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Rethinking Trade Preferences to Help Diversify African Exports

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Successful economic development is generally accompanied by fast growing employment and exports in activities that are new for the countries concerned, including manufacturing, 'non-traditional' agriculture, and service sectors. In Asia, export diversification has strongly assisted development and has been contagious across the region: the first countries to diversify served both as models and as springboards. In Africa this process has yet to start.

Africa's trade dilemma

Africa has lagged behind partly because its economic reforms lagged Asia: in the 1980s when Asia first broke into global markets no mainland African country provided a comparable investment climate. Now a number of well-located African cities – such as Accra, Dakar, Mombassa, Maputo and Dar es Salaam – offer reasonable investment climates. However, they face the obstacle that Asian cities with comparable investment climates now have established clusters of firms in the new export sectors. Within these clusters, firms have the advantages of shared knowledge, availability of specialist inputs and a developing pool of experienced labour.

Africa's potential export locations do not have these advantages and face an entry threshold, or 'chicken-and-egg' problem. Until clusters are established, costs will be above those of Asian competitors, but because costs are currently higher individual firms have no incentive to relocate. If Africa is to diversify its exports and create employment it must develop such efficient clusters of modern sector activity. Where it is feasible, this offers a more reliable development path than the commodity extraction model which Africa has followed to date.

Trade Preferences

Trade preferences offer a potential way out of this dilemma. Preferences are offered by developed countries to developing countries under the Generalised System of Preferences (GSP) and a number of other schemes including the EU's 'Everything but Arms' initiative (EBA) and the US's 'African Growth and Opportunities Act' (AGOA). Until now such schemes have generally failed to provide developing countries with the opportunity to develop their productive and export capabilities in new areas. They have failed for a number of reasons: they have had limited product coverage; preferences have excluded the countries that are best placed to benefit from them; they have been accompanied by investment deterring uncertainty; and they have had complex and restrictive regulations, particularly to do with rules of origin.

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The fundamental importance of trade preferences is that they can give countries a window of opportunity in which to develop capacity in new sectors. However, for preferences to do this effectively they must meet two criteria. The first is that they enable countries to specialise in a narrow range of activities, or 'tasks'. An increasing part of world economic activity now takes the form of production networks, in which production of a good is fragmented between many countries, with each specialising in one narrow task in the production process. This is a global phenomenon, and it holds potential for Africa since it is much easier to develop capabilities in a narrow range of tasks than in integrated production of an entire product. The implication for preferential trading schemes is that rules of origin must be liberal enough not to exclude countries from participation in such production networks.

The second criterion is that preferences should be open to countries that are close to the threshold of developing globally competitive clusters of activity. GSP preferences are designed to favour the least developed countries (LDCs). While it is indeed appropriate to favour countries that are least developed, the practical consequence is the exclusion of countries such as Kenya

1 Personal views of authors and not reflecting institutional positions.

and Ghana, which have just arrived at the threshold. For diversification to be feasible a country must have a minimum range of complementary capabilities. Kenya and Ghana are manifestly more likely to surmount the entry threshold than Liberia and Somalia. The effect has therefore been to exclude precisely those African countries best-placed to take advantage of preferences for export diversification. The challenge facing strategies for assisting African development is to get the process of diversification started in the region, and so it is essential to include the most feasible locations.

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Both these points are illustrated by the example of apparel. Although apparel is a relatively straightforward sector, producing goods from scratch requires capability in the production of cotton and other materials, in transforming them into yarn and fabric, and in assembling them into garments, together with such skills as design and marketing. Granting preferences simply for the export of garments is of little value unless either (i) the country already has a substantial proportion of these capabilities, or (ii) is able to import many of the inputs to the final product, rather than undertaking all these stages domestically. Too often current preference schemes have closed off these options.

Is there any evidence that appropriately designed trade preferences could elicit a supply response in Africa? AGOA is an interesting natural experiment, as it has two key differences from other schemes. The first is that AGOA is not restricted to LDCs, and is currently available to 38 Sub-Saharan African (SSA) countries, including Kenya, Ghana and S. Africa[2]. Thus, AGOA has already set a clear precedent that preferences for Africa can be extended beyond LDCs. The second concerns its rules of origin. As with EBA, rules of origin severely limit the impact of the scheme, but within AGOA there is one exception to these restrictive rules of origin, namely for apparel.

After its introduction, AGOA was modified by a 'special rule' clause which relaxes rules of origin for apparel imports. Under this rule making up fabric into apparel is sufficient to confer origin, so countries can use fabric imported from third countries in their apparel exports to the US. The 'special rule' applies to 25 SSA countries, including Kenya and some other non-LDCs. However, until December 2006 it was only renewed by Congress for short periods and the resulting uncertainty can be presumed to have significantly weakened supply response. Even with this limitation, a new econometric analysis finds that the 'special rule' increased African apparel exports to the US sevenfold.[3]

2 For details on eligibility see *www.agoa.gov/eligibility/country_eligibility.html*

3 'Rethinking Trade Preferences: How Africa can Diversify its Exports', Paul Collier and Anthony J. Venables, CEPR DP6262, 2007; forthcoming, *World Economy.*

The efficacy of AGOA in apparel is evident even from a simple chart of export performance (Figure 1). The effect of AGOA is seen most clearly for Africa countries other than Mauritius. Exports from these countries to the EU and USA ran at very similar levels until 2000, after which those to the US increased from around $300m to $1,500m per annum, while those to the EU stagnated. The econometric study increases confidence that this change was causal because it is able to rule out the other likely explanations.[4]

As might be expected given the benefits of clustering, the growth of exports to the US has been concentrated in a few countries, as illustrated in Figure 2. The bottom line is exports from Kenya, now amounting to some $270m per annum, and the difference between this and the line above is Madagascar, with exports to the US of around $300m per annum. SACU (South Africa, Botswana, Lesotho, Namibia and Swaziland) exports have reached $700m and Mauritius's exports have held around the $250m level. The combined apparel exports to the US of all other SSA countries is only some $50m, although within this there are some very fast growing totals, such as Malawi.

Making preferences work

Improvements in trade preferences could be carried forward in a number of different ways. A new preference scheme, focused on Africa and offering access to substantially all OECD markets, is the most ambitious option, but opportunities also exist within existing schemes, or schemes that are currently under negotiation, such as the EU's Economic Partnership Agreements. The improved preferences should be guided by the following principles:

1. Rules of origin should be as generous as possible. The 'special rule' in AGOA provides a model of demonstrated efficacy, and so might usefully be extended to sectors beyond apparel. Of course, rules of origin cannot be completely abandoned; they are needed to prevent trade 'deflection', with products routed through eligible countries merely for warehousing, packaging, or very simple assembly. However, when they are too restrictive, as with EBA, no new activities become profitable and the scheme is ineffective.
2. The coverage of products should ideally be wide, as already established by EBA. Proposals made in the WTO's Doha Round (the 'Hong Kong' offer) would enable OECD governments to exclude up to 3% of product lines for preferential tariff cuts. This is likely to be too restrictive since it could potentially be used to exclude the few product niches in which entry-level African cities are likely to be viable. However, precisely because African diversification is likely to occur in a relatively narrow and, to an extent, foreseeable product range, it is more important that these products be included than that coverage be universal. The incentives for export activities to establish in Africa will be greatest where the OECD still has significant tariff protection and these

4 See footnote 3

Figure 1 Apparel exports from SSA, $ million

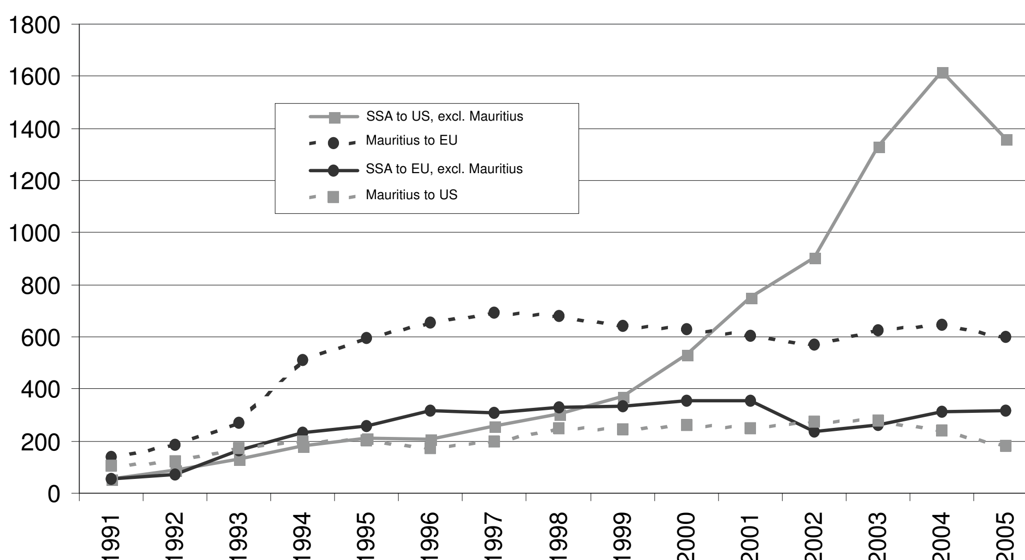
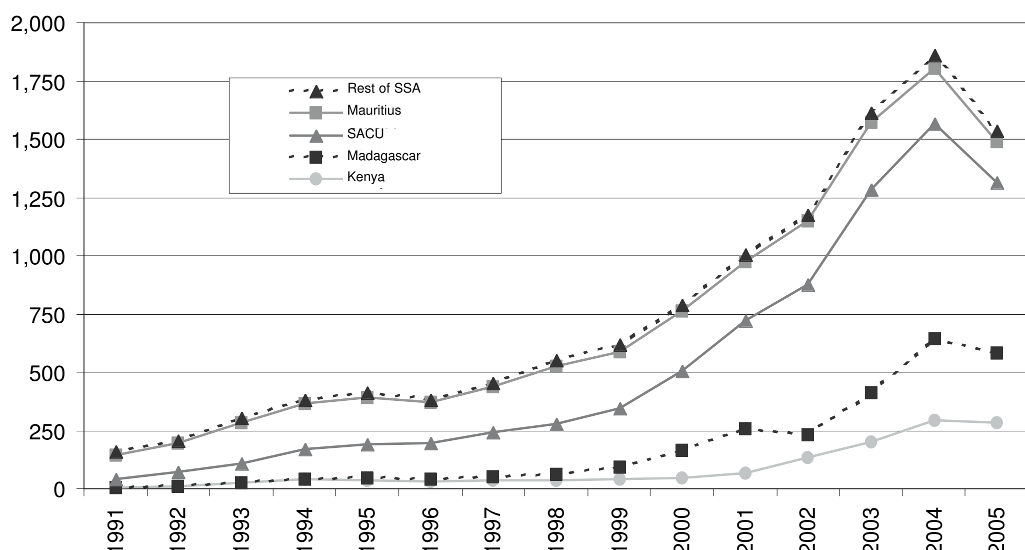


Figure 2 Apparel exports to US from SSA, $ million



products are concentrated primarily in garments and footwear.

3. Country coverage must extend beyond the least developed countries to other African countries that are close to or at the threshold of being able to develop modern sector production and export activity.
4. The duration of a scheme could be time-bound (say to 2015). The introduction of a time limit has an economic rationale, as well as giving WTO compatibility for a non-reciprocal scheme. It would help to create a sense of urgency on the part of both beneficiary governments and donors to coordinate complementary actions that will be necessary for export diversification. Further, as the non-LDCs succeed in getting over the entry threshold, the phase-out of preferences for them will concentrate the preference advantage on the African LDCs. During the coming decade the governments of these countries can prepare their economies for exporting by modelling themselves on the emerging successes in their more advanced neighbours.

The prospects opened by effective trade preferences would also provide a more focused agenda for donors. In those countries already close to the threshold of entry into new export markets, aid might be targeted on improving trade-related aspects of infrastructure and the business environment, as envisaged in current aid-for-trade proposals. For the least developed, aid might be targeted at the longer-term objective of helping them to get to the point at which they would be able to benefit from preferences once they became the exclusive beneficiaries. the business environment, as envisaged in current aid-for-trade proposals. For the least developed, aid might be targeted at the longer-term objective of helping them to get to the point at which they would be able to benefit from preferences once they became the exclusive beneficiaries.

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