

## **Editor's Preface to Alemayehu Geda *Finance and Trade in Africa***

At the start of a new millennium and after almost half a century of independence, the African economy seems trapped in a low-level disequilibrium. This not only condemns millions of people to a life of poverty but also blocks the process by which human and material capital can be accumulated. Many of Africa's economic problems are to be found within her own state and civil society, but it is too easy – and too convenient for the rest of the world – to attribute all economic problems to 'governance'. The fact is that Africa is an integral part of the world economy, open to financial and trade shocks and without the means to protect itself effectively against these shocks.

There are 51 countries in Africa, which accounts for 12 per cent of the world population. Yet, according to IMF estimates, the region generates only 3.3 per cent of world GDP at 1998 purchasing power parity and 1.8 per cent of world exports of goods and services. By comparison, Italy alone accounts for 3.4 per cent of world output and 5.7 per cent of world trade. This apparent marginalization is, of course, asymmetric. Although the world may not 'need' Africa in an economic sense, what happens in the world economy does have profound effects on Africa through commodity prices, interest rates, foreign investment flows, migrant remittances and aid budgets. African policymakers – and indeed ordinary Africans – are well aware of this asymmetry but seem powerless to affect it, or even to reframe the agenda of international debate.

Indeed, the prevailing orthodoxy in Washington and Brussels tends to be that this is an out-of-date socialist view, based on discredited 'dependency' theories, originating in the independence struggle. The importance of the world economy to Africa is not denied, of course, but national governments are enjoined to adjust to 'economic reality' and 'market discipline' in order to stimulate exports and promote foreign investment. The danger that the efforts of individual countries trying to adjust will lead to a 'race to the bottom' in labour standards, environmental safeguards and tax concessions is ignored; as is the 'fallacy of composition' inherent in the small-country assumption, leading to the over-expansion of commodity supplies and declining prices.

The problem is thus one of economic *perception* as well as one of economic *reality*. What has been missing, perhaps, is a modern view of the world economy from an African standpoint. Alemayehu Geda is perhaps uniquely qualified to undertake this task, since, possibly alone among young African economists, he possesses the technical skills to see beyond the platitudes of the 'North-South' debate. Thus, he examines external economic relations as a variable, rather than as a given. Hence, domestic economic events become endogenous to the model rather than simply at the behest of policy makers. This shows, on the one hand, how limited the options really are for domestic policymakers (especially if they act individually and only for short periods) and, on the one hand, the crucial importance of changing international arrangements – particularly trade and investment rules rather than aid.

In this book, Alemayehu Geda constructs a rigorous model of the world economy. This is based on earlier work by The Hague based 'Finance and Development' research group on global economic accounting and modelling. Some of this work is reported in two previous volumes in this series- Rob Vos' *Debt and Adjustment in the World Economy* (1994) and Joke Luttick's *Accounting for the World Economy* (1998). These set the foundations of how the world economy can be modelled, in a tractable fashion that allows the effect of trade and investment flows upon macroeconomic balances in any one developing region to be identified. In this way, the global framework required to analyse the full effect of aid and other capital flows from 'North' to 'South', as well as the effect of northern macroeconomic policies on the 'South' can be set up in such a way as to be compatible with the variables used in the analysis of structural adjustment.

The book opens with an outline of the historical origins of African debt and external finance problems, arguing that the debt problem results from the structure of its trade, in general, and commodity trade in particular. That the twin effects of low income elasticities and low price elasticities in northern markets have led to declining terms of trade and high price volatility is generally agreed. The issue, then, seems to be why Africa has not switched to other export products – manufactures, services or processed raw materials – which offer better growth prospects. However, such a switch requires capital (infrastructure and plant) and skills (or 'human capital') which Africa does not currently possess. Debt and aid have both been used in an effort to

overcome this constraint – but to no avail. The book then moves on to examine what existing economic theory has to say about this issue, providing a useful survey of theories of international finance, primary commodity trade models, and macroeconomic frameworks coming from an African perspective. In particular, the incisive analysis of macromodels currently being used in Africa is valuable for the insight it provides into import compression, fiscal response and ‘Dutch disease’ from the point of view of a domestic ‘consumer’ rather than an international ‘producer’ of knowledge. Indeed, in this book, Alemayehu Geda provides the basis for a textbook for advanced African students of economics that would take them beyond the one-country technical and dependency political perspectives.

The empirical part of the book explores the patterns of capital flows to the region and their relationship to foreign exchange earnings from commodities, where the declining terms of trade are not balanced by aid or debt flows in the short run, while in the long run these latter lead to unsustainable liability positions. Fiscal response to these external shocks and the consequences for the real exchange rate are then analysed, closing the circle, so to speak, as we return to the chronic trade deficit. On the basis of these data and the theoretical framework discussed above, Alemayehu Geda builds a simulation model of the region, which is a *tour de force*, not only in technical terms, but also as an alternative interpretation of reality. This empirical work demonstrates what should be the conventional wisdom but unfortunately is usually overlooked: that investment is the key to the problem and its possible solution.

What lessons does this book hold for the economic future of Africa? The author is too modest to put forward strong policy recommendations himself, although his main conclusions do have serious policy implications. Firstly, his view that the debt problem in Africa is essentially a commodity problem is amply confirmed. In part, this implies that the HIPC process led by the UK and the World Bank – which, while limited in scope to bilateral debt, and thus hardly reducing the bulk of the debt which is now multilateral, at least indicates a political commitment to act – will have little lasting effect unless export capacity and prices are raised. Secondly, his findings on the mixed effects of aid on growth - both through the ‘Dutch disease’ effect of overvalued currencies on exports, and through the diversion of public investment away from production – imply that (a) more aid should be channelled towards small

export farmers, so as to promote exports and reduce poverty; and (b) that aid should be accompanied by expansionary policies in order to keep the exchange rate competitive.

Thirdly, his conclusion that Africa is highly vulnerable to changes in world interest rates – due not to capital market effects but rather to their impact on commodity prices resulting from the activities of speculators – implies that action can only be taken at an international level as part of the construction of the new ‘global financial architecture’. Fourthly, his finding that fiscal deficits are largely exogenously determined by aid flows has important implications in terms of the need for donors to co-ordinate their actions in order to ensure macroeconomic sustainability, rather than leaving this task to the IMF.

These various findings imply that trade relations will need to be improved. The question, then, is how? Improved access to northern markets for processed primary commodities, and, in particular, the replacement of the Lome system with improved access to the European market, would be a first and important step. Commodity price stabilisation schemes are currently out of favour, and would require the full co-operation of the major importing transnational corporations in order to work at all. However, this is a problem of price volatility around the trend, as well as the declining trend itself. Reducing this volatility would benefit both importers and exporters and thus should not be impossible to achieve through a properly administered buffer stock system. The market mechanism alone cannot achieve this result, since hedging ranges are so short, so this would have to be a form of public intervention. However, the long-term downward direction of the terms of trade is difficult. It wouldn't matter so much if volume was increasing fast enough to raise the income terms of trade (as is happening with labour-intensive manufactures), but this is not, in fact, the case. The market for tropical commodities is oligopsonistic and riddled with restrictive practices – examples being sugar and cotton in the US, bananas and coffee in Europe as well as minerals. Therefore, a producer's cartel may be the only theoretically viable solution. However, in spite of the recent success of OPEC in driving up oil prices, Africa is unlikely to be able to organize such a cartel, in view of the worldwide competition in those commodities, which it supplies.

In fact, Africa needs to change the mix (or at the very least upgrade the quality) of its primary export products, with the continent unlikely to be able to compete within the foreseeable future. This requires investment, and investment not so much by foreign companies (which is in fact already fairly high as a proportion of the total by international standards) but by domestic investors such as firms, flight capital and households. More than savings, risk is the main problem here, since there is plenty of capital held overseas and also plenty of liquidity within the banking system. However, this cannot be undertaken by each African country in isolation, but rather requires an international agreement on investment rules and stabilisation of commodity prices. In other words, the *orderly* insertion of Africa into the global market.

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