inefficiency also plays a role. Non-labour costs such as the cost of credit, transport and indirect costs are also higher in Africa than in major developing countries exporting manufactured products. Hence, low competitiveness has prevented African firms from moving into exporting. As a result, these firms have not been able to benefit from the “learning from exporting” effect that can lead to productivity gains of up to 50 per cent in the long term.

26. A second aspect constraining firms' expansion into exports is the limited level of investment in African economies. This level was expected to increase in response to the new policy environment created by trade liberalization. Empirically, however, it appears that investment levels did not increase noticeably following liberalization. This suggests that the investment response to trade liberalization was constrained by factors such as poor infrastructure, low investor protection and poorly functioning credit markets.

27. A third feature of African manufacturing firms that constrains their expansion is their small size. African manufacturing firms are too small to engage in competition for exports with much larger firms from other developing regions. Firm size is also related to the issues of efficiency and access to investment outlined above. In particular, it is linked with the poorly functioning credit market in many African countries.

28. The firm-level constraints to production and export discussed above highlight the challenges that must be overcome if Africa's manufacturing export performance is to be improved. Indeed, the proponents of trade liberalization considered that the main barrier to manufacturing exports in African countries was the restrictive trade policies of African Governments and that removing these barriers would therefore promote exports. In fact, even after the successful dismantling of a large part of Africa's trade barriers, there are still many constraints faced by manufacturing firms that continue to limit their export performance today.

## **V. African manufacturing and comparative advantage**

29. Many analysts have attributed Africa's limited success in exporting manufactured products to the continent's comparative advantage. This influential position holds that, given the continent's endowments of natural resources, labour and capital, it should focus on exporting unprocessed primary commodities and use the revenue gained to purchase manufactured goods from abroad.

30. The comparative advantage argument is, however, flawed on many accounts. First, the assumptions underlying the argument are empirically untenable, especially in Africa. Full employment of resources, perfect competition and immobile factors of production cannot be considered close approximations of the reality in most African countries. Second, the comparative advantage hypothesis sees all products as being equivalent, when in fact there are important differences between primary agricultural product exports and manufactured exports. Indeed, primary commodity exports have faced declining terms of trade when compared to manufactures during the twentieth century and their prices tend to be considerably more volatile than those of manufactures. Additionally, the global commodity chains through which these products are marketed typically leave only a small proportion of the final selling price for producers. It appears, therefore, that confining African countries to the production of primary commodities amounts to condemning them to remain locked in the commodity trap. Africa needs to create a competitive advantage in the production of manufactured products, as many other developing countries have done. The products that a country specializes in by developing its competitive advantage have a strong influence on that country's development.

31. Manufactured goods, and especially technology-intensive products, are characterized by improving secular terms of trade and more positive externalities for the domestic economy than agricultural products. Additionally, specialization in higher value-added products carries higher dynamic gains over the long term. In other words, countries acquire new comparative advantages over time depending on which products they specialized in at the outset. Comparative advantage, therefore,

needs to be seen as a dynamic attribute that needs to be actively cultivated rather than a static constraint imposed by countries' natural resource endowments.

## **VI. Strengthening Africa's export performance: some policy perspectives**

32. Export performance in Africa has not improved much in the years following trade liberalization. This lack of response points to the need to identify the constraints that continue to limit export performance. Indeed, trade liberalization measures have comprehensively addressed macroeconomic policies such as overvalued exchange rates and restrictive trade policies that constrained export performance. The lack of a supply response to the removal of these constraints suggests that there are deeper problems related to the production and marketing of exports in both the agricultural and manufacturing sectors. There is therefore a need for policies specifically targeting the constraints that continue to dampen export performance in African countries.

33. More specifically, Governments in Africa should focus on promoting and enabling horizontal and vertical diversification towards higher value-added products. This can be done through a combination of incentives to promote, for example, investment in irrigation facilities or other aspects of agricultural production and exports, as well as through the direct provision of physical infrastructure, agricultural research, extension services and export facilitation services.

34. In the medium to long term, Governments should also review the opportunities to tackle such issues as land tenure systems and the gender division of labour in rural areas in order to improve the productivity of agriculture.

35. Steps can also be taken at the global level to improve agricultural export performance in Africa. First, there should be effective liberalization of agricultural trade in developed-country markets. Second, it may be desirable to revisit options that have been explored in the past, such as international commodity agreements and diversification funds, in order to improve the terms on which African agricultural exporters interact with the market. Finally, Aid for Trade and other technical assistance programmes should be directed at upgrading Africa's trade infrastructure. This would enable African countries to strengthen their capacity to trade more efficiently and attain quality and consistency in their exports, including by meeting the health and safety requirements for food in their export markets.

36. In manufacturing as in agriculture, more attention needs to be paid to production and marketing aspects in order to facilitate a substantial increase in exports. In particular, manufacturing firms' competitiveness needs to be addressed as a priority; it is arguably the most important determinant of participation in export markets. Competitiveness needs to be tackled at the level of both the economy and the firm. At the level of the economy, weaknesses in basic productive infrastructure need to be remedied. Key sectors such as power generation, water supply, telecommunications and transport need to be improved in order to build a competitive export sector. At the level of the firm, labour productivity must be increased through such measures as vocational and on-the-job training, the sharing of best practices and other capacity-building measures. Efficient export promotion agencies can also help firms to identify and seize opportunities in export markets.

37. The positive effect of firm size on many indicators of performance and on exports highlights the need to promote large firms. This is particularly important in Africa, where firm size distribution is heavily skewed towards very small firms.

One way of promoting larger firms is to encourage foreign direct investment in Africa's manufacturing sector, as firms with foreign ownership tend to be larger than domestic ones and are more export-oriented. Measures should also be taken to increase domestic investment in existing firms to allow these firms to grow and export more. Both these strategies will require improvements to the investment and business environments in African countries.

38. Another crucial aspect to consider in order to improve the export performance of manufacturing firms in Africa is their access to factors of production. Limited access to capital, for example, has been identified in many African countries as a key constraint to firms' growth. There is an urgent need, therefore, to improve the efficiency of the credit market in African countries. One way to do this would be to reduce the information asymmetry between small firms and financial institutions by creating credit information bureaus to collect information on creditworthiness and share it with potential lenders. Closer relations should also be encouraged between the private sector and financial institutions in African countries. Banks and other lending agencies could, for example, provide business advisory services in order to improve the performance of firms that they lend to.

39. Overall, it appears that if African countries are to reap the potential benefits of trade liberalization, attention now needs to be refocused on the productive and marketing constraints facing African agricultural and manufacturing producers.

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