AFRICA’S MACROECONOMIC PERFORMANCE AND PROSPECTS

KEY MESSAGES

• Africa’s economic growth continues to strengthen, reaching an estimated 3.5 percent in 2018. This is about the same rate achieved in 2017 and up 1.4 percentage points from the 2.1 percent in 2016. In the medium term, growth is projected to accelerate to 4 percent in 2019 and 4.1 percent in 2020. And though lower than China’s and India’s growth, Africa’s growth is projected to be higher than that of other emerging and developing countries.

• Improved economic growth across Africa has been broad, with variation across economies and regions. Non-resource-rich countries—supported by higher agricultural production, increasing consumer demand, and rising public investment—are growing fastest (Senegal, 7 percent; Rwanda, 7.2 percent; Côte d’Ivoire, 7.4 percent). Major commodity-exporting countries saw a mild uptick or a decline (Angola, –0.7 percent), while Nigeria and South Africa, the two largest countries, are pulling down Africa’s average growth.

• The positive growth outlook is clouded by downside risks. Externally, risks from uncertainty in escalating global trade tensions, normalization of interest rates in advanced economies, and uncertainty in global commodity prices could dampen growth. Domestically, risks from increasing vulnerability to debt distress in some countries, security and migration concerns, and uncertainties associated with elections and political transition could weigh on growth.

• Growth remains insufficient to address the structural challenges of persistent current and fiscal deficits and debt vulnerability. One way to accelerate growth in the medium to long term and overcome the structural challenges is to shift imports to intermediate and capital goods and away from nondurable consumption goods. For African countries, a 10 percentage point increase in the share of capital goods in total imports could, five years later, reduce the share of primary goods by 4 percentage points, amplifying the effectiveness of diversification rooted in transferring technology and accumulating capital.

• Vigorous public finance policy interventions are needed in tax mobilization, tax reform, and expenditure consolidation to ensure debt sustainability. Policymakers need to adopt countercyclical policy measures to stabilize inflation and reduce growth volatility. Macroprudential policies should be used to reduce vulnerability to capital flow reversal and shift inflows toward more-productive sectors. For a sample of African countries, a 1 percent increase in public savings (by reducing the budget deficit) is correlated with a 0.7 percent improvement in the current account balance.

• For countries in a monetary union, well-functioning, cross-country fiscal institutions and rules are needed to help members respond to asymmetric shocks. Debt and deficit policies should be consistent across the union and carefully monitored by a credible central authority. And the financial and banking sector should be under careful supervision by a unionwide independent institution.
A frica’s macroeconomic performance and prospects

Economic fundamentals in most African countries have improved, and inflationary pressures are low or have subsided in countries with stable exchange rates. But where exchange rates have depreciated, inflationary pressures remain high, and central banks have tightened monetary policy. Many countries have pursued fiscal consolidation to contain deficits, but there have been slippages in some, threatening debt sustainability and aggravating current account deficits. The average current account deficit is projected to decline from 5.4 percent in 2016 to 3 percent in 2020, and the average fiscal deficit is projected to decline from 7 percent to 3.7 percent. Attention has to be paid to the quality of fiscal consolidation to mitigate the impact on long-term growth.

The long-term trend in the structure and composition of current account balances suggests that countries that tended to allocate a higher share of their export earnings to import intermediate and capital goods grew faster, sustained better external trade balances, and mobilized domestic savings. This organic link among exports, productive imports, and growth provides an important pathway for structural change to accelerate growth.

This chapter is organized as follows. The first section describes African economies’ growth performance and prospects and identifies growth drivers. The second section assesses progress and challenges for macroeconomic stability. And the final section discusses external imbalances and trade deficits, emphasizing a long-term perspective taking into account present external deficits, the composition of exports and imports, and the direction of domestic investment in the assessment of the long-term sustainability of current account deficits.

GROWTH PERFORMANCE AND OUTLOOK

Economic recovery continues

After peaking at 4.7 percent in 2010–14, Africa’s real GDP growth slowed to 3.5 percent in 2015 and 2.1 percent in 2016 (2.2 percent excluding Libya), due partly to the drastic drop in oil prices and other regional shocks such as drought in East Africa and Southern Africa (figure 1.1 and table 1.1; see also table A1.1 in annex 1.1). A gradual recovery followed, with growth picking up to 3.6 percent in 2017 (3.0 percent excluding Libya) and an estimated 3.5 percent in 2018.1 Growth is projected to accelerate to 4 percent in 2019 and 4.1 percent in 2020. About 40 percent of African countries are projected to see growth of at least 5 percent in 2019, while about 25 percent are projected to see growth of less than 3 percent.

While the recovery from the 2016 trough is good news for Africa, the projected medium-term growth of 4 percent is insufficient to make a dent in unemployment and poverty. Population growth of more than 2 percent implies that GDP per capita will increase less than 2 percent,2 leaving convergence with middle- and high-income economies slow to materialize. And the growth path is insufficient to create enough jobs for the growing labor force. The working-age population is projected to increase an average of 2.75 percent a year between 2016 and 2030.3 Assuming average employment-to-GDP elasticity of 0.4,4 economic growth of 6.9 percent a year is required just to absorb new entrants to the labor force, far above the highest growth rate attained in this decade. Even with employment-to-GDP elasticity of 0.6, growth would need to exceed 4.6 percent a year to stabilize the unemployment rate (figure 1.2). The challenge is thus twofold: to raise the current growth path and to increase the efficiency of growth in generating employment.

Africa’s low elasticity of employment with respect to growth reflects an economic structure that depends heavily on primary commodities and the extractive sector, with little progress in labor-intensive manufacturing. This is a major concern given the substantial positive effect of manufacturing-driven growth acceleration on employment’s responsiveness to economic growth (see chapter 2).
While the recovery from the 2016 trough is good news for Africa, the projected medium-term growth of 4 percent is insufficient to make a dent in unemployment and poverty.

The recent commodity price rebound supported the recovery of commodity-exporting countries
The recovery in growth since 2016 among Africa’s commodity exporters has been driven by the rebound in commodity prices (box 1.1). Over the past two years the price of Brent crude oil has risen about 177 percent (from a 10-year low of $27.45 in February 2016 to $74.34 in October 2018). This has helped oil exporters (notably Algeria, Angola, Chad, Congo, Gabon, Libya, and Nigeria) recover but also pushed up inflation in oil-importing countries. Both supply factors (the agreed production restrictions between the

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**FIGURE 1.1** Real GDP growth in Africa, 2010–20

![Real GDP growth in Africa, 2010–20](chart)

Source: African Development Bank statistics and International Monetary Fund.

**TABLE 1.1** Real GDP growth in Africa, 2010–20

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Source: African Development Bank statistics and staff calculations.
**Box 1.1 Commodity price fluctuations and GDP uncertainty in Africa**

A global vector autoregression model is used to quantify the short-, medium-, and long-term sensitivity of Africa’s GDP to a one standard deviation shock in commodity prices, which is roughly equivalent to a $30 increase in the price of crude oil (that is, from the current $50 to about $80). In the short term, commodity price fluctuations explain 7–21 percent of GDP instability (box figure 1). The impact of commodity price volatility on GDP is smallest in non-resource-intensive countries, 8 percent, and largest in mineral- and metal-exporting economies, 22 percent. In the medium to long term, commodity price fluctuations explain a larger share of GDP instability, up to 28 percent in oil-exporting countries and 37 percent in mineral- and metal-exporting countries.

These results point to the vulnerability and high exposure of many African countries to fluctuations in global commodity prices. Although commodity price fluctuations explain a smaller proportion of GDP instability in the short term, which could be the result of countercyclical monetary and fiscal policies applied to stabilize the economy, in the medium term, commodity prices have a stronger influence on fluctuations in GDP.

**Box Figure 1. Proportion of GDP instability in Africa explained by commodity price fluctuations in the short, medium, and long term**

Source: African Development Bank staff calculations.
Organization of the Petroleum Exporting Countries and Russia, the reimposition of sanctions on Iran, and the sociopolitical crisis in Venezuela) and robust global demand are driving the current price rebound. The outlook for oil prices remains unclear, given the uncertainty of global geopolitical risks, coordinated production restrictions, and industrial demand changes. Growth projections for 2019 and 2020 assume that oil prices stabilize at $70. Because oil prices are so volatile, oil-exporting economies are better off building reserves and sovereign wealth funds during periods of recovery to ensure sufficient buffers against future shocks and maintain fiscal sustainability.

Energy subsidies in many African countries constitute a considerable fiscal burden. Despite the drop in global oil prices, energy subsidies as a share of GDP have remained mostly unchanged. Among oil-exporting economies, Angola, Cameroon, and Nigeria had a similar share in the pre-peak period (2013 and 2014) and the post-peak period (2015–17), but in Libya, Algeria, and Congo, the share increased (figure 1.3). Most oil importers saw small changes, though some countries (including Egypt, Tunisia, Morocco, Benin, and Togo) reduced subsidies as a share of GDP, and a few (including South Africa, Zambia, Mozambique, and Ghana) increased them (figure 1.4). Subsidy reforms must be geared toward more-efficient and better targeted social safety nets for the most vulnerable. This could improve public finance management, create more fiscal space for much-needed public investments in infrastructure, and improve the debt situation.

**North Africa leads the growth recovery, but East Africa remains the most dynamic region**

Of Africa’s projected 4 percent growth in 2019, North Africa is expected to account for 1.6 percentage points, or 40 percent (figure 1.5). But average GDP growth in North Africa is erratic because of Libya’s unstable development. After declining for three years, Libya’s GDP increased in 2017 and 2018 because of higher oil production. Despite this, the country’s GDP remains roughly 15 percent below its pre-revolution level. But the political and humanitarian crisis continues, and the highly uncertain outlook depends on achieving political stability. Tunisia’s economy is gradually recovering after near stagnation in 2015 and 2016 because of security problems and social conflicts.
Growth is driven by improved tourism and manufacturing production and a more expansive fiscal policy. Unlike other main commodity exporters, Algeria weathered the commodity price shock in 2015 and 2016 through expansionary fiscal policies; growth is expected to weaken in 2019 and 2020. Morocco’s growth has been boosted by agricultural production and extractive industries and supported by accommodative monetary policy, as inflation remains low. Egypt’s growth remains positive, and its stabilization program is now paying off. Growth is driven by the return of investor confidence, private consumption, and higher exports, which have benefited from adjustments in the real exchange rate.

East Africa, the fastest growing region, is projected to achieve growth of 5.9 percent in 2019 and 6.1 percent in 2020 (table 1.2). Between 2010 and 2018, growth averaged almost 6 percent, with Djibouti, Ethiopia, Rwanda, and Tanzania recording above-average rates. But in several countries, notably Burundi and Comoros, growth remains weak due to political uncertainty. In South Sudan, GDP continues to fall due to political and military conflicts and because the 2015 peace agreement has not been implemented.
West Africa saw high growth until 2014, but an economic slowdown followed due to the sharp drop in commodity prices and the Ebola crisis. Nigeria, Africa’s largest economy and largest oil exporter, fell into recession in 2016. Its gradual recovery in 2017 and 2018, helped by the rebound of oil prices, is restoring growth in the region. Other countries—including Benin, Burkina Faso, Côte d’Ivoire, Ghana, Guinea, and Senegal—have seen growth of at least 5 percent in the past two years and are projected to maintain it in 2019 and 2020.

Growth in Central Africa is gradually recovering but remains below the average for Africa as a whole. It is supported by recovering commodity prices and higher agricultural output. Several countries have reduced public spending, including on investment, to restore debt sustainability. After rapid growth, Equatorial Guinea’s economy has been shrinking since 2013 as oil production declines and the nonoil sector has been too weak to compensate. In 2018, its real GDP was about a third below its level six years ago.

Growth in Southern Africa is expected to remain moderate in 2019 and 2020 after a modest recovery in 2017 and 2018. Southern Africa’s subdued growth is due mainly to South Africa’s weak performance, which affects neighboring countries. Low public and private investment and risks of lower sovereign credit ratings are weighing on growth in the region. In Botswana, growth accelerated due to improved diamond trade, services and investment, the recovery of agriculture after the drought, and the expansionary fiscal policy and accommodative monetary policy resulting from moderate inflation. Mauritius also continues its steady growth, driven mainly by strong consumption and higher exports, including tourism.

At the country level, slow growth in Nigeria and South Africa is dampening Africa’s average growth. They account for a large share of Africa’s GDP but only 0.2–0.4 percentage point of Africa’s GDP growth (figures 1.6 and 1.7). Ethiopia, continuing on a high growth path, accounts for about 0.2 percentage point more than South Africa, despite accounting for a smaller share of Africa’s GDP. Egypt, the third largest African economy, accounts for more than 1 percentage point of Africa’s growth.

### TABLE 1.2 Real GDP growth in Africa, by region, 2010–20

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Source: African Development Bank statistics.

### The drivers of economic growth are gradually rebalancing

Consumption has historically been the main source of demand in Africa, hovering around 80 percent of GDP, while investment, the second largest contributor, has remained around or below 25 percent of GDP since the early 2000s. However, consumption as a share of GDP has declined since 2016 while investment and net exports have picked up (figures 1.8–1.10). Though fiscal consolidation measures to reduce deficits have constrained public consumption and investment in some countries, Benin, Botswana, Burkina Faso, Côte d’Ivoire, Djibouti, Ethiopia, Senegal, Tanzania, and Uganda have all increased public investment. On the other hand, conditions for the private sector have improved in Egypt, Ethiopia, and Seychelles, subsequently increasing FDI.

The drivers of Africa’s economic growth have been gradually rebalancing in recent years. Consumption’s contribution to real GDP growth declined from 55 percent in 2015 to 48 percent in 2018, while investment’s contribution increased from 14 percent to 48 percent. Net exports, historically a drag on economic growth, have had a positive contribution since 2014 (figure 1.11). But despite the rebalancing trend, most of the top-growing countries still rely primarily on consumption as an engine of growth.
Figure 1.6: Real GDP growth, by country, 2018

Source: African Development Bank statistics.
FIGURE 1.7 Contribution to GDP growth in Africa, by country, 2010–20

Source: African Development Bank statistics and staff calculations.
Note: Calculated as the average growth rate of countries weighted by the countries’ share of Africa’s total GDP.

FIGURE 1.8 Consumption as proportion of GDP in Africa, emerging and developing Asia, and Latin America and the Caribbean, 2001–18

Source: African Development Bank statistics and International Monetary Fund.
**FIGURE 1.9** Investment as a proportion of GDP in Africa, emerging and developing Asia, and Latin America and the Caribbean, 2001–18

![Graph showing investment as a proportion of GDP in Africa, emerging and developing Asia, and Latin America and the Caribbean, 2001–18. The graph illustrates the trends in investment over the years, with separate lines for each region. The x-axis represents the years from 2001 to 2018, and the y-axis represents the percent of GDP. Source: African Development Bank statistics and International Monetary Fund.]

**FIGURE 1.10** Net exports as a proportion of GDP in Africa, emerging and developing Asia, and Latin America and the Caribbean, 2001–18

![Graph showing net exports as a proportion of GDP in Africa, emerging and developing Asia, and Latin America and the Caribbean, 2001–18. The graph illustrates the trends in net exports over the years, with separate lines for each region. The x-axis represents the years from 2001 to 2018, and the y-axis represents the percent of GDP. Source: African Development Bank statistics and International Monetary Fund.]

Source: African Development Bank statistics and International Monetary Fund.
Countries that have improved their fiscal and external positions and that have low or moderate debt will probably be resilient to new external shocks.

MACROECONOMIC STABILITY: SOME PROGRESS, BUT CHALLENGES REMAIN

Inflationary pressures have eased

Africa’s average inflation fell from 12.6 percent in 2017 to 10.9 percent in 2018 and is projected to further decline to 8.1 percent in 2020. Double-digit inflation occurs mostly in conflict-affected countries and countries that are not members of a currency union (figure 1.12). Inflation is highest in South Sudan, at 188 percent, due to the lingering economic crisis. Inflation is lowest, at 2 percent or less, in members of the Central African Economic and Monetary Community and the West African Economic and Monetary Union and particularly in members of the CFA zone because of its link to the euro.

Where inflationary pressures have abated and exchange rates have stabilized—Ghana, Morocco, South Africa, Tanzania, and Uganda—central banks have gradually eased monetary policy. But in several countries—Egypt and...
**Box 1.2 Potential impacts of escalating trade tensions: Modest contraction but opportunities for deeper intraregional integration in Africa**

As the trade tensions between the United States and its major trading partners escalate, the World Trade Organization estimates that growth in global trade volume could decline from 4.4 percent to 3.9 percent in 2018 and to 3.7 percent in 2019.¹

Impulse response multipliers from an orthogonalized 1 percentage point (contraction) shock in global trade volume in a parsimoniously specified global vector autoregression model help provide estimates of how these tensions could affect African countries, depending on the nature and intensity of their main exports.

In the short term (within one year), the impact of the trade tensions on Africa’s GDP is about ±0.07 percent of GDP (box figure 1). In the medium term (within three years), the negative impact of the contraction in global trade volumes grows larger. It is strongest for other resource-intensive exporters, at −2.5 percent, followed by oil exporters, at −1.9 percent, and weakest for non-resource-exporting economies, at −1.1 percent (box figure 2).

There are several possible explanations for this pattern. African countries’ size, openness to, and trade intensity with the United States and China are significant—more than 60 percent of Africa’s exports go to the United States, China, and Europe, and more than 70 percent of Africa’s imports originate from these countries. So a decline in demand for Africa’s exports due to a slowdown in the global economy prompted by tariffs is an important channel that could affect Africa.

But despite the modest negative effects, Africa could—with the right policy responses—turn the increasing trade tensions into an opportunity to improve competitiveness and deepen intraregional integration. One way is to take advantage of the dislocation and trade diversion caused by the tensions to become the new supplier of goods previously supplied, for example, by China to the United States. Capturing even a small portion of the dislocation from increasing trade protectionism could benefit Africa.

**Note**
1. WTO 2018.
Tunisia—monetary policy remains tight or has become more restrictive to contain inflation.

**Fiscal positions are gradually improving**

Some countries weathered the sharp drop in commodity prices in 2014 better than others. Mauritania, Mozambique, and Democratic Republic of Congo were moderately affected and moved from a stable growth path to a vulnerable or slower one. By contrast, Algeria and Nigeria, among the largest economies in Africa, saw weakening macroeconomic stability amid slow growth, making macroeconomic policy levers compete between growth and stabilization objectives. Côte d’Ivoire, Ethiopia, Rwanda, Tanzania, and Uganda maintained their stable growth path, suggesting that other drivers of growth, such as public investment, helped maintain growth momentum (figure 1.13). Oil- and mineral-exporting countries such as Congo, Equatorial Guinea, Liberia, Sierra Leone, and South Sudan had the largest fiscal deficits and the lowest real GDP growth. In response to narrower fiscal space, these commodity exporters reduced expenditures to improve their fiscal balances, despite lower growth rates, suggesting procyclical behavior. The fiscal behavior during this recent boom-bust confirms previous findings that African countries have heterogeneous policy responses to external shocks, a more nuanced finding than what recent studies have reported. Africa’s average fiscal deficit declined from 7 percent in 2015 and 2016 to an estimated 4.5 percent in 2018 and is projected to further decline to 4 percent in 2019 and 3.7 percent in 2020 (figure 1.14). In oil-exporting countries, the rebound of oil prices and fiscal consolidation measures reduced the average fiscal deficit from 8.7 percent of GDP in 2016 to an estimated 4.5 percent in 2018 and, assuming oil prices remain stable, should push it further down to 3.8 percent in 2019 and 3.5 percent in 2020. In oil-importing countries, the average fiscal deficit has remained lower than in oil-exporting countries and is projected to decline slightly, from an estimated 4.5 percent in 2018 to 4 percent in 2019 and 2020. Despite these improvements, fiscal buffers remain limited in many countries. Fiscal deficits are expected to remain at 10 percent of GDP or higher in Burundi, Djibouti, Eritrea, and Zimbabwe and at 5–10 percent in Comoros, Egypt, Mozambique, eSwatini, and Zambia.
Several countries achieved fiscal consolidation by increasing tax revenue and, at times, lowering expenditures. Revenue increases were due partly to higher commodity prices and increased growth, but several countries also implemented tax reforms. For example, Algeria and Egypt increased their value added tax, while Angola introduced one that will take effect in 2019. And several countries (Botswana, Kenya, Mauritania, Morocco, Rwanda, and Zambia) introduced an online platform to pay taxes. Domestic resource mobilization has improved but falls short of the continent’s developmental needs. The average ratio was about 17 percent in 2017, below the 25 percent needed to finance development objectives such as the
Sustainable Development Goals. But there is wide variation across countries, from 2.8 percent in Nigeria to 31 percent in Seychelles and 36 percent in Lesotho.

On the expenditure side, lower oil revenue and nonoil tax revenue have led African governments to greatly reduce current and capital expenditures to contain public deficits. Capital expenditure fell from 9.4 percent of GDP in 2014 to 7.6 percent in 2018 (figure 1.15). Since 2015, consolidation has been more pronounced for current expenditure (figure 1.16). To contain rising debt, further fiscal consolidation will be necessary, particularly reducing recurrent expenditure. But limiting government spending should not affect growth-enhancing spending. Given the importance of public investment in catalyzing private investment, particularly in core infrastructure (such as energy and transport), public expenditure should be well targeted to ensure that poverty-reducing social sectors and key infrastructure investments are adequately protected.

**Financial flows reflect changing global and country conditions**

Although current account deficits have been deteriorating (see the last section of this chapter), total external financial inflows to Africa increased from $170.8 billion in 2016 to $193.7 billion in 2017, which represents a 0.7 percentage point increase in net financial inflows as a ratio of GDP (from 7.8 percent in 2016 to 8.5 percent in 2017; figure 1.17).

Remittances continue to gain momentum and dominate the other components of capital flows, at $69 billion in 2017, almost double the size of portfolio investments. Meanwhile, FDI inflows shrank from the 2008 peak of $58.1 billion to a 10-year low of $41.8 billion in 2017. Underlying factors include the global financial crisis and the recent rebalancing of portfolios due to rising interest rates among advanced economies.

A closer look reveals marked differences in FDI inflows across African regions and countries between 2005–10 and 2011–17. North Africa, which attracted the most FDI among African regions in 2005–10, was the only region where FDI decreased between the two periods (figure 1.18). This was due mainly to political uncertainties and transitions. Egypt and Libya recorded a large decline, though Egypt recovered. West Africa attracted the most FDI among African regions in 2011–17 (FDI increased substantially in Ghana and to a lesser extent in...
Remittances increased from $62 billion in 2016 to almost $70 billion in 2017, with Nigeria having the largest inflow (several other countries but declined in Nigeria). East Africa benefited from the largest FDI growth among African regions during 2011–17 (with Ethiopia accounting for 60 percent of the increase after Chinese and Turkish firms announced additional FDI in manufacturing).

Remittances increased from $62 billion in 2016 to almost $70 billion in 2017. Nigeria has the largest inflow of remittances. Among smaller countries, remittances are particularly large in Senegal, Tunisia, and Uganda. In Senegal remittances amounted to about 10 percent of GDP in
Official development assistance (ODA) to Africa peaked in 2013 at $52 billion and has since declined to $45 billion in 2017, with fragile states receiving more ODA as a percentage of GDP than nonfragile states (figure 1.19). All regions saw ODA increase between 2005–10 and 2011–16; East Africa and West Africa remain the highest recipients (figure 1.20).
Debt levels are rising, but there is no systemic risk of debt crisis

In 2017, Africa’s gross government debt-to-GDP ratio reached 53 percent, with considerable heterogeneity across countries (figure 1.21). Of 52 countries with data, 16 (including Algeria, Botswana, Burkina Faso, and Mali) have a debt-to-GDP ratio below 40 percent, and 6 (Cabo Verde, Congo, Egypt, Eritrea, Mozambique, and Sudan) have a ratio above 100 percent. The International Monetary Fund Debt Sustainability Approach classifies 16 countries as being at high risk of debt distress or in debt distress. While debt vulnerabilities have increased in some countries, the continent as a whole does not face the systemic risk of debt crisis.

The drivers of the recent rise in debt differ by country, but the 2014 commodity price decline is a leading source of deteriorating fiscal positions, especially among oil exporters. The average debt-to-GDP ratio among oil exporters increased from 19 percent to 43 percent between 2013 and 2017, compared with an increase from 52 percent to 62 percent among oil importers. Public investment has also risen, to build the necessary infrastructure in the transition to middle-income status, leading to large foreign and domestic borrowing. The continent’s infrastructure needs are $130–$170 billion a year, with a financing gap of $68–$108 billion. For some countries, the recent surge in terror-related security threats has also prompted a need to prop up security spending, pushing debt levels higher.
The composition of debt in Africa has shifted away from official and concessional foreign debt toward commercial debt, which has greater service costs. External debt service as a proportion of exports increased from 5 percent in 2013 to 10 percent in 2016 (the most recent year with data). The move toward international capital markets was encouraged by the speed of access to financing, keen interest from institutional investors for frontier markets, and the signaling value of access to commercial Eurobond borrowing. In 2017, bond issues from Côte d’Ivoire, Egypt, Nigeria, Senegal, South Africa, and Tunisia amounted to $19.3 billion, bringing the cumulative total since 2010 to $69.5 billion. Africa’s credit landscape has also seen a shift from traditional bilateral lenders, in Europe and the United States, toward emerging creditors. For example, new loans from China to Africa increased from $2 billion in 2003 to $17 billion in 2013, before stabilizing around $13 billion in 2015.

Debt accumulation in Africa reflects debt’s function in financing crucial infrastructure for development and export capacity and in buffering against short-term macroeconomic fluctuations. Efficiently investing funds mobilized through debt boosts the productive capacity of capital-scarce economies and generates growth that pays for itself in the longer run.

The recent rising debt levels across many countries in Africa and the concern it has raised indicate an opportune time to explore the role of debt accumulation in financing productive investments, in particular through intermediate and capital goods imports. The next section examines the dynamics of the trade balance and explores the conditions under which debt can be sustained in the future if the composition of imports tilts toward investment goods.

**EXTERNAL IMBALANCES AND IMPLICATIONS FOR LONG-TERM GROWTH**

Africa’s external imbalances have worsened, measured by both the current account and the trade balance. The weighted average current account deficit was 4 percent of GDP at the end of 2017 (the median was 6.7 percent) and, despite recent improvement, has been deteriorating since the end of the 2000s. This could threaten external sustainability and require sharp adjustments in the future.
This section summarizes recent trends in the current account, identifies the components of the current account imbalance, and investigates the recent evolution of domestic savings and investment, emphasizing the role of decreased public revenue and rising public and private capital formation in expanding the savings–investment gap in many African economies.9

**BOX 1.3 What defines external sustainability?**

The traditional analyses of current account sustainability focus on aggregate dynamics of the current account to determine whether a country is more or less likely to meet its external solvency constraints in the medium and long term or whether it will require external adjustment (through default on external liabilities, import contraction, or exchange rate devaluation).1 This has led to an emphasis on monitoring private and public external borrowing, the real exchange rate, the variation in public deficits, and aggregate capital formation, as well as short-run liquidity. In traditional definitions, a country is said to be externally solvent if the present discounted value of future trade surpluses is equal to current external indebtedness.2 When this is not the case, a country is more likely to require a future “hard landing” in the form of a sharp adjustment of monetary, exchange rate, fiscal, and capital account policies, often brought forward by agent anticipations of such constraints in the future. However, a country can run very large current account deficits for an extended period and still meet the solvency condition as long as there are sufficient surpluses at some point, so the intertemporal external constraint imposes only mild restrictions on current account imbalances over time.5

Most traditional analyses of current account sustainability have focused on modeling aggregate dynamics of external imbalances, looking at the current account or trade balance as a whole. They relate their current level to a recommended “optimal” level of the current account (such as the one derived from a theoretical model of intertemporal consumption smoothing), or a “predicted” level drawing on fundamental economic drivers. These include external balance assessments6 performed by international institutions such as the International Monetary Fund, which traditionally focus on the appropriate level of the real exchange rate required to bring the current account back to equilibrium, modeled on the basis of fundamental drivers, such as demographics, savings rates, fiscal constraints, natural resources wealth, and dependency ratios.

This chapter offers evidence that, among African countries, disaggregating the dynamics of the trade balance to focus on the role of imports of consumption, capital, and intermediate goods provides additional information about the degree of current account sustainability. Among African economies, many of which exhibit large current account deficits that have fostered worries among international investors and donors about external sustainability, current account deficits driven by capital and intermediate goods imports are more likely to lead to future industrialization and the generation of export capacity and trade surpluses, compared with current account deficits produced by large imports of consumption goods. Moreover, such capital and intermediate goods imports constitute a crucial link in structural transformation by allowing economies to rely less on volatile commodity and raw material exports, further improving the sustainability of the export mix and external solvency.

Notes
1. For an early reference, see Milesi-Ferretti and Razin (1996).
4. See, for example, Phillips et al. (2013).
The organizing framework relies on an intertemporal view of the current account, focusing on net exports of goods as a key indicator of future sustainability to study the link between the composition of imports, the potential growth of export-generating industries, and the structural transformation of African economies (box 1.3). Based on the balance-of-payments constraint theory (that external financing gaps must turn into surpluses in the long run to avoid external default or sharp consumption adjustments), Africa’s current external deficits may be justified if they sow the seeds for future surpluses. This will be the case as long as higher imports are consistently associated with rising capital formation, followed by an increased share of manufacturing and tradable industries in value added, an improved position in global value chains, and a gradual repayment of external liabilities.

Recent current account dynamics

Despite rapid and generalized economic progress, Africa has been plagued with widespread external imbalances for the past 15 years. Part of the initial decline in the current account was driven by large capital income outflows, and trade balances remained positive until recently, dropping after 2010 when export prices of raw materials plummeted (figure 1.22).

Since the Great Recession, significant current transfer inflows (including aid) have reduced the size of external imbalances in Africa, but the main reason for the recent accumulation of external debt and rising current account deficits is the sharp deterioration of the net exports balance. Net income payments to foreign factors (in particular, investment income accruing to foreign corporations operating in the natural resources and manufacturing sectors) have also contributed to rising external deficits, representing a net aggregate outflow of nearly $40 billion a year for the continent.

While most African countries ran a current account deficit in 2017, with the largest in Djibouti, Guinea, and Liberia, a few countries had a surplus. The reason and qualitative interpretation behind the surpluses vary: they can be driven by diversification in exports, as in the success stories of Botswana and eSwatini, but they are more often the result of a substantial drop in GDP and

Africa’s current external deficits may be justified if they sow the seeds for future surpluses


Source: African Development Bank statistics and International Monetary Fund World Economic Outlook and Balance of Payment Statistics database.
The rapid accumulation of foreign liabilities is likely to weigh on the current account for several years. Subsequent import contraction following reduced domestic consumption, as in Libya and Nigeria, and thus represent a sharp external adjustment after years of imbalances.

Oil exporters and Central Africa have seen large declines in current account balances, though since 2016, the external imbalances are gradually being addressed and external financing gaps have begun to close in several oil-producing countries. Raw material exporters have typically seen better current account balances than other countries throughout the 2000s, but they have also faced much more volatility and were hit particularly hard by the drop in commodity prices in 2013–16. While all regions have seen a decline in external balances since 2014, Central Africa and North Africa were most severely hit (figure 1.23). This is consistent with the role of oil and other commodities in Central Africa and the increasing security challenges posed by terror threats in both Central Africa and North Africa.

From 1990 to 2000, imports kept pace with exports in Africa, leading to a period of narrow trade deficits (figure 1.24). The commodity price supercycle that came into effect in early 2000 enabled exports to outpace imports, leading to a trade surplus at the continent level for much of the decade. This trend recently reversed as commodity prices collapsed, leading to lower export earnings while imports decline at a slower pace. As a result, the trade deficit has widened, implying rapid accumulation of foreign liabilities that are likely to weigh on the current account for several years.

Heterogeneity in export and import dynamics across African regions is key to understanding recent trends at the aggregate level. In particular, declining tourism revenue in North Africa (following rising security challenges) and falling raw material prices affecting Central Africa and West Africa are crucial to understanding the recent export dynamics across regions. In Central Africa, exports as a share of GDP declined by close to 15 percentage points from 2011 to 2016, following negative terms of trade shocks and limited real exchange rate depreciation due to high domestic inflation (figure 1.25). Exports as a share of GDP declined markedly after 2010 in most regions, though not as much in Southern Africa (where South Africa plays a prominent role and has less exposure to commodity price changes, thanks to a more diversified export mix). Imports as a share of GDP decreased in East Africa but remained high in Central Africa and North Africa, increasing divergence and the need for large external funding inflows.

FIGURE 1.23 Current account balances in Africa by exporter type, region, and country

![Current account balances in Africa by exporter type, region, and country](image-url)
Exports as a share of GDP declined markedly after 2010 in most regions, though not as much in Southern Africa.
Assessing the evolution of exports and imports in the five largest African economies—Nigeria, Angola, Algeria, Egypt, and South Africa—helps flesh out recent trade dynamics. The sharp reduction in exports in oil- and hydrocarbon-producing economies, notably Algeria and Angola, between 2000 and 2016 was not matched by a similar reduction in imports, leading to rising trade balance deficits (figure 1.26). Exports declined in all the economies except South Africa, which is more insulated from global commodity price shocks; imports rose in Algeria and South Africa.
Determinants of current account imbalances

Domestic investment and savings dynamics are seen here as drivers of the need for external borrowing. Indeed, while the current account can be seen as the excess of domestic absorption over consumption, or the sum of net exports and net foreign factor payments, national accounting also implies that the current account mirrors the excess of domestic investment over savings (box 1.4).

Low domestic savings in Africa since 2000, driven in particular by rising public deficits, has...
fostered a need for external borrowing in the form of loans and foreign portfolio and direct investment. Investment rates have remained high throughout the past decade, at 22 percent of GDP, and required sustained current account deficits because domestic absorption exceeded production. There is a close association between domestic savings and investment and current account deficits (figure 1.27). In particular, domestic public savings have been a key driver of current account imbalances in Africa. Rising fiscal deficits brought about by stagnating tax

FIGURE 1.27 The relationship between the current account balance and public and private savings and investment in Africa, 2000–17

Source: African Development Bank statistics, World Bank World Development Indicators, and International Monetary Fund World Economic Outlook.
Investment in Africa has increased, albeit slowly, but domestic savings have been highly volatile, losing ground in the 1990s, recovering in the 2000s, and crashing heavily recently (figure 1.28). Investment in Africa has increased, but domestic savings have been highly volatile, losing ground in the 1990s, recovering in the 2000s, and crashing heavily recently (figure 1.28).

**FIGURE 1.28** Weighted average investment and public and private savings in Africa, 1990–2017

Percent of GDP

- **Private savings**
- **Public savings**
- **Investment**

Source: African Development Bank statistics, World Bank World Development Indicators, and International Monetary Fund World Economic Outlook.

**FIGURE 1.29** Investment and savings in Africa, by region, 2000–17

Percent of GDP

- **Investment**
- **Savings**

Source: African Development Bank statistics, World Bank World Development Indicators, and International Monetary Fund World Economic Outlook.
Savings have plummeted in most regions since 2015, particularly in West Africa and commodity-exporting countries, due partly to rising fiscal deficits arising from the drop in oil prices (see figure 1.29). In East Africa, higher investment was not matched with a decline in savings, which points to one explanation for the region’s relative overperformance: large external financing needs driven mostly by productive capital investment rather than a drop in public or private savings.

Analysis suggests strong persistence of trade surpluses and deficits. Industrialization plays a role in shifting from trade deficits to surpluses, even conditional on levels of development (proxied by GDP per capita and the share of services in value added). The share of industry in value added, the share of urban population in the largest city, and the urbanization rate all show a positive correlation with the current account balance, after country and year fixed effects are controlled for, suggesting a relationship between specializing in higher value added manufactured goods produced at larger scale and running a trade surplus (table 1.3). Countries with rising urbanization and industrialization rates include several export diversification success stories: from 2012 to 2016, Cabo Verde’s urbanization rate went up 11 percentage points, to 66 percent, and Tanzania’s went up 9. Some countries, however, witnessed an urbanization decline—for example, Zimbabwe (from 35 percent in 2002 to 32 percent in 2016).

Level of development also appears positively correlated with current account and trade balances, providing suggestive evidence for a growth path in which foreign capital inflows gradually lead to industrialization and reduced dependency on external funding. Public deficits (measured as overall government balance as a share of GDP) appear to drive down the current account, suggesting the existence of “twin deficits” on the continent. This has been documented elsewhere in the literature and points to the limited ability of domestic savings to cushion changes in government deficits and to the key role of government in generating and receiving most of the export revenues stemming from raw materials and the exploitation of natural resources.

Competitiveness is also a key driver of current account and external surpluses. A rise in the real
exchange rate index leads to a deterioration of net exports, though the magnitude of the effect is limited. Industrialization is associated with an improved current account balance, while importing consumer goods and specializing in services are correlated with worse current account and trade balances. Higher domestic investment, both public and private, leads to larger deficits today, as domestic savings prove insufficient to finance government and private sector needs for productive infrastructure. This points to the key tradeoff for developing countries, between present deficits and export capacity-generating investment (see the next section). Higher public and private investment shares in GDP are indeed associated with larger trade balance deficits today, in line with the savings–investment gap interpretation of external imbalances, and suggesting that investment is a key driver of Africa’s current account funding needs. In other words, investing today in Africa requires large foreign capital inflows and capital goods imports.

**Digging deeper: import content and future growth**

Not all trade deficits are created equal. Among African countries, disaggregating the dynamics of the trade balance, with a focus on imports of consumption, capital, and intermediate goods, provides further information on future current account sustainability. The recent literature on current accounts, export-led growth, and structural change also helps in assessing the viability of recent external imbalances in Africa using a disaggregated, sector-level analysis of import and export content rather than from an aggregate external position perspective. The focus here is on two subdimensions of trade-induced structural change: imports of capital goods, which are subsequently used in production and allow a country to develop a strong domestic manufacturing and capital base, and imports of intermediate goods, which allow further integration into global value chains, a key determinant of growth in living standards for developing economies. Disaggregated trade data at the broad industry level emphasize the degree to which African economies are shifting, or not, toward imports of capital goods and intellectual property–intensive products, which are likely to trigger growth in export-led industries.

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**TABLE 1.3 Trade balance regression**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lagged trade balance (% of GDP)</td>
<td>0.531***</td>
</tr>
<tr>
<td>(0.023)</td>
<td></td>
</tr>
<tr>
<td>Real GDP growth (annual %)</td>
<td>0.062*</td>
</tr>
<tr>
<td>(0.036)</td>
<td></td>
</tr>
<tr>
<td>Industry value added (% of GDP)</td>
<td>0.447***</td>
</tr>
<tr>
<td>(0.038)</td>
<td></td>
</tr>
<tr>
<td>Population growth (%)</td>
<td>20.880</td>
</tr>
<tr>
<td>(21.884)</td>
<td></td>
</tr>
<tr>
<td>Overall government balance (% of GDP)</td>
<td>0.073***</td>
</tr>
<tr>
<td>(0.025)</td>
<td></td>
</tr>
<tr>
<td>Gross private capital formation (% of GDP)</td>
<td>-0.427***</td>
</tr>
<tr>
<td>(0.028)</td>
<td></td>
</tr>
<tr>
<td>Gross public capital formation (% of GDP)</td>
<td>-0.315***</td>
</tr>
<tr>
<td>(0.039)</td>
<td></td>
</tr>
<tr>
<td>Consumer price inflation (annual %)</td>
<td>0.008</td>
</tr>
<tr>
<td>(0.014)</td>
<td></td>
</tr>
<tr>
<td>Real exchange rate index (2000=100)</td>
<td>-0.001*</td>
</tr>
<tr>
<td>(0.0004)</td>
<td></td>
</tr>
<tr>
<td>Log GDP per capita ($)</td>
<td>6.482**</td>
</tr>
<tr>
<td>(2.703)</td>
<td></td>
</tr>
<tr>
<td>Log GDP per capita ($), squared</td>
<td>-0.216</td>
</tr>
<tr>
<td>(0.199)</td>
<td></td>
</tr>
<tr>
<td>Number of observations</td>
<td>945</td>
</tr>
<tr>
<td>(R^2)</td>
<td>0.678</td>
</tr>
<tr>
<td>Adjusted (R^2)</td>
<td>0.648</td>
</tr>
<tr>
<td>F-statistic</td>
<td>165.388***</td>
</tr>
<tr>
<td>(df = 11; 865)</td>
<td></td>
</tr>
</tbody>
</table>

* Significant at the 10 percent level; ** significant at the 5 percent level; *** significant at the 1 percent level.

Source: African Development Bank statistics, World Bank World Development Indicators and World Integrated Trade Statistics, and International Monetary Fund World Economic Outlook.

Note: Includes country and year fixed effects.

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Africa remains heavily specialized in raw material exports with low jobs content and low complexity (notably fossil fuels). They account for about 40 percent of exports in the region, the most specialized in the world (figure 1.31). The lack of reallocation of employment away from labor-intensive, low-productivity raw materials (as well as non-tradable services and light manufacturing) toward tradable industries with higher external economies of scale is one of the bottlenecks jeopardizing the continent’s growth prospects. Moreover, this pattern of specialization is associated with several risks: volatile terms of trade, limited potential for
Future industrialization and greater export capacity and trade surpluses are more likely to follow current account deficits that are driven by capital and intermediate goods imports.

differentiation and market power, reduced ability to exploit scale and knowledge externalities, and dependency on external demand fluctuations.

In African countries, a higher share of capital goods in merchandise imports is associated with lower specialization in raw materials in the future. There is a strong correlation between a higher share of capital goods in imports in one year and a lower share of raw materials in exports five years later, after the current share of raw materials in exports, GDP per capita, and country and year fixed effects are accounted for (figure 1.32). Regression analyses emphasize the key role of intermediate and capital goods in reducing future reliance on raw materials exports and triggering self-perpetuating industrialization, urbanization, and structural change. The effect is strongest in North Africa, possibly because the region has a higher level of development and less reliance on raw material exports.

Intermediate and capital goods imports
Future industrialization and greater export capacity and trade surpluses are more likely to follow current account deficits that are driven by capital and intermediate goods imports than current account deficits that stem from large imports of consumption goods. The share of capital goods in imports is largest in the fastest growing emerging regions, including East Asia and Pacific, and lower on the African continent, where it is closer to the share in Europe and Central Asia. Moreover, the share of capital goods in imports has declined in Africa, stagnating at about 25 percent, compared with the nearly 40 percent in Latin America and East Asia.

The share of intermediate and capital goods in imports in 2015 (the most recent year with disaggregated data) varies widely across African countries. It is highest among producers specializing in light manufacturing, tourism, and other services, including Madagascar, Tunisia, and Morocco, which are already well integrated into global value chains (figure 1.33). These countries have specialized in exports of textiles, integrated circuits, insulated wires, and small electronics and supply traditional purchasers, notably those in the European Union, with low-cost light manufacturing. They have captured at least part of the value generated by the accumulation of tasks along global value chains. By contrast, capital equipment goods and machinery are imported mostly by large fuel producers and heavy industry exporters, including Niger, Algeria, Angola, and South Africa, which export mostly raw materials and hydrocarbons or heavy industry products (chemicals, metal products, cars, and coal and coal-derived products).

Capital goods imports play a virtuous role in structural change, growth in export-led industries, and subsequent reversals of external and current account imbalances. Long-term growth in income per capita appears correlated with a higher share of capital imports. Regression analyses show that countries where imports have focused on upstream, capital-intensive products and industries have been more likely to see accelerated growth, increased industrialization, an improved trade balance, and lower external debt following a rise in exports and import substitution relative to countries in which initial imports were driven mostly by final consumption sectors. After country and year fixed effects and the initial share of industry and manufacturing in value added are accounted for, higher capital goods imports are likely to lead to a rise in industry’s share of GDP (figure 1.34). The importance of capital goods imports is further supported by their strong correlation with future growth and poverty reduction. Growth in GDP per capita in five years is associated with the share of capital goods in total imports, even after various observables and country and year fixed effects are controlled for.

After the current share of exports in GDP, log GDP per capita, and country and year fixed effects are accounted for, higher current investment leads to future improvement in export performance and the trade balance 5 and 10 years later, with short-term improvement correlated more closely with private investment and long-term improvement correlated more closely with public investment.

African countries with the highest shares of manufacturing in value added also have higher levels of development. They follow the well-established path of industrialization, urbanization, and upward movement in the value added chain. Higher private capital formation has a strong impact on future export growth (figure 1.35). The impact is similar across African regions, though weaker in West Africa and
African countries with the highest shares of manufacturing in value added also have higher levels of development.

**FIGURE 1.31 Share of raw materials in exports, by world region, 1990–2015**

![Graph showing share of raw materials in exports by world region from 1990 to 2015](image)

Source: African Development Bank statistics and World Bank World Development Indicators and World Integrated Trade Statistics.

**FIGURE 1.32 Relationship between share of capital goods in merchandise imports and share of raw materials in exports five years later in Africa**

![Scatter plot showing relationship between share of capital goods in merchandise imports and share of raw materials in exports five years later](image)

Source: African Development Bank statistics and World Bank World Development Indicators and World Integrated Trade Statistics.

Note: Covers 54 African countries with data for 2000–17. The regressions include country fixed effects to remove the effect of time-invariant country characteristics and year fixed effects to net out the effect of aggregate trends affecting the continent as a whole.
weaker and less robust in Central Africa, where capital investment has been targeted mostly toward hydrocarbon and raw material extraction and is thus less correlated with future export growth because the terms of trade associated with such specialization is highly volatile. Improved export performance following a large rise in private investment is driven by faster industrialization. Higher private investment is associated with a sharp rise in the share of industry in value added in five years.

Beyond capital goods imports, integration into global value chains is a key factor for development
FIGURE 1.34 Relationship between share of capital goods in imports and future industry and manufacturing shares in value added in Africa

![Graph showing the relationship between share of capital goods in imports and future industry and manufacturing shares in value added in Africa.](image)

Source: African Development Bank statistics and World Bank World Development Indicators and World Integrated Trade Statistics.

Note: Covers 54 African countries with data for 2000–17. The regressions include country fixed effects to remove the effect of time-invariant country characteristics and year fixed effects to net out the effect of aggregate trends affecting the continent as a whole.

FIGURE 1.35 Relationship between gross private capital formation and future exports as a share of GDP and industry share in value added in Africa

![Graph showing the relationship between gross private capital formation and future exports as a share of GDP and industry share in value added in Africa.](image)

Source: African Development Bank statistics and World Bank World Development Indicators and World Integrated Trade Statistics.

Note: Covers 54 African countries with data for 2000–17. The regressions include country fixed effects to remove the effect of time-invariant country characteristics and year fixed effects to net out the effect of aggregate trends affecting the continent as a whole.
Integration into global value chains is a key factor for development and structural change and structural change in developing countries. It drives the convergence of living standards through several channels: technology transfers and know-how externalities, logistical support and additional export opportunities, and reduced volatility of trade and the cost to discover trade partners. For Africa, a rise in intermediate goods imports is associated with a higher share of industry in value added in five years—a strong association that holds when country and year fixed effects, initial share of industry, and GDP per capita are controlled for (figure 1.36).

After country and year fixed effects, the shares of capital goods in imports, and the share of raw materials in exports are controlled for, a higher share of intermediate goods imports is also associated with a higher World Economic Forum Global Competitiveness Index score (figure 1.37). Some of Africa’s success stories of global integration and export diversification also show high shares of intermediate goods in imports in recent years, with growing trends in Madagascar, Ethiopia, and Tunisia in recent years (figure 1.38).

Monetary and financial integration: Assessing the challenges

Africa is home to three monetary unions—the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Common Monetary Area—and political leaders across the continent have been talking about creating new ones or expanding the existing three. A major rationale for these monetary unions is the expected political benefit of ultimately having a single currency for the continent, as a symbol of African unity. Another more technical rationale involves the costs and benefits of engaging in such unions, whether regional or continental.

As noted in last year’s African Economic Outlook, countries engage in monetary unions with the hope of macroeconomic and structural benefits. The benefits include a stable exchange rate and macroeconomic environment, less external vulnerability, greater intraregional trade, more financial integration, lower transaction costs (as currency conversion costs fall)—and thus faster growth and more convergence among member

**FIGURE 1.36** Relationship between intermediate goods imports and future industry share in value added in Africa

- **Share of industry in value added 5 years later (percent)**
- **Share of intermediate goods in imports (percent)**

Source: African Development Bank statistics and World Bank World Development Indicators.

*Note:* Covers 54 African countries with available data for 2000–17. The regressions include country fixed effects to remove the effect of time-invariant country characteristics and year fixed effects to net out the effect of aggregate trends affecting the continent as a whole.
Some of Africa’s success stories of global integration and export diversification also show high shares of intermediate goods in imports in recent years.
countries. But there also are costs. By definition, monetary unions limit member countries’ flexibility to use monetary instruments to adjust to external shocks.

The standard framework that many economists use to assess the viability of a monetary union and the scope for expanding one is the optimal currency area.\textsuperscript{19} In theory, membership in a monetary union can be beneficial depending on the degree of openness and intraregional trade, the degree of labor and factor mobility, the symmetry of shocks across countries, and the system for sharing risk and providing financial support to countries facing severe economic difficulties.

Masson, Debrun, and Pattillo (2015) use that general framework to try to answer three questions. First, are the existing monetary unions in Africa economically viable? Second, should existing monetary unions be expanded, or should new ones be created? Third, what lessons come from the Eurozone? They conclude that African monetary unions are economically viable, with net economic gains from membership in the West African Economic and Monetary Union, though the benefits are not equal across member countries (table 1.4). Because currencies are pegged to the euro, countries benefit from greater monetary stability. But they are worse off since they cannot use exchange rate adjustments to cushion the effect of fiscal and external shocks. The results are similar for the Common Monetary Area, pegged to the South African rand.

Should existing monetary unions be expanded? For example, should the West African Economic and Monetary Union include the Economic Community of West African States? When Gambia, Ghana, and Guinea are added to the West African Economic and Monetary Union, there are net gains (if reduced) for both current and new members (table 1.5). When Nigeria is added, current members would not benefit, although it could be welfare-enhancing for Nigeria, which would gain from a more stable currency. But without Nigeria, expanding the monetary union in West Africa erodes the net gains accruing to both current and new members.

On lessons from the eurozone, Masson, Debrun, and Pattillo (2015) indicate that, in addition to satisfying the macroeconomic convergence criteria, closer integration in other dimensions is needed to reap the gains from a monetary union. Specifically, they recommend close coordination of banking supervision and a lender-of-last-resort facility at the union level. They also suggest that member countries in currency unions should be willing to bail out others in extreme circumstances, among other noneconomic dimensions.

Such a generally positive assessment of African monetary unions has drawn skepticism from other researchers,\textsuperscript{20} and several criticisms can be leveled against the optimal currency area theory (see box 3.3 in chapter 3). First, the theory can be difficult to test and validate empirically, especially in countries with insufficient or inaccurate data on

\begin{table}[h]
\centering
\begin{tabular}{lccc}
\hline
\textbf{Net welfare gain from membership in the West African Economic and Monetary Union (% of GDP)} & Nan & Nan & Nan \\
\hline
\textbf{Net welfare gain} & 0.87 & 1.28 & 1.28 & 1.93 & 0.77 & 1.48 & 0.93 \\
\textbf{Fiscal asymmetry} & –0.45 & –0.09 & –0.06 & 0.56 & –0.06 & 0.18 & –0.37 \\
\textbf{Monetary externality} & 1.44 & 1.44 & 1.44 & 1.44 & 1.44 & 1.44 & 1.44 \\
\textbf{Shock asymmetry} & –0.13 & –0.07 & –0.10 & –0.05 & –0.61 & –0.14 & –0.15 \\
\hline
\end{tabular}
\caption{Net welfare gain from membership in the West African Economic and Monetary Union (% of GDP)}
\end{table}

A monetary union needs well-functioning, cross-country fiscal institutions and rules, which can help members respond to asymmetric shocks.

Key macroeconomic variables. Second, differences in labor markets (institutional arrangements, union behavior) will not necessarily disappear over time as the monetary union takes hold. Third, differences in economic performance across countries in a monetary union may not be decisive. Indeed, a demand shock concentrated in only one country may be unlikely and would be offset by the importance and the structure of trade. Moreover, the dissimilarity in industry structures is often the end point of efficient monetary integration, not the starting point. Here’s why. The interaction of higher returns and lower transport costs leads to uneven regional development, facilitating the clustering of firms in some places, creating core and peripheral regions. In such circumstances, reducing transport costs would facilitate locating production where it is cheapest but also concentrate production in one location to realize economies of scale. This new economics of space tends to localize industries in a monetary union’s countries where the returns are higher and eventually to have countries specialize within the union—that is, a monetary union’s members have a different economic structure only much later.

Considering such limits to the assessment criteria of optimal currency area proponents, two other issues must be analyzed: the lack of strong and credible mechanisms for fiscal coordination within African currency unions and the uncertainty about creating and distributing the revenues from printing money (seigniorage):

- **Lack of coordination.** Monetary unions, with their explicit coordination of monetary and exchange rate policies, require strong cooperation in the fiscal policies of all member states. Given the structural differences among the various areas of any given union, fiscal policies must be the stabilizers, with transfers offsetting a member’s economic difficulties. But highly divergent fiscal policies could put unbearable strains on the union, especially if they lead to conflicting balance of payment movements. The “fiscal federalism” that helps Germany, the United States, and other federal currency areas succeed despite having economically diverse regions is absent in African monetary unions. Compounding the problem is that government revenue from taxing international trade and transactions varies greatly across African countries in the same monetary union. So, member countries do not have the same incentives for economic integration.

- **Loss of seigniorage.** The opportunity cost of relinquishing the use of seigniorage should be factored into estimates of the gains from monetary integration among African countries. Government revenue from printing money can sometimes amount to fairly high proportions of GDP and to more than 10 percent of total revenue. It is a source of revenue because, simply by printing money to pay for its expenditures, a government generates inflation, thus lowering the real value of payments and taxing existing holders of money.

What, then, does a monetary union need if it is to be effective? It needs well-functioning, cross-country fiscal institutions and rules, which can help members respond to asymmetric shocks.

### TABLE 1.5 Net welfare gain or loss from adding countries one by one to the West African Economic and Monetary Union (% of GDP)

<table>
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<tr>
<th>For new members</th>
<th>Net welfare gain or loss</th>
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<th>Burkina Faso</th>
<th>Côte d’Ivoire</th>
<th>Mali</th>
<th>Niger</th>
<th>Senegal</th>
<th>Togo</th>
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<td>0.0006</td>
<td>0.0006</td>
<td>0.0005</td>
<td>0.0005</td>
<td>0.0006</td>
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<td>0.0037</td>
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<td>0.0008</td>
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<td>0.0007</td>
<td>0.001</td>
<td>0.0009</td>
<td>0.0006</td>
</tr>
<tr>
<td>Nigeria</td>
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<td>-0.0175</td>
<td>-0.016</td>
<td>-0.0133</td>
<td>-0.0114</td>
<td>-0.017</td>
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</table>

Source: Masson, Pattillo, and Debrun 2015.
Policies to lower the cost to transfer money and to improve platforms for diaspora investment and other incentives can increase the availability of critical resources for financing development.
Policy interventions focused on increasing the share of intermediate and capital goods in imports could help countries benefit from scale and scope economies.

The rising share of capital and intermediate goods relative to consumption goods in imports support the presumption that external debt tends to be used sensibly, to fund essential infrastructure and industrial investment likely to eventually reverse trade balance deficits.

Policy interventions focused on increasing the share of intermediate and capital goods in imports could help countries benefit from scale and scope economies and exploit knowledge transfers from more advanced production processes. First, higher private investment is associated with future improvement in the trade balance. Countries may thus sustain current large external deficits, as long as tax incentives, institutional frameworks, and basic infrastructure are in place to channel capital investment toward the sectors most likely to drive a trade balance reversal. Second, emphasizing urbanization and a reallocation of the most productive resources toward export-intensive areas that are well integrated into global value chains appears to be key to aggregate productivity growth. Third, among African success stories of export diversification, improving the external tariff structure to avoid an undue burden on intermediate and capital goods is also a relevant policy intervention to level the playing field and foster a structural shift in the import mix from consumer to capital goods. Fourth, ensuring integration into global value chains by upholding technical and labor standards and reinforcing regional integration enables countries to move up the ladder of specialization and reverse external imbalances. Fifth, reinvesting surpluses from commodity price windfalls toward sectors with higher productivity growth and more potential for integration into global value chains is crucial to make trade an inclusive part of structural change in Africa.

Finally, the immediate gains from African monetary integration, one of the aspirations of regional and continental integration, may be much more elusive—and the macroeconomic challenges much greater—than conventional analysis predicts. The standard framework that many

FIGURE 1.39 Relationship between the current trade balance and the future trade balance in Africa

Source: African Development Bank statistics and World Bank World Development Indicators. Note: Covers 54 African countries with available data for 2000–17. The regressions include country fixed effects to remove the effect of time-invariant country characteristics and year fixed effects to net out the effect of aggregate trends affecting the continent as a whole.
economists use (the optimal currency area) can be difficult to validate for countries with too little accurate data on key macroeconomic variables. It is unlikely that differences in labor markets will disappear rapidly over time. It is also unlikely that shocks will hit only one member and not be generalized to many or all of them. So it is unlikely that an African supranational authority will have the resources to come to the aid of countries facing severe economic difficulties.

For countries in a monetary union, well-functioning, cross-country fiscal institutions and rules are needed to help members respond to asymmetric shocks. The free movement of labor, capital, and goods should be a reality—not just a goal. Debt and deficit policies should be consistent across the union and carefully monitored by a credible central authority. And the financial and banking sector should be under careful supervision by a unionwide independent institution capable of enforcing strict prudential rules. Each of these four requirements is a tall order. Together, they present enormous macroeconomic challenges.
### TABLE A1.1 Macroeconomic developments in Africa, 2010–20

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| Oil-importing countries     | −3.9    | −4.8 | −4.6 | −4.6 | −4.2             | −4.0             | (continued)
### TABLE A1.1 Macroeconomic developments in Africa, 2010–20 (continued)

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*Source: African Development Bank statistics and staff calculations.*
NOTES

1. In 2017, a substantial increase in oil production boosted Libya’s growth rate to 64 percent, distorting the picture of the continent’s recovery.
2. Real GDP per capita growth is estimated at 0.9 percent in 2018 and is projected to be 1.5 percent in 2019.
5. Recent International Monetary Fund staff calculations show zero pass-through for oil exporters and positive pass-through of about 47 percent for oil importers.
9. See the methodology in Chinn and Prasad (2003) or more recently Phillips et al. (2013).
12. While exports of raw materials correspond to increased public and private revenue from abroad, they should also be properly accounted for in any complete definition of genuine savings, which considers the depletion of natural capital. Indeed, adjusted net savings, which incorporate both net investment in human capital in the form of education and health spending and the negative effect from the deterioration of the natural environment, were negative over the period for several major natural resource exporters. See Bolt, Matete, and Clemens (2002) for a complete definition of adjusted net savings.

REFERENCES


