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Impact of the East Asian Crisis on African Industry

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Summary

This paper seeks to analyse the impact of the Asian crisis on African manufacturing sector. Section one contains a brief evaluation of the literature on the nature and causes of the Asian crisis. Section two describes the impact of the crisis on the international economic environment assessing trends in both developed and developing countries with a view to identifying new international opportunities and challenges for African industry. Section three analyses the impact on African industry and the concluding section presents policy recommendations for enhancing the productivity and competitiveness of African industry.

I. The nature and causes of the Asian crisis

The East Asian crisis had its origins in the breathtakingly rapid liberalisation of financial markets that occurred in a three-year period roughly 1994-1997. This resulted in a massive inflow of foreign capital in the form of both bank loans and portfolio investment. The maintenance of conservative fiscal and monetary stances and stable over-valued currencies increased the attractiveness of Asian markets to foreign investors.

The dramatic loss of confidence in 1997 cannot be attributed to deteriorating fundamentals. Weaknesses in the financial sector and in corporate governance had existed the since mid 1990s. and had not hindered macroeconomic growth and stability. Liberal macroeconomic policies facilitated a subordination of East Asian economies to world capital markets and this exacerbated domestic structured weaknesses – such as low productivity, banking sector fragility and financial maturity mismatches. This increased national economic vulnerability to capital flight. Financial supervision become different and risky financing strategies became increasingly attractive as policy liberalisation proceeded. Liberal macroeconomic policies accommodated the policy preference of both lenders and creditors for unhedged options.

International financial markets function in a way, which distorts risk pricing and encourages herd behaviour among creditors. Creditors are in too much of a hurry to undertake adequate due diligence of borrowing firms – and currency and liabilities maturities mismatches are a direct consequence of this. It is for this reason that Radelet and Sachs (1998) note that "the structural deficiencies of the international capital markets were primarily responsible for the depth, severity extent and simultaneity of the crisis. An easy availability of foreign funds also led to deterioration in the quality of project financing. Foreign inflows fuelled speculative booms in stock and bond markets and financed a substantial proportion of the investment in real estate and other non-tradable. Reduced efficiency of investment was reflected in rapid deterioration of ICORs throughout East Asia (Park and Song p. 7). International investors thus "exacerbated adjustment costs. The consequences of their panic proved their perception of the economic and political difficulties in a self-fulfilling way "(p.9).

Panic withdrawals occurred because there are no institutional mechanisms for regulating the international lending of private banks and financial companies. The East Asian crisis was triggered by the withdrawal of about $100 billion during second half of 1997.

Essentially international loan markets fail when they cannot adequately distinguish between insolvent and illiquid borrowers. Even if such a distinction can be made a liquidity crisis can be turned into an insolvency crises by the inability of the lenders to act collectively. Diamond and Dybig (1983) have developed a formal model to show that the rational action of individual banks is consistent with the inability of the banking system as a whole to take the type of collective action that is necessary to prevent liquidity crisis from turning into a crises of insolvency. Diamond and Dyborg show that is the failure of the creditors to take collective action that drives the borrowers into insolvency.

The East Asian crisis has ~~tuned~~ turned out to be more ~~probiacted~~ protracted than originally anticipated. In most crisis affected countries growth has remained negative during 1998 and prospects for 1999 are not bright. Unemployment now typically exceeds 5 percent and despite interest rate rises and the implementation of other IMF sponsored stabilisation measures foreign capital is not returning to Asia. Similarly, massive devaluation since 1997 has not led to a significant stimulation of export growth. The continuing slow down in East Asia has had an impact on world economic growth.

II. Global impact of the crisis

II.A. Impact on the OECD countries

Most forecasters expect world output growth to be about 2 percent in 1998. The IMF (1998 b) forecasts a 2 percent world output growth rate for 1999 but an average OECD growth rate of 1.9 percent down from an expected 2.0 percent in 1998. Growth prospects are seen to have worsened for the United States, Japan and the European Union. Trade prospects are also unpromising – import growth is expected to be about 4.5 to 4.7 percent and export growth 4.2 percent in the OECD countries in 1999.

Not all – or even most – of this slow down in the major industrialised countries can be attributed to the continuing crisis in Asia but integration between OECD and East Asian financial markets has been increasing. Trade relations are also important. However most analysts including the IMF recognise that domestic factors – not external shocks – are the major cause of OECD slow down. This is so even in Japan. Nevertheless contagion can spread easily as the wild speculative swings on American and European bourses during late 1998 illustrate. The flooding back of capital from East Asian countries in search of safe haven(s) has significantly lowered bond yields and affected interest sensitive spending specially in the United State(s). Europe which was widely acclaimed as being relatively immune from the Asian crisis has also suffered from financial panic in the wake of the plummeting dollar and growth of output and employment is expected to slow down significantly. A slow down of external (sector) growth can have much more serious implications for Europe than for the United States.

Increased financial volatility is expected to lower European growth by between 0.5 to 1.0 percent during 1999 and a liberal monetary stance with repeated interest rate cuts may be necessary to avoid recession. This may restrict the applicability of the growth and stability pact of June 1997 and also undermine the authority of the newly established European Central Bank.

Growth prospects have also been revised downward for the United States. In December 1998 the IMF forecast a 1999 US growth rate of just 1.8 percent. Supply side factors are seen as important in sustaining the long expansion of the US economy during 1991-98. A major factor has been the willingness of low income American workers to accept substantial cuts in take home pay. Wages in the United States will be under greater pressure due to the competitive devaluation of the East Asian countries.

Using a compatible general equilibrium model (CGE) Liu et al (1998) show that exchange rate changes in the crisis economies can add significantly to the US trade deficit. Their simulations show that exports and production could decline significantly as a consequence of Asian devaluation, in the US textile, apparel, machinery, transport and intermediate manufactures sectors. Applying these simulation results to economic models of conflict (Noland 1996). Liu et al show that the projected trade changes increases the likelihood of bilateral friction between the US and the East Asian countries - specially the Republic of Korea.

Japan is likely to be the most seriously affected economy. The IMF now expects GDP growth to have been minus 2.5 percent in 1998. In May 1998, it had forecast a zero rate of growth for the Japanese economy during 1998. The Japanese economy will continue contracting during 1999. The IMF forecasts a 0.5 percent rate of growth, but this is probably over optimistic. December 1998 official estimates show that unemployment now exceeds 5 percent – a higher unemployment rate than that in the United States for the first time in Japan's history. Japanese imports will also continue to contract during 1999. Stimulative fiscal measures have so far proved ineffective and re-capitalisation of banks with large infected

portfolios is proving difficult. More than 50 percent of the foreign loans extended by Japanese banks are directed to the East Asian region, which also accounts for about 40 percent of Japanese exports. The Asian crisis has thus significantly exacerbated the vulnerability of the Japanese financial system. An East Asian slowdown will further weaken Japanese institutions. A continued banking crisis in Japan will lead to a transfer of dollar assets held by Japanese business in the United States. This may increase US interest rates and increase debt-servicing costs of many developing countries.

It seems reasonable to conclude (a) that the direct impact of the East Asian crisis has been modest in the case of the United States and Europe (b) but pronounced in the case of Japan (c) however the indirect effect may turn out to be significant since the Asian crisis represents the beginning of a change in investor expectations in world currency and capital markets. The dangers of a crisis of liquidity turning into a major generalised crisis of solvency in a major OECD economy have increased.

II.B. Impact on developing countries

1998 has been an exceptionally difficult year for the developing countries. GDP growth at about 2.1 percent has been below that of the industrial countries for the first time in many years. The IMF expects growth to increase to above 3 percent in 1999 but this is unlikely. Downward, revision of IMF growth expectations for 1999 characterise all developing country regions – Asia, Africa, Latin America, and West Asia. The IMF expects the crisis hit South East Asian countries to contract at the rate of one percent during 1999. GDP fell by about 11 percent in these countries during 1998.

Developing country imports grew by just 1 percent in 1998. Export growth fell from 10.6 percent in 1997 to 3.4 percent in 1998. Nonfuel commodity prices fell by 14 percent in dollar terms in 1998 and are likely to fall further in 1999. This has put tremendous pressure on developing country terms of trade which declined by 4 percent during 1998 and are unlikely to improve in the current year.

The external debt of developing countries will probably exceed $2 billion in 1999. Net private flows fell by about 6 percent form US$ 123.5 billion in 1997 to just $56 billion in 1998. Net official flows to developing countries are expected to fall form $27.6 billion in 1998 to $2.3 trillion in 1999.

All developing countries have been affected by the Asian crisis though to different degrees. Indeed one important lesson of the crisis is that the greater the insularity of a country the lesser the negative impact of an international crisis. Thus despite its regional proximity "China has been relatively immune to contagion from the crisis because vehicles for financial speculation are limited" (IMF 1998b p. 15). It's trade position remains strong and it has large international reserves. Growth is widely expected to exceed 7 percent in 1998 and the (modest) shift from export to domestic demand orientation that is required in some big industries are expected to be achieved relatively painlessly.

The direct impact on south Asia is also small but growth in much of South East Asia will remain negative during 1999. Falling demand in the crisis economies will effect export growth in Singapore, Taiwan Province of China and Hong Kong China which depend heavily on regional trade and tourism. Latin America appears much more vulnerable to contagion as the 1998 crisis in Brazil has shown; Latin American countries depend heavily on foreign capital inflows to finance external deficits. This dependence will increase because export growth is expected to fall during 1999. Net private flows to Latin America have fallen form $87.5 billion in 1997 to about $75 billion in 1998. They are expected to fall further to about $66 billion in 1999. Public capital flows have been negative every year since 1996. 1999 net official outflows will probably exceed $4 billion.

Latin American countries typically send less than 5 percent of their exports to East Asia and Japan. However decline in the prices of fuel, metals and forestry products – partly due to a fall in east Asian demand – will significantly hurt many Latin American countries. Competitive devaluation of the East Asian countries will

also affect Latin American exports of chemical products, steel, textile, and footwear. But the most important cost of the crisis which Latin America will have to bear will be due to stiffening of terms of international private sector borrowing.

Developing countries are expected to pursue corrective domestic policies in the context of a deteriorating international environment. The East Asian crisis is widely recognised as the most serious setback world capitalism has endured since the Second World War. While the direct and immediate impact of the crisis on regions such as South Asia and Africa has been limited they are likely to be seriously hurt by the slowdown in world output investment and export growth and by continued lack of effective governance of international financial markets.

III. Impact on Africa

III.A. Macroeconomic Impact

African growth prospects have worsened in recent years. GDP growth has fallen from an annual average of about 5 percent in 1994-1996 to 3.7 percent in 1998 according to the IMF. The EIU expects a decline to 1.2 percent in 1998. African's current account deficit rose from $5 billion in 1997 to $15 billion in 1998 and is unlikely to fall in 1999. This reflects stagnation of exports and a rising debt servicing burden. Debt service payments now exceed $32 billion and the total debt to GNP ratio exceeds 220 percent. According to IMF estimates net external private flows to Africa declined from $14.0 billion in 1997 to $6.4 billion in 1998. Net official flows were negative in 1997 – minus $2.3 billion. They were about $2.9 billion in 1998 but the IMF expects them to be negative – minus $1.3 billion in 1999.

As the Africa Competitiveness Report (1998) shows there is no evidence of foreign direct investment upsurge in Africa - the continental share of world FDI flows was 1.4 percent in 1996, the year in which it recorded its highest real growth rate for almost two decades. In 1997 FDI flows to Africa were $4.7 billion again about 1 percent of global FDI (World Economic Forum 1998 p. 37).

There are no prospects of an increase in FDI flows to Africa in the medium run. A macroeconomic strategy focussed on increasing African's attractiveness to foreign investors can seriously hurt many African countries. Structural adjustment programs in place in most African countries since the early 1980s have failed to revive public and private investment growth in Africa.

The macroeconomic impact of the East Asian crisis on Africa will be experienced primarily through a reduction in net ODA flows. This will lead to a further fall in public investment. Ram (1996) has shown that the absence of public investment reduces the productivity of private investment. The HIPC program has had very limited impact and a major international initiative in this respect is clearly needed.

Reviving investment growth and restoring public sector financial viability in Africa requires a departure from the macroeconomic strategy of the SAF/ESAF era. The main impact of the Asian crisis on the African economies is likely to be indirect - mediated through the deterioration in the international economic environment with major African trading and investment partners experiencing a significant growth slow down. Africa can not expect an acceleration of trade or private investment growth in an international economic environment characterised by near stagnation. Macroeconomic strategy must therefore, focus on revitalising domestic demand and an efficient import substitution.

This requires both the adoption of a pro-growth fiscal and monetary stance and extensive institutional restructuring to ensure its sustainability. The primary objective of macroeconomic policy of African countries in the present international environment should be the achievement of significant factor productivity growth. Improved international competitiveness should be seen as a consequence of factor productivity growth and not as an end in itself.

III.B. **Impact on trade and investment**

While African export growth has been slow, trade / GNP ratios are in line with population and income per capita levels. Econometric studies show that there is no association between a measure of "openness" and export growth for African countries (Rodrik 1998 b, Mosley forthcoming). There is little direct correspondence between African and East Asian export structure – resource endowments as measured by land labour ratios and average educational level of workers are vastly different. Moreover Wood and Meyer (1998) show that the actual manufactured share of total African exports is lower than the level predicted on the basis of their resource endowments. Export of manufacturers from African countries will typically not be in product areas which compete with East and South East Asian exports. Africa's dynamic comparative advantage lies in increased processing of agricultural and mineral products and there are lessons to be learnt in this respect form the past experiences of Malaysia, Indonesia and Thailand.

The crisis has induced a revival of industries such as palm oil processing, paper, rubber, wood and furniture in the South East Asian countries. Prospects for expanding palm oil exports from Africa are not bright since Malaysia has a very strong R and D and marketing support system. There are better prospects for countries such as Cameroon, Gabon and Ghana in the timber, wood and (perhaps) paper industries although competition from both Thailand and Indonesia is likely to be stiff. Thailand is also a strong competitor as far as cassava exports to Europe are concerned. Competition in textiles, clothing, leather manufacturers and footwear in European markets may not be stiff because of African countries privileged access under the Lome agreement. However, these goods may increasingly penetrate domestic African markets. Efficient import substitution seems difficult because of the small size of national markets in Africa. While inter-regional trade flows have almost doubled during the last decade intra-regional manufactured export growth remains confined to a relatively small group of goods – cement aluminium sheet, iron plate and woven cotton fabric. Considerable scope exits for efficient import

substitution on an intra-regional basis in agricultural machinery, food manufacturing, textile, footwear, clothing and some fertilisers.

Decline in primary commodity prices is likely to have a large negative impact on Africa. Prices of primary commodities have fallen by about 10 percent since mid 1997 – i.e., the onset of the Asian crisis. The crisis-hit economies are major consumers of petroleum products, base metals, crude, coarse grain, rubber, oil meals, and fats and oils. They accounted for a large proportion of the net export growth in these product groups during 1990-1997. Moreover, the large currency depreciation of the Asian countries is likely to depress world prices for timber, rice, rubber and palm and other vegetable oil. As late as July 1997 many forecasters were predicting strong price growth in many of these products and IMF expectations of an African growth upturn were at least partially premised on these optimistic expectations. Decline in copper prices will seriously affect Zambia, gold (Ghana, Mali and South Africa), diamonds (Ghana, Botswana) and cotton (Benin, Cote 'Idvoure, Burkina Faso, Chad, Cameroon, Mali and Togo).

Medium term prospects for commodity prices are not bright. According to World Bank projection's prices of agricultural commodities are expected to decline by 14 percent and metal prices are expected to fall by 17 percent during 1995-2010. Africa's terms of trade will therefore, continue to decline (World Bank 1998).

Africa will not be significantly affected by the stagnation of private foreign investment or by the stiffening of lending terms. Africa receives about 1 percent of global DFI and DFI portfolio flows are volatile.

East Asian companies are very small investors in Africa. Mallampaly estimated that Asian firms accounted for just 1 percent of cumulative FDI flows to Africa during 1993-96 – the EU's share was 59 percent the United States 21 percent and Japan's 5 percent (1998 p. 32). DFI to Africa is highly concentrated. However, there has been strong DFI growth in Botswana, Equatorial Guinea, Mozambique, Namibia, Sudan, Thailand and Uganda in the 1990s

– but again there is no sustained East Asian investor interest in these countries. Survey evidence in 1998 reveals that South Korean investors are planing to divest in Africa (Mallapaly 1998 p 17-19). East Asian investment in the textile and clothing sector in Mauritius and Lesotho does not seem to be affected.

There is also no evidence to show that money flowing out of East Asia is going to Africa. The South African bourse displayed strong signs of contagion and other African stock markets have also declined in the second half of 1998. National bourses – with the exception of South Africa and Egypt – are simply too small to attract major international investor interest. Indeed as far as private capital is concerned Africa is probably a net exporter – it has been estimated that almost 40 percent African wealth is invested abroad (UK, DID 1998).

Africa's major concern must be the stagnation of ODA flows which are a partly consequence of the bail out packages put together for East Asia and Brazil. While net ODA flows are expected to be positive in 1998 and 1999, no major increase is envisaged. Progress on debt cancellations is very slow and the commodity producing sectors receive very little from ODA flows. Net official flows for 1998 ~~flows~~ that were estimated at $4.4 billion by the IMF in May 1998 were estimated in September 1998 to have been only $2.9 billion. Similarly the September 1998 IMF outlook revises the estimate for 1997 net public inflow from $8.4 billion to <u>minus</u> $2.3 billion. Thus, the expectation that net official flows to Africa will be positive is tentative and uncertain.
It may therefore be concluded that:

I. The direct impact of the Asian crisis on African trade is likely to be limited.
II. The indirect impact is likely to be significant. Africa will be seriously affected by slowing down of world output and trade growth and specially by the continuing decline in commodity prices.

III. Impact on private capital flows is also not likely to be significant. There is little likelihood of funds being diverted from Asian to African markets.

IV. There may be a major diversion of public concessional funds. ODA may decline significantly, as a consequence of public funding of programmes for the crisis economies particularly, Indonesia and Russia. A fall in ODA can have a serious impact on investment and output growth in Africa.

III.C. *Impact on manufacturing*

Major branches in Sub-Saharan Africa are food manufacturing, textiles, beverages, iron and steel transport equipment and metal products. Together these branches account for over 50 percent of Sub-Saharan African MVA. Food manufacturing, textiles, leather, industrial chemicals, plastic products and other non-metallic minerals have grown at an average rate which is above that of the average rate of growth of MVA during 1990-96. The share of the East Asian countries in African manufactured exports and the exports of the major industrial branches are small. The main destination of these exports are the OECD countries specially Europe. A contraction of the East Asian demand is not likely to significantly affect African manufactured exports, which in any case, have a small share in total exports by most African countries – though for some countries such as; Mauritius, South Africa, Zimbabwe, Serra Leone, Gambia, Cape Verde, they remain important accounting typically for over 25 percent of export revenues. But even for these countries the East Asian markets have not been and are not likely to be important. The major impact on manufactured exports will be felt due to the contraction of growth in OECD markets. As table 4 shows the East Asian economies account for almost a quarter of world manufactured imports in mid 1990s. A fall in growth in the East Asian markets is thus; likely to have a major impact on world manufactured trade.

Manufactured product groups most likely to be particularly affected; are few in number, as on the number of African countries that have a significant potential to expand manufactured exports over the medium run. This group includes Mauritius, Rwanda, Ghana, Togo, Malawi, Serra Leone and Uganda. Wood and Mayer (1998) have shown that: most of these countries can expand the share of manufactured to total exports from about 5 percent to 20 percent, on the basis of a more efficient and fuller utilisation of the existing resource base.

Manufacturing product groups are likely to be particularly affected by the slow down of demand in world markets including primary sector, processed semi-manufactures, textiles, wearing apparel and leather products. Wood based manufactures might also be affected by the expansion of exports from Indonesia and Thailand. The share of processed to total agricultural exports from Africa is only 10 percent.

As noted above Indonesia, Malaysia and Thailand have been successful exporters of processed primary products – food products (Thailand), coca processing, rubber, wood and paper (Malaysia) timber, wood and paper products, food products and non-metallic mineral products (Indonesia). These product groups have low capital and technology intensities and the squeeze on industrial financing in East Asia has seen a revival of these branches. African exporters might find increased competition from South East Asian processed products in European markets. Plywood, furniture and processed timber exports from Thailand and Indonesia are said to have done well during 1998 in Europe (FT 19-10-1998, FEER, 14-11-1998).

Export of dynamic agricultural products (defined as meat and meat products, diary products, fish and fish products, ~~fish and processed products~~, vegetable and nuts, foodstuff, oil seeds, vegetable and animal oils and spices) from Africa increased from $2.54 billion in 1980 to $3.48 billion in 1990 to $3.85 billion in 1994. Sub-Saharan Africa's exports of these products rose from $1.54 billion in 1980 to $2.05 billion in 1994. Sub-Saharan Africa's shares

in dynamic agricultural export from Africa has thus fallen from 60 percent in 1980 to 53.2 percent in 1994. Major success stories remain limited to a small group of firms with good foreign connections located in Kenya, Tanzania, Gambia and Zimbabwe and exporting horticultural products. Lack of crop related research remains a crucial constraint on the expansion of non-traditional agricultural exports from Sub-Saharan Africa.

African manufactured export growth is restricted by the fact that unit labour costs are much higher than in Bangladesh, Indonesia, Thailand, India, and other competing countries. Moreover, in general, unit labour costs in Africa actually increased after 1980 relative to those in competing countries, although in many cases real wages stagnated or even declined. On the other hand, some African economies with relatively high wages, such as Mauritius, Morocco, and South Africa, have been among the region's most successful exporters of goods such as textiles, and footwear. Strong productivity growth in these economies has been an essential ingredient of their export success.

In Africa as a whole labour productivity growth has been very low – output growth has been mainly due to an increase in input (specially labour) use and not due to improved factor productivity. UNIDO estimates (1997) show that revealed comparative advantage (RCA) indices have risen in the case of clothing, leather products, footwear wood products and furniture during 1980-95. However, only a small number of countries have experienced significant positive RCA growth.

Productivity growth is not related to growth in international competitiveness at a product level. Highest-ranking branches in term of RCA values have the lowest ranks in term of productivity growth – textile, cement and beverages branches with strong productivity growth are domestic demand oriented. An export oriented strategy will therefore, not stimulate productivity growth in African manufacturing.

The impact of the crisis on African manufacturing will be limited for several reasons. East Asian and African trade and investment links are not very extensive. African manufactures do not directly compete with Asia exports except in a small number of product categories. The crisis has led to a serious deterioration in the international trading environment. However, African manufacturing exports cannot be expected to grow rapidly in such an environment nor can foreign manufacturing investment in Africa be expected to increase. It is therefore, necessary that attention be focussed on efficient import substitution and on increasing intra-regional trade in manufacture. This require that policies should focus on enhancing manufacturing sector productivity improving labour skills and upgrading production technology. Potential demand for agricultural based and labour intensive industry – clothing, footwear, processed grain, edible oils, animal feed – is strong as its demand for agricultural machinery, irrigation construction equipment and fertilisers. But this potential or latent demand can become effective demand only when domestic income rises significantly over the medium run. There is thus a need for a domestic demand oriented and employment intensive investment strategy which is principally sourced by domestic household and corporate savings and which is primarily focussed on the growth of the hundreds of thousands of small scale manufacturing enterprises spread through out Africa. A central concern must be to solve the problem of the "missing middle" by increasing horizontal integration within small scale sector and the vertical integration of small and large scale enterprises so as to enhance the flow of technological knowledge from the later to the former.

Promoting efficient import substitution and enhancing regional integration of manufacturing sectors and enterprises – and of the mechanisms that finance them – requires several policy initiatives. These are discussed in the concluding section of this paper.

IV. Policies for African Industrial Development in the post crisis international environment

IV.A. Macro Policy Stance

While Africa appears to be somewhat insulated from the direct impact of the Asian crisis, international capital movement volatility can play a destabilising role in countries such as Cote d'Ivoire, Egypt, Kenya, South Africa and Zimbabwe. The international vulnerability of most African countries is mainly due to their dependence on primary commodity exports and on concessional ODA flows. Reducing such vulnerability requires both macroeconomic and institutional restructuring. It is also very important to synchronise macroeconomic and institutional changes.

Regulating capital flows should be a key feature of macroeconomic strategies. During periods of expansion in particular greater selectivity should be exercised with regard to kinds and amounts of inflows. A particularly important objective should be to discourage the inflow of speculative capital. In Africa it is particularly important to adopt measures to stem domestic capital flight. This is estimated as being anywhere between 40 to 60 percent of national savings in a typical year (Brinkman 1998).

Macroeconomic and institutional policies must be concerned with strengthening the financial sector. Accountancy, legal and regulatory arrangements need to be formalised and streamlined. In most cases, rules for loan classification, loan loss provision and disclosure do not exist. The problem of non-performing loans has become crucial. Financial reforms have been ineffective and long term investment financing has virtually dried up. Perhaps the most important lesson to be learnt from the East Asian crisis is that persisting with financial liberalisation can be disastrous for industry. The banking regulating framework is undeveloped in virtually all-African countries and Africa is not ready for capital account liberalisation or banking sector privatisation. Africa is particularly vulnerable to the negative effects of private capital inflows since capital and money markets are shallow and very vulnerable to manipulation and possibilities for the effective use of sterilisation

measures are limited because of large budget deficits and impact on interest rates.

Arguing against financial liberalisation is not arguing against foreign investment. Both direct and portfolio investment must be welcomed but countries must develop a capacity to exclude speculators and much can be learned from the experiences of countries that have avoided a financial crisis in Asia – China, Taiwan province of China – and from Chile. All have made extensive use of selective credit control to restrict the inflow and outflow of hot money. These experiences can not of course be simply copied, each country needs to develop a capital market regime based on its own structure, characteristics and needs.

In the face of stagnant FDI and ODA flows macroeconomic strategy must focus on stimulating domestic saving. Here the key policy is not interest rate liberalisation but institutional restructuring. The experiences of China, Taiwan Province and Singapore show that if the financial sector is well regulated the consequences of international panic are not likely to be of crisis proportions. Bank regulations must clearly demarcate publicly guaranteed from non public guaranteed deposits and loans; Bank vulnerability can also be reduced by using deposit insurance schemes and by strictly regulating short term external transaction of all financial institution.

The overall fiscal and monetary stance must be growth enhancing. There is the over-riding need in Africa to rapidly increase public investment and to enhance its efficiency. This ultimately depends upon stimulating productivity growth in the real economy.

IV.B. Productivity Growth In Industry

Successful industrial development is usually based on continuous positive interaction between strong states and strong markets (Mesner 1997, Lall 1992). The essence of this interaction is the creation of a shared vision of industrial progress thorough a process of dialogue between public and private sector decision makers.

Systemic supportive needs of the types of industries that are likely to flourish in Africa are modest. Industries, which operate relatively, mature technologies – food manufacturing, clothing, footwear, toys even electronic assembly – are not as dependent on world class suppliers of intermediates and machinery and specialised services as the knowledge intensive branches. But policy support remains particularly important for reducing transport costs, enhancing market size, developing info and infrastructures, strengthening marketing systems and improving negotiation capacity for acquiring foreign capital and technology. Enterprise bench marking should be institutionalised and national R and D capacity strengthened to achieve enterprise technological upgrading.

Manufacturing branches likely to experience export falls and increased domestic competitions as a consequence of the Asian crisis include textiles, clothing, footwear and food manufacturing. Agricultural machinery and fertiliser branches should also be targeted in an industrial strategy which is domestic demand oriented and seeks a sustainable increase in total factor productivity. Some suggestion for increasing productivity in these branches are given below:

Food processing: Cocoa-processing capacity should not be increased. African countries are unlikely to become internationally competitive in this product group. Export prospects are better for dehydrated vegetables and horticultural products (but not for fruit juices). Key constraints on enhancing productivity in these product groups are (a) absence of an efficient packaging industry (b) lack of quality control technologies. Good export prospects also exist for processed fish products specially cephalopods, anchoires herring and sardines. Exploiting this export potential requires better utilisation of existing processing capacity and enhancing the technology upgrading and increased processing provisions of the Euro-African fishing agreements. Improvement in production technologies better provision of agricultural machinery and fertiliser can also enhance productivity in cassava, maize and millet

production and processing units. Significant export and domestic demand potential exists in this product group.

Textiles and clothing: both domestic demand and export potential exists in a wild range of product groups. Efficient import substitution requires a reduction of capacity utilisation and rationalisation of existing production structures not addition to production capacity. Creating vertical and horizontal links between spinning and weaving units is important. Restraint must be placed on imports of second hand clothing. Import restraint may also be useful for encouraging production of synthetic fibre (specially nylon) in Algeria and Nigeria. Exports can be enhanced by synchronising national export strategies While the sourcing strategies of major international buyer groups. Strategic alliances between European and African textile sector firms can enhance technological flows. There is also scope for increasing the share of locally produced yarn and fabric in OPT/CMT arrangements. Strategic alliances between East Asian and African textile manufacturer at the lower price end of the market are also feasible.

Leather and footwear: There is likely to be increased competition from many East Asian countries and also penetration of African markets by East Asian firms. Shoe-producing companies have not been relocating to Africa because of low productivity and high transaction costs. Given Africa's abundant leather resources and cheap labour significant export growth in e.g. sports footwear is possible but currently about 75 percent of world sportswear production takes place in East and South East Asia and given the devaluation of the East Asian currencies, this proportion will probably rise. Export growth requires a rapid increase in labour productivity and acquisition of skills related to sports footwear productions. Given this, Africa can benefit from outsourcing and relocation by European shoe manufactures.

Agricultural machinery: A major constraint on investment growth is the unavailability of estimates of existing effective demand in the small holding sector. Also demand is exceptionally volatile so committing funds on a long term basis is risky. Policy measures for

assessing and stabilising effective demand are called for. In East Asia demand growth and stabilisation have been achieved by the establishment of firmer co-operation for purchasing and distributing agricultural equipment. ODA funds may be used for this purpose as well as for providing concessional bridge financing for joint ventures for the production of agricultural machinery.

Fertilisers: The major constraint on the growth of fertiliser use in Africa is lack of effective demand due principally to low farmers' income but also to the lack of availability of complementary inputs machinery, distribution materials, application information credit, etc. ODA funds should be targeted for relieving these "supply side" (from the perspective of the fertiliser user) constraints where feasible. A comprehensive rehabilitation plan - involving increases in capacity utilisation, efficient use of raw materials and energy, modernisation of equipment, management restructuring, etc. – should be put in place for a selected number of such plants and ODA funds should be committed to such rehabilitation plans. Using ODA funds for this purpose can act as a catalytic agent for attracting foreign investment in the form of BOT deals debt equity swaps etc.

IV.C. International policy initiatives to sustain industrial growth in Africa

Africa has been indirectly affected by the Asian crisis. Export markets have contracted. Primary commodity prices have fallen. Foreign capital inflows have stagnated. The growth optimism of the mid 1990s has disappeared what international action is required to sustain African industrial growth.

At the most general level there is a need for a fundamental overhaul of the international financial system premised on a theoretical legitimisation of capital controls - at least a return to the orthodoxy of the Bretton Woods era. Financial crises have invariably been precipitated by financial deregulation and capital account liberalisation. This undermines financial supervision and regulatory regimes and feeds speculative baubles. Large-scale

capital inflows usually lead to over extension of lending, asset quality deterioration and laxity in risk assessment.

Existing arrangements for preventing a crisis of liquidity from turning into a crisis of solvency are inadequate. Redesigning the international financial architecture is necessary to ensure that the costs of crisis are shared equitably between borrowers and lenders. Increasing IMF resources will not achieve this – it will merely intensify moral hazard. Amending the articles of agreement of the Fund to allow it to mandate capital account convertibility will immensely increase the volatility of international financial markets.

On the other hand debt standstill arrangements can be useful for manufacturing sector restructuring access to working capital during the restructuring period is important. The experience of the United Sates shows that unilateral declaration of a standstill by a debtor country protects it effectively from the over reaction of financial markets and significantly slows down capital outflow. Proposals aimed at reducing the myriad weaknesses of cross border trading and investment arrangements also have relevance for improving industrial performance. As the experience of the European Union has shown regional co-ordination of investment policies can play an important part in preventing currency disorders and capital market panics. Regional banks – such as the Inter American Bank – have proposed that public and private financial institutions jointly provide funds for the type of "reverse REPO" arrangement negotiated by Argentina in 1995.

Improved regional co-operation has assumed increased importance. In the case of African manufacturing, a domestic demand oriented strategy represents the only viable option – export markets are contracting and falling commodity prices translate into falling prices for processed manufactures and semi-manufactures. A domestic demand oriented strategy in Africa must be regional not national. Three key regional policy initiatives are (a) monetary and fiscal policy harmonisation (b) co-operation for technological upgrading in biotechnology and informatics and (c) development of

a joint regulating stances on international trade and investment issues.

International action is required to reverse the decline in ODA flows to Africa. This requires sustained efforts to enhance the scope and impact of debt cancellation schemes. Secondly, efforts must be made to revise the decline in ODA flows to the commodity sectors, specially manufacturers. ODA funds may be used for the following purpose.

A. Financing projects that enhance food security agricultural productivity and capacity to repay foreign debt.
B. Industrial rehabilitation and industrial and financial sector privatisation initiatives.
C. Facilitating foreign investment – specially the strengthening of local equity and bond markets.

Technical assistance is required to increase national capacities in the application of biotechnological and informatics related systems for increasing productivity in the agro-related industries. An informatics net work, which provides information on technological development in these areas as well as facilitates marketing of the production of these industries, is also required. Technical assistance should also focus the technological upgrading of small-scale enterprise.